4. Assessment of Compliance with Fiscal Rules

Key Messages

- The Medium-Term Objective (MTO) of a structural deficit no more than 0.5 per cent of GDP was reached in 2017, a year earlier than expected based on Budget 2018 projections. The degree to which cyclical factors were estimated to have improved the deficit was revised, leading to a smaller structural deficit. As the MTO was met in 2017, the requirements to adjust the structural balance in 2017 are not binding.

- Based on the Department's current CAM-based estimates of the output gap, it is likely that the structural balance adjustment requirement and expenditure limit for 2018 will be reset. In this case, the 2018 convergence margin under the Expenditure Benchmark would no longer apply and currently outlined spending plans will be less than the allowable limit, which is appropriate (Chapter 1). However, there is a risk of non-compliance with the MTO in 2018 based on current output gap estimates.

- Medium-term forecasts are provided to 2021 in *SPU 2018*, yet the Department should extend its horizon back to a five-year-ahead basis. Over the period 2019 –2021, plans currently show compliance with the rules. The structural balance is at risk of deteriorating beyond the MTO in 2018, leading to adjustment requirements in 2019. This deterioration is offset by an improvement in 2019, which is sustained over the medium term. This structural balance path is largely due to the estimated effects of the cycle, with the general government balance slowly improving.

- There are risks that the MTO might be breached again in 2018. However, if it is sustained, the Expenditure Benchmark will play a less binding role from 2019 and would not trigger non-compliance on its own. The Expenditure Benchmark allows more than enough scope to sustain current activities, while also allowing for increases in investment. The Council continues to recommend committing to adhering to the Expenditure Benchmark – at least as a minimum standard – even after the MTO is achieved. Doing so would help to ensure that spending growth is more sustainable than it otherwise would be, notwithstanding some degree of procyclical bias affecting the spending rule.

4.1 Introduction

A core function of the Council's mandate is to assess compliance with the fiscal rules. This includes Ireland's Domestic Budgetary Rule as set out in the 2012 *Fiscal Responsibility Act* (*FRA*). It also includes the EU fiscal rules with reference to the EU *Stability and Growth Pact* (*SGP*). This chapter examines the consistency of the projections contained in SPU 2018 with the Preventative Arm of the *SGP*. In particular it examines compliance in relation to the Medium-Term (Budgetary) Objective (MTO), and the Expenditure Benchmark.

The assessment of the rules in this chapter examines compliance on the basis of the Department of Finance's CAM-based estimates in the *SPU 2018* and considering the Council's own assessment of one-off/temporary measures.[56] No new one-off items have been included in *SPU 2018* since *Budget 2018*. Table 4.1 provides a summary assessment of compliance with the fiscal rules.

4.2 *Ex-Post* Assessment for 2017

As per the Fiscal Responsibility Act 2012, the Council assesses *ex-post* compliance with the fiscal rules under the domestic framework and the EU Preventative Arm. Final assessments of compliance with the rules for a given year are undertaken using outturn data released in Spring of the following year. The latest of such assessments is for 2017 (IFAC, 2018a). Figures relating to the structural balance presented in *SPU 2018* reflect estimates of the output gap and potential growth on the basis of an adjusted version of the Commonly Agreed Methodology (CAM). Adjustments were introduced by the Department of Finance in response to the higher-than-expected growth outturns in 2017 and the view that this was caused by substantive distortions unrelated to the domestic economy.[57]

[56] While the assessment of the rules is currently based on the EU Commonly Agreed Methodology (CAM), the Department of Finance has now developed alternative measures of the output gap. Under the Department's preferred alternative output gap measure, the MTO is assessed to have been surpassed as early as 2015, and the measure shows current plans maintaining the MTO over the medium term (2018-2021). The same semi-elasticity of the deficit to the output gap is used as for the CAM. See Chapter 1 for more details on compliance under the alternative estimates.

[57] The European Commission deemed that an adjustment to estimates of potential for 2017 would be appropriate. However, the exact implementation differed from what the Department had anticipated. This will be reflected in revised estimates from the Department.

Table 4.1: Assessment of Compliance with the Fiscal Rules[1, 2]

