3. Assessment of Budgetary Forecasts

3.1 Introduction

Under the Fiscal Responsibility Bill, the Council is required to provide an assessment of official forecasts, including budgetary forecasts. This chapter assesses recent budgetary projections by the Department of Finance with a particular focus on those contained in the *Stability Programme Update* (*SPU*) 2012. Consistent with the approach outlined in Chapter 2, a multi-faceted approach is followed consisting of: (i) a review of the accuracy of past Department of Finance projections; (ii) an examination of the latest Department of Finance projections; (iii) a comparison of the *SPU 2012* forecasts with the contemporaneous forecasts of other agencies; and (iv) an exploration of the impact of macroeconomic uncertainty on the fiscal aggregates using scenario analysis and fan charts.

The chapter is organised as follows. In Section 3.2, the accuracy of Department of Finance budgetary projections in 2011 is reviewed. Section 3.3 describes the projections from *SPU 2012*, which are assessed in Section 3.4. In order to capture uncertainties, the effect on the main fiscal aggregates of some alternative growth scenarios is considered in Section 3.5. Section 3.6 concludes.

3.2 How Close were the 2011 Budgetary Outturns to the Department of Finance Forecasts?

Based on the most recent National Accounts data (September 2012), the 2011 General Government deficit was €20.2 billion.[16] This represented an improvement of approximately €0.4 billion relative to the estimated outturn in the Maastricht returns (April 2012), mainly reflecting the impact of accrual adjustments.[17] Furthermore, the revision to the level of nominal GDP in 2011 helped the deficit ratio to fall to 12.7 per cent (from 13.1 per cent at the time of Maastricht returns). The underlying deficit, which excludes the impact of bank-related (deficit increasing) capital transfers, was significantly lower, at €14.4 billion, or 9.0 per cent of GDP, well within the 10.6 per cent target set by the ECOFIN Council in December 2010 under the excessive deficit

[16] The NIE for 2011 includes new General Government tables which help the assessment of budgetary data.

[17] The Maastricht returns (EDP Notification Tables) are submitted to Eurostat by each Member State twice a year, at end-March and end-September. These tables contain official estimates for the levels of General Government balance and debt for the preceding four years as well as forecasts for the current year. The tables are compiled by the Department of Finance and the Central Statistics Office. Figures relative to GDP are based on the July 2012 NIE 2011 release, which was not available at the time of the Maastricht returns.

procedure.[18] The fiscal targets for 2011 under the EU/IMF Programme, which included quarterly targets for the Exchequer primary balance, were also met in full. The level of gross General Government debt at end-2011 rose by €24.9 billion, to €169.1 billion, or 106.4 per cent of GDP, driven primarily by the deficit as well as by positive stock-flow adjustments.

The estimated outturn figures for 2011 from the Maastricht returns are the basis for *SPU 2012* and allow an assessment of the accuracy of Department of Finance budgetary projections for 2011 (Table 3.1). Direct comparisons between the forecasts and outcome figures, however, are complicated by technical changes during the period as to how some of the data are classified and accounted for. Specifically, the decision by Eurostat in early 2012 to classify €5.8 billion of injections into Irish financial institutions as capital transfers rather than financial transactions resulted in the General Government deficit in 2011 being significantly revised upwards. Moreover, methodological changes introduced by the Department of Finance in *SPU 2012* to improve accounting consistency between the Department and the CSO contributed to other large deviations in certain categories. For example, changes in the recording of local authority housing rentals, introduced by the CSO in 2011 to agree with Eurostat standards, contributed to a large increase of close to €1 billion in both Government receipts and expenditure, with no effect on the overall balance. This change had a particularly large effect on items such as "Social Payments" and the revenue item "Other", between *Budget 2012* and *SPU 2012*.[19]

Data revisions also underlie part of the differences between the Department's projections and the *SPU* estimated outcomes. In particular, the *SPU 2012* estimated outcome figure for Government investment spending in 2011, at €5.2 billion (reflecting the CSO estimate submitted as part of the Maastricht returns at end-March), was some €1 billion higher than the projection in *Budget 2012*. However, the CSO have recently revised downwards the figure for investment to €4.2 billion, more in line with the projections made by the Department in *Budget 2012*.

[18] Of the net €16.5 billion that was injected into Irish financial institutions in 2011, €5.8 billion was ultimately classified in March 2012 as a capital transfer, which added approximately 3.6 per cent of GDP to the 2011 deficit.

[19] While the methodological change affects the comparability of the numbers for a particular category, it does not affect the overall balance because it equally affects both receipts and expenditures. This change is documented on page 50 of *SPU 2012*.

Table 3.1: Department of Finance Projections for 2011 and Estimated Outturn

€ billions	***SPU 2011***	***Budget 2012***	***SPU 2012***	***NIE 2011***
	Apr-11	Dec-11	Apr-12	Sept-12
General Government Deficit (Underlying)	15.7	15.6	20.5 (14.7)	20.2 (14.4)
General Government Deficit, % of GDP (Underlying)	10.0	10.1	12.9[20] (9.3)	12.7 (9.0)
Revenue	55.4	54.2	55.8	
Taxes	38.2	36.8	37.1	
Other	17.2	17.4	18.7	
Expenditure	71.0	69.7	76.4	
Government Services[21]	26.2	27.6	26.5	
Social Payments	26.8	26.9	28.1	
Interest	5.9	5.1	5.4	
Investment	4.5	4.2	5.2	
Other	7.6	5.9	11.2	
Local Government Balance	-0.2	-0.2	0.0	0.0
General Government Debt	173.2	166.1	169.3	169.1

Source: SPU 2011, Budget 2012, SPU 2012, CSO and IFAC calculations.
Notes: Figures are on a General Government basis. The expenditure category 'Other' includes banking capital transfers of €5.8 billion. There was a correction to Ireland's end-2010 General Government Debt figure of €3.6 billion which distorts the debt comparison between the April 2011 SPU and the estimated outturn.

Another significant development contributing to the gap between the projection for interest expenditures between *SPU 2011* and *SPU 2012* was the reduction in interest costs arising from the EU Leaders agreement in July 2011. Partly as a result, interest costs in 2011 were about €0.5 billion below the 2011 *SPU* forecast.[22]

[20] The deficit ratio outturn figure is based on the revised GDP figure from NIE 2011, which came out after *SPU 2012*.

[21] Government Services defined here as Compensation of Employees and Intermediate Consumption. According to the *SPU*, intermediate consumption is current spending on goods and services by government units. Compensation of employees is the total remuneration paid to employees within the General Government sector.

[22] The National Treasury Management Agency (NTMA) forecasts national debt interest expenditure which is the largest component of General Government interest expenditure.

