Irish Fiscal Advisory Council

Fiscal Assessment Report

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CONTENTS

BOXES

APPENDICES

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, Whitaker Institute, 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), Dr Róisín O'Sullivan, Associate Professor, Smith College, Massachusetts and Mr. Michael G. Tutty.

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

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This report was finalised on 20 November 2015. More information on the Irish Fiscal Advisory Council can be found at www.fiscalcouncil.ie

SUMMARY ASSESSMENT

The Irish economy is experiencing a strong economic recovery, but faces numerous uncertainties about the pace of future growth. A confluence of favourable external developments along with a recovery in domestic economic activity is driving rapid growth in the Irish economy, faster than that of its EU neighbours. Notwithstanding the positive central growth scenario, numerous fragilities in the external environment and domestic risks mean that these growth prospects are far from assured. Following prudent fiscal policy during relatively good times will help ensure a sustainable growth path and limit the need for austerity measures in any future downturn.

While the planned fiscal stance from 2016 meets the requirements of the rules, the Council assesses that the decision to loosen the fiscal stance in 2015 was a deviation from prudent economic and budgetary management. *Budget 2016* showed an increase in gross government expenditure for 2015 of €1.5 billion compared to the projection in *SPU 2015.* The additional spending absorbs the majority of the better than expected tax revenues in 2015 and results in a significantly more expansionary fiscal stance than earlier planned by the Government. This keeps the deficit and debt higher than could have been achieved and provides an unnecessary stimulus to an already fast-growing economy. Using unexpected incoming revenues to fund permanent increases in expenditure at a time of strong economic growth has worrying echoes of past fiscal policy errors and goes against the spirit of the new budgetary framework. In addition, an unusually large surge in corporation tax receipts accounts for a large proportion of the better than expected tax revenue in 2015. While the Revenue Commissioners have noted that the majority of the corporation tax overperformance in 2015 is not due to one-off factors, until there is more certainty as to the sustainability of this gain, the Council is concerned about the decision to use unexpected revenues to increase expenditure.

Despite starting from a less favourable position than could have been achieved in 2015, the fiscal stance for 2016 and later years is consistent with the deficit and debt remaining on a downward path. The Council's September 2015 *Pre-Budget Statement* assessed that the planned budget package for 2016 in the *Spring Economic Statement (SES)* was within the range of prudent policies. *Budget 2016* contained a €1.5 billion package of planned spending increases and tax cuts for 2016 in line with the package proposed in the Government's *SES* in April. As this package comes on top of the increase in spending for 2015, the fiscal stance in 2016 is less prudent than planned in the *SES*. Nevertheless, government revenues in 2016 are forecast to grow at a higher pace than non-interest government spending by some margin, which is appropriate given the on-going recovery. The projections signal an intention to comply with the Preventive Arm of the *Stability and Growth Pact (SGP)* and the domestic Budgetary Rule from 2016, which would be consistent with prudent policy.

***Budget 2016* did not address previously identified weaknesses with the Government's medium-term fiscal plans beyond 2016.** The Government's projections for the deficit and debt in *Budget 2016* from 2017 onwards are based on mainly technical assumptions and do not present a realistic picture of the public finances over the medium term. The Budget forecasts again show an implausibly large decline in the ratio of non-interest government spending to GDP over the medium term. The forecasts fail to show how the Government intends to use the fiscal space that will be available in the coming years to reduce the deficit and debt while implementing its stated policy commitments and accommodating spending pressures. Analysis in this Report shows that funding current levels of public services in future years and accommodating likely expenditure needs would absorb the majority of the estimated fiscal space available after 2016. Further tax cuts would make it very difficult to fund these expenditure pressures while complying with the rules.

The system of multi-year expenditure ceilings – a core component of the Government's budgetary framework – is not being implemented effectively owing to continuous upward revisions to spending. The failure to respect expenditure ceilings raises the risk of funding increases in expenditure from windfall revenue sources. The domestic Medium-Term Expenditure Framework should be strengthened to ensure that multi-annual planning becomes a central element of the budget process.

Budget projections imply compliance with the relevant fiscal rules in 2016 but there is limited room for manoeuvre. Under the Budget forecasts, the Expenditure Benchmark will be complied with in 2016 but with no margin for overruns. Any expenditure increases similar to those announced for 2015 would likely lead to a breach of the EU Expenditure Benchmark. Moreover, there has been a sustained pattern of overruns in health spending in recent years. The European Commission projects that spending will be 0.4 per cent of GDP above the Expenditure Benchmark in 2016, and consequently note that there is a risk of a deviation from this Benchmark next year. The risk of non-compliance is heightened in light of the weaknesses of the domestic expenditure ceilings designed to operationalise the Expenditure Benchmark.

1. ASSESSMENT OF THE FISCAL STANCE

KEY MESSAGES

- The Irish economy is recovering strongly with GDP growth in 2015 well above its estimated underlying long-run potential rate. While there is likely to be some spare capacity in the economy at present, as reflected in the current high level of unemployment, the nature and pace of the recovery underway should see the disappearance of the demand shortfall in the economy in the near term. While economic recovery is helping to improve the public finances, Ireland's high level of debt following the crisis means there is limited room for manoeuvre in the event of an adverse shock. Reducing the debt to safer levels must remain a key policy priority.

- While the planned fiscal stance from 2016 meets the requirements of the fiscal rules, the Council assesses that the decision to loosen the fiscal stance in 2015 was a deviation from prudent economic and budgetary management. *Budget 2016* showed an increase in government expenditure for 2015 of €1.5 billion compared to the projection in *SPU 2015.* This more expansionary stance than planned in the April *Spring Economic Statement (SES)* keeps the deficit and debt higher than could have been achieved and provides an unnecessary stimulus to an already fast-growing economy. Had the better than expected tax revenues in 2015 been used for deficit reduction rather than higher spending, a balanced budget could have been achieved at least one year earlier than forecast in *Budget 2016.*

- *Budget 2016* contained a €1.5 billion package of spending increases and tax cuts in line with the *SES*. As this package comes on top of the increase in spending for 2015, the fiscal stance in 2016 is less prudent than planned in the *SES*. Nevertheless, government revenues in 2016 are forecast to grow at a higher pace than non-interest government spending by some margin, which is appropriate given the on-going recovery. The Budget projections signal an intention to comply with the Preventive Arm of the *SGP* and the domestic Budgetary Rule from 2016, which is consistent with prudent policy.

- The fiscal forecasts in *Budget 2016* do not provide a meaningful anchor for medium-term budgetary planning. Expenditure projections imply a large decline in the ratio of government spending to GDP of over 5 percentage points by 2021 that is not realistic given underlying expenditure pressures that are likely to emerge in the coming years. The absence of a realistic medium-term plan for the public finances is of serious concern, in particular given the weaknesses in the Government's new system of multi-annual expenditure ceilings.

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)*. The sections below draw on the analysis in later chapters in assessing the fiscal stance in *Budget 2016*. The Council's assessment is informed by the extent of compliance with the fiscal rules along with a complementary economic assessment that takes into account the state of the public finances, the stage of the economic cycle and the growth prospects for the economy. Section 1.2 reviews the fiscal stance in *Budget 2016* based on these considerations. The medium-term fiscal stance is discussed in Section 1.3 including problems with the medium-term fiscal projections in *Budget 2016* and the Government's compliance with its own budgetary framework.

1.2 The Fiscal Stance in 2015 and 2016

Table 1: Summary of Main Fiscal Aggregates (General Government Basis)

	2014	2015	2016	2017	2018	2019	2020	2021
Main Aggregates, % of GDP								
General Government Balance	-3.9	-2.1	-1.2	-0.5	0.2	1.0	1.8	2.5
Interest (% of GDP)	4.0	3.2	3.0	2.9	2.8	2.6	2.5	2.3
Primary balance	0.1	1.1	1.7	2.3	3.0	3.6	4.3	4.8
Potential output, % change (CAM)*	2.7	3.4	4.1	4.3	3.8	3.3	3.2	3.5
Output gap as % pot GDP (CAM)	-0.4	2.3	2.5	1.6	1.0	0.8	0.6	0.0
Structural balance (CAM)	-3.9	-3.4	-2.6	-1.4	-0.3	0.6	1.5	2.5
Change in structural balance	*0.3*	*0.5*	*0.8*	*1.1*	*1.1*	*0.9*	*0.9*	*1.1*
Structural primary balance (CAM)	0.0	-0.2	0.4	1.5	2.4	3.2	4.0	4.8
Change in primary structural balance (p.p. change)	*0.0*	*-0.2*	*0.6*	*1.1*	*1.0*	*0.8*	*0.8*	*0.9*
General Government Debt	107.5	97.0	92.8	90.3	86.7	83.5	79.8	75.7

Source: CSO and Department of Finance (*Budget 2016*).
Note: *CAM Methodology refers to the EU Commonly Agreed Methodology for estimating potential output.

1.2.1 Demand Management/Debt Sustainability Trade-off

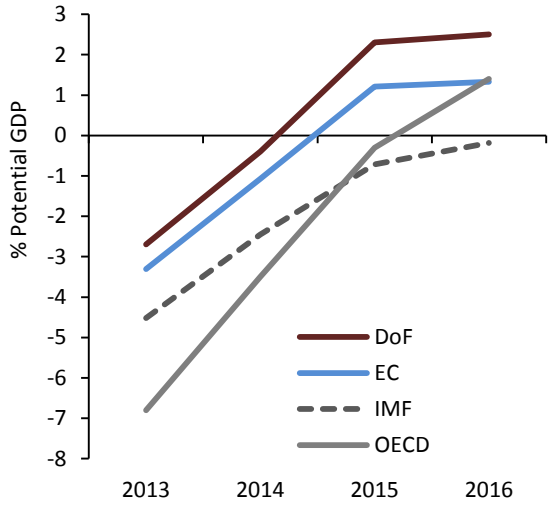
The setting of fiscal policy in recent years has required a difficult balancing of the need to support domestic demand and employment, the need to restore the State's creditworthiness and the requirement to put the public finances on a sustainable path. For most of the period from 2008 to 2014, different components of this trade-off have pulled in different directions. With output below potential and with high unemployment from 2009 to 2013, standard demand management considerations would have favoured a delay of fiscal adjustment measures in the absence of other constraints. However, the fragility of Ireland's creditworthiness and the size of the debt and deficit meant there was little option but to implement the large scale expenditure reductions and tax increases over this period. Given the improvements in the public finances and the economy in

recent years, it is useful to consider an updated assessment of the different elements of the trade-off.

Turning first to the macroeconomic context for *Budget 2016,* as discussed in detail in Chapter 2, the Irish economy is currently in the midst of a buoyant recovery driven by favourable external developments as well as a pick-up in domestic economic activity. Although demand conditions in the Euro Area remain weak, the economy is benefiting from strong foreign demand from its other key trading partners – the UK and US. Ireland's external competitiveness has been boosted by the depreciation of the euro against the currencies of its main trading partners which has driven strong growth in Irish exports. Low interest rates and the fall in oil prices since 2014 are also contributing to the strength of the recovery in economic activity.

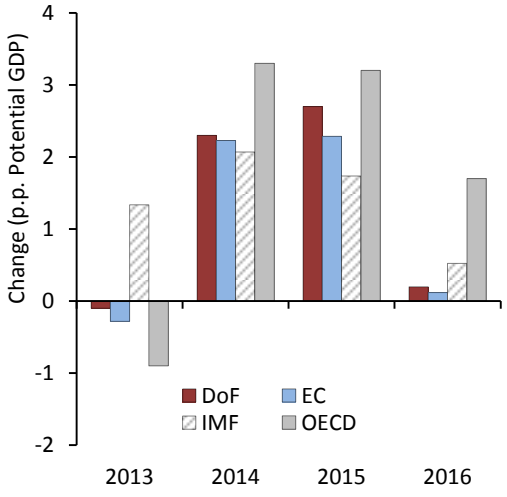
With these significant tailwinds, the central forecast from the Department of Finance on which the fiscal projections in *Budget 2016* are based is for strong growth of 6.2 per cent in 2015 and 4.3 per cent in 2016 with economic growth forecast to moderate to an average of over 3.2 per cent per annum from 2017-2021. As discussed in Chapter 2, the pace of recovery in economic activity (GNP and GDP) both this year and in 2014 has implications for the measured size of the output gap. The output gap is defined as the difference between actual and potential GDP, expressed as a share of potential GDP. A range of estimates of the output gap produced by various institutions are shown in Figure 1.1a.

FIGURE 1.1A: OUTPUT GAP ESTIMATES (% POTENTIAL GDP)



Sources: European Commission Autumn 2015, *Budget 2016;* IMF WEO October 2015; OECD *Economic Outlook 2015*.

FIGURE 1.1B: CHANGE IN OUTPUT GAP ESTIMATES

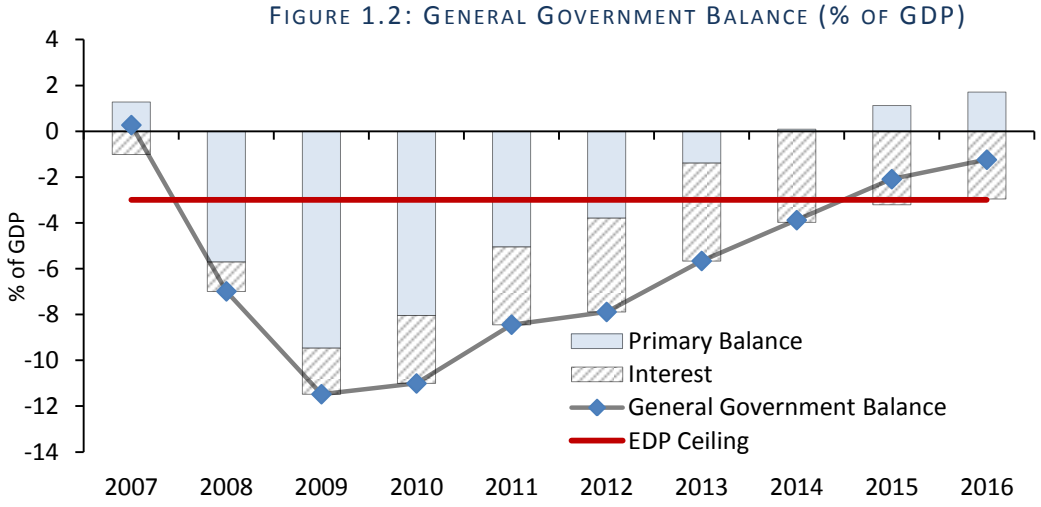


Sources: European Commission Autumn 2015, ; *SPU 2015;* IMF *WEO April 2015*; OECD *Economic Outlook 2015*.

The current official estimate of the output gap published in *Budget 2016* using the EU Commonly Agreed Methodology (CAM) is a positive gap of 2.3 per cent for 2015. This estimate is not consistent with a range of other indicators of imbalances in the economy. One indication that the official numbers overstate the size of any positive output gap is that the estimate of the underlying equilibrium unemployment rate (NAWRU) for 2015 is extremely high at 10.3 per cent. Estimates of the output gap from the IMF are shown in Figure 1.1a. These suggest the persistence of an output shortfall in the economy in 2015 which closes by 2016, in contrast to the Department of Finance estimates using the CAM which show a large positive output gap in 2015 and 2016.

While uncertainty surrounds the precise level and sign of the output gap currently, a more consistent picture emerges by looking at the change in the output gap (Figure 1.1b). All four estimates shown in Figure 1.1b indicate a rapid closing of the negative output gap after 2013. Furthermore, as discussed in Chapter 2, given the pace of economic growth now being observed and with domestic demand growing strongly, it appears that any remaining negative output gap in the economy will likely be eliminated over the short term. While there are currently no signs of abnormal wage or inflationary pressures requiring calming policy measures, the nature and pace of the economic recovery already underway indicates that the economy does not need a further fiscal stimulus to add to growth at this time.

FIGURE 1.2: GENERAL GOVERNMENT BALANCE (% OF GDP)

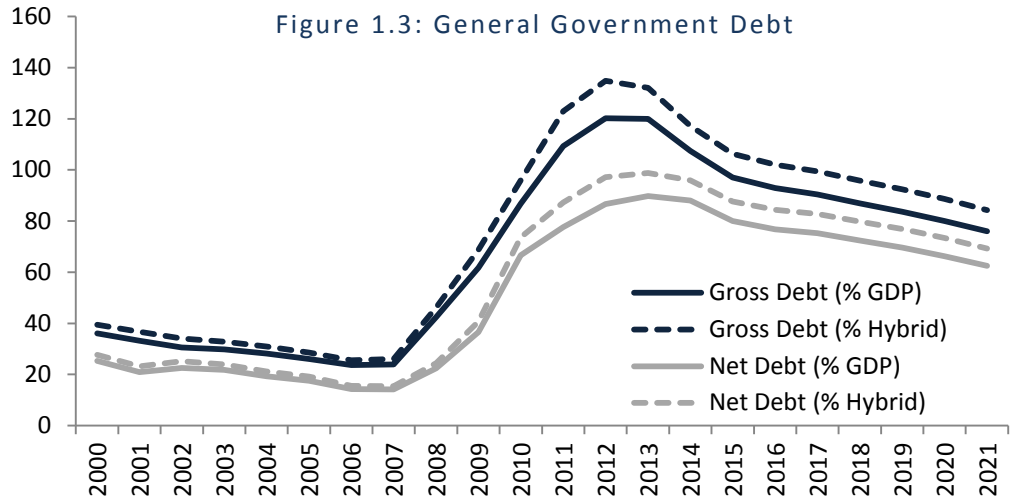


Source: CSO; *Budget 2016.*

As explained in detail in Chapter 3, the public finances have continued to improve despite budgetary overruns in some areas through a combination of strong tax receipts and savings from lower debt servicing costs and falling unemployment. The General Government deficit fell to 3.9 per cent of GDP in 2014 and is expected to be around 2.1 per cent this year, despite the decision to allocate the majority of the better than expected tax revenues in 2015 towards higher expenditure.

The General Government primary balance, the deficit or surplus in the government accounts when debt servicing costs are excluded, recorded a small surplus in 2014, which is projected to increase further in 2015 and 2016 (Figure 1.2). As output grows rapidly and reflecting the reduction in cash and other financial assets, the General Government gross debt to GDP ratio has continued to fall and is expected to measure around 97 per cent of GDP by the end of 2015 compared to a peak of 120 per cent of GDP in 2013.

Figure 1.3: General Government Debt



Sources: Department of Finance; internal IFAC calculations.
Note: Changes in EDP debt instrument assets for forecast years are assumed to be in line with *Budget 2016* projected changes in cash balances.

Despite these improvements in the public finances, further progress is needed to ensure that the debt to GDP ratio is put on a firm downward path. Ireland's debt ratio remains high by both historical and international standards. The scale of the debt burden following the crisis is even more apparent when measured as a share of GNP or the Council's hybrid measure of output (Figure 1.3).[1] A debt ratio of close to 100 per cent of GDP leaves the economy exposed to shocks that could create unsustainable debt dynamics.

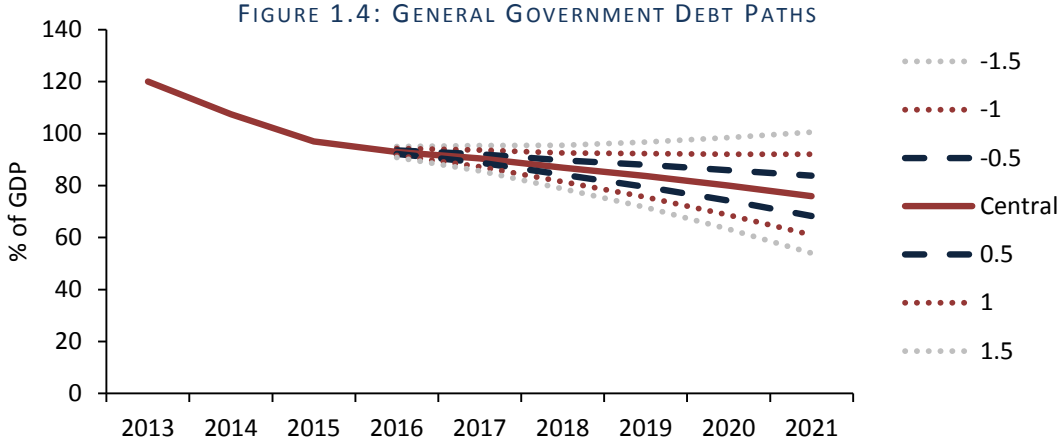
As discussed further in Chapter 2 and Chapter 3, although the near-term prospects for the economy are positive, substantial risks surround the central projections contained in the Budget. These risks stem from both internal and external sources. Among the domestic risks is the highly concentrated nature of production in the Irish economy, whereby a small number of sectors and firms account for the bulk of manufacturing output and exports. This specialisation of Irish trade leaves the economy exposed to a potential loss of output in the event of a re-organisation of these firms' global production chains. External risks include the impact on the Irish economy of a

[1] 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).

slowdown in the US or UK economies or that potential growth in the Euro Area is substantially lower following the financial crisis (McQuinn and Whelan, 2015).

Were one or more of these risks to materialise, growth would be slower and unemployment higher than envisaged in current forecasts. This would make it more challenging to reduce the debt to GDP ratio in line with current projections and there is a risk that the debt could start rising again. This is illustrated in Figure 1.4 which shows the sensitivity of the debt GDP ratio to different nominal GDP growth shocks. A negative shock which resulted in nominal GDP growth being 1.5 percentage points lower than in the *Budget 2016* forecasts would see the debt to GDP ratio stagnate at its current high level before rising again by the end of the decade.

FIGURE 1.4: GENERAL GOVERNMENT DEBT PATHS



Sources: Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.
Note: The figure shows alternative projections of the debt-to-GDP ratio based on GDP growth forecasts that deviate from *Budget 2016* projections by 0.5, 1.0 and 1.5 percentage points in either direction.

Weighing up these considerations, an assessment of the debt sustainability/demand tradeoff for 2015 suggests a less challenging context for setting fiscal policy than in recent years. The current high level of unemployment might suggest the appropriateness of an expansionary fiscal stance to ensure the economy returns to equilibrium. However, the rapid growth now being observed and the pace at which the economy's spare capacity is being reduced argue against the need for an expansionary fiscal stance. With domestic demand recovering strongly and unemployment falling, the need to eliminate the remaining budget deficit and to put the debt on a firm downward path takes clear precedence over using a more expansionary fiscal stance to stimulate an already rapidly growing economy.

1.2.2 THE FISCAL STANCE IN *BUDGET 2016*

The Council's assessment of the fiscal stance in *Budget 2016* covers the years 2015 and 2016. The €1.5 billion package announced on budget day on Tuesday, 13 October was at the upper limit of

the €1.2 to €1.5 billion range signalled in *SPU 2015.* The more significant new information in relation to the Government's budgetary plans for 2015 and 2016 came in the White Paper published in advance of the budget on Friday, 9 October 2015. The White Paper is published annually in advance of the Budget and contains revised estimates for government revenue and expenditure for the current year along with forecasts for the following year on a no-policy change basis. In the case of this year's White Paper, the figures showed a significant increase in government expenditure for 2015 compared to earlier Government plans.

As described in Chapter 3 (Figure 3.1), *Budget 2016* contained an increase in gross current government expenditure of over 4 per cent for 2015 compared to the initial forecast for current spending in *Budget 2015.* In total, the estimate for gross current and capital expenditure in 2015 was revised up by €1.5 billion compared to *SPU 2015* (April 2015) and by €2.3 billion compared to *Budget 2015* (October 2014) (Table 2). A breakdown of the increase in spending for 2015 compared to the initial *Budget 2015* estimates shows that just under 40 per cent of the additional spending was allocated to the health area, with social protection, education and transport accounting for the bulk of the remainder.

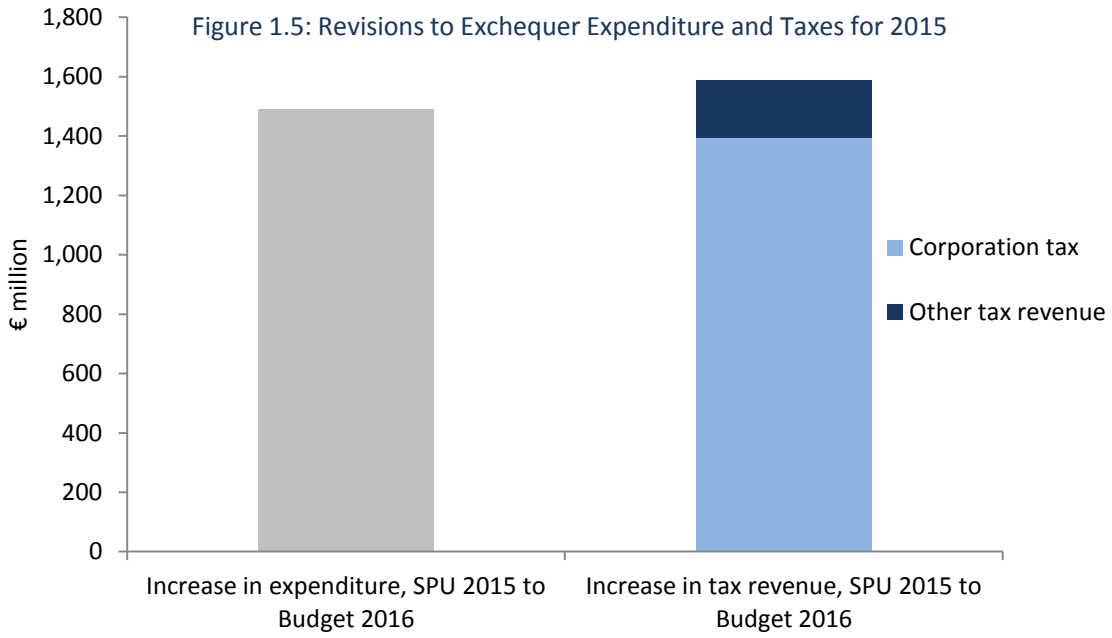
TABLE 2: REVISIONS TO EXCHEQUER TAX REVENUE AND EXPENDITURE FOR 2015, € MILLION

	***Budget 2015* (A)**	***SPU 2015* (B)**	**Change (B-A)**	***Budget 2016* (C)**	**Change (C-B)**	**Total Change (C-A)**
Gross Current Expenditure	49,034	49,715	***681***	51,040	***1,325***	***2,006***
Gross Capital Expenditure	3,550	3,670	***120***	3,835	***165***	***285***
Total Voted Expenditure	52,584	53,385	***801***	54,875	***1,490***	***2,291***
Exchequer Tax Revenue (Tax + PRSI)	50,497	51,497	***1,000***	53,086	***1,589***	***2,589***

Note: The Budget 2015 gross voted current spending figure is adjusted to reflect the disestablishment of the HSE Vote.

Upward revisions to spending for the current year between the budget estimate and the White Paper are not unprecedented. For 2015, the increase in expenditure to cover the overrun in the health area was in keeping with the pattern of consistent spending overruns in this area (IFAC, 2015c). Estimates of the deficit for 2015 and 2016 in IFAC's *Pre-Budget 2015 Statement* (IFAC, 2015d) incorporated an expected €600 million overrun in health spending. However, as discussed in Chapter 3, the scale of the upward revision to spending for 2015 contained in this year's White Paper was significantly greater than the expected overrun in health and was also the largest such revision recorded in recent years.

Figure 1.5: Revisions to Exchequer Expenditure and Taxes for 2015

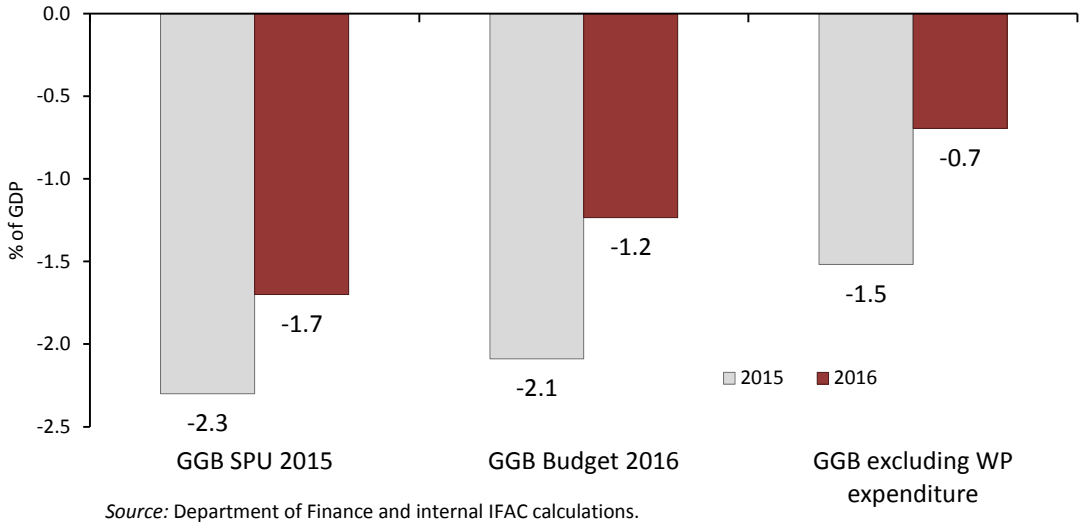


Source: Department of Finance and internal IFAC calculations.
Note: The increase in expenditure between *SPU 2015 and Budget 2016* (grey column) refers to total gross voted current and capital exenditure. Tax revenue (right hand column) is the sum of Exchequer tax revenue plus PRSI.

The announcement in *Budget 2016* of the decision to increase total gross Exchequer spending by an extra €1.5 billion in 2015 has a number of implications for assessing the fiscal stance. Since the majority of the additional current spending in 2015 is carried into the base level of spending for 2016, the overall package of budgetary measures, combining the announcements in *Budget 2016* and the White Paper, implies a significantly looser fiscal stance for both 2015 and 2016 than projected in the April 2015 *SES/SPU*.

Budget 2016 shows that the Government expects Exchequer tax and PRSI revenues in 2015 to be €1.6 billion higher than forecast in *SPU 2015* while total gross current and capital spending is being increased by €1.5 billion compared to *SPU 2015* (Table 2). This means that the majority of the overperformance in tax revenue in 2015 (compared to the *SPU* 2015 forecast) is being used to fund higher expenditure this year (Figure 1.5). Using unexpected revenues to fund increases in expenditure goes against the spirit of the new budgetary framework and has worrying echoes of past fiscal policy errors made in Ireland during the boom. As described in Chapter 3 (see Box D), better than expected corporation tax receipts account for the majority of the overperformance in tax revenues up to September 2015 (Figure 1.5). The uncertainty at present surrounding the drivers of the corporation tax overperformance in 2015 argues against using this additional revenue to fund increases in expenditure that could be difficult to unwind.

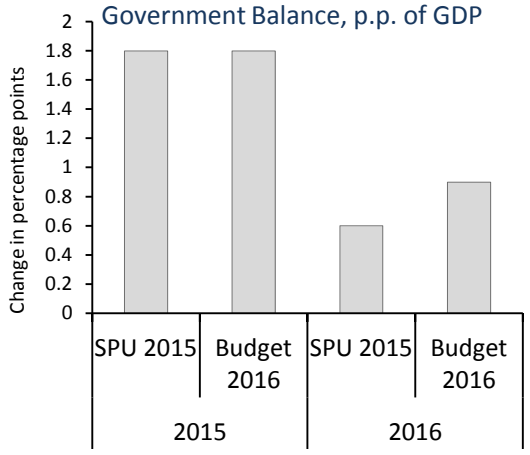
Figure 1.6: Projections for the General Government Deficit in 2015 and 2016



Source: Department of Finance and internal IFAC calculations.

