Box I: Inflation and the Government’s 5% Spending Rule

This box reviews the Government’s 5% Spending Rule and its design, particularly considering the recent high-inflation environment.

The Government’s spending rule in principle

As part of the *Summer Economic Statement* in 2021, the Government outlined a new expenditure rule that would seek to anchor ‘core’ expenditure growth — Exchequer spending less Covid-related expenditure — over the medium term. The rule would effectively seek to tie expenditure growth to the estimated sustainable nominal growth rate of the economy, at 5 per cent per year. The Council had for many years argued in favour of implementing credible spending rules, with this latest development broadly welcomed.

At the time of the rule being proposed, the Council also outlined that a range of issues relating its design required further attention. These included:

1) the backward-looking nature of estimating the economy’s sustainable growth rate, rather than focussing on medium-term forecasts of potential output;
2) the narrow focus on *Exchequer* spending rather than on a general government basis;
3) the lack of a statutory footing for the rule;
4) the lack of a link to departmental ceilings set for each year;
5) the potential disconnect with other domestic fiscal rules;
6) the absence of a role for factoring in a meaningful debt target;
7) the omission of the impact of tax policy changes (in other words, tax cuts are ignored in the rule as it is designed, which is a clear flaw); and
8) the absence of a clear procedure for how the rule would operate in the case of under- or over-spends.

Without these facets, the stated benefits by Government of minimising revenue windfalls being spent on permanent increases and maintaining high levels of capital spending are being undermined. Also, without an anchor to a debt target or structural balance, the rule is in danger of locking in large deficits or high debt ratios (see Box E, Fiscal Council 2021b).

The Government’s spending rule in practice

The Government appears to have stuck to the 5% Spending Rule since it was initiated. The rule is operationalised as a growth rate of spending applied to a nominal allocation in levels, rather than growth rates on outturns over the medium-term. This means that while the growth rates fluctuate around the anchor of 5 per cent, the medium-term levels remain broadly unchanged.

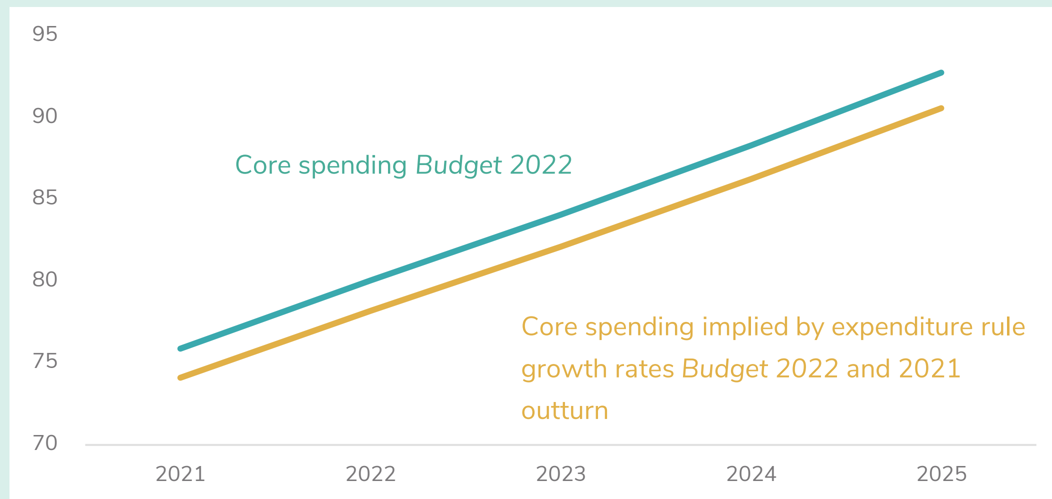
For example, the level of core spending in 2021 anticipated in *Budget 2022* has since been revised down by around €1.8bn, however the level of core spending in 2022 has remained unchanged in *SPU 2022* from what was forecast in *Budget 2022*.

This leads to an expected growth rate in core spending of 8.1 per cent in 2022, rather than the 5.5 per cent growth rate for 2022 anticipated in *Budget 2022*, which was more aligned with the 5% Spending Rule.

Applying the originally anticipated growth rates to the actual core spending outturn in 2021 shows that spending levels will only be temporarily higher in 2022 relative to this counterfactual as a result of the higher growth rate of spending being projected, medium-term spending levels are essentially unchanged from *Budget 2022* expectations (Figure I1).

