ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

KEY MESSAGES

- In the short term, the primary aim of fiscal policy continues to be the successful correction of the excessive deficit in 2015. Under the most recent projections for a deficit of 2.7 per cent of GDP in 2015, Ireland remains on track to formally exit the EDP in 2016. However, as highlighted in earlier chapters, significant risks to meeting the deficit ceiling of 3 per cent remain.

- Following EDP exit, there is limited room for manoeuvre if the Budgetary Rule and the Expenditure Benchmark are to be respected in 2016. Any significant expenditure increase or discretionary revenue reduction would likely lead to a breach of these rules and the possible introduction of sanction procedures.

- When discretionary revenue changes are factored in, the upward revisions to expenditure ceilings introduced in *Budget 2015* mean that real expenditure is planned to grow at a faster pace in 2015 and 2016 than permitted under the Expenditure Benchmark. While not meeting the test of a 'significant deviation' from the allowable rate of expenditure growth, any further upward revision to expenditure, or further discretionary reductions in revenues, risks possible sanctions under the preventive arm of the SGP.

- Despite clarification that the Medium term Budgetary Objective (MTO) deadline of 2018 no longer applies, it appears that this target remains for *Budget 2015*. This requires a large structural cumulative adjustment of over 2½ percentage points of GDP between 2016 and 2018.

- The expected improvement in the general government balance as a share of GDP between the budget and latest outturn for the last two years is driven in part by changes in the estimation of one-off and temporary measures. Much of the remaining improvement arises from revisions to the forecast of nominal GDP. As the date for EDP exit approaches, transparency on the classification of one-off factors is increasingly important.

4.1 INTRODUCTION

The Council's mandate includes reporting on compliance with the Budgetary Rule and also monitoring compliance with the full range of EU fiscal rules as part of a broader assessment of the fiscal stance. *Budget 2015*, the *Draft Budgetary Plan* and the *Comprehensive Expenditure Report 2015-2017 (CER 2015-2017)* update the Government's fiscal forecasts for the period to 2018, relative to those published in the *SPU 2014*, (Table 4.1). The figures used in this chapter adjust the general government deficit for the period 2016 to 2018 published in *Budget 2015* to account for the domestic expenditure ceilings published in the *CER 2015-2017*, which are not included in the published Budget figures. This chapter examines the consistency of this plan with the fiscal rules and discusses some of the key operational elements of the fiscal framework at both the domestic and European levels, with reference to the impact of the recent ESA 2010 statistical revisions. This chapter also includes a box on the identification and treatment of one-off and temporary measures in the structural balance.

TABLE 4.1: SUMMARY OF MAIN FISCAL AGGREGATES ADJUSTED FOR EXPENDITURE CEILINGS

	2013	2014	2015	2016	2017	2018
Main Aggregates, % of GDP						
General Government Balance	-5.7	-3.7	-2.7	-2.0	-1.1	0.0
Structural Balance (SB)	-4.4	-4.4	-3.4	-2.7	-1.4	-0.1
Change in the SB	*3.1*	*0.0*	*1.0*	*0.7*	*1.2*	*1.4*
Output Gap (% of Potential GDP)	-2.4	-0.1	1.0	1.0	0.7	0.1
General Government Debt	123.3	110.5	108.5	104.2	100.9	96.0

In assessing the compliance of fiscal plans with individual rules, the status of these rules within the broader fiscal framework must be borne in mind. At the European level, fiscal rules are set within the two pillars of the Stability and Growth Pact (SGP): a Preventive Arm that operates in 'normal' times; and a Corrective Arm that operates when significant fiscal imbalances need to be rectified. Ireland is currently in an Excessive Deficit Procedure (EDP) within the Corrective Arm of the SGP. While there is no explicit legal provision stating that the Corrective Arm takes precedence over the Preventive Arm, this is implicit in the operation of the European fiscal framework.[1] Consequently,

[1] In the Preventive Arm, fiscal policy guidance is given in the Country Specific Recommendations (CSRs) approved by the EU Council. In the Corrective Arm, the EU Council issues an EDP recommendation, which replaces any guidance in the former. For a country that has an EDP recommendation, the fiscal part of the CSR simply recommends that this be implemented. Ireland's latest CSR following *SPU 2014* requires, "...the correction of the excessive deficit in a sustainable

while all rules are assessed in this chapter for the period to 2015, the fiscal rule that must be adhered to in this period is the correction of the excessive deficit in 2015 and the successful exit of the EDP.[2] As part of the wider assessment of the fiscal stance the other fiscal rules that would apply in the absence of an EDP are also monitored and reported by the Council for the period to 2015. We begin our assessment of compliance with an analysis of where Ireland stands in relation to its exit from the EDP.

4.2 Excessive Deficit Procedure Exit

On the basis of the *Budget 2015* forecast deficit of 2.7 per cent of GDP for next year, the EDP ceiling of an underlying general government deficit of 3 per cent of GDP will be complied with. In the event of the 3 per cent ceiling not being met in a sustainable manner, the EC would undertake an assessment of effective action.[3] In their decision on Ireland's EDP, the EU Council recommended a structural balance improvement ("fiscal effort") of at least 9½ per cent of GDP be achieved over the period 2011 to 2015.[4] On the basis of a 'top-down' analysis of the structural balance estimate in *Budget 2015*, the structural deficit is expected to be reduced by 6.4 percentage points between 2011 and 2015. The EC's "adjusted fiscal effort" measure of "effective action" also shows a shortfall against the required 9½ percentage point improvement.[5]

As noted in the June *FAR*, the analysis of fiscal effort should: (i) reference the achievement of expenditure plans; (ii) the implementation of discretionary revenue measures; (iii) the composition of growth; and (iv) the tax richness of economic growth. A simple 'bottom-up' analysis of *ex ante* discretionary consolidation undertaken in the June *FAR* indicated some 9.2 percentage points of GDP has been undertaken between 2011 and 2014. A similar analysis in *SPU 2014* estimated the discretionary consolidation adjustment at 9½ percentage points over the same period. However,

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manner by 2015 through underpinning the budgetary strategy with additional structural measures while achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. After the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0,5 % of GDP each year...".

