Chapter 4

Assessment of Compliance with Fiscal Rules

4. Assessment of Compliance with Fiscal Rules

Key Messages

- The European Commission assesses compliance with the fiscal rules based on the Vade Mecum on the Stability & Growth Pact, using the EU's Commonly Agreed Methodology (CAM) for estimating the output gap. For some time, the CAM-based output gap estimates for Ireland have given an implausible estimate of the position of the economy in the cycle. Structural balance figures based on these estimates of the output gap are therefore not a reliable indicator of the underlying budgetary position.

- With that in mind, the Council has adopted a new "principles-based approach" to assessing Ireland's Domestic Budgetary Rule. This new approach addresses a number of issues that arise in assessing the EU fiscal rules, using the Vade Mecum. The Council's new approach makes the assessment simpler and more robust, including using the Department of Finance's alternative method, rather than the CAM, to measure potential output.

- On this basis, the Medium-Term Objective (MTO) of a structural balance of no less than –0.5 per cent of GDP was achieved in 2018 as the structural balance was +0.2 per cent of GDP. However, there was a significant deterioration in the structural balance in 2018, with the structural balance falling by 1.2 percentage points. Based on SPU 2019 projections, the structural balance is forecast to be +0.1 per cent of GDP in 2019 and, based on technical assumptions for expenditure growth (which may be unrealistic), is set to remain at the MTO from 2020–2023.

- Net expenditure breached the Expenditure Benchmark limit in 2018. Under the principles-based approach, net expenditure grew by 6 per cent, which is above the 5 per cent Expenditure Benchmark limit. Net expenditure is forecast to grow below the Expenditure Benchmark limit for 2019, but this would be at risk in the case of a large overrun in expenditure occurring again.

- The Council recommends at least adhering to the Expenditure Benchmark — as a minimum standard — based on the limit set under the Council's principles-based approach. This would help ensure that spending growth is in line with prudent and sustainable budget management.

- The Council assesses that an appropriate debt commitment would be helpful as an anchor for medium-term fiscal policy. The commitment should take into account sustainability concerns, and be well specified and time limited. It should be clearly indicated whether the debt commitment is a target or a ceiling.

- The Government's Medium-Term Expenditure Framework is not working. Repeated, procyclical revisions to expenditure ceilings look set to continue. This risks repeating the mistakes of the past, with revisions to expenditure ceilings now of a similar magnitude to those immediately prior to the crisis.

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* (FRA), and the EU fiscal rules, as set out in the *Stability and Growth Pact* (SGP). This chapter examines the consistency of the projections outlined in the *SPU 2019* with Ireland's Domestic Budgetary Rule and with the preventive arm of the SGP. In particular it examines compliance in relation to the Medium-term Budgetary Objective (MTO), the Expenditure Benchmark, and the Debt Rule.

The assessment in this chapter examines compliance with Ireland's Domestic Budgetary Rule based on the Council's new "principles-based approach" to the budgetary rule, using the Department's GDP-based estimates of potential output in *SPU 2019* and considering the Council's own assessment of one-off/ temporary measures.[67] While legal compliance with the EU fiscal rules is assessed based on the *Vade Mecum on the Stability & Growth Pact*, using the EU's Commonly Agreed Methodology (CAM) for estimating the output gap, the Council has identified a number of short comings with this methodology, and therefore has opted to base its assessment of the Domestic Budgetary Rule on a framework that is more appropriate for Ireland.

Budget 2019 incorporated a one-off windfall of €0.35 billion for corporation tax in 2018, relating to a change in International Accounting Standards, and this is incorporated in the Council's assessment of the fiscal rules.[68] Additionally, *SPU 2019* incorporated a one-off expenditure of €0.2 billion for 2018 relating to the payment of arrears to medical consultants following the settlement of a court process. Table 4.1 provides a summary assessment of compliance with the Domestic Budgetary Rule and the Debt Rule.

[67] See Appendix F for a summary of the Council's "principles-based approach". For a more detailed outline of the Council's new "principles-based approach", to the domestic budgetary rule, and the Council's reasoning for taking this approach, see Box A of *Ex-Post Assessment of Compliance with the Domestic Budgetary Rule 2018* (IFAC, 2019a).

[68] The treatment in this chapter differs from that of the Department of Finance, presented in the documents for *SPU 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]