% GDP unless stated, deviations…negative=non-compliance

	2015	2016	2017	2018	2019	2020	2021
Corrective Arm:							
General Government Balance Net of One-Off Items	-1.9	-0.5	-0.3	-0.2	-0.1	0.3	0.4
General Government Debt	76.9	72.8	68.0	66.0	63.5	60.2	58.7
1/20th Debt Rule Limit[3]	109.0	95.7	81.9	71.2	68.0	65.2	62.8
Debt Rule met?	N/A	N/A	N/A	N/A	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule:							
I. Structural Balance Adjustment Requirement							
MTO for the Structural Balance	0.0	0.0	-0.5	-0.5	-0.5	-0.5	-0.5
MTO met?	N	N	Y	N	Y	Y	Y
CAM Structural Balance	-1.5	-0.9	-0.5	-0.9	-0.4	0.1	0.3
Actual/Planned Change in CAM Structural Balance	1.9	0.3	0.5	-0.4	0.5	0.5	0.2
Minimum Change in Structural Balance Required	-	0.6	-	- [2]	0.1	0.0	0.0
1yr Deviation (€bn)	-	-0.7	-	-	1.1	1.9	2.9
1yr Deviation (pp)	-	-0.3	-	-	0.3	0.6	0.8
2yr Deviation (€bn)	-	-	-	-	-	1.5	2.4
2yr Deviation (pp)	-	-	-	-	-	0.4	0.7
II. Expenditure Benchmark							
Reference Rate of Potential Growth (% y/y) (R_t)	-	1.9	3.3	3.4	4.5	4.5	4.4
Convergence Margin (C_t)	-	1.8	0.0	0.0	0.6	0.0	0.0
Real Corrected Expenditure Growth Limit (% y/y) (= $R_t - C_t$)	-	0.1	3.3	3.4	4.0	4.5	4.4
Actual/Planned Real Expenditure Growth Rate (% y/y)	5.9	-1.2	3.1	1.5	2.2	0.9	2.9
1yr Deviation (€bn)	-	0.9	0.1	1.4	1.3	2.7	1.1
1yr Deviation (% GDP)	-	0.3	0.0	0.4	0.4	0.8	0.3
2yr Deviation (€bn)	-	-	0.6	0.8	1.4	2.1	2.0
2yr Deviation (% GDP)	-	-	0.2	0.2	0.4	0.6	0.6
Nominal spending increase permitted before DRMs* (€bn)	-	1.2	3.0	3.3	3.9	4.4	4.6
Actual/Planned spending increases before DRMs* (€bn)	4.4	0.3	2.9	2.0	2.5	1.7	3.4
Current Macroeconomic Aggregates							
Real GDP Growth (% y/y)	25.6	5.1	7.8	5.6	4.0	3.4	2.8
CAM Potential GDP Growth (% y/y)	4.8	5.4	8.0	4.7	4.7	3.7	3.2
CAM Output Gap	0.8	0.5	0.3	1.2	0.6	0.4	0.2
GDP Deflator Applicable (% y/y)	0.9	1.7	1.2	1.3	1.3	1.3	1.5

Sources: CSO; Department of Finance; and internal IFAC calculations.

Notes:

[1] Assessments examine the *SPU 2018* revenue and expenditure plans, using the Department of Finance's estimates of potential output and considering the Council's views on one-off/temporary measures. No new one-off items have been included in *SPU 2018* however following publication of the SPU the Department indicated a capital transfer presently included as spending in 2021 may be included as a one-off in future estimates. At present this is not included in the above calculations. This treatment differs to that applied in the "Assessment of Compliance with the Domestic Budgetary Rule in 2017" (IFAC, 2018a), which used the Commission's Spring 2018 output gap estimates for the structural balance as these are the basis of ex-post assessments of compliance. 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.*

[2] The Council assesses the MTO as achieved in 2017 so that no further adjustments to the structural balance are required in 2017. Based on the current estimate of the 2017 structural balance an adjustment would not be required in 2018. However, the Commission will maintain some requirements fixed until the final assessment in Spring 2019. There is a risk that Spring 2019 estimates will not show the MTO as met in 2017 and the previous adjustment requirement would still apply. The MTO is due to be updated for 2020/2021. This update was unavailable at the time of writing and the MTO is kept constant at -0.5 per cent.

[3] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress towards the reference value of 60 per cent of the GDP. A transition period applies till the end- 2018.

4.2.1 MTO and Structural Balance Adjustment Requirements

The MTO for Ireland for the period 2017-2019 was set by the Commission as a structural balance of -0.5 per cent of GDP. Assessing the structural balance on the basis of the Department of Finance CAM output gap estimates shows the MTO was achieved in 2017 with a structural balance of -0.45 per cent. Therefore, the adjustment requirement for 2017 no longer applies.[58] Box H examines the MTO and compliance with the fiscal rules over time.

Box H: Compliance with the Fiscal Rules Before the Crisis

This box examines the fiscal rules in the context of the run-up to the crisis years in Ireland (2004–2007). From 2000–2005, nominal GDP growth averaged 10.7 per cent, government revenue grew 9.9 per cent annually and the unemployment rate remained below 5 per cent. While such headline measures remained favourable during 2006 and 2007, by 2008 the downturn had begun: the unemployment rate increased to 6.8 per cent and nominal GDP contracted sharply by 4.8 per cent. A severe fiscal crisis ensued, contributing to a deep recession, despite the presence of fiscal rules intended to safeguard against unsustainability of the public finances.

The Medium-Term Budgetary Objective

Following its implementation in 1998, the EU *Stability and Growth Pact* was reformed in 2005 to incorporate a Medium-Term budgetary Objective (MTO) specific to each EU Member State. Progress toward achieving the MTO has been measured according to the structural budget balance. This is calculated by subtracting the cyclical component of the budget balance, estimated using output gaps produced by the EU Commonly Agreed Methodology, from the general government balance as a share of GDP along with any one-off or temporary items that apply. The MTO supplemented the existing *Pact* requirements in recognising the impact of the economic cycle on the public finances. Member States with large debt or deficits would enter an "Excessive Deficit Procedure", with potential sanctions applying if corrective actions were ignored.

