term. Box E outlines the implications of a spending rule on the structural balance.

For further details on the Council's assessment of compliance with the fiscal rules see section S9: Supporting information.

Box E: Implications of a spending rule on the structural balance

In the Summer Economic Statement, the Government introduced a spending rule for core gross voted expenditure. The Council which had on several occasions called for the introduction of a spending rule, broadly welcomed the Government move. However, the Council highlighted a number of shortcomings with the current rule (See Box B, Fiscal Council 2021b). This box examines the implications of a spending rule on the structural balance by providing a simple illustration of the mechanics at play.

Appropriately specified spending rules are closely linked to the notion of maintaining an unchanged underlying, or "structural" balance.[41] Absent any revenue policy changes, it is often assumed that sustainable government revenues grow one-for-one with the sustainable growth rate of the economy. Tying a spending rule to the sustainable growth rate of the economy ensures that the underlying budgetary position does not deteriorate.[42] Following such a spending rule may result in headline deficits in a downturn, or indeed large surplus in a boom due to cyclical fluctuations of the economy, but the underlying budgetary position would be unchanged. However, if the underlying budgetary position is in deficit at the time the spending rule is implemented, the new spending rule will perpetuate a structural deficit. In addition, if the debt ratio is already at an elevated level at the time the spending rule is implemented, and the spending rule does not factor this in, it can perpetuate elevated debt levels if spending is grown at the limit each year.

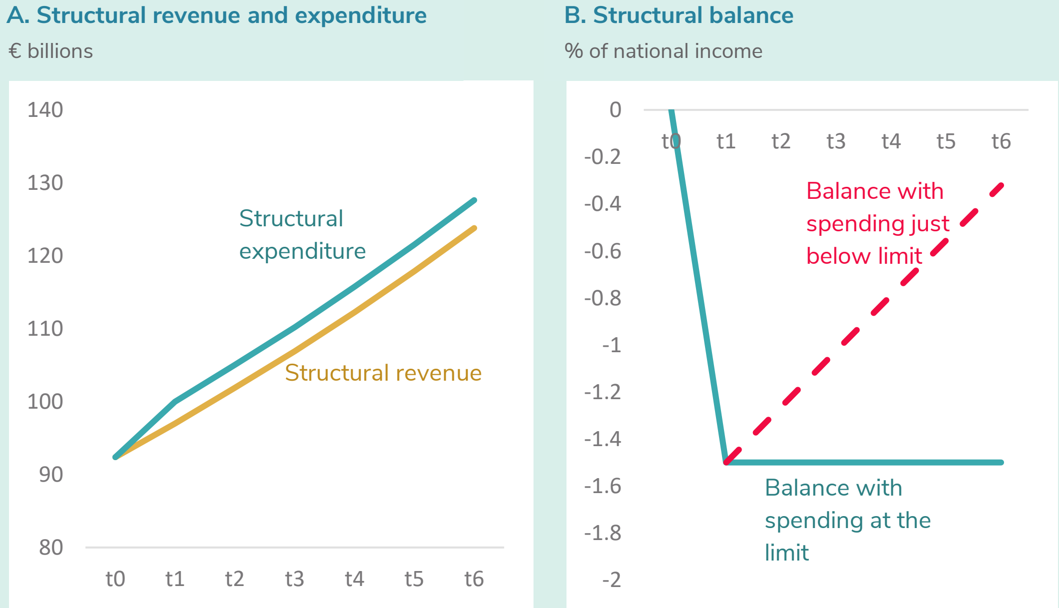
By way of illustration, we assume that the sustainable growth rate of the economy is 5 per cent and at time t_0 the government starts with a structural balance (i.e., no deficit or surplus). At time t_1 the government chooses to increase spending at a faster rate than sustainable growth. This opens up a structural deficit of 1.5 per cent of national income. At this point, the government introduces a spending rule that ties the increase in structural spending to the sustainable growth rate of the economy. That is, structural spending cannot grow by more than 5 per cent. Finally, each year, the government choses to spend at the limit of its new spending rule. The paths for both structural revenue and expenditure under this scenario are shown in Figure E.1A. The green line in Figure E.1A shows the resulting path of the structural deficit which as a result of growing spending at the limit of the spending rule, is unchanged relative to when the rule was first implemented.

However, if instead of increasing spending at the limit, the government chooses to spend below the limit by 0.5 percentage points (i.e. growing permanent spending by 4.5 per cent), the structural balance improves significantly, with the deficit almost closed in the 5th year (Figure E.1b).

[41] The structural balanced is defined as the government's budget balance, excluding one-off and temporary measures, and adjusted for the cyclical position of the economy.

[42] Typically, spending rules are set net of additional tax measures. That is, if a government wishes to increase spending at a faster rate than the limit would allow (i.e. expand the size of government in the economy), it can raise offsetting tax measures to ensure that on a net basis the spending limit is complied with. This ensures that the rule is agnostic on the size of government in the economy.

Figure E.1: Growing spending just below the limit significantly improves the structural balance



Sources: Fiscal Council workings. Get the data.
Note: The dashed red line indicates the path for the structural balance if structural expenditure grows at 4.5 per cent each year instead of the limit of 5 per cent.

The simple illustration above shows how, while a spending rule is welcome it can: 1) make permanent an underlying deficit if spending is at the limit each year; and 2) if spending plans are designed to grow marginally below the limit it can ensure that any slight overruns still remain sustainable and also drastically improve the sustainability of the public finances. Given the uncertainty around the sustainable growth rate of the economy, Ireland's high debt level and the possibility of overruns, it would be prudent to plan to grow spending by less than the limit.

Over the medium–term (2023–2025), on a general government basis, net expenditure is currently forecast to grow below the nominal 5 per cent limit (see Table S9.1), resulting in an improvement of the structural balance.