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Fiscal Space in the Republic of Ireland: A Very Short Primer

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SUMMARY

The parameters for Budget 2017 are set by the requirements of the *preventive* arm of the Stability and Growth Pact (SGP). The preventive arm is assessed under two main pillars. These are the *Structural Balance Rule* and the *Expenditure Benchmark Rule*.

Adherence to the fiscal rules limits the net fiscal space for new commitments to somewhere between €900 million and €1 billion in 2017. The net fiscal space available in 2018 ranges from €1.2 billion to €2.6 billion with the exact figure depending on underlying assumptions related to calculation of the economy's output gap and structural deficit.

Based on current potential growth projections the net fiscal space available in each of 2019-2021 is close to €3 billion per annum. However, the Irish Fiscal Council estimates that demographic and inflation pressures on public spending just to 'stand-still' in terms of public service delivery and benefits will cost €6 billion extra public spending by 2021.

KEY POINTS

- This NERI inBrief provides a short introduction to the concept of fiscal space. The fiscal space is the projected amount of resources available to government for additional expenditure while ensuring compliance with the fiscal rules.
- The Irish Govermnment estimates the net fiscal space available over the period 2017-2021 is €11.3 billion. However, this estimate is based on an assumption that the economy is running a structural deficit of 2% of potential output in 2016 and that the economy is overheating.
- A strong case can be made that the economy is not overheating in 2016 and that the structural deficit is better than 1% of potential output in 2016. If this is correct it implies additional fiscal space in 2018 and cumulative net fiscal space of as much as €12.7 billion out to 2021.
- Long-run economic growth and employment goals can best be achieved by prioritising use of the available fiscal space to increase public capital investment levels, along with increased spending on education and research and development.

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Fiscal Rules

A balanced budget in structural terms is a balanced budget after adjusting for the cyclical position of the economy and is calculated net of once-off factors such as asset sales. The **structural balance rule** says that any country not at its **Medium-Term Budgetary Objective (MTO)** must achieve a specified minimum improvement in its structural balance. Ireland's MTO requires a structural deficit of no worse than 0.5% of potential GDP and a minimum annual improvement of 0.6 percentage points until the lower limit of the MTO is reached.

The structural balance remains constant if spending grows in line with potential GDP; improves if spending grows below potential GDP, and deteriorates if spending grows faster than potential GDP. The European Commission currently estimates that the structural deficit is 2% in 2016. This means that public spending is required to grow at a slower rate than potential GDP in 2017.

The **expenditure benchmark rule** places a cap on the annual corrected growth of public spending that can only be exceeded if new **discretionary revenues measures** are taken which structurally increase government revenue, for example an increase to tax rates. The cap is equal to the medium-term growth rate of potential GDP and is called the **reference rate**. The reference rate is updated yearly based on a forward and backward looking ten year average for nominal potential GDP growth.

The European Commission estimates the reference rate for real potential growth is 3.3% in 2017, and that the GDP price deflator is 1.2%. Thus, if Ireland had achieved its MTO there would be permitted nominal expenditure growth of 4.5% in 2017.

The expenditure benchmark also makes use of a concept called the **convergence margin**. The convergence margin is applied to every country in the preventive arm of the SGP not already at its MTO. This ensures that the allowable growth in net expenditure will be less than the reference rate and is scaled appropriately for each country so that the required improvement is made over the year. The convergence margin reduces Ireland's allowable expenditure growth by 2 percentage points in 2017. As such, the permitted nominal growth in expenditure is 2.5%.

To calculate available fiscal space under the expenditure benchmark we must first correct the measured growth in the public expenditure aggregate to exclude interest expenditure and co-financing of EU funding. We must also adjust for cyclical unemployment expenditure, while the figure for gross fixed capital formation (investment) must be adjusted to reflect the four year average. Smoothing investment spending in this way compensates for its inherently volatile and lumpy nature.

An adjustment is also made for net discretionary measures (mainly tax cuts or tax increases). New policy measures taken to reduce government revenue will reduce on a one-for-one basis the allowable increase in public spending and vice versa. Tax cuts therefore mean less money available for pensions, health, childcare, education, housing, and other areas of public spending.

When all of these adjustments are made the **nominal corrected expenditure aggregate** on a no policy change basis increases from €67.8 billion in 2016 to €68.5 billion in 2017. This is an increase of marginally over 1%. However, as noted above, Ireland is actually allowed to increase its corrected nominal expenditure by 2.5% in 2017 so there is unused fiscal space of almost 1.5 percentage points on top of the already allocated corrected nominal expenditure of €68.5 billion. In nominal terms the extra space amounts to between €900 million and €1 billion.

This represents an upward revision from earlier estimates of €500 million. The upward revision in the 2017 fiscal space is explained by the upward revision of the reference rate from 4% to 4.5%. Cumulative net fiscal space for the five years is at least €11.3 billion and potentially €12.7 billion.

