October 2024

Briefing

The EU's New Fiscal Rules

Summary

- The new EU fiscal rules came into effect this year. They mainly involve a spending rule. But these do mean any credible constraint due to their emphasis on GDP and the way they treat exceptional corporation tax.

- It is not clear what action, if any, the European Commission might take if Ireland breaches its annual spending limits. It may not face any sanctions so long as the debt ratio remains below 60% of GDP and the deficit below 3% of GDP. These are not appropriate benchmarks for Ireland.

- This poses a problem. With the EU rules probably being ineffective for Ireland, the public finances may be subject to very little external scrutiny.

- The only tool that might plausibly safeguard the public finances is a national rule. The Net Tax and Spending Rule introduced in 2021 fits the bill. But it needs to be adhered to. Future governments can show they are serious about managing the public finances sustainably by bringing the rule into legislation. Or, at the very least, they could seek cross-party agreement on the rule like in the Netherlands, Finland and Sweden.

This briefing note was prepared for an engagement with the Select Committee on Budgetary Oversight on 23rd October 2024. It draws on previous Council work including the Analytical Note "Ireland's spending rule and the third wave of the EU's fiscal rules" by Eddie Casey and Brian Cronin.

The New Rules

The EU has reformed its fiscal rules. Rather than focusing on structural budget balances, these now focus on a spending rule. The rule sets limits on how fast government expenditure can grow. Faster spending growth is allowed, once taxes are raised to fund it.

The limits depend on government debt. Countries with higher debt ratios have less wiggle room. The goal of the rules is to place government debt ratios on a safe downward path over the long term. This should avoid risks that countries have to cut back suddenly, with adverse impacts on neighbouring countries.

Why new Rules?

The new fiscal rules aim to address concerns with the old system. They respond to criticisms that previous rules were 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.

How the rules work: scenario modelling

The rules are assessed on the basis of a series of stress tests.

The European Commission assesses each Member State's path for its government debt-to-GDP ratio and the size of its budget deficit relative to the 3% of GDP limit.

The idea is to assess each government's likelihood of remaining within these criteria after what it calls an initial "adjustment period", which is typically the next four years.[1] The debt ratio should be on a plausibly downward path or stay below 60% of GDP afterwards and the deficit should not exceed 3% of GDP.

It involves looking at various scenarios covering the 5-10 years after the adjustment period.

These include:

1. An assessment of the probability that debt ratios will rise indefinitely. The idea here is that the debt ratio should

[1] Member states can ask to lengthen this to seven years so long as they commit to certain reforms and investments that improve resilience and growth potential, support fiscal sustainability, and address common EU priorities.

have at least a 70% probability of declining over the five years after the adjustment period ends.

2. A scenario where the budget balances go back to more normal levels, historically speaking.
3. A scenario where the difference between growth rates and interest costs worsens permanently.
4. A financial stress scenario where interest costs rise temporarily.

Fig 1 How the timeline works

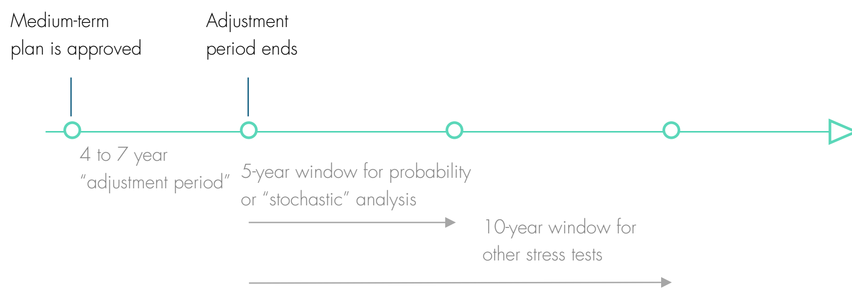
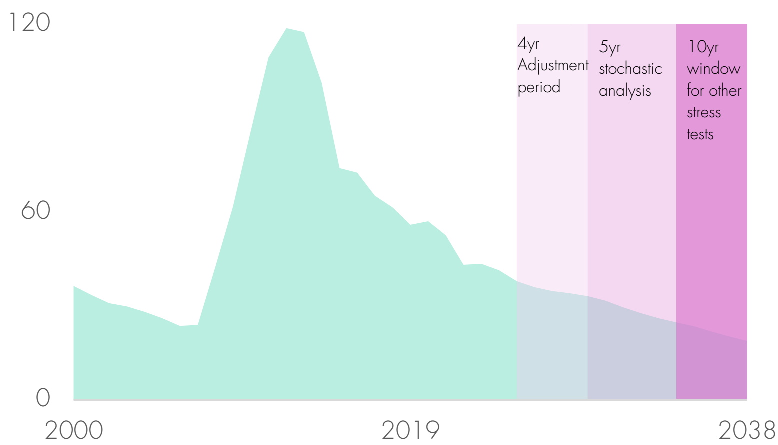


