Irish Fiscal Advisory Council

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Pre-Budget 2015 Statement

September 2014

Irish Fiscal Advisory Council

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KEY MESSAGES

- In the past, Ireland's fiscal policy has shown an unfortunate tendency to contribute to boom and bust economic cycles that have harmed the economy and have had very negative social consequences. We are now entering a crucial period for breaking this pattern. Fiscal policy must remain focussed on the goal of repairing the public finances even in the face of short-term improvements in key indicators. This is required in order to underpin a return to sustainable medium-term economic growth.

- Government expenditure is likely to exceed revenue by around €7 billion in 2014. The overall level of debt is now five times higher than at the outset of the crisis and is 1.2 times the size of the economy. This highlights the continued vulnerability of the overall fiscal position.

- Going into *Budget 2015*, the latest data suggest that macroeconomic and fiscal developments in 2014 have been significantly better than expected. This means that uncertainty regarding the likelihood that Ireland will meet its short-run Excessive Deficit Procedure (EDP) targets for 2014 and 2015 has been substantially reduced. This is a welcome achievement and means that a full Budget adjustment of €2 billion would most likely comfortably secure compliance with the 3 per cent ceiling in 2015.

- Compliance with the official targets does not mean that the overriding task of repairing the public finances has been accomplished. The 3 per cent ceiling should be regarded as the maximum tolerable deficit level, not a prudent level.

- The Fiscal Council remains of the view that the most appropriate course of action is to implement the final instalment of the fiscal consolidation plan, and then to follow the less demanding requirements of the Budgetary Rule in later years. A premature easing in fiscal adjustment now would increase the risk of additional consolidation being necessary in future.

- In the medium-term, the Government will face considerable challenges in maintaining tight expenditure control under current plans due to demographic and other demand and cost pressures. This argues against any premature erosion of the government's revenue raising capacity in the forthcoming Budget.

- In order to reduce the debt-to-GDP ratio, Ireland will likely need to run a primary surplus well above the level expected to be reached in 2015. Maintaining the fiscal discipline required to achieve large primary budget surpluses will become politically harder following a long period of fiscal consolidation and as crisis memories fade.

- *Budget 2015* will be the first since Ireland exited the EU/IMF Programme. By adopting a prudent budgetary stance, the Government can send a strong signal reinforcing its stated resolve to rectify the remaining weaknesses in the public finances.

1. INTRODUCTION

In recent years successive governments had little choice but to implement an enormous programme of fiscal retrenchment against a backdrop of an already weak economy and labour market. The huge increase in the government deficit, mounting bank losses partly funded by government expenditure and the State's eventual loss of market creditworthiness necessitated the introduction of tough measures to repair the public finances. This strongly pro- cyclical stance, which increased the depth and severity of the downturn, has been a recurrent feature of Irish fiscal policy making for the last 30 years.[1] Consequently the stance of fiscal policy has contributed to the damaging pattern of boom and bust in the Irish economy over a long period.

Countries such as Canada and Sweden that went through financial and fiscal crises in the 1990s responded by putting in place strengthened budgetary institutions and policies. These effectively institutionalised the memory of the crises, allowing them to weather the recent global crisis relatively well. Ireland has also responded to its severe crisis with a range of reforms, including adopting a strong set of national and European budgetary institutions. Recent Government statements in relation to pursuing safe budgetary policies and avoiding boom-bust cycles are welcome. With the State having exited the official EU/IMF programme and progress with economic recovery being made, the coming years will demonstrate whether Ireland has learned from past mistakes and will take the actions necessary to break the historic cycle of boom and bust.

In November 2011, the Government published its *Medium-Term Fiscal Statement* (MTFS) setting out the planned tax increases and expenditure cuts to be implemented over the period 2012 to 2015. The purpose of the planned fiscal consolidation was to return the public finances to safety and in the process to comply with EC requirements to reduce the deficit in the public finances to below 3 per cent of GDP by 2015. Having already implemented austerity measures amounting to almost €20 billion between summer 2008 and 2011, the MTFS envisaged the introduction of further additional fiscal consolidation measures amounting to €12 billion from 2012 to 2015. To date, the Government has implemented 83

[1] See Kearney, I. (2012). "Measuring Fiscal Stance", Special Article in *Quarterly Economic Commentary,* Autumn 2012, p. 67-88.

per cent of the consolidation outlined in the 2011 plan with the final instalment of this planned austerity program, €2 billion in tax increases and expenditure cuts, to be implemented in *Budget 2015*.