Per Cent of GDP unless stated. For deviations, negative values = non-compliance

	2017	2018	2019	2020	2021	2022	2023
Corrective Arm							
General Government Balance Excl. One-Offs	-0.2	0.0	0.2	0.4	0.7	1.0	1.3
General Government Debt	68.5	64.8	61.1	55.8	55.4	53.2	51.6
1/20th Debt Rule Limit	81.9	71.5	67.9	64.2	60.0	60.0	60.0
Debt Rule met?	Y	Y	Y	Y	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule							
Structural Balance Adjustment Requirement							
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
Structural Balance	1.5	0.2	0.1	-0.1	0.1	0.1	0.3
MTO met?	Y	Y	Y	Y	Y	Y	Y
Minimum Change in Structural Balance Required	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Change in Structural Balance	1.0	-1.2	-0.2	-0.2	0.3	0.0	0.1
1yr Deviation (€bn)	-	-	-	-	-	-	-
1yr Deviation (p.p.)	-	-	-	-	-	-	-
2yr Deviation (€bn)	-	-	-	-	-	-	-
2yr Deviation (p.p.)	-	-	-	-	-	-	-
Expenditure Benchmark							
(a) Reference Rate of Potential Growth (% y/y)	3.5	3.4	3.4	3.4	3.2	3.1	3.0
(b) Convergence Margin	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	3.5	3.4	3.4	3.4	3.2	3.1	3.0
GDP Deflator used	0.4	1.5	1.5	1.7	1.7	1.6	1.6
Limit for Nominal Net Expenditure Growth (% y/y)	**3.9**	**5.0**	**4.9**	**5.1**	**4.9**	**4.7**	**4.7**
Net Expenditure Growth (% y/y)	5.1	6.0	3.3	3.6	3.2	3.1	2.8
Net Expenditure Growth (Corrected for one-offs) (% y/y)	4.8	6.0	3.6	3.6	3.2	3.1	2.8
1yr Deviation (Corrected for one-offs) (€bn)	-0.6	-0.7	1.0	1.2	1.4	1.3	1.7
1yr Deviation (Corrected for one-offs) (% GDP)	-0.2	-0.2	0.3	0.3	0.4	0.4	0.4
2yr Deviation (Corrected for one-offs) (€bn)	0.1	-0.6	0.1	1.1	1.3	1.4	1.5
2yr Deviation (Corrected for one-offs) (% GDP)	0.1	-0.2	0.0	0.3	0.4	0.4	0.4
Limit for Nominal Net Expenditure Growth (€bn)	**2.6**	**3.5**	**3.7**	**4.0**	**4.0**	**4.0**	**4.1**
Net Expenditure Increase (€bn)	3.4	4.2	2.5	2.8	2.6	2.6	2.4
Net Expenditure Increase (Corrected for one-offs) (€bn)	3.2	4.2	2.7	2.8	2.6	2.6	2.4
Current Macroeconomic Aggregates							
Real GDP Growth (% y/y)	7.2	6.7	3.9	3.3	2.4	2.5	2.6
Department's alternative Potential GDP Growth (% y/y)	7.4	4.1	3.1	2.6	2.2	2.0	2.2
Department's alternative GDP Output Gap	-2.9	-0.5	0.2	0.8	1.0	1.4	1.8
GDP Deflator Used (% y/y)	0.4	1.5	1.5	1.7	1.7	1.6	1.6

Sources: CSO; Department of Finance; and internal IFAC calculations.
Notes: [1]All figures are presented on a General Government basis. The approach to assessment here differs from previous FAR assessments. Assessments examine the *SPU 2019* revenue and expenditure plans, using the Council's principles-based approach to the Domestic Budgetary Rule and considering the Council's views on one-off/temporary measures. For more information about the changes to the Council's assessment approach see Appendix F of this report and Box A of IFAC's *Ex-post assessment of compliance with the domestic budgetary rule 2018* (IFAC, 2019a). In 2017, a one-off expenditure of €0.2 billion in relation to a refund of domestic water charges is included in the Council's assessment. A one-off windfall of €0.35 billion in corporation tax revenue for 2018 is included in the Council's assessment of the structural balance as well as a one-off expenditure of €0.2 billion, in 2018, due to a settlement in relation to pay arrears for medical consultants. The outlier for 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] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress toward the reference value of 60 per cent of the GDP. A transition period applied until the end of 2018.
[3]Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which may be unrealistic (see Chapter 3).

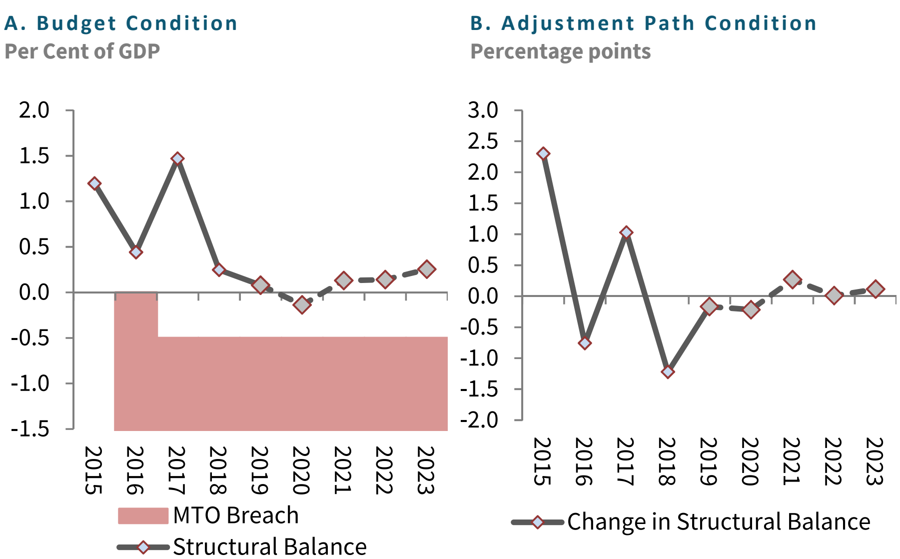
4.2 *Ex-Post* Assessment for 2018

This section reviews the Council's *ex-post* assessment for 2018, which was carried out in IFAC's *Ex-post assessment of compliance with the domestic budgetary rule 2018* (IFAC, 2019a). This assessment was based on the Council's new principles-based approach to the Budgetary Rule as outlined in Box A of the Council's *ex-post* assessment (IFAC, 2019a) and summarised in Appendix F.