When these technical and external factors are taken into account, the main factors that contributed to the €1.2 billion improvement between the deficit projected in the *Budget* and the underlying deficit outcome for 2011 comprise: a better than expected end-year Exchequer position of about €0.3 billion; tax accrual adjustments mainly relating to delayed corporation tax receipts received in 2012 but counted as part of 2011; and a small surplus in the local government sector, where a deficit of €0.2 billion had been anticipated.

Between *SPU 2011* and *Budget 2012*, there was a sizable downward revision to the level of gross debt, which had been overstated by €3.6 billion, due to an accounting error.[23] However, the level of General Government debt was subsequently revised upwards in the *SPU* to €169.3 billion, due mainly to an early European Financial Stability Facility (EFSF) payment of approximately €1 billion and borrowings from NAMA of €0.7 billion. In the NIE, the level of debt in 2011 was revised marginally to €169.1 billion.

In summary, the underlying deficit in 2011 was significantly lower than had been anticipated in both the *SPU 2011* and in *Budget 2012*. It would appear that the forecasts underestimated some revenue and expenditure categories. Pure forecasting errors (consistent also perhaps with the existence of buffers in the official projections), methodological changes, data revisions and some unanticipated reduction in interest costs contributed to the deviations. Interpretation of movements in fiscal aggregates, including the identification of forecast errors, is complicated by these factors. The Council, therefore, urges the Department to make available publicly and in a timely manner comprehensive details of any changes that significantly affect the official forecasts.

3.3 The Budgetary Projections in *SPU 2012*

2012

In *SPU 2012*, the projected 2012 deficit was revised to 8.3 per cent of GDP from 8.6 per cent in *Budget 2012* (Table 3.2).[24] The improvement, despite a downward revision in forecast growth, appears to reflect mainly an overestimation of interest payments, an underestimation of receipts from the bank guarantee and dividend payments on the State's preference shares in AIB.

[23] This error led to an internal and external review of the compilation of General Government debt statistics, which were published by the Department of Finance in June 2012. These reports noted the complexity of the work involved and a duplication of effort across agencies. It was recommended that the CSO take overall responsibility for debt reporting.

[24] The EDP deficit ceiling set by the ECOFIN Council for 2012 is 8.6 per cent of GDP.

Understanding what is behind changes to deficit projections is crucial for interpreting and monitoring fiscal aggregates and the Council urges the Department of Finance to document clearly and in a timely manner when major changes to projections occur and the reasons behind them. This could be done by presenting recent vintages of forecasts side by side, with major revisions highlighted and explained.

Table 3.2: *SPU 2012*: Key Aggregates to 2015

€ billions	2011	2012	2013	2014	2015
Exchequer Deficit	24.9	18.7	14.5	10.4	6.8
General Govt. Deficit	20.5	13.1	12.4	8.1	5.0
Primary Deficit	15.2	6.7	3.1	-1.4	-5.0
Structural Deficit	12.4	11.9	11.3	8.5	6.3
Gross Debt	169.3	186.7	197.5	204.5	210.0
% of GDP					
Exchequer Deficit	15.9	11.7	8.9	6.1	3.8
General Govt. Deficit	13.1	8.3	7.5	4.8	2.8
Primary Deficit	9.7	4.2	1.9	-0.8	-2.8
Structural Deficit	7.9	7.5	6.9	5.0	3.5
Gross Debt	108.2	117.5	120.3	119.5	117.4
Memo items:					
Nominal GDP	156.5	158.9	164.2	171.2	178.9
Nominal GDP Growth (% change)	0.3	1.6	3.3	4.3	4.5
Assumed Discretionary Fiscal Adjustment	5.3	3.8	3.5	3.1	2.0
EDP Ceiling for General Govt. Deficit, % of GDP	10.6	8.6	7.5	5.1	2.9

Source: SPU 2012 and end-year Exchequer Returns.
Note: The EDP ceiling is the maximum underlying General Government balance allowed under the European Council's recommendations to Ireland as per 7 December 2010.

2013-2015

The *SPU* projections covering 2013-2015 are based on a planned consolidation of €8.6 billion set out in the *Medium-Term Fiscal Statement (MTFS)* published in November 2011 (Table 3.3). The precise tax and expenditure measures that underlie this budgetary plan have yet to be announced.

However, there has been a notable increase in the amount of information contained in the MTFS and subsequently in the *Comprehensive Expenditure Report 2012-2014 (CER),* the *Infrastructure and Capital Investment Framework,* and in the latest EU/IMF Programme Memorandum of Understanding. The *MTFS* provided an indicative split of consolidation at an aggregate level across tax, current and capital expenditure headings. Furthermore, spending decisions in particular will be informed by the *CER*, which sets out expenditure ceilings over the period 2012 to 2014.

Table 3.3: Indicative Consolidation Measures Underlying *SPU 2012*

€ billions	2013	2014	2015
Total Consolidation	**3.5**	**3.1**	**2.0**
Tax	1.25	1.1	0.7
Expenditure	2.25	2.0	1.3
Current	1.7	1.9	1.3
Capital	0.55	0.1	0.0

Source: Medium Term Fiscal Statement.

In the *SPU*, the General Government deficit is forecast to fall to less than 3 per cent of GDP in 2015, in line with the target set by the ECOFIN Council. The *SPU* projections over this period are similar to those in *Budget 2012*. The debt to GDP ratio is expected to peak in 2013 at 120.3 per cent. These projections assume a sustained upturn in economic activity over the period to 2015. In particular, the labour market outlook is expected to improve with employment increasing next year and with the unemployment rate declining.

According to *SPU 2012*, the expenditure to GDP ratio is forecast to decline to 2015, despite a marked rise in interest payments arising mainly from the ending of the interest holiday on the promissory notes.[25] Interest costs are expected to rise sharply, both in absolute terms (Table 3.4) and as a share of GDP. In contrast, all other main expenditure headings are projected to decline, contributing to a fall in primary spending of €4.2 billion. Government services, defined as the sum of compensation of employees (public sector pay) and intermediate consumption, is forecast to fall by €1.7 billion over the period, with social payments expected to decline by €1.6 billion. The *SPU* projections imply General Government revenue increasing at a rate close to the anticipated growth in nominal GDP. The increase in General Government revenue in Table 3.4 reflects the assumed

[25] This was discussed in detail in the Council's previous *Fiscal Assessment Report* (IFAC 2012a, pp. 26-29).

impact of new tax measures, carryover effects from past tax announcements and also the effects of economic growth.[26]

Table 3.4: *SPU* Projected Changes in Government Revenue and Expenditure

€ billions	2013	2014	2015	Cumulative 2013-15
Total Revenue	**2.0**	**2.8**	**2.6**	**7.5**
Tax	*2.6*	*2.6*	*2.3*	*7.6*
Total Expenditure	**1.3**	**-1.6**	**-0.4**	**-0.7**
Compensation of Employees	*-0.4*	*-0.3*	*-0.3*	*-0.9*
Intermediate Consumption	*-0.2*	*-0.3*	*-0.2*	*-0.8*
Social Payments	*-0.4*	*-0.9*	*-0.3*	*-1.6*
Investment	*-0.2*	*-0.2*	*0.0*	*-0.4*
Other	*-0.2*	*-0.1*	*0.0*	*-0.3*
Interest	*2.7*	*0.2*	*0.6*	*3.5*
Primary Expenditure	-1.3	-1.8	-1.0	-4.2

Source: SPU 2012 and IFAC calculations.
Note: Numbers rounded to one decimal place.

