Fiscal Rules

Exceptional circumstances coming to an end

4. FISCAL RULES

Exceptional circumstances coming to an end

The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules were activated at the start of the Covid-19 pandemic in 2020 and will remain in place throughout 2023.[47] This allows Ireland to temporarily deviate from the requirements under both the domestic and EU fiscal rules in these years.

The rules remain effectively suspended.

In March, the European Commission (2023a) confirmed that the general escape clause will be deactivated at the end of 2023.[48] In addition, the Council assesses that "exceptional circumstances" will also cease to exist at year-end. The European economy has rebounded, such that it has surpassed its pre-Covid levels and overcome the acute phase of the energy price shock caused by Russia's invasion of Ukraine. However, uncertainty remains high.

Table 4.1 presents a summary of the Council's previous assessments of compliance with the Domestic Budgetary Rule, as well as the Council's assessment for 2023.[49]

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

	2017	2018	2019	2020-2023
Spending Rule	Breach	Significant Deviation	Compliant	Exceptional Circumstances
Structural Balance Rule	Compliant	Compliant	Compliant	
Overall Assessment	Compliant	Compliant	Compliant	

Source: Fiscal Council workings.
Notes: 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 the 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" means that the limit for the corresponding rule was exceeded by less than 0.5% of GDP or 0.5% of GNI*.

Under 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 existed in 2022, it has assessed that the Government would have complied with the Domestic Budgetary Rule and the corresponding 3% of GDP deficit limit imposed by the Stability and Growth Pact (SGP) in any event.

[47] For an overview of these dispensations see Box K from the *May 2020 FAR*.

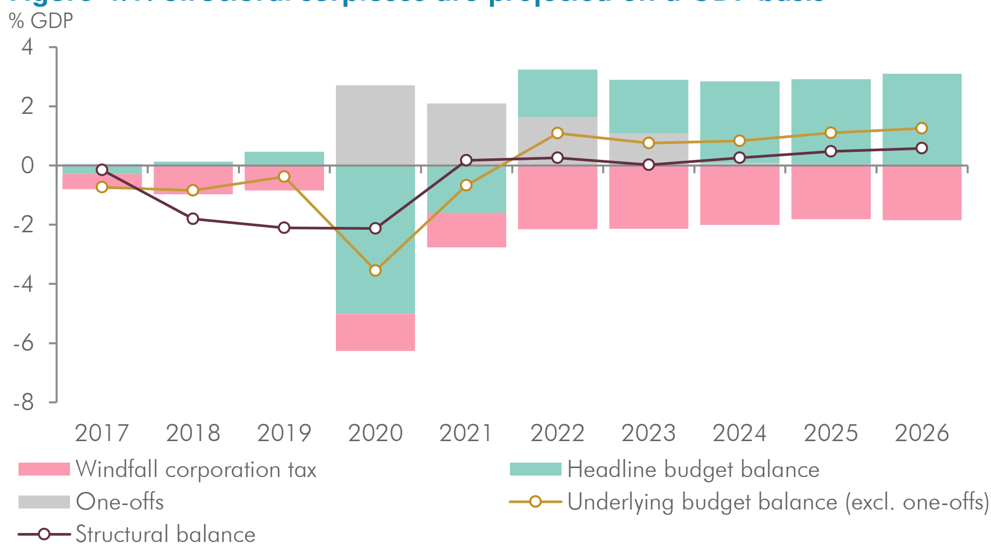
[48] The press release from the Commission can be viewed here: https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1410

[49] This is based on the Council's principles-based approach to the Domestic Budgetary Rule. For further information see Table S6.2 in the supporting information section.

Legal compliance with the fiscal rules continues to be assessed against GDP. A general government surplus of 1.6% of GDP was run in 2022 (Figure 4.1). In addition, Ireland's debt-to-GDP ratio stood at 45% at the end of 2022, and is projected to fall further to 32% by end-2026. These outturns are well within the 60% limit of the SGP. However, this assessment relies on a GDP-based measure, which does not paint an accurate picture of the Irish economy.[50]

Although the escape clause continues until year-end, the structural balance is projected to remain marginally in surplus in 2023 and to improve in subsequent years. Therefore, Ireland would be on track to comply with domestic and EU fiscal rules, assuming these rules are reinstated in their current form in 2024 (Figure 4.1). However, the Commission has recently tabled legislative proposals to reform the EU's fiscal framework from 2024.