[2] The Council's current understanding is that the Budgetary Rule will not be in effect until the excessive deficit has been corrected. The Council will be seeking legal clarification of this position prior to the next report.

[3] The latest EC Autumn 2014 forecasts show a general government deficit of 2.9 per cent of GDP in 2015 and, under a no-policy-change assumption, a 3.0 per cent of GDP general government deficit in 2016. This gives an indication of the uncertainty around the sustainability of the correction of the excessive deficit, which is required for a successful EDP exit.

[4] The EU Council also recommended that, "Irish authorities should seize opportunities, including from better economic conditions, to accelerate reducing the gross debt ratio towards the 60%-of-GDP reference value." (7 December 2010, 17210/10).

[5] This method attempts to take into account forecast errors that have become apparent since the EU Council EDP Recommendation. In order to do this it accounts for (i) revisions to potential output growth, (ii) the impact of revisions to the revenue elasticity arising from composition of economic growth or of revenue windfalls/shortfalls and (iii) the possible impact of other unexpected events.

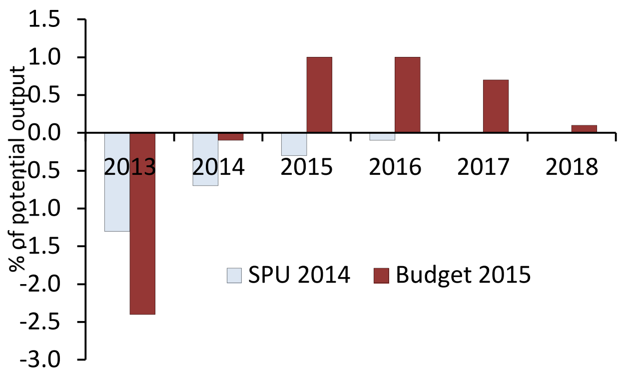
neither analysis factors in the expansionary measures contained in *Budget 2015*. In addition, both assessments are conducted on the *ex ante* measures as announced in previous budgets. A detailed *ex post* assessment of individual measures would be required to determine if the planned revenue increases and expenditure reductions have been delivered in full and meet the adjustment recommended by the EU Council. The most recent assessment by the EC from June this year estimates that a discretionary fiscal effort of 9.9 per cent of GDP has been made between 2011 and 2014 on a 'bottom-up' basis. This analysis will be updated in the forthcoming EC opinion on Ireland's Draft Budgetary Plan.

4.3 Compliance with the Budgetary Rule

EU measure of the Structural Budget Balance

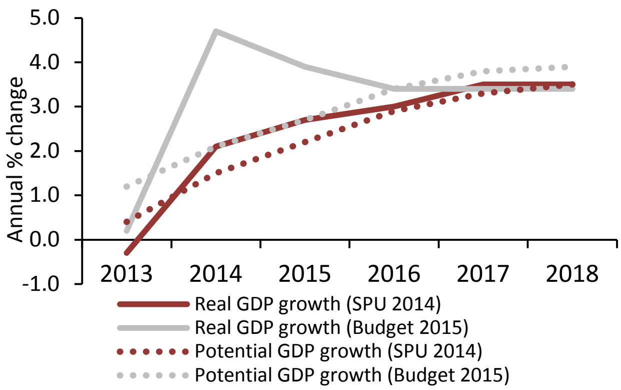
Compliance with the Budgetary Rule has been significantly impacted by statistical revisions related to the move to the *European System of Accounts 2010 (ESA 2010)*. These revisions have a direct deficit- to-GDP reducing impact, as the nominal deficit is reduced and nominal GDP increases (Chapter 3 and Analytical Note 6).

Figure 4.1A: Comparison of Output Gap Estimates



Source: Stability Programme Update 2014 and Budget 2015.

Figure 4.1b: Comparison of real and potential GDP growth

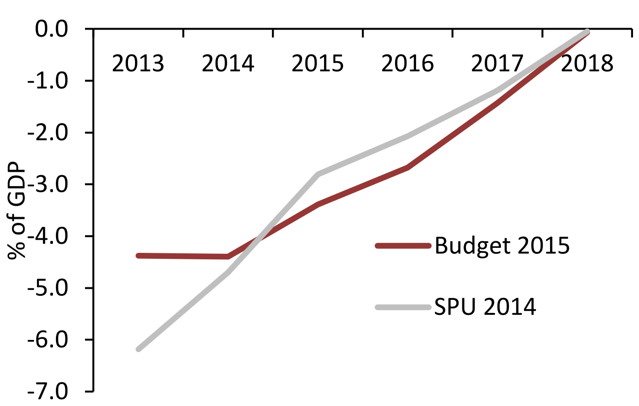


Source: Stability Programme Update 2014 and Budget 2015.

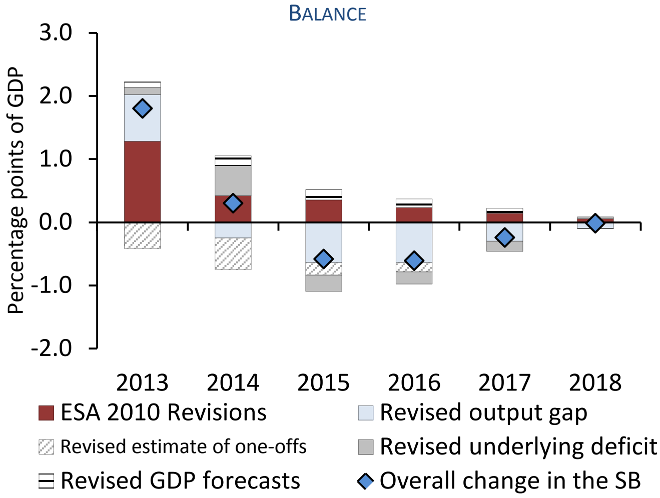
There is also an indirect impact through the effect of these revisions on the estimation of the output gap and the implied proportion of the change in the headline balance due to changes in the business cycle. Figure 4.1 shows that the revised Department of Finance macroeconomic forecasts - which also reflect ESA 2010 revisions - leads to significant changes to the output gap from *SPU 2014*.

