Fiscal Rules

Exceptional circumstances continue

4. FISCAL RULES

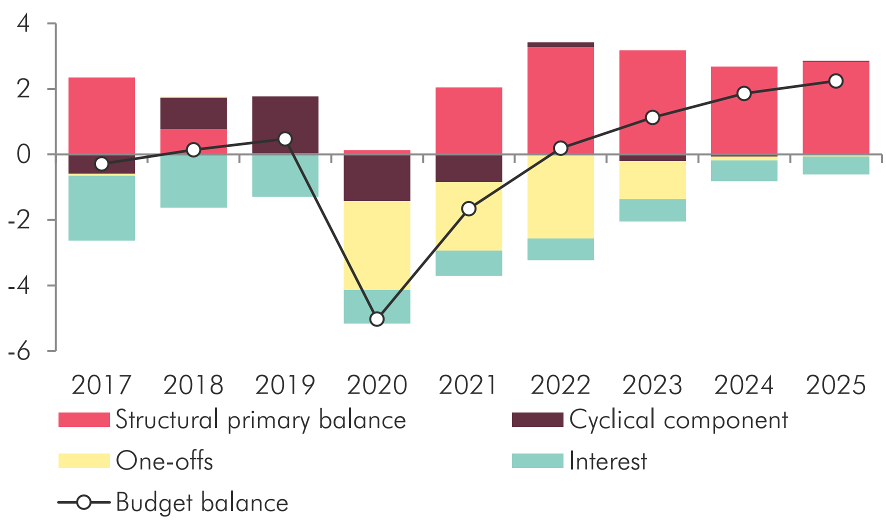
Exceptional circumstances continue

The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules were activated at the start of the Covid-19 pandemic in 2020 and have remained in place into 2022.[64] This allows Ireland to temporarily deviate from the requirements under both the domestic and EU fiscal rules in these years.

The rules remain effectively suspended

The European Commission has also announced that present conditions warrant the extension of the general escape clause through 2023.[65] The Commission cited high uncertainty and downside risks in the context of the war in Ukraine, along with energy price increases and supply-chain disturbances as contributing to this decision. It expects to deactivate the general escape clause in 2024.

Figure 4.1: Structural surpluses are projected



Source: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Note: The structural element of the budget balance is estimated using the top-down approach. This is the approach used in assessing legal compliance with the fiscal rules. The cyclical budgetary component is calculated as 0.52 times the Department's GVA-based output gap measure.

Although the escape clause offers some fiscal leeway, the structural balance is projected to be in surplus in 2022 and in subsequent years. Therefore, Ireland is on track to comply with domestic and EU fiscal rules, should they be reinstated in their current form in 2024 (Figure 4.1). The windfall corporation tax receipts flatter the fiscal balance. But, even in the absence of these excess revenues, the structural balance is expected to be in surplus from 2022— well within the formal requirements of the rules (Figure 4.2).

Even in the absence of excess corporation tax receipts, the structural balance is expected to be in surplus from 2022.

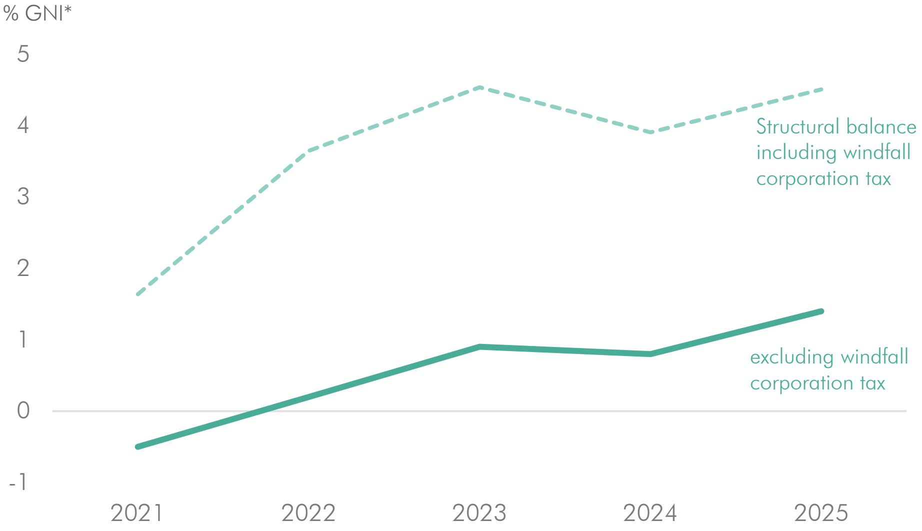
Despite the rapid increase in spending, both this year and next, net expenditure growth is forecast to be below the Expenditure Benchmark limit — under the

[64] See Box K from the May 2020 FAR for an overview of these dispensations.

[65] The press release from the Commission can be viewed here: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3182

Council's principles-based approach to the fiscal rules.[66] Based on current projections, net expenditure is set to be below the Expenditure Benchmark limit over the forecast horizon. The debt-to-GDP ratio is estimated to be below 60% of GDP this year and is likely to remain below this level over the forecast horizon.[67]

Figure 4.2: Structural balance in surplus without windfalls



Source: Department of Finance and Fiscal Council workings. Get the data.
Note: Figure shows the Council's bottom-up approach to estimating the structural balance. The "windfall" corporation tax receipts rely on the Department of Finance estimates of these for the period shown.

