4. Assessment of Compliance with Fiscal Rules

Key Messages

- The projected 2.1 per cent deficit for 2015 presented in *Budget 2016* should lead to a successful correction of the excessive deficit under the Excessive Deficit Procedure (EDP).

- The domestic Budgetary Rule will also be met for 2015. Adhering to the requirements of the EDP is sufficient for the Budgetary Rule to be met for both 2014 and 2015. The annual improvement in the measured structural balance projected in *Budget 2016* is 0.8 per cent of GDP in 2016. If achieved, this would comply with the required change of 0.6 per cent of GDP set in spring of this year under the Preventive Arm of the Stability and Growth Pact (SGP) and would also meet requirements for the domestic Budgetary Rule.

- The projected change for 2016 in government spending adjusted for discretionary revenue changes only just complies with the Expenditure Benchmark (EB), leaving no margin for overruns. The European Commission assessment of *Budget 2016* points to a risk of some deviation from the EB. The latest increase to planned Departmental expenditure in 2015 requires an additional upward revision to the Government's own expenditure ceilings, further undermining their multi-annual character. Previous *Fiscal Assessment Reports* have documented a persistent pattern of budgetary overruns in health spending. Recognising the weakness of the domestic expenditure ceilings in controlling spending, there are risks to compliance with the EB in 2016 in the absence of a buffer. The domestic framework should be strengthened to support medium-term expenditure planning and execution.

- One of the challenges to the European fiscal governance system is the increasingly complex design of the fiscal rules. Given that these rules continue to evolve, simplifying the framework is likely to be a medium- to long-term objective. It is essential, therefore, that the methodologies, definitions and processes underpinning the complex rules be made public prior to the national 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 Government's plans as contained in *Budget 2016* with these fiscal rules. The immediate target for fiscal policy is the correction of the excessive deficit within the Corrective Arm of the *Stability and Growth Pact* (*SGP*) in 2015. As outlined in Section 4.2, correcting the excessive deficit this year ensures that the requirements of both the domestic and European frameworks are met.

Having corrected the excessive deficit, Ireland will move into the Preventive Arm of the *SGP* in 2016*,* with consistent requirements set under the domestic Budgetary Rule. Requirements applying to both the structural balance and to annual growth in government expenditure are assessed under these rules in Section 4.3.[1]

Section 4.4 examines the domestic Medium-Term Expenditure Framework (MTEF), particularly the performance of the Government and Ministerial expenditure ceilings. This chapter also includes a box on the process of setting and assessing compliance with fiscal targets under the preventive arm of the *SGP*.

4.2 Excessive Deficit Procedure Exit

Under the Excessive Deficit Procedure (EDP) Ireland's General Government deficit must be lower than the 3 per cent of GDP ceiling for 2015. The correction must be undertaken in a sustainable manner so that the deficit is expected to adhere to this ceiling into the medium term. Given the *Budget 2016* projected deficit of 2.1 per cent of GDP in 2015, this ceiling will likely be met with a buffer, particularly in light of the larger than expected post-Budget increases in tax revenues discussed in Chapter 3.[2,3] Furthermore, *Budget 2016* shows a future path for the General Government deficit that is consistent with a sustainable correction. A sustainable correction is also

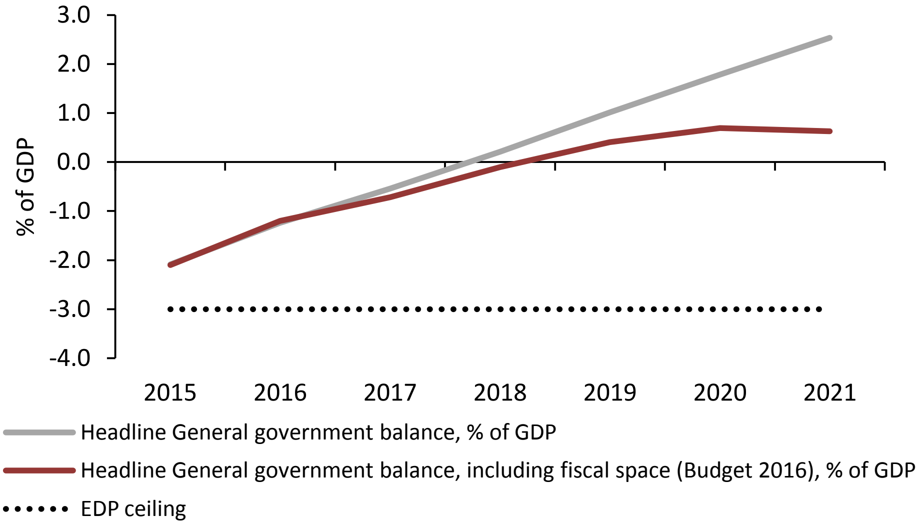
[1] While the Council's formal requirement to assess (*ex post*) compliance with the Budgetary Rule is backward-looking in nature, the mandate of the Council to assess the fiscal stance suggests considering compliance on a forward-looking basis also.

[2] The latest EC assessment of *Budget 2016* (EC, 2015e) shows the deficit remaining below this ceiling for 2016 and 2017. However, the EC note that decisions taken in 2015 are not in line with the EU Council's EDP recommendation that windfalls be used to accelerate deficit and debt reduction. Furthermore, this assessment indicates that effective action was not taken in respect of the required aggregate improvement in the structural balance.

