European Financial & Monetary Policies

Past Experiences and Current Challenges

Edited by:

Irina Bilan

Constantin-Marius Apostoaie

EDITURA UNIVERSITĂȚII „ALEXANDRU IOAN CUZA" DIN IAŞI

Irina Bilan • Constantin-Marius Apostoaie

(coordinators)

EUROPEAN FINANCIAL AND MONETARY POLICIES. PAST EXPERIENCES AND CURRENT CHALLENGES

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Scientific advisors:
Professor Ph.D. Francisco Flores Muñoz (Universidad de La Laguna, Spain)
Professor Ph.D. Stanimir Kabaivanov (Plovdiv University "Paisii Hilendarski", Bulgaria)

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700539 - Iaşi, str. Munteni, nr. 34, tel./fax: (0232) 314947
http:// www.editura.uaic.ro e-mail: editura@uaic.ro

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Irina BILAN is currently associate professor Ph.D. at the Department of Finance, Money and Public Administration, Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași. Her area of expertise includes public finance, international finance, money and banking, and social security systems. She performed research and documentation visits at Paris Dauphine University (France, 2010), University of Poitiers (France, 2015), University of Bolton (the United Kingdom, 2018), University of Zaragoza (Spain, 2018) and University of Michigan-Flint (the USA, 2019), and taught within the Erasmus programme in Italy, Turkey, Kazakhstan, Belgium, Spain, Morocco, Kyrgyzstan, Egypt, Croatia, Vietnam, etc. She attended training programmes on the subject of "Management of tertiary activities" (2011), "SAP, ERP and School Management" (2011-2012), "Didactics of teaching humanities" (2012), "Panel data econometrics" (2018). She is the coordinator of the Jean Monnet Module EUCONOMICS (2020-2023) and member of several others Erasmus+programmes. She published as an author or coauthor a book, several book chapters, and more than 70 papers in journals indexed in international databases or volumes of national and international conferences.

Constantin-Marius APOSTOAIE is currently associate professor Ph.D. at the Department of Finance, Money and Public Administration, within the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași. His area of expertise includes banking and financial institutions, non-bank financial intermediation ('shadow banking'), financial markets, European integration, sustainable finance, green banking, project management, financial education. He has a rich experience in project management (as director or team member) within several educational and research projects (in financing lines such as: Horizon 2020, Erasmus+, Erasmus Mundus, COST, POSDRU, POSCCE, POCU, UEFISCDI). He has enriched his teaching techniques and methods in various research and teaching visits in multiple universities in Europe, mainly in Barcelona, Cordoba, Madrid, Zaragoza, and Valencia (Spain), in New York and Michigan (USA), in Strasbourg and Bordeaux (France), in Bayreuth and Frankfurt (Germany), Bruxelles (Belgium), Karviná (Czech Republic), in Casablanca and Marrakech (Marroco), Chişinău (Rep. of Moldova) and others. As a researcher, he published, as a single author or coauthor, several books and book chapters, and more than 70 papers in scientific journals indexed in international databases or volumes of national and international conferences.

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CHAPTER 1

INSTITUTIONAL FRAMEWORK OF THE EUROPEAN FINANCIAL AND MONETARY POLICIES

Mihaela Tofan[1]

1.1. Introduction

The legal order of the European Union requires an institutional framework suitable for the perfect functioning of the legal system of the 27 member states, all of them recognizing the priority of EU law over national regulations. This situation manifests in the financial and monetary field, especially when there is a conflict between the rules that emerge from the national law system and the rules of the legal system adopted at the EU level (Amicorum and Garavelli, 2005). The Europeanization of all branches of law impacts even the fields for which the sovereignty of states is preserved, as the influence of EU law is more and more dynamic.

The institutional framework at the EU level is drawn up by the provisions of Article 13 of the Treaty on the EU, according to which the Union shall have an institutional framework that shall aim to promote its values, advance its objectives, serve its interests, those of its citizens and those of the Member States, and ensure the consistency, effectiveness, and continuity of its policies and actions.

Thus, the Union's institutions are:

- the European Parliament,
- the European Council,
- the Council,
- the European Commission (hereinafter referred to as the Commission),
- the Court of Justice of the European Union,

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[1] Mihaela Tofan is Ph.D. habil., professor of law at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.

- the European Central Bank,
- the Court of Auditors.

Each institution shall act within the limits of the powers conferred on it in the Treaties and in conformity with the procedures, conditions, and objectives set out in them. The institutions shall practice mutual sincere cooperation.

The provisions relating to the European Central Bank and the Court of Auditors and detailed provisions on the other institutions are set out in the Treaty on the Functioning of the European Union.

1.2. European institutions with general competencies in the monetary and financial area

1.2.1. The European Parliament

In the original text of the Treaties that built the EU, the democratic institution of the communities was called "Assembly" and received the title of European Parliament in 1962, according to Article 3 of the Single European Act. Today, the members of the Parliament are elected by the citizens with the right to vote from all the member states of the European Union, and the legitimacy of their activity is recognized based on the following provisions:

Article 10 of the Treaty on the European Union (TEU) establishes that the functioning of the Union is based on the principle of representative democracy and the Citizens are represented directly, at the level of the Union, in the European Parliament, while the Member States are represented in the European Council by their Heads of State or Government and in the Council by their governments, which in turn are democratically accountable either to national parliaments or to their citizens.

This is the mechanism revealing the way every citizen participates in the democratic life of the Union, ensuring that decisions are made as openly as possible and at the closest level to the citizen (Deplano, 2011). Political parties at the European level contribute to the formation of European political consciousness and to the expression of the will of the citizens of the Union, as the quorum for voting is established by the rules of procedure (OECD, 2020).

Organizational structure

The European Parliament is composed of 705 representatives of the peoples of the member states, elected by direct universal suffrage, for a period of 5 years. The number of elected representatives from each member state differs depending on the population of the respective state. The 1976 Act on the procedure for electing parliamentary representatives by direct suffrage establishes only a few minimal rules, such as:

- the principle of a single vote;
- the election to take place during a period that begins on Thursday morning and ends on the following Sunday;
- the minimum age for voting is 18 years.

Each state sets the rules regarding the electorate (the only condition established in a uniform manner is the minimum age), eligibility, and voting methods (all states have adopted a system of proportional representation, with national or local lists). The general rules regarding the composition of the European Parliament are provided by Article 14 paragraph (2) of the TEU, stating that the European Council unanimously adopts, at the initiative of the Parliament and with its approval, a decision establishing the composition of the Parliament. In the same article, it is stipulated that the European Parliament must be composed of no more than 751 representatives of the citizens of the Union (750 members plus the president). In addition, citizens' representation is ensured on a proportionally decreasing basis, with a minimum threshold of six members for each member state and no member state can have more than 96 seats.

The principle of degressive proportionality means that, although the total number of seats is allocated according to the size of the Member States' population, the Member States with larger populations accept to be under-represented in favor of a greater representation of EU countries with smaller populations: the larger the country, the smaller the number of seats in relation to its population (Cegiełkaa and Lykob, 2014). This concept has been defined in more detail in the decisions of the European Council adopted under Article 14(2) TEU, since the entry into force of the Treaty of Lisbon.

Following the UK's withdrawal from the EU, the country's 73 seats have been redistributed and the total number of seats was reduced from 751 to 705, thus the share of some of the member states increasing. The number of deputies elected from each member state to the European Parliament is as follows:

Germany – 96, France – 79, Italy – 76, Spain – 59, Poland – 52, Romania – 33, The Netherlands – 29, Belgium, Greece, Hungary, Portugal, Sweden and the Czech Republic – 21, Austria – 19, Bulgaria – 17, Finland, Denmark and Slovakia – 14, Ireland – 13, Croatia – 12, Lithuania – 11, Latvia and Slovenia – 8, Estonia – 7, Cyprus, Luxembourg and Malta – 6.

The status of members of the European Parliament is regulated by both European and national law. Parliament, by internal regulation, can impose rules of conduct for the members. The combination of the European mandate with a national mandate is authorized at the European level but is prohibited at the national level by all member states (Scheppele *et al.,* 2021).

The internal organization of the European Parliament includes the Bureau, the Conference of Presidents, committees, and parliamentary political groups. The President of the Parliament, the 14 vice-presidents, and the 5 quaestors are elected by the members of the Parliament by secret ballot for a period of 2 and a half years (half of the mandate) and they all form the Bureau.

According to the Rules of Procedure, the President of the Parliament is elected from among the MEPs for a term of two and a half years, which can be renewed (Article 19 of the Rules of Procedure). The President represents the Parliament in external relations and with the other EU institutions, he oversees plenary debates and ensures that Parliament's Rules of Procedure are followed. At the opening of each meeting of the European Council, the President of the European Parliament presents the institution's point of view and concerns regarding the items on the agenda and other topics (Archick, 2014). After the adoption by the Parliament of the European Union budget, the President signs it, thus becoming operational. The President of the Parliament signs, together with the President of the Council, all legislative acts adopted through the ordinary legislative procedure. The President may be replaced by one of the 14 Vice-Presidents (Article 23 of the Rules of Procedure).

The political bodies of the Parliament are:

- The Bureau (Article 24 of the Rules of Procedure, composed of the President and the 14 Vice-Presidents),
- Conference of Presidents (Article 26 of the Rules of Procedure – President and political group presidents),
- five quaestors (Article 28 of the Rules of Procedure – responsible for the administrative and financial matters of MEPs),

- Conference of committee presidents (Article 29 of the Rules of Procedure),
- Conference of delegation presidents (Article 30 of the Rules of Procedure).

The term of office of vice-presidents, quaestors, committee, and delegation presidents, is, similar to the mandate of the President of the European Parliament, of two and a half years (Article 19 of the Rules of Procedure).

The main political groups of the European Parliament are:

- Group of the European People's Party (Christian Democrats) and European Democrats – EPP – DE,
- Group of the Party of European Socialists PSE,
- Group of the Alliance of Liberal Democrats for Europe (ALDE),
- Greens Group European Free Alliance (V/ALE),
- Confederal Group of the United European Left/Nordic Green Left – GUE/NGL,
- Union Group for Europe of Nations – UEN,
- Independence and Democracy Group - IND/DEM,
- The Unregistered Group.

Members of the European Parliament are not organized in national delegations, but, depending on political affinities, in transnational groups. Under the Rules of Procedure, a political group must comprise representatives elected from at least a quarter of the Member States and it may be made up of at least 25 Members (Article 33 of the Rules of Procedure). The political groups hold meetings in the week before the session period and during the session weeks, and some political groups correspond to supranational political parties active at the EU level (Hague and Harrop, 2004, p. 185).

The Parliament supports the creation of a favorable environment for the development of true European political parties and foundations, including the adoption of framework legislation (Van Biezen, 2003, p. 53). Article 224 of the TFEU is the legal basis for adopting, in accordance with the ordinary legislative procedure, a statute for political parties at the European level and the rules on their funding. In 2003, a funding system for European political parties was created, which allowed the establishment of political foundations at the EU level. These rules were amended by Regulation (EU, Euratom) 2018/673, with a view to strengthening the European dimension of European political parties, ensuring a fairer distribution of funds, and improving enforcement. Among the most important European political foundations, there are: the Center for European Studies “Wilfried Martens”, the Foundation for European Progressive Studies, the European Liberal Forum, the European Environmental Foundation, the Institute of European Democrats, Transform Europe, and the New Direction - Foundation for Reform in Europe (Johansson and Raunio, 2022).

The currently existing European parties are: the group of the European People's Party (Christian Democrats) (EPP), the Party of European Socialists (PES), the Alliance of Liberals and Democrats for Europe (ALDE), the Greens, the Alliance of European Conservatives and Reformists (AECR), the European Left Party (LEFT), the Movement for a Europe of Freedoms and Democracy (MELD), the European Democratic Party (PDE/EDP), the European Free Alliance (ALE), the European Alliance for Freedom (EAF), the European Alliance of National Movements (AEMN), the European Christian Political Movement (ECPM) and the European Democrats (EUD). These supranational parties cooperate closely with the corresponding political groups within the European Parliament.

Parliament adopted a resolution in 2012 urging European political parties to nominate candidates for the post of Commission President, to strengthen the political legitimacy of both Parliament and the Commission. These provisions were put in place ahead of the 2014 elections, when top-list candidates ran for the first time for high-ranking positions in the EU institutions. Following those elections, one of these first candidates, Jean-Claude Juncker, was elected President of the Commission by the Parliament on 22 October 2014. In its Decision of 7 February 2018 on the revision of the Framework Agreement on relations between the European Parliament and the European Commission, the Parliament indicated that it rejects any candidate for the position of President of the Commission who is not appointed as the first candidate on the list (Spitzenkandidat) of a European political party, in view of the European elections of 2019. However, in 2019 this process of investing the President of the Commission was abandoned, but the political legitimacy of the President of the Commission was maintained and the degree of involvement and awareness of EU citizens regarding the electoral process increased.

The work of the Parliament takes place in three different cities:

- the secretariat is in Luxembourg;
- the parliamentary committees meet in Brussels;
- parliamentary sessions take place in Strasbourg, with additional sessions in Brussels.

The plenary is, strictly speaking, the European Parliament, its meetings are presided by the President and the plenary meetings are public. Parliament meets every month (except August) in plenary session in Strasbourg, the session period lasting four days, from Monday to Thursday. Additional sessions are held in Brussels.

Powers of the European Parliament

The main attributions of the European Parliament concern the legislative power, the competence in the field of the budget and the control of the activity of the European executive (Anglmayer, 2020). There are also duties with a secondary role that fall to the European Parliament, namely duties in the field of foreign policy, duties to respond to petitions addressed by European citizens, etc. Parliament is co-legislative, meaning it has the power to adopt and amend legislation and that it decides on the EU's annual budget on an equal footing with the Council. It also supervises the work of the Commission and the other European bodies and cooperates with the national parliaments of the EU countries.

Regarding legislative competences, the Parliament participates in the elaboration of very varied European legislative acts, depending on the field to which they belong and the relevant legal basis for each of the acts concerned. The role of the Parliament has progressively evolved from an exclusively consultative participation to the co-decision procedure, thus acquiring an equal position with the Council (Tofan and Verga, 2023, p. 173).

Most EU legislation is adopted through the ordinary legislative procedure, also known in the past as 'codecision'. This is the standard decision-making procedure, which gives the European Parliament and the Council of the European Union equal powers. Since the entry into force of the Treaty of Nice, this procedure applies to 46 areas of collaboration, allowing the adoption of legislative acts on immigration, energy, transport, climate change, the environment, consumer protection and economic governance. Therefore, the co-decision procedure can be qualified as the common law legislative procedure (Hagedorn, 2003). In principle, in case of agreement between the versions voted by the Council and the Parliament, the act is adopted in a first reading; in case of disagreement, only a successful conciliation allows the adoption of the relevant act.

The Parliament has exclusive powers regarding the amendment of the European primary legislation, outlined by the Single European Act (EUA), when it was stipulated that any accession treaty of a new member state and any association treaty are subject to the consent of the Parliament. This procedure applies, after the EUA, to international agreements with important budgetary implications for the Communities (replacing the advisory procedure established in 1975), and after the Maastricht Treaty, it also applies to agreements that establish a specific institutional framework or that involve the modification of an act adopted according to the co-decision procedure. The acts related to the electoral procedure are also subject to the approval of the Parliament. The consent is also required if the Council wishes to declare that there is a real risk of a member state committing a serious violation of the fundamental principles of the EU, before the notification of sanctions to the respective member state.

The Maastricht Treaty granted the Parliament a right of legislative initiative, limited to the faculty of asking the Commission to present a proposal.

The budgetary powers provide that the Parliament has the final vote on the budget, cumulating powers on the control of its execution and the discharge on the execution of the union budget. The Parliament is one of the two branches of the budgetary authority and is involved in the budgetary process from the preparation stage, especially regarding the general guidelines and the type of expenditures (Tofan, 2019, p. 135). When debating the budget, it has the prerogative to submit amendments and changes, the Treaty of Lisbon eliminating the distinction between compulsory and non-compulsory expenditure and granting the European Parliament increased powers regarding the annual budget procedure. Parliament definitively adopts the budget and controls its execution, examines the annual general report, and grants a discharge for the execution of the budget (Article 276 EC).

The powers of control over the European executive are emphasized by the political responsibility of the Commission before the Parliament (Curtin, 2009, p. 52). The Parliament has several instruments of control over the EU executive, namely:

A. Vesting of the Commission

After 1981, Parliament adopted the practice of unofficially "vesting" the Commission by approving its program. By the Treaty of Maastricht (1992) for the subordination of its prior approval the appointment by the member states of the President and the members of the Commission, as a collegial body. The Treaty of Amsterdam went further, requiring the appointment of the President of the Commission to be approved in advance by Parliament, before the appointment of the other members of the college (Commissioners). According to the Treaty of Lisbon, the candidate for the post of President of the Commission will have to be chosen considering the results of the European elections.

B. Motion of censure

The Treaty of Rome states that the motion of censure against the Commission requires a two-thirds majority of the votes cast, representing a majority of the constituent members of the Parliament. The approval of the motion determines the resignation of the members of the European Commission, altogether.

C. Parliamentary questions

These take the form of written and oral questions, with or without debate, and questions addressed during the question hour. The Commission and the Council, or their respective members, are required to respond.

D. Commissions of Inquiry

The Parliament has the power to set up temporary commissions of inquiry to examine breaches of the law or maladministration in the application of EU law.

E. Control over the common foreign and security policy and, respectively, police and judicial cooperation

In these areas, the Parliament has the right to be informed, it may ask the Council questions or recommendations and it must be consulted on the main aspects and fundamental options of the common foreign and security policy and on any measure envisaged, except for common positions in the matter of police and judicial cooperation. The Treaty of Lisbon enshrines the Parliament's legislative power in almost all aspects of police and judicial cooperation, as well as the other areas that fall within the area of freedom, justice, and security, subject to the legislative procedure of common law (co-decision).

The Parliament is consulted on the main aspects and fundamental decisions in the field of foreign and common security policy and on all measures that concern these fields, except for common positions in the matter of political and judicial cooperation. The creation of the post of High Representative of the Union for CFSP by the Lisbon Treaty has increased the influence of the Parliament, as he/she is the Vice-President of the Commission.

The Parliament examines the petitions addressed to it by the citizens of the Union regarding the subjects of importance for the Community's fields of activity (Vogiatzis, 2021). The Parliament appoints the Ombudsman/European Mediator, empowered to receive complaints regarding cases of bad administration in the actions of community institutions and bodies. The Parliament has the right to initiate actions before the Court of Justice of the European Union, in case of violation of the treaty by another institution. At the same time, the Parliament has a right to intervene in certain cases, for example, to support the claims of one of the parties.

1.2.2. The European Council

Both the European Council and the Council of the European Union are institutions of the European Union. The European Council is a political institution, created in an unconventional way and not through a treaty, due to the interest that prior to the organization of the official meetings of the heads of state and government within the Council of the European Union, to have a discussion and a preliminary agreement of the main decision-makers for all states (Tofan and Verga, 2023, p. 190).

The European Council is the high-level conference (summit) of the heads of state and governments of the member states of the EU. The first of these “European summits” took place in Paris in 1961, and they became more frequent from 1969. The European summit in Paris in February 1974 decided that these meetings should take place regularly under the name of the “European Council”, which would have the ability to adopt a general approach to European integration issues and to ensure that EU activities are properly coordinated.

The Single Act (1986) included the European Council for the first time in the corpus of community treaties, defining its composition and establishing that it meets twice a year. The Maastricht Treaty (1992) formalized its role within the EU's institutional process.

The Treaty of Lisbon transforms the European Council into an EU institution (Article 13 of the TEU) and defines its tasks, which are to "give the Union the necessary impetus for its development and define its general political orientations and priorities" (Article 15 of the TEU). The European Council and the Council of the European Union (hereinafter referred to as "the Council") agreed to divide section II of the EU budget (Article 43 letter b of the Financial Regulation), which is why the general budget has only 10 sections and not 11, although the European Council and the Council are distinct institutions.

Organization and functioning

The meetings of the European Council are convened by its president when the heads of state and/or government of the 27 member states and the president of the Commission meet (Article 15 paragraph 2 of the TEU). The High Representative of the Union for Foreign Affairs and Security Policy participates at the European Council and the President of the European Parliament is usually invited to speak at the beginning of the meeting (Article 235 paragraph 2 of the TFEU).

The President is elected by the European Council itself, for a term of two and a half years, which can be renewed only once, and he represents the EU internationally. In general, the European Council takes decisions by consensus, but many important appointments are made by qualified majority, notably regarding its President, the election of the candidate for President of the European Commission and the appointment of the High Representative of the Union for Foreign Affairs and Security Policy and the President of the European Central Bank (Wessels, 2016, p. 104).

The European Council normally meets four times a year. Since 2008, it has met more often, especially during the financial crisis and the subsequent debt crisis in the euro area. Migrant flows to the EU and internal security issues have led to the convening of special meetings of the European Council. Since 2016, heads of state and government have also met in the "EU-27" configuration, without the United Kingdom, initially informal, prior to the UK's notification of withdrawal from the EU under Article 50 of the TEU in March 2017. After the notification, several formal "European Council (Article 50)" meetings were held with the participation of the EU-27.

Members of the European Council meet in the format of "intergovernmental conferences" (IGCs); these conferences of the representatives of the governments of the member states are convened to debate and agree on changes to the EU treaties. Before the entry into force of the Treaty of Lisbon (2009), this was the only procedure for revision of treaties. It is now called the ordinary review procedure. The IGC, convened by the president of the European Council, decides unanimously on the changes of the primary sources of European law.

Powers of the European Council

A. Position within the EU institutional system

In accordance with Article 13 of the TEU, the European Council is part of the "single institutional framework" of the Union and its role is to provide general political impetus rather than to act as a decision-making body in the legal sense of the word. It takes decisions with legal consequences for the EU only in exceptional cases and it has acquired several institutional decision-making powers. Currently, the European Council is authorized to adopt binding acts that can be appealed to the Court of Justice of the European Union, including in cases where it refrains from deciding (Article 265 of the TFEU).

Article 7 paragraph 2 of the TEU gives the European Council the power to initiate, with the approval of the European Parliament, the procedure to suspend the rights of a member state following the suspicion of a serious violation of EU principles.

B. Relations with other institutions

The European Council takes decisions completely independently and, most of the time, it does not require an initiative from the Commission or the involvement of the Parliament. However, the Treaty of Lisbon maintains an organizational link with the Commission, given that its president is a non-voting member of the European Council, and the High Representative of the Union for Foreign Affairs and Security Policy participates in the debates.

The European Council often asks the Commission to submit preparatory reports for its meetings. Article 15 paragraph 6 lit. d of the TEU stipulates that the President of the European Council presents a report to the European

Parliament after each meeting of the European Council. The President of the European Council also meets monthly with the President of the Parliament as well as the leaders of the political groups and, since February 2011, it has agreed to answer written questions from MEPs about its political activities. The Parliament can also exercise a certain informal influence through the presence of its President at European Council meetings, through the meetings of party leaders within the corresponding European political families, as well as through the resolutions it adopts on the items on the agenda of the meetings, the outcome of the meetings and the formal reports presented by the European Council.

Treaty of Lisbon created the new position of High Representative of the Union for Foreign Affairs and Security Policy, an additional method to propose and implement foreign policy on behalf of the European Council. The President of the European Council ensures the EU external representation in matters relating to its common foreign and security policy, without prejudice to the powers of the High Representative of the Union for foreign affairs and security policy.

The role/mission of the European Council

1. *At the institutional level*

The European Council provides the EU with "the impulses necessary for its development" and defines its "general political orientations and priorities" (Article 15 paragraph 1 of the TEU). The European Council decides by qualified majority on the formations of the Council and the calendar of the rotating presidencies.

2. *Foreign policy and security issues*

The European Council defines the general principles and guidelines of the common foreign and security policy (CFSP) and adopts decisions on common strategies for its implementation (Article 26 of the TEU). It decides unanimously whether it is appropriate to recommend to the member states to adopt measures aimed at the gradual definition of a common EU defense policy, in accordance with Article 42 paragraph 2 of TUE.

If a member state intends to oppose the adoption of a decision for vital reasons of national policy, the Council, with qualified majority, may request the European Council to rule on the matter in question, adopting the decision unanimously (Article 31 paragraph 2 of TUE). The same procedure is applied if the Member States decide to establish enhanced cooperation (Article 20).

3. Economic governance and the multiannual financial framework (MFF)

Since 2009, the sovereign debt crisis has transformed the European Council and the summits of the eurozone countries into the main actors in confronting the repercussions of the global banking crisis. Several member states received financial aid packages through ad-hoc or temporary agreements that were decided at the level of heads of state or government, and which were later ratified by the member states. Financial aid is granted through the European Permanent Stability Mechanism. To ensure closer collaboration in terms of economic and financial policy, the EU member states negotiated and adopted the Treaty on Stability, Coordination and Governance (the "Fiscal Pact"), which allows for stricter control of the EU budgetary and socioeconomic policies.

The European Council plays an important role in the European Semester (Schoutheete, 2017, pp. 55–79). In spring meeting, it issues policy guidelines on macroeconomic, fiscal, and structural reform and growth-enhancing policies. In June, it approves recommendations arising from the evaluation of national reform programs developed by the European Commission and discussed within the Council. The European Council got involved in the negotiation of the Multiannual Financial Framework (MFF), where it plays a key role in reaching political agreement on key political issues in the MFF Regulation, such as spending limits, spending programs and (funding) resources.

4. Police and judicial cooperation in criminal matters

At the request of a member of the Council, the European Council decides whether a consolidated cooperation can be established in a field related to it (Article 20 of the TEU). The Treaty of Lisbon introduced several new gateway clauses that allow the European Council to change the decision-making formula within the Council from unanimity to a majority vote.

5. Strategic orientation of EU activities

The European Council was effective in adopting the general guidelines for EU action. On June 27, 2014, the European Council established five priority areas to be a point of orientation in the EU's activity:

(1) jobs, economic growth, and competitiveness,

(2) empowering and protecting citizens,

(3) energy and climate policies,

(4) freedom, security and justice, and

(5) The EU as a powerful world actor.

These priorities appear in a document entitled "Strategic Agenda for the Union in a Changing World", used to plan the work of the European Council and underpin the work programs of other EU institutions. The European Council also contributed to overcoming the impasse in the decision-making process at the EU level.

In June 2018, the European Council adopted a decision on the composition of the European Parliament, which allows member states to implement the internal measures necessary to organize elections for the 2019-2024 legislature. In March 2018, the EU-27 European Council adopted guidelines on the framework for future relations with the United Kingdom after Brexit. According to the guidelines, the EU wants the closest possible partnership with the UK, covering, among other things, trade and economic cooperation, as well as security and defence. In 2019, the European Council took note of the letter of 5 April 2019 from the Prime Minister of the United Kingdom, Theresa May, requesting a further extension of the deadline referred to in Article 50(3) TEU. The European Council agreed on an extension until 31 October 2019 to allow for the ratification of the Withdrawal Agreement.

In October 2019, the European Council, in EU-27 format, approved the Revised Withdrawal Agreement and Revised Political Declaration, to allow for an orderly exit of the United Kingdom from the European Union.

On 29 October 2019, following the United Kingdom request, the European Council adopted a decision to extend the period referred to in Article 50(3) TEU until 31 January 2020, giving more time for the process of ratification of the Withdrawal Agreement, which entered into force on 31 January 2020. It marks the end of the period under Article 50 TEU and the start of a transition period until 31 December 2020, when the UK is no longer an EU member state but a third country (Kaya, 2020).

1.2.3. The Council (former Council of the European Union)

The Council of the European Union was established by the founding treaties, initially having different names: the Special Council of Ministers (by the ECSC Treaty), and the Council (by the Treaties of Rome, establishing the

EEC and EURATOM). After the unification of the executives (1965), the established name is the Council of Ministers or the Council of the European Union, and by the TFEU it is called only the Council.

Along with the European Parliament, the Council is the institution that adopts EU legislation through regulations and directives and presents non-binding decisions and recommendations. In its fields of competence, the Council takes decisions by simple majority, qualified majority, or unanimity, depending on the legal basis of the act to be approved (Novak, 2018, p. 29).

Within the single institutional framework of the European Union, the Council exercises the powers conferred on it by Article 16 of the Treaty on European Union (hereinafter referred to as "TEU") and Articles 237-243 of the Treaty on the Functioning of the European Union (hereinafter referred to as "TFEU").

The Council (ex Council of the European Union) is composed of representatives of the governments of the member states. Its structure differs depending on the specific field targeted by the agenda, each state being represented by the government member who is responsible for the field in question (foreign affairs, finance, social issues, transport, agriculture, etc.). When the foreign ministers of the member states participate in the Council, the council can be called the General Council. If relevant ministers are present depending on the issue considered on the agenda, other than the foreign ministers, the council is called the specialized Council for the concerned field. If both foreign ministers and relevant ministers for a targeted field participate in a meeting, the council is called the Joint Council; the meeting of these councils is less frequent today. The EU Council comprises 27 members (number equal to the number of EU member states) and its seat is in Strasbourg (Tofan and Verga, 2023, p. 256).

Apart from the "Foreign Affairs" Council, the Council is chaired by the representative of the state exercising the presidency of the European Union: it changes every six months according to the order established by the Council, deciding unanimously (Article 16 paragraph 9 of the TEU). The presidency of each formation of the Council, except for the Foreign Affairs formation, is designated by pre-established groups of three member states for a period of 18 months, with each member of the group holding the presidency for a period of six months. The presidency is be exercised by Sweden and Spain in 2023, Belgium and Hungary in 2024. The European Council can change the order of holding the presidency [Article 236(b) of the TFEU].

The Committee of Permanent Representatives (COREPER), formed by the permanent representatives of the member states, prepares the work of the Council, and executes the mandates it assigns to it (Article 240 of the TFEU). The Committee is chaired by a representative of the Member State that exercises the presidency of the General Affairs Council, i.e. the presidency by rotation (Ruhrmann and FitzGerald, 2016). However, the Political and Security Committee, which monitors the development of the international situation in the field of the common foreign and security policy, is chaired by a representative of the High Representative of the Union for Foreign Affairs and Security Policy.

COREPER meets every week to prepare the work of the Council and coordinate activities related to co-decision with the European Parliament. The Committee is divided into two groups:

- COREPER I, made up of Deputy Permanent Representatives, which prepares activities related to more technical areas such as agriculture, employment, education, or the environment, and
- COREPER II, which deals with matters related more to “high-level policy”, in particular foreign, economic and monetary affairs, justice and home affairs.

COREPER is assisted in its preparatory activities by approximately 10 committees and 100 specialized working groups. When the Council acts in its legislative capacity, the meetings are open to the public (Article 16 paragraph 8 of the TEU). The Secretary General of the Council is appointed by the Council pursuant to Article 240 of the TFEU. Council meetings are held in Brussels and Luxembourg (April, June and October sessions). Currently, the Council has 10 formations, three of which meet regularly (General Affairs, External Relations, Economic and Monetary Affairs -ECOFIN).

The institutional treaties regulate 3 methods of voting within the council: simple majority, qualified majority, and unanimity.

Simple majority is met when a decision is adopted if there are more votes for than against. Each member of the Council has one vote, therefore simple majority is met if at least 14 members of the Council votes. The simple majority rule is applied when the treaty does not provide otherwise and, although it represents the standard way of making decisions, in practice it is only applied in the case of a limited number of decisions: the Rules of Procedure of the Council, the organization of the General Secretariat of the Council and the rules of the activity of its commissions (Hayes-Renshaw and Wallace, 2006).

Qualified majority is used most of the time in Council deliberations.

The method of calculation for the qualified majority in the Council is found in the Treaty of Lisbon and in Article 16 paragraph 4 of TUE. According to this article, a favorable vote of at least 55% of the members of the Council, representing at least 65% of the population of the Union, is required. Numerically, this means at least 15 Member States out of 27. If the proposal does not come from the Commission or the High Representative, the so-called qualified consolidated majority rule applies: the required percentage of Council members voting in favor of the proposal is 72% (comprising at least 20 Member States out of 27), again representing at least 65% of the Union's population.

The Treaty of Lisbon further extended the scope of qualified majority decisions to 68 regulatory areas, mostly within the ordinary legislative procedure. The qualified majority also applies to the appointment of the President and members of the Commission, the members of the Court of Auditors, the European Economic and Social Committee and the Committee of the Regions.

Unanimity is provided as a method of voting in the council only for a limited number of decisions, but among the most important (taxation, social policy, etc.), in accordance with the provisions of the Treaty of Lisbon. However, Article 48 paragraph 7 of the TEU provides for a bridge clause that allows the Council to decide by qualified majority instead of unanimity in certain areas. In addition, in the case of certain policies, the Council may decide (unanimously) to extend the use of qualified majority, e.g. Article 81 paragraph 3 of the TFEU on family law measures that have cross-border implications. In general, the Council tries to achieve unanimity even when unanimity is not required (Mattila, and Lane, 2001). This preference dates to the "Luxembourg Compromise" of 1966, which ended the conflict between France and the other member states, France refusing to switch from unanimity to qualified majority voting for certain areas (agriculture). The text of the compromise states: "When, in the case of a decision that can be taken by a majority of votes on the proposal of the Commission, very important interests of one or more partners are at stake, the members of the Council shall endeavour, within a reasonable period of time, to find solutions that can be adopted by all members of the Council, respecting their mutual interests and those of the Community".

A similar solution was found through the "Ioannina Compromise" in 1994 to protect certain member states that were close to meeting the deadlock minority. According to this compromise, if the respective states expressed their intention to oppose a decision by the Council by qualified majority, the Council had to do everything in its power, within a reasonable time, to reach a solution satisfactory to most of the member states.

Duties of the Council

The Council (formerly the Council of the European Union) represented the true legislature of the communities, but currently its power in this field is shared with the European Parliament. In a more synthetic expression, the council has six fundamental attributions:

- based on the proposals submitted by the Commission, the Council adopts the Community legislation; in many areas, the Council shares legislative power with the European Parliament;
- ensures the coordination of the EU general economic policies;
- concludes international agreements between EU and one or more states or international organizations;
- establishes the EU budget, together with the European Parliament;
- defines the common foreign and security policy of the EU, based on the guidelines drawn by the European Council;
- coordinates cooperation between judicial courts and national political forces in criminal matters.

Based on the proposals presented by the Commission, the Council adopts together with the European Parliament, EU legislation, in the form of regulations and directives (Article 294 of the TFEU). Alone, it adopts individual decisions, non-binding recommendations (Article 288 of the TFEU) and resolutions.

The Council is one of the two branches of the budgetary authority that adopts the EU budget, together with the European Parliament. The Council establishes, deciding unanimously, within a special legislative procedure, the provisions applicable to the system of own resources and the multiannual financial framework (Articles 311 and 312 of the TFEU). In the latter case, the Parliament must give its consent by the vote of the majority of its members. The ongoing multiannual financial framework covers the years 2021-2027 (Costaș and Tofan, 2023, p. 430).

The Council concludes the EU international agreements, negotiated by the Commission and approved, in most cases, by the Parliament (Article 218 paragraph 6 of the TFEU). The Council, acting by qualified majority (starting with the Treaty of Nice), appoints the members of the Court of Auditors, the Economic and Social Committee and the Committee of the Regions.

The Council coordinates the economic policies of the member states (Article 121 of the TFEU) and, without prejudice to the competences of the European Central Bank, takes political decisions in the monetary field. The eurozone member states elect a president for a two and a half year term (Articles 136 and 137 of the TFEU) and the finance ministers of the countries that use the euro meet on the eve of the meeting of the Economic and Financial Affairs Council.

The Council also exercises several economic governance functions within the European Semester. At the beginning of the cycle, in autumn, the Council examines the specific recommendations for the euro area based on the annual growth survey, then in June and July, it adopts the country-specific recommendations after they have been approved by the European Council. Article 136 of the TFEU was amended by Decision 2011/199/EU of the European Council on the legal basis for stability mechanisms, such as the European Stability Mechanism.

1.2.4. The European Commission

At the time of the establishment of the European Communities, each organization had its own executive body: the High Authority for the European Coal and Steel Community (ECSC, 1951) and a commission for each of the two communities created by the Treaty of Rome (EEC and Euratom, 1957). For the effectiveness of the activities carried out, but also for efficiency and cost reduction, the 1965 Merger Treaty was negotiated and signed, providing the merger of the executive bodies of the CEEC, EEC and Euratom, the most important of which was the Commission. The expiration of the ECSC Treaty (2002) determined the full transfer to the European Commission of the assets and prerogatives that were provided for in this treaty, to ensure the financing of research activities in the sectors related to the coal and steel industry.

Along with the evolution of the Communities and the European Union, the European Commission experienced an expansion of its activities and powers, the Commission being the EU institution that has the monopoly of legislative initiatives and executive powers (Tofan and Verga, 2023, p. 356).

Today, the activity of the European Commission is founded from a legal point of view, on the following provisions:

- Article 17 of the Treaty on European Union (TEU),
- articles 234, 244-250, 290, and 291 of the Treaty on the Functioning of the European Union (TFEU),
- The Treaty establishing a single Council and a single Commission of the European Communities (Merger Treaty).

The Commission is the main executive body of the European Union and is made up of one commissioner for each member state (27 commissioners). The Treaty of Lisbon provided the number of Commission members to two-thirds of the number of member states, starting from November 1, 2014, for reasons of efficiency of decision-making within this institution. Since the member states were reluctant to apply this measure, the possibility was preserved for the European Council to determine the number of members of the Commission by unanimous vote (Article 17 paragraph 5 of the TEU), which means that, yet the number of members of the European Commission equals the number of member states.

In connection with the appointment of the members of the European Commission, the Treaty of Lisbon provides that the members of the European Council start the investiture procedure of the Commission by deciding with a qualified majority, through the proposal of the European Parliament, the candidate for the position of President of the Commission. The nominated person will be announced after the consultations with the representatives of the member states and considering the elections for the European Parliament (Heritier *et al.,* 2015). The candidate for the position of president is designated by the Parliament with majority of its members and validated by the council convened at the level of heads of state or government. The competences and powers of the president increased by the Maastricht Treaty and lately by Lisbon Treaty. Based on consultations with the representatives of the member states, the Council of the European Union votes by qualified majority on the list of candidates for the positions of commissioner, established by the president of the European Commission. All the members of the Commission, both the president and the other members, will be approved by vote by the members of the European Parliament and subsequently, appointed by the European Council (Koerner, 2019).

According to the provisions of the Treaty on the EU, the members of the Commission must be citizens of the member states, elected according to their general competences and must offer all guarantees of independence. In the performance of their duties, they neither seek nor accept instructions from any government or other body. Moreover, they must refrain from any act incompatible with the nature of their functions. Each member state undertakes to respect this nature and not to try to influence the members of the Commission in the exercise of their duties. The members of the Commission enjoy the privileges and immunities established by the Protocol on the Privileges and Immunities of the European Communities (Pech, 2022).

The Maastricht Treaty states that the mandate of commissioners corresponds to the Parliament's five-year term and can be renewed. During the term of office, the commissioners are responsible in their own name and based on the collective responsibility that characterizes the entire activity of the Commission. Personal liability derives from Article 245 of the TFEU, which provides that the members of the Commission exercise their functions in complete independence, in the general interest of the Union; cannot ask for or take instructions from any government/other external body. They cannot exercise any other professional activity, remunerated or not. For breach of these duties, commissioners may be dismissed by the Court of Justice, at the request of the Council or the Commission (Article 247 of the TFEU).

Based on the provisions of Article 234 of the TFEU, the Commission acts and, implicitly, is responsible for the actions taken in accordance with the rigors of the principle of collegiality, which dominates the activity of the Commission. Each of the commissioner is responsible for the way of preparing the works for her/his field of activity, but also for the execution of the decisions taken, although the assumption of these decisions is made in the plenary session of the Commission. The meetings are not public, and the Commission's debates are confidential. As an effect of the principle of collegiality, if the Parliament adopts a motion of censure against the Commission, all its members must resign.

The commission acts under the leadership of its president, who decides on its internal organization. The President assigns the Commission's activity sectors to the members. Thus, each commissioner is responsible for a specific thematic area and has authority over the respective administrative services. Yet, the expansion of the Union with 10 states in 2004 left several commissioners without their own portfolio and they were assigned for 6 months next to the commissioners already in office.

The President has the power to appoint the vice-presidents and, among them, those who fulfill the mission of his de jure substitutes (as first vice-presidents). The High Representative is automatically the Vice-President of the Commission. The Commission has a General Secretariat made up of 33 Directorates-General, which develop, administer, and implement EU policies, legislation and funds. In addition, there are 20 specialized departments (services and agencies) dealing with horizontal or ad hoc issues. There are also six executive agencies, such as the Research Executive Agency, which carry out tasks delegated to them by the Commission but have their own legal personality.

With a few exceptions, the decisions of the Commission are adopted with a majority of its members (Article 250 of the TFEU). Members of the Commission meet weekly to discuss politically sensitive issues and to adopt proposals that must be agreed by oral procedure, while fewer sensitive matters are adopted by written procedure. Management or administration measures can be adopted by means of an enabling system, whereby the college gives one of its members the authority to take decisions on its behalf (this is particularly important in areas such as agricultural aid or anti-dumping measures), or by sub-delegation, where decisions are delegated at an administrative level.

Powers/attributions of the European Commission

The European Commission exercises four main powers:

A. Legislative initiative

As a rule, the Commission holds the monopoly over the initiative in the legislative process at the level of the European Union (Article 17 of the TEU), formulating normative proposals to be adopted by the two institutions with legislative powers, Parliament and Council. The Lisbon treaty also recognizes the citizens' legislative initiative, under strict conditions and with a rather complicated procedure. Thus, the Commission's competence to make legislative proposals is mostly exclusive and has a very high value for European Union law because the legislative bodies cannot discuss a new normative project unless there is a legislative proposal in this sense emanating from the Commission. The Commission draws up and submits to the Council and the Parliament all legislative proposals (regulations and directives) necessary for the implementation of the Treaties (Ponzano *et al.,* 2018).

As regards the budget area, the Commission has the competence to prepare the draft budget, which will be presented to the Council and the Parliament in accordance with Article 314 of the TFEU (1.2.5). The budget proposal made by the Commission is based on the estimates and proposals of all the revenues and expenses that all the other EU institutions make, but the Commission makes and sends the final statements to the Parliament and the Council and proposes the amount of the contribution for each EU body, as well as the number of staff members it considers it needs for the next financial year. In accordance with Article 319 of the TFEU, Parliament has the right to grant discharge to the Commission (Tofan, 2019, p. 213).

There are also areas where the legislative initiative of the European Commission is limited. For example, the Commission has a role in the management of the economic and monetary union, in which capacity it makes recommendations to the Council for the general guidelines of the economic policies of the member states and warns where there is a risk that these policies are incompatible with the guidelines (Costaș and Tofan, 2023, p. 468). The Commission also makes proposals and recommendations related to the existence of an excessive deficit in a member state in the euro zone, but also if a member state outside the euro zone has difficulties for the balance of payments. Within the Common Foreign and Security Policy, the duties rest with the High Representative of the Union for Foreign Affairs and Security Policy and the European External Action Service (EEAS).

The Treaties give the Commission the power to make recommendations, draw up reports and opinions. They also provide for the Commission to be consulted on certain decisions, such as the admission of new Member States to the Union (Article 49 of the TEU). The Commission is consulted on changes to the statutes of other institutions and bodies, such as the Statute of Members of the European Parliament, the European Ombudsman and the Court of Justice.

B. Competence to monitor the implementation of Union legislation

In its capacity as the executive body of the European Union, the European Commission implements the decisions of the Council and executes the Union budget, being also responsible for its management and correct application, implementing the policies and programs adopted by the Parliament and the Council (Tofan and Verga, 2023, p. 260). The enforcement powers conferred by the treaties are as follows:

- budget execution - after the adoption of the budget, starting from January 1 of the following financial year, each member state makes the payments owed to the EU, through monthly contributions to the EU budget, deposited in a bank account on the name of the European Commission at the national Ministry of Finance or at the central bank;
- authorizing member states to take the safeguard measures provided for in the treaties, especially during transition periods (Article 201 of TFEU);
- application of competition rules, by verifying the aid granted by the state, in accordance with Article 108 of the TFEU.

C. The Commission is the "guardian" of compliance with the treaties

The European Commission must supervise the way in which European legal rules are respected by individuals, by member states and by all European institutions and bodies, in general (Cleynenbreugel, 2015). Exercising its powers, the European Commission can impose sanctions on individuals or companies that violate European law. The Commission has the powers to start the necessary procedures by which the Member States are invited to remedy a certain situation, within a predetermined period. Also, the Commission can refer the Court of Justice of the European Union to the settlement of a dispute based on a case of violation of European law by member states, citizens, or European institutions/organizations.

Primary European law (the Treaties) gives the Commission the power to ensure the proper implementation of both the Treaties themselves and any decisions taken for these purposes (secondary legislation). The Commission fulfills this role through the "infringement procedure" applied to Member States under Article 258 of the TFEU.

Article 291 of the TFEU introduced new rules regarding the way in which the Commission exercises its powers conferred for the implementation of the legislative acts adopted by the Parliament and the Council, respectively "the mechanisms of control by the Member States of the exercise of enforcement powers by the Commission" and the way of appeal in the event of a conflict.

The Treaty of Lisbon states a new category of legislative acts, which lie between legislative and implementing acts, i.e. "delegated non-legislative acts" (Article 290 of the TFEU), of general scope, which supplement or amend certain non-essential elements of the legislative act (called "basic acts").

Rarely, the Commission has its own regulatory powers, as in Article 106 of the TFEU, which authorizes the Commission to ensure the application of Union rules regarding public enterprises and those providing services of general economic interest and to address the corresponding directives or decisions to the Member States in this regard.

D. The Commission represents the European Union

The Commission leads the EU negotiations for concluding international agreements with third countries or with international organizations, in close connection with committees specially designated by the Council and within the limits of the directives drawn up by the Council. The Commission has an important political role, being responsible to the European Parliament. Based on an express authorization from the Council, the Commission is competent to negotiate international agreements, in accordance with Articles 207 and 218 of the TFEU, which are then presented to the Council for conclusion. In the area of foreign and security policy, agreements are negotiated by the High Representative of the Union for Foreign Affairs and Security Policy.

1.2.5. The Court of Justice of the European Union

Since its creation, in 1952, the mission of the European Court of Justice of the European Union (ECJ) has been to guarantee "respect for the law in the interpretation and application" of primary law rules (treaties concluded at EU level). To achieve this mission, the Court:

- controls the legality of the acts of the institutions of the EU;
- ensures that the member states fulfil their obligations from the treaties;

- interprets Union law at the request of national courts.

Thus, the court represents the judicial authority of the European Union and, in collaboration with the courts of the member states, ensures the uniform application and interpretation of European law.

The Court of Justice of the European Union (CJEU) seats in Luxembourg and it is composed of two courts: the Court of Justice and the General Court (created in 1989). For a short period of time, this system of courts also included the Civil Service Tribunal, created in 2004, which ceased its activity on 1 September 2016, transferring all its powers to the General Court (formerly the Court of First Instance), in the context of the reform of the Union's jurisdictional architecture.

Since each member state has its own language and a specific legal system, CJEU is a multilingual institution within the judicial institutional system of the member states. Its language regime has no equivalent in any other court in the world, as each of the official languages of the Union can be used as a language of proceedings. CJEU has the obligation to respect full multilingualism because of the need to communicate with the parties in the language of the process and to ensure the dissemination of its jurisprudence in all member states.

CJEU is composed of 27 judges (one corresponding judge for each of the EU member states) and 11 advocates general. Judges and advocates general are appointed by common agreement by the governments of the member states, after consulting a committee whose role is to issue an opinion on the capacity of the candidates to exercise the respective functions (Shaelou and Veraldi, 2020). Their mandate is for six years and it can be renewed. They are chosen from among personalities who offer all the guarantees of independence and who meet the conditions required for the exercise, in their countries, of the highest jurisdictional functions or whose competence is recognized.

The judges appoint the president and the vice-president, for a period of three years that can be renewed. The President directs the work of the Court of Justice and presides over the meetings and deliberations in the case of the largest court panels. The vice-president assists the president in the exercise of his functions and replaces him in case of impediment (Tofan and Verga, 2023, p. 335).

The CJEU is an institution that operates permanently, subject to judicial holidays. Advocates-general assist the Court, helping it to fulfil its tasks. They are a special type of participants in the jurisdictional activity, specific to the CJEU, with the role of presenting, with complete impartiality and in complete independence, the legal opinion called "conclusions" in the cases assigned to them. Their presence in complex cases ensures a competent analysis of the aspects of European law before the judges who form the invested panel with the respective case. Their mission should not be confused with that of lawyers or prosecutors, nor with any other similar participant in the trials brought to trial.

The Registrar is the general secretary of the institution, whose services she/he directs under the guidance and authority of the President of the Court. The Court can judge in a plenary session, in the Grand Chamber (fifteen judges) or in chambers of five or three judges. The Court meets in plenary session in the special cases provided for by the Statute of the Court (among others, when it must pronounce the dismissal of the Ombudsman or *ex officio* order the dismissal of a European Commissioner who has not complied with his obligations) and when he considers that a case is of exceptional importance.

The Court meets in the Grand Chamber at the request of a member state or an institution that is a party to a process, as well as in particularly complex or important cases. The other cases are resolved in chambers of five or three judges. The presidents of the chambers of five judges are elected for a period of three years, and those of the chambers of three judges for a period of one year. The Court validly deliberates in the presence of an odd number of judges. If an even number participates in a meeting, the youngest of the judges must refrain from participating in the deliberations (Tofan and Verga, 2023, p. 340).

Based on the rules of primary law, the CJEU has well-defined jurisdictional powers, which it exercises within the preliminary questions procedure and different categories of actions. The rules of EU law provide for the following types of procedures before the CJEU:

- Procedure of preliminary questions,
- The action in finding non-fulfilment of obligations,
- Action in cancellation,
- The action in ascertaining the abstention from acting,
- The appeal.

The General Court (initially the court of first instance) came into existence based on the provisions contained in the Single European Act of 1987 and began its activity in 1989, from the need to reform the system of judicial defence of

European law, in the sense of identifying and applying mechanisms that would relieve the Court's activity and shorten the period required for the pronouncement of solutions in cases concerning the norms of EU law. The goal proposed and achieved in the activity of the court was that any case with which it is invested should be resolved within a maximum time frame of 3 years.

The General Court gathers at least one judge from each member state (after the entry into force of the Treaty of Lisbon some of the member states have 2 judges, today the court gathers 54 judges). Judges are appointed by mutual agreement for a 6-year term by the state governments and are chosen from among the people who offer all the guarantees of independence and possess the capacity required by the norms of national law to exercise the highest judicial functions in the state.

Unlike the Court of Justice, the court of first instance does not use advocates general, yet any member of the tribunal, apart from the president, may be asked to act as an advocate general in certain cases. The rule of operation of the court is represented by the action within the Chambers composed of 3 to 5 judges, exceptionally with plenary meetings taking place. The Treaty of Nice provides, among other things, the possibility of setting up jurisdictional chambers in addition to the Court of First Instance, which would set up special courts in certain fields of activity (Kochenov and Butler, 2021).

The General Court has the jurisdiction to judge:

- actions brought by natural or legal persons against the acts of the institutions, bodies, offices or agencies of the EU (e.g., actions filed by an enterprise against a decision of the Commission by which it was fined), as well as against the normative acts that directly concern them and against the abstention from acting of these institutions, bodies, offices or agencies;
- actions brought by the Member States against the Commission;
- actions brought by the member states against the Council regarding acts adopted in the field of state aid, trade protection measures ("dumping”) and when Council exercises enforcement powers;
- actions aimed at obtaining compensation for damages caused by the institutions or bodies, offices or agencies of the EU or their agents;
- actions based on contracts concluded by the European Union in which the jurisdiction of the Court is expressly provided for;

- actions in the field of intellectual property directed against the European Union Office for Intellectual Property (EUIPO) and against the Community Plant Variety Office (OCSP);
- disputes between the institutions of the EU and their staff regarding labor relations, as well as the social insurance system (the activity carried out for a short period by the Civil Service court).

The decisions of the General Court can be challenged within two months with an appeal, limited to questions of law, to the Court of Justice. It is why initially it was called the Court (Tribunal) of First Instance.

1.3. The most important European institutions with specific competencies in the monetary and financial area

1.3.1. The Court of Auditors

The existence of an own budget of the European Communities required the establishment of a body to monitor the execution of this budget, namely an institution equivalent to the institutions that exercise the external public audit on public expenditure at the level of the member states, most often called Courts of Accounts (Tofan, 2019, p. 146).

The creation of the European Court of Auditors is in line with the application and consolidation of the financing of the Communities through own resources and in the context of assigning to the European Parliament the tasks of discharging the Commission for budget execution. The establishment of the Court of Accounts was foreseen by the Treaty of 1975 regarding the reform of the budget procedure. Despite its name, the Court of Accounts is not a jurisdiction, but an institution of external financial control.

Since the beginning of its activity in 1977, the European Court of Auditors fulfils the role of external auditor of the EU and its seat is in Luxembourg. The Court was set up to manage the EU's finances and help ensure accountability for the collection and spending of the EU budget. The European Court of Auditors ensures a control through democratic mechanisms of the execution of the EU budget, in front of the European citizens, along with the extension of the powers of the Parliament in the field of budgetary control.

The European Economic Community needed from the beginning of its activity an institution that would ensure a completely independent external audit on the execution of its own budget, that would help the Parliament and the Council to ensure the democratic control of its finances. At the creation of the Community in 1958, this task has been carried out by a small audit committee, which lacked the skills and resources to ensure an adequate audit of the rapidly growing budget. The main impetus for the creation of the European Court of Auditors came from Mr. Heinrich Aigner, the President of the Committee on Budgetary Control of the European Parliament, who, in 1973, argued convincingly for the establishment of an external audit body at Community level. The President of the Court of Justice of the European Communities at that time, Mr. Hans Kutscher welcomed the creation of the Court of Auditors, which he called “the financial conscience of the Community” (Costaș and Tofan, 2023, p. 580).

The European Court of Auditors became an independent European institution on 1 November 1993, with the entry into force of the Maastricht Treaty. The Court's independence and authority have been strengthened, since after 1992 the European Court of Auditors is mentioned among the main institutions of the EU, alongside the Commission, the Council and the Parliament.

The Court's role became even stronger in 1999 with the entry into force of the Treaty of Amsterdam, which reaffirmed the Court's independence and expanded its audit powers in several policy areas. The treaty emphasized the Court's role in the fight against fraud and allowed it to take actions before the Court of Justice to protect its prerogatives from possible infringements by the other EU institutions.

The 2003 Treaty of Nice confirmed the principle that the Court's college should be composed of one member from each Member State and underlined the importance of the Court's cooperation with national audit institutions.

The Treaty of Lisbon, which entered into force on 1 December 2009, reaffirmed the mandate of the Court and its status as an EU institution. Another development that is of particular interest to the Court is the changes brought by the treaty regarding the management and control of EU funds, which strengthens the budgetary powers of the European Parliament and emphasizes the responsibility of the member states for the execution of the budget.

The structure of the Court of Auditors developed in parallel with the evolution of the European Union. From nine members and 120 staff in 1977, the Court now has 27 members – spread over five chambers – and almost 900 staff with operational or administrative tasks, who come from all Member States. As an audit institution equal with supreme audit institutions from member states or from third countries, the European Court of Auditors aims to be at the forefront of developments in the field of public finance auditing, collaborating with other supreme audit institutions to develop professional standards and best practices.

The European Court of Auditors is composed of one representative for each member state, chosen from among the personalities who belong or have belonged to the respective country, working in external control institutions or who have special merits for this function and offer the strongest guarantees of independence (Stephenson, 2016).

The Court of Auditors functions as a collegial body, each member being assigned a specific field of activity. The Court adopts opinions or annual reports, with a majority of its members. The members of the Court are appointed by the Council, after consulting the European Parliament, following their nomination by the respective Member States. Members are appointed for a renewable term of six years. They must exercise their duties in complete independence and in the general interest of the European Union.

In addition to membership of the Court's college, members are assigned to one of five chambers. They adopt audit reports and opinions and make decisions on wider strategic and administrative matters. Also, each member is responsible for several specific tasks, mainly in the audit field. The audit activities underlying the preparation of a report are carried out by the Court's audit staff, under the coordination of a member, who is assisted by a cabinet. The member then presents the report for adoption at the level of the chamber and/or at the level of the Court plenary. Once adopted, the report is presented to the European Parliament, the Council and other relevant stakeholders, as well as the media.

The Court is organized into five chambers, within which the members of the Court and the audit staff are assigned (Tofan, 2019, p. 148). The members of each chamber elect a dean for a renewable two-year term. Each chamber has two areas of responsibility:

- adopting special reports, specific annual reports, and opinions; and
- the preparation of the annual report on the general budget of the EU and the annual report on the European development funds, with a view to their adoption by the full Court.

The Court meets in the full College of 27 members approximately twice a month to debate and adopt various documents, such as the Court's main annual publications: the report on the EU general budget and the report on the European Development Funds.

The audit quality control committee consists of the audit quality control member and one member from each chamber. This committee deals with the Court's audit policies, its audit standards and methodology, audit support and development, and audit quality control.

The administrative committee is composed of the deans of the chambers, the president of the Court, the member responsible for institutional relations and the member responsible for audit quality control. The committee deals with all administrative matters and decisions on matters related to communication and strategy. The President (*primus inter pares*) of the European Court of Auditors is elected by the members, from among them, for a renewable term of three years. The President presides over the Court's meetings, ensures that the Court's decisions are implemented, and that the institution and its activities are well managed. On 13 September 2016, Mr Klaus-Heiner Lehne, the German member of the Court, was elected as President of the European Court of Auditors, thus becoming the 11th President of the institution. His mandate was renewed on 12 September 2019.

The Secretary General is the most senior official in the institution and is appointed to this position by the Court, for a renewable term of six years. He is responsible for staff management and administration, in the areas of human resources, finance and general services, information, workspace and innovation, and translation, language services and publications. The Secretary-General is also responsible for the secretariat of the Court (Costaș and Tofan, 2023, p. 585).

The Court is divided into 10 departments (audit and administrative) which, in turn, form flexible teams constituted according to the tasks for which they are responsible, to ensure an optimal exploitation of resources and the development of the necessary expertise.

