Irish Fiscal Advisory Council

Fiscal Assessment Report

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2. Assessment of Budgetary Forecasts

Summary

- The General Government deficit in 2013 is likely to be close to 7.3 per cent of GDP and within the EDP deficit ceiling of 7.5 per cent. The main risks to this outlook relate to the extent of the current expenditure overrun in the Department of Health and the uncertainty surrounding the tax take in the final two months of the year.

- The decision to reduce the planned fiscal adjustment in *Budget 2014* has eliminated the previously existing margin of safety relative to the key 3 per cent Stability and Growth Pact deficit ceiling for 2015. An analysis based on historic growth forecast errors indicates that the probability of breaching the 3 per cent ceiling has risen from an estimated 1-in-3 to an estimated 1-in-2, assuming no changes in the previously announced adjustments of €2 billion for *Budget 2015*.

- The budgetary projections in *Budget 2014* are assessed to be appropriate, but are contingent on the delivery of significant expenditure savings and the achievement of the projected acceleration in economic growth. Additional risks stem from contingent liabilities associated mainly with the banking sector and risks relating to interest rates. These sources of risk should be borne in mind in a forward-looking assessment of the public finances and warrant increased attention in Government publications.

- There was some public confusion on the size and composition of the budgetary adjustment contained in *Budget 2014*. Notwithstanding welcome recent improvements in fiscal reporting, future Budget statements should identify more clearly the impacts of consolidation measures.

- There has been a tendency for the Department of Finance to underestimate the outturn for non-tax revenues and to overestimate interest expenditures in recent official forecasts. It would be helpful for the Department to outline in more detail how these forecasts are derived.

- Current expenditure ceilings have not been binding with aggregate revisions to ceilings of €0.6 billion in 2013 and €0.9 billion in 2014. The majority of this ‘slippage’ appears to arise from weaker economic conditions and policy decisions.

2.1 Introduction

Under the *Fiscal Responsibility Act*, the Council is required to assess the official forecasts in relation to each Budget and Stability Programme. This chapter assesses the budgetary forecasts contained in *Budget 2014* following the approach of the previous *Fiscal Assessment Report* (IFAC, 2013a). This involves a number of steps: (i) a review of recent Department of Finance forecasts including the outlook for 2013 (Section 2.2); (ii) an assessment of the forecasts in *Budget 2014*, which includes a comparison with recent forecasts of other agencies (Section 2.3); and (iii) an examination of the sensitivity of the main budgetary aggregates to changes in the economic outlook as well as a broader assessment of risks (Section 2.4).

2.2 Department of Finance Budgetary Projections for 2013

According to *Budget 2014*, the General Government deficit in 2013 is projected to be 7.3 per cent of GDP. This is lower than was envisaged in both the *2013 Stability Programme* (*SPU, 2013*) and in *Budget 2013* (Table 2.1).[39] The improvement relative to *Budget 2013* is approximately 0.27 per cent of GDP and 0.16 per cent relative to *SPU 2013*.

The outlook for overall General Government revenues in 2013 is marginally weaker in *Budget 2014* than in *SPU 2013*, although there have been important compositional changes reflecting weaker growth. Direct and indirect taxes are approximately €0.6 billion lower than envisaged in *SPU 2013* and are now closer to what was expected in *Budget 2013*. The weaknesses on the tax side are likely to be partly offset by stronger receipts from social contributions and other sources of non-tax revenue (which includes Central Bank surplus income and bank guarantee receipts). Since the publication of *Budget 2014*, the Exchequer data for October were released. On the revenue side, taxes were marginally up on the tax profile set earlier in the year with social contributions remaining ahead of profile (Annex E).

Government expenditure for 2013 has been revised downward by €0.6 billion from *SPU 2013* due to lower projected interest payments and weaker investment spending.[40] The other main components of Government expenditure (public sector pay, intermediate consumption and social payments) have been relatively unchanged throughout the course of the year. There are risks,

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[39] The General Government deficit to GDP ratio in 2012 was revised up to 8.2 per cent (from 7.6 per cent) just prior to *Budget 2014*. This mainly reflected a reallocation of €0.7 billion of receipts from mobile phone licences from 2012 to 2013.

[40] Interest costs have been revised downwards considerably since *SPU 2013* reflecting a better interest rate environment and reduced borrowing by the NTMA in the final quarter of the year.

however, associated with the Health budget where pressures appear to have re-emerged in recent months. In the period to end-October, net voted current spending in the Department of Health at €10.5 billion was €147 million above budget. The underlying expenditure pressures in Health are a cause of concern and have previously been documented by the Council (IFAC, 2012b, 2013a). (Soft budget constraints in the public finances are discussed in Box G). Other areas of spending are likely to come in close to target helped in part by stronger than anticipated receipts from PRSI contributions and the National Training Fund.[41]

The Council is of the view that a General Government deficit of 7.3 per cent of GDP for 2013 is achievable, given data to end-October. However, there are three main sources of risk to this outlook. First, expenditure pressures in the Health budget could intensify. Second, the outlook for taxes this year is more uncertain reflecting the change in the timing of the Budget (discussed in detail in Box E). Third, there is a possibility that ongoing supports provided to the financial sector (such as the IBRC liquidation) could affect the budget deficit. Finally, it is worth noting that there are a number of one-off factors affecting the General Government outlook for this year, notably receipts arising from mobile licence sales and costs associated with the liquidation of IBRC.[42]

These risks could be compensated for in other areas. In particular, there has been a tendency for the Department of Finance to underestimate the outturn from non-tax revenues (Figure 2.1). These primarily relate to Central Bank surplus income and bank guarantee fees. In addition, interest expenditures have been overestimated by approximately €0.5 billion by the Department of Finance in 2012 and 2013.[43] Given the increasing share of interest spending in GDP and recent divergences from forecast, it would be helpful for the Department and the NTMA to outline in more detail how interest projections are derived.

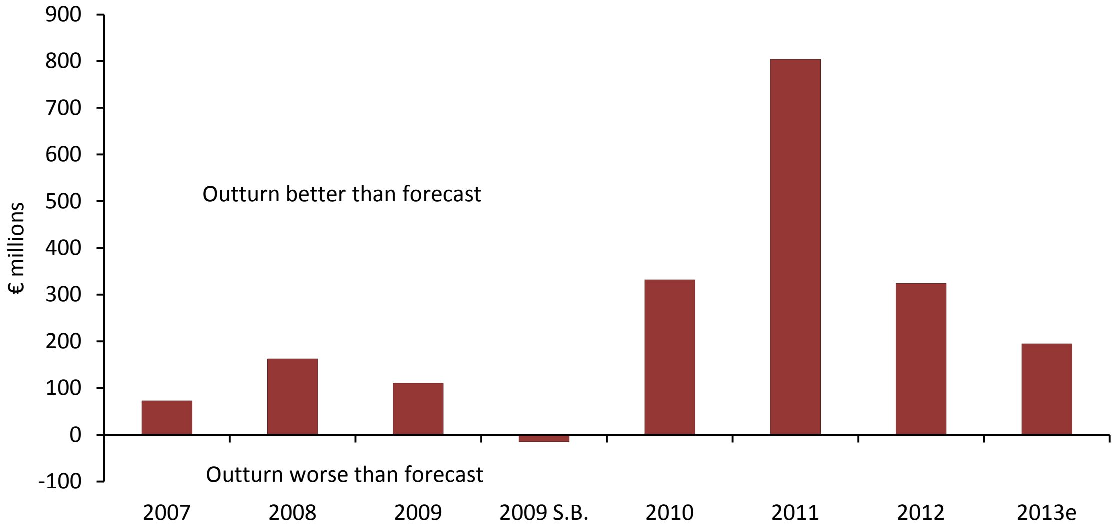
[41] These revenue streams are netted off gross expenditures.

[42] In total, the reclassification of mobile phone sales from 2012 to 2013 improves the 2013 budget deficit by €0.7 billion. This is more than offset, however, by exceptional payments made under the Eligible Liabilities Scheme, which adds €1.1 billion to the deficit in 2013.

[43] This figure is based on forecasts for interest expenditure in 2012 (General Government basis) and the *SPU 2013* outlook for interest expenditure in 2013 relative to the latest outlook in *Budget 2014*.

The General Government debt to GDP ratio is projected to peak this year at 124 per cent of GDP. The level of debt has increased at a faster rate than the deficit of late reflecting a decision to build up a buffer of liquid financial assets (for more details, see Chapter 4 and also Barnes and Smyth, 2013).

FIGURE 2.1: NON-TAX REVENUES: OUTTURN-FORECASTS



Note: Figure depicts one-year ahead forecast for Exchequer non-tax revenues versus actual outturn. 2009 S.B. refers to the Supplementary Budget.

