Assessment of Compliance with the Domestic Budgetary Rule in 2019

May 2020

Irish Fiscal Advisory Council

This report can be downloaded at www.FiscalCouncil.ie

Background

The Fiscal Responsibility Act 2012 (FRA) established the Irish Fiscal Advisory Council (the Council) as a statutory body and legislated for the implementation of national fiscal rules.

Under the FRA, part of the mandate of the Council is to monitor and, at least once in each year provide an assessment of compliance with the domestic Budgetary Rule.[1] Independently, the European Commission made their own assessment of compliance with the EU fiscal rules for 2019, and that assessment is the legal basis for compliance with the EU fiscal rules.[2]

This note primarily assesses compliance with the Domestic Budgetary Rule using the Council's "principles-based approach", but also includes an assessment based on the Council's previous methodology in the appendix (Appendix B).[3]

This note outlines the Council's assessment for 2019, based on data available as of spring 2020 including the Maastricht returns (i.e., the first official outturns for the previous year's annual general government statistics), preliminary GDP data for the

[1] 1 FRA Section 8(2) specifies the Council's role as to "monitor, and at least once in each year, provide an assessment of, whether any obligation under section 2(1)(a) or 6(1), or to do things specified in a plan under section 6(1), is being complied with". Section 2(1)(a) relates to the Budgetary Rule and notes: "the Government shall endeavour to secure that—(a) the requirement imposed by section 3 (the budgetary rule)…are complied with". Section 6(1) covers the "Correction Mechanism", that sets plans to secure compliance with the Budgetary Rule when not met: "if the Commission addresses a warning to the State under Article 6(2) of the 1997 surveillance and coordination Regulation or if the Government consider that there is a failure to comply with the budgetary rule which constitutes a significant deviation for the purposes of Article 6(3) of that Regulation, the Government shall, within 2 months, prepare and lay before Dáil Éireann a plan specifying what is required to be done for securing compliance with the budgetary rule".

[2] The European Commission found that Ireland was complaint with the Medium-term Budgetary Objective for 2019 and the Expenditure Benchmark and was therefore compliant with the EU fiscal Rules. See *Assessment of the 2020 Stability Programme for Ireland*: https://ec.europa.eu/info/sites/info/files/economy-finance/ie_assessment_2020_sp.pdf.

[3] See Box A of Fiscal Council's Ex-post assessment of compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a) for the reasoning behind this approach and see Appendix A for summary details of the two approaches.

previous year (Q4 Quarterly National Accounts), and the Department of Finance's latest potential output and output gap estimates.[4, 5]

[4] *SPU 2020* did not include updated estimates of potential output and the output gap due to the heightened uncertainty about such estimates for the current year at this time. Therefore, this assessment uses estimates of potential output for 2019 that were included in *Budget 2020.* These estimates were on the basis of forecasts for a no-deal Brexit at the end of October 2019. To the extent that this did not materialise, estimates of potential output growth for 2019 would be relatively higher, implying a smaller positive output gap than estimated in *Budget 2020*, all else equal. As this assessment will show, the MTO was achieved. The higher potential output and smaller positive output gap and would imply a more positive structural balance estimate, and a higher limit for the Expenditure Benchmark for 2019, so the conclusion about compliance with the domestic budgetary rule would be unchanged were a smaller positive output gap and higher potential output estimate used. There is no reason to believe the Covid-19 pandemic would alter the "actual" potential or sustainable growth rate of the economy for 2019. Whether the Covid-19 pandemic would alter the "estimate" of potential output for 2019, due to the filtering techniques used to derive these estimates, is a separate matter.

[5] Under the Council's principles-based approach, deviations from the Expenditure Benchmark are assessed using modified gross national income (GNI*). The CSO has not yet produced the 2019 outturn for GNI*. As such, this note relies on the Department of Finance's latest estimate of GNI* include in SPU 2020. As the MTO is achieved in 2019, the use of the Department's estimate in this instance does not alter the Council's overall assessment of compliance with the Domestic Budgetary Rule.

Summary Assessment

Table 1 outlines the main information relevant for assessing compliance with the Domestic Budgetary Rule in 2019 under the Council's principles-based approach. Initially, the Budget Condition is assessed (i.e., whether the structural balance is at the Medium-Term Objective (MTO) requirement). Then, if the MTO has not been reached, the Adjustment Path Condition is assessed (i.e., whether the required pace of convergence towards the MTO is achieved).

