4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

KEY MESSAGES

- The immediate aim of fiscal policy continues to be the successful correction of the excessive deficit in 2015. Adhering to the requirements of the Excessive Deficit Procedure (EDP) will also lead to the Budget Rule being met this year.

- The anomaly identified by the Council that would have led to excessive tightness of the Expenditure Benchmark (EB) in 2016 has been resolved by the European Commission and the Department of Finance.

- The Council has serious concerns regarding the compliance of the Government's fiscal plan with the Budgetary Rule in 2016. *SPU 2015* forecasts show an insufficient fall in the structural deficit to meet the requirements of the Budgetary Rule. Considerable risks to compliance are also evident for the Expenditure Benchmark in 2016.

- Ireland's post-crisis budget framework should help avoid boom-and-bust cycles and reduce government debt. It is therefore important that the letter and spirit of the rules, and the Government's own budgetary framework, are respected in fiscal plans. The Council is strongly of the view that government plans should be based on expected compliance with the fiscal rules and that the reasons for any deviation should be clearly explained.

- For the period post-2016, assessing compliance with the fiscal rules is problematic as the budgetary forecasts do not reflect stated policy. The Government's stated intention is to pursue minimum compliance with the rules over this period.

- The move to an annual update of the Expenditure Benchmark, while ensuring consistency with the official structural balance target, weakens the already fragile domestic framework for the setting of multi-annual expenditure ceilings. The domestic *Medium-Term Expenditure Framework (MTEF)* should be strengthened to ensure that multi-annual planning becomes a central element of the budget process.

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. This chapter examines the consistency of the *Stability Programme Update 2015* (*SPU 2015*) and the Government's plans with the fiscal rules. It discusses some important recent changes to key operational elements of the fiscal framework at both the domestic and European levels. This chapter also includes a box on changes and exceptions in the assessment of the path to the Medium-Term budgetary Objective (MTO).

When assessing the compliance of the Government's fiscal plans with individual rules, the status of these rules within the broader European and domestic fiscal framework must be borne in mind. At a European level the immediate target in the short term is the correction of the excessive deficit within the Corrective Arm of the *Stability and Growth Pact* (*SGP*). As the excessive deficit is expected to be corrected this year, the Preventive Arm of the *SGP* will come to the fore from 2016, which includes an assessment of the structural balance and the Expenditure Benchmark (EB).[1]

4.2 Excessive Deficit Procedure Exit

The Excessive Deficit Procedure (EDP) ceiling of an underlying general government deficit of 3 per cent of GDP will likely be met with a buffer in 2015 given the forecast headline deficit of 2.3 per cent of GDP in *SPU 2015*. Furthermore, the excessive deficit appears to be undergoing correction in a sustainable manner, i.e. the deficit is set to remain below the 3 per cent ceiling over the medium-term.[2]

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. 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. While an assessment on the basis of the structural balance estimate in *SPU 2015* shows a shortfall against the required 9½ percentage point improvement, the latest estimate of fiscal effort by the EU Commission, on the basis of permanent consolidation measures, implies effective action was taken.[3,4]

---

[1] 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 also.

[2] In their Country Specific Recommendations on the SPU and National Reform Programme (May 2015), the EC foresee "...a timely and durable correction of the excessive deficit by 2015 ..." (p. 3).

[3] A 'bottom-up' or 'narrative' approach evaluates the fiscal effort by adding up the measures adopted in actual budgets and reported in budget documentation or other verifiable communication (EC, 2015).

Following a successful exit of the EDP, transition arrangements under the Debt Rule will apply for three years - until the end of 2018 if the 3 per cent ceiling is met this year – before the normal requirements of the Rule begin to apply.[5] These requirements - part of the Corrective Arm of the SGP - are not anticipated to present a binding constraint on fiscal policy over the forecast period.

4.3 COMPLIANCE WITH THE BUDGETARY RULE

The Budgetary Rule is a key pillar of the domestic fiscal framework and has been in force since its legal commencement on 31 December 2012.[6] It is framed in terms of a requirement to achieve a specified structural budget balance. The domestic Budgetary Rule effectively mirrors the Preventive Arm of the *Stability and Growth Pact* (*SGP*). This will come into operation once the EDP ends in 2015.

In recent years under the EDP, the pace of reduction in the measured structural balance has generally been in excess of the greater than 0.5 percentage points annual improvement required under the Preventive Arm, with the exception of 2014. [7] In procedural terms, the *Fiscal Responsibility Act 2012* specifies that one means of respecting the Budgetary Rule is through the structural balance 'converging towards the medium-term budgetary objective in line with the timeframe set in accordance with the 1997 surveillance and coordination Regulation' (Section 2(4a)). This requirement is satisfied in the EU regulations where the fiscal path set out under the EDP is met.[8]

Once the excessive deficit has been corrected, the assessment of the Budgetary Rule will focus on progress to reduce the structural deficit to meet Ireland's Medium-Term Objective (MTO)

[4] Previous Stability Programme Updates indicated compliance with the requirements of effective action on a 'bottom-up' basis; however *SPU 2015* does not include an updated estimate.

[5] The debt rule states that debt in excess of the 60 per cent debt to GDP ratio must be reduced by at least 1/20th per year on average For a more detailed discussion, see *Analytical Note 5: Future Implications of the Debt Rule.*

[6] http://www.irishstatutebook.ie/pdf/2012/en.si.2012.0522.pdf.