The revisions to the estimated path of the structural balance since the last official estimates in *SPU 2014* are shown in Figure 4.2A. The size of the revisions highlight the practical challenges involved with applying rules based on the structural balance to guide fiscal policy. Figure 4.2B expands this analysis and shows the main sources of the revision. These also include revised estimates of one-off and temporary measures and the forecast net impact of policy decisions on the underlying balance in later years. The revisions to the 'underlying balance' show the positive effect of the over-performance of taxes in 2014 and the negative impact of *Budget 2015* policy measures from 2015.

FIGURE 4.2A: REVISION TO THE ESTIMATED STRUCTURAL BALANCE



FIGURES 4.2B: DECOMPOSITION OF DIFFERENCE IN THE STRUCTURAL BALANCE



Note: Positive changes in the components result in a reduced structural deficit. The changes to the cyclical adjustment include changes resulting from the ESA 2010 revisions to data.
Source: Budget 2015, SPU 2014, IFAC calculations. The fiscal forecasts in *Budget 2015* assume constant Departmental expenditure from 2016 to 2018. The above figures are adjusted to fully reflect the Ministerial Expenditure ceilings published in the *CER 2015-2017*. 2013 figures are based on the latest CSO data, *SPU 2014* data and unpublished output gap estimates. ESA 2010 revisions include revisions to both the nominal general government and nominal GDP.

On the basis of current data the change in the structural balance to 2013 is consistent with the requirements of the Budgetary Rule.[6] The Department of Finance estimates a structural deficit of 4.4 per cent of GDP for 2013, which does not meet the MTO for Ireland of a structural balance (see Figure 4.3). However, the reduction in the structural deficit of 3.1 percentage points of GDP between 2012 and 2013 more than meets the Adjustment Path condition, which requires an annual improvement in the structural balance exceeding 0.5 percentage points for Ireland (see Figure 4.3).[7]

The estimated structural balance improvement is almost double that reported for 2013 in the *SPU 2014*. Most of the improvement comes directly from the ESA 2010 revisions as well as positive contributions from a change in the output gap (see Figure 4.2b). While these impacts are somewhat offset by revisions to estimated one-off and temporary measures in 2013, the combined

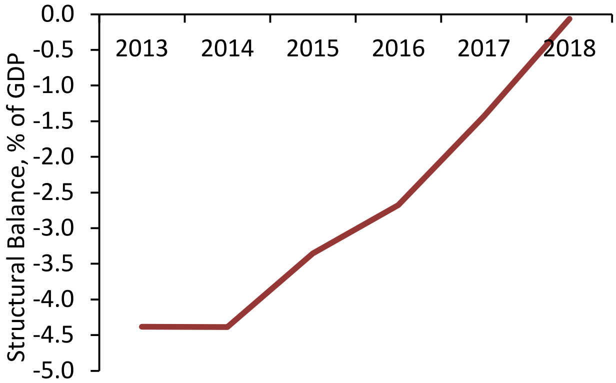
[6] This includes Government Finance Statistics data from the CSO and information provided by the Department of Finance.

[7] As Ireland has a debt ratio of greater than 60 per cent of GDP, under the terms of the SGP, the annual change in the structural balance must be greater than the 0.5 percentage point benchmark to comply with the Adjustment Path condition. Discussions at EU level are continuing as to what complies with "greater than 0.5%" in this context.

effect is to reduce the estimated structural deficit in 2013 from 6.2 per cent in *SPU 2014* to 4.4 per cent.

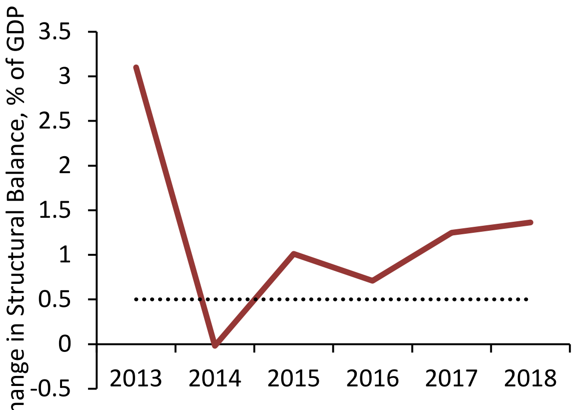
FIGURE 4.3: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE

A. BUDGET CONDITION



Note: Medium Term Budgetary Objective for Ireland is a structural balance.
Source: Budget 2015, Department of Finance.

B. ADJUSTMENT PATH CONDITION



Note: Medium Term Budgetary Objective for Ireland is a structural balance.
Source: Budget 2015, Department of Finance.

The estimated structural deficit-to-GDP ratio for 2014 remains flat at the 2013 level of 4.4 per cent based on the data in *Budget 2015*. In addition to not meeting the MTO requirement, this also indicates an insufficient annual improvement in the structural balance for compliance with the Adjustment Path condition.[8] However, this reduced annual change to 2014 does not reflect a reduced 'fiscal effort' in 2014. The more modest reductions in the headline balance in 2014 as compared to 2013 are offset by the treatment of 'one-offs' and the re-estimated very sharp reduction in the output gap, which implies that much of the improvement in the general government balance is measured as cyclical in nature. The Budgetary Rule will be assessed on an *ex post* basis for 2014 in the Council's 2015 reports.

EX ANTE ASSESSMENT OF 2015 TO 2018

While the Council's formal requirement to assess (*ex post*) compliance with the Budgetary Rule is backward-looking in nature, the mandate of the Council to assess the fiscal stance suggests considering compliance on a forward-looking basis. The fiscal position for 2015 is driven by the requirement to run an underlying general government balance of below 3 per cent of GDP for successful exit of the EDP. *Budget 2015* also implies a sufficient reduction in the structural balance to comply with the Budgetary Rule in 2015.