The MTO therefore encouraged Member States to consider the underlying sustainability of budgetary policies. It recognised that adherence to the 3 per cent limit on budget deficits could mask unsustainable budgetary positions depending on cyclical or transient developments.

For the mid-2000s, Ireland's MTO was to maintain a budgetary position that was "balanced in structural terms".[59] The *Stability Programme Update (SPU)* for 2006 showed a structural surplus of 1.8 per cent of GDP for 2007, indicating significant over-compliance with the MTO requirements.[60] Figure H.1 compares Ireland's latest estimates of the cyclically adjusted budgetary position during the 2000s with historical real-time estimates that informed each year's upcoming budgetary plans at the time. The historical real-time estimates in Figure H.1 use figures from *SPUs* published in 2003–2006, while the latest figures are from *SPU 2018*.

While the historical real-time data show an underlying balance of close to zero for 2003–2006, an exception is the *SPU 2006* estimate for 2007, which indicates an underlying surplus of 2 per cent of GDP. The latest estimate shows an underlying deficit of 2½ per cent – a much less healthy budgetary position. However, 2007 is the only year from this period for which the revision to the underlying budgetary data is negative. Figure H.1 suggests that even in hindsight (except for 2007),

[58] Under the fiscal rules, structural balance adjustment requirements are formally set in the Spring of the previous year (year t-1) and can be reset only in Autumn t-1 or Spring t+1 (the *Vade Mecum on the Stability and Growth Pact 2018*). The 2017 requirements can now be reset following the publication of outturn data.

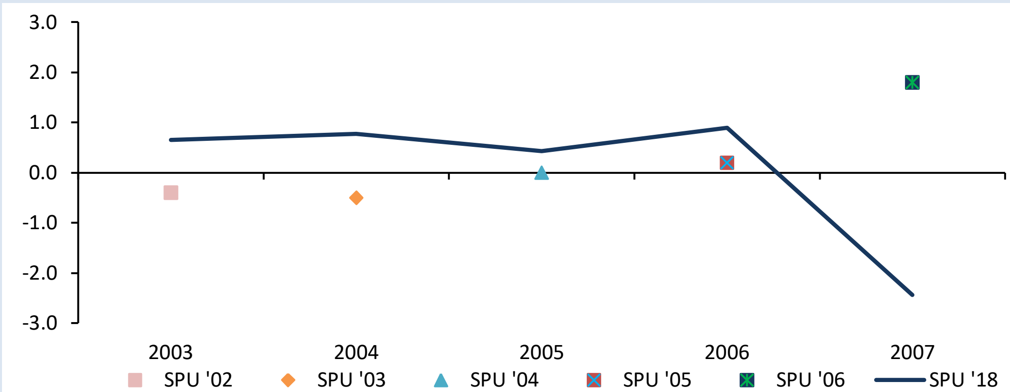
[59] European Commission (2007), page 5 of *Economic Assessment of the Stability Programme of Ireland* (update as of December 2006).

[60] European Commission *Autumn 2006* forecasts also showed compliance with the *Pact*.

the fiscal rules did not indicate concerns for the sustainability of the public finances.

Figure H.1: Cyclically Adjusted Budget Balance for the Pre-Crisis Years

Per cent of potential GDP

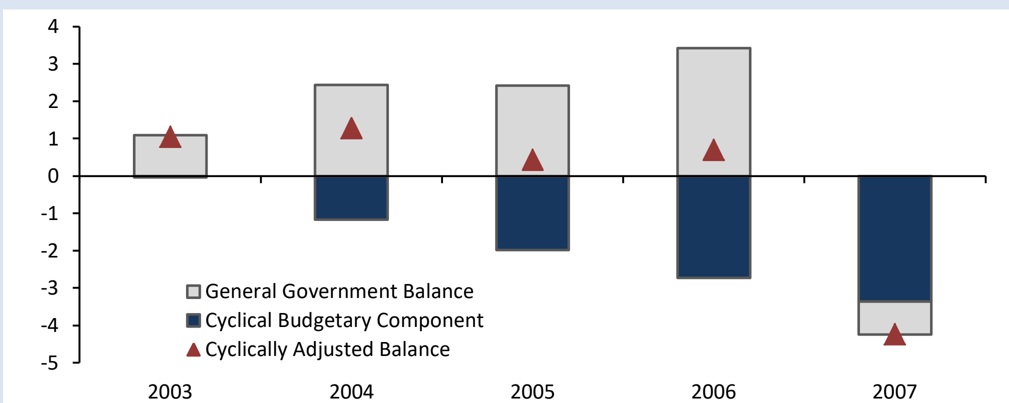


Sources: Department of Finance.
Note: Historical *SPU* estimates for the cyclical budgetary component have been re-estimated here using the most recently available 'budget sensitivity factor', 0.5275.

