Irish Fiscal Advisory Council

Fiscal Assessment Report

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Introduction

This Fiscal Assessment Report is the second assessment report of the Irish Fiscal Advisory Council. The report assesses the macroeconomic and budgetary projections set out by the Government in *Budget 2012*, including the appropriateness of the overall fiscal stance over the period to 2015, in advance of the Stability Programme Update (SPU) which will be published in April.

Macroeconomic Assessment

The Irish economy grew by an estimated 0.7 per cent in Gross Domestic Product (GDP) terms in 2011, although it contracted in the second half of the year. The return to positive annual growth for the first time since 2007 was helped by a robust export performance, as domestic demand contracted further.

In *Budget 2012*, the Department of Finance projected real GDP growth of 1.3 per cent for this year together with average annual real GDP growth of 2.8 per cent for the period 2013 to 2015. In the Council's view, the macroeconomic projections in *Budget 2012* were broadly appropriate at the time of publication. However, the latest economic data and more recent external growth projections suggest that the Department of Finance's real GDP forecast for 2012 is now on the high side. The high degree of uncertainty in the global economy, particularly in the Euro Zone, means that prospects for Irish exports and domestic demand for this year are now more muted than was the case when the Budget was published. This has been reflected in the more recent forecasts of other agencies where growth prospects for 2012 have been revised downwards. These downward revisions have been a feature of recent forecasts for Ireland. While the Council shares the emerging consensus that growth in 2012 will now be lower than that envisaged in *Budget 2012*, it is difficult at this early juncture to assess the extent of the shortfall.

For the period 2013 to 2015, there is an unusually high degree of uncertainty surrounding Irish growth prospects. This partly reflects unknowns relating to possible external developments. In addition, from a domestic perspective, the behavioural dynamics – of households, investors and financial institutions – in the "post-bubble" Irish economy are quite some way from being understood at this stage. Some time is likely to be required before the implications of these elements can be fully factored into a more solidly based assessment. Against this background, the Council is of the view that it would be helpful if the presentation of forecasts were to give greater prominence to uncertainty and include a clear assessment of the overall balance of risks. This could be done through the use of error bands around forecasts as well as a more detailed assessment of alternative short- and medium-term scenarios.

Budgetary Assessment

The latest information suggests an estimated underlying General Government deficit of approximately 10 per cent of GDP in 2011, which is in line with the Budget and *SPU* projections. All quarterly fiscal targets under the EU/IMF programme in 2011 were complied with, despite the contraction in the economy in the second half of the year. The end-2011 Exchequer deficit was about €300 million better than had been anticipated in the Budget.

Budget 2012 involved a consolidation package of €3.8 billion, with €3.2 billion in new tax and expenditure measures aimed at achieving a General Government deficit target of 8.6 per cent of GDP this year. This adjustment package was higher than had been initially planned in last April's *SPU* (€3.6 billion) and reflected, in part, a weaker outlook for growth. The need for larger fiscal adjustment to meet existing targets had been signalled prior to the Budget in the Council's first assessment report (IFAC 2011).

The main tax change in *Budget 2012* was the increase in the standard rate of VAT. Analysis undertaken by the Council indicates that the Budget projection for VAT receipts in 2012 was broadly appropriate. The macroeconomic outlook for 2012 has weakened since the Budget was published and it now appears that the risks of attaining a General Government deficit of 8.6 per cent of GDP in 2012 are weighed to the downside. This may point to the need for additional fiscal restraint during 2012, although it is too early in the year to provide a firm assessment.

For 2013 to 2015, the broad consensus across official forecasters projects a fall in the General Government deficit to GDP ratio to approximately 3 per cent in 2015. These forecasts take into account the sharp rise in interest expenditures from 2013 onwards, partly due to the ending of the interest holiday on the promissory note issued by the Government. The gross debt to GDP ratio will remain elevated and is expected to peak in 2013 at 119 per cent of GDP. Simulations undertaken by the Council highlight the sensitivity of budgetary forecasts to changes in the macroeconomic outlook. For example, in the event that nominal GDP growth were to end up 1 per cent weaker per annum over the period 2012 to 2015 than envisaged in *Budget 2012*, the debt to GDP ratio would not stabilise by 2015 without additional discretionary measures. In any event, debt levels will remain high over the medium-term and vulnerable to negative growth shocks.

More broadly, the introduction of expenditure ceilings for the years 2012-2014 as part of the 2011 *Comprehensive Expenditure Report* was a significant development in further strengthening the budgetary architecture in Ireland. The recent NTMA bond switch exchange offer has reduced the projected funding requirements in 2014, while a restructuring of the current promissory note arrangement could have a similar positive effect on the public finances. Finally, the size and composition of the Government's balance sheet, and the associated exposure to risk, can have an important impact on the public finances. In this regard, a clear and comprehensive regular assessment of the elements involved is warranted in budgetary and SPU documents.

Assessment of the Fiscal Stance

Policy makers face a clear and unenviable dilemma when choosing the appropriate medium-term fiscal stance. On one hand, more ambitious fiscal adjustment weakens demand and slows the economy. On the other hand, slower fiscal adjustment reduces fiscal sustainability, putting the economy on a higher debt/GDP path. Higher debt levels can be unsafe insofar as they undermine credibility and jeopardise both market and official funding. Such a path can also be unfair in that it pushes burdens to younger generations. There is also a growing body of international evidence that suggests that high debt levels undermine longer-run growth prospects. At the same time, most international evidence, as well as simulations for the Irish economy, do not indicate that the current Irish adjustment path is self-defeating in terms of reducing deficit and debt ratios. There is more uncertainty in the international debate about effects of fiscal adjustment on creditworthiness, although the Irish experience supports the beneficial impact of adjustment on this dimension as well.

The Government's plan to reduce the General Government deficit from approximately 10 per cent of GDP in 2011 to 8.6 per cent of GDP in 2012 was based on a real growth rate of 1.3 per cent in 2012. However, some deterioration in growth prospects since the Budget announcement raises a question mark as to whether this deficit target can be attained with currently planned consolidation measures. Given the continuing fragile nature of Ireland's creditworthiness (despite some recent improvement), it is important that, if necessary, measures be taken to ensure that the General Government deficit target of 8.6 per cent of GDP is adhered to.

As regards 2013-2015, the headline targets for the General Government deficit set out in *Budget 2012* remain within the range of appropriate courses of action. Nevertheless, the Council continues to believe, on balance, that there is a strong argument for greater consolidation than currently envisaged by the Government. This assessment takes into account factors such as the deterioration in the growth outlook, some improvement in Ireland's creditworthiness and the Government's choice of a less ambitious budgetary target for 2012 than that underlying the Council's October 2011 analysis. An alternative adjustment path could involve cumulative additional budgetary adjustments of the order of €2.8 billion compared with those currently envisaged by the Government. Simulations indicate that such an adjustment path would yield a General Government deficit of 1.7 per cent of GDP in 2015 (compared to the Government's target of 2.9 per cent and the Council's October 2011 proposal of 1 per cent) and a primary surplus of 4 per cent of GDP (see Summary Table).

Summary Table:
Alternative General Government Deficit Targets and Discretionary Adjustments

General Government Balance, % of GDP	2012	2013	2014	2015
SPU **(April 2011)**	-8.6	-7.2	-4.7	-2.8
IFAC October 2011 Alternative Adjustment Path	-8.4	-6.4	-3.6	-1.0
Budget 2012 **(December 2011)**	-8.6	-7.5	-5.0	-2.9
IFAC April 2012 Alternative Adjustment Path	-8.6	-7.4	-4.6	-1.7
Assumed Consolidation, € billions				
SPU	3.6	3.1	3.1	2.0
IFAC October 2011 Alternative Adjustment Path	4.4	3.9	3.8	3.7
Budget 2012	3.8	3.5	3.1	2.0
IFAC April 2012 Alternative Adjustment Path	4.2*	3.9	3.8	3.7

*Using *Budget 2012* projections as a benchmark and assuming zero buffers, Council simulations indicate that an additional discretionary adjustment of €0.4 billion would be required to achieve the GGB target of -8.6 per cent of GDP for 2012.

Policies can be considered that aim to preserve credibility while retaining policy flexibility. Assuming shorter-term creditworthiness constraints and programme commitments are not overriding, fiscal consolidation paths could be outlined in terms of discretionary measures, rather than the actual deficit to GDP ratio. Such an approach could lessen the possible downward spiral effects of negative growth surprises and better facilitate the operation of automatic stabilisers.

1. Introduction

The Irish Fiscal Advisory Council was established in June 2011 as part of a wider agenda of reform of Ireland's budgetary architecture. Forthcoming legislation under the Fiscal Responsibility Bill will establish the Council as an independent body on a statutory basis. The role of the Council is to independently assess, and comment publicly on, whether the Government is meeting its own stated targets and objectives, with a mandate to assess the appropriateness and soundness of the Government's macroeconomic forecasts, budgetary projections and fiscal stance. It will also assess compliance with fiscal rules that will be put in place as part of the upcoming Fiscal Responsibility Bill.

A theme of this report is the unusual uncertainty surrounding macroeconomic forecasts and budgetary projections in the post-bubble Irish economy. The need for greater use of techniques such as error bands, fan charts and sensitivity analysis in the medium-run budgetary documents is highlighted. Various additional topics are considered, including: the reliability of VAT forecasts, alternative macroeconomic scenarios and policy options that could allow for a more flexible response to cope with uncertainty.

Chapter 2 assesses the medium-term macroeconomic forecasts set out in *Budget 2012.* More recent forecasts and data on the Irish economy are also examined in this context, as is the pattern of downward growth revisions by the main domestic and international forecasting bodies. The unusual uncertainty surrounding Ireland's medium-term growth prospects is discussed.

Chapter 3 assesses the Government's medium-term budgetary projections, including the outlook for 2012 in light of recent macroeconomic developments. The chapter assesses the Department of Finance VAT forecasts and the fiscal implications of the promissory notes. Recognising the uncertainties surrounding growth prospects, the chapter also assesses the sensitivity of the medium-term projections to changes in the macroeconomic outlook.

Finally, Chapter 4 assesses the appropriateness of the Government's proposed fiscal stance over the period to 2015. The chapter revisits the arguments put forward in the October 2011 *Fiscal Assessment Report*, which at the time argued for stronger fiscal consolidation.

The Council is chaired by Professor John McHale, National University of Ireland, Galway. The other members are Mr Sebastian Barnes, Organisation for Economic Co-operation and Development; Professor Alan Barrett, Trinity College Dublin (on secondment from the Economic and Social Research Institute); Dr Donal Donovan, University of Limerick (formerly of the International Monetary Fund) and Dr Róisín O'Sullivan, Associate Professor, Smith College, Massachusetts. The Secretariat is Diarmaid Smyth (Head of Secretariat), Rachel Joyce and Eimear Leahy. Council members would like to thank the Secretariat for their excellent work in producing this report.

2. Macroeconomic Assessment

2.1 Introduction

A key element of the Council's mandate is to provide an assessment of the macroeconomic projections set out by the Government. The Department of Finance issued three macroeconomic forecasts in 2011: the *Stability Programme Update (SPU)* in April; the *Medium Term Fiscal Statement (MTFS)* in November and *Budget 2012* in December. This chapter reviews the Government's projections underpinning *Budget 2012* in the light of the most recent forecasts of the Economic and Social Research Institute (ESRI), the Central Bank of Ireland (CBI), the Organisation for Economic Co-operation and Development (OCED), the European Commission (EC) and the International Monetary Fund (IMF).

The chapter is structured as follows: Section 2.2 assesses the macroeconomic forecasts for 2012-2015. In Section 2.3, the particularly high degree of uncertainty that surrounds current medium-term growth projections for Ireland is considered. Section 2.4 concludes.

2.2 Macroeconomic Forecasts

In the middle of last year, there was a growing belief that output had at least stabilised. Quarterly National Accounts data had shown positive Gross Domestic Product (GDP) growth in the first two quarters of 2011, a pattern not seen since Q3 2006. However, data for the third and fourth quarters showed that the economy had contracted again. In terms of both Gross National Product (GNP) and GDP, the economy appears now to be back at 2005 levels, with minor oscillations around that level since mid-2009. While the GDP/GNP figures for the latter part of 2011 were disappointing, there was some positive news with regard to employment, with the number employed rising by 10,000 between Q3 and Q4 2011 on a seasonally adjusted basis.

The Irish economy of late has, in effect, performed as a dual economy, with the domestic side contracting and the external sector providing the impetus to growth. The highly open nature of the economy implies that growth in Ireland's main trading partners is fundamental in determining overall growth performances. Between the publication of the *SPU* in April 2011 and the Budget in December 2011, the outlook for the US, the UK and the world economy deteriorated significantly (Table 2.1). The most recent IMF *World Economic Outlook* (IMF, 2012b) generally suggests even weaker external growth prospects in the short-term compared to the external assumptions underlying *Budget 2012*. For example, the IMF expects the Euro Zone to contract by 0.5 per cent in

2012, compared to the positive growth of 0.2 per cent that was envisaged in *Budget 2012.* On the other hand, positive employment developments have occurred in the US recently; for example, the numbers employed grew by over 227,000 in February 2012 (Bureau of Labor Statistics, 2012).

Table 2.1: External Assumptions: % Growth in GDP

2012	***SPU***	***Budget 2012***	***WEO Update* Jan 2012**
Euro Zone	1.8	0.2	-0.5
UK	2.3	0.5	0.6
US	2.6	2.0	1.8
Weighted World GDP	2.1	0.8	0.4
2013	***SPU***	***Budget 2012***	***WEO Update* Jan 2012**
Euro Zone	n.a.	1.4	0.8
UK	n.a.	1.8	2.0
US	n.a.	2.5	2.2
Weighted World GDP	n.a.	1.8	1.4

Note: Weighted World GDP figures based on Council calculations.

2.2.1 Growth in 2011

The Department of Finance's forecast for real GDP growth in 2011 remained relatively unchanged throughout last year at close to 1 per cent. Since the Budget, the Central Statistics Office (CSO) has published estimates for 2011, which point to an annual GDP growth rate of 0.7 per cent. The data also show a marked slowdown in growth in the second half of 2011, particularly in terms of GNP.[1] For the year as a whole, the CSO estimates that GNP in volume terms declined by 2.5 per cent, as against a projected growth rate of 0.4 per cent in the Budget.[2] The major discrepancy between movements in GNP and GDP in 2011 was due to a marked increase in net factor income outflows.[3]

[1] On a seasonally adjusted basis, GDP grew by 1.1 per cent (quarter-on-quarter) in Q1 and Q2 but then declined by 1.1 per cent in Q3 and by 0.2 per cent in Q4. The corresponding figures for GNP are -3.8, 0.7, -1.9 and -2.2 per cent (CSO, 2012a).