[3] While the excessive deficit is likely to be corrected in 2015, a decision of the EU Council is required to formally end, or 'abrogate' an EDP following the improvement of the budget deficit to less than the 3 per cent of GDP ceiling. This assessment is based on "notified", i.e., outturn data provided by countries as part of the Maastricht Returns the following year. The sustainability element is assessed by reference to EC fiscal forecasts. For all countries that entered an EDP after November 2011, compliance with the debt criteria is also required, including in its forward-looking specification. As Ireland entered an EDP prior to the November 2011, reform of the *SGP* this second requirement does not apply in the abrogation assessment.

robust to the use of an adjusted deficit estimate that allows for full use of the fiscal space available under the rules, as identified in *Budget 2016*.[4]

FIGURE 4.1 SUSTAINABLE CORRECTION OF THE EXCESSIVE DEFICIT



Source: Budget 2016 and internal IFAC calculations

Following the recent reforms to the *SGP* the structural balance path set under the Corrective Arm (the EDP) must now be consistent with the minimum requirements under the Preventive Arm of the SGP. This approach is designed to smooth the transition between the Corrective and Preventive Arms of the *SGP* and would avoid pro-cyclical fiscal policy adjustments where a country is experiencing strong growth while in an EDP. As Ireland entered an EDP prior to the reforms an annual structural balance path was not set as part of the EDP. However, had these revised criteria been in force for Ireland this year, the scope for additional expenditure increases would likely have been curtailed.

Following a successful correction of the excessive deficit at end-2015, transition arrangements under the Debt Rule will apply for the next three years – until the end of 2018 – before the normal requirements of the Rule begin to apply.[5] These requirements – related to the Corrective Arm of the SGP – are not anticipated to present a binding constraint on fiscal policy over the medium term as the projected pace of reduction of the debt-to-GDP ratio is significantly faster than required under the Debt Rule.

[4] Table A.8 in *Budget 2016* estimates available fiscal space under the EB. This is incorporated into the General Government Balance estimates shown in Figure 1.

[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 IFAC Analytical Note 5: Future Implications of the Debt Rule.

4.3 Compliance with the Budgetary Rule

The Budgetary Rule is a key pillar of the domestic fiscal framework.[6] The domestic Budgetary Rule effectively mirrors the SGP and so will reflect requirements under the Preventive Arm once the excessive deficit has been corrected in 2015. The Fiscal Responsibility Act 2012 (FRA) identifies two ways of meeting the requirements of the Budgetary Rule. The 'budget condition' is met where the medium-term budgetary objective (MTO) is achieved. If a country is not at its MTO, the 'adjustment path condition' requires that the structural balance must be on an appropriate adjustment path towards it.[7] The assessment of this adjustment focuses on the change in the structural balance but also considers expenditure growth by reference to the EU Expenditure Benchmark (EB).

While the EB is designed to support achieving the targeted structural balance improvement, there are a number of scenarios where they may give differing signals as to compliance with the rules (IFAC, 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.[8]

4.3.1 *Ex Post* and In-Year Assessments for 2014 and 2015

The requirements under the Budgetary Rule are legally satisfied by meeting the EDP targets for both 2014 and 2015. Consequently, on the basis of figures in *Budget 2016,* the Budgetary Rule is met for 2014 and is forecast to be met with a buffer for 2015.

Compliance with the relevant fiscal rules in 2015 required only that the deficit be below the 3 per cent of GDP ceiling in line with the EDP. However, it is notable that, following the significant upward revision to spending in 2015 since *Budget 2015*, neither the change in the structural balance nor expenditure growth under the EB would have met the required improvements under the Preventive Arm had they applied. [9]

4.3.2 *Ex Ante* Assessment of 2016 to 2021

The *ex ante* assessment of the Budgetary Rule for 2016 and for later years focuses on the speed of structural deficit improvement towards meeting Ireland's Medium-Term Objective (MTO), and also

[6] The Budgetary Rule has been in force since its legal commencement on 31 December 2012 following the ratification of the Fiscal Treaty (http://www.irishstatutebook.ie/pdf/2012/en.si.2012.0522.pdf).

[7] In procedural terms, the *Fiscal Responsibility Act 2012* specifies that the Budgetary Rule is respected where the structural balance is "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 where the fiscal requirements set out under the EDP are met.

[8] 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.

[9] While neither the path of the structural balance nor the EB determine compliance with the Rule until 2016, they are assessed as part of the wider analysis of the fiscal stance for 2015.

includes an analysis of expenditure growth using the Expenditure Benchmark (EB). Box F presents the key procedures to set these requirements.

Box F: Setting Fiscal rules in the Preventive Arm of the SGP

This box summarises the procedures for setting the key fiscal targets under the Preventive Arm of the *SGP* and highlights some of the main issues related to their assessment. To a large extent processes governing the operation of the European rules have been made public through, for example, the *Vade Mecum on the Stability and Growth Pact* (EC, 2013) and subsequent clarification documents. At a national level, the *Medium-Term Budgetary Framework* (Department of Finance, 2014) document outlined the operation of the domestic framework. However, there remain a number of procedures that have not yet been published in detail, some of which can have significant impacts on the interpretation of the rules. The approach to 'freezing' minimum fiscal requirements under the rules at the time of the spring assessment has yet to be formally published despite being key to establishing the fiscal parameters for *Budget 2016*.[10] While giving a broad overview of the Preventive Arm, this box focuses mainly on the more recent developments to the framework, the details of which have yet to be formally made public by the EC.

