Box J: An Assessment of Ireland's Compliance with the Fiscal Rules for 2018 under EU Methods

This Box assesses Ireland's compliance with the EU fiscal rules under EU methods. While the Commission's formal assessment of Ireland's compliance with the EU fiscal rules was not available at the time of writing this report, the figures underlying the Commission's assessment were. The Commission will make its formal assessment of Ireland's 2018 Ex-post compliance with the EU fiscal rules in June 2019.

For a number of years, the Council and others have identified problems in assessing the EU fiscal rules for Ireland. In particular, the Council has questioned the plausibility of the CAM estimates of potential output and the output gap which are central elements in assessing compliance with the EU fiscal rules. Typically, the CAM-based estimates of the output gap for Ireland are procyclical, subject to large revisions and to ad hoc changes in the methodology, often with questionable merit.

Since 2016, Ireland has been subject to the Preventive Arm of the *Stability and Growth Pact*, which has estimates of potential output and the output gap at its core. While the CAM-based estimates of the output gap have been dubious for some time, the implications of these estimates in terms of compliance/non-compliance with the rules have not been as severe as they are now.

At this juncture, taking into account some recent methodological changes, the CAM-based estimates of the output gap are particularly implausible for Ireland. Given the availability of alterative estimates of the output gap for Ireland (Casey, 2018; Murphy *et al.* 2019), and the considerable differences between these more plausible estimates and the CAM-based estimates, the Council now uses these alternative estimates as part of its principles-based approach to assessing the rules.

The Output Gap

Between the European Commission's Autumn 2018 and Spring 2019 forecasts, there have been substantial revisions to the Commission's CAM-based estimates of the output gap. These revisions are largely as a result of methodological changes between the two output gap vintages. The changes are outlined below:

1. **Capacity Utilisation Indicator.** The Capacity Utilisation Indicator (CUBS) is a measure of how much excess capacity there is in the economy. It is used to detrend Total Factor Productivity (TFP). Previously, the CUBS series for Ireland was available only for 1985–2008 due to data availability issues. A new CUBS series has since been constructed by the Commission and now spans 1985–2018. This new CUBS series was included for the first time in the Commission's Spring 2019 estimates.
2. **A 2018 Dummy.** The Commission's Autumn 2018 estimates of the output gap include a dummy variable for 2018 which was used to detrend TFP. The Commission had previously included dummies for 2015 and 2017 on the basis of outturn data when growth rates were deemed to be higher than plausible.[71] The 2018 dummy was included due to a perceived, higher-than-plausible forecasted growth rate for 2018 of

[71] In 2015 and 2017 the headline growth rates were judged to be significantly distorted due to activities of the multinational sector and were deemed to be too high to be plausible growth rates for the underlying economy. As a result, dummies were required to take account of these distortions.

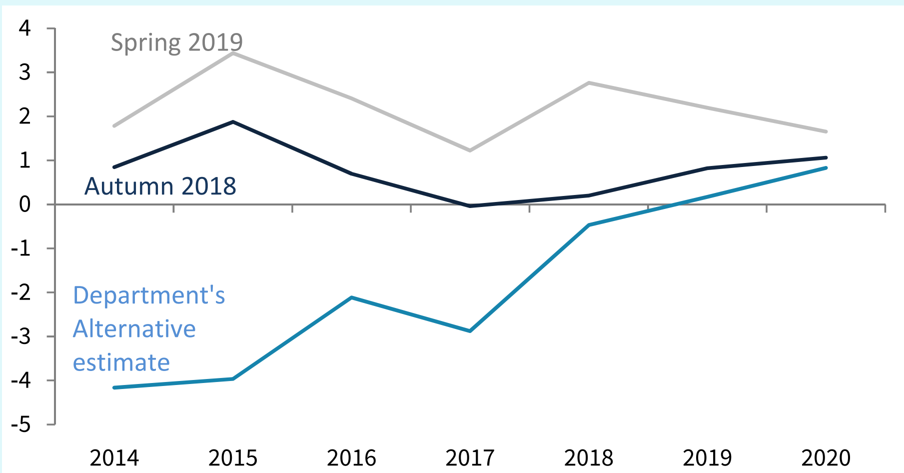
7.8 per cent. Subsequently, the preliminary outturn for 2018 showed a lower than expected growth rate for 2018 of 6.7 per cent. As a result, in the Commission's Spring 2019 forecasts, the decision was taken to remove the dummy for 2018.[72]

The use of the new extended CUBS series contributed approximately 0.8 percentage points to the upward revision in the output gap for 2018, while the removal of the dummy for 2018 contributed approximately 1.4 percentage points.[73]

