Ex-Post Assessment of Compliance with the Domestic Budgetary Rule in 2016

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Irish Fiscal Advisory Council

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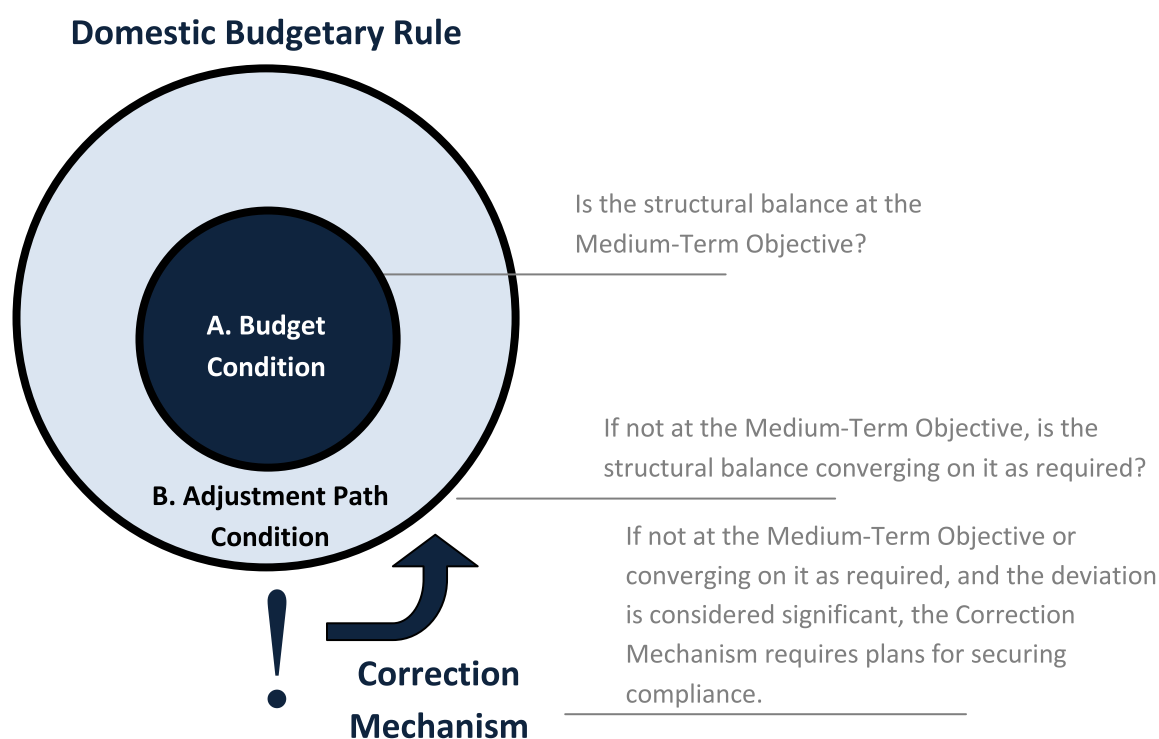
Background

The *Fiscal Responsibility Act (FRA)*, which came into effect in December 2012, established the Irish Fiscal Advisory Council (IFAC) as a statutory body and legislated for the implementation of national fiscal rules. These reforms were part of a wider agenda of budgetary reform, set out in the *National Recovery Plan 2011-2014*, the *Programme for Government 2011* and the EU-IMF Programme of Financial Support for Ireland.

Under the *FRA*, part of the mandate of IFAC is to monitor and at least once in each year provide an assessment of compliance with the Domestic Budgetary Rule.[1] This publication outlines the Council's *ex-post* assessment for the previous year based on data available as of spring including the Maastricht returns (i.e., the first official outturns for the previous year's annual general government statistics) and preliminary GDP data for the previous year (Q4 *Quarterly National Accounts*). Appendix 1 gives further information on the Domestic Budgetary Rule.