3.4 An Assessment of the *SPU 2012* Budgetary Forecasts and the Near-Term Fiscal Outlook

3.4.1 The Outlook for 2012

Exchequer Deficit

The most up-to-date information on current budgetary trends is provided by the monthly Exchequer returns, which appear to be broadly in line with the General Government outlook set out in the *SPU*. In the latter, the Exchequer deficit was projected to be €18.7 billion this year, although that figure is now likely to be lower due to the settlement of the 2012 Irish Bank Resolution Corporation (IBRC) Promissory Note payment with a Government bond rather than cash from the Exchequer.[27] In the first eight months of the year, the overall Exchequer deficit amounted

[26] The indicative consolidation measures in Table 3.3 refer to the estimate of the consolidation required to meet the deficit targets set by the ECOFIN Council based on the view of the economy and the public finances at the time of the *MTFS*.

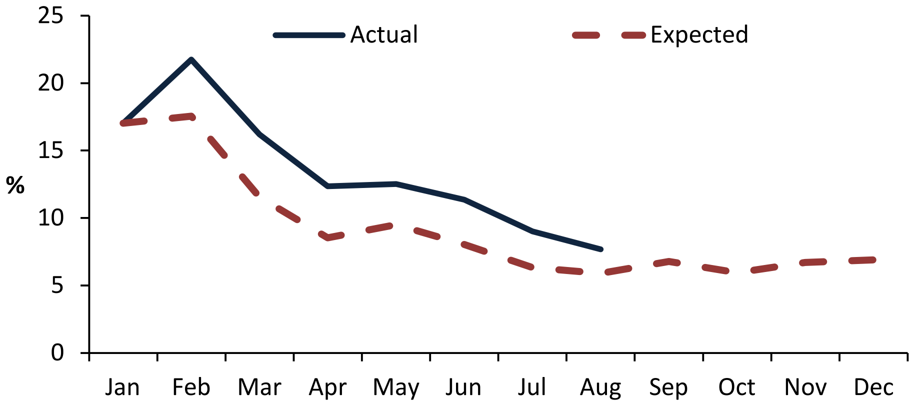
[27] The Exchequer deficit projection in the SPU for 2012 included €3.1 billion in respect of the promissory note payment to IBRC, although ultimately settlement of this payment was through a Government bond.

to €11.3 billion. Higher debt servicing costs coupled with payments to Irish Life (of €1.3 billion) and loans to the Insurance Compensation Fund (of €0.5 billion) added to the deficit in the first eight months of the year, although these payments were anticipated.[28,29]

Tax Revenue

The Exchequer revenue data indicate that taxes to end-August were 1.7 per cent (or €365 million) ahead of the Department of Finance's target (Figure 3.1).[30] Three of the four largest tax categories (Income, VAT and Corporate tax) recorded revenues ahead of the cumulative profile expected by the Department of Finance. As usual, the outturn for the entire year will be especially influenced by the intake for November, the month in which a large part of the taxes that are particularly difficult to forecast, notably corporate and (non-PAYE) income taxes, are collected.

Figure 3.1: Exchequer Tax Outturn and Adjusted Profile to End-August 2012: % change on the same month in the previous year



Source: Exchequer Returns.
Note: The Department of Finance published revised tax profiles in May 2012 to adjust for a reclassification of PRSI income to Income tax. The profile was also adjusted to allow for €251 million in Corporation Tax income that related to December 2011.

This precise treatment was not reflected until after the publication of the *SPU* in the end-April Exchequer statement, which was published on May 2 2012.

[28] On June 29, it was announced that the Minister for Finance had acquired Irish Life for €1.3 billion to complete the recapitalisation as directed by the Central Bank as part of the Prudential Capital Assessment Review (PCAR) in 2011.

[29] Under the 1964 Insurance Act the Minister for Finance may advance funds to the Insurance Compensation Fund (ICF) on the recommendation of the Central Bank. Payments to the ICF by the Exchequer are classified as financial transactions and do not affect the General Government deficit.

[30] In May 2012 the Department of Finance published revised estimates for the 2012 Exchequer tax profile, due to a technical reclassification between PRSI and income tax.

Non-Tax Revenue

Non-tax related income streams have become more significant in recent years, reflecting in part the State's heavy involvement in the banking sector (See Box B). Specifically, General Government revenues relating to activities undertaken to support financial institutions in Ireland have increased from €0.8 billion in 2008 to an estimated €2.6 billion in 2011.[31] These sources of income need to be closely monitored. For the first eight months of 2012, Exchequer non-tax revenues amounted to €2.4 billion. This represented a year-on-year increase of close to 50 per cent, partly as a result of timing factors[32] and interest on contingent capital notes, which were received for the first time in July 2012. Given their increased importance, a detailed breakdown of the components of non-tax revenues and explanations behind their evolution are warranted in both *Budget* and *SPU* publications.

Box B: Banking Related Revenues in the Exchequer Data

Significant income streams arise from the State's involvement in the banking sector. Some of these income streams are included as part of non-tax related income, which has increased as a share of total Exchequer revenue from 1.3 per cent in 2007 to 7.5 per cent in 2011.

