Irish Fiscal Advisory Council

Fiscal Assessment Report

November 2013

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3. Assessment of Compliance with Fiscal Rules

Summary

- *Budget 2014* projections imply compliance with the Budgetary Rule in 2013 and in each forecast year out to 2016. This is because the Adjustment Path Condition for the structural balance to converge towards Ireland's Medium Term Budgetary Objective is met.

- *Budget 2014* projections imply that there is almost no margin of safety in respect of the 3 per cent Stability and Growth Pact deficit ceiling in 2015 (and the ending of the Excessive Deficit Procedure (EDP)).

- Medium Term Budgetary Objectives (MTO) have been revised, raising Ireland's MTO from a structural deficit of 0.5 per cent of GDP to a balanced budget in structural terms. This change – other things equal – would require close to an additional €0.8 billion of consolidation after 2016, although there is significant uncertainty about how much adjustment the rules will ultimately require.

- The revised structural balance estimates provided by the Department of Finance show improvements of at least 1 percentage point of GDP a year for the years 2014 and 2015 compared to the figures in *SPU 2013*. This level shift implies that, at the minimum required pace of adjustment of the structural balance under the budgetary rule, there are two years of structural balance adjustment after 2016 to reach the MTO.

- The *Budget 2014* documentation did not include the updated estimates of the structural balance. This is a serious gap given that the Budgetary Rule uses this measure. These data were subsequently provided to the Council.

- The EU "Two Pack" of governance reforms came into force on 30 May 2013. This brings a number of changes to fiscal procedures and institutions in Ireland. The Council's mandate has been extended to include endorsement of macroeconomic forecasts prepared by the Department of Finance. The Commission has also clarified the interpretation of some of the existing EU rules.

3.1 INTRODUCTION

The Council's mandate includes monitoring compliance with the Budgetary Rule and compliance with the full range of fiscal rules is part of the Council's assessment of the fiscal stance. This Chapter assesses compliance with the fiscal rules in line with the full explanation of the rules set out in the previous *Fiscal Assessment Report* by the Council (IFAC, 2013a).

Section 3.2 assesses the consistency of *Budget 2014* with the fiscal rules, including the implications of the debt rules and expenditure benchmark in the light of recent clarification from the European Commission. Section 3.3 considers the coming into force in May 2013 of two new EU regulations, known as the "Two Pack", which include the allocation of a new "endorsement" function to the Council (see Chapter 1).

3.2 COMPLIANCE WITH THE FISCAL RULES

This section assesses the consistency of *Budget 2014* projections with the Budgetary Rule, which the Council is explicitly required to monitor, as well as compliance with wider Irish and EU fiscal rules.

3.2.1 COMPLIANCE WITH THE BUDGETARY RULE

The official documentation for *Budget 2014* did not include an estimate for the structural budget balance. Given that fiscal policy is now subject to rules set in terms of the structural balance, this is a serious gap in the information provided by the Department of Finance.[96]

Projections underlying *Budget 2014* - provided at the Council's request after the Budget - are consistent with compliance with the Budgetary Rule in 2013, 2014 and in each year out to 2016, when the projections end, as the Adjustment Path Condition of improving the structural balance by at least 0.5 percentage points of GDP would be complied with in all years (Table 3.1).[97]

[96] There is a formal EU requirement for this information to be published in Stability Programmes. While there is currently no such requirement for the Budget documentation, this is a key piece of information. The requirements of the "Two Pack" will mean that a draft budgetary plan must be published as part of the budgetary documentation from 2014. This draft budgetary plan would include an assessment of the cyclical position in line with that provided in the *Stability Programme Update*. Guidelines on the information to be included in draft budgetary plans are provided by the European Commission (See EC, 2013b). In a formal sense, compliance with the Budgetary Rule is assessed using data produced at the time of the *Stability Programme Update*. Nevertheless, if the rules are to provide a guide to policy, estimates are needed for each budgetary exercise (see April 2013, *Fiscal Assessment Report*).

[97] These structural balance projections were supplied to the Council on 24 October and made public in answers to a Parliamentary Question on 5 November 2013 (Numbers 151/152).

