

# **Chapter 4**

## **Assessment of Compliance with the Fiscal Rules**

## 4. Assessment of Compliance with the Fiscal Rules

### Key Messages

- As a result of the Covid-19 pandemic, the Council, in May, assessed that “exceptional circumstances” exist for 2020. This allows for deviations from the requirements set under Ireland’s Domestic Budgetary Rule. The European Commission has also activated the general escape clause under the Stability and Growth Pact (SGP), which allows for deviations from the requirements set under the EU fiscal rules.
- The general government deficit for 2020 is forecast to be 6.2 per cent of GDP, exceeding the 3 per cent deficit limit in the SGP. While the activation of the general escape clause means deviation from the requirements under the rules is allowed, it does not suspend the procedures of the SGP. Therefore, in May, the European Commission found Ireland non-compliant with the deficit criterion of the SGP for 2020, meaning Ireland will likely enter an Excessive Deficit Procedure (EDP).
- Exceptional circumstances will continue to exist into 2021 and the general escape clause will remain in place. The Council assesses that this is appropriate given the on-going Covid-19 pressures.
- The general government deficit is forecast to improve by 0.5 percentage points, to 5.7 per cent of GDP in 2021. However, the structural deficit is forecast to be relatively unchanged in 2021, at 0.8 per cent of GDP.
- Over the medium term, based on the Council’s Extended Budget forecasts, the deficit to GDP ratio should fall below the 3 per cent deficit limit in the SGP, in 2022. Ireland will then be under the preventive arm of the SGP.
- At the time of writing, the Government has not produced a full set of expenditure ceilings this year, as required by law. Every year, the Government is required by law to produce a set of expenditure ceilings for the following three years. Typically, these expenditure ceilings are set on budget day. However, it appears that expenditure ceilings were set for only 2021, instead of the required ceilings for 2021-2023. The Department have

indicated that these ceilings will now be published in the Revised Estimates in December.

- The Council assesses that GDP is not an appropriate metric against which to assess compliance with the fiscal rules. It would be more appropriate if the domestic fiscal rules, outlined in the *Fiscal Responsibility Act, 2012*, were assessed based on a more relevant measure of the domestic economy like Modified Gross National Income (GNI\*). However, this would require legislative change.

## 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 consistency of the projections laid out in *Budget 2021* 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.

In the Council’s May 2020 Fiscal Assessment Report (FAR), the Council assessed that “exceptional circumstances” exist for 2020, in light of the Covid-19 pandemic.<sup>64</sup> “Exceptional circumstances” is a provision included in the Fiscal Responsibility Act, 2012 that allows for temporary deviation from the requirements under Ireland’s Domestic Budgetary Rule. In March 2020, the European Commission 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.<sup>65</sup> The European Commission has not set any quantitative fiscal adjustment requirements for 2021.

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 2021* 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.<sup>66</sup> Therefore, since 2018, the Council has opted to base its assessment

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<sup>64</sup> See Box K of the May 2020 FAR (Fiscal Council, 2020c).

<sup>65</sup> 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](https://ec.europa.eu/info/sites/info/files/economy-finance/2_en_act_part1_v3-adopted_text.pdf).

<sup>66</sup> The Department of Finance did not estimate any CAM-based estimates of potential output and the output gap for *Budget 2021*.

of the Domestic Budgetary Rule on a framework that is more appropriate for Ireland.<sup>67</sup> Table 4.1 provides a summary assessment.

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<sup>67</sup> 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<sup>1, 2, 3, 4</sup>**

