Chapter 4

Assessment of Compliance with Fiscal Rules

4. Assessment of Compliance with Fiscal Rules

Key Messages

- The Department of Finance's *Budget 2019* forecasts indicate that Government plans were not consistent with complying with the fiscal rules for 2018 and 2019. Based on estimates presented in *Budget 2019*, the Medium-Term Objective (MTO) of a structural deficit of no more than 0.5 per cent of GDP will not be met in 2018 following a sizeable deterioration in the CAM-based estimate of the structural balance, now forecast to deteriorate to a deficit of 1.2 per cent of GDP. This largely reflects changes to the estimated output gap, and the volatility of the current estimates, with the output gap estimated to increase by 2.6 percentage points in 2018.

- The MTO requirement would not be met in 2019 either, with a structural deficit of 0.7 per cent of GDP. Revisions to the CAM output gap and further risks of slippage (including overruns in spending) might worsen the forecasted breach of the MTO.

- The MTO was achieved, for the first time, in 2017. Significant revisions to the CAM output gap estimates contributed to an improvement of the structural balance for 2017. This resulted in a structural surplus of 0.4 per cent of GDP for 2017.

- Net expenditure growth for 2018 is likely to be below the Expenditure Benchmark limit. In 2019, net expenditure growth is expected to be 4.3 per cent, which is below the 5.9 per cent increase allowed under the Expenditure Benchmark. However, there are risks of slippage and the Expenditure Benchmark limit may be breached if expenditure overruns occur, e.g. Department of Health overruns or unbudgeted welfare increases (like the Christmas Bonus).

- The Council welcomes the Department of Finance's alternative estimates of potential output. The Council recommends at least meeting the Expenditure Benchmark based on these estimates as a minimum standard.

This would help to ensure that spending growth is in line with sustainable and prudent budget management.

- Estimated compliance with the rules can reflect volatility in the CAM estimates of the output gap between years. The estimates have been revised significantly over the past year. Yet the rules do point towards the lack of progress in the underlying budgetary position in recent years, despite favourable growth. There has been a consistent pattern of upward revisions to expenditure ceilings in recent years, which echoes mistakes of the past.

- The Council assess that setting an appropriate debt commitment would be helpful, taking into account sustainability concerns. The commitment should be well specified. It should be time limited with a specific date by which the objective should be achieved and it should be clearly specified whether the commitment would be a target or a ceiling.

4.1 Introduction

The Council's mandate includes assessing compliance with Ireland's Domestic Budgetary Rule as set out in the *Fiscal Responsibility Act 2012* and the EU fiscal rules as set out in the *Stability and Growth Pact*. This chapter examines the consistency of the projections contained in *Budget 2019* with the Preventative Arm of the *Stability and Growth Pact*. In particular, it examines compliance in relation to the Medium-Term (Budgetary) Objective (MTO), the Expenditure Benchmark and the Debt Rule.[1]

The assessment of the rules in this chapter is based on the Department of Finance's estimates in *Budget 2019* using the EU Commonly Agreed Methodology (CAM) and considering the Council's own assessment of one-off/temporary measures.[2,3] *Budget 2019* included a one-off windfall of €0.7 billion for corporation tax in 2018 and this is incorporated in the Council's assessment of the fiscal rules.[4] Table 4.1 provides a summary assessment of compliance with the fiscal rules.

[1] The Debt Rule is due to come into force in full, for Ireland, in 2019, after the end of the three year transition period from 2016-2018. See Section 4.4.4 and Box F for details.

[2] A number of issues make the CAM output gap less plausible for Ireland. See Box E of the November FAR (IFAC, 2017e) for details. As a result, the Department of Finance recently developed alternative models of potential output, which appear more plausible, on which the Department base their budgetary figures. However, the legal requirement for assessment of the fiscal rules is based on the EU Commonly Agreed Methodology.

[3] Since the publication of *Budget 2019*, the European Commission have deemed that additional adjustments to the methodology for producing estimates of the CAM potential output would be necessary for Ireland. These adjustments are reflected in the Commission's Autumn 2018 forecasts, but are not reflected in the Department's *Budget 2019* forecasts. The assessment of the fiscal rules in this chapter is based on the forecasts presented in *Budget 2019.*

[4] The treatment in this chapter differs to that of the Department of Finance, presented in the documents for *Budget 2019*. The Council assesses that an adjustment should be made to account for the one-off nature of the windfall in order to arrive at the underlying structural balance.

Table 4.1: Assessment of Compliance with the Fiscal Rules[1, 2, 3]

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

	2017	2018	2019
Corrective Arm			
General Government Balance Excl. One-Offs	-0.2	-0.3	0.0
General Government Debt	68.4	64.0	61.4
1/20th Debt Rule Limit	81.9	71.5	67.7
Debt Rule met?	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule			
Structural Balance Adjustment Requirement			
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**
CAM Structural Balance	0.4	-1.2	-0.7
MTO met?	Y	N	N
Minimum Change in Structural Balance Required	**-**	**-**	**-**
Change in CAM Structural Balance	0.6	-1.5	0.5
1yr Deviation (€bn)	-	-4.9	1.6
1yr Deviation (p.p.)	-	-1.5	0.5
2yr Deviation (€bn)	-	-	-1.6
2yr Deviation (p.p.)	-	-	-0.5
Expenditure Benchmark			
(a) Reference Rate of Potential Growth (% y/y)	-	3.4	4.5
(b) Convergence Margin	-	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	-	3.4	4.5
GDP Deflator used	-	1.3	1.3
Limit for Nominal Net Expenditure Growth (% y/y)	**-**	**4.8**	**5.9**
Net Expenditure Growth (% y/y)	4.5	3.9	4.3
Net Expenditure Growth (Corrected for one-offs) (% y/y)	4.2	4.1	4.3
1yr Deviation (Corrected for one-offs) (€bn)	-	0.4	1.2
1yr Deviation (Corrected for one-offs) (% GDP)	-	0.1	0.3
2yr Deviation (Corrected for one-offs) (€bn)	-	-	0.8
2yr Deviation (Corrected for one-offs) (% GDP)	-	-	0.2
Limit for Nominal Net Expenditure Growth (€bn)	**-**	**3.4**	**4.4**
Net Expenditure Increase (€bn)	3.0	2.7	3.2
Net Expenditure Increase (Corrected for one-offs) (€bn)	2.8	2.9	3.2
Current Macroeconomic Aggregates			
Real GDP Growth (% y/y)	7.2	7.5	4.2
CAM Potential GDP Growth (% y/y)	7.4	4.6	4.5
CAM Output Gap	-1.0	1.6	1.3
GDP Deflator Used (% y/y)	1.2	1.3	1.3

Notes:

[1] Assessments examine the *Budget 2019* revenue and expenditure plans, using the Department of Finance's CAM estimates of potential output and considering the Council's views on one-off/temporary measures. A new one-off windfall of €0.7bn in corporation tax revenue for 2018 is included in the Council's assessment of the structural balance. The treatment here 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 in the expenditure benchmark, as discussed in the *June 2017 FAR* (IFAC, 2017c).

