



**Irish Fiscal  
Advisory Council**

# **Fiscal Assessment Report**

June 2015

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## FOREWORD

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

The mandate of the Irish Fiscal Advisory Council is:

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

The Council submits its *Fiscal Assessment Reports* to the Minister for Finance and within 10 days releases them publicly.

The Council is chaired by Professor John McHale, National University of Ireland, Galway. Other Council members are Mr Sebastian Barnes, Organisation for Economic Co-operation and Development; Dr Íde Kearney, Dutch Central Bank (De Nederlandsche Bank) and Dr Róisín O'Sullivan, Associate Professor, Smith College, Massachusetts.

The IFAC secretariat consists of Eddie Casey, Thomas Conefrey, Sarah Doyle, Andrew Hannon and John Howlin.

The Council would like to acknowledge the help of Rónán Hickey and Linda Kane (Central Bank of Ireland), Niall Conroy (ESRI), and the staff of the Central Statistics Office. Thanks to Deirdre Whitaker for her expert assistance with copy editing.

This report was finalised on 29 May 2015. More information on the Irish Fiscal Advisory Council can be found at [www.fiscalcouncil.ie](http://www.fiscalcouncil.ie)



## SUMMARY ASSESSMENT

**The recovery in the Irish economy has gathered momentum with stronger growth and lower unemployment benefitting the public finances.** With positive Exchequer tax data for the early months of 2015, it is likely that the Government will succeed in bringing the deficit to below 3 per cent in 2015 and exit the Excessive Deficit Procedure (EDP) based on the 2015 outturn.

**An important accomplishment of recent years has been the institutionalisation of a new budgetary framework. If respected, this framework provides an important safeguard against a return to the boom-bust cycle.** In the context of Ireland's new *Medium-Term Budgetary Framework (MTBF)*, the *Spring Economic Statement (SES)* provides a useful innovation in Ireland's medium-term planning by setting out the broad policy stance for 2016 in advance of the budget in October. However, the implementation of the new budgetary framework shows weaknesses that could undermine its effectiveness.

**The plan in *Stability Programme Update 2015 (SPU 2015)* for 2016 is not in line with the requirements of the domestic Budgetary Rule or the Preventive Arm of the *Stability and Growth Pact (SGP)* on a forward-looking basis.** Until Ireland reaches its Medium-Term Objective (MTO) of a balanced budget in structural terms, the Government is required to lower the structural deficit by 0.6 per cent of GDP each year. *SPU 2015* sets out a plan that lowers this deficit by just 0.3 per cent of GDP in 2016, thus falling short of this requirement on a forward-looking basis. The rule to lower the structural deficit is supported by the Expenditure Benchmark (EB), which sets a limit on allowable expenditure growth. As described by the Council in April, the original method for calculating the EB contained an anomaly. This has now been corrected. However, the Government has introduced a further adjustment for "tax buoyancy" that goes against the letter and spirit of the EB rule. The Council does not include this tax buoyancy effect in its calculation of the EB and on this basis there is a considerable risk of non-compliance with the rule in 2016. The Council is strongly of the view that Government plans should be based on expected compliance with the fiscal rules and that the reasons for any deviation should be clearly explained.

**The budgetary projections in *SPU 2015* do not present a full picture of the likely costs of demographic ageing and cost pressures in delivering existing programmes, as well as not taking into account explicit Government commitments to reduce taxes.** The post-2016 budgetary projections in *SPU 2015* are based on mainly technical assumptions for government revenue and expenditure and as a result show over-compliance with the fiscal rules even though stated policy in the *Spring Economic Statement* is to target minimum rule compliance. The ratio of non-interest government spending to

GDP is projected to fall by over 5 percentage points between 2015 and 2020. This would appear very challenging to achieve while maintaining current services and meeting demands for increases in public services due to demographic and other pressures. Fully accounting for ageing and cost pressures would lead to a less favourable budgetary position over the medium term than shown in the *SPU 2015* projections. Any discretionary tax cuts would further increase the need to squeeze public spending over the coming years making it difficult to fund known future expenditure demands.

**Post-2016, the medium-term projections for expenditure and tax revenue in *SPU 2015* do not fully meet the requirements of a medium-term fiscal plan as envisaged in the Government’s budgetary framework.** Under the Budgetary Frameworks Directive, plans should be provided both on a no-policy change basis and also based on “policies envisaged” by the Government. *SPU 2015* falls short of these requirements. Providing detailed budgetary plans as envisaged in the Directive is a more demanding task than current practice; however, a realistic projection for the medium-term budgetary position is essential in assessing the fiscal stance.

**The move to annual revisions to the allowable expenditure growth under the Expenditure Benchmark has removed the multi-year anchor from the domestic medium-term expenditure ceilings.** These multi-year expenditure ceilings represent a core component of the new domestic budgetary architecture. This system is not working effectively because the Government has consistently made adjustments to the ceilings. This undermines its value as an expenditure planning and control tool. The Government needs to clarify how the system of multi-year ceilings will operate under the revised EB framework.

**Alternative models for estimating Ireland’s medium-term potential growth should be developed.** It is essential that the Government’s macroeconomic forecasts for the medium term are well-founded to provide a sound basis for setting the public finances on a sustainable path. Ensuring this requires the development of a fuller picture of the supply-side of the economy, outside of the EC framework required to measure compliance with the fiscal rules. To this end, the Department of Finance should develop supply-side estimates of potential growth that are aligned to their forecasts and actual view of the medium term.



# 1. ASSESSMENT OF THE FISCAL STANCE

## KEY MESSAGES

- The recovery in the Irish economy has gathered momentum with stronger growth and lower unemployment benefitting the public finances. With positive Exchequer tax data for the early months of 2015, it is likely that the Government will succeed in bringing the deficit to below 3 per cent in 2015 and exit the Excessive Deficit Procedure (EDP).
- Ireland's new budgetary framework can help avoid a repeat of past mistakes which aggravated the impact of the crisis. The framework supports the maintenance of sound public finances and should help to tame the tendency of the Irish economy towards boom-bust cycles.
- *SPU 2015* forecasts indicate that the fall in the structural budget deficit in the Government's plan is insufficient to meet the requirements of the Budgetary Rule in 2016. Compliance with the Expenditure Benchmark (EB) would also be called into question if tax buoyancy arising from the proposed budgetary package for 2016 is excluded. The inclusion of such buoyancy appears to go against the letter and spirit of the EB rule. Rather than a plan that falls short of the requirements, adjustment in line with the minimum improvement required under the rules would have been appropriate in 2016 in light of Ireland's high debt levels and improved cyclical conditions.
- Beyond 2016, there is an inconsistency in *SPU 2015* between the projections for public finances that imply large annual improvements in the structural deficit and the stated Government policy intention to target minimum rule compliance. The budgetary position over the coming years would be less favourable if the Government's projections are adjusted to reflect stated policy intentions and a likely higher level of expenditure than envisaged in current plans.
- The Budgetary Frameworks Directive requires the Government to provide medium-term projections of each major expenditure and revenue item based on unchanged policies as well as on the basis of envisaged policies. *SPU 2015* falls short of these requirements. Tax forecasts assume no change in policy after 2016 while spending profiles do not adequately take account of underlying expenditure pressures. Providing detailed budgetary projections as envisaged in the Frameworks Directive is a more demanding task relative to current practice. However, such projections are essential to provide a realistic and comprehensive framework for medium-term budgetary planning.

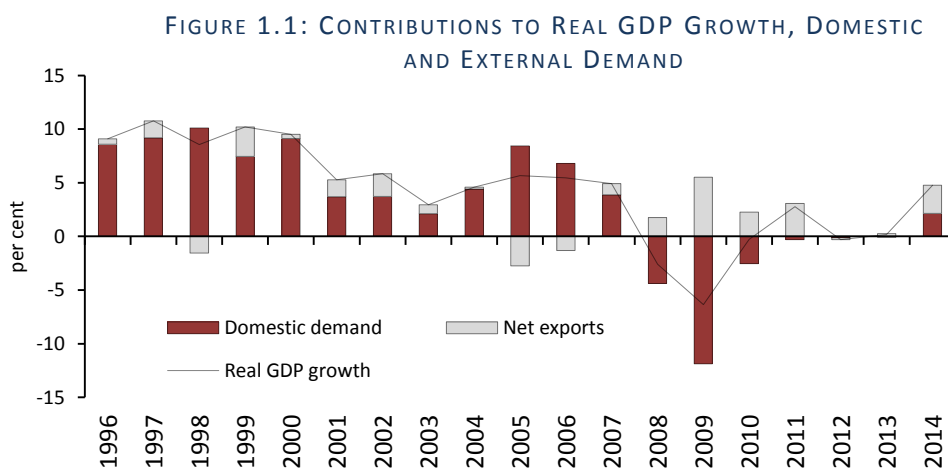
## 1.1 INTRODUCTION

The Fiscal Council has a mandate under the *Fiscal Responsibility Acts 2012 and 2013* to assess the Government’s fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. This chapter draws on the analysis in later chapters in assessing the fiscal stance in *SPU 2015*. With Ireland having exited the EU-IMF official support programme and likely to reduce the deficit to below the 3 per cent EDP ceiling in 2015, the new budgetary framework comprising domestic and European components should set the parameters for fiscal policymaking in the coming years.

Section 1.2 provides an overview of recent macroeconomic developments that provided the backdrop to *SPU 2015*. Section 1.3 outlines how the new budgetary framework supports basic principles of sound budgetary management. Section 1.4 provides an assessment of the fiscal stance in 2016 and over the medium-term as set out in *SPU 2015*, drawing attention to weaknesses in the implementation of Ireland’s new budgetary framework.

## 1.2 MACROECONOMIC CONTEXT FOR STABILITY PROGRAMME UPDATE 2015

Preliminary National Accounts estimates from the CSO indicate that economic activity as measured by GDP expanded by 4.8 per cent in 2014. On a GNP basis, the economy is estimated to have grown by 5.2 per cent last year following a solid expansion in 2013. The data for 2014 indicate that a broad-based recovery in the economy has commenced after the severe recession that followed the financial crisis and the collapse of the domestic property market bubble. As shown in Figure 1.1, and discussed further in Chapter 2, a notable aspect of the recovery in the economy in 2014 was the expansion in domestic demand, the first such increase since 2007. This was driven by a rise in investment by households and firms. Looking ahead, Department of Finance forecasts expect balanced economic growth to continue over the medium term.



Sources: CSO, internal IFAC Calculations.

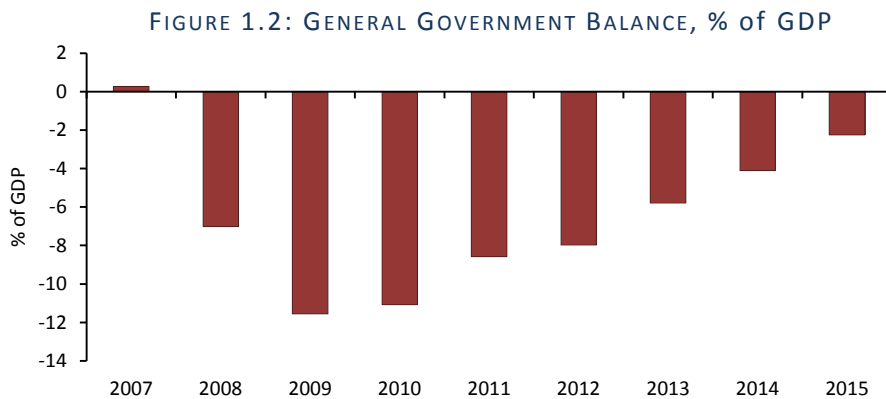
TABLE 1.1: SUMMARY OF MAIN FISCAL AGGREGATES

	2014	2015	2016	2017	2018	2019	2020
<b>Main Aggregates, % of GDP</b>							
<b>General Government Balance</b>	-4.1	-2.3	-1.7	-0.9	-0.1	0.7	1.7
<b>Official measure of the Structural Balance (SB)</b>	-4.0	-2.6	-2.3	-1.3	-0.3	0.8	2.1
<b>Change in the SB</b>	0.0	1.4	0.3	1.0	1.0	1.1	1.3
<b>Official measure of the Output Gap (% of Potential GDP)</b>	-0.9	0.4	1.0	0.7	0.4	-0.2	-0.8
<b>General Government Debt</b>	109.7	105.0	100.3	97.8	93.6	89.4	84.7

Sources: CSO and Department of Finance.

Notes: The estimates of the output gap and the structural deficit shown in this table are those published by the Department of Finance using the official harmonised methodology of the European Commission.

Assisted by the resumption of strong economic growth and the impact of the consolidation measures implemented since 2008, the underlying general government deficit fell from a peak of 11.6 per cent in 2009 to 4.1 per cent in 2014. The deficit is expected to fall to well below the 3 per cent Excessive Deficit Procedure (EDP) ceiling in 2015 (Table 1.1 and Figure 1.2).



Source: SPU 2015.

Note: Chart shows the underlying general government balance net of banking related transfers. 2007 to 2014 are actual outturns. 2015 is a forecast from SPU 2015.

Given the magnitude of the crisis, it was not always obvious that a recovery pattern of the type now being observed - with a strong rebound in growth and a falling deficit – would come to pass. While the main objective of fiscal policy since 2008 has been on reducing the deficit and restoring the state's creditworthiness, we are now entering an important phase where fiscal policy must be used to ensure that a sustainable pattern of growth is established for the medium term.

### 1.3 IRELAND'S NEW BUDGETARY FRAMEWORK

A positive legacy of the economic crisis has been the introduction of a new budgetary framework in Ireland comprising both domestic and European elements. While Ireland was subject to the conditions and related surveillance under the EU-IMF Programme, many of the provisions of the new budgetary framework were effectively in abeyance as the targets under the bailout programme superseded the requirements under the new framework. Now that the state has exited the EU-IMF programme and is due to exit the EDP later this year, normal operation of the new budgetary framework has commenced.

Despite its complexity and imperfections in some areas, the budgetary framework with complementary European and national elements provides a valuable structure to guide Irish fiscal policy. The national components of the fiscal framework are set out in detail in the *Medium-Term Budgetary Framework (MTBF)*. Core components are the Budgetary Rule set out in the *Fiscal Responsibility Act 2012* and the *Medium-Term Expenditure Framework* set out in the *Ministers and Secretaries (Amendment) Act 2013*. Taken together the rules and enforcement mechanisms are designed to be consistent with the requirements of the Preventive Arm of the SGP. Consistency between the national and EU frameworks allows the two sets of formal rules and enforcement procedures to reinforce each other: the monitoring, peer pressure and financial-sanction procedures of the SGP helps give credibility to the national rules; the monitoring and enforcement procedures of the national rules – including roles for both the Dáil and the Fiscal Advisory Council – provide a degree of domestic oversight and ownership of the overall rules framework.

The framework should help ensure that three basic principles of sound budgetary management are followed:

*i. Counter-Cyclicality*

Fiscal policy has the potential to play an important stabilising role in the face of macroeconomic shocks. This occurs through the operation of automatic stabilisers – e.g., expenditures such as unemployment benefits increase and most revenues decrease in a recession – or through discretionary policies that “lean against the wind” of the economic cycle. Unfortunately, Irish fiscal policy has in the past been predominantly pro-cyclical.<sup>1</sup> This pattern of pro-cyclical fiscal policy has been a major contributor to the severe boom-bust cycles to which the Irish economy has been susceptible over the last half a century.

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<sup>1</sup> See Kearney (2012).

The use of counter-cyclical fiscal policy as a macroeconomic policy instrument can differ depending on the cyclical position of the economy. When the economy is operating above its long-run potential, as was the case in Ireland during the property bubble, tight fiscal policy can be used to counter overheating. By allowing the automatic stabilisers to work and through discretionary fiscal policy actions to stimulate the economy, counter-cyclical fiscal policy can also be used to help close the output gap when the economy is operating below its potential.

The counter-cyclical role of fiscal policy is especially important where monetary policy is not available as a demand management tool. Given the sluggish recovery in the euro area relative to the Irish economy, interest rates are expected to remain at low levels over the medium term. Since interest rates in future years could be inappropriately low given the cyclical position of the Irish economy, this enhances the role of fiscal policy in managing the economic cycle.<sup>2</sup>

Without a strong framework, there is a risk that as crisis memories fade support for sound fiscal policy will fade too. Political pressures related to the electoral cycle could result in budgetary policy moving in an overly expansionary and therefore pro-cyclical direction, despite the damage this has caused in the past.

## ii. Sustainability

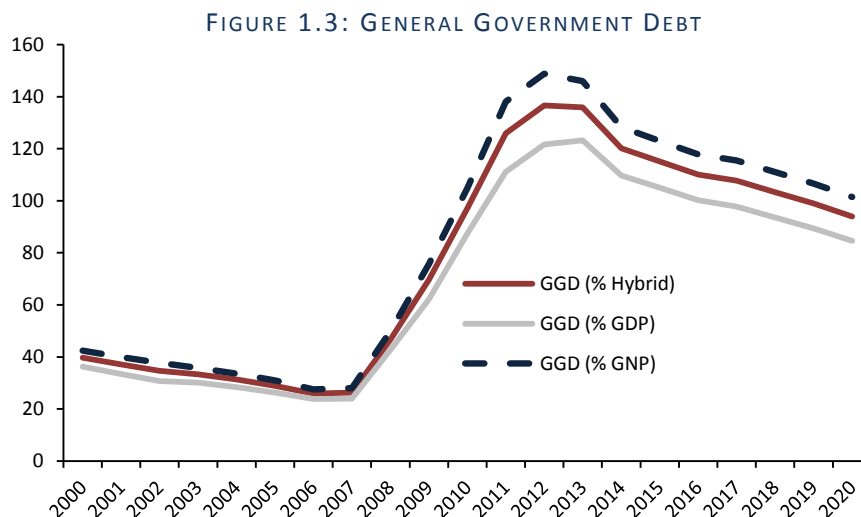
A basic condition for fiscal sustainability is that the debt-to-GDP ratio is stable at an appropriate level or can reasonably be expected to become so in the future. Concerns about sustainability lead to reduced creditworthiness and higher borrowing costs.

The economic and financial crisis has left Ireland with a legacy of high debt levels. The gross debt to GDP ratio peaked at just under 124 per cent before declining to 110 per cent in 2014. Although projected to decline steadily over the coming years, the ratio is expected to remain at high levels over the period to 2020. The debt-sustainability challenge appears more arduous when alternative measures of fiscal capacity are used (see Figure 1.3). The figure shows the projected evolution of alternative debt to fiscal capacity ratios: GDP (peaking at 124 per cent in 2013), GNP (149 per cent) and the Council's Hybrid (147 per cent) measure of fiscal capacity.<sup>3</sup>

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<sup>2</sup> See FitzGerald *et al.* (2010).

<sup>3</sup> The hybrid measure of output is an intermediate measure of fiscal capacity between GDP and GNP. It puts differential weight on GNP and the excess of GDP over GNP, defined as:  $H = GNP + 0.4(GDP - GNP)$ . For details see IFAC (2012b).



Source: Department of Finance; internal IFAC calculations.

Notwithstanding the exceptionally low level of interest rates recently observed, events in the euro area have shown how susceptible states can be to self-fulfilling crises of confidence. States without their own independent monetary policy are especially vulnerable. Sound fiscal management requires achieving and sustaining safe debt levels, including a margin to allow for unanticipated macroeconomic shocks. Compliance with the Budgetary Rule and the Debt Rule<sup>4</sup> should be consistent with delivering the necessary primary budgetary balance to put the debt-to-GDP ratio on a declining path towards safer levels.

### *iii. Stability*

Economic theory points to the value of stable tax rates over time. For a given profile of government spending, economic efficiency is enhanced by stable rates. This is because economic distortions associated with taxation tend to rise in a non-linear way with the tax rate. Total tax-related distortions are then lower with a stable tax rate than with one that fluctuates. With the profile of government spending likely to rise given demographic pressures, stable tax rates could require a period of surpluses to reduce debt or accumulate assets in advance of higher spending needs.

Unfortunately, the principles of sound budgetary management can sometimes pull in different directions. For example, the setting of fiscal policy during the crisis has required a difficult balancing of the need to support domestic demand/employment and the need to put the public

<sup>4</sup> The debt rule states that debt in excess of the 60 per cent debt to GDP ratio must be reduced by at least 1/20<sup>th</sup> per year on average.

finances on a sustainable path. With the economy underperforming relative to potential in recent years, the principle of counter-cyclicality would have favoured an easing of the fiscal stance to offset weak demand in the absence of other constraints. Unfortunately, the constraints imposed by Ireland's high debt levels and the need to restore creditworthiness meant that the principle of sustainability required that the deficit be reduced and the debt moved to lower levels.

With the economy now recovering strongly, new considerations come into play in assessing how best to balance the principles. Estimates produced using the harmonised methodology indicate that Ireland will have a small positive output gap in 2015, suggesting that the economy is operating above potential this year. The Council is of the view that, although the output gap has narrowed since 2012, the economy may still be operating somewhat below potential in 2015. Department of Finance projections envisage strong GDP growth averaging 3.6 per cent per annum from 2015 to 2018. If realised, growth rates of this magnitude could see output returning to close to potential in the near term.

While there is likely to be some spare capacity in the economy currently, the need to provide an additional stimulus from fiscal policy in the current context is weak. At the same time, debt levels remain high following the crisis and there is still a deficit in the government accounts. Balancing these factors, the Council assesses that a policy of following minimum compliance with the rules in 2016 is appropriate.

The new budgetary framework represents a step forward in strengthening budgetary planning and could help narrow the gap between sound and actual fiscal policies. However, as discussed in the next section, the budgetary plans set out in *SPU 2015* fall short of meeting what is required under the new budgetary framework in some key respects.

#### **1.4 THE PATH OF THE PUBLIC FINANCES IN *SPU 2015***

Under its mandate, the Council is required to assess the appropriateness of the Government's fiscal stance with reference to the requirements of the SGP. It is also required to assess compliance with the Budgetary Rule of the *Fiscal Responsibility Act 2012*. The *Stability and Growth Pact (SGP)* includes both a Corrective Arm – operationalised through the Excessive Deficit Procedure (EDP) – and a Preventive Arm, which is focused on attaining a structural budget balance over the medium term. The headline general government deficit is expected to fall to below 3 per cent of GDP in 2015 meaning that the requirements of the Corrective Arm of the *SGP* will have been complied with.

After 2016, the public finances will be subject to the provisions of the Preventive Arm of the SGP<sup>5,6</sup>. The Preventive Arm aims to ensure that a country follows appropriate fiscal policies, through monitoring and surveillance. Under the Preventive Arm, the Government is required to ensure that the budgetary position is at, or moving at a sufficient pace towards, the Medium-Term budgetary Objective (MTO). Ireland's MTO is for a balanced budget in structural terms.

#### 1.4.1 THE FISCAL STANCE IN 2016

Based on estimates of the structural deficit using the EC harmonised methodology, Ireland is currently above its MTO of a balanced budget in structural terms. The country must meet a required minimum adjustment path to the MTO in terms of an annual reduction in the structural deficit of greater than 0.5 percentage points of GDP.<sup>7</sup> The structural deficit refers to that part of the deficit which will not be eroded by the cyclical upswing in economic growth. To support this requirement, the Preventive Arm places limits on the rate of growth of government spending through the Expenditure Benchmark. The Expenditure Benchmark essentially says that annual expenditure growth should not exceed the medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.

In its *Analytical Note* published in April, the Council drew attention to an anomaly in the calculation of the Expenditure Benchmark in 2016. Subsequently, changes were agreed at an EC level which allowed for the existing Expenditure Benchmark calculation for 2016 to be updated and also introduced changes to the process of setting the Benchmark in later years (see Chapter 4).

The tax and expenditure forecasts in *SPU 2015* include the impact of a budgetary package of €1.2 billion in 2016, split evenly between expenditure increases and tax cuts. Turning first to the Budgetary Rule, the solid red line in Figure 1.4 shows the projected annual change in the structural deficit from *SPU 2015*. The broken line shows the required 0.6 per cent improvement under the Budgetary Rule and the Preventive Arm. For 2016, the projected improvement in the structural

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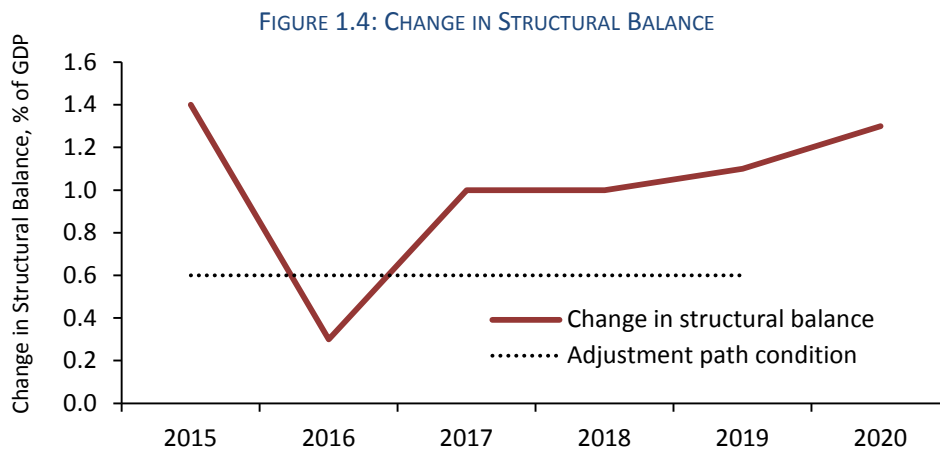
<sup>5</sup> The Department of Finance has usefully brought the various elements together in its Medium-Term Budgetary Framework (MTBF) document. The document is available at: <http://www.finance.gov.ie/sites/default/files/131219%20Medium%20Term%20Budgetary%20Framework%20-%20FINAL%20REV.pdf>.

<sup>6</sup> The procedures and policies for implementing the SGP are presented in the EC's *Vade Mecum* (EC, 2013) available at: [http://ec.europa.eu/economy\\_finance/publications/occasional\\_paper/2013/pdf/ocp151\\_en.pdf](http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp151_en.pdf)

<sup>7</sup> As Ireland has a debt ratio of greater than 60 per cent of GDP, under the terms of the SGP, the annual change in the structural balance must be greater than 0.5 percentage points of GDP to comply with the Adjustment Path condition. It has been decided at EC level that 0.6 percentage points of GDP is an appropriate minimum pace of adjustment.



deficit is 0.3 percentage points of GDP and, therefore, the *SPU* projections fall short of meeting the requirements of the Government's Budgetary Rule in 2016.<sup>8</sup>



*Note:* Medium-Term Budgetary Objective for Ireland is a structural balance. This is planned to be achieved in 2019 and consequently the Adjustment Path condition does not apply in 2020.

*Source:* *SPU 2015*, Department of Finance.

Rather than a plan that falls short of the requirements, greater adjustment in line with the minimum 0.6 per cent structural improvement required under the fiscal rules would be appropriate in 2016. Such an approach would deliver a lower headline deficit for 2016 and, by complying with the Budgetary Rule, signal the Government's commitment to the new budgetary framework.<sup>9</sup>

The requirements under the Preventive Arm of the *SGP* are also assessed on the basis of the Expenditure Benchmark. Under the Benchmark, increases in expenditure are permitted if fully offset by discretionary revenue-raising measures, for example, an increase in tax rates or another structural revenue-raising measure. Increases in revenue due to tax buoyancy<sup>10</sup> from the economic cycle cannot be used to fund higher expenditure. As explained in Chapter 4, in calculating the allowable fiscal space under the Expenditure Benchmark, *SPU 2015* includes the impact of tax buoyancy as a result of the assumed budget package for 2016.

<sup>8</sup> As discussed in Chapter 4, this difference between the planned improvement of 0.3 per cent and the 0.6 per cent requirement is not large enough to be deemed a "significant deviation" under the EU rules.

<sup>9</sup> In relation to 2016, the statement published by the IMF in May 2015 following the Third Post-Programme Monitoring Discussion states that: "IMF staff estimate that the implied structural primary adjustment is modest, at about ¼ percent of GDP. (These estimates use a different potential output methodology than the EU). Stronger adjustment, of ½ percent of GDP, is appropriate in view of Ireland's high public debt and strong growth, implying a deficit target of about 1.5 percent of GDP." See: <http://www.imf.org/external/np/ms/2015/050115.htm>

<sup>10</sup> An example of tax buoyancy is the increase in revenues from stamp duty and capital gains taxes which accrued from the construction boom of the 2000s.