The **Medium-Term budgetary Objective** (MTO) is a structural balance target that aims to (i) provide a safety margin against the EDP limit, (ii) ensure the sustainability of public debt, and (iii) allow room for manoeuvre particularly for investment needs. The MTO is set by Member States every three years but is subject to a minimum MTO calculated by the EC. This minimum MTO formalises the three aims of the MTO (see IFAC, 2013).[11] The minimum MTO is due to be revised before the end of this year but aspects of the calculation have yet to be finalised and published. The final MTO to be targeted for the 2017 to 2019 period will subsequently be decided by Government and published in next year's *SPU*. The EC allow a range of ±0.25 per cent when assessing whether countries have reached the MTO to allow for uncertainties in estimation.

If a country is not yet at its MTO the *SGP* requires that fiscal policy ensure an **appropriate change in the structural balance toward MTO**. Under the Fiscal Compact, the standard structural balance adjustment for a country not at MTO is an annual improvement of 0.5 per cent. However this adjustment is varied according to country specific economic conditions, the debt level and fiscal sustainability.

The various possible annual improvement requirements are formalised in the matrix published by the EC on 13 January 2015, and are presented in Figure F.1.[12] The planned adjustment is set out by countries in their annual *SPUs* and subsequently assessed by the EC. Countries with a debt of greater than 60 per cent of GDP must improve their structural balance by an annual amount greater than 0.5 per cent of GDP in normal economic times. This requirement for an improvement of greater than 0.5 percentage points has been operationalised within EC assessments as at least 0.6 percentage points.

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

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[10] The failure to publish details of the approach to 'freezing' targets in Spring of each year has also been specifically noted by the Advisory Division of the Dutch Council of State (see *Budget Supervision September Report 2015 of the Advisory Division of the Council of State*, 14 September 2015 (W06.15.0305/III/B).

[11] A key input into this minimum MTO is the analysis undertaken by the EU Economic Policy Committee's Ageing Working Group.

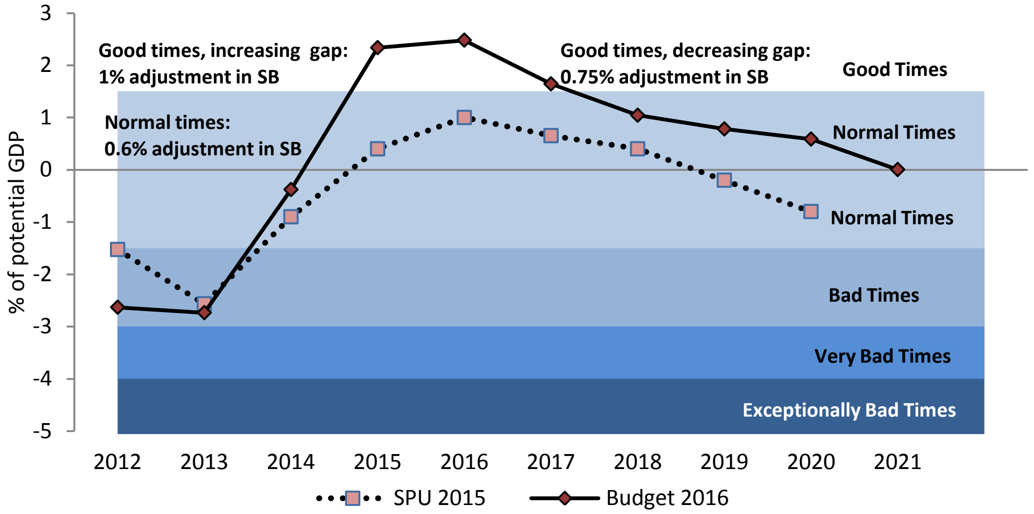
[12] The EC publication (EC, 2015a) *Making best use of the flexibility within the existing rules of the Stability and Growth Pact* is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52015DC0012.

	Condition	Required minimum annual structural balance adjustment: Debt below 60% of GDP and no sustainability risk	Required minimum annual structural balance adjustment: Debt above 60% or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap < -3	0	0.25
Bad times	-3 ≤ 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 ≤ 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

The structural balance adjustment as defined in the matrix above is effectively frozen based on the EC spring forecasts and sets the minimum requirement in all subsequent assessments of that year, including the subsequent Budget and for *ex post* assessments. For example, the minimum required structural balance improvement of 0.6 percentage points for the change between 2015 and 2016 that was set based on EC Spring 2015 Forecasts provides the basis for assessing compliance for 2016 now and in the future. However, the revised estimate of the output gap in *Budget 2016* implies this would have increased to 1 per cent in the absence of the ‘freezing’ requirement.[13]

[13] The EC’s latest forecast (EC, 2015c) is for an output gap of 1.3 per cent in 2016 (published in their Autumn 2015 Forecasts in November 2015) and would mean the economy remains in ‘normal times’.

FIGURE F.2 REVISION TO OUTPUT GAP ESTIMATES
SPU 2015 AND *BUDGET 2016*



Note: The figures above relate to a country with a debt-to-GDP ratio of greater than 60 per cent.
Source: IFAC presentation based on EC publication *Making best use of the flexibility within the existing rules of the Stability and Growth Pact*

The choice of freezing the target at spring rather than the autumn assessments in the year prior to the budget year implies a greater emphasis on the need for certainty over the benefits of incorporating more up-to-date information in setting budget targets. This 'freezing' treats upward and downward revisions to the output gap differently as it can allow for a slower improvement in the structural balance but not for any increase.[14] The details of this 'freezing' procedure have not yet been formally made public by the EC.