TABLE 3.1 SUMMARY OF MAIN FISCAL AGGREGATES[98]

	2013	2014	2015	2016
Main Aggregates, % of GDP				
General Government Balance	-7.3	-4.8	-2.9	-2.4
Structural Balance	-5.3	-3.6	-1.6	-1.1
Output Gap (% Potential GDP)	-3.3	-2.9	-2.7	-2.5
General Government Debt	124.1	119.9	118.3	114.5

The fiscal position is expected to remain over the projection horizon some distance from the two other conditions that would lead to compliance with the Budgetary Rule: the headline budget balance would remain in deficit, and the Medium Term Budgetary Objective (MTO) of a balanced budget in structural terms would not be achieved.

The projected improvement in the structural balance is at least one percentage point for all years from 2013 to 2015, considerably larger than the minimum required adjustment of 0.5 percentage points. Despite many uncertainties there is some margin to accommodate negative shocks without jeopardising compliance with the Budgetary Rule in the years to 2015.

In meeting the required structural adjustment, cyclical shocks should — by definition — have no effect on the structural balance. The main sources of risk to meeting the rules are structural deteriorations in the fiscal position. These could arise either because of unexpected changes in policy, such as higher than planned non-cyclical spending, or because of a measured deterioration in the structural balance resulting from differences between the anticipated and actual impact of the cycle and/or revised estimates of the output gap.[99]

The *Fiscal Responsibility Act* allows for deviations from the required adjustment path if this arises "…only as a result of exceptional circumstances and the failure does not endanger fiscal sustainability in the medium term" and is "consistent with the rules of the Stability and Growth

[98] Table shows the underlying General Government Balance as defined by the Department of Finance.

[99] Paradoxically, a key risk at Budget time for meeting structural balance targets for the same year is *higher* than anticipated output. Given that fiscal outturns for much of the year are already largely known and assuming potential output is fixed, a stronger than anticipated growth outturn implies that more of the gain in revenue is cyclical and less of the improvement in the budget balance is structural than anticipated (put another way, this outcome implies that the cyclical elasticity of revenue is revealed to be lower than assumed in the structural budget adjustment).

Pact (SGP)". The SGP allows for temporary deviations from the adjustment path which are not regarded as significant before applying EU procedures.[100,101]

Future Implications of the MTO

By 2015 and the scheduled closing of the Excessive Deficit Procedure (EDP), the structural balance is estimated to reach -1.6 per cent of GDP. Ireland's MTO for the structural balance was revised in 2013 from -0.5 per cent of GDP to a balanced budget in structural terms in line with EU procedures (Box H). The main reason for the stricter MTO resulting from this exercise is the higher debt-to-GDP ratio since the previous estimate was made in 2009 (based on data for 2008). This tightening in the required structural balance – other things equal – would require additional consolidation of close to €0.8 billion at some point to reach the new standard compared with the previous MTO.

Box H: The Medium-Term Budgetary Objective (MTO)

The Medium-Term Budgetary Objective (MTO) and progress towards it, is one of the conditions underpinning the Irish Budgetary Rule, as well as forming the cornerstone of the "preventive arm" of the EU Stability and Growth Pact. It is set at the EU-level for each country using a formula. This box provides an overview of how the MTO is set and how progress towards it is measured.

Setting The MTO

The MTO is set in terms of the structural budget balance (i.e. the cyclically-adjusted General Government balance net of one-off and temporary measures.)

MTOs are set for all countries in an EU-wide exercise at regular three year intervals, most recently in 2009 and then again in 2013. The MTO is determined by a formula taking into account a number of considerations as set out below. Until 2013, this formula was not made fully public.

The MTO can never be lower than a deficit of -1 per cent of GDP in structural terms for any Euro Area country. Countries, such as Ireland, that signed the EU Fiscal Compact have committed to MTOs no lower than -0.5 per cent of GDP until their debt ratio is significantly below 60 per cent of GDP and the risks in terms of long-term sustainability of public finances are low.

Subject to these constraints, the MTO is set to meet three objectives:

- A safety margin with respect to the 3 per cent of GDP deficit limit. This is based on

[100] Temporary deviations from the adjustment path of 0.5 percentage points in one year or cumulatively over two years from the MTO are allowed *ex post*.

[101] Exceptional circumstances are defined in the *Fiscal Responsibility Act 2012 and 2013* as "…a period during which an unusual event outside the control of the State has a major impact on the financial position of the General Government, or …a period of severe economic downturn".

achieving the lowest percentile of country-specific output gap estimates over the historical sample, given the estimated elasticity of the budget to the output gap.