[2] The use of GNP rather than GDP may have important implications for the measurement and assessment of fiscal and debt sustainability. The Council intends to consider these issues in a subsequent report.

[3] Net factor income from the rest of the world amounted to -€31.8 billion in 2011 as compared with -€27.3 billion in 2010 (constant market prices).

2.2.2 Growth Forecasts for 2012

The Department of Finance forecast for real GDP growth in 2012 was revised downwards throughout the course of 2011 from 2.5 per cent in the *SPU* to 1.3 per cent in *Budget 2012*. Despite this downward revision, this projection remains higher than the most recent assessments of all of the other main agencies considered here, which range from 0.5 to 1 per cent. Projections for nominal GDP, which are most relevant for budgetary projections, made by the IMF, the EC, the ESRI and the CBI are also lower than those in the Budget (Table 2.2).

There is a consensus that exports will remain the main driver of growth in 2012 and that all three components of domestic demand will decline. As a result, labour market conditions are expected to remain anaemic. Although the Department of Finance envisages employment to contract only slightly, the forecasts of other agencies, particularly the ESRI, are significantly more pessimistic. Prospects for the average unemployment rate across the main forecasting bodies are, however, broadly similar as a result of assumptions on migration and participation.

Notwithstanding the downward revisions to the real GDP growth rate by the Department of Finance, the projections for nominal GDP were in essence unchanged between the *MTFS* in November and *Budget 2012* in December due, in part, to a larger projected change in the GDP deflator in the Budget.[4] The latter partly reflected the assumed impact of the Value Added Tax (VAT) increase in the Budget. More recent forecasts from other agencies have a weaker profile for nominal GDP in 2012; in particular the CBI's forecast is some €2 billion below that of the Budget.

On the basis of the more recent quarterly data, as well as a further recent deterioration in the international economic outlook, it appears that the *Budget 2012* growth projections are now on the high side. This view is shared by other domestic and external forecasting agencies, although it is still relatively early in the year to make a firm assessment.

Forecasts by external agencies of the Irish and world economy for 2012 made around the time of the Budget noted unusually large downside risks to published projections.[5] While *Budget 2012*

[4] In the *MTFS*, the Department of Finance projected a real GDP growth rate of 1.6 per cent in 2012, with a nominal increase of 2.3 per cent. In *Budget 2012*, the projection for real GDP was brought down to 1.3 per cent with nominal GDP growth of 2.5 per cent due to a higher deflator.

[5] This includes the EC, IMF and OECD forecasts for the World and Euro Zone economies and for the Irish economy with the exception of the EC forecast for Ireland in November, where risks were "broadly balanced", although in February

included a discussion of risks and sought to quantify the implications of some individual elements involved, it did not contain an assessment of this aspect. It would be desirable for the macroeconomic projections in the Budget to include, as a matter of course, a more extensive discussion and a clearer assessment of the overall balance of risks.[6]

Table 2.2: Macroeconomic Forecasts 2012

% change unless otherwise stated	Budget	CBI	ESRI	OECD	EC	IMF
	Dec-11	Jan-12	Feb-12	Nov-11	Mar-12	Mar-12
Real GDP	1.3	0.5	0.9	1.0	0.5	0.5
Real GNP	0.7	-0.7	0.1	n.a.	n.a.	n.a.
Consumption	-1.3	-1.5	-1.8	-0.5	-1.6	-1.6
Investment	-1.0	-5.5	-3.3	-2.7	-4.6	-4.5
Government	-2.2	-4.2	-2.5	-2.1	-2.4	-1.9
Exports	3.6	3.9	3.4	3.3	2.8	2.8
Imports	1.6	1.8	1.1	1.2	1.0	1.0
Current Account (% GDP)	1.7	1.9	2.2	1.7	1.6	1.3
Employment	-0.2	-0.6	-1.5	-0.4	-0.8	-1.0
Unemployment Rate (%)	14.1	14.6	14.0	14.1	14.5	14.5
Harmonised Index of Consumer Prices (HICP)	1.9	1.6	1.4	0.8	1.6	1.6
GDP Deflator	1.1	1.2	1.2	0.9	1.4	1.4
Nominal GDP (€ billions)	159.1	157.2	158.0	159.8	158.8	158.8
Nominal GDP	2.5	1.6	2.0	1.9	1.9	1.9

2.2.3 Growth Forecasts for 2013

There is a broad based belief that growth will gain momentum in 2013, due to an improvement in the global economy and a gradual pick up in domestic demand. Such a pattern is consistent with earlier assumptions of an imminent recovery which did not, however, come to fruition.

2012 the EC again revised down its forecasts. The IMF's Fifth Review for Ireland published in February 2012 notes "...significant downside risks from the euro area crisis coupled with domestic vulnerabilities" (IMF, 2012a, p10).

[6] In the *MTFS* there was a chapter discussing risks, but there was no clear conclusion on the balance of risks.

The consensus forecast is for real GDP growth of around 2.0 to 2.4 per cent in 2013, with net exports again considered to be the main positive element. It is generally assumed that real Government expenditures will continue to fall, while some agencies expect that this will be offset by a return to positive consumption growth. There is some disagreement about the prospects for investment with the ESRI and the CBI forecasting a decline (Table 2.3). It is generally expected (with the exception of the ESRI) that employment will grow next year, with the unemployment rate expected to fall by between 0.3 and 0.8 percentage points.

Table 2.3: Macroeconomic Forecasts 2013

% change unless otherwise stated	Budget	CBI	ESRI	OECD	EC	IMF
	Dec-11	Jan-12	Feb-12	Nov-11	Mar-12	Mar-12
Real GDP	2.4	2.1	2.3	2.4	2.0	2.0
Real GNP	1.7	1.0	1.0	n.a.	n.a.	n.a.
Consumption	0.0	0.2	-1.0	0.5	0.5	0.5
Investment	3.2	-0.6	-1.9	2.7	3.0	3.0
Government	-2.2	-2.0	-2.0	-2.2	-1.8	-1.5
Exports	4.5	5.0	3.8	5.8	3.8	3.8
Imports	2.8	3.6	1.6	4.7	2.7	2.8
Current Account (% GDP)	2.5	3.0	3.4	2.2	2.1	1.4
Employment	0.8	0.4	-0.8	0.4	0.7	0.7
Unemployment Rate (%)	13.5	14.1	13.7	13.7	13.7	13.7
HICP	1.4	1.0	1.3	0.9	1.2	1.2
GDP Deflator	1.0	1.0	0.6	1.0	1.2	1.2
Nominal GDP (€ billions)	164.6	162.1	162.6	165.3	164.0	163.9
Nominal GDP	3.4	3.1	2.9	3.5	3.3	3.2

2.2.4 Growth Forecasts for 2014-2015

Expectations for growth in 2014 and 2015 are broadly similar across the main agencies, at around 3 per cent (Table 2.4). There appears to be a broad consensus that although exports will continue to be the driving force, components of domestic demand (with the exception of Government expenditure) will contribute more positively over the medium-term. A further tentative decrease in the unemployment rate is anticipated, as the recovery in the labour market becomes more broadly based.

Table 2.4: Macroeconomic Forecasts 2014 and 2015

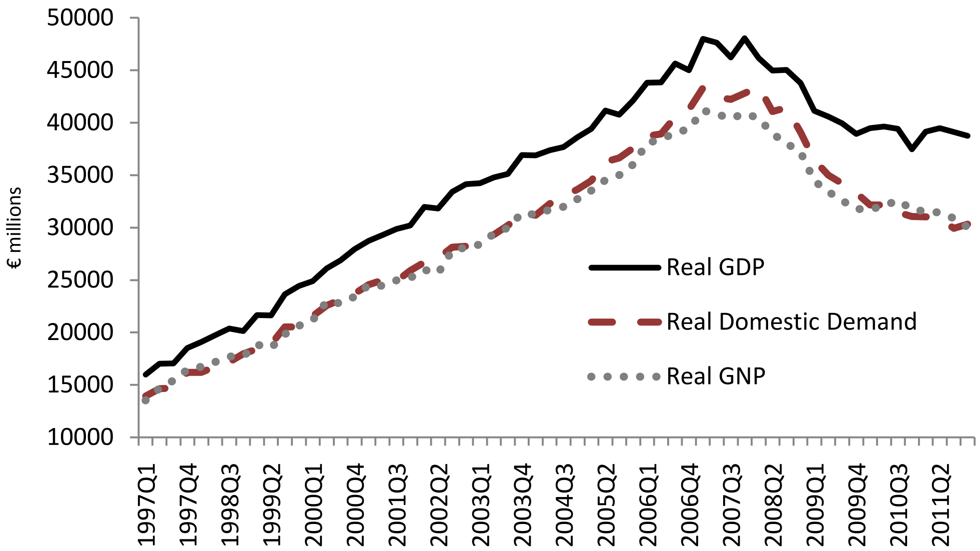
% change unless otherwise stated	Budget		EC		IMF	
	Dec 2011		March 2012		March 2012	
	2014	2015	2014	2015	2014	2015
Real GDP	3.0	3.0	2.7	3.0	2.7	2.9
Real GNP	2.3	2.3	n.a.	n.a.	n.a.	n.a.
Consumption	1.0	1.2	1.8	1.9	1.2	1.5
Investment	4.6	4.8	4.4	5.2	4.3	7.5
Government	-2.3	-2.1	-3.7	-3.2	-1.3	-1.2
Exports	4.8	4.8	4.9	4.9	4.5	4.9
Imports	3.4	3.5	3.8	4.0	3.5	4.5
Current Account (% GDP)	3.3	3.7	2.8	3.3	1.2	1.3
Employment	1.2	1.6	1.4	2.0	1.3	1.7
Unemployment Rate (%)	12.9	11.6	13.0	12.1	13.0	12.1
HICP	1.5	1.9	1.4	1.8	1.3	1.6
GDP Deflator	1.3	1.5	1.5	1.6	1.5	1.7
Nominal GDP (€ billions)	171.6	179.4	171	178.8	170.9	178.8
Nominal GDP	4.3	4.5	4.3	4.6	4.3	4.6

2.3 Unusual Uncertainty: Whither the Irish Economy?

Uncertainty is a constant and unavoidable feature of economic forecasting. Although one can look back at the “Celtic Tiger” phase of Irish economic growth and see a clear underlying trend, it should be remembered that there was significant uncertainty regarding the trend at the time. But even if uncertainty about trend growth is nothing new, ascertaining with confidence medium-term growth prospects is especially challenging for the post-bubble Irish economy.

Figure 2.1 shows the evolution of real quarterly output and domestic demand over the past 15 years. The economy went from a long period of strong growth through the Celtic Tiger and property bubble phases, to a sharp drop in output between 2007Q4 and 2009Q4, followed by a period of generally flat output in GDP terms (and declining domestic demand) since the beginning of 2010. The debate in recent years has been about whether the economy is about to "turn a corner" or will continue to "bounce along the bottom" for some time to come.

Figure 2.1: Evolution of Quarterly Real GDP, Real GNP and Real Domestic Demand (Seasonally Adjusted, 2009 Prices)

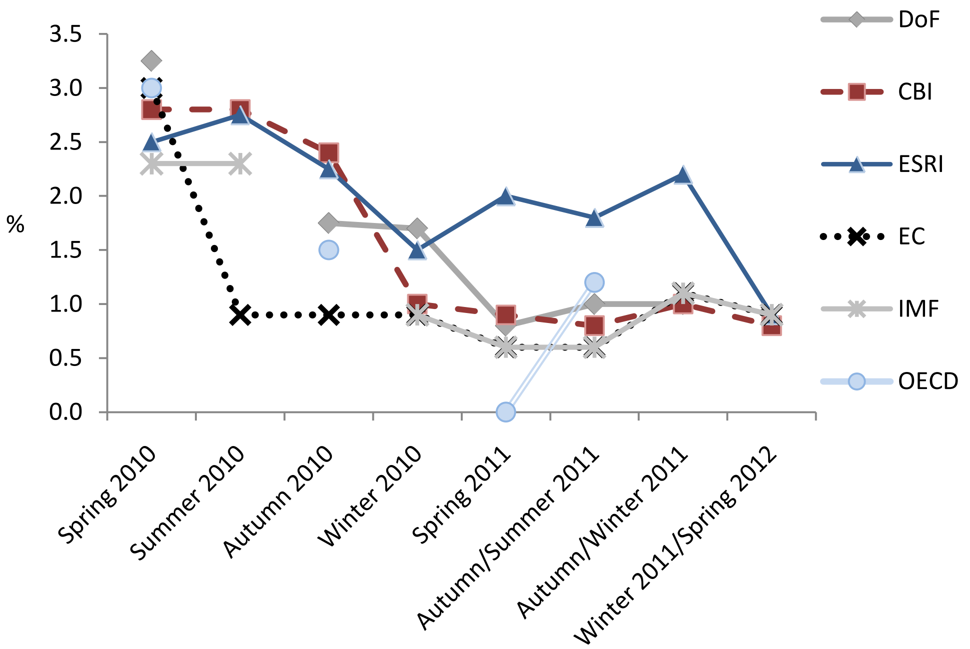


Source: CSO, 2012a.

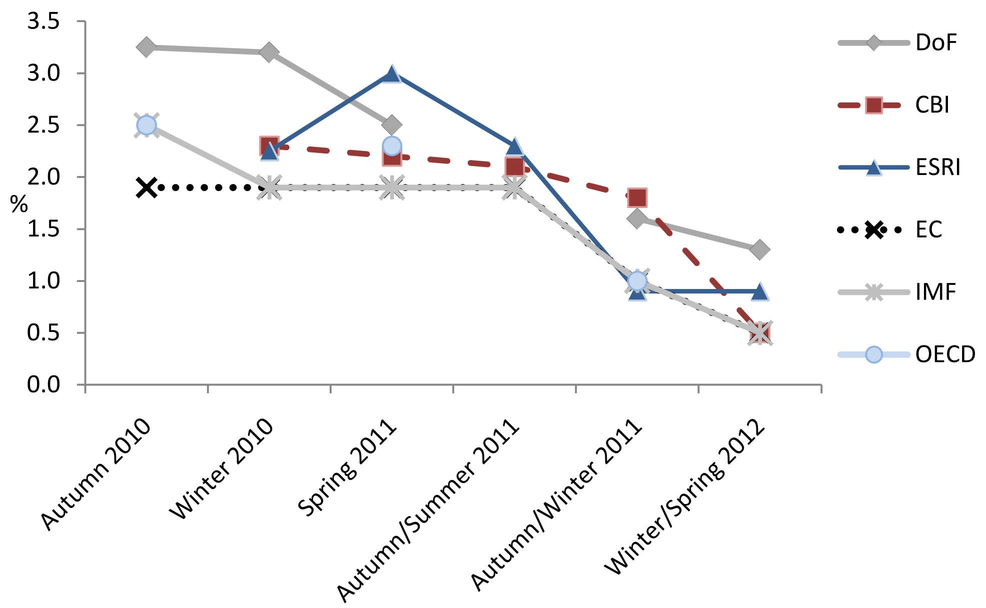
One indication of the uncertainty about the direction of the economy is that growth projections with one- and two-year horizons have been repeatedly adjusted in the same direction in the recent past. Figure 2.2 illustrates the generally downward revision of real GDP growth projections for 2011 and 2012 by the main forecasting agencies. However, the horizon has been continuously pushed outwards. While partly due to a slower than expected external recovery, this may point to significant difficulties in understanding and analysing the dynamics of the Irish economy at this juncture.

