Irish Fiscal Advisory Council

Fiscal Assessment Report

November 2013

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FOREWORD

The Irish Fiscal Advisory Council was established as part of a wider agenda of reform of Ireland's budgetary architecture as envisaged in the Programme for Government 2011. The Council was initially set up on an administrative basis in July 2011, and was formally established as a statutory body in December 2012 under the *Fiscal Responsibility Act (FRA)*. The Council is a public body funded from the Central Fund. The terms of its funding are set out in the *FRA*.

The mandate of the Irish Fiscal Advisory Council is:

- To endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- To assess the official forecasts produced by the Department of Finance;
- To assess Government compliance with the budgetary rule as set out in the *FRA*;
- To assess whether the fiscal stance of the Government in each Budget and Stability Programme Update is conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact.

The Council submits its *Fiscal Assessment Reports* to the Minister for Finance and within 10 days releases them publicly.

The Council is chaired by Professor John McHale, National University of Ireland, Galway. Other Council members are Mr Sebastian Barnes, Organisation for Economic Co-operation and Development; Professor Alan Barrett, Economic and Social Research Institute; Dr Donal Donovan, University of Limerick (formerly International Monetary Fund staff) and Dr Róisín O'Sullivan, Associate Professor, Smith College, Massachusetts.

The Council would like to acknowledge the help of Yvonne McCarthy, Loretta O'Sullivan and Dwayne Price (Central Bank of Ireland) as well as Deirdre Whitaker.

Finally, the Council would like to thank the Council Secretariat - Diarmaid Smyth (Chief Economist and Head of Secretariat), John Howlin and Rachel Joyce - for their extensive contributions to the report.

This report was finalised on 19 November 2013. More information on the Irish Fiscal Advisory Council can be found at www.fiscalcouncil.ie

SUMMARY ASSESSMENT

Further progress is being made in repairing the public finances, but changes to planned budgetary adjustments have removed the margin of safety.

Good progress continues to be made in bringing sustainability to the public finances and restoring the borrowing capacity of the State. The General Government debt-to-GDP ratio is projected to peak this year at 124.1 per cent before declining by approximately 10 percentage points over the period to 2016. Overall, the Government's planned fiscal stance is assessed to be conducive to "prudent economic and budgetary management".

However, 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 suggests 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 planned adjustments for *Budget 2015*.

There should be no reduction in the Government's previously announced adjustments of €2 billion for 2015.

The Council has endorsed the macroeconomic projections underlying Budget 2014.

Under new EU requirements, the Council has been tasked with independently scrutinising and endorsing the macroeconomic projections underpinning Budgets and Stability Programme Updates. This is a significant change in Ireland's budgetary architecture and should help to improve the accuracy and transparency of official macroeconomic forecasts. The Council has developed its own forecasting methods and analytical capacity to support this function. The approach to the endorsement exercise is described in detail in this report.

The Council's endorsement is based on whether the forecasts are within an endorseable range of appropriate forecasts, taking into account the methodology and the plausibility of the judgements involved. This range reflects, in part, the uncertainty surrounding any growth forecast.

As part of the endorsement exercise, the Council expressed a significant reservation about one element of the macroeconomic forecasts prepared for *Budget 2014*. This reservation related to the implied quarterly profile for consumption spending. However, following clarifications by the

Department of Finance on the assumptions relating to data revisions, the Council assessed that the forecasts were within its endorseable range.

But risks are tilted to the downside.

The Department of Finance is projecting real GDP growth of 0.2 per cent in 2013, rising to 2 per cent in 2014. Growth this year is being depressed by a number of factors. These include a background of ongoing balance sheet repair, budgetary consolidation and weak demand in Ireland's main trading partners. The pharmaceuticals "patent cliff" is also reducing the growth of net exports. Uncertainties relating to these elements mean that risks to the forecasts are tilted to the downside for 2014.

Budget projections are assessed to be appropriate.

The budgetary projections in *Budget 2014* are assessed to be appropriate, but are contingent on the delivery of significant expenditure savings and achieving the projected acceleration in economic growth. Additional risks stem from contingent liabilities associated mainly with the banking sector.

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 clearly the impacts of consolidation measures.

And budgetary projections are consistent with compliance with all national and European fiscal rules.

Budget 2014 projections imply compliance with the national Budgetary Rule in 2013 and in each forecast year out to 2016. This is because the Adjustment Path Condition for the structural balance to converge towards Ireland's Medium-Term Budgetary Objective (MTO) is met.

The Council would have supported an application for a precautionary credit line.

Given a fragile international financial environment, the Council would have supported an application for a precautionary credit line. Provided it had come with reasonable terms and conditions, such a facility would have provided valuable additional protection against any renewed funding pressures as Ireland exits the EU/IMF assistance programme.

1. ENDORSEMENT AND ASSESSMENT OF MACROECONOMIC FORECASTS

SUMMARY

- Under the so-called "Two Pack" of EU regulations, the Council has been assigned as the independent body required to endorse the macroeconomic projections underpinning Budgets and Stability Programme Updates. The obligation for the Department of Finance to submit its forecasts to external scrutiny and approval is a significant change in Ireland's budgetary architecture. This should help to improve the accuracy and transparency of official macroeconomic forecasts.

- The Council has developed its own forecasting methods and analytical capacity in order to provide a benchmark set of projections against which to judge the Department of Finance's forecasts.

- The Council endorsed the macroeconomic forecasts underlying *Budget 2014* based on a provisional final set of projections provided by the Department of Finance in advance of the Budget. The Council was satisfied that these forecasts were within its endorseable range, taking into account the methodology and the plausibility of the judgements made.

- As part of the endorsement exercise, the Council expressed a significant reservation relating to the quarterly profile for personal consumption expenditure given the Central Statistics Office's (CSO) estimates for the first half of 2013. This was resolved following clarifications by the Department of Finance regarding their assumptions relating to possible data revisions.

- The macroeconomic forecasts in *Budget 2014* assume GDP growth of 0.2 per cent in 2013, accelerating to 2 per cent in 2014, supported by stronger domestic demand and net exports.

- The growth outturn for 2013 is likely to be depressed by a number of specific factors. These include a background of on-going balance sheet repair, budgetary consolidation and anaemic demand in some of Ireland's main trading partners. The pharmaceuticals "patent cliff" is also likely to have a dampening effect on export growth over several years. These headwinds are expected to ease gradually, enabling net exports and domestic demand to pick up into 2014.

- There are considerable risks around the *Budget 2014* growth forecast. The Council agrees with the assessment in the Budget documentation that while there are risks on both sides of the forecast, they "appear to be tilted to the downside".

1.1 Introduction

The Council was given an additional mandate in July 2013 to endorse the macroeconomic projections in future Budgets and Stability Programme Updates. This marks a significant change in Ireland's budgetary architecture. For the Council, it creates an important new responsibility. Section 1.2 provides the background to the endorsement function. Section 1.3 sets out the Council's general approach to endorsement in terms of a framework and the methodologies used to support the endorsement exercise. Section 1.4 summarises some of the key elements of how this approach was applied to the endorsement of the *Budget 2014* projections.

The Council's mandate to assess the official macroeconomic projections remains in place, alongside the endorsement function. Section 1.5 provides the Council's overview of economic developments and an assessment of the forecasts contained in *Budget 2014*. Finally, Section 1.6 concludes with an assessment of the uncertainty surrounding the economic outlook.

1.2 The Basis for the Endorsement Function

In 2011, the Council was established as an independent body to "assess" the Government's macroeconomic projections, both on a backward- and forward-looking basis. However, there was no obligation for the Government to take the Council's assessments into account.[1] These assessments were qualitative in nature and the Council did not comment on the forecasts ahead of any budgetary decisions or relevant EU discussions.

In July 2013, the Council was given a new endorsement function fulfilling requirements under the so-called "Two Pack" of EU regulations, now enshrined in Irish law (see Chapter 3). The operational elements associated with this function are set out in a Memorandum of Understanding (MoU) signed between the Department of Finance and the Council (Box A).[2]

[1] The Government has responded to the Council's previous *Fiscal Assessment Reports* in its official publications.

[2] The MoU is available at: http://www.fiscalcouncil.ie

BOX A: THE ENDORSEMENT FUNCTION AND THE MEMORANDUM OF UNDERSTANDING

The Council's endorsement function has its origins in the "Two Pack" of new EU fiscal regulations that came into force on 30 May 2013.[3]

One element of the "Two Pack" — which deals largely with procedures to strengthen fiscal governance in the Euro Area and to reduce fiscal and financial risks — is the requirement that the macroeconomic forecasts underpinning Budgets and Stability Programme Updates must either be made independently or endorsed by independent bodies.

In Ireland, the Government decided that the "endorsement" approach would be adopted. The Department of Finance remains responsible for the forecasts, with the Council tasked as the independent body which would undertake the endorsement function. Following discussions, a joint Memorandum of Understanding (MoU) was signed by the Council and the Department of Finance.

Formally, the endorsement function has been implemented through an amendment to the *Fiscal Responsibility Act 2012* that provides a new element to the Council's mandate, to "...endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme will be based".[4] For the purposes of the Budget, the forecasts do not include the impact of final decisions on discretionary tax and expenditure measures.

The MoU between the Council and the Department of Finance governs the operational aspects of the endorsement function. It sets out the background to the endorsement exercise and provides details on the coverage of the macroeconomic projections endorsed, the information requirements and the approach to be followed. The timing and arrangements around the endorsement process are also dealt with in the MoU.

The MoU is in line with guidelines on how to implement the "Two Pack", including the requirement to put in place arrangements to govern the implementation process (EC, 2013b). These include:

- The Council will communicate regularly about its approach to the endorsement function, including the analysis underpinning its assessments.
- The Council will make clear whether or not it endorses the forecasts. In the event that the Council were to conclude that it had significant reservations when presented with the preliminary forecasts in advance of the Budget or the Stability Programme, this would be communicated to the Department of Finance. Further discussions could then take place to produce a revised forecast addressing the concerns that the Council raised. If at the end of the process the Council was not in a position to endorse the macroeconomic forecasts, the absence of an endorsement and underlying reasons for it would be set out by the Council.

[3] Formally, (1) EU Regulation No 473/2013 on common provisions for monitoring and assessing draft budget plans and ensuring the correction of excessive deficit of the Member States in the Euro Area, and (2) Regulation No 472/2013 on the strengthening of economic and budgetary surveillance of Members States in the Euro Area experiencing or threatened with serious difficulties with respect to their financial stability.

[4] The *Ministers and Secretaries (Amendment) Act 2013* amends the *Fiscal Responsibility Act* (2012) to include a macroeconomic forecast endorsement function.