The treatment of tax buoyancy arising from the budget package as a discretionary revenue raising measure in *SPU 2015* would appear to go against the letter and spirit of the Expenditure Benchmark. The point of the Expenditure Benchmark is to ensure that expenditure growth is linked to sustainable revenue growth, which is in turn linked to growth in potential output and discretionary tax changes. Revenue growth based on the temporary demand effects of an expansionary fiscal package does not meet this criterion. Furthermore, no provision for the use of “buoyancy” appears in the formal descriptions of the working of the Expenditure Benchmark rule.

Given the planned fall in the structural budget deficit is insufficient to meet the requirements of the Budgetary Rule in 2016, it is especially important that the Expenditure Benchmark is complied with in 2016. On the basis of current calculations, the scope for any further increases in expenditure or discretionary reductions in revenues beyond the €1.2 billion package set out in the *SPU* is limited, even allowing for the inclusion of buoyancy. As discussed in Chapter 4, excluding the tax buoyancy effect in 2016 there is a considerable risk of non-compliance with the EB based on the *SPU 2015* projections.

The Council has a responsibility under the Fiscal Responsibility Act to assess whether “. . . the fiscal stance for the year or years concerned is . . . conducive to prudent economic and budgetary management” [*FRA* 8(4)(b)]. The requirements for EDP exit are likely to be complied with in 2015 thereby meeting this prudence test. Post EDP exit, the Council’s assessment of the fiscal stance will be informed by compliance with the Budgetary Rule and the Preventive Arm of the Stability and Growth Pact (SGP). A decision on the prudence of the fiscal stance for 2016 will be made in the next *Fiscal Assessment Report* following the publication of *Budget 2016*.

#### **1.4.2 MEDIUM-TERM FISCAL STANCE IN *SPU 2015***

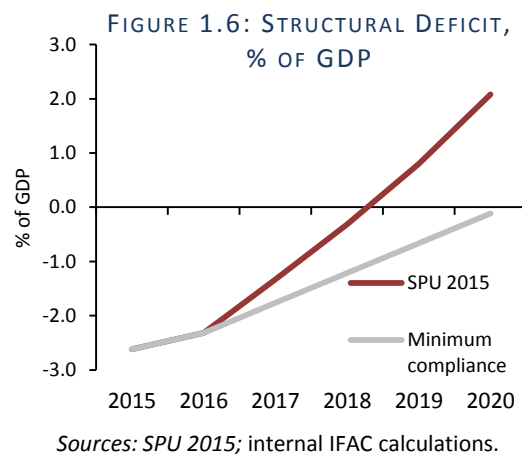
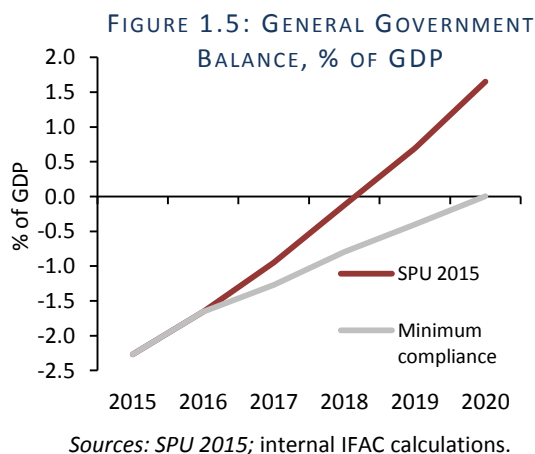
A realistic projection for the medium-term budgetary position is essential for setting the fiscal stance. As discussed in Chapter 3, the budgetary projections in *SPU 2015* do not take full account of the likely costs of demographic ageing and cost pressures in delivering existing programmes, as well as not taking into account explicit Government commitments to reduce taxes. The illustrative scenario in Chapter 3 shows that, based on certain assumptions, fully accommodating ageing and cost pressures would see a higher level of government spending than contained in the Government’s plan. This would imply a less favourable budgetary position over the coming years than shown in the *SPU 2015* projections.

As stated in the *SPU*, the Government’s intention is to comply with the minimum requirements to achieve its MTO of a balanced budget in structural terms. This would suggest some room for spending increases in nominal terms to fund the likely expenditure needs identified in Chapter 3,

but tight spending constraints and strong cost pressures would continue to constrain public services, pay and welfare payments. Any discretionary tax cuts would further increase the need to squeeze public spending over the coming years.

The *Spring Economic Statement (SES)* states that the Government intends to move towards the MTO at the minimum rate of greater than 0.5 per cent of GDP rather than at the faster rate envisaged in the SPU projections. This would imply annual adjustments from 2017 around half as large as is contained in the *SPU*. *SPU 2015* does not provide deficit and debt projections consistent with this stated policy intention. The document notes that that the difference between the SPU projections and what is required for minimum rule compliance indicates the availability of considerable fiscal space after 2016.

Assuming the Government implements its stated policy of limiting fiscal adjustment to the minimum required under the rules, Figure 1.5 and Figure 1.6 show the path of the actual and structural deficits compared to the projections in *SPU 2015*. Assuming that fiscal policy is set in accordance with stated policy of meeting minimum rule compliance, there would be larger deficits over the 2017 to 2019 period and the government accounts would be broadly in balance by 2020 compared to the large surplus contained in the *SPU* projections. The scenarios for the structural deficit are shown in Figure 1.6. Under the *SPU* forecasts, the Government would meet its MTO (of a balanced budget in structural terms) by 2018. Assuming smaller structural adjustments are actually implemented after 2017, the MTO would not be reached until two years later in 2020.



In providing medium-term projections for the public finances, the Government should ensure that these reflect actual Government policy intentions along with the Department’s best assessment of the actual likely future path of deficit. This is essential if the forecasts contained in the *SPU* are to provide a meaningful anchor for medium-term budgetary planning.

As part of the “six-pack” of EU fiscal governance reforms, the Budgetary Frameworks Directive requires that member states put in place Medium-Term Budgetary Frameworks (MTBFs). These frameworks are required to include, inter alia, procedures for providing medium-term budgetary projections on both a no-policy-change and policy-change basis. The Statutory Instrument implementing the framework in Irish law<sup>11</sup> states that the framework shall include procedures for establishing the following:

- (i) projections of each major expenditure and revenue item of the general government with more specifications on the central government and social security level, for the budget year and beyond, based on unchanged policies;
- (ii) a description of medium-term policies envisaged with an impact on general government finances, broken down by major revenue and expenditure item, showing how the adjustment towards the medium-term budgetary objectives is achieved compared to projections under unchanged policies.

As outlined above and discussed in detail in Chapter 3, the medium-term projections for expenditure and tax revenue in *SPU 2015* do not fully meet the requirements of a medium-term fiscal plan as envisaged in the Budgetary Frameworks Directive.

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<sup>11</sup> <http://www.irishstatutebook.ie/pdf/2013/en.si.2013.0508.pdf>

## 2. ASSESSMENT AND ENDORSEMENT OF MACROECONOMIC FORECASTS

### KEY MESSAGES

- The Council endorsed the *SPU 2015* macroeconomic forecasts to 2020. Taking into account the uncertainties and judgemental elements involved, it was satisfied that these forecasts were within an endorsable range.
- The underlying growth trajectory for the near term continues to strengthen, with evidence mounting that the recovery is now broadening into the domestic economy. If activity continues to strengthen, questions concerning the sustainability of growth rates and risks of an eventual overheating will become more pertinent.
- It is essential that the Government's forecasts for the medium term are well-founded to provide a sound basis for setting the public finances on a sustainable path. Ensuring this requires the development of a fuller picture of the supply-side outside of the EC framework, which is only required for fiscal surveillance. To this end, the Department of Finance should develop a set of medium-term baseline estimates for the supply-side that are aligned to their forecasts for actual variables. This may require greater prioritisation and allocation of resources by the Department towards developing such estimates as it is likely to remain a pivotal issue for future endorsements.
- While near-term prospects for the economy have clearly improved, with risks more balanced than in previous years, chances that growth may disappoint cannot be ignored. The error margins around Irish growth forecasts are very high by international standards and unusual uncertainties regarding the present outlook exist. Notwithstanding recent positive developments, the Euro Area – Ireland's largest trading partner – has yet to durably escape a protracted recession. Developments in Greece and a planned British referendum on EU membership further magnify near-term levels of uncertainty for the external environment. Domestic challenges also exist, with household, corporate and public sector debt still at relatively high levels.

## 2.1 INTRODUCTION

The Council's fourth endorsement exercise covers the set of macroeconomic projections in *SPU 2015*, representing a longer horizon (2015-2020) than in *Budget 2015*.<sup>12</sup> The timeline for the endorsement process is detailed in Appendix C. As in previous exercises, the Department of Finance provided high levels of cooperation in all of their interactions with the Council.

The ongoing development of the "suite of models" approach has seen the Secretariat continue to develop its set of tools for both short-term and medium-term forecasting. Since November, considerable efforts have been made to build on an understanding of supply-side estimates of the Irish economy in particular. These are all the more urgent given the centrality of potential output estimates to Ireland's fiscal rules as well as the well-documented<sup>13</sup> concerns with the standard EU Commission approach. For the short term, new models of the GDP deflator, trade prices, consumption and incomes have been added while input into a new working paper (Casey and Smyth, 2015) investigating the importance of revisions in quarterly macroeconomic data provides additional insight for the endorsement mandate.<sup>14</sup>

Section 2.2 discusses the *SPU 2015* forecasts and puts these in context relative to forecasts of other agencies, while Section 2.3 provides an assessment of the uncertainty and risks surrounding the economic outlook. Section 2.4 concludes by outlining the endorsement process as it applied to the *SPU 2015* projections. Three boxes are included: the first reviews the impact of contract manufacturing on net exports last year; the second updates the Council's analysis of the pattern of errors in the Department of Finance's growth forecasts; and the third documents some of the Council's recent work on supply-side estimates of the economy.

## 2.2 AN ASSESSMENT OF THE MACROECONOMIC FORECASTS IN *SPU 2015*

### 2.2.1 SHORT-TERM FORECASTS, 2015-2016

*SPU 2015* expects last year's resurgent growth to continue into the remainder of 2015, with real GDP projected to expand by 4.0 per cent, followed by a 3.8 per cent expansion in 2016. While trade developments in the multinational sector flattered growth rates at the beginning of 2014, evidence of a broadening recovery has since strengthened.

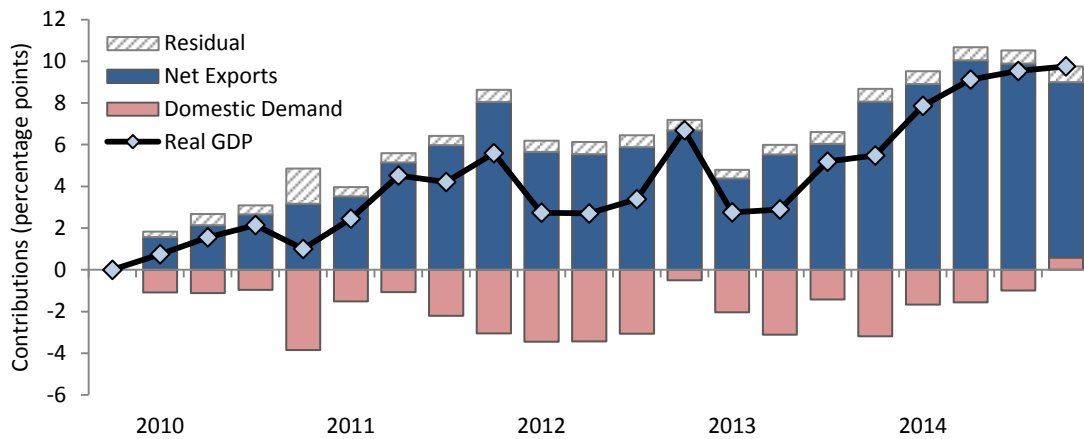
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<sup>12</sup> The endorsement function is outlined in detail in IFAC, (2013b) and in IFAC, (2014a).

<sup>13</sup> See, for example, IFAC (2014b), Analytical Note 2, Bergin and Fitzgerald (2014), and Department of Finance (2003).

<sup>14</sup> In addition to discussions with Council members, an important input into the preparation of the Benchmark projections involves rounds of discussions with other external forecasters, coming from a wide variety of different perspectives. For this round of forecasts, the Secretariat held discussions with economists and forecasters at the EU Commission, the ESRI and Goldman Sachs. The Secretariat also met with the CSO to gain further insights into recent *National Accounts* and *Balance of Payments* data.

FIGURE 2.1: CUMULATIVE CONTRIBUTION TO REAL GDP GROWTH SINCE 2009 TROUGH



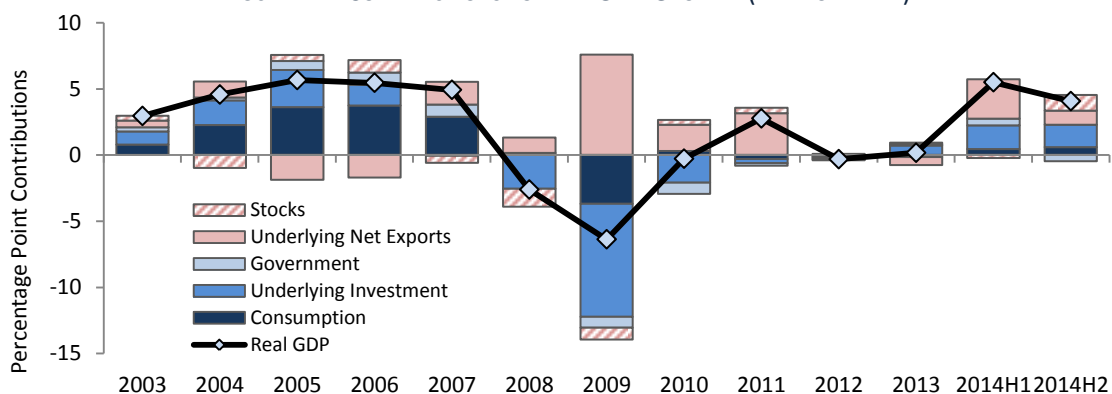
Sources: CSO and internal IFAC calculations.

Note: Q4 2010 data correct for the statistical discrepancy. Domestic demand includes changes in stocks.

The prolonged drag from domestic demand during the crisis appears to have finally abated. In particular, last year’s real GDP growth outturn of 4.8 per cent saw a primarily export-led recovery (Figure 2.1) partly supported by expanding underlying investment activity (i.e., excluding aircraft) as well as a nascent recovery in consumer spending.

It is useful to consider the 2014 performance in two halves. The boost from contract manufacturing activities (Box A) to growth rates in the first half of 2014 – when real GDP registered a year-on-year increase of 5½ per cent – unwound in the latter half of the year as associated royalty/licenses imports offset the increase in exports (see Box A). The negative impact from this unwinding was limited, however, due to a pick-up in underlying activity in the latter half of the year (Figure 2.2). Sharp increases in stocks – expected to be related to imported items for eventual consumer purchase – were evident in the final quarter, while net exports (on an underlying basis) still made a solid contribution to real GDP growth even as imports accelerated.

FIGURE 2.2: CONTRIBUTIONS TO REAL GDP GROWTH (YEAR-ON-YEAR)

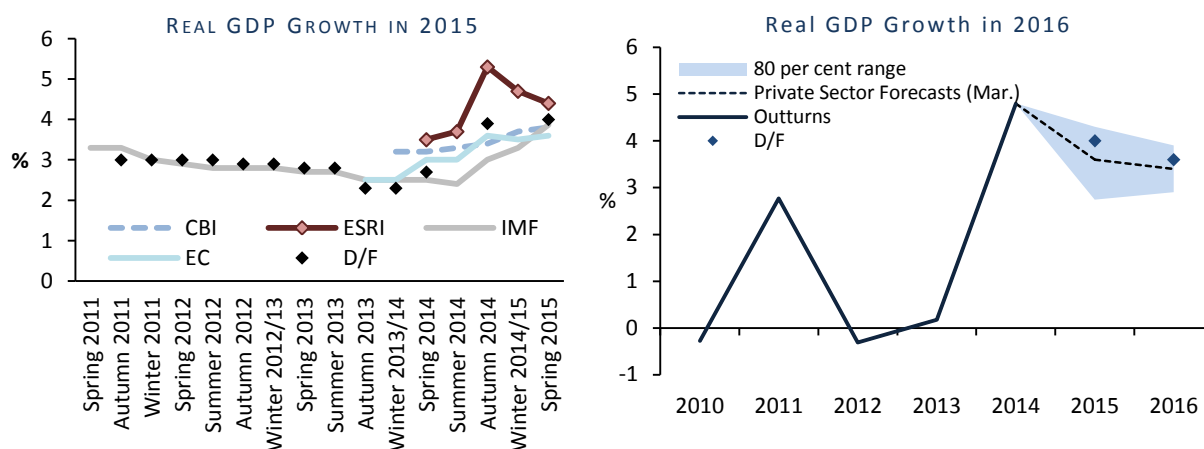


Sources: CSO; internal IFAC calculations.

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

Looking ahead, the recovery in domestic demand is expected to coincide with more favourable external factors. Moderate gains in real incomes and a sturdy pace of employment creation bode well for consumption, while supply pressures in commercial and residential sectors will likely fuel further investment growth. The euro depreciation, weaker oil prices and an improved outlook in key trading partners, meanwhile, should boost trade performance. Most forecasters have consequently revised upwards projections of real GDP growth rates for this year and continued strength is envisaged for 2016, with projections broadly concentrated in the 3-4 per cent range (Figure 2.3).

FIGURE 2.3: COMPARATIVE REAL GDP FORECAST VINTAGES (% CHANGE YEAR-ON-YEAR)

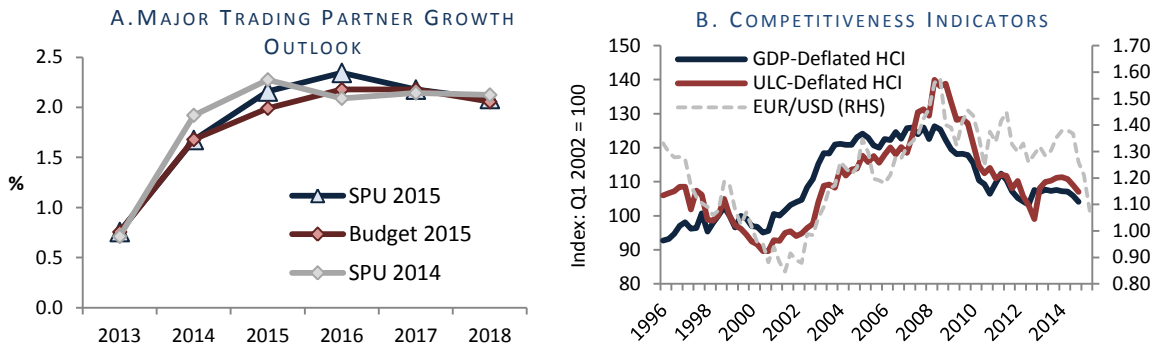


Sources: Department of Finance (D/F); European Commission; International Monetary Fund (IMF); Central Bank of Ireland (CBI); Focus Economics and the Economic and Social Research Institute (ESRI).

**Exports** should continue to aid real GDP growth this year and next. Projected external demand growth is slightly better than at Budget time (Figure 2.4 A), when brisk UK and US growth rates were already factored in. The improvement stems from the Euro Area outlook, where a more accommodative monetary stance, a weaker euro and lower oil prices are all supportive of renewed activity. The latter factors should benefit Irish competitiveness, adding further stimulus to real exports (Figure 2.4 B) and building on the reversal in competitiveness losses visible since 2008.



FIGURE 2.4: EXTERNAL TRADE FUNDAMENTALS IMPROVE



Sources: Department of Finance (D/F); internal IFAC calculations.

Notes: Trading partner forecasts are trade-weighted EC/IMF real GDP forecasts for UK; US and Euro Area as used by D/F. HCI = Harmonised Competitiveness Indicators; ULC = Unit Labour Costs.

### BOX A: CONTRACT MANUFACTURING IN 2014

At the time of the November *Fiscal Assessment Report*, outturns for the first two quarters of 2014 were the most recent official National Accounts estimates of real GDP growth in 2014. As noted in the November *FAR*, these outturns were being heavily influenced by an activity referred to as ‘contract manufacturing’. This Box reviews the role played by this activity over the course of last year.

#### CONTRACT MANUFACTURING

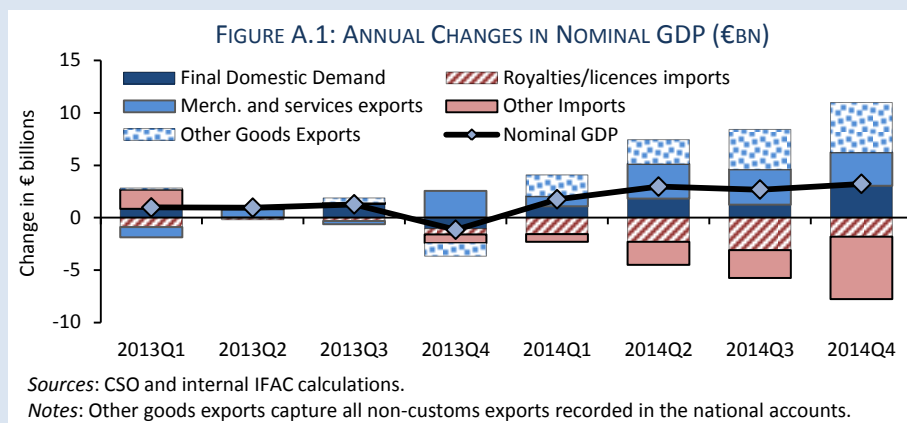
Contract manufacturing activities occur when an Irish-resident firm (not necessarily Irish-owned) contracts a manufacturer overseas to produce a good for supply to an end-client abroad. The sale of the good is recorded as an Irish export of goods, while the contracted production is considered an import of services.<sup>15</sup> The value added that accrues to Ireland is the sale price of the good produced less some assortment of the following costs: manufacturing services used; the supply of material inputs used in production; imports of royalties for use of the patents; and imports of other services including transport.

In its previous *Fiscal Assessment Report*, the Council noted that the activity served to flatter early-year outturns, while also magnifying the degree of uncertainty around projections for net exports. It was also noted that it would be unlikely to boost domestic employment and that the contribution to the tax base was unclear. In terms of a full-year impact, it was believed at the time that the activities might represent a temporary, once off boost to real GDP growth for 2014 or that they might actually unwind in full before year-end.

#### IMPACT IN 2014

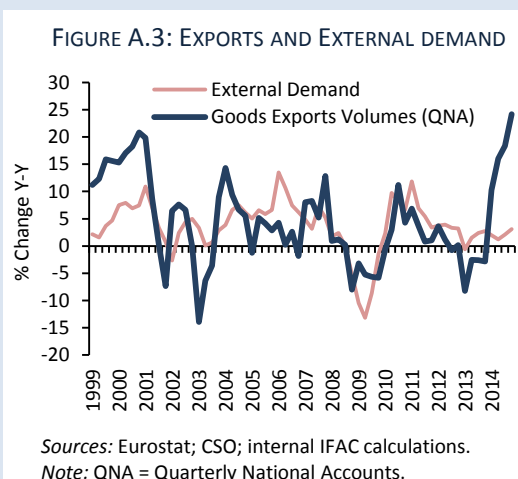
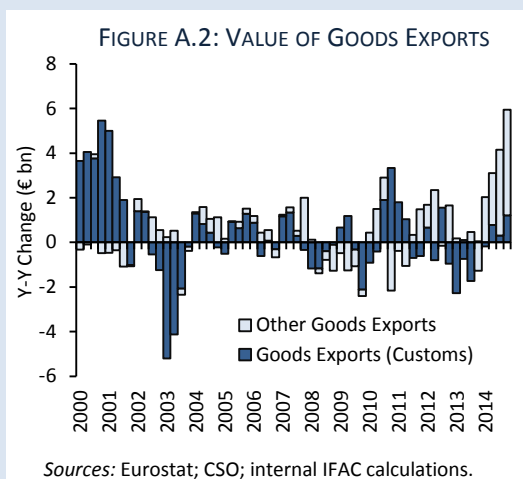
Data for 2014 suggest that the initial impact from Contract Manufacturing on GDP growth did unwind in the second half of the year. Fortunately, accelerated activity elsewhere offset the impact of this unwinding. The unwinding emerged as sharp increases in imports of royalties (including patents related to the use of intellectual property that covered finished products) offset the early-year boost from contract manufacturing-related exports. Total royalties/licenses imports were particularly strong in the third quarter of 2014 (Figure A.1).

<sup>15</sup> These activities, which reflect the complex global supply chains that multinational enterprises (MNEs) partake in, are expanded on in Box 1 of *Budget 2015* and Box 1 of the *IMF’s 2015 Article IV Consultation – Staff Report* (IMF, 2015a). The CSO have noted that as of March 2015 only 16 companies resident in Ireland were engaged in contract manufacturing, while the IMF (2015) note that the issue is most important in the pharmaceutical sector.



As a result of this unwinding, the CSO (2015) noted that contract manufacturing was “...not particularly significant” in explaining the provisional real GDP growth estimate for the full year at 4.8 per cent, though associated activities did have an impact on individual quarters. Although the net impact in 2014 is likely to be small, it is not possible to be precise as regards the exact scale of the impact on growth for two reasons in particular: (i) the activities in question relate to a very small number of companies and thus fall under the CSO’s limits for discretion/uncertainty so that confidentiality issues are not breached; and (ii) data limitations mean it is not possible to net specific quantities of imports against corresponding exports relating to contract manufacturing activities.

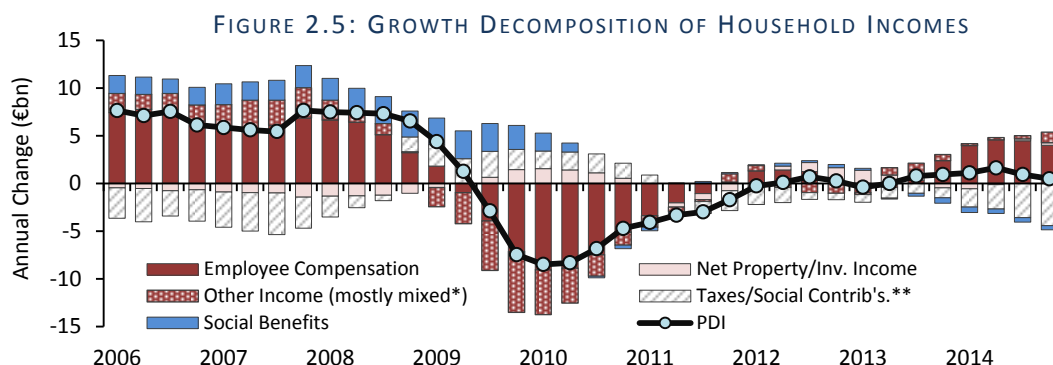
Looking ahead, there may continue to be some impact from adjustments to goods exports like that of contract manufacturing. Such activities have caused goods exports – as measured in the National Accounts<sup>16</sup> – to deviate more than usual from customs data on exports (Figure A.2) as well as usually reliable indicators of external demand (Figure A.3). However, we anticipate that this will continue to be offset by related import growth so that the net effect should be relatively negligible even if gross imports and exports data continue to be impacted.



**Personal consumption** volume growth is expected to continue to be less subdued in the near term than in recent years (see Table 2.1 forecast summary). Spending on services towards the end of 2014 was less weak than in previous quarters, thus raising expectations that overall spending will

<sup>16</sup> The National Accounts measure of goods traded include adjustments to the primary data sourced from the monthly international trade series covering goods exports/imports (i.e., customs data). As well as contract manufacturing activities, the former also reflect merchandising and other conceptual adjustments.

accelerate further this year, while high-frequency retail sales data point to strong durables consumption in the first quarter. Income data are supportive of the outlook: hourly earnings trends for households are more positive, while employment growth appears to have gathered pace again after a slight hesitation in early 2014. Furthermore, taxes and social contributions are not expected to dampen disposable incomes as much as in previous years, given the less contractionary fiscal stance (Figure 2.5).



Sources: CSO Institutional Sector Accounts; internal IFAC calculations.

\* Mixed income includes compensation for work by self-employed persons & family members as well as any operating surplus; \*\* includes other net current transfers.

Household spending is likely to face constraints, however. Savings rates appear to have already descended from crisis highs, limiting the scope for further falls to fuel consumption. In addition, household deleveraging – while progressing – is expected to continue in the near-term, with debt levels far above international levels and historical norms. Recent research (McCarthy and McQuinn, 2014) suggests that higher incomes are associated with additional deleveraging, which may also imply a more limited than usual pass-through of rising incomes to consumer spending.

