

### **Box A: Measuring Government Stimulus using Net Policy Spending**

To better understand how much stimulus the government is providing by way of its budgetary decisions, it is important to look at the sum impact of a government's budgetary decisions. This means focusing, not just on spending changes, but on tax changes too. This box explores a way to gauge the government's budgetary stance that relies on an adjusted measure of spending: "net policy spending". Based on the adjusted measure of net policy spending, the pace of annual budgetary increases in 2018 and 2019 looks to be fast, and beyond what can be deemed as prudent or sustainable.

#### **What is Net Policy Spending?**

Net policy spending measures total government spending, with some adjustments made to get a truer reflection of what is under the control of the government and to allow for offsetting tax changes. The measure is similar in many respects to what is considered under the spending rule (the Expenditure Benchmark's corrected expenditure aggregate), but there are a number of important differences.

Starting with general government Total Expenditure ( $TE$ ), we deduct interest costs ( $i$ ), one-off expenditure items (*oneoffs*), and estimated cost/savings on unemployment benefits arising from the cycle (*cyclical\_benefits*).<sup>1</sup> Removing interest costs is useful when these: (i) reflect past decisions rather than current policies (i.e., depend on the stock of debt); (ii) are volatile or unpredictable; (iii) are important from an economic perspective (Ireland's interest payments traditionally flow more to non-resident than resident holdings); and (iv) reflect the inflation-interest nexus (high interest costs in times of high inflation may overstate the extent of the deficit that would prevail in a low-inflation environment, especially when real interest rates diverge from real growth rates). Investment could be treated differently, as in the "Golden Rule". However, both investment and current spending contribute to demand, both impact the wider government balance sheet, and certainty on the supply-side benefits would be needed to treat investment differently. Also, public investment levels are planned to ramp up from low levels so that the increase in the level is likely to persist rather than to be the result of temporary increases, which might warrant smoothing.

When considering the growth rate of this measure in a given year, we also recognise the efforts made by a government to offset spending increases with new tax measures. We do so by

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<sup>1</sup> General government data is broader than the Exchequer data often given more domestic focus. General government data include the Social Insurance Fund and expenditure of all arms of government, whereas the Exchequer represents only a portion of total government.

including a further adjustment for Discretionary Revenue Measures (*DRMs*) in the current year “t”, and by comparing this against the same measure without the DRM adjustment in the previous year “t-1”. Broadly speaking, these DRMs are the total tax-raising or tax-reducing measures that a government may introduce, at its discretion, in a given year.<sup>2</sup> The adjustment for DRMs means that we are considering *net* spending by a government rather than just one side of the government’s budget.<sup>3</sup>

The measure is given by:

$$\text{Net Policy Spending} = TE - i - \text{oneoffs} - \text{cyclical\_benefits} [-\text{DRMs}]$$

where DRMs are deducted in year t but not in year t-1 when obtaining growth rates. Total expenditure and interest costs are obtained from the CSO, but one-offs, cyclical benefits and DRMs are all Department of Finance estimates.<sup>4</sup>

The measurement of cyclical benefits also deserves careful consideration. The Expenditure Benchmark estimates this item of spending on the basis of estimates of the natural rate of unemployment, which are highly procyclical and implausible (Casey, 2018). A better way to get at changes in these costs is to assume that the natural rate of unemployment does not change so frequently from year to year. While this assumption may be inappropriate for the medium to long term, it is a reasonable assumption for assessing short-run developments. We therefore consider a natural rate of unemployment that is constant at 5.5 per cent—the level that the Department of Finance often assumes the economy will converge to over the medium term.<sup>5</sup> In sum, the measure considered here uses the one-offs assessed as applicable by the Council, cyclical benefits calculated on the basis of an unchanged natural rate of unemployment, and DRMs as estimated by the Department of Finance.

### **Net policy Spending Increases in Recent Years**

The real net policy spending measure shows a pace of spending increases in recent years at rates of 3½–5 per cent each year (Figure A.1). In 2015—when large within-year spending increases were introduced—the growth rate was 4.5 per cent. The pace of spending growth was similar in 2016 and 2017 before climbing to 5 per cent in 2018 and a currently forecast growth rate of 3.4 per cent for 2019. This compares to planned real increases of 3.5 per cent and 2.7 per cent in 2018 and 2019, respectively, based on the earlier *Summer Economic Statement 2018* and *SPU 2018* plans. Note that the faster pace of primary expenditure growth in recent years is dampened by revenue-raising measures that are included in the net policy spending measure.

