

### **Box E: Fiscal Rules under Department of Finance's Alternative Output Gap Estimates**

This box assesses the implications for the fiscal rules if they were applied using the Department of Finance's alternative estimates of the output gap rather than the EU's Commonly Agreed Methodology (CAM).

The CAM-based estimates of the output gap have a number of shortcomings and can lead to implausible estimates of the output gap, particularly for small, open economies such as Ireland. Consequently, the Department has recently developed a new suite of supply-side models of the Irish economy to estimate the output gap. The Department's preferred estimate of the output gap is the mid-point of a suite of GDP-based estimates of the output gap, yet they also produce a suite of Domestic GVA-based estimates. Below, adherence with the MTO and the Expenditure Benchmark is assessed on the basis of both of the alternative estimates of the output gap.<sup>1</sup>

#### **MTO and Structural Balance Adjustment Requirements<sup>2</sup>**

The MTO is designed to provide a safety margin with respect to the headline deficit limit of 3 per cent of GDP and to allow for debt ratios to converge towards prudent levels. It also gives consideration to the stage of the economic cycle, and the economic and budgetary impact of ageing populations. It is designed to allow room for budgetary manoeuvre, in particular taking into account public investment needs. The MTO for Ireland is currently set at a structural deficit of no greater than 0.5 per cent of GDP.

A comparison of structural balance estimates using the different alternative output gap estimates is shown in Figure E.1. Estimates of the structural balance based on the Department's GDP-based output gap (see Chapter 2, Figure 2.1.A) show that the MTO would have been achieved as early as 2015 had it applied, though estimates using the Department's other alternative (based on Domestic GVA) only show compliance from 2017. CAM-based estimates show that the MTO was achieved in 2017.

All of the estimates show deterioration in the structural balance from 2017 to 2018. The most severe deterioration is shown by the CAM-based estimates, where the closing of the negative output gap is more pronounced. This reflects strong real GDP growth, which is distorted by the activities of foreign-owned multinational enterprises. More plausibly, the Domestic GVA-based estimates would show a smaller closing of the output gap over the same period. Both sets of alternative estimates would suggest that, while there have been improvements in the cyclical position of the economy, it would appear that there has not been a comparable improvement in the headline budget balance.

By way of illustration, Figure E.2 shows the decomposition of the structural balance from 2014 to 2019 for the GDP-based alternative output gap estimates. The structural balance remains relatively unchanged from 2018 to 2019, with a minor negative cyclical budget component being offset by improvements in the General Government balance. The cyclical budgetary component arising from the alternative estimates is less erratic than the CAM-based equivalent (Figure 4.2) and is consistent with the output gap closing in 2018 and turning positive in 2019. The alternative GDP-based estimates show the MTO being adhered to over the

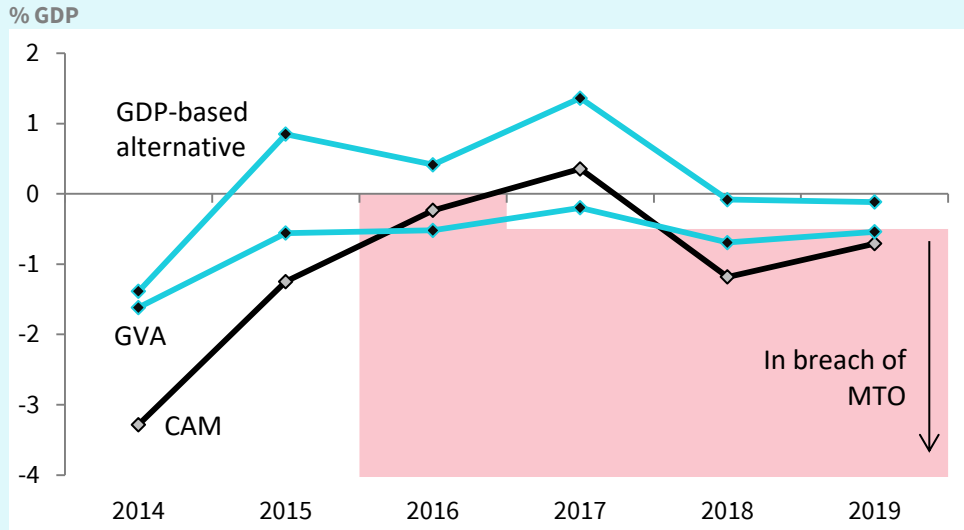
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<sup>1</sup> Assessments of the Debt Rule based on the backward and forward looking benchmarks are independent of the estimates of the output gap. Assessment of compliance with the cyclically-adjusted Debt Rule, which is based on estimates of the output gap, only comes into effect if both the backward-looking and forward-looking benchmarks are breached. As a result, compliance with the Debt Rule, based on the alternative estimates of the output gap, is not assessed in this box. See Box F for details on the Debt Rule.

<sup>2</sup> Consistent with the rest of Chapter 4, the one-off of €0.7 billion in corporation tax in 2018 is included in the structural balance.

period 2015–2019. As the MTO would be adhered to on the basis of these estimates, there would be no adjustment requirements for these years.