**Investment** spending is expected to continue a strong cyclical recovery. Notwithstanding this, the exceptionally low base and various brakes on responses to tightened supply mean that the *SPU* does not expect the building and construction sector to converge on its historical share of GDP (excluding the “bubble” period) even by 2020. A diminished capital stock also means that firms are expected to continue restoring underlying machinery and equipment investment (i.e., excluding aircraft) at a brisk pace.

**The GDP deflator** in 2015 is expected to benefit from improving terms of trade amid weaker oil prices and a substantive depreciation in the euro, particularly vis- à-vis the US dollar. Continued rental cost growth will add to otherwise relatively subdued domestic inflationary pressures (given the weight of imputed rents in National Accounts-measured personal consumption). The GDP

deflator is expected to moderate next year as oil price declines reverse (in line with futures markets) and as exchange rate effects fall out of the base.

TABLE 2.1: *SPU 2015* MACROECONOMIC FORECASTS (TO 2016)

<i>% change in volumes unless stated</i>	2013	2014	2015	2016
GDP	0.2	4.8	4.0	3.8
GDP Deflator	1.0	1.2	2.8	1.5
Nominal GDP	1.2	6.1	6.9	5.4
GNP	3.2	5.2	3.9	3.5
Consumption	-0.8	1.1	2.4	2.5
Investment	-2.4	11.3	15.3	12.1
Government	1.4	0.1	1.1	1.6
Exports	1.1	12.6	7.6	4.8
Imports	0.6	13.2	8.7	5.4
Current Account (% of GDP)	4.4	6.2	7.2	6.4
Employment	2.4	1.7	2.2	2.2
Unemployment Rate	13.1	11.3	9.6	8.8
Inflation (HICP)	0.5	0.3	0.2	1.1
Nominal GDP (€ billions)	174.8	185.4	198.3	208.9

Sources: CSO and Department of Finance (*SPU 2015*).

### 2.2.2 MEDIUM-TERM FORECASTS, 2017-2020

The *SPU* forecasts annual real GDP growth to slow towards 3 per cent by 2020: below the average of the past 20 years, but above most expectations for advanced economies<sup>17</sup> (Table 2.2). This picture is broadly in line with *Budget 2015*, with economic activity driven by domestic demand initially, before exhibiting a more balanced composition after 2018 as the contribution of net exports to growth rises while growth in domestic activity moderates.

TABLE 2.2: REAL GDP GROWTH RATE FORECASTS

<i>% change</i>	2014	2015	2016	2017	2018	2019	2020
Real GDP Growth	4.8	4.0	3.8	3.2	3.2	3.0	3.0
Domestic Demand (p.p.) <sup>1</sup>	2.8	3.4	3.3	2.2	1.7	1.5	1.5
Net Exports (p.p.) <sup>1</sup>	2.2	0.6	0.5	1.0	1.5	1.5	1.4

Source: Department of Finance (*SPU 2015*).

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

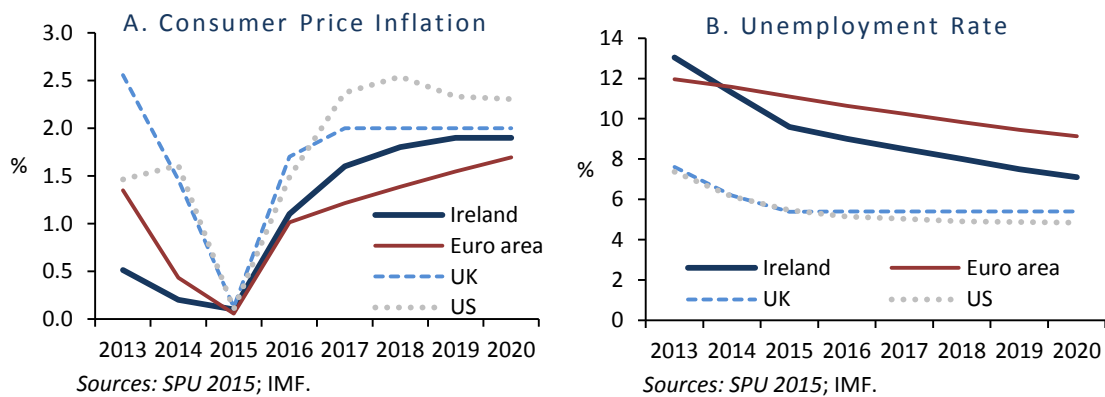
While the medium-term outlook is within a plausible range, the extent to which growth might be fuelled by the external sector in later years could prove challenging. For the growth composition beyond 2018 outlined in *SPU 2015* to be realised, recent competitiveness gains would have to be

<sup>17</sup> By comparison, the IMF (WEO, April 2015) project growth rates over 2017-2020 for 37 advanced economies averaging 2.3 per cent per annum. The *SPU* projections would, therefore, place Ireland just inside the upper quartile of the IMF projections for advanced economies in later years.

sustained in the face of rising domestic pressures. *SPU 2015* forecasts consumer price inflation exceeding Euro Area rates (Figure 2.6 A), and a stronger labour market (Figure 2.6 B), yet real hourly wage growth (HICP-adjusted) is projected to weaken to 0.4 per cent per annum over 2017-2020 from 1.1 per cent over 2014-16. It is essential that the Department’s labour market and income projections are consistent with expectations for overall activity, especially compared to that in economies whose products compete with Ireland’s.

There is vast uncertainty as to the current cyclical position of the economy, which certain statistical methods may fail to grasp if used in isolation (Box B). In the absence of a clear sense of equilibrium, one might look to a variety of indicators of slack or tensions on productive capacity in order to help to inform an understanding of this position. In this respect, broad-based real wage and price pressures across the economy as well as the strong current account surplus do not appear indicative of tensions as yet.<sup>18</sup> Even if unambiguous signs of pressures may not be immediately obvious, there are huge uncertainties and risks to this perspective that warrant careful attention.

FIGURE 2.6: CONSISTENCY OF MEDIUM-TERM PROJECTIONS



Assessing the medium-term forecasts in the *SPU* is complicated by the Department’s reliance on the EC methodology as the central guide for supply-side forecasts in later years. While the Department produces – but does not publish – some variations on this approach, a richer alternative should form part of the supply-side assessment.<sup>19</sup> The EC methodology follows a standard approach to medium-term forecasting that anchors these in a set of projections for productivity, capital and labour. However, in the *SPU*, the supply-side estimates merely conform to the EC methodology. Technical projections on this basis may be necessary for fiscal surveillance requirements, but they do not have to represent the Department’s only detailed estimates of the

<sup>18</sup> See also Appendix B on house prices.

<sup>19</sup> As well as some variants of the EC methodology, the Department has produced some unpublished HP filtering estimates, however, these do not appear to represent substantive alternatives to the EC methodology.

supply-side. Well-documented problems with the EC approach mean that medium-term demand forecasts are also not well aligned with these supply-side figures.<sup>20</sup>

This approach, for example, leads to estimates of potential output growth exceeding projected real GDP growth by more than half a percentage point in each of 2019 and 2020 (Table 2.3). Beyond the business cycle horizon, it is normally expected that actual and potential output growth would converge, but this is not the case for SPU projections.

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

	% change	2014	2015	2016	2017	2018	2019	2020
<i>SPU</i> 2015	Real GDP Growth	4.8	4.0	3.8	3.2	3.2	3.0	3.0
	Nominal GDP Growth	6.1	6.9	5.4	4.2	4.4	4.2	4.2
	Potential GDP Growth	2.0	2.7	3.2	3.5	3.6	3.6	3.6
	Output Gap (% potential GDP)	-0.9	0.4	1.0	0.7	0.4	-0.2	-0.8
<i>Budget</i> 2015	Real GDP Growth	4.7	3.9	3.4	3.4	3.4	-	-
	Nominal GDP Growth	5.2	5.3	5.1	5.2	5.2	-	-
	Potential GDP Growth	2.1	2.7	3.4	3.8	3.9	-	-
	Output Gap (% potential GDP)	-0.1	1.0	1.0	0.7	0.1	-	-

Source: Department of Finance.

The EC methodology attributes a large share of potential growth to changes in labour supply. This problematic approach is due to the fact that estimates of equilibrium unemployment rates (NAWRU<sup>21</sup>) track actual rates of unemployment very closely.<sup>22</sup> As such, swings in actual unemployment are considered to be almost entirely structural in nature under the EC approach.

Irish labour supply responds to excesses/shortfalls in demand through standard channels like unemployment rates, but migration also plays a substantive role. That such flows are highly responsive to changing economic activity is not surprising, but the relative scale of these flows when compared to the size of the existing labour force is (e.g., net inward migration flows were equivalent to 4½ per cent of the total labour force in 2006, Figure 2.7).<sup>23</sup> Furthermore, FitzGerald *et al.* (2013) show that net migration sensitivity is much higher for the working age (15-64) population

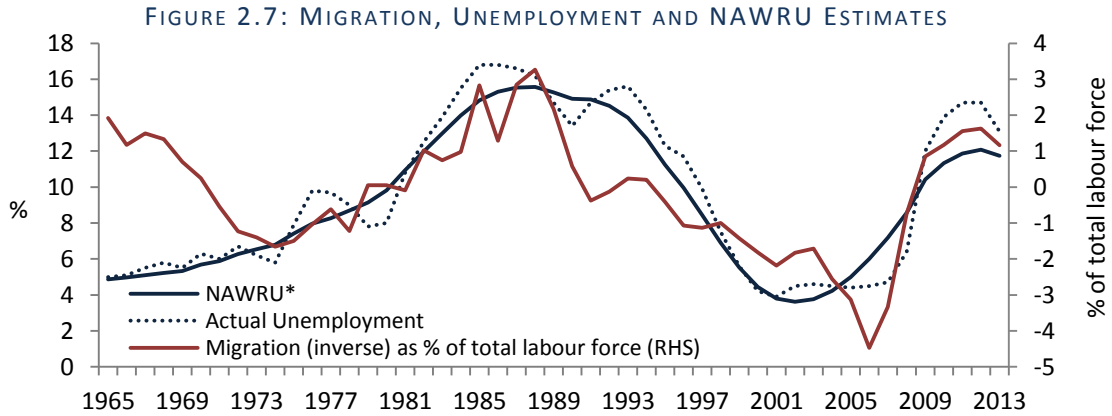
<sup>20</sup> Criticisms of the approach are widely noted, including by the Department itself (Department of Finance, 2003) and in several of the Council's previous reports (IFAC, 2014a Chapter 2 and Analytical Note 2; IFAC, 2013a; and IFAC, 2011 Box 3.1). Bergin and FitzGerald (2014) also provide a very useful discussion in the context of the structural balance.

<sup>21</sup> Defined as the 'Non-Accelerating Wage Rate of Unemployment' (NAWRU).

<sup>22</sup> Potential labour inputs in the EC methodology are measured as:  $[(POPW \times PARTS \times (1 - NAWRU)) \times HOURST]$  where *POPW* is the Population of Working Age; *PARTS* the Smoothed Participation Rate; *NAWRU*, the structural unemployment rate; and *HOURST* is trend average hours worked.

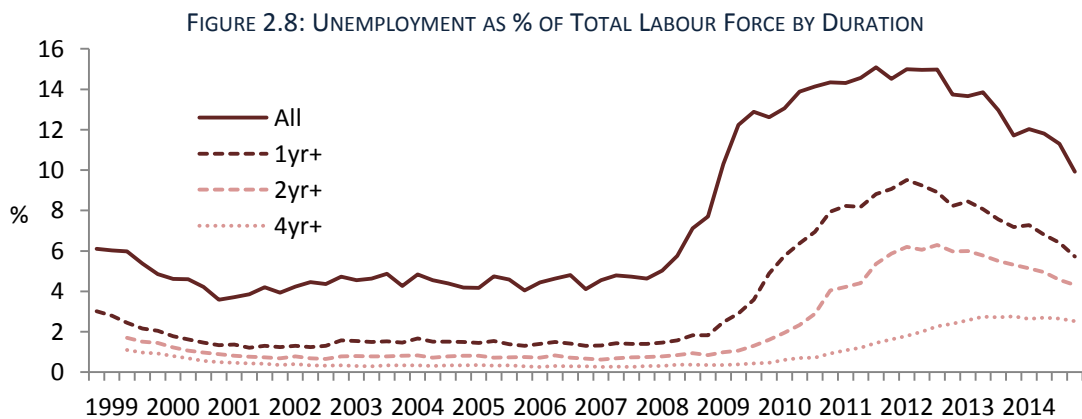
<sup>23</sup> The openness of the Irish labour market to additional inflows of labour can limit wage pressures as unemployment rates decline. This can obscure estimates of the natural rate of unemployment if signalled by inflation.

than for the dependent population. As such, migration can exacerbate already procyclical estimates of the working force in Ireland, in turn contributing to more volatile potential growth estimates.<sup>24</sup>



Sources: AMECO; Eurostat and internal IFAC calculations.  
 \* EU Commission estimates as of *Winter 2014* forecasts.

It is quite feasible that true structural unemployment remains lower than current actual levels and estimates of the NAWRU. Following Ireland’s fiscal crisis in the 1980s, the EC-estimated NAWRU will likely continue tracking actual unemployment downwards as activity recovers. Recent data on actual long-term unemployment show rapid declines in unemployment rates among those who have been unemployed for longer than one year since a peak in early 2012 (Figure 2.8). Indeed, only the very long-term unemployed (i.e., longer than four years) appear unresponsive to recent aggregate declines. The extent to which various measures of unemployment track activity makes it harder to identify more generalised disequilibria in the domestic economy, which are of greater relevance for fiscal sustainability.<sup>25</sup>



Sources: CSO; Eurostat; internal IFAC calculations.

<sup>24</sup> Department of Finance estimates of potential output growth for Ireland more than double between 2013 (1.3 per cent) and 2020 (3.6 per cent), with the contribution from labour rising from 0.3 to 1.5 percentage points, respectively.

<sup>25</sup> The IMF (2015b) find that changes in gross value added of multinational-dominated sectors (i.e. where foreign ownership exceeds 80 per cent) have no statistically significant impact on revenues net of discretionary measures.

The Council sees it as essential that the Department's projections for the medium term are well-founded. Ensuring this requires the development of a fuller picture of the supply-side. There are a number of advantages to developing a set of alternative approaches for medium-term projections:

- the Department could align their medium-term growth projections more closely with their actual best assessment of future supply-side developments;
- This would facilitate a more realistic basis for assessing fiscal expectations over the medium term as well as associated risks; and
- it would enable more effective responses to anomalies that arise in terms of fiscal surveillance<sup>26</sup> as well as potentially providing a more reasonable basis for implementing the fiscal rules.

#### "MEDIUM-TERM BASELINE" PROJECTIONS OF SUPPLY-SIDE

Future Department publications should seek to establish alternative estimates for the medium term. These projections should not employ the same framework as that underpinning the EC methodology, which are required solely for the purposes of EU fiscal surveillance, but would represent the Department's medium-term baseline projections of the supply-side. The medium-term baseline projections could be based on the Department's forecasts of actual real GDP and real investment growth for the short-term, while different income and labour market assumptions would underpin the projections than those used in tandem with EC methodology estimates.<sup>27</sup>

Producing a set of medium-term baseline projections should be part of an overall upgrading of the assessment of and methodology for medium-term projections. Additional cross-checks that ensure the consistency and robustness of forecasts should also be developed. These would be particularly useful for verifying forecast changes in incomes and employment, which are central to estimates of potential output. As part of progress towards a wider set of forecasting tools that could eventually be used by the Department for the medium term, consideration could be given to approaches emphasising the endogeneity of factor supply (e.g., capital and labour) to the attractiveness of foreign investment towards Ireland and the demand for Irish output as influenced by relative

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<sup>26</sup> Potential output estimates derived from the EC harmonised methodology are currently used as the basis for fiscal surveillance measures like the Expenditure Benchmark and the Budgetary Rule (Chapter 4). Issues that recently arose in relation to the Expenditure Benchmark were highlighted in a previous *Analytical Note* (IFAC, 2015a).

<sup>27</sup> These may also serve as a better basis for revenue projections used by the Government for outer years.



productivity and price competitiveness. This approach is similar to that underpinning the new modelling work on Ireland within COSMO for example.<sup>28</sup>

An obvious starting point for progress on developing more reasonable estimates of the supply side might concentrate on arriving at an appropriate estimate of equilibrium for the Irish labour market. Overcoming this problem may require closer attention being paid to migration assumptions and their interaction with the relative performance of Irish economic activity. In addition, given Ireland's high openness and membership of a monetary union, accounting for other possible disequilibria in the economy (e.g., imbalances in the current account, housing and credit markets) is vital in order to better estimate the cyclical position (Box B).<sup>29</sup>

#### **BOX B: TOWARDS MORE RELEVANT MEASURES OF POTENTIAL OUTPUT**

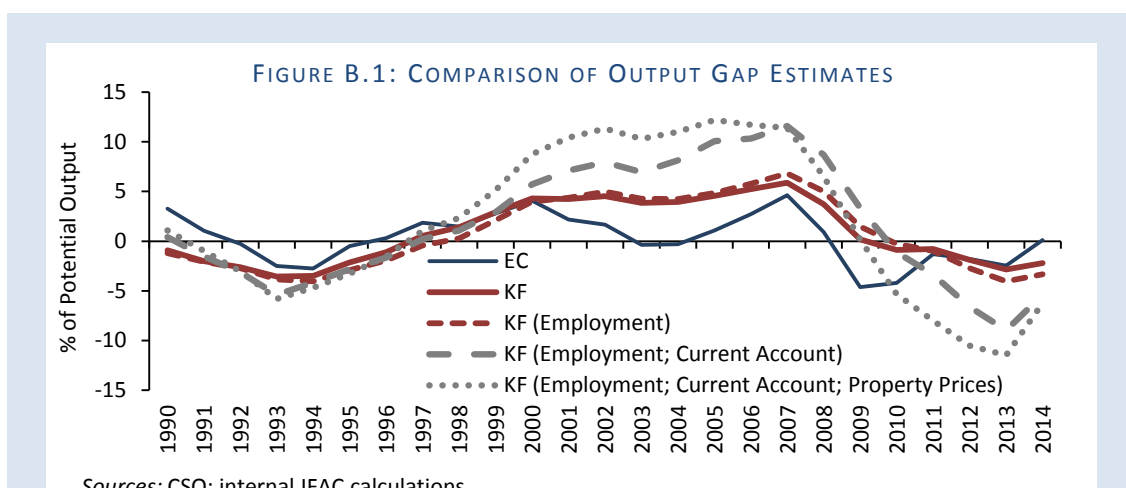
Potential output estimates and estimates of the cyclical position of the economy are important inputs to the design of sustainable fiscal and macroeconomic policies. In the past, however, estimates of these for Ireland have been problematic. The EC methodology, which underpins the fiscal rules, has come in for particular criticism related to the real-time estimates of potential output it produces. This Box outlines the work that the Council has engaged in to progress toward more appropriate measures for assessing the fiscal stance as well as to help in assessing medium-term forecasts produced by the Department of Finance.

#### **ACCOUNTING FOR OTHER IMBALANCES**

For the purposes of fiscal sustainability, estimates of economic potential should strive to account for imbalances in the economy that have a significant bearing on government revenue and expenditure. A number of these are overlooked by the EC methodology and incorporating them may help to overcome a key failing of the methodology during the bubble period, when severe credit and housing imbalances contributed to an unsustainable revenue base, yet were not highlighted by estimates under the EC methodology. Various imbalances such as those related to Ireland's balance of payments position have been cited as important factors (Bergin and FitzGerald, 2014).

<sup>28</sup> COSMO (COre Structural MOdel of the Irish economy) is one model class in the joint ESRI/Central Bank project intended to develop a suite of modern macroeconomic models of Ireland suitable for policy analysis, forecasting and simulation over a three year horizon. For more details, see <http://www.modelling-ireland.com/>

<sup>29</sup> Bergin and FitzGerald (2014) highlight the importance of such disequilibria, while drawing attention to how unhelpful the volatility of NAWRU estimates under the EC methodology can be. The small and open nature of the Irish economy can lead to behaviour more akin to that of a regional economy than a typical national economy. Regional economies can display periods of self-reinforcing growth as inward migration supports scale economies and incomes, thus attracting further inward flows.



One approach that seeks to resolve this issue is to use multivariate filters that incorporate other variables, which signal such imbalances. A common approach in the literature is to augment a multivariate Kalman filter with structural economic relationships. These incorporate additional data intended to better inform or guide the filtering process. Most approaches in recent literature combine earlier strands of research that focus on the Philips Curve, for example. Using this model, one can produce what might be considered a basic potential output estimate to which additional information can be incorporated such as financial, trade, credit and housing imbalances. There have been some criticisms of this approach.<sup>30</sup>

Figure B.1 compares the use of the various Kalman filter estimates to the EC Harmonised Method. Various indicators of potential imbalances are added to a basic KF (with drift) in order to better inform the degree of slack that exists in the economy. These additional indicators are incorporated through the output gap equations as proposed by Borio *et al.* (2014). The estimated overheating in the economy pre-crisis is more significant when using the various multivariate filters as compared to the EU approach; with a deeper dip below potential during the crisis and post-crisis period also evident. However, growth above potential begins in the late 1990s, which is slightly earlier than would be expected a priori, (e.g., Honohan, 2009). Additional issues arise in that the magnitude of some of the output gaps estimated under the various KF approaches appear unusually large; some of the indicators of imbalances, when included over the full estimation period, appear statistically insignificant; issues of instability with respect to parameter estimation can arise; and, finally, structural breaks in trend growth rates may not be adequately addressed.

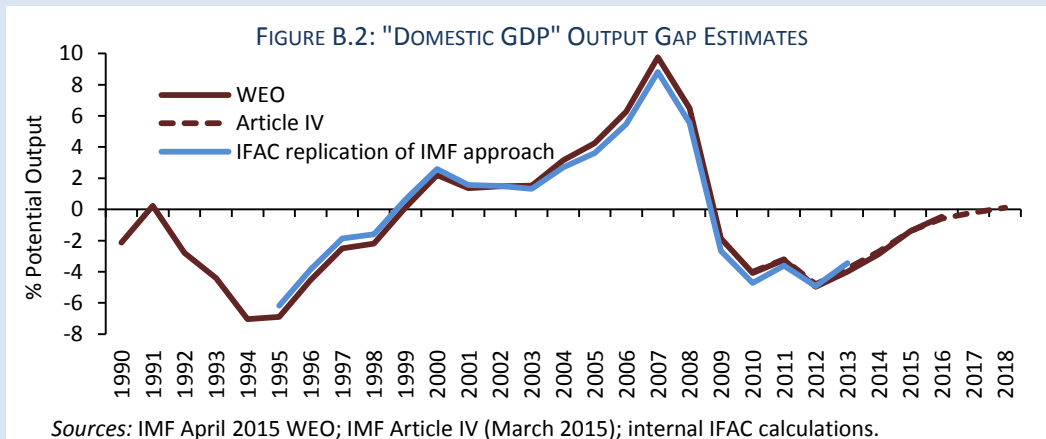
#### FOCUSING ON DOMESTIC SECTORS

For the purposes of fiscal sustainability, focusing on activity outside of the volatile multinational-dominated sectors may also be of more relevance. The multinational sector in Ireland has relatively little fiscal impact compared to more domestic-oriented sectors, while their impact on employment is also relatively low.<sup>31</sup> For these reasons, the IMF (2015a and 2015b) have adopted an alternative approach as a guide for the medium term

<sup>30</sup> Borio *et al.* (2014) criticise the imposition of economic theory on Kalman filter estimates as the resulting output gaps are highly sensitive to the model specification. These can also perform poorly in real time and are arguably more opaque than other methods. They suggest the adoption of a more 'parsimonious approach' that involves incorporating additional, observable economic data directly in the output gap equation as an explanatory variable rather than imposing economic relationships to direct the filter.

<sup>31</sup> Recent analysis by the IMF (2015b) also suggests that changes in GVA of these sectors do not have a statistically significant impact on revenues.

that involves filtering real GDP excluding the multinational-dominated sectors as measured by the CSO. This approach yields a measure of trend growth that might be labelled “domestic GDP”. The corresponding output gap estimates (Figure B.2) show a relatively intuitive excess emerging in the 2000s, magnified in the pre-crisis period, and followed by a sharp swing into negative territory before gradually recovering in the post-crisis period.



While an approach that emphasises domestic sectors has obvious advantages, there are drawbacks. For instance, the common problem of end-point bias can result in an overweighting of the most recent outturns when estimating trend growth rates under some statistical filters. Moreover, the use of a univariate filter could lead to a failure to pick up on other critical imbalances that matter for public finances, such as a housing bubble, for example. Estimates of the multinational-dominated sectors’ GVA are also produced with a longer lag relative to headline GDP figures. Finally, as noted previously, filtering methods in general may fail to capture large structural changes in trend growth.

#### AREAS FOR DEVELOPMENT

The issues outlined above give a sense of the challenges facing policymakers when determining sustainable fiscal policies on the basis of medium-term macroeconomic activity. The Council views progress on multivariate filter approaches as part of the toolkit for developing alternative estimates of potential output. In addition to statistical filters, further work is planned that would develop analyses in a number of key areas pertaining to the imbalances that matter most for the public finances. The work being undertaken as part of the Central Bank of Ireland/ESRI Macro Modelling Project could also shed light on important questions around Ireland’s medium-term growth potential.

### 2.2.3 RECONCILIATION TABLES

The *SPU* provides a reconciliation table reflecting changes between the endorsed projections and those that are published in the document itself, which account for the €1.2 billion extra fiscal measures for 2016 announced. Additional tables were provided to the Council outlining the details of these differences.<sup>32</sup>

<sup>32</sup> This requirement is reflected in the MoU between the Department and IFAC.

The fiscal package for 2016 is expected to boost overall real GDP for 2015 by an additional 0.2 percentage points relative to the endorsed set of forecasts. At an aggregate level, this increase appears reasonable. Most of the impact arises in the form of increased consumer spending expected to result from income gains following tax and expenditure changes. The remaining changes arise due to higher estimates for investment (capital spending) and government consumption (current spending).<sup>33</sup> Employment estimates were revised up slightly on account of budgetary measures which impacted on both public and private workforce estimates.

Supply-side estimates were also subject to some revisions between the endorsed and *SPU* projections, with potential output higher by 0.2 percentage points on average over the forecast horizon. The increases, in part, reflected the changes to demand-side forecasts described above, which impact on key inputs to the estimation of potential output (e.g., employment, employee compensation, investment, etc.).<sup>34</sup> While such changes – in so far as they are clearly linked to budgetary measures – are understandable sources of revisions, methodological changes should not occur between the endorsed and published forecasts.<sup>35</sup> As a principle, views regarding supply-side potential should not be influenced by small changes arising from demand-side measures of this sort. The fact that it does further suggests issues with the methodology used. This is an avoidable source of change between the endorsed and final set of projections and the Council expects that sufficient margins will be allowed in the chosen parameters to prevent such technical changes from occurring in future.

#### 2.2.4 FORECASTS OF OTHER AGENCIES

Most forecasting agencies envisage real GDP growth continuing to expand briskly as in the *SPU* over the near term. Compositional differences – although weighted toward domestic demand slightly more in *SPU* – are less pronounced than on previous occasions (Figure 2.9).

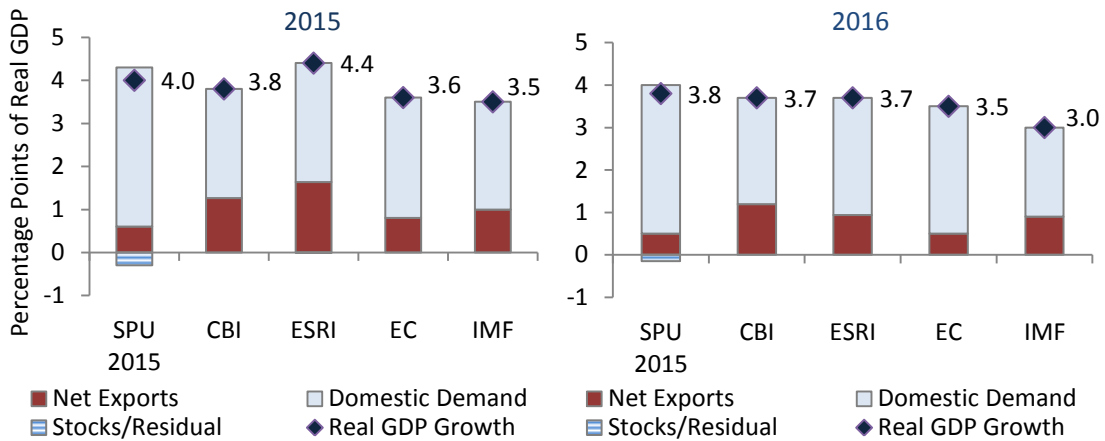
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<sup>33</sup> The forecasts assume a marginal propensity to consume out of income of 0.8, while an overall import content assumption of 0.5 is applied to the increase in final demand due to fiscal measures.