[2] As the Council assesses the MTO as achieved in 2017, no adjustments to the structural balance are assumed required in 2017 and 2018. However, it is expected that the European Commission will retain their requirements until a final spring 2019 assessment of 2018. In spring 2019, it is anticipated that there will be a negative convergence margin applied for 2018, due to the over achievement of the MTO in 2017. The Council assesses compliance without this. The adjustment requirement for 2019 is frozen by the European Commission at zero meaning a negative convergence margin for 2019. The Expenditure Benchmark limits presented here therefore differ to those presented in the budget documents and in the European Commission's opinion on Ireland's Draft Budgetary Plans.

[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 until the end of 2018.

4.2 In-year assessment for 2018

Analysis based on the Department's latest available estimates indicates that the MTO was achieved for 2017 (see Appendix F for a review of the *ex-post* assessment of 2017). The adjustment requirements and spending limits for 2018 were set by the European Commission in spring 2017, when this achievement was not anticipated.[5] The Commission will not formally lift these requirements until spring 2019. In spring 2019, it is anticipated that the European Commission will assess the MTO as having been met for 2017, as a result, there will be no formal requirement for 2018, other than adherence to the MTO.

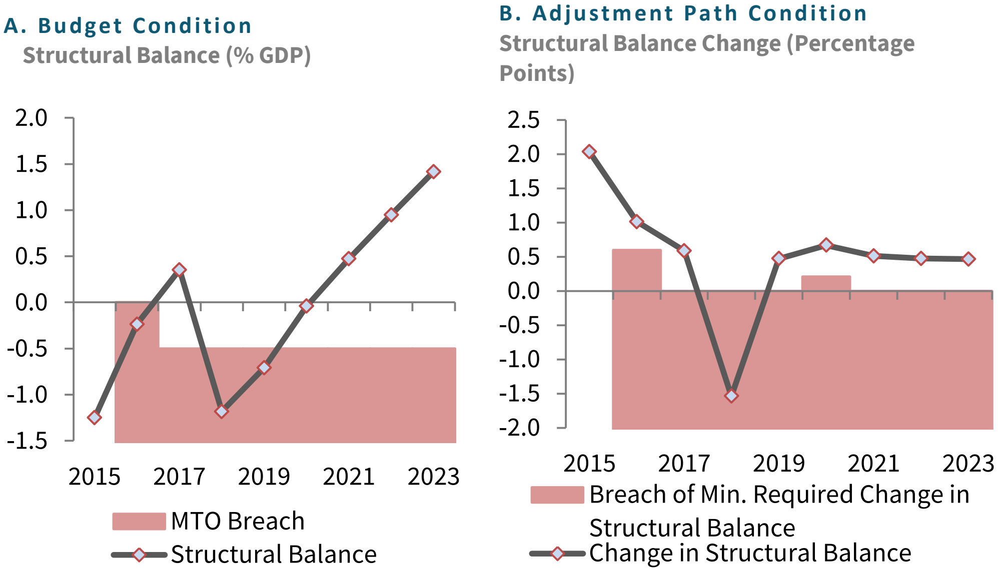
MTO and Structural Balance Adjustment Requirements

The structural balance is forecast to deteriorate to a deficit of 1.2 per cent of GDP for 2018 (Figure 4.1a); this represents a deterioration of 1.5 per cent of GDP compared with 2017 (Figure 4.1b). The MTO of a structural deficit of 0.5 per cent of GDP will therefore not be achieved in 2018 based on the Department's CAM-based estimates and the Council's assessment of one-off items. As the MTO was achieved in 2017, the only requirement was to ensure the continued adherence to the MTO. The deviation of 0.7 per cent of GDP from the MTO is classified as a significant deviation from the MTO.[6]

[5] The requirements for 2018 could only be reset on two occasions, Autumn 2017 or Spring 2019 for the *ex-post* assessment.

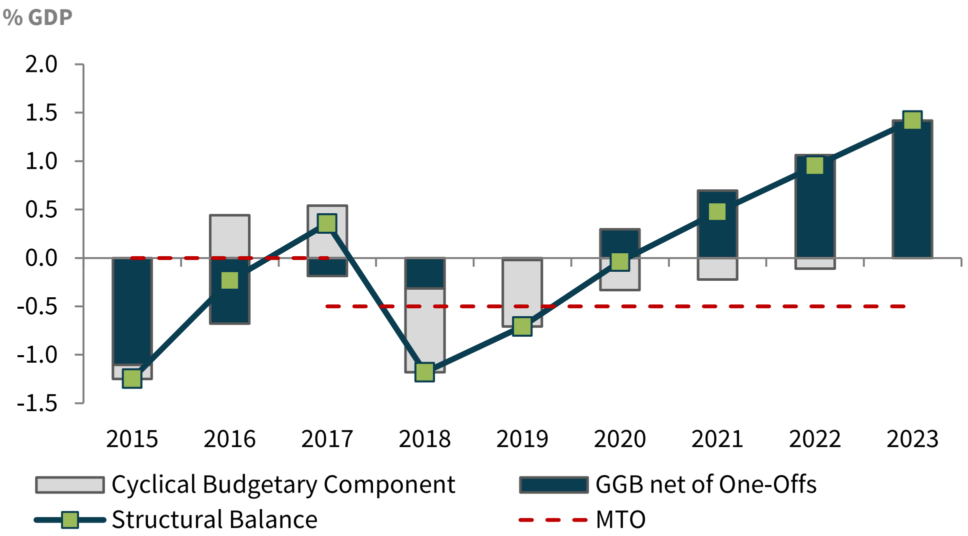
[6] The *Vade Mecum* (EC, 2018a) states that "For Member States at their MTO, a significant deviation is assessed with respect to a requirement of 0% of GDP, which is usually reflected in the first recommendation of the CSR [Country Specific Recommendation] as 'ensure that the medium-term budgetary objective continues to be adhered to' or 'avoid deviating from the medium-term budgetary objective'".