MTO and Structural Balance Adjustment Requirements

The Council assessed that the MTO, of a structural balance of no less than –0.5 per cent of GDP, was achieved in 2018, with a structural balance of +0.2 per cent of GDP. As the MTO was achieved in 2018, the adjustment path condition did not apply. Despite the achievement of the MTO there was a significant deterioration of the structural balance in 2018, with the structural balance falling by 1.2 percentage points (Figure 4.1). This was despite a considerable over performance of corporation tax, which is counted under these methods as structural improvements in revenue, but these receipts may not be linked to the underlying economy. As a result, the degree to which there was deterioration in the underlying structural balance for 2018 is, to some extent, masked by this over performance of corporation tax.

Figure 4.1: Assessment of compliance with the budgetary rule



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The MTO for Ireland 2017-2022 is set at -0.5 per cent of GDP. This was achieved in 2017 and 2018, so the adjustment path condition is not assessed as the requirement is to simply remain at the MTO. Dashed lines represent forecasts that are largely as a result of technical assumptions on expenditure, which may be unrealistic (Chapter 3).

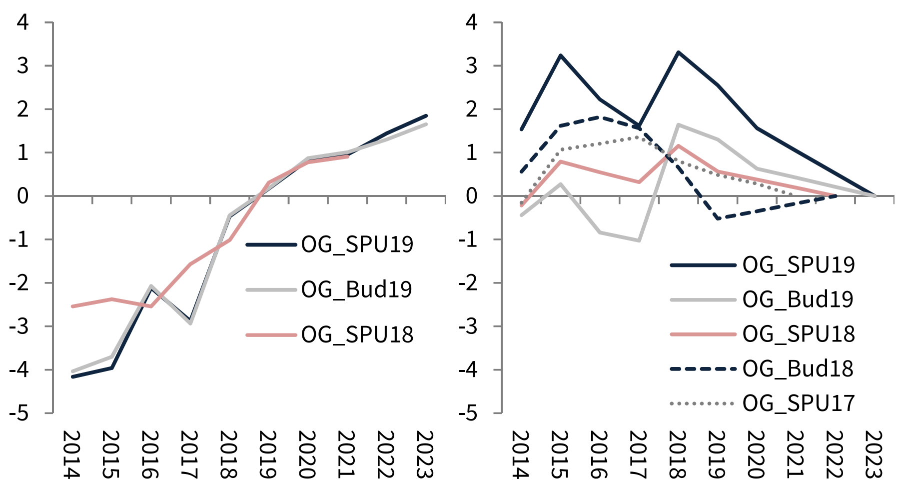
While the sample size is currently small, the Department's GDP-based estimates of the output gap appear less prone to significant revisions than the CAM-based estimates of the output gap. In particular, overtime and across vintages, the Department's estimates are very similar (Figure 4.2).[69] By this metric, and given the more plausible path of the Department's GDP-based output gap estimates, these estimates are a more reliable basis for assessing the fiscal rules.

With the output gap closing, and the cyclical position of the economy close to balance in 2018, a larger general government surplus would have been required to maintain the structural balance at the same level as in 2017 (Figure 4.3). Instead, the actual improvement in the budget balance was insufficient to prevent a sharp deterioration in the structural position.

Figure 4.2: Output gap vintages

Per Cent of GDP

A. Department's GDP-based Output Gap | **B. Department's CAM-based Output Gap**

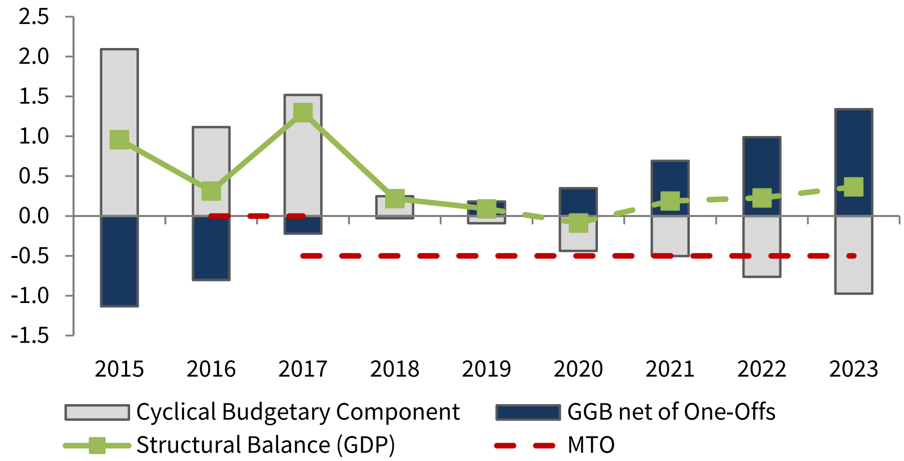


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The Department's GDP-based estimates of the output gap are based on the mid-point of its suite of GDP-based models. The *SPU 2018* vintage of the output gap for the Department's GDP-based estimates was at the early stage of the development of these estimates and included an additional model not included in the Department's suite of models in subsequent vintages. The CAM-based estimates of the output gap involve closure of the output gap over the medium-term. As a result, the output gap returns toward zero at the end of each forecast horizon.

[69] The *SPU 2018* vintage of the output gap for the Department's GDP-based estimates was at an early stage of the development of these estimates. At the time, it included an additional model that is no longer included in their suite of models as of the subsequent two vintages.

Figure 4.3: Structural balance decomposition

Per Cent of GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: GGB is the general government balance. The cyclical budgetary component is estimated as: –0.588 x output gap, where the output gap is the Department of Finance's GDP-based output gap. Dashed lines represent forecasts that are largely as a result of technical assumptions on expenditure, which may be unrealistic (Chapter 3).

