Chapter 4

Assessment of Compliance with the Fiscal Rules

4. Assessment of Compliance with the Fiscal Rules

Key Messages

- The Medium-term Budgetary Objective (MTO) was achieved in 2019 under the Council's principles-based assessment. The structural balance of -0.2 per cent of GDP was above the MTO of a structural balance of -0.5 per cent of GDP. Net expenditure grew by 4.9 per cent in 2019, just below the Expenditure Benchmark limit. However, taking 2019 and 2018 together, there was a deviation of 0.2 per cent of GNI* from the Expenditure Benchmark limit. In 2019, Ireland was fully compliant with the Debt Rule.

- Due to the Covid-19 pandemic, the Council deems that "exceptional circumstances" exist for 2020. This allows for the deviation from the requirements under Ireland's Domestic Budgetary Rule. In addition, the European Commission has activated the "general escape clause" of the Stability and Growth Pact (SGP), which allows for deviation from the EU fiscal rules for 2020. This leeway in the rules is both welcome and warranted, in order to allow a response to both the public health emergency and the severe economic downturn.

- Despite the activation of the "general escape clause", the European Commission may open an Excessive Deficit Procedure (EDP) as the Commission has found that the deficit criterion for 2020 has not been fulfilled. Ireland's general government deficit-to-GDP ratio is forecast to be 7.4 per cent in 2020 and will exceed the 3 per cent deficit limit in the SGP. Furthermore, in 2020, Ireland's debt-to-GDP ratio is forecast to return above the 60 per cent limit in the SGP.

- Depending on the future path of the Covid-19 pandemic, the Council may decide that "exceptional circumstances" continue to exist for 2021. Separately the European Commission may deem the "general escape clause" still active for 2021, in which case, deviation would be allowed from any requirements for 2021 under the Domestic Budgetary Rule and the EU fiscal rules. Absent "exceptional circumstances" and the "general escape clause" continuing into 2021, if an EDP is opened, requirements for the general government deficit for 2021 would be set under the EDP. These

requirements would be formulated in both nominal and structural terms. An improvement in the general government deficit is forecast for 2021, with the deficit falling to 4.1 per cent of GDP. Under these projections, complying with potential EDP recommendations may not require any further discretionary fiscal adjustment.

4.1 Introduction

The Council's mandate includes assessing compliance with Ireland's Domestic Budgetary Rule, as set out in the Fiscal Responsibility Act 2012 (FRA), and the EU fiscal rules, as set out in the Stability and Growth Pact (SGP).

This chapter assesses the *ex-post* compliance of the 2019 outturns and the *ex-ante* consistency of the projections laid out in *SPU 2020* with Ireland's Domestic Budgetary Rule and with both the preventive arm and the corrective arm of the SGP. In particular, it examines compliance with the Medium-term Budgetary Objective (MTO), the Expenditure Benchmark, the Deficit Rule and the Debt Rule.

The Fiscal Responsibility Act 2012 makes provision for deviation from Ireland's Domestic Budgetary Rule if "exceptional circumstances" exist (see Box K). The Council's mandate includes assessing whether "exceptional circumstances" exist or have ceased to exist. In light of the Covid-19 pandemic, the Council is of the opinion that "exceptional circumstances" exist for 2020. In addition, the European Commission has activated the "general escape clause" in the SGP to allow Member States to depart from their budgetary requirements under the EU fiscal rules for 2020.[51]

The assessment in this chapter examines compliance with Ireland's Domestic Budgetary Rule, based on the Council's "principles-based approach" to the budgetary rule, using the Department of Finance's GDP-based estimates of potential output in *Budget 2020* (for 2019 only) and considering the Council's own assessment of one-off/temporary measures. While legal compliance with the EU fiscal rules is assessed based on the *Vade Mecum on the Stability & Growth Pact (2019)*—using the EU's Commonly Agreed Methodology (CAM) for estimating the output gap—the Council and the Department have identified a number of shortcomings with this methodology. Therefore, the Council has opted to base its assessment of the Domestic Budgetary Rule on a framework that is more appropriate for Ireland.[52]

[51] See the *Communication from the Commission to the Council on the activation of the General Escape Clause of the Stability and Growth Pact* (March, 2020): https://ec.europa.eu/info/sites/info/files/economy-finance/2_en_act_part1_v3-adopted_text.pdf.

