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).