Reforming Ireland's Budgetary Framework:

A Discussion Document

Department of Finance

March 2011

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Under the EU/IMF Programme of Support, Ireland is committed to implementing a range of reform measures in the area of budgetary management, including multi-year fiscal planning and effective prioritisation of public expenditure over the medium term. In addition, negotiations are now at an advanced stage at EU level on bringing about reforms to national and EU-wide systems of economic governance. This overall context for budgetary reform, including an account of the reform measures that have been implemented to date in Ireland, is outlined more fully in Chapter 1 of this Discussion Document.

In that context, the Department of Finance has prepared this Discussion Document in order to set out the range of potential policy options. We hope this helps to inform debate on these issues. Decisions on each of these matters will, naturally, be a matter for Government.

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Secretary General
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March 2011

Executive Summary

Context for Budgetary Reform

Ireland has a long-established budgetary framework that is effective in managing expenditure allocations from year to year. Since 2006, a series of reforms have been introduced to make the budgetary process more transparent and effective. However, international and domestic observers of the Irish economy have identified weaknesses within the traditional framework when it comes to multi-annual fiscal planning and management, including with respect to expenditure. As in most EU countries, the national fiscal framework has not proven effective in ensuring that Ireland stayed within the budgetary ceilings set out in the EU Treaty and the Stability & Growth Pact (SGP).

The processes of economic and budgetary governance are now under active review at EU level, and specific proposals have been tabled to help ensure that all EU Member States manage their national budgets in a sustainable way. Reform proposals have also been developed at national level, including by the Joint Oireachtas Committee on Finance and the Public Service. Ireland has already moved to implement a number of these proposals, and some commitments in this area were set out in the *National Recovery Plan 2011-2014* and in *Budget 2011*. In addition, specific target dates for action on these matters have been agreed under the EU/IMF Programme of Financial Assistance. This Discussion Paper sets out specific options and proposals for implementing these measures.

A Stronger, Clearer Framework for Medium-term Fiscal Planning

Under the proposed new arrangements, the annual budgetary cycle would become more of a whole-of-year process, rather than being focused exclusively on the December Budget, and would acquire a stronger multi-annual dimension. In line with the agreed "EU Semester," the annually-updated Stability Programme, showing the Government's forecasts and plans for the evolution of the public finances over the medium term, is brought forward from December to April each year. This gives a more forward-looking focus to the Stability Programme. The subsequent annual Budget giving effect to the first year of the plan would be prepared in line with the Programme parameters taking account of the various policy orientations received – from both domestic and European sources – as well as updating for later information on the economic and fiscal front.

In particular, the existing SGP requirement to specify a "medium-term budgetary objective" of running the public finances broadly in balance, in normal times, would acquire a central significance as an anchor of budgetary policy over the medium term. The annual Stability Programme would set out the Government's proposed budgetary objective, along with sensitivity testing of the underlying budgetary forecasts to take adequate account of potential risks and guard against the emergence of structural imbalances.

Ensuring Sustainable Public Finances – the introduction of "Fiscal Rules"

Amongst the key departures in budgetary management contained in the proposed suite of reforms is the introduction of more formal "fiscal rules" backed up by legislation. The proposed rules are designed to underpin the credibility of Ireland's system of budgetary management, by ensuring that minimum rules of good practice are observed throughout the economic cycle. Three specific rules are proposed:-

1. *Public Finances Correction Rule:* this would govern the pace of budgetary correction, to ensure that the EU Treaty limits for the public deficit (3% of GDP) and debt levels (60% of GDP) are respected. The rule would require that the primary budget balance be improved by a defined minimum amount (of between 0.75% and 1.5% of GDP) each year.
2. *Prudent Budget Rule:* this would assist in maintaining budgets at a balanced position over the medium-term, as required under the SGP. Similar to the Correction Rule, this measure would specify a minimum improvement in the primary budget balance of 0.5% of GDP until the medium-term budgetary objective has been reached. The minimum annual improvement would be expressed in cyclically-adjusted terms.
3. *Sustainable Expenditure Growth Rule:* this rule, which would apply in 'good economic times', would limit expenditure growth to the ability of the economy to generate resources, as measured by the underlying rate of economic growth. Higher rates of expenditure growth would need to be financed through additional taxation, thereby forging a direct and immediate link between spending choices and revenue raising.

It is proposed that the rules would be enforced on a "comply or explain" basis. In other words, the Government, in setting out its medium-term budgetary plans, would have to comply with the rules or explain to Dáil Éireann why it considered it necessary to depart from such controls. It is likely that rules *1* and *2* above will determine policy for some time while the process of fiscal consolidation continues.

Medium-term Expenditure Framework

In conjunction with the above rules, the expenditure aspects of budgetary planning would be strengthened through the introduction of a Medium-term Expenditure Framework, based on international best practice. The annually-updated Stability Programme would set out fixed limits for expenditure ("Aggregate Expenditure Levels") for each year, broken down in turn into multi-annual "Ministerial Expenditure Ceilings" to bring greater clarity and discipline into expenditure management. This approach will set a premium on effective structural planning and prioritisation of resources within each Department and Office. The framework would include flexibility measures, to ensure it is responsive to evolving pressures and priorities, including provision for carryover of unspent funds from one year to the next.

Importantly, it is also proposed that a comprehensive Government Expenditure Assessment (GEA) would be undertaken to set initial expenditure allocations, and to ensure that programmes are performing efficiently and effectively in delivering on the Government's priorities. A new GEA exercise should be conducted periodically (every 2-3 years) by the Department of Finance, in line with new or revised Programmes for Government. This would enable a strategic and transparent allocation of resources.

The conduct of the GEA would be based upon domestic experience (including the analysis that informed the July 2009 Report of the *Special Group on Public Service Numbers & Expenditure Programmes,* and the ongoing Value-for-Money & Policy Reviews) as well as international good practice such as the UK's Comprehensive Spending Reviews. The introduction of 'sunset clauses' and strict 'cash-limiting' for programmes generally, as recommended in the Special Group Report, would also complement the proposed GEA process.

Budgeting for Performance

There is also a strong case for budgetary reform at the more micro-level. The existing process of resource allocation is heavily focused on financial inputs *("how much money is being spent?")* rather than outputs and impacts *("what is being achieved and delivered with this money?").* While reforms such as the introduction of the Annual Output Statements have improved the expenditure framework, there is much scope for further progress.

The introduction of a new system of 'performance budgeting' should bring a sharper focus on the actual outputs and outcomes delivered with scarce public resources. The proposed approach – which has been piloted in the 2011 Estimates – involves embedding useful performance information into the annual Estimate in addition to existing information on financial resources. This initiative should facilitate Dáil Éireann in holding Ministers and Departments to account for the effective and efficient use of resources, and would link effectively with other performance-related initiatives under the *Transforming Public Services* reform agenda, including improved value-for-money arrangements and clearer target-setting for State agencies.

Subject to the views of the Dáil and the Government on the pilot exercise, it is intended that the pilot budgeting process will be rolled out to all Departments and Offices from the 2012 Estimates.

An independent Budget Advisory Council

There are growing moves at international level to supplement the traditional Governmental apparatus of budgetary planning and decision-making with independent fiscal institutions. The advantages cited for establishing such bodies include greater transparency of the budgetary process through public commentary on fiscal policy assumptions and decisions of government, and stronger critique of official forecasts and proposed fiscal policy objectives. Essentially, an independent fiscal body can have a "soft enforcement" role which helps to support a government's capacity to adhere to budgetary policy.

It is proposed that a Budget Advisory Council for Ireland should have an independent remit to assess and comment publicly upon the Government's budgetary plans and forecasts, and to assess compliance with the fiscal rules set out in this Discussion Paper. In order to be effective, the membership of the proposed Council should be no more than five respected individuals with a strong track record in economic and financial matters and, to ensure added-value to the overall process, it should include international expertise. Appointments should be for a fixed period and it is envisaged that they would be made after consultation with the relevant Oireachtas committee.

A New Legal and Administrative Framework

It is proposed that a reformed fiscal framework should operate within a new legal context and be underpinned by new administrative arrangements. The key elements of the new architecture can be provided for in law by means of a *Fiscal Responsibility Bill,* and draft heads of a Bill are included with this Discussion Paper. Revised and realigned administrative arrangements, including Circulars from the Department of Finance, can give effect to other components of the new framework such as the detailed arrangements for operating the Medium-Term Expenditure Framework, strengthened value-for-money arrangements and the development of performance budgeting.

1. The Budgetary & Economic Context for Fiscal Reform

1.1 Ireland's existing system of budgeting

Ireland operates a traditional, annual cash-based system of government accounting. This system have been augmented by a number of significant reforms in recent years, which are outlined in section 1.3. The following timetable is normally followed each year.

Year 1

(a) **June-July:** The Government considers a Budgetary Strategy Memorandum (BSM), and decides upon the overall budgetary targets for the following year *(year 2),* and the implications for overall tax and expenditure policy. The BSM, while not published, also has a multi-annual aspect in that it sets out the macroeconomic and fiscal outlook for the medium term.

(b) **July-September:** Each Government Department prepares its requests for resources for *year 2,* taking account of the underlying level of services and the overall expenditure parameters decided by Government on foot of the BSM.

(c) **End-September**: Submission and subsequent publication of Maastricht Statistical Returns to Eurostat, reporting on General Government balance and debt levels for the previous four years (historical) and an update of the current year outlook.

(d) **September-November:** Ministers engage with the Minister for Finance to discuss the final expenditure allocation for *year 2,* and decisions on the annual "Estimates of Expenditure" are made collectively at Government level.

(e) **October or November:** Since 2006, the Government has published a "Pre-Budget Outlook" each autumn, giving an indication of the status of the public finances in advance of the policy decisions to be announced in the December Budget. The Pre-Budget Outlook also sets out the medium term macro-economic growth prospects and the associated fiscal targets.

(f) **Saturday before Budget:** Publication of the *White Paper on Receipts & Expenditure* showing pre-Budget position for *year 2.*

(g) **December:** The annual Budget sets out the Estimates of Expenditure for the coming year (*year 2*), together with tax policy decisions, so that the overall budgetary position for that year is presented in a coherent and comprehensive way to the Dáil. The allocations for voted current spending (i.e. spending by Government Departments and Offices) are set out on a one-year basis. Since 2004 the allocations for capital spending have been set out as part of a Multi-annual Capital Investment Framework.

(h) The December Budget normally includes an updated Stability Programme, a document required under the EU's Stability & Growth Pact outlining medium-term projections and plans for fiscal policy at a broad level.

Year 2

(i) **January**: Publication of the monthly profiles for tax revenue and debt servicing, with the expenditure profiles published after the Revised Estimates Volume. This provides for transparent monitoring of the annual budgetary targets throughout the year.

(j) **February:** Revised Estimates of Expenditure are produced, giving further details of expenditure proposals, along with preliminary detailed expenditure outturns for *year 1* for comparison purposes. These Revised Estimates, which may include some minor additional expenditure since the Budget, are considered by Dáil Committees, in conjunction with Departments' Annual Output Statements, before being voted on by the Dáil.

(k) **End-March:** Submission and subsequent publication of Maastricht Statistical Returns to Eurostat, reporting on General Government balance and debt levels for the previous four years (historical) and an update of the current year outlook.

(l) **Throughout the year:** The Government is regularly updated on the budgetary position and the emerging economic outlook, with policy orientations on the need for additional action if necessary. The Exchequer position is monitored and reported on publicly at the end of each month. Demands for additional spending in *year 2* by Departments are met in the first instance by reallocation of existing resources and then, if necessary, by Supplementary Estimates voted by the Dáil. By the time overall expenditure for *year 2* is formally approved by the Oireachtas through the annual Appropriation Act at end-December, the outturn for expenditure may have moved from the original Budget day allocation (i.e. the allocation under (g) above).

(m) **June-July:** The following year's BSM is prepared as the cycle starts once again. The starting budgetary position for the subsequent year – *year 3* – is reassessed, as it may have drifted considerably from the previous multi-year projections.

The above approach has strengths in terms of the management and control of cash allocations from year to year. However, many key themes of public financial management over recent decades – including effective multi-annual fiscal planning and accounting for performance and efficiency – are not ideally catered for by these arrangements. The proposals in this Discussion Paper are aimed at adapting Ireland's existing budgeting system to take account of these developments. Decisions on these matters are of course ultimately a matter for Government and the Oireachtas.

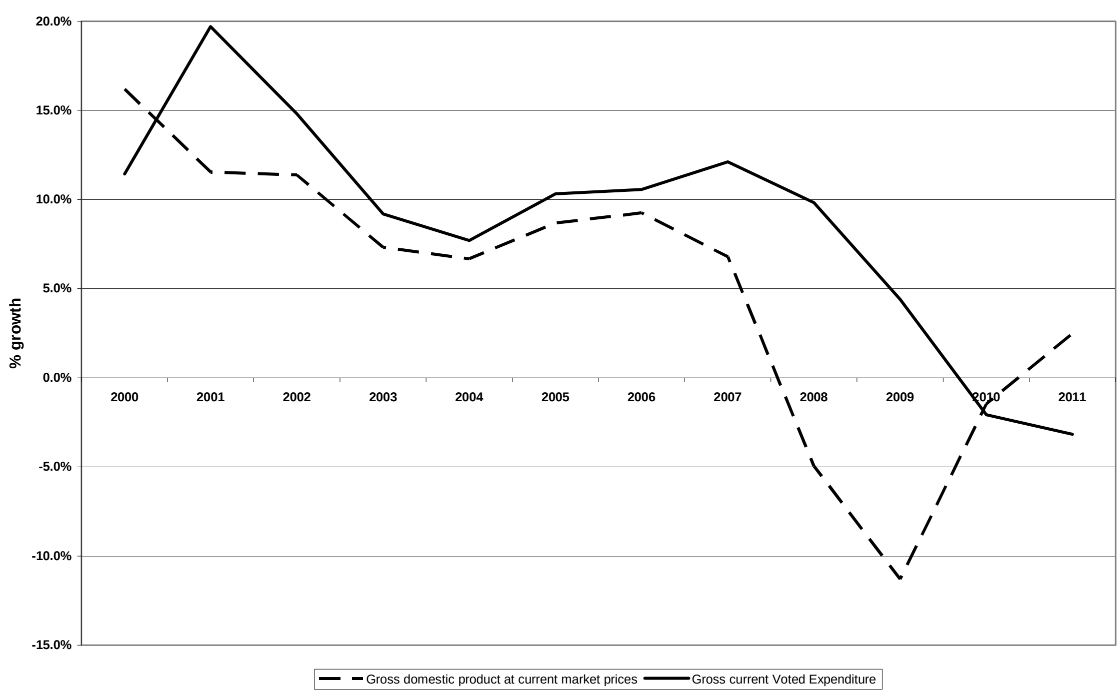

Figure 1.1: Comparison of expenditure growth with GDP growth 2000-2011
(Source: Department of Finance)

1.2 Expenditure Management in Ireland 2000-2011

One of the criticisms that is sometimes levelled at Ireland's budgeting system is that, by its nature, it facilitates levels of annual expenditure growth that are higher than would be considered prudent, and higher than might originally have been planned by a Government.