[52] For more information on the Council's principles-based approach see Appendix D of this report and Box A of the Fiscal Council's *Ex-post Assessment of Compliance with the Domestic Budgetary Rule 2018* (Fiscal Council, 2019a).

Table 4.1: Assessment of compliance with the fiscal rules[1, 2, 3]

% of GDP unless otherwise stated. For deviations, negative values = non-compliance

	2019	2020	2021
Corrective Arm			
General government balance excl. one-offs (% GNI*)[4]	0.7	-13.3	-7.3
General government balance excl. one-offs	0.4	-7.4	-4.1
General government balance Limit	-3.0	-3.0	-3.0
General government debt (% GNI*)[4]	99.2	124.6	122.1
General government debt	58.8	69.1	68.4
1/20th Debt Rule Limit	67.4	60.0	63.9
Debt Rule met?	Y	Y	-
Preventive Arm & Domestic Budgetary Rule			
Structural balance adjustment requirement			
MTO for the structural balance	**-0.5**	**-0.5**	**-0.5**
Structural balance	-0.2	-	-
MTO met?	Y	-	-
Minimum change in structural balance required	**0.0**	**0.0**	-
Change in structural balance	-0.4	-	-
1yr deviation (€ bn)	-	-	-
1yr deviation (p.p.)	-	-	-
2yr deviation (€ bn)	-	-	-
2yr deviation (p.p.)	-	-	-
Expenditure Benchmark			
(a) Reference rate of potential growth (% y/y)	3.4	-	-
(b) Convergence margin	0.0	-	-
(a-b) Limit for real net expenditure growth (% y/y)	3.4	-	-
GDP deflator used	1.5	-	-
Limit for nominal net expenditure growth (% y/y)	**5.0**	-	-
Net expenditure growth (% y/y)	4.6	5.8	0.7
Net expenditure growth (corrected for one-offs) (% y/y)	4.9	5.8	1.4
1yr deviation (corrected for one-offs) (€ bn)	0.0	-	-
1yr deviation (corrected for one-offs) (% GNI*)	0.0	-	-
2yr deviation (corrected for one-offs) (€ bn)	-0.5	-	-
2yr deviation (corrected for one-offs) (% GNI*)	-0.2	-	-
Limit for nominal net expenditure growth (€bn)	**3.7**	-	-
Net expenditure increase (€bn)	3.5	4.6	0.6
Net expenditure increase (corrected for one-offs) (€bn)	3.7	4.6	1.2
Current Macroeconomic Aggregates			
Real GDP growth (% y/y)	5.5	-10.5	6.0
Potential GDP growth (% y/y)	4.0	-	-
GDP output gap	1.0	-	-
GDP deflator used (% y/y)	1.5	1.2	1.5

Sources: CSO; Department of Finance; and Fiscal Council workings.

Notes: [1]All figures are presented on a general government basis. Assessments examine the *SPU 2020* revenue and expenditure plans, using the Council's principles-based approach to the Domestic Budgetary Rule and considering the Council's views on one-off/temporary measures. Potential output and output gap estimates for 2019 are taken from *Budget 2020*. Due to the exceptional uncertainty surrounding estimates of potential output and output gap, no estimates of these variables have been calculated by the Department of Finance for 2020-2021. For more information on the Council's principles-based approach see Appendix D of this report and Box A of Fiscal Council's *Ex-post Assessment of Compliance with the Domestic Budgetary Rule 2018* (Fiscal Council, 2019a). [2] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress toward the reference value of 60 per cent of GDP. Once the debt-to-GDP ratio falls below 60 per cent, the requirement is to maintain a ratio below 60 per cent. [3] Figures in red indicate a significant deviation from the limit. Figures in amber indicate some deviation from the limit. [4]The general government balance and general government debt are shown here as a per cent of GNI* for reference purposes only. Legal compliance with the corrective arm of the SGP is assessed based on GDP ratios. These GNI* ratios are based on the earlier Nominal GNI* figures provided by the Department for SPU 2020. The estimates were corrected in a later version of the report, yet the differences are relatively minor.