- Ensure sustainability or rapid progress towards sustainability of public debt, taking into account the economic and budgetary impact of ageing. This is set as the sum of:
  - The budget balance needed to stabilise the debt-to-GDP ratio at 60 per cent given long-term growth and interest rate projections.
  - An additional 2.4 basis points for each additional percentage point by which the debt to GDP ratio exceeds 60 per cent.
  - One-third of the budget balance required to meet the present value of future age-related expenditure.[102]
- Allow room for budgetary manoeuvre, in particular taking into account public investment needs.

For Ireland, the upward revision to the MTO since it was previously set in 2009 (which tightened the MTO from a structural deficit of 0.5 per cent of GDP to balance) arises from a combination of the major changes of circumstances since the crisis, along with some minor methodological changes. The main driver is the higher debt-to-GDP ratio.

Measuring Progress Towards The MTO

Until the MTO is met, the EU rules require improvement in the structural balance each year with 0.5 per cent of GDP as a benchmark. A greater effort can be sought in good times with effort more limited in bad times. Progress is assessed on the basis of plans for the current and the next year (*ex ante* assessment) and also for the previous year (*ex post* assessment).

If there is "significant deviation" *ex post* from this path, this can open the way to a recommendation from the EU and sanctions.

Signification deviations are assessed using two complementary indicators:

- The size of the deviation in the structural balance from the adjustment path to the MTO.
- An expenditure benchmark that public spending grows below the medium-term potential growth rate of the economy (see Box I).

In both cases, a deviation of 0.5 percentage points of GDP in one year or 0.25 percentage points in each of two consecutive years is considered significant.

[102] Formally, this can be expressed as:

$$\mathrm{MTO}^{*} = -\left({(60\% * \mathrm{g})}\big/{(1+\mathrm{g})} \right) + (0.024\mathrm{b} - 1.24) + 0.3\dot{3} * \mathrm{S2E},$$

where *g* is the long-run nominal growth rate, *b* is the debt-to-GDP ratio and *S2E* is an EC indicator of future ageing costs.

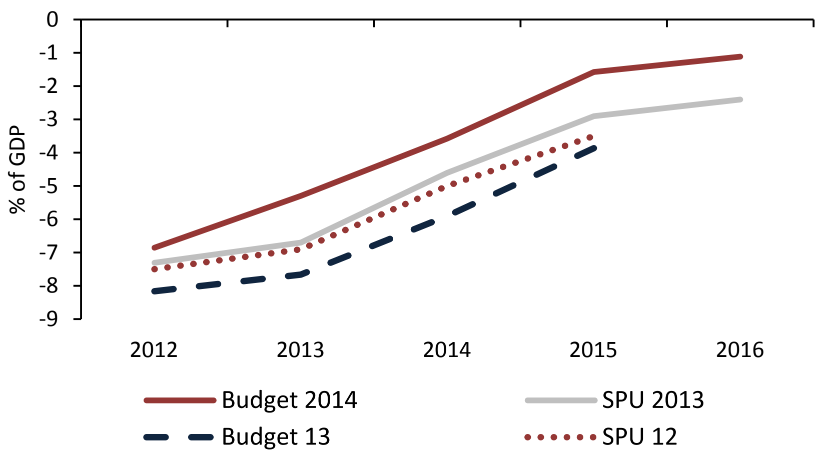
(***Note:*** *This footnote was amended 12 December 2013.)*

Given this new MTO, just over two more years of additional improvements in the structural balance at the minimum required pace of 0.5 percentage points would be required from 2016 to reach the MTO under the *Budget 2014* projections. As discussed in Chapter 4, this would allow for only small increases in nominal spending in the absence of measures to increase revenues. From an EU perspective, a faster rate of convergence than the minimum 0.5 percentage points may be expected given Ireland's high debt levels.[103]

However, measuring and projecting the structural balance is challenging. Estimating the output gap, forecasting the future path of potential GDP and adjusting the budget balances for the cycle remain uncertain and imprecise. Given this imprecision and that the MTO is not projected to be a met for a number of years, there is significant uncertainty about what the rules will ultimately require in terms of the total amount of consolidation.