Expenditure Benchmark

The Expenditure Benchmark is used as a measure of progress toward the MTO. While the Expenditure Benchmark does not technically apply, under the *SGP,* when the MTO is exceeded (provided overachievement was not as a result of windfalls), the Council still assesses compliance with the Expenditure Benchmark as it is useful in assessing the stance of fiscal policy. In particular, given that there is considerable uncertainty about the exact position of the structural balance for Ireland (see Box K), the Expenditure Benchmark can, at times, provide a better indication of the prudence of fiscal policy. However, the Expenditure Benchmark is not without its faults (see Barnes & Casey, 2019), and as such, the Council recommends that the Expenditure Benchmark should–at a minimum–be considered an upper limit, and may at times be beyond, what the Council would deem prudent.

For 2018, the limit set under the Expenditure Benchmark, using the Council's principles-based approach, was a growth rate of 5.0 per cent. Net Expenditure, less one-off expenditure items, grew by 6.0 per cent in 2018, 1.0 percentage point faster than the limit provided by the Expenditure Benchmark.[70]

[70] This limit is based on the Council's new Principles-based approach to the Domestic Budgetary Rule, which was not available at the time policy was set for 2018 (*Budget 2018*). However, the Government was also not in compliance with the Expenditure Benchmark limit that was available

Table 4.2 shows the contributions of each of the adjustments made to general government expenditure to arrive at net expenditure, the assessed growth rate under the rules. One of the key adjustments to arrive at the net expenditure figure is the smoothing of capital investment (GFCF). Actual increases in GFCF are removed from the spending figure, and replaced by the four year average of GFCF, to smooth out the cost of large projects. Had this adjustment not applied to reflect the consistent build up in public investment in Ireland, net expenditure would have grown by 6.8 per cent in 2018, significantly above the limit set by the Expenditure Benchmark. The discretionary revenue measures partially offset the other adjustments made, but these measures were not sufficient to bring expenditure below the Expenditure Benchmark limit for 2018.

The Council's November 2018 FAR (IFAC, 2018e) had deemed the Expenditure Benchmark for 2018 complied with based on forecasts presented in *Budget 2019*. Since then, the CSO has released provisional outturn data for 2018 showing higher than forecasted general government expenditure of approximately €0.8 billion (largely due to underestimated social payments), and lower than expected expenditure on gross fixed capital formation (GFCF) of approximately €0.3 billion. The combination of these two factors has caused the net expenditure figure to be higher than was previously outlined in the November 2018 FAR (IFAC, 2018e), and hence why a breach is now shown for 2018.

at the time policy was set (See Appendix Table G.1). As a result, the Council assesses that the Expenditure Benchmark was breached for 2018.

Table 4.2: Contributions of adjustments to net expenditure growth

Per cent of Net Expenditure

		2017	2018	2019	2020
	Walk to Net Expenditure Growth (Net of one-offs)				
ΔGGE	**General Government Expenditure Growth**	**3.0**	**6.6**	**4.5**	**2.9**
-ΔInt	Interest	0.5	0.8	0.6	0.6
-ΔEU	EU Co-Financed Current Spending	-0.1	0.0	0.0	-0.1
-ΔGFCF	Public Investment (GFCF)	-0.1	-1.7	-1.6	-0.4
+ΔavGFCF	Four-Year Avg of Public Investment	0.7	0.8	1.0	0.9
-ΔUC	Cyclical Unemployment Expenditure	1.0	0.6	0.1	0.1
-DRMs	DRMs	0.1	-1.2	-1.3	-0.4
	Net Expenditure Growth	5.1	**6.0**	**3.3**	**3.6**
-ΔOOE	One-Off Expenditure Items	-0.3	-0.1	0.3	0.0
ΔNE	**Net Expenditure Growth (Net of one-offs)**	**4.8**	**6.0**	**3.6**	**3.6**
	Limit for Net Expenditure Growth (% y/y)	**3.9**	**5.0**	**4.9**	**5.1**

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 are based on the Council's principles-based approach to the Domestic Budgetary Rule. Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which may be unrealistic (see Chapter 3). A negative number for DRMs indicates that, in net terms, revenue raising measures were introduced. These discretionary revenue measures reduce the measured level of net expenditure growth under the Expenditure Benchmark thereby allowing general government spending to grow at a faster rate.

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.

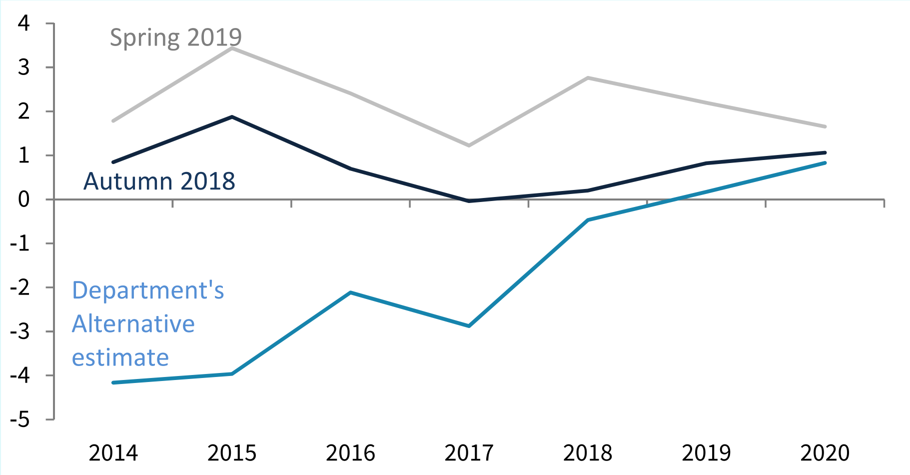
7.8 per cent. Subsequently, the preliminary outturn for 2018 showed a lower than expected growth rate for 2018 of 6.7 per cent. As a result, in the Commission's Spring 2019 forecasts, the decision was taken to remove the dummy for 2018.[72]