[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. At a European level this has been operationalised as a 0.6 percentage point improvement for countries such as Ireland in 'normal times' and with a debt-to-GDP ratio greater than 60 per cent. As the official forecasts of the output gap indicate Ireland will remain in 'normal times' (see Box G), this 0.6 per cent adjustment is also applied in the *ex ante* analysis.

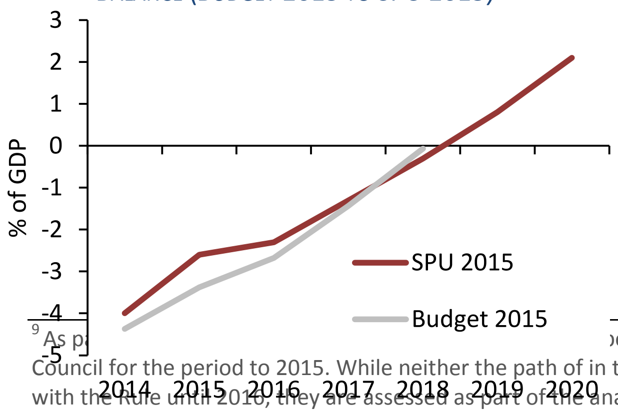
[8] This occurs irrespective of whether a 0.6 percentage point reduction is achieved.

consistent with the provisions of the Preventive Arm of the SGP, which includes an analysis of the Expenditure Benchmark (EB).[9]

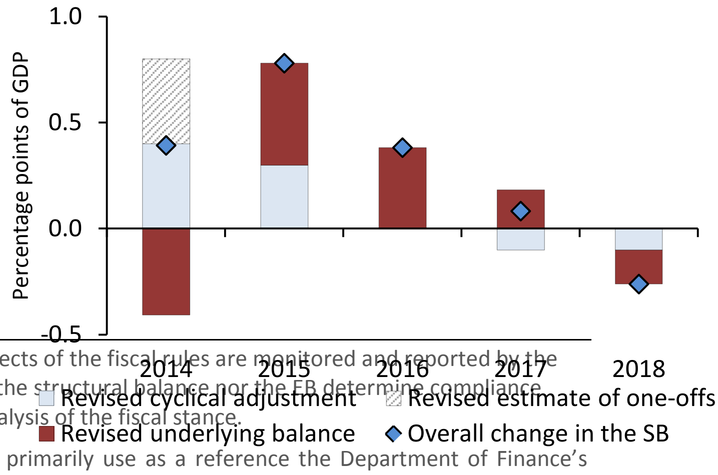
While the EB is designed to support achieving the targeted structural balance improvement, there are a number of scenarios where they may give differing signals as to compliance with the rules as set out in *IFAC Analytical Note No. 7* issued in April 2015 (IFAC, 2015). In the event of such conflicting signals from these measures, the Council will form a view on compliance with the Budgetary Rule based on an analysis of the particular reasons causing the differing signals.[10]

There have been material revisions to the official estimate of the structural balance between *Budget 2015* and *SPU 2015* with positive revisions to the structural balance for 2014 to 2016 and then smaller revisions for 2017 and 2018 (see Figures 4.1A and 4.1B).[11] The revised improvement in the structural balance between 2015 and 2016 is 0.4 percentage points smaller than estimated in *Budget 2015*. This change reflects the revised forecasts for the net impact of policy decisions on the balance (discussed in Chapter 3) and the impact of revised output gap estimates. While the revision in the underlying deficit improved the structural deficit in both 2015 and 2016 by a broadly equivalent amount, the change in the cyclical component in 2015 flattens the structural deficit path between these years as compared to the previous *Budget 2015* path. [12]

FIGURE 4.1A: CHANGE IN THE ESTIMATED STRUCTURAL BALANCE (*BUDGET 2015 TO SPU 2015)*



FIGURES 4.1B: DECOMPOSITION OF DIFFERENCE IN THE STRUCTURAL



[9] As p[illegible]pects of the fiscal rules are monitored and reported by the Council for the period to 2015. While neither the path of in the structural balance nor the EB determine compliance with the Rule until 2016, they are assessed as part of the analysis of the fiscal stance.

[10] In undertaking the assessment of rules the Council will primarily use as a reference the Department of Finance's forecasts and estimates, with analysis and sensitivity tests of key assumptions and forecasts where appropriate and necessary.

[11] The official measure of the structural balance produced by the Department of Finance can be summarised as follows:

Structural Balance = (Actual Balance) – (Cyclical element) – (One-off and temporary measures)

The 'cyclical element' is estimated by applying a constant budgetary semi-elasticity to the relevant output gap for a particular year. The approach to estimating the structural balance must be consistent with the requirements of the Treaty on Stability, Coordination and Governance; the "annual structural balance of the general government" refers to the annual cyclically-adjusted balance net of one-off and temporary measures" (*Treaty on Stability, Coordination and Governance, 2012*). The budget semi-elasticity for Ireland is currently 0.53. (EC, 2014).

[12] The 'underlying' balance is the nominal general government deficit adjusted for the impact of financial sector measures.

