



**Irish Fiscal  
Advisory Council**

# **Fiscal Assessment Report**

June 2016

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## FOREWORD

The Irish Fiscal Advisory Council was established as part of a wider agenda of reform of Ireland's budgetary architecture as envisaged in the *Programme for Government 2011*. The Council was initially set up on an administrative basis in July 2011, and was formally established as a statutory body in December 2012 under the *Fiscal Responsibility Act (FRA)*. The Council is a public body funded from the Central Fund. The terms of its funding are set out in the *FRA*.

The mandate of the Irish Fiscal Advisory Council is:

- To endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- To assess the official forecasts produced by the Department of Finance;
- To assess government compliance with the Budgetary Rule as set out in the *FRA*;
- To assess whether the fiscal stance of the Government in each Budget and Stability Programme Update (SPU) is conducive to prudent economic and budgetary management, including with reference to the provisions of the *Stability and Growth Pact*.

The Council submits its *Fiscal Assessment Reports* to the Minister for Finance and within ten days releases them publicly.

The Council is chaired by Professor John McHale (Whitaker Institute, National University of Ireland, Galway). Other Council members are Mr Sebastian Barnes (Organisation for Economic Co-operation and Development); Mr Seamus Coffey (University College Cork), Dr Íde Kearney (Dutch Central Bank, De Nederlandsche Bank) and Mr. Michael G. Tutty.

The IFAC secretariat consists of Eddie Casey, Thomas Conefrey, Niall Conroy, Sarah Doyle, Andrew Hannon and Andrew Kennedy.

The Council would like to acknowledge the help of Ronán Hickey, Central Bank of Ireland, and the staff of the Central Statistics Office. The Council would also like to thank Anna de Courcy for copy editing the report.

This report was finalised on 01 June 2016. More information on the Irish Fiscal Advisory Council can be found at [www.fiscalcouncil.ie](http://www.fiscalcouncil.ie)

## SUMMARY ASSESSMENT

**The recovery in the Irish economy has been impressive and is helping to alleviate the on-going legacy problems of the crisis.** Given the gravity of the recent recession and financial crisis, the Irish economy has recovered at a stronger pace than expected. The Government's cost of borrowing is currently at historically low levels, helped by initiatives at a European level and the actions of previous Governments in broadly adhering to an effective fiscal adjustment programme. It is important to recognise, however, that hard-won credibility can quickly be eroded unless budgetary responsibility is maintained. Although falling, the still high level of the debt-to-GDP ratio leaves the public finances vulnerable to domestic and international risks or renewed tensions in sovereign debt markets. Through full implementation of Ireland's budgetary framework, the new Government can solidify Ireland's restored creditworthiness and prevent a return to the boom-bust cycle.

**There is uncertainty about the fiscal position over the coming years owing to a lack of published detail on the commitments in the programme for government.** The Council welcomes the commitment in the *Programme for a Partnership Government* to comply with all fiscal rules and to reform the budget process to allow for greater scrutiny. The document contains a list of new spending priorities while announcing an intention to reduce some taxes, add €4 billion to the existing capital investment programme and establish a Rainy Day Fund. The document does not reconcile the overall cost of the various policy proposals with an estimate of the resources that will be available in future years to fund new tax and spending measures. The Government should publish detailed plans that demonstrate how the policy commitments in the programme will be funded within the estimated remaining fiscal space, allowing for the cost of maintaining existing public services. Until this detail is provided, it is unclear how the Government's plans in the programme for government are consistent with meeting the fiscal rules and reducing the deficit and debt.

**The Council welcomes Ireland's pending exit from the Corrective Arm of the *Stability and Growth Pact (SGP)*, but it is now important that the requirements of the Preventive Arm of the pact and the domestic Budgetary Rule are followed.** Following the reduction of the General Government deficit to below 3 per cent of GDP on an expected durable basis, the European Commission has recommended that Ireland move from the Corrective to the Preventive Arm of the *SGP*. In line with the domestic Budgetary Rule, the Preventive Arm sets requirements for the annual improvement in the structural budget balance and also sets limits on the allowable rate of expenditure growth net of discretionary revenue measures under the Expenditure Benchmark.

**The projections in *Stability Programme Update 2016 (SPU 2016)* show only a modest improvement in the public finances in 2016 and do not fully comply with the requirements of the domestic Budgetary Rule or the Preventive Arm of the *Stability and Growth Pact (SGP)*.** The projected fall in the structural deficit in the *SPU* is just 0.4 percentage points of GDP in 2016, thus falling short of the requirement under the fiscal rules to reduce it by 0.6 percentage points. While an outperformance on revenue in 2016 could secure compliance with this rule given current expenditure plans, a repeat of the within-year increase in expenditure seen in 2015 through the supplementary estimates process should be avoided. Full compliance with the Expenditure Benchmark (EB) would also not be achieved if the impact of a technical one-off transaction involving AIB in 2015 was excluded from the calculation of rule compliance. Availing of this once-off transaction to allow additional spending in 2016 would go against the spirit of the rules and is not needed considering the current fast growth in the economy and the on-going risks to the public finances.

**Preliminary estimates suggest the availability of €0.9 billion for tax cuts and spending increases in *Budget 2017* under the fiscal rules.** This is on top of a similar amount already allocated to meet existing spending commitments in 2017. Taking into account the underlying growth in the economy, a package of this size would imply a reduction in the budget deficit and a modestly contractionary fiscal stance. The rapid pace of recent economic growth and falling unemployment limit the economic case for a more expansionary stance. Moreover, the debt-to-GDP ratio remains high leaving the economy more vulnerable to numerous domestic and external risks. Based on these considerations, and assuming that expenditure plans for 2016 are adhered to, the Council's preliminary assessment is that an overall budgetary package of this magnitude for 2017 would be consistent with prudent economic and budgetary management. The Council's *Pre-Budget Statement* in September 2016 will re-examine the appropriate stance for 2017 using the most up-to-date information available at that time.

**Provided the economy is growing at a sustainable rate, it would likely be appropriate for the Government to use the available fiscal space under the rules after 2017. However, a tighter stance than required by the rules might be needed to prevent overheating in the economy and to ensure the Government has scope to increase spending during a future downturn.** Ireland's past record of pro-cyclical fiscal policy was a major contributor to the boom-bust cycle which has inflicted severe damage on the economy over the last half a century. With the economy now recovering strongly, should signs of overheating emerge, the Government may need to go beyond the formal implementation of the fiscal rules to ensure that the public finances remain on a sustainable path. This could be achieved by the Government using unexpected revenue surges to run larger budget surpluses, possibly supported by the establishment of a Rainy Day Fund as proposed in the programme for government. This is important considering the volatility of corporation tax revenue and its

increased concentration among a small number of companies. An appropriately designed Rainy Day Fund could give the Government scope to operate counter-cyclical fiscal policy to boost the economy during future downturns. It could also help the Government to avoid the need for forced fiscal consolidation in the event of a sudden loss of market access. Continuing to adhere to the Expenditure Benchmark after the Medium-Term Objective of a 0.5 per cent of GDP structural deficit has been achieved – a position that goes beyond the formal requirements of the *SGP* – would also limit the risk of transitory revenue gains being used to fund permanent increases in expenditure.

**The medium-term projections in *SPU 2016* for 2017-2021 understate likely future expenditure pressures and do not present an informative picture of the public finances after 2016.** The *SPU* figures for 2017 to 2021 are technical projections that assume no tax or expenditure policy changes in future budgets. The expenditure projections do not make any allowance for inflation or public pay changes after 2018 and as a result significantly understate likely future expenditure pressures. The Council’s “stand-still” estimate of expenditure – maintaining the current level of real public services and benefits given a full accounting for demographic changes and inflation – would result in an additional €6 billion of public expenditure by 2021. Future budgetary forecasts should incorporate the major items of expenditure and revenue both on the basis of unchanged (real) policies and in line with the Government’s stated policy objectives. This is required by the EU directive on Medium-Term Budgetary Frameworks (MTBF).

**Public capital investment in the *SPU 2016* projections is projected to remain low by historical and international standards.** After allowing for depreciation of the existing stock, the current *Infrastructure and Capital Investment Plan 2016-2021* implies only a modest increase in the stock of public capital over the medium term. Even allowing for the additional capital spending announced in the programme for government, public capital investment would remain at historically low levels. From a forecasting perspective, maintaining public capital investment at such low levels might be difficult to sustain taking into account unmet demand following years of curtailed investment since 2008, current projections for economic growth and future demographic changes.

**The Department of Finance should continue to develop additional models for estimating Ireland’s medium-term potential growth to ensure signs of overheating are detected.** An important failure of macroeconomic surveillance in Ireland during the 2000s was that the extent of the overheating in the economy was not identified in time. To avoid a repeat of this past failure of macroeconomic management, it is essential that the Government’s forecasts for the medium term are well-founded. The Department of Finance should continue to develop a set of additional medium-term baseline estimates for the supply side outside of the EU Commonly Agreed Methodology (CAM).

# 1. ASSESSMENT OF THE FISCAL STANCE

## KEY MESSAGES

- The recovery in the Irish economy is continuing at an impressive pace with GDP growth in 2015 well above its long-run potential rate. While output in the economy from 2009-2014 was significantly below what could be sustainably produced, the recent strong growth in GDP means that the demand shortfall in the economy is likely to disappear in the near term. Reducing public debt to a safer level must remain a key policy priority to protect the economy and public finances against numerous downside domestic and external risks.
- The projections in *Stability Programme Update 2016 (SPU 2016)* show only a modest improvement in the public finances in 2016. The *SPU* indicates that the projected fall in the structural budget deficit in 2016 is insufficient to meet the requirements of the National Budgetary Rule. While an outperformance on revenue in 2016 could secure compliance with this rule given current expenditure plans, a repeat of the within-year increase in expenditure seen in 2015 through the supplementary estimates process should be avoided. Full compliance with the Expenditure Benchmark (EB) in 2016 would also not be achieved if the impact of a one-off transaction in 2015 involving AIB was not included in the calculation of rule compliance.
- The Department of Finance has indicated a preliminary estimate of €0.9 billion of fiscal space for 2017 under the rules, in addition to a similar amount already allocated to meet existing spending commitments. Taking into account the forecast growth in the economy, a package of this size would be consistent with a modestly contractionary fiscal stance. The rapid pace of recent economic growth and falling unemployment limits the economic case for a more expansionary stance. Moreover, the debt-to-GDP ratio remains high leaving the economy more vulnerable to risks. Based on these considerations, and assuming that expenditure plans for 2016 are adhered to, the Council's preliminary assessment is that an overall budgetary package of this size for 2017 would be consistent with prudent economic and budgetary management.
- Post-2017, provided the economy is growing at a sustainable rate, it would be appropriate for the government to use the available fiscal space under the rules. However a tighter fiscal stance than the minimum required by the rules may be needed should signs of overheating begin to emerge and to ensure windfall revenue gains are saved. Continued adherence to the Expenditure Benchmark and the establishment of a Rainy Day Fund – as proposed in the programme for government – could help ensure an appropriate fiscal stance over the medium term that would provide more room for manoeuvre during a future downturn.

## 1.1 INTRODUCTION

The Fiscal Council has a mandate under the *Fiscal Responsibility Act 2012* to assess the Government's fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. The sections below draw on the analysis in later chapters in assessing the fiscal stance outlined in *SPU 2016*. The Council's assessment is informed by the extent of compliance with the fiscal rules along with a complementary economic assessment that takes into account the state of the public finances, the stage of the economic cycle and the growth prospects for the economy. Section 1.2 reviews the current cyclical position of the economy along with recent trends in the public finances. Section 1.3 reviews the short-run fiscal stance in 2016 and 2017 as set out in the *SPU* while the medium term stance is discussed in Section 1.4.

## 1.2 OVERVIEW OF ECONOMY'S MACROECONOMIC AND FISCAL SUSTAINABILITY POSITION

The position of the Irish economy and the sustainability of the State's public finances are the key considerations in assessing the appropriateness of the fiscal stance. Previous *Fiscal Assessment Reports* have explained how the setting of fiscal policy during the crisis years from 2008 required a trade-off between the need to support domestic demand and employment in the economy and the need to repair the public finances to restore the State's creditworthiness. With the economy operating below its long-run potential and with a double digit unemployment rate for much of the period from 2008, in the absence of other constraints, standard demand management considerations would have favoured an expansionary fiscal stance to support the economy. However, the fragility of Ireland's creditworthiness and the size of the debt and deficit meant there was little option but to pursue a contractionary fiscal stance with large-scale expenditure reductions and tax increases.

Given the improvements in the economy and the public finances since 2011, it appears that the different elements of the demand-management/debt sustainability trade-off are no longer pulling in opposite directions as during the crisis years. As discussed in detail in Chapter 2, the central macroeconomic forecasts in *SPU 2016* foresee a continuation of strong economic growth in 2016 and 2017, building on the already vigorous recovery recorded up to 2015.

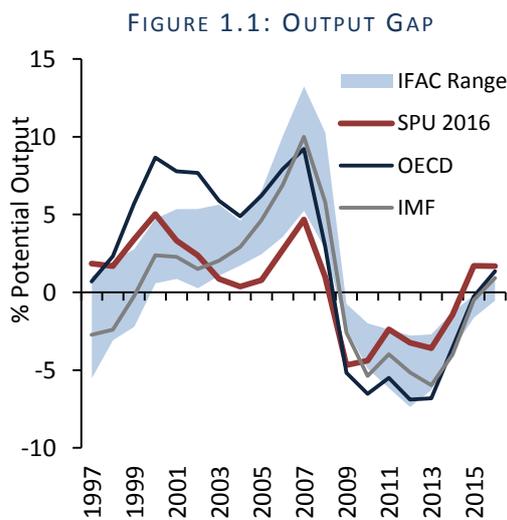
TABLE 1.1: SUMMARY OF MAIN FISCAL AGGREGATES IN *SPU 2016* (GENERAL GOVERNMENT BASIS)

% of GDP unless stated	2015	2016	2017	2018	2019	2020	2021
Headline General Government Balance	-2.3	-1.1	-0.4	0.4	1.2	2.0	2.8
General Government Balance (underlying basis)*	-1.3	-1.1	-0.4	0.4	1.2	2.0	2.8
Interest expenditure	3.1	2.7	2.6	2.4	2.2	2.1	1.9
Primary Balance	0.8	1.6	2.1	2.8	3.4	4.1	4.7
Primary Balance (underlying basis)*	1.8	1.7	2.1	2.8	3.4	4.1	4.7
GDP growth (real annual % change)	7.8	4.9	3.9	3.9	3.3	3.1	2.9
Potential Output (% change, CAM-based)	4.4	5.0	5.0	4.2	3.5	3.3	2.8
Output Gap (CAM-based)	1.7	1.7	0.7	0.4	0.2	0.0	0.0
Structural balance (CAM-based)	-2.4	-2.0	-0.8	0.1	1.0	2.0	2.8
<i>Change in Structural Balance</i>	0.9	0.4	1.2	0.9	0.9	0.9	0.8
Structural Primary Balance (CAM-based)	0.7	0.7	1.8	2.5	3.3	4.1	4.7
<i>Change in Primary Structural Balance (p.p.)</i>	0.0	0.0	1.0	0.7	0.8	0.8	0.6
General Government Debt	93.8	88.2	85.5	81.3	77.7	73.3	68.9

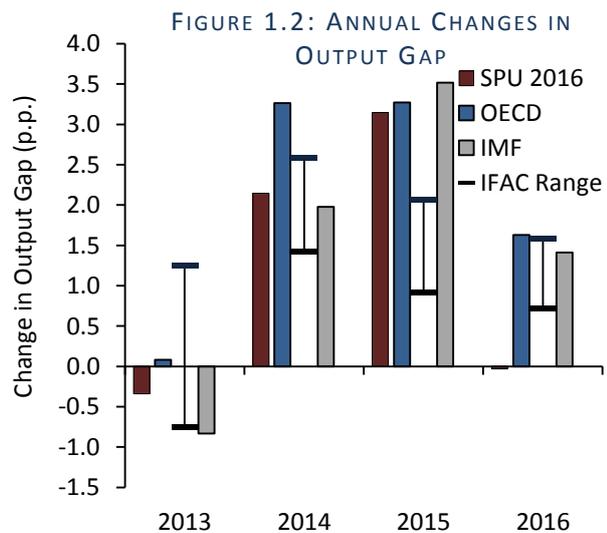
Source: Department of Finance (*SPU 2016*).

Notes: \* Underlying General Government balance excludes the impact of the AIB-related share transaction on the deficit in 2015.

The fast pace of growth has implications for the estimated size of the economy’s output gap. The output gap is defined as the difference between actual and potential GDP, expressed as a share of potential GDP. Estimates of the output gap for Ireland are subject to much uncertainty, in particular given the openness of the labour market and the importance of migration in an Irish context. Estimates by the Council of the output gap based on a number of standard approaches from the international literature are shown in the blue shaded area in Figure 1.1; estimates of the annual change in the output gap are presented in Figure 1.2.



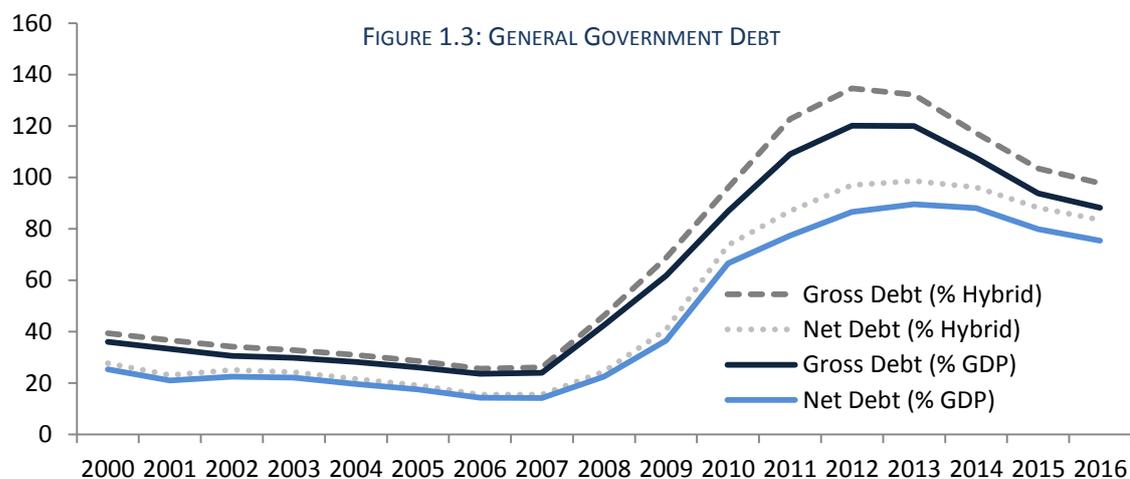
Sources: *SPU 2016*; IMF *WEO* (April 2016); OECD *EO* (Nov '15); internal IFAC calculations.



Sources: *SPU 2016*; IMF *WEO* (April 2016); OECD *EO* (Nov '15); internal IFAC calculations.

Although a large negative output gap opened up during the crisis, current estimates produced by various institutions suggest that the output gap is close to zero or positive in 2016 as shown in Figure 1.1. Official estimates from *SPU 2016* based on the EU Commonly Agreed Methodology appear to overstate the size of any positive output gap and are inconsistent with other indicators of imbalances in the economy (see Chapter 2 and Appendix C). The change in the output gap is shown in Figure 1.2. The estimates by each of the institutions shown in the chart point to a rapid closing of the output gap since 2013. Taken together, the recent strong growth in GDP and the projections for further robust growth this year means that by end-2016 there is unlikely to be a significant demand shortfall in the economy. In these circumstances, a further stimulus from fiscal policy is not needed at this time from a demand-management perspective.

The overall position of the public finances and the sustainability of the debt is a second important consideration in determining the appropriate fiscal stance. As discussed in detail in Chapter 3, the public finances have continued to improve and, as shown in Figure 1.3, the General Government gross debt-to-GDP ratio is projected to fall to around 88 per cent of GDP by the end of 2016 compared to a peak of 120 per cent in 2013.

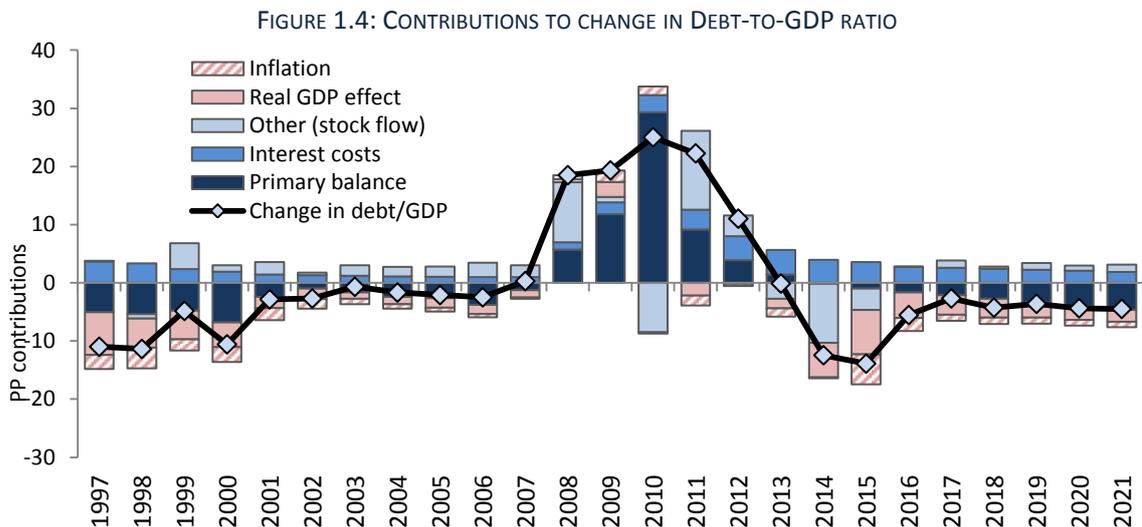


Sources: Department of Finance; internal IFAC calculations.

Despite these improvements, the task of repairing the public finances following the recent crisis is not yet complete and the financial position of the State remains highly susceptible to adverse shocks that could cause the deficit and debt to start rising again. As previously pointed out by the Council, Ireland’s key fiscal ratios when expressed as a share of GDP overstate the underlying health of the government accounts. This is because Irish GDP is boosted by the exceptional profitability of multinational corporations based in Ireland, with the majority of these profits ultimately repatriated out of the country. Expressing the debt as a share of GNP or the Council’s

hybrid measure of output (Figure 1.3) highlights the scale of Ireland’s current debt burden following the crisis.<sup>1</sup> With a nominal gross debt of almost €204 billion at the end of 2015, or close to 100 per cent of national output (as measured by hybrid), the public finances remain exposed to shocks that could create unsustainable debt dynamics.

In addition, although the debt-to-GDP ratio has fallen sharply in recent years – by a cumulative 26 percentage points from 2013 to 2015 – this fast pace of decline is due to a number of exceptional factors that are not likely to reoccur in future years. As shown in Figure 1.4 below, unusually strong growth in real and nominal GDP along with once-off factors such as the liquidation of IBRC (shown as “other” in the chart) have accounted for most of the recent steep decline in the gross debt-to-GDP ratio. As growth slows to more normal rates from 2017 onwards, the pace of reduction in the debt-to-GDP ratio will be more modest and more challenging to achieve.



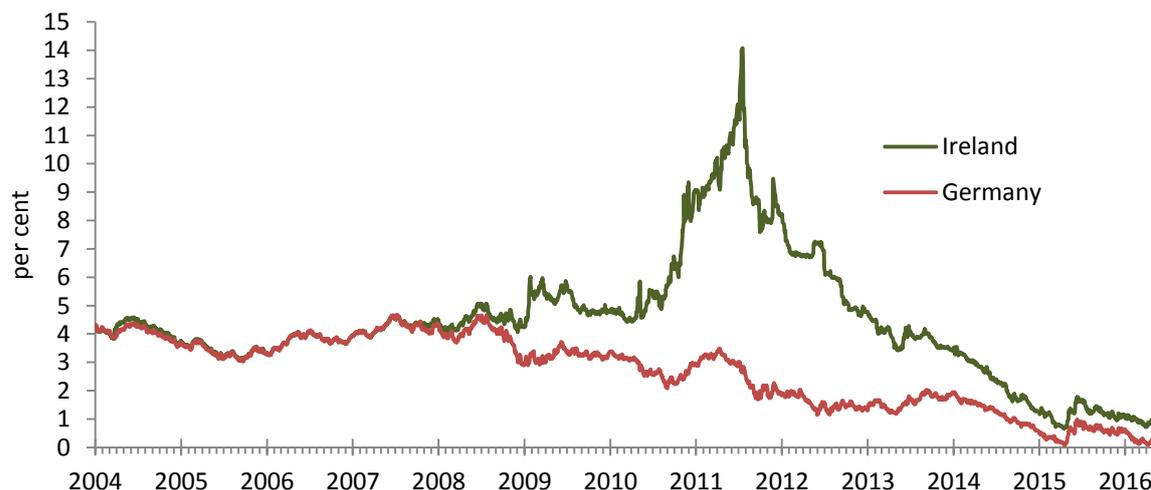
Sources: Department of Finance; CSO; internal IFAC calculations.

The current interest rate environment is exceptionally benign with yields on Irish government debt at historically low levels. The fall in the Government’s cost of borrowing has been driven by a number of developments including actions by the ECB and other initiatives at a European level that have lowered long-term borrowing costs and reduced the perceived riskiness of government debt (Figure 1.5). The fall in the risk premium for Ireland also reflects the fruits of domestic policy actions, in particular the credible actions of previous governments in broadly adhering to an effective fiscal adjustment programme. It is important to recognise, however, that hard-won

<sup>1</sup> The hybrid measure of output is an intermediate measure of fiscal capacity between GDP and GNP. It puts differential weight on GNP and the excess of GDP over GNP, defined as:  $H = GNP + 0.4(GDP - GNP)$ . For details see IFAC (2012b).

credibility can quickly be eroded and that sentiment in financial markets can reverse abruptly if commitment to a prudent fiscal stance begins to fade. Through full implementation of Ireland's budgetary framework, the new Government can protect the State's creditworthiness and help maintain the current favourable financing conditions into the future.

FIGURE 1.5: TEN-YEAR GOVERNMENT BOND YIELDS



Sources: Bloomberg, Datastream and internal IFAC calculations.

As discussed further in Chapter 2 and Chapter 3, while the central projections for the economy contained in *SPU 2016* are positive, numerous risks surround the outlook for Irish growth. If one or more of these risks were to materialise, the economy could be derailed from the current favourable growth trajectory with lower GDP growth and higher unemployment than forecast in *SPU 2016*. A weaker growth performance than currently projected would result in a higher debt-to-GDP ratio and there is a risk that the debt could start rising again. As shown in Chapter 3, a negative shock which lowered GDP growth by 1.5 percentage points below the *SPU 2016* baseline each year would cause the debt-to-GDP ratio to stagnate at its current high level before rising again by the end of the decade, in the absence of corrective policy action. A shock of this magnitude would not be exceptional given the historic volatility of Irish GDP growth.

This analysis of both elements of the demand management/debt sustainability trade-off feeds into the Council's assessment of the fiscal stance in the sections that follow.

### 1.3 ASSESSMENT OF THE FISCAL STANCE IN 2016 AND 2017

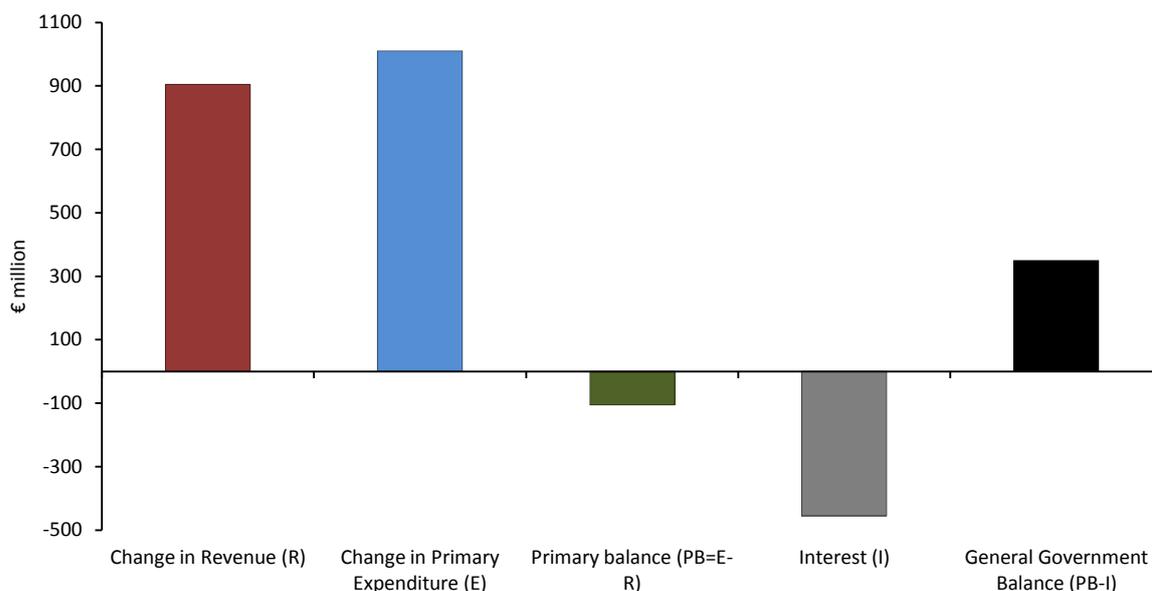
The Council is required under its statutory mandate to assess the prudence of the fiscal stance, including with reference to the requirements of the EU's *Stability and Growth Pact (SGP)*. It is also required to assess compliance with the domestic Budgetary Rule contained in the *Fiscal*

*Responsibility Act, 2012*. From 2016, the public finances will be subject to the provisions of the Preventive Arm of the *SGP*. Under the Preventive Arm, the Government is required to ensure that the budgetary position is at, or moving at a sufficient pace towards, the Medium-Term Budgetary Objective (MTO) (see Box G in Chapter 4). Ireland's MTO is for a General Government deficit of 0.5 per cent of GDP in structural terms. As well as taking into account compliance with the fiscal rules, the Council's assessment of the fiscal stance is based on an economic analysis that considers the state of the public finances, the stage of the economic cycle and the growth prospects for the economy.

It is useful to start the assessment of the fiscal stance by examining the change in the underlying General Government deficit. For this analysis, the underlying deficit refers to the headline figure excluding the one-off share transaction involving AIB in 2015. The underlying deficit is unaffected by many of the measurement problems that impact other indicators of the fiscal stance such as the structural deficit, although it has the drawback of being affected by cyclical factors. *SPU 2016* projects a very modest improvement in the underlying General Government balance of just 0.2 percentage points of GDP in 2016. This small improvement is entirely due to the expected reduction in debt interest expenditure in 2016. Figure 1.6 decomposes the projected change in the underlying deficit for this year. The increase in non-interest government spending (excluding the AIB share transaction in 2015) is projected to be larger than the rise in government revenue in 2016. As a result, the Department of Finance is projecting that the government balance excluding interest expenditure (the primary balance – the green column in Figure 1.6) will deteriorate marginally in 2016.

These projections for the overall General Government balance are underpinned by forecasts for government expenditure and revenue. As discussed in Chapter 3, the forecasts for the nominal level of expenditure and tax revenue in *SPU 2016* are unchanged from the *Budget 2016* figures. *SPU 2016* kept its forecast for the level of tax revenue in 2016 unchanged despite the corporation tax outturn for 2015 being higher than expected. As discussed in Chapter 3, the reasons why the predicted level of tax revenue in 2016 was not revised upwards consistent with the stronger 2015 revenue base are unclear. It would be helpful for the Department of Finance to provide more information on the unchanged corporation tax forecast in *SPU 2016*.

FIGURE 1.6: CHANGE IN GENERAL GOVERNMENT EXPENDITURE, REVENUE AND UNDERLYING BALANCE IN 2016



Source: SPU 2016 and internal IFAC calculations

Note: The change in expenditure excludes the impact of the financial transaction involving AIB in 2015.

Based on estimates of the structural deficit using the EU Commonly Agreed Methodology (CAM), Ireland is currently above its MTO of a budget deficit of 0.5 per cent of GDP in structural terms. The country must meet a required minimum adjustment path to the MTO in terms of an annual reduction in the structural deficit which for 2016 has been set at 0.6 percentage points of GDP.<sup>2</sup> The structural deficit refers to that part of the deficit which will not be eroded by the cyclical upswing in economic growth. To support this requirement, the Preventive Arm of the *SGP* places limits on the rate of growth of government spending through the Expenditure Benchmark. The Expenditure Benchmark essentially says that annual expenditure growth should not exceed the medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.

In *Budget 2016* published in October 2015, the projected fall in the structural deficit was 0.8 percentage points of GDP. In *SPU 2016* published in April this year, the projected improvement in the structural deficit is now lower at 0.4 percentage points of GDP and, therefore, the *SPU* projections fall short of meeting the requirements of the Government's Budgetary Rule in 2016.<sup>3</sup>

<sup>2</sup> As Ireland has a debt ratio of greater than 60 per cent of GDP, under the terms of the *SGP*, the annual change in the structural balance must be greater than 0.5 percentage points of GDP to comply with the adjustment path condition. It has been decided at EC level that 0.6 percentage points of GDP is an appropriate minimum pace of adjustment. As discussed in Chapter 4, the current projected deviation from the required structural balance adjustment in 2016 would not be considered "significant" under the rules.

<sup>3</sup> As discussed in Chapter 4, this difference between the planned improvement of 0.4 per cent and the 0.6 per cent requirement is not large enough to be deemed a "significant deviation" under the EU rules.

The smaller projected fall in the structural deficit in *SPU 2016* compared to the *Budget 2016* forecast is due in part to the lower deficit outturn for 2015 than expected at the time of October's budget. As the headline deficit forecast for 2016 in the *SPU* is broadly unchanged from the *Budget 2016* forecast, the fall in the deficit between 2015 and 2016 is now smaller as a result of the lower realised deficit outturn for 2015. While an overperformance in tax revenue in 2016 could secure compliance with the structural balance rule given current expenditure plans, to avoid undermining the budgetary framework, it is important that official projections show planned compliance with the fiscal rules.

The requirements under the Preventive Arm of the *SGP* are also assessed on the basis of the Expenditure Benchmark (EB). The Eurostat decision to classify the 2015 preference share conversion in AIB as a capital injection had the effect of increasing the expenditure base for 2015 which eases the EB for 2016. Although expenditure could be raised in 2016 without formally breaking EB rule, a repeat of the significant in-year increase in expenditure in 2015 through the supplementary estimates process should be avoided in 2016 given the position of the public finances and the economy. For the purpose of assessing compliance with the structural balance – the other pillar of the Preventive Arm – the AIB transaction is explicitly designated as a one-off exceptional item and does not impact the budgetary calculations. Due to an anomaly in the fiscal rules, the same transaction is not treated as a one-off when calculating the available room under the EB. Based on these factors, it would not be appropriate to increase spending further this year by taking advantage of this anomaly. A further increase in spending this year would also widen the deviation from the required improvement in the structural deficit and further undermine the new system of multi-year expenditure ceilings.

*SPU 2016* states that “While the Department of Public Expenditure and Reform will do everything possible to maintain expenditure within existing allocations, it is likely that over the course of the year, voted spending pressures amounting to c. ¼ per cent of GDP could materialise; at the same time, there is potential upside to the revenue projections. It is envisaged that this can be accommodated within the fiscal rules.” It is not clear what factors have given rise to this almost €600 million in unanticipated spending pressures emerging in 2016, just six months after Departments' spending allocations were announced in October's budget. This suggests problems with the Departments' estimates of future spending pressures, as discussed further below and in Chapter 3.