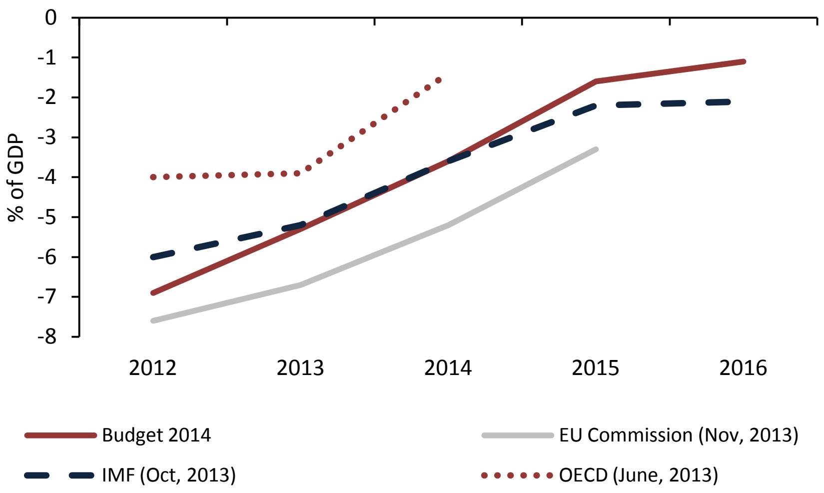
The difficulty in measuring the structural balance is highlighted by recent revisions to estimates by the Department of Finance. The estimates of the output gap and consequently the structural balance in *Budget 2014* have changed significantly since *SPU 2013*. The latest estimates for the structural balance are compared to previous estimates published by the Department of Finance in Figure 3.1 and to the latest estimates from other institutions in Figure 3.2.

FIGURE 3.1 COMPARISON OF DEPARTMENT OF FINANCE STRUCTURAL BALANCE ESTIMATES FOR IRELAND



[103] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), known as the Fiscal Compact, states in Article 3.1 (b) that "The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks".

FIGURE 3.2 COMPARISON OF LATEST STRUCTURAL BALANCE ESTIMATES FOR IRELAND



The Department of Finance estimates of the structural budget balance are relevant to assessment of compliance with the Budgetary Rule as set out in the *FRA*, although the EU rules (and compliance with the preventative arm of the SGP) continue to be assessed relative to European Commission estimates, as discussed in the previous *Fiscal Assessment Report*.[104]

Efforts to improve the Department of Finance and EU methodologies are welcome. A more comprehensive set of methodologies is needed in Ireland to improve the understanding of the cyclical position of the economy and the public finances.

3.2.2 COMPLIANCE WITH OTHER IRISH AND EU FISCAL RULES

The Council has no formal mandate to monitor the Irish Debt Rule and EU fiscal rules.[105] However, it is required in its assessment of the fiscal stance to include "…reference to the provisions of the Stability and Growth Pact".

In terms of compliance with other Irish and EU rules:

- Ireland remains subject to an EU Excessive Deficit Procedure (EDP) as the General Government deficit exceeds the three per cent of GDP deficit criterion of the SGP. However, Ireland is

[104] See Chapter 3, Section 3 of April 2013 Fiscal Assessment Report.

[105] Independent monitoring of compliance with the Budgetary Rule is a requirement of the EU Fiscal Compact but this obligation does not cover the domestic Debt Rule.

complying with its obligations to bring down the deficit under the EDP and the Troika programme. *Budget 2014* projections show the headline deficit is expected to fall to 2.9 per cent of GDP by 2015, leaving almost no margin to accommodate negative shocks. The requirement of progress towards the MTO is effectively the same as under the Adjustment Path Condition of Budgetary Rule and would therefore be met. If the 3 per cent limit were to be breached, the European Commission would then assess whether "effective action" had been taken ("conditional compliance") using a range of criteria before making a recommendation to the EU Council for a decision.[106,107] The EU Council may extend the deadline for deficit correction, usually by one year. While such an extension is not automatic, and new nominal and structural targets may be introduced, a number of countries have had their EDP deadlines extended earlier this year. If effective action is judged not to have been taken, this will lead to a fine, typically of the order of 0.2 per cent of the previous year's GDP, payable to the ESM.[108]

- Debt remains higher than the "Debt Rule" and SGP debt criterion requirements of 60 per cent of GDP and the EU benchmark for convergence towards the debt criterion (see Annex I). These requirements do not apply while Ireland is subject to the EDP and this will be followed by a transition period of three years.