TABLE 2.1: DEPARTMENT OF FINANCE PROJECTIONS FOR 2013

€ Billions	*Budget 2013*	*SPU 2013*	*Budget 2014*
	Dec 2012	Apr 2013	Oct 2013
General Government Deficit	**12.7**	**12.6**	**12.1**
General Government Deficit, % of GDP[44]	**7.6**	**7.5**	**7.3**
Structural Deficit, % of GDP	7.7	6.7	5.3
Primary Deficit, % of GDP	2.0	2.6	2.7
Revenue	57.6	58.7	58.5
Tax	41.2	41.9	41.4
Social Contributions	9.7	9.8	9.9
Other	6.7	7.1	7.2
Expenditure	70.4	71.3	70.7
Government Services	27.2	27.3	27.0
Social Transfers	26.2	28.2	28.4
Interest	9.3	8.2	7.6
Investment	3.1	3.2	3.0
Other	4.6	4.4	4.7
Primary Expenditure	61.1	63.1	63.0
Debt	203.5	207.0	205.9
Debt, % of GDP	121.3	123.3	124.1
Nominal GDP	167.7	167.9	165.9
Nominal GDP, % growth	2.8	2.6	1.2

Sources: Budget 2013, SPU 2013 and *Budget 2014.*
Note: Numbers may not sum due to rounding.

[44] The Excessive Deficit Procedure (EDP) General Government deficit ceiling for Ireland in 2013 is 7.5 per cent of GDP (5.1 per cent in 2014 and 2.9 per cent in 2015).

Box E: Impact on Forecasts of Budget moving to October

The shift in the Budget from December to October has implications for forecasting. This arises primarily from the administration of the Irish tax (and social contributions) system – with a very large proportion of income tax (including self employed income) and corporate taxes collected in the final quarter of the year (specifically in November — see Table E1). In addition, corporate and self-employed income taxes are typically more difficult than other taxes to predict. Forecasts of other sources of revenue as well as overall expenditures are less affected by the movement in the timing of the Budget.[45]

Table E1: Proportion of Exchequer Taxes Due in The Final Quarter of 2013[46]

% of Total	October	November	December	Total
Income Tax	9	14	8	31
VAT	2	15	2	19
Corporate Tax	3	29	10	42
Excises	8	8	13	29
Other	8	13	18	38
Total Exchequer Taxes	**6**	**15**	**8**	**29**

With a December budget, around 90 per cent of Exchequer taxes on average would have been received prior to the finalisation of the Budget forecasts. In 2013, 70 per cent of the projected tax take for the year was received prior to the Budget.[47] The Department of Finance also had to prepare its macroeconomic forecasts with two months fewer high frequency economic data.

The potential impact on the accuracy of tax revenue forecasts can be assessed using a regression equation of the form:

$$T_t = \alpha + \beta\, T_m + \varepsilon$$

Where T_t is the Exchequer tax outturn in year t and T_m is the Exchequer tax take for the first “m” months of year t. The equation is estimated for 9 and 11 months of data for each year from 2004 to 2012 for individual tax heads and for overall tax revenue.

As expected, the resulting root mean square errors (RMSE) (Table E2 and Figure E1) indicate that forecasting accuracy for total Exchequer taxes deteriorates when only 9 months of data are used. The forecasting of corporate taxes is by far the most affected – but these account for a relatively small proportion of overall revenue (approximately 11 per cent). In contrast, the two largest tax heads, income tax and VAT, showed a more modest impact.

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[45] For example, 85 per cent of non-tax revenues are collected by end-July, with Exchequer spending evenly apportioned throughout the year.

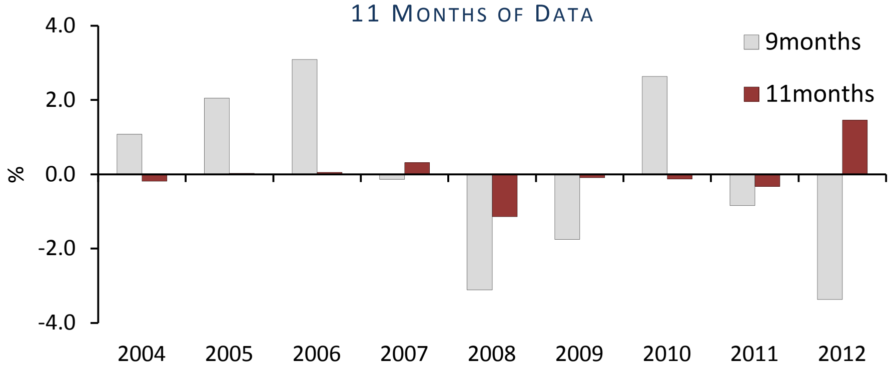
[46] Based on Department of Finance estimates for Exchequer taxes.

[47] The projected Exchequer tax take for 2013 prior to *Budget 2014* was €38 billion. By end-September, tax receipts amounted to €27 billion.

TABLE E2: SUMMARY OF EXCHEQUER TAX ERRORS

RMSE, %	9 months	11 months
Income Tax	0.6	0.6
VAT	1.1	0.4
Corporate Tax	19.9	2.8
Excises	1.0	1.6
Other	1.6	2.7
Total Exchequer Taxes	**2.3**	**0.6**

FIGURE E1: TAX REVENUE FORECASTING ERRORS BASED ON 9 AND 11 MONTHS OF DATA



Note: Figure shows percentage error from estimating the current year Exchequer tax take, based on 9 and 11 months of data.

What impact would a decline in overall tax forecasting accuracy of this scale have on the Exchequer deficit forecast? To illustrate the likely effect, the 2012 Exchequer deficit of 9.1 per cent of GDP is taken as a baseline. The impact of two forecast errors is then considered: first a negative tax forecast error of 2.3 per cent and then a negative error of 0.6 per cent (the RMSE for 9 and 11 months of data, respectively). All other revenue and expenditure items are held constant at their actual outturn levels. This exercise suggests that the Exchequer deficit (as a percentage of GDP) would have been projected at 9.6 per cent based on 9 months of data, significantly worse than the actual outturn, while for 11 months of data the projection would have been very close to the actual outturn at 9.2 per cent. This shows that the change of timing of the Budget could have a policy-relevant impact on forecast accuracy.

In summary, the movement of the Budget to October increases the risk that tax-forecasting and fiscal-deficit errors will be larger. This might warrant extra caution in setting the fiscal stance so as to ensure budgetary targets are met and fiscal rules are complied with. Moreover, this analysis takes no account of additional difficulties associated with preparing macroeconomic forecasts with two months fewer data. Recognising the issues arising from the existing structure of the Irish tax system, the Department of Finance has initiated a consultation process to bring forward the payment of taxes currently due in November.[48]

[48] This relates to pay and file dates for self-assessed income tax, capital gains tax and capital acquisitions tax. See *Consultation on Pay & File dates in the context of a Budget Day on or before 15th October*, Department of Finance, 2013.

2.3 An Assessment of *Budget 2014* Forecasts

2.3.1 Outlook for 2014

In 2014, the General Government deficit is expected to improve to 4.8 per cent of GDP based on the budgetary adjustments of €2.5 billion and nominal GDP growth of 2.9 per cent. The amount of consolidation was scaled back from the €3.1 billion adjustment previously signalled by the Government.[49] There was some public confusion relating to the size of the budgetary adjustment in *Budget 2014* due to this statement:

> A further €0.53 billion in revenues arising from measures introduced previously (the "carry-over") are estimated to benefit 2014. In addition, expenditure measures introduced previously will contribute a further €0.1 billion to consolidation. €0.6 billion of the budgetary adjustment comes from additional resources and savings elsewhere. Adding all of these to the €1.85 billion in new policy measures outlined above gives a total adjustment package of €3.1 billion in 2014. *Budget 2014*, page C.14, footnote 3.

Budgetary adjustments are usually understood to include new revenue and expenditure measures as well as the carry-over effects of measures from the previous year. They do not typically include the items contributing to the €0.6 billion in "additional resources and savings" referred to above, details of which are included in Table 2.2. These savings should not be considered "consolidation measures". Budget statements should be as clear as possible in distinguishing between new and existing policy measures and their impact on the economy, and should avoid the potential for confusion caused by adding items to the standard measures of adjustment.[50]

From 2014 onwards, a draft budgetary plan will need to be included in the budgetary documentation to meet new EU requirements. This will show the main General Government revenue and expenditure components on a no policy change basis as well as on a post-budget basis including details of the discretionary measures introduced in the Budget. This should enhance transparency.

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[49] In *SPU 2013*, the Government proposed a €3.1 billion adjustment for 2014 involving expenditure measures of €2.0 billion and revenue measures of €1.1 billion.

[50] A recent IMF assessment found that Ireland scored well in terms of budget reporting (see Annex G). This was however published prior to *Budget 2014*.

TABLE 2.2: FISCAL ADJUSTMENT IN *BUDGET* 2014

€ Billions	New Measures	Carry Forward	Total
A. Departmental Expenditure[51]	**1.5**	**0.1**	**1.6**
Of which:			
Current	*1.4*	*0.1*	*1.5*
Capital	*0.1*	-	*0.1*
B. Tax[52]	**0.4**	**0.5**	**0.9**
C. (= A+B) Consolidation in *Budget 2014*	**1.9**	**0.6**	**2.5**
D. Additional Resources and Savings[53]			**0.6**
Of which:			
Reduction in cost estimate for the Live Register			*0.15*
Reduction in estimate for NTMA Debt service costs			*0.2*
Increase in estimate for Central Bank surplus income			*0.1*
State asset related adjustments			*0.15*
E. (=C+D) Consolidation and Additional Resources and Savings			**3.1**

The main General Government revenues and expenditure projections underlying *Budget 2014* are shown in Table 2.3 (for comparisons with *Budget 2013* and *SPU 2013*, see Annex Table F.1). Total General Government revenue is projected to increase by €2.4 billion in 2014. This constitutes a downward revision since *SPU 2013*, reflecting a weaker outlook for nominal GDP. Taxes as a share of GDP have been rising in recent years by close to one percentage point of GDP per annum. The outlook for taxes in 2014 is slightly below this rate of increase and appears reasonable given the taxation measures in the Budget and the outlook for nominal GDP growth.[54] The projections for revenues included large tax carryover effects arising from past budgetary measures, notably the

[51] The *Expenditure Report 2014* also makes reference to a further €0.3 billion in "Additional Pressures". This refers to the savings effort made by Departments to address increased service pressures while delivering the required consolidation set out in Table 2.2.