Furthermore, the latest estimate of the budgetary position for 2003–2006 provides even less indication of the difficulties that lay ahead, compared to real-time data. Figure H.2 shows the revisions in estimates of the underlying budget balance for years prior to the crisis, with differences allocated between revisions to the general government balance and cyclical budgetary components.[61] Prior to 2007, the general government balance (GGB) (grey) consistently outperformed prior-year *SPU* forecasts, but the current estimates suggest that this revision should have been viewed as primarily cyclical (blue).

Figure H.2: Change in Estimates of the Cyclically Adjusted Budget Balance

Per cent of potential GDP (GGB per cent of GDP)



Sources: Department of Finance.
Note: Historical *SPU* estimates for the cyclical budgetary component have been re-estimated here using the most recently available 'budget sensitivity factor', 0.5275.

The Fiscal Rules and Sustainability of the Public Finances

Various changes have been introduced to the fiscal rules since the crisis, with the intention of improving the sustainability of fiscal policymaking in the European Union. However, design issues

[61] The differences compare each year's ex-ante forecast (informing budget-day decisions) with the latest estimate. These are not typical forecast errors, in that actual estimates are never observed.

with the fiscal rules remain, and the risk of severe fiscal crises is a particular concern for Member States with volatile economies. For Ireland and other small open European economies, the strict application of the EU methodology may produce implausible estimates of the output gap, meaning the cyclical budgetary component can be prone to significant measurement error. Such issues have been explored in greater detail in previous Council publications (IFAC, 2017e). While successive governments have achieved considerable success in stabilising the public finances since the crisis, overall, fiscal policy in Ireland over the past 15 years shows that real-time compliance with the fiscal rules is no guarantee of sustainability in the public finances. Caution is therefore advisable in order to mitigate the risk of future fiscal crises.

4.2.2 Expenditure Benchmark

The preventative arm of the *SGP* is designed to guide public finances towards the MTO. Under the fiscal rules, once the MTO is attained the Expenditure Benchmark does not formally apply.[62] As such an assessment of adherence to the Expenditure Benchmark is not strictly required for 2017. The Council recommends continued adherence to the Expenditure Benchmark, estimated using appropriate estimates of potential growth and the NAWRU, as a minimum standard to provide an anchor for the public finances, given the advantages it offers in improving the sustainability of spending growth over time. The performance of spending in relation to the Benchmark for 2017 is briefly examined here.

For Member States at the MTO, the convergence margin no longer applies as part of the Expenditure Benchmark. As shown in Table 4.1, once the convergence margin is eliminated, as the MTO is achieved, spending is within the expenditure growth limit.

4.3 In-year Assessment for 2018

The most recent data suggests that the MTO was attained in 2017 (Section 4.2). The adjustment requirements and spending limits for 2018 were set by the European Commission in Spring 2017, when this achievement was not anticipated (based on CAM estimates of the output gap). The Commission will not formally lift these requirements until Spring 2019 and so there is still a possibility that revisions to the structural balance could lead to an assessment that the MTO was not achieved in 2017 and hence the adjustment requirements for 2018 still being assessed.[63] Given

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[62] Member States are not expected to over-achieve the MTO. Therefore, if the structural balance has exceeded the MTO in year t and budgetary plans do not jeopardise the MTO, deviations are not considered. However, the Expenditure Benchmark may still form part of the overall assessment of compliance with the fiscal rules (European Commission, 2018a).

[63] These requirements for 2018 could be reset only on two occasions: Autumn 2017 or at the Spring 2019 ex-post assessment.

that the MTO is currently estimated to have been achieved in 2017, however, the Council's assessment assumes that requirements outside of sticking to the MTO will not apply for 2018.

4.3.1 MTO and the Structural Balance Adjustment Requirements

The adjusted-CAM-based structural balance may widen to a deficit of 0.9 per cent of GDP in 2018 (Figure 4.1a); a deterioration from the MTO of 0.4 percentage points (Figure 4.1b). [64,65] This indicates there are risks to MTO achievement in 2018 using these output gap estimates, but any improvement in the balance to –0.75 or above will be deemed compliant with the MTO.[66] As the MTO has been reached in 2017, and the structural balance path is based on distance from the MTO in the previous year, it is likely the 2018 structural balance requirement will be revised in Spring 2019.[67] Therefore, in Spring 2019 the 2018 adjustment path will likely no longer apply (the dashed line in Figure 4.1b).

The 2018 structural balance deterioration is followed by a counteracting improvement in 2019. The path of the structural balance is largely due to the cyclical component, which is determined by large movements in the adjusted-CAM estimates of the output gap (Figure 4.2) against the background of relatively slow improvement in the general government balance. While compliance with the MTO and the domestic Budgetary Rules are important, the deterioration in 2018 is an artefact of the methodology used to calculate the cyclical adjustment and the deviation would be corrected the following year.[68]

[64] This planned change in the structural balance would not meet the previously set minimum required adjustment of 0.58 percentage points. Current estimates show a significant deviation in the adjustment path condition on a one- and two-year basis, compared to this requirement.

