Irish Fiscal Advisory Council

Ireland's spending rule and the third wave of the EU's fiscal rules

Analytical Note No. 20

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June 2023

Abstract

Spending rules are taking on greater importance as a means of safeguarding economic sustainability. At home, Ireland's National Spending Rule has helped guide the public finances since being introduced in summer 2021. At EU level, proposals for a new wave of fiscal rules reforms will also focus on a spending rule as the main anchor.

This note explores both spending rules. We show that Ireland is likely to face less scrutiny under the new EU fiscal rules, given distortions to GDP and the boost to the public finances from substantial injections of corporation tax receipts paid by foreign multinationals. However, an assessment that looks through these factors would likely see Ireland qualify for closer monitoring.

Building on international best practice, we argue that the National Spending Rule should be further developed as a "first line of defence". This would help to ensure sound management of the economy and public finances at home. It would help Ireland avoid the boom-to-bust mistakes of its past, enhance the credibility of Ireland's fiscal policy, and avoid an abrupt and potentially challenging entry into the new EU fiscal rules.

Suggested reference:

Casey, E., and B. Cronin (2023). "Ireland's spending rule and the third wave of the EU's fiscal rules". Irish Fiscal Advisory Council Analytical Note Series No. 20. Dublin. Available at: www.FiscalCouncil.ie

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Background

The Government's National Spending Rule has been in operation from summer 2021. It has been used to steer the broad trajectory for the public finances in both Budget 2022 and Budget 2023, while also forming the basis for official spending projections for 2024 to 2026.

To date, the rule has proven a useful anchor. Despite being introduced at a time of high inflation and considerable pressures to increase spending, it has largely withstood these pressures. Instead of increasing permanent spending, the Government employed sizeable temporary supports to address pandemic costs and to support households and businesses with higher energy costs. These supports are likely to fall out of spending as energy costs wane: core net spending will have increased broadly in line with the underlying growth of the economy.

The proposed EU fiscal rules reforms mean that spending rules are now taking on even greater importance. The EU is currently undergoing a major set of reforms to how fiscal rules will operate at a European level. The first wave of the EU fiscal rules focused on strict limits: a 3% of GDP deficit and 60% debt ratio. The second wave of fiscal rules evolved to take account of cyclical conditions and to allow more scope for supporting the economy in a downturn, with the introduction of cyclically-adjusted balance targets and a spending rule linked to potential growth.

The third wave of EU reforms looks set to promote the use of a single clear operational anchor for guiding the public finances in a sustainable direction. This would take the form of a spending path initially set on the basis of sustainable growth in the economy and revenues. The level of spending can be adjusted up or down if taxes are raised or lowered, to keep net spending on the agreed path. The rules put more focus on a sustainable path for government debt ratios rather than specific targets. This recognises the inherent uncertainty of debt sustainability. While ceilings, such as the 60% of GDP debt limit would remain in place, their influence over how the framework operates would be less prominent.[1] The new rules also seek to reduce the reliance on difficult-to-measure unobservables, such as the output gap.

However, the reformed EU fiscal rules could come with familiar challenges for Ireland. Ireland remains a small open economy subject to large distortions from foreign-owned multinationals and volatile growth dynamics. A role for unobservable measures, such as potential output, remains in the new rules and GDP-based measures will be at their heart.

[1] Rather than focusing directly on the ceiling of a 60% debt-to-GDP ratio, the rules target a plausible downward path for debt ratios judged to be high risk.

As we show, Ireland is likely to face less stringent scrutiny from Brussels. GDP remains the only metric used across countries to measure the size of their respective economies. In the case of Ireland, GDP is overstated because of the activities of foreign-owned multinationals. Specifically, Ireland's debt ratio is measured as being low using GDP, and much lower than what more appropriate measures, such as GNI*, would suggest. In addition, Ireland's collection of excess corporation tax receipts from a handful of multinationals flatters its budgetary position.

An assessment of Ireland's debt sustainability that accounts for GNI* and excess corporation tax receipts would yield a very different picture for how Government debt is likely to evolve. While the path for the debt ratio is still encouraging on this basis, it could entail closer monitoring under the new EU fiscal rules if the adjustments were allowed for.

Given Ireland's underlying fiscal position and the distortions in the application of the EU rules, we argue that a domestic Irish "first line of defence" is needed in terms of fiscal rules that would support sound policymaking at home.

Building on its early success, the Government should further develop its National Spending Rule to ensure prudent economic and budgetary management.

This would mean that, if the EU rules are not providing sensible guidance for Ireland, Ireland would have some mechanism to ensure sound policy is being run domestically. Implementing an effective fiscal rule would bring Ireland in line with international best practice in terms of domestic fiscal policy.

This note first explores how the new EU fiscal rules are expected to work, and their application to Ireland when using the standard GDP-based assessment (Section 1).

We next show what an "in principle" assessment of the new EU fiscal rules might look like if GNI* was used instead of GDP while also taking account of other Irish-specific features (Section 2).

Finally, we show how Ireland's own National Spending Rule has worked to date and how it might be further developed, including with reference to international best practice and specific case studies (Section 3).

1. Ireland likely to face less scrutiny under new EU fiscal rules

Over the medium term, Ireland is unlikely to be under the microscope when it comes to the new EU fiscal rules.

This is for two reasons.

First, its government debt ratio is currently below 60% of GDP and is projected to stay below this level. It was recorded at 44.7% of GDP at the end of 2022 and is projected to fall further to 32% by end-2026. Moreover, the Commission's debt assessments put it at 25% of GDP by 2033, with only a 10% probability that it fails to fall from current levels. Risk scenarios also show it remaining below 60% by 2033 (European Commission, 2023a).

Second, the injection of corporation tax receipts paid by a handful of foreign-owned multinationals flatters Ireland's budget balance and, as a result, its debt path. These push what would be a deficit into surplus and help keep debt ratios on a low path.

In this section, we explore how the GDP-based assessment of the new EU fiscal rules might look for Ireland.

But first, we briefly explain how the new rules are likely to work.

How the new EU fiscal rules are expected to work

The proposed new EU fiscal rules look set to start with the Commission assessing the path for government debt over a long time horizon, at least 14 years, and the deficit relative to a 3% of GDP ceiling. Assuming the 3% deficit limit is not exceeded, each Member State will have country-specific limits set on how fast net spending can grow. The speed would be adjusted depending on its debt path. This ranges from no constraint, for low debt countries, to quite slow net spending increases relative to medium-term output growth for high debt countries. These adjustments to the speed at which net spending grows would take effect over a period of four to seven years in the case of high debt countries.[2]

The idea is to put the debt ratio on a plausibly downward path over the long term by undertaking fiscal adjustment for an initial period of four to seven years. The adjustment takes place through slower net spending

[2] Member States will benefit from a more gradual fiscal adjustment path should they put forward a specific set of reform and investment commitments that comply with certain criteria. We explain these criteria in the Annex.

increases than might otherwise be considered sustainable. Sustainable here means in line with usual — or "potential" — economic growth, and, by extension, revenue growth. This is one area where an unobservable measure, potential growth, remains in place in the new framework.

In cases where the debt path is assessed as potentially risky, the Commission will put forward a path for each country's net government expenditure that it thinks will set the debt ratio on a suitable downward path. This expenditure path will involve a constraint on net spending growth lasting from four to seven years.

It is then up to each Member State to provide its own assessment of what adjustment path might achieve a sustainable debt path. This will be assessed in turn by the Commission and the EU Council. Assessments by independent fiscal institutions, such as the Irish Fiscal Advisory Council would be reflected in the Member State's report on this. Eventually, an agreed set of spending ceilings would be put in place for the subsequent four to seven years.

To illustrate how the rules would work, take the example of a high debt and low debt country. The high debt country in Figure 1 starts with a debt ratio of about 100% of GDP. Whereas the low debt country starts with a debt ratio of 45%. To keep things simple, we assume that neither country is expected to breach the 3% deficit limit so that all that matters is the expected debt path.