[1] *FRA* Section 8(2) specifies the Council's role as to "monitor, and at least once in each year provide an assessment of, whether any obligation under section 2(1)(a) or 6(1), or to do things specified in a plan under section 6(1), is being complied with". Section 2(1)(a) relates to the Budgetary Rule and notes: "the Government shall endeavour to secure that—(a) the requirement imposed by section 3 (the budgetary rule)…are complied with". Section 6(1) covers the "Correction Mechanism", that sets plans to secure compliance with the Budgetary Rule when not met: "if the Commission addresses a warning to the State under Article 6(2) of the 1997 surveillance and coordination Regulation or if the Government consider that there is a failure to comply with the budgetary rule which constitutes a significant deviation for the purposes of Article 6(3) of that Regulation, the Government shall, within 2 months, prepare and lay before Dáil Éireann a plan specifying what is required to be done for securing compliance with the budgetary rule".

Main Assessment Table

Table 1 outlines the main information relevant for assessing compliance with the Domestic Budgetary Rule in 2016 based on the CSO's Annual *Government Finance Statistics* publication as released in April of this year (revised 24th April), and estimates of the output gap as reported by the European Commission in their *Spring 2017* forecasts.[2]

First, the Budget Condition is assessed (i.e., whether the structural balance is at the MTO requirement). Second, the Adjustment Path Condition is assessed (i.e., whether the required pace of convergence towards the MTO is achieved when the structural balance is not currently at this).

Table 1: Main Assessment Table of compliance for 2016
% GDP unless stated

	Required	Actual	Compliant	Deviation (% GDP)	Deviation (€ billion)	Significant Deviation[1]
A. Budget Condition						
Structural Balance	0.0	-1.7	**Not at MTO**	-	-	-
B. Adjustment Path Condition						
I. Change in Structural Balance						
One-year change (p.p.)	0.6	0.3	**No**	-0.3	-0.7	**No**
Two-year avg. change (p.p.)	-	-	-	-	-	-
II. Expenditure Benchmark[2]						
One-year growth rate (%)	0.1	-1.2	**Yes**	-	-	-
Two-year avg. growth rate (%)	-	-	-	-	-	-

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's Annual *Government Finance Statistics* publication as released in April of this year. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be not applicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission in their latest *Spring* Forecasts. Requirements under the rules may be unfrozen in certain conditions (Section 2).
[1] A "significant deviation" is the term for the threshold that determines potential triggering of sanctions in the domestic and EU fiscal rules. It equates to a threshold of ≥0.5 per cent of GDP for one-year or an average of ≥0.25 per cent of GDP for two years. As 2016 is the first year since Ireland exited the EDP, only the one-year change is applicable. The two-year change will also be assessed beginning in 2017.
[2] The requirement for the Expenditure Benchmark is set as a growth limit in real terms. As a result of recent changes, the impact of one-off expenditure measures will be systematically corrected for in the Expenditure Benchmark assessment and one-off revenue measures removed from discretionary revenue measures, as noted in Section 1.1.2 of the *Vade Mecum* Update (European Commission, 2017). This is assumed not to apply for the 2016 *ex-post* assessment. Had this applied in 2016, the Expenditure Benchmark would have been breached by 0.4 per cent of GDP (equivalent to €1.0 billion), though this remains less than a significant deviation.

[2] Commonly-Agreed Methodology (CAM) estimates are used by the European Commission in formal legal assessment of annual compliance with the fiscal rules. The Council (and the Department of Finance) have raised repeated concerns regarding the usefulness of these estimates in determining the actual cyclical position of the Irish economy.

The rest of this publication is organised as follows: Section 1 outlines the assessment of the Budget Condition; Section 2 outlines the assessment of the Adjustment Path Condition; and Section 3 outlines the fiscal stance as indicated by the estimated change in the structural primary balance according to the definition in the *FRA*.

1. Budget Condition

The Budget Condition requires that the structural balance is in balance or in surplus and is deemed to be respected if the structural balance is at the Medium-Term Objective as set under the Preventive Arm. The *FRA* specifies that a failure to meet the requirement is only permitted as a result of exceptional circumstances and if it does not endanger medium-term fiscal sustainability.

