4. Assessment of the Fiscal Stance

4.1 Introduction

As part of its mandate under the Fiscal Responsibility Bill (FRB), the Fiscal Council shall ". . . in relation to each *Budget* and *SPU*, provide an assessment of whether the fiscal stance for the year or years concerned is, in the opinion of the Fiscal Council, conducive to prudent economic and budgetary management, including by reference to the provisions of the Stability and Growth Pact ." (Department of Finance, 2012b). This chapter provides an assessment of the fiscal stance set out in the 2012 *Stability Programme Update* (*SPU*) – the most recent statement of the Government's fiscal policy position. It also considers the question of debt sustainability.

The chapter is organised as follows. In Section 4.2, the Government's fiscal stance is reviewed and assessed with particular consideration to developments on debt sustainability, market assessments of state creditworthiness and aggregate demand conditions. Section 4.3 takes up the issue of debt sustainability, focusing on a comparison of feasibility calculations based on GDP and GNP measures of fiscal capacity. A hybrid measure is introduced that puts differential weight on GNP and the excess of GDP over GNP as an intermediate measure of fiscal capacity. Section 4.4 concludes.

4.2 Assessing the Fiscal Stance: An Update

Table 4.1 shows key indicators of the Government's fiscal stance for the period to 2015. The table also records the Council's suggested alternative stance, which involves a relatively modest degree of additional adjustment compared to the Government's baseline.

In previous reports, the Council concluded that the Government's fiscal stance was appropriate (IFAC, 2011 and IFAC, 2012a) and thus, in the language of the FRB, "conducive to prudent economic and budgetary management". However, after balancing competing factors relating to supporting growth and achieving debt sustainability, the Council made a case for additional adjustments over the period to 2015.

Table 4.1 The Fiscal Stance: Alternative Assessments

GGB (% of GDP)	2013	2014	2015
SPU 2011	-7.2	-4.7	-2.8
IFAC Alternative October 2011	-6.4	-3.6	-1.0
Budget 2012	-7.5	-5.0	-2.9
IFAC Alternative April 2012	-7.4	-4.6	-1.7
SPU 2012	-7.5	-4.8	-2.8
IFAC Alternative September 2012	-7.5	-4.5	-1.9
Primary Balance (% of GDP)	**2013**	**2014**	**2015**
SPU 2011	-1.1	1.7	3.4
IFAC Alternative October 2011	-0.9	2.2	4.7
Budget 2012	-1.9	0.8	2.8
IFAC Alternative April 2012	-1.8	1.2	4.0
SPU 2012	-1.9	0.8	2.8
IFAC Alternative September 2012	-1.9	1.0	3.7
Debt (% of GDP)	**2013**	**2014**	**2015**
SPU 2011	118.0	116.0	111.0
IFAC Alternative October 2011	117.0	115.3	109.8
Budget 2012	119.0	118.0	115.0
IFAC Alternative April 2012	119.8	118.6	114.7
SPU 2012	120.3	119.5	117.4
IFAC Alternative September 2012	120.3	119.4	116.8

Assumed Consolidation € billions	2013	2014	2015	2013 - 2015
SPU 2011	3.1	3.1	2.0	8.2
IFAC Alternative October 2011	3.9	3.8	3.7	11.4
Budget 2012	3.5	3.1	2.0	8.6
IFAC Alternative April 2012	3.9	3.8	3.7	11.4
SPU 2012	3.5	3.1	2.0	8.6
IFAC Alternative September 2012	3.5	3.5	3.5	10.5

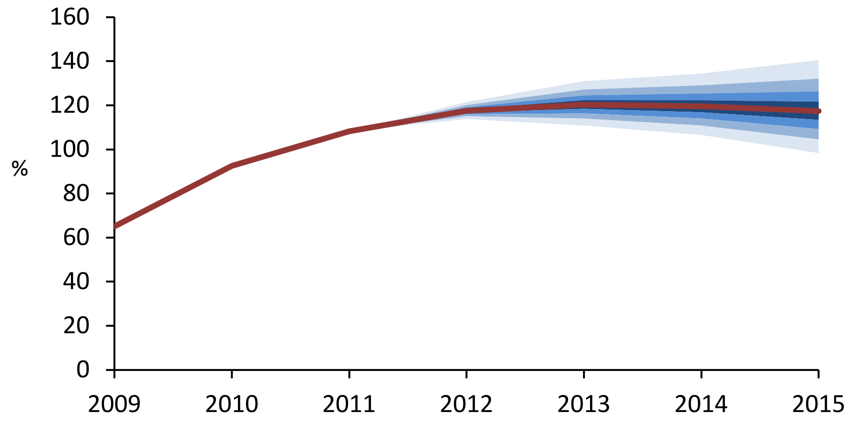
The Council's approach to identifying the appropriate fiscal stance recognises a trade-off between supporting domestic demand and the need to ensure debt sustainability, in part with a view to regaining market access and sustaining access to official-creditor support (as and if needed), under reasonable conditions. To assess the recent evolution of this trade-off, the most recent projected path for the debt to GDP ratio, market indicators of creditworthiness and the main macroeconomic aggregates are reviewed in turn.

4.2.1 Debt Sustainability

Figure 4.1 shows the Government's most recent central projection for the debt to GDP ratio out to 2015. The debt ratio is projected to peak next year at 120.3 per cent of GDP, with small declines over the following two years. By 2015, the debt ratio is projected to be declining at a rate of 2.1 percentage points of GDP, helped by a projected primary budget surplus of 2.8 per cent of GDP.

There is significant uncertainty surrounding these debt projections as illustrated by the fan chart in Chapter 3 (which is repeated in Figure 4.1). It should be stressed that these fan charts must be treated with care given the limitations of using past forecast errors to form judgements on uncertainty surrounding future projections.[40] Moreover, the fan charts do not incorporate non-growth related determinants of fiscal uncertainty. Nevertheless, even allowing for these limitations, the fan charts do highlight the fragility of debt sustainability over the medium-term. For example, they would imply an approximately 40 per cent chance of the debt to GDP ratio failing to stabilise over the projection period in the absence of offsetting policy measures.