Figure 4.1: Assessment of Compliance with the Budgetary Rule



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The minimum MTO for Ireland 2017-2019 is set at -0.5 per cent of GDP. This was achieved in 2017 and so the 2018 adjustment path condition is expected to be 0.0 per cent of GDP once requirements are re-examined in 2019. Based on the Commission's latest estimates it is anticipated that there will be no adjustment requirement for 2019 when this requirement is re-examined. Required changes are calculated based on the previous year's structural balance.

Figure 4.2: CAM Structural Balance Decomposition

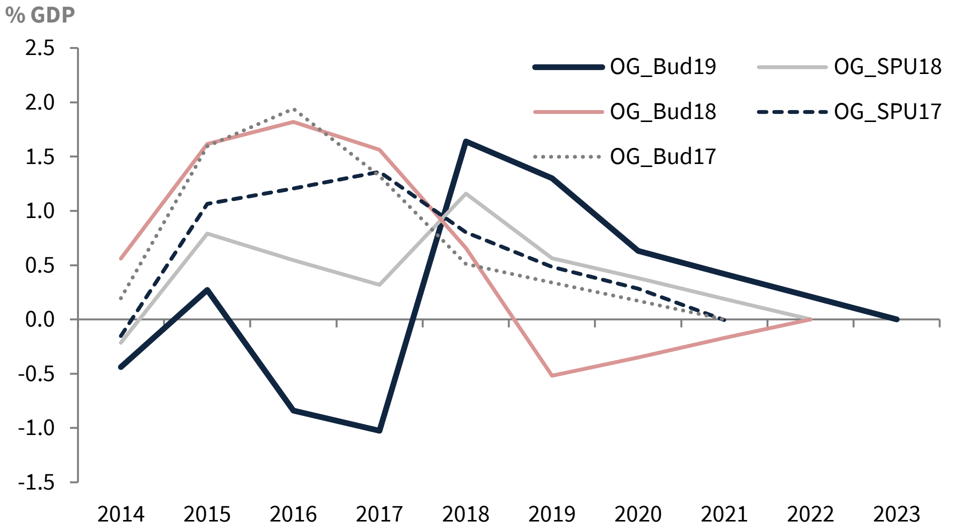


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The cyclical budgetary component is estimated as: -0.5275 × output gap, where the output gap is the Department of Finance's CAM-based estimate. The CAM-based estimate of the output gap involves closure of the output gap over the medium-term. The MTO is due to be updated in 2019, for 2020-2022. This update was unavailable at the time of writing and the MTO is assumed constant at -0.5 per cent of GDP.

The deterioration of the structural balance between 2017 and 2018 is predominantly due to the estimated cyclical budgetary component, with the nominal general government balance largely unchanged across the two years once adjusted for one–offs (Figure 4.2). The large swing in the cyclical budget component is a result of the large and implausible swing in the CAM output gap between 2017 and 2018 (Figure 4.3): the output gap for 2017 is estimated to be -1 per cent of GDP and +1.6 per cent of GDP in 2018. The output gap estimated for 2017, at the time of *Budget 2018*, was + 1.6 per cent of GDP, while the estimates of the output gap from *Budget 2019* show an output gap of –1.0 per cent of GDP for 2017. This significant swing in the estimated output gap over a short period of time is not plausible, and is another example of the poor results of the CAM output gap in relation to Ireland.[7]

However, as shown in Box E, the structural balance based on the Department of Finance's alternative estimates of the output gap also point to a deterioration of the structural balance in 2018. The GVA-based estimate of the structural balance shows a deterioration of 0.5 per cent of GDP for 2018, while the GDP-based estimate of the structural balance shows a deterioration of 1.4 per cent of GDP for 2018. All indications are that there was a significant deterioration in the structural balance in 2018.

Figure 4.3: CAM Output Gap Vintages



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The CAM-based estimate of the output gap involves closure of the output gap over the medium–term. As a result, the output gap declines towards zero at the end of each forecast horizon. The European Commission deemed that an adjustment to estimates of potential output for 2017 would be appropriate in response to higher-than-expected growth outturns in 2017. However, the exact implementation differed from what the Department had anticipated. Consequently, the changes in estimates of the output gap between *SPU 2018* and *Budget 2019* are partially as a result of the Department subsequently adopting the European Commission's approach.

[7] See Box E of the November FAR (IFAC, 2017e).

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.[8]

MTO and Structural Balance Adjustment Requirements[9]

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

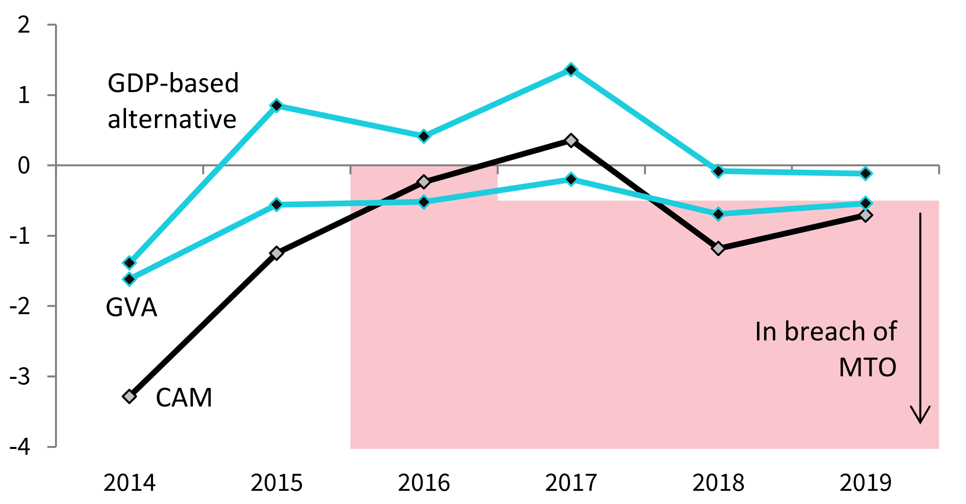
[8] Assessments of the Debt Rule based on the backward and forward looking benchmarks are independent of the estimates of the output gap. Assessment of compliance with the cyclically–adjusted Debt Rule, which is based on estimates of the output gap, only comes into effect if both the backward–looking 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.