For the 2016 assessment, a structural balance of 0.0 per cent of GDP applies as Ireland's MTO.[3]

Table 2: Budget Condition
% GDP

	Requirement (MTO)	Actual	At MTO?
A. Budget Condition			
Structural Balance 2015	0.0	-2.0	**No**
Structural Balance 2016	0.0	-1.7	**No**

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's Annual *Government Finance Statistics* publication as released in April of this year. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be not applicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission in their latest *Spring* Forecasts. Requirements under the rules may be unfrozen in certain conditions (Section 2).

The 2016 structural balance is currently estimated as -1.7 per cent of GDP. The Budget Condition (i.e., the MTO) was not met in 2016.

Exceptional circumstances are not judged to exist. Although a number of macroeconomic risks to the downside exist, including those related to 'Brexit', many of these have not materialised as yet and the central scenario is still a forecast of medium-term economic growth by the Department of Finance.

[3] Ireland's minimum MTO was revised in February 2016 and is now set as a structural deficit of 0.5 per cent of GDP for the period 2017-2019, though the previous requirement set at 0.0 per cent of GDP still applies for 2016. The Council's *Fiscal Assessment Report* of June 2016 explains the recent update to Ireland's minimum MTO (see Box F of the report).

2. Adjustment Path Condition

Ireland breached the Adjustment Path requirement of the Domestic Budgetary Rule requirement for 2016, but not by an amount considered significant (i.e., a "significant deviation") within the terms of the rule. It is also assessed by reference to the Expenditure Benchmark rule, the requirements of which would also have been breached if not for a one-off conversion of State-owned AIB preference shares in 2015.

Requirements:

The Adjustment Path Condition is a requirement that applies when the MTO is not being met. It requires that the structural balance is converging towards the MTO in accordance with the 1997 Surveillance and Coordination Regulation. Failure to meet the requirement is only permitted as a result of exceptional circumstances and the non-endangerment of medium-term fiscal sustainability.

Assessment of compliance with the Domestic Budgetary Rule incorporates a dual assessment of requirements for both (I) the Structural Balance and (II) the Expenditure Benchmark – these are also the two pillars of the Preventive Arm of the *SGP* (Appendix 1).

The requirements for the Adjustment Path Condition for 2016 were that (I) the Structural Balance adjust by at least 0.6 percentage points and (II) the pace of modified expenditure growth net of discretionary measures did not exceed 1.8 per cent year-on-year. These requirements are set on the following basis.

For 2016, the minimum adjustment requirement for the Structural Balance was 0.6 percentage points of GDP. This adjustment requirement is set with reference to the European Commission's "matrix" as shown in Table 3. The requirement is frozen in spring of the preceding year on the basis of European Commission output gap estimates. These may be unfrozen in certain circumstances. For example, if there is a risk of an overachievement of the MTO, then the adjustment requirement is reduced to only that much which would see the MTO met and not overachieved. This can also occur where a severe economic worsening is identified (corresponding to a classification under "bad times" to "exceptionally bad times" conditions in the matrix shown in Table 2).

As the debt-to-GDP ratio is set to remain above 60 per cent and given that the European Commission's output gap estimate for 2016 of 0.8 per cent as estimated in *Spring 2015* (European Commission, 2015) falls within the "normal times" category (between +/- 1.5 per cent), the

adjustment requirement is set as >0.5 percentage points. This is operationalised as an adjustment of at least 0.6 percentage points.

Table 3: Matrix for Specifying the Annual Fiscal Adjustment towards the MTO

Percentage point change in structural balance required (annual)

	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 ≤ 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

Source: *Vade Mecum* Update (European Commission, 2017).

This adjustment requirement informs the maximum pace of expenditure growth permitted under the Expenditure Benchmark through the Convergence Margin. As the structural balance adjustment requirement is 0.6 percentage points, the Convergence Margin is set as 1.8 percentage points on the basis of the following calculation:

$$C_t = \frac{0.5}{PE_{t-1}} * \frac{Adj_t}{0.5} = \frac{0.5}{0.34} * \frac{0.6}{0.5} = 1.8$$

where C_t is the Convergence Margin, as derived from the required pace of adjustment towards the MTO (Adj_t) and the previous year's level of Primary Expenditure as a percentage of GDP (PE_{t-1}).