[52] Tax measures consisted of stamp duties (€0.3 billion), income tax (€0.2 billion), excise duty (€0.1 billion), VAT (-€0.3 billion) as well as some other smaller changes.

[53] This information was not published with the budgetary documentation but was included in the Minister for Finance's reply to Parliamentary Questions 44688/13, 44829/13 and 44830/13 on 22 October 2013. Previously such measures have been presented within the Budget documentation; notably the €660 million in "Other" measures detailed in *Budget 2011* and the €100 million in "increased dividends" shown as part of last year's Budget.

[54] The outlook for Exchequer tax revenues in 2014 is marginally weaker (by €50 million) than in the pre-Budget *Estimates for Receipts and Expenditure*.

local property tax.[55] There are also some positive one-off items acting to improve the deficit in 2014.[56]

TABLE 2.3: *BUDGET 2014* PROJECTED CHANGES IN GOVERNMENT REVENUE AND EXPENDITURE

	2014	2015	2016	Cumulative 2014-16
Main Aggregates, % of GDP				
General Government Balance [57]	**-4.8**	**-2.9**	**-2.4**	
Primary Balance	**0.0**	**2.0**	**2.6**	
General Government Debt	**120.0**	**118.4**	**114.6**	
Nominal GDP Growth, %	**2.9**	**3.7**	**4.4**	
Projected Changes in Government Revenue and Expenditure, € billions				
Total Revenue	**2.4**	**2.4**	**1.8**	**6.6**
Tax	2.4	2.2	1.7	6.3
Social Contributions	0.4	0.2	0.3	0.9
Other	-0.4	0.0	-0.2	-0.6
Total Expenditure	**-1.6**	**-0.4**	**1.0**	**-1.0**
Compensation of Employees	-0.3	-0.4	0.0	-0.6
Intermediate Consumption	-0.2	0.2	0.2	0.3
Social Payments	-0.5	-1.2	0.2	-1.6
Interest	0.5	0.6	0.5	1.6
Other	-1.2	0.4	0.1	-0.7
Primary Expenditure	**-2.1**	**-1.0**	**0.4**	**-2.7**

Note: Numbers rounded to one decimal place.

General Government expenditure in 2014 is expected to decline by €1.6 billion as a result of the expenditure measures in *Budget 2014* and an improved outlook for the labour market.[58] Staying within this target will be heavily dependent on achieving €1.5 billion in predominantly current expenditure savings.[59] The two largest spending Departments, Health and Social Protection, are

[55] For details see: http://oireachtasdebates.oireachtas.ie/debates%20authoring/debateswebpack.nsf/(indexlookupdail)/20131002~WRL?opendocument#WRL01800

[56] In 2014, sales of the national lottery licence improve the budget deficit by €0.4 billion.

[57] This refers to the underlying balance. This is the General Government balance less financial sector measures as defined by the Department of Finance. Financial sector measures add €10 million to the deficit in 2013, €90 million in 2014, €100 million in 2015 and €50 million in 2016.

[58] The unemployment rate is projected to average 12.4 per cent in 2014 (down from 14.7 per cent in 2012 and 13.5 per cent in 2013).

[59] This is also reflected in the difference between current expenditure estimates in the pre-Budget *Estimates for Receipts and Expenditure* and the outlook in *Budget 2014*. In the former, voted Exchequer current expenditure was

expected to deliver savings of €0.7 billion and €0.3 billion, respectively. These savings are part of the revised departmental expenditure ceilings for the period to 2016.

While further steps to develop a Medium-Term Expenditure Framework are welcome, current expenditure ceilings have not been binding with aggregate revisions to ceilings of €0.6 billion in 2013 and €0.9 billion in 2014 (Box F). The majority of this 'slippage' appears to arise from weaker economic conditions and policy decisions. Some of these revisions would appear to fall outside of the defined "escape clauses" and hence breach the provisions of a detailed administrative Circular issued by the Department of Public Expenditure and Reform on the rules and procedures applying to the expenditure ceilings.[60] The Circular specifies the circumstances in which both the aggregate and Ministerial three-year ceilings may be revised and also links the setting of ceilings with the expenditure benchmark (see Box F).

Achieving the planned savings in Health remains uncertain given the recent history of expenditure overruns in that Department. Expenditure overruns in Health have averaged €260 million per annum over the past 4 years (Figure 2.2). These overruns have been documented previously by the Council (IFAC, 2012b) and may reflect broader problems relating to public expenditure incentive structures (see Box G).

For 2014, one-third of the assumed expenditure savings in Health arise from pay-related measures. The credibility of the budgetary projections would be aided by the provision of greater detail on the quantification of the projected impact of planned budgetary measures. The Health Services Executive (HSE) national service plan is not due to be published until end-November. Given the recent history of overspending in the health area and the challenges in fully implementing the proposed savings measures for 2014, ensuring adherence to the health expenditure ceiling will be a key test of the new Medium-term Expenditure Framework (see Box F and Annex H).

While the Council has concerns over the delivery of the planned expenditure savings in 2014, the projected deficit of 4.8 per cent of GDP based on the macroeconomic outlook is assessed to be appropriate. This assessment is also shared by the European Commission and by the IMF (Table 2.4). However, with interest expenditures set to rise further in 2014 and with investment spending at such low levels, there are fewer buffers in place to safeguard against slippages on the

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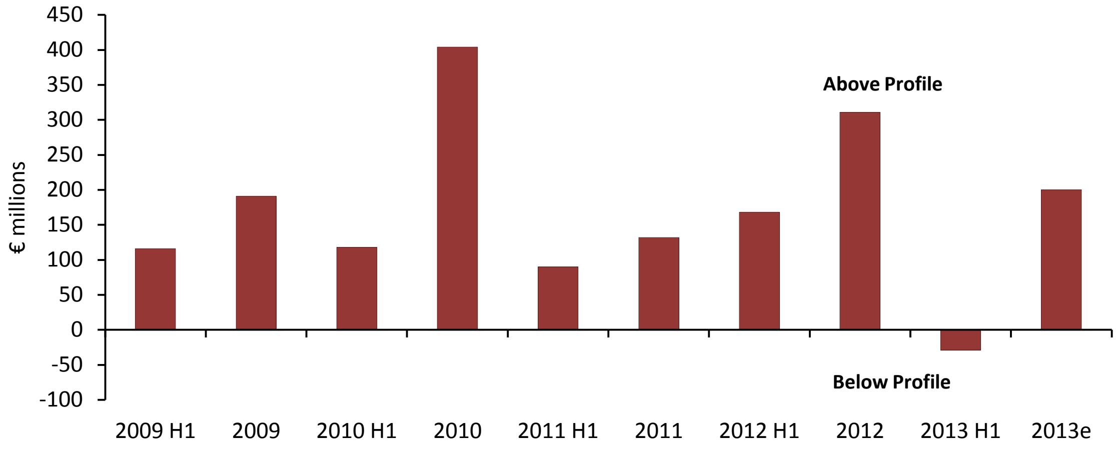
projected to be €39.7 billion on a no policy change basis in 2014. As a result of the measures in the Budget, this figure has been revised down to €38.4 billion.

[60] http://per.gov.ie/wp-content/uploads/Circular-15-13.pdf

expenditure side. Similarly, the ending of the bank guarantee scheme will also reduce room for manoeuvre on the revenue side in 2014. With this in mind, the margin of safety relative to the EDP deficit ceiling in 2014 of 5.1 per cent has narrowed by half a percentage point since *SPU 2013.*[61]

FIGURE 2.2: CUMULATIVE OVERRUNS IN CURRENT EXPENDITURE IN THE DEPARTMENT OF HEALTH: MID-YEAR VS END-YEAR[62]



[61] In *SPU 2013*, the underlying General Government deficit was projected to by 4.3 per cent of GDP in 2014.

[62] Chart assumes a current voted expenditure overrun in Health of €200 million in 2013.

Box F: The Medium-Term Expenditure Framework

Background

The *National Recovery Plan 2011-2014* published by the Department of Finance in November 2010 outlined a range of budgetary reforms including a Medium-term Expenditure Framework (MTEF) with multi-annual ceilings on expenditure. These proposals were then incorporated into the agreement entered into with the EU/IMF in 2010. Specifically, the EU/IMF Programme included an explicit commitment on the part of Ireland to introduce effective multi-annual expenditure ceilings.

The initial proposal for a MTEF was expanded upon as part of the Department of Finance discussion document *Reforming Ireland's Budgetary Framework*.[63] The new Government detailed its proposed approach in the *Comprehensive Expenditure Report 2012-2014* in December 2011 (CER). This also introduced gross current departmental ceilings for 2012 to 2014 on an administrative basis.[64] The Council documented these ceilings in its previous *Fiscal Assessment Report* (IFAC, 2013a).