Figure I1: Core spending is projected to be higher in 2022 only than had the Government grown spending by its originally forecast growth rates

€ billion



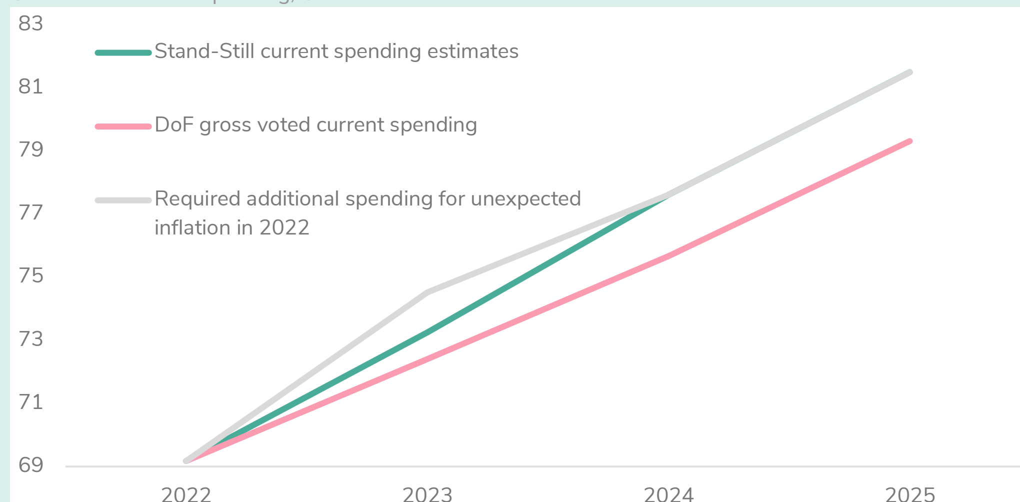
Source: *Budget 2022*, *SPU 2022* and Fiscal Council workings. Get the data.
Notes: The green line shows *Budget 2022* core expenditure forecasts, yellow line outlines the levels of spending that would have been implied by the 2021 outturn and core spending growth rates from Budget 2022.

The spending rule and inflation

As part of *Budget 2022*, annual HICP inflation was forecast to be, on average, 2.5 percentage points lower in 2022 and 2023 than the latest SPU projections. Given that the spending rule appears to be applied in nominal level terms, the unexpected inflation would typically reduce the amount of real spending that could occur relative to earlier plans, although at present the 2021 underspends create some leeway. To illustrate the tensions that can arise with a rule specified in nominal terms when inflation is higher than expected, Figure H2 shows how unexpected inflation has pushed Stand-Still costs above spending levels anticipated in SPU 2022 over the medium term under the rule (Figure I2).

Figure I2: Inflation 'catch-up' costs in 2023 would drive spending higher than Current Stand-Still estimates

Gross voted current spending, € billion



Source: *SPU 2022* and Fiscal Council workings. Get the data.
Notes: The grey line above represents the additional cost of recovering the real level of service provision in 2023, following the higher than expected inflation seen in 2022. This is calculated as the difference in HICP, wages and GNP deflator between *Budget 2022* and *SPU 2022*.

This further complicates the budgetary arithmetic and creates challenges for policymakers. This would require policymakers to make a clear choice about whether or not to fully adjust spending to higher inflation, to make cuts in some areas or to raise taxes. With higher-than-expected inflation, it becomes more difficult to keep to the spending plans specified in nominal terms without real falls in the levels of services provided. For example, the unexpectedly high price increases seen in 2022 would permanently reduce the real value of services in the absence of a 'catch-up' in spending. Figure I2 shows how such a catch-up effect would translate into higher spending in 2023 if policy intended to fully compensate for the excess of unexpected inflation in 2022.

At the same time however, inflation is in net terms likely to boost revenues all other things equal. As noted earlier (Box E), higher inflation may generate higher revenues, assuming that consumers and businesses do not scale back on purchases and that wages increase. All equal, this would help the budget balance and – if the spending rule is followed – lead policy to tighten.

Incorporating inflation into the spending rule

Taken together, these factors illustrate the complexity surrounding both the impact of inflation on the public finances and the pressures that will be exerted on the spending rule when specified in nominal terms.

Adjusting the rule to accommodate inflation could be done by specifying the rule in real terms (for example, as a 3 per cent real spending rule) with inflation allowed to vary in line with actual forecast rates. This approach is used in a number of countries including the Netherlands. However, revisions to forecasts, temporary supply shocks and the varying incidence of pressures complicate the picture.

Alternatively, the spending rule may continue to be specified in nominal terms as is currently the case. As Lane (2021) points out, a spending rule that takes account of the ECB's 2 per cent inflation target on a symmetric basis would actually improve the utility of the rule as a counter-cyclical tool by increasing the fiscal space available during periods of below-target inflation and vice versa.

From an economic perspective, it makes little sense to increase the overall expenditure ceiling on the back of unexpectedly high inflation, particularly in the case of a negative supply shock such as the global economy is experiencing now. The same argument would apply, for example, to a deflationary period.

One option would be to retain the nominal targets but with an allowance for an inflation adjustment where forecasts deviate too far from trend. This could necessitate specifying the required deviation in levels, growth rates, and the nature of the driver, or this could be addressed on an ad-hoc basis.