4.2 *Ex-post* assessment of 2019

This section reviews the Council's *ex-post* assessment of 2019 which is published alongside this FAR.[53] This section assesses the compliance of fiscal outturns for 2019 with the domestic budgetary rule. In particular, it examines compliance with the MTO, the Expenditure Benchmark and the Debt Rule. The assessment is based on the Council's Principles-based approach to the Domestic Budgetary Rule using the Department's GDP-based estimates of potential output.[54]

MTO and structural balance adjustment requirements

As the MTO was achieved in 2018, the requirement for 2019 was to remain at the MTO. The MTO was achieved in 2019, with a structural balance of -0.2 per cent of GDP, above the MTO of a structural balance of no lower than -0.5 per cent of GDP (Table 4.1). However, the structural balance deteriorated by 0.4 per cent of GDP over 2019.

Expenditure Benchmark

Net expenditure (excluding one-offs) grew by 4.9 per cent in 2019, just below the Expenditure Benchmark limit of 5.0 per cent. Net expenditure growth was 1.2 percentage points higher than was forecast in *Budget 2020.* A downward revision, by the CSO, to the level of expenditure in 2018 accounts for 0.4 percentage points of the unanticipated growth in net expenditure. The remaining 0.8 percentage points can be attributed to the level of net expenditure in 2019 being higher than planned in *Budget 2020.*

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[53] See https://www.fiscalcouncil.ie/publications/ for further details.

[54] *SPU 2020* did not include updated estimates of potential output and the output gap due to the heightened uncertainty about such estimates for the current year, at this time. Therefore, this section uses estimates of potential output for 2019 that were included in *Budget 2020.* These estimates were on the basis of forecasts for a no-deal Brexit at the end of October 2019. To the extent that this did not materialise, estimates of potential output growth for 2019 would be relatively higher, implying a smaller positive output gap than estimated in *Budget 2020* all else equal. As this section will show, the MTO was achieved and net expenditure grew below the Expenditure Benchmark limit. The smaller positive output gap and higher potential output would imply a more positive structural balance estimate, and a higher limit for the Expenditure Benchmark for 2019, so the conclusion about compliance with the Domestic Budgetary Rule would be unchanged were a smaller positive output gap and higher potential output estimate used. There is no reason to believe the Covid-19 pandemic would alter the "actual" potential or sustainable growth rate of the economy for 2019. Whether the Covid-19 pandemic would alter the "estimate" of potential output for 2019, due to the filtering techniques used to derive these estimates, is a separate matter.

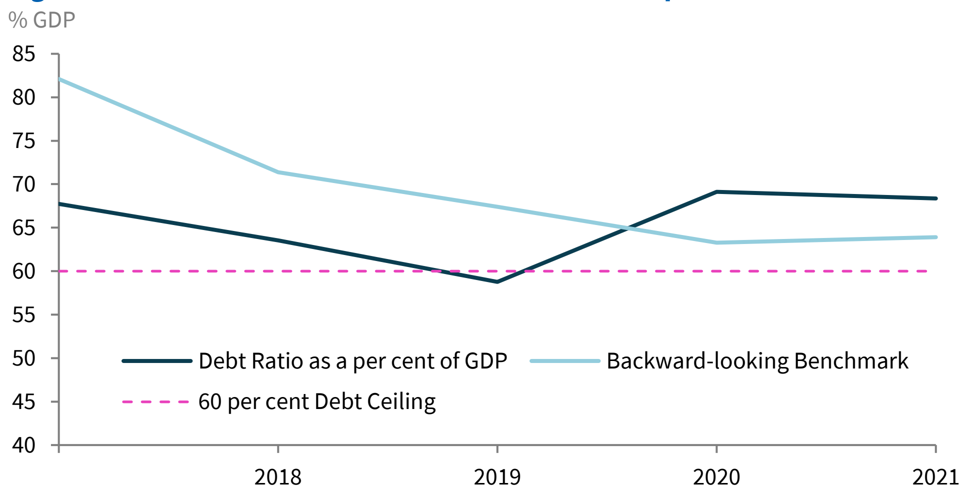
On a two-year basis, taking 2018 and 2019 together, there was a breach of the Expenditure Benchmark, with net expenditure growing by 0.2 per cent of GNI* more than allowed. However, this breach is not considered significant deviation from the Expenditure Benchmark.[55]

