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 start of the Covid-19 pandemic in 2020 and have continued into 2022.[77] In the case of the general escape clause, the European Commission recently announced that it considers the conditions required to maintain the activation of the clause as met for 2023, with its deactivation to occur in 2024.[78] The Commission cited high uncertainty and downside risks in the context of the war in Ukraine, along with energy price increases and supply chain disturbances as contributing to this decision.

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, along with provisions to address the humanitarian implications of the war in Ukraine in 2022.

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 2022.[79]

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

	2017	2018	2019	2020	2021	2022
Spending Rule	Breach	Significant Deviation	Compliant	Exceptional Circumstances	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% 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% of GNI* for the spending rule, or 0.5% of GDP for the structural balance rule. A "breach"

[77] See Box K from the May 2020 FAR for an overview of these dispensations.

[78] The press release from the Commission can be viewed here: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3182

[79] 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.

means that the limit for the corresponding rule was exceeded by less than 0.5 per cent of GDP or 0.5% of GNI*.

To assess Ireland's fiscal position, the Council advocates using GNI* as an appropriate measure of the size of the domestic economy. However, legal compliance with the fiscal rules is assessed against GDP, which exaggerates the capacity of the domestic economy and is somewhat disconnected from its underlying performance. This can flatter Ireland's compliance with the rules on an underlying basis and would obscure the degree of adjustment required in the event of a downturn.

As part of the Fiscal Responsibility Act 2012, the Council has a mandate to monitor and assess compliance with the domestic budgetary rule on at least an annual basis. While the Council deemed that exceptional circumstances related to the pandemic prevailed in 2021, the Council has assessed that the Government would have been compliant with the domestic budgetary rule and the corresponding 3 per cent of GDP deficit threshold stipulated in the SGP in any case.

The fiscal rules have been met in the short term, and are forecast to be complied with in the medium-term

A general government deficit of 1.9 per cent of GDP was run in 2021 (Figure 4.1).[80]. Similarly, while the onset of Covid-19 led to a sharp increase in borrowing to fund the fiscal response to the crisis, the debt-to-GDP ratio stood at 56 per cent in 2021, below the 60 per cent limit of the SGP, although this relies on a GDP-based measure which presents a misleading picture for Ireland.

Much of the contingent funding set aside for Covid-19 related spending in 2022 will be used to support the humanitarian response to the war in Ukraine and cushion the impact of rising energy prices for households and firms. However, in 2023, significant costs associated with the settlement of refugees from the conflict are also expected.

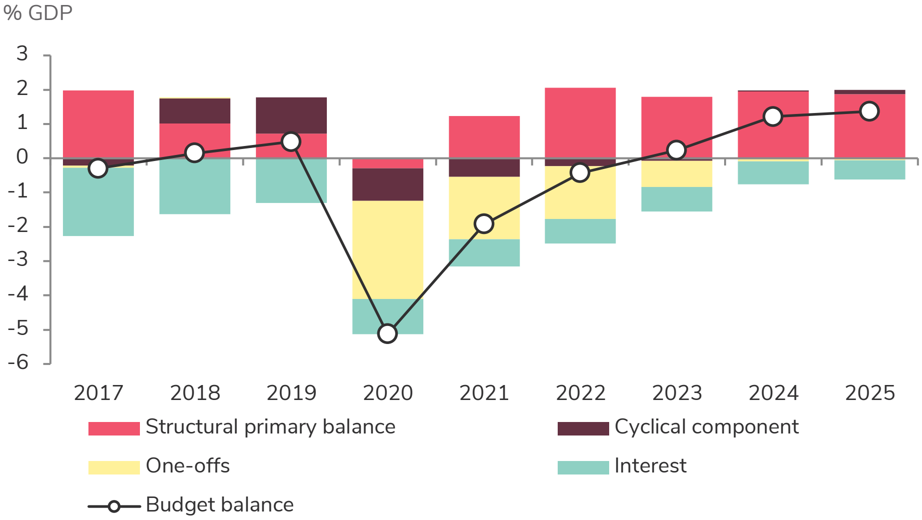
Despite this, based on *SPU 2022* forecasts, both the headline and structural balance are forecast to improve both this year and next to levels that would yield compliance with the fiscal rules. The headline general government deficit is forecast to fall to 0.4 per cent of GDP in 2022, below the 3 per cent limit in the SGP.

[80] 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 structural balance is projected to be positive in 2022 and throughout the forecast period. In 2022, it is forecast to be 1.4 per cent of GDP, therefore complying with the Medium-term Budgetary Objective (MTO) of a structural deficit of no more than 0.5 per cent of GDP. Should these forecasts transpire, the fiscal rules would be complied with in 2022 and up to 2025 and would not see the Adjustment Path Condition applied.