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

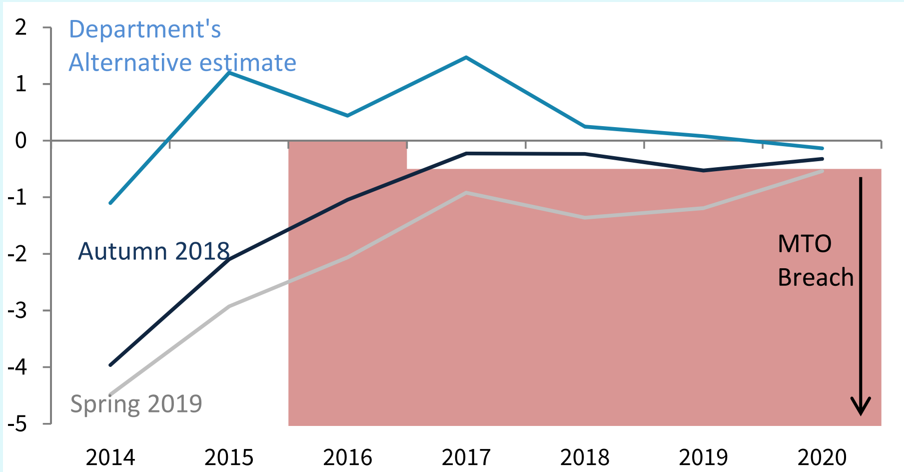
[72] The dummy for 2017 was included based on outturn data showing a growth rate of 7.2 per cent, which at the time was deemed, by the Commission, to be an implausible growth rate for the underlying economy. Whereas, the growth rate of 6.7 per cent for 2018 is deemed, by the Commission, to be a plausible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

4.3 In-year Assessment for 2019

This section assesses whether the Department's plans for 2019, based on forecasts in the *SPU 2019,* are compliant with the fiscal rules. The Debt Rule will apply in full for the first time in 2019, following the end of a three year transition period from 2016–2018.

Based on *SPU 2019* estimates the structural balance is currently forecast to comply with the MTO in 2019 with a modest margin. Net Expenditure growth is projected to be below the limit set by the Expenditure Benchmark.

MTO and Structural Balance Adjustment Requirements

As the MTO was achieved for 2018, there is no adjustment requirement for 2019. A structural balance of +0.1 per cent of GDP is currently forecast for 2019. This will see the structural balance largely unchanged from 2018. However, a degree of caution is required in interpreting this forecast compliance. Given that an MTO breach lies within the range of structural balance estimates (see Box I), there is a need to control spending to ensure that expenditure overruns do not occur again and the structural balance does not deteriorate further than currently planned.

Expenditure Benchmark

Net expenditure growth for 2019 is currently forecast to be 3.6 per cent, which is below the Expenditure Benchmark limit of 4.9 per cent. The low net expenditure growth figure for 2019 is partially as a result of the breach in 2018 leading to a much higher base for 2019.

Additionally, in general government terms, expenditure was €0.8 billion higher, in 2018, than forecast in *Budget 2019,* but *SPU 2019* forecasts of general government expenditure for 2019 do not appear to have been adjusted upward significantly in light of this higher level of spending which occurred in 2018 (see Chapter 3). It is therefore possible that the 2019 figure for general government expenditure is an underestimation.

Given the possible underestimation outlined above, and the fact that between *Budget 2018* and year-end 2018, actual expenditure was approximately 3.4 per cent

(€2.7 billion) larger than planned, there are risks that a repeat of this expenditure overrun would lead to a breach of the Expenditure Benchmark in 2019. [74]

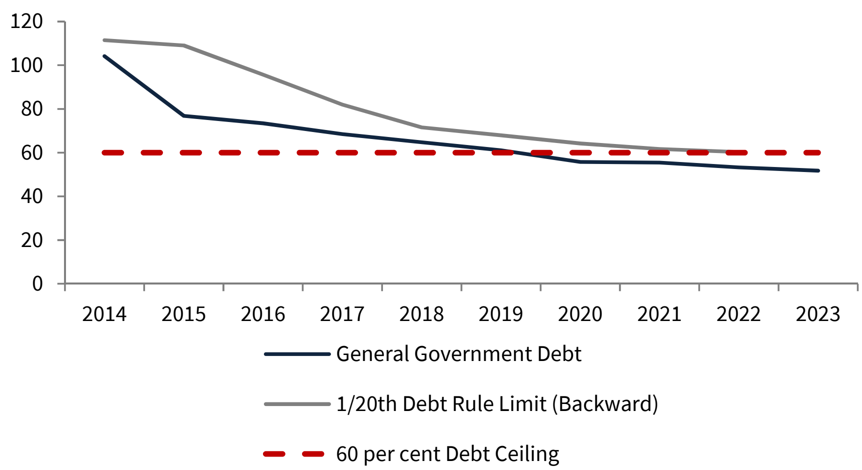
Debt Rule

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. The Debt Rule applies in full for the first time in 2019. The Debt Rule essentially requires that the debt-to-GDP ratio be below 60 per cent of GDP or reducing each year by 1/20th of the gap above 60 per cent.[75] The Debt Rule is forecast to be complied with in 2019, with the debt-to-GDP ratio below the limit set by the backward-looking benchmark (Figure 4.4).