In its most recent Fiscal Assessment Report published in June 2014, the Irish Fiscal Advisory Council recommended that the Government implement the full €2 billion consolidation in the forthcoming Budget. Going into *Budget 2015*, the data available for the year to date suggest that macroeconomic and fiscal developments in 2014 have been better than expected: GDP growth has accelerated in the first half of 2014 and the fiscal position up to August is ahead of that projected at the time of *Budget 2014* (October 2013). On the basis of the most recent data, it now seems likely that the government's deficit ceiling for 2014 will be met by a margin.

Assuming that the recovery in the economy currently underway continues in 2015 and in the absence of any significant negative shocks or disappointments relative to projections, estimates suggest that the implementation of the €2 billion adjustment in the forthcoming budget would be sufficient to achieve a deficit outturn somewhat lower than the ceiling of less than 3 per cent.

The government deficit has narrowed substantially as a result of the steadfast adherence to fiscal commitments up to now. Recognising the sizeable risks to fiscal sustainability which still remain, there are important reasons why the Government should implement significant consolidation in the forthcoming budget. The benefits of a last significant fiscal effort, as outlined in this paper, outweigh the likely negative short-term economic impact.

The structure of this paper is as follows. Section 2 describes the austerity measures implemented since 2008 and briefly assesses their impact. Section 3 reviews the current public finance position and assesses the likelihood that official deficit targets will be met. Section 4 explains the remaining risks to fiscal sustainability which underpin the need to maintain a prudent budgetary stance in the forthcoming Budget for 2015.

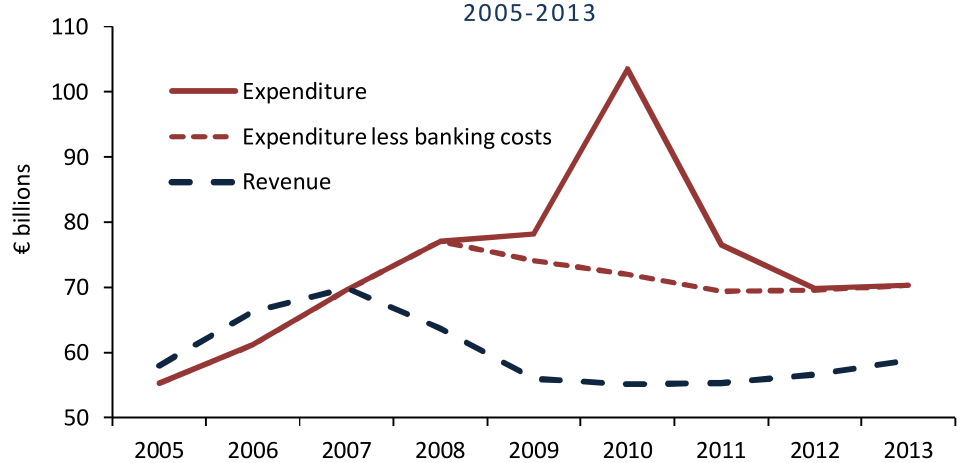
2. The Public Finances 2008-2013

2.1 Developments in Government Revenue and Expenditure

The coincident collapse of the domestic property bubble and the impact of the global financial crisis precipitated a collapse in output, income and prices in the economy. Using Gross National Product (GNP) in current prices as a measure of the size of the economy, by the end of 2011 the economy was almost one-fifth (or €30.6 billion) smaller than at its peak in 2007. The collapse in output caused the tax base to shrink and led to a massive decline in government revenues. This was compounded by an over-reliance on transactions-based property taxes in the years preceding the crash. The loss of output also had stark consequences for the labour market. From peak levels in 2007, employment declined by 16 per cent and the unemployment rate more than trebled. Consequently, at the same time as the recession saw an enormous erosion of the tax base, crisis-related government expenditures, such as unemployment benefit payments, increased.

Figure 1 shows the path of government expenditure and revenue since 2005. By 2007, government revenues and expenditure were broadly in line. However, this masked a major structural weakness in the public finances that was exposed when the recession hit. The bursting of the credit and property bubbles very quickly destabilised the public finances. As shown in Figure 1, total government revenues declined sharply from 2007 onwards and by the end of 2012 were one fifth or €13.3 billion lower than in 2007. By the end of 2013, after 6 years of fiscal consolidation, government revenues are still estimated to be €11 billion lower than in 2007.

Figure 1: General Government Expenditure, 2005-2013



Sources: CSO; Eurostat; Department of Finance (*SPU 2014*); IFAC calculations.
Note: Banking costs here are taken as capital injections recorded as deficit increasing. Figures are presented on an ESA 95 basis for consistency.