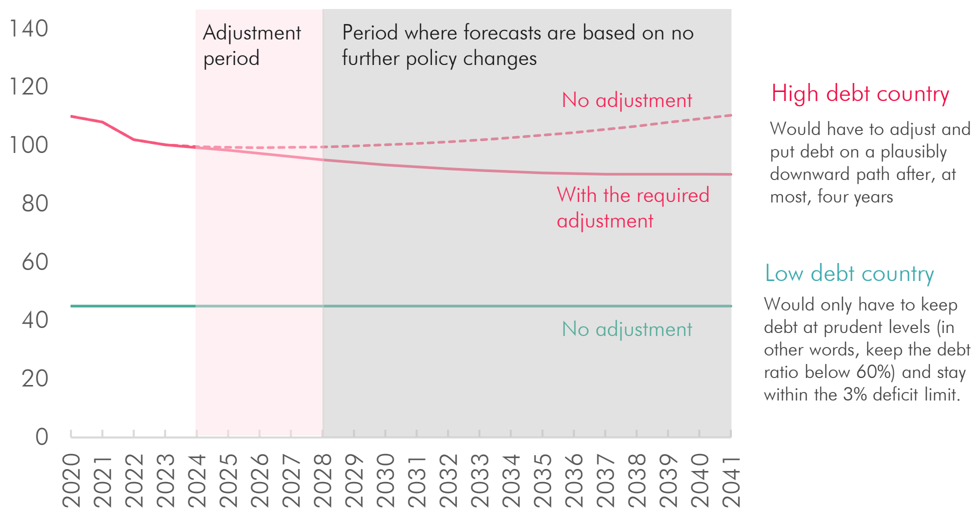
In this simple example, projections for the low debt country show that it is expected to continue to have a debt ratio below 60% of GDP. In that case, there would, broadly speaking, be no requirement for any adjustment. The new EU fiscal rules would impose only very mild constraints on the country. There would be no need to adjust spending or taxes, and so long as the 3% deficit is not breached, the next four years would see little in the way of scrutiny under the rules.

By contrast the high debt country would face some more tangible constraints. This is because, in the absence of any adjustments to spending or tax increases, its debt ratio would not be likely to fall over a long period of time.

In order to bring the debt ratio onto a plausible downward path over the forecast period, the high debt country would have to grow net spending at a slower pace than trend economic growth. The pace of increase it would be allowed under the rules would be determined in such a way that the path for its debt ratio after the adjustment period, assumed as the default four years here, would be plausibly downwards. This would be assessed on the basis of a no-policy-change assumption after the initial four-year adjustment period, with only ageing costs being added in to an otherwise steady set of baseline projections.

Figure 1: The path for debt plays a key role in how the rules work

Debt ratio (% GDP)



Source: Fiscal Council workings.

As always, the implementation involves lots of details and careful assessments. Rather than just a single forecast, for example, the assessment of a country's debt path will look at the probabilities around different possible debt paths as well as some specific stress scenarios. We set out these and other details in the Annex.

Assessing Ireland under the new EU fiscal rules based on GDP

We now look at how the new EU fiscal rules might apply to Ireland.

Here we show the path for Ireland's government debt ratio as a % of GDP. Although an inappropriate measure of the Irish economy (Fiscal Council, 2021), GDP will continue to form the basis for the EU assessments.[3]

We base the macro-fiscal projections used on the official *SPU 2023* projections. We extend these forecasts with a number of assumptions.[4] Under the proposals, the Commission's projections and assumptions would play a key role. We've designed the extended projections to be in line with what it would be likely to use.

The SPU projections imply that the Government debt ratio will steadily fall towards 15% of GDP by 2037 on GDP basis (Figure 2). This would bring

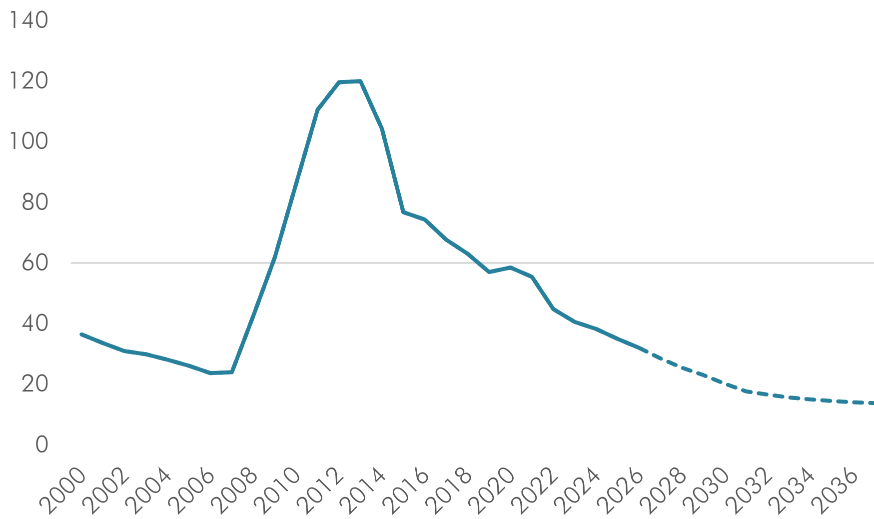
[3] The Council showed in Box C of the *December 2021 Fiscal Assessment Report* how GNI* proves a better measure than GDP for assessing public finances and sustainability, for modelling taxes, and for understanding real economy measures such as employment.

[4] The key assumptions are that growth rates and inflation remain unchanged after 2030, policy rates fall back to 1.5% by 2030, the excess part of corporation tax receipts unwinds over three years (2027 to 2029), NTMA bond issuance continues in line with recent trends, and ageing costs raise current expenditure in line with the Council's Long-term Sustainability Report (2020). This adds about 0.2% of GNI* to primary expenditure each year from 2026. Public investment stays constant as a share of GNI* at 4.3% after 2026. Similarly, total revenue stays constant as a share of GNI* except for the unwinding in estimated "windfall corporation tax receipts.

it close to levels that existed prior to the financial crisis. The path is encouraging, although, as we note later, the exact assumptions may be unrealistic, given various pressures, notably those related to climate spending.

Figure 2: Ireland's debt-to-GDP projections extended

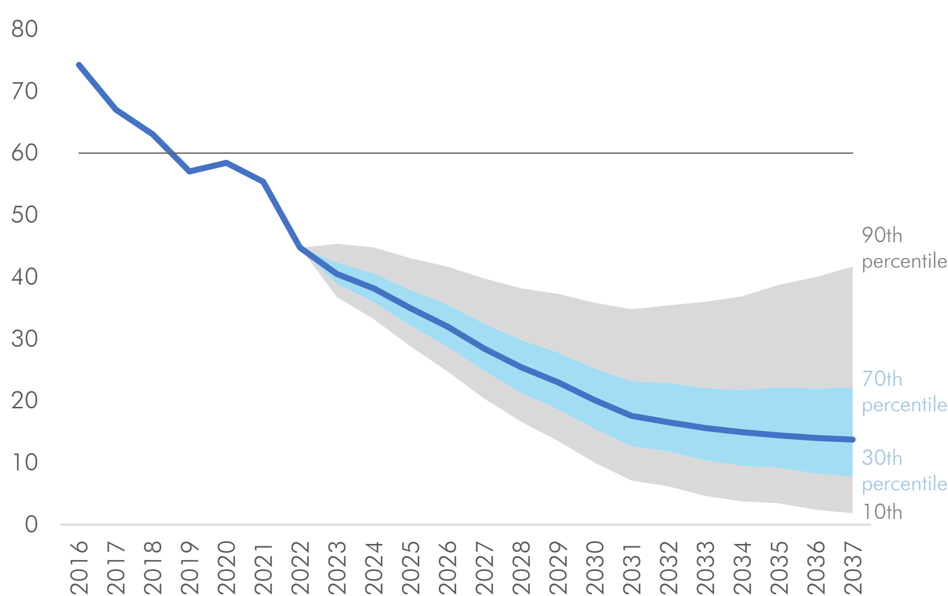
% GDP, gross general government debt



Next, we assess the probabilities around that path. We use the Maq model (Casey and Purdue, 2021) to develop "stochastic" projections. These are basically projections that assign a probability to various possible paths for the debt ratio. The probabilities draw on historical information for individual variables and how these variables interact. This includes the relationships between growth, inflation, and changes in the levels of taxation and government spending.

