Assessment of Compliance with the Domestic Budgetary Rule in 2017

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Irish Fiscal Advisory Council

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Background

The *Fiscal Responsibility Act (FRA),* which came into effect in December 2012, established the Irish Fiscal Advisory Council (IFAC) as a statutory body and legislated for the implementation of national fiscal rules. These reforms were part of a wider agenda of budgetary reform, set out in the National Recovery Plan 2011-2014, the Programme for Government 2011 and the EU-IMF Programme of Financial Support for Ireland.

Under the *FRA*, part of the mandate of IFAC is to monitor and, at least once in each year provide an assessment of compliance with the Domestic Budgetary Rule.[1] This publication outlines the Council's assessment for the previous year based on data available as of spring including the Maastricht returns (i.e., the first official outturns for the previous year's annual general government statistics) and preliminary GDP data for the previous year (Q4 Quarterly National Accounts). For further information on the Domestic Budgetary Rule see Appendix 1 of the *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule in 2016* (IFAC, 2017).

[1] *FRA* Section 8(2) specifies the Council's role as to "monitor, and at least once in each year, provide an assessment of, whether any obligation under section 2(1)(a) or 6(1), or to do things specified in a plan under section 6(1), is being complied with". Section 2(1)(a) relates to the Budgetary Rule and notes: "the Government shall endeavour to secure that—(a) the requirement imposed by section 3 (the budgetary rule)…are complied with". Section 6(1) covers the "Correction Mechanism", that sets plans to secure compliance with the Budgetary Rule when not met: "if the Commission addresses a warning to the State under Article 6(2) of the 1997 surveillance and coordination Regulation or if the Government consider that there is a failure to comply with the budgetary rule which constitutes a significant deviation for the purposes of Article 6(3) of that Regulation, the Government shall, within 2 months, prepare and lay before Dáil Éireann a plan specifying what is required to be done for securing compliance with the budgetary rule".

Main Assessment Table

Table 1 outlines the main information relevant for assessing compliance with the Domestic Budgetary Rule in 2017. Initially, the Budget Condition is assessed (i.e., whether the structural balance is at the Medium-Term Objective (MTO) requirement). Then, if the MTO has not been reached, the Adjustment Path Condition is assessed (i.e., whether the required pace of convergence towards the MTO is achieved).

IFAC assesses the MTO as reached in 2017 on the basis of the European Commission's Commonly Agreed Methodology (CAM) output gap estimates.[2]

Table 1: Summary of Assessment of Compliance for 2017

	Required/ Limit	Actual	Compliant	Deviation (% GDP)	Deviation (€bn)	Siginificant Deviation[a]
A. Budget Condition						
Structural Balance (% GDP)	-0.5	0.0	Yes, At MTO			
B. Adjustment Path Conditions						
I. Change in Structural Balance						
One-year change (p.p.)	-	-	N/A	-	-	N/A
Two-year avg. change (p.p.)	-	-	N/A	-	-	N/A
II. Expenditure Benchmark (Limit)[b]						
One-year growth rate (%)	-	-	N/A	-	-	N/A
Two-year avg. growth rate (%)	-	-	N/A	-	-	N/A

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's *April 2018 Annual Government Finance Statistics* publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission (*Spring 2018*). Requirements under the rules may be reset in certain conditions, including achievement of the MTO. N/A's refer to when compliance is not assessed. Overachievement of the MTO is not required and so the structural balance adjustment is not assessed. Member States that have exceeded their MTO do not need to be assessed for compliance with the Expenditure Benchmark. [a] A "significant deviation" is the term for the threshold that determines potential triggering of sanctions. [b] The Expenditure Benchmark requirement is set as a growth limit in real terms.

[2] The European Commission's CAM-based output gap estimates (*Spring 2018)* are used by the Commission in formal legal assessments of compliance with the fiscal rules. The Council (and the Department of Finance) have raised repeated concerns regarding the usefulness of these estimates in determining the actual cyclical position of the Irish economy. In *SPU 2018* the Department implemented an adjustment to the CAM to take account of high growth seen in 2017, in part due to a "surge" in contract manufacturing. The 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.