As the economy contracted, government expenditure increased by €7.5 billion in 2008, partly reflecting the rapid rise in unemployment. Total expenditure, excluding the €43 billion transferred to the banks had declined to 2007 levels by 2013. The composition of expenditure changed significantly during the crisis. Current expenditure on goods and services declined between 2008 and 2013. In contrast, expenditure on transfer payments increased sharply and there was a €5 billion increase in expenditure on national debt interest related to the rapid accumulation of government debt during the crisis. Government investment[2], which fell by 71 per cent in nominal terms between 2008 and 2013, bore a disproportionate share of the consolidation effort.

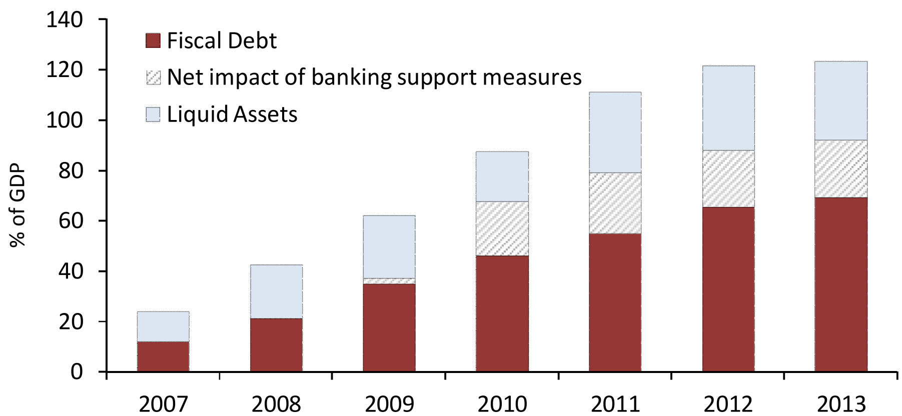
2.2 Fiscal Consolidation and Resolving the Debt Crisis

The deterioration in the fiscal position aggravated by the scale of the direct capital injections into the banks had a major impact on government debt. By 2013 it had increased to 123 per cent of GDP from just over 40 per cent in 2008. Figure 2 shows how the composition of debt evolved over the period 2007-2013. Funds transferred to the banking system accounted for about one-third of the increase over this period. The remainder of the increase in the debt

[2] This refers to gross fixed capital formation of Central and Local Government.

was due to the accumulated fiscal deficits from 2008.[3] In order to create the conditions necessary for a return to sustained growth in output and employment, Government policy since 2008 has focussed on measures to reduce the fiscal deficit and achieve a reduction in the overall stock of debt over the medium term.

FIGURE 2: GENERAL GOVERNMENT DEBT, 2007 -2013



Sources: CSO; IFAC calculations.
Notes: Figures based on ESA2010 data.

Figure 3 summarises the *ex ante* expenditure cuts and tax increases undertaken and planned over the period 2008-15.[4] The *ex ante* figures are nominal amounts (expressed as a percentage of GDP in Figure 3) which show the *ex ante* fiscal position. The *ex ante* figures do not take account of the negative impact of consolidation on economic activity.[5] Reductions in expenditure, both current and capital, comprise just under two-thirds of the actual and planned consolidation measures. In total the measures implemented over the 2008-2013 period amounted to an *ex ante* fiscal adjustment of €27.1 billion. In addition, a further consolidation of €2.5 billion was introduced in Budget 2014 with a further adjustment of €2 billion originally pencilled in for 2015.

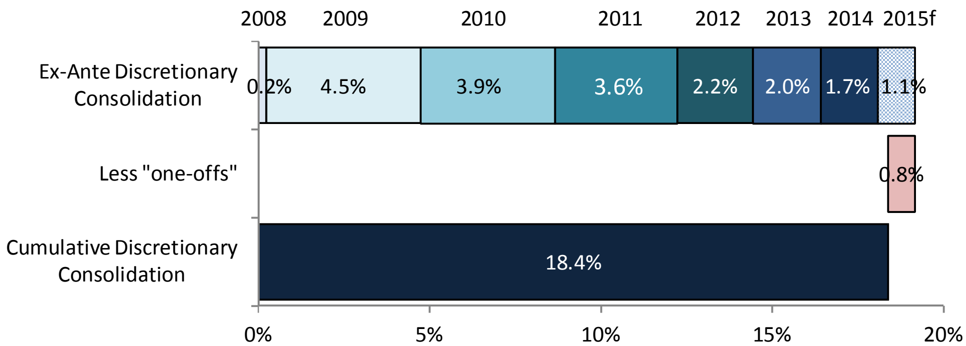
[3] Part of the accumulated deficits that added to the debt stock over this period will no doubt have resulted from the fall in aggregate demand caused by stresses in the banking system over and above the direct costs borne by the State alone. Accurately quantifying these additional costs is far more difficult.

[4] The figures for the period 2008-2014 refer to the actual *ex ante* consolidation amounts implemented since 2008. The figure for 2015 is from the MTFS.