<sup>34</sup> IFAC 2014a, *Analytical Note No. 2* details these inputs to supply-side estimates.

<sup>35</sup> On this occasion, it appears that certain technical adjustments included in the endorsed forecasts – and permitted under guidelines on the EC methodology – subsequently caused limits to be breached when the fiscal measures announced in the *SPU* were included. This necessitated that changes be made to the endorsed forecasts in order to ensure compliance with the guidelines.

FIGURE 2.9: COMPARATIVE REAL GDP GROWTH CONTRIBUTIONS (PERCENTAGE POINTS)



Sources: SPU 2015; ESRI (Quarterly Commentary Spring 2015); IMF (Article IV, Mar 2015); Central Bank Quarterly Bulletin 2, Apr 2015; and European Commission (European Economic Forecast, Spring 2015).

For the medium term, the Department is forecasting activity growth of a relatively similar pace to that expected by other forecasters over this time horizon (Table 2.4). The range of projections for later years of between 2½ per cent and 3 per cent per annum on average is relatively typical of medium-term projections currently envisaged for Ireland.<sup>36</sup>

TABLE 2.4: MEDIUM-TERM MACROECONOMIC FORECASTS TO 2018

% change unless stated	2014	2015	2016	2017	2018	2019	2020
<b>SPU 2015</b>							
GDP	4.8	4.0	3.8	3.2	3.2	3.0	3.0
Employment	1.7	2.2	2.2	1.9	1.9	1.8	1.7
Productivity	3.0	1.7	1.5	1.2	1.2	1.2	1.2
<b>IMF (April WEO)*</b>							
GDP	4.8	3.9	3.3	2.8	2.5	2.5	2.5
Employment	1.7	2.0	2.0	1.5*	1.5*	1.5*	1.5*
Productivity (implied)**	3.0	1.9	1.3	1.3	1.0	1.0	1.0
<b>OECD (Nov 2014)***</b>							
GDP	4.8	3.3	3.2	3.3	3.0	2.8	2.8

Sources: SPU 2015; ESRI (Medium-Term Review 2013); IMF (12<sup>th</sup> Review); OECD.

\* Employment growth rates for 2017 onwards are taken from the March 2015 Article IV Consultation-Staff Report

\*\* Implied productivity is simply GDP growth less employment growth.

\*\*\* OECD projections for 2017 onwards are taken from the OECD May 2014 long-term baseline projections.

### 2.3 RISKS

Near-term prospects for the economy have clearly improved, with risks more balanced than in previous years. The Council welcomes the fact that *SPU 2015* clearly notes the balance of risks to the Department’s macroeconomic forecasts having failed to do so in more recent publications.

<sup>36</sup> ESRI (FitzGerald *et al.* (2013)) also produce medium-term forecasts, albeit the most recent update is from mid-2013. The central “recovery” scenario outlined at that time envisaged real GDP growth rates averaging 4 per cent per annum over 2016-2018, with implied productivity growth of 1.7 per cent.

Statements like these are seen as critical inputs into discussions around the macroeconomic and fiscal outlook and the Council had repeatedly requested their inclusion in previous *Fiscal Assessment Reports*.<sup>37</sup>

Welcome improvements are evident in efforts to bring together previously fragmented risk analyses, including through the *National Risk Assessment* publication. Where relevant risks remain pertinent – such as those documented in the *National Risk Assessment* – it might be more useful to incorporate these into a single risk discussion that gives a more comprehensive sense of risk exposure. To improve transparency, this discussion might be more appropriately incorporated into the *SPU* itself.

TABLE 2.4: MACROECONOMIC RISKS COVERED IN *SPU 2015*

Risk	Direction	Details
Oil Prices	Upside	This is largely positive for competitiveness and for household real purchasing power. Some downside risks exist if oil prices rise faster than expected.
Exchange Rates	Upside	Euro depreciation vis-à-vis sterling and US dollar aid exports destined for markets outside the euro area, namely the UK and US.
Household Debt	Downside	Prioritisation of household income rises for further debt reduction rather than consumption might spell downside risk to consumption forecasts.
Competitiveness	Downside	Possibility that wage/productivity growth exceeds that of Euro Area and elsewhere, thus damaging competitiveness.
Euro Area Growth	Downside	Euro Area shows more encouraging growth prospects of late, but has a recent history of growth disappointments. Uncertainties surrounding developments in Greece could induce re-emergence of financial stress.
Global Financial Markets	Downside	Risks of a return to global financial market turbulence could increase due to asset market mispricing or low market liquidity.
Deflation	Downside	Deflation could raise real interest rates and depress aggregate demand.
Banking System	Downside	Progress has been made on restoring financial viability of banking system, but vulnerabilities in asset books may weigh on bank credit ratings.
Geopolitical Risks	Downside	Any acceleration in tensions could pose downside risks for growth.

Source: *SPU 2015*.

Note: The direction of risk is inferred from but not specified in *SPU 2015*.

Even though risks are judged to be now more evenly balanced than in recent years – when downside risks dominated – *SPU 2015* still highlights manifold risks to the downside (summarised in Table 2.4). The external environment, in particular the Euro Area, is central to the *SPU* discussion. The region accounts for one-third of Irish exports when customs data and services trade data are

<sup>37</sup> In a written response to concerns raised in the *June 2014 FAR*, the Minister noted that “...a statement on the overall balance of risks can be provided in future”. However, *Budget 2015* again failed to include such a statement despite a substantive risk discussion documenting predominantly downside risks. In a similar response to the *November 2014 FAR*, the Minister noted that “...given the sensitive and often self-fulfilling nature of annotating such risks, the existing high-level approach taken in these documents is considered sufficient”. The Council does not accept these reasons for not providing an assessment of the balance of risks. A salutary lesson from the recent property bubble is that it is better to officially recognise risks at an early stage so that appropriate preventative measures can be taken.

both accounted for. This is roughly the same as the UK and US combined. Recent data suggest that risks of deflation and recession have subsided in the monetary union, but the lack of evidence of a durable escape from recession remains concerning.<sup>38</sup> Immediate risks relate to developments in Greece.<sup>39</sup> However, new research suggests that the Euro Area may face more secular declines in potential output growth related to ageing and declining fertility rates among other factors.<sup>40</sup>

The British referendum on EU membership could magnify uncertainties over the near term, while longer term implications of any departure – if voted for – are unclear. The UK accounts for approximately 16 per cent of Ireland’s exports, with a high concentration of more labour-intensive sectors represented. Uncertainties produced by the referendum lead-in itself could stymie investment, thereby weakening the UK economy’s near-term outlook, but also having ramifications for long-run potential growth if capital stock accumulation is substantially reduced. In terms of outcomes, a departure or even renegotiated terms of membership would likely have wide-ranging implications for free movement of goods, services and labour. It could also alter the contours of decision making at EU level as well as potentially transforming the relative competitiveness environment, with knock-on effects for future FDI flows.

It is envisaged that Euro Area interest rates will remain low for a protracted period. While accommodative for near-term growth and beneficial for highly indebted sectors, financial stability risks are posed by a continued easing in the monetary stance. If Euro Area monetary conditions were to remain highly accommodative into the medium term, there is also a risk that such a continued easing might eventually prove inappropriately loose for the anticipated cyclical rebound in Ireland. An expected normalisation in US monetary policy could also lead to disruption in financial markets if not handled smoothly.

Domestically, there is a risk that the so-called balance sheet recession represses growth rates more than expected and heightens vulnerabilities to falling incomes or rising interest rates. Household debt levels when expressed as a proportion of disposable incomes, though falling, remain among the highest in the EU at just under 169 per cent. Parts of the non-financial corporate sector also

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<sup>38</sup> The sluggish exit from recession led the official arbiter of the business cycle for the region (CEPR, 2014) to preclude calling an end to a recession estimated to have started in late-2011 when it met last year.

<sup>39</sup> Though direct economic and financial exposures to Greece are relatively limited in Ireland and most Euro Area member states, uncertainties created by an exit could heighten redenomination risk attached to debt of other member states, with consequent impacts on sovereign and bank funding costs, on creditworthiness more generally and on business and consumer confidence.

<sup>40</sup> McQuinn and Whelan (2015) identify weakening trends in TFP growth and capital accumulation as additional areas for more enduring concern. These have been aggravated further by crisis legacies including weak private investment across the region, which – given public and private debt overhangs – could continue to dampen potential output. Echoing these concerns, the IMF (2015c) point to skill erosion related to high structural and youth unemployment rates in some Euro Area economies as possibly depressing growth further.

face high levels of indebtedness, while difficulties accessing credit remain apparent, with domestic reliance on bank funding very high compared to other economies.<sup>41</sup> Other domestic risks to be considered relate to possible cost competitiveness pressures related to recent rapid house price increases and supply constraints (Appendix B).

There are few signs of overheating apparent in the economy at present as the recovery takes hold after the balance sheet recession. However, forecasts suggest that the economy will grow substantially in the coming years. This would most likely close any negative output gap, but also raises the question of whether the economy risks overheating at some point. One scenario is that euro area interest rates would remain low, while cyclical conditions in Ireland would warrant a tighter policy stance. As in the past, there are risks that the true level of sustainable demand and output could be misperceived. For example, were potential output growth to be lower than is currently thought for Ireland, then actual growth rates at their current pace could lead to a rapid closing of the output gap and a potential overshooting of the economy's equilibrium.

The Irish economy is inherently more volatile than others: absolute real GDP forecast errors are among the widest in the EU (IMF, 2013); quarterly data show some of the largest historical revisions in the OECD;<sup>42</sup> and the influence of large multinational-dominated sectors means that substantial variations in output can arise quite abruptly without increasing domestic resource utilisation.<sup>43</sup> These issues pose substantial difficulties for forecast accuracy, with confidence intervals particularly wide in Ireland and further increased by the uncertainties and risks described above. Illustrating this in part, Figure 2.10 shows the fan chart surrounding the Department's growth forecasts to 2016 based on past errors along with the range related to expected data revisions for the historical period.

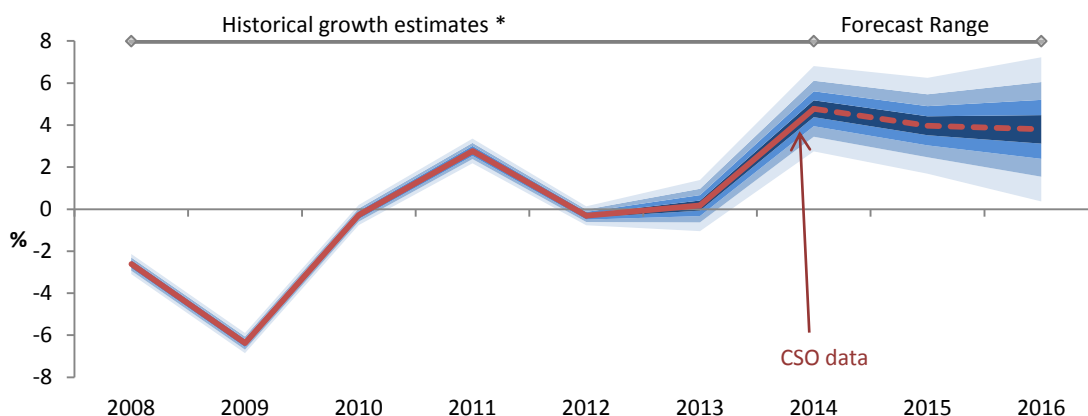
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<sup>41</sup> The Central Bank (2014) notes that aggregate debt-interest costs remain above euro area equivalents, but that nearly 84 per cent of SMEs have debt-to-turnover ratios less than one-third, while one third of SMEs have no debt at all.

<sup>42</sup> Even when controlling for relatively high historical growth rates revisions are still among the highest recorded in the OECD (Casey and Smyth, 2015).

<sup>43</sup> CSO data show that three broad categories of multinational-dominated sectors accounted for close to one quarter of total gross value added in the economy in 2013.



FIGURE 2.10: REAL GDP FAN CHART BASED ON *SPU 2015* PROJECTIONS (TO 2016)

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

\* Distributions or 'fans' around historical growth estimates are based on previous revisions to real GDP data. Both forecast errors and revisions are based on 1999-05 sample.

## 2.4 ENDORSEMENT OF THE *STABILITY PROGRAMME UPDATE 2015* PROJECTIONS

This section details the fourth endorsement exercise undertaken by the Council covering *SPU 2015*, outlining the Council's considerations around the time of the endorsement (Appendix C details the timeline). Data available at the time may differ from that available for the purposes of the assessment. The forecasts for the endorsement were predicated on a no policy change basis (i.e., a neutral *ex ante* discretionary budget adjustment).

The Council endorsed the *SPU 2015* macroeconomic forecasts to 2020. It was satisfied that these were within its endorsable range, taking into account the methodology and the plausibility of the judgements made. The endorsement process focuses on several key dimensions: the plausibility of the methodology used; the pattern of recent forecast errors; and comparisons with Benchmark and other projections.

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

In relation to medium-term projections, the correct application of the common European Commission (EC) methodology to estimate trend supply-side variables was verified as at the time of the endorsement of the spring 2014 *SPU* projections. Although the Council endorsed the medium-term forecasts produced by the Department to 2020, this does not amount to an endorsement of the EC methodology as the most adequate approach for describing Ireland's cyclical position and potential output in the medium term. The Department of Finance (2003) has itself long

documented the difficulties associated with estimates of Ireland's potential output and output gap in terms of estimating the overall fiscal stance. Due to the difficulties associated with estimating supply-side trend variables using the EU methodology as well as in linking these to actual forecasts, the Council's endorsement instead refers to the actual demand-side projections.

Further efforts toward developing medium-term, supply-side projections, which are consistent with the Department's views on the demand-side are essential, however, as explained in Section 2.2. This may require a greater prioritisation and possibly allocation of resources by the Department towards development as it is likely to remain a pivotal issue for future endorsements.<sup>44</sup>

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

Third, comparisons with the full set of Benchmark projections<sup>45</sup> and other forecasts showed less of a deviation with the Department's own forecasts than in previous endorsement rounds both in aggregate and across components. The flow of high frequency economic data at the time of the endorsement was largely positive with respect to growth. In addition, real GDP growth rate differences were negligible relative to Benchmark projections, while price deflator projections were considered to be within a reasonable range (Appendix Table A.1). The Department's projections were slightly higher than consensus estimates available at the time, though the most recent forecasts showed broadly upwards revisions.

#### **BOX C: DECOMPOSITION OF FORECAST ERRORS (AN UPDATE)**

Understanding deviations between Government forecasts of the macroeconomy and actual outturns forms an essential part of the endorsement process within the Council's mandate and its role in assessing macroeconomic projections.

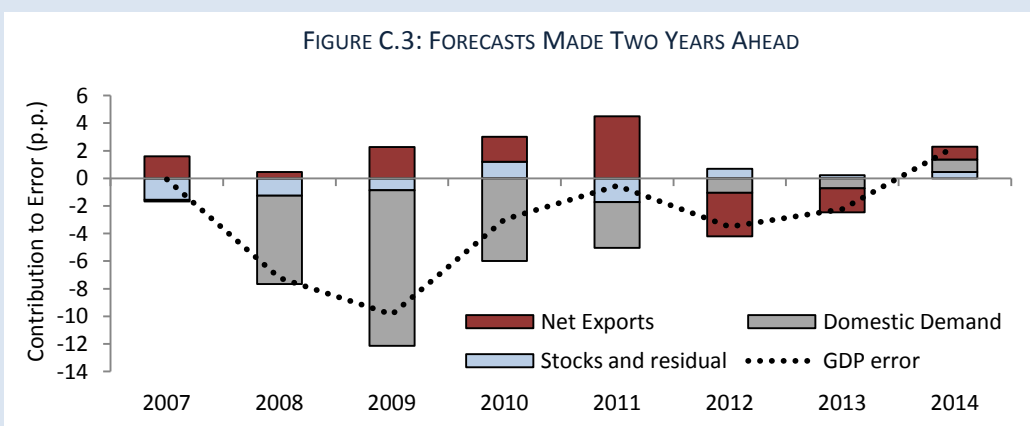
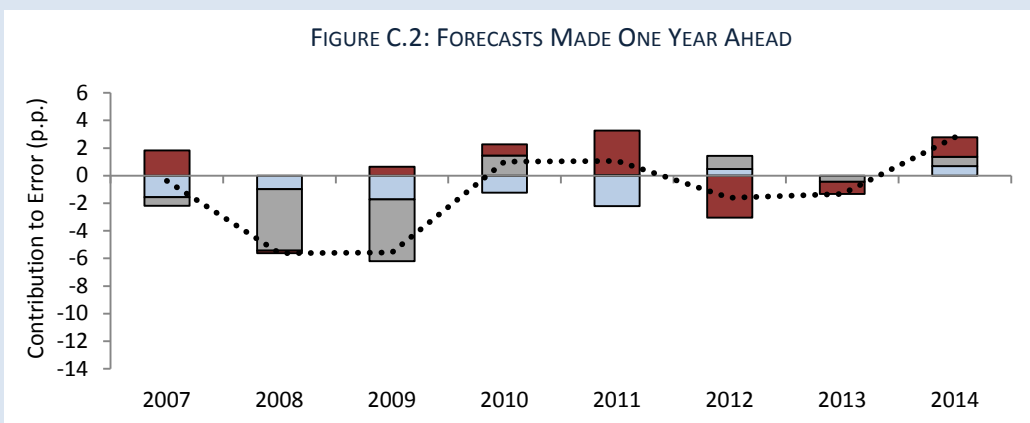
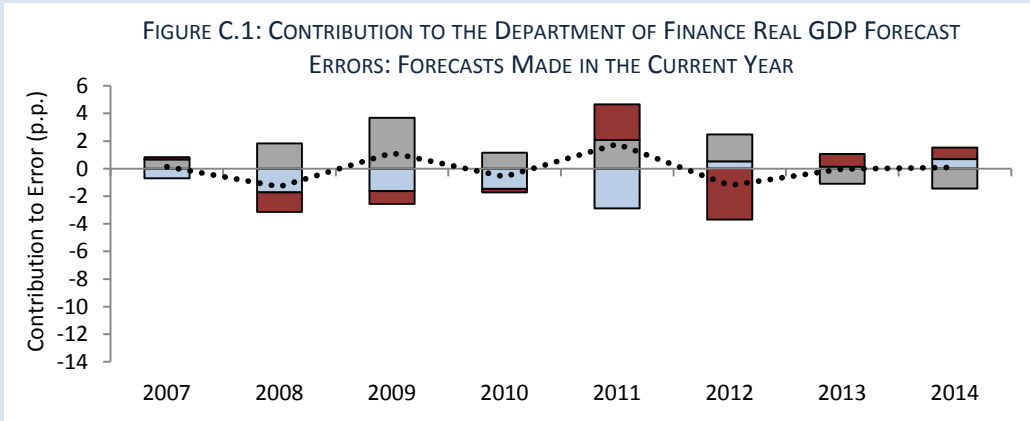
The *April 2013 FAR* (Box A) highlighted a clear systematic tendency for Department of Finance forecasts to overestimate domestic demand – which is more tax-rich in nature – in preceding years, with the reverse true for net exports. This Box updates the analysis, using the latest available data for 2007-14, documenting the sources of real GDP forecast errors at different horizons (Figures C1–C3).

For the earlier crisis years, the Department's systematic tendency to over-estimate domestic

<sup>44</sup> For the near-term at least, the fiscal rules are likely to be evaluated on the basis of the EC methodology so the Department will necessarily be required to continue to engage with this method also.

<sup>45</sup> Benchmark projections form a key part of the endorsement process (see IFAC, 2013b and 2014a).

demand is still evident – though this tendency appears to have lessened of late. A more sluggish than expected export performance in 2012 and 2013 coincided with specific developments in the multinational-dominated sectors of the economy. In particular, underestimation of the pharmaceutical patent cliff and declines in the gross value added from ICT-related sectors (Nov 2014 FAR, Box C) likely prompted large forecast errors on the contribution of net exports to real GDP growth. By comparison, 2014 real GDP growth over-performed on all fronts relative to earlier expectations as a broadening recovery surprised most forecasters.



Sources: Department of Finance (Budget/SPU documents); internal IFAC calculations.

### 3. ASSESSMENT OF BUDGETARY FORECASTS

#### KEY MESSAGES

- In a welcome development, *SPU 2015* provides in advance some detail on the likely policy changes in *Budget 2016*. It assumes a €1.2 billion budget package split evenly between tax cuts and spending increases.
- The deficit for 2015 is now forecast to fall to 2.3 per cent. Given the strong performance of tax revenues in the first four months of 2015, and spending that is marginally below profile, this appears achievable.
- Expenditure forecasts after 2016 explicitly provide for an additional €0.3 billion each year to account for demographic pressures but include no further policy measures. Published tax revenue forecasts assume no policy changes after 2016. Given the clear indications that future policy changes are likely to include both tax cuts and possible increases to expenditure, as well as the stated Government intention to target minimum compliance with the fiscal rules, these forecasts do not provide a well-specified plan for the likely budgetary position over the coming years.
- The medium-term budget forecasts in *SPU 2015* imply a fall in the ratio of non-interest government spending to GDP of over 5 percentage points. An illustrative scenario for government expenditure indicates that such a reduction in spending would be extremely difficult to achieve while maintaining existing public services and accounting for known demographic and other cost pressures.
- Given these shortcomings, the deficit projections in *SPU 2015* do not provide a useful picture of the fiscal position after 2016 and fall short of the requirements envisaged in the Budgetary Frameworks Directive. While it is not expected that specific revenue and expenditure measures would be detailed over the medium term, full acknowledgement of spending pressures, the overall value of intended revenue measures and, consequently, a deficit path should play a central role in medium term projections.

### 3.1 INTRODUCTION

This chapter assesses the latest set of budgetary forecasts produced by the Department of Finance. Section 3.2 reviews the accuracy of Department of Finance forecasts for 2014. Section 3.3 assesses the forecasts for revenue and expenditure contained in *SPU 2015* and, in particular identifies concerns related to the medium-term expenditure forecasts. Section 3.4 examines the sensitivity of the main budgetary aggregates to changes in the economic outlook as well as providing a broader assessment of risks.

### 3.2 DEPARTMENT OF FINANCE BUDGETARY PROJECTIONS FOR 2014

Table 3.1 shows how the Department of Finance's budgetary projections for 2014 have evolved over time and compares them to the outturn. The General Government deficit of 4.1 per cent of GDP is lower than forecast in *Budget 2014* and *SPU 2014* but higher than that expected in *Budget 2015*.

Revenues in 2014 strongly outperformed early forecasts and even exceeded the revised forecasts in *Budget 2015* published in October 2014 as both taxes and other sources of revenue (including Central Bank surplus income and dividends from semi-state bodies) exceeded expectations.

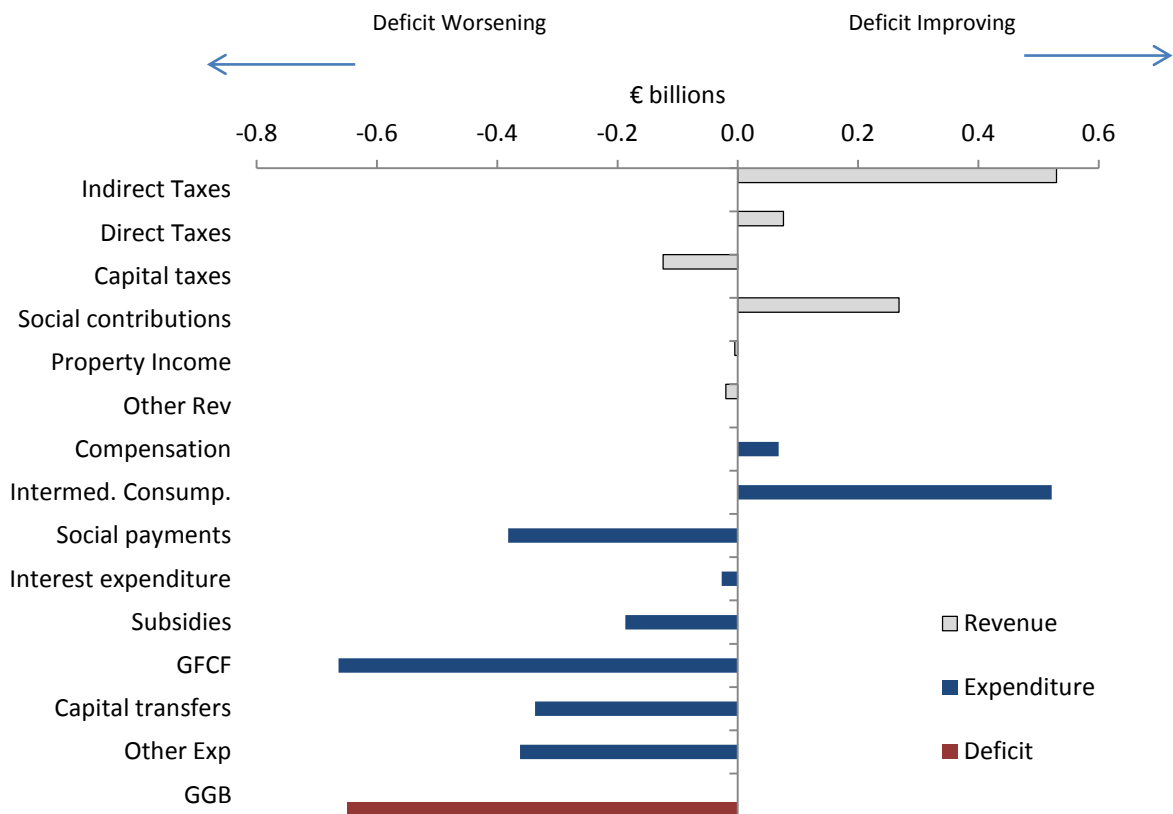
TABLE 3.1: DEPARTMENT OF FINANCE PROJECTIONS FOR 2014 (ADJUSTED FOR ESA 2010)

€ Billions	<i>Budget 2014</i>	<i>SPU 2014</i>	<i>Budget 2015</i>	<i>Outturn</i>
	Oct-13	Apr-14	Oct-14	Apr-15
<b>General Government Balance</b>	<b>-8.2</b>	<b>-8.0</b>	<b>-6.9</b>	<b>-7.6</b>
<b>General Government Balance, % of GDP</b>	<b>-4.4</b>	<b>-4.3</b>	<b>-3.7</b>	<b>-4.1</b>
<i>Primary Balance, % of GDP</i>	0.0	0.0	0.3	-0.1
<b>Revenue</b>	61.9	62.0	64.0	64.7
<i>Tax</i>	44.6	44.7	45.9	46.3
<i>Social Contributions</i>	10.3	10.1	10.6	10.8
<i>Other</i>	7.0	7.1	7.6	7.5
<b>Expenditure</b>	70.1	70	70.9	72.3
<i>Government Services</i>	26.7	26.6	27.9	27.3
<i>Social Transfers</i>	28.2	28.2	28.1	28.5
<i>Interest</i>	8.2	8	7.5	7.5
<i>Investment</i>	2.6	2.7	2.8	3.5
<i>Other</i>	4.4	4.4	4.6	5.5
<b>Primary Expenditure</b>	<b>61.9</b>	<b>62</b>	<b>63.4</b>	<b>64.8</b>

Source: Department of Finance; internal IFAC calculations

The revenue outperformance was more than offset by higher expenditure, with original Budget 2014 expenditure plans exceeded by €2.2 billion (Figure 3.1). As late as October 2014, the Government was only expecting to overspend by €0.9 billion. Much of this is due to technical factors such as the inclusion of Irish Water and recognising the Waterford Crystal pension liability. Comparing *Budget 2015* forecasts for the year 2014 with the eventual revenue and expenditure outturns, it can be seen that expenditure was higher across most categories (exceptions are compensation of employees and intermediate consumption) and was only partially offset by strong taxes, particularly direct taxes including VAT and excise receipts. Gross Fixed Capital Formation (investment) in particular was significantly different from *Budget 2015* expectations with the eventual outturn being some €0.7 billion, or 35 per cent, higher than forecast.<sup>46</sup> Box D shows the extent to which the overspend is explained by the preliminary classification of Irish Water as part of general government (Box D).

FIGURE 3.1: BUDGET 2015 - OUTTURN



Source: Department of Finance.

Note: Bars to the left denote components that were worse for the deficit relative to *Budget 2015* forecast, bars to the right denote components that were better for the deficit relative to *Budget 2015* forecast.