The **Expenditure Benchmark** complements the adjustment path assessment with an analysis of expenditure growth. While it was originally reset every three years, it is now reset on an annual basis. Details of this new procedure have yet to be made public by the EC. Consistent with the structural balance adjustment, the permitted real expenditure growth rate for the following year is set based on the EC Spring forecasts. The real expenditure growth rate is set using a reference rate calculated using a forward and backward looking ten year average of potential growth. Where a country is not at its MTO, a convergence margin is applied based on the required annual adjustment in the structural balance.

In calculating allowable nominal growth the GDP deflator is applied to the volume growth allowed under the rule to achieve a nominal spending figure. This is calculated for the following year using an average of the spring and autumn EC forecasts and this averaged deflator is fixed or 'frozen' for all subsequent assessments. There remains some uncertainty surrounding the nominal permitted rate of expenditure growth when the budget is announced as the EC's autumn forecasts are typically published the following month. For a small open economy such

[14] Where economic conditions are seen to worsen between the Spring and Autumn assessments such that the revised output gap is less than -3 per cent or less ('very' or 'exceptionally bad' times), the required adjustment would reflect the more up-to-date lower structural balance requirement. Furthermore, where data has been revised so that the Autumn assessment indicates the MTO has been met, this assessment will prevail over the frozen requirements. In either of these cases where a later assessment indicates a higher adjustment should have been required, the lower 'frozen' requirement prevails. However, the EC have indicated it would be desirable for a country in such a position to step up the pace of adjustment towards MTO in their budgets.

as Ireland's, changes in the terms of trade arising from exchange rate developments can have a large impact on the GDP deflator. This may cause significant fluctuations to allowed expenditure growth under the EB that are not appropriate to sustainable and prudent fiscal management. This later issue will be considered by the Council in its analysis of the EB as part of the *ex post* assessment of the Budget Rule.[15]

Complexity and transparency

Eyraud and Wu (2015) recently concluded that one of the main challenges to the European fiscal governance system is the increasingly complex design of the fiscal rules. Given that these rules continue to evolve and their design is subject to constraints, simplifying the framework is likely to be a medium- to long-term objective. However, to minimise this perceived complexity, the methodologies, definitions and processes underpinning the rules must be published. An announcement by the EC on 21 October goes some way to addressing concerns about transparency in the operation of the *SGP.* Positive developments in this regard are the announcement that the *Vade Mecum on the Stability and Growth Pact* is to be updated annually and furthermore that the EC will share the data underpinning its surveillance decisions with Member States, national Fiscal Councils and, following consultation with Member States, with the public.[16]

If there is to be full ownership of the fiscal framework at a national level, then information key to setting budgetary targets must be available prior to the national budget process. This would remove any ambiguity related to the status of procedures. The timely publication of information is particularly important given EC plans, also outlined on 21 October, to simplify the EU framework without changing its legal basis, which will lead to further procedural changes in future.

STRUCTURAL BALANCE PATH AND THE MTO

The revisions to the structural balance in 2016 between *SPU 2015* and *Budget 2016* are largely as a result of upward revisions to potential output due to the pro-cyclical nature of its estimation. These revisions increase the structural balance as a share of GDP while changing the annual improvement in the structural balance in 2016 from 0.3 in *SPU 2015* to 0.8 percentage points of GDP in *Budget 2016*.

TABLE 4.1 SUMMARY OF STRUCTURAL BALANCE AND COMPONENTS, *BUDGET 2016*

% change unless stated	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP growth, %	5.2	6.2	4.3	3.5	3.2	3.1	3.0	2.9
Headline General Government balance, % GDP	-3.9	-2.1	-1.2	-0.5	0.2	1.0	1.8	2.5
One off temporary measures, % of GDP [a.]	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0

[15] For example, if the EB applied in 2015, the deviation based on the average of the EC's Spring and Autumn 2014 Forecasts would be 0.8 per cent of GDP. Applying the latest GDP deflator estimate for 2015 and leaving all other things equal would imply additional space under the EB of 0.4 per cent. While the scale of this change is unusual it demonstrates the importance of the GDP deflator in setting nominal expenditure growth under the EB.

[16] As set out in the October 21 2015 Economic and Fiscal Governance Proposals. See http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/communication-emu-steps_en.pdf

Cyclical budgetary component, % Pot GDP	-0.2	1.2	1.3	0.9	0.6	0.4	0.3	0.0
Estimated using: Potential GDP growth, % Pot GDP	*2.7*	*3.4*	*4.1*	*4.3*	*3.8*	*3.3*	*3.2*	*3.5*
Output gap, % Pot GDP	*-0.4*	*2.3*	*2.5*	*1.6*	*1.0*	*0.8*	*0.6*	*0.0*
Structural budget balance [a.]	**-3.9**	**-3.4**	**-2.6**	**-1.4**	**-0.3**	**0.6**	**1.5**	**2.5**
Annual change in the structural budget balance	*0.3*	*0.5*	*0.8*	*1.1*	*1.1*	*0.9*	*0.9*	*1.1*
Two year average	1.5	0.4	0.7	1.0	1.1	1.0	0.9	1.0

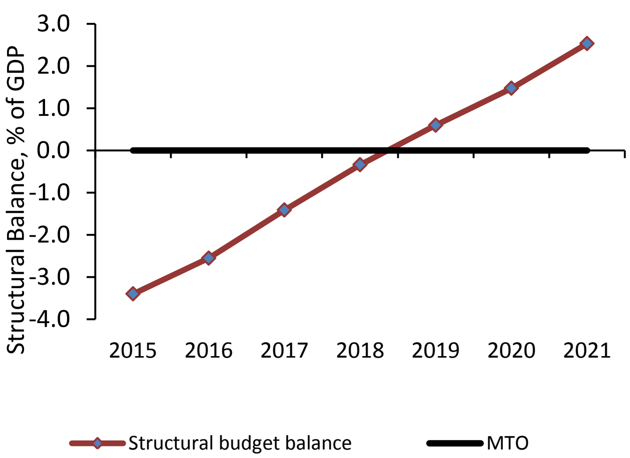
[a.] The one-off and temporary measures presented here have been adjusted following discussions with the Department of Finance, with consistent adjustments to structural balance figures.