Figure 4.1: Evolution of the Debt to GDP Ratio



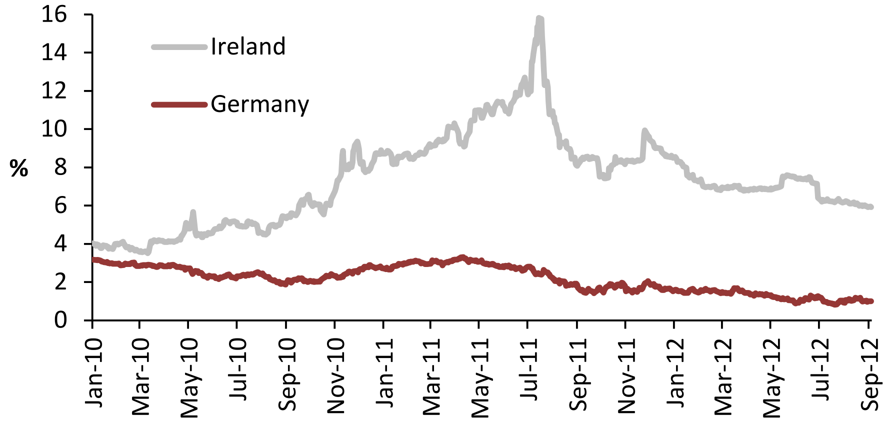
Source: SPU 2012 and IFAC calculations.

[40] The construction of the fan charts is explained in detail in Annex A.

4.2.2 Market Assessments of Creditworthiness

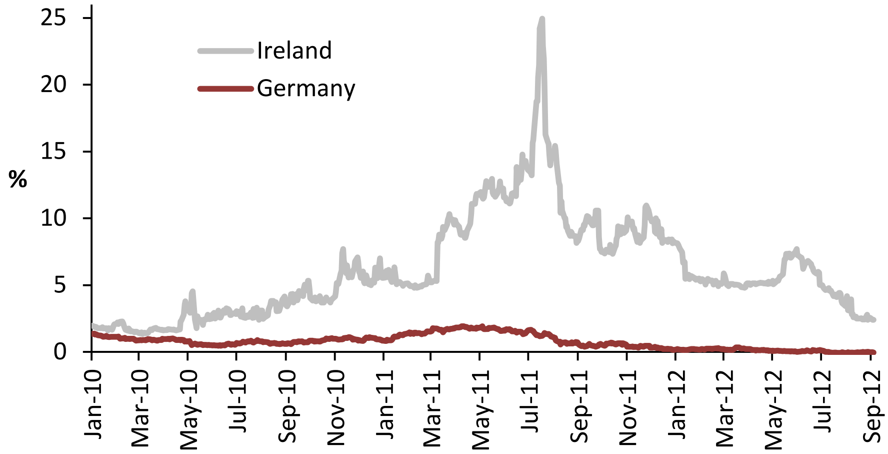
Ireland's creditworthiness (as measured by secondary market bond yields) has improved since the Council's previous *Fiscal Assessment Report*, continuing a general trend since July 2011. Market indicators of creditworthiness worsened in the weeks prior to the June 29 Euro Zone leaders' summit, with the deterioration particularly marked at the 2-year maturity (see Figures 4.2a and 4.2b). Yields have declined substantially since late June, and there has also been a noticeable steepening of the yield curve since comments on bond-buying proposals at the short-end of the yield curve were made by ECB President, Mario Draghi, during a press conference in August.[41]

Figure 4.2a: 8-Year Bond Yield



Source: DataStream.

Figure 4.2b: 2-Year Bond Yield



Source: DataStream.

[41] The transcript is available at: http://www.ecb.int/press/pressconf/2012/html/is120802.en.html

To the surprise of many analysts, Ireland made a return to the bond markets in 2012. The initial return in late January involved an exchange of €3.5 billion of an existing bond maturing in 2014 (30 per cent of the nominal amount of the bond outstanding) for a newly issued 2015 bond. In early July, €0.5 billion of 3-month Treasury Bills were auctioned at a yield of 1.8 per cent, with bids covering 2.8 times the offered amount. In late July, €1.04 billion of 2013 and 2014 bonds were switched in 5- and 8-year maturities, and €4.19 billion were sold in outright cash sales at an overall average yield of 5.95 per cent. Finally, in response to demand for sovereign annuities following the introduction of the Pensions Board's revised funding standard, €1 billion of "amortisation bonds" were sold on August 23 at an average yield of 5.91 per cent. These developments have helped significantly to ease Ireland's funding requirements in 2014.

A combination of factors has contributed to the fall in yields, which have taken place against a background of a worsening of the broader Euro Zone crisis, with concerns of unsustainable yields spreading from the current programme countries to Italy and Spain. These include: a positive record in meeting Ireland's fiscal adjustment targets, the passage of the referendum on the "Fiscal Compact", and, more recently, expectations of bond-buying by the ECB that would bring down yields to more sustainable levels in return for European Stability Mechanism (ESM) programme conditionality. The fall in Irish yields since end-June has also been attributed in a large part to measures that would reduce the burden of Ireland's Government debt related to the banking-sector recapitalisations. The June 29 statement following the Euro Zone leaders' summit stated:[42]

> The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme. Similar cases will be treated equally.

Details of this examination are expected in the coming months.

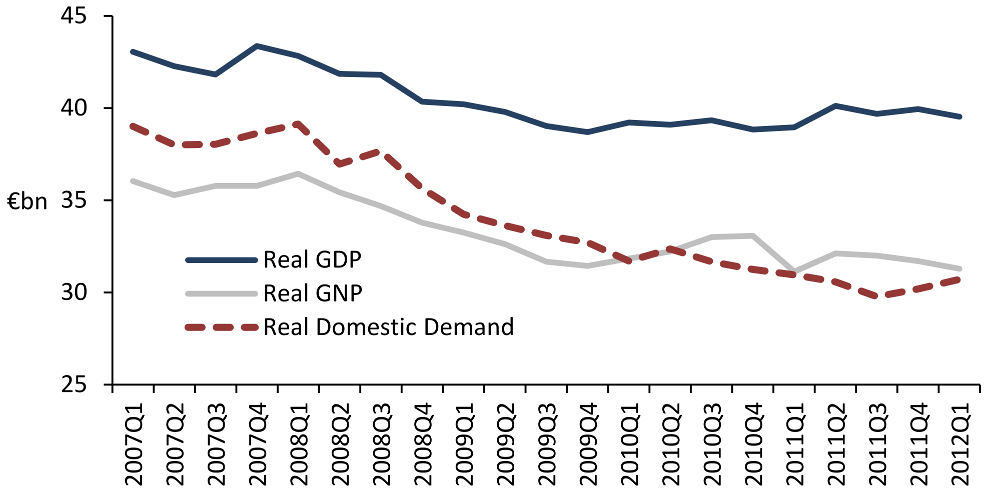
4.2.3 State of Aggregate Demand

The Irish economy's output performance remains weak, following a broadly "L-shaped" pattern (see Figure 4.3). National accounts data released in July showed that real GDP grew at a revised 1.4 per cent in 2011, up from an initial estimate of 0.7 per cent, driven by strong export growth that more than offset a decline in domestic demand. Real GNP declined by 2.5 per cent in 2011, partly