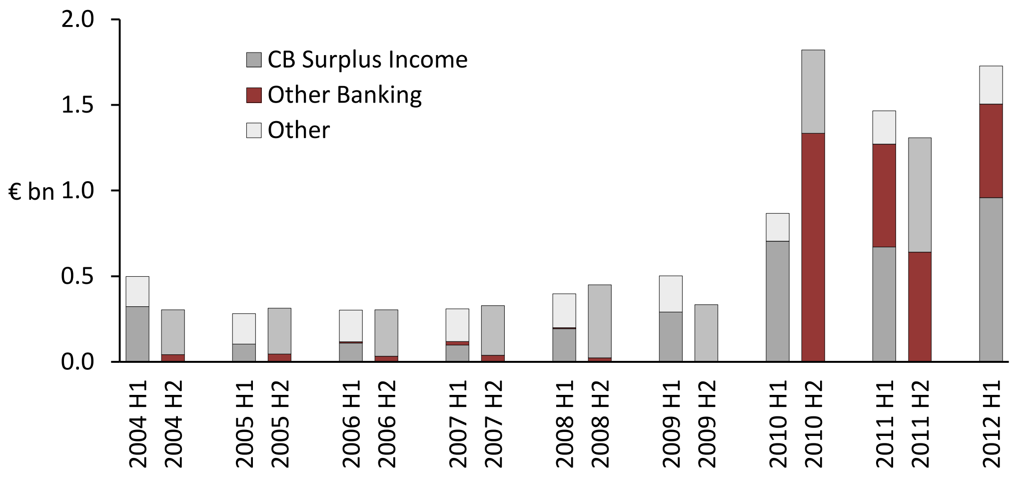
Half-year figures for non-tax revenues are split into broad banking and non-banking categories in Figure B1. Within the banking category, the major item is Central Bank Surplus Income. In June 2012, the Central Bank of Ireland (CBI) transferred just under €1 billion to the Exchequer arising from profits made in 2011. The CBI received net interest income of €1.6 billion in 2011 (inflows of €3.7 billion and outflows of €2.1 billion). Of the inflows, €1.6 billion in interest was earned on the extension of exceptional liquidity assistance (ELA). There has also been significant income relating to the Credit Institutions Scheme in recent years. The latter generated €0.5 billion in the first half of 2012.[33]

[31] See Eurostat Financial Summary Tables for Ireland.

[32] There were three bank guarantee payments in the year to August 2012 compared to two a year previously.

[33] The Credit Institutions (Eligible Liabilities Guarantee) Scheme was introduced by the Minister for Finance to maintain the stability of the financial system. Institutions covered under the scheme are required to pay a fee to participate in the scheme. More details are available from: http://www.ntma.ie/ELGScheme/CreditInstitutionsELGScheme.php

Figure B1: Half-Year Figures for Exchequer Non-Tax Revenue



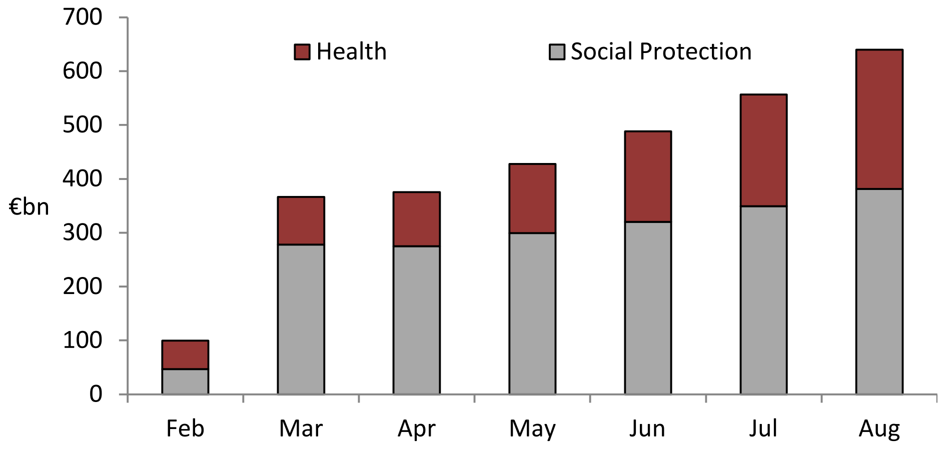
Source: Exchequer Returns.
Note: Other banking is defined here as income from the 'Credit Institutions Scheme' plus other smaller banking related receipts.

Expenditure

In terms of Exchequer expenditure, there are underlying pressures in the Health and Social Protection budgets. These two areas, combined with Education, account for just over 80 per cent of net voted expenditure.[34] Figure 3.2a shows the excess of current spending for Health and Social Protection relative to Government targets on a monthly basis. As of end-August the combined overrun, adjusted to reflect some technical factors, was estimated to be about €640 million, or 2.3 per cent of voted current spending. Over half of the overspend in Social Protection reflected weaker than expected PRSI receipts. The technical factors refer to adjustments to allow for a reclassification of PRSI receipts, which had the effect of increasing net voted spending by the Department of Social Protection. Furthermore, an earlier than expected receipt from the UK Department of Health reduced the overrun in the Health budget.

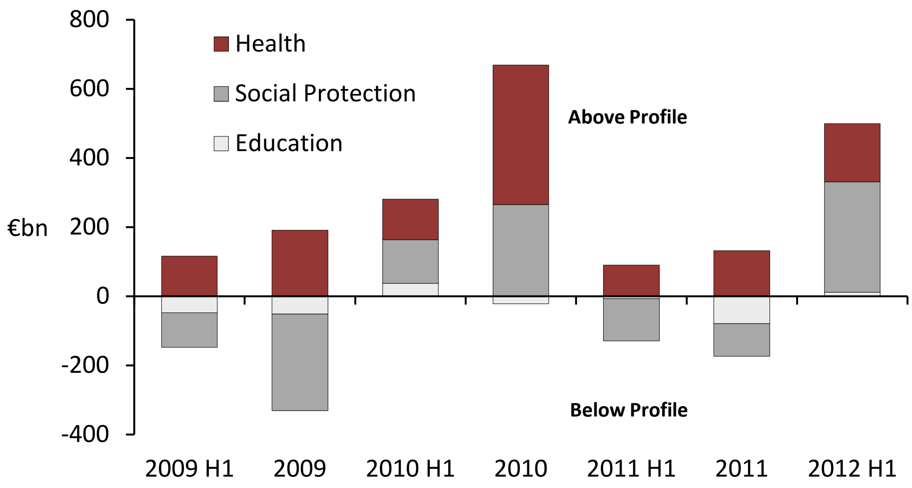
[34] Government expenditure is partly organised into "votes" which are approved by the Dáil each year, following the publication of the *Revised Estimates Volume* (*REV*). Total Government expenditure also includes non-voted items, such as interest payments on Government debt. A further distinction arises between gross and net expenditures. The former includes expenditure by the Social Insurance Fund, National Training Fund and also "appropriations-in-aid", which are receipts retained by Departments and Agencies, to use towards their overall spend, whereas net spending is the overall drawdown of money from the Exchequer. According to the REV, total voted expenditure in 2012 is projected to be approximately €44 billion, with gross spending of €56 billion.

Figure 3.2a: Adjusted Monthly Current Expenditure Overrun in Health and Social Protection in 2012[35]



The most recent review mission by the EU/IMF noted the need to closely monitor spending in these key areas (EC, ECB and IMF, 2012). The overrun in Health spending, in particular, is consistent with a pattern of overruns experienced in recent years, which is shown in Figure 3.2b along with the other main expenditure categories.