For 2017, the Government has announced a preliminary estimate of nominal fiscal space of €0.9 billion.<sup>4</sup> This is on top of a similar amount already allocated to meet existing spending commitments in 2017. Combining this pre-committed spending increase with the estimate of new fiscal space for 2016 implies an overall package of approximately €1.8 billion for 2017. A package of this size would be consistent with a modestly contractionary fiscal stance. The *Fiscal Responsibility Act 2012 (FRA 2012)* defines the fiscal stance in terms of the change in the structural primary balance. *SPU 2016* projects a 1.1 percentage point improvement in the structural primary balance in 2017 on a no-policy change basis. Assuming a budgetary package of €0.9 billion of new measures as indicated by the Department of Finance is introduced, the structural primary balance would improve in 2017 (by 0.7 percentage points of GDP), still consistent with a contractionary stance. Based on the approach used in calculating the Expenditure Benchmark, the projected growth in government expenditure net of discretionary tax changes in 2017 is also below the economy's estimated potential growth rate, providing a further indication of a contractionary stance.

The Council has a responsibility under the *FRA* to assess whether "...the fiscal stance for the year or years concerned is....conducive to prudent economic and budgetary management" [*FRA* 8(4)(b)]. This assessment covers both 2016 and 2017. The rapid pace of recent economic growth and falling unemployment limits the economic case for a more expansionary stance. Moreover, the debt-to-GDP ratio remains high leaving the economy more vulnerable to numerous domestic and external risks. Based on these considerations, and assuming that expenditure plans for 2016 are adhered to, the Council's preliminary assessment is that an overall budgetary package of this size for 2017 would be consistent with prudent economic and budgetary management. Government revenues in 2017 are forecast to grow at a faster pace than non-interest government spending which is appropriate given the on-going recovery. The projections signal an intention to comply with the Preventive Arm of the *Stability and Growth Pact* and the domestic Budgetary Rule, which would be consistent with prudent policy.

The Council's *Pre-Budget Statement* in September 2016 will re-examine the appropriate stance for 2017 using the most up-to-date information, including that contained in the Government's forthcoming *Summer Economic Statement*.

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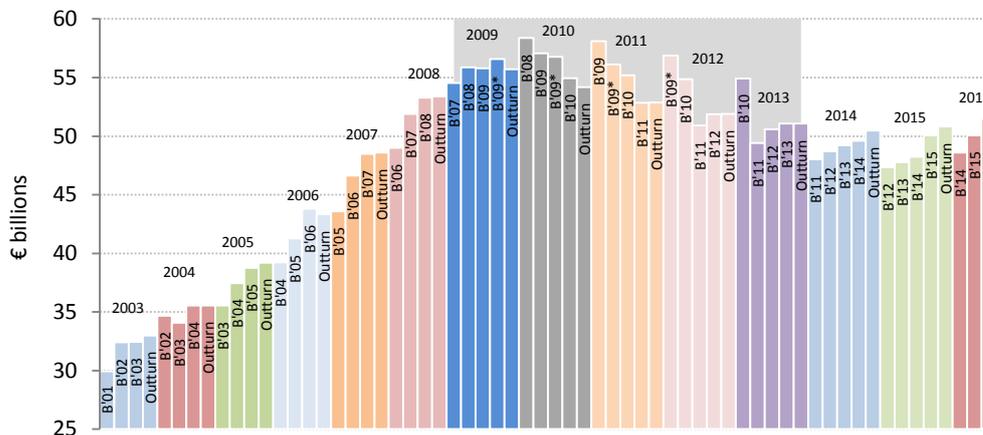
<sup>4</sup> See: <http://www.finance.gov.ie/what-we-do/economic-policy/publications/speeches/ireland%E2%80%99s-stability-programme-update-2016-opening>

## 1.4 THE MEDIUM-TERM FISCAL STANCE

### 1.4.1 THE MEDIUM-TERM EXPENDITURE FORECASTS IN *SPU 2016*

A credible projection for the medium-term budgetary position is essential for setting the fiscal stance. Without projections for the public finances that take into account the Government’s planned tax and spending policy measures, Ireland is in danger of repeating the mistakes of the past when budgeting was done on an ad hoc year-by-year basis. This flawed approach to budgetary planning gave rise to the damaging pre-crisis pattern of pro-cyclical adjustments to spending and there are signs of this pattern becoming re-established (Figure 1.7). The chart provides evidence of a clear pro-cyclical trend with expenditure plans being revised upwards during expansionary phases (2003-2008) and downwards during the recessionary period (2009-2013). A similar pattern is being repeated in the 2014-2016 period.

FIGURE 1.7: GROSS CURRENT EXPENDITURE FORECASTS



Source: Department of Finance; internal IFAC calculations.

Note: Bars show forecasts from various budgets followed by outturns for each year (e.g., B'15 = expenditure forecasts in *Budget 2015*). Each set of coloured bars relates to forecast/outturn expenditure for year specified above. Grey shaded region covers crisis period 2009-2013.

As described in Chapter 3, the expenditure forecasts do not provide for any increase in the cost of providing the current level of public services in line with expected inflation. This profile for government spending underestimates future expenditure pressures given the likelihood that expenditure will need to rise in line with inflation, unless real expenditure cuts are implemented. The Council’s stand-still expenditure estimate – maintaining the current level of real public services and benefits given a full accounting for demographic changes and inflation – would result in government spending being around €6 billion higher by 2021 than in the *SPU 2016* projections. In line with the requirement under the Budgetary Frameworks Directive, it is important that the Government’s fiscal plans include as much information as possible on future policy commitments so that the resulting projections are realistic (see Box D in Chapter 3).

In this context, the Government should ensure that the major expenditure and tax commitments contained in the new programme for government (see Box A) are fully incorporated into the next set of budgetary projections to be published in *Budget 2017*. It is not necessary that the fiscal projections would detail all of the specific tax and spending policy measures envisaged by government, however the forecasts for overall expenditure and tax revenue should include the impact of the main intended policy measures. The Government should publish realistic forecasts that demonstrate how the policy commitments in the programme will be funded from the estimated available resources while reducing the deficit and debt and complying with the fiscal rules.

#### **BOX A: A PROGRAMME FOR A PARTNERSHIP GOVERNMENT**

A *Programme for a Partnership Government* was officially published on 11 May 2016, after the release of *SPU 2016* at the end of April. The document states that the Government will “maintain our commitment to meeting in full the domestic and EU fiscal rules as enshrined in law”. The programme also proposes a number of reforms to the budgetary process to allow for greater Oireachtas oversight of budget decisions, including a *Spring Statement* in April that would set out the parameters for the forthcoming budget. The April 2015 *Spring Economic Statement* and National Economic Dialogue held in July last year were useful innovations to the budgetary process and it would be a positive development if the progress with these initiatives could be built on.<sup>5</sup>

Although the programme for government contains some information on the Government’s budgetary plans, there is insufficient detail in the document to allow for a comprehensive assessment. The programme does not detail at the outset the Government’s estimate of the resources (or fiscal space) that will be available for new expenditure and tax policy changes in the coming years. It is expected that an up-to-date estimate of the likely resources that will be available to fund new policy commitments will be provided in the upcoming June *Summer Statement*. This estimate would usefully be complemented by an estimate of the “stand-still” cost of providing the existing level of public services and (real) benefits. Although any decision to maintain current services and benefits is of course a policy decision for the Government, an estimate of the stand-still cost would provide decision makers and the public with a more informative estimate of the resources that could be available for new initiatives given the estimated available fiscal space (see Chapter 3).

Some limited information on Government plans is available in the programme document. In particular, it states that future budgets will involve at least a 2:1 split between public spending and tax reductions. It also commits to spending “at least an additional €6.75 billion in delivering public services by 2021 compared to 2016”.

In terms of detailed spending commitments, the document does not specify whether the total spending figure (€6.75 billion) includes some expenditure already committed and included in the projections in *SPU 2016* or whether it is on top of existing commitments. Moreover, among other policy commitments, the document states that the Government “will support the gradual, negotiated repeal of the Financial Emergency Measures in the Public Interest Acts

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<sup>5</sup> An outline of how the new budgetary process will operate is available from the Department of Public Expenditure and Reform here: <http://www.per.gov.ie/en/government-approves-proposals-for-reform-of-the-budget-process/> A *Summer Economic Statement* is due to be published by the Government in mid-June 2016.

having due regard to the priority to improve public services and...will reverse the public service pension reductions introduced during the crisis by 2021...". No estimate of the cost of these proposed public pay and pension changes is provided. On capital expenditure, the document proposes Oireachtas approval for "a cumulative, additional €4 billion in Exchequer capital investment up to 2021".

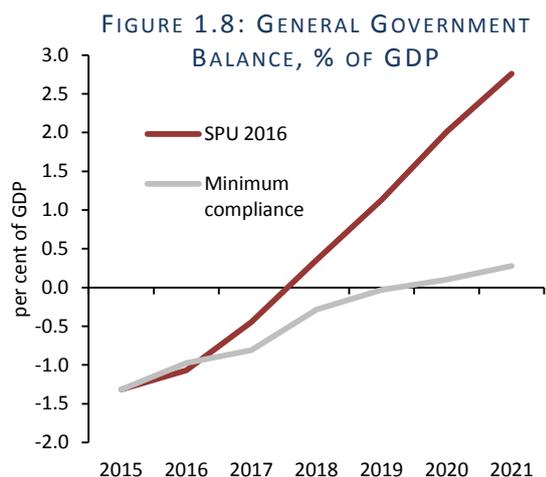
On taxation, the *Programme for a Partnership Government* commits to the continued phasing out of the Universal Social Charge. The document states that this and other reductions in personal tax rates will be largely funded through higher taxes in other areas, for example through non-indexation of personal tax credits and bands. However, the document does not provide specific estimates of the cost of planned tax reductions or of the amount of new revenue that would be raised from the planned offsetting tax changes.

The programme for government commits to establishing a Rainy Day Fund. Details on how the fund would be structured, or the planned amount to be allocated to the fund each year after meeting the expenditure and tax commitments outlined elsewhere in the programme, are not specified.

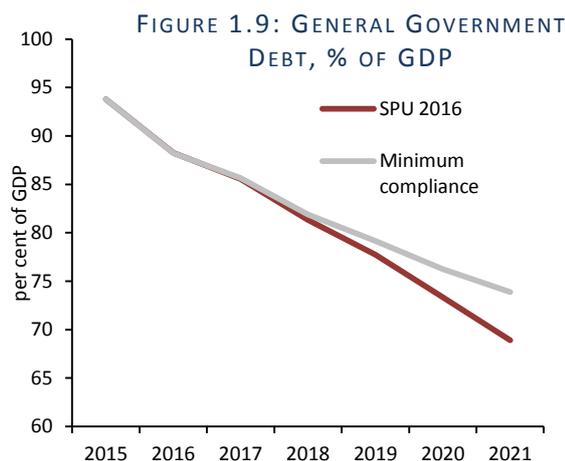
#### 1.4.2 THE FISCAL RULES AND SETTING THE APPROPRIATE FISCAL STANCE OVER THE MEDIUM TERM

In the April 2015 *Spring Economic Statement (SES)*, the previous Government stated that it intended to adopt a fiscal policy stance that meets minimum compliance with the fiscal rules. Since the tax and spending projections in *SPU 2016* from 2017 onwards are purely technical and do not include policy changes consistent with this intention, the projections imply significant over-compliance with the fiscal rules after 2016. *SPU 2016* does not provide deficit and debt projections consistent with the policy intention to follow minimum rule compliance.

Assuming the new Government implements a policy of minimum compliance with the fiscal rules, Figure 1.8 and Figure 1.9 show the path of the deficit and debt compared to the projections in *SPU 2016*. There would be larger headline deficits over the 2017 to 2019 period and the government accounts would be broadly in balance by 2021 compared to the large surplus contained in the *SPU* projections. The scenarios for the debt-to-GDP ratio are shown in Figure 1.9. Under the *SPU* projections, the debt-to-GDP ratio is projected to fall to 69 per cent of GDP by 2021. Assuming a policy of minimum rule compliance is implemented from 2017 on, the debt ratio would continue to decline but would be around 5 percentage points of GDP higher by 2021.



Sources: SPU 2016; internal IFAC calculations based on Council's Fiscal Feedbacks Model.



Sources: SPU 2016; internal IFAC calculations based on Council's Fiscal Feedbacks Model.

Beyond 2017, the Council assesses that if the economy is growing at close to its long-run potential and there are no signs of overheating, then it would be appropriate from a macroeconomic management perspective for the Government to use the available fiscal space under the rules. A fiscal stance in line with minimum rule compliance implies an (approximately) balanced budget is maintained and would be consistent with further reductions in the debt-to-GDP ratio.

As set out in Chapter 4, once a country is deemed to exceed its MTO, the Expenditure Benchmark no longer formally applies. The EB limits annual government expenditure growth to the economy's medium-term potential GDP growth unless the excess is matched by discretionary revenue measures. The *Vade Mecum* (EC, 2016) states that "The deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the Medium-Term Budgetary Objective, taking into account the possibility of significant revenue windfalls and the budgetary plans laid out in the stability/convergence programme do not jeopardise that objective over the programme period".

However, there would be a benefit for the Government in continuing to respect the Expenditure Benchmark even if not formally required to do so. There are a number of methodological issues with both rules that can sometimes give rise to misleading signals. Following the two rules is likely to lead to more robust fiscal policy decisions than relying exclusively on the structural balance measure. The latter rule is calculated based on annual estimates of potential output and the output gap. These estimates, produced using the Commonly Agreed Methodology (CAM), tend to track actual growth quite closely. Furthermore, during a period of strong growth, there is a risk that incoming cyclical revenues, such as the very strong property-related revenues in the pre-crisis years or surges in corporation tax, would be treated as structural rather than cyclical.

Going beyond the minimum implementation of the fiscal rules could be appropriate should signs of overheating in the economy emerge, and to avoid windfall revenue gains being used to fund permanent increases in expenditure. Continuing to follow both rules could help deliver larger budget surpluses during good times than would be possible with minimum rule compliance. This would allow the Government scope to increase spending in the event of a possible downturn in the economy.

The establishment of a Rainy Day Fund (RDF) as contained in the new programme for government could be one useful way to augment the existing budgetary framework (See Box B), provided it is designed and managed appropriately. An alternative to the establishment of a RDF would be for the Government to run larger budget surpluses and to use this cash to reduce the debt. There are two main advantages associated with the establishment of a RDF. Firstly, the establishment of a RDF could provide a way for the Government to sustain the attainment of budget surpluses over time. By committing to allocate funds to the RDF during good times, it could help the Government to withstand political pressures to loosen fiscal policy when tax revenue is growing strongly. In this way, the RDF could act as a counterweight to the problem of deficit bias – the tendency of governments to run deficits and allow debt levels to rise over time.

Secondly, while allocating some of the available fiscal space to the fund during good times would imply a tighter fiscal stance than would otherwise be the case, it is important to recognise that the existence of the fund could help to protect the Government against the need to implement forced fiscal consolidation in the event of a loss of market confidence. From the perspective of balance sheet management, a further benefit of the RDF is that it would provide the State with access to useful financial assets in the event of a crisis. Ireland's National Pension Reserve Fund (NPRF) fulfilled this role during the recent crisis, although not initially designed for this purpose.

#### **BOX B: RAINY DAY FUNDS**

There are relatively few examples of Rainy Day Funds (RDFs) in operation in a European or international context. In cases where such funds exist, they vary in both their purpose and their operation. Motivations range from counter-cyclical policy to dealing with known long-term structural problems to providing insurance in the event of financial crises. The motivation will tend to influence the source of funds and how they are used.

##### Structural Issues

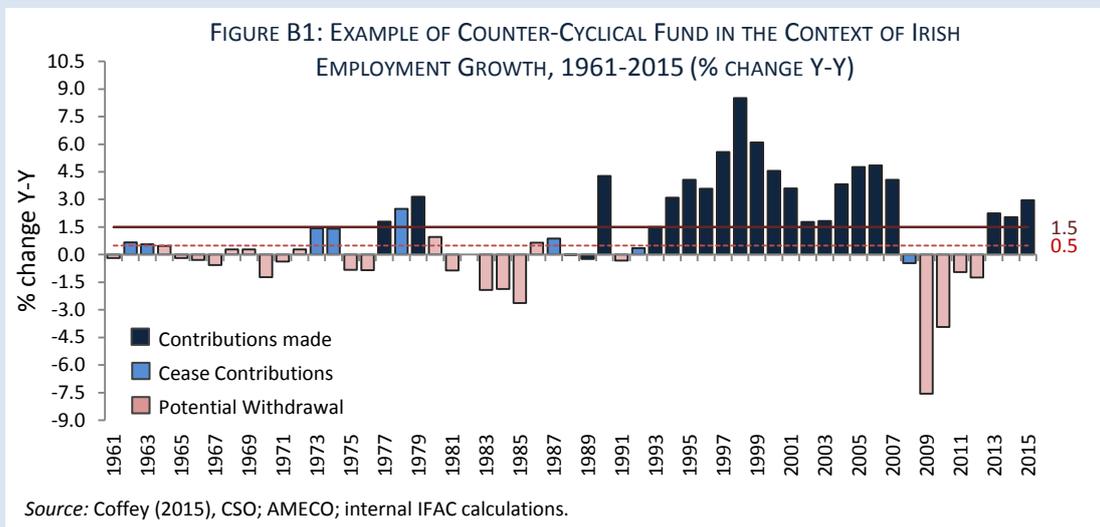
The most common type of sovereign wealth fund appears to be those set up when a country experiences large economic gains from a temporary or uncertain source. The classic case of this is countries with natural resources such as Norway's sovereign wealth fund. Because of their long-term goals, these funds typically act as investment vehicles that have low liquidity in the short term. This may be appropriate for providing funds to allow

for economic transition away from an oil-based economy or to provide for the cost of future pensions. Ireland’s NPRF had such a strategy in mind and it was particularly unsuited to acting as a fund for financial stability or counter-cyclical policy. Having invested heavily in equities on the assumption that there would be no withdrawals before 2025, the NPRF lost over 30 per cent of its value in 2008 – the year before its first investment in the Irish banking sector.

Counter-cyclical fund

Several US states use RDFs to smooth their expenditure over time. Because many states are prevented by law from borrowing, the fall in state revenues that comes with cyclical downturns would, in the absence of a fund, require cutting back on expenditure. The only example of a counter-cyclical fund in the Eurozone appears to be in Finland. However, this operates quite differently to the relatively simple US-style funds. In Finland’s case, cyclical buffers are accumulated in an unemployment insurance fund. The fund charges employers a social insurance contribution that more than covers the cost of providing unemployment benefits in good times, allowing buffers to build up. In ‘bad times’ the rate charged on employers is cut, lowering the cost of labour and encouraging employers to keep employment rates up. The fund was introduced in 1999 as a response to the fact that external devaluation would not be possible in EMU so internal devaluation should be made as easy as possible.

Coffey (2015) proposes a fund that accumulates based on setting aside 5 per cent of the difference between GDP and GNP every year (this would have amounted to 0.8 per cent of GNP in 2014; the NPRF typically targeted 1 per cent). The rationale for this is that it amounts to roughly half of the benefit from corporation tax paid by multinational corporations (MNCs) every year. These revenues are volatile in the short term and uncertain in the longer term since they are dependent on the commercial decisions of a small number of MNCs (see Chapter 3).



The proposal has counter-cyclicity built into it because, when employment growth falls below 1.5 per cent, the government could temporarily stop payments to the fund and when it falls below 0.5 per cent, withdrawals would be allowed. Importantly, the proposal would actually remove these yearly savings from the budget arithmetic so that achieving a balanced budget in structural terms would have to be done by excluding the revenues being diverted to the RDF. This was a major shortcoming in the design of the NPRF which resulted in the Government essentially borrowing the funds used to make payments into the NPRF each year.

The SGP does not include any specific provisions relating to the operation of a RDF. Issues

such as how a country would run down a counter-cyclical fund within the confines of the fiscal rules would need to be worked out over time.

It would also be important to consider the potential cost to the State of investing in the fund. Cash invested in the fund could instead be used to run larger budget surpluses and to reduce the debt, thereby lowering national debt interest payments. The rate of return on the fund in comparison to the interest rate being paid on the national debt would need to be considered.

Finally, whether the fund is set up as a tool for counter-cyclical management or as a pension liability fund, the rules regarding its governance would need to be specified. This would include putting in place safeguards to prevent inappropriate uses of the fund and laying out clearly the criteria under which the fund's resources could be accessed.

## 2. ASSESSMENT AND ENDORSEMENT OF MACROECONOMIC FORECASTS

### KEY MESSAGES

- The Council endorsed the *SPU 2016* macroeconomic forecasts to 2021. Taking into account the uncertainties and judgemental elements involved, it was satisfied that these forecasts were within an endorsable range.
- While growth is forecast to moderate over the next few years from the exceptionally strong rates recorded in 2014 and 2015, the near term prospects look encouraging. Although there is much uncertainty surrounding the cyclical position of the economy at the moment, continuing strong growth could, within a few years, raise concerns around overheating and sustainability.
- The error margins around Irish growth forecasts are very high by international standards. The recent strong growth in the Irish economy has been aided by improving external conditions, namely a weak exchange rate, trading partner growth, low oil prices and accommodative monetary policy. Any reversal of these external factors would have a negative impact on growth prospects in Ireland. While much of the focus on risks centres on external conditions, domestic risks also exist with supply constraints in the housing sector and the high concentration of the Irish export base chief among them.
- To avoid a repeat of past failures of macroeconomic management, it is essential that the Government's forecasts for the medium term are well-founded. This requires an augmentation of the Department of Finance's current toolkit for medium-term macroeconomic forecasting. An important failure of macroeconomic surveillance in Ireland during the 2000s was that the extent of the overheating in the economy was not identified at the time. The failure to detect the signs that the economy was growing at an unsustainable rate facilitated excessively loose fiscal policy leading to the damaging social and economic consequences of the crisis. A broader range of supply-side methodologies might have helped avoid this failure.
- The Department's medium-term forecasts are currently produced using the EU Commonly Agreed Methodology (CAM), which is only required for fiscal surveillance, and which the Department has long recognised is not appropriate for Ireland. Building on the work already commenced, the Department of Finance should continue to develop a complementary set of medium-term baseline estimates for the supply side based on methodologies better suited to the characteristics of the Irish economy. There are risks that signs of overheating may again be missed if the Department exclusively relies on the CAM.

## 2.1 INTRODUCTION

The Council's sixth endorsement exercise covers the set of macroeconomic projections in *SPU 2016* covering the same horizon (2016-2021) as *Budget 2016*. The timeline for the endorsement process is detailed in Appendix B. As in previous exercises, the Department of Finance provided high levels of cooperation in all of their interactions with the Council.

To support these endorsement and assessment functions, the Council has continued its development of a "suite of models" approach (IFAC, 2013b), with an expanded set of tools used for both short-term and medium-term forecasting. Since November, further efforts have been made by the Council to advance alternative supply-side estimates of the Irish economy. These are essential for assessing the cyclical position of the economy as well as for understanding the economy's medium-term supply-side potential.

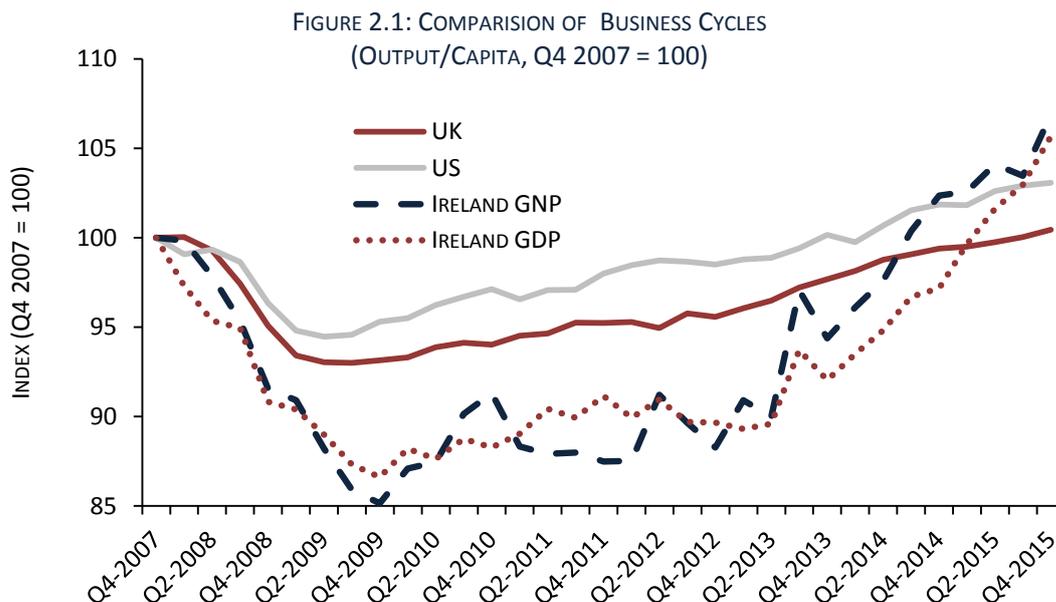
Section 2.2 discusses the *SPU 2016* forecasts and puts these in context relative to the forecasts of other agencies, while Section 2.3 provides an assessment of the uncertainty and risks surrounding the economic outlook. Section 2.4 concludes by outlining the endorsement process as it applied to the *SPU 2016* projections. A box is also included, reviewing the impact of investment in aircraft and intangibles on contributions analysis.

## 2.2 AN ASSESSMENT OF THE MACROECONOMIC FORECASTS IN SPU 2016

### 2.2.1 SPU 2016 SHORT-TERM FORECASTS, 2016-2017

Strong growth in 2015 saw the recovery of the Irish economy accelerate, with provisional estimates showing growth of 7.8 per cent. While the headline figures suggest that the recent recovery is led by domestic demand, stripping out both investment and imports of aircraft and intangibles, the underlying contributions show that recent growth is more balanced (for more details, see Box C). External conditions were very favourable in 2015, with reasonable growth in Ireland's key trading partners, favourable exchange rates and low oil prices leading to a strong contribution from underlying trade.

With a strong recovery underway from the recent recession and financial crisis, it is worth examining where this recovery stands relative to the UK and US. Figure 2.1 compares Irish GDP and GNP per capita since its peak (Q4 2007) to the UK and US. The chart shows that while output per head in the Irish economy fell more rapidly than either of the comparators, it is now experiencing a more rapid recovery. With the Irish economy having rebounded strongly following the deep recession and with output per head exceeding its pre-crisis peak, it remains to be seen how long the recent high growth rates can continue before more moderate growth rates resume.



Source: OECD, CSO and Internal IFAC calculations.

SPU 2016 expects last year’s very strong growth to moderate significantly in 2016, with real **GDP** projected to expand by 4.9 per cent, followed by a 3.9 per cent expansion in 2017. The 2016 forecast implies a sharp slowdown in the pace of quarter-on-quarter growth relative to last year if current CSO estimates for recent quarters are taken at face value. This is largely a reflection of the very strong carryover effect from 2015 of 3.3 per cent.<sup>6</sup> With this in mind, a 0.6 per cent quarter-on-quarter average growth rate would be consistent with the Department’s 4.9 per cent forecast for annual GDP growth in 2016 (Table 2.1). The forecasts also imply a significant pick-up in average quarter-on-quarter real GDP growth in 2017 (1.2 per cent per quarter) – twice the rate of expansion forecast for 2016. It would appear that little weight has been given to quarterly profiles or carryovers when formulating the forecasts in *SPU 2016* even though these can provide valuable and unbiased information.

TABLE 2.1: IMPLIED AVERAGE QUARTER-ON-QUARTER GROWTH RATES

<b>% change in volumes unless stated</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
<b>SPU 2016</b>	1.5	2.3	0.6	1.2

Sources: CSO and Department of Finance (*SPU 2016*).

The *SPU 2016* forecasts indicate that the recent strong **personal consumption** growth is expected to continue in 2016 and 2017 (see Table 2.2 for a summary of *SPU 2016* forecasts). Income data are supportive of this outlook with real personal disposable income set to rise this year, driven mainly

<sup>6</sup> The carryover effect refers to the annual 2016 growth rate that would be observed were seasonally adjusted real GDP to remain unchanged at its Q4 2015 level.

by employment growth. The high frequency data on retail sales and car sales are also supportive of this positive outlook.

While the trend of **investment** growth was overstated in the headline figures for 2015 due to strong growth in import-intensive intangibles, there was also strong underlying growth (see Box C for details on underlying and headline investment). Underlying machinery and equipment investment (i.e., excluding aircraft) is expected to continue its recent pace of growth this year. Building and construction is also expected to pick up, albeit from a low base. There is already significant pent up demand in the housing sector as completions have remained well below estimates of annual requirements for some time. Duffy *et al.* (2014) estimate 25,000 dwellings per annum are required to meet demand due to demographics and new household formation. The level of housing completions has been around half the estimated requirement since 2009.<sup>7</sup> While the headline investment-to-GDP ratio may appear to be back to historical norms, the underlying measure (i.e., excluding aircraft and intangibles) appears to still be well below its historical average (Box C, Figure C3), hence the recent strong growth in underlying investment may be expected to continue. Both building and construction and underlying machinery and equipment are forecast to contribute to this strong growth.

**Export** growth contributed strongly to overall activity in 2015 but is forecast to slow down significantly in the next two years, albeit from a very high base, according to the forecasts in *SPU 2016*. While headline goods exports are exaggerated somewhat by contract manufacturing,<sup>8</sup> much of this is offset in GDP terms by the associated rise in imports of royalties. External conditions were very favourable in 2015, with growth in trading partners, depreciation of the exchange rate and low oil prices. These factors are expected to largely remain in place in 2016.<sup>9</sup> There are, however, obvious downside risks to the external environment, with the most immediate risks being those associated with a possible Brexit (Section 2.3). **Import** growth is also set to slow significantly in the Department's projections, albeit from a very high base. Most of the growth in 2015 came from services, specifically royalty costs and purchases of intellectual property.

The *SPU* forecasts **stock changes** to halve this year. This makes a significant negative contribution (-0.7 percentage points) to forecasted GDP growth for 2016. Stock changes have grown

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<sup>7</sup> *SPU 2016* forecasts completions to reach 25,000 in 2019.

<sup>8</sup> See Box A of IFAC (2015a) for details of these activities.

<sup>9</sup> The UK and US combined account for as many Irish exports as the Euro Area, hence trading partner growth is forecast to be favourable in 2016.

considerably for the last three years, so the forecast implies a large reversal of recent growth. The Department do not forecast any contribution to growth from stocks from 2017 on.

TABLE 2.2: *SPU 2016* MACROECONOMIC FORECASTS (TO 2018)

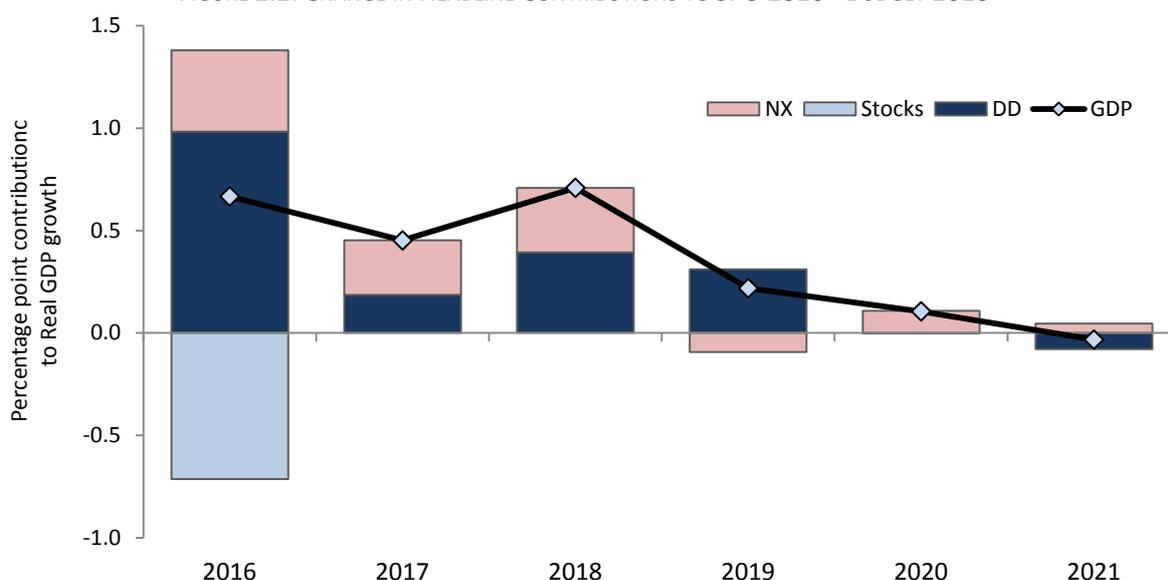
<i>% change in volumes unless stated</i>	2014	2015	2016	2017	2018
<b>GDP</b>	5.2	7.8	4.9	3.9	3.9
<b>GDP Deflator</b>	0.1	5.3	2.6	1.2	1.3
<b>Nominal GDP</b>	5.3	13.5	7.6	5.2	5.3
<b>GNP</b>	6.9	5.7	4.1	3.7	3.7
<b>Consumption</b>	2.0	3.5	3.9	2.7	2.4
<b>Investment</b>	14.3	28.2	13.5	7.0	4.8
<b>Government</b>	4.6	-0.8	1.5	1.6	1.3
<b>Exports</b>	12.1	13.8	8.0	5.5	5.1
<b>Imports</b>	14.7	16.4	9.0	5.8	4.6
<b>Stock Changes (pp. Contribution)</b>	0.5	0.4	-0.7	0.0	0.0
<b>Current Account (% of GDP)</b>	3.6	4.4	4.5	3.9	3.8
<b>Employment</b>	1.7	2.6	2.6	2.3	2.3
<b>Unemployment Rate</b>	11.3	9.5	8.4	7.8	7.0
<b>Inflation (HICP)</b>	0.3	0.0	0.4	1.7	1.9
<b>Nominal GDP (€ billions)</b>	189.0	214.6	231.0	243.0	255.8

Sources: CSO and Department of Finance (*SPU 2016*).

The **GDP deflator** grew strongly in 2015, mainly driven by terms of trade effects. These effects were mainly as a result of the depreciation of the Euro, particularly against the Dollar. The effects are expected to fade in 2016 under the assumption that there will be no further exchange rate changes, leading to a moderation in GDP deflator growth. The contributions to growth in the overall GDP deflator are forecast to be evenly split between exports and domestic demand this year, with only the domestic side contributing to growth in the deflator thereafter.

Figure 2.2 shows the changes in the contributions to growth in *SPU 2016* from *Budget 2016*. For 2016, the contributions from domestic demand and net exports have both been revised upward. Changes in stocks now contribute negatively, having been forecast to make no contribution to growth in 2016 in *Budget 2016*. For 2017 and 2018, both domestic demand and net exports are expected to contribute more strongly than previously forecast. For the later years of the *SPU* forecasts, the forecast level of growth is not significantly different to that projected in *Budget 2016*.

FIGURE 2.2: CHANGE IN HEADLINE CONTRIBUTIONS TO SPU 2016 - BUDGET 2016



Sources: Department of Finance; CSO; internal IFAC calculations.

### BOX C: CONTRIBUTIONS TO GROWTH, HEADLINE VS. UNDERLYING

Real GDP growth is often usefully decomposed into contributions from domestic demand and net exports to give a sense of how much growth is driven by international factors, such as demand for Ireland’s exports, and how much by domestic drivers, such as consumer spending or government spending. In Ireland’s case, the composition of growth has additional significance given the large role of the multinational sector in exporting and importing.