[9] 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

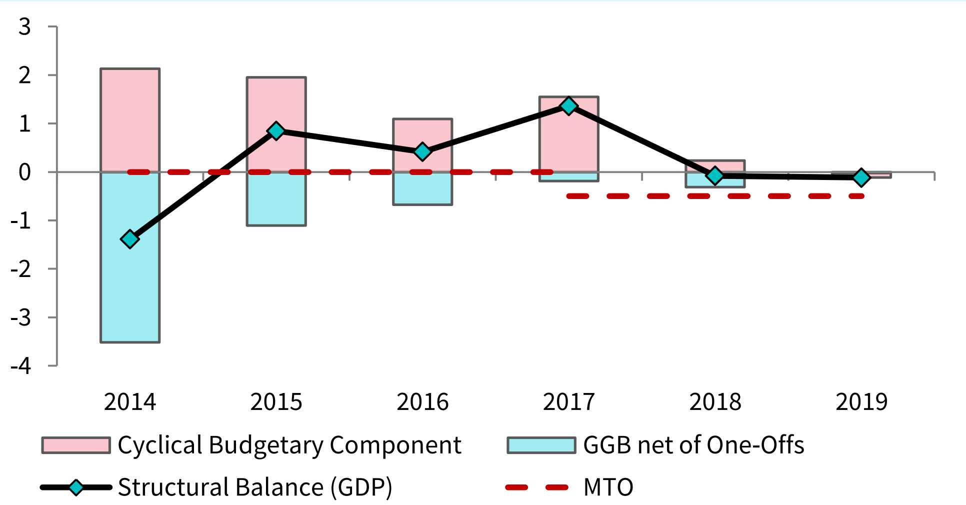
% GDP



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 × 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

% 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 GDP–based estimate.

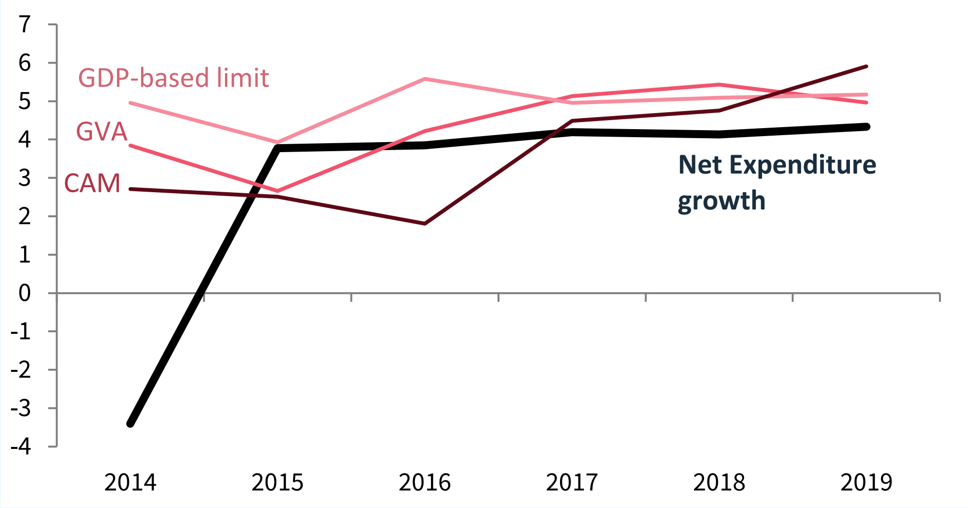
Expenditure Benchmark

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.[10] 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.

[10] However, the legal requirement for compliance with the Expenditure Benchmark is based on the CAM–based estimate of potential output.

Expenditure Benchmark

The Expenditure Benchmark is used a measure of progress towards the MTO. Under the fiscal rules, once the MTO has been achieved the Expenditure Benchmark is not formally binding, although it is considered as part of an overall assessment.[11]

Net expenditure in 2018, less one-off expenditure measures, is forecast to increase by 4.1 per cent year-on-year. This is below the Expenditure Benchmark of 4.8 per cent year-on-year increase and so the Expenditure Benchmark will not be breached in 2018. However, due to the adjustments used to arrive at the net expenditure figure, this rule gives an inappropriate signal for 2018.[12]

Below is an outline of how the Net Expenditure Aggregate — used for assessing compliance with the Expenditure Benchmark — is arrived at:

$$\begin{aligned} Net\ Expenditure\ [Net\ of\ oneoffs]_t \\ &= GGE_t - Int_t - EU_t - (GFCF_t - avGFCF_t) - UC_t - DRM_t \\ &- [OOE_t] \end{aligned}$$

Where GGE_t is general government expenditure at time t, Int_t is interest payments at time t, EU_t is funds matched by EU co–financing at time t, $GFCF_t$ is government gross fixed capital formation at time t, $avGFCF_t$ is the average government gross fixed capital formation for years $t-3$ to year t, UC_t is the cyclical unemployment expenditure at time t, and DRM_t is the discretionary revenue measures at time t.[13,14] A further correction is made to adjust for one-offs in expenditure spending, OOE_t, at time t.

Shown in Table 4.2 are the contributions of each component to the net expenditure growth figure. As can be seen from the table, were it not for the adjustments from

[11] 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).

[12] The European Commission's application of the fiscal rules allows for a negative convergence margin, in year *t,* if the MTO has been overachieved in year *t-1.* This allows more room for manoeuvre under the Expenditure Benchmark as the limit is then set higher than would otherwise be the case. The use of a negative convergence margin in the application of the Expenditure Benchmark is not something that the Council uses in its assessment.

[13] Cyclical unemployment expenditure is estimated using the CAM NAWRU.

[14] When calculating growth rates of net expenditure for year *t,* the previous year's net expenditure figure does not include the adjustment for DRMs.

GFCF and DRMs reducing the net expenditure figure, the Expenditure Benchmark would not have been adhered to for 2018 and 2019. If public investment (GFCF) is starting from a low level and there is a trend increase in investment (i.e., non-temporary increase)— as is the case for Ireland, where significant increases in public investment have occurred or are planned in 2018 and 2019—then, due to the nature of the adjustments made to arrive at the net expenditure figure, the Expenditure Benchmark may allow more-than-prudent increases.