Figure 3: Ireland's stochastic debt-to-GDP projections

% GDP, gross general government debt



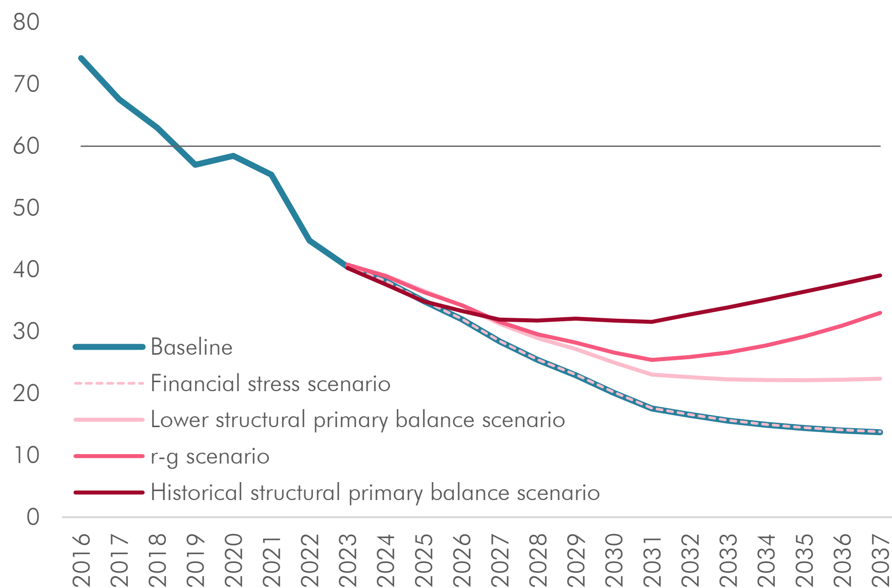
The stochastic projections suggest, with a 90% degree of confidence, Ireland's debt ratio would remain below 60% of GDP out to 2037 (Figure 3). Under the proposals, the Commission would initially use its own method to assesses the risks (Commission, 2023a) as well as a number of specified scenarios.[5]

It is unclear what level of certainty will be applied by the Commission as a threshold for judging a path that is kept "plausibly" prudent or on a downward trajectory. However, for this exercise, we assume that the 70th percentile would be one possible threshold, which is in line with indications from the Commission.[6] If the 70th percentile were to be used as a threshold, the projections suggest that this threshold would be consistent with a 35% of GDP ratio in 2037 — hence below 60% of GDP.

We next turn to a set of shock scenarios that the new EU fiscal rules will likely use. These may not map exactly onto the stress tests used in the new framework, but the indications are that they will be quite close to this (see the Annex for more detail on how we calibrate these shocks).

Figure 4: Ireland's debt-to-GDP ratio under shock scenarios

% GDP, gross general government debt



The results again suggest that — on a GDP basis — Ireland would be unlikely to exceed the 60% of GDP debt limit even under these stress scenarios. The most challenging scenario in Ireland's case is the scenario where the structural primary balance is assumed to revert to historical norms. In this scenario, the debt ratio climbs to 40% of GDP by 2037

[5] The Commission's (2023a) *Debt Sustainability Monitor 2022* outlines the scenarios involved and the approach it uses to modelling debt paths stochastically.

[6] See slide 23 of the presentation by Pamies (2023).

from a low of about 32% in 2027. The scenario implies a substantial worsening in the budget balance from currently projected levels.

This approach gives an overly benign assessment

When based on GDP, there are strong reasons to suggest that the rules, as applied to Ireland, will provide an overly benign assessment.

GDP is clearly an unsuitable measure for Ireland. Economists consider it an unreliable measure of the size of the Irish economy. This has led to the development of GNI* as a more reliable alternative. The GNI* measure, which focusses more closely on the domestic Irish economy, is statistically better able to explain year-to-year movements in taxes. It has smaller forecast errors when predicting government revenues. It is better than GDP at explaining and predicting employment developments. And, internationally, GNI tends to be very close in size to GDP.[7]

For these reasons, GNI* tends to be a more meaningful measure of the Irish economy. In particular, it reduces the statistical distortions linked to globalised activities that have less of a bearing on fiscal and real-economy developments.

Ireland is also benefiting from exceptional levels of corporation tax receipts. The current level of corporation tax receipts is clearly risky and far beyond what can be explained by the domestic Irish economy. The Department of Finance estimates that close to half of receipts in 2022 were in excess of what could be explained by domestic activity. That is €10.8 billion of the total €22.6 billion of corporation tax collected. The receipts are incredibly concentrated, with just ten corporate groups contributing 60% of that €22.6 billion.

To overcome these issues, we next consider a more tailored assessment that uses GNI* rather than GDP and takes account of excess corporation tax receipts and domestic output gap measures when determining the stress tests.

[7] See Box C of the Fiscal Council's December 2021 Fiscal Assessment Report for more detail on these aspects.

2. A tailored assessment would highlight more risks

In a second assessment, we explore what the new EU fiscal rules might look like if applied to Ireland in a more tailored way.

Specifically, we make three adjustments:

1) we use GNI* instead of GDP;

2) we base our assessments of the structural balance on domestic measures of the output gap rather than the EU commonly agreed methodology that has known problems with procyclicality; and

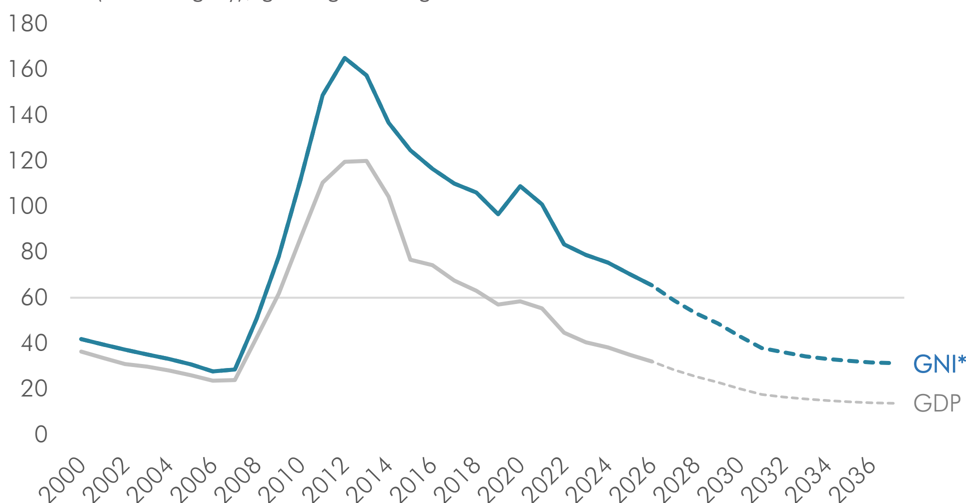
3) we adjust for windfall corporation tax receipts in our estimates of typical historical structural balances used in the stress scenarios.

Using the same assumptions as in Section 1, the extended projections for the debt ratio — this time on a GNI* basis — show a continued fall in the debt ratio (Figure 5).

However, unlike the GDP-based assessment, the debt-to-GNI* ratio would be projected to fall below 60% at a later stage, in 2027. It would then be projected to decline to a higher ratio at just over 30% by 2037.

Figure 5: Ireland's debt-to-GNI* projections extended

% GNI* (GDP in grey), gross general government debt

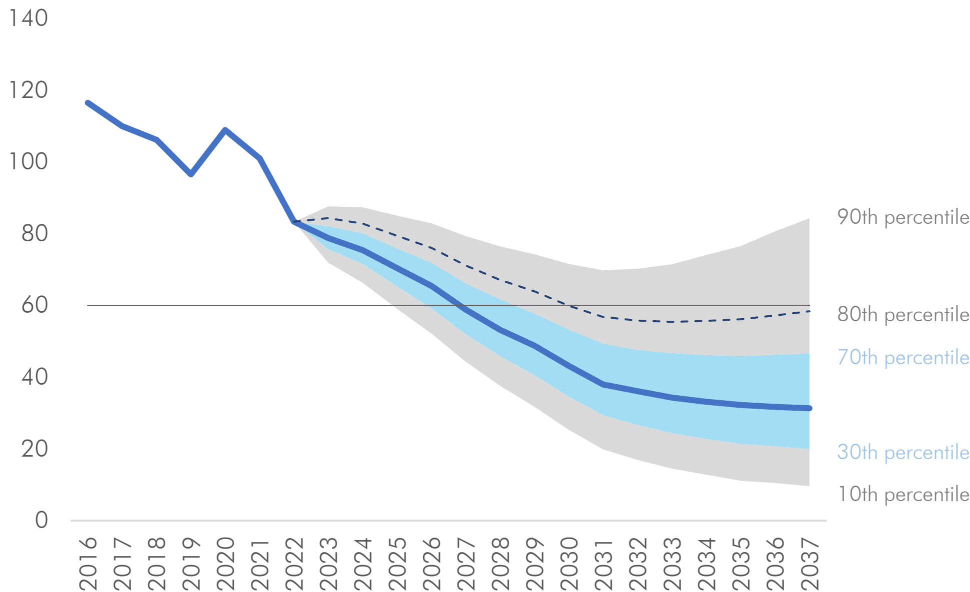


As before, we next assess the probabilities around that path. The stochastic projections on this occasion suggest that there is a roughly 20% probability that the debt-to-GNI* ratio would rise above 60% by 2037

(Figure 6).[8] This is not a trivial risk but it would fall outside of the 30% (or 70th percentile) threshold that we assume will be used in the new EU fiscal rules.