1. Budget Condition

The Budget Condition requires that the structural balance is in balance or in surplus. This condition is deemed to be respected if the structural balance is at the MTO as set under the Preventative Arm of the Stability and Growth Pact. If the Budget Condition requirement is not met, the structural balance is subject to the Adjustment Path Conditions discussed in Section 2. If failure to meet the requirement is the result of exceptional circumstances, and provided that it does not endanger medium-term fiscal sustainability, it is permitted.

Current estimates suggest the Budget Condition (i.e., the MTO) was met in 2017. For the 2017 assessment, a structural balance of -0.5 per cent of GDP applies as Ireland's MTO. The structural balance for 2017 is currently estimated as- 0.02 per cent of GDP. Therefore, these estimates show the MTO was met in 2017.

Table 2: Budget Condition
Per cent of GDP

	Requirement (MTO)	Actual	At MTO?
A. Budget Condition			
Structural Balance 2016	0.0	-1.7	No
Structural Balance 2017	-0.5	-0.0	Yes

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The 2016 structural balance assessment is held constant as in the *Ex-Post* Assessment carried out in May 2017 (IFAC, 2017). All fiscal outturns are taken from the CSO's *April 2018 Annual Government Finance Statistics* publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission (*Spring 2018*). Requirements under the rules may be reset in certain conditions, including achievement of the MTO.

The Council assess that achievement of the MTO was not due to windfall revenues. Achievement of the MTO should be assessed taking into account revenue windfalls. If overachievement of the MTO were due to revenue windfalls, the Expenditure Benchmark would still apply. The long-term sustainability of certain revenues, in particular corporation tax, is uncertain. However, Coffey (2017) notes the 2015 level shift in corporation tax receipts is likely to be sustainable in the medium-term to 2020. While the Council assesses that these revenues are not deemed to be windfalls as per the methodology applied in the assessment of the Domestic Budgetary Rule, considerable concerns remain about the long-run sustainability of these receipts.

2. Adjustment Path Condition

The Adjustment Path Condition of the Domestic Budgetary Rule does not apply in 2017. The Adjustment Path Condition is a requirement which applies when the MTO is not met. As the MTO was achieved in 2017, and this achievement is not deemed contingent on windfall revenues, the adjustment requirement is no longer assessed as applying (Table 3).

Table 3: Adjustment Path Conditions

	Required/ Limit	Actual	Compliant	Deviation (% GDP)	Deviation (€bn)	Siginificant Deviation[a]
B. Adjustment Path Conditions						
I. Change in Structural Balance						
One-year change (p.p.)	0.60	0.79	**N/A**	**-**	**-**	**N/A**
Two-year avg. change (p.p.)	0.60	0.55	**N/A**	-0.05	-0.15	**N/A**
II. Expenditure Benchmark (Limit)[b]						
One-year growth rate (%)	1.23	3.09	**N/A**	-0.43	-1.27	**N/A**
Two-year avg. growth rate (%)	0.66	0.94	**N/A**	-0.05	-0.13	**N/A**

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's *April 2018 Annual Government Finance Statistics* publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices 2 and 3). Estimates of the Output Gap are as reported by the European Commission (*Spring 2018*). Requirements under the rules may be reset in certain conditions, including achievement of the MTO. Requirements in this table are those set prior to MTO achievement. Overachievement of the MTO is not required and so the structural balance adjustment is not assessed. Member States that have exceeded their MTO do not need to be assessed for compliance with the Expenditure Benchmark. N/A's refer to when deviations or compliance is not assessed.
[a] A "significant deviation" is the term for the threshold that determines potential triggering of sanctions in the domestic and EU fiscal rules. It equates to a threshold of ≥0.5 per cent of GDP for one-year or an average of ≥0.25 per cent of GDP for two years. As the second year since Ireland exited the EDP, 2017 would have been the first year the two year deviation was applicable for Ireland. However, due to the MTO having been met in 2017, on the basis of current estimates, the structural balance adjustment requirement and compliance with the Expenditure Benchmark is not assessed.
[b] The Expenditure Benchmark requirement is set as a growth limit in real terms.

