4. Assessment of Compliance with Fiscal Rules

Key Messages

- The Medium-Term Objective (MTO) for the public finances is expected to be achieved in 2018, based on forecasts contained in *Budget 2018*. The current MTO targets a structural deficit – that is, a budget deficit corrected for one-off items and the impact of the business cycle – of 0.5 per cent of GDP. While breaches in required progress towards the MTO are estimated for 2016–2017, the expected change in the structural balance exactly meets the requirement for 2018.

- Much of the improvement in the structural balance for 2018 is due to a large decline in the output gap as measured by the EU Commonly Agreed Methodology (CAM). While such a fall in the output gap appears implausible, the level of the CAM output gap for Ireland in 2018, at 0.7 per cent of estimated potential GDP, does appear broadly reasonable. As such, the MTO's achievement next year would reflect a budget that is broadly in balance.

- *Budget 2018* forecasts suggest non-compliance with the Expenditure Benchmark, with forecast spending 0.1 per cent of GDP (€0.4 billion) in breach of the two-year average for 2017 and 2018. This second pillar of the fiscal rules is designed to ensure spending growth remains anchored to growth in medium-term potential output and revenue. However, the European Commission's estimates of policy-induced revenue increases, which can be used to offset higher spending under the rule, are far lower across 2017 and 2018 than those indicated in *Budget 2018*. Assessing compliance with the rule using the Commission's data would show considerably larger estimated breaches.

- The Council recommends following all fiscal rules beyond the MTO's forecast achievement. In advance of the MTO's achievement, this chapter investigates the adjustments to 2018 expenditure plans that would ensure full compliance. Reducing expenditure by €0.7 billion in 2018 would mean compliance with the Expenditure Benchmark on a two-year basis. A re-allocation of €1 billion from current to capital expenditure would also achieve compliance without any reduction in total spending, owing to provisions for smoothing of investment spending contained in the fiscal rules.

- As Ireland's budgetary framework continues to evolve, better adherence to the Medium-Term Expenditure Framework would strengthen efforts to ensure sound economic and fiscal management. Meanwhile, issues regarding the proposed Rainy Day Fund's impact on assessment of the fiscal rules require further investigation and more dialogue at the European level.

4.1 Introduction

The Council's key functions include assessment of compliance with the domestic Budgetary Rule (legislated for in the 2012 *Fiscal Responsibility Act*) and its equivalents at EU level (under the *Stability and Growth Pact* (*SGP*)), and assessment of the fiscal stance. With the Excessive Deficit Procedure (EDP) having been closed in 2015, on achievement of a general government deficit below 3 per cent of Gross Domestic Product (GDP), Ireland exited the Corrective Arm of the *SGP* and entered its Preventive Arm in 2016.[1] This chapter examines the consistency of the projections contained in *Budget 2018* with requirements under the Preventive Arm of the *SGP*. In particular, these requirements relate to measuring annual progress towards a Medium-Term (Budgetary) Objective (MTO), and ensuring that plans for expenditure growth are made on a basis that is sustainable.[2]

Section 4.2 provides a review of the *ex-post* assessment of compliance for 2016 contained in last May's *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule for 2016* (IFAC, 2017a), followed by a brief discussion of some technical aspects of the Council's assessment of compliance with the fiscal rules in Box I. New estimates for the in-year assessment of compliance in 2017 are then discussed in Section 4.3. Forecasts contained in *Budget 2018* are the basis for *ex-ante* assessments of compliance for 2018–2021, detailed in Section 4.4; the focus of this assessment falls on 2018 given that the policies have been established in the recent Budget. Further analysis of Ireland's budgetary framework concludes the chapter in Section 4.5.

The chapter includes reference to some of the EU Commonly Agreed Methodology's (CAM) many shortcomings in terms of estimating potential growth and the output gap for Ireland (see also Boxes B and E). The discussion also employs scenario analysis to estimate the required adjustment to expenditure plans that would ensure full compliance with the Expenditure Benchmark for a two-year assessment of 2017–2018. While transitional arrangements for the Debt Rule are currently applicable, its normal requirements will not come into effect until 2019 (once three years have passed since the EDP's closing), and forecasts for 2020 and 2021 indicate compliance.

[1] Although the fiscal rules are assessed with respect to GDP, in accordance with legal requirements of the relevant legislation, the Council believes other aggregates such as modified gross national income (GNI*) represent more appropriate indicators of the Irish economy (see Chapters 1 and 2).

[2] The MTO for Ireland over 2017-2019 is a target currently set at 0.5 per cent of GDP for the structural deficit – that is, the budget deficit adjusted for one-off items and the impact of the economic cycle.