The European Court of Auditors is the external auditor of the European Union and its activity is based on the following fundamental values:

- *Independence:* the members of the European Court of Auditors carry out their work free from any influences that could compromise our professional judgment or that could be considered likely to compromise our professional judgment.

- *Integrity:* the members of the Court act honestly and reliably, exclusively in the public interest of the EU, and aim to be an example to follow in their professional activity and in the way they manage their mission at the institutional level.
- *Objectivity:* Court members must demonstrate impartiality and neutrality and draw up audit conclusions based on sufficient, relevant and reliable evidence.
- *Transparency:* issue clear, complete and accessible reports, published in all EU languages, respecting privacy and data protection requirements.
- *Professionalism:* The Court brings together staff who demonstrate and maintain the highest levels of knowledge, expertise and skills, both in the audit profession and in financial management and EU policy management.

Since its creation in 1977, the Court has aimed to contribute to improving the EU's financial management. During this time, new member states joined the EU, the EU budget was expanded, and the Union acquired new powers and created new bodies. The European Court of Auditors is tasked with verifying all revenue and expenditure accounts of the Community and of all community bodies, to guarantee compliance between Union expenditure, budgetary rules and regulations, as well as compliance with the principles of administrative and accounting law.

The Courts of Accounts control the budget execution by the EU institutions and the member states, all the persons who manage income and expenses on behalf of the EU, as well as all the natural and legal persons who benefited from payments in the form of expenses from the union budget. The control in the member states is carried out in collaboration with the competent national institutions and services, which are obliged to send the Court all the documents and information it requests.

The Court of Accounts presents every year to the Council and the European Parliament a statement on the execution of the budget, as well as on the legality and regularity of the adjacent operations. An annual report highlighting the court's observations on the financial management of the EU is sent to all European institutions and published in the Official Journal. The report underlines the points that would be possible or desirable to be improved and the institutions' responses to the Court's observations are also published in the Official Journal.

The Court of Accounts also has advisory powers. The other institutions of the Union can, and in some cases must, request the opinion of the Court of Accounts. The Court can present comments on the points contained in the special reports, equally published on various media communication channels, including by publication in the Official Journal. The powers of the Court of Accounts are very broad, expressing examination of the aspects of legality and regularity of the Community's revenues and expenses; domain control over institutions and member states; the assistance function of the budgetary authorities; responsibility for exercising permanent control of accounts.

The starting point for the audit activity of the European Court of Auditors is the EU budget and Union policies, mainly in areas related to economic growth and employment, added value, public finances, the environment and combating climate change. The Court's audit of budget execution covers both revenue and expenditure. The main lines of action of the European Court of Auditors aim at:

- Improving the accountability of EU institutions to European citizens,
- Elaboration of reports for EU decision-makers,
- Close cooperation with other supreme audit institutions.

Up to 80% of the EU budget is subject to shared management with the member states. They cooperate with the Commission in establishing oversight and internal control mechanisms to ensure that EU funds are spent properly and in accordance with the rules. Thus, the control exercised has both an EU and a national dimension. In addition to the work carried out by the Court, numerous Supreme Audit Institutions in the Member States audit European funds that are managed and spent by their national administrations.

The Court is committed to being at the forefront of developments in the field of public finance management and auditing. It plays an important role in the development and implementation of international standards (eg by INTOSAI). The results obtained over the years are evaluated by external experts, who confirm the high quality of the Court's reports. Constantly, the Court's recommendations are accepted by the Commission, and the reports drawn up on the status of the actions taken following these recommendations highlight their positive impact (Tofan, 2019, p. 155).

As the external auditor of the EU, the European Court of Auditors does not have the mandate to investigate cases where there are suspicions of fraud against the financial interests of the European Union. However, the Court actively collaborates in combating fraud against the EU budget, reporting to the European Anti-Fraud Office (OLAF) any suspicion of fraud, corruption or other illegal activity affecting the EU's financial interests. The Court may identify potential cases of fraud during its activities or may be informed by third parties of such cases. OLAF is responsible for the EU's fight against fraud, as well as protecting the Union's financial interests. At the same time, the Court collaborates with the EPPO, the European public prosecutor's office responsible for investigating, prosecuting the perpetrators of crimes affecting the financial interests of the EU. The European Court of Auditors and the EPPO signed a partnership that entered into force on 3 September 2021, establishing a cooperative relationship in order to protect the EU budget.

1.3.2. The European System of Central Banks

Article 109F of the Treaty establishing the European Union provides for the establishment of a European Monetary Institute (EMI), as a measure to achieve the second stage of the Economic and Monetary Union. EMI was a basic pillar of European monetary integration and is the forerunner of the European System of Central Banks. The European banking system involves an organization of credit institutions on three levels (Tofan, 2019, p. 168):

- a higher level, where we find the European Central Bank;
- an intermediate level, which includes the European System of Central Banks;
- a lower level, which includes all credit institutions that offer services to individuals and legal entities.

The EU law in the banking field affected, equally, all three levels presented, the member countries being forced to adjust the regulatory framework of the credit institutions that are established and carry out activity on their territory, to change the regulations regarding the national banks if there were inconsistencies with the European provisions and to accept the privileged and absolutely independent position of the European Central Bank.

The emergence of the European Central Bank and the European System of Central Banks on June 1, 1998 represented the transposition into practice of two normative innovations, not so much through the way these bodies were established, but especially through the tasks and powers assigned to them. The European System of Central Banks (ESCB) and the European Central Bank (ECB) were established based on Article 4A of the Treaty establishing the European Community. These institutions fulfil their tasks and carry out their activities, in accordance with the provisions of the Treaty and of their statute, contained in Protocol 3 of the Treaty of the European Union.

ESBC's main objective is to maintain price stability, according to Article 105, paragraph 1 of the European Community Treaty. The ESCB supports the general economic policies in the union, to contribute to the achievement of the community objectives provided for in Article 2 of the treaty: the harmonious and balanced development of economic activities, a sustainable and balanced growth of economic activities, a sustainable and non-inflationary growth that respects the environment, a high degree of convergence of economic performances (Randzio-Plath and Padoa-Schioppa, 2000).

Regarding the operation of the ESCB, we draw our attention to Article 107 of the EC Treaty, supplemented by the provisions of Protocol 3 of the EU Treaty, according to which neither a national central bank nor a member of the decision-making bodies can request or accept instructions from the community institutions or bodies, the governments of the member states or any other bodies.

Community institutions and bodies, as well as the governments of the member states undertake to respect this principle and not to try to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks. This rule gives a high degree of independence to the ESCB, which is imperative for the proposed tasks.

The ESCB consists of the ECB and the national central banks of the member states of the European Union. The ESCB does not have its own legal personality nor its own governing bodies, being governed by the governing and decision-making bodies of the ECB.

The European System of Central Banks (ESCB) has as its main attributions:

- defining and implementing the single monetary policy in the euro area;
- management of operations on the foreign exchange market;

- holding and managing the official currency reserves of the participating countries;
- promoting an operational payment system;
- money issue in the euro area;
- collaboration with central banks in banking prudential supervision;
- advisory functions (in the relationship with the European institutions);
- the collection of statistical information in the field, through collaboration with the central banks at the level of each member state.

At the same time, the European System of Central Banks has the obligation to support the implementation of the EU's general economic policies, to the extent that it does not contradict its main objective, i.e. ensuring price stability (Siekmann, 2015).

The European Central Bank (ECB) has legal personality by virtue of Article 16, paragraph 106 of the EC Treaty and enjoys in each of the member states the widest legal capacity, recognized to legal entities by national legislation. Based on this fact, the ECB can acquire and alienate movable and immovable property and it is able to stand in court.

The ECB ensures that the tasks entrusted to the ESCB are fulfilled through its own activities. The ECB officially started its activity in June 1998, replacing the European Monetary Institute. The headquarters of the ECB is in Frankfurt, in a modern building (Eurotower) specially built to house this institution.

The capital of the ECB, operational since the bank was established, amounts to 5 billion euros and can be increased by decision of the Board of Governors, with a qualified majority according to the provisions of Article 10.3. The National Central Banks (NCBs) are the only ones authorized to subscribe and hold the capital of the ECB. Capital subscription is carried out according to the distribution grid established in Article 29, and the shares of central banks cannot be assigned, pledged, or seized.

The contribution of each national central bank is established in proportion to its share of the capital subscribed to the ECB. The ECB is fully entitled to hold and manage the reserves transferred to it and to use them for the purposes established by the statute. Each national central bank has a claim on the ECB, corresponding to its contribution, and the ECB can claim additional foreign exchange reserves from the central banks, in accordance with the subscribed quota, and above the limit of 50 billion euros.

Analyzing the legal norms that laid the foundations for the operation of this institution, we can easily state that the most important of the attributes conferred on the European Central Bank by its founding statute is its independence. The principle of independence assumes that the bank has absolute autonomy over decision-making and over the implementation of the policies assigned to it by the constitutive acts.

In the specialized literature, the independence of the ECB was analyzed from several points of view (Costaș and Tofan, 2023, p. 601). Thus, we can conclude that:

- From an institutional point of view, the ECB has a legal personality distinct from the personality of any other legal entities, by comparison with the EU institutions that do not have a personality distinct from the personality of the union.
- From the point of view of the staff working in the ECB's decision-making and management bodies, the constituent normative provisions of the ECB guarantee the absolute independence of those who work at the ECB vis-à-vis the governments of the states of which they are citizens.
- From a functional point of view, the ECB has the possibility to take decisions independently of any other institution or political body, unique at the European level or specific to one of the member states.
- From a financial point of view, the ECB's patrimony is autonomous from the EU budget. The ECB and ESCB can have their own income from the activities they can carry out, according to the statute; these revenues are managed autonomously.

At the same time, critical points of view were expressed regarding the independence offered to the ECB and its officials. It is said that we may doubt that some independent officials have a keener knowledge and consciousness of the general interest than governments, if it is true that they can more easily escape the demands of pressure groups, they may just as well be mistaken or have an erroneous view of the workings of the economy (Buchanan and Dorf, 2016). Thus, the adjustment of the economic policy becomes effective to the extent that the independence of these officials is linked, in the long term, to their mandate. According to the theory of bureaucracy, it is permissible to think that bankers at the central level can privilege personal objectives, maintain their physical well-being, develop their prestige and even their income, objectives that are not necessarily in agreement with the objectives of the state and the citizens.

The three decision-making and management bodies of the ECB are the Executive Board, the Board of Governors and the General Board (Costaș and Tofan, 2023, p. 605).

The executive council is also called the executive council, executive committee or directorate - Executive Board - and is made up, according to Article 11 of the ECB Statute, of six members. The members of the Executive Board are appointed by the European Council, on the recommendation of the Council of the European Union, after consulting the European Parliament and the ECB Governing Council.

The mandate of all members is eight years, non-renewable, a measure taken to ensure the independence of the European Central Bank. When designating the first members, with the exception of the president, an appointment system was adopted for different periods: the vice-president was appointed for four years and the other members have a mandate between five and eight years. The gradual partial renewal was designed to ensure both continuity and independence of the Executive Council in action.

The members of the Executive Council must be citizens of the union, residents of member countries participating in the euro zone, have authority and professional experience in the recognized monetary-banking field. During the mandate, they are incompatible with any other profession or trade, remunerated or not, unless they obtain a special exemption from the Board of Governors. They do not represent the countries from which they come but must consider the interests of the ECB and act exclusively for the fulfilment of its functions and missions.

Since decisions are taken within the Executive Council by voting, based on the simple majority of votes and each member has one vote, in case of equality of votes, the vote of the president has a decisive role. To validate the decisions, a presence quorum of 2/3 of the members is required (that is, at least 4 members of the Executive Council must be present at the deliberations).

The Council of Governors is made up, according to Article 101 of the Statute of the ESCB and the ECB, of the members of the Executive Council and from the governors of the central banks in the euro area. It is the supreme decision-making body of the ESCB and the ECB.

According to the provisions of Article 10 of the statute, council meetings are secret, but council members can decide to make the outcome of deliberations public (Article 10.4). The confidential character of the meetings has given rise to accusations regarding the reduced transparency in the ECB's actions, but it is motivated by the absolute independence of the members of the ECB and the Council, in making decisions.

The Council usually meets twice a month, at the ECB headquarters in Frankfurt, and its decisions are usually anticipated by the global financial markets. As a rule, the meetings of the Board of Governors take place every 2 or 3 weeks, and teleconferences are called even more often than that.

The members of the Board of Governors must act independently and not as members of the countries from which they come, to achieve the objectives of the ECB established by statute. Since the council is a collegial body, the principle of one person/one vote was adopted and not a weighting of voting rights, as happens, for example, within the International Monetary Fund or the World Bank, depending on the importance of the country that the person expressing his vote represents (Tofan, 2019, p. 170).

In the perspective of EU enlargement, the ECB had to formulate proposals regarding the functioning of the ESCB. Thus, the principle of rotating votes in the Council of Governors was proposed, from the moment when the number of eurozone members is greater than 15, with the possibility that the application of the decision will be postponed until the moment when the number of governors will be greater than 18. This system applies starting from 01.01.2015; depending on the size of the GDP and the banking activity (the aggregate balance sheet of financial institutions), each country should be assigned to a category, and then share the votes with other countries, as follows:

1. until the number of countries in the eurozone does not exceed 21, there will be two groups of countries, the first group consisting of five governors who will share four votes, and the second group regardless of the number of governors (maximum 16) will share 11 votes;
2. from the moment there will be 22 governors or more, there will be three groups: in the first group, there will continue to be five governors who will share four votes, in the second group there will be 8 votes, and in the third, three votes will be shared.

The failure recorded in the process of adopting the European constitution determined a general reaction of caution regarding any change in the decision-making process and the institutional mechanisms already verified by past activity. The expansion of the Union, however, requires the adoption of some measures that facilitate the development of activities specific to each institution, including, in a union with 27 members.

The third decision-making body of the ECB is the General Council, formed according to Article 45.2 of the statute, from the president of the ECB and the vice-president of the ECB, the governors of the national central banks of the member states of the European Union (all 27). When all countries will have adopted the EURO as a single currency, the operation of the General Council will no longer be justified, it will be confused, at that moment, with the current Council of Governors.

The national central banks of the states outside the eurozone have a marginal role in the decision-making process related to monetary policy, the General Council's attributions being more consultative. This council also meets at the ECB headquarters in Frankfurt, but once every three months.

The highly decentralized organization has sometimes been criticized in the specialized literature, with the ECB being considered more decentralized than the Bundesbank or the US Federal Reserve System. The federal structure of the ECB and the ESCB is better outlined by reporting the activity and organization of the Board of Governors to similar bodies in Germany and the USA. Thus, the Executive Council represents the federal component, and the Council of Governors represents the national component.

The activity of the Board of Governors is carried out in compliance with the principle of separation of monetary policy attributions - supervisory attributions; in this sense, the meetings of the council take place based on agenda that separates meetings for aspects related to the monetary policy and for those related to the exercise of supervision/monitoring powers (Bossu and Rossi, 2019).

Following the financial crisis in 2008, new representative and management bodies were organized at the ECB level, with the main role in supervising the banking activity. The supervisory committee meets twice a month to discuss, forecast and fulfil the ECB's supervisory duties. The supervisory committee elaborates the proposals for decisions of the Board of Governors (Goodhart *et al.*, 2014).

The supervisory committee is composed of:

- the president (appointed for a term that cannot be renewed for 5 years),
- the vice-president (elected from among the members of the ECB Executive Board),
- 4 representatives of the ECB,
- representatives of the national supervisory authorities from the countries that are in the eurozone.

The management committee supports the activities of the Supervisory Board and prepares its meetings, and it is composed of: the president and vice-president of the Supervisory Committee, a representative of the ECB and five representatives of the national supervisory authorities, appointed by the Supervisory Committee organized at the level of the ECB for a period of one year, on the principle of rotation to ensure a correct representation of all the states in the eurozone. The activity of these organisms proved the efficiency of the reform of the regulatory framework in this respect.

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CHAPTER 2

EUROPEAN UNION'S BUDGET AND ITS ROLE IN SHAPING THE FUTURE OF EUROPE

Ana-Maria Bercu[1], Silvia-Maria Carp[2]

2.1. Introduction

The annual budget of the Union as provided for in Part Six, Title II, Chapter 3 of the Treaty on the Functioning of the European Union (TFEU) is the instrument that determines and authorises, for each financial year, the total amount of appropriations for revenue and expenditure considered necessary for the European Union and the European Atomic Energy Community (European Commission, 2021). Its establishment took place in 1957 with the ratification of the Treaty of Rome which upheld the principle of financial solidarity (Fîrțescu, 2017).

The general budget of the European Union is the act that provides for and authorises for each financial year, all the estimated receipts and payments necessary for the functioning of the European Union. In doctrine, the Union budget is defined as an act that authorises the annual financing of all Community activities and interventions, the necessary resources, priorities, and objectives set (Costaș and Tofan, 2023).

Since the formation of the European Coal and Steel Community until today, the Union budget has undergone several changes. A large part of these changes is also due to the enlargement of the European project from 6 to 28 (by 31 January 2021), i.e. 27 members at present. According to Costaș and Tofan (2023), since 1970 the budget of the European Economic Community has been 3 billion escudos, largely made up of agricultural expenditure for the common agricultural

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[1] Ana-Maria Bercu is Ph.D. habil., professor of public administration at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.
[2] Silvia-Maria Carp is Ph.D. student in administrative sciences at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iasi.

policies. At its inception, the budget was financed from two main resources: taxes collected from imports of agricultural products and customs duties on imports of products from outside the European Community (Fîrțescu, 2017).

2.2. Underlying principles of the EU budget

The budget of the European Union is drawn up and implemented with the following budgetary principles in mind (European Commission, 2021):

a. The principle of unit of account stipulates that from 1 January 1999, the budget of the European Union shall be drawn up and implemented in Euro.

b. The principle of unity and the principle of budgetary accuracy which implies that all Union revenue and expenditure under the budget is recorded in a single document.

c. The principle of budgetary unity refers to the fact that the budget must be presented and managed as a single, distinct financial unit. This means that all government revenue and expenditure must be included in a single budget document and managed as a single financial entity. This principle ensures that the budget is transparent and easy to understand, and that revenue and expenditure are effectively monitored and reported. On the other hand, *the principle of budgetary accuracy* refers to the fact that the budget must be drawn up in a precise manner and accurately reflect the government's financial situation and policy objectives. This means that revenue and expenditure must be accurately estimated and that the budget must be managed in an efficient and accountable way to ensure the optimal use of financial resources. The principle of budgetary accuracy is closely linked to the principle of budgetary transparency and accountability. Together, these principles contribute to ensuring an accountable and transparent budgetary process that is in the public interest (Șaguna and Tofan, 2010). These principles contribute to an effective monitoring of the conditions for the use of Community resources and are governed by Article 268 of the EC Treaty and Articles 4 and 5 of Council Regulation 1605/2002 (Maufort, 2016).

d. The principle of annuality which provides the adoption of the budget for each financial year and the use, in principle, of both payment appropriations and commitment appropriations for the financial year in question during that year. The principle of annuality is a key principle of the European Union budget, which states that expenditure and revenue must be planned, approved, and implemented for each financial year (Costaș and Tofan, 2023).

On the expenditure side, the principle of annuality means that all expenditures must be planned and approved in each individual fiscal year, and funds that are not used in one fiscal year cannot be transferred to the next. This is because the EU budget is based on the principle of commitment and payment funds, which means that commitments and payments must be made in the same financial year. On the revenue side, the principle of annuality applies in a similar way, in that revenue must be estimated and collected for each individual financial year (Costaș and Tofan, 2023; Maufort, 2016).

The principle of annuality is of paramount importance for ensuring proper control of expenditure and revenue by the European Parliament and the Council of the European Union, as well as for maintaining budgetary transparency and accountability. It also allows the European Union to manage its budget efficiently and to take decisions quickly and in line with current needs.

e. The principle of equilibrium implies that the estimates of revenue for the budget year must equal the payment appropriations for that year. Borrowing operations to cover any budget deficit are not compatible with the own resources system and are not authorised. In accordance with the principle of unit of account, the budget is drawn up and implemented in Euro and the accounts must be presented in Euro. In a balanced budget, revenue is equal to or greater than expenditure, which means that the European Union does not exceed its financial resources and does not borrow to cover current expenditure. If the budget is in deficit, the European Union may have to borrow or cut spending to make up the difference. The principle of balanced budgets is closely linked to the principle of fiscal discipline, which requires Member States to manage their public finances responsibly and avoid accumulating undue debt (Bilan, 2015). This principle has been reinforced by the Maastricht Treaty and, more recently, by the Stability and Growth Pact, which requires Member States to respect certain deficit and debt limits (Maufort, 2016).

f. The principle of universality implies that total revenue must cover total payment appropriations, except for a limited number of revenues, which are earmarked to finance specific expenditures. Revenue and expenditure are budgeted in full, without adjustment between them (Tofan, 2018).

g. The principle of specificity implies that each appropriation must have a specific purpose and be allocated to a specific objective to prevent any confusion between appropriations, and EU priorities. These objectives include, among others, the promotion of economic, social, and territorial cohesion, sustainable development, environmental protection, job creation, research and innovation, promotion of EU rights and values. The principle of specificity is important to ensure that expenditure from the EU budget is efficient and effective in the sense that it is earmarked for specific and clear objectives and contributes to the achievement of EU policy and priorities. This principle also allows for better evaluation and monitoring of the performance of the EU budget. To ensure that the principle of specificity is respected, the EU budget is structured into different categories of expenditure, such as expenditure for the common agricultural policy, expenditure for cohesion policy, expenditure for research and innovation etc. (Tofan, 2018; Fîrțescu, 2017).

h. The principle of sound financial management is defined in relation to the principles of economy, efficiency, and effectiveness (Fîrțescu, 2017).

i. The principle of economy refers to ensuring that expenditure is made in the most efficient way possible and that costs are proportionate to expected benefits (Costea 2021).

j. The principle of efficiency implies a balance between the means used and the results obtained.

k. The principle of effectiveness implies the achievement of the objectives that were set and the results that were expected (Șaguna and Tofan, 2010).

l. The principle of transparency ensures good information on budget execution and accounts. According to this principle, the EU budget and the way EU funds are used must be transparent and accessible to all EU citizens. This implies publishing clear and relevant information about the EU budget, including the amounts allocated to different policies and programmes, as well as about the beneficiaries of EU funds and how they are used (Șaguna and Tofan, 2010; Minea and Costaș, 2011).

2.3. Sources of European budget law

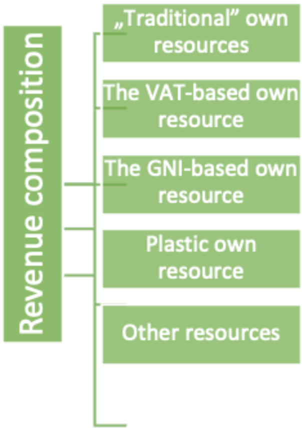
The European budgetary system comprises all the regulations that determine the way in which financial-budgetary relations are conducted at EU level. The budgetary system is made up of the primary rules, which are contained in the Treaties, followed by the secondary sources of European law represented by regulations, decisions, and directives, the complementary sources, and, finally, the case law of the Court of Justice of the EU (Costaș and Tofan, 2023).

Over time, the European budgetary system has undergone a series of changes, mainly marked by the need to keep pace with the rapid development of European integration, but also to limit the risks of conflicts that may arise between Parliament, the Council, and the European Commission. The budgetary mechanisms which were established by the Treaty of Paris in 1951 and later in, the Treaty of Rome in 1957, have undergone a whole series of changes over the years. The Treaty of Rome was amended and supplemented by the Treaty of Maastricht in 1992, the Treaty of Amsterdam in 1997, and the Treaty of Nice in 2003 (European Parliament). With the entry into force on 1 December 2009 of the Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, the European Union replaced the European Communities, except for the European Atomic Energy Community. The Treaty of European Communities was also replaced by the Treaty on the Functioning of the European Union.

While since 1958 all budgetary power was in the hands of the Council, the role of the European Parliament in adopting the budget became more consolidated with the signing on 22 April 1970 of the "Treaty amending certain budgetary provisions" and the signing on 22 July 1975 of the "Treaty amending certain financial provisions" (General Secretariat of the Council, 2012). With the 1970 Treaty, Parliament was given the right to have the final say on the category of non-compulsory expenditure, and since the 1975 Treaty it has had the right to approve or reject the draft budget. The changes to the 1970 Treaties made the European Parliament the institution with the most legitimacy and led to several major changes in budget negotiations. The power imbalance between Parliament and the Council led to conflicts between the two institutions, which lasted for 10 years, from 1978 to 1988, when a financial reform took place, materialized by Interinstitutional Agreements (Fîrțescu, 2017).

2.4. The revenues and expenditures of the European Union

The **European Union's revenue** is the financial resources collected from the Member States and other sources to finance the Union's budget (see Figure 2.1). Since the Maastricht Treaty, the financing regime that was originally laid down in Article 201 [269] EC has been modified. According to para. 1, subject to other revenue, the budget is to be financed by own resources. Since 1 January 1980, all Community expenditure has been covered by own revenue (Manolache, 2006).



Source: own computation based on Schwarcz (2022)

Figure 2.1. Revenue composition of the EU budget

Traditional own resources fall into two broad categories, namely customs duties levied on imports from non-EU countries and agricultural levies (Minea and Costaș, 2011). Agricultural levies were for a long time the EU's only source of revenue, but over time their share has declined by 2-3%. On the other hand, customs duties have had a much more surprising evolution, according to Cosmin Flavius Costaș and Mihaela Tofan. While in 1971 they accounted for 25% of total revenue, they doubled after only 4 years (1975) to 50%. Today, their share is only 10% (Costaș and Tofan, 2023). The main purpose of the Common Customs Tariff is to harmonise import or export duties at the EU's external borders, with the Union becoming the owner of these duties by virtue of a Council decision (Minea and Costaș, 2011).

The value-added tax levies are a uniform percentage rate that is applied to the harmonised base of each Member State of the Union (Costea, 2021). Although since 1988 the bases have had a percentage of 55% of GNI, according to Decision 94/728/EC, Euratom and Council of 1994, the percentage of the bases has decreased to 50% of GNI (Fîrțescu, 2017).

Gross National Product (GNP) levies are the annual contribution of Member States to the EU budget, which is calculated based on the gross national income of the states. These contributions are the EU's largest source of revenue. Their calculation formula comprises a summation of all the Union's budgetary expenditure, from which are deducted amounts representing value added tax levies, agricultural levies, and customs duties levied on imports from non-EU countries, and amounts from other revenue. The final balance is distributed as a tax burden on the Member States, considering GNP (Minea and Costaș, 2011).

The plastic waste-based resource was introduced by Council Decision (EU, EURATOM) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing Decision 2014/335/EU, Euratom as from 1 January 2021, and is a national contribution based on the quantity of waste that comes from non-recycled plastic packaging, with a levy rate of 0.80 EUR/kilogram. Member States whose GNI is below the EU average benefit from a forestry reduction corresponding to 3.8 kg/capita. At present, this resource provides 3-4% of EU budget revenue (European Parliament).

The Union's ***other revenues*** are represented by unused resources from the previous year, taxes on the salaries of staff in the EU institutions, fines imposed on companies that do not comply with European rules (Costea, 2021), revenue from the sale or rental of goods, revenue resulting from services provided against cost, interest on late payment of own resources by Member States etc. (Fîrțescu, 2017).

Regarding **budgetary expenditure**, the Council and Parliament jointly approve these in the European Union (EU). The annual budget must respect the spending limits agreed in the Multiannual Financial Framework (MFF) for different categories of expenditure, such as those related to the single market, cohesion, and natural resources. Flexibility instruments are in place to allow the EU to respond to unforeseen needs. In addition, the use of budget guarantees and financial instruments has a leverage effect on EU spending. Apart from the MFF, total EU spending for the period 2021-2027 includes the temporary recovery instrument NextGenerationEU, which aims to help the EU economy recover from the COVID-19 pandemic. Overall, the EU has a comprehensive framework for managing its budget, which ensures that spending is aligned with its policy objectives and reflects the evolving needs of the Union. Although, as stated above, the NextGenerationEU instrument is intended to help the EU economy recover, the uncertain conditions produced by the pandemic call for political accountability, fiscal diligence and not least the ability of Member State governments to react proactively. Better coordination, accountability and common frameworks for action are therefore needed to properly manage this recovery tool.

Following an agreement between the three institutions that contribute to the EU budget (Commission, Council, and Parliament), the European Parliament has divided budget expenditure into two types: compulsory and non-compulsory expenditure (Minea and Costaș, 2011). In the case of compulsory expenditure, it is the Council that has the final say, while in the case of non-compulsory expenditure, it is the Parliament that decides whether to approve it.

The structure of the EU budget is as follows (according to the Official Journal of the European Union, 2021):

- SECTION I: EUROPEAN PARLIAMENT
- SECTION II: EUROPEAN COUNCIL AND COUNCIL
- SECTION III: COMMISSION
- SECTION IV: COURT OF JUSTICE OF THE EUROPEAN UNION
- SECTION V: COURT OF AUDITORS
- SECTION VI: EUROPEAN ECONOMIC AND SOCIAL COMMITTEE
- SECTION VII: COMMITTEE OF THE REGIONS
- SECTION VIII: EUROPEAN OMBUDSMAN
- SECTION IX: EUROPEAN DATA PROTECTION SUPERVISOR
- SECTION X: EUROPEAN EXTERNAL ACTION SERVICE

The Union's budget is constantly in a transitional state, as needs change over time and new ones emerge. Although it began as an instrument that was intended to compensate the agricultural sector, it is becoming an instrument to promote economic growth, precisely to be able to face new global challenges (Ferrer and Wynn, 2007).

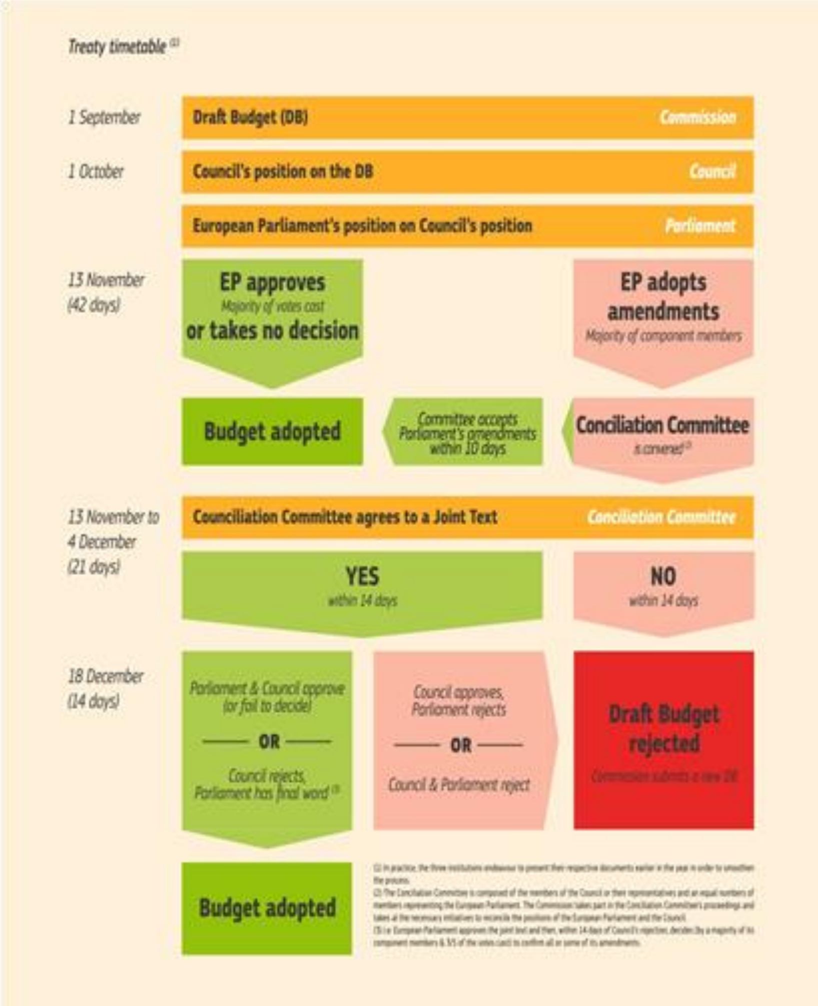
2.5. The budgetary procedure

The process of establishing the budget must respect several precise rules, stemming from the principle of budgetary discipline, which requires the Commission together with the Member States to ensure that manages financial resources efficiently and effectively. The institutions responsible for adopting the EU budget are the Council of the European Union and the European Parliament, which have different roles in the process. The Council of the European Union is made up of representatives of the governments of the Member States and has the power to adopt the EU budget together with the European Parliament, while the European Parliament is made up of elected representatives of EU citizens and has the right to approve or reject the budget.

Since the entry into force of the Lisbon Treaty, the budgetary procedure has become simpler and more transparent, based on budgetary co-decision. Previously, both the Council and Parliament had to hold two readings during the budgetary procedure, making the process simpler. Article 314 TFEU sets out the framework within which the budgetary procedure will be conducted, with Parliament and the Council adopting the Union's annual budget in accordance with a special legislative procedure (TFEU, 2012).

The process of adopting the EU budget, according to James (2023), starts with the European Commission presenting a draft budget for the next financial year (1 January to 31 December) (see Figure 2.2). This draft budget is based on the EU's political priorities and the financial needs of its institutions and programmes. According to the above-mentioned article, each institution is obliged to draw up an estimate of its expenditure by 1 July so that it can be included in the next budget year. The European Commission compiles the statements submitted and draws up a draft budget, which it initially submits to the Council and Parliament by 1 September. It should be noted that the Commission may amend the draft budget if the situation so requires, but no later than when the Conciliation Committee meets.

In the second stage of the adoption of the draft budget, the Council sends its position on the draft budget to the European Parliament. Under Article 314(3), the Council must forward its position on the draft budget together with the reasons that led to its position by 1 October at the latest.



Source: according to the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/how-it-works/annual-lifecycle/preparation_en)

Figure 2.2. The budgetary procedure of the EU

The third stage is Parliament's reading. At this stage, Parliament has 42 days to communicate its decision. Article 314(4) stipulates that if, within 42 days, Parliament approves the Council's position or fails to give its opinion, the budget is definitively approved. If it adopts amendments together with most of its component members, the revised draft is forwarded to the Council and the

Commission, and the President of Parliament and the President of the Council must convene the conciliation committee. If within 10 days of the Council's convening the Conciliation Committee informs the Council that it approves Parliament's amendments, the Conciliation Committee shall not meet again.

In the fourth stage, the Conciliation Committee, composed of an equal number of representatives of the Council and Parliament, meets and has 21 days to reach an agreement on a draft joint budget. If no common position on the draft budget is reached after the above-mentioned deadline, the Commission is obliged to establish and present a new draft budget. If, however, a consensus is reached, paragraph 6 provides that Parliament and the Council have 14 days from the date of agreement to adopt the joint draft budget. If a common position is reached or no decision is taken, or one of the institutions approves the draft and the other takes no decision, the President of Parliament declares the draft budget finally adopted. However, if no agreement is reached, the system of provisional twelfths is established until the final draft is adopted.

The European Commission attaches to the draft budget a series of documents designed to give an overview of the EU budget and to provide the Council of the European Union and the European Parliament with the information they need to assess the draft budget and decide whether to approve or reject it. According to Costaș and Tofan (2023), the Commission also attaches to the draft budget a financial programming for the coming years:

- a statement including the draft budget with the initial estimates and where there are different estimates from those drawn up by the other institutions and the reasons for the differences, if any;
- documents showing all staff employed in the EU and the type of employment contract, a list of posts broken down by policy area, etc;
- an analysis of income and expenditure and information on staff employed in Union agencies;
- a working document covering the planned implementation of appropriations and outstanding commitments from the previous budget year;
- a working document covering the administrative expenditure to be implemented by the Commission;
- summary of all contributions per EU programme or fund, etc.

2.6. Institutions involved in the budgetary procedure

The European Commission plays an important role in the preparation of the EU budget, as laid down in the EU Treaties and the Financial Regulations. According to the Treaty on the Functioning of the European Union, the European Commission has a number of competences around four main categories, such as initiative powers, powers to monitor the implementation of Union legislation, implementing powers, and, last but not least, regulatory and advisory powers. The budgetary initiative power implies, according to Article 314 TFEU, that the Commission must group together all the forecasts received from the Union institutions and forward them to the Council and Parliament. Article 317 of the same Treaty provides for the responsibility of the Commission and Member States alike to ensure that EU budget expenditure is effectively coordinated and monitored. The Commission supervises how EU money is spent and ensures that it is used in accordance with EU policies and programmes.

The European Commission is responsible, under Article 318, for reporting on the use of EU funds and for ensuring transparency and accountability in their use. The Commission provides the European Parliament and the Council of the European Union with detailed information on EU expenditure and revenue and reports on budgetary developments in its annual reports.

The Council of the European Union is one of the main decision-makers of the European Union. According to Article 11(1), the Council of the European Union, together with the European Parliament, exercises legislative and budgetary functions as well as policymaking or coordinating functions. Paragraph 2 of the same article stipulates that the Council shall include a representative of each Member State at ministerial level. The Presidency of the Council is held by the representatives of the Member States in the Council on a rotating basis (The Treaty on European Union - Official Journal of the European Union, 2012).

The Council of the European Union is involved in the legislative process alongside the European Parliament, mainly through the ordinary legislative procedure or co-decision, which applies in policy areas where the EU has exclusive or shared competence with the Member States. In such cases, the Council bases its legislative decisions on proposals submitted by the European Commission. In addition, the Council is responsible for coordinating economic and budgetary policies between Member States, with the aim of strengthening economic governance in the EU. The Council also monitors budgetary policies and strengthens the EU's budgetary framework, while addressing the legal and practical aspects of the euro, financial markets, and capital flows (Council of the European Union, 2016).

The European Parliament has an important role in the European Union budgeting process. According to the Treaty on the Functioning of the European Union (2012), the European Parliament has the decision-making power to approve the budget, following a process of negotiations with the Council of the European Union; it has the power to amend the budget, but these amendments are subject to negotiation with the Council etc.

After all EU Member States ratified the Lisbon Treaty, the European Parliament's law-making powers were extended. Before the ratification of the Treaty, the European Parliament only had legislative powers in certain areas, such as the environment, transport, the internal market, employment, social policy, education, public health, and consumer protection. After the ratification of the Treaty, the European Parliament also gained legislative powers in areas such as agriculture and fisheries, support for poorer regions, security and justice, trade policy, cooperation with countries outside the European Union and implementing acts.

2.7. EU multiannual financial frameworks 2007-2020 and NextGenerationEU

The European Union's Multiannual Financial Framework (MFF) is a seven-year budgetary planning instrument that sets the EU's annual spending limits, determines funding priorities, and allocates resources between different EU policy areas. The MFF covers a wide range of spending areas, including agriculture, research and innovation, regional development, and external policy, among others (Olivares, 2022).

The MFF is negotiated and approved by EU Member States and the European Parliament. The process of negotiating the MFF involves a series of discussions and compromises between EU institutions, which can often be difficult due to the diversity of EU Member States' interests and priorities. According to the European Commission (2021) the MFF is an essential tool for the implementation of EU policies and programmes as it provides predictability and stability for EU funding priorities in the long term. It also ensures that EU spending is in line with its overall objectives and values, such as promoting economic growth, social cohesion, and environmental sustainability.

Another important aspect of the MFF is its role in ensuring the financial stability and sustainability of the EU, to ensure stricter budgetary discipline and to improve the functioning of the budgetary procedure and interinstitutional cooperation. (European Commission, 2014). The MFF is designed to ensure that EU spending is in line with available resources and that it does not exceed its own revenue limits. This is achieved through a system of own resources, which includes revenue from customs duties, value-added tax, and a share of Member States' gross national income. As we will see during this paper, the expenditure side of the EU budget is made up based on expenditure categories, as is the case for revenue. This expenditure structure is, according to Dan Lupu et al. (2018), the one that gives a much clearer picture of how to act to promote economic growth and development.

In the following pages, we will briefly review the last three EU multi-annual frameworks, focusing on the 2007-2013 and 2014-2020 frameworks, to see how revenue and expenditure have evolved. The budgets used in our analysis have been taken from the European Commission's website, and as a working method, we have chosen to produce graphs for each major budget heading over the period of each multiannual framework. It should be noted that the amounts included in our analysis are represented by the amounts under the heading "EU27/28" and not "Total".

2.7.1. The Multiannual Financial Framework (MFF) 2007-2013

The European Union's (EU) Multiannual Financial Framework (MFF) 2007-2013 has been the budgetary planning instrument for the EU during this period. According to the European Commission's report on the MFF 2007-2013, total EU revenue over the period was EUR 1,025.2 billion, while total expenditure was EUR 929 billion (EUR-Lex, 2005).

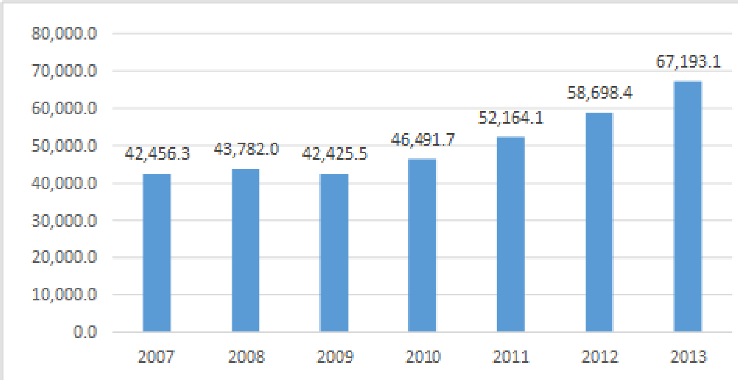
The main sources of EU revenue during the MFF 2007-2013 were traditional own resources (TOR), which include customs duties and agricultural levies, and value-added tax (VAT) contributions from Member States. According to the European Parliament report on the MFF 2007-2013, TOR accounted for about 20% of total EU revenue during that period, while VAT contributions accounted for about 12% (European Parliament, 2020).

EU spending during the MFF 2007-2013 was split across different policy areas, including cohesion policy, agricultural and rural development, and external relations. According to the European Commission report, the largest policy area in terms of expenditure was cohesion policy, which received around 36% of the total budget, followed by agriculture and rural development with around 33% and external relations with around 6% (European Commission, 2017).

According to Tofan (2018) in 2005, the European Union faced a difficult situation due to the rejection of the EU Constitution in France and the Netherlands. In this context, it was essential to reach a rapid agreement on the Union's financial perspectives for 2007-2013 for political, budgetary, and practical reasons. The Interinstitutional Agreement of 17 May 2006 stipulated a total budget of €864.3 million for the period, equivalent to 1.048% of Member States' gross national income. To facilitate the use of structural and cohesion funds, the European Council introduced flexibility mechanisms, which increased the duration of a project's funding from two to three years.

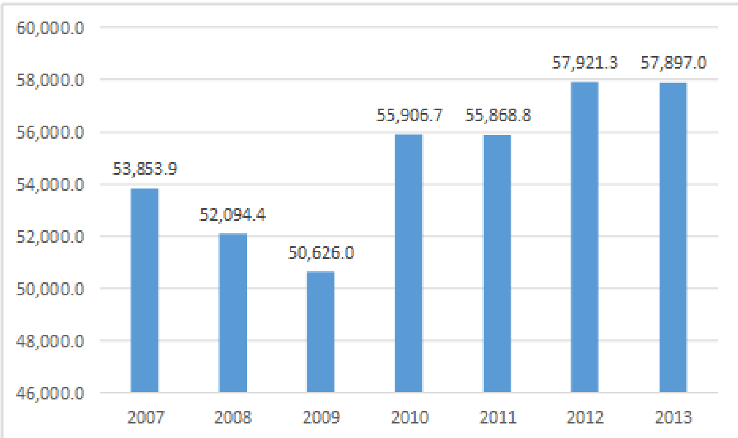
Spending on ***sustainable development*** totalled EUR 353,210.0 million, with amounts on an upward trend from EUR 42,456.3 million in 2007 to EUR 67,193.1 million in 2013, an increase of EUR 24,736.8 million (see Figure 2.3). This section of the budget has been crucial to the EU's efforts to transform itself into a smart, sustainable, and inclusive economy that promotes high levels of employment, productivity, and social unity. Several of the flagship initiatives set out in the Europe 2020 Strategy were funded under this budget category, including 'Innovation Union', 'Youth on the Move', 'Resource Efficient Europe', 'An Agenda for New Skills and Jobs', and 'An Industrial Policy for the Globalisation Era' and other actions that covered the internal market, taxation and customs union, education and research etc. (European Commission, 2014).

The budget section dedicated to the ***conservation and management of natural resources*** (see Figure 2.4) in the EU totalled €384.168 billion in expenditure over the period 2007-2013. Most funds were allocated to the subcategories of market expenditure and direct aid and development (290 billion), followed in second place by rural development (80 billion).



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.3. Sustainable growth expenditures in the EU for the period 2007-2013



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

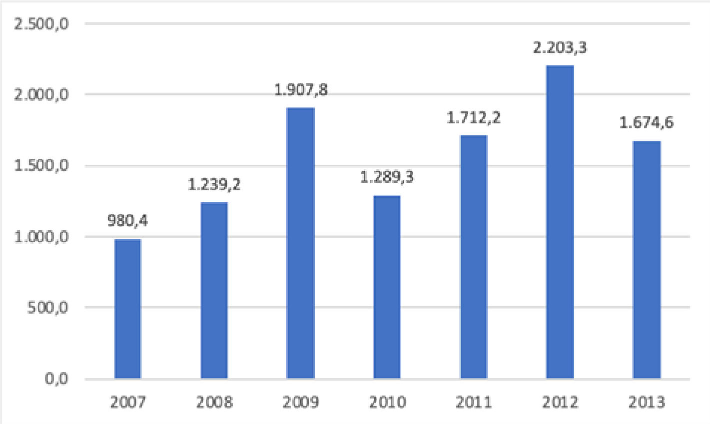
Figure 2.4. Preservation and management of natural resources expenditures in the EU for the period 2007-2013

This section of the budget covered funding for EU programmes in agriculture, rural development, fisheries, and environment. The EU's Common Agricultural Policy aimed to promote the production of safe, high-quality food, encourage innovation in agriculture and food processing, and support farmers. It provided financial support to farmers through direct payments and measures to respond to market disturbances such as storage and export refunds. In addition, the EU has worked to enhance the economic potential of rural areas by promoting diversification of their activities and protecting rural heritage through the European Agricultural Fund for Rural Development (European Commission, 2014).

According to the European Court of Auditors, the majority of financial resources were allocated to two main headings of the multiannual financial framework during the period. The first, known as Heading 1.b, focused on promoting growth and jobs through cohesion and accounted for 36% of the commitment ceiling and 34% of the payment ceiling. The second heading, called Heading 2, concerned the conservation and management of natural resources, in particular in the field of agriculture, and accounted for 42% of the commitment ceiling and 45% of the payment ceiling. In total, these two headings accounted for 78% of the funds committed and 79% of the funds paid during the period specified (European Court of Auditors, 2014).

The budget heading ***citizenship, freedom, security, and justice*** aims to strengthen the position of the European Union as a region of freedom, security, and justice by introducing a streamlined framework composed of three programmes, namely "Freedom of movement and solidarity in the area of external borders, asylum and immigration", "Security" and "Justice and fundamental rights". This new structure would replace all existing mechanisms and Member States would have significant responsibility for the allocation and management of funds. Under the first programme, the European Commission has suggested setting up an External Borders Agency, anticipating that EU bodies such as Europol, Eurojust, and the European Police College would become part of this agency. In addition, the proposal aims to ensure access to basic goods and services and to promote European culture and diversity. Finally, it also aims to create a mechanism for rapid and coordinated action in times of solidarity and crisis (EUR-Lex, 2005).

Over the period 2007-2013, expenditure totalled EUR 11,006.9 million, with the largest amount allocated (see Figure 2.5) in 2012, totalling EUR 2,203.3 million.



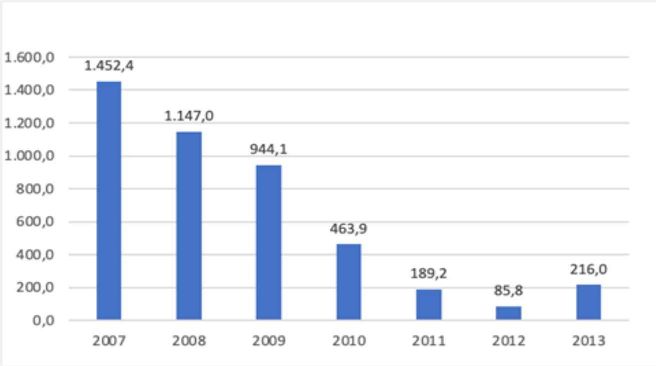
Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.5. Citizenship, freedom, security, and justice expenditures in the EU for the period 2007-2013

The budget section "The EU as a global partner" has allocated funds for EU operations beyond its borders, with the main aim of promoting stability, security, and prosperity in neighbouring regions. By adopting a more proactive foreign and security policy, the EU has been able to deploy crisis management and peacekeeping operations not only in Europe but also further afield (European Commission, 2014).

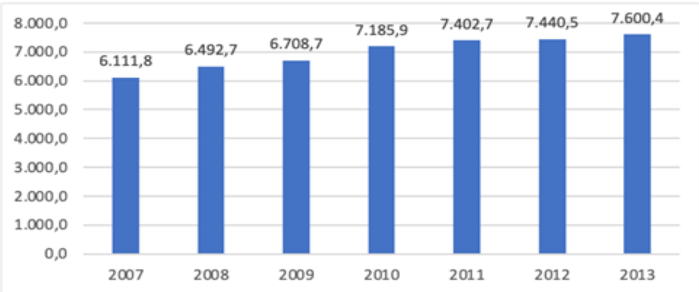
In the period 2007-2013 (see Figure 2.6), the Union allocated funds amounting to EUR 4,498.5 million. According to this figure, we can see that the highest amount was allocated in 2007 (EUR 1,452.4 million) and then gradually decreased to EUR 85.8 million in 2012.

Expenditure under the ***Administration section*** (see Figure 2.7) at EU level totalled EUR 48,942.7 million, from EUR 6,111.8 million in 2007 to EUR 7,600.4 million in 2013, an increase of EUR 1,488.6 million over the 7 years analysed.



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.6. The EU as a global partner: expenditures in the EU for the period 2007-2013

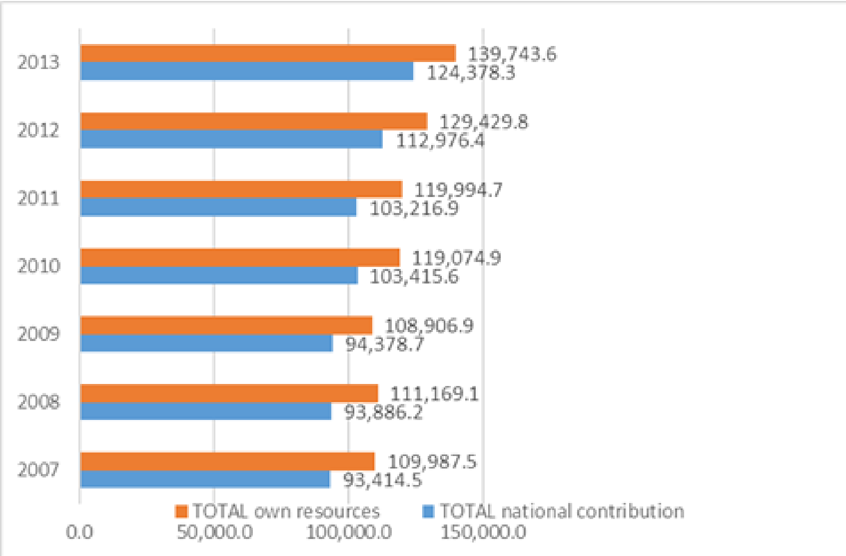


Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.7. Administration expenditures in the EU for the period 2007-2013

EU revenues are regulated and determined by a Council Resolution, which requires unanimity in the Council and ratification by each Member State. Council Decision 2007/436 (ORD 2007) entered into force on 1 March 2009, but applies retroactively from 1 January 2007, making the own resources payments for 2009 in line with ORD 2007 for 2007 and 2008. Own resources refer to revenue that automatically accrues to the EU to finance its budget, without requiring a subsequent decision by national authorities. The total amount of own resources needed to finance the budget is calculated by subtracting other revenue from total expenditure and the total amount of own resources may not exceed 1.23% of the EU's gross national income (European Commission, 2014).

EU revenue for the 2007-2013 period totals EUR 903,612.4 million, divided into two main categories, namely traditional resources, and own resources from national contributions (see Figure 2.8).



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.8. EU revenue for the period 2007-2013

2.7.2. The Multiannual Financial Framework (MFF) 2014-2020

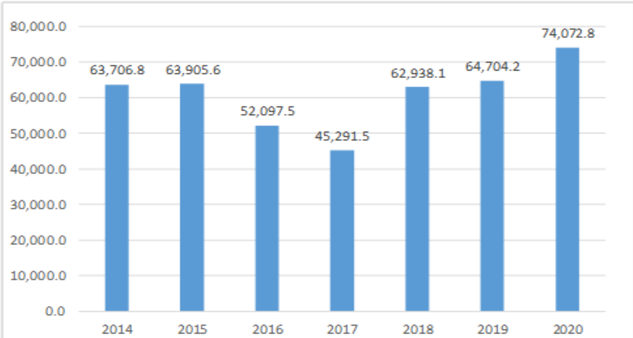
The MFF 2014-2020 was the first MFF to be negotiated and adopted in line with the new legal requirements of the Lisbon Treaty. This marked a significant change as the MFF was for the first time enshrined in a formal regulation and the negotiations were led by the new President of the European Council, Hermann Van Rompuy (Becker, 2012). Prior to the implementation of the Lisbon Treaty, the Council, the European Parliament (EP) and the Commission agreed on a Multiannual Financial Framework (MFF) through an Interinstitutional Agreement. However, the Lisbon Treaty established the practice of multiannual financial planning, requiring that the MFF be adopted by a Council regulation for a minimum period of five years (as per Article 312 TFEU). The adoption of this regulation follows a special legislative procedure, which requires unanimity in the Council and the approval of the European Parliament. In addition, the Lisbon Treaty allows the option of an interinstitutional agreement to accompany the MFF regulation (European Parliament, 2020).

Although EU competences have increased after the enlargement of the Union to 28 Member States and the implementation of the Lisbon Treaty, the European Council and the European Parliament decided to reduce the overall level of the MFF 2016-2020. At 2011 prices, the MFF totalled €960 billion in commitment appropriations and €908 billion in payment appropriations, which indicates a 3.5% reduction in commitment appropriations and a 3.7% reduction in payment appropriations compared to the financial framework 2007-2013 (European Commission, 2013).

On 7 March 2017, the Council decided to amend the EU's Multiannual Financial Framework (MFF) for the period 2014-2020 to align it with the new priorities. The adjustments will increase EU support for tackling the migration crisis, strengthening security, promoting growth, and generating jobs. The updated MFF will provide an additional €6.01 billion to reinforce key priorities between 2017 and 2020, of which €2.55 billion will be allocated to tackling migration issues, strengthening security, and reinforcing external border control. In addition, €1.39 billion will be available to tackle the root causes of migration, while €2.08 billion will support economic growth and job creation through various effective initiatives such as the Youth Employment Initiative (€1.2 billion more), Horizon 2020 (€200 million more) and Erasmus+ (€100 million more) (Council of the European Union, 2017).

The European Union's spending on smart and inclusive growth is driven by its overarching policy objectives, such as the Europe 2020 Strategy, which sets out the EU's objectives for smart, sustainable, and inclusive growth.

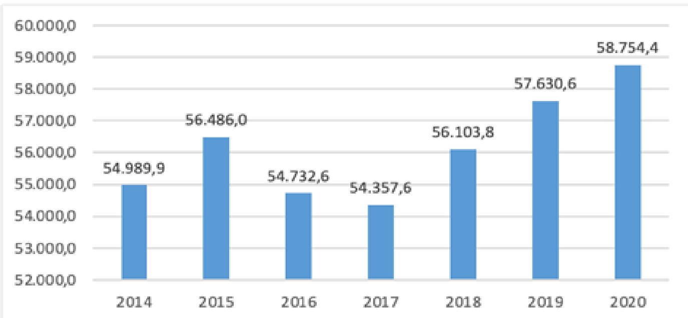
As can be seen from Figure 2.9, spending on smart and favourable growth starts from €63,706.8 million in 2014 to €74,072.8 million in 2020. Most funds have been allocated to the budget article responsible for economic, social, and territorial cohesion policy.



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.9. Smart and inclusive growth expenditures in the EU for the period 2014-2020

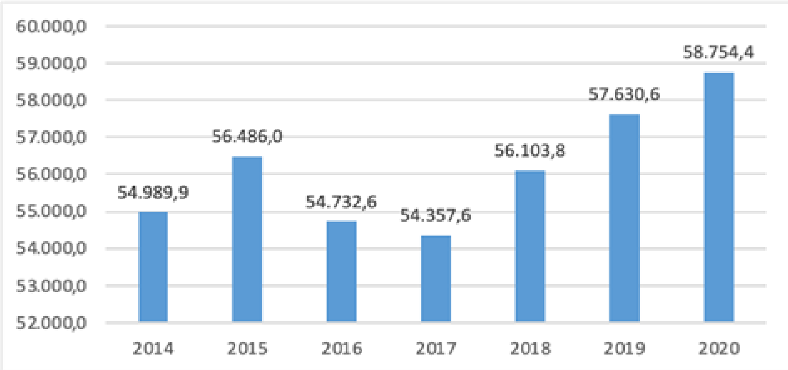
Sustainable growth and the protection of natural resources were key priorities in the European Union's (EU) multiannual financial framework for 2014-2020. This section of the budget includes spending on the common agricultural policy, the common fisheries policy, rural development, and environmental measures. In the period 2014-2020, €393,054.9 millions of funds were allocated, of which a large part was market expenditure and direct payments. For a clearer picture of the evolution of expenditure under this section in the 2014-2020 MFF, see Figure 2.10).