Given that the 10-year average of potential output growth rates informing the Reference Rate was set as 1.9 per cent, the following Expenditure Benchmark (EB_t) maximum permitted real growth rate applies:

$$EB_t = RR_{t-1} - C_{t-1}$$

$$= 1.9 - 1.8 = 0.1$$

where RR, the Reference Rate, is the average over a 10-year period of potential output growth estimates (from t-5 to t+4, i.e. 2011 to 2020 for the 2016 assessment).

In nominal terms, this permitted growth rate can be re-stated using the corresponding GDP deflator:

$$Nominal_{EB_t} = \left(\left(1+\frac{EB_t}{100}\right)*\left(1+\frac{P_t}{100}\right)-1\right)*100$$

$$= \left(\left(1+\frac{0.1}{100}\right)*\left(1+\frac{1.71}{100}\right)-1\right)*100 = 1.8$$

where P_t is the corresponding deflator for the 2016 assessment. This gives the allowed rate of nominal expenditure growth net of discretionary revenue measures. Expenditure can grow at a slower or faster rate than the allowed rate depending on whether revenue-reducing or revenue-increasing measures are also introduced. Under the Expenditure Benchmark the growth rate of expenditure is assessed net of the discretionary revenue measures introduced.

I. Structural Balance:

Table 4: Structural Balance Requirements and Estimates

% GDP unless stated

	Required	Actual	Compliant	Deviation (% GDP)	Deviation (€billion)	Significant Deviation[1]
I. Change in Structural Balance						
One-year change (p.p.)	0.6	0.3	**No**	-0.3	-0.7	**No**
Two-year avg. change (p.p.)	-	-	-	-	-	-

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's Annual *Government Finance Statistics* publication as released in April of this year. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be not applicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission in their latest *Spring* Forecasts. Requirements under the rules may be unfrozen in certain conditions.
[1] A "significant deviation" is the term for the threshold that determines potential triggering of sanctions in the domestic and EU fiscal rules. It equates to a threshold of ≥0.5 per cent of GDP for one-year or an average of ≥0.25 per cent of GDP for two years. As 2016 is the first year since Ireland exited the EDP, only the one-year change is applicable. The two-year change will also be assessed beginning in 2017.

II. Expenditure Benchmark:

Table 5: Expenditure Benchmark Limit and Estimates

% change year-on-year unless stated

	Limit	Actual	Compliant	Deviation (% GDP)	Deviation (€billion)	Significant Deviation[1]
II. Expenditure Benchmark[2]						
One-year growth rate (%)	0.1	-1.2	**Yes**	-	-	-
Two-year avg. growth rate (%)	-	-	-	-	-	-

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's Annual *Government Finance Statistics* publication as released in April of this year. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be not applicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission in their latest *Spring* Forecasts. Requirements under the rules may be unfrozen in certain conditions.
[1] A "significant deviation" is the term for the threshold that determines potential triggering of sanctions in the domestic and EU fiscal rules. It equates to a threshold of ≥0.5 per cent of GDP for one-year or an average of ≥0.25 per cent of GDP for two years. As 2016 is the first year since Ireland exited the EDP, only the one-year change is applicable. The two-year change will also be assessed beginning in 2017.
[2] The requirement for the Expenditure Benchmark is set as a growth limit in real terms.
As a result of recent changes, the impact of one-off expenditure measures will be systematically corrected for in the Expenditure Benchmark assessment and one-off revenue measures removed from discretionary revenue measures, as noted in Section 1.1.2 of the *Vade Mecum* Update (European Commission, 2017). This is assumed not to apply for the 2016 *ex-post* assessment. Had this applied in 2016, the Expenditure Benchmark would have been breached by 0.4 per cent of GDP (equivalent to €1.0 billion), though this remains less than a significant deviation.

3. Fiscal Stance as Indicated by the Structural Primary Balance

The fiscal stance is defined in the *FRA* in terms of the change in the structural primary balance. That is the primary balance excluding one-offs (i.e., the general government balance excluding interest costs and one-off items) and adjusted for the cycle.