Given the nature of the distortions in the GDP figures for Ireland, relating to the multinational sector, the Debt Rule is unlikely to be a constraint on medium-term fiscal policy. The distortions also mean that the sustainability of Ireland's debt levels should not be judged using a debt-to-GDP ratio. Instead, a more appropriate measure of national income should be used, like GNI*.[76]

Figure 4.4: Compliance with the Debt Rule: Backward 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 *SPU 2019*.

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[74] Approximately €0.5 billion of this increase can be attributed to statistical reclassification of the Approved Housing Bodies, while a further €0.2 billion can be attributed to a one-off, not anticipated in *Budget 2018*.

[75] See Box F of the November 2018 FAR (IFAC, 2018e) for an explainer on the Debt Rule.

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

In light of these issues with the Debt Rule, the Council assesses that a more appropriate debt commitment should be developed. The commitment should better reflect sustainability concerns, should be time limited (with a specific date at which the commitment would be achieved), and it should be clearly specified as to whether the debt commitment is a target or a ceiling. The Government had previously set a debt target of 55 per cent of GDP (which it subsequently dropped all mention of, without explanation). 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.

Box K: The Uncertainty in assessing Compliance with the Fiscal Rules

This Box attempts to illustrate the uncertainty in assessing compliance with the fiscal rules. A central issue when assessing compliance with the fiscal rules is that it relies on the estimation of unobservables, such as potential output and the output gap. Estimating these unobservables is inherently uncertain and no estimation technique can accurately capture the true position of these unobservables at any point in time. It follows that assessing compliance with the fiscal rules based on these unobservables is surrounded by some uncertainty regarding the position of the economy in the cycle.

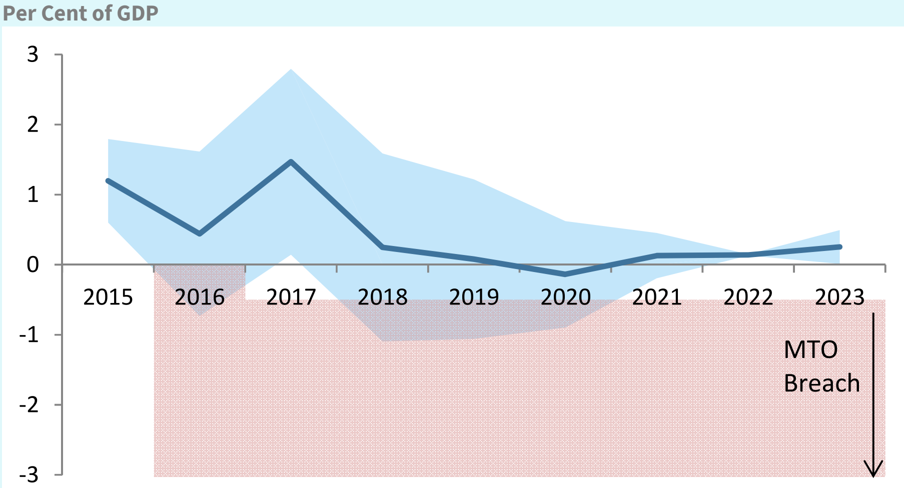
One advantage of the Council's new principles-based approach to the budgetary rule is that the framework is based on the Department's suite of GDP-based estimates of potential output. As the framework is based on a suite of models, the various estimates can be used to illustrate, to some degree, the uncertainty in the fiscal rules. By taking the maximum and the minimum of the estimates of potential output and the output gap, one can show a range of estimates of the structural balance and the Expenditure Benchmark. This is not possible with the potential output and output gap estimates produced using the CAM, as the estimates produced using the CAM are simply point estimates from a single model and so it is not possible to display a range of possible estimates.

Structural Balance Range

The Department's GDP-based estimate of the output gap is the mid-point of its two GDP-based estimates. Using these two estimates of the output gap it is possible to create a range of structural balance estimates. Figure K.1 shows the range of structural balance estimates using these output gap estimates. While the structural balance estimate using the mid-point of the output gap estimates shows that the MTO is met in all years, the range clearly overlaps with an MTO breach in some years. At its widest, the range of structural balance estimates is 2.7 percentage points in 2018, illustrating a considerable degree of uncertainty about a point estimate for the structural balance in that year.

Figure K.1: Structural balance range

Per Cent of GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Blue shaded region contains the range of structural balance estimates using the Department's minimum and maximum of their alternative GDP-based output gap estimates. Blue line represents the structural balance estimate using the mid-point of the Department's alternative GDP-based estimates.

Expenditure Benchmark Range

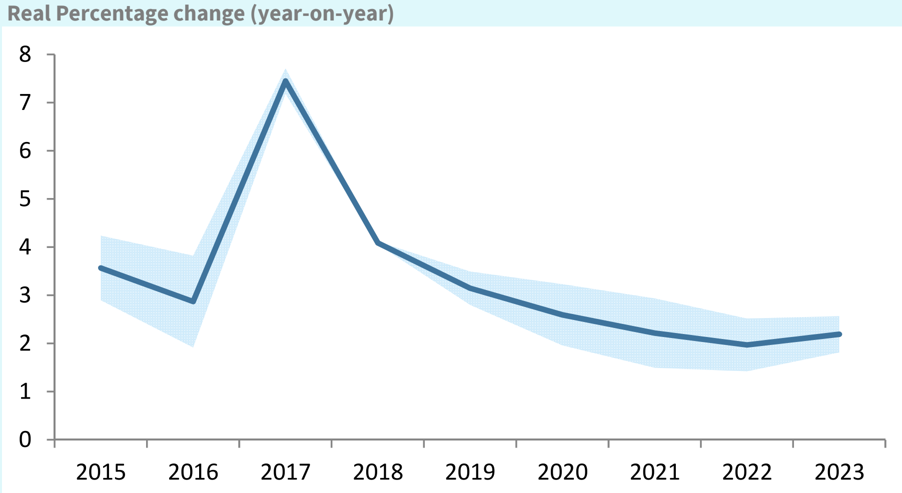
The reference rate for the Expenditure Benchmark is a 10–year average of potential output growth rates. Figure K.2 shows the range of potential output growth rates using the

