The Commission's proposals represent some shift away from a rules-based framework and could represent a relaxation of the existing fiscal rules depending on what fiscal paths are agreed. They may grant some countries more time to achieve reductions in their debt ratios. A key question is whether they will improve national ownership and compliance with the framework as intended.

The proposals would likely require legislative reforms to the Fiscal Responsibility Act (2012), which transcribes the fiscal rules for Ireland. The Act has an emphasis on structural balance targets and the debt rule, which could be all but abandoned in the new framework. It has no explicit mention of a spending rule. The proposed risk-based surveillance approach may have an impact on EU level scrutiny of the Irish public finances if it is GDP based or if the GNI*-based debt ratio declines as anticipated.

However, these reforms would likely have important implications for Ireland's legislation

Box E: Potential reforms to the EU fiscal rules

The European Commission (2022) recently published potential reforms to the EU fiscal rules. The reforms, if implemented, would see a shift towards a focus on a fiscal trajectory proposed by each Member State to put the debt ratio on a downward path or keep it at low levels. A net spending rule would be used to achieve this. The 3% of GDP budget deficit limit would be kept, but other parts of the fiscal rules would be eliminated. Among other elements, a large role is foreseen for national independent fiscal institutions.

The Commission's proposals seek to address concerns surrounding the current fiscal rules. They respond to criticisms that the rules have become overly complex, weakly enforced, and too reliant on unobservable indicators, such as the output gap, that are difficult to measure and subject to frequent revisions (EU IFI Network, 2021; Martin, Pisani-Ferry and Ragot, 2021; European Fiscal Board, 2019).

The Commission's proposals aim to simplify the framework, boost transparency, and encourage greater national ownership and compliance.

This box takes an initial look at the proposals.

Overview of the reforms

The Commission's main proposal involves moving from multiple rules currently in force to a simpler set of rules. The main focus would be on a fiscal trajectory proposed by each Member State for the debt ratio and approved by the ECOFIN — the part of the Council of the EU comprising Member States' economics and finance ministers. This would be guided by a reference adjustment path set out by the Commission (see below) and could take into account analysis from independent fiscal institutions (IFIs), such as the Fiscal Council.

This would be operationalised using a spending rule that would be set to achieve the fiscal trajectory proposed by each Member State. This should ensure that the debt ratio is on a downward path at the relevant horizon in cases where debt ratios are judged to be relatively high.

The net primary spending measure excludes interest, temporary spending on unemployment related to the cycle, and adjusts for the impact of tax measures. It is essentially the same measure that is used for the current "Expenditure Benchmark". Tax-raising measures would allow for larger spending increases, whereas tax cuts would reduce the scope for spending increases (although the rule is set differently).

It is proposed to eliminate most other rules. This includes the Medium-Term Objective (MTO) — a minimum requirement for the budget balance adjusted for the cycle and one-offs — and the Expenditure Benchmark, a spending rule designed to achieve the MTO. The Commission also plans to dispense with the existing "1/20th" Debt Rule — a rule that broadly reduces the gap between a Member State's debt ratio and 60% of GDP by 1/20th every year. However, it proposes keeping the 3% of GDP deficit limit.

A risk-based approach to surveillance would be introduced based on debt ratios and a broader range of sanctions would be available.

Many key details remain unclear or are yet to be determined. For example, it is not clear whether one-off measures will be excluded from the net spending rule, given that they are, by definition, non-recurring and largely considered outside of a government's control.

Requirements under the reference adjustment paths

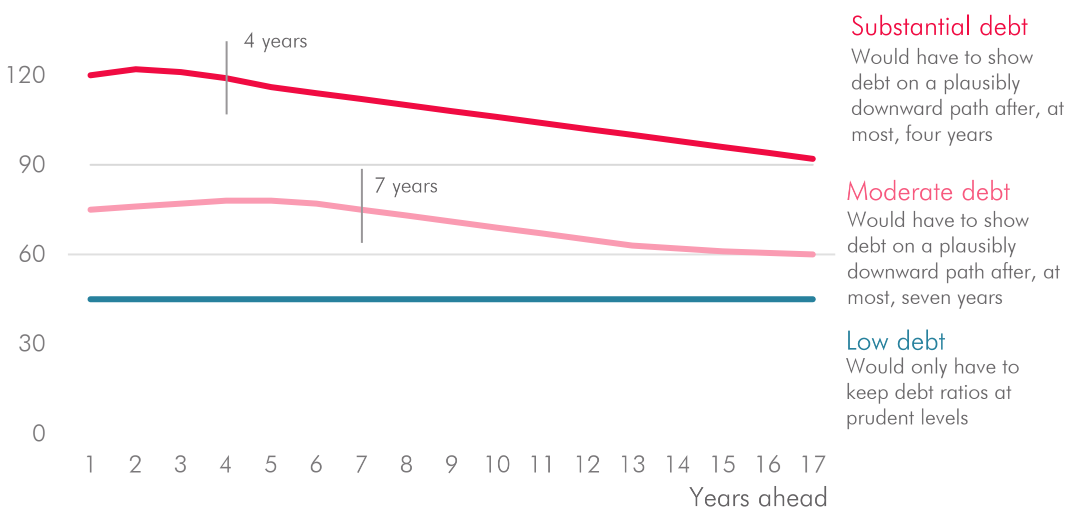
Under the proposals, the Commission would set out reference adjustment paths based on a country's debt ratio. Some Member States would be defined by the Commission as having "substantial" debt ratios — those exceeding 90% of GDP. Member States with "moderate" debt ratios would have ratios of between 60 and 90% of GDP. Lastly, those with "low" debt ratios would have ratios below 60% of GDP.