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

	2019	2020	2021
<b>Corrective Arm</b>			
General government balance (% GNI*) <sup>4</sup>	0.9	-10.7	-9.8
General government balance	0.5	-6.2	-5.7
<b>General government balance Limit</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-3.0</b>
General government debt (% GNI*) <sup>4</sup>	95.6	107.8	114.7
General government debt	57.4	62.6	66.6
<b>1/20th Debt Rule Limit</b>	<b>67.1</b>	<b>60.0</b>	<b>61.7</b>
Debt Rule met?	Y	Y	Y
<b>Preventive Arm &amp; Domestic Budgetary Rule</b>			
<b>Structural balance adjustment requirement</b>			
<b>MTO for the structural balance</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.5</b>
Structural balance	-0.3	-0.9	-0.8
MTO met?	Y	N	N
<b>Minimum change in structural balance required</b>	<b>-</b>	<b>0.0</b>	<b>-</b>
Change in structural balance	-0.4	-0.6	0.1
1yr deviation (€ bn)	-	-2.2	0.2
1yr deviation (p.p.)	-	-0.6	0.1
2yr deviation (€ bn)	-	-1.7	-1.0
2yr deviation (p.p.)	-	-0.5	-0.3
<b>Expenditure Benchmark</b>			
(a) Reference rate of potential growth (% y/y)	3.5	3.6	3.4
(b) Convergence margin	0.0	0.0	0.0
(a-b) Limit for real net expenditure growth (% y/y)	3.5	3.6	3.4
GDP deflator used	3.1	0.6	0.9
<b>Limit for nominal net expenditure growth (% y/y)</b>	<b>6.7</b>	<b>4.1</b>	<b>4.4</b>
Net expenditure growth (% y/y)	3.6	15.9	7.4
Net expenditure growth (corrected for one-offs) (% y/y)	3.9	0.8	9.6
1yr deviation (corrected for one-offs) (€ bn)	2.1	2.7	-4.3
1yr deviation (corrected for one-offs) (% GNI*)	1.0	1.3	-2.0
2yr deviation (corrected for one-offs) (€ bn)	0.2	2.4	-0.8
2yr deviation (corrected for one-offs) (% GNI*)	0.1	1.2	-0.4
<b>Limit for nominal net expenditure growth (€bn)</b>	<b>5.1</b>	<b>3.3</b>	<b>3.6</b>
Net expenditure increase (€bn)	2.8	12.8	6.9
Net expenditure increase (corrected for one-offs) (€bn)	3.0	0.6	7.8
<b>Current Macroeconomic Aggregates</b>			
Real GDP growth (% y/y)	5.6	-2.4	1.7
Potential GDP growth (% y/y)	4.3	2.0	1.5
GDP output gap	1.3	-3.1	-2.9
GDP deflator used (% y/y)	3.1	0.6	0.9

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

Notes: <sup>1</sup>All figures are presented on a general government basis. Assessments examine the *Budget 2021* 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 (see Box H for an outline of one-off/temporary measures). Potential output and output gap estimates are taken from *Budget 2021*. 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). <sup>2</sup>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. <sup>3</sup>Figures in red indicate a significant deviation from the limit. Figures in amber indicate some deviation from the limit. <sup>4</sup>Exceptional circumstances exist for 2020, and 2021. Therefore, deviations from the requirements for these years are allowed. <sup>5</sup>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.

## 4.2 Summary of past compliance with the Domestic Budgetary Rule

Ireland entered the current crisis in reasonable fiscal position. However, if it adhered to spending limits, Ireland would have been in a better position to deal with the current crisis. Table 4.2 provides a summary of the Council’s past assessments of the Domestic Budgetary Rule.

**Table 4.2: The Council’s assessment of compliance with the Domestic Budgetary Rule**

	2016	2017	2018	2019
Spending Rule	Compliant	Breach	Significant Deviation	Compliant
Structural Balance Rule	Compliant	Compliant	Compliant	Compliant
Overall Assessment	Compliant	Compliant	Compliant	Compliant

Sources: Fiscal Council workings.

Note: The structural balance rule requires that the structural balance be above the medium-term budgetary objective (MTO) (set at -0.5 per cent of GDP for 2016-2019) or moving towards the MTO at an adequate pace. The spending rule requires that the net government expenditure be below the average medium-term potential growth rate of the economy (the Expenditure Benchmark). Significant Deviation means that the limit for the corresponding rule was exceeded by more than 0.5 per cent of GNI\* for the spending rule, or 0.5 per cent of GDP for the structural balance rule. Breach means the limit for the corresponding rule was exceeded by less than 0.5 per cent of GDP or 0.5 per cent of GNI\*.