Figure 6: Ireland's stochastic debt-to-GNI* projections

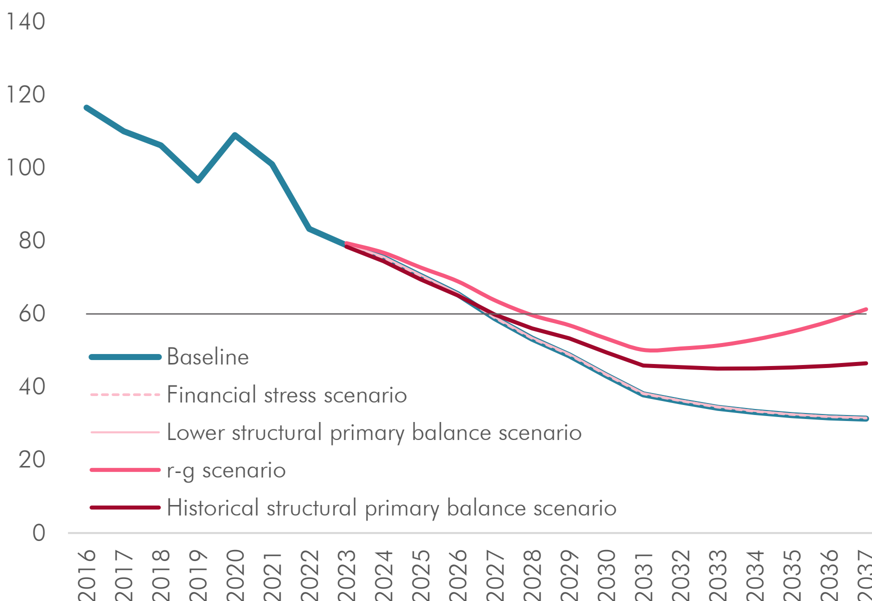
% GNI*, gross general government debt



The shock scenarios also point to minor risks Ireland's debt-to-GNI* ratio would not remain below 60% in the assumptions used (Figure 7).

Figure 7: Ireland's debt-to-GNI* ratio under shock scenarios

% GNI*, gross general government debt



[8] The confidence intervals are different for the GNI*- and GDP-based estimates as they rely on historical interactions between these measures and other variables as well as information about each measure's own volatility.

This outcome hinges on the "r-g" or "more adverse interest-growth differential" scenario.[9] It shows a debt-to-GNI* ratio falling to about 50% in 2031 but then steadily climbing and eventually rising above 60% again in 2037. It is unclear to what extent the results of a single scenario would determine guidance from the Commission for adjustment requirements. It seems likely that the assessment would take into account the full set of scenarios and stochastic projections rather than just one scenario showing risks in a much later period.

The results on this basis are quite different to the GDP-based assessment, underlining the substantial distortions to economic activity as measured that are caused by foreign-owned multinational enterprises.

Were the distortions associated with GDP to be recognised under the EU rules, Ireland might face some modest adjustment requirement. This is on the basis that the stress scenario involving a more adverse growth and interest rate outcome would show some risks, and that the probability of a debt ratio rising above 60% is higher on GNI* basis. However, any adjustment would still likely be quite small. In particular, as the other stress tests do not signal risks of debt ratios rising above 60%. And the degree to which the adverse growth and interest rate scenario exceeds the 60% level is small and limited to the end of the projection horizon.

We can estimate what adjustment might be required if set on a GNI* basis and designed so as to prevent the adverse interest-growth differential scenario from rising above 60%. This would amount to an estimated downward adjustment to primary expenditure growth rates of less than 0.1 percentage points per annum over the course of the period 2024 to 2027 when compared to the baseline.

There are important aspects to the baseline projections, particularly spending pressures, that are not considered in these exercises:

1) The technical assumption underpinning the projections used here is that current spending rises in line with nominal GNI*, thus keeping its share of GNI* constant after 2026, except for the addition of ageing costs. This results in a growth rate for primary expenditure that averages 4.8% per annum over 2027 to 2037. This is roughly in line with the 5% assumed in the National Spending Rule if applied from 2027 onwards. However, it could prove lower than what is likely, given other pressures.

2) One pressure that Ireland has not factored into its future spending plans is the amount of public expenditure that will be required to

[9] This shock is in line with the "r-g" scenario set out in the Commission's (2023) Debt Sustainability Monitor. We implement it as 1) a shock to nominal growth of -0.5 percentage points per annum; and 2) a shock to policy rates that produce an effective interest rate that is 0.5 percentage points greater on average over the forecast period.

meet its climate objectives. These require a 51% reduction in overall greenhouse-gas emissions by 2030. However, estimates of how much additional public investment might be required to achieve these targets are uncertain. They could add upwards of 2% of GNI* to public investment spending every year out to 2030.[10] This would potentially represent a substantial increase in current plans, depending on the extent to which this is dealt with it in the context of existing capital plans.

3) There are lots of other spending pressures anticipated for future years. These include the major Sláintecare reforms to how healthcare is provided in Ireland, addressing longstanding housing shortages, and the Government's plans to raise defence spending.

4) The Council estimates that "Stand-Still" pressures, the costs associated with accommodating demographic and price pressures, could amount to larger increases than is assumed in the *SPU 2023* baseline projections (see *Fiscal Assessment Report, June 2023*).

[10] This assumes that the Government makes some intervention to facilitate climate investments without positive financial returns. The Climate Action Plan 2021 notes that about 40% (about €5½ billion annually or 2% of GNI*) of the total estimated €125 billion investment costs of achieving these targets — both public and private —would be unlikely to have positive investment returns. This means that the State would probably have to make some intervention, perhaps up to the full amount, over 2021–2030 to encourage these investments. It's likely that the costs would now be higher, given that they were produced at a time when inflation was lower and projected to remain so. FitzGerald (2021) provides a better articulated assessment of the additional annual investment costs to meet the 2030 targets and lands on similar estimates at between 1.7 and 2.3% of GNI*. However, these estimates assume the agriculture sector cuts its emissions by either 51% or, in the more costly scenario, by 33%. However, since then, the Government announced official sectoral targets involving a smaller (–25%) reduction by the sector, which suggests overall costs will be higher.

3. A domestic “first line of defence” is needed

There are several benefits to having a framework of rules and institutions that support prudent economic and budgetary management.

The likelihood is that the EU fiscal rules, as applied, will leave Ireland with little external scrutiny. This reflects the application on a GDP basis, which — given its distortions — leads to an overly benign outlook. However, there are still some risks evident from the analysis in Section 2 when the same analysis is done on a GNI* basis and recognising other important domestic factors.

This means that Ireland will need to develop its own clear ideas about how to manage the public finances sustainably. Absent this, there is a risk that Ireland acts without an anchor in terms of how it budgets within the new EU fiscal framework. Furthermore, if it were at some point to enter requirements imposed by the EU rules suddenly, there is a risk that the adjustments required could be demanding.

One specific point for Ireland is that the 0.5 percentage points of GDP annual adjustment requirement for countries running larger-than-3% deficits would be particularly demanding. Reflecting Ireland’s high GDP level, this would amount to an annual structural adjustment of €2.8 billion (more than 1% of GNI*). This is equivalent to about one-eighth of Ireland’s annual health outlays.

For these reasons, a first “line of defence” domestic fiscal framework is needed. The National Spending Rule is well placed to play this role.

To date, the National Spending Rule has proven useful in guiding the public finances since it was introduced in summer 2021 (Figure 8).