Fig 2 How the timelines look for Ireland

% GDP, Ireland's gross debt-to-GDP ratio



Source: Department of Finance projections.

Why the Rules Don't Work Well for Ireland

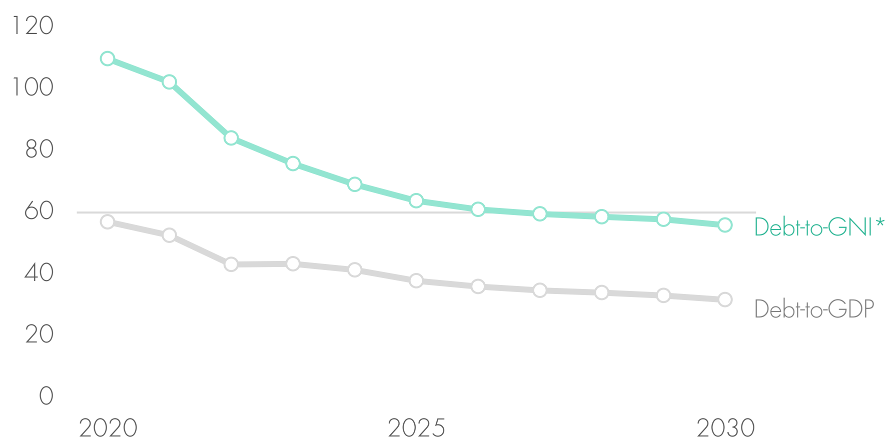
GDP Basis

The new rules may not work well for Ireland. For one, Ireland's debt ratio, when measured on a GDP basis is low and projected to stay below 60% of GDP. This means that Ireland faces little scrutiny under the new rules.

The new rules fail to recognise that GDP is not a good measure of national income for the Irish economy. It includes the profits of foreign multinationals which are not available for use by Irish residents. Huge worldwide exports by foreign multinationals are accounted for in Irish exports underpinning GDP. The gap between GNI* and GDP has grown to over €200 billion. This means that Ireland's debt ratio relative to national income is understated when scaled against GDP.

Fig 3 **How it differs with GNI* rather than GDP**

Ireland's gross debt ratios



Source: Department of Finance projections.

A better measure is to scale debt against Ireland's modified measure of national income — GNI*. This has a tighter link to things like jobs created and the more reliable tax revenues. It gives a more accurate picture of Ireland's debt sustainability. On this measure, the Department of Finance projects that gross debt will remain above 60% of GNI* until 2027.

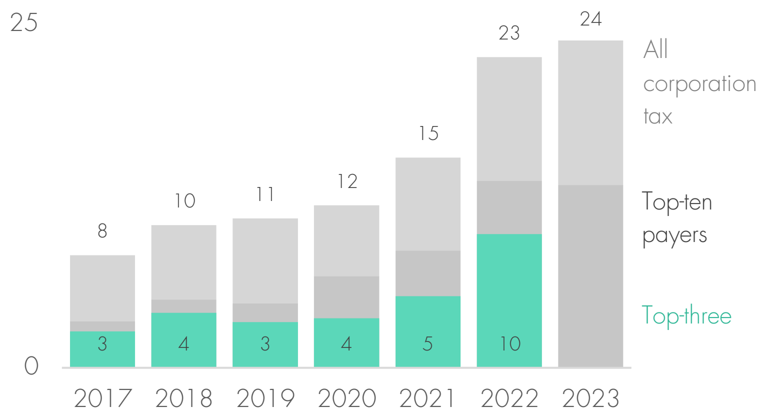
Corporation Tax

A second issue is that the rules do not treat Ireland's corporation tax receipts as exceptional despite their high concentration and the risk that they could fall suddenly and sharply.