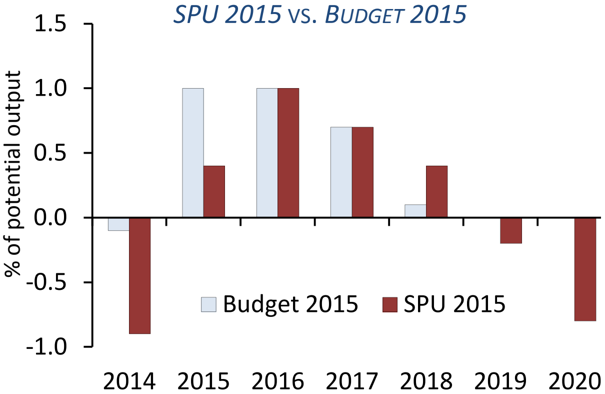
Source: Internal IFAC calculations based on *SPU 2015* and *Budget 2015*.

Note: Positive changes in the components result in a reduced structural deficit. The fiscal forecasts in *Budget 2015* assume constant Departmental expenditure from 2016 to 2018. The *Budget 2015* figures shown above are adjusted to fully reflect the Ministerial Expenditure ceilings published in the *Comprehensive Expenditure Report 2015-2017*.

The fiscal forecasts for the period post-2016 are not fully reflective of the Government stated fiscal aims (see Chapter 3) and, as such, the revisions to the structural balance for this period are of limited use in assessing the *ex ante* compliance with rules.

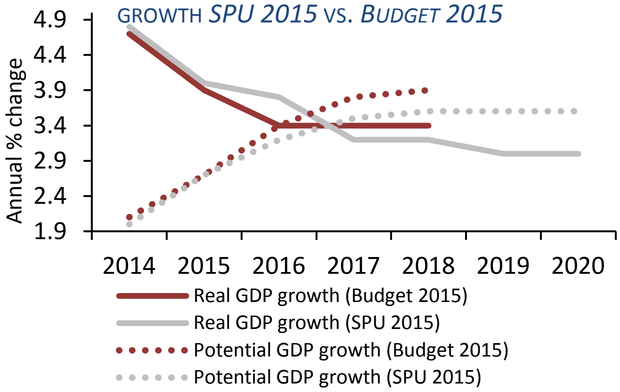
The output gap estimates are largely unchanged in 2016 and 2017. However, Figure 4.2 shows that these revised forecasts lead to significant changes in the output gap in 2014 and 2015 and also in 2018 as compared to *Budget 2015*.

FIGURE 4.2A: COMPARISON OF OUTPUT GAP ESTIMATES *SPU 2015* VS. *BUDGET 2015*



Source: SPU 2015 and *Budget 2015.*

FIGURE 4.2B: COMPARISON OF REAL AND POTENTIAL GDP GROWTH *SPU 2015* VS. *BUDGET 2015*



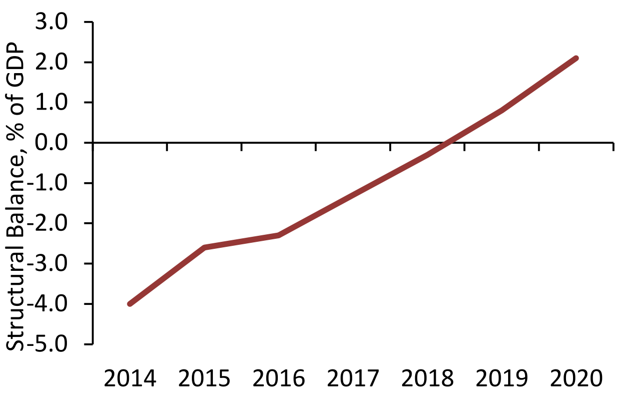
Source: SPU 2015 and *Budget 2015.*

EX POST AND IN-YEAR ASSESSMENTS FOR 2014 AND 2015

The current official measure of the structural balance shows that the structural deficit remained flat between 2013 and 2014, despite an improvement in the headline deficit, which fell by 1.7 percentage points from 5.8 per cent to 4.1 per cent (see Figure 4.3). Although this would not have delivered the 0.6 percentage point change required under the Adjustment Path condition, this does comply with the Budgetary Rule and EU requirements for the procedural reasons set out above. In addition, this apparent lack of progress arises as a result of the differing impact of the technical ESA2010 revisions in 2013 and 2014 (see IFAC, 2014b). It does not reflect a lack of 'fiscal effort' in 2014, as reflected by the actions taken in *Budget 2014*.

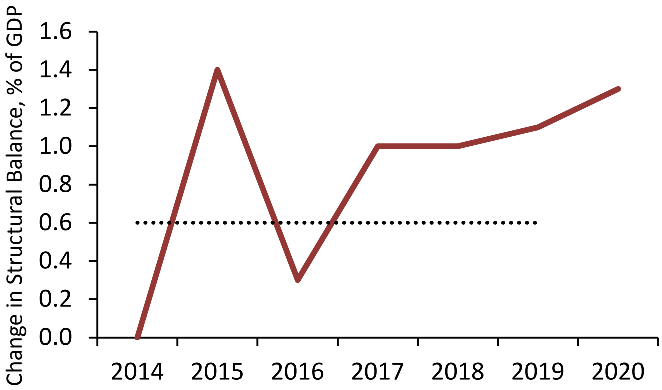
FIGURE 4.3: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE

A. BUDGET CONDITION



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

B. ADJUSTMENT PATH CONDITION



Note: Medium-Term Budgetary Objective for Ireland is a structural balance. This is planned to be achieved in 2019 and consequently the Adjustment Path Condition does not apply in 2020.
Source: SPU 2015, Department of Finance.