The Council assesses the rule on a net basis in line with the Department’s description of the rule.[11] On that basis, the rule was complied with in 2022 both with respect to the original and revised ceilings. For 2023, the Government plans a deviation of the rule to allow an increase of 6.3% in core spending, given exceptionally high inflation. However, the overall net increase is still well below the projected rate of inflation and potential growth. Moreover, the Government’s projections for later years are

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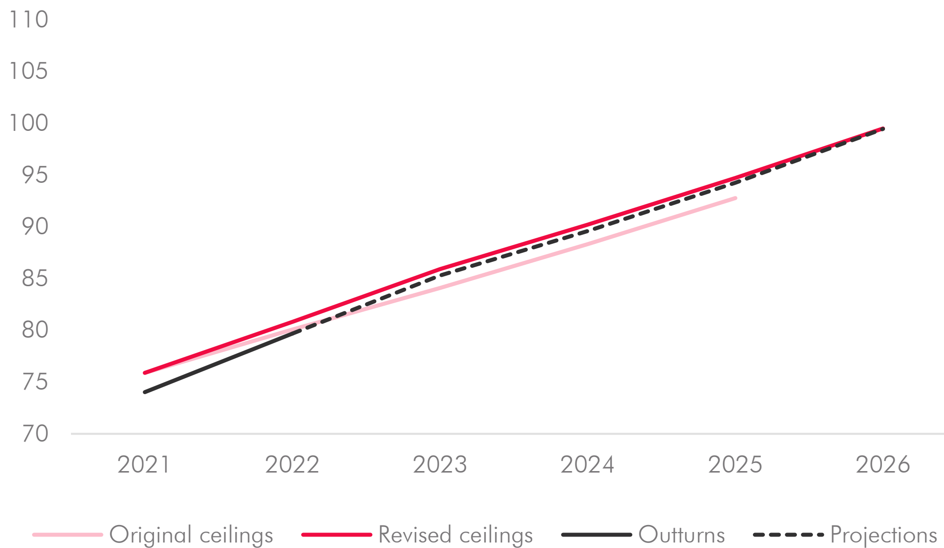
[11] The *SPU 2023* (Department of Finance, 2023, p. 30) notes that “…the Government’s spending rule is calibrated on the basis of net spending, i.e. spending net of discretionary taxation measures. Accordingly, the expenditure ceiling figure would be different – higher or lower – if the Government introduced discretionary tax changes.” To account for discretionary tax changes in full, the Council also incorporates the impact of non-indexation of the tax system. That is, the revenue-raising impact that would result if income tax bands and/or credits were not adjusted in line with general wage changes as people drift into higher effective rates of tax.

anchored by the spending rule. The Council assessed that the upward revision to the ceilings introduced in *Budget 2023* were warranted, given the exceptional shock to inflation, which looked set to imply a sustained rise in the price level and would otherwise have been disruptive.

Figure 8: Spending rule performance to date



It is early days, but the National Spending Rule has thus far helped in guiding the public finances and resisting different expenditure pressures. This comes amid the emergence of various challenges, including the energy shock. The rule has largely helped the Government to withstand these pressures. Instead of increasing permanent spending drastically, the Government employed sizeable temporary supports to address pandemic costs and to support households and businesses with higher energy costs. These supports are projected to fall out of spending as energy costs wane. The rate of increase in the spending rule was revised up in *Budget 2023* recognising the exceptional inflationary pressures. The Council assessed that this approach was likely to be sustainable.[12]

However, if the National Spending Rule is to be an effective safeguard in future, it needs further development.

What are the benefits of spending rules?

Developing the National Spending Rule further would have many benefits.

1) The overarching goal of a spending rule is fiscal sustainability. Spending rules help governments avoid getting into situations where they have over-extended themselves and are no longer able to borrow to meet ongoing commitments for public services and

[12] It noted in the November 2022 Fiscal Assessment Report that "the temporary deviation from the 5% Spending Rule is relatively limited, with core spending rising by 6.8% instead for 2023. The Council assesses that the permanent spending increases in both years are likely to be sustainable. These increases do not compensate for inflation in full, but the gap for lower income households is more than made up for by substantial temporary supports."

supports. By tying spending increases to a speed of increase that can sustainably be covered by growth in the economy and taxes, these rules help to ensure that large structural deficits — sometimes hidden if the economy is temporarily growing strongly or benefiting from windfall taxes — do not emerge. Large deficits add to debt sustainability concerns, leading to higher borrowing costs and potentially even the loss of market access. In turn, this can necessitate a sudden and painful need for austerity measures, often at a time when the economy is already in a downturn and could do with additional fiscal support. Keeping the underlying budget balance is also conducive to stabilising the economy and avoiding procyclical fiscal policies.

2) Net spending rules that take into account discretionary tax changes help to control the overall fiscal stance, while giving governments flexibility about the taxation and spending choices. This allows them to vary the size of government in a sustainable way. In effect, this rule provides control of the underlying budget balance without heavy reliance on unobserved variables and also serving to limit measurement error.

3) Another benefit of spending rules, if they are credible, is that they can enhance the credibility of governments. Specifically, they help to foster more realistic and sustainable planning for the future. For example, they can encourage governments to take a long-term approach to challenging areas such as climate, health, and pensions, while also tackling other priorities. Furthermore, they can give Departments and public agencies greater certainty around funding they are likely to have in future. This, in turn, helps develop broader strategies around longer-term projects by helping public bodies better coordinate cross-department spending.

4) With spending rules, the public can also have a better sense of what might be coming in terms of policy, benefits, supports, and taxes. This helps improve certainty for households and businesses. It also helps to communicate the trade-offs that are involved in managing the public finances sustainably.

5) Ireland's credibility on the markets can also be helped by spending rules. This can result in lower borrowing costs, leaving more resources available to fund ongoing expenditure and public investment.

This is where further development of Ireland's National Spending Rule can help.

Why a spending rule rather than other forms of rules?

Spending rules have taken on greater significance in national budgetary frameworks, as well as forming the core part of how the new EU fiscal rules will work.

This reflects several attractive features spending rules have when compared to other types of fiscal rules:

Control: Spending rules involve a target that the Government traditionally has more control over. This is particularly true when compared to headline deficit targets, as deficits incorporate revenue as well as expenditure. Deficit-based rules therefore depend heavily on the performance of the economy and can be undermined by short-term cyclical fluctuations and windfall tax receipts if these are not accounted for properly.

Both aspects are highly relevant to Ireland with its history of volatile boom-to-bust growth cycles as well as the property-related windfalls received in the 2000s and, more recently, the excess corporation tax receipts the state is now collecting.

Measurability: By focusing primarily on expenditure and discretionary tax changes, net spending rules achieve a greater degree of simplicity and transparency compared to other rules. They tend to involve more limited adjustments for unobservables, such as the current state of the business cycle (the output gap) and how revenues respond to current conditions. This gives greater certainty to all stakeholders as regards how the government is performing relative to the fiscal rule.

Are national spending rules successful?

There are numerous examples of national spending rules that have proved effective in promoting sustainable management of the public finances.

Begg, Kuusi, and Kylliäinen (2023) emphasise some of the key factors promoting success of spending rules:

History and culture play a key role, with episodes of deep economic crisis often influencing how frameworks evolve, with a “never again” motive proving potent. The likelihood of rules proving successful is improved if there are strong independent fiscal institutions monitoring them regularly.

Legal status is important. International evidence suggests that there tends to be higher compliance with expenditure rules when enshrined in law or in a coalition agreement (Cordes, Kinda, and Muthoora, 2015). Putting rules in legislation also forces countries to spell out exactly how they will work and limits the opportunities for the rules to be adjusted in an inappropriate way as and when political pressures arise.

Cross-party agreement can reinforce the success of a spending rule, as well as public confidence in government plans. Governments that take ownership and show responsibility help, and healthy political debate does not have to undermine the system. Political consensus also helps to deal with economic or other shocks, insofar as it makes it easier to agree on difficult policy choices. Indeed, Cordes, Kinda, and Muthoora (2015) note the popularity of spending rules with coalition governments where individual parties can credibly fix multi-year expenditure targets in their coalition agreement for the term of office.

Are there downsides to spending rules?

There are some potential downsides to spending rules and areas that need care in terms of the design of the rule.

First, there is a view that **spending rules might risk constraining certain parts of spending**. Public investment is sometimes cited as a particular concern. However, the evidence there is mixed.