Corporation tax receipts more than quadrupled since 2014. They reached €24 billion in 2023. They are incredibly concentrated. The top ten payers account for 56%, and we estimate that just three multinationals made up 43% of corporation tax receipts in 2022 (Figure 4). The biggest taxpayers are concentrated in the tech and pharma sectors.

Fig 4 Corporation tax is incredibly concentrated

€ billions, corporation tax



Sources: Revenue Commissioners, Cronin (2023), and Fiscal Council.
Note: Estimates for top-three are not yet available for 2023.

This concentration is risky. It leaves Irish corporation tax receipts prone to sudden upswings and possibly exposed to sharp reversals. For now, these receipts continue to increase. This flatters the budgetary position. However, the receipts could suddenly fall depending on developments related to a handful of multinationals in just a couple of sectors. This could be due to a sudden shift in fortunes, restructurings, or a change in international or U.S. tax policies.

This means that the benign assessment the EU rules provide for Ireland is overly optimistic and a poor gauge of how sustainably the public finances are being managed.

How will the rules be enforced?

The Commission's Role

The European Commission is responsible for monitoring and enforcing the EU fiscal rules. It can take action against Member States that do not comply. The Commission would provide an assessment of the risk to debt sustainability in each Member State. It would use this to determine the level of adjustment needed in each country.

Typical Calendar

The Commission would monitor compliance with the rules on an ongoing basis. It would carry out regular reviews, typically in the spring and autumn.

Spring: The spring review would focus on each country's "Annual Progress Report" and assess its fiscal plans. The Commission would assess whether a Member State has complied with its binding net expenditure growth limit. It would also monitor the implementation of agreed reforms and investments.

Autumn: The autumn review would focus on the assessment of Member States' progress in implementing their fiscal plans.

The reviews would assess compliance with the rules and look at the overall state of the public finances across the EU.

In terms of the documents that the Government must submit to the European Commission, the medium-term fiscal-structural plans require Member States to provide fiscal projections and macroeconomic assumptions. They must also detail structural reforms and investment plans. These plans should be aligned with EU recommendations.

The Fiscal Council's Role

Gaps in the Current Mandate

The Fiscal Council's role in the EU's fiscal rules is limited. The Council's mandate does not currently include monitoring and enforcing the EU's fiscal rules, although it is required to take account of them in its assessments.

Both the Council and Ireland's Budgetary Rule were instated in the Fiscal Responsibility Act (2012). The Budgetary Rule was intended to be a direct transposition of the EU fiscal rules into Irish law. And the Fiscal Council has a role in monitoring it. However, with the EU fiscal rules now having changed, this creates potential inconsistencies between the Act and the EU rules as they now stand.

Specifically, Ireland's national Budgetary Rule hinges on a "medium-term objective". This is basically an objective for the budget balance when adjusted for the cycle and other temporary factors. It was the cornerstone of the previous fiscal rules.

However, the medium-term objective at the core of Ireland's Budgetary Rule was defined in relation to the 1997 surveillance and coordination Regulation.[2] This regulation has since been repealed.[3]

It could be argued that the Fiscal Responsibility Act and its references to the Budgetary Rule are not necessarily incompatible with the new EU fiscal rules. As in, both still hinge on a 3% of GDP deficit limit and 60% debt-to-GDP limit. And while the medium-term objective may be gone, the main thrust of the rules is still to achieve fiscal sustainability over a long horizon. But the inconsistency is not ideal.

Potential Roles

The Council could play a valuable role in monitoring and enforcing the EU's fiscal rules. It could do this by making the rules more transparent and providing independent analysis of compliance with these rules and how relevant they are to sustainability.

The need for Ireland to have a rule that works

Benefits of a Spending Rule

It is important that Ireland have some fiscal rule in place that works. The EU's fiscal rules are unlikely to act as any constraint on Ireland for some time.