Figure 4.1: Structural surpluses are projected on a GDP basis



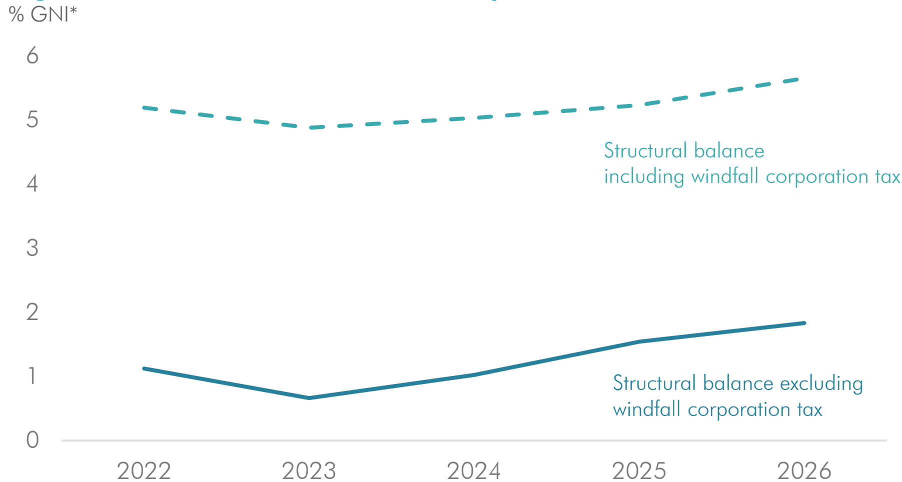
Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Notes: The structural element of the budget balance is estimated using the top-down approach. This is the approach used in assessing legal compliance with the fiscal rules. The cyclical budgetary component is calculated as 0.52 times the Department's GVA-based output gap measure. The underlying budget balance (excl. one-offs) refers to the headline budget balance adjusted for one-offs and windfall corporation tax. Windfall corporation tax receipts are estimated by the Department of Finance from 2021 onwards. For 2017-2020 the Council's estimates are used. Estimates of revenue and expenditure one-offs are those judged by the Council.

Even in the absence of excess corporation tax receipts, the structural balance is expected to remain in surplus.

The windfall corporation tax receipts flatter the fiscal balance. But, even when these excess revenues are removed, the structural balance is expected to be in surplus over the coming years. Figure 4.2 shows this surplus as a share of GNI*, a more appropriate measure for the Irish economy.

[50] The Council advocates using GNI* as a more appropriate benchmark for assessing Ireland's fiscal position. Ireland's debt-to-GNI* ratio is forecast to be 79% at the end of 2023 and fall to 65% by the end of 2026.

Figure 4.2: Structural balance in surplus without windfalls



Sources: Department of Finance and Fiscal Council workings. Get the data.
Note: The structural balance is measured on a top-down basis using the Council's estimates of one-off items together with the Department of Finance's alternative estimates for the output gap, its GNI* forecasts, and its estimates of windfall corporation tax receipts.

Supporting Information section S6 provides a full overview of compliance with the fiscal rules based on the Council's principles-based approach.

Medium-term Expenditure Framework

Ireland's Medium-term Expenditure Framework was established in 2013 as part of a broader package of budgetary reform in Ireland. It is designed to help Governments to plan further ahead than they have previously tended to do. Rather than focus solely on the following year, the framework aims to ensure budgets become more focused on the future, with a clear emphasis on realistic medium-term planning.

The framework legally compels the Government to set ceilings for how much each department will spend over the next three years. However, for the third year in a row, the Government failed to publish these spending ceilings on Budget Day, last September. Instead, they were again published in December. The persistent exclusion of these expenditure ceilings from the budgetary process implies that they are set, not with a view to imposing realistic spending controls, but as a tick-the-box exercise to comply with legal requirements.

Furthermore, the medium-term estimates produced by the Department of Public Expenditure and Reform for individual department ceilings are highly unrealistic. In many areas, including health, they ignore demographic, price, and wage pressures and assume essentially constant levels of current spending in nominal terms. The Department leave large unallocated amounts that are then allocated where needed at a later stage. This approach to applying the ceilings undermines their credibility and is a backwards step in terms of transparency and the overall functioning of the fiscal framework.