Figure 2.2: Revisions to 2011 and 2012 Real GDP Growth Forecasts

a. Revisions to 2011



b. Revisions to 2012



In considering growth prospects, it is useful to distinguish between three sources of uncertainty. First, there is unusual uncertainty about the size of the current output gap (or equivalently the current level of potential output). The bursting of the property bubble has led to substantial downward revisions in estimates of potential output. This creates uncertainty about the level of aggregate demand that the Irish economy could sustain without inflationary pressures and other macroeconomic imbalances building up. At present, the IMF estimates Ireland's 2012 output gap at approximately -5.7 per cent; this compares with a Department of Finance estimate (using the standardised EC methodology) of -2.3 per cent. These estimates are undoubtedly subject to large error bands.

Second, there is unusual uncertainty about the rate at which the output gap will be closed through growth in aggregate demand. International evidence suggests that countries grow slowly after a financial crisis (Reinhart and Rogoff, 2009). This reflects, in part, the demand-reducing effects of impaired balance sheets, as households and businesses struggle to repair their financial positions (Koo, 2011). In this context, two factors particularly prevalent in Ireland are the high levels of household debt and the extent to which net worth has fallen since the recession began.[7] These are likely to have a large effect on consumption but have yet to be quantified precisely for Ireland.[8] Much of the fall in net worth is driven by the collapse in the housing market; house prices declined by 49 per cent since their peak in 2007 (CSO, 2012b). These demand effects can be compounded by weak credit growth, as banks are themselves forced to deleverage, and may shift from the relaxed standards that characterised the boom to excessive caution in the recession. Furthermore, in the case of funding productive investments in the small and medium sized enterprises (SME) sector, there is concern that the skills needed to assess investment proposals may have disappeared from Ireland's banks during a period when so much lending was directed towards property.[9]

[7] Although the value of household liabilities has declined steadily since late 2008, real disposable incomes have also fallen meaning that the leverage ratio has remained relatively constant since 2010. Overall household net worth has fallen by 35 per cent from its peak in Q2 2007 (Central Bank of Ireland, 2012b).

[8] Hogan and O'Sullivan (2007) examined the link between private consumption and housing wealth in Ireland using data from 1970 to 2003. They found that over the period the propensity to consume out of housing wealth was generally zero. However, they noted that there may be an asymmetry in the consumption and saving behaviour of households. Moreover, the size of the recent decline in housing wealth has been far greater than what occurred during the authors' sample period. The authors also noted that evidence from elsewhere suggests that consumption reacts more strongly when house prices are declining than when prices are rising.

[9] The CSO Access to Finance survey showed that enterprises that applied to banks for a loan in 2007 were successful in 95 per cent of cases, while in 2010 the success rate dropped to 55 per cent (CSO, 2011).

Third, in the aftermath of the property bubble there is unusual uncertainty over the trend growth of potential output itself. Of course, the long-run prospects for the Irish economy were subject to considerable debate even before the crisis. Barry (2006) emphasised the “regional economy” nature of the Irish economy, with its unusual openness to capital and labour flows. Such economies can avoid the resource constraints that limit potential growth prospects in more closed economies. However, they may also be subject to greater output variability and be more sensitive to global growth performance. On the other hand, Whelan (2010) points out that Ireland’s potential for rapid catch-up growth was largely exhausted even before the crisis, making it difficult to grow consistently at rates above the roughly 2 per cent level that characterises mature industrial economies.

A key element in Ireland’s growth prospects is the path of foreign direct investment (FDI). This continues to be a vital source of growth for the Irish economy as evidenced by some recent positive announcements. However, it cannot be taken for granted in the medium-term. Competition from other countries, ongoing EU-level discussions regarding the possible introduction of a common consolidated corporate tax base (CCCTB) and tax initiatives from the US administration aimed at increasing the taxation of US multinationals could pose a multitude of challenges. That said, Barry and Bergin (2010) emphasise that Ireland is relatively well positioned due to the sector composition of the multinational presence in the economy, especially in the areas of information/communication technology, pharmaceuticals and international financial services.

The unusual level of uncertainty surrounding growth prospects underlines the need to improve the transparency of official forecasts. The Council urges that additional information be provided on error bands around central forecasts. This would also be useful as a basis for undertaking sensitivity analysis for associated budgetary projections (see Chapter 3). This could include so-called “fan charts” which show the probability of a range of outcomes.[10]

2.4 Conclusions

In the Council’s view the macroeconomic projections set out by the Government in *Budget 2012* were broadly appropriate at the time. However, the latest economic data and most recent external growth projections that have subsequently become available suggest that the Department of Finance’s real GDP forecast for 2012 is now on the high side. Given the very high level of

[10] See Cronin and Dowd (2011) for one application of this technique for Ireland.

uncertainty in the global economy, particularly the Euro Zone, prospects for Irish exports and domestic demand in 2012 are now muted; this has been reflected in the more recent forecasts of other agencies. The Council shares the emerging consensus that growth in 2012 will now be lower than was envisaged in *Budget 2012*, although it is difficult at this early juncture to assess the extent of the shortfall.

As regards the medium-term outlook, there is an unusually high degree of uncertainty surrounding Irish growth prospects. This partly reflects unknowns relating to possible external developments. However, the behavioural dynamics - of households, investors and financial institutions - in the "post-bubble" Irish economy are quite some way from being understood at this stage. Some time is likely to be required before the implications of these elements can be fully factored into a more solidly based assessment.

Given such uncertainties, it would be helpful if the presentation of macroeconomic forecasts were to give greater prominence to including a clearer assessment of the overall balance of risks involved.

3. Budgetary Assessment

3.1 Introduction

This chapter considers the outlook for the public finances, including an assessment of the latest forecasts from the Department of Finance set out in *Budget 2012*. The underlying General Government deficit in 2011 now looks likely to be just under 10 per cent of GDP.[11] The Budget forecasts a further improvement in the deficit for 2012 (8.6 per cent). However, as discussed in the preceding chapter, conditions have become less favourable since the Budget was published, mainly reflecting concerns over the outlook for growth. This suggests that a careful assessment of the prospects for attaining the 8.6 per cent budget deficit target is warranted.

The chapter is structured as follows. The outturn for the public finances in 2011 is briefly discussed in Section 3.2. In Section 3.3, the main policy measures of *Budget 2012* and the central forecasts for 2012 are discussed. Section 3.4 examines the outlook for the period 2013 to 2015. Given the uncertainty surrounding the Irish growth outlook at present, Section 3.5 considers some alternative growth scenarios and the associated implications for the public finances. In Section 3.6, some aspects of Government debt are discussed. Section 3.7 concludes.

3.2 Budgetary Outturn in 2011

The public finance outturn in 2011 on a General Government basis was close to Department of Finance expectations. The *Stability Programme Update* (*SPU*) had projected a General Government deficit of 10 per cent of GDP for 2011, whereas the *Budget 2012* estimate was for a deficit of 10.1 per cent, below the 10.6 per cent EU/IMF programme deficit ceiling. In comparison, both the EC and the IMF in their most recent forecasts estimated a deficit of 9.9 per cent of GDP. Furthermore, all quarterly fiscal targets under the EU/IMF programme were achieved.

On the revenue side, the budgetary outturn was helped by a significant increase in tax revenues last year, in part reflecting the effects of the Universal Social Charge (USC) reclassification and measures emanating from the Jobs Initiative Pension Fund levy.[12] Excluding the USC, taxes on an

[11] The General Government deficit in 2010 was 31.3 per cent of GDP. The underlying deficit in 2010 was approximately 11.5 per cent of GDP according to the *MTFS*.

[12] Note that the data referenced here is on an Exchequer basis as complete General Government data for 2011 was not available at the time of writing. The USC replaced the income and health levy, and receipts from the USC are now collected as part of income tax. The health levy had previously been collected as a departmental receipt rather than a tax receipt.

Exchequer basis were up 0.8 per cent in 2011 (or 7.2 per cent with no adjustments). However, there is a concern arising from the weakening in tax receipts as a whole in the second half of 2011.

On the expenditure side, the health levy reclassification associated with the USC distorted the "headline" expenditure figures. Total voted expenditure declined by 1.6 per cent in 2011, although the USC adjusted figure indicated a larger decline in voted spending of 5.7 per cent compared with the previous year. The fall in spending reflected further significant declines in capital expenditure. Interest expenditures, however, increased sharply in 2011, with the costs of servicing the national debt increasing by over €1 billion to reach close to €5.4 billion.

Following the Budget, the end-year Exchequer returns were about €300 million better than had been anticipated, mainly reflecting savings on the expenditure side.[13] The March 2012 Maastricht returns, which will be published in April 2012 will provide updated General Government deficit and debt outturns for 2011.[14] The current estimate is for an underlying General Government deficit in 2011 of approximately 10 per cent.

General Government (including the National Pension Reserve Fund) made capital injections of €17.6 billion into Allied Irish Bank, Bank of Ireland and Irish Life and Permanent in 2011. To date, these injections have not been recorded in the General Government balance. However, some of these injections are likely to be reclassified as a deficit-impacting capital transfer and so will affect the "headline" balance. The March 2012 Maastricht returns will record a judgement on this, and will be published by Eurostat and the Department of Finance later this month. The Excessive Deficit Procedure (EDP) targets set by Ecofin exclude the effect of bank support measures, and so any reclassification will not necessitate additional fiscal adjustments to meet the targets.

3.3 Budgetary Outlook for 2012

3.3.1 *Budget 2012*

The main budgetary projections underlying *Budget 2012* are shown in Table 3.1. The headline consolidation package of €3.8 billion presented in *Budget 2012*[15] was €0.2 billion higher than

[13] *Budget 2012* had estimated an end-year Exchequer deficit of €25.2 billion for 2011, whereas the actual outturn was €24.9 billion. The Exchequer deficit in 2011 was heavily affected by banking related payments of €9.6 billion. If the impact of banking related expenditure is excluded, the 2011 deficit was €2.7 billion lower than in 2010.

[14] Maastricht returns are submitted to Eurostat by each Member State twice a year, at end-March and end-September.

[15] If account is taken of the carryover effects from the USC, the adjustment increases to approximately €4.3 billion.

originally planned in the previous Budget and in the *SPU*. The need for additional consolidation to meet the 2012 deficit target had been raised by the Council in the October 2011 *Fiscal Assessment Report*, partly on the basis of a weaker outlook for nominal GDP. Furthermore, the *Medium-Term Fiscal Statement* (*MTFS*) signalled the need for greater consolidation for both 2012 and for the period to 2015 compared with the *SPU*. The *MTFS* indicated a requirement for €12.4 billion in adjustment rather than €11.8 billion over the period 2012-15 in order to attain a General Government deficit of less than 3 per cent of GDP.

Table 3.1: *Budget 2012*: Key Aggregates to 2015

€ billions	2011	2012	2013	2014	2015
General Govt. Deficit	15.6	13.7	12.4	8.5	5.2
Gross Debt	166.1	183.0	195.8	202.5	206.3
Exchequer Deficit[16]	24.9	18.9	14.1	10.2	7.0
Exchequer Deficit excl. banking measures	15.3				
Nominal GDP	155.3	159.1	164.6	171.6	179.4
Nominal GDP Growth (% change)	-0.5	2.5	3.4	4.3	4.5
% of GDP					
General Govt. Deficit	10.1	8.6	7.5	5.0	2.9
Gross Debt	107	115	119	118	115
Primary Deficit	6.7	4.4	1.9	-0.8	-2.8
Exchequer Deficit	16.0	11.9	8.6	5.9	3.9
Structural Deficit	8.6	8.0	7.1	5.3	3.7
Memo items:					
Assumed Discretionary Fiscal Adjustment	5.3	3.8	3.5	3.1	2.0
Average Interest Rate (%)	3.6	4.0	5.1	5.1	5.0

Source: *Budget 2012* and end-year Exchequer returns.

The tax and expenditure measures announced in the Budget are summarised in Table 3.2. Broadly speaking, these entailed new consolidation measures of €3.2 billion, consisting of €1.0 billion from taxation and €2.2 billion from expenditure measures, together with carryover effects of €0.6

[16] The figure for the Exchequer Deficit in 2011 is from the end-year Exchequer returns rather than the Budget figure which was €25.2 billion.

billion. This implied a total consolidation of €3.8 billion. On a General Government basis, total revenue is projected to be approximately €54.9 billion in 2012 (up from an estimated €54.2 billion in 2011), with overall expenditure this year projected to be approximately €68.6 billion (compared to an estimated €69.7 billion in 2011).[17]

Table 3.2: *Budget 2012*: New Measures

€ billions		2012
Revenue	VAT	0.6
	Excises	0.2
	Other Taxes (including Household Charge)	0.2
	Total	**1.0**
Expenditure Savings	Current	1.4
	Capital	0.8
	Total	**2.2**
New Budget Measures	**Total**	**3.2**

Source: *Budget 2012*.

The capital programme was reduced by a further €0.8 billion with current expenditure reductions of €1.4 billion. The latter is facilitated by further reductions in public service numbers, as part of the Government's commitment to reduce the size of the public service to 282,500 by end-2015. Most of the current expenditure savings were targeted in the three biggest departmental areas: Health, Education and Social Protection, which together accounted for approximately 84 per cent of all voted current expenditure in 2011.