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 net of One-Off Items	GGBn	-1.3	-0.8	-0.3	-0.2	-0.1	0.2	0.8
General Government Debt	GGD	76.9	72.8	70.1	69.0	67.1	63.5	61.2
1/20th Debt Rule (Backward/Forward-looking Benchmark)		109.0	95.7	81.9	71.9	69.5	67.8	65.8
Preventive Arm & Domestic Budgetary Rule:								
Pillar I. Structural Balance Adjustment Requirement								
CAM Structural Balance	SB	-2.0	-1.7	-1.1	-0.5	0.2	0.4	0.9
Actual/Planned Change in CAM Structural Balance (p.p.)	**ΔSB**	**1.8**	**0.3**	**0.6**	**0.58**	**0.7**	**0.3**	**0.5**
Minimum Change in Structural Balance Required (p.p.)	**REQ**	**-**	**0.6**	**0.6**	**0.58**	**0.0**	**0.0**	**0.0**
1yr Deviation (€bn) ...negative = non-compliance		-	-0.7	0.0	0.0	-	-	-
1yr Deviation (p.p.) ...negative = non-compliance		-	-0.28	0.01	0.00	-	-	-
2yr Deviation (€bn) ...negative = non-compliance		-	-	-0.4	0.0	-	-	-
2yr Deviation (p.p.) ...negative = non-compliance		-	-	-0.14	0.00	-	-	-
Pillar II. Expenditure Benchmark								
Reference Rate of Potential Growth (% y/y)	R	-	1.9	3.3	3.4	3.8	3.9	3.9
Convergence Margin (p.p.)	C	-	1.8	2.0	2.3	0.0	0.0	0.0
Limit on Real Expenditure Growth (% y/y) = $R_t - C_t$	**EB**	**-**	**0.1**	**1.2**	**1.1**	**3.8**	**3.9**	**3.9**
Actual/Planned Real Expenditure Growth (% y/y)	**er**	**5.8**	**-1.2**	**2.2**	**1.2**	**1.6**	**1.9**	**1.6**
1yr Deviation (€bn) ...positive = non-compliance		-	-0.9	0.6	0.1	-	-	-
1yr Deviation (% GDP) ...positive = non-compliance		-	-0.33	0.22	0.02	-	-	-
2yr Deviation (€bn) ...positive = non-compliance		-	-	-0.1	0.4	-	-	-
2yr Deviation (% GDP) ...positive = non-compliance		-	-	-0.06	0.12	-	-	-
Nominal spending increase permitted before DRMs*	EB€	-	1.2	1.6	1.7	3.6	3.9	4.2
Actual/Planned spending increases before DRMs* (€bn)	er€	-	0.3	2.3	1.7	2.1	2.3	2.4
Current Macroeconomic Aggregates								
Real GDP Growth (% y/y)	y	25.6	5.1	4.3	3.5	3.2	2.8	2.6
CAM Potential GDP Growth (% y/y)	y^*	4.2	5.6	4.5	4.5	4.4	3.6	3.1
CAM Output Gap (% of Potential GDP)	OG	2.2	1.7	1.6	0.7	-0.5	-0.4	-0.2
GDP Deflator Applicable (% y/y)	p	0.9	1.7	1.2	1.3	1.1	1.3	1.5

*Discretionary Revenue Measures

Sources: *Budget 2018*, European Commission *Spring 2017* forecasts and internal IFAC calculations.

Note: The assessments above cover the key parts of the fiscal rules under the *SGP*'s Preventive Arm and the domestic Budgetary Rule. It is based on fiscal plans and macroeconomic forecasts included in *Budget 2018*. One-off items may differ with those of the Department of Finance as the estimates above reflect the Council's views on what are applicable or valid as one-off/temporary measures. The only one-off items stripped out of the Expenditure Benchmark are those that have been identified since December 2016 (this reflects the timing of changes in how the rules are applied). Potential output is derived using estimates based on the EU Commonly Agreed Methodology (CAM). The outlier for "CAM Potential GDP Growth" for 2015 is replaced by the average of the 2014 and 2016 rates, as discussed in the June 2017 *FAR*. European Commission estimates of reference rates, convergence margins, GDP deflators and minimum adjustments in the structural balance are applicable for Preventive Arm requirements. These are frozen based on each year's preceding Commission *Spring* forecast for years up to 2018. Figures relevant to the 2016 assessment (i.e. in both 2015 and 2016) are frozen based on the Council's May 2017 Ex-Post Assessment of Compliance with the Domestic Budgetary Rule for 2016. As such, there are differences between some CAM-based estimates, deflators and deviations shown in Table 4.1 and those published in *Budget 2018* (see Box I).

If a €2.1 billion one-off expenditure item in 2015 (relating to the conversion of AIB Preference Shares into Ordinary Shares, classified as government expenditure by the CSO) were excluded from the Expenditure Benchmark calculations, the "Actual/Planned Real Expenditure Growth Rate" for 2015 would have been 2.9 per cent and 2.5 per cent in 2016, which would have resulted in an Expenditure Benchmark breach of 0.6 per cent of GDP (€1.6 billion) in 2016.

4.2 Review of *Ex-Post* Assessment for 2016

This section provides a review of the Council's May 2017 *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule for 2016*. Figures relating to the structural balance presented in *Budget 2018* reflect new estimates for 2016 of the CAM-based output gap and potential growth. An improvement is shown in *Budget 2018* for the change in the structural balance – however, the legal assessment of rule adherence is based on the fact that the European Commission's *Spring 2017* (European Commission, 2017b) estimates, which are used for EU assessments, are frozen for 2016. Box I describes the freezing approach and other technical aspects of the Council's assessment of compliance with the fiscal rules.

As described in Box H of the June 2017 *FAR* (IFAC, 2017b), revenue and expenditure classified by the Council as one-off is excluded from published general government data when assessing compliance with the fiscal rules. The Department of Finance's treatment of one-off items for 2016 is now in line with the assessments of the Council and the Commission.