However, as a result of recent changes to National Accounts, headline domestic demand and net exports as published by the CSO may not give the best indication of underlying growth drivers. In particular, the inclusion of Research and Development (R&D) expenditure and aircraft purchases by Irish resident aircraft leasing companies in investment expenditure has made the interpretation of headline aggregates less straightforward (see CSO (2015) and FitzGerald (2015) for details). This Box highlights the importance of examining different measures of domestic demand and net exports when using contributions analysis to determine the drivers of growth in the economy.<sup>10</sup>

As almost all aircraft purchases in Ireland are imported and the vast majority of these aircraft operate outside of Ireland, the impact of this investment on the domestic economy and employment is minimal. As a result, while an increase in aircraft purchases will boost investment, it will also lead to a corresponding increase in imports leaving real GDP growth unaffected. A similar issue arises with investment in intangibles, of which typically two-thirds is imported. Furthermore both activities can be highly volatile and influenced by firm-specific factors.

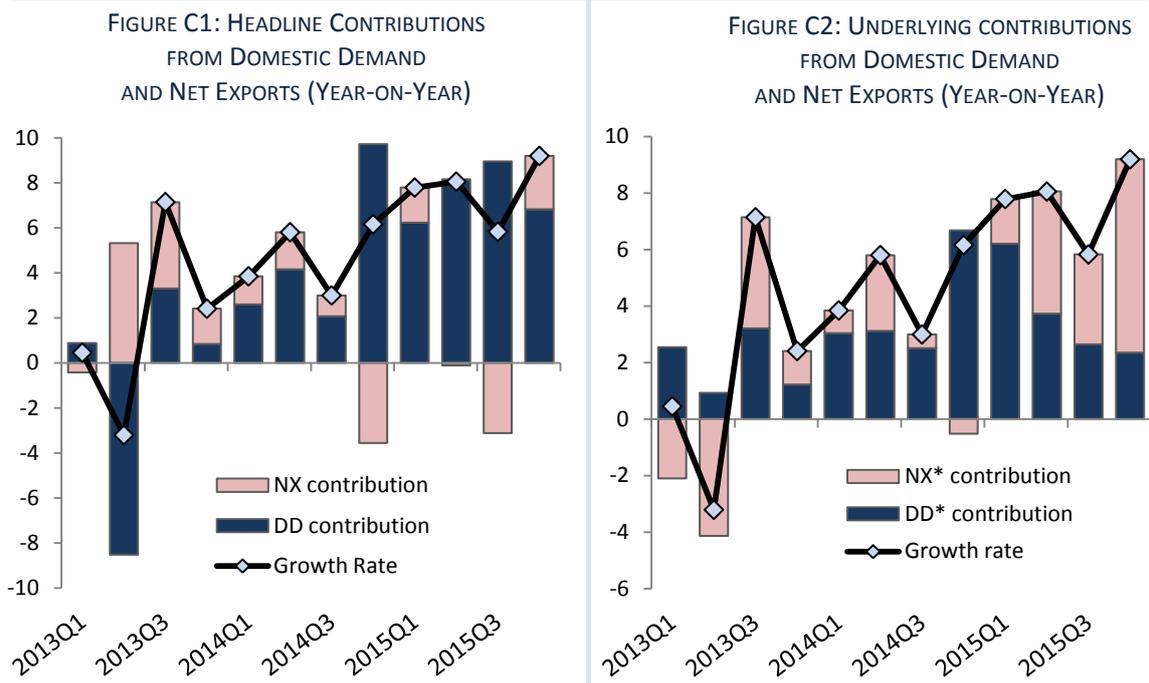
Given the high import content of investment in intangibles and aircraft, a better approach to

<sup>10</sup> Domestic demand consists of personal consumption, investment, value of physical changes in stocks and net expenditure of central and local government. Net exports consist of exports less imports.

measuring underlying developments is to strip both activities out of domestic demand and net exports. While headline domestic demand is inflated by the investment activities, headline net exports are reduced by the associated imports.

Figure C1 and C2 compare the headline and underlying contributions of domestic demand and net exports to growth over the last 12 quarters. Looking at the most recent quarters, it is noticeable that there are strong contributions from headline domestic demand. In the last five quarters in particular, headline domestic demand appears to be the sole driver of growth based on the unadjusted data. The apparent lack of a significant positive contribution from net exports to overall GDP growth in 2015 is out of line with many other indicators of export growth such as growth in trading partners, lower oil prices, accommodative monetary policy and currency devaluation. All of these indicators point towards an improvement in net exports in 2015 in contrast to the position indicated by the unadjusted data. Looking at the underlying measures in Figure C2, the underlying contributions to growth are much more balanced than the headline figures would suggest. This large divergence is due to substantial investment in intangibles, which pushes up headline investment and imports, while the underlying measures remain unchanged.

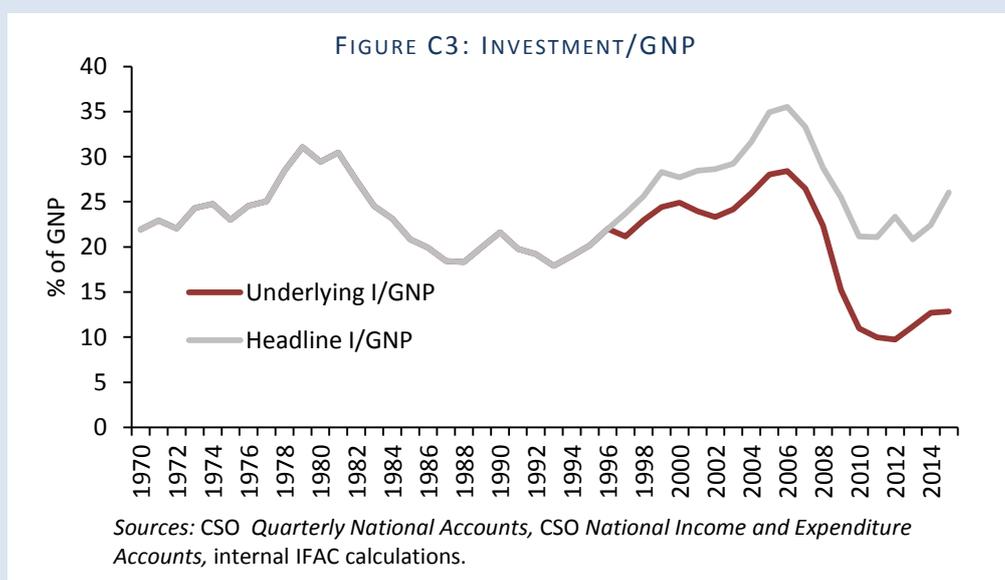
This highlights the importance of going beyond the headline measures of domestic demand and net exports in order to decipher the underlying pattern of growth in the Irish economy. Given the continuing significant impact of aircraft and intangibles on measured investment and imports, it will be necessary to make these adjustments to the headline National Accounts statistics on an on-going basis.



Sources: Department of Finance; CSO; internal IFAC calculations.

Notes: "Underlying" investment and net exports strip out intangibles and aircraft purchases in full as these are, in the main, imported, with little impact on real GDP.

It is also useful to consider the impact from these activities on investment expenditure as a share of GNP. The fall of investment in the recent crisis has been well documented, with the decline most pronounced in the building and construction sectors.<sup>11</sup> As reflected in Figure C3 above, headline investment has been growing strongly for the last two years, helping to return headline investment-to-GNP levels to long-run, historical levels. However, much of the increase has been in aircraft and intangibles such that underlying investment remains extremely low when compared to historical levels. On this basis, one might expect underlying investment to grow faster than GNP for the next few years to restore this ratio closer to its historical average. An analytical note released together with this *Fiscal Assessment Report* highlights the low level of public investment in recent years, which contributes to the low level of underlying investment apparent in Figure C3.



### 2.2.2 SPU 2016 MEDIUM-TERM FORECASTS, 2018-2021

There have been very significant revisions to *Budget 2016* estimates of potential output growth and the output gap, shown in Figure 2.3 and Table 2.3. This leads to a materially different picture of potential output growth in the near term, with a much smaller (positive) output gap over the forecast horizon, and leaving GDP in 2018-2021 5.3 per cent higher than forecast in autumn 2016.

<sup>11</sup> Data on investment in aircraft and intangible assets is only available from 1997. In any event given the low levels of investment in aircraft and intangibles in the late 1990s it is probably safe to assume that the underlying and headline investment-to-GDP ratios would be quite close in the pre-1997 period.

These changes reflect a change in how Department of Finance applies the CAM methodology<sup>12</sup>, but also shows the sensitivity of these estimates to data releases, impacting on both the current estimates as well as historical estimates (the 2014 output gap has been revised down by more than a percentage point relative to Budget day estimates).

FIGURE 2.3: VINTAGES OF MEDIUM-TERM PROJECTIONS

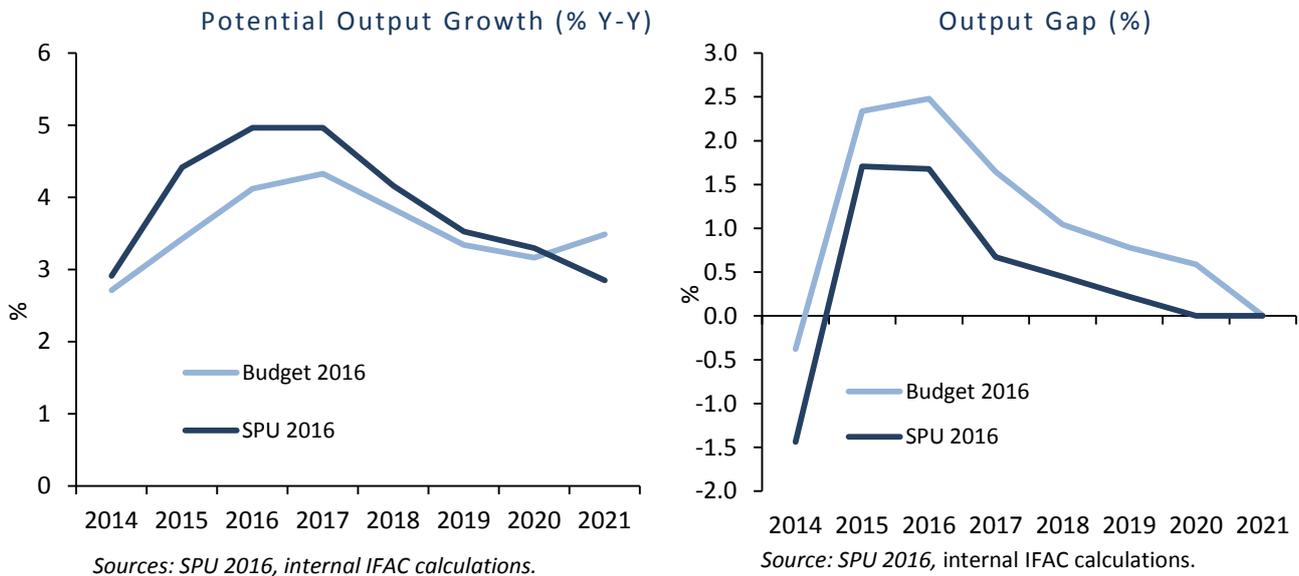


TABLE 2.3: MEDIUM-TERM DEMAND AND SUPPLY-SIDE FORECASTS

	% change	2015	2016	2017	2018	2019	2020	2021
<i>SPU 2016</i>	Real GDP Growth	7.8	4.9	3.9	3.9	3.3	3.1	2.9
	Nominal GDP Growth	13.5	7.6	5.2	5.3	4.6	4.4	4.2
	Potential GDP Growth	4.4	5.0	5.0	4.2	3.5	3.3	2.8
	Output Gap (% potential GDP)	1.7	1.7	0.7	0.4	0.2	0.0	0.0
<i>Budget 2016</i>	Real GDP Growth	6.2	4.3	3.5	3.2	3.1	3.0	2.9
	Nominal GDP Growth	11.2	6.2	4.7	4.5	4.3	4.2	4.1
	Potential GDP Growth	3.4	4.1	4.3	3.8	3.3	3.2	3.5
	Output Gap (% potential GDP)	2.3	2.5	1.6	1.0	0.8	0.6	0.0

Source: Department of Finance.

Table 2.4 shows the forecast contributions to growth from underlying net exports and domestic demand over the medium term as set out in *SPU 2016*. The forecasts show a positive contribution to growth from net exports over the forecast horizon. The contribution of underlying domestic demand is forecast to moderate gradually by 2021 but is expected to make a larger contribution to growth than net exports in each year.

<sup>12</sup> *SPU 2016* states that this change in methodology is to ensure a greater alignment between the Department’s application of the CAM and that which the EC will use when assessing compliance with the fiscal rules.

TABLE 2.4: REAL GDP GROWTH FORECASTS AND CONTRIBUTIONS (UNDERLYING BASIS)

% change	2016	2017	2018	2019	2020	2021
Real GDP Growth	4.9	3.9	3.9	3.3	3.1	2.9
Domestic Demand (p.p.) <sup>1</sup>	2.9	2.9	2.2	2.2	1.9	1.7
Net Exports (p.p.) <sup>1</sup>	2.0	1.0	1.7	1.1	1.2	1.1

Source: Department of Finance (*SPU 2016*).

<sup>1</sup>Contributions to real GDP growth rates in percentage points. Domestic demand includes changes in inventories.

The consistency between the Department's labour market and income projections and the forecasts for overall activity has been raised in previous endorsement rounds and documented by the Council in subsequent *Fiscal Assessment Reports*. While the labour market and income projections in *SPU 2016* imply some erosion of competitiveness (due to increases in hourly pay relative to labour productivity), with external trading partner demand relatively unchanged, the forecasts for overall activity imply a continuing strong contribution from net exports and a fall in those from domestic demand. An erosion of competitiveness could lead to a weaker performance from net exports than projected in *SPU 2016*.

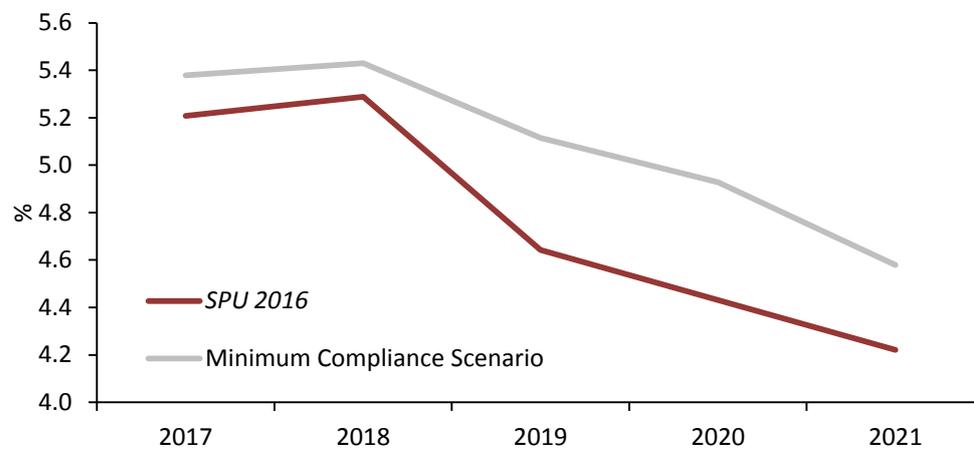
TABLE 2.5: PRODUCTIVITY GROWTH FORECASTS

% change	2015	2016	2017	2018	2019	2020	2021
Real GDP per employee	5.1	2.3	1.6	1.6	1.6	1.5	1.4
Real GNP per employee	3.1	1.5	1.4	1.4	1.1	1.0	0.9

Source: Department of Finance (*SPU 2016*).

The fiscal projections underpinning the macroeconomic forecasts published in *SPU 2016* are produced on the Department's no-policy change basis and imply over-compliance with the fiscal rules. If, instead, a looser fiscal stance is followed in line with minimum rule compliance, GDP growth would be between  $\frac{1}{2}$  and  $\frac{3}{4}$  of a percentage point higher per annum over the medium term compared to the projections in *SPU 2016* (Figure 2.4). This is based on a static analysis using the Council's fiscal feedback's model. Given that the existing forecasts in *SPU 2016* already imply quite strong GDP growth from 2016-2021, there is a risk that an additional fiscal policy stimulus could raise growth to a level consistent with overheating in the economy.

FIGURE 2.4: SIMULATING THE EFFECT OF FISCAL POLICY STANCE IN LINE WITH MINIMUM RULE COMPLIANCE: NOMINAL GROWTH RATES (2017 - 2021)



Note: The minimum compliance scenario shows nominal growth simulated using the Council's fiscal feedbacks model assuming minimum compliance with fiscal rules.

Source: SPU 2016 and internal IFAC calculations.

While ascertaining the current cyclical position of the economy is difficult, one can look at a broad range of indicators for signs of overheating or unsustainability (see Appendix C). The SPU forecasts unemployment to be over 8 per cent on average this year implying a fourth quarter unemployment rate of 7.9 per cent, though the latest monthly labour market figures which were revised downwards in May, show seasonally adjusted unemployment to be at this level as of April. It is not clear what unemployment rate is consistent with stable inflationary pressures in Ireland and the Department's only anchor in this regard is the CAM-based NAWRU, which tends to track actual unemployment quite closely.<sup>13</sup> Nonetheless, clear price and wage pressures are not yet apparent so that the labour market does not appear to be portraying signs of an overheating economy at present.

On the current account of the balance of payments, based on an underlying measure,<sup>14</sup> there are also no clear signs of overheating, with an underlying surplus of 1 per cent forecast in SPU 2016 for this year. The recovering net international investment position would also suggest that immediate pressures are not apparent. Domestically, low investment ratios and the absence of substantial credit market easing would also imply the absence of overheating.

Looking at the housing market, it is worth noting that the immediate pre-crisis period was characterised by strongly rising house prices, credit and construction activity, all of which ultimately proved unsustainable. A review of various indicators does not reveal signs of unsustainable credit and

<sup>13</sup> NAWRU stands for non-accelerating wage rate of unemployment and is a measure intended to capture the unemployment rate at which wage growth is stable.

<sup>14</sup> Correcting for the effect of redomiciled PLCs as described by FitzGerald (2013).

construction growth – indeed quite the contrary. As noted in Table 2.5, the main risks from the housing sector currently emanate from a lack of supply, leading to higher prices. The housing market will require careful on-going monitoring as there is a risk that the current problems in this area could also have wider negative macroeconomic and labour market consequences.

The shortage of available housing appears to be most acute in urban areas. Prohibitive construction costs are frequently cited as one factor constraining supply. There is some evidence of a divergent performance in costs relative to prices (Appendix C, Figure 5.A). The construction cost index compiled by the CSO suggests that costs are now above the level observed at their peak in the third quarter of 2008. By comparison, property prices have undergone a sharp correction and remain approximately 33 per cent below their peak values.

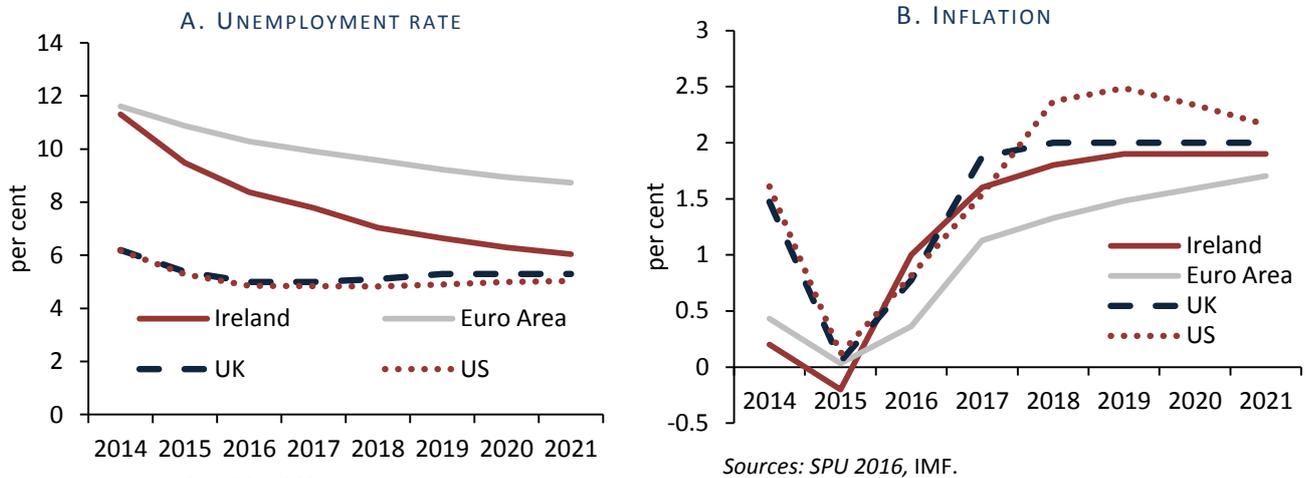
On balance, while there is uncertainty about the exact cyclical position of the economy at this time, with little evidence of either a major demand shortfall or signs of overheating, it would appear that the economy is currently operating fairly close to its potential level. With this in mind the official forecasts for the output gap in *SPU 2016* of 1.7 per cent for 2015 and 2016 appear to be somewhat above what other indicators of the output gap would suggest. This situation is one which is likely to be changing quite rapidly, however, with economic activity forecast to grow at high rates in coming years and unemployment falling relatively fast.

Given that the cyclical position of the economy is likely to be changing quickly, it is essential that a more robust set of tools is deployed to assess whether the economy could be overheating. As highlighted previously by the Council (IFAC, 2015b, 2015d), the Commonly Agreed Methodology (CAM) (EC, 2014a) is inappropriate for estimating the cyclical position of the Irish economy, but remains the only public view the Department gives of supply-side developments. Given the persistent problems with this methodology it is essential that the Department continues to develop alternative, more realistic measures of the productive capacity of the Irish economy. These more credible measures should have a role in identifying potential risks or signs of overheating which the CAM is not well equipped to do.

While pointing out the problems with the CAM as far back as 2003, the Department of Finance has continued to largely rely on the methodology for producing their estimates of the economy's medium-term potential growth and the output gap. The CAM is used by the EC for the purpose of fiscal surveillance, and the estimates produced using this methodology must be reported by the Department in the budget and SPU, however the Department is free to develop and report alternative projections to the CAM-based estimates, an approach which is widely used in other countries. With this

excessive<sup>15</sup> reliance on the CAM to estimate the supply side, there is a danger of not detecting signs of imbalances in the economy before they emerge.

FIGURE 2.5: CONSISTENCY OF MEDIUM-TERM PROJECTIONS



This *SPU* contains a significant change in the way the CAM is applied, as noted in the *SPU* document. In previous *Stability Programme Updates* and budgets, the demand-side forecasts for the full forecast period out to 2021 were used to estimate the CAM supply-side trends, i.e., the data used to calculate potential output based on the CAM consisted of historical information up to 2014/2015, which were then extended to 2021 using the Department’s demand-side forecasts. For *SPU 2016*, demand-side forecasts are primarily only used as inputs for the supply-side to 2017. From 2018 onwards, the output gap is assumed to close mechanically by 2021.

While recent changes to the supply-side approach mean a closer alignment of the Department’s methodology to that used by the EU Commission, this means that the Department’s actual supply-side views are more difficult to ascertain in *SPU 2016*. This trade-off between consistency with the Commission’s approach and expressing a realistic central view on the economy could be avoided if the Department were to also systematically publish estimates of the supply side in line with their actual views of the cyclical position of the Irish economy. This approach is taken in many other Euro Area members, including many of the smaller countries.<sup>16</sup> The Council notes the work recently undertaken by the Department on developing alternative approaches to estimating potential output. This work was briefly summarised in the *SPU* and a related Working Paper is planned by the Department.

<sup>15</sup> See Box B of IFAC (2015d) for details on other EU finance ministries using alternative approaches to the CAM.

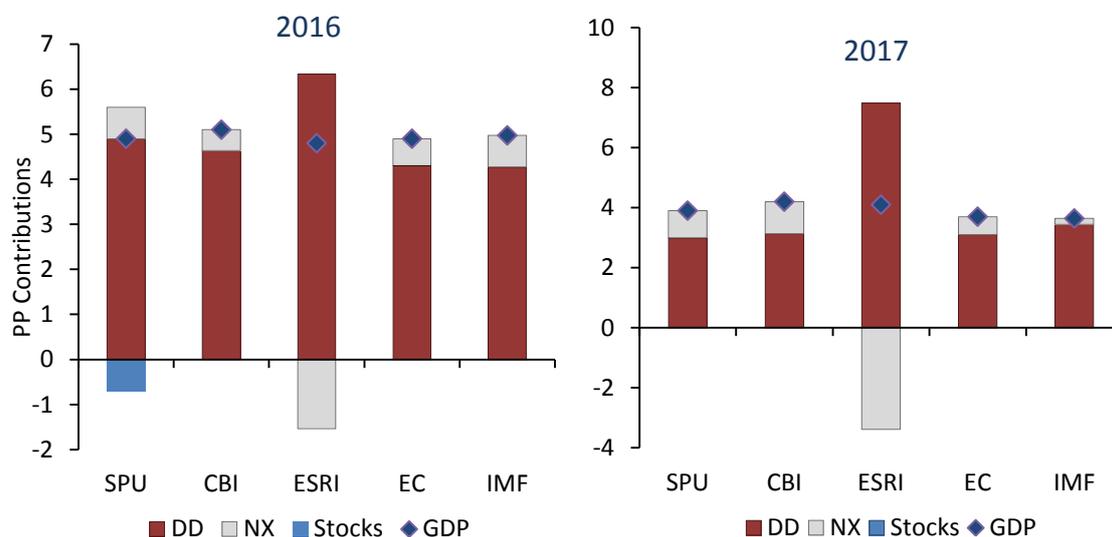
<sup>16</sup> Box B in the November 2015 *FAR* shows that EU finance ministries can also choose to show multiple measures of the output gap and do not have to rely solely on estimates produced under the CAM.

The extent to which reliance on the CAM could result in the Department mis-diagnosing the true underlying cyclical position of the economy can be easily illustrated using the most recent estimates provided in *SPU 2016*. The current supply-side estimates in *SPU 2016* suggest the presence of a large positive output gap of 1.7 per cent of potential GDP in 2016, implying that the economy is currently overheating. Potential output growth is estimated at 5 per cent in both 2016 and 2017. After 2017, the CAM assumptions used by the Department (by design) ensure that the output gap is closed by 2021 even though growth rates average 3.4 per cent per annum over 2017-2021. This is achieved by keeping potential growth rates above actual growth rates over the forecast period. This picture of the supply side of the economy as implied by the Department’s estimates in *SPU 2016* is open to question when taking into account a range of indicators of imbalances in the economy and alternative supply-side estimates (see Appendix C and Chapter 1), in particular the estimate of the output gap (+1.7 per cent) for 2016.

### 2.2.3 FORECASTS OF OTHER AGENCIES

Most forecasting agencies envisage real GDP growth slowing down significantly as in the *SPU* over the near term. For 2016, all agencies forecast growth to be mainly due to domestic demand. There are some compositional differences for 2017, with the *SPU* and the Central Bank forecasting larger net exports contributions than other agencies (Figure 2.6).

FIGURE 2.6: COMPARATIVE REAL GDP GROWTH CONTRIBUTIONS (PERCENTAGE POINTS)



Sources: *SPU 2016*; ESRI (*Quarterly Commentary Spring 2016*); IMF (*World Economic Outlook, April 2016*); Central Bank *Quarterly Bulletin 2, April 2016*; and European Commission (*European Economic Forecast, Spring 2016*).

### 2.3 RISKS

While the near term prospects for the Irish economy are strong, substantial risks surround this central forecast. In the last two years a number of external factors have become more favourable. However, these remain beyond the control of domestic policy makers and could reverse quickly, with negative consequences for baseline forecasts. Exchange rates have boosted competitiveness; a looser monetary policy stance has helped a strained credit environment; oil prices remain subdued; and continued demand growth is projected in Ireland's major trading partners, even with recent downward revisions to world trade. Given the open nature of the Irish economy, changes to the external environment could have a sizeable impact on the economy.

In *SPU 2016*, the Department noted that risks have become increasingly tilted to the downside, mainly citing external factors.<sup>17</sup> The Council welcomes the approach taken in *SPU 2016* which mirrors previous *Fiscal Assessment Reports* by providing risks in matrix form while also including both the expected likelihood and impact of risks considered.

On the external side, the *SPU* analysis of risks gives less attention to financial market risks stemming from the normalisation of interest rates in the US economy. Domestically, competitiveness pressures have been highlighted in a number of recent reports by the National Competitiveness Council. These have, in particular, cited the emergence of infrastructure bottlenecks, high property costs, and skills shortages among other factors that could undermine recent competitiveness gains.

While there are limited signs of the economy overheating at present, strong growth in the coming years is forecast. This would close any existing negative output gap and could potentially lead to overheating in the coming years. With output growth and inflation in the Euro Area remaining subdued,<sup>18</sup> accommodative monetary policy looks set to continue. While this loose stance has been helpful for Ireland in recovering from a deep recession, there is a risk that monetary policy could soon be looser than would be ideal for Ireland. The last crisis showed the impact that inappropriate monetary policy can play in amplifying the business cycle. With this in mind fiscal and macroprudential policy may need to be tighter than would otherwise be the case to prevent overheating.

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<sup>17</sup> The *SPU* notes that "it would appear that external risks have intensified since the Budget last October".

<sup>18</sup> Forecasts for both output and inflation were revised down in the recent Spring Forecasts of the European Commission.

TABLE 2.6: RISK ASSESSMENT MATRIX FOR MAIN DOWNSIDE RISKS

Risk	Relative Likelihood	Impact
<b>Euro Area Risks</b>	M	With strong growth rates forecast in <i>SPU 2016</i> , the Irish economy may be in danger of overheating in the next few years. This is in stark contrast to the rest of the Eurozone, which continues to struggle with modest growth and below target inflation. With this in mind, it is easy to see how monetary policy could be looser than ideal for Ireland in the coming years, as it was in the lead up to the last crisis.
<b>Housing market</b>	H	While there are potential upside risks to forecasts for investment if construction activity gets back to equilibrium levels, there are negative implications for competitiveness if commercial property and house price inflation continues.
<b>Competitiveness</b>	M	Competitiveness losses could arise as a result of various cost pressures. These include unit labour costs which could be driven by property price/rent increases. Any reversal of last year's exchange rate depreciation would negatively impact on competitiveness. Oil prices were also favourable last year and a reversal of these movements would be a drag on growth.
<b>Emerging Market Slowdown</b>	M	While the direct impact of any emerging market slowdown would be relatively limited, second round impacts could be significant due to lower demand from trading partners.
<b>UK Exit from EU</b>	M	While difficult to confidently quantify, the impact of a UK exit from the EU on the Irish economy would be substantial. Both trade disruption and subdued demand from the UK would impact on Irish exports. A depreciation of Sterling would also negatively impact Irish export performance.
<b>Concentration of Irish Export base</b>	M	The Irish economy remains reliant on a small number of sectors for much of its output. While this remains the case, sector or firm specific shocks could have a disproportionately large impact on the Irish economy. Specifically, changes to the US tax code, particularly in relation to corporation tax, could have a large impact on inward FDI.
<b>Geopolitical Tensions</b>	L	Any escalation in geopolitical tensions could pose downside risks for growth through trade linkages and disruptions in financial transactions.
<b>Global Financial Markets</b>	M	Interest rates remain low in the Euro Area, UK and US aiding growth prospects but potentially raising financial stability concerns. In addition, normalisation of monetary policy will need to be carefully managed in the Eurozone (this has already begun in US).
<b>Private Debt and Credit Conditions Constraining Activity</b>	M	Household, government and corporate debt levels remain high. This results in an increased vulnerability to increases in interest rates or funding costs. Economies with higher levels of debt may also be more exposed to external shocks.

Note: Qualitative likelihood assessments based on Council assessments: H= High; M = Medium; L = Low.

Apart from inappropriate monetary policy, other risks arise from the Eurozone. Recent episodes in Greece and Cyprus have shown that regional bank runs are possible in the Eurozone, particularly among countries in the periphery. While Ireland's direct exposure to other peripheral states is small, second-round effects of increased risk premia and eroded consumer/business confidence would be significant. Concerns remain over the ECB's preparedness to deal with any re-emergence of tensions in sovereign debt markets. While the policy of Outright Monetary Transactions (OMT) is in place, this has been largely untested in calming market fears surrounding peripheral sovereigns.

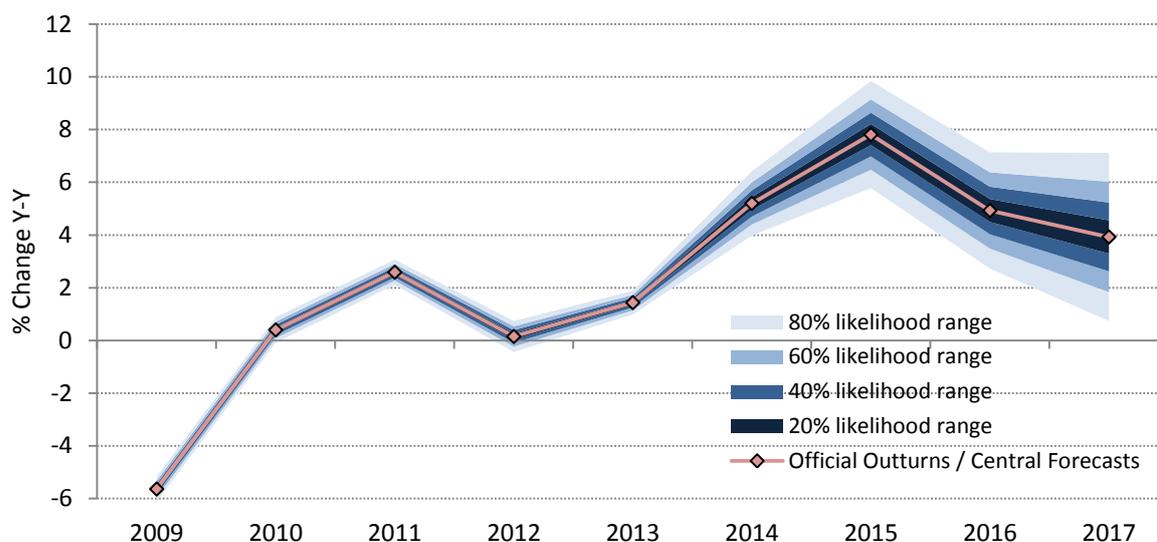
One of the main risks to the external environment is the result of the referendum on the UK's membership of the EU. There are many different impacts a leave vote could imply for Ireland. The referendum could magnify near-term uncertainties, thus negatively affecting UK investment and subsequent trade to the region (UK accounts for 16 per cent of Irish exports). The UK Treasury has recently estimated that the UK economy could be 6.2 per cent to 8.2 per cent smaller in 15 years than would otherwise be the case, showing the scale of the implications of an exit from the EU. Even ignoring the trade disruption effects, the subdued demand for Irish exports due to lower UK output growth would be substantial. Sterling would likely depreciate in the event of an exit, which would also act as a drag on Irish exports. Upside risks also exist, particularly in terms of potential FDI flows.

The high degree of concentration of the Irish economy in a number of key activities has been highlighted in previous *Fiscal Assessment Reports*. As a result of this, firm- or sector-level shocks could have a disproportionately large impact on the Irish economy. One such shock could be a change in US corporation tax law, which could have implications for inward FDI.