On the taxation side, the major change was the increase in the standard VAT rate from 21 per cent to 23 per cent which was projected to yield approximately €0.6 billion in 2012. The projected revenue yield arising from the VAT rate increase was the subject of considerable debate following the Budget. However, analysis undertaken as part of this report suggests that the Budget's projections for VAT were broadly appropriate (see Box A). The other main tax changes amounted to approximately €0.4 billion, and included the introduction of the household charge and changes to excise duties and capital taxes. Overall, following *Budget 2012*, taxes on an Exchequer basis are

[17] Based on *Budget 2012.* General Government Revenue includes tax revenue, social contributions, property income and other smaller revenue items.

projected to increase by 4.8 per cent this year, as against a 4.1 per cent pre-Budget projection (which did not include the impact of the new policy measures).[18]

Box A: Forecasts for VAT from *Budget 2012*

Introduction

The major discretionary tax change in Budget 2012 was the 2 percentage point increase in the standard VAT rate from 21 per cent to 23 per cent, with effect from 1 January 2012. VAT is the second largest of the major tax heads and this rate change attracted considerable attention.[19]

VAT Announcements in 2012

The standard VAT rate increase was projected in *Budget 2012* to yield €560 million in 2012, accounting for just over half of the €1.0 billion in announced new tax measures.[20] These numbers refer to the "static" impact of the tax measures – that is, the impact assuming no change in consumer or business behaviour.[21] The other major VAT change for 2012 arises out of the May 2011 Jobs Initiative (JI) and its introduction of a temporary second reduced rate of VAT of 9 per cent. This temporary measure was estimated to cost an additional €230 million in 2012, once again on a static basis.[22] These two VAT changes give a static €330 million increase in projected VAT revenue for this year, all other things being equal. The actual VAT increase projected in the Budget, however, was €265 million. The €65 million difference between this number and the static estimate captures, among other things, any impact of the higher tax rate on the tax base and other judgemental factors.

VAT Forecasting Approach

The Department of Finance forecasts VAT receipts using a standard tax forecasting equation which links VAT to the growth in nominal personal consumption expenditure:

[18] On the broader General Government basis, taxes are projected to increase by 3.8 per cent in 2012.

[19] See Dáil Éireann Debate, Reference: 40236/11, 14 December 2011.

[20] The full year effect was estimated at €670 million, which reflects the fact that VAT receipts in the early part of 2012 relate to purchases made (at a lower rate of VAT) in late 2011.

[21] A separate figure of -€775 million in the Budget captures the buoyancy effect of all new budgetary measures, including the impact of the VAT rate increase on nominal personal consumption expenditure that constitutes the tax base for VAT.

[22] The full year effect of this measure in 2012 was estimated to be €350 million whereas the effect in 2011 was estimated to be €120 million. This gives an estimated marginal effect of €230 million in 2012.

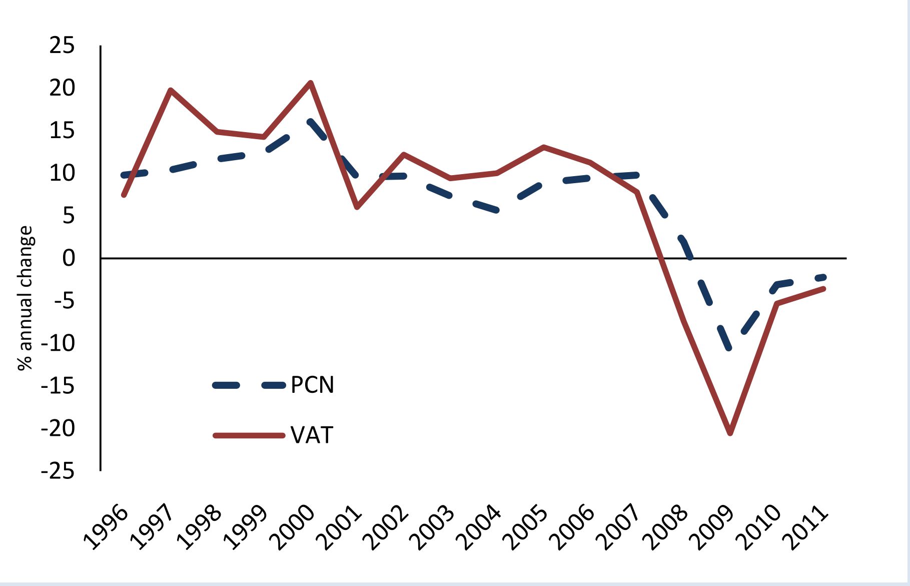
$$VAT_t = (VAT_{t-1} - T_{t-1}) * ((1 + dPCN_t) * E) + M_t + J_t$$

where VAT_t is the VAT take in year *t*, T_{t-1} are one-off items affecting the VAT yield in year *t-1*, $dPCN_t$ is the projected growth rate in nominal personal consumption expenditure in year *t*, *E* is the elasticity between VAT revenue and the tax base, assumed to be 1, M_t is the estimated static yield from any changes in tax policy affecting receipts in year *t* and J_t can be viewed as a judgemental factor in year *t* and could reflect items not easily captured in a standard tax equation.

The key factors driving the VAT take are the outturn for the previous (or outgoing) year, which is adjusted for one-off factors, and the forecast for growth in the tax base (nominal personal consumption expenditure). Any impact of the change in the tax rate on the tax base would be reflected in the estimate for *dPCN*.

Linking projected VAT revenue to the evolution of a consumption-based macroeconomic aggregate is a standard approach to tax forecasting. Apart from some decoupling of the series between 2006 and 2008 due to property market developments, Figure A.1 shows a reasonably close correlation between the growth rates in nominal personal consumption expenditure and VAT receipts.

Figure A.1: Nominal Personal Consumption and VAT Receipts



Source: CSO and Department of Finance Exchequer Statements.

Given that VAT applies only to some components of consumption and applies at different rates to those components, the relationship between VAT revenue and personal consumption may vary over time, especially in the face of budgetary changes to VAT rates. The question arises therefore as to whether an elasticity factor of 1 is an appropriate approximation of this relationship. One way to gauge this is to look at recent VAT revenue forecasting performance. Overall tax forecasting errors in Ireland have not been out of line with international experience and VAT projections produced by the Department of Finance had the lowest forecast error of all of the major taxes over the period 1999-2006.[23] This suggests that the current elasticity assumption is not unreasonable.

Assessing the *Budget 2012* VAT Projection

The Budget forecast a 2.7 per cent increase (€265 million) in VAT receipts in 2012 to €9,995 million (Table A.1). To assess this forecast, the Council first calculated a VAT revenue projection for 2012 based on the forecasting equation presented above, the available estimate at the time of the Budget for the end-year 2011 VAT outturn, the projected growth in the tax base (using data underlying *Budget 2012*) and the effects of the static budgetary measures. The judgemental factor, J_t, was set to zero.

At the time of the Budget, the VAT outturn for 2011 was not known and so the estimate of €9,730 million available at the time (compared with an outturn of €9,741) was used as an input into the Council's calculation. To calculate the nominal growth in personal consumption expenditure for 2012, the data underlying *Budget 2012* giving a volume decline in personal consumption expenditure of 1.3 per cent and a deflator of 1.7 per cent were taken.[24] Finally, approximately €330 million was included to account for the static impact of

[23] A recent paper by Buettner and Kauder (2010) compares tax forecast errors across a group of 12 OECD countries and shows that Ireland's relative performance was reasonable over the 10 years to 2009. A paper prepared by the Tax Forecasting Methodology Review Group (2008) finds that over the period 1999-2006, the average Root Mean Square Error (RMSE) for overall adjusted tax projections was 5.9 per cent, whereas the VAT error was 4.6 per cent. The report attributed a significant portion of the overall tax error to large errors in capital taxes relating to property market developments. An earlier IMF study found that the overshooting of tax revenue compared to forecasts in Ireland largely arose due to stronger than expected economic growth and that the Department of Finance growth forecasts were similar to those of other institutions at the time (IMF, 2005). Overall, the evidence indicates that the Department of Finance's VAT forecasting performance has been reasonable.

[24] These forecasts compared with the *MTFS* estimates of a volume decline of 1.0 per cent in personal consumption, with a deflator of 1.1 per cent.

the new VAT measures announced in the JI and *Budget 2012* discussed above. No other temporary factors were included.[25]

Table A.1 contains the outcome of the Council's exercise and includes the Budget estimate for comparison. Using the approach described above gives a projected VAT yield of €10,096 million, a number that is approximately €100 million or 1 per cent higher than the Budget estimate. The difference in the projected revenue increase may reflect a number of factors: possible differences in the tax base growth figure used by the Council versus that used in the official forecast, which may include some adjustments; any judgemental factors included in the Budget forecast; or any unpublished information on expected VAT yields and factors not captured by a relatively simple equation. This exercise confirms that the VAT revenue increase of €265 million forecast in the Budget is consistent with this standard approach to forecasting.

A key element of the forecast is whether the estimated impact of the VAT rate change on nominal personal consumption expenditure growth is reasonable. Ideally, a measure of the elasticity of the tax base to the tax rate could be calculated by looking at the change in the projected growth in nominal personal consumption expenditure after the announced change in the VAT rate. This exercise is complicated, however, by the fact that the change in the available *dPCN* number reflects more than just the VAT change. For example, the change in the projected growth in both nominal and real personal consumption expenditure between the *MTFS* and the Budget incorporates changes in general macroeconomic conditions and possible balance sheet repair activities of households.

Since *Budget 2012*, the CBI published a forecast for nominal personal consumption growth of 0.1 per cent in 2012 (CBI, 2012). Table A.1 shows that using this forecast instead for *dPCN* but maintaining all other *Budget 2012* assumptions gives a projected VAT take of €10,066 million in 2012, a figure that is closer to, although still higher than, the *Budget 2012* projection. As an alternative cross-check, it is useful to look at the *dPCN* rate implied by the Budget VAT projection for 2012 using the forecasting equation and keeping all other elements the same. The resulting growth rate of 0 per cent compares to a 0.4 per cent projected increase in the Budget. This suggests that the Budget number includes some

[25] Although the JI measure is temporary, its marginal impact for 2012 was included in *M* for simplicity.

modest adjustments for judgemental factors and other information not captured by the standard equation above.

Table A.1: VAT Forecast for 2012

€ millions	2011	2012	Change
***Budget 2012* Estimate**	9,730	9,995	265
IFAC Estimate using Budget dPCN	9,730	10,096	366
IFAC Estimate using CBI dPCN	9,730	10,066	336

Source: *Budget 2012* and Council calculations.
Note: Rounding may affect totals.

Conclusions

The Budget day forecast for VAT based on the information available at that time appears to have been constructed in a reasonable manner. The forecasting equation used is standard, VAT forecast errors have not been unusually large by international standards and estimating the VAT take using an alternative estimate for nominal personal consumption growth from the CBI gives rise to a projected VAT yield for 2012 that is quite close to the *Budget 2012* forecast.

There are a number of issues that arise, however, in particular surrounding the need for improved transparency. For example, the extent to which the increase in VAT (or other budgetary measures) affects the forecast for nominal personal consumption expenditure and other macroeconomic aggregates is not clear. Ideally, a pre- and post-Budget forecast should be published for key macroeconomic aggregates and information should be provided on the extent to which these changes are driven by specific factors. The Department of Finance does publish a figure for the aggregate buoyancy effect of the total new Budget measures on the tax take (see footnote 21) but it would be useful if more information were available about the construction of this aggregate.

3.3.2 Possible Outturn for 2012

In Chapter 2 it was noted that the macroeconomic outlook for 2012 has deteriorated over the past few months with significant uncertainty surrounding medium-term economic prospects. It is useful to consider what the budgetary outturn for 2012 might be given lower GDP growth forecasts. This is done using a fiscal feedback model which was developed by the Council in order to replicate the baseline projections from *Budget 2012*.[26] This model, which allows for a two-way simultaneous relationship between nominal GDP growth and the primary deficit, is based on standard assumptions for key budgetary parameters. The growth assumptions can be changed in order to trace through the main impacts on key budgetary aggregates.

The most recent forecasts from the IMF and the EC project a 2011 General Government deficit of 9.9 per cent as compared with a Budget day estimate of 10.1 per cent. However, both agencies have lower nominal GDP growth forecasts for 2012 (1.9 per cent) than *Budget 2012* (2.5 per cent) (see Table 3.3). The model is used to explore the combined impact of the improved starting point (assuming the better than projected fiscal outturn for 2011 is carried forward into 2012) and the lower forecast for nominal growth. This simulation indicates a budget deficit of 8.8 per cent of GDP in 2012 (Table 3.4) which is only slightly higher than that forecast in *Budget 2012*.[27]

Table 3.3: General Government Forecasts for 2012

% of GDP	***Budget 2012***	**IMF**	**EC**	**OECD**	**ESRI**
	Dec-11	**Mar-12**	**Mar-12**	**Nov-11**	**Feb-12**
Overall Balance	-8.6	-8.6	-8.6	-8.7	-8.6
Revenue	34.5	34.5	35.5	35.4	n.a.
Expenditure	43.1	43.2	44.1	44.1	n.a.
Primary Balance	-4.4	-4.5	-4.4	-4.5	n.a.
Debt	115	113.7	113.1	112.9	115
Nominal GDP Growth (% change)	2.5	1.9	1.9	1.9	2.0

Note: The Central Bank of Ireland does not publish General Government forecasts.

Although the above model implies a deficit outcome for 2012 larger than that of the Budget, in view of the margins of error and the uncertainty involved, caution is needed before drawing any firm conclusions. For example, the revenue forecast in the Budget may reflect a prudent approach to allow for possible slippages.[28] Furthermore, there may be scope for restraining certain

[26] For more details on this model IFAC (2011).

[27] The calculations are based on *Budget 2012* numbers but are updated for the latest EC and IMF forecasts and end-2011 Exchequer returns.

[28] It should also be noted that the European Commission (2012) stated that there were "....some buffers present in the Budget" for Ireland.

expenditures (such as the pace of outlays on capital projects) as the year progresses. Funding costs might also turn out to be lower than forecast.

Table 3.4: Simulation of Impacts of Revised 2011 General Government Deficit and Revised Nominal GDP Growth Forecasts

% of GDP	2011	2012	2013	2014	2015
Nominal GDP (IMF Mar-12)	-0.5	1.9	3.2	4.3	4.6
Gross Debt	106.8	115.7	120.2	119.5	116.6
Primary Deficit	6.6	4.6	2.2	-0.5	-2.6
General Government Deficit	9.9	8.8	7.8	5.3	3.2
Memo Items:					
Assumed Fiscal Adjustment, € bn	-5.3	-3.8	-3.5	-3.1	-2.0
Implicit Interest Rate (%)	3.6	4.0	5.0	5.1	5.1

Source: Council simulations.

Notes: The adjustment for 2012 includes a carryover of €0.6 billion from 2011 measures. The carryover from the USC is assumed to be included in the base projections (i.e., it is not assumed to be part of the additional discretionary measures undertaken for 2012). The IMF nominal GDP growth rates are taken for the period 2012-15.