Assessing compliance with the National Spending Rule

The National Spending Rule seeks to anchor "core expenditure" growth over the medium term.[51] Although the rule lacks a statutory footing and the Council is not legally mandated to assess compliance with it, an assessment is useful in determining the effectiveness of the rule as an anchor. This represents the first such assessment, given the rule guided spending for the first time in 2022.

The rule itself aims to limit core spending growth to 5% each year, in line with the estimated trend growth rate of the Irish economy. This approach implies a broadly sustainable pace of expenditure growth, given revenues also tend to grow at this rate. Until now, it was unclear whether the rule was a net spending measure. However, *SPU 2023* (Department of Finance, 2023, p. 30) notes that:

> *"The Government's spending rule is calibrated on the basis of net spending, i.e., spending net of discretionary taxation measures. Accordingly, the expenditure ceiling figure would be different – higher or lower – if the Government introduced discretionary tax changes"*.

This implies that the National Spending Rule focuses on *net* core spending. In other words, it treats new revenue-raising measures (such as tax increases) as permanent measures that offset spending increases.[52] By contrast, it regards new revenue-reducing measures (such as tax cuts) as permanent measures that lower the scope for spending increases. However, *SPU 2023* only shows forecasts of core spending without adjusting for tax measures. In addition, the Department makes no reference to the original ceilings first set out in *Budget 2022*.

In 2022, the Government complied with its National Spending Rule. The Council assesses compliance with the rule on a net basis, in line with the Government's description of the rule. Table 4.2 shows how the original ceiling for core spending, set in *Budget 2022*, was €80.1 billion. This was then revised up to €80.8 billion in November 2022 in *Budget 2023*. Actual core spending amounted to €80.0 billion at year-end 2022 and the net impact of new tax measures was negligible when the impact of non-indexation was accounted for.

In 2022, the Government complied with its National Spending Rule.

Therefore, net core spending amounted to €80.0 billion in 2022, €0.8 billion below the latest ceiling, set in *Budget 2023*. Current spending accounted for €0.34 billion of the underspend, with the capital underspend amounting to €0.44 billion.

[51] Core expenditure is exchequer spending excluding one-off and temporary measures, primarily those related to the cost of supporting Ukrainian refugees, Covid-related expenditures, and once-off cost-of-living measures. Given the National Spending Rule only applies to exchequer spending, it ignores significant public outlays, such as those made by Approved Housing Bodies in local government.

[52] These tax measures include the expected yields arising from the non-indexation of the income tax system.

Table 4.2: The Government complied with its spending rule in 2022
€ billions

	2021	2022	2023	2024	2025	2026
Core spending						
Budget 2022 ceilings	75.9	80.1	84.1	88.3	92.8	
Latest ceilings	75.9	80.8	85.9	90.2	94.7	99.5
Outturns	74.1	80.0				
Projections			85.9	90.2	94.7	99.5
Assessed on basis of spending alone						
Vs original ceiling		-0.1	1.8	1.9	1.9	
Vs latest ceiling		-0.8	0.0	0.0	0.0	0.0
Assessed net of tax measures						
Revenue-raising measures	0.6	1.1	1.8	1.6	1.3	1.1
Revenue-reducing measures	0.1	1.1	1.5	0.6	0.5	0.5
Net measures	0.4	0.0	0.3	1.0	0.8	0.6
Net core spending outturn	73.6	80.0				
Net core spending projections			85.6	88.9	92.6	96.8
Vs original ceiling		-0.1	1.5	0.6	-0.2	
Vs latest ceiling		-0.8	-0.3	-1.3	-2.1	-2.7

Sources: Department of Finance and Fiscal Council workings. Get the data.
Notes: Net core spending refers to core spending, adjusted for the impact of tax measures, and includes the expected yields arising from the non-indexation of the income tax system. Revenue-raising measures (such as tax increases) can be used to offset bigger spending increases, whereas revenue-reducing measures (such as tax cuts) would lower the scope for spending increases. Estimates of revenue-reducing and revenue-raising measures are those judged by the Council.