The obligation for the Department of Finance to submit its forecasts in advance to external scrutiny and endorsement is a significant change in Ireland's budgetary architecture. Until recent years, there was no direct review of official forecasts produced by the Department of Finance and the new function is a significant extension of the Council's role.[5]

The aim of the endorsement function is to help to ensure that forecasts are both unbiased and as accurate as possible. In particular, many countries have suffered from "optimism bias" in official forecasts, where the political system creates incentives to make over-optimistic growth forecasts that imply strong revenue growth so as to appear to ease fiscal constraints. In the case of Ireland, it is not clear that there has been such a bias although there have been periods marked by large and persistent forecast errors (see for example, IFAC, 2012b, 2013a). Outside scrutiny of the Department of Finance's macroeconomic projections could help to improve forecast performance.[6]

1.3 The Council's Approach to Endorsement

The Council is required to "…endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance…". The MoU further specifies that it should:

> …consider the appropriateness of the forecasts (as most likely projections), taking into account the suitability of the underlying forecast methodology and the plausibility of the judgements embedded in the projections.

This section sets out the framework and underlying methodologies used by the Council to inform its endorsement.

1.3.1 The Council's Endorsement Framework

The Council's approach to endorsement focuses on whether the macroeconomic forecasts are within a range of appropriate forecasts. The range, referred to as the "endorsable range" is informed by benchmark projections prepared by the Council's Secretariat (see below). The concept of a range reflects the high degree of underlying uncertainty surrounding economic forecasting,

[5] There were occasional assessments of the Department of Finance's forecasting performance but these were not systematic. For example, see the 2010 report *Strengthening the Capacity of the Department of Finance*, available from: http://www.finance.gov.ie/documents/publications/reports/2011/deptreview.pdf

[6] As well as the Council's endorsement function, at a European level, macroeconomic surveillance has been tightened as a result of reforms to the *Stability and Growth Pact*.

including the possibility of data revisions.[7] The point forecasts contained within each Budget (and Stability Programme) remain the responsibility of the Department of Finance and it would be inappropriate for the Council to undertake the role of forecaster by insisting on specific forecast numbers.

The endorseable range is informed by the Council's work on gauging the historical level of macroeconomic uncertainty. This is reflected in fan chart analysis undertaken by the Council based on the size of past forecast errors.[8] It is recognised, however, that the pattern of previous forecast errors may not necessarily be a reliable guide to current (and future) uncertainties.

The Council does not see the determination of the range as a mechanical exercise. It is anticipated that its size will be meaningfully informed by judgements about the acceptability of different ranges of uncertainty. The size of the endorseable range will vary across time and for different variables depending on economic conditions, making a fixed numerical range inappropriate. Moreover, by not specifying an explicit range, the potential for the range to influence the setting of Department of Finance forecasts is avoided.[9]

The Council is required to assess whether the forecasts are appropriate as "most likely" projections. As explained in Box B, this makes clear what assumptions about risk are embodied in the forecast and could determine whether a specific forecast number is within the endorseable range.

[7] See MoU "…The Council recognises the inherent uncertainty surrounding forecasts and that appropriate forecasts may lie within a range…"; "While point estimates of macroeconomic variables are required as forecast outputs, both parties note that output volatility and the magnitude of revisions to Irish economic aggregates can be large."

[8] See, Annex A: Fan Charts to Represent Forecast Uncertainty, pp. 71-73, in IFAC, 2012b.

[9] If the range was known, the Department of Finance might have an incentive to try to anticipate the Council's benchmark projection and endorseable range and set its forecasts accordingly. While there is no reason to believe that this would happen in practice, the possibility may warrant some caution in indicating any specific range.

BOX B: FORECASTS ON A "MOST LIKELY" BASIS – THE MEANING OF THE BUDGET PROJECTIONS

The MoU requires the Council to assess the appropriateness of Department of Finance forecasts "…. as most likely projections". This makes explicit — for the first time — the basis of the Department of Finance's macroeconomic forecasts and provides useful information about how to interpret and evaluate the forecasts.

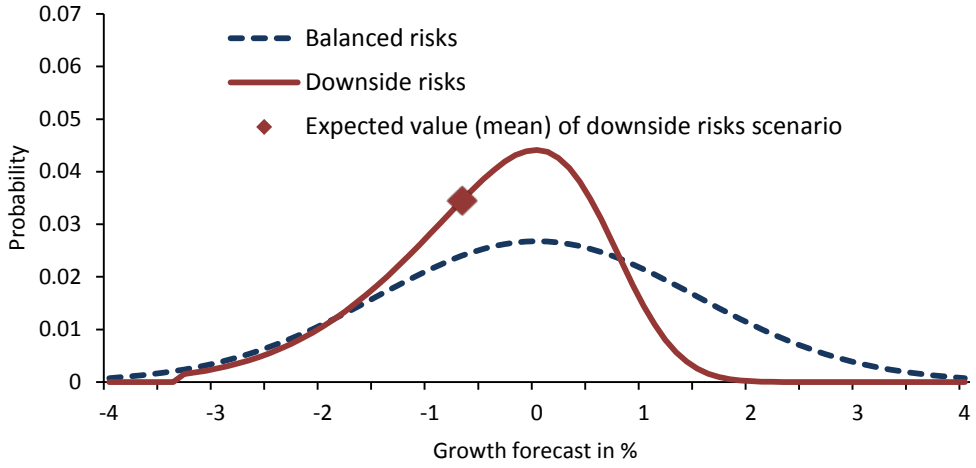
Given the volatility of the economy and the effect of unforeseen shocks, economic forecasts are inherently uncertain. A complete forecast would, therefore, give a range of outcomes with their corresponding probabilities. This could be expressed as a probability distribution, as the Council regularly shows through fan charts. However, projections are typically made and reported as a single figure. This requires a choice of a number to summarise the central tendency of the forecast distribution.

"Most likely" (modal) projections refer to the outcome with the highest probability of occurring, irrespective of where this is on the probability distribution. By contrast, a common alternative assumption is to make an expected-value forecast, i.e., the average of each possible outcome weighted by its probability. In many cases, including previous Department of Finance projections, the basis of the forecasts is not explicit.

Most-likely and expected-value forecasts can be identical or similar in many cases, for example, if the distribution of outcomes follows a Normal distribution.

However, there may be substantial differences if the distribution of risks is skewed. For example, Figure B1 shows the probability distribution for two different forecasts. The most likely outcome in both cases is zero growth. With balanced risks around the forecast (blue line), the expected-value forecast is also for zero growth. By contrast, for a forecast with risks tilted on the downside (red line), the expected-value forecast is -0.7 per cent.

FIGURE B1: COMPARISON OF A BALANCED AND SKEWED FORECAST DISTRIBUTION



Note: Both forecast distributions have a mode of zero and a standard error of 1.5, which is equivalent to the one-year ahead forecast uncertainty in the Council's fan charts.

Are most-likely forecasts "conservative"? This depends on the distribution of risks. If downside risks predominate, the most-likely forecast is not conservative because it effectively places no weight on low probability, high impact events. By contrast, if risks are on the upside, the most-likely forecast — which will be lower than the expected-value — could be viewed as a conservative approach.

The Stability and Growth Pact requires Stability Programmes to be based "...on the most likely macro-fiscal scenario or on a more prudent scenario". The "most likely" forecasting approach embodied in the MoU effectively rules out making forecasts that are deliberately more prudent than the modal forecast.

However, from the viewpoint of setting policy, it is important to know the balance of risks, as well as the most likely forecast as these could affect the policy stance. For example, the Budget documentation includes an explicit statement of economic risks. When downside risks predominate, policymakers might want to build buffers in the public finances through policy decisions to protect against bad outcomes.

The Council's endorsement of *Budget 2014* covers the set of macroeconomic projections for 2013 and 2014, including GDP but also a range of components and other variables. Focusing on a set of variables is justified because the budgetary projections depend both on GDP and a range of other components, such as consumption for VAT or household incomes for income tax. Furthermore, a soundly-based forecast needs to be internally consistent in terms of the projections for different items, given the accounting relationships and economic links between different variables. The relevant set of forecasts includes the main expenditure components of GDP, the balance of payments, incomes, the labour market and prices.[10] The Council pays particular attention to those variables that have the greatest impact on the public finances.

In addition to the quantitative aspects of the forecast, the Council's approach to endorsement takes account of other elements, including the methodology used and the soundness of judgements involved.[11]

As set out in the MoU, the "provisional final" forecasts provided to the Council for endorsement do not include the impact of specific discretionary tax and expenditure measures included in the

[10] The MoU specifies "The set of key variables taken into account in the endorsement will cover those published in the Budget and the Stability Programme and will include, inter alia: (i) real and nominal aggregate GDP and GNP changes; (ii) changes in major expenditure components (nominal and real), namely, personal consumption of goods and services, gross domestic fixed capital formation, net expenditure by central and local Government on current goods and services, exports of goods and services, and imports of goods and services; (iii) the current account of the balance of payments; (iv) factor income and average wage compensation, employment and unemployment; and (v) HICP inflation and the GDP deflator".

[11] See IFAC, 2013a, Section 1.5.

Budget. Moreover, they may be based on an aggregate adjustment amount that differs from the final amount of adjustment depending on the timing of information availability. This created (in the case of *Budget 2014*) a difference between the forecasts underlying the Budget, which were based on an adjustment package of €2.5 billion and the forecasts endorsed by the Council based on a total package of €3.1 billion. In general, the differences between these forecasts should be small in the absence of significant policy changes at the time final budgetary decisions are taken.

1.3.2 Endorsement Methodology

The Council's endorseable range is informed by benchmark projections prepared by the Council's Secretariat (these are shown in Annex A). This involves a full-scale forecasting exercise and the development of a range of forecasting tools.[12] Technical analysis is complemented by the use of judgement in interpreting and adjusting the output from statistical models.

This forecasting exercise and set of benchmark projections help the Council to analyse relevant economic developments, to develop an understanding of key underlying economic trends, and to gain further insight into what forecasts could be considered as appropriate and endorseable. The benchmark projections draw heavily on the work of the Council's Secretariat and do not necessarily represent a collective forecast by the Council.

To ensure that the Council is able to provide an independent analysis of, and to effectively challenge the Department of Finance forecasts, the benchmark projections are completed *before* the Council engages in in-depth endorsement meetings with the Department of Finance.

The Council's benchmark projections may differ from the forecasts produced by the Department of Finance. However, the forecasts could still be endorseable either because (i) the differences are sufficiently small to be within the endorseable range, or (ii) if the Department of Finance provides convincing reasons for forecasts further from the benchmark projections. These reasons could include incorporating data or information that the Council did not have when making its benchmark projections, or a strong justification for different judgements to those embodied in the benchmark.