[42] The full statement is available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

reflecting the profitability of the multinational sector given the strong export growth. On a quarter-on-quarter basis, preliminary estimates indicate that both seasonally adjusted real GDP and real GNP declined in the first quarter of 2012 by 1.1 and 1.3 per cent respectively. However, quarterly real domestic demand (seasonally adjusted) recorded its first quarter-on-quarter increase since the second quarter of 2010.

Figure 4.3: Quarterly Macroeconomic Performance, 2007Q1-2012Q1



Source: QNA, July 2012.
Note: Constant Prices (Chain Linked 2010), Seasonally Adjusted.

Seasonally adjusted retail sales (excluding motors) have declined compared to the same period last year, although the pace of decline has fallen. The index, in real terms, was down annually by 0.5 per cent in the three month period to July. Household budgets continue to be squeezed by declines in disposable incomes and increases in commodity prices. Income uncertainty and balance sheet repair underpin the maintenance of a high savings rate. On a positive note, the KBC Ireland/ESRI Consumer Sentiment Index continued the trend of improvements in August, with the three-month moving average rising to a value of 66.7, which compares to a value of 56 over the same period in 2011.

National residential property prices (houses and apartments) continue to decline, with the CSO's Residential Property Price Index recording an annual fall of 13.6 per cent in July.[43] However, house prices in Dublin have been broadly stable since the beginning of 2012. This could portend a broader

[43] In 2009, 2010 and 2011, residential property prices fell by 18.3, 13.1 and 13.2 per cent respectively.

stabilisation, notwithstanding the likelihood of further protracted periods of decline in areas with significant demand-supply mismatches.

Credit conditions remain tight. The total credit extended to Irish households has contracted further, although the pace of contraction has slowed. For credit to non-financial businesses, the stock of medium- to long-run loans to non-financial businesses has shown a further fall, although the trend of increases in short-term lending (mainly overdrafts) has continued in 2012. Recent Central Bank of Ireland research points to tight credit-supply conditions with the Irish rejection rate for credit applications the second highest in the Euro Zone, while SMEs are among the most likely to have faced increased collateral requirements, increased interest rates, or lower loan quantities (Holton and McCann, 2012). Overall, the process of household, enterprise, Government and bank deleveraging continues to weigh on domestic demand conditions.

On the export front, the main international forecasting agencies have reduced their projections for regional and global growth. The recent performance of the United Kingdom's economy has been notably weaker than expected, likely reflecting the burden of the same deleveraging processes that are curbing Irish domestic demand. Irish goods exports declined marginally in the first half of the year compared to the same period in 2011. Data on service exports are less up to date, but national accounts data for the first quarter show exports from this sector were 11.9 per cent higher in volume terms than in the first quarter of 2011.[44]

As discussed in Chapter 2, the Government (in common with other agencies) forecasts a return to a stronger growth in 2014 and 2015. This follows a pattern of stronger projected growth beyond a two-year window. The Government's baseline scenario involves a stabilisation and then a return to domestic demand growth, which, combined with a continued strong performance in net exports, would allow for a return to positive growth. Indeed, there is a possibility that growth could exceed expectations, as the adverse feedback loops – or vicious cycles – that currently plague the Irish economy diminish. However, the pattern of downward revisions to forecasts as the horizon shortens – and the failure of growth improvements to materialise – also points to significant downside risks to these forecasts (see Chapter 2). These revisions reflect the difficulties forecasters have in gaining a firm understanding of the post-bubble Irish economy and the ongoing volatility of the international economy.

[44] Overall, exports (at constant prices) were 6.1 per cent higher in the first quarter than in the same period of 2011.

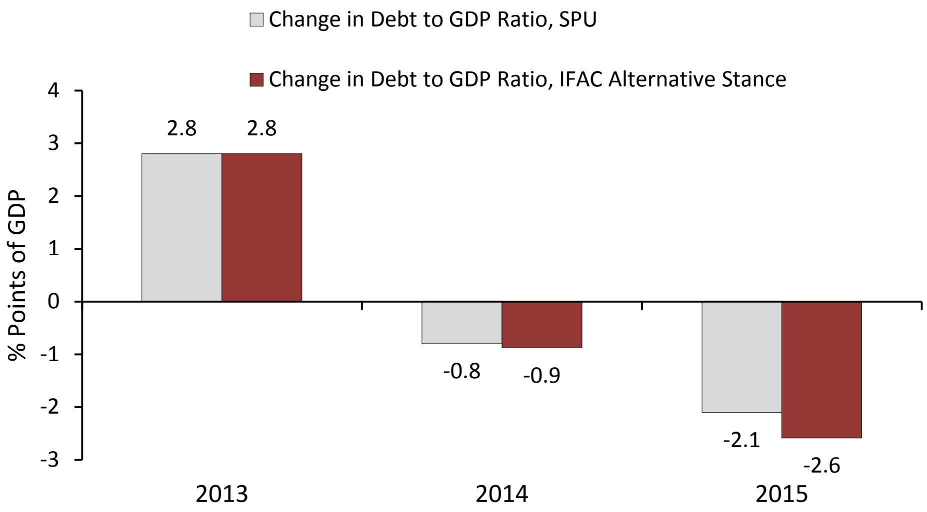
The implications of slower growth on the appropriate size of near-term fiscal adjustments depend, in part, on the likely persistence of the slowdown. A temporary period of slow growth is more easily accommodated without increasing the size of discretionary adjustments. In the April 2012 *Fiscal Assessment Report*, the Council noted that, subject to programme targets, temporary growth shortfalls could be accommodated without additional discretionary measures. However, a sustained period of slower growth caused by either weaker than expected potential GDP growth or a long-lasting shortfall in domestic demand would increase the risk that the debt ratio is on an unsustainable path.