Debt Rule

The Debt Rule applied in full in 2019, following the end of a three-year transition period from 2016-2018. The requirement for 2019 was that the debt-to-GDP ratio be below the 1/20th Debt Rule limit.[56]

Ireland was fully compliant with the rule in 2019, as debt-to-GDP ratio fell to 58.8 per cent of GDP, below both the 1/20th Debt Rule limit and the 60 per cent of GDP reference value in the SGP (Figure 4.1). However, if measured against a more appropriate estimate of the domestic economy, like GNI*, the debt ratio was significantly higher at 99.2 per cent.[57]

Figure 4.1: The debt ratio is forecast to exceed the 60 per cent debt limit in 2020



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: As there are currently no estimates for the debt-to-GDP ratio beyond 2021, the forward-looking benchmark for the Debt Rule cannot be calculated at this time.

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[55] Under the Council's principles-based approach to Ireland's Domestic Budgetary Rule, a significant deviation from the Expenditure Benchmark is a deviation of more than 0.5 per cent of GNI* on a one-year basis, and 0.25 per cent of GNI* on a two-year basis.

[56] If the debt-to-GDP ratio is above 60 per cent of GDP, the Debt Rule requires that the ratio falls by, on average one-twentieth of the excess between the actual debt-to-GDP ratio and 60 per cent of GDP. This requirement is expressed as a benchmark debt-to-GDP ratio. See Box F of the November 2018 FAR for further details (Fiscal Council, 2018e).

[57] The FRA specifies that compliance with the Debt Rule is judged on the basis of a debt-to-GDP ratio. However, Ireland's GDP figures are distorted due to the globalisation activities of a few large multinational corporations and is therefore not an appropriate metric to judge Ireland's debt burden against.

4.3 In-year assessment of 2020

Due to the unprecedented Covid-19 pandemic, the Council is of the opinion that "exceptional circumstances" exist for 2020 (see Box K). The Covid-19 pandemic is a major unprecedented and unforeseen shock to the economy and to the public finances. It therefore falls under the definition of exceptional circumstances and it is appropriate that leeway is provided under the rules to manage it. The existence of exceptional circumstances allows for a deviation from the requirements under Ireland's Domestic Budgetary Rule. In addition, the European Commission has activated the "general escape clause" in the SGP for 2020. This allows for a deviation from the requirements under the SGP for 2020.

However, the activation of the general escape clause does not suspend the procedures of the SGP. As such, the European Commission has issued an Article 126(3) as a result of the general government balance breaching the -3 per cent SGP limit in 2020.[58] However, despite finding that Ireland is non-compliant with the deficit criterion for 2020, the European Commission has said, in light of the exceptional uncertainty caused by the Covid-19 pandemic, a decision on launching an *Excessive Deficit Procedure* (EDP) (for all Member States found non-compliant) should not be taken at this time.[59] The European Commission has said they will reassess the situation on the basis of the Commission's Autumn 2020 Economic Forecast and the *Budget 2021* forecasts.

The Department's current forecast is for a general government deficit of 7.4 per cent of GDP for 2020 (Figure 4.2). Approximately €6.5 billion is included as measures under the general escape clause for 2020.[60] Excluding this from the general