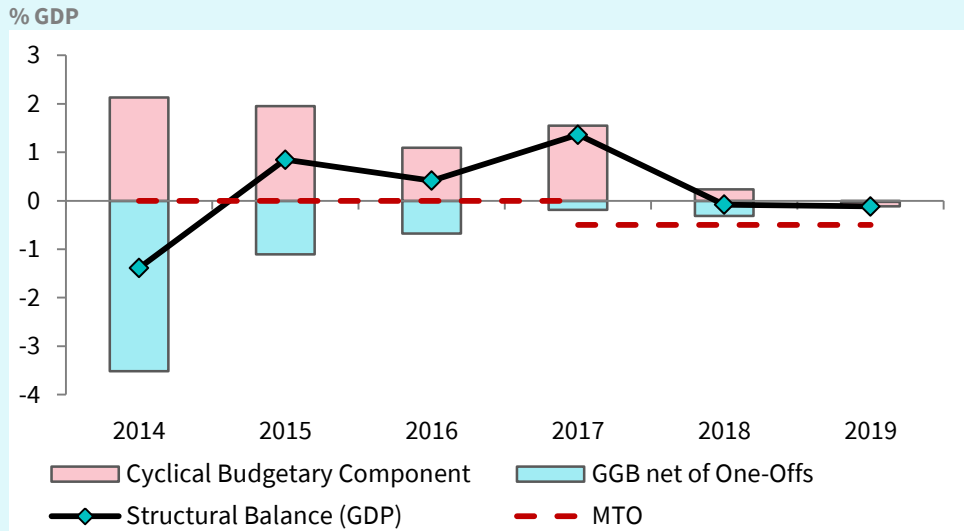
**Figure E.1: Structural Balance Estimates with Alternative Output Gaps**



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

Note: The structural balance is derived on the basis of estimate of the output gap using the CAM; the Department’s preferred GDP-based alternative; and the Department’s GVA-based alternative. The cyclical budgetary component is estimated as:  $-0.5275 \times$  output gap in each case and is added to the general government balance less one-off items.

**Figure E.2: Structural Balance Decomposition Based on the Department’s GDP Estimate of the Output Gap**



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

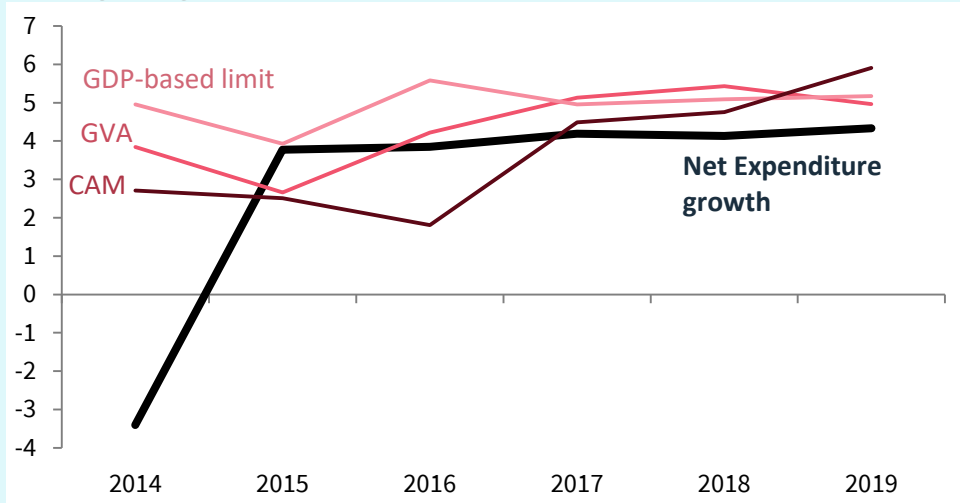
Note: The cyclical budgetary component is estimated as:  $-0.5275 \times$  output gap, where the output gap is the Department of Finance’s GDP-based estimate.

### Expenditure Benchmark

The second pillar of the fiscal rules is the Expenditure Benchmark. Figure E.3 shows a comparison of the Expenditure Benchmark based on the Department’s CAM-based estimates and the Department’s two alternative sets of estimates of potential output over the period 2015–2019.

Net expenditure growth would have been below the limit set by the Department’s GDP-based estimates of the Expenditure Benchmark for all years in the forecast horizon. Calculations of the Expenditure Benchmark limit using the Department’s GDP-based estimates of potential are less volatile than the CAM-based estimates over this period, and provide a more plausible path for expenditure growth over the medium-term, than the CAM-based estimate, although there are a number of issues with the operation of the Expenditure Benchmark (see below, and section 4.2.2).

**Figure E.3: Spending Growth and Alternative Expenditure Limits**  
Percentage change (year-on-year)



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

Note: Net expenditure growth is an adjusted measure that is net of discretionary revenue measures. The CAM-based limit includes reference rates that have been frozen by the European Commission. Consistent with the Council’s assessment, these limits do not incorporate a negative convergence margin though the rules as applied by the Commission allow for this to happen (i.e., if a Member state overachieves its MTO in year  $t-1$ ).

While the Expenditure Benchmark is excessively pro-cyclical (Casey *et al.* 2018), the Council recommends at least meeting the Expenditure Benchmark, without the application of a negative convergence margin — as a minimum standard — based on the Department’s GDP-based estimate of potential output as these provide a more stable growth path for expenditure.<sup>3</sup> However, it is clear from recent years that the limits being set by the Expenditure Benchmark are still quite high, and that the adjustments made under the Expenditure Benchmark are serving to produce actual spending growth rate estimates that are lower than might otherwise be the case if measured appropriately. This is particularly true in relation to adjustments made for increases in public investment. While the rules smooth recent increases to allow for temporary fluctuations, increases in public investment in Ireland in recent years are part of a trend increase intended to bring investment levels to a higher steady state level.

<sup>3</sup> However, the legal requirement for compliance with the Expenditure Benchmark is based on the CAM-based estimate of potential output.