Figure 3.2b: Cumulative Overruns in Current Expenditure: Mid-Year Vs End-Year[36]



[35] The figure allows for a technical reclassification which meant that net voted expenditure by the Department of Social Protection was significantly ahead of profile in the early months of the year. Specifically, there was a reclassification of an estimated €243 million in PRSI receipts to income tax to end-July, which resulted in higher net voted spending by the Department of Social Protection. The figure also excludes an early payment of €130 million from the UK Department of Health, which had the effect of reducing the reported Health Vote Group overspend in July.

[36] The early payment from the UK Department of Health does not affect the series for the first half of 2012. The profile for Social Protection spending in 2012 was revised to allow for the PRSI reclassification issue.

Expenditure Ceilings

In 2011, the Government outlined a new medium-term expenditure framework that set out current expenditure ceilings for each of 2012, 2013 and 2014. The *CER* defines the ceilings for 2012 as "binding and fully specified in terms of programme level allocations" (Department of Public Expenditure and Reform, 2011 p. 21). It also specifies that Departments that exceed their ceiling in any given year would have to offset that overspend in the following year, although there may be some leeway in the case where the department "cannot absorb the full required adjustment" (Department of Public Expenditure and Reform, 2011 p.79). As this is the first time these multi-year expenditure ceilings are in effect, it is not clear how exactly any overrun in spending in 2012 would be treated in following years. This underscores the importance of complete documentation as to how overruns are treated in subsequent years in the event that the 2012 ceiling is breached for a particular department, including their impact on other department allocations. Moreover, any impact of annual expenditure overruns on medium-term forecasts should be documented explicitly.

Budgetary Outlook for 2012

Overall, the projected *SPU* General Government deficit of 8.3 per cent of GDP for 2012 appears achievable, given the cumulative trends in the Exchequer data and the economic outlook. This assessment is shared by the EU/IMF and by the ESRI and OECD. The main risks centre on the potential for weaker than anticipated growth in the second half of the year and emerging spending pressures in key areas.

3.4.2 The Outlook for 2013 to 2015

The *SPU 2012* envisages a fall in the budget deficit to below 3 per cent of GDP by 2015. This is premised on a sustained upturn in nominal and real growth rates and additional budgetary consolidation of €8.6 billion. Both the ESRI and the OECD anticipate that the deficit in 2013 will be close to the *SPU* outlook. This target is also reflected in the projections contained in the agreed programme with the EU and IMF.[37]

[37] In the Council's previous *Fiscal Assessment Report* it was noted that the EC and IMF forecasts for the fiscal outlook for 2013 to 2015, as published in the first quarter of 2012, were similar to the Department of Finance's outlook from *Budget 2012* (IFAC, 2012a).

Table 3.5: Fiscal Outlook 2013 to 2015

	2013	2014	2015
General Government Balance (% of GDP)			
SPU 2012 **(April 2012)**	-7.5	-4.8	-2.8
IMF (June 2012)	-7.5	-4.7	-2.9
EC (June 2012)	-7.5	-4.8	-2.9
General Government Debt (% of GDP)			
SPU 2012	120.3	119.5	117.4
IMF	121.2	119.7	116.2
EC	120.2	119.7	117.4
Nominal GDP Growth (% change)			
SPU 2012	3.3	4.3	4.5
IMF	3.1	4.1	4.5
EC	3.1	4.1	4.5

The *SPU 2012* projections are contingent upon a sustained period of expenditure restraint (Figure 3.3a). Primary expenditure (defined as General Government expenditure less interest payments) is forecast to decline on average by 2.2 per cent per annum from 2013 to 2015, or in real terms by about 3.5 per cent per annum.[38] Cumulatively, primary spending is projected to fall as a share of GDP by approximately 7 percentage points (Figure 3.3b). Implicit in the expenditure projections, particularly for social payments, is the assumed recovery in the labour market.

[38] The real growth rate here is an approximation based on the *SPU 2012* numbers. Primary spending is deflated using the GDP deflator, which is projected to average 1.2 per cent per annum from 2013 to 2015 in the *SPU*. In practice, the price of Government purchases and investments, as well as the rate of increase of Government wages and welfare payments, may evolve differently from the GDP deflator. In the *SPU*, labour market wages are projected to rise by 1.4 per annum. No details are published, however, on the split between private and public sector wages.

Figure 3.3a: *SPU* Projections for Growth in Major Expenditure Categories

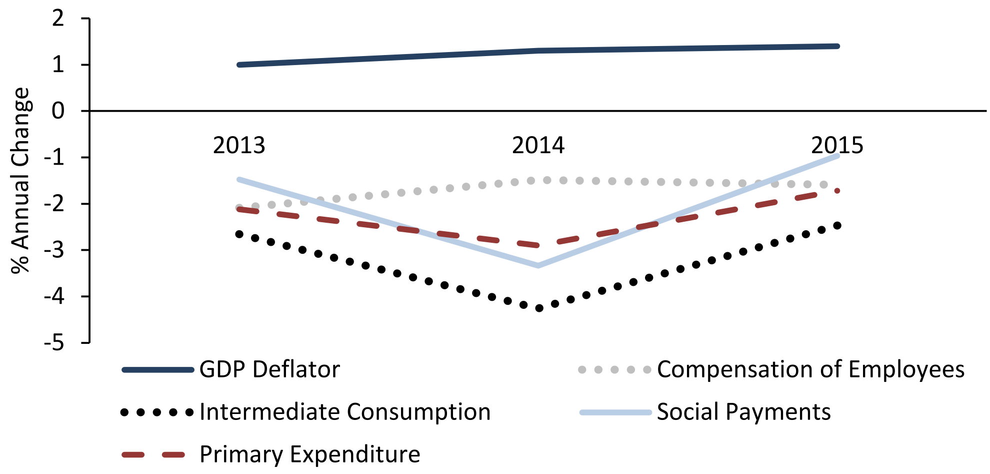
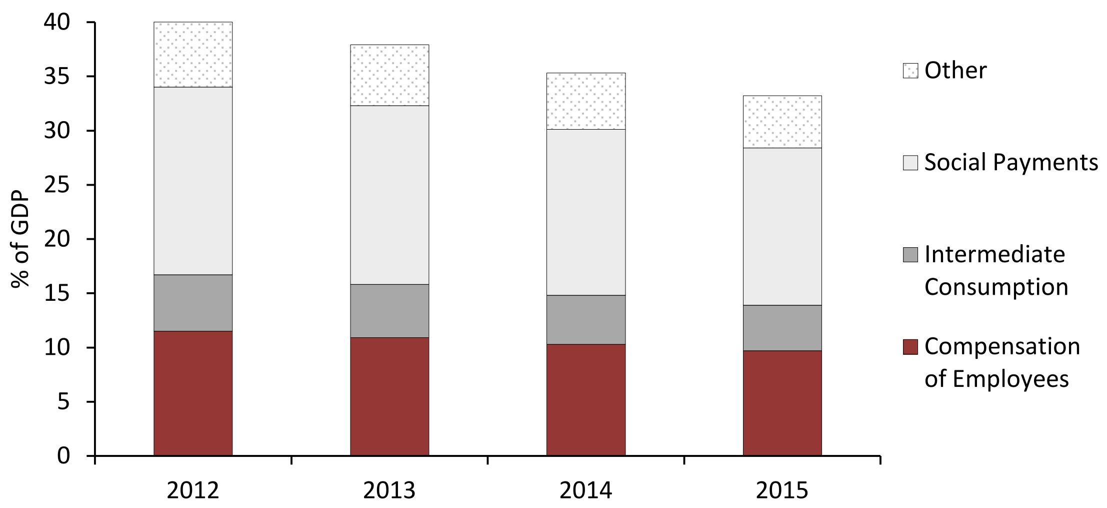
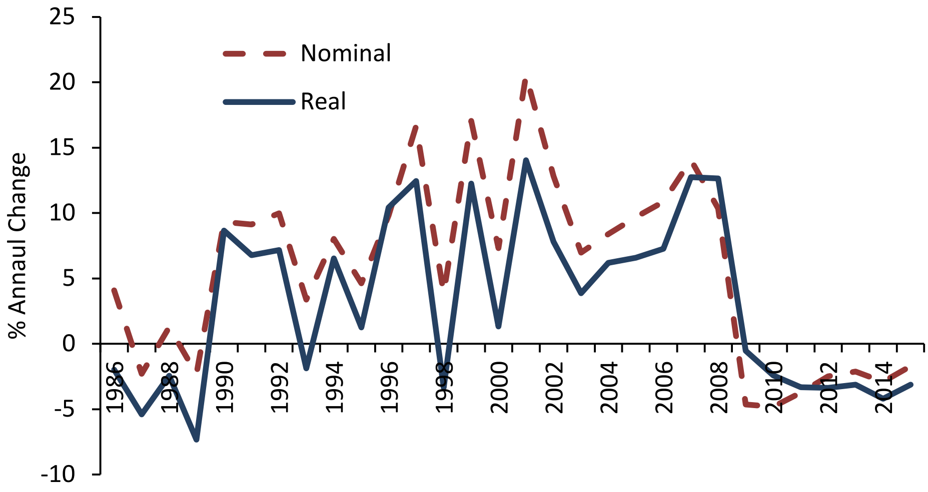