4.2.4 Assessment of the Fiscal Stance

The Council assesses that the Government's fiscal stance is conducive to prudent economic and budgetary management. Weighing the different factors noted above, however, the Council continues to believe that additional fiscal adjustment relative to current plans is warranted. However, taking into account the continued weakness in demand conditions and observed improvements in market assessments of creditworthiness, the Council has modestly scaled back the amount of additional adjustment under this alternative fiscal stance. Overall, the suggested additional discretionary adjustment was €2.8 billion in the previous report, bringing the total 2013-2015 adjustment to €11.4 billion. The additional suggested adjustment over the Government's baseline in this report is €1.9 billion over 2013-15, for a total of €10.5 billion (see Table 4.1). Under this alternative stance, the total required discretionary adjustment is €3.5 billion in each year from 2013 to 2015. The most significant difference between this and the Government's plan is that the pace of adjustment planned for 2013 is carried through into 2014 and 2015. This reflects the need to have the debt to GDP ratio on a firmer downward path at the end of the projection horizon.

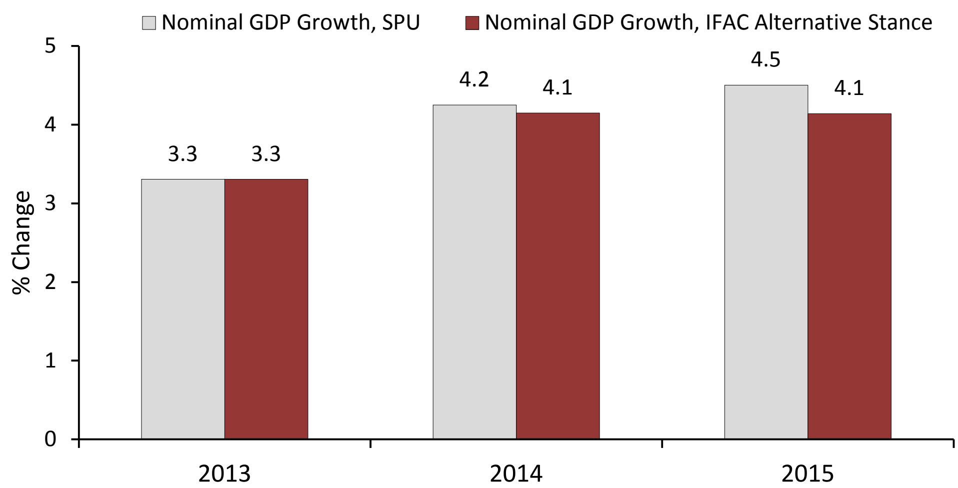
Council estimates of the impacts of the additional adjustments on debt sustainability and nominal GDP growth are recorded in Figures 4.4 and 4.5. The additional adjustments would raise the rate of debt ratio reduction in 2015 by approximately half a percentage point. This is mainly driven by a larger primary budget surplus in 2015 of 3.7 per cent of GDP, compared with 2.8 per cent of GDP under the Government baseline. Assuming a multiplier of 0.5, the additional adjustments would reduce the nominal GDP growth rate by an average of 0.2 percentage points over 2013-15. The growth reducing effect is largest in 2015 (0.4 percentage points), owing largely to the concentration of additional recommended adjustment in that year. Assuming the reduction in the nominal GDP growth rate is divided proportionately between the real growth rate and the GDP deflator, the real GDP growth rate would be lowered by an average of 0.1 percentage points over the three-year period. The additional adjustment is not recommended lightly given the existing pressures on domestic demand and the high burden of unemployment. It can be viewed as providing a small amount of additional insurance against failure to stabilise the debt ratio and the achievement of a robust return to market creditworthiness.

Figure 4.4: Comparison of Change in Debt to GDP Ratio under *SPU* and Alternative IFAC Stance



Source: SPU 2012 and IFAC calculations.

Figure 4.5: Comparison of Projected Nominal Growth Rates under *SPU* and Alternative IFAC Stance



Source: SPU 2012 and IFAC calculations.

4.2.5 The Government's Stimulus Programme

In July 2012, the Government announced a fiscal stimulus package amounting to €2.25 billion over 2012-2018, mainly intended to cover previously postponed infrastructural projects in the Transport, Education, Health and Justice sectors. The Government estimates that these projects will generate 13,000 jobs. It is envisaged that the funding will come from a combination of loans from the European Investment Bank (EIB), a run-down of liquid assets held by the National Pension Reserve Fund (NPRF), allocation of a portion of privatisation revenues, a new licensing arrangement for the National Lottery and the use of public-private partnerships (PPPs), although the precise composition and timing of the expenditures in question were not specified. No information has been made available regarding the expected rate of return of the projects.[45]

In the context of the broader fiscal adjustment effort, the question arises as to possible rationales for a programme of capital spending – labelled "stimulus" – that is in some sense separate from the fiscal adjustment effort already planned. It is useful to consider the arguments for and against such an approach.

The special financing arrangements may appear to ease the debt sustainability costs of the package. However, although the use of financial assets in the NPRF means that the stimulus spending does not add to gross Government debt, it does raise measures of financial net debt given the rundown of the State's financial assets. From a debt sustainability perspective, financial net debt is arguably a more pertinent measure than gross debt, even if it is not the focus of European fiscal rules. Moreover, the use of privatisation-related revenue to fund the programme means that these funds are not available to reduce debt. Furthermore, the use of State guarantees for EIB borrowing or under PPPs creates off balance sheet or contingent liabilities. These liabilities could be equivalent to public debt to the extent that they can involve a future repayment burden and hence affect potential investors' assessments of creditworthiness. Alternatively, the State may be foregoing future income, as for example by allowing a private contractor to charge for the use of a toll road. Overall, although diversified financing mechanisms for State spending should be explored, referring to a particular segment of the overall adjustment plan as a "stimulus", does not take away the need to consider carefully the impact of reducing assets or increasing actual/contingent liabilities on the State's financial position.