4.2.1 MTO and Structural Balance Adjustment Requirements

The 2017–2019 MTO for Ireland was set by the Commission targeting a structural balance of -0.5 per cent of GDP. For this first pillar of the fiscal rules, the requirement for 2016 was for an improvement in the structural balance of 0.6 of a percentage point. Figure 4.1 shows the latest Commission estimates (*Spring 2017* forecasts) indicate a breach in the rule in 2016.[3]

The estimated breaches assessed by the Commission in their *Spring 2017* publication are now frozen – that is, the estimates for 2016 will not be re-estimated by the Commission when assessing compliance 2017 next spring. Consequently, any breaches that have been assessed as having occurred cannot be revised away by statistical vagaries or re-classifications.[4]

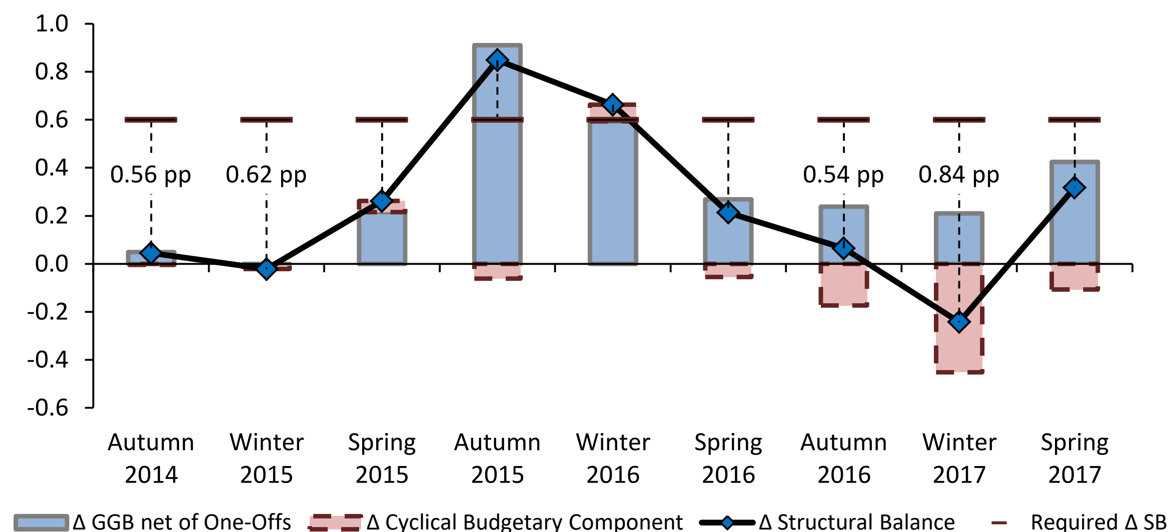
As described in Box I, the Council's approach is similar to that of the Commission, and a description of the Council's assessment is included in the May 2017 publication, *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule in 2016*.

[3] Although more recent estimates are available as part of the Commission's *Autumn 2017* forecasts, these are not relevant to the 2016 assessment, as the estimates of relevant figures in the Commission's *Spring 2017* forecasts have been frozen.

[4] The structural balance for Ireland is equal to the ratio of the general government balance net of one-off items to GDP, less the cyclical budgetary component – the product of a semi-elasticity parameter (equal to 0.5275) and the output gap. The semi-elasticity parameter intends to capture the sensitivity of the budget balance to the economic cycle. According to Box 1.4 of the *Vade Mecum* (EC, 2017), the EU average is 0.5 with a range of 0.31-0.65.

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

Components of Change (Δ) in the CAM Structural Balance (% GDP)



Sources: European Commission (forecast vintages); Department of Finance (*Budget 2018*); and internal IFAC calculations.

Notes: *Budget 2018* applies updated estimates for 2015 and 2016 of the structural balance's components, in particularly the output gap, whereas the Commission's *Spring 2017* forecasts have been frozen.

The Cyclical Budgetary Component is estimated as: 0.5275 * output gap, where the output gap is estimated using the Commonly Agreed Methodology. Significant deviations (greater than 0.5 percentage points) are shown above.

4.2.2 Expenditure Benchmark

Results for the second pillar of the fiscal rules, the Expenditure Benchmark, are shown in Table 4.1 above. The figures reveal compliance in 2016, with a margin of 0.33 per cent of GDP (€0.9 billion).[5] This outcome hinges on the inclusion of a €2.1 billion one-off expenditure item related to an AIB share transaction as part of aggregate public expenditure in 2015. Details of this transaction have been discussed in previous Council publications, including the June 2017 *FAR*. Were it not for this factor's inclusion, there would have been a significant deviation under the Expenditure Benchmark in 2016 of 0.6 per cent of GDP (€1.6 billion). The Council assesses that the one-off item should not have been used as an artificial means of permanently increasing expenditure in 2016. As discussed in *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule for 2016*, it is clear that the Government availed of this additional space despite its source being inherently transitory.

[5] Consistent with the treatment of the Structural Balance rule, Table 4.1 reflects the frozen assessment of the Expenditure Benchmark for 2016 (discussed in Section 4.2.1).

Box I: The Council's Assessment of the Preventive Arm

This box briefly discusses three technical aspects of the Council's assessment of compliance with the fiscal rules. These are (i) *ex-post* assessments of compliance, (ii) one-off items, and (iii) discretionary revenue measures (DRMs). The treatment of these items and differences compared to the corresponding treatment of the Department of Finance and the European Commission are summarised in Table I1 below.