[8] The latest EC estimates of the structural balance (*European Economic Forecast-Autumn 2014*) show a reduction from -4.8 per cent of GDP to -3.8 per cent of GDP between 2013 and 2014.

As was the case in *SPU 2014*, the Government's last published fiscal plan, *Budget 2015* plans for the MTO to be met in 2018. However, the path to meeting the MTO has been adjusted, with both technical and policy factors playing a part (see Figure 4.2B).

The statistical ESA 2010 revisions that improved the structural balance estimates for 2013 and 2014 also impact in later years, albeit with a reduced effect. In addition, planned changes to underlying taxes and expenditure under *Budget 2015* are deficit increasing for all subsequent years.[9]

The Government's medium-term fiscal plan set out in *SPU 2014* was determined by the 2018 deadline to meet the MTO proposed by the EU Commission in 2013 (in the 'calendar of convergence'). In the June *FAR*, the Council assessed that meeting the MTO of a balanced budget in structural terms in 2018 appeared to go beyond the minimum requirements of the fiscal rules as the 2013 calendar of convergence no longer applied. In his response to the FAR published in June 2014 the Minister for Finance stated:

> Following discussions on the necessary consistency between the fiscal compact and the *Stability and Growth Pact (SGP)*, and as part of a discussion on the 2014 Country Specific Recommendations, the European Commission has clarified that the deadline for MTO achievement is not fixed but the required annual improvement in the structural balance is. Consistent with *SGP* rules, Member States not at their MTOs must improve their structural balance by at least 0.5 per cent of GDP per annum.[10]
>
> Minister for Finance, Letter to the Irish Fiscal Advisory Council (22 July 2014)[11]

All other things being equal, this would allow the Government to loosen the fiscal stance in the period post-2015 relative to *SPU 2014*, while still complying with the required change in the structural balance.

In 2016, there is limited room for further fiscal slippage following *Budget 2015* while still complying with the Adjustment Path condition. However, as shown in Figure 4.3, the change in the structural balance remains significantly in excess of that required for minimum compliance with the rules for 2017 and 2018 given that 2018 appears to remain as the government's deadline for achieving

[9] The over-performance in tax revenues in 2014 leads to an improved structural balance in 2014, however, this increase in taxes is more than offset by other policy changes in taxation and expenditure for later years.

[10] As a high debt country the adjustment for Ireland is greater than 0.5 per cent per annum.

[11] This letter is available on the Fiscal Council website:

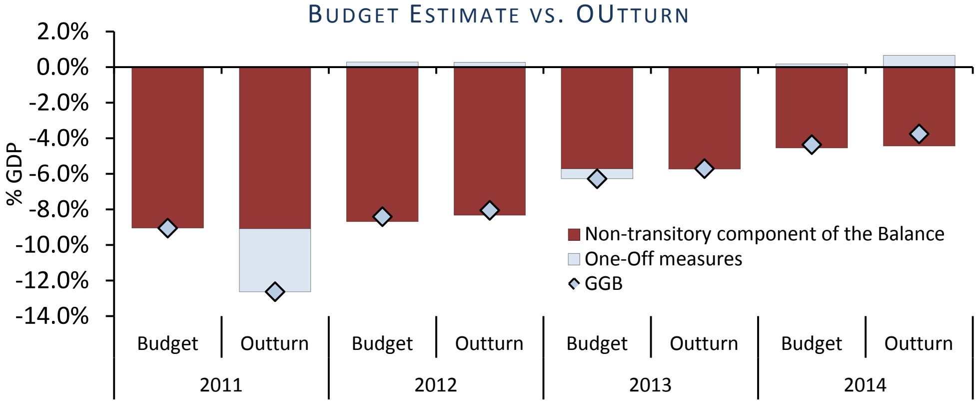
http://www.fiscalcouncil.ie/wp-content/uploads/2012/08/Response-from-Minister-to-IFAC-June-2014-FAR.pdf structural balance.[12] The bulk of the structural adjustment to meet MTO in 2018 has been back-loaded into 2017 and 2018. The plan to out-perform the requirement of the EU rules and to make greater efforts in 2017 and 2018, without a clear justification appears to reflect the use of technical assumptions rather than a well developed and detailed medium-term fiscal plan for 2016 to 2018. This issue is discussed in Chapters 1 and 3.

Box D: Treatment of One-Off and Temporary Measures

A key tool in assessing the fiscal stance is the structural balance. This represents the position of the public finances if the economy were to be operating at full potential and when one-off and temporary measures are excluded. A common approach to identifying the structural balance is to adjust the general government balance to remove non-structural elements, particularly those revenues and expenditures driven by the position of the business cycle. There has been much discussion, particularly in Ireland, concerning the problems with identifying the cyclical element of the balance through the estimation of potential output. However, it is also important to analyse the impact of one-off or temporary measures and transactions on the headline balance.[13]

In recent years, one-off and temporary measures have played a significant part in obscuring the movements of the headline deficit position in Ireland and elsewhere. The impact of this is most obvious in the exclusion of one-off and temporary measures in support of the financial system from the assessment of compliance with the EDP. Figure D.1 extends this analysis to exclude all one-off and temporary measures. It is notable that while there is an improvement in the general government balance as a share of GDP in 2013 and 2014 - between budget and outturn - this is driven in part by changes in the estimation of one-off and temporary measures, with much of the remainder from revisions to the forecast of nominal GDP.

Figure D.1 'Non-Transitory' component of the GGB Budget Estimate vs. OUtturn



Source: Budgets (Various years), GFS (CSO) and Department of Finance data.
Note: To aid comparison the Budget estimates of the general government balance (GGB) and the non-transitory component of the balance are adjusted for the impact of the ESA 2010 statistical revisions to the deficit.

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[12] The Budget states: "Profiled structural adjustment for 2016-2018 exceeds the minimum correction path prescribed by the Council of the EU" (Ireland's *Draft Budgetary Plan*, Table 7a; CSR Recommendations).

[13] One-off measures typically involve "...large, non-recurrent operations, whose impact on fiscal balance usually falls predominantly in the year when the related operations are recorded with no sustained change in the inter-temporal budget position and hence no implications for fiscal sustainability" (Bornhurst *et al*, 2011).