Supporting Information section S7 provides a full overview of compliance with the fiscal rules based on the Council's principles-based approach.

Medium-term Expenditure Framework

Ireland's Medium-term Expenditure Framework is intended to help it budget over a longer time period than governments have tended to in the past. In other words, the idea is to help set out conditions that would ensure budgets are more forward-looking, with a greater emphasis on medium-term planning, rather than focusing on just the Budget for the next year.

Under its Medium-term Expenditure Framework, the Government is legally required to set ceilings for how much each department will spend for the following three years. However, for the third year in a row, these ceilings have not been published as part of Budget-day documentation. Instead, the ceilings have been relegated in terms of their importance and are only being published in December as of recent years.

[66] See Table S7.2 for a summary of the Council's principles-based approach to the domestic budgetary rule.

[67] The legal requirement is to assess the debt ratio relative to Ireland's GDP. However, due to well-known distortions in Ireland's GDP due to the globalisation activities of a few large multinationals, this is not an appropriate benchmark for Ireland. A more appropriate metric for Ireland is the debt-to-GNI* ratio. This is forecast to be 86% at the end of 2022 and fall to 73% by the end of 2025.

As noted in the guidelines around Ireland's Medium-term Expenditure Framework (MTEF) (Department of Public Expenditure and Reform, 2013, p.42), the principle is one of transparency:

> *"The MTEF model is centred upon the principles of transparency and openness in regard to the setting and review of Departmental spending priorities, and upon the necessity for clear medium-term planning so that available resources are deployed, managed, and re-allocated (as appropriate) to best effect. A major feature of the MTEF is the move from the previous system of annual budgeting to a system of preparing three year parameters for current expenditure for Government Departments and Offices."*

The Government's failure to publish these ceilings on Budget Day, and their lack of integration into the budgetary framework more generally, represents a backwards step in transparency and a weakness in the overall fiscal framework.

The Government's failure to publish ceilings on Budget Day is a backwards step

Moreover, in delaying the publication of ceilings, the Government is not abiding by its own guidelines to publish these in October of each year. This is stated in the requirements around the framework (Department of Public Expenditure and Reform, 2013, p.43)

> *"Following Government Decision, these ceilings will be published in the Expenditure Report issued by the Department of Public Expenditure & Reform in October of each year and will be reported upon in the Stability Programme Update published by the Department of Finance in April of each year. Any changes to existing ceilings will be reconciled fully."*

The Government's 5% Spending Rule has become a useful guide for medium-term spending. It should help to give certainty around the availability of fiscal resources in future and provide a platform from which to produce realistic medium-term spending ceilings. The Government should avail of this and publish realistic spending ceilings on Budget Day from here on out.

The Government should use its Spending Rule as a platform to publish ceilings on Budget Day

Revisions to the fiscal rules

In November, the European Commission issued a communication containing proposals for how the revised EU fiscal rules could look (Box E). A multiyear net spending rule would form the operational part of the rules. Countries would propose a fiscal path that would put the debt ratio on a downward path, which would be subject to approval by the EU Council and where structural reforms and investment could allow a less ambitious path. The proposals envisage a larger role for national independent fiscal institutions (IFIs) like the Council.

A net spending rule would be at the heart of the potential revised rules

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.

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

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.

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

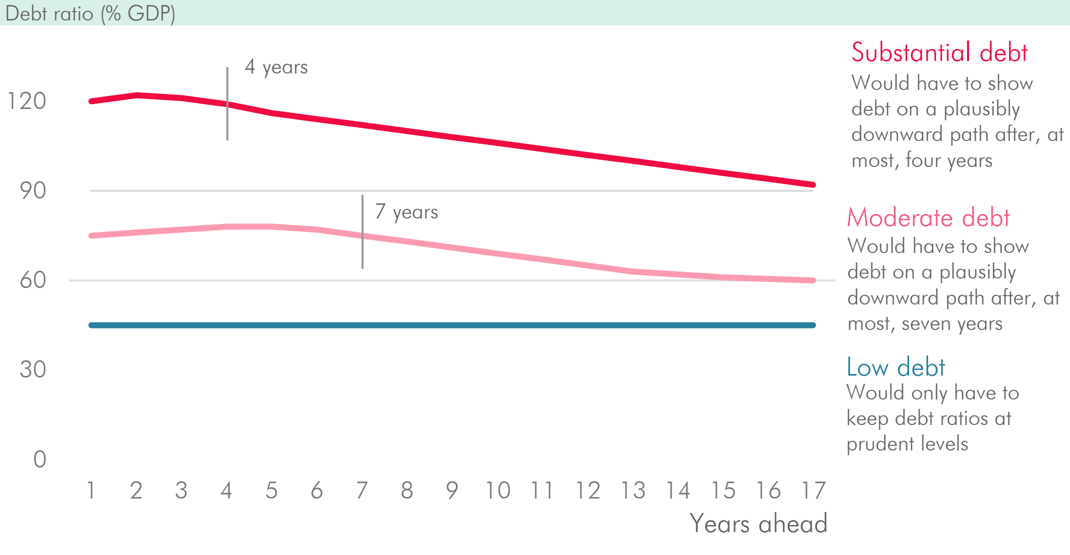
Under the proposals, the Commission would set out reference adjustment paths based on a country's debt ratio. Some Member States would be defined by the Commission as having "substantial" debt ratios — those exceeding 90% of GDP. Member States with "moderate" debt ratios would have ratios of between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

[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.