4. Assessment of Compliance with Fiscal Rules

Key Messages

- Having successfully exited the Corrective Arm of the *Stability and Growth Pact (SGP)* in 2015, with a budget balance higher than -3 per cent of GDP and a falling debt ratio, Ireland is now assessed under the Budgetary Rule requirements of the domestic *Fiscal Responsibility Act* as well as under the requirements of the Preventive Arm of the *SGP*. The first pillar of the rules relates to the structural balance; the second pillar relates to the Expenditure Benchmark.

- Ireland's structural balance for 2016 was -1.4 per cent, an increase of 0.3 percentage points, compared to 2015. This falls short of the minimum required increase of 0.6 percentage points of GDP – a breach of €0.7 to 0.8 billion. In 2016, the growth in expenditure net of discretionary revenue measures was below the maximum allowable rate, but this was only due to a temporary, one-off conversion of State-owned AIB preference shares. Had this transaction not been included as expenditure for 2015, the Expenditure Benchmark rule would also have been breached for 2016. This breach would have been €1 billion (0.4 per cent of GDP).

- The information published in *SPU 2017* was not sufficient to allow full assessment of compliance with the fiscal rules for 2016. Estimates for changes in the structural balance and expenditure growth for 2016 are missing, as are details on individual one-off expenditure and revenue measures. Transparency would be improved if such data were routinely reported in the *SPU*.

- *SPU 2017* plans show non-compliance with both pillars of the fiscal rules for 2017. The structural deficit is estimated to fall by 0.2 percentage points of GDP, less than a required 0.6 percentage points, with real expenditure growth exceeding the Expenditure Benchmark limit by €0.6 billion (0.2 per cent of GDP). For a two-year assessment, *SPU 2017* plans risk a significant deviation for both pillars. A preliminary estimate for the structural balance is €0.9 billion (0.35 per cent of GDP) above the limit. Based on an updated application of the Expenditure Benchmark, a deviation of €0.8 billion (0.3 per cent of GDP) is expected. A significant deviation could potentially lead to sanctions. The 2017 estimates are preliminary, but suggest that the public finances will have to be managed carefully, as there is little scope for any expenditure overruns or additional discretionary revenue measures during 2017.

- For 2018 onwards, compliance hinges on expenditure plans being consistent with ceilings set for future years. However, continuation of a well-documented pattern of upward revisions to spending in 2016 and previous years could undermine compliance. Effective implementation of the domestic budgetary framework would help support medium-term expenditure plans.

4.1 Introduction

The Council's mandate includes reporting on compliance with Ireland's domestic Budgetary Rule and monitoring compliance with the full range of EU fiscal rules as part of the broader assessment of the fiscal stance.[1] This Chapter examines recent compliance with these fiscal rules and the consistency of the projections contained in *SPU 2017* with the rules.

The primary target of fiscal policy from 2009 to 2015 was the correction of the excessive deficit as part of the Corrective Arm of the *SGP*. This correction was completed in 2015, ensuring that the requirements of both the domestic and European rules frameworks were met. The focus for Ireland has shifted to measures that seek to prevent fiscal policy from entering unsustainable territory, including requirements set under the domestic Budgetary Rule and the Preventive Arm of the *SGP.*

Section 4.2 follows this introduction and includes an *ex-post* assessment for 2016. Box H then assesses the nature of one-off/temporary measures relevant to the 2016 assessment. Section 4.3 provides a within-year assessment of compliance with the fiscal rules for 2017, while Section 4.4 covers the period 2018-2021. These assessments examine the budgetary plans and economic forecasts included in *SPU 2017*, considering the Council's views on one-off/temporary measures.[2] The Medium-Term Expenditure Framework (MTEF) is a mechanism that should support the achievement of Ireland's requirements under the Preventive Arm of the *SGP* (Section 4.5). It includes aggregate ceilings for departmental expenditure. Box I examines alternative implementations of the domestic ministerial expenditure ceilings.

4.2 *Ex-Post* Assessment for 2016

The 2016 assessment of the fiscal rules covers Ireland's requirements under the domestic *Fiscal Responsibility Act (FRA)* as well as the EU Preventive Arm. Last year (2016) was the first year for which both the domestic Budgetary Rule and the Preventive Arm rules applied, following the closing of the excessive deficit in 2015. Final (*ex-post*) assessments of compliance with the fiscal rules are only determined in each subsequent spring when outturn data for the preceding year

[1] The Budgetary Rule is a key pillar of the domestic fiscal framework, mirroring *SGP* Preventive Arm requirements for the Medium-Term Budgetary Objective (MTO) that sets a target for the structural balance (set at -0.5 per cent of GDP for 2017-2019). The *FRA 2012* defines two ways of meeting Budgetary Rule requirements: (i) when the structural balance is at or exceeding the MTO (the "budget condition"); (ii) when the structural balance is on an appropriate path towards the MTO (the "adjustment path condition"). The assessment of the Budgetary Rule focuses on the change in the structural balance, but also considers expenditure growth by reference to the Expenditure Benchmark.

