Fiscal Rules

Exceptional circumstances continue

4. FISCAL RULES

Exceptional circumstances continue

The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules have been activated since the beginning of the Covid-19 pandemic.[37] These flexibilities in both the domestic and EU fiscal rules allow for deviations from the normal requirements. The activation of these clauses has allowed for an appropriate fiscal response to the pandemic in 2020 and 2021. Table 4.1 shows a summary of the Council's previous assessments of compliance with the Domestic Budgetary Rule, as well as the Council's assessment for 2021.[38]

Table 4.1: The Council's assessment of compliance with the Domestic Budgetary Rule

	2017	2018	2019	2020	2021
Spending Rule	Breach	Significant Deviation	Compliant	Exceptional Circumstances	Exceptional Circumstances
Structural Balance Rule	Compliant	Compliant	Compliant		
Overall Assessment	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 minus 0.5 per cent of GDP for 2016–2019) or moving towards the MTO at an adequate pace. The spending rule requires that 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. A "breach" means that the limit for the corresponding rule was exceeded by less than 0.5 per cent of GDP or 0.5 per cent of GNI*.

The general government deficit in 2021 is forecast to be 3.1 per cent of GDP (Figure 4.1).[39] This is marginally above the 3 per cent of GDP limit in the Stability and Growth Pact (SGP). As a result, the Government will be non-compliant with the domestic budgetary rule in 2021. However, the Council deems that this is a result of the ongoing exceptional circumstances. Despite the large borrowing related to the Covid-19 pandemic, the debt-to-GDP ratio is forecast to fall by 3.2 percentage points, to 55.2 per cent of GDP. This is below the 60 per cent of GDP reference value in the SGP.

The fiscal rules are forecast to be complied with over the medium-term

[37] See Box K of the May 2020 Fiscal Assessment Report for further details on the exceptional circumstances clause and the general escape clause (Fiscal Council, 2020).

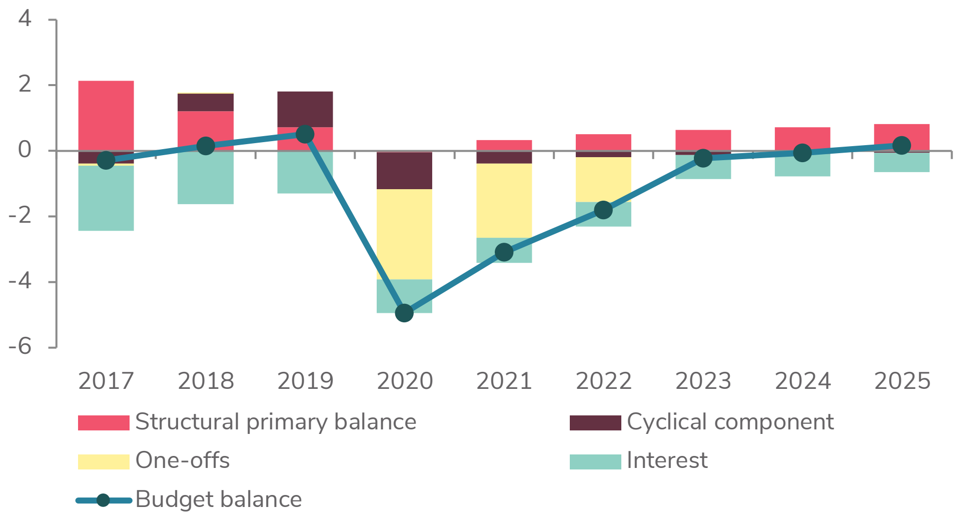
[38] This is based on the Council's Principles-based approach to the Domestic Budgetary Rule. For further information see table S9.3 in the supporting information section.

[39] While the Council recommends using GNI* as a more appropriate benchmark for assessing Ireland's fiscal position, legal compliance with the fiscal rules continues to be assessed against GDP.

The Council has not yet determined whether exceptional circumstances will continue into 2022. However, both the headline and structural balance are forecast to improve in 2022. The headline general government deficit is forecast to fall to 1.8 per cent of GDP, below the 3 per cent limit in the SGP. The structural deficit is forecast to be 0.2 per cent of GDP, which is at the Medium-term Budgetary Objective (MTO) of a structural deficit in 2022 of no more than 0.5 per cent of GDP. Should these forecasts transpire, the fiscal rules would be complied with in 2022.

Figure 4.1: Both headline and structural balances are forecast to improve

% GDP



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Note: The structural element of the budget balance is estimated using the top-down approach, This is the approach used in assessing legal compliance with the fiscal rules. The cyclical budgetary component is calculated as 0.52 times the Department's GVA-based output gap measure.

The medium-term orientation of the fiscal rules is currently uncertain. The European Commission recently relaunched a review of the EU's economic governance, including the EU's fiscal rules. [40] It is the Commission's intention to provide guidance on any potential reforms well in time for 2023. The Network of EU IFIs (of which the Fiscal Council is a member) has published a contribution paper to the governance review, which outlines the views of the leadership of the Network (EUIFI, 2021).

However, based on *Budget 2022* forecasts, the current fiscal rules would be complied with over the medium term. The Government's introduction of a new spending rule helps in achieving this compliance over the medium-

[40] The review was relaunched on 19th October 2021. Further information on the review can be found at: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/economic-governance-review_en.

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.

