4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

KEY MESSAGES

- Ireland's deficit for 2015 met the minimum deficit requirement (below 3 per cent of GDP) under the Excessive Deficit Procedure, while forecasts suggest that this achievement will be sustained. This has led to the abrogation of (i.e., exit from) the Excessive Deficit Procedure.

- *Budget 2017* plans show non-compliance with the Budgetary Rule requirements of the domestic *Fiscal Responsibility Act* and EU Preventive Arm for 2016 and 2017. These are the first two years in which the requirements of both sets of rules will apply following the closing of the excessive deficit. In both years, however, the planned non-compliance does not exceed the threshold of a "significant deviation" in the EU framework, which can trigger sanctions.

- The first pillar of the domestic Budgetary Rule and the EU Preventive Arm relates to the structural balance. The Department's projected reduction of 0.3 percentage points of GDP in the structural deficit for 2016 falls short of the minimum adjustment of 0.6 percentage points required under both rules, though the deviation is not considered a significant deviation. The rule is met on an *ex ante* basis for 2017.

- The second pillar is the Expenditure Benchmark. The expected growth rate of government spending in 2016 looks set to be lower than the maximum permitted under this rule. However, compliance is facilitated by a temporary, one-off boost to the spending base in 2015 that results from the conversion of AIB preference shares held by the State. Had this transaction been excluded from 2015 spending, the Department's projections for 2016 would imply a breach of the Expenditure Benchmark rule this year of close to €1.4 billion (0.5 per cent of GDP). This breach would amount to a significant deviation in the EU framework. For 2017, official projections show expenditure exceeding the maximum permitted under the Expenditure Benchmark by €0.2 billion, albeit the excess does not currently represent a significant deviation.

- *Budget 2017* currently indicates compliance with the fiscal rules for 2018 onwards. In part, this achievement hinges on expenditure plans being consistent with ceilings set for 2017-2021. However, there are risks that a well-documented pattern of upward revisions to spending in 2016 and previous years, if continued, could undermine compliance. Effective implementation of the domestic budgetary framework would help support the design and execution of medium-term expenditure plans.

4.1 INTRODUCTION

The Council's mandate includes reporting on compliance with Ireland's domestic Budgetary Rule and also monitoring compliance with the full range of EU fiscal rules as part of the broader assessment of the fiscal stance.[1] This Chapter examines the consistency of the projections contained in *Budget 2017* with these fiscal rules.

Since 2009, the primary target of fiscal policy has been the correction of the excessive deficit within the Corrective Arm of the *Stability and Growth Pact* (*SGP*) by 2015. This correction was completed in 2015, ensuring that the requirements of both the domestic and European frameworks are met (Section 4.2). The focus for Ireland now shifts to measures that seek to prevent fiscal policy from entering unsustainable territory, including requirements set under the domestic Budgetary Rule and the Preventive Arm of the *SGP.* These apply for 2016 (Section 4.3) and for all subsequent years (Section 4.4).[2] The Medium-Term Expenditure Framework (MTEF) is designed to support the achievement of these requirements, and includes aggregate ceilings for departmental expenditure (Section 4.5). Three boxes are included in this Chapter: the first outlines the assessment of compliance with the Budgetary Rule (Box E); the second examines the definition of fiscal space that has emerged in the Irish context (Box F); and the third explores the impact of the revised 2015 National Accounts outturns on the fiscal rules (Box G).

4.2 *EX POST* ASSESSMENT FOR 2015

The assessment of the fiscal rules for 2015 covers Ireland's requirements under the Excessive Deficit Procedure (EDP) for a General Government deficit below 3 per cent of GDP in 2015. This correction should be deemed sustainable such that the deficit could be expected to remain below this level into the medium term.

The excessive deficit was closed with a buffer, with a deficit outturn of 1.9 per cent of GDP estimated for 2015. Excluding a one-off AIB transaction, which boosted total expenditure in 2015,

[1] The Budgetary Rule is a key pillar of the domestic fiscal framework, mirroring *SGP* Preventive Arm requirements for the Medium-Term Budgetary Objective (MTO) that sets a target for the structural balance (set at -0.5 per cent of GDP for 2017-2019). The *Fiscal Responsibility Act 2012* defines two ways of meeting Budgetary Rule requirements: (i) when the structural balance is at or exceeding the MTO (the 'budget condition'); (ii) when the structural balance is on an appropriate path towards the MTO (the 'adjustment path condition'). The assessment of the Budgetary Rule focuses on the change in the structural balance but also considers expenditure growth by reference to the Expenditure Benchmark.

[2] While the Council's formal requirement to assess (*ex post*) compliance with the Budgetary Rule is backward-looking in nature, the Council's mandate to assess the fiscal stance suggests considering compliance on a forward-looking basis.

the deficit outturn is lower again at 1 per cent.[3, 4] The EDP was formally abrogated (i.e., ended) in June 2016 and *Budget 2017* forecasts show an expected sustainable correction.[5]

The closure of the excessive deficit in 2015 is sufficient to comply with the domestic Budgetary Rule and EU Corrective Arm rules in the same year. However, the significant upward revisions to spending in late 2015 set out just ahead of *Budget 2016* would have led to excess expenditure almost twice the amount considered "significant" under the Preventive Arm rules that were in force for the following year.[6]

4.3 In-Year Assessment for 2016

With the government deficit no longer considered excessive, the focus shifts to preventive measures and ensuring the medium-term sustainability of the public finances. This is the first year that both the domestic Budgetary Rule and the EU Preventive Arm rules apply following the closing of the excessive deficit. Final (*ex post*) assessments of compliance with the fiscal rules will only be determined in each subsequent spring when outturn data for the preceding year become available (Box E outlines the assessment of compliance with the Budgetary Rule).

Budget 2017 plans indicate that the domestic Budgetary Rule and the structural balance pillar of the EU fiscal rules are not expected to be complied with in 2016. While the second pillar of the EU fiscal rules – the Expenditure Benchmark – is technically complied with, the plans show that this is facilitated primarily by significant one-offs, which artificially boost the previous year's base. Table 4.1 summarises the fiscal rule requirements and the detailed calculations underpinning the Expenditure Benchmark on the basis of the *ex post Budget 2017* fiscal projections, which incorporate the use of estimated net fiscal space available over the forecast period.

[3] A temporary, one-off increase in the 2015 spending base stems from the conversion of €2.1 billion of AIB preference shares into ordinary shares. The transaction is treated by Eurostat as a capital transfer owing primarily to the increased risk associated with potential returns on ordinary shares as opposed to preference shares.

[4] An alternative denominator to scale the deficit against would be the preliminary, unrevised Q4 2015 GDP estimates. These estimates, which show GDP growth of 13.5 per cent for 2015, have the advantage of excluding MNE-related distortions in 2015, yet fail to account for other important unrelated revisions. On the basis of the unrevised nominal GDP level, the deficit for 2015 would have been 2.2 per cent (or 1.2 per cent excluding the AIB transaction).

[5] The Council decision reflected the correction of the deficit to below 3 per cent of GDP in 2015 and Commission Spring 2016 Forecasts which showed the deficit remaining below the EDP ceiling for 2016-2017 on a no-policy-change assumption.

[6] Compliance with the annual structural balance adjustment requirement and the Expenditure Benchmark was not required prior to 2016, but both rules are assessed as part of the wider analysis of the fiscal stance for 2015. Recent *SGP* reforms mean that the Corrective Arm structural balance path must also be consistent with any Preventive Arm requirements. The reform is intended to smooth transitions between both arms, while also avoiding pro-cyclical policies when a Member State is experiencing strong growth during an EDP. As Ireland entered an EDP prior to these reforms, a consistent structural balance path was not required.