The experience of the past decade is that voted expenditure grew at a high rate. From 2001 to 2007, annual expenditure growth averaged around 10%, which was higher than the annual rates of economic growth in these years, as illustrated by Figure 1.1 on the previous page. If measured against the underlying or "trend" rate of GDP growth, the gap between spending and the actual resource-generating capacity of the economy during this period was wider still.

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. This point is borne out by Figure 1.2 which is taken from the July 2009 Report of the *Special Group on Public Service Numbers and Expenditure Programmes.* The chart shows the three-year expenditure projections as published each year in the annual Budget volumes for 2000 to 2006, compared against the actual outturns for expenditure in each of the three projection years. It shows that while the first-year outturns – those voted in the Dáil – typically came within 1% of the projection, the second-year outturns came in ahead of projection by 6% on average (equivalent to €3.2 billion in 2011 terms), while the third-year outturn overran by around 12% on average (equivalent to €6.3 billion). In short, the existing budgetary process focuses attention on the year ahead, whereas expenditure trends and pressures that fall outside this annual frame of reference do not receive the same attention or control; and by the time these future years are reached, earlier projections will invariably have been superseded.

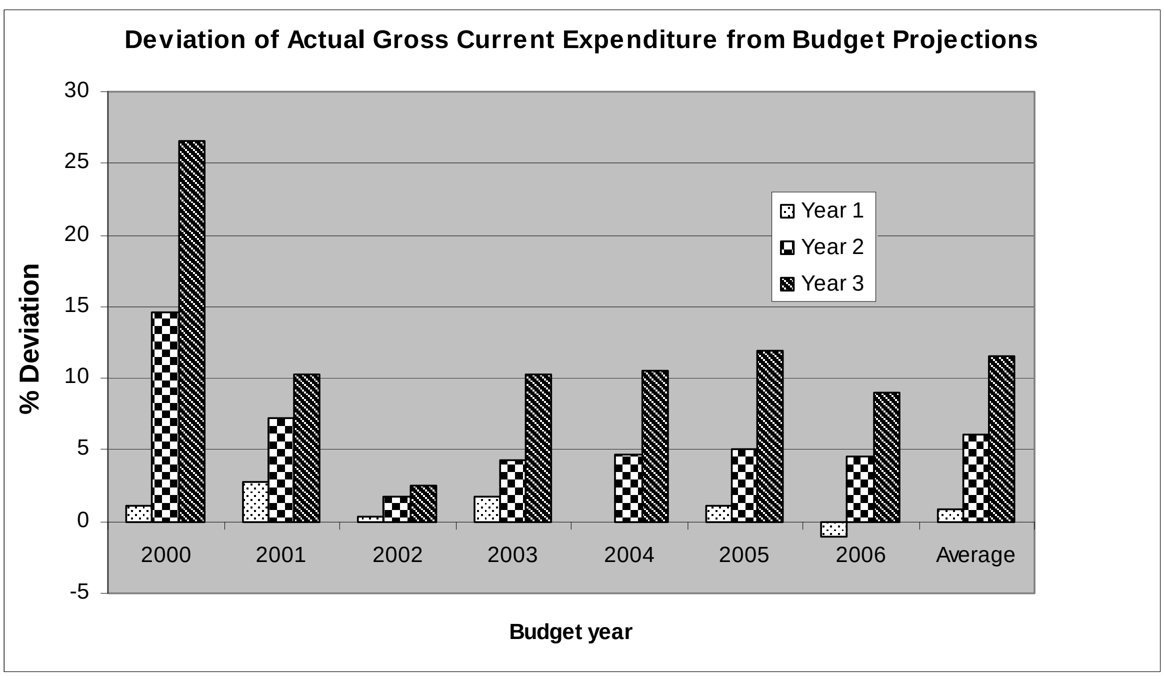

Figure 1.2: Deviation of Gross Current Expenditure from multi-year Budget Projections, 2000-2006 (source: Report of the *Special Group on Public Service Numbers & Expenditure Programmes,* 2009)

The Special Group concluded that "a stable multi-annual framework within which policy-makers can anchor their medium-term planning is required if public expenditure in Ireland is to be put on a sustainable footing", and went on to recommend the "implementation of a mechanism of medium-term envelopes to govern current expenditure growth."[1]

The need for such an effective medium-term anchor is now even more pressing given the need to achieve further fiscal consolidation over coming years.

1.3 Budgetary reforms to date in Ireland

Since 2006 in particular, attention has been given to modernising and streamlining Ireland's traditional budget mechanisms. The following developments in particular are of note:-

(a) *Pre-Budget Outlook (PBO)* – This document was introduced in 2006, to replace the previous *Economic Review & Outlook* that was published each summer by the Department of Finance. The PBO has usually been published in October / November each year, presenting a multi-annual overview of the economic and budgetary context within which the following December's Budget would be framed.

(b) *Unified Budget* – Prior to 2007, the annual Estimates of Expenditure were published separately in November (the "Abridged Estimates"), setting out the allocations for all major areas of expenditure apart from Social Welfare. The Social Welfare expenditure allocations were announced instead in December along with the tax policy measures, with a consolidated (and more detailed) "Revised Estimates" volume produced the following February. In 2007, this long-standing procedure was overhauled through the introduction of a "unified budget", whereby all expenditure and tax policy decisions were announced together on Budget day, with the Expenditure Estimates produced as part of the Budget documentation.

(c) *Annual Output Statements* – In order to supplement the financial information in the Estimates with performance-related information, and to assist in the process of Dáil scrutiny of the allocations, Annual Output Statements were introduced in 2007 setting out the public service outputs expected to be delivered by each Minister with the public funds being sought (See Chapter 4 for further details on this initiative and for proposals for further reform in this area.)

Since 2008, the imperative of addressing the sharp deterioration in the public finances, and of identifying proposals for budgetary consolidation (including in the context of the Special Group exercise referred to above*)* has pre-empted the scope for additional reforms. However, this Discussion Document is intended to set out a workable agenda for further significant and necessary reforms.

1.4 The evolving EU fiscal framework

Overall budgetary policy in Ireland is already subject to a number of requirements under the EU Treaty and the Stability & Growth Pact (SGP). These provisions are intended to promote a coherent approach to fiscal policy within the EU and the Euro area, and to provide a stable and credible foundation for Economic and Monetary Union (EMU).

In particular, the EU framework commits all Member States to avoid running deficits on their public finances of greater than 3% of GDP, and debt levels greater than 60% of GDP; and to seek to maintain their public finances at close to a budgetary balance or surplus in ordinary circumstances. The key provisions of the SGP are outlined in Box 1.1 below.

[1] pg 11, *Report of the Special Group on Public Service Numbers and Expenditure Programmes*, July 2009.

Box 1.1 The Stability & Growth Pact (SGP)

The EU Treaty provides at Article 121 that "Member States shall conduct their economic policies as a matter of common concern and shall coordinate them with the Council". Article 126 requires that "Member States shall avoid excessive government deficits", having regard to upper limits of 3% of GDP in the case of deficits, and 60% of GDP in the case of government debt levels. Article 126 also provides for an "excessive deficit procedure" which may culminate in the levying of a fine on the Member State concerned.

The Treaty provisions above are elaborated upon in the Stability & Growth Pact. At present, the SGP is made up of three key documents:-

- the Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact;
- Council Regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. This sets out the 'preventative' dimension of the Pact, requiring Member States to set out annual medium-term macroeconomic programmes (stability and convergence programmes), which are assessed by the Commission and the Council; and
- Council Regulation (EC) No. 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure. This specifies the 'corrective' dimension of the Pact in more detail.

These Regulations (which form part of EU law) were modified in 2005 on foot of the Council Report of 20 March 2005 on improving the implementation of the Stability and Growth Pact.

Over the past year, in response to severe difficulties experienced by almost all EU Member States in managing their public finances, proposals have been developed at EU level for strengthening the provisions of the SGP, and making the EU and national systems of economic governance more effective. The key elements of these proposals are as follows[2]:-

- The annual EU processes for policy coordination and monitoring should be made clearer, with the creation of an "EU semester" in the early part of the year, during which all Member States would set out their broad medium-term budgetary and economic plans, in advance of the national budgetary procedures later in the year.

- To prevent Member States from running into difficulty with public finances, a new "principle of prudent fiscal policy-making" should be adopted, whereby annual expenditure growth should be kept at or below a prudent, medium-term rate of growth for the economy, unless additional expenditure is financed through additional tax measures.
- Clearer annual targets should be set to bring about a reduction in excessively high debt levels.
- Enforcement of the SGP provisions should be stepped up, by requiring Member States to lodge financial deposits which may be turned into a fine, if a Member State has not taken action to comply with the SGP. The voting procedures at EU level would also be modified to promote effective decision-making.
- More detailed and systematic monitoring of macroeconomic imbalances and 'bubbles' will be introduced, with a new "excessive imbalance procedure" to require Member States to correct imbalances that might put at risk the functioning of EMU.

[2] A full list of European Commission reform proposals can be found at: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm

- All Member States should be required to put in place strong fiscal frameworks, which should include the following elements:-
    - an effective medium-term budgetary planning horizon (at least three years) with detailed projections for the main areas of expenditure and revenue;
    - numerical fiscal rules to bring public finances back into line with SGP obligations;
    - clear and credible budgetary forecasts, with a possible role for an independent fiscal council.

EU leaders agreed last year that the proposed EU semester would be introduced from 2011, with the annual Stability Programme to be brought forward to April. The other proposals for reforming economic governance are currently under discussion at EU level.

1.5 Oireachtas Proposals for Fiscal Reform

Several of the specific budgetary reform proposals set out under 1.4 above would be appropriate to Ireland's circumstances, whether or not required under EU law. Indeed, it is notable that the Joint Oireachtas Committee on Finance and the Public Service produced a detailed report in November 2010 on "Macroeconomic Policy and Effective Fiscal and Economic Governance". The Report, which took account of a specially-commissioned analysis by Prof. Philip Lane of Trinity College Dublin, addresses similar topics and includes a range of recommendations, some of which are similar to those emerging from the EU process.

The key proposals of the Joint Oireachtas Committee relevant to the subject of this Discussion Paper can be summarised as follows:-

- Governments should be required to set out a timescale for getting public spending levels and tax levels back onto a sustainable trend level.
- Estimates of Expenditure should be re-formatted, from the 2011 Estimates onwards, to link all activity, administration and other costs against projects.
- Multi-annual budgeting should be introduced, with overruns in one year balanced by under-runs in subsequent years.
- Fiscal rules should be introduced, taking account of recommendations from an All Party Oireachtas Committee.
- The Department of Finance should develop its modelling and surveillance capacity, with the setting up of a specialist macroeconomic analysis unit.
- An independent Economic Advisory Council would assess the fiscal objectives of the previous Budget, suggest budgetary adjustments to be considered when deviations from the trend level occur, and comment on the effectiveness of policy and forecasting.
- A separate Budgetary Review Council would monitor and analyse the economy and develop policy scenarios, and possibly analyse scenarios proposed by opposition members of the Oireachtas. This Council would also prepare an annual fiscal monitoring report to evaluate fiscal policy outcomes relative to targets, and evaluate whether the fiscal position is sustainable.
- The Budgetary Review Council should monitor compliance with fiscal rules, and it (or the Economic Advisory Council) should recommend suspension and reintroduction of the rules in appropriate circumstances.
- A "rainy day account" reserve fund should be established, rather than draw upon the National Pension Reserve Fund for various contingencies.

1.6 Reform proposals under the National Recovery Plan 2011-2014 and EU/IMF Programme of Financial Support

Building on previous commitments made in *Budget 2010*, the *National Recovery Plan 2011-2014*, published in November 2010, outlined a range of budgetary reforms which are in line with the EU proposals, and which also reflected certain recommendations of the Joint Oireachtas Committee.

In particular, section 3.5 of the Plan set out the following specific proposals for fiscal reform:-

- A reformed annual budget process, with draft medium-term plans submitted with the annual Budget in December, and subject to a process of consultation before final plans are submitted to the EU each April; the subsequent Budget would then be framed on the basis of the medium-term plans.
- A new Medium Term Expenditure Framework with multi-annual ceilings for expenditure in each area, to ensure that public expenditure is managed within fixed, sustainable limits and to guide the planning and delivery of structural reforms.
- An independent Budget Advisory Council to provide an independent commentary on the Government's budgetary plans and forecasts.
- The introduction of "performance budgeting" to set out more clearly the public service outputs and impacts of spending programmes in the annual Estimates, and to show the totality of financial and staffing resources associated with each programme.
- A Fiscal Responsibility Law to put key reform measures on a statutory basis and to put the principle of keeping the public finances on a sustainable footing into law.

These reform proposals form part of the agreement entered into with the EU/IMF. Specifically, the EU/IMF Programme includes explicit commitments on the part of Ireland to the reformed budget formation process in a time-bound manner; a Fiscal Responsibility Law to include provision for a medium-term expenditure framework with effective multi-annual ceilings on expenditure; and an independent Budget Advisory Council to be established in 2011.

Taking account of these explicit commitments, this Discussion Paper has been prepared, and seeks to set out some credible options and proposals for giving operational effect to these measures.

2. Fiscal Rules

2.1 Rationale and principles for Fiscal Rules

The soundness and stability of the public finances is a key barometer of the health of the economy, and of its ability to generate resources to fund public services in a sustainable manner. Sound public finances also underpin confidence in all sectors of the domestic economy, and among international investors, and this in turn helps to support growth and job creation.

For these reasons, the EU Treaty and the Stability & Growth Pact contain strong commitments on the part of all EU Member States to manage public finances in a prudent and sustainable fashion. Economic developments over the past number of years, across a broad range of Member States, illustrate that domestic institutional arrangements have not been sufficient to make good on these commitments.

More generally, there has been growing international recognition of the desirability of adopting effective rules and principles to govern the conduct of fiscal policy. 'Fiscal rules' – which can be defined as 'any permanent constraints on the conduct of fiscal policy in terms of one or more measures of fiscal performance[3] – are seen as useful for governments in helping them to resist an inherent 'pro-cyclical' bias in fiscal policy (see section 2.4 and Box 2.4 below for more details on cyclical effects). In essence, the rationale goes, those lobbying for additional expenditure or tax reliefs usually pay insufficient attention to the government's 'inter-temporal budget constraint', which requires that all government expenditure must ultimately be paid for either by existing or by future taxpayers[4].