- The EU has an expenditure benchmark that real non-interest expenditure growth, net of certain components of expenditure (see Box I), should not exceed the growth in potential GDP plus the relevant GDP deflator, except if fully offset by discretionary revenue increases, less an additional margin to ensure that the structural budget balance converges to the MTO. As shown in Box I, the expenditure benchmark implies that this spending should fall by at least 0.7 per cent in real terms over each of the next three years. This would be met under current official projections out to 2016.

[106] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-07_council/2010-12-07_ie_126-7_council_en.pdf

[107] An analysis of effective action is undertaken by the European Commission and incorporates an assessment of the impact of forecast errors on the setting of the initial targets. This approach is formalised under the reforms to the SGP in 2011 (see section 2.3.2.1. of EC (2013c)). On finalising its assessment the European Commission will then make a recommendation to the EU Council.

[108] A fine may be cancelled on the grounds of exceptional economic circumstances or following a reasoned request from the country within 10 days of the EU Council decision.

- While the exact role of the expenditure benchmark is still somewhat unclear, the structural balance appears to take precedence over the expenditure benchmark in the assessment of progress towards the MTO. The differences in methodology between the MTO and the expenditure benchmark allow for a more thorough assessment of compliance with the rules and the particular factors that may lead to non-compliance. This may be especially important if the required MTO is not met. In this case, meeting the expenditure benchmark could help with compliance with EU requirements. There may also be differences between compliance with the expenditure benchmark and *ex post* compliance with MTO requirements if forecast errors or revisions in the structural balance mean that the MTO requirements are not met despite sufficient discipline in terms of spending.

BOX I: THE EU EXPENDITURE BENCHMARK

The assessment by the EU of progress towards the MTO uses the structural balance as a reference, but also includes an analysis of expenditure net of discretionary revenue measures. The expenditure benchmark is therefore not a "rule" in the same sense as other requirements but does need to be taken into consideration. It is considered by the European Commission to be a complementary indicator to the budgetary rule. Specifically, the expenditure benchmark is an important factor in the overall assessment of compliance with the preventive arm of the Stability and Growth Pact when a country is not at its MTO.[109]

The expenditure benchmark is also designed as a complementary measure to ensure countries stay at their MTOs by providing guidance about how expenditure should be set to fulfil the adjustment path condition and then maintain the structural budget balance at the MTO level thereafter. This is being applied in Ireland, where the expenditure benchmark is being used to inform the setting of the multi-year expenditure ceilings (see Chapter 2).

THE EXPENDITURE BENCHMARK

The expenditure benchmark essentially says that annual expenditure growth should not exceed the medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. If expenditure increases in a given year at the medium-term reference rate of potential GDP, the benchmark ensures that there is no change in the structural budget balance.

For countries that have not reached their MTOs, an additional convergence margin is set for the appropriate growth rate of expenditure that is below the medium-term rate of potential GDP growth, as well as requiring that any discretionary tax cuts are financed through lower

[109] For example, in their assessment of the German Stability Programme Update for 2013, the European Commission states that "the growth rate of Government expenditure, net of discretionary revenue measures, will exceed the reference medium-term rate of potential GDP growth in 2013. However, the expenditure benchmark is not binding given that it is intended to underpin the necessary adjustment towards the MTO (which Germany plans to continue to comply with). Moreover, the programme foresees that the growth rate of Government expenditure will again be below the reference rate in 2014".

spending or higher non-tax revenues or both.

Expenditure is measured excluding interest, cyclical unemployment benefit spending and Exchequer co-financing of EU programmes, and investment costs are smoothed over a four year period.

To Calculate The Benchmark

The medium-term rate of potential GDP growth is calculated over a 10-year window, incorporating estimates for the past 5 years of data, the current year and forecasts for the next 4 years from the European Commission. This will be re-calculated every three years.

The convergence margin is subtracted from the medium-term growth rate. It is set so that the structural budget balance improves by 0.5 per cent of GDP as required under the adjustment path condition of the MTO.[110] The margin is higher if the public sector is smaller because a larger proportional change in spending is needed to achieve a given improvement in the budget balance as a share of GDP. For Ireland, the expenditure benchmark would require General Government expenditure to decline by 0.7 per cent each year. This reflects a low medium-term rate of 0.6 per cent less a convergence margin of 1.4 per cent.

