

Meeting with Oireachtas Committee on Finance, Public Expenditure, NDP Delivery and Reform, and Taoiseach

Opening Statement by Mr Sebastian Barnes, Chairperson of the
Irish Fiscal Advisory Council, Wednesday 10th May 2023

Opening Statement

Thank you for inviting the Fiscal Council to discuss the EU Fiscal Rules.

The Council's mandate is to:

- assess and endorse the Government's macroeconomic forecasts;
- assess its budgetary projections;
- assess compliance with domestic fiscal rules; and
- to provide an assessment of the overall fiscal stance.

The Council has not undertaken a formal assessment of the proposed changes to the EU fiscal framework.

However, the Council takes a close interest in these reforms. As members of the informal Network of EU Independent Fiscal Institutions, we have participated in a number of contributions to this debate. These are available publicly on the Networks website.

EU Fiscal rules

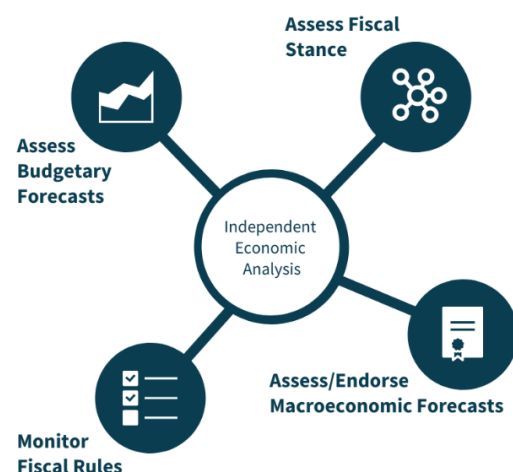
Fiscal rules, frameworks and institutions provide useful guidance in setting fiscal policy. They help ensure sound economic management of the public finances and improve the focus on the medium term.

In the EU context, fiscal rules have a special role in ensuring that individual countries do not put the wider euro area at risk as we experienced in 2010.

Designing fiscal rules for countries in the euro area is a challenging task given the diversity of different economic situations and different traditions and institutions.

Since the Stability and Growth Pact was put in place in 1997, there have been 3 regimes:

- the original Pact focused on the 3% of GDP deficit and 60% of debt ceiling;



- the amended Pact in 2005 focused on a target for the structural budget balance adjusted for the economic cycle;
- the “six-pack” of reforms in 2011 aimed to reinforce this approach.

For the past 3 years with Covid and the energy crisis, “exceptional circumstances” have prevailed and normal operation of the rules has been suspended. This is set to end this year.

The proposed reforms

The Stability and Growth Pact has been widely criticised on two grounds: first, the rules are seen as overly complex and not always delivering sound advice; and, second, compliance and enforcement of the rules has been inadequate.

The European Commission published on 26 April detailed legislative proposals to reform the EU fiscal rules, building on the mandate agreed by Ministers at the ECOFIN meeting in March.

The reforms aim to simplify the framework, strengthen the medium-term focus and increase compliance by improving national ownership.

These reforms are a major change in direction, although some familiar features remain. Much of the existing framework based on the structural balance would disappear.

In simple terms, the new framework would have three steps [\[Slide 1\]](#):

- First, the Commission would propose a 4 year reference spending path [\[Slide 2\]](#). This is designed to put the debt ratio on a downward path over the following 10 years and to meet a set of other conditions. This path takes into account pensions costs. This window can be extended to 7 years under certain conditions.
- Second, each Member State would propose its own national fiscal trajectory for spending, which could differ from the Commission’s proposal [\[Slide 1\]](#). This would need to be approved at EU level.
- Third, compliance with this spending path would be monitored and enforced at EU level and by national fiscal councils.

Broadly speaking, this regime would apply to countries with deficits greater than 3% of GDP and debt ratios above 60%.

The potential advantages of this regime are that — on the one hand — it allows for a more tailored design of fiscal requirements through a

rich process to set the adjustment path. On the other hand, it gives a simpler operational target based on spending that should be easier to enforce. The whole approach has a much stronger medium-term focus.

However, there remain important open questions.

First, the European Commission has yet to publish simulations of the spending paths, so we do not ultimately know what these will imply for fiscal policy in each Member State nor how robust the underlying calculations are.

Second, how far this regime increases national ownership and compliance remains to be seen. Much will depend on the degree of political will to support this system.