TABLE 4.1: SUMMARY ASSESSMENT OF COMPLIANCE WITH RULES (% GDP UNLESS STATED)

	Code	2015	2016	2017	2018	2019	2020	2021
Corrective Arm:								
General Government Balance	GGB	-1.9	-0.9	-0.4	-0.3	0.2	0.7	1.1
General Government Debt	GGD	78.6	76.0	74.3	72.7	70.2	65.8	63.0
Debt Rule Benchmark [1]		109.2	96.5	83.6	74.7	72.9	71.2	68.5
Preventive Arm & Domestic Budgetary Rule:								
I. Minimum Structural Balance Adjustment Requirement								
Cyclical Budgetary Component = β*(OG) …where β=0.53	CGGB	0.8	1.0	0.6	0.3	0.2	0.1	0.0
One-Off Temporary Measures	v	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Structural Balance = GGB - CGGB - v	SB	-2.2	-1.9	-1.1	-0.5	0.0	0.6	1.1
Annual Change in Structural Balance	**ΔSB**	**1.9**	**0.3**	**0.8**	**0.6**	**0.5**	**0.6**	**0.5**
Minimum Annual Adjustment Requirement [2]	**REQ**	**n.a.**	**0.6**	**0.6**	**0.6**	**0.0**	**n.a.**	**n.a.**
Deviation (p.p.) = ΔSB - REQ …negative = non-compliance		n.a.	-0.3	0.2	0.0	0.5	n.a.	n.a.
II. Expenditure Benchmark								
Reference Rate of Potential Growth (% y/y) [3]	R		1.9	3.3	3.3	3.5	3.6	3.5
Convergence Margin (p.p.) = (0.5/(TE-i))*(REQ/0.5) [3]	C		1.8	2.0	1.6	0.1	0.0	0.0
Real Corrected Expenditure Growth Limit [2] (% y/y) = R_t - C_t	**EB**	**n.a.**	**0.1**	**1.3**	**1.6**	**3.3**	**3.6**	**3.5**
General Government Expenditure (€bn)	TE	75.3	74.5	76.6	78.7	80.9	82.5	84.3
Interest Expenditure (€bn)	i	6.7	6.2	6.1	6.0	5.7	5.4	5.0
Gross Fixed Capital Formation (€bn)	GFCF	4.3	4.6	5.1	5.8	6.6	6.8	7.2
Gross Fixed Capital Formation 4yr-average (€bn)	$GFCF_{4yr}$	3.9	4.2	4.5	4.9	5.5	6.1	6.6
Gross Fixed Capital Formation Adjustment (€bn) = $GFCF_t$-$GFCF_{4yr}$	inv	0.5	0.4	0.5	0.8	1.1	0.8	0.6
Cyclical Unemployment Expenditure (€bn) [4]	u	-0.3	-0.4	-0.2	-0.2	-0.3	-0.6	-1.0
Government Expenditure Co-Financing EU Funding (€bn)	EU	0.4	0.4	0.5	0.5	0.5	0.5	0.6
Corrected Expenditure Aggregate = TE - i - inv - u - EU (€bn)	TE^*	68.1	67.9	69.7	71.6	73.9	76.5	79.1
Net Discretionary Revenue Measures, "DRM" (€bn)	DRM	-0.9	-0.7	0.0	0.1	-0.1	-0.2	-0.2
Nominal Corrected Expenditure less DRM (€bn) = TE_t^* - DRM_t	TE_t^{*DRM}	69.0	68.6	69.7	71.5	74.0	76.6	79.2
…Nominal Growth (% y/y) = (TE_t^{*DRM}/TE_{t-1}^*-1)*100	e	6.9	0.7	2.7	2.6	3.4	3.7	3.6
…Real Growth (% y/y) = ((1+e/100)/(1+p/100)-1)*100	**er**	**5.9**	**-0.9**	**1.6**	**1.4**	**2.1**	**2.3**	**2.0**
Real Corrected Expenditure Growth Limit [2] (% y/y) = R_t - C_t	**EB**	**n.a.**	**0.1**	**1.3**	**1.6**	**3.3**	**3.6**	**3.5**
Deviation (p.p.) = er - EB_t …positive = non-compliance	d	n.a.	-1.0	0.3	-0.2	-1.3	-1.3	-1.6
Deviation (€bn) = d*TE_{t-1}^{*DRM} …positive = non-compliance		n.a.	-0.7	0.2	-0.1	-0.9	-1.0	-1.2
Deviation (% GDP) …positive = non-compliance		n.a.	-0.3	0.1	0.0	-0.3	-0.3	-0.4
Relevant Macroeconomic Aggregates:								
Real GDP Growth (% y/y)	y	26.3	4.2	3.5	3.8	3.6	3.0	2.8
Potential GDP Growth (% y/y)	y^*	24.6	4.0	4.2	4.5	3.7	3.2	3.0
Output Gap	OG	1.6	1.8	1.1	0.5	0.3	0.2	0.0
GDP Deflator Applicable (% y/y) [5]	p	0.9	1.7	1.1	1.2	1.3	1.5	1.6

Sources: Budget 2017 (ex post projections including expected allocation of fiscal space); and internal IFAC calculations.

[1] The Backward- and Forward-Looking Benchmark are calculated on the same basis but the assessment relates to different years (the assessment of the former is for year "t", while the latter is for two years later, i.e. year "t+2").

[2] Annual adjustment requirements (determined by EC Matrix, Appendix G) and real Corrected Expenditure Growth Limit for year "t" are frozen in spring of the previous year. Requirements for outer years are therefore indicative only.

[3] CAM-based potential output estimates from *Budget 2017* averaged over t-5 to t+4. EC Reference Rate and Convergence Margin estimates apply for Preventive Arm requirements.
[4] Cyclical unemployment expenditures based on average benefits, unemployment rates and CAM-based NAWRU.
[5] The updated EC deflator is frozen at 1.2 per cent for 2017, implying a €0.1 billion (0.05 per cent of GDP) deviation.

4.3.1 MTO and Structural Balance Adjustment Requirements

The Government's structural budget balance is projected not to meet the Medium-Term Objective (MTO) in 2016, thus not fulfilling the domestic Budgetary Rule's "Budget Condition". Both the domestic Budgetary Rule and the EU rules require that appropriate adjustments are made towards the MTO of a structural balance of -0.5 per cent of GDP.[7] The current CAM-based estimate of the structural balance for 2016 is -1.9 per cent of GDP.[8]

The Department of Finance's official budgetary projections show that the adjustments toward the structural balance target falls short of requirements under the domestic Budgetary Rule and the EU rules for 2016. Requirements for an adjustment in the structural balance of +0.6 percentage points of GDP were set in spring 2015. However, the Department is currently forecasting a change in the balance (adjusted for one-offs and cyclical developments) of just +0.3 percentage points (Figure 4.1), which falls to +0.1 percentage points when the estimates of one-offs from the European Commission for 2015 are applied (Table 4.2). This represents a deterioration in the size of the adjustment that had been expected in April, when the Department's *SPU* projections also showed a deviation from the minimum requirements (a change of +0.4 percentage points was indicated at the time). The smaller structural adjustment is due to: (i) a smaller improvement in the headline deficit and (ii) more of the recovery in the economy being judged as cyclical following revisions to output gap estimates that show a larger cyclical recovery in 2016.[9] These factors are offset to some extent by a reduced level of one-off/temporary measures estimated for 2015.

Table 4.2: Structural Balance Changes in *Budget 2017* using Different Estimates of One-off/Temporary Measures (% GDP)

		2015	2016	2017
Department of Finance Estimates of One-Off/Temp Measures	One-off/temp measures	-0.5	0.0	0.0
	Structural Balance Implied	-2.2	-1.9	-1.1
	Change in Structural Balance Implied		0.3	0.8

[7] Ireland's minimum MTO was revised in February 2016 and is now set as a structural deficit of 0.5 per cent of GDP for the period 2017-2019, though the previous requirement set at 0.0 per cent still applies for 2016.

[8] As noted in previous *Fiscal Assessment Reports*, structural balance estimates derived from output gaps on the basis of the CAM may be inappropriate for Ireland (Chapter 2). The structural balance comprises the General Government Balance of -0.9 per cent of GDP in 2016, minus half the output gap level (based on a 0.53 semi-elasticity), minus one-offs.