Advanced economies tend to mitigate these risks by ensuring that their budgetary frameworks and procedures are well designed to ensure that these distortions do not arise (Cordes, Kinda, and Muthoora, 2015).

There is also compelling evidence that the procyclical bias of fiscal policy — something spending rules seek to contain — has been responsible for declines in the public capital stock in recent decades in advanced and emerging countries (Alesina et al., 2008). Haughwout (2019) shows for the US that transportation infrastructure investment occurs disproportionately in good times and decreases when the economy weakens.

One solution advocated by Portes and Wren Lewis (2015) is that governments can prevent public investment being squeezed in times of austerity by having explicit public investment targets as a share of national income.

Another solution is to have so-called "contingent fiscal plans" that safeguard public investment and encourage governments to maintain a catalogue of capital projects that can immediately be put into action if the labour market weakens significantly. This entails having infrastructure projects on the shelf that would be automatically triggered during a recession, with the aim of reducing procyclicality (Haughwout, 2019). During recessions, high-quality projects that would be able to start quickly are prioritised for funding and commencement.

Second, there are difficult questions about **how to measure spending**. For example, certain parts of government spending are cyclical in nature — rising in downturns and falling in good times. This includes spending on unemployment benefits. How you take account of these fluctuations when

assessing how spending is evolving on an underlying basis can be complicated. There are various options, ranging from making complex adjustments for the cycle and how this spending evolves with it, to excluding it in full. One compromise is to simply assume a fixed natural unemployment rate that is not subject to the vagaries of estimation procedure and the timing of when estimates are produced. Similarly, some parts of spending are clearly once-off in nature and should be removed in principle. This obviously should not be left open to discretion by policymakers solely: for example, introducing tax cuts that are declared temporary. Instead, it should be based on the principle of being inherently once-off in nature.

Third, it can be difficult to identify the **sustainable growth rate** that anchors the spending rule. Typically, this is based on an assessment of trend growth rates and there are multiple ways to identify these for any economy. In the case of small, open economies such as Ireland it proves more difficult to identify appropriate growth rates, given how much growth can vary over the course of a cycle. These challenges are compounded by distortions to the measurement of Ireland's economic activity resulting from foreign-owned multinationals. It should also involve a forward-looking element that takes account of potential changes in growth linked to, among other things, demographic changes. These issues are in part addressed by exercises such as the Department of Finance's move towards producing longer-term macroeconomic projections based on a careful growth accounting assessment.

Fourth, **how to deal with inflation** is potentially quite tricky. The rule can be specified in real terms (for example, as a 3% real spending rule) with inflation allowed to vary in line with actual forecast rates. This approach is used in a number of countries, including the Netherlands. However, revisions to inflation forecasts and temporary supply-side shocks complicate this. Alternatively, the spending rule may continue to be specified in nominal terms as is currently the case. Lane (2021) points out that aligning spending rules with the ECB's 2% inflation target on a symmetric basis would help the rule act as a countercyclical tool by increasing the fiscal space available during periods of below-target inflation and vice versa. From an economic perspective, it makes little sense to increase overall spending levels on the back of unexpectedly high inflation, particularly in the case of an adverse supply-side shock such as the global economy is experiencing now. The same argument would apply, for example, to a deflationary period. A sensible option here is to ignore the desire for a rule that specifies every possible circumstance. The rule could aim for a 2% inflation assumption, hence retaining the nominal targets, but with an allowance for higher or lower nominal net spending increases where forecasts deviate too far from trend. This could necessitate specifying the required deviation in levels, growth rates, and

the nature of the driver, or this could be addressed on an ad-hoc basis, including through get-out clauses.

Fifth, **coverage** is key. To avoid an incentive for governments to increase spending in areas that is not covered by the spending rule, the rule itself should extend to a sufficiently broad measure of government activities. An ideal approach is to have the rule cover general government spending rather than excluding parts of government such as local government and non-commercial semi-state bodies. This would help to align the national and EU rules. Again, this is something the Dutch approach involves.

International case studies

We consider four case studies that are of relevance to Ireland's design of its spending rule. This draws on reporting by the OECD (2016; 2011; 2005), IMF (2022; 2015), and Begg, Kuusi, and Kylliäinen (2023). We first give a brief overview of the spending rule framework in each country and then summarise the key features relevant for Ireland's National Spending Rule in Table 1.

Netherlands

Since the Netherlands exited an Excessive Deficit Procedure requiring it to restore a deficit below 3% of GDP in 2014, its annual budget process has become more focused on its own national, multi-annual expenditure ceilings rather than on the EU fiscal rules.

The Dutch framework involves a trend-based expenditure ceiling — that is, where expenditure ceilings are fixed to align with trend growth in revenues. The idea is to allow revenues fluctuate over the course of the cycle. There is a strict separation between expenditures and revenues, therefore windfalls on the revenue side of the budget cannot be used for additional government spending.

The expenditure ceilings are set in real terms, adjusting for actual inflation, and are determined through coalition agreement at the start of a government term.

The ceilings are expected to remain in place for the entirety of the government's four-year term. The requirement to stay within the ceiling is based on an informal requirement. Only the fundamentals of the rules are set in law (Law on Sustainable Government Finances).

The ceilings are set on a general government basis and cover around 85% of total general government expenditure.

In general, the Dutch fiscal framework garners significant praise and cross-party support. Independent institutions like the Centraal Plan Bureau and the Council of State play a crucial role in how the rules are assessed.

There are challenges: some aspects of the rule are complex; it can be difficult to define exceptional times when spending can be placed outside of the ceilings; and there are difficulties linking the ceilings to longer-term ageing pressures, though large funds have been built up to finance pensions and climate action.

Finland

Finland's spending rule was introduced in the early 1990s and reformed in 2003. It is still the most significant fiscal rule in Finland. Like the Netherlands, Finland sets four-year spending ceilings, aligned with the parliamentary term. These ceilings are set in real terms and adjusted for inflation each year. They cover about 75% of central government spending, with interest, cyclical and externally funded spending areas excluded.[13]

Unlike other countries, the framework is not in legislation and instead relies on strong cross-party political agreement. The ceilings are set at the beginning of government terms for 4 years as part of the Government Programme. The requirement to stay within the ceiling is therefore based on an informal requirement rather than being set in law. However, the rule attracts substantial weight in discussions at a national level and has strong public support.

Challenges with the rule are 1) the spending limits are not always consistent with other fiscal policy objectives, including the EU rules and employment goals; 2) the ceilings historically left out large parts of general government (about 60-65%); and 3) discretionary revenue measures are ignored in the system (VTV, 2021).[14]

Sweden

Sweden sets multi-year ceilings for central government and pension expenditures. The nominal spending ceilings are set for a three-year period with the third year updated annually.

Once adopted, the ceilings cannot be changed except for some technical adjustments. The framework lacks an escape clause but includes a "budgetary margin" that allows some flexibility for additional expenditure arising from unforeseen cyclical factors and inflation.[15]

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[13] The cyclical areas excluded are unemployment benefits, social assistance, wage guarantees and housing allowances, except in cases where the criteria related to these are changed with an impact on expenditure. Externally funded expenditure relates to technically transmitted payments and external funding contributions.

[14] This year, the coverage of the spending rule looks set to expand substantially due to large administrative reforms that bring social and health care spending from local government to within central government.

[15] The budgetary margin is set as 1% of the forecast expenditure for year t, 1.5% for t+1, 2% for t+2, and 3% for t+3.

The rule has proven effective and has never formally been exceeded.[16] Monitoring and evaluation of fiscal policy is carried out by a number of independent bodies, including the Fiscal Policy Council, which acts as a fiscal watchdog. This is seen to add transparency and clarity about the aims and effectiveness of policy (Jonung, 2014). The legal requirements are broadly defined, with the strong political commitment to the framework mostly achieved through established practice and potential reputational costs to government (Begg, Kuusi, and Kylliäinen, 2023).

Switzerland

The debt brake rule is the cornerstone of the Swiss fiscal framework and is embedded within the Federal Constitution. It targets a balanced budget over the business cycle by limiting overall federal expenditure to the expected level of tax revenues adjusted for the cycle.[17] The expenditure ceilings are set in real terms and adjusted for annual inflation.