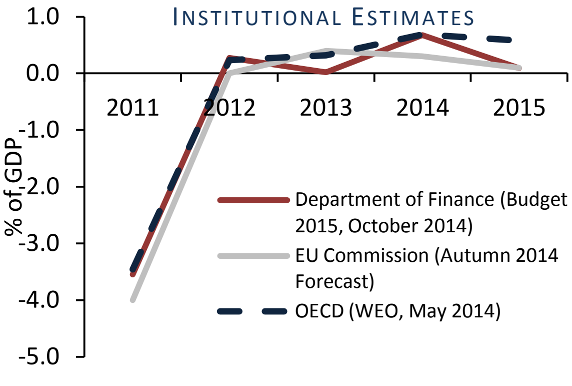
Figure D.1 uses one-offs as identified by the Department of Finance. However, the identification of one-offs and temporary measures can be somewhat subjective. For example, in Budgets 2011 and 2013 a temporary increase in dividends to the State was identified as part of the consolidation package, however, these increases were not classified as one-off. Part of the problem in this instance may be due to the difficulty in identifying the temporary element of on-going transactions.[14]

Identification of One-Off measures

In identifying one-off or temporary measures, both the EU Commission and the IMF employ a 'bottom-up' method, identifying items and adjusting for individual transactions, similar to the Department of Finance. This approach can, however, suffer from information asymmetries between monitoring institutions and the national authorities and requires detailed guidelines on classification.[15]

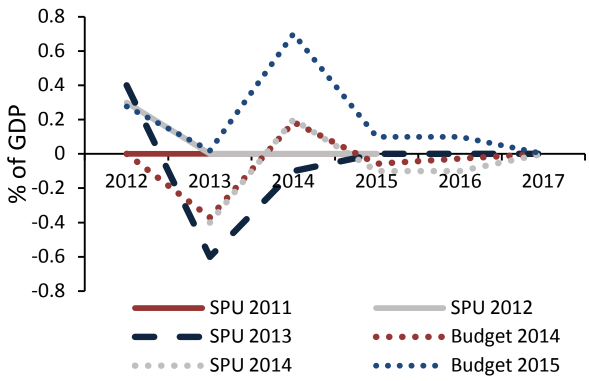
The OECD takes a more 'top down' approach and identifies the presence of one-offs and temporary transactions through deviations in trend net capital transfers (Joumard *et al.*, 2008).[16] This method ensures consistency of treatment across countries. It is transparent as data are freely available in the National Accounts and hence allows for easier review of any *ex post* changes. However, it may omit one-off transactions outside net capital transfers For example, for Ireland it would not account for the treatment of the pension fund levy.[17] Figures D.2A and D.2B compare the latest international estimates for Ireland with those of the Department of Finance and compares different vintages of Department of Finance estimates. The 'bottom-up' method to estimating one-off and temporary measures applied by both the Department of Finance and the EC can lead to differing estimates of the structural balance. However, it is the EC estimate that is ultimately used when assessing compliance with the European rules.

Figure D.2A: Comparison of Institutional Estimates



Note: Budget 2015 and EC Autumn Forecasts are on an ESA 2010 basis.

Figure D.2B: Comparison of Vintages



Note: Budget 2015 is on an ESA 2010 basis.

[14] Similarly, the reduction in the VAT rate on accommodation, restaurants, and certain cultural activities was not included as a temporary measure despite being identified as such when introduced in 2011. However, as it is a deficit increasing measure, it may have been excluded on this basis as these are typically not accounted for as one-off or temporary under the principles applied by the EC.

[15] See Larch and Turrinni (2009) and Bornhurst *et al.* (2011) for an overview of the EC and IMF guidance on the identification of one-off and temporary measures.

[16] The trend is derived using a HP filter approach. The use of this method also raises the issue of the end-point bias in HP filtered estimates.

[17] Such one-offs could be adjusted for individually while preserving the core approach.

Forecasting one-off and temporary measures into the medium term can be challenging. While one-off transactions can arise or change in scale without prior warning, the nature of transactions can also be revised as the ending of a scheme or policy comes close, e.g. the changed treatment of the pension fund levy as a temporary measure in *Budget 2015*.

The use of one-offs transactions in fiscal policy is particularly relevant in Ireland at present given the renewed importance of the budgetary framework. There is evidence that the introduction of a fiscal rules framework based on numerical targets for the headline balance can create an incentive for governments to circumvent it using so-called accounting stratagems, including the use of one-off measures.[18] Consequently, adjustments that may normally be viewed as technical can take on a more strategic role in the budget framework.[19] Koen and Van den Noord (2006) demonstrate that as deficit rules tend to become more binding, recourse to one-offs and other fiscal stratagems is more likely. In the European context, the EU Commission has shown that while in theory one-off adjustments should be both deficit increasing and decreasing, on average they have tended to be deficit-reducing. This analysis also examined the size and incidence of one-offs measures and shows that there is a tendency across Euro Area countries for there to be more - and larger - one-offs when members state are close to the 3 per cent deficit ceiling that applies to the Corrective Arm of the SGP.

While the scope to use one-off and temporary measures will be more limited under both the preventive arm of the SGP and the national Budgetary Rule, the degree of judgement involved in identifying such transactions implies that they require ongoing scrutiny. Even though not all one-off and temporary transactions are under the direct control of Government, there is still sufficient scope for discretionary actions to flatter movements even in key structural fiscal indicators. Given the importance of identifying one-off and temporary measures for both the Corrective and Preventive Arms, a more transparent approach should be taken by both the EC and the Department of Finance. While both institutions have shared their detailed estimates with the Council, these estimates should be published as a matter of course.

Expenditure Benchmark

The EU Expenditure Benchmark (EB) limits growth in general government expenditure, excluding a number of factors.[20,21] As the EB sets a limit on the real growth of this adjusted expenditure aggregate a GDP deflator is used to adjust the nominal growth rate of the aggregate. A further adjustment is made where there is a discretionary change to revenues being collected. This change is symmetrical: a discretionary decrease (increase) in revenues effectively reduces (increases) the growth in the expenditure aggregate that complies with the EB.[22] As the EB forms part of the

[18] These incentives are reinforced in electoral periods (Buti *et al.*, 2006).