[12] This is consistent with the requirement of the MoU that "The Council will seek to develop and maintain the technical capacity and analytical expertise to evaluate in detail macroeconomic projections for Ireland. The Council will communicate regularly as to its approach to the endorsement function, including the analysis underpinning its assessments."

The basic framework underlying the benchmark projections is a system of equations mirroring the expenditure side of the national accounts with GDP and GNP derived using a "bottom up" approach from their components. In some cases, these components are in turn derived from forecasts of their sub-components. For example, investment is built up from investment in housing, other building and construction, and machinery and equipment. Demand components are linked to labour market variables, incomes and the output side of the economy. These linkages aim to achieve consistency across the various elements of the forecast.

Economic projections are conditional on a range of exogenous assumptions. These include interest rates, exchange rates, oil prices and growth rates outside of Ireland.[13] The assumptions used in the benchmark projections are broadly similar to those underlying *Budget 2014* and follow standard forecasting practices. For growth in Ireland's major trading partners (Euro Area, UK and US), the latest data were taken based on estimates from agencies such as the OECD, the IMF and the European Commission.

The benchmark projections are based around a "suite of models" approach. Given the uncertainty around the forecasts from any single model, it is prudent to look across a range of forecasts from different economic models to build up a more robust picture. It is generally accepted that the average across a range of forecast models outperforms and is more robust than relying on a single model (Bates and Granger, 1969; Stock and Watson, 1999). The Council will continue to develop this approach.

The models used include some based on the equations used by the Department of Finance and some developed by the Council's Secretariat. In some cases, Department of Finance models have been refined or adjusted. In contrast to some models that are estimated to maximise statistical fit over the historical sample, the Council's approach was to evaluate models by their forecasting performance. This is done by estimating equations up to some past date and then calculating the forecast errors if those estimates had been used to make forecasts. This approach more closely mirrors what forecasters have to do in real time.

[13] For exchange rates, oil prices and Euribor interest rates, the average of the ten days prior to the forecast exercise is calculated and then used as the value that applies over the remainder of the current quarter. For the remaining forecast horizon, Euribor and oil price assumptions are based on market forward rates. Demand in Ireland's major trading partners is also an exogenous assumption. This is calculated on the basis of trade shares over the period 1992 to 2012 which were fixed for the forecast horizon. Trade shares are then combined with the latest forecasts of import demand taken from various international sources in order to derive measures of external demand.

The benchmark projections rely heavily on quarterly CSO data, specifically from the *Quarterly National Accounts* and the *Quarterly National Household Survey*, both in the estimation of models and forecasting. Although quarterly data in Ireland are volatile and prone to revision, the volatility is part of the dynamics of the economy and should not be ignored. Furthermore, understanding the quarterly dynamics – within the constraints of the data – is necessary to make accurate predictions for annual National Accounts variables. The emphasis on quarterly data was a key input into the benchmark projections for 2013 (as well as carry-over effects into 2014 – see Box C).

This model-based analysis is then augmented with judgement to come to the final set of benchmark projections. This approach is in line with that taken by the major forecasting agencies in Ireland such as the Central Bank of Ireland, the Economic and Social Research Institute (ESRI) and the Department of Finance and internationally, by the IMF, OECD and European Commission.

The use of judgement is necessary for two reasons. Firstly, there are many factors affecting the economy in the short-term that are not described by macroeconomic models. For example, investment in Ireland is heavily influenced by aircraft purchases. The timing of these purchases reflects firm-specific developments in a small number of individual companies. These have to be taken into account outside of the normal macroeconomic framework. Secondly, macroeconomic models and the available data provide only a partial description of the economy that needs to be augmented by well-reasoned judgements to generate forecasts that may be more accurate. For example, the current balance sheet recession has many unprecedented features that cannot be captured using models based on historical data.

An important additional input into the preparation of the benchmark projections involved a round of discussions with other forecasters, coming from a wide range of different perspectives.[14] The purpose of these discussions was to get a range of views on issues forecasters were dealing with, both data-related as well as substantive economic matters.

[14] In September 2013, the Secretariat had discussions with forecasters at the Central Bank, the European Commission, the ESRI, the IMF, Davy, Goodbody, Investec, the Nevin Economic Research Institute and Mr Joe Durkan of University College Dublin. The Secretariat also met with the CSO to gain further insights into topical issues and to gain more information on the statistical treatment of a number of key variables.

1.4 Endorsement of the *Budget 2014* Projections

The first endorsement exercise by the Council covered the *Budget 2014* forecasts for 2013 and 2014 and was carried out under the terms of the MoU. The Department of Finance provided a good level of cooperation to the Council, including in responding to questions and requests for additional information.[15]

The timeline underlying the endorsement process is set out in Figure 1.1.

Figure 1.1: Timeline for the Endorsement of *Budget 2014* Projections

Date	
23-24 September	Benchmark projections were finalised in advance of receiving forecasts for *Budget 2014* from the Department of Finance.
24 September	The Council received the preliminary set of "provisional final" forecasts from the Department in line with requirements under the MoU.
25 September	These forecasts were presented by Department of Finance staff to the Council's Secretariat explaining the underlying reasoning and answering clarifying questions. Two Council members also participated in the meeting.
29 September	The Council met to discuss the Department of Finance forecasts.
30 September	Department of Finance staff met with the full Council and Secretariat to present and answer substantive questions on the "provisional final" forecasts. These forecasts were unchanged from those provided to the Council the previous week. The Council raised questions on a number of issues.
	Following the meeting, the Department provided further clarification on their forecast for consumption. The Council subsequently decided that a "significant reservation" (as per the MoU, section 5) remained over the consumption forecast.
1 October	As specified in the MoU, the Council Chair communicated its "significant reservation" to Department staff.
1-3 October	The Department provided further clarification on its consumption forecast and committed to including information on the potential for upward revisions to *Quarterly National Accounts* personal consumption data for the first half of 2013 in the Budget documentation.
4 October	The Chair of the Council issued a letter to the Department of Finance endorsing the set of macroeconomic forecasts for 2013 and 2014 in *Budget 2014*. This letter was published on 9 October.

[15] The Council's Secretariat also met with Departmental staff early in the summer to discuss the main equations and data used in their macroeconomic forecasts.

As described earlier, the framework and methodology for the process were developed over the summer. This work included the preparation of a set of benchmark projections that were finalised on 24 September, incorporating the *Quarterly National Accounts* release of 19 September but *before* receiving the preliminary set of forecasts specified in the MoU from the Department of Finance. These benchmark projections, which were not shared with Department of Finance staff, are set out in Annex A.

Following the receipt of the Department of Finance's preliminary forecasts and a presentation of these projections to the Council's Secretariat and some Council members, the Council met to consider the preliminary forecasts. The Council's examination of the forecasts included comparing them to the benchmark projections and against its sense of the endorseable range, as well as assessing the consistency of the overall set of projections. Subsequently, Department of Finance staff presented to the full Council and Secretariat the "provisional final" forecasts, which were unchanged from the preliminary forecasts presented the week before.[16] These forecasts had previously been shared with Ministers by Departmental staff. The Council questioned Departmental officials, based on issues identified by the Council in its earlier deliberations, and requested some additional information.

The overall forecasts for real GDP growth for 2013 and 2014 in the Department's "provisional final" forecasts were quite close to the benchmark projections. However, as is evident from Annexes A and B, the composition of growth differed. In particular, the benchmark projection for exports was much stronger, and that for consumption much weaker, compared with the Department's forecast.[17,18] Given the nature of short-term forecasting, some divergences were to be expected and the Council's endorsement methodology is designed with that in mind.

In the case of exports, the Council found explanations provided by Department of Finance staff for a weaker forecast to be plausible. These explanations included further information available to Department staff about how to include developments in the crucial pharmaceuticals sector (the so-

[16] These forecasts were subsequently presented to the Joint Oireachtas Committee on Finance, Public Expenditure and Reform on 8 October 2013.

[17] The benchmark projections include export growth of 0.6 per cent and 4.3 per cent respectively for 2013 and 2014 compared with -0.6 per cent and 1.9 per cent in the Department of Finance's forecasts.

[18] The benchmark projections include consumption growth of -0.4 per cent and 0.4 per cent respectively for 2013 and 2014 compared with -0.2 per cent and 1.1 per cent in the Department of Finance's forecasts.

called "patent cliff") in their export projections.[19] In light of these clarifications, the Council viewed the export growth forecasts as within an appropriate range.

The Council remained concerned, however, about the internal consistency of the provisional final forecasts for personal consumption expenditure. Taking the published CSO quarterly estimates of a decline in consumption in 2012Q4 and 2013Q1 and modest growth in 2013Q2 as given, the Department's projections for annual growth in 2013 appeared to imply implausibly high growth rates in the third and fourth quarters of the year. The quarterly profile implied by taking the CSO data as given looked problematic even in the context of a likely bounce back in consumption in the second half of 2013 as a result of some sector-specific factors (discussed in Section 1.5.1). The relationship between annual growth rates and quarterly growth profiles is explored in more detail in Box C.

BOX C: ANNUAL GDP GROWTH AND CARRYOVER EFFECTS

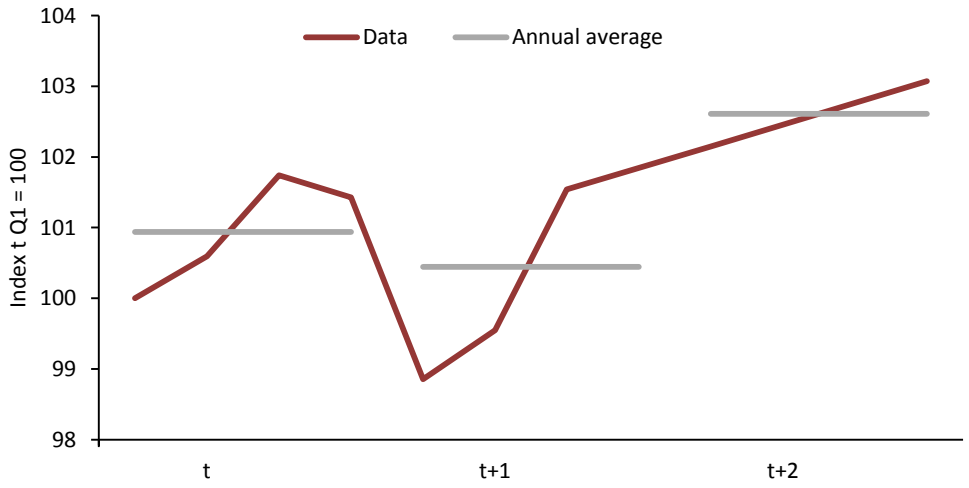
The Budget includes forecasts for annual GDP and other variables, both in terms of their level and the growth rate between calendar years. Department of Finance forecasts are made for these annual aggregates.