Two further steps to finalise the implementation of the MTEF were taken in 2013.

(i). The enactment of the *Ministers and Secretaries (Amendment) Act 2013*. This Act sets out the coverage of the three year aggregate ceilings and provides that both the aggregate ceiling and Ministerial ceilings must be set and revised by Government decision.

and

(ii). The publication of a more detailed administrative Circular on the rules and procedures applying to the ceilings. The administrative Circular provides for: the circumstances in which both the aggregate and Ministerial three-year ceilings may be revised (escape clauses) and for a reconciliation with previous ceilings where this occurs; the carryover of savings between years; the sanction mechanisms applying where Departments exceed ceilings; and for periodic comprehensive reviews of expenditure. The Circular also links the setting of ceilings with the expenditure benchmark requirements at a European level. The expenditure benchmark is discussed in Box I.

Annex H sets out more detail on the operational arrangements of the MTEF.

The MTEF represents a significant move to top-down multi-annual budgeting from the more incremental, bottom-up approach that was previously in place. The traditional estimates process focused on the following year's expenditure allocation with Departments submitting incremental 'demands', which were then negotiated between Ministers. The multi-annual

[63] http://www.finance.gov.ie/documents/publications/guidelines/budgetref.pdf

[64] http://www.budget.gov.ie/budgets/2012/Documents/CER%20-%20Estimates%20Final.pdf

dimension of expenditure planning was seen as indicative, non-binding and subject to future budgetary processes. The approach led to significant weaknesses in multi-annual planning rather than in budget execution.[65] The new approach puts in place binding three-year ceilings on Departmental expenditure, which are set within the overall fiscal rules established in the *Fiscal Responsibility Acts 2012 and 2013*.

Revised Expenditure Ceilings

The revisions to the administrative ceilings for 2013 and 2014 since the CER are shown in Tables F1 and F2.

Table F1: Revisions to Gross Departmental Expenditure Ceilings for 2013

	Budget Planning		***Budget Execution***
€ millions	***Comprehensive Expenditure Report 2012-2014***	***Expenditure Report 2013***	***Revised Estimates Volume 2013***
	Ceiling Dec 2011	**Ceiling Dec 2012**	**Original Estimate Apr 2013**
Social Protection	19,906	20,246	20,233
Health	13,565	13,627	13,624
Education, incl. NTF	8,525	8,514	8,456
Justice	2,198	2,200	2,163
Agriculture	1,057	1,057	1,049
Others	5,429	5,594	5,606
Unallocated	-91	-170	15
TOTAL (GEC)	50,589	51,068	51,146

It can be seen that there have been aggregate revisions of €0.6 billion to the ceilings in 2013 and €0.9 billion in 2014. The majority of this ‘slippage’ appears to arise from (i) the impact of the weaker macroeconomic outlook on unemployment-related welfare payments and (ii) policy decisions to raise expenditures in selected Departments.[66] The recent *Expenditure Report 2014* presents reconciliations of both aggregate and individual Ministerial ceilings.

[65] Volume I of the *Report of the Special Group on Public Service Numbers and Expenditure Programmes (2009)* compared the three-year expenditure projections that were published each year in the annual Budget volumes for 2000 to 2006 against the actual outturns for expenditure in each of those years and determined that while the first-year outturns typically came within 1 per cent of the projection, the second-year outturns came in ahead of projection by 6 per cent on average, while the third-year outturn overran by around 12 per cent on average.

[66] *Budget 2013* explicitly provided for increases to the Social Protection and Health gross current ceilings for 2013 of €150 million and €60 million respectively. *Budget 2014* provided for increases on Social Protection (€150 million); Health (€187 million) and Justice and Equality (€77 million), with more minor increases for a number of other Departments. Additional, more minor, increases were also made to ceilings for other Departments for both years.

While these reconciliations represent a significant step forward in transparency, the increase of €400 million arising from "changed composition of consolidation" and further €45 million arising from "expenditure decisions" fall outside of the defined "escape clauses" for increasing the aggregate ceiling and consequently breach the provisions of the Circular.[67]

As part of *Budget 2014*, the current expenditure ceiling for 2014 was revised upwards by €0.4 billion to €49.6 billion (Table F3). This reflects the decision to scale back on the planned consolidation effort for 2014 by €0.4 billion. All other things being equal, the ceilings should have been lowered by €0.2 billion on account of better than expected labour market conditions. Revisions to the capital expenditure ceiling over the period to 2016 were marginal.

TABLE F2: REVISIONS TO GROSS DEPARTMENTAL EXPENDITURE CEILINGS FOR 2014

	Budget Planning		
€ millions	***Comprehensive Expenditure Report 2012-2014***	***Expenditure Report 2013***	***Expenditure Report 2014***
	Ceiling Dec-11	**Ceiling Dec-12**	**Ceiling Oct-13**
Social Protection	19,296	19,633	19,631
Health	13,359	13,420	13,263
Education, incl. NTF	8,453	8,453	8,219
Justice	2,083	2,065	2,097
Agriculture	1,029	1,029	1,019
Others	5,270	5,392	5,402
Unallocated	*-774*	*-760*	*-25*
TOTAL (GEC)	48,716	49,232	49,606

TABLE F3: *BUDGET 2014*: CURRENT EXPENDITURE CEILINGS TO 2016

€ Billions	**2014**	**2015**	**2016**
Gross Current Expenditure	49.6	48.3	48.6
Health	13.3	13.1	13.1
Social Protection	19.6	19.4	19.4
Education	8.2	8.2	8.2
Other Departments	8.5	7.7	8.0
Unallocated Savings	0.0	0.8	0.4

[67] As the escape clauses are not defined in the *Ministers and Secretaries (Amendment) Act 2013*, these increases do not breach the legislation. The Commission has also highlighted concerns that providing for "escape clauses" in the Circular rather than the legislation leaves room for ad hoc modifications of the ceilings, (see ://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp162_en.pdf)

Box G: Incentive Challenges in Public Expenditure Management: The Soft Budget Constraint and the Ratchet Effect

In the light of persistent expenditure overruns in health spending, this box focuses on some of the structural challenges that can affect the allocation and control of public expenditure, with an emphasis on the difficulties of ensuring spending Departments face appropriate incentive structures. It focuses in particular on two incentive challenges that face all public expenditure systems: the soft budget constraint and the ratchet effect.

The Soft Budget Constraint

The concept of the "soft budget constraint" (SBC) was introduced by János Kornai in the context of state-controlled firms. However, it has found wide application across various areas of economics, including the challenges of controlling public expenditure and avoiding bailouts of financial firms. In Kornai's original formulation, the budget constraint is *soft* – notwithstanding *ex ante* threats to impose a hard constraint – where the decision maker in control of day-to-day expenditure anticipates that the constraint is likely to be relaxed *ex post* if the original constraint is not met.[68] The concept has been reformulated using game-theoretic tools as a dynamic commitment problem, where the central authority cannot credibly commit to enforce a hard budget constraint *ex post* (see, e.g., Dewatripont and Maskin, 1995).[69]

Not surprisingly, the SBC has found particular application in the area of public expenditure. The SBC-related incentive challenge is likely to be especially difficult when it comes to health spending. There is a pattern of spending overruns in public health spending in Ireland. If health spending is not adequately controlled relative to budgeted spending early in the year, the implications of imposing hard budget constraints later in the year can be severe – e.g., avoidable suffering and possibly even deaths.

Anticipating a relaxation of constraints in the face of such consequences, decision makers are

[68] Kornai (1992, p. 143) describes the soft budget constraint in the following terms:

"The extending of external assistance is a random variable with a given probability distribution, of which the firm's decision maker (and his or her superiors) have a subjective "perception." The greater the subjective perception, that is, the safer the firm is in assuming it will receive external assistance, the softer the budget constraint. Another interpretation is the following: The promise to enforce the observation of the budget constraint is a commitment of the bureaucracy that it will not tolerate persistent loss-making. Hardness versus softness refers to the credibility of this commitment."

[69] Kornai *et al.* (2003) provides a synthesis of the subjective probability and dynamic consistency interpretations.

less fearful that the hard constraint will ultimately be imposed, and face weaker incentives to control spending earlier in the year in ways that are less detrimental to users of health services.

Looking at the problem through the lens of the SBC makes clear that simply "talking tough" in relation to a willingness to follow through on threats of hard constraints is unlikely to be sufficient to improve expenditure control. There must be a change in the incentive structures in a way that minimises *ex post* harm to service users. Possible changes to the structures include more intense monitoring and reporting earlier in the budget period, more direct remuneration or career consequences for decision makers where budget constraints are not met, potential forfeiture of local control if there is a pattern of failure to meet budget constraints, or direct consequences in terms of future budgets as a result of current-year budget overruns (although such threats may also face credibility problems).[70]

THE "RATCHET EFFECT"

Another common incentives-related challenge in public expenditure systems is known as the "ratchet effect". This refers to the phenomenon where future budgets are determined by current spending. In particular, under-spending of the current year's budget can lead to budget reductions for future years, in turn leading to perverse incentives to fully spend the current allocation, even where it is recognised that the marginal value of the spending is low. The ratchet effect can interact negatively with the SBC where the need to reduce the future budgets of under-spending Departments is increased by the need to "bail-out" overspending Departments (see, e.g., Roland, 2000).