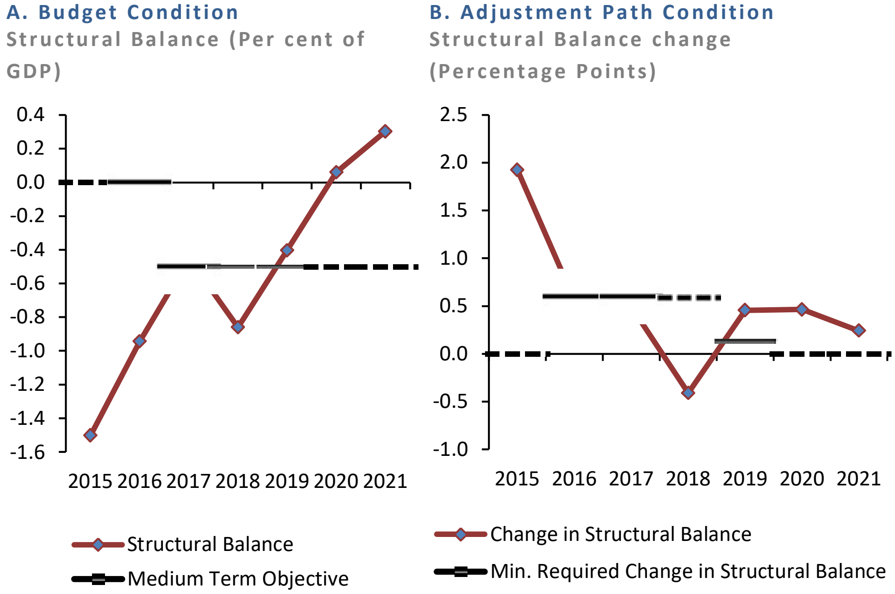
[65] Adjustments to the CAM were introduced by the Department of Finance in response to the higher-than-expected growth in 2017 outturns (Section 2.2).

[66] Under the Commission's current output gap estimates the 2018 structural balance (-0.6) is assessed as within the margin of tolerance for the MTO and 2018 is deemed broadly compliant.

[67] There is still a risk that in Spring 2019 the estimates of the structural balance will not show the MTO as met in 2017. This would lead to the previous adjustment requirement still applying.

[68] Estimates at the time of the *November 2017 FAR* (IFAC, 2017e) suggested that the output gap would fall from +1.6 to +0.7 per cent of potential GDP from 2017 to 2018. Given the pace of growth in the economy, the change in the output gap is more likely to be positive than negative over this period (Chapter 1 and 2). The most recent estimates of the output gap show an increase from +0.3 to +1.2 per cent of potential GDP from 2017 to 2018. The November 2017 FAR also examined issues in relation to estimates of the output gap using the CAM and its impact on the structural balance. Chapter 1 examines the implications for the structural balance and the Expenditure Benchmark of the alternative output gap estimates produced by the Department of Finance in *SPU 2018*.

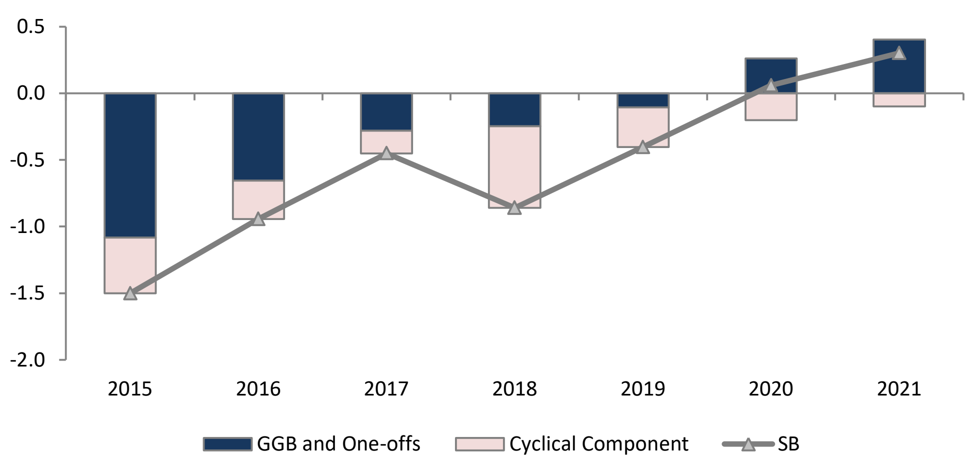
Figure 4.1: Assessment of Compliance with the Budgetary Rule



Sources: Department of Finance; and internal IFAC calculations.
Note: Dashed black lines indicate conditions that are not yet determined or are not expected to apply once the MTO has been reached. The minimum MTO for Ireland 2017-2019 is set at 0.5 per cent. This was achieved in 2017 and so the 2018 adjustment path condition is expected not to apply once requirements are re-examined in 2019. As there is a risk that the MTO will not be achieved in 2018, the adjustment path may still apply until the MTO is once again achieved. Required changes are calculated based on the previous year's structural balance.

Figure 4.2: Structural Balance Decomposition

Per cent of GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The cyclical budgetary component is estimated as: 0.5275 × output gap, where the output gap is the Department of Finance’s CAM-based estimate.