Implications Of The Benchmark

In principle, the expenditure benchmark is designed to achieve MTO-based requirements and therefore does not add additional constraints on policy, but rather shows what is needed to achieve requirements for the structural balance. It implies that real General Government expenditure will need to decline in nominal terms for some time. The scenarios shown in Chapter 4 develop the implications of the MTOs for expenditure more systematically.

There are, however, some cases where the expenditure benchmark and the MTO could give different signals:

- The expenditure benchmark excludes interest payments, while the MTOs are set in terms of the overall structural budget balance (including interest). This can lead to differences. For example if spending on interest payments falls as a share of GDP, the MTO could be achieved without meeting the expenditure benchmark.
- The expenditure benchmark uses a different (10 year average) measure of potential output than the assessment of progress towards the MTO in a given year, again creating possibilities of different signals. For example, the backward-looking element of the medium-term potential growth calculation in the expenditure rule could imply a weaker growth number than that used to derive the MTO and therefore the expenditure benchmark could require a more positive budget balance.
- The cyclical adjustment of the budget balance could be affected by measurement or forecasting errors, leading to a shortfall in the MTO despite compliance with the expenditure benchmark.
- The MTOs are set in structural terms and are net of one-off and other temporary

[110] It can be shown that, if revenues grow in line with potential nominal GDP and interest spending is constant as a share of GDP, the 0.5 percentage point adjustment can be achieved by a convergence margin of 50/(primary expenditure as a percentage of GDP).

measures. Such one-off adjustments are not applied to the calculation of the expenditure benchmark.

Given recent revisions to estimates of the output gap and potential output, the locking in of current expenditure benchmarks based on estimates in spring 2013 for three years may mean that expenditure growth is more constraining than necessary to fulfil the adjustment path conditions to the MTO than more up-to-date estimates would suggest.

Meeting the expenditure benchmark will not only be challenging during the adjustment to the MTO, but requires spending to be neutral with respect to the cycle thereafter. Given that the wage bill is a large share of Government spending, public sector wages may need to be decoupled from the cycle. This could be difficult to achieve. Alternatively, other forms of spending could be made more strongly counter-cyclical or discretionary tax increases could be made when the economy is growing faster than trend.

3.3 The EU "Two Pack"

The so-called "Two Pack" of new EU fiscal regulations came into force on 30 May 2013.[111] This section sets out the main features of these new rules and focuses specifically on the new endorsement function it adds to the Council's mandate.

The "Two Pack" largely deals with institutions and procedures to strengthen fiscal governance in the Euro Area and reduce fiscal and financial risks.

The main elements of this legislation are (EC, 2013b):

- All Euro Area countries will follow a common budgetary timeline with a draft Budget by 15 October and the Budget legislated by the end of the year. In Ireland, this has required moving the Budget process to earlier in the year. There is a new coordinated EU surveillance exercise in the autumn and new reporting requirements, allowing the Commission to submit an opinion on the draft budget.
- The macroeconomic forecasts underpinning the Budget and the Stability Programme Updates must either be made independently or endorsed by independent bodies. In Ireland, as discussed in Chapter 1, the Council has been assigned the role of endorsing the forecasts produced by the Department of Finance.

[111] Formally, (1) EU Regulation No 473/2013 on common provisions for monitoring and assessing draft budget plans and ensuring the correction of excessive deficit of the Member States in the Euro Area, and (2) Regulation No 472/2013 on the strengthening of economic and budgetary surveillance of Members States in the Euro Area experiencing or threatened with serious difficulties with respect to their financial stability.

- Independent bodies must monitor compliance with the domestic fiscal rules put in place under the EU Fiscal Compact.[112] In Ireland, the Council's mandate already included monitoring the Budgetary Rule, as well as a role in the operation of the automatic correction mechanism in the case that the rule is not met.
- The obligation for Euro Area countries that enter Excessive Deficit Procedures (EDP) in the future to submit an Economic Partnership Programme describing the structural reform measures that will contribute to exiting the EDP.
- Better coordination of national debt issuance plans through new reporting obligations.
- Stronger monitoring and surveillance procedures for Euro Area countries experiencing or threatened with serious financial stability difficulties.

[112] Treaty on the Stability, Coordination and Governance in Economic and Monetary Union (TSCG).