In practice, there is a variety of fiscal policy rules in place across various OECD countries, based variously upon the budget balance, public sector borrowing, or the level of public sector debt. Rules can be designed to give effect to (or support) fiscal consolidation objectives or to underpin ongoing fiscal discipline. A common principle is that, by increasing the credibility of a government's budgetary policy, such rules can help lower the cost of government borrowing. Effective fiscal rules can also reinforce broader monetary policy by reducing the perceived risk that unsustainable public sector deficits might be 'monetised', e.g. by printing new currency and bringing about higher inflation rates.

It is generally accepted that, for any fiscal rules to be useful and effective, they should take account of a number of principles of good practice, the most important of which are as follows:-

- *Simple:* Rules should be easy to understand by all, rather than framed in technical terms.
- *Clearly defined and transparent:* A fiscal rule should make clear which indicator is to be targeted, which institutions are affected, and any specific escape clauses, in order to avoid ambiguities and ineffective enforcement. The rule should be capable of being monitored in a transparent way in government plans.
- *Adequate:* Fiscal rules should be adequate in terms of achieving their stated goal. Meeting a rule, which is in itself ineffective in achieving debt-sustainability (for example), would be counter-productive.
- *Flexible:* Rules must be flexible to accommodate external shocks beyond the control of the authorities. Overly-mechanistic rules, which would not allow a government to respond appropriately in all circumstances, would not command enduring support and are not appropriate.

[3] G. Kopits and S. Symansky (1998), 'Fiscal Policy Rules' (IMF, Washington DC, *Occasional Paper No 162*)
[4] See for example: Carling R. and Kirchner S. (2009), 'Fiscal Rules for Government: Reforming Australia's Fiscal Responsibility Legislation' (Centre for Independent Studies, *Policy Monographs: 98*)

- *Enforceable:* It should be clear from the outset what processes will be used to apply and enforce the fiscal rules in practice. Institutional arrangements in this regard vary widely across countries, ranging from financial and judicial sanctions, to oversight by independent fiscal institutions, and/or parliamentary accountability mechanisms, with associated reputational implications for government.

Selecting particular country-specific fiscal rules is a matter for careful political consideration, as recognised by the Joint Oireachtas Committee on Finance and the Public Service in its Report of November 2010 (see section 1.5 above). On the basis of the above considerations, this Chapter sets out some proposals for new fiscal rules that may be appropriate for Ireland, to introduce greater clarity and transparency into the overall management of the public finances, and to provide both the Government of the day and the public at large with useful 'benchmarks' against which to assess official policy. In particular, sensible fiscal rules will underpin the credibility of the Irish State, both domestically and internationally, as regards our ability to manage our affairs in a responsible way.

2.2 Correcting the Public Finances

Ireland is now, and is likely to be for several years to come, in a 'correction' or 'consolidation' phase whereby we must bring our public finances back to a sustainable position. The Government's *National Recovery Plan 2011-2014* and *Budget 2011* specifies certain fiscal commitments for the coming years, and these are reflected in the EU/IMF Agreed Programme of Support.

More generally, taking account of the experience of the recent past, it would be a sensible course of action to set down a 'public finances correction rule', which would specify a minimum annual course of budgetary correction to which the State would be committed. Such a rule would form a basis for the pursuit of more sustainable public policy over the longer term.

2.2.1 When is a budgetary correction required?

In designing such a rule, the first question is how to identify when a budgetary correction is required. A straightforward approach is to link this rule to the budgetary parameters laid down in the EU Treaty – a 3% maximum deficit level, and a 60% maximum level for government debt (both expressed on a "general government" basis which includes all of the government sector, including local authorities). On this basis, the correction rule would apply whenever Ireland is (or is projected to be) running a budgetary stance that is likely to conflict with these deficit and debt limits. The precise pace of correction under a fiscal rule could be adjusted to take account of the severity of the position of the public finances.

2.2.2 How should a correction be specified?

The next question is how to specify a minimum correction to the public finances. The most obvious target is the deficit or debt levels themselves – e.g. such a fiscal rule might require the Government to reduce the overall budget deficit as a percentage of GDP or reduce the debt ratio by a certain minimum amount each year. A difficulty with this simple type of approach, however, is that these ratios are influenced by factors not directly under the control of Government: principally, interest rates and the growth rate of GDP. This means that such a basic 'fiscal rule' may be breached, despite whatever reasonable action may be taken by Government; and the credibility of the rule as a benchmark of good fiscal behaviour would be undermined.

For these reasons, a more appropriate target for budgetary action would be the underlying budgetary balance, or the 'primary' budget balance, which excludes interest costs. While the primary balance is also impacted by growth prospects, the Government can directly influence the primary balance from year to year through its tax and expenditure policies. Favourable economic growth, which boosts tax revenues and brings down social welfare and other "demand-led" expenditures, would also tend to move the primary balance in a positive direction. Moreover, the primary budget balance has a direct bearing upon budgetary sustainability – see Box 2.1 below.

Box 2.1 Debt Dynamics and the Primary Budget Balance

The sustainability of the public finances concerns the behaviour of the ratio of debt to GDP. This behaviour is determined by the interaction of the following variables: the initial stock of *government debt* outstanding, the *average interest rate* on government debt, the rate of nominal *GDP growth*, and the government's *primary budget balance* (i.e. the underlying balance between revenues and expenditure, not including debt-interest costs).

When the interest rate is higher than the growth rate of GDP, there will be a tendency for the ratio of debt to GDP to rise. To offset this tendency, the government must run a surplus on its primary budget balance. The size of the primary surplus required will depend on the margin by which the interest rate (both its present rate and future expectations) exceeds the GDP growth rate and on the initial stock of debt. In general, the greater the gap between the interest rate and the growth rate, and the higher the stock of debt, the bigger the primary surplus that is needed to stop the debt ratio from rising, i.e. to stabilise the debt ratio.

For example: if the average interest rate on government debt is 6%, GDP is growing by 4% (in nominal terms) and the debt/GDP ratio is 100%, then a primary budget surplus amounting to 2% of GDP would be needed to stabilise the debt ratio. In these conditions, a primary surplus smaller than 2% (or a primary deficit) would cause the debt ratio to increase further; a larger primary surplus, on the other hand, would cause the debt ratio to fall.

Since the onset of the current economic and financial crisis, Ireland has been running a large primary budget deficit and experiencing a contraction in GDP which has given rise to an exceptionally large margin between the interest rate on government debt and the rate of change in GDP. The result of this combination of circumstances has been an enormous rise in the stock of debt and the debt ratio.

Of course, there have been protracted periods during which the opposite combination has been in place. Throughout most of the 1990s and the early years of the past decade, the rate of growth in GDP was higher than the interest rate on government debt (in some years by a very substantial margin). In these circumstances, a primary budget deficit would have been consistent with a reduction in the debt/GDP ratio. In the event, primary surpluses were typically achieved during this period, as a result of which the debt/GDP ratio fell sharply.

Budget 2011 projects the primary budget balance to move from a deficit of -9.2% of GDP in 2011 (excluding one-off and temporary measures) to a surplus of 2.7% of GDP by 2014.

2.2.3 What level of budgetary correction should be targeted?

The overriding objective of a fiscal correction rule should be to move the public finances decisively in the direction of sustainability, and to allow for public debt levels to be stabilised and brought down. Government action to correct the public finances involves moving the primary budget balance from a deficit position towards a balanced or surplus position. At a certain point, rather than continue to increase the primary surplus, it will be sufficient to maintain it at a certain level so as to ensure debt-sustainability and satisfactory debt-reduction. The questions that arise, therefore, are *(i)* what minimum annual pace of budgetary correction should be targeted, and *(ii)* what level of primary surplus is sufficient, beyond which a fiscal rule need not require a further annual increase?

Under the terms set out in *Budget 2011*, the primary budget balance is projected to improve by approximately 2½% of GDP on average each year until 2014. This will involve considerable and sustained fiscal consolidation, at the upper end of what has been achieved heretofore in any other OECD country. After 2014, some further improvements will likely be needed over subsequent years to bring about further reductions in the debt level, which is currently projected to stand at around 100% of GDP by 2014 on the basis of the information known at the time of *Budget 2011*.

As a general principle, it would seem appropriate to target a minimum annual improvement that takes account of the severity of position of the public finances. A standard annual improvement of the order of 1½% in the primary balance would be an appropriate *minimum* adjustment, in circumstances where an excessive deficit, or an unsustainably high debt position, need to be addressed. (It would of course be open to a Government to plan for a more rigorous fiscal correction, if considered appropriate.) When an acute threat to budgetary sustainability has eased, a more modest *minimum* improvement in the primary balance could be set for each year.

The detailed budgetary equations governing debt-sustainability are quite complex[5], but some useful parameters are outlined in Table 2.1 below. The table shows that maintaining a primary budget surplus of around 2½% of GDP would bring about a reduction of 30 percentage points in the debt ratio over 15 years, under a certain central set of economic assumptions. A faster 10-year reduction would require a sustained primary balance of around 3½%. These results are fairly sensitive to the economic assumptions used: more pessimistic assumptions regarding economic growth and interest rates would require higher primary surpluses to achieve similar rates of debt reduction[6]. Naturally, the higher the primary surplus that is run (whether through discretionary fiscal action, or the positive effects of economic buoyancy, or both), the more quickly the debt level will be run down.

Table 2.1 ***Debt Dynamics under various assumptions***

Primary Budget Balance (expressed as % of GDP) required to reduce an initial Debt level to a final Debt level over a certain time period:-			
	*Economic assumptions used:**		
Debt reduction:	*Pessimistic*	*Standard*	*Optimistic*
120% to 90% of GDP over:-			
20 years	3.7	2.1	0.4
15 years	4.2	2.6	0.9
10 years	5.2	3.6	1.9
100% to 70% of GDP over:-			
20 years	3.3	2.0	0.6
15 years	3.8	2.5	1.1
10 years	4.8	3.5	2.1
80% to 50% of GDP over:-			
20 years	2.9	1.9	0.8
15 years	3.4	2.4	1.3
10 years	4.4	3.4	2.3

* Pessimistic scenario: nominal GDP growth 4.0%, interest rate 6.0%; Standard scenario: nominal GDP growth 4.5%, interest rate 5.0%; Optimistic scenario: nominal GDP growth 5.5%%, interest rate 4.5%

[5] For further details of the precise budgetary equations governing debt sustainability, a useful technical summary document is at http://www.imf.org/external/pubs/ft/tnm/2010/tnm1002.pdf

[6] While the levels of *primary* surplus required for a given increment of debt-reduction are fairly stable, across different assumptions regarding the starting debt level the *overall* budgetary balance would be more favourable at lower debt levels owing to the significantly lower debt-servicing costs (which are not reflected in the primary balance).

2.2.4 Unadjusted or Cyclically-adjusted targets

A final consideration is whether the annual improvement in the primary surplus, and its upper limit, should be expressed in unadjusted terms or in 'cyclically-adjusted' terms (i.e. correcting for the stage of the economic cycle).

- The latter approach has the advantage of being less 'pro-cyclical' in nature, i.e. not adding to a boom or delaying a recovery (see discussion on this point under section 2.4 below).
- On the other hand, setting a limit in unadjusted terms is more transparent and as such easier to track. This is particularly so in the case of Ireland's small, open economy where there are difficulties associated with calculating the cyclically-adjusted budget balance (see also Box 2.5 below).
- Moreover, the SGP ceilings on deficits and debt levels are set in unadjusted terms; therefore it would be appropriate to take clear and measurable steps to correct any breach of these ceilings.

On balance, it is proposed that straightforward unadjusted targets should be set for improvement to the primary balance, when the public finances are in 'correction' mode. A different approach would, however, be recommended for management of the public finances in more normal times – see 2.3 below.

2.2.5 Summary – Proposed "Public Finances Correction Rule"

It is proposed that a "public finances correction rule" should have the following elements:-

- Whenever the State is in breach of the EU's 3% deficit and 60% debt ceilings, the primary budget balance should be improved by **at least 1.5% of GDP each year.**

- If the State has brought the deficit to below 3% of GDP, but the debt level is still above 90% of GDP, then this minimum pace of consolidation should be maintained until the debt level falls below this level. Progressive savings in debt-interest costs should allow for a speedy adjustment to below the 90% figure – a figure that is viewed by many market participants as a key benchmark of ongoing sustainability.

- If the deficit level is below the 3% ceiling, and the debt figure has been brought back below the 90% threshold, then debt dynamics become more favourable, and a **less onerous annual consolidation of 0.75% of GDP** (at minimum) in the primary balance should be targeted, until the debt figure is also back within its ceiling of 60% of GDP.

- Once the primary balance has moved into surplus, then it may be sufficient to maintain it at a certain level rather than increase it further. Accordingly, the fiscal rule might specify that further improvements in the primary balance are not automatically required beyond a **surplus level of 4% of GDP** (having regard to the parameters set out in Table 2.1 above)**.** Of course, it would be open to a Government to target a higher primary surplus if it considered this appropriate – however a fiscal rule should not, it is suggested, seek to curtail Government discretion beyond this point.

A draft Head for inclusion in a Fiscal Responsibility Bill is set out at Box 2.2 below, illustrating how a Public Finances Correction Rule might be framed. It should be acknowledged that the parameters proposed above are related to the economic assumptions used (and the associated calculations set out at Table 2.1 above); changes or updates to these assumptions might have a bearing upon the final parameters chosen. In any event, the core objective of such an approach is to provide clear, numerical targets for correcting serious imbalances in the public finances, in a way that is effective and economically justified.

Box 2.2 draft *Head A – Public Finances Correction Rule*

(1) If the General Government Deficit or the General Government Debt of the State exceeds or is projected to exceed the appropriate reference value (respectively 3% or 60% of GDP) in any year that is the subject of the Budget or the Stability Programme, then *subject to Head D** the provisions of *subsection (2)* shall apply in respect of the subsequent year or years.

(2) In any year to which this subsection applies, the following rule shall be observed:-

- a) the primary budget balance as a percentage of the relevant forecast for Gross Domestic Product for that year shall be improved by at least the following amount, *viz.:*
  - i. the minimum consolidation amount as specified in *subsection (3);* or, if lower –
  - ii. such an amount as will cause both the General Government Deficit and the General Government Debt not to be in excess of the appropriate reference values in that year;

  provided that the primary budget balance shall not be required to be improved in any year, by virtue of the operation of this section, beyond a surplus of 4 per cent. of Gross Domestic Product.