[45] The briefing note from the Department of Public Expenditure and Reform is available here: http://per.gov.ie/wp-content/uploads/Briefing-Note-17-7-12-_2_2.pdf.

Another possible rationale can be thought of in terms of shifting the trade-off between domestic demand and creditworthiness.[46] All else equal, a more stimulative fiscal stance would increase domestic demand, but is also likely to cause creditworthiness to deteriorate by worsening the fiscal position. Part of this deterioration is likely to come from expectations of larger deficits in the future, recognising the difficulty of credibly committing to make any stimulus programme a once-off. The separate-stimulus approach could be seen as providing an instrument to allow a once-off stimulus programme, while helping to maintain the credibility of longer-term fiscal adjustment. While recognising this argument in principle, the Council believes that any improvement in the trade-off is likely to be slight – it will be hard to credibly commit to such stimulus action being truly once-off.

Apart from supporting overall domestic demand, it might be considered desirable to allow for higher capital spending for its own sake, especially since Ireland's adjustment programme to date has relied heavily on cuts to capital spending. However, if this is the goal, it would be preferable to build the capital expenditure package directly into the overall adjustment programme.

Weighing the above considerations, as well as the importance of ensuring transparency, the Council has significant reservations regarding the appropriateness of the separate-stimulus approach under current conditions. Any policy action should be in the context of the main adjustment programme. On the substantive question of whether there should be an increase in capital spending, the Council does not believe that the total amount of Government spending set out in the fiscal stance underlying *SPU 2012* should be increased without explicit revenue-raising offsets. However, recognising the difficult financing conditions in sovereign bond markets, the Council supports the exploration of financing mechanisms such as loans from the EIB and well-structured PPPs to finance capital expenditure set out in the main programme. Close attention would need to be given to the effects on the broader State balance sheet.

[46] In the international debate on fiscal adjustment, many economists have called for efforts to support the economy in the short run, while making credible commitments to reduce deficits and debt over the longer run.

4.3 Debt Sustainability and the GDP Versus GNP Debate

4.3.1 The Appropriate Measure of Fiscal Capacity

The rapid rise in the State's indebtedness combined with continued high deficit levels has raised concerns about Ireland's debt sustainability. For the purposes of this discussion, debt sustainability is defined as the achievement of a debt to income path consistent with market creditworthiness and long-run solvency constraints. In turn, this path implies required paths for the actual and structural primary budget deficits. The question then becomes whether these paths are economically and politically feasible. Economic feasibility requires that fiscal adjustments actually bring down the primary deficit, i.e. they are not directly self-defeating (see IFAC 2012a, p.46). Political feasibility requires that the needed structural adjustment can find sufficient political support to secure implementation.

In the Irish context, a much-debated issue among economists is whether GDP or GNP is the appropriate measure of fiscal/revenue capacity when judging debt sustainability. For most countries, the distinction is of minor importance given the closeness of the two measures. As documented in Chapter 2, however, Irish GNP was only approximately 80 per cent of GDP in 2011 (see Figure A1).

Taking either of the extremes of GDP or GNP is problematic. GDP is problematic as a measure of fiscal capacity because a euro of the excess of GDP over GNP (which is dominated by multinational profits) is likely to provide less revenue capacity than a euro of GNP. On the other hand, going to the other extreme of using just GNP puts zero weight on the revenue potential of the excess component. This suggests the value of a hybrid measure, where an appropriate relative value is placed on a euro of the excess component relative to a euro of GNP.

4.3.2 A Hybrid Measure of Fiscal Capacity

One approach to assigning weights is to use regression analysis that links GDP/GNP to past tax revenues, controlling for trends in tax policies. An analysis for the period 1985 to 2011 is described in Box C. This analysis implies that a euro of the GDP – GNP excess is worth approximately 0.4 of a unit of GNP in terms of tax revenues, although a wide confidence interval surrounds this estimate.

Box C: A Hybrid Measure of Fiscal Capacity

Nominal GDP is often used as a measure of a country's revenue/fiscal capacity. This is reflected, for example, in the use of the path of the debt to GDP ratio in judgements of debt sustainability. For Ireland, however, GNP has often been considered a more meaningful measure of fiscal capacity, given the large share of foreign multinational profits in GDP. Although subject to Irish corporate taxation, these profits are generally thought to provide a low tax yield per euro of income compared to other components of GDP. This has led many observers to recommend focusing on GNP as a superior indicator of fiscal capacity.

This box explores an intermediate position, where GDP is divided into two components: GNP and the excess of GDP over GNP (with the latter equal to the negative of net factor income). We then allow the two components to have different capacities in calculating an overall hybrid measure of fiscal capacity.

One way to identify the relative capacities is to examine the historic relationship between the two components using a simple regression analysis. Letting R represent total revenue, the relationship between revenue and the two components can be written as:

$$R = \gamma_1 GNP + \gamma_2 (GDP - GNP).$$

The coefficients on GNP and the GDP—GNP excess are the measures of fiscal capacity. The value of a euro of the excess relative to a euro of GNP is given by the ratio of the coefficients, $\frac{\gamma_2}{\gamma_1}$.

As all the aggregates have strong time trends, we run the regression in first differences. We also explore specifications which include a polynomial in time to control for changes in tax rates/new taxes and a crisis indicator for the years 2008 to 2011. The data for the regressions are for the period 1985 to 2011, with total revenue measured as General Government revenue.

The results are shown in Table C1. Estimated coefficients are reasonably stable across specifications. In general, the coefficient on the GDP—GNP excess is imprecisely estimated, with p values around 0.15. The value of the key relativity measure varies from a low of 0.33

to a high of 0.43, with a value of 0.40 in the base specification (regression 3). The coefficients on the time-trend variables (which crudely control for tax policies) are statistically insignificant, as is a crisis "dummy" for the period 2008-2011. We use the values from this base specification in constructing the hybrid measure as, *H* = *GNP* + 0.4(*GDP* – *GNP*).