The estimated structural deficit for 2015 is forecast by the Department of Finance to fall by 1.4 percentage points to 2.6 per cent of GDP. This is more than double the 0.6 percentage point change required to comply with the Adjustment Path condition outside of an EDP, although it remains some distance from the MTO.

EX ANTE ASSESSMENT OF 2016

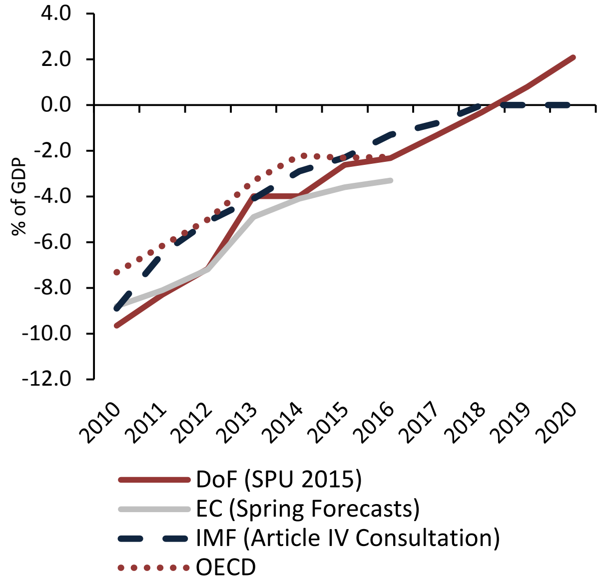
On the basis of the forecasts contained in *SPU 2015,* the annual structural adjustment required under the Budgetary Rule will not be met in 2016 with an improvement of only 0.3 percentage points rather than the required 0.6 per cent. This difference is not large enough to be deemed a “significant deviation” under the EU rules.[13] However, it is a serious concern that the Government has set out a plan that breaches a key component of both the domestic and European frameworks on an *ex ante* basis.

This concern is underlined by the size of the planned change in the headline deficit between 2015 and 2016 in *SPU 2015* of 0.6 percentage points. This could only deliver the required improvement in the structural balance if the improvement is entirely structural in nature. However, this is very

[13] 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 cumulatively over two consecutive years.

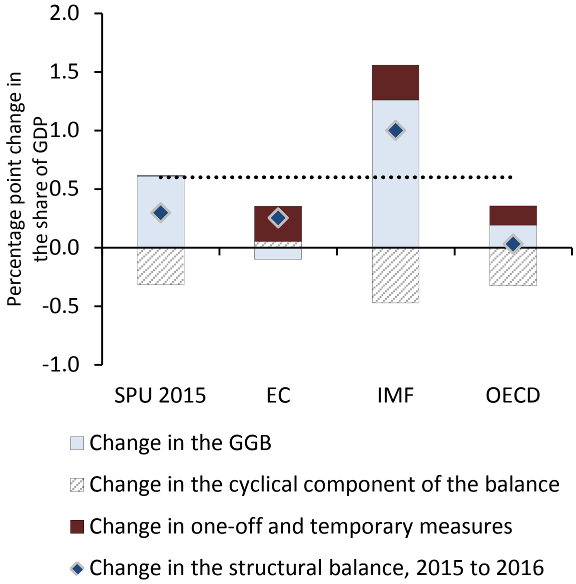
unlikely to be the case. *SPU 2015* indicates that most of the forecast reduction in the deficit to 2016 is, 'attributable to buoyant tax receipts on the back of a growing economy.'(*SPU 2015*, p. 16).

FIGURE 4.4A: COMPARISON OF LATEST STRUCTURAL BALANCE ESTIMATES



Source: SPU 2015 (April 2015), *EC's Spring 2015 Economic Forecasts, IMF's Article IV Consulation (March 2015)* and the OECD's *World Economic Outlook* (November 2014).

FIGURE 4.4B: ANNUAL CHANGE IN THE STRUCTURAL BALANCE, 2015-2016



Source: Internal IFAC calculations based on *SPU* 2015 (April 2015), EC's *Spring 2015 Economic Forecasts*, IMF's *Article IV Consulation* (March 2015) and the OECD's *World Economic Outlook* (November 2014).

Given the inherent uncertainty in estimating the structural balance, it is useful to compare estimates across different institutions (see Figure 4.4). The latest EC Spring estimates of the structural balance for 2015 and 2016 indicate an improvement of 0.3 per cent, while the latest IMF estimate is for a 1 per cent change and the OECD forecast is for an unchanged structural balance between these years*.* However, the IMF's estimate assumes a larger improvement in the headline general government balance than *SPU 2015* and would imply only a 0.2 percentage point improvement in the structural balance starting from the *SPU 2015* headline balance.

The Council is strongly of the view that Government plans should be based on expected compliance with the fiscal rules. The *Spring Economic Statement* clearly identifies this as a difficulty for 2016, "... a particular issue arises with relation to 2016 whereby compliance with the expenditure benchmark is met on current estimates but delivery of structural adjustment is lower than required" (p. 35). Where there is a planned deviation from the rules, as clearly contained in *SPU 2015*, the reasons should be clearly explained.

Box F: Changes in the assessment of the Path to the Medium-Term Budgetary Objective (MTO)

For countries not yet at their MTO the EU rules require an "appropriate" annual improvement in the structural balance. As set out under the reformed Stability and Growth Pact, a greater effort can be sought in good times with effort more limited in bad times.