Table 4.2: Contributions of Each Component to Net Expenditure Growth

Per cent of Net Expenditure

		2017	2018	2019
Walk to Net Expenditure Growth				
ΔGGE	**General Government Expenditure Growth**	**3.2**	**5.5**	**5.6**
-Δ Int	Interest	0.5	0.7	0.4
-ΔEU	EU co-financed current spending	-0.1	0.0	0.0
-ΔGFCF	Public Investment (GFCF)	-0.1	-2.1	-1.3
+ΔavGFCF	Four-year avg of Public Investment	0.6	0.9	1.0
-ΔUC	Cyclical Unemployment Expenditure	0.3	0.0	-0.1
-DRMs	DRMs	0.1	-1.2	-1.3
	Net Expenditure Growth	**4.5**	**3.9**	**4.3**
-ΔOOE	**One-offs**	-0.3	0.3	0.0
ΔNE	**Net Expenditure Growth [Net of one-offs]**	**4.2**	**4.1**	**4.3**
	Limit for Net Expenditure Growth (% y/y)	-	**4.8**	**5.9**

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Rounding may affect totals. All figures are in nominal terms and are expressed as a percentage of the previous year's net expenditure (less adjustment for DRMs), unless otherwise stated. Δ Indicates the change in the variable from year *t-1* to year *t*. Limits presented here do not incorporate a negative convergence margin when over achievement of the MTO has occurred in year *t-1*.

Table 4.3: Other Net Expenditure Aggregates

Per cent of Net Expenditure

	2017	2018	2019
Net Expenditure (NE)	4.2	4.1	4.3
NE (NAWRU = 5.5)	5.0	4.8	4.8
NE (No GFCF smoothing)	3.6	5.3	4.5
NE (NAWRU = 5.5, No GFCF smoothing)	4.4	5.9	5.0
Expenditure Benchmark Limit	-	**4.8**	**5.9**

Note: The table shows the percentage net expenditure growth, less one-offs, in all cases. All figures are in nominal terms and are expressed as a percentage of the previous year's corresponding net expenditure (less adjustment for DRMs), unless otherwise stated. The NAWRU of 5.5 per cent is the Department of Finance's stated belief about the natural rate of unemployment. Limits presented here do not incorporate a negative convergence margin when over achievement of the MTO has occurred in year *t-1*.

Table 4.3 shows alternative formulations of the net expenditure aggregate (less expenditure one-offs). When a more plausible natural rate of unemployment (NAWRU) is used, the Expenditure Benchmark limit would have been breached in 2018, although this breach would have been only marginal.[15] Without the adjustment for public investment (GFCF), net expenditure would have been above the limit set by the Expenditure Benchmark in 2018. These alternative aggregates, taken together with the net policy spending measure in Box A, all suggest that there was an imprudent increase in spending in 2018 above sustainable levels.

[15] The CAM NAWRU has a number of flaws; it is procyclical, and is highly correlated with actual unemployment.

4.3 Ex-Ante Assessment for 2019

This section assesses the Department's plans for compliance with the fiscal rules for 2019 based on *Budget 2019* forecasts. The Debt Rule will apply in full from 2019 onwards after the end of the three-year transition period from 2016–2018 but it is unlikely to be a binding constraint on fiscal policy for the foreseeable future (see Box F for a detailed explanation of the Debt Rule).

Based on the Department's estimates, the structural balance is currently forecast not to meet the MTO requirement in 2019. Net expenditure growth is forecast to be below the limit set by the Expenditure Benchmark for 2019. However, there are further risks of slippage for 2019.

MTO and Structural Balance Adjustment Requirements

A structural deficit of 0.71 per cent of GDP is expected for 2019, which will not meet the MTO requirement of a structural deficit of no more than 0.5 per cent of GDP (based on the Department's estimates under the CAM). However, the structural balance is within the European Commission's "margin of tolerance" of 0.25 per cent of GDP from the MTO. In this case, the MTO would be deemed — by the Commission — to be achieved for 2019.[16] The "margin of tolerance" is used to alleviate some of the uncertainty involved in the calculation for the structural balance and formulating fiscal policy in order to be compliant with the upper limits of the "margin of tolerance" is not prudent budget management. As the structural balance is set to be at the upper limit of the "margin of tolerance", based on the Department's estimates, there is a risk that the MTO would be deemed, by the Commission, not met for 2019. This could happen if expenditure overruns occur, revenue does not meet targets, or revisions to the output gap occur.[17]

There is no adjustment requirement for 2019.[18]

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[16] Section 4.3.3 discusses scenarios where this might not be the case.

[17] A recent IGEES analytical note found that average annual absolute revision to the output gap for Ireland was almost 1 percentage point over the period 2003–2016 (Bedogni and Meaney, 2018). Upward revisions to the output gap would have a detrimental effect on the structural balance.

[18] The updated requirement is as a result of latest estimates by the European Commission, showing adherence to the MTO for 2018. This update to a no adjustment requirement is reflected in this chapter. However, the use of a negative convergence margin under the Expenditure Benchmark is not reflected in this chapter.

Expenditure Benchmark

Net expenditure for 2019 is expected to grow below the limit set by the Expenditure Benchmark. Net expenditure is forecast to grow by 4.3 per cent year-on-year in 2019, which is less than the 5.9 per cent limit set by the Expenditure Benchmark. The Department's forecasts based on the CAM show that the MTO will not be met for 2019. There are also risks that the Commission will deem the MTO as not being achieved. In such cases, the Expenditure Benchmark may be used in an overall assessment of compliance with the fiscal rules. Over the medium term, the Council recommends at least adhering to the Expenditure Benchmark, without a negative convergence margin, based on more plausible estimates of potential output for Ireland. This would help to ensure spending growth is in line with sustainable and prudent budget management.[19]

Scenario Analysis of Expenditure Benchmark and Structural Balance

This section provides a scenario analysis of the Expenditure Benchmark and structural balance based on a scenario which accounts for continued overruns in health and a payment of the Christmas bonus (which persistently has not been budgeted for). The average overrun in health over the last six years (including the forecast for 2018) was €466 million. [20] While the Christmas bonus is expected to cost €265 million in 2018. We assume the Christmas bonus will cost in the region of €270 million for 2019, due to increases in social welfare payments included in *Budget 2019*. Based on these two additional expenditures, Table 4.4 details how these would affect compliance with the Expenditure Benchmark when they are included for 2019, and assuming no offsetting factors.

[19] The Expenditure Benchmark based on CAM estimates of the potential output exhibits pro-cyclical tendencies which may not provide a good foundation for sustainable spending increases. The use of a negative convergence margin exacerbates these tendencies. See Box E for details of the Expenditure Benchmark based on the Department of Finance's preferred estimates for potential output.