4.3.2 Expenditure Benchmark

When the MTO is reached, expenditure is no longer limited by the convergence margin and it can grow in line with estimated potential GDP growth.[69] However, limiting expenditure growth in line with the reference potential growth rate could ensure that the MTO is maintained. Assuming that requirements are reset in Spring 2019 such that the convergence margin no longer applies for 2018, planned spending is within the limit of permitted expenditure growth.[70]

4.4 *Ex-ante* Assessment for 2019–2021

This section assesses the Department's plans in terms of compliance over the period 2019–2021. The plans suggest that the MTO will be exceeded from 2019 onwards, albeit that the budgetary plans over this period could be looser than currently forecast (Chapter 1). The Debt Rule, which has been subject to transitional arrangements since 2016, will apply in full in 2019, but is likely to be a relatively less binding constraint, with the debt ratio expected to fall below the 60 per cent of GDP reference value in 2021.[71]

4.4.1 MTO and Structural Balance Adjustment Requirements

Current estimates suggest that the structural balance, which is at risk of deviation from the MTO in 2018, will return to within the MTO in 2019. The MTO was set for 2017–2019 at -0.5 per cent of GDP. Plans outlined in *SPU 2018* show a structural balance of -0.4 per cent of GDP in 2019 and overachievement of the MTO. Following the Commission's *Spring 2018 Forecasts,* there is an adjustment requirement of 0.1

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[69] As with the structural balance, the requirements of the Expenditure Benchmark cannot be formally reset by the European Commission until spring 2019 as part of its *ex-post* assessment. However, given the current 2017 estimate of the structural balance it is likely that the requirements will be reset, which will eliminate the convergence margin. The Expenditure Benchmark is still assessed as part of an overall assessment of compliance. If overachievement of the MTO is due to significant revenue windfalls, deviations in the Expenditure Benchmark will be considered (European Commission, 2018a).

[70] Assessing the expenditure plans in *SPU 2018* against the Commission's current requirements shows a planned breach of the Expenditure Benchmark on a one-year basis and a significant deviation on a two-year basis in 2018.However, on the basis of MTO achievement in 2017, it is likely these requirements will be reset.

[71] The transition arrangement was put in place for countries with a debt ratio greater than 60 per cent of GDP in the Excessive Deficit Procedure 8 November 2011. Over the transition period, countries are assessed on whether they are making sufficient progress towards debt criteria compliance. The adjustment over this three-year period is the least demanding after taking account of the effect of the cycle and the forward-looking rule, while still ensuring the debt rule is complied with by the end of the transition arrangements.

per cent of GDP in 2019 due to the forecast non-maintenance of the MTO in 2018.[72] Under the SPU plans this requirement is expected to be met. Provided the MTO is met and maintained no further adjustments would be required and deviations from previously set requirements would not be formally assessed.[73]

The MTO and adjustment requirements have yet to be set for 2020 and 2021. These requirements will be set in line with the European Commission guidelines (European Commission, 2018a) and will depend on the assessment of compliance in the preceding years, the general government balance and the estimates of the output gap. For detail on how the MTO is set, see Box F (IFAC, 2016a). Based on current estimates, the MTO would be maintained regardless of whether it remains at -0.5 per cent or if a more demanding target of 0.0 per cent is adopted.

4.4.2 Expenditure Benchmark

Given the risk of non-achievement of the MTO in 2018, the spending growth limit for 2019 under the Expenditure Benchmark will be reduced to ensure adjustment back towards the MTO. A "convergence margin" will apply, thus limiting expenditure growth to a pace below the ten-year average of potential output growth (the "reference rate") (as shown in Table 4.1). Once the MTO is achieved and maintained the convergence margin will not apply thereafter.[74] The plans outlined in *SPU 2018* currently show compliance with this requirement (2019–2021).

4.4.3 Debt Rule

The Debt Rule requirements will take full affect following the closing of the three-year transition period at the end of 2018. In essence the Debt Rule requires that the debt-to-GDP ratio should make annual progress towards the reference value of 60 per cent of GDP.[75] This rule is not likely to be a binding constraint on fiscal policy over the medium term. As outlined in Table 4.1, the reduction in the general government debt

[72] Although the structural balance for 2018 is assessed by the Commission to be within the margin of tolerance (within 0.25 per cent of the MTO), the Commission still requires the difference between this margin and the exact MTO to be adjusted for in the following year.

[73] While technically, under current requirements, there is an expected significant deviation in 2019 on a two-year basis, this is largely driven by the projected deviation in 2018. If the 2018 requirements are reset in Spring 2019 this two-year deviation is unlikely to still apply, as set out in Table 4.1. Furthermore, if the MTO was met in 2019 this requirement would not be formally assessed.

[74] The Expenditure Benchmark is still assessed as part of an overall assessment of compliance. If overachievement of the MTO is due to significant revenue windfalls, deviations in the Expenditure Benchmark will be considered (European Commission, 2018a).