(3) The minimum consolidation amount shall be:

- a) 1.5 percentage points, in the case where the General Government Deficit is (or is projected to be) in excess of the appropriate reference value or a General Government Debt level is (or is projected to be) in excess of 90% of Gross Domestic Product, in any particular year referred to in *subsection (1);* and
- b) 0.75 percentage points, in other cases.

**Head D – see section 2.5 for discussion of 'exceptional provisions' clause.*

2.3 Moving towards Medium-term Stability: a "Prudent Budget Rule"

Apart from avoiding excessive deficits and excessive debt levels, Ireland is committed under the Stability & Growth Pact to identifying a 'medium-term objective' of fiscal policy, which should aim at running annual budgets 'close to balance or in surplus' (see Box 2.3 below). The precise budgetary objective, which may vary from country to country, should be designed to provide a reasonable 'safety margin' against the risk of running an excessive (above 3%-of-GDP) deficit over the course of the economic cycle.

In several countries, the medium-term budgetary objective is a key anchor within the national fiscal framework, serving to orient aggregate budgetary policy, and as a focus for public and political accountability on this matter. Chapter 3 gives further details about the medium-term budgetary objective, including how it should be specified in Ireland's case and how it should feature in the proposed new medium-term fiscal framework.

Box 2.3 The "medium-term budgetary objective"

Under the Stability & Growth Pact (SGP), all Member States should adopt a medium-term budgetary objective (MTBO) which provides a "safety margin" against breaching the 3% deficit limit. The objectives should be country-specific, and in the case of euro area countries the objectives "shall be specified within a defined range between –1% of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures." The SGP also requires that each country should set out its MTBO, and the multi-year adjustment path of its public finances towards this objective, in a "Stability Programme" which should be updated each year.

In selecting an appropriate MTBO, countries would need to take account of a number of factors including the sensitivity of their public finances to changes in the economic cycle (see Box 2.5), and the desirability of setting a clear public target for sound budgeting. In Sweden, for example, the public finances are managed so as to ensure that a structural budget surplus of 1% of GDP is maintained over the economic cycle.

While Ireland still has a significant degree of budgetary consolidation ahead before we approach a balanced budgetary position, it is proposed that a clear MTBO should be a central anchor within our medium-term fiscal framework into the future. The precise specification of the target would be a matter for each Government to decide, and would be reflected clearly in the annual Stability Programme.

In circumstances where Ireland is not running an excessive deficit or debt level, but Ireland has not yet reached the medium-term objective as established by the Government, it would be appropriate to specify an annual adjustment path to move the public finances in this direction. It is proposed that the annual adjustment path, to be laid down each year in the updated Stability Programme (see sections 3.2-3.3 below), should be framed by reference to a "prudent budget rule". Such a fiscal rule would be similar in nature to the Public Finances Correction rule but the specified minimum adjustment can be smaller, since underlying debt dynamics would be more favourable in these circumstances. Moreover, as the medium-term objective is expressed in cyclically-adjusted terms (in order to allow for a counter-cyclical approach to budgetary management – see discussion on this point under section 2.4 below), it is appropriate that the annual improvement under this rule should also be calculated in such terms.

Accordingly, it is proposed that the Prudent Budget Rule should specify a minimum annual improvement of the primary budget balance of **0.5% of GDP** in cyclically-adjusted terms**,** until the medium-term objective has been reached.

A suggested draft Head of a Prudent Budget Rule is provided in Box 2.4 below.

Box 2.4 draft *Head B – Prudent Budget Rule*

(1) If, in any year that is the subject of the Budget or the Stability Programme, not being a year to which *subsection (2)* of *Head A* applies*, the General Government Deficit exceeds or is projected to exceed the medium-term budgetary objective specified by the Government, then *subject to Head D*+ the provisions of *subsection (2)* shall apply in respect of the subsequent year or years.

(2) In any year to which this subsection applies, the cyclically-adjusted primary budget balance as a percentage of the relevant forecast for Gross Domestic Product for that year shall be improved by at least the following amount, *viz.:*

a) 0.5% percentage points; or, if lower –
b) such an amount as will cause the General Government Deficit not to exceed the medium-term budgetary objective in that year;

provided that the primary budget balance shall not be required to be improved in any year, by virtue of the operation of this section, beyond a surplus of 4 per cent of Gross Domestic Product.

** this clause ensures that the "prudent budget rule" does not apply whenever the "public finances correction rule" is in operation.*
+*Head D – see section 2.5 for discussion of 'exceptional provisions' clause.*

2.4 Managing in Good Economic Times: a "Sustainable Expenditure Growth Rule"

Once the public finances are back at a sound underlying position, and in compliance with SGP rules in relation to the 'medium-term objective', a key objective of fiscal policy is to prevent the emergence of fiscal trends which might put this hard-won position at risk. Indeed, as the last decade has shown, the fiscal challenges presented by times of economic 'boom', when resources are plentiful, can be more difficult to identify and to manage than the fiscal challenges arising in times of economic downturn, when at least the required policy action is clear.

At EU level, a central proposal in the reform of the 'preventative' aspect of the Stability & Growth Pact is the need to focus upon controlling overall expenditure growth. This is because discretionary public expenditure tends to accelerate during economic 'good times'; while in economic downturns, when a gap might emerge between revenues and overall expenditure (leading to escalating public deficits), it is difficult to rein spending back in again – both because of additional costs that arise in an economic downturn (e.g. unemployment payments) and because of the disruption that is felt by citizens when public benefits are scaled back, quite apart from the negative impact that fiscal consolidation may have on economic growth.

In other words, public expenditure policy in general tends to be "pro-cyclical" – i.e. spending tends to expand more than it should in 'good times', when ideally it should be managed tightly so as to control economic activity back towards its underlying trend level and prevent the emergence of 'bubbles'; and this in turn means that discretionary spending tends to be curtailed sharply in economic downturns, when ideally the Government should have some leeway to inject further spending into the economy so as to provide some measure of appropriate economic stimulus. Pursuing 'counter-cyclical' policies provides this leeway by storing up surpluses in the years of strong growth. Arguably, pursuing such counter-cyclical fiscal policy is even more important for countries operating in an Economic and Monetary Union where fiscal policy at national level is the principal remaining tool of macroeconomic policy.

Box 2.5 The "underlying rate of economic growth"

In general terms, *'economic growth'* may be defined as growth in the value of goods and services produced in an area; or growth in the level of income generated by those living in an area; or growth in the standard of living of the inhabitants of an area.

Gross Domestic Product (or GDP) is a standard international measure of economic activity, and can be defined as the total monetary value of goods and services produced within a country within a given timeframe. The underlying or 'trend' growth rate of GDP is the rate of growth which would prevail if there were no cyclical factors at work.

Cyclical factors, in economic terms, are those variations in aggregate economic activity arising from either a systematic acceleration or a deceleration of activity throughout the economy generally, or throughout key sectors of the economy; both the acceleration and deceleration being greater than would be warranted by reference to the underlying growth capacity of the economy. Cyclical expansions (or 'booms') can arise where demand leads to levels of production above what is sustainable by reference to underlying growth factors in the economy: in such circumstances, nominal GDP growth is higher than the trend growth rate. Cyclical downturns can arise where consumer demand is depressed, and/or during the correction phase of an unsustainable period of expansion: in such circumstances, nominal GDP growth is lower than the trend growth rate.

The theory and modelling of the 'economic cycle' or 'business cycle' is complex, but essentially involves a calculation of the growth capacity of the economy, by reference to the underlying growth rate in supply side factors such as the labour force and labour productivity. The trend growth rate has to be estimated using statistical formulas (unlike actual or nominal GDP which can be measured). There are a variety of techniques available to estimate the trend growth rate but there is no universally-agreed approach. Moreover, in an open economy such as Ireland, estimates of trend growth are subject to more uncertainty than elsewhere (for instance, it is very difficult to capture the underlying growth rate in the labour force given the openness of the labour market / migration).

However, the Department of Finance does produce regular estimates of the trend growth rate based on a harmonised methodology developed for all Member States by the European Commission. Other measures and models have been developed by bodies such as the ESRI and the Central Bank of Ireland. It would be anticipated that one of the proposed functions of a Budget Advisory Council would be to provide an independent assessment and critique of the official economic forecasts produced by the Department of Finance as well as taking account of other relevant forecasts (see Chapter 5).

Accordingly, a sensible rule of fiscal policy in such circumstances is to **maintain expenditure growth in line with the underlying rate of growth in the economy.** This would prevent expenditure from running ahead of the underlying ability of the economy to generate resources, and would allow for spending to be managed in a counter-cyclical way, helping to smooth the economic cycle and prevent the emergence of imbalances or "bubbles". Estimating the "underlying rate of growth" in the economy is a difficult technical issue, but practical approaches are available (as discussed in Box 2.5 above).

It may be advisable to restrict this rule to current expenditure, and to exclude capital expenditure from its scope. This is because (i) current expenditure is much less amenable to discretionary adjustment than capital expenditure, and therefore poses more problems for budget sustainability; and (ii) the restriction would reduce the scope for policy-makers to meet – or appear to meet – budgetary targets by cutting into capital expenditure (which is often linked to investment in the productive capacity of the economy) while shying away from the need to address underlying issues in current expenditure management. A draft Head of such a Sustainable Expenditure Growth Rule is set out in Box 2.6 below.

Box 2.6 **draft *Head C – Sustainable Expenditure Growth Rule***

(1) Subject *to Head D*⁺, in any year that is the subject of the Stability Programme, not being a year to which *subsection (2)* of *Head A* or *subsection (2)* of *Head B* applies*, Gross current Government expenditure shall not be planned to increase relative to the previous year at a rate greater than the underlying, medium-term nominal rate of economic growth referable to that year, unless and to the extent that a higher rate of growth in any year in such expenditure is met by a discretionary increase in tax receipts referable to that year.

** this clause ensures that the "sustainable expenditure growth rule" does not apply whenever the "public finances correction rule" or the "prudent budget rule" is in operation.*
+Head D – see section 2.5 for discussion of 'exceptional provisions' clause.

2.5 Status and application of the proposed Fiscal Rules

The fiscal rules are intended to set out clear and sensible guidelines for managing the public finances, against which official targets can be set and assessed by the Government, the Oireachtas and the general public. The rules should be seen as mandatory, i.e. rules which the Government of the day is obliged to respect when preparing its medium-term fiscal plans (see Chapter 3 for further details of the proposed fiscal planning framework), as distinct from purely aspirational or discretionary guidelines.

However, it would not be appropriate for any legislative or administrative provisions to seek to remove all discretion from a Government in managing the fiscal affairs of the State. Exceptional circumstances may arise (e.g. natural disasters or health-related national emergencies) when a Government may consider it necessary to set aside fiscal rules on a temporary basis. Indeed, the Stability & Growth Pact already recognises that fiscal targets may need to be adjusted in times of 'severe economic downturn', and the draft EU Directive on Budgetary Frameworks acknowledges the need to provide for exceptional circumstances when the normal rules of fiscal management should be suspended.

Accordingly, it is proposed that the fiscal rules should be balanced with an "exceptional provisions" clause, whereby the Government of the day may deviate from the rules when preparing its medium-term fiscal plans, **provided that it sets out its reasons in writing** when it lays its plans before the Dáil. The Dáil would then consider and debate the fiscal plans on the basis set out in Chapter 3.

In other words, what is proposed is a **"comply or explain" approach,** which has as its starting point the expectation that the Government of the day should comply with the fiscal rules; but allows the Government the flexibility to deviate from these plans if necessary, provided that it explains its reasons for doing so to the Dáil. To ensure that such a procedure would not come to be abused, it may be appropriate to require that any such explanation should also be formally approved by the Dáil. It is suggested that this approach strikes an appropriate balance between the requirements of a normative fiscal framework, the executive responsibility of the Government, and proper transparency and accountability to the Dáil as regards the exercise of this responsibility. Box 2.7 below sets out a suggested draft Head for inclusion in a Fiscal Responsibility Bill to provide for such an approach.

Box 2.7 draft *Head D – Exceptional provisions*

(1) The relevant provisions of *Heads A, B, C, E* and *F* shall not apply in any circumstance where, in the opinion of the Government, the temporary lifting of the relevant provisions is justified by reference to
  a) the existence of a state of national emergency
  b) a severe macroeconomic disturbance, or
  c) such other exigencies as may be specified,

  provided that this opinion is set out by the Minister for Finance in a statement made to and approved by Dáil Éireann.

(2) Any such statement shall be made to Dáil Éireann either at the time of presentation of the Budget or the Stability Programme, as appropriate, or at such earlier date as the Minister for Finance may consider appropriate.

(3) Any such statement shall also specify the period of time during which the Government considers it appropriate that the relevant provisions should be temporarily lifted.

As regards the period of application of each rule, each of the proposed fiscal rules is designed to be of relevance to different stages of the economic cycle and different stages in the evolution of the public finances – from periods when fiscal correction is needed (as at present), to achieving medium-term budget balance, through to more favourable economic times. It is proposed that only one fiscal rule should be in operation at any one time (the draft Heads in Boxes 2.2, 2.4 and 2.6 provide for this). This approach will provide clear guidance as to which rule should inform fiscal policy, and avoid any confusion or ambiguity on this point.

It is also proposed that the fiscal rules should have effect prospectively rather than retrospectively. In other words, the rules would apply to the fiscal plans set down by the Government for future years; but if it should transpire that the budgetary position in those years does not match the fiscal rules (e.g. because economic growth, tax revenues or demand-driven expenditure growth have deviated significantly from earlier forecasts), this would not in itself represent a 'breach' of the rules. It should be noted that the Government's fiscal plans and forecasts would be subject to independent assessment and critique by the Budget Advisory Council (see Chapter 5), and that the Government would be required to present a new fiscal plan every year, updated as necessary to ensure that the medium-term objective is maintained or achieved (see Chapter 3).

Finally, given that the primary means of ensuring compliance with the fiscal rules is through accountability before Dáil Éireann, it is for consideration what role the Courts should have in these matters. In the UK, for example, the Courts are excluded under the *Fiscal Responsibility Act 2010* (see Box 2.8 below). It would be a matter for Government, in light of advice from the Attorney General's Office, to consider what is legally appropriate in an Irish context.

Box 2.8 The UK's *Fiscal Responsibility Act 2010*

As part of its own national framework of budgetary management, the UK introduced a Fiscal Responsibility Act in 2010 which includes (under sections 1 and 2) some requirements for progressive reduction of net public borrowing and debt levels, and provision for other fiscal rules. The Act requires (under section 3) the laying of regular progress reports and compliance reports before Parliament.