A tendency to formulate plans that are at the limit of what is allowed under the rules, coupled with repeated Health overruns and providing the Christmas bonus without budgeting for it in advance, has led to the Expenditure Benchmark being breached in recent years.

While the structural balance was compliant with the rules in all years, this was flattered by corporation tax receipts that are in excess of what can be explained by underlying economic activity.

### 4.3 In-year assessment for 2020

Due to the unprecedented Covid-19 pandemic and its effect on the economy and on the public finances, the Council assessed that “exceptional circumstances” exist for 2020 (see Box K, May 2020 FAR). 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”, which allows for a deviation from the requirements under the SGP for 2020.

Ireland’s general government deficit is forecast to be 6.2 per cent of GDP (Figure 4.1). This is above the deficit limit of 3 per cent of GDP. The activation of the general escape clause does allow for the deviation from the normal budgetary requirements under the SGP, but it does not suspend the procedures of the Pact. The European Commission has therefore issued an Article 126(3) as a result of the general government deficit breaching the 3 per cent SGP limit in 2020.<sup>68</sup> However, despite finding that Ireland is non-compliant with the deficit criterion for 2020, the European Commission has not yet launched an *Excessive Deficit Procedure* (EDP).<sup>69</sup>

The estimated structural balance is set to deteriorate from a position of close to balance in 2019, to a deficit of 0.9 per cent of GDP in 2020 (Table 4.1).<sup>70</sup> While there is particularly high uncertainty around the measurement of the output gap and the structural balance in the context of the Covid-19 pandemic, it is clear that many of the spending measures taken have been temporary in nature and that the economy will recover over time (see Box H for a discussion of these issues). This should ensure

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<sup>68</sup> 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, which was already in an EDP) as all Member States are forecast to breach the 3 per cent deficit limit in 2020.

<sup>69</sup> For the 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](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 in May of 2020: [https://ec.europa.eu/info/publications/2020-european-semester-commission-communication-country-specific-recommendations\\_en](https://ec.europa.eu/info/publications/2020-european-semester-commission-communication-country-specific-recommendations_en). In their opinion on the draft budgetary plan, the European Commission has again opted to defer opening the EDP (European Commission, 2020).

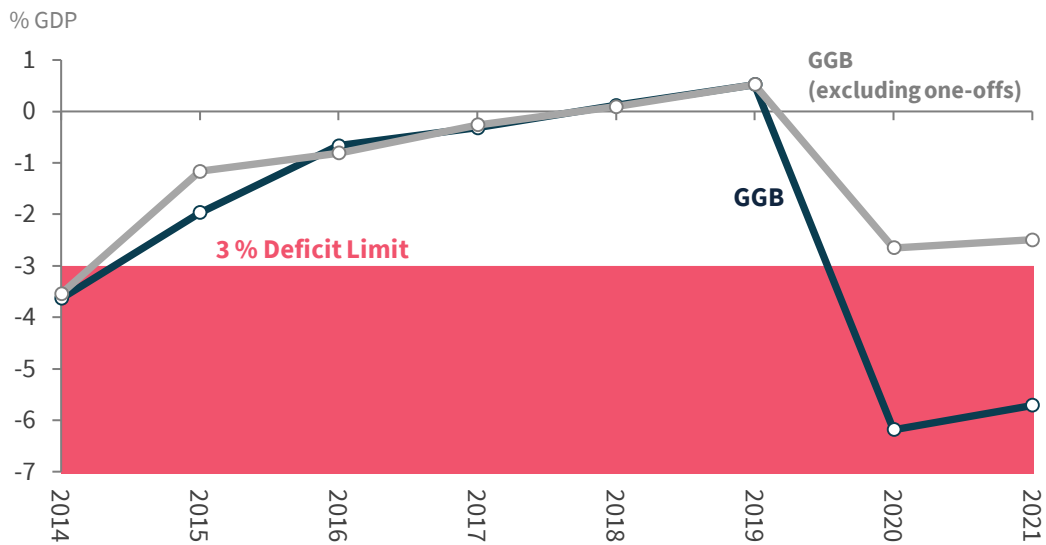
<sup>70</sup> Estimates of the structural balance at this time are exceptionally uncertain. Box H outlines some of the issues in relation to estimating the structural balance during the current crisis. In addition, the continued strong performance of corporation tax, over and above what can be explained by the underlying economy, masks some of the deterioration in the structural balance. See Box H of the May 2020 FAR for further details on this overperformance of corporation tax (Fiscal Council, 2020a)



that the deterioration in the structural balance will be much less than the change in the headline position.