The proposals would also significantly strengthen the role of national independent fiscal institutions (IFIs) [\[Slide 3\]](#). The Commission notes that “[they] have proven their capacity to foster fiscal discipline and strengthen the credibility of Member States’ public finances”. IFIs would be given a range of new tasks, building on their existing activities, and there would be EU requirements on countries to strengthen their capacity.

Implications for Ireland

What does this mean for Ireland?

Given the use of GDP, Ireland will most likely be classified as a low debt country. The debt ratio was 45% of GDP at the end of 2022. However, on a more appropriate GNI* basis, Ireland would have a debt ratio around 83%. Yet the fiscal trajectory is relatively benign given the surpluses projected and this would likely not imply any changes in policy.

Ireland will most likely not face intensive scrutiny under the new framework. Indeed, Ireland’s unusual circumstances mean that historically it has been compliant with the EU rules (outside of the banking crisis), but largely as these rules have been insufficiently demanding. Compliance has been helped by the surges in corporation tax receipts.

The domestic Irish framework will therefore need to play a critical role to ensure the economy and the public finances are kept on a stable path.

In short, the domestic framework should be the “first line of defence” with the EU rules providing a back-up. This should help to ensure that Ireland has fiscal rules that work.

The Government's National Spending Rule introduced in the summer of 2021 is a sensible framework and has helped to steer the public finances through the energy crisis. It is similar in spirit to the national fiscal trajectory at EU level.

This should be reinforced by enshrining the National Spending Rule in law, so that it is more specific and harder to ignore. This would help ensure that governments — both current and future — only increase net spending in way that is sustainable and not in a way that relies on exceptional and potentially reversible revenues.

Given the huge inflows of corporation tax from a small number of foreign multinationals and Ireland's now historically low unemployment rates, saving a large part of corporation tax receipts is necessary to avoid overheating the economy.

The National Reserve Fund should be redeveloped. One option would be to make it a Pension Reserve Fund that would save incoming revenues, while helping to put the pension system on a sustainable footing.

For the Irish Fiscal Council, the proposed range of tasks in the Commission proposals broadly fits with our existing tasks but would be extended in some ways. This would require some additional resources.

Given the proposed changes at EU level, the 2012 Fiscal Responsibility Act would need to be overhauled to reflect the new requirements and remove what would become legacy requirements. This would be an important opportunity to strengthen the domestic budgetary framework by including the National Spending Rule and, potentially, a new Pension Reserve Fund.

Overall, the main gain to Ireland from these reforms should be in making the euro area more stable and reducing debt in other countries with riskier levels of debt. However, it comes with opportunities to strengthen our own budgetary arrangements to manage what are likely to be more complicated times ahead.



Irish Fiscal Advisory Council

Supporting slides for Opening Statement

Sebastian Barnes
Irish Fiscal Advisory Council
10 May 2023

1. Simplified Overview of How the EU rules Would Work

EC proposes 5-year reference adjustment path for spending



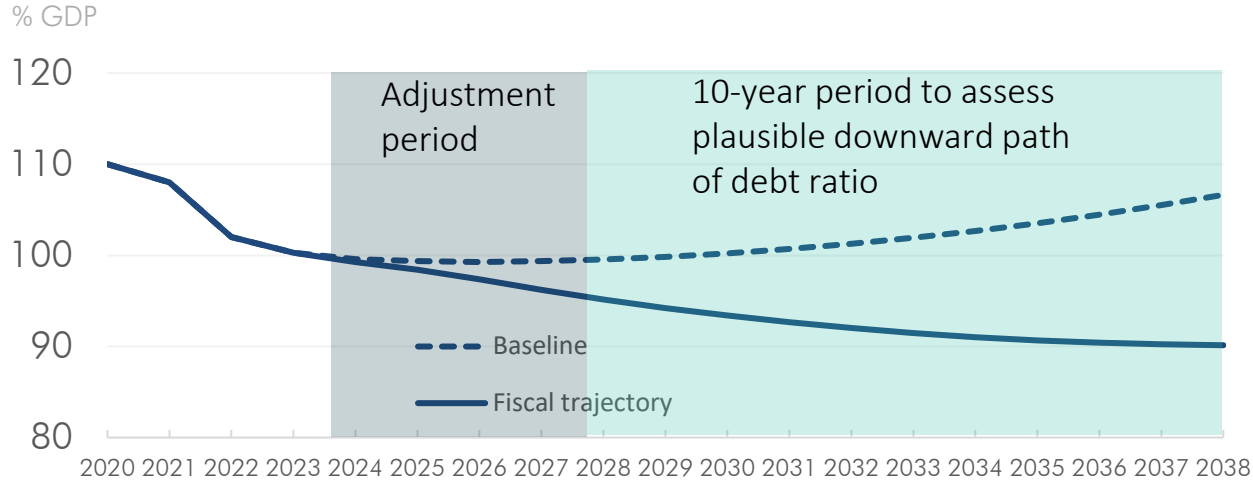
Country sets out national fiscal trajectory, EC/Council agree