[19] This tendency has been associated with Goodhart's law, which is normally formulated as "When a measure becomes a target, it ceases to be a good measure".

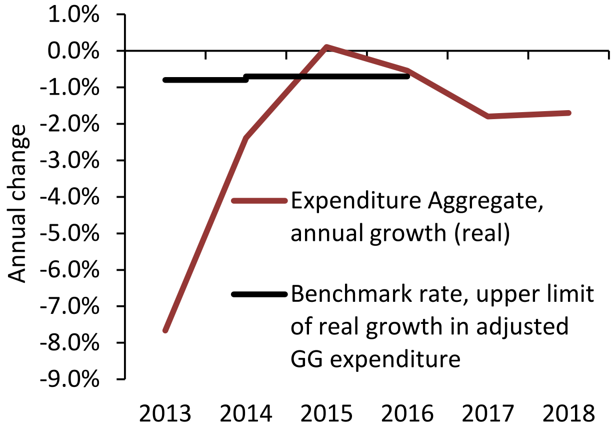
[20] The expenditure aggregate used in the assessment of the EB is calculated as general government expenditure excluding interest, cyclical unemployment benefit spending and certain spending on EU programmes and adjusted for exceptional investment costs relating to infrastructure.

[21] While ESA 2010 impacts on general government expenditure, this is mainly a level effect and does not change the annual growth rate substantially of the measured expenditure aggregate.

[22] In relation to the EB, Article 5 of EU Regulation 1466 states, "... the Council and the Commission shall assess whether the growth path of government expenditure, taken in conjunction with the effect of measures being taken or planned on the revenue side, is in accordance with the following conditions [...](c) for Member States that have not yet reached

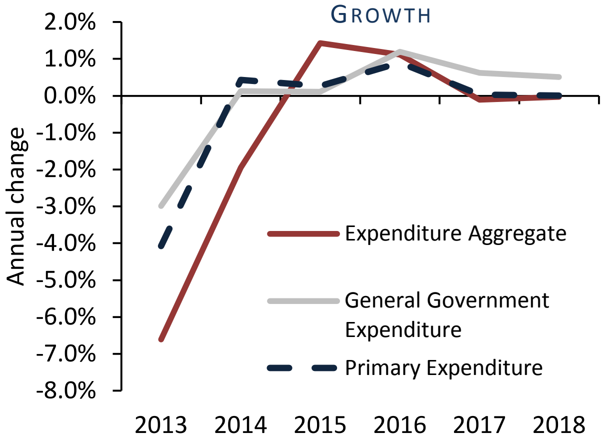
Preventive Arm of the SGP, it will only fully come into force for Ireland in 2016, following the expected correction of the excessive deficit in 2015.

Figure 4.4a: Compliance with the EU Expenditure Benchmark



Source: Budget 2015.

Figure 4.4b: Nominal Expenditure Growth



Source: Budget 2015.

On the basis of *Budget 2015* estimates, the expenditure aggregate assessed under the EU Expenditure Benchmark (EB) is estimated to have fallen by just below 8 per cent and 2½ per cent in 2013 and 2014 respectively.[23,24] This compares to a reference rate of real growth of -0.8 per cent in 2013 and -0.7 per cent in 2014 under the EB (see Figure 4.4a). It therefore meets the requirements in both years.

The changes announced in *Budget 2015* led to the previously identified domestic Government Expenditure Ceiling and individual Ministerial Expenditure ceilings being broken. This significant upward revision to the Government Expenditure Ceiling, combined with the discretionary reduction in revenues, means the EB is not complied with in 2015.[25] However, as the deviation is less than 0.5 per cent of GDP it is not considered "significant" under the SGP. Figure 4.5 shows that in the absence of discretionary revenue reductions the EB would have been complied with. This

their medium-term budgetary objective, discretionary reductions of government revenue items are matched either by expenditure reductions or by discretionary increases in other government revenue items or both".

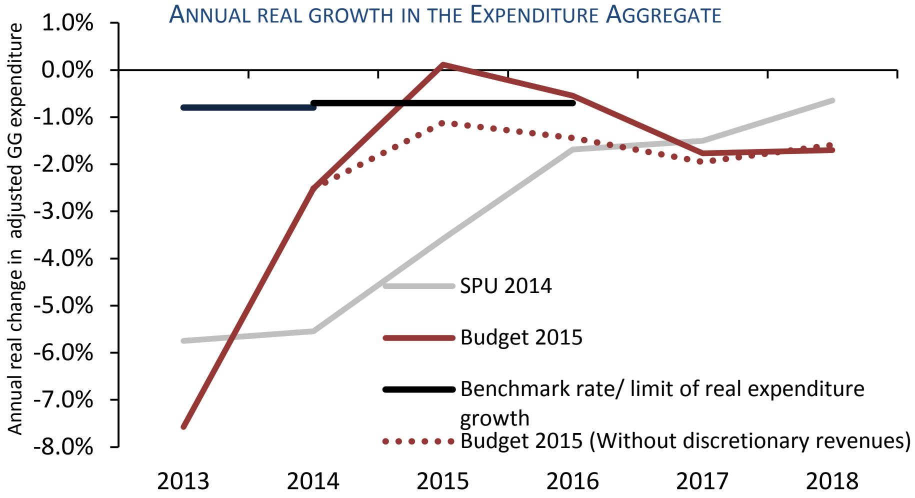
[23] The figures used in the assessment of compliance with the expenditure benchmark are contained in Table 5(b) of *Ireland's Draft Budgetary Plan* for 2015. For the following years, figures are taken from table A7 of *Budget 2015*, with the exception of discretionary revenues, which are taken from Table A6.

[24] The deflator used in this calculation is the average of the forecast deflators produced by the Department of Finance in their *SPU 2013* and *Budget 2014* forecasts for 2013 and the average of the *SPU 2014* and *Budget 2015* forecasts for 2014.