Figure 3.3b: *SPU* Projections for Primary Expenditure Categories



Judging by historical experience, delivering on these expenditure adjustments will be challenging. Figure 3.4 illustrates, for comparison purposes, the nominal and real growth rates for primary Government expenditures (excluding the exceptional banking related capital transfers between 2009 and 2011) during 1996-2011, with *SPU* projections included to 2015. While there have been years in which primary spending declined, a sustained period of nominal contraction had not occurred before the onset of the current crisis. Given the extent of the adjustments involved, it is important for policymakers not to reduce their margins of manoeuvre to achieve the necessary consolidation by selectively putting certain measures – e.g. social welfare rates, public sector pay and tax rates – out of bounds. The Council has expressed this view in its earlier reports.

Figure 3.4: Adjusted Primary Expenditure 1986-2015



Source: Eurostat and IFAC calculations based on SPU for years 2012-15.
Notes: Primary expenditure excludes exceptional banking related capital transfers from 2009 to 2011. Real series based on GDP deflator.

3.5 The Impact of Different Macroeconomic Assumptions on Key Budgetary Aggregates

A core message from Chapter 2 and in the Council's previous *Fiscal Assessment Report* is the high uncertainty surrounding prospects for growth in the post-bubble Irish economy. The Council's fiscal feedbacks model (see Annex B), together with the fan chart methodology used already in Chapter 2, can be used to examine the impact of different growth assumptions on the budgetary projections.

3.5.1 Deficit and Debt Ratios with Alternative Paths for GDP

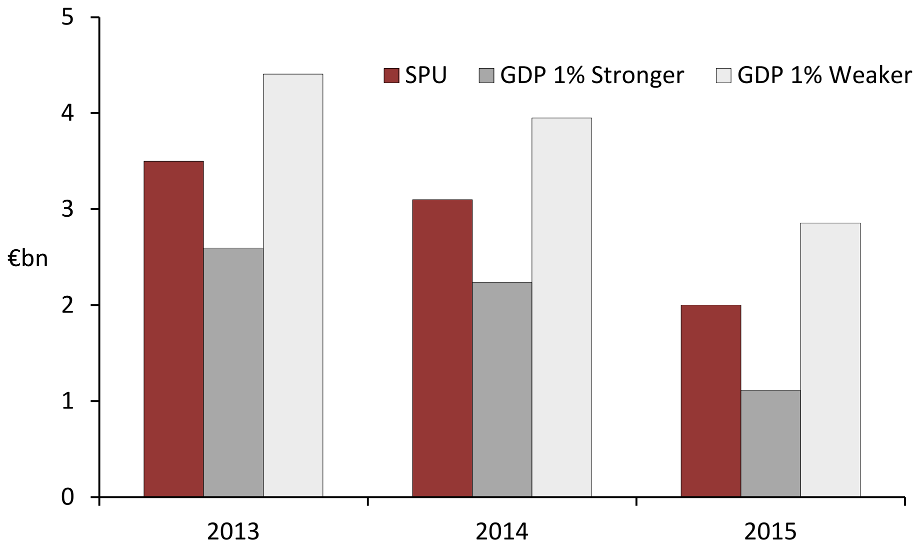
The *SPU* fiscal projections assume average annual nominal GDP growth of 4 per cent between 2013 and 2015. Table 3.6 illustrates two alternative growth scenarios. In the event that nominal growth is 1 per cent weaker per annum, the deficit remains above the 3 per cent target in 2015 and the gross debt ratio fails to stabilise. Thus, additional consolidation measures would then be necessary to meet the 2015 target (Figure 3.5). Conversely, if growth is 1 per cent stronger per annum, the deficit falls to 1.5 per cent of GDP in 2015. The primary budget surplus increases, facilitating a decline in the debt ratio. In such a scenario, less consolidation than currently planned would be needed to meet existing targets.

Table 3.6: Budgetary Aggregates (% of GDP) and Selected GDP Growth Scenarios

SPU 2012	2013	2014	2015
Nominal GDP Growth	3.3	4.3	4.5
Gross Debt	120.3	119.5	117.4
Primary Deficit	1.9	-0.8	-2.8
General Government Deficit	7.5	4.8	2.8
Nominal GDP 1 per cent weaker per annum			
Gross Debt	121.9	123.0	123.2
Primary Deficit	2.3	0.0	-1.7
General Government Deficit	8.0	5.6	4.1
Nominal GDP 1 per cent stronger per annum			
Gross Debt	118.8	116.1	111.8
Primary Deficit	1.5	-1.5	-3.9
General Government Deficit	7.0	3.8	1.5

Source: IFAC calculations.

