Irish Fiscal Advisory Council

Pre-Budget 2016 Statement

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Irish Fiscal Advisory Council

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KEY MESSAGES

The recovery in the Irish economy has gathered momentum with buoyant export growth now being supported by a recovery in domestic demand. The improvements mean that the Government is likely to comfortably succeed in reducing the deficit to below the 3 per cent ceiling in 2015. Given uncertainty around the outlook for the international economy and Ireland's high debt level, continued policy vigilance is required to bolster the resilience of the economy and the public finances to potential adverse shocks.

The Council's assessment of the prudence of the fiscal stance looks at compliance with the Government's budgetary framework, complemented by an assessment of the stance from an economic perspective. The Council is required under its statutory mandate to assess whether the fiscal stance is conducive to prudent economic and budgetary management, including with reference to the fiscal rules. One element of this assessment is the extent of compliance with the Government's own budgetary framework. The EU and national components of the framework together provide critical long-run protection against the type of pro-cyclical policies that caused such serious problems in the past. This assessment is complemented by an economic analysis that weighs appropriate management of the economy so as to avoid boom-bust cycles against the need to put the public finances on a path to safer levels.

The *Budget 2016* fiscal plan should be consistent with all the requirements of the new budgetary framework. The Government set out a plan in the *Spring Economic Statement* which implied a reduction in the estimated structural budget deficit of just 0.3 per cent of GDP in 2016. This falls short of the requirement to reduce this deficit by 0.6 per cent under both domestic and European rules. An updated forecast of the structural deficit will be provided in *Budget 2016*. Based on revisions to data since the publication of *Stability Programme Update 2015* in April, the new projections may show compliance with the rules. To avoid undermining the integrity of the new framework, the Council is strongly of the view that the plan outlined in the budget should be consistent with meeting all of the rules in 2016 and later years.

The proposed tax and spending package for *Budget 2016* as announced in the *Spring Economic Statement* is within the range of prudent policies from an economic perspective. The proposed €1.2-€1.5 billion package reduces the primary (non-interest) structural deficit insofar as expenditure growth, adjusted for discretionary tax changes, is kept below the estimated potential growth of the

economy. While the Council considers it probable that there is still a degree of slack in the economy, it is likely to be diminishing rapidly given high growth outturns and falling unemployment. This limits the economic case for a more expansionary stance. In addition, the debt to GDP ratio remains extremely high, leaving debt sustainability vulnerable to adverse growth and interest rate shocks in the context of a volatile global economic environment. Weighing these factors, and on the basis that it is consistent with full compliance with the rules, the proposed package is assessed to be at the upper end of the range of prudent policies from an economic perspective. In current circumstances, given the vulnerabilities of the economy and the public finances and the need to avoid undermining the budgetary process, it is important that further positive growth or Exchequer news in advance of the budget does not lead to an upward deviation from the pre-announced Government plan for *Budget 2016*.

Decisions about tax cuts in the forthcoming budget should take place in the context of well-specified medium-term plans that recognise underlying spending pressures. The budgetary projections in *SPU 2015* out to 2020 published in April 2015 implied a steep fall in the ratio of non-interest government spending to GDP and did not present a full picture of the likely costs of demographic ageing and cost pressures in delivering existing programmes. In the absence of offsetting savings, tax cuts would mean an even tighter squeeze on public spending over the coming years than already envisaged in the Government's plan, making it more difficult to fund future current and capital expenditure needs. The plan in *Budget 2016* should set out a realistic path for the government deficit and debt based on expenditure projections that take full account of future pressures and government revenue forecasts that include the impact of pre-announced policy commitments.

1. INTRODUCTION

The Council's mandate includes assessing the prudence of the Government's fiscal stance. The basis for the Council's assessment is twofold: first, the Council assesses whether the fiscal plan set out in the budget and Stability Programme complies with the Government's new budgetary framework; and second, a complementary economic analysis is carried out that assesses the compliance of the fiscal stance with the basic principles of sound budgetary management: counter-cyclicality, sustainability and stability.