<sup>46</sup> Gross fixed capital formation is impacted by statistical treatment of the sale of the National Lottery licence.

**BOX D: STATISTICAL TREATMENT OF IRISH WATER**

With effect from 1 January 2014, Irish Water is responsible for public water services in Ireland. Irish Water has been provisionally classified within general government and is also included in general government for the purposes of the *SPU* projections. However, the CSO have proposed that Irish Water be classified outside of general government and Eurostat's final adjudication will be reflected at the time of *Budget 2016*.<sup>47</sup> This Box describes the impact on general government resulting from the preliminary classification.

Table D.1 shows the breakdown of the net General Government Balance (GGB) impact arising from the preliminary classification.<sup>48</sup> It is important to note that Local Government Fund (LGF) and Exchequer support in the form of the government operational subvention are incurred regardless of the classification decision. These are deducted from total expenditure to show the overall net deficit impact of Irish Water. The impact is expected to raise the deficit by 0.3 per cent of GDP for 2015 and by an average of 0.2 per cent of GDP over the period 2016-2020.<sup>49</sup> The impact also raises general government debt, with the impact rising from 0.3 per cent of GDP in 2015 to almost 1 per cent by 2020.

TABLE D.1: BREAKDOWN OF IRISH WATER IMPACT ON GENERAL GOVERNMENT

€ billion unless stated	2014	2015	2016	2017	2018	2019	2020
Total Revenue	0.25	0.50	0.51	-	-	-	-
...of which Domestic Charges	0.00	0.27	0.27	-	-	-	-
...of which Non-Domestic	0.25	0.23	0.24	-	-	-	-
Support from LGF/Exchequer *	0.52	0.40	0.48	-	-	-	-
Total Expenditure	1.10	1.48	1.39	-	-	-	-
...of which Capital	0.32	0.68	0.60	-	-	-	-
...of which Operational (incl. interest)	0.78	0.80	0.79	-	-	-	-
Net GGB impact	-0.34	-0.58	-0.39	-0.26	-0.29	-0.45	-0.37
Net GGB impact (% GDP)	-0.18	-0.29	-0.19	-0.12	-0.13	-0.19	-0.15
Net GG debt impact (% GDP)**	0.08	0.29	0.47	0.57	0.67	0.83	0.95

Sources: *SPU 2015*; Department of Environment.

\* This includes consolidation of transactions between Irish Water and Local Authorities.

\*\* Two-year bridging facility provided by National Pensions Reserve Fund in 2013 (extended in 2014) has no impact.

As a regulated utility, Irish Water's operating and capital cost plans are reviewed by the Commission for Energy Regulation. The regulator has set a maximum "allowed revenue" to end-2016, which Irish Water can recover from customers' bills (domestic and non-domestic), taking account of the Government subvention. The first customers' bills started issuing in April 2015 and charges for households have been capped until end-2018. This results in less revenues from domestic customers than originally envisaged and no revenue in 2014. In each of 2015 and 2016, Irish Water expects billed income from domestic and non-domestic customers to total some €0.5 billion. On the expenditure side, the regulator has also set efficiency targets to end-2016 on Irish Water's operating and

<sup>47</sup> If the final Eurostat decision on the classification of Irish Water places it outside general government, the Government has noted that it will consider how best to make use of any improvement in the fiscal forecasts that would result.

<sup>48</sup> A breakdown beyond 2016 is not available as 2017-2020 forecasts are subject to future budgetary/regulatory reviews.

<sup>49</sup> The impact reflects: Total Revenue (€0.5bn) + LGF/Exchequer Support (€0.4bn) - Total Expenditure (€1.48bn).

capital costs.<sup>50</sup> Current plans envisage €0.68 billion of capital expenditure in 2015 and operational expenditure (including interest costs) of €0.8 billion, with total expenditure expected to fall in 2016 from €1.48 billion to €1.39 billion, largely on account of lower capital expenditure.

### 3.3 ASSESSMENT OF SPU 2015 FORECASTS

TABLE 3.2: SPU 2015 BUDGETARY FORECASTS

	2015	2016	2017	2018	2019	2020
<b>Main Aggregates as % of GDP</b>						
General Government Balance	-2.3	-1.7	-0.9	-0.1	0.7	1.7
Primary Balance	1.1	1.5	2.2	2.9	3.6	4.3
Structural Balance	-2.6	-2.3	-1.3	-0.3	0.8	2.1
General Government Debt	105.0	100.3	97.8	93.6	89.4	84.7
Nominal GDP (€ billions)	198.3	208.9	217.8	227.3	236.9	246.8
Nominal GDP Growth	6.9	5.4	4.2	4.4	4.2	4.2
<b>Projected Levels of Government Revenues and Expenditure (€ billions)</b>						
Total revenue	68.0	69.3	71.1	73.2	75.5	77.9
Taxes on production and imports	22.2	23.1	23.8	24.4	25.1	25.8
Current taxes on income, wealth	25.9	26.9	27.7	29.0	30.3	31.6
Capital taxes	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	11.3	11.4	11.7	12.1	12.5	13.0
Property Income	2.8	2.2	2.0	1.9	1.8	1.7
Other Rev	5.4	5.4	5.4	5.4	5.4	5.4
Total Expenditure	72.6	72.9	73.1	73.5	73.9	73.8
Compensation of employees	19.2	19.5	19.6	19.7	19.8	19.9
Intermediate consumption	9.6	9.5	9.6	9.7	9.7	9.7
Social payments	27.5	27.5	27.6	27.7	27.8	27.9
Interest expenditure	6.9	6.8	6.9	7.0	6.9	6.7
Subsidies	2.1	2.1	2.1	2.1	2.1	2.1
GFCF	3.7	3.7	3.6	3.6	3.8	3.7
Capital transfers	1.2	1.3	1.2	1.1	1.1	1.1
Other Exp	2.5	2.5	2.5	2.6	2.7	2.7
Primary Expenditure	65.7	66.1	66.2	66.6	67.0	67.1

Source: Department of Finance.

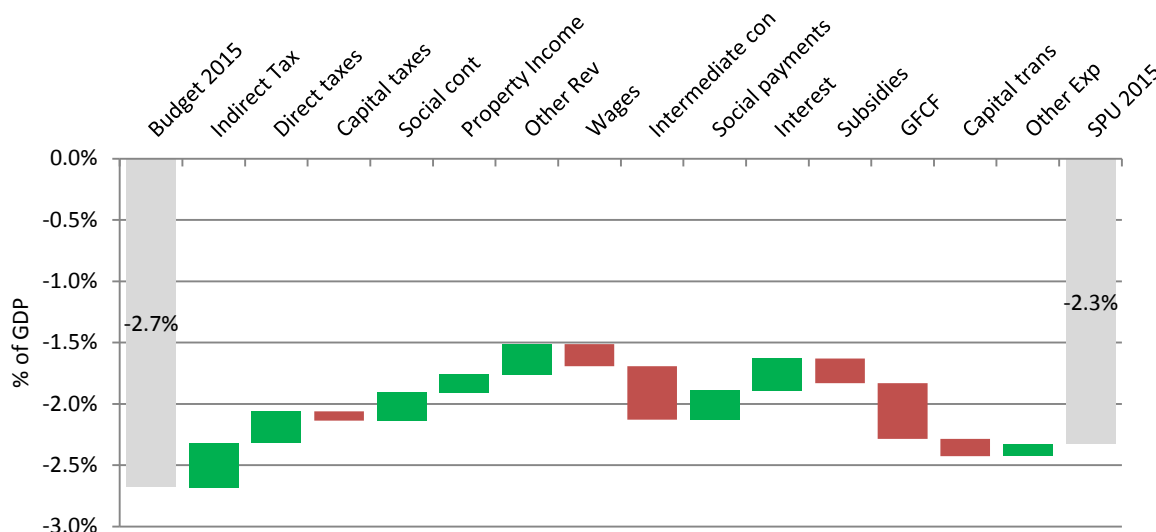
<sup>50</sup> For example, these require Irish Water to reduce their operating costs by 7 per cent annually to end-2016 or just over €50 million per annum.



### 3.3.1 FORECASTS FOR 2015

Figure 3.2 shows how *SPU 2015* has revised the *Budget 2015* forecast for the general government deficit for 2015 from 2.7 per cent to 2.3 per cent of GDP. The provisional inclusion of Irish Water in general government has led to the upward revision of spending on intermediate consumption and gross fixed capital formation. The total Irish Water impact on the deficit in 2015 is expected to be €580 million or 0.3 per cent of GDP (see Box D). Excluding the impact of Irish Water, the forecast for the deficit in 2015 would now be 2 per cent. A final decision on the statistical treatment of Irish Water will be made in the October release of the Government Finance Statistics.

FIGURE 3.2: REVISION TO 2015 DEFICIT: *SPU 2015* v. *BUDGET 2015*



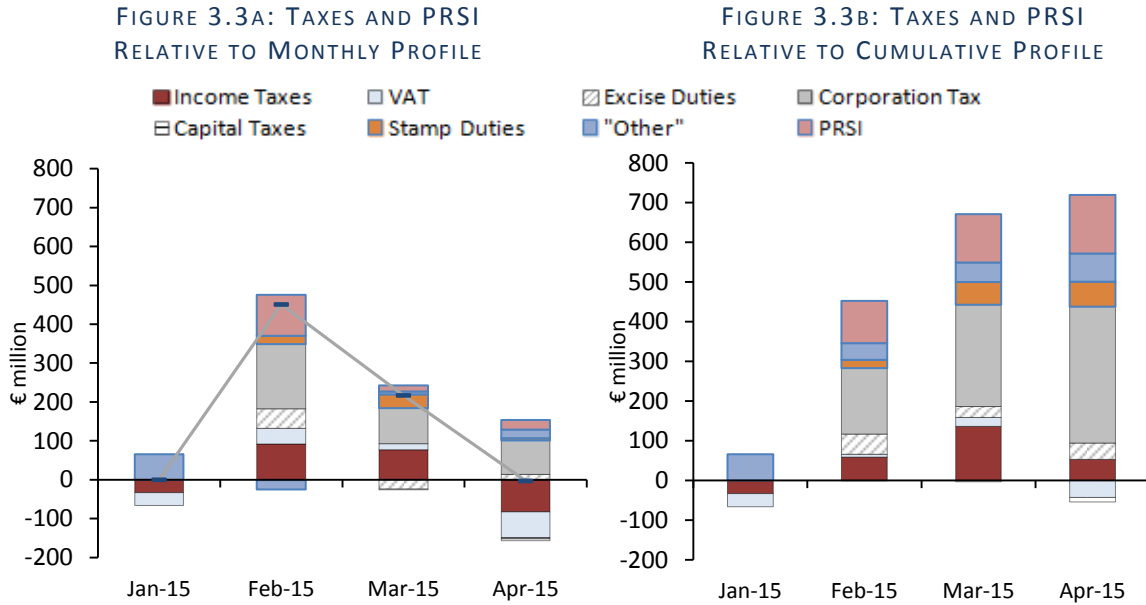
Source: Department of Finance.

Note: Floating bars show the sources of revision to the 2015 deficit, a green bar represents a positive factor (deficit reducing), a red bar represents a negative factor (deficit increasing).

Despite the effect from the statistical treatment of Irish Water, the deficit forecast has improved due to a number of factors, including lower interest expenditure (€520 million). Expenditure on social payments has also been revised down by €470 million reflecting improving unemployment numbers. Other revenue has also been revised up, reflecting the fact that once again the Central Bank surplus income is expected to be higher than profiled. Some of these gains are offset by projected increases to departmental spending which have mainly been allocated to the government wage bill.

One of the biggest contributors to revised forecasts since *Budget 2015* has been taxes. A €1.1 billion upward revision relative to *Budget 2015* comes amid strong Exchequer Returns, with taxes and PRSI for the first four months ahead of end-April 2015 profiles by some €665 million (4.4 per cent, Figure 3.3). Were this performance to continue throughout the rest of the year, the end-year overperformance could be larger than the revised figures, resulting in (all else equal) a deficit that

could fall below 2 per cent. Caution is advised at this early stage, however. In particular, the tax take for the month of April 2015 was below profile.<sup>51</sup> Furthermore, the overperformance in the first four months of 2015 is dominated by corporation taxes, whereas the three largest tax heads (income tax, VAT and excise) are all close to profile.<sup>52</sup>



Source: Department of Finance.  
 Note: Other taxes include customs and property tax.

Source: Department of Finance.  
 Note: Other taxes include customs and property tax.

On the spending side, gross voted current expenditure and interest payments are both below profile. Taken together, the positive outturn for tax revenues and slightly lower than profiled spending led to a year-to-date Exchequer balance in April 2015 that is €889 million better than profile.<sup>53</sup>

REVENUE REVISIONS: BUDGET 2015 TO SPU 2015

To understand why taxes are coming in ahead of profile in the year to date, leading to upward revisions in SPU 2015, it is useful to analyse what has changed since the Budget 2015 tax profiles were published in October 2014.

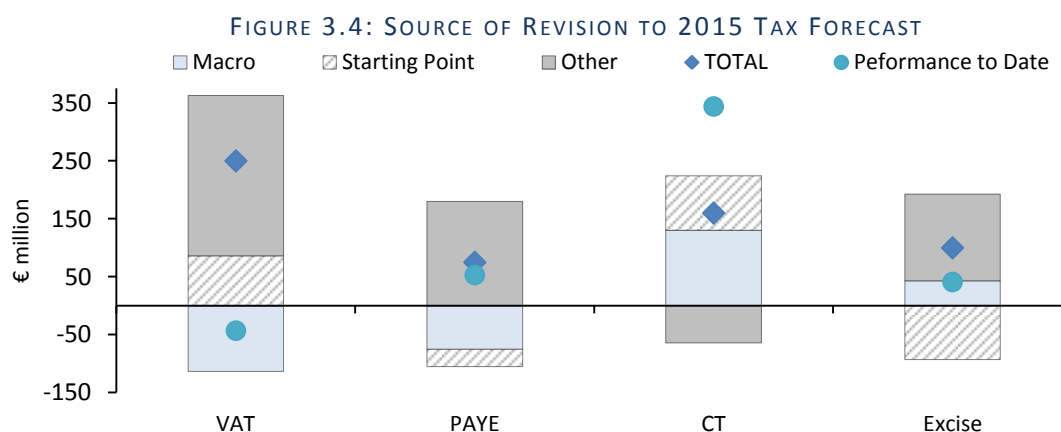
<sup>51</sup> Department of Finance note that an underperformance in income tax in April is largely due to lower than expected DIRT receipts due to lower interest rates.

<sup>52</sup> Department of Finance note that €120 million of corporation tax receipts in March were of an unexpected and one-off nature.

<sup>53</sup> Flows not affecting General Government Balance are excluded.

Figure 3.4 shows the revision to the four largest tax heads from *Budget 2015* to *SPU 2015*. It breaks down the source of that revision into (i) an update to the economic outlook for 2015 (“macro”), (ii) confirmation of the final tax take for 2014 (“starting point”), and (iii) an “other” source of revision, which captures miscellaneous factors and Department of Finance judgement. Figure 3.4 also compares the total revision relative to the performance against the *Budget 2015* profile at end-April.

The main revisions to the tax forecasts since *Budget 2015* have been to corporation tax and VAT. For corporation tax, the outlook for profits in 2015 in the SPU is viewed to have improved and the starting point was confirmed to be higher than thought at Budget time.<sup>54</sup> However, the performance of corporation tax to date is much higher than the revision to the full-year forecast; this would suggest that the Department of Finance are expecting the performance for the rest of the year to be below profile.



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

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

VAT stands out as the tax head that, despite currently underperforming relative to profile, is subject to the largest upward revision since *Budget 2015*. The downward revision to the forecast for personal consumption expenditure (PCE), which is the macroeconomic driver for VAT, is partly offset by the starting point being higher. The bulk of the revision is, therefore, a result of other factors. This other category largely reflects a view that VAT is likely to outperform relative to PCE. The previous *FAR* noted the unusually strong growth in VAT relative to PCE. A possible explanation is that, as PCE begins to grow again, consumers return to buying more discretionary items, such as

<sup>54</sup> Profits are proxied by Gross Operating Surplus, which is defined as total gross value added minus compensation of employees.

cars, which attract a higher rate of VAT than necessities. If this is the case, VAT may temporarily become more sensitive to consumer spending than it has been in the past.

### 3.3.2 FORECASTS FOR 2016-2020

Under the Budgetary Frameworks Directive, EU member states were to put in place a Medium-Term Budgetary Framework (MTBF). Under the framework, documents such as *SPU 2015* would contain forecasts for the major revenue and expenditure items on a no-policy change basis. These would be accompanied by a breakdown of the kind of policies it is anticipated would be required to meet the medium-term budgetary targets for each component.<sup>55</sup> The projections for expenditure in *SPU 2015* fall short of meeting the requirements of a medium-term plan as envisaged in the Directive. The revenue forecasts in *SPU 2015* assume certain policy changes for 2016 but none thereafter. This is despite the fact that the *Spring Economic Statement* signalled that the income tax cuts in *Budget 2015* were the start of a multi-year programme of income tax reform. *SPU 2015* describes the expenditure forecasts as ‘no-policy change’, however, as discussed below, it is not clear what precisely this implies and there is no reconciliation between this ‘no-policy change’ scenario and what government expenditure would be over the medium term taking account of budget and other policy measures.

Given these shortcomings, the deficit projections in *SPU 2015* do not provide a useful picture of the fiscal position after 2016. While it is not expected that specific revenue and expenditure measures would be detailed over the medium term, full acknowledgement of spending pressures, revenue targets and, consequently, a deficit path should play a central role in medium term projections.

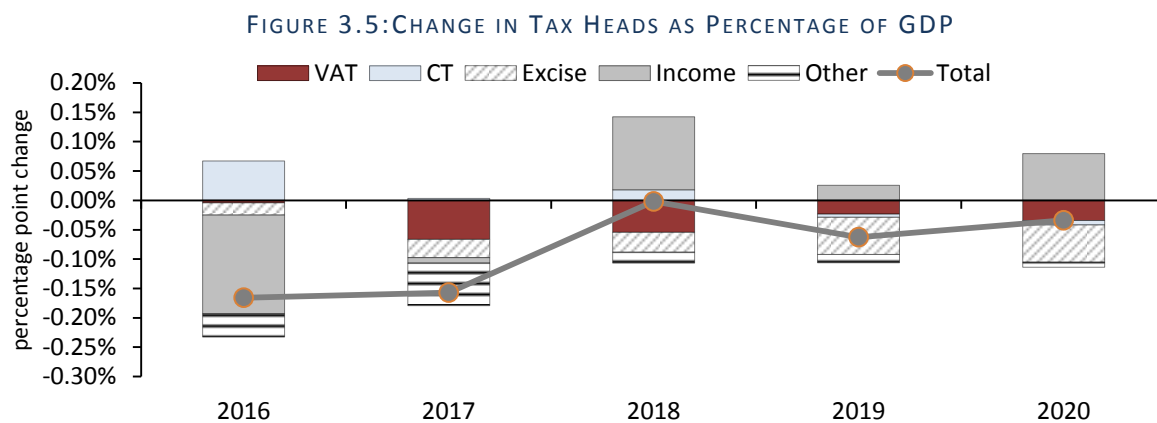
#### REVENUE

Revenue and, in particular, taxes have been revised up since Budget 2015, reflecting both the large revision to the 2015 forecast on foot of strong Exchequer Returns in early 2015 and the improved economic outlook. However, it is notable that in 2017 and 2018, taxes on income and wealth have been revised down relative to *Budget 2015*. This is because *SPU 2015* forecasts are based on a new methodological approach of assuming that income tax bands are indexed to growth in compensation of employees. This is the first time that such an assumption has been employed and reflects the idea that when wages are growing, the non-indexation of income tax bands effectively raises additional revenue by increasing the tax burden for given real incomes.

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<sup>55</sup> In particular, the European Commission’s *Guidelines on the format and content of Stability and Convergence Programmes* (EC, 2012) indicates that “Each Member State should appropriately define a scenario at unchanged policies and make public the involved assumptions, methodologies and relevant parameters.” Furthermore, “The programmes should describe the budgetary and other economic policy measures being taken, envisaged or assumed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the general government balance.”

The forecasts for tax revenue beyond 2016 do not include any policy measures such as further reductions in income tax or the Universal Social Charge (USC). Even without cuts to tax rates, revenues in *SPU 2015* are forecast to fall as a percentage of GDP. While taxes generally grow in line with GDP, they are actually forecast to fall from 24.4 per cent of GDP in 2015 to 23.8 per cent in 2017.<sup>56</sup> This is because some of the main tax revenue drivers, particularly consumption, are not expected to grow as fast as overall GDP.



Source: Department of Finance

Note: Other taxes relate to stamp duty, capital gains tax, capital acquisitions tax, customs and local property tax.

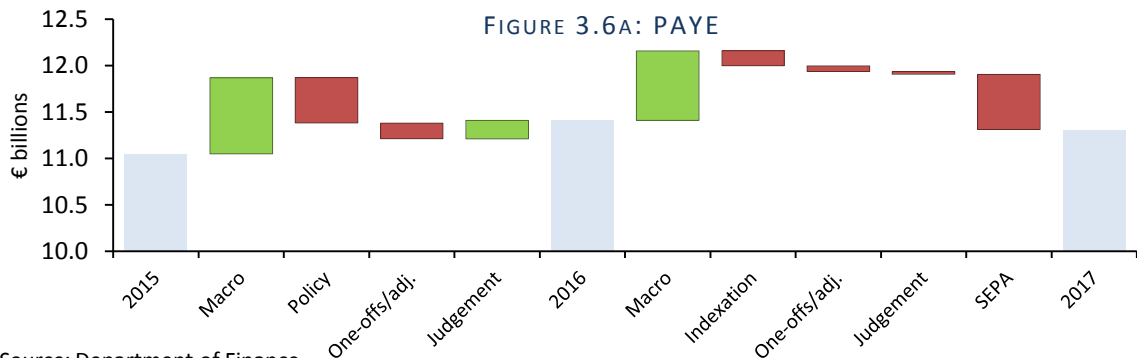
Figure 3.5 shows how the total change in taxes as a percentage of GDP is broken down between tax heads. The big four taxes of VAT, corporation tax (CT), excise and income tax accounted for 92 per cent of total taxes in 2014. During the years 2016-2020 there is a gradual decline in taxes as a percentage of GDP. A more detailed decomposition of the sources of change over these years, shown below, suggests that the expected growth in the big four tax heads is in line with the historical relationship between them and the performance of their economic drivers. The fall as a percentage of GDP is caused by a divergence between the performance of these individual drivers and nominal GDP. In particular, nominal consumption is forecast to grow 1.1 percentage points slower than nominal GDP from 2016-2020. This leads to VAT and Excise growing more slowly than GDP over the forecast horizon.

Figure 3.6 (A-D) shows how the forecasts for taxes set out in *SPU 2015* are expected to evolve from the 2015 outturn to 2017. In each case, the macro bars show how much of the change is due to growth in that tax head’s most important economic driver. The Department of Finance forecasts assume that the relationship between the tax head and the macro driver remains constant over time. This may not always be the case and is a potential source of error. In all cases the Department of Finance have used judgement to adjust the forecast upwards in 2016. This reflects a belief that

<sup>56</sup> This is despite the fact that *SPU 2015* notes that taxes have been growing faster than GDP in recent years.

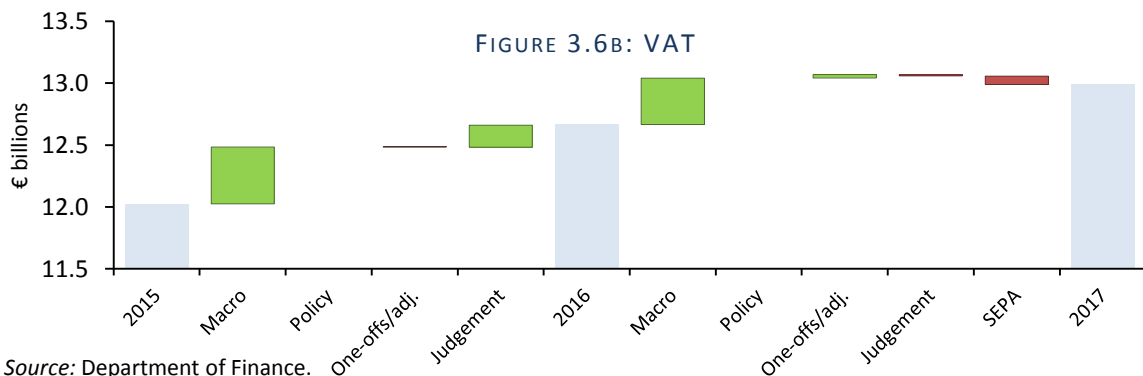
the forecast based purely on the historical relationship with a tax head’s macro driver may be underestimating the likely outturn. For example, as noted earlier, recent outturns for VAT have been significantly higher than would be predicted based solely on the forecasting formula. The use of discretion is, therefore, helping to correct the forecasting formula and in 2016 leads to taxes as a percentage of GDP to be 0.3 percentage points higher than they otherwise would be.

FIGURE 3.6 A-D: SPU 2015 TAX FORECASTS



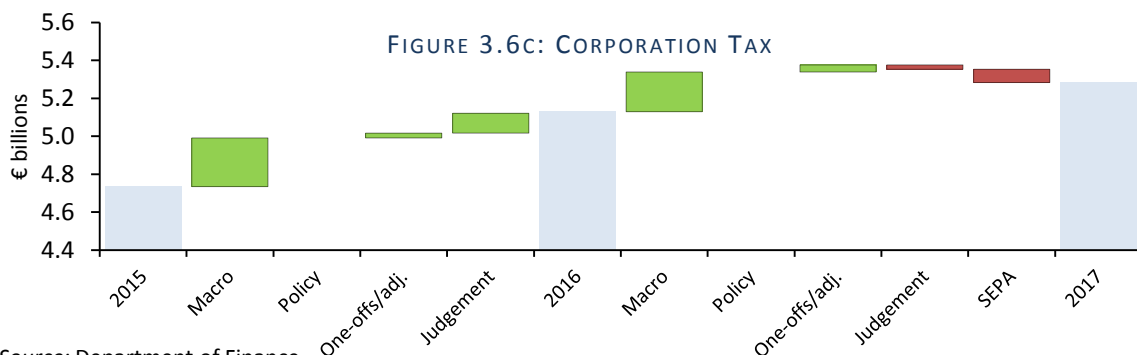
Source: Department of Finance.

Note: Floating bars show transition from 2015 tax take to 2016 and from 2016 to 2017. Green is positive, red negative. The macro driver is the non-agricultural wage bill.



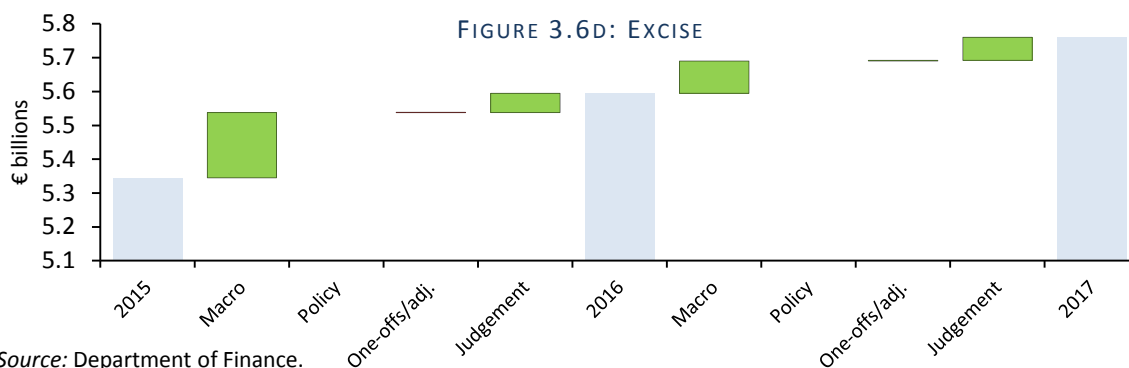
Source: Department of Finance.

Note: Floating bars show transition from 2015 tax take to 2016 and from 2016 to 2017. Green is positive, red negative. The macro driver is nominal consumption adjusted for tourism spending.



Source: Department of Finance.

Note: Floating bars show transition from 2015 tax take to 2016 and from 2016 to 2017. Green is positive, red negative. The macro driver is Gross Operating Surplus (a proxy for company profits).



Source: Department of Finance.

Note: Floating bars show transition from 2015 tax take to 2016 and from 2016 to 2017. Green is positive, red negative. The macro drivers are nominal consumption and value of car purchases.