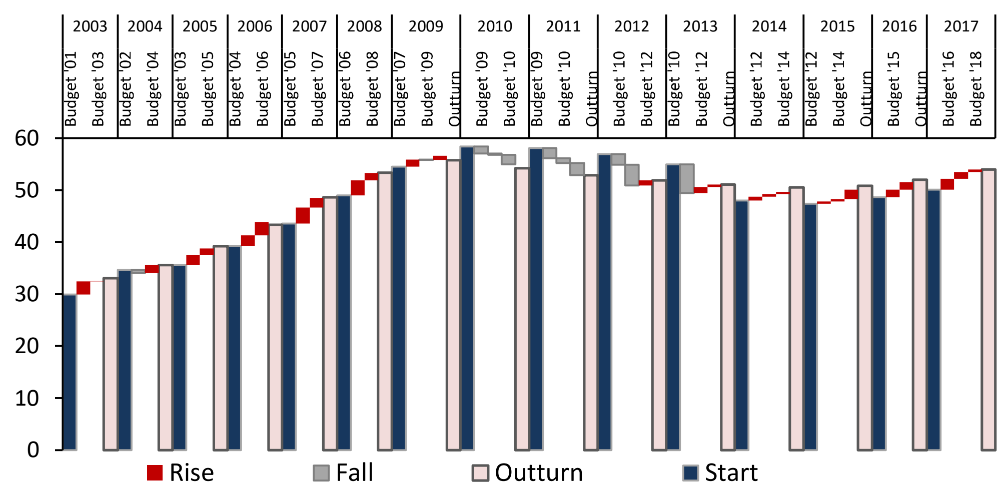
[75] The rule requires the debt ratio to fall by an average of one-twentieth of the excess between this limit and the actual debt ratio. For more information on the debt rule, see Howlin (2014).

is projected to exceed the requirements of the one-twentieth rule on the basis of existing plans and will fall below the 60 per cent of GDP reference value in 2021 after which the one-twentieth rule will no longer apply. Although the official assessment of the debt position under the rules is based on GDP, consideration should also be given to other measures such as the debt-to-GNI* ratio and debt-to-revenue due to the poor link between GDP and debt-servicing capacity for Ireland.[76]

4.5 Medium-term Expenditure Framework

Ireland's domestic budgetary framework is defined by the Medium-Term Expenditure Framework (MTEF). The MTEF was introduced to provide a better mechanism of expenditure management and certainty over the medium term. Under the MTEF the Government must provide three-year-ahead ministerial expenditure ceilings for each Department consistent with aggregate spending growth allowed under the Expenditure Benchmark. While these expenditure ceilings were designed to act as an upper limit for expenditure, aiding expenditure management and control, in practice repeated revisions to these ceilings impede their usefulness. Figure 4.3 below shows the pattern of revisions to expenditure forecasts since 2003, leading up the introduction of the MTEF in 2011, and following its introduction.

Figure 4.3: Evolution Gross Current Expenditure Forecasts
Percentage change (year-on-year)



Sources: Department of Finance; and 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).

[76] General government debt as a per cent of GNI* is expected to reach 86.8 per cent in 2021.

A clear cyclical pattern is visible, with increases in expenditure in the lead up to the crisis: a time characterised by strong, albeit unsustainable, growth. This was one of the factors leading to the introduction of the MTEF in 2011. Successive downward revisions of ceilings and ultimately lower outturns are seen following the crisis. Recently, the pattern of upward revisions to spending ceilings has returned. A continuation of such procyclical adjustments could undermine future public spending management. As noted in previous *Fiscal Assessment Reports* continuous upward revisions of ceilings reduce their credibility and contribute to the problem of a "soft budget constraint".[77] In turn, this can lead to further subsequent revisions in future. As discussed in Box I, the European Commission is seeking to strengthen medium-term fiscal sustainability in part through increased focus on the medium-term path of public expenditure.

Box I: The Medium-term Orientation of the Fiscal Framework

This box considers the possible implications of the proposed EU Council directive "laying down the provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States" (European Commission, 2017d). The proposal seeks to support medium-term planning to a greater extent by improving the medium-term focus of the fiscal rules, in particular in relation to the growth path for expenditure.

The Council, along with other members of the Network of EU Independent Fiscal Institutions (IFIs), welcomed this proposed directive in a statement by the Network.[78] While the proposed role of IFIs in determining the adequacy of the medium-term requirements has yet to be clarified, the greater focus on fiscal sustainability and the medium-term path of expenditure is broadly seen as positive by the Council.

Medium-term Fiscal Framework

The proposed directive requires strengthening of the medium-term fiscal framework in domestic legislation, to support fiscal sustainability. The suggested approach aligns to the existing structural balance and Expenditure Benchmark rules:

(i) The MTO would be set to achieve a ratio of government debt to GDP not in excess of the reference value of 60 per cent.

(ii) A new medium-term growth path of government expenditure net of discretionary revenue measures consistent with the MTO or adjustment path towards it.

The second part shifts focus from incremental expenditure planning to a medium-term outlook.

Greater Focus on Medium-term Expenditure Growth

Presently, the fiscal rules involve setting expenditure limits annually through the Expenditure

[77] The soft budget constraint, as originally formulated (Kornai, 1992), posits that a budget constraint is soft where the decision maker in control of day-to-day expenditure anticipates that the constraint is likely to be relaxed *ex-post* if the original constraint is not met, notwithstanding any ex ante threats to impose a hard constraint. Where the budget-setting process is weak, this may further 'soften' the constraint as the manager – knowing plans are poorly set – has less of an incentive to adhere to them.