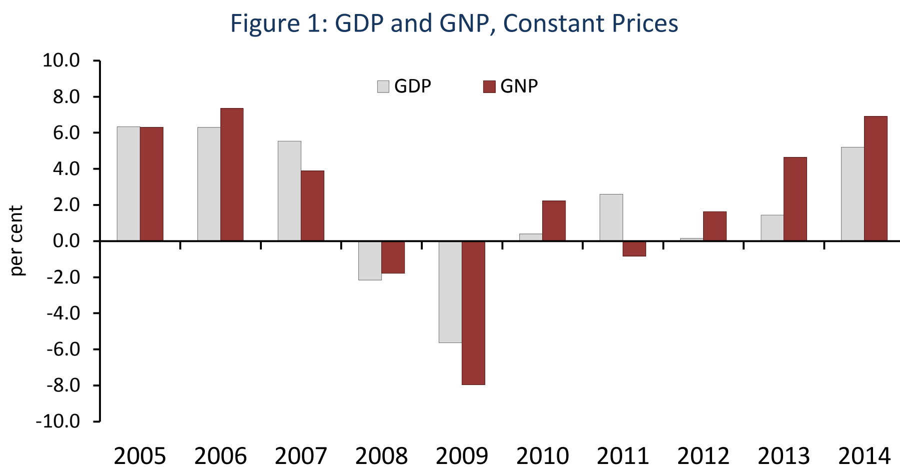
The remainder of this *Pre-Budget 2016 Statement* reviews the fiscal stance in advance of *Budget 2016* in line with these two components of the Council's assessment. In April, the Government announced a tax and expenditure package of €1.2 to €1.5 billion for *Budget 2016.* The Council's June 2015 *Fiscal Assessment Report* explained how, for 2016, the Government's plan failed at that time to fully comply with the requirements of the domestic budgetary rule and the Preventive Arm of the *Stability and Growth Pact (SGP)*. Given the importance of respecting the new budgetary framework along with due consideration for the latest macroeconomic and fiscal data, this Statement provides an updated assessment of the fiscal stance in advance of *Budget 2016.*

2. THE MACROECONOMIC AND FISCAL CONTEXT FOR *BUDGET 2016*

2.1 MACROECONOMIC DEVELOPMENTS IN 2015

Deciphering the pattern of growth in the Irish economy has become more difficult in recent years as *National Accounts* data are being impacted by a range of factors which serve to obscure the underlying trend in the economy (see FitzGerald, 2015).[1] While there is some uncertainty as to the precise magnitude of underlying growth, preliminary *National Accounts* data for the first quarter of 2015 along with revised data for 2014 indicate that the recovery in the economy continues to gather momentum. As measured by either real GDP or GNP, Figure 1 shows that the economy has been growing since 2012, with the rate of growth accelerating in recent years. *National Accounts* data for the first half of 2015 point to further strong expansion in economic activity with average quarterly GDP growth of 2 per cent for the first two quarters of the year.

Figure 1: GDP and GNP, Constant Prices



Source: CSO *National Income and Expenditure Accounts 2015*.

[1] Traditionally, GNP was said to represent a better measure of economic activity for Ireland as it excluded the profits made by Irish resident Multinational Corporations (MNC) which distorted the GDP data. However, a number of factors, specifically the effect of re-domiciled PLCs, can also distort trends in GNP. As a result, GNP may not present a reliable picture of underlying economic activity.

The expansion in economic activity appears to be becoming more broad-based with domestic demand (excluding aircraft) and exports both contributing to growth over recent quarters.[2] Gross export and import flows as measured in the *National Accounts*, along with industrial production data, are impacted by contract manufacturing, making an assessment of the strength of underlying drivers difficult using these metrics. Nevertheless, a range of other indicators of economic activity less impacted by measurement issues – especially employment and unemployment trends, but also retail sales and monthly trade data – provide evidence of strong economic growth in 2014 and continuing in 2015.

Taken together, the combination of improved external conditions and the gradual recovery in domestic demand create a more favourable macroeconomic context for *Budget 2016* than has existed since the onset of the recession and financial crisis in 2008. However, the international economic and financial environment remains highly volatile, with risks ranging from contagion due to the recent turbulence in China and other emerging markets to the challenges associated with monetary policy "normalisation" in the United States (see IMF, 2015a). Recent Euro Area data have also increased doubts about the success of the European Central Bank's (ECB) quantitative easing programme in raising growth rates and returning inflation to the ECB's target of close to, but below 2 per cent.

2.3 Implications for Fiscal Position in 2015 and 2016 Relative to *Stability Programme Update (SPU) 2015: Illustrative Scenario*

Based on the latest Exchequer data to end-August an illustrative updated scenario for the public finances is developed for both 2015 and 2016. This updated scenario reflects likely changes to the main tax and expenditure variables which may cause a deviation from the end-year position as envisaged in the fiscal path underpinning *SPU 2015* and the *Spring Economic Statement (SES)*.

To construct this scenario, the *SPU 2015* figures are adjusted to take account of observed taxation and expenditure developments up to end-August 2015.[3] The scenario assumes the

[2] Due to the size of the airline industry in Ireland, as well as the presence of a significant aircraft leasing sector, investment in the Irish *National Accounts* is boosted by purchases of aircraft. As these aircraft are imported and then largely used to service routes abroad, it is helpful when examining trends in underlying domestic investment to deduct aircraft purchases.