The structural primary balance is an appropriate measure of the fiscal stance as it provides an estimate of the budget surplus or deficit adjusting for the cyclical position of the economy, while removing one-offs and debt-servicing costs that are outside of the control of the Government. While there is uncertainty around the level of the structural primary deficit or surplus at a given point in time, estimates of the change in this measure may provide a more useful indicator of changes in the fiscal position.

Table 6: Indicators of the Fiscal Stance

% GDP unless stated

	2014	2015	2016
Primary Balance (excl. one-offs)			
Level	0.3	1.5	1.6
Change (p.p.)	2.1	1.2	0.1
Structural Primary Balance			
Level	0.1	0.7	0.6
Change (p.p.)	-0.4	0.6	0.0

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's Annual *Government Finance Statistics* publication as released in April of this year. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be not applicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission in their latest *Spring* Forecasts.

The change in the structural primary balance shown above indicates a broadly neutral fiscal stance for 2016. While the Council has repeatedly stated reservations with the approach to cyclical adjustment used by the Department of Finance and the European Commission for Ireland, it is clear that the cyclically-adjusted improvement in the public finances slowed down considerably in 2016.

Setting aside the cyclical consideration, and looking at the actual primary balance (excluding one offs) shows a minimal change in 2016 of just +0.1 percentage points. Using the Commonly Agreed Methodology, estimates show that the economy continued expanding above its potential output growth rate in 2016, such that the output gap rose slightly. The structural primary balance is estimated to have remained unchanged compared to 2015.

A detailed discussion of the fiscal rules and an assessment of the fiscal stance will be provided in the Council's forthcoming *Fiscal Assessment Report*, which is scheduled for publication in June.

Appendix 1: Information on the Domestic Budgetary Rule

This Appendix covers specific features of the Domestic Budgetary Rule not detailed in the Background Section.

Domestic Budgetary Rule:

The Domestic Budgetary Rule is a fiscal rule in domestic legislation that applies to the budgetary position each year. It consists of two elements, either of which is to be satisfied: (A) the "Budget Condition" and (B) the "Adjustment Path Condition".

A. Budget Condition

The Budget Condition is a requirement that the budgetary position of the General Government is in balance or in surplus. The budgetary position in this context refers to the structural balance, while the Budget Condition is also deemed to be respected if the structural balance is at the Medium-Term Objective (MTO), which may be a deficit, as set under the Preventive Arm.[4] The *FRA* specifies that a failure to meet the requirement is only permitted as a result of exceptional circumstances and if it does not endanger medium-term fiscal sustainability.

B. Adjustment Path Condition

The Adjustment Path Condition is a requirement that applies when the MTO is not being met, and requires that the structural balance is converging towards this in accordance with the 1997 Surveillance and Coordination Regulation. As with the Budget Condition, failure to meet the requirements of the Adjustment Path Condition is only permitted as a result of exceptional circumstances and the non-endangerment of medium-term fiscal sustainability.[5]

In effect, the requirements mean that the structural balance is either at the MTO or moving towards it at a rate typically of at least 0.5 percentage points per annum. If the Domestic Budgetary Rule is not being met, a "Correction Mechanism" sets plans to secure compliance with the Domestic Budgetary Rule.

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[4] This reading of the text of the *FRA* is based on legal clarifications obtained by the Council. In particular, clarifications were obtained that the structural balance is the variable of interest for assessing the budgetary position and that the MTO satisfies the requirement of a balance or surplus budgetary position. The MTO applicable for 2016 was 0.0 per cent, while for 2017-2019 a structural deficit of 0.5 per cent applies.

[5] As the *FRA* effectively translates the Preventive Arm requirements of the *SGP* into domestic legislation following the Fiscal Stability Treaty, approved by referendum in 2012, the *FRA*'s definitions of the MTO, exceptional circumstances and significant deviations are interpreted as being consistent with the *SGP*.

Correction Mechanism:

The Correction Mechanism sets out specific requirements when the Government assesses that there is a failure to comply with the Domestic Budgetary Rule (constituting a “significant deviation” – see below) or when the European Commission issues a warning to the State under the 1997 Surveillance and Coordination Regulation relating to such a deviation. In such circumstances, the *FRA* requires that the Government lay before the Dáil, within two months, a plan specifying what actions are required to secure compliance with the Domestic Budgetary Rule.