Table I1: Treatment of *Ex-Post* Assessments, One-Off Items and DRMs

	IFAC	European Commission	Department of Finance
Ex-Post Assessments of Compliance – currently 2016	Frozen based on the IFAC *ex-post* assessment[6], with one-off items not excluded from the Expenditure Benchmark	Frozen based on Commission (*Spring 2017*) forecasts	The Department use latest estimates as opposed to freezing past deviations for the Expenditure Benchmark
One-off items	Assessed by IFAC and excluded from the Expenditure Benchmark for items identified since Dec 2016	Assessed by the Commission and systematically excluded from the Expenditure Benchmark (for all years)	Assessed by the Department, excluded from the Expenditure Benchmark for items identified since Dec 2016
Discretionary Revenue Measures	IFAC Assessment of Department *(Budget 2018)* estimates	Commission (*Autumn 2017*) estimates	Department *(Budget 2018)* estimates

Sources: IFAC, European Commission and Department of Finance.

(i) *Ex-Post* Assessment of Compliance

The Council's approach to *ex-post* assessments of compliance follows that used by the Commission in freezing the assessed level of compliance made in spring for the previous year. As a result, revisions to historical data for 2015 and 2016 that would affect any estimated breaches for 2016 will not be reflected in assessments of 2017 and 2018 compliance. The Department's estimates are slightly different in that they use updated estimates of the 2016 deviation for the Expenditure Benchmark rule in 2016 (*SES 2017* included €0.8 billion of over-compliance compared with €0.9 billion according to *Budget 2018*).

While the required adjustment in the structural balance may unfreeze in certain circumstances, in general the freezing of historical figures adds a degree of stability to the process of meeting fiscal targets.[7] A key advantage of the approach is that deviations that have been assessed as having occurred cannot be revised away by statistical vagaries or reclassifications. Given the variability inherent to estimates of the Irish economy, achieving fiscal targets due to a "moved-goalposts" effect should not necessarily be deemed adherence to the rules; equally, failing to achieve fiscal targets on a similar basis should not result in penalties.

[6] The Council's ex-post assessment for 2016 is presented in *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule for 2016* (IFAC, 2017a), based on the CSO's *Government Finance Statistics* outturns published in April 2017, Department forecasts published in SPU 2017 and using the Commission's *Spring 2017* estimate of the output gap. Council figures are similar to those in the Commission's *Spring 2017* publication. An exception is for assessment of the Expenditure Benchmark (with one-off items not excluded) owing to differences in the Commission's estimate of 2016 DRMs, which was €0.4 billion higher than the Department's estimate of -€0.8 billion; i.e., the Department's estimate of the negative impact of discretionary tax-reducing measures was double the size of the Commission's estimate. For further discussion on the quality of estimates for DRMs, see Box F.

[7] The most recent update to the Commission's *Vade Mecum* (European Commission, 2017a) describes two criteria for unfreezing, including "very bad or exceptionally bad economic times, measured as an output gap below -3 [per cent] of potential output", and revisions to a structural balance wherein a Member State's "delivery on its original [structural-balance adjustment] requirement would imply an over-achievement of its MTO".

(ii) One-off items

The Council assesses one-off items submitted for consideration by the Department in accordance with five Commission criteria outlined in Box H of the June 2017 *FAR*, and determines which of the items are applicable. This is an important process in that it affects compliance with the fiscal rules, and provides improved understanding of the underlying fiscal position. The Council's treatment of one-off items for assessment of the Expenditure Benchmark is effectively the same as that of the Department, wherein such items are excluded for 2017 onwards. This treatment differs from that of the Commission, reflecting the most recent update to the *Vade Mecum* (European Commission, 2017a) in systematically excluding one-off items for all years.

(iii) Discretionary Revenue Measures

In assessing compliance with the Expenditure Benchmark, the Council makes an assessment of the DRMs based on the information contained in the *Budget*; in practice, DRM estimates applied by the Council have been very similar indeed and often identical to those contained in the *Budget*. Meanwhile, the Commission uses its own estimates of DRMs and applies a different treatment to certain DRM components, in particular regarding the non-indexation of income-tax bands and carryover of previous years' measures.[8] The Commission's estimates have occasionally differed from those of the Department. In particular, the Department's estimates of total DRMs in *Budget 2018* were -€0.8 billion for 2016, €0.0 billion for 2017 and +€1.0 billion for 2018; the corresponding Commission figures were -€0.4 billion, -€1.0 billion and +€0.2 billion, respectively.

4.3 In-Year Assessment for 2017

Analysis based on the latest data implies a breach in the Expenditure Benchmark for 2017. A new presentation for assessing compliance with the Expenditure Benchmark is then examined, in which one-off expenditure and revenue items are excluded from calculations of the real expenditure growth rate. This approach is applied to one-off items identified after December 2016. Although the Expenditure Benchmark continues to register a breach for 2017, the technically compliant outcome in 2016 described in the previous section means there is no deviation for the two-year average of 2016–2017. However, the breach in 2017 risks becoming a significant deviation when applying the Commission's discretionary revenue measures (DRMs) estimates.