[2] While the Council's formal requirement to assess (*ex-post*) compliance with the Budgetary Rule is backward-looking in nature, the Council's mandate to assess the fiscal stance suggests considering compliance on a forward-looking basis. The Council has re-assessed its treatment of one-off/temporary measures for the purposes of assessing compliance with the fiscal rules. It now assesses individual one-off items for their applicability. Box H outlines the approach used by the Council.

become available. The Council's *ex-post* assessment for the domestic Budgetary Rule for 2016 is also set out in a separate Council publication from 23 May 2017.[3]

Table 4.1 summarises the requirements and estimated compliance for all years out to 2021 based on recent outturns and the latest official projections as in *SPU 2017*. Though applicable, the Debt Rule is not likely to present a binding constraint. Box H describes the impact of one-off/temporary measures on compliance with the fiscal rules in 2016. Note that Appendix G presents the same information as in Table 4.1, but with one-off/temporary expenditure measures not excluded from the analysis relating to the Expenditure Benchmark (pillar II). This is necessary to reflect applicable figures for the 2016 and 2017 assessments, where budgetary policies were framed before a change in methodology by the European Commission determined that one-off/temporary measures would be systematically excluded.[4]

Before detailing the *ex-post* assessments, the Council notes that the tables provided in *SPU 2017* are insufficient in two key respects for assessing compliance with the fiscal rules. First, information that would allow an assessment of changes in the structural balance and/or expenditure growth is not provided in the publication.[5] Second, information on individual one-off expenditure and revenue amounts (item-by-item) is central to the assessment of compliance, but is not provided in the *SPU*. Additional information has been provided by the Department to the Council, but in the interests of transparency, such information should be routinely reported in future budget and SPU publications.

[3] See IFAC (2017), "*Ex-Post* Assessment of Compliance with the Domestic Budgetary Rule in 2016".

[4] Section 1.1.2 of the *Vade Mecum Update* (European Commission, 2017)

[5] The *SPU 2017* tables omit 2015 figures from the presentation. The Department are not required to present figures for year t-2 (i.e., 2015 in this case) when producing Stability Programme Updates, but could choose to do so. Another option would be to show the relevant expenditure growth rates and changes in the structural balance alongside requirements. Previous reports such as *Budget 2017* had included the change in the structural balance for example as "structural effort" in percentage points (Table 12, *Budget 2017*), but *SPU 2017* neglects to include this.

Table 4.1: Summary Assessment of Compliance with Rules (% GDP unless stated)

	Code	2015	2016	2017	2018	2019	2020	2021
Corrective Arm:								
General Government Balance	GGB	-2.0	-0.6	-0.4	-0.1	0.1	0.6	1.0
General Government Debt	GGD	78.7	75.4	72.9	71.2	69.5	65.2	62.9
1/20th Debt Rule (Backward/Forward-looking Benchmark)		109.2	96.5	83.5	74.1	71.8	70.1	67.7
Preventive Arm & Domestic Budgetary Rule:								
Pillar I. Structural Balance Adjustment Requirement								
CAM Structural Balance	SB	-1.7	-1.4	-1.1	-0.5	-0.1	0.4	1.0
Actual Change in CAM Structural Balance	**ΔSB**	**1.9**	**0.3**	**0.2**	**0.6**	**0.4**	**0.6**	**0.6**
Minimum Change in Structural Balance Required	**REQ**	**n.a.**	**0.6**	**0.6**	**0.6**	**0.0**	**n.a.**	**n.a.**
1yr Deviation (p.p.) ...negative = non-compliance		n.a.	-0.3	-0.4	0.0	n.a.	n.a.	n.a.
2yr Deviation (p.p.) ...negative = non-compliance		n.a.	n.a.	-0.35	-0.19	n.a.	n.a.	n.a.
Pillar II. Expenditure Benchmark								
Reference Rate of Potential Growth (% y/y)	R	n.a.	1.9	3.3	3.5	3.5	3.6	3.5
Convergence Margin (p.p.)	C	n.a.	1.8	2.0	2.4	0.0	0.0	0.0
Limit on Real Expenditure Growth (% y/y) = $R_t - C_t$	**EB**	**n.a.**	**0.1**	**1.3**	**1.1**	**3.5**	**3.6**	**3.5**
Actual Real Expenditure Growth (% y/y)	**er**	**2.5**	**1.6**	**2.1**	**1.1**	**1.2**	**1.5**	**1.1**
1yr Deviation (€bn) ...positive = non-compliance		n.a.	1.0	0.6	0.0	-1.6	-1.5	-1.8
1yr Deviation (% GDP) ...positive = non-compliance		n.a.	0.4	0.2	0.0	-0.5	-0.5	-0.5
2yr Deviation (€bn) ...positive = non-compliance		n.a.	n.a.	0.8	0.3	-0.8	-1.6	-1.7
2yr Deviation (% GDP) ...positive = non-compliance		n.a.	n.a.	0.30	0.11	-0.26	-0.50	-0.51
Nominal spending increase permitted before DRMs (€bn)		n.a.	1.2	1.7	1.6	3.6	3.9	4.0
Relevant Macroeconomic Aggregates								
Real GDP Growth (% y/y)	y	26.3	5.2	4.3	3.7	3.1	2.7	2.5
CAM Potential GDP Growth (% y/y)	y^*	24.8	5.1	4.2	4.3	3.4	2.9	2.8
CAM Output Gap	OG	1.1	1.2	1.4	0.8	0.5	0.3	0.0
GDP deflator applicable (% y/y)	p	0.9	1.7	1.2	1.3	1.5	1.7	1.7

Sources: SPU 2017, EC *Spring 2017* forecasts and internal IFAC calculations.