The only tax head to be adjusted for policy measures is income tax where the *Budget 2016* tax package is assumed to impact revenue from this source. In 2017, the indexation bar reflects the cost of increasing the PAYE tax bands in line with growth in the non-agricultural wage bill. PAYE is also adversely affected by the carryover from tax cuts in previous years. Finally, there is a large downward adjustment to PAYE in 2017 related to the timing of SEPA payments as a result of the lower number of banking days at the end of 2017. These payments will occur in 2018 instead. In general government accounting, which is done on an accruals basis, this timing issue will have no effect. This SEPA issue also impacts VAT and corporation tax but to a lesser extent.

#### EXPENDITURE

Expenditure over the period 2016-18 has been revised up by an average of €1.3 billion. Part of this is accounted for by the inclusion of Irish Water from 2014 onwards. A €600 million expenditure package is proposed for 2016. Increases in the outer years reflect the inclusion of an extra €300 million each year to cover the cost of demographic pressures.

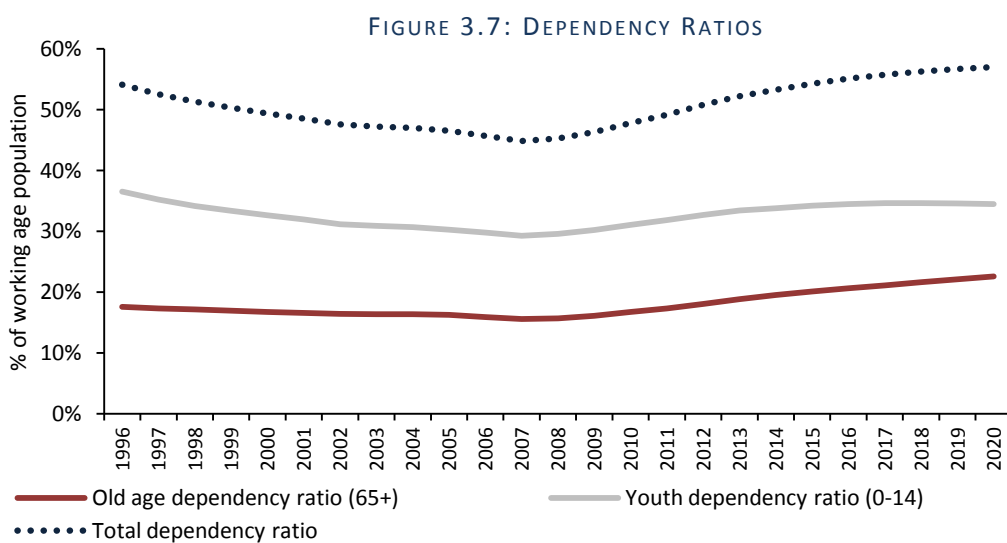
The *Comprehensive Expenditure Report 2015-2017 (CER 2015-2017)* published in October 2014 set out new expenditure ceilings on foot of a review of all areas of expenditure. A comprehensive review process should have detailed the policies necessary to reconcile bottom-up spending demands (including demographic pressures, rising costs and pay) with a medium-term fiscal policy. In this case, the aggregate expenditure ceilings would act as a good forecast for spending out to 2017 as they act to prevent spending from rising above them. Unfortunately, the process does not appear to have worked in this manner with the ceilings set out in October 2014 being replaced with forecasts on a 'no-policy change' basis.

The precise meaning of no-policy change after 2016 is unclear from *SPU 2015*. The expenditure projections take account of the impact of falling unemployment-related spending. It seems that increases in public sector pay have not been allowed for and capital expenditure is left unchanged

after 2017, pending the publication of the *Capital Expenditure Review*. Beyond this, it is uncertain whether the additional €300 million each year is sufficient to maintain the same level of public services. As discussed below, *SPU 2015's* projections imply a significant fall in spending as a percentage of GDP.

In the coming years, the state faces demands for higher expenditure in health, education, social protection and pensions as the composition of Ireland's population changes. In addition, the cost of providing the existing level of public services is likely to rise in line with the forecast general rise in prices and wages in the economy. Given the steep fall in the overall ratio of spending to GDP between 2015 and 2020 of over 5 percentage points, it appears unlikely that current plans make adequate provision for known future expenditure demands. In particular, the medium-term forecasts do not appear to include provision for increases to public sector pay, social welfare rates or capital expenditure.

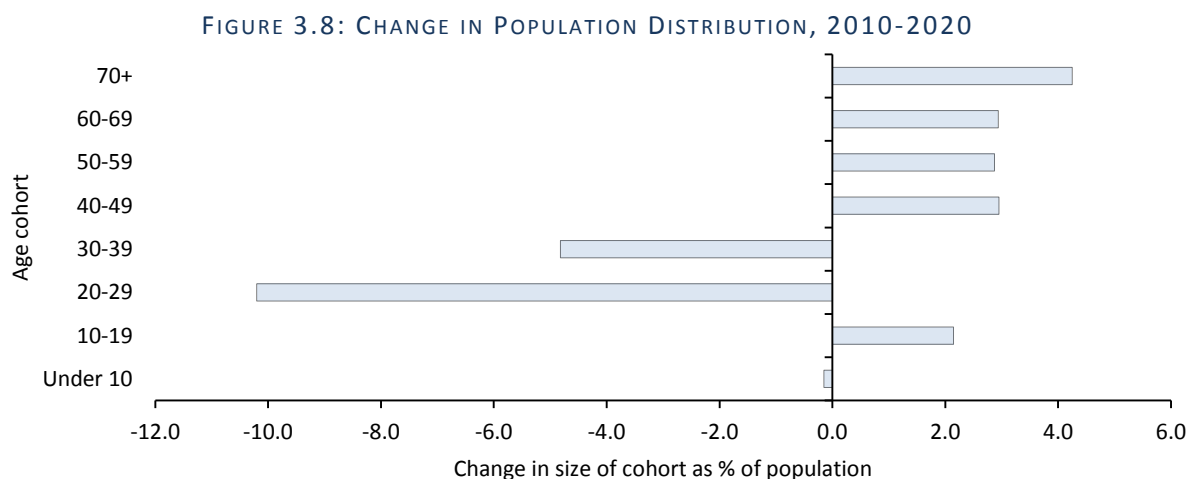
An insight into the demographic changes that will give rise to expenditure pressures in the coming years is illustrated in Figure 3.7 and Figure 3.8. The projections are calculated using population and migration statistics from the CSO along with assumptions on fertility, mortality, migration, labour force and participation to calculate scenarios for the population by single year of age over a medium-term horizon. As a result of population ageing, the old age dependency ratio (the population aged over 70 years as a proportion of the working-age population) is expected to rise by over two percentage points by 2020 and to continue increasing thereafter. This will have important implications for public expenditure across a range of areas such as health and pensions.



Source: Internal IFAC calculations.



Figure 3.9 provides an illustration of likely changes in the population structure by 2020. With the ageing of the large cohort currently in their 20s and early 30s, a significantly larger proportion of the population is expected to be in the older age cohorts by 2020 while the proportion in the younger age groups will shrink significantly.



Source: Internal IFAC calculations.

Taking these projections for the population and indexing various categories of government expenditure to relevant prices in the economy, it is possible to construct an illustrative scenario for the public finances that takes account of the demographic pressures faced by the state in the coming years as illustrated above. For the purpose of this exercise, the same forecasts for government revenue as contained in *SPU 2015* are used but a new illustrative scenario for government expenditure is set out. The scenario is not intended to provide a forecast for government expenditure but rather an illustration of the possible path of spending taking account of demographics and increases in the cost of providing public services without offsetting policy changes. Box E contains a description of the assumptions and indexation rules used to generate this medium-term expenditure scenario.

**BOX E: ASSUMPTIONS FOR ILLUSTRATIVE MEDIUM-TERM EXPENDITURE SCENARIO**

In order to construct a medium-term scenario, government expenditure is split into five headline components: health, education, social payments (including social welfare pensions), national debt interest and other. The assumptions used in generating the scenario are set out below and are in line with those commonly employed for an exercise of this type.

**HEALTH AND EDUCATION**

For health and education, pay and non-pay spending are modelled separately. The volumes of both pay and non-pay spending are linked to expected service demand arising from

demographic changes. Price changes for pay and non-pay spending are indexed to relevant deflators. For health, service demand is proxied by the change in the number of under-65 equivalents in the population while for education demand is proxied by the change in the population of potential students. The pupil-teacher ratio is assumed to remain unchanged at its current level. Pay rates in both cases are assumed to grow in line with economy-wide per capita nominal wages, the forecasts for which are taken from *SPU 2015*. The volumes of non-pay expenditure in health and education are assumed to grow in line with expected demand linked to demographics. Prices are indexed to the GDP deflator.

### SOCIAL PAYMENTS

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

- i. Old age payments: These are assumed to grow in line with the change in the population aged over 65 with payment rates indexed to growth in prices.
- ii. Child related payments: The volume is estimated using the change in the population aged under 17. Payment rates are assumed to grow in line with prices.
- iii. Unemployment benefits are linked to macro-economic dynamics rather than directly to demographics. The approach used is broadly the same as that applied by the Departments of Public Expenditure and Reform and Social Protection. This approach translated changes in unemployment to movements in the Live Register and then applies an average cost per individual.<sup>57</sup> The average cost term is indexed to price increases over the projection period.
- iv. Other payments: these include disability payments, back to education allowance, back to work allowances and other social payments. This category is assumed to grow in line with the change in the total population and prices.

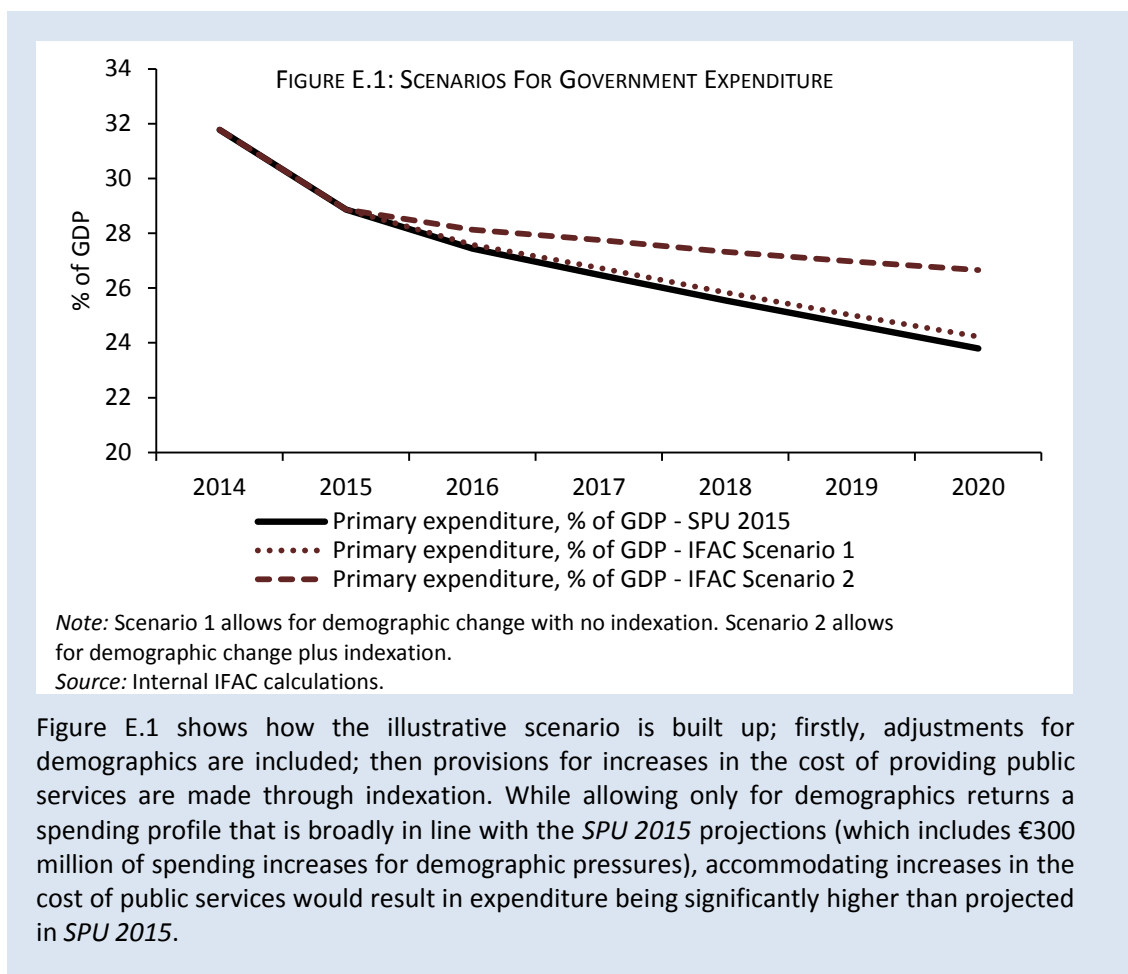
### NATIONAL DEBT INTEREST

The Exchequer deficit is given by the gap between expenditure and revenue. National debt interest is calculated as the difference between the Exchequer balance projected in this scenario and the relevant figure underpinning *SPU 2015*, multiplied by the average interest rate. This gives the additional interest payments for a given year which is added to the interest bill on the outstanding stock of debt for the previous year to arrive at the figure for total national debt interest.

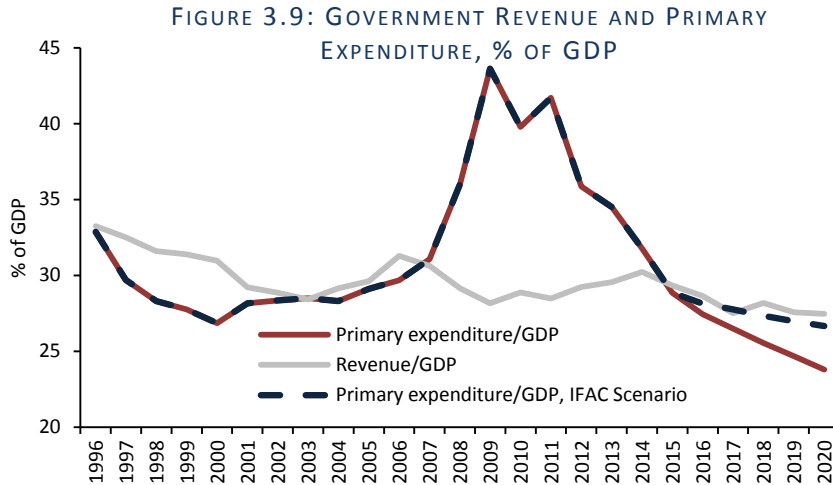
<sup>57</sup> This approach can be summarised as follows:

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

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

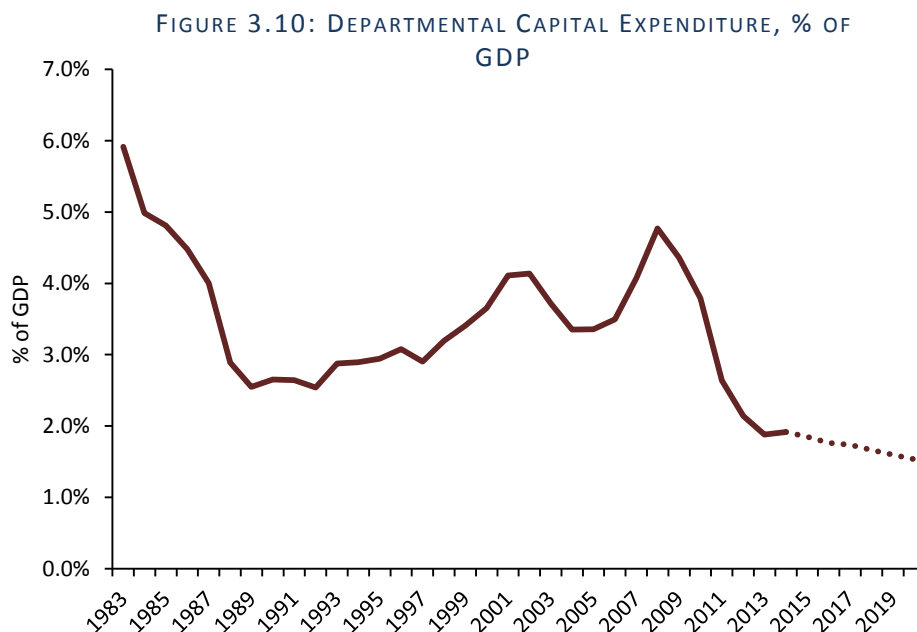


Based on the assumptions and methodology described in Box E, Figure 3.9 shows the path of government expenditure in this illustrative scenario compared to the projections contained in *SPU 2015*. The scenario includes provision for higher expenditure as a result of demographic pressures, and price and wage increases (Scenario 2 as described in Box E). In this illustrative scenario, government primary expenditure as a ratio of GDP falls by around 2 percentage points between 2015 and 2020. *SPU 2015* in contrast envisages a 5 percentage point fall in the expenditure to GDP ratio over the same period.



Note: Chart shows exchequer revenue and primary expenditure as a share of GDP.  
 Source: SPU 2015 and internal IFAC calculations.

It is important to note that this scenario does not change the projections for capital expenditure contained in SPU 2015 as shown in Figure 3.10. The chart shows that SPU 2015 forecasts envisage capital spending remaining at historic lows for an extended period. It is, therefore, likely that the upcoming review of capital expenditure will lead to upward adjustments to capital spending, with consequent impact on the overall level of government expenditure currently used as the basis for the SPU 2015 forecasts for the public finances.



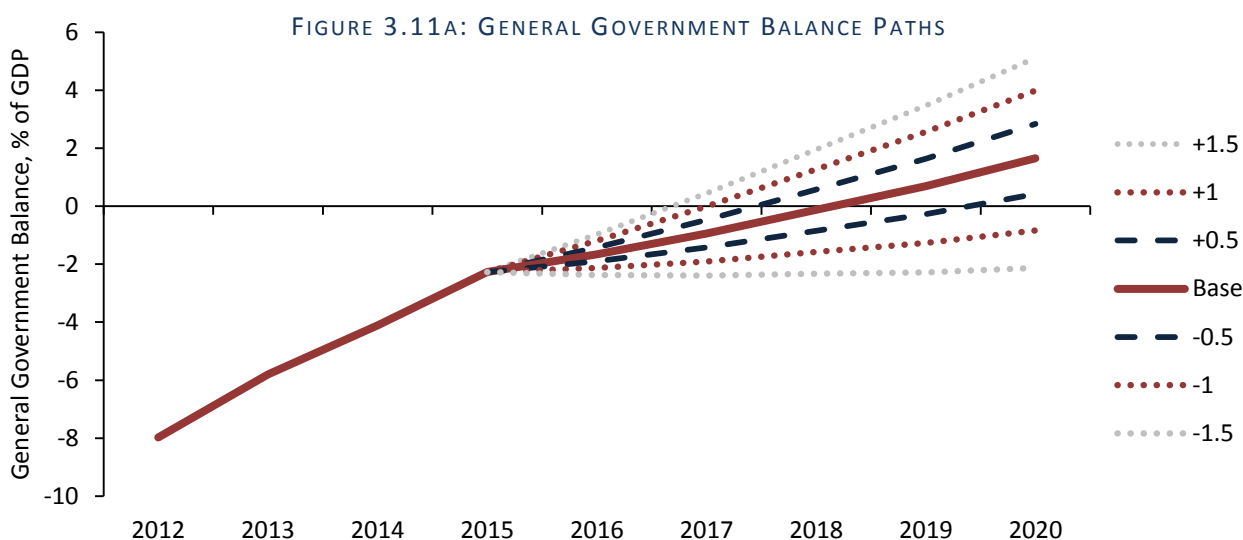
Source: SPU 2015, Budget and Economic Statistic (Department of Finance).

### 3.4 SENSITIVITY AND RISK ANALYSIS

#### 3.4.1 GROWTH RISKS

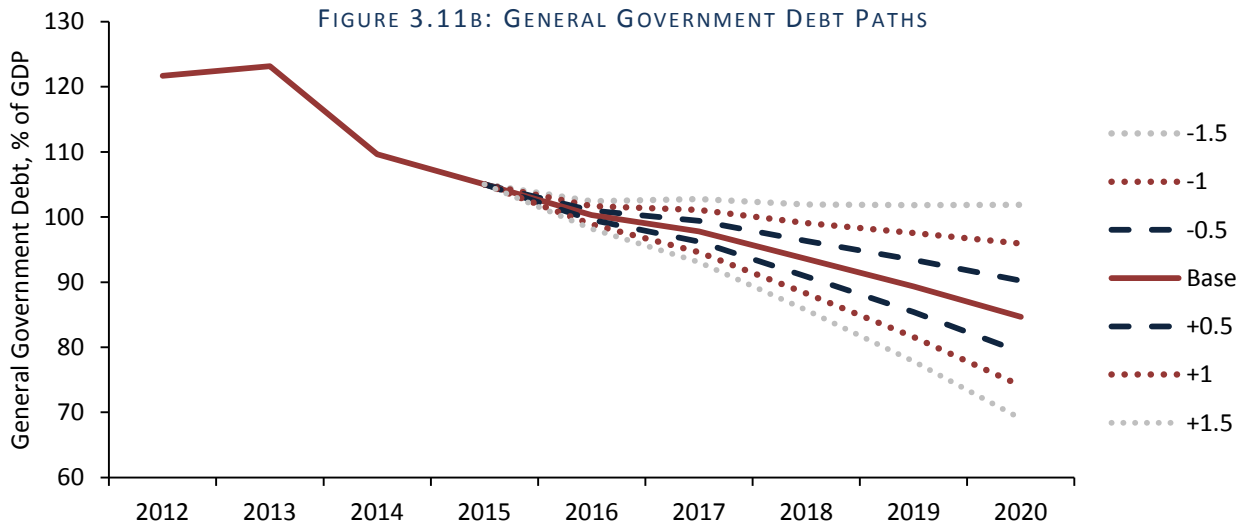
Over the medium term, the attainment of a zero deficit by 2018 and surplus by 2020 remains dependent on economic growth. The Council’s Fiscal Feedbacks Model can be used to estimate the affects of different future growth assumptions on the deficit and debt level. The results of assuming growth of plus or minus 1.5 per cent, 1 per cent and 0.5 per cent are shown in Figures 3.11A and 3.11B, below. Typical errors around the Department of Finance’s nominal GDP growth rates are just under 2 percentage points.<sup>58</sup>

The graphs indicate that in an adverse scenario where nominal GDP growth from 2016 onwards disappoints by 1.5 percentage points each year, the deficit stagnates at just above 2 per cent, with the debt-to-GDP ratio remaining above 100 per cent. Even in a scenario where nominal growth disappoints by just half a percentage point each year (roughly a quarter of the typical in-year error), a General Government surplus only emerges in 2020 and debt remains above 90 per cent of GDP.



Source: Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.  
 Note: The figure shows alternative projections of the balance ratio based on GDP growth forecasts that deviate from SPU projections by 0.5, 1.0 and 1.5 percentage points in either direction.

<sup>58</sup> Typical forecast error refers to the Root Mean Square Error of the Department of Finance’s forecast for the current year.



Source: Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.  
 Note: The figure shows alternative projections of the balance ratio based on GDP growth forecasts that deviate from SPU projections by 0.5, 1.0 and 1.5 percentage points in either direction.

### 3.4.2 INTEREST RATE RISKS

Interest rates have recently retreated from historically low levels amid higher volatility in international bond markets. The yield on Irish 10 year bonds had fallen below 0.7 percentage points but was trading just above 1.2 per cent at end-May. Despite this rise, the current level represents a dramatic reversal of the situation in 2011 when bond yields peaked at over 14 per cent, while spreads have also tightened substantially over the same period.<sup>59</sup>

There is a risk that bond yields continue to retreat from current low levels. Developments in Greece could act as a catalyst for rising Euro Area yields in addition to moderating deflation risks and a normalisation in US monetary policy. While nearly four-fifths of outstanding Irish debt carries a fixed interest rate and so is insulated from interest rate movements, funding requirements<sup>60</sup> of nearly €13 billion per annum (or 5½ per cent of GDP) are estimated over the period 2016-2020. Assuming that debt-funding is used to finance these requirements in full, a shock to prevailing interest rates of 1.5 percentage points could raise the annual average interest rate by up to 0.4 percentage points.

<sup>59</sup> Spreads at the time of writing (vis-à-vis German Bunds) were less than 70 basis points, compared to almost 11½ percentage points in mid-2011.

<sup>60</sup> Funding requirements are proxied by the sum of maturing debt and Exchequer borrowing requirements.

There are mitigating factors such as the degree to which floating-rate debt instruments are converted to fixed rates through hedging activities by the NTMA and the fact that a large share of variable rate interest payments are subject to circular flows.<sup>61</sup> However, rises in average interest rates can also serve to aggravate risks of entering a self-reinforcing “bad equilibrium” as in the recent crisis period.<sup>62</sup>

### 3.4.3 BALANCE SHEET RISKS

Balance sheet risks have diminished considerably over the last number of years. Nonetheless, the Government still faces a number of risks from items both on and off balance sheet. Contingent liabilities fell to €30.5 billion in 2014 down from €66.9 billion in 2013 and €148.5 billion in 2011, with a large portion of the fall accounted for by the closure of the ELG scheme to new entrants in March 2013 and the ending of Exceptional Liquidity Assistance. The *SPU* projections, however, do not explicitly incorporate a large number of potential upside risks related to these items, which have a reasonable probability of being realised over the forecast horizon. It should be recalled, however, that explicit contingent liabilities were also low prior to the crisis. This did not prevent private-sector liabilities becoming actual liabilities of the State. While moves towards banking union – and especially the *Bank Resolution and Recovery Directive (BRRD)* – have reduced implicit contingent liabilities – past experience shows that the fiscal risks associated with the financial system require careful monitoring.

The risks emanating from both NAMA and the banking sector generally have receded. The ending of the ELG scheme had no significant effect on deposit retention and deposits now account for around two-thirds of bank funding. All three covered banks have returned to market funding and have reduced reliance on Eurosystem facilities. NAMA has repaid €19.4 billion (64 per cent) of the €30.2 billion of senior bonds guaranteed by government – a target originally planned for 2016. By end-2016, NAMA now aims to have paid down 80 per cent of the senior bonds it issued. On the

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<sup>61</sup> Following the IBRC liquidation in February 2013, the Central Bank acquired a range of assets that included a portfolio of floating rate notes in exchange for the original Promissory Notes. The first sale of floating rate notes was in December 2014, when €500 million in nominal amounts were sold to the NTMA, leaving approximately €24.5 billion of remaining assets. By law, the Central Bank can retain up to 20 per cent of any profits made on these assets for the purpose of adding to its accounting reserves; any amount not retained is distributed to the Exchequer. When the Central Bank sells one of its floating rate bonds, it realises a gain which is then recorded as part of its profit. While such bonds are held by the Central Bank, interest paid on them also contributes to the Central Bank's profits, partly offset by the effective cost of funds to the Central Bank (currently, just 0.05 per cent). In May 2015, the Central Bank reaffirmed its intention to “...dispose of the government bonds as soon as possible, provided conditions of financial stability permit.” It also repeated that the minimum schedule for disposals was “...€0.5 billion up to the end of 2014, €0.5 billion per annum up to 2018, €1 billion per annum for each of the next five years and €2 billion per annum after that. This position remains unchanged.” See Central Bank (2015) FAQ Special Portfolio for more detail.

<sup>62</sup> The classic “bad equilibrium” concept focuses on the effects of default fears related to rising interest rates and subsequent deteriorations in debt dynamics. Rising default concerns can lead to larger risk premia on Government borrowing; the resulting high interest rates, in turn, worsen a country's debt dynamics, and this reinforces initial fears (see Calvo, 1988, for the classic multiple-equilibria model).

basis of the performance to date and rising property prices, the risk that this contingent liability might crystallize appears to have fallen significantly. Some downside risks arising from NAMA and the banking sector could materialise if unexpected signs of stress tied to a wider deterioration in the macroeconomic environment or international financial markets were to emerge. As the baseline *SPU* fiscal projections do not incorporate any positive proceeds from these areas, the potential losses associated with explicit contingent liabilities are relatively low.