In 2019, the debt ratio fell below the 60 per cent of GDP limit under the SGP for the first time since 2008. However, the debt ratio is now forecast to breach the limit again, with a ratio of 63 per cent of GDP expected in 2020.

**Figure 4.1: The general government balance is forecast to exceed the 3 per cent deficit limit for the first time since 2014**



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

Note: GGB stands for general government balance. See Box H and Table H.1 for one-offs.

## Box H: Covid-19, the structural balance, and one-off/temporary measures

This box outlines the challenges in estimating the structural balance in light of the Covid-19 pandemic. It also provides a preliminary examination of the extent of one-off and temporary measures introduced in response to the Covid-19 pandemic on the basis of the standard approaches adopted in the fiscal rules.<sup>71</sup>

In its Draft Budgetary plan submitted to the European Commission, the Department of Finance included estimates of the structural balance.<sup>72</sup> However, following guidance from the European Commission, these estimates of the structural balance did not incorporate any one-off/temporary measures related to Covid-19. While at present it may be difficult to determine what measures are truly one-offs, to get a true sense of the structural balance, the impact of one-off/temporary measures needs to be factored in.<sup>73</sup>

### Uncertainty, measurement issues and the structural balance

In normal times, the in-year and year-ahead estimates of structural balance are surrounded by some degree of uncertainty. Often, this is due to issues relating to measuring the current point the economy is at in the economic cycle (the output gap), and also due to the uncertainty in estimating the effect that changes in the cyclical position of the economy have on government revenue and expenditure.<sup>74</sup> The effect that the Covid-19 pandemic has had on the economy has exacerbated these issues.

The lasting effect of the Covid-19 crisis on the economy is not yet known. As a result, estimating the potential or sustainable level the economy can currently operate at is challenging. For instance, it is not yet known how many businesses will no longer be viable and how many job losses will become permanent.<sup>75</sup> The more viable businesses that fail, the lower the potential productive capacity of the economy. This creates substantial uncertainty about the current level of potential output and how far away from that level the economy is currently operating at.

Furthermore, the Covid-19 crisis is not a typical economic downturn. The structural balance adjusts the headline government balance for revenues and expenditures which typically fluctuate in line with the economic cycle. When an economy is booming, revenues are higher and expenditures are lower, than they would be if the economy were operating at a sustainable level. Similarly, in a downturn, revenues are lower, and expenditures are higher than they might otherwise be. However, the magnitude of this typical relationship between the budget balance and the economic cyclical may not hold for this unique downturn.

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<sup>71</sup> The structural balance is estimated as:  $SB_t = GGB_t - Oneoffs_t - 0.588 \times OG_t$ , where GGB, the general government balance, and one-offs are expressed as a per cent of GDP, and OG is the output gap expressed as a percentage of potential GDP. Alternatively, Modified Gross National Income (GNI\*) can be used instead of GDP as a denominator.

<sup>72</sup> These estimates were not included in the documentation published on Budget Day (13<sup>th</sup> October 2020), but were submitted to the European Commission on 15<sup>th</sup> October 2020.

<sup>73</sup> Without factoring in one-off/temporary measures, the estimate is not a true structural balance, but simply a cyclically adjusted balance.

<sup>74</sup> A separate issue in estimating the structural balance, but unrelated to Covid-19, is the continued overperformance of corporation tax receipts that cannot be explained by the underlying performance of the domestic economy (for further information, see Box H of the May 2020 FAR (Fiscal Council, 2020a)). The structural balance estimates do not reflect the degree to which these receipts may prove transient.