Figure 3.5: Low and High Growth Scenarios: Additional Discretionary Adjustments to Meet Existing General Government Deficit Targets

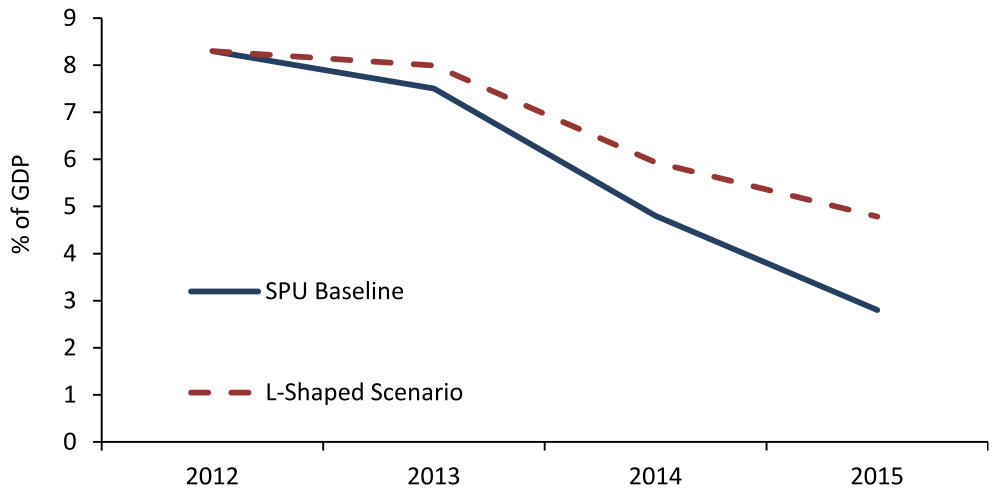


Source: SPU 2012 and IFAC calculations.

3.5.2 An Illustrative "L-Shaped" Scenario

In the construction of the fan chart for nominal GDP in Chapter 2, it was assumed that risks to growth were balanced (symmetric). However, the recent experience of forecast errors suggests that risks around the macroeconomic forecasts are likely to be greater on the downside relative to the *SPU* projections. In particular, given the nature of the current "balance sheet" recession and with uncertain growth prospects internationally, the recovery in growth may be delayed implying a prolonged "L-shaped" recession. Figures 3.6 a and 3.6b show an illustrative scenario for the public finances for this risk based on the assumption that there is no growth in real GNP during 2013-2015, consistent with only very modest growth of nominal GNP and significantly weaker GDP growth than in the *SPU*.[39] Under this illustrative scenario, pressures on the public finances would be considerably greater and in the absence of further additional measures, the debt ratio would fail to stabilise.

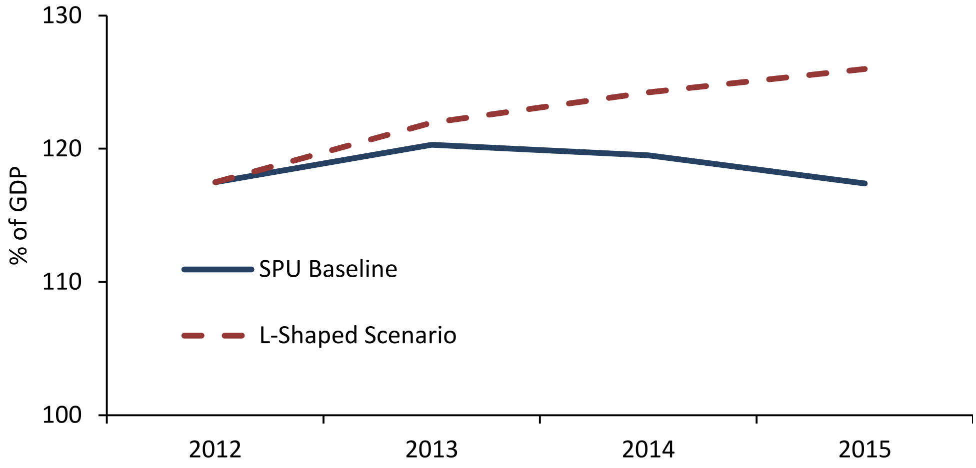
Figure 3.6a: L-Shaped Scenario, General Government Deficit % of GDP



Source: SPU 2012 and IFAC calculations.

[39] Specifically, nominal GDP growth averages 2.5 per cent per annum over the period compared to 4 per cent in the SPU baseline

Figure 3.6b: L-Shaped Scenario, General Government Debt % of GDP



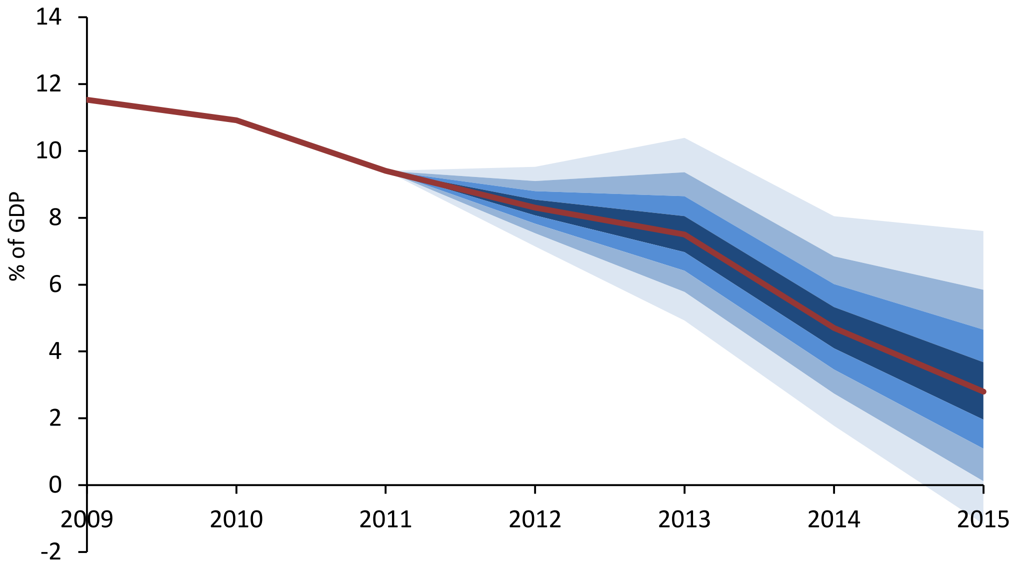
Source: SPU 2012 and IFAC calculations.