The new expenditure ceilings framework attempts to minimise the damage done by the ratchet effect by allowing some carryover of unspent funds to future years.[71] Regular comprehensive expenditure reviews should also ensure that Departmental expenditure allocations reflect value considerations, instead of perversely rewarding bad – and punishing good – expenditure-management performance.

Overall, the new expenditure ceiling framework – reinforced by the expenditure benchmark under the revised Stability and Growth Pact and regular comprehensive expenditure reviews – appears to be a significant step forward in public expenditure management. However, careful attention will be required to ensure that the SBC and ratchet effect incentive challenges are tackled in the actual implementation of the new framework.

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[70] The Department of Public Expenditure and Reform Circular 15/13 describing the implementation of the expenditure ceiling rules notes:
"[I]f the Department fails to implement the Government Decision and breaches the expenditure ceiling, on foot of a proposal from the Minister for Public Expenditure and Reform, the Government may require that the Department "repay" the overrun in the next year. In such circumstances, the Department will be subject to an offsetting adjustment in the Ministerial Expenditure Ceiling for the following year and will be required to devise policy measures to live within the reduced allocations. In circumstances where the Department cannot absorb the full required adjustment in the following year's expenditure ceiling, the Government can decide that it may be necessary either to spread the adjustment over two or more years or, in circumstances where the overall Government Expenditure Ceiling and/or the Government targets for the public finances do not allow such an approach, to allocate the balance of reductions across other Departments so that the overall expenditure path remains on target. This will require re-prioritisation of resources within each Ministerial envelope."

[71] See Item 15 of Circular 15/13, Medium-Term Expenditure Framework: Application to Current Expenditure, Department of Public Expenditure and Reform, 2013.

2.3.2 Outlook for 2015 and 2016

In 2015 and 2016, the General Government deficit is projected to fall to 2.9 per cent and 2.4 per cent of GDP, respectively (Table 2.3). These projections are premised on robust revenue growth, expenditure restraint and previously announced plans for further consolidation of €2 billion. As a result of the reduced level of consolidation in 2014 and weaker growth prospects, the margin of safety relative to the 2.9 per cent deficit limit for 2015 (set by the ECOFIN Council) no longer exists.[72]

The projections for 2015 and 2016 assume a sustained recovery in nominal and real rates of growth. Primary expenditure is forecast to decline by 1.6 per cent in 2015 before increasing modestly in nominal terms in 2016. Implicit in the expenditure projections (notably for social payments) is the assumed recovery in the labour market (Figure 2.3).

There were quite significant revisions to the budgetary projections in 2015 and 2016, contrary to the statement in *Budget 2014* that "...the fiscal outlook in 2015 remains broadly unchanged". For 2015, revenues are €0.7 billion weaker with expenditure €0.6 billion higher in *Budget 2014* relative to the outlook in *SPU 2013* (Annex Tables F.2 and F.3). As a result, the underlying General Government deficit to GDP ratio in 2015 was revised upwards by 0.7 percentage points between *SPU 2013* and *Budget 2014* to 2.9 per cent.

The debt to GDP ratio is expected to peak at 124.1 per cent in 2013 before declining over the projection period, helped by the attainment of a primary surplus in 2015 and 2016 and a reduction of cash balances of just over €11 billion to fund gross financing requirements.[73] The maturity profile of Government debt has lengthened in recent months reflecting the decision by EU ministers to lengthen the maturities of Irish borrowing under the EU/IMF programme as well as the decision to replace the promissory notes with long-term bonds.[74]

[72] In *SPU 2013*, the deficit in 2015 was projected to be 2.2 per cent of GDP.

[73] At end-September 2013, Exchequer cash and other short-term cash management balances including deposits amounted to €25.6 billion.

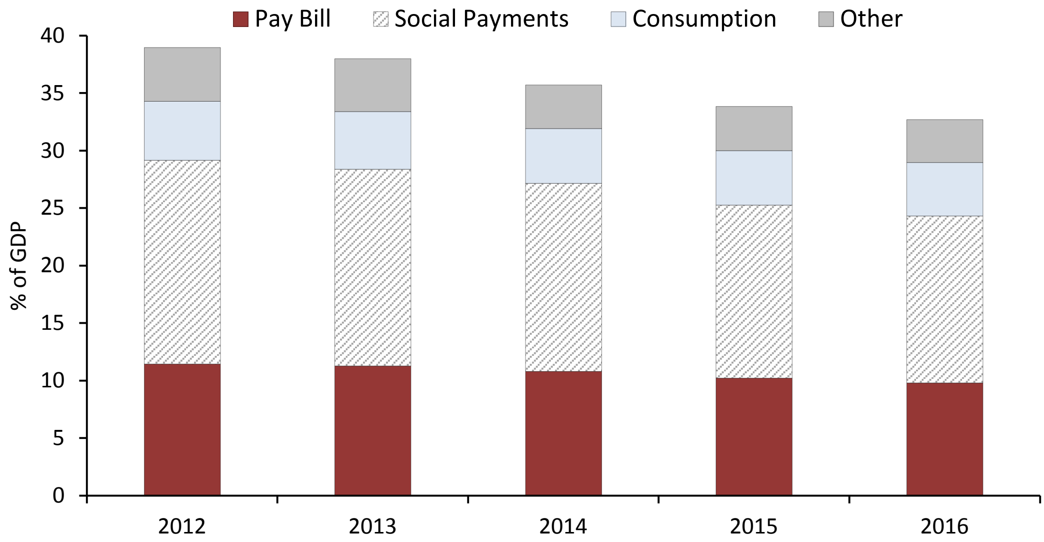
[74] The weighted average maturity of long-term Irish Government debt has been extended from just over 7 years at end-2012 to 11 years in mid-2013 as a result of these developments. The decision of EU ministers refers to the European portion of Irish borrowing from the EU/IMF.

TABLE 2.4 FISCAL OUTLOOK TO 2016

% of GDP	*Budget 2014*	IMF Oct 2013	ESRI Oct 2013	EC Nov 2013	OECD Nov 2013
2013					
General Government Balance	-7.3	-7.5	-7.0	-7.4	-7.4
Primary Balance	-2.7	-2.6	NA	NA	NA
Structural Balance	-5.3	-5.2	NA	-6.7	NA
General Government Debt	124.1	123.3	123.9	124.4	132.3
Nominal GDP, % y/y	1.2	1.6	1.8	1.0	2.3
2014					
General Government Balance	-4.8	-4.9	-4.4	-5.0	-5.0
Primary Balance	0.0	0.1	NA	NA	1.3
Structural Balance	-3.6	-3.6	NA	-5.2	NA
General Government Debt	120.0	121.0	119.7	120.8	130.8
Nominal GDP, % y/y	2.9	3.0	3.9	2.5	NA
2015					
General Government Balance	-2.9	-2.9	NA	-3.0	-3.1
Primary Balance	2.0	2.1	NA	NA	NA
Structural Balance	-1.6	-2.2	NA	-3.3	NA
General Government Debt	118.4	118.3	NA	119.1	128.6
Nominal GDP, % y/y	3.7	4.0	NA	3.6	NA
2016					
General Government Balance	-2.4	-2.4	NA	NA	NA
Primary Balance	2.6	2.5	NA	NA	NA
Structural Balance	-1.1	-2.1	NA	NA	NA
General Government Debt	114.6	116.2	NA	NA	NA
Nominal GDP, % y/y	4.4	4.1	NA	NA	NA

Note: Budget 2014 figures refer to the underlying General Government Balance. IMF figures for budget balances exclude financial sector support. OECD figures refer to General Government net lending. Both the IMF and ESRI forecasts were published prior to *Budget 2014*.

FIGURE 2.3: *BUDGET 2014* PROJECTIONS FOR PRIMARY EXPENDITURE CATEGORIES



2.4 SENSITIVITY AND RISK ANALYSIS

There remains considerable uncertainty around the Budget projections for the public finances. This section updates analysis in earlier Council assessments on risks related to growth but also examines other sources of risk, some of which were highlighted in recent reports by the IMF (IMF, 2013a and IMF, 2013b, see also Annex G).

The Budget included a 'Statement of Risks and Sensitivity Analysis' (*Budget 2014*, pp C.23-C.26). Risks to the central economic forecasts were judged to "be tilted to the downside" (see Chapter 1). Fiscal risks were reported due to normal uncertainty associated with tax forecasts, increased by the unpredictable impact on corporation tax receipts of the carry-forward of losses and the change in timing of the Budget. In addition, there are also contingent risks associated with NAMA following the liquidation of IBRC, although the European Commission has indicated that this would be likely not to affect Ireland's compliance with EDP obligations.

The Council's assessment of the fiscal risks is set out below. A significant risk, not included in the *Budget 2014* assessment, stems from the forthcoming comprehensive assessment of the banking sector involving a supervisory risk assessment, an asset quality review and a stress test and the potential impact on banking capital needs. There are also a number of significant medium-term risks that, while still highly uncertain, should be considered in assessing the fiscal outlook.

