Box B: The Government's new spending rule is welcome but needs work

With the Summer Economic Statement, the Government committed to a new expenditure rule. This is something the Council had been recommending for several years.[1] This box examines the recent experience with Ireland's medium-term expenditure framework as well as international experience of expenditure frameworks, in light of the new expenditure rule and highlights some shortcomings with the new rule.

A credible medium-term expenditure framework, together with realistic costing helps to make explicit the cost of current budgetary decisions into the future. Anchoring medium-term spending (net of new tax measures) to a sustainable growth rate of the economy can help to ensure prudent fiscal policies and to prevent expenditure drift, provided that changes in spending and sustainable revenues are well aligned and there is not a large structural deficit or debt sustainability problem to begin with.

Ireland has had a statutory medium-term budgetary framework since the Ministries and Secretaries (Amendment) Act 2013. This was a reform instituted after the crisis years to correct a major shortcoming in policy formulation prior to the financial crisis. A discussion document on reforming Ireland's budgetary Framework post financial crisis noted that, in the years leading up to the financial crisis, there was not enough control of medium-term spending:

> *"The challenges in restraining expenditure growth were rooted not in any deficiency in the annual expenditure management processes – in fact the annual Estimates of Expenditure, as voted by the Dáil, were adhered to quite closely each year. Instead,* ***the shortcomings lay in the almost complete focus being placed on the first year's spending plans, with the multi-annual dimension of expenditure planning often seen as indicative, non-binding and subject to future budgetary processes****",*
>
> (Department of Finance, 2011).

Figure B1A shows the Government's repeated pattern of large spending overruns in the run up to the financial crisis. A similar pattern has been evident since the medium-term expenditure framework was introduced in 2013 (Figure B1B). Spending has exceeded initial ceilings by on average 7.3 per cent since 2015. It is clear that there continues to be an almost complete focus on one-year-ahead spending plans, while the medium-term ceilings continue to be "seen as indicative, non-binding and subject to future budgetary process". [2]

Despite the introduction of the medium-term expenditure framework, increases since 2015 have been of a similar magnitude to those prior to the financial crisis.[3] This has also been coupled with deficiencies in controls on spending levels within the year. Large within-year overspends have been evident in recent years —something which was not persistently the case prior to the financial crisis.

It is clear that Ireland's medium-term spending framework has not been working. It was envisaged at the time of its introduction, that the 2013 expenditure framework would be based on

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[1] See, for example, Fiscal Council (2018a, p,29).

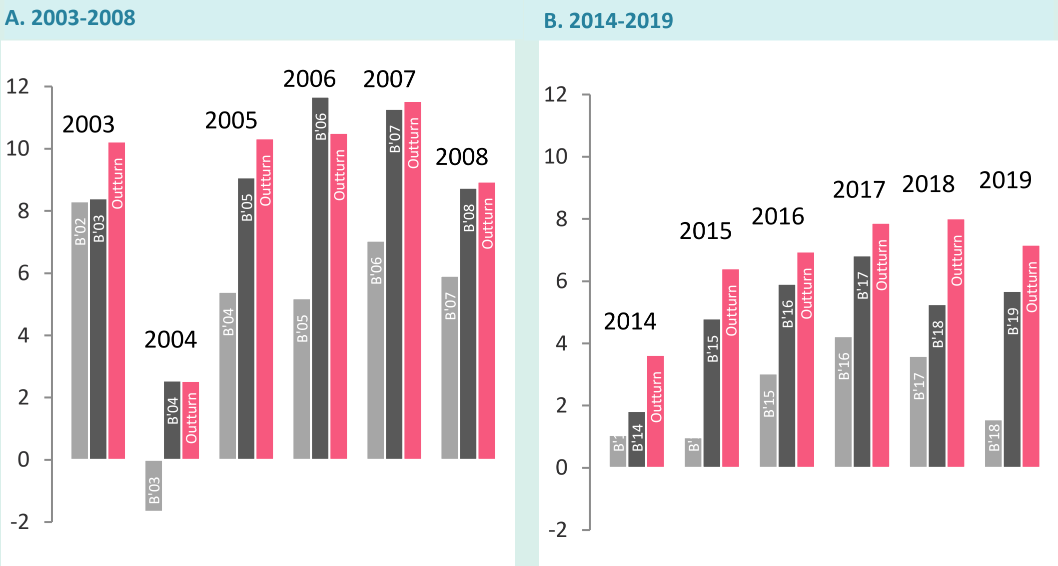
[2] Indeed, the current Minister for Finance (and former Minister for Public Expenditure and Reform) said as much, when speaking to the Oireachtas Committee on Budgetary Oversight on the matter: "I take a different view. If that is the path we go down, we will get to a point where a Minister for Finance in the future will be making decisions on tiny parts of his or her budget. It is the preserve of Ministers…. to be able to decide how they allocate a degree of funding at budget time. Expenditure growth in the future will be higher than the figures to which the Deputy is referring but that will be the result of budget day decisions" (Committee on Budgetary Oversight debate -Thursday, 18 Apr 2019).