[3] The revenues for income tax, VAT and excise are based on the trends for the first eight months of the year being maintained for the remainder of 2015. A small adjustment for one-off tax revenue in 2015 is made to the base effect for 2016. Similarly, the trend for PRSI is maintained for the remainder for 2015 and this is carried into

implementation of €1.2 billion package of tax reductions and spending increases in *Budget 2016* and uses the macroeconomic forecasts as published in *SPU 2015*. Based on the latest Exchequer tax outturns (August 2015), the scenario assumes that tax and PRSI revenues will be €1 billion higher in 2015 compared to *SPU 2015.* This is somewhat offset by an assumed overall increase in spending in 2015 of €0.5 billion.[4] This higher level of tax revenue and expenditure in 2015 is assumed to carry forward into the baseline for 2016. Tax revenues in 2016 are assumed to grow in line with the growth rate of the main macroeconomic drivers as projected in *SPU 2015.*

TABLE 1: ILLUSTRATIVE SCENARIO ANALYSIS OF 2015 AND 2016 DEFICIT POSITION

	Outturn		*SPU 2015* Forecast		Updated Scenario	
	2013	2014	2015	2016	2015	2016
General Government Deficit	5.8	4.0	2.3	1.7	1.9	1.3

Note: Rounding may affect totals.

Assuming the Government implements a budget package of €1.2 billion, the General Government Deficit would narrow in this scenario to 1.3 per cent in 2016, down from around 2 per cent in 2015 (Table 1). As a result, taking into account the most recent available information, the short-run Excessive Deficit Procedure (EDP) target to reduce the deficit to below 3 per cent in 2015 is likely to be met with a significant buffer.[5] There are risks to these estimates, both upside and downside, as they do not take account of, for example, an overrun in spending beyond that assumed here or further trend improvements arising from the updated economic forecasts for 2016 reflecting recent *National Accounts* data or an increase in the budget package of €1.2 billion presented in *SPU 2015*.

2016. A slowdown in the strong trend in corporation tax is assumed, but with some over performance against profile for the remaining months of the year based on the level of pre-payments to date. .

[4] The majority of an assumed €0.6 billion overrun on Departmental spending arises in Health, and is offset in part by further savings on debt interest costs of €0.1 billion.

[5] The deficit figures for 2013 and 2014 presented in Table 1 are updated to reflect the latest figures from the CSO, published in the *Government Finance Statistics, Quarter 1 2015* and *National Income and Expenditure Accounts 2014* releases. The updated scenario allows for an equivalent level increase in nominal GDP in 2015 and 2016 in calculating the deficit to GDP ratio compared to the *SPU 2015* forecast, but does not assume any further changes to the SPU's macroeconomic assumptions that would impact on revenue or expenditure growth.

3. ASSESSMENT OF THE FISCAL STANCE IN ADVANCE OF *BUDGET 2016*

The Council's assessment of the prudence of the overall fiscal stance is informed by the extent of compliance with the fiscal rules, cross-checked by an economic assessment to confirm appropriate consideration of cyclical demand management and debt sustainability issues. This section reviews issues relevant to both components of the Council's assessment.

3.1 COMPLIANCE WITH IRELAND'S NEW BUDGETARY FRAMEWORK

An important achievement of recent years has been the institutionalisation of a new budgetary framework for Ireland. The key elements of the new framework have been described by the Council in previous Fiscal Assessment Reports (IFAC, 2014, IFAC, 2015b). Experience has demonstrated how, in the absence of a strong budgetary framework, a failure to look beyond the annual budget horizon and pro-cyclical fiscal policy have the potential to cause the public finances and the economy to move off a sustainable path. Although not perfect, the new much strengthened framework – a combination of domestic and EU rules, institutions and procedures – contains the key ingredients to help avoid the worst of the fiscal policy errors made in Ireland in the past.

Recognising the importance of a strong budgetary framework, the Government has enshrined many of its key elements into domestic law and some other welcome innovations in the budget process have been introduced. The effectiveness of these changes will depend critically on the quality of the implementation.

In the *Spring Economic Statement* (SES) published in April 2015, the Government for the first time set out in advance the size of the fiscal package to be contained in the October budget. The National Economic Dialogue held in July, at which IFAC participated, acted as a forum for debate over how the fiscal package of €1.2 to €1.5 billion could be utilised. Announcing the planned budgetary package earlier in the year should reinforce the link between the medium-term fiscal focus of the *Stability Programme Update (SPU)* in April and October budget decisions. In addition, it should help to anchor budget spending decisions in the face of information during the year about fiscal outturns. This could help to avoid the practice whereby incoming cyclical revenues are used to increase the size of the budget package. For

the longer run, a national dialogue about economic and fiscal priorities should help to improve prioritisation and planning.