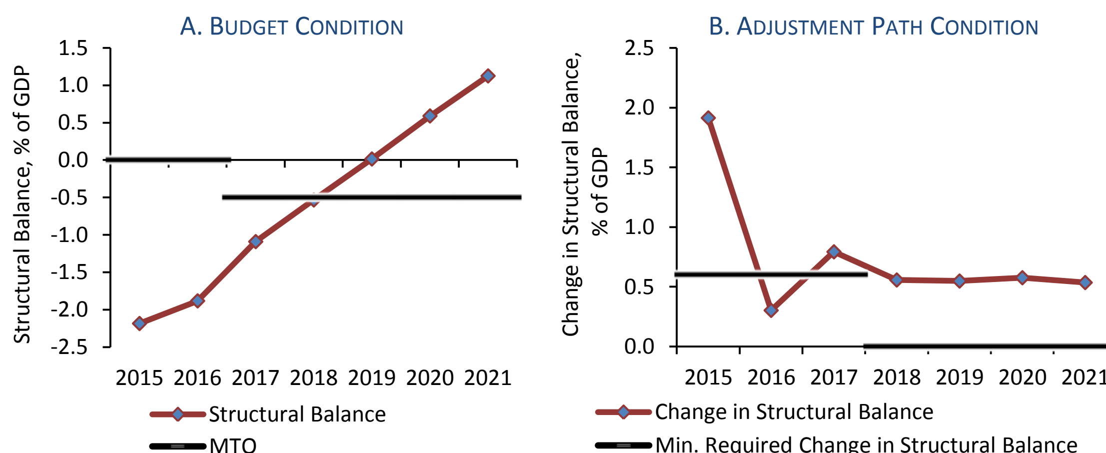
[9] The European Commission (2016d) also indicated in spring that a breach was likely for 2016 in the absence of further measures. Based on their own projections, the estimated change in the structural balance relevant for assessing *ex ante* compliance was 0.2 percentage points for 2016. A subsequent recommendation noted that Ireland was "…expected to broadly comply with the provisions of the Stability and Growth Pact," but that "…further measures will be needed to ensure compliance in 2016".

European Commission Estimates of One-Off/Temp Measures	One-off/temp measures	-0.8	-0.1	0.0
	Structural Balance Implied	-1.9	-1.8	-1.1
	Change in Structural Balance Implied		0.1	0.8

Sources: Department of Finance*;* EU Commission.

The Department of Finance forecasts reflect different levels of one-off/temporary measures in *Budget 2017* than those considered by the European Commission, leading to a larger structural balance adjustment under the Department's figures (Table 4.2). The only one-off included by the EU Commission for 2015 is the €2.1 billion adjustment for the AIB transaction. The Department, however, factors in other one-offs in 2015 including amounts related to dividends received from the ESB and pension levy receipts. The removal of these revenues worsens the structural balance position in 2015, which has the effect of improving the change in the structural balance between 2015 and 2016 – the period over which a deviation from the fiscal requirement is indicated in *Budget 2017.* Applying the same one-off estimates for 2015 as used in the Commission's autumn assessment to *Budget 2017* plans would see the projected 0.3 percentage point improvement in the structural balance for 2016 fall to 0.1 percentage points. This would represent a significant deviation from the fiscal requirement. This also highlights how differences between assessments by the European Commission and Department depend not only on the CAM, but also on the definition of one-offs and other issues. The Council has previously noted that the identification of one-off/ temporary measures can be somewhat subjective. There is also international evidence that the introduction of a fiscal rules framework based on numerical targets for fiscal metrics can create incentives for governments to use one-off measures strategically.[10]

FIGURE 4.1: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE



Sources: *Budget 2017 (ex post* projections including expected allocation of fiscal space); internal IFAC calculations.

[10] See Box D (IFAC, 2014b) on the treatment of one-off and temporary measures. Koen and Van den Noord (2005) demonstrate that as deficit rules become more binding, recourse to one-offs and other stratagems is more likely. Alt et al. (2012) offer a useful and more recent survey of the literature.

Note: The minimum MTO for Ireland was revised to -0.5 for 2017-2019 and is planned to be achieved in 2018 so that the adjustment path condition no longer applies thereafter. Required changes above are calculated based on the previous year's structural balance.

There are important implications if the structural balance adjustment for 2016 falls short of the required 0.6 percentage points of GDP in the *ex post* assessment by a wide margin. For instance, if the shortfall exceeds 0.5 percentage points, then an overall assessment by the European Commission (Appendix G) could lead to a Significant Deviation Procedure being initiated, which would apply greater scrutiny to the other pillar of the rules, the Expenditure Benchmark.[11] Indeed, the Commission's *ex ante* opinion notes that budget plans indicate a significant deviation from the structural balance adjustment requirements for 2016. The Commission therefore adjusts for the one-off AIB transaction as part of their Expenditure Benchmark assessment. This assessment points to 'broad compliance' on account of a breach of the threshold of significance still being marginally avoided (i.e., the breach is an amount "below but close to" the 0.5 per cent of GDP threshold).[12]

4.3.2 Expenditure Benchmark

The Expenditure Benchmark is intended to be consistent with requirements set for the structural balance, though the rules may give conflicting signals under certain circumstances.[13] While *Budget 2017* indicates non-compliance with the structural balance rule for 2016, the Expenditure Benchmark rule is complied with. The opposing signals regarding compliance highlights an anomaly in their application. This arises due to a differing treatment of one-off items. The Expenditure

[11] See Box G (IFAC 2016a) for additional detail on the Preventive Arm assessment process.

[12] The European Commission (2016d) focuses upon the Expenditure Benchmark when it notes the risk of a deviation from adjustment requirements towards the MTO in 2016. It highlights how the structural balance adjustment indicates a significant deviation and how expenditure growth – when adjusted for the one-off AIB transaction as part of an overall assessment – exceeds the maximum growth rate permitted. The latter is currently noted as being close to but below a significant deviation, thus resulting in an overall assessment of broad compliance: "In 2016, whereas the improvement of the structural balance…significantly deviates from the required adjustment, the growth rate of government expenditure, net of discretionary revenue measures, is expected to be below the expenditure benchmark. Taking all factors into consideration, including a one-off transaction in 2015, the expenditure benchmark would point to a deviation from the requirement which is below but close to 0.5% of GDP. On that basis, the overall assessment points to a risk of some deviation from the required adjustment path towards the MTO in 2016…Overall, the Commission is of the opinion that the Draft Budgetary Plan of Ireland, which is currently under the preventive arm and subject to the transitional debt rule, is broadly compliant with the provisions of the SGP".

[13] While the EB is designed to support achieving the targeted structural balance improvement, there are a number of scenarios where they may give differing signals as to compliance with the rules (IFAC, 2015c). This is especially true if (i) there are one-offs or temporary measures, which are not captured in the EB as in the structural balance; (ii) if current year estimates of potential output growth diverge substantially from the ten-year average used in the calculation of the EB's reference rate; (iii) if a fall in the true structural balance is masked, for example, by revenue windfalls, or pro-cyclical adjustments to estimates of potential output, or (iv) if movements in interest expenditure are impacting the structural balance, while the EB is based on primary expenditure EB. In such cases, the estimated structural balance alone may fail to sufficiently capture underlying changes in the fiscal position. In the event of such conflicting signals, the Council will form a view on compliance with the Budgetary Rule based on an analysis of the particular reasons underlying any conflicts. In undertaking the assessment of rules, the Council will primarily refer to the Department's forecasts and estimates, with analysis and sensitivity tests of key assumptions and forecasts where appropriate and necessary.

Benchmark, unlike the structural balance, fails to account for the same one-off or temporary items relevant for spending. Achieving compliance with the Expenditure Benchmark is therefore aided by the higher spending base in 2015 stemming from the conversion of the €2.1 billion of AIB preference shares into ordinary shares. This temporary, one-off increase in 2015 expenditure falls out of the spending base in 2016. As a result, the growth rate in spending as assessed under the Expenditure Benchmark is artificially lowered.

