Box F: What is Fiscal Space?

This Box outlines the concept of 'fiscal space'. While the term is used to refer to several different concepts in the economic debate, in Ireland it has come to refer to the scope available for policy changes under the fiscal rules.[1] Given the complexity of the fiscal rules, the concept of fiscal space can serve as a potentially useful summary measure for policymakers and the public. When taken into consideration with estimates of stand-still costs (Box D) and policy changes envisioned, the measure can help to contribute to a more informed basis for budgetary planning. However, there remains much confusion around the concept of fiscal space and a clear definition is needed.

The Definition of Fiscal Space Used in Ireland

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

- 'Gross fiscal space' refers to the scope available before any relevant pre-committed tax/spending changes are included;
- 'Net fiscal space' refers to the remaining scope available after these pre-commitments are included (e.g., after including expenditure increases to address demographic changes, agreed pay rises, etc.).

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

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

Uncertainties around Estimates

There is regularly a significant amount of debate about fiscal space, which is not helped by the uncertainties involved in calculating the space expected to be available over a number

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

of years. These uncertainties may arise in relation to:

- *How the fiscal rules interact:* this is particularly important with respect to the two key pillars, the Expenditure Benchmark and structural balance requirements.[2] For any given year, the most binding rule will be the one that sets the upper limit on the available fiscal space for that year.
- *The actual budgetary stance adopted in later years:* budgetary decisions made in one year will impact on subsequent years. Any over/under-compliance with the requirements of the fiscal rules in a given year could entail additional/reduced fiscal space for subsequent years.
- *Revisions to relevant data:* This applies to both historical and forward-looking estimates of observable inputs that are used as the basis for assessing the fiscal rules. These may include macroeconomic variables such as real GDP growth and economy-wide inflation,[3] as well as fiscal variables like General Government expenditure, revenue and debt interest costs. Also relevant are estimates of unobservable variables like potential output growth and the output gap, which need to be determined so as to set fiscal policy that appropriately considers the cyclical position of the economy.

The Importance of Assessing All Pillars of the Fiscal Rules

The Department has to date focused on the Expenditure Benchmark (EB) as the basis for identifying available fiscal space in future years. The use of the EB is preferred by the Department over the structural balance rule due to the EB's advantage of being less subject to revision. This reflects the fact that the EB relies on smoothed, ten-year averages of potential output growth estimates, rather than the annual estimates used for the structural balance calculations. The preference for smoothed estimates reflects the tendency for the Commonly Agreed Methodology, which is used for monitoring and enforcing the EU fiscal rules, to produce highly variable, and often pro-cyclical potential output growth estimates for small, open economies like Ireland.[4]

Although the Expenditure Benchmark has the advantage of being relatively more insulated from large revisions and is more intuitive to communicate than changes in the structural balance, fiscal space calculations should still be cognisant of all of the fiscal rules.[5] The interaction of the twin pillars of the fiscal rules is an important feature that can help to prevent unexpected anomalies leading to inappropriate guidance for the fiscal stance in a given period. A recent example of this is the AIB share transaction in 2015 which was treated as a one-off in the calculation of compliance with the structural balance rule but not in the case of the Expenditure Benchmark.

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

[3] As measured by the GDP deflator.

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

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