Earlier this year, the EC clarified the definitions of the "good" and "bad" times that would be applied in their assessments (see figure F.1). On the basis of the *SPU 2015* forecasts, Ireland is in "normal times". However, with a debt of greater than 60 per cent of GDP, Ireland must improve the structural balance by an amount greater than 0.5 per cent of GDP. This requirement for an improvement of greater than 0.5 percentage points has been operationalised in the latest EC assessments as 0.6 percentage points.

Figure F.1: Matrix for specifying the annual fiscal adjustment towards the MTO under the SGP

	Condition	Required minimum annual structural balance adjustment	
		Debt below 60% of GDP and no sustainability risk	Debt above 60% or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 $\leq$ output gap < -3	0	0.25
Bad times	-3 $\leq$ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 $\leq$ output gap < 1.5	0.5	>0.5
Good times	output gap > 1.5	> 0.5 if growth below potential, > 0.75 if growth above potential	> 0.75 if growth below potential, > 1 if growth above potential

Some investments deemed to be equivalent to major structural reforms may, under certain conditions, justify a temporary deviation from MTO or from the adjustment path towards it.[14] The EC have now clarified the circumstances under which a country can benefit from this "investment clause". These include requirements that the country in question is running a large, negative output gap of greater than 1.5 per cent of GDP and that the deviation from the fiscal adjustment path preserves a safety margin to the 3 per cent ceiling. There are also specific clauses relating to the inclusion of different types of investment projects and the treatment of co-funding arrangements.

[14] Article 5 of Regulation 1466/97 provides that "[…] the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth […]."

Countries implementing major structural reforms are allowed to deviate temporarily from their MTO or the adjustment path towards it. This allows countries to cater for the short-term costs of implementing structural reforms that will have long-term positive budgetary effects, including by raising potential sustainable growth. The EC have also clarified that this “structural reform clause” will form part of their assessment where the reforms are major, either individually or as a package, and must have direct long-term positive budgetary effects. There is some debate at a European level as to whether planned reforms are in fact sufficient to meet the requirements set out under the Treaty, or whether some firmer commitment should be required. Planned reforms may be included *ex ante* where a country presents a comprehensive and detailed medium-term structural reform plan.

4.3.1 Expenditure Benchmark Assessment 2014-2016

The EB is complied with on an *ex post* basis in 2014.[15] While the growth rate of spending in 2015 is likely to exceed the EB the basis of the figures in *SPU 2015*, the EB does not apply on a procedural basis as compliance with the EDP is sufficient.

The anomaly in the estimation of the Expenditure Benchmark (EB) in 2016, identified by the Council in *Analytical Note No. 7* issued in April (IFAC, 2015), has been addressed by the European Commission and the Department of Finance. This anomaly led to the EB being excessively tight for 2016.[16]

It has been agreed at a European level that both the reference rate, which remains a 10 year average of potential GDP growth, and the convergence margin will be updated on an annual basis rather than held constant over a three year window.[17] This allows for the EB to take account of the more up-to-date estimates of potential GDP growth.

This move to an annual update of the EB ensures greater consistency *ex ante* with the structural balance target to meet the MTO, removing the possibility of this type of anomaly. However, it substantially weakens the anchoring of spending in a multi-annual framework and likely reduces the predictability of medium-term plans (see section 4.4).

[15] The allowable rate of real growth under the EB is calculated by reference to a 10 year average of real potential growth (the ‘reference rate’) - from (t-5) to (t+4) - and, where the MTO is not yet complied with, a convergence margin is then subtracted.

[16] IFAC (2015) showed that the previous EB was more constraining on fiscal policy than either an alternative estimate of the EB based on an updated estimate of the reference rate or the requirements for the annual change in the structural balance.

[17] A transition period will apply for Member States who do not wish to update their EB for 2016. The annual update will apply to all Member States from 2017.

On the basis of the EC Spring 2015 economic forecasts, the EB sets the increase in allowable real expenditure to 0.1 per cent in real terms for 2016. This amounts to a €1 billion annual increase in the amount of nominal spending within the terms of the EB; representing a €1.1 billion change from the pre-adjustment position set out in the Council's *Analytical Note* (IFAC, 2015b). The reference rate has been updated from 0.6 per cent to 1.9 per cent (based on the EC's *Spring Economic Forecasts*). However, this is somewhat offset by two changes to the convergence margin in the EB calculation. The first is to update the baseline primary expenditure ratio from 2013 to 2015 data. The second is to ensure the convergence margin is consistent with the required 0.6 percentage point change in the structural balance (the previous convergence margin was based on a 0.5 percentage point requirement). The revision to the EC's forecast for the 2016 GDP deflator between the Winter and Spring forecasting rounds also has a significant impact on the allowable increase in nominal expenditure growth. The impact of recent changes to the setting of the EB are summarised in Table 4.1.

Table 4.1: Allowable Expenditure Growth under the Expenditure Benchmark

Vintage and Range	Measure	2016
Calculations based on *Analytical Note 7 (IFAC, 2015)*	Reference Rate	0.6
	Convergence Margin	1.4
	Expenditure Benchmark: real %	-0.7
	Implied nominal growth, %	-0.1
	Implied nominal change, €billion	-0.1
Calculation based on *SPU 2015*	Reference Rate	1.9
	Convergence Margin	1.8
	Expenditure Benchmark: real	0.1
	Implied nominal growth	1.6
	Implied nominal change, €billion	1.0
Implied nominal change since IFAC Analytical Note, €billion		*1.1*

Figure 4.5A shows that, based on the *SPU 2015* fiscal forecast, the EB is complied with in 2016, while Figure 4.5B shows nominal growth in the main expenditure aggregates as set out in *SPU 2015*.