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.10. Sustainable growth: natural resources expenditures in the EU for the period 2014-2020

The section of the budget devoted to security and citizenship expenditure includes measures related to asylum and migration, the EU's external borders and internal security. A budget of €20,067.9 million has been allocated in the MFF 2014-2020, with the largest amount allocated in 2020, i.e. €4,888.6 million (see Figure 2.11).

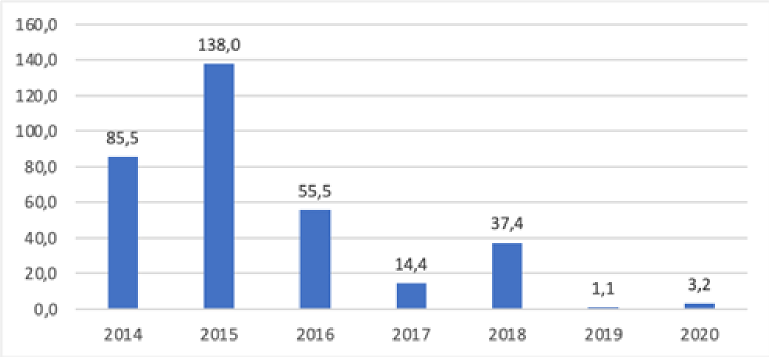


Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.11. Security and citizenship expenditures in the EU for the period 2014-2020

EU spending under the Global Europe section (see Figure 2.12) is earmarked specifically for its international activities, which include providing humanitarian aid and supporting development initiatives. However, it is worth noting that the European Development Fund is an exception as it receives direct financial assistance from EU Member States (Council of the European Union, 2023).

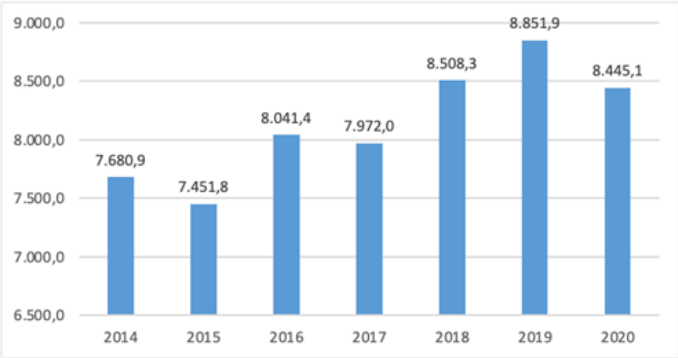
EU administrative expenditure amounted to EUR 56,951.4 million in the MFF 2014-2020. According to the figure below (Figure 2.13), it decreased in 2020 compared to the previous year by EUR 406.8 million, one of the possible explanations being the outbreak of the COVID-19 pandemic and the establishment of the lockdown.



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

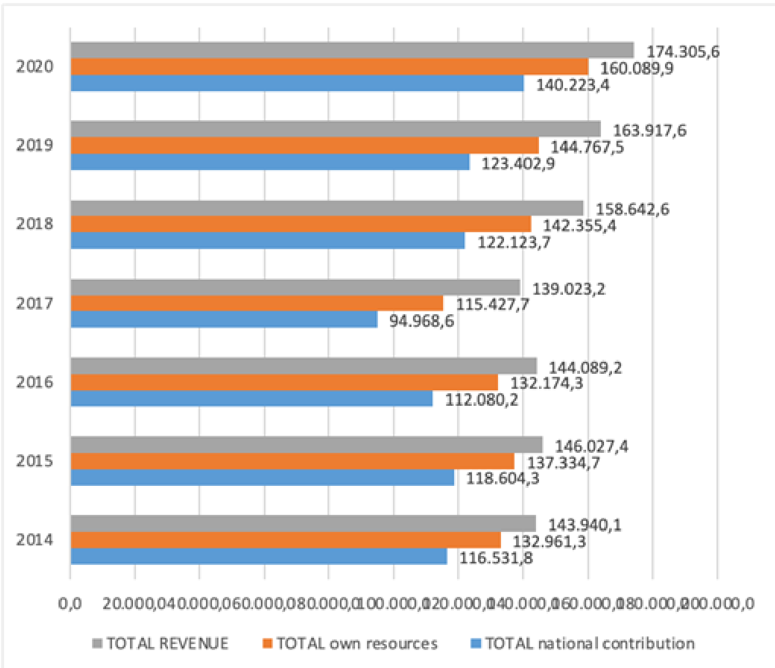
Figure 2.12. Global Europe expenditures in the EU for the period 2014-2020

The revenue of the general budget of the European Union can be classified into two main categories: own resources and other revenue, as specified in Article 311 of the Treaty on the Functioning of the European Union. This article stipulates that the budget must be financed entirely from own resources, without excluding other revenue. The main source of budgetary financing is the own resources system, which was introduced in 1970 by Council Decision 70/243/ECSC, EEC, Euratom of 21 April 1970 (ORD 1970). Other revenue represents a very small part of the overall financing. There are currently three main categories of own resources: traditional own resources, the VAT-based resource, and the GNI-based resource. These resources are complemented by correction mechanisms. However, the revenue from traditional own resources alone is insufficient to cover the expenditure of the EU budget (see Figure 2.14). On average, the share of traditional own resources (net of 75%, i.e. after deduction of 25% for collection costs) in total own resources reached around 14% in the period 2007-2013.



Source: own computation from the European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.13. Administration expenditures in the EU for the period 2014-2020



Source: own computation from European Commission (https://commission.europa.eu/strategy-and-policy/eu-budget/long-term-eu-budget/2014-2020/spending-and-revenue_en)

Figure 2.14. Total revenue in the EU for the period 2014-2020

2.7.3. The Multiannual Financial Framework (MFF) 2021-2027

The EU's long-term budget, covering the period 2021-2027, and the additional recovery instrument NextGenerationEU, amounts to a total of €2,018 trillion in current prices (equivalent to €1,800 billion in 2018 prices) (see Figure 2.15).

Source: European Commission (2021)

Figure 2.15. The EU's 2021-2027 long-term budget & NextGenerationEU

This unprecedented financial response aims to support the repair of the economic and social damage caused by the COVID-19 pandemic and facilitate the transition to a more sustainable and modern Europe. The package consists of two components, namely the Multiannual Financial Framework 2021-2027, with a total value of €1.211 trillion in current prices (€1.074 trillion in 2018 prices), and the temporary recovery instrument, NextGenerationEU, worth €806.9 billion (€750 billion in 2018 prices).

NextGenerationEU is a temporary recovery instrument worth €806.9 billion in current prices to be used through the EU's long-term budget, with a particular focus on 2021-2023. The funds allocated from NextGenerationEU will be spread across several programmes and will be provided to EU countries and beneficiaries in the form of both grants (€407.5 billion) and loans (€385.8 billion) in current prices. The bulk of the NextGenerationEU funds (€723.8 billion in current prices) will be channelled through the Recovery and Resilience Facility (RRF) programme. The RRF is designed to provide substantial financial support for public investment, particularly in areas such as green and digital projects. Support will be distributed through grants (€338.0 billion) and loans (€385.8 billion), in current prices. The grant portion of the RRF will be allocated between EU countries based on several criteria, including GDP per capita, unemployment levels, population, and the impact of the COVID-19 crisis. Part of the allocation will be determined later, considering the loss of real GDP in 2020 and cumulatively over the period 2020-2021. To be eligible for support from the RRF, EU countries must submit recovery and resilience plans to the Commission, showing how they intend to use the funds. These plans must consider the challenges identified in the European Semester as well as those related to the green and digital transition. The Commission will assess these plans and the European Council will give its approval. The funds will be disbursed once the milestones and targets that Member States have committed to achieve have been met (European Commission, 2021).

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CHAPTER 3

FEATURES AND RECENT CHALLENGES OF EU MEMBER STATES' TAX POLICIES

Adina Dornean,[1] Ovidiu Stoica[2]

3.1. Introduction

Tax policy is an important component of economic policy that provides governments with the financial resources they need to exist and function effectively. Moreover, tax policy "is central to national sovereignty" (European Commission, Directorate-General for Communication Citizens Information, 2015, p. 3). In the European Union (EU), the responsibility for tax policy is left to the Member States, which may delegate central-level responsibilities to regional or local levels, depending on the constitutional or administrative structure (Stoica and Martin, 2009). Tax sovereignty is considered the major pillar of the sovereignty of countries because of two closely related reasons: differences in economic development among the Member States, and the effect of tax rates and tax policies on the growth of a country's economy (Podviezko *et al.,* 2019).

Tax sovereignty is among the fundamental sovereign rights of the Member States which, in this field, have conferred only limited powers at the EU level. The adoption of measures requires unanimity and, except for areas related to the budget, the European Parliament has the exclusive right to consultation. The objective of EU tax policy is to guarantee the fundamental principles of the internal market and the free movement of capital. However, the existence of different tax regimes may affect the internal market and the economic and

[1] Adina Dornean is Ph.D. habil., professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.
[2] Ovidiu Stoica, Ph.D. is professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași and head of the Department of Finance, Money and Public Administration.

monetary union. For this reason, member states are prohibited from discriminating, and the EU has the obligation of harmonization. At the same time, tax policy must be fully consistent with other EU policies such as economic, employment, health and consumer protection, innovation, competition, environmental, and energy policies. In this context, the need for tax coordination is obvious, especially in the VAT and excise fields which require harmonization.

In recent years, tax policy has become a common problem for the entire Europe, and as a result, it is treated by reporting to international documents. Thus, in 2001, the European Commission presented a comprehensive strategy for the EU's future taxation policy (European Commission, 2001), which mentioned that EU countries' tax policies have to support the EU policy objectives. For example, the Lisbon European Council of March 2000 established as a goal that the EU had to become the most competitive and dynamic knowledge-based economy in the world by 2010. According to this objective, tax policy had to contribute to achieving it. From 2000 until now, the EU objectives have changed according to the realities of the time periods.

Tax policy is very important in combating crises and ensuring sustainable economic growth, considering that "the cure for secular stagnation, as well as for the balance of underutilization, is an active fiscal policy" (Hansen, 1927, p. 67). We consider that the tax policy must have as its starting point the reality in which we live, a reality that is characterized by phenomena such as economic crisis, globalization, the IT and technological revolution, globalization, the expansion and consolidation of economic integration, and international cooperation processes. We therefore live in a constantly changing world, so tax policy must be able to respond through flexibility, realism, and pragmatism to the rapid and complex changes determined by the effects of the economic crisis and the intensification of the globalization and integration processes.

Thus, facing the EU's worst economic and political crisis since its inception, European political leaders signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union on March 2, 2012. The purpose of the treaty (known also as the Fiscal Stability Treaty) was to strengthen fiscal discipline in the euro area through the so-called "balanced budget rule" and an automatic mechanism to take corrective action. The treaty was designed after eurozone heads of state and government decided in

December 2011 that stronger measures were needed to strengthen stability in the eurozone.

Thus, the crisis cancelled years of economic and social progress and highlighted the structural deficiencies of Europe's economy. In this context, a strategy was needed to enable the EU to emerge from the crisis stronger and to transform the EU into a smart, sustainable, and inclusive economy, characterized by higher levels of employment, productivity, and social cohesion. The EU 2020 Strategy, as the successor to the Lisbon Strategy, provided an overview of Europe's social market economy for the 21st century and established the objective for the 2010-2020 decade.

Meanwhile, the world has evolved rapidly and long-term challenges (globalisation, pressure on resources, aging) have intensified or new challenges have occurred (COVID-19 pandemic, Ukraine war). The European Commission proposed a new strategy for the 2020-2030 decade, entitled "Towards a sustainable Europe by 2030", which focuses on sustainable development, defined as "the development that meets the needs of present generations without compromising the ability of future generations to meet their needs" (European Commission, Directorate-General for Communication, 2019, p. 6).

Every decade had its challenges and the EU had to adapt its objectives and strategy accordingly. Similarly, EU Member States' tax policies had to contribute to achieve it.

In the current economic context characterized by instability and uncertainty, taxation plays a special role, especially in those countries where an acceleration of fiscal consolidation efforts is being attempted. Special attention goes to the changes in the national tax policies with the role of an attempt to solve the problems they face but, at the same time, to those that lead to the achievement of the national policy objectives.

3.2. Features of EU member states' tax policies

Tax policies are designed to provide sufficient tax revenue to finance public expenditures. Given the different levels of economic development of EU Member States, tax policy is a Member State's competence with EU-level influences. In this context, EU Member States' tax policies have to provide stable resources for government spending, encourage investment, stimulate job creation, and support the EU objectives. What they have in common the EU Member States' tax policies is the fact that they have to create a better environment for business, reform the corporate tax system to correspond to digitalisation and globalization, fight against tax abuse, contribute to the transition towards a greener economy (European Commission, Directorate-General for Taxation and Customs Union, 2020) which allows the fulfilment of the EU's climate objectives according to the European Green Deal (European Commission, Directorate-General for Taxation and Customs Union, 2022a). In this context, tax policies of EU countries need to ensure the sustainability of tax revenues while preserving national tax policy choices and social justice.

In 2019, the year before the COVID-19 pandemic, total receipts from taxes and social contributions (total tax revenues) at the EU-27 level, measured as a percentage of GDP (the tax burden), was relatively stable from 2013 at 41% of GDP (Table 3.1). This represents a 2.2 percentage points (pp) increase from the value recorded in 2009 (39.2%), in the middle of the global financial crisis. The EU's tax burden is relatively high compared with other advanced economies (European Commission, Directorate-General for Taxation and Customs Union, 2021, p. 24), since the OECD average was 33.39% in 2019 (OECD, 2023).

Table 3.1. Total receipts from taxes and social contributions, EU-27 and Member States, 2007-2021, % of GDP

Countries	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
EU 27	40.1	39.6	39.2	39.1	39.5	40.5	41.0	41.0	40.8	41.0	41.0	41.1	41.0	41.1	41.7
Belgium	45.5	46.3	45.7	46.0	46.9	47.8	48.6	48.2	47.4	46.6	47.1	47.2	45.8	46.0	46.0
Bulgaria	30.5	30.6	26.7	25.4	25.5	26.1	28.1	28.4	28.9	29.2	29.8	29.7	30.3	30.5	30.7
Czechia	34.6	33.5	32.5	32.9	34.0	34.5	34.9	34.2	34.3	35.1	35.4	36.0	35.9	36.0	36.0
Denmark	47.7	46.0	46.3	46.3	46.3	46.9	47.3	49.9	47.3	46.6	46.5	45.2	47.8	48.0	48.8
Germany	39.3	39.7	40.1	38.8	39.1	39.7	39.9	39.6	40.1	40.5	40.7	41.2	41.4	41.1	42.4
Estonia	31.1	31.4	35.2	33.4	31.7	31.9	31.9	32.4	33.6	33.8	33.1	33.2	33.8	33.6	33.8
Ireland	32.2	30.5	29.0	28.5	29.2	29.6	29.9	30.0	24.1	24.6	23.5	23.2	22.7	20.7	21.9
Greece	33.5	33.7	32.9	34.5	36.8	39.4	38.7	39.4	39.8	42.1	42.3	42.7	41.9	41.3	41.5
Spain	37.3	33.0	30.6	32.3	32.1	33.3	34.1	34.8	34.7	34.4	34.6	35.4	35.4	37.7	39.0
France	44.5	44.4	44.1	44.2	45.4	46.5	47.5	47.7	47.7	47.6	48.3	48.1	47.1	47.5	47.0
Croatia	36.8	36.7	36.1	35.6	34.8	35.5	36.1	36.2	36.7	37.0	36.9	37.5	37.5	36.9	35.8
Italy	41.5	41.3	41.8	41.5	41.4	43.4	43.5	43.2	43.1	42.4	42.1	41.9	42.4	42.8	43.6

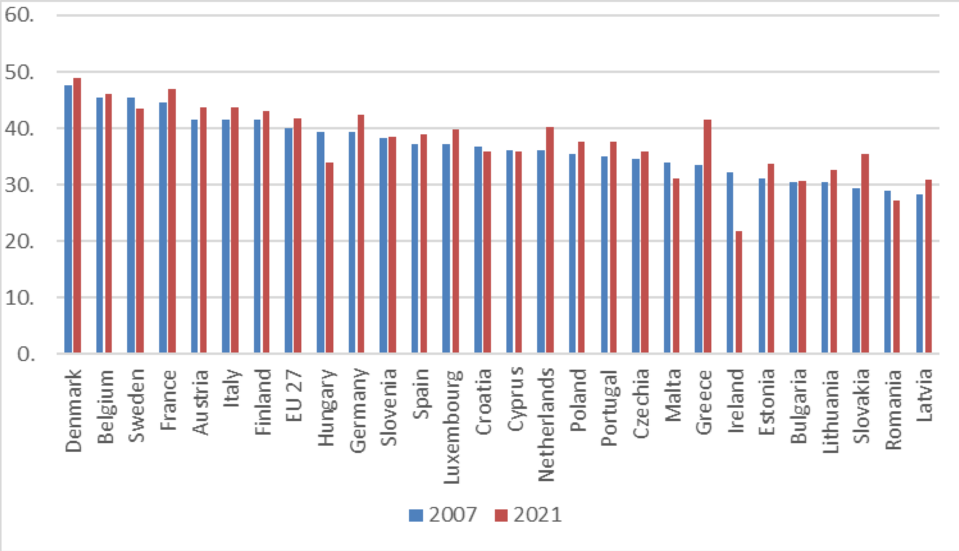
Countries	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Cyprus	36.1	34.7	31.8	31.7	31.7	31.6	31.7	33.6	33.1	32.2	32.8	33.1	34.2	34.0	36.0
Latvia	28.4	28.2	27.7	28.5	29.3	29.3	29.6	30.0	30.1	31.0	31.4	31.4	31.1	31.2	30.8
Lithuania	30.4	31.0	30.7	28.7	27.5	27.3	27.2	27.8	29.3	30.0	29.7	30.4	30.6	31.1	32.6
Luxembourg	37.1	36.3	37.7	37.0	37.5	37.8	37.6	37.5	36.2	36.9	38.1	40.8	41.0	39.6	39.8
Hungary	39.4	39.4	38.9	36.9	36.5	39.0	38.6	38.5	38.8	39.2	38.0	36.9	36.4	36.1	34.0
Malta	34.0	33.0	33.1	32.2	33.0	32.8	32.5	32.6	30.5	31.5	31.1	31.1	30.6	30.3	31.2
Netherlands	36.1	36.5	35.7	36.1	36.0	36.1	36.6	37.6	37.5	38.9	39.2	39.3	39.7	40.3	40.2
Austria	41.6	42.4	42.0	41.9	42.0	42.6	43.4	43.5	43.9	42.4	42.5	42.9	43.2	42.6	43.7
Poland	35.5	35.2	32.3	32.6	33.0	33.3	33.4	33.3	33.4	34.5	35.2	35.9	36.0	36.4	37.7
Portugal	35.0	34.9	33.3	33.7	35.4	34.4	37.1	37.0	37.0	36.6	36.5	37.0	36.7	37.5	37.6
Romania	29.0	27.4	25.9	26.5	27.0	26.6	27.5	27.5	28.0	27.1	26.0	26.6	26.7	26.9	27.3
Slovenia	38.3	37.8	37.6	38.3	37.8	38.2	37.8	37.7	37.9	37.9	37.6	37.7	37.7	37.8	38.5
Slovakia	29.3	29.1	29.0	28.0	29.0	28.8	31.0	31.9	32.6	33.1	34.0	34.1	34.6	34.9	35.5
Finland	41.5	41.2	40.9	40.7	41.9	42.5	43.5	43.6	43.7	43.9	43.0	42.5	42.4	41.9	43.1
Sweden	45.4	44.5	44.2	43.4	42.5	42.7	43.1	42.7	43.2	44.7	44.7	44.4	43.5	43.1	43.5

Source: Eurostat (gov_10a_taxag)

Overall tax revenues as a percentage of GDP decreased between 2007 and 2010 during the years of the financial crisis, from 40.1% to 39.1%. With the economic recovery, we can notice that beginning with 2011, tax revenues as a percentage of GDP started to rise again, and by 2012 they were above the pre-crisis levels, reaching 41,7 % of GDP in 2021. In this context, we noticed that since 2009, the tax burden has increased at EU level, inclusively after COVID-19 crisis occurred. Even in 2020, annual tax revenue in the EU, in nominal terms decreased 3.9% (European Commission, Directorate-General for Taxation and Customs Union, 2022a, p. 21). first decrease in tax revenue since 2009, when in the middle of the previous economic and financial crisis, as a percentage of GDP (the tax burden) it increased to 41.1% (Table 3.1 and Figure 3.1). The explanation for the tax revenue increase as a percentage of GDP consists in the higher decrease of GDP compared to tax revenue.

At the Member States' level, the tax-to-GDP ratio increased in most countries in 2020, when the COVID-19 crisis hit. In 15 Member States the tax-to-GDP ratios increased, but in the majority of cases tax revenue in nominal terms decreased, but as GDP drops were larger, the ratio increased. There were strong yearly increases in the tax-to-GDP ratio in Spain (2.3 pp) and Portugal (0.8 pp). The main drops were registered in Ireland (2 pp) and Luxembourg (1.4 pp).

Therefore, since 2009, the tax burden has increased in most Member States. However, the level of total taxation differs considerably between countries. In 2021, the tax to GDP ratio varied between 21.9% in Ireland and 48.8% in Denmark.



Source: the authors based on data from Eurostat (gov_10a_taxag)

Figure 3.1. Total receipts from taxes and social contributions, EU-27 and Member States, 2007-2021, % of GDP

Total tax revenues come from direct taxes, indirect taxes, and social contributions. According to Data on Taxation (European Commission, 2023), on average, at the EU level, each category accounts for around a third of the total tax revenues. The highest proportion of direct taxes (as a percentage of total taxes) is registered in Denmark (67.6%), Croatia has the highest proportion of indirect taxes (53.6%) and Slovakia the highest proportion of social contributions (43.3%).

The EU needs a fair, efficient, and stable tax framework that meets public financing needs, while also creating an environment that supports sustainable growth with high levels of investment and jobs.

There are 27 tax systems in the EU, with important differences between them in terms of the applied fiscal regimes. The differences between the tax systems are a source of inefficiency in the functioning of the single market and a premise of fiscal competition, which can become harmful for the Member States' finances. Also, this can generate conflicts caused by the attraction by some states of larger tax bases, who have a higher mobility, from other member states.

The EU plays only a subsidiary role in terms of taxes and social security contributions. Its purpose is not to standardize national tax systems, but simply to ensure that they are compatible, not only with each other, but also with the objectives of the EU Treaty. In this context, the aspects in which the EU gets involved in taxation issues, somewhat limited, are reflected in the Treaty on EU and especially in the principle of subsidiarity. The Treaty delimits the EU's scope of action in taxation matters, which it limits mainly to aspects of multilateral supervision, the proper functioning of the single market, competition issues regarding state fiscal aids, fiscal discrimination, and ad hoc fiscal measures, to achieve specific objectives of the EU. Article 5 of the Treaty introduces the principle of subsidiarity and tends to limit the field of action of the European Commission in fiscal matters, stating that "in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level (European Union, 2012, p. 6).

All Member States recognize the need for national tax policies to be, to a certain extent, coordinated to prevent harmful fiscal competition and to contribute to the achievement of EU objectives. Although the provisions of the Treaty of Rome regarding tax policy are reduced to only a few articles (90-93), tax policy developed because of the need to adapt in relation to the evolution of the EU, which gradually transformed from a customs union into an Economic and Monetary Union.

However, the EU tax policy is imposed with difficulty as it encounters a series of obstacles, given the fact that its objectives aim not only at eliminating traditional forms of fiscal discrimination between Member States, double taxation or tax evasion but also at the means by which the EU imposes the harmonization of policies and national legislations. In this context, if tax policy is important for each individual state, it becomes essential in the case of a group of states that intend to act and develop together, because the tax policy measures applied in a country usually have an impact on other countries as well.

Thus, fiscal harmonization within the EU became necessary in the context of maintaining national competenciess in making tax policy decisions - considered as an expression of the sovereignty of the Member States, on the one hand, and the requirement to remove obstacles in the functioning of the common market, on the other hand. At the same time, the proper functioning of the mechanisms of the single market requires the prevention of distortions generated by the major differences between the tax systems of the member countries, by eliminating discrimination and tax subsidies, respectively through the compatibility of the tax application regimes, without pursuing their uniformity.

The tax harmonization in the euro area is a slow process and regardless of whether unification is reached in this area or not, it is important that the objective remains the same, namely ensuring that the tax policies of EU Member States do not have an unwanted, negative impact on the others.

3.3. The structure of EU member states' taxation systems: similarities and differences

The design of Member States' taxation systems is different according to the tax rates applied by each country and depending on what activities are taxed. Traditionally, taxes are classified as direct or indirect.

Table 3.2 presents the share of direct taxes in GDP recorded in the EU countries during the period 2007-2021. At the EU-27 level, the proportion of direct taxes in GDP increased with 1.5 pp in the last ten years (2011 being the first year after the global financial crisis when the direct taxes started to increase, and 2021 the first year after the COVID-19 pandemic). In 2021, there are 10 countries that registered higher levels of direct taxes (as a percentage of GDP) than the EU-27 average, 16 countries with lower levels than the EU-27, and one country that registered the same value as the EU-27 (France). Among the countries that registered the highest proportions of direct taxes in GDP, we can mention Denmark (32.5%) followed, at a respectable difference, by Sweden (18.4%) and Finland (17.1). On the opposite side is Romania with the lowest share of direct taxes (5.2% of GDP) followed by Croatia and Hungary with equal values (5.6%).

Table 3.2. Direct taxes, EU-27 and Member States, 2007-2021, % of GDP

Countries	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
EU-27	13	12.8	12.1	11.9	12.1	12.6	12.9	12.9	12.9	13.0	13.2	13.2	13.2	13.3	13.6
Belgium	16.7	17	15.8	16.1	16.7	17.1	17.8	17.7	17.3	16.9	17.5	17.7	16.4	16.5	16.7
Bulgaria	7.7	6.2	5.2	4.9	4.8	4.8	5.2	5.5	5.7	5.8	6.1	6.1	6.1	6.1	6.7
Czechia	8.8	8.2	7.5	7.2	7.4	7.4	7.6	7.7	7.7	8.0	8.1	8.5	8.5	8.5	7.7
Denmark	28.8	28.1	28.5	28.6	28.6	29.3	29.9	32.8	30.3	29.6	29.8	28.3	31.3	31.3	32.5
Germany	12.2	12.5	11.7	11.1	11.5	12.1	12.3	12.3	12.5	12.9	13.1	13.4	13.4	12.8	13.7
Estonia	7.3	7.7	7.4	6.6	6.3	6.6	7.2	7.4	7.8	7.5	7.2	7.4	7.3	7.7	8.4
Ireland	13.4	12.5	12.0	11.8	12.3	12.9	12.9	12.9	10.7	10.9	10.4	10.7	10.4	10.1	10.9
Greece	8.4	8.4	8.8	8.4	9.5	11.1	10.6	9.9	9.6	10.3	10.1	10.4	9.9	9.3	9.4
Spain	13	10.7	9.5	9.5	9.6	10.4	10.5	10.7	10.5	10.4	10.6	11.0	10.8	11.6	12.4
France	12.2	12.2	11.0	11.5	12.1	12.8	13.2	13.1	13.1	12.9	13.3	13.7	13.6	13.7	13.6
Croatia	7.5	7.2	7.2	6.5	6.3	6.2	6.5	6.2	6.0	6.4	6.2	6.3	6.5	6.5	5.6
Italy	14.5	14.7	14.9	14.3	14.2	14.9	15.2	14.7	14.7	14.9	14.5	14.1	14.4	15.2	15.1
Cyprus	11.9	11.1	9.6	9.4	10.1	9.9	10.4	10.4	9.8	9.3	9.5	9.5	9.3	9.6	10.4
Latvia	8.3	9	7.0	7.4	7.4	7.6	7.7	7.7	7.7	8.2	8.4	7.3	6.9	7.0	7.1
Lithuania	9.1	9.2	5.9	4.6	4.3	4.8	5.0	5.0	5.4	5.6	5.4	5.7	8.8	8.7	9.8
Luxembourg	13.3	13.3	13.6	13.6	13.6	13.6	13.6	13.3	13.9	14.4	14.9	17.0	17.0	15.9	16.0
Hungary	10.1	10.3	9.6	7.8	6.2	6.7	6.5	6.7	6.8	7.3	7.2	6.6	6.6	6.7	5.6
Malta	12.9	12.2	12.9	12.1	12.5	12.9	13.3	13.3	12.5	13.3	13.3	12.9	13.1	13.0	13.7
Netherlands	11.3	11	11.1	11.2	10.7	10.2	10.2	10.8	11.5	11.8	12.9	12.7	13.4	13.5	13.8
Austria	13.3	13.9	12.6	12.7	12.8	13.1	13.7	13.8	14.2	12.9	13.0	13.6	13.7	12.9	13.9
Poland	8.3	8.4	7.2	6.8	6.8	7.0	6.8	6.9	6.9	7.2	7.4	7.8	7.9	7.9	8.4
Portugal	9.2	9.3	8.6	8.5	9.4	9.1	11.3	10.9	10.7	10.1	9.9	10.1	9.7	10.0	9.7
Romania	6.6	6.4	5.9	5.7	5.8	5.5	6.0	6.2	6.6	6.5	6.1	4.9	4.8	4.7	5.2
Slovenia	9.1	8.8	8.1	8.0	7.8	7.5	7.0	7.2	7.2	7.5	7.5	7.9	7.8	7.8	8.5
Slovakia	6.3	6.6	5.7	5.4	5.5	5.6	6.2	6.7	7.1	7.2	7.2	7.3	7.2	7.2	8.0
Finland	17.2	17.1	15.7	15.6	16.0	15.8	16.4	16.6	16.8	16.6	16.8	16.3	16.3	16.3	17.1
Sweden	20.3	18.8	18.4	18.1	17.5	17.4	17.7	17.8	18.3	18.9	19.0	18.6	18.1	18.1	18.4

Source: Data on Taxation (European Commission, 2023)

Regarding indirect taxes, the situation is different (Table 3.3). If Denmark ranks first in direct taxes, in this case, at the level of the EU Member States, Sweden ranks first in terms of indirect tax, as percentage of GDP with 21.7 in 2021, followed by Croatia (19.1%) and Hungary (17.8). In 2021, there are 13 EU Member States positioned above the EU average and 13 EU Member States that registered a share of indirect taxes in GDP below the EU average. In Belgium, the share of indirect taxes in GDP of 13.8% correspond to the EU-27 average.

Table 3.3. Indirect taxes, EU-27 and Member States, 2007-2021, % of GDP

Countries	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
EU-27	13.4	13	12.8	13.1	13.2	13.5	13.6	13.7	13.7	13.6	13.6	13.7	13.7	13.4	13.8
Belgium	13.3	13.2	13.1	13.4	13.5	13.8	13.8	13.7	13.5	13.8	13.7	13.8	13.7	13.4	13.8
Bulgaria	16.2	16.9	14.3	13.9	14.0	14.5	15.5	15.1	15.4	15.6	15.5	15.0	15.5	15.3	15.2
Czechia	10.7	10.5	10.9	11.2	12.0	12.4	12.7	12.0	12.3	12.4	12.4	12.1	12.0	11.6	11.7
Denmark	17.7	16.6	16.4	16.3	16.4	16.4	16.3	16.0	16.1	16.1	15.9	16.0	15.7	15.9	15.5
Germany	11	11	11.4	11.0	11.2	11.1	11.0	10.9	11.0	10.9	10.8	10.8	10.9	10.4	11.1
Estonia	13.4	12.2	14.7	13.9	13.6	13.9	13.5	13.9	14.4	14.8	14.2	14.0	14.4	13.5	13.5
Ireland	13.2	12.2	11.0	10.9	10.5	10.6	10.9	11.0	8.7	8.9	8.4	8.0	7.8	6.5	7.1
Greece	12.7	12.7	11.8	12.8	13.9	14.2	14.5	15.9	16.3	17.5	17.5	17.6	17.5	16.6	17.1
Spain	11.6	9.6	8.2	10.0	9.8	10.4	11.2	11.6	12.0	11.8	11.8	11.9	11.7	11.6	12.4
France	15	14.8	15.0	14.8	15.2	15.4	15.6	15.8	15.9	16.1	16.4	16.6	16.9	17.1	16.8
Croatia	18	17.8	16.8	17.3	16.9	17.8	18.3	18.3	18.9	19.1	19.3	19.7	19.8	18.7	19.1
Italy	14.5	13.7	13.5	14.0	14.1	15.3	14.9	15.4	15.2	14.5	14.6	14.6	14.5	13.9	14.7
Cyprus	17.4	16.7	14.4	14.3	13.7	14.0	13.8	15.0	15.0	14.8	14.9	15.1	14.6	13.4	14.3
Latvia	12.2	10.9	11.2	12.3	12.8	12.8	13.2	13.6	13.8	14.4	14.3	14.6	14.3	14.1	13.6
Lithuania	11.9	11.9	11.8	12.0	11.8	11.3	11.2	11.4	11.9	11.9	11.8	11.7	11.7	11.9	12.3
Luxembourg	13.1	11.9	11.9	11.8	12.1	12.3	12.3	12.7	10.8	10.9	11.4	11.7	11.6	11.2	12.0
Hungary	15.9	15.7	16.4	17.3	17.3	18.6	18.7	18.6	18.8	18.2	18.0	18.2	18.1	18.2	17.8
Malta	14.4	13.8	13.3	13.4	13.5	13.0	12.6	12.8	12.0	12.2	11.9	12.3	11.6	10.8	10.7
Netherlands	11.8	11.7	11.4	11.4	11.1	10.9	11.2	11.6	11.5	12.0	12.0	12.1	12.4	12.8	12.8
Austria	13.9	14	14.4	14.4	14.5	14.7	14.6	14.5	14.5	14.5	14.3	14.0	14.1	13.7	14.0
Poland	14.5	14.7	13.1	14.0	14.1	13.3	13.1	13.2	13.1	13.6	14.0	14.2	14.0	14.1	15.4

Countries	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Portugal	14.5	14.1	12.6	13.3	13.9	13.9	13.8	14.3	14.7	14.9	15.0	15.3	15.1	14.7	15.3
Romania	12.2	11.4	10.3	11.7	12.5	12.7	12.9	12.8	13.4	11.6	10.5	10.4	10.6	10.4	10.8
Slovenia	14.7	14.1	13.7	14.2	14.1	14.5	15.0	15.0	14.9	14.7	14.4	14.1	14.0	12.8	13.3
Slovakia	11.3	10.7	10.7	10.4	11.3	10.7	11.4	11.6	11.7	11.6	12.0	12.0	12.2	12.2	12.4
Finland	12.7	12.5	12.9	13.0	13.8	14.1	14.4	14.4	14.2	14.4	14.1	14.2	14.2	14.1	14.0
Sweden	22.2	22.4	22.5	22.1	21.7	22.0	22.0	21.7	21.6	22.5	22.4	22.4	22.0	21.6	21.7

Source: Source: Data on Taxation (European Commission, 2023)

Also, in EU countries, employers and employees pay social contributions. The share of total actual compulsory social contributions is presented in Table 3.4. Regarding social contributions we notice that due to the COVID-19 pandemic, social security contributions, as a percentage of GDP, grew in 2020 with 0.3 pp from 13.1% in 2019 to 13.4% in 2020 (European Commission, Directorate-General for Taxation and Customs Union, 2022b). Moreover, the share of social security contributions increased in almost all countries (24) the exception being Ireland, Hungary, and Finland. A specific situation we observed in Denmark, that registered extremely low share of social contributions (0.1% of GDP) the explanation being the fact that the most welfare spending is financed out of general taxation. An opposite situation can be observed in Czechia where it was recorded the highest share in GDP of 16.5%.

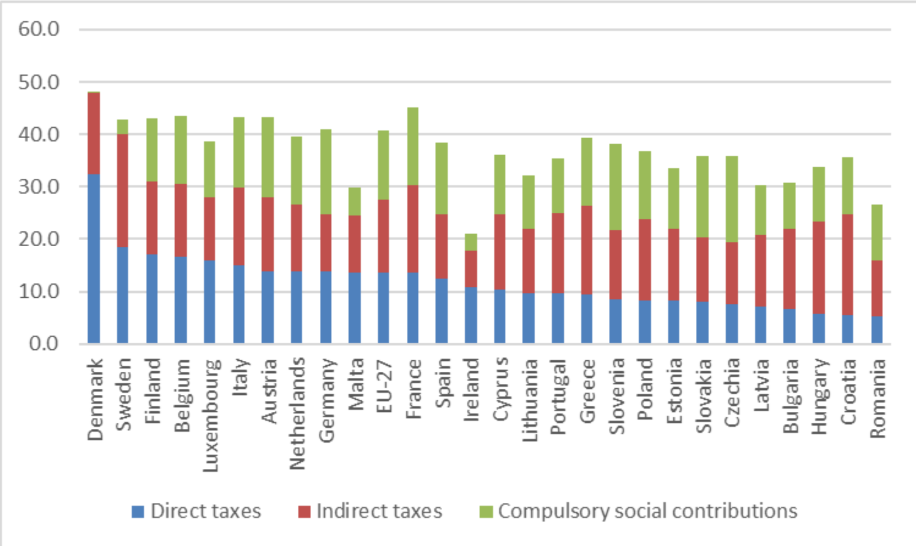
Table 3.4. Total actual compulsory social contributions, EU-27 and Member States, 2009-2021, % of GDP

Countries	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
EU-27	13.2	12.9	13.0	13.2	13.2	13.2	13.1	13.2	13.1	13.2	13.1	13.4	13.2
Belgium	14.4	14.0	14.2	14.3	14.4	14.2	14.2	13.6	13.5	13.4	13.3	13.6	13.1
Bulgaria	7.2	6.6	6.7	6.8	7.4	7.8	7.8	7.7	8.2	8.7	8.8	9.1	8.9
Czechia	14.1	14.4	14.6	14.7	14.6	14.4	14.3	14.6	14.8	15.4	15.4	15.9	16.5
Denmark	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1
Germany	15.5	15.2	15.0	15.2	15.2	15.1	15.2	15.4	15.5	15.7	15.9	16.4	16.2
Estonia	12.9	12.7	11.6	11.2	11.0	10.9	11.1	11.2	11.4	11.5	11.7	12.1	11.6

Countries	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Ireland	5.2	5.1	5.1	4.8	4.9	4.8	3.8	3.9	3.7	3.7	3.7	3.3	3.2
Greece	10.2	11.0	10.9	11.1	10.8	10.5	10.7	11.1	11.7	11.9	12.1	12.9	12.9
Spain	12.0	11.9	11.8	11.7	11.5	11.6	11.4	11.4	11.5	11.7	12.2	13.8	13.6
France	16.2	16.1	16.2	16.4	16.7	16.9	16.7	16.6	16.7	16.0	14.8	14.7	14.7
Croatia	12.0	11.8	11.7	11.4	11.2	11.7	11.5	11.3	11.3	11.3	11.1	11.4	10.9
Italy	13.2	13.0	12.8	13.0	13.0	12.9	12.9	12.7	12.7	13.0	13.2	13.5	13.5
Cyprus	7.8	8.0	7.9	7.7	7.6	8.3	8.3	8.1	8.4	8.5	10.3	11.0	11.3
Latvia	9.2	8.6	8.9	8.7	8.5	8.4	8.3	8.1	8.4	9.1	9.5	9.7	9.7
Lithuania	12.5	11.6	11.0	10.8	10.8	11.1	11.6	12.1	12.2	12.6	9.6	10.2	10.2
Luxembourg	10.9	10.3	10.5	10.6	10.4	10.2	10.2	10.2	10.5	10.8	11.0	11.1	10.6
Hungary	12.8	11.7	12.8	13.6	13.3	13.2	13.2	13.7	12.7	12.0	11.7	11.1	10.5
Malta	5.6	5.4	5.8	5.6	5.5	5.4	5.0	5.1	5.0	5.1	4.9	5.6	5.4
Netherlands	12.6	12.9	13.6	14.5	14.7	14.6	13.9	14.7	13.8	14.0	13.4	13.6	13.1
Austria	14.1	14.0	14.0	14.1	14.5	14.5	14.5	14.5	14.6	14.7	14.9	15.5	15.3
Poland	11.1	10.9	11.2	12.1	12.4	12.2	12.4	12.7	12.9	13.1	13.2	13.5	13.0
Portugal	8.6	8.6	8.9	8.7	8.9	9.0	9.0	9.1	9.2	9.3	9.6	10.4	10.4
Romania	9.0	8.5	8.7	8.4	8.7	8.5	8.1	8.1	8.5	10.5	10.5	11.0	10.5
Slovenia	15.5	15.8	15.6	15.8	15.5	15.3	15.4	15.4	15.4	15.4	15.6	16.8	16.4
Slovakia	12.4	11.9	11.9	12.2	13.2	13.4	13.6	14.1	14.5	14.6	14.9	15.3	15.5
Finland	12.1	12.0	12.0	12.6	12.5	12.6	12.6	12.7	11.9	11.8	11.8	11.5	12.0
Sweden	2.8	2.6	2.7	2.8	2.8	2.7	2.7	2.7	2.7	2.8	2.7	2.7	2.7

Source: Data on Taxation (European Commission, 2022b)

The structure of tax systems varies significantly across the EU Member States. Figure 3.2. highlights the share of each category of taxes, by type, in total GDP in EU countries in 2021. If Denmark has the highest share of direct taxes in GDP (32.5%), followed by Sweden and Finland, in the field of social contributions registered the lowest level between EU countries, only 0.1% of GDP. Romania occupies the last place, registering the lowest percentage of only 5.2% of GDP, representing direct taxes. Regarding indirect taxes, the highest share in GDP is recorded in Sweden with 21.7%, followed by Croatia and Hungary.



Source: Data on Taxation (European Commission, 2022b)

Figure 3.2. Direct taxes, indirect taxes, and actual compulsory social contributions, EU-27 and Member States, 2021, % of GDP

According to the European Commission, Directorate-General for Taxation and Customs Union (2022a, p. 140), which prepares the annual reports on EU Member States' tax policies, during the last two decades, the overall composition of tax revenue in the EU countries has remained relatively stable. Thus, if we look at the current tax mix in the EU countries, by the economic function of the tax base, it relies heavily on labour taxes, including social contributions, which account for more than 50% of the overall tax revenue in the EU-27. The second biggest component is represented by consumption taxes, primarily VAT (with more than 15% of total tax revenues). Other tax bases contribute relatively little: environmental taxation accounts for about 6%, property taxes 5%, and corporate income tax 7% of total tax revenues.

The current EU Member States' taxation systems had to deal not only with various crises that affected the EU, but also with the challenges determined by population ageing, digitalisation, globalisation, and environmental externalities.

3.4. Reforms of tax policies in the EU member states in times of Covid-19 crisis

The COVID-19 pandemic hit economies mostly in the second quarter of 2020 and the impact was important given that the GDP growth at the global level declined with 3.4% in 2020 (OECD, 2022). In 2020, most economies experienced output declines in 2020, compared to the 2008 global financial crisis, when the developed economies were more affected than emerging-market economies. In 2021, global GDP growth reached 5.8%, a level which was above pre-pandemic levels in most economies. However, despite the swift recovery, the effect of the crisis was still visible at the end of 2021 because the GDP recorded was lower than the GDP projected before the pandemic. In the case of EU Member States, according to the European Fiscal Monitor (EU Independent Fiscal Institutions, 2022), their economies known an increase of real GDP about 5% on average in 2021.

Tax policies should be designed taking account of efficiency, equity, and sustainability principles. But when a crisis occurs, like the 2020 health crisis which spread all over the world, including EU countries, tax policies should take into consideration the need to address the damage brought about by the COVID-19 pandemic, which “has elevated the need for fiscal policy action to an unprecedented level” (Dornean and Oanea, 2022, p. 137).

Tax policy was an essential part of the policy response to the economic, social, and fiscal challenges that the EU faced in the context of the pandemic.

Taking into consideration the estimations made by EU fiscal councils (EU Independent Fiscal Institutions, 2020 p. 2) - a decline in real GDP of between -2% to -13% in 2020, a budget deficit in 2020 to be on average 8% of GDP across EU Member States, an average rise of the gross public debt by 14%-15% of GDP in 2020 - EU governments provided “an unpreceded fiscal response to the crisis” (European Commission, Directorate-General for Taxation and Customs Union, 2022a, p. 19).

Since the beginning of the COVID-19 crisis, the EU countries have introduced over a thousand budgetary measures, which included public spending measures, most of them, revenue measures and liquidity measures, to counter the effects of the pandemic. The total size of the fiscal measures cost about 5% of

GDP in 2020 and 4% in 2021, and it was projected to 1% in 2022 (EU Independent Fiscal Institutions, 2022, p. 2).

The European Fiscal Monitor classified the measures in two categories: on one hand, the measures with direct budgetary impact, respectively spending and revenue measures and in the other hand, the measures with indirect budgetary impact, such as loans, guarantees and tax deferrals. The size of COVID-19-related fiscal measures adopted between 2020 and 2022 country are substantial different across EU countries. The first place is occupied by Hungary with the largest relative value of fiscal measures that counts 24% of GDP. There are also other five countries that have spent more than 10% of GDP for fiscal measures to counter the effects of the pandemic in the period between 2020 and 2022: Greece (19%), Ireland (18%), Latvia (15%), Italy (11%) and Austria (11%) (EU Independent Fiscal Institutions, 2022, January, p. 12).

Given the economic and social situation, the EU Member states had to respond to the pandemic challenges (Checherita-Westphal *et al.,* 2022), including through reforms of tax policies. The EU governments have taken decisive action to contain and mitigate the spread of the virus and to limit the adverse impacts on their citizens and their economies. Table 3.5. provides an overview of the tax measures taken by EU countries in 2020 during the immediate crisis phase and highlights that personal income tax (PIT), corporate income tax (CIT) and value added tax (VAT) have been the most reformed taxes.

Table 3.5. Tax policy measures taken by EU Member States, by tax type

Country	Personal income tax (PIT)	Corporate income tax (CIT)	Social security contributions (SSCs)	Property taxes	Value Added Tax (VAT)	Other consumption taxes	Other
Austria							
Belgium							
Bulgaria							
Croatia							
Cyprus							
Czech Republic							
Denmark							
Estonia							

Country	Personal income tax (PIT)	Corporate income tax (CIT)	Social security contributions (SSCs)	Property taxes	Value Added Tax (VAT)	Other consumption taxes	Other
Finland		■			■		
France	■	■	■		■		■
Germany	■	■	■		■		■
Greece	■		■	■	■		■
Hungary		■	■		■	■	■
Ireland	■		■	■	■		■
Italy	■	■	■	■	■	■	■
Latvia	■				■		
Lithuania	■	■					■
Luxembourg	■	■			■		■
Malta		■			■	■	■
Netherlands	■	■	■		■		■
Poland	■	■	■	■	■		■
Portugal	■	■	■		■		■
Romania		■				■	■
Slovak Republic	■	■	■				■
Slovenia			■		■		■
Spain	■	■	■	■	■	■	■
Sweden	■	■	■		■		■

Source: OECD (2020)

Throughout 2020 and 2021, EU Member States implemented a number of tax measures to support business activity and mitigate the impact of the pandemic on households by direct support. For the business environment, these measures have consisted of tax cuts for businesses; tax deferrals for corporate income tax (CIT), property tax, value-added tax (VAT), and social security contributions (SSCs); tax incentives to favour investment, to counteract the liquidity crisis and support businesses' productivity. Also, some countries introduced a favourable tax treatment of losses or an extension of the tax-filing deadlines. To help households, a number of EU countries chose to cut rates (in those countries that apply a flat tax system) or to adjust tax brackets (in those countries that apply a progressive tax system), also allow for deferral of payments or personal income tax (PIT) and social security contributions (SSC) waivers. Moreover, many EU Member States gave tax relief to households, employers, and the self-employed. Therefore, we observed that many EU countries reformed their PIT and SSC systems, and many boosted the digitalisation of their tax administrations (European Commission, Directorate-General for Taxation and Customs Union, 2022a, p. 19).

All Member States have taken *tax measures to protect business cash flows*, notably through tax deferrals for CIT, PIT, property tax, VAT, and SSCs payments for employers, with the objective to help businesses keep their employees. Changes to the tax treatment of losses (i.e., carry forward and backward provisions) have been introduced by Czechia, Poland, and Slovakia. In Austria, Belgium, Finland, and Luxembourg, the favourable tax treatment of losses has often been accompanied by extended tax-filing deadlines. In many Member States, the COVID-19 outbreak fell within the period in which income tax return filing and payments were due. In this context, offering several weeks or months to pay the taxes helped businesses (European Commission, Directorate-General for Taxation and Customs Union, 2021, p. 106). Croatia, Hungary, and Spain applied *tax cuts for businesses*, measures that have been generally more targeted, often to SMEs.

Several Member States have introduced *more flexibility for tax debt repayment* (European Commission, Directorate-General for Taxation and Customs Union, 2022b, p. 22). Thus, Belgium, Finland, France, Hungary, Lithuania, and the Netherlands offer easier access to and extension of debt payment plans; Belgium, Cyprus, France, Germany, Greece, Hungary, Ireland, Italy, Lithuania, Malta, Romania, and Spain suppressed all penalties for late tax payments. Belgium, France, Greece, Ireland, Latvia, Lithuania, and Romania have introduced quicker processing and acceleration of tax refunds or reimbursements (VAT and other taxes), with a positive effect on business cash flows.

Some of the tax measures taken in the context of the COVID-19 pandemic, encouraged businesses to help healthcare institutions. In this context, Belgium and Italy introduced *full or partial deductibility for CIT and PIT purposes of donations made to healthcare institutions*. On the other hand, Belgium and Slovenia implemented tools to safeguard the VAT deduction on items donated by businesses to healthcare institutions.

The overall impact on tax revenues and its relation to GDP is rather country-specific. It depends on the type of measures; the magnitude and length of the support; the economic structure of each country, the sectors that have been affected, and the sectors and companies that have received support (or even benefitted from the pandemic); and the type of employment that was shed and for how long (for example, high-income versus low-income workers). It is thus difficult to establish a general one-size-fits-all explanation for all Member States (European Commission, Directorate-General for Taxation and Customs Union, 2022b, p. 22).

Crises are thus often a necessary stimulant for the development of European integration. In fact, each crisis affects the union in different ways. Some create conditions for progress, but others are divisive and harmful (Lehne, 2022).

3.5. Towards a fiscal union and a single fiscal policy in the EMU. Pros and cons

After the 2008 global financial crisis, there is a consensus regarding the need of a fiscal union in the EU (Van Rompuy *et al.,* 2012), and even more for the economic and monetary union (EMU) (Allard *et al.,* 2013; Franco and Goretti, 2013; Mursa, 2014; Buti and Guersent, 2017; Berger *et al.,* 2019; Gadatsch *et al.,* 2019), given the high level of interdependence and spill-overs between euro area countries (Van Rompuy *et al.,* 2012). The president of the European Council highlighted also that beyond the measures implemented under the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance, for the functioning of the EMU is necessary "a qualitative move towards a fiscal union" (Van Rompuy *et al.,* 2012, p. 5), that suppose "the development of a stronger capacity at the European level, capable to manage economic interdependences, and ultimately the development at the euro area level of a fiscal body, such as a treasury office" (Van Rompuy *et al.,* 2012, p. 6).

Franco and Goretti (2013) consider the fiscal union as the "integration of the fiscal policies of some nations", where the decisions about taxation and public expenditure are taken by common institutions. But this is not the case of the EU. The authors (Franco and Goretti, 2013) argue pro and against a fiscal union in the EU. Considering the sovereign debt crisis, which revealed the weakness of the European institutional framework, including neglect of macroeconomic imbalances, they bring arguments for a fiscal union. Thus, in their opinion, the Stability and Growth Pact (SGP) did not guarantee the adoption of prudent fiscal policies in good times; also, there were no procedures for managing sovereign debt crisis; and besides these, macroeconomic imbalances can undermine fiscal sustainability and sharpen financial tensions. In this context, they agreed that a monetary union cannot work without a fiscal union. The increase in moral hazard, the increase of political tensions, and the absence of a true political union are the arguments against a fiscal union that Franco and Goretti (2013) underlined.

Even though important efforts were made to address the gaps in EMU's architecture by adopting "Six-Pack" legislation, "Two-Pack" regulation, and the Fiscal Compact (Iara, 2015), Allard *et al.* (2013, p. 196) also expressed their support for a fiscal union in EMU. In their approach, the fiscal union is considered as "a set of fiscal rules and arrangements, including possibly cross-country transfers, commonly agreed on by euro area member states to deepen fiscal integration". In their opinion, the benefits from fiscal integration would consist of the following: the likelihood of future crises will decrease and if they occur, they would be less severe and less prone to systemic spillovers; in their opinion, fiscal integration would raise the confidence about the viability of the union; better fiscal coordination; avoiding excessively restrictive fiscal stances during severe recessions. Of course, the fiscal union supposes some costs, very well highlighted by Allard *et al.* (2013): the loss of some stabilization capacity at the country level resulting from stronger control of national budgets and the transfer of some fiscal responsibility to the centre; the political costs; the operational challenges; the costs of union versus the costs of ex-post crisis measures.

Later, in 2019, in their study, Gadatsch *et al.* (2019, p. 2) consider that it is necessary a deeper fiscal integration, and as argument for their belief, they highlighted that "a fiscal interconnection has the potential to overcompensate for the costs resulting from the abandonment of individual states' "own" monetary policy in a monetary union". Apart from the economic argument, they analyzed the impact of three different forms of a fiscal union for Germany and the rest of the euro area: the tax harmonisation, the equalisation of public revenues, and the creation of a centralized supranational fiscal union. The result was quite surprising because, according to their analysis, the benefits for Germany and the rest of the euro area would be insignificant in each of the three scenarios.

Moreover, for Germany, the existence of a centralized fiscal union at the start of EMU would have determined important GDP and consumption losses. Also, the effects in terms of risk sharing of asymmetric shocks would be minor within fiscal integration.

Even if in the years after the 2008 global crisis, there was increasing pressure exerted by the most important EU countries to adopt and accept a common fiscal policy, there are opinions according to which a common fiscal policy can be especially harmful to the poorer countries of Eastern Europe (Mursa, 2014). In his paper, Mursa (2014) argues that a common fiscal policy, designed to support the euro currency, has some significant drawbacks. In his opinion, this will lead to the increase of the tax burden in all countries, which would be to the disadvantage of the Eastern Europe countries, which use lower tax rates to attract foreign investment from the rich countries of the EU. Another disadvantage would consist in the higher degree of centralization of budgetary expenditures in the EU.

Starting from the idea of the "development at the euro area level of a fiscal body, such as a treasury office", proposed by Van Rompuy *et al.* (2012, p. 6), in 2017 we can notice that there was some progress to improve fiscal surveillance through the creation of the European Fiscal Board (Buti and Guersent, 2017) that evaluate the implementation of the Union fiscal framework and the appropriateness of the actual fiscal stance at euro area and national level.

Economic and monetary union is not complete because there is no common fiscal policy and the European Central Bank is not the lender of last resort (Duff, 2022). In this context, EMU will remain fundamentally vulnerable to shocks and if it is desired to be complete, EMU needs more fiscal union (Berger *et al.,* 2019).

Table 3.6. The steps of EMU towards a fiscal union

Principal Requirements	Progress since the 2008 Crisis	What More Is Needed
1) Fiscal risk sharing • Macroeconomy • Banking union backstop	• Small-scale centralized investment initiative • Conditional liquidity provision, usually at below- market rates (European Stability Mechanism) • Single resolution fund (Single Resolution Mechanism)	• Macroeconomic risk sharing of relevant size • Common deposit insurance • Robust jointly financed bank resolution fund
2) Governance • Policy coordination • Rules	• Various increasingly complex fiscal governance reforms • Single Supervisory Mechanism	• Effective coordination • Simpler but more effective rules to reduce moral hazard
3) Markets • Factor market integration • Incentivizing fiscal and financial institution discipline • Reducing the risk of adverse self-fulfilling equilibria in sovereign debt markets	• Stronger supervision, higher lossabsorption buffers, and bail-in requirements • Financial market integration not fully recovered from the 2008 crisis • Collective action clauses introduced	• Fully unified supervision, • regulation, deposit insurance, and resolution to defuse the countrylevel sovereign-bank nexus • Full capital market union • Credible limitations on taxpayerfunded bailouts, supported by a minimum of risk sharing

Source: Berger *et al.* (2019, p. 26)

"To a certain extent, the issue of forming a fiscal union is probably illustrative of the future existential issue the EU will have to face: finding the right equilibrium between necessary integration and the danger of overriding its role" (Amand, 2017).

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CHAPTER 4

ADDRESSING NATIONAL PRIORITIES THROUGH PUBLIC SPENDING IN THE EUROPEAN UNION COUNTRIES

Dan Lupu[1]

4.1. Introduction

The health crisis caused by COVID-19 has in turn generated an economic crisis that has led to public policy reactions of national governments. However, the increase in public spending during the pandemic was achieved through the global increase in the level of sovereign debt, to already high levels for many countries (Alloza *et al.,* 2022). In the case of Romania, the increase in public debt was spectacular during this period with over 20% GDP: from 30% GDP in 2019 to over 50 GDP in 2022 (Romanian Fiscal Council, 2022). In this new situation generated by the increase in sovereign debts and implicitly the interest for their payment, government resources are under additional pressure. Previous structural factors (population aging, international migration, digitization, increasing inequality, ecological transition, and geopolitical problems) have already substantially affected public resources. In the following years, under the impact of so many important endogenous events, the need for public spending will expand dramatically to be able to meet the new needs that have arisen. Faced with these common difficulties, the European economies must formulate a coordinated and coherent response in order to properly face the new risks that have appeared (Schuknecht, 2020).

For their part, the national governments on the domestic level must seriously think about making public expenditures more efficient by structuring and sizing them in the medium and long term, depending on the appropriate

[1] Dan Lupu is Ph.D. habil., associate professor of public administration at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.

fulfillment of society's needs (Rosen and Geyer, 2004). In democratic countries, determining the structure of public expenditures within public finances starts from two major components: the preferences of the population determined by social needs and the possible sources of income. The efficiency of a certain public expenditure starts from the fulfillment of the basic and previous functions of their functions so that they can be sustained in front of society. Evaluating the effectiveness of public spending is an important problem in society, especially since in Romania in many crucial fields (health, education, infrastructure) there are many opportunities for their improvement.