On the question of accountability for compliance, the UK Act provides as follows under section 4:-

4. Accountability to Parliament

(1) Each report made under or by virtue of section 3 must be laid before Parliament.
(2) The only means of securing accountability in relation to—
 (a) the duties in section 1, and
 (b) duties imposed by orders under section 2,
is that established by the provision made by or under section 3 for the making of progress reports and reports as to compliance and the duty imposed by subsection (1).
(3) Accordingly, the fact that—
 (a) any duty in section 1, or
 (b) any duty imposed by an order under section 2,
has not been, or will or may not be, complied with does not affect the lawfulness of anything done, or omitted to be done, by any person.

3. Medium Term Fiscal Planning

3.1 Existing multi-annual budgeting procedures

While Ireland's established procedures for annual expenditure management are robust, as outlined in Chapter 1, the mechanisms for medium-term budgeting have not kept pace with best practice internationally. External commentators including the IMF, OECD and European Commission have identified weaknesses in adopting and adhering to multi-annual fiscal plans, and in particular have noted that a firm 'top-down' approach to managing current expenditure growth is lacking. As outlined in section 1.4, the need for an effective medium-term budgetary framework is a key focus of ongoing EU-level discussions on reforming fiscal governance.

Over recent years, a number of multi-annual budgeting mechanisms have been developed.

- Stability Programmes have been prepared each year, in line with the SGP requirements (see section 1.4 above), providing three-year projections for Ireland's main budgetary aggregates and for the evolution of the public finances
- Capital expenditure has been managed on the basis of five-year rolling envelopes since 2004, with provision for carry-over of up to 10% of an unused capital allocation from one year to the next
- Three-year Administrative Budget Agreements have been put in place, governing civil service payroll and administration costs in Government Departments and offices
- Multi-year "Employment Control Frameworks" were introduced in 2009 to manage the progressive reduction in staff numbers across all areas of the public service.

Building on these developments, towards a more comprehensive medium-term framework for fiscal planning, should allow for a firmer collective commitment to budgetary targets and greater planning and control of expenditure.

The publication of a four-year *National Recovery Plan 2011-2014* in November 2010, with fixed targets for tax and expenditure policy over the years ahead, marked a significant step towards full medium-term budgetary planning in Ireland. This Chapter outlines how Ireland's existing budgetary processes can be further developed in support of such an overall approach.

3.2 The annually-updated Stability Programme

Under the Stability and Growth Pact (SGP), euro area Member States must prepare a report on their medium term budgetary strategies, called a Stability Programme (Non-euro members prepare a corresponding Convergence Programme). In this document, which is updated each year, each Government sets out projections for the main economic indicators and budgetary aggregates for future years, and the expected 'trajectory' towards achieving the SGP objective of keeping the public finances close to a balanced position or in surplus over the medium term.

Up to now, the SGP rules have required that the Stability Programme be published before end-November each year, or (in Ireland's case) no later than the December Budget; and that the document cover at least the three years ahead (i.e. the year covered by the annual Budget, plus the two subsequent years)[7]. The multi-annual projections set out in the Stability Programme

[7] No Stability Programme was published with *Budget 2011* (December 2010), because of the publication in November 2010 of the four-year *National Recovery Plan 2011-2014* and the agreed move at EU level to the European Semester.

have tended to be indicative rather than fixed or 'normative' in nature, and are not strictly linked to the annual budget allocations in successive years.

3.3 Building on the Stability Programme for stronger medium-term fiscal planning

The leaders of the EU Member States agreed at the European Council of 17 June 2010 that, as part of the new "EU Semester", the Stability Programme should be brought forward to April of each year, with the subsequent annual Budget framed in line with the Programme parameters. This arrangement will require all countries to spell out their overall budgetary plans at a much earlier stage in the year than has traditionally been the case in Ireland.

Taking account of *Budget 2010* and as subsequently set out in the *National Recovery Plan 2011-2014,* it is now proposed to build on this EU-wide initiative to develop a stronger medium-term element to budgetary planning in Ireland, in keeping with the more general reform of EU fiscal governance arrangements set out in Chapter 1.

The planned approach is to develop the annually-updated Stability Programme into a fully-fledged medium-term fiscal plan, as part of a transparent whole-of-year process of budget formation. This approach will involve the following elements:-

- publication of an initial draft of the Stability Programme in the early part of each year; this will allow for the draft document to be considered by the relevant Oireachtas Committee, and be assessed by the independent Budget Advisory Council;
- having taken account of the outcome of the discussion and debate, the Stability Programme will be finalised and submitted to the EU in April, in line with the requirements of the Stability & Growth Pact;
- the Stability Programme will specify the *medium-term budgetary objective,* towards which the Government is steering the public finances, and will show the annual plans and projections for revenues and expenditure for each of the next three years, in line with this objective – see Box 3.1 above;
- the budgetary projections must continue to take full account of the costs arising from all Government decisions and policies in place over the period of the Programme;
- the Programme will include a detailed analysis and forecast of the economy, with an assessment of risks including any potential imbalances or 'bubbles' within the economy;
- the Programme will also show how the budgetary plans for each year conform to the fiscal rules;
- the proposed Budget Advisory Council will also have a role in assessing whether the rules are complied with, and in providing an independent assessment of the budgetary plans and forecasts (see chapter 5);
- the Stability Programme will include limits or 'ceilings' on expenditure that will apply over each of the next three years (see 3.4 below for more details on this key element of the Programme); and
- taking account of the latest information to hand and also the various policy orientations received both domestically and internationally, the December Budget will be prepared on the basis of the tax and expenditure aggregates set out in the April Stability Programme Update.

In summary, the proposal is to build on existing long-standing features of the Irish budgetary system – the annual Budget and Stability Programme – and institute a new 'top-down' approach to planning and managing the public finances over the medium term. Within this framework, which should ensure overall budgetary sustainability and credibility, Governments and the Oireachtas will continue to exercise their full range of discretion over the design and delivery of specific policy interventions across all areas of Government activity. Box 3.1 below provides indicative draft wording for this.

Box 3.1 Draft *Head E – Medium Term Budgetary and Economic Planning*

(1) At the same time as the Budget is presented each year in respect of a particular year, or within a period of three months thereafter, the Government shall, subject to *Head D**, prepare and present to Dáil Éireann a draft version of the Stability Programme, in which the Government shall set out its preliminary plans and projections for the main economic and budgetary parameters for a period of not less than two years following the particular year.

(2) After taking cognisance of such commentary upon this document as it may consider appropriate, including the assessment provided by the Budget Advisory Council, the Government shall prepare and present to Dáil Éireann a final version of the Stability Programme at such time as it considers appropriate during the course of the particular year mentioned in subhead (1); and, subject to *Head D**, the Government shall proceed to prepare a Budget for the subsequent year in accordance with the budgetary and economic parameters set out in this Stability Programme, taking account of the latest information to hand and various policy orientations it has received.

(3) The Stability Programme shall include a statement of the medium-term budgetary objective, and, subject to *Head D**, the plans and projections contained in this document shall be consistent with the maintenance of, achievement of, or convergence towards, this objective over the period of time covered by the Stability Programme, on the basis of the economic and budgetary information that is available at the time of preparation of each such document.

(4) The Stability Programme shall take full account of the costs and savings projected to arise from the implementation of policies that have been agreed by the Government.

(5) The Stability Programme shall include an assessment of real or potential macroeconomic imbalances and other factors that might, in the opinion of the Minister for Finance, put at risk the achievement of the budgetary plans set out in the document.

(6) Subject to *Head D**, the economic and budgetary parameters set out in the Stability Programme Update shall comply with the fiscal rules, on the basis of the economic and budgetary information that is available at the time of preparation of each such document.

**Head D – see section 2.5 for discussion of 'exceptional provisions' clause.*

3.4 A Medium-term Expenditure Framework (MTEF)

A central element of the proposed fiscal framework is a more definite approach to multi-annual expenditure management, in line with best practice in other countries and taking account of the developments at EU level in terms of fiscal governance reform.

In many economies throughout the EU and elsewhere in the OECD, medium-term expenditure frameworks (MTEFs) are an established feature of overall budgetary and economic management. The various advantages that are cited for MTEFs are summarised in Box 3.2 below.

Box 3.2 Advantages of Medium-Term Expenditure Frameworks (MTEFs)

What MTEFs Do	*How They Do It*	*Who Benefits*
1. Reinforce aggregate fiscal discipline	By constraining budget appropriation and execution in future years to levels consistent with the Govt's medium-term fiscal objectives	Finance Ministers Taxpayers Future Generations
2. Facilitate a more strategic allocation of expenditure	By abstracting from the immediate pressures and legal and administrative constraints that impinge upon the annual budget process	Prime Ministers Planning Ministers Parliamentarians
3. Encourage more efficient inter-temporal planning	By providing greater transparency and certainty to budget holders about their likely future resources	Line Ministries Agencies Local Governments

Source: IMF Fiscal Affairs Department

In order for an MTEF approach to be effective, the following prerequisites are identified by the IMF:-

- *A credible annual budget process* – In Ireland's case, the annual budget process is well-established and is effective in terms of managing budgetary allocations (see section 1.2).
- *Prudent medium-term macroeconomic projections* – Ireland's official record in medium-term economic forecasting compares relatively favourably with other forecasters (see section 5.3). The proposed introduction of a Budget Advisory Council and its oversight role (Chapter 5) would further enhance the credibility both of the annual budget process and of the official forecasting function.
- *A stable medium-term fiscal framework* – Section 3.3 above outlines how the medium-term dimension of fiscal management would be strengthened for Ireland.
- *Comprehensive and unified budget process* – Section 1.3 outlines a number of recent reforms to Ireland's budget process, including the introduction of a unified budget in 2007.

On the basis of the above considerations, it would seem that an effective MTEF process could be introduced successfully in Ireland.

3.5 Elements of an MTEF for Ireland

A new "medium-term expenditure framework" (MTEF) for Ireland was outlined in the *National Recovery Plan 2011-2014,* based on best practice in other EU countries and taking into account the background and preparatory work that has been undertaken within the Irish public service for some time. The key features of the proposed MTEF are:

> *(i) Aggregate Expenditure Levels* – The starting point for an MTEF is a Government decision on an overall, 'top down' upper limit for aggregate voted current spending for the multi-year period ahead, consistent with the broader fiscal targets as set out in the Stability Programme. This limit should be expressed in nominal terms for simplicity and clarity.
>
> *(ii) Governmental Expenditure Assessment (GEA)* – A comprehensive review of all areas of Government spending should be conducted every 2-3 years to assess the relative contribution of each area towards meeting Government commitments, and to evaluate its relative priority in terms of resource allocation policy. This periodic re-evaluation may coincide with new or revised Programmes for Government, and should provide a sound evidence-based approach for a re-orientation of Government policy. Further details on the proposed GEA approach are set out at section 3.7 below.
>
> (*iii) Ministerial Current Expenditure Envelopes* – Once the Aggregate Expenditure Levels are decided, and in light of the outcome of a GEA exercise, the Government should apply nominal cash ceilings for current expenditure within each Ministerial Vote Group (of which there are 15 at present), so that programmes can be managed and prioritised within a fixed, determinate 'envelope' of spending over the multi-annual period. International experience is that this multi-year horizon for spending allocations is essential in order to focus upon meaningful structural reforms.
>
> *(iv) Continuity and Effective Medium-term Control* – The expenditure ceilings should be seen as effective operational limits over the three-year period. The ceilings, including Ministerial envelopes, should be set out each year in the Stability Programme. The subsequent Budget gives effect to the first year of the fiscal plan set out in the Programme, including detailed Estimates of Expenditure in line with the Ministerial envelope. As a rule, the following year's Stability Programme should not vary the previously-set expenditure allocations for *years 1* and *2*, and should roll on the fiscal frame of reference to include a new *year 3.* However, setting sensible 'envelopes', and providing the right balance between firmness and flexibility, is important from the outset – see section 3.6 below.
>
> *(v) Numbers Policy and Administrative Budget Agreements* – The other multi-annual expenditure management mechanisms currently in use – namely the Employment Control Frameworks (ECFs) for controlling staff numbers and the Administrative Budget Agreements – would be subsumed into the overall multi-annual framework. Capital spending, which is subject to multi-annual provisions of its own, would continue to be handled in parallel under these existing arrangements.

The *National Recovery Plan 2011-2014* specified initial expenditure limits for the period to 2014, and set out Ministerial Current Expenditure Ceilings for each year. It will be a matter for an incoming Government to determine whether, and to what extent, these initial limits may have to be adjusted in line with a new Programme for Government.

3.6 Design features of an MTEF: Balancing Control with Flexibility

The risk with any medium-term expenditure framework is that it could become a mechanistic exercise, which is not responsive enough to the needs and priorities of the Government, or to the challenges encountered by Ministers and Departments in managing a complex and diverse range of programmes. It is important to strike an appropriate balance between, *on the one hand,* a firm framework that provides a degree of certainty to policy makers, and assurance regarding the credibility of the overall fiscal plans, and *on the other hand* a flexible approach which allows for sensible adjustments and promotes good expenditure management.

Accordingly, it is proposed that the following specific elements should be factored into Ireland's new expenditure framework.

a) Not all current expenditure shares the same characteristics, or is amenable to multi-annual control in the same way. The different components of expenditure should be disaggregated and subject to discrete treatment. In particular:-

- core "*Demand-led" Schemes* which are sensitive to the economic cycle, such as unemployment payments, should be funded and managed on an annual basis and catered for separately within the overall budgetary planning process;
- *Pay commitments* should be managed on the basis of established multi-annual numbers ceilings (ECFs) and centrally-determined pay policy; and
- in principle, *all other Programme allocations* would also be managed on a multi-annual basis within the Ministerial Expenditure Envelopes.

b) As a general principle, Ministers and their Departments are responsible for managing strictly within the envelope allocation; policy proposals and structural reforms should be drawn up on an ongoing basis, as necessary to keep within this constraint. In particular, policy within each area should be managed fluidly and flexibly to ensure that the imperative of staying within the allocated ceiling is respected. All areas of programme expenditure beyond core cyclically-sensitive support schemes will in effect be "cash limited" – no additional funds will be available if the scheme exhausts its allocation – and this will require an enhanced managerial focus within all Departments.

c) In managing expenditure from year to year, a primary focus should be kept upon the overall Aggregate Expenditure Level – this is the key variable that affects the overall budgetary position. The Ministerial envelopes should also retain their continuity throughout the process, in the interests of setting a fixed framework for operational and policy planning. However, it should be open to a Government to make some limited reallocations across Ministerial envelopes from year to year, provided that the Aggregate Expenditure Level continues to be respected.

d) As in the case of Capital expenditure, Departments would be allowed to carry over some element of their unused envelope allocations from one year to the next. This should promote good resource management and remove any incentives to use up allocations by end-year, even though such expenditure might not be optimal in value-for-money terms. It is proposed that a maximum carryover amount of between 1% and 3% should be considered, which is less than the 10% level allowed for Capital[8]. As in the case of Capital, the carryover amount would only be available for one year, so as to avoid an accumulation of unspent funds over several years.

e) Conversely, any overruns on an envelope allocation within a year should be treated as advances from the following year's allocation. This will require re-prioritisation of resources within the envelope, unless a compelling case can be made for drawing upon the central contingency reserve (see *(h)* and *(i)* below).