3.4 Budgetary Outlook 2013-15

3.4.1 Main Fiscal Aggregates

The main fiscal forecasts for 2013-2015 are set out in Table 3.5. *Budget 2012* envisages a major improvement in the public finances over this period, with the deficit falling to below 3 per cent of GDP by 2015. The projections are premised on a sustained upturn in nominal and real growth rates over the period and additional budgetary consolidation of €8.6 billion.

The profiles for the deficit and debt (relative to GDP) in *Budget 2012* are close to those in last April's *SPU*, although the General Government deficit is now higher in 2013, 2014 and marginally higher in 2015. Importantly though, the amount of consolidation over the period was adjusted upwards from an initially planned €11.8 billion between 2012 and 2015 to €12.4 billion in the Budget (and prior to that, the *MTFS*). The Department of Finance's outlook for 2013-15 is similar to that of the EC and the IMF.

A key feature of the public finances from 2013 onwards is the sharp rise in interest expenditures, which are projected to double from €5.1 billion in 2011 to €10.2 billion in 2015. This reflects the financing of the accumulating Budget deficits as well as the end of the promissory note interest holiday (see Box B).[29]

Table 3.5: Fiscal Outlook 2013 to 2015

General Government Balance (% of GDP)	2013	2014	2015
Budget 2012 **(Dec-11)**	-7.5	-5.0	-2.9
IMF (Mar-12)	-7.5	-5.0	-3.0
EC (Mar-12)	-7.6	-4.8	-3.0
General Government Debt (% of GDP)			
Budget 2012	119.0	118.0	115.0
IMF	118.4	118.0	115.2
EC	118.6	117.4	114.7
Nominal GDP Growth (% change)			
Budget 2012	3.4	4.3	4.5
IMF	3.2	4.3	4.6
EC	3.3	4.3	4.6
Memo items:			
Assumed Discretionary Fiscal Adjustment, € billions	3.5	3.1	2.0

[29] On March 29, the Minister of Finance announced that following discussions, the payment of €3.06 billion promissory note instalment due to be made on March 31, 2012 would be settled by the delivery of a long term government bond, rather than in cash (see Box B for details).

Box B: Fiscal Implications of the Promissory Notes[30]

The promissory notes issued by the Government to Anglo Irish Bank and Irish Nationwide Building Society (INBS) during 2010 have important implications for Ireland's fiscal position, funding requirements and the outlook for debt sustainability. The use of the notes as collateral to secure funding also impacts significantly on the financial operations and balance sheet of the Central Bank of Ireland (CBI).

On March 31 2010, the first promissory note (PN) was issued by the Irish Government to Anglo Irish Bank in an amount of €8.3 billion. Subsequently the total amount of PNs issued to both Anglo and INBS increased to €30.6 billion (Anglo €25.3 billion and INBS €5.3 billion). Following the amalgamation of Anglo Irish Bank and INBS into one entity, the Irish Bank Resolution Corporation (IBRC), in July 2011, the separate notes were combined as one PN.

The purpose of the PN, which is carried on the IBRC balance sheet as an asset, is to ensure that IBRC can be considered a sound bank for capital adequacy purposes. The inherent value of the PN was recognised at the time of receipt as an accounting reserve. Accounting and revenue reserves qualify as capital for regulatory purposes. The PNs must be valued at par at the time of receipt in the institutions' accounts, otherwise the fair value on receipt would be less than par and more notes would be required. The interest rate charged is therefore based on the long-term Government bond yield appropriate at the time of issue by the Government.

Under the terms of the PNs, following an initial interest payment in 2010, a two year interest "holiday" is specified in 2011 and 2012. To compensate, this is followed by a higher rate applicable in 2013 and subsequent years such that the average rate on the PNs over their entire life is sufficient to allow them to be recorded in the institutions' balance sheets at face value. The weighted average interest rate of the PN (absent the interest holiday) is estimated to be 5.8 per cent. However, due to the interest holiday the weighted average interest rate from January 2013 is 8.2 per cent.

Payment by the Government to IBRC of the principal and interest amounts due under the PNs began in 2011 and ends in 2031. Table B.1 shows the cash payments due over the lifetime of

[30] Note that, with the exception of the Update section of this box, the information was prepared prior to the March 29 announcement by the Minister of Finance on the March 31 promissory note payment.

the PN. Total payments (interest plus amortisation) amount to €3.1 billion annually during 2011-2023 and decline thereafter, with a total cost of €47.4 billion.

Table B.1: Promissory Note Schedule: Anglo and INBS

€ *billions*	Total Payments Due	Of which: Capital	Of which: Interest		Total Payments Due	Of which: Capital	Of which: Interest
2011	3.1	2.5	0.6	**2022**	3.1	2.2	0.9
2012	3.1	3.1	0.0	**2023**	3.1	2.3	0.8
2013	3.1	2.6	0.5	**2024**	2.1	1.5	0.6
2014	3.1	1.2	1.8	**2025**	0.9	0.5	0.5
2015	3.1	1.3	1.8	**2026**	0.9	0.5	0.4
2016	3.1	1.4	1.7	**2027**	0.9	0.6	0.3
2017	3.1	1.5	1.6	**2028**	0.9	0.7	0.3
2018	3.1	1.6	1.4	**2029**	0.9	0.7	0.2
2019	3.1	1.7	1.3	**2030**	0.9	0.8	0.1
2020	3.1	1.9	1.2	**2031**	0.1	0.1	0.0
2021	3.1	2.0	1.1	**Total**	**47.4**	**30.6**	**16.8**

Source: Oireachtas Priority Questions [29344/11], 13 October 2011.

Note: Figures rounded to one decimal place.

Impact on the Exchequer Borrowing Requirement

The effect of the PN on the Exchequer Borrowing Requirement (EBR) is significant. Figure B.1 shows the projected EBR from *Budget 2012* out to 2015. Starting in 2011, €3.1 billion was added directly to the EBR as a result of the repayment of part of the PN. The impact gradually reduces as the PN is paid down (reflecting the schedule shown in Table B.1).

Impact on the General Government Balance (GGB) and Debt

The GGB is calculated on an accruals (as opposed to cash) basis and the PN treatment is slightly more complex. In 2010, the full amount of the PN was accrued to the GGB, which added €30.85 billion (19.8 per cent of GDP) to the deficit. In addition, there was an interest charge of €0.6 billion added to the GGB in 2010.[31] Combined, these two factors contributed to the 31.3 per cent General Government deficit in that year.

[31] This also includes the promissory note to EBS.

Post 2010, the PN directly impacts on the General Government deficit through the interest charge. In 2011 and 2012, the terms of the PN provide that no interest payments are to be made. The Irish authorities have confirmed that under ESA95 (Eurostat) government accounting rules, because an "interest holiday" is involved, no interest need be recorded on the PNs on a General Government basis in those years. However, from 2013 onwards (once the interest holiday expires), there is an interest charge accrued to the General Government deficit. This is a significant amount, with an estimated €1.9 billion added to interest (and hence General Government expenditure) in 2013. This directly affects the GGB (Figure B.2). The accrued interest will decline as the notes are repaid but will average close to €1.4 billion a year for the decade from 2013 onwards.

As regards General Government debt, the full value of the PN was added to the stock of debt as of end-2010. For debt purposes, the treatment of the PN is in accordance with Table B.1, other things being equal; the principal repayments reduce the debt.

Figure B.1: Exchequer Borrowing Requirement (*Budget 2012*)

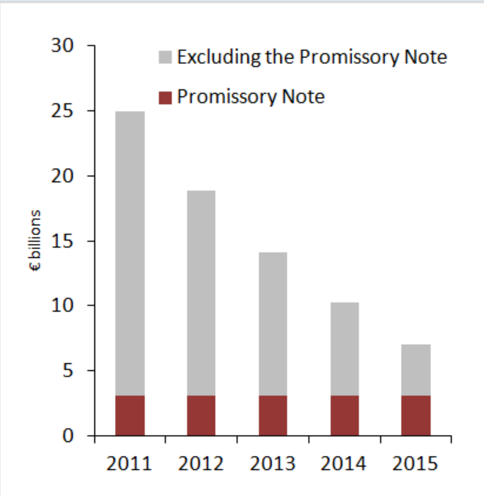
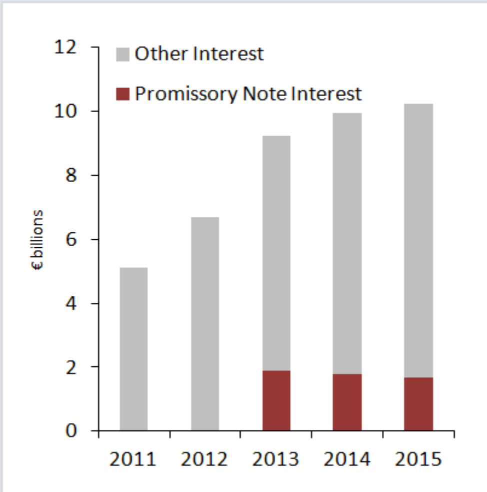


Figure B.2: General Government Interest Expenditure



Source: *Budget 2012*.

Use of the Promissory Note

Although capital under the PN is only subscribed (in cash terms) by the Government on a phased basis, the full par value of the PN of €30.6 billion was recognised initially on the IBRC balance sheet.

As alternative financing sources were reduced the PN was used by IBRC as collateral in order to obtain ever larger amounts of Emergency Liquidity Assistance (ELA) from the CBI in order to be able to meet all of its financial obligations (deposits and bonds) as they fall due for payment. As with all repurchase agreements entered into by the CBI, the PN itself is not shown on the balance sheet of the CBI, but rather is maintained as collateral for the ELA transaction.

ELA is provided under Section 5B(d) of the Central Bank Act of 1942, which empowers the CBI to lend against security to credit institutions in pursuit of financial stability objectives. ELA is extended in return for collateral not accepted as part of the usual Eurosystem monetary operations and the financial risk involved is borne by the CBI. However, the extension of ELA involves “letters of comfort” provided by the Irish Government. These Ministerial guarantees are provided to the extent that the collateral provided does not extend to the complete ELA funding needs of the bank in question.

The interest rate charged by the CBI on ELA extended to IBRC is based on the refinancing rate charged by the ECB plus a margin. As noted above, the level of the interest rate charged on the PN and paid to IBRC affects the cash budgetary outlays of the Exchequer. It will also affect the net financial position of IBRC which is, however, fully owned by the State. Thus, changes in IBRC’s financial position would not have an impact on the Government and IBRC combined.

Promissory Note Update

On March 29, the Minister of Finance announced that, following discussions, the payment of €3.06 billion due to be made on March 31, 2012 under the PN arrangement would be settled by the delivery of a long-term Irish Government bond, rather than in cash. It is intended that ultimately this bond will be financed for one year, on commercial terms, with the Bank of Ireland, who may in turn refinance the bond with the ECB. The approach would reduce the level of ELA provided by the CBI to IBRC as scheduled. The planned deferral of the cash payment due on March 31 means that €3.1 billion less will be drawn down from available EU/IMF programme funds in 2012. Owing to the differential in the interest rate on the Government bond used for settlement (6.8 per cent) and the average interest rate on programme funds (3.5 per cent), this change will result in approximately €90 million being added to the General Government deficit over the remaining nine months of this year.

3.4.2 Spending Plans for Future Years

Expenditure ceilings have been put in place for the years 2012-2014 as part of the 2011 Comprehensive Expenditure Review (CER). CER exercises will be undertaken approximately every three years. This process contributes to increasing the credibility of future spending plans. The CER is part of a broader upgrading of Ireland's budgetary architecture, which aims to achieve good advance planning, open and transparent resource allocation, and critical scrutiny of value-for-money and effective performance.

The ceilings for current spending were set out ahead of *Budget 2012* in the *Comprehensive Expenditure Report 2012-2014* and those for capital spending in the *Infrastructure and Capital Investment 2012-16: Medium Term Exchequer Framework*. Specifying expenditure ceilings for three years at departmental level adds to the credibility and transparency by underlining that some broad political decisions about the scale and composition of consolidation have been taken. While spending decisions will continue to be voted each year, broad expenditure allocations are decided from an administrative perspective only every three years. This will serve to replace the previous annual Estimates 'campaign' (in which the overall level of departmental current spending was determined on a year-by-year basis).[32] In this context, the transparency of the process would be enhanced if the cyclical elements of spending, including on social welfare and unemployment, were identified more clearly.

3.5 Alternative Fiscal Scenarios under Different Growth Projections

3.5.1 Positive and Negative Growth Scenarios over the Period to 2015

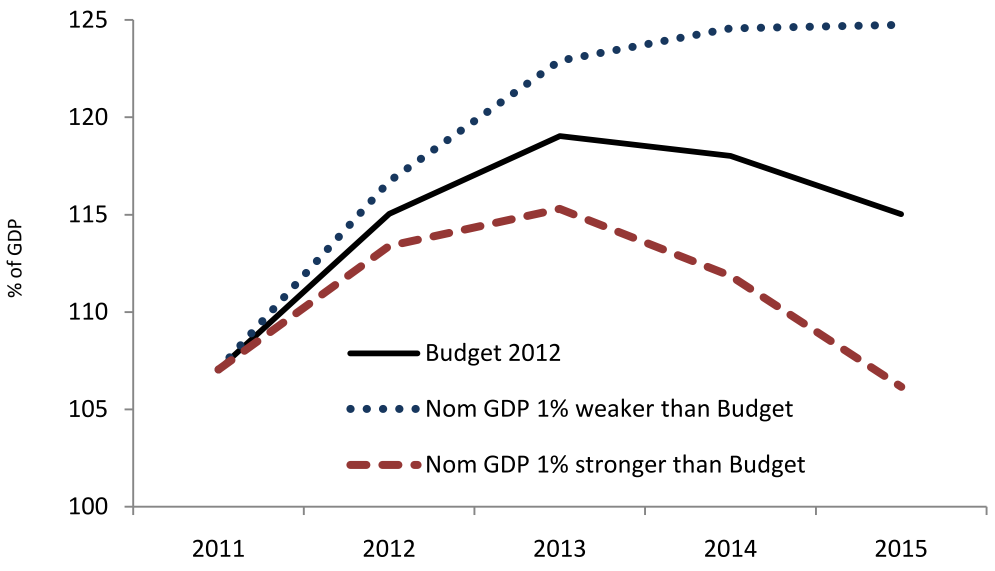
This Section sets out positive and negative alternative growth scenarios compared with the *Budget 2012* forecast. In *Budget 2012*, nominal GDP growth is expected to average 3.7 per cent per annum from 2012 to 2015. The exercises assume that nominal GDP growth is 1 per cent weaker/stronger

[32] "The annual Estimates 'campaign', conducted privately within the system of public administration, is being replaced by a modern, multi-annual framework which will allow for full transparency about the allocations available to each Department over the coming three-year period. This will open the way for structural, medium-term planning and prioritisation within each area, with full public input and parliamentary oversight" (page 74 of the *Comprehensive Expenditure Report: 2012-14*).

per annum than in the Budget, under a no policy change scenario.[33] The impact on the debt to GDP ratio is shown in Figure 3.1, and the main results are summarised in Table 3.6.