Of particular importance, however, is the evaluation of public expenditures from the perspective of two other basic components: their level and the allocation method for different fields. For this reason, the comparison of the public expenditure structure of Romania with the corresponding European countries is particularly instructive. This chapter seeks to carry out an in-depth analysis of the structure and recent evolution of Romania's government expenditures, individually and compared to similar European countries. For our comparative analysis, we will take into account several aggregates of states: mainly and throughout the analysis the European Union (as being made up of 28 states); Euro Area (only EU member states that have adopted the euro common currency); Emerging and Developing Europe (Eastern European states, under development, some of which are members of the EU and some are not); advanced economies (the most developed states with a high-income level) and G7 (the most developed states in the world). Our analysis is carried out on two levels: the first level involves a comparative analysis of government spending in Romania with the economies of developed states, G7, EU, Euro Area, and the second level a comparative analysis of Romania with the European Union states. In this chapter, we give greater importance to the European Union aggregate in all comparisons starting from practical considerations of data availability, the series for this being accessible and the similar component of the EU countries to Romania's economy in terms of membership and development.

Our analysis shows that government spending in Romania was the lowest among European Union countries, being considerably below their average both as a percentage of GDP and in real terms (Purchasing Power Parity) per inhabitant. Compared to their level in 1990, public expenditures in Romania experienced insignificant variations compared to the EU average from the point of view of percentage in GDP, remaining broadly constant, if not actually decreasing. In contrast, Romania's public expenditures per capita during the mentioned period tripled. Figures 4.1-4.4 show that Romania failed to establish a welfare state compared to European states in the last 35 years, corresponding to the social economic model established in Western Europe. A possible explanatory cause could be the lack of an appropriate fiscal framework that can support the financing of long-term expenses on its own. Romania's government expenditures varied between 31.019% of GDP in 2017 and 41.532% in 1992, compared to values between 46.273 and 52.675% for the European Union. The global financial crisis of 2008 led to the continuous decrease of public spending in Romania, through the adoption of strong austerity policies (from 37.43% to 31.019% GDP). The reduction of government revenues during this period also generated a continuous increase in public debt, Romania having to be extremely careful in the future to achieve a proper balance between government expenditures and revenues according to the population's standards for the government (Romanian Fiscal Council, 2022).

Compared to similar European states, Romania spends sometimes higher amounts than the average for economic actions, which shows the high weight of the state's involvement in the economy and the high level of losses of state enterprises that must be covered from the state budget. For all other public expenditure categories, the Romanian state spends much less than the European average. Formulated in other terms, in comparison with the EU, the structure of public expenditures in Romania is heavily weighted by expenditures on economic actions, being in absolute terms 8.4% compared to 4.4%.

At the level of Romania, an important factor of regression compared to the European states is the government's inability to stimulate the physical or human capital of the population. Spending on public investments or education significantly influences a state's ability to accumulate physical and human capital. A series of articles from specialized literature show that an increase in productivity for the entire economy can be obtained by developing public capital, which in turn will have a driving effect on private capital (Barro, 1990). Education spending encourages human capital for the population, employees and entrepreneurs alike, having effects in increasing individual productivity and the general efficiency of the economy (Fatás and Mihov, 2013). Increasing the share of public spending on infrastructure and education in Romania at the expense of economic actions will have beneficial effects on the future development of the economy, the net financing capacity of the economy, and finally the sustainability of the public debt. The decreasing proportion of the public sector in capital expenditures in Romania is a factor slowing down the potential growth of the economy and the activity of companies. These types of government spending also promote the reduction of inequality between present and future generations. Policies such as educational expenses are previously redistributive, compared to those such as supporting state enterprises with losses or social benefits, which are posteriorly redistributive. The growing problem of increasing social inequality in Romania can be solved by the appropriate adoption of previous redistribution measures, similar to those practiced by other European states. The labour market of the future, influenced by declining demographic trends, the digitalization of the productive system, and the energy transition, makes massive investments in the training of the population absolutely necessary (Blanchet *et al.,* 2022).

This chapter also examines another significant trend existing between Romania and the EU states regarding the increased volatility of public expenditures during the economic cycle. Starting from the analysis of public expenditure components over a long period of over 30 years with 3 economic crises, we show that Romania has a higher fiscal volatility than EU states, determined by the greater effect of variation of macroeconomic factors.

4.2. Some conceptual notions on public spending

The notion of public expenditure is difficult to specify and examine within a specific definition, unanimously accepted in specialized literature and practice. A first and most important distinction is given by the market - non-market activity for an economic entity. In this sense, even if an institution is managed by the public administration but produces private goods that it distributes on a market, it will be considered an economic entity and will be removed from the sphere of the public administration sector (Gruber, 2005).

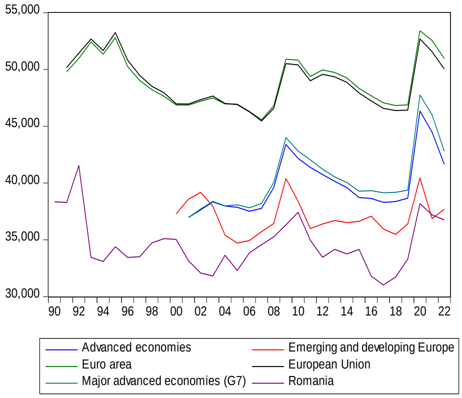
Contrary to the ESA, the public sector is made up of two large components: the public administration sector itself, which carries out an activity on a public market, as well as public entities that operate on a competitive market. At the international level, although there are significant differences between countries regarding the provision of public services, including education, health, highways or utilities, and the market-non-market differentiation, the concepts are interchangeable between them: public sector expenditures with government expenditures and public expenditures. The specialized literature and practice use any of the three previous concepts to determine and highlight public government expenditures (Forman *et al.,* 2020).

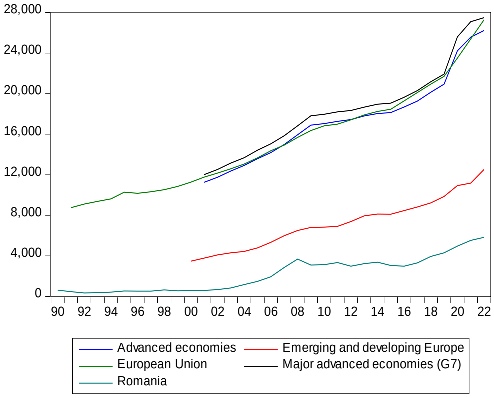
The period taken into consideration in the analysis represents the longest time period for which data are accessible: 1990-2022. This chapter presupposes a detailed evaluation of the trend of public spending in the last three decades, with greater differences towards the last period. The foundations of the public sector in Romania and comparisons with other European states as well as the recent developments generated by the COVID-19 health crisis also presuppose the directions of analysis of this article.

4.3. Overall public spending in the EU. An international perspective

Starting with the 1980s, for a large number of countries in the world, there was an increase in the weight of public expenditures, even reaching the doubling of their percentage (from values of 20% GDP to over 45% today). However, in the last 20 years, the percentage of public expenditures in developed economies has undergone slight changes in the range of 45-50%, in the long term remaining practically unchanged (Hauptmeier *et al.,* 2015). Romania, on the other hand, experienced important changes and fluctuations in public expenditures: if in the 90s they exceeded 40%, in the 2000s they reached 30%, so in recent years they have increased to 35% (see Figure 4.1). The trend is more obvious if public expenditures are expressed per capita in purchasing power parity (PPP) where an increase from 1500USD (PPP) to over 4000USD (PPP) is observed (Figure 4.2). This phenomenon of GDP growth per capita in positive correlation with the growth of public expenditures has been properly studied in the specialized literature (Durevall and Henrekson, 2011).

In most European states, in the second half of the 20th century, there was an increase in public expenditures as a result of the increase in the role of the state in the economy (Cepparulo and Mourre, 2020). In Romania, which started from a communist and centralized system with high shares of public spending, the opposite phenomenon occurred: sharp decreases in public spending in the economy until the mid-2000s. Later, starting in 2005, public spending and Romania's GDP began easily to converge with that of European Union countries.





Source: IMF (2023) and World Bank (2023)

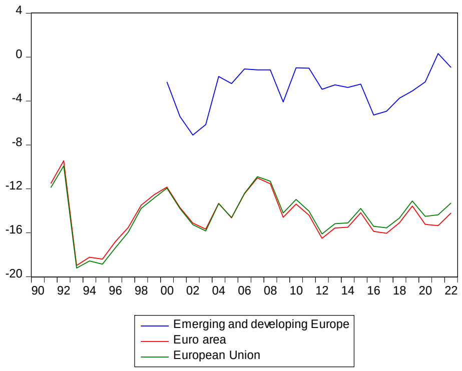
Source: IMF (2023) and World Bank (2023)

Figure 4.1. Public spending (% of GDP) **Figure 4.2. Public spending per capita $ (PPP)**

In the last 20 years, even after the financial crisis of 2008 and subsequent austerity measures, the difference in public spending between Romania and the EU average has remained relatively constant (Figure 4.3). Moreover, compared to the other ex-communist states, the difference in state expenditures did not experience significant changes (Figure 4.3). During this period, the difference of 12-15 percent between Romania and the average of the EU states was maintained (Figure 4.3). It should be noted that this maintenance was done through the “freezing” of Romania's public expenditures, in some years showing even a decrease, in rare cases even maintaining the trend with the low growth rate of EU expenditures (below 3%). On the other hand, the difference in public spending per capita between Romania and the EU increased extremely much during this period; if in 1990, Romania had 1500 USD/per capita, in 2022 it would have 5800 USD/per capita; The EU had 8750 USD in 1990, so that in 2022, it exceeded 27300 USD/per capita (World Bank, 2023). And compared to the other former communist states, the discrepancy is major: in 1995 an average of 3484 USD/per capita, and in 2022, 12500 USD per capita. Only in relation to these states, the difference in absolute and relative expenses decreased as an expression of purchasing power parity (Romanian Fiscal Council, 2021).

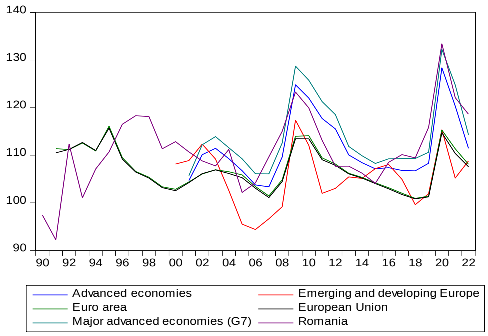
In general, public spending as a share of GDP (per capita) of Romania was during this period, and even during the pandemic period, at least 15% higher than the average of the whole of Europe. In some states (Finland, France, Sweden), public expenditures were higher than 50% of GDP, and in others (Ireland, Estonia) around 30%, which illustrates the big difference even between European states (OECD, 2021).

Romania's public spending as a percentage of GDP was 36.75%, which is a much lower value than 50.03% for the EU or 50.95% for the Euro Area (Figures 4.1 and 4.3). However, these values are similar to those for emerging European states, with a weight of 37.69%. Romania's government spending per capita was 5,825.45 USD/PPS compared to the EU average of 27,276.74 USD/PPS or the emerging Europe average of 12,516.78 USD/PPS (Figure 4.2). This value is the lowest among the EU states, showing the fact that the public sector and budget allocations in Romania are manifested mainly towards developing states, rather than towards developed European states (Eurostat, 2022).



Source: IMF (2023) and World Bank (2023)

Figure 4.3. Comparison vs. the EU (difference)



Source: IMF (2023) and World Bank (2023)

Figure 4.2. Public spending per capita $ (PPP)

Another indicator calculated in the study and very important for the analysis is represented by the level of public expenditures as a share of the public revenues of the respective state. This indicator has an extremely high value for the Romanian state of 118.60% compared to the European average of 107.57% (Figure 4.4). The

European states respected a series of budgetary restrictions for the public administration and financial limitations stipulated in the European Fiscal Compact, a fact not achieved by the Romanian state. With public expenditures of 37.69% of GDP and public revenues of 30.98%, Romania experienced large deficits, being the only country under the excess deficit procedure.

For European states, the average public expenditure/revenue is close to 100%, which would be in line with a balanced budget. However, Romania had expenses of 5825.45 USD/per capita and revenues of only 4911.84 USD/per capita. In other words, the public administration of Romania spent 914 USD/per capita more than the revenues obtained, thus increasing the public deficit and having to resort to increasing the public debt (Romanian Fiscal Council, 2021).

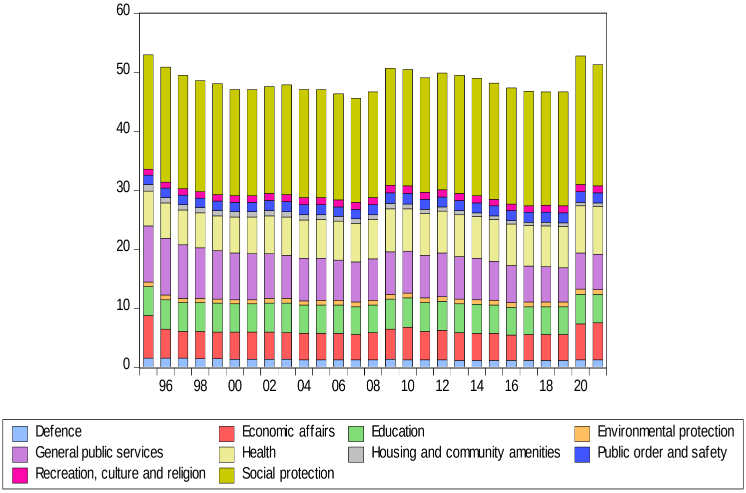
4.4. The functional structure of public expenditure in Romania and other EU countries

Depending on their destination, public expenses are divided into ten categories, according to the functional classification (COFOG): general public services; education; health; economic affairs; social protection; defense; public order and safety; environmental protection; housing and community amenities; and recreation, culture, and religion (Eurostat, 2022).

The distribution and especially the analysis of public expenditures by specific functions must be carried out with great care. For some functional fields (health or social protection) between countries there may be institutional variations, which generate certain uncertainties when making comparisons between countries (Alloza *et al.,* 2022). For health, the financing systems can be different for European countries: for the Nordic countries (Norway, Denmark, Sweden) the system is entirely public, and for others (Germany, Austria) the system is mixed (public and private).

In Romania, over 80% of total public expenditures are allocated for only five major functions (social protection; education; health; general public services; and economic affairs). On the other hand, in the EU the percentage is higher and reaches 90% only in four areas (without economic affairs). There are significant differences between European states in the distribution of expenses by functional areas (OECD, 2021). For most categories of public expenditures (seven out of ten categories), the allocation made by Romania is lower than the EU average, considering the size of the economy and the similarity with the other eastern countries. However, for only three areas, which are not very important in a country's economy and which do not have long-term multiplying effects (defense; public order and safety; economic affairs), the share of public expenditure in Romania is higher than the European average (Figures 4.5 and 4.6).

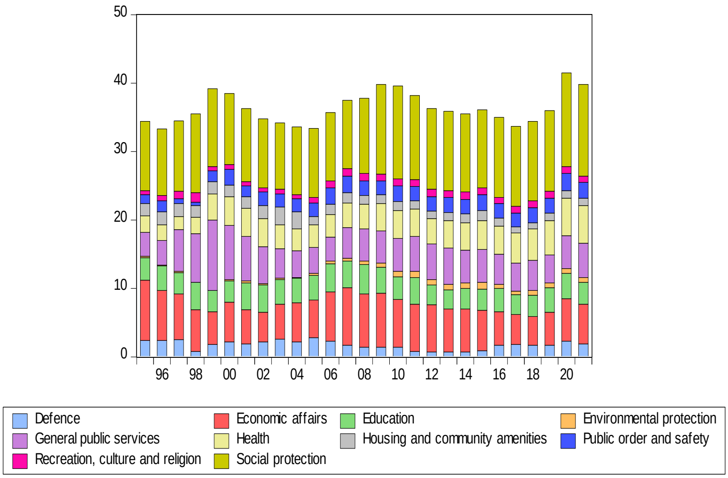
Romania spent more on economic actions than the EU average in most of this period (with differences between 1.5-2.8%), during the pandemic years reaching similar values. On the other hand, compared to the EU, expenses per person in Romania are lower than the European average for all functions.



Source: Eurostat (2022)

Figure 4.5. The functional structure of public expenditures in the EU

Regarding the individual composition, Romania gives a higher priority to expenses related to defense, and public order and safety (Figures 4.5 and 4.6). According to Figures 4.5 and 4.6, Romania spent 0.6% more on defense than the EU average. By 0.7% more was spent in Romania for public order and safety. The category with economic actions had more government expenditures in Romania than in any European state, the difference being higher a decade ago (+2.8%) and currently less substantial (+0.2%).



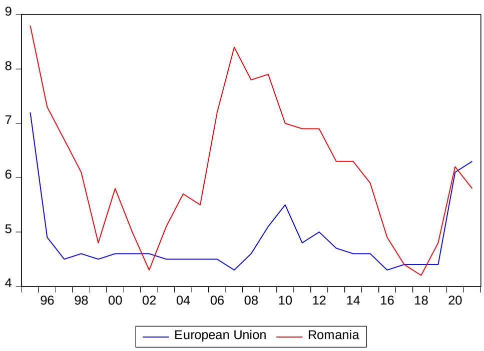
Source: Eurostat (2022)

Figure 4.6. The functional structure of public expenditures in Romania

Over time, there has been a change in the relative weight of different categories of public spending, with some categories showing increases and others, decreases. In particular, the expenses related to the fields related to defense and security have increased in importance compared to other European countries in the last decade (Schuknecht, 2020). While the other European countries decreased these categories of expenses, Romania kept them intact, and even slightly increased them reaching 2.3% (+0.6% compared to the average) and 2.0% (+0.7% compared to the average).

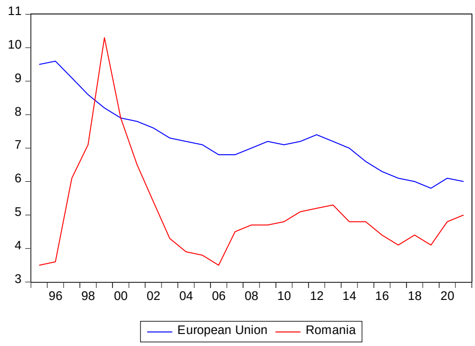
In Romania, expenses with economic affairs are more procyclical and more volatile compared to other types, in the years of economic growth exceeding a percentage of 7.5% in the years 2000-2015 and subsequently falling to a percentage of 6.5%. in fact, Romania spent more than any European country on economic actions in the years before the pandemic. However, starting with 2014, expenses in this category began to decrease constantly over time, reducing by a percentage of 2.0% in the last decade (see Figure 4.7.). The accentuated economic instability of Romania in the last two decades was largely the cause of these substantial changes in this type of expenditure. However, the major problem of Romania in their extensive use is given by their volatility and procyclicality (Romanian Fiscal Council, 2022). Compared to the EU average, Romania spends 1.5-2.7% more. In terms of per capita spending, the differences fade in favour of the EU average, where the amounts are higher in absolute terms: if in Romania an amount of 340 USD/capita (PPS) is allocated in the European Union, it exceeds 1,320 USD/capita (PPS), i.e. about 400% more. The large share of these expenses for economic problems belongs to the expenses with investments both in Romania (46% of the total expenses) and in the EU (37%). Another important component for the implementation of economic expenses is represented by subsidies. In the case of Romania, this category includes a series of funds intended to compensate energy tariffs (40%), transport (30%), and subsidies granted to small and medium-sized companies (25%). Unlike the EU, in Romania the relative dimensions of the three components are different, but their combined importance is similar. For Romania, the expenses for the transport sub-function mostly assume investments in highways and roads as well as expenses with subsidies granted for the transport of the population. The subsidies granted to small and medium-sized companies (approximately 800 million euros) represented another important component in this category. Mainly, the funds were allocated for professional training programs, reconversion, and employment stimulation by the programs run through the Employment Office (Eurostat, 2022).

At the beginning of the 2000s, Romania spent a higher percentage than the EU average for general public services (10.3% compared to 8.25%) (see Figure 4.8). The first decade of the 2000s represented a sharp decrease in these types of expenses in the Romanian state, reaching a minimum value of 3.8% in 2005. After this year, this type of expense gradually increases and reaches values close to 5% of GDP, anyway lower than the European average. Within this category of expenses, an important subcategory is represented by the interest expenses of the Romanian state. If in the first decade of the 21st century they represented important sums in public expenditures of over 45%, later as the loans were repaid, they began to decrease, which also determined a sharp decrease of this subcategory in the category of general public services. Romania, at the time of the outbreak of the financial crisis in 2008, was doing quite well, having a low external debt compared to GDP, of only 18%. Under these conditions, the sovereign debt crisis manifested in Europe during 2012-2013 did not create tensions in the market for sovereign bonds and the sudden increase in financing costs and implicitly in Romania's public debt (IMF, 2023). Between Romania and the EU average there are significant differences for this subcategory of expenses, in the EU the average for public debt payment exceeds 8.0% of total expenses, while in Romania it does not exceed 4.5%. Within this category, there are other important sub-functions of expenses: for the executive and legislative bodies; for financial and fiscal affairs; and foreign affairs; and for general public services. Within these categories, the largest amounts are allocated for the remuneration of employees in the public system in Romania. On the other hand, in terms of per capita expenses, it can be observed that in Romania they are found in a slightly lower proportion compared to the EU average for this category (290 USD/per capita (PPP) in Romania versus 1,363 USD/per capita (PPP) in the EU) (Eurostat, 2022).



Source: Eurostat (2022)

Figure 4.7. Public expenditure on economic affairs - Romania vs. EU



Source: Eurostat (2022)

Figure 4.8. Public expenditure on general public services – Romania vs. EU

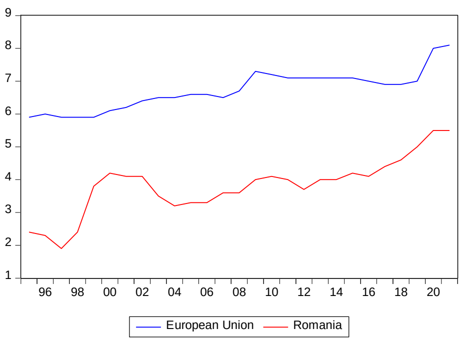
In Romania, health expenses represent an important part of the state's expenses, just like in the EU. If at the beginning of the 1995s they were found in an insignificant percentage of only 1.9%, later they started to grow reaching 4.2% in the 2000s (Figure 4.9). Starting with the 1st decade of the 21st century, health expenses gradually increase by approximately 1 percentage point, reaching to currently representing 5.5% of GDP. Compared to the EU average, these expenses are also lower by at least 2.5% for the entire analysed period. Health expenditures per capita represent the same significant difference between Romania and the EU average (320 USD/per capita (PPP) versus 2210 USD/per capita (PPP). In Romania, the national government is the main provider of medical assistance, the expenses for medical assistance being more compensation for the medical services provided, than social benefits for the entire population. In 2022, the majority of health expenditures were attributed to employee remuneration (45%), drugs purchased on the market (26%) and intermediate consumption, and other final consumption expenditures (approximately 25%). The three subcomponents represent over 95% of all public health expenditures (Eurostat, 2022).

In Romania, the remuneration of health employees represents an amount spent by 10 percentage points more than in the EU, and in the EU states this component is equally important. The provision of medical assistance in the EU states is generated by the existing discrepancies as a result of the various models practiced in European countries: in a number of states medical services are provided by the national government (Spain, UK, Sweden), while others (Germany, Austria) purchases through the competitive market.

Within this category of public expenses, most of the amounts allocated for medical assistance go to hospital and outpatient services. The two combined costs represent the most important amounts in the share of health expenses both in Romania (72%) and in the EU states (78%). In Romania, the share of expenses for outpatient services is lower, but it is compensated by a higher proportion of hospital expenses. At the same time, within the two subcategories, in Romania, the remuneration of the medical staff represents the majority of expenses for hospital (80%) and outpatient (65%) services. Another important component of this type of expenditure is represented by the expenditure on medicines necessary for the health system; such as the purchase of medical products, equipment, and consumables. In 2022, they amount to USD 3.5 billion in Romania, which is still lower than those in the EU states. In Romania, in the last decade, in order to reduce expenses in this field, the pharmaceutical co-payment was implemented for large categories of the population and medicines (Romanian Fiscal Council, 2022).

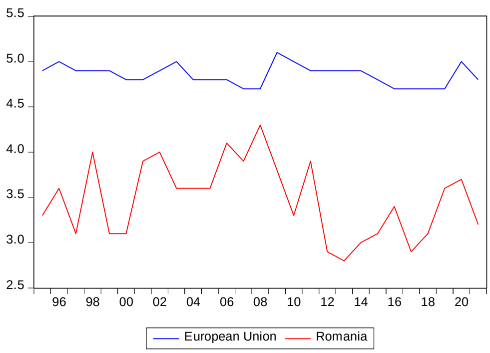
For Romania, education expenses as a percentage of GDP followed a downward trend, lagging behind the EU level. If in the 2000s, the expenses for education had a percentage of 4% of GDP (lower than in the EU), in the last years they decreased by 1 percentage point, reaching 3% (see Figure 4.10). This difference compared to the EU average assumes at least 2% percentage of GDP. For the per capita expenditures for education, the situation is even more dramatic: in Romania, the expenditures were 174 USD/inhabitant (PPP) compared to 1363 USD/inhabitant (PPP). This situation shows the chronic underfunding of education in the Romanian state, the nominal amounts being more than 9 times lower than the European average (Eurostat, 2022).

Employee remuneration represents the main component of education expenses in Romania. The salary of employees is the most important subcategory within this category, being similar to the relative weight of the average of the EU states (65% in Romania compared to 70% in the EU). In Romania, there is a form of education financing represented by amounts allocated for each student by the state. Under these conditions, in the case of the institutional systems used to provide educational services, the expenses for private schools were also included, but they are subsidized by the state according to the principle shown above. Another important subcategory present is given by the expenses with student scholarships, but which are a significantly smaller amount than those of the European states. By education category, primary, elementary, and secondary total over 75% of the amounts spent on education. The biggest gap between Romania and the EU average can be found in the investment category, which represents 3.5% compared to 8.3%.



Source: Eurostat (2022)

Figure 4.9. Public expenditure on health - Romania vs. EU

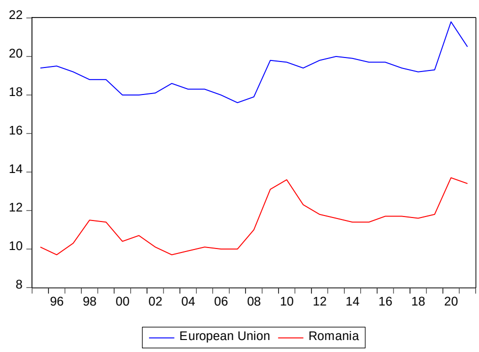


Source: Eurostat (2022)

Figure 4.10. Public expenditure on education – Romania vs. EU

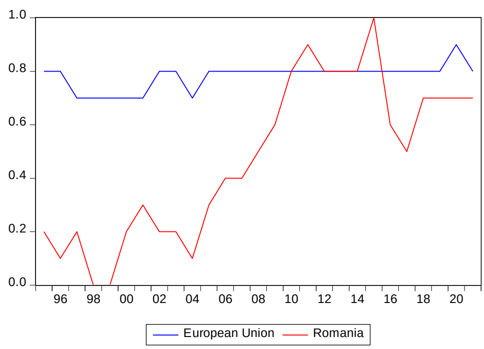
In the last 35 years, Romania has known two distinct periods for the allocation of social insurance expenses. If until the 2000s they did not represent more than 10 percentage points of GDP, in the last decade they started to grow, reaching over 14%. However, even with these increases, Romania is behind the

EU average by at least 8% (see Figure 4.11). In Romania and in the EU, the largest category of public expenditure is represented by social protection in terms of scale, although there are minor variations between states. In the last decades, the difference between Romania and the EU has remained constant in relation to GDP, in terms of social insurance expenses. The financial crisis of 2008 had a particular impact on the expenses of the Romanian state regarding social protection, increasing them by more than 4 percentage points (Eurostat, 2022). But an important part of these expenses is represented by pension expenses, over 80%. Compared to the EU states, the pensions paid by the Romanian state present a series of significant differences. Thus, the sums received by Romanian pensioners are net sums, these persons are not taxed for these transfers; of such persons, no social contributions for health are withheld for the amounts transferred to the elderly. Under these conditions, if the effort of the Romanian state, represented by the exemption from income tax and health contributions, were taken into account, the share of social protection expenses can rise by 1.5-2% of GDP.



Source: Eurostat (2022)

Figure 4.11. Public expenditure on social protection - Romania vs. EU



Source: Eurostat (2022)

Figure 4.12. Public expenditure on environmental protection – Romania vs. EU

In Romania, social protection expenses are realized by their nature as social benefits. These social benefits represented over 80% of the total social protection expenses, which are financed mainly from the social insurance funds. And at the EU level, there are similar situations where social benefits represent the vast majority of social expenses (over 60% in the EU) (Alloza *et al.*, 2022). The breakdown of social protection expenses by sub-functions has similar approaches both in Romania and in the EU. Expenditures for pensions (transfers related to old age) stand out in this category, with higher weights for Romania. The second largest area of expenditure, social protection related to illness and disabilities, shows similarities between the Romanian state and the EU (approximately 15% for each of them). The third important category, unemployment expenses, represents a smaller percentage in Romania of 3.3% compared to 6% for the EU.

The rest of the expenditure categories represent a smaller share of the total public expenditure (12% in Romania and 12.5% in the EU). Due to their smaller scale, these expenditure categories are highly dependent on GDP. In Romania and the EU, the total of the other categories of expenses represents between 4-5% in 2022 (with lower values for the Romanian state) and represents public final consumption expenses (Romanian Fiscal Council, 2022).

Spending on environmental protection involves a wide range of actions such as waste and wastewater management, pollution reduction and biodiversity and landscape conservation. In Romania, this category of expenses has a weight close to the European average, being 0.65% compared to 0.8% in European countries (Figure 4.12). An important thing to point out is the fact that at the beginning of the analysed period, they had a very small share in the national budget, of only 0.1%, so that in the last decades, through the adoption of European rules regarding the environment, they gradually increased to 0.65%. for this category of expenses, the difference compared to EU is the smallest, showing their convergence.

In conclusion, this study compares Romania with a series of states (EU, Euro Area, Emerging Europe) to carry out an analysis regarding the volume, trends and composition of public expenditures. Following the previous analysis, two main conclusions can be drawn.

First, Romania's public expenditures have a significantly lower weight (-15%) than that of their European counterparts. This is highlighted by the fact that the Romanian state is in the lower half of the reference group from the point of view of the economy. A possible explanatory cause for these reduced public expenses in the European landscape is the fact that the public revenues obtained by Romania are much lower than the European average (around 30%). As large categories of expenses, two stand out in particular: social protection and economic affairs, at the expense of physical or human investments, such as education and research.

Secondly, in Romania, for the formulation of medium and long-term strategies, a series of important factors characteristic of this country must be highlighted. The level of public expenditure in Romania, although much lower than for many European countries, is still considerable in comparison with its level of tax revenues. This results in a determining feature for the future attempt to increase public expenditures in the part of economic viability, namely the simultaneous increase of public revenues. Global trends that have appeared in other states cause the pressure of the population and the state to increase even more on this income-expenditure binomial. Within these trends, we can mention the demographic ones (the declining population and international migration will generate considerable increases in social protection expenses related to the aging of the population) and the transition to more sustainable energy sources. The influence of the economic growth desired by the government and the population must take into account the structure of government expenditures. In Romania, those categories of public expenses that support the most long-term growth, such as investments and education, are underfunded, compared to EU states. In addition, these previously redistributive public policies generate a reduction in inequality and relate a superior equity between generations.

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CHAPTER 5

GOVERNMENT DEBT POLICIES IN THE EU MEMBER STATES: THE PATH TOWARD SUSTAINABILITY

Irina Bilan[1]

5.1. Introduction

When enough regular public revenue is not available for governments to finance public expenditure, the resulting budget deficit may be funded by means of borrowing and public debt accumulates. In simple terms, public debt refers to the liabilities of government units toward their creditors: citizens, domestic or foreign financial and non-financial corporations, international financial institutions, and governments of foreign countries.

Government debt is a reality in all the EU countries, as persistent (and sometimes, large) budget deficits are more of a 'norm' than an exceptional situation. Since the inception of the European Monetary Union (EMU), keeping public debt under acceptable limits has been continuously on the EU and national authorities' policy agenda. In particular, participating countries have been struggling to keep the gross, consolidated debt of the government sector, at face value (the so-called 'Maastricht debt'), below 60% of their GDP.

Preventing unsustainable government debt accumulation and poor debt structures (in terms of foreign currency, maturity, or interest rate composition) (IMF, 2001) are major objectives of government debt policies. Nevertheless, these call for a broader, macroeconomic policy approach. Keeping government debt levels and growth rates under control requires, for instance, an adequate fiscal policy, which reflects a wide range of decisions on public expenditures,

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[1] Irina Bilan is Ph.D., associate professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.

revenues, budget balances, and the financing of government deficits contributing to debt accumulation.

A country's public debt is sustainable when the government can "meet all its current and future payment obligations without exceptional financial assistance or going into default" (Hakura, 2020, p. 60). Government debt sustainability is not only about debt levels and growth but also about the overall quality of government finance. Moreover, other types of debts (e.g., liabilities of public sector units publicly guaranteed by the government) may pose a risk and must be taken into consideration. The amount of 'sustainable' debt that a country can incur depends on many factors, among which are the quality of the domestic and international economic environment, prior expertise in debt management, or the quality of its policies and institutions.

Ensuring public finance sustainability and keeping government debt levels under control are highly relevant for deepening European integration and the smooth functioning of the European Monetary Union (EMU), and several theoretical and practical arguments support it.

First, reaching and sustaining low government debts and budget deficits are essential for economic growth and high employment, as they help keep interest rates low and support monetary authorities to reach their goal of keeping inflation under control. A stable macroeconomic environment is further conducive to investment, growth, and employment (European Commission, 2000). A high government debt and large budget deficits may, on the contrary, negatively affect long-term growth through several channels: (a) an increase in risk premia on sovereign debt (and further, on private debt), which brings public spending up and leads to higher debt burden; (b) an increase in taxes or primary spending cuts to service the debt; (c) a decrease in private investment and private capital accumulation (crowding-out effect) (European Commission, 2010).

Second, low government debt and deficits ensure the fiscal space much needed for governments to smooth the business cycle and tackle possible adverse economic shocks. Over the long run, fiscal space is needed to deal with other stringent challenges, such as the budgetary costs of population aging and climate change.

Third, within the EMU, fiscal policy is the sole instrument available to national governments to stabilise the economy and reach different economic policy goals. Enhanced fiscal discipline allows national governments to perform their tasks and avoid the overburdening of the single monetary policy and the European Central Bank (ECB) (European Commission, 2000).

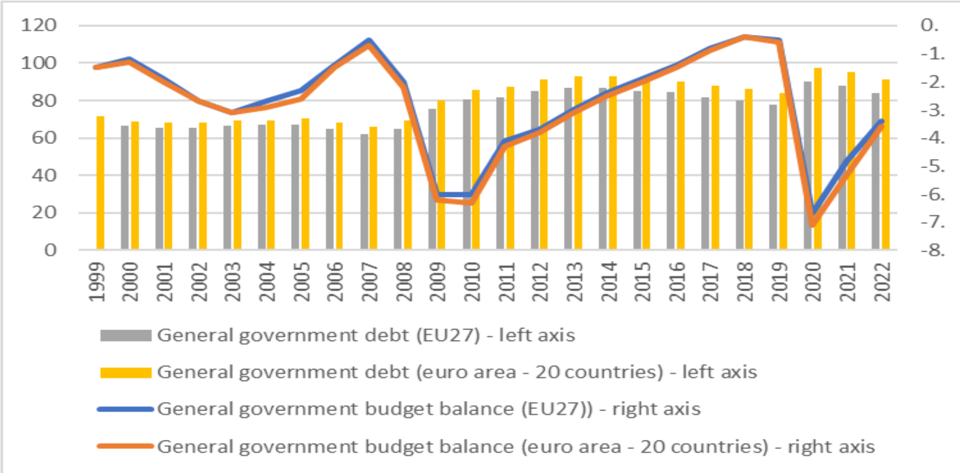
Fourth, in a highly integrated area such as the EMU, crises may have far-reaching effects, beyond the national borders, as spillover effects may occur. Preventing public debt crises is essential not only for protecting the indebted country but also the other euro area member states that may incur negative effects. The recent sovereign debt crisis in Europe clearly reconfirmed the need to address unsound fiscal policies as common problems and enhance the supranational EU framework for their prevention.

Approaches to tackling high government debts and unsustainable public finance rely on two mechanisms, namely market discipline and fiscal rules (Balassone, Franco and Zotteri, 2004). While improving market functioning and its ability to sanction and constrain the unsustainable behaviour of governments is a desired outcome in the EU, fiscal rules are at the core of the European architecture for ensuring public finance sustainability, and their role has become stronger in time. Fiscal rules are long-lasting constraints on fiscal policy, generally defined in terms of an indicator of fiscal performance (Kopits and Symansky, 2008). More often, they come under the form of a numerical ceiling or target of a budgetary indicator (such as the budget balance, debt, borrowing, overall public expenditure or revenue, or one of their structural components), expressed as a ratio to GDP.

In this chapter, we overview the main government debt developments in the EU member states since the euro was introduced, in 1999. We look at both 'standard' government liabilities and contingent obligations which, although not included in the Maastricht debt, may pose significant risks to debt sustainability. Moreover, we present the EU (national and supranational) architecture created to prevent unsustainable public finances and debt accumulation in the EU member states, which continuously evolved to adapt to changing economic and political conditions and new challenges.

5.2. Overview of government debt developments in the European Union

High government debt levels and large budget deficits have always been a problem in the EU member states. Despite efforts to keep debt levels within acceptable limits, below 60% of GDP (as required to join the eurozone), little long-lasting progress has been registered over time (see Figure 5.1 and Table 5.1).



Source: Government finance statistics database (Eurostat, 2023a)

Figure 5.1. General government budget balance and debt in EU27 and euro area over 1999-2022 (average values, as % of GDP)

Throughout the 90s, as countries sought to fulfill the convergence criteria for adopting the single European currency, strong fiscal adjustment measures were undertaken, mainly based on expenditure cuts and, to a lesser extent, tax increases. The budget deficit of the yet-to-be euro area decreased by 3.5% of GDP during 1993-1997, despite the unfavourable economic conditions (European Commission, 2000). Nevertheless, in 1999, when the euro became a reality, government debt levels were still well above 70% of GDP, with some countries (Belgium and Italy) registering debts above 100%. Moreover, six out of the eleven countries joining the euro area in 1999 still had debts above the Maastricht cap. Therefore, further fiscal consolidation measures were required to bring debt levels down and budget balances to a position close to balance or in surplus.

Starting with 2001, fiscal consolidation lost momentum and the trend reversed. The budget deficit of the euro area (20) reached 2% of GDP in 2001 and increased to 3.1% in 2003. In the EU27, the budget deficit increased from 1.9% to 3.1% of GDP. In terms of EU27's government debt, it increased just slightly, from 65.6% of GDP in 2001 to 66.7% in 2003. The slowdown in economic growth and the work of automatic stabilisers partially explain this outcome. The measures aimed at reducing the tax burden, not fully compensated by expenditure consolidation, further contributed to the deterioration of the budgetary outcomes. In addition, criticism pointed out the failure to strictly impose the provisions of the Stability and Growth Pact, designed to ensure fiscal discipline in the newly created euro area (see section 5.4.1).

Budget balances consistently improved from 2004 to 2007, before the economic and financial crisis of 2008. In the eurozone, the budget deficit decreased from 3.1% of GDP in 2003 to 0.7% in 2007, while in the EU the progress was even more significant (to 0.5% of GDP). This improvement was mostly a structural one, although a broad-based economic recovery positively contributed, at the end of this period (European Commission, 2007). Nevertheless, government debt returned to a declining path only in 2006, and this trend persisted for only another year. Government debt decreased from 67.1% of GDP in 2005 to 62.3% in 2007 in the EU, and from 70.3% of GDP in 2005 to 65.9% in 2007 in the euro area.

Despite progress, fiscal consolidation efforts in these years were insufficient to bring government debt below 60% of GDP in many countries. In 2007, before the outbreak of the economic and financial crisis in Europe, many EU countries still had difficult fiscal positions and were highly indebted. Nine out of the 27 EU countries had government debts above the Maastricht threshold, namely, Austria, Belgium, France, Germany, Greece, Hungary, Italy, Malta, and Portugal.

Table 5.1. Government debt in the EU member states over 1999-2022 (as % of GDP)

Country/Year	1999	2002	2005	2008	2011	2014	2017	2020	2022
Austria	66.7	66.7	68.6	68.7	82.4	84.0	78.5	82.9	78.4
Belgium	115.4	105.4	95.1	93.2	103.5	107.0	102.0	112.0	105.1
Bulgaria	75.3	51.0	26.6	13.0	15.2	27.0	25.1	24.5	22.9
Croatia	28.8	36.5	40.9	39.0	63.4	83.8	76.5	87.0	68.4
Cyprus	55.8	60.5	63.4	45.5	65.8	108.8	93.2	113.8	86.5
Czech Republic	15.2	25.8	27.7	28.1	39.7	41.9	34.2	37.7	44.1
Denmark	n.a.	49.1	37.4	33.3	46.1	44.3	35.9	42.2	30.1
Estonia	6.4	5.7	4.7	4.5	6.2	10.6	9.1	18.5	18.4
Finland	44.1	42.6	42.1	34.7	51.9	64.5	66.0	74.7	73.0
France	60.5	60.3	67.4	68.8	87.8	94.9	98.1	114.6	111.6
Germany	60.4	59.9	67.5	65.7	79.4	75.3	65.2	68.7	66.3

Country/Year	1999	2002	2005	2008	2011	2014	2017	2020	2022
Greece	98.9	104.9	107.4	109.4	175.2	180.3	179.5	206.3	171.3
Hungary	60.4	55.6	60.5	71.8	80.3	76.5	72.1	79.3	73.3
Ireland	46.6	30.9	26.1	42.5	110.5	104.3	67.6	58.4	44.7
Italy	113.3	106.4	106.6	106.2	119.7	135.4	134.2	154.9	144.4
Latvia	12.1	13.0	11.9	18.5	45.1	41.6	38.9	42.0	40.8
Lithuania	22.7	22.2	17.6	14.6	37.1	40.5	39.1	46.3	38.4
Luxembourg	8.1	7.5	8.0	14.6	18.5	21.9	21.8	24.5	24.6
Malta	61.7	63.1	69.9	61.8	70.0	62.1	47.8	52.9	53.4
Netherlands	58.7	48.9	49.8	54.7	61.7	67.9	57.0	54.7	51.0
Poland	38.9	41.7	46.6	46.7	55.1	51.4	50.8	57.2	49.1
Portugal	55.4	60.0	72.2	75.6	114.4	132.9	126.1	134.9	113.9
Romania	21.7	24.8	15.9	12.3	32.3	39.2	35.3	46.9	47.3
Slovakia	47.1	45.3	34.7	28.6	43.2	53.5	51.5	58.9	57.8
Slovenia	23.7	27.4	26.4	21.8	46.5	80.3	74.2	79.6	69.9
Spain	60.8	51.2	42.4	39.7	69.9	105.1	101.8	120.4	113.2
Sweden	60.5	49.8	48.7	37.5	37.2	45.0	41.4	39.8	33.0

Note: (i) n.a – non-available value.

Source: Government finance statistics database (Eurostat, 2023a)

The situation further escalated starting in 2008 when, in order to cope with the economic crisis and fall in GDP, strong discretionary fiscal policy action was required to complement the positive impulse to the economy coming from the automatic stabilisers. The European Economic Recovery Programme (EERP), the EU's framework for addressing the economic downturn launched in November 2008, called for substantial discretionary fiscal support of at least 1.5% of GDP (European Commission, 2009). In practice, the total gross fiscal stimulus measures adopted were estimated to reach 2.9% of GDP in 2009 and 2010 (European Commission, 2010). Nevertheless, the actual fiscal stimulus packages varied across the EU member states, depending, in part, on their individual circumstances and available fiscal space. In some cases (more notably, Luxembourg, Poland, Hungary, Sweden, and Finland), permanent measures were quite important (European Commission, 2010), imposing a long-term burden on public finances.

In addition, significant public intervention took place to support the banking system, strongly hit by the crisis, in the form of the acquisition of financial assets, issuing of guarantees for financial liabilities, relief of impaired assets, liquidity support, or bank recapitalisation. Just up to 2009, the EU countries supported their banking sectors with measures counting for about 13% of GDP (European Commission, 2009). While some measures led to the immediate deterioration of both budget balances and government debt positions, some others were reflected only in higher government debts (e.g., the acquisition of financial assets). Moreover, in some other cases (e.g., the issuing of guarantees for other agents' financial liabilities), although there was no immediate increase in government deficit nor debt, these led to high fiscal risk accumulation under the form of contingent liabilities (see section 5.3.2).

Altogether, the action of automatic stabilisers, along with governments' discretionary interventions in the economy, the support to the financial (banking) system, and rising interest rates on government bonds because of the higher risk premiums required on the financial markets, led to the severe deterioration of EU member states' budget balances and debts, which raised serious concerns about the EU governments' financial sustainability. The overall budget deficit increased in the EU27 from 0.5% of GDP in 2007 to 6% of GDP in 2009 and 2010, and government debt increased from 62.3% of GDP in 2007 to 75.7% in 2009 and 80.4% in 2010. Moreover, in 2009 and 2010, the corrective arm of the SGP was applied to almost all the EU countries. The averages mask even more detrimental situations in some countries. Some EU member states (e.g., Ireland, Spain, Croatia, Latvia, Lithuania) had low government debt levels before the economic and financial crisis but these increased sharply. In other EU countries (Belgium, Greece, Italy, and Portugal), the already high public debts increased to over 100% of GDP.

The unravelling of the Greek debt crisis put further pressure on the EU's member states public finances, as financial support was granted to Greece and sovereign risk premia increased to unprecedented levels in the euro area countries with high fiscal and macroeconomic risks (European Commission, 2010). Overall budget deficits shrank in the EU27 in 2011 and 2012, to 4.1% of GDP and 3.7% of GDP, respectively, and an important part of this improvement was in structural terms. In addition, many countries managed to cut their deficits below 3% of GDP (Austria, Bulgaria, Germany, Italy, Latvia, Hungary). Nevertheless, extremely high budget deficits persisted in Ireland, Greece, Spain, and Portugal, while in other EU countries more modest consolidation measures were registered (Czech Republic, France, Croatia, Netherlands, Poland, Romania, Slovenia, or Slovakia). Against this backdrop, government debt continued to increase in EU27 up to 2014, although at a smaller pace, from 80.4% of GDP in 2010 to 86.9% of GDP in 2014.

Up to the outbreak of the COVID-19 pandemic in 2020, the situation of public finances consistently improved in the EU member states, reflecting both the higher commitment of countries toward fiscal sustainability and the improvement in their national and EU fiscal surveillance frameworks. The overall budget deficit decreased in the EU27 from 2.4% of GDP in 2014 to 0.5% in 2019, while the average EU countries' government debt reached 77.7% of GDP in 2019. At the end of 2019, no member state was subject to the Excessive Deficit Procedure, although high risks were signalled in Hungary and Romania (European Commission, 2020).

Nevertheless, budget deficits and public debts once again increased in 2020, as the health crisis hit Europe very hard and emergency measures were adopted in all EU countries to stop the spread of the COVID-19 pandemic and alleviate its economic consequences. Member states' actions were complemented by strong EU-level response, and budget deficits and debts grew to even greater levels than the ones registered during the previous crisis. Except for Denmark and Sweden, all EU member states had budget deficits above 3% of GDP in 2020, while the average EU general government debt reached 90% of GDP.

As the pandemic situation was improving, the EU countries were looking forward to a period of strong economic expansion, with positive revenue developments and a decrease in budget deficits and debts. Nevertheless, the energy crisis, inflation, and war in Ukraine hindered these plans, and consolidation outcomes were more modest than expected in 2022. While budget deficits decreased to 3.4% of GDP in the EU and 3.6% in the euro area, and government debt to 84% of GDP in the EU and 91.5% in the euro area, important fiscal risks must be addressed and prudent fiscal policy is required in many EU member states. In 2022, eleven EU countries still registered budget deficits above 3% of GDP (with Italy as high as 8%), and thirteen countries had debt levels above 60% of GDP. Therefore, addressing high debt levels and large budget deficits is still on the policy agenda of many countries. This would allow minimising their effects negative effects on long-term growth, while also creating additional fiscal space to deal with persisting older and newer threats to long-term public finance sustainability, such as the high budgetary costs of population aging (with the provision of old-age pensions, healthcare, and long-term care), with mitigating the impact of climate change and ensuring the transition toward a climate-neutral economy, or with dealing with the large immigration flows toward the EU countries from war-afflicted countries.

5.3. Contingent liabilities - A hidden type of debt

5.3.1. Conceptual grounds and role in the EU economic governance framework

In addition to actual liabilities, the government may incur contingent liabilities, which are only potential by nature, becoming effective and implying a public financial effort only when certain conditions are met, or a particular event takes place. In other words, they do not involve current cash flows, but potential future flows of funds (Towe, 1993). Since their budgetary impact cannot be known until they come due, they are a hidden form of debt, which impacts future government finances and complicates any fiscal analysis (Polackova, 1999).

Aside from contingent liabilities, as opposed to actual or direct liabilities, the literature distinguishes between explicit and implicit obligations. While the former are explicitly recognised by law or a contract, the latter are more of a moral obligation of the government, reflecting public interest or the interests of different groups (Polackova, 1999). One example in this respect is the liabilities toward future generations of retirees when public pension schemes are in place. Some more examples are reflected in Table 5.2.

Under conventional budget methodologies, contingent liabilities are not accounted for at the time the obligation is incurred, but when (and if) an actual expenditure is made (Towe, 1993). Only when such liabilities imply additional expenditure for the government, do they affect the annual budget balance and debt. Moreover, regular government debt indicators usually do not include contingent liabilities, due to their uncertain nature. In the EU, according to Council Regulation (EC) no. 479/2009 of 25 May 2009, contingent obligations are not part of the government debt indicator (Maastricht debt) used in the Excessive Deficit Procedure (EDP).

However, it is widely acknowledged that contingent liabilities are very important for policy analysis and the amount of such obligations should not be overlooked when evaluating the long-term sustainability of public finance. As recognised by ESA 2010, “a high level of contingencies may indicate an undesirable level of risk on the part of those units offering them” (Eurostat, 2023b) and it is important to assess such contingencies, even when no expenditure is incurred. The evaluation of contingent liabilities should complement the assessment of direct government liabilities (debt) when designing a comprehensive budgetary framework.

As such, substantial efforts have been made at the EU level, in recent years, to define, collect, and disseminate data about these potential government obligations, especially in the context of the endeavours to reinforce the EU economic governance framework, starting in 2011 (in particular, the so-called ‘six-pack’) (Eurostat, 2023b). Acknowledging their growing relevance, Council Directive 2011/85/EU of 8 November 2011 emphasised that more attention should be paid to government contingencies, broadly defined as “possible obligations depending on whether some uncertain future event occurs, or present obligations where payment is not probable or the amount of the probable payment cannot be measured reliably” (Council Directive 2011/85/EU, Article 26). The same Directive indicated potential sources of contingencies (Article 26) and required relevant information to be collected for all sub-sectors of the general government (Article 14.1).

Table 5.2. Typology of government liabilities

Liabilities	**Direct** *(obligation in any event)*	**Contingent** *(obligation depends on a specific event that may or may not take place)*
Explicit *(obligation recognized by law or a contract)*	• Debt instruments (loans, bonds, etc.) issued by central, local, or other general government units; • Budgetary expenditures (current or legally binding over the long run, such as the salaries or pensions of civil servants).	• Government guarantees for loans issued to public or private sector entities; • State guarantees on private investments; • Trade and exchange rate guarantees on private investments; • State insurance schemes (deposit insurance, crop insurance, flood insurance, etc.)

Liabilities	**Direct** *(obligation in any event)*	**Contingent** *(obligation depends on a specific event that may or may not take place)*
Implicit *(more like a moral obligation)*	• Future public pensions (other than civil service pensions), if not required by law; • Social security schemes, if not required by law; • Future health care funding, if not required by law.	• Defaults of public and private entities on their nonguaranteed debt; • Costs of banking failure, not covered by state insurance; • Failure of nonguaranteed pension funds, employment funds, or social security funds; • Default of the central bank on its liabilities; • Military financing, environmental recovery, disaster relief.

Source: adapted after Polackova (1999)

Up to present, four major types of contingent explicit liabilities have been identified to have a potentially important impact on public budgets and fiscal sustainability in the EU Member States and included in data-collecting initiatives at the EU level (European Commission, 2019):

- government guarantees,
- the liabilities of public corporations,
- off-balance PPPs, and
- government non-performing loans.

a. Government guarantees

These are the most common forms of contingent liabilities. These refer to the guarantees granted by general government units to third parties, either as on-off or standardised guarantees (European Commission, 2019). Some examples include the guarantees granted to public or private corporations for their loans or bonds, mortgage loan guarantees, student loan guarantees, or trade and exchange rate guarantees.

Data reported on government guarantees in the EU Member States as part of the Excessive Deficit Procedure (EDP) refer to the consolidated version, therefore including only the guarantees granted by general government units to entities classified outside the general government sector. Intra-governmental guarantees (such as a guarantee issued by the central government for a local government unit loan) are excluded, as being actual and explicit liabilities of local governments and, therefore, part of the general government debt and general balance sheet. Excluded are also the guarantees issued within the guarantee mechanism under the Framework Agreement of the European Financial Stability Facility (EFSF), derivative-type guarantees, deposit insurance guarantees or similar schemes, and guarantees issued regarding events whose occurrence is difficult to cover via commercial insurance (natural disasters, large scale floodings, etc.) (European Commission, 2013).

Government guarantees are an important instrument of public policy, allowing for the access to borrowing of agents who would otherwise be excluded, or significantly diminishing their borrowing costs. Governments could use them to influence conditions on financial markets, and spur production, investment, and saving in the national economy (OECD, 2006), while incurring lower costs over the short run compared to alternative measures such as outright government support through subsidies or tax cuts. These are good policy options for keeping the impact on the budget balance and government debt to a minimum. However, over the long run, they might prove to be more expensive (Polackova, 1999).

The value of the guarantees issued can be easily known, as governments keep records of them. However, evaluating potential government payments stemming from these guarantees is not at all straightforward, because it is not possible to make a reliable estimation of the risk of call for each individual loan; hence, the ‘potential’ nature of such government obligations.

Nevertheless, some distinctions can be made between one-off and standardised guarantees. Compared to the former, the latter suppose repeated (large number) and smaller-size (lower-value) transactions, with very similar features and pooling of risks. Therefore, in this case, some estimates can be made, based on the number of individual defaults expected within the large number of guarantees issued (European Commission, 2019). As such, it is possible for the government to calculate and perceive a fee for covering the risk of default, just like an insurance company does (OECD, 2006). Government involvement could come in the form of a significantly lower fee compared to an equivalent market fee. This fee can be raised to a guarantee fund used to cover the losses from defaulting loans. Future government expenditure stemming from guarantees issuing is limited, in this case, to losses above the levied fees.

b. Liabilities of public corporations

Public (financial and non-financial) corporations are government-controlled entities that are not included in the general government sector. Since they are market units, they should operate similarly to private corporations, cover their expenses from revenues, and repay their own debts. However, they may operate in sensitive sectors and provide goods and services that are essential to the well-functioning of an economy. Moreover, for policy reasons, they may provide such goods and services at lower prices, which impacts their financial situation. In the case of financial and economic challenges, it is not unusual for governments to intervene and take over the obligations of such corporations. Therefore, the liabilities of public corporations are a potential liability for the government.

c. Off-balance PPPs

Public Private Partnerships (PPPs) are long-term contractual arrangements between government units and private companies used to develop projects in infrastructure or service production, such as public transportation networks, parks, educational or health infrastructure, etc. From a policy perspective, these allow the government to deliver large infrastructure projects when there is little fiscal space. The initial impact on capital expenditure is lower, as the costs of the project are distributed over a longer period (Ireland Department of Finance, Economics Division, 2021). Although a useful policy instrument, ongoing PPPs agreements involve future potential liabilities for the government and future risks.

d. Government non-performing loans

Non-performing loans (NPLs) are loans held by the government for which principal and/ or interest payments are overdue.[2] They do not fully comply with

[2] A more rigorous definition requires loans to satisfy three criteria in order to be considered NPLs: interest and/ or principal payments are more than 90 days overdue;

the definition of contingent liabilities, as they are rather government assets than liabilities, recognised in the government's balance sheet (Ireland Department of Finance, Economics Division, 2021). However, they imply potential losses, and therefore, should be taken into consideration when assessing fiscal risks, just like in the case of the previous contingent liabilities.

Evaluating the overall risk for public finance should take into consideration potential overlapping. For example, the government could issue a guarantee for a government-controlled corporation, which is recorded as both governmental guarantees and liabilities of government-controlled entities.

5.3.2. Recent developments in the EU Member States

Contingent liabilities were brought into the spotlight in the EU during the global crisis of 2008-2010 and the subsequent euro area government debt crisis when policy responses in many countries involved large-scale government guarantees, especially related to the liabilities of the financial sector. Nevertheless, even before public guarantees have played an important role for reaching other policy objectives, such as supporting investors, consumers, or achieving a better allocation of credit resources.

In response to the banking sector crisis, governments in some EU countries effectively acted as guarantors of last resort, in addition to other measures such as the direct provision of capital by public authorities or liquidity by central banks (Estrella and Schich, 2011). In this way, a significant burden as contingent liabilities was created, which seriously affected the creditworthiness of some EU governments (Estrella and Schich, 2011).