## 4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

### KEY MESSAGES

- The immediate aim of fiscal policy continues to be the successful correction of the excessive deficit in 2015. Adhering to the requirements of the Excessive Deficit Procedure (EDP) will also lead to the Budget Rule being met this year.
- The anomaly identified by the Council that would have led to excessive tightness of the Expenditure Benchmark (EB) in 2016 has been resolved by the European Commission and the Department of Finance.
- The Council has serious concerns regarding the compliance of the Government's fiscal plan with the Budgetary Rule in 2016. *SPU 2015* forecasts show an insufficient fall in the structural deficit to meet the requirements of the Budgetary Rule. Considerable risks to compliance are also evident for the Expenditure Benchmark in 2016.
- Ireland's post-crisis budget framework should help avoid boom-and-bust cycles and reduce government debt. It is therefore important that the letter and spirit of the rules, and the Government's own budgetary framework, are respected in fiscal plans. The Council is strongly of the view that government plans should be based on expected compliance with the fiscal rules and that the reasons for any deviation should be clearly explained.
- For the period post-2016, assessing compliance with the fiscal rules is problematic as the budgetary forecasts do not reflect stated policy. The Government's stated intention is to pursue minimum compliance with the rules over this period.
- The move to an annual update of the Expenditure Benchmark, while ensuring consistency with the official structural balance target, weakens the already fragile domestic framework for the setting of multi-annual expenditure ceilings. The domestic *Medium-Term Expenditure Framework (MTEF)* should be strengthened to ensure that multi-annual planning becomes a central element of the budget process.

## 4.1 INTRODUCTION

The Council's mandate includes reporting on compliance with Ireland's domestic Budgetary Rule and also monitoring compliance with the full range of EU fiscal rules as part of the broader assessment of the fiscal stance. This chapter examines the consistency of the *Stability Programme Update 2015 (SPU 2015)* and the Government's plans with the fiscal rules. It discusses some important recent changes to key operational elements of the fiscal framework at both the domestic and European levels. This chapter also includes a box on changes and exceptions in the assessment of the path to the Medium-Term budgetary Objective (MTO).

When assessing the compliance of the Government's fiscal plans with individual rules, the status of these rules within the broader European and domestic fiscal framework must be borne in mind. At a European level the immediate target in the short term is the correction of the excessive deficit within the Corrective Arm of the *Stability and Growth Pact (SGP)*. As the excessive deficit is expected to be corrected this year, the Preventive Arm of the *SGP* will come to the fore from 2016, which includes an assessment of the structural balance and the Expenditure Benchmark (EB).<sup>63</sup>

## 4.2 EXCESSIVE DEFICIT PROCEDURE EXIT

The Excessive Deficit Procedure (EDP) ceiling of an underlying general government deficit of 3 per cent of GDP will likely be met with a buffer in 2015 given the forecast headline deficit of 2.3 per cent of GDP in *SPU 2015*. Furthermore, the excessive deficit appears to be undergoing correction in a sustainable manner, i.e. the deficit is set to remain below the 3 per cent ceiling over the medium-term.<sup>64</sup>

In the event of the 3 per cent ceiling not being met in a sustainable manner, the EC would undertake an assessment of effective action. The EU Council recommended a structural balance improvement ("fiscal effort") of at least 9½ per cent of GDP be achieved over the period 2011 to 2015. While an assessment on the basis of the structural balance estimate in *SPU 2015* shows a shortfall against the required 9½ percentage point improvement, the latest estimate of fiscal effort by the EU Commission, on the basis of permanent consolidation measures, implies effective action was taken.<sup>65,66</sup>

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<sup>63</sup> While the Council's formal requirement to assess (*ex post*) compliance with the Budgetary Rule is backward-looking in nature, the mandate of the Council to assess the fiscal stance suggests considering compliance on a forward-looking basis also.

<sup>64</sup> In their Country Specific Recommendations on the SPU and National Reform Programme (May 2015), the EC foresee "...a timely and durable correction of the excessive deficit by 2015 ..." (p. 3).

<sup>65</sup> A 'bottom-up' or 'narrative' approach evaluates the fiscal effort by adding up the measures adopted in actual budgets and reported in budget documentation or other verifiable communication (EC, 2015).

Following a successful exit of the EDP, transition arrangements under the Debt Rule will apply for three years - until the end of 2018 if the 3 per cent ceiling is met this year – before the normal requirements of the Rule begin to apply.<sup>67</sup> These requirements - part of the Corrective Arm of the SGP - are not anticipated to present a binding constraint on fiscal policy over the forecast period.

### 4.3 COMPLIANCE WITH THE BUDGETARY RULE

The Budgetary Rule is a key pillar of the domestic fiscal framework and has been in force since its legal commencement on 31 December 2012.<sup>68</sup> It is framed in terms of a requirement to achieve a specified structural budget balance. The domestic Budgetary Rule effectively mirrors the Preventive Arm of the *Stability and Growth Pact (SGP)*. This will come into operation once the EDP ends in 2015.

In recent years under the EDP, the pace of reduction in the measured structural balance has generally been in excess of the greater than 0.5 percentage points annual improvement required under the Preventive Arm, with the exception of 2014.<sup>69</sup> In procedural terms, the *Fiscal Responsibility Act 2012* specifies that one means of respecting the Budgetary Rule is through the structural balance ‘converging towards the medium-term budgetary objective in line with the timeframe set in accordance with the 1997 surveillance and coordination Regulation’ (Section 2(4a)). This requirement is satisfied in the EU regulations where the fiscal path set out under the EDP is met.<sup>70</sup>

Once the excessive deficit has been corrected, the assessment of the Budgetary Rule will focus on progress to reduce the structural deficit to meet Ireland’s Medium-Term Objective (MTO) consistent with the provisions of the Preventive Arm of the SGP, which includes an analysis of the Expenditure Benchmark (EB).<sup>71</sup>

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<sup>66</sup> Previous Stability Programme Updates indicated compliance with the requirements of effective action on a ‘bottom-up’ basis; however *SPU 2015* does not include an updated estimate.

<sup>67</sup> The debt rule states that debt in excess of the 60 per cent debt to GDP ratio must be reduced by at least 1/20<sup>th</sup> per year on average. For a more detailed discussion, see *Analytical Note 5: Future Implications of the Debt Rule*.

<sup>68</sup> <http://www.irishstatutebook.ie/pdf/2012/en.si.2012.0522.pdf>.

<sup>69</sup> As Ireland has a debt ratio of greater than 60 per cent of GDP, under the terms of the SGP, the annual change in the structural balance must be greater than the 0.5 percentage point benchmark to comply with the Adjustment Path condition. At a European level this has been operationalised as a 0.6 percentage point improvement for countries such as Ireland in ‘normal times’ and with a debt-to-GDP ratio greater than 60 per cent. As the official forecasts of the output gap indicate Ireland will remain in ‘normal times’ (see Box G), this 0.6 per cent adjustment is also applied in the *ex ante* analysis.

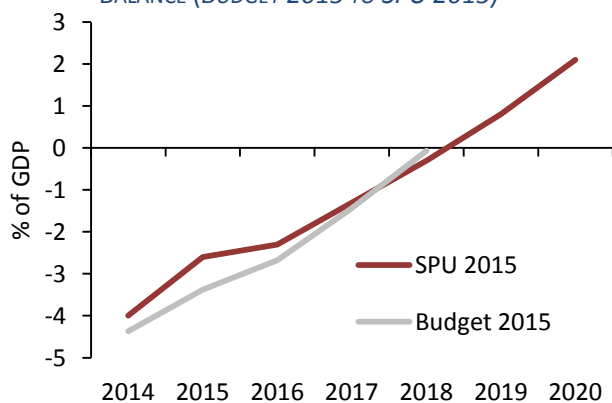
<sup>70</sup> This occurs irrespective of whether a 0.6 percentage point reduction is achieved.

<sup>71</sup> As part of the wider assessment of the fiscal stance, all aspects of the fiscal rules are monitored and reported by the Council for the period to 2015. While neither the path of the structural balance nor the EB determine compliance with the Rule until 2016, they are assessed as part of the analysis of the fiscal stance.

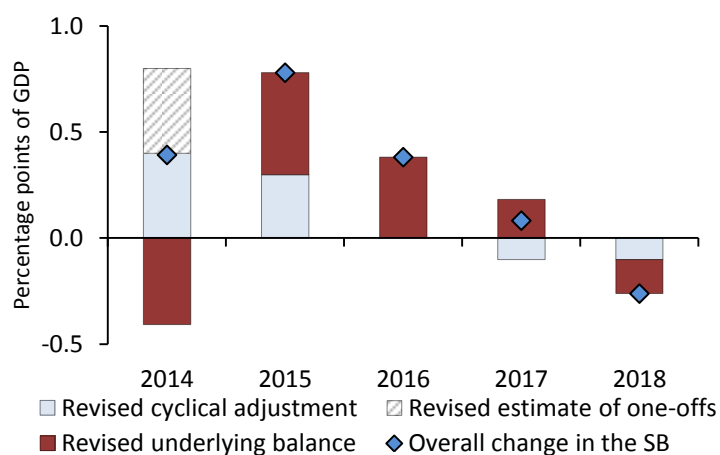
While the EB is designed to support achieving the targeted structural balance improvement, there are a number of scenarios where they may give differing signals as to compliance with the rules as set out in *IFAC Analytical Note No. 7* issued in April 2015 (IFAC, 2015). In the event of such conflicting signals from these measures, the Council will form a view on compliance with the Budgetary Rule based on an analysis of the particular reasons causing the differing signals.<sup>72</sup>

There have been material revisions to the official estimate of the structural balance between *Budget 2015* and *SPU 2015* with positive revisions to the structural balance for 2014 to 2016 and then smaller revisions for 2017 and 2018 (see Figures 4.1A and 4.1B).<sup>73</sup> The revised improvement in the structural balance between 2015 and 2016 is 0.4 percentage points smaller than estimated in *Budget 2015*. This change reflects the revised forecasts for the net impact of policy decisions on the balance (discussed in Chapter 3) and the impact of revised output gap estimates. While the revision in the underlying deficit improved the structural deficit in both 2015 and 2016 by a broadly equivalent amount, the change in the cyclical component in 2015 flattens the structural deficit path between these years as compared to the previous *Budget 2015* path.<sup>74</sup>

FIGURE 4.1A: CHANGE IN THE ESTIMATED STRUCTURAL BALANCE (*BUDGET 2015 TO SPU 2015*)



FIGURES 4.1B: DECOMPOSITION OF DIFFERENCE IN THE STRUCTURAL



Source: Internal IFAC calculations based on *SPU 2015* and *Budget 2015*.

Note: Positive changes in the components result in a reduced structural deficit. The fiscal forecasts in *Budget 2015* assume constant Departmental expenditure from 2016 to 2018. The *Budget 2015* figures shown above are adjusted to fully reflect the Ministerial Expenditure ceilings published in the *Comprehensive Expenditure Report 2015-2017*.

<sup>72</sup> In undertaking the assessment of rules the Council will primarily use as a reference the Department of Finance's forecasts and estimates, with analysis and sensitivity tests of key assumptions and forecasts where appropriate and necessary.

<sup>73</sup> The official measure of the structural balance produced by the Department of Finance can be summarised as follows:

$$\text{Structural Balance} = (\text{Actual Balance}) - (\text{Cyclical element}) - (\text{One-off and temporary measures})$$

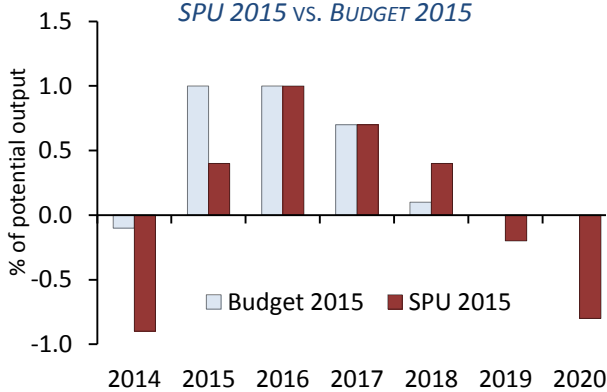
The 'cyclical element' is estimated by applying a constant budgetary semi-elasticity to the relevant output gap for a particular year. The approach to estimating the structural balance must be consistent with the requirements of the Treaty on Stability, Coordination and Governance; the "annual structural balance of the general government" refers to the annual cyclically-adjusted balance net of one-off and temporary measures" (*Treaty on Stability, Coordination and Governance, 2012*). The budget semi-elasticity for Ireland is currently 0.53. (EC, 2014).

<sup>74</sup> The 'underlying' balance is the nominal general government deficit adjusted for the impact of financial sector measures.

The fiscal forecasts for the period post-2016 are not fully reflective of the Government stated fiscal aims (see Chapter 3) and, as such, the revisions to the structural balance for this period are of limited use in assessing the *ex ante* compliance with rules.

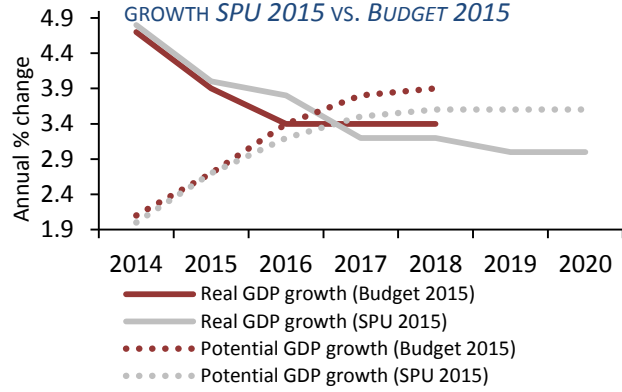
The output gap estimates are largely unchanged in 2016 and 2017. However, Figure 4.2 shows that these revised forecasts lead to significant changes in the output gap in 2014 and 2015 and also in 2018 as compared to *Budget 2015*.

FIGURE 4.2A: COMPARISON OF OUTPUT GAP ESTIMATES  
*SPU 2015 vs. BUDGET 2015*



Source: *SPU 2015* and *Budget 2015*.

FIGURE 4.2B: COMPARISON OF REAL AND POTENTIAL GDP  
*GROWTH SPU 2015 vs. BUDGET 2015*

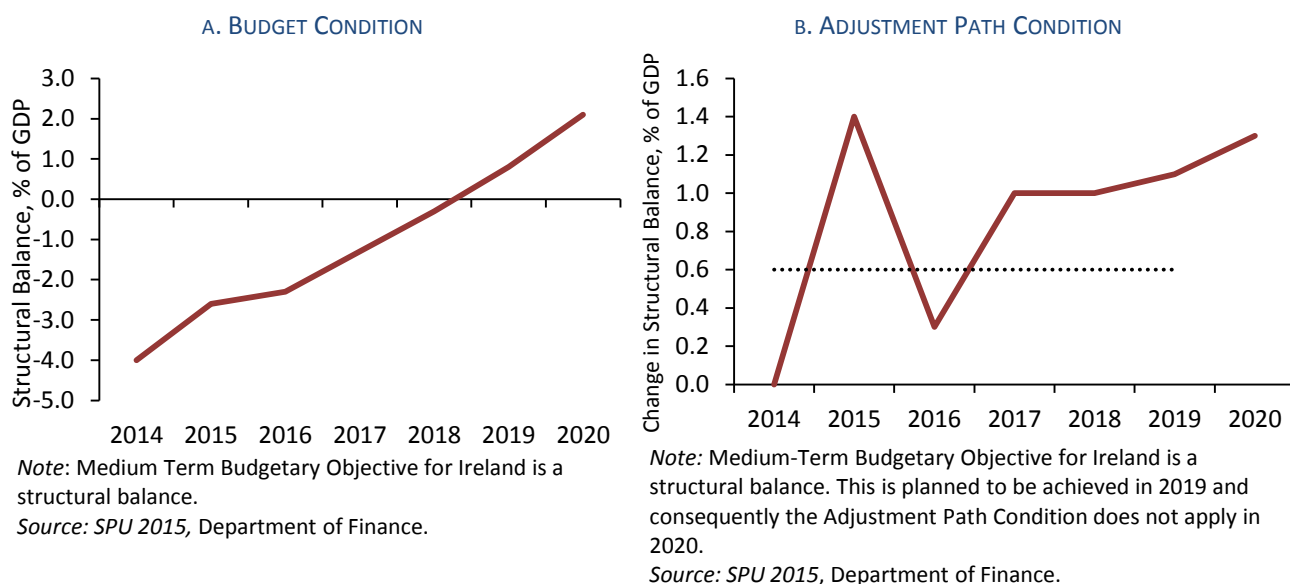


Source: *SPU 2015* and *Budget 2015*.

#### EX POST AND IN-YEAR ASSESSMENTS FOR 2014 AND 2015

The current official measure of the structural balance shows that the structural deficit remained flat between 2013 and 2014, despite an improvement in the headline deficit, which fell by 1.7 percentage points from 5.8 per cent to 4.1 per cent (see Figure 4.3). Although this would not have delivered the 0.6 percentage point change required under the Adjustment Path condition, this does comply with the Budgetary Rule and EU requirements for the procedural reasons set out above. In addition, this apparent lack of progress arises as a result of the differing impact of the technical ESA2010 revisions in 2013 and 2014 (see IFAC, 2014b). It does not reflect a lack of ‘fiscal effort’ in 2014, as reflected by the actions taken in *Budget 2014*.

FIGURE 4.3: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE



The estimated structural deficit for 2015 is forecast by the Department of Finance to fall by 1.4 percentage points to 2.6 per cent of GDP. This is more than double the 0.6 percentage point change required to comply with the Adjustment Path condition outside of an EDP, although it remains some distance from the MTO.

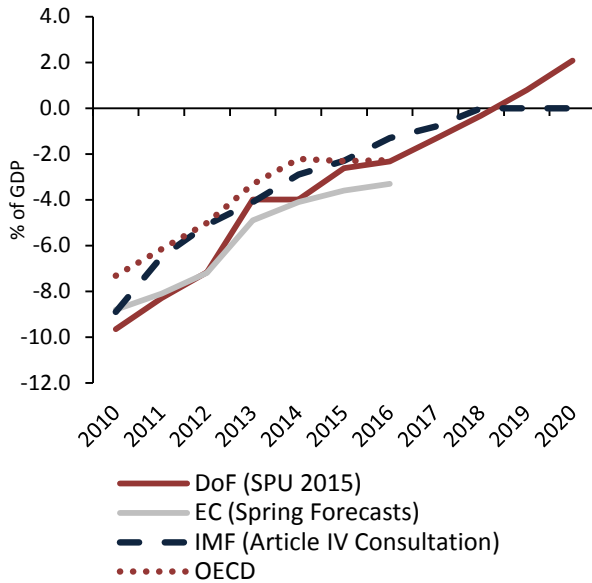
EX ANTE ASSESSMENT OF 2016

On the basis of the forecasts contained in SPU 2015, the annual structural adjustment required under the Budgetary Rule will not be met in 2016 with an improvement of only 0.3 percentage points rather than the required 0.6 per cent. This difference is not large enough to be deemed a “significant deviation” under the EU rules.<sup>75</sup> However, it is a serious concern that the Government has set out a plan that breaches a key component of both the domestic and European frameworks on an ex ante basis.

This concern is underlined by the size of the planned change in the headline deficit between 2015 and 2016 in SPU 2015 of 0.6 percentage points. This could only deliver the required improvement in the structural balance if the improvement is entirely structural in nature. However, this is very unlikely to be the case. SPU 2015 indicates that most of the forecast reduction in the deficit to 2016 is, ‘attributable to buoyant tax receipts on the back of a growing economy.’ (SPU 2015, p. 16).

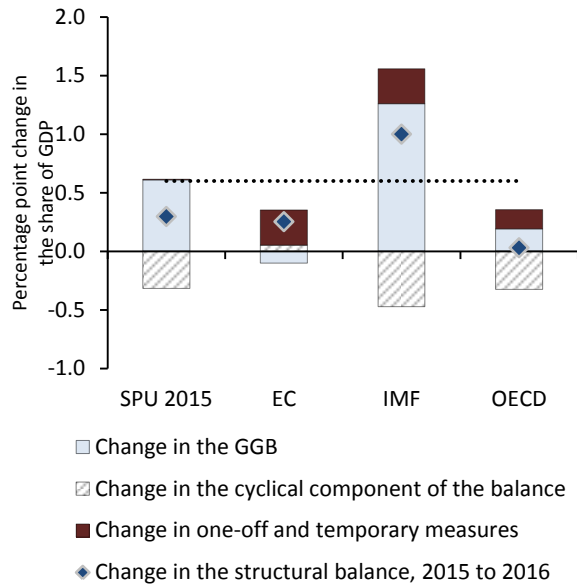
<sup>75</sup> Under the SGP, a significant deviation arises where there is a deviation of 0.5 per cent of GDP from the required growth rate in any given year, or cumulatively over two consecutive years.

FIGURE 4.4A: COMPARISON OF LATEST STRUCTURAL BALANCE ESTIMATES



Source: SPU 2015 (April 2015), EC's Spring 2015 Economic Forecasts, IMF's Article IV Consultation (March 2015) and the OECD's World Economic Outlook (November 2014).

FIGURE 4.4B: ANNUAL CHANGE IN THE STRUCTURAL BALANCE, 2015-2016



Source: Internal IFAC calculations based on SPU 2015 (April 2015), EC's Spring 2015 Economic Forecasts, IMF's Article IV Consultation (March 2015) and the OECD's World Economic Outlook (November 2014).

Given the inherent uncertainty in estimating the structural balance, it is useful to compare estimates across different institutions (see Figure 4.4). The latest EC Spring estimates of the structural balance for 2015 and 2016 indicate an improvement of 0.3 per cent, while the latest IMF estimate is for a 1 per cent change and the OECD forecast is for an unchanged structural balance between these years. However, the IMF's estimate assumes a larger improvement in the headline general government balance than *SPU 2015* and would imply only a 0.2 percentage point improvement in the structural balance starting from the *SPU 2015* headline balance.

The Council is strongly of the view that Government plans should be based on expected compliance with the fiscal rules. The *Spring Economic Statement* clearly identifies this as a difficulty for 2016, "... a particular issue arises with relation to 2016 whereby compliance with the expenditure benchmark is met on current estimates but delivery of structural adjustment is lower than required" (p. 35). Where there is a planned deviation from the rules, as clearly contained in *SPU 2015*, the reasons should be clearly explained.

### BOX F: CHANGES IN THE ASSESSMENT OF THE PATH TO THE MEDIUM-TERM BUDGETARY OBJECTIVE (MTO)

For countries not yet at their MTO the EU rules require an “appropriate” annual improvement in the structural balance. As set out under the reformed Stability and Growth Pact, a greater effort can be sought in good times with effort more limited in bad times.

Earlier this year, the EC clarified the definitions of the “good” and “bad” times that would be applied in their assessments (see figure F.1). On the basis of the *SPU 2015* forecasts, Ireland is in “normal times”. However, with a debt of greater than 60 per cent of GDP, Ireland must improve the structural balance by an amount greater than 0.5 per cent of GDP. This requirement for an improvement of greater than 0.5 percentage points has been operationalised in the latest EC assessments as 0.6 percentage points.

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

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

Some investments deemed to be equivalent to major structural reforms may, under certain conditions, justify a temporary deviation from MTO or from the adjustment path towards it.<sup>76</sup> The EC have now clarified the circumstances under which a country can benefit from this “investment clause”. These include requirements that the country in question is running a large, negative output gap of greater than 1.5 per cent of GDP and that the deviation from the fiscal adjustment path preserves a safety margin to the 3 per cent ceiling. There are also specific clauses relating to the inclusion of different types of investment projects and the treatment of co-funding arrangements.

Countries implementing major structural reforms are allowed to deviate temporarily from their MTO or the adjustment path towards it. This allows countries to cater for the short-term costs of implementing structural reforms that will have long-term positive budgetary effects, including by raising potential sustainable growth. The EC have also clarified that this “structural reform clause” will form part of their assessment where the reforms are major, either individually or as a package, and must have direct long-term positive budgetary effects. There is some debate at a European level as to whether planned reforms are in fact sufficient to meet the requirements set out under the Treaty, or whether some firmer commitment should be required. Planned reforms may be included *ex ante* where a country presents a comprehensive and detailed medium-term structural reform plan.

<sup>76</sup> Article 5 of Regulation 1466/97 provides that “[...] the Council and the Commission shall take into account the implementation of major structural reforms which have direct long-term positive budgetary effects, including by raising potential sustainable growth [...].”



#### 4.3.1 EXPENDITURE BENCHMARK ASSESSMENT 2014-2016

The EB is complied with on an *ex post* basis in 2014.<sup>77</sup> While the growth rate of spending in 2015 is likely to exceed the EB the basis of the figures in *SPU 2015*, the EB does not apply on a procedural basis as compliance with the EDP is sufficient.

The anomaly in the estimation of the Expenditure Benchmark (EB) in 2016, identified by the Council in *Analytical Note No. 7* issued in April (IFAC, 2015), has been addressed by the European Commission and the Department of Finance. This anomaly led to the EB being excessively tight for 2016.<sup>78</sup>

It has been agreed at a European level that both the reference rate, which remains a 10 year average of potential GDP growth, and the convergence margin will be updated on an annual basis rather than held constant over a three year window.<sup>79</sup> This allows for the EB to take account of the more up-to-date estimates of potential GDP growth.

This move to an annual update of the EB ensures greater consistency *ex ante* with the structural balance target to meet the MTO, removing the possibility of this type of anomaly. However, it substantially weakens the anchoring of spending in a multi-annual framework and likely reduces the predictability of medium-term plans (see section 4.4).

On the basis of the EC Spring 2015 economic forecasts, the EB sets the increase in allowable real expenditure to 0.1 per cent in real terms for 2016. This amounts to a €1 billion annual increase in the amount of nominal spending within the terms of the EB; representing a €1.1 billion change from the pre-adjustment position set out in the Council's *Analytical Note* (IFAC, 2015b). The reference rate has been updated from 0.6 per cent to 1.9 per cent (based on the EC's *Spring Economic Forecasts*). However, this is somewhat offset by two changes to the convergence margin in the EB calculation. The first is to update the baseline primary expenditure ratio from 2013 to 2015 data. The second is to ensure the convergence margin is consistent with the required 0.6 percentage point change in the structural balance (the previous convergence margin was based on a 0.5 percentage point requirement). The revision to the EC's forecast for the 2016 GDP deflator between the Winter and Spring forecasting rounds also has a significant impact on the allowable

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<sup>77</sup> The allowable rate of real growth under the EB is calculated by reference to a 10 year average of real potential growth (the 'reference rate') - from (t-5) to (t+4) - and, where the MTO is not yet complied with, a convergence margin is then subtracted.

<sup>78</sup> IFAC (2015) showed that the previous EB was more constraining on fiscal policy than either an alternative estimate of the EB based on an updated estimate of the reference rate or the requirements for the annual change in the structural balance.

<sup>79</sup> A transition period will apply for Member States who do not wish to update their EB for 2016. The annual update will apply to all Member States from 2017.

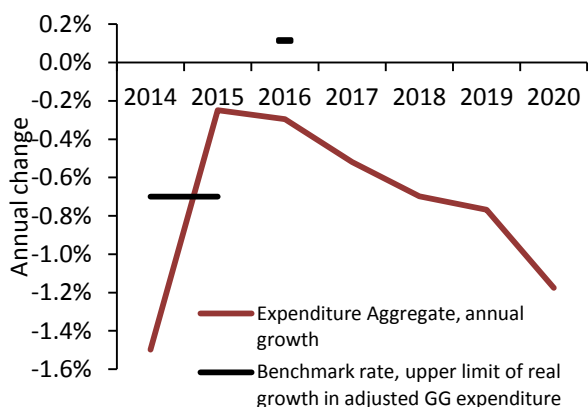
increase in nominal expenditure growth. The impact of recent changes to the setting of the EB are summarised in Table 4.1.

Table 4.1: Allowable Expenditure Growth under the Expenditure Benchmark

Vintage and Range	Measure	2016
Calculations based on <i>Analytical Note 7 (IFAC, 2015)</i>	Reference Rate	0.6
	Convergence Margin	1.4
	Expenditure Benchmark: real %	-0.7
	Implied nominal growth, %	-0.1
	Implied nominal change, €billion	-0.1
Calculation based on <i>SPU 2015</i>	Reference Rate	1.9
	Convergence Margin	1.8
	Expenditure Benchmark: real	0.1
	Implied nominal growth	1.6
	Implied nominal change, €billion	1.0
<i>Implied nominal change since IFAC Analytical Note, €billion</i>		<i>1.1</i>

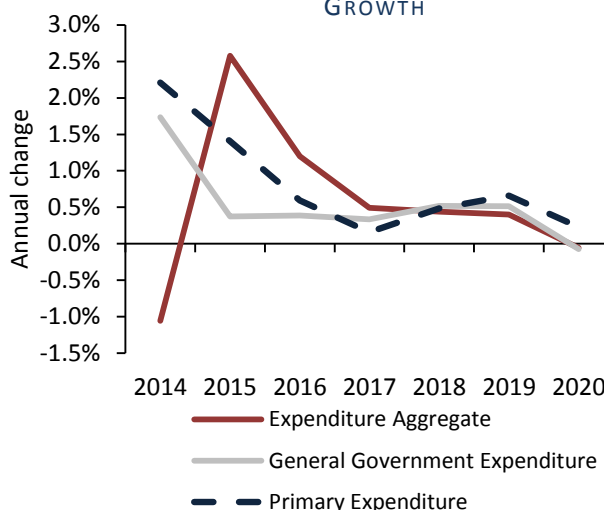
Figure 4.5A shows that, based on the *SPU 2015* fiscal forecast, the EB is complied with in 2016, while Figure 4.5B shows nominal growth in the main expenditure aggregates as set out in *SPU 2015*.