[8] Capital projects usually involve large blocks of spending which are not easily split up. This is the main reason for the higher carryover for capital than that proposed for current expenditure.

f) In the case of the cyclically-sensitive, demand-led schemes, any unanticipated savings would automatically accrue to the benefit of the Exchequer (and go toward debt-reduction), rather than be transferred across to fund the expansion of other (non-demand-led) services.

g) In particular, a practical approach would be to apportion all such "annually managed" allocations to distinct Votes, separate from the other Programme spending which would have been grouped within the same overall Vote up to now. (Moneys within the same Vote can be reallocated from one area to another through a process known as 'virement'. However, moneys cannot be transferred from one Vote to another without going back to the Dáil to seek a Supplementary Estimate.)

h) Conversely, unanticipated overruns in such demand-led schemes should be funded as follows:-

   a. *In the first instance* from a central Fiscal Contingency Reserve to be included in the overall fiscal plan.
   b. *In the second instance,* from savings elsewhere within overall expenditure – including with recourse to policy adjustments where necessary – as decided by Government.

i) The Fiscal Contingency Reserve should be factored into the budgetary arithmetic at aggregate level. Any draw-downs from the reserve, for particular lines of Government expenditure (or indeed for shortfalls in tax revenues), should be formally reconciled in the budgetary documentation from one year to the next (see *(k)* below). The Reserve should be established at a suitably prudent proportion of GDP each year (although given current budgetary circumstances, the full accumulation of such a reserve may need to take place over a number of years).

j) Expenditure allocations would not automatically be carried over from year to year, but would be subject to an 'efficiency dividend' whereby overall administrative savings of 2-3% must be realised from each year. This approach would reflect, for the public service, the type of annual productivity improvements that are expected in the private sector from advances in IT and management practice.

k) To underpin the effectiveness and credibility of the Ministerial Expenditure Envelopes, the Government should provide a full reconciliation each year of any deviations from the prior envelope allocation. In line with best practice in other countries, these reconciliations would identify the impact of changes in (a) macroeconomic variables such as GDP growth, wage and price inflation, (b) volumes of programme beneficiaries, (c) discretionary policy including reallocations, (d) drawdown of carryovers and contingency reserve, and (e) other factors for each Envelope, together with a summary report for overall expenditure.

l) It should be noted that the annually-managed elements of expenditure are not excluded from the scope of expenditure reductions or expansions that may fall to be considered by the Government from time to time. The principal difference is that the demand-led, cyclically-sensitive allocations must be re-visited each year (in the context of the Stability Programme) in light of updated economic forecasts, whereas the multi-annual envelope allocations would not normally be re-visited or adjusted, apart from in the context of the periodic GEA exercise. Any policy changes to core demand-led areas would, by their nature, require decisions at Government rather than Ministerial level, and this requires a distinct management of these areas.

m) Moreover, the number of demand-driven schemes that are managed annually should be kept as limited as possible, by reference to those schemes (such as unemployment payments) which are sensitive to the economic cycle. For effective multi-annual Government control of expenditure, the Ministerial Expenditure Envelopes should cover at least 75-80% of overall voted current spending.

n) The ability of Ministers and Departments to manage their net allocations effectively is hampered by the existence of standalone or extra-budgetary funds, and reliance on receipts of levies and other Appropriations-in-Aid which can fluctuate. It would be more efficient if all such extra-budgetary funds were phased out, and all receipts accrued to the one fund (i.e. the Exchequer). Under this approach, Ministers would be able to focus more clearly on the control of expenditure outlays.

3.7 Governmental Expenditure Assessment (GEA)

The periodic GEA exercise provides an important additional flexibility for the proposed expenditure framework. The GEA is the proposed means of evaluating the relative priorities in terms of the resources allocated and would involve assessing the relative contribution of expenditure areas towards meeting the Programme for Government commitments.

The design of the GEA will draw upon domestic experience including the 2009 exercise that led to the Report of the *Special Group on Public Service Numbers and Expenditure Programmes,* and the VFM and Policy Reviews that are now an established feature of programme assessment; as well as drawing upon international experience, including that of the UK Treasury in its periodic "Comprehensive Spending Reviews". The GEA exercise would be similar in some respects to the analysis carried out by the Special Group, albeit shorter, more intensive, and with a focus on assessing programme effectiveness by reference to Government priorities.

In light of the outcomes of the GEA process, the Ministerial Expenditure Ceilings can be reassessed at intervals of 2 to 3 years, and re-configured to reflect new priorities while remaining within aggregate budgetary limits.

By its nature, the GEA exercise should be aligned with the Government cycle i.e. with the finalisation of new or renewed Programmes for Government. The GEA should ensure that resource allocation policy is responsive to political priorities, rather than driven purely by administrative concerns. The periodic reviews would also allow for alignment with Statements of Strategy (which are reviewed every 3 years, or following a change of Government), so that Departments and Offices can re-assess their strategic objectives and priorities in line with the available resources.

Parallel improvements to the existing suite of Value-for-Money measures would also complement the effective functioning of the GEA process. In particular, it is recommended that "sunset clauses" be applied to all new and existing expenditure programmes, whereby all such programmes would lapse automatically unless their effectiveness can be demonstrated through a rigorous appraisal. In principle, such an approach could also be applied to tax expenditures. Similarly, as also recommended in the Special Group Report, all expenditure programmes should be formally "cash-limited" so that they do not create an open-ended demand upon the Exchequer. Finally, building upon an existing provision in capital expenditure management, Departments would be restricted from entering into sundry multi-year spending commitments – contractual, legal or policy-related – that cannot be afforded within their multi-year ceilings. This approach will put a premium upon accurate forecasting of costs and prioritisation of resources by Government.

3.8 Legislative and Administrative Initiatives

The core elements of the expenditure framework – namely the ability of the Government to set out expenditure limits over the medium term, and the specification of areas to which these limits should apply – are appropriate to inclusion in a Fiscal Responsibility Bill. This would meet the basic requirement that the expenditure limits should be seen as effective, in support of the Government's overall fiscal planning objectives, and not purely indicative or aspirational in nature.

Equally however, many of the elements outlined in sections 3.4-3.6 above are too detailed for inclusion in national legislation. It is proposed that these detailed elements should be specified at administrative level, including a Department of Finance Circular to be applied by all Departments. This is the approach followed in the implementation of the multi-annual capital investment framework arising from the 2004 Finance Act, which allows for carryover of unspent capital funds from one year to the next.

On this basis, a draft Head providing for medium-term expenditure limits is set out in Box 3.3 below.

Box 3.3 **draft *Head F: Multi-annual limits on expenditure***

(1) The Stability Programme Update shall include, for each year, estimates of the maximum level of Government-directed current expenditure, both at aggregate level (an ‘Aggregate Expenditure Level’), and, subject to subsection (5), by reference to each area of expenditure which falls under the area of responsibility of a Minister of the Government (‘Ministerial Expenditure Ceiling’).
(2) Subject to *Head D**, the Aggregate Expenditure Level for each year shall conform with the Sustainable Expenditure Growth Rule.
(3) With the approval of the Minister for Finance, and notwithstanding subsection (1), any particular Ministerial Expenditure Ceiling or Ceilings or such Ceilings generally may be calculated and expressed by reference to some specified portion of Government-directed current expenditure, rather than the totality of such expenditure.
(4) Subject to *Head D** and to sub-section (6), the Estimates for Public Services for each year shall conform with the Aggregate Expenditure Level and Ministerial Expenditure Ceilings laid down in the Stability Programme immediately preceding the publication of those Estimates.
(5) With the approval of the Minister for Finance, the Estimates for Public Services for a particular year may vary from the Ministerial Expenditure Ceilings for that year, provided that the Aggregate Expenditure Level for that year is still complied with.
(6) If in a particular year the amount of expenditure incurred under a particular Ministerial Expenditure Ceiling is, or is projected to be, less than the full amount provided in that year in respect of that Ceiling, then, with the approval of the Minister for Finance, the corresponding Ministerial Expenditure Ceiling for the following year may be increased by an amount of not more than the shortfall amount, or, if less, 3% of the Ministerial Expenditure Ceiling for the particular year.
(7) If in a particular year the amount of expenditure incurred under a particular Ministerial Expenditure Ceiling is, or is projected to be, in excess of the full amount provided in that year in respect of that Ceiling (whether by way of Supplementary Estimate approved by Dáil Éireann or otherwise), then the corresponding Ministerial Expenditure Ceiling for the following year may be decreased by the amount of the excess.
(8) Nothing in this section shall be interpreted as abridging the functions or prerogatives of Dáil Éireann in regard to the consideration and approval of Estimates for Public Services in any year.

**Head D – see section 2.5 for discussion of ‘exceptional provisions’ clause.*

4. Budgeting for Performance

4.1 Existing Arrangements for Expenditure Budgeting

Up to now, Ireland's system of resource allocation has been based almost exclusively upon the traditional Vote accounting framework, whereby financial allocations are authorised by the Dáil and accounted for on a subhead-by-subhead basis.

In practice, detailed Estimates of Expenditure for each Department or Office are laid before the Dáil each year, and are in turn referred to the relevant Dáil Select Committees for consideration and discussion. Subsequently, each Estimate returns to the Dáil for a vote: this Dáil approval provides the formal basis for expenditure to take place in that year.

At the end of each year, an Appropriation Act is passed by the Oireachtas, providing a statutory basis for the allocations already voted by the Dáil. At the start of the following year, each Department and Office prepares Appropriation Accounts, which are audited by the Comptroller & Auditor General and considered in detail by the Public Accounts Committee of the Dáil.

This traditional approach, which is founded upon the *1866 Exchequer & Audit Departments Act,* has strengths in terms of financial transparency and accountability for public funds. However, a weakness with this approach is that it gives little detail about how effectively the funds have been, or will be, used. Up to now, the Estimates documentation has provided no information about public service outputs, or overall impacts in terms of benefits to the general public, from the way these funds have been used and managed. Likewise, it is hard to tell from the Estimates material whether services are being delivered efficiently, and how many staff are involved in delivering the various public programmes.

However, since 2007, each Department has been required to produce an Annual Output Statement (AOS), which is designed to address some of the deficiencies outlined above. In particular, the AOS identifies each of the strategic Programmes of a Department – in line with its Statement of Strategy – and re-presents the expenditure information on this Programme basis. Moreover, under each Programme, the Department sets out its "outputs" – the practical public services it has delivered in the previous year, as well as those services it is aiming to deliver with the funds provided for the year ahead. These documents are presented to the relevant Dáil Select Committee at the same time as it is considering the corresponding Estimate.

4.2 "Performance Budgeting"

The development of the AOS approach should be seen as in keeping with the movement towards 'performance budgeting', which has been a core theme in international public financial management over the past decade or more. Performance budgeting involves a focus upon what is delivered with public funds, and factoring this into the resource-allocation process, in preference to the traditional approach of focusing more narrowly on how much is being spent.

There are a variety of approaches under this broad heading, ranging from basic "presentational" approaches, whereby performance information is made available when financial allocations are being discussed; "performance-informed budgeting", which involves some element of integration of performance data into the resource-allocation process; through to more direct "performance-related" or "performance-based" budgeting systems, which aim to link expenditure allocations more closely to the delivery of certain objectives.

The AOS system used in Ireland is at the "presentational" end of the spectrum. The AOS has not been intended to supplant the traditional Estimate format. Instead, the AOS is routinely presented to each Dáil Select Committee at the same time as it is considering the corresponding Estimate.

In its 2008 Review of the Irish Public Service, the OECD was broadly supportive of the AOS approach. The OECD also called for a range of improvements to the performance information being used, and to the way it is built into the budgeting process. While the AOS makes a good deal of extra information available, the financial information is usually configured differently from the Estimate, because the subhead approach and the strategic Programme approach are not always fully aligned. This does not make for the best use of the AOS information when the Dáil Committees scrutinise the annual Estimates. In addition, the quality of the performance indicators is not uniform, and the focus has been placed on outputs rather than on outcomes or impacts. As a result, the AOS has up to now had limited impact in enhancing discussion and debate on resource allocation policy.

4.3 Pilot project in 2011 Estimates

To address these issues, a pilot project has been undertaken for the 2011 Estimates to strengthen the performance element of budgeting along the lines recommended by the OECD. In particular, key high-level performance information is integrated as part of the annual Estimate, rather than in a separate document. This approach to 'performance budgeting' involves:-

- full alignment between the subhead structure of the Estimate and the 'Programme' structure used in the AOS and Statement of Strategy;
- integration of Administration subheads alongside the corresponding Programme subheads, to show the full costs of delivering each Programme; and
- inclusion of concise, high-level performance information – both as regards outputs and impacts – as part of the annual Estimate document. The types of performance information to be contained in the Estimate are discussed in Box 4.1 below.

The exercise will involve moving Ireland along the spectrum of performance budgeting, towards a more integrated 'performance-informed' model.

The pilot participants include a mainly policy-focused area (the Department of Finance and the wider Finance Group of Votes) along with an area focused mainly on operation and service delivery (the Department of Agriculture, Fisheries & Food). The 2011 Revised Estimates for these areas have been prepared on the new Programme Estimate basis, and an example of a Programme Estimate from the Estimate for the Department of Finance is included in Box 4.2 at pages 32-33 below for reference.

4.4 Next Steps

It will be a matter for Dáil Éireann and its relevant Committees to assess the Programme Estimate format, and to determine what refinements may be needed to make the approach effective in facilitating the scrutiny of the annual Estimates, and holding Ministers and Departments to account.

Subject to the considerations of the Dáil and Government, the performance budgeting approach should be rolled out across Departments and Offices generally from the 2012 Estimates. The increased focus on organisation-level performance is in keeping with the *Transforming Public Services* agenda and should promote a greater emphasis on effective performance and delivery within each organisation, down to and including individual staff level.

Box 4.1 Performance information in the proposed Programme Estimate

'Performance information' is information on the extent to which public funds are being used effectively and efficiently, to achieve their intended results in terms of delivering services to the public.