The COVID-19 pandemic resumed the growth trend of contingent liabilities in 2020 and 2021, although at a smaller scale compared to the previous crisis. In addition to other policy support measures with direct budgetary impact, extensive government guarantee programmes were introduced in many EU

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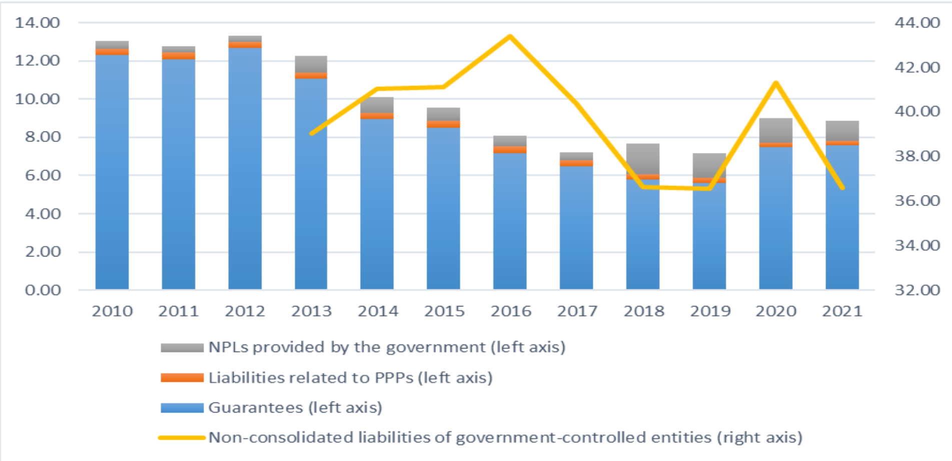
interests payments of 90 or more days overdue have been capitalized, refinanced or delayed by agreement; payments are less than 90 days overdue, but there are serious reasons to believe that they will not be made fully or partially (Ireland Department of Finance, Economics Division, 2021).

countries to cushion the effects of the health crisis, resulting in a substantial increase not only in direct but also contingent liabilities.

Except for the obligations of public corporations, government guarantees on third-party liabilities (and occasionally, assets) represent the most important form of contingent obligations in the EU (see Figure 5.2). In 2010, the average value of guarantees for the EU member states reached 12.33% of GDP, and this decreased to less than half by 2019 (5.6% of GDP). The increase to 7.56% of GDP by 2021 reflects the EU governments' efforts to support financial and non-financial corporations and mitigate the effects of the COVID-19 pandemic. Other types of contingent liabilities, such as the obligations related to off-balance PPPs and the NPLs provided by the government sector usually represent less than 0.5% of GDP, although an increase in NPLs to over 1% is registered after 2018.



Notes: (i) average values for the EU countries for which data are available in each year; (ii) data on the liabilities of government-controlled corporations have been presented separately because of their non-consolidated version; some corporations' liabilities could correspond to others' assets, hereby an overstating of the potential obligation incurred by the government.

Source: author's calculations based on Eurostat (2023b)

Figure 5.2. Contingent liabilities in EU-27 over 2010-2021 (% of GDP)

If we look at the situation of different EU member states, as depicted in Table 5.3, we see that the highest amount of government guarantees was registered, in 2021, in Germany (17.31% of GDP), closely followed by Austria (17.05%) and Finland (17%). In most of the Central and Eastern European countries (Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, and Slovakia) and Ireland, such guarantees represent less than 2% of GDP. With some notable exceptions (such as Italy, Portugal, Romania, and Spain), most guarantees take the form of one-off guarantees. Moreover, most guarantees are issued by the central government, which generally assumes the function of economic stabilisation and responsibility of providing support to the real economy in times of need or for specific policy reasons.

Liabilities related to PPPs outside government accounts are of small scale in all the EU countries, with values above 1% of GDP only in Portugal and Slovakia. In both these cases, the obligations mainly relate to motorway projects (Eurostat, 2023c). The same situation is recorded for the NPLs provided by the government sector, although Cyprus exceptionally stands out with 20.2% of GDP, due to the take-out of an important amount of NPLs (€7.5 bln.) from Cyprus Cooperative Bank, a state-owned financial corporation, in August 2018.

Table 5.3. Composition of contingent liabilities in the EU member states, in 2021 (% of GDP)

Country	Guarantees			Liabilities from PPPs	NPLs	Liabilities of government-controlled corporations
	Overall	One-off	Standardised			
Austria	17.05	17.05	0.00	0.12	0.03	27.04
Belgium	8.54	7.95	0.59	0.42	0.06	48.84
Bulgaria	0.40	0.35	0.05	0.00	0.02	11.64
Croatia	1.91	1.80	0.12	0.06	1.11	9.08
Cyprus	5.95	5.95	0.00	0.07	20.19	14.71
Czech Republic	0.73	0.73	0.00	0.16	0.43	18.95
Denmark	11.05	10.96	0.09	0.17	0.36	32.47
Estonia	1.70	0.16	1.54	0.04	0.23	12.64
Finland	17.00	15.01	2.00	0.02	0.08	51.32
France	15.25	12.88	2.37	0.00	0.07	n.a.

Country	Guarantees			Liabilities from PPPs	NPLs	Liabilities of government-controlled corporations
	Overall	One-off	Standardised			
Germany	17.31	17.31	0.00	0.00	0.03	94.88
Greece	14.40	13.43	0.97	0.18	0.27	163.00
Hungary	9.11	6.36	2.75	0.88	0.04	16.22
Ireland	0.25	0.15	0.10	0.58	0.16	37.03
Italy	16.01	6.00	10.01	0.01	0.34	68.39
Latvia	1.94	0.54	1.40	0.03	0.08	18.78
Lithuania	1.19	0.48	0.71	0.07	0.05	10.00
Luxembourg	8.74	7.51	1.23	0.00	0.00	73.49
Malta	8.16	6.82	1.34	0.04	0.00	18.12
Netherlands	4.42	4.42	0.00	0.00	0.04	n.a.
Poland	3.06	1.43	1.62	0.00	0.09	49.57
Portugal	6.06	2.80	3.26	2.01	1.42	40.93
Romania	4.09	0.71	3.38	0.00	0.11	8.31
Slovakia	0.97	0.08	0.89	1.52	0.12	3.60
Slovenia	5.51	5.39	0.12	0.00	1.76	24.77
Spain	11.61	2.98	8.63	0.25	0.85	5.64
Sweden	11.81	11.81	0.00	0.00	0.53	55.33

Note: (i) n.a – non-available value.

Source: Eurostat (2023b)

The liabilities of public corporations are, on the contrary, very important, with values over 50% of GDP in countries like Finland, Germany, Italy, Luxembourg, Sweeden, and Greece (163% of GDP), and below 10% in Croatia, Romania, Slovakia, and Spain. Debt funding is not unusual for the public economic sector, just like for the private one, and such debts, although important, should be repaid from the companies' own resources. However, even at relatively low levels of public corporations' debt, this could imply a high risk for the government when accompanied by poor financial management of such corporations.

5.4. EU architecture for preventing government debt crises and ensuring public finance sustainability

5.4.1. Supranational EU fiscal governance framework

Since the early days of the European Union, as plans for a monetary union were drawn, it has been clear that ensuring macroeconomic stability and the fiscal discipline of participating countries is an essential condition for such an endeavour's success. The Treaty on European Union (TEU) of 1992, also known as the Maastricht Treaty, set four nominal convergence criteria for joining the eurozone, among which sustainable public finance. Article 104c of TEU (and further, 126 of the Treaty on the Functioning of the European Union -TFEU) asks member states to avoid "excessive government deficits" and enacts the Commission with the task of monitoring budgetary developments (government deficits and debts) in participating countries. Moreover, it sets the procedural steps to be followed for establishing that such a deficit exists and correcting measures. The Protocol No. 12 on the excessive deficit procedure annexed to the Treaty defines explicit quantitative limits (as % of GDP) for budgetary indicators: government deficit should be below the threshold of 3%, and public debt should not exceed 60%.

In time, the initial fiscal provisions have been further developed and amended by primary and secondary EU legislation (Delivorias, 2021), to cope with the new challenges and an ever-changing European economic and political environment. In particular, the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in EMU complemented the provisions of the Maastricht Treaty and came to represent, altogether, the three major pillars of the EU's fiscal governance framework.

The Stability and Growth Pact (SGP) was introduced in 1997, to ensure further incentives for the EU countries to keep sound budgetary positions once the single currency was adopted. The SGP relies on two main dimensions: the 'preventive arm' (Council Regulation (EC) no. 1466/97 of 7 July 1997) and the 'corrective arm' (Council Regulation (EC) no. 1467/97 of 7 July 1997). The 'preventive arm' provides guidance for budgetary planning and execution for the EU countries that do not deal with excessive deficits, while the 'corrective arm' establishes the steps to be followed and measures to be applied for the excessive deficits to be corrected, in the EU member states for which the Excessive Deficit Procedure (EDP) was opened.

Over the years, the SGP suffered several amendments, starting with the reform of 2005, which allowed for better consideration of the national circumstances of individual countries and added more economic rationale to the budgetary rules (European Commission, 2023a) by introducing the structural budget balance as a reference for assessing the course of fiscal policies in the EU member states. Further on, following the onset of the economic and financial crisis and later government debt crisis in Europe, additional legislative measures were introduced to deal with the weaknesses in the fiscal governance framework, through the adoption of the 'Six-Pack', in 2011 (which added an expenditure benchmark to the SGP and defined the pace of debt reduction appreciated as satisfactory), and 'Two-Pack', in 2013 (which set out enhanced surveillance requirements for different fiscal situations and strengthened cooperation in budgetary matters).

In 2012, the inter-governmental Treaty on Stability, Coordination and Governance (TSCG) established stricter provisions than the ones of the SGP through its fiscal part, known as the 'Fiscal Compact', requiring national provisions to be introduced targeting the fiscal objectives set by the SGP (European Commission, 2023a).

Overall, the current EU fiscal governance framework relies on several major features (see Figure 5.3).

Anchors	**Operational instruments**
- overall budget deficit below 3% of GDP - overall government debt below 60% of GDP - country-specific MTOs for the structural budget deficit	- expenditure benchmark based on potential GDP growth - minimum structural budget balance adjustment if below MTO - debt correction benchmark
Enforcement	**Institutional features**
- European Commission through the Excessive Deficit Procedure (EDP)	- national fiscal councils - European Fiscal Board - medium-term fiscal planning

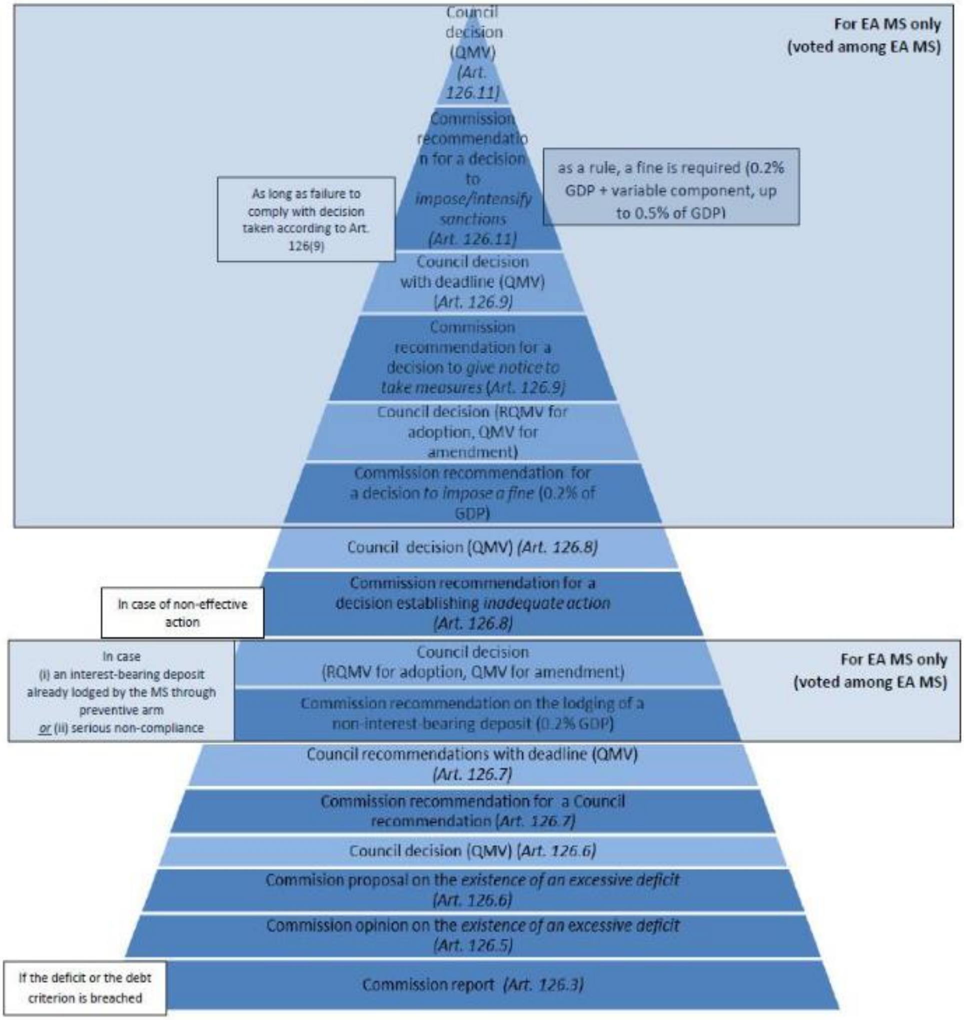
Source: adapted after Arnold *et al.* (2022)

Figure 5.3. Main features of the current EU fiscal governance framework

Quite surprisingly, the budget deficit and government debt quantitative limits are unchanged after more than 30 years since their enactment through the Treaty of Maastricht. The overall budget deficit should not overpass 3% of GDP unless the increase is exceptional, of small value, and temporary, and government debt should be below 60% of GDP unless it is declining at a reasonable pace to within acceptable limits. In operational terms, the diminishing rate is deemed acceptable when the government debt in excess over the 60% threshold decreases by at least 5% (1/20th) each year, on average over a three-year period.

Under the 'corrective arm' of the SGP, when the above thresholds are breached, the EDP may be launched. Compared to the pre-crisis situation, the current EU fiscal framework puts greater emphasis on government debt, since the EDP can be opened for a country not only when the deficit rule is broken but also when government debt is higher than 60% of GDP and not reducing at a sufficiently high pace. The EDP entails several steps (outlined in art. 126 of the TFEU) that are followed consecutively until the excessive deficit is corrected (see Figure 5.4 for an outline of these procedural steps). Sanctions may be applied when countries fail to correct their unsustainable public finance, ranging from a simple obligation to publish additional information when issuing bonds and securities, to imposing a fine as % of a country's GDP (in the case of the euro area member states).

In addition to the 3% budget deficit and 60% government debt rules, under the 'preventive arm' of the SGP member states have committed to ensure budgetary positions close to balance or in surplus over the medium term. The main argument behind this is the need to take full advantage of the built-in stabilisers when economic conditions are unfavourable, without breaching the deficit limit and becoming subject to sanctions under the 'corrective arm' of the SGP (Artis and Buti, 2000). In this respect, the EU member states set country-specific medium-term budgetary objectives (MTOs), defined in structural terms (accounting for the impact of economic downturns and one-off measures), which may be revised every three years. The MTOs cannot be lower than a structural deficit of 1% of GDP for the euro area countries. In addition, the signatory countries of the Fiscal Compact committed to keep MTOs above a deficit of 0.5% of GDP, until their public debt is well below 60% of GDP and there are no threats to long-term fiscal sustainability. When the medium-term objectives are not met, the EU countries must at least improve their fiscal position by adjusting their structural budget balance with 0.5% of GDP each year as a benchmark (European Commission, 2023b), with more progress expected in good times and less under unfavourable economic conditions. The Commission and the Council monitor the EU countries' progress towards their MTOs.



Source: European Commission (2023c)

Figure 5.4. Stages of the Excessive Deficit Procedure (EDP)

Under the 'preventive arm' of the SGP, a government expenditure benchmark was introduced in 2011 to foster progress toward MTOs. This expenditure benchmark limits the annual growth rate of government spending in relation to the medium-term rate of GDP growth in a country. EU member states that have not reached their MTOs should have a growth rate of government expenditure below this reference rate of economic growth for the progress to be deemed adequate. This rule does not limit in any way the level or growth rate of government spending but ensures that equivalent permanent funding is provided.

The surveillance and coordination of fiscal and overall economic policies in the EU is enabled through the European Semester, introduced in 2011. This framework ensures a wider approach, beyond fiscal issues, which permits for the alignment of the goals of national fiscal, economic, and employment policies (European Commission, 2023d). Within it, member states draw and submit, in spring each year, national reform programmes and medium-term fiscal plans (called stability programmes for the euro area countries, and convergence programmes for the other), presenting, among others, their plans to comply with EU's fiscal rules and existing country-specific recommendations (European Commission, 2023d). On these grounds, the Commission draws country reports for each member state and formulates proposals for country-specific recommendations, which should be incorporated into the budgetary plans for the next year. The euro area countries must also submit to the Commission, in autumn each year, the draft budgetary plans for the following year; the recommendations formulated by the Commission must be considered when drawing the final version of the national budgets.

To strengthen commitments to ensuring fiscal sustainability, independent national fiscal institutions were created, following the requirements spelled out in the 'Two-Pack' and the Fiscal Compact. Their responsibilities are to monitor the national government's compliance with numerical budgetary targets, assess the appropriateness of fiscal policy, and provide specific policy recommendations.[3] At the EU level, the European Fiscal Board was set up in 2015, with the mandate to advise the European Commission on budgetary

[3] For more details on the organization, functioning and role of the independent fiscal institutions see Chapter 7.

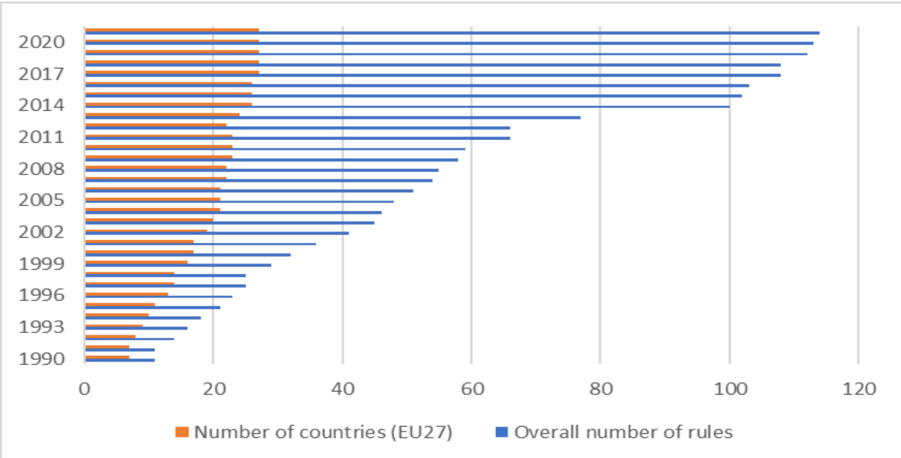
matters. More explicitly, its role is to advise the Commission on the appropriate fiscal stance for the eurozone, assess the implementation of the EU fiscal framework and make proposals for its development, and cooperate with the national independent fiscal institutions (European Commission, 2023e).

In the end, despite major progress, the existing set of EU supranational fiscal rules and procedures is still perfectible. The first review of the SGP after its major reforms in 2011 and 2013, which was carried out in 2014, emphasised that there was not enough evidence on the effectiveness of the new fiscal framework because of the short time since its reformation (Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions COM/2014/0905 final). A second review of the effectiveness of the current framework, performed in 2020, highlighted not only strengths, but also paths for further improvements, and the European Commission further launched a new initiative for reforming the EU fiscal governance. In November 2022, it made public the guidelines for the reform, including a wide range of changes in the design and operational features of the SGP. In April 2023, a package of three proposals to revise the economic governance framework was launched, including changes in the preventing and correcting arms of the SGP and a more important role of independent fiscal institutions (IFIs) - see Höflmayr (2023) for an overview of these proposals.

5.4.2. Domestic fiscal rules of the EU member states

In addition to the common set of rules at the supranational level, the EU member states introduced their own set of domestic rules to ensure fiscal discipline and limit government debt. The two categories of rules are complementary, as they act together to achieve the common objective of public finance sustainability in the European Union. The existence of rules at the national level, adapted to the specific realities of the country in question, increases the chances of success of the rules established at the European level, as they express the political will and explicit commitment of national governments to ensure fiscal discipline (Bilan, 2015). Nevertheless, recent evidence shows that the existence of domestic rules is not enough per se; only well-designed national rules that are complied with support compliance with supranational fiscal rules (European Commission, 2022a).

Domestic fiscal rules became a generalized practice in the EU member states with the Treaty on Stability, Coordination and Governance in EMU, which obliged the signatory countries to transpose into national legislation its fiscal provisions (in particular, a budgetary position in balance or in surplus, interpreted as a structural budget deficit not exceeding the country's MTO). Nevertheless, the need to complement the EU fiscal framework by introducing national numerical rules is older than this. In a report on the SGP's reform of March 2005, the Council of the European Union stated that "national budgetary rules should be complementary to Member States' commitments under the Stability and Growth Pact" (Council of the European Union, 2005).

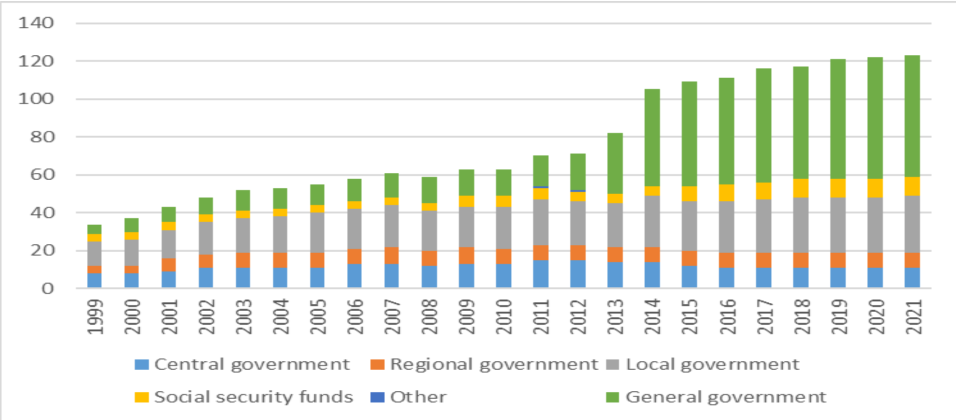


Source: computed by the author based on data from the Fiscal governance database (European Commission, 2022b)

Figure 5.5. Overall national fiscal rules in EU 27 (1990-2021)

The practice of national fiscal rules to prevent unsustainable debt levels does not have a very long history in EU27. Figure 5.5 shows that the number of rules, as well as the number of countries implementing them, have grown steadily over the last three decades, more pronounced after the global economic and financial crisis of 2008-2009. If in 1990 only 7 countries out of 27 had such rules, their number reached 27 (100%) in 2017, with the Czech Republic being the last EU country to introduce such rules. In addition, the number of fiscal rules increased tenfold, from just 11 in 1990 to 114 in 2021.

In time, fiscal rules have been introduced for all government levels (see Figure 5.6). However, if before 2013 most numerical rules concerned local public authorities (13 out of a total of 34 in 1999, and 23 out of a total of 71 in 2012), the situation changed in subsequent years. It can be noted, especially since 2011, a sharp increase in the number of rules applied to the general government; in 2021, more than half (64 out of 123) rules were applied to this government sector.



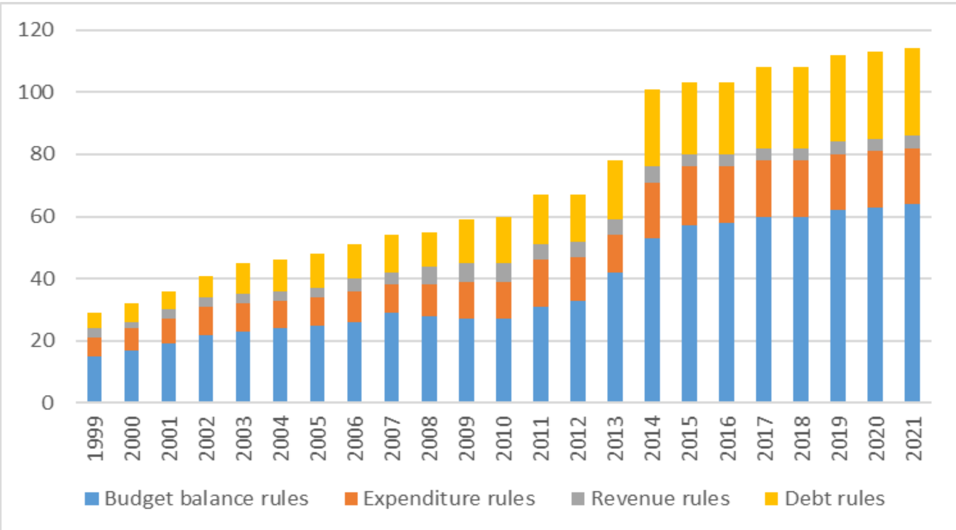
Note: (i) The rules concerning several government levels are reported as multiple rules (e.g., a rule concerning both the local and federal government is reported as two distinct rules).

Source: computed by the author based on data from the Fiscal governance database (European Commission, 2022b)

Figure 5.6. Number of national fiscal rules in EU 27, by level of government (1999-2021)

If in the past it was considered necessary to allow for a more extensive possibility of discretionary action for the central authorities (which, according to the “Musgravian” view, assume the responsibility of economic stabilisation) compared to the local or federal governments, so that fiscal rules concerned especially the lower levels of government, the challenges of the last decades have brought forward the need to equally establish fiscal rules limiting the unsustainable behaviour of the central authorities (or of the general government, in which they are included) (Bilan, 2015). Therefore, out of the 27 EU member states, at the end of 2021, 8 had rules for central governments, 18 for local ones, 4 for regional governments, and 6 for social security authorities; at the same time, all the EU countries had fiscal rules covering the general government. A high degree of coverage of these rules is essential for ensuring high efficiency in preventing the unsustainable debt increases, especially when access to loans is allowed to public authorities at all levels (Bilan, 2015).

Regarding the targeted budgetary outcomes, fiscal rules can refer to either the size of government debt (limiting the gross or net public debt as a percentage of GDP, etc.), the budget balance (requiring for a balanced budget, limiting the structural budget balance as a percentage of GDP, etc.), budget revenues or expenditure (ceiling the annual budgetary expenditure or limiting their annual growth rate). In the practice of EU countries, most rules concern the budget balance, as can be seen from Figure 5.7. In 2021, out of the 114 existing rules, 64 (more than half) limited the budget balance, only 28 the level of public debt, and only 22 the budget revenues or expenditures.



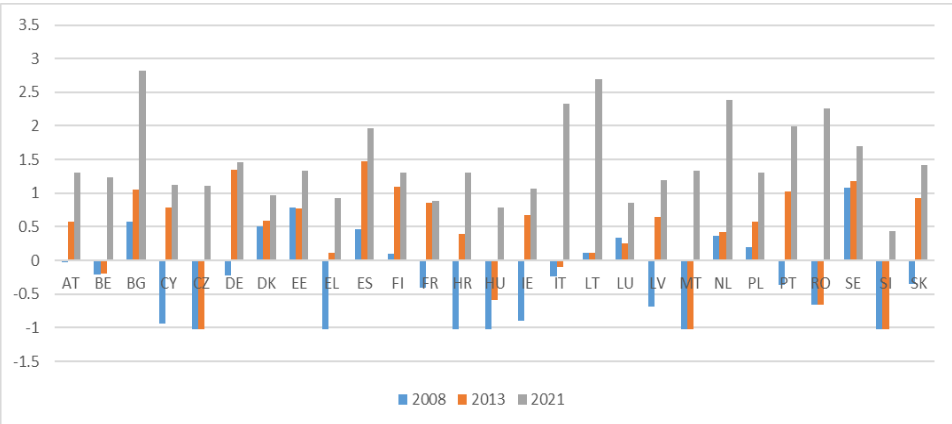
Note: (i) The rules concerning several budgetary variables are reported as multiple rules

Source: computed by the author based on data from the Fiscal governance database (European Commission, 2022b)

Figure 5.7. Number of national fiscal rules in EU 27, by type of rule (1999-2021)

Therefore, the rules aimed at controlling the size of the budget deficit, as a generating factor of government debt are, most often, preferred by public authorities to the detriment of those regarding the quantitative limitation of the debt stock. In practice, it is generally considered that the best results are obtained when these two categories of rules are combined (Bilan, 2015). However, in the EU member states, out of the 27 countries that have implemented rules at the national level, only 21 combine budget balance rules with debt rules. Nevertheless, most rules regarding the budget balance and public debt are applied at the level of the general government.

Achieving positive effects through the implementation of rules controlling fiscal outcomes does not depend only on the targeted budgetary variables and their coverage but is also conditional on the existence of monitoring institutions and appropriate enforcement/sanctioning mechanisms (Bilan, 2015). Moreover, it is important if the rules are established by the constitution (which makes them more 'unbreakable'), law, or are the result of budgetary procedures. From this point of view, progress prior to the crisis was quite fragile. According to the European Commission (European Commission, 2009), at the end of 2008, many of the existing national fiscal rules were not accompanied by independent monitoring institutions and functional enforcement mechanisms to ensure the correction of the governments' 'off-the-path' behaviour, when the rules were violated.



Source: computed by the author based on data from the Fiscal governance database (European Commission, 2022b)

Figure 5.8. Fiscal rules strength index in EU 27

In the post-crisis period, not only the number of rules grew but they became stronger, which is reflected by the increase in the value of the fiscal rules strength index, measuring the ability of all the rules in force in a country to correct unsustainable public behaviour. It can be noticed from Figure 5.8 that the value of the index increased over the period 2008-2021 in all EU member states, more accentuated in Bulgaria, Italy, Lithuania, Netherlands, and Romania.

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CHAPTER 6

INDEPENDENT FISCAL INSTITUTIONS AS SAFEGUARDS OF FISCAL POLICY SUSTAINABILITY IN THE EUROPEAN UNION

George Georgescu[1], Bogdan Căpraru[2]

6.1. Introduction

Following the global financial crisis of 2008-2009, many European countries have set up independent fiscal institutions (IFIs), also known as fiscal councils. IFIs are independent, watchdog-type public institutions with a mandate to assess objectively and, in some cases, provide non-partisan advice on fiscal policy and its performance. They are composed of specialists in the field, usually from academia and experts from financial and banking institutions. IFIs serve - often in combination with credible fiscal rules - to promote sound fiscal policies and sustainable public finances.

The first IFIs date back to 1936 in Belgium, and later similar institutions were established in the Netherlands (1945), Denmark (1962), Austria (1970) and the United States (1974). Based on the experience of these first IFIs, during the 1990s both economists and academia increasingly emphasized the idea that good practices developed by independent central banks should be extended to the fiscal-budgetary field.

Following the global financial crisis of 2008-2009, the number of such institutions almost tripled (from 10 at the end of 2006 to 37 at the end of 2015), the largest increase being recorded in the European Union (EU). By 2019, all the

[1] George Georgescu is senior researcher at the National Institute for Economic Research Costin C. Kirițescu – Romanian Academy and member of the Fiscal Council of Romania.

[2] Bogdan Căpraru is Ph.D. habil., professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași and member of the Fiscal Council of Romania.

EU member states had established independent fiscal institutions. This is due to the fiscal and budgetary reforms taking place within the EU after the crisis. The idea of setting up independent fiscal institutions is older, being supported by International Monetary Fund (Annett *et al.,* 2005) and OECD staff members through its Economic Survey publications. Academic literature has addressed the need for such institutions since the mid-1990s. Thus we mention von Hagen and Harden (1994), Blinder (1997), Wyplosz (2002), Fritzes and Wyplosz (2005), Calmfors (2003, 2005), and Wren-Lewis (1996, 2003).

In combination with fiscal-budgetary rules (limiting budget deficits and public debt), these new institutions were designed to strengthen budgetary discipline. Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States introduced for the first time the need for independent fiscal institutions to be involved in the budgetary process. According to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (2013), euro area Member States must have an independent institution to monitor compliance with fiscal rules at the national level and also to validate and/or provide macroeconomic projections.

Following the Five Presidents' Report - entitled "Completing Europe's Economic and Monetary Union", the European Fiscal Board was established in October 2015, a supranational entity that would fulfill the role of an IFI at EU level. Its main responsibilities are: to assess the implementation of the Union's budgetary framework and the adequacy of budgetary guidelines in the euro area and at European level; to make suggestions for the future evolution of the Union's budgetary framework; to assess the prospective budgetary orientation for the euro area as a whole, on the basis of economic reasoning, as well as the appropriate national budgetary guidelines, in accordance with the rules set out in the Stability and Growth Pact; to cooperate with national IFIs; to provide ad-hoc advice to the President of the Commission (European Commission, 2023d).

In 2010, one of the first independent fiscal institutions after the crisis was established in Romania (in 2007 in Sweden and in the same year in the United Kingdom) - the Romanian Fiscal Council, which was set to oversee the proper functioning of public finances in our country. It operates according to the provisions of the Fiscal Responsibility Law no. 69/2010 which entered into force on April 23, 2010.

6.2. Mission and functions of IFIs in the EU. Legal requirements and correction mechanisms

Discretionary fiscal policies suffer from two major shortcomings, which are interdependent: a propensity for growing budget deficits and pro-cyclicality. The budget deficit involves higher public expenditures than revenues, and pro-cyclicality involves fiscal policy actions that amplify the phases of the business cycle (e.g., tax reductions during boom phases or tax increases during recessions).

In order to keep these shortcomings under control, a series of fiscal rules have been introduced, mostly numerical. Thus, the two nominal convergence criteria are implemented across the EU: limiting the budget deficit to 3% of GDP and the public debt to 60% of GDP. These constitute a prevention mechanism to ensure the soundness of public finances. They are set out in the EU's Stability and Growth Pact (SGP) which denotes a set of rules governing the coordination of fiscal policies in EU countries.

In April each year, euro area countries submit stability programs to the Commission and the Council, while non-euro area countries submit convergence programs to the same institutions. These include the country's medium-term budgetary objective (MTO), as well as information on how it will be achieved, and an analysis of the effects that changes in the main economic assumptions underlying the program could have on the country's fiscal position. The Commission examines these programs and, if the criteria are not met, the Council will initiate an Excessive Deficit Procedure (EDP) on the basis of the Commission's recommendations. The latter mechanism requires the country to present a plan with the corrective measures and policies it will apply, as well as the deadlines for their implementation, and it is possible to impose fines on euro area countries that do not comply with the recommendations (EUR-LEX, 2023).

But these fiscal rules alone cannot prove effective in the absence of independent institutions that enhance their visibility and increase control over them. Deviations from optimal fiscal policies are due to a number of phenomena such as the fiscal illusion, the time inconsistency of fiscal policies, as well as the inclination of some governments to strategically reduce the fiscal space of following governments (Jankovics and Sherwood, 2017).

Through continuous monitoring by these independent institutions, the level of transparency and accountability in the budgetary process increases. At the same time, the information asymmetry is diminishing and the quality of the debates on fiscal policy is increasing. Through independent analysis, evaluation and forecasting, such entities can raise public awareness concerning the consequences of certain fiscal policy pathways, contributing to a culture of stability. Therefore, a fiscal council can increase the electoral and reputational costs of non-compliant policies and breached commitments. Last but not least, an IFI can make direct contributions to the budgetary process - e.g. forecasts or assessments of structural positions, technically assisting governments in avoiding non-compliance with fiscal rules. They can identify sensitive fiscal policy options and even make recommendations. The activity of IFIs is all the more effective if there is good collaboration and openness between them and government authorities (IMF, 2013).

A 2017 analysis of the International Monetary Fund (IMF, 2017) shows that only in the case of states that have fiscal rules, accompanied by the existence of independent arrangements to monitor compliance with them, are recorded lower public debt costs, this result being found even in countries with a "mixed" record in terms of fiscal responsibility. Also, Debrun and Kinda (2014) showed that the activity of IFIs is correlated with budget executions complying with fiscal rules and better accuracy forecasts, if these institutions have the following characteristics: they are independent from a political standpoint; they are present and vocal in the public space (especially through the media); they have a mandate to monitor the numerical targets of budget execution (especially the budget deficit); they make fiscal-budgetary forecasts and/or critically analyze those performed by the government.

The mandates with which IFIs are invested at EU level differ from country to country, but common responsibilities can be identified for making/approving/analyzing macroeconomic and budgetary forecasts, as well as monitoring compliance with established fiscal rules. In Romania, the Fiscal Council fulfills attributions such as: evaluates the macroeconomic projections taken into account when substantiating the revenue forecast of the general consolidated budget, estimates the impact of measures likely to influence the budget balance, analyzes the budget execution and the extent to which it corresponds to the proposed targets, monitors compliance with fiscal rules, issues recommendations on current and future fiscal policy.

In what concerns the independent macroeconomic forecasts for the preparation of the 2019 draft budget (European Parliament, 2019), the involvement of IFIs in euro area countries was as follows: in 6 countries it was carried out by IFIs (Belgium, Netherlands, Luxembourg, Austria, Slovenia, and Finland), in 12 countries it was approved by IFIs (Germany, Estonia, Ireland, Greece, Spain, France, Cyprus, Latvia, Lithuania, Malta, Portugal, and Slovakia), out of which in 6 countries it received critical comments (Estonia, Greece, France, Portugal, and Slovakia), Italy approving only the macroeconomic forecast of the final form of the state budget. In what concerns the convergence programs for non-euro countries, they were not based entirely on IFIs' macroeconomic and budgetary forecasts in any of the Member States.

6.3. Typology and structural characteristics

IFIs can be divided into three basic institutional models (IMF, 2013).

Model 1. Independent institutions, which are closest to the model suggested in academic literature. They are not related to the political factor in terms of appointment and accountability mechanisms. These institutions operate on the basis of Fiscal Responsibility Laws which guarantee their independence. We find this institutional model in Romania, Bulgaria, Cyprus, Germany, Greece, Hungary, Ireland, Malta, Portugal, Slovakia, and Sweden.

Model 2. IFIs that are formally under the executive or legislative leadership of the political system, with a well-defined mandate and strict guarantees of independence from the parliamentary bodies of which they are an integral part (known as Parliamentary Budget Offices) or within a ministry. The latter have operational independence as a result of the reputation gained from their non-partisan role in the budgetary process and public debate. We find this institutional model in EU countries such as Belgium, Croatia, Denmark, the Netherlands, Slovenia. Parliamentary budget offices can be found in Austria, Croatia, Greece, Ireland, and Italy.

Model 3. IFIs associated with other independent institutions such as central banks (Austria - Fiscal Advisory Council - FISK, Estonia) and audit institutions (Finland, France, and Lithuania). This approach allows IFIs to benefit from the independence of the host institution and from the economies of scale involved by integrating its activities under the umbrella of a single institution, but requires clear procedures to avoid confusion about the mandates and functions of the host institution and of the IFIs.

Countries such as Austria (models 2 and 3), Finland (models 2 and 3), Greece (models 1 and 2), and Ireland (models 1 and 2) have two entities acting as IFIs.

As it can be observed in Table 6.1, EU IFIs are heterogeneous in terms of their characteristics. Firstly, there are large differences concerning the terms of office, which may be limited to a number of years or involve permanent employees (Independent Monitoring and Evaluation of Fiscal Policy Function - National Audit Office of Finland). The shortest term of office is 3 years in Sweden and the longest in Romania, of 9 years. With regard to the renewal of mandates, they may be unlimited (Austria, Belgium, Croatia, Denmark, Estonia, Finland, Germany, Hungary, and Luxembourg), renewed only once (Czech Republic, Cyprus, France, Greece - Parliamentary Budget Office, Ireland - Irish Fiscal Advisory Council, Latvia, Lithuania, Netherlands - Netherlands Bureau for Economic Policy Analysis, Malta, Portugal, Slovenia, Sweden, and United Kingdom) or cannot be renewed (Romania, Greece - Hellenic Fiscal Council, Italy, Slovakia, and Spain).

The size of the board and of the technical staff also differs. Thus, there are fiscal councils that have only technical staff (Lithuania, Netherlands, and Spain), while the largest number of board members is 24 in Belgium, and the lowest is 2 in Hungary and the United Kingdom. There are also major differences in the mechanism for appointing board members: who appoints and where the members come from.

The Romanian Fiscal Council is an independent institution, established by the Fiscal Responsibility Law no. 69/2010 which is composed of 5 members with experience in the field of macroeconomic and budgetary policies, subject to strict eligibility criteria. The members of the Fiscal Council are appointed by decision of the Parliament for a period of 9 years, at the proposal of the Romanian Academy, the National Bank of Romania, the Bucharest University of Economic Studies, the Romanian Banking Institute, and the Romanian Association of Banks, which each nominate one person.

On September 11, 2015, at the third informal meeting of EU IFIs held in Bratislava (Slovakia), the EU Independent Fiscal Institutions Network (EU IFIs) was established. The network is a voluntary and inclusive institution, open to all independent fiscal supervisory entities operating in the EU. It provides a platform for exchanging views, expertise and resources in areas of common interest. The agreement has already been signed by 32 IFIs from 26 European countries, the list being: Austria, Belgium (2 institutions), Bulgaria, Cyprus, Croatia, Czech Republic, Denmark, Estonia, Finland (2 institutions), France, Germany, Greece (2 institutions), Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands (2 institutions), Portugal, Romania, Slovakia, Slovenia (2 institutions), Spain, Sweden, and the United Kingdom.

Table 6.1. IFIs in the EU

Country	Name of the IFI	Year of establishment	Term of office (years)	Renewal of mandate	Personnel	
					Board	Technical staff
Austria	Fiscal Advisory Council (FISK)	1970	6	Unlimited	15	6
Belgium	High Council of Finance (HRF/CSF)3	1936	5	Unlimited	24	15
	Federal Planning Bureau	1994	9	Unlimited	1	90
Bulgaria	Fiscal Council	2015	6	n.a.	5	n.a.
Czech Republic	Czech Fiscal Council (CFC)	2018	6	Once	3	8
Cyprus	Fiscal Council of Cyprus	2014	6	Once	3	3-6
Croatia	Fiscal Policy Committy	2013	5	Unlimited	7	n.a.
Denmark	Danish Economic Council	1962	Up to 6	Unlimited	21	30
Estonia	Fiscal Council of Estonia	2014	5	Unlimited	5	1,5
Finland	National Audit Office of Finland	2013	Permanent employees	n/a		4
	Finnish Economic Policy Council (EPC)	2014	5	Unlimited	5	2
France	High Council of Public Finance (HCFP)	2013	5	Once	11	2,5

Country	Name of the IFI	Year of establishment	Term of office (years)	Renewal of mandate	Personnel	
					Board	Technical staff
Germany	Independent Advisory Board to the Stability Council	2013	5	Unlimited	8	1
Greece	Hellenic Fiscal Council	2015	5	Cannot be renewed	4	13
	Parliamentary Budget Office	2011	5	Once	5	11
Hungary	Fiscal Council	2011	6	Unlimited	2	3
Ireland	Irish Fiscal Advisory Council (IFAC)	2011	4	Once	5	6
Italy	Parliamentary Budget Office (PBO)	2014	6	Cannot be renewed	3	24
Latvia	Fiscal Discipline Council	2014	6	Once	6	4
Lithuania	Budget Policy Monitoring Department – National Audit Office of Lithuania (BPMD)	2015	5	Once		7
Luxembourg	National Council of Public Finances (CNFP)	2014	4	Unlimited	7	2
Netherlands	Netherlands Bureau for Economic Policy Analysis (CPB)	1945	7	Once		117
	Raad van State	2014	99	-	5	16
Malta	Fiscal Advisory Council	2014	4	Once	3	4
Portugal	Portuguese Public Finance Council (CFP)	2012	7	Once	5	18
Romania	Fiscal Council of Romania	2010	9	Cannot be renewed	5	20
Slovakia	Council for Budget Responsibility (CBR)	2012	7	Cannot be renewed	3	15-20
Slovenia	Slovenian Fiscal Council	2017	5	Once	3	4
Spain	Independent Authority of Fiscal Responsibility	2014	6	Cannot be renewed		35
Sweden	Swedish Fiscal Policy Council (FPC)	2007	3	Once	6	5

Country	Name of the IFI	Year of establishment	Term of office (years)	Renewal of mandate	Personnel	
					Board	Technical staff
United Kingdom	Office for Budget Responsibility (OBR)	2010	5	Once	2	22
EU	European Fiscal Board (EFB)	2016	3	Once	4	7

Source: Independent Fiscal Institutions Database (OECD, 2021)

6.4. Minimum operating standards

While the constituent format of IFIs has been left to the discretion of the states (taking into account the specific circumstances of their establishment, the specific administrative structure and the particularities of the internal institutional environment, at EU level, and in particular, of the euro area countries which signed the TSCG - Fiscal Compact - applied since 2013), the European Commission has established a set of common principles for monitoring budget projections, mechanisms for correcting deviations from the MTO and/or excessive deficits, strengthening economic and budgetary surveillance for the purpose of maintaining financial stability, including on the role and independence of IFIs, as institutions responsible at national level for monitoring compliance with these principles and rules (European Commission, 2012).

The EU IFIs, based on the experience of its members (fiscal councils and institutions with similar responsibilities in the EU) and on some inaccuracies in the legal framework for the functioning of these institutions at national level, has redefined and adapted these principles to the specifics of their responsibilities, promoting them as minimum operating standards[3], recommended to be implemented in all EU countries.[4] They are briefly presented below.

First of all, IFIs must have ***sufficient and stable human and financial resources*** to ensure full functional autonomy in fulfilling their mandate. It was

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[3] See: *Defining and Enforcing Minimum Standards for Independent Fiscal Institutions* (EU Network of Independent Fiscal Institutions, 2016).

[4] It should be noted that in 2014, the OECD Council recommended IFIs in the Member States to follow a series of principles, similar to those established at EU level (Von Trapp and Nicol, 2008, pp. 20-22).

found that, in general, the resources of IFIs in the EU are lower than those of similar institutions in non-EU countries. The immunization of IFIs' budgets against possible discretionary interventions/reductions by decision-makers can be done through multi-annual budgeting. When establishing the budgets of IFIs, the standards corresponding to the status of independent institutions must be taken into account, similar to the case of central banks. It is important for the management of IFIs to have a ***high degree of flexibility in allocating resources*** within the envelope of their own budgets, as well as total autonomy in hiring and/or firing technical staff, provided there is an attractive and competitive salary package which gives the necessary attributes of competence and stability.

Ensuring access to relevant information, in real time and unrestricted, is an essential principle and a prerequisite for ensuring the functionality of IFIs. This information, provided by government tax authorities, in addition to the numerical details strictly concerning the configuration of the fiscal-budgetary projection, must include the methodologies and assumptions considered in the macroeconomic projection and budgetary planning, with the possibility for IFIs to request additional information from ministries of finance or directly from other providers, as well as their obligation to make them available in a timely manner. The transmission of data and information by government tax authorities before they become public may prove useful, while ensuring their confidentiality. It is essential that the degree of accessibility to information related to the field of activity of IFIs is similar to that granted to other national public authorities (Parliament, Constitutional Court, Court of Accounts, etc.). Also, the participation of IFIs in government committees/commissions on statistical issues involving fiscal data and/or budgetary procedures may be appropriate.

Implementation of the principle/procedures "Comply or Explain" according to which the fiscal policy authorities have the obligation to respond publicly, within a set timeframe, to the opinions/recommendations formulated by the IFIs. Given that the IFIs' mandate covers a wide area of responsibilities, it is recommended to create the appropriate legal framework for this requirement, with clear deadlines for fiscal authorities, as well as the obligation to justify and substantiate the informational content of responses, both in the case of the opinions, as well as of the IFIs' recommendations, the latter having to be supplemented with the implementation schedule of the compliance actions. In this respect, the importance of organizing bilateral technical meetings that would contribute to clarifying/reconciling differences of opinions cannot be omitted.

Protection against political pressure/interference is crucial to ensuring the functionality of IFIs. The selection and appointment of members needs to be made on the basis of criteria based on professional experience and competence, in compliance with strict rules on conflict of interests, and the mandate should be set independently of electoral cycles, and may include parliamentary public hearings.

In addition to opinions and recommendations on fiscal-budgetary projections, IFIs have the opportunity to prepare reports and analyzes on their own initiative, in line with the mandate. Depending on the institutional framework for each country, it is considered that the most appropriate protection against possible political pressures can be ensured by IFIs' accountability exclusively to Parliament. Another line of defense, complementary to it, is the ***international monitoring*** at the EU level, which involves the creation of tools to coordinate the practices of IFIs, an idea under debate in the European Commission.

In 2019, in order to implement these principles, aiming to ensure the increase in the operational capacity of IFIs, a proposal was made aiming to incorporate them into European legislation or, if this cannot be done within a reasonable timeframe, to introduce them in a ***voluntary Code of Conduct*** signed by all EU Member States, accompanied by a recurrent monitoring procedure by the European Commission, complemented by an appropriate evaluation mechanism[5].

6.5. Channels of influence and evaluations of the effectiveness of IFIs

In general, although there are difficulties in quantitatively assessing the impact of IFIs on fiscal-budgetary outcomes, they are considered to have a positive influence in the context of budgetary processes and an accountable public finance management.

Formally, IFIs do not have the power to intervene on fiscal-budgetary policies, but they have a “soft” power of influence, exercised by increasing public awareness on these policies, especially in the case of significant slippages

[5] See: *Network Statement on the Need to Reinforce and Protect EU IFIs* (EU Network of Independent Fiscal Institutions, 2019).

from fiscal discipline and responsibility. The soft power of IFIs is based on two pillars: credibility and communication.

Credibility is gained over time and depends on the recognized expertise of members, the quality of analysis, the substantiation of opinions and recommendations, independence from the government, political neutrality. However, a high degree of credibility does not matter too much if it is not accompanied by an ***effective and consistent communication***, capable of leading to increased fiscal transparency or higher political costs for governments that ignore IFIs' recommendations (Claeys, 2019).

The communication channels are multiple, respectively through the publication of opinions and reports, organization/participation in public debates, seminars and conferences, parliamentary hearings, interaction with the press and media channels.

By publicly providing objective information on the state of public finances, the impact of current and projected fiscal-budgetary policies, or signaling the deviations from previous commitments and/or breaches of fiscal discipline rules, including from the perspective of potential irreconcilabilities regarding intergenerational equity, IFIs can contribute to clarifying the political scene and electoral options by correctly informing citizens.

Thus, voters can knowingly sanction macroeconomic and fiscal-fiscal policy errors, the unfulfillable electoral promises and/or medium and long-term adverse costs, rewarding on the other hand sustainable policies and rational political players, while market participants can benefit from a clearer perspective on the functionality of power balances, the soundness of public finance management and the quality of central and local government institutions (European Commission, 2019).

A European Commission study classifies the types of impact according to the influence of the opinions and recommendations formulated by IFIs transmitted on three channels (European Commission, 2014). Thus, first of all, the IFIs work developed according to their mandate have a ***direct impact*** on the government fiscal authorities, which must adjust their strategy and budget construction in relation to the opinions and recommendations received. Second, a high degree of credibility of IFIs, can stimulate the government to follow a precautionary approach in conducting fiscal policy, due to the fear of being exposed to possible justified public criticism, which represents an ***implicit***

impact. Third, the opinions and recommendations of IFIs are likely to increase the scrutiny of the institutions involved in the control of budgetary processes (Parliament, EU authorities, etc.), which, although is potential, is defined as an ***indirect impact***.

From this point of view, as is revealed in the mentioned study, IFIs can be considered as *"**accountability-multiplier**",* the messages transmitted having a wide variety of receivers, thus contributing to increase their overall effectiveness, according to the reliability and credibility levels.

Internally, these recipients include the general public, who benefit from additional information, national parliaments, which can use the IFIs deliverables to document their own analyzes, including the annual budget executions, public institutions with responsibilities for monitoring the compliance with legal rules (Constitutional Court, Court of Accounts), which can use information for better substantiation their assessments.

Externally, the European Union institutions will use the deliverables of IFIs to document the fiscal monitoring reports, and also the international financial institutions (IMF, World Bank), the rating agencies and/or business associations and foreign investors interested in independent evaluations from a reliable source, in terms of the macroeconomic and fiscal-budgetary developments, the medium and long-term sustainability of public finances, the predictability of fiscal legislation.

According to a recent study published under the auspices of the IMF (Beetsma *et al.,* 2018), the results of an econometric analysis on the ***efficiency*** of IFIs revealed that the work of independent fiscal councils contributes to mitigating the biased optimism of the budget projection and improving its accuracy. At the same time, the study reveals that complying with the rules is encouraged, partly precisely by IFIs influence on the accuracy of budgetary planning. The authors of the study draw attention to the fact that, given the still limited experience of IFIs and the difficulties in setting statistical causal relationships, these results should be interpreted with caution. Other studies addressing this issue also show that, for the time being, there is insufficient information, data and evidence to support unequivocal affirmations about the efficiency of the IFIs (Beetsma *et al*., 2017).

In terms of ***effectiveness***, is to be emphasized that, it must be assessed in relation to the ultimate goal of IFIs activity, namely to strengthen the fiscal responsibility of the authorities, as defined by the implemented fiscal rules.

On the opposite, in terms of the ***ineffectiveness*** of IFIs' activity, this may be determined by the insufficient allocation of financial and human resources in relation to the assigned mandate, regulatory breaches in guaranteeing access to data and information, lack of communication channels and adequate working conditions with the government fiscal authorities, sometimes even conflicting with them, including due to political interference.

Based on the *Fiscal Governance Database*, DG ECFIN started in 2017 to assess the degree of the ***extension of IFIs' attributions*** according to their official mandate on ***covering the issue of fiscal responsibility***, by calculating the SIFI index (Scope Index of Fiscal Institutions). This index covers 6 dimensions of the IFIs' mandate:

- Monitoring the observance of fiscal rules,
- Macroeconomic/budgetary forecast,
- Evaluation of fiscal policy and key financial indicators (financial impact - policy costing),
- Analysis of the long-term sustainability of public finances,
- Promoting fiscal transparency,
- Fiscal policy recommendations.

The results of this evaluation for 2021 for the EU-26 states are presented in Table 6.2.

Table 6.2. SIFI score for independent tax institutions in EU-26 countries

Country/Institution	Score	Country/Institution	Score
Austria	83.57	**Ireland**	68.21
Bulgaria	55.18	**Italy**	74.29
Belgium	60.00	**Lithuania**	55.71
Czech Republic	51.25	**Luxembourg**	72.68
Cyprus	66.79	**Latvia**	52.50
Germany	51.96	**Malta**	72.14
Denmark	46.25	**Netherlands**	70.54

Country/Institution	Score	Country/Institution	Score
Estonia	51.43	**Portugal**	71.43
Greece	62.14	**Romania**	64.29
Spain	68.93	**Sweden**	44.29
Finland	56.07	**Slovenia**	61.96
France	46.43	**Slovakia**	49.64
Croatia	42.50		
Hungary	51.43		

Source: Scope Index of Fiscal Institutions Database (European Commission, 2022b)

With the specification that these results should not be interpreted as a complete proxy of the IFIs efficiency (Jankovics and Sherwood, 2017), over a relatively large range of values, respectively between 42.50 and 83.57, t is found that ***Romania is evaluated with a score of 64.29*** meaning a high degree of coverage of the fiscal responsibility issue assigned by the mandate to the Fiscal Council, which is not surprising considering the particular circumstances of its establishment.[6]

6.6. Good practices: MoU and coordination/cooperation intentions

There is a consensus that one of the best practices of IFIs in the EU is to ***conclude Memorandum of Understanding*** (MoU) agreements with the fiscal authorities, as the main instrument for operating within the minimum standards described above, for establishing an adequate framework for collaboration, as well as effective mechanisms for interaction with internal partners, facilitating access to information and exchange of views, compliance with Comply or Explain procedures, in the spirit of fiscal responsibility and mutual interinstitutional respect.

[6] The legislation on fiscal-budgetary responsibility (Law no. 69/2010), which specifies the attributions, organization and functioning of the Fiscal Council (Chapter X, Art. 53-Art.61), was one of the conditionalities of the Stand-By agreement concluded in May 2009, through which the IMF provided Romania with a financial assistance package totaling 12.95 billion euro (IMF, 2009, p. 23).

From this point of view, according to a survey conducted in 2016, a number of 12 IFIs reported having signed MoUs, usually with the Ministries of Finance (Jankovics and Sherwood, 2017).

Some of these (in Bulgaria and Cyprus) covered only the provision of economic and budgetary data, including the management of information requests, others (in Ireland, Italy, the United Kingdom, Portugal, and Latvia) included in addition, information exchange arrangements, details of specific working relationships with government agencies, statistical authorities, ministries, research institutes.

However, in many cases (Bulgaria, Cyprus, Germany, etc.), MoUs are not available on the web pages, not even the national language versions, which is likely to reduce their potential contribution to the transparency of IFIs activities.

By scrutinizing the MoUs available on the IFIs sites that make them public (Italy, Portugal, Ireland, Estonia, and Latvia) it is noticed that, despite the heterogeneity of their structure, there are some common elements, covering the essential aspects of an adequate collaboration to strengthen fiscal responsibility and respect IFIs' mandate, such as the definition of working procedures and the precise specification of information requirements, timing and communication channels. For example, the ***deadline for submitting the draft budget for the opinion of the Fiscal Council is 1-2 weeks before its submission to the Government for approval***, during which the Ministry of Finance responds to the clarifications and/or additional information requested by the IFIs, including by organizing joint meetings, if applicable.

Another important provision in the MoU for two countries (Ireland and Latvia) that can be a reference example is the ***establishment of a reconciliation mechanism*** for situations where divergence of opinion arises between the Ministry of Finance and the Fiscal Councils.

It is known that European legislation has established the general framework of IFIs' responsibilities, the most important being monitoring compliance with national rules on taxation and fiscal discipline and/or with those of the Member States of the Euro area, primarily numerical fiscal rules, the verification of the occurrence of the circumstances that can lead to the activation of the correction mechanisms, respectively, conformity of the procedures with the national rules in these cases, the evaluation of the quality of the forecasts that substantiate the fiscal-budgetary projections, etc. (European Commission, 2019).