Note: The Preventive Arm and domestic Budgetary Rule assessments above examine the revenue and expenditure plans included in *SPU 2017*, using the Department of Finance's estimates of potential output and considering the Council's views on one-off/temporary measures. One-off items assessed to be applicable by the Council have been excluded from total expenditure for the purposes of assessing compliance in accordance with Section 1.1.2 of the *Vade Mecum Update* (European Commission, 2017). It should be noted that this treatment differs from what was applied in the Council's May 2017 publication, the "*Ex-Post Assessment of Compliance with the Domestic Budgetary Rule in 2016*" (IFAC 2017), in which the European Commission's Spring 2017 output gap estimates were used for the structural balance as these form the basis for any *ex-post* assessments of compliance.

Table AG.1 in Appendix G shows the table above where one-offs are not stripped out of the Expenditure Benchmark. If the one-off €2.1 billion AIB transaction in 2015 was included as additional expenditure, this would result in an over-compliance relative to the Expenditure Benchmark limit for the 2016 one-year assessment and the 2017 two-year assessment. Potential output is based on CAM-based estimates. EC Reference Rate and Convergence Margin estimates apply for Preventive Arm requirements and are frozen for years up to 2018.

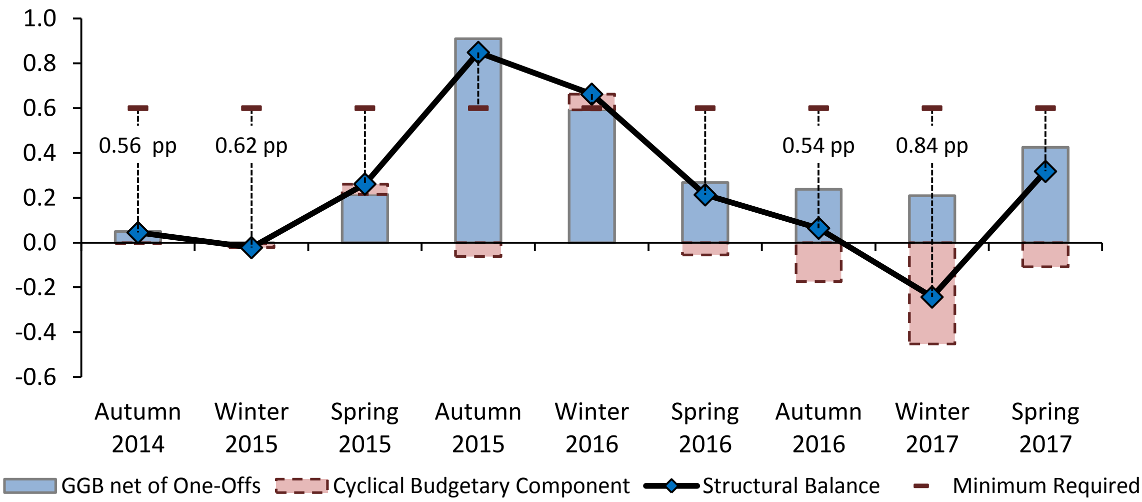
4.2.1 MTO and Structural Balance Adjustment Requirements

The first pillar of the fiscal rules relates to the structural balance. For 2016, the requirement was to reduce the structural deficit by a minimum of 0.6 percentage points of GDP. The actual reduction achieved was 0.3 per cent of GDP, implying a breach under the rules equivalent to €0.7 to 0.8 billion.[6] When all the one-off/temporary measures for 2015 and 2016 included by the Department are applied, this results in a more favourable outturn in relation to the requirements, implying a reduction in structural deficit of 0.5 per cent of GDP (albeit, still short of requirements). Box H discusses which of the one-off/temporary measures the Council views as applicable for 2015 and 2016.

Figure 4.1 shows the evolution of the Commission's estimated annual change in Ireland's structural balance for 2016 across different forecast vintages. The change is decomposed into changes in the General Government Balance (excluding one-offs) and changes in the cyclical component of the deficit. The deviation relative to the minimum required change in the structural balance of +0.6 per cent of GDP is shown where it constitutes a "significant deviation". Note that from spring 2016 onwards, the forecasts suggest a change in the general government balance (excluding one-offs) of less than the 0.6 percentage points required.