[5] The *ex post* effect of the consolidation was smaller than the size of the *ex ante* measures due to the impact of the adjustments on output, employment and prices, see Kearney (2012).

The cumulative size of the *ex ante* fiscal consolidation measures over the period to 2015 amounts to an adjustment of just under one-fifth of annual GDP.

FIGURE 3: FISCAL CONSOLIDATION, % OF GDP

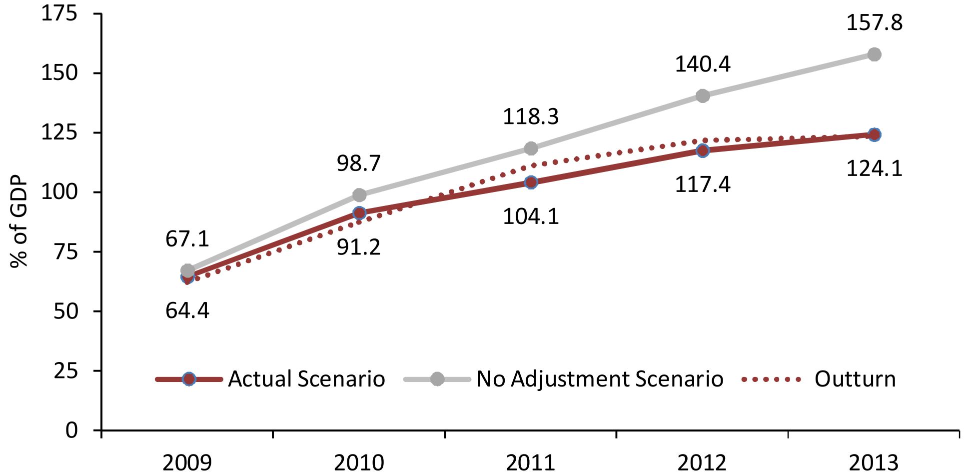


Sources: CSO; Department of Finance; IFAC calculations.

The programme of tax increases and expenditure cuts implemented in successive budgets succeeded in first stabilising the deficit and then contributed to the the achievement of sequentially smaller deficits. The underlying general government balance (excluding transfers to the banking sector) fell to 5.7 per cent of GDP in 2013, down almost half from peak. The tough fiscal measures which have been introduced since 2008 have also helped to stabilise the debt, albeit at a very high level. The Council have used the fiscal feedbacks model to show that in the absence of the fiscal adjustment, the general government debt would have been 34 percentage points of GDP higher in 2013 and would have continued to rise unsustainably (Figure 4).

The Council has highlighted how the trade-off between demand and creditworthiness / sustainability has made fiscal policy making in recent years extremely challenging. While the consolidation measures introduced during the crisis have successively stabilised and improved the public finances, the measures have been strongly pro-cyclical and have reduced output and incomes at a time of economic weakness (see FitzGerald *et al.* 2013).

FIGURE 4: GENERAL GOVERNMENT DEBT TO GDP RATIO, ACTUAL AND NO ADJUSTMENT SCENARIO



Source: Fiscal Assessment Report, November 2013.
Note: Actual Scenario as outlined at the time of the Fiscal Assessment Report, November 2013.

3. The Public Finances in 2014

3.1 Fiscal Position up to August 2014

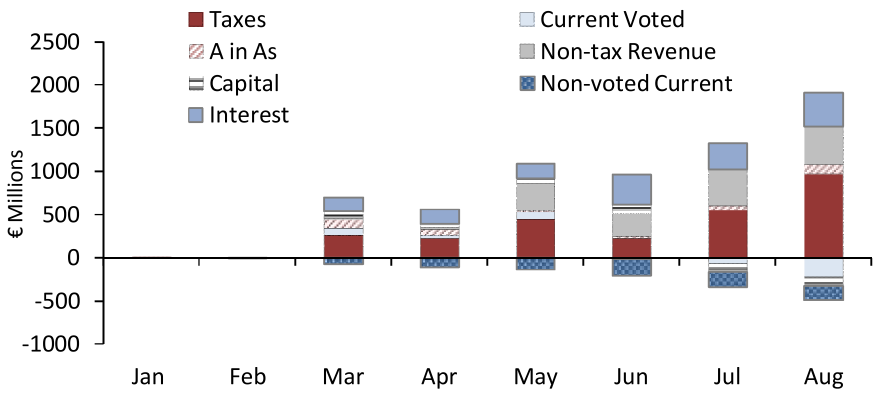
Exchequer returns up to August 2014 show that all major tax receipts are ahead of profile. Together, taxes and PRSI are ahead by €1.1 billion. In June and July, the lion's share of the over-performance is associated with VAT, PRSI and Excise. While caution is needed looking at a single month's figures, there are signs of more broad-based improvement in August with Income Tax, Corporation Tax and Other Taxes recording a strong performance. It should be noted that some of the improvement in tax revenues up to August was due to one-off factors.[6] Some of the gains under these tax headings are not likely to continue to the same extent in future months.