<sup>75</sup> To date, there has been limited impact of the crisis on firm insolvencies, likely due to government business supports, loan payment breaks and other support measures introduced since the onset of the Covid-19 pandemic (see McGeever, Sarchi and Woods, 2020). However, these supports will not continue indefinitely, and a prolonged crisis will increase the likelihood of more business closures.

For instance, the typical elasticities between economic activity and income tax have performed poorly at estimating the fall in tax revenue (they predicted a much larger fall in tax revenue than was the case). This is partly due to the composition of the employment losses (mainly at the lower end of the income distribution) and the progressive tax system (those at the lower end of the distribution pay less taxes). Similarly, the typical elasticities used to estimate the response of the Government's budget to the economic cycle will not accurately capture the dynamics of this crisis. This will lead to measurement error in the structural balance.

In addition to those measurement issues, there is also some uncertainty around the degree to which measures introduced in response to this crisis are temporary or permanent measures. While temporary measures affect the headline budget balance, they do not affect the underlying budgetary position and so do not affect the structural balance. This box uses the best available information to determine what can currently be considered one-off/temporary measures to get a preliminary estimate of the structural balance.

### **Expenditure one-offs**

As a starting point, all Covid-19 related expenditures are considered temporary measures. This amounts to some €16.7 billion in 2020 and €11.9 billion in 2021 on a general government basis. However, as outlined above, the structural balance also adjusts the headline government balance for expenditure that is cyclical in nature. Typically, this accounts for unemployment-related expenditure, which rises in downturns and falls in upturns in the economy. As a result, some of the Pandemic Unemployment Payment (PUP) expenditure can be considered cyclical. Were the PUP not in place, many of the recipients would likely have received standard unemployment benefits. To avoid double-counting these expenditures, the amounts for the PUP are subtracted from the Covid-19 related expenditure above.<sup>76</sup>

### **Revenue one-offs**

Revenue one-offs for 2020 include: (1) an assumed (by the Department of Finance) unrecovered tax warehousing costing €500 million; (2) a temporary cut in the standard rate of VAT costing €280 million in 2020; and (3) €580 million relating to one-off stamp duty receipts.<sup>77</sup> For 2020, these net to a one-off reduction in revenue of €200 million (Table H.1). The one-offs assumed for 2021 are €140 million for the stay-and-spend initiative and €160 million from the reduction of the standard rate of VAT. These measures net to a one-off reduction in tax revenue of €300 million in 2020.

Table H.1 outlines the amounts the Council deems as one-offs at this time. In the future, some of these measures currently considered temporary, may be considered permanent.

With the above caveats in mind, Figure H.1 decomposes the headline general government balance into one-offs, interest payments, a cyclical component, and the structural primary balance. While most of the deterioration in the general government balance in 2020 can be attributed to one-off/temporary measures introduced in response to Covid-19, there was also a structural deterioration (Figure H.1). The headline general government balance is forecast to improve marginally in 2021. This is mainly due to a fall in one-off/temporary measures in 2021. This leaves an estimated structural primary balance of -0.9 per cent of GNI\* largely unchanged from 2020.

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<sup>76</sup> Note, this adjustment only applies to the one-offs included in this chapter, to avoid double counting of unemployment-related expenditure in the assessment of the Expenditure Benchmark and the structural balance.

<sup>77</sup> This receipt relates to a single, large transaction that incurred a tax liability. While tax receipts are not usually considered for one-offs, on this occasion the amount was considered worthwhile as it was (a) inherently once off in nature, (b) large (greater than 0.1 per cent of GNI\*), and (c) outside of the usual volatility associated with this tax head.