Figure 4.1: Evolution of Estimated Change in Structural Balance for 2016

Components of Change in Structural Balance (% GDP)



Sources: European Commission (various forecast vintages).
Note: The Cyclical Budgetary Component is estimated as: 0.5275(Output Gap), where the output gap is based on the Commonly Agreed Methodology. Significant Deviations are shown above in percentage points.

Notably, the estimates in *Autumn 2016* and *Winter 2017* relative to *Spring 2016* show a cyclical upswing (resulting in a negative cyclical budgetary component change), which implies a breach of

[6] Note that this estimate of the breach in nominal terms is derived from the Department's own estimates of potential output. As Ireland exited the Corrective Arm of the *SGP* in 2015, the two-year requirement does not apply until 2017.

the first-pillar requirement. In the most recent estimate from the Commission's *Spring 2017* publication, there is a smaller change in the cyclical component. This reflects a faster potential output growth rate in 2016 which is driven in part by large capital contributions resulting from substantial imports of intangible assets in the fourth quarter of 2016. A "minimalist" approach to compliance with the fiscal rules can increase the likelihood of breaches occurring given the variability of estimates of the deficit, nominal GDP and the output gap.

4.2.2 Expenditure Benchmark

The second pillar of the Domestic Budgetary Rule and the Preventive Arm is the Expenditure Benchmark. Compliance with this pillar of the rules was only secured in 2016 due to a temporary, one-off boost to the spending base in 2015. This was the result of a conversion of AIB preference shares held by the State. Had this transaction not been treated as expenditure in 2015, the Expenditure Benchmark limit for expenditure growth in 2016 would have been breached by over €1 billion (0.4 per cent of GDP). The Council's May 2017 publication, *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule* (IFAC 2017), reflects the technically compliant outcome described above (also shown in Table AG.1 in Appendix G). However, Table 4.1 in this *FAR* instead reflects the underlying expenditure position, of particular relevance to the *ex-ante* assessment of the two-year performance for 2016 to 2017 (detailed in Section 4.3).[7]

Clearly, the treatment of one-off items is central to assessments of underlying developments in the budgetary aggregates as well as to monitoring compliance with the fiscal rules. In the interests of transparency, the Council has decided to publish information on one-off items. Box H looks at data for 2015 and 2016, which are relevant to the latter year's *ex-post* assessment.

Box H: One-Off/Temporary Measures Relevant to 2016 Assessment

This Box sets out the Council's approach to identifying one-off measures and assesses those that were relevant to the fiscal rules in 2016. A key part of the assessment of compliance with the fiscal rules involves stripping out any one-off or temporary measures (collectively referred to as "one-off measures") that might impact the deficit in a given year. One-off measures are intended to capture items with a transitory impact that do not lead to a sustained change in the budgetary position.

[7] Note that the European Commission now intends to assess the Expenditure Benchmark by systematically stripping out one-off/temporary measures, described in Section 1.1.2 of the *Vade Mecum Update* (European Commission, 2017).

The identification and measurement of one-offs is an important part of assessing compliance with the fiscal rules. It is subject to a large degree of discretion and there is evidence internationally of strategic use of one-offs to achieve fiscal outcomes that appear more favourable.[8] To facilitate a clear understanding of what can be classified as one-offs, and to counteract potential "fiscal gimmickry", the European Commission has developed a set of guiding principles for identifying one-offs:[9]

- **Principle I:** One-off measures are intrinsically non-recurrent.
- **Principle II:** The one-off nature of a measure cannot be decreed by law or by an autonomous government decision. It should be possible to evaluate the one-off nature of a measure unambiguously upon announcement and this should not depend on the way in which it has been announced by the policymaker (e.g. if the measure is announced as temporary or permanent).
- **Principle III:** Volatile components of revenue or expenditure should not be considered one-off. Cyclical parts of revenue or expenditure should not be considered as one-off, as this impact is already corrected for via the cyclical adjustment of the general government balance. While revenue or expenditure components may still exhibit a significant degree of volatility, one-offs are not primarily intended to smooth time series and should therefore not be used to correct for this kind of volatility.
- **Principle IV:** Deliberate policy actions that increase the deficit do not, as a rule, qualify as one-offs. In order to give policymakers the right incentive to fully recognise permanent budgetary impacts, there is a strong presumption that deliberate policy actions that increase the deficit are of a structural nature. These measures should only exceptionally be classified as one-offs, in cases where it can be unambiguously demonstrated that they have an intrinsic temporary nature.
- **Principle V:** Only measures having a significant impact on the General Government balance should be considered one-offs. As a rule, measures worth less than 0.1 per cent (rounded) of GDP should not be considered one-offs. Such measures are more likely to constitute normal volatility of public finances and their non-classification as one-offs avoids excessive complexity in monitoring government revenue and expenditure.

The Council's assessment of one-off classifications applied for 2015 and 2016 by the Department of Finance and the European Commission is informed, in part, by these guiding principles. However, neither the Department nor the Commission has provided a detailed taxonomy of the one-off items included for the year. Instead, one-off items are typically shown in net and/or aggregate terms with little or no information on their nature or justifications for their recognition as such.