Figure 4.5A: Compliance with the EU Expenditure Benchmark

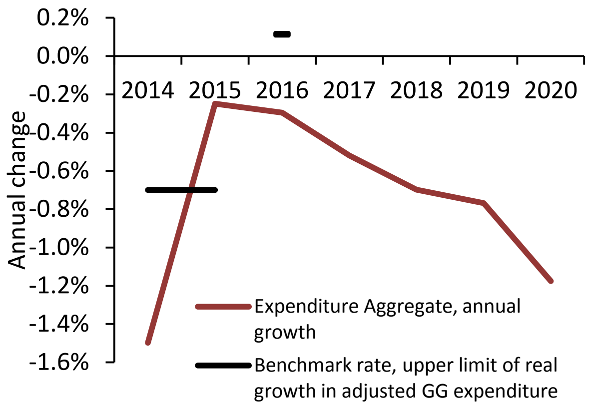
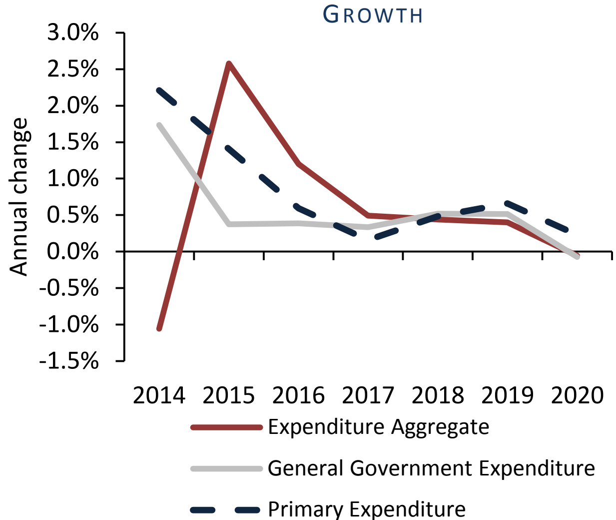


Figure 4.5B: Nominal Expenditure Growth



Source: SPU 2015 and EC *Spring Economic Forecasts*.

Under the EB, increases in expenditure are permitted if fully offset by discretionary revenue-raising measures, for example an increase in tax rates. For countries not yet at their MTO such as Ireland, the reverse also applies so policy decisions to reduce revenues lower the allowable rate of spending growth.[18] The additional carryover impact of €0.3 billion into 2016 arising from taxation changes made in *Budget 2015* reduces allowable expenditure growth in 2016. In addition, the proposed tax package of €0.6 billion envisaged for *Budget 2016* also reduces allowable expenditure growth. The *SPU* includes two revenue increases that offset the impact of proposed 2016 cuts. These items have not been treated as discretionary revenue increases in past *SPU*s.

(i) *Non-indexation of tax*

In the presence of wage growth, such 'non-indexation' of income tax bands and credits to prices increases the tax-take. The estimated effects of non-indexation of taxes (€0.3 billion) have been included in the aggregate discretionary revenue measures (DRM) used in the calculation of the EB. The inclusion of the impact of non-indexation is not unreasonable given that it reflects a policy decision that directly affects government revenue in a structural sense.

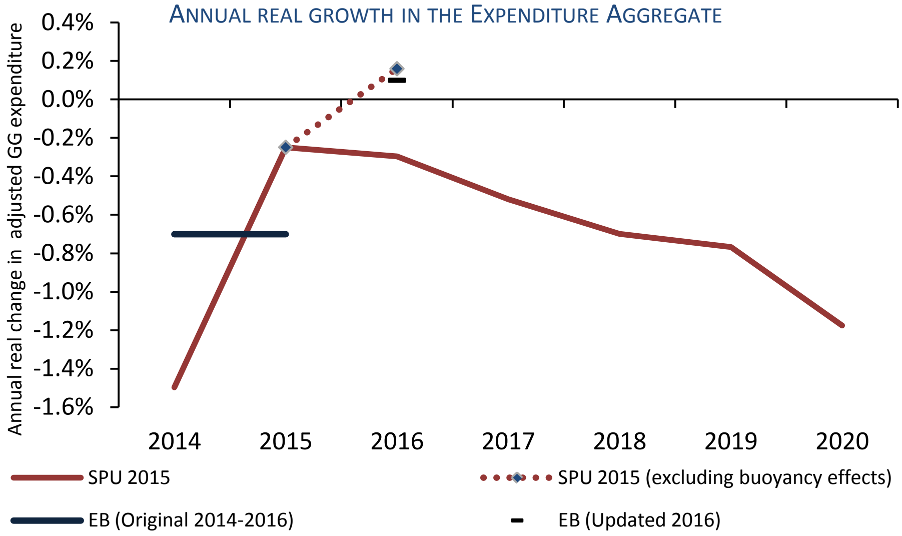
(ii) *"Tax buoyancy" arising from proposed policy changes*

SPU 2015 estimates a positive second round impact of the proposed policy changes to tax and expenditure in the budget on the tax-take of €0.3 billion.[19]

[18] The Department of Finance quantifies the tax buoyancy of budget measures and incorporates it in the tax revenue forecasts.