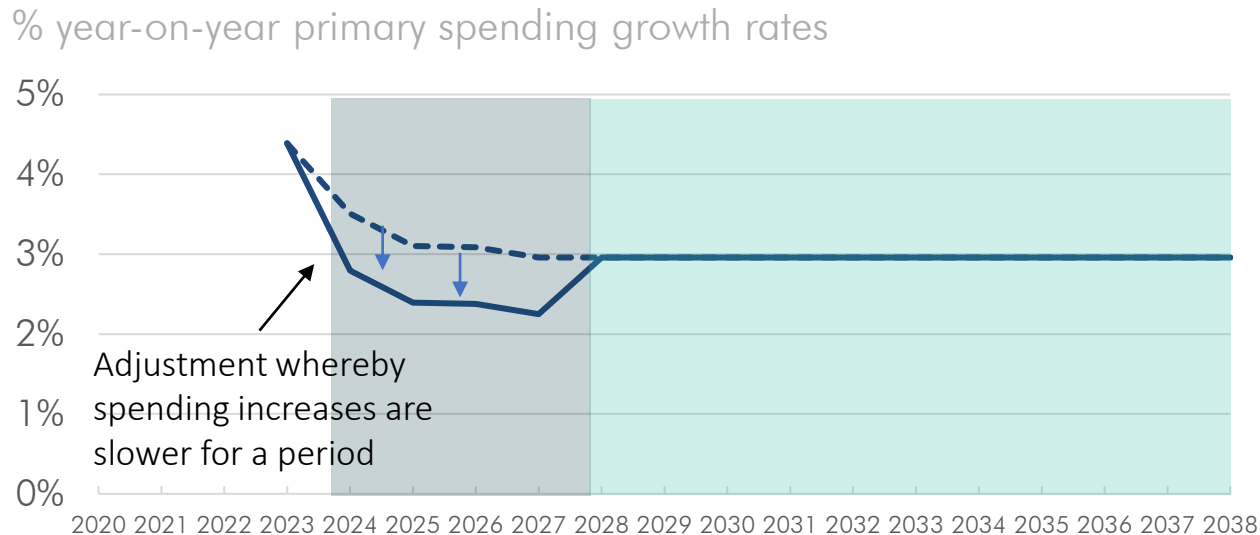
Monitoring and enforcement of spending rule

2. How will the EC set the adjustment path?

Illustrative scenario for a debt-to-GDP ratio on the fiscal trajectory



Primary spending path in baseline "no policy" change scenario v fiscal trajectory



- The debt ratio over the 10-year period is on a plausibly downward path or stays at prudent levels
- Deficit is brought and kept $< 3\%$ GDP
- Minimum balance adjustment of 0.5% GDP if deficit $> 3\%$ GDP
- Adjustment effort is not backloaded
- Debt ratio falls over period as a whole
- Expenditure growth remains below medium-term output growth

3. Role of Independent Fiscal Institutions (IFIs)

- Tasks
 - Produce/endorse **medium-term** macroeconomic and **budgetary** forecasts
 - Produce debt sustainability assessments
 - Assess the impacts of structural policies on fiscal sustainability and growth
 - Monitor compliance with national spending rule
 - Monitor compliance with the Union fiscal framework
 - Review national budgetary frameworks
 - Participate in regular hearings in the national Parliament
- A “comply-or-explain” principle applies to these tasks

Past assessments by the Council on its “Principles-Based Approach”

	2016	2017	2018	2019	2020	2021
Spending rule	✓	✗	✗	✓	Exceptional circumstances	
Structural deficit rule	✓	✓	✓	✓		
Overall assessment	✓	✓	✓			

- ✓ Compliant
- ✗ Breach
- ✗ Significant Breach

Further reading

[Managing Government Debt at High Altitude: Velocity, Instability and Headwinds](#) (Barnes, Casey & Jordan-Doak, Fiscal Council WP, March 2021)

[Ireland's next ramp-up in public investment](#) (Conroy, Casey and Jordan-Doak, Fiscal Council Analytical Note 13, 2021)

Fiscal Council [Long-term Sustainability Report](#) (June, 2020)

[VOXEU article: Euro area budget rules on spending must avoid the pro-cyclicality trap](#) (Casey and Barnes, June 2019).