Figure 5 decomposes the full Exchequer overrun for 2014 up to August into its core components. Gross Voted Current Expenditure is €221 million above profile due to overruns in Health with Social Protection and Education close to profile. On the capital side, gross departmental spending is €77 million below profile. In terms of gross voted expenditure, overruns in Health have now reached €320 million. In previous months, the overrun was mostly offset by savings in other departments but this was no longer the case in August. If health overruns continue to grow at this pace, the total overrun would be more than half a billion euro by end-December 2014.

Non-tax revenue is also significantly ahead of profile, reflecting the larger than forecast Central Bank surplus and dividends. Capital spending is higher than profile because, despite a saving in voted capital expenditure, non-voted capital spending is higher due to a capital contribution to Irish Water. Non-voted current spending is above profile due a higher EU Budget contribution and other factors. Interest savings of €390m are a large contributor to the better than expected Exchequer deficit.

[6] Income tax was boosted by higher than expected Life Assurance Exit Tax (LAET). Corporation Tax returns were also impacted by one-off payments.

FIGURE 5: CUMULATIVE EXCHEQUER PERFORMANCE



Source: Department of Finance; IFAC calculations.
Note: Adjusted to exclude items that balance on both revenue and expenditure.

At this point of the year, it is difficult to draw firm conclusions about what these trends mean for the full year outturn, but an over-performance is likely. While it is typical that large tax increases or shortfalls relative to profile by August increase further by December, reversals in the trend have also occurred in previous years. This should emphasise the uncertainty that still surrounds the year-end outturn for 2014 and hence the starting point for 2015.

3.2 IMPLICATIONS FOR FISCAL POSITION IN 2014 AND 2015 RELATIVE TO *STABILITY PROGRAMME UPDATE (SPU) 2014*: ILLUSTRATIVE SCENARIO

Based on the latest Exchequer data to end-August an illustrative baseline scenario for the public finances is developed for both 2014 and 2015. This scenario focuses on the main fiscal variables which may cause a deviation from the end-year position envisaged in the *SPU 2014*. Taking account of the Exchequer data for the first eight months of 2014, Table 1 sets out the assumptions on the changes in government revenue and expenditure in 2014 and 2015 relative to the forecasts contained in the *SPU 2014*.

TABLE 1: ASSUMPTIONS ON DEFICIT IMPACTING CHANGES RELATIVE TO *SPU 2014*

€ billions	2014	2015
Tax and PRSI and Departmental Expenditue	-0.8	-0.7
Reduced interest expenditure (additional to those incl. in *SPU 2014*)	-0.2	-0.2
Other	-0.3	-0.5
Total	**-1.2**	**-1.4**

To construct this scenario, the information in Table 1 is used to adjust the *SPU 2014* figures to take account of the observed taxation and expenditure developments up to end-August 2014.[7] The scenario assumes the implementation of €2 billion adjustment in *Budget 2015*. We also take account of an improvement in nominal GDP relative to the *SPU 2014* forecasts on the back of underlying improvements in the most recent macroeconomic data, as well as the upward revision to nominal GDP levels following ESA 2010.

TABLE 2: ILLUSTRATIVE SCENARIO ANALYSIS OF 2014 AND 2015 POSITION

	Outturn		*SPU 2014* Forecast		Updated Scenario	
	2012	2013	2014	2015	2014	2015
General Government Balance	-8.1	-5.7	-4.8	-2.9	-3.7	-1.9

Note: Rounding may affect totals

Assuming the Government implements the €2 billion adjustment, the general government balance would narrow in this scenario to 3.7 per cent in 2014 and 1.9 per cent in 2015 (Table 2). As a result, taking into account the most recent available information, the short-run EDP target to reduce the deficit to below 3 per cent in 2015 would be met with a significant buffer. There are large risks to these estimates, both upside and downside, as they do not take account of, for example, an overrun in health spending beyond that assumed here, improvements in nominal GDP as contained in recent National Accounts data or possible savings from an early repayment of loans from the IMF which may begin to materialise in 2015.

