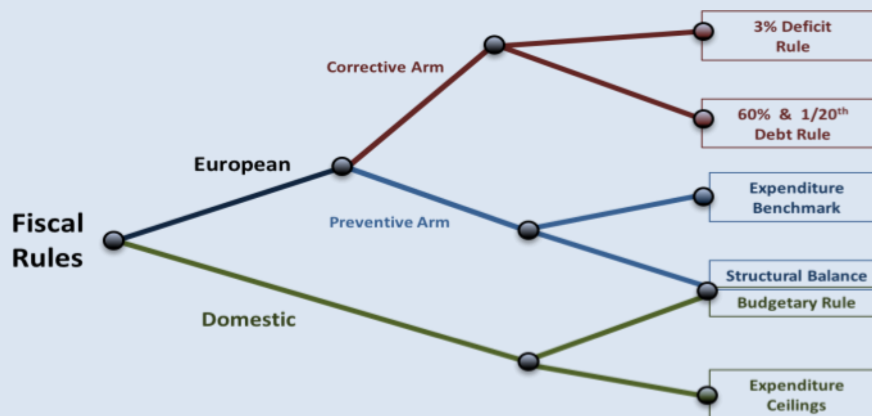
Box G: Implications of 2015 GDP Outturn for Fiscal Rules

The exceptional 26.3 per cent real GDP growth rate for 2015 had numerous implications.[1] It made assessments of sustainability with respect to Ireland's debt and deficit levels less informative when using GDP as a measure of the potential tax base, and it created greater uncertainty as to the cyclical position of the economy. Both aspects had further knock-on effects for the operation of the fiscal rules. This Box explores the risks of potential distortions to the fiscal rules from the 2015 GDP outturn and how these were mitigated.

Importance of Actual and Potential GDP for the Fiscal Rules

As a standard measure of the health of the economy, GDP forms a key input to the European and also domestic fiscal rules. Figure G1 summarises the fiscal rules, separating these into their domestic and European components. With Ireland having exited the Corrective Arm in 2015 on the basis of having a deficit level sustainably below 3 per cent of GDP and a debt ratio reducing at a sufficient pace, the main requirements of the European fiscal rules have shifted to those of the Preventive Arm, though Corrective Arm requirements are still relevant as defining entry into the an Excessive Deficit Procedure.

Figure G1: The European and Domestic Fiscal Rules



Corrective Arm

Both the defined 60 per cent debt and 3 per cent deficit limits for the Corrective Arm are expressed as a share of GDP. As a result of the sharply higher 2015 GDP level, both the deficit and debt ratios are lower relative to a situation where GDP levels excluded any distortions. The margin between 2015 deficit levels and the 3 per cent limit has therefore widened, while the excess on the debt ratio to the 60 per cent level has narrowed sharply. Given that the debt rule effectively requires a one-twentieth annual reduction in the gap between the current debt ratio and a 60 per cent level, this requirement has become less constraining than it otherwise would have been. It is important to note, however, that the effect of these distortions is relatively limited. Other Preventive Arm requirements are more binding than the requirements of the debt rule alone and the deficit projected under

[1] Box A in the *Pre-Budget 2017 Statement (*IFAC 2016b) examines the National Accounts for 2015 in more detail. In particular, it highlights the distortions to real GDP/GNP caused by some activities of multinational enterprises. The output and exports produced by these can add to both GDP and GNP even though the production of the output may take place outside the state with little or no domestic labour used in the production process.

minimum compliance with the Preventive Arm is in any case consistent with a level not exceeding 3 per cent.

Preventive Arm

At the core of the EU Preventive Arm is a target for a country's structural balance and progress towards this is assessed on the basis of two pillars: (i) structural balance adjustment requirements, as complemented by (ii) the Expenditure Benchmark.[2] Given that the MTO for Ireland for 2017-2019 was already fixed at the minimum level permitted under the fiscal compact, -0.5 per cent of GDP, the GDP revisions have relatively limited bearing on this target.

The key channel through which the pillars of the Preventive Arm are affected by the 2015 GDP distortions is through the measurement of potential output. The structural balance is a measure of the underlying trend in the budget balance that attempts to abstract from cyclical developments. The cyclical component of the structural balance is identified by the gap between actual and potential GDP levels (i.e., the output gap), while the overall structural balance is also expressed as a share of estimated potential output levels. In a similar vein, the Expenditure Benchmark sets a maximum growth rate for government spending on the basis of assumed sustainable levels of long-run economic growth (this growth rate is set as the ten-year average of potential output growth).

The Domestic fiscal rules were also prone to the same GDP-related distortions. As the domestic Budgetary Rule mirrors the structural balance requirements under the Preventive Arm, this would have been subject to the same GDP-related distortions. Furthermore, the Government expenditure ceiling used to set a top-down maximum for departmental expenditure ceilings is set with reference to permitted expenditure levels under the Expenditure Benchmark.

Mitigating Risks to Fiscal Policy

Potential output estimates are clearly central to the fiscal rules. Revisions to the Commonly Agreed Methodology as applied to Ireland (Appendix D) were therefore necessary to ensure that implications for the fiscal rules were not radically revised. In the absence of these, persistent distortions to potential output growth could have arisen from the exceptional GDP growth rate in 2015. In particular, the 2015 distortions could have artificially inflated potential GDP growth rates across a number of years (with implications for the Expenditure Benchmark), while also leading to a drastically different path for the output gap (relevant for the structural balance).[3] The adjustments to the Commonly Agreed Methodology have limited the effect of the exceptional growth rate in 2015 from distorting application of the fiscal rules in two ways:

(1) By ensuring that sharp increases in potential output are largely kept to 2015 and are prevented from feeding through to surrounding years.

[2] Box G (IFAC 2016a) provides an introductory guide to the Preventive Arm and the domestic Budgetary Rule, outlining the main features of these rules which become operational in full over the coming years.

[3] Potential growth rates for surrounding years would have been distorted in particular by smoothed estimates of TFP, whereas changes in the output gap (relevant for the structural balance adjustment requirements) would have been influenced by widening the gap between forecast actual and potential GDP estimates.

(2) By leaving the initial output gap level and projected changes in this relatively unchanged compared to estimates prior to the sharp revisions to real GDP.

The adjustments help mitigate risks to fiscal policy from changes in the fiscal rules, though some issues remain. In particular, the 25 per cent potential output growth rate estimated for 2015 should be ignored when determining the relevant ten-year average growth rate for the Expenditure Benchmark as it is clearly not relevant for the identification of sustainable long-run growth rates.[4] Furthermore, close monitoring of the adjustments will be required to ensure that subsequent estimates are not impacted by the recent changes.

[4] The Department of Finance acknowledge this in *Budget 2017* when they interpolate an average value of 3.7 per cent for 2015 in their application of the Expenditure Benchmark.