Discerning how appropriate the "one-off" classifications are requires careful consideration of the merits of each one-off proposed. As a general rule, the Council views the one-off label as (i) something only applicable in cases where the one-off nature of the item is unambiguous (i.e., not for conventionally volatile items) and (ii) something that should apply only for reasonably large items or related items (i.e., amounting to more than 0.1 per cent of GDP). This should limit the risk of promoting poor incentives with respect to transparency and the sustainable management of the budgetary position. A further useful benchmark against which to assess tax

[8] A fiscal rules framework that is based on numerical maximum-allowable levels can create incentives for governments to use one-off measures strategically. Box D (IFAC, 2014b) explores the treatment of one-offs in detail, while Koen and Van den Noord (2005) demonstrate that as deficit rules become more binding, recourse to one-offs and other stratagems is more likely. Alt *et al.* (2014) offer a useful and more recent survey of the literature in this area.

[9] These guiding principles are extensively explained in Chapter II.3 of the 2015 Report on Public Finances in EMU (European Commission, 2016). The Section 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.

one-offs is the historical volatility of the tax head itself.

It is important that a high degree of transparency is evident for the identification of one-offs given the scope for discretion involved. Estimates in *Budget 2017* and *SPU 2017*, however, give no detail as to the nature or justification for the four separate one-offs items forming the basis for the Department's assessment of the structural balance change between 2015 and 2016.[10] The Department has shared with the Council additional information on one-offs identified.

Table H.1: One-Off/Temporary Measures Relevant for 2016 Assessment

€ millions

One-Off item	Rationale for Inclusion as One-Off	Department of Finance		European Commission		IFAC	
		2015	2016	2015	2016	2015	2016
AIB Transaction*	Treatment of conversion of state-owned AIB preference shares into ordinary shares as a capital transfer implies a temporary boost to expenditure. Expenditure treatment is due to increased risk linked to potential returns.	2,110		2,110		2,110	
EFSF Pre-Paid Margin	A prepaid margin on the borrowings from the European Financial Stability Facility was repaid to the Exchequer.		-550		-550		-550
Other		-610	-230				
EU Budget Contribution*	Step-change in contribution to EU Budget prompted by GNI revisions		170*		170*		170*
Total Impact of Exclusion of One-Offs on General Government Balance (GGB)		1,500	-610	2,110	-380	2,110	-380
…as a % GDP		0.6	-0.2	0.8	-0.1	0.8	-0.1
Implied Change in Underlying GGB (excluding one-offs/temp measures above)			0.6		0.4		0.4
Implied Change in Structural Balance			**0.5**		**0.3**		**0.3**

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Figures are rounded to nearest €10 million. A positive figure means that the one-off item decreases the GGB in that year, so the GGB, excluding one-offs, is higher than the CSO's published GGB.
* Amount is less than 0.1% GDP.

Table H.1 lists the items that were included as one-offs by the Department and the Commission for the purposes of assessing the required +0.6 percentage point change in the structural balance between 2015 and 2016. These also form part of the *ex-post* assessment of compliance with the domestic Budgetary Rule in 2016. There are significant differences between the Department's and Council's assessments of one-offs, which net over €0.6 billion in 2015 and €0.2 billion in 2016.

Assessing the one-offs proposed by the Department, the Council judges the AIB Transaction,

[10] Moreover, while data on the aggregate impact of one-offs are made available by the Commission, detailed information on the classification of one-off operations for Member States subject to the Stability and Growth Pact is not systematically provided. As such, it is not possible to evaluate whether or not inconsistencies in classification exist over time and across countries (Marinheiro, 2015).

EFSF pre-paid Margin and EU Budget Contribution to meet the necessary criteria as discussed in this Box. The AIB Transaction involved conversion of state-owned preference shares and is considered an artificial boost to expenditure in 2015. The EFSF pre-paid margin involved a one-off receipt as a result of an unusual funding structure pertaining to an EFSF loan drawn down in February 2011 and maturing in July 2016, therefore representing a non-recurring boost to 2016 revenue.[11] The EU Budget Contribution item refers to one-off expenditure in 2016 resulting from the CSO's *National Income and Expenditure 2015*. While the level shift in 2015 GNI is not necessarily temporary, the additional expenditure allocated to 2016 relating to the 2015 increase is one-off in nature due to effective double counting of this amount.

Overall, the Council's assessment is that a narrower list of one-offs than used by the Department is warranted. In particular, the items comprising the "other" aggregate are judged to correspond better with normal volatility of their respective General Government categories, and in any case the individual components do not exceed 0.1 per cent of GDP. Using the Council's one-offs, the change in the structural balance for 2016 is +0.3 percentage points of GDP, which falls short of the +0.6 percentage point adjustment requirement. As with the Department's estimated change in structural balance of +0.5 percentage points, the breaches are not large enough to trigger potential sanctions.

4.3 In-Year Assessment for 2017

For 2017, *SPU 2017* plans would breach both pillars of the Domestic and EU fiscal rules, based on the new application of the fiscal rules. The change in the structural balance is expected to be less than required and spending growth net of discretionary revenue measures is expected to exceed the limit set under the Expenditure Benchmark.