From 2016, the public finances will be subject to the provisions of the Preventive Arm of the *SGP*[6, 7]. Ireland's domestic budgetary rule, enshrined in the *Fiscal Responsibility Act (FRA)*, mirrors the requirements of the *SGP*. Under the Preventive Arm, the Government is required to ensure that the budgetary position is at, or moving at a sufficient pace towards, the medium-term budgetary objective (MTO). Ireland's medium-term budgetary objective is for a balanced budget in structural terms.[8] Under this rule, based on the most recent official projections, the estimated structural deficit must be reduced by 0.6 per cent of GDP each year until the medium-term objective is reached. The rule to lower the structural deficit is supported by the Expenditure Benchmark (EB) which sets a limit on allowable expenditure growth.

In the June 2015 *Fiscal Assessment Report,* the Council described how the Government's plan in the *Stability Programme Update* for 2016 fell short of meeting the requirements of the budgetary framework. Regarding the Budgetary rule, *SPU 2015* set out a plan that showed the structural deficit improving by just 0.3 per cent of GDP in 2016 rather than the required 0.6 per cent, based on estimates produced by the Department of Finance using the harmonised methodology for calculating potential output.[9] The Council also noted that compliance with the second pillar of the framework – the Expenditure Benchmark – would also be called into question if a tax buoyancy effect is excluded.

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

[7] The procedures and policies for implementing the SGP are presented in the EC's "Vade Mecum" available here: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp151_en.pdf

[8] The structural balance is the surplus or deficit in the government's budget having adjusted for the cyclical position of the economy and the impact of one-offs.

[9] An assessment of *SPU 2015* by the European Commission (EC) calculates an improvement of 0.8 per cent in the structural balance in 2016 (EC, 2015b). This is based on an exercise designed to use information provided in the SPU. In a second exercise, the EC use their own Spring 2015 forecasts to estimate the change in the structural balance. On that basis, the EC report an estimated reduction in the structural deficit of 0.3 per cent in 2016, short of the 0.6 per cent requirement under the rules.

Given the measurement difficulties and complexities around the structural balance, the change in the actual General Government Balance can provide a useful cross-check when assessing the projected fiscal stance in 2016. As shown in Table 1, the SPU projections see the overall deficit falling from 2.3 per cent of GDP in 2015 to 1.7 per cent in 2016, a reduction of 0.6 per cent.[10] Part of this 0.6 per cent improvement in the headline balance will be driven by the cyclical recovery in the economy as higher economic activity generates additional tax revenue. Therefore, the improvement in the structural deficit for 2016 must be less than the required 0.6 per cent. Put another way, given the anticipated cyclical upswing in 2016, a targeted 0.6 reduction in the structural deficit means that the actual deficit will need to fall by more than 0.6 per cent in 2016.

It is important for the credibility of the budgetary process that the Government's fiscal plans show full compliance with the domestic and EU fiscal rules based on the Department of Finance's own estimates of the structural improvement. Moreover, under the Fiscal Responsibility Act, the Council's assessment of compliance with the Budgetary Rule will be based on the Government's own official forecasts, rather than the EC projections.

The requirement to lower the structural deficit is supported by the Expenditure Benchmark (EB) rule (see IFAC, 2015a). Under the EB, expenditure growth should not exceed the economy's medium-term rate of potential output growth unless the excess is offset by discretionary revenue raising measures. *SPU 2015* included the impact of tax buoyancy from the announced budget package for 2016 as a discretionary revenue raising measure in calculating the allowable fiscal space under the EB. As explained by the Council in its June 2015 *Fiscal Assessment Report,* revenue growth from the temporary demand effects of a budget package is not a discretionary revenue raising measure. As a result, the Council views the inclusion of tax buoyancy from budget measures as going against both the letter and spirit of the Expenditure Benchmark.

Since the publication of *SPU 2015* in April this year, new macroeconomic and fiscal data have become available and there have also been revisions to past data. It is possible that, taking into account the updated data, the plan outlined in *Budget 2016* will show compliance with the rules. The Council is strongly of the view that Government plans should be based on

[10] In the updated scenario for the deficit presented in Section 2, the projected improvement in the overall deficit between 2015 and 2016 is also 0.6 per cent.

expected compliance with the rules. This is essential to avoid undermining the budgetary framework, which would leave the economy more vulnerable to shocks over the longer term.