Department's GDP-based estimates. The range of potential output growth rates, for the most part, lies between 4 per cent and 2 per cent growth, with potential output growth spiking in 2017. The range of potential output growth rates is at its widest in 2016, at 1.9 percentage points, while the range is at its narrowest in 2018 at approximately 0.1 percentage points. Again, there is considerable variability in the range of potential output growth rate estimates.

Using the 10-year average of the potential output growth rates reduces the variability in the reference rate for the Expenditure Benchmark, and ensures that the reference rate is not overly sensitive to individual point estimates of potential growth. However, one caveat of this is that the revisions to potential output growth estimates occur for the entire time horizon and usually in the same direction and so do not just affect individual point estimates of potential output growth (Barnes & Casey, 2019).

Figure K.2: Range of potential output growth

Real Percentage change (year-on-year)



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Blue shaded region contains the range of potential output growth estimates using the Department's minimum and maximum of their GDP-based output gap estimates. Blue line represents the potential output estimate using the mid-point of the Department's alternative GDP-based estimates. The outlier for Potential GDP Growth for 2015 is replaced by the average of the 2014 and 2016 rates, as discussed in the June 2017 FAR (IFAC, 2017c).

Figure K.3 shows the range for the Expenditure Benchmark limit using the Department's two GDP-based estimates of potential output. The dynamics of the range for the Expenditure Benchmark limit is considerably less erratic than that of the range for the structural balance, and is a clear indication of the power of taking the 10-year average in reducing the variability in the assessed rate. The range for the Expenditure Benchmark limit is relatively stable throughout the forecast horizon, with the range at its widest in 2019, at 1 percentage point (narrowest is 0.8 percentage points). Assessing compliance with the Expenditure Benchmark over this horizon is relatively more clear cut than assessing the structural balance, with the net expenditure growth being either completely above or below the range for the Expenditure Benchmark limit in all years.[77]

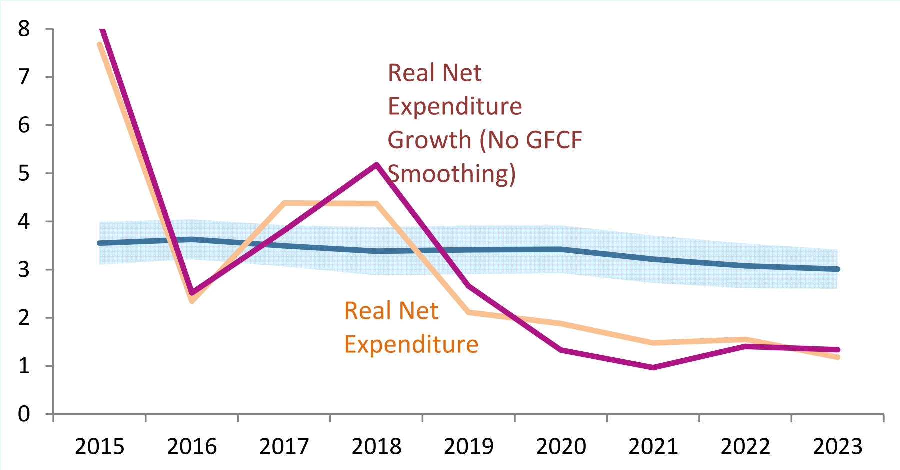
The uncertainty in estimating the position of the economy in the cycle and its potential growth rate mean that, while the principles-based approach to the rules is a good guide for policy, policymaking should take a prudent approach and not rely too heavily on minimal compliance with the rules. A safety margin, in terms of compliance with the rules would be helpful for

[77] For one year, 2017, the non-GFCF smoothed net expenditure growth was marginally inside the Expenditure Benchmark range. However, this is not the assessed figure in terms of the rules.

prudent policy given the uncertainty illustrated.

Figure K.3: Expenditure benchmark range

Percentage change (year-on-year)



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Blue shaded region shows the range of the Expenditure Benchmark limits using estimates of the minimum and maximum potential output growth rates from the Department's alternative GDP-based estimates. Blue line represents Expenditure Benchmark limit in real terms using the mid-point of the Department's alternative GDP-based potential output estimates.

4.4 *Ex-Ante* Assessment for 2020-2023

This section assesses compliance of the Department's forecasts for 2020–2023 with the fiscal rules. However, the forecasts for expenditure, and therefore the government balance, are based on unrealistic technical assumptions for these years and therefore the consistency of these projections with the rules does not provide much meaningful guidance (see Chapter 3).