For countries with substantial debt challenges, the trajectory would be based on a four-year net primary spending path that — if maintained — would put the debt ratio on a plausible downward course over a ten-year horizon. Those with a moderate debt challenge would have more time — at most, seven years — to ensure that their debt ratios are on a downward path.[68] Those with low debt ratios would essentially need to keep the debt ratio stable and below 60% at the ten-year horizon. In addition, all countries would need to stay within the 3% of GDP budget deficit limit over the medium term.

Figure E1 uses indicative debt ratio estimates to map out how this downward path might look in practice.

Figure E1: Paths would depend on how high debt ratios are initially

Debt ratio (% GDP)



Source: Fiscal Council workings.
Notes: Substantial debt ratios are defined as more than 90% of GDP, intermediate as 60 to 90% of GDP, and low as below 60% of GDP.

Each Member State would come up with their own four-year net spending plan, taking account of the Commission's recommendations. The plan would cap net spending at a certain level each year. It would also contain country-specific reform and investment commitments. The ECOFIN would endorse the plan upon a positive assessment by the Commission. In addition, a Member State could extend its four-year plan by up to three years, provided the extra time facilitated investment and structural reforms which supported debt sustainability and matched common EU priorities, such as achieving a fair green and digital transition.

Enforcement

The revised fiscal rules would be underpinned by new enforcement mechanisms at the EU level. A Member State could be non-compliant with the revised fiscal rules in three ways.

[68] The communication notes for high debt, "the reference net expenditure path should ensure that by the horizon of the plan (4 years)[…]the 10-year debt trajectory at unchanged policies is on a plausibly and continuously declining path," and for moderate debt, "…the reference net expenditure path should ensure that[…]at most 3 years after the horizon of the plan, the 10-year debt trajectory is on a plausibly and continuously declining path at unchanged policies".

First, it could breach the 3% of GDP budget deficit limit. As is the case currently, a deficit-based Excessive Deficit Procedure (EDP)[69] would be opened in this instance.

Second, a Member State could deviate from the path set out in its agreed net spending plan. Should this occur, the severity of the sanction would depend on whether the Commission has assessed the Member State as having a substantial, moderate, or low debt ratio. For those with a substantial debt ratio, a debt-based EDP would be opened, by default. For those rated as moderate, a debt-based EDP could potentially be opened.

Third, a Member State could fail to implement its structural reform and investment commitments.

Moreover, the Commission would look to use a wider range of potential penalties, including financial sanctions, reputational sanctions, and a suspension of EU funding.[70]

When might the reforms to the rules be implemented?

The Commission intends to swiftly agree upon the revised rules with the Member States, with a view to activating them from 2024. However, it is unclear whether the changes will involve legislative change and how and in what form Members States and the European Parliament will agree to the proposals.

The Commission plans to provide guidance to Member States for fiscal policy in Q1 2023. It then proposes that each Member State would submit their four-year net spending plan for assessment by the Commission in April 2023. The ECOFIN would aim to endorse the plan by June 2023, subject to a positive assessment by the Commission.

The Commission would also monitor compliance by each Member State on an ongoing basis. For example, starting in autumn 2023, it would assess the extent to which a Member State's draft budgetary plan for 2024 complies with its endorsed net spending plan. In Spring 2025, the Commission would then assess whether a Member State complied with the targets set out in its net spending plan in 2024.

The Commission envisages that IFIs, such as the Irish Fiscal Advisory Council, could have a role to play in informing the design of the adjustment path and in monitoring compliance. However, it notes that such a role would require improving the set-up of these IFIs. The Commission and the ECOFIN would continue to make the final decisions when assessing and endorsing net spending plans and evaluating compliance.

Implications for Ireland

The rules, if implemented, will have several implications for Ireland:

1. Although unlikely to be binding, the revised fiscal rules would require the Department of Finance to produce macroeconomic forecasts with a more long-term focus. For example, in *Budget 2023*, the forecasts only covered three years ahead — shorter than the five-year-ahead forecast horizon adopted by the Department in previous years. However, the Commission proposes that net spending plans would map out estimates of relevant macro-fiscal variables at least 14 years into the future.
2. Given a Member State's debt burden will continue to be expressed in terms of GDP, the new rules are unlikely to give useful guidance for Ireland. This is because Ireland's GDP levels are artificially high due to distortions caused by the globalisation activities of a few foreign-owned multinational enterprises. The debt-to-GNI* ratio is a more appropriate measure of Ireland's debt sustainability.
3. The proposed rule changes would likely require an updating of Ireland's Fiscal Responsibility Act (2012). This would include moving from a structural balance target to a target for net primary spending (not currently included in the Act), and the removal of the "1/20th" Debt Rule. This would present an opportunity for the Government to put its own national Spending Rule on a statutory footing. In addition, the Spending Rule could be amended such that it captures general government spending, is linked to debt targets, and recognises the impact of tax measures. These changes could ensure that the Government's Spending Rule becomes a cornerstone of fiscal policy — one better tailored to Ireland's domestic conditions and not subject to the distortions that come from more one-size-fits-all approaches that depend on GDP and harmonised estimates of potential output.

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[69] An Excessive Deficit Procedure (EDP) refers to a procedure according to which the Commission and the Council of the EU monitor national budget balances and public debt to assess and/or correct the risk of excessive deficit. A breach of the 3% of GDP deficit limit will result in the opening of a 'deficit-based' EDP, as could a deviation from the agreed net spending path, depending on the debt ratio.
[70] The Commission suggests lowering the amounts of existing financial sanctions to make them more effective. In addition, reputational sanctions would be enhanced. For example, the Commission suggests that Ministers from those Member States assigned an EDP could be required to present their proposed corrective measures in the European Parliament.