Such a performance would highlight the fact that a continuation of the exceptional circumstances clause within the rules would be inconsequential for Ireland, as it is set to comply regardless. It also demonstrates that while any extension of the clause may be justified on the grounds of the war in Ukraine and the fallout from this, Ireland remains relatively less economically exposed to the conflict than other EU members. However, a broader slowdown in the Eurozone would of course have negative implications for the Irish economy.

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



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 future of the fiscal rules in the Eurozone remains unclear in the medium term. The European Commission's review of the EU's economic governance and fiscal rules is ongoing, and it is still intended that guidance will be provided to Member States regarding any broad reforms to the rules well in advance of 2023.

Last September, the Network of EU Independent Fiscal Institutions (IFIs), of which the Fiscal Council is a member, released a publication as part of its submission to the governance review by the European Commission regarding the rules. It highlighted areas where the expertise of IFIs could be more efficiently deployed to enhance the fiscal governance framework of the EU. These included producing assessments of measurement issues, budgetary forecasting, compliance with fiscal rules, and in generating overall assessments of the fiscal position of the member in question (EUIFI, 2021).

The Network recently released two further papers as part of this topic, including on the possible future role of IFIs in the EU semester and outlining its views in more detail on the need for an expanded role for IFIs in many countries and ways in which this might be achieved, including the introduction of legislative backing for a set of "minimum standards" to help support a wider role for national IFIs in fiscal governance at the EU level (EUIFI, 2022a; EUIFI, 2022b).

The Government's introduction of a new spending rule helps to achieve the compliance with the rules over the medium-term, but will still be subject to upward pressure as inflation overshoots in 2022 and 2023 may be built into the base of spending to some degree (see Box I below for a more comprehensive overview of this topic).

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

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.

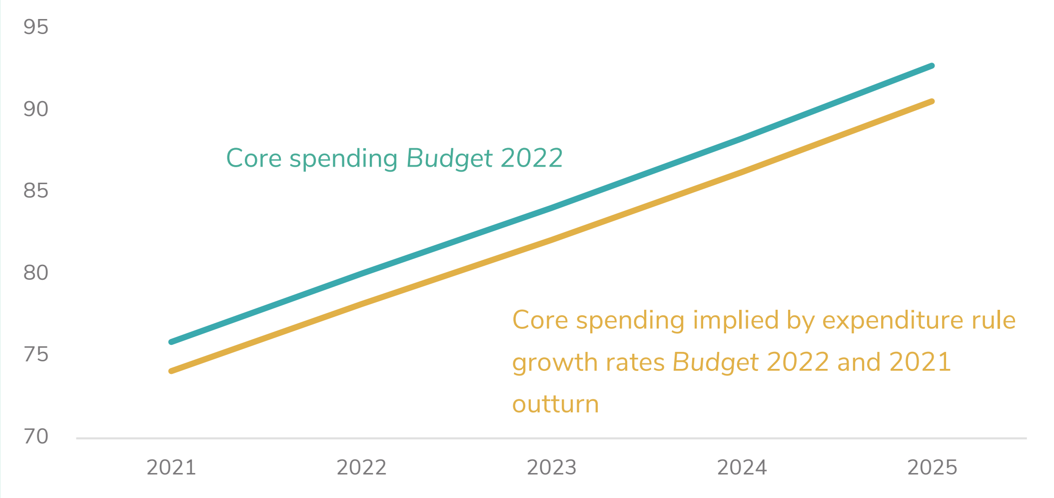
For example, the level of core spending in 2021 anticipated in *Budget 2022* has since been revised down by around €1.8bn, however the level of core spending in 2022 has remained unchanged in *SPU 2022* from what was forecast in *Budget 2022*.