This is a standard approach. However, it can lead to growth projections that are unintuitive or appear misleading given the irregular (seasonally-adjusted) pattern of quarterly growth in the economy measured in the National Accounts. Furthermore, an annual growth rate covers developments over 8 quarters and can therefore give a rather backward-looking picture of growth around turning points. Therefore, care is needed in interpreting annual growth forecasts as these may not closely match the underlying pattern in the quarterly data.

Taking a hypothetical example, the (seasonally-adjusted) aggregate in Figure C1 has an irregular pattern of growth. However, the aggregate clearly reaches a trough at the beginning of year t+1 and expands continuously thereafter to reach a higher level by the end of t+1 than at the end of period t. However, the annual average level over the four quarters of year t+1 is actually *lower* than it was in period t and therefore the annual growth rate registers a *contraction* between t+1 and t, despite the recovery that is occurring during that year. This is an example of how annual growth rates may present a misleading picture of the underlying quarterly developments.

[19] Developments in the pharmaceuticals sector were already factored into the benchmark projections but in a different way.

FIGURE C1: AN ECONOMIC AGGREGATE WITH IRREGULAR DATA



At the same time, the increase in the level of the aggregate during the course of year t+1 means that, even if the aggregate were to stay at that level it reaches by the end of t+1 throughout t+2, there would be a strong annual growth rate registered in t+2 even with no actual growth during the course of that year. This is known as the "carryover" effect.

For the example above, these effects are shown in Table C1.This shows the negative growth measured on an annual growth basis in t+1 and the very strong growth in t+2, despite only modest assumed quarterly improvements during that year. The table also shows growth rates measured as the change between the fourth quarter of one year and the fourth quarter of the preceding year. This can give a clearer picture of how much the economy has grown during the course of the year.

TABLE C1: HYPOTHETICAL EXAMPLE OF GROWTH AND CARRYOVERS

% Change	t	t+1	t+2
Annual Growth	-0.3	-0.5	2.2
Of which carryover		0.5	1.4
Q4/Q4 Growth	0.8	0.4	1.2

An implication of carryover effects is that annual growth rates are very sensitive to growth rates in the early quarters of the year – varying one-for-one with growth in the first quarter (other things equal) – but depending much less on developments towards the end of the year (varying one-for-four with growth in the fourth quarter). However, the carryover for the following year is strongly affected by growth in the final quarters of the previous year.

It is important for forecasts to reflect these underlying developments in quarterly terms in the formulation of annual growth projections. Otherwise, there is a risk that annual growth rates that seem reasonable actually imply quarterly growth profiles that are implausible, suggesting that the annual growth forecasts are in fact unlikely. While a lot of the variation in early CSO estimates of the quarterly profile may be revised away, much of the volatility in expenditure from quarter-to-quarter is a real feature of a volatile economy such as Ireland's and needs to be taken into account for annual forecasts to be accurate.

The Council's "significant reservation" on this aspect was subsequently communicated to Department staff on an informal basis, as set out in the MoU. In response, Department officials agreed to explain, as part of the *Budget 2014* documentation, their rationale for the quarterly profile implied by their annual consumption forecasts, and in particular to reference the potential for upward revisions to consumption data for the first half of 2013. As a result, the *Budget 2014 Economic and Fiscal Outlook* included the following statement:

> The quarterly profile for personal consumption expenditure has been somewhat erratic over the course of this year, in part due to a structural change in the vehicle registration system which has had the effect of smoothing the purchase of vehicles over the course of the year. Initial estimates for consumer spending for the first quarter were subsequently revised upwards, and the possibility of further revisions cannot be excluded, particularly in an environment in which high-frequency data (core retail sales) point to a relatively strong pace of expansion in the third quarter.[20]

An upward revision in the CSO consumption data for the first half of 2013 – a by no means unlikely possibility given the normal volatility and frequency of revisions to such data – would reduce the implied growth needed in the second half of the year to meet the Department's forecast for consumption growth in 2013. On this basis, the Council concluded that its concerns had been adequately addressed and a letter endorsing the set of forecasts in *Budget 2014* was sent by the Chair of the Council to the Secretary General of the Department of Finance on 4 October 2013.

1.5 An Assessment of Forecasts Contained in *Budget 2014*

1.5.1 Macroeconomic Forecasts in *Budget 2014*

The "provisional final" macroeconomic forecasts underlying *Budget 2014* were endorsed by the Council (see Annex B). The macroeconomic outlook was, however, revised between the endorsement and the publication of *Budget 2014*, reflecting a lower level of consolidation in the Budget.[21] The Department is expecting real GDP growth of 0.2 per cent in 2013 and 2 per cent in 2014 (Table 1.1).

[20] *Budget 2014*, page C.6.

[21] The provisional final forecasts endorsed by the Council assumed €3.1 billion in consolidation measures for 2014. The actual consolidation was €2.5 billion.

TABLE 1.1: *BUDGET 2014* MACROECONOMIC FORECASTS

% change unless otherwise stated	2012	2013	2014	2015	2016
Real GDP	0.2	0.2	2.0	2.3	2.8
Real GNP	1.8	1.0	1.7	1.7	2.1
Consumption	-0.3	-0.2	1.8	1.2	1.1
Investment	-1.0	4.9	6.8	5.9	5.1
Government	-3.7	-0.9	-1.9	-1.5	0.2
Exports	1.6	-0.6	1.9	2.7	4.2
Imports	0.0	-0.4	1.5	2.1	3.5
Current Account (% of GDP)	4.4	4.4	4.0	3.8	3.7
Employment	-0.7	1.6	1.5	1.3	1.3
Unemployment Rate (%)	14.7	13.5	12.4	11.8	11.4
Inflation (HICP)	2.0	0.7	1.2	2.0	2.0
Nominal GDP (€ billions)	164.0	165.9	170.6	177.0	184.7

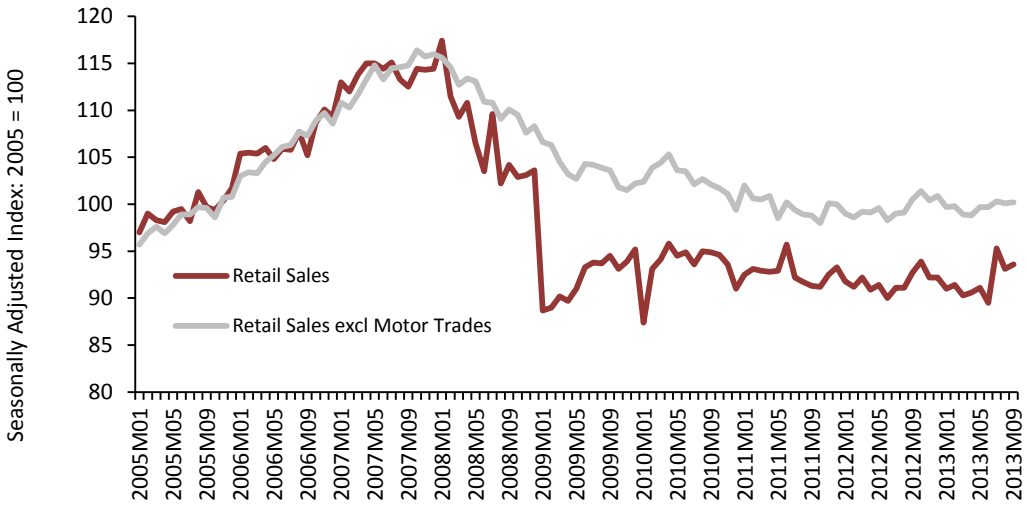
The growth outturn for 2013 is likely to be depressed by a number of specific factors, including the "patent cliff" in the pharmaceutical sector reducing exports, and one-off factors that reduced domestic demand in the first half of the year.[22] This comes against the background of on-going balance sheet repair and budgetary consolidation, as well as anaemic demand in some of Ireland's main trading partners. However, these headwinds are expected to ease gradually over the forecast horizon enabling a pick-up in net exports and domestic demand into 2014, boosted by the unwinding of some sector specific factors affecting 2013.

Personal consumption expenditure growth is expected to contract in 2013. This reflects a weak outturn for the first half of the year, in part due to changes in the car registration system that depressed sales. This impact should unwind in the second half of the year; more recent indicators,

[22] *Quarterly National Accounts* data for the first half of 2013 were weak with real GDP down 1.1 per cent year-on-year. The volume of exports of goods and services declined by 1.5 per cent in the first half of 2013 (twice the rate of decline of imports) with personal consumption expenditure down by 1.2 per cent over the same period.

such as the retail sales index (Figure 1.2) are consistent with a pick-up in consumption spending.[23] For 2014, positive consumption growth is envisaged helped in part by stronger real disposable incomes. While high levels of debt and fiscal consolidation will continue to weigh on consumption, the improved outlook for the labour market (and disposable incomes in turn) should encourage spending. The personal savings ratio is also expected to decline as confidence improves.

FIGURE 1.2: RETAIL SALES INDEX



Investment spending is expected to grow at a healthy rate in 2013 and to accelerate in 2014. Data for the first half of the year point to a strong underlying recovery in most components of investment, although very weak aircraft purchases kept overall growth subdued (Figure 1.3).[24, 25] Output in the construction sector appears to be strengthening, although overall housing and construction investment continues to be at very low levels and accounts for a much smaller share of investment than during the pre-crisis period. The positive trends in investment, including favourable indications on foreign direct investment inflows, suggest stronger growth in capital formation in 2014.

Government spending is expected to contract by 0.9 per cent in 2013 and by 1.9 per cent in 2014, partly reflecting the effect of current and past consolidation measures. The overall level of

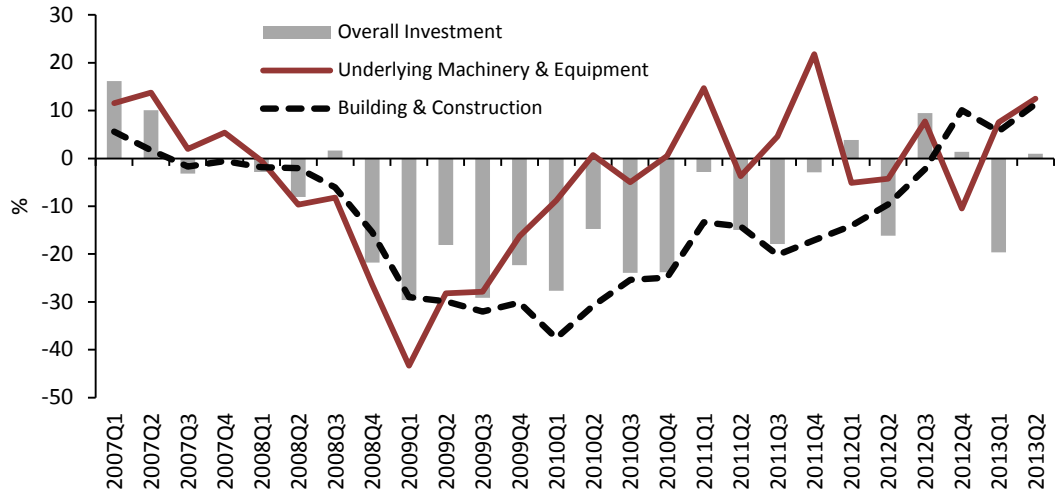
[23] Retail sales data to end-September show a 2.5 per cent annual rise in the volume of total retail sales in the third quarter of the year. Retail sales excluding motor trades were up 0.6 per cent over the same period.