The plan to secure compliance with the Domestic Budgetary Rule should:

a) specify the period over which compliance with the Domestic Budgetary Rule is to be achieved,

b) if that period is longer than a year, specify annual targets to be met in moving towards such compliance,

c) specify the size and nature of the revenue and expenditure measures that are to be taken to secure such compliance, and

d) outline how any revenue and expenditure measures that are to be taken will relate to different subsectors of the General Government.

The plan must also be consistent with: (i) the *Stability and Growth Pact* (*SGP*) rules, (ii) recommendations made to the State under the *SGP* in relation to the period over which compliance with the Domestic Budgetary Rule is to be achieved, and the size of measures to be taken to secure such compliance, and (iii) the current stability programme.

The Council’s Assessment

In line with the requirements of the *FRA*, the Council’s assessment specifically refers to:

i. whether failure to comply with the Domestic Budgetary Rule constitutes a significant deviation;

ii. whether the Government’s own plans to secure compliance with the Domestic Budgetary Rule, as required under the Correction Mechanism, are being achieved, and

iii. whether, in the Council’s opinion, exceptional circumstances exist or have ceased to exist.

Assessment of compliance with the Domestic Budgetary Rule incorporates a dual assessment of requirements for both *(I) the Structural Balance* and *(II) the Expenditure Benchmark* – the two pillars of the Preventive Arm of the *SGP*.[6]

Medium Term Objective (MTO)

At the core of the Domestic Budgetary Rule as well as the Preventive Arm of the *SGP* is the MTO. The MTO is a value for the structural balance that should be achieved, and maintained, over the cycle, in order to ensure sustainable public finances and provide a safety margin to safeguard respect of the Treaty reference values for the deficit (3 per cent of GDP) and the debt (60 per cent of GDP) at times of negative output gaps.

While Member States are required to set their MTOs in their Stability Programmes, the European Commission calculates a minimum value for each country based on an agreed methodology.[7]

In most circumstances, the minimum MTO is reset every three years based on a methodology used by the European Commission, which estimates a country-specific lower bound for the MTO. Member States then adopt either an MTO in line with those lower bounds or a more ambitious one, if in their view circumstances are deemed to warrant it.[8] In February 2016, the minimum MTO for Ireland was lowered from structural balance equivalent to 0.0 per cent of GDP to a structural deficit of 0.5 per cent of GDP. This applies for the period 2017-2019.

A margin of tolerance of 0.25 per cent of GDP applies when assessing whether the structural balance is at the MTO. For example, if the MTO is set as a structural deficit of 0.5 per cent of GDP and the estimated structural deficit is 0.74 per cent of GDP, it is assessed to be at the MTO.

Dual Assessment Approach

Assessing the Domestic Budgetary Rule involves a dual assessment approach. This means that compliance with both the requirements for (I) the Structural Balance and (II) the Expenditure

[6] The Council has received legal clarification that (i) the assessment of the Budgetary Rule includes an analysis of expenditure net of discretionary measures; and (ii) Budgetary Rule requirements, though applicable since December 2012, are legally satisfied by meeting Excessive Deficit Procedure requirements to 2015 (i.e., the requirements for a government deficit below 3 per cent of GDP and for government debt levels below 60 per cent of GDP or sufficiently diminishing and approaching the reference value at a satisfactory pace).

[7] For an example of the application of this agreed methodology to Ireland, see Box F, *Fiscal Assessment Report*, June 2016 (IFAC 2016a).

[8] The minimum value is intended to: (i) provide a safety margin with respect to the 3 per cent deficit limit in light of past economic (and associated budgetary) volatility; (ii) ensure sustainability or rapid progress towards this. This is assessed against the need to ensure the convergence of debt ratios towards prudent levels, while giving consideration to the economic and budgetary impact of ageing populations; (iii) in compliance with above, allow room for budgetary manoeuvre, in particular taking into account public investment needs.