In the 2011 Revised Estimates, the financial allocations for the pilot Departments and Offices are presented in a new format that closely follows the Strategic Programmes of each organisation. The allocations are supplemented with the following performance information, which again is designed to mirror the corresponding commitments from the Statements of Strategy.

High-Level Objectives or *Goals* are broad statements of intent, focused on outcomes (see below), and covering a particular sector or distinct sphere of activity.

Outputs provide a specific and tangible indication of achievement or delivery for a given amount of resources. They may be qualitative and/or quantitative in nature and they serve to identify and, ideally, measure progress in a specific area of activity. While it is usually clear what resources are being spent in a given area, it is not always clear what is being bought with those resources – this is what the outputs are designed to show.

Impacts (also referred to as *Outcomes)* are the overall benefits or changes for individuals, groups or society arising from pursuing a particular policy or policies. As a general rule, positive outcomes arise indirectly from the successful delivery of well-chosen outputs.

In addition to including *Impact indicators,* the Programme Estimate format includes more general *Context indicators,* designed to provide a sense of the overall environment in which policy is being made. Because impacts are medium-term rather than short-term in nature, these indicators are shown on a three-year basis to show the broad 'direction of travel' in these areas.

The experience of other countries is that the quality of performance indicators used becomes more refined over time, on the basis of constructive and critical engagement on the part of the parliamentary bodies whose role it is to scrutinise the proposed allocations.

Moreover, a clearer specification of outputs and impact indicators will help in assessing the effectiveness and efficiency of public spending in particular areas. The VFM and Policy Review process, which seeks to evaluate particular expenditure programmes on a performance basis, will also benefit from the heightened emphasis on performance generally.

More generally, a solid foundation of performance-informed budgeting should lead on to a general expectation that, whenever demands are made for public funds, these should be matched with specific performance targets. The more direct "performance-based budgeting" approach lends itself most readily to introduction in State agencies, which have clearly-defined mandates and functions. The precise approach to be adopted is a matter for Government to decide, in light of experience and progress in the performance budgeting area.

Box 4.2 **Programme Estimate for *Department of Finance (Public Service Management Division)***

[6] ***Office of the Minister for Finance*** *[6]*

6

OFFICE OF THE MINISTER FOR FINANCE

I. Estimate of the amount required in the year ending 31 December 2011 for the salaries and expenses of the Office of the Minister for Finance, including the Paymaster-General's Office, for certain services administered by the Office of the Minister and for payment of certain grants and grants-in-aid.

Sixty-two million, five hundred and seven thousand euro

(€62,507,000)

II. Programmes under which the Subheads for this Vote will be accounted for by the Office of the Minister for Finance. (a)

	2010 Provisional Outturn			2011 Estimate			Change 2011 over 2010
	Current	Capital	Total	Current	Capital	Total	
PROGRAMME EXPENDITURE	€000	€000	**€000**	€000	€000	**€000**	%
A - BUDGET, TAXATION & ECONOMIC POLICY	9,409	-	**9,409**	9,699	-	**9,699**	3%
B - PUBLIC EXPENDITURE & SECTORAL POLICY	24,022	188	**24,210**	23,116	301	**23,417**	-3%
C - FINANCIAL SERVICES POLICY	10,666	-	**10,666**	9,043	-	**9,043**	-15%
D - PUBLIC SERVICE MANAGEMENT POLICY (b)	24,769	89	**24,858**	28,144	274	**28,418**	14%
Gross Total :-	68,866	277	**69,143**	70,002	575	**70,577**	2%
Deduct :-							
E - APPROPRIATIONS-IN-AID	7,544	-	**7,544**	8,070	-	**8,070**	7%
Net Total :-	61,322	277	**61,599**	61,932	575	**62,507**	1%
				Net Increase (€000)			908
Exchequer pay included in above net total			*33,538*			*35,918*	*7%*
Associated Public Service employees			*600*			*633*	*5%*
Exchequer pensions included in above net total			*4*			*4*	-
Associated Public Service pensioners			*3*			*3*	-

ADMINISTRATION (c) *Functional split of Administrative Budgets, which are included in the above Programme allocations*	2010 Provisional Outturn			2011 Estimate			Change 2011 over 2010
	Current	Capital	Total	Current	Capital	Total	
	€000	€000	**€000**	€000	€000	**€000**	%
(i) SALARIES, WAGES AND ALLOWANCES ...	34,971	-	**34,971**	36,171	-	**36,171**	3%
(ii) TRAVEL AND SUBSISTENCE	332	-	**332**	481	-	**481**	45%
(iii) TRAINING AND DEVELOPMENT AND INCIDENTAL EXPENSES	959	-	**959**	950	-	**950**	-1%
(iv) POSTAL AND TELECOMMUNICATIONS SERVICES	755	-	**755**	850	-	**850**	13%
(v) OFFICE EQUIPMENT AND EXTERNAL IT SERVICES	1,880	-	**1,880**	1,500	-	**1,500**	-20%
(vi) OFFICE PREMISES EXPENSES	641	-	**641**	725	-	**725**	13%
(vii) CONSULTANCY AND OTHER SERVICES	7	-	**7**	35	-	**35**	400%
Gross Total :-	39,545	-	**39,545**	40,712	-	**40,712**	3%

(a) This Vote is presented on a Programme basis as part of the pilot phase of the Performance Budgeting initiative - see General Note for further information.

(b) The functions of the Employee Assistance Service will transfer to Vote 6 with effect from mid-2011. Increased costs on 2011 Administrative Pay and Non-Pay reflect this transfer.

(c) To provide improved clarity in relation to Administration, the costs associated with the former Value for Money and Policy Review Initiative subhead have been redistributed to the relevant pay and non-pay expenditure headings.

Box 4.2 Programme Estimate for *Department of Finance (Public Service Management Division)*

III. Details of Programmes - Objectives, Outputs and Financial & Human Resources

PROGRAMME EXPENDITURE

D - PUBLIC SERVICE MANAGEMENT POLICY

High Level Goal: To formulate and promote policies which drive efficiency and effectiveness across the public service, which support national income and pensions development (with particular reference to the public service) and which are consistent with budgetary sustainability, competitiveness and high standards of service delivery

Financial & Human Resource Inputs

Numbers 2010	Numbers 2011		2010 Provisional Outturn Current	Capital	Total	2011 Estimate Current	Capital	Total
			€000	€000	**€000**	€000	€000	**€000**
282	*302*	D.1 - ADMINISTRATION - PAY (a)	16,904	-	**16,904**	17,484	-	**17,484**
		D.2 - ADMINISTRATION - NON-PAY (a)	2,741	-	**2,741**	2,842	-	**2,842**
		D.3 - INSTITUTE OF PUBLIC ADMINISTRATION (GRANT-IN-AID)	3,400	-	**3,400**	3,000	-	**3,000**
1	*1*	D.4 - GAELEAGRAS NA SEIRBHÍSE POIBLÍ	232	-	**232**	120	-	**120**
		D.5 - CIVIL SERVICE ARBITRATION & APPEALS PROCEDURE	32	-	**32**	65	-	**65**
		D.6 - REVIEW BODY OF HIGHER REMUNERATION IN THE PUBLIC SERVICE	48	-	**48**	1	-	**1**
		D.7 - PUBLIC SERVICE BENCHMARKING BODY	-	-	-	1	-	**1**
		D.8 - COMMITTEE FOR PERFORMANCE AWARDS	-	-	-	1	-	**1**
		D.9 - CENTRE FOR MANAGEMENT & ORGANISATIONAL DEVELOPMENT	1,032	89	**1,121**	1,330	200	**1,530**
		D.10 - COMMISSIONS & SPECIAL INQUIRIES	210	-	**210**	5	-	**5**
-	*11*	D.11 - CHANGE MANAGEMENT FUND (b)	64	-	**64**	2,170	-	**2,170**
		D.12 - CIVIL SERVICE CHILDCARE INITIATIVE	45	-	**45**	25	-	**25**
		D.13 - CONSULTANCY & OTHER SERVICES	61	-	**61**	1,100	74	**1,174**
		Programme Total:-	**24,769**	**89**	**24,858**	**28,144**	**274**	**28,418**
283	*314*	***of which pay:-***	***17,092***	-	***17,092***	***18,449***	-	***18,449***

***Key Outputs* ***

Public Service Activity:	*2010 outputs*	*2011 output targets*
Development and implementation of policies to minimise the overall Public Service pay bill, maintain industrial relations stability in the Public Service and provide general advice on national incomes policy issues and conditions of employment with a view to enhancing competitiveness	Cost of Public Service pay bill reduced significantly through the application of financial emergency measures legislation which reduced pay rates and prohibits pay increases in addition to the pension related deduction, as well as through the ongoing application of the moratorium and of the incentivised voluntary exit mechanisms. Consequent industrial action resolved through reaching the Public Service Agreement 2010-2014.	Ensuring the cost of the Public Service paybill is further reduced in line with the agreed Employment Control Frameworks and pay ceilings and with Government policy on achieving fiscal stability, while supporting the optimum delivery of priority services through measures such as redeployment of staff.
Management of staffing levels and administrative budgets in the Civil Service in accordance with Government policy	Civil service numbers reduced to 36,437. Employment Control Framework (ECF) of 36,437 achieved and exceeded.	A reduction in civil service numbers in line with the targets outlined in the National Recovery Plan to bring the size of the civil service down to 36,164. A €30m reduction in non-pay administrative expenditure.
Development and delivery of a sustainable and coherent public service pension policy consistent with national pensions and budgetary policy	Preparations made for the introduction of a single public service pensions scheme; preparations made for the introduction of a public service pension reduction; input made to the DSP National Pensions Framework.	Implementation of a single public service pension scheme for new entrants, including introducing necessary legislation; continue to input to the implementation of the National Pensions Framework.
Measures to develop and modernise the Public Service in the context of Transforming Public Services (TPS), the Public Service Agreement and the National Recovery Plan	Arrangements for the implementation of the Public Service Agreement were established. Initiatives advanced in relation to shared services, business process improvement, performance, leadership.	Implementation of actions plans under Public Service Agreement and modernisation initiatives under TPS.
Delivery of the Government ICT and eGovernment programme, to carry out research, pilot and implement appropriate strategies, policies, technology architectures and procurement approaches for ICT across the Civil and Public Service and to provide ICT facilities and services for the Department	Approval of new eGovernment Strategy by Government and improved ranking in international benchmarking. Reduced costs through tighter control and aggregated procurement arrangements.	Further development and ongoing implementation of eGovernment Strategy. Pilot and assess cloud computing implementations.

Context and Impact indicators

		2008	*2009*	*2010*
1 -	World Bank Aggregate Indicator of Government Effectiveness	92.75%	90.34%	88.10%
2 -	Public Satisfaction with service received from Civil Service Organisations	80%	78%	n/a
3 -	Civil Service Numbers	39,313	37,356	36,437
4 -	Gross Public Service pay bill (as % of Gross Current Expenditure)	€17.190bn (31.40%)	€17.514bn (31.99%)	€16.045bn (29.31%)
5 -	Gross Public Service pension bill (as % of Gross Current Expenditure)	€2.149bn (3.93%)	€2.558bn (4.67%)	€2.774bn (5.07%)
6 -	Accrued pension liability at 31 December	€108 Billion	€116 Billion	n/a
7 -	International eGovernment ranking (EU Commission eGovernment Sophistication Benchmark)	17	Joint 7	Joint 1

* *In addition to its role in relation to the formulation and implementation of Public Service Management Policy, the Division is also responsible for a number of Departmental and Civil Service wide services including the Office of the Chief Medical Officer, the Employee Assistance Service, Disability Liaison, Equality, the Civil Service Training and Development Centre, the Minister's Office, the Central FOI Policy Unit and the Departmental Corporate Services Division. Government Accounting and the Paymaster General's Office are also included in this programme.*

(a) *The functions of the Employee Assistance Service will transfer to Vote 6 with effect from mid-2011. Increased costs on 2011 Administrative Pay and Non-Pay reflect this transfer.*

(b) *The functions of the Change Management Fund have been split between Vote 6 and Vote 2 with effect from 1 January 2011. The figures for Programme D.10 reflect this transfer of functions.*

5. An independent Budget Advisory Council

Research suggests that, within an overall fiscal framework, an independent fiscal institution can support a government's capacity to adhere to a prudent medium-term budgetary policy and to comply – and be seen to comply – with fiscal rules. The use of such institutions, commonly known as Fiscal Councils, has expanded internationally, as has the role they play within each country's fiscal framework. In the European Union in 2008, twenty-seven independent institutions existed across seventeen Member States[9].

As outlined in Chapter 1, Ireland is committed under the IMF/EU Programme of Assistance to establishing an independent Budget Advisory Council and has agreed a timetable for its establishment. This chapter outlines a range of considerations regarding the design of such an independent body, with particular focus on the role and functions it should have in the proposed new budgetary framework.

5.1 Fiscal councils: Nature and Rationale

The following definition of a fiscal council has been offered in a recent OECD Working Paper[10]:

> *"a publicly-funded entity staffed by non-elected professionals mandated to provide non-partisan oversight of fiscal performance and/or advice and guidance - from either a positive or normative perspective - on key aspects of fiscal policy"*.

By making aspects of fiscal policy independent of government and placing them outside the political arena, fiscal councils – it is argued – can help to inform the general public and elected representatives, and enhance confidence and transparency regarding the actual state of fiscal policy in a country. Raising the visibility of the issues in this way may have a positive impact on fiscal discipline. Also, in establishing a fiscal council, a government may make a clear statement of intent in relation to better fiscal performance.

Literature on the subject suggests that there are a number of ways in which an independent fiscal council can potentially contribute to improved fiscal performance. These include:

- improving the transparency of the budgetary process through monitoring and publicly commenting on the fiscal policy assumptions and decisions of government,
- providing an opinion on the long-run fiscal implications of tax and spending measures, thus contributing to improving the transparency of budgetary decisions,
- making independent revenue and expenditure projections whether based on current or prospective policies, and
- monitoring fiscal performance under a politically-agreed medium-term fiscal framework, including adherence to numerical fiscal rules.

[9] *Public Finances in EMU 2010* (European Commission), p.103.
[10] Hagemann, R. (2010), "Improving Fiscal Performance Through Fiscal Councils", *OECD Economics Department Working Papers*, No. 829, OECD Publishing. doi: 10.1787/5km33sqsqq9v-en

5.2 Design criteria for fiscal councils

The design of fiscal councils and the roles they perform vary from country to country. At the same time, a number of criteria are put forward as being necessary for fiscal councils to be effective: -

- **Clear and achievable mandate**: the agency's mandate should be unambiguous and achievable, and the delegation of responsibility should have an economic rationale (e.g. to reduce 'deficit bias') and should be backed by strong legal provisions.
- **Independence**: the agency should have full autonomy in carrying out the tasks necessary to fulfil its mandate including those relating to staffing.
- **Visibility**: there must be active and unfettered dissemination of the agency's analysis and reports. Credibility is gained through sustained, high-quality and visible independent analysis.
- **Accountability**: elected representatives must be able, on behalf of voters, to conduct *ex post* evaluations to ensure that the delegated powers are in fact being used in pursuit of the agency's mission.