At 2.6 per cent of GDP the 2016 structural balance – as measured by the EU harmonised approach – is below the current MTO of a structural balance and does not fulfil the 'budget condition' of the Budgetary Rule. However, the measured annual improvement of 0.8 percentage points of GDP exceeds the required change in the structural balance of 0.6 percentage points of GDP for 2016 set in spring and ensures the Budgetary Rule is complied with on an *ex ante* basis.

Figure 4.2 compares the structural balance path to the requirements for the structural balance under the Budgetary Rule to 2021.[17] While the 2016 fiscal requirements are now set, some uncertainty remains for subsequent years in the forecast horizon. For 2017 the *ex ante* required change in the structural balance would increase to 0.75 percentage points of GDP based on the EC 'matrix', as Ireland's output gap is projected to be 1.6 per cent. While the main structural balance path presented in *Budget 2016* would comply with this tighter requirement in 2017, the margin would be lower with this stricter requirement.[18] The required adjustment for 2017 will be formally set based on the EC spring 2016 output gap forecasts. While a fiscal forecast is provided to 2021 in *Budget 2016,* it is technical in nature (see Chapter 3).

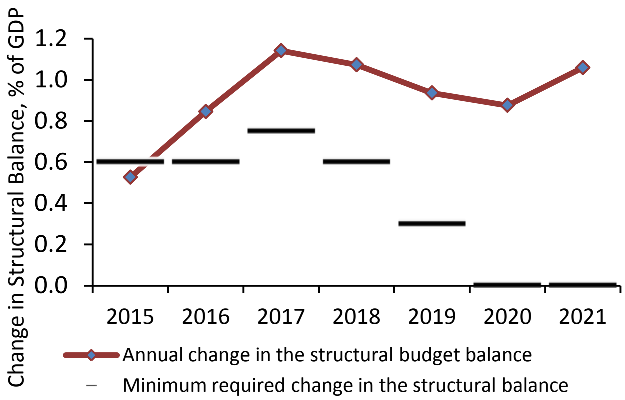
FIGURE 4.2: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE

A. BUDGET CONDITION



Note: The current Medium Term Budgetary Objective (MTO) for Ireland is a structural balance.
Source: Budget 2016, Department of Finance.

B. ADJUSTMENT PATH CONDITION



Note: The current 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 from that year. The required changes above are calculated based on the structural balance from the previous year. If the minimum adjustment was undertaken for the whole period the MTO would be achieved in 2020, a year later than planned in *Budget 2016*.
Source: Budget 2016, Department of Finance.

The MTO structural balance requirement will be revised in spring 2016 for 2017 to 2019. The MTO to be targeted for these years will be set by Government in *SPU 2016* (see Box F). Based on a preliminary estimation, the minimum MTO requirement may be a deficit of up to 0.5 per cent of GDP. While this estimate is subject to change following data updates and revisions, a loosening of minimum MTO appears likely. In reaching a decision regarding setting the actual MTO for 2017 to 2019 in the next SPU the Government should also have regard to factors excluded from the formal calculation of the minimum MTO.[19]

EXPENDITURE BENCHMARK

Signals from the EB are an important complement to the structural balance in assessing the adjustment path, as deterioration of the underlying balance may be masked by revenue windfalls not sufficiently captured in the official estimate of the structural balance. Table 4.2 sets out the detailed calculations for the EB and the assessment of the EB for 2016 to 2021 on the basis of the main *Budget 2016* fiscal projections.

The estimated tax revenue buoyancy arising from the *Budget 2016* package, which had been provisionally included by the Department of Finance as a discretionary measure for 2016 in *SPU 2015*, has been dropped from the calculation in *Budget 2016*. Indexation of income tax is assumed

[19] For example, the debt-to-GDP ratio is a key consideration when setting the MTO, however for Ireland a more appropriate measure may be the debt-to-GNP or a hybrid measure as proposed by the Council (IFAC, 2012b). Furthermore, in Ireland's case the measure of potential output – used in the estimates of long-term economic growth - is subject to a great deal of uncertainty (see IFAC, 2015a).

to reduce revenues in future years.[20] The Council is satisfied that these issues, which arose in the assessment of *SPU 2015,* have been addressed appropriately in *Budget 2016*.[21]