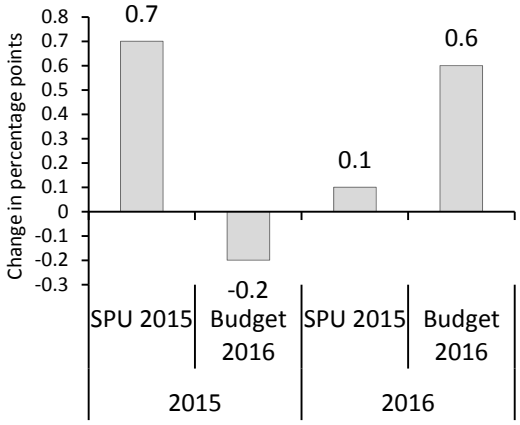
By spending a large proportion of this year's better than expected tax revenues, the opportunity to achieve a lower deficit in 2015 and 2016 has been missed. The forecast deficit for 2015 in *Budget 2016* is 2.1 per cent (compared to 2.3 per cent in *SPU 2015*). The Council's fiscal feedbacks model can be used to estimate the likely deficit for 2015 and 2016 assuming the additional spending in 2015 was used instead for deficit reduction (Figure 1.6). Had total spending not been increased in 2015, the General Government deficit would likely have been around 1.5 per cent of GDP in 2015 and a deficit of well below 1 per cent would have been attainable in 2016 (Figure 1.6). In this scenario a balanced budget would be achieved in 2017, one year earlier than projected in *Budget 2016*. All else being equal, the looser fiscal stance for 2015 than earlier planned by the Government prolongs the process of returning Ireland's high debt to lower levels at a time when the economy remains vulnerable to adverse shocks.

Figure 1.7a: Change in General Government Balance, p.p. of GDP



Source: Department of Finance based on EU Commonly Agreed Methodology (CAM).

Figure 1.7b: Change in Structural Primary Balance, p.p. of GDP



Source: Department of Finance based on Commonly Agreed Methodology (CAM).

Figure 1.7a and Figure 1.7b show the change in the headline General Government Balance and structural primary balance in 2015 and 2016 as projected in both *SPU 2015* and *Budget 2016.* Despite the significant improvement in tax revenues between the SPU in April and October, *Budget 2016* projects the same 1.8 percentage points of GDP fall in the headline deficit as contained in the *SPU* (Figure 8a).

The fiscal stance in the *Fiscal Responsibility Act (FRA)* 2012 is defined in terms of the change in the structural primary balance. The structural primary balance is an appropriate measure of the fiscal stance as it provides an estimate of the underlying budget surplus or deficit adjusting for the cyclical position of the economy. Although there is uncertainty around the level of the structural primary deficit or surplus at a point in time, assessing estimates of the change in this measure provide a more robust indicator of changes in the fiscal position rather than focusing only on the level of the structural primary deficit.

By examining revisions to the change in the structural primary balance between *SPU 2015* and *Budget 2016*, an insight can be gained into the extent of the loosening of the fiscal stance as 2015 progressed. As shown Figure 1.7b, the structural primary balance in *SPU 2015* was forecast to improve from a surplus of 0.1 per cent of GDP in 2014 to a 0.8 per cent surplus in 2015, an improvement of 0.7 percentage points. In contrast, the revised projections in *Budget 2016* show a deterioration in the structural primary balance of 0.2 percentage points between 2014 and 2015 (Table 1 and Figure 1.7b). The expected deterioration in the budgetary position as measured by the change in the structural primary balance in *Budget 2016* is consistent with the more expansionary fiscal stance in October's Budget compared to the planned stance in the April 2015 *SPU.*

As discussed in Chapter 3 and Chapter 4, the decision to increase spending in 2015 means that the Government's previously set expenditure ceilings will be raised. The ceilings set in *Budget 2015* (October 2014) were already increased in April 2015 in the *SPU*. The continuous within-year raising of the ceilings means that this new system for managing expenditure allocation – a core component of the Government's budgetary framework – is not being implemented effectively. The failure to implement and respect multi-annual expenditure ceilings raises the risk of funding increases in expenditure from windfall revenue sources. Proper adherence to the system of expenditure ceilings would have avoided the type of late upward revision to expenditure announced in the White Paper for 2015.

In its *Pre-Budget 2016 Statement* the Council welcomed the improvement to the budgetary process involving the announcement in April of the size of the tax and spending package for the October Budget. The announcement in April of the planned budget package of €1.2-€1.5 billion set the parameters for the discussions at the first National Economic Dialogue held in July. To protect the integrity and usefulness of the new process, it was important for the Government not to deviate from its commitment in April 2015 in respect of the pre-announced budget package. The decision to increase expenditure in 2015 beyond the plan announced in the *Spring Economic Statement* undermines this new reform to the budgetary process.

Ireland is in an unusual position in 2015 regarding compliance with the fiscal rules as this is the final year of the Excessive Deficit Procedure (EDP) and the Expenditure Benchmark does not apply (see Box F in Chapter 4). The only binding rule in 2015 is the requirement to reduce the deficit to below the 3 per cent EDP ceiling. Had the requirements of the Preventive Arm of the SGP (which will apply from 2016 onwards) been in effect in 2015, neither the required improvement in the structural balance or the Expenditure Benchmark rules would have been complied with.

The Council has a responsibility under the *FRA* to assess whether "...the fiscal stance for the year or years concerned is....conducive to prudent economic and budgetary management" [FRA 8(4)(b)]. This assessment covers both 2015 and 2016. While the planned stance from 2016 meets the requirements of the rules, the Council assesses that the move to a more expansionary fiscal stance in 2015 than was envisaged in the April *SPU* was a deviation from prudent economic and budgetary management. The decision to increase spending in 2015 on foot of better than expected tax revenues goes against the spirit of the fiscal rules and results in extra borrowing and a higher deficit than could have been achieved had the revenues been used for debt reduction. While the fiscal stance in 2015 would not lead to a formal breach of any of the requirements of the *Stability and Growth Pact* based on current official projections, the increase in spending for 2015 undermines the domestic expenditure ceilings.

Despite starting from a less favourable position than could have been achieved in 2015, the fiscal stance for 2016 and later years is consistent with the deficit and debt remaining on a downward path. The Council's September 2015 *Pre-Budget Statement* assessed that the planned budget package for 2016 in the *Spring Economic Statement (SES)* was within the range of prudent policies from an economic perspective. *Budget 2016* contained a €1.5 billion package of planned spending increases and tax cuts for 2016 in line with the plan outlined in the Government's *SES* in April. As this package comes on top of the increase in spending for 2015, the fiscal stance in 2016 is less prudent than planned in the *SES*. Nevertheless, government revenues in 2016 are forecast to grow at a higher pace than non-interest government spending by some margin, which is appropriate given the on-going recovery. The projections signal an intention to comply with the Preventive Arm of the *Stability and Growth Pact (SGP)* and the domestic Budgetary Rule, which would be consistent with prudent policy.

1.3 The Medium-Term Fiscal Stance

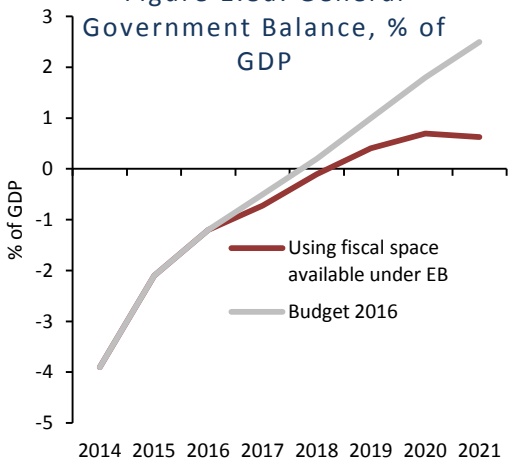
As stated in the April 2015 *SPU* and *Spring Economic Statement*, over the medium term the Government's intention is to comply with the minimum requirements to achieve its medium-term objective (MTO) of a balanced budget in structural terms. On the basis of official estimates of the structural balance published in *Budget 2016,* the minimum requirements would imply a 0.75 per cent reduction in the structural deficit in 2017 with 0.6 per cent annual improvements required thereafter until the MTO is reached.

The projections in *Budget 2016* show improvements in the structural deficit significantly in excess of these requirements despite the stated Government commitment to target minimum compliance. The difference between the forecasts in *Budget 2016* and what is required for minimum compliance corresponds to an estimate of the additional fiscal space that will be available under the rules to address spending pressures and Government policy commitments.

Budget 2016 provides estimates of the additional fiscal space that would be available (under the Expenditure Benchmark) after 2016 consistent with the Government policy of minimum compliance. However, as discussed in Chapter 3, the budget forecasts do not show the resulting path for the public finances assuming this fiscal space is used for expenditure increases and/or tax reductions. Figure 1.8a and Figure 1.8b below show the path of the actual and structural deficits compared to the projections in *Budget 2016*. Assuming that fiscal policy is set in accordance with the stated policy of meeting minimum rule compliance, there would be larger headline budget deficits over the 2017 to 2019 period and the budget surplus by 2021 would be almost two

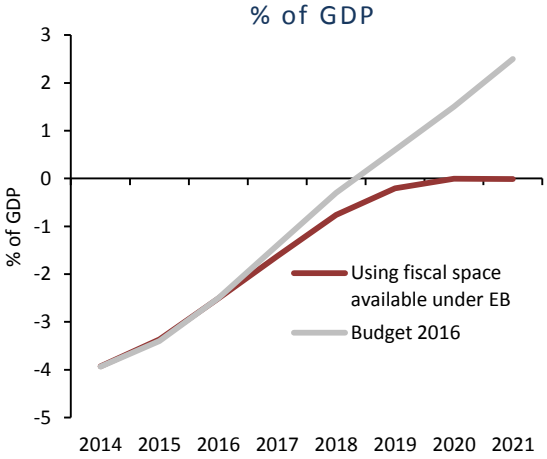
percentage points smaller than in the *Budget 2016* projections. The scenarios for the structural deficit are shown in Figure 1.8b. Under the Budget forecasts, the Government would come close to meeting its MTO (of a balanced budget in structural terms) by 2018. Assuming the Government use the fiscal space identified in *Budget 2016*, the MTO would not be reached until one year later in 2019.

Figure 1.8a: General Government Balance, % of GDP



Note: The red line shows the path of the General Government Balance assuming the estimated fiscal space under the Expenditure Benchmark (EB) as calculated in *Budget 2016* is used.
Source: Budget 2016 and internal IFAC calculations.

Figure 1.8b: Structural Balance, % of GDP



Note: The red line shows the path of the structural balance assuming the estimated fiscal space under the EB as calculated in *Budget 2016* is used.
Source: Budget 2016 and internal IFAC calculations.

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 likely future path of deficit. This is essential if the forecasts contained in the Budget are to provide a meaningful anchor for medium-term budgetary planning.

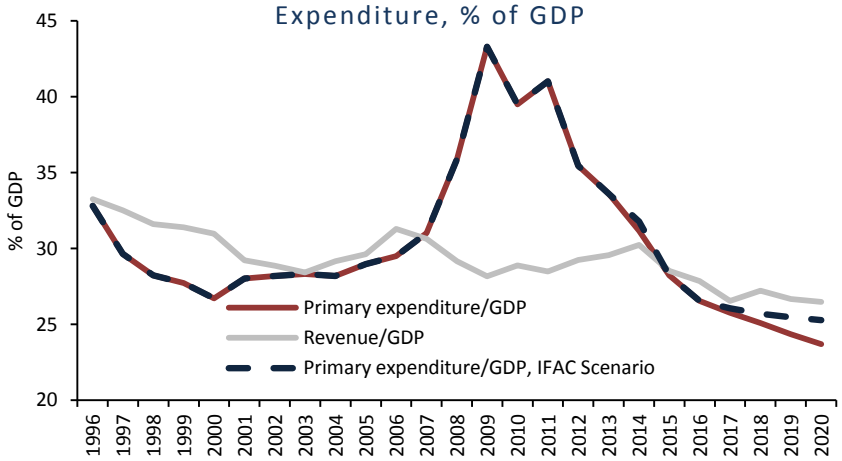
A key weakness of fiscal policy making in Ireland prior to the crisis was that the budgetary process paid insufficient attention to medium-term expenditure management. This is acknowledged in the Department of Finance's 2011 document *Reforming Ireland's Budgetary Process.*[2] In this context, the Government's failure to implement the new system of multi-annual expenditure ceilings – the key crisis reform designed to address the previous failure of expenditure management – is of serious concern to the Council. As discussed in Chapter 4, the continuous upward revisions to the ceilings since their introduction undermine multi-annual expenditure management and is not consistent with best practice expenditure planning. The expenditure ceilings were also designed as a way to implement the Expenditure Benchmark, a key component of the Government's budgetary framework. Recognising the weakness of the domestic expenditure ceilings in controlling spending,

[2] Available here: http://www.finance.gov.ie/sites/default/files/budgetref.pdf

there are risks to compliance with the EB in 2016 since there is no buffer. The Medium-Term Expenditure Framework should be strengthened and the Government should commit to the system of multi-annual expenditure management if the mistakes of the past are to be avoided.

Following exit from the *Excessive Deficit Procedure (EDP)* in 2015, Ireland's national budgetary framework comprising the domestic Budgetary rule – which mirrors the requirements of the Preventive Arm of the *SGP* – along with the expenditure ceilings will come into operation. As outlined in previous Fiscal Assessment Reports (IFAC 2014a, 2015b), despite its complexity and imperfections in some areas, the budgetary framework provides a valuable structure to guide Irish fiscal policy. Evidence from the international literature indicates that commitment to a strong fiscal framework can promote an improved fiscal performance by helping to counteract the pressures that lead to deficit bias and procyclical fiscal policy (Fabrizio and Mody, 2006). There is also some evidence that credible independent fiscal institutions in tandem with a strong budgetary framework can contribute to improve the conduct of fiscal policy (European Commission, 2006).

Figure 1.9: Government Revenue and Primary Expenditure, % of GDP



Note: Chart shows exchequer revenue and primary expenditure as a share of GDP.
Source: Budget 2016 and internal IFAC calculations.

A core requirement of Ireland's budgetary framework is the need to provide credible medium-term plans for the public finances. As explained by the Council in successive *Fiscal Assessment Reports* (IFAC, 2014b, IFAC, 2015b), a major weakness of Government plans set out in recent budgets and Stability Programme Updates is the absence of a realistic medium-term plan for the public finances. This weakness has not been addressed in *Budget 2016.* The Government's current projections for the public finances, based on technical assumptions, imply an implausibly large squeeze on government spending over the medium term, with the ratio of government spending to GDP projected to fall by over 5 percentage points by 2021. The tax forecasts do not reflect

commitments announced in *Budget 2016,* including the plan to abolish the Universal Social Charge (USC).

As demonstrated in the Council's June 2015 report and in Chapter 3 of this Report, the profile for government spending in *Budget 2016* is not realistic taking into account increases in the cost of maintaining existing public services and higher demand for additional services due to demographic and other cost pressures (Figure 1.9). Based on the projections in *Budget 2016,* the analysis in Chapter 3 illustrates that meeting likely future expenditure needs would absorb the majority of the estimated fiscal space available after 2016. Further tax cuts would make it very difficult to fund these expenditure pressures while complying with the rules.

2. ASSESSMENT AND ENDORSEMENT OF MACROECONOMIC FORECASTS

KEY MESSAGES

- Central projections for economic activity in 2015 and 2016 are very positive, though the outlook is marked by considerable uncertainties. External factors are relatively favourable to growth at present: exchange rates have boosted competitiveness; a looser monetary policy stance has helped a strained credit environment; oil prices are roughly half their 2014 level; and growth in Ireland's major trading partners has been reasonable. Substantial risks surround the central projections contained in the Budget, however, and error margins around Irish growth rates remain among the largest of advanced economies. Each of the factors mentioned could reverse quickly, with negative consequences for baseline forecasts.
- The Council endorsed the draft *Budget 2016* macroeconomic forecasts to 2016. Taking into account the uncertainties and judgemental elements involved, it was satisfied that these forecasts were within an endorsable range. The central forecasts in *Budget 2016* covering 2015 and 2016 appear plausible. Domestic demand forecasts are slightly stronger than in IFAC Benchmark projections prepared by the Council's Secretariat, with net exports weaker.
- Additional expenditure measures for 2015 were embedded in the Department's 2015 macroeconomic projections, but were not fully communicated to the Council during the endorsement process. As part of the annual review of the Memorandum of Understanding, the Council will propose changes to ensure that the precise fiscal assumptions underlying the macroeconomic forecasts made by the Department are explicitly communicated to the Council.
- The Council noted the correct application of the commonly agreed methodology for supply-side projections. Contrary to some other indicators of slack in the economy, such as still high unemployment levels, supply-side estimates produced under the commonly agreed methodology show a large positive output gap in 2015 that subsequently narrows by the end of the forecasting horizon (2021). While there may still be some spare capacity in the economy at present, uncertainty around these estimates is high and the nature and pace of the recovery underway is likely to see any demand shortfall in the economy disappear over the near term.
- 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. This requires the development of a fuller picture of the supply-side outside of the commonly agreed methodology, which is used primarily for fiscal surveillance. The Council note the progress made by the Department on this front since the last *Assessment Report*. Further progress is necessary as the credibility of estimates will remain an important issue in future endorsements.

2.1 Introduction

As part of its statutory mandate, the Council is required to undertake an endorsement exercise for the macroeconomic forecasts underlying the Stability Programme and annual Budget. It is also required to provide an assessment of the macroeconomic forecasts. This chapter reviews the endorsement exercise for *Budget 2016* and assesses the macroeconomic forecasts provided in the budgetary documentation. This fifth endorsement exercise undertaken by the Council covers a shorter horizon of forecasts (2015-2016) than in the *SPU 2015*.[3] The timeline for the endorsement process is detailed in Appendix C.

To support these endorsement and assessment functions, the Council has continued its development of a "suite of models" approach (IFAC, 2013b), with an expanded set of tools used for both short-term and medium-term forecasting. Since June, further efforts have been made to advance alternative supply-side estimates of the Irish economy. These are essential for assessing Ireland's fiscal stance as well as for understanding the economy's medium-term supply side potential. For the short term, new models of consumption have also been added.

Section 2.2 discusses the *Budget 2016* macroeconomic forecasts and puts these in context relative to other agency forecasts. Section 2.3 provides an assessment of the uncertainty and risks surrounding the outlook as well as an assessment of imbalances in the economy at present. Section 2.4 concludes by outlining the endorsement process as it applied to the *Budget 2016* projections. Two boxes are included: the first examines alternative approaches to estimating potential output for Ireland and the second documents practices among EU finance ministries in terms of their reporting of output gap estimates.

2.2 An Assessment of the Macroeconomic Forecasts in *Budget 2016*

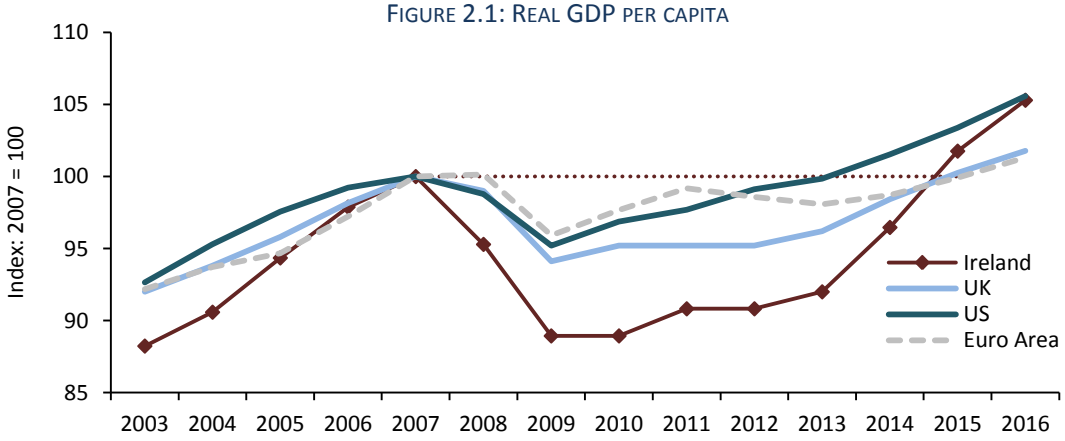
2.2.1 Background to Forecasts

Recognising the slow growth that typically follows a financial crisis, many forecasters expected a period of sub-par performance as households and businesses restrained their spending as they repaired balance sheets that had deteriorated during the crisis. However, there is also a strand of evidence that suggests the strength of recoveries is dependent on the length and severity of preceding downturns. The concept of a post-recession 'bounce-back' is documented in literature examining historical US real GDP dynamics and this framework may help explain the recent

[3] The endorsement function is outlined in detail in IFAC (2013b) and in IFAC (2014a). As the SPU represents the national medium-term fiscal plan, the endorsement related it covers a longer time range than that of the Budget. Benchmark projections prepared by the Secretariat form a key part of the endorsement process (see IFAC, 2013b and 2014a). 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 ESRI, Bank of Ireland and the IMF. The Secretariat also met with the CSO to gain further insights into recent *National Accounts* and *Balance of Payments* data.

dynamics of the Irish economy.[4] Given the severity of the crisis, a sharp 'bounce-back' might reasonably be expected, notwithstanding the need for balance sheet repair, which then eventually gives way to an expansion phase with more moderate growth rates in later years.[5] This pattern appears consistent with recent developments in the Irish economy (Figure 2.1), while the prevailing outlook is also for sharp initial growth rates to moderate in coming years.

FIGURE 2.1: REAL GDP PER CAPITA



Sources: CSO; *Budget 2016*; IMF and internal IFAC calculations.

The sharpness of the recovery may reflect two further aspects: (i) Ireland's capacity to regain competitiveness seems to set it apart from other economies, and could explain some of the relatively strong growth bounce-back, at least on the net export side; and (ii) mounting external supports including record low global interest rates, low oil prices, a sharp euro depreciation and recovering demand in Ireland's key trading partners have also reinforced the recovery momentum. While output has responded strongly and climbed above its pre-crisis peak, unemployment levels remain high compared to pre-crisis levels.

In terms of composition, much of the impetus to growth has shifted towards domestic demand since 2013. This contrasts with the large contributions from traded sectors during the crisis years.

[4] An example of a model with discrete economic phases is provided in Sichel's (1994) three-regime model, which allows for distinct expansion, recession, and recovery phases. Kim *et al.* (2005) extend the analysis, arguing that relating the strength of the recovery to the preceding recession mirrors actual business cycle features better than standard models. Applying the model to international data, they find the 'bounce-back' effect to be typically smaller outside of the US, corresponding to larger permanent effects of recessions. Additional support is provided in Galvao (2000); Beaudry and Koop (1993); Friedman (1964; 1993); and Wynne and Balke (1992; 1996).

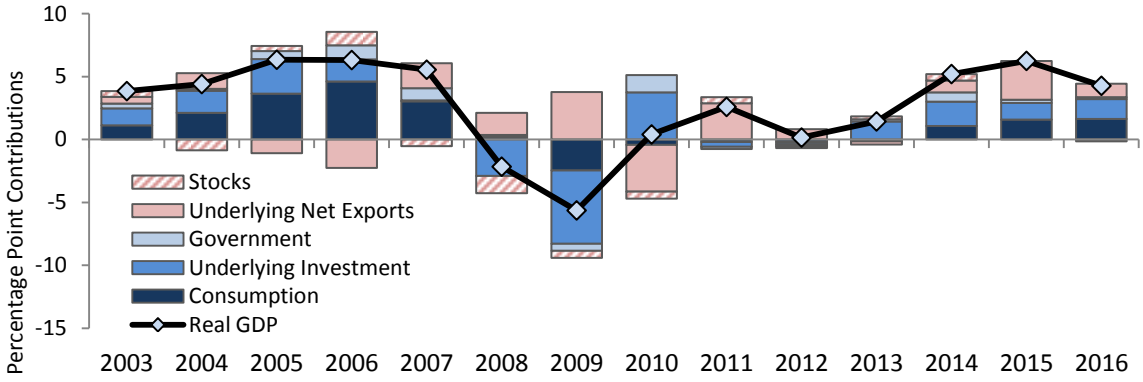
[5] "Balance sheet recessions" (Koo, 2011) following financial crises can dampen activity as private sector agents repair balance sheets by increasing savings or paying down debt. Substantial variation exists, but average recoveries in output per capita can take about 4½ years to exceed their pre-crisis peak following a financial crisis, compared to 1½ years for standard business cycle recessions (BIS, 2014). The recent Irish episode is likely to have taken 7-8 years using either GNP or GDP per capita. Household nominal debt has eased since 2008, however, while recent research (Lawless *et al.*, 2015) shows that 43 per cent of Irish households in 2013 held no debt (the reported Euro Area average incidence of debt is lower, with 56 per cent of households having no debt). Substantial variation is also evident across Irish age categories (the 34-44 year age category, for example, shows higher relative debt burdens).

The resurgence in domestic demand visible from 2013 has to date been predominantly driven by underlying investment expenditure (i.e., excluding aircraft and intangible investment), albeit a large share may stem from multinational-dominated sectors for whom financing conditions have been less constrained. From its trough in mid-2012, some two-thirds of the increase in underlying investment has arisen from increased expenditure on machinery and equipment investment (excluding aircraft) and close to a quarter from non-residential construction. Substantive contributions from consumer spending only began to emerge last year (Figure 2.2).

2.2.2 Short-Term Forecasts, 2015-2016

Budget 2016 forecasts the recent dynamism of the economy to sustain itself through 2015, before moderating slightly in 2016. The Department forecasts real GDP growth of 6.2 per cent for this year and 4.3 per cent for 2016. This follows last year's growth of 5.2 per cent.

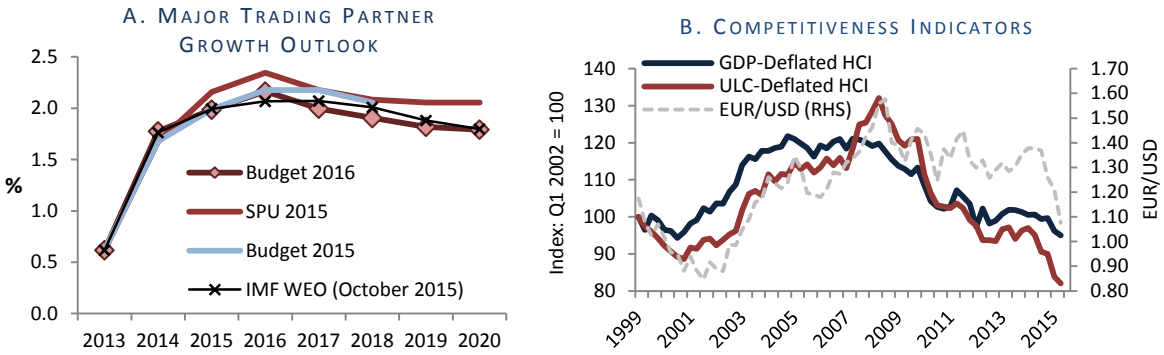
Figure 2.2: Contributions to Real GDP Growth (Year-on-Year)



Sources: CSO; Department of Finance; internal IFAC calculations.
Note: "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 continue. Ongoing supply pressures in commercial and residential sectors should fuel further expansions in investment even if machinery and equipment spending moderates. *Budget 2016* anticipates that real incomes will rise at a reasonable pace. In combination with a strong pace of employment creation, this should spur further expansions in private consumption. In addition, a weaker euro, lower oil prices, historically low global interest rates and continued growth in key trading partners are all expected to be factors that further boost trade performance in the near term.

FIGURE 2.3: EXTERNAL TRADE FUNDAMENTALS



Sources: Department of Finance (D/F); internal IFAC calculations.
Note: Trading partner forecasts are export-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.

Net Exports are expected to aid real GDP growth this year and next. Central forecasts of external demand growth are still reasonably positive (Figure 2.3 A), even after accounting for some deterioration in Emerging Market (EM) prospects.[6] Competitiveness is being bolstered by a sharp depreciation in the euro (Figure 2.3 B). Allied to the previous reversal of boom-time losses, this has restored competitiveness levels to those not seen since 2000 – a year described as 'unsustainably super-competitive' (O' Farrell, 2015; O'Brien, 2010 ; Cassidy and O'Brien, 2007; and Lane, 2004).

Investment spending is expected to continue its cyclical recovery from a low base, with some degree of catch-up also possible given recent weaknesses. Various impediments[7] mean that *Budget 2016* does not foresee investment in dwellings returning to long-run levels[8] by 2021. The Department's projections appear appropriately conservative in light of recent failures of housing supply to respond to demand, particularly in urban areas (ESRI, 2015). Shortages of commercial property, most notably in Dublin, are expected to prompt rising investment activity in the next few years, with many projects in early commencement stages.[9]

More encouraging is the pace of expansion in machinery and equipment investment. The latter is likely to be close to levels reached in the early-2000s next year. Diminished capital stock levels in industry and elsewhere should see investment continue to expand briskly in the near term.

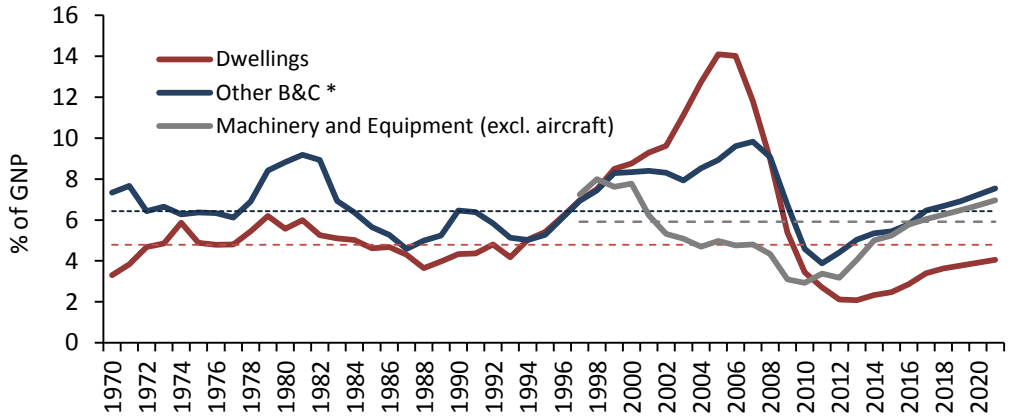
[6] Using weighted real GDP growth in the US, UK and Euro Area is one proxy for external demand. On this basis, demand growth averaging 2 per cent per annum over the forecast period would be slightly weaker than the average 2½ per cent annual growth rates that prevailed during the period 2000 to 2007.

[7] Appendix B examines housing developments in further detail.

[8] Long-run levels refer to the median excluding the "bubble" period (taken as 2003-2007) here, although the median is relatively unchanged under alternative interpretations such as the 2000-2008 period, for example.

[9] The Central Bank (2015) highlight these supply pressures, noting in particular Dublin city centre office vacancy rates, which fell from a peak of over 23.5 per cent in 2010 to less than 10 per cent in Q1 2015. More recent reports suggest a pick-up in development activity in recent months, albeit from a low base (CBRE, 2015). NAMA has also announced significant commercial property development plans concentrated in the Dublin Docklands.