Household debt-to-disposable incomes, though falling, remain among the highest in the EU at 155 per cent and parts of the non-financial corporate sector also face high levels of indebtedness. Income gains could be prioritised for debt reduction rather than consumption, spelling downside risks to consumption forecasts. The 2015 Q4 Institutional Sector Accounts indicated a large increase in the savings rate both in the quarter and for the whole year. If this were to be reflected in National Accounts data then there would be a downside risk to consumption forecasts. Higher levels of debt also mean greater sensitivities to interest rate increases.

As has been highlighted in previous *Fiscal Assessment Reports* the Irish economy has historically been one of the most volatile in the OECD, along with a tendency towards large revisions. With this in mind Figure 2.7 shows the historic data and *SPU* forecasts with fans based on historical revisions and forecast errors.

FIGURE 2.7: REAL GDP FAN CHART BASED ON *SPU 2016* PROJECTIONS



Sources: CSO, Department of Finance and internal IFAC calculations.

Note: Distributions or 'fans' around historical growth estimates are based on previous revisions to real GDP data. Forecast errors based on 1999-2007; 2010-2015 sample.

## 2.4 ENDORSEMENT OF THE *STABILITY PROGRAMME UPDATE 2016* PROJECTIONS

This section details the sixth endorsement exercise undertaken by the Council covering *SPU 2016*, outlining the Council's considerations around the time of the endorsement and the process itself (Appendix B details the timeline). Data available at the time may differ from that available for the purposes of the assessment. The forecasts for government consumption provided for the endorsement were predicated on the Department's no-policy change basis (i.e., the only increases in expenditure were those in line with the Department's estimates of demographic pressures and the costs of pay agreements to 2018).

The Council endorsed the *SPU 2016* macroeconomic projections to 2021. It was satisfied that the central scenario outlined was within its endorsable range, taking into account the methodology and the plausibility of the judgements made. The endorsement process focuses on several key dimensions: the plausibility of the methodology used; the pattern of recent forecast errors; and comparisons with the Council's Benchmark and other projections.<sup>19</sup>

First, focusing on the methodology used by the Department of Finance, the Council remains satisfied that short-term projections (2016 and 2017) broadly conform to standards set by other forecasting agencies both internationally and domestically. The Department continues to provide detailed information on models used in the development of its forecasts for assessment by the

<sup>19</sup> The IFAC Benchmark projections are prepared by the Secretariat for the endorsement exercise.

Council. Despite this, the Council notes that there seems to be little weight placed on the quarterly profiles and carryovers of GDP, which can, notwithstanding their volatility, provide useful information with regard to forecasting future GDP growth.

Although the Council endorsed the medium-term forecasts produced by the Department to 2021, this does not amount to an endorsement of the CAM as the most adequate approach for describing Ireland's cyclical position and potential output in the medium term. Further efforts toward developing medium-term, supply-side projections which are consistent with the Department's views on the demand-side are essential, as explained in Section 2.2. The Council notes the on-going work documented in *SPU 2016* and looks forward to alternative estimates of potential growth and the output gap being published in future budgets and SPUs, given that this is likely to remain a key issue in future endorsements.

The correct application of the Commonly Agreed Methodology (CAM) and the mechanical application of this methodology to estimate trend supply-side variables were verified. However, there are some inconsistencies in how the approach is applied versus the guidelines from the Commission. According to the CAM, the depreciation rate is supposed to be held constant from its last observed value (in this case 2014). In the *SPU 2016* the depreciation rate is forecast to rise every year from 2017, to highs never previously seen in the Irish data (9 per cent). This has the effect of lowering the capital stock and consequently potential output.

Second, in terms of the pattern of errors in recent Department of Finance forecasts, the Council has in the recent past emphasised some evidence of systematic bias related to the domestic and external split of aggregate demand. As detailed in recent *Fiscal Assessment Reports*, the previously observed bias appears to have diminished in more recent periods. The Council will continue to monitor the Department's forecast errors in future for the presence of any such bias.

Third, comparisons with the full set of Benchmark projections showed a larger deviation with the Department's forecasts than in previous endorsement rounds both on aggregate and across components of growth. While the Department's estimates for growth in 2016 were lower than IFAC's Benchmark projections, they were assessed to be within a reasonable range. Most of this difference can be accounted for by the difference in forecasts for changes in stocks, although it can also be seen as reflecting the Council's greater emphasis on the use of information from quarterly data. The Department's forecasts were in line with consensus forecasts available at the time. In terms of composition, the Council's Benchmarks projected growth to be more trade oriented initially, with more domestic demand-led growth in the outer years. The Department's projections for the GDP deflator were also somewhat lower than IFAC's Benchmarks. Most of the high-

frequency indicators available at the time were broadly positive. Department staff provided a high level of cooperation with the Council during the endorsement process.

### 3. ASSESSMENT OF BUDGETARY FORECASTS

#### KEY MESSAGES

- For 2016, the *Stability Programme Update (SPU)* kept the tax revenue forecasts for 2016 unchanged from *Budget 2016* despite corporation tax ending 2015 higher than expected. In order to assess the fiscal forecasts, the reasons for the Department of Finance's approach to this year's corporation tax forecast should be clearly outlined. This is particularly important given the larger share of corporation tax in total tax revenue and its increased concentration among a small number of companies.
- Expenditure projections are left unchanged from the *Revised Estimates* published in December 2015. *SPU 2016* notes that expenditure is likely to increase in 2016 to accommodate unanticipated spending pressures that have emerged just six months since Departments' spending allocations from *Budget 2016* were set.
- For the medium term, *SPU 2016* does not provide a forecast of the likely future expenditure and revenue levels. Instead technical projections are used that assume there are no new tax or spending policy changes enacted between 2017 and 2021. The expenditure projections do not fully allow for likely stand-still cost pressures in providing public services, including inflation.
- The Council recommends that future budgetary forecasts should detail the major items of expenditure and revenue on the basis of unchanged policies and as per the government's budget objectives, as required by the directive on Medium-Term Budgetary Frameworks (MTBF). Although this is a more demanding task than current practice, it would greatly improve the quality of the Department's budgetary forecasts after 2017 and provide more certainty as to the likely fiscal position over the medium term.
- The Council's stand-still expenditure estimate – based on a calculation of the cost of providing today's level of public services in future years – implies that almost €6 billion in additional spending would be required by 2021 compared to the *SPU* projections. These expenditure projections differ significantly from the purely technical figures set out in *SPU 2016*. If these costs are met, the path for the General Government balance would be considerably less favourable, reaching a surplus of 0.9 per cent of GDP in 2021 compared to *SPU 2016's* projection of 2.8 per cent of GDP.

### 3.1 INTRODUCTION

This chapter assesses the latest set of budgetary forecasts produced by the Department of Finance in *SPU 2016*. Section 3.2 discusses developments in the main fiscal aggregates since *Budget 2016*. The section focuses on corporation tax and the Department of Finance's unchanged *SPU* forecast for 2016. Section 3.3 assesses the forecasts for revenue and expenditure contained in *SPU 2016*. The expenditure and tax revenue projections in *SPU 2016* are examined and an update of the Council's stand-still estimate of public expenditure over the 2016-2021 period is presented. Section 3.4 examines the sensitivity of the main budgetary aggregates to changes in the economic outlook as well as providing a broader assessment of risks.

### 3.2 DEVELOPMENTS SINCE *BUDGET 2016* FORECASTS

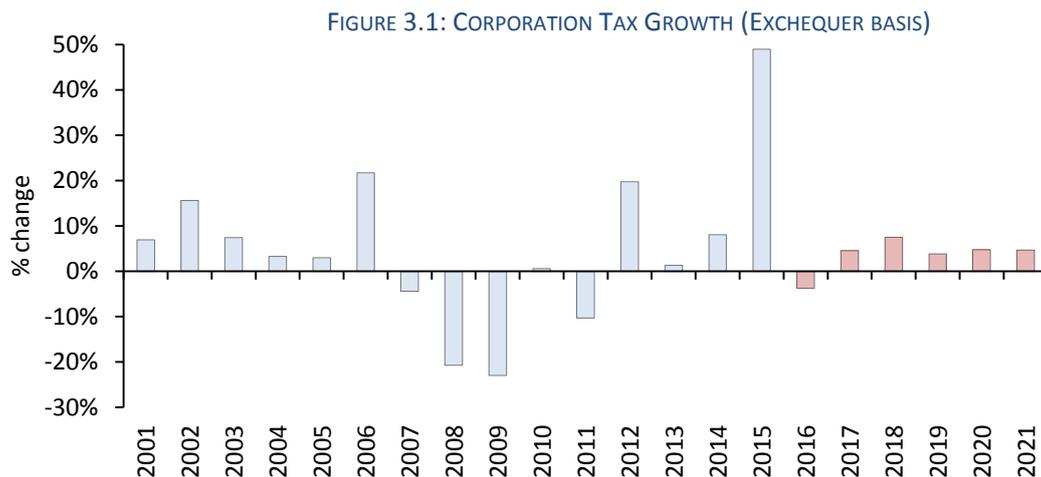
#### TAXES 2015 – 2016

The tax revenue forecasts in *SPU 2016* suggest the Department of Finance may be taking a conservative approach to this year's revenue forecasts following last year's surge in corporation tax receipts. Total tax revenues in 2015 came in €1 billion higher than the October 2015 budget day forecast of €44.6 billion. However, *SPU 2016* left the forecast for the level of tax revenues in 2016 unchanged at €47.2 billion, implying a cut in the expected growth in tax revenues from 5.8 per cent to 3.5 per cent, despite the forecast for economic growth being revised upwards.<sup>20</sup>

The primary reason that overall tax revenue is now projected to grow more slowly in 2016 than forecast on budget day is corporation tax (CT). The revision to forecast growth in corporation tax receipts is significant. Figure 3.1 shows the annual growth rates for CT, both historical and forecast. This tax heading had been expected to grow by almost 8 per cent in 2016 but is now expected to contract by 3.7 per cent based on the *SPU* forecasts. The outturn for CT receipts from this tax head were €0.7 billion higher than those forecast by the Department of Finance in October. Had the Department maintained its *Budget 2016* forecast for the growth in CT revenue in 2016 and applied this growth rate to the higher realised corporation tax base for 2015, the forecast for this year's tax take would have been around €0.7 billion higher.

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<sup>20</sup> The general practice adopted by the Department is to not revise tax forecasts in-year on the basis of revised macroeconomic forecasts.



Source: Department of Finance, *SPU 2016*.

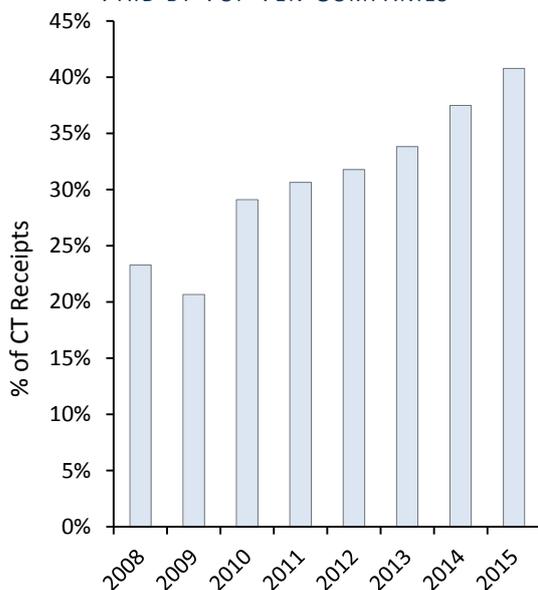
If the exceptionally high receipts during 2015 were not due to one-off factors then it would be expected that the additional 2015 revenues would be built into the base for the 2016 forecast and the Department would be forecasting positive CT growth similar to October’s Budget. A letter from the Chairman of the Revenue Commissioners to the Minister for Finance suggested that almost all of the excess in corporation tax should be built into the forecast for future years, while noting the uncertainties around this tax heading.<sup>21</sup> At the time of writing the letter in November, it was believed that of the €2.3 billion overperformance in 2015, just €300 million related to one-off factors. Critically, however, this was a preliminary assessment and based on the assumption of no decline in the Irish profits of large corporations.<sup>22</sup> While conservatism is warranted given the volatility of this tax head as can be seen in Figure 3.1, the reasons why the higher 2015 CT outturn does not appear to have been factored into the latest forecast for 2016 are not explained in the *SPU*. While recognising the constraints related to publishing corporation tax data given the small number of companies involved, it would be helpful if the rationale for the Department’s unchanged 2016 corporation tax forecast could be more clearly outlined.

Figure 3.2 shows how the concentration of CT receipts has risen, with over 40 per cent of CT paid by just ten companies in 2015 – up from 21 per cent in 2009. Figure 3.3 illustrates the rising vulnerability of total tax revenue to the tax affairs of a very small number of companies. In 2015, corporation tax payments from the top ten companies amounted to over 6 per cent of total Exchequer tax revenue – approximately the same proportion of overall Exchequer tax revenue accounted for by stamp duty in 2007.

<sup>21</sup> Letter dated 20<sup>th</sup> November 2015 is available [here](#).

<sup>22</sup> The letter indicated that this was a preliminary finding made “On the assumption that there are no further currency fluctuations or decline in the profitability of the larger corporate groups”.

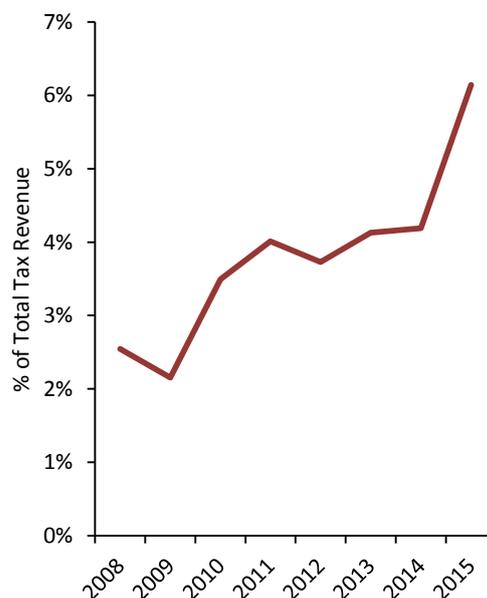
FIGURE 3.2: CORPORATION TAX PAID BY TOP TEN COMPANIES



Sources: Tancred (2016); Pigott and Walsh (2014); authors' analysis of Revenue data; Minister, Department of Finance parliamentary question response (17 July 2014); and own workings.

Note: Corporation tax is shown on an Exchequer basis.

FIGURE 3.3: TOP TEN COMPANIES % OF TOTAL TAX REVENUE

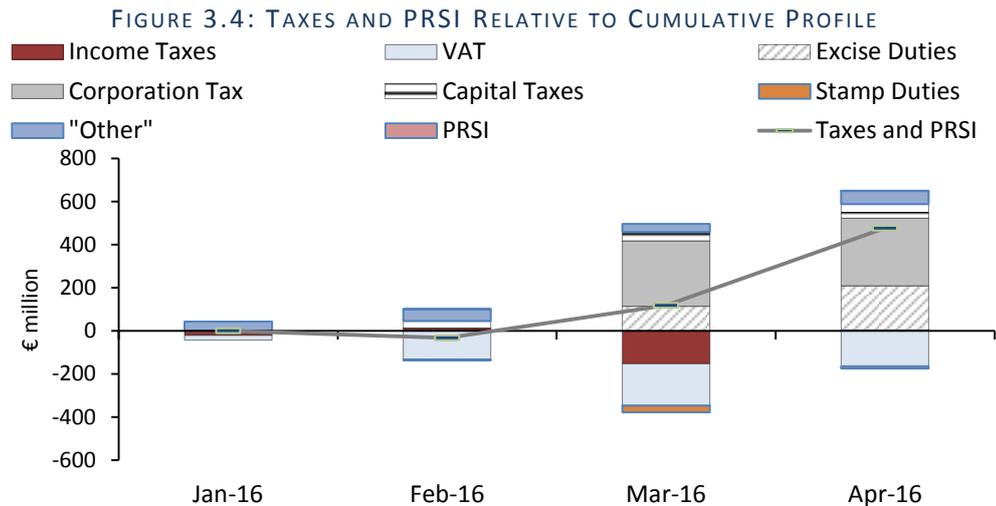


Sources: Revenue (2016); Pigott and Walsh (2014); authors' analysis of Revenue data; Minister, Department of Finance parliamentary question response (17 July 2014); and own workings.

Note: Corporation tax is shown on an Exchequer basis.

Looking at the available data for the year to date (Figure 3.4), CT in the year to April is €315 million ahead of profile and 21 per cent higher than the same period in 2015. The Department of Finance has indicated that €300 million of this relates to unexpected payments which could be repaid over the course of the year, although it is not clear what factors would lead to these payments being refunded by the end of the year. Where possible, while recognising data confidentiality constraints, it would be useful if the Department of Finance and Revenue could furnish more detail with the monthly Exchequer returns explaining trends in corporation tax data. Should the 2015 increase of 50 per cent prove to be a more permanent level-shift, there would be an upside risk to the *SPU 2016* forecast for tax revenue.

For the other main tax headings – income tax, VAT and excise duty – neither the 2015 outturn nor the revision to the 2016 GDP growth forecast provide grounds for a revision of the *Budget 2016* projections, suggesting that the Department's unchanged *SPU* forecast is appropriate for these tax headings. For the year to end-April, they are close to their expected profile (Figure 3.4). Appendix D provides a more detailed analysis of tax forecasts.



Source: Department of Finance.

Note: These overruns are relative to Budget profile. SPU 2016 kept tax forecasts the same.

### EXPENDITURE 2015 -2016

Having announced a substantial increase in 2015 current expenditure prior to *Budget 2016*, the Government came in under its spending target by €0.2 billion, helping to improve the underlying deficit relative to *Budget 2016* expectations. However, this positive impact on the headline General Government deficit was more than offset by the Eurostat decision to classify the conversion of €2.1 billion of preference shares in AIB into ordinary shares as a capital transfer, thereby including it in General Government expenditure. By increasing the expenditure base in 2015, this decision has implications for compliance with the Expenditure Benchmark in 2016, although the structural balance rule is unaffected (see Chapter 4).

For 2016 current expenditure, *SPU 2016* notes that spending could be raised by around €0.6 billion compared to the current forecast to accommodate spending pressures unforeseen in October's Budget. There is some evidence from the monthly Exchequer data of a re-occurrence of a spending overrun in the health area in 2016. If this spending overrun occurs and is not offset by a tax revenue overperformance, the General Government balance target of 1.1 per cent of GDP for 2016 may be missed.

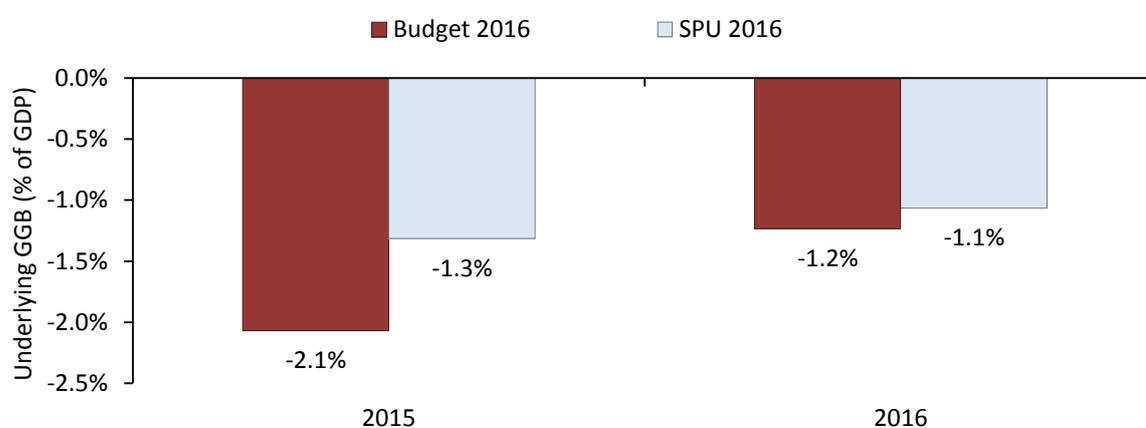
### GENERAL GOVERNMENT BALANCE 2015-2016

Figure 3.5 shows how the General Government balance on an underlying basis (i.e. after removing the impact of the AIB transaction in 2015) has been revised in *SPU 2016*. The 2015 change largely relates to the surge in corporation tax discussed above. However, as all of these receipts do not appear to be built into the base for 2016, the revision to the 2016 deficit forecast is small. As discussed above, it is possible that the corporation tax overrun for the year to date will be built upon in the second half of 2016. This could lead to a lower 2016 deficit outturn than forecast in the

SPU, provided the tax overshoot is not offset by higher spending. One of the implications of a lower 2016 General Government balance is that the requirement of a 0.6 percentage point improvement in the structural balance might be achieved.

It is noteworthy that a single tax head (which constituted just 11 percent of total Exchequer tax receipts in 2014) is exerting such a large influence on the overall General Government balance and its continued volatility bolsters the case for regarding corporation tax receipts with caution in future.

FIGURE 3.5: UNDERLYING GENERAL GOVERNMENT BALANCE



Source: Department of Finance.

Note: The underlying balance is the balance after adjusting for the effect of transfers between the financial sector and the government. In 2015, the adjustment relates to the conversion of preference shares in AIB into ordinary shares.

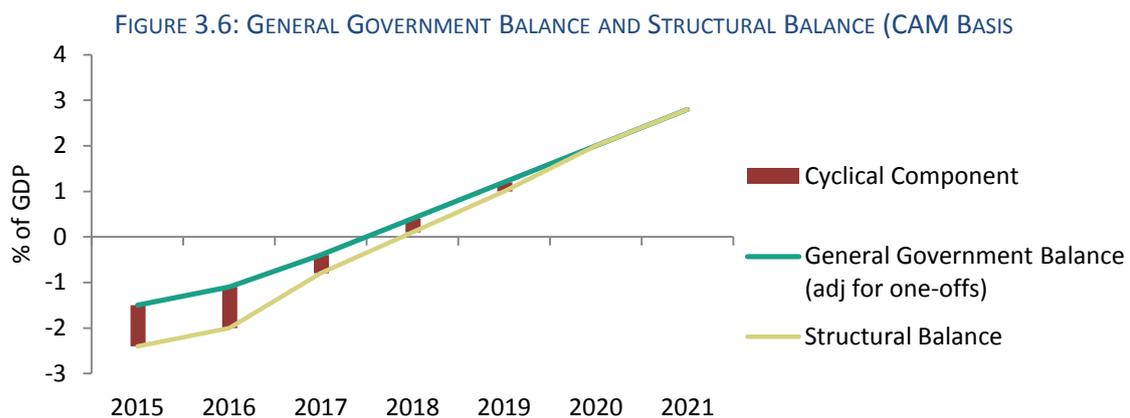
### 3.3 SPU 2016 MEDIUM-TERM FORECASTS

SPU 2016 has a slightly more positive trajectory for the General Government balance than that contained in Budget 2016 as the tax revenue forecasts for all years after 2016 have been revised up. After a small projected improvement in 2016, the deficit is forecast to fall to -0.4 per cent of GDP in 2017, with a small surplus projected in 2018.

Thereafter, the General Government balance is projected to move into very large positive territory (Figure 3.6). However, this reflects the assumption that no tax or expenditure policy changes are implemented between now and 2021. In particular, the projections for the deficit in SPU 2016 are based on expenditure forecasts that appear to underestimate future spending pressures.<sup>23</sup>

<sup>23</sup> The tax revenue forecast contains a provision for the indexation of the income tax system at a cost of €0.4 billion per annum.

Article 9 of the directive on Medium-Term Budgetary Frameworks (MTBF)<sup>24</sup> requires that the government set out projections for the major items of expenditure and revenue at unchanged policies and provide a reconciliation between these projections and the actual budgetary objectives of government (see Box D). These are to be accompanied by an assessment of how the policies envisaged are likely to impact the long-term sustainability of government finances. For the medium term, the ‘unchanged policies’ projections should not just include policies that have been legislated for.<sup>25</sup> The implications of more realistic expenditure forecasts are discussed further below.



Source: Department of Finance.

Note: General Government balance (GGB) is adjusted for one-offs, the largest of which relates to the conversion of AIB preference shares. Structural balance estimates are based on the EC Commonly Agreed Methodology.

Figure 3.6 shows the General Government balance (adjusted for one-offs) and the structural balance (the General Government balance adjusted for the effects of the economic cycle and one-offs). In calculating the structural balance, the Department of Finance uses the output gap estimated using the Commonly Agreed Methodology (see Chapter 2 for a discussion of this). Due to the positive output gap estimated by the Department for 2016, the structural deficit is estimated to be 0.9 percentage points of GDP larger than the actual General Government deficit in 2015 and 2016. The structural balance is projected to slowly converge on the General Government balance by 2020 as *SPU 2016* assumes that the output gap will close to zero over the forecast horizon.

<sup>24</sup> [COUNCIL DIRECTIVE 2011/85/EU](#)

<sup>25</sup> See [Box 1.6](#) of the *Vade Mecum* on the Stability and Growth Pact.

#### **BOX D: MEDIUM-TERM BUDGETARY FRAMEWORKS AND EXPENDITURE FORECASTS**

Article 9 of the Directive on Medium-Term Budgetary Frameworks (MTBF) states that Member States must adopt MTBFs that provide for a fiscal planning horizon of at least three years and that these multiannual frameworks should include the following:

- (a) comprehensive and transparent multiannual budgetary objectives in terms of the General Government deficit, debt and any other summary fiscal indicator such as expenditure, ensuring that these are consistent with any numerical fiscal rules as provided for in Chapter IV in force;
- (b) projections of each major expenditure and revenue item of the General Government with more specifications on the central government and social security level, for the budget year and beyond, based on unchanged policies;
- (c) a description of medium-term policies envisaged with an impact on General Government finances, broken down by major revenue and expenditure item, showing how the adjustment towards the Medium-Term Budgetary Objectives is achieved compared to projections under unchanged policies;
- (d) an assessment as to how in the light of their direct long-term impact on General Government finances, the policies envisaged are likely to affect the long-term sustainability of the public finances.

Up to now, the practice in Ireland in each budget and SPU has been to provide a single forecast of government expenditure and tax revenue. Both the *National Recovery Plan 2011-2014* and the November 2011 *Medium-Term Fiscal Statement* contained budgetary projections which included the targeted levels of expenditure and revenue along with the changes to expenditure (current and capital) and taxation policies necessary to achieve them. However, more recently budgetary projections have been made on a purely technical basis. For example, the expenditure projections in *SPU 2016* make provision for pure demographic pressures and the impact of the Lansdowne Road Agreement until 2018. The impact of potential changes in public sector pay after 2018 or changes to benefit rates or allowances in line with inflation, or additional potential policy changes are not included. The projections for tax revenue assume no tax policy changes in future budgets. It is important that the requirements of the Directive are met by providing a forecast of expenditure both at unchanged policies and a forecast that incorporates the effect of planned policies over a multiannual horizon.

This raises the question of what should be included in a no-policy change expenditure forecast. In the most recent *Vade Mecum* on the Stability and Growth Pact, the European Commission describes a no-policy change as an extrapolation of past trends in a way that is “consistent with past policy orientations”. The Commission also states that “measures which formally require a legal step (such as the adoption of a law in parliament) but which have been taken in the past quasi automatically....can be included in the no-policy change scenario, even though they have not yet been formally approved, provided that it is reasonable to assume that the past practice will be continued. In addition, measures which have been announced, but not yet included in (draft) legislation, can still be incorporated, provided that these measures have been specified in sufficient detail and to which the

government is credibly committed.”

It is reasonably clear from this that a no-policy change under the Directive should take account of evolving demographics and labour market trends. There is some ambiguity as to how rising prices should be factored into the no-policy change, particularly for expenditure items that are not formally linked to inflation. The Council recommends that where there is evidence of a clear historical precedent or trend in certain items of government expenditure, it is reasonable for a no-policy change scenario to assume that such trends will apply in future years.

The requirement under the Directive that forecasts also be provided on the basis of envisaged policies implies that the Government’s medium-term fiscal plans should incorporate the impact of planned major tax and expenditure changes. In Ireland’s case, this would mean, for example, that the budgetary forecasts would include the major tax and spending priorities outlined in the programme for government. It is not expected that the forecasts would detail each specific tax and spending policy measure envisaged by Government, however the forecasts for overall expenditure and tax revenue should include the impact of the main intended policy measures.

The Council’s stand-still expenditure estimate (see below) includes the impact of rising demand for public services linked to demographics along with assumed increases in the cost of providing the current level of services as prices in the economy increase in line with inflation. This focuses on maintaining existing services and benefit levels in real terms. Fixing items like social payments in the face of rising costs of living implies a cut in the real value of social payments and the stand-still expenditure estimate produced by the Council corrects for this. Equally, the fact that the cost of certain health treatments is likely to rise will have the effect of pushing up the level of expenditure required to maintain existing services. Leaving the health expenditure ceiling unchanged in the face of rising costs of health procedures is (in the absence of productivity gains) equivalent to a discretionary reduction in the number of procedures the health system intends to provide. This approach is taken on all major items of government spending and resembles the methodology used in the Dutch Stability Programme Update<sup>26</sup> where a ‘constant arrangements’ projection is made over the long term.

Current medium-term fiscal projections incorporate only a small subset of available information on future developments that are likely to impact the actual level of Government expenditure and revenue. The Government should enhance the quality of its medium-term budgetary forecasts by providing projections based on a realistic set of assumptions in line with the requirements of the Budgetary Frameworks Directive. This is a more demanding task relative to current practice but is necessary if the Government’s official projections are to provide a reliable guide to the future position of the public finances for the medium term.

<sup>26</sup> See Dutch SPU [April 2015](#).

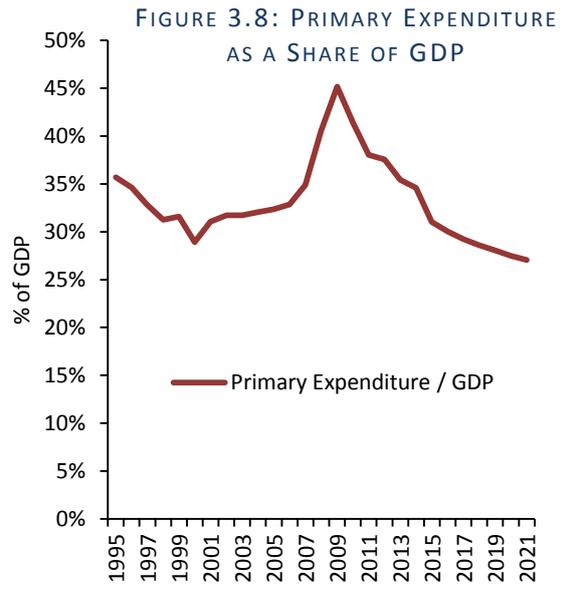
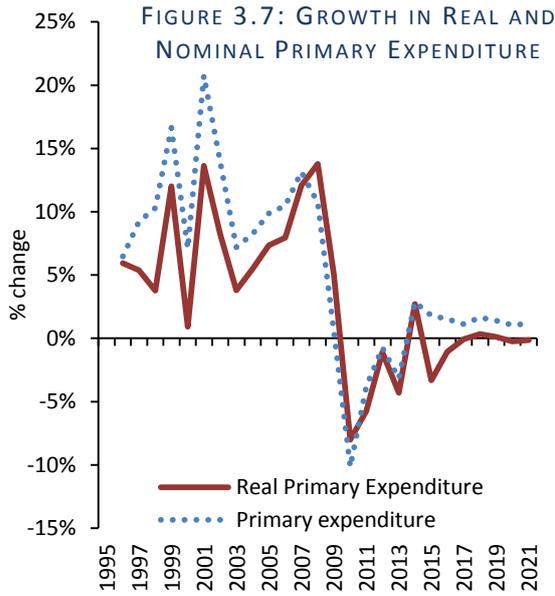
## EXPENDITURE

The *SPU 2016* expenditure forecasts over the medium term are broadly in line with those published in *Budget 2016*. The forecasts allow for modest growth in government expenditure which is only sufficient to cover some demographic pressures, the Lansdowne Road Agreement (which expires in 2018) and the capital spending contained in the *Infrastructure and Capital Investment Plan 2016-2021*. As discussed in Box D, the expenditure projections in the *SPU* fall short of the requirements of the *Budgetary Frameworks Directive* which specifies that forecasts be provided on both a no-policy change and a policies envisaged basis. Figure 3.7 shows the growth in primary expenditure in both nominal and real terms. Real expenditure is projected to register zero or slightly negative growth from 2017-2021. Figure 3.8 shows that, as a result of the very low expenditure growth forecast, *SPU 2016* projects primary expenditure as a percentage of GDP to fall to record low levels.

The expenditure projections in *SPU 2016* are likely to underestimate future spending levels for two reasons. They do not allow for the rising costs of providing public services in line with inflation and it is assumed that none of the available fiscal space in the coming years is used for new spending or tax policies in line with those contained in the *Programme for a Partnership Government*. With implausibly low projections for medium-term expenditure that do not take account of envisaged policies or inflation, the pattern of persistent upward revisions to expenditure ceilings (see Figure 3.9) is likely to be repeated. The importance of proper implementation of expenditure ceilings and the consequences of persistent breaches has been discussed in the Council's previous *Fiscal Assessment Reports* and in Chapter 4 of this report.<sup>27</sup>

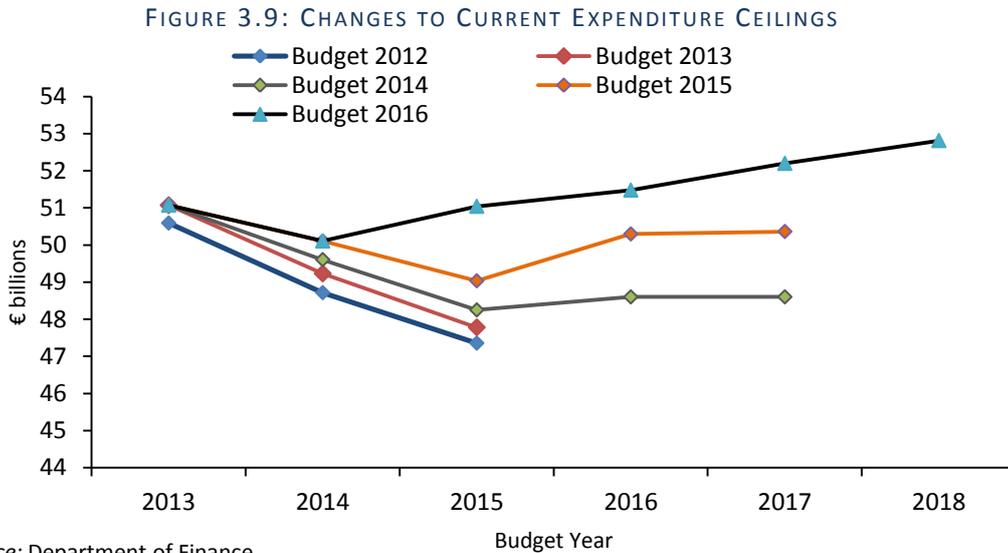
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<sup>27</sup> In particular it is discussed in *Fiscal Assessment Reports* (FARs) of June 2014, November 2014 and June 2015 (IFAC 2014a, 2014b, 2015b).



Sources: Department of Finance and CSO.  
 Note: Real primary expenditure (on a General Government basis) is derived from nominal primary expenditure using the GDP deflator. Excludes the cost of financial sector transfers.

Sources: Department of Finance and CSO.  
 Note: Primary expenditure is on a General Government basis and excludes the cost of financial sector transfers.