The Council assess that the MTO was achieved in 2019. The Expenditure Benchmark limit for 2019 was complied with, although technically this does not apply once the MTO is achieved. **As a result, the Council assesses that the Domestic Budgetary Rule was adhered to in 2019.**

Table 1: Summary Assessment of Compliance for 2019

	Required/ Limit	Actual	Compliant	Deviation	Deviation	Significant Deviation
A. Budget Condition				**(% GDP)**	**(€bn)**	
Structural Balance (% GDP)	**-0.5**	**-0.2**	**Yes, At MTO**			
B. Adjustment Path Conditions						
I. Change in Structural Balance						
One-year change (p.p.)						
Two-year avg. change (p.p.)						
	Technically no longer applies once MTO is achieved					
II. Expenditure Benchmark (Limit)[a]						
One-year growth rate (%)						
Two-year avg. growth rate (%)						

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices C and D). Estimates of the output gap are as reported in Table A11 of the Budget 2020. The budgetary semi-elasticity used is 0.588 as estimated in Fiscal Council Analytical note 12. Overachievement of the MTO is not required and so the structural balance adjustment is not assessed. Member States that have exceeded their MTO do not need to be assessed for compliance with the Expenditure Benchmark.
[a] The Expenditure Benchmark requirement is set as a growth limit in nominal terms.

1. Budget Condition

The Budget Condition set out in the FRA requires that the budgetary position of the general government be in balance or in surplus. This condition is deemed to be met if the general government structural balance is at the MTO. The MTO is set under the Preventive Arm of the Stability and Growth Pact and was set as a structural deficit of no more than 0.5 per cent of GDP for 2019. If the Budget Condition requirement is not met, the structural balance is subject to the Adjustment Path Conditions discussed in Section 2. If failure to meet the requirement is the result of exceptional circumstances and it does not endanger medium-term fiscal sustainability, a deviation from the requirement is permitted.

Table 1 shows the Budget Condition for 2019. The structural deficit was 0.2 per cent of GDP. As a result, the MTO, of a structural deficit of no more than 0.5 per cent of GDP, was achieved in 2019.

Table 2: Budget Condition

	Requirement (MTO)	Actual	At MTO?
A. Budget Condition			
Structural Balance 2019	-0.5	-0.2	Yes

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices B and C). Estimates of the output gap are as reported in Table A11 of the Budget 2020. The budgetary semi-elasticity used is 0.588 as estimated in Fiscal Council Analytical note 12.

The Council assesses that the achievement of the MTO was not due to windfall revenues under the standard definition. Achievement of the MTO is assessed taking into account revenue windfalls. Revenue windfalls are defined as per the methodology outlined in the Vade Mecum. If overachievement of the MTO were due to revenue windfalls, the Expenditure Benchmark would still apply. While the Council assesses that these revenues are not deemed to be windfalls as per the standard definition, **considerable concerns remain** about the long-run sustainability of these receipts, particularly corporation tax.

2. Adjustment Path Condition

The Adjustment Path Condition of the Domestic Budgetary Rule does not apply in 2019. The Adjustment Path Condition is a means of ensuring the structural balance is on a suitable path towards the MTO and it incorporates the Expenditure Benchmark. As the MTO was achieved in 2019, and this achievement is not deemed contingent on windfall revenues, the Adjustment Path Condition, technically no longer applies.

While the Adjustment Path Condition does not formally apply the Council still assesses the Expenditure Benchmark. The Expenditure Benchmark limit for 2019 was an expenditure growth rate of 5.0 per cent. Net expenditure grew by 4.9 per cent in 2018, below the Expenditure Benchmark limit (Table 3). However, on a two-year basis, taking 2018 and 2019 together, there was a deviation of 0.2 per cent of GNI* from the Expenditure Benchmark limit. This deviation is not considered significant. With that in mind, **the Council assesses that the Expenditure Benchmark was complied with in 2019.**

Table 3: Adjustment Path Condition

	Required/ Limit	Actual	Compliant	Deviation	Deviation	Significant Deviation
B. Adjustment Path Conditions						
I. Change in Structural Balance				**(% GDP)**	**(€bn)**	
One-year change (p.p.)	0.00	-0.4	**N/A**	-0.4	-1.4	**N/A**
Two-year avg. change (p.p.)	0.00	-0.7	**N/A**	-0.7	-2.4	**N/A**
II. Expenditure Benchmark (Limit)[a]				**(% GNI*)**	**(€bn)**	
One-year growth rate (%)	5.0	4.9	**N/A**	-	-	**N/A**
Two-year avg. growth rate (%)	4.6	5.2	**N/A**	0.2	0.5	**N/A**

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices C and D). Estimates of the output gap are as reported in Table A11 of the Budget 2020. The budgetary semi-elasticity used is 0.588 as estimated in Fiscal Council Analytical Note 12. N/A's refer to when rules do not technically apply. Overachievement of the MTO is not required and so the structural balance adjustment and the Expenditure Benchmark do not technically apply is not assessed.
[a] The Expenditure Benchmark requirement is set as a growth limit in nominal terms.