It is possible to assess the implications for the Expenditure Benchmark of treating one-off items in the same manner as they are treated for the structural balance. Stripping out the AIB transaction in 2015 – thereby looking through the inconsistent treatment of one-offs – the Department's spending projections would imply non-compliance with the Expenditure Benchmark requirements. On the basis of current *Budget 2017* plans, the associated overspend for 2016 would amount to approximately €1.4 billion or 0.5 per cent of GDP (Figure 4.2). In June, the Council noted that weaknesses in expenditure management in recent years, including a pattern of overspending in Health, could lead to a widening of the already evident underlying breach of the Expenditure Benchmark (IFAC, 2016a). Since then, an additional €540 million voted expenditure for this year was announced in the 2016 Revised Estimates Volume published in June, together with a further €310 million in October as part of the *Budget 2017* estimates. While these amounts translate to additional spending under the Expenditure Benchmark of less than the nominal €850 million, they still boost spending well beyond the initial allocation.[14]

4.3.3 Debt Rule

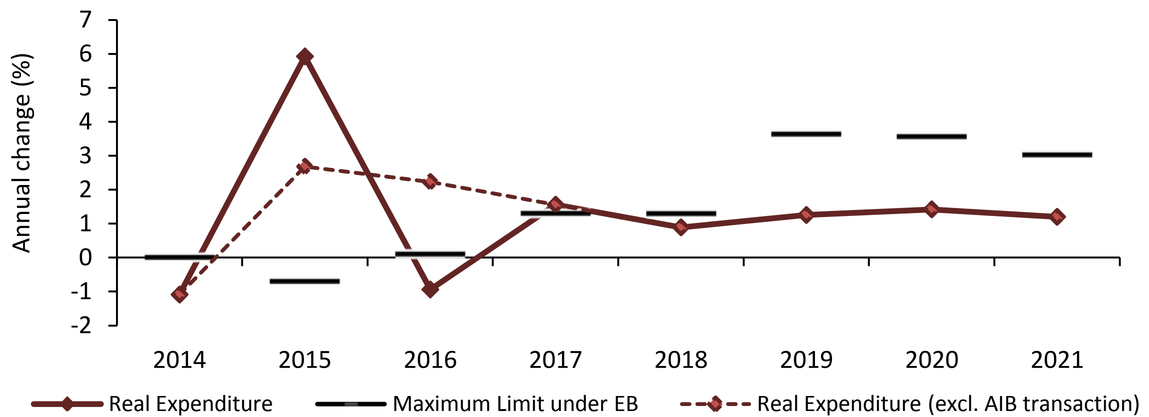
Transitional arrangements under the Debt Rule apply until end-2018 before normal Debt Rule requirements take effect from 2019 onwards.[15] The requirements are less constraining in Ireland's case relative to the other fiscal rules.[16] Table 4.1 shows that the Department's debt ratio projections fall below the two main criteria of the Debt Rule (the "backward-" and "forward-looking benchmarks") in all forecast years.

[14] The principle of 'capital smoothing' applied under the Expenditure Benchmark rule means that investment expenditure is averaged over a four year period (year "t-3" to year "t") so that only the current year difference relative to this average is accounted for. This is intended to limit the extent to which large investment projects are penalised.

[15] The debt rule broadly requires debt in excess of 60 per cent GDP to be reduced by at least 1/20th per year on average. For a more detailed discussion, see IFAC *Analytical Note 5: Future Implications of the Debt Rule* (IFAC, 2014c).

[16] Given the starting debt-to-GDP ratio of 78.6 per cent at end-2015, the 1/20th rule approximates to, at minimum, a 20-year period over which the debt ratio would have to converge to 60 per cent.

Figure 4.2: Compliance with the Expenditure Benchmark



Source: Budget 2017 (ex post figures incorporating allocated use of fiscal space*)* and EC *Spring Economic Forecasts.*
Note: Real expenditure is the adjusted aggregate relevant for the assessment of the EB. It excludes interest spending, expenditure on EU programmes fully matched by EU funds revenue and cyclical elements of unemployment benefit expenditure. In addition, investment spending is averaged over a four-year window to smooth the impact of large investment projects The EB is complied with where the real expenditure aggregate grows slower than maximum limit permitted under the EB. This growth rate is adjusted to reflect discretionary revenue measures.

Box E: Assessment of Compliance with the Budgetary Rule

Next year will be the first year in which the Council will make an *ex post* assessment of compliance with the Budgetary Rule. The assessment will be made with reference to the annual outturns and requirements for 2016. This Box outlines the procedural aspects of the assessment of compliance as specified under the *Fiscal Responsibility Act (FRA)*.

The *FRA* requires the Council to monitor and provide an assessment of compliance with

obligations under the Budgetary Rule. This assessment specifically refers to:

i. whether failure to comply with the Budgetary Rule constitutes a significant deviation;
ii. whether the Government's own plans to secure compliance with the Budgetary Rule, as required under the Correction Mechanism, are being achieved, and
iii. whether, in the Council's opinion, exceptional circumstances exist or have ceased to exist.[17]

Budgetary Rule: The Budgetary Rule consists of two elements: the "Budget Condition" and the adjustment path condition. The "Budget Condition" is a requirement that the budgetary position of the General Government is in balance or in surplus.[18] The adjustment path condition applies when the MTO is not being met, and requires that the structural balance is converging towards this in accordance with the 1997 Surveillance and Coordination Regulation. Failure to meet the requirement is only permitted as a result of exceptional circumstances and the non-endangerment of medium-term fiscal sustainability.[19]

Correction Mechanism: The *FRA* lays out specific requirements to initiate a "correction mechanism" when the Government assesses that there is a failure to comply with the Budgetary Rule (which constitutes a "significant deviation") or when the European Commission issues a warning to the State under the 1997 Surveillance and Coordination Regulation relating to such a deviation. In such circumstances, the *FRA* requires that the Government lay before the Dáil, within two months, a plan specifying what is required to secure compliance with the Budgetary Rule. This should:

a) specify the period over which compliance with the Budgetary Rule is to be achieved,

[17] *FRA* Section 8(2) specifies the Council's role as to "monitor, and at least once in each year provide an assessment of, whether any obligation under section 2(1)(a) or 6(1), or to do things specified in a plan under section 6(1), is being complied with". Section 2(1)(a) relates to the Budgetary Rule and notes: "the Government shall endeavour to secure that—(*a*) the requirement imposed by *section 3* (the budgetary rule)…are complied with". Section 6(1) covers the "Correction Mechanism", that sets plans to secure compliance with the Budgetary Rule when not met: "if the Commission addresses a warning to the State under Article 6(2) of the 1997 surveillance and coordination Regulation or if the Government consider that there is a failure to comply with the budgetary rule which constitutes a significant deviation for the purposes of Article 6(3) of that Regulation, the Government shall, within 2 months, prepare and lay before Dáil Éireann a plan specifying what is required to be done for securing compliance with the budgetary rule".

[18] Based on legal clarifications, the Council is of the view that the budgetary position in this context refers to the structural balance. The *FRA* specifies that a failure to meet the requirement is only permitted as a result of exceptional circumstances and if it does not endanger medium-term fiscal sustainability. The Budget Condition is also deemed to be respected if the structural balance is at the Medium-Term Objective (MTO) as set under the Preventive Arm.

[19] As the *FRA* effectively translates *SGP* Preventive Arm requirements into domestic legislation following the Fiscal Stability Treaty, approved by referendum in 2012, the MTO, exceptional circumstances and significant deviations are interpreted as consistent with the former. The Council has clarified two elements in relation to how the Budgetary Rule is to be assessed: First, Budgetary Rule requirements, though legally applicable since December 2012, are legally satisfied by meeting EDP requirements to 2015. From 2016 on, the "Budget Condition" and the adjustment path condition operate in full. Second, assessment of compliance with the Budgetary Rule incorporates a dual assessment of requirements for both the structural balance and the Expenditure Benchmark. Regulation (EU) No. 1175/2011, 16 November 2011 and the *Vade Mecum* 2016 specify that significant deviations refer to deviations in structural balance adjustments toward MTO or deviations in expenditure developments net of discretionary revenue measures impacting on the government balance, where the deviation is at least 0.5 per cent of GDP in a single year or at least 0.25 per cent on average per year in two consecutive years.

b) if that period is longer than a year, specify annual targets to be met in moving towards such compliance,
c) specify the size and nature of the revenue and expenditure measures that are to be taken to secure such compliance, and
d) outline how any revenue and expenditure measures that are to be taken will relate to different subsectors of the General Government.