[7] No further improvement in tax revenues for the remainder of 2014 beyond that realised for the period up to August is assumed. €0.7 billion of the €1 billion over-performance up to end-August is carried forward into the base for 2015. Similarly, no further over-performance is assumed in PRSI and this is carried into the 2015 base. The exclusion of swaps from the deficit under the new ESA 2010 guidelines reduced the 2013 deficit by €0.3 billion and a similar impact is assumed in 2014 and 2015. An additional €0.25 billion in Central Bank surplus income is included for 2015 on the basis of the over performance in 2014 relative to the Budget figure. Offsetting these improvements are an assumed overrun in the Department Health this year which carries forward to 2015; a small assumed increase in the EU budget contribution; and a small underperformance in departmental receipts.

4. Evaluation of the Fiscal Stance in Advance of *Budget 2015*

There has been a substantial reduction in uncertainty regarding the likelihood that Ireland will meet its short-run EDP target of reducing the deficit to below 3 per cent of GDP by 2015 if current plans are implemented. Meeting this target has been the key focus of fiscal policy in recent years. While compliance with domestic and EU Budgetary Rules is a welcome achievement and an important milestone on the road to fiscal sustainability, it is not the sole objective of the fiscal adjustment.

The underlying rationale for the implementation of the fiscal consolidation measures since 2008 was to correct the unsustainable gap between government revenue and expenditure and to move the debt away from dangerous levels. While progress towards achieving this goal has been made through complying with the EDP, compliance itself does not mean that the overriding task of repairing the public finances has been accomplished. This is a prerequisite for ensuring a return to sustained growth in output, employment and incomes in the economy.

The focus for fiscal policy must remain on the broader objectives, including safeguarding the long-run sustainability of the public finances and maintaining market creditworthiness. These are essential ingredients in ensuring the conditions exist for a return to sustainable growth in incomes and employment. Viewed in this light, while a budget adjustment of €2 billion may not now be needed to meet compliance with the 3 per cent ceiling in 2015, there are important reasons why the Government should implement a significant fiscal adjustment in the forthcoming Budget.

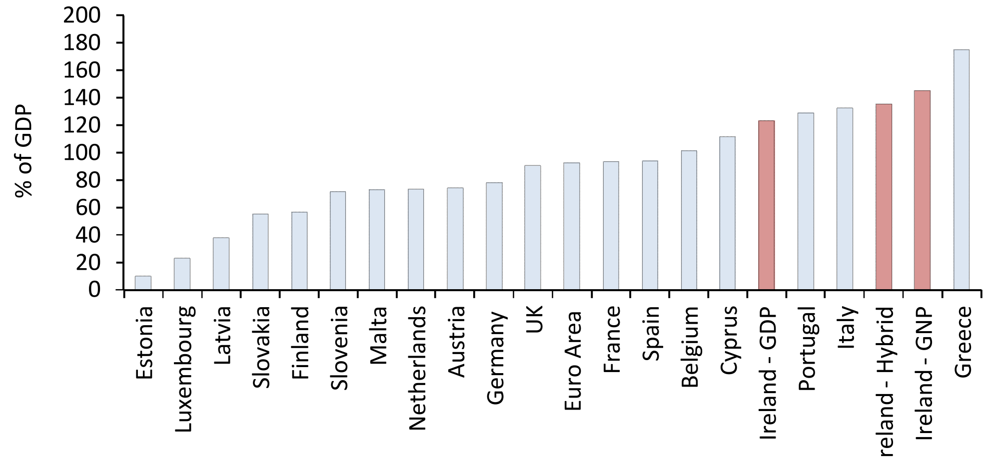
(i) Government Deficit and Debt Levels Remain High

As shown in Section 2, while significant progress has been made in repairing Ireland's public finances, a large gap still exists between government revenue and expenditure. For 2014, the difference is estimated at around €7 billion. The additional government borrowing required to finance the deficit in 2014 will add to the existing large stock of debt accumulated during the crisis. The general government gross debt measured €215 billion or 122 per cent of GDP in Q1 2014. The overall fiscal position therefore remains vulnerable to shocks that could lead the debt-to-GDP ratio to increase again without additional corrective measures.

The structural deficit is the deficit which remains after output in the economy has returned to potential. The other part of the deficit – the cyclical component – will be eliminated as the economy recovers and unemployment falls. The fiscal consolidation measures introduced since 2008 have significantly reduced the size of the structural deficit. Nevertheless, it is likely that at least some part of the remaining deficit is structural. If the Government proceeds with a significant fiscal adjustment effort in the forthcoming budget as contained in previous plans, the remaining structural deficit would be further reduced, lessening the requirement for further efforts in the coming years. By contrast, if the fiscal adjustment is postponed in *Budget 2015*, it implies the need for a larger adjustment in subsequent budgets than would otherwise be the case. If adjustment in *Budget 2015* were very modest, a return to a more restrictive fiscal stance in future budgets could be needed that would be costly and difficult to achieve.