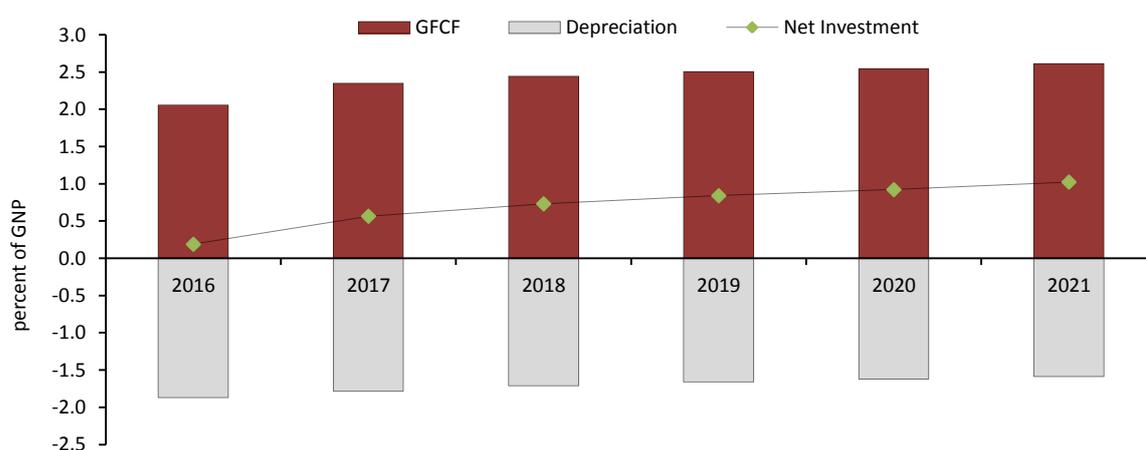
Source: Department of Finance.

The Council’s stand-still expenditure estimates include provisions for demographics and policy commitments already made (such as the Lansdowne Road Agreement) but also make assumptions about the rising costs of providing public services from 2017-2021 (see Box E). These indexation assumptions, outlined previously in the November 2015 FAR (IFAC, 2015d) and again in Box E, essentially tie the costs of providing public services to the projected general rise in prices in the

economy.<sup>28</sup> Social transfers are assumed to rise with the cost of living, as measured by the Harmonised Index of Consumer Prices (HICP). Most other non-pay costs are linked to the GDP deflator. On pay, the projections take the assumption that the Lansdowne Road Agreement remains in place until 2018, and thereafter public sector pay rises in line with wages in the overall economy. Importantly, the indexation assumptions are not policy recommendations but show the cost of maintaining public services and the real value of welfare payment rates at their current level over the next five years.

The projections for capital spending are based on the *Infrastructure and Capital Investment Plan 2016-2021* and the *Programme for a Partnership Government*. For the purpose of the projections, it is assumed that investment under the existing capital plan is increased by €800 million each year from 2017-2021 to take account of the extra €4 billion in capital spending as set out in the programme for government. It is worth noting that, even with the additional expenditure announced in the programme for government, the projections allow for only a small increase in capital spending from the current level. Figure 3.10 shows that the projections for capital spending imply a very limited net increase in the public capital stock, despite the rising demands in the form of a growing population and projected economic growth (see Figure 3.10 and IFAC Analytical Note 9).

FIGURE 3.10: PUBLIC INVESTMENT (% GNP)



Source: SPU 2016, internal IFAC calculations.

Note: Depreciation is assumed to be 4 per cent per annum over the period 2015-2021. The additional €4 bn GFCF outlined in the programme for government is included by adding €0.8 bn in each year from 2017 to the SPU 2016 GFCF projections.

<sup>28</sup> See Box E of the *Fiscal Assessment Report*, November 2015.

### BOX E: MEDIUM-TERM EXPENDITURE SCENARIO

This Box updates the medium-term scenario for government expenditure contained in IFAC's November 2015 *Fiscal Assessment Report*.<sup>29</sup> In order to construct a medium-term scenario, government expenditure is split into five headline components: health, education, social payments (including social welfare pensions), national debt interest and other. The assumptions used in generating the scenario are set out below. Appendix E provides detail on the demographic assumptions underpinning the scenario.

#### HEALTH

For health spending, the model takes the Department of Public Expenditure and Reform's estimates for demographic pressures and then adds in the cost of indexation. To calculate estimates of demographic pressures in health, the Department models four areas of health spending separately: acute services, Primary Care Reimbursement Service (PCRS), Nursing Home Support Scheme (NHSS) and older persons services. The Department uses detailed unpublished data from the Hospital In-Patient Enquiry Scheme (HIPE) to produce estimates of expenditure pressures in these four areas.<sup>30</sup> Pay rates until 2018 rise in line with the June 2015 Lansdowne Road Agreement. Thereafter, pay costs are indexed to growth in non-agricultural wages. Non-pay costs are indexed to the GDP deflator from 2017-2021.

#### EDUCATION

For education, pay and non-pay spending are also modelled separately. The volumes of both pay and non-pay spending are linked to expected service demand arising from demographic changes. Price changes for pay and non-pay spending are indexed to relevant deflators. For education demand is proxied by the change in the population of potential students. The pupil-teacher ratio is assumed to remain unchanged at its current level. Pay rates until 2018 in the public sector are assumed to grow in line with the increases contained in the Lansdowne Road Agreement. Thereafter, public sector pay is assumed to grow in line with non-agricultural wages. The volumes of non-pay expenditure in education are assumed to grow in line with expected demand linked to demographics. Prices are indexed to the GDP deflator.

#### SOCIAL PAYMENTS

This element of expenditure can be split into four broad components:

- i. Old age payments: These are assumed to grow in line with the change in the population aged over 65 with payment rates indexed to growth in prices measured by HICP.
- ii. Child-related payments: The volume is estimated using the change in the population aged under 17. Payment rates are assumed to grow in line with HICP.
- iii. Unemployment benefits are linked to macroeconomic dynamics rather than directly to demographics. The approach used is broadly the same as that applied by the

<sup>29</sup> The construction of this scenario broadly follows the methodology set out in Barrett (2006).

<sup>30</sup> See presentation from IGEES medium-term spending projections available here: <http://igees.gov.ie/wp-content/uploads/2016/03/Irelands-Changing-Demographic-Profile-Implications-for-Public-Expenditure.pdf>

Departments of Public Expenditure and Reform and Social Protection. This approach translated changes in unemployment to movements in the Live Register and then applies an average cost per individual.<sup>31</sup> The average cost term is indexed to HICP over the projection period.

- iv. Other payments: these include disability payments, back to education allowance, back to work allowances and other social payments. This category is assumed to grow in line with the change in the total population and HICP.

#### CAPITAL EXPENDITURE

The scenario uses the projections for capital spending over the medium term as set out in *SPU 2016*, updated to reflect the recent announcement in the programme for government. The *SPU 2016* forecasts are based on the Government's *Infrastructure and Capital Investment Plan 2016-2021* announced in September 2015. In line with the announcement in the programme for government, capital spending is increased by a further €4 billion by 2021 compared to the September 2015 plan. This is assumed to be implemented by increasing capital spending by an additional €800 million per annum from 2017-2021 compared to the *SPU 2016* projections.

#### NATIONAL DEBT INTEREST

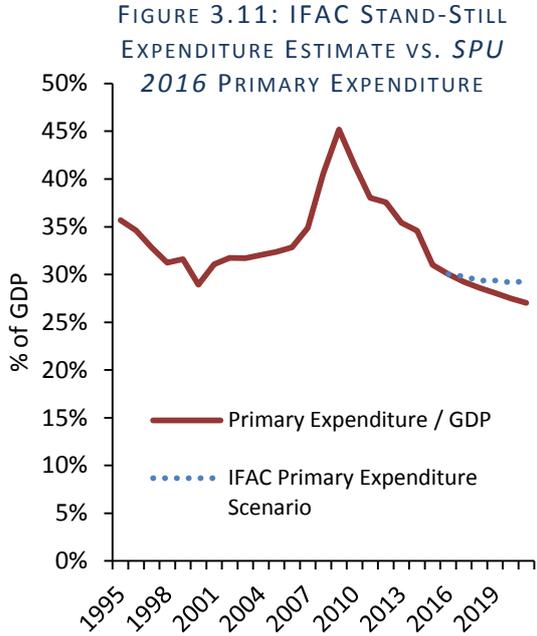
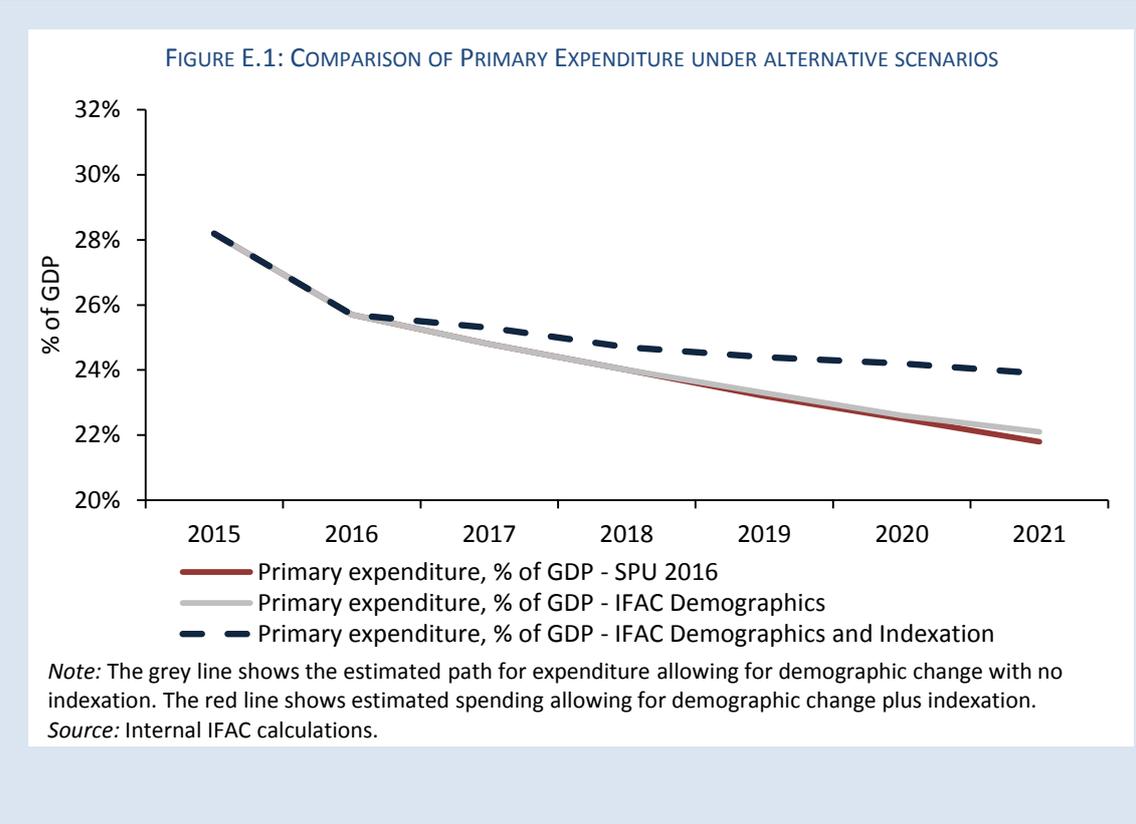
The Exchequer deficit is given by the gap between expenditure and revenue. Additional national debt interest is calculated as the difference between the Exchequer balance projected in this scenario and the relevant figure underpinning *SPU 2016*, multiplied by the average interest rate. The gives the additional interest payments for a given year which is added to the interest bill on the outstanding stock of debt for the previous year to arrive at the figure for total national debt interest.

Figure E1 shows how the illustrative scenario is built up. Firstly, adjustments for demographics are included; then provisions for increases in the cost of providing public services are made through indexation. The results in Figure E1 show that allowing only for demographic costs and the current public service pay agreement out to 2018 returns a spending profile somewhat higher than *SPU 2016* projections. The SPU forecasts include approximately €0.4 billion per annum of spending increases for demographic pressures. Allowing for demographics and accommodating estimated increases in the cost of providing public services over time would result in expenditure being significantly higher than projected in *SPU 2016*. Primary Exchequer expenditure as a share of GDP would be around 2 percentage points of GDP higher by 2021 compared to the projections in *SPU 2016*.

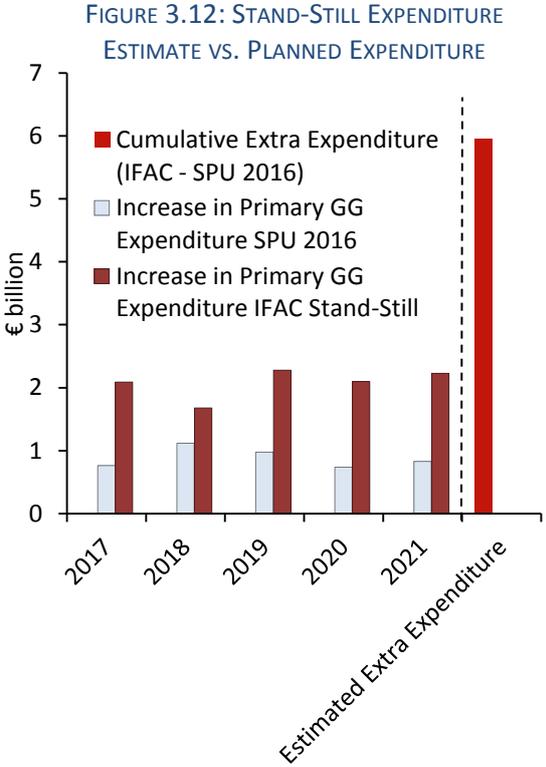
<sup>31</sup> This approach can be summarised as follows:

$$UB_{t+1} = UB_t + (LR_{t+1} - LR_t) * LRC_t + (New\ policy\ measures) + J_{t+1}$$

where UB is the nominal sum of Jobseeker's Allowance and Jobseeker's Benefit, LR is the average annual number of persons on the Live Register, LRC is the average cost per Live Register Claimant and N is the net impact of new measures introduced in this area in the budget. The final term is assumed to be zero in the post-2016 period for this exercise.



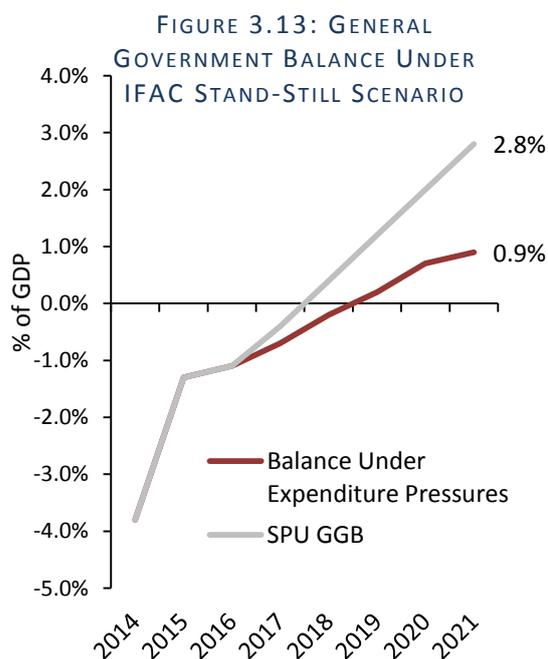
**Source:** Dept of Finance and IFAC internal calculations  
**Note:** Primary expenditure is on a General Government basis and excludes transfers to the financial sector.



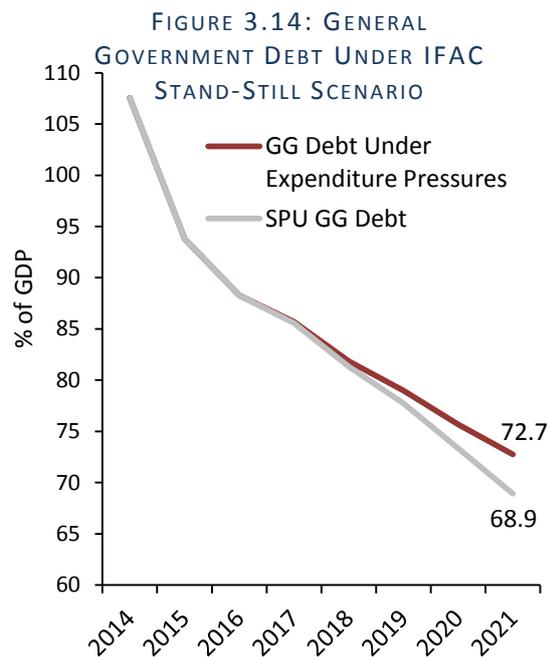
**Source:** SPU 2016 and internal IFAC calculations.

Figure 3.11 compares the projection for primary expenditure in *SPU 2016* with the results of the stand-still expenditure estimate outlined above. The consequence of indexing expenditure to prices in the economy is that primary spending as a share of GDP does not continue to fall to historically low levels as in the *SPU 2016* projections but instead flattens off over the forecast horizon. Figure 3.12 shows what this means in nominal terms by comparing the planned level of expenditure increases in *SPU 2016* with the increases the Council estimates are necessary to keep pace with rising costs and demographics. Over 2017-2021, the cumulative extra spending based on the Council’s stand-still estimate amounts to €6 billion.

The implications for the deficit and debt are shown in Figures 3.13 and 3.14. While *SPU 2016* projects a General Government surplus emerging in 2018 and rising to 2.8 per cent of GDP by 2021, full accounting for estimated demographics and inflation means a budget surplus is not attained until 2019, which only rises to 0.9 per cent of GDP by 2021 compared to the *SPU* forecast of a 2.8 per cent for the same year. General Government debt would still continue to fall quite rapidly as a share of GDP but would be 4 percentage points of GDP higher than the *SPU* forecast in 2021.



Source: *SPU 2016* and internal IFAC calculations.  
 Note: Chart shows the path of the deficit in *SPU 2016* and an adjusted deficit path assuming higher government spending in line with the IFAC expenditure scenario.



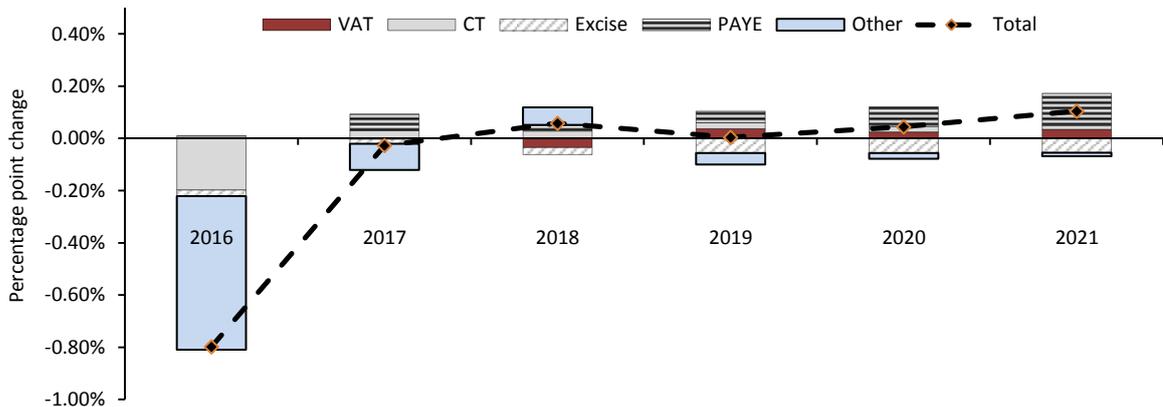
Source: *SPU 2016* and internal IFAC calculations.  
 Note: Chart shows the path of the debt-to-GDP ratio in *SPU 2016* and an adjusted deficit path assuming higher government spending in line with the IFAC expenditure scenario.

**REVENUE**

The revenue forecasts in *SPU 2016* (on an Exchequer basis) for the period 2016-2021 assume no tax policy changes over the forecast horizon.<sup>32</sup> Revenue forecasts for 2017 onwards have been revised upwards relative to the forecasts outlined in *Budget 2016*. While tax receipts are expected to grow broadly in line with nominal GDP over the medium term, total tax revenue is expected to fall as a percentage of GDP from 21.3 per cent in 2015 to 20.6 per cent in 2021. Figure 3.15 below shows the change in each tax head as a percentage of GDP. The chart strips out the impact on PAYE revenues in 2017 related to the timing of Single European Payments Area (SEPA) payments which results in fewer banking days at the end of 2017.

Appendix D describes the important factors influencing the *SPU 2016* forecasts for the four main tax heads over the period 2016-2021.

**FIGURE 3.15: CHANGE IN TAX HEADS (% GDP), 2016-2021**



Source: Department of Finance, internal IFAC calculations

Note: Other taxes include stamp duty, capital gains, capital acquisitions customs and local property tax. Note that the adjustment of c. €1.0 billion for SEPA payments has been stripped out of 2017/2018.

With regards to non-tax revenue sources, the Department has revised non-tax revenue projections upwards by €200 million in 2016 primarily due an increase in Central Bank of Ireland (CBI) surplus income. From 2017-2021, non-tax revenue has also been revised upwards, mainly driven by CBI income. The CBI has also increased disposals of the Floating Rate Notes (FRN) relating to the liquidation of IBRC. Under ESA 2010, capital gains realised by national central banks are conceptually identical to holding gains and are thus not considered income. Therefore, the portion of the capital gain arising from disposals transferred to the Exchequer serves to reduce net government debt only, and does not affect the General Government deficit.

<sup>32</sup> The forecasts for income tax revenue assume non-indexation of the income tax system.

Capital resources remain largely unchanged over the medium term relative to the *Budget 2016* forecasts. However, capital resources are set to benefit from a €1.6 billion redemption of contingent convertible capital notes (CoCos) in AIB in 2016. Such redemptions are treated in a similar fashion to capital gains earned from FRN disposals, and therefore lower net government debt, but do not affect the General Government deficit.

### 3.4 RISKS

#### GROWTH

Over the medium term, the emergence of a surplus in 2018 and the continuation along the trajectory projected in *SPU 2016* depends not only on keeping expenditure flat in real terms, but also on the forecast economic growth materialising. The most immediate potential shock comes from the risk of UK exit from the European Union which would likely have a large negative impact on the Irish economy in the near term. More generally, the economic forecasts underlying the fiscal projections in *SPU 2016* remain dependent on a number of external factors remaining in Ireland's favour. Recent exchange rate developments have boosted Ireland's competitiveness abroad, oil prices have been subdued, and the economy is expected to benefit from growing demand in its main trading partners, even with recent downward revisions to world trade. Given the open nature of Ireland's economy, changes in the prevailing external environment could have a significant impact on the future growth rates.

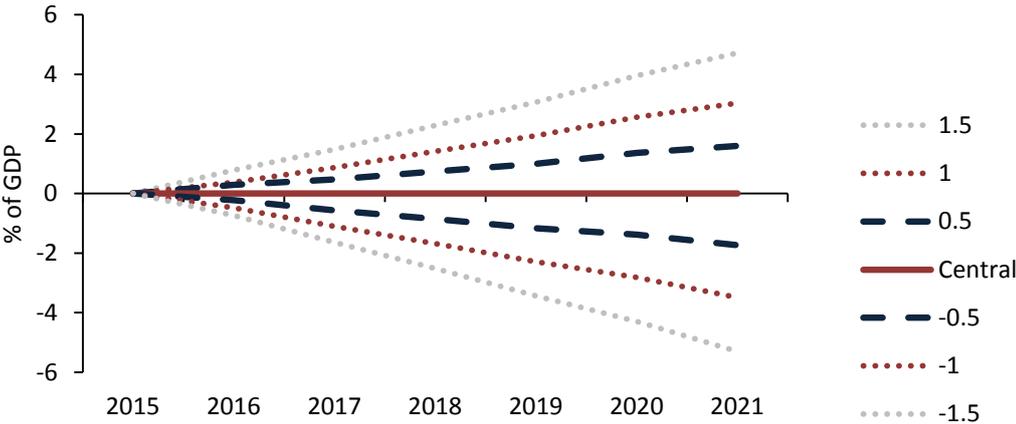
Continued subdued growth in the Eurozone is likely to ensure the continuation of loose monetary policy and further stimulus cannot be ruled out. While this monetary policy stance has helped support the Irish recovery up to now, there is a risk that it could lead to overheating in the future. In this case, competitiveness could be eroded and the risk of a future correction in the Irish economy would rise. While deficit and debt ratios may temporarily benefit from higher growth, these gains may prove unsustainable over the longer term. For a more in depth discussion of risks to the Irish economy, see Section 2.3.

The Council's Fiscal Feedbacks Model (IFAC, 2012b) can be used to estimate the effects of different future growth assumptions on the deficit and debt level. The results of assuming growth of plus or minus 1.5 per cent, 1 per cent and 0.5 per cent are shown in Figures 3.16A and 3.16B, below. Typical errors around the Department of Finance's nominal GDP growth rates are just under 2 percentage points.<sup>33</sup>

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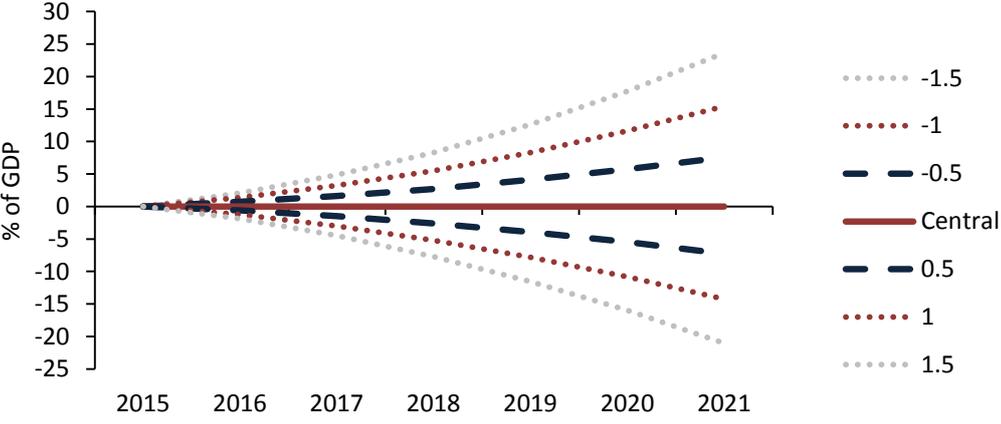
<sup>33</sup> Typical forecast error refers to the Root Mean Square Error of the Department of Finance's forecast for the current year.

FIGURE 3.16A: GENERAL GOVERNMENT BALANCE PATHS



Source: IFAC internal calculations.  
Note: Lines depict how far the deficit would be pushed away from the baseline scenario under different shocks to growth in each year.

FIGURE 3.16B: GENERAL GOVERNMENT DEBT PATHS



Source: IFAC internal calculations.  
Note: Lines depict how far the deficit would be pushed away from the baseline scenario under different shocks to growth in each year.

Under the assumption of no change in policy, the model indicates that in a mildly adverse scenario of growth disappointing by 0.5 percentage points each year, the General Government balance in 2021 would be almost 2 percentage points of GDP lower than the baseline forecast. As a result, the debt level is almost 8 percentage points of GDP higher by 2021. In a scenario where growth disappoints by as much as 1.5 percentage points of GDP in each year, the General Government balance could be pushed higher than the baseline forecast by over 5 per cent of GDP in the absence of offsetting policy action. This would leave debt levels substantially higher by 2021. These scenarios illustrate how what are, in the context of past forecast errors, relatively minor

disappointments in growth can lead to the public finances being returned to much more fragile position, if sustained over a number of years.

On the other hand, while growth forecasts are already quite high, there is also a chance that the economy grows even faster than projected in *SPU 2016*. In this scenario, the deficit could be eradicated in 2017 with large surpluses thereafter and debt falling quickly over the period 2018-2021.

#### **OTHER FISCAL RISKS**

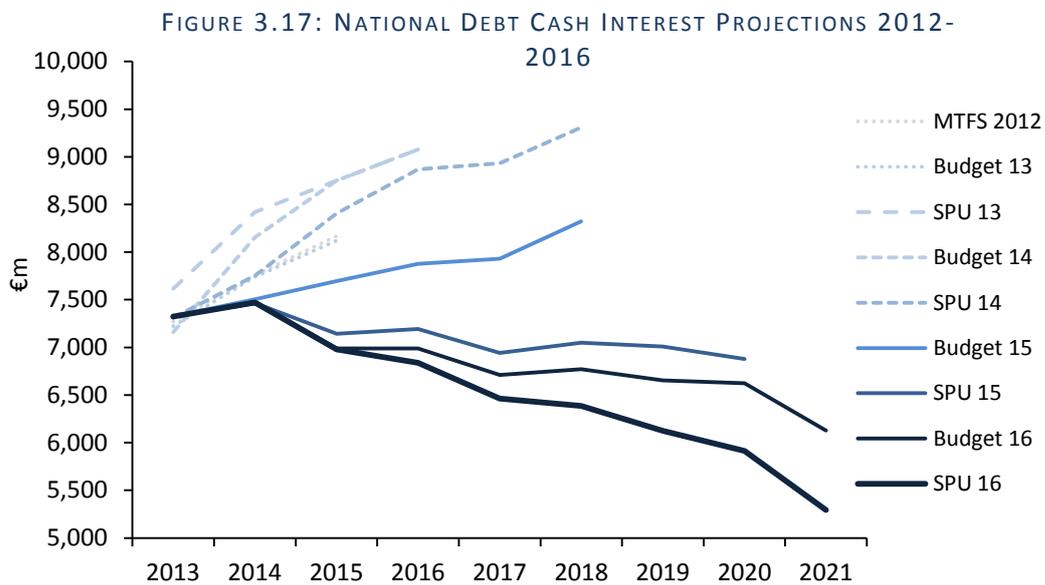
Some of the other potential risks are highlighted in the risk matrix of Table 3.1. Uncertainty surrounding corporation tax (CT) has increased in the last year. Having unexpectedly grown by nearly 50 per cent in 2015, the Department of Finance is now forecasting a contraction of 3.7 per cent in 2016. The unprecedented scale of the 2015 growth rate raises the uncertainty around the future trajectory of CT growth. The historical volatility of corporation tax stems, in part, from the concentration of receipts – the proportion of CT paid by the top ten companies rose to 41 per cent in 2015. It is important that the attainment of future budgetary targets does not become overly vulnerable to large swings in corporation tax receipts.

Expenditure control also presents a significant risk to the deficit projections. As Figure 3.9 (above) shows, expenditure ceilings have been subject to frequent revision. The failure to adequately plan for emerging expenditure pressures is likely to lead to a less favourable path for the General Government balance than projected in *SPU 2016*. When new spending initiatives are added to these expenditure pressures, the problem could be exacerbated. Moreover, there has been a pattern of persistent spending overruns in the health area (see IFAC, 2015c).

One of the factors offsetting upward expenditure revisions has been falling interest costs on Ireland's national debt. Figure 3.17 shows how interest costs have continuously been revised down as debt has been restructured, IMF loans have been repaid, and the interest rate environment has improved substantially. Recent upgrades to Ireland's credit rating have helped to support this. While it is possible that further reductions in the debt interest burden relative to current projections can be achieved in the coming years, the prospect of further substantial falls in market interest rates on Irish debt or restructuring of programme loans has lessened. It is also important to acknowledge that, as recent history shows, the prevailing interest rate environment can change very quickly and often due to events outside of Ireland's control such as renewed uncertainty in Eurozone sovereign debt markets or a global recession. However, the relatively long maturities on Irish debt and the high proportion of debt at fixed interest rates should help to insulate Ireland from moderate interest rate shocks. For example, the Council estimates that a 2 percentage point

shock to interest rates would increase the average interest rate for the period 2018-2021 by 0.6 percentage points.

The potential for large scale disposal of bank assets appears to have receded in the short term due to recent financial market volatility. A planned initial public offering in AIB has been postponed until 2017. There remain, however, potential balance sheet upside risks emanating from possible surpluses from the IBRC liquidation and a possible eventual surplus when NAMA is wound down. The size of the State’s contingent liabilities has also declined significantly in recent years, standing at €16.7 billion (7.8 per cent of GDP) in 2015. Other contingent liabilities do exist, however, in the form of implicit guarantees to support the banking sector and callable collateral in various international organisations.



Sources: Department of Finance; internal IFAC calculations.

TABLE 3.1: RISK MATRIX

Risk	Relative Likelihood	Impact
<b>Corporation Tax Risk</b>	H	The level of concentration makes corporation tax receipts susceptible to large swings due to the tax affairs of a small number of multinational corporations. In 2015, the top ten taxpayers accounted for over 6 per cent of total Exchequer tax revenue.
<b>Expenditure Planning</b>	H	The government's spending forecasts continue to be below the Council's estimates of the cost of maintaining current services levels into the future. Unless the Government intends to cut the real value of public services and benefits, it is likely the <i>SPU 2016</i> expenditure projections will prove to be too low.
<b>Expenditure Control</b>	H	Related to the first two risks above, there is a risk that because current expenditure projections inadequately provision for future spending pressures, it may be difficult for spending in certain departments to be kept within the initial ceilings. The temptation to raise expenditure ceilings can often be compounded by tax overruns relative to initial projections which facilitate increases in expenditure through late supplementary estimates.
<b>Contingent Liabilities</b>	L	Measured contingent liabilities currently stand at €16.7 billion. However, the State also has other contingent liabilities in the form of implicit guarantees to the banking sector, callable capital in international organisations and public-private partnerships.
<b>Legacy Banking Assets</b>	M	The State continues to hold substantial assets as a legacy from the financial crisis. As at 31 <sup>st</sup> December 2015, the value of the State's holdings in AIB and Bank of Ireland stood at €14.8 billion. <sup>34</sup> On the basis of current market prices, the State's holdings of shares in Permanent TSB stands at €0.7 billion. <sup>35</sup> In addition, the most recent projection of the likely surplus arising from NAMA is €2 billion. <sup>36</sup> Following the liquidation of IBRC, it is expected that approximately €2 billion will remain for distribution to creditors, including the State. <sup>37</sup>
<b>Interest Rate Risks</b>	L	Downward revisions to interest costs have helped to offset rising voted expenditure levels in recent years. A reversal of the benign interest rate environment could see upward revisions to expenditure ceilings being compounded by rising interest costs. In an extreme scenario, spiralling interest rates could lead to liquidity problems in manner similar to late-2011 when Ireland was 'locked out' of sovereign bond markets.

<sup>34</sup> Based on reported holding by the Irish Strategic Investment Fund (see [here](#)) plus €1.6 billion of Contingent Convertible Capital held by the Exchequer with a face value of €1.6 billion.

<sup>35</sup> Based on 75 per cent share holding and market cap of €0.96 billion as at 25/05/2016.

<sup>36</sup> See <https://www.nama.ie/about-us/news/news-detailed-view/news/nama-redeems-a-further-EUR25-billion-in-senior-debt-and-exceeds-80-debt-redemption-target-9-months/>

<sup>37</sup> See answer to parliamentary question on 19<sup>th</sup> January 2016: <https://www.kildarestreet.com/wrans/?id=2016-01-19a.285>

## 4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

### KEY MESSAGES

- The estimated 2.3 per cent of GDP deficit for 2015 presented in *SPU 2016* should mean that Ireland meets previous Council recommendations and the minimum deficit requirements (below 3 per cent of GDP) under the Excessive Deficit Procedure (EDP), with forecasts for later years suggesting that this will be sustained.
- 2016 is the first year in which both the domestic Budgetary Rule and the EU Preventive Arm rules apply. The first pillar of these rules relates to the structural balance. The Department's projected change of 0.4 percentage points in the structural deficit in 2016 falls short of the minimum adjustment required under the rules, though the deviation, equivalent to 0.2 per cent of GDP, is not considered a "significant deviation" in the EU framework.
- The second pillar of the rules framework is the Expenditure Benchmark. The expected growth rate of government spending in 2016 looks set to be lower than the maximum permitted under this rule. Compliance looks likely given a temporary, one-off boost to the spending base in 2015 resulting from the conversion of the State's AIB preference shares. Had this transaction not been included in spending last year, the Department's spending projections for 2016 would imply a breach of the Expenditure Benchmark rule this year of close to €0.7 billion (0.3 per cent of GDP), although – again – this would not be considered a "significant deviation" in the EU framework.
- The *SPU 2016* Projections for 2017 onwards indicate substantial over-compliance with the fiscal rules, but are based on technical fiscal projections that assume no budget changes for 2017-2021.
- Previous *Fiscal Assessment Reports* have documented persistent patterns of upwards revisions to expenditure. Recognising the weakness of the domestic expenditure ceilings in preventing this, there are risks to compliance with both of the key pillars of the fiscal rules in the absence of appropriate buffers. There is a continued need for the domestic budgetary framework to be strengthened to support medium-term expenditure planning and execution.