[78] http://www.euifis.eu/images/STATEMENT_FINAL.pdf

Benchmark. The permitted expenditure growth rate is set in the Spring of the previous year on the basis of the European Commission Spring Forecasts.[79] In contrast, the new proposal would set the path for government expenditure growth at the start of a new government's term. This would then apply for the entirety of the government's term. This path would be set so as to ensure that fiscal plans adhere to the MTO or converge towards it over the medium-term.

The proposed changes have two key potential advantages:

- A less incremental year-by-year approach to expenditure plans and a more medium-term emphasis.
- Preventing contribution to expenditure drift over time, a feature of the current rules.

Expenditure drift occurs under the current fiscal rules because any deviation in spending in one year is built into the base for determining the expenditure limit in the following year. In the event of a positive deviation in expenditure, the annual approach sees expenditure grow from the higher level of spending (the opposite could also be true if the expenditure outturn were temporarily lower than allowable spending, leading to expenditure growing from a lower base). Such deviations could lead to a drift in expenditure over time to unsustainable levels.

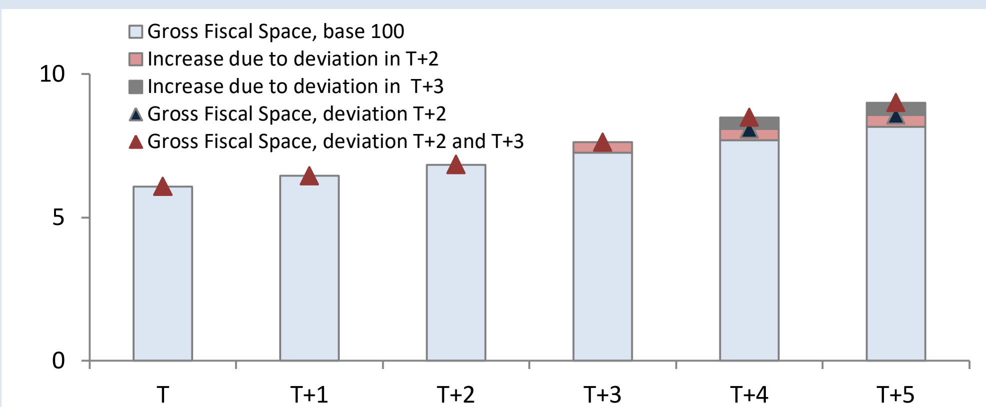
The proposed changes may eliminate this drift as the growth path of expenditure would be set at the outset of the government's term and actual expenditure could be assessed against this path. Any positive or negative deviation would need to be unwound the following year. This is important to avoid expenditure slippages being rewarded with higher spending in future years, and to avoid prudent policies whereby less is spent than allowed by the ceiling leading to permanently lower spending.

Illustration of How this Would Work

Figure I.1 provides an illustrative example of the possible impact of the proposed change. Assuming a new government is formed in period T and expenditure in T-1 was €100 billion. Given a reference rate of 4 per cent, a deflator of 2 per cent, and no convergence margin, the expenditure limit would be 6.1 per cent. Assuming this rate applies for the following five years, setting a medium-term path of expenditure for the term of the government would lead to gross fiscal space of €42.5 billion. This would be the case under the proposed rule changes.

Figure I.1: Illustrative scenario gross fiscal space under alternative spending paths

€ billion, change year-on-year



Sources: Internal IFAC calculations.
Notes: This scenario does not include any discretionary revenue measures.

However, if expenditure limits are reset annually, as under the rules presently in place, this path

[79] The real expenditure growth rate is set using a reference rate calculated using a forward- and backward- looking 10- year average of potential growth. Where a country is not at its MTO, a convergence margin is applied based on the required annual adjustment in the structural balance toward the MTO.

may change. If there was a deviation from allowable expenditure in T+2 by 5 per cent, leading to an outturn and new base of €125 billion for T+3, the gross fiscal space calculated for the period T to T+5 could be €43.7 billion. Furthermore, if there was a further deviation of 5 per cent in period T+3, the expenditure base for period T+4 would be €139.5 billion, and the gross fiscal space over the period T to T+5 would then increase to €44.5 billion. As such, deviations in expenditure from plans may lead to an increasing drift away from the original expenditure path.

Medium-term Budgetary Planning

The new approach under the proposed regulation could strengthen medium-term expenditure planning. As discussed above there are benefits in terms of fiscal sustainability as the new rules could ensure that deviations in expenditure are not built into the base. Furthermore, setting expenditure limits at the start of a government's term could allow for more certainty with regard to expenditure over the term. This could improve medium-term budgeting by providing more credible ceilings for expenditure hence avoiding the soft budget constraint (an issue discussed in previous Fiscal Assessment Reports for example see IFAC, 2017b, 2017d). Additionally, it could improve accountability under the rules as actual expenditure could be assessed against the planned expenditure path to identify deviations more accurately throughout the period.