Under this lower growth scenario, the 8.6 per cent General Government deficit target would be missed in 2012, with the deficit reaching 9.2 per cent. The debt ratio would not stabilise and would increase to nearly 125 per cent of GDP in 2015, as against a peak of 119 per cent (in 2013) in the Budget. Furthermore in 2015, the Government deficit would reach 5.2 per cent of GDP. To meet the 2015 EU/IMF programme deficit targets would then require additional discretionary adjustments amounting cumulatively to €4.6 billion over the period 2013-15 (Figure 3.2). It is important to stress these figures are purely scenarios as opposed to recommendations.

Figure 3.1: Debt to GDP Ratio: Low and High Growth Scenarios



Source: Council simulations.

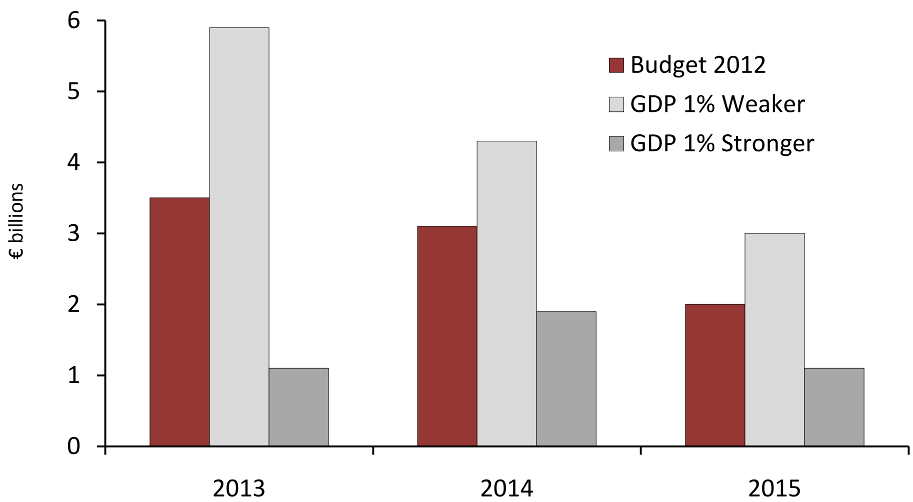
[33] The baseline figures are the numbers underlying the *Budget 2012* projections as opposed to revised post-Budget figures.

Table 3.6: Budgetary Aggregates (as % of GDP) and GDP Growth Scenarios

Budget 2012	2012	2013	2014	2015
Nominal GDP Growth	2.5	3.4	4.3	4.5
Gross Debt	115.0	119.0	118.0	115.0
Primary Deficit	4.4	1.9	-0.8	-2.8
General Government Deficit	8.6	7.5	5.0	2.9
Nominal GDP 1 per cent weaker per annum				
Gross Debt	116.7	122.9	124.6	124.8
Primary Deficit	4.9	2.9	0.7	-0.9
General Government Deficit	9.2	8.7	6.7	5.2
Nominal GDP 1 per cent stronger per annum				
Gross Debt	113.4	115.3	111.9	106.1
Primary Deficit	3.9	0.9	-2.2	-4.5
General Government Deficit	8.0	6.4	3.4	0.8
Memo items:				
Assumed Fiscal Adjustment, € billions	-3.8	-3.5	-3.1	-2.0
Implicit Interest Rate (%)	4.0	5.0	5.1	5.1

Source: Council simulations.

Figure 3.2: Low and High Growth Scenarios: Additional Discretionary Adjustments to Meet Existing General Government Deficit Targets



Source: Council simulations.

A scenario in which nominal GDP growth is 1 per cent stronger per annum over the period 2012-15 than in the Budget (implying an average annual nominal growth rate of 4.7 per cent) is also examined. Under this scenario, the deficit to GDP ratio would fall below the 8.6 per cent target in 2012 (Table 3.6). Furthermore, the debt to GDP ratio would decline more rapidly to 106.1 per cent in 2015, as against a gross debt ratio of 115 per cent in the Budget (Table 3.6 and Figure 3.2). This reflects a larger primary surplus and an improved interest rate/growth differential which leads to more favourable debt dynamics.

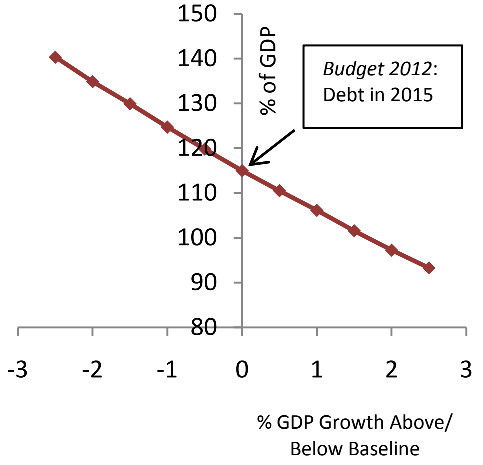
3.5.2 Alternative Paths for GDP

The relationship between alternative growth paths, the consolidation required to meet budgetary targets and the implications for the public finances are summarised in Figure 3.3. Recognising the uncertainties involved, deviations of between +/-2.5 per cent per annum around the Budget nominal growth rate forecasts for each of the years 2012 to 2015 are considered. The simulations in Figures 3.3a and 3.3b, assume no change in the Government's currently planned discretionary budget adjustments which total €12.4 billion over this period. Figure 3.3c plots the additional discretionary adjustments that would be needed in order to comply with existing EU/IMF programme targets (given these growth scenarios). The results serve to emphasise the sensitivity of the budgetary projections to the underlying growth assumptions.

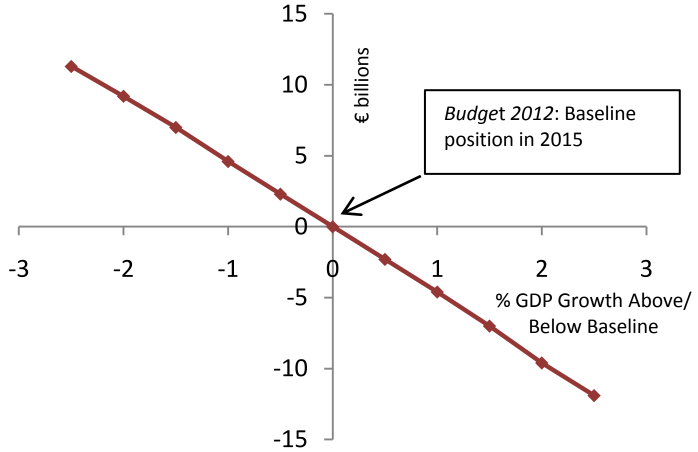
Figure 3.3: Relationship between Alternative Growth Paths and Fiscal Outcomes

a. General Government Deficit Ratio in 2015

b. General Government Debt Ratio in 2015



c. Required Budgetary Adjustment to Meet Existing Targets in 2015



Source: Council simulations.

3.6 Government Debt

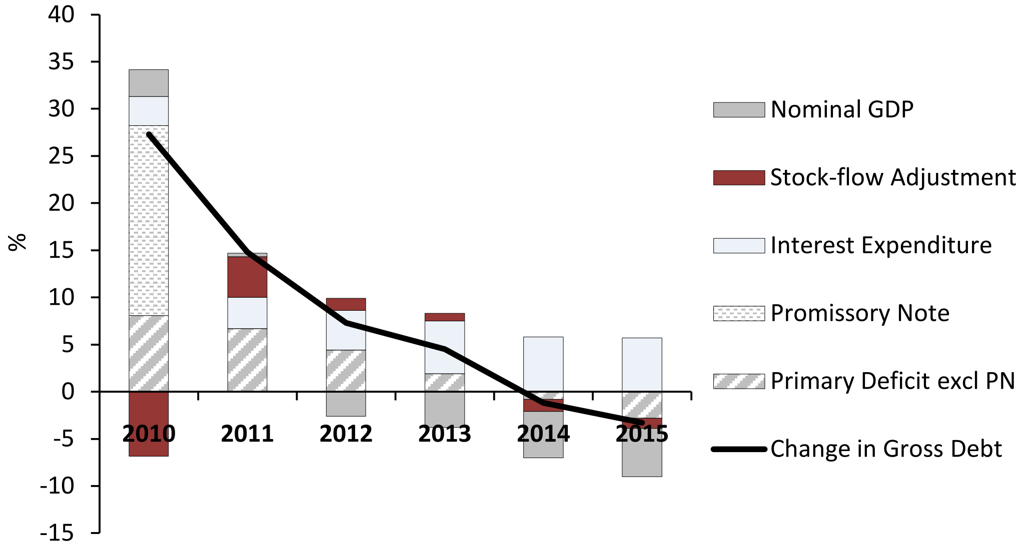
3.6.1 Evolution of Government Debt

As indicated in *Budget 2012*, the gross General Government debt ratio at end-2011 stood at 107 per cent of GDP and was projected to peak at 119 per cent of GDP in 2013. The figure of 119 per cent is almost identical to that of the most recent projections of the IMF and EC (Table 3.5).[34] The main factors contributing to the increase in the debt ratio are shown in Table 3.7 and in Figure 3.4. Conventional analysis typically focuses mainly on gross government debt. Other elements are also very important to consider, however, especially given recent Irish developments, such as the policy actions taken vis-à-vis the banking sector. On the one hand, the very large investments by the National Pension Reserve Fund (NPRF) in Irish banks, as well as the substantial cash balances held by the NTMA imply net debt levels that are considerably lower than those of gross debt. However, the existence of contingent liabilities (including under the Eligible Guarantee Scheme, the Deposit Guarantee Scheme, and relating to National Asset Management Agency (NAMA) bonds) also need to be considered carefully.

The size and composition of the Government's balance sheet, and the associated exposure to risk (especially that relating to the banking sector), can have an important impact on the public finances. In this regard, a clear and comprehensive regular assessment of the elements involved is warranted in budgetary and SPU documents. The Council intends to address in more depth these issues in its forthcoming work.

[34] The sensitivity of the projected path for the debt ratio to the underlying growth assumptions was illustrated in Section 3.5.

Figure 3.4: Contributions to Change in Gross Debt Ratio



Source: *Budget 2012* and Council calculations.

Table 3.7: General Government Debt Dynamics 2011-15

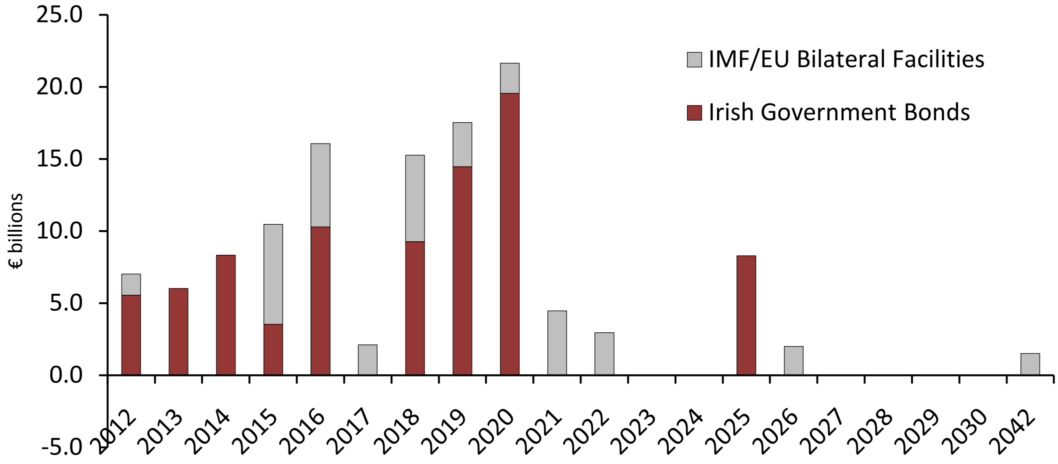
% of GDP	2011	2012	2013	2014	2015
Gross Debt	107	115	119	118	115
Change in Debt	14.8	7.3	4.5	-1.2	-3.3
Contributions to Change in Gross Debt Ratio					
General Government Deficit	10.1	8.6	7.5	5.0	2.9
Stock-flow Adjustment	4.3	1.3	0.8	-1.3	-1.1
Nominal GDP	0.4	-2.6	-3.8	-4.9	-5.1
Composition of Stock-Flow Adjustment					
Change in Exchequer Deposits	-0.9	-0.4	1.1	-1.7	-1.5
Interest Adjustments	-0.3	0.0	-0.8	0.1	0.0
Net Banking Recapitalisation	4.2	0.8	0.0	0.0	0.0
Accrual Adjustments	0.3	0.2	0.1	0.1	0.1
Impact of NPRF	0.3	0.2	0.2	0.2	0.2
Other	0.8	0.5	0.2	0.1	0.2

Source: *Budget 2012.*

3.6.2 Maturity Profile of Irish Debt and Bond Yields

In 2011, €34.5 billion was borrowed under the EU/IMF programme at an average interest rate of 3.7 per cent and an average maturity of 7.5 years. Most of this was used to fund the Exchequer deficit (€24.9 billion), which included requirements for bank recapitalisation (€6.5 billion) and to refinance maturing debt (€9.1 billion) (NTMA, 2012). The maturity profile of Irish debt is depicted in Figure 3.5. In January 2012, the National Treasury Management Agency (NTMA) was able to switch the maturity of some €3.5 billion of bonds (30 per cent of the 2014 bonds) into 2015, which reduces the projected funding requirement in 2014.

Figure 3.5: Maturity Profile of Irish Bonds (end-January 2012)



Source: NTMA.