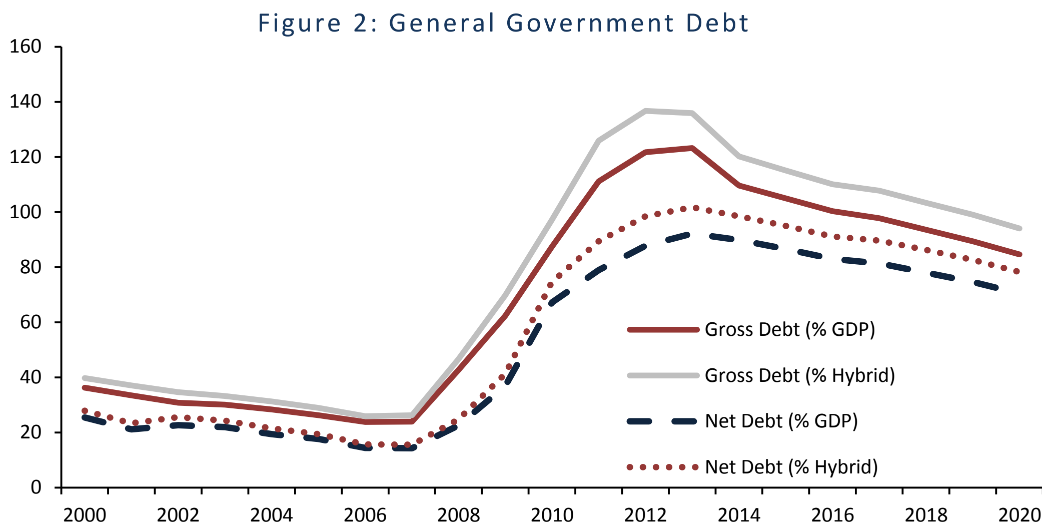
The Council's *ex post* assessment of the fiscal stance will take into account whether the Government has met both the structural balance and Expenditure Benchmark requirements. In a scenario where the Government complies with one rule (for e.g., the structural balance rule) but shows limited compliance or fails to comply with another (for e.g., the Expenditure Benchmark), the Council will examine the particular reasons causing the differing signals as well as the amount of structural fiscal effort undertaken by the Government.[11] In circumstances where the Government set out in advance a plan which envisages non-compliance with one of the two rules, this could make it difficult to demonstrate *ex post* that sufficient fiscal effort had been undertaken to merit an overall conclusion of compliance.

[11] This is in line with the approach under the Preventive Arm whereby, in the event of conflicting signals from the structural balance and Expenditure Benchmark rules, an "overall assessment" is carried out. This assessment examines the reasons for non-compliance as well as the amount of structural effort undertaken by the Government.

3.2 Demand Management/Debt Sustainability Trade-Off

The Council's approach to identifying the appropriate fiscal stance takes into account the trade-off between supporting domestic demand and the need to ensure debt sustainability, in part with a view to maintaining robust debt market access.

Figure 2: General Government Debt



Source: Department of Finance *SPU 2015*; IFAC internal calculations.

Debt Sustainability

Figure 2 shows the debt to GDP ratio out to 2020 on the basis of the forecasts contained in *SPU 2015.* Although the debt to GDP ratio has declined from its peak of 124 per cent in 2013 to 105 per cent in Q1 2015, the crisis leaves Ireland with a legacy of high debt levels by historical and international comparison. Despite Ireland initially having a very low debt to GDP ratio in 2007 of 24 per cent, the debt level rose very sharply during the recession to the extent that Ireland lost market access. With the gross debt level currently over 100 per cent of GDP, the vulnerability of the public finances to an adverse growth or interest rate shock is heightened. The debt sustainability challenge is more difficult when alternative measures of fiscal capacity (shown in Figure 2) are used. The figure shows the projected evolution of

alternative debt to fiscal capacity ratios: GDP and the Council's Hybrid measures of fiscal capacity.[12]