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<sup>2</sup> The impact of non-indexation is included from 2014 onwards, but not for previous years.

<sup>3</sup> Bedogni and Meaney (2017) also consider the government budgetary stance in terms of the growth in corrected expenditure using the Expenditure Benchmark adjustments. However, they do not alter the treatment of estimates of cyclical unemployment, which is important given that these tend to be estimated in a procyclical manner, nor the smoothing of public investment.

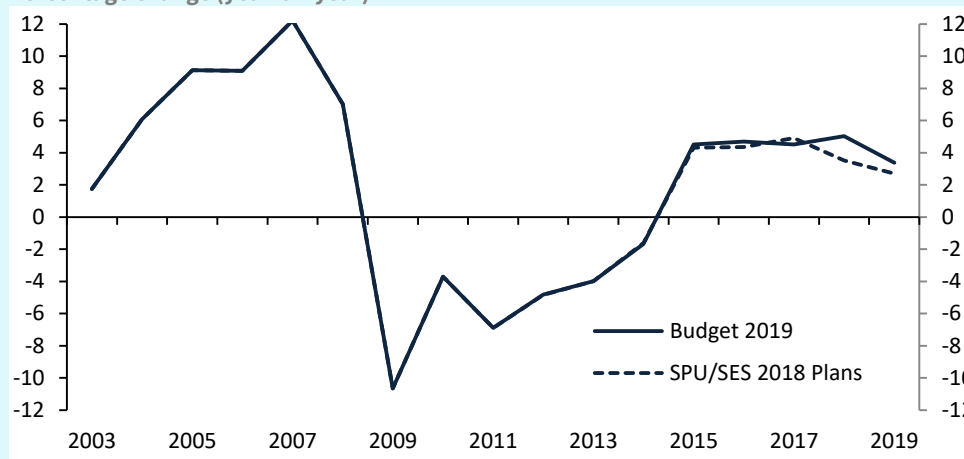
<sup>4</sup> The Council assesses the Department’s one-offs and DRMs, e.g., Box H (IFAC 2017c). The full-year DRM impact is used here and is typically larger than the estimated first-year cost (e.g., due to the timing of a measure’s introduction meaning a shorter window in the first year). A notable inclusion in DRMs often ignored is “non-indexation”: the additional revenue raised by government from individuals who see their tax bill increase as they drift into higher tax bands when incomes rise. Both one-offs and DRMs form a key part of the calculations of the fiscal rules, and are thus prone to “fiscal gimmickry”. Alt *et al.* (2014) and Koen and Van den Noord (2005) explore how numerical fiscal rules can create incentives for governments to use one-off items strategically. Box D (IFAC, 2014b) explores one-offs in detail.

<sup>5</sup> Note that, as in the fiscal rules, this is compared with the actual unemployment rate to estimate the amount of cyclically unemployed individuals that exist, while average unemployment benefits per person are derived from the latest annual outturn for Eurostat data on unemployment expenditure (COFOG99 item GF1005) and Labour Force Survey data on numbers unemployed.

### Sustainable Budgetary Increases

One way to gauge whether budgetary decisions are sustainable or not is to compare the growth in this net primary spending measure against what can be deemed “sustainable” over the medium to long term. The estimates of potential output growth rates developed by the Department of Finance and the Council indicate central estimates of 2.5 per cent and 3.5 per cent, respectively using the same demand-side forecasts. Assuming a one-to-one relationship between domestic economic growth and revenue growth, this would imply sustainable growth rates in the region of 2.5 to 3.5 per cent per annum on a real basis. Compared to this range, the recent annual real net policy spending increases averaging approximately 4.2 per cent in 2018 and 2019 look to be outside of what might be deemed as prudent. This could spell risks for the sustainability of these spending increases, especially if the pattern is repeated over a number of years.

**Figure A.1: Real Net Policy Spending Increases in Recent Years**  
Percentage change (year-on-year)



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

Note: Real Net Policy Spending = total general government expenditure less interest, one-offs, cyclical unemployment benefits, and discretionary revenue measures. It is HICP-deflated. Cyclical unemployment benefits are calculated on the assumption of an unchanged natural rate of unemployment of 5.5 per cent.