**Table H.1: One-off and temporary measures**

€ millions unless stated

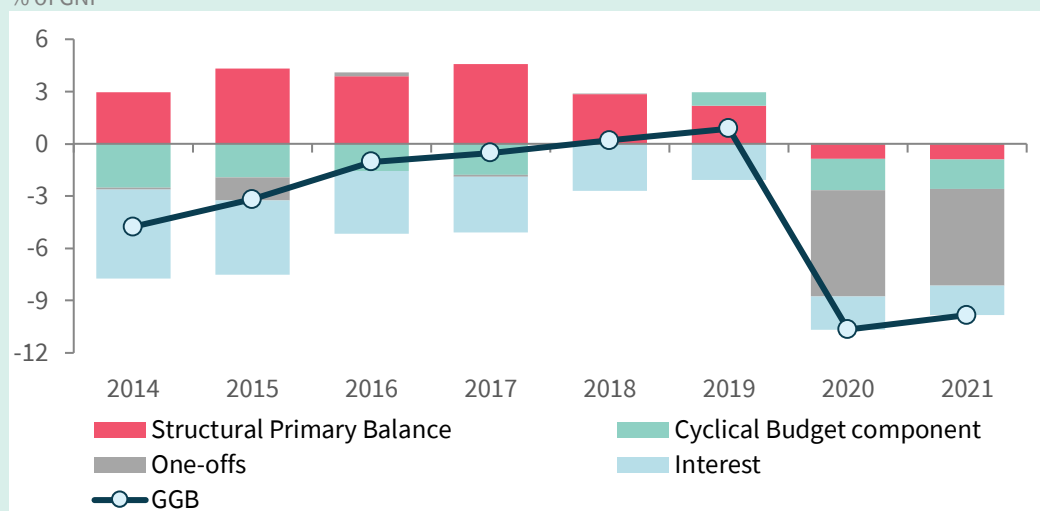
	2020	2021
<b>Expenditure</b>		
Covid-19	16,699	11,887
less PUP	-4,550	-644
Expenditure one-offs	12,149	11,243
<b>Revenue</b>		
Tax warehousing write-off	-500	
VAT standard rate cut	-280	-160
Stay and Spend		-140
Stamp Duty	580	
Revenue one-offs	-200	-300
<b>Total one-offs</b>	<b>-12,349</b>	<b>-11,543</b>

Sources: Department of Finance; and Fiscal Council workings.

Note: The PUP expenditure is excluded from one-offs to avoid double counting of this expenditure in the adjustments for the Expenditure Benchmark and the structural balance. The cut in the rate of VAT for the tourism sector is not considered a one-off at this time. The previous time this measure was introduced it remained in place for several years. Instead, it is classified as a discretionary revenue-reducing measure. The figure for stamp duty relates to revenue from one extremely large transaction that incurred a tax liability.

**Figure H.1: Decomposition of the general government balance**

% of GNI\*



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

Note: The cyclical budget component is calculated as 0.588 times the Department's GDP output gap estimates.

#### **4.4 Ex-ante assessment of 2021**

The Council assesses that exceptional circumstances will continue to exist for 2021. In addition, the European Commission has not set any quantitative fiscal requirements for 2021. This means that the appropriate leeway within the rules has been granted to allow an adequate fiscal response to the Covid-19 pandemic to continue into 2021.

In 2021, the general government deficit is forecast to remain above the 3 per cent deficit limit in the SGP. It is forecast to be 5.7 per cent of GDP in 2021, an improvement of 0.5 per cent of GDP relative to 2020. Were measures deemed to be one-offs excluded, the deficit would be 3.4 per cent of GDP.

The structural deficit is forecast to be 0.8 per cent of GDP, a 0.1 percentage point improvement over 2020. Despite exceptional circumstances applying, the rules may continue to provide useful guidance. Net expenditure (corrected for one-offs) is forecast to grow by 9.6 per cent in 2021. While the normal requirements to adhere to limits under the Expenditure Benchmark do not apply for 2021, this expenditure is above the 4.4 per cent growth limit that would have applied, indicating that there was a significant unfunded expansion in 2021.

The debt ratio is forecast to rise to 66.6 per cent of GDP in 2021 (114.7 per cent of GNI\*).

## 4.5 Medium-term compliance with the fiscal rules

As Ireland has been found non-compliant with the deficit criterion of the SGP in 2020, Ireland will likely be placed in an excessive deficit procedure and subject to the corrective arm of the SGP once the general escape clause ceases to be in place. While it is currently uncertain what fiscal requirements will be in place after the general escape clause is no longer active, the current minimum fiscal requirement under an EDP is a fiscal adjustment of 0.5 per cent of GDP in structural terms.<sup>78</sup>

However, based on the Extended Budget 2021 forecasts (Box D and Box G), the deficit is forecast to fall below the 3 per cent deficit limit in the SGP in 2022.<sup>79</sup> Should this transpire, Ireland would be under the Preventive arm of the SGP in 2023.