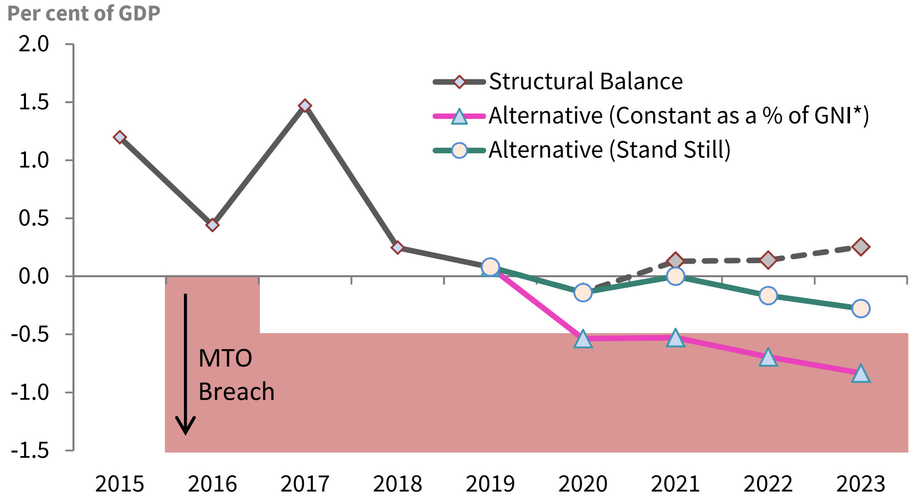
MTO and Structural Balance Adjustment Requirements

The MTO for 2020–2022 is now set as a structural deficit of 0.5 per cent of GDP. Based on the latest government forecasts, the MTO will be achieved for all years. As such, no adjustment requirement will apply for these years. The structural balance is forecast to stay relatively constant over the forecast horizon, fluctuating marginally with increases in the general government balance largely offsetting the cyclical component (Figure 4.2).

These projections suggest that the room under the fiscal rules for additional spending or tax cuts beyond those in current technical projections will be relatively limited in the coming years unless these are offset by additional revenue-raising measures or efficiency gains.

As an illustration, Figure 4.5 shows alternative paths for the structural balance, based on the alternative scenarios for general government expenditure presented in Table 3.3 (Chapter 3). Both alternative scenarios show a less benign path for the structural balance. In particular the scenario which shows general government expenditure remaining constant as a share of GNI* shows a sharp deterioration in the structural balance in 2020, and declining further by 2023. In this scenario, the structural balance would breach the MTO in each of the years, 2020–2023.

Figure 4.5: Alternative scenarios for the structural balance



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The "Alternative (Constant as % GNI*)" scenario the shows structural balance which would arise from holding general government expenditure constant as a share of GNI*, using GNI* forecasts from *SPU 2019*. The "Alternative (Stand Still)" scenario shows the structural balance which would arise when adding in the additional IFAC Stand-Still costs for demographics and public sector pay over the pre-commitments for these items (and carryover costs) in *SPU 2019* forecasts. In both alternative scenarios general government revenue is adjusted to account for the increases in government expenditure (relative to *SPU 2019)*. This is done using the Council's Fiscal Feedbacks Model.

Expenditure Benchmark

Based on forecasts in *SPU 2019* the Expenditure Benchmark will be complied with for all years in the forecast horizon. However, these expenditure forecasts are largely based on technical assumptions and may be unrealistically low (see Chapter 3).

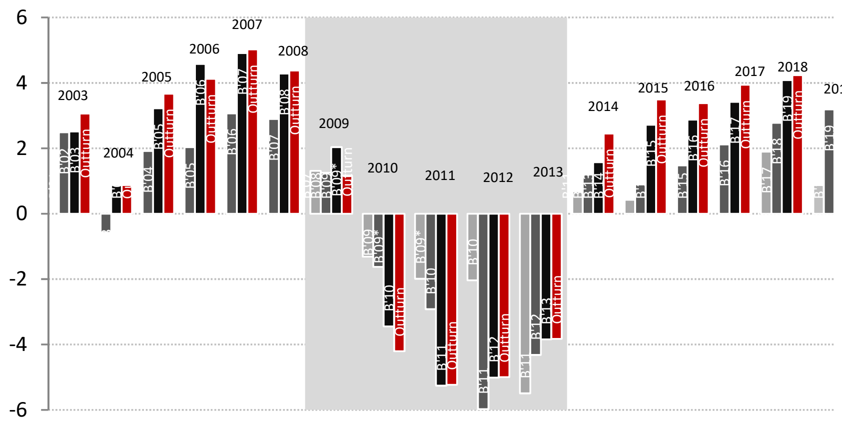
Debt Rule

The debt-to-GDP ratio is forecast to fall below the 60 per cent reference value in 2020, for the first time since 2008. Once this happens, compliance with the Debt Rule requires that the debt ratio remain below 60 per cent. This is forecast to be the case for 2021–2023.

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 for managing expenditure over the medium-term and ensure 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 4.6: Change in gross expenditure ceilings (relative to initial ceiling)
€ Billions



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: 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 4.6 shows the change in gross expenditure forecasts since 2003. There is a clear cyclical pattern in the revisions to these expenditure forecasts. The change in the initial ceiling to outturn for 2018 mirrors the change seen in 2006, with a €4 billion increase over the initial ceiling. This pattern which could continue in 2019, echoes the mistakes of the past, undermines the credibility of these ceilings and indicates that these ceilings are seen by government departments as a "soft budget constraint".

It is inevitable that policy priorities will change from year to year, but it is not prudent budgetary management to continuously allocate increases in funding across all departments, beyond already-budgeted-for increases. Instead, funding should be appropriated to individual departments within the overall ceiling (which in itself should be realistic), to reflect policy changes. This has not been the case, with quite significant upward revisions to expenditure ceiling across all departments in recent years. Revisions to the expenditure ceilings have been particularly large for each of the four largest government departments (Appendix H).