The plan must also be consistent with (i) the *SGP* rules, (ii) recommendations made to the State under the *SGP* in relation to the period over which compliance with the Budgetary Rule is to be achieved, and the size of measures to be taken to secure such compliance, and (iii) the current stability programme.

Subsequent to the Council making its assessment, the *FRA* also notes that IFAC will share this with the Minister, and then publish it within ten days. If the Government does not accept the Council's assessment in relation to compliance with the Budgetary Rule, the Minister is required to prepare and lay before Dáil Éireann a statement of the Government's reasons for not accepting it within two months of being given a copy of the assessment.[20] If the Government accepts an assessment of non-compliance amounting to a significant deviation, the Correction Mechanism applies. These provisions are consistent with what is referred to as the "comply or explain" principle.

4.4 Ex Ante Assessment of 2017 to 2021

The *ex ante* assessment of compliance with the fiscal rules for 2017 and later years focuses on the pace of structural deficit adjustment towards meeting Ireland's updated MTO. This also includes an analysis of spending growth using the Expenditure Benchmark (EB). Box F explains the concept of "fiscal space" as used in an Irish context by the Department of Finance and how it is governed by the application of these rules over the period. The debt rule, though applicable, is not likely to present a binding constraint (Section 4.3).

4.4.1 MTO and Structural Balance Adjustment Requirements

The Department currently projects a structural balance of -1.1 per cent of GDP for 2017. This represents an improvement of 0.8 percentage points on the previous year, and therefore exceeds the 0.6 percentage point adjustment required.[21] If the structural balance path envisaged in *Budget 2017* plans were to be followed, then the projected 0.6 percentage point adjustment in 2018 would

[20] *FRA* Section 8(5) and 8(6) note: "(5) The Fiscal Council shall, as soon as practicable after completing an assessment under this section, give a copy of the assessment to the Minister and publish the assessment within the period of 10 days beginning on the day on which the copy is so given. (6) If the Government do not accept an assessment of the Fiscal Council in relation to any of the matters referred to in subsection (3), the Minister shall, within 2 months of being given a copy of the assessment under subsection (5), prepare and lay before Dáil Éireann a statement of the Government's reasons for not accepting it".

[21] The 0.6 percentage point structural balance adjustment requirement is set according to the EC "matrix" (Appendix F) on the basis that the Commission's output gap estimate for 2017 of 0.6 per cent falls within the "normal times" category (between +/- 1.5 per cent), and the debt-to-GDP ratio is set to remain above 60 per cent. The requirement is frozen in spring of the preceding year.

be sufficient to meet the MTO of -0.5 per cent of GDP. Once the MTO has been achieved, no further adjustments are required as long as the MTO is maintained. The *Vade Mecum* (EC, 2016c) also notes that, under the EU framework, countries exceeding their MTO "do not need to be assessed for compliance with the Expenditure Benchmark".[22]

Unlike the *SPU 2016* projections, which are based on a no-policy change assumption for later years, the structural balance path outlined in *Budget 2017* is based on the assumption that the fiscal space available in 2017-2021 is used in accordance with the Government's stated intentions. This scenario accounts for stated commitments to use the available additional net fiscal space for new expenditure and revenue measures, as well as leaving some amounts unallocated. The *SES 2016* indicates that these unallocated amounts are to be directed to a Rainy Day Fund once the MTO is achieved. However, as *Budget 2017* proposes that these amounts be retained within an Exchequer contingency reserve, they would not reduce the net fiscal space available (i.e., because any allocations would remain as savings within General Government, they would not be treated as General Government expenditure). All else being equal, a decision to use these unallocated funds for expenditure rather than for maintaining savings in the Rainy Day Fund would reduce the projected overachievement of the MTO.

Figure 4.1 compares the projected structural balance path in *Budget 2017* to the expected annual requirements out to 2021.[23] Though 2016 and 2017 fiscal requirements are now set, some uncertainty remains for subsequent years. Requirements will depend on the degree of compliance for preceding years and on supply-side estimates underpinning the EC "matrix" (Appendix G).

4.4.2 Expenditure Benchmark

For 2017, the maximum growth rate in spending permitted under the Expenditure Benchmark for 2017 has been set at 1.3 per cent in real terms. However, *Budget 2017* sets out plans that indicate real spending growth of 1.6 per cent – exceeding the maximum permitted limit. The excess over

[22] The updated *Vade Mecum* (2016) notes that in the case of Member States exceeding their MTO, these "can deviate from the requirements of the Expenditure Benchmark without it being considered significant, as long as the MTO is maintained". The *Vade Mecum* also clarifies that revenue windfalls will be considered when judging whether these are partly responsible for the overachievement of the MTO in any *ex post* assessment.

[23] The path of minimum compliance is calculated on an annual basis by reference to the structural balance path published in *Budget 2017*. It assumes that the structural deficit of 2 per cent forecast in *Budget 2017* is met, 0.6 per cent adjustments are then required in 2017 and 2018, with a final 0.3 per cent adjustment applying in 2019.

the limit amounts to €0.2 billion (or 0.1 per cent of GDP), which is not considered a significant deviation in the EU framework.[24]

Recognising the projected breach in 2017, *Budget 2017* notes that expenditure in 2017 "includes €200 million in respect of EU budget contributions which may not be met within the benchmark ceiling". While the excess matches the increase in the EU budget contribution, the fact that planned expenditure was already set at the maximum limit permitted by the Expenditure Benchmark is a concern. The Expenditure Benchmark does not distinguish between EU budget contributions and other items of expenditure. Furthermore, this approach overlooks the value of maintaining reasonable buffers that are founded on the basis of realistic expenditure forecasts. The Council is of the view that – at minimum – official plans should aim to comply with the fiscal rules on an *ex ante* basis. Setting out forecasts that, *ex ante*, imply non-compliance increases the risk of a significant deviation subsequently materialising if expenditure overruns emerge or if rule parameters change unexpectedly (e.g., following revisions to input data for the Expenditure Benchmark).

Box F: What is Fiscal Space?

This Box outlines the concept of 'fiscal space'. While the term is used to refer to several different concepts in the economic debate, in Ireland it has come to refer to the scope available for policy changes under the fiscal rules.[25] Given the complexity of the fiscal rules, the concept of fiscal space can serve as a potentially useful summary measure for policymakers and the public. When taken into consideration with estimates of stand-still costs (Box D) and policy changes envisioned, the measure can help to contribute to a more informed basis for budgetary planning. However, there remains much confusion around the concept of fiscal space and a clear definition is needed.

The Definition of Fiscal Space Used in Ireland

In essence, the definition of fiscal space that has emerged in the Irish policy context is that of an *estimate* of the scope for future spending increases or tax cuts possible while complying with the domestic and EU fiscal rules. It can be further described in gross or net terms:

- 'Gross fiscal space' refers to the scope available before any relevant pre-committed tax/spending changes are included;

[24] Note that when the *Budget 2017* plans are updated to reflect the frozen GDP deflator estimate to be used by the European Commission in its assessment, the deviation falls to €0.1 billion or (0.05 per cent of GDP).

[25] For instance, Heller (2005) defines fiscal space as "…room in a government´s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy." Ostry et al. (2010) also refer to sustainability considerations when defining fiscal space as "…the difference between a country's current level of debt and the maximum level of debt, the latter implied by the country's historical record of fiscal adjustment". Such definitions rely on strong assumptions concerning estimates of sustainable thresholds outside of a rule-based framework.

- 'Net fiscal space' refers to the remaining scope available after these pre-commitments are included (e.g., after including expenditure increases to address demographic changes, agreed pay rises, etc.).