[3] For context, inflation forecasts surprised on the upside in 2005-2008, and inflation surprised on the downside in 2014-2019. Had inflation been as forecast, the deviations over the period 2005-2008, would have been relatively lower, while the deviations from 2014-2019 would have been relatively higher.

international best practice. The document itself noted that "the expenditure aspects of budgetary planning would be strengthened through the introduction of a Medium-term Expenditure Framework, based on international best practice", (Department of Finance, 2011). However, the Medium-term Expenditure Framework that resulted from the 2013 reforms is not considered in line with international best practice.[4]

Figure B1: Revisions to expenditure ceilings have been of a similar magnitude to those prior to the Great Recession

% deviation from original ceiling



Sources: Department of Finance; Department of Public Expenditure and reform; and Fiscal Council workings.
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.

Case study – The Medium-term Expenditure framework of the Netherlands[5]

The Dutch Budgetary framework has long served as a standout example of good medium-term budgeting. The framework is primarily built around medium-term spending ceilings (Vierke & Masselink, 2017).[6]

The Dutch framework works on the basis of what is considered a trend-based mechanism — that is, revenues are allowed to fluctuate over the cycle, without prompting a need to adjust the public finances, but expenditure ceilings must be respected regardless of cyclical developments. This

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[4] For instance, Ireland's framework is assessed across five dimensions in a European Commission assessment of the quality of medium-term expenditure frameworks. The quality of Ireland's Medium-term Framework is towards the bottom half of the EU countries, with a score of 0.67. The quality of the medium-term Framework is assessed across five dimensions: 1) the coverage of the spending included under the ceilings; 2) how the medium-term plans relate to the annual budgetary process; 3) involvement of the national parliament in setting the medium-term plans; 4) involvement of independent fiscal institutes in setting the medium-term plans; and 5) the level of detail included in the medium-term plans. See here for further details: https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/medium-term-budgetary-framework_en

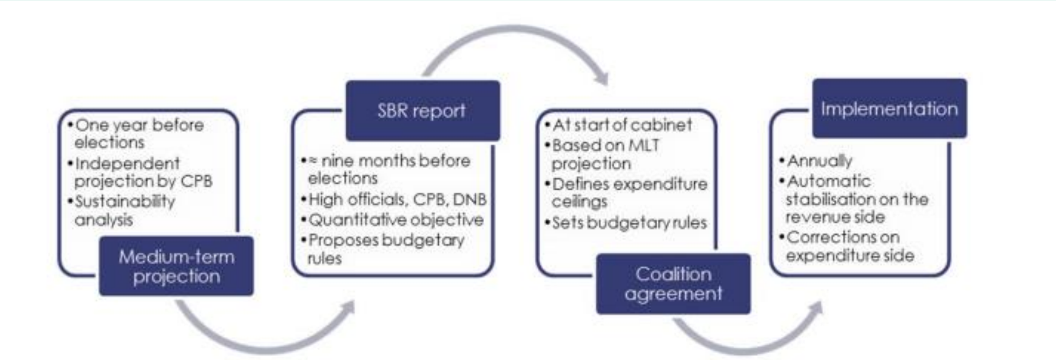
[5] See Vierke & Masslink (2017) for a detailed description of the Dutch medium-term expenditure framework and how it relates to the EU fiscal rules: https://ec.europa.eu/info/sites/default/files/economy-finance/eb027_en.pdf

[6] Ireland's framework is built around the annual budgetary process.

trend-based framework is similar to the principle behind the Expenditure Benchmark in the EU fiscal rules. However, under the Dutch Framework the focus is on the *level* of spending rather than on annual growth rates in spending. Spending ceilings are fixed at the start of a government term, and these remain in place for the entirety of the four-year term. This prevents "spending drift" from occurring whereby an overspend in one year can then get carried forward to other years, while still ostensibly complying with individual yearly limits on the pace spending can grow at. Ireland's framework has historically been weak in this respect. Ceilings, both departmental and overall, are revised every year based on outturn data. This means that overspends in previous years typically get baked in for subsequent years and there is no mechanism to re-align spending levels with sustainable increases in revenue.

Figure B2 gives an overview of the Dutch Framework. Prior to elections, medium-term projections set the background for which political parties base their election policies on. These policies are independently costed prior to the election. Once a government is formed, a fully costed programme for government based on the medium-term projections is agreed. This is the basis for the expenditure ceilings that are then in place for the entirety of the government term. Execution of the expenditure ceilings are monitored annually, with corrections on the expenditure side if overruns occur.