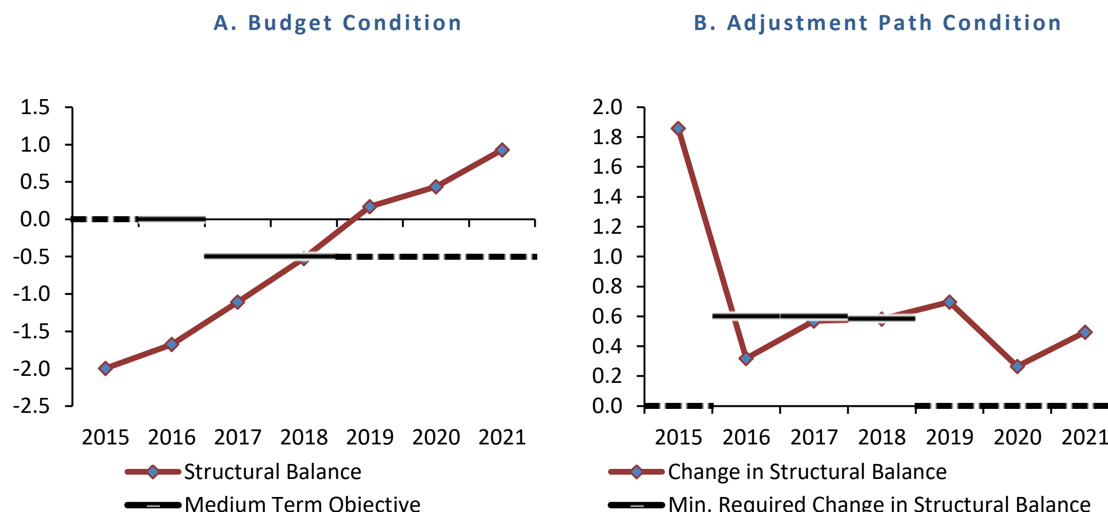
4.3.1 MTO and the Structural Balance Adjustment Requirements

The CAM-based structural balance is expected to narrow to a deficit of 1.1 per cent of GDP in 2017, an improvement of 0.6 of a percentage point (as shown in the two panels of Figure 4.2). This would show full compliance with the adjustment path condition for the structural balance. The majority of this improvement is due to an increase of 0.5 of a percentage point of GDP in the general

[8] Correspondence with the Commission indicates that non-indexation of income-tax bands would be taken into account in the event of an overall assessment.

government balance excluding one-off items, which is forecast to reach a deficit of 0.3 per cent of GDP in 2017.[9]

Figure 4.2: Assessment of Compliance with the Budgetary Rule
(A) Structural Balance (% of GDP); (B) Change in Structural Balance (Percentage Points)



Sources: Budget 2018; and internal IFAC calculations.
Note: The minimum MTO for Ireland was revised to a structural balance of -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 indicate conditions that are not yet determined (Panel A), but are not expected to apply once the MTO has been reached (Panel B).

At the time of the *June 2017 FAR*, there was a smaller forecast change in the 2017 structural balance at +0.2 of a percentage point. One reason behind the difference is that the forecast for nominal GDP in 2017 was lower than that contained in *Budget 2018*. Another factor is that the last *FAR*'s estimate of the CAM output gap for 2017 was lower by 0.2 of a percentage point.

In the latest CAM estimates for 2017, the positive output gap narrows by 0.1 of a percentage point compared to 2016. As discussed further in Box B, the CAM may not provide a satisfactory measurement of the output gap for Ireland, and its measurements may exhibit procyclical tendencies. A positive output gap above 1.5 per cent for Ireland is unlikely to be realistic at present, with limited wage pressure and a still-recovering labour market. Furthermore, the direction of the change implies cooling in the economy, which is also unlikely to be realistic at present (Chapter 1). A more realistic estimate might resemble a negative output gap that is closing, with the change in the CAM output gap instead bearing a positive sign, which would be less helpful for achieving compliance with a required improvement in the structural balance. A more negative output gap could also imply that the MTO has already been met or overachieved.

[9] The estimate of the general government deficit in 2016 was revised down. This explains the fiscal balance's higher contribution to the change in the structural balance in 2017. The frozen estimates for 2016 are based on the April release's deficit of €1.5 billion, whereas Budget 2018's uses the October release's estimated deficit of €1.9 billion.

4.3.2 Expenditure Benchmark

Assessment of the Expenditure Benchmark for 2017 shows a forecast breach of 0.2 per cent of GDP (€0.6 billion). The two-year assessment for the average of 2016 and 2017 shows expected compliance. However, if the Council's assessment applied the Commission's estimated DRMs for 2017, this would result in breach of the Expenditure Benchmark that could risk incurring sanctions at EU level. As discussed in Box I, substantial differences may arise between the Department's estimates of DRMs and those of the Commission, mainly as a result of differences in treatment of non-indexation of income-tax bands and carryover impacts from previous years' measures. In particular for 2017, the Department's estimate of DRMs for 2017 is €0.0 billion while the Commission puts this figure at –€1.0 billion. This implies a revenue-neutral estimate of the measures contained in *Budget 2017* by the Department, compared to a sizeable revenue-reducing estimate by the Commission.