FIGURE 2.4: INVESTMENT SUB-COMPONENTS AS % GNP



Sources: CSO; *Budget 2016*; internal IFAC calculations.
Note: Respective long-run median (in same colours) of each series shown by horizontal lines.
* The D/F definition of other B&C includes investment expenditure on roads, transfer costs as well as NIE-defined other building and construction (including commercial development).

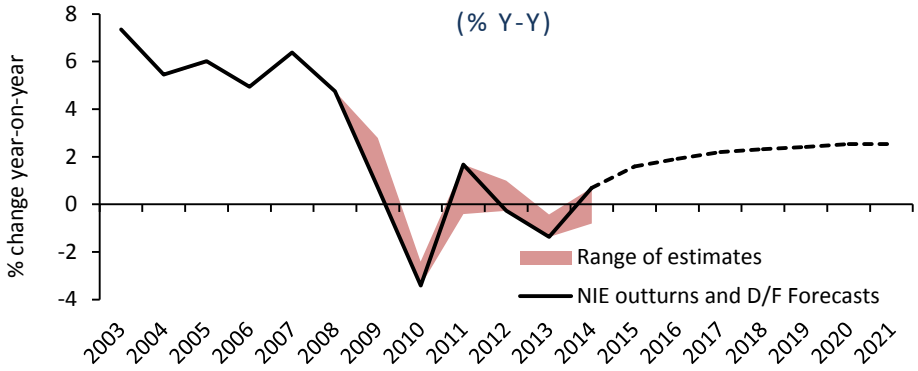
Revised data show **personal consumption** spending for recent years, particularly on services, representing less of a drag to overall activity than previously indicated. The less volatile components of retail sales – which move more closely with aggregate consumption – have been growing at a pace of 2½-3½ per cent year-on-year in recent months. Furthermore, the implied quarterly growth rates behind the Department's annual forecasts (see Table 2.1 forecast summary) remain close to half their pre-crisis averages.[10] By raising disposable incomes, tax reductions and continued employment growth should also spur further consumption growth.

While consumption forecasts appear consistent with the income growth assumed by the Department, various official estimates give conflicting signals about actual earnings trends of late. Hourly compensation growth rates range from -0.8 per cent to +0.7 per cent for 2014 (Figure 2.5). This uncertainty around historical estimates clouds the outlook for consumption. In addition, more recent information on savings rates suggests that these may have already descended from crisis highs, limiting the scope to fuel consumption growth. [11] Finally, although falling, household debt levels remain in excess of international and historical norms. For these reasons, the outlook on consumer spending appears more uncertain than usual, even if high-frequency indicators show continued strength.

[10] Quarterly growth rates in consumption averaged 1.4 per cent over Q1 2000 – Q4 2007; 1.5 per cent over Q1 1998 – Q4 2007; and 1.6 per cent over Q1 1998 – Q4 2002. By comparison, the implied quarter-on-quarter growth rates in the Department's projections suggest growth of 0.8 per cent per quarter.

[11] The Institutional Sector Accounts show the household savings rate having descended to 5 per cent in 2014, which places it inside its long-run (1999-2014) annual average of 7½ per cent. Excluding elevated rates during the crisis period the long-run average would be closer to 6½ per cent.

FIGURE 2.5: ESTIMATES OF HOURLY EMPLOYEE COMPENSATION (% Y-Y)



Sources: CSO (National Income and Expenditure (NIE); Institutional Sector Accounts; Earnings Hours and Employment Costs Survey; Quarterly National Household Survey); Department of Finance; internal IFAC calculations.

The GDP deflator is showing an expected sharp rise in 2015 amid the boost to the terms of trade for goods following the reduction in oil prices and the weaker euro, particularly vis- à-vis the US dollar. Strong rental cost growth (which impacts imputed rents) is offsetting modest falls in other consumer prices. Next year, the GDP deflator is forecast to moderate as exchange rate effects fall out of the base.

The **Labour market** is expected to continue recovering through 2016. Economy-wide employment grew by 2.6 per cent in the first half of 2015, with 10 of the 14 sectors recording year-on-year increases. The contraction in the labour force appears to have stabilised, while an assumed reversal in net migration outflows should further boost labour capacity from next year.

TABLE 2.1: *BUDGET 2016* MACROECONOMIC FORECASTS (TO 2016)

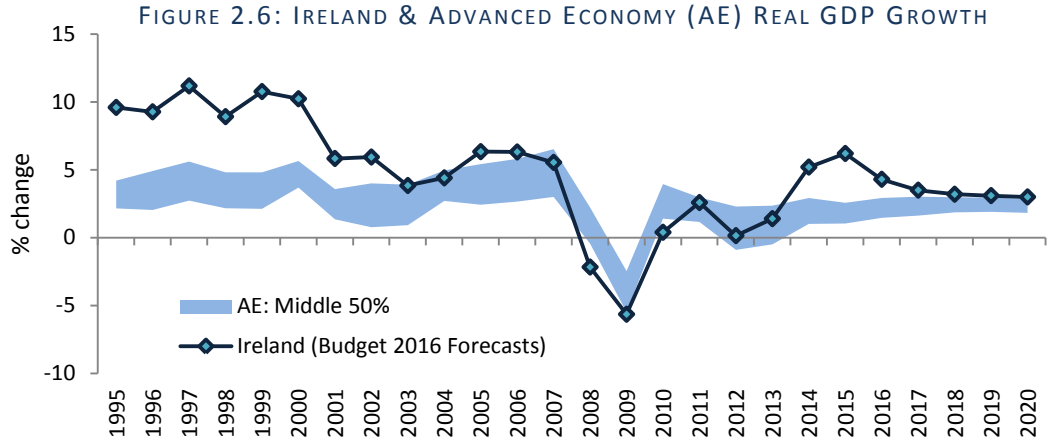
% change in volumes unless stated	2013	2014	2015	2016
GDP	1.4	5.2	6.2	4.3
GDP Deflator	1.2	0.1	4.6	1.8
Nominal GDP	2.6	5.3	11.2	6.2
GNP	4.6	6.9	5.5	3.9
Consumption	-0.3	2.0	3.5	3.5
Investment	-6.6	14.3	13.0	12.5
Government	1.4	4.6	1.9	1.1
Exports	2.5	12.1	11.9	6.9
Imports	0.0	14.7	12.1	8.2
Current Account (% of GDP)	3.1	3.6	6.9	6.2
Employment	2.4	1.8	2.8	2.4
Unemployment Rate	13.0	11.3	9.5	8.3
Inflation (HICP)	0.5	0.3	0.1	1.2
Nominal GDP (€ billions)	179.4	189.0	210.2	223.1

Sources: CSO and Department of Finance (*Budget 2016).*

2.2.3 Medium-Term Forecasts, 2017-2021

Budget 2016 forecasts annual real GDP growth to slow to approximately 3 per cent per annum by the end of the forecast horizon. This is similar to April's *SPU* projections and places Ireland below its average performance since the mid-1990s, but just inside the upper-25 per cent of projected growth rates for advanced economies (Figure 2.6).

Figure 2.6: Ireland & Advanced Economy (AE) Real GDP Growth



Sources: CSO; *Budget 2016* forecasts; IMF (WEO, October 2015).

In the medium term, economic activity is expected to become more balanced in composition from 2018 on as the contribution of net exports to growth rises while growth in domestic activity moderates (Table 2.2). The composition of growth projected by the Department for the outer period does not contain as strong a net export contribution as assumed at SPU-time. As noted previously (IFAC, 2015b), there are numerous challenges to ensuring that net exports continue to contribute substantively to real GDP growth in later years as rising domestic pressures threaten recent competitiveness gains. Concerns that cost pressures are already emerging in relation to labour, property, health insurance, education and a range of business services come against a backdrop of expectations for low inflation across the EU.[12]

The Department reports estimates produced using the commonly agreed methodology as its supply-side forecasts. On the face of it, these estimates point to significant overheating in the economy, with a positive output gap of 2½ per cent estimated for both 2015 and 2016, which only unwinds by 2021. Furthermore, the estimate of potential output growth for 2016, at over 4 per cent, is at the very upper range of estimates typically assumed for Ireland. This results in the output gap increasing by just 0.2 percentage points between 2015 and 2016 and possibly understates the degree to which any cyclical upswing might be driving the recovery.

[12] The National Competitiveness Council (2015) notes these concerns in detail in *Ireland's Competitiveness Scorecard 2015* and highlights the difficulty of achieving further cost reductions in light of expectations of low inflation throughout the EU. In relation to labour costs, the concern is primarily the extent to which these might outpace productivity growth.

While estimates under the Commonly Agreed Methodology (CAM) suggest significant overheating, a variety of indicators would suggest little unambiguous evidence of tensions on productive capacity (IFAC, 2015b). A lack of broad-based real wage and price pressures across the economy as well as a strengthening current account surplus – even if adjusted for the activities of redomiciled PLCs – imply tensions are not yet obvious. Furthermore, labour market conditions appear to show additional slack, with credit markets and the housing sector also lacking clear signs of overheating.[13] Even if unambiguous signs of pressures may not be immediately apparent, the pace that the output gap is closing (or opening up) is still likely to be quite fast given the strength of the near-term outlook. Looking beyond the CAM estimates, the nature of the recovery underway would likely see any demand shortfall in the economy disappear over the near term.

TABLE 2.2: BUDGET 2016 MEDIUM-TERM FORECASTS SUMMARISED

% change	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP Growth	5.2	6.2	4.3	3.5	3.2	3.1	3.0	2.9
Domestic Demand (p.p.) [1]	4.3	3.1	3.1	2.6	1.7	1.6	1.6	1.5
Net Exports (p.p.) [1]	0.9	3.1	1.1	0.8	1.5	1.5	1.4	1.4
Potential GDP Growth	2.7	3.4	4.1	4.3	3.8	3.3	3.2	3.5
Output Gap (CAM) [2]	-0.4	2.3	2.5	1.6	1.0	0.8	0.6	0.0

Source: Department of Finance (*Budget 2016).*
[1] Contributions to real GDP growth rates differ from *Budget 2016* calculations as they adjust for imports of aircraft and intangibles in both investment and imports. Domestic demand includes changes in inventories.
[2] Output gap estimates in *Budget 2016* are estimated using the Commonly Agreed Methodology (CAM).

Recognising the uncertainty related to estimating the cyclical position of the economy, it is essential that the Government broaden its analysis of the supply-side. Forecasts for the medium term should be 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 CAM, which is only required for fiscal surveillance and which the Department – among others – has been critical of in the past.[14] While necessary for fiscal surveillance requirements, such estimates do not have to represent the Department's only detailed supply-side views. As noted in Box B, many EU Finance Ministries report alternative supply-side estimates in their analysis of the macroeconomy as part of regular Stability/ Convergence Programmes.

The Council note the progress made by the Department in developing alternative supply-side estimates since the last *Assessment Report*. Further progress is necessary as the credibility of

[13] See also Appendix B on macroeconomic imbalances and Appendix C on house prices.

[14] Criticisms of the approach are well-documented, including those of the Department itself (Department of Finance, 2003) and in a number of the Council's previous reports (IFAC, 2015a, Chapter 2; 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. Issues whereby medium-term demand forecasts may not be well aligned with supply-side figures produced under the methodology are also evident in the *Budget 2016* estimates. For example, this leads to potential output growth exceeding real GDP growth by more than half a percentage point in 2021 (Table 2.2). Typically, actual and potential output growth rates are assumed to converge beyond the business cycle horizon.

estimates will remain a pivotal issue in coming endorsements, including that covering the medium-term forecasts in next spring's *SPU*.

BOX A: ALTERNATIVE POTENTIAL OUTPUT ESTIMATES AND "A MODULAR APPROACH"

Estimates of potential output and the output gap represent critical inputs to the design of sustainable fiscal and macroeconomic policies. This box provides an update of the progress[15] the Council is making towards developing appropriate measures for assessing the fiscal stance and in assessing medium-term forecasts produced by the Department of Finance.

ALTERNATIVE BASELINE ESTIMATES OF POTENTIAL OUTPUT

The Council has examined several approaches to producing estimates of potential output. It is anticipated that these will be supplemented with various indicators of disequilibrium, particularly those of relevance to the public finances. Before incorporating these, however, several methods of obtaining baseline estimates of potential are examined.

The nature of the Irish economy, in particular the large presence of multinational-dominated sectors, may warrant the use of alternative measures of economic activity other than GDP when estimating potential output. While GNP may be considered a better measure of domestic economic activity, it is also subject to its own accounting issues (FitzGerald, 2013). A focus on domestic sectors of the economy where fiscal impact is of greatest interest could also be satisfied by using a more specific separation of domestic and multinational-dominated sectors.

One approach, which mirrors approaches developed by the IMF (also Box B, IFAC, 2015b), is to use estimates of "domestic" GVA (i.e., the GVA of sectors not dominated by foreign-owned multinational enterprises (MNEs)). A basic Kalman filter (with drift) is employed to identify cyclical activity and underlying "potential domestic GVA". The output gap denominator then incorporates the GVA of MNE-dominated sectors.[16]

$$\frac{"Domestic"\ GVA - Kalman\ Filtered\ ("Domestic"\ GVA)}{Kalman\ Filtered\ ("Domestic"\ GVA) + MNC\ GVA} * 100$$

A second approach is to use standard measures of economic activity: real GDP and real GNP. Cumulative Foreign Direct Investment (FDI) inflows are controlled for in the filtering process to account for any associated structural changes in the economy over time.[17]

Figure A.1.A shows the output gap estimates produced under each method. The variation is not especially wide across estimation techniques, albeit the GDP and GNP approaches show a more pronounced peak and trough in potential than estimates under the "domestic GVA" approach. All estimates suggest that the economy approached equilibrium between 1998 and 1999, before a large positive gap opened up. The estimates are also relatively consistent for the most recent period, suggesting an output gap in 2016 that is either closed or slightly negative. Estimates of potential growth underpinning these approaches range between 2½ - 3½ per cent per annum over the medium term.

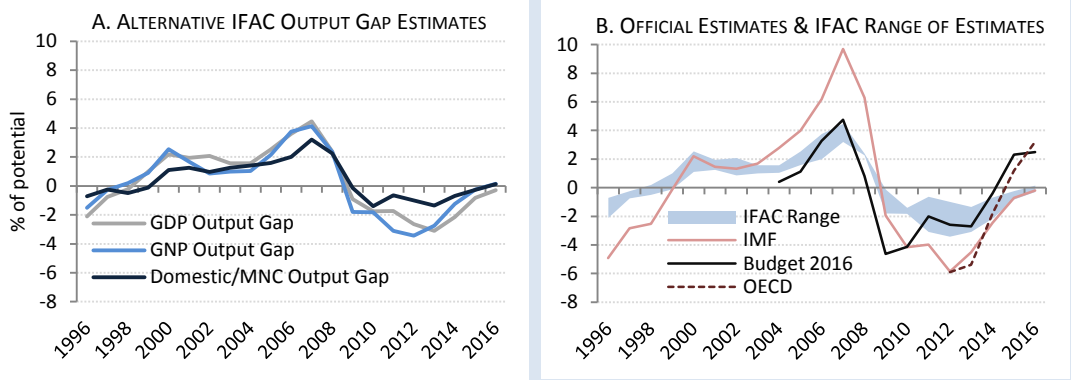
[15] See, for example, IFAC (2015a), Box B, and IFAC (2014b), Analytical Note 2.

[16] MNE activity is assumed to be relatively unconstrained by domestic resource utilisation and is taken to scale up or down the economy's overall level of potential output. By scaling the gap between actual "domestic" activity and its potential level against the sum of MNE-led activity plus the potential level of domestic activity, this gives a sense of how domestic activity is performing relative to wider economic potential. For forecast years, a simplifying assumption is made whereby domestic GVA is assumed to grow in line with final domestic demand less investment in intangibles and aircraft, to which its growth rates are highly correlated.

[17] This approach is similar to that outlined in Šrámková *et al.* (2010) where cumulative greenfield FDI is used. The rationale is that FDI inflows contribute to changes in potential growth rates over time. For 2015 and 2016, FDI inflows are assumed to run at a similar pace to the most recent annual outturns.

Comparing the output gap estimates to official estimates produced by other institutions for GDP, we can see that the range of estimates outlined above displays relatively smaller magnitudes. For more recent years, the range lies closer to IMF estimates, which contrast with *Budget 2016* and OECD estimates that signal an emergence of large positive output gaps.

FIGURE A.1: ALTERNATIVE OUTPUT GAP ESTIMATES AND COMPARISONS WITH OFFICIAL ESTIMATES



Sources: Internal IFAC calculations; CSO; *Budget 2016* Projections; IMF (*WEO*, Oct 2015); OECD (Sep 2015).

TOWARDS A *MODULAR APPROACH*

The use of univariate filters similar to those used in the analysis above can lead to a failure to detect other critical imbalances that matter for public finances, such as housing bubbles. To counteract this, the Council is also developing a *Modular Approach* to better understand the cyclical position of the economy. This involves assessing key sources of imbalances that can explain the deviation of the economy from its potential, with a view to examining these "*modules*" in a more systematic manner. Means of incorporating this information directly into baseline estimates of potential output can then subsequently be explored.[18]

To better understand the current budget balance relative to a balance when the economy is operating at more normal levels, cyclical indicators that matter most for the public finances are of central importance. In this respect, indicators of credit, housing, labour market, and current account imbalances are among some of the initial areas of focus.

Incorporating additional indicators that might point to disequilibria in the economy formally into an econometric specification of potential output poses several difficulties. First, finding suitable indicators as well as measuring these correctly can be an extensive process. Second, incorporating the information into estimates of potential in an appropriate manner can also present problems. Third, chosen indicators of disequilibria may subsequently prove insignificant or inappropriate when included, requiring further iterations of earlier steps.

As an input to producing suitable indicators for estimates of potential and to ensure that imbalances are monitored more rigorously, the Council has begun documenting imbalances related to the "modules" specified above (Appendix E). This has a number of advantages. It mirrors more closely how economists actually think about the existence of overheating or slack in the economy. It also allows for more substantive analyses of specific areas, compared to a situation in which a statistical filter or alternative estimate of potential is applied in isolation. The various indicators used (Section 2.3.2) suggest that the output gap is unlikely to be strongly positive at present,[19] albeit the considerable pace of growth anticipated for coming years suggests that any negative gap could close rapidly, while uncertainty levels surrounding such estimates remain high.

[18] Additional indicators can be incorporated through output gap equations as proposed by Borio *et al.* (2014).

[19] As suggested by CAM-based *Budget 2016* projections and OECD projections, for example.

BOX B: USE OF ALTERNATIVE OUTPUT GAP MEASURES BY EU FINANCE MINISTRIES

This Box outlines the reporting of output gaps by Finance Ministries subject to EU fiscal frameworks. It assesses whether alternative estimates of the output gap are typically shown alongside (or in place of) estimates produced under the commonly agreed methodology, how alternative estimates are presented, and whether the approach used by the Department of Finance may be improved in light of the presentational approaches adopted elsewhere. Presenting alternative approaches is a favourable means of highlighting the uncertainty that surrounds estimates of the supply-side.

The output gap is an important indicator of the state of an economy's output relative to the output that could be produced if the economy were in a "normal" state.[20] Since an economy's potential growth cannot be observed and has to be estimated, the statistical and econometric methods used can be a source of some contention.[21] For these and other reasons, it is often advisable not to rely on any single method of estimating the output gap. The Department of Finance, however, presents estimates under the commonly agreed methodology as its official assessment of the output gap, thus mirroring the EU Commission's approach. The Department have expressed serious reservations with the approach's validity for Ireland in the past (as have others), however, and the fiscal rules do not explicitly preclude the use of alternative measures.

TABLE B.1: STABILITY/ CONVERGENCE PROGRAMME OUTPUT GAP REPORTING ACROSS COUNTRIES

Country	No. Output Gap Measures Reported	Commonly Agreed Methodology Output Gap Reported	Where	Alternative Output Gap Reported	Where	Link
Austria	1	Yes	Table 5	No	-	SP
Belgium	1	No	-	Yes	Table 6	SP
Bulgaria	1	Yes	Table 5	No	-	CP
Croatia	1	Yes	Table 5	No	-	CP
France	4	Yes	Table 5	Yes	Text (pp.10)	SP
Germany	1	Yes	Table 17	No	-	SP
Hungary	1	No	-	Yes	Table 4	CP
Italy	2	Yes	Table III.9	-	-	SP
Latvia	2	Yes	Text (pp.16)	Yes	Table 5	SP
Lithuania	1	No	-	Yes	Table 9	CP
Luxembourg	2	Yes	Box 2	Yes	Table 5	SP
Malta	1	Yes	Table 5	No	-	SP
Netherlands	1	Yes	Table 5	No	-	SP
Poland	1	Yes	Table 1	No	-	CP
Romania	1	Yes	Table 5	No	-	CP
Slovakia	2	Yes	Tables 4 and 5	Yes	Table 3	SP
Slovenia	1	Yes	Table 4.4	No	-	SP
Spain	1	Yes	Table 4.6.1	No	-	SP
Sweden	1	No	-	Yes	Table 3	CP
UK	18	Yes	Chart 3.8	Yes	Chart 3.1	CP

* Note that the Netherlands Ministry technically only shows the CAM output gap in their Stability Programme, even though the CPB – who produce the estimates – report on alternative estimates in certain publications.

[20] A normal state might refer to, for example, a situation where factors of production like labour and capital are being best employed, with unemployment near its natural rate, and productivity at trend levels and capital fully utilised.

[21] This is particularly relevant for small open economies like Ireland's where *ex post* national accounts revisions are large, labour supply is highly elastic and subsequent estimates of the output gap are subject to pronounced levels of uncertainty.

Table B.1 examines the cross-country variation in output gap reporting. Of the 20 Finance Ministries examined, 9 clearly present alternative output gap measures. In some cases these are completely unique approaches, while in others, they are adaptations of the commonly agreed methodology. It is not unusual for a country to present multiple alternative output gap estimates, including those from other agencies, where these are available, such as in the UK and France. Of the smaller economies examined, 8 out of the 14 rely on the CAM without presenting alternative estimates, whereas 6 of the 14 present their own favoured approach. Three of these (Latvia, Luxembourg and Slovakia) present estimates under both the CAM as well as their own preferred approaches.

The presentational form employed by those finance ministries that show several alternatives varies. In most cases, to avoid confusion, the preferred estimate of the output gap is included in the main Table describing cyclical developments. Estimates produced under the commonly agreed methodology are then given relatively more limited coverage, simply being referred to in the text or in accompanying charts.

Based on international practice, it does not appear unusual to see Finance Ministries presenting alternative estimates of the output gap to that of the Commonly Agreed Methodology. Given the advantages of doing so for Ireland where output gap estimates are subject to high levels of uncertainty, it would be advisable for the Department of Finance to examine its own presentational approach with a view to supplementing the estimates currently provided.

2.2.3 Reconciliation Tables Between Endorsed and Budget Forecasts

Budget 2016 provides a reconciliation table reflecting changes between the endorsed projections and those that are published in the document itself, which account for the €0.3 billion additional fiscal measures announced for 2016 over and above the €1.2 billion previously assumed in the *SPU*. Additional tables were provided to the Council outlining the details of these differences.[22]

The fiscal package for 2016 is projected to boost overall real GDP for 2016 by an additional 0.1 percentage points relative to the endorsed set of forecasts. At an aggregate level, this increase appears reasonable and results entirely from increased consumer spending as a result of after-tax income gains and increased transfers.[23] Employment estimates were revised up slightly on account of budgetary measures, while the unemployment rate was 0.1 percentage points lower for 2016.

While the Department provided a post-*Budget 2016* reconciliation for its 2016 forecasts, it did not reconcile its forecasts for 2015. This was surprising given that additional spending for 2015 for the final months of the year was only first outlined in the *White Paper* (9 October). This was of a similar magnitude to the entire Budget package and would have been expected to further boost growth rates in both 2015 and 2016.

[22] This requirement is reflected in the MoU between the Department and the Council.

[23] 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.

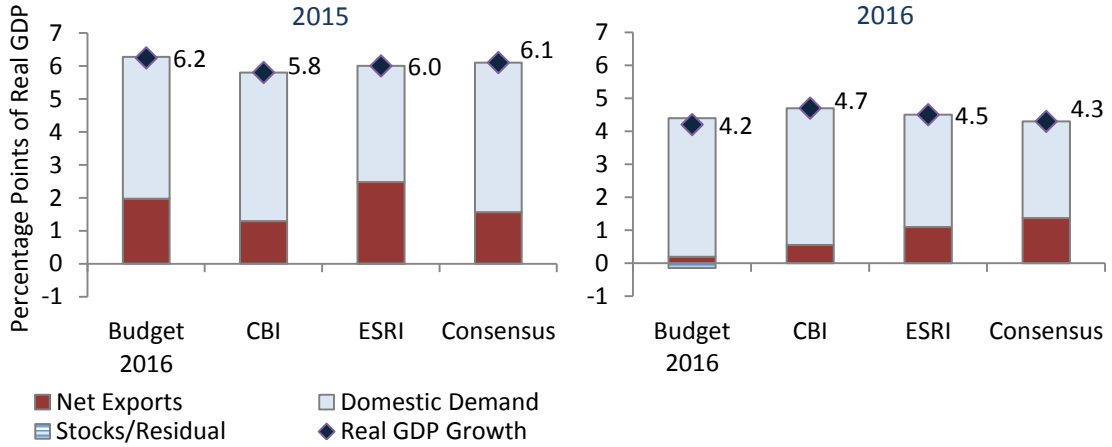
Subsequent to the endorsement, the Department of Finance clarified to the Council that the additional expenditure announced in the *White Paper* was embedded in the pre-endorsement projections as well as in the technical assumption provided to the Council for Government Consumption expenditure. This means that the projected gross expenditure numbers for 2015 produced by the Department in September included additional expenditure of €1.5 billion above that forecast in April – representing a significant change to the fiscal assumptions which impacts on related macroeconomic variables.

This issue raises two procedural aspects related to the endorsement process. First, changes to the assumed fiscal stance were not explicitly made clear to the Council during the endorsement period in September. Second, the *Memorandum of Understanding* governing the "endorsement function" stipulates that "...provisional final macroeconomic forecasts provided by the Department are to incorporate the impact of the most recent, officially-articulated consolidation/expansion measures foreseen in the Budget". In this instance, the last official position was clarified by the Department in its interactions with the Council as being the measures contained in the April *SPU*. This would also suggest that any deviation from these assumptions should have been communicated clearly. As part of the annual review of the MoU, changes will, therefore, be proposed to ensure that the precise fiscal assumptions underlying the macroeconomic forecasts made by the Department of Finance are explicitly communicated to the Council.

2.2.4 Forecasts of Other Agencies

Most agencies have upgraded near-term forecasts of real GDP growth to account for the rapid pace of expansion visible in the first half of 2015. Compositional assumptions consistently indicate that contributions from domestic demand will outweigh those from the traded sector in projections for 2016 (Figure 2.7).

Figure 2.7: Comparative Real GDP Growth Contributions (Percentage Points)



Sources: Budget 2016; ESRI *(Quarterly Commentary Autumn 2015);* Central Bank *Quarterly Bulletin 4, Oct. 2015;* and private sector consensus forecasts, Sept. 2015.

For the medium term, the Department is forecasting real GDP growth close to that projected by the IMF over the same horizon (Table 2.3). Projections for later years tend to lie within a relatively tight range of between 2½ per cent and 3 per cent per annum.[24]

TABLE 2.3: MEDIUM-TERM MACROECONOMIC FORECASTS TO 2021

% change unless stated	2015	2016	2017	2018	2019	2020	2021
Budget 2016							
GDP	6.2	4.3	3.5	3.2	3.1	3.0	2.9
Employment	2.8	2.4	2.0	1.9	1.8	1.7	1.6
Productivity	3.4	1.8	1.5	1.3	1.3	1.3	1.3
IMF (Oct WEO)*							
GDP	4.8	3.8	3.2	3.0	2.7	2.5	..
Employment	2.5	2.0	1.6	1.6	1.6	1.5	..
Productivity (implied)**	2.3	1.8	1.6	1.4	1.1	1.0	..

Sources: Budget 2016; and IMF (2015b) *(3rd Post-Program Staff Report and WEO October 2015).*
* Employment growth rates for 2017 onwards are taken from the June 2015 Post-Programme Staff Report
** Implied productivity is simply GDP growth less employment growth.

2.3 RISKS AND IMBALANCES

2.3.1 RISKS

Although projections for near-term economic activity look exceptionally good for Ireland, substantial risks surround the Department's central outlook. Since 2014, a number of external factors have become more favourable, but remain beyond the control of domestic policy makers and could reverse quickly, with negative consequences for baseline forecasts. Exchange rates have boosted competitiveness; a looser monetary policy stance has helped a strained credit environment; oil prices are close to half 2014 levels; and continued demand growth is projected in Ireland's major trading partners, even with recent downward revisions to world trade.

Recognising the openness of the economy and the vulnerability to external developments, *Budget 2016* now describes the balance of risks to the Department's macroeconomic forecasts as being tilted to the downside. This contrasts with its views at the time of the *SPU* last April when risks were considered more broadly balanced following positive developments in late 2014 and early 2015.[25] It also echoes the IMF's (2015) assessment of the balance of global financial and economic risks.

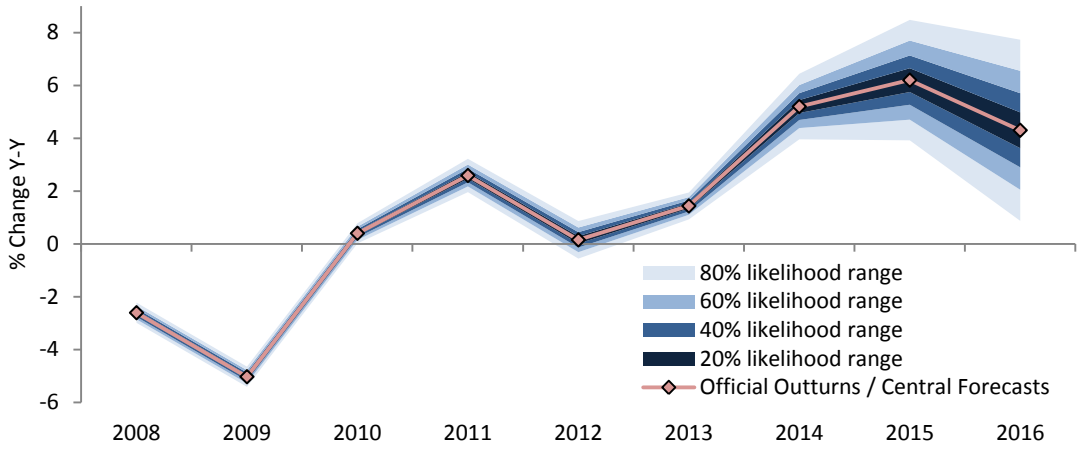
[24] Few forecasts for the medium term are available. However, the ESRI (2015) note a similar range in terms of their estimates for potential output growth. Referring to estimates based on work in Byrne and McQuinn (2014), they suggest potential output growth rates in Ireland are in the region of 2.5 to 3 per cent per annum. They also note that the Irish economy will be at or very near its potential level in 2016. McQuinn and Whelan (2015) suggest more modest output growth prospects for 2014-2023, averaging 1.2 to 1.8 per cent under varying scenario assumptions for migration levels and growth-enhancing structural reforms.