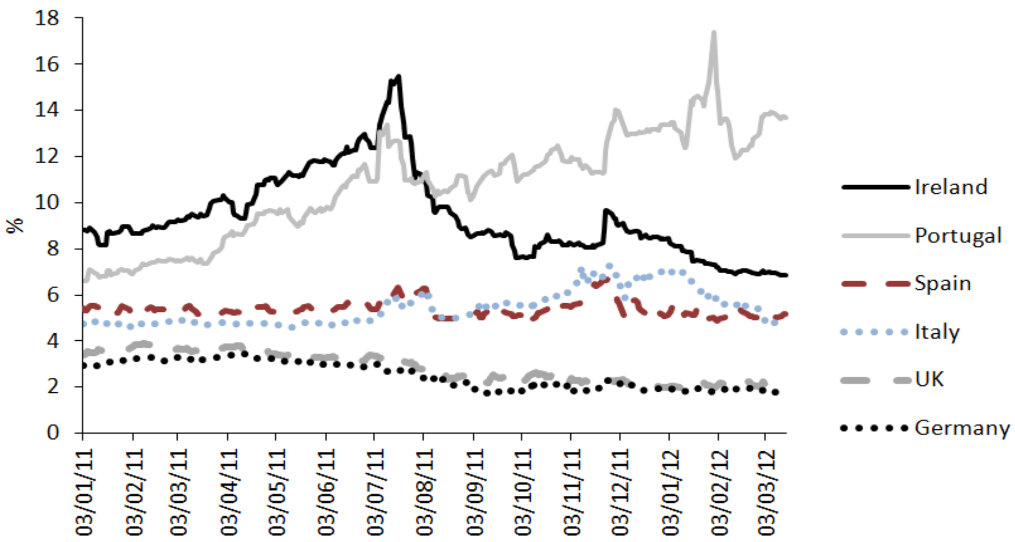
Irish sovereign bond yields have come down from approximately 8.1 per cent last October to 6.9 per cent in March (Figure 3.6).[35] It is difficult to assess the extent to which these developments represent a major underlying improvement in Ireland's perceived creditworthiness, particularly given continuing uncertainty regarding developments in the Euro Zone. On balance, however, there appears to have been a steady improvement in sentiment towards Irish sovereign debt in recent months.

One element of Ireland’s debt profile that has received significant attention is the promissory notes issued by the Government. These account for approximately €1.8 billion in interest to be paid in each of the coming years, compared with interest of around €8 billion to other creditors. As outlined in Box B, servicing and amortising the PNs requires a payment from the General

[35] The chart shows Irish 9 year sovereign bond yields whereas for the other countries 10 year yields are shown.

Government finances to the IBRC, which is publicly owned, and creates a cash flow need that must be borrowed from other sources or met through greater restraint on the public finances. A restructuring of the promissory note arrangement that reduced the near-term funding requirements, even where the net present value of obligations were to be unaffected, would reduce the immediate rollover needs and could improve the maturity profile of Government obligations, although higher interest and debt repayments could be required in the future.

Figure 3.6: Bonds Yields January 2011 – March 2012



Source: Bloomberg.

3.7 Conclusions

The latest information suggests an estimated underlying General Government deficit of approximately 10 per cent of GDP in 2011, which is in line with the Budget and *SPU* projections.[36] This outcome, which is similar to the *Budget 2012* target of 10.1 per cent, implies that all ceilings under the EU/IMF programme were met by comfortable margins, and was achieved despite the economy contracting in the latter half of the year.

As regards 2012, the weakening in growth prospects necessitated an increase in the planned budgetary adjustment this year to €3.8 billion (in *Budget 2012*) from €3.6 billion (at the time of the

[36] As stated earlier, this estimate is based on the capital injections of €17.6 billion into Allied Irish Bank, Bank of Ireland and Irish Life and Permanent in 2011 not being recorded in the General Government balance.

SPU). The main tax change in *Budget 2012*, was the increase in the standard rate of VAT. The Council’s analysis suggests that the projection for VAT in *Budget 2012* was broadly appropriate. The macroeconomic outlook for 2012 has become worse since the Budget was published and it now appears that the risks of attaining a General Government deficit of 8.6 per cent of GDP in 2012 are weighed to the downside. This may point to the need for additional fiscal measures (which might include some extra restraints on Government spending in the latter part of the year) in order to meet this target although it is too early in the year to provide a firm assessment.

For 2013 to 2015, there is a broad consensus on the macroeconomic and fiscal outlook across official forecasters with the General Government deficit to GDP ratio projected to fall to approximately 3 per cent in 2015. These forecasts take into account a sharp rise in interest expenditures from 2013 onwards, partly on the basis of the ending of the interest holiday on the promissory note. According to *Budget 2012* projections, the gross debt to GDP ratio would peak in 2013 at 119 per cent of GDP before declining to 115 per cent in 2015. The simulations presented in this chapter have served to highlight the sensitivity of budgetary forecasts to changes in macroeconomic parameters.

More broadly, the introduction of expenditure ceilings for the years 2012-2014 as part of the 2011 *CER* was a significant development in further strengthening the budgetary architecture in Ireland. The recent NTMA bond switch exchange offer has reduced the projected funding requirements in 2014, while a restructuring of the current promissory note arrangement could have a similar positive effect on the public finances. Finally, on a broader issue, the size and composition of the Government's balance sheet, and the associated exposure to risk, can have an important impact on the public finances. In this regard, a clear and comprehensive regular assessment of the elements involved is warranted in budgetary and SPU documents.

The following chapter considers the appropriate fiscal stance of the Government for 2012 and the following three years.

4. Assessment of the Fiscal Stance

4.1 Introduction

Policy makers face a dilemma when choosing the appropriate medium-term fiscal stance. On one side, more ambitious fiscal adjustment weakens demand and slows the recovery. On the other, slower fiscal adjustment endangers fiscal sustainability, putting the economy on a higher debt/GDP path. Higher debt levels can be *unsafe* insofar as they undermine credibility and jeopardise both market and official funding. Such a path can also be *unfair* in that it pushes burdens to younger generations. Finally, there is a growing body of international evidence that suggests high debt levels *undermine* longer-run growth prospects.

This chapter updates the Council's assessment of the fiscal stance in light of macroeconomic and budgetary developments since the October 2011 *Fiscal Assessment Report*, including the Government's most recent statement of its medium-term fiscal stance as set out in *Budget 2012*. A major theme of Chapters 2 and 3 has been the uncertainty surrounding growth and budgetary projections. In terms of the demand-sustainability trade-off, a negative growth surprise worsens the Government's dilemma; it both deepens the recession and leads to a deterioration in underlying debt sustainability. The nature of the appropriate policy response depends, inter-alia, on whether the growth change is likely to be temporary or permanent.

Chapter 3 addressed the key question of whether the deterioration in the growth outlook for nominal GDP might affect the projected deficit for this year – currently 8.6 per cent of GDP. In terms of the policy choice for 2012 the issue arises as to whether there should be adjustments to the deficit target and/or to the planned discretionary fiscal measures – currently €3.8 billion – if the attainment of this target appears to be in question. The possible implications for the appropriate fiscal stance for 2013-2015 also need to be considered. In addition, it is appropriate to discuss approaches that would facilitate more policy flexibility while still preserving credibility.

This chapter is structured as follows: Section 4.2 revisits the main arguments made in the October 2011 report in favour of a more ambitious deficit-reduction path and considers afresh the appropriate fiscal stance for 2012 and subsequent years. Section 4.3 explores policy options that could allow for a more flexible response to cope with uncertainty. Section 4.4 concludes.

4.2 Assessing the Fiscal Stance: An Update

Recognising the underlying demand-sustainability trade-off, the Council's October 2011 report (IFAC, 2011) made the following assessment of the fiscal stance:

> *Weighing the different elements involved, retaining the current SPU deficit targets as a percentage of GDP is viewed as within the range of appropriate courses of action. Relaxing these targets is not considered to be a viable option, given the key need to safeguard hard won gains and the creditworthiness constraints imposed by both the market and official creditors.*

However, the assessment noted that:

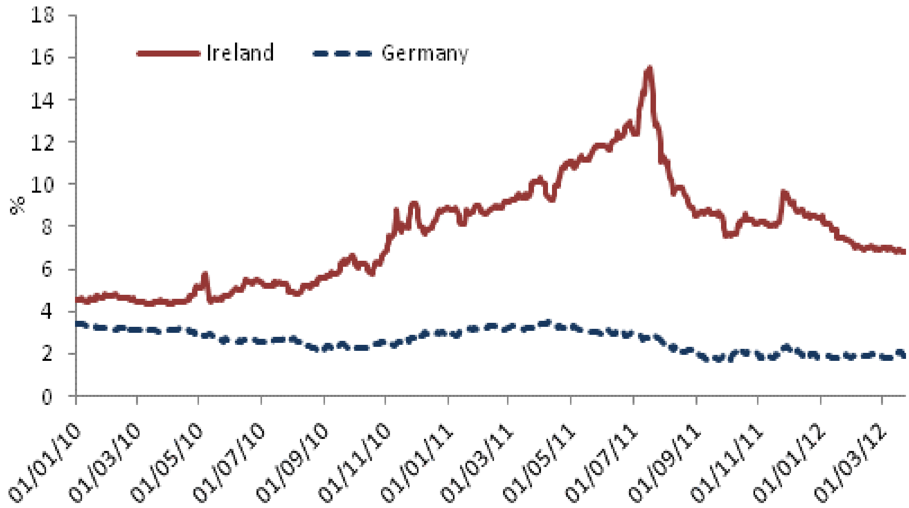
> *While staying the course with current programme targets is thus one possibility, after considering various relevant factors, the Council sees a strong argument for strengthening the fiscal consolidation effort beyond that targeted in the SPU. In particular, the current targets would leave the debt to GDP ratio on a relatively slow downward path. The Council believes that a GGD target of the order of 1 per cent of GDP for 2015 would be appropriate, which compares to the current SPU target of 2.8 per cent.*

The remainder of this section revisits the main arguments from the October 2011 report in light of subsequent developments.

4.2.1 Funding Vulnerabilities

Although the EU/IMF programme conditionally includes funding in 2013, the Council argued that the longer-term funding situation from either market or official sources was not secure. Notwithstanding a significant fall in secondary market yields since July, yields were still above levels consistent with market access (see Figure 4.1). Moreover, the evolution of Euro Zone crisis resolution policies was still in flux, with significant concerns stemming from the unresolved crisis in Greece and rising bond yields in Spain and Italy.

Figure 4.1: Bonds Yields Ireland and Germany January 2010–March 2012



Source: Bloomberg.

Note: Ireland: 9 year sovereign bond, Germany: 10 year bond. This data corresponds to Figure 3.6.

Irish sovereign bond yields have fallen further since last October. Although it is not possible to account for the fall in yields with any precision, the improving credibility of Ireland's adjustment policies, actions by the ECB to shore up longer-term funding in the Euro Zone banking system and developments in Euro Zone crisis resolution policies appear to have reduced perceptions of default risk. Ireland has increasingly separated itself from Greece and Portugal in terms of secondary bond market assessments of creditworthiness. Overall, funding vulnerabilities have subsided somewhat, which tends to reduce the force of the argument for a more ambitious adjustment to reinforce credibility. However, at this juncture, the degree of vulnerability remains elevated, suggesting a modest weakening in the case for a more ambitious adjustment path on these grounds.

4.2.2 Fragile Debt Sustainability

When the starting debt to GDP ratio is high, nominal growth (or nominal interest) rate shocks can have a significant impact on debt sustainability. The October 2011 report examined how debt sustainability would be affected by negative growth shocks. One way to provide an improved buffer against unstable debt dynamics is to put the primary deficit as a share of GDP on a steeper downward path.

As discussed in Chapters 2 and 3, the downgrading of near-term nominal growth prospects has led to a modest deterioration in the debt to GDP path. Chapter 2 also stressed the especially high degree of uncertainty surrounding medium-term growth projections. In light of this, the Council views the case for building a larger buffer into the primary deficit reduction path to provide some insurance against adverse shocks to be at least as strong as in its earlier report.

4.2.3 Slow Path of Debt Reduction

Apart from the (interrelated) concerns over funding and debt sustainability, a slow path of debt reduction from current high levels raises other issues. There is a growing body of empirical research work that points to weaker growth beyond a debt/GDP threshold of about 90 per cent even though the causal mechanisms at work are poorly understood.[37] Moreover, recognising that debt levels will eventually have to be substantially reduced, maintaining high debt levels over the medium-term puts a heavy burden on younger generations, who will also have to bear the rising fiscal costs associated with an ageing population. A more ambitious adjustment effort means that more of the heavy lifting would be front loaded, with the debt to GDP ratio on a relatively steeper downward path post-2015.

4.2.4 State of Demand

Pulling in the opposite direction from these arguments for more ambitious medium-term deficit reduction is the current weak state of domestic and external demand. The escalation of the Euro Zone crisis in the second half of 2011 has curbed demand prospects further, both dampening demand for Irish exports and undermining domestic business and consumer confidence. To the extent that this weakening of demand reflects temporary factors, it points to the appropriateness of a less pro-cyclical policy in the near term.

4.2.5 Balancing the Arguments

Weighing up these arguments, the Council considers that the Government's General Government deficit target of 8.6 per cent of GDP for 2012 (Table 4.1) is appropriate given the current growth outlook for 2012. This may point to the need for additional fiscal measures this year (which might include some extra restraints on Government spending in the latter part of 2012).

[37] See Reinhart and Rogoff (2010).

Table 4.1: The Fiscal Stance: Alternative Assessments

GGB (% of GDP)	2012	2013	2014	2015
SPU (April 2011)	-8.6	-7.2	-4.7	-2.8
IFAC October 2011 Alternative Adjustment Path	-8.4	-6.4	-3.6	-1.0
Budget 2012 (December 2011)	-8.6	-7.5	-5.0	-2.9
IFAC April 2012 Alternative Adjustment Path	-8.6	-7.4	-4.6	-1.7
Primary Balance (% of GDP)	**2012**	**2013**	**2014**	**2015**
SPU	-3.9	-1.1	1.7	3.4
IFAC October 2011 Alternative Adjustment Path	-4.0	-0.9	2.2	4.7
Budget 2012	-4.4	-1.9	0.8	2.8
IFAC April 2012 Alternative Adjustment Path	-4.4	-1.8	1.2	4.0
Debt to GDP (% of GDP)	**2012**	**2013**	**2014**	**2015**
SPU	116.0	118.0	116.0	111.0
IFAC October 2011 Alternative Adjustment Path	115.2	117.0	115.3	109.8
Budget 2012	115.0	119.0	118.0	115.0
IFAC April 2012 Alternative Adjustment Path	115.6	119.8	118.6	114.7

Assumed Consolidation € billions	2012	2013	2014	2015	2012 - 2015
SPU	3.6	3.1	3.1	2.0	11.8
IFAC October 2011 Alternative Adjustment Path	4.4	3.9	3.8	3.7	15.8
Budget 2012	3.8	3.5	3.1	2.0	12.4
IFAC April 2012 Alternative Adjustment Path	4.2*	3.9	3.8	3.7	15.6

*Using *Budget 2012* projections as a benchmark and assuming zero buffers, Council simulations indicate that an additional discretionary adjustment of €0.4 billion would be required to achieve the GGB target of -8.6 per cent of GDP for 2012.

