Box I: Medium Term Expenditure Ceilings

This Box discusses the concept of medium term expenditure ceilings, which are an important tool for expenditure management. They are intended as upper limits on departmental expenditure set a number of years in advance (typically three years). This Box compares the current approach to setting ceilings as favoured by the DPER with an alternative approach as proposed by the Council.

Medium Term Expenditure Framework

The Medium Term Budgetary Framework (Department of Finance, 2014) is a procedural manual that sets out the operation of medium term expenditure ceilings in accordance with the EU directive on Medium-Term Budgetary Frameworks.[1] It notes that each year an Expenditure Report will set out Ministerial Expenditure Ceilings for the next three years, calculated to ensure compliance with the Expenditure Benchmark (one of the pillars of the fiscal rules).

The Medium Term Expenditure Framework further clarifies rules and procedures for how ceilings are to be set by DPER.[2] Specifically, it notes that the expenditure ceilings will act as an upper limit on expenditure for each year and sets out the limited circumstances under which revisions to the ceilings can be made.[3] It notes that it is the responsibility of the Minister and Heads of Departments to ensure that the ceilings are adhered to and to reprioritise as necessary within them. The EU directive on Medium-Term Budgetary Frameworks also requires future budgetary forecasts to incorporate major items of expenditure and revenue both on the basis of unchanged (real) policies and in line with the Government's stated policy objectives.

Alternative Approaches

The current approach sees non-pay expenditure ceilings held flat in nominal terms, with the Department asserting that this as the best way to promote efficiency savings and reprioritisation within existing multi-annual ceilings. The Council, however, is of the view that if ceilings are seen as a soft-budget constraint, the incentive to reprioritise and achieve efficiency gains is undermined. The Council envisages an alternative approach in which incentives could be improved by setting more realistic expenditure projections underlying the ceilings, which take account of realistic pressures, including some price effects. It is important to note that the Council is not suggesting that automatic or semi-automatic indexation should be adopted as a policy. Table I.1 outlines similarities and differences of the two approaches.

As noted in previous publications (IFAC 2014a, 2014b, 2015a, 2016a), the Council views regular revisions to the Ministerial Expenditure Ceilings as inconsistent with the credibility of expenditure ceilings and the direct result of unrealistic expenditure forecasting (Figure I.1).

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[1] Council Directive 2011/85/EU

[2] Circular 13/15, Department of Expenditure (2013).

[3] For the aggregate Government Expenditure Ceiling: (i) If specified exceptional circumstances occur (e.g. severe macroeconomic shocks etc.); (ii) if compensatory discretionary measures are introduced, e.g. through changes to tax policy resulting in increased revenues in a year; and (iii) to reflect special arrangements for specified expenditure categories (e.g., cyclical expenditure).
For the individual Ministerial Exp. Ceilings: (i) following a Government decision to vary the aggregate Government Expenditure Ceiling; (ii) to reflect a Comprehensive Review of Expenditure by implementing proposals for new Ministerial Expenditure Ceilings; (iii) if the Government considers that there are good and pressing reasons of public policy for allowing reallocation of resources among Ministerial Expenditure Ceilings, (iv) If an adjustment of one or more individual Ministerial Expenditure Ceilings becomes necessary due to a failure of one or more Departments/Offices to comply with their Ceilings for the current year (a Supplementary Estimate would be required under existing provisions); (v) to reflect special arrangements for cyclical expenditure and certain other expenditure categories; and (vi) if a Department has carried over funds from one year to the next.

Table I.1: Alternative Approaches to MECs

Current Approach to MECs vs. Alternative Approach

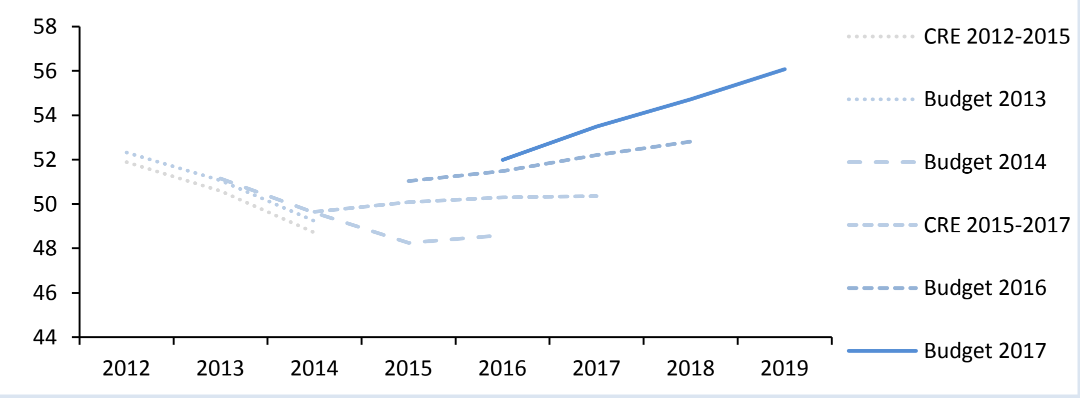
	Current Approach	Alternative Approach
Baseline Forecasts	• Allow for demographic pressures • Allow for other non-price pressures • Hold non-pay spending broadly flat • Does not allow for price effects	• Allow for demographic pressures • Allow for other non-price pressures • Allow for price effects by considering deflators to indicate what would be needed to maintain real public pay and benefits.
Rationale for Forecasting Approach	Non application of price increases is the best way to generate efficiency dividends and promote productivity	No use of deflators ⇨ unrealistic forecasts ⇨ reinforces likelihood of future upward expenditure revisions in future (soft budget constraint)
Allocation of Fiscal Space	Hold majority of fiscal space outside Departmental ceilings, so as to allow Government to address emerging, unforeseen, social/economic pressures	Leave limited amount of fiscal space unallocated for net primary expenditure to allow for changes in fiscal rules inputs/parameters and/or unforeseeable spending pressures
Carryover Impacts of New Measures	Incorporate in forecasts[1] (not incorporated for 2018-2019 in *Budget 2017* expenditure forecasts)	These should always be incorporated in forecasts

[1] Note that for expenditure forecasts in *Budget 2017*, the carryover impact of new measures was not incorporated, as was the Department's supposed preferred approach (Mid-Year Expenditure Report 2016).

Regular upward revisions of ceilings can create a "soft budget constraint". When new expenditure pressures are regularly accommodated by upward revisions to Ministerial ceilings, incentives for managing expenditure within budgets are weakened, thus increasing the likelihood that future expenditure overruns occur. This has been identified as a particular issue in the Health sector (Howlin, 2015).

Figure I.1: Gross Current Expenditure Ceilings

€ Billions



Sources: Department of Public Expenditure & Reform; and internal IFAC calculations.

The current approach to medium term expenditure ceilings seeks to establish a commitment mechanism as opposed to forecast expenditure. However, the frequent upward revision of these ceilings impacts on the credibility of this commitment and the mechanism fails to function as an effective commitment tool.