[25] Note that the estimated increase in 2014 expenditure increases the base and consequently reduces the annual growth rate in 2015.

highlights the importance of balancing expenditure demands with tax measures that erode the revenues when setting fiscal policy.

FIGURE 4.5: COMPLIANCE WITH EXPENDITURE BENCHMARK
ANNUAL REAL GROWTH IN THE EXPENDITURE AGGREGATE



Source: Budget 2015, SPU 2014, and internal calculations.

Furthermore, the Council has previously noted that the method used in estimating the cyclical component of unemployment benefit expenditure can flatter compliance with the EB.[26] *Budget 2015* estimates unemployment related payment savings of over €400 million in 2015.[27] However, as a significant element of these reduced costs is assumed to be structural, the difference can be used to fund increased structural expenditure without adversely affecting compliance with the EB.[28]

In 2016, the forecast growth of -0.5 per cent in adjusted expenditure does not comply with the minimum requirements (-0.7 per cent) of the EB. This takes into account the planned increases to expenditure in the *CER 2015-2017* and the additional carryover impact of revenue measures introduced in *Budget 2015*. While the deviation in 2016 would not be considered 'significant' it leaves very limited scope for any further increases to expenditure or discretionary reductions in revenues. [29] A significant deviation from the EB could lead to the imposition of sanctions.

[26] This is derived by applying a projected cost per person employed to an estimate of the unemployment gap (i.e., difference between the actual and structural unemployment rates). The latter is the estimated NAWRU consistent with the harmonised EU methodology. This method of estimating structural unemployment underestimates the unemployment gap (FAR, 2014a). As a consequence, this method tends to attribute less of the fall in unemployment related spending to changes in the cycle than may be appropriate.

[27] This saving is against the last forecast for 2015 rather than a year-on-year reduction.

[28] The Non-Accelerating Wage Rate of Unemployment (NAWRU) for 2015 estimated by the Department of Finance is 10.7 per cent of the labour force.

[29] Under the SGP, a significant deviation arises where there is a deviation of 0.5 per cent of GDP from the required growth rate in any given year, or an average deviation of 0.25 per cent of GDP over two consecutive years.

Furthermore, the average deviation over 2015 and 2016 is 0.2 per cent of GDP, which leaves an even narrower margin. Any changes to expenditure ceilings in *Budget 2016* must fully comply with Department of Public Expenditure and Reform Circular setting out the rules and procedures for Ireland's Medium-Term Expenditure Framework.

The EB for the period after 2016 has not been formalised, but the real growth rate in the expenditure aggregate is estimated by the Council to be -2.0 per cent and -1.8 per cent in 2017 and 2018.[30] The EC have indicated the benchmark for these years will be estimated in late 2015.[31] A concern in this regard is the EC method of extending their forecasts into the medium term, which tends to place significant weight on recent historical data observations. This can lead to the EC forecasts for growth and unemployment displaying a pro-cyclical pattern: during downturns, the methodology produces very low estimates of future growth while forecasting high unemployment. As growth recovers, and crisis period data points are followed up with stronger realised figures for growth and unemployment, this can result in significant upward revisions to the medium-term outlook using the EC methodology.[32.] Using the latest EC Autumn forecasts implies an EB of 0.3 per cent for the period 2017-2019; an estimate based on the *Budget 2015* would give a limit of just under 1 per cent.

The European and domestic budgetary framework can play a vital role in ensuring the sustainability of the public finances over the medium-term. Following EDP exit all aspects of the Preventive Arm of the SGP will apply and will have a key role in the setting of domestic fiscal policy. Both the EC and the Department of Finance must ensure there is clarity and transparency around the setting and assessment of the fiscal rules. Moreover, the mechanisms established in recent years to manage the public finances, specifically the medium-term expenditure framework (MTEF), must be respected if fiscal plans are to be successfully executed.

[30] This includes the impact of the increase in expenditure ceilings in the *Comprehensive Expenditure Report 2015-2017*.

[31] For a country not yet at their MTO the EU EB rate of growth is calculated as follows:

$(\sum_{t-5}^{t+4} g_t) - (C_t)$, where g_t is the potential growth in t, and C_t is the convergence margin to ensure an annual adjustment of 0.5 percentage points of GDP per annum towards the MTO and is stated as $C_t \cong \frac{50}{e_t}$, where e_t is primary expenditure as a share of GDP. A higher adjustment effort – through a larger convergence margin – is required for when a country is considered to be in economic good times, whereas the effort might be more limited in economic bad times. The ESA2010 upwards revisions to both nominal GDP and general government expenditure have a relatively limited impact on the setting of the EB through changes to e_t. The exact impact on the forecasts for 2016 is not available but on the basis of the adjustments for 2014, the estimated effect is to increase the EB by up to 0.2 percentage points.

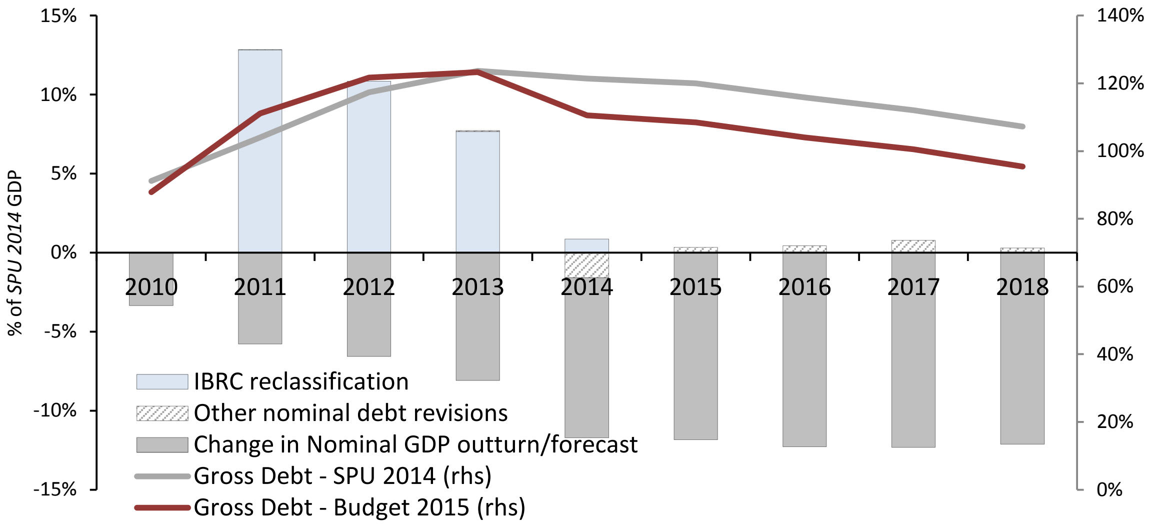
[32] See Analytical Note 2 (FAR 2014a)