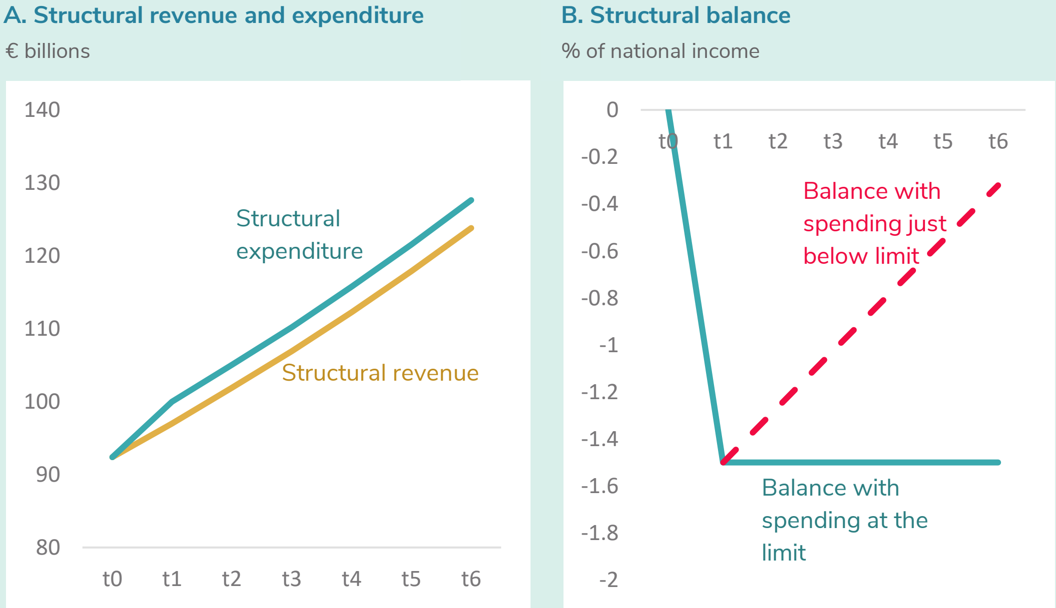
By way of illustration, we assume that the sustainable growth rate of the economy is 5 per cent and at time t_0 the government starts with a structural balance (i.e., no deficit or surplus). At time t_1 the government chooses to increase spending at a faster rate than sustainable growth. This opens up 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.

4.1 Medium-term Expenditure Framework

Under the medium-term expenditure framework, the Government is required to set expenditure ceilings for the following three financial years. Ceilings are required to be set for overall expenditure and for each department. This framework was introduced in order to provide a better mechanism for controlling spending over the medium-term and to ensure that the Expenditure Benchmark is complied with.

Medium-term ceilings were not published in the Budget, as was typically done in the past.

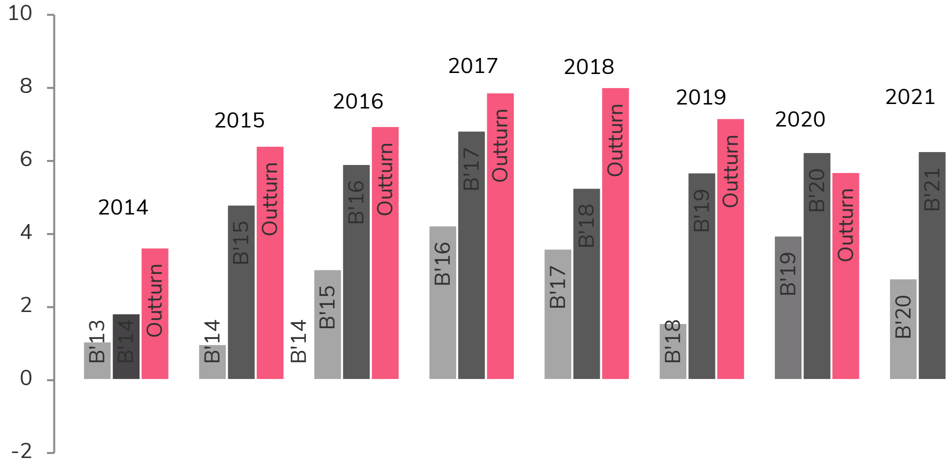
The Government failed to publish three-year ahead expenditure ceilings in the Expenditure Report on Budget Day, even though these ceilings have previously been published in the Expenditure Report alongside all budgets from 2014–2020.[43] The failure to publish these ceilings as part of the budget process represents a backwards step. It decreases transparency and undermines the new spending rule as the expenditure ceilings are not fixed as part of the budgetary process but instead as part of a technical exercise. This further gives the impression that the ceilings are seen as indicative and non-binding.

In the years leading up to the pandemic, frequent revisions to the expenditure ceilings also suggest that these ceilings are seen as indicative and non-binding (Figure 4.2). Prior to the pandemic, there had been a period of procyclical increases in the ceilings, with the outturn in 2019 €6.9 billion higher than originally planned.

[43] Expenditure Report 2021 did not include three-year-ahead expenditure ceilings. The Department originally cited uncertainty around Covid-19 and Brexit as the reason for not providing these. After the Council highlighted the legal requirement to publish these and lay them before the Dáil, the Department indicated that these ceilings would be fixed as part of the Revised Estimates process in December 2020 and were published then. The Department have indicated that the three-year-ahead ceilings that are to be set this year, will be published in December 2021 as part of the Revised Estimates process.

Figure 4.2: Change in gross voted current expenditure ceiling relative to initial ceiling

% deviation from original ceiling



Sources: CSO; Department of Finance; and Fiscal Council workings. [Get the data.]
Note: Bars show the change in forecasts from various budgets followed by outturns, versus the earliest budget forecast for that year (e.g., B'15 = expenditure forecasts in Budget 2015 minus the earliest forecast for the specified year). Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above. Note that figures for Budget 2021, and the outturn for 2020 are Covid-19-adjusted (they incorporate only "core" expenditure).