Table C1: Relationships Between Government Revenue, GDP and GNP 1985 to 2011

	1	2	3†	4	5	6	7
Δ GDP	0.37***						
	(0.03)						
Δ GNP		0.41***	0.40***	0.40***	0.40***	0.43***	0.39***
		(0.03)	(0.03)	(0.03)	(0.03)	(0.04)	(0.07)
Δ (GDP - GNP)			0.16	0.17	0.14	0.15	0.13
			(0.09)	(0.11)	(0.11)	(0.11)	(0.11)
Time					30.41	-192.47	-217.19
					(31.98)	(164.56)	(170.17)
Time Squared						7.81	10.13
						(5.66)	(6.60)
Crisis (2008 to 2011 = 1)							-1548.32
							(2186.06)
Constant	None	None	None	-40.62	-469.14	550.03	717.98
				(285.93)	(530.36)	(903.47)	(944.45)
Estimated γ_2/γ_1	NA	NA	0.40	0.43	0.35	0.35	0.33
Adjusted R Squared	0.89	0.88	0.90	0.87	0.87	0.88	0.88
Obs	26	26	26	26	26	26	26

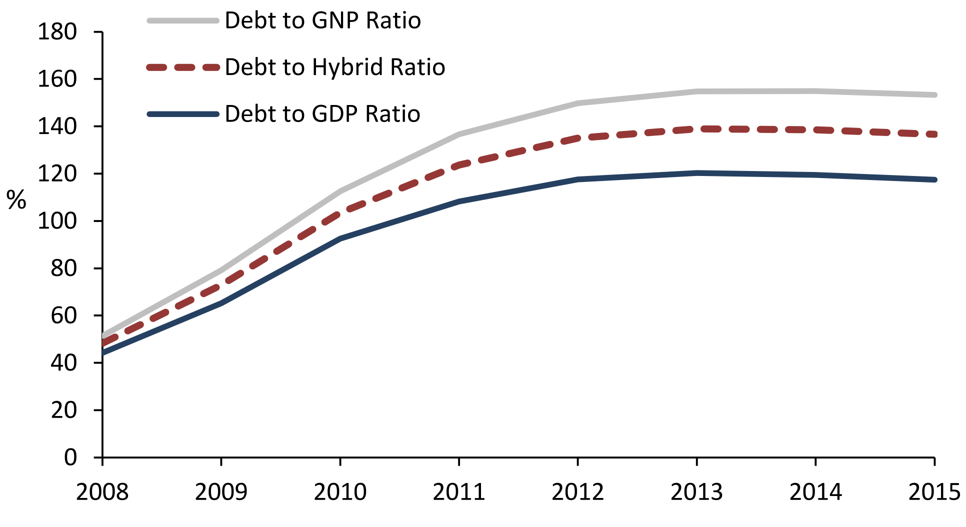
*Note: Standard errors in parentheses. Statistical significance: *** 1 per cent; **5 per cent; *10 per cent. †Regression 3 is the base specification.*

Overall, the result from the simple regression analysis suggests a hybrid measure, *H*, of the form: *H* = *GNP* + 0.4(*GDP* – *GNP*). Care must be taken in using this measure given the sensitivity of the relationship between net factor income and the composition of gross factor income flows. However, given the limitations of the primary measures, it is useful at this stage to explore the implications of this illustrative hybrid measure for assessments of debt sustainability. The next section examines debt sustainability for three candidate income measures of fiscal capacity: GDP, GNP and the hybrid measure based on the 0.4 weighting.

4.3.3 Debt Sustainability for Alternative Measures of Fiscal Capacity

The projected evolution of the three debt-to-income measures based on *SPU 2012* projections are shown in Figure 4.6. (In each case, the year-specific nominal debt level is the same, with the differences arising from the income denominator used.) Not surprisingly, moving to a GNP-based measure substantially shifts the debt-to-income path upwards, with the ratio reaching a peak of 154 per cent in 2014. By construction, the hybrid-based measure lies between the GDP- and GNP-based measures, with a peak of 138.9 per cent in 2013.

Figure 4.6: Comparison of Evolution of Debt to Income Ratio under Alternative Income Definitions

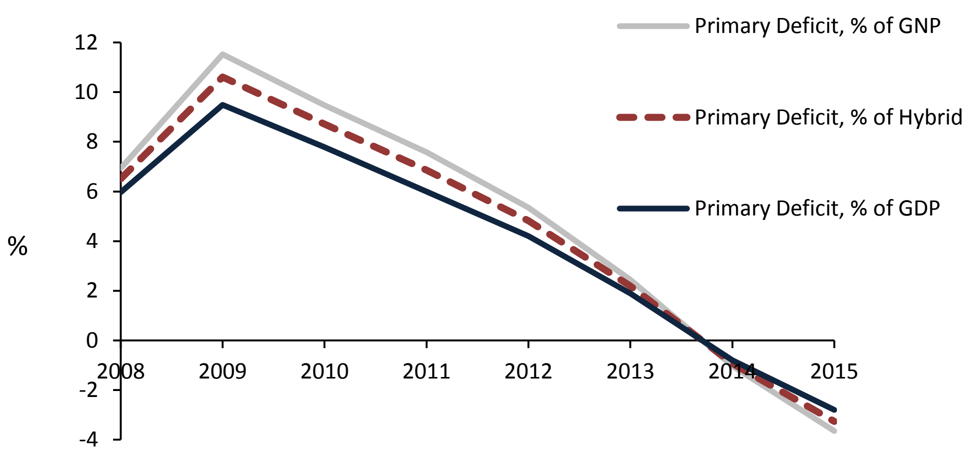


Source: SPU 2012 and IFAC calculations.

A key issue is how the choice of income measure to use in the debt-to-income ratio changes the view of the feasibility of fiscal adjustment and, thus, debt sustainability. The focus is on the feasibility of the planned adjustments with reference to international experience and Irish adjustments achieved to date. A first approach is to examine the feasibility of the *planned* fiscal adjustment out to 2015 under the current programme, implicitly assuming that this is sufficient to achieve debt sustainability. A second approach is to consider how a shift to a GNP or hybrid measure as the correct measure of perceived fiscal capacity would change the *required* adjustment for debt sustainability.