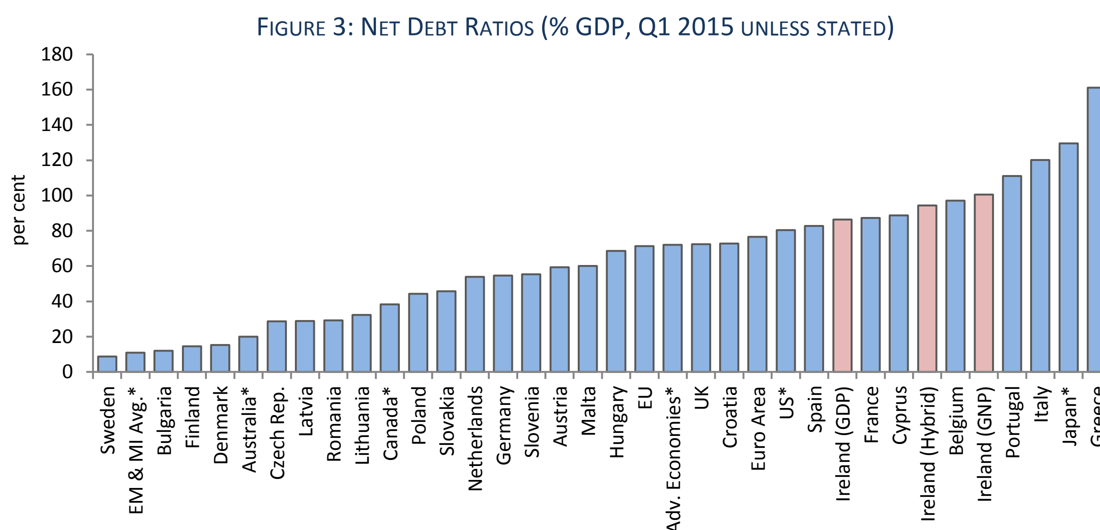


FIGURE 3: NET DEBT RATIOS (% GDP, Q1 2015 UNLESS STATED)

Sources: Eurostat; IMF Fiscal Monitor (April 2015); CSO and internal IFAC calculations.
Notes: Other than those countries marked by an asterisk, all net debt ratios are based on Q1 2015 Government Finance Statistics from Eurostat or the CSO (for Ireland). Net debt is calculated as Gross Consolidated Debt less EDP debt instrument assets (F2: Currency and Deposits; F3: Debt securities; and F4: Loan assets).
* IMF 2015 estimates are reported for those countries not covered by Eurostat Q1 Government Finance Statistics. For cross-country comparability, net debt levels reported are those of national statistical agencies for countries that have adopted the 2008 System of National Accounts (Australia, Canada, United States) excluding unfunded pension liabilities of government

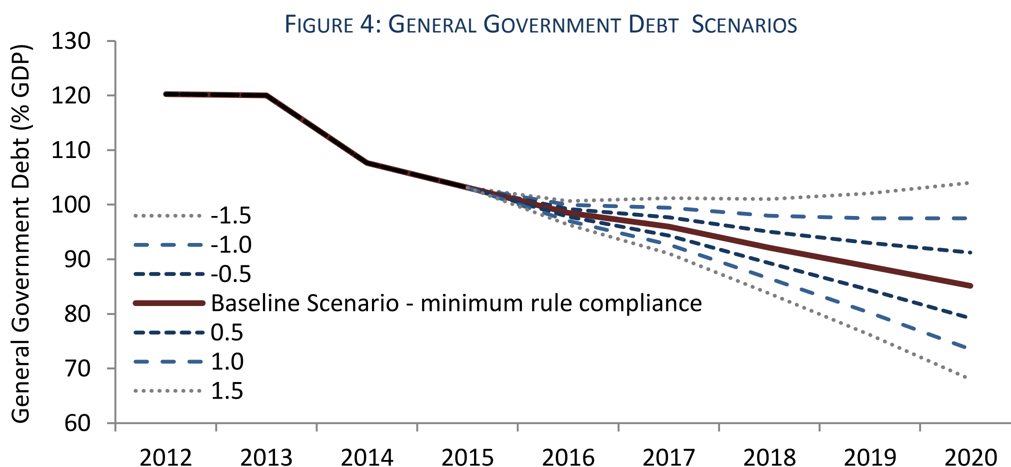
Owing to the State's holdings of financial assets, Ireland's debt burden is lower when measured on a net basis. Debt dynamics, based on current growth and interest rates, are also favourable. Nevertheless, as shown in Figure 3, the net debt burden in 2015 is high by international comparisons. With a debt level of this magnitude, Ireland's "fiscal space" (Ostry *et al.,* 2010) is limited implying that the risk that adverse shocks could destabilise the debt is high. This is illustrated in Figure 4 which uses the Council's Fiscal Feedbacks Model to show the sensitivity of the debt to GDP ratio to different nominal GDP growth shocks.[13]

[12] 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).

[13] *SPU 2015* projections assume over compliance with the fiscal rules after 2016. This assumption is contrary to the minimum compliance policy that is set out in the *SES*. The "Baseline" debt to GDP ratio projection shown in Figure 4 adjusts the profile for the debt to GDP ratio in *SPU 2015* assuming minimum compliance with the fiscal rules until 2020.