[EU Economic Governance Proposal Reform: Issues and Insights from EU IFIs](#) (EU IFI Network, March 2023)

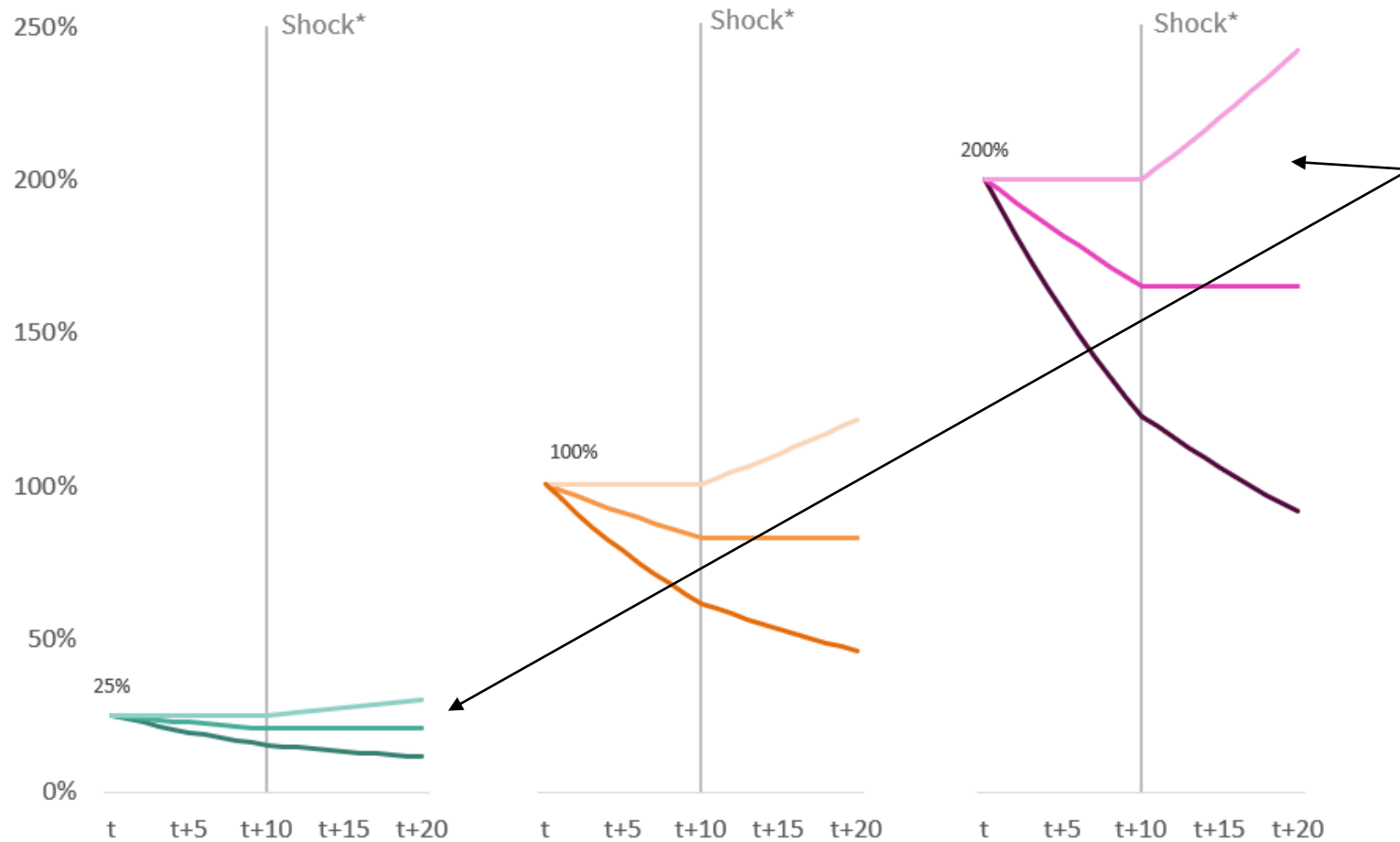
[The Capacity of National IFIs to Play an Enhanced Role in EU Fiscal Governance](#) (EU IFI Network, November 2022)

[EU Fiscal and Economic Governance Review: Contribution from the Network of Independent EU Fiscal Institutions](#) (EU IFI Network, September 2021)