## 4.1 INTRODUCTION

The Council's mandate includes reporting on compliance with Ireland's domestic Budgetary Rule and also monitoring compliance with the full range of EU fiscal rules as part of the broader assessment of the fiscal stance.<sup>38</sup> This Chapter examines the consistency of the projections contained in *SPU 2016* with these fiscal rules. The target for fiscal policy since 2009 has been the correction of the excessive deficit within the Corrective Arm of the *Stability and Growth Pact (SGP)* by 2015. This correction looks to have been completed in 2015, ensuring that requirements of both the domestic and European frameworks are met (Section 4.2).

Having corrected the excessive deficit, Ireland is set to move into the Preventive Arm of the *SGP* in 2016, with the domestic Budgetary Rule setting requirements that are consistent with this (Section 4.3). Requirements for 2017 on are assessed in Section 4.4.<sup>39</sup> Section 4.5 examines the domestic Medium-Term Expenditure Framework (MTEF), particularly the performance of the aggregate expenditure ceilings. This Chapter also includes a box that introduces the Preventive Arm of the *SGP*, and a box that explains recent changes to the medium-term structural balance target.

## 4.2 EX-POST ASSESSMENT FOR 2015

Excessive Deficit Procedure (EDP) requirements were that Ireland's General Government deficit be reduced to below 3 per cent of GDP for 2015. This correction was to be undertaken in a sustainable manner so that the deficit would be expected to adhere to this ceiling into the medium term. The ceiling has been met with a buffer, with a deficit outturn of 2.3 per cent of GDP estimated for 2015. On an "underlying" basis, excluding the once-off AIB transaction, the deficit outturn is lower again at 1.3 per cent. The *SPU* forecasts show an expected sustainable correction, which is also robust to the use of an adjusted deficit estimate that assumes minimum compliance with the fiscal rules (Figure 4.1). The EU Commission issued a formal recommendation to end the EDP in May 2016.<sup>40</sup>

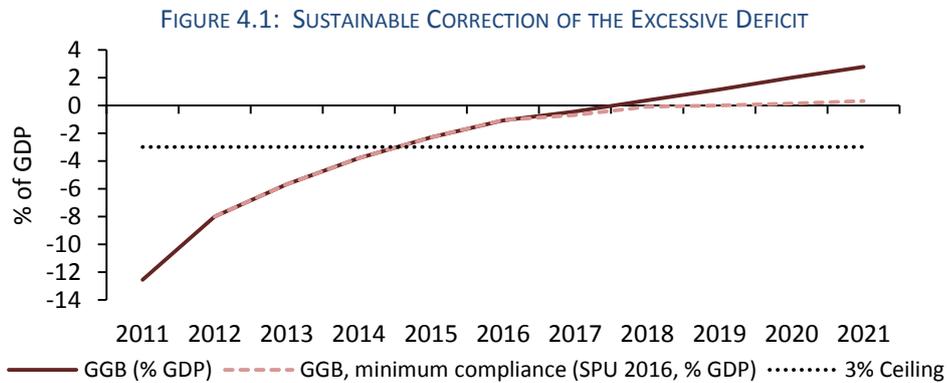
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<sup>38</sup> The Budgetary Rule is a key pillar of the domestic fiscal framework, which effectively mirrors the *SGP* and Preventive Arm requirements for coming years. The *Fiscal Responsibility Act 2012 (FRA)* defines two ways of meeting the requirements of the Budgetary Rule. The 'budget condition' is met where the Medium-Term Budgetary Objective (MTO) is achieved. When the structural balance is not at or exceeding the MTO, the adjustment path condition requires the structural balance to be on an appropriate adjustment path towards it. Assessment of this focuses on the change in the structural balance but also considers expenditure growth by reference to the Expenditure Benchmark (EB).

<sup>39</sup> While the Council's formal requirement to assess (*ex-post*) compliance with the Budgetary Rule is backward-looking in nature, the Council's mandate to assess the fiscal stance suggests considering compliance on a forward-looking basis.

<sup>40</sup> A May 2016 recommendation from the EU Commission to the EU Council to formally end, or 'abrogate', the EDP followed the budget deficit reduction to less than the 3 per cent of GDP ceiling in 2015. This assessment is based on "notified", i.e., outturn data, provided by countries as part of the Maastricht Returns. The latest EU Commission Spring Forecasts show the deficit remaining below the EDP ceiling for 2016-2017, thus satisfying the sustainability element.

By meeting the EDP target for 2015, the domestic and EU fiscal rules are also complied with. It is notable that, following the significant upward revision to spending in late-2015 set out just ahead of *Budget 2016*, expenditure growth would have far exceeded the Preventive Arm’s upper limits had these applied.<sup>41</sup> Indeed, the degree of spending increases was such that these would have led to a deviation more than twice the size considered “significant” under the rules.



Source: SPU 2016 and internal IFAC calculations.

Note: GGB refers to the General Government balance.

### 4.3 IN-YEAR ASSESSMENT FOR 2016

Following a successful correction of the excessive deficit at end-2015, the focus shifts to preventive measures and to ensuring the medium-term sustainability of the public finances. This is the first year that both the domestic Budgetary Rule and the EU Preventive Arm rules apply. It is also the first year that the Debt Rule applies, with transition arrangements in effect until end-2018.

On the basis of the Department of Finance’s budgetary projections, the adjustment towards the structural balance target required under both the domestic Budgetary Rule and the EU fiscal rules will not be complied with in 2016. The Expenditure Benchmark also appears to signal concerns of non-compliance, when it is adjusted for significant one-offs in the previous year’s base. Table 4.1 provides a summary of all of the requirements of the rules as well as setting out the detailed calculations underpinning the Expenditure Benchmark on the basis of the main *SPU 2016* fiscal projections.

<sup>41</sup> While neither the path of the structural balance nor the EB determined compliance with the Budgetary Rule prior to 2016, they are assessed as part of the wider analysis of the fiscal stance for 2015. Recent *SGP* reforms mean that the Corrective Arm structural balance path must also be consistent with any Preventive Arm requirements. The reform is intended to smooth transitions between both arms, while also avoiding pro-cyclical policies when a Member State is experiencing strong growth during an EDP. As Ireland entered an EDP prior to these reforms, a consistent structural balance path was not required. Had the criteria been in force for Ireland in 2015, the scope for additional expenditure increases towards the end of the year would likely have been curtailed.

TABLE 4.1: SUMMARY ASSESSMENT OF COMPLIANCE WITH RULES (% GDP UNLESS STATED)

	Code	2015	2016	2017	2018	2019	2020	2021
<b>Corrective Arm:</b>								
<b>Excessive Deficit Procedure</b>								
General Government Balance	GGB	-2.3	-1.1	-0.4	0.4	1.2	2.0	2.8
General Government Debt	GGD	93.8	88.2	85.5	81.3	77.7	73.3	68.9
Debt Rule Benchmark <sup>1</sup>		110.3	102.1	92.7	86.2	82.5	79.3	75.6
<b>Preventive Arm &amp; Domestic Budgetary Rule:</b>								
<b>I. Minimum Structural Balance Adjustment Requirement</b>								
Cyclical Budgetary Component = $\beta \cdot (\text{OG})$ ...where $\beta=0.53$	CGGB	0.9	0.9	0.4	0.2	0.1	0.0	0.0
One-Off Temporary Measures	v	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Structural Balance = GGB - CGGB - v	SB	-2.4	-2.0	-0.8	0.1	1.0	2.0	2.8
<b>Annual Change in Structural Balance</b>	<b><math>\Delta\text{SB}</math></b>	<b>0.9</b>	<b>0.4</b>	<b>1.2</b>	<b>0.9</b>	<b>0.9</b>	<b>0.9</b>	<b>0.8</b>
<b>Minimum Annual Adjustment Requirement <sup>2</sup></b>	<b>REQ</b>	<b>n.a.</b>	<b>0.6</b>	<b>0.6</b>	<b>0.3</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>
Deviation (p.p.) = $\Delta\text{SB} - \text{REQ}$ ...negative = non-compliance		n.a.	-0.2	0.6	0.6	n.a.	n.a.	n.a.
<b>II. Expenditure Benchmark</b>								
Reference Rate of Potential Growth (% y/y) <sup>3</sup>	R		1.9	3.2	3.4	3.6	3.7	3.7
Convergence Margin (p.p.) = $(0.5/(\text{TE}-i)) \cdot (\text{REQ}/0.5)$ <sup>3</sup>	C		1.8	2.1	1.2	0.0	0.0	0.0
<b>Real Corrected Expenditure Growth Limit <sup>2</sup> (% y/y) = <math>R_t - C_t</math></b>	<b>EB</b>	<b>n.a.</b>	<b>0.1</b>	<b>1.1</b>	<b>2.2</b>	<b>3.6</b>	<b>3.7</b>	<b>3.7</b>
General Government Expenditure (€bn)	TE	75.4	73.9	74.7	75.6	76.4	77.0	77.5
Interest Expenditure (€bn)	i	6.7	6.3	6.3	6.1	6.0	5.8	5.4
Gross Fixed Capital Formation (€bn)	GFCF	3.9	4.0	4.0	4.2	4.8	5.1	5.5
Gross Fixed Capital Formation 4yr-average (€bn)	GFCF <sub>4yr</sub>	3.7	3.8	4.0	4.0	4.2	4.5	4.9
Gross Fixed Capital Formation Adjustment (€bn) = $\text{GFCF}_t - \text{GFCF}_{4\text{yr}}$	inv	0.2	0.2	0.0	0.2	0.5	0.6	0.6
Cyclical Unemployment Expenditure (€bn) <sup>4</sup>	u	-0.1	-0.2	-0.2	-0.3	-0.5	-0.7	-0.8
Government Expenditure Co-Financing EU Funding (€bn)	EU	0.4	0.4	0.5	0.5	0.5	0.6	0.6
Corrected Expenditure Aggregate = $\text{TE} - i - \text{inv} - u - \text{EU}$ (€bn)	TE*	68.2	67.2	68.0	69.1	69.9	70.7	71.6
Net Discretionary Revenue Measures, "DRM" (€bn)	DRM	-0.9	-0.7	0.1	0.5	0.4	0.4	0.4
Nominal Corrected Expenditure less DRM (€bn) = $\text{TE}_t^* - \text{DRM}_t$	TE <sub>t</sub> <sup>*DRM</sup>	69.1	68.0	67.9	68.6	69.5	70.3	71.2
...Nominal Growth (% y/y) = $(\text{TE}_t^{\text{*DRM}} / \text{TE}_{t-1}^* - 1) \cdot 100$	e	7.2	-0.4	1.0	0.8	0.6	0.6	0.7
<b>...Real Growth (% y/y) = <math>((1+e/100)/(1+p/100)-1) \cdot 100</math></b>	<b>er</b>	<b>6.2</b>	<b>-2.0</b>	<b>-0.2</b>	<b>-0.5</b>	<b>-0.7</b>	<b>-0.7</b>	<b>-0.6</b>
<b>Real Corrected Expenditure Growth Limit <sup>2</sup> (% y/y) = <math>R_t - C_t</math></b>	<b>EB</b>	<b>n.a.</b>	<b>0.1</b>	<b>1.1</b>	<b>2.2</b>	<b>3.6</b>	<b>3.7</b>	<b>3.7</b>
Deviation (p.p.) = $\text{er} - \text{EB}_t$ ...positive = non-compliance	d	n.a.	-2.1	-1.3	-2.7	-4.3	-4.4	-4.3
<b>Relevant Macroeconomic Aggregates:</b>								
Real GDP Growth (% y/y)	y	7.8	4.9	3.9	3.9	3.3	3.1	2.9
Potential GDP Growth (% y/y)	y*	4.4	5.0	5.0	4.2	3.5	3.3	2.8
Output Gap	OG	1.7	1.7	0.7	0.4	0.2	0.0	0.0
GDP Deflator Applicable (% y/y)	p	0.9	1.7	1.3	1.3	1.3	1.3	1.3

Source: SPU 2016 and internal IFAC calculations.

<sup>1</sup> The Backward- and Forward-Looking Benchmark are calculated on the same basis but the assessment relates to different years (the assessment of the former is for year "t", while the latter is for two years later, i.e. year "t+2").

<sup>2</sup> Annual adjustment requirements (determined by EC Matrix, Appendix F) and real Corrected Expenditure Growth Limit for year "t" are frozen in spring of the previous year. Requirements for outer years are therefore indicative only.

<sup>3</sup> The reference rate of potential growth is based on CAM estimates from SPU 2016 averaged over t-5 to t+4. EC estimates of the Reference Rate and Convergence Margin will apply for the Preventive Arm requirements.

<sup>4</sup> Cyclical unemployment expenditure costs are based on average benefits and the gap between unemployment rates and the CAM-based NAWRU.

## MTO AND STRUCTURAL BALANCE ADJUSTMENT REQUIREMENTS

The Government's structural budget balance is projected not to fully meet the Medium-Term Objective (MTO) requirement in 2016, thus not fulfilling the Budgetary Rule's "Budget Condition". Both the domestic Budgetary Rule and the EU rules therefore require that appropriate adjustments are made towards the MTO. Ireland's minimum MTO was revised in February 2016 and is now set as a structural deficit of 0.5 per cent of GDP for the period 2017-2019 (Box F), though the previous requirement set at 0.0 per cent still applies for 2016. The current CAM-based estimate of the structural balance for 2016 is -2.0 per cent of GDP.<sup>42</sup>

The Department of Finance's budgetary projections show that the adjustment towards the structural balance target required under the domestic Budgetary Rule and the EU rules will not be achieved in 2016. The required reduction in the structural deficit amounts to 0.6 percentage points of GDP as set in Spring 2015; however, the Department is currently forecasting a deficit change (adjusted for one-offs and cyclical developments) of just 0.4 percentage points (Figure 4.2). The estimated change differs from that estimated by the EU Commission primarily on account of different estimates of one-off/temporary measures relevant for 2015 (Table 4.2).<sup>43</sup> The change implies that both the adjustment path condition of the domestic rules and the EU rules' structural balance adjustment requirement would not be met in 2016 based on the *SPU* forecasts.

TABLE 4.2: ESTIMATES OF ONE-OFF/TEMPORARY MEASURES (% GDP)

	2015	2016	2017	2018	2019	2020	2021
Department of Finance Estimates ( <i>SPU 2016</i> )	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
EU Commission Estimates ( <i>Spring 2016</i> )	-1.0	0.0	0.0	-	-	-	-

Sources: Department of Finance *SPU 2016*; EU Commission *Spring 2016 European Economic Forecast* (EC, 2016a).

The annual change in the structural deficit for 2016 is lower than indicated at budget time due to a number of factors. Stronger than expected tax receipts at the end of 2015, particularly corporation tax, resulted in a significantly lower deficit outturn for 2015 than previously projected. Despite the increase in the revenue base for 2015 compared to the budget day forecasts, *SPU 2016* left the tax revenue projection for 2016 unchanged (as discussed in Chapter 3). The stronger 2015 base

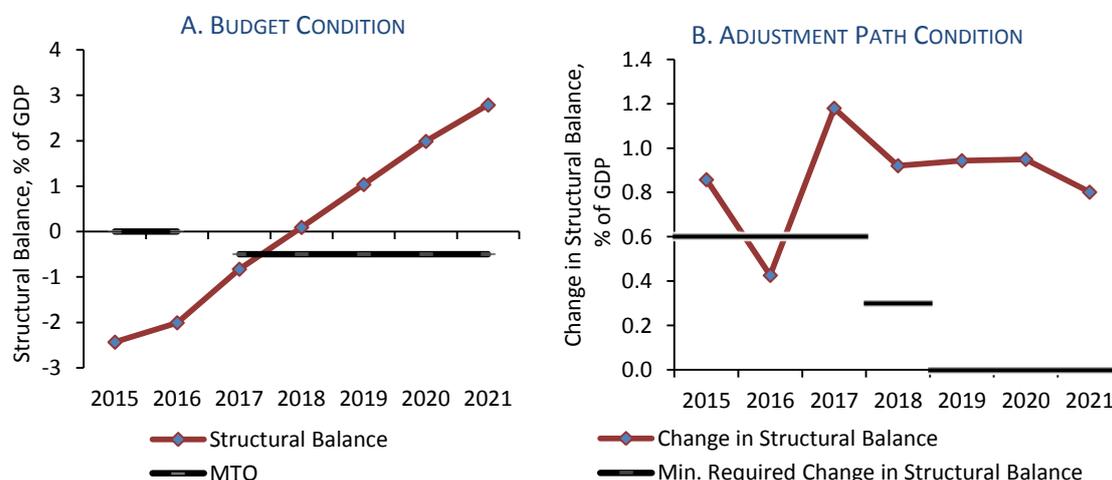
<sup>42</sup> Structural balance estimates derived from CAM output gaps may be inappropriate for Ireland (Chapter 2).

<sup>43</sup> Based on a recalculated structural balance change that incorporates some of the information from the *SPU*, the EU Commission (2016c) estimates show an expected reduction of just 0.1 percentage points – again, short of the required 0.6 percentage points. Assessing the *SPU* and taking account of the Commission's 2016 spring forecasts, including with respect to the EB pillar, the Commission recommendation for a Council recommendation notes that Ireland is "...expected to broadly comply with the provisions of the Stability and Growth Pact". Nevertheless, it is noted that "...further measures will be needed to ensure compliance in 2016". The estimated change in the structural balance relevant for assessing *ex-ante* compliance with the structural balance rule is that based on the Commission's own forecasts, however, which show a 0.2 percentage point change for 2016 (EU Commission, 2016c).

coupled with a revenue forecast for 2016 unchanged from October's budget, mean a smaller deficit reduction than forecast in *Budget 2016*.<sup>44</sup>

There are important implications if the structural balance adjustment for 2016 falls short of the required 0.6 percentage points of GDP in the *ex-post* assessment by a wide margin. For instance, if the shortfall exceeds 0.5 percentage points (the *SPU* currently estimates a shortfall of 0.2 percentage points), then the Commission's overall assessment (Appendix F) could lead to a Significant Deviation Procedure (Box G) being initiated. The Commission's overall assessment would also scrutinise more closely the reasons for the Expenditure Benchmark being achieved and therefore giving a contrasting signal of compliance to that of the structural balance adjustment.

FIGURE 4.2: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE



Sources: *SPU 2016*; internal IFAC calculations.

Note: The minimum MTO for Ireland was revised to -0.5 for 2017-2019 and is planned to be achieved in 2018 so that the adjustment path condition no longer applies thereafter. Required changes above are calculated based on the previous year's structural balance. If minimum adjustments were undertaken, the MTO would be achieved in 2019, a year later than planned in *SPU 2016*.

## EXPENDITURE BENCHMARK

The Expenditure Benchmark is intended to complement the analysis of requirements set for the structural balance, though the rules may give conflicting signals under certain circumstances.<sup>45</sup> For

<sup>44</sup> The level of the structural balance estimated for 2016 has also been revised up since Budget-time. These revisions are largely the result of higher estimates of potential output growth for 2016 (now estimated at 5 per cent, compared to 4.1 per cent previously) and associated reductions in the level of the output gap (now estimated as 1.7 per cent, compared to 2.5 per cent). These changes reflect the pro-cyclical nature of estimation under the Commonly Agreed Methodology and serve to produce a structural balance estimate for 2016 that is higher than previously indicated.

<sup>45</sup> While the EB is designed to support achieving the targeted structural balance improvement, there are a number of scenarios where they may give differing signals as to compliance with the rules (IFAC, 2015d). This is especially true if (i) there are one-offs or temporary measures, which are not captured in the EB as in the structural balance; (ii) if current year estimates of potential output growth diverge substantially from the ten-year average used in the calculation of the EB's reference rate; or (iii) if a fall in the true structural balance is masked, for example, by revenue windfalls, or pro-cyclical adjustments to estimates of potential output. In such cases, the estimated structural balance alone may fail to

2016, spending increases are expected to fall substantially below those permitted by the Expenditure Benchmark.

The reason for the conflicting signals between the insufficient progress under the structural balance rules and the margin under the spending rule is primarily due to the calculation of the Expenditure Benchmark not excluding one-off items or temporary measures. This is in contrast to the structural balance calculation which does remove such items. Not removing the one-off items for the purposes of the Expenditure Benchmark calculation has a pronounced effect on estimated spending in 2015. The EB is a growth-based rule, so that the once-off boost to spending in 2015 serves to raise the base when assessing this year's growth rate.

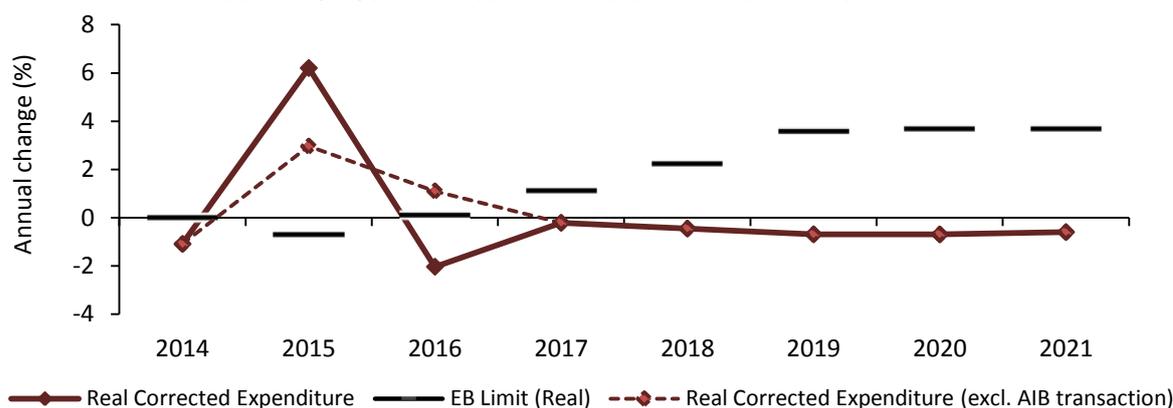
The temporary, one-off increase in the 2015 spending base stems from the conversion of €2.1 billion of AIB preference shares into ordinary shares. The transaction is treated by Eurostat as a capital transfer owing primarily to the increased risk associated with potential returns on the shares. The decision boosts overall expenditure in 2015 by €2.1 billion. As a result, the permitted ceiling for corrected expenditure is now much higher in 2016 than had previously been estimated, even though there is a deviation from the minimum structural balance adjustment requirement.

Looking at the Expenditure Benchmark excluding the AIB transaction and thereby looking through the inconsistent treatment of one-offs, the Department's spending projections would also imply non-compliance with the Expenditure Benchmark requirements for 2016 when the AIB transaction in 2015 is disregarded. The associated overspend would amount to approximately €0.7 billion (0.3 per cent of GDP) on the basis of current *SPU* plans (Figure 4.3). Given weaknesses in expenditure management in recent years, including the pattern of overspending in Health, there are risks that this underlying breach (i.e., the deviation stripping out the one-off AIB transaction) could widen by end-year (Section 4.5).

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sufficiently capture underlying changes in the fiscal position. In the event of such conflicting signals, the Council will form a view on compliance with the Budgetary Rule based on an analysis of the particular reasons underlying any conflicts. In undertaking the assessment of rules, the Council will primarily refer to the Department's forecasts and estimates, with analysis and sensitivity tests of key assumptions and forecasts where appropriate and necessary.

FIGURE 4.3: COMPLIANCE WITH THE EXPENDITURE BENCHMARK



Source: SPU 2016 and EC Spring Economic Forecasts.

Note: The real corrected expenditure projections in SPU 2016 are purely technical in nature and assume no budget changes for 2017-2021. EB is complied with where real corrected expenditure aggregate grows slower than EB rate. This real growth rate is adjusted to reflect the scale of discretionary revenue measures. EB limit estimated based on SPU 2016 inputs. Assessment will use EC estimates.

## DEBT RULE

Transitional arrangements under the Debt Rule apply until end-2018 before normal Debt Rule requirements take effect.<sup>46</sup> The requirements are unlikely to present a binding constraint on medium-term fiscal policy as the projected pace of reduction of the debt-to-GDP ratio is significantly faster than Debt Rule requirements. For instance, Table 4.1 shows that the Department's debt ratio projections – which are technical and assume no budget changes for 2017-2021 – fall below the two main criteria of the Debt Rule (the “backward-” and “forward-looking benchmarks”) in all forecast years.

### 4.4 EX-ANTE ASSESSMENT OF 2017 TO 2021

The *ex-ante* assessment of compliance with the fiscal rules for 2017 and later years focuses on the pace of structural deficit adjustment towards meeting Ireland's updated MTO (Box G). This also includes an analysis of spending growth using the Expenditure Benchmark (EB). The debt rule, though applicable, is not likely to present a binding constraint (Section 4.3).

#### MTO AND STRUCTURAL BALANCE ADJUSTMENT REQUIREMENTS

The Department currently projects a structural balance of -0.8 per cent of GDP for 2017. This represents an improvement of 1.2 percentage points on the previous year, and therefore exceeds the 0.6 percentage point adjustment requirement.<sup>47</sup> If the structural balance path envisaged in the

<sup>46</sup> The debt rule states that debt in excess of the 60 per cent debt-to-GDP ratio must be reduced by at least 1/20<sup>th</sup> per year on average. For a more detailed discussion, see IFAC *Analytical Note 5: Future Implications of the Debt Rule* (IFAC, 2014a).

<sup>47</sup> The 0.6 percentage point structural balance adjustment requirement is set according to the EC “matrix” (Appendix F) on the basis that the Commission's output gap estimate for 2017 of 0.6 per cent falls within the “normal times”

*SPU* were to be followed, then the estimate for 2017 would be just short of the required MTO level of -0.5 per cent of GDP. On this path, an adjustment of 0.3 percentage points in 2018 would, in this context, be sufficient to meet the MTO of a 0.5 per cent deficit in structural terms in 2018. Once the MTO has been achieved, no further adjustments are required as long as the MTO is maintained. In addition, the *Vade Mecum* (EC, 2016c) notes that countries that have “...exceeded their MTO do not need to be assessed for compliance with the Expenditure Benchmark”.<sup>48</sup>

The structural balance path outlined in the *SPU*, however, is based on technical fiscal projections that assume no budget changes for 2017-2021. This scenario does not account for stated commitments to use the additional net fiscal space available. Previous statements have also signalled intentions of moving towards the MTO at the minimum required rate.<sup>49</sup> While the technical projections show the MTO being met in 2018, if a minimum compliance policy is followed, this could have implications for when the MTO is achieved.

The *SPU*'s projected structural balance improvements post-MTO achievement would be unlikely to materialise in a minimum compliance scenario. If budgetary projections were consistent with minimum rule compliance, this would see the structural deficit remain at the MTO value of -0.5 per cent of GDP rather than rise to a 2.8 per cent surplus by 2021 (Chapter 3). Figure 4.2 compares the structural balance path to the expected requirements out to 2021.<sup>50</sup> Though 2016 and 2017 fiscal requirements are now set, some uncertainty remains for subsequent years. Requirements will depend on the degree of compliance for preceding years and on supply-side estimates underpinning the EC “matrix” (Appendix F).

#### EXPENDITURE BENCHMARK

The fiscal path provided in *SPU 2016* for the period 2017-2021 includes no significant policy changes and is largely technical in nature (discussed in detail in Chapter 3). The technical forecasts show marked over-compliance in relation to expected allowable growth rates under the EB beyond 2017. If the projections were to incorporate expected budgetary decisions, however, the extent of

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category (between +/- 1.5 per cent), and the debt-to-GDP ratio is set to remain above 60 per cent. The requirement is frozen in spring.

<sup>48</sup> The updated *Vade Mecum* (2016) notes that in the case of Member States exceeding their MTO, these “can deviate from the requirements of the Expenditure Benchmark without it being considered significant, as long as the MTO is maintained”. The *Vade Mecum* also clarifies that revenue windfalls will be considered when judging whether these are partly responsible for the overachievement of the MTO in any *ex-post* assessment.

<sup>49</sup> The Spring Economic Statement (Department of Finance, 2015b) notes: “...it is the intention of this Government to ensure that we move towards the MTO at this minimum rate on average over the coming years.”

<sup>50</sup> The path of minimum compliance is calculated on an annual basis by reference to the structural balance path published in *SPU 2016*. It assumes that the structural deficit of 2 per cent forecast in *SPU 2016* is met, 0.6 per cent adjustments are then required in 2017 and 2018, with a final 0.3 per cent adjustment applying in 2019.

over-compliance for 2017-2021 suggested by the *SPU* would not materialise. For 2017, initial indications suggest that the maximum permitted growth rate in spending permitted under the Expenditure Benchmark for 2017 has now been set at 1.2 per cent in real terms as of the spring 2016 EU Commission forecasts.<sup>51</sup>

#### 4.5 THE MEDIUM-TERM EXPENDITURE FRAMEWORK (MTEF)

The MTEF represents a core domestic budgetary reform in recent years, requiring the government to provide three-year-ahead expenditure ceilings for each department.<sup>52</sup> Upper limits on overall General Government expenditure are set by the Expenditure Benchmark, while individual Ministerial ceilings are intended to control Departmental expenditure within these upper limits.<sup>53</sup> The reform is designed to assist the planning and delivery of service reforms, and to avoid the type of expenditure management problems observed prior to the crisis.

Persistent revisions to expenditure ceilings since 2011 serve to undermine public spending management. Without improved systems of expenditure planning, it is likely that recent upward revisions to expenditure ceilings will continue the pre-crisis pattern of pro-cyclical adjustments (Figure 4.4). Recent years have seen spending pressures underestimated and execution problems addressed by relaxing overall government expenditure ceilings, particularly in the Health area.<sup>54</sup> There are indications of a similar trend emerging in 2016. Though such increases may help to address underlying pressures in some areas, they may also damage expenditure control incentives and practices, thus perpetuating the cycle of upward revisions to ceilings.

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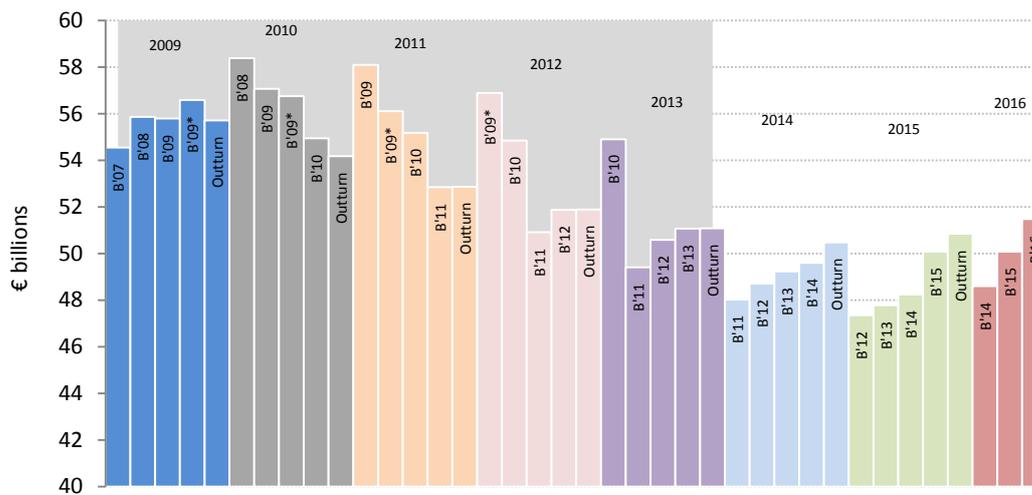
<sup>51</sup> The full set of parameters relevant for the Preventive Arm, based on EC *Spring Forecasts*, have not yet been published.

<sup>52</sup> The MTEF is set out in the *Ministers and Secretaries (Amendment) Act 2013* and Departmental Circular 15/13.

<sup>53</sup> See Medium-Term Budgetary Framework (Department of Finance, 2014b). The *Ministers and Secretaries (Amendment) Act 2013*, which legislated for the ceilings, provides for both an aggregate ceiling on gross Departmental expenditure, including the Social Insurance Fund) - the Government Expenditure Ceiling - and for individual Ministerial ceilings. Furthermore, it requires that the aggregate of the Ministerial ceilings be no more than the Government Expenditure Ceiling. The legislation provides that where the Government has decided on a Government Expenditure Ceiling, they may make a further decision to revise the Government Expenditure Ceiling to a lesser or greater amount. Subject to such a revision the Government may revise the Ministerial Expenditure Ceilings.

<sup>54</sup> In both 2014 and 2015, the effective limit on fiscal policy was the deficit ceiling under the EDP, which permitted upward revisions to spending through changes to the GEC as revenues were higher than expected. This increase in the GEC created room for individual Ministerial ceilings to be increased to allow for higher than anticipated expenditure without a breach of individual Ministerial ceilings. The MTEF sets out sanctions where an individual Ministerial ceiling is breached in a given year. These sanctions are semi-automatically imposed and escalate to the repayment of excess spending from future ceilings.

FIGURE 4.4: GROSS CURRENT EXPENDITURE FORECASTS



Source: Department of Finance; internal IFAC calculations.

Note: Bars show forecasts from various budgets followed by outturns (e.g., B'15 = expenditure forecasts in Budget 2015). Each set of coloured bars relates to forecast/outturn expenditure for year specified above. Grey shaded region covers crisis period 2009-2013.

The weakness of the domestic MTEF is a continuing concern. Poor implementation of the domestic MTEF may, at least in part, relate to perceptions of this being primarily an EU-level instrument rather than a strategic tool for guiding national policy (Sherwood, 2015). The MTEF's weaknesses are aggravated by amendments to the Expenditure Benchmark, which mean that aggregate ceilings are updated annually rather than being set in advance for three years.<sup>55</sup> The change implies the absence of a fixed, multi-year, "top-down" anchor for expenditure. In the absence of an appropriately functioning MTEF, this risks a return to permanent expenditure increases that are based on positive short-term macroeconomic dynamics.

There are also weaknesses in relation to reconciling "bottom-up" departmental pressures and policy costs with the aggregate ceilings. A major difficulty with the recent application of ceilings in Ireland is that the aggregate of all Ministerial ceilings has been set at exactly the same levels as the overall government expenditure ceiling (e.g., with reference to the maximum permitted by the Expenditure Benchmark). Another approach would be to allow some margin between the sum of Ministerial ceilings and the targeted level of total expenditure set by the government expenditure

<sup>55</sup> There also remain inconsistencies between the operation of the EB and the domestic MTEF. The upward revision to the Government Expenditure Ceiling in 2015 highlights the importance of the base expenditure level when operating an expenditure growth rule. A repeat of the in-year upward revisions to expenditure would likely cause a breach of the EB in 2016. However, a further consideration is that spending below the permitted level would lead to a reduction in the permitted level of spending in subsequent years. This could lead to a situation where inefficient expenditure is undertaken to avoid the erosion of the base expenditure level. The carryover provision in the domestic framework is designed to avoid this by allowing for savings in one year to be carried over to the next. However, under the EB any such carryover would still be considered a reduction in the base expenditure level. If the expenditure planning process is to be successful such inconsistencies should be resolved.

ceiling. This would facilitate revenue uncertainties and legitimate expenditure overruns. Importantly, it would also address uncertainties about the maximum aggregate expenditure level that is allowable under the Expenditure Benchmark given annual updates to this. Setting ceilings in line with the expected maximum can lead to certain risks. If ceilings are set too high, subsequent downward revisions to the maximum level permitted by the EB could necessitate spending reductions to stay within permitted limits. Similarly, if unexpected spending pressures arise, addressing these could lead to a deviation from the EB limit when ceilings are initially too high.