Figure 6 shows Ireland's general government gross debt-to-GDP ratio in 2013 in comparison to 17 other Euro Area countries and the UK. In the wake of the crisis, Ireland's debt ratio is the fourth highest in the Euro Area and is over 30 percentage points higher than the average for the 18 country bloc. Current financial market conditions are exceptionally benign with the interest rate on Irish government debt at record low levels. Nevertheless, for a given level of debt, the possibility remains that market tensions could re-ignite and bring creditworthiness into question. In such a scenario, the risk premium on Irish debt could increase and trigger a self-fulfilling confidence crisis that raises investor fears of future default. The consolidation measures introduced since 2008 have helped to stabilise overall debt levels; however more progress is needed in order to reduce the debt to safer levels.

Figure 6: General Government Gross Debt



Source: Eurostat and CSO; IFAC calculations.
Note: Data for Ireland are from the CSO based on ESA 2010. Data for other countries from Eurostat on ESA95 basis. See IFAC (2012) for description of Hybrid measure for Ireland.

(ii) Medium-Term Expenditure Constraints

In the medium-term, projections for government expenditure are set within the parameters of domestic and EU rules. The EU Expenditure Benchmark (EB) is designed to ensure that expenditure policies are consistent with remaining at the Medium-Term Budgetary Objective (MTO) (that the government accounts are in balance or surplus) or are on the appropriate adjustment path towards it. Under the EB, real expenditure growth must grow at a rate at or below average potential growth in the economy unless there are offsetting adjustments in government revenue. The EB is used to inform the setting of the multi-year expenditure ceilings introduced in 2012 as part of Ireland's new Medium Term Expenditure Framework (MTEF).

Between 2014 and 2016, real annual growth in the expenditure aggregate assessed under the EU EB is limited to -0.7 per cent. This sets the upper limit on allowed expenditure growth over the coming years. The binding domestic aggregate expenditure ceilings and the individual Ministerial ceilings operate to ensure Exchequer expenditure remains within this upper limit. The domestic expenditure ceilings imply a larger real reduction in expenditure than required for compliance with the EB.

The multi-annual expenditure ceilings were designed to constrain expenditure to ensure it remains consistent with the Government's medium-term fiscal objectives. In addition, the move from one-year ahead expenditure allocations to multi-year expenditure planning was intended to facilitate greater planning and more effective control of expenditure by reducing the extent to which expenditure allocations are influenced by short-term considerations or pressures which arise to increase spending when economic conditions improve.

Over the medium-term, achieving the expenditure reductions envisaged in current plans or even the less restrictive EU EB will be extremely challenging. This reflects the likely desire to maintain the current level of public services, and pressures to increase spending as a result of greater demand for services in health and education, as well as increases in the state's pension liabilities. The public investment budget has already been cut to low levels, and there are rigidities in many areas of spending, including the public pay bill.

The ongoing *Comprehensive Expenditure Review* should be used to identify spending priorities and efficiencies so as to limit the damage to public services and protections. However, given the underlying pressures, care needs to be taken in pursuing policies that reduce revenue-raising capacity or introduce significant new spending commitments as part of a scaled back adjustment package.

(iii) Requirement to Put Debt on a Strong Downward Path

The path of the debt to GDP ratio is determined by the interaction of: the initial stock of *government debt* outstanding, the *average interest rate* on government debt, the rate of nominal *GDP growth,* and the government's *primary budget balance* (i.e. the budget balance, excluding debt-interest costs). The size of the primary surplus required to achieve a given rate of debt reduction will depend on the margin by which the interest rate exceeds the GDP growth rate and on the initial stock of debt.

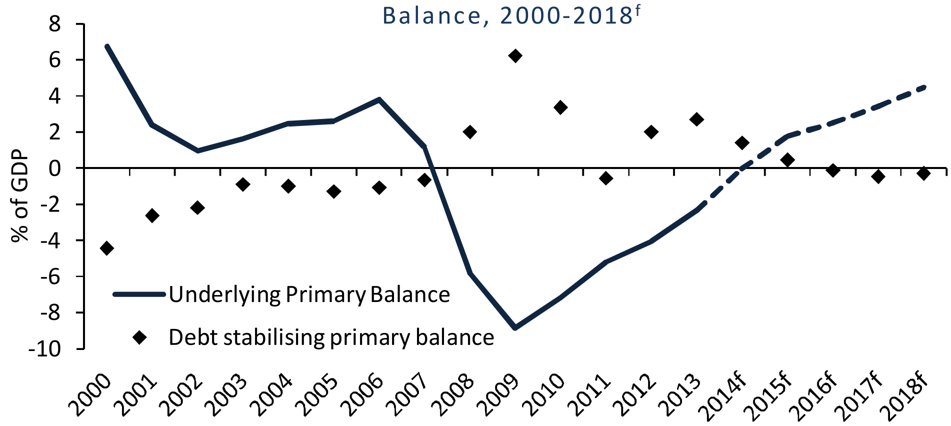
The forecasts in the *SPU 2014* envisage a gradual fall in the overall debt-to-GDP ratio over time.[8] This is to be achieved by running a primary budget surplus averaging over 3 per cent of GDP from 2015 (Figure 7). In a recent paper, Eichengreen and Panizza (2014) use a sample of 54 emerging and advanced economies over the period 1974-2013 to study what type of economic and political variables are associated with large and persistent primary surpluses.