Additional Slides

Debt, interest rates and risks

Debt-to-GNI* ratio with the same shock scenarios



Risks are wider at higher debt ratios

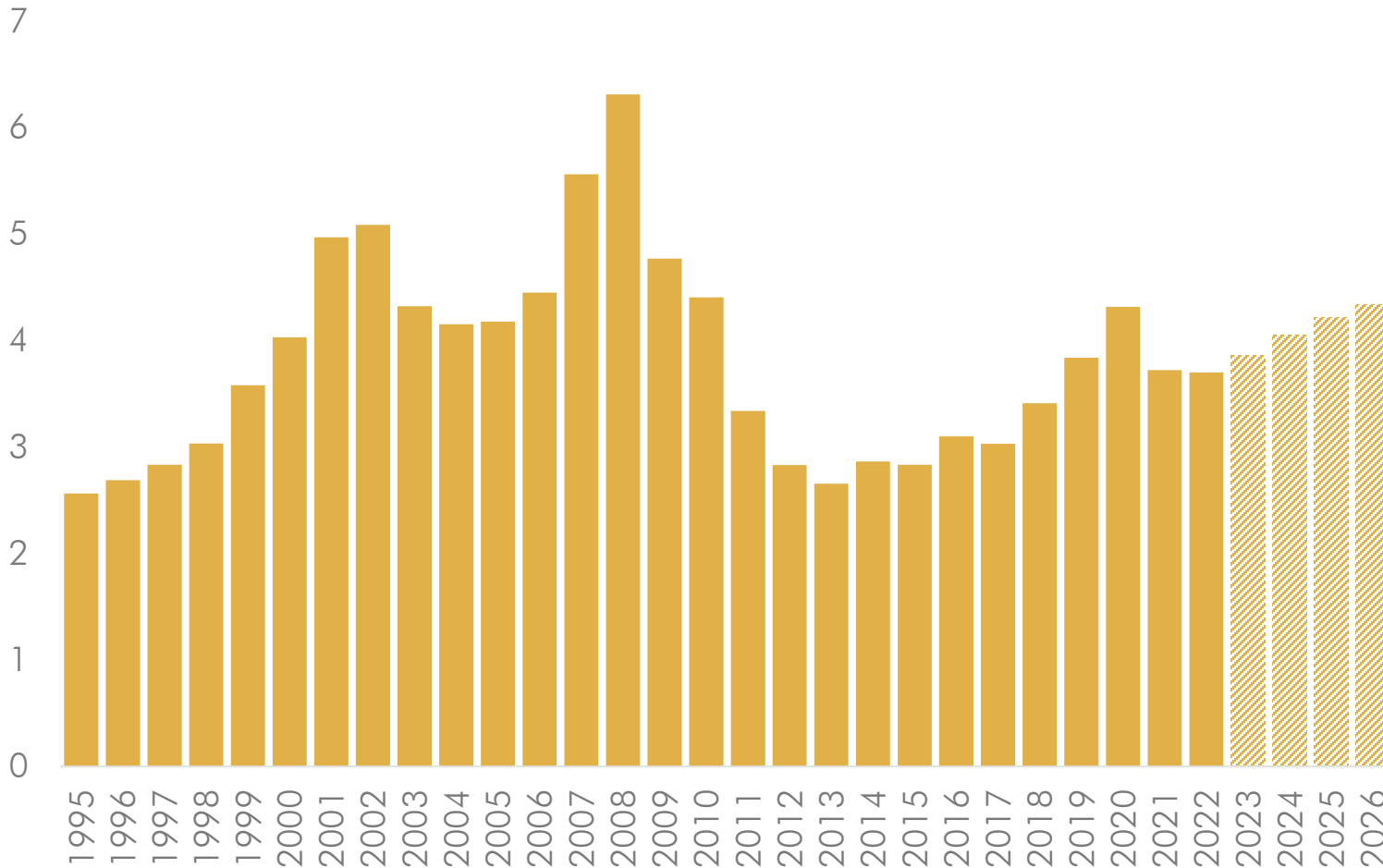
- Medium-term focus on debt/GDP ratio and pensions is sensible
- Interest-growth differential is hard to predict
- Debt ratio is a better anchor as slower moving and more predictable
- Future pension costs are a major commitment



Public investment rates

Ireland: Public Investment Rates

% GNI*, general government gross fixed capital formation



Public investment is already planned to increase

- OECD norms are about 3 to 4% of GDP
- Ireland plans to raise public investment rates to 4.3% by 2026.
- Earlier plans were to raise it to higher than this (closer to 5%).
- Capital constraints appear to be an issue.