Three broad classes of risk are assessed in this Section and are summarised in Table 2.5. These risks centre on the uncertainty surrounding the macroeconomic outlook, possible balance sheet risks as well as changes in interest rates. Other more qualitative/external sources of risk are briefly discussed at the end of the Section.

TABLE 2.5: RISK MATRIX

Source of Risk	Nature of Risk
(a) Growth	• Historical volatility of Irish growth and susceptibility of the economy to conditions in the international economy. • Uncertainty surrounding the persistence of the balance sheet recession and deleveraging effects on domestic demand. • Uncertainty surrounding the pharmaceutical "patent cliff" and its impact on output and employment.
(b) Balance Sheet	• Banking sector requiring additional capital. • Liquidation of IBRC results in a shortfall for NAMA. • Lower than anticipated recovery on other NAMA assets. • Government required to put additional funds into certain sectors (e.g., insurance, housing). • Public pension liabilities. • Private pension liabilities (e.g., Waterford Crystal case). • Opportunities to sell Government assets more quickly/at higher price than currently assumed.
(c) Interest Rate	• Euro Area rates increase. • Spread on Irish debt narrows/widens.

2.4.1 SENSITIVITY OF FISCAL RATIOS TO GROWTH SHOCKS

The uncertainty surrounding Irish growth prospects has been repeatedly highlighted by the Council. From Chapter 1, it is clear that these uncertainties remain (and are tilted to the downside) and are compounded this year by the impact of the pharmaceuticals "patent cliff". The Council's Fiscal Feedbacks model can be used to illustrate the effect on the key fiscal ratios of alternative growth assumptions. In Figure 2.4, the growth rate in nominal GDP is allowed to vary within +/- two percentage points of the *Budget 2014* baseline. For example, if growth turns out to be one percentage point weaker per annum, then the General Government deficit by 2015 would be approximately one percentage point above the *Budget 2014* baseline (Figure 2.4a) with the impact on the debt ratio shown in Figure 2.4b.

FIGURE 2.4: ALTERNATIVE GROWTH PATHS AND FISCAL OUTCOMES

FIGURE 2.4a: GENERAL GOVERNMENT DEFICIT

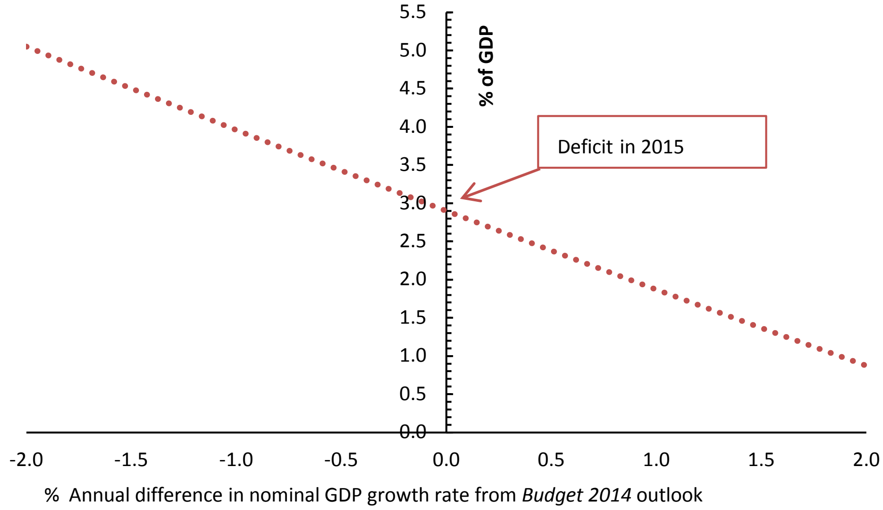
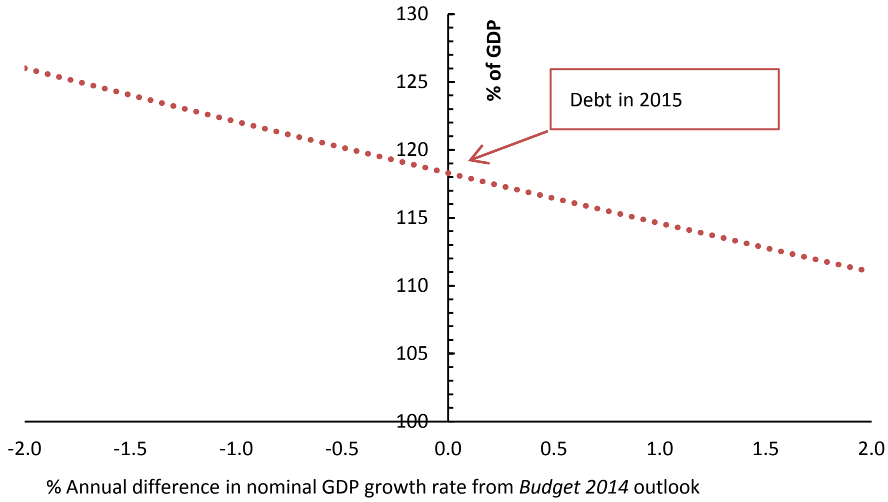


FIGURE 2.4b: GENERAL GOVERNMENT DEBT



Fan charts based on *Budget 2014* are shown in Figure 2.5 and suggest a 1-in-2 probability that the deficit to GDP ratio would be above the 2.9 per cent of GDP EDP deficit ceiling in 2015 in the absence of offsetting adjustments (IFAC, 2012c and 2013a).[75] The risk of missing the EDP deficit ceiling has increased since the Council's *Fiscal Assessment Report* last April. In that report, there was a 1-in-3 probability of the deficit target in 2015 being exceeded. The increased risk reflects a combination of weaker growth prospects and the decision to lower the consolidation effort in 2014

[75] The fan charts are constructed to take account of growth shocks as opposed to other types of risk.

from €3.1 billion (as set out in *SPU 2013*) to €2.5 billion in *Budget 2014*. The fan charts also imply an estimated 1-in-3 probability that the debt to GDP ratio will fail to stabilise by 2015 unless further policy measures beyond those currently planned are taken (Figure 2.5b).

FIGURE 2.5: FAN CHARTS FOR KEY FISCAL INDICATORS

FIGURE 2.5a: GENERAL GOVERNMENT DEFICIT

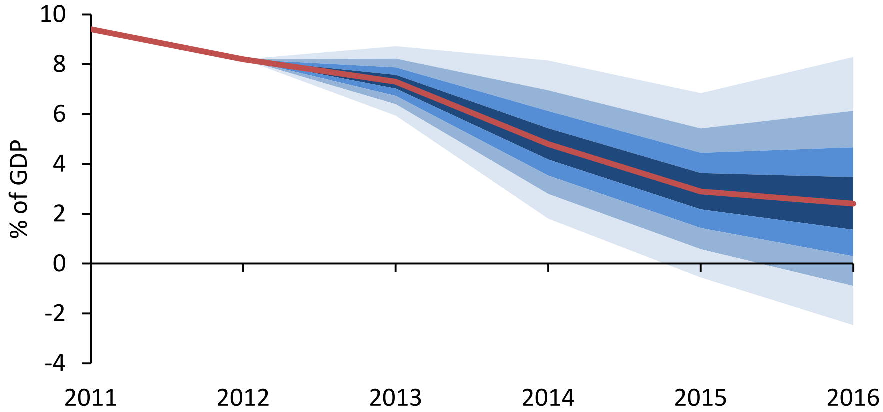
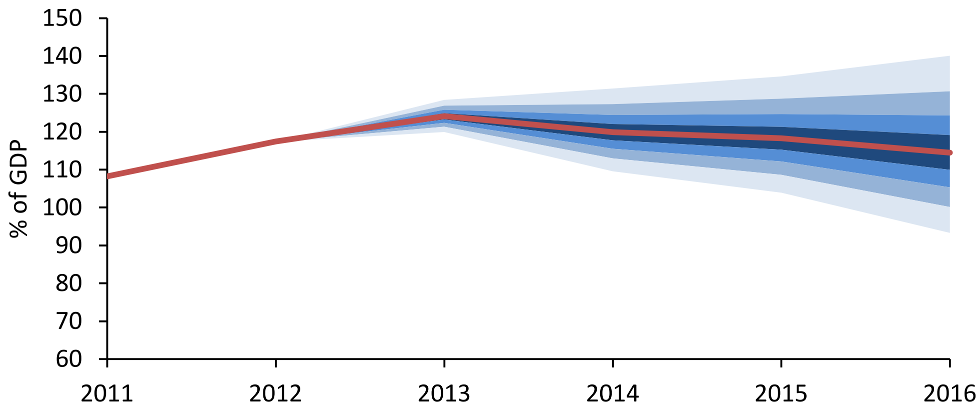


FIGURE 2.5b: GENERAL GOVERNMENT DEBT



2.4.2 Sensitivity of Fiscal Ratios to "Other" Shocks

Balance Sheet Risks

The Government's balance sheet contains a wide range of assets and liabilities as well as important off-balance sheet (contingent and implicit) liabilities.[76] According to the CSO, contingent liabilities were valued at €125 billion in the second quarter of 2013.[77] These are mainly accounted for by existing guarantees given by the Government and off-balance sheet Public Private Partnerships. Contingent liability exposures have steadily declined since their peak in 2008 reflecting the ending of the bank guarantee scheme for new liabilities and the ending of the Exceptional Liquidity Assistance provided to IBRC (for more details see, Barnes and Smyth, 2013).