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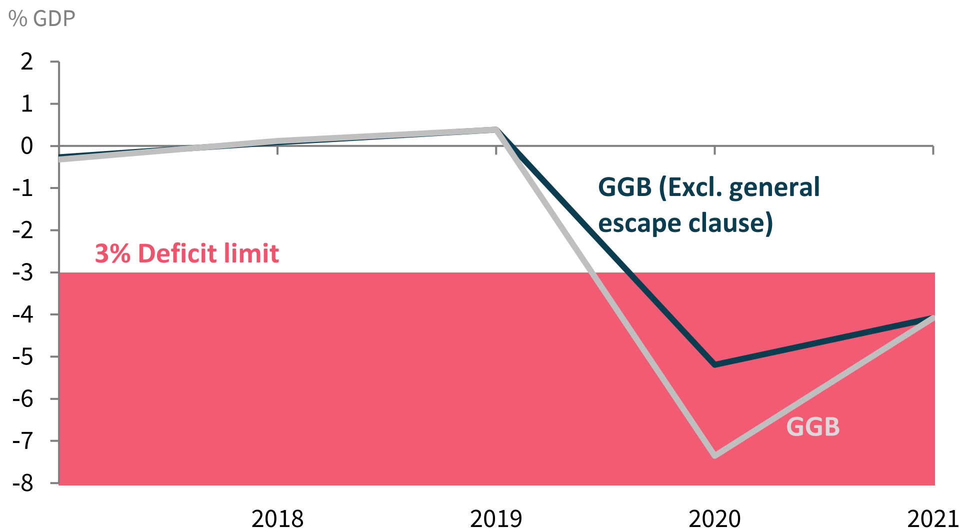
[58] Under the SGP, the European Commission is required to prepare an Article 126(3) report if the 3 per cent deficit limit is breached, or is forecast to be breached (the forecast can be from the Member State or the European Commission forecasts). This report considers a series of factors and assesses whether an EDP should be launched. An Article 126(3) report was issued for all Member States (except for Romania, who were already in an EDP) as all Member States are forecast to breach the 3 per cent deficit limit in 2020.

[59] For Article 126(3) report for Ireland see: https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-541-ie_en.pdf. See Box 1 of the *2020 European Semester: Commission Communication on Country Specific Recommendations* for an outline of the rationale behind not launching an EDP for Member States at this time: https://ec.europa.eu/info/publications/2020-european-semester-commission-communication-country-specific-recommendations_en.

[60] The expenditure and revenue measures included under the general escape clause are only those which specifically relate to the Government's response to the Covid-19 pandemic.

government balance gives a deficit of 5.2 per cent of GDP. The European Commission currently has a much more benign forecast for the general government balance, with the deficit forecast to be 5.6 per cent of GDP. Were the €6.5 billion excluded, the general government deficit would be 3.4 per cent under the Commission's forecast. The debt-to-GDP ratio for 2020 is forecast to be 69.1 per cent of GDP, which is above the 60 per cent of GDP limit in the SGP (Figure 4.1).[61]

Figure 4.2: The general government balance is forecast to exceed the 3 per cent deficit limit



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: The headline general government balance is shown in grey. Approximately €6.5 billion is included under the general escape clause for 2020 and this is incorporated into the General Government balance excluding general escape clause series shown in navy.

Box K: Exceptional Circumstances and the General Escape Clause

Ireland is subject to domestic fiscal rules, as set out in the Fiscal Responsibility Act 2012 (FRA), and the EU fiscal rules. Both sets of rules envision scenarios in which the Government needs to use fiscal resources to respond to circumstances beyond its control or alternatively, respond to a severe economic downturn.

Exceptional Circumstances under Ireland's Domestic Budgetary Rule

Ireland's Domestic Budgetary Rule allows for deviation from the budgetary rule if exceptional circumstances exist. As specified in the FRA, the Council's mandate includes assessing whether exceptional circumstances exist or have ceased to exist. Exceptional circumstances are defined in the FRA as:

[61] Once below the 60 per cent debt-to-GDP limit, breaching this limit also automatically triggers an Article 126(3) report from the European Commission, unless the debt ratio falls below the 60 per cent limit over the Commission's forecast horizon. Unlike the deficit limit, a breach of the Debt Rule can only be confirmed on the basis of outturn data and not on forecasts. As such, an Article 126(3) report is not required to be issued on the debt criterion at this time.

"(a) a period during which an unusual event outside the control of the State has a major impact on the financial position of the general government, or

(b) a period of severe economic downturn,

within the meaning of the Stability and Growth Pact".