[20] See Box D for details.

Table 4.4: Scenario Analysis of the Expenditure Benchmark

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

	2017	2018	2019
Expenditure Benchmark			
(a) Reference Rate of Potential Growth (% y/y)	-	3.4	4.5
(b) Convergence Margin	-	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	-	3.4	4.5
GDP Deflator used	-	1.3	1.3
Limit for Nominal Net Expenditure Growth (% y/y)	**-**	**4.8**	**5.9**
Net Expenditure Growth (% y/y)	4.5	3.9	5.3
Net Expenditure Growth (Corrected for one-offs) (% y/y)	4.2	4.1	5.3
1yr Deviation (Corrected for one-offs) (€bn)	-	0.4	0.4
1yr Deviation (Corrected for one-offs) (% GDP)	-	0.1	0.1
2yr Deviation (Corrected for one-offs) (€bn)	-	0.3	0.4
2yr Deviation (Corrected for one-offs) (% GDP)	-	0.1	0.1
Limit for Nominal Net Expenditure Growth (€bn)	**-**	**3.4**	**4.4**
Net Expenditure Increase (€bn)	3.0	2.7	4.0
Net Expenditure Increase (Corrected for one-offs) (€bn)	2.8	2.9	4.0

Note: Data are adjusted to include an overspend of €466 million in health and a Christmas bonus of €270 million in 2019. Limits presented here do not incorporate a negative convergence margin when over achievement of the MTO has occurred in year *t-1*.

The scenario above indicates that expenditure growth would increase by a further 1 percentage point year-on-year, if these measures were to occur in 2019. This would lead expenditure to be close to the limit of 5.9 per cent year-on-year growth set by the Expenditure Benchmark, leaving little room (€400 million) for any further slippage in expenditure.

Based on the expenditure scenario above, and under the assumption that 50% per cent of the overrun in expenditure (€368 million) is returned to general government in the form of increased tax revenue, a scenario analysis is carried out for impact on the structural balance.[21] In this scenario the structural balance for 2019 would no longer be considered, by the Commission, to be at the MTO as the structural balance of -0.82 per cent of GDP would be outside their “margin of tolerance” from the MTO (Table 4.5).

[21] The assumption of 50% of the expenditure being returned to the exchequer as tax revenue would be considered a favourable scenario in terms of adherence to the fiscal rules. The Christmas bonus has historically been paid in the first week of December. As a result, it is unlikely that there would be significant revenue return in the financial year arising from this payment.

Table 4.5: Scenario Analysis of the Structural Balance
% GDP unless stated, deviations: negative=non-compliance

	2017	2018	2019
Structural Balance Adjustment Requirement			
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**
CAM Structural Balance	0.4	-1.2	-0.8
MTO met?	Y	N	N
Minimum Change in Structural Balance Required	**-**	**-**	**-**
Change in CAM Structural Balance	0.6	-1.5	0.4
1yr Deviation (€bn)	–	-4.9	1.2
1yr Deviation (p.p.)	–	-1.5	0.4
2yr Deviation (€bn)	–	–	-1.8
2yr Deviation (p.p.)	–	–	-0.6

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data are adjusted to include an overspend of €466 million in health, a Christmas bonus of €270 million, and an increase in revenue of €368 million in 2019.

As the MTO would not be met and net expenditure growth would be close to the limit set by the Expenditure Benchmark for 2019, should this scenario arise, there is a risk of failure to comply with the fiscal rules for 2019.

Debt Rule

The requirements for the Debt Rule will come into effect in full from 2019, following the conclusion of the three-year transition period from 2016–2018. See Box I for details on the Debt Rule and how it is applied. In essence, the Debt Rule requires that the debt-to-GDP ratio be reduced by an average of at least 1/20th per year of the gap above 60 per cent of GDP. The debt ratio for 2019 is forecast to fall to 61.4 per cent of GDP, which is below the 1/20th Debt Rule limit. Due to the nature of the distortions in the GDP figures for Ireland, the 60 per cent ceiling value measured relative to GDP is more easily attained than in other economies for a given capacity of the domestic economy to support the debt; measured relative to GNI*, the debt ratio is approximately 40 percentage points higher than the ratio based on GDP.[22] Based on Government forecasts, the debt ratio is due to fall below the 60 per cent of GDP level in 2020 (Appendix H Table H.1). Once this occurs, the requirement is to maintain a debt-to-GDP ratio below the 60 per cent of GDP ceiling. This is forecast to be the case for 2021–2023.

[22] The forecast for GNI* for 2019 is taken from the Department of Finance's forecast, which is based on a purely technical assumption that GNI* moves in line with GNP.

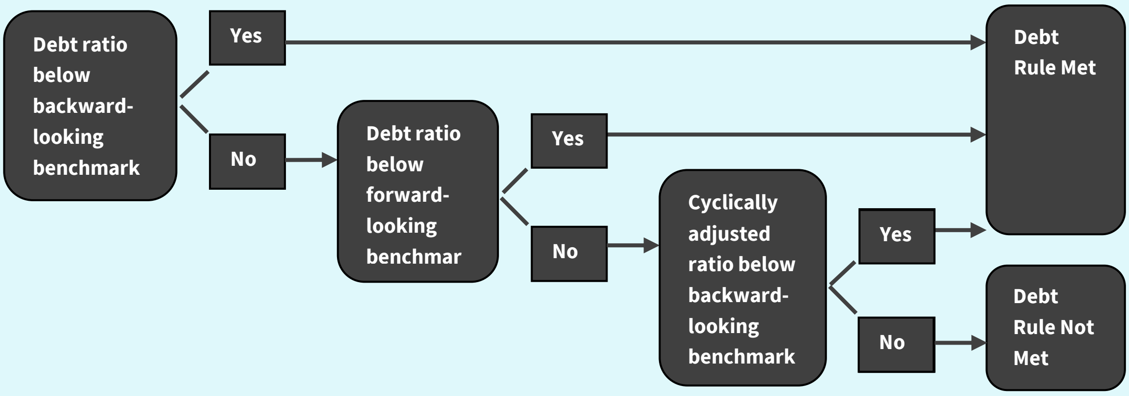
Box F: Introductory Guide to the Debt Rule

This Box outlines how the Debt Rule will apply once it becomes fully applicable to Ireland in 2019. The Debt Rule is one of the EU fiscal rules set out in the *Stability and Growth Pact* and is part of the “six-pack” of reforms implemented in 2011. The Debt Rule came into force in Ireland with the adoption of the *Fiscal Responsibility Act 2012.* Following the exit of the *Excessive Deficit Procedure* (EDP) in 2015, Ireland entered into a transition period from 2016-2018, which limited the legal requirements for adherence to the Debt Rule. From 2019 onwards, the Debt Rule will apply in full.