The Swiss Federal Audit Office examines the budgets and assesses compliance with the rule. Where spending exceeds the ceilings, it must be compensated for in subsequent years. Where spending is below the ceiling, the balance can only be used to repay debt. Budgeted spending has generally fallen below the ceiling since introduced.

An exemption clause (for natural disasters or severe recessions) allows the ceilings to be increased, provided it is approved by a qualified parliament majority. However, this spending must be compensated for at most six years after the end of the exceptional circumstances.

The rule has some drawbacks: 1) it can lead to excessive fiscal tightening in the aftermath of a crisis; 2) it relies heavily on unobservable indicators such as trend GDP; and 3) it tends to be based on overly cautious revenue forecasts and, thus, has led to frequent underspends (relative to approved ceilings).

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[16] There is a recent exception. In 2020, the Government proposed an increase in the level of the ceiling for 2020. This was followed by approved increases for 2021 and 2022. The Swedish National Audit Office described the raised level for 2020 as in line with the Swedish framework. However, it described 2021 and 2022 increases as incompatible with the framework and at risk of leading to less effective spending priorities (Begg, Kuusi, and Kylliäinen, 2023; Riksrevisionen, 2020).

[17] The business cycle adjustment factor consists of the ratio between trend (real) GDP and actual (real) GDP. If the adjustment factor is greater than 1, the expenditure ceiling is set such that expenditures may exceed expected tax revenues. In other words, a structural budget deficit is allowed. On the other hand, if the adjustment factor is less than 1, the expenditure ceiling is set below expected tax revenues, and a structural budget surplus is required (Beljean and Geier 2013).

Table 1: Selected countries with spending rules

	Date spending rule was introduced	How long is it set for	Is it in legislation	Is set in growth or levels	Nominal or real	Is it net of tax changes	Coverage	Escape clause
Netherlands	1994	Duration of government (4 years)	Mainly set by Coalition agreement (though basics of rule are set in law)	Levels	Real	Yes	Covers 80–90% of general government expenditure	No (but introduced for pandemic)
Finland	2003	Duration of government (4 years)	Coalition agreement	Levels	Real	No	Central Gov. (primary non-cyclical expenditure ~ 75% total central government spending)	No (but introduced for pandemic)
Sweden	1997	Three years ahead	Coalition agreement (1997-2009) Legal from 2010	Levels	Nominal	No	Primary Central Gov. + Social Security (nearly all)	No (but ceilings raised for pandemic)
Switzerland	2003	Multi-year period	Legal (Constitution, 2001)	Levels	Real	Yes	Total federal expenditure	Yes

Sources: OECD (2016; 2011; 2005); IMF (2022; 2015); Vierke and Masselink (2017); and Begg, Kuusi, and Kylliäinen (2023).

What does this mean for Ireland's National Spending Rule?

The Irish Fiscal Advisory Council has assessed that the National Spending Rule should be fleshed out further along a number of key dimensions.

Legal Status: Spending rules should ideally be formed out of a political consensus that attracts cross-party support. However, there are benefits to literally writing down exactly how it is envisaged that a rule works.

There are trade-offs between having flexible and rigid rules. Flexible rules might try to capture more special instances, but with added complexity. Whereas rigid rules will ignore these but come with the benefit of being simpler, more transparent, and being easier to assess by a greater number of stakeholders.

It should be noted that not every circumstance will be covered by a spending rule regardless of how carefully designed it is. This is one reason why escape clauses are a useful part of any design and why they feature in many international examples.

On balance, the Council assesses that a legislative standing for the spending rule would be better than a rule that has no legal standing. It would clarify how the rule actually works; it would push its design towards being more carefully set out; and it would enhance the credibility of future government plans.

Net basis: The spending rule should be maintained as a "net" spending rule. That is, it should allow governments to expand the overall size of government in terms of public outlays should they see fit to do so. This can be achieved by ensuring that the spending rule treats tax-raising measures as allowing equivalent increases in spending over and above the existing limit. Of course, this is with the condition that those tax increases sustainably increase the level of government revenue taken in. Similarly, governments that reduce taxes should have this decision reflected in the rule through a requirement for lower spending so as to ensure sustainability. In this sense, the rule should treat permanent tax cuts as equivalent to permanent spending increases. The measurement of discretionary revenue measures should — from an economic perspective — be considered relative to a baseline where income tax bands are indexed, so that the proceeds of not indexing the tax system are recognised as a tax-raising measure.

The appropriateness of 5%: The rule should incorporate a five-year review mechanism, ideally aligned to the political cycle, whereby the appropriateness of the real growth rate underpinning allowable spending growth would be re-assessed in light of the most recent evidence. It should be based on domestic measures and forecasts of underlying economic activity, such as potential real GNI* growth, hence abstracting from distortions related to foreign-owned multinationals.

In terms of inflation, the 2% assumption currently implicit in the National Spending rule is reasonable. However, an allowance for exceptionally higher or lower levels of inflation should be considered in cases where this is judged to persist over the medium to long term. This could involve specifying a threshold for inflation rates above or below which some adjustment is made to the assumed inflation measure used. In more severe cases, this could be addressed through the activation of escape clauses.

Protecting public investment: The Council assesses that the spending rule could be complemented with a minimum target for Public Investment as a share of national income (for example as a % of GNI*). This would help to ensure that capital spending is not cut substantially, with the result that there are unsustainable and damaging declines in the net public capital stock.

Escape clauses: Escape clauses can be a key feature of well-designed spending rules. Ireland's National Spending Rule should ideally have a clear escape clause linked to periods of an exceptional deterioration in economic prospects impacting the public finances. It should involve independent assessments, with the Fiscal Council obviously suited to this, given its existing mandate.[18]

Debt anchor: Ensuring that spending rules do not lock in a spending trajectory that entails persistent increases in the debt ratio is difficult. In Ireland's case, this could be addressed in several ways. It could involve a forecasting assessment that ensures the debt-to-GNI* ratio does not surpass some threshold. This could be with some assigned level of probability as in stochastic assessments. The 60% level is, by design, arbitrary and by no means a "magic number". However, keeping debt ratios below this level does help prevent the risks of "non-linear" or explosive debt dynamics that are typically seen at higher debt ratios from materialising (Barnes, Casey, and Jordan-Doak, 2021).[19]

There are arguments that an appropriate level for Ireland would be lower than 60% of GNI*, given the historical volatility of its growth rates and revenues. Sweden's debt anchor involves a limit of 35% of GDP.

In cases where medium- to long-term projections show the debt ratio rising above the chosen threshold, a downward adjustment to spending increases over the five-year period should be allowed for to ensure that the threshold is not breached. As in the proposals for the new fiscal rules,

[18] The Council's mandate incorporates a requirement for it to formally assess whether or not exceptional circumstances exist or have ceased to exist in the context of the domestic Budgetary Rule.

[19] Taking the case of assumed maximum primary surpluses of 2.5% — which is around the 90th percentile for Ireland's structural primary balance over the period 2000–2022 — the authors show that for a wide range of interest rates, debt ratios can tend to exhibit highly non-linear increases in the risks of explosive debt dynamics in the region of debt ratios running from 50 to 100%.

this should be based on a most likely set of projections that take account of ageing-related spending pressures.

Coverage: The spending rule should encompass all the institutions falling under the general government classification. This would avoid expenditure shifting between different layers of government to circumvent the spending limits.

Strengthening the design of Ireland's National Spending Rule in this way would contribute towards strengthening the credibility of Ireland's fiscal policy. It would increase the long-term focus of budgetary policy and would be conducive to sound economic and budgetary management. It would provide a "first line of defence" given that the EU rules are unlikely be binding on Ireland for some time. Finally, it would raise transparency around fiscal policy choices, including for the public, the Oireachtas and financial markets. Compliance could be monitored by the Fiscal Council. This would be supported by strong buy-in to the institutional framework.

Annex

Technical aspects of the new EU Fiscal Rules

In the case of high debt countries, the new fiscal rules are likely to see the Commission put forward a path for net expenditure that covers a minimum adjustment period of 4 years. This could be extended by a maximum of 3 years if the Member State commits to certain reforms and investments.[20]

For countries assessed to have low debt ratios, and with deficits no greater than 3% of GDP, the Commission will provide technical information to Member States. This would seek to ensure that the government deficit is kept below 3% of GDP over the medium term. It would take the form of guidance on an appropriate structural primary balance to run without any additional policy measures over a 10-year period after the end of the national medium-term fiscal-structural plan.