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



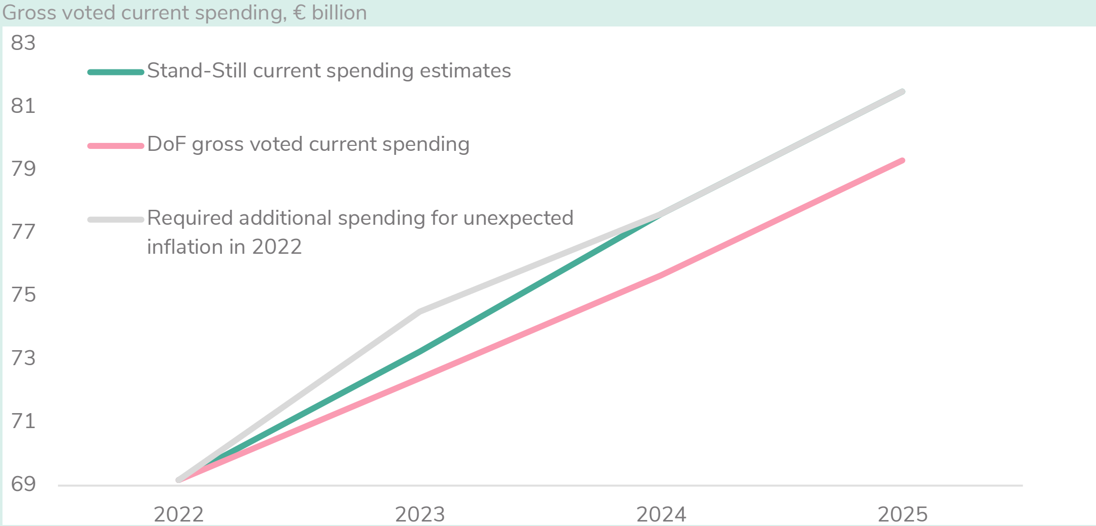
Source: *Budget 2022*, *SPU 2022* and Fiscal Council workings. Get the data.
Notes: The green line shows *Budget 2022* core expenditure forecasts, yellow line outlines the levels of spending that would have been implied by the 2021 outturn and core spending growth rates from Budget 2022.

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.

4.1 Medium-term Expenditure Framework

The medium-term expenditure framework, established in 2013 as part of a wider package of budgetary reform in Ireland, requires the Government to set and publish departmental expenditure ceilings for the upcoming three years. This change was part of an intention to provide both an anchor for spending over the medium-term and to ensure that the Expenditure Benchmark is complied with.

Recent experience has demonstrated that this framework is not working as intended. There have been consistent overruns in spending relative to the levels specified as part of these expenditure ceilings. Furthermore, these deviations have been on a similar scale to that which took place prior to the financial crisis.

Medium-term departmental ceilings are based on unrealistic technical assumptions

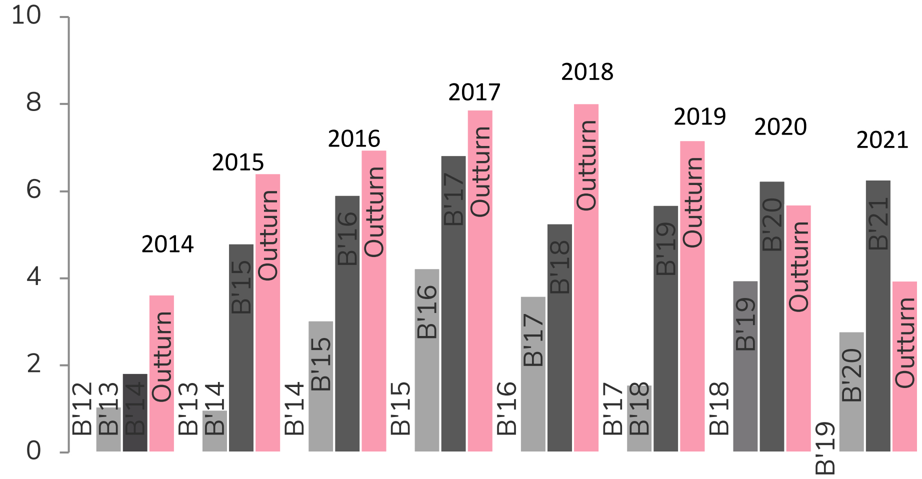
As part of *Budget 2022*, the Government failed to publish the required ceilings, despite this taking place each year between 2014 and 2020.[81] This suggests that the production of the expenditure ceilings was not part of the core budgetary process but rather a technical exercise, with the eventual ceilings being agreed by Government only in December 2021 as part of the Revised Estimates process. The failure to publish these ceilings at the time of the budget and their lack of integration into the budgetary framework more generally represents a backwards step in transparency and a weakness in the overall fiscal framework.

Furthermore, the current baseline core current departmental ceilings, contained in the December 2021 Revised Estimates, have been held constant for both 2023 and 2024. This contributes further to the indication that the ceilings are non-binding, unlikely to act as a constraint on procyclical spending, and have little relevance or connection with the Government's new 5% Spending Rule.

[81] 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 2021 and were published then.

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 outturns for 2020 and 2021 are Covid-19-adjusted (they incorporate only "core" expenditure).