3. Fiscal Stance as Indicated by the Structural Primary Balance

As set out in the FRA, the Council's mandate also requires an assessment of the fiscal stance. The fiscal stance is defined in the FRA as the change in the annual structural primary balance. The structural primary balance is the general government balance adjusted for the economy's cyclical position and excluding one-off items and interest costs. While there is considerable uncertainty about point estimates of the level of the structural primary balance, changes in this estimate can provide a more accurate picture of the change in the underlying fiscal position of the state.

Table 4: Indicators of the Fiscal Stance

Per cent of GDP (unless otherwise stated)

	2017	2018	2019
Primary Balance (Excluding one-offs)			
Level	1.7	1.7	1.7
Change (p.p)		0.0	-0.1
Structural Primary Balance (Excluding one-offs)			
Level	3.2	1.8	1.1
Change (p.p)		-1.4	-0.8

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices C and D). Estimates of the output gap are as reported in Table A11 of the Budget 2020. The budgetary semi-elasticity used is 0.588 as estimated in a Fiscal Council Analytical Note 12.

The structural primary balance deteriorated 0.8 percentage points in 2019. This comes after a deterioration of the structural primary balance of 1.4 percentage points in 2018. This indicates that there was a continued worsening in the fiscal position in 2019. This is despite the recurrence of a considerable overperformance of corporation tax in 2019, which, as the Council has highlighted on numerous occasions, is unlikely to be linked to the performance of the underlying domestic economy. If not for the overperformance of corporation tax, the underlying fiscal position would have been far worse.

A more detailed discussion of the fiscal rules and an assessment of the fiscal stance is provided in the Council's Fiscal Assessment Report published alongside this Assessment (Fiscal Council, 2020).

Bibliography

Carroll, K., (2019). Irish Fiscal Advisory Council Analytical Note No. 12, Budgetary Semi-Elasticity, (Forthcoming). Dublin. Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

European Commission, (2019). Vade Mecum on the Stability and Growth Pact. Institutional Paper 101. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip101_en.pdf

Fiscal Council, (2018). Fiscal Assessment Report, November 2018. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

Fiscal Council, (2019). Assessment of Compliance with the Domestic Budgetary Rule in 2018, May 2019. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

Fiscal Council, (2020). Fiscal Assessment Report, May 2020. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

Appendix A: Summary of the Council's Principles-Based Approach to the Budgetary Rule

Table A.1: Outline of the Council's principles-based approach to the Budgetary Rule

Criteria	Fiscal Council's Principles-based approach	Fiscal Council Old Approach (prior to May 2019)
Potential Output and the Output Gap	The Department's GDP-based estimates of potential output and the output gap.	For the *ex-post* Assessment, the European Commission's own CAM-based estimates were used.
Reference Rate for Expenditure Benchmark	Based on the Department's latest estimates of GDP-based potential output growth (i.e. not frozen).	Reference rate frozen by the Commission in spring of year *t-1*, for assessment of year *t.* The same reference rate is used for the *ex-post* assessment.
Deflator for Expenditure Benchmark	Based on the Department's latest estimates of the demand-side GDP deflator (i.e. not frozen).	Based on the European Commission's estimates of the GDP deflator, frozen in spring of year *t-1.*
Adjustment Requirement and Convergence Margin	Based on the latest estimates of distance from the MTO in year *t-1* (i.e. not frozen). No negative convergence margin applied.	Compliance assessed based on the most favourable of the adjustment requirements and convergence margins in the spring or autumn of year *t-1*, or spring of *t+1* for the *ex-post* assessment (all based on the Commission's estimates of the output gap). No negative convergence margin applied.
NAWRU	Assumed constant at 5.5%.	The European Commission's CAM-based estimates of the NAWRU.
Margin of Tolerance	No margin of tolerance.	No margin of tolerance.
Significant Deviation from the Expenditure Benchmark	0.5% and 0.25% of GNI* for 1-year and 2-year assessment respectively.	0.5% and 0.25% of GDP for 1-year and 2-year assessment respectively.
Budgetary Semi-Elasticity	0.588	0.522

Note: For a full explanation of the Council's Principles-based Approach (PBA) to the Domestic Budgetary Rule see Box A of Ex-post assessment of compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a).