[24] Excluding transport equipment, investment in volume terms was up 9.1 per cent in the first half of the year. Building and construction investment grew by 8.5 per cent with machinery and equipment (excluding transport) up 9.8 per cent.

[25] Company financial statements indicate that significant future aircraft purchases are planned and it is assumed that some deliveries will be taken in the second half of 2013.

consolidation in *Budget 2014* was reduced by €0.6 billion to €2.5 billion relative to plans prior to the Budget. This is expected to exert a small positive effect on GDP growth.[26]

FIGURE 1.3: ANNUAL CHANGES IN INVESTMENT



Note: Underlying Machinery & Equipment Investment excludes transport equipment.

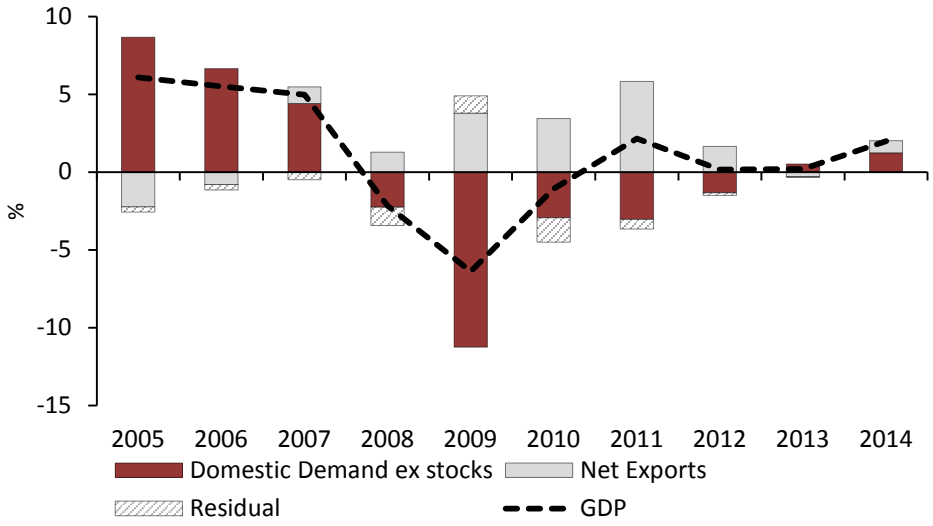
Exports of goods and services were very weak in the first half of the year in large part due to the effects of the "patent cliff". This is occurring as the patents on a number of key domestically produced pharmaceuticals products expire, leading to a reduction in the value of goods exports. Pharmaceutical exports account for around half of Irish manufactured goods exports. The precise speed and extent of the patent cliff effects are not fully known, although the Department of Finance has provided some detailed analysis.[27] These developments have made it more difficult to forecast exports and have contributed to a breakdown in the historic relationship between exports and their main determinants. As a consequence, goods exports are likely to be affected significantly over the next few years. In contrast, services exports (which now account for around half of total exports) are expected to remain robust. Over the forecast horizon, total exports should benefit from a strengthening in demand in Ireland's major trading partners, domestic competitiveness improvements and the resilience of the services sector.

[26] This can be seen from the fact that GDP growth in 2014 was revised up from 1.8 per cent to 2 per cent between the forecasts endorsed by the Council (which assumed consolidation of €3.1 billion) and *Budget 2014*.

[27] See Enright and Dalton (2013), *The Impact of the Patent Cliff on Pharma-Chem Output in Ireland,* available from: http://www.finance.gov.ie/viewdoc.asp?DocID=7850&CatID=45&StartDate=1+January+2013

Imports are projected to contract in 2013 before growing in 2014, reflecting the more positive outlook for exports and personal consumption. Overall, net exports are expected to contribute negatively to growth in 2013, before turning positive in 2014 (Figure 1.4).

FIGURE 1.4: CONTRIBUTIONS TO GROWTH[28]



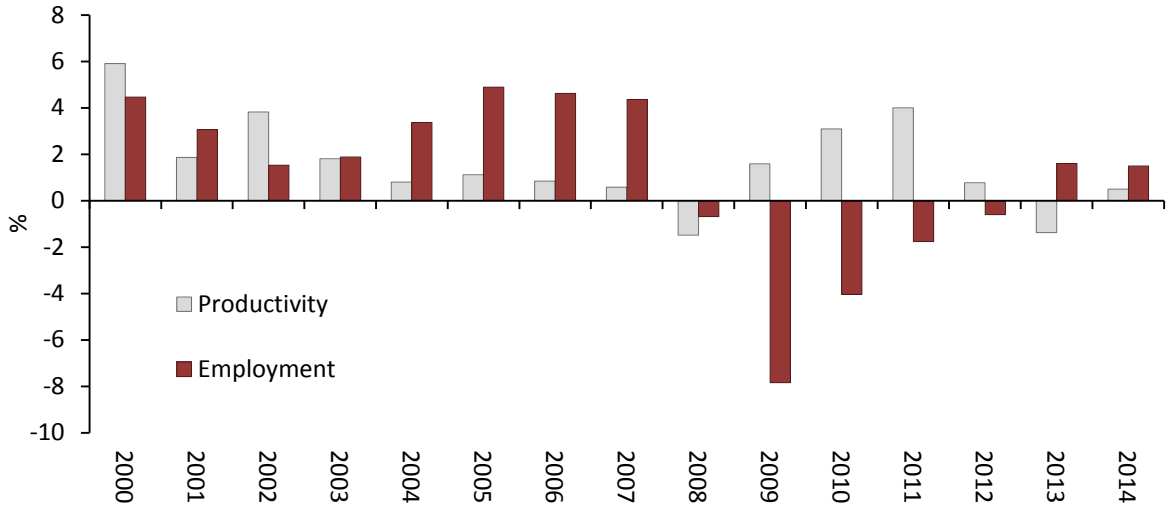
Labour market data have been positive over the past year, despite the relative weakness of GDP growth. Economy-wide employment grew by 1.5 per cent in the first half of the year according to the *Quarterly National Household Survey* (QNHS). Employment increased in 9 of the 14 sectors in the second quarter of 2013, relative to the previous year. More recent data from the live register show a continued decline in the unemployment rate.[29] The positive employment developments signal that firms are becoming more optimistic in terms of demand prospects. In contrast, data from the survey on *Earnings Hours and Employment Costs* (EHECS) paints a less positive picture with very weak earnings growth (although inflation remains subdued). This points to the need for caution in assessing employment prospects.

Taken together, the strength of employment relative to output growth implies an unusually large decline in measured productivity in 2013 (Figure 1.5). This may partly reflect the unusual decline in activity in pharmaceuticals, typically a high value-added sector with low employment.

[28] Forecast years based on the outlook in *Budget 2014*.

[29] In the three-month period to end-October, the number of persons on the register declined by 2.2 per cent quarter-on-quarter. In October, the standardised unemployment rate was 13.2 per cent (down from 14.3 per cent in October 2012).

FIGURE 1.5: ECONOMY-WIDE PRODUCTIIVTY AND EMPLOYMENT GROWTH



For 2015 and 2016, the forecasts in *Budget 2014* envisage average annual GDP growth of 2.6 per cent. These projections were not subject to endorsement by the Council. The forecasts essentially repeat the outlook presented in most two- to three-year ahead forecasts for the Irish economy. More favourable external demand conditions and a sustained improvement in domestic expenditure are the main underlying factors.

An assessment of Ireland's growth prospects must balance the recent positive signals of recovery – employment growth, stabilisation in retail sales, underlying investment growth – against continuing concerns about the persistence of the "balance-sheet recession" (Box D). The unpredictable dynamics of a balance-sheet recession means that there remain significant risks around current projections for the economy, as evidenced by a continued pattern of downward revisions to growth forecasts (see IFAC, 2012a, 2012b, and 2013a).

BOX D: THE DYNAMICS OF BALANCE SHEET RECESSIONS

This box reviews the underlying dynamics of Ireland's post-crisis balance sheet recession. This remains a significant downside risk to the current macroeconomic forecasts.

There are a number of adverse feedback loops that typify a post-crisis balance sheet recession (Figure D1).[30] Stressed balance sheets in the Government, financial and non-financial sectors tend to interact in ways that slow post-crisis growth. Starting with the Government sector, Ireland's gross debt as a share of GDP rose from about 25 per cent at the end of the boom to close to 125 per cent today. A significant proportion of this increase was due to the direct costs of covering losses of the banking system, with the remainder due to the sharp rise in the deficit as the economy contracted and property-related revenues collapsed. These debt and deficit developments – together with uncertainty about future prospects – led to a loss of the Government's market borrowing capacity, which in turn fed back to the banking system (through lost credibility of liability guarantees, the credibility of capital backstops, and direct losses on Government bonds) and also to the real economy (through the need for pro-cyclical retrenchment and heightened uncertainty).[31, 32] The two-way interaction between the Government and the banks is sometimes referred to as the "diabolic loop".[33]

A feature of a balance-sheet recession is that households and businesses attempt to repair their balance sheets by curtailing spending, reducing debt and selling assets (Koo, 2009). While these actions might be rational at the individual level, they can lead to a cascade of falling incomes and asset prices, worsening the incomes and balance sheets of other businesses and households in the economy. The forces of retrenchment are heightened by the effects of uncertainty in the face of the unpredictable dynamics of the recession, and also by the fact that important trading partners may be simultaneously suffering similar problems.[34]

Figure D2 shows the large rise in the gross saving rate during the crisis, although there are recent signs that the rate has fallen back.[35] Figure D3 shows the rapid build-up of household debt prior to the crisis. The nominal value of household debt has been substantially reduced in recent years, in part because many households remain credit constrained. However, debt has fallen only slightly relative to disposable income given the spillovers from household-

[30] Reinhart and Rogoff (2009) document the long history of weak growth performance following financial crises. IMF (2013) examines the adverse interactions between high levels of debt in the Government, financial and non-financial private sectors of the economy.