### Box I: Making the domestic fiscal rules more relevant

Ireland's Domestic Budgetary Rule and the Debt Rule are outlined in the *Fiscal Responsibility Act, 2012* (FRA). These largely mirror EU requirements. However, the domestic rules could be made more relevant to Ireland's circumstances and better aligned to the original intentions of the framework.

Under the FRA, the following definition is given for the structural balance:

“annual structural balance of the general government’, in relation to a year, means the general government deficit or general government surplus for the year, cyclically adjusted and net of one-off and temporary measures, expressed as a percentage of gross domestic product at market prices”

Similarly, the definition for both (1) the debt ratio under the Debt Rule, (2) the lower limit of the Medium-term budgetary objective, are also expressed as a percent of GDP.

However, 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 globalisation activities of the multinational sector, GDP is not an appropriate measure of the size of Ireland's domestic economy (see, amongst others, Fiscal Council (2016b; 2016c; 2017b)).<sup>80</sup>

This was exacerbated in 2015, when real GDP grew by approximately 25 per cent, largely due to the globalisation activities of a few large multinationals. As a result, the CSO developed a new measure of domestic economic activity, modified Gross National Income (GNI\*), that strips out many of the components that distort the GDP figures.<sup>81</sup>

This implies that GDP-based rules do not align well to Ireland's situation. By overstating national income, the overstate the size of the tax base. Dividing deficits and debt by GDP means that these ratios are lower than for other countries relative to the true level of national

<sup>78</sup>For further details, see Article 3(4) of Regulation (EC) 1467/97: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01997R1467-20111213&from=EN>.

<sup>79</sup> Indeed, the European Commission's Autumn 2020 forecasts show the same.

<sup>80</sup> See, for instance, Box D of the June 2017 Fiscal Assessment Report (Fiscal Council, 2017c).

<sup>81</sup> GNI\* is constructed by taking gross national income (GNI) and adjusting for the factor income of redomiciled companies, the depreciation of R&D service imports and Intellectual Property trade, and the depreciation on aircraft leasing.

income. For instance, a deficit of 3 per cent of GDP in 2019 would equate to €10.7 billion, or 5 per cent of GNI\*. Similarly, a debt ratio of 60 per cent of GDP in 2019, would equal a debt ratio of 100 per cent of GNI\*. This implies that the rules are significantly laxer than intended.

The Council assesses that a more appropriate basis for defining the variables in the FRA would be to define them in terms of GNI\* rather than GDP. GNI\* is now well-accepted and widely used in Ireland. However, putting the FRA on a sounder economic footing, by using GNI\* instead of GDP, will require legislative changes to the FRA. Making this change would ensure that the rules are fully relevant for Ireland and based on the most relevant economic measures.

#### **4.6 Medium-term Expenditure Framework**

The Medium-term Expenditure Framework (MTEF) was a reform introduced in the Ministers and Secretaries (Amendment) Act 2013 to provide a better mechanism to control spending over the medium term and to ensure the Expenditure Benchmark is complied with. The framework requires that, at least once every financial year, the government sets expenditure ceilings for the following three years. The framework requires that ceilings be set for overall expenditure and for ministerial departments.

Typically, these expenditure ceilings are set on Budget Day. However, only expenditure ceilings for 2021 were set out in the Expenditure Report on budget day, instead of the required ceilings for 2021–2023. The Department initially cited the uncertainty surrounding the Covid-19 pandemic and Brexit as a reason for not providing expenditure ceilings for 2022–2023. After the Council highlighted the legal requirement for these ceilings, the Department then indicated that these would be provided in the Revised Estimates for 2021, published in December.<sup>82</sup>

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<sup>82</sup> The overall medium-term expenditure ceilings and total ministerial expenditure ceilings for years  $t+2$  and  $t+3$  have never before been included in the Revised Estimates.