4.3.1 MTO and Structural Balance Adjustment Requirements

The Government's structural budget balance is not projected to meet the Medium-Term Objective (MTO) in 2017, thus failing to fulfil the Domestic Budgetary Rule's "Budget Condition". Both the Domestic Budgetary Rule and the Preventive Arm of the *SGP* require that appropriate adjustments are made towards the MTO of a structural balance of -0.5 per cent of GDP. The current CAM-based estimate of the structural balance for 2017 is -1.1 per cent of GDP.[12]

The Department of Finance's official *SPU 2017* projections show that the adjustments toward the structural-balance target fall short of requirements under the domestic Budgetary Rule and the Preventive Arm of the *SGP* for 2017. Requirements for an adjustment in the structural balance of +0.6 percentage points of GDP were set in spring 2015, while the Department's forecasts currently

[11] The original EFSF loan amounted to €4.2 billion, of which a €3.6 billion drawdown was received and the balance retained by the issuers as a credit-enhancing provision, given Ireland's sub-Investment Grade sovereign credit rating at the beginning of the EU/IMF Programme of Assistance. Following the removal of European loan margins for Programme countries agreed during 2011, and later the extension of European-loan maturities agreed in 2013, the margin retained on the first EFSF loan was scheduled for return to Ireland in July 2016.

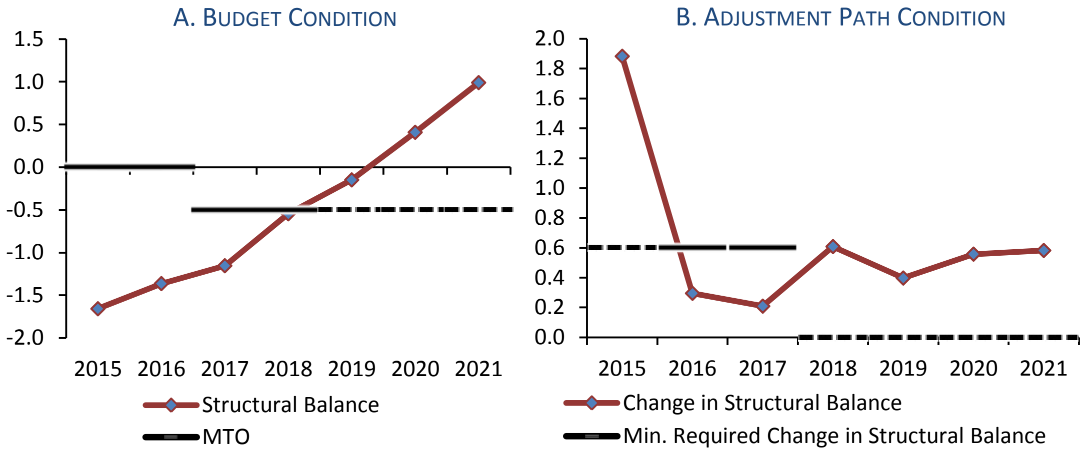
[12] As noted in previous *Fiscal Assessment Reports*, structural balance estimates derived from output gaps on the basis of the CAM may be inappropriate for Ireland (Chapter 2). The structural balance comprises the General Government Balance of -0.4 per cent of GDP in 2017, minus half the output gap level (based on a 0.5275 semi-elasticity), minus one-offs.

imply a change in the balance (adjusted for one-offs and cyclical developments) of +0.2 percentage points.[13] The Department's forecasts reflect different levels of one-off/temporary measures in *SPU 2017* from those considered applicable by the Council and the Commission, leading to a smaller preliminary structural-balance adjustment in 2017 under the Department's figures.

Over a two-year assessment, *SPU 2017* plans risk a significant deviation for the first pillar – that is, an average deviation over 2016 and 2017 above 0.25 per cent of GDP. A preliminary estimate for the structural balance change is €0.9 billion (0.35 per cent of GDP) above the limit. A significant deviation could potentially trigger sanctions following a Significant Deviation Procedure.

Figure 4.2: Assessment of Compliance with the Budgetary Rule

(A) Structural Balance (% of GDP); (B) Change in Structural Balance (Percentage Points)



Sources: *SPU 2017*; and internal IFAC calculations.

Note: The minimum MTO for Ireland was revised to -0.5 per cent of GDP for 2017-2019 and is planned to be achieved in 2018 so that the adjustment path condition no longer applies thereafter. Required changes above are calculated based on the previous year's structural balance. Dashed black lines in the graphs above indicate conditions that either did not yet apply, or are not expected to apply once the MTO has been reached.