The Government has revised up its ceiling for 2023, taking spending to a level above what would be implied by a 5% growth path. This decision was made to allow spending to adapt to the elevated levels of inflation at present.[53] In its latest projections, core spending is expected to grow by €5.9 billion in 2023. From 2024, core spending is forecast to grow in line with the National Spending Rule once again. On a net basis, the projections imply that the Government will continue to comply with the rule, with additional space available due to the yields arising from the non-indexation of the income tax system.

Revisions to the fiscal rules

In April, the European Commission (2023b) provided more detail on how the EU fiscal rules might be reformed. This builds on the initial proposals set out last November and follows extensive discussions among EU Member States. Box F discusses the changes relative to the November proposals.

There are several key aspects to the latest proposals. First, there are stricter requirements for debt reduction in high-debt countries and for deficit reductions when above 3% of GDP. Second, the reforms may require changes to domestic

[53] For a discussion on the appropriateness of this decision, see Chapter 3.

legislation enshrining the fiscal rules in Irish law. Third, they entail an expanded role for national independent fiscal institutions, such as the Fiscal Council.

Crucially, Ireland is likely to face less scrutiny under the new EU fiscal rules. This reflects their focus on GDP-based measures (Casey and Cronin, 2023). However, a more appropriate assessment on a GNI* basis and reflecting excess corporation tax would signal greater risks. The Council assesses that the National Spending Rule should be further developed as a "first line of defence" to ensure sound management of the economy and public finances at home.

Box F: Updated reform proposals to the EU fiscal rules

In April, the European Commission (2023b) published its latest reform proposals for the EU fiscal rules. These proposals build on the Commission's initial set of ideas from November last year (European Commission, 2022), and follow on from discussions among EU Member States. Box E of the *November 2022 Fiscal Assessment Report* discussed the original proposals in greater detail. Here, we take a look at the key elements of the updated proposals.

The November communication introduced the concept of a risk-based economic governance framework based on a country's debt ratio. Under the proposals, the scale and speed of the required fiscal adjustment depended on whether a Member State had a substantial, moderate, or low debt challenge.[54] However, these categories no longer exist. Instead, there are only two categories:

1) Member States with a deficit above 3% of GDP or a debt ratio above 60% of GDP.
2) Member States with a deficit below 3% of GDP and a debt ratio below 60% of GDP.

At the outset, all Member States would be expected to prepare "medium-term fiscal-structural plans". These medium-term plans will map out a Member State's net spending path, as well as its reform and investment commitments. Low debt countries would face little scrutiny. The Commission would only provide them with guidance on the structural primary balance necessary to comply with the 3% deficit limit. This would assume no additional policy measures in the 10 years following the period covered by the four-year plan.

However, high debt countries or those with deficits greater than 3% would come under a much sharper focus. First, the Commission would put forward a reference adjustment path for net spending that would ensure debt is put on a plausibly downward course, and the deficit is brought or kept below 3% of GDP over the medium term. These countries would then consider this reference path when designing their own medium-term plans, which would cap net spending increases at a slower rate than might otherwise be considered sustainable.[55] The plan would cover a minimum adjustment period of four years, which could be extended by up to three years if the Member State commits to certain reforms and investments.[56] The plan will be binding once approved by the ECOFIN.[57]

In addition, the latest proposals also involve an assessment by the Commission as to whether:

- The debt ratio at the end of the path (between 4 and 7 years out) is below its level in the year before the path begins;
- In cases where Member States run deficits greater than 3% of GDP, that this is reduced by 0.5% of GDP each year. The proposals are ambiguous in terms of what this 0.5% refers to;