TABLE 4.2: CALCULATION OF THE EXPENDITURE BENCHMARK, 2016 AND 2017

	2015	2016	2017	2018	2019	2020	2021
Expenditure Benchmark (limit of real expenditure growth):		**0.1** [a.]	**0.3**	**1.0**	**1.2**	**3.4**	**3.5**
Reference Rate of potential Growth, %		*1.9*	*2.8*	*3.1*	*3.3*	*3.4*	*3.5*
Less Convergence Margin, %		*1.8*	*2.5* [b.]	*2.1*	*2.1*	*2.2*	*2.2*
Assessment of Compliance with Expenditure Benchmark:							
a. General Government Expenditure, €bn	**73.8**	**74.1**	**75.0**	**76.0**	**76.9**	**77.6**	**78.3**
b. Less Interest Expenditure, *€bn*	*6.7*	*6.6*	*6.7*	*6.7*	*6.7*	*6.7*	*6.4*
c. Less Gross Fixed Capital Formation adjustment, €bn [c.]	*0.5*	*0.4*	*0.2*	*0.2*	*0.6*	*0.6*	*0.6*
d. Less Cyclical unemployment expenditure, €bn	*-0.3*	*-0.4*	*-0.3*	*-0.3*	*-0.4*	*-0.6*	*-0.4*
e. Less Government expenditure co-financing EU funding, €bn	*0.4*	*0.4*	*0.5*	*0.5*	*0.5*	*0.5*	*0.6*
f. Corrected expenditure aggregate = (a-b-c-d-e), €bn	**66.5**	**67.0**	**67.9**	**68.8**	**69.5**	**70.4**	**71.1**
g. Less Net Discretionary Revenue Measures (DRM), €bn		*-0.7*	*0.1*	*0.5*	*0.4*	*0.4*	*0.4*
h. Corrected expenditure aggregate net of DRM = (f-g), €bn		67.8	67.8	68.3	69.1	70.0	70.7
i. Nominal growth in expenditure aggregate adjusted for DRM = $((h_t - f_{t-1})/ f_{t-1})$, %		1.9	1.1	0.6	0.5	0.6	0.5
j. GDP Deflator, %		1.7	1.2	1.2	1.2	1.2	1.2

[20] As indexation of income tax is assumed, if the Government decides not to fully index income tax bands to wage growth this would create additional fiscal space.

[21] Other discretionary revenue measures include the carryover impact of *Budget 2015* and *Budget 2016,* which are included in the following year in both cases reducing discretionary revenues. Additional, more minor discretionary changes to revenue include revenues from additional compliance and anti avoidance measures arising from increased resources to the compliance function of the Revenue Commissioners and changes to property tax rates where this has been decided by Local Authorities.

k. Real growth in expenditure aggregate adjusted for DRM, %		**0.2**	**0.0**	**-0.6**	**-0.7**	**-0.5**	**-0.7**
l. Deviation (negative indicates compliance) =((k- EB)*f), % of GDP		**0.0**	**-0.1**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
m. Nominal increase in spending permitted =f*(1+EB)*(1+j), €bn		**1.2**	**1.0**	**1.5**	**1.6**	**3.2**	**3.3**

Source: Budget 2016 and internal IFAC calculations.
[a.] While *SPU 2015* shows permitted real growth of 0.05 per cent, calculations in this document are based on 0.1 per cent.
[b.] This differs from the calculation presented in *Budget 2016* which estimates a convergence margin based on a 0.6 per cent adjustment in the structural balance. A convergence margin is applied to countries not yet at MTO and is linked to the required annual change in the structural balance. Based on the output gap in *Budget 2016,* the higher adjustment is required. The final target will be set based on EC *Spring 2016 Forecasts.*
[c.] Gross fixed capital formation is averaged over four years (from'‘t-3’ to ‘t’) to avoid penalising countries for large capital projects.

All available fiscal space under the EB has been used for 2016 and there is in fact a small deviation from permitted growth, which is not considered significant.[22] However, an expenditure overrun of the scale seen in 2014 or 2015 on Departmental expenditure would, all other things being equal, lead to significant deviation under this rule. Furthermore the recent assessment of *Budget 2016* by the EC, on the basis of its own forecasts, indicates a deviation of 0.4 per cent of GDP.

As the Government have used all available fiscal space in 2016, the nominal increase in allowable General Government spending between 2015 and 2016 is €1.2 billion. However, due to an anomaly in the number of pay and pension payment dates in 2015 an additional €0.3 billion of fiscal space is available in the expenditure base for 2016.[23] This arises because the EB is a growth based rule, so that the additional payment in 2015 is included in the base for calculating the level of expenditure for 2016 but creates room for additional spending as this payment does not recur in 2016.

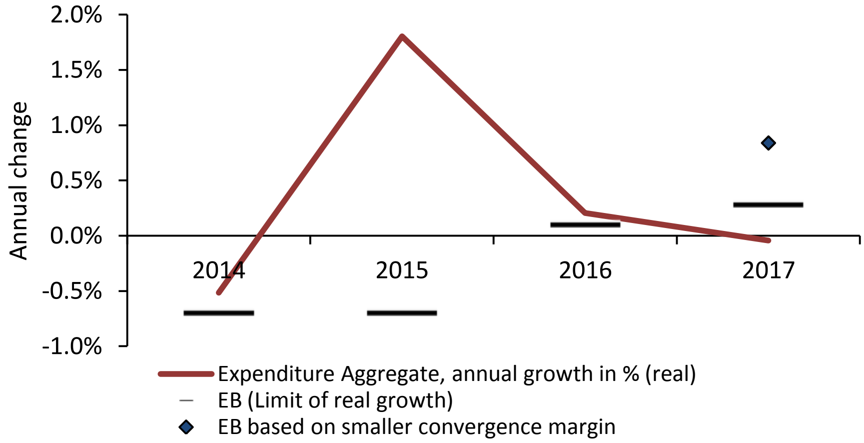
Fiscal space under the EB does not fully reflect the increased level of spending for 2016 evident between *SPU 2015* and *Budget 2016*. As the EB is a limit on growth of expenditure rather than on the level of overall spending, all other things being equal, a change in the base leads to a corresponding change in the permitted level of spending for all future years. While the EB does not apply in 2015, Figure 4.3 shows that the actual spending in 2015 is well in excess of what would have been permitted. Without this increase in 2015, spending in 2016 would have to be €1.7 billion lower in order to comply with the EB in 2016. Overall, while this increase in the expenditure base in 2015 complies with the European fiscal rules applying to Ireland in 2015, it is contrary to

[22] 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.