4.3.2 Expenditure Benchmark

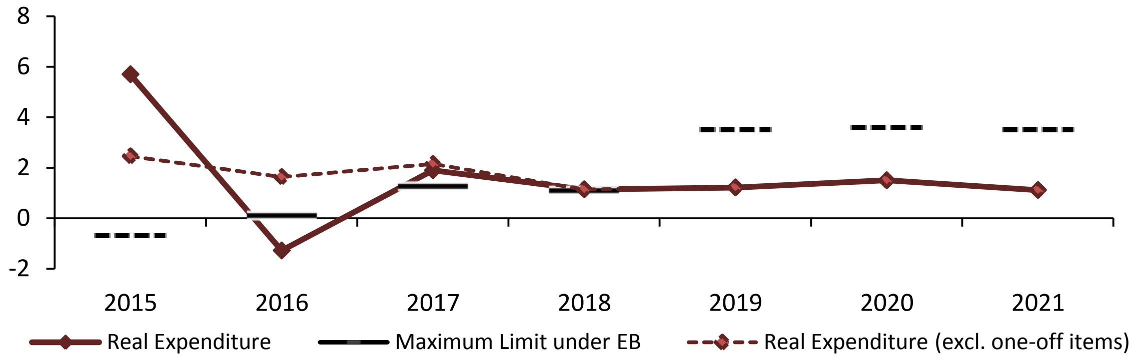
SPU 2017 plans would breach the Expenditure Benchmark rule in 2017. This is the same as the indications at budget time using the Department's own estimates. Real expenditure growth is expected to be 2.0 per cent in 2017, above the limit of 1.3 per cent. As shown in table 4.1, these plans imply a one-year deviation of 0.2 per cent of GDP (equivalent to €0.6 billion), and a two-year deviation of 0.3 per cent (equivalent to €0.8 billion), above the 0.25 per cent threshold for a "significant deviation". The 2017 estimates are preliminary, but suggest that the public finances will have to be managed carefully, as there is little scope for any expenditure overruns or additional discretionary revenue measures during 2017.

[13] European Commission estimates suggest that the change in the structural balance in 2017 may just meet the minimum required change.

Appendix G presents an alternative version of Table 4.1 with one-off/temporary measures not excluded from the calculations for assessing compliance with the second pillar, the Expenditure Benchmark. The Appendix is included due to the change in assessment policy, described in Section 1.1.2 of the *Vade Mecum Update* (European Commission, 2017). The current approach indicates that one-offs will be systematically stripped out of total expenditure when assessing the Expenditure Benchmark. This change was introduced in December 2016, after Budget 2017 plans had been published. The alternative table without one-offs excluded shows no two-year breach for 2017, though the one-year breach relative to 2016 expenditure levels remains.

Figure 4.3: Compliance with the Expenditure Benchmark

Annual Percentage Change in Real Expenditure



Sources: SPU 2017 and EC *Spring Economic Forecasts*.
Note: Real expenditure is the adjusted aggregate relevant for the assessment of the Expenditure Benchmark (EB). It excludes interest spending, expenditure on EU programmes fully matched by EU funds revenue and cyclical elements of unemployment benefit expenditure. Investment spending is averaged over a four-year window to smooth the impact of large investment projects. The EB is complied with where the real expenditure aggregate grows slower than maximum limit permitted under the EB. This growth rate is adjusted to reflect discretionary revenue measures. Dashed black lines in this graph refer to the maximum limit for adjusted real expenditure growth under the EB, in years when either the rules were not applicable, or when the rules are not expected to be applicable following achievement of the MTO (Section 4.3.1).

Figure 4.3 reveals the performance of real expenditure (including and excluding one-off items) relative to the Expenditure Benchmark over the assessment horizon. In November, the Council noted that weaknesses in expenditure management in recent years, including a pattern of overspending in Health, could lead to a widening of this underlying breach of the Expenditure Benchmark for 2017 (IFAC, 2016a).

4.4 *Ex-Ante* Assessment of 2018 to 2021

The *ex-ante* assessment of compliance with the fiscal rules for 2018 and later years focuses on the pace of structural adjustment towards meeting Ireland's updated MTO. An analysis of spending growth using the Expenditure Benchmark is also included. The debt rule, though applicable, is likely to represent less of a binding constraint.

4.4.1 MTO and Structural Balance Adjustment Requirements

If the fiscal path envisaged in *SPU 2017* were to be followed, the 2018 adjustment would be sufficient to meet the MTO of -0.5 per cent of GDP. No further adjustments are required if the MTO (once achieved) is maintained.

Figure 4.2 in the previous Section compares the projected structural balance path in *SPU 2017* to the expected annual requirements out to 2021. While the fiscal requirements for 2018 have been set, some uncertainty remains for subsequent years. Requirements will depend on the degree of compliance for preceding years and on supply-side estimates underpinning the EC "matrix" (see Figure G.1).[14]

Further detail is expected from the Department with regard to the specification of the Rainy Day Fund, first indicated as a policy intention in the *Summer Economic Statement 2016*. As described in Chapter 3, amounts allocated to this fund would remain within an Exchequer contingency reserve, and as such would not be treated as General Government expenditure. Clarity on these and other features of such a counter-cyclical buffer will be welcome.