For 2013-2015, the Council assesses that the deficit targets as a share of GDP in *Budget 2012* are within the range of appropriate courses of action. In the October 2011 *Fiscal Assessment Report*, the Council saw a strong argument for a more ambitious fiscal adjustment effort aimed at achieving a General Government deficit of 1 per cent of GDP in 2015, compared with the Government's target deficit of 2.9 per cent. While the Council believes that the reasons for moving to a steeper medium-term deficit reduction path remain valid, a number of factors have arisen which this assessment now needs to take into account. First, economic growth has slowed in the intervening six months and the short-term macroeconomic outlook has weakened. Second, there is evidence to suggest that Ireland's creditworthiness has improved. Third, the target for the 2012 budget deficit adopted by the Government was less than the alternative adjustment path set out by the Council. This means that adherence to the budgetary adjustment path proposed in the October 2011 *Fiscal Assessment Report* would now require more consolidation in future years, compared with what was envisaged by the Council at that time.

Based on these considerations, the Council believes that there is still a strong case for favouring an adjustment path that is more ambitious than that outlined in *Budget 2012*. The Council does not, however, suggest going beyond the additional consolidation amounts set out in the October 2011 *Fiscal Assessment Report*. In summary, therefore, the Council sees a strong case for a total adjustment effort of the order of €11.4 billion for 2013-15, approximately €2.8 billion above current Government proposals. Simulations indicate that this would entail a General Government deficit of 1.7 per cent of GDP in 2015 (Table 4.1). This is a higher deficit than that suggested by the Council in October (1.0 per cent of GDP), but it is lower than the Government's current target (2.9 per cent of GDP). The Council's proposals would imply a sizable primary surplus of approximately 4 per cent of GDP in 2015.

Box C: Self-Defeating Fiscal Adjustment

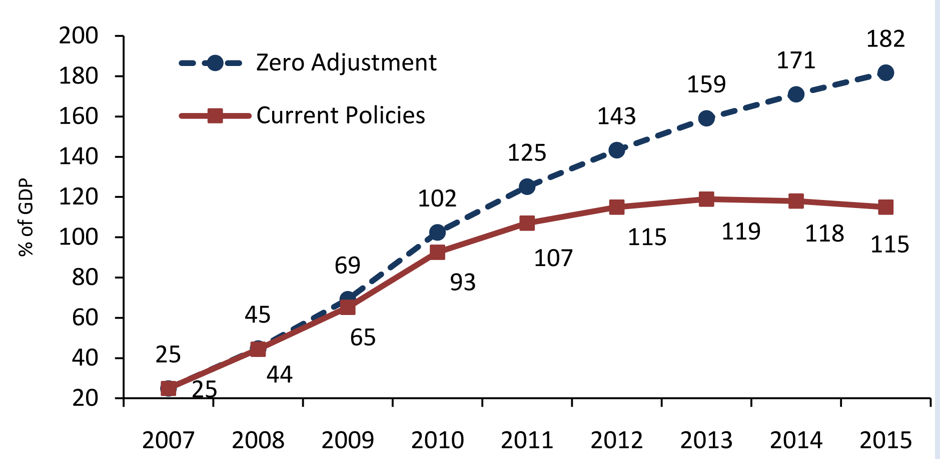
The existence of a demand-sustainability trade-off depends on two assumptions. The first assumption is that fiscal contractions actually reduce demand and output – that is, the expansionary fiscal contraction (EFC) hypothesis does *not* apply. If fiscal contractions are expansionary it would be possible, all else equal, to both improve growth performance while also reducing the deficit and improving underlying debt sustainability. As reviewed in the October 2011 report, the most authoritative international evidence does not tend to support the EFC hypothesis. The second assumption (and focus of this box) is that discretionary fiscal contractions do improve sustainability – that is, discretionary fiscal contractions are not self-defeating in terms of the underlying objective of improving the fiscal position.

The non self-defeating hypothesis comes in different forms depending on the focal fiscal measure.

One (weak) form of the non self-defeating hypothesis focuses on the **primary (i.e. non-interest) deficit as a share of GDP**. A discretionary fiscal contraction can be said to be non self-defeating provided that, all else equal, the primary deficit as a share of GDP does not rise. Not surprisingly, the empirical challenge comes from the "all else equal" requirement: numerous factors besides the discretionary fiscal stance can affect the actual primary deficit. In the Irish case, the primary deficit (excluding banking related fiscal costs) fell from 9.7 per cent of GDP in 2009 to an estimated 6.7 per cent of GDP in 2011, and is projected to fall further to 4.4 per cent of GDP in 2012 according to *Budget 2012* projections. This occurred despite weak growth and especially weak growth in domestic demand, with the latter being especially important for fiscal performance. Real GDP growth was -0.4 per cent in 2010 and 0.7 per cent in 2011; real domestic demand growth was -4.9 per cent in 2010 and -3.0 per cent in 2011. Most observers agree that the substantial discretionary fiscal measures adopted did contribute to the disappointing growth performance. However, growth was also held back by external factors, business/household deleveraging, an impaired credit system and weak confidence. The fact that the underlying primary deficit did decline despite these factors is not consistent with this form of the self-defeating hypothesis.

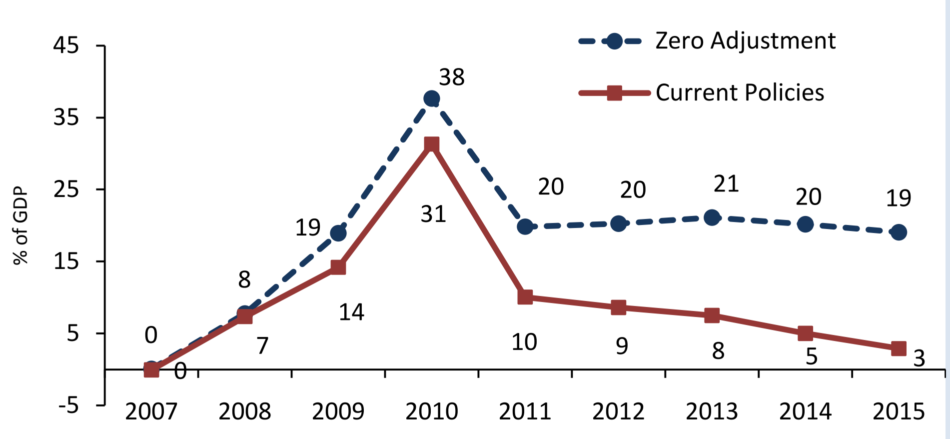
Using the fiscal feedback model, Figures C.1 and C.2 show the results of a simulation of how the main fiscal aggregates would have evolved if no fiscal adjustment had been pursued from July 2008.

Figure C.1: Debt to GDP Ratio:
Current Policies versus Zero Fiscal Adjustment



Source: Council simulations.

Figure C.2: General Government Deficit:
Current Policies versus Zero Fiscal Adjustment



Source: Council simulations.

This simulation should only be taken as a crude indicator insofar as it does not take account of adverse confidence effects as the main fiscal aggregates spin out of control. However, even ignoring these effects, the simulation shows the General Government deficit rising to over 20 per cent of GDP by 2012 under the zero-adjustment scenario with debt dynamics on a clearly unsustainable path.

A second (semi-strong) form of the non self-defeating hypothesis focuses on the **debt to GDP ratio.** A discretionary fiscal contraction can be said to be non self-defeating provided that, all else equal, the debt to GDP ratio does not rise. Owing to a potentially large negative effect on the denominator relative to the numerator, it is possible for the debt to GDP ratio to rise even if the primary deficit as a share of GDP falls with discretionary fiscal adjustments. Indeed, in the model there is a value of the deficit multiplier above which the debt to GDP ratio will rise due to large adverse growth effects. Simulations using the model show that the multiplier would have to be greater than 3.8 for additional discretionary fiscal contraction in 2012 to actually leave the debt to GDP ratio higher in 2015. Such a high value is not plausible for a small open economy such as Ireland's where the multiplier is generally considered to be about 0.5.

A third (strong) form of the non self-defeating hypothesis focuses on **creditworthiness** (measured, say, by secondary market bond yields). A discretionary fiscal contraction can be said to be non self-defeating provided that, all else equal, creditworthiness does not deteriorate. Owing to a possible additional adverse effect on market confidence from slower growth, a fiscal contraction could in principle lead to a worsening of creditworthiness even if the underlying primary deficit and debt positions improve (see, for example, Blanchard, 2011). Although care must be taken in interpreting movements in bond yields given its multiple underlying determinants, the significant decline in market spreads for Irish bonds since July 2011 does not suggest that the fiscal adjustment programme is undermining creditworthiness even if it is leading to slower growth.

4.3 Preserving Credibility while Retaining Flexibility

Chapters 2 and 3 emphasised the high level of uncertainty that surrounds growth and budgetary projections in a post-bubble Irish economy. As a general matter, the unavoidable presence of uncertainty – even when it is less pronounced than in the current Irish context – suggests the desirability of policies that, subject to maintaining credibility, could allow a degree of flexibility in the deficit-reduction path when faced with growth surprises.

A significant concern is that such surprises could lead to a "chasing your tail" effect, whereby disappointing growth outcomes force increased discretionary adjustments to meet targets, which further undermine growth. Even if the adjustments are not actually self-defeating, (as discussed in Box C), the improvement in the fiscal position might not be a sufficient return in terms of the cost of reduced growth and employment.[38]

However, this consideration may have to be set against the reality that in some circumstances, such as those that Ireland currently faces, adherence to a pre-set fiscal target may be required because of overriding creditworthiness constraints. For this reason the Council has recommended that in Ireland's current situation, retaining the deficit target of 8.6 per cent of GDP for 2012 should take precedence and that relaxing the headline targets to 2015 is not a viable option.

If there were not overriding creditworthiness constraints or commitments under financial support programmes with official creditors, there would be an advantage in terms of the trade-off between credibility and other objectives to setting out the path of future fiscal policy in a way that does not require a pro-cyclical response to possible negative growth surprises. One approach would be to specify deficit-reduction targets in cyclically adjusted terms. Given the well-known difficulties of measuring the cyclically adjusted budget balance, this could be operationalised by making the discretionary fiscal adjustments the focal target rather than the actual deficit as a share of GDP (IFAC, 2012). Any disappointment in growth would tend to increase the deficit (for example, tax revenues would fall relative to projections). If the consolidation path were set in terms of the actual budget deficit, this would force additional discretionary measures, leading to a further slowing of growth. However, such measures would not be required if the path were set in advance in terms of actual discretionary adjustments. Thus, the Government could continue to adhere to its

[38] Recent detailed case study and econometric research into what leads to successful implementation of fiscal adjustment programmes by IMF researchers (Mauro, 2011), points to growth surprises as the most important factor affecting the actual implementation of fiscal plans.

plan – and thereby help preserve credibility – while limiting the pro-cyclical nature of the fiscal response.

A key consideration in implementing this approach is the cause of the growth surprise. A surprise caused by a temporary weakness in demand (say, due to a transitory downturn in key export markets) provides a stronger case for accommodation. There is unlikely to be a case for delayed adjustment when a negative growth surprise is due to a more permanent downward revision in the underlying trend growth rate – indeed, it might be necessary to increase the planned adjustment to the extent that lower potential output of the economy raises the underlying cyclically adjusted deficit.

4.4 Conclusions

The Government's plan to reduce the General Government deficit from approximately 10 per cent of GDP in 2011 on an underlying basis to 8.6 per cent of GDP in 2012 was based on a real growth rate of 1.3 per cent in 2012. However, some deterioration in growth prospects since the Budget announcement raises a question mark as to whether this deficit target can be attained with currently planned consolidation measures. Given the continuing fragile nature of Ireland's creditworthiness (despite some recent improvement), it is important that, if necessary, measures be taken to ensure that the General Government deficit target of 8.6 per cent of GDP is adhered to.

As regards 2013-2015, the headline targets for the General Government deficit set out in *Budget 2012* remain within the range of appropriate courses of action. Nevertheless, the Council continues to believe on balance that there is a strong argument for greater consolidation than currently envisaged by the Government. This assessment takes into account factors such as the deterioration in the growth outlook, some improvement in Ireland's creditworthiness and a less ambitious budgetary target for 2012 than that underlying the Council's October 2011 analysis. An alternative adjustment path would involve cumulative additional budgetary adjustments of the order of €2.8 billion compared with those currently envisaged by the Government. Council simulations indicate that such an adjustment path would yield a General Government deficit of 1.7 per cent of GDP in 2015 (compared to the Government's target of 2.9 per cent and the Council's October 2011 proposal of 1.0 per cent) and a primary surplus of 4 per cent of GDP.

Policies can be considered that aim to preserve credibility while retaining policy flexibility. Assuming shorter-term creditworthiness constraints and programme commitments are not overriding, fiscal consolidation paths could be outlined in terms of discretionary measures, rather than the actual deficit to GDP ratio. Such an approach could lessen the possible downward spiral effects of negative growth surprises and better facilitate the operation of automatic stabilisers.

Glossary

Automatic stabilisers: An institutional feature of an economy that dampens its macroeconomic fluctuations, e.g., an income tax, which acts like a tax increase in a boom and a tax cut in a recession.

Cyclical adjustment: The adjustment of figures such as GDP, government spending, tax revenues, or the budget deficit to show what they would be if total activity was at its trend or potential level.

Cyclically adjusted budget balance (CABB): This is the actual budget balance net of the cyclical component. The CABB gives a measure of the underlying trend in the budget balance. The structural balance is the CABB excluding one-off items.

Elasticity: A measure of the responsiveness of the behaviour of one variable as a result of a change in another variable.

Exchequer balance: The traditional domestic budgetary aggregate which measures the central government's net surplus or borrowing position.

Fiscal stance: A measure of the intended impact of discretionary fiscal policy. It can be defined as the change in the primary structural budget balance relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General Government balance (GGB): The GGB measures the fiscal performance of all arms of government. It provides an accurate assessment of the fiscal performance of a more complete government sector. The GGB does not reflect the position of commercial State sponsored bodies as these agencies are classified as being outside the general government sector.

Output Gap: The output gap is the difference between actual output and estimated potential output at a particular point in time.

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

Primary balance: Government net borrowing or net lending excluding interest payments on consolidated government liabilities.

Stock-flow adjustment: This 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.

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