Appendix B: Assessment of compliance with the Domestic Budgetary Rule, using the Commonly Agreed Methodology.

This Appendix outlines the Council's assessment for the previous year, 2018, based on data available as of spring including the Maastricht returns (i.e., the first official outturns for the previous year's annual general government statistics) and preliminary GDP data for the previous year (Q4 Quarterly National Accounts) using the EU's CAM for estimating the output gap.[6]

However, it is the assessment that is presented in the main text of this note that represents the Council's view on compliance with the Budgetary Rule, not this appendix.

[6] The EU's CAM-based output gap estimates are the legal basis for assessing the EU fiscal rules.

A.1 Main Assessment

Table A.1 outlines the main information relevant for assessing compliance with the Domestic Budgetary Rule in 2019. Initially, the Budget Condition is assessed (i.e., whether the structural balance is at the Medium-Term Objective (MTO) requirement). Then, if the MTO has not been reached, the Adjustment Path Condition is assessed (i.e., whether the required pace of convergence towards the MTO is achieved or if the Expenditure Benchmark is adhered to).

The Council assesses that the MTO was not achieved for 2019 on the basis of the European Commission's CAM-based output gap estimates.

The Council assesses that the requirements under the Adjustment Path Conditions were met in 2019. **Therefore, the Council assesses that the Domestic Budgetary Rule was adhered to in 2019.**

Table A.1: Summary Assessment of Compliance for 2019

	Required/ Limit	Actual	Compliant	Deviation (% GDP)	Deviation (€bn)	Significant Deviation
A. Budget Condition						
Structural Balance (% GDP)	-0.5	-0.7	**No, Not at MTO**	-	-	**N/A**
B. Adjustment Path Conditions						
I. Change in Structural Balance						
One-year change (p.p.)	0.0	0.3	**Yes**	-	-	**N/A**
Two-year avg. change (p.p.)	0.2	0.5	**Yes**	-	-	**N/A**
II. Expenditure Benchmark (Limit)[a]						
One-year growth rate (%)	5.9	4.6	**Yes**	-	-	**N/A**
Two-year avg. growth rate (%)	4.5	4.8	**No**	-0.1	-0.2	**No**

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices C and D). Estimates of the output gap are as outlined in the European Commission's Spring 2020 forecasts. The budgetary semi-elasticity used is 0.522. A "significant deviation" is the term for the threshold that determines potential triggering of sanctions in the domestic and EU fiscal rules. It equates to a threshold of ≥0.5 per cent of GDP for one-year or an average of ≥0.25 per cent of GDP for two years. The Expenditure Benchmark requirement is set as a growth limit in nominal terms. A negative convergence margin is not applied.

A.2 Budget Condition

The Council assesses that the Budget Condition was not met based on the EU's methodology. Based on the European Commission's CAM based estimates of the output gap, the MTO of a structural deficit of no more than 0.5 per cent of GDP was not met for 2019, with an estimated structural deficit of 0.7 per cent of GDP (Table A.2).

Table A.2: Budget Condition

	Requirement (MTO)	Actual	At MTO?	Deviation (% GDP)	Deviation (€bn)	Significant Deviation
A. Budget Condition						
Structural Balance 2019	-0.5	-0.7	**No, Not at MTO**	-	-	**N/A**

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices B and C). Estimates of the output gap are as outlined in the European Commission's Spring 2020 forecasts. The budgetary semi-elasticity used is 0.522.

A.3 Adjustment Path Condition

As the MTO was not achieved for 2019, the Adjustment Path Condition of the Domestic Budgetary Rule applies. The Adjustment Path Condition is a means of ensuring the structural balance is on a suitable path towards the MTO and it incorporates the Expenditure Benchmark. Adjustment requirements for year t are set in the spring of year t-1. These requirements can only be reset in autumn of year t or spring of year t+1, if these vintages have a more favourable adjustment requirement in terms of compliance

The adjustment requirement for 2019 was set in autumn 2018 based on the European Commission's Autumn 2018 forecasts, which—at the time—forecast that the MTO would be achieved for 2018. This means that there was no adjustment requirement for 2019, despite the MTO no longer being shown to be achieved for 2018.[7]

In 2019, the structural balance improved by 0.3 per cent of GDP (Table A.3). As a result, the adjustment path condition was achieved. Net expenditure grew by 4.6 per cent in 2019, below the Expenditure Benchmark limit of 5.9 per cent.[8] There was a deviation from the Expenditure Benchmark on a two-year basis (taking 2018 and 2019 together), but this did constitute a significant deviation. **As a result, the Council assesses that the Adjustment Path Condition was adhered to in 2019.**

[7] See Fiscal Council (2019) for the *ex-post* assessment of 2018.