Considerable uncertainty surrounds these liabilities both in terms of their measurement and the likelihood of them becoming actual costs for Government. The banking sector has been a significant source of shocks to the economy in recent years with implicit (and explicit) Government commitments resulting in tangible costs for the public finances. Exceptional payments to the banking sector have had a significant impact on the headline General Government Balance since 2009 (Table 2.6). In this context, it is surprising that the recent risk analysis in *Budget 2014* included very limited references to possible further shocks arising from the banking sector.

Table 2.6: Fiscal Ratios and Banking Payments, Percentage of GDP

	General Government Balance	Underlying General Government Balance	Contribution from Banking Payments
2009	-13.7	-11.2	2.5
2010	-30.6	-10.6	20.0
2011	-13.1	-8.9	4.2
2012	-8.2	-8.2	0.0

Source: Department of Finance, 2013.

[76] Contingent liabilities are commitments, such as guarantees, that could lead to liabilities if triggered, while implicit liabilities have no contractual basis but could nevertheless lead to expenses for the Government in the future.

[77] Contingent liabilities tend to be reported solely in terms of their maximum possible exposure. This gives very little idea of what the risks are as the maximum figures say nothing about the likelihood of risks materialising. Hence, great care is warranted in interpreting these data.

POTENTIAL LIABILITIES ARISING FROM THE BANKING SECTOR

As regards exposures relating to the banking sector, 2014 will be a significant year in terms of the potential realisation of further costs to the State. Ireland is required to undertake an asset quality review with banks taking remedial actions ahead of the 2014 stress test (IMF, 2013). [78] These will take place in the context of a comprehensive assessment by the ECB, compromising a supervisory risk assessment, an asset quality review and a stress test. The latter is to be coordinated with the wider stress test managed by the European Banking Authority (EBA).[79]

There is a risk that these reviews could lead to additional capital needs for Irish banks. In the event of a bank needing additional capital, a key question is the source of that capital. EU policy suggests that for viable banks this should:

> ...first and foremost, be made up with private sources of capital. If private sources of capital are insufficient or not readily available, public backstops might need to be drawn upon, in compliance with national practices and European rules, with the overriding goal of ensuring financial stability.[80]

The ESM can in some circumstances provide support if national Governments face difficulties in providing necessary financing. This will, however, be contingent upon progress at a European level on the common supervision of banks.

From a European perspective, three points are worth noting:

- National Governments remain responsible for ensuring that any shortfall in bank capital is met up to the minimum regulatory standard of 4.5 per cent tier-1 capital.
- The ESM could provide additional funds subject to an appropriate level of bail-in of existing creditors in line with both the forthcoming 'EU Bank Recovery and Resolution Directive' and EU state aid rules.[81, 82]

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[78] See IMF tenth review, June 2013, pp. 20, 57 and 64.

[79] The ECB is assuming its supervisory role in November 2014. For details, see: http://www.ecb.europa.eu/press/pr/date/2013/html/pr131023.en.html

[80] European Central Bank, "Note on Comprehensive Assessment", October 2013. http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf

[81] ESM funds for this purpose are currently capped at €60 billion. This is line with revised EU state aid rules, which foresee bail-in of junior but not senior debt holders. Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication') (2013/C 216/01), 30 July 2013.

[82] The national authorities are required to contribute 20 per cent of any capital injection in the first two years and 10 per cent thereafter. This requirement can be suspended if the Government is unable to meet it.

- Retroactive recapitalisation could take place in exceptional cases (to be decided on a case-by-case basis).

In this context, the latest EU Council statement on 15 November on the European banking system is informative. The Council confirmed that:

> ..in the eventuality that the comprehensive assessments/stress tests reveal a capital shortfall, the established pecking order (first private sources, then national and euro area/EU instruments) will apply.[83]

POTENTIAL BANK CAPITAL REQUIREMENTS

The main official assessment of the state of the Irish banking system was provided by the Central Bank in the *2011 Financial Measures Programme (FMP)*, (see Central Bank of Ireland 2011). This involved a stress test of the capital requirements of AIB, BOI, ESB and PTSB using base and stress macroeconomic scenarios to ensure that the banks would remain well-capitalised.

As part of this process, the Central Bank published three-year projected loan losses for the Irish banks, based on lifetime loan losses. It was hoped that this process would help assure markets that capital requirements would be sufficient to cover even extreme and improbable losses. Estimates of the expected net incomes and deleveraging outcomes relating to each of the covered banks were also prepared in order to arrive at the amounts required (including both asset sales and recapitalisation) to ensure sufficient capital was put in place to absorb future losses.

Changes in the capital requirements of banks are driven by a number of variables. These include loan losses and profits/losses on deleveraging and operating profits/losses. Furthermore, changes in the size of the balance sheet, movements in capital requirements linked to the risk profile of bank assets (as reflected in the calculation of risk-weighted assets (RWA)) and changes in regulatory standards all play a role. Loan and deleveraging losses had been the most significant variables in previous years (Central Bank of Ireland, 2013). However, loan losses now appear to have emerged as the most important variable determining performance given that deleveraging targets have been virtually completed, associated loan haircuts (i.e., the differences between purchase prices paid by investors or acquirers and the nominal value) turned out relatively more favourable than expected and operating profits before impairments appear to be recovering.

In terms of prospective three year losses in the FMP, the Central Bank of Ireland in June 2012 published a review (the "PCAR 2011 Review") of recent bank performance relative to the three

[83] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/139613.pdf

year loan losses anticipated in the original FMP.[84] The overall performance of the economy has turned out to be between the base and stress scenarios although closer to the stress scenario in terms of some of the key macroeconomic drivers.[85] Actual losses from December 2010 to June 2012 were equivalent to 104 per cent of the base-case estimated losses but only about three-quarters of losses implied by the stress scenario. Stress case scenario losses over the three years were estimated by the Central Bank at €27.7 billion, comprising (i) the December 2010 stock of provisions of €9.9billion; and (ii) anticipated loan impairment charges to end-2013 of €17.8 billion.

As regards possible lifetime losses, as of June 2013, the Irish headquartered banks covered by the initial FMP Report had reported approximately €54.3 billion in loan impairments relative to a combined gross loan book of €214.1 billion.[86] Reflecting these impairments and in recognition of these expected losses, loan loss provisions amounting to approximately €28.2 billion (or 52 per cent of the value of impaired loans) have been set aside by the banks in order to cover any losses incurred over and above the recoverable value of assets underlying these loans. Under the FMP exercise, the post-deleveraging lifetime loan losses were projected at €27.5 billion in the base case scenario and €40.1 billion under the adverse scenario. For the adverse scenario to have materialised, compared to present levels, a considerable rise in loan impairments and/or a very low recovery rate would be required. For instance, other things being equal, nearly three-quarters of impairments occurring to date would have to materialise as actual lifetime losses.[87]

Table 2.7 provides an update of the performance of the banks to June 2013 using the half yearly financial statements of each of the three Irish-headquartered banks. These estimates suggest that as a result of the recent accumulation of impairment charges, actual losses realised to date have moved closer to (albeit remaining somewhat below) those of the three-year stress scenario set out in the FMP. However, while impairments now stand at close to 26 per cent of total gross loans in the three main banks, they appear to be rising at a slower pace, as of the first six months of 2013. It is worth noting that in the Central Bank review, new guidelines were cited as one factor that has

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[84] Available at: http://www.centralbank.ie/regulation/industry-sectors/credit-institutions/documents/pcar%202011%20review%20final.pdf

[85] Real GDP growth was expected to average 1.3 per cent per annum from 2010 to 2013 in the base case and 0.0 per cent in the stress case, compared to an actual outcome (using the most recent Central Bank forecast) of 0.5 per cent. On the other hand, the unemployment rate has been lower than envisaged.

[86] The banks covered in the original FMP now exist as PTSB, Bank of Ireland and AIB following the sale of Irish Life and the merger of EBS with AIB.

[87] For a similar analysis, see Seamus Coffey, 'Mortgages in the Covered Banks', 16th Sep 2013. Available at: http://economic-incentives.blogspot.ie/2013/09/mortgages-in-covered-banks.html

driven a more conservative recognition of loan losses compared to the original loan loss forecasts assumed.

Apart from expected loan losses, future bank operating profitability and regulatory criteria will all play a role in assessing the financial position of the banks. Thus, a clearer analysis of any possible new capital needs for Irish banks must await the comprehensive assessment referred to above. Given the risks inherent in the State's balance sheet as a result of previous capital injections to the banking sector, it is desirable that any new capital needs that might emerge are sourced from the private sector or the ESM if possible. However, given the importance of adequately capitalised banks to a well-functioning credit system — which may require a continuing cushion relative to whatever are the minima set by the European-wide regulatory authorities — further injections might prove unavoidable.