Figure J.1 shows a comparison of the Commission's Spring 2019 and Autumn 2018 estimate of the output gap, alongside the Department's latest alternative GDP-based estimate of the output gap. Neither the Commission's Autumn 2018 nor Spring 2019 estimates of the output gap show particularly plausible paths for Ireland's output gap given the dynamics of the economy and the degree of slack in recent years. In particular, the Commission's Spring 2019 estimates of the output gap show a positive output gap in 2015 and 2018 which are of a similar magnitude to that shown in the run up to the crisis in 2007. Given other cyclical indicators available and the degree of slack in the economy, these estimates are especially implausible. This gap is then assumed to narrow over the coming years, despite expected overheating pressures.

Figure J.1: Comparison of output gap vintages

Per Cent of GDP



Sources: European Commission; Department of Finance; and internal IFAC calculations.
Note: Autumn 2018 and Spring 2019 relate to the Commission's CAM-based estimates of the output gap. The Department's alternative GDP-based estimate of the output gap is as presented in *SPU 2019.*

The Structural Balance

Based on the Commission's Spring 2019 output gap figures the MTO was not achieved. The structural balance for 2018 is estimated to be –1.4 per cent of GDP, below the MTO of a structural balance of –0.5 per cent of GDP (Figure J.2). Based on these figures, Ireland is expected to be considered to have a significant deviation from the MTO for 2018.

Given that a significant deviation from the MTO has occurred, and there is a breach of the Expenditure Benchmark based on the EU's methodology (see below), there is a possibility of

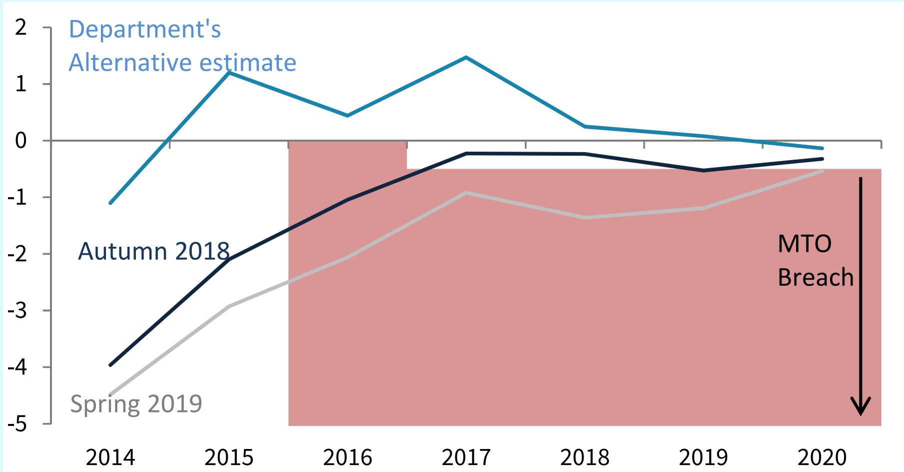
[72] The dummy for 2017 was included based on outturn data showing a growth rate of 7.2 per cent, which at the time was deemed, by the Commission, to be an implausible growth rate for the underlying economy. Whereas, the growth rate of 6.7 per cent for 2018 is deemed, by the Commission, to be a plausible growth rate for the underlying economy.

[73] Based on analysis carried out by the Department of Finance.

the imposition of sanctions for this non-compliance, although this is unlikely.

Figure J.2: Comparison of structural balance vintages

Per Cent of GDP



Sources: European Commission; Department of Finance; and internal IFAC calculations.
Note: Autumn 2018 and Spring 2019 relate to the estimates of the structural balance using the Commission's CAM-based estimate of the output gap, taking into account the Council's view of one-offs. The Department's alternative GDP-based estimate of the structural balance is as presented in Table 4.1.

The Expenditure Benchmark

While the Council has a number of issues with the measurement of the structural balance under the CAM, and with assessing compliance with the MTO based on these estimates, the assessment of compliance with the Expenditure Benchmark is more consistent between the EU approach and the principles-based approach. Both suggest there was a breach of the Expenditure Benchmark for 2018.

While the CAM output gap estimates are the legal basis for assessing compliance with the EU fiscal rules, given the issues raised above, relating to the plausibility of these estimates and subsequently the assessment of the structural balance, the Council believes that due consideration should be given to alternative estimates of the output gap and what these imply for the structural balance estimates in the Commission's overall assessment of compliance. Furthermore, under the Council's principles-based approach, which uses alternative estimates of the output gap, the Council has deemed that the Domestic Budgetary Rule has been complied with for 2018 (IFAC, 2019a).