Table 1: Getting to the Fiscal Space (post 2016 Summer Economic Statement)

			2017	2018	2019	2020	2021
A		Reference rate of Potential Growth (% y/y)	3.3	3.4	3.6	3.7	3.7
B		GDP Deflator Applicable (% y/y)	1.2	1.3	1.3	1.3	1.3
C		Application of Convergence Margin (percentage point)	-2.0	-2.1	0.0	0.0	0.0
D	*(A+B-C)*	Corrected Nominal Expenditure Growth Limit (%y/y)*	2.5	2.6	4.9	5.0	5.1
E		Corrected Expenditure Aggregate (€bn)**	68.6	69.6	70.4	71.3	72.2
F		Net Discretionary Revenue Measures (€bn)	0.1	0.5	0.4	0.4	0.4
G	*(E-F)*	Corrected Expenditure less DRM (€bn)***	68.5	69.1	70.0	70.9	71.8
H	*(G/E_{t-1})*	Nominal growth (%y/y)*	1.0	0.9	0.6	0.6	0.7
I	*((E_{t-1} (1+D/100))*	Permitted Expenditure (€bns)*	69.5	70.4	73.0	74.0	74.9
J	*(I+F)*	Allowable Corrected Expenditure adjusted for DRMs (€bn)	69.6	70.9	73.4	74.4	75.3
K	*(D-H)*	Unused Fiscal Space within Growth Limit (percentage point)*	1.5	1.7	4.3	4.4	4.4
L	*(J-E_{t-1})*	Gross Fiscal Space adjusted for DRMs (€bn)*	1.8	2.3	3.8	4.0	4.0
M		Pre-committed Expenditures****	0.8	1.1	0.9	0.9	1.0
N	***(L-M)***	**Net Fiscal Space (€bn)***	**1.0**	*******1.2**	**3.0**	**3.1**	**3.0**

Sources: Nevin Economic Research Institute (July, 2016) Summer Quarterly Economic Observer; Irish Fiscal Advisory Council (June, 2016) Fiscal Assessment Report, Department of Finance (June 2016) Summer Economic Statement.

Notes: *Rounding affects totals.
**Corrected expenditure is estimated at €67.8billion in 2016.
***DRMs are Discretionary Revenue Measures.
****Total includes €0.9bn for the public capital programme, €0.6bn for the Lansdowne Road Agreement, €2bn for voted expenditure including demographics and €1bn for other commitments. The Irish Fiscal Council estimate ythat demographic and inflationary pressures on spending will cost €6bn between 2016-2021 in order to stand still in terms of benefits and public service delivery.
*****Non-application of the convergence margin increases the fiscal space by €1.4billion. In such an event net fiscal space would rise to €2.6billion in 2018.

Fiscal Space is Sensitive to Growth

The fiscal space is sensitive to the potential growth rate of the economy. A structural shock to the economy; a secular productivity decline, or sustained under-investment or underperformance of employment growth, would damage the economy's output growth potential (shown to average 3.5% in Table 1).

The OECD (2013) projects a real GDP growth rate of 3% out to 2030 an estimate that is supported by Crafts (2014). Potential GDP growth could well be higher than this in the short-to-medium term given expectations for above trend employment growth over the next five years. However, we cannot be sure that this level of employment growth will in fact materialise. An average reference rate of real potential growth of 3% over the next five years, as opposed to 3.5%, would reduce the cumulative net fiscal space by around €1.8 billion over the next five years.

Not all fiscal measures have the same impact on potential output. In particular, long-run productivity growth can be facilitated through appropriate investments in education and skills (human capital), equipment and infrastructure (physical capital), and supports for innovation and Research and Development. Thus, over the long-run investments in these areas can actually increase the fiscal space available to government.

As it happens, the Government estimates it will have €11.3 billion of fiscal space and proposes to allocate €5.7 billion (50.8%) to spending, €2.5 billion to tax cuts (€22.5%) and €3 billion (26.5%) to a countercyclical 'rainy day' fund.

Fiscal Space is Sensitive to Output Gap Estimates

The convergence margin reduces the cumulative fiscal space by €2.8 billion over the period 2017-2018 (€1.4 billion in each year). To determine whether it is necessary to apply the convergence margin we must first estimate the structural balance. The structural balance cannot be directly observed and measuring it requires us to first estimate the output gap – i.e. the cyclical position of the economy.

A negative output gap means the economy is performing below its potential and implies the structural balance is better than the underlying budget balance. On the other hand, a positive output gap means the economy is overheating and implies the structural balance is worse than the underlying budget balance. Estimates of the output gap are uncertain and often subject to substantial revision even years later. This is particularly the case for a small open economy like Ireland's with relatively large migration flows.

The Department of Finance and the European Commission estimate that the structural deficit will be 2% of potential GDP in 2016. This is worse than the estimate for the general government balance and implies the economy is overheating. The projections are based on the Commission mandated harmonised methodology.

The Commission' methodology for estimating structural parameters has been critiqued by Klär (2013) and by Bergin and Fitzgerald (2014). One reason the Commission's methodology appears flawed is that it is overly pro-cyclical with estimates for structural unemployment too closely following recent trends in actual unemployment. As a result, the Commission's estimate for structural unemployment is very likely to be too high. This is generating an 'overheating bias' in their output gap calculations.

A strong case can be made that the economy is not overheating in 2016. The economy's still high unemployment rate; the evident lack of domestic price and wage pressure in the economy; the current account surplus even after correcting for redomiciled PLCs; the improving net international investment position; the low underlying investment ratio and lack of housing supply, and finally, the lack of private sector credit market easing, cumulatively suggests that actual output is still **below** its potential output in 2016.

Given the weight of evidence it appears that Ireland's output gap is negative. If this is correct it means that the structural deficit is somewhat better than the current deficit in the government's finances and most likely below 1% of potential output. On balance, application of the convergence margin to the Budget 2017 calculations appears to be reasonably appropriate.

On the other hand, applying the convergence margin would improve the public finances sufficiently for Ireland to achieve its MTO of a structural deficit no worse than 0.5% of potential GDP. At that point it would be unnecessary to apply the convergence margin to future budgets. This would increase the net fiscal space available in Budget 2018 by €1.4 billion.

References

This NERI *Research inBrief* accompanies the NERI's Summer 2016 Quarterly Economic Observer (QEO). The QEO contains a full list of all of the references, data and findings used in this *inBrief*.