[23] Public Servants and public service retirees paid on a weekly basis will have an additional pay day in 2015 as there are slightly more than 52 weeks in a given year. This leads to an extra day for staff not paid on a monthly basis.

the spirit of the rules and led to a significant revision to the domestic expenditure ceilings in 2015 (see Section 4.4).

FIGURE 4.3: COMPLIANCE WITH THE EU EXPENDITURE BENCHMARK



Source: Budget 2016 and EC *Spring Economic Forecasts.*
Note: EB is complied with where the adjusted expenditure aggregate grows at a rate less than the indicated benchmark rate. This real growth rate has been adjusted to reflect the scale of discretionary revenue measures.

For 2017, the required structural balance improvement of 0.75 percentage points of GDP, implied by the output gap estimate in *Budget 2016*, would imply a larger convergence margin and consequently a lower permitted rate of expenditure growth than presented in *Budget 2016* (see Figure 4.3). Complying with the EB in 2017 may allow for less fiscal space than indicated in *Budget 2016.*[24]

The fiscal path provided in *Budget 2016* for the period 2017 to 2021 includes no significant policy changes and is largely technical in nature as discussed in Chapter 3.

4.4 THE MEDIUM-TERM EXPENDITURE FRAMEWORK

As set out in the Medium-Term Budgetary Framework, the EB is used to establish the upper limit on General Government expenditure for Ireland.[25] The aggregate Government Expenditure ceiling (GEC) and the individual Ministerial ceilings both operate as mechanisms to control Departmental expenditure within this upper limit.[26] While multi-annual ceilings have been established since the

[24] The latest EC forecasts estimate an output gap of 0.3 per cent in 2017, which would imply a structural balance adjustment of 0.6 percentage point of GDP and, consequently, a larger allowable rate of expenditure growth.

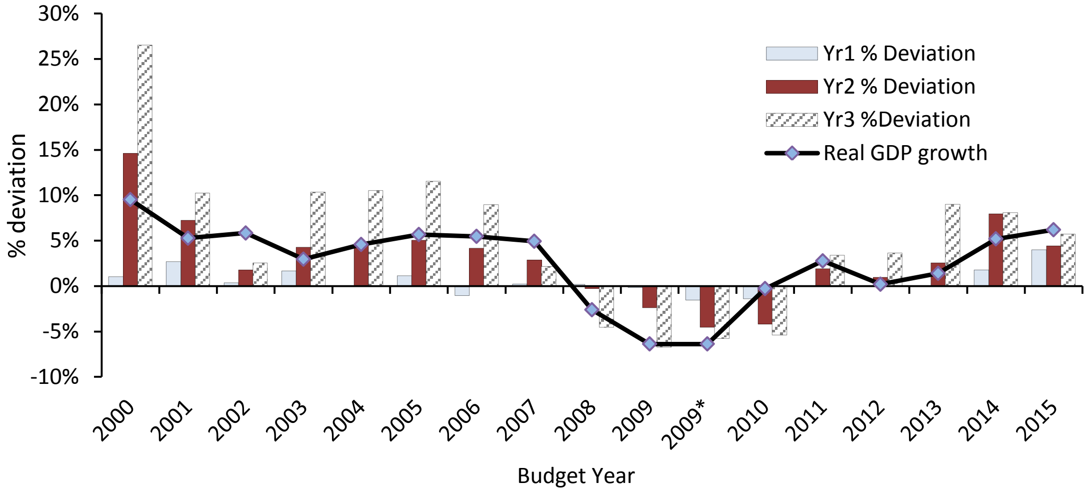
[25] See Medium-Term Budgetary Framework (Department of Finance, 2014).

[26] 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. The legislation provides that where the Government have decided on a Government Expenditure Ceiling, they may make a further decision to revise the

Comprehensive Expenditure Report 2012-2014, they have to date been set by reference to the prevailing EDP requirements. As discussed in Section 4.2, the EDP deficit path allowed for a significant increase to spending in 2015 as a result of unexpected revenue increases.

Even prior to 2015, there have been regular revisions to both the overall multi-annual GEC and individual Ministerial Expenditure Ceilings. Such persistent revisions undermine multi-annual public expenditure management by creating uncertainty around the scale of future resources, both in aggregate and for individual Departments. Without improvements to the existing system of expenditure planning it is likely the recent upward revisions to expenditure ceilings will continue to revert to the pre-crisis pattern of pro-cyclical adjustments (see Figure 4.4).

FIGURE 4.4 GROSS CURRENT EXPENDITURE, % DEVIATION FROM FORECAST



Source: Department of Finance
Note: * denotes the Supplementary budget in 2009. Bars show the forecast error for 1 year ahead, 2 years ahead and 3 years ahead. Latest figures for 2016 to 2018 (used in calculation the latest deviation from Budget 2015 years 2 and 3) are adjusted by €1 billion to reflect the change in the treatment of the HSE from 2015.