The Debt Rule in Operation

The core of the Debt Rule effectively requires that the debt-to-GDP ratio be below 60 per cent of GDP or sufficiently falling towards this upper limit. In essence, if the debt-to-GDP ratio is above 60 per cent of GDP, the rule requires that the ratio falls by, on average one-twentieth of the excess between the actual debt-to-GDP ratio and 60 per cent of GDP. This requirement is expressed as a benchmark debt-to-GDP ratio.

There are three criteria used when assessing progress towards the 60 per cent of GDP ceiling value, with the least stringent of these criteria being used to assess compliance with the Debt Rule. The three criteria are: (1) the backward-looking benchmark, (2) the forward-looking benchmark, which is compared to $t + 2$ forecast of the debt-to-GDP ratio, and (3) a cyclically adjusted debt-to-GDP ratio, which is compared to the backward-looking benchmark. The criteria are applied sequentially, as outlined in the flow chart below:



Formally, these are calculated as:

Backward looking Benchmark

$$= 60\% + \left(\frac{0.95}{3}\right)(b_{t-1} - 60\%) + \left(\frac{0.95^2}{3}\right)(b_{t-2} - 60\%) + \left(\frac{0.95^3}{3}\right)(b_{t-3} - 60\%)$$

Forward looking Benchmark

$$= 60\% + \left(\frac{0.95}{3}\right)(b_{t+1} - 60\%) + \left(\frac{0.95^2}{3}\right)(b_t - 60\%)$$

$$+\left(\frac{0.95^3}{3}\right)(b_{t-1}-60\%)$$

$$Cyclically\ Adjusted\ ratio = \frac{B_t + \sum_{j=0}^{2} C_{t-j}}{Y_{t-3}\prod_{h=0}^{2}\left(1+y_{t-h}^{pot}\right)(1+p_{t-h})}$$

where b_t is the debt-to-GDP ratio at time t, B_t is the nominal debt level at time t, C_t is the cyclical component of the budget balance at time t, Y_t is the nominal GDP at time t, y_t^{pot} is the potential output at time t, and p_t is the price deflator at time t.[23]

In the event that the Commission deems that the debt-to-GDP ratio is in breach of all three criteria, the Commission will prepare a report, which takes a number of factors into account before coming to a conclusion as to whether the debt criterion has been breached, which can in turn lead to the Commission recommending the launch of an *Excessive Deficit Procedure*.[24,25]

Once the debt-to-GDP ratio falls below the 60 per cent of GDP ceiling value, this limit becomes the binding criteria. Breaching the 60 per cent of GDP ceiling limit from below automatically triggers a report from the Commission, unless the debt-to-GDP ratio returns below the ceiling value over the Commission's forecast horizon.[26]

Compliance with the Debt Rule over the forecast horizon

Figure F.1 shows the forecasted compliance with the backward-looking and forward-looking benchmark. Over the period 2014–2023, both the backward-looking benchmark and the forward-looking benchmark were complied with. The debt-to-GDP ratio is forecast to fall below the 60 per cent of GDP ceiling in 2020 (Figure F.1A), for the first time since 2008.

[23] For legal compliance with the Debt Rule, assessment of compliance with the forward-looking benchmark is based on European Commission forecasts of future debt-to-GDP ratios based on unchanged policies. Similarly, assessment of compliance with the cyclically adjusted ratio is based on the Commission's CAM estimates of potential output.

[24] The factors taken into account include among others, an assessment of the overall economic environment, adherence to the MTO, or adjustment path towards it, implementation of structural reforms and pension reforms, the expected timeline for compliance with the debt rule and the contribution of stock-flow adjustments to the breach.

[25] Should the European Council adopt the Commission's recommendation to launch an EDP, this would involve a requirement to adhere to annual targets for the nominal and structural deficits so that the by the end of the correction period, the debt-to-GDP ratio is compliant with the Debt Rule. Non-compliance with the EDP may lead to a sanction of a non-interest bearing deposit of maximum 0.2 per cent of GDP being lodged with the Commission. Further non-compliance with the EDP may lead to suspension of commitments — or payments — of the European Structural and Investment funds and/or fines of up to 0.5 per cent of GDP, which may be supplemented by the European Investment Bank reconsidering its investment policy towards the Member State.

[26] In addition to the factors outlined above, one of the relevant factors that the Commission take into account when coming to a conclusion as to whether or not to recommend launching an *Excessive Deficit Procedure*, when the 60 per cent of GDP ceiling value is breached from below, is the cyclically adjusted debt-to-GDP ratio.

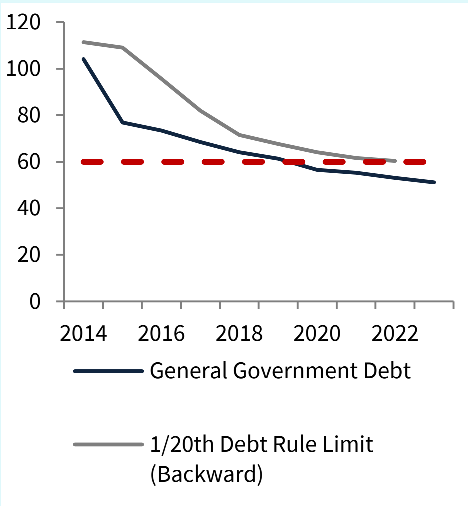
Implications of the Debt Rule for Ireland

The Debt Rule as currently formulated has a number of flaws. Essentially, the Debt Rule requires significant frontloading of consolidation, if the debt-to-GDP ratio is substantially above 60 per cent of GDP, or it imposes minimal fiscal effort, if the debt-to-GDP ratio is relatively close to the 60 per cent of GDP ceiling value (Barnes *et al.,* 2016).