FIGURE 4.5A: COMPLIANCE WITH THE EU EXPENDITURE BENCHMARK



Source: *SPU 2015* and *EC Spring Economic Forecasts*.  
 Note: EB is complied with where the adjusted expenditure aggregate grows at a rate less than the indicated benchmark rate. This real growth rate is adjusted to reflect the scale of discretionary revenue measures.

FIGURE 4.5B: NOMINAL EXPENDITURE GROWTH



Source: *SPU 2015*.  
 Note: The GDP deflator is applied to the expenditure aggregate to estimate the nominal growth in this variable.

Under the EB, increases in expenditure are permitted if fully offset by discretionary revenue-raising measures, for example an increase in tax rates. For countries not yet at their MTO such as Ireland, the reverse also applies so policy decisions to reduce revenues lower the allowable rate of

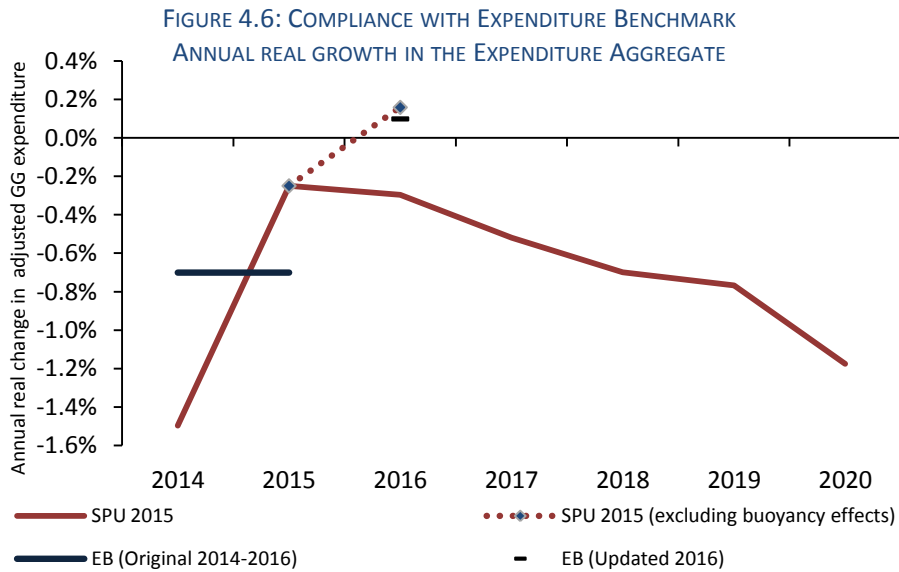
spending growth.<sup>80</sup> The additional carryover impact of €0.3 billion into 2016 arising from taxation changes made in *Budget 2015* reduces allowable expenditure growth in 2016. In addition, the proposed tax package of €0.6 billion envisaged for *Budget 2016* also reduces allowable expenditure growth. The *SPU* includes two revenue increases that offset the impact of proposed 2016 cuts. These items have not been treated as discretionary revenue increases in past *SPUs*.

(i) *Non-indexation of tax*

In the presence of wage growth, such ‘non-indexation’ of income tax bands and credits to prices increases the tax-take. The estimated effects of non-indexation of taxes (€0.3 billion) have been included in the aggregate discretionary revenue measures (DRM) used in the calculation of the EB. The inclusion of the impact of non-indexation is not unreasonable given that it reflects a policy decision that directly affects government revenue in a structural sense.

(ii) *“Tax buoyancy” arising from proposed policy changes*

*SPU 2015* estimates a positive second round impact of the proposed policy changes to tax and expenditure in the budget on the tax-take of €0.3 billion.<sup>81</sup>



<sup>80</sup> The Department of Finance quantifies the tax buoyancy of budget measures and incorporates it in the tax revenue forecasts.

<sup>81</sup> This means that the assumed boost to economic activity from the proposed budgetary package for 2016 of €1.2 billion results in a second-round increase in tax revenue of €0.3 billion through the actions of the fiscal multiplier (assumed 0.5) and the automatic stabiliser coefficient (assumed 0.5). The buoyancy impact of budget packages are typically published as part of the budget documentation.

Figure 4.6 shows that excluding the tax buoyancy effect in 2016, there is considerable risk of non-compliance with the EB on the basis of the *SPU 2015* projections. It is unclear as yet how the European Commission would treat a tax buoyancy effect. The Council sees no argument for the inclusion of a temporary demand effect of this nature in the calculation of EB compliance given the objective to match structural changes in spending and revenues. This adds to the Council's serious concerns about *SPU 2015* setting out plans that do not meet the required minimum change in the estimated structural balance in 2016.<sup>82</sup>

#### EX ANTE ASSESSMENT OF 2017-2020

For the post-2016 period, assessment of compliance with the rules is problematic as the *SPU 2015* fiscal forecasts are stated to be predicated on a 'no-policy change' basis (see Chapter 3). The path of the structural balance complies with the required annual change in the structural balance for all years and the MTO is planned to be achieved in 2019. However, the Government's stated intention is to 'ensure that we move towards the MTO at this minimum rate on average over the coming years...' (p. 37, *Spring Economic Statement*). Under the European and domestic framework the minimum annual adjustment of 0.6 percentage points applies each year; it is not based on a multi-year average. Consequently, larger planned medium-term adjustments cannot be used to balance smaller than required adjustments in the short term.

#### 4.4 THE MEDIUM-TERM EXPENDITURE FRAMEWORK

The move to an annual update of the Expenditure Benchmark weakens the already fragile domestic framework for the setting of multi-annual expenditure ceilings as the formal, multi-annual 'top-down' anchor has been removed.<sup>83</sup> Recent years have seen regular re-setting of both the Government Expenditure Ceiling and Ministerial Expenditure Ceilings.<sup>84</sup> These revisions undermine multi-annual public expenditure management through creating uncertainty around the scale of

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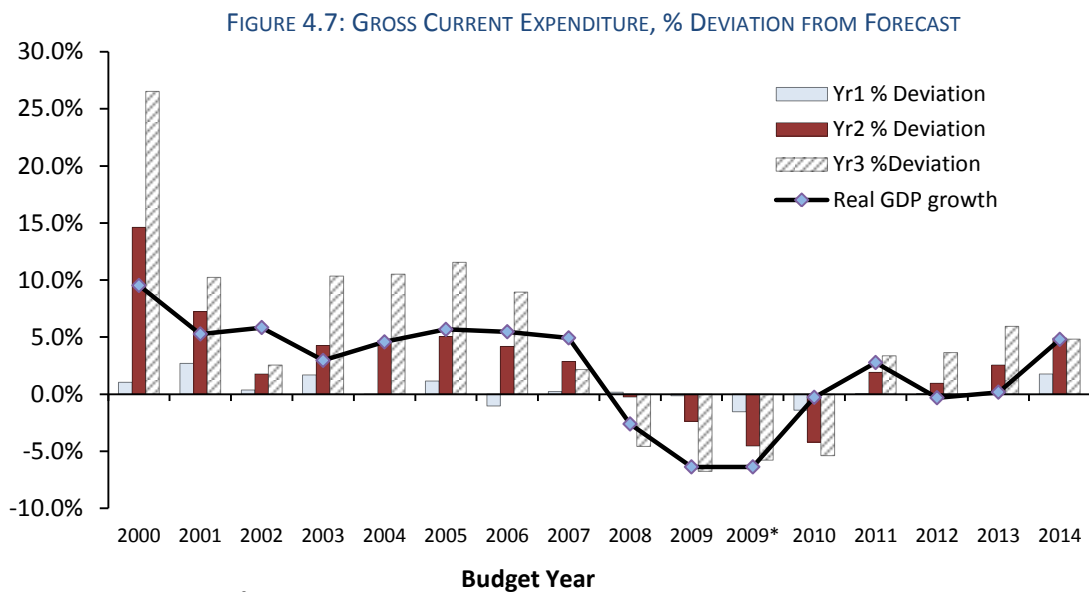
<sup>82</sup> In addition, the Council has previously noted that the methodology used in identifying the cyclical component of unemployment benefit expenditure may also flatter compliance with the EB. This is derived by applying a projected cost per person employed to an estimate of the unemployment gap (i.e., difference between the actual and structural unemployment rates). The latter is the estimated NAWRU consistent with the harmonised EU methodology. This method of estimating structural unemployment underestimates the unemployment gap (*FAR*, 2014a). As a consequence, this method tends to attribute less of the fall in unemployment related spending to changes in the cycle than may be appropriate.

<sup>83</sup> In the *Medium Term Budgetary Framework* (Department of Finance, 2014b) it is stated that the expenditure ceilings operationalise the EB.

<sup>84</sup> The Ministers and Secretaries (Amendment) Act 2013, which legislated for the ceilings, provides for both an aggregate ceiling on gross Departmental expenditure, including the Social Insurance Fund) - the Government Expenditure Ceiling - and for individual Ministerial ceilings. Furthermore, it requires that the aggregate of the Ministerial ceilings be no more than the Government Expenditure Ceiling.

future resources, both in aggregate and for individual Departments.<sup>85</sup> Given that the aim of the *Comprehensive Review of Expenditure 2015-2017 (CER 2015-2017)* was to ‘help avoid incrementalism and support budget discipline’, the upward revision to the Government Expenditure Ceiling in *SPU 2015* without adequate explanation is a significant concern. Furthermore, this upwards revision should – within the government’s own budgetary framework – have led to revised Ministerial expenditure ceilings. The failure to provide these in *SPU 2015* adds to the concern about the commitment to medium-term expenditure management and compliance with the post-crisis medium-term budgetary framework.

Multi-annual ceilings were introduced to address serious expenditure management problems evident in Ireland prior to the crisis, which resulted in repeated pro-cyclical re-setting of future expenditure levels (see Figure 4.7). Without the top-down ‘anchor’ on expenditure provided by the advance setting of the EB for three years and proper implementation of the domestic ceilings, there is a risk of a return to structural increases to medium-term expenditure based on positive short-term macroeconomic dynamics.<sup>86</sup>



Source: Department of Finance.

Note: Bars show the forecast error for 1 year ahead, 2 years ahead and 3 years ahead. Latest figures for 2016 and 2017 (used in calculation of the latest deviation from Budget 2014 years 2 and 3) are adjusted by €0.9 billion to reflect the change in the treatment of the HSE in 2014. This adjustment is made for comparison

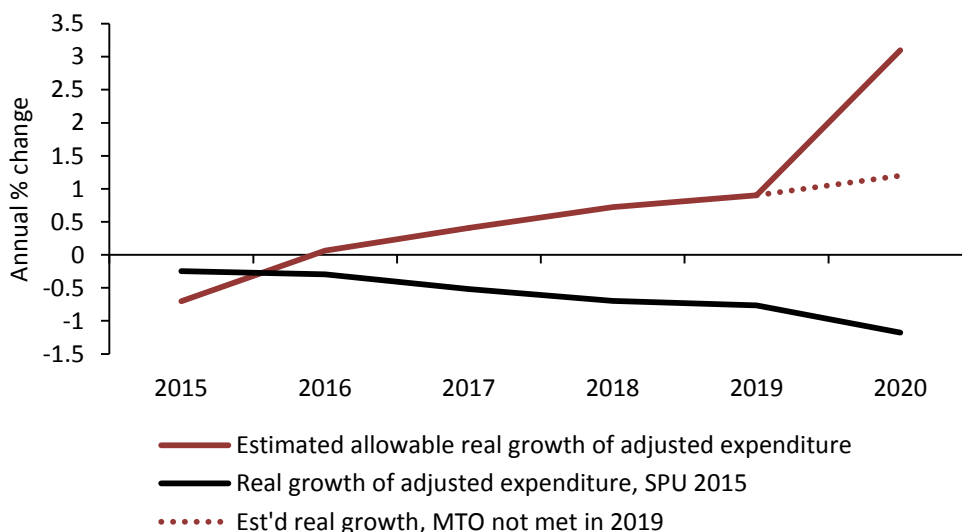
<sup>85</sup> As noted by the EC (2015), these revisions also imply that the current set falls somewhat short of the EU Council’s recommendation asking Ireland to ‘ensure the binding nature of the government expenditure ceiling including by limiting the statutory scope for discretionary changes’.

<sup>86</sup> One of the latest Country Specific Recommendations for Ireland from the EC is to limit the existing discretionary powers to change expenditure ceilings beyond specific and predefined contingencies.

In addition to this counter-cyclical aspect, the domestic Medium Term Expenditure Framework (MTEF) should also improve medium-term budgetary planning and expenditure efficiency by; (i) setting an *ex ante* constraint on both total and Ministerial spending having regard to the estimate of the fiscal space that will be available over the next medium-term cycle, and (ii) requiring each Department to ensure strategy is consistent with the multi-annual constraint allocated to it (see Schick, 2009). Consequently, an MTEF should reconcile the ‘top-down’ fiscal rules, with ‘bottom-up’ Departmental pressures and policy costs. Without this clear link between macro fiscal policies and Departmental resources over the medium term, there is a danger that increasing expenditure rigidities or unaddressed inefficiencies may lead to a breach of the rules or, at a minimum, lead to less efficient public spending.

The new EB methodology can be used as a basis to estimate an allowable rate of expenditure growth into the medium term. Figure 4.8 shows the estimated allowable real growth in the expenditure aggregate to 2020 based on *SPU 2015* data and compares it to the path for the expenditure aggregate in *SPU 2015*. *SPU 2015* projections for expenditure growth are significantly below estimated allowable expenditure growth under the EB over the forecast period.

FIGURE 4.8: ESTIMATED ALLOWABLE REAL EXPENDITURE GROWTH UNDER THE EB



Source: Internal IFAC calculations based on *SPU 2015*.

Note: Solid red line indicates estimates based on *SPU* data, with MTO being met in 2019 and no convergence margin adjustment in 2020. Dotted line indicates impact of a convergence margin in 2020. Potential output growth in 2021 to 2023 is assumed to be 3 per cent.

Once a realistic medium-term limit on overall expenditure has been determined, the Government should use this as the basis of setting both the Government expenditure ceiling and Ministerial expenditure ceilings for the following three years. It is essential in a multi-year framework that spending limits are set several years in advance and not revised other than in limited, clearly

defined circumstances. One difficulty with the application of this approach to date in Ireland is that the aggregate of all Ministerial ceilings has been set exactly at the Government Expenditure Ceiling. While the Government may choose to continue with this approach, an alternative would be to allow a 'margin' between the sum of the Ministerial ceilings and the total expenditure set under the Government Expenditure Ceiling. This margin would reflect uncertainty around revenue and allow space for possible and legitimate expenditure overruns. This allows normal modest budget deviations to be managed in a routine manner without breaking the multiannual commitments. In any case, expenditure ceilings are by their nature asymmetric as they represent an upper limit on spending but, if necessary, Government can choose a lower level of expenditure in a given year without formally adjusting the ceiling.

## APPENDIX A: FISCAL COUNCIL BENCHMARK PROJECTIONS 23 MARCH

As part of the endorsement process, the Council's Secretariat produced a set of Benchmark projections in advance of its meetings with the Department of Finance. The Benchmark projections were finalised on 23 March 2015 and are summarised in Appendix Table A.1.

APPENDIX TABLE A.1: BENCHMARK PROJECTIONS FOR 2015-2017

% change in volumes unless otherwise stated	2015	2016	2017
<b>GDP</b>	4.0	3.7	3.4
<b>Consumption</b>	2.2	1.9	2.0
<b>Investment</b>	10.4	11.0	6.3
<b>Government</b>	1.1	1.0	1.0
<b>Stock changes (% of GDP)</b>	0.9	0.9	0.9
<b>Exports</b>	4.3	4.4	5.0
<b>Imports</b>	4.3	4.6	5.0
<b>Net Exports (p.p. contribution)</b>	1.0	0.8	1.2
<b>Domestic Demand (p.p. contribution)</b>	3.0	2.9	2.2
<b>Stock Changes (p.p. contribution)</b>	0.0	0.0	0.0
<b>Current Account (% GDP)</b>	6.4	6.1	5.9
<b>Employment</b>	2.3	2.2	1.7
<b>Unemployment Rate (%)</b>	9.8	8.9	8.2
<b>HICP</b>	0.2	1.3	1.5
<b>GDP Deflator</b>	2.3	1.8	1.5
<b>Nominal GDP (€ billions)</b>	197.3	208.3	218.5
<b>Nominal GDP</b>	6.4	5.6	4.9

Source: Internal IFAC calculations.

The Council's "endorsable range" is informed by, but not mechanically linked to, the uncertainty captured in fan chart analysis. The fan chart approach is also applied retrospectively so that uncertainty around outturn revisions can also be graphically represented (Figure 2.10).

The fan chart bands for the historical period effectively show the typical scale of revisions applying to historical estimates of real GDP growth over a five year period.<sup>87</sup> As detailed in Casey and Smyth (2015), typical confidence intervals surrounding estimates for the latest annual outturn are not especially narrower than that for the current forecast year.<sup>88</sup> While this source of uncertainty

<sup>87</sup> Quill (2008) notes that in practice CSO data beyond five years rarely changes materially except for methodological reasons.

<sup>88</sup> Revisions for the latest full-year of data are typically large, especially when it comes to the first estimate of real GDP growth (i.e., with the release of the fourth quarter QNA results). A typical Root Mean Squared Error (RMSE) value of 1.6 for the previous full year of data compares to a RMSR of 1.8 for the current year's forecast. This means that the uncertainty surrounding the current forecast year can be little less than that of the previous year for which four



narrows after the *NIE* release in summer, large uncertainties around the most recent annual outturns can still remain.<sup>89</sup>

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

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quarters of data are available. The RMSR for the previous year narrows to 0.9 after the release of the *National Income and Expenditure* accounts in the summer of each year, but remains relatively large.

<sup>89</sup> The fan chart is based on the typical scale of revisions that can be expected after the NIE release (i.e., after the second vintage of estimates for the previous annual outturn) and is, therefore, more aligned with the information available at the time of the budgetary endorsement exercise.

## APPENDIX B: HOUSE PRICE RISKS UPDATE

The Council continues to monitor various indicators with respect to housing market trends given the attendant risks to both economic activity and to the public finances. This section updates previous analyses using the latest available data.

Appendix Figure B.1 gives a summary analysis highlighting the rise in housing valuations from their recent trough. Taking simple ratios of prices to disposable incomes and rents would suggest valuations were similar to those observed in the late-1990s/early-2000s.<sup>90</sup> User costs appear to have reduced substantially, but actual price expectations may be overstated when using recent historical price changes.<sup>91</sup> Indeed, survey expectations appear to have moderated following the introduction of new macroprudential regulations that limit mortgage lending. All else being equal, the lower survey-based price rise expectations would suggest more neutral user costs of capital in housing.

Supply pressures seem likely to contribute to upward price pressure in the near term, however. Overall completions of new housing have begun to rise, yet remain shy of estimated demand in regions like Dublin city and its suburbs.

More sustainable solutions to shortages might seek to address barriers to construction responses in the form of regulations and associated costs as highlighted by Lyons (2014). Weak early-2014 data on planning permissions appear to confirm some lags to supply responses and representative groups indicate concerns that this could be linked to policy delays (SCSI, 2015).

As noted in previous *FARs*, risk assessment of the housing market would be well served if more frequent regional analyses were produced as migration and other assumptions evolve. Data availability with respect to regional household numbers and current and projected housing stocks could also be improved on. This would help to ensure that the risks of price growth expectations becoming dislodged from fundamentals are limited in future.

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<sup>90</sup> McQuinn (2014) uses a variety of models to estimate the percentage difference between actual and fundamental Irish house prices based on quarterly data for 1981-2013. As of their last estimate (for Q4 2013), prices were estimated to be 12-27 per cent below fundamental values.

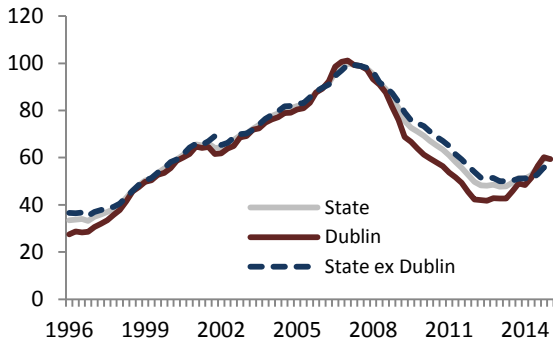
<sup>91</sup> The recent four-quarter average is used here and implies price growth of 14.3 per cent over the next twelve months. However, survey price expectations from Daft.ie taken in December 2014 showed twelve-month expectations fell back to less than 4 per cent following the introduction of the macroprudential regulations.

**APPENDIX FIGURE B.1: IRELAND: HOUSING**

Even with recent increases, real prices average close to 40 per cent below peak levels.

**Real Residential Property Prices (HICP adj.)**

Index: Q1 2007=100

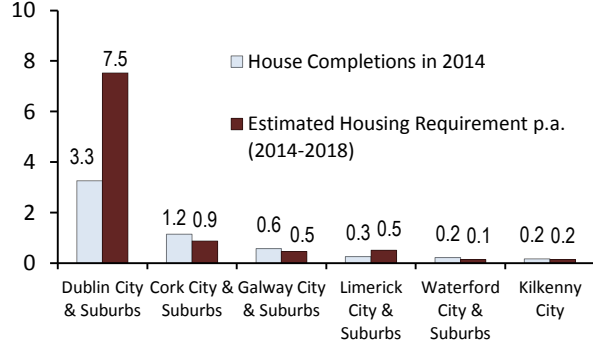


Sources: ESRI/PTSBS; CSO.

...and supply pressures remain evident, most notably in Dublin.

**Estimated housing requirements/completions**

Units (000s)

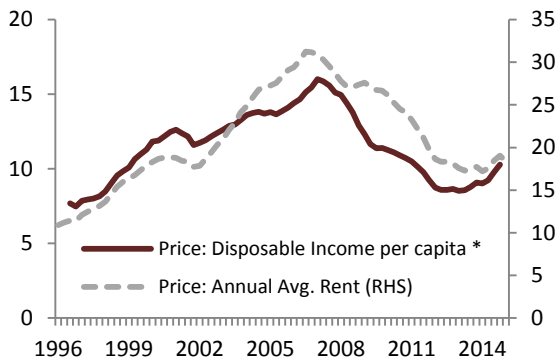


Sources: Housing Agency; DoECLG.

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

Valuations have risen slightly from low levels in part due to the localised supply pressures.

**Housing Valuation Ratios**

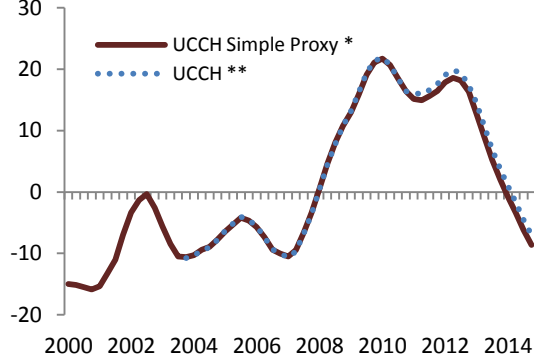


Sources: ESRI/PTSBS; CSO.

\*Average house prices divided by moving 4-quarter sum of adjusted personal disposable income per capita.

User costs derived from recent price rises appear negative, but survey expectations have moderated.

**User Cost of Capital for Housing (UCCH)**



Sources: Central Bank of Ireland; CSO; ESRI/PTSBS.

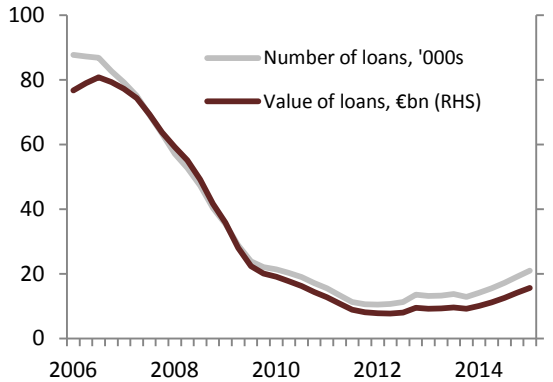
\* New mortgage rates less annual price change for past 4Qs.

\*\*Includes first-time buyer taxes/subsidies; down-payments; depreciation / maintenance.

Loan volumes continue to show a steady rise from their low base.

**Annualised Residential Mortgage Lending**

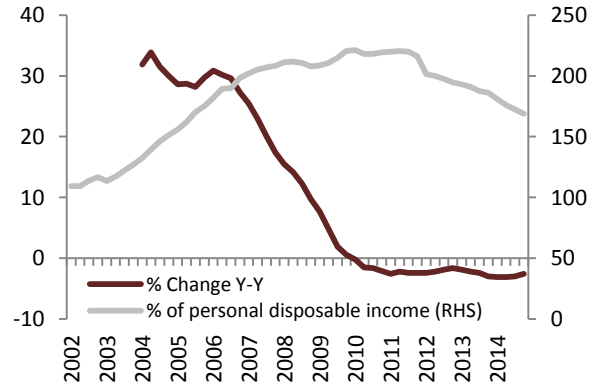
First-time buyer and mover purchaser loans



Source: IBF/PwC Mortgage Market Profile.

...although – in net terms – negative loan growth continues to reflect household deleveraging.

**Loans to Irish Households for House Purchase**



Sources: Central Bank of Ireland; CSO.

Note: Stock is proxied by Long-term loans; ESA-95 basis pre-2012.

## APPENDIX C: TIMELINE FOR ENDORSEMENT OF *SPU 2015* PROJECTIONS

Date	
23 January	Department of Finance officials attend IFAC Council meeting for discussion regarding their approach to the production of medium-term forecasts and changes to the methodology for estimating potential output.
12 March	CSO release <i>Quarterly National Accounts</i> estimates for Q2 2014.
13 March	The Secretariat and Department of Finance met the CSO to clarify technical details of latest <i>Quarterly National Accounts</i> estimates.
16 March	The Secretariat received Department of Finance technical assumptions underpinning <i>SPU 2015</i> forecasts. <sup>92</sup>
23 March	After consideration by the Council, Benchmark projections are finalised by the Secretariat prior to receiving preliminary forecasts from the Department of Finance.
24 March	The Council received preliminary forecasts from the Department in line with <i>Memorandum of Understanding</i> requirements.
26 March	The first endorsement meeting took place with the Department of Finance presenting their forecasts to the Secretariat. A number of clarifications of a factual nature were requested.
	The Secretariat submitted a number of queries to the Department in relation to the forecast set. <sup>93</sup>
27 March	The Department of Finance provided more details to IFAC in response to the queries received.
30 March	The Council met to discuss the Department of Finance forecasts. Following this, Department of Finance staff met with the full Council and Secretariat to present their latest forecasts and to answer questions. The Council sought information regarding a number of forecast components. <sup>94</sup>
31 March	The Council met to discuss the Department of Finance forecasts in detail and to finalise a decision on the endorsement.
1 April	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying <i>SPU 2015</i> .
28 April	The endorsement decision is published together with the Department's forecasts in the Draft <i>SPU 2015</i> . This is formally submitted to the EC and the endorsement letter is published.

<sup>92</sup> These included assumptions related to oil prices, interest rates, exchange rates, Net expenditure by central and local government on current goods and services and sources of forecasts for major trading partners.

<sup>93</sup> Mainly covering quarterly profiles, income assumptions and the breakdown of investment forecasts.

<sup>94</sup> Primarily concerning expectations of medium-term expenditure growth and supply-side estimates, but also assumptions for incomes, savings rates, investment, credit conditions, the budgetary assumptions underpinning the forecasts and risks related to external assumptions.

## GLOSSARY<sup>95</sup>

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

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

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

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

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

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

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

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

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<sup>95</sup> These definitions are taken directly from the European Commission. See European Economy, Occasional Papers 151, May 2013, *Vade Mecum on the Stability and Growth Pact*.

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

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

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

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

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

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

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

**Primary budget balance:** The budget balance net of interest payments on general government debt.

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

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

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

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

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

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

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

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

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