Benchmark are taken into account. Both measures are designed to be complementary and they represent the two pillars of the Preventive Arm of the *SGP*.

I. Structural Balance

The Structural Balance is the actual budget balance adjusted for the cycle and stripped of any one-off or temporary measures (referred to collectively as “one-offs”). It gives a measure of the underlying trend in the budget balance.

The structural balance is therefore calculated as:

$$SB = GGB - \beta * OG - v$$

where SB is the Structural Balance; GGB is the actual General Government Balance; β is the semi-elasticity of the actual General Government Balance to the Output Gap (OG) and v is the impact of one-offs.[9]

Note that one-offs are inherently subject to some discretion. To facilitate a clear understanding of what can be classified as one-offs, a set of guiding principles are required. The Council’s assessment of one-offs is informed by the set of guiding principles used by the European Commission.[10] Discerning how appropriate the classifications are requires careful consideration of the merits of any one-off proposed. In general, the Council views the one-off label as (i) something only applicable in cases where the one-off nature of the item is unambiguous (e.g., not for conventionally volatile items); (ii) something that should apply only for reasonably large items or related items (i.e., amounting to more than 0.1% GDP). This should limit the risk of promoting poor incentives with respect to transparency and to the sustainable management of the budgetary position.

[9] The output gap measures the cyclical position of an economy and is defined as the difference between actual and potential output as a percentage of potential output. It is estimated by the Department of Finance and the European Commission using an agreed production function method, endorsed by the ECOFIN Council on 12 July 2002. The method identifies the different components of potential output, including capital and labour inputs and trend productivity.

The semi elasticity of the actual General Government Balance to the Output Gap measures the effect of output movements on the General Government Balance, when assuming the economy is running at its potential (i.e. in the absence of cyclical deviations). This captures the cyclical component of the deficit, i.e., the impact of the output gap both on the numerator of the ratio (the budget balance) and on the denominator of the ratio (GDP). The semi-elasticity is estimated on the basis of a methodology developed by the OECD and agreed by the Output Gap Working Group. For more detail, see Box 1.4 of the *Vade Mecum on the Stability and Growth Pact*, 2016 Edition (European Commission, 2016). As of 2016, it ranged from 0.31 to 0.65 across EU Member States, suggesting significant differences in the cyclicality of the budget balance. For Ireland, the estimate applicable in 2016 was 0.53.

[10] These guiding principles are extensively explained in Chapter II.3 of the 2015 Report on Public Finances in EMU, (32), which also provides examples of frequently occurring one-offs and discusses a number of measures that have ‘borderline’ characteristics, but which ultimately have not been considered one-off measures.

The Adjustment Path Condition requires the Structural Balance to be converging on the MTO at a pace determined by the degree of compliance for preceding years, current debt ratios and on supply-side estimates underpinning the EC "matrix" (Table 3).

II. Expenditure Benchmark

The Expenditure Benchmark involves an analysis of growth in government expenditure net of discretionary revenue measures. It is designed as a complement to the analysis of the change in the Structural Balance.

The Expenditure Benchmark sets a maximum pace of growth for a modified expenditure aggregate net of any discretionary measures. The modified expenditure aggregate assessed is obtained as follows:

General Government Expenditure

- \- Interest expenditure
- \- Expenditure on EU programmes which is fully matched by EU funds revenue
- \+ Gross fixed capital formation averaged over t-3 to t
- \- Gross fixed capital formation (for year t)
- \- Cyclical unemployment benefit expenditure
- = **Modified Expenditure Aggregate (E_t)**
- \- Incremental year t impact of discretionary revenue measures (DR_t)
- = **Modified Expenditure Aggregate Net of Discretionary Revenue Measures (E_t-DR_t)**
- % Net expenditure growth rate for year t: $g_t = (E_t - DR_t - E_{t-1})/E_{t-1}$

  Deflated with GDP deflator to obtain net expenditure growth in real terms.[11]