Given the lack of harmonized practices, as noted in a 2018 European Fiscal Board report (European Commission, 2018), there are in fact significant differences in the responsibilities and constraints faced by IFIs in critical areas, such as access to information, macroeconomic and budgetary forecasts preparation, timing and coverage of opinions and assessments on the implementation of fiscal rules and associated compliance risks, the existence of structured channels of communication with decision-makers etc., which makes necessary, from the perspective of achieving a high degree of convergence, ***to align with EU best practices*** and to harmonize the tasks and responsibilities, as well as the operational capacity, which would allow increased efficiency of these institutions.

As Debrun (2019), one of the most renowned analysts in the field of IFIs, points out in addressing the issue of their coordination within the EU, two relevant dimensions would be relevant, namely ***vertical,*** conditioned by an information system between each national fiscal council and the European Commission, an element already constituted, by the establishment in 2015 of the independent European Fiscal Board, with an advisory role in coordination and surveillance of the economic and budgetary policies of the Member States (EU Decision 1937), as well as ***horizontally***, from which the idea of creating a platform for the exchange of opinions, expertise and concerns of common interest through the voluntary establishment in 2015 of the EU IFIs network, to which most fiscal councils in member countries, including Romania, are currently affiliated.

However, a common framework of cooperation and coordination capable of articulating, in a consistent and coherent way, all the components of a functional architecture of the IFIs system at EU level still have some important phases to go through, requiring, as a fundamental premise, an agreement of the member states on the harmonization of the regulatory, competence and activities' agendas corresponding to the fiscal councils' mandates, involving major difficulties in mitigating the asperities of this process in relation to the likely reservations of Member States concerning the adjusting of their national legal framework which may be a lengthy process.

6.7. EU economic governance review. Preliminary analysis

In the European Union, during the pandemic period and subsequently, when it became obvious that the economic foundations were still unfavourable, the suspension of the fiscal rules was extended until the end of 2023. During this time, discussions have been held at the level of the European Commission and the Member States regarding the need to reform these fiscal rules, with better-adapted ones to the new realities and perspectives. Most criticisms revealed that the existing fiscal rules did not prevent budget deficits and debt risks, having a pronounced procyclical character, not taking into account the imbalances between investments and saving in the private sector, and at the same time proving to be excessively complex and difficult to enforce (Zettelmeyer *et al.,* 2022; Allenbach-Ammann, 2022; Medas and Balakrishnan, 2022; Muñoz, 2022; Thygesen *et al.,* 2022).

Moreover, the fiscal framework of the European Union does not have an instrument that can contribute to macroeconomic stabilization as a whole and to avoiding procyclical policies during declines. This is particularly important when the monetary policy is at *zero lower bound*, as was the case in 2013-2020. The fiscal policy could have had the ability to prove effective in counteracting extreme shocks, such as the Covid-19 pandemic, or to respond to the concerns about secular stagnation. However, although some EU countries have benefited from a certain fiscal space, it was not enough to cope with the pandemic challenges. The fiscal-budgetary situation and the sovereign debts deteriorated quickly in all Member States. Solving this problem would have made necessary a central fiscal capacity for macroeconomic stabilization at the EU level (Strauch, 2022).

The pandemic reminiscences, the energy crisis, the climate change, and the Ukrainian war have brought new challenges in 2022. Several EU countries would face difficult problems in implementing the existing rules caused by the increase of public debts and considerable need for public investments. The application of actual rules, once the general escape clause is deactivated in 2024, would require severe and counterproductive adjustments, especially in the highly indebted states. For example, in the case of Italy, the rule of annual debt reduction by 1/20 would involve reducing the debt by about 5% of GDP every year for 20 years. Such magnitude would affect the foundations of economic growth not only in the case of highly indebted states, to which is added the fact that supporting the energy transition of EU member countries, as well as the green and digital transition, needs significant budgetary allocations for public investments.

The key issues discussed in this context have focused on reducing complexity and increasing the degree of adaptability to the situation of each country, to ensure better enforcement of the new framework for economic and fiscal governance (Piana, 2022; EU Network of Independent Fiscal Institutions, 2021). Also, the need for this new framework to imply more realistic strategies aimed at reducing debts that allow public finance stability and support growth through investments and reforms has been emphasized.

In these circumstances, the new framework of economic and fiscal governance would have to ensure the basic objective of debt sustainability in a simple, clear, and credible way, without imposing a fiscal tightening that would involve adverse economic costs. At the same time, it must be able to support reforms in terms of combating climate change, ensuring energy security and education improvement, and being oriented to solve the huge challenges related to the aging of the population.

The attention has to focus on the efficient coordination of medium-term policies and macroeconomic surveillance, and the revised framework must be designed so that it can respond to future challenges. In addition, it must be endowed with higher fiscal "buffers" so as to absorb shocks more easily and maintain an adequate balance between flexibility and credibility.

On 8 November 2022, the European Commission launched a set of orientations aimed at the reform of the European Union's economic governance framework to more prudent and stability-oriented policies, by prioritizing new fiscal rules as an anchor of debt sustainability (European Commission, 2022a).

It is proposed the transition to a transparent EU risk-based surveillance fiscal framework, that differs between countries depending on the specific challenges to the public debt. Based on stronger national ownership, the medium-term fiscal structural plans represent the cornerstone of the framework proposed by the Commission. In this way, the fiscal, reform, and investment objectives, including those of addressing macroeconomic imbalances where it is necessary, will be integrated into a single medium-term plan of every Member State, meant to create a coherent and rational process. The Member States would have greater freedom in establishing their path of fiscal adjustment, as well as the national commitments of consolidating their fiscal trajectories. Basically, a single operational indicator will remain - the net primary expenditures, respectively the expenditures under the Government control - as a basis for establishing the fiscal adjustment path and carrying out the annual fiscal surveillance, thus significantly simplifying the operational framework.

As a component of the EU's common surveillance framework, the European Commission would provide a reference adjustment path, which covers a four-year period, based on its own methodology of debt sustainability analysis (DSA), which should ensure that the debts of the Member States with high or medium debt risks would be placed on a plausibly and continuously declining trajectory for 10 years, and the budget deficit would credibly remain below the 3% reference value established in the Treaty on EU (Blanchard *et al.,* 2022).

In a second stage, the Member States would present national fiscal structural plans to establish their medium-term fiscal trajectory for the next four years, as well as priority reforms and public investment commitments. Depending on the particular situation, the EU Member States may propose a longer period of fiscal adjustment by up to three years if the trajectory is based on a set of reforms and investments that support the public debt sustainability and respond to the common priorities and objectives of EU. In the third stage, the national fiscal structural plans of the Member States would be assessed by the European Commission, and if these evaluations are positive, they are subject to the approval of the Council of the EU.

It is intended that the implementation of the fiscal structural plans will be permanently monitored by the European Commission, and the Member States would present annually progress reports to ensure transparency and facilitate their implementation.

Under these conditions the excessive deficit procedure based on the criterion of the budget deficit (threshold 3% of GDP) would be maintained, while the one based on the public debt criterion (threshold 60% of GDP) would be activated in case a Member State with a debt of over 60% of GDP deviates from the trajectory of net expenditures assumed.

The orientations of the European Commission on the fiscal governance reform include the consolidation of the enforcement mechanisms, which would make use of financial sanctions more efficiently by reducing their magnitude, to which stronger reputational sanctions are added. The macroeconomic conditionality for the cohesion funds and for the recovery and resilience facility would be applied in a similar way, i.e. the EU funds can be suspended if the Member States have not taken effective measures to correct their excessive deficit.

In addition, a new tool would ensure the implementation of reforms and investment commitments, supporting a longer adjustment trajectory. Thus, a possible failure of the implementation of these commitments could result in a more restrictive adjustment trajectory, as well as the imposition of financial sanctions.

The credibility and transparency of the proposed reforms depend significantly on the improvement of the quality of government finance statistics and fiscal information. The European Union should engage in a major renewal of the quality of government finance statistics and the completion of the available information about the fiscal framework in the Member States, the budgets and the medium-term fiscal strategies. This should include fiscal statistics consolidated at the EU level, providing supplementary budget data regarding results, balance sheets of the public sector institutions, the exchange of information between Member States and the European Commission.

However, the EC proposal for the new economic governance framework has also some shortcomings, among other: it gives too much power to the Commission because it could impose technical trajectories (primary net expenditures, public debt, budget deficit, structural deficit) and the related fiscal adjustment effort different from the Member States proposals; many assumptions in the DSA involve policy judgements and the resulting debt trajectory is contestable; the inclusion of potential GDP growth rate and cyclically adjusted variables in calculating the net primary expenditures raises imprecision questions; remains to be clarified how investments and reforms for green and digital transition would be taken into account (Wyplosz, 2023; Blanchard and Zettelmeyer, 2023; Heimberger, 2023; EU Network of Independent Fiscal Institutions, 2023).

On 26 April 2023 the European Commission published the legislative proposals meant to implement the new economic governance rules, maintaining basically the same approach as in November 2022, with a more in-depth technical specifications (European Commission, 2023a; 2023b; 2023c).

Under these circumstances it is worth mentioning the increasing role of Independent Fiscal Institutions, in line with the increase in the national ownership of the EU new fiscal framework implementation, the main tasks to be assigned to them, if it the case, by expended mandates, so as to:

- produce annual and multiannual macroeconomic and budgetary forecasts or endorse those of the budgetary authorities;
- produce debt sustainability assessments underlying the government's medium-term planning or endorse those provided by the budgetary authorities;
- assess the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorse those provided by the budgetary authorities;
- monitor compliance with country-specific numerical fiscal rules and with the Union fiscal framework;
- conduct, on a regular basis, reviews of the national budgetary framework, in view to assess the consistency, coherence and effectiveness of the framework;
- assess the compliance of the budgetary outturns data reported in the annual progress report on the implementation of the national medium-term fiscal structural plan, in particular on the net expenditure path, reform and investment commitments;
- provide an opinion on the relevant factors when the European Commission assess the existence of an excessive deficit and, if is the case, on the adequacy of the measures taken by the Member State concerned in implementing the corrective net expenditure path recommended by the EC.

As one can see, these tasks are extremely complex, many of them exceeding the current mandates and competences of IFIs, which, as we mentioned, are very heterogeneous in terms of their set-up, institutional design and operational functions. Besides the fact that it is very difficult, if not impossible, to correlate the timing for implement the new fiscal rules starting with 2024 and for bringing to the same denominator the mandates of IFIs, including the new tasks assigned, based on an European directive – supposed to prepared - which would require about two years for being transposed into the national legislation of all the Member States, the most sensitive problem is generated by the involvement of these independent institutions in the policy design when performing the assessments and the related risk of conflict of interest that would ensue (Dăianu, 2023).

Overall, regardless the final format of the EU new economic governance framework and the tasks assigned to IFIs, the most important is that they keep their functional autonomy in relation to the national budgetary authorities, the unification of minimum standards regarding adequate and stable own resources to carry out their mandates, good and timely access to information, adequate safeguards for their independence, capacity to make public their assessments (EU Network of Independent Fiscal Institutions, 2022).

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CHAPTER 7

EU LOCAL GOVERNMENTS AND THEIR ROLE IN GUIDING FINANCIAL POLICIES

Elena Cigu (Rusu)[1], Anca-Florentina Gavriluţă (Vatamanu)[2]

7.1. Introduction

The importance of local governance has increased significantly within the states of the European Union, given the tendency of states to relieve themselves of local responsibilities by transferring competencies from the central level to local public authorities based on the principles of decentralization and local autonomy. Administrative powers cannot be exercised without a financial dimension, which are the financial powers implemented through the local public finance system that determines the creation and development of local public financial policies. Local finances meet better and more efficiently the requirements of public utilities in the territory, manifesting in conditions of local autonomy. In other words, the instrument for achieving local autonomy in financial terms is with the help of local public finances through the basic functional instrument, the local budget.

In this context, the local public finance system is integrated into the financial system where financial policies are established and implemented. Local public financial policies developed significantly because of the decentralization process and the increase in the importance of the local budget in the budgetary system.

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[1] Elena Cigu (Rusu) is Ph.D., associate professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.
[2] Anca-Florentina Gavriluță (Vatamanu) is Ph.D., assistant professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.

The chapter is structured as follows: section 2 provides a theoretical approach of the importance of local financial policies for promoting good financial management practices; section 3 presents the trends and recent development regarding local governments in the EU member states; section 4 summarizes the case of Romania based on fiscal decentralization as the foundation of local financial policies taking into consideration the legal framework and the status of fiscal decentralization through the quantitative analysis of main indicators of fiscal decentralization over the period 2006-2021.

7.2. The importance of local financial policies for promoting good financial management practices

The local context and the entire decision-making process are directly influenced by the entity's financial position, while the efficiency of local financial policies and the viability of the fiscal framework also depend directly on the specifics of the financial policies adopted by the legislative bodies. Each political party or political formation will develop its government program to preserve and consolidate power, considering internal and international issues, and the legislative forum establishes if the economic, social, and other objectives that need to be achieved by the government team during the investiture period, respects the criterion of constitutionality. Financial policies have the role of providing stability and continuity over the years, and even if the elected officials change, it is necessary to establish reference criteria according to which the local authority can measure performance.

The program accepted by the legislative forum directly affects the dimension of the local financial policy, establishing internally the objectives of an economic and social nature (the rate of economic growth, the specifics of investments, the relations between the public and private sectors, the size of consumption in the reference period, the unemployment curve, the price index, the evolution of wages, pensions and other income derived from human labor, actions in the field of education, social protection, medical protection, national defense, environmental protection, etc.). On the external level, relations with the neighborhood are defined, with an emphasis on the political, economic, scientific, cultural, and military dimensions, etc. Achieving the established objectives requires important financial resources from the state, financial policy becoming an integral part of the state's general planning, and the system of public financial relations generated by the procurement, allocation, and use of financial resources to satisfy public needs is defined by reporting to the state finance system and the local financial system.

According to the Government Finance Officers Association (GFOA), which is a professional association of approximately 19,000 state, provincial, and local government finance officers in the United States and Canada, “Financial policies are fundamental to a strategic, long-term approach to financial management because they provide written guidelines for financial decision-making and set strategic intent for financial management.” We may all agree that financial policies set expectations for government operations, serve as a framework for financial decisions, and aid in the maintenance of effective financial management. That's why transparent and responsible local finance management has grown to be acknowledged as a critic of the integrity of the local public sector and for earning and retaining local communities' trust in governments (Shah, 2007).

By creating the appropriate institutional framework through legislative initiatives, the state interconnects itself with the mission of balancing the supply-demand balance on the labor market, developing strategies for the recovery of the economy or promoting effective employment policies, and this approach also involves a series of internal and external partners, such as local communities, education associations, research institutions, research units, international organizations. Therefore, the specifics of the financial policy and the size of budgetary fiscal responsibility represent an important factor in shaping public sector performance and improving all governance levels.

The importance of local financial policies in promoting good financial management practices depends not only on the local government's financial accounting and reporting but also on its capacity to manage revenue and expenditure, assure good procurement practices, manage local issue debt, and assure adequate local government internal control, capable of ensuring efficiency and integrity. Even if the budgets are not the products of accounting structure, being requested by the executive of a sovereign government, once have been approved, become the responsibility of financial officers and ***local government's financial accounting and reporting*** refers to the government's capacity to ensure accounting discipline, by transforming accounting procedures in types of control capable of controlling spending, establishing relevant measures of the cost of services provided and reducing corruption by carefully managing the flow of income and expenditures in local public administrations. ***Local government cash management*** has undergone significant development since 1970 when cash management was focused on paying bills and collecting fees, fines, and other revenues. The contemporary period follows a cash management cycle in terms of government funds and focuses on the management of investments, short-term borrowing, collection methods, fund concentration, and cost-effective methods for processing receipts and disbursements. In terms of ***local government procurement and safeguards against corruption***, we can mention the implication of local public policy goals and procedures capable of reducing corruption and promoting sound financial management of public resources (Hunja, 2003). Another requirement for consolidating good financial management practices at the local level is to ***manage fiscal stress and debt challenges***, by using best practices and fulfilling fiscal allocation functions. Finally, ***local government internal and external control*** becomes crucial for ensuring efficiency, accountability, and integrity and focuses on the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with applicable legal frameworks.

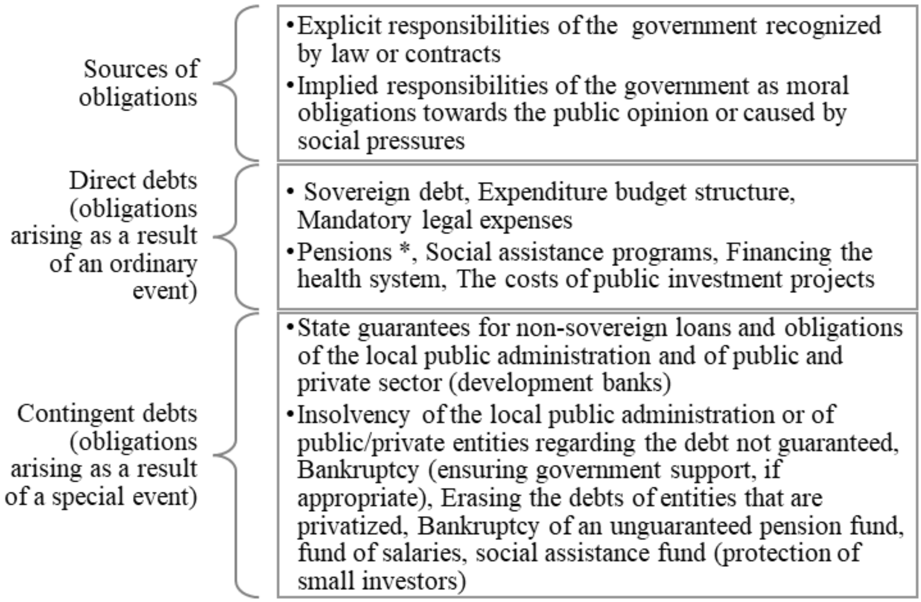
Even though the macroeconomic level and local public administrations have different approaches to financial policy, the local level is focused on enhancing the capabilities and responsibilities of the deliberative and executive bodies in the local public administration by establishing complex financial strategies that create and maintain an overall vision of the entire financial activity, the outputs implications are similar:

- Develops institutionalized best practices for financial management;
- Clarifies strategic goals for financial management;
- Defines boundaries;
- Supports strong bond rating and lowers borrowing costs;
- Promotes long-term strategic thinking and proactive management;
- Manages financial condition risks;
- Guideline and restrictions that affect the amount and type of local debt issued;
- Complies with established best practices for public management.

Overall, it seems that the debt management policy is an important issue and, in addition to the income and expenditure policy, it seems to be the core of the analysis related to local financial policies and their involvement in the promotion of good financial management practices. According to Oxford City Council (2003), debt management policy should focus on written rules, exemptions, and limitations that govern the debt issuance procedures. It's essential to consider the following when developing a local debt management strategy:

- To define the scope and purpose of local debt management strategy;
- To think perspective and to approach long-term planning, by establishing when it is pertinent to utilize debt;
- To correlate national debt rules with the international legal framework and to establish the type of debt permitted;
- To pay attention to the intergenerational cost of local public debt, by establishing debt structure and repayment options;
- To include in local financial strategy some debt issuance practices, correlated to local fiscal capacity and existing fiscal space.

A public debt that is not properly managed over time may become unsustainable or reach a level where the executive can't meet its current and future obligations for paying off the public debt service. The executive can turn to decreasing or rescheduling the public debt in tandem with the inability to sustain an acceptable level of economic development, leading to serious financial crises with a considerable negative economic impact. That's why fiscal risk management became an important tool to improve governments' processes and based on literature validation, the following fiscal risk matrix can be established (see Figure 7.1).



Note: * If there is no legal mandate from the government to fulfill those responsibilities

Source: Brixi and Schick (2002)

Figure 7.1. Fiscal risk matrix

According to Liu and Waibel (2008), subnational insolvency is a recurrent phenomenon in development. As nations decentralize spending, taxing, and borrowing and expand subnational credit markets, insolvency procedures become more significant. The authors demonstrate that solid subnational insolvency procedures, like private insolvency law, predictably assign default risk while allowing breathing room for orderly debt restructuring and fiscal adjustment. Related to this point of view, it is required to mention the importance of the fiscal risk management cycle which has become an increasingly prominent topic in public finance in general and local finance in particular. There is no doubt that the management of government public debt and the deterioration of market circumstances are related. In addition to the financial audit on the annual general account of the public debt and audits regarding the evaluation of economy, efficiency, and effectiveness of public debt management, which are known in specialized literature, the Supreme Audit Institutions were forced to address the complexity of the mechanisms of the financial markets in correlation with the macroeconomic conditions of the last decades and with the uncertainties regarding the evolution of the sovereign debt crises. As a result of the enormous effects of the future servicing of the public debt on the public budgets, the audit of the performance of the management of the public debt has acquired an increasing relevance. Even if we cannot predict what events with adverse impacts on public finances may develop next year or the year after, policymakers can set up the public finances proactive and in a resilient way by following the fiscal risk matrix, identifying types of fiscal risk, and ensuring compliance with fiscal rules.

7.3. Local governments in the EU member states - Trends and recent developments

Scientists and public decision-makers are interested in the function of local governments within the European Union. The legal and social framework from the EU level provides democratic guarantees and common standards for individuals throughout Europe. All around Europe, local governments are being given new duties as a result of changes in national and international law as well as the demographic shift in the continent, which requires improvement in the quality, effectiveness, and outcomes of public services. Table 7.1 provides details for each member state of the European Union as well as a historical look at administrative divisions within those states.

Table 7.1. Administrative divisions in the member states of the European Union

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
Austria	Federal state: municipalities (Gemeinden) and regions (Länder)	*Local level*: 2357 municipalities *Regional level*: 9 Regions (Länder)	At the *local level:* social services, public order, urban planning and land development, water, sewage, roads and household refuse, urban transport, safety, culture, health At the *regional level*: energy distribution, law and order, health, sports and leisure, environment, transport	8,979,894	4.6 %
Belgium	Federal state: (gemeenten), provinces (provincies), regions (gewesten), and communities (gemeenschappe)	*Local level*: 589 municipalities (gemeenten) *Intermediary level:* 10 provinces (provincies) *Regional level*: 3 regions (gewesten)	At the *local level*: public order, registry office, spatial and urban planning, housing, water and sanitation, environment, waste management, road management and mobility, culture, sports and youth, social policy, local economy, employment, education, cultural infrastructures At the *Intermediary level:* social infrastructures and policies, environment, economy, transport, housing, local finance and taxation At the *Regional level:* spatial and urban planning, housing, agriculture, employment, environment, international relations, external trade, scientific research, energy, transport	11,592,952	6.1%
Bulgaria	Unitary state composed of municipalities (obshtina).	Independent legal entity with its own property and budget. Most municipalities are divided into districts.	education, health, social services, culture, public services, sports and leisure, water supply and sewage, tourism, household refuse, road, park and lighting maintenance, territorial development, transport, building and maintenance of public buildings, environment	6,877,743	7.6%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
Czech Republic	Unitary state composed of municipalities (obec) and regions (kraje).	*Local level:* 6 250 municipalities (obec) *Regional level:* 14 regions (kraje)	At the *local level:* municipal budget, local development, agriculture and forest management, municipal police, water supply and sewage, household refuse, primary education, housing, social services, spatial planning, cooperation with other municipalities and regions, public transport. At the r*egional level:* secondary education, road network, social services, environment, transport, regional development, health	10,505,772	3.6%
Cyprus	Unitary state composed of communities (koinotites) and municipalities (dimoi)	*Local level:* 484 communities (koinotites) and 39 municipalities (dimoi)	urban planning, protection of the environment, water supply, land development, household refuse	900,356	6.6%
Croatia	Unitary state composed of municipalities, towns, cities (grad), and counties (županija).	*Local level*: 429 municipalities, 106 towns and 21 cities (grad) *Regional level:* 21 counties (županija)	*Municipalities and towns*: localities and housing, regional and town planning, childcare, social wel-fare primary health care, education, culture, sports, consumer protection, environment, fire prevention, civil protection, regional traffic *Cities*: maintenance of public roads, building and renting permits	3,957,715	13.1%
Denmark	Unitary state composed of municipalities (kommuner) and regions (regioner).	*Local level*: 98 municipalities (kommuner) *Regional level*: 5 regions (regioner)	At the l*ocal level:* primary education, childcare, care for the elderly, integration of refugees and immi-grants, environmental protection and waste manage-ment, assistance to the unemployed, economic deve-lopment, culture and sports At the *regional level*: health care, hospital, health insurance, mental health treatment, social services and special education, regional development, busi-ness promotion, tourism, nature and environment,	5,856,733	4.9%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
			employment, culture, transport, soil pollution		
Estonia	Unitary state composed of rural municipalities (vald) and cities (linn)	*Local level:* 193 rural municipalities (vald) and 33 cities (linn)	At the l*ocal level:* education, social welfare, health services, culture, leisure and sports, social housing, urban and rural planning, tourism, public transport, water supply, sewage, public lighting and central heating, environment, waste collection and disposal, road and cemetery maintenance, local taxes	1,330,932	8.0%
Finland	Unitary state composed of municipalities (kunta) and regions (maakunnan liitto).	*Local level:* 336 municipalities (kunta) *Regional level*: the Region of Kainuu and the Åland Islands	At the *local level:* health care, social services, education, culture and leisure, sports, territorial planning, building and maintenance of technical infrastructure and environment, business and em-ployment, independent taxation rights and finances At the *regional level*: a) Region of Kainuu - social and welfare services, health care, education (shared with municipalities), b) Åland Islands - education, culture, police, health care, social affairs, employment	5,541,017	3.0%
France	Unitary state composed of municipalities, departments, and regions.	*Local Level*: 36 682 municipalities *Intermediate level:* 96 departments and 5 overseas departments *Regional authorities*: 22 regions and 4 overseas regions	At the *local Level*: a) *Traditional competencies* - registry office functions, electoral functions, education, maintenance of municipal roads, land development and planning, local public order, b) *Decentralised competencies* -planning, education, economic development, housing, health, social work, culture At the *intermediate level*: social and health action, urban and equipment planning, education, culture and heritage, economic development, environment *Regional authorities*: economic development, territorial development and planning, transport,	67,749,632	6.8%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
			education, and job training programmes, culture, construction and maintenance of secondary schools, Health		
Germany	Federal state composed of the federal and the regional level	*Local level*: 11 500 municipalities (Gemeinden) and cities (Städte) *Intermediary level:* more than 300 counties (Kreise) *Regional level*: 16 regions (Länder)	At the *local level*: urban planning, municipal taxation, public security and order, municipal roads, public transport, water supply and wastewater management, flood control and management, firefighting, social aid and youth, child care, housing, school building and maintenance, cemeteries At the *intermediary level:* construction and maintenance of intermediary roads, social services and youth, collecting and managing household refuse, health care, food safety, protection of nature and environment, foreign affairs, disaster management, public transport At the *regional level:* Legislation, public administration, police, homeland security, taxation, justice, culture, university education, education, environment, legal supervision of local self-government	83,160,871	2.6%
Greece	Unitary state composed of municipalities (dimos) and self-governed regions (peripheria).	*Local level*: 325 municipalities (dimos) *Regional level*: 13 self-governed regions (peripheria)	At the *local level:* building permits and urban planning applications, social welfare, issuing of professional licenses, agriculture, livestock and fisheries, transport infrastructure, health care, edu-cation At the *regional level:* regional development planning, “green” development	10,641,221	8.4%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
Ireland	Unitary state composed of boroughs, towns, cities, and counties	*Local level:* 5 boroughs and 80 towns *Intermediary level*: 5 cities and 29 counties	At the *local level:* road construction and maintenance, housing, leisure facilities, urban planning *At the intermediary level*: urban planning, road infrastructure, water supply and treatment, waste management and environment, housing, fire services and civil defence, libraries, local arts, culture and leisure facilities, coordination of public services across different agencies operating locally	5,033,165	13.6%
Italy	Unitary state composed of municipalities (comuni), provinces (provincia), and regions (regione)	*Local level*: 8 094 municipalities (comuni) Intermediary level: 101 provinces (provincia) *Regional level*: 20 regions (regione)	At the *local level:* services, urban planning, economic development, public services, land development, environment, culture At the *intermediary level*: environment, civil protection, culture, waste collection, employment, education, transport, hunting and fisheries, maintenance and enhancement of water, resources and energy At the *regional level:* international relations with other regions and with the EU, external trade, health, land development, transport, production and delivery of energy urban planning, agriculture	59,109,668	6.7%
Latvia	Unitary state composed of municipalities (novads) and cities (pilseta).	*Local level*: 110 municipalities (novads) and 9 cities (pilseta)	At the *local level*: water, waste management, public services and infrastructure, management of forests, primary and secondary education, culture, public health, social services, child welfare, social housing, licensing for commercial activities, public order and civil protection, urban development, statistical information collection, public transport, training for teachers	1,884,490	4.1%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
Lithuania	Unitary state composed of municipalities (savivaldybè)	*Local level*: 60 municipalities (savivaldybè)	At the *local level*: budget, pre-school, primary and secondary education, civil protection, culture, environment, sanitation, housing, transport, labour market measures and promotion of entrepreneurship, primary health care, public services and municipal property management, spatial planning, local development, sports, tourism	2,800,839	6%
Luxembourg	Unitary state composed of municipalities	*Local level:* 106 municipalities	At the *local level*: local land development, social assistance, culture and sports, preschool and primary education, environment, water management and sanitation, waste management, funerals, regulatory and police force, fire and rescue services, road maintenance and traffic management	640,064	5.1%
Malta	Unitary state composed of local councils (kunsill lokali)	*Local level*: 68 local councils (kunsill lokali)	At the *local level: m*aintenance of public areas, maintenance of road infrastructure, public libraries, waste collection, local enforcement system, street lighting, management of devolved properties	518,536	11.7%
Netherlands	Unitary state composed of municipalities (gemeenten) and provinces (provincies).	*Local level*: 418 municipalities (gemeenten) *Regional level*: 12 provinces (provincies)	At the *local level*: urban planning, housing, tourism, civil engineering, transport, health, primary education, employment, childcare, social services, law and order, culture and sports At the *regional level*: regional planning, social housing, environment, culture, leisure and sport, public transport, road maintenance and traffic, energy, tourism, regional broadcasting	17,533,044	4.9%
Poland	Unitary state composed of municipalities (gminy), counties (powiaty), and	*Local level*: 2 479 municipalities (gminy) *Intermediary level*: 379 counties	At the *local level*: public transport, social services, housing, environment, culture, pre-school and primary education	37,747,124	6.8%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
	regions (voivodship-województwo).	(powiaty),which includes the 65 municipalities with special status Regional level: 16 regions (voivodship-województwo)	At the *intermediary level:* road building and maintenance, secondary education, civil protection, environment, employment, health At the *regional level:* economic development, higher education, environment, employment, social policy, regional road management		
Portugal	Unitary state composed of parishes (freguesias), municipalities (municípios), and autonomous regions	*Local level*: 4 259 parishes (fr eguesias) and 308 municipalities (municípios) *Regional level*: 2 autonomous regions (Açores and Madeira)	At the *local level:* a) In Parish - education, road and park maintenance, social facilities for children and the elderly, culture, environment, health, residence permits, pet licenses. b) In municipalities - health, environment, culture, management of municipal assets, public works, urban planning	10,325,147	5.5%
Romania	Unitary state composed of municipalities (comune), towns (orase), cities (municipii), and counties (judete)	*Local level*: 2 861 municipalities (comune), 217 towns (orase) and 103 cities (municipii) *Regional level*: 41 counties (judete)	At the *local level*: housing, local police, urban planning, waste management, public health, transport infrastructure and urban transport planning, water supply and sewage system, district heating, pre-school, primary, secondary, vocational, and technical education, local heritage administration, administration of parks and open green public areas At the *regional level: r*egional development, economic, environmental and social development, management of public services, urban planning and landscaping, water supply, sewage, public transport, public health, transport infrastructure, social assistance, education, cooperation between local and national authorities	19,119,880	5.8%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
Slovakia	Unitary state composed of municipalities (obce), cities (mestá), and self-governing regions (samosprávne kraje)	*Local level*: 2 792 municipalities (obce) and 138 cities (mestá) *Regional level*: 8 self-governing regions (samosprávne kraje)	At the *local level*: road maintenance, public transport, environment, water supply, sewage and municipal waste, local development, housing, pre-school and primary school, social assistance, health, culture and sports, participation in regional planning At the *regional level:* regional road network, land development, regional development, secondary education, hospitals, social services, culture, participation in civil defense, licenses for pharmacies and private physicians	5,447,247	3.0%
Slovenia	Unitary state composed of municipalities (občin)	*Local level*: 211 municipalities (občin)	At the *local level:* public safety and protection, housing, land development, urban planning, trade and industry, environment, roads network, transport, pre-school and primary education, social security, water treatment and waste collection	2,108,079	8.2%
Spain	Unitary state composed of municipalities (municipios), county councils (diputaciones), Canary Island county councils (cabildos), Balearic Island county councils (consejos insulares), autonomous cities (ciudades autónomas), and autonomous communities (comunidades autonómas)	*Local level*: 8 117 municipalities (municipios), county councils (diputaciones), Canary Island county councils (cabildos) and Balearic Island county councils (consejos insulares) *Regional level*: 17 autonomous communities (comunidades autonómas) and 2 autonomous cities (ciudades autónomas)	At the *local level*: water supply, street lighting, urban traffic, food security, road maintenance, sewage and waste At the *regional level*: territorial development, civil engineering, economy, agriculture, culture, social policies, environmental management, development of economic activities, health, education	47,415,750	5.5%
Sweden	Unitary state composed of municipalities (kommuner), county councils (landsting),	*Local level*: 290 municipalities (kommuner) *Regional level:* 17 county councils	At the *local level*: mandatory competencies such as social services, childcare and pre-school, primary and secondary education, care for the elderly,	10,415,811	5.1%

Coun-try	State structure	Characteristics of the form of organization	Competences	Inha–bitants*	Real GDP growth
	and regions (regioner).	(landsting) and 4 regions (regioner)	support for the physically and intellectually disabled, primary healthcare, environmental protection, spatial planning, refuse collection and waste disposal, rescue and emergency services, water supply and sewerage, road maintenance, and optional competencies such as culture, housing, energy, employment, industrial and commercial services At the *Regional level:* Mandatory competencies such as healthcare, dental care, public transport (via a regional public transport authority), and optional competences such as regional development, culture, tourism		
Hungary	Unitary state composed of municipalities (települések),cities (városok), cities with county rank (megyei jogú városok), capital city districts (fővárosi kerületek), and counties (megyék).	*Local level:* 3 175 municipalities (települések), cities (városok), cities with county rank (megyei jogú városok), capital city districts (fővárosi kerületek) and the City of Budapest *Intermediary level*: 19 counties (megyék)	At the *local level:* local development, urban planning, protection of the environment, housing, public transport, social services, primary schools, maintenance of roads, public areas, cemeteries and sewage, water resources, fire services, culture At the *intermediary level:* secondary schools, cultural infrastructures (libraries and museums), maintenance of retirement homes and hospitals, land development, tourism	9,708,891	7.1%

Source: Regulation (EC) No. 1059/2003; European Commission (2023); The Council of European Municipalities and Regions (CEMR) (2023)

Austria is a federal state composed of municipalities and regions. At the local level, has 2357 municipalities (Gemeinden), the municipal council (Gemeinderat), the local administrative board (Gemeindevorstand), and the mayor (Bürgermeister). The Regional Level consists of 9 regions (Länder) which have their constitution and include a regional parliament, a regional government, and a regional governor. According to Table 7.1, in 2021 Austria had 98,979,894 million inhabitants and a real GDP growth rate of 4.6%. The constitution establishes the relationship between the provinces and the central government. The central government has the majority of administrative, legislative, and judicial authorities, including taxation, welfare, and police. The Länder, which has all residual powers, serves as the executor of federal authority. Each province has its unicameral legislature, which is chosen through proportional representation. Every legislation must be presented to the proper federal minister for approval through the province governor (Landeshauptmann). If such an agreement is not reached, the law might be reinstated by a majority vote in the provincial legislature. In the event of a protracted confrontation between federal authorities and provincial legislatures, the Constitutional Court may be petitioned for resolution. Local governments in Austria are autonomous, carrying out their autonomous activities as well as tasks allocated by the federation and the specific Land.

Belgium is a federal state composed of municipalities, provinces, regions, and communities. At the local level, there are 589 municipalities with the largest competencies. At this level, we find the municipal council, which represents the legislative body with direct implications on local policy, the college of the mayor, which is the executive body, and the mayor, who is responsible for municipal administration and heads the municipal police. At the intermediary level, Belgium has 10 provinces and an institutional architecture that includes: the provincial council which is the deliberative body, and provincial authority, with direct implication on the province's governmental body and holds legislative, executive, and judicial powers, the governor of the province which is the federal government's commissioner and regional community commissioner. In 2021 Belgium had 11,592,952 million inhabitants and a real GDP growth rate of 6.1%.

Bulgaria is a unitary state composed of 264 municipalities at the local level, most municipalities are divided into districts and the local institutional architecture includes a municipal council with direct implications on the deliberative area. The mayor is the executive body and is focused on implementing the policies adopted by the municipal council. In 2021 Bulgaria had 6,877,743 million inhabitants and a real GDP growth rate of 7.6%.

Czechia is a unitary state composed of municipalities and regions. The local institutional architecture includes 6,250 municipalities at the local level and 14 regions at the regional level. At the local level, we find the implications of the Municipal Council, which has the status of a deliberative body, The municipal council is the executive body, and the mayor represents the municipality. In 2021 Czech Republic had 10,505,772 inhabitants and a real GDP growth rate of 3.6%. According to the literature, in the Czech Republic, the regulation of budgetary responsibility and state oversight of the performance of municipalities and regions are included in a complex package of laws. Regions, as a level of local government, supervise municipalities based on a delegated competence granted by the central level, and the central administration has the competence to supervise the local level (Kadečka, 2012). A recent study conducted by Čmejrek (2023) reveals that on the profile of the Czech Republic, the separation of autonomous and delegated competencies is indefinite in numerous areas, and the division of municipalities according to the performance of delegated competencies is vague and incomprehensible to citizens. Small municipalities' lack of administrative ability has been attempted to remedy during the past 20 years by forming associations of municipalities after the French model. The author reveals the necessity to draw attention to the variations between the local government structures in the two nations as well as the shortcomings of the Czech combined model.

Cyprus is a unitary state composed of communities and municipalities. At the local level, there are 484 communities and 39 municipalities. The Community Council (legislative board) and the President (the chair of the Community Council) are involved at the level of the communities. At the level of municipalities, we find the Municipal Council and the mayor, the first being the deliberative assembly of the municipality and the second the executive authority of the municipality. In 2021 Cyprus had 900,356 inhabitants and a real GDP growth rate of 6.6%. Cyprus currently ranks among the most centralized nations in Europe, although over the past ten years, there has been much discussion of local government reform initiatives, including decentralization and territorial consolidation (Kirlappos, 2017). In March 2022, the House of

Representatives adopted the Local Government Reform, approving a set of proposals that are focused on restructuring Cyprus municipalities and communities.

Croatia is a unitary state composed at the local level of 429 municipalities, 106 towns, 21 cities, and 21 counties at the regional level. In Croatia, municipalities are self-government units and at this level, we find the municipal council and the mayor. In cities, we also find the city executive body (the mayor) and the city assembly (the representative body). The regional level includes the city of Zagreb and 20 other counties. According to Table 7.1, in 2021 Croatia had 3,957,715 inhabitants and a real GDP growth rate of 13.1%.

Denmark is a unitary state composed at the local level of 98 municipalities and the regional level of 5 regions. The institutional architecture for the local level includes executive committees that are in charge of local administration, the mayor, and the municipal council. At the regional level, we find the regional council, which is a deliberative body and has implications for regional development, the executive committees, which help the regional council implement its decisions, and the chairman, who heads the council and administration. In 2021 Denmark had 5,856,733 inhabitants and a real GDP growth rate of 4.9%. According to the literature, Denmark is a country where local governments play a more extensive role in the provision of public services and tend to achieve better development outcomes (Dafflon, 2002; Lotz, 2005). Many countries rely on "devolved" local administrative bodies, which are a hierarchical part of the state administration and do not have their own elected political leadership.

Estonia is a unitary state composed at the local level of 193 rural municipalities and 33 cities. The municipal council is the municipality's legislative body, the local government is the executive body, and the mayor represents the local government. In 2021 Estonia had 1,330,932 inhabitants and a real GDP growth rate of 8.0%.

Finland is a unitary state composed at the local level of 336 municipalities and the Region of Kainuu and the Åland Islands at the regional level. At the regional government level, in 2005, the experimental region of Kainuu was established to deal with challenges such as immigration, unemployment, and the aging population. The experimental period ended at the end of 2012. The regional council is the executive body of the regions, where its members are elected by direct universal suffrage for 4 years. The president of the region is elected by the regional council for a 4-year term. The Åland Islands fall within the status of an autonomous province. The government is the executive authority. This autonomous province also has a legislative assembly, whose members are elected by universal suffrage. In 2021 Finland had 5,541,017 inhabitants and a real GDP growth rate of 3.0%.

France is a unitary state composed at the local level of 36,682 municipalities, 96 departments, and 5 overseas departments at the intermediate level, and 22 regions and 4 overseas regions at the regional level. Governance at the level of the Regions includes at the institutional level the Regional Council or the Territorial Assembly (in Corsica), which is the deliberative body of the region. The regional council consists of regional councilors elected by direct universal suffrage for a 6-year term. The regional council elects its president from among its members. Starting from August 2004, the Regional Councils can manage European structural funds. In 2021 France had 67,749,632 inhabitants and a real GDP growth rate of 6.8%.

Germany is a federal state composed of the federal and regional levels. At the local level, we find 11,500 municipalities and cities. The institutional architecture for the local level includes the council system, the mayor, the local council, and the magistrate system. At the intermediary level are more than 300 counties which are a constitutional part of the regions (Länder). Governance at the regional level (Lander) involves the institutional infrastructure of the Parliament (Landtag), which is the legislative body of the region. It consists of members elected by direct universal suffrage for a 4-year term. The parliament elects the minister-president of the region. The Government (Landesregierung) is the executive body of the regions and is elected by Parliament for a 4-year term. The government elects the minister-president. The Minister-President (Ministerpräsident) presides over the government and has the exclusive power to appoint and dismiss the region's ministers. Also, the Minister-President enforces the decisions of the local Council.

Greece is a unitary state composed of 325 municipalities and 13 self-governing regions. The governance of municipalities includes the Municipal Council, which consists of members elected by direct universal suffrage for a 4-year term and is the deliberative authority. At the local level, the institutional architecture includes the municipal council, the executive committee, which is the executive body of the municipality, and the mayor, who represents the municipality. The institutional architecture of regional governance includes the Regional Council, which is directly involved in regional authority, the executive committee which is the executive body of the region, and the head of the region which is involved in the area of regional development plans and solving administrative issues. In 2021 Greece had 10,641,221 inhabitants and a real GDP growth rate of 8.4%.

Ireland is a unitary state composed at the local level of 5 boroughs and 80 towns, at the intermediary level of 5 cities and 29 counties. At the local government level, we find the borough council or town council and borough clerk or town clerk and of course, the mayor elected every year by borough or town council members and presides over the council. At the territorial/intermediate government level, the City Council or County Council is elected by direct universal suffrage and proportional representation for a 5-year term. In 2021 Ireland had 5,033,165 inhabitants and a real GDP growth rate of 13.6%.

Italy is a unitary state composed at the local level of 8,094 municipalities, at the intermediary level of 101 provinces, and at the regional level of 20 regions. At the level of local government, the Local Council is elected by universal suffrage for 5 years. The local council is the main legislative and decision-making body of the municipality. The council mainly votes on the municipal budget. The local executive committee is the executive authority of the municipality that implements the decisions taken by the local council, and its members, called deputies, are appointed by the mayor. The mayor is elected by universal suffrage for a 5-year term, being a member of the Executive Committee. The governance of the provinces involves the institutional architecture of the Provincial Council (which decides on the public policies of the province and votes on the budget, being elected by direct universal suffrage for 5 years.

The Provincial Executive Committee implements the decisions of the Provincial Council. Its members, who are appointed by the President of the province, cannot be members of the Provincial Council. The president is elected by direct universal suffrage for a 5-year term. At the level of regional government, the Regional Council is the legislative body of the region. The Council can submit bills to the National Parliament and dismiss the chairman of the Regional Executive Committee.

Latvia is a unitary state composed at the local level of 110 municipalities and 9 cities. Based on the Latvian Local Authorities Act, it is highlighted that local institutions are directly involved in performance at the local level. Local governance is exercised through the local Council, which is the legislative authority at the local level. Its members are councilors elected by direct universal suffrage for 4 years. The council elects the president of the local council and the members of the standing committees from among its councilors. Both the finance committee and the social, education, and culture committee are mandatory. The president of the local council is elected by and from within the local council for a 4-year term. He chairs the local council and the finance committee. In 2021 Latvia had 1,884,490 inhabitants and a real GDP growth rate of 4.1%. A Human Development Index (HDI) of 0.863 shows that Latvia counts as one of the most highly developed economies by the UN definition. Additionally, according to Vilka, (2012), in Latvia, local authorities have the right to borrow only to finance capital expenditure, and short-term borrowing is accepted only to cover short-term fiscal deficit.

Lithuania is a unitary state composed of 60 municipalities at the local level. The institutional architecture at the local level includes the local council, which is the municipality's legislative body, the director of administration, which is involved in executive tasks, and the mayor, who is elected for four years. In 2021 Lithuania had 2,800,839 inhabitants and a real GDP growth rate of 6%.

Luxembourg is a unitary state composed of 106 municipalities. At the local level, the institutional architecture includes the municipal council, the college of the mayor, and the aldermen, the mayor. In 2021 Luxembourg had 640.064 inhabitants and a real GDP growth rate of 5.1%.

Malta is a unitary state composed at the local level of 68 local councils. The local Council is the deliberative authority. The mayor represents the interface of administrative representation and chairs local council meetings. The executive secretary heads the local council. In 2021 Malta had 518,536 inhabitants and a real GDP growth rate of 11.7%. Pirotta, (2001) reveals that Malta has strong political parties and a strong local government system, thus being explained the growth rate of 11.7% in 2021.

Netherlands is a unitary state composed of 418 municipalities and 12 provinces. At the local level, the architectural configuration is based on the local council which is the municipality’s deliberative body, the college of mayor and aldermen which is the executive body, and the mayor which is the local council and the college of mayor and aldermen. According to Table 7.1, in 2021 Netherlands had 17,533,044 inhabitants and a real GDP growth rate of 4.9%. At the regional level, the institutional architecture includes provincial states, the provincial executive board, and the queen's commissioner. According to Louw *et al.* (2003), spatial policy implementation necessitates intervention in the land market. Therefore, local governments in the Netherlands also operate as land developers.

Poland is a unitary state composed at the local level of 2479 municipalities and the architectural configuration includes the municipal council, the mayor, and the head of the municipal administration. The intermediary level includes 379 counties which include the 65 municipalities with special status. The institutional architecture includes the county council, executive board, and the head of the county.

Portugal is a unitary state composed of 4259 parishes and 308 municipalities at the local level (municípios) and 2 autonomous regions at the regional level. Local government includes at the level of Parish the parish assembly and executive committee. At the level of municipalities, we find the municipal assembly, the mayor, and the executive council. The regional level includes Açores and Madeira, which are 2 autonomous regions, the institutional architecture includes the legislative assembly, the president, and the minister of the republic.

Romania is a unitary state composed of 2861 municipalities, 217 towns, and 103 cities. At the regional level, we find 41 counties. The Local Council, which is the deliberative body of the local public administration, is responsible for carrying out local governance at the level of communes, cities, and municipalities in Romania. The number of councilors in the local council is decided by the order of the prefect by the demographic configuration of the administrative-territorial unit. Councillors are elected by direct universal suffrage for a 4-year term. The local council's activities center on the management of public services, public and private property, and economic, social, and environmental development.

Slovakia is a unitary state composed of 2792 municipalities and 138 cities at the local level. At the regional level, we find 8 self-governing regions. According to Table 7.1, in 2021 Slovakia had 5,447,247 inhabitants and a real GDP growth rate of 3.0%. The Local Council (obecné zastaupiteîstvo in municipalities and mestské zastaupiteîstvo in cities) is the deliberative body of the local government and is composed of members elected by direct universal suffrage for a four-year term.

Slovenia is a unitary state composed of 211 municipalities at the local level. The municipal council and the mayor represent the institutional configuration at the local Slovenian level. The municipal council is the municipality's deliberative body, with members elected by direct universal suffrage for a four-year term. The vice-mayors are appointed by and from among the Council members on the Mayor's recommendation. The council is in charge of making the municipality's major decisions, such as establishing local development plans and the municipal budget, as well as deciding on the acquisition or sale of municipal properties. The mayor is the executive body of the municipality and is chosen for a four-year term through direct universal suffrage.

Spain is a unitary state composed at the local level of 8117 municipalities, county councils, Canary Island county councils, and Balearic Island county councils. The architectural configuration of the local level includes the local council, local government council, and the mayor. At the regional level, we find 17 autonomous communities and 2 autonomous cities. The deliberative body is the regional assembly. Its members are elected for a four-year term through direct universal suffrage. The regional assembly has decentralized legislative authority. The regional government council is the executive body, and its members are appointed by the president. It is also in charge of regulating and initiating laws. In 2021 Spain had 47,415,750 inhabitants and a real GDP growth rate of 5.5%.

Sweden is a unitary state composed at the local level of 290 municipalities and the regional includes 17 county councils and 4 regions. At the local level, the institutional architecture includes the municipal assembly, the municipal executive committee, and the specialized committees. The regional level includes the county council or regional council assembly and the executive committee of the county or regional council assembly. In 2021 Sweden had 10,415,811 inhabitants and a real GDP growth rate of 5.1%. Wollmann (2004) suggested that the conventional model of democratically accountable, multi-functional, and territorially sustainable local government from Sweden performs quite well in terms of policy coordination, democratic involvement, and political accountability.

Hungary is a unitary state composed of 3175 municipalities, cities, cities with county rank, capital city districts, and counties. At the local level, we find the body of representatives, which is the municipality's legislative body, the mayor, and the notary, which executes the mayor's decisions. In 2021 Hungary had 9,708,891 inhabitants and a real GDP growth rate of 7.1%.

Most municipal government decisions are ultimately influenced by the financial health of an entity. The state connects itself to its goals of developing strategies for the recovery of the economy, promoting effective employment policies, and balancing the supply-demand balance in the labor market through an appropriate institutional framework and legislative initiatives. This approach also involves several internal and external partners, including local communities, education associations, research institutions, research units, international organizations, and other groups. As a result, the details of the financial policy and the scope of the budgetary fiscal responsibility have a significant role in determining how well the public sector performs overall and at what level. The effectiveness of local financial policies in encouraging good financial management practices depends not only on the local government's financial accounting and reporting, but also on its ability to control revenue and expenditure, ensure ethical procurement procedures, manage local issue debt, and ensure adequate local government internal control that can guarantee effectiveness and integrity.

7.4. Fiscal decentralization as foundation of local financial policies – the case of Romania

The regulatory framework for fiscal decentralization in Romania is based on Law No. 273/2006 on local public finances, Law No. 195/2006 on decentralization, and Law no. 227/2015 regarding the Fiscal Code. Of course, a representative contribution is brought by the Local Public Administration Law No. 215/2001, amended and supplemented, as well as by Law No. 199/1997 on the ratification of the European Charter of Local Self-Government. The most integrative normative act, which partially abrogates legal texts from the Local Public Administration Law no. 215/2001 and from the Decentralization Framework Law no. 195/2006, is Emergency Ordinance no. 57/2019 on the Administrative Code that creates a unitary framework for the manifestation of decentralization in its two forms, administrative and financial.

From the perspective of the Administrative Code (art. 5, letter f), decentralization represents the transfer of administrative and financial powers from the level of the central public administration to the level of the public administration of the administrative-territorial units, together with the financial resources necessary for their exercise. Thus, by definition, the Romanian legislator establishes the forms of decentralization, respectively administrative and financial.

Part III of the Administrative Code is entirely dedicated to local public administration, and its Title II, totaling 8 articles (art. 76-83), develops decentralization. Of course, multiple aspects of the organization of the public administration are also identified in Title III General Regime of Local Autonomy.

The principles (Administrative Code, 2019, art. 76) based on which the decentralization process is carried out are the following: a) subsidiarity; b) ensuring the resources corresponding to the transferred competencies; c) the responsibility of local public administration authorities about their powers; d) ensuring a stable, predictable decentralization process, based on objective criteria and rules, which does not constrain the activity of local public administration authorities or limit local financial autonomy; and e) equity.

The rules of the decentralization process are provided in art. 77 of the Administrative Code (2019), stating that the Government, ministries and other specialized bodies of the central public administration transfer powers to local public administration authorities at the level of communes, cities, municipalities or counties, as the case may be, respecting the principle subsidiarity and the criterion of the geographical area of the beneficiaries, according to which the transfer of competence regarding the provision of public service is made to that level of the local public administration that best corresponds to the geographical area of the beneficiaries.

The transfer of competence is carried out by law and is based on impact analyses and some systems of monitoring indicators, developed by the ministries and other specialized bodies of the central public administration, in collaboration with the coordinating ministry of the decentralization process and with the associative structures of local public administration authorities.

For the competencies proposed to be decentralized, which are exercised by decentralized structures or subordinated to the ministries and other specialized bodies of the central public administration, organized at the local level, no pilot phases are organized.

The institutional framework of the decentralization process is regulated by art. 81-83 (Administrative Code, 2019). According to the law, the coordinating Ministry of the decentralization process is the ministry with attributions in the field of public administration. The coordinating ministry of the decentralization process approves, according to the law, the initiatives and draft normative acts regarding administrative and financial decentralization, developed by the ministries, respectively by the other specialized bodies of the central public administration.

Ministries, other specialized bodies of the central public administration, and local public administration authorities must transmit to the coordinating ministry of the decentralization process all the information necessary for the foundation, implementation, and monitoring of the decentralization process.

For the general coordination of the decentralization process, the Interministerial Technical Committee for Decentralization operates, headed by the minister with attributions in the field of public administration, as the coordinator of the public administration reform. The representatives of the associative structures of the local public administration authorities are also part of the Interministerial Technical Committee. At the level of ministries and other specialized bodies of the central public administration, working groups for the decentralization of competencies are established. The way of organization, operation, and attributions of the technical structures are established by a decision of the Government.

The Committee for Local Public Finances, established under the terms of the law that regulates local public finances, complementary to its role in the process of drafting financial regulations, has an advisory role in the drafting and implementation of financial and fiscal decentralization policies. The representatives of the associative structures of the local public administration authorities are also members of the Committee for Local Public Finances.

The coordinating ministry of the decentralization process and the ministry with attributions in the field of public finance, through the specialized structures, jointly ensure the technical secretariat of the Interministerial Technical Committee for Decentralization and the Committee for Local Public Finances.

The monitoring of the state of the decentralization process (Administrative Code, 2019, art. 83) is carried out by the coordinating Ministry of the decentralization process, which annually presents to the Government, for information, a report on the state of progress of the decentralization process.

From the perspective of the Decentralization Law no. 195/2006, according to Chapter IV Competencies of local public administration authorities, to ensure public services of local interest, local public administration authorities exercise, under the terms of the law, exclusive powers, shared powers, and delegated powers.

According to art 20-21 (Decentralization Law no. 195/2006), local public administration authorities, in the exercise of exclusive powers, have the right to make decisions and dispose of the resources and means necessary to achieve them, in compliance with the legal norms in force. Local public administration authorities at the level of communes and cities exercise exclusive powers regarding: a) administration of the public and private domain of the commune or city; b) administration of road transport infrastructure of local interest; c) administration of cultural institutions of local interest; d) administration of public sanitary units of local interest; f) water supply; g) sewerage and purification of waste and rainwater; h) public lighting; i) sanitation; j) primary social assistance services for the protection of children and the elderly; k) primary and specialized social assistance services for victims of family violence; k1) community medical assistance; k2) medical assistance provided in some sanitary units with beds; l) local public passenger transport; l1) issuance of notices/authorizations; m) other competences established according to the law.

The local public administration authorities at the county level (Decentralization Law no. 195/2006, art. 22) exercise exclusive powers regarding: a) the administration of airports of local interest; b) the administration of the public and private domain of the county; c) the administration of cultural institutions of county interest; d) administration of public health units of county interest; e) primary and specialized social assistance services for victims of family violence; g) issuance of notices/authorizations; h) medical assistance provided in some sanitary units with beds; i) other competences established according to the law.

In the exercise of shared competencies (Decentralization Law no. 195/2006, art. 23), the local public administration authorities at the level of communes and cities collaborate with the public administration authorities at the central or county level, as the case may be, under the conditions established by law. In the exercise of shared competencies, the local public administration authorities at the county level collaborate with the public administration authorities at the central level, under the conditions established by law.

Local public administration authorities at the level of communes and cities exercise shared powers with central public administration authorities (Decentralization Law no. 195/2006, art. 24) regarding: a) the supply of thermal energy produced in a centralized system; b) the construction of social and youth housing; c) state pre-university education, with the exception of special education; d) public order and safety; e) granting social aid to people in difficulty; f) prevention and management of emergency situations at the local level; g) medico-social assistance services addressed to people with social problems; h) primary social assistance services for people with disabilities; h1) social services for the elderly; i) community public services for the registration of persons; j) administration of the road transport infrastructure of local interest at the level of the communes; k) financing of personnel expenses related to doctors and medical assistants, as well as expenses for medicines and sanitary materials from medical and social assistance units ; l) territorial planning and urban planning; m) other competences established according to the law.

The public administration authorities at the level of communes and cities (Decentralization Law no. 195/2006, art. 25) exercise shared powers with the public administration authorities at the county level, in the case of the provision of public utility services through regional operators.