[25] While the shape of the distribution around central forecasts may not be known, the Department's view of the balance of risks represents an important input into discussions around the macroeconomic and fiscal outlook.

Table 2.4 provides an assessment of the likelihood and impact of the main known downside risks to the outlook in *Budget 2016*. This structure offers a more coherent way of highlighting potential problems and assessing vulnerabilities.

The Irish economy is inherently more volatile than others, ranking as one of the most volatile economies in the developed world (Appendix D). Absolute real GDP forecast errors are among the widest in the EU (IMF, 2013); and quarterly data show some of the largest historical revisions in the OECD.[26] The large influence of multinational-dominated sectors means that substantial variations in output can arise quite abruptly without requiring changes in domestic resource utilisation.[27] These issues pose substantial difficulties for forecasters and policy makers. Standard confidence intervals are typically very wide in Ireland and are magnified further by the uncertainties and risks described above. Illustrating this in part, Figure 2.8 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.

FIGURE 2.8: REAL GDP FAN CHART BASED ON *BUDGET 2016* PROJECTIONS (TO 2016)



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

[26] Even when controlling for relatively high historical growth rates revisions are still among the highest recorded in the OECD (Casey and Smyth, 2015).

[27] 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. The contribution is likely overstated, however. Were large income outflows to be accounted for, the impact in relation to real GNP may be of a significantly smaller scale.

TABLE 2.4: RISK ASSESSMENT MATRIX FOR MAIN DOWNSIDE RISKS

Risk	Relative Likelihood	Impact
Emerging Market Slowdown	H	Ireland's direct exposure to Emerging Markets (EMs) is relatively low representing less than 10 per cent of total exports. Limited information on direct FDI and private sector financial exposures also suggests that these are relatively negligible. Indirect trade exposures exist through Ireland's key trading partners, e.g., export exposures to China are not insignificant in the US (7.1 per cent), UK (3.6 per cent) and Germany (6.5 per cent) in 2014. More importantly, direct linkages likely understate the potential contagion effects through financial channels which could pose the greatest risks in the case of a more disruptive weakening in EMs (IMF, 2015).
British Exit from EU	M	The referendum could magnify near-term uncertainties, thus negatively affecting UK investment and subsequent trade to the region (UK accounts for 16 per cent of Irish exports). A departure could have wide-ranging implications for free movement of goods, services and labour; could alter the contours of EU decision making; and could alter relative competitiveness levels, impacting on FDI flows (ESRI, 2015). Upside risks also exist, particularly in terms of potential FDI flows.
Geopolitical Tensions	M	Geopolitical tensions, though assumed to ease in coming years, are high in a number of countries including Ukraine, parts of the Middle East and parts of Africa. An escalation in tensions could pose downside risks for growth through trade linkages and disruptions in financial transactions.
Euro Area Risks	M	The Euro Area accounts for one-third of Irish exports and had been showing more encouraging growth prospects of late, but recent tailwinds (lower oil prices and accommodative monetary policy) might have suggested a stronger than realised performance. Recent official forecasts have downgraded the growth outlook for the Euro Area. A recent history of growth disappointments and weakening trends in productivity growth and capital accumulation pose additional concerns. If Euro Area monetary conditions remained highly accommodative over the medium term, this could also prove inappropriately loose for the anticipated cyclical rebound in Ireland. Monetary policy responses now appear more ready to prevent deflationary risks, although doubts remain about the effectiveness of the available instruments.
Global Financial Markets	M	Risks of a return to global financial market turbulence could increase due to asset market mispricing or low market liquidity, particularly in the absence of a smooth normalisation in US monetary policy.
Private Debt and Credit Conditions Constraining Activity more than Expected	M	Household debt-to-disposable incomes, though falling, remain among the highest in the EU at 167 per cent and parts of the non-financial corporate sector also face high levels of indebtedness. Income gains could be prioritised for debt reduction rather than consumption, spelling downside risks to consumption forecasts. High levels of debt make firms more susceptible to adverse growth conditions and rising interest rates. Difficulties accessing credit also remain apparent, with domestic reliance on bank funding very high compared to other economies.
Competitiveness and Exchange Rates	M	Competitiveness losses could arise as a result of various cost pressures, including in property (Appendix B: Housing Market Risks Update), and if unit labour cost growth were to exceed that of EU and other economies. A reversal in favourable exchange rate movements could also threaten recent gains.
Risks to Foreign Direct Investment (FDI) Inflows	L	FDI has played a large role in the rise of average living standards since the 1950s. However, there are vulnerabilities associated with heavy reliance on multinational enterprises and risks of reduced FDI inflows could materialise in the context of a changed strategic focus under modernised tax rules.

Note: Qualitative likelihood assessments based on Council assessments: H= High; M = Medium; L = Low.

2.3.2 Imbalances

Long-run imbalances in the economy, particularly those of relevance to the public finances, are an important consideration in addition to more immediate macroeconomic risks. Appendix E summarises various indicators that focus on such imbalances (see also Box A).

From a review of the indicators, few signs of overheating are apparent in the economy at present, although continuous monitoring is required given how quickly signs of imbalances can emerge. High unemployment rates, low employment ratios and an absence of rising inflationary pressures are all suggestive of additional slack in the labour market, although rising private sector job vacancy rates could be indicative of some modest tightening (Appendix Figure E.1). Rising current account surpluses and a recovering net international investment position (Appendix Figure E.2) would tend to imply an absence of immediate pressures. This is supported by investment activity that is currently below historical norms and an absence of substantial credit market easing (Appendix Figures E.3 and E.4).

There may be some degree of slack in the economy at this moment in time, yet forecasts suggest that the economy will grow substantially in the coming years, while unemployment rates are also set to fall by another 3 percentage points by 2020 bringing these to levels consistent with high wage and price pressures in the early-2000s. Real estate shortages also have the potential to fuel near-term wage pressures. If any negative output gap were to exist, this would most likely close quickly given current economic developments. This raises the question of whether the economy risks overheating at some point in the near future. As in the past, there are also risks that the true level of sustainable demand and output could be misperceived.

2.4 Endorsement of the *Budget 2016* Projections

This section details the fifth endorsement exercise undertaken by the Council covering *Budget 2016,* outlining the Council's considerations around the time of the endorsement and the process itself (Appendix C details the timeline). The endorsement process refers to earlier data than that available for the Council's more recent assessment of macroeconomic forecasts (Section 2.2).

As noted in Section 2.2.3, assumptions related to the fiscal stance differed relative to those in the last published official position – *SPU 2015* – due to the inclusion of additional expenditure measures as contained in the *White Paper*. The measures were significant, implying additional expenditure of €1.6 billion in 2015, albeit some €0.6 billion related to Health expenditure was largely anticipated in advance of the endorsement. Having examined the related macroeconomic impact, the Council believes that this would not have altered its decision to endorse the macroeconomic projections underpinning *Budget 2016*. It does, however, raise procedural issues

related to the endorsement, which the Council intends to resolve as part of the annual review of the MoU that governs the endorsement process.

The Council endorsed the *Budget 2016* macroeconomic forecasts to 2016. 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: (i) the plausibility of the methodology used; (ii) the pattern of recent forecast errors; and (iii) comparisons with Benchmark and other projections.

First, focusing on the methodology used by the Department of Finance, the Council is satisfied that short-term projections broadly conform to standards set by other forecasting agencies both internationally and domestically. The Department provides 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 commonly agreed methodology to estimate trend supply-side variables was verified as at the time of the endorsement of the *SPU* projections. Although the Council endorsed the supply-side forecasts produced by the Department, this does not amount to an endorsement of the CAM as the most adequate approach for describing Ireland's cyclical position and potential output in the medium term. Due to the difficulties associated with estimating supply-side trend variables using the CAM as well as in linking these to actual forecasts, the Council's endorsement instead refers to the actual demand-side projections. The Council noted in its letter that work is underway by the Department to develop alternative approaches to potential output/output gap estimation and expects that further progress will be made in future.

Second, in terms of the pattern of errors in recent Department of Finance forecasts, the Council has previously pointed to some evidence of systematic bias related to the domestic and external split of aggregate demand (IFAC, 2015b). As detailed in Appendix F, this bias appears to have diminished in more recent periods, with revisions to historical data suggesting that patterns of bias may be more relevant for outer years (i.e., two years or more). The Council will continue to monitor the Department's forecast errors for the presence of any such bias.

Third, comparisons with the full set of Benchmark projections showed relatively modest deviations with the Department's own forecasts for 2015 and 2016 (Appendix Table A.1). Those forecasts of other agencies that had been updated to reflect the second quarter of national accounts data also showed relatively minor differences at aggregate level. The flow of high frequency economic data at the time of the endorsement was largely positive with respect to real growth. Price deflator projections, though high, were considered to be within a reasonable range.

3. ASSESSMENT OF BUDGETARY FORECASTS

KEY MESSAGES

- *Budget 2016* significantly raised public spending for the final months of 2015 relative to earlier plans contained in *Budget 2015* and the April 2015 *SPU*, even after allowing for an overrun in health. However, upward revisions to forecasts for tax revenues and lower debt servicing costs mean that the forecasts for the deficit and debt in *Budget 2016* are more favourable compared to earlier projections in *SPU 2015.*

- Tax receipts in 2015 have benefited from a substantial increase in corporation tax as well as more moderate gains in some other tax heads. While *Budget 2016* attributes the exceptional rise in corporation tax receipts in 2015 to improved trading conditions, there remains uncertainty over the underlying drivers of the strong performance of corporation tax this year. Corporation tax revenues are in excess of what could be explained by ordinary year-to-year improvements in the measure of profitability used by the Department of Finance.

- The forecasts for the public finances in *Budget 2016* are dependent on corporation tax continuing to grow off of its current, higher than expected, base and no further changes to expenditure ceilings set out in *Budget 2016*. Expenditure projections after 2016 explicitly provide for an additional €0.4 billion each year to cover demographic costs but do not fully incorporate the cost of providing current levels of public services in future years or possible tax changes in line with stated Government policy. As a result the projections for the budget balance in *Budget 2016* do not provide a useful picture of the fiscal position over the medium term.

- To illustrate the range of future deficit trajectories, this chapter estimates the deficit that would result from full use of the additional fiscal space available under the Expenditure Benchmark. It also compares the allowable expenditure growth under the fiscal rules to the estimated growth in expenditure necessary to accommodate future expenditure pressures. The analysis illustrates that accommodating spending pressures over the coming years would absorb a large proportion of the estimated fiscal space available after 2016. Further tax cuts would make it very difficult to fund expenditure pressures while complying with the rules.

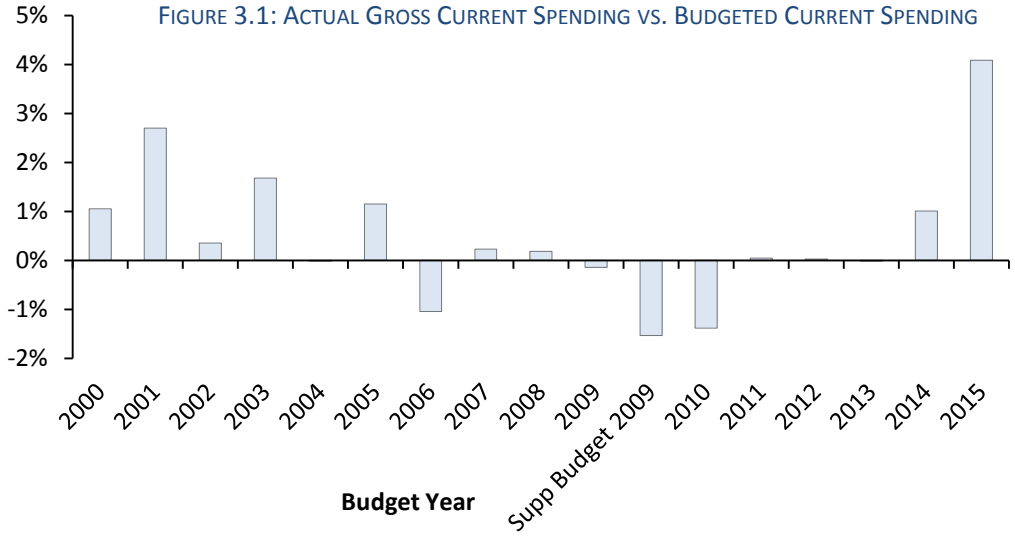
3.1 Introduction

As required under the Council's mandate, 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 2015. Section 3.3 assesses the forecasts for revenue and expenditure contained in *Budget 2016*. 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 Budgetary Projections for 2015

The deficit for 2015 is projected in *Budget 2016* to be 2.1 per cent of GDP. Revenues in 2015 are supported by exceptionally high corporation tax growth, along with more modest overshoots for the other tax heads. Some of these revenues are being used to reduce the 2015 deficit, but a substantial portion will be used to accommodate spending pressures and to facilitate new spending policies for this year.

Figure 3.1: Actual Gross Current Spending vs. Budgeted Current Spending

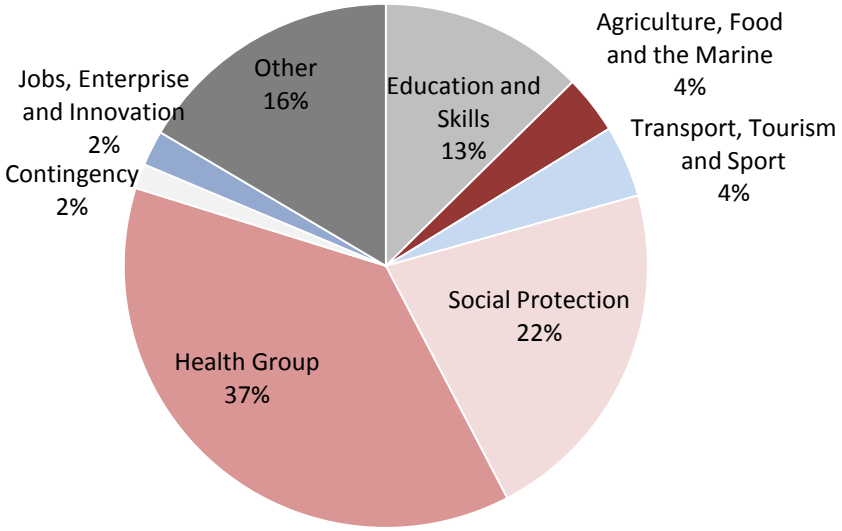


Source: Department of Finance.
Note: The figure compares the budgeted gross voted current expenditure (Exchequer basis) to the actual outturn. The *Budget 2015* gross voted current spending figure is adjusted to reflect the disestablishment of the HSE Vote.

Figure 3.1 shows that under the latest plans, current voted expenditure in 2015 will exceed projections at the time of *Budget 2015* by more than 4 per cent. This is the largest difference in over a decade. In 2014 there was a much smaller overrun of 1 per cent, which was largely as a result of an overrun in the health area. For 2015, health spending will again exceed its initial Budget allocation substantially, but the additional spending in this area will be added to by higher spending in other Departments which had previously stayed below or close to their expenditure ceilings. Capital expenditure was also revised up by €285 million for 2015 (8 per cent). Figure 3.2 shows

which sectors are absorbing the increase in expenditure for 2015 compared to the forecast in *Budget 2015*.

FIGURE 3.2: COMPOSITION OF CHANGE IN GROSS VOTED EXPENDITURE



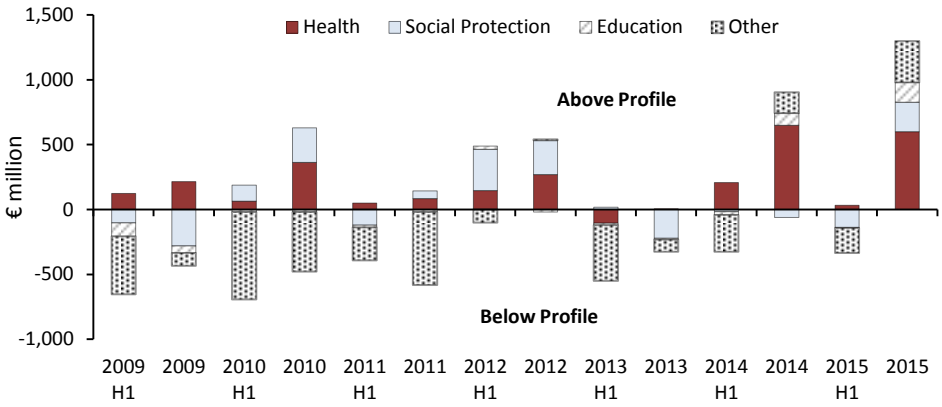
Source: Department of Finance.
Note: The figure compares the Budget 2015 gross voted expenditure (Exchequer basis) to the Budget 2016 estimate. The *Budget 2015* gross voted current spending figure is adjusted to reflect the disestablishment of the HSE Vote.

These spending overruns come just twelve months after the Government renewed its multi-annual expenditure ceilings in the *Comprehensive Expenditure Report 2015-2017* (*CER 2015-2017)*, which revised up expenditure ceilings in 2015 and 2016. The scale of the latest revision to the expenditure ceilings, and the upward revision to every expenditure ceiling outlined since the first *Comprehensive Review of Expenditure* in 2012, suggests that ceilings do not provide a reliable estimate of future spending.

BOX C: HEALTH EXPENDITURE IN 2015 AND IMPLICATIONS FOR FUTURE EXPENDITURE CEILINGS

The Council have previously drawn attention to the issue of spending on public health exceeding planned levels (IFAC, 2015). Until 2013, overruns in this area were largely offset at the aggregate level by below budget spending by other Departments (Figure C.1). However, in 2014 and 2015 net spending by all Departments exceeded the budgeted allocations by €0.8 and €1.3 billion.[28] The largest single source of these Exchequer overruns was the Health area, accounting for €647 million (77 per cent) in 2014 and a planned €600 (46 per cent) in 2015.[29]

FIGURE C.1 CUMULATIVE OVERRUNS IN EXCHEQUER EXPENDITURE: MID-YEAR VS END-YEAR



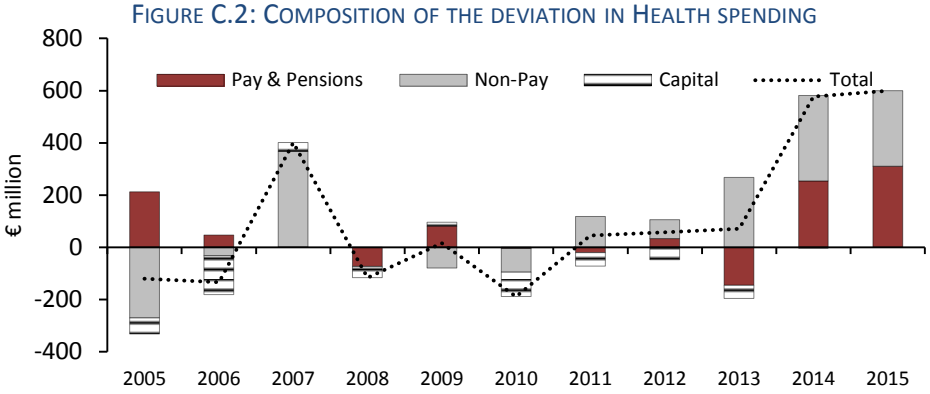
Source: Department of Finance, *Monthly Exchequer Returns.*
Note: These figures show Exchequer (net) Departmental expenditure as reported in the monthly Exchequer Returns. As gross expenditure has only been reported on a monthly basis since 2013 net expenditure provides a series for comparison.

For both 2014 and 2015, the overrun is divided broadly evenly between pay and non-pay expenditure, with pensions running slightly ahead of budget and capital spending on target (Figure C.2). Given that over 70 per cent of spending is in the hospitals area, this would indicate that much of the pay issue arises in this area. On the basis of the 2015 forecast outturns, health represents 99 per cent of the total Departmental pay overrun, but only 28 per cent of the non-pay. This seems to indicate specific problems with the Department of Health's pay budget that have not been resolved through the change in 2015 from a system of limits on staffing levels (the Employment Control Framework) to Departmental pay ceilings. These problems may arise from difficulties in implementing pay related reforms leading to higher average pay than expected, larger than planned staffing or a combination of both.

[28] The gross expenditure figure reflects expenditure by Departments and offices regardless of the source of funding. Exchequer expenditure, or net expenditure, is net of receipts received directly by Departments including the pension-related deduction, certain EU co-funding payments and pension contributions. It also excludes expenditure by the Social Insurance Fund and the National Training Fund financed through the 'own income' of the funds. The difference in 2014 is mainly accounted for by higher than expected PRSI receipts that reduce the Exchequer cost. Gross spending has only been reported on a monthly basis since July 2013.

[29] While the higher than budgeted spending among Departments may, to some extent, represent a policy decision reflecting the position relative to fiscal rules in 2015, it seems unlikely that significant savings will arise across Departments in future given the impact of a reduced base on permitted expenditure the following year (see Section 4.4).

FIGURE C.2: COMPOSITION OF THE DEVIATION IN HEALTH SPENDING



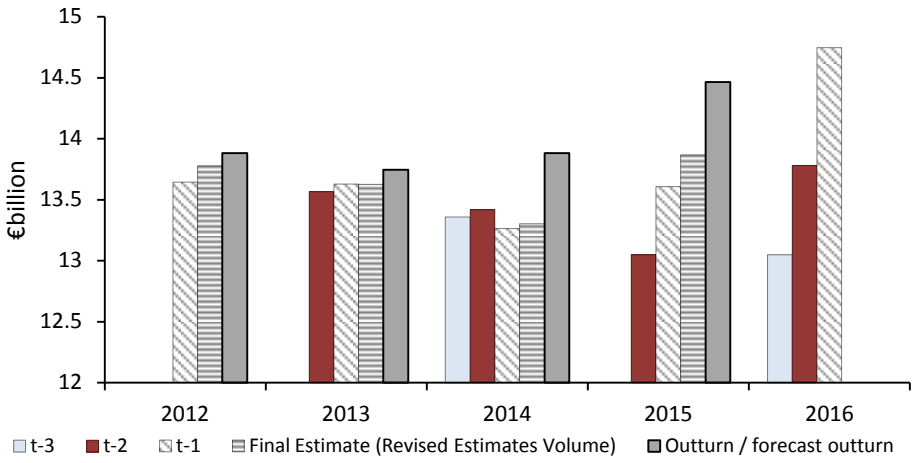
Source: Department of Public Expenditure and Reform databank and Revised Estimates for Public Services, various years.
Note: The deviation in health spending including both the Department of Health and the HSE. This may somewhat understate the extent of overruns as the Department of Health typically spends less than its budget allocation.

The majority of over-spending in recent years arose mainly in the hospitals and Primary Care Reimbursement Service (PCRS) areas. The latest HSE Monthly Performance Report for end-August shows that the largest deviations are again in these areas: a €122 million overrun in the hospitals area and €68 million in PCRS. The State Claims Agency, which is also under the remit of the HSE, was also running significantly ahead of profile by €61 million.

The potential negative feedback between poor budget setting and poor expenditure management now appears particularly marked in the health area, with expenditure overruns leading to significant upward revisions to future multi-annual ceilings.[30] In 2015, a €0.6 billion overrun is expected despite an upward revision of €0.8 billion from the initial ceiling for 2015 in *Expenditure Report 2014* (see Figure C.3). A continuation of this trend into 2016 would have implications for planning and managing expenditure within the budgetary framework.

[30] In relation to budget implementation, IFAC (2015) identified the 'soft budget constraint' (SBC) as a possible structural difficulty in managing health expenditure within the budget year. This theory posits that, notwithstanding *ex ante* threats to impose a hard constraint, the budget constraint is soft where the decision maker in control of day-to-day expenditure anticipates that the constraint is likely to be relaxed *ex post* if the original constraint is not met. Where the budget setting process is weak, this may further 'soften' the constraint as the manager – knowing plans are poorly set – has less of an incentive to adhere to them. The existence of a SBC may also weaken the budget planning process where budget allocations have been persistently exceeded in the past and led to ambitious targets being set.

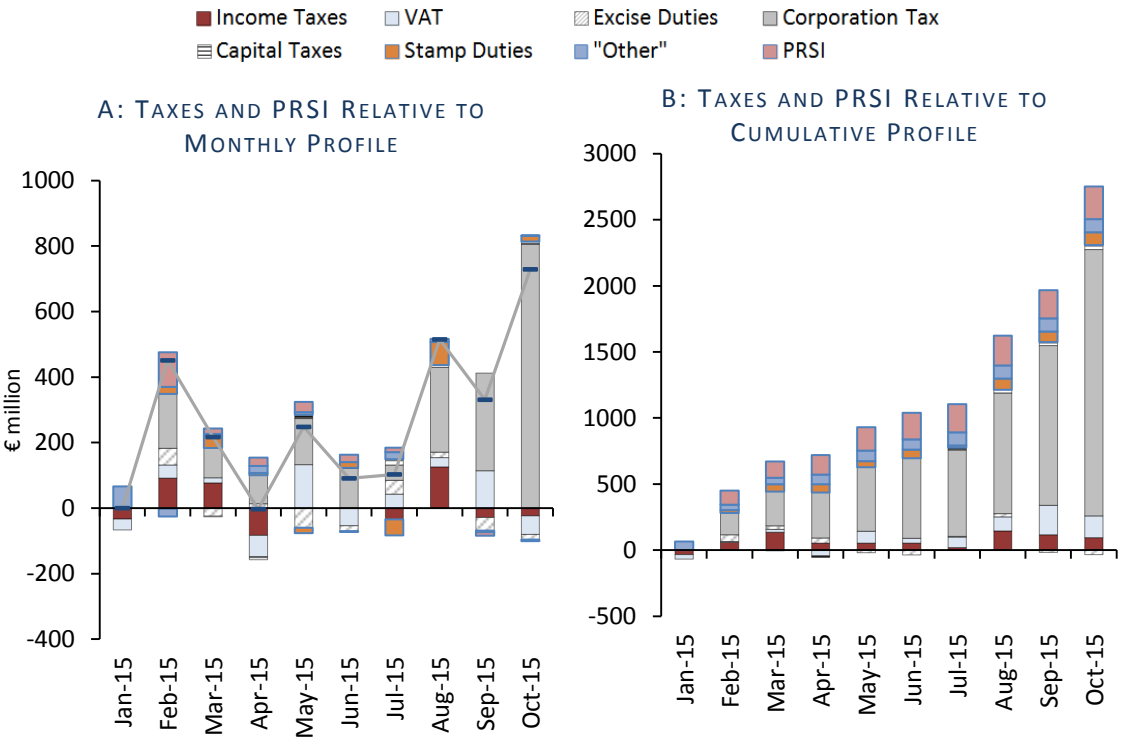
Figure C.3 Evolution of Health Multi-annual ceilings



Source: Comprehensive Expenditure Reports and Expenditure Reports, 2012 to 2016*,* Department of Public Expenditure and Reform *databank and Revised Estimates for Public Services* 2012 to 2015*.*
Note: The outturn figure for 2015 is the forecast outturn reported in *Budget 2016*. The ceilings and outturn from 2014 are adjusted for comparison puposes to reflect changes in the structure of Health spending that do not reflect changes in the actual level of expenditure. The Revised Estimates and outturn figures for 2014 and all subsequent figures are adjusted for the transfer of funding to the Department of Children and Youth Affairs. The Revised Estimates and outturn figures for 2015 and all subsequent figures are adjusted for the move to a net grant approach for the HSE arising from the merging of the HSE Vote into the Department of Health Vote in 2015.

Despite the significant additional spending in 2015, the deficit will likely be better than expected at the time of *SPU 2015* in April due to very high growth in tax revenues this year. Figure 3.3A shows how taxes have performed relative to the expected tax take in *Budget 2015* in each month, while Figure 3.3B shows how persistent overperformances each month have accumulated to leave taxes and PRSI for the year to end October €2.7 billion ahead of expectations. What is striking is the degree to which the tax overshoot is dominated by corporation tax – accounting for around 74 per cent of the overperformance in the year to date. Indeed if the corporation tax overperformance by end-October is maintained, corporation tax will likely exceed the revised *Budget 2016* expectation with implications for next year's forecast. Without this surge in corporate taxes, the tax overrun would be much more modest and would not have covered the extra spending announced for 2015.

FIGURE 3.3



Source: Department of Finance.
Note: These overruns are relative to Budget profile.

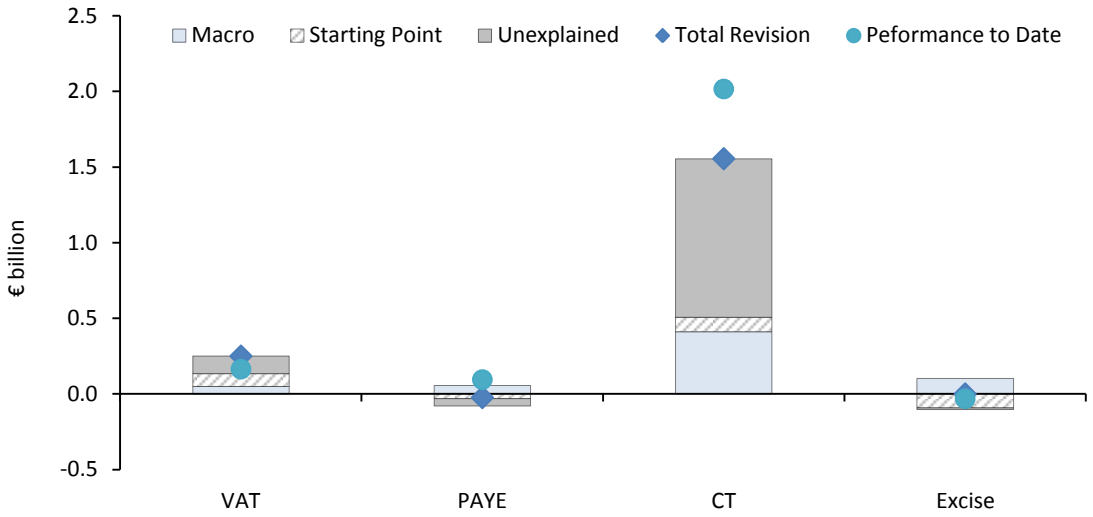
Source: Department of Finance.
Note: These overruns are relative to Budget profile.

Figure 3.4 shows how the four largest tax heads have been revised since *Budget 2015* and how much of this revision can be explained by either the Department of Finance's revised view of the economy (macro), or by the mis-estimation of the 2014 tax take in *Budget 2015* (starting point error). What remains is referred to as the 'unexplained' error.[31]

While the *Budget 2015* estimates for three of the four tax heads in Figure 3.4 look likely to have been broadly accurate, corporation tax was significantly underestimated in *Budget 2015*. Most of the revision to corporation tax cannot be explained by the revision to the macroeconomic aggregate used to forecast corporation tax (namely, gross operating surplus or 'profits') or the starting point error. The corporation tax overrun in 2015 is discussed further in Box D.

[31] These sources reflect the form of the tax forecasting equation. In general, the equation used is: Tt+1 =[(Tt + Carryovers from previous budgets)(1+CPI)] + New Measures+ One-offs + Judgement. It is errors arising from the three latter terms that cannot be identified *ex post*.