The net expenditure path would seek to ensure:

- A plausible downward path for the debt ratio, or one staying at prudent levels, with this broadly based on a 60% of GDP limit;
- A government deficit brought and kept below 3% of GDP. Where the deficit exceeds 3%, it must be reduced by at least 0.5% of GDP each year. The proposals are ambiguous in terms of what the 0.5% refers to;
- A debt ratio at the end of the path (between 4 and 7 years out) that is below its level in the year before the path starts; and
- The fiscal adjustment effort over the horizon of the plan is at least proportional to the total effort over the entire adjustment period.[21]

The Commission will apply the following principles to assessing compliance with the net expenditure path.

[20] This depends on the debt and growth challenges faced. The reforms and investments considered would have to: (i) be growth enhancing; (ii) support fiscal sustainability; (iii) address the common priorities of the Union; (iv) address relevant country-specific recommendations addressed to the Member State concerned, including under the Macroeconomic Imbalances Procedure; (v) ensure overall levels of nationally financed public investment over the lifetime of the national medium-term fiscal-structural plan are higher than the medium-term level before the period of that plan. In addition, they would have to sufficiently detailed, front-loaded, time-bound and verifiable.

[21] Our interpretation here is that, in the case of an extended adjustment period of seven years, the adjustment in the first four years would have to be equivalent to 4/7ths of the overall adjustment required to put debt ratios on a plausible downward path.

For Member States having public debt above 60% of GDP or a government deficit above 3% of GDP, the path will have to ensure that:

1) the 10-year debt trajectory, in the absence of further budgetary measures, is on a plausibly downward path or stays at prudent levels by the end of the adjustment period;

2) the deficit is brought and kept below 3% of GDP in the absence of further budgetary measures over the same 10-year period;

3) where the deficit is expected to be above 3% of GDP and the excess is not close and temporary, the trajectory must also be consistent with existing speeds of correction;[22]

4) the adjustment effort is not postponed towards the final years of the adjustment period. In other words, the fiscal adjustment effort over the period of the national medium-term fiscal-structural plan is at least proportional to the total effort over the entire adjustment period;

5) the public debt ratio at the end of the planning horizon is below the public debt ratio in the year before the start of the technical trajectory; and

6) the national net expenditure growth remains below medium-term output growth as a rule over the horizon of the plan.[23]

The assessment of a "plausible" downward path for the debt ratio is based on the following conditions[24]:

1) The public debt ratio should be declining, or stay at prudent levels, under the deterministic scenarios of the Commission's medium-term public debt projection framework described in the Debt Sustainability Monitor 2022;

2) the risk of the public debt ratio not decreasing in the five years following the adjustment period of the national medium-term fiscal-structural plan is sufficiently low. The risk is assessed with the help of the Commission's stochastic analysis.

The Commission's Debt Sustainability Monitor 2022 identifies many deterministic scenarios. However, these four would appear to be central to any assessment that would be relevant for Ireland:

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[22] The benchmark here is referred to under Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and it notes that the "…Council recommendation made in accordance with Article 104c (7) shall establish a deadline of four months at the most for effective action to be taken by the Member State concerned. The Council recommendation shall also establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances."

[23] Note that this is a condition for the Commission's technical trajectory but not one that technically applies for a Member State's own net expenditure path as legislative proposals currently stand.

[24] See Annex V of the proposed Regulation (European Commission, 2023b).

1. The adverse "r-g" scenario

The adverse "r-g" scenario assumes a permanent 1 percentage point worsening in the difference between the average effective interest rate and economic growth rates.[25] This higher differential is obtained by applying simultaneous adverse shocks to (short- and long-term) market interest rates and to economic growth.

2. The financial stress scenario

This scenario assumes a temporary increase in interest rates by 1 percentage point in the first projection year (2023 here). In the Commission's approach, a risk premium is included for countries with debt ratios over 90% of GDP in 2021.

3. Historical structural primary balance scenario

This scenario is meant to help assess what would happen if the budget balance reverted to historical norms. It assumes that the country sees its structural primary balance gradually revert to its historical average over four years. This happens after the first two forecast years (and so takes place between t+3 and t+7). In our case, we assume that the structural primary balance adjusts between 2025 and 2028. In line with the Commission, approach, we base the historical average on available data for 2007 to 2021.[26]

4. Lower structural primary balance scenario

This assumes the structural primary balance worsens over the forecast period. In levels, the cumulative forecast change over 2022 to 2024 is reduced by half and the structural primary balance remains at that level afterwards.

These scenarios, together with the stochastic debt sustainability analysis, serve to inform the classification of a country as being either high or low debt. Hence, they inform the assessment of whether an adjustment

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[25] This is informed by previous research (Pamies et al., 2021). The Commission models the risk premium as equal to 0.06 times the excess of the 2021 debt level over 90%, in those countries where debt exceeded 90% of GDP in 2022.

[26] Note that, to align with the Commission's approach, we use estimates based on the commonly agreed methodology as implemented by the Commission. This puts Ireland's average structural primary balance over the period 2007 to 2021 at -1.2% of GDP. The Department of Finance *SPU 2023* projections would imply a structural primary surplus of 2.8% for 2025. This would imply a gradual adjustment of 4 percentage points of GDP in the structural primary balance to return it to its historical average. In 2023 terms, that would mean a substantial €22 billion weakening in the budget balance phased in over the course of the four years. For the GNI*-based approach, we use the alternative output gap estimates produced by the Department of Finance, which rely on Domestic GVA to produce estimates, and we adjust for the Department's estimates of windfall corporation tax receipts in full. This entails a structural primary balance of 1.6% of GNI* in 2025 as compared to a historical average of -1.3% and so a cumulative worsening in the scenario equivalent to 2.9 percentage points of GNI*.

requirement is needed or not. If needed, the adjustment is understood to be set in such a way as to minimise the risks of these scenarios involving a breach of the 60% of GDP debt ratio threshold.

Extensions to the adjustment path

Each Member State will have the possibility of extending its adjustment path up to a maximum of three years. This would be permitted in certain cases.

First, a Member State would submit its Medium-Term Fiscal-Structural Plan — the cornerstone of the new framework. The plan would include all reform and investment commitments that will be taken by Member States to address the challenges identified in the context of the European Semester including the country-specific recommendations.

Second, these reform and investment commitments would be assessed in turn by the Commission and the EU Council. They could allow an extension of the fiscal adjustment horizon provided that, as a whole, the commitments meet certain criteria such as being:

1) growth-enhancing: examples include addressing ageing challenges, improving labour market functioning, increasing labour supply, encouraging innovation, strengthening skills, improving the business environment (governance, respect for rule of law, independent, quality and efficient justice systems, functioning and effective tax systems, effective insolvency and robust anti-corruption and anti-fraud frameworks), removing barriers to the Single Market and addressing strategic dependencies,

2) supporting fiscal sustainability: examples include reforms to pension systems, reforms improving the cost-effectiveness of public expenditure, or reforms increasing tax collection

3) consistent with common priorities of the Union defined in Annex VI of the proposed Regulation. The common priorities are:

    a. The European Green Deal, including the transition to climate neutrality by 2050, and the translation at national level through the National Energy and Climate Plans [27]
    b. The European Pillar of Social Rights including targets on employment, skills and poverty reduction by 2030 [28]

[27] Communication COM(2019) 640 final of 11 December 2019 from the Commission 'The European Green Deal' and Decision (EU) 2022/591 of the European Parliament and of the Council of 6 April 2022 on a General Union Environment Action Programme to 2030 (OJ L 114, 12.4.2022, p.22).

[28] (2017/C 428/09) Interinstitutional Proclamation on the European Pillar of Social Rights (OJ C 428, 13.12.2017, p. 10).

c. The Digital Decade Policy Programme 2030, and reflected at national level through the National Digital Decade Strategic Roadmaps [29]
d. A Strategic Compass for Security and Defence - For a European Union that protects its citizens, values and interests and contributes to international peace and security.[30]

To qualify for an extension, these reform and investment commitments would have to be sufficiently detailed, front-loaded, time-bound and verifiable.

[29] Decision (EU) 2022/2481 of the European Parliament and of the Council of 14 December 2022 establishing the Digital Decade Policy Programme 2030 (OJ L 323, 19.12.2022, p. 4).

[30] Council of the European Union, COPS 130

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