3. Fiscal Stance as Indicated by the Structural Primary Balance

As well as formally assessing the Domestic Budgetary Rule the *FRA* requires the Council to assess the fiscal stance. The fiscal stance is defined in the *FRA* as the change in the annual structural primary balance of general government. The primary balance, in Table 4, describes the general government balance excluding interest costs, which are outside of the control of the Government, and one-off items. This is then further adjusted for the impact of the cyclical position of the economy. As such, it is seen as an appropriate measure of the fiscal stance. This section uses the Department of Finance's estimates of the output gap to examine the change in the structural primary balance. A detailed discussion of the fiscal rules and an assessment of the fiscal stance will be provided in the Council's forthcoming *June 2018 Fiscal Assessment Report*.

Table 4: Indicators of the Fiscal Stance

Per cent GDP, unless stated

	2015	2016	2017
Primary Balance (excl. one-offs)			
Level	1.5	1.6	1.7
Change (p.p)		0.1	0.1
Structural Primary Balance (Department of Finance, CAM-Based Output Gap)			
Level	1.1	1.3	1.5
Change (p.p)		0.2	0.2
Structural Primary Balance (Based on Department of Finance Preferred Output Gap Estimates)			
Level	2.8	2.9	2.5
Change (p.p)		0.1	-0.4

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: All fiscal outturns are taken from the CSO's *April 2018 Annual Government Finance Statistics* publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices 2 and 3). Estimates of the Output Gap are as per the Department of Finance in *SPU 2018.*

CAM estimates would suggest the Structural Primary Balance was broadly unchanged in 2017, whereas the Department's preferred alternative estimates would suggest a deterioration. Using the CAM, estimates of the output gap show the economy above but converging towards potential in 2017. Adjusting the primary balance for the cyclical position of the economy leads to an improvement of +0.2 percentage points in the structural primary balance. Without accounting for the cyclical position of the economy, the primary balance tells a similar story with a slightly smaller improvement of 0.1 percentage points. Using the alternative output gap outlined in *SPU 2018* as the Department's preferred measure gives a similar change in the structural primary balance in 2016 of 0.1 percentage points but a deterioration of 0.4 percentage points in 2017.[3] The Council's own estimates of the cyclical position of the economy (Casey, 2018) would suggest a slight deterioration in the structural primary balance in 2017.

[3] To obtain a structural primary balance using the alternative estimates of the output gap, the same semi-elasticity of the deficit to the output gap used for CAM-based estimates is used (i.e., a semi-elasticity of 0.53).

Appendix 1: Information on One-Offs

Following a request from the Council, this Appendix contains the information on one-offs provided by the Department of Finance for the purposes of assessing compliance with the Domestic Budgetary Rule:

Item	**2015 Impact (€m)**	**2016 Impact (€m)**	**2017 Impact (€m)**	**Rationale**
AIB reclassification	-2,113*			One-off Eurostat treatment of expt
EFSF		554*		A prepaid margin on the borrowings from the European Financial Stability Facility was repaid to the exchequer.
Refund of domestic water charges			-178*	
EU Budget Own Resource Decision		-170*		Expt that has a transitory budgetary effect.
Other	607			
Total Impact on General Government Balance	**-1,506**	**384**	**-178**	

* Items marked with an asterisk are those that are also assessed by the Council as being applicable and equate to a total impact of €2.1 billion for 2015 (the AIB reclassification) -€0.38 billion for 2016 (incorporating the European Financial Stability Facility (EFSF) and EU Budget Own Resource Decision), and €0.18 million for 2017 (refund of domestic water charges) .

Appendix 2: Detail on Discretionary Revenue Measures

On request from the Council, this Appendix contains the information on Discretionary Revenue Measures that was provided by the Department of Finance for the purposes of assessing compliance with the Domestic Budgetary Rule.

Item and Details	**2016 Impact (€m)**	**2017 Impact (€m)**
Budget 2015 carryover	-193	
Carry over from previous budgets	-141	
Budget 2016 measures	-332	
Budget 2016 carryover		-176
Carry over from previous budgets		62
Budget 2017 measures		90
Budget 2017 carryover		
Carry over from previous budgets		
Budget 2018 measures		
General Government Measures	-61	-49
Total Impact on GGB	**-727**	**-74**

Note: DRMs are based on the figures contained in the Draft Budgetary Plans.

Bibliography

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