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.

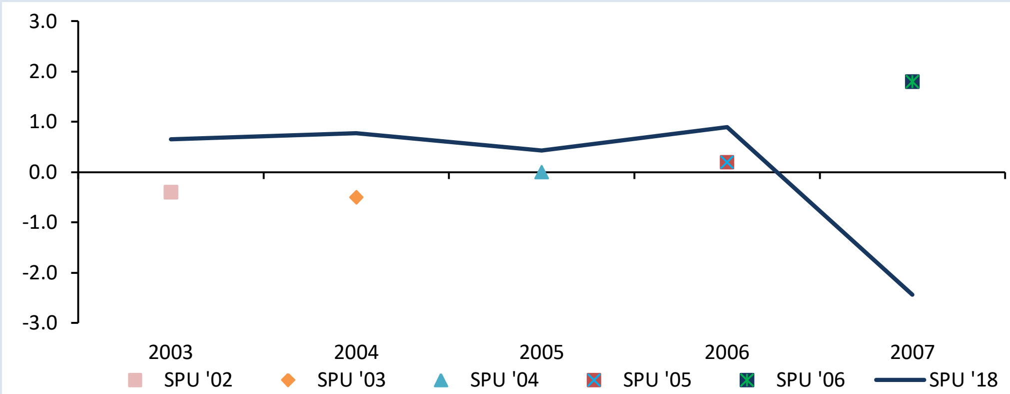
[59] European Commission (2007), page 5 of *Economic Assessment of the Stability Programme of Ireland* (update as of December 2006).

[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

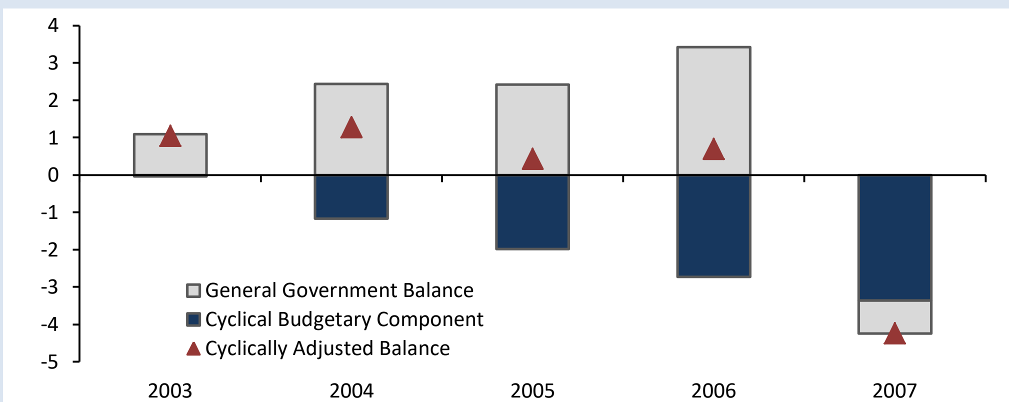


Sources: Department of Finance.
Note: Historical *SPU* estimates for the cyclical budgetary component have been re-estimated here using the most recently available 'budget sensitivity factor', 0.5275.

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

[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.