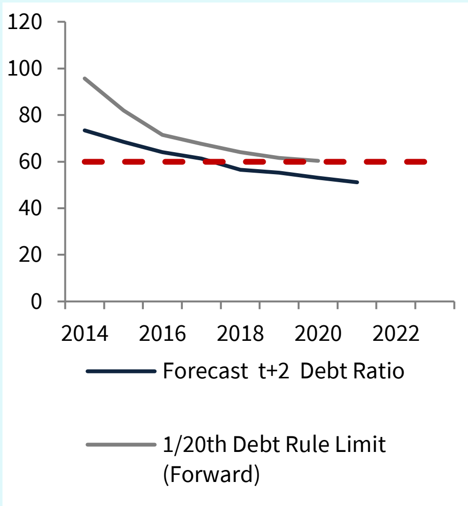
In addition, due to the nature of the distortions in the GDP figures for Ireland, relating to the multinational sector, this rule is not expected to be a binding constraint on medium-term fiscal policy for Ireland. The sustainability of Ireland's debt levels should not be assessed on the basis of the debt-to-GDP ratio due to these distortions. Sustainability of Ireland's debt levels should be judged on a more appropriate measure of national income than the GDP figures, like GNI*.[27]

Figure F.1: Compliance with the Debt Rule

A. Backward-looking Benchmark
Per Cent of GDP



B. Forward-looking Benchmark
Per Cent of GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The figures show the Department of Finance's forecasts of the debt ratio from *Budget 2019.* Legal compliance with the forward-looking benchmark is assessed on the basis of the European Commission forecasts.

The Council assesses that a more appropriate debt commitment should be chosen by the Government. The commitment should better reflect sustainability concerns — like a debt-to-GNI* ratio, rather than a debt-to-GDP ratio — and should be time limited with a specific date by which the objective should be achieved.[28] It should be clearly specified whether the commitment would be a target or a ceiling. Further, it should be specified whether it is a steady-state debt target to be achieved on average over the cycle or whether it is intended to be maintained permanently.

[27] See Box A of the June 2017 FAR (IFAC, 2017c) for details on ratios other than the debt-to-GDP ratio to assess sustainability on.

[28] The Government previously set a debt target of 55 per cent of GDP. This target was not well specified, not time-bound and was not set against an appropriate denominator. As a result, this was not an appropriate target.

4.4 *Ex-ante* Assessment for 2020–2023

Appendix H Table C.1 provides a summary of assessment of the fiscal rules for 2020–2023. However, the forecasts for expenditure in these later years are unrealistic (see Chapter 3).

MTO and Structural Balance Adjustment Requirements

The MTO for 2020-2023 is due to be set by the Government in 2019. Under the assumption that the same MTO, of a deficit of 0.5 per cent of GDP, will be set for these years, it is forecast that the MTO will be adhered to over this horizon.

The adjustment requirement for the structural balance for 2020 would be 0.2 per cent of GDP based on current forecasts, but this requirement will be formally set by the European Commission in spring 2019. It is forecast that this will be achieved in 2020 and that the structural balance would exceed the MTO by an increasing margin from 2020 to 2023. As a result, no adjustment requirement is expected to apply over this period. However, these are not reliable estimates of the structural balance, and are likely to change due to revisions to the CAM estimates of the output gap and expected higher expenditure than is currently planned (Chapter 3).

Expenditure Benchmark

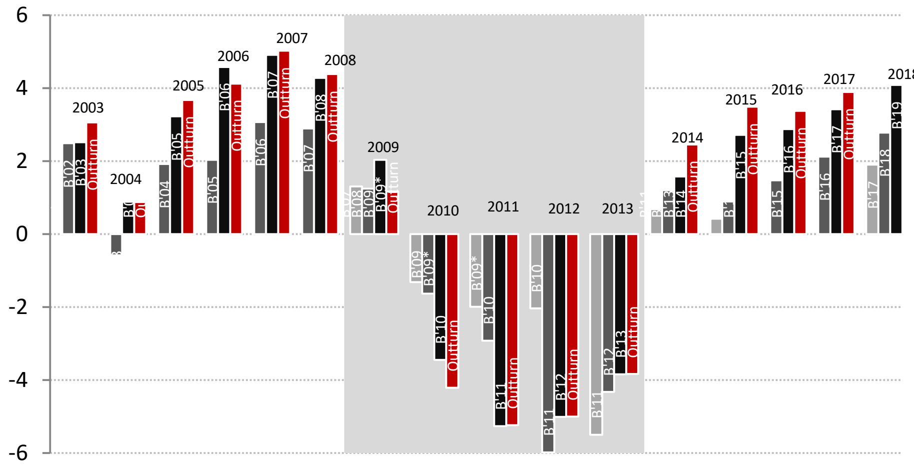
Based on *Budget 2019* forecasts the Expenditure Benchmark would be adhered to for the period 2020-2023. However, these forecasts are not credible and may be unrealistically low for a number of reasons (see Chapter 3).

4.5 Medium-Term Expenditure Framework

The Medium-term Expenditure Framework (MTEF) is a reform introduced after the crisis years and is legislated for in the *Ministers and Secretaries (Amendment) Act 2013.* The MTEF was introduced to provide a better mechanism of managing expenditure over the medium-term and ensures that the Expenditure Benchmark is adhered to. The MTEF requires the Government to set limits to overall public expenditure for the following three years, while Ministerial expenditure ceilings are established to ensure aggregate expenditure remains within overall limits.

Figure 4.4: Change in Gross Current Expenditure Forecasts

€ Billions



Source: Department of Finance; internal IFAC calculations.
Note: Bars show the change in forecasts from various Budgets followed by outturns, versus the earliest Budget forecast for that year (e.g., B'15 = expenditure forecasts in *Budget 2015* minus the earliest forecast for the specified year). Grey shaded region covers crisis period 2009-2013. Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above.

Figure 4.4 shows the revisions to current expenditure forecasts since 2003. There is a clear cyclical pattern to the revisions to expenditure forecasts that has continued in 2018. During the crisis years, there was a pattern of consistent downward revisions to expenditure plans. In recent years, we have witnessed a return to upward revisions to both expenditure forecasts and expenditure outturns. The pattern of upward revisions to the expenditure ceilings undermines the credibility of the ceilings and indicates that they are seen by government departments as a "soft budget constraint". In the last number of years, upward revisions to the expenditure ceilings have been quite significant in the four largest departments (Appendix G). In-year increases for 2018 were particularly large for the Department of Health, the Department of Education and Skills, and the

Department of Employment Affairs and Social Protection. The continued upward revisions to expenditure forecasts risks undermining the fiscal position of the state, risks repeating the mistakes of the past, and reduces the ability of public finances to absorb negative shocks in the future.