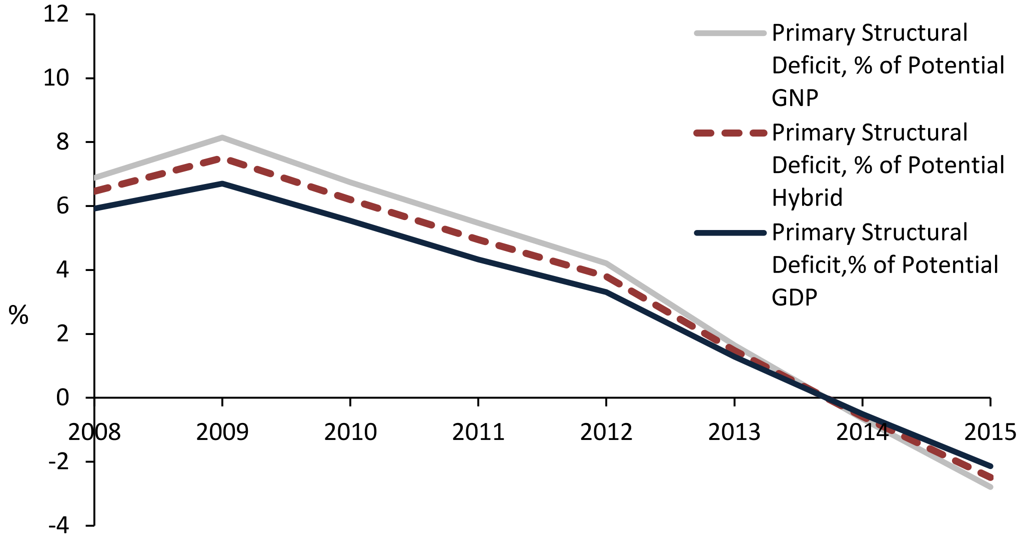
Considering the first approach, Figure 4.7 shows the evolution of the projected primary deficit as a percentage of income under the three income measures. The figure is constructed to show how the three primary deficit ratios would need to evolve in order to reach the primary deficit/GDP ratio of 2.8 per cent specified in *SPU 2012* to 2015. Figure 4.8 shows the corresponding evolution of the projected structural primary deficit under the three measures. Moving from the GDP-based measures to either the GNP- or hybrid-based measures increases the size of the total measured adjustment (as percentages of income) and also the maximum primary surplus as a share of income that must be achieved. Table 4.2 summarises the implied changes in the primary and structural primary balance for each of the three income measures. The total required improvement in the primary balance is 2.9 percentage points larger under the GNP- than under the GDP-based measure over the period 2009-2015 (15.2 versus 12.3). The difference between these measures for the structural primary balance is 2.1 percentage points (10.9 versus 8.8). In terms of the maximum primary and structural primary balance that must be achieved, the GNP-based measure is 0.9 (3.7 versus 2.8) and 0.7 (2.8 versus 2.1) percentage points higher respectively.

Figure 4.7: Comparison of Evolution of the Primary Deficit as a Share of Income under Alternative Income Definitions



Source: SPU 2012 and IFAC calculations.

Figure 4.8: Comparison of Evolution of the Structural Primary Deficit as a Share of Potential Income under Alternative Income Definitions



Source: SPU 2012 and IFAC calculations.

Table 4.2: Planned Changes in the Primary Balance, Alternative Income Measures, 2009 to 2015.

GDP	**Percentage Point Change 2009-2015**	**Peak Value (Year)**
Primary Balance (% of GDP)	12.3	2.8 (2015)
Structural Balance (% of Potential GDP)	8.8	2.1 (2015)
GNP		
Primary Balance (% of GNP)	15.2	3.7 (2015)
Structural Balance (% of Potential GNP)	10.9	2.8 (2015)
Hybrid		
Primary Balance (% of Hybrid)	13.9	3.3 (2015)
Structural Balance (% of Potential Hybrid)	10.0	2.5 (2015)

Source: SPU 2012 and IFAC calculations.

The feasibility of any large-scale fiscal adjustment programme will be country and time dependent. Nevertheless, one perspective on feasibility can be gleaned from international comparisons of what other OECD economies have achieved in the past. Table 4.3 shows the maximum six-year improvement in both the primary and cyclically adjusted primary balance (CAPB) over the period

1995 to 2011. It also shows the size and timing of the maximum actual and primary structural balances that were achieved in each country. While the required Irish adjustments are not unprecedented, the table confirms the enormous comparative debt sustainability challenge Ireland faces, made even more difficult by having to take place during a period of weak growth. If a GNP- or hybrid-based measure is taken as a more appropriate measure of fiscal capacity for Ireland to compare with the GDP-based adjustments internationally, the challenge facing Ireland looks even greater.

Another perspective on the feasibility of the required adjustment comes from comparing the remaining adjustment task with the demonstrated capacity from what has been achieved already. Figures 4.7 and 4.8 show that significant achievements in the primary and structural primary deficits have been already achieved in Ireland, including through a period when recession and evaporating revenues such as stamp duty and VAT on new houses were bearing down on overall tax receipts.

The second approach is to consider whether the required fiscal adjustment to achieve sustainability itself increases once an indicator other than GDP is viewed as the appropriate measure of fiscal capacity. As a concrete illustration of the issue, suppose that sustainability requires that Ireland be on a path to a debt to income ratio equal to 60 per cent by some target date. If the appropriate measure of fiscal capacity (and thus the appropriate denominator in the debt to income ratio) is, say, GNP, the ultimate target expressed as a share of GDP would be 48 per cent (60 X 0.8) – assuming GNP is just 80 per cent of GDP. This would require an even greater pace of adjustment in the primary balance, posing an even greater challenge in terms of feasibility.