[8] The SPU 2014 figures do not incorporate the latest macroeconomic and fiscal information explored in the scenario in Section 3.2.

The authors find that while there are some examples of primary surpluses of at least 3 per cent of GDP for five years, instances of larger and longer primary surpluses than this are rare in a historical context.

There are political and economic explanations for why large primary surpluses are difficult to achieve and sustain. When tax revenues increase, the political system typically comes under pressure to spend the additional revenues. These pressures are particularly intense following a period of fiscal consolidation when various groups in society who shouldered the burden of fiscal consolidation during bad times demand a dividend when the recovery starts. Economic considerations, such as weak trading partner growth, can also mitigate against Government efforts to run large primary surpluses.

Figure 7: Primary Balance and Debt-Stabilising Primary Balance, 2000-2018^{f}



Sources: CSO; Department of FInance (*SPU 2014*); IFAC calculations.

This highlights the considerable challenges that will face the Irish authorities in achieving the primary surpluses which will likely be required in order to bring about a substantial reduction in the debt-to-GDP ratio in the coming years. Maintaining the fiscal discipline required to achieve primary budget surpluses will become politically harder as crisis memories fade. In addition there is a risk that public fatigue with prolonged fiscal retrenchment could make it difficult to achieve the primary surpluses needed to reduce the debt-to-GDP ratio significantly. In this environment, it is questionable that the right course of action is to now scale back to a significant degree on what was to be the last big push in the agreed adjustment plan. Moreover, limiting the build-up of debt by implementing significant consolidation in the forthcoming budget would also limit the size of the peak primary surplus that must be achieved.

(iv) Signal of Commitment to New Fiscal Framework Post Programme Exit

The strengthening of Ireland's fiscal framework comprising both European and national elements is an important positive legacy of the crisis. The June 2014 *Fiscal Assessment Report* elaborated on some of the main benefits of the new framework. Three advantages of the new framework governing fiscal policy setting were highlighted. First, the framework has the potential to limit the tendency towards boom and bust cycles by reducing the scope for over-expansionary fiscal policy during times of economic growth. As demonstrated in Kearney (2012), Irish fiscal policy has been predominantly pro-cyclical throughout the last three and a half decades. During the boom, fiscal policy failed to lean against the property bubble which contributed to the public finances and the banks becoming over-reliant on the fortunes of the construction sector. Since 2008, partly as a result of previous fiscal policy mistakes, the fiscal stance has, by necessity, again been strongly pro-cyclical with the government implementing an enormous austerity programme in the midst of a deep economic downturn. Thus the experiences of the last two decades alone demonstrate the costs of an inappropriate fiscal policy stance.

Second, for countries with high debt levels the fiscal framework can assist in ensuring that overall debt is reduced to safer levels. Under the Debt Rule, countries such as Ireland with debt-to-GDP ratios in excess of 60 per cent are required to reduce their debt levels over time. Ireland's "fiscal space" (Ostry *et al*., 2010) is limited implying that the risk that adverse shocks could destabilise the debt is high. There is also evidence that high debt levels are associated with lower growth rates. The provisions of the fiscal framework make it more likely that fiscal policy actions will be consistent with gradually reducing debt levels over time.

Finally, a well-designed fiscal framework can increase the credibility of Government commitments with regard to sound management of the public finances. If a government demonstrates strong adherence to the provisions of the fiscal framework, this provides reassurance of the political system's intention to remain committed to a path of prudent fiscal management aimed at eliminating the government deficit and reducing the debt to a sustainable level.

The need to meet the conditions of the EU/IMF Programme and the EDP has played a prominent role in influencing the broad parameters of budgetary policy in recent years. During this period, the Government's fiscal policy decisions were made in the context of the need to comply with the formal conditions of the Bailout Programme as well as regular reviews and intensive surveillance by the EU and IMF. With Ireland having exited the official EU/IMF Programme, the Government can send a strong signal reinforcing its stated resolve to rectify the remaining weaknesses in the public finances by adopting a prudent budgetary stance in the forthcoming Budget.

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