It is important to note that the definition that has evolved domestically is just one interpretation of the concept. Indeed, the usage of the term 'fiscal space' has been applied for quite different purposes elsewhere, with many uses of it focusing on broader concepts of the sustainability of the financial position or stability of the economy rather than specific limits imposed by fiscal rules.

Focusing on the Irish use of the concept, fiscal space first came to prominence in Ireland following the publication of estimates in *Budget 2016*. The Budget document (Table A8) identified what was referred to as "gross available fiscal space" for discretionary expenditure and taxation measures each year between 2016 and 2021 on the basis of the Department's interpretation of the maximum permitted spending under one of the fiscal rules – the Expenditure Benchmark (EB). In Table A9 of the Budget book, pre-committed spending increases (mainly relating to demographics and the Lansdowne Road Agreement) were deducted from the estimate of gross fiscal space to arrive at a net fiscal space figure.

Uncertainties around Estimates

There is regularly a significant amount of debate about fiscal space, which is not helped by the uncertainties involved in calculating the space expected to be available over a number of years. These uncertainties may arise in relation to:

- *How the fiscal rules interact:* this is particularly important with respect to the two key pillars, the Expenditure Benchmark and structural balance requirements.[26] For any given year, the most binding rule will be the one that sets the upper limit on the available fiscal space for that year.
- *The actual budgetary stance adopted in later years:* budgetary decisions made in one year will impact on subsequent years. Any over/under-compliance with the requirements of the fiscal rules in a given year could entail additional/reduced fiscal space for subsequent years.
- *Revisions to relevant data:* This applies to both historical and forward-looking estimates of observable inputs that are used as the basis for assessing the fiscal rules. These may include macroeconomic variables such as real GDP growth and economy-wide inflation,[27] as well as fiscal variables like General Government expenditure, revenue and debt interest costs. Also relevant are estimates of unobservable variables like potential output growth and the output gap, which need to be determined so as to set fiscal policy that appropriately considers the cyclical position of the economy.

[26] See Box G of IFAC (2016a) for an introduction to the key elements of the Preventive Arm of the *Stability and Growth Pact (SGP)* and the domestic Budgetary Rule. This covers the key rules that apply for the purposes of estimating fiscal space, including the Expenditure Benchmark and the structural balance requirements.

[27] As measured by the GDP deflator.

The Importance of Assessing All Pillars of the Fiscal Rules

The Department has to date focused on the Expenditure Benchmark (EB) as the basis for identifying available fiscal space in future years. The use of the EB is preferred by the Department over the structural balance rule due to the EB's advantage of being less subject to revision. This reflects the fact that the EB relies on smoothed, ten-year averages of potential output growth estimates, rather than the annual estimates used for the structural balance calculations. The preference for smoothed estimates reflects the tendency for the Commonly Agreed Methodology, which is used for monitoring and enforcing the EU fiscal rules, to produce highly variable, and often pro-cyclical potential output growth estimates for small, open economies like Ireland.[28]

Although the Expenditure Benchmark has the advantage of being relatively more insulated from large revisions and is more intuitive to communicate than changes in the structural balance, fiscal space calculations should still be cognisant of all of the fiscal rules.[29] The interaction of the twin pillars of the fiscal rules is an important feature that can help to prevent unexpected anomalies leading to inappropriate guidance for the fiscal stance in a given period. A recent example of this is the AIB share transaction in 2015 which was treated as a one-off in the calculation of compliance with the structural balance rule but not in the case of the Expenditure Benchmark.

4.5 The Medium-Term Expenditure Framework (MTEF)

A major domestic budgetary reform following the crisis has been the introduction of the MTEF. The MTEF requires the government to provide three-year-ahead expenditure ceilings for each Department, with upper limits on expenditure set in accordance with the Expenditure Benchmark.[30] In theory, individual Ministerial ceilings are designed to control Departmental expenditure within these upper limits.[31] The intention is to assist the planning and delivery of service reforms, while avoiding the expenditure management problems observed prior to the crisis.

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[28] Criticisms of the approach are well-documented, including those of the Department itself (Department of Finance, 2003) and in a number of the Council's previous reports (IFAC, 2015a, Chapter 2; IFAC 2014a, Chapter 2 and Analytical Note 2; IFAC, 2013a; and IFAC, 2011 Box 3.1). Bergin and FitzGerald (2014) also provide a very useful discussion in the context of the structural balance.

[29] The *Vade Mecum* (EC, 2016e) notes that countries that have "…exceeded their MTO do not need to be assessed for compliance with the Expenditure Benchmark".

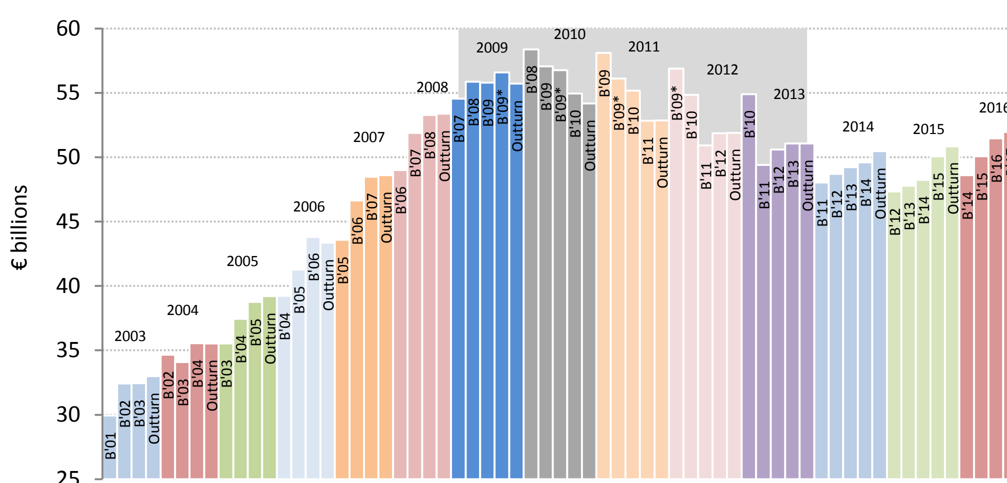
[30] The MTEF is set out in the *Ministers and Secretaries (Amendment) Act 2013* and Departmental Circular 15/13.

[31] See Medium-Term Budgetary Framework (Department of Finance, 2014b). The *Ministers and Secretaries (Amendment) Act 2013*, which legislated for the ceilings, provides for both an aggregate ceiling on gross Departmental expenditure, including the Social Insurance Fund - the Government Expenditure Ceiling - and for individual Ministerial ceilings. Furthermore, it requires that the aggregate of the Ministerial ceilings be no more than the overall Government Expenditure Ceiling. The legislation provides that where the Government has decided on a Government Expenditure Ceiling, they may make a further decision to revise the Government Expenditure Ceiling to a lesser or greater amount. Subject to such a revision the Government may revise the Ministerial Expenditure Ceilings.

4.5.1 Pattern of Expenditure Ceiling Revisions

Similar to the pre-crisis period, a pattern of revisions to expenditure ceilings has been evident since 2011 (Figure 4.3). The recent trend of underestimating spending pressures and addressing execution problems by relaxing overall government expenditure ceilings within the year, particularly in the Health area, has continued into 2016. Additional 2016 expenditure increases of €500 million for Health and €40 million for the Department of Justice were announced mid-year in the *2016 Revised Estimates Volume* and were followed by another €310 million in October as part of the *Budget 2017* estimates.

Figure 4.3: Gross Current Expenditure Forecasts



Source: Department of Finance; internal IFAC calculations.
Note: Bars show forecasts from various Budgets followed by outturns (e.g., B'15 = expenditure forecasts in *Budget 2015*). Each set of coloured bars relates to forecast/outturn expenditure for year specified above. Grey shaded region covers crisis period 2009-2013.