A particular issue in the setting of ceilings in Budgets 2014 and 2015 has been upward revisions to future ceilings based on in-year revisions to Departmental spending. These revisions are of concern as they, at least in part, arise from budget execution problems being addressed through relaxing the total expenditure ceiling, or GEC.[27] While the increases to spending may have allowed for underlying expenditure pressures to be addressed in some areas, it has also weakened incentives to control expenditure and may have damaged expenditure control practices.

Government Expenditure Ceiling to a lesser or greater amount. Subject to such a revision the Government may revise the Ministerial Expenditure Ceilings.

[27] In both 2014 and 2015, the effective limit on fiscal policy was the deficit ceiling under the EDP, which permitted upward revisions to spending through changes to the GEC as revenues were higher than expected. This increase in the GEC created room for individual Ministerial ceilings to be increased to allow for higher than anticipated expenditure without a breach of individual Ministerial ceilings. The MTEF sets out sanctions where an individual Ministerial ceiling is breached in a given year. These sanctions are semi-automatically imposed and escalate to the repayment of excess spending from future ceilings.

The weakness of the domestic MTEF is of concern for the Council, particularly in the absence of a formal top-down 'anchor' on expenditure previously provided by the advance setting of the EB for three years.[28] The multi-annual revisions to the GEC, while compliant with domestic legislation and requirements under the Corrective Arm of the SGP, go beyond the limited circumstances identified in the Circular detailing the design of the MTEF.[29] Under the domestic framework, revisions to the GEC are permitted in these circumstances; (i) under exceptional circumstances, as defined in the FRA, (ii) through the introduction of compensatory discretionary revenue measures, or (iii) where adjustments are related to spending on cyclically related unemployment spending or EU co-funded payments. While the circumstances under which individual Ministerial ceilings may be revised are more numerous, and include an overall revision to the GEC, the GEC can only be increased in the three instances above.

For 2016, revisions to the GEC would only be possible in the circumstances set out in the Circular as it is set at the maximum level of expenditure permitted under the EB. Given the weakness of the MTEF, the recent pattern of overspending, particularly in health, and the lack of a buffer in 2016, there is a risk of a breach of the EB next year.

[28] There also remain inconsistencies between the operation of the EB and the domestic MTEF. The upward revision to the GEC in 2015 highlights the importance of the base expenditure level when operating an expenditure growth rule. As noted in Section 4.3 a repeat of the in-year upward revisions to expenditure would likely cause a breach of the EB in 2016. However, a further consideration is that spending below the permitted level would lead to a reduction in the permitted level of spending in subsequent years. This could lead to a situation where inefficient expenditure is undertaken to avoid the erosion of the base expenditure level. The carryover provision in the domestic framework is designed to avoid this by allowing for savings in one year to be carried over to the next. However, under the EB any such carryover would still be considered a reduction in the base expenditure level. If the expenditure planning process is to be successful such inconsistencies should be resolved.

[29] See Circular 15/13, *Medium-Term Expenditure Framework: Application to Current Expenditure* is available at http://circulars.gov.ie/pdf/circular/per/2013/15.pdf.

Appendix A: Fiscal Council Benchmark Projections 22 September

As part of the endorsement process, the Council's Secretariat produced a set of Benchmark projections in advance of its meetings with the Department of Finance. The Benchmark projections were finalised on 22 September 2015 and are summarised in Appendix Table A.1.

Appendix Table A.1: Benchmark Projections for 2015-2016

% change in volumes unless otherwise stated	2015	2016
GDP	6.4	4.6
Consumption	2.9	1.9
Investment	12.5	11.4
Government	1.4	1.0
Stock changes (% of GDP)	0.9	0.9
Exports	11.2	3.7
Imports	10.7	3.1
Net Exports (p.p. contribution)	2.5	1.3
Domestic Demand (p.p. contribution)	3.9	3.3
Stock Changes (p.p. contribution)	0.0	0.0
Current Account (% GDP)	6.3	5.8
Employment	2.8	2.5
Unemployment Rate (%)	9.5	8.3
HICP	0.2	1.3
GDP Deflator	3.2	1.4
Nominal GDP (€ billions)	207.6	220.4
Nominal GDP	9.8	6.1

Source: Internal IFAC calculations.

The Council's "endorsable range" is informed by, but not mechanically linked to, the uncertainty captured in fan chart analysis. The fan chart approach is also applied retrospectively so that uncertainty around outturn revisions can also be graphically represented (Figure 2.8).

The fan chart bands for the historical period effectively show the typical scale of revisions applying to historical estimates of real GDP growth over a five year period.[30] It is important to note that the fan chart for the forecast period is symmetric by construction even though the Council may interpret the balance of risks to be weighted in a certain direction at a given point in time.

[30] Quill (2008) notes that in practice CSO data beyond five years rarely changes materially except for methodological reasons. As detailed in Casey and Smyth (2015), typical confidence intervals surrounding estimates for the latest annual outturn are not especially narrower than that for the current forecast year. Revisions for the latest full-year of data are typically large, especially when it comes to the first estimate of real GDP growth (i.e., with the release of the fourth quarter QNA results). A typical Root Mean Squared Error (RMSE) value of 1.6 for the previous full year of data compares to a RMSR of 1.8 for the current year's forecast. This means that the uncertainty surrounding the current forecast year can be little less than that of the previous year for which four quarters of data are available. The RMSR for the previous year narrows to 0.9 after the release of the *National Income and Expenditure* accounts in the summer of each year, but remains relatively large.