4.4 Compliance with other Irish and EU Fiscal Rules

The Debt Rule

Both the level and the path of the debt-to-GDP ratio are affected by the revised treatment of IBRC and the impacts on nominal GDP (see Figure 4.6 and *Analytical Note No. 6*).

Figure 4.6: Revision to the Debt-to-GDP Ratio
SPU 2014 to *Budget 2015*



Source: CSO, *SPU 2014* and *Budget 2015*

Following the correction of the excessive deficit next year Ireland will be subject to transition arrangements under the Debt Rule.[33] These arrangements apply to countries which were in an EDP when the 2011 six-pack amendments to the SGP were adopted. The purpose of these arrangements is to give these countries a period of adjustment to adapt their structural adjustments to a level needed to comply with the reformed debt criteria, while still progressing towards compliance. During those three years, the debt requirement will be judged according to whether the countries in question make sufficient progress towards compliance. Sufficient progress towards compliance is defined by the two-pack Code of Conduct as the minimum linear structural adjustment ensuring that – if followed – Member States will comply with the debt rule at the end of the transition period.

Due to the construction of the benchmark criteria under the Debt Rule, the ESA 2010 revisions also impact the target debt levels. However, as the full debt benchmarks need only be complied with in 2019 the major volatility from ESA 2010 will have fallen out of the arithmetic. The reductions required by the revised debt criteria are matched by the lower path of the debt ratio. The

[33] The transition period begin with the correction of the deficit which will typically take place in the year before the EDP is formally ended or 'abrogated'.

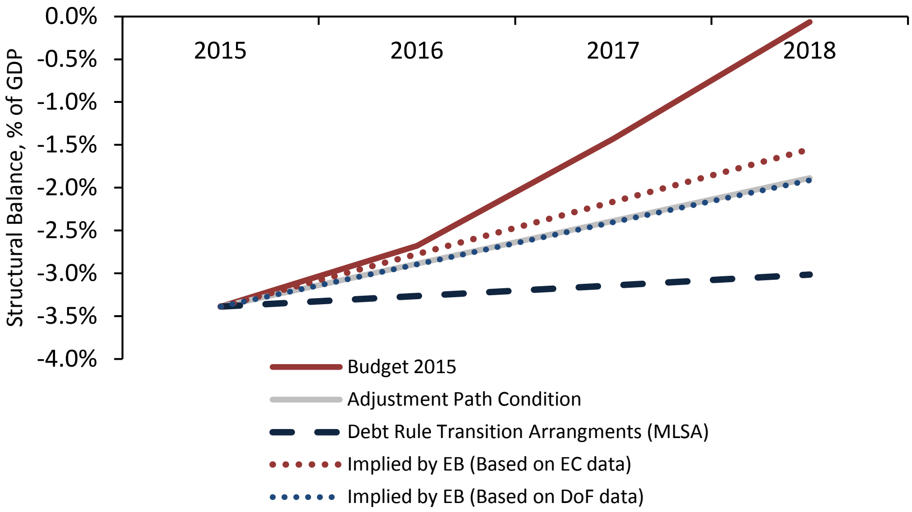
structural adjustments between 2016 and 2018 required under transition arrangements are broadly unchanged.

COMPARISON OF FISCAL RULES

As the Debt Rule is expressed as an annual change in the structural balance for the period to end-2018 when transition arrangements apply to Ireland, it is possible to directly compare the relative structural deficit position to the minimum requirements under the Budgetary Rule and to the planned path in *Budget 2015*. It is further possible to express the EB as a change in the structural balance given the assumption that nominal tax revenues grow at the same rate as nominal GDP.[34] The inclusion of the EB should be seen as largely illustrative. For the purpose of the stylised comparison in Figure 4.7, two alternative scenarios are estimated. The first holds the real rate of growth in the expenditure aggregate held at +0.3 per cent for 2017 and 2018 (equivalent to the EB under EC potential output and primary expenditure forecasts), while the second assumes it is +0.9 per cent (the Department of Finance potential output forecast). Depending on the choice of EB used, it is shown to be more binding than, or equally as binding, as the Adjustment Path condition of the Budgetary Rule over the period to 2018. In any case, based on currently available data, the structural deficit path for 2017 and 2018 is shown to be steeper than required under any of the rules.

[34] The structural balance consistent with minimum compliance under the EU EB is calculated by applying the maximum real expenditure growth under the benchmark to the expenditure aggregate calculated for 2015. This is then deflated using the forecast GDP deflators. This is repeated for all years to 2018. A general Government balance figure is estimated by adding cyclical unemployment costs, EU payments, a capital expenditure adjustment and debt interest (adjusted for the impact of the change in expenditure). This general government expenditure figures are then used to re-estimate the general government balance. By applying the cyclical adjustment and estimates for one-off and temporary measures the structural balance can be estimated. The required change in this structural balance consistent with compliance with this EB is expressed linearly over the period for comparison with the other rules.

FIGURE 4.7: ILLUSTRATIVE COMPARISON OF ALTERNATIVE RULES
STRUCTURAL BALANCE PATH



Source: Internal calculations
Note: The Adjustment Path condition is based on an annual improvement of 0.5 percentage points in the structural balance.