[19] This means that the assumed boost to economic activity from the proposed budgetary package for 2016 of €1.2 billion results in a second-round increase in tax revenue of €0.3 billion through the actions of the fiscal multiplier (assumed 0.5) and the automatic stabiliser coefficient (assumed 0.5). The buoyancy impact of budget packages are typically published as part of the budget documentation.

FIGURE 4.6: COMPLIANCE WITH EXPENDITURE BENCHMARK
ANNUAL REAL GROWTH IN THE EXPENDITURE AGGREGATE



Source: Internal IFAC calculations based on *SPU 2015* and *Budget 2015.*

Figure 4.6 shows that excluding the tax buoyancy effect in 2016, there is considerable risk of non-compliance with the EB on the basis of the *SPU 2015* projections. It is unclear as yet how the European Commission would treat a tax buoyancy effect. The Council sees no argument for the inclusion of a temporary demand effect of this nature in the calculation of EB compliance given the objective to match structural changes in spending and revenues. This adds to the Council's serious concerns about *SPU 2015* setting out plans that do not meet the required minimum change in the estimated structural balance in 2016.[20]

Ex ante Assessment of 2017-2020

For the post-2016 period, assessment of compliance with the rules is problematic as the *SPU 2015* fiscal forecasts are stated to be predicated on a 'no-policy change' basis (see Chapter 3). The path of the structural balance complies with the required annual change in the structural balance for all years and the MTO is planned to be achieved in 2019. However, the Government's stated intention is to 'ensure that we move towards the MTO at this minimum rate on average over the coming years...' (p. 37, *Spring Economic Statement*). Under the European and domestic framework the minimum annual adjustment of 0.6 percentage points applies each year; it is not based on a multi-year average. Consequently, larger planned medium-term adjustments cannot be used to balance smaller than required adjustments in the short term.

[20] In addition, the Council has previously noted that the methodology used in identifying the cyclical component of unemployment benefit expenditure may also flatter compliance with the EB. 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.

4.4 THE MEDIUM-TERM EXPENDITURE FRAMEWORK

The move to an annual update of the Expenditure Benchmark weakens the already fragile domestic framework for the setting of multi-annual expenditure ceilings as the formal, multi-annual 'top-down' anchor has been removed.[21] Recent years have seen regular re-setting of both the Government Expenditure Ceiling and Ministerial Expenditure Ceilings.[22] These revisions undermine multi-annual public expenditure management through creating uncertainty around the scale of future resources, both in aggregate and for individual Departments.[23] Given that the aim of the *Comprehensive Review of Expenditure 2015-2017* (*CER 2015-2017)* was to 'help avoid incrementalism and support budget discipline', the upward revision to the Government Expenditure Ceiling in *SPU 2015* without adequate explanation is a significant concern. Furthermore, this upwards revision should – within the government's own budgetary framework – have led to revised Ministerial expenditure ceilings. The failure to provide these in *SPU 2015* adds to the concern about the commitment to medium-term expenditure management and compliance with the post-crisis medium-term budgetary framework.

Multi-annual ceilings were introduced to address serious expenditure management problems evident in Ireland prior to the crisis, which resulted in repeated pro-cyclical re-setting of future expenditure levels (see Figure 4.7). Without the top-down 'anchor' on expenditure provided by the advance setting of the EB for three years and proper implementation of the domestic ceilings, there is a risk of a return to structural increases to medium-term expenditure based on positive short-term macroeconomic dynamics.[24]

---

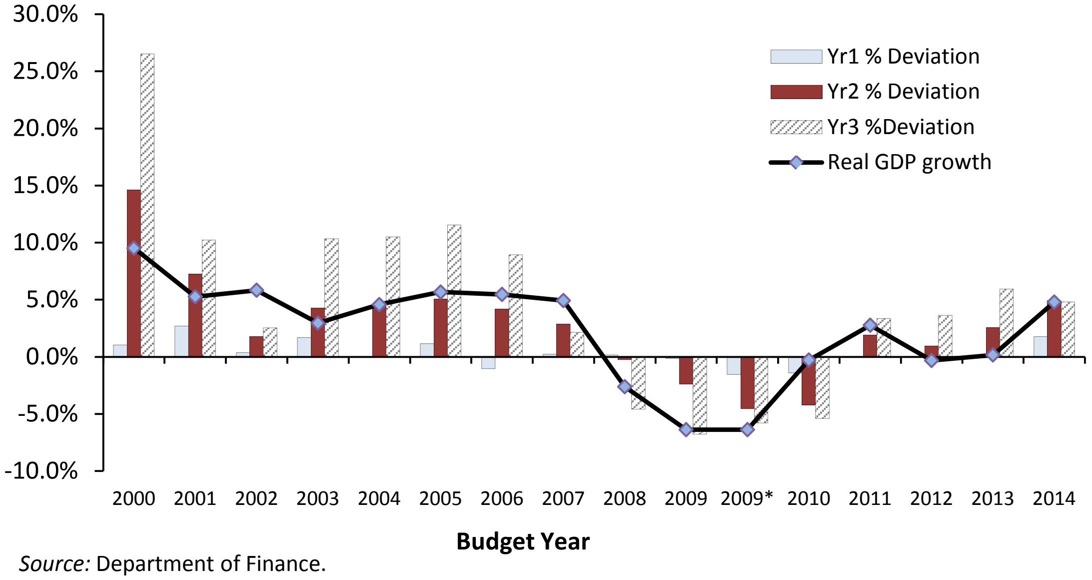
[21] In the *Medium Term Budgetary Framework* (Department of Finance, 2014b) it is stated that the expenditure ceilings operationalise the EB.