Annual revisions to government expenditure plans comply with domestic legislation and the Corrective Arm of the *SGP*, but go beyond that permitted by the Circular, which outlines the design of the Irish MTEF.<sup>56</sup> The domestic MTEF framework permits revisions to ceilings (i) under exceptional circumstances, as defined in the *FRA*, (ii) through the introduction of compensatory discretionary revenue measures, or (iii) where adjustments are related to spending on cyclically related unemployment spending or EU co-funded payments. Given that the preventive arm requirements, consistent with the domestic Budgetary Rule, are now operational in full, revisions to Government Expenditure ceilings from 2016 onwards will only be possible in the circumstances set out in the Circular when spending is already at maximum levels permitted by the Expenditure Benchmark (i.e., consistent with a policy of minimum rule compliance).

#### **BOX F: THE UPDATE TO IRELAND'S MEDIUM-TERM OBJECTIVE (MTO)**

This box explains the recent update to Ireland's minimum MTO. While Member States are required to set their MTOs in their Stability Programmes, the European Commission calculates a minimum value for each country based on an agreed methodology. The MTO requirement was lowered from a requirement of a balanced structural deficit (i.e., a structural balance equivalent to 0.0 per cent of GDP) to a structural deficit of 0.5 per cent of GDP. The decision was taken in February 2016 and will apply for the period 2017-2019.

In most circumstances, the minimum MTO is reset every three years and is intended to:

- (i) provide a safety margin with respect to the 3 per cent deficit limit in light of past economic (and associated budgetary) volatility;
- (ii) ensure sustainability or rapid progress towards this. This is assessed against the need to ensure the convergence of debt ratios towards prudent levels, while giving consideration to the economic and budgetary impact of ageing populations;
- (iii) in compliance with above, allow room for budgetary manoeuvre, in particular taking into account public investment needs.

Three bounds are designed to achieve the above aims. The bounds are based on estimates of the burden of Implicit Liabilities and Debt (ILD), the structural balance required to ensure that the 3 per cent of GDP *SGP* limit is not breached during a normal economic cycle (the Minimum

<sup>56</sup> See Circular 15/13, *Medium-Term Expenditure Framework: Application to Current Expenditure* is available at <http://circulars.gov.ie/pdf/circular/per/2013/15.pdf>.

Benchmark (MB)) and, finally, a minimum bound applicable to certain Member States :

1. **MTO<sup>ILD</sup>**: adds expected ageing costs and reflects sustainability of public debt.
2. **MTO<sup>MB</sup>**: estimates a typical (representative) output gap; uses the sensitivity of the deficit to this to derive a minimum deficit level that sets a safety margin to 3 per cent ceiling.
3. **MTO<sup>Euro/ERM2</sup>**: an additional lower bound of -1 per cent for Euro Area and ERM2 Member States.

The minimum MTO requirement is set as the maximum (or most constraining) of the above bounds (rounded to the lowest ¼ percentage point of GDP):

$$MTO_{min} = \max (MTO^{ILD}, MTO^{MB}, MTO^{Euro/ERM2})$$

The primary driver of the recent change in Ireland's minimum MTO requirement is the MTO<sup>ILD</sup> (Table F1). The MTO<sup>ILD</sup> is the sum of three components: (i) the budgetary balance that would stabilise the debt ratio at 60 per cent of GDP; (ii) a supplementary debt-reduction effort, when debt levels are above 60 per cent of GDP; and, (iii) the budgetary adjustment that would cover a fraction of the present, discounted value of projected age-related expenditure increases. Estimates of ageing costs are produced by the Ageing Working Group under the EU Economic Policy Committee every three years as part of a review of the impact of long term demographic trends on the public finances. The reason for the lessening of the ILD bound is primarily related to lower projections of future ageing costs, with these driven in the main by downward revisions to future spending on public sector occupational pensions. These are also evident in downward revisions to expected benefit ratios (i.e., average pensions in relation to average wages – see EU Commission, 2015b). Estimates of ageing costs over such long horizons are subject to a considerable degree of uncertainty related to demographic and economic developments as well as other factors.

TABLE F1: CALCULATIONS UNDERPINNING THE UPDATED MTO (% GDP)

Period Covered	MTO Components					MTO <sup>ILD</sup> Sub-Components		
	(i) MTO <sup>MB</sup>	(ii) MTO <sup>Euro/ERM2</sup>	(iii) MTO <sup>ILD</sup> =a+b+0.33*c	Max of (i,ii,iii)	MTO (rounded down to nearest 1/4pp)	(a) Debt-stabilising balance	(b) Additional Debt Reduction Effort	(c) Increase in Cost of Ageing
2014-2016	-1.2	-1.0	0.2	0.2	0.0	-2.6	1.4	4.2
2017-2019	-1.3	-1.0	-0.3	-0.3	-0.5	-2.5	1.3	2.4
Change (p.p.)	-0.1	0.0	-0.5	-0.5	-0.5	0.1	-0.1	-1.8

The debt-to-GDP ratio is also a key consideration when setting the MTO<sup>ILD</sup>. For Ireland, a more appropriate measure may be the debt-to-GNP or a hybrid measure as proposed by the Council (IFAC, 2012b) on the grounds that either can more appropriately capture fiscal capacity. Had either of these measures been used to assess the sustainability of debt, it is likely that the MTO would have been reset at either -0.25 per cent (using the Hybrid) or 0.0 per cent (GNP).

### **BOX G: INTRODUCTORY GUIDE TO THE PREVENTIVE ARM AND THE BUDGETARY RULE**

This box introduces the key elements of both the Preventive Arm of the *SGP* and the domestic Budgetary Rule, which will become operational in full over the coming years. The focus under the Preventive Arm primarily relates to medium-term sustainability. Several rules form part of the Preventive Arm, which seek to ensure that growth in government spending does not exceed long-run economic growth, while also ensuring that the budgetary position is broadly balanced. In addition, the *SGP* rules seek to guide high government debt towards safer levels in a phased manner.

Domestic legislation mirrors and reinforces the *SGP* requirements, with the Budgetary Rule a core component of the national budgetary framework. Independent monitoring of compliance with the Budgetary Rule is an EU Fiscal Compact requirement and forms part of IFAC's mandate.<sup>57</sup>

#### **THE PREVENTIVE ARM**

##### *The Medium-Term Budgetary Objective (MTO)*

At the core of the Preventive Arm is the MTO – a target for a country's structural balance set by Member States but subject to a minimum EC requirement that is revised every three years. It is designed to (i) provide a safety margin against the 3 per cent of GDP, EDP deficit limit, (ii) ensure the sustainability of public debt, and (iii) allow room for manoeuvre, in particular for investment spending. A margin of 0.25 per cent of GDP is allowed when assessing MTO achievement to account for estimation uncertainty. Ireland's current MTO has been reset as a structural balance of -0.5 per cent of GDP for 2017-2019, having been set at 0.0 per cent of GDP for the preceding period.

Progress towards the MTO is assessed on the basis of two pillars: (i) Structural Balance adjustment requirements, as complemented by (ii) the Expenditure Benchmark.

##### *i: Structural Balance Adjustment Requirements*

For countries not yet meeting their MTO, the Preventive Arm requires gradual annual adjustments toward this. Typical adjustment requirements are for an annual improvement of 0.5 per cent of GDP, but are tailored according to current economic conditions.

The requirements may be larger or smaller depending on economic growth, the output gap, debt levels and broader assessments of debt sustainability risks. For instance, requirements are generally greater when the economy is performing strongly, such as when output is above trend levels and growth rates are exceeding estimates of potential output growth. By contrast, when economic growth is low or negative the requirements may be loosened or even suspended. This provides for an appropriate degree of countercyclicality (i.e., "leaning against the wind") in both good times and bad. It can also help to prevent budgetary policy from aggravating boom-bust cycles. A table, referred to as the European Commission's "matrix" (EC, 2015a) shows the specific requirements for annual adjustments (Figure F.1 in Appendix F).<sup>58</sup> The planned adjustment is set out by countries in their annual *SPUs* and is then assessed by the European Commission.

Some additional, limited flexibility is permitted for certain investment spending and structural reform plans as well as for unusual or "exceptional" circumstances outside of a Member State's control, with major impacts on the government's financial position. This flexibility is granted on

<sup>57</sup> Treaty on the Stability, Coordination and Governance in Economic and Monetary Union (TSCG).

<sup>58</sup> The EC publication (EC, 2015a) *Making best use of the flexibility within the existing rules of the Stability and Growth Pact* is available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52015DC0012>.

the basis that it does not endanger medium-term fiscal sustainability, with deviations from the MTO or adjustment path towards it only justified on a temporary basis. The investment and structural reform flexibilities must conform to strict criteria and are limited to temporary deviations individually of 0.5 per cent of GDP, with cumulative limits of 0.75 per cent.

#### *ii: The Expenditure Benchmark*

The Expenditure Benchmark complements the structural balance adjustment path assessment with an analysis of government spending growth.

A maximum allowable real expenditure growth rate for the following year is set annually. It is based on a ten-year average of the economy's estimated potential growth rate ("reference rate").<sup>59</sup> To obtain a nominal allowable spending figure, a GDP deflator forecast (averaged over spring and autumn EC forecasts) is added to the volume growth rate permitted under the rule. Relevant estimates of the GDP deflator, the output gap and potential output growth are set and fixed or "frozen" in spring of the previous year and apply to all subsequent assessments.<sup>60</sup> Finally, where a country is not at its MTO, an additional requirement ensures that the allowable growth rate is consistent with structural balance adjustment requirements (the "convergence margin").

#### *Assessment*

Assessment of compliance with the Preventive Arm requirements is conducted on an *ex-ante* and *ex-post* basis, with an overall assessment of both the Expenditure Benchmark and the structural balance adjustment requirements conducted in cases where one of the requirements is deviated from. The *ex-post* assessment is of particular importance as it may lead to a Significant Deviation Procedure. This can result in sanctions for Member States including an interest-bearing deposit equal to 0.2 per cent of the previous year's GDP (equivalent to €0.4bn as of 2015).<sup>61</sup> Commission assessments of compliance focus on stability and convergence programmes and draft budgets submitted by Member States such as *SPU 2016* and *Budget 2016*.

*In-year* and *ex-ante* assessments cover a Member State's plans for the current and next year ("t" and "t+1"), on the basis of in-year estimates and budgetary plans, complemented by a risk assessment based on the Commission forecasts. They cannot lead to a Significant Deviation Procedure, but aim to facilitate appropriate policy guidance and to inform policy debate.

*Ex-post* assessments cover the previous year ("t-1") and the average of the previous two years ("t-1" and "t-2"), on the basis of outturn data validated by Eurostat. If, following an overall assessment, the *ex-post* analysis concludes that a significant deviation from the adjustment

<sup>59</sup> Estimates are based on the Commonly Agreed Methodology, which has its drawbacks. In particular, the method has a tendency to produce pro-cyclical measures of potential output growth, such that potential output growth rates follow actual GDP growth rates quite closely, thus constraining the counter-cyclical scope of fiscal policy (Chapter 2).

<sup>60</sup> Two exceptions to this freezing of requirements apply: first, when economic conditions worsen between the spring and autumn EC assessments such that the revised output gap falls below -3 per cent (i.e., if a Member State falls into 'very' or 'exceptionally bad' times). In such cases, the required adjustment is updated. Furthermore, where data has been revised so that subsequent assessments indicate the MTO has been met, this assessment will prevail over the frozen requirements.

<sup>61</sup> A Council recommendation follows any Significant Deviation Procedure and outlines necessary policy measures to address the deviation. If the Member State fails to take appropriate action within a given deadline, a decision on no effective action and the imposition of sanctions are possible. The Council votes on such decisions with reverse qualified majority voting. Votes occur within ten days of the Commission's recommendation and the Council may also vote to amend the recommendation and adopt the amended text as a Council decision, by qualified majority voting.

path to the MTO or from the MTO itself has occurred, the Commission will address a warning, launching a Significant Deviation Procedure.

#### **THE BUDGETARY RULE**

Mirroring the requirements of the Preventive Arm on a national level is the Budgetary Rule requirement as set out in the *Fiscal Responsibility Act (FRA)*. The Act effectively translates the Preventive Arm requirements into domestic legislation following the Fiscal Stability Treaty, which was approved by referendum in 2012.<sup>62</sup> The Budgetary Rule has been in force since its legal commencement on 31 December 2012.

The Budgetary Rule and associated enforcement mechanisms are designed to be consistent with the requirements of the Preventive Arm of the *SGP*, while IFAC has a responsibility as a part of its mandate for monitoring and assessment of the Budgetary Rule.

#### *The “Budget Condition” and the adjustment path condition*

The key elements of the Budgetary Rule are the “Budget Condition” and the adjustment path condition.

The “Budget Condition” is a requirement that the budgetary position<sup>63</sup> of the General Government is in balance or in surplus. A failure to meet the requirement is only permitted as a result of exceptional circumstances and if it does not endanger medium-term fiscal sustainability. The Budget Condition is also deemed to be respected if the structural balance is at the Medium-Term Objective as set under the Preventive Arm.

The adjustment path condition applies when the Medium-Term Objective is not being met, and requires that the structural balance is converging towards this. The timeframe for convergence is set in accordance with the 1997 Surveillance and Coordination Regulation. Failure to meet the requirement is also only permitted as a result of exceptional circumstances and when it does not endanger medium-term fiscal sustainability.

#### *Assessment*

The *Fiscal Responsibility Act (FRA)* lays out specific requirements to initiate a “correction mechanism” when the Government assesses that there is a failure to comply with the Budgetary Rule (which constitutes a “significant deviation”) or when the European Commission issues a warning to the State under the 1997 Surveillance and Coordination Regulation relating

<sup>62</sup> The referendum on the Thirtieth Amendment of the Constitution (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) Bill 2012 was held on 31 May 2012.

<sup>63</sup> Based on legal clarifications, the Council is of the view that the budgetary position in this context refers to the structural balance.

to such a deviation.<sup>64</sup> In such circumstances, the *FRA* requires that the Government lay before the Dáil, within two months, a plan specifying what is required to secure compliance with the Budgetary Rule.<sup>65</sup> The plan must also be consistent with *SGP* requirements.

Furthermore, if the Government does not accept an assessment by the Fiscal Council regarding compliance with the Budgetary Rule – including compliance with any correction plan put in place to meet the rule – the *FRA* requires that the Minister, within two months of being given a copy of the Council’s assessment, provide a statement to the Dáil on the reasons why it has not been accepted.<sup>66</sup>

The Council has clarified two elements in relation to how the Budgetary Rule is to be assessed:

1. *EDP requirements*: The Council is of the view that Budgetary Rule requirements, though legally applicable since 31 December 2012, are legally satisfied by meeting EDP requirements to 2015. From 2016 on, the “Budget Condition” and the adjustment path condition will operate in full.
2. *Dual assessment*: The Council, following legal clarifications, is of the view that assessment of compliance with the Budgetary Rule incorporates a dual assessment of requirements for both the structural balance and the Expenditure Benchmark.

#### ADDITIONAL INFORMATION

More detail on the operation of the European rules is covered in the updated *Vade Mecum on the SGP: 2016 Edition* (EC, 2016c).<sup>67</sup> Detail on the domestic rules framework is available in the Medium-Term Budgetary Framework (Department of Finance, 2014), with core components being the Budgetary Rule as set out in the *Fiscal Responsibility Act (2012)* and the Medium-Term Expenditure Framework set out in the *Ministers and Secretaries (Amendment) Act 2013*.

<sup>64</sup> Regulation (EU) No. 1175/2011, 16 November 2011 and the *Vade Mecum* 2016 specify that significant deviations refer to deviations in structural balance adjustments toward MTO or deviations in expenditure developments net of discretionary revenue measures impacting on the government balance, where the deviation is at least 0.5 per cent of GDP in a single year or at least 0.25 per cent on average per year in two consecutive years.

<sup>65</sup> *FRA* Article 6(1): “If the Commission addresses a warning to the State under Article 6(2) of the 1997 Surveillance and Coordination Regulation or if the Government considers 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 two months, prepare and lay before Dáil Éireann a plan specifying what is required to be done for securing compliance with the Budgetary Rule.” Article 6(3): “The provision made by the plan shall be consistent with – (a) the rules of the Stability and Growth Pact.”

<sup>66</sup> *FRA* Article 8(6): “If the Government do not accept an assessment of the Fiscal Council in relation to any of the matters referred to in subsection (3), the Minister shall, within two months of being given a copy of the assessment under subsection (5), prepare and lay before Dáil Éireann a statement of the Government’s reasons for not accepting it.”

<sup>67</sup> The *Vade Mecum* will now be updated annually as set out in the 21 October 2015 Economic and Fiscal Governance Proposals. In addition, the EC has committed to sharing data underpinning its surveillance decisions with Member States, national Fiscal Councils and, following consultation with Member States, with the public in future. See [http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/communication-emu-steps\\_en.pdf](http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/communication-emu-steps_en.pdf)

## APPENDIX A: FISCAL COUNCIL BENCHMARK PROJECTIONS 7 APRIL

As part of the endorsement process, the Council's Secretariat produced a set of Benchmark projections in advance of its meetings with the Department of Finance. The Benchmark projections were finalised on 7 April 2016 and are summarised in Appendix Table A.1.

APPENDIX TABLE A.1: BENCHMARK PROJECTIONS FOR 2016-2018

% change in volumes unless otherwise stated	2016	2017	2018
<b>GDP</b>	6.0	4.0	3.4
<b>Consumption</b>	4.0	2.8	2.4
<b>Investment</b>	7.5	4.1	3.3
<b>Government</b>	1.4	2.0	1.4
<b>Stock changes</b>	0.0	0.0	0.0
<b>Exports</b>	11.2	6.2	6.7
<b>Imports</b>	10.9	5.9	6.5
<b>Net Exports (p.p. contribution)</b>	2.3	1.5	1.4
<b>Domestic Demand (p.p. contribution)</b>	3.7	2.4	2.0
<b>Stock Changes (p.p. contribution)</b>	0.0	0.0	0.0
<b>Current Account (% GDP)</b>	5.8	6.1	6.0
<b>Employment</b>	2.4	1.9	1.8
<b>Unemployment Rate (%)</b>	8.1	7.3	6.9
<b>HICP</b>	0.2	1.5	1.7
<b>GDP Deflator</b>	2.6	2.5	1.9
<b>Nominal GDP (€ billions)</b>	233.3	248.6	261.9
<b>Nominal GDP</b>	8.7	6.5	5.4

Source: Internal IFAC calculations.

The Council's "endorsable range" is informed by, but not mechanically linked to, the uncertainty captured in fan chart analysis. The fan chart approach is also applied retrospectively so that uncertainty around outturn revisions can also be graphically represented (Figure 2.7).

The fan chart bands for the historical period effectively show the typical scale of revisions applying to historical estimates of real GDP growth over a five-year period.<sup>68</sup> As detailed in Casey and Smyth (2015), typical confidence intervals surrounding estimates for the latest annual outturn are not especially narrower than those for the current forecast year.<sup>69</sup> While this source of uncertainty

<sup>68</sup> Quill (2008) notes that in practice CSO data beyond five years rarely changes materially except for methodological reasons.

<sup>69</sup> Revisions for the latest full-year of data are typically large, especially when it comes to the first estimate of real GDP growth (i.e., with the release of the fourth quarter QNA results). A typical Root Mean Squared Error (RMSE) value of 1.6 for the previous full year of data compares to a RMSE of 1.8 for the current year's forecast. This means that the

narrows after the *NIE* release in summer, large uncertainties around the most recent annual outturns can still remain.<sup>70</sup>

It is important to note that the fan chart for the forecast period is symmetric by construction even though the Council may interpret the balance of risks to be weighted in a certain direction at a given point in time.

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uncertainty surrounding the current forecast year can be little less than that of the previous year for which four quarters of data are available. The RMSE for the previous year narrows to 0.9 after the release of the *National Income and Expenditure* accounts in the summer of each year, but remains relatively large.

<sup>70</sup> The fan chart is based on the typical scale of revisions that can be expected after the NIE release (i.e., after the second vintage of estimates for the previous annual outturn) and is, therefore, more aligned with the information available at the time of the budgetary endorsement exercise.

**APPENDIX B: TIMELINE FOR ENDORSEMENT OF SPU 2016 PROJECTIONS**

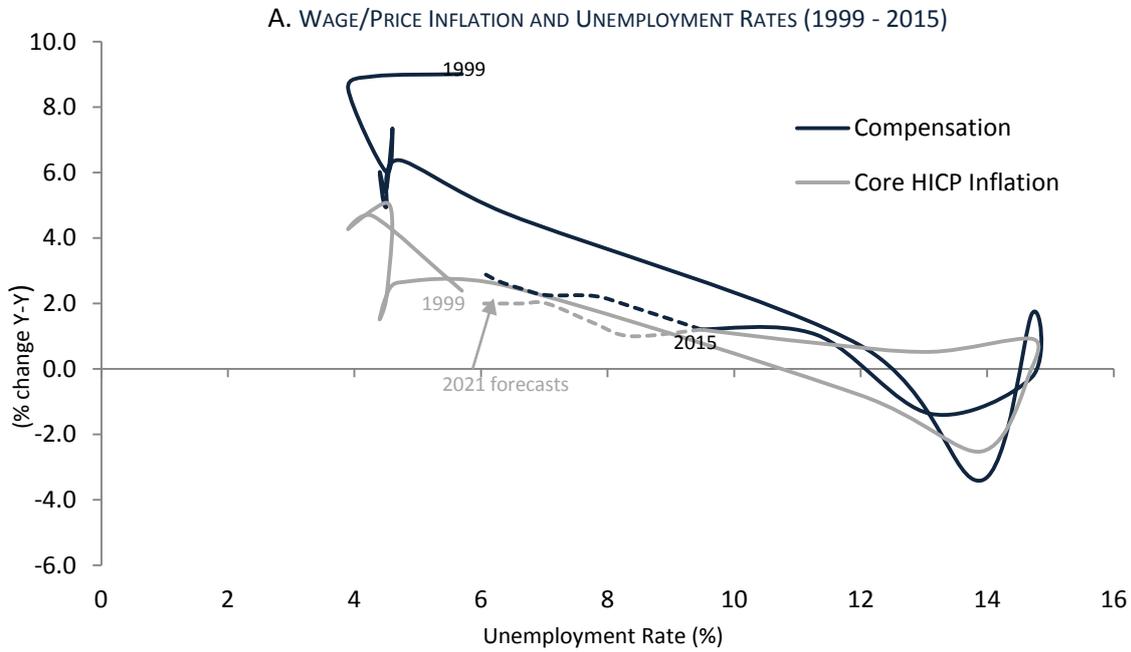
Date	
10 March	CSO release <i>Quarterly National Accounts</i> estimates for Q4 2015.
14 March	The Secretariat and Department of Finance met the CSO to clarify technical details of latest <i>Quarterly National Accounts</i> estimates.
16 March	The Secretariat received Department of Finance technical assumptions underpinning <i>SPU 2016</i> forecasts. <sup>71</sup>
7 April	After consideration by the Council, Benchmark projections are finalised by the Secretariat prior to receiving preliminary forecasts from the Department of Finance.
7 April	The Council received preliminary forecasts from the Department in line with <i>Memorandum of Understanding</i> requirements.
13 April	The first endorsement meeting took place with the Department of Finance presenting their forecasts to the Secretariat. A number of clarifications of a factual nature were requested.
	The Secretariat submitted a number of queries to the Department in relation to the forecast set. <sup>72</sup>
18 April	The Council met to discuss the Department of Finance forecasts. Following this, Department of Finance staff met with the full Council and Secretariat to present their latest forecasts and to answer questions. The Council sought information regarding a number of forecast components. The Council then finalised a decision on the endorsement.
20 April	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying <i>SPU 2016</i> .
28 April	The endorsement decision is published together with the Department's forecasts in the Draft <i>SPU 2016</i> . This is formally submitted to the EC and the endorsement letter is published.

<sup>71</sup> These included assumptions related to oil prices, exchange rates, net expenditure by central and local government on current goods and services and sources of forecasts for major trading partners.

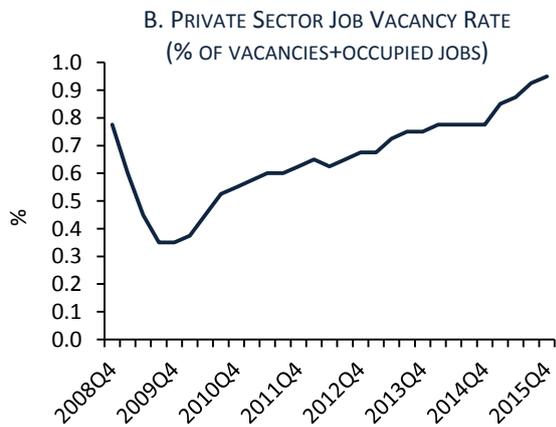
<sup>72</sup> Mainly covering quarterly profiles, income assumptions and the application of the Commonly Agreed Methodology, in particular the mechanical extensions applied and the depreciation rate used.

**APPENDIX C: SUMMARY INDICATORS OF ECONOMIC IMBALANCES**

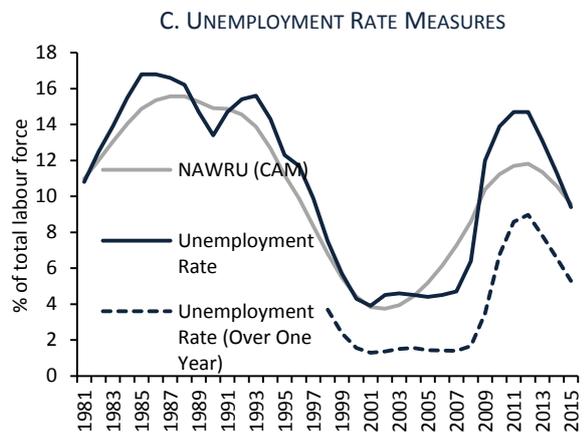
FIGURE C.1: LABOUR MARKET



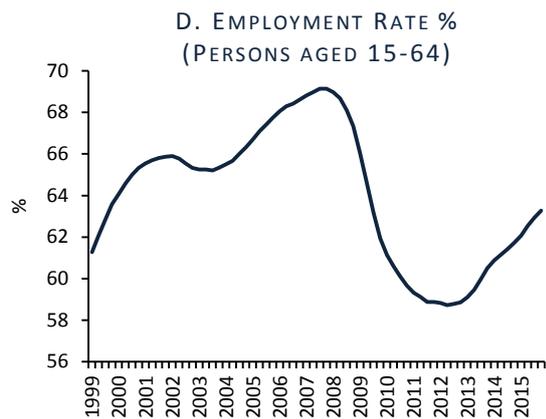
Sources: CSO; SPU 2016 projections and internal IFAC calculations.  
 Note: NIE compensation per QNHS employee hour is used as compensation measure.



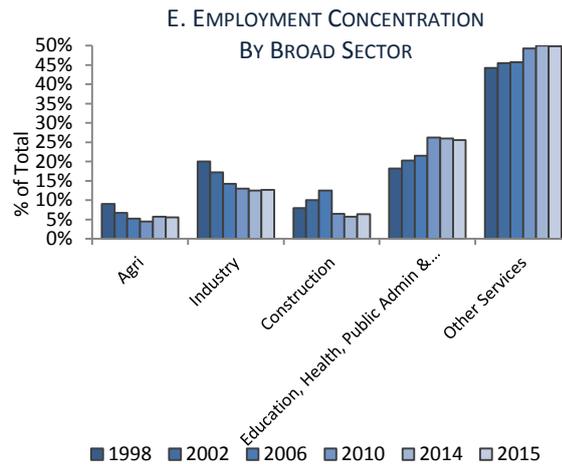
Sources: CSO; internal IFAC calculations.  
 Note: Four quarter moving average of job vacancy rate shown.



Sources: European Commission estimates (Commonly Agreed Methodology); CSO.

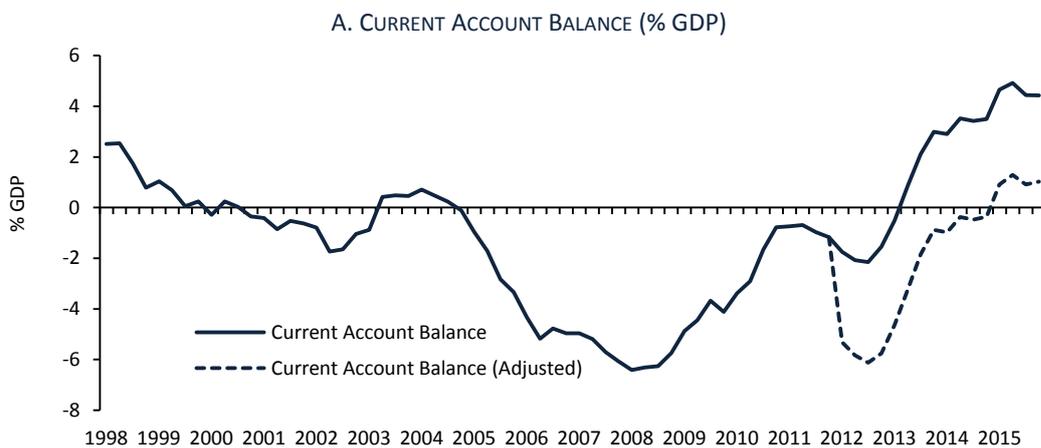


Sources: CSO; internal IFAC calculations.  
Note: 4 quarter moving average shown.

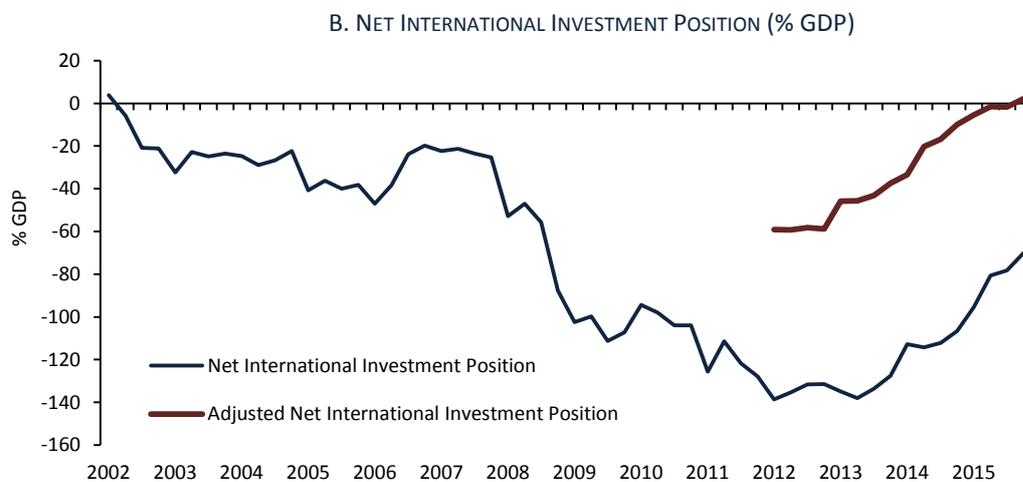


Sources: CSO; internal IFAC calculations.

FIGURE C.2: EXTERNAL BALANCES

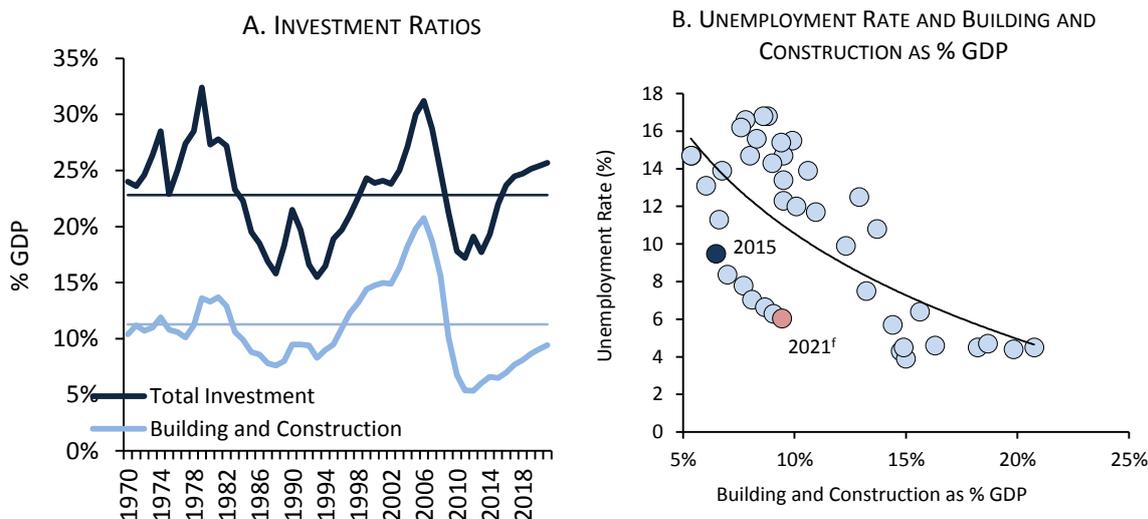


Sources: CSO; internal IFAC calculations.  
Note: Adjusted measure excludes estimated impact of redomiciled PLCs.



Sources: CSO; Eurostat and internal IFAC calculations.  
Note: Adjusted measure excludes IFSC activities and NFCs.

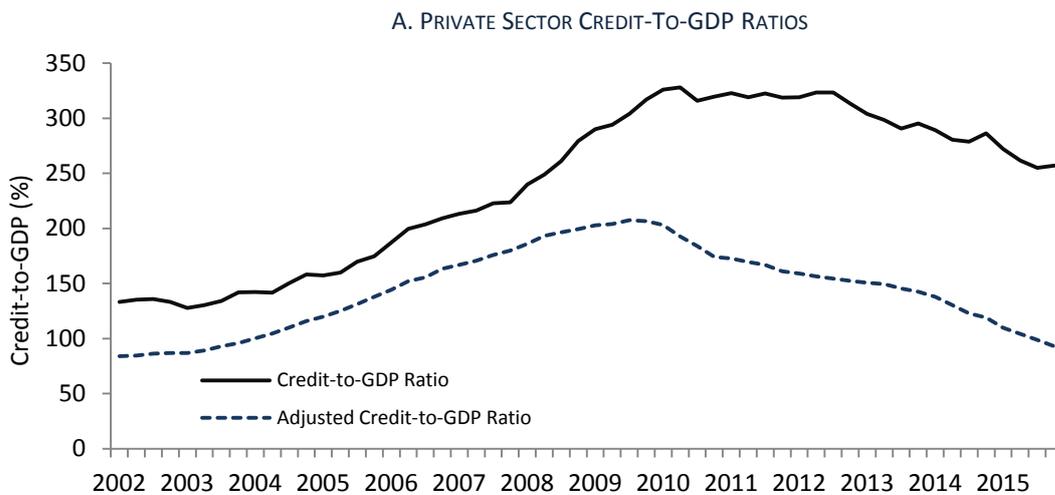
FIGURE C.3: INVESTMENT INDICATORS



Sources: CSO; AMECO; Department of Finance.  
Notes: Horizontal lines = historical avg (1970-2015).