TABLE 2.7: UPDATE OF IRISH-HEADQUARTERED BANK PERFORMANCE RELATIVE TO PROJECTED LOSSES IN THE FMP (€ BILLION)

	Losses 2011-2013		Actual losses to June 2012	Losses from June 2012 to June 2013	Actual Losses to June 2013	% FMP Scenarios	
	Base	Stress	(PCAR 2011 Review)	(IFAC Update)	(IFAC Update)	Base	Stress
BOI	7.4	10.1	5.8	1.3	7.1	96.0	70.3
AIB	10.5	14.2	12.2	2.0	14.2	135.3	100.1
PTSB	2.1	3.4	2.8	0.9	3.7	175.4	108.4
Total	**20.0**	**27.7**	**20.8**	**4.2**	**25.0**	**125.0**	**90.2**

Source: Bank financial reports, Central Bank of Ireland PCAR 2011 Review and internal calculations.
Note: Based on starting stock of provisions and income statement impairment charges as reported in PCAR 2011 Review updated using banks' income statement impairment charges to June 2013. Rounding may affect the totals. As in the PCAR 2011 Review, the above updated estimates for June 2012 to June 2013 exclude impairments on land/development loans.

INTEREST RATE SHOCKS

The Government faces significant funding requirements over the medium-term. This reflects a combination of future fiscal deficits and ongoing debt redemptions. According to *Budget 2014* projections, the Government will need to raise approximately €12 billion per annum to 2016. In addition, approximately 20 per cent of the stock of Government debt is at variable rates.[88] Both the stock of "variable debt" and financing requirements are susceptible to changes in the interest rate.

The Fiscal Feedbacks model can be used to trace out the effect of different interest rates on the main fiscal aggregates. The *Budget 2014* average interest rate outlook is modified to allow for a +/- 150 basis point change in nominal interest rates from 2014 to 2016.

In the event that interest rates rise by 150 basis points, the average interest rate (the ratio of interest payments to the stock of Government debt) would rise, but by proportionately less (Figure 2.6). This reflects the large proportion of existing debt held at fixed rates. The sources behind the movement in interest rates (including movements in the inflation rate) are not factored into the analysis that follows.

With a 150 basis point increase in rates, the deficit increases by about 0.5 percentage points of GDP over the projection period in the absence of offsetting adjustments (Table 2.8). The impact on the General Government debt ratio is relatively modest in the short-term, with debt rising by about 1.4 percentage point by 2016.[89] The results are broadly symmetrical for a decline in rates.

TABLE 2.8: INTEREST RATE SHOCKS[90]

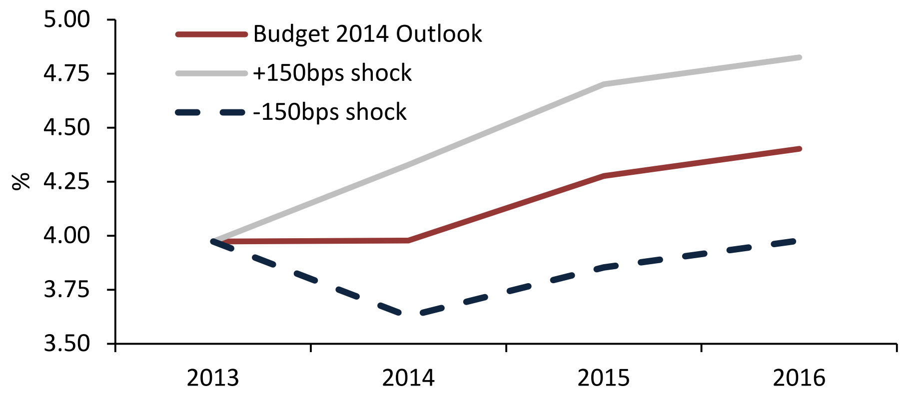
% of GDP	2014	2015	2016
Baseline			
General Government Debt	119.9	118.3	114.5
General Government Balance	-4.8	-2.9	-2.4
Average Interest Rate	4.0	4.2	4.4
+150 Basis Points			
General Government Debt	120.3	119.3	115.9
General Government Balance	-5.2	-3.5	-2.9
Average Interest Rate	4.3	4.7	4.8
-150 Basis Points			
General Government Debt	119.5	117.4	113.1
General Government Balance	-4.4	-2.4	-1.9
Average Interest Rate	3.6	3.9	4.0

[88] This is primarily accounted for by the €25 billon in new floating rate bonds that replaced the promissory notes in February 2013.

[89] While the effects on the debt ratio are likely to be modest (relative to the stock of debt) out to 2016, the impact would compound over time.

[90] Numbers are rounded to one decimal place. The figures relate to the underlying General Government Balance.

FIGURE 2.6: AVERAGE INTEREST RATE



The scenarios above do not consider the underlying reasons behind interest rate changes. Rates can move through changes to the risk premium and/or through changes to the risk-free rate. These are likely to be important. At present, Euro Area interest rates are at historically low levels. Whether the ECB moves to raise interest rates depends on inflationary prospects across the Euro Area. The prospect of higher rates in the context of stronger growth throughout the Euro Area would be a more favourable scenario than a case where growth remains weak in Ireland.[91] The domestic economy is also likely to have become more susceptible to changes in the interest rate since the beginning of the financial crisis due to the increase in private sector indebtedness (ESRI, 2013).[92]

Given the risks of rising “risk free” rates internationally owing to a possible reduction in monetary easing, a rise in marginal and variable financing costs for the Irish Government could also reduce any buffers the State has when seeking to reach deficit targets. Further, any deterioration in the perceived creditworthiness of the Irish Government is also likely to lead to higher rates through the risk premium channel.

[91] The scenarios do not distinguish between increases in real and nominal interest rates.

[92] ESRI Medium-term Review: 2013-2020, ESRI (2013).

Other Sources of Risk

There exist a number of other sources of macroeconomic or fiscal risk. It is not possible to assign any degree of probability to their occurrence or to assess their potential quantitative impact. One such unknown relates to a possible exit at some stage by the UK from the EU ("a Brexit").[93]

Another medium-term risk relates to the outlook for Ireland's corporate tax rate. The relatively low statutory tax rate, as well as the transparency and predictability of the regime, have been important factors underlying the growth of the multinational sector which plays a key role in macroeconomic and fiscal performance. Over 1,000 international companies have located in Ireland with estimated employment (direct and indirect) of over 285,000 persons. Total direct employment by US multinationals alone was estimated at over 100,000 in 2009-2010, while their direct fiscal contribution in terms of corporate tax and PAYE is of the order of €2.5 billion to €3.0 billion.[94]

In recent years, attention has focused on a number of occasions on the Irish corporate tax regime. Concerns have been raised by some EU partners as regards the low statutory rate (which remains the sole prerogative of national Governments to decide). There are also proposals to introduce a new (voluntary) EU-wide system for calculating the base for corporate taxation (the so called Common Consolidated Corporate Tax Base (CCCTB) approach) which could impact upon the effective tax rate payable by enterprises. Most recently, based on analysis undertaken by the OECD, the G-7 and G-20 have raised the issue of "base erosion and profit shifting" (BEPS). These are arrangements whereby multinational corporations can avail of various features of national tax systems to ensure that substantial parts of their overseas profits are not taxable. In this regard, in

[93] UK Prime Minister Cameron has announced a decision to hold a referendum on a possible UK exit in 2017, assuming his party is returned to power in the intervening general election. A Brexit could have considerable implications for the Irish economy, especially if it entailed restrictions on the free movement of goods, services and labour between the UK and the EU. Ireland's financial services industry could also be impacted if the regulatory and supervisory regimes were to diverge significantly.

[94] Comprehensive and timely data on the macroeconomic and fiscal impact of the multinational sector in Ireland are not readily available. However, Walsh (2010) as well as US Bureau of Economic Analysis data provide some broad indications, especially in the case of US multinationals. During 2009-2010 the value added of US companies is estimated to have averaged around €45 billion, or about one-fifth of Irish GDP. Within the Irish manufacturing sector, value added by the pharmaceutical and computer, electronics and optical sectors (both heavily dominated by multinationals, both from the US and elsewhere) averaged over €16 billion. In addition to the direct (and indirect) employment impact, US multinationals contributed €1.7 billion in corporation tax in 2009 (the latest year for which data are available) and an estimated €700 million in PAYE taxes in 2011.

May 2013, the structures used by overseas subsidiaries of Apple Corporation based in Ireland became the subject of particular US public attention.[95]

Concerns on these issues stem from several interrelated considerations, including: the fiscal pressures currently facing many industrial countries; perceptions of "equity and fairness"; fears of a "race to the bottom" among national tax regimes; and potential misallocation of resources arising from the favouring of activities with low pre-tax but high after-tax rates of return.

It is not possible to assess whether or when initiatives currently under discussion might lead to significant changes in corporate tax regimes, at either the international or individual country level. However, given the importance of the multinational sector in Ireland's medium-term growth strategy, it would be desirable to undertake an assessment of the risks were the corporate tax regime, for whatever reason, to be subject to gradual modification over time.

In a document accompanying *Budget 2014* entitled "Ireland's International Tax Strategy", the Department of Finance announced the Government's intention to include in the Finance Bill a change to Irish company residency rules aimed at eliminating the use of mismatches to allow companies to be "stateless" in terms of their place of tax residence. Such a move would address issues raised in connection with the Apple controversy referred to above, and would alleviate an important potential reputational risk for Ireland.

[95] See for example OECD (2013). "Action Plan on Base Erosion and Profit Sharing"; Senator Carl Levin (2013) "Offshore Profit Shifting and the US Tax Code ,Part II (Apple Inc)", May 21; and IMF (2013), Fiscal Monitor.