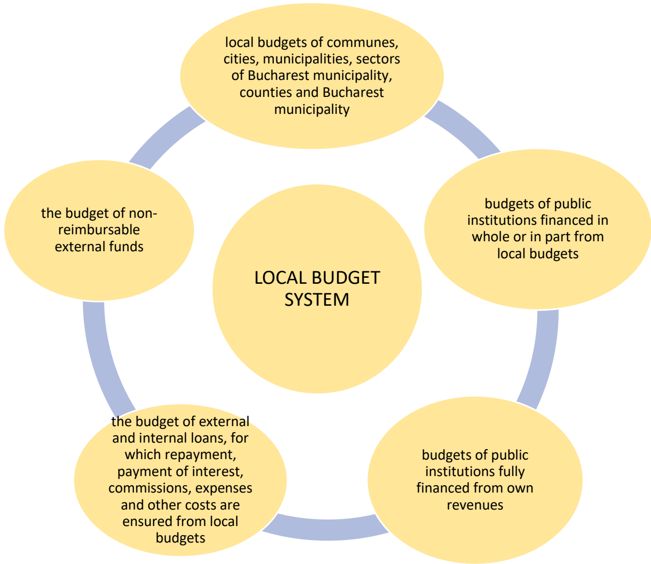
The public administration authorities at the county level (Decentralization Law no. 195/2006, art. 26) exercise shared powers with the authorities at the central public administration level regarding: a) administration of road transport infrastructure of county interest; b) special education; c) medico-social assistance services addressed to people with social problems; d) primary and specialized social assistance services for child protection; e) specialized social assistance services for people with disabilities; e1) social services for people elderly; f) community public services for the records of persons; g) agricultural consultancy, at the county level; h) the financing of personnel expenses related to doctors and medical assistants, as well as the expenses of medicines and sanitary materials from medical and social assistance units; i) other competences established according to the law.

The local public administration authorities exercise delegated powers (Decentralization Law no. 195/2006, art. 27-28) by the central public administration authorities regarding the payment of allowances and allowances for children and adults with disabilities. Local public administration authorities also exercise other powers, according to the law.

The fiscal code (Law no. 227/2015) establishes local taxes and fees, respectively in Title IX (art. 453-495): building tax, land tax, tax on means of transport, fees for the issuance of certificates, notices, and authorizations, fees for the use of advertising and publicity means, the tax on performances, special taxes and other local taxes. Thus, the code establishes all the technical elements of these taxes, identifying management autonomy on the part of local public authorities that have at their disposal taxable values between a minimum and a maximum, tax rates between a minimum and a maximum, the increase of taxes and fees up to at 50%, leaving the possibility of establishment at their discretion.

Law no 273/2006 on local public finances is defining because it establishes the principles, general framework, and procedures regarding the formation, administration, employment, and use of local public funds, as well as the responsibilities of local public administration authorities and public institutions involved in the field of local public finances (Law no. 273/2006 on local public finances, art. 1). Thus, the provisions of the law apply in the field of elaboration, approval, execution, and reporting of the local budget system (Figure 7.2).

A fundamental aspect is the regulation of loans and local public debt in chapter IV of Law no. 273/2006 on local public finances, where in art. 63 the prudential rules for contracting or guaranteeing loans are established. In this sense, administrative-territorial units/Subdivisions are prohibited from accessing loans or guaranteeing any type of loan, if the total annual debts representing the installments due on the contracted and/or guaranteed loans, the interest and related commissions, including the following loan to be contracted and/or guaranteed in the respective year, they exceed the limit of 30% of the arithmetic average of their income, reduced by the income from the capitalization of some assets, for the last 3 years before the year in which the authorization of repayable financing to be contracted is requested and /or guaranteed.



Source: computed by authors based on Law no. 273/2006 on local public finances, art. 1

Source: computed by authors based on Law no. 273/2006 on local public finances, art. 1

Figure 7.2. The local budget system

A fundamental aspect is the regulation of loans and local public debt in chapter IV of Law no. 273/2006 on local public finances, where in art. 63 the prudential rules for contracting or guaranteeing loans are established. In this sense, administrative-territorial units/Subdivisions are prohibited from accessing loans or guaranteeing any type of loan, if the total annual debts representing the installments due on the contracted and/or guaranteed loans, the interest and related commissions, including the following loan to be contracted and/or guaranteed in the respective year, they exceed the limit of 30% of the arithmetic average of their own income, reduced by the income from the capitalization of some assets, for the last 3 years prior to the year in which the authorization of repayable financing to be contracted is requested and /or guaranteed.

The calculation of the limit is presented as follows:

The local financial identity from the perspective of fiscal decentralization can be achieved through the quantitative analysis of the indicators of fiscal decentralization: the vertical fiscal imbalance, the level of local autonomy, the level of self-financing, revenues and expenditure decentralization, fiscal importance, and the index of fiscal decentralization.

These indicators can be identified in Table 7.2.

Table 7.2. Indicators of fiscal decentralization

Year	Level of self-financing	Level of local autonomy	Revenues decentralization	Expenditure decentralization	Vertical fiscal imbalance	Local fiscal importance	Index of fiscal decentralization
2006	0.48	0.46	0.26	0.23	0.39	0.23	0.33
2008	0.49	0.44	0.27	0.22	0.45	0.22	0.33
2010	0.52	0.47	0.26	0.20	0.45	0.20	0.32
2012	0.47	0.48	0.24	0.22	0.49	0.22	0.32
2014	0.46	0.48	0.25	0.23	0.43	0.23	0.33
2016	0.49	0.45	0.27	0.23	0.44	0.23	0.34
2018	0.50	0.47	0.19	0.18	0.50	0.18	0.30
2020	0.50	0.50	0.22	0.17	0.50	0.17	0.29

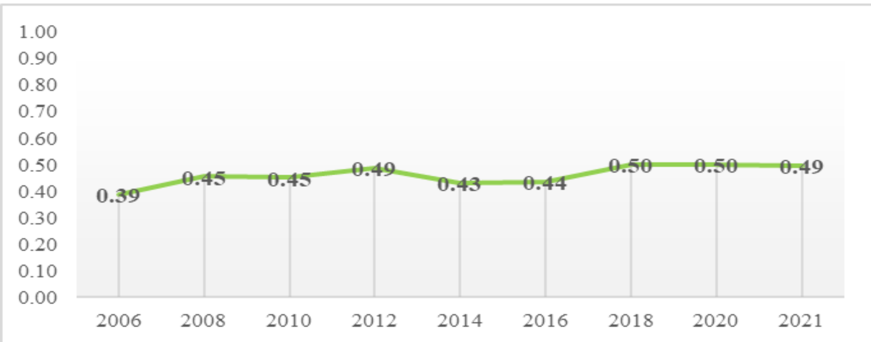
Year	Level of self-financing	Level of local autonomy	Revenues decentralization	Expenditure decentralization	Vertical fiscal imbalance	Local fiscal importance	Index of fiscal decentralization
2021	0.53	0.50	0.21	0.17	0.49	0.17	0.30

Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023) and The Ministry of Finance database (2023)

Each of the indicators (I) is set in the reference interval [0,1], where: I=0 can be described as perfect fiscal centralization whereby subnational expenditure is fully funded by fiscal transfers from the national government; I=1 can be described as perfect fiscal decentralization whereby total public expenditure is fully funded by subnational governments; 0,05<I<1 can be described as 'relative fiscal decentralization' and 0<I<0,05 can be described as 'relative fiscal centralization'.

According to the data in Table 7.2, the status of Romania can be seen as a state with 'relative fiscal centralization', which means that the decentralization process is not yet completed until the financial capacity of the local communities increases in real terms and they will not be so dependent on transfers from other public budgets and, in particular, from the state budget.

The Financial dependence index or Vertical Fiscal Imbalance represents the financial dependence of local authorities on the level of the central administration, respectively the amount of expenses made by local public administrations on account of inter-administrative transfers.



Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023) and The Ministry of Finance database (2023)

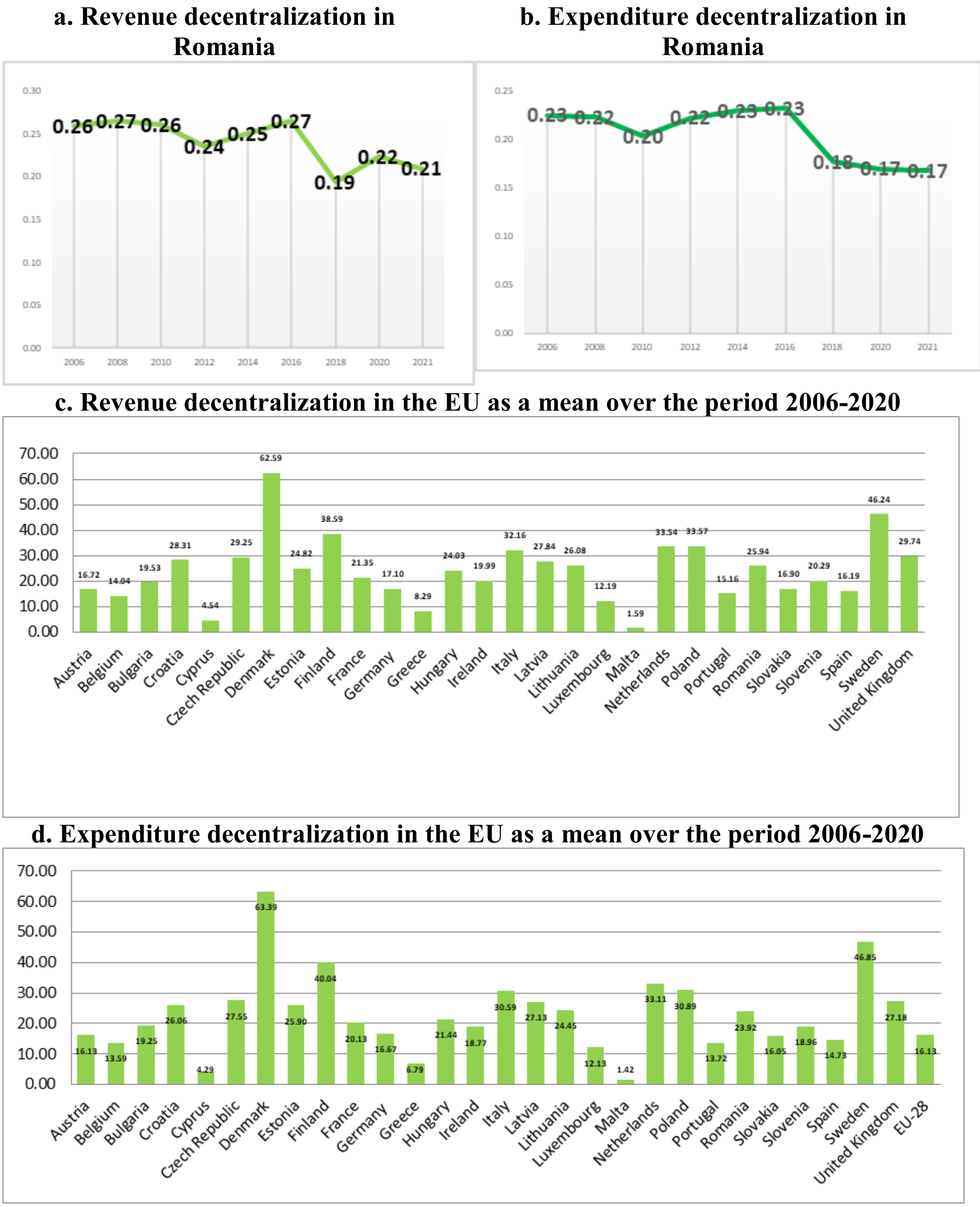
Figure 7.3. Vertical fiscal imbalance

Vertical fiscal imbalance (Figure 7.3) is at the upper limit of the first half of the interval [0,1], which justifies Romania's position as a country with a relative decentralization process, the lowest value being 0.39 at the beginning of the period and the highest value at the level of 0.5, starting with the year 2018.

The weight of the local budget in the budget system is reflected by two indicators viewed in the mirror, respective revenue decentralization and expenditure decentralization (Figure 7.4), as a share of local revenue or expenditure in total national budget system (general consolidated budget).

According to Figure 7.4, the weight of the local budget in the budgetary system in Romania has a slight downward trend, representing 21% in the case of revenues and 17% in terms of expenditure. In the case of Romania, revenue decentralization was the highest in 2008 and 2016, with a value of 0.27, respectively the local budget represented 27% of the total budget system on the revenue side. The decentralization of expenditure showed a maximum in the years 2008, 2014 and 2016, having the highest value of 0.23.

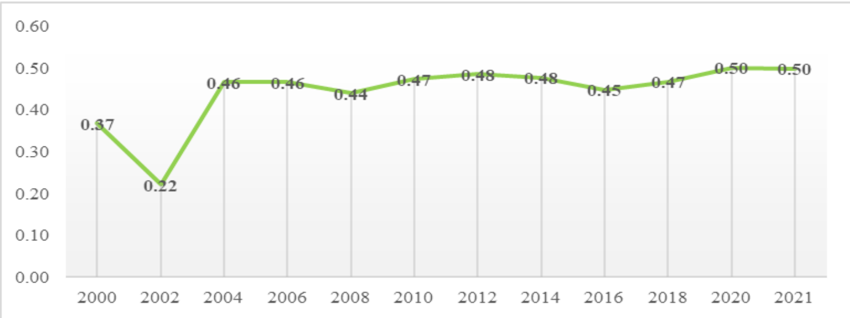
The configuration of the European Union based on these two indicators as a mean over the period of time 2006-2020 presents Denmark with the indicator values that reflect a very high degree of fiscal decentralization, respectively over 60%. Denmark is the country in the European Union with the highest level of decentralization. The lowest level of the indicators is found in Malta, Cyprus, and Greece, where a very low decentralization process can be identified as a result of the fact that these countries are small in terms of territory and population. The European Union average is around 16%-17%. Revenue decentralization and expenditure decentralization are under 20% in 11 states of the European Union, respectively Austria, Belgium, Bulgaria, Croatia, Germany, Ireland, Luxembourg, Portugal, Slovakia, Slovenia, and Spain. Revenue decentralization and expenditure decentralization are between 20% and 30% in 9 countries of the European Union, respectively Croatia, Czech Republic, Estonia, France, Hungary, Latvia, Lithuania, Romania, and the United Kingdom. A level over 30% of these two fiscal decentralization indicators is found in Finland, Italy, Netherlands, Poland, and Sweden.



Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023), the Ministry of Finance database (2023), and Eurostat database (European Commission, 2023)

Figure 7.4. Revenue decentralization and expenditure decentralization

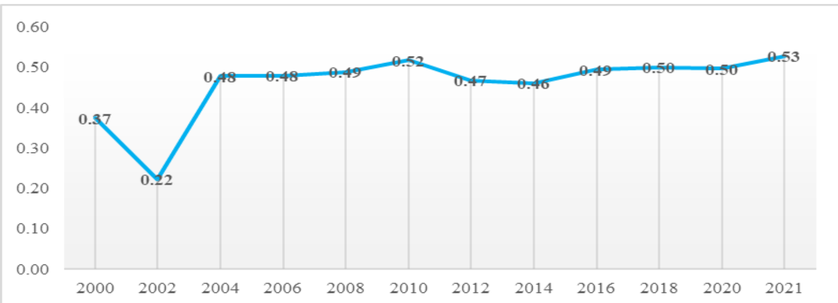
The most frequent possibility of measuring financial autonomy recognized by specialized literature is the ratio between own revenues and total revenues of the local budgets of administrative-territorial units, based on the rationale according to which the share of own revenues in the total sources of income at the local level is higher, the more the administrative-territorial unit has the freedom to spend as it deems so as to ensure the coverage of public needs, which translates into a wide autonomy. In this context, the level of local autonomy is reflected in Figure 7.5.



Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023) and the Ministry of Finance database (2023)

Figure 7.5. Local autonomy

This indicator shows slight variations in the analysed period, they reach the level of 50%, which encourages us to believe that the local public authorities have managed to identify sources of own income to satisfy public needs. Own revenues include both local taxes and unconditional transfers. The lowest level was registered in 2002, respectively 0.22.



Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023) and the Ministry of Finance database (2023)

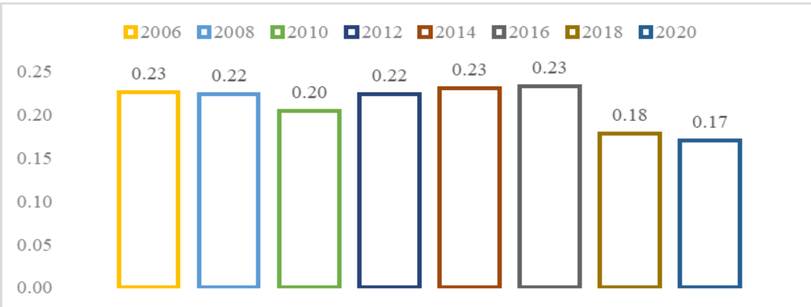
Figure 7.6. Level of self-financing

In addition to the level of local autonomy (Figure 7.6), the indicator of the level of self-financing is calculated as a ratio between the level of own revenue and the total expenditure of local budgets. The indicator exceeds 0.5 towards the end of the period. In 2002, the indicator had the lowest level of 0.22, or 22% auto self-financing.

In the case of Romania, a peculiarity is the inclusion of the decomposed quotas from the income tax in the category of own revenue of the local budget together with local taxes, according to art. 5 of the Local Public Finances Law no. 273/2006.

Another indicator of fiscal decentralization is fiscal importance (see Figure 7.7), which includes expenditures of the state budget and all local budgets, from where transfers are excluded.

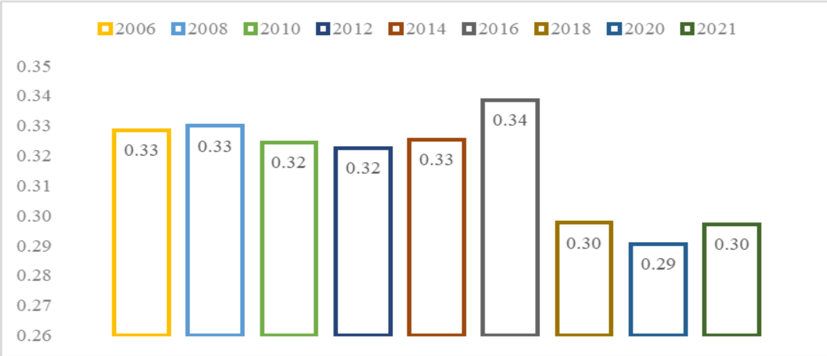
Fiscal importance in Romania does not exceed the level of 0.23, being at the lowest level towards the end of the period of 0.17 in 2020 and 2021.



Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023) and the Ministry of Finance database (2023)

Figure 7.7. Fiscal importance

A representative indicator is also the Fiscal Decentralization Index (Figure 7.8), developed by Vo (2009) as a geometric mean between fiscal importance and self-financing capacity.



Source: computed by authors using the Directorate for Local Fiscal and Budgetary Policies database (2023) and the Ministry of Finance database (2023)

Figure 7.8. Fiscal Decentralization Index

The value of the indicator is less than 0.5, which determines the positioning of Romania rather in the situation of relative fiscal centralization, being justified by the sub-national expenditure mostly financed by fiscal transfers from the national government.

The decentralization process in Romania is legally based in accordance with the vision of the states of the European Union, but in practice (in practice) in many communities the administrative competencies are far ahead of the financial competencies, which determines the intervention of the state through transfers. The decentralization process continues to be a priority for decision-makers in Romania and the other countries of the European Union because it constitutes a firm response to the needs of the local communities and represents an ex-ante conditionality in the multiannual budget programming process at the European Union level. Decentralization is not an end in itself, but a method to provide more efficient public services, in accordance with the requirements and preferences of the beneficiaries.

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CHAPTER 8

MONETARY POLICY OF THE EUROPEAN CENTRAL BANK AND ITS IMPLICATIONS FOR THE EURO AREA ECONOMY

Angela Roman[1]

8.1. Introduction

It is widely accepted internationally that, in the long run, the appropriate fundamental aim of monetary policy is price stability. By maintaining price stability, monetary policy would contribute significantly to other economic objectives, namely economic growth, better employment and increased social welfare.

Since 2003, when the ECB's monetary policy strategy was last assessed, the Euro area and global economies have experienced major structural changes as well as significant shocks, such as the recent global crisis and the COVID-19 pandemic crisis, which have led to economic recession and decrease of inflation. Among the significant transformations, those generated by globalisation, demographic ageing, digitalisation, and climate change stand out in particular. These transformations have profound implications for all policy areas, including monetary policy, which means that they need to be rigorously monitored (Holm-Hadulla *et al.,* 2021).

The profound negative effects of the recent international crisis, the sovereign debt crisis and the COVID-19 pandemic crisis have prompted unprecedented reactions by European Central Bank.

The actions undertaken by the European Central Bank consisted of significant and repeated decreases in the monetary policy interest rate, adjustments of the monetary policy operating framework and, mainly, the design and implementation of unconventional measures.

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[1] Angela Roman is professor PhD. hab. at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.

The monetary policy measures implemented aimed to improve the functioning of the financial markets, support the flow of credit to the real economy and the smooth functioning of the monetary policy transmission mechanism.

In the conditions of the alarming increase in inflation, the European Central Bank has repeatedly raised the key interest rates and it would seem that it will move from non-conventional monetary policy measures to conventional monetary policy measures. The policy interest rate is also intended to resume its crucial role as signal for the monetary policy stance.

The success of the single monetary policy depends on the ability of the ECB to fulfill its responsibilities of maintaining price stability.

8.2. The fundamental objective and monetary policy strategy of the European Central Bank

Monetary policy refers to decisions and measures taken by the monetary authority of a country or monetary area or union with the aim of influencing the price and availability of money in the economy. At the same time, monetary policy is a major component of economic policy, playing a significant role in achieving its most important objective, namely stable and sustainable economic growth over the long term. Central banks can make their most important contribution to achieving this objective by keeping inflation low and stable.

It is widely accepted internationally that, in the long run, the appropriate fundamental aim of monetary policy is price stability. By maintaining price stability, monetary policy would contribute significantly to other economic objectives, namely economic growth, better employment and increased social welfare. Thus, monetary policy makes its most important contribution to increasing the welfare of the population by ensuring price stability (Isărescu, 2008).

The significant contribution of price stability to high rates of economic growth and employment is highlighted by its advantages, including (ECB, 2004):

- Price stability improves the transparency of relative prices, which allows for a more efficient allocation of resources and therefore increases output and welfare. When prices are stable, individuals and firms can make appropriate consumption and investment decisions, and this would allow for an efficient allocation of resources in the economy.

- When prices are stable, the risk premium included in interest rates is reduced, which fosters investments and therefore economic growth and the creation of new jobs.
- Under conditions of price stability, the diversion of resources from productive uses to unnecessary hedging operations against inflation is avoided.
- Price stability contributes to maintaining social cohesion and stability.
- Price stability contributes to financial stability, which would ensure the normal functioning of the financial intermediation process. This, in turn, allows for the efficient allocation of financial resources from depositors to investors and, implicitly, for the enhancement of economic growth.

Currently, the statutes of most central banks state that the fundamental aim of monetary policy is to ensure and maintain price stability.

In the Euro area, monetary policy is made and implemented by the Eurosystem, which comprises the European Central Bank (ECB) and the national central banks (currently the central banks of the 20 Euro area Member States). According to the Treaty on the functioning of the European Union, the primary objective of the monetary policy of the Eurosystem is to *maintain price stability* in the Euro area and hence *safeguard the purchasing power of the Euro*. Moreover, the Eurosystem must support the general economic policies in the European Union in order to contribute to achieving its objectives, which are laid down in Article 3 of the Treaty on European Union. These objectives are balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. The Treaty on European Union therefore sets out a clear hierarchy of objectives for the Eurosystem, showing that price stability is the most important contribution monetary policy can make to achieving a favourable economic climate and a high level of employment.

In the US, the Federal Reserve System (FED) has as its statutory objectives "maximum employment, stable prices, and moderate long-term interest rates" (Federal Reserve Act, Section 2A). Therefore, unlike the ECB, the Federal Reserve System has a multi-objective mandate. In the case of the Federal Reserve System, according to the statute, price stability is not explicitly specified as a primary objective of monetary policy. However, Fed officials have repeatedly clarified that by "maximum employment" they mean "maximum sustainable employment", i.e. non-inflationary employment, so that full employment and price stability are both main objectives, of equal importance, while keeping long-term interest rates at a moderate level is a secondary objective (Roman and Bilan, 2015, p. 114).

The profound negative effects of the recent international crisis on national economies and financial systems show the implications of omitting the financial stability objective from the statute of most central banks (Dikau and Volz, 2021). In this context, some central banks have reconsidered or adjusted their mandate with respect to financial stability (Ingves, 2011). For example: the Bank of England has price stability and financial stability as its primary objectives; the Bank of Japan has price stability and financial system stability as its primary objectives; the Central Bank of Malaysia has price stability and financial stability as its primary objectives of equal importance; the National Bank of Denmark has three primary objectives: maintaining price stability, promoting the smooth operation of the payments system and maintaining the stability of the financial system.

In Romania, the National Bank of Romania Act states that "the primary objective of the NBR is to ensure and maintain price stability" and "without prejudice to its primary objective of ensuring and maintaining price stability, the NBR supports the general economic policy of the Government" (Art. 2, Law No. 312/June 2004).

Central banks, which have price stability as a fundamental objective, use explicit (quantitative) definitions of this objective. For example, in the case of the European Central Bank, by July 2021, under the monetary policy strategy adopted in 2003, price stability meant a situation where the inflation rate, as measured by the harmonised index of consumer prices in the Euro area, was "below, but close to 2% over the medium-term". As of July 2021, following the adoption of the new monetary policy strategy, the ECB Governing Council considers that "price stability is best maintained by aiming for a 2% inflation target over the medium term" (ECB, 2021a). In the case of the Bank of Japan, since January 2013, price stability is defined by reference to the "price stability target" at 2 percent in terms of the year-on-year rate of change in the consumer price index (Bank of Japan, 2013). In the US, in August 2020, Fed officials announced the revision of the monetary policy strategy and stressed that an appropriate monetary policy will aim for “inflation moderately above 2 percent for some time” (Federal Reserve System, 2020).

In the case of central banks that practise direct inflation targeting, price stability is defined by reference to the numerical target to be achieved, which may be a fluctuation band or a certain percentage with or without a fluctuation band.

With reference to the first central bank which introduced, in 1990, direct inflation targeting, namely the Central Bank of New Zealand, its monetary policy has had two main objectives since 2018: price stability in the medium term and supporting maximum sustainable employment. The Bank's Monetary Policy Committee states that they aim for an inflation rate between 1% and 3% on average over the medium term, with a focus on keeping average inflation close to the 2 percent target midpoint (Reserve Bank of New Zealand, 2022). In March 2021, Bank officials announced that, at the request of the government, the Central Bank would include house price sustainability in its assessments of financial stability and explain the impact of monetary policy decisions on housing market developments (Dăianu, 2021). Housing prices play an important role in the central bank's mandate because they influence price stability and maximum sustainable employment. Rising housing prices increase household spending, which in turn influences economic activity, employment and consumer prices.

In recent years, the major negative effects of climate change on economies and even on financial stability have led central banks to intensify their focus on examining the extent to which climate change affects achieving their objectives. However, climate change is a complex topic because little is known about the interaction between climate and economic activity or about the propagation of climate-related risks on the financial system and the economy (Arseneau and Osada, 2023).

In terms of international practice, we see that some central banks have explicitly included the *promotion of sustainable growth or development* as a secondary objective in their mandates. For example, in the statute of the Central Bank of the Czech Republic we identify the following statement “without prejudice to the primary objective (maintaining price stability), the National Bank of the Czech Republic shall support the economic policies of the Government aimed at sustainable economic growth. According to its statute, in force since December 2020 , the Hungarian National Bank (Magyar Nemzeti Bank - MNB) has as its primary objective to achieve and maintain price stability, but also "without prejudice to its primary objective, the MNB shall support the maintenance of the stability of the system of financial intermediation, the enhancement of its resilience, its sustainable contribution to economic growth; furthermore, the MNB shall support the economic policy of the government using the instruments at its disposal".

To highlight central banks' concern for development or sustainable growth, the study by Dikau and Volz (2021), which examines, with reference to 135 central banks, the extent to which climate risks are included in central banks' mandates, is of interest. The results of the study show over half of the central banks analysed have a mandate that includes a sustainable growth or development objective, either explicitly or indirectly in the form of a mandate aiming to support the government's economic policies, which would include sustainability objectives. The authors point out that central banks should include climate-related risks and mitigation policies in their core policy implementation frameworks even if their mandates do not explicitly refer to sustainability. This is necessary because climate change and mitigation policies have significant implications for macroeconomic and financial stability.

With reference to the single monetary policy, the primary objective of maintaining price stability was explicitly mentioned in the Treaty establishing the European Community, but without a clarification of the meaning of the term "price stability". In October 1998, the Governing Council of the ECB announced a quantitative definition of price stability, namely that "price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the Euro area of below 2%. Price stability is to be maintained over the medium-term". In May 2003, following a comprehensive assessment of the monetary policy strategy of the ECB, the Governing Council confirmed this definition and stated that by the definition of price stability it aims to maintain the inflation rate "below, but close to 2% over the medium-term".

The expression "*the Harmonised Index of Consumer Prices (HICP) for the Euro area"* signals the fact that the objective of maintaining price stability is being pursued throughout the Euro area. The Harmonised Index of Consumer Prices, published by Eurostat, is considered the index that best assesses the variations in time in the prices of a representative basket of consumer goods and services purchased by the population of the Euro area.

The phrase "*below the 2% level*" emphasized the explicit indication of an upper limit for the inflation rate, measured on the basis of the HICP, which would be compatible with medium-term price stability. The expression "*close to 2%"* suggests that deflation is also inconsistent with price stability. Moreover, the quantitative definition of price stability also takes into account a possible measurement bias in the HICP and the potential implications of inflation differentials in the Euro area (ECB, 2011a).

The phrase "*over the medium-term*" emphasises that monetary policy cannot influence short-term developments (over several weeks or months) in prices and inflation. Monetary policy measures have an impact on prices and in general on the real economy after a significant time framework and the magnitude of the impact is uncertain. Therefore, monetary policy cannot counteract all unanticipated disturbances with short-term effects on prices (such as, for example, shocks caused by movements in international prices for raw materials). The manifestation, over the short-term, of a certain degree of volatility in inflation is therefore inevitable.

In the context of adopting new monetary policy strategies of the European Central Bank (which was published on 8 July 2021), the price stability objective is formulated in terms of a specific quantitative target, i.e. the Governing Council considers that "price stability is best maintained by aiming for a two per cent inflation target over the medium term" (ECB, 2021a).

The concern with the quantitative definition of price stability is justified because of a number of advantages, including (ECB, 2004, p. 51):

- The quantitative definition contributes to the *transparency of monetary policy*. By specifying a clear quantitative target, the Eurosystem contributes to making its monetary policy framework easier to understand and its monetary policy more transparent.
- The quantitative definition contributes to *increasing the ECB's responsibilities*. The quantitative definition is a benchmark for the public to assess the ECB's performance. If there is divergence between price developments and the definition of price stability, the ECB will have to explain the measures adopted to achieve the objective.

- The quantitative definition would contribute to *enhancing the credibility and effectiveness of monetary policy*. The quantitative definition provides guidance to the public for forming expectations of future price developments. Given that the ECB's commitment to maintaining the stability of prices is credible, inflation expectations are stabilized, which in turn helps to increase the credibility and effectiveness of monetary policy.

To achieve the primary objective of monetary policy, monetary authorities use certain *monetary policy strategies*. They show how monetary policy decisions are taken, implemented and communicated to the public in order to achieve the ultimate objective pursued by the monetary authorities. The monetary policy strategies are designed to link monetary policy instruments to achieving the final objectives pursued.

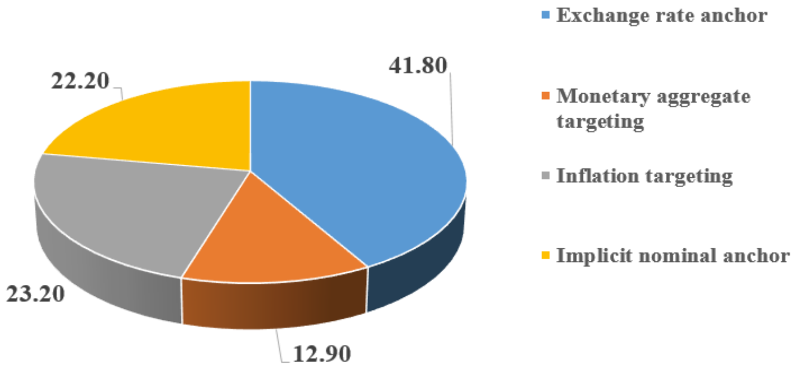
Essentially, a monetary policy strategy indicates the objectives of monetary policy, the instruments available to achieve these objectives, as well as the indicators underlying monetary policy decisions.

Depending on the manner in which the final objective is achieved, monetary policy strategies fall into two categories, namely: *indirect strategies*, which imply certain intermediate objectives (targets) that allow the final objectives (targets) to be achieved; *direct strategies*, which aim to *directly target the final objective*. Both types of strategies have in common the use of a nominal anchor in the management of monetary policy. The nominal anchor is a nominal macroeconomic variable (such as exchange rate, monetary aggregates, inflation target) that is fixed or limited to a certain level in order to ensure price stability. Depending on the characteristics of the economy (degree of development, type of financial system, degree of openness to the outside world, etc.), the monetary authorities may choose one of the following nominal anchors: exchange rate, monetary aggregates, interest rate, nominal income or GDP, level of inflation (Mishkin, 1999).

According to economic practice, indirect monetary policy strategies include: exchange rate anchor, monetary aggregate targeting and the strategy of monetary policy with an implicit nominal anchor. By comparison, direct monetary policy strategies include the inflation targeting framework.

As an example, the monetary policy strategies applied in International Monetary Fund (IMF) member countries in 2022 are shown in Figure 8.1. Based on information published by the IMF (2023), it can be seen that about 42% of

IMF member countries practice exchange rate targeting, 23.2% practice Inflation targeting, 22.2% practice implicit nominal anchor and about 13% of IMF member countries use Monetary aggregate targeting.



Note: * percent of IMF members as of April 30, 2022. Includes 190 member countries and the following territories: Aruba; Curaçao, and Sint Maarten; Hong Kong SAR and Macao SAR

Source: author elaboration based on IMF (2023)

Figure 8.1. Monetary policy strategies in the IMF member countries, 2022*

In the non-euro area EU member states, monetary policy strategies differ from country to country, although the fundamental objective of monetary policy is the same, namely price stability (see Table 8.1).

Table 8.1. Official monetary policy strategies of the non-euro area EU Member States, 2022

States	Currency	Monetary policy strategy	Features
Bulgaria	Bulgarian lev	Exchange rate target	Exchange rate target: fixed to the euro at BGN 1.95583 per euro within the framework of a currency board arrangement. From July 10, 2020, it participates in the Exchange Rate Mechanism (ERM II) with a the standard fluctuation band of plus or minus 15 percent around the central rate of the lev (1 EUR= 1.95583 leva).

States	Currency	Monetary policy strategy	Features
Czech Republic	Czech koruna	Inflation targeting	Inflation target: 2% ±1 percentage point. Floating exchange rate.
Denmark	Danish krone	Exchange rate target	Participates in ERM II with a ±2.25% fluctuation band around a central rate of DKK 7.46038 per euro. In recent years, the Danmarks Nationalbank (DN) has consistently maintained a stable krone within less than 1% of the central rate.
Hungary	Hungarian forint	Inflation targeting	Inflation target: 3% medium-term target with ±1 percentage point to assess target achievement (ex post). The de jure exchange rate arrangement is free floating. The de facto exchange rate arrangement is classified as floating because of discretionary intervention by the Magyar Nemzeti Bank (MNB) in the foreign exchange market.
Poland	Polish zloty	Inflation targeting	Inflation target: 2.5% ±1 percentage point. Free-floating exchange rate.
Romania	Romanian leu	Inflation targeting	Inflation target: 2.5% ±1 percentage point since 2013. The de jure exchange rate arrangement is managed floating. The de facto exchange rate arrangement is classified as crawl-like.
Sweden	Swedish krona	Inflation targeting	Inflation target: annual increase in the Consumer Price Index of 2%. The de jure and de facto exchange rate arrangements are free floating.

Source: author elaboration based on ECB (2014, p. 81) and IMF (2023)

In the Euro area, the ECB's initial monetary policy strategy was adopted in 1998 and revised in 2003. It was based on three main elements, namely (ECB, 2021b):

- *A quantitative definition of price stability* expressed as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the

Euro area of below, but close to 2% over the medium-term. This definition of price stability has also been known as the double-key formulation of the price stability objective.

- *A medium-term stance of monetary policy* given that monetary policy decisions feed through to inflation with a time lag.
- *A comprehensive analysis of the risks to price stability*, which has been carried out under the two pillars, i.e., economic analysis and monetary analysis.

Since 2003, when the ECB's monetary policy strategy was last assessed, the Euro area and global economies have experienced major structural changes as well as significant shocks, such as the recent global crisis and the COVID-19 pandemic crisis, which have led to economic recession and decrease of inflation. Among the significant transformations, those generated by *globalisation, demographic ageing, digitalisation and climate change* stand out in particular. These transformations have profound implications for all policy areas, including monetary policy, which means that they need to be rigorously monitored (Holm-Hadulla *et al.,* 2021). In this context, in January 2020, the Governing Council of the European Central Bank launched a *review of its monetary policy strategy*, which was expected to be completed by the end of 2020 (ECB, 2020a). However, the serious problems caused by the COVID-19 pandemic prompted the ECB to extend the assessment of its monetary policy strategy until mid-2021 (ECB, 2020c). The assessment covered the quantitative formulation of price stability, the range of monetary policy instruments, economic and monetary analyses and the ECB's communication arrangements. In addition, other major issues such as *financial stability*, *employment*, *digitalisation* and *climate change* were also part of the assessment.

On 8 July 2021, the European Central Bank published *its new monetary policy strategy*, which is the result of a rigorous 18-month evaluation (January 2020-July 2021) of the strategy it has been pursuing since 2003.

The ECB's new monetary policy strategy is identified by the following (ECB, 2021a; ECB, 2021b; ECB, 2021c):

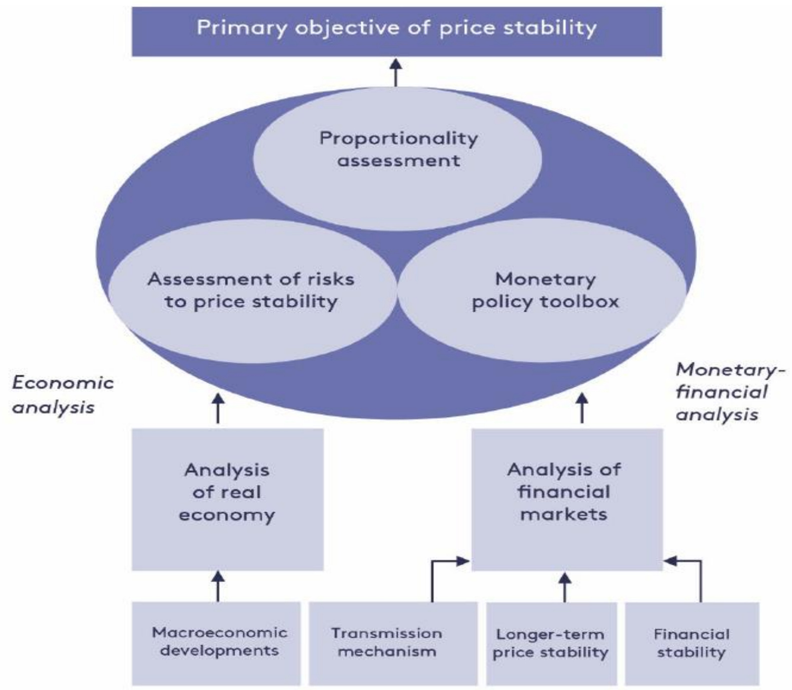
- *Adopting a symmetric 2% inflation target over the medium term.* The Governing Council considers that price stability is best maintained by aiming for a 2% inflation target over the medium term. The price stability objective is therefore formulated in terms of a specific quantitative target, replacing the formulation in the previous strategy (i.e., “below, but close to, two per cent”). The new inflation target is both an important element of the new strategy and a major change from the previous strategy, in which the ECB's mandate was expressed in terms of a price stability objective. Symmetry refers to the fact that both negative and positive deviations of inflation from the target are undesirable.

- The new target of 2% inflation is *simple, clear and easy to communicate* so it is expected to contribute to a more solid anchoring of longer-term inflation expectations.
- *The Harmonised Index of Consumer Prices* (HICP) *remains the appropriate index* for quantifying the price stability objective for the Euro area. This index is therefore considered relevant for measuring inflation in the Euro area for monetary policy purposes. In order to enhance the representativeness of the HICP and to ensure comparability across countries, the Governing Council envisages gradually including owner-occupied housing costs in the HICP. This is intended to make inflation more relevant to the population.
- The new strategy is based on the *medium-term orientation of monetary policy*, which takes into account the fact that monetary policy decisions are transmitted to the economy and inflation after a certain period of time and the impact is uncertain. The medium-term orientation would also allow the Governing Council to take into account other variables relevant to the pursuit of price stability, such as employment and financial stability, when taking monetary policy decisions.
- The new monetary policy strategy is based on a *revised integrated analytical framework,* comprising two interrelated analyses, namely (*1*) *the economic analysis* and (*2*) *the monetary and financial analysis*. These two types of analyses provide meaningful and solid information on possible risks to price stability. The new framework replaces the previous two-pillar framework. The *economic analysis* focuses in particular on short-term developments in economic growth, employment and inflation. The *monetary and financial analysis* has undergone significant changes since the 2003 review, which have been driven by the problems generated by the recent global financial crisis. In this type

of analysis, much attention is paid to the functioning of the monetary policy transmission mechanism, in particular, through the credit, bank lending, risk-taking and asset pricing channels. Monetary and financial analysis also continues to pay attention to monetary and credit aggregates in order to assess the functioning of the monetary policy transmission mechanism. In addition, monetary and financial analysis assesses, at regular intervals, the interactions between monetary policy and financial stability. In essence, the revised integrated analytical framework replaces the previous two-pillar framework and discontinues the cross-checking of the information resulting from the monetary analysis with the information from the economic analysis. Compared to the previous two-pillar analytical approach, the new integrated framework emphasises the consideration of the inherent macro-financial linkages between the real economy, the monetary system and the financial system in terms of the underlying structures, shocks and adjustment processes (Lane, 2021).

- The new strategy underlines the *key role of communication* of the ECB's monetary policy decisions. From this perspective, the Governing Council is committed to explaining monetary policy strategy and decisions as clearly as possible to the public.
- The Governing Council recognises *the major implications of climate change* for price stability and is therefore committed to an action plan, which, inter alia, aims to include climate factors in monetary policy assessments, identify and assess financial risks from climate change and improve the risk management framework.

In essence, the new monetary policy strategy reflects changes in economic analysis, but also in monetary and financial analysis since 2003, the importance of monitoring the transmission mechanism of monetary policy and the recognition that financial stability is a precondition for price stability (ECB, 2021c, July). The main content of the ECB's new monetary policy strategy is highlighted briefly in Figure 8.2.



Source*:* van‘t Klooster (2022, p. 6)

Figure 8.2. The ECB’s new monetary policy strategy

In the context of a rapidly changing economic environment, the ECB's new monetary policy strategy will need to be reviewed much more regularly than in the past. For the coming years, some foreseeable developments (such as progress towards a digital currency, improvements in the architecture of the European Monetary Union, increasing role of non-bank financial intermediaries, etc.) would require further revisions. From this perspective, the Governing Council underlines that the next review of the monetary policy strategy is foreseen to occur in 2025.

8.3. The ECB's conventional monetary policy and key features

According to Article 12.1 of the Statute of the European System of Central Banks (ESCB), the ECB has the authority to elaborate the single monetary policy and to issue the necessary guidelines to ensure its proper implementation uniformly across national central banks (NCBs).

In order to achieve its fundamental objective of maintaining price stability in the Euro area, the Eurosystem is able to use a set of monetary policy instruments and procedures which form the operational framework for monetary policy.

Under normal (non-crisis) conditions, the Eurosystem's operational framework comprises a set of conventional monetary policy tools, which are represented by (A) open market operations, (B) standing facilities and (C) the minimum reserve system.

A. Open market operations

Open market operations are conducted to steer interest rates, manage the liquidity situation in the financial market and signal the stance of monetary policy.

Depending on their specific purpose, open market operations can be grouped into four categories, namely:

a) main refinancing operations,
b) longer-term refinancing operations,
c) fine-tuning operations,
d) structural operations.

Open market operations are conducted through the following instruments:

- main refinancing operations and longer-term refinancing operations are carried out exclusively by means of reverse transactions;
- fine-tuning operations can be carried out through: reverse transactions; foreign exchange swaps for monetary policy purposes; the collection of fixed-term deposits;
- structural operations can be carried out through reverse transactions; the issuance of ECB debt certificates; and outright transactions.

Open market operations are initiated by the ECB, which also decides on the terms and conditions for their execution and on the instrument to be used.

The main refinancing operations (MROs) are regular reverse transactions that provide liquidity, usually with a frequency and duration of one week. These operations are typically the most important means of financing of credit institutions in the Euro area. The interest rate on these operations is the main “key interest rate” of the Eurosystem and represents, together with the interest rates on standing facilities, the *key monetary policy instrument of the Eurosystem*.

While before the recent international crisis the main refinancing operations were the most important monetary policy instrument of the Eurosystem, since the crisis, the importance of this instrument has changed due, for example, to the implementation of new monetary policy measures, namely non-conventional measures (Bank of Finland, 2023).

The longer-term refinancing operations **(**LTROs) are liquidity-providing reverse transactions, conducted by the Eurosystem with the aim to provide long-term liquidity to the banking sector. These operations normally have a maturity of three months and are conducted each month by the Eurosystem on the basis of standard tenders.

The Eurosystem may also conduct other longer-term refinancing operations, with a maturity of more than three months. For example, in recent years, such operations have had maturities of up to 48 months (the *targeted longer-term refinancing operations*) and have aimed to provide incentives for banks to increase lending to the real economy.

Fine-tuning operations (FTOs) are open market operations with different maturities, which are conducted by the Eurosystem to smooth the effects on interest rates caused by unexpected liquidity fluctuations. The main characteristics of FTOs are: may be conducted either as a liquidity-providing or as a liquidity-absorbing operation; have a frequency and maturity that are normally not standardised; are normally executed by the Eurosystem through quick tenders or bilateral procedures; are executed in a decentralised manner by the by the national central banks; counterparties have to fulfil required eligibility criteria; when conducted by means of reverse transactions, they are based on eligible assets as collateral.

Structural operations are conducted when the ECB wants to adjust the structural position of the Eurosystem vis-à-vis the financial sector.

The main operational features of structural operations are: are liquidity-providing or liquidity-absorbing operations; have a frequency and maturity that is not standardised; are executed by means of tender or bilateral procedures; are executed in a decentralised manner by the by the national central banks; liquidity-providing structural operations are based on eligible assets as collateral, with the exception of outright purchases.

The main features of the Eurosystem's open market operations are highlighted in Table 8.2.

Table 8.2. Characteristics of the Eurosystem's monetary policy operations

Categories of the monetary policy operations	Types of instruments		Maturity	Frequency	Procedure
	Provision of liquidity	Absorption of liquidity			
Open market operations					
Main refinancing operations (MROs)	Reverse transactions	-	One week	Weekly	Standard tender procedures
Longer-term refinancing operations (LTROs)	Reverse transactions	-	Three months (*)	Monthly (*)	Standard tender procedures
Fine-tuning operations	Reverse transactions	Reverse transactions	Non-standardised	Non-standardised	Tender procedures
	Foreign exchange swaps	Foreign exchange swaps	Non-standardised	Non-standardised	Tender procedures
	-	Collection of fixed-term deposits			
Structural operations	Reverse transactions	Reverse transactions	Non-standardised	Non-standardised	Standard tender procedures
	-	Issuance of ECB debt certificates	Less than 12 months	Non-standardised	Standard tender procedures
	Outright purchases	Outright sales	-	Non-standardised	Tender procedures Bilateral procedures
Standing facilities					
Marginal lending facility	Reverse transactions	-	Overnight	Access at the discretion of counterparties	
Deposit facility	-	Deposits	Overnight	Access at the discretion of counterparties	

Note: * The Eurosystem may conduct — on a non-regular basis — LTROs with a maturity other than three months. Such operations are not specified in the indicative calendar for the Eurosystem's regular tender operations.

Source: ECB (2015, p. 3)

B. Standing Facilities are the second main monetary policy instrument of the Eurosystem and allow Euro area credit institutions to borrow from, or deposit overnight liquidity at their national central banks (NCBs), on their own initiative. Compared with open market operations, standing facilities are used at the initiative of eligible credit institutions.

The main features of the Eurosystem's standing facilities are presented in Table 8.2. The Eurosystem offers two overnight standing facilities: the marginal lending facility and the deposit facility.

The marginal lending facility allows credit institutions that are facing short-term liquidity needs to borrow overnight liquidity from their national central banks, against eligible collateral.

The national central banks may provide liquidity under this facility by means of repurchase agreements or collateralised loans.

The interest rate on the marginal lending facility normally provides a ceiling for the overnight money market interest rate and is one of the Eurosystem's key interest rates. Therefore, credit institutions use the marginal lending facility provided that they have no other alternative. For example, in the context of the recent financial crisis, given the concerns about the liquidity and solvency of some banks, many credit institutions decided to retain more liquidity at central banks and deposit additional reserves under the deposit facility, instead of lending money to other banks (Delivorias, 2015).

The deposit facility enables credit institutions with excess liquidity to make overnight deposits with the national central banks.

The maturity of deposits made under the *deposit facility is* overnight and the interest rate applying to the deposits is announced in advance by the Eurosystem**.**

The interest rate on the deposit facility normally provides a floor for the overnight market interest rate and is one of the Eurosystem's key interest rates. Thus, credit institutions use the deposit facility given that no other possible placement of excess liquidity is available.

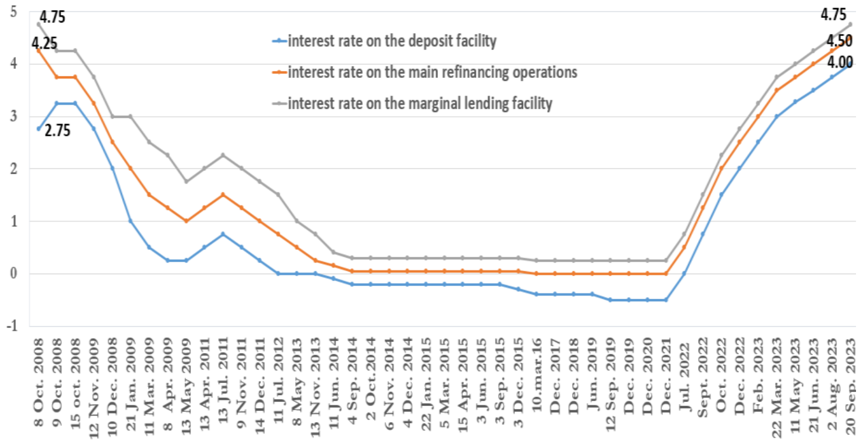
Interest rates on standing facilities delimit the corridor within the overnight money market interest rate may fluctuate. The interest rate corridor can be used as one tool to signal the stance of monetary policy. Since the financial crisis, the deposit facility rate has become a key instrument in steering short-term market rates (Bank of Finland, 2023).

For the Eurosystem, the interest rates policy is based on three key interest rates, which are set by the Governing Council of the ECB, namely:

- *the interest rate on the main refinancing operations* (MRO), which is the main key interest rate, around which fluctuates the overnight money market interest rate;
- *the interest rate on the marginal lending facility,* which normally provides a ceiling for the overnight money market interest rate;
- *the interest rate on the deposit facility,* which normally provides a floor for the overnight market interest rate.

Against the backdrop of the recent international crisis and the COVID-19 pandemic, the ECB progressively lowered, in the period from October 2008 until June 2022, the interest rate on the main refinancing operations (MRO) from 4.25% to an all-time low of 0.00% in March 2016 (a level that was maintained until July 2022) (see Figure 8.3). The interest rates on standing facilities have been progressively reduced since October 2008, from 4.75% (the interest rate on the marginal lending facility) and 2.75% (the interest rate on the deposit facility) to 0.25% (the interest rate on the marginal lending facility) in March 2016 and minus 0.50% (the interest rate on the deposit facility) in September 2019. These interest rates remained unchanged until July 2022.

The ECB's decision to significantly reduce interest rates was adopted considering the prolonged low inflation, weak dynamics of economic growth and sluggish economic prospects. It is worth noticing the negative interest rate on the deposit facility in order to discourage credit institutions to place money at the Eurosystem and, thus, foster the efficient transfer of excess liquidity to the real economy. The Governing Council of the ECB decided for the first time to practice a negative interest rate on the deposit facility in June 2014, when the level of this rate was reduced from 0% to minus 0.10%. In September, 2014, the interest rate on the deposit facility was reduced to minus 0.20%, and subsequently decreased to minus 0.30% (from December 2015), minus 0.40% (from March 2016) and minus 0.50% (from September 2019).



Source: own processing after https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

Figure 8.3. The evolution of key ECB interest rates (%), in the period July 2008 - September 2023

On 21 July 2022, in the context of the significant increase in the inflation rate in the Euro area (driven by the rise in energy and food prices triggered by the war in Ukraine), the Governing Council decided for the first time since 2011 to raise the three key ECB interest rates by 50 basis points, and the deposit facility rate left negative territory for the first time since 2014 (ECB, 2023a, p. 8). Thus, the interest rate on the main refinancing operations, the interest rates on the marginal lending facility and the deposit facility have increased to 0.50%, 0.75% and 0.00% respectively, starting from 27 July 2022 (ECB, 2022b).

Continued high inflation has prompted the Governing Council to raise key interest rates again in September, October and December 2022. Thus, as of 21 December 2022, the interest rates on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility stood at 2.50%, 2.75% and 2.00%, respectively (ECB, 2022d).

In order to restore price stability over the medium term, in the first nine months of 2023, the Governing Council repeatedly increased the key interest rates in February, March, May, June, July, August and September 2023. Thus, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility were at the level of 4.50%, 4.75% and 4.00% respectively, from 20 September 2023 (ECB, 2023c).

Looking ahead, the Governing Council will continue to be concerned that the three key interest rates make a significant contribution to returning inflation to the 2% target.

C. Minimum reserves

The ECB is empowered to require Euro area banks to hold a certain amount of funds, known as minimum reserves, in their accounts at the national central bank.

The Eurosystem uses minimum reserves to stabilize money market interest rates and to tighten or ease liquidity conditions (monetary aggregates) in the money market to enable the ECB to efficiently steer these monetary aggregates (ECB, 2011b).

The level of reserves (Bank of Spain, 2023) is calculated on the basis of the bank's balance sheet prior to the start of the maintenance period, by applying a percentage (known as the reserve ratio) to certain balance sheet items (known as the reserve base). The required minimum reserve rate was 2% during 1999-2011 and was reduced to 1% from 18 January 2012.

Regarding the remuneration of minimum reserves, until 20 December 2022, minimum reserve holdings up to the level of the minimum reserve requirement have been remunerated at the average interest rate of the Eurosystem's main refinancing operations over the maintenance period. On 27 October 2022, the Governing Council of the ECB decided to set the remuneration of minimum reserves at the Eurosystem's deposit facility rate. As of 20 September 2023, minimum reserves are remunerated at a rate of 0% (ECB, 2023a).

Between 2014 and 2022, interest was charged on excess liquidity held on Eurosystem accounts by Euro area banks to the interest rate on the deposit facility. To alleviate the direct cost of negative interest rates for banks, the ECB adopted a two-tier system for remunerating excess liquidity holdings between September 2019 and September 2022, thus exempting part of banks' excess cash reserves from the negative deposit facility rate (Austrian National Bank-Oesterreichische Nationalbank, 2023). Following the raising of the deposit facility rate to above zero (14 September 2022), the Governing Council decided in its meeting of 8 September 2022 to suspend the two-tier system.

Since the recent international crisis, minimum reserves have become less relevant in the implementation of monetary policy, as banks' deposits with the central bank have increased due to the introduction of new refinancing operations and asset purchase programmes (Bank of Finland, 2023).

In conclusion, the Eurosystem uses conventional monetary policy instruments to influence financing conditions and economic developments in the Euro area, which in turn affect inflation.

8.4. Unconventional monetary policy of the ECB in times of crisis

The profound negative effects of the recent international crisis, the sovereign debt crisis and the COVID-19 pandemic crisis have prompted unprecedented reactions by central banks, which have implemented new monetary policy instruments, called *unconventional instruments*.

The main unconventional monetary policy measures adopted by the Eurosystem between the recent international crisis (2008) and the outbreak of the COVID-19 pandemic crisis are outlined below.

Unlimited provision of liquidity through "fixed rate tenders with full allotment" in both the main refinancing operations (MROs) and the long-term refinancing operations (LTROs). Under normal, crisis-free, circumstances, the refinancing operations within the Eurosystem occur in a pre-set amount, within a variable rate tender procedure. Thus, in comparison with the period prior to the crisis, the credit institutions in the Euro area have unlimited access to central bank liquidity at the main refinancing rate, provided they present adequate collateral. This measure was introduced in order to provide short-term financing support to banks, and to attenuate the negative impact of the potential liquidity risk on credit availability to businesses and households (Roman, 2015).

A *negative interest rate on the deposit facility* was practiced with the aim of discouraging credit institutions from placing money in the Eurosystem and thus stimulating credit flows to the real economy. The ECB Governing Council first decided on a negative interest rate on the deposit facility in June 2014, when the level of this rate was reduced from 0% to minus 0.10%.

Forward guidance

In July 2013, the Board of the Governing Council of the ECB decided to adopt a new non-standard measure of monetary policy, namely *forward guidance*, used by the central banks in order to communicate the orientation of monetary policy with respect to the future path of policy interest rates (ECB, 2014, p. 258). The purpose of forward guidance is to guide expectations concerning the future evolution of the key ECB interest rates.

Over the years, the formulation of the ECB's forward guidance has been adapted several times.

