TASC opening statement to the Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach

I would first like to thank the committee for the invitation to present some of our thoughts on the fiscal rules and the findings of our report.

The EU fiscal rules are one of if not the most important aspects of EU economic policymaking. Over the years, they have grown more complicated and difficult to understand, have often been breached by member states, and have proven inadequate at preventing the emergence of sovereign crises. It is unanimously agreed that they are in need of major reform.

The original rule that government debt to GDP should not exceed 60% and that the government deficit should not exceed 3% was arbitrary, not grounded in economic analysis or evidence. The value of 60% reflected the average value prevailing among member states when the rules were first formulated, the 1980s. Given certain assumptions about inflation and growth, a 3% deficit rule emerged if debt was to be stabilised at 60%.

A number of reforms were subsequently added, especially after the financial crisis. A debt reduction rule was introduced specifying the speed of debt reduction while also giving force to the structural deficit, the deficit that is independent of the business cycle. An expenditure benchmark was also introduced, which limits government spending based on the growth in potential output. As we detail in our report, the structural deficit suffers from severe measurement problems. The expenditure benchmark, while slightly better than a structural balance rule, is also problematic. Adhering to the debt reduction rule, where states have to reduce debt by 1/20th of the difference between the current debt and the target 60% level, would also be hugely problematic, generating significant austerity in many countries in Europe. A return to normal would make it very difficult for Europe to meet its emissions targets.

On 9 November 2022, the Commission published a communication on reform of the EU fiscal rules The main thrust is that member states would negotiate country-specific debt-reduction plans with the Commission. For member states where debt is deemed to be risky risk, debt is to converge towards 60% over the course of a decade, with the 3% deficit rule also remaining in place. The Commission first conducts an analysis and puts forward a "reference adjustment path", which constitutes the initial position. Member states then respond by proposing medium-term fiscal adjustment plans. These set out country-specific fiscal trajectories and public investment and reform commitments, not least in the area of climate change. Once accepted, annual member-state budgets then commit to implementing the planned fiscal trajectory over four years to ensure the ten-year debt trajectory is sustainable.

Last week the Commission clarified that countries in breach of the 60% and 3% limits will have to ensure that debt is on a downward path after four years, or remains at 'prudent levels'. It seems debt will have to fall after four years. Net expenditure is also not to exceed the growth in potential output of the economy. For countries in breach of the 3% deficit rule, a fiscal adjustment of 0.5% per annum will be required. For countries with debt below 60% and deficits below 3% the Commission will issue guidance based on the structural deficit to ensure that remains the case.

That the main implementation indicator for countries in breach is to be net expenditure, as opposed to an unobservable and unmeasurable structural deficit, is positive. However, it should be noted that the structural balance is retained for low-risk countries. The abolition of the general 1/20th debt-reduction is also welcome, though it is disappointing that it has been replaced by a 0.5% rule for high-deficit countries and a short timeframe for debt reduction. Moreover, much will hinge on the initial reference adjustment path by the Commission and the debt sustainability analysis underpinning it.

Our view is that the focus on debt and deficit is misplaced, especially in a period of low interest rates. When states borrow and the principal payment on that borrowing comes due, governments typically do not draw down or use their cash balances to repay the obligation. More commonly, they “rollover” the debt, issuing new debt to repay the old. Similarly, this new debt is likely to be rolled over in the future, and so on. It is, therefore, not so much the level of debt or size of the deficit per se that imposes an economic cost, but the burden of servicing that debt. In an era of low interest rates, the level of debt has become a poorer and poorer measure of financial unsustainability. The burden of servicing debt and the amount of debt accumulated have been diverging across member states of the EU, including Ireland.

A reformed fiscal ruleset would ideally have the burden of servicing debt as its main anchor. A number of proposals have been forwarded, such as when the net debt burden exceeds 3% of GDP, corrective action should be taken. We are of course cognizant of the political realities of the EU, and such an overhaul is unlikely. Revising the debit limit to 100% would therefore be a welcome step. Similarly, setting up an EU climate investment fund to aid member states to meet their emissions targets would also be useful. Many other reforms have been proposed.

This is a crucial juncture for the EU and its member states and we once again thank the Committee for the invitation and look forward to the discussion.