SUMMARY ASSESSMENT

Estimates of domestic economic activity suggest that the economy continues to grow at a reasonably solid rate, although high-frequency data indicate the pace of growth may have slowed in 2016. A range of data on domestic output, expenditure and employment show that the economy continues to grow in 2016, but there is some evidence of a loss of momentum as the year has progressed. While the Department of Finance's central projection is for real GDP growth of 3.5 per cent in 2017 and an average of around 3 per cent for the years 2018 to 2021, these growth prospects are far from assured as the Irish economy remains vulnerable to numerous domestic and international risks. A GDP growth rate just ½ a percentage point lower than currently forecast each year would mean the public finances would remain in deficit out to 2021. To protect the public finances in the face of risks and to lay the foundations for sustainable growth, reducing Ireland's high debt to safer levels should remain a priority.

Incomplete implementation of Ireland's new budgetary framework leaves the economy and public finances more exposed in the face of adverse events. Successive governments have achieved considerable success in stabilising the public finances since the crisis. In addition, a new budgetary framework has been put in place to help achieve a phased reduction in the debt to safer levels and to ensure that there is sufficient fiscal credibility to avoid forced austerity in bad times. However, incomplete implementation of the new framework leaves the economy and public finances more exposed to severe shocks such as a "hard Brexit".

The projections in *Budget 2017* show a marked slowdown in the pace of improvement in the public finances in 2016. The forecasts do not fully comply with the requirements of the Budgetary Rule of the domestic *Fiscal Responsibility Act* or the Preventive Arm of the EU *Stability and Growth Pact (SGP)* in 2016. Despite continued revenue growth and savings from falling unemployment and debt interest costs, the projected improvement in the General Government balance (stripping out financial sector measures) is just 0.1 percentage point of GDP in 2016, while the primary balance (i.e. the balance excluding debt interest spending) is forecast to deteriorate in 2016. The projected fall in the structural balance in 2016 is just 0.3 percentage points, thus falling short of the requirement under the fiscal rules to reduce it by 0.6 percentage points. Excluding a technical one-off transaction involving AIB in 2015, the Expenditure Benchmark rule would also not be complied with in 2016. These compliance problems are a source of concern, coming in the first full year of the normal operation of the domestic Budgetary Rule and the Preventive Arm of the EU *SGP*.

Taking 2016 and 2017 together, the size of the overall package of measures announced by the Government goes beyond the limit considered prudent by the Council. Combining within-year expenditure increases for 2016 with the €1.3 billion expansion for 2017 and some pre-committed spending for next year, gives an overall package of measures amounting to €3 billion (or €3.7 billion in a full year), a more expansionary stance than planned in the July 2016 *Summer Economic Statement.* Within-year expenditure increases over the course of 2016 absorb the majority of the better than expected tax revenues, which are mainly due to corporation tax. Using unexpected tax revenue for difficult to reverse spending increases goes against the spirit of the new budgetary framework and is especially risky when the source of the additional revenue is corporation tax. A repeat of the pattern evident in 2016 over several years has the potential to undermine the public finances and would not be conducive to prudent economic and budgetary management.

Current fiscal projections for 2017 and 2018 are consistent with the deficit and debt remaining on a downward path, but the scope for any slippage from the current plans is limited. The *Budget 2017* forecasts for 2017 show compliance with structural balance rule; however, the projections indicate a €200 million breach of the Expenditure Benchmark (EB). It is important for the credibility of the budgetary process that the Government's fiscal plans show full compliance with the domestic and EU fiscal rules based on the Department of Finance's own forecasts. A repeat of the pattern of within-year increases in expenditure in 2017, as has occurred in 2015 and 2016, would not be appropriate and would widen the deviation from the EB.

Under the new budgetary framework, current projections indicate that any further increases in expenditure in 2017 for higher public sector pay will have to be offset by lower spending in other areas or higher taxes. To help keep the public finances on a sustainable path, the fiscal rules effectively set limits on the size of the deficit and expenditure growth net of discretionary revenue measures. For 2017, the available fiscal space under the rules has already been allocated in *Budget 2017* for tax cuts and expenditure increases. As a consequence, any new increases in expenditure – such as to fund higher public sector pay – imply lower spending in other areas unless offset by compensatory tax changes. In 2018, €0.7 billion will be required to meet the carry-over cost of tax cuts and expenditure increases introduced in *Budget 2017.* On current estimates, this absorbs over half of the fiscal space for 2018, implying very limited scope for new initiatives in the absence of offsetting savings or new revenue raising measures.

The quality of the medium-term budgetary forecasts published by the Department of Finance has improved. The Department of Finance has published forecasts for total revenue, expenditure, the deficit and the debt that include the use of the estimated fiscal space in *Budget 2017*. These forecasts

are more meaningful and realistic than the medium-term projections published previously which were purely technical and did not show the path of the public finances consistent with the Government's stated policy intention to use the available fiscal space.

The system of multi-year expenditure ceilings – a core component of the Government's budgetary framework – is not working effectively due to continuous upward revisions to spending. Every expenditure report since 2012 contained upward revisions to the previously published ceilings. The idea of the multi-annual expenditure ceilings is to move away from short-term year-to-year budgeting to a more strategic approach to resource allocation that provides clarity to Departments on the resources that will be available over several years. The limited implementation of the system of expenditure ceilings impedes such expenditure planning and raises the risk of increases in expenditure being funded from windfall revenue sources.

An essential input into good expenditure planning is an estimate of the cost of continuing to provide existing services and real benefit levels. As an input to the expenditure planning process, a useful starting point is an estimate of the cost of providing today's level of public services and benefits in future years, accounting for price and demographic pressures. This is the idea behind the "stand-still" scenario developed by the Council. Contrary to some portrayals of the Council's approach, this exercise is not intended as a forecast or recommendation for automatic indexation, but rather as a means of informing decision makers of the portion of available fiscal space that would be required to maintain the existing provision of public services and preserve the purchasing power of social protection benefits. The results of the analysis in this Report indicate that accommodating estimated demographic pressures and the cost of maintaining real public services and benefits would absorb almost the full amount currently budgeted for expenditure increases from 2017-2021.