Figure B2: The Dutch Framework



Sources: Vierke & Masselink (2017).
Notes: The CPB is an independent fiscal institute similar to the Fiscal Council. The SBR is a non-partisan national advisory group on budgetary policy. The DNB is the Dutch Central Bank. The MLT is the medium-term projection.

Ireland's newly proposed expenditure rule

The introduction of the new spending rule is an opportunity to strengthen Ireland's medium-term budgetary framework. The new spending rule was set out in the *Summer Economic Statement*:

> *"Over the medium term out to 2025, anchoring core expenditure growth to an appropriate trend growth rate for the economy of c. 5 per cent can provide a pathway back to a more sustainable budgetary position, while also providing the necessary resources to enhance our public services, social supports and infrastructure."*
>
> (*Summer Economic Statement*, 2021).

The Council welcomes the adoption of an explicit spending rule for the medium term based on sustainable growth in the economy and revenues. This should help to ensure a better medium-term budgetary anchor is in place to help with prudent management of the public finances. Combined with more realistic fiscal projections that properly reflect the future cost of providing existing levels of public services and welfare rates (including pensions as the population ages) should help to avoid the need to revise the spending ceiling systematically.

However, there are still some aspects of the proposed rule that should be clarified and developed. The expenditure rule should seek to have the following features:

1) Under the assumption that a trend growth rate of the economy is about 5 per cent, growing expenditure by 5 per cent would only be sustainable provided that there were no additional

tax cuts.[7] However, on top of the 5 per cent growth in core expenditure, the Department have also incorporated tax cuts of €0.5 billion per year in their budgetary package. This does not leave the public finances on a sustainable footing, given the Department's own assumption of the trend growth rate of the economy.

2) The new expenditure rule should be put on a statutory footing. Without primary legislation, the rule may be seen as indicative and non-binding and this would increase the likelihood that ceilings repeatedly get revised, repeating the mistakes of the past.
3) The trend growth rate should be better informed by the expected potential growth rate of the economy, together with projections of inflation. The Mid-year Expenditure Review (MYER) outlines how the trend growth rate was set, by looking at historical GNI*, PRSI and tax revenue growth rates.[8] However, past growth rates are no indication of future growth rates, and as such should not be used to inform future spending limits.[9]
4) Due to recent imprudent increases in permanent spending included as part of *Budget 2021*, sticking to the current spending rule is likely to lock in a higher path for spending than would have been the case if the rule had applied before the pandemic. This risks the Government also locking in a structural deficit over the medium term. However, the rule should also ensure a steady medium-term pace of debt reduction is achieved, which would be consistent with a smaller structural deficit. This link to debt sustainability is something that is missing from the rule as it is operationalised.
5) The expenditure rule appears to only cover "core" Exchequer spending. The expenditure rule should be on a whole of government basis or "general government" basis. This would ensure that close to one fifth of government spending does not get excluded from the rule. The spending currently left out includes local government spending and spending by public sector bodies such as approved housing bodies.[10] If expenditure in areas outside of the Exchequer grows by more than the 5 per cent limit, this could lead to imprudent increases in general government expenditure.
6) At the moment, it is not clear how spending overruns are to be dealt with. Past precedent has been to simply revise up ceilings when overruns occur. There should be an explicit statement in *Budget 2022* outlining how overruns are to be dealt with. Overruns in one year should be either offset by offsetting new revenue-raising measures or by a corresponding lower growth rate in the following year so that the level of spending (adjusted for revenue raising measures) remains on a sustainable path.[11] This could be better formalised by setting the expenditure rule in levels of expenditure (adjusted for revenue raising measures), instead of growth rates.

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[7] Growing expenditure in line with the economy's trend growth rate can help ensure that the public finances are on a sustainable footing, provided that sustainable revenues grow in line with the trend growth rate of the economy. This is often a reasonable assumption provided that policy does not change. However, introducing tax cuts would mean that revenues grow below the trend growth rate of the economy, which creates a divergence between changes in spending and sustainable revenues. To ensure that the public finances are on a sustainable footing, if tax cuts are implemented, expenditure should grow by a correspondingly lower growth rate than the trend growth rate. On the other hand, tax-raising measures should allow expenditure to grow by a corresponding higher growth rate.

[8] See here for details: https://www.gov.ie/en/collection/d2e199-mid-year-expenditure-reports-myer/

[9] This is particularly the case when the past growth rates used incorporate a period in which corporation tax performed above what can reliability be explained by the underlying domestic economy. As such, using such growth rates is not a reliable indicate of the future sustainable growth rate of the economy.

[10] In addition, the debt, deficit, expenditure, and revenue figures for the fiscal rules are all assessed on a general government basis.

[11] In recent years, spending overruns have been masked by unexpected corporation tax receipts, meaning that these overruns were not reflected in worsening deficit figures (See Box D of the *November 2018 Fiscal Assessment Report*; Fiscal Council, 2018b).