Table 4.3: International Comparisons of Fiscal Adjustments, 1995-2011

	Max CAPB	Year	Max PB	Year	Max Δ in CAPB*	Start Year	Max Δ in PB*	Start Year
Hungary	2.7	1997	8.0	2011	6.9	2006	13.7	2006
Finland	6.9	2000	7.9	2000	8.3	1995	13.2	1995
Norway	-0.1	2000	16.1	2006	2.9	1995	12.1	1995
Sweden	4.8	2000	5.7	2000	7.9	1995	10.6	1995
Germany	1.8	2007	3.9	2000	3.2	2002	10.4	1995
Netherlands	3.4	1999	4.9	2000	1.7	1995	9.6	1995
Czech Rep.	-1.9	2011	0.0	2007	3.9	2003	9.0	1995
UK	3.3	1999	6.0	2000	5.5	1995	8.8	1995
Slovak Rep.	-0.1	2000	-0.9	2007	4.2	1997	7.4	2000
Iceland	3.2	2006	5.6	2006	4.0	2001	6.7	2002
Canada	5.4	1999	6.0	2000	4.3	1995	5.6	1995
Japan	-3.2	2008	-1.4	2006	2.5	2003	5.5	2003
Estonia	1.4	2003	2.2	2006	1.4	1998	4.9	1999
Slovenia	-0.3	2003	1.0	2007	0.0	1995	4.8	1995
Luxembourg	4.2	1997	4.7	2001	3.2	1995	4.7	1996
Spain	2.3	2006	3.7	2006	2.8	1995	4.5	1995
Denmark	4.8	2005	6.0	2005	2.3	2000	3.7	1995
United States	2.9	1998	3.9	2000	2.0	1995	3.7	1995
France	0.8	1999	1.1	2000	1.5	1995	3.6	1995
New Zealand	5.1	2006	5.7	2006	2.5	1999	3.6	1999
Austria	2.0	1997	2.5	2001	1.5	1996	3.5	1995
Chile	2.2	2008	2.7	2008	2.6	1995	3.5	2003
Poland	0.4	1996	0.7	1995	1.5	2002	2.7	2002
Australia	3.2	1999	3.4	1999	1.6	1995	2.6	1995
Belgium	6.8	1998	6.4	2001	0.9	1995	2.4	1996
Korea	4.0	2000	4.2	2000	1.9	1997	2.1	1997
Italy	5.4	1997	6.0	1997	1.8	2005	1.9	1995
Portugal	-0.3	1995	-0.4	1997	2.0	2001	1.5	2006
Greece	4.8	1999	3.5	1998	4.9	2006	1.3	1995

Source: OECD.
*Notes: CAPB = Cyclically Adjusted Primary Balance, PB = Primary Balance. *Change is calculated over 6 year periods.*

4.3.4 Reducing Ireland's Debt Burden

Following the June 29 Euro Zone leaders' summit, expectations have risen of some relief on the portion of Ireland's debt (roughly 40 per cent of GDP) that relates to the cost of bank recapitalisations. Two broad avenues have been raised. First, there is the possibility of more advantageous financing arrangements to replace those associated with the current promissory note arrangement used to bailout Anglo and INBS (see IFAC, 2012a, p. 26 for a detailed discussion of the fiscal implications of the promissory note arrangements). This could involve reducing the net present value of the Anglo/INBS-related debt. Second, following a possible Spanish precedent, as noted in the Summit communiqué,[47] the ESM could decide to purchase the Government's equity stakes in other "pillar" banks without this involving any liability of the Irish sovereign to the ESM. To the extent that the receipts from such purchases are used to pay down debt, this would reduce the outstanding value of gross Government debt. However, assuming the ESM would pay no more than fair value for these stakes, this would not reduce the State's net financial debt, as the value of financial assets would be reduced in tandem with the State's liabilities. Nevertheless, such asset sales would take future risks relating to the value of the State holdings off the State's balance sheet. Implementation of the Spanish approach (and hence its potential retroactive application to Ireland) is conditional upon the establishment of a pan European financial regulator. End-2012 has been mentioned as a possible date for this action. However, it should be noted that that current ESM support to the Spanish banking sector, involves a liability to the Spanish state. The establishment of a pan European regulator could take more time to put in place.

[47] The June 29 post-summit communiqué stated: "When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly. This would rely on appropriate conditionality, including compliance with state aid rules, which should be institution-specific, sector-specific or economy-wide and would be formalised in a Memorandum of Understanding. The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme. Similar cases will be treated equally." The full statement is available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

4.4 Summary

- As most recently set out in *SPU 2012*, the Government's fiscal stance is assessed to be "conducive to prudent economic and budgetary management". However, debt sustainability and creditworthiness remain fragile. Weighing the risks to debt sustainability and ongoing weakness in the real economy, the Council supports an alternative fiscal stance involving a total of €1.9 billion of additional adjustments in the period to 2015 compared to the Government's baseline. Due to continued weakness in demand and some further improvement in market assessments of Ireland's creditworthiness, the amount of additional adjustment over the period is scaled back by €0.9 billion since the Council's previous *Fiscal Assessment Report*, with no additional adjustments for 2013 in the Council's alternative scenario. Model-based projections indicate that this alternative scenario would yield a primary budget surplus of 3.7 per cent of GDP in 2015, which is 0.9 per cent of GDP higher than under current plans. This would result in the debt to GDP ratio falling at a rate of 2.6 percentage points of GDP in 2015, which is 0.5 percentage points faster than under current plans. The Council believes that this would provide additional insurance, albeit limited, in the effort to ensure debt sustainability.

- While recognising possible rationales for a stimulus programme that is in some sense separate from the main adjustment programme, balancing the relevant considerations – including the importance of transparency – the Council is of the view that any relaxation sought by the Government in the overall fiscal stance would be better achieved within the context of the main fiscal adjustment programme. On the substantive question of whether there should be an increase in capital spending, the Council does not believe that the total amount of Government spending set out in the fiscal stance underlying *SPU 2012* should be increased without explicit revenue-raising offsets.

- Judgements about debt sustainability are coloured by whether it is believed GDP or GNP provides the most appropriate measures of Ireland's fiscal capacity. However, each of these primary measures has limitations. The GNP measure ignores the revenue potential of the excess of GDP over GNP (which is dominated by the profits of multinational enterprises operating in Ireland). The GDP measure implicitly assumes that the revenue capacity of a euro of the GDP – GNP excess is equal to a euro of GNP. An intermediate or "hybrid" measure that puts differential weight on the fiscal capacity of a euro of GNP and a euro of the excess is also developed. Ireland's required fiscal adjustment is challenging under all of the measures, and most so under the GNP measure. A more encouraging perspective emerges when the additional adjustments are compared to what has been achieved already in the fiscal adjustment process. While relief on the banking-related part of Ireland's debt is unlikely to be a panacea, any relief would increase the chances of a successful adjustment, measured by a robust return to market creditworthiness.