[31] See Zoli (2013) for an examination of the links between sovereign risk and the funding costs faced by Italian banks during the crisis.

[32] Jordà *et al.* (2013) examine how the adverse impacts of the credit-driven boom-bust cycle are conditioned by Government debt levels in the aftermath of a financial crisis.

[33] See, e.g., Brunnermeier *et al*. (2011).

[34] Inflation often helped to lower the real burden of household and business debt in past financial crises. Inflation in Ireland and across the Euro Area has remained extremely low, although persistent deflation has been avoided.

[35] CSO, Institutional Sector Accounts measure.

level balance-sheet repair to domestic demand.[36]

FIGURE D1: ADVERSE FEEDBACK LOOPS

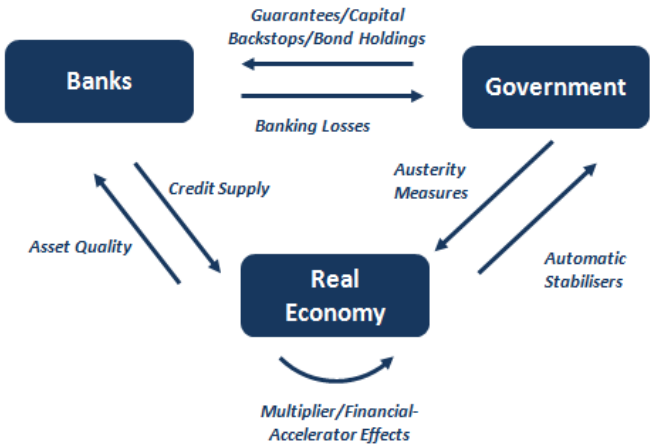
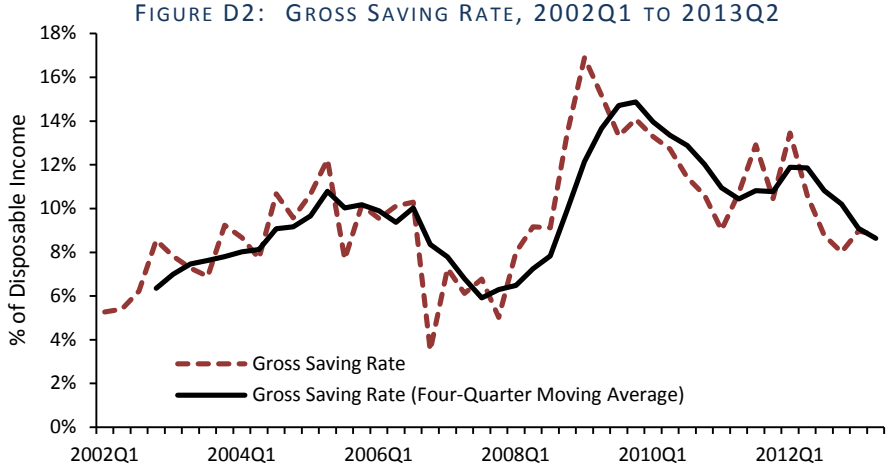


FIGURE D2: GROSS SAVING RATE, 2002Q1 TO 2013Q2



Source: CSO.

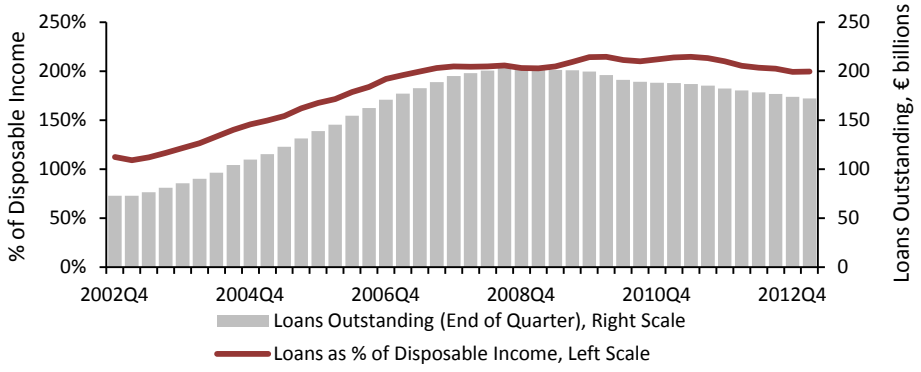
A central feature of Ireland's balance-sheet recession has been the impairment of balance sheets in the banking system. A two-way positive interaction between credit and property prices fuelled the initial price and construction bubbles. In the wake of the bursting of those bubbles, this interaction has worked in reverse. While the impairment of bank balance sheets is not the only contributor to weak credit growth – other factors are the impaired balance sheets of potential borrowers and weak credit demand – there is evidence that banks across the Euro Area have tightened lending standards and raised interest margins as they themselves attempt to deleverage and improve operating income in the face of

[36] See IMF 2012 for an examination of how the balance-sheet recession has affected the consumption of Irish households. See Mian *et al*. (2013) for county-level evidence from the United States on how marginal propensities to consume are affected by household-balance-sheet health.

uncertain capital positions and funding conditions.

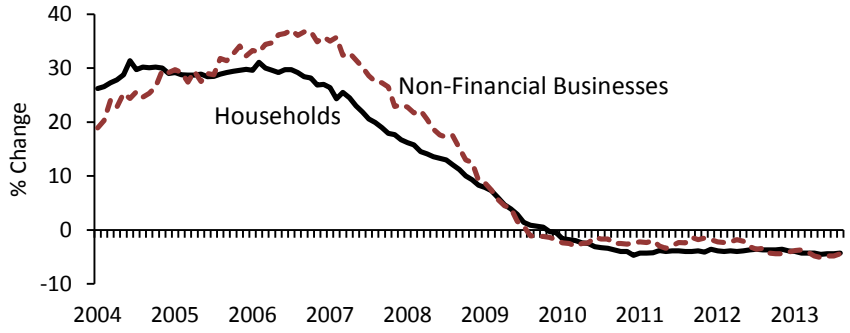
Figure D4 shows the rapid pre-crisis growth and then contraction in the stock of credit extended to households and businesses.[37] A significant part of the contraction reflects the paying down of loans as part of the balance-sheet repair process. Concerned about risks to solvency, businesses may forgo profitable investment opportunities, instead choosing to pay down debt and build liquidity reserves.

FIGURE D3: HOUSEHOLD LOANS OUTSTANDING



Note: Disposable income equals sum over last four quaters.
Sources: Central Bank of Ireland (Loans); Central Statistics Office (Disposable Income).

FIGURE D4: GROWTH RATES IN CREDIT TO THE PRIVATE SECTOR, JANUARY 2004 TO AUGUST 2013, PERCENTAGE CHANGE FROM SAME MONTH IN PREVIOUS YEAR

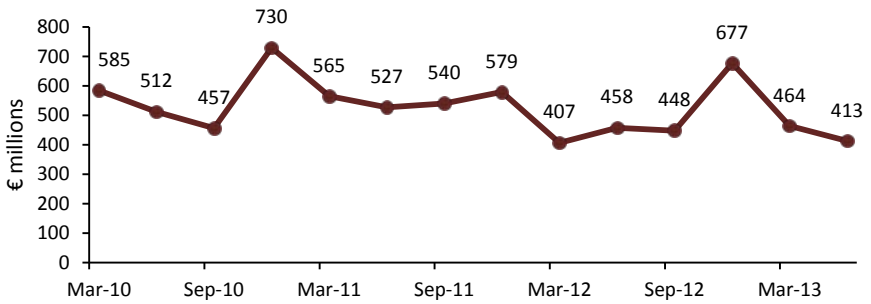


Source: Central Bank of Ireland.

In terms of supporting domestic demand growth, it is important that new lending continues to take place. Figure D5 shows the recent evolution in gross new lending to the non-financial/non-property SME sector. This lending has not yet shown significant signs of recovery.

[37] There is a large literature in macroeconomics that studies the effects of credit availability on business-cycle dynamics. The credit-channel of shock transmission focuses on the way that shocks are amplified through "financial-accelerator" effects, as balance sheets become impaired and credit rationing increases (see, e.g., Bernanke *et al*.1994; Bernanke and Gertler, 1995).

FIGURE D5: NEW CREDIT ADVANCED TO NON-FINANCIAL/NON-PROPERTY IRISH SMES, MARCH 2010 TO JUNE 2013



Note: Gross new lending is the amount of new credit facilities drawn-down during the quarter by SME counterparties, i.e. where this credit facility was not part of the outstanding amount of credit advanced at the end of the previous quarter. Gross new lending is defined to exclude renegotiations or restructuring of existing loans.

Source: Central Bank of Ireland.

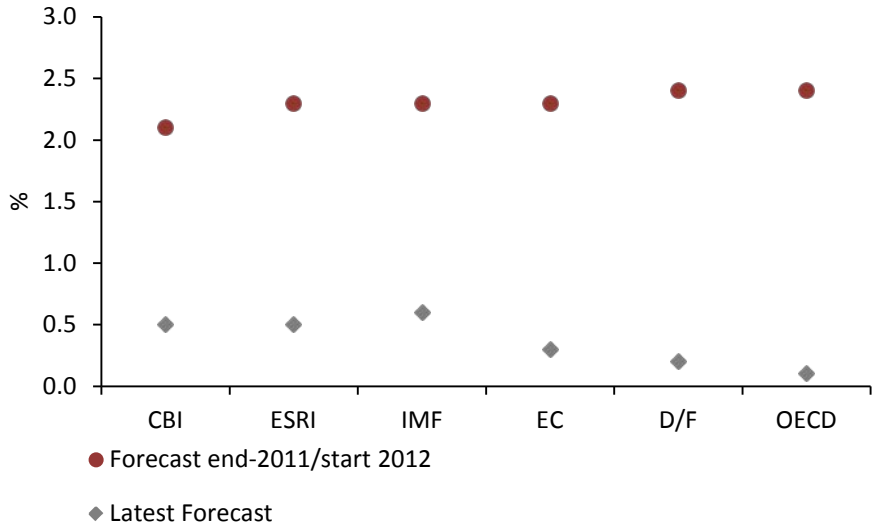
Set against these adverse dynamics, stabilising forces should eventually gain momentum, as balance sheets are repaired, the stock of postponed spending increases, liquidity targets are reached and fears about the future gradually recede. The restoration of the Government's own creditworthiness is likely to be a necessary stabilising force, helping to underpin confidence in the banking system, and lessening fears that it will be unable to effectively phase required fiscal adjustments over time.