FIGURE 3.4: SOURCE OF REVISION TO 2015 TAX FORECAST FROM BUDGET 2015 TO BUDGET 2016



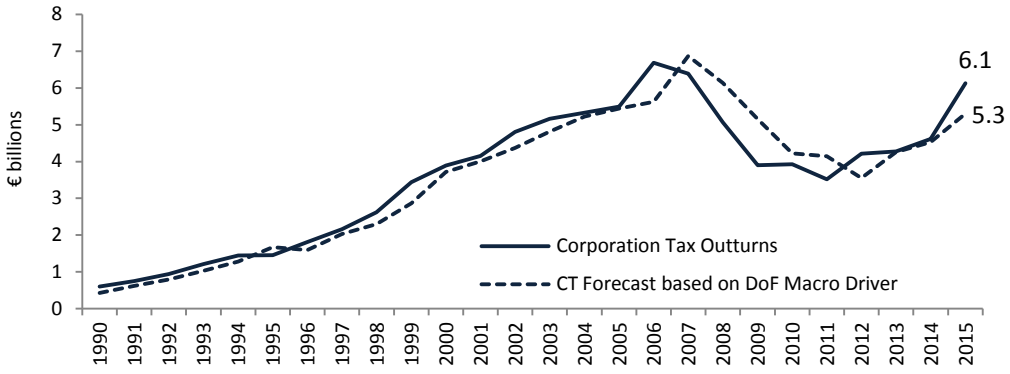
Source: Internal IFAC Calculations.

BOX D: CORPORATION TAX IN 2015

The latest Exchequer returns show that by the end of October 2015 receipts from corporation tax were just over €2 billion higher than expected by the Department of Finance in *Budget 2015*. The better than expected performance of this single tax heading accounts for three-quarters of the overall tax overperformance in 2015. This box examines the nature of the large forecast error for corporation tax in 2015.

One of the inputs used by the Department of Finance to forecast corporation tax receipts is Gross Operating Surplus (GOS) (or profits) from the National Income and Expenditure Accounts. The Department assume that annual changes in corporation tax receipts move in line with changes in GOS, before accounting for various one-offs and judgement factors that could impact the tax take. Figure D.1 shows the actual outturn for corporation tax receipts compared to the predicted outturn based on the Department of Finance's assumed relationship between trends in GOS and tax receipts before any judgmental/one-off issues are accounted for. The chart shows that although tax receipts predicted by GOS broadly track actual receipts, divergences between the two series are also evident over time. For 2015, the predicted outturn for corporation tax based purely on GOS is significantly lower than the expected actual outturn in *Budget 2016.* In *Budget 2016,* the Department revised up its estimate of the increase in GOS in 2015 to 15 per cent; however, this still leads to a predicted corporation tax outturn for 2015 around €0.8 billion lower than forecast in *Budget 2016.*

FIGURE D1: CORPORATION TAX OUTTURNS AND BASIC FORECASTS

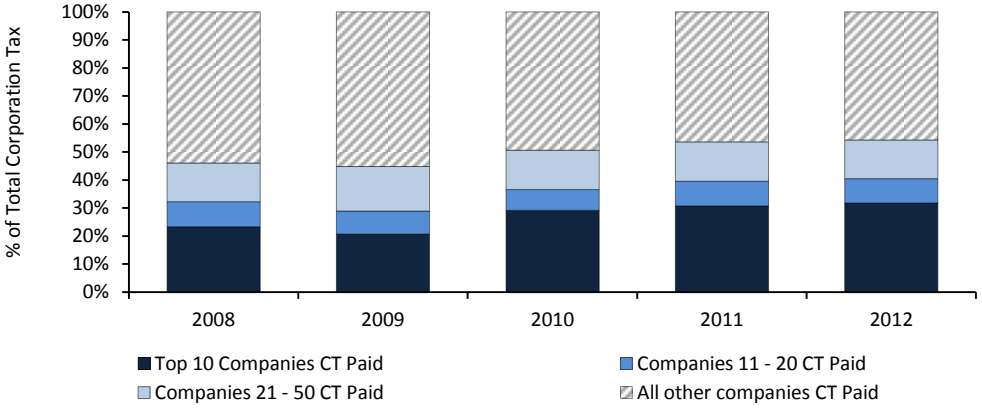


Source: Department of Finance; internal IFAC calculations.
Note: Outturn for 2015 is taken from *Budget 2016.*

Figure D.2 shows that around half of corporation tax is dependent on the profits of a relatively small number of companies. In 2012 – the latest year for which such data are available – 54 per cent of corporation tax was paid by the top 50 companies and this proportion has increased over time. It appears that a large proportion of the corporation tax overperformance in 2015 is due to Multinational Corporations (MNCs).[32] As a result of this concentration of tax receipts among a small number of companies, it is possible for growth in corporation tax to diverge from the broader National Accounts measure of profits (GOS) used by the Department of Finance to forecast corporation tax, as appears to have occurred in 2015. The Department believe that the return to pre-crisis levels for corporation tax in 2015 primarily reflects improved trading conditions and that the higher level of corporation tax receipts in 2015 will be carried forward into the tax base for 2016 and later years.

The highly concentrated nature of corporation tax receipts on its own raises risks to the Exchequer as company specific factors can impact the overall corporation tax yield. While the Revenue Commissioners have stated that the majority of the increase in corporation tax in 2015 is not due to one-off or windfall factors, further analysis of what is driving the apparent increase in the taxable profits of Irish resident companies for 2015 is necessary to determine the sustainability of the increase in corporation tax revenues this year.

FIGURE D.2: CORPORATION TAX: TOP 10, 20 & 50 CORPORATE GROUPS (% OF TOTAL PAYMENTS)



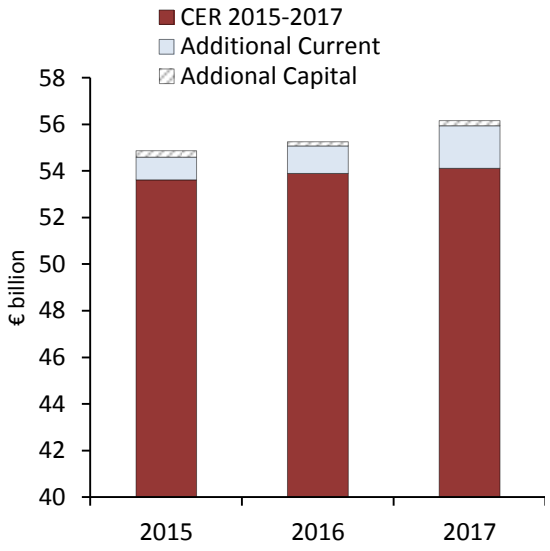
Source: Pigott and Walsh (2014); authors' analysis of Revenue data.

[32] https://www.kildarestreet.com/wrans/?id=2015-11-10a.316

3.3 *Budget 2016* Forecasts

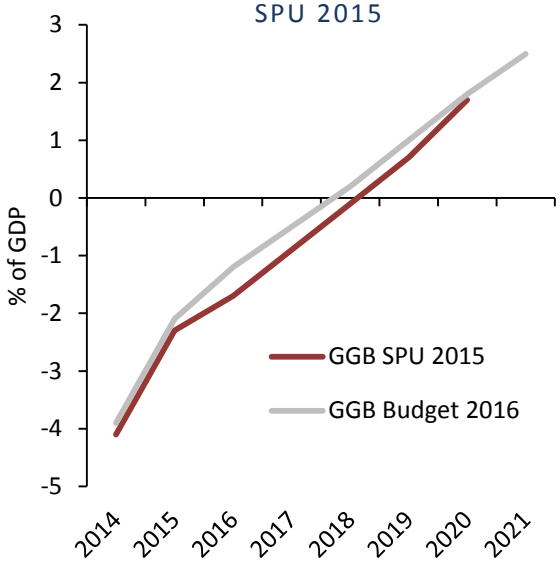
Despite expenditure being considerably higher over the period 2015-2021 compared to earlier projections (Figure 3.5), the forecast deficit path in *Budget 2016* has improved relative to the projections in *SPU 2015*. There are a number of factors driving the improved forecast for the budget balance over the forecast horizon. Cyclical revenue gains from strong economic growth will improve the balance, supported by lower than expected debt servicing costs. Department of Finance tax revenue forecasts are also boosted by the assumption that tax rates are not reduced after 2016 (despite commitments to reduce some taxes in *Budget 2016*), along with the assumption that the recent increase in corporation tax represents a permanent upward level shift to corporation tax receipts in 2015.

Figure 3.5: Additions to Gross Voted Expenditure



Source: Department of Finance.
Note: CER refers to the Comprehensive Expenditure Report published alongside *Budget 2015*.

Figure 3.6:General Government Balance Under Budget 2016 and SPU 2015

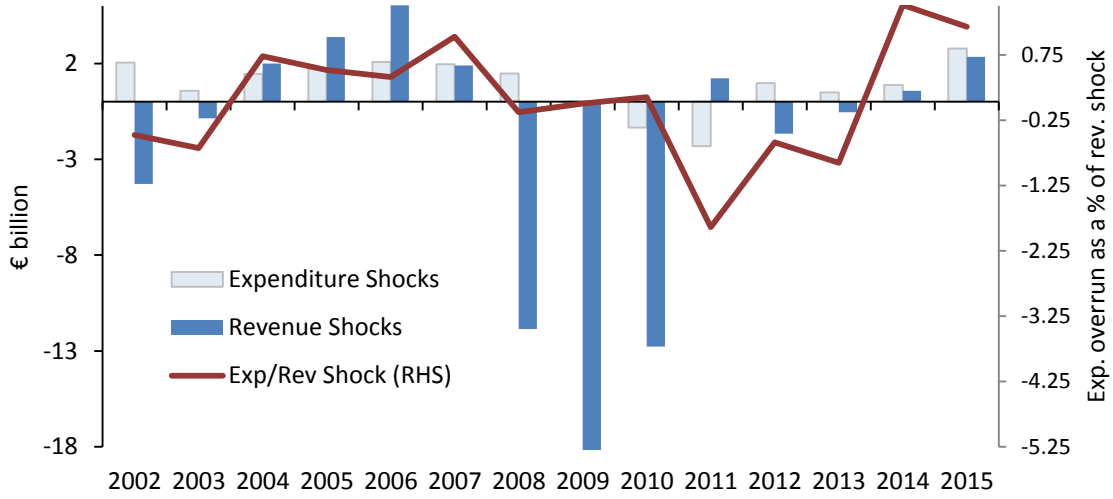


Source: Department of Finance.

A further issue for forecasts of the budget balance is the credibility of expenditure ceilings and the fact that, for the outer years in particular, the projections do not accommodate known expenditure pressures or other policy commitments. The forecast for the General Government balance after 2016 assumes adherence to expenditure ceilings. However, as discussed in Chapter 4, the system of expenditure ceilings is not being operated effectively and the ceilings have been revised upwards continuously since their introduction. Unless the problem of continuous upward revisions to previously announced expenditure ceilings is addressed, the forecasts in *Budget 2016* likely overstate the improvement in the deficit as expenditure overruns are likely to re-occur.

Based on past experience in Ireland, higher expenditure over the medium term is more likely when revenue exceeds expectations. The red line in Figure 3.7 shows the proportion of unexpected revenue (relative to the forecast in the Budget for the previous year) that is used to fund expenditure overruns in the current year, while the bars show the nominal amounts of expenditure overruns. The graph shows that large expenditure overruns tend to correlate with positive unexpected revenue gains. However, it is important to note that this likely understates the true degree of procylicality, given that the automatic stabilisers imply that spending falls as tax revenues rise.

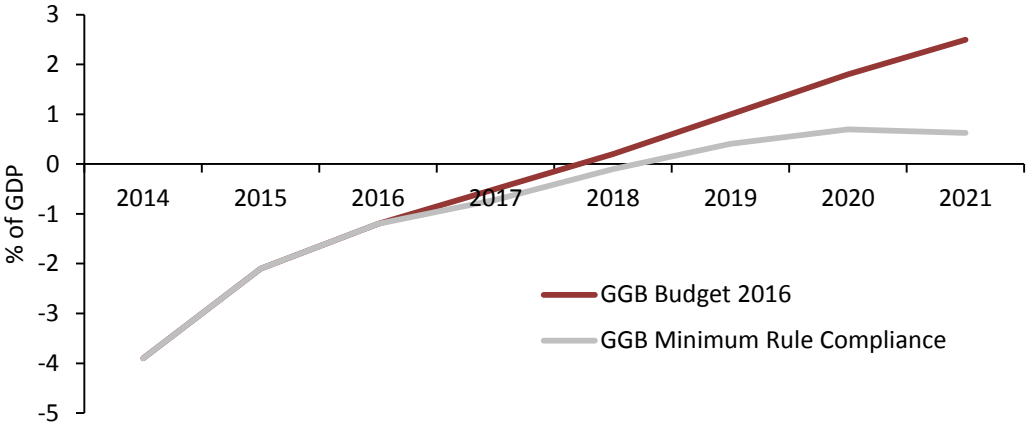
FIGURE 3.7: RELATIONSHIP BETWEEN REVENUE OVERSHOOTS AND EXPENDITURE OVERRUNS



Source: Internal IFAC calculations
Note: Expenditure and Revenue Shocks are taken as the difference between the outturn in a given year ,t, and the forecast in the Budget for year t-1. For example, shocks in 2014 are calculated as the outturn for 2014 minus the forecast for 2014 contained in *Budget 2013*For 2015, the *Budget 2016* expectation is treated as an outturn.

The deficit projections in *Budget 2016* imply overcompliance with the requirements of the fiscal rules despite the stated Government intention to target minimum compliance (see chapter 4). As a result, the fiscal forecasts in *Budget 2016* leave room for spending increases or tax reductions while meeting the minimum requirements of the rules. *Budget 2016* outlines how much fiscal space (as defined by the Expenditure Benchmark rule) will be available to the Government for additional budget measures in each year from 2017-2021. Figure 3.8 illustrates an alternative path for the government balance based on a scenario where the Government uses all the available fiscal space in each year, keeping all other forecasts and assumptions unchanged. In this scenario the budget surplus in 2021 reaches 0.6 per cent of GDP as opposed to the 2.5 per cent surplus projected in *Budget 2016.*

FIGURE 3.8: DEFICIT SCENARIO WHERE ALL FISCAL SPACE IS USED

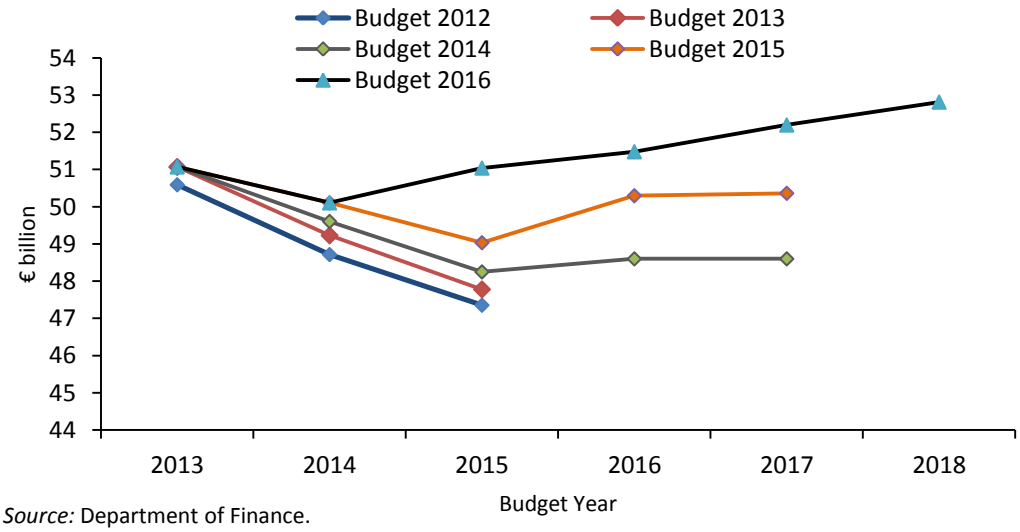


Source: Budget 2016 and internal IFAC calculations.
Note: "GGB Budget" is the General Government Deficit in *Budget 2016.* "Minimum Rule Compliance" shows the adjusted deficit assuming the fiscal space under the EB as identified in *Budget 2016* is used.

EXPENDITURE

The introduction of expenditure ceilings does not appear to have constrained spending, particularly for spending more than one year ahead. The importance of proper implementation of expenditure ceilings and the consequences of persistent upward revisions to the ceilings has been discussed in the Council's previous Fiscal Assessment Reports (IFAC, 2015b. 2014b). Figure 3.9 shows how expenditure ceilings have consistently been revised upwards as the year in question draws nearer.

FIGURE 3.9: CHANGES TO CURRENT EXPENDITURE CEILINGS



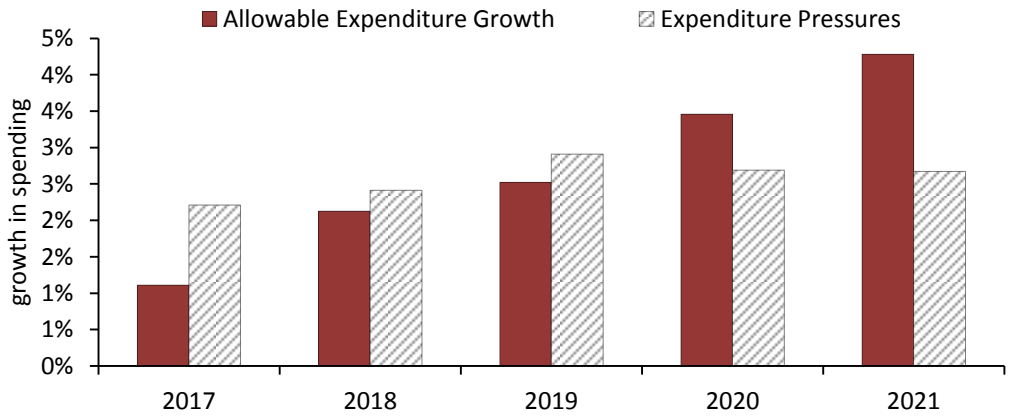
Source: Department of Finance.

Since the forecasts imply overcompliance with the rules, the profile for spending in *Budget 2016* is below the maximum allowable spending level under the Expenditure Benchmark rule. Under the

rules, this fiscal space can be used for either tax cuts or increased expenditure. The Council has previously raised concerns over the extent to which the Government's medium-term expenditure plans incorporate foreseeable expenditure pressures.

The *June 2015 Fiscal Assessment Report* provided an illustrative scenario showing how expenditure may need to rise faster than Government projections in order to maintain the existing level of public services and accommodate likely spending pressures. Figure 3.10 updates this scenario (see Box E) and compares the estimated expenditure growth necessary to accommodate spending pressures to the allowable expenditure growth when there are no new tax changes and all of the space under the rules is used for additional spending. The analysis illustrates that meeting likely future expenditure needs would absorb the majority of the estimated fiscal space available after 2016. Further tax cuts would make it very difficult to fund these expenditure pressures while complying with the rules.

Figure 3.10: Estimated Expenditure Pressures Compared With Allowable Expenditure Growth



Source: Internal IFAC calculations.
Note: Expenditure pressures are estimated under the assumptions outline in Box E. Allowable expenditure refers to expenditure growth that would be compliant with the Expenditure Benchmark. The calculation of allowable expenditure growth assumes indexation of the income tax system. If the Government decides not to fully index income tax bands, this would create additional fiscal space.

BOX E: ILLUSTRATIVE MEDIUM-TERM EXPENDITURE SCENARIO

This Box updates the medium-term scenario for government expenditure contained in IFAC's June 2015 *Fiscal Assessment Report.*[33] 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.

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 until 2018 in the public sector are assumed to grow in line with the increases contained in the June 2015 *Lansdowne Road Agreement.* Thereafter, public sector pay is assumed to grow in line with non-agricultural wages. 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 macroeconomic 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.[34] 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.

CAPITAL EXPENDITURE

[33] The construction of this scenario broadly follows the methodology set out in Barrett (2006).

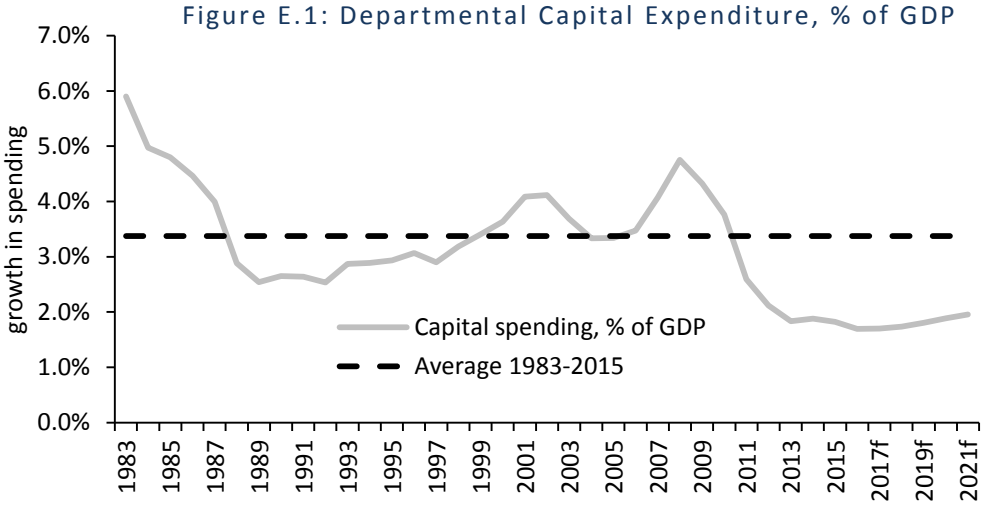
[34] This approach can be summarised as follows:

$$\mathrm{UB}_{t+1} = \mathrm{UB}_t + (\mathrm{LR}_{t+1} - \mathrm{LR}_t) * \mathrm{LRC}_t + (\text{New policy measures}) + \mathrm{J}_{t+1}$$

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.

The scenario uses the projections for capital spending over the medium term as set out in *Budget 2016.* The forecasts for capital spending in the Budget are based on the Government's *Infrastructure and Capital Investment Plan 2016-2021* announced in September 2015. Figure E.1 shows the path of capital expenditure as a share of GDP under the new plan. The forecasts imply a small rise in capital spending by the end of the decade; however, the chart shows that capital spending is projected to remain at very low levels by historical standards over the forecast horizon.

Figure E.1: Departmental Capital Expenditure, % of GDP

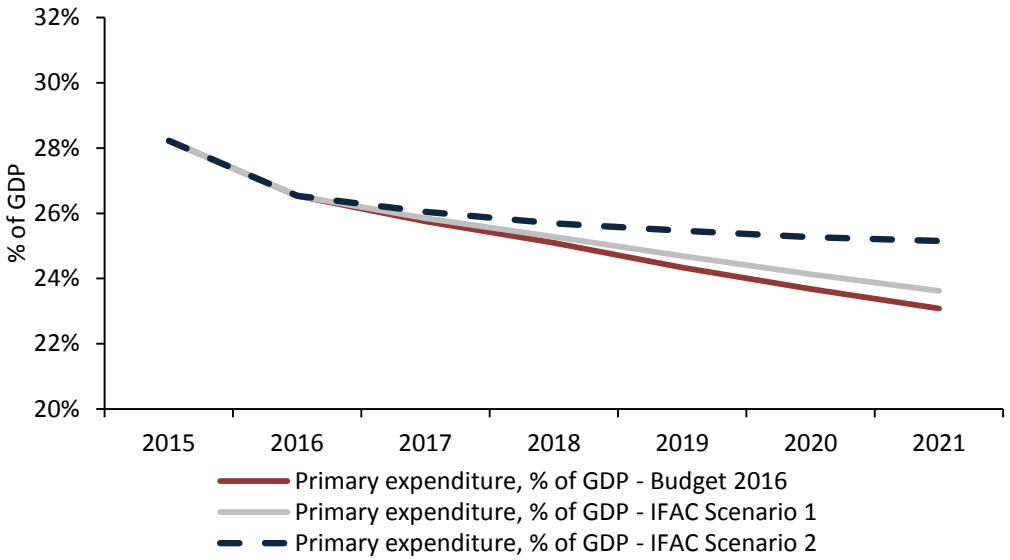


Source: Budget 2016, Budget and Economic Statistics (Department of Finance).

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 *Budget 2016*, multiplied by the average interest rate. The 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.

FIGURE E.2: COMPARISON OF PRIMARY EXPENDITURE UNDER ALTERNATIVE SCENARIOS



Note: Scenario 1 allows for demographic change with no indexation. Scenario 2 allows for demographic change plus indexation.
Source: Internal IFAC calculations.

Figure E.2 shows how the illustrative scenario is built up. Firstly, adjustments for demographics are included; then provisions for increases in the cost of providing public services are made through indexation. The results in Figure E2 show that allowing only for demographic costs and the current public service pay agreement out to 2018 (Scenario 1) returns a spending profile broadly in line with the *Budget 2016* projections. The Budget forecasts include approximately €0.4 billion per annum of spending increases for demographic pressures. Allowing for demographics and accommodating estimated increases in the cost of providing public services over time (Scenario 2) would result in expenditure being significantly higher than projected in *Budget 2016*. Primary government expenditure as a share of GDP would be around 2 percentage points of GDP higher by 2021 compared to the projections in *Budget 2016.*

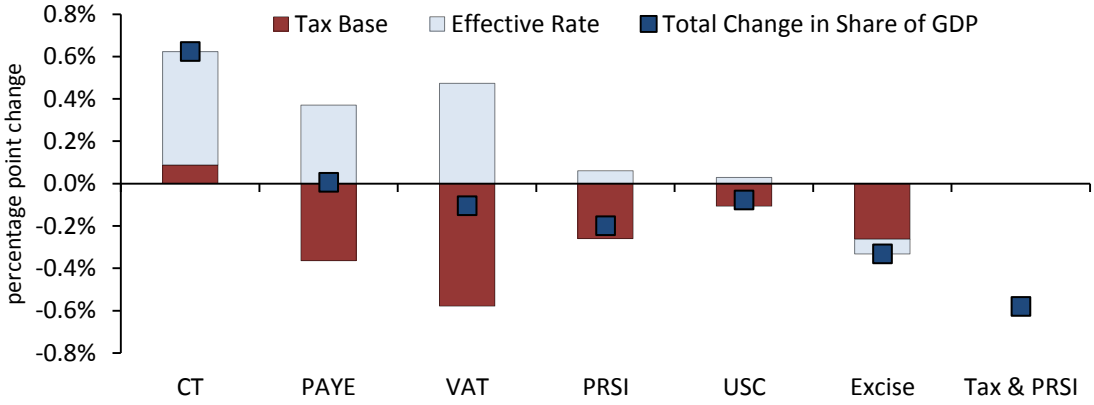
REVENUE

Reflecting the improved macroeconomic environment, tax revenues have been revised upwards in *Budget 2016* and are expected to grow broadly in line with nominal GDP from 2015-2021. Figure 3.11 shows how the tax-to-GDP ratio is expected in *Budget 2016* to evolve between 2014 and 2021. The chart decomposes the forecast changes into shifts in the implied effective rate of tax and the impact of the tax base growing faster or slower than GDP. The chart shows that corporation tax is the only tax heading that is forecast to grow as a share of GDP. This is only partially explained by growth in profits (as measured by gross operating surplus). Since corporation tax is growing faster than profits, this implies that the effective rate is increasing.[35]

[35] Where tax revenues grow faster than their tax base, the effective rate of tax on that base is said to increase, even where no change in policy has occurred.

For all other tax heads, tax bases are forecast to grow more slowly than GDP which, all else being equal, will cause the tax-to-GDP ratio to fall. Low projected growth of PAYE revenues reflects low wage growth relative to GDP in the short term. In some cases, such as PAYE, this effect is partly offset by a rising implied effective rate. Since this suggests that PAYE is growing faster than wages, it is consistent with some level of fiscal drag as nominal wages rise and individuals drift into higher tax brackets. However, as discussed below, the *Budget 2016* forecasts for PAYE assume that the tax bands are indexed to growth in non-agricultural wages.

FIGURE 3.11: SOURCES OF CHANGE IN TAX-TO-GDP RATIO 2014-2021



Source: IFAC internal calculations.
Note: Chart shows change in share of GDP due to performance of tax base relative to GDP growth, and due to changes in the effective rate of tax. Although not strictly a tax, PRSI is included in the calculation.

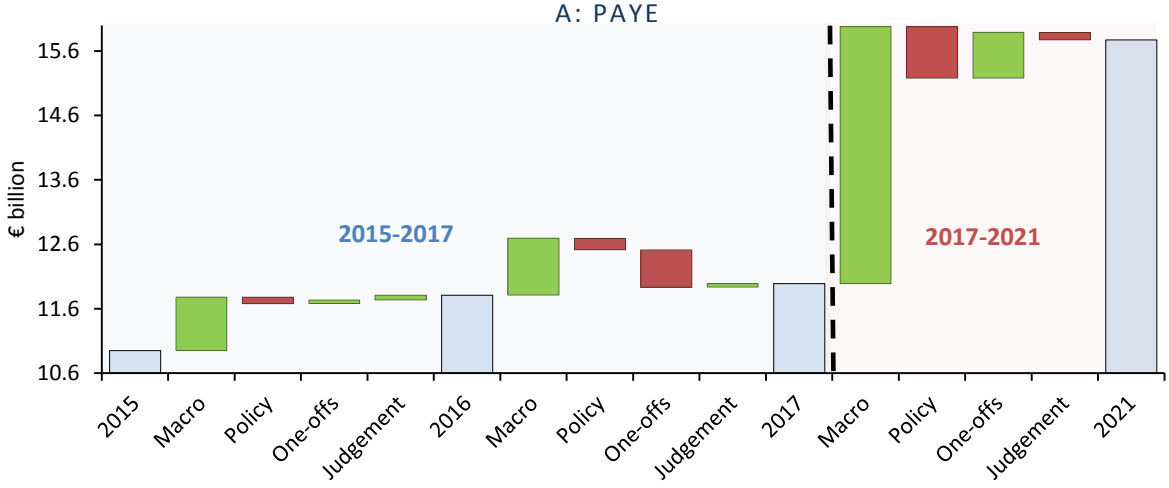
Figure 3.12 shows the most important factors influencing the *Budget 2016* forecasts for the four largest tax heads. In each case, the forecasts for 2016 and 2017 are shown separately while the forecasts for 2017-2021 are shown cumulatively. The floating bars show the size of the increase in taxes due to that source. For each tax head the 'macro' component – the rise in taxes due to growth in the tax base – is the largest source of tax growth. In the case of PAYE, the chart shows that policy - here in the form of assumed indexation of tax bands to wages - reduces the tax take in all years. As shown in Figure 3.11, however, this has not been sufficient to stop the apparent rise in the effective rate, suggesting that some level of fiscal drag is still present in the forecasts.