Sources: CSO; Department of Finance projections & internal IFAC calculations.

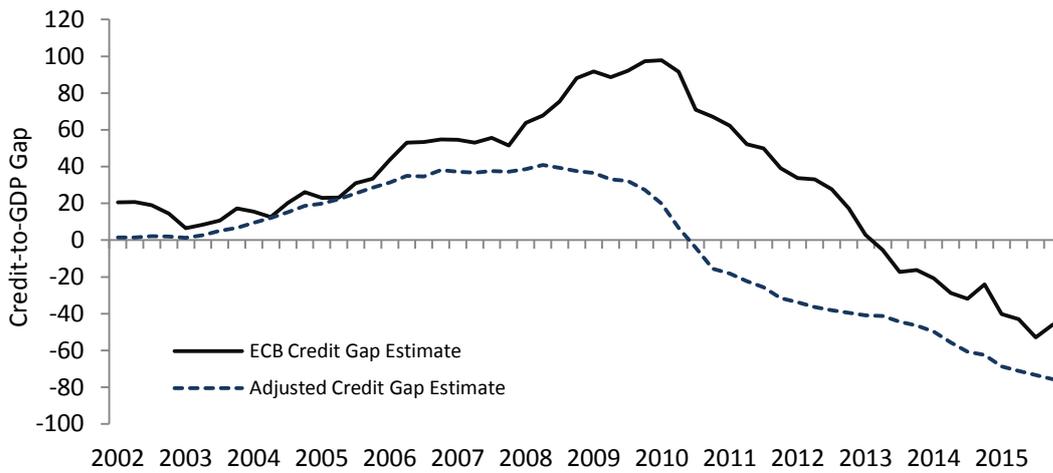
FIGURE C.4: ADDITIONAL CREDIT INDICATORS



Sources: Central Bank of Ireland; CSO; internal IFAC calculations.

Notes: The adjusted credit-to-GDP ratio is constructed as Irish resident private sector enterprise credit (ex fin. intermediation) plus total loan liabilities of Irish households. It is intended to adjust for the impact of multinational non-financial corporations on the aggregate ratio given that associated credit is often sourced outside of Ireland (for a similar approach, see Box 6: Macro-Financial Review 2015:I, Central Bank of Ireland). The ratio is calculated following a similar methodology to that in ESRB recommendation (18 June 2014) on guidance for setting counter-cyclical buffer rates (ESRB/2014/1). This specifies a credit ratio as:  $(CREDIT_t / (GDP_t + GDP_{t-1} + GDP_{t-2} + GDP_{t-3})) \times 100\%$ .

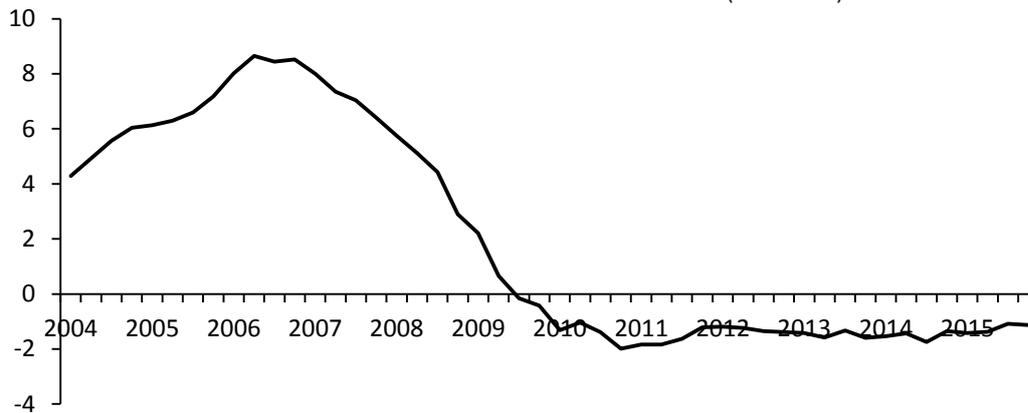
B. PRIVATE SECTOR CREDIT-TO-GDP GAPS



Sources: Central Bank of Ireland; CSO; ECB; internal IFAC calculations.

Notes: The adjusted credit gap is calculated following a similar methodology to that in ESRB recommendation (18 June 2014) on guidance for setting counter-cyclical buffer rates (ESRB/2014/1). For the underlying trend credit ratio, a recursive Hodrick-Prescott filtered trend ratio is specified, with smoothing parameter lambda = 400,000 to capture the long-term trend in the behaviour of the credit-to-GDP ratio. The credit-to-GDP gap is given by:  $GAP_t = RATIO_t - TREND_t$ .

C. ADJUSTED PRIVATE SECTOR CREDIT FLOW (% OF GDP)

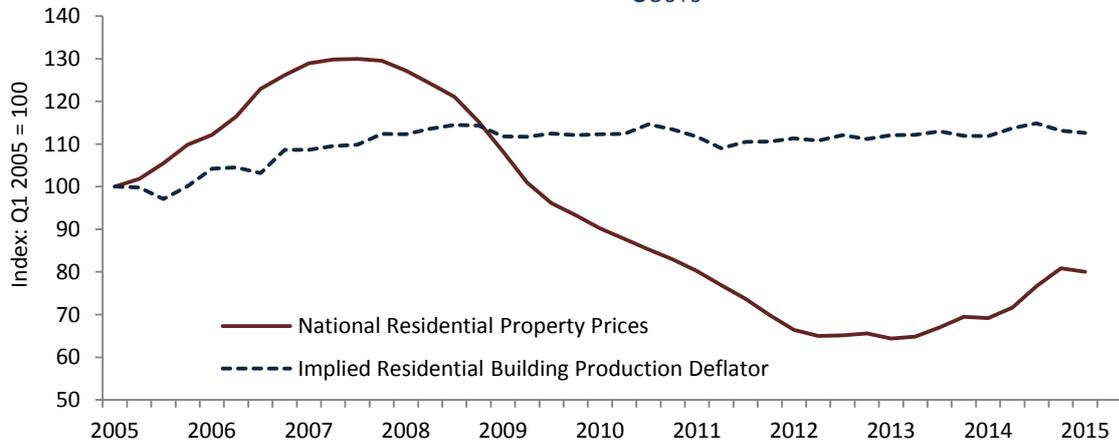


Note: 4 Q moving average.

Source: Central Bank Money, Credit and Banking and Quarterly Financial Accounts (transaction series used) & internal IFAC calculations.

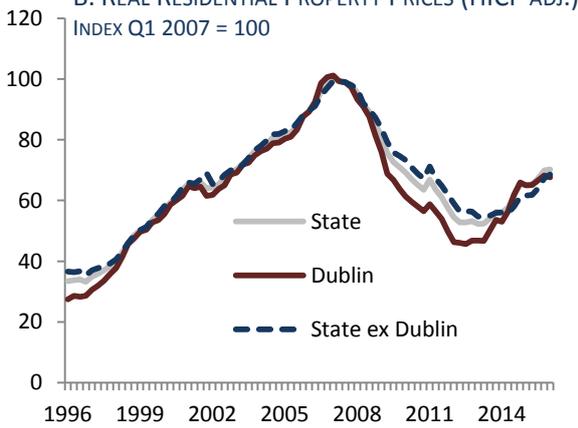
FIGURE C.5: HOUSING INDICATORS

A. IRISH RESIDENTIAL PROPERTY: NOMINAL PRICES AND IMPLIED PRODUCTION COSTS



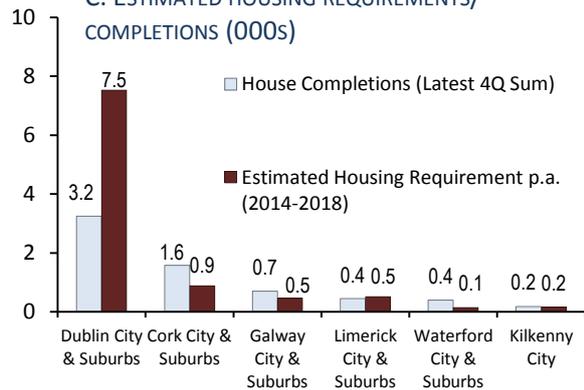
Sources: CSO; internal IFAC calculations.

B. REAL RESIDENTIAL PROPERTY PRICES (HICP ADJ.)  
INDEX Q1 2007 = 100



Sources: ESRI/PTS; CSO.

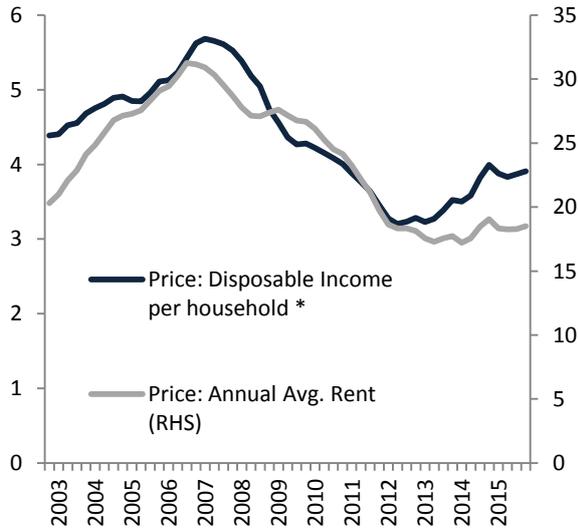
C. ESTIMATED HOUSING REQUIREMENTS/  
COMPLETIONS (000s)



Sources: Housing Agency; DoECLG.

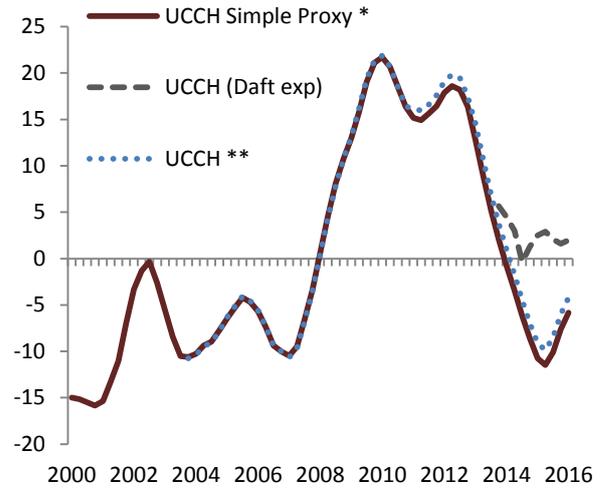
Note: Completions cover rural + urban settlements; requirements only cover settlements of 1,000.

D. HOUSING VALUATION RATIOS



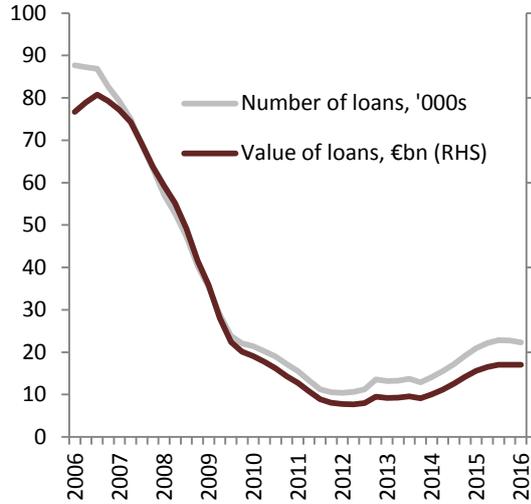
Sources: ESRI/PTSb; CSO.  
 \* Average house prices divided by moving 4-quarter sum of adjusted personal disposable income per capita

E. USER COST OF CAPITAL FOR HOUSING (UCCH)



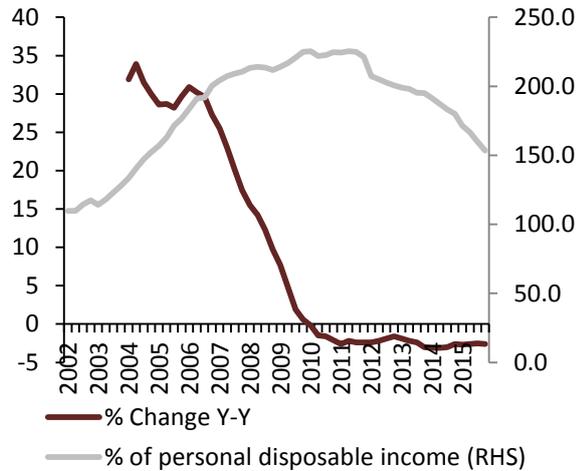
Sources: Central Bank of Ireland; CSO; ESRI/PTSb.  
 \* New mortgage rates less annual price change for the past 4 Qs.  
 \*\* Includes first-time buyer taxes/subsidies; down-payments; depreciation/maintenance. 'Daft' uses Daft.ie 12mo price expectations.

F. ANNUALISED RESIDENTIAL MORTGAGE LENDING  
 First-time buyer and mover purchase loans



Sources: IBF/PwC Mortgage Market Profile.

G. LOANS TO IRISH HOUSEHOLDS FOR HOUSE PURCHASE



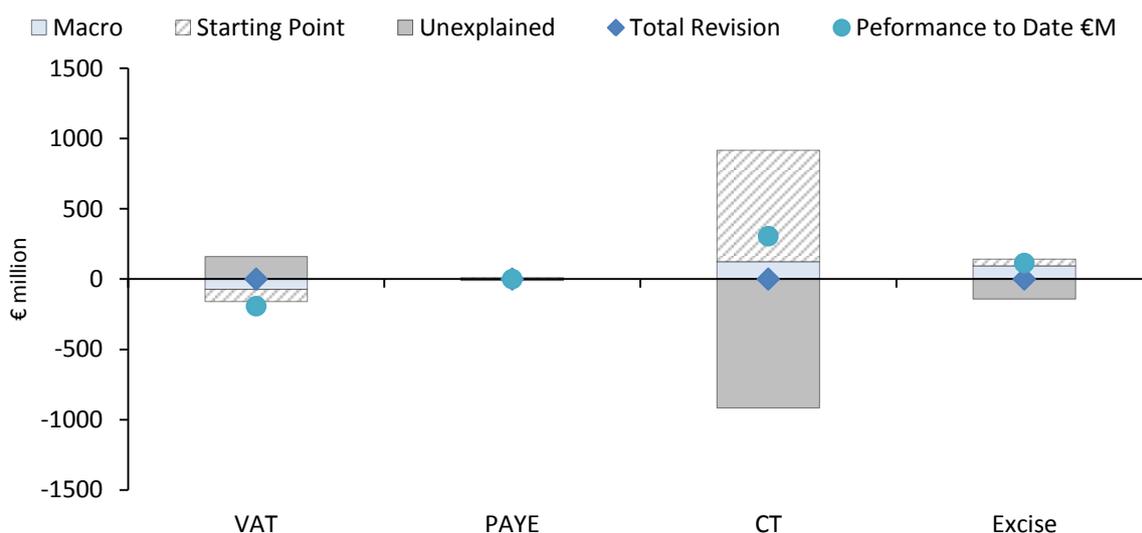
Sources: Central Bank of Ireland; CSO.  
 Note: Stock is proxied by Long-term loans; ESA-95 basis pre-2012.

## APPENDIX D: REVENUE FORECAST REVISIONS: BUDGET 2016 TO SPU 2016

The headline forecasts for the four main tax heads outlined in *SPU 2016* have not been revised relative to the forecasts produced for *Budget 2016* last October. However, while the forecasted yields remain unchanged, the forecasts have been updated given stronger than expected outturns in 2015 and changes in the macroeconomic environment. Figure D.1 shows the revision to the four largest tax heads from *Budget 2016* to *SPU 2016*. It breaks down the source of that revision into (i) an update to the economic outlook for 2016 (“macro”), (ii) confirmation of the final tax take for 2015 (“starting point”), and (iii) an “other” source of revision, which captures miscellaneous factors and Department of Finance judgement.

The chart shows that the main error in corporation tax was the starting point, reflecting the strong over-performance of this tax head in 2015. The macroeconomic driver of corporation tax, gross operating surplus, has also been revised upwards slightly. However, the large unexplained component offsets these upward revisions completely, and much of this is attributable to downward judgement applied by the Department of Finance given the ongoing uncertainty with regards to the sustainability of the corporation tax overruns. The chart also indicates that the performance of corporation tax to date is ahead of profile by some €305 million. This over-performance is attributable to a number of one-off payments by a small number of large firms amounting to €300 million; stripping this out leaves corporation tax on profile.

FIGURE D.1 : SOURCE OF REVISION TO 2015 TAX FORECAST



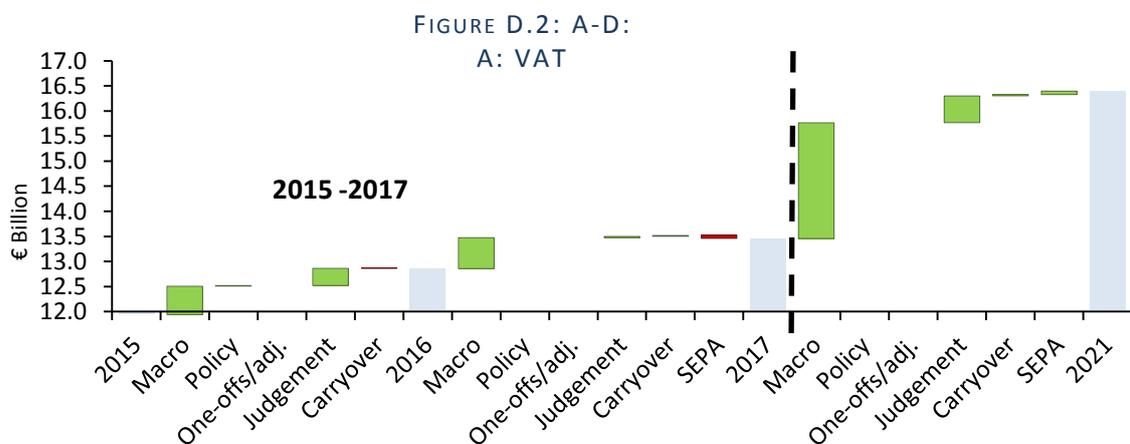
Sources: Department of Finance, CSO, internal IFAC calculations.

Note: Chart breaks the total revision to forecast down into a macro component, a starting point component and an other component. Performance to date shows tax receipts at end-April relative to profile. A positive performance to date indicates taxes are above profile.

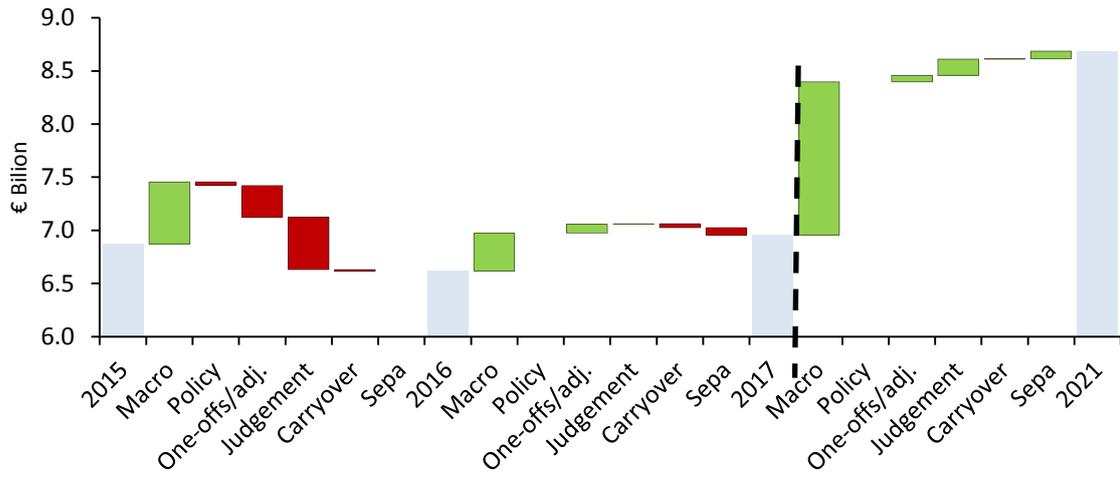
Turning to the other tax heads, the chart shows modest revisions to the main components, with PAYE almost unaltered since *Budget 2016*. Excise is marginally ahead of profile, which is likely due to an accelerated pace of branded tobacco purchases by retailers ahead of the introduction of plain packaging laws. VAT is approximately 3.8 per cent points below profile, while income tax is 0.1 per cent or €6 million above profile as of end-April. In the absence of quarterly National Accounts data for 2016 Q1, it is difficult to attribute this under-performance to any particular factor.

Figure D.2 (A-D) shows the most important factors influencing the *SPU 2016* forecasts for the four main tax heads over the period 2016-2021. In each case, the forecasts for 2016 and 2017 are shown separately while the forecasts for 2017-2021 are shown cumulatively. The floating bars show the size of the increase in taxes due to that source. In the case of corporation tax (panel B), the effect of one-off payments and measures, and the substantial downward judgement applied by the Department of Finance for 2016 can be seen.

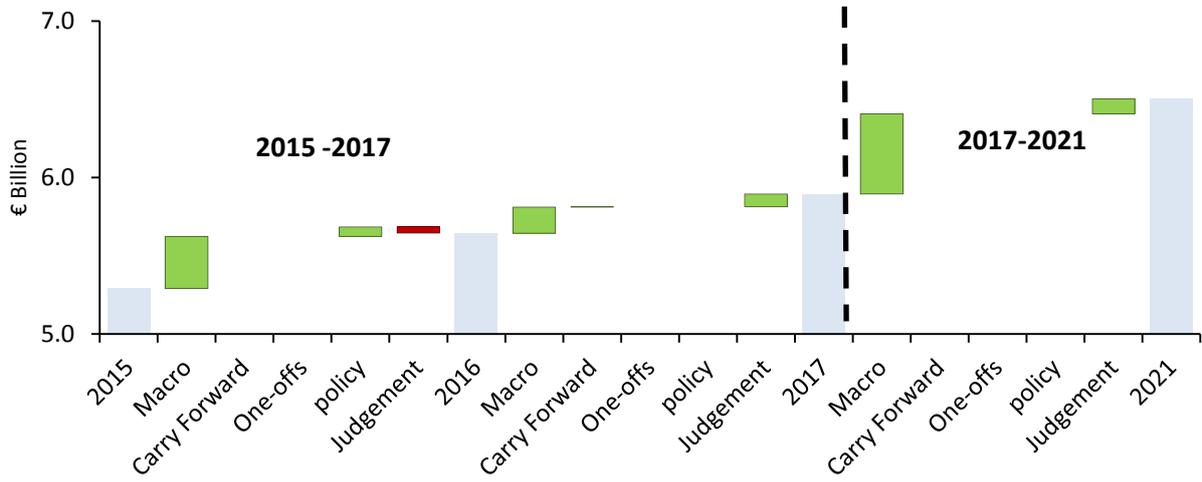
One key assumption used in the generation of the PAYE forecast is the indexation of the income tax system. This pulls down the PAYE forecast by €150 million per-annum from 2017 onwards with a further €50 million drag from carryover due to the indexation effects in each of the following years. The total cost of indexation on Income tax is approximately €400 million per annum from 2017. Furthermore, there is a large downward adjustment to PAYE in 2017 related to the timing of Single European Payments Area (SEPA) payments as a result of fewer banking days at the end of 2017, which will shift approximately €1 billion in Exchequer revenues from 2017 into 2018. While this will affect the Exchequer position, it will have no impact on the General Government since it is recorded on an accruals basis. Both VAT and corporation tax are also affected by this, but to a much lesser extent



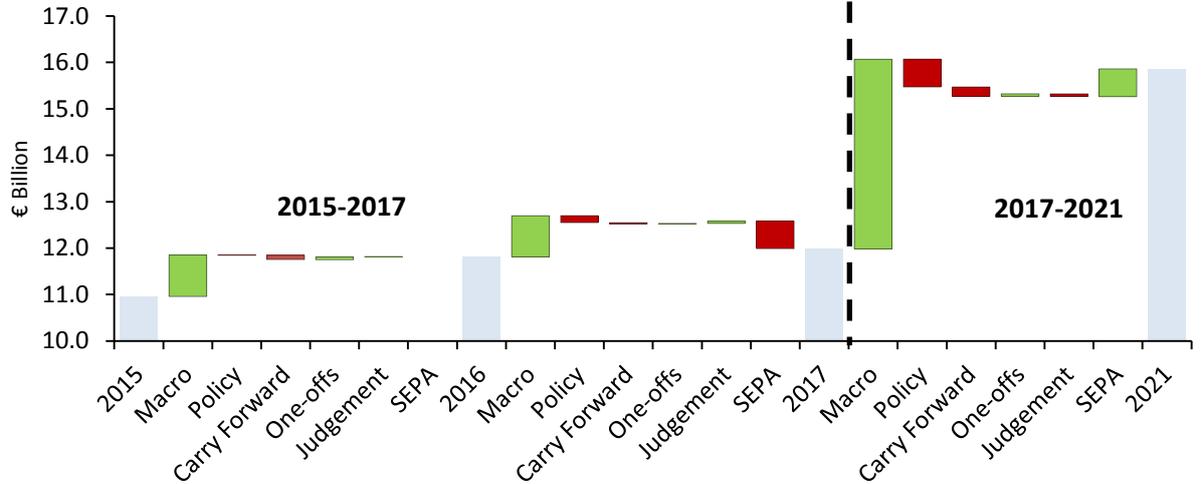
B: CORPORATION TAX



C: EXCISE



D: PAYE



## APPENDIX E: DEMOGRAPHIC PROJECTIONS

The Council's baseline medium-term expenditure scenario is based on demographic projections and price indexation. This Appendix sets out the key assumptions on fertility, mortality and migration which underpin the demographic projections.

### FERTILITY

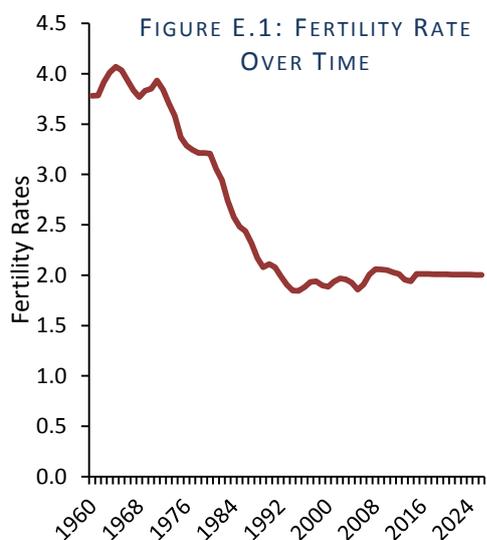
Ireland's relatively high fertility rates put it among Europe's forerunners (along with France, Sweden and the UK). In projecting forward the total fertility rate, the model adopts the assumption of the EC Ageing Working Group that the rate converges on the average forerunner fertility rate of 1.99 by 2040. For Ireland, this means very little change, particularly over a five-year forecast horizon. This trend in total fertility is applied proportionally across all age cohorts. This level of total fertility will leave Ireland below the replacement rate of 2.1 (Figure E.1 and Figure E.2).

### MORTALITY

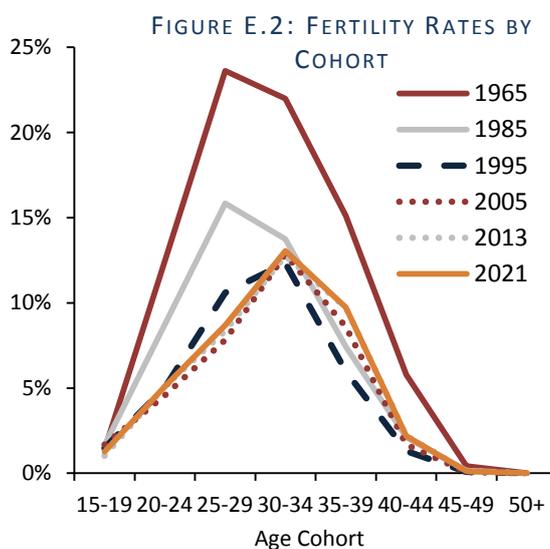
Following the CSO (2013) mortality projection methodology, the assumptions used for the mortality projections are that annual rates of improvement in mortality rate will decline from 3 per cent for males and 2.5 per cent for females until 2035. Then, for the post-2035 period the assumed rate of decline in mortality falls to 1.5 per cent for both sexes.

### MIGRATION

The scenario takes the same migration assumptions as those contained in *SPU 2016*. These forecast that net migration turns positive in 2016 and rises gradually to a net inflow of 20,000 per annum, higher than the CSO's M2 projection of 10,000. The age and gender profile of emigrants and immigrants is assumed to remain the same as those observed in 2015.



Source: Eurostat and IFAC internal calculations



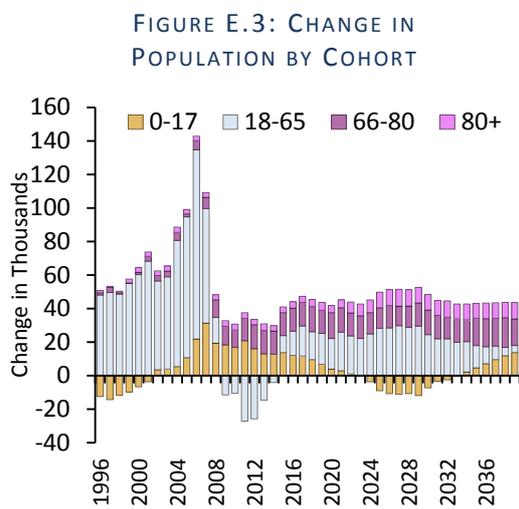
Source: Eurostat and IFAC internal calculations

### LABOUR FORCE PARTICIPATION AND UNEMPLOYMENT

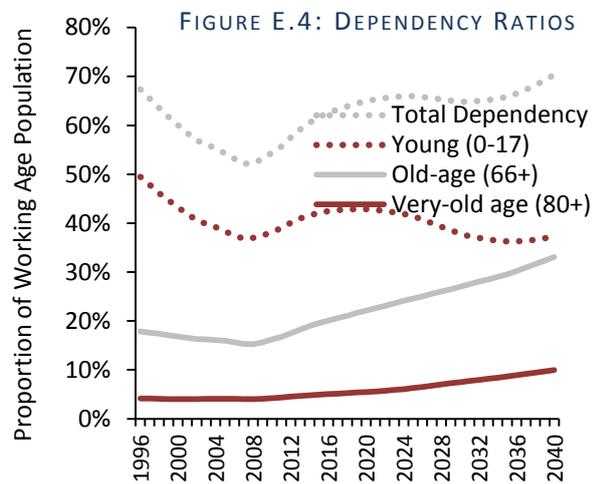
The other relevant factor for projecting government expenditure is the number of people requiring unemployment benefit. The Council’s adopts the same projections for unemployment as the Department of Finance in *SPU 2016*.

### IMPLICATIONS

Based on these assumptions, the demographic model produces projections for the population by single year of age. The projections show that future population growth will be heavily skewed towards older cohorts (Figure E.3). In the near term, the younger cohorts will also contribute substantially to population growth. The consequent rise in the dependency ratio will make it more difficult to meet the cost of maintaining services for both the old and young cohorts (Figure E.4).



Source: Internal IFAC calculations.



Source: Internal IFAC calculations.

## APPENDIX F: CHAPTER 4 FIGURES

FIGURE F.1: MATRIX FOR SPECIFYING THE ANNUAL FISCAL ADJUSTMENT TOWARDS THE MTO UNDER THE *SGP*

	Condition	Required minimum annual structural balance adjustment	
		Debt below 60% of GDP and no sustainability risk	Debt above 60% or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	$-4 \leq \text{output gap} < -3$	0	0.25
Bad times	$-3 \leq \text{output gap} < -1.5$	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	$-1.5 \leq \text{output gap} < 1.5$	0.5	> 0.5
Good times	output gap $\geq 1.5$	> 0.5 if growth below potential, $\geq 0.75$ if growth above potential	$\geq 0.75$ if growth below potential, $\geq 1$ if growth above potential

Source: *Vade Mecum* Update (EC, 2016).

Note: Requirements of > 0.5 percentage points are operationalised within EC assessments as at least 0.6 percentage points.

FIGURE F.2: THE OVERALL ASSESSMENT UNDER THE PREVENTIVE ARM

Expenditure Benchmark \ Structural Balance	Adjustment delivered	Deviation	Breach of "significance" threshold
Benchmark Respected	Compliance	Need an overall assessment (cannot lead to a significant deviation procedure)	Need an overall assessment ( <i>can</i> lead to a significant deviation procedure)
Deviation	Need an overall assessment ( <i>cannot</i> lead to a significant deviation procedure)	Need an overall assessment (cannot lead to a significant deviation procedure)	Need an overall assessment ( <i>can</i> lead to a significant deviation procedure)
Breach of "significance" threshold	Need an overall assessment ( <i>can</i> lead to a significant deviation procedure)	Need an overall assessment ( <i>can</i> lead to a significant deviation procedure)	Need an overall assessment, but strong presumption of significant deviation ( <i>can</i> lead to a significant deviation procedure)

Source: *Vade Mecum* Update (EC, 2016).

Note: The threshold for "significance" is judged to be 0.5 per cent of GDP or more for the year under consideration, or an average deviation of 0.25 per cent of GDP over two years.

## GLOSSARY<sup>73</sup>

**Automatic stabilisers:** Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

**Budget balance:** The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses General Government aggregates.

**Cyclical component of budget balance:** That part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap.

**Discretionary fiscal policy:** Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of automatic stabilisers.

**Excessive Deficit Procedure (EDP):** A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State.

**Expenditure rules:** A subset of fiscal rules that target (a subset of) public expenditure.

**Fiscal consolidation:** An improvement in the budget balance through measures of discretionary fiscal policy, either specified by the amount of the improvement or the period over which the improvement continues.

**General Government:** As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the excessive deficit procedure, the General Government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

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<sup>73</sup> These definitions are taken directly from the European Commission. See European Economy, Occasional Papers 151, May 2013, *Vade Mecum on the Stability and Growth Pact*.

**Maastricht reference values for public debt and deficits:** Respectively, a 60 per cent General Government debt-to-GDP ratio and a 3 per cent General Government deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union.

**Medium-Term Budgetary Framework:** An institutional fiscal device that lets policy makers extend the horizon for fiscal policymaking beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under Medium-Term Budgetary Frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

**Medium-Term Budgetary Objective (MTO):** According to the reformed *Stability and Growth Pact*, stability programmes and convergence programmes present a Medium-Term Objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms.

**Minimum benchmarks:** The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the Medium-Term Budgetary Objectives (MTO).

**One-off and temporary measures:** Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position.

**Output gap:** The difference between actual output and estimated potential output at any particular point in time.

**Potential GDP:** The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

**Primary budget balance:** The budget balance net of interest payments on General Government debt.

**Primary structural budget balance:** The structural budget balance net of interest payments.

**Pro-cyclical fiscal policy:** A fiscal stance which amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the cyclically-adjusted budget balance unchanged over the economic cycle but lets the automatic stabilisers work.

**Public debt:** Consolidated gross debt for the General Government sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

**Sovereign bond spread:** The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

**Stability and Growth Pact (SGP):** Approved in 1997 and reformed in 2005 and 2011, the *SGP* clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The *SGP* consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997).

**Stability programmes:** Medium-term budgetary strategies presented by those Member States that have already adopted the Euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*.

**Stock-flow adjustment:** The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

**Structural budget balance:** The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance.

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