1.5.2 *BUDGET 2014* FORECASTS COMPARED WITH OTHER AGENCIES

The *Budget 2014* forecasts are generally in line with the broad consensus among the forecasting community that the economy will grow modestly this year but that GDP growth will pick up in 2014 (Annex C). Most agencies foresee growth of about 0.5 per cent in 2013 with growth of approximately 2 per cent forecast for 2014. Exceptions include the ESRI who foresee real GDP growth of 2.6 per cent in 2014 with the European Commission expecting growth of 1.7 per cent.

As noted in previous *Fiscal Assessment Reports*, forecast agencies have consistently revised down forecasts over time. This could reflect an underestimation of downward pressures created by the balance sheet recession as well as weaker than expected international growth outturns. This pattern has continued during the second half of 2013 with downward revisions to growth projections. In Figure 1.6, current estimates of growth in 2013 by the main forecasting agencies are shown relative to forecasts made at the end of 2011/beginning of 2012.

FIGURE 1.6: FORECAST FOR REAL GDP GROWTH IN 2013



1.6 UNCERTAINTY SURROUNDING FORECASTS

Irish macroeconomic forecasts are the subject of considerable uncertainty. This partly reflects the inherent volatility in the economy, the unknown impact of the balance sheet recession as well as other domestic and global financial risks. The presence of significant one-off factors affecting consumption and investment in 2013, as well as the "patent cliff", add to these uncertainties.

Budget 2014 reports on a number of short- and medium-term macroeconomic risks. It notes that "...risks to the central forecast emanate from both external and internal sources, and appear to be tilted to the downside".[38] This clear statement of the overall balance of risks is welcome. It improves transparency and communication around the forecasts. The downside risks include the fragility of the emerging recovery and risks to consumption from high levels of debt. Upside risks include a stronger rebound in export demand and a more pronounced recovery in domestic demand. The risk that the negative effect on exports from the pharmaceuticals sector could be greater than anticipated is also noted.

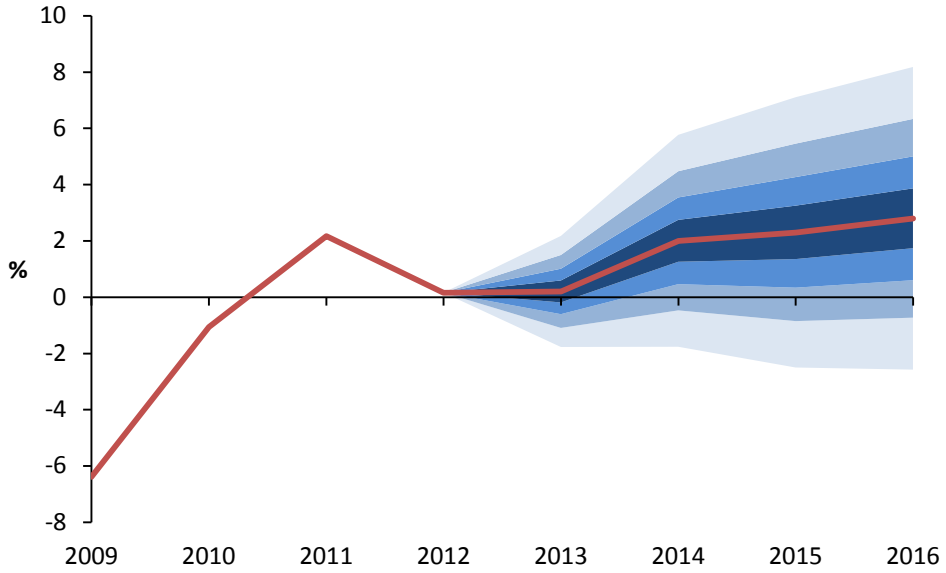
The Council itself assesses that risks remain tilted to the downside, although the potential for forecast errors in either direction around turning points is high and upside risks should not be overlooked. An important source of risks is the possible re-intensification of financial stability

[38] Given that the Budget forecasts are on a "most likely" basis (see Box B), this suggests that it is more likely than not that the macroeconomic outturns will be weaker than the projections if standard assumptions about the risk distributions are applied. (That is, the expected value of the macroeconomic variables would be lower than the *Budget 2014* most likely projections).

tensions in the Euro Area, not least in view of the forthcoming asset quality review and stress tests of the banks (see Chapter 2). Looking further ahead, the medium-term growth potential of the Irish economy is highly uncertain in the wake of the crisis.

The Council's fan chart analysis provides some gauge of forecast uncertainty, albeit based on historical forecast errors. By construction, the fan charts assume that risks are balanced. A fan chart based on the GDP growth projections in *Budget 2014* is shown in Figure 1.7.

FIGURE 1.7: FAN CHART FOR REAL GDP GROWTH



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,

[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.

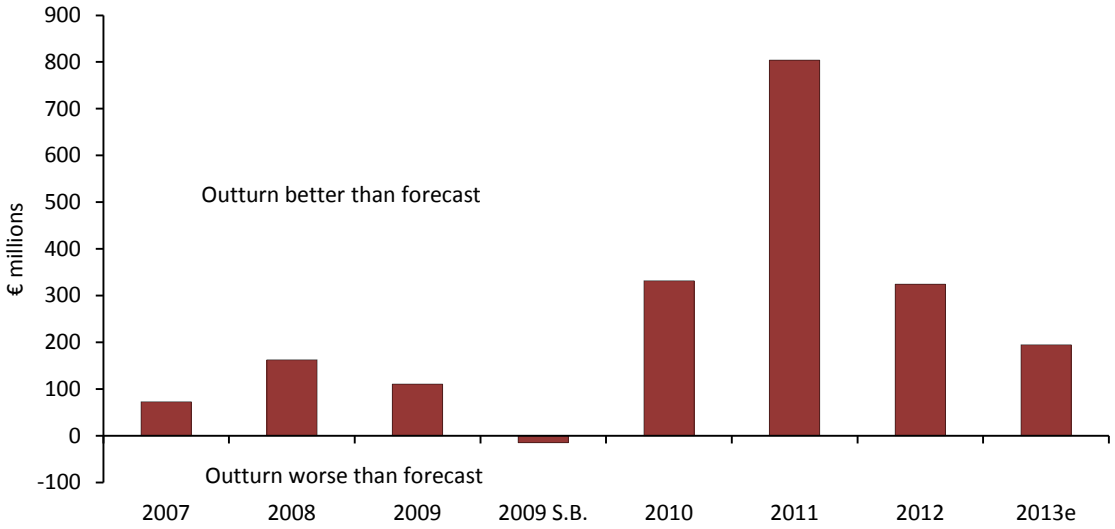
[41] These revenue streams are netted off gross expenditures.

[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.

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

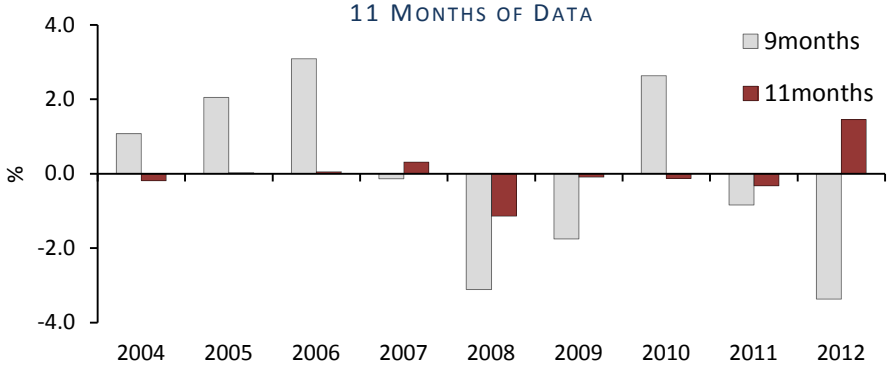
[46] Based on Department of Finance estimates for Exchequer taxes.

[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.

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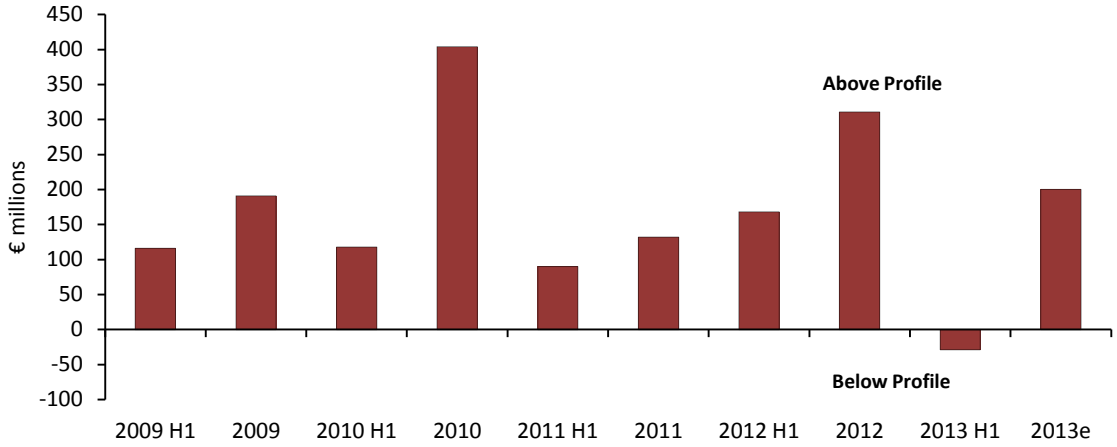
projected to be €39.7 billion on a no policy change basis in 2014. As a result of the measures in the Budget, this figure has been revised down to €38.4 billion.

[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.

[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.

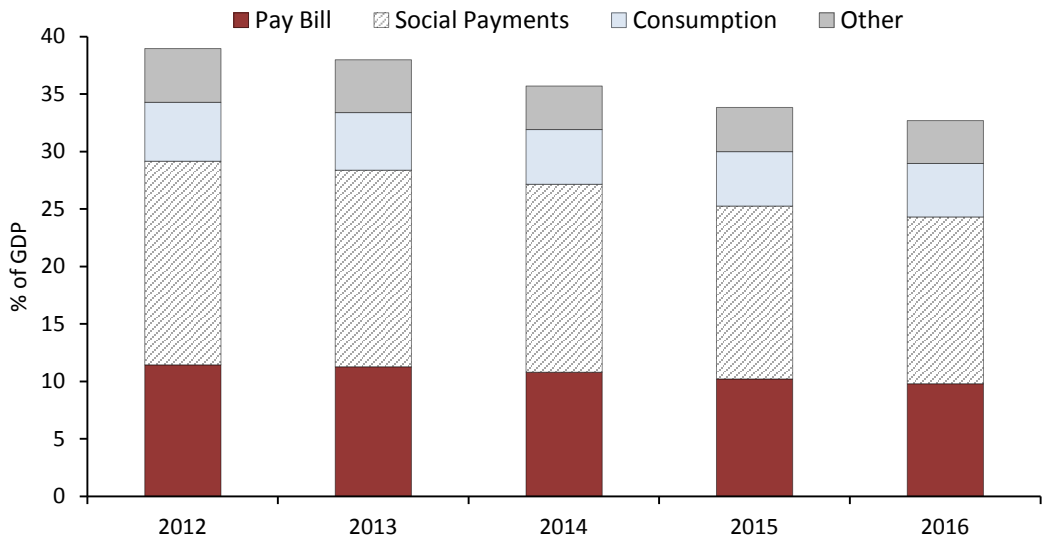
[74] The weighted average maturity of long-term Irish Government debt has been extended from just over 7 years at end-2012 to 11 years in mid-2013 as a result of these developments. The decision of EU ministers refers to the European portion of Irish borrowing from the EU/IMF.