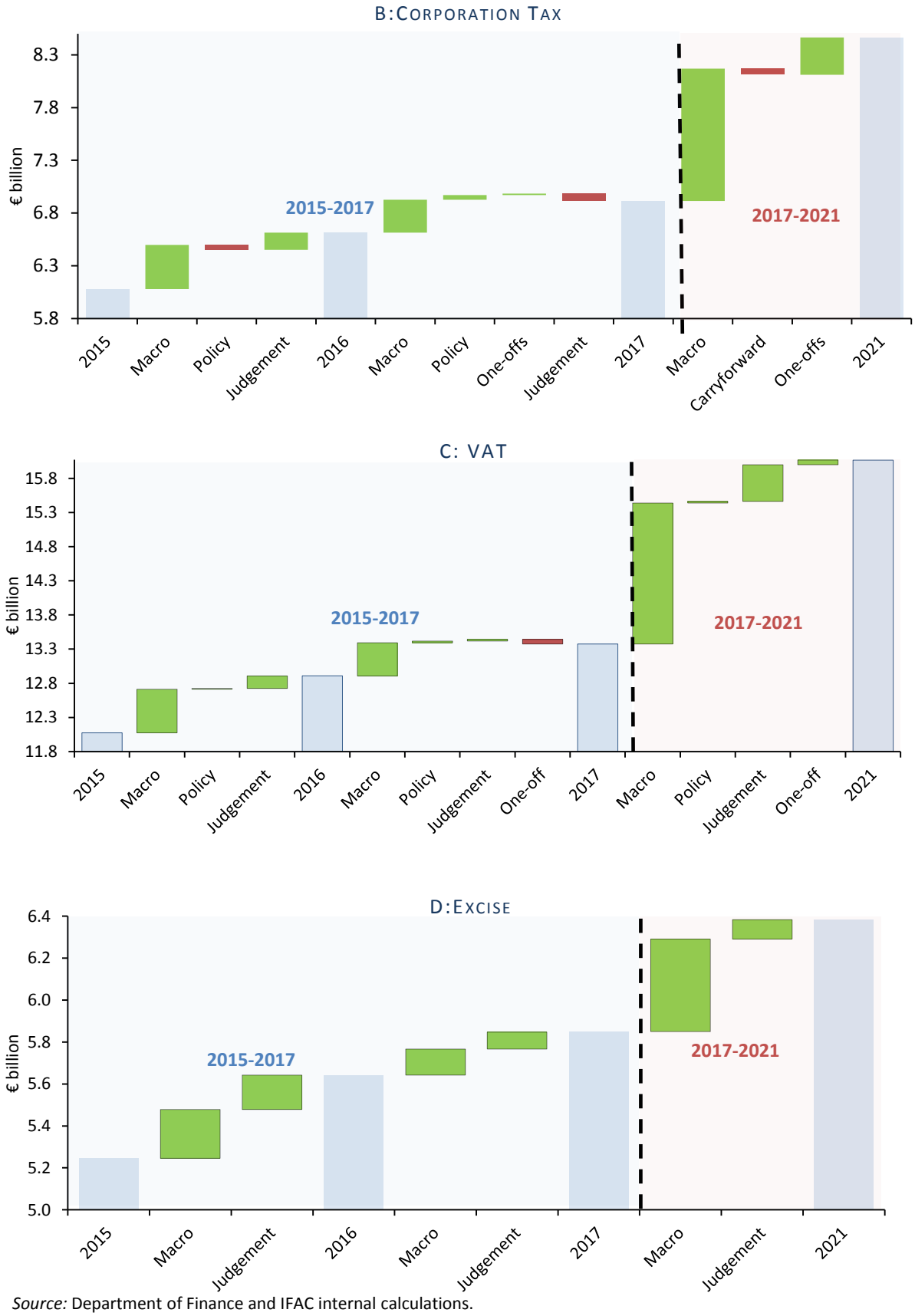
One key assumption used in these forecasts is that the response of taxes to growth in the macro/tax base does not change over time. If it is the case that certain taxes are more responsive during cyclical upswings, then it may be appropriate to use judgement to boost the tax forecast over and above what is expected on the basis of growth in the tax base alone.

For corporation tax, the Department of Finance have used judgement to increase their forecast for this tax head over the projection period. This reflects an assumption that while taxes will again

grow faster than implied by the growth in profits in 2016, the divergence will be much smaller than in 2015. The forecast for 2016 and later years assumes that the large rise in corporation taxes in 2015 will not be reversed in 2016 so that there has been a level shift upwards in tax revenue this year. It should also be noted that the sources of growth shown in Figure 3.12b are built on top of the estimated 2015 tax take. As noted above, however, it is likely that the *Budget 2016* estimate of tax revenues for 2015 will be exceeded.

FIGURE 3.12 A-D
A: PAYE





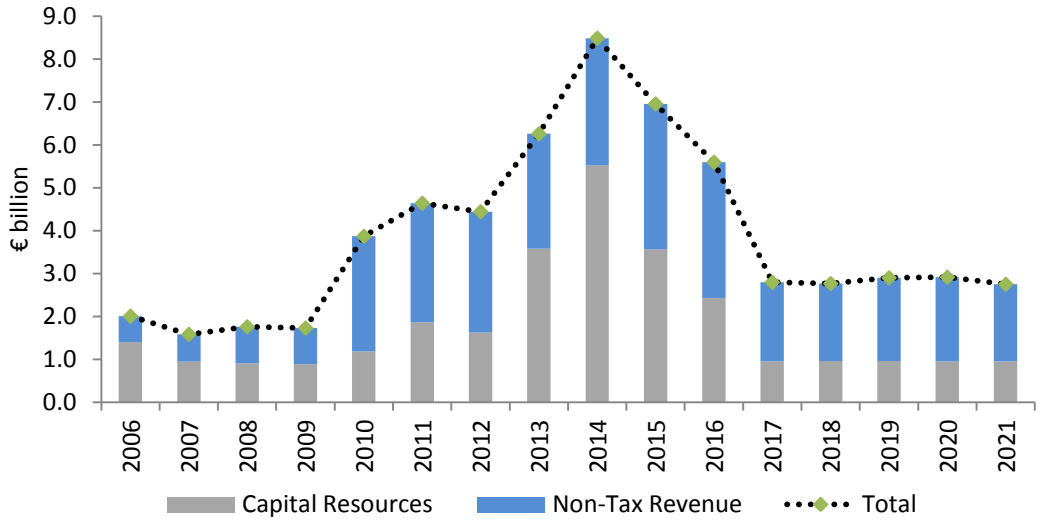
Source: Department of Finance and IFAC internal calculations.
Note: Floating bars show transition from the tax take between years specified. Green implies a positive contribution from that source, red implies a negative contribution.

In relation to non-tax revenue, Central Bank surplus income is expected in *Budget 2016* to fall by €130 million in 2016. In addition, the portion of Central Bank income considered 'non-entrepreneurial' will increase so that the contribution of Central Bank surplus income to General Government revenue is expected to fall by over €400 million.[36] However, these non-entrepreneurial incomes will still reduce the Exchequer Borrowing Requirement (EBR). The Exchequer is projected to benefit from the dividends of semi-states over the forecast horizon. Dividends are expected to rise modestly in 2016 but this is on foot of income from Ervia which is considered non-entrepreneurial and so does not benefit General Government revenues. Non-tax revenues are expected to decline after 2016 as these exceptional incomes are expected to be smaller from 2017 (Figure 3.13).

Income from capital resources is also forecast to fall after 2016 as a result of the assumption that no further disposals of bank assets occur. This assumption in *Budget 2016* is made on the basis of uncertainty over the precise timing of the disposals. However, the disposal of bank assets is likely to continue over the forecast horizon. The value of the State's various holdings in AIB, BoI and PTSB is estimated in *Budget 2016* at €15 billion (or c.5 per cent of 2021 GDP), although this is subject to market conditions. If this amount was realised, it could reduce the debt-to-GDP ratio compared to the projections in *Budget 2016*. Additional upside risks emanate from possible surpluses from the IBRC liquidation and the wind-down of NAMA (currently estimated to be €1.75 billion) which could be used to reduce the debt GDP ratio in the coming years.

[36] Entrepreneurial income excludes the proceeds of sales of assets or the distribution of revaluation gains.

FIGURE 3.13: NON-TAX REVENUE AND CAPITAL RESOURCES, 2006-2021



Source: Finance Accounts and *Budget 2016,* Department of Finance.

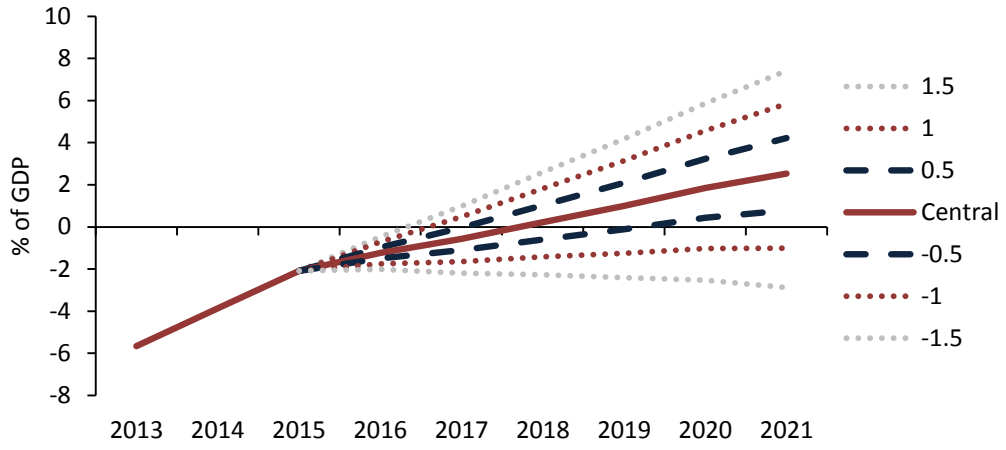
3.4 RISKS

GROWTH

Over the medium term, the attainment of a zero deficit by 2018 and surplus from 2019 onwards 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 for given spending and tax plans. 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 3.14A and 3.14B, below. Typical errors around the Department of Finance's nominal GDP growth rates are just under 2 percentage points.[37]

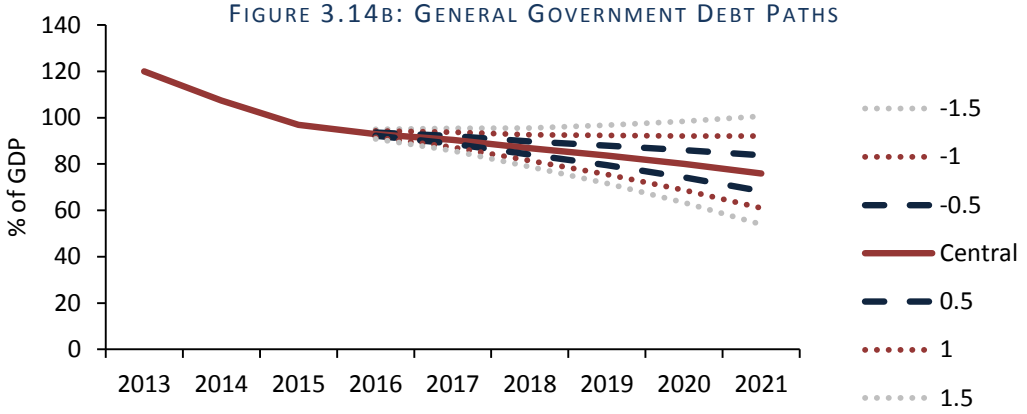
[37] Typical forecast error refers to the Root Mean Square Error of the Department of Finance's forecast for the current year.

FIGURE 3.14A: GENERAL GOVERNMENT BALANCE PATHS



Source: Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.
Note: The Figure shows alternative projections of the General Government Balance based on GDP growth forecasts that deviate from *Budget 2016* projections by 0.5, 1.0 and 1.5 percentage points in either direction.

FIGURE 3.14B: GENERAL GOVERNMENT DEBT PATHS



Source: Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.
Note: The Figure shows alternative projections of the General Government Balance based on GDP growth forecasts that deviate from *Budget 2016* projections by 0.5, 1.0 and 1.5 percentage points in either direction.

Under the assumption of no change in policy, the model indicates that in a mildly adverse scenario of growth disappointing by 0.5 percentage points each year, the attainment of a surplus would be delayed until 2019 without some scaling back of commitments and the size of the surplus in 2021 is considerably smaller. As a result, debt levels do not fall as quickly and the debt-to-GDP ratio remains above 80 per cent in 2021. In a scenario where growth disappoints by 1.5 percentage points over the medium term, the deficit does not close and actually begins to widen slightly. The corresponding path for debt shows the debt-to-GDP ratio returning to 100 per cent of GDP by 2021. These scenarios illustrate how what are, in the context of past forecast errors, relatively minor disappointments in growth, but if sustained over a number of years, can lead to the public

finances being returned to a much more fragile position or more difficult policy choices having to be made.

On the other hand, while current projections already envisage strong economic growth from 2016, forecasts for growth in the Irish economy in recent years have proven to be too pessimistic. Faster growth than projected in *Budget 2016* would see the deficit eliminated by 2017 with larger surpluses and reductions in the debt than contained in *Budget 2016* from 2018-2021. In the most optimistic growth scenario shown in Figure 3.14b, debt levels fall below 60 per cent of GDP by 2021.

TABLE 3.1: RISK ASSESSMENT MATRIX FOR MAIN DOWNSIDE RISKS

Risk	Relative Likelihood	Impact
Corporation Tax Risk	H	The dependence of Ireland on a small number of MNCs with large corporation tax contributions has increased. The significant unanticipated increase in corporation tax receipts in 2015, coupled with the decision to boost the level of spending in 2015 on foot of this increase, raises risks to the public finances.
Expenditure Control	H	Cost management problems and budgetary overruns remain in the health area. Without an effective system of domestic expenditure ceilings, there is a risk of a return to continuous upward revisions to spending based on positive short-term macroeconomic and fiscal developments. If this risk materialised, the expenditure projections in *Budget 2016* would likely prove to be an underestimate of actual future spending levels.
Contingent Liabilities	L	As measured, contingent liabilities have declined considerably in recent years, now standing at 13.3 per cent of GDP in 2014. Most of this relates to the Eligible Liabilities Guarantee on deposits and remaining exposure to NAMA. Other contingent liabilities do exist, however, in the form of implicit guarantees to support the banking sector and callable collateral in various international organisations. The most significant is the obligation to contribute additional capital in the case of a default on the European Stability Mechanism by a programme country.
Interest Rate Risks	L	While the interest rate environment remains benign, the recent past has demonstrated how quickly this can change due to events that may be outside of the State's control. Shocks to the interest rate facing the Irish State could aggravate the risk of the state slipping into a "bad equilibrium" where higher interest costs can trigger default fears that are self-fulfilling in that they lead to an increased risk premium, pushing interest rates higher still until the State is 'locked out' of bond markets. Mitigating this risk is the fact that 92 per cent of Ireland's current debt is at fixed interest rates and that a budget surplus is expected to emerge in 2018.[38] Nonetheless, another global recession or financial crisis could have the potential to disrupt Ireland's economic recovery, widen the deficit and see a return of the dangerous debt dynamics of the recent past.

[38] Comptroller and Auditor General, (2015).

4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

KEY MESSAGES

- The projected 2.1 per cent deficit for 2015 presented in *Budget 2016* should lead to a successful correction of the excessive deficit under the Excessive Deficit Procedure (EDP).

- The domestic Budgetary Rule will also be met for 2015. Adhering to the requirements of the EDP is sufficient for the Budgetary Rule to be met for both 2014 and 2015. The annual improvement in the measured structural balance projected in *Budget 2016* is 0.8 per cent of GDP in 2016. If achieved, this would comply with the required change of 0.6 per cent of GDP set in spring of this year under the Preventive Arm of the Stability and Growth Pact (SGP) and would also meet requirements for the domestic Budgetary Rule.

- The projected change for 2016 in government spending adjusted for discretionary revenue changes only just complies with the Expenditure Benchmark (EB), leaving no margin for overruns. The European Commission assessment of *Budget 2016* points to a risk of some deviation from the EB. The latest increase to planned Departmental expenditure in 2015 requires an additional upward revision to the Government's own expenditure ceilings, further undermining their multi-annual character. Previous *Fiscal Assessment Reports* have documented a persistent pattern of budgetary overruns in health spending. Recognising the weakness of the domestic expenditure ceilings in controlling spending, there are risks to compliance with the EB in 2016 in the absence of a buffer. The domestic framework should be strengthened to support medium-term expenditure planning and execution.

- One of the challenges to the European fiscal governance system is the increasingly complex design of the fiscal rules. Given that these rules continue to evolve, simplifying the framework is likely to be a medium- to long-term objective. It is essential, therefore, that the methodologies, definitions and processes underpinning the complex rules be made public prior to the national 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 Government's plans as contained in *Budget 2016* with these fiscal rules. The immediate target for fiscal policy is the correction of the excessive deficit within the Corrective Arm of the *Stability and Growth Pact* (*SGP*) in 2015. As outlined in Section 4.2, correcting the excessive deficit this year ensures that the requirements of both the domestic and European frameworks are met.

Having corrected the excessive deficit, Ireland will move into the Preventive Arm of the *SGP* in 2016, with consistent requirements set under the domestic Budgetary Rule. Requirements applying to both the structural balance and to annual growth in government expenditure are assessed under these rules in Section 4.3.[39]

Section 4.4 examines the domestic Medium-Term Expenditure Framework (MTEF), particularly the performance of the Government and Ministerial expenditure ceilings. This chapter also includes a box on the process of setting and assessing compliance with fiscal targets under the preventive arm of the *SGP*.

4.2 Excessive Deficit Procedure Exit

Under the Excessive Deficit Procedure (EDP) Ireland's General Government deficit must be lower than the 3 per cent of GDP ceiling for 2015. The correction must be undertaken in a sustainable manner so that the deficit is expected to adhere to this ceiling into the medium term. Given the *Budget 2016* projected deficit of 2.1 per cent of GDP in 2015, this ceiling will likely be met with a buffer, particularly in light of the larger than expected post-Budget increases in tax revenues discussed in Chapter 3.[40,41] Furthermore, *Budget 2016* shows a future path for the General Government deficit that is consistent with a sustainable correction. A sustainable correction is also

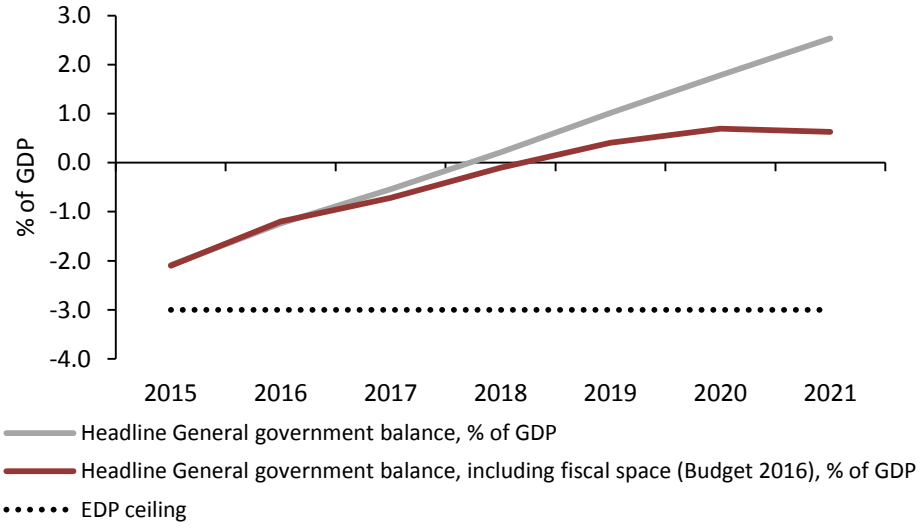
[39] While the Council's formal requirement to assess (*ex post*) compliance with the Budgetary Rule is backward-looking in nature, the mandate of the Council to assess the fiscal stance suggests considering compliance on a forward-looking basis also.

[40] The latest EC assessment of *Budget 2016* (EC, 2015e) shows the deficit remaining below this ceiling for 2016 and 2017. However, the EC note that decisions taken in 2015 are not in line with the EU Council's EDP recommendation that windfalls be used to accelerate deficit and debt reduction. Furthermore, this assessment indicates that effective action was not taken in respect of the required aggregate improvement in the structural balance.

[41] While the excessive deficit is likely to be corrected in 2015, a decision of the EU Council is required to formally end, or 'abrogate' an EDP following the improvement of the budget deficit to less than the 3 per cent of GDP ceiling. This assessment is based on "notified", i.e., outturn data provided by countries as part of the Maastricht Returns the following year. The sustainability element is assessed by reference to EC fiscal forecasts. For all countries that entered an EDP after November 2011, compliance with the debt criteria is also required, including in its forward-looking specification. As Ireland entered an EDP prior to the November 2011, reform of the *SGP* this second requirement does not apply in the abrogation assessment.

robust to the use of an adjusted deficit estimate that allows for full use of the fiscal space available under the rules, as identified in *Budget 2016*.[42]

FIGURE 4.1 SUSTAINABLE CORRECTION OF THE EXCESSIVE DEFICIT



Source: Budget 2016 and internal IFAC calculations

Following the recent reforms to the *SGP* the structural balance path set under the Corrective Arm (the EDP) must now be consistent with the minimum requirements under the Preventive Arm of the SGP. This approach is designed to smooth the transition between the Corrective and Preventive Arms of the *SGP* and would avoid pro-cyclical fiscal policy adjustments where a country is experiencing strong growth while in an EDP. As Ireland entered an EDP prior to the reforms an annual structural balance path was not set as part of the EDP. However, had these revised criteria been in force for Ireland this year, the scope for additional expenditure increases would likely have been curtailed.

Following a successful correction of the excessive deficit at end-2015, transition arrangements under the Debt Rule will apply for the next three years – until the end of 2018 – before the normal requirements of the Rule begin to apply.[43] These requirements – related to the Corrective Arm of the SGP – are not anticipated to present a binding constraint on fiscal policy over the medium term as the projected pace of reduction of the debt-to-GDP ratio is significantly faster than required under the Debt Rule.

[42] Table A.8 in *Budget 2016* estimates available fiscal space under the EB. This is incorporated into the General Government Balance estimates shown in Figure 1.

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

4.3 COMPLIANCE WITH THE BUDGETARY RULE

The Budgetary Rule is a key pillar of the domestic fiscal framework.[44] The domestic Budgetary Rule effectively mirrors the SGP and so will reflect requirements under the Preventive Arm once the excessive deficit has been corrected in 2015. The Fiscal Responsibility Act 2012 (FRA) identifies two ways of meeting the requirements of the Budgetary Rule. The 'budget condition' is met where the medium-term budgetary objective (MTO) is achieved. If a country is not at its MTO, the 'adjustment path condition' requires that the structural balance must be on an appropriate adjustment path towards it.[45] The assessment of this adjustment focuses on the change in the structural balance but also considers expenditure growth by reference to the EU Expenditure Benchmark (EB).

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 (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.[46]

4.3.1 *EX POST* AND IN-YEAR ASSESSMENTS FOR 2014 AND 2015

The requirements under the Budgetary Rule are legally satisfied by meeting the EDP targets for both 2014 and 2015. Consequently, on the basis of figures in *Budget 2016,* the Budgetary Rule is met for 2014 and is forecast to be met with a buffer for 2015.

Compliance with the relevant fiscal rules in 2015 required only that the deficit be below the 3 per cent of GDP ceiling in line with the EDP. However, it is notable that, following the significant upward revision to spending in 2015 since *Budget 2015*, neither the change in the structural balance nor expenditure growth under the EB would have met the required improvements under the Preventive Arm had they applied.[47]

[44] The Budgetary Rule has been in force since its legal commencement on 31 December 2012 following the ratification of the Fiscal Treaty (http://www.irishstatutebook.ie/pdf/2012/en.si.2012.0522.pdf).

[45] In procedural terms, the *Fiscal Responsibility Act 2012* specifies that the Budgetary Rule is respected where the structural balance is "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 where the fiscal requirements set out under the EDP are met.

[46] 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.

[47] 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 wider analysis of the fiscal stance for 2015.

4.3.2 *Ex Ante* Assessment of 2016 to 2021

The *ex ante* assessment of the Budgetary Rule for 2016 and for later years focuses on the speed of structural deficit improvement towards meeting Ireland's Medium-Term Objective (MTO), and also includes an analysis of expenditure growth using the Expenditure Benchmark (EB). Box F presents the key procedures to set these requirements.

Box F: Setting Fiscal rules in the Preventive Arm of the SGP

This box summarises the procedures for setting the key fiscal targets under the Preventive Arm of the *SGP* and highlights some of the main issues related to their assessment. To a large extent processes governing the operation of the European rules have been made public through, for example, the *Vade Mecum on the Stability and Growth Pact* (EC, 2013) and subsequent clarification documents. At a national level, the *Medium-Term Budgetary Framework* (Department of Finance, 2014) document outlined the operation of the domestic framework. However, there remain a number of procedures that have not yet been published in detail, some of which can have significant impacts on the interpretation of the rules. The approach to 'freezing' minimum fiscal requirements under the rules at the time of the spring assessment has yet to be formally published despite being key to establishing the fiscal parameters for *Budget 2016*.[48] While giving a broad overview of the Preventive Arm, this box focuses mainly on the more recent developments to the framework, the details of which have yet to be formally made public by the EC.

The **Medium-Term budgetary Objective** (MTO) is a structural balance target that aims to (i) provide a safety margin against the EDP limit, (ii) ensure the sustainability of public debt, and (iii) allow room for manoeuvre particularly for investment needs. The MTO is set by Member States every three years but is subject to a minimum MTO calculated by the EC. This minimum MTO formalises the three aims of the MTO (see IFAC, 2013).[49] The minimum MTO is due to be revised before the end of this year but aspects of the calculation have yet to be finalised and published. The final MTO to be targeted for the 2017 to 2019 period will subsequently be decided by Government and published in next year's *SPU*. The EC allow a range of ±0.25 per cent when assessing whether countries have reached the MTO to allow for uncertainties in estimation.

If a country is not yet at its MTO the *SGP* requires that fiscal policy ensure an **appropriate change in the structural balance toward MTO**. Under the Fiscal Compact, the standard structural balance adjustment for a country not at MTO is an annual improvement of 0.5 per cent. However this adjustment is varied according to country specific economic conditions, the debt level and fiscal sustainability.

The various possible annual improvement requirements are formalised in the matrix published by the EC on 13 January 2015, and are presented in Figure F.1.[50] The planned adjustment is set out by countries in their annual *SPUs* and subsequently assessed by the EC. Countries with a debt of greater than 60 per cent of GDP must improve their structural balance by an annual amount greater than 0.5 per cent of GDP in normal economic times. This requirement for an

[48] The failure to publish details of the approach to 'freezing' targets in Spring of each year has also been specifically noted by the Advisory Division of the Dutch Council of State (see *Budget Supervision September Report 2015 of the Advisory Division of the Council of State*, 14 September 2015 (W06.15.0305/III/B).

[49] A key input into this minimum MTO is the analysis undertaken by the EU Economic Policy Committee's Ageing Working Group.

[50] The EC publication (EC, 2015a) *Making best use of the flexibility within the existing rules of the Stability and Growth Pact* is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52015DC0012.

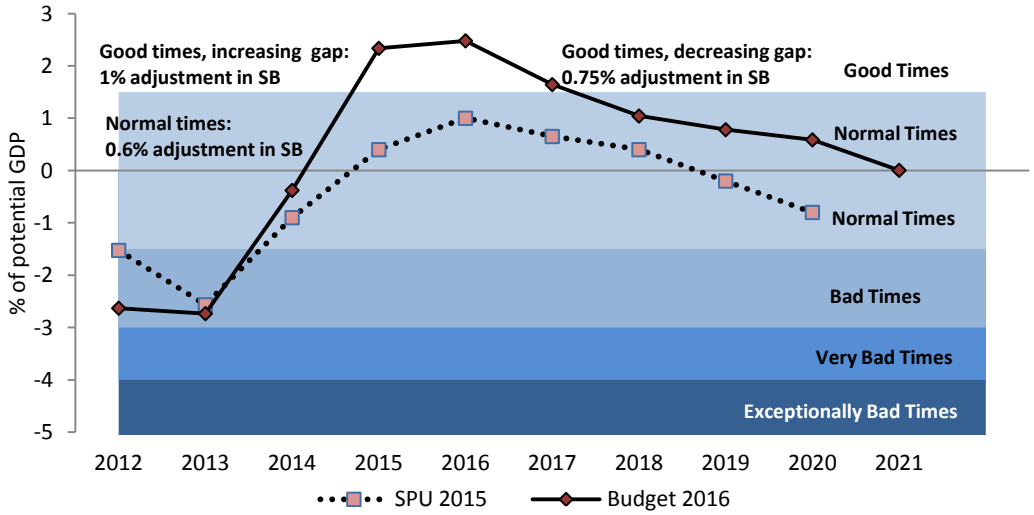
improvement of greater than 0.5 percentage points has been operationalised within EC assessments as at least 0.6 percentage points.

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 ≤ output gap < -3	0	0.25
Bad times	-3 ≤ 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 ≤ 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

The structural balance adjustment as defined in the matrix above is effectively frozen based on the EC spring forecasts and sets the minimum requirement in all subsequent assessments of that year, including the subsequent Budget and for *ex post* assessments. For example, the minimum required structural balance improvement of 0.6 percentage points for the change between 2015 and 2016 that was set based on EC Spring 2015 Forecasts provides the basis for assessing compliance for 2016 now and in the future. However, the revised estimate of the output gap in *Budget 2016* implies this would have increased to 1 per cent in the absence of the 'freezing' requirement.[51]

FIGURE F.2 REVISION TO OUTPUT GAP ESTIMATES
SPU 2015 AND *BUDGET 2016*



Note: The figures above relate to a country with a debt-to-GDP ratio of greater than 60 per cent.
Source: IFAC presentation based on EC publication *Making best use of the flexibility within the existing rules of the Stability and Growth Pact*

[51] The EC's latest forecast (EC, 2015c) is for an output gap of 1.3 per cent in 2016 (published in their Autumn 2015 Forecasts in November 2015) and would mean the economy remains in 'normal times'.

The choice of freezing the target at spring rather than the autumn assessments in the year prior to the budget year implies a greater emphasis on the need for certainty over the benefits of incorporating more up-to-date information in setting budget targets. This 'freezing' treats upward and downward revisions to the output gap differently as it can allow for a slower improvement in the structural balance but not for any increase.[52] The details of this 'freezing' procedure have not yet been formally made public by the EC.

The **Expenditure Benchmark** complements the adjustment path assessment with an analysis of expenditure growth. While it was originally reset every three years, it is now reset on an annual basis. Details of this new procedure have yet to be made public by the EC. Consistent with the structural balance adjustment, the permitted real expenditure growth rate for the following year is set based on the EC Spring forecasts. The real expenditure growth rate is set using a reference rate calculated using a forward and backward looking ten year average of potential growth. Where a country is not at its MTO, a convergence margin is applied based on the required annual adjustment in the structural balance.

In calculating allowable nominal growth the GDP deflator is applied to the volume growth allowed under the rule to achieve a nominal spending figure. This is calculated for the following year using an average of the spring and autumn EC forecasts and this averaged deflator is fixed or 'frozen' for all subsequent assessments. There remains some uncertainty surrounding the nominal permitted rate of expenditure growth when the budget is announced as the EC's autumn forecasts are typically published the following month. For a small open economy such as Ireland's, changes in the terms of trade arising from exchange rate developments can have a large impact on the GDP deflator. This may cause significant fluctuations to allowed expenditure growth under the EB that are not appropriate to sustainable and prudent fiscal management. This later issue will be considered by the Council in its analysis of the EB as part of the *ex post* assessment of the Budget Rule.[53]

Complexity and transparency

Eyraud and Wu (2015) recently concluded that one of the main challenges to the European fiscal governance system is the increasingly complex design of the fiscal rules. Given that these rules continue to evolve and their design is subject to constraints, simplifying the framework is likely to be a medium- to long-term objective. However, to minimise this perceived complexity, the methodologies, definitions and processes underpinning the rules must be published. An announcement by the EC on 21 October goes some way to addressing concerns about transparency in the operation of the *SGP.* Positive developments in this regard are the announcement that the *Vade Mecum on the Stability and Growth Pact* is to be updated annually and furthermore that the EC will share the data underpinning its surveillance decisions with Member States, national Fiscal Councils and, following consultation with

[52] Where economic conditions are seen to worsen between the Spring and Autumn assessments such that the revised output gap is less than -3 per cent or less ('very' or 'exceptionally bad' times), the required adjustment would reflect the more up-to-date lower structural balance requirement. Furthermore, where data has been revised so that the Autumn assessment indicates the MTO has been met, this assessment will prevail over the frozen requirements. In either of these cases where a later assessment indicates a higher adjustment should have been required, the lower 'frozen' requirement prevails. However, the EC have indicated it would be desirable for a country in such a position to step up the pace of adjustment towards MTO in their budgets.