There are reasonable concerns that this phenomenon could undermine future public spending management. Such adjustments, if continued, could risk a return to the pattern of pro-cyclical adjustments that marked the pre-crisis period. The adjustments also risk damaging expenditure control incentives and practices, which can perpetuate the cycle of upward revisions to ceilings.[32] While multi-annual ceilings should not be entirely inflexible to developing needs, a pattern of repeated upward revisions to overall expenditure ceilings reduces the incentive for individual Ministries to identify and implement savings. Such a pattern can, *ex ante,* suggest the availability of

[32] In introducing the MTEF, the *Comprehensive Expenditure Review 2012-2014* and subsequent Expenditure Reports, outlined the intention to move away from an approach where expenditure was determined by "...demands and bids from the spending Ministries...with little regard to medium-term plans or constraints upon overall allocations" to a multi-annual approach that "...provides clarity about the resources Departments will have available over a number of years and reinforces fiscal discipline" (Expenditure Report 2014).

extra resources above pre-determined ceilings and can reduce incentives to strategically allocate resources, thereby becoming subject to the problems of the 'soft budget constraint'.[33]

Reflecting on the Council's concerns, the *Mid-Year Expenditure Report* (*MYER*) notes that recent expenditure revisions – unlike pre-crisis revisions – reflect flexibility required to meet deficit reduction targets while also allowing the Government to address social priorities and to support economic recovery. The *MYER* notes that the primary anchor up to 2015 was the target for the headline General Government deficit and that this allowed for flexibility in terms of adjusting expenditure when tax growth and interest costs were better than expected. With Preventive Arm requirements operating in full from 2016 onwards, however, the scope for long-lasting expenditure increases to follow positive short-term macroeconomic dynamics will be more limited. In particular, if spending is already at maximum levels permitted by the Expenditure Benchmark (i.e., consistent with a policy that uses available fiscal space in full) then revisions to overall Government Expenditure ceilings will only be possible in specific circumstances.[34]

4.5.2 The Design of Effective Expenditure Ceilings

One possible way to address the operational features of the Preventive Arm would be to construct expenditure forecasts comprising: (1) realistic, credible ceilings at Ministerial level that fully incorporate expected spending plans; and (2) the setting of an appropriate buffer between the sum of Ministerial ceilings and the upper limit of total expenditure as permitted under the Expenditure Benchmark. This buffer could allow for revenue uncertainties and legitimate expenditure overruns, while being calibrated to allow for uncertainties in relation to the maximum aggregate expenditure level allowable under the Expenditure Benchmark given annual updates to this.

While official budgetary projections have moved towards a more realistic scenario that includes the use of estimated net fiscal space available for future years (i.e., the *ex post* projections), this policy is not applied effectively to the design of Ministerial Expenditure Ceilings. In particular, the Ministerial Expenditure Ceilings in the *Expenditure Report 2017* have two major drawbacks:

[33] The soft budget constraint, as originally formulated (Kornai, 1992), posits that a budget constraint is soft where the decision maker in control of day-to-day expenditure anticipates that the constraint is likely to be relaxed *ex post* if the original constraint is not met, notwithstanding any *ex ante* threats to impose a hard constraint. Where the budget setting process is weak, this may further 'soften' the constraint as the manager – knowing plans are poorly set – has less of an incentive to adhere to them.

[34] The domestic MTEF framework permits revisions to ceilings: (i) under exceptional circumstances, as defined in the *FRA*, (ii) through the introduction of compensatory discretionary revenue measures, or (iii) where adjustments are related to spending on cyclically related unemployment spending or EU co-funded payments.

- *For 2017, aggregate Ministerial Expenditure Ceilings are set exactly in line with the permitted expenditure level under the Expenditure Benchmark.* This policy carries obvious risks. When set too close to permitted limits, unexpected spending pressures or downward revisions to the maximum permitted levels of spending could necessitate spending reductions or tax increases to ensure compliance with the fiscal rules (Figure 4.4).

- *For 2018 and 2019, currently planned expenditure already exceeds the ceilings, and therefore upward revisions to the ceilings will likely be required.* The 2018 and 2019 ceilings do not incorporate the anticipated use of estimated net fiscal space. Specifically, they exclude known carryover costs of measures introduced in *Budget 2017* and they do not allocate resources to individual Ministries even though new measures are anticipated.[35] This approach effectively guarantees upward revisions to ceilings by setting unrealistically low planned expenditure levels and, correspondingly, unrealistically large buffers. The rationale for producing ceilings in such a way is to facilitate the strategic achievement of efficiency gains.[36] However, in cases where the upward revisions are already anticipated, the credibility and usefulness of the ceilings as a tool for expenditure planning and management is undermined, and the dangers related to soft budget constraints apply. These costs may well outweigh the benefits of an approach that sets very tight initial ceilings (essentially setting out large buffers and targeting incentives for efficiency gains). It should also be noted that allocating the estimated fiscal space to be used as buffers to individual Ministries in advance would not rule out the achievement of efficiency gains nor would it prevent reallocations between Departments in future years. It would, however, provide more realistic ceilings consistent with the overall forecasts for expenditure in *Budget 2017*.[37]

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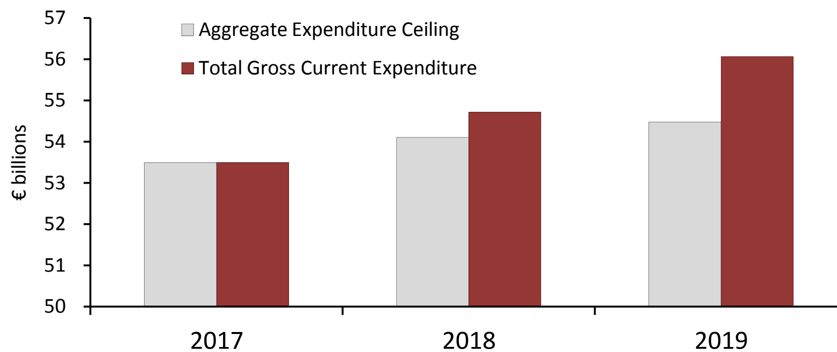
[35] Tables 5 and 6 of the *Expenditure Report 2017* set out gross current and capital Ministerial Expenditure Ceilings, and include a category labelled "resources to be allocated" amounting to €1.1 billion in 2018 and €1.5 billion in 2019. The amounts are based on the indicative allocation of available net fiscal space from 2017 onwards. *Budget 2017* notes that, "beyond 2017, specific allocation by Vote will take place as decided on an annual basis to reflect policy decisions yet to be taken". According to *Expenditure Report 2017,* the Ministerial Expenditure Ceilings only take account of demographic pressures in Health, Education and Social Protection as well as additional expenditure in Agriculture from the roll-out of the rural development programme. The 2017 costs for the Lansdowne Road Agreement have been allocated to Departments as part of their 2017 ceilings. The Expenditure report, however, notes that unallocated resources for 2018 onwards are to be available to meet "the cost of new measures in 2018 and 2019 and the carryover cost of *Budget 2017* measures". They will therefore be allocated among Departments and added to their ceilings for those years.

[36] Ministerial expenditure is kept to a large extent fixed in nominal terms while pay rates are only adjusted to reflect new public service pay and pensions agreements decided by Government. The MYER notes that "the non-application of price increases…is a mechanism utilised in other jurisdictions to generate efficiency dividends and promote productivity where State bodies are effectively challenged to maintain the existing level of service with less resources".

[37] It could be expected that Departments would include some unallocated resources or buffer when setting their individual expenditure ceilings in order to accommodate unexpected expenditure increases which could arise over the medium term. The resources to be allocated category included in the *Expenditure Report 2017* differs from this idea of a buffer. It is a single aggregate category that corresponds to the total estimated fiscal space for expenditure increases in 2017 and 2018. The resources are not assigned to individual Departments.