In relation to the issue of independence, this might be ensured by public financing, preferably underpinned by law and by specific appointment procedures especially for the governing board of the body[11].

5.3 Role in preparation and/or assessment of official budget forecasts

At present, the practice in most EU member states, including Ireland, is that finance ministers rely on macro-economic forecasts prepared by their Departments for their budgetary preparations. The approach recently followed by Sweden in 2007 when it established its Fiscal Policy Council was consistent with this.

However, in a small number of countries, the task of preparing macroeconomic forecasts in the context of the annual Budget has been assigned to independent bodies. Where this is the case, good practice indicates that the body should be given access to the same internal information as used by the national statistics office, the ministry of finance and other government bodies that might be involved in the performance of this function.

Long-standing examples of such countries include Austria, Belgium and the Netherlands[12]. More recently the Office for Budget Responsibility (OBR) was established in the UK in May 2010. The intention is that the OBR will have direct control over forecasts and will make all key judgements that drive official projections[13].

There is some research evidence[14] to suggest that: -

(a) macroeconomic forecasting in a budgetary context which is carried out by a ministry of finance or by a body influenced by political considerations may be subject to an optimism bias, thus leading to a deficit bias;
(b) an 'optimism bias' in relation to growth forecasts has a measurable negative effect on budgetary outcomes; and
(c) delegation of the forecasting function to an independent agency may reduce the potential for bias to creep into forecast preparation.

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[11] Public Finances in EMU 2010 (Page 106)
[12] In Austria, the projections are prepared by the Austrian Institute of Economic Research. In Belgium, they are prepared by the Bureau Fedéral du Plan while in the Netherlands they are prepared by the Central Planning Bureau. With the exception of the Austrian agency, these bodies are provided for in law. The Austrian agency exists on an administrative basis.
[13] At present, the OBR operates on an administrative basis but legislation is currently being prepared to place it on a statutory footing.
[14] Jonung, Lars and Larch, Martin, Improving Fiscal Policy in the EU: The Case for Independent Forecasts. Economic Policy, Vol. 21, No. 47, pp. 491-534. Also, Hagemann, R. (2010), "Improving Fiscal Performance Through Fiscal Councils", *OECD Economics Department Working Papers*, No. 829.

However, the evidence in support of these propositions is limited. For example, one of the key research papers in this regard (Jonung and Larch, 2006), which is referenced by the European Commission in Public Finances in EMU 2010, is based on an examination of four EU member states only (France, Germany, Italy and the UK).

Also, there is evidence to support the view that the preparation of forecasts by finance ministries does not automatically imply that an optimistic bias will be present in those forecasts. In the Jonung and Larch study, for example, the UK emerged as the exception in the study and showed no evidence of optimism bias in relation to forecast preparation (despite the fact that, at the time, the forecasts were prepared by the UK Treasury). The study advanced no satisfactory reasons to explain why the UK differed from the other three countries or why its forecasts were less biased.

In Ireland's case, information on the performance of official economic growth forecasts was published in the 2006 Budget Book (see Appendix A). This showed the average divergence between the outturn, as measured by the CSO, and annual forecasts for the period 1997 to 2004 produced by a number of agencies including the Department of Finance. In that context, the Department's forecasts published on budget day each year compared well against those from other forecasting institutions. In this regard, access to what might be termed "*internal*" information is not considered to have been a factor of any significance which might favour the Department over the other forecasters. The data published in 2006 was since updated and published in summary form in October 2010 as part of a presentation made at the Kenmare Economic Workshop[15] – see Appendix B.

While somewhat dated at this point, in 2004 the ECB published an analysis[16] (see Appendix C) on the extent to which a bias existed in the budgetary forecasts relating to government balances and economic growth across the then fifteen EU Member States for the period 1999 to 2003. The results were broadly favourable in relation to Ireland's forecasting performance. Among other things, the analysis indicated that Ireland's growth forecasts in the survey period were less biased than those prepared by Austria, Belgium and the Netherlands where independent agencies undertook the forecasting work.

5.4 Proposed basis of a Budget Advisory Council for Ireland

In terms of the type of budgetary advisory council that might be appropriate for Ireland, such a body could be delegated to perform a number of the standard functions outlined in section 5.1 above, in line with best international practice. It is envisaged that the entity would have a statutory basis to help to underline its independence.

Broadly, the core function of the Council would be to assess the Government's fiscal projections and the proposed fiscal stance, including compliance with the fiscal rules. It would have a duty to report publicly and routinely on these matters both to the Government (*via* the Minister for Finance) and the Oireachtas (*via* an appropriate Committee).

The Council would be independent in nature, comprised of persons with relevant expertise and experience, of national and international standing. It need not be a large body. Appointments to the Council would be made by the Minister for Finance after consultation with the Oireachtas and the relevant Committee. In order to be effective, the membership of the proposed Council should be no more than five respected individuals with a strong track record in economic and financial matters and, to ensure added-value to the overall process, the body should ideally include international expertise. Appointments should be for a fixed period and it is envisaged that they

[15] In the data presented in 2006, the Department of Finance had the second-least divergence from outturn. Data for the period 1995 to 2009 indicate that the Department had the least divergence from outturn over the survey period A separate exercise for the period 2001-2009 covering a wider range of variables (GDP, GNP, CPI, HICP and Employment) also produced results consistent with these findings. However, there were some gaps in data arising from the fact that not all the agencies produced forecasts for each variable on a consistent basis over the period reviewed.
[16] see ECB Monthly Bulletin, September 2004

would be made after consultation with the relevant Oireachtas Committee. It is proposed that legislative arrangements relating to the terms of office of members and to the creation and operation of the Council will be generally consistent with recent practice in the establishment of a body with an independent character[17]. A small secretariat of appropriately qualified staff, drawn from the existing civil or public service, would provide research and administrative support to the Council. In overall terms, the experience in countries such as Sweden is that the establishment of a Council could add value and should not have to have substantial additional expenditure associated with it.

On the basis of these considerations, draft heads of legislation to establish a Budget Advisory Council are set out in Box 5.1 below.

Box 5.1 **draft *Head G: Establishment of Budget Advisory Council***

(1) There shall be established a body to be known as the Budget Advisory Council (in this Act referred to as the Council) to fulfil the functions assigned to it by this Act.
(2) The Council shall be independent in the performance of its functions, and may set its own internal procedures.
(3) Members of the Council shall be appointed by the Minister for Finance, after consultation with the Oireachtas.
(4) Membership of the Council shall consist of no more than 5 persons and particular weight will be given in the selection process to persons with significant international experience.
(5) The term of office of members of the Council and such other procedures or terms relating to the establishment, membership and operation of the Council as the Minister may consider appropriate, shall be as prescribed by the Minister.
(6) Members of the Council may be awarded such fees or other remuneration and such expenses as the Minister may from time to time determine.
(7) The costs of the Council shall be met from moneys voted by the Oireachtas.

draft *Head H: Role and Functions of the Council*

(1) The functions of the Council shall be:-
   a. to provide an assessment of the soundness of the economic and budgetary projections and forecasts set out by the Government in the Budget and the Stability Programme Update;
   b. to provide an assessment of the appropriateness of the fiscal stance set out by the Government in the Budget and Stability Programme Update, including the proposed medium-term budgetary objective, with particular regard to whether they are conducive to prudent economic and budgetary management, including by reference to the provisions of the Stability & Growth Pact;
   c. to provide an assessment of whether the budgetary plans set out in the Budget and Stability Programme Update are consistent with the fiscal rules; and
   d. to perform such other functions as may be assigned by the Minister.
(2) The assessments referred to in subsection (1) above shall be provided by the Council to the Minister in writing as soon as may be, and each such assessment shall be published by the Council at a date not earlier than three days, and not later than ten days, after such provision.
(3) The Council shall provide an annual report of its work to the Minister who shall arrange to lay the report before the Houses of the Oireachtas as soon as possible.

[17] One possible model in this regard is the arrangements for the Central Bank of Ireland Commission which was established by the Central Bank Reform Act 2010 and which has a strong independent character underpinned by statute.

Appendix A

Extract from Department of Finance Budget Book 2006

2.6 Forecast Performance

It is of interest to review the track record of the Budget economic forecasts against those of other forecasting agencies. In recent months both the IMF and the ESRI[18] have concluded that all forecasters of the Irish economy have, particularly in the 1990's, consistently underestimated economic growth, mainly due to upside growth surprises. This was most clearly the case for external demand, which is particularly difficult to forecast in a globally-integrated economy like Ireland.

The table below shows the average divergence between the outturn as measured by the CSO and the annual forecasts for the 1997 to 2004 period produced by a number of agencies, including the Department of Finance. The results, as measured by the 'error' level across the different agencies, are very similar. The spread may well be explained, at least in part, by the timing of publication and the availability of up-to-date information. Information availability constrains all forecasts, particularly as short-term forecasting does not readily lend itself to the application of econometric or model-based analysis. The main conclusion from this analysis is that performance of the official forecasts published on Budget day compare well against those of other forecasting institutions.

Table 7 – Economic Forecast Performance 1997-2004

Forecaster	Publication	Divergence from Outturn[19]
Central Bank	*Winter Bulletin*	2.66%
ESRI	*Winter QEC*	2.92%
EU Commission	*Autumn Forecast*	2.57%
IMF	*WEO – Sept./Oct.*	2.80%
OECD	*Outlook – Nov. /Dec.*	2.62%
Dept. of Finance	*Budget*	2.59%

Source: Department of Finance

[18] *The Quarterly Economic Commentary Forecasting Record 1994 to 2004*, QEC Autumn 2005. *Ireland: Selected Issues*, IMF Country Report No. 05/370, October 2005

[19] Divergence from the CSO outturn is measured using Root Mean Squared Forecast Error.

Appendix B

Average divergence between the outturn, as measured by the CSO, and annual forecasts for the period 1995 to 2009 produced by a number of agencies including the Department of Finance

FORECAST PERFORMANCE

GDP

	Forecast made late : for :	1995 1996	1996 1997	1997 1998	1998 1999	1999 2000	2000 2001	2001 2002	2002 2003	2003 2004	2004 2005	2005 2006	2006 2007	2007 2008	Q1/Q2 2009 2009	RMSE	Rank
NIE 2009	**GDP - outturn**	8.1%	11.5%	8.4%	10.9%	9.7%	5.7%	6.5%	4.4%	4.6%	6.0%	5.3%	5.6%	-3.5%	-7.6%		
Budget Day	**DoF**	5.8%	6.5%	8.0%	6.7%	7.4%	8.8%	3.9%	3.5%	3.3%	5.1%	4.8%	5.3%	3.0%	-7.7%	2.89%	1
Winter QEC	**ESRI**	6.0%	5.5%	6.5%	6.3%	7.3%	7.3%	3.0%	3.5%	3.5%	5.0%	5.0%	5.4%	2.3%	-7.9%	2.98%	3
Winter Bulletin	**Central Bank**	5.5%	5.8%	8.0%	7.5%	7.8%	8.0%	2.8%	4.3%	3.5%	5.3%	4.8%	5.5%	3.5%	-8.3%	3.01%	6
Autumn	**Commission**	5.5%	5.8%	8.7%	8.2%	6.9%	8.2%	3.3%	4.2%	3.7%	4.8%	4.8%	5.3%	3.5%	-9.0%	2.99%	5
Sept/Oct WEO	**IMF**	5.0%	5.5%	5.8%	7.0%	7.0%	6.9%	4.9%	5.3%	3.8%	5.0%	4.9%	5.6%	3.0%	-8.5%	2.99%	4
December	**OECD**	5.5%	6.2%	7.3%	6.7%	7.5%	7.9%	3.7%	3.6%	3.6%	5.5%	5.0%	5.1%	2.9%	-9.8%	2.93%	2

RMSE	**1996** SFE	**1997** SFE	**1998** SFE	**1999** SFE	**2000** SFE	**2001** SFE	**2002** SFE	**2003** SFE	**2004** SFE	**2005** SFE	**2006** SFE	**2007** SFE	**2008** SFE	**2009** SFE	**Mean SFE** 1996-2009
DoF	0.057%	0.246%	0.002%	0.176%	0.053%	0.096%	0.070%	0.008%	0.017%	0.008%	0.003%	0.001%	0.429%	0.000%	0.08%
ESRI	0.046%	0.355%	0.037%	0.216%	0.061%	0.026%	0.126%	0.008%	0.012%	0.010%	0.001%	0.001%	0.342%	0.001%	0.09%
Central Bank	0.070%	0.326%	0.002%	0.115%	0.038%	0.053%	0.144%	0.000%	0.012%	0.006%	0.003%	0.000%	0.497%	0.005%	0.09%
Commission	0.070%	0.321%	0.001%	0.073%	0.079%	0.062%	0.105%	0.000%	0.008%	0.015%	0.003%	0.001%	0.497%	0.020%	0.09%
IMF	0.099%	0.355%	0.069%	0.152%	0.074%	0.014%	0.027%	0.008%	0.006%	0.010%	0.002%	0.000%	0.429%	0.008%	0.09%
OECD	0.070%	0.277%	0.013%	0.176%	0.049%	0.048%	0.081%	0.007%	0.010%	0.003%	0.001%	0.003%	0.416%	0.049%	0.09%

Appendix C

Member States (EU 15) forecasting biases by country 1999 - 2003

	Budget Balance	GDP Growth (real)
Austria	0.12	-0.71
Belgium	0.22	-0.63
Denmark	-0.13	-0.63
Finland	0.21	-0.42
France	-1.43	-1.03
Germany	-1.36	-1.21
Greece	-1.97	-0.17
Ireland	-0.81	-0.26
Italy	-1.25	-1.21
Luxembourg	0.85	-1.6
Netherlands	-0.91	-1.11
Portugal	-1.62	-1.79
Spain	-0.08	-0.41
Sweden	-0.51	-0.31
United Kingdom	-0.58	-0.08

Note: values closer to zero indicate less bias in the forecasts

Summary (closest to zero)

	Budget balance	Real GDP Growth
Ireland	8th	3rd
Austria	2nd	9th
Belgium	5th	joint 7th
Netherlands	10th	11th

Source: ECB Monthly Bulletin, September 2004