More generally, assessment of the Expenditure Benchmark for both 2016 and 2017 has been complicated by an update to the rule's application provided by the Commission concerning the impact of one-off items. This change was agreed upon in December 2016 and formalised in the *Vade Mecum* (European Commission, 2017a). These events occurred after plans for Ireland's fiscal policy in 2017 had been set down in *Budget 2017* (published in October 2016). Prior to the update, one-off items had not been excluded in calculating the growth rate of applicable spending, which is moderated by revenue-raising measures. This growth rate is compared to the Expenditure Benchmark's limit (equal to the reference rate less the convergence margin) to evaluate whether the corrected[10] aggregate public expenditure for a given year adheres to the Expenditure Benchmark rule.

As discussed in Box I, the Commission has indicated that assessment of compliance with the Expenditure Benchmark will systematically exclude one-off items.[11] The Council believes that it is more appropriate to assess the Expenditure Benchmark with the methodology that applied at the particular time the policies were formed. This is in line with the views of the Department, described in Box 5 of *SES 2017*.

[10] The "Actual/Planned Real Expenditure Growth Rate" in Table 4.1 is equal to the growth rate of the corrected expenditure aggregate (CEA) net of discretionary revenue measures (DRMs) compared to a previous year's CEA. The CEA itself is equal to total general government expenditure adjusted for one-off expenditure items, interest, smoothed public investment (equal to public investment net of its four-year rolling average), spending on EU programmes fully matched by EU funds revenue, and the cyclical component of unemployment benefit payments. CEA net of DRMs is equal to CEA less DRMs, revenue measures mandated by law, and the change in one-off revenue items. The change in one-off revenue items therefore mitigates the expenditure-growing properties that otherwise accumulate with additional DRMs. See Annex 8, "A Numerical Example of the Expenditure Benchmark", in the Commission's *Vade Mecum* (European Commission, 2017a).

[11] To ensure that comprehensive details of the Expenditure Benchmark had been presented, the Council published an appendix (Table AG.1) to the June 2017 *FAR* containing an assessment table where one-off measures had not been excluded. For this *FAR*, assessment of the Expenditure Benchmark has reverted to using just one assessment table, for which only one-off items that have been identified since the December 2016 decision are excluded from relevant calculations.

In practice, for the 2017 assessment this approach implies the non-exclusion from the calculation of the "Actual/Planned Real Expenditure Growth Rate" for 2017 of a one-off revenue item received in July 2016.[12] This affects the Expenditure Benchmark assessment for 2017 in that DRMs net of the change in one-off revenue items provides flexibility within the Expenditure Benchmark rule for additional increases in expenditure, provided they are fully funded by non-transitory revenue increases.

4.4 *Ex-Ante* Assessment for 2018–2021

Turning to *ex-ante* assessments of 2018–2021, *Budget 2018* forecasts the MTO's achievement in 2018, with the structural balance rising in 2018 exactly as required. Much of the improvement in the structural balance for 2018 is due to a large and implausible decline in the CAM output gap. While such a fall in the output gap appears implausible, owing to issues regarding its calculation (Box B), its level does appear broadly reasonable at 0.7 per cent of estimated potential GDP. As such, the MTO's achievement next year would reflect a budget that is broadly in balance.

Breaches are still forecast for the Expenditure Benchmark in 2018, and a scenario analysis in this section investigates the changes to expenditure plans that would be required to achieve full compliance. For 2019 onwards, the MTO would be achieved and hence expenditure growth would be less constrained compared to recent years.

4.4.1 MTO and Structural Balance Adjustment Requirements

For 2018, the structural balance is forecast in *Budget 2018* to reach a deficit of 0.5 per cent of GDP, equal to the MTO. This is expected to be achieved by an increase in the structural balance that is exactly in line with the minimum-required adjustment of 0.58 of a percentage point.[13] The achievement of the required adjustment (and therefore the MTO) in 2018 is related to a large fall in the CAM output gap from +1.6 to +0.7 per cent of potential GDP. As discussed in the previous sections of this chapter, and in Chapter 1, the direction of the change of the output gap is more likely to be rising (from a negative position) than falling (from positive).

However, it is important to note that the achievement of the MTO would occur with any CAM output gap that is zero or below, given that the general government balance net of one-offs is forecast to reach a deficit of 0.2 per cent of GDP in 2018. While achieving the required structural

[12] The amount was €0.55 billion received from the European Stability Mechanism in lieu of a pre-paid margin relating to a loan received by Ireland in 2011 under the EU/IMF Programme. €3.6 billion was received from the European Financial Stability Facility in February 2011 for a loan with face value of €4.2 billion; referred to in footnote 1: http://www.ntma.ie/business-areas/funding-and-debt-management/euimf-programme/.

[13] This adjustment requirement was frozen by the Commission based on its *Spring 2017* assessment. While the minimum required change in the structural balance according to the adjustment-requirement matrix (see Appendix E for details) is ">0.5 percentage points" – operationalised as 0.6 of a percentage point – the Commission's estimate of the structural balance for end-2017 at the time of its *Spring 2017* assessment was 1.08 per cent of GDP. Since delivery of a 0.6 percentage-point adjustment would lead to over-compliance with the MTO requirement (-0.5 per cent of GDP), the adjustment requirement was frozen at 0.58 of a percentage point (the difference between the MTO and the *Spring 2017* structural balance).

balance increase is helped by an implausibly large reduction in the CAM output gap in 2018, the CAM's estimate of the output gap for that year of 0.7 per cent of potential GDP does appear to be reasonable. As such, the CAM-based estimate of the structural balance of –0.5 per cent of GDP in 2018 is also plausible, implying a budget that is broadly in balance after accounting for the impact of the economic cycle.