With the EU rules not working for Ireland, and limited commitment to domestic rules, there are big risks. It will be down to future governments to decide whether, with each passing budget, they will show fiscal restraint.

Having its own rule would provide a "first line of defence" for Ireland. It would help avoid the risk of repeating boom-to-bust policies witnessed in the past. And it would make Ireland's budgeting more credible.

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[2] See Part 1 of the Fiscal Responsibility Act 2012 where it says "the "medium-term budgetary objective" means the medium-term budgetary objective required by the 1997 surveillance and coordination Regulation". Also, see Part 2 (3) where it notes that the Budgetary Rule is complied with "if the annual structural balance of the general government is at the medium-term budgetary objective".

[3] See for example the Council Directive amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

International Examples

There are several examples of countries where national rules have been effective in avoiding dangerous budgetary outcomes.

National rules have tended to play an important role. Looking at examples in Europe, research suggests that they are good at avoiding pro-cyclical policy — exactly the kind of boom-to-bust policies Ireland has had trouble with in the past (Belu Manescu and Bova, 2020).

Moreover, the same research suggests they work better with several factors in place. Namely, if they have a stronger legal footing, if they are monitored independently, set as multi-year ceilings rather than growth rates, and if there are some consequences to not meeting them.[4]

Examples of national spending rules that have worked well include:

The Netherlands

Since 2014, the Netherlands has been more focused on its own national, multi-year spending ceilings than on the EU fiscal rules.

The Dutch rule involves ceilings based on trend growth in revenues. It means that revenue windfalls cannot be used for additional government spending.

The ceilings are set in real terms, adjusting for actual inflation, and are determined through coalition agreement at the start of a government term. These ceilings remain in place for the entirety of the government's four-year term. They are based on an informal requirement. Only the fundamentals of the rules are set in law.

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

[4] The research also finds they are complied with in almost 80% of cases.

Finland

Finland introduced its own national spending rule in the early 1990s. It involves four-year spending ceilings set at the beginning of government terms. These ceilings are set in real terms and adjusted for inflation each year.

The rule remains the most significant fiscal rule in Finland. This is despite the fact that, unlike other countries, the framework is not in legislation. Instead, it relies on strong cross-party political agreement. However, the rule attracts substantial weight in discussions at a national level and has strong public support.

Sweden

Sweden also has national rules on multi-year spending ceilings. These have been in place Coalition agreement (1997-2009) and on a legal basis from 2010.

The rule involves ceilings that are set for three years. The third year is then updated annually. 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).

The rule has proven effective. Up to 2020, it was never formally exceeded. Several independent bodies monitor it, including Sweden's own fiscal council. This adds to transparency and makes clear why it exists (Jonung, 2014).

Ireland's National Spending Rule

Ireland has its own spending rule. The rule was introduced in the Summer Economic Statement published in 2021. The rule limits the growth of government spending to 5% per year. Later government publications clarified that it was a "net" rule. That is, it allows faster spending increases where these are offset by tax increases. Vice versa, it allows slower spending increases when taxes are being cut.

To date the rule has not been met. Increases in spending net of tax changes were closer to 9% in each of years 2022, 2023 and 2024 than the limit of 5%. Part of this was due to the challenges of dealing with high inflation. However, the breaches go beyond simply allowing for high inflation. Such an approach is risky as it also adds to inflation pressures.

The Fiscal Council believes that a net tax and spending rule like this is a sensible tool that can play a pivotal role in safeguarding Ireland's economic future. If set as multi-year ceilings, it can help to ensure that Ireland's public finances are managed in a sustainable way.

The rule is better tailored to Irish-specific circumstances. It is already informed by the Department of Finance's view of potential or trend growth. And it overcomes issues related to GDP and exceptional levels of corporation tax receipts.

Having a rule like this has other benefits. It helps focus budgetary policy on tackling long-term issues. With more certainty around funding, Departments would be better placed to coordinate how they deliver on major challenges.

For the rule to work, future governments need to show that they are serious about managing the public finances sustainably.

One way to do this would be to set the rule in legislation. Or, at the very least, governments should seek cross-party agreement on the broad outlines of such a rule as in Finland and in Sweden.