[53] For example, if the EB applied in 2015, the deviation based on the average of the EC's Spring and Autumn 2014 Forecasts would be 0.8 per cent of GDP. Applying the latest GDP deflator estimate for 2015 and leaving all other things equal would imply additional space under the EB of 0.4 per cent. While the scale of this change is unusual it demonstrates the importance of the GDP deflator in setting nominal expenditure growth under the EB.

Member States, with the public.[54]

If there is to be full ownership of the fiscal framework at a national level, then information key to setting budgetary targets must be available prior to the national budget process. This would remove any ambiguity related to the status of procedures. The timely publication of information is particularly important given EC plans, also outlined on 21 October, to simplify the EU framework without changing its legal basis, which will lead to further procedural changes in future.

Structural Balance path and the MTO

The revisions to the structural balance in 2016 between *SPU 2015* and *Budget 2016* are largely as a result of upward revisions to potential output due to the pro-cyclical nature of its estimation. These revisions increase the structural balance as a share of GDP while changing the annual improvement in the structural balance in 2016 from 0.3 in *SPU 2015* to 0.8 percentage points of GDP in *Budget 2016*.

Table 4.1 Summary of Structural Balance and Components, *Budget 2016*

% change unless stated	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP growth, %	5.2	6.2	4.3	3.5	3.2	3.1	3.0	2.9
Headline General Government balance, % GDP	-3.9	-2.1	-1.2	-0.5	0.2	1.0	1.8	2.5
One off temporary measures, % of GDP [a.]	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Cyclical budgetary component, % Pot GDP	-0.2	1.2	1.3	0.9	0.6	0.4	0.3	0.0
Estimated using: Potential GDP growth, % Pot GDP	*2.7*	*3.4*	*4.1*	*4.3*	*3.8*	*3.3*	*3.2*	*3.5*
Output gap, % Pot GDP	*-0.4*	*2.3*	*2.5*	*1.6*	*1.0*	*0.8*	*0.6*	*0.0*
Structural budget balance [a.]	**-3.9**	**-3.4**	**-2.6**	**-1.4**	**-0.3**	**0.6**	**1.5**	**2.5**
Annual change in the structural budget balance	*0.3*	*0.5*	*0.8*	*1.1*	*1.1*	*0.9*	*0.9*	*1.1*
Two year average	1.5	0.4	0.7	1.0	1.1	1.0	0.9	1.0

[a.] The one-off and temporary measures presented here have been adjusted following discussions with the Department of Finance, with consistent adjustments to structural balance figures.

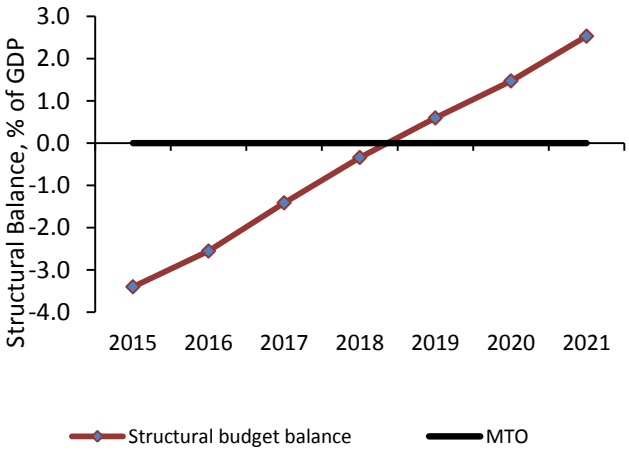
At 2.6 per cent of GDP the 2016 structural balance – as measured by the EU harmonised approach – is below the current MTO of a structural balance and does not fulfil the 'budget condition' of the Budgetary Rule. However, the measured annual improvement of 0.8 percentage points of GDP exceeds the required change in the structural balance of 0.6 percentage points of GDP for 2016 set in spring and ensures the Budgetary Rule is complied with on an *ex ante* basis.

[54] As set out in the October 21 2015 Economic and Fiscal Governance Proposals. See http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/communication-emu-steps_en.pdf

Figure 4.2 compares the structural balance path to the requirements for the structural balance under the Budgetary Rule to 2021.[55] While the 2016 fiscal requirements are now set, some uncertainty remains for subsequent years in the forecast horizon. For 2017 the *ex ante* required change in the structural balance would increase to 0.75 percentage points of GDP based on the EC 'matrix', as Ireland's output gap is projected to be 1.6 per cent. While the main structural balance path presented in *Budget 2016* would comply with this tighter requirement in 2017, the margin would be lower with this stricter requirement.[56] The required adjustment for 2017 will be formally set based on the EC spring 2016 output gap forecasts. While a fiscal forecast is provided to 2021 in *Budget 2016,* it is technical in nature (see Chapter 3).

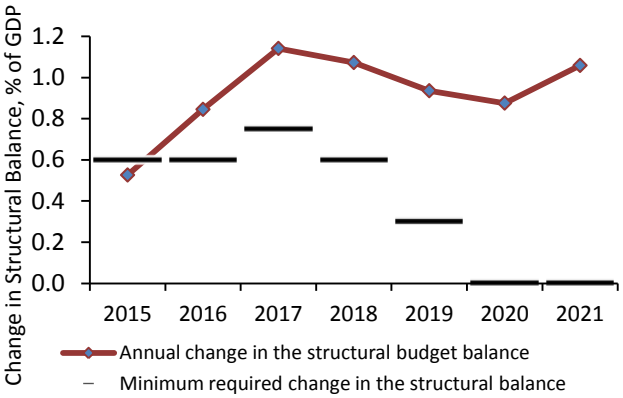
FIGURE 4.2: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE

A. BUDGET CONDITION



Note: The current Medium Term Budgetary Objective (MTO) for Ireland is a structural balance.
Source: Budget 2016, Department of Finance.

B. ADJUSTMENT PATH CONDITION



Note: The current 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 from that year. The required changes above are calculated based on the structural balance from the previous year. If the minimum adjustment was undertaken for the whole period the MTO would be achieved in 2020, a year later than planned in *Budget 2016*.
Source: Budget 2016, Department of Finance.

The MTO structural balance requirement will be revised in spring 2016 for 2017 to 2019. The MTO to be targeted for these years will be set by Government in *SPU 2016* (see Box F). Based on a preliminary estimation, the minimum MTO requirement may be a deficit of up to 0.5 per cent of GDP. While this estimate is subject to change following data updates and revisions, a loosening of

[55] The path of minimum compliance is calculated on an annual basis by reference to the structural balance path published in *Budget 2016*. It assumes that the structural deficit of 2.6 per cent forecast in *Budget 2016* is met, and that a 0.75 per cent improvement is required in 2017 given *Budget 2016* output gap estimates. An improvement of 0.6 per cent adjustment then applies in 2018. To meet the MTO, without exceeding requirements, an improvement of 0.3 percentage points is required in 2019. Once MTO has been achieved no further improvements are required. If a policy of meeting only minimum compliance were followed for all years from 2016, this would imply that a structural balance would be achieved in 2020, a year later than planned in *Budget 2016*.

[56] The EC's Autumn 2015 Forecasts, published in November 2015, estimate that the output gap will be 0.3 per cent in 2017, leaving the economic position in 'normal times' and requiring a structural balance an adjustment of 0.6 percentage points of GDP.

minimum MTO appears likely. In reaching a decision regarding setting the actual MTO for 2017 to 2019 in the next SPU the Government should also have regard to factors excluded from the formal calculation of the minimum MTO.[57]

EXPENDITURE BENCHMARK

Signals from the EB are an important complement to the structural balance in assessing the adjustment path, as deterioration of the underlying balance may be masked by revenue windfalls not sufficiently captured in the official estimate of the structural balance. Table 4.2 sets out the detailed calculations for the EB and the assessment of the EB for 2016 to 2021 on the basis of the main *Budget 2016* fiscal projections.

The estimated tax revenue buoyancy arising from the *Budget 2016* package, which had been provisionally included by the Department of Finance as a discretionary measure for 2016 in *SPU 2015*, has been dropped from the calculation in *Budget 2016*. Indexation of income tax is assumed to reduce revenues in future years.[58] The Council is satisfied that these issues, which arose in the assessment of *SPU 2015,* have been addressed appropriately in *Budget 2016*.[59]

[57] For example, the debt-to-GDP ratio is a key consideration when setting the MTO, however for Ireland a more appropriate measure may be the debt-to-GNP or a hybrid measure as proposed by the Council (IFAC, 2012b). Furthermore, in Ireland's case the measure of potential output – used in the estimates of long-term economic growth - is subject to a great deal of uncertainty (see IFAC, 2015a).

[58] As indexation of income tax is assumed, if the Government decides not to fully index income tax bands to wage growth this would create additional fiscal space.

[59] Other discretionary revenue measures include the carryover impact of *Budget 2015* and *Budget 2016,* which are included in the following year in both cases reducing discretionary revenues. Additional, more minor discretionary changes to revenue include revenues from additional compliance and anti avoidance measures arising from increased resources to the compliance function of the Revenue Commissioners and changes to property tax rates where this has been decided by Local Authorities.

TABLE 4.2: CALCULATION OF THE EXPENDITURE BENCHMARK, 2016 AND 2017

	2015	2016	2017	2018	2019	2020	2021
Expenditure Benchmark (limit of real expenditure growth):		**0.1** [a.]	**0.3**	**1.0**	**1.2**	**3.4**	**3.5**
Reference Rate of potential Growth, %		*1.9*	*2.8*	*3.1*	*3.3*	*3.4*	*3.5*
Less Convergence Margin, %		*1.8*	*2.5* [b.]	*2.1*	*2.1*	*2.2*	*2.2*
Assessment of Compliance with Expenditure Benchmark:							
a. General Government Expenditure, €bn	**73.8**	**74.1**	**75.0**	**76.0**	**76.9**	**77.6**	**78.3**
b. Less Interest Expenditure, €bn	*6.7*	*6.6*	*6.7*	*6.7*	*6.7*	*6.7*	*6.4*
c. Less Gross Fixed Capital Formation adjustment, €bn [c.]	*0.5*	*0.4*	*0.2*	*0.2*	*0.6*	*0.6*	*0.6*
d. Less Cyclical unemployment expenditure, €bn	*-0.3*	*-0.4*	*-0.3*	*-0.3*	*-0.4*	*-0.6*	*-0.4*
e. Less Government expenditure co-financing EU funding, €bn	*0.4*	*0.4*	*0.5*	*0.5*	*0.5*	*0.5*	*0.6*
f. Corrected expenditure aggregate = (a-b-c-d-e), €bn	**66.5**	**67.0**	**67.9**	**68.8**	**69.5**	**70.4**	**71.1**
g. Less Net Discretionary Revenue Measures (DRM), €bn		*-0.7*	*0.1*	*0.5*	*0.4*	*0.4*	*0.4*
h. Corrected expenditure aggregate net of DRM = (f-g), €bn		67.8	67.8	68.3	69.1	70.0	70.7
i. Nominal growth in expenditure aggregate adjusted for DRM = $((h_t-f_{t-1})/ f_{t-1})$, %		1.9	1.1	0.6	0.5	0.6	0.5
j. GDP Deflator, %		1.7	1.2	1.2	1.2	1.2	1.2
k. Real growth in expenditure aggregate adjusted for DRM, %		**0.2**	**0.0**	**-0.6**	**-0.7**	**-0.5**	**-0.7**
l. Deviation (negative indicates compliance) =((k- EB)*f), % of GDP		**0.0**	**-0.1**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
m. Nominal increase in spending permitted =f*(1+EB)*(1+j), €bn		**1.2**	**1.0**	**1.5**	**1.6**	**3.2**	**3.3**

Source: Budget 2016 and internal IFAC calculations.

[a.] While *SPU 2015* shows permitted real growth of 0.05 per cent, calculations in this document are based on 0.1 per cent.

[b.] This differs from the calculation presented in *Budget 2016* which estimates a convergence margin based on a 0.6 per cent adjustment in the structural balance. A convergence margin is applied to countries not yet at MTO and is linked to the required annual change in the structural balance. Based on the output gap in *Budget 2016,* the higher adjustment is required. The final target will be set based on EC *Spring 2016 Forecasts.*

[c.] Gross fixed capital formation is averaged over four years (from't-3' to 't') to avoid penalising countries for large capital projects.

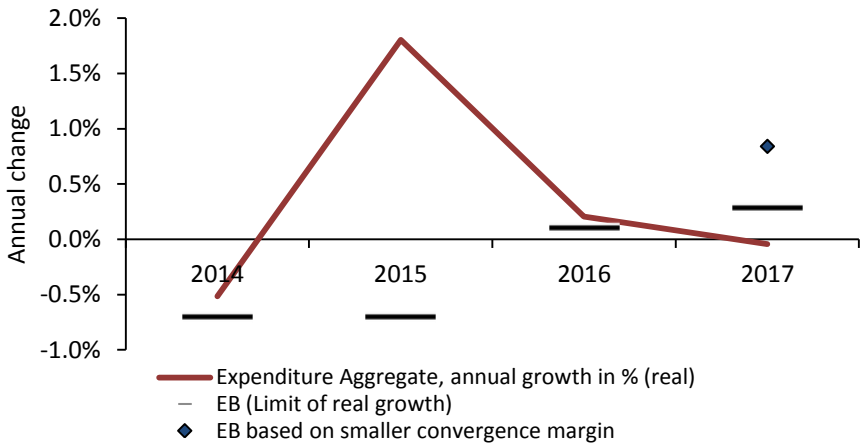
All available fiscal space under the EB has been used for 2016 and there is in fact a small deviation from permitted growth, which is not considered significant.[60] However, an expenditure overrun of the scale seen in 2014 or 2015 on Departmental expenditure would, all other things being equal, lead to significant deviation under this rule. Furthermore the recent assessment of *Budget 2016* by the EC, on the basis of its own forecasts, indicates a deviation of 0.4 per cent of GDP.

[60] 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.

As the Government have used all available fiscal space in 2016, the nominal increase in allowable General Government spending between 2015 and 2016 is €1.2 billion. However, due to an anomaly in the number of pay and pension payment dates in 2015 an additional €0.3 billion of fiscal space is available in the expenditure base for 2016.[61] This arises because the EB is a growth based rule, so that the additional payment in 2015 is included in the base for calculating the level of expenditure for 2016 but creates room for additional spending as this payment does not recur in 2016.

Fiscal space under the EB does not fully reflect the increased level of spending for 2016 evident between *SPU 2015* and *Budget 2016*. As the EB is a limit on growth of expenditure rather than on the level of overall spending, all other things being equal, a change in the base leads to a corresponding change in the permitted level of spending for all future years. While the EB does not apply in 2015, Figure 4.3 shows that the actual spending in 2015 is well in excess of what would have been permitted. Without this increase in 2015, spending in 2016 would have to be €1.7 billion lower in order to comply with the EB in 2016. Overall, while this increase in the expenditure base in 2015 complies with the European fiscal rules applying to Ireland in 2015, it is contrary to the spirit of the rules and led to a significant revision to the domestic expenditure ceilings in 2015 (see Section 4.4).

FIGURE 4.3: COMPLIANCE WITH THE EU EXPENDITURE BENCHMARK



Source: Budget 2016 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 has been adjusted to reflect the scale of discretionary revenue measures.

For 2017, the required structural balance improvement of 0.75 percentage points of GDP, implied by the output gap estimate in *Budget 2016*, would imply a larger convergence margin and consequently a lower permitted rate of expenditure growth than presented in *Budget 2016* (see

[61] Public Servants and public service retirees paid on a weekly basis will have an additional pay day in 2015 as there are slightly more than 52 weeks in a given year. This leads to an extra day for staff not paid on a monthly basis.

Figure 4.3). Complying with the EB in 2017 may allow for less fiscal space than indicated in *Budget 2016.*[62]

The fiscal path provided in *Budget 2016* for the period 2017 to 2021 includes no significant policy changes and is largely technical in nature as discussed in Chapter 3.

4.4 The Medium-Term Expenditure Framework

As set out in the Medium-Term Budgetary Framework, the EB is used to establish the upper limit on General Government expenditure for Ireland.[63] The aggregate Government Expenditure ceiling (GEC) and the individual Ministerial ceilings both operate as mechanisms to control Departmental expenditure within this upper limit.[64] While multi-annual ceilings have been established since the Comprehensive Expenditure Report 2012-2014, they have to date been set by reference to the prevailing EDP requirements. As discussed in Section 4.2, the EDP deficit path allowed for a significant increase to spending in 2015 as a result of unexpected revenue increases.

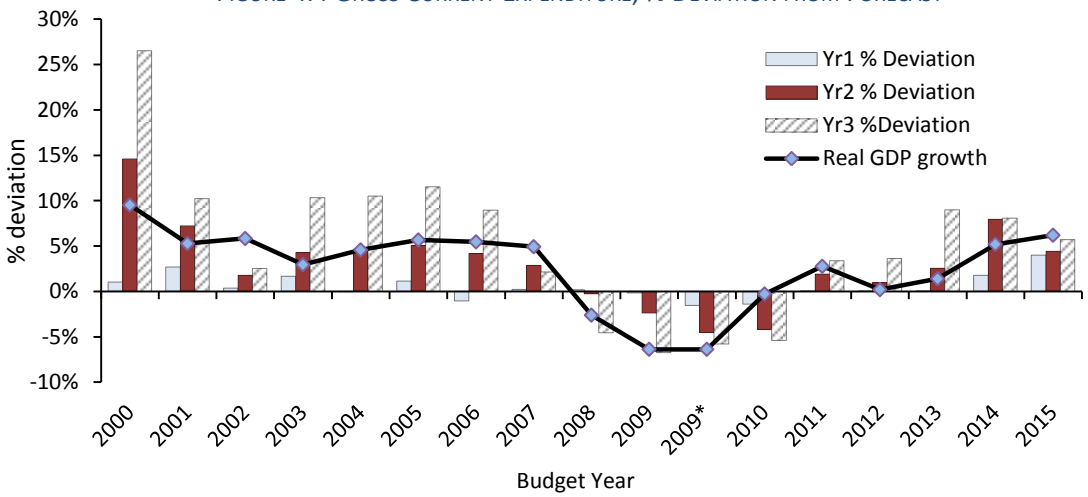
Even prior to 2015, there have been regular revisions to both the overall multi-annual GEC and individual Ministerial Expenditure Ceilings. Such persistent revisions undermine multi-annual public expenditure management by creating uncertainty around the scale of future resources, both in aggregate and for individual Departments. Without improvements to the existing system of expenditure planning it is likely the recent upward revisions to expenditure ceilings will continue to revert to the pre-crisis pattern of pro-cyclical adjustments (see Figure 4.4).

[62] The latest EC forecasts estimate an output gap of 0.3 per cent in 2017, which would imply a structural balance adjustment of 0.6 percentage point of GDP and, consequently, a larger allowable rate of expenditure growth.

[63] See Medium-Term Budgetary Framework (Department of Finance, 2014).

[64] 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. The legislation provides that where the Government have decided on a Government Expenditure Ceiling, they may make a further decision to revise the Government Expenditure Ceiling to a lesser or greater amount. Subject to such a revision the Government may revise the Ministerial Expenditure Ceilings.

FIGURE 4.4 GROSS CURRENT EXPENDITURE, % DEVIATION FROM FORECAST



Source: Department of Finance
*Note: ** denotes the Supplementary budget in 2009. Bars show the forecast error for 1 year ahead, 2 years ahead and 3 years ahead. Latest figures for 2016 to 2018 (used in calculation the latest deviation from Budget 2015 years 2 and 3) are adjusted by €1 billion to reflect the change in the treatment of the HSE from 2015.

A particular issue in the setting of ceilings in Budgets 2014 and 2015 has been upward revisions to future ceilings based on in-year revisions to Departmental spending. These revisions are of concern as they, at least in part, arise from budget execution problems being addressed through relaxing the total expenditure ceiling, or GEC.[65] While the increases to spending may have allowed for underlying expenditure pressures to be addressed in some areas, it has also weakened incentives to control expenditure and may have damaged expenditure control practices.

The weakness of the domestic MTEF is of concern for the Council, particularly in the absence of a formal top-down 'anchor' on expenditure previously provided by the advance setting of the EB for three years.[66] The multi-annual revisions to the GEC, while compliant with domestic legislation and requirements under the Corrective Arm of the SGP, go beyond the limited circumstances identified

[65] In both 2014 and 2015, the effective limit on fiscal policy was the deficit ceiling under the EDP, which permitted upward revisions to spending through changes to the GEC as revenues were higher than expected. This increase in the GEC created room for individual Ministerial ceilings to be increased to allow for higher than anticipated expenditure without a breach of individual Ministerial ceilings. The MTEF sets out sanctions where an individual Ministerial ceiling is breached in a given year. These sanctions are semi-automatically imposed and escalate to the repayment of excess spending from future ceilings.

[66] There also remain inconsistencies between the operation of the EB and the domestic MTEF. The upward revision to the GEC in 2015 highlights the importance of the base expenditure level when operating an expenditure growth rule. As noted in Section 4.3 a repeat of the in-year upward revisions to expenditure would likely cause a breach of the EB in 2016. However, a further consideration is that spending below the permitted level would lead to a reduction in the permitted level of spending in subsequent years. This could lead to a situation where inefficient expenditure is undertaken to avoid the erosion of the base expenditure level. The carryover provision in the domestic framework is designed to avoid this by allowing for savings in one year to be carried over to the next. However, under the EB any such carryover would still be considered a reduction in the base expenditure level. If the expenditure planning process is to be successful such inconsistencies should be resolved.

in the Circular detailing the design of the MTEF.[67] Under the domestic framework, revisions to the GEC are permitted in these circumstances; (i) under exceptional circumstances, as defined in the FRA, (ii) through the introduction of compensatory discretionary revenue measures, or (iii) where adjustments are related to spending on cyclically related unemployment spending or EU co-funded payments. While the circumstances under which individual Ministerial ceilings may be revised are more numerous, and include an overall revision to the GEC, the GEC can only be increased in the three instances above.

For 2016, revisions to the GEC would only be possible in the circumstances set out in the Circular as it is set at the maximum level of expenditure permitted under the EB. Given the weakness of the MTEF, the recent pattern of overspending, particularly in health, and the lack of a buffer in 2016, there is a risk of a breach of the EB next year.

[67] See Circular 15/13, *Medium-Term Expenditure Framework: Application to Current Expenditure* is available at http://circulars.gov.ie/pdf/circular/per/2013/15.pdf.

APPENDIX A: FISCAL COUNCIL BENCHMARK PROJECTIONS 22 SEPTEMBER

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 22 September 2015 and are summarised in Appendix Table A.1.

APPENDIX TABLE A.1: BENCHMARK PROJECTIONS FOR 2015-2016

% change in volumes unless otherwise stated	2015	2016
GDP	6.4	4.6
Consumption	2.9	1.9
Investment	12.5	11.4
Government	1.4	1.0
Stock changes (% of GDP)	0.9	0.9
Exports	11.2	3.7
Imports	10.7	3.1
Net Exports (p.p. contribution)	2.5	1.3
Domestic Demand (p.p. contribution)	3.9	3.3
Stock Changes (p.p. contribution)	0.0	0.0
Current Account (% GDP)	6.3	5.8
Employment	2.8	2.5
Unemployment Rate (%)	9.5	8.3
HICP	0.2	1.3
GDP Deflator	3.2	1.4
Nominal GDP (€ billions)	207.6	220.4
Nominal GDP	9.8	6.1

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 2.8).

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.[68] 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.

[68] Quill (2008) notes that in practice CSO data beyond five years rarely changes materially except for methodological reasons. 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. 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 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.

APPENDIX B: HOUSING MARKET 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 as summarised in Appendix Figure B.2.

Price- to- disposable income and price- to- rent ratios both indicate that housing valuations have stabilised at levels just below those observed in the early 2000s. CSO figures indicate that year-on-year property price inflation has fallen from 24.7 per cent to 7.9 per cent in Dublin over the past year, but has increased in the rest of the country.[69] The User Cost of Capital for Housing (UCCH) attempts to compare all relevant housing costs against expected house price changes. Forward-looking surveys of price expectations (e.g., Daft.ie Surveys) would suggest that housing costs are positive, whereas taking recent historical price changes as an indicator of price expectations would suggest negative costs. Inflation expectations are difficult to capture and the UCCH is clearly sensitive to the approach used. Given the recent moderation in price rises, the forward-looking survey price expectations is likely to be a more appropriate measure at present.

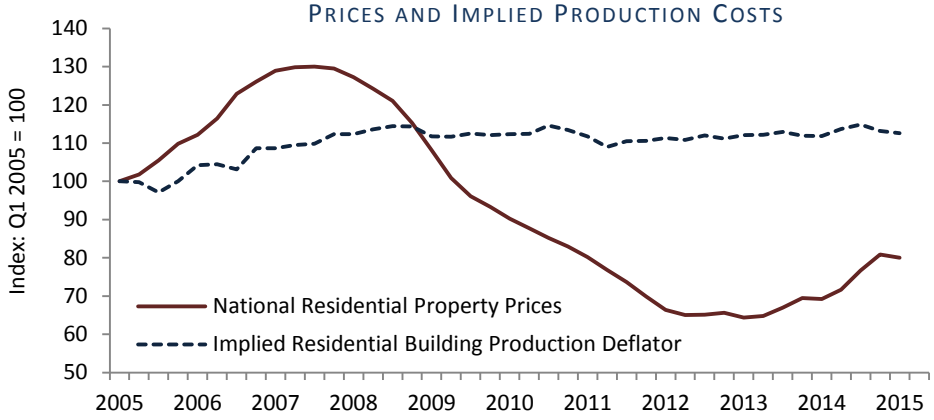
An ongoing concern is the acute supply shortage in the housing market, particularly in urban areas. Duffy, Byrne and FitzGerald (2014) suggest at least 25,000 new units will be required *per annum* over the coming 15 years to adequately meet demand. However, completions are set to be closer to 13,000 units in 2015. Barrett, Duffy and McQuinn (2015) highlight a number of potential supply constraints, namely planning regulations, infrastructure, inability to access finance and the cost of building. The Department of Finance (2015) suggests that, whereas during the boom years developers could expect close to 100 per cent bank-financing, developers now tend to be subject to a maximum of 65 per cent senior debt finance for 'shovel-ready' developments for which there is proven demand. Such constraints may be further exacerbated by developers not having rebuilt sufficient reserves of risk capital in the wake of the crash.

Prohibitive construction costs are frequently cited as one factor constraining supply. There is some evidence of a divergent performance in costs relative to prices (Appendix Figure B.1). The construction cost index compiled by the CSO suggests that costs are now roughly at the same level observed at their peak in the third quarter of 2008 (just 1.8 per cent below these levels). By comparison, property prices have undergone a much sharper correction, remaining approximately 36 per cent below their peak values.

[69] The Q3 2015 *Daft.ie House Price Report* also indicates that year-on-year property price inflation has softened in Dublin, but has increased substantially for the rest of the country (from 2.1 per cent in mid-2014 to over 13 per cent in the third quarter of 2015). CSO data indicate a similar acceleration outside of the capital.

The immediate pre-crisis period was characterised by strongly rising house prices, credit and construction activity, all of which ultimately proved unsustainable. A review of various indicators does not reveal signs of unsustainable credit and construction growth – indeed quite the contrary. House prices have grown strongly in recent years, but we do not detect signs of significant overvaluation based on standard metrics. Moreover, it is not apparent that recent price growth has become embedded in price growth expectations. Thus, while housing market developments will require careful ongoing monitoring, we do not detect signs of an unsustainable expansion in activity at this time.

APPENDIX FIGURE B.1: IRISH RESIDENTIAL PROPERTY: NOMINAL PRICES AND IMPLIED PRODUCTION COSTS



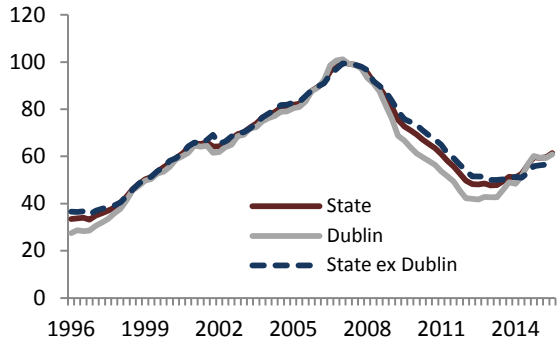
Sources: CSO; internal IFAC calculations.

APPENDIX FIGURE B.2: IRELAND: HOUSING

Real price rises have moderated and remain roughly 40 per cent below their peak.

Real Residential Property Prices (HICP adj.)

Index: Q1 2007=100

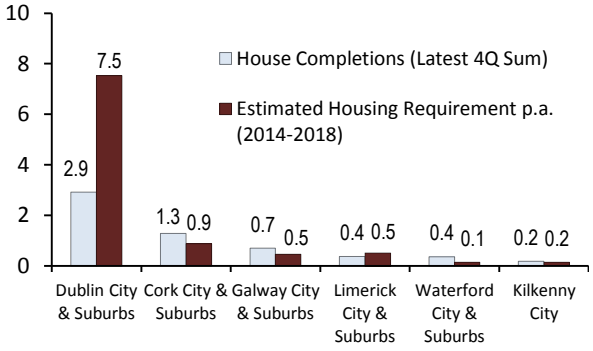


Sources: ESRI/PTSB; CSO.

Estimated regional requirements and completions data signal ongoing supply pressures in Dublin.

Estimated housing requirements/completions

Units (000s)

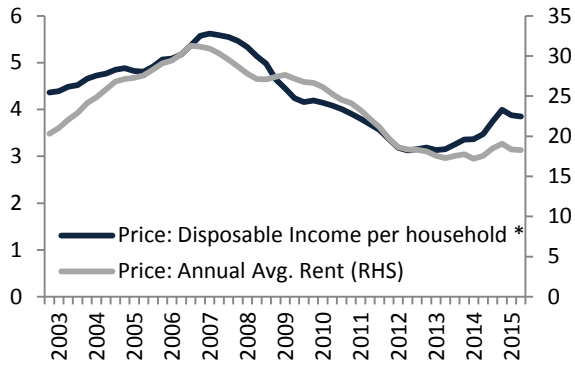


Sources: Housing Agency; DoECLG.

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

Changes in valuation ratios have also moderated since the end of 2014.