4.4.2 Expenditure Benchmark

The maximum growth rate in spending permitted under the Expenditure Benchmark for 2018 has been set at 1.2 per cent in real terms, rising to above 3 per cent for 2019 to 2021. While compliance is projected to be met for 2019 to 2021, *SPU 2017* plans would narrowly breach both pillars of the fiscal rules in terms of the two-year assessment for 2018. The pattern of persistent revisions to budgeted current expenditure ceilings has been discussed in previous Council publications (see, for example, Figure 3.9 in the June 2016 *FAR* (IFAC, 2016a)) and if repeated could risk sanctions due to a significant deviation.

4.4.3 Debt Rule

Transitional arrangements under the Debt Rule apply until end-2018 before normal Debt Rule requirements take effect from 2019. The debt rule broadly requires debt in excess of 60 per cent GDP to be reduced by at least 1/20th per year on average.[15] Relative to the other fiscal rules, the Debt Rule is expected to present less of a binding constraint on medium-term fiscal policy. The Department's debt-ratio projections are shown in Table 4.1 and fall well below the two main criteria of the Debt Rule (the "backward-" and "forward-looking benchmarks") in all forecast years.

[14] For example, failure to meet the MTO in 2018 as planned could mean further conditions are required, with these being set with reference to the EC "matrix".

[15] For a more detailed discussion, see IFAC *Analytical Note 5: Future Implications of the Debt Rule* (Howlin, 2014).

4.5 The Medium-Term Expenditure Framework (MTEF)

The MTEF requires the Government to provide expenditure ceilings for each department covering the three years ahead from each budget year.[16] The intention is to assist the planning and delivery of service reforms, while avoiding the expenditure management problems observed prior to the crisis.

As described in previous Council publications, there has been a pattern of upward revisions to expenditure ceilings, in particular since 2011. For example, expenditure overruns have been a significant feature of the Health area, a subject of previous research by the Council.[17] In 2016, a total of €0.4 billion was spent on the Health area budget over and above what was allocated in the *Comprehensive Expenditure Review 2015-2017*.

The preparation of medium-term budgetary projections has improved in recent years, with a more realistic scenario that includes the use of estimated net fiscal space available in future years. However, these projections are not used to set the Ministerial Expenditure Ceilings, which remain lower. This practice seems to signal that ceilings are expected to be revised up in the central case. The Council continues to advocate the construction of realistic and credible ceilings at Ministerial level that fully incorporate expected spending plans. It is important to note that the Council is not suggesting that automatic or semi-automatic indexation should be adopted as a policy. However, as argued in previous Fiscal Assessment Reports, realistic expenditure forecasts that take both volume and price effects into account are important to underpin effective expenditure planning and control. The Council has outlined an alternative broad approach to setting medium-term Ministerial expenditure ceilings that builds on the recent reforms to the budgetary process (Box I).

Spending limits that are founded on CAM-based potential output growth rates – as is the case with the Expenditure Benchmark – may exhibit pro-cyclical tendencies. In particular, the CAM has a known tendency toward producing measures of potential output growth rates that follow actual GDP growth rates quite closely (as discussed in previous *FAR* and other Council publications). Furthermore, the possibility for mismatches between permitted expenditure growth rates and real GDP growth forecasts warrants caution in terms of setting an appropriate path for future expenditure.

[16] The MTEF is set out in the *Ministers and Secretaries (Amendment) Act 2013* and Departmental Circular 15/13.

[17] Howlin (2015), 'Controlling the Health Budget: Annual Budget Implementation in the Public Health Area'

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 that are 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.[18] 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.[19] 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.[20] 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 is 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).

[18] Council Directive 2011/85/EU

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

[20] 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.

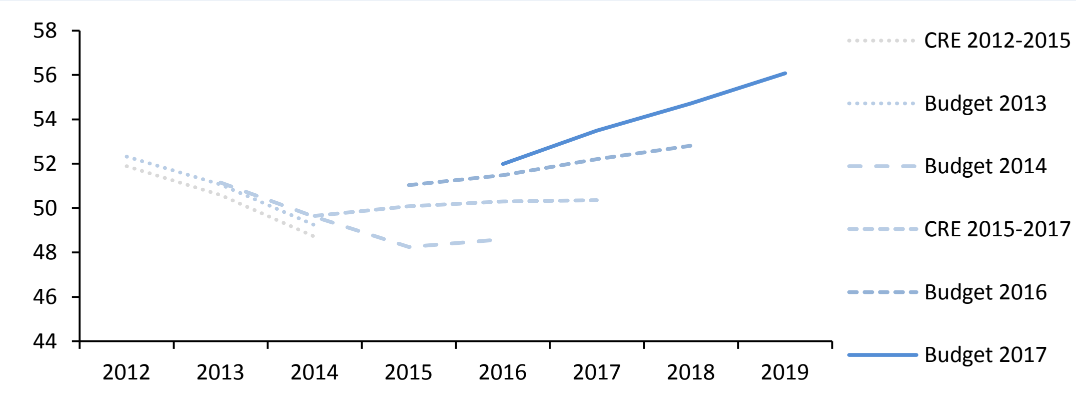
Table I.1: Alternative Approaches to MECs
Current Approach to MECs vs. Alternative Approach

	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.