4.4.2 Expenditure Benchmark

With the achievement of the MTO forecast in 2018, increases in spending will not be constrained by the inclusion of a convergence margin in the application of the Expenditure Benchmark in 2019 and beyond. The Council recommends continued adherence to the Expenditure Benchmark as an anchor for the public finances, given the advantages it offers in improving the sustainability of spending growth over time.

Estimates based on *Budget 2018* figures currently indicate a risk of a breach of the Expenditure Benchmark rule in 2018. The forecasts indicate near-exact (i.e., minimum) compliance for 2018, but factoring in the expected 2017 breach of 0.2 per cent of GDP indicates a two-year breach of 0.1 per cent of GDP (€0.4 billion). However, these estimates would be worsened somewhat when the European Commission's assumptions regarding DRMs are considered. As described in Section 4.3.2 above, Box I shows differences in DRM estimates for the Department and the Commission; in cumulative terms, the Commission's estimates for 2017 and 2018 imply €1.8 billion less revenue attributable to discretionary policy than is estimated by the Department. Furthermore, although *Budget 2018* plans target the achievement of the MTO, this remains an uncertain outcome. Any further slippage in compliance with the Expenditure Benchmark could result in the MTO not being achieved. This in turn would mean that the Expenditure Benchmark would still formally apply.[14]

4.4.3 Scenario Analysis of Expenditure Benchmark Compliance

To provide context on the relationship between 2018 expenditure plans and compliance with the Expenditure Benchmark, a scenario analysis is undertaken below. The exercise firstly determines what level of expenditure reduction in 2018 would result in compliance for both a one- and two-year assessment of the Expenditure Benchmark; the change required is larger for the two-year assessment, from the need to compensate for the breaches currently projected for 2017.[15] A second scenario investigates what re-allocation of total expenditure towards public capital spending in 2018 would result in compliance for both a one- and two-year assessments. Table 4.2 summarises the findings.

[14] However, the Commission overall assessment would likely include non-indexation of income-tax bands. This would mean a lower breach than implied by using the Commission's *Autumn 2017* DRM estimates in full.

[15] Rather than simple addition of the relevant deviations shown in Table 4.1, this exercise instead takes account of the dynamics involved in assessment of the Expenditure Benchmark, as deviations are determined with reference to corrected expenditure aggregates (CEAs) discussed previously in this chapter.

Table 4.2: Scenario Analysis for Expenditure Benchmark Compliance in 2018
€ billion

Scenarios:	€ bn
Expenditure adjustments required to achieve:	
One-year compliance	-0.1
Two-year compliance	-0.7
Expenditure re-allocation to capital spending required to	
One-year compliance	+0.1
Two-year compliance	+1.0

Sources: Budget 2018 and internal IFAC calculations.
Note: Expenditure re-allocations to investment required to achieve compliance reflects existing flexibility within the Expenditure Benchmark.

For the first scenario, compliance with the Expenditure Benchmark on a two-year basis would require a reduction of €0.7 billion. In a scenario where public expenditure in 2018 is re-allocated towards public capital expenditure (with no change in overall spending), compliance would be achieved with a €1.0 billion re-allocation to public investment for a two-year assessment. This reflects the relatively favourable treatment of capital expenditure compared to current expenditure contained in the fiscal rules; the difference between current-year capital spending and its four-year rolling average is excluded from the growth in spending as assessed by the Expenditure Benchmark.

4.4.4 Debt Rule

Normal requirements of the Debt Rule will take effect from 2019, following the conclusion of a three-year period of transitional arrangements since Ireland exited the Corrective Arm of the SGP. The Debt Rule broadly requires a debt ratio to reduce by an average of at least 1/20th per year of the gap above 60 per cent GDP; this requirement is expected to present less of a binding constraint on Irish medium-term fiscal policy than may be the case for other elements of the fiscal rules, in particular if the MTO is not met in 2018. The Department's debt ratio projections are shown in Table 4.1 and fall well below the backward- and forward-looking benchmarks of the Debt Rule in all forecast years.

4.5 Budgetary Framework

This section discusses two areas of relevance to Ireland's budgetary framework: the Medium-Term Expenditure Framework (MTEF) and the proposed Rainy Day Fund (RDF).