A key policy priority should be ensuring that the debt level remains on a downward path to safer levels over the coming years. The path of the debt to GDP ratio is determined by the interaction of: the initial stock of government debt outstanding, the average interest rate on government debt, the rate of nominal GDP growth, stock-flow adjustments (including any proceeds from the sale of state assets) and the government's primary budget balance (i.e., the budget balance, excluding debt-interest costs). The size of the primary surplus required to achieve a given rate of debt reduction will depend on the margin by which the interest rate exceeds the GDP growth rate and on the initial stock of debt. The forecasts in the *SPU 2015* envisage a fall in the overall debt-to-GDP ratio from 105 per cent of GDP in 2015 to 85 per cent in 2020. To achieve a sustained reduction in the debt-to-GDP ratio, improvements in the primary budget balance – the excess of tax revenues over non-interest spending – are required. By complying with the budgetary framework, it is more likely that the Government's fiscal policy decisions will be consistent with delivering and maintaining the required improvements in the primary balance.

FIGURE 4: GENERAL GOVERNMENT DEBT SCENARIOS



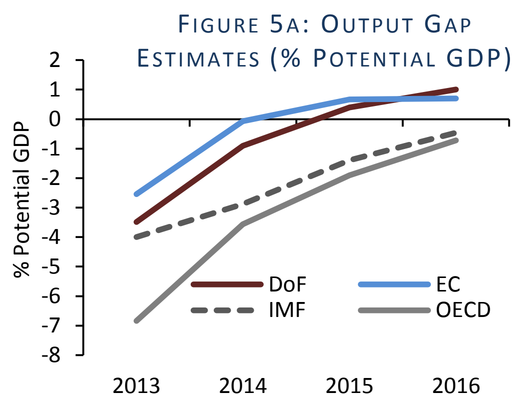
Sources: Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.
Notes: The figure shows alternative projections of the debt-to-GDP ratio based on GDP growth forecasts that deviate from *SPU* projections by 0.5, 1.0 and 1.5 percentage points in either direction. The illustrative "baseline" scenario assumes Department of Finance *SPU 2015* projections for 2016-2020 adjusted for minimum compliance with the Budgetary Rule.

The Cyclical Position of the Economy

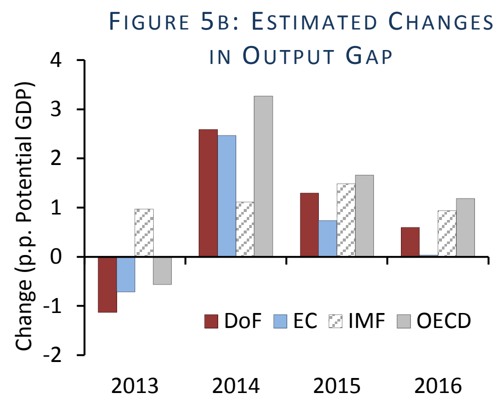
As discussed in Section 2.1, the recovery in the Irish economy has gathered momentum with buoyant export growth now being supported by a recovery in domestic consumption and investment. The broadening recovery has seen output as measured by both GDP and GNP re-

gaining their 2007 peaks. When considering the cyclical position of the economy, it is useful to examine both the level and the rate of change in the output gap (Figure 5A and Figure 5B). The output gap captures the difference between the economy's actual level of output in a given year and its potential output assuming full resource utilisation.

Regarding the level of the output gap, official estimates produced using the harmonised methodology show a small positive output gap in 2015. Given the problems with this methodology, it likely understates the extent of the output shortfall in the economy. Estimates produced by other institutions including the OECD and IMF suggest a small negative output gap in 2015 (Figure 5A). Looking at the change in the output gap, a consistent picture emerges. All four estimates shown in Figure 5B indicate a rapid closing of the negative output gap from 2014 to 2016. Given the profile and pace of growth now being observed, it appears likely that any remaining negative output gap in the economy will close over the short term.



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



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

3.3 Assessment of the Fiscal Stance for 2016

The Irish economy is now showing clear signs of having pulled through the crisis and, barring adverse shocks, could continue to record steady growth over the medium term. To achieve this outcome, three key objectives should be prioritised in shaping budgetary policy in the coming years:

- First, fiscal policy must remain focused on making further inroads into the legacy problems of the recession including eliminating the remaining budget deficit and reducing the debt.

- Second, fiscal policy decisions should be cognisant of known future pressures on the public finances; this includes recognition of the need for a reliable tax base to finance higher future expenditure pressures not adequately accounted for in current plans (IFAC, 2015b).

- Third, the resilience of the economy to possible risks should be bolstered by appropriately prudent fiscal policy that respects the budgetary framework. Proper implementation of the framework would enhance the credibility of the Government's plans, help avoid a repeat of past mistakes and would be consistent with reducing the debt.