Under the SGP, a severe economic downturn is defined as a negative real GDP growth or a period of low real GDP growth relative to potential.[62] While only one criterion is necessary for exceptional circumstances to exist, clearly the Covid-19 pandemic and its impact on both the public finances and the economy mean that both criteria are satisfied in 2020. As a result, **the Council deems that exceptional circumstances exist for 2020.**

Based on current forecasts, criterion (b), outlined above, would not be satisfied for 2021. However, depending on the future path of the Covid-19 pandemic, it may transpire that criterion (a) will be met in 2021 (or, for a potentially longer period in a worst-case scenario).[63] In this case, exceptional circumstances will continue to exist in 2021 and deviations from the budgetary requirements for 2021 will be allowed.

The General Escape Clause in the EU Fiscal Rules

On 13th March, the European Commission activated the general escape clause in the SGP. This clause allows for temporary deviation from the budgetary requirements for all Member States in a situation of generalised crisis caused by a severe economic downturn in either the euro area or the EU. The application of the general escape clause does not suspend the procedures of the SGP, but instead allows for temporary deviation from its requirements for as long as the general escape clause is active.

The European Commission has said the general escape clause will remain in place for as long as necessary for Member States to contain the Covid-19 outbreak and mitigate its negative socio-economic effects.[64] This leaves open the option to extend the application of the general escape clause beyond 2020.

Exiting the General Escape Clause and the Cessation of Exceptional Circumstances

Once the general escape clause no longer applies and exceptional circumstances cease to exist, under the EU fiscal rules, Ireland must adopt a corrective plan.[65] This plan will have a minimum pace of structural adjustment (usually 0.5 per cent of GDP) and will be binding over the budgets covered by the correction period.

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[62] This definition is potentially problematic for Ireland. While GDP is an appropriate estimate of the size of the domestic economy in most EU countries, due to well-documented issues relating to the multinational sector, GDP is not an appropriate measure of the size of Ireland's domestic economy and is currently an inflated estimate of the productive capacity of the domestic economy. This feature of Ireland's GDP figures may at times flatter Ireland's compliance with the fiscal rules as ratios are often specified as a per cent of GDP (i.e. deficit-to-GDP and debt-to-GDP; the inflated GDP figures lead to a larger denominator and therefore a smaller ratio than might otherwise be the case). However, it also causes Ireland's GDP growth rates to be distorted. This may lead to a disparity between GDP growth and the underlying growth of the domestic economy. A scenario may arise in which the underlying growth of the domestic economy is negative, but GDP growth is positive, in which case, while the underlying growth rate of the domestic economy may warrant the classification as a period of severe economic downturn. However, this would not be classified as such under the SGP, solely on the basis of the distortion in Ireland's GDP figures. In this instance exceptional circumstances cannot be deemed to exist under the definition used ins criterion (b).

[63] Criterion (b) may also be met in 2021 in a more severe scenario.

[64] For further details, see: https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_500.

[65] For further details, see *Common Principles on National Fiscal Correction Mechanisms* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52012DC0342.

4.4 *Ex-ante* assessment of 2021

If exceptional circumstances and the general escape clause continue into 2021, deviation from the fiscal rules will be allowed again for 2021, provided that any deviation does not endanger long-run sustainability of the public finances. As outlined in Box K, once the general escape clause ceases to be in effect, Ireland must adopt a corrective plan. As the European Commission has deemed that Ireland has not fulfilled the deficit criterion for 2020, it is likely that this plan will be outlined as part of the EDP. Were an EDP launched, Ireland would be under the corrective arm of the SGP.

If the general escape clause and exceptional circumstances do not continue into 2021, and were an EDP to be launched, requirements for the fiscal rules for 2021 would then be given under the EDP. Under an EDP a deadline would be set for the correction of the excessive deficit.[66] The EDP would set annual targets for both the nominal and structural balance. Under normal circumstances, an annual fiscal effort of at least 0.5 per cent of GDP, defined in structural terms, would be required under an EDP. In nominal terms, Ireland's general government balance is forecast to improve by more than 3.3 per cent of GDP in 2021. The European Commission forecasts that the structural balance will improve by 1.0 per cent of GDP in 2021. If the minimum fiscal adjustment were set, and the European Commission's forecasts were to transpire, this improvement of the structural balance would meet the minimum adjustment requirement. In this case, no discretionary fiscal adjustment would be required to adhere to the fiscal rules for 2021.

[66] The existence of "exceptional circumstances" would allow for this deadline to be extended.