Housing Valuation Ratios

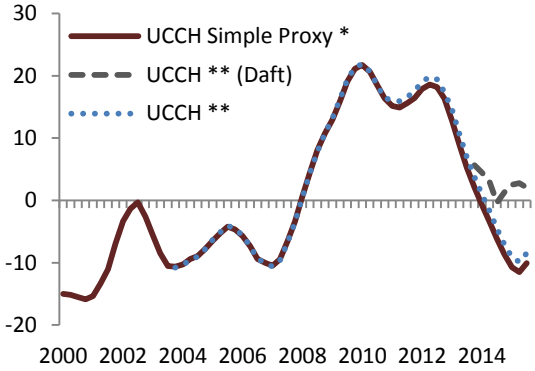


Sources: ESRI/PTSB; CSO.

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

User costs – when based on survey expectations – may now be slightly positive.

User Cost of Capital for Housing (UCCH)



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

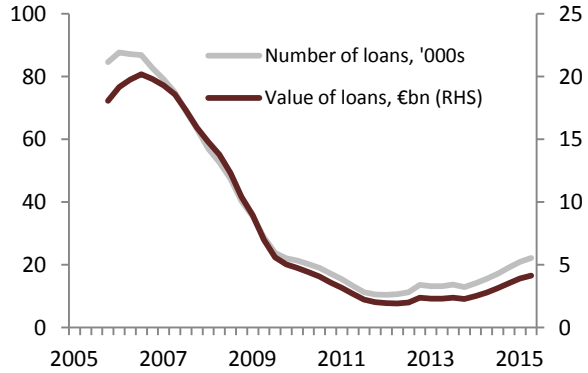
* New mortgage rates less annual price change for past 4Qs.

**Includes first-time buyer taxes/subsidies; down-payments; depreciation/maintenance. 'Daft' uses Daft.ie 12mo price expectations.

Loan volumes are expanding, albeit from a very low base.

Annualised Residential Mortgage Lending

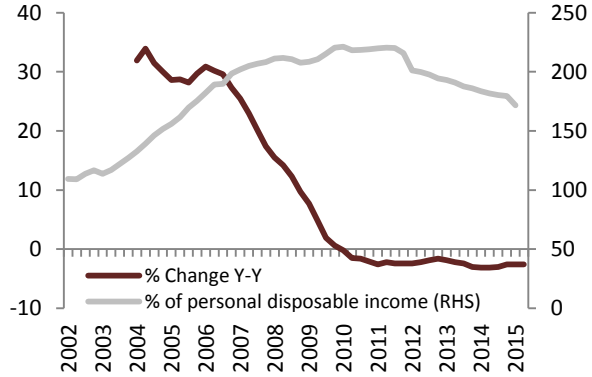
First-time buyer and mover purchaser loans



Source: IBF/PwC Mortgage Market Profile.

Negative net lending continues to reflect household deleveraging and modest growth in loan issuance.

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 *BUDGET 2016* PROJECTIONS

Date	
10 September	CSO release *Quarterly National Accounts* estimates for Q2 2015.
15 September	The Secretariat and Department of Finance met the CSO to clarify technical details of latest *Quarterly National Accounts* estimates.
18 September	The Secretariat received Department of Finance technical assumptions underpinning *Budget 2016* forecasts.[70]
22 September	After consideration by the Council, Benchmark projections are finalised by the Secretariat prior to receiving preliminary forecasts from the Department of Finance.
	The Council received preliminary forecasts from the Department in line with *Memorandum of Understanding* (*MoU*) requirements.
23 September	The Department of Finance provided more details to IFAC in response to the queries received, including quarterly profiles and details on investment forecasts.
24 September	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.
29 September	The *MoU* deadline (ten working days prior to Budget day) for the Department to provide at a meeting with the Council its "provisional final" macroeconomic forecasts passes.
30 September	The Council receives preliminary final forecasts from the Department in electronic form.
1 October	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.[71]
2 October	The Council met to discuss the Department of Finance forecasts in detail and to finalise a decision on the endorsement.
	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *Budget 2016*.
	The endorsement decision is published.
13 October	The Department's forecasts are published in *Budget 2016* together with the reconciliation of 2016 forecasts to account for the larger than assumed budgetary package.
15 October	The Draft Budgetary Plan for 2016 was formally submitted to the EC.

[70] 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.

[71] Primarily concerning supply-side estimates for 2015 and 2016, fiscal assumptions underpinning the projections, assumed savings rates, deflator assumptions, assumed credit conditions underpinning the forecasts and risks related to external assumptions.

APPENDIX D: VOLATILITY OF IRISH REAL GDP GROWTH RATES

A large literature examines the volatility of Irish macroeconomic data and the associated propensity for large revisions to macroeconomic aggregates (Conroy, 2015; Casey and Smyth, 2015; Quill, 2008; Bermingham, 2006; McCarthy, 2003; and Ruane, 1975).

Measuring the Mean Absolute Deviation (MAD) of growth rates, Conroy (2015) notes that volatility in quarterly GNP and GDP in Ireland is amongst the highest in the OECD. This is attributed to a number of sectors, predominantly those with strong multinational corporate presences such as the manufacturing sector, and the distribution, transport, software and communications sectors. Their finding of a positive correlation between average real GDP growth rates and the MAD might be expected given that the MAD will itself be inflated by higher growth rates:

$$MAD = \sum \frac{|x_i - \bar{x}|}{n}$$

...where x is the real GDP growth rate in period i and $\bar{x}$ is the average over the sample n periods.

To account for this correlation and to attempt to look through cross-country differences in growth rates, one can use the Coefficient of Variation (CoV), which divides the sample standard deviation (σ) by the sample mean (μ):

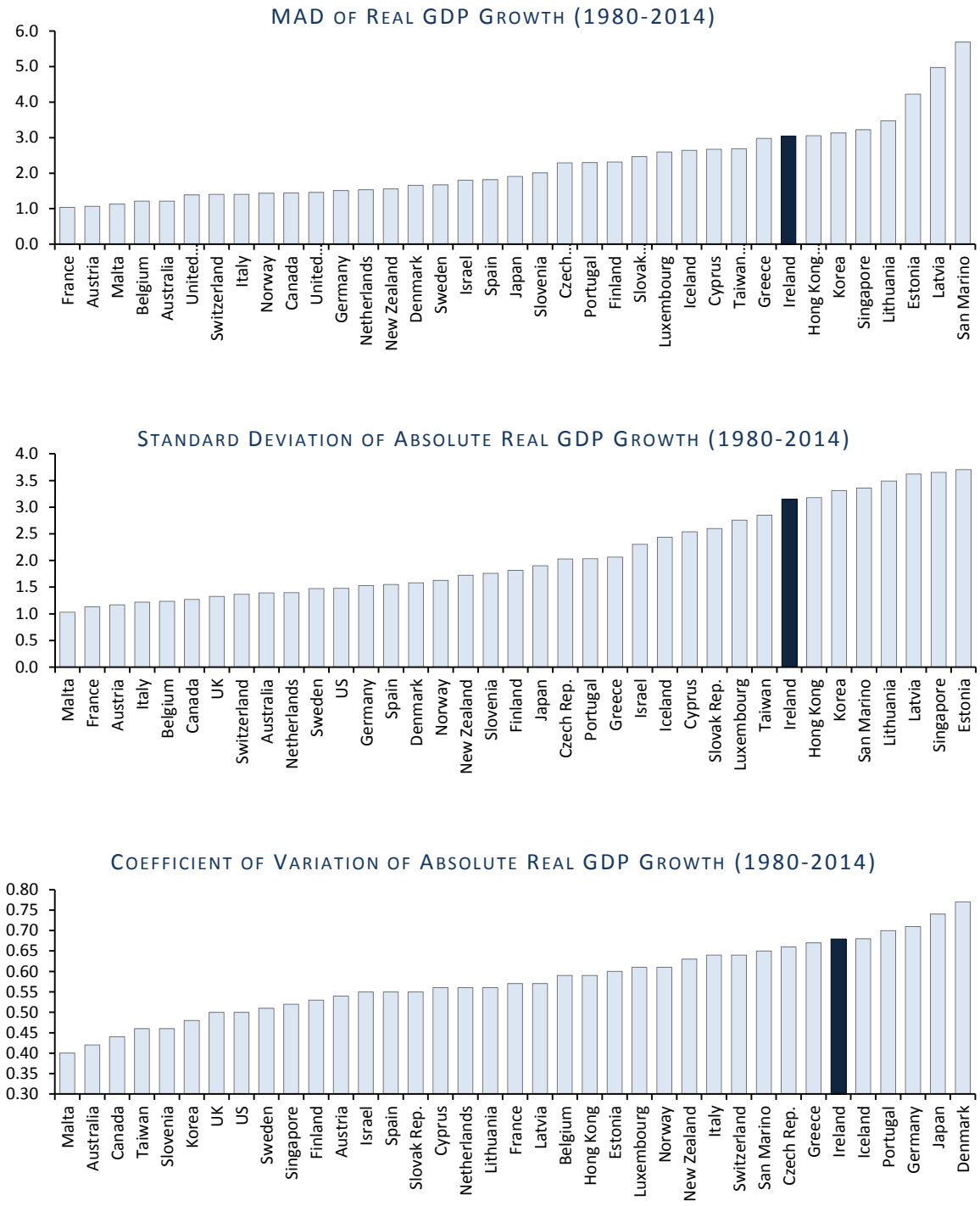
$$Standard\ Deviation = \sigma = \sum \frac{|x_i - \bar{x}|}{n}$$

$$CoV = \frac{\sigma}{\mu}$$

On the basis of all three measures – the MAD, the sample standard deviation and the CoV, Irish real GDP growth rates rank among the most volatile of the advanced economies observed over the period 1980-2014. This finding holds even when comparatively high growth rates are controlled for under the CoV measure.

The extent of the volatility of Irish real GDP poses challenges for forecasters as well as policy makers. Heightened volatility around current economic activity means that error margins are also much wider. In such an environment, it is essential to account for higher degrees of uncertainty when designing policy.

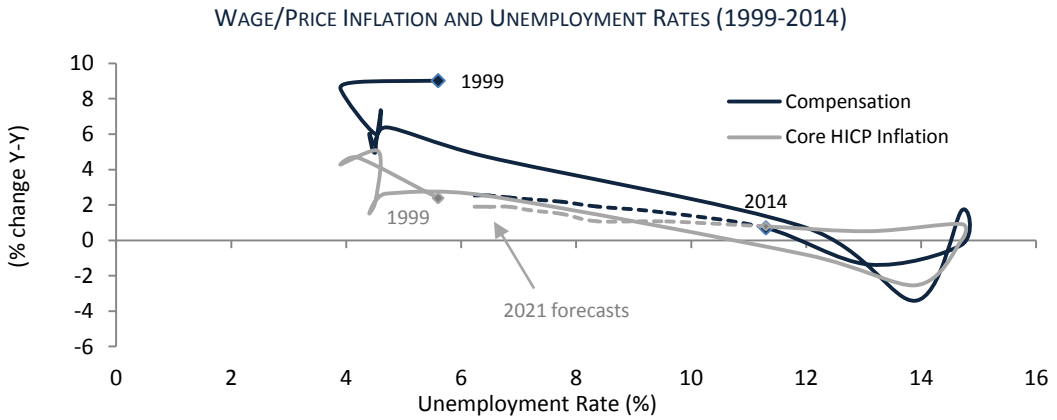
APPENDIX FIGURE D.1: ADVANCED ECONOMIES: MEASURES OF VOLATILITY



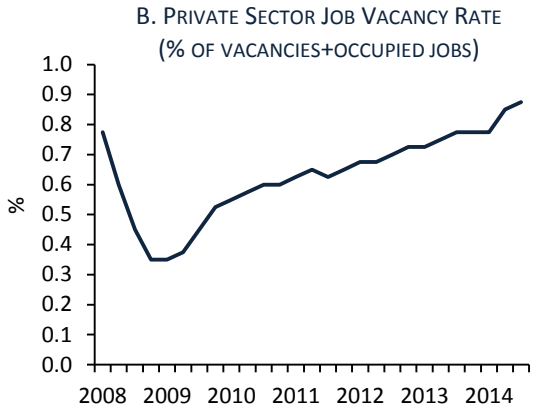
Sources: IMF WEO (October 2015) and internal IFAC calculations.
Note: All advanced economies as defined in the World Economic Outlook Database, October 2015 are included for comparison.

APPENDIX E: SUMMARY INDICATORS OF ECONOMIC IMBALANCES

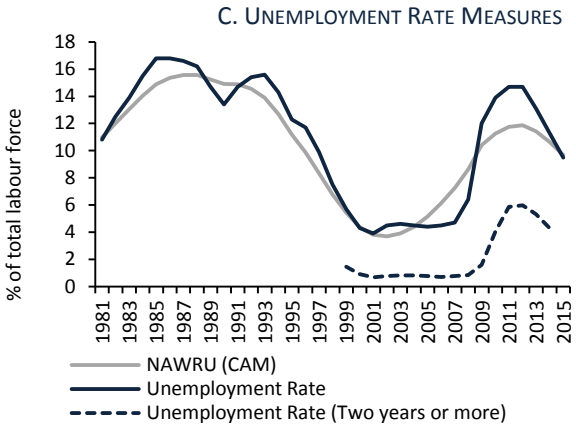
FIGURE E.1: LABOUR MARKET



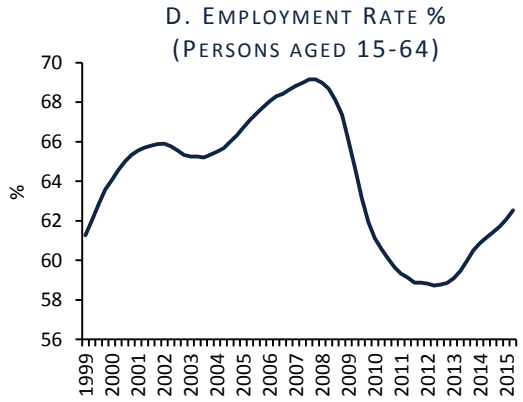
Source: CSO; Budget 2016 projections and internal IFAC calculations.
Note: NIE compensation per QNHS employee hour is used as compensation measure.



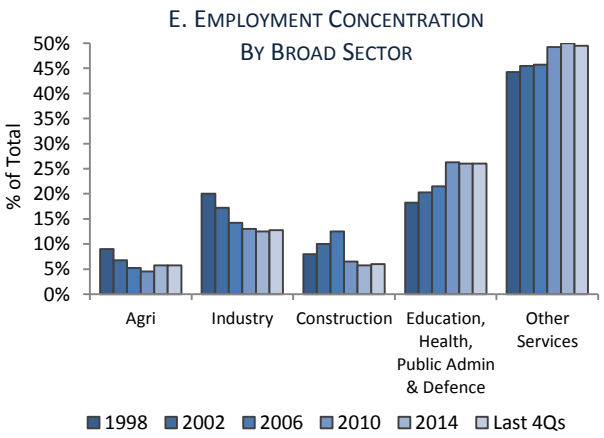
Source: CSO; internal IFAC calculations.
Note: Four quarter moving average of job vacancy rate shown.



Source: European Commission estimates (Commonly Agreed Methodology); CSO; and Eurostat.

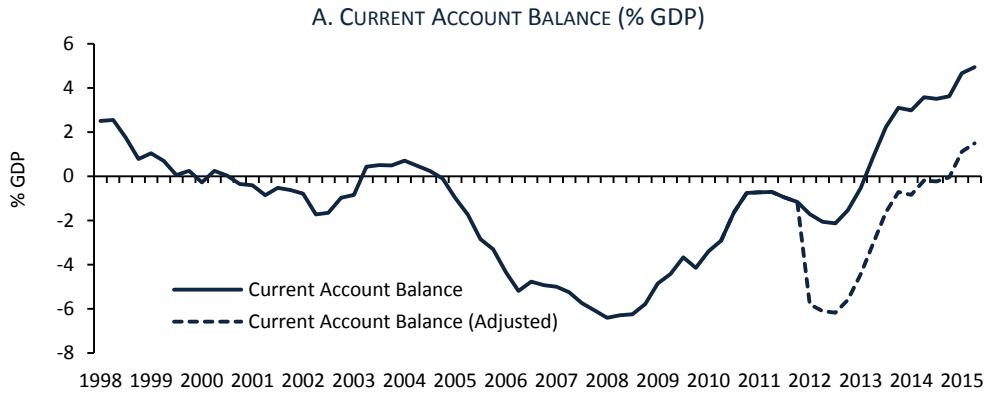


Source: CSO; internal IFAC calculations.
Note: Four quarter moving average shown.

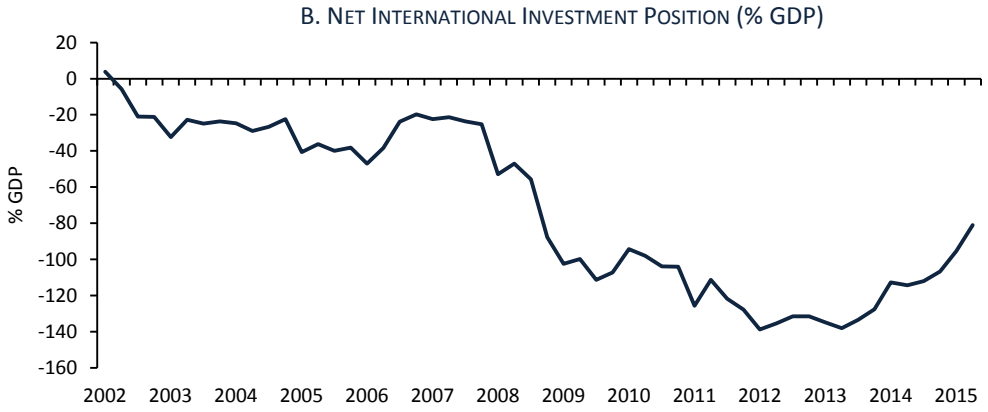


Source: CSO; internal IFAC calculations.

FIGURE E.2: EXTERNAL BALANCES

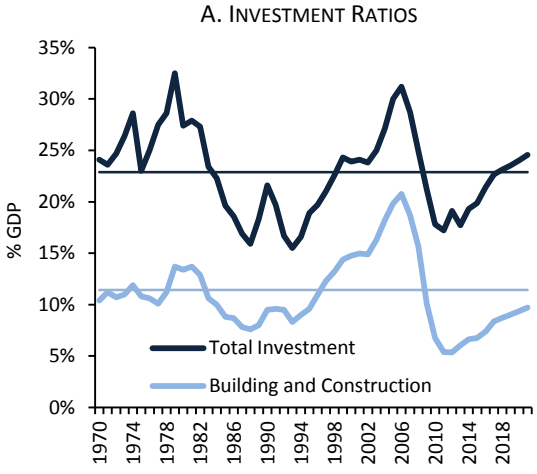


Source: CSO; internal IFAC calculations.
Note: Adjusted measure excludes estimated impact of redomiciled PLCs.

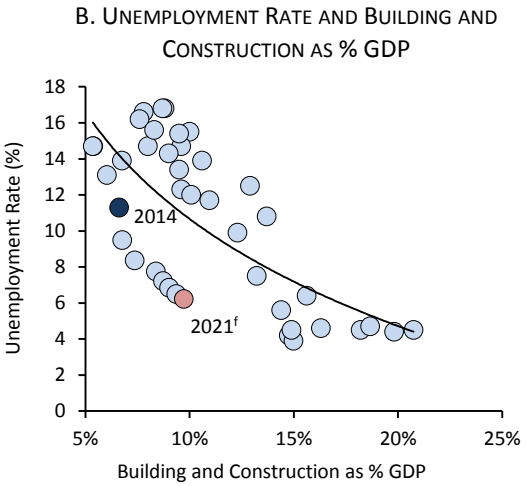


Source: Eurostat.

FIGURE E.3: INVESTMENT INDICATORS



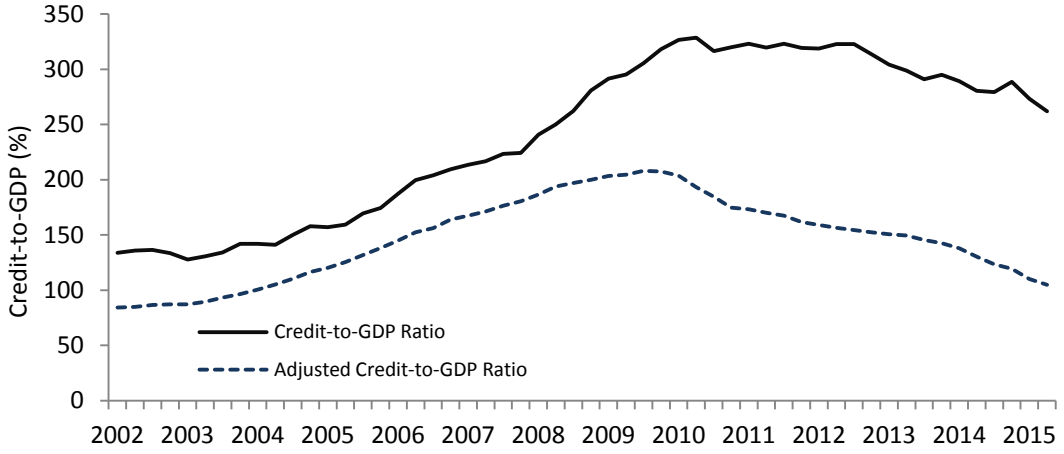
Sources: CSO; AMECO; Department of Finance.
Notes: Horizontal lines = historical avg (1970-2014).



Source: CSO; Department of Finance projections & internal IFAC calculations.

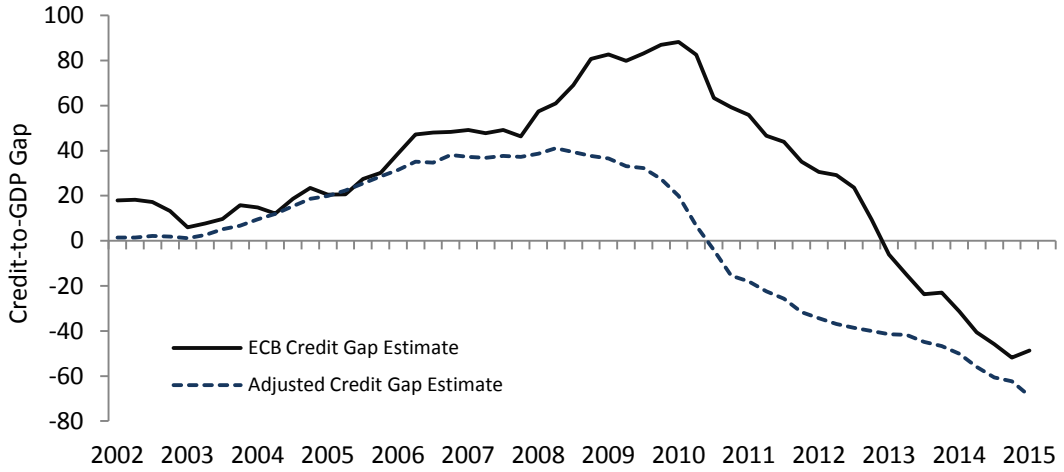
FIGURE E.4: ADDITIONAL CREDIT INDICATORS

A. PRIVATE SECTOR CREDIT-TO-GDP RATIOS



Sources: Central Bank of Ireland; CSO; internal IFAC calculations.
Note: The adjusted credit-to-gap ratio is constructed as Irish resident private sector enterprise credit (ex financial intermediation) plus total loan liabilities of Irish households. It is intended to adjust for the impact of multinational non-financial corporations on the aggregate ratio given that associated credit is often sourced outside of Ireland (for a similar approach, see Box 6: Macro-Financial Review 2015:I, Central Bank of Ireland). The ratio is calculated following a similar methodology to that in ESRB recommendation (18 June 2014) on guidance for setting countercyclical buffer rates (ESRB/2014/1). This specifies a credit ratio as: $(CREDIT_t / (GDP_t + GDP_{t-1} + GDP_{t-2} + GDP_{t-3})) \times 100\%$.

B. PRIVATE SECTOR CREDIT-TO-GDP GAPS



Sources: Central Bank of Ireland; CSO; ECB; internal IFAC calculations.
Note: The adjusted credit gap is calculated following a similar methodology to that in ESRB recommendation (18 June 2014) on guidance for setting countercyclical buffer rates (ESRB/2014/1). For the underlying trend credit ratio, a recursive Hodrick-Prescott filtered trend ratio is specified, with smoothing parameter lambda = 400,000 to capture the long-term trend in the behaviour of the credit-to-GDP ratio. The credit-to-GDP gap is given by: $GAP_t = RATIO_t - TREND_t$.

APPENDIX F: DECOMPOSITION OF FORECAST ERRORS (UPDATED FOR REVISIONS)

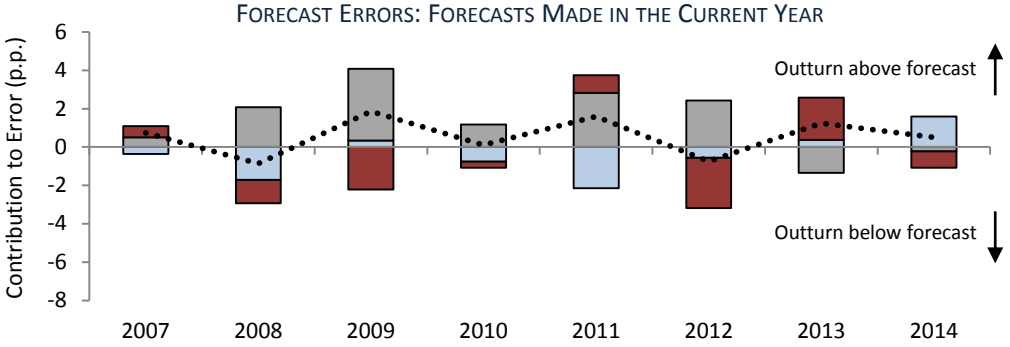
Understanding the Government's macroeconomic forecast errors plays a key role in both the Council's endorsement process and broader assessments of the Department's macroeconomic projections. This Appendix documents the sources of real GDP forecast errors at different horizons using the latest available data for 2007-14 (Figures F.1–F.3).

Previous analyses, such as in the *June 2015 FAR (Box C)* and the *April 2013 FAR* (Box A) highlighted tendencies for Department of Finance forecasts to overestimate domestic demand, with the reverse true for net exports. Following July 2015 revisions to the National Accounts data for recent years, however, this pattern of bias is now less unambiguous.

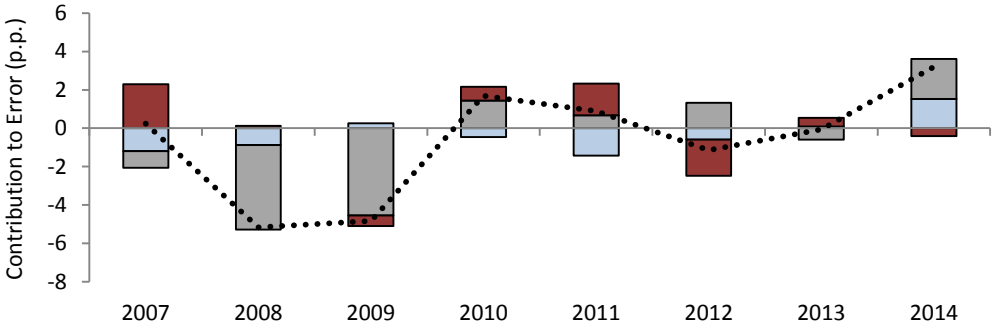
It remains the case that Department forecasts at the longer (1- to 2-year) horizon tended toward over-optimism when it came to domestic demand contributions expected over 2007-2013. By contrast, nearer-term forecasts of expected contributions from domestic demand were revised down such that from 2010-2012 these were typically more conservative than necessary. This provides a more nuanced picture of the bias highlighted in previous *FARs*. It seems clear that near-term forecasts were probably too conservative when assessing the expected domestic performance once the crisis began. However, forecasts for further ahead (i.e., the 2-year horizon) continued to anticipate a sharp recovery that failed to materialise until 2014, when domestic activity was some 2.3 percentage points of GDP stronger than projected. Examining the components in more detail confirms this pattern. All of the domestic expenditure components (Consumption, Government and Investment) on average fared better than forecast by the Department at the shorter horizon from 2011 on (Table F.1). However, at the longer (2-year) horizon, consumption and investment continued to fall short of expectations.

In terms of net export contributions, forecasts made two years ahead reveal that the Department tended to underestimate the extent to which net exports would sustain the recovery from 2007-2011. The acyclical nature of many of Ireland's exporting sectors (such as the pharm-chem and ICT sectors) helps to explain this outperformance. For 2012, declines in the gross value added from ICT-related sectors (November 2014 FAR, Box C) likely prompted large forecast errors at all horizons on the contribution of net exports to real GDP growth that year. Nearer-term forecasts of net export contributions by the Department do not exhibit a clear pattern of bias, however, and the errors on average have been very small in the most recent four-year period.

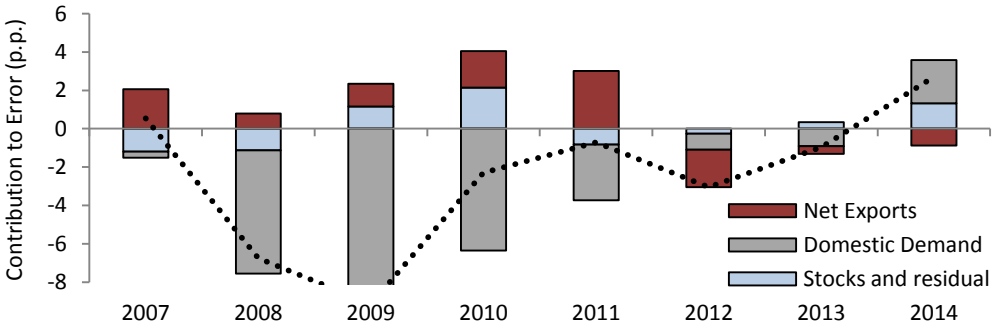
APPENDIX FIGURE F.1: CONTRIBUTION TO THE DEPARTMENT OF FINANCE REAL GDP FORECAST ERRORS: FORECASTS MADE IN THE CURRENT YEAR



APPENDIX FIGURE F.2: FORECASTS MADE ONE YEAR AHEAD



APPENDIX FIGURE F.3: FORECASTS MADE TWO YEARS AHEAD



Sources: Department of Finance (Budget/SPU documents); internal IFAC calculations.
Note: The analyses above adjust for methodological changes introduced in 2015, which led to the incorporation of the impact of aircraft purchases by leasing companies resident in Ireland. Vertical axis is tapered to focus on most recent errors at the expense of Chart C.3's 2009 observation.

APPENDIX TABLE F.1: DEPARTMENT OF FINANCE REAL GDP GROWTH FORECAST ERRORS

	2007-14			2011-14		
Error Contributions (p.p.)	**year = t**	**year = t+1**	**year = t+2**	**year = t**	**year = t+1**	**year = t+2**
Consumption	0.4	-0.4	-1.2	0.4	0.0	-0.5
Government	-0.1	0.0	-0.1	0.2	0.4	0.3
Investment	1.0	-0.3	-2.0	0.3	0.4	-0.4
Exports	0.7	0.9	0.0	1.0	1.4	0.5
Imports	-1.1	-0.6	0.7	-1.1	-1.5	-0.6
Domestic Demand	1.4	-0.6	-3.4	0.9	0.9	-0.6
Net Exports	-0.4	0.3	0.7	-0.1	-0.1	-0.1
Real GDP	0.6	-0.6	-2.5	0.6	0.7	-0.5
Stocks and Residual	-0.4	-0.3	0.2	-0.2	-0.1	0.1

GLOSSARY[72]

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.

[72] 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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