3.5.3 Fan Charts for Key Budgetary Indicators

Fan charts illustrating the impact of alternative growth paths on the public finances are shown in Figure 3.7, with the centre of the fan representing the *SPU 2012* projection. The width of the fan represents the range of possible outcomes for the fiscal aggregates based on past nominal GDP forecast errors. While there are some limitations with these charts, as described in Annex A, they do serve to highlight the fragility of the fiscal position.

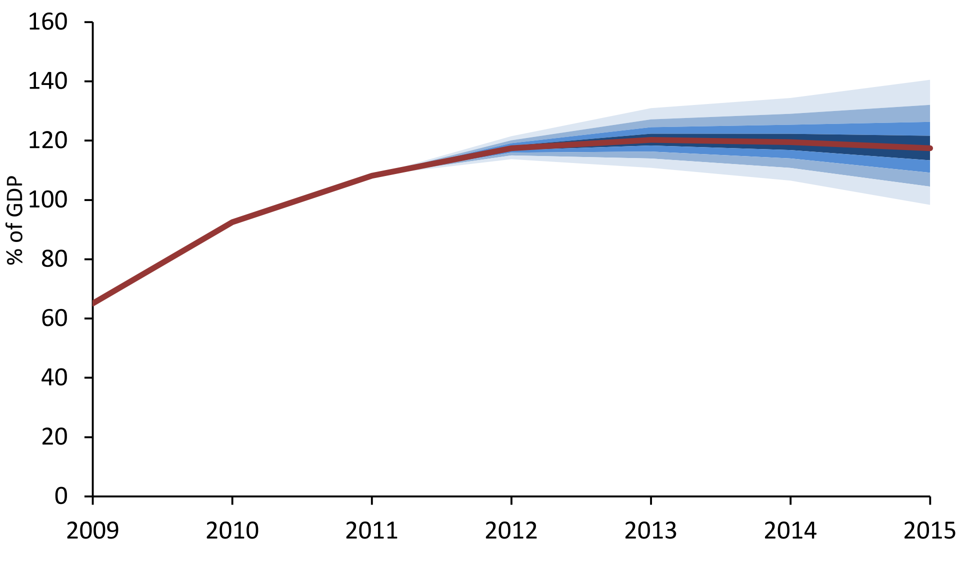
For example, according to this methodology, there is an estimated 30 per cent probability that the deficit to GDP ratio would be above 4.6 per cent of GDP by 2015, in the absence of offsetting policy adjustments (Figure 3.7a). Similarly, there would be approximately a 40 per cent probability that the debt to GDP ratio fails to stabilise by 2015 (Figure 3.7b). A fan chart was also constructed for the additional cumulative budgetary adjustments that might be necessary in the event of growth deviations, so as to meet existing EDP deficit targets (Figure 3.7c). This chart shows that there is an estimated 30 per cent probability that additional cumulative adjustments of more than €3.6 billion over the period would be needed to comply with the 2.8 per cent deficit target for 2015.

Figure 3.7a: General Government Deficit



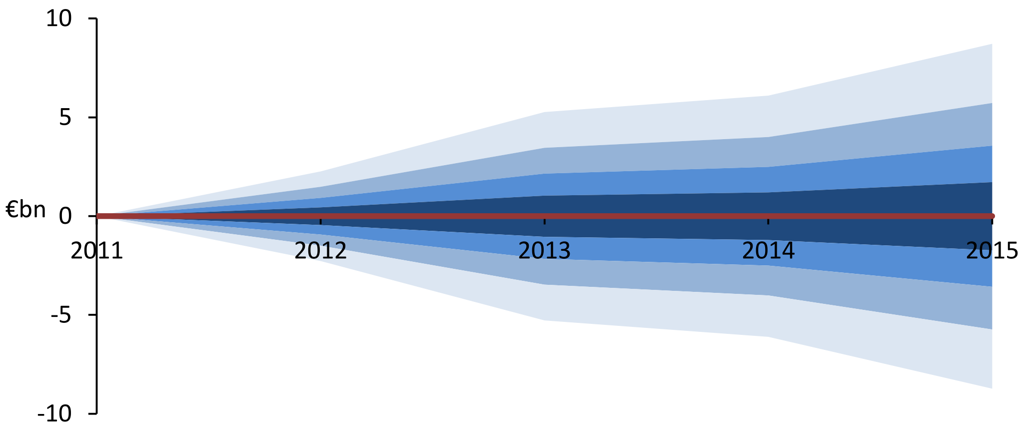
Source: SPU 2012 and IFAC calculations.

Figure 3.7b: General Government Debt



Source: SPU 2012 and IFAC calculations.

Figure 3.7c: Cumulative Additional Budgetary Adjustments Required to Meet *SPU 2012* General Government Deficit Targets



Source: SPU 2012 and IFAC calculations.

3.6 Summary

This chapter assessed recent budgetary forecasts produced by the Department of Finance, with a particular focus on those in *SPU 2012*. The main findings are:

- The underlying General Government deficit outturn for 2011 was 9.0 per cent of GDP. This compares with a projection of 10.0 per cent in *SPU 2011* and 10.1 per cent of GDP in *Budget 2012* and represented a €1.2 billion improvement over the *Budget 2012* projection. The EDP deficit ceiling of 10.6 per cent of GDP was comfortably met. At a more disaggregated level, there were some significant differences between projections and outturns, in part reflecting methodological changes. The deficit projection for 2012 has been revised from 8.6 per cent in *Budget 2012* (December 2011) to 8.3 per cent in *SPU 2012* (April 2012) despite a downward revision to growth. This reflected, in part, revisions to projected interest payments and banking fees that helped to improve the outlook. Non-tax revenues relating to the State's involvement in the banking sector have increased significantly in recent years, and should be closely monitored.

- A General Government deficit of 8.3 per cent of GDP for 2012 looks achievable at this stage given the cumulative trends in the Exchequer data and the economic outlook. That said, there have been significant spending overruns in Health and Social Protection. The current year overrun in Health reflects a similar pattern in recent years.

- To facilitate adequate assessment of budgetary projections, the Council urges that comprehensive and timely explanations be provided publicly on: (i) methodological changes and data revisions that impact the fiscal outturn or official forecasts; (ii) sources of major modifications to forecasts and; (iii) the components of non-tax revenues.

- The *SPU 2012* projections for 2013-2015 are in line with projections from other agencies.

- At a more disaggregated level, the *SPU* projections show the need for significant real expenditure reductions in all main categories, notwithstanding underlying spending pressures. Given the extent of the required total adjustment, the Council again urges that all adjustment margins be kept under close review, including tax rates, public-sector pay and pensions and welfare rates.

- Sensitivity analysis undertaken by the Council reveals risks around budgetary targets and the fragility of debt sustainability.