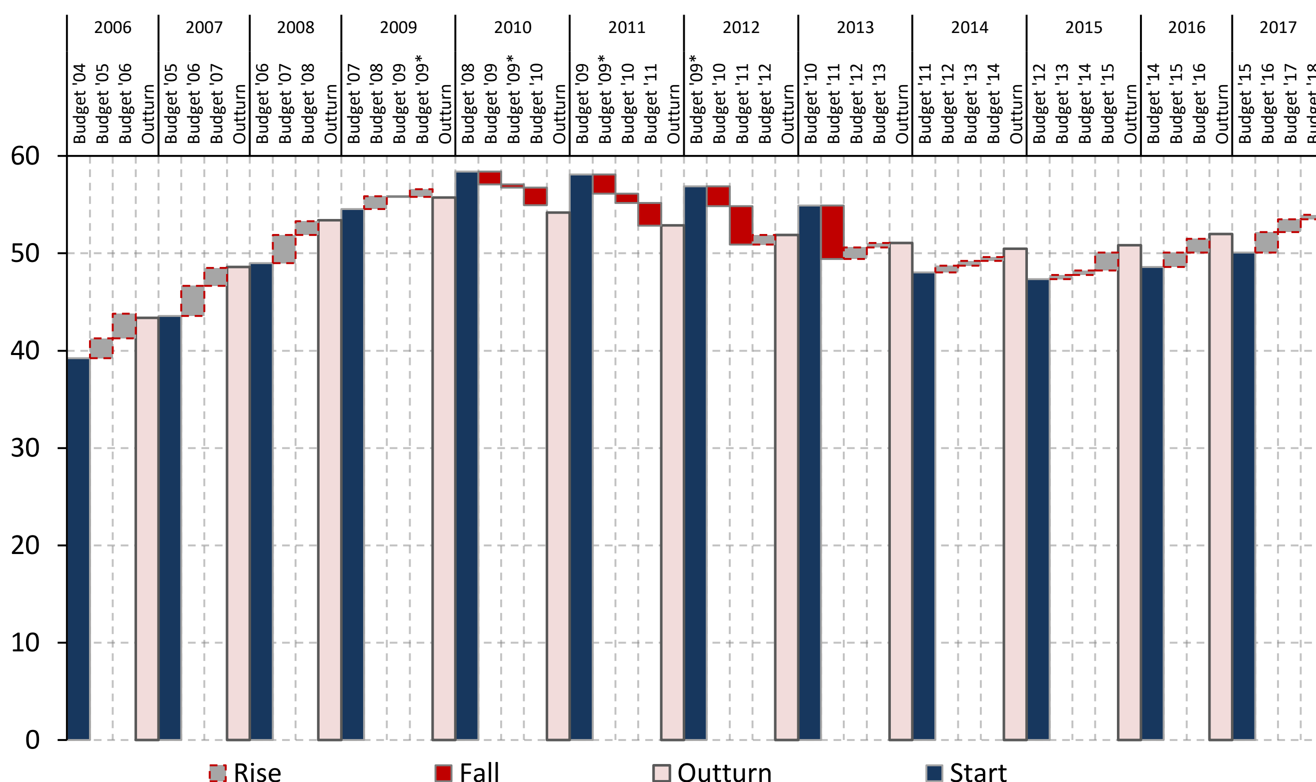
The MTEF is a core reform introduced since the crisis years, and the MTEF is legislated for in the *Ministers and Secretaries (Amendment) Act 2013*. With reference to the Expenditure Benchmark, limits to overall public expenditure are set for the following three years, while Ministerial expenditure ceilings are established to ensure aggregate expenditure remains within overall limits.

As shown in Figure 4.3, in recent years there has been a return towards annual upward revisions to expenditure plans over successive Budgets, in a pattern that broadly resembles the economic cycle.

While the *Budget 2018* rise in estimated 2017 current expenditure is moderate compared to the previous two increases, the cumulative difference compared to the Budget 2015 is €3.9 billion. A pro-cyclical approach to expenditure management weakens the capacity of the public finances to absorb negative shocks. Better adherence to the MTEF would strengthen the role of the Expenditure Benchmark in moderating the downside risks of a slowdown in economic growth.

Figure 4.3: Evolution Gross Current Expenditure Forecasts

€ billion



Sources: Department of Finance; internal IFAC calculations.
Note: Rise and Fall bars indicate changes to each year's expenditure plans introduced in successive budgets, followed by a year's outturn (e.g., "Budget '15" refers to expenditure forecasts contained for a particular year in *Budget 2015*).

As discussed in Box A of this *FAR*, the introduction of an RDF has the potential to strengthen Ireland's MTEF if the fund could provide a further countercyclical buffer. However, as described in the Department's recent RDF Consultation Paper (published alongside *Budget 2018*), the fund is instead envisaged as providing funding for unforeseen, emergency expenditure measures that would conform to the definition of a one-off item. If the expenditure measures were granted this classification, the approach would avoid potential difficulties with drawing down spending for the assessment of the Expenditure Benchmark (as one-off items are excluded from assessed expenditure).

However, given the adherence to multiple criteria required to achieve one-off classification, the Department's plans for use of the fund may struggle to obtain any exceptional status. These criteria were examined in Box H of the *June 2017 FAR* and require that items be intrinsically non-recurrent,

not decreed by law, beyond the usual volatility of revenue and expenditure, not the result of deliberate policy choices, and larger than 0.1 per cent of GDP in size. Furthermore, in the absence of a very large shock to the economy, it may prove challenging to obtain relief for the RDF-related expenditure through the investment, unusual event or structural reform clauses under the Preventive Arm of the *SGP*.

Overall, the reliance on exceptional relief for RDF-related expenditure inherently limits the scope of the fund to act as a counter-cyclical buffer. Indeed, this scope is also constrained by the cap limiting planned contributions to a maximum of €500 million per annum (discussed in Chapter 1). Issues regarding the fund's interaction with the Expenditure Benchmark's application require further investigation. Greater engagement with the Commission on this issue may result in enhanced flexibility under the fiscal rules, facilitating more opportunities for smoothing the effects of the cycle on public finances.