[8] The Fiscal Council does not apply a negative convergence margin when assessing compliance with the Expenditure Benchmark. See Chapter 4 of the November 2018 Fiscal Assessment Report for details (Fiscal Council, 2018).

Table A.3: Adjustment Path Condition

	Required/ Limit	Actual	Compliant	Deviation (% GDP)	Deviation (€bn)	Significant Deviation
B. Adjustment Path Conditions						
I. Change in Structural Balance						
One-year change (p.p.)	0.0	0.3	**Yes**	-	-	**N/A**
Two-year avg. change (p.p.)	0.2	0.5	**Yes**	-	-	**N/A**
II. Expenditure Benchmark (Limit)[a]						
One-year growth rate (%)	5.9	4.6	**Yes**	-	-	**N/A**
Two-year avg. growth rate (%)	4.5	4.8	**No**	-0.1	-0.2	**No**

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices C and D). Estimates of the output gap are as outlined in the European Commission's Spring 2020 forecasts. The budgetary semi-elasticity used is 0.522.N/A's refer to when rules do not technically apply. Overachievement of the MTO is not required and so the structural balance adjustment and the Expenditure Benchmark do not technically apply is not assessed.
[a] The Expenditure Benchmark requirement is set as a growth limit in nominal terms. A negative convergence margin is not applied.

A.4 Fiscal Stance as Indicated by the Structural Primary Balance

The structural primary balance is the general government balance adjusted for the economy's cyclical position and excluding one-off items and interest costs.

The structural primary balance, as measured using the European Commission's CAM-based estimates of the output gap, was unchanged in 2019 with a structural primary balance of 0.6 per cent (Table A.4). This indicates that the fiscal position was unchanged relative to 2018.

Table A.4: Indicators of the Fiscal Stance

Per cent of GDP (unless otherwise stated)

	2017	2018	2019
Primary Balance (Excluding one-offs)			
Level	1.7	1.7	1.7
Change (p.p)		0.0	-0.1
Structural Primary Balance (Excluding one-offs)			
Level	0.4	0.6	0.6
Change (p.p)		0.2	0.0

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: All fiscal outturns are taken from the CSO's April 2020 Annual Government Finance Statistics publication. One-offs and discretionary measures are as reported by the Department of Finance unless the Council assesses these classifications to be inapplicable (Appendices C and D). Estimates of the output gap are as outlined in the European Commission's Spring 2020 forecasts. The budgetary semi-elasticity used is 0.522.

Appendix c: Information on One-offs

This Appendix contains the information on one-offs provided by the Department of Finance to the Council for the purposes of assessing compliance with the domestic Budgetary Rule:

Item	2018 Impact (€ m)	2019 Impact (€ m)	Rationale
One-off Corporation Tax Receipts	300		Statement of the Minister for Finance and Public Expenditure and Reform on Budget day 2018: "Corporation tax revenue has been growing strongly and a significant part of the growth for this year is due to changes in international accounting standards (IFRS 15). Around €0.7 billion of the 2018 over-performance is estimated as one-off." The Revenue Commissioners have since clarified that only €0.35 billion of this was related to changes in international accounting standards, and only this component meets the Council's criteria for a one-off. This was later revised down to €0.3 billion in *Budget 2020* documents.
Medical Consultant's Pay settlement	213		One-off payment due to a settlement following a court process in relation to pay arrears
Total Impact on General Government Balance	**87**	**0**	

Appendix c: Detail on Discretionary Revenue Measures

This Appendix contains the information on Discretionary Revenue Measures provided by the Department of Finance to the Council for the purposes of assessing compliance with the domestic Budgetary Rule:

Item and Details	2018 Impact (€ m)	2019 Impact (€ m)
Carryover from previous budgets	65	
Budget 2018 measures	787	
Carryover from previous budgets		350
Budget 2019 measures		875
Total Impact on General Government Balance	**852**	**1225**