Targeted longer-term refinancing operations (TLTROs)

On 5 June 2014, the Governing Council of the ECB announced the performance of a series of eight targeted longer-term refinancing operations (TLTROs), over the course of two years, aiming at improving bank lending to the Euro area non-financial private sector, excluding loans to households for house purchase. The Governing Council of the ECB announced conducting *targeted longer-term refinancing operations* (the first program of *longer-term refinancing operations*- TLTROs I), in order to improve bank lending to the Euro area non-financial private sector, excluding loans to households for house purchase. These operations provide banks with long-term financing on favourable terms for up to four years. The amount lent to a bank is conditional on the bank's lending behaviour.

TLTROs are targeted operations, as the amount that banks can lend is linked to their lending to non-financial corporations and households. The ECB launched three series of TLTROs: TLTRO I in 2014, TLTRO II in 2016 and TLTRO III in 2019.

In 2020, following the outbreak of the COVID-19 pandemic, the ECB offered more attractive terms for the TLTRO III series to maintain bank lending to households and businesses during the pandemic crisis.

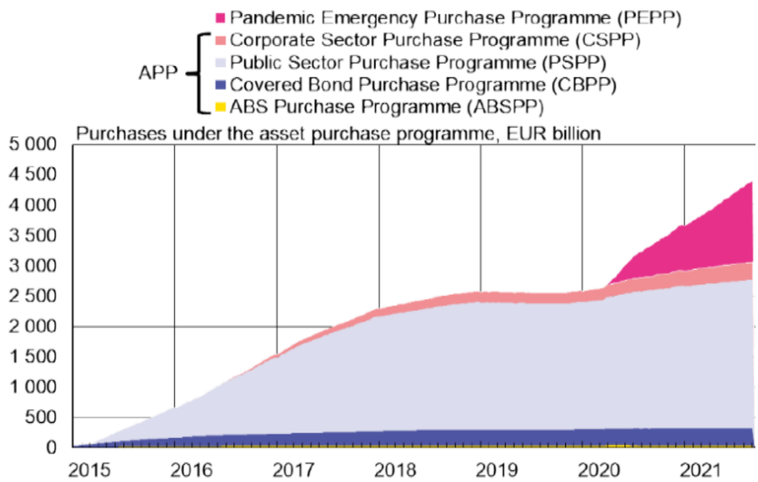
Expanded Asset Purchase Programme (APP)

On 22 January 2015 an expanded asset purchase programme (APP) was launched, by means of which the ECB announced the further expansion of its monetary policy.

The *expanded asset purchase programme* is also known by the name of quantitative easing, or QE, constitutingan unconventional form of monetary policy where a central bank creates new money to buy financial assets, like government bonds (Delivorias, 2015). Through asset purchases within this program, the substantial easing of financing conditions and consequently the reduction of the financing cost for firms and households is sought. In these conditions, investments and consumption are stimulated, contributing to a return of inflation rates towards 2% target in the medium term and to the stimulation of the economic activity in the euro area.

Currently, the expanded asset purchase programme (APP) consists of the third covered bond purchase programme (CBPP3), the asset-backed securities purchase programme (ABSPP), the public sector purchase programme (PSPP) and the corporate sector purchase programme (CSPP).

The evolution of purchases under the asset purchase programme can be seen in Figure 8.4. The asset purchase programmes introduced by the Eurosystem aimed to improve the functioning of the financial markets, support the flow of credit to the real economy and the smooth functioning of the monetary policy transmission mechanism.



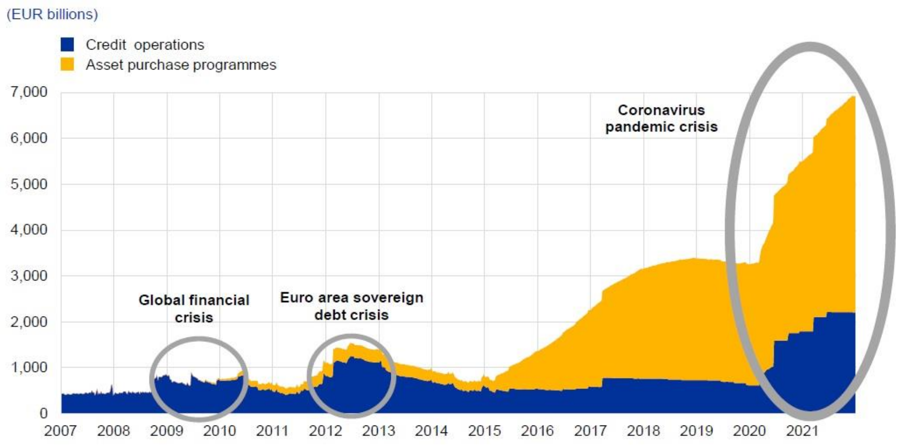
Source: Kilponen and Kontulainen (2021, p. 12)

Figure 8.4. Purchases under the asset purchase programme, 2015-2021

In the context of the economic crisis generated by the COVID-19 pandemic, the ECB adopted *new unconventional monetary policy measures* to support credit flows to the real economy, including:

- *conducting supplementary longer-term refinancing operations* at an interest rate equal to the interest rate on the deposit facility (minus 0.50%) to support the provision of liquidity in the Euro area financial system;
- *easing of conditions for targeted longer-term refinancing operations* (TLTRO III) underway between June 2020 and June 2021, by reducing their interest rate by 0.25 percentage points;
- in March 2020, the Governing Council announced the *Pandemic Emergency Purchase Programme* (PEPP) as an additional asset purchase programme (ECB,2020b); the PEPP is a temporary asset purchase programme of private and public sector securities;
- in April 2020 the Governing Council announced a series of so-called *pandemic emergency longer-term refinancing operations* (PELTROs).

The intensive use of the Eurosystem's monetary policy implementation framework has led to unprecedented levels of monetary policy operations over the period 2020-2021 (see Figure 8.5).

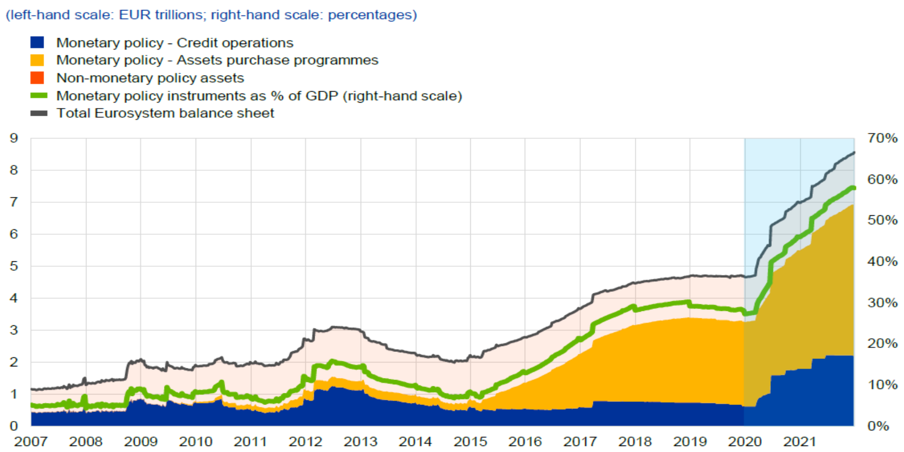


Source: Corsi and Mudde (2022, p. 8)

Figure 8.5. Monetary policy operations

The monetary policy measures implemented in the context of the COVID-19 pandemic crisis led to a significant increase in the Eurosystem's balance sheet (see Figure 8.6). This was mainly due to the implementation of the Pandemic

Emergency Purchase Programme (PEPP), but also to increased demands for the TLTRO III series. At the end of 2021, the Eurosystem balance sheet had reached a historic high of 8.4 trillion Euro, an increase of 3.8 trillion Euro since 31 December 2019. The share of monetary policy assets increased, both as a percentage of GDP and as a percentage of the Eurosystem balance sheet. Thus, monetary policy assets increased from 3.3 trillion Euro at the end of 2019 to 6.8 trillion Euro at the end of 2021. At the same time, monetary policy assets have reached a share of almost 60% of Euro area gross domestic product (Corsi and Mudde, 2022).



Source: Corsi and Mudde (2022, p. 47)

Figure 8.6. Monetary policy assets in the Eurosystem balance sheet

As regards the effectiveness of the unconventional monetary policy measures implemented by the ECB, the analytical assessment of these measures in the context of the review of the monetary policy strategy found that each of the unconventional instruments (negative interest rates, forward guidance, asset purchases and long-term refinancing operations) was effective in influencing the real economy (ECB, 2021b).

In April 2022, with energy and commodity prices rising significantly, the Governing Council stressed that net asset purchases under the asset purchase programme (APP) should cease in the third trimester of 2022. Thus, in June

2022, the Governing Council decided to end net asset purchases under its asset purchase programme (APP) as of 1 July 2022 (ECB, 2022a).

In July 2022, with the decision to increase interest rates, the ECB approved the addition of a new instrument to its monetary policy toolkit, namely the *Transmission Protection Instrument* (TPI), to support the transmission of monetary policy in the Euro area (ECB, 2022c).

In conclusion, the unconventional monetary policy measures are temporary and are designed to be used only under crisis conditions. Thus, as the functioning of the financial markets and the economy improves, it is no longer necessary to maintain them. Therefore, the exit from these extraordinary measures depends on the state of the financial markets in particular, and of economy in general.

By a gradual exit from unconventional measures, central banks intend to return to a normal monetary policy. The policy interest rate is also intented to resume its crucial role as signal for the monetary policy stance.

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C H A P T E R 9

MONETARY POLICY AND NON-BANK FINANCIAL INTERMEDIATION. A FOCUS ON THE EU COUNTRIES

Constantin-Marius Apostoaie[1], Irina Bilan[2]

9.1. Introduction

Even though 'traditional' bank lending is a very important source of funding (in the European countries, at least), incumbent banks aren't always able to cope with the growing financial needs of an economy, and this is where other forms of financial intermediation come into play to provide a valuable and viable funding alternative. Specifically, non-bank financial intermediation (the Financial Stability Board preferring this term, since 2018, to the more well-known 'shadow banking'), a particular form of market-based finance, has become more significant in the last years, especially during and after the 2008 global financial crisis (which rather fueled the expansion of this particular financial sector) – see ESRB (2019) for the European case. The general interest in market-based finance was also fueled by the belief that bank-based financial intermediation leads to systemic risk, and countries can enhance their resilience by augmenting the proportion of market-based financing in the financial structure (Langfield and Pagano, 2016; Bats and Houben, 2017). Nonetheless, non-bank financial intermediation is itself "less resilient due to dense interconnectedness, liquidity and maturity mismatches, credit enhancement, significant leverage, a highly runnable funding base, and missing access to public backstops" (Hodula, 2018). Later on, Hodula and Libich (2023) revisit these attributes as being "dense interconnectedness, insufficient transparency,

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[1] Constantin-Marius Apostoaie is Ph.D., associate professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.
[2] Irina Bilan is Ph.D., associate professor of finance at the Faculty of Economics and Business Administration, Alexandru Ioan Cuza University of Iași.

liquidity and maturity mismatches, credit enhancements, extortionate leverage, a highly runnable funding base, and a limited access to public backstops".

In simple terms, Non-Bank Financial Institutions (NBFIs) are financial entities that, although do not have a full banking license to operate, can provide alternative financial services to any individual or entity that may require funding (including for launching a new business). Non-Bank Financial Intermediation (NBFI) can involve a variety of activities, including but not limited to: micro-loans and venture capital, investment intermediaries (finance companies, mutual funds and money market funds), contractual savings (pension funds and insurance companies) and others (Mishkin, 2007). According to Malatesta *et al.* (2016), NBFIs can conduct either all three or any one of the typical banking functions: maturity, credit, and liquidity transformation. Wallison (2012) makes an interesting comparison between the two forms of financing, banking and non-banking: should one strip apart the 'financial innovation' component that characterizes shadow banking (SB) in general, through the process of regulation, you are left with plain, old 'boring banking'.

After surveying the existing literature and analyzing the multitude of definitions and specific approaches, some common characteristics can be agreed upon when 'unpacking' the concept (Apostoaie and Bilan, 2020):

(i) there is clearly a process of credit intermediation, associated with some forms of maturity and liquidity transformation, as well as leverage;

(ii) there are no public safety nets (investors are not offered public guarantees if their funds are mismanaged by shadow banking institutions) and no access to central bank liquidity (shadow banks cannot request financial aid if they confront themselves with funding problems);

(iii) the entities and activities in the 'shadows' are fragile and less regulated as opposite to traditional banking institutions;

(iv) the absence or trivial regulation associated with the lack or weak regulatory arbitrageurs in the shadow banking sector may drive the financial system towards a point of systemic fragility (associated with high levels of systemic risk).

Despite the fact that some financial activities occur outside the regulated banking sector, shadow banking is nonetheless part of the financial system and it is the central bank's duty to keep up with the developments in the NBFI sector, especially because of the interactions with its monetary policy. Managing a reliable and workable monetary policy is of keen importance for every central bank, since it reaches people, businesses and governments. Previous literature revealed that the SB sector can make monetary policy may lose traction in stabilizing the financial system and the overall macroeconomy, the monetary transmission mechanism becoming "sectorally impaired" (Brunnermeier and Sannikov, 2014).

In this context, this chapter explores the interconnections between this continuously evolving segment of the financial system (created by non-bank financial intermediaries) and a central bank's monetary policy; the focus is on the euro area.

9.2. Some theoretical considerations on shadow banking

The most influential works on providing definitions for the concept were the ones of Pozsar (2008), Adrian and Shin (2009), Pozsar *et al.* (2010), Tucker (2010), and Adrian and Shin (2011). Another wave of manuscripts that brought some light in defining the concept include the ones of Claessens *et al.* (2012), Claessens and Ratnovski (2014a), IMF (2014b), Claessens *et al.* (2015), Adrian (2018), and Rubio (2018). Hodula (2018) breaks up the existing shadow banking definitions into two main groups according to their focus:

i) Some definitions focus on the entity that carries on SB activities, also known as *the entity-based approach*; under this approach, Pozsar *et al.* (2010, 2013) define shadow banks as: "financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector guarantees".

ii) Other definitions address the activities that the entity carries on, also known as the *activity-based approach*; within this framework, Claessens *et al.* (2012) and Claessens and Ratnovski (2014a) define SB as: "all financial activities, except regular banking, which rely on a private or public backstop to operate".

Among the first official (institutional) definitions of the concept was provided by the Financial Stability Board (FSB) in 2011, according to which shadow banking is "the system of credit intermediation that involves entities and activities outside the regular banking system" – see FSB (2011, p. 1) or FSB (2012b, p. 1). A rather similar definition of the concept was provided by the US

Financial Crisis Inquiry Commission (FCIC), highlighting also the 'inverse parallelism' principle mentioned earlier by Lysandrou and Nesvetailova (2014). To quote: "bank-like financial activities that are conducted outside the traditional commercial banking system, many of which are unregulated or lightly regulated" (FCIC, 2010). Nonetheless, the FSB reconsidered its approach in the light that not all 'entities and activities outside of the regular banking system' presents the same level of risk to the traditional banking sector. The narrower definition referred to those specific 'entities and activities outside of the regular banking system' that "raise i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or ii) regulatory arbitrage concerns" (FSB, 2012a).

ESRB is mapping and monitoring shadow banking threats that originate either from financial institutions ("entity-based approach") or from their activities ("activity-based approach"). The International Monetary Fund (IMF) also uses the same dual approach (activities vs. entities) to make a schematic summary of the different definitions of and perspectives on shadow banking till 2014. Table 9.1 depicts the main definitions that fit in one of the three categories, oriented towards activities, entities or both (Apostoaie, 2017). It also proposes a new and interesting definition of the concept, based on non-traditional (noncore) funding. To quote: "financing of banks and nonbank financial institutions through noncore liabilities constitutes shadow banking, regardless of the entity that carries it out" (IMF, 2014a, p. 68).

Starting with 2019, many authors and institutions would replace the term "shadow banking" with the term "non-bank financial intermediation" (NBFI). In the eight edition of the Report, the FSB adopts the term NBFI, to emphasise "the forward-looking aspect of the FSB's work" (FSB, 2019). In addition, FSB declares that the change is just of terminological nature and does not affect either the substance or the coverage of the monitoring exercise. The monitoring exercise is part of the FSB's strategy to enhance the resilience of NBFI. The focus is on those parts of NBFI that perform economic functions which may give rise to bank-like financial stability risks, i.e., the narrow measure of non-bank financial intermediation. FSB was also among the first institutions to combine the two approaches mentioned by Hodula (2018) and suggested considering both the financial entity and its market activities (under an 'activity-of-entity' based approach). The European Systemic Risk Board also adopted the 'activity-of-entity' approach in tackling shadow baking and has followed the other institutions in renaming the concept, replacing the "EU Shadow Banking Monitor" with the currently in use "EU Non-Bank Financial Intermediation Risk Monitor" (ESRB, 2019).

Table 9.1. Different definitions of Shadow Banking as classified by the IMF

Activities	Entities
Unregulated or lightly regulated bank-like intermediation (FCIC, 2010) Money market funding of capital market lending (Mehrling *et al.*, 2013) All financial activities, except traditional banking, requiring private or public backstop to operate (Claessens and Ratnovski, 2014b)	Levered-up financial intermediaries with liabilities perceived akin to bank deposits (McCulley, 2007) Maturity transformation outside banking social contract (Ricks, 2010) Entities that conduct maturity, credit, and liquidity transformation without government guarantee or access to central bank liquidity (Pozsar *et al.*, 2010, 2013)
Market-funded, credit intermediation system involving maturity or liquidity transformation through securitization and secured-funding mechanisms (Deloitte, 2012)	Nonbank financial institutions that behave like banks, borrow short, leverage, and lend and invest long in illiquid assets, but less regulated (Acharya *et al.*, 2013)

Dual approach (A & E)	Credit intermediation involving entities and activities outside the regular banking system (FSB, 2013) Provision of financial products and services by shadow entities and financial markets (Schwarcz, 2012) Institutions, old contracts (repo), and more esoteric instruments (ABCP, ABS, CDO, and the like) (Gorton and Metrick, 2012) Entities with liabilities supposedly redeemable at par but without a government guarantee, and instruments that trade as if they have a zero performance risk (Kane, 2014)

Source: IMF (2014a, p. 91)

Another topic intensively debated in academic literature refers to the measurement of shadow banking. Consistent efforts have been made by the international community to monitor and measure shadow banking but, unfortunately, there is not yet a 'one-fit glove'. One widely employed measure consists in using the aggregated financial assets of *Other Financial Intermediaries* (OFI) as an instrument to measure shadow banking (an 'entity-based approach'). OFI include all non-bank financial corporations and quasi corporations that are engaged mainly in financial intermediation and provide primarily long-term funding, and are not central banks, banks, insurance corporations, pension funds, public financial institutions, or financial auxiliaries. Given the shortcomings of this measure (it accounts for entities that are not engaged in shadow banking activities, therefore overstating the true dimensions of shadow banking), the FSB turned to the 'economic-function-based' narrow measure of shadow banking (which assumes an 'activity-based approach'). The FSB proposal to measure shadow banking classifies NBFIs in accordance with five economic functions that involve non-bank credit intermediation with some risks to financial stability. With regard to using the OFI as an instrument for measuring shadow banking, one must bear in mind that the OFI definition used by the FSB and the one used by the euro area accounts statistics are different, as the former includes money market funds (MMFs), whereas the latter excludes them (Apostoaie and Bilan, 2019). In general, activity-based approaches are preferred to entity-based approaches given that the former, if used alone, would be insufficient owing to 'the limitations of balance sheet data for risk analysis, such as measuring off balance-sheet exposures and financial derivatives, and owing to the need to account for specific interactions between entities' (ESRB, 2016).

9.3. The nexus between monetary policy and shadow banking

A milestone in the scientific literature on the nexus between monetary policy and shadow banking is provided by Hodula (2018, 2019). He investigates the relationship between monetary policy and the balance sheet growth of both bank and non-bank (shadow) financial intermediaries. In his works, he shows that the relationship between central bank's policy and shadow banking growth is level-dependent and may be determined by the relative magnitude of interest rates in the economy (bringing into the spotlight the two main motives driving the relationship, which are discussed later one). Hence, given the presence of another channel through which monetary policy may influence the financial system's stability, the author underlines the idea that monetary policy should not be used as a safeguard for financial stability, and that monetary and macroprudential policy should work closely together. Of course, there are also some other factors that compete to instill growth in the NBFI sector, such as: increasing demand of long-term institutional investors, more stringent capital regulation, and faster financial development. Older studies bring forward the tighter reserve and other regulatory requirements that pushed traditional consumers of bank loans to look for alternatives (e.g., Duca, 1992). Albeit that, the focus of this paper is not on such factors.

Hodula (2018, 2019) brings forward ***two main motives*** that explain the growth of the shadow banking sector: a "funding costs" motive and a "search-for-yield" motive. One the one hand, there is the "funding costs" motive of financial institutions, implying there is a positive relationship between monetary policy and shadow banks, but a negative one with the traditional banks. Briefly put, when a restrictive monetary policy stance is adopted (i.e., there are tight monetary conditions associated, in general, with a high interest rate environment), incumbent banks, to save their profits, tend to diminish their lending and other activities, as these are confronted with additional capital costs. These banks also may be incentivized to bypass the higher funding costs by increasing their market activities, such as securitization, asset trading, etc. Such a behaviour might lead to a migration of assets out of the traditional banking system and into the 'shadows'. In addition to banks, economic agents might look for funding in the shadow banking sector, to refund their existing loan contracts (since the high interest rates might fuel the existing repayments costs of such existing loans).

On the other hand, there is the "search-for-yield" motive of banks which brings forward a negative relationship between monetary policy actions and shadow banking. This relationship was more visible in the aftermath of global financial crisis, when the empirical link between monetary policy and traditional banking weakened considerably, while the relationship with shadow banking turned negative (Hodula, 2020). Post-2008, many central banks pushed the interest rates to all-time lows. This affected the yields, lowering them considerably, and drove investors to look for more profitable investments (causing massive inflows into investment funds).

In another paper, Hodula *et al.* (2023) investigate more in depth these two motives, by disaggregating shadow banking into two main components: Other Financial Intermediaries (OFIs) and Investment Funds (IF). As mentioned in the earlier section, Money Market Funds are much smaller in magnitude (about 40% of GDP in the euro area as of end-2018), so they don't make a lot of difference in the analysis (the authors deciding to include them in the IF aggregate value). Their research accounted for the relative size of the level of interest rates, distinguishing between a 'low-interest regime' and a 'normal regime' (exploring two different interest rate thresholds, 1.25% and 0.21%). The results revealed that a tighter monetary policy stance is associated with slower growth in the Investment Funds category, but, at the same time, an accelerated growth of the OFI component. On the other hand, a losing monitoring policy stance is generally associated with an accelerated growth of the Investment Funds component. In conclusion, financial vehicle corporations and derivatives dealers seem to fuel the *funding-cost motive*, whereas equity, hedge and real-estate funds feed the *search-for-yield motive.*

Prior to Hodula (2018), other studies regarded the relationship between monetary policy and shadow banking development to be positive. Nelson *et al.* (2018), for example, found that "surprise monetary contractions tended to reduce the assets of commercial banks", but, at the same time, "tend to expand shadow bank assets, rather than reduce it" (using VAR models on US data, over the period 1966–2007). The authors bring forward the "waterbed effect" of monetary policy concept to highlight the fact that monetary policy shocks tend to affect differently the balance sheets of banks and shadow banks. Their investigation generated disbelief on the idea that monetary policy could usefully "get in all the cracks" of the financial sector in a uniform way, as other studies suggested (Stein, 2013). This paper is among many others that emphasize the heterogeneity in the balance sheet dynamics of financial intermediaries (He *et al.*, 2010; Pozsar *et al.*, 2010).

Agnello *et al.* (2020) also investigated the nexus between monetary policy and the shadow banking sector. In particular, using quarterly data for the United States over the 1946-2016 period and various econometric frameworks, the authors investigate the response of the central bank to the growth rate of the

NBFIs' size. The results revealed that an increase in the total volume of assets of the securities' brokers and dealers and the NBFI sector is associated with a rise in the federal funds rate. The subsequent Bayesian structural vector autoregression model employed by the authors brought forward that "an unexpected monetary policy contraction leads to a fall on impact in both the asset growth rate of securities' brokers and dealers and the asset growth rate of the shadow banking sector, as a result of the deterioration in liquidity conditions" (Agnello *et al.*, 2020, p. 16). Nonetheless, since the response becomes positive later-on (6-8 eight quarters after the initial shock), the authors imply that NBFIs overcome the challenge posed by the liquidity dry up with an intensification of the activity of securitization. Their results are in line with that of Nelson *et al.* (2018).

Chen *et al.* (2018) investigated how monetary policy in China influenced banks' shadow banking activities (during 2009-2015) and came to the conclusion that "contractionary monetary policy […], although exerting an expected effect on traditional bank loans, stimulated shadow banking and encouraged banks to bring shadow banking products onto their balance sheets in the form of risky non-loan assets" Chen *et al.* (2018, p. 3892). The authors strongly argue an increase of the NBFI sector dampens the effectiveness of central bank's monetary policy on the banking system.

Another interesting study that explores the relationship between monetary policy and shadow banking is that of Boulware *et al.* (2014). Using the repo market as a measurement of NBFI (on US data), the authors reveal that contractionary monetary policy shocks lead to maturity substitution in the repo activity. Hence, the credit activity in the repo market turned out to be more sensitive to changes in the monetary policy stance than the exiting literature to date had revealed. Ultimately, given that monetary policy can contribute to systemic risk in the NBFI sector (by offsetting the maturity substitution), the authors recommend that central bankers should extend their focus towards macroprudential concerns (in addition to the standard focus on real activity and price stability). Earlier literature already highlighted that it is of critical importance to understand the transmission mechanism of monetary policy through the repo market (Kohn, 2008).

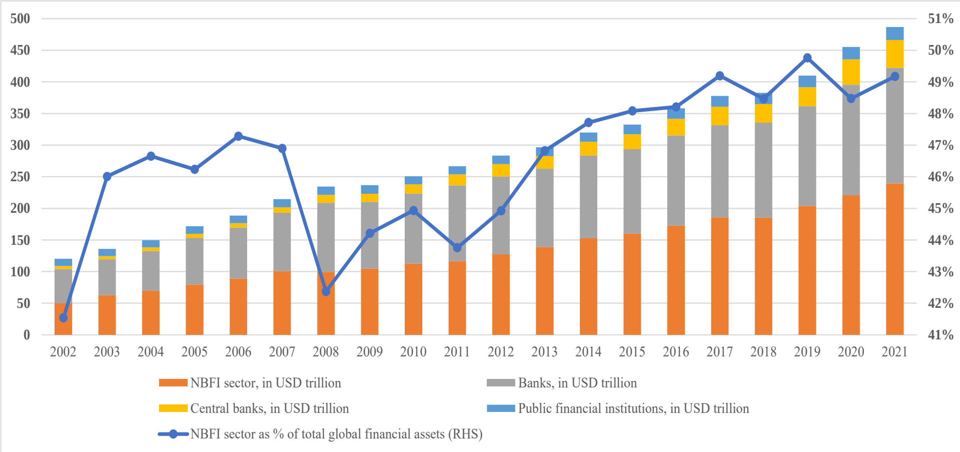
A critical feature of NBFI that might imped the efficiency of the monetary policy's transmission mechanism and central bank's role of lender-of-last-resort is that shadow banks lack access to central banks' refinancing operations (d'Avernas *et al.*, 2020b). This is of great importance especially when central banks need to tackle a liquidity crisis. This scenario was briefly but clearly explained in d'Avernas *et al.* (2020a) but then extensively detailed in d'Avernas *et al.* (2020b). The authors develop an asset pricing model with both traditional banks and NBFIs, where incumbent banks normally intermediate liquidity between the central bank and shadow banks. During a liquidity crisis, NBFIs "are left without a lender-of-last-resort, and central bank liquidity operations with banks are not sufficient to mitigate the crisis." The authors provide evidence that extending the accessibility of emergency lending facilities to a wider range of institutions (including NBFIs) can have a positive impact on mitigating the decline in asset prices, thus helping to constrain the severity of a financial crisis. To ease liquidity stress beyond the incumbent banking sector towards the NBFI sector, central banks can employ unconventional monetary policy instruments such as central bank swap agreements (where central banks lend each other currencies) or asset purchase programmes from the central bank (known also as Quantitative Easing). Another distinctive feature of shadow banks that makes monetary policy lose its grip on the financial system was brought forward by Hodula *et al.* (2023). The authors speak about the inadequate regulation of NBFIs and how these can, in this process, impede the efficiency of monetary policy or even worse, turn around central bank's role from 'problem solver' to 'troublemaker'.

All these weaknesses of NBFIs but also of financial institutions in general, put the central bank in a difficult situation. Having to take its monetary policy mandate seriously while considering the role of financial institutions in the monetary system, a central bank may find it very difficult to neutralize the effects of adverse financial developments, forcing it to provide support to financial institutions or financial markets (undermining, in the process, the independence of the central bank in question). This phenomenon was thoroughly explained by Brunnermeier and Sannikov (2014) under the concept of "financial dominance". When the other actors of the financial landscape stop taking the central bank's policy as a given to properly adapt their behavior (also known as 'monetary dominance'), forcing the central bank itself to take the situation of the financial system as a given and adapt its policies accordingly, then we are witnessing a regime with 'financial dominance'. This, in turn, involves a form of "hidden *fiscal* *dominance*, a situation where the weakness of private banks is a result of them having been and being pressured into funding their governments and where central bank support provides these governments with indirect access to the printing press” (Brunnermeier and Sannikov, 2014, pp. 42-43). Hence, central bankers are some-how caught ‘between a rock and a hard place’ (Hodula, 2019).

9.4. Global and European shadow banking landscape

The latest available data on the evolution of shadow banking having a global coverage is provided by the FSB in their *Global Monitoring Report on Non-Bank Financial Intermediation 2022* (FSB, 2022). The report depicts global trends in the financial system’s main sectors for the period ending in 2021. The NBFI sector experienced a strong growth in 2021, driven by the economic recovery. While credit intermediation by NBFI also increased, it did so at a slower pace than credit intermediation by the banking sector. This report focuses on the subset of NBFI activities that may be more likely to give rise to vulnerabilities, such as leveraged lending, asset management, and market making. The report's findings are based on data from 29 jurisdictions that account for around 80% of global GDP. The report's findings are important for policymakers, regulators, and market participants because they provide insights into the latest trends and risks in the NBFI sector.

At a global level, the financial assets’ total sum continued to exhibit strong growth in 2021, increasing by 7.7% to $486.6 trillion (see Figure 9.1). The strong growth in central bank, bank, and public financial institution assets exhibited in 2020 slowed down in 2021 in most jurisdictions, as some of the pandemic-related measures put in place to support the economy and the functioning of key financial markets started to be gradually relaxed or replaced by more targeted measures. Nonetheless, traditional banking continues to be the largest form of financial intermediation, in 21 jurisdictions, with banks holding around 37.6% of total global financial assets.

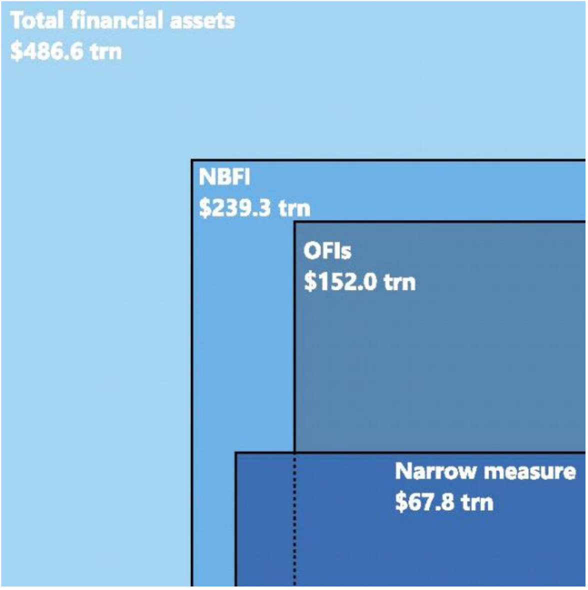


Source: developed by authors using data from FSB (2022)

Figure 9.1. Total global financial assets

The growth of the global financial assets is mainly due to the expansion of the NBFI sector (driven by higher valuations and inflows into investment funds, which benefited from the economic recovery). The shadow banking sector grew by 8.9% in 2021, reaching a size of $239.3 trillion, which is higher than its 5-year average growth rate of 6.6% (see Figure 9.2). As a result, the NBFI sector's share of total global financial assets increased from 48.6% to 49.2% in 2021.

Figure 9.2 should provide an idea of the size of the main monitoring aggregates at a global level. Total financial assets, NBFI and OFIs include participating jurisdictions and all the euro area countries, whereas the narrow measure includes only participating jurisdictions. The semi-dashed area shows the narrow measure representing assets that were not from OFIs and that correspond to ICs included in EF4 and to other financial auxiliaries unallocated to the five economic functions.

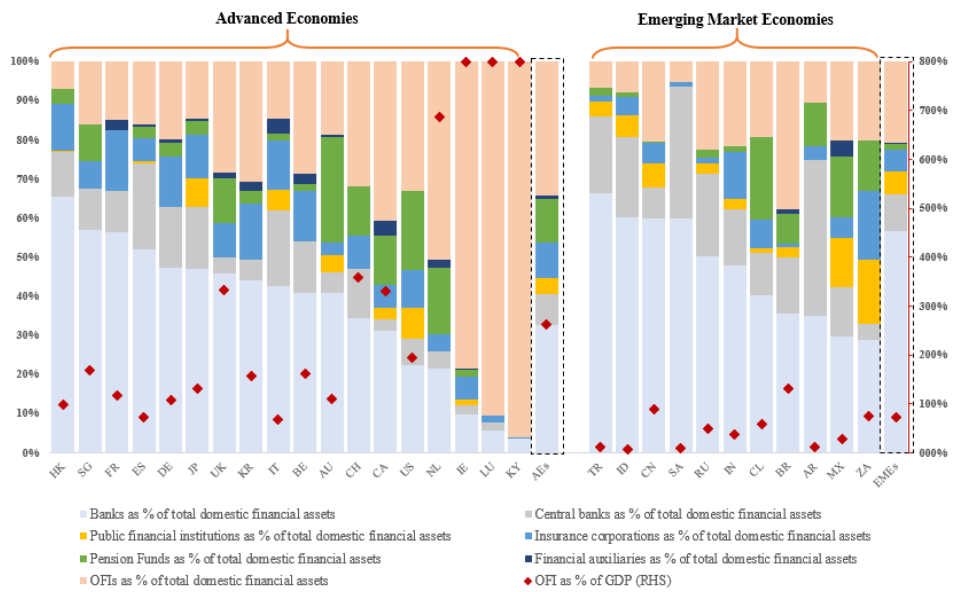


Source: FSB (2022)

Figure 9.2. Size of monitoring aggregates and composition of the narrow measure at a global level (end of 2021)

The NBFIs' assets classified into the five economic functions set out in the FSB monitoring approach grew by 9.9% in 2021, broadly in line with the overall growth of the NBFI sector. The narrow measure of the NBFI sector reached \$67.8 trillion in 2021, representing 28.3% of total NBFI assets and 14.1% of total global financial assets. While assets of all economic functions and in most jurisdictions have grown, the largest growth was observed for collective investment vehicles with features making them susceptible to runs (EF1), which remained by far the largest economic function.

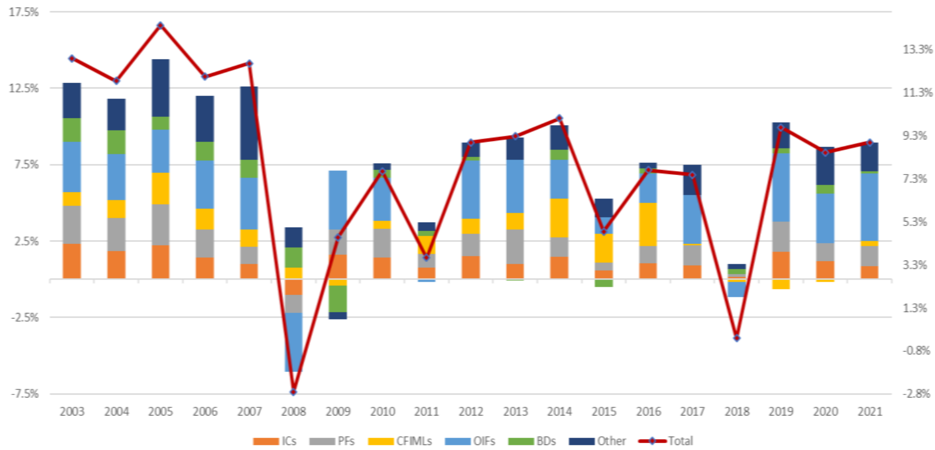
In Figure 9.3, one can notice the structure of the financial system across multiple jurisdictions clustered in two groups (advanced economies and emerging market economies), at the end of 2021. As seen, OFIs represents by far the largest component of the NBFI sector (with a share of 31.2% of total global financial assets), while also being the largest entity type in seven jurisdictions. In most of those cases, OFI assets amounted to several times the respective jurisdictions' GDP. The shares of PFs and ICs are broadly stable, representing 9.2% and 8.3% of total global financial assets in 2021, respectively. Macro-financial conditions changed significantly in 2022, with high inflation in advanced and emerging market economies leading to central bank tightening and rising nominal interest rates. This has had a significant impact on financial markets, with bond issuers, investors, and financial intermediaries all facing challenges. The NBFI sector, in particular, is facing a variety of challenges due to the diversity of its activities.



Source: developed by authors using data from FSB (2022)

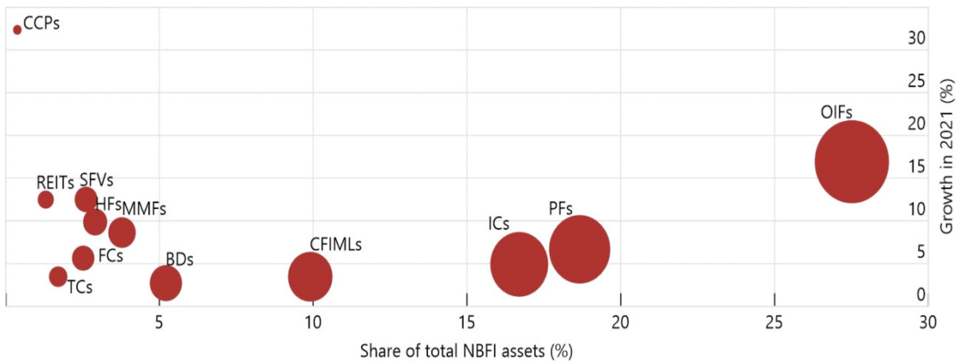
Figure 9.3. The structure of the financial system across advanced and emerging market economies

Figure 9.4 reveals the contributors to the growth of the NBFI sector over the 2003-2021 period (as %), while Figure 9.5 focuses on the size and growth of major NBFI subsectors in 2021. Growth in other investment fund (OIF) assets were responsible for just over a half of the overall change in NBFI sector assets in 2021, while ICs and PFs were collectively responsible for a quarter of NBFI sector asset growth. On the one hand, OIFs includes equity funds, fixed income funds and other funds such as mixed funds, referenced investment funds, external debt investment funds, currency funds, asset allocation funds, etc., but, on the other hand, the sector excludes HFs, real estate investment trusts and real estate funds (REITs), and MMFs. The 'Others' component include MMFs, HFs, SFVs, TCs, REITs and CCPs.



Source: developed by authors using data from FSB (2022)

Figure 9.4. Contribution to NBFI sector growth over the 2003-2021 period



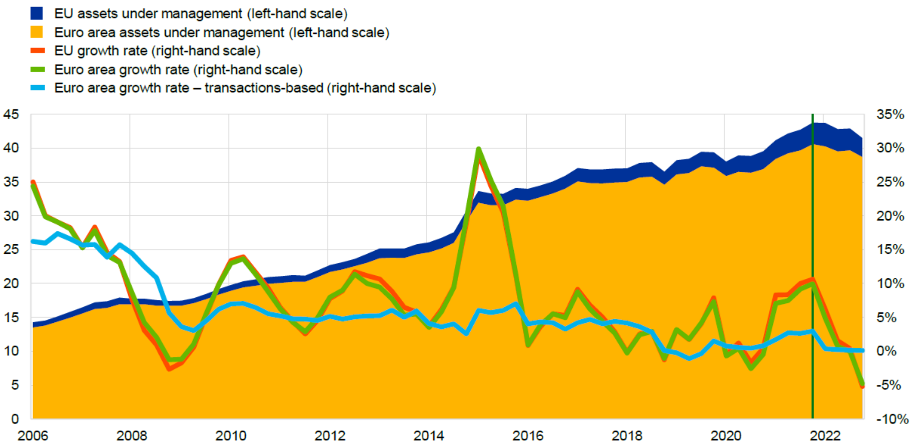
Note: The size of a circle corresponds to the size of the entity relative to the total NBFI sector and the overall data does not account for Russia.

Source: FSB (2022)

Figure 9.5. Size vs. growth in 2021 of major NBFI subsectors

Taking a closer look at the European level, the ESRB has published the EU Non-bank Financial Intermediation Risk Monitor 2023 (ESRB, 2023b), which for the first time includes crypto-assets and associated intermediaries. This is a significant development, as it recognizes the growing importance of these new financial instruments and the potential risks they pose to the financial system. Crypto-assets are now worth trillions of dollars, and their use is growing rapidly. Centralized finance platforms and decentralized finance protocols are also becoming increasingly popular, and they provide a variety of financial services, including lending, borrowing, and trading. The inclusion of crypto-assets and associated intermediaries in the NBFI Monitor is a first and long waited step. It will help policymakers, regulators, and market participants to better understand the risks posed by these new financial instruments and to develop appropriate mitigation strategies.

Alongside traditional NBFIs such as investment funds and other financial institutions (OFIs), ESRB's report now also includes stablecoins, centralised finance (CeFi) platforms, and decentralised finance (DeFi) protocols. In 2022, risks to the stability of the EU financial system increased due to rising geopolitical tensions, higher-than-expected inflation, and tightening financial conditions. This led to a decline in the combined assets of the EU NBFI sector (investment funds and OFIs) to €41.5 trillion by the end of 2022, from €43.8 trillion in late 2021. However, they maintained levels above the €39.0 trillion threshold established at the end of 2020 – see Figure 9.6.



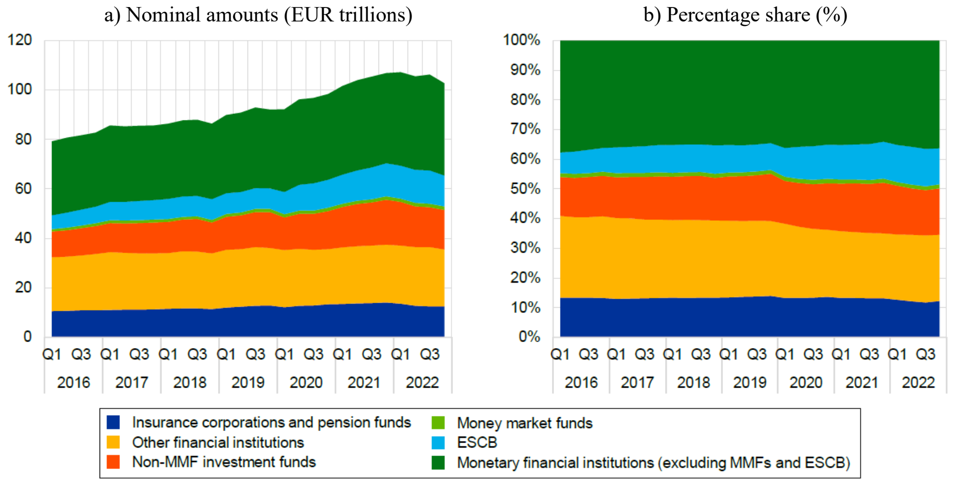
Note: LHS: EUR trillions; RHS: annual growth rates in percentages. Red and green lines indicate annual growth rates based on changes in outstanding amounts. The blue line indicates the annual growth rate based on transactions, i.e., excluding the impact of exchange rate variations or other revaluations and statistical reclassifications.

Source: ESRB (2023a)

Figure 9.6. Assets under management in EU and euro area IF and OFIs

According to the latest FSB data, assets of investment funds and OFIs accounted for 39% of the European financial sector assets, compared with 40% in 2021 – see Figure 9.7. The overall decline that was registered in 2022 was mainly generated by the decrease in the total assets of EU investment funds (by 11%) and OFIs (by 2%) due to valuation losses, as well as a slowdown in the growth of non-bank credit (representing 20% of external debt funding).

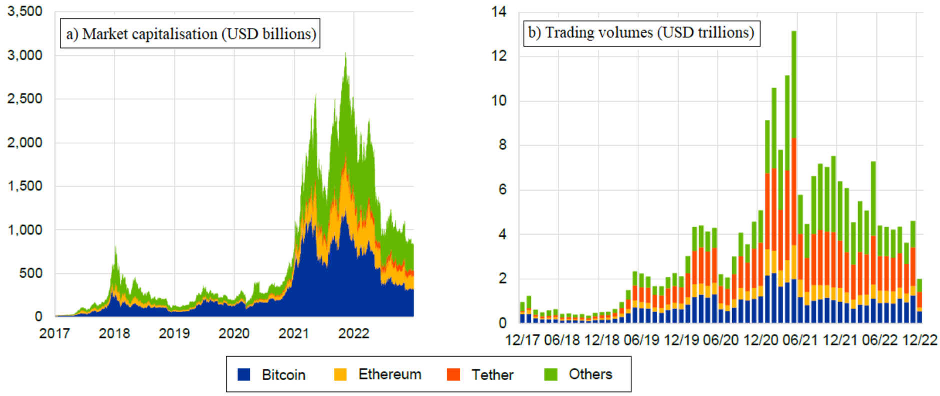
Crypto-assets and their associated intermediaries also came under stress during 2022, with several large collapses and a broad-based drop in valuation. However, the overall size of the global crypto ecosystem remains small compared with NBFI (€930 billion, compared to €41.3 trillion, respectively) – see Figure 9.8. While the combined value of crypto-assets ('market capitalisation') peaked at close to €2.6 trillion in November 2021, the market subsequently contracted to less than €930 billion at the end of 2022.



Note: Based on financial accounts data for the total financial assets of the financial sector of the euro area plus non-euro area EU Member States. To exclude central banks from the MFI time series, the European System of Central Banks (ESCB) is estimated based on BSI data for the Eurosystem and national central bank data for the non-euro area EU central banks.

Source: ESRB (2023a)

Figure 9.7. Structure of the EU financial sector



Source: processed by author after ESRB (2023a)

Figure 9.8. Structure of the EU financial sector

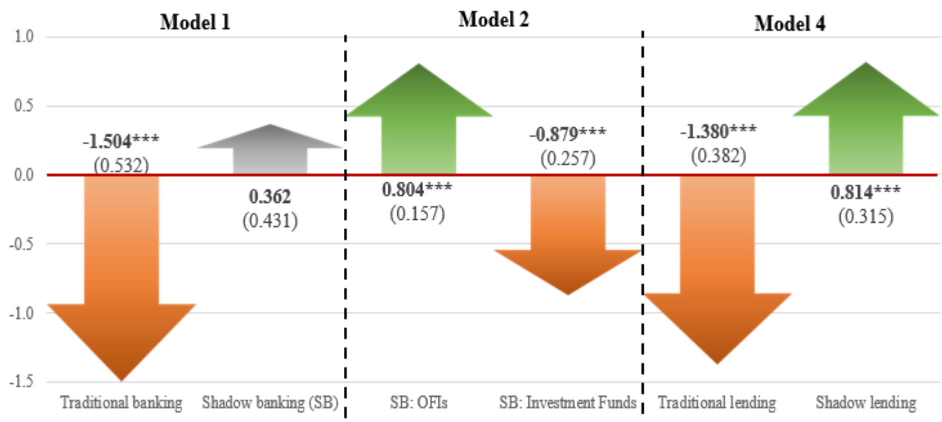
Despite the drawbacks of the EU NBFI sector, investment funds and OFIs remained an important source of funding to EU non-financial corporations. Non-bank credit (from these institutions) increased slightly and stood at 20% at the end of 2022. In 2022 loans provided to EU non-financial corporations by OFIs increased in nominal terms, while loans provided by investment funds decreased slightly. Both market-based and non-bank credit have roughly doubled since the Global Financial Crisis (ESRB, 2023b).

9.5. Monetary policy, traditional banking and shadow banking

This section builds upon the paper of Hodula and Libich (2023) who investigate the link between monetary policy, traditional banking and shadow banking. Hodula and Libich (2023) compile a novel dataset with disaggregated shadow banking components for the twelve initial euro-area member countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain (these countries jointly accounting, on average, over the 2003-2018 period, for more than 80% of total assets of the EU's shadow banking system, and a similar proportion of its traditional banking sector). The aim of their paper was to assess the link between ECB's monetary policy setting and the rise of the shadow banking sector in the euro area over the 1999-

2019 period. The authors develop 3 models using total assets in the TB sector as well as the NBFI sector, and one model using the amount of outstanding loans.

We will not present in details the estimated results for the four models as these are incorporated in the work of Hodula and Libich (2023). We will only reflect and discuss upon the values of those autoregressive equations (graphically depicted in Figures 9.9 and 9.10) and their implications for the nexus between monetary policy and NBFI.



Note: The values represent the results of the autoregressive equation for Models 1, 2 and 3. Arrows in color reflect values which are statistically significant, while arrows in gray reflect values that are not statistically significant. Statistical significance is indicated by ***, ** and * for 1%, 5% and 10% level of significance, respectively (with p-values in parenthesis). Models 1 and 2 consider the total assets of the financial sectors, while Model 4 considers the amount of outstanding loans of the two financial sectors.

Source: developed by authors using data from Hodula and Libich (2023)

Figure 9.9. The impact of the Monetary Conditions Index on TB and SB (and its two components), as well as on traditional lending and shadow lending

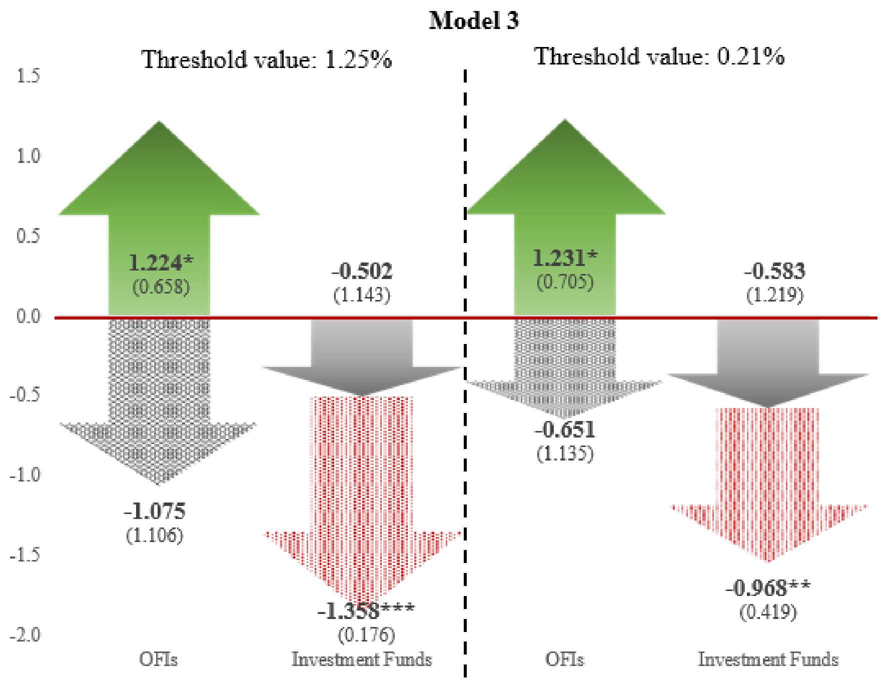
As one can notice in Figure 9.9, within Model 1, traditional banking intermediation and non-bank financial intermediation respond differently to changes in monetary policy conditions. As expected, a monetary policy contraction tends to inhibit the overall growth of the traditional banking sector (as central bankers might strive to obtain). Given the increase in the monetary policy interest rate, funding costs generally follow this behavior which then leads to a cutback in traditional banks' lending. From a quantitative perspective, a 1 percentage-point (pp) monetary policy tightening is expected to slow down the growth of traditional banks' total assets by 1.504 pp in the short term (within a year), and about 2.58 pp in the long term.

Nonetheless, the same monetary policy stance does not seem to have a significant impact on constraining the development of the shadow banking sector as a whole (hence, the lack of statistical significance for the values of the equation, depicted by the grey arrow) implying that central bankers may not be so effective in stabilizing the macroeconomic environment.

Hence, when central bankers might be required to tighten monetary policy conditions, traditional banks may see themselves forced to bypass the higher funding costs by increasing their market activities (such as securitization, asset trading, etc.). In addition to banks, economic agents might look for funding in the shadow banking sector (where specific traditional banking assets could have already migrated to), to refund their existing loan contracts (since the high interest rates might fuel the existing repayments costs of such existing loans).

The results of the baseline regression when disaggregating the shadow banking sector into the two segments (Other Financial Intermediaries or OFI, and Investment Funds or IF), and focusing explicitly on these, are graphically presented under Model 2 in Figure 9.9. It seems that a monetary policy tightening reduces the growth of the IF's total assets, while, at the same time, it has the opposite effect on OFI's total assets (and nurtures it). From a quantitative perspective, a 1 pp monetary policy tightening, is expected to slow down the growth of IF' total assets by 0.879 pp in the short term, and, at the same time, feed the growth of OFI's total assets by about 0.804 pp. This highlights yet again that "stricter monetary policy conditions may motivate traditional banks to look for cheaper funding in the shadow banking system (through securitization vehicles)" (Hodula and Libich, 2023, p. 9).

Model 4 strongly confirms the results already revealed in the first two models (which use the total volume of assets), by employing a narrower specification of the two financial sectors (TB and SB), namely using the outstanding loans originating from traditional and shadow banking (specifically OFIs). A tighter monetary policy stance tends to reduce the growth of loans in the TB sector but has the power to accelerate it in the NBFI sector. From a quantitative perspective, a 1 pp monetary policy contraction, is expected to reduce the growth of traditional loans by 1.38 pp (in the short term), but nurtures the expansion of shadow loans by around 0.81 pp.



Note: The values represent the results of the autoregressive equation for Model 3. Arrows in full green reflect values which are statistically significant, while arrows in gray reflect values that are not statistically significant, when considering only the MCI as independent variable ('normal times'). Dotted arrows in red reflect values which are statistically significant, while dotted arrows in gray reflect values that are not statistically significant, when considering, as independent variable, the interaction between MCI and the interest-rate environment (a low interest-rate regime). Statistical significance is indicated by ***, ** and * for 1%, 5% and 10% level of significance, respectively (with p-values in parenthesis). Model 3 considers the total assets of the two financial sectors.

Source: developed by authors using data from Hodula and Libich (2023)

Figure 9.10. The impact of the Monetary Conditions Index on the two components of shadow banking in different interest rate environments

Hodula and Libich's Model 4 goes more in-depth to test the validity of the existing nexus between monetary policy and non-bank financial intermediation when considering the existence of a low-interest rate environment such as the one the world economy is experiencing since the 2008 Global Financial Crisis. Figure 9.10 graphically represents the values for the autoregressive equation when accounting for the relative magnitude of interest rates, which also could be used as proxy for an economic and policy regime (Davig and Leeper, 2008). Hodula and Libich (2023) use a dummy variable to reflect the relative magnitude of interest rates in the economy. Hence, it takes the value of 1 if the 3M interbank rate is lower than 1.25%, and it takes the value of 0 otherwise (1.25% being close to the median value of the 3M interbank rate over the 1999 Q1 - 2019 Q1 period). In addition, the authors consider an alternative interest rate threshold of 0.21%, which marks the bottom decile of the distribution.

As one can easily notice in Figure 9.10, in normal times the relationship between the monetary policy stance and the OFIs growth is positive and statistically significant (at the 10% level). A 1 pp monetary policy contraction is expected to stimulate the growth of OFIs' total assets by about 1.22-1.23 pp (in the short term), and about a 2.09 pp rise in the long term. However, when switching to a low interest-rate environment, the statistical significance disappears (the indicators having negative values). As such, the funding-cost motive previously acknowledged, does not seem to be valid under a very low interest regime, probably reflecting "a general escape from risk and balance sheets cleansing of toxic assets during recessions" (Hodula and Libich, 2023, p. 9). On the other hand, this makes room for a search-for-yield motive (well visible through IF). In 'abnormal times' (periods with a low interest-rate environment) the relationship between the monetary policy stance and the IFs growth becomes negative and statistically significant (at the 10% level). In other words, a looser monetary policy stance is accompanied by significant inflows into IF. Under the 1.25% threshold, a 1 pp in monetary policy easing is expected to stimulate the growth of IF with around 1.36 pp in the short run, and a 2.18 pp in the long run. When accounting for the 0.21 threshold, the increase is about 0.97 pp in the short run and a 1.54 pp in the long run.

In conclusion, as we explore the connections between the continuously evolving segment of the financial system (created by non-bank financial intermediaries) and the central bank's monetary policy, we lean on the work of Hodula and Libich (2023) who investigate the link between monetary policy, traditional banking and shadow banking (in 'normal times' as well as in a low-interest rate environment such as the one the world economy is experiencing since the 2008 Global Financial Crisis).

Monetary policy actions can lead to a shift from traditional banking to the riskier shadow banking sector. As already acknowledged, a tight monetary policy promoted by central bankers can encourage shadow banking by reducing funding costs (for traditional banks). On the other hand, a loose monetary policy can intensify the search for yield, also leading to an expansion of the non-bank financial intermediation sector. In other words, Central Banks can have a significant impact on the behavior of financial institutions and investors, and this can lead to increased risk-taking and a shift to riskier activities, such as NBFI.

Policymakers and regulators alike need to be aware of the risks posed by shadow banking and take steps to mitigate them. This may include tightening regulations on shadow banks and/or using monetary policy in a way that discourages risky lending and investment.

Hodula and Libich (2023) also call for a reform of the current regulatory setup of the financial banking system. If financial regulation is inadequate and monetary policy actions promote the boom of the NBFI sector, monetary policy should not ignore its effect on medium-term trends in the financial and housing markets. The authors highlight the importance of disaggregating the NBFI sector into its components and provide lessons for the use of stabilization policies and the design of the regulatory framework.

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