[22] 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 Government Expenditure Ceiling.

[23] As noted by the EC (2015), these revisions also imply that the current set falls somewhat short of the EU Council's recommendation asking Ireland to 'ensure the binding nature of the government expenditure ceiling including by limiting the statutory scope for discretionary changes'.

[24] One of the latest Country Specific Recommendations for Ireland from the EC is to limit the existing discretionary powers to change expenditure ceilings beyond specific and predefined contingencies.

FIGURE 4.7: GROSS CURRENT EXPENDITURE, % DEVIATION FROM FORECAST

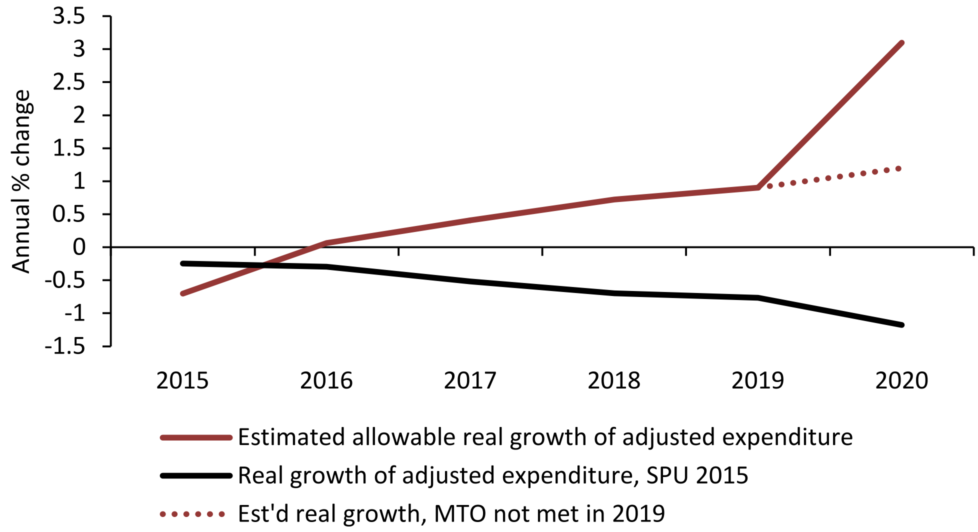


Source: Department of Finance.
Note: Bars show the forecast error for 1 year ahead, 2 years ahead and 3 years ahead. Latest figures for 2016 and 2017 (used in calculation of the latest deviation from Budget 2014 years 2 and 3) are adjusted by €0.9 billion to reflect the change in the treatment of the HSE in 2014. This adjustment is made for comparison

In addition to this counter-cyclical aspect, the domestic Medium Term Expenditure Framework (MTEF) should also improve medium-term budgetary planning and expenditure efficiency by; (i) setting an *ex ante* constraint on both total and Ministerial spending having regard to the estimate of the fiscal space that will be available over the next medium-term cycle, and (ii) requiring each Department to ensure strategy is consistent with the multi-annual constraint allocated to it (see Schick, 2009). Consequently, an MTEF should reconcile the 'top-down' fiscal rules, with 'bottom-up' Departmental pressures and policy costs. Without this clear link between macro fiscal policies and Departmental resources over the medium term, there is a danger that increasing expenditure rigidities or unaddressed inefficiencies may lead to a breach of the rules or, at a minimum, lead to less efficient public spending.

The new EB methodology can be used as a basis to estimate an allowable rate of expenditure growth into the medium term. Figure 4.8 shows the estimated allowable real growth in the expenditure aggregate to 2020 based on *SPU 2015* data and compares it to the path for the expenditure aggregate in *SPU 2015*. *SPU 2015* projections for expenditure growth are significantly below estimated allowable expenditure growth under the EB over the forecast period.

FIGURE 4.8: ESTIMATED ALLOWABLE REAL EXPENDITURE GROWTH UNDER THE EB



Source: Internal IFAC calculations based on *SPU 2015.*
Note: Solid red line indicates estimates based on *SPU* data, with MTO being met in 2019 and no convergence margin adjustment in 2020. Dotted line indicates impact of a convergence margin in 2020. Potential output growth in 2021 to 2023 is assumed to be 3 per cent.

Once a realistic medium-term limit on overall expenditure has been determined, the Government should use this as the basis of setting both the Government expenditure ceiling and Ministerial expenditure ceilings for the following three years. It is essential in a multi-year framework that spending limits are set several years in advance and not revised other than in limited, clearly defined circumstances. One difficulty with the application of this approach to date in Ireland is that the aggregate of all Ministerial ceilings has been set exactly at the Government Expenditure Ceiling. While the Government may choose to continue with this approach, an alternative would be to allow a ‘margin’ between the sum of the Ministerial ceilings and the total expenditure set under the Government Expenditure Ceiling. This margin would reflect uncertainty around revenue and allow space for possible and legitimate expenditure overruns. This allows normal modest budget deviations to be managed in a routine manner without breaking the multiannual commitments. In any case, expenditure ceilings are by their nature asymmetric as they represent an upper limit on spending but, if necessary, Government can choose a lower level of expenditure in a given year without formally adjusting the ceiling.