In this context, the revised projections in *Budget 2016* should show full compliance with the budgetary framework. This means that the projections in *Budget 2016* should envisage a minimum 0.6 percentage point improvement in the estimated structural deficit in order to be in compliance with the rules on an *ex ante* basis. A decision to set out a plan which falls short of compliance with the Government's framework could undermine the framework in its early years of operation and would negatively impact the Council's assessment of the prudence of the overall stance.

Reducing the structural deficit in 2016 is also appropriate based on an economic assessment. The assumed budget package of €1.2 to €1.5 billion is less than the nominal increase in government revenue in 2016 if revenues grow in line with potential GDP growth. This illustrates why the fiscal stance in 2016 could be considered mildly contractionary since only part of the increase in revenues as the economy grows is being used to reduce taxes and increase spending. This is appropriate given the position of the economy and the necessity to reduce the deficit and lower the debt.

While the Council considers it probable that there is still a degree of slack in the economy, it is likely to be diminishing rapidly given high growth outturns and falling unemployment. This limits the economic case for a more expansionary stance. At the same time, there is a need

to reduce Ireland's high debt levels to lessen the vulnerability of the economy to adverse shocks. Ireland's growth outlook remains highly dependent on developments in the international economy. While demand conditions in Ireland's main trading partners are currently strong and exchange rate developments are favourable, given the high debt level, the Irish economy is vulnerable to a slowdown in external demand that would reduce growth in Ireland. This would have a negative knock-on effect on the public finances.

Weighing up these factors and considering the three priorities noted above, an improvement in the structural deficit in 2016 in line with the minimum required under the rules is appropriate and can help ensure that the remaining budget deficit is eliminated and the debt is placed on a firm downward path. Given recent data revisions, the proposed €1.2 to €1.5 billion package may be consistent with achieving the required 0.6 per cent reduction in the structural deficit.[14]

The question arises as to what the Government should do if full rule compliance is consistent under the new forecasts with a total tax and spending package of more than the upper end of the Government's April 2015 commitment (for a package of €1.2 to €1.5 billion). Announcing in advance the planned budget package represents a useful innovation in Ireland's budgetary framework and can contribute to avoiding a pro-cyclical approach to fiscal policy whereby additional revenues are spent as they come in. This improvement would be undermined by an upward deviation from the pre-announced €1.2 to €1.5 billion package in the forthcoming budget. In addition, from an economic perspective, it would be more appropriate in the current circumstances to use unanticipated tax receipts to reduce the debt to safer levels.

3.4 Assessment of the Fiscal Stance: Medium-Term Considerations

A core requirement of Ireland's new 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 *Budget 2015* and in *SPU 2015* is the absence of a realistic medium-term plan for the public finances. The Government's current projections for the public finances, based on technical assumptions, imply an implausibly large squeeze on government spending over the

[14] Preliminary calculations based on revised macroeconomic data from the CSO since the publication of *SPU 2015* suggest an estimated improvement in the structural balance for 2016 of close to the required 0.6 per cent.

medium-term, with the ratio of government spending to GDP projected to fall by 5 percentage points by 2020. As demonstrated in the Council's June 2015 report, this profile for government spending 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 pressures. Any decisions about tax cuts in the budget should take place in the context of well-specified medium-term plans that recognise underlying spending pressures.

The forthcoming budget in October should not only set out the parameters for policy in 2016 but should also contain a plan which links the Government's annual budgets to longer-term fiscal targets. Such plans are a requirement of the Government's own budgetary framework and are essential to increase the predictability of the budgetary planning process and to provide a link between resource allocation and Government policy and priorities. The scope for the Government to improve its budgetary plans in line with the requirements of the *Budgetary Frameworks Directive* was acknowledged in Minister Noonan's response to IFAC's June 2015 *Fiscal Assessment Report.*[15]

The lack of a well-anchored medium-term plan raises the risk that incoming cyclical revenues from the recovery in the economy will be spent rather than saved, undermining the public finances in the medium term. This risk is heightened given implementation problems with the system of multi-year expenditure ceilings. The ceilings were introduced to address serious expenditure management problems evident in Ireland prior to the crisis which resulted in repeated pro-cyclical re-setting of future expenditure levels. So far this system has not operated effectively with the Government raising the ceilings consistently since their introduction. Given the change to the operation of the Expenditure Benchmark with the move to an annual update, the Government should clarify in *Budget 2016* how the system of multi-year ceilings will operate given the revised EB framework.

[15] See: http://www.fiscalcouncil.ie/wp-content/uploads/2012/01/Response-from-Minister-Noonan-to-FAR-June-2015.pdf

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