The growth rate of the modified expenditure aggregate (net of any discretionary revenue measures) is then compared against a maximum allowable real growth rate. This maximum allowable growth rate (the "Expenditure Benchmark") is linked to the long-term average potential growth of the economy (the Reference Rate). The Convergence Margin is applied to bring the structural balance to the MTO at a pace that is consistent with the Adjustment Path Condition. The Expenditure Benchmark applies for the year t+1 to the modified expenditure aggregate in t. The Expenditure Benchmark (EB) is obtained as follows:

$$EB_t = RR_{t-1} - C_{t-1}$$

[11] The deflator that applies is the EC Spring GDP deflator forecast made in year t for year t+1.

where RR, the Reference Rate, is the average over a 10-year period of potential output growth estimates y^* (the average is for the years t-5 to t+4):

$$RR_t = \sum_{t-5}^{t+4} \frac{1}{10} y_t^*$$

and C is the Convergence Margin, which is derived from the required pace of adjustment towards the MTO in the following year (Adj_{t+1}) and this year's level of Primary Expenditure (i.e., general government expenditure less interest payments, PE_t):

$$C_t = \frac{0.5}{PE_t} * \frac{Adj_{t+1}}{0.5}$$

To ensure that the Expenditure Benchmark is consistent with the required change in the Structural Balance, this assessment accounts for the impact of one-off measures both on expenditure and discretionary revenue measures. This approach is in line with the spirit of both the Domestic Budgetary Rule and the revised *SGP*.[12]

Significant Deviation

A significant deviation is taken as referring to any deviation in structural balance adjustments toward MTO where the deviation is equivalent to at least 0.5 percentage points of GDP in a single year or at least 0.25 percentage points on average per year in two consecutive years.[13] The same thresholds apply for the Expenditure Benchmark (i.e., for deviations in expenditure developments net of discretionary revenue measures impacting on the government balance).

Exceptional Circumstances

The definition for exceptional circumstances is as agreed in the *SGP*. This includes an unusual event outside the control of the state with a major impact on the financial position of the general government, or periods of severe economic downturn as defined in the *SGP*, including at the level of the euro area. This comprises a negative annual GDP volume growth rate or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential.[14]

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[12] The *FRA* specifies that, in the context of the Budgetary Rule, the structural balance means the general government balance, cyclically adjusted and net of one-off and temporary measures. A consistent assessment of the Expenditure Benchmark therefore accounts for one-off measures. This is consistent with the approach outlined in the Economic and Financial Committee Opinion (14814/16) as subsequently endorsed by the Council of the European Union (15205/16) and as retained when assessing 'effective action' under the Excessive Deficit Procedure.

[13] Regulation (EU) No. 1175/2011, 16 November 2011 and the Vade Mecum 2016.

[14] Council Regulation (EC) No 1056/2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

Appendix 2: Information on One-Offs

Following a request from the Council, this Appendix contains the information on one-offs provided by the Department of Finance for the purposes of assessing compliance with the Domestic Budgetary Rule:

Item	2015 Impact (€m)	2016 Impact (€m)	Rationale
Total Impact on General Government Balance	**1,506**	**-614**	
… of which:			
AIB reclassification	2,113*		One-off Eurostat treatment of expt
EFSF		-554*	A prepaid margin on the borrowings from the European Financial Stability Facility was repaid to the exchequer.
EU Budget Own Resource Decision		170*	Expt that has a transitory budgetary effect.

** Items marked with an asterisk are those that are also assessed by the Council as being applicable and equate to a total impact of €2.1 billion for 2015 (the AIB reclassification) and -€0.38 billion for 2016 (incorporating the EFSF and EU Budget Own Resource Decision).*

Appendix 3: Detail on Discretionary Revenue Measures

On request from the Council, this Appendix contains the information on Discretionary Revenue Measures that was provided by the Department of Finance for the purposes of assessing compliance with the Domestic Budgetary Rule.

Item and details	**2016 Impact (€m)**	**2017 Impact (€m)**
Budget 2015 carryover	-193	
Carryover from previous budgets	-138	
Budget 2016 measures	-396	
Budget 2016 carryover		-176
Carryover from previous budgets		62
Budget 2017 measures (including non-indexation)		100
Total Impact on GGB	**-727**	**-15**

Note DRMs are based on the figures contained in the Draft Budgetary Plans.