Progress on improving systems of expenditure planning will be vital to ensuring that domestic expenditure ceilings and EU Preventive Arm requirements are complied with in coming years. To this end, both the *MYER* and *Budget 2017* note that "work is currently underway to develop a common framework for modelling government spending that extends beyond an analysis of demographic drivers". The suggestion of going beyond the current analysis of demographic drivers and of using scenario analyses as a basis for developing appropriate buffers against uncertainty in later years is welcome. As the Council has argued in previous *Fiscal Assessment Reports*, realistic expenditure forecasts that take into account both volume and price effects are important to underpin effective expenditure planning and control. To this end, the Council has outlined an alternative broad approach to setting medium-term Ministerial expenditure ceilings that builds on the recent reforms to the budgetary process, while allowing for reasonable buffers (IFAC, 2016b).

FIGURE 4.4: GROSS VOTED EXPENDITURE VS EXPENDITURE CEILINGS



Sources: Department of Finance; and Department of Public Expenditure Reform.
Note: The aggregate ministerial ceilings are compared to the *ex post* expenditure projections in *Budget 2017* which allocate available net fiscal space to expenditure for 2018 onwards.

It is important to note that the identification of sustainable spending limits which guide the design of the MTEF is founded on the basis of CAM-based potential output growth rates. These estimates are prone to procyclicality themselves, producing measures of potential output growth rates that follow actual GDP growth rates quite closely (Appendix D shows how this tendency was mitigated following the 2015 sharp GDP growth outturn). This feature can constrain the scope for expenditure limits to be set in a manner that reflects cyclical developments as intended.

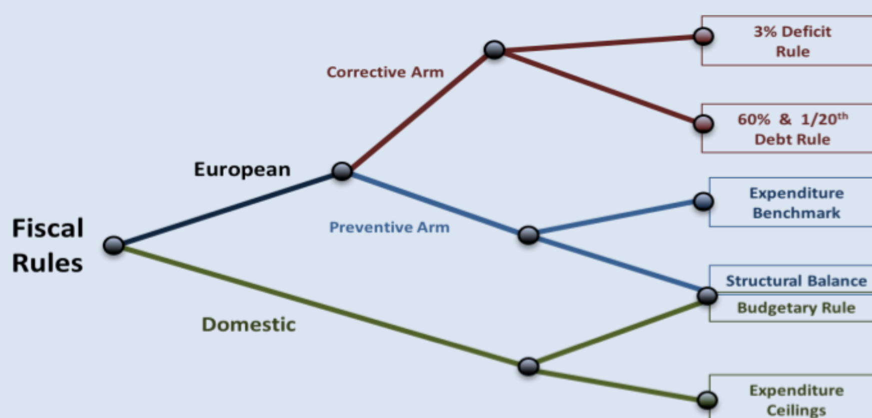
Box G: Implications of 2015 GDP Outturn for Fiscal Rules

The exceptional 26.3 per cent real GDP growth rate for 2015 had numerous implications.[38] It made assessments of sustainability with respect to Ireland's debt and deficit levels less informative when using GDP as a measure of the potential tax base, and it created greater uncertainty as to the cyclical position of the economy. Both aspects had further knock-on effects for the operation of the fiscal rules. This Box explores the risks of potential distortions to the fiscal rules from the 2015 GDP outturn and how these were mitigated.

Importance of Actual and Potential GDP for the Fiscal Rules

As a standard measure of the health of the economy, GDP forms a key input to the European and also domestic fiscal rules. Figure G1 summarises the fiscal rules, separating these into their domestic and European components. With Ireland having exited the Corrective Arm in 2015 on the basis of having a deficit level sustainably below 3 per cent of GDP and a debt ratio reducing at a sufficient pace, the main requirements of the European fiscal rules have shifted to those of the Preventive Arm, though Corrective Arm requirements are still relevant as defining entry into the an Excessive Deficit Procedure.

Figure G1: The European and Domestic Fiscal Rules



Corrective Arm

Both the defined 60 per cent debt and 3 per cent deficit limits for the Corrective Arm are expressed as a share of GDP. As a result of the sharply higher 2015 GDP level, both the deficit and debt ratios are lower relative to a situation where GDP levels excluded any distortions. The margin between 2015 deficit levels and the 3 per cent limit has therefore widened, while the excess on the debt ratio to the 60 per cent level has narrowed sharply. Given that the debt rule effectively requires a one-twentieth annual reduction in the gap between the current debt ratio and a 60 per cent level, this requirement has become less constraining than it otherwise would have been. It is important to note, however, that the effect of these distortions is relatively limited. Other Preventive Arm requirements are more binding than the requirements of the debt rule alone and the deficit projected under

[38] Box A in the *Pre-Budget 2017 Statement* (IFAC 2016b) examines the National Accounts for 2015 in more detail. In particular, it highlights the distortions to real GDP/GNP caused by some activities of multinational enterprises. The output and exports produced by these can add to both GDP and GNP even though the production of the output may take place outside the state with little or no domestic labour used in the production process.

minimum compliance with the Preventive Arm is in any case consistent with a level not exceeding 3 per cent.

Preventive Arm

At the core of the EU Preventive Arm is a target for a country's structural balance and progress towards this is assessed on the basis of two pillars: (i) structural balance adjustment requirements, as complemented by (ii) the Expenditure Benchmark.[39] Given that the MTO for Ireland for 2017-2019 was already fixed at the minimum level permitted under the fiscal compact, -0.5 per cent of GDP, the GDP revisions have relatively limited bearing on this target.

The key channel through which the pillars of the Preventive Arm are affected by the 2015 GDP distortions is through the measurement of potential output. The structural balance is a measure of the underlying trend in the budget balance that attempts to abstract from cyclical developments. The cyclical component of the structural balance is identified by the gap between actual and potential GDP levels (i.e., the output gap), while the overall structural balance is also expressed as a share of estimated potential output levels. In a similar vein, the Expenditure Benchmark sets a maximum growth rate for government spending on the basis of assumed sustainable levels of long-run economic growth (this growth rate is set as the ten-year average of potential output growth).

The Domestic fiscal rules were also prone to the same GDP-related distortions. As the domestic Budgetary Rule mirrors the structural balance requirements under the Preventive Arm, this would have been subject to the same GDP-related distortions. Furthermore, the Government expenditure ceiling used to set a top-down maximum for departmental expenditure ceilings is set with reference to permitted expenditure levels under the Expenditure Benchmark.

Mitigating Risks to Fiscal Policy

Potential output estimates are clearly central to the fiscal rules. Revisions to the Commonly Agreed Methodology as applied to Ireland (Appendix D) were therefore necessary to ensure that implications for the fiscal rules were not radically revised. In the absence of these, persistent distortions to potential output growth could have arisen from the exceptional GDP growth rate in 2015. In particular, the 2015 distortions could have artificially inflated potential GDP growth rates across a number of years (with implications for the Expenditure Benchmark), while also leading to a drastically different path for the output gap (relevant for the structural balance).[40] The adjustments to the Commonly Agreed Methodology have limited the effect of the exceptional growth rate in 2015 from distorting application of the fiscal rules in two ways:

(1) By ensuring that sharp increases in potential output are largely kept to 2015 and are prevented from feeding through to surrounding years.

[39] Box G (IFAC 2016a) provides an introductory guide to the Preventive Arm and the domestic Budgetary Rule, outlining the main features of these rules which become operational in full over the coming years.

[40] Potential growth rates for surrounding years would have been distorted in particular by smoothed estimates of TFP, whereas changes in the output gap (relevant for the structural balance adjustment requirements) would have been influenced by widening the gap between forecast actual and potential GDP estimates.

(2) By leaving the initial output gap level and projected changes in this relatively unchanged compared to estimates prior to the sharp revisions to real GDP.

The adjustments help mitigate risks to fiscal policy from changes in the fiscal rules, though some issues remain. In particular, the 25 per cent potential output growth rate estimated for 2015 should be ignored when determining the relevant ten-year average growth rate for the Expenditure Benchmark as it is clearly not relevant for the identification of sustainable long-run growth rates.[41] Furthermore, close monitoring of the adjustments will be required to ensure that subsequent estimates are not impacted by the recent changes.

[41] The Department of Finance acknowledge this in *Budget 2017* when they interpolate an average value of 3.7 per cent for 2015 in their application of the Expenditure Benchmark.