Box F: Substantial EU fiscal rule reforms come into force

In April, the Council of the European Union adopted significant reforms to the EU fiscal rules[53]. This followed extensive discussions among Member States around how best to enhance budgetary discipline and encourage greater compliance with the rules. The Fiscal Council previously published a detailed examination of what these reforms will mean for Ireland.[54] However, now that the revised rules have been finalised, we revisit their implications for Ireland.

Overview of the rules

The key objective of the new rules is to put a Member State's debt ratio on a plausibly downward path or to keep it at low levels. To achieve this, a multi-year net spending rule will form the operational part of the rules. All Member States must submit a 'medium-term fiscal-structural plan' by 20 September this year.[55] The plan will cover a four or five-year period,[56] although it can be extended by up to three years if the Member State commits to certain reforms and investments.[57]

The plan will set a maximum growth rate of nationally financed net primary spending each year.[58] This net spending limit will be binding once approved by the Council of the EU. The agreed net expenditure path will then remain unchanged for the duration of the five-year plan unless a new government assumes office (in which case the plan can, but does not have to be revised).

Every spring, countries are then required to submit Annual Progress Reports. The European Commission will use these to assess compliance with the maximum growth rate in net primary spending.[59] In doing so, the Commission will also set up a 'control account' — a way to keep track of the cumulative upward and downward deviations of actual net spending from the agreed path.

In the new framework, countries with debt ratios above 60% of GDP or deficits greater than 3% of GDP will come under much sharper focus. For these countries, the Commission will put forward a reference adjustment path for net spending that would ensure debt is put on a plausibly downward course, and the deficit is brought or kept below 3% of GDP over the medium term.[60] The Commission will issue this reference path by mid-June. These countries must then consider this reference path when designing their medium-term plans. These plans would be designed so as to cap net spending increases at a slower

[53] See press release here.
[54] Box F of the June 2023 Fiscal Assessment Report explored these proposals in greater detail.
[55] This deadline may be extended if agreed with the European Commission.
[56] The number of years covered by the medium-term fiscal structural plan should be the same as the length of the national legislature; in Ireland's case this would be five years.
[57] The criteria include whether the reform and investment commitments are: 1) growth-enhancing; 2) support fiscal sustainability; 3) in line with common EU priorities, such as the European Green Deal; 4) address relevant country-specific recommendations issued by the Commission; and 5) keep public investment at or above previous medium-term levels of investment.
[58] Nationally financed net primary expenditure is defined as general government expenditure excluding interest, one-offs, EU-funded spending, national spending on programmes co-funded by the EU, and temporary spending on unemployment related to the cycle. It adjusts for the net impact of tax measures; tax-raising measures would allow for larger spending increases, whereas tax cuts would reduce the scope for spending increases. Unlike the Expenditure Benchmark it replaces under the current guidance, it does not smooth out investment costs over a four-year period.
[59] These will replace Stability Programme Updates and National Reform Plans.
[60] The reference path would also have to be consistent with the 'debt sustainability safeguard' and the 'deficit resilience safeguard'. The 'debt sustainability safeguard' requires debt to decline on average by at least 1 pp. of GDP per year as long as debt exceeds 90% of GDP, and by at least 0.5 pp. of GDP per year as long as debt stands between 60% and 90% of GDP. The 'deficit resilience safeguard' requires an annual adjustment of at least 0.4 pp of GDP (0.25 pp. in case of extension) in structural primary terms until the structural balance is above or equal to –1.5% of GDP.

rate than would otherwise be considered sustainable, with a view to steadily reducing debt ratios over time.[61]

However, those countries with debt ratios below 60% of GDP and a deficit below 3% of GDP will be subject to less scrutiny under the new rules. These countries, such as Ireland, will not be issued with a reference adjustment path. They will, in effect, fall outside the focus of the new rules. They may request 'technical information' from the Commission on the structural primary balance necessary to keep the deficit below 3% of GDP and the debt ratio below 60% of GDP during the period covered by the plan and the subsequent 10 years afterwards, assuming no policy changes.[62] However, these countries are not under any obligation to request this information.

Ireland will continue to face little scrutiny under the EU fiscal rules

Ireland is unlikely to come under much scrutiny under the new EU fiscal rules. GDP continues to form the basis of the Commission's debt ratio assessments despite it being an inappropriate measure of the Irish economy. This is because Ireland's GDP levels are artificially inflated by distortions linked to the activities of a relatively small number of foreign-owned multinational enterprises. Ireland's debt ratio is currently below 60% of GDP and is projected to stay below this level. In addition, substantial injections of windfall corporation tax receipts continue to flatter Ireland's budget balance and, thus, its debt path, even though there are serious concerns about the reliability of these revenues.

It is not clear what action, if any, the European Commission might take if a country like Ireland breaches annual limits. If Ireland were to exceed the binding annual limits on the growth in nationally financed net primary expenditure, it may not face any sanctions so long as the debt ratio remains below 60% of GDP and the deficit below 3% of GDP.

What this means for domestic legislation?

The new EU fiscal rules may require an updating of Ireland's Fiscal Responsibility Act (2012), which transcribes the fiscal rules for Ireland. The Act has an emphasis on structural balance targets and a debt rule. It does not explicitly mention a spending rule. However, the new EU rules abolish the '1/20th Debt Rule' and move away from a structural balance target to a target for net primary spending.[63]

Therefore, the new rules present an opportunity for the Government to put its own National Spending Rule on a statutory footing. In addition, the National Spending Rule could be amended such that it captures general government spending, is linked to debt targets, and protects public investment with a minimum steady state target set as a percentage of GNI*. These changes could ensure that the National 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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[61] In this instance, sustainable means in line with usual — or "potential" — economic growth, and, by extension, revenue growth.
[62] This 'technical information' would also ensure the so-called 'deficit resilience safeguard' is fulfilled. In other words, the structural primary balance would be consistent with a structural budget deficit at or below 1.5% of GDP, even after the headline budget deficit is below 3% of GDP.
[63] If the debt-to-GDP ratio was above 60% of GDP, the '1/20th Debt Rule' required that the ratio fell by, on average, one-twentieth of the excess between the actual debt-to-GDP ratio and 60% of GDP. However, this rule has been abandoned under the new EU fiscal rules.