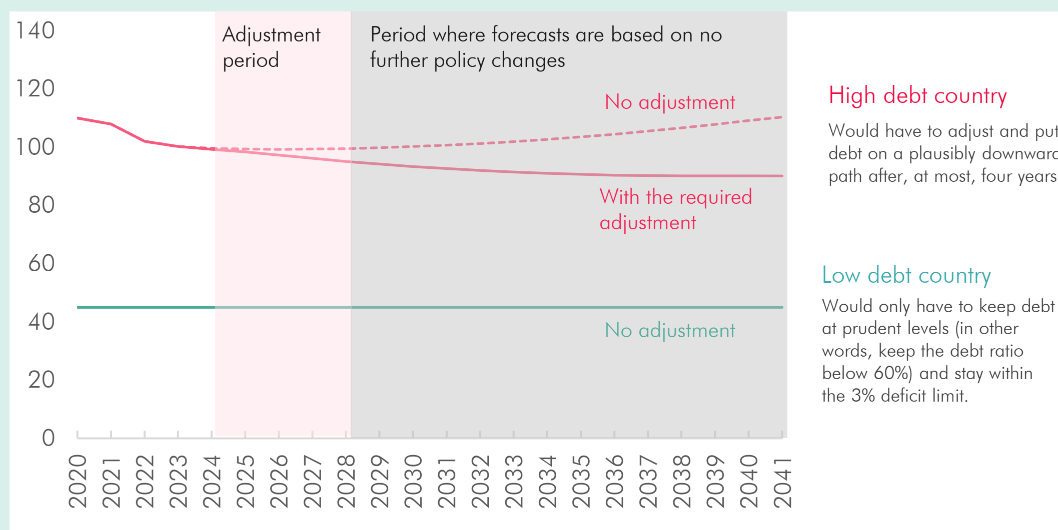
[54] A substantial debt challenge was defined as a debt ratio above 90% of GDP. A moderate debt challenge was defined as a debt ratio between 60% and 90% of GDP. Lastly, a low debt challenge was defined as a debt ratio below 60% of GDP (European Commission, 2022).
[55] In this instance, sustainable means in line with usual — or "potential" — economic growth, and, by extension, revenue growth. This is one area where an unobservable measure (potential growth) remains in place in the new framework.
[56] The criteria include whether the reform and investment commitments are: 1) growth-enhancing; 2) support fiscal sustainability; and 3) in line with common EU priorities, such as the European Green Deal (European Commission, 2023).
[57] The ECOFIN is the part of the Council of the EU comprising Member States' economics and finance ministers.

- In cases where Member States benefit from an extended fiscal adjustment period, that they deliver most of the adjustment during the first four years covered by the plan;

To illustrate how the new proposals might work, Figure F1 provides an illustrative example. We take two countries, one with a starting debt ratio of around 100% and the other with a starting debt ratio of 45%. For simplicity, we assume neither country is expected to breach the 3% deficit limit such that all that matters is the expected debt path. The low debt country would not come under much scrutiny, provided it complies with the 3% deficit limit. By contrast, the high debt country would have to grow net spending at a slower rate than otherwise planned, thereby ensuring its debt ratio is on a plausibly downward trajectory by the end of the adjustment period (assumed to be four years here).

Figure F1: The path for debt plays a key role in how the rules work

Debt ratio (% GDP)



Source: Casey and Cronin (2023)

Looking ahead, the Commission intends to swiftly agree upon the revised rules with the Member States, with a view to activating them from 2024. However, the proposed legislative changes will need to be agreed by both the European Parliament and the ECOFIN.

What do the latest proposals mean for Ireland?

Ireland is unlikely to come under much scrutiny under the proposed reforms to the EU fiscal rules (Casey and Cronin, 2023). GDP will continue to underpin the Commission's debt ratio assessments despite it being an inappropriate measure of the Irish economy. Ireland's debt ratio is currently below 60% of GDP and is projected to stay below this level. In addition, substantial injections of corporation tax receipts continue to flatter Ireland's budget balance and, as a result, its debt path.

Casey and Cronin (2023) explore how the proposed new framework might look were it better tailored to Ireland. They substitute GNI* for GDP and adjust for excess corporation tax receipts when determining the stress tests. They find a very different, albeit still encouraging, picture for how public debt is likely to evolve. The Commission's approach, if applied on this basis, might involve closer monitoring under the new EU fiscal rules if these aspects were allowed for.

Independent fiscal institutions could take on wider responsibilities

The proposals envisage a stronger role for independent fiscal institutions (IFIs), such as the Irish Fiscal Advisory Council. While traditionally mandated to assess compliance with *national* budgetary rules, the reforms propose IFIs assess compliance with the *EU rules* as well. That is, they would assess whether the budgetary outturns reported in the Government's annual progress reports comply with the agreed net spending path. However, to deliver upon this expanded role, the Commission notes that IFIs would require greater levels of resources and improved access to data.

Moreover, IFIs would be expected to carry out a number of additional tasks. These include:

- producing or endorsing budgetary forecasts underpinning the Government's medium-term plans;
- assessing the Government's debt sustainability analyses;
- assessing the impacts of policies with fiscal sustainability and growth-enhancing implications.