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

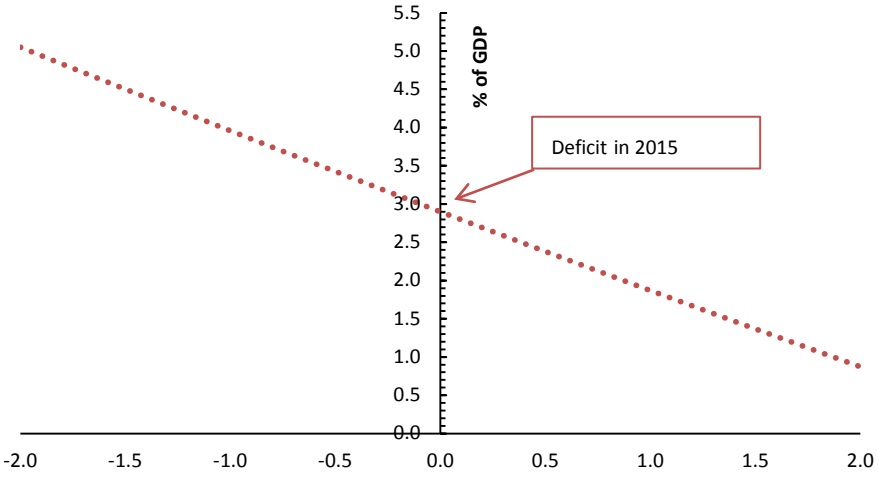
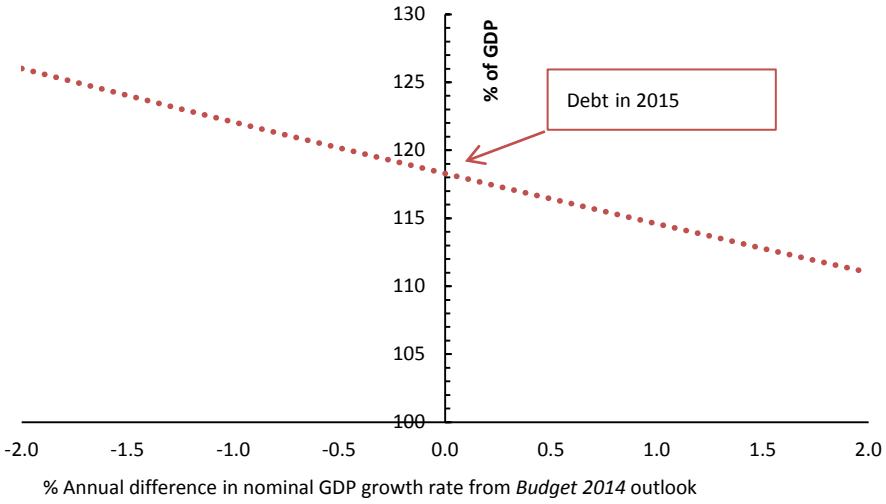


FIGURE 2.4b: GENERAL GOVERNMENT DEBT



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

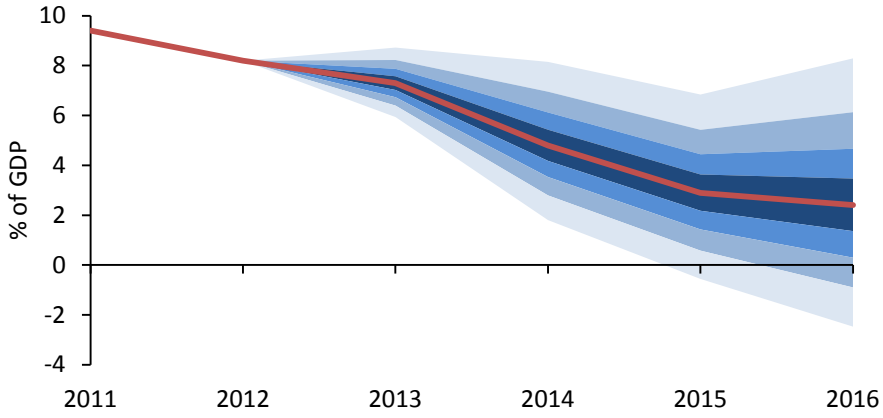
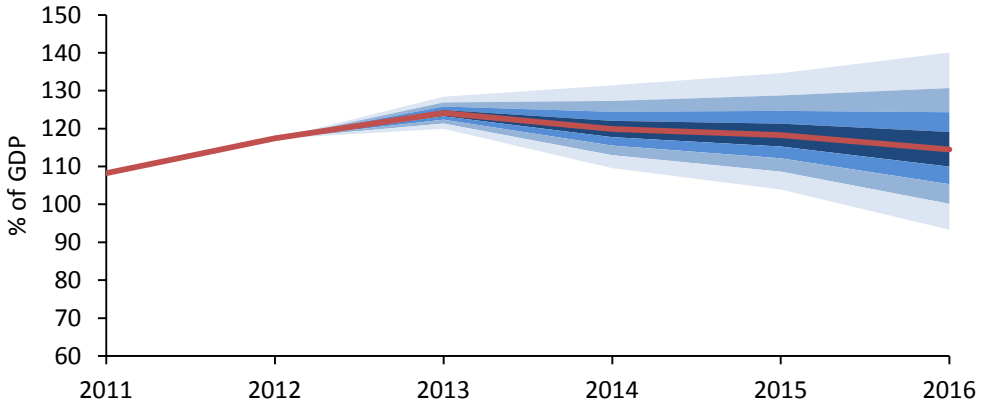


FIGURE 2.5b: GENERAL GOVERNMENT DEBT



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

[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]

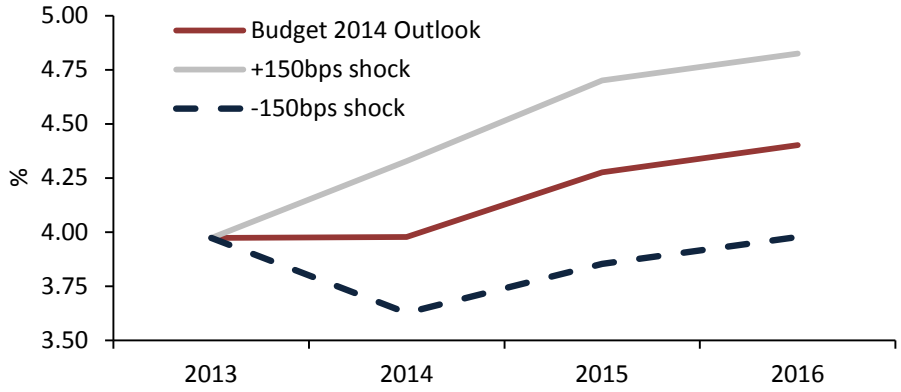
% of GDP	2014	2015	2016
Baseline			
General Government Debt	119.9	118.3	114.5
General Government Balance	-4.8	-2.9	-2.4
Average Interest Rate	4.0	4.2	4.4
+150 Basis Points			
General Government Debt	120.3	119.3	115.9
General Government Balance	-5.2	-3.5	-2.9
Average Interest Rate	4.3	4.7	4.8
-150 Basis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

3. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

SUMMARY

- *Budget 2014* projections imply compliance with the Budgetary Rule in 2013 and in each forecast year out to 2016. This is because the Adjustment Path Condition for the structural balance to converge towards Ireland's Medium Term Budgetary Objective is met.

- *Budget 2014* projections imply that there is almost no margin of safety in respect of the 3 per cent Stability and Growth Pact deficit ceiling in 2015 (and the ending of the Excessive Deficit Procedure (EDP)).

- Medium Term Budgetary Objectives (MTO) have been revised, raising Ireland's MTO from a structural deficit of 0.5 per cent of GDP to a balanced budget in structural terms. This change – other things equal – would require close to an additional €0.8 billion of consolidation after 2016, although there is significant uncertainty about how much adjustment the rules will ultimately require.

- The revised structural balance estimates provided by the Department of Finance show improvements of at least 1 percentage point of GDP a year for the years 2014 and 2015 compared to the figures in *SPU 2013*. This level shift implies that, at the minimum required pace of adjustment of the structural balance under the budgetary rule, there are two years of structural balance adjustment after 2016 to reach the MTO.

- The *Budget 2014* documentation did not include the updated estimates of the structural balance. This is a serious gap given that the Budgetary Rule uses this measure. These data were subsequently provided to the Council.

- The EU "Two Pack" of governance reforms came into force on 30 May 2013. This brings a number of changes to fiscal procedures and institutions in Ireland. The Council's mandate has been extended to include endorsement of macroeconomic forecasts prepared by the Department of Finance. The Commission has also clarified the interpretation of some of the existing EU rules.

3.1 Introduction

The Council's mandate includes monitoring compliance with the Budgetary Rule and compliance with the full range of fiscal rules is part of the Council's assessment of the fiscal stance. This Chapter assesses compliance with the fiscal rules in line with the full explanation of the rules set out in the previous *Fiscal Assessment Report* by the Council (IFAC, 2013a).

Section 3.2 assesses the consistency of *Budget 2014* with the fiscal rules, including the implications of the debt rules and expenditure benchmark in the light of recent clarification from the European Commission. Section 3.3 considers the coming into force in May 2013 of two new EU regulations, known as the "Two Pack", which include the allocation of a new "endorsement" function to the Council (see Chapter 1).

3.2 Compliance with the Fiscal Rules

This section assesses the consistency of *Budget 2014* projections with the Budgetary Rule, which the Council is explicitly required to monitor, as well as compliance with wider Irish and EU fiscal rules.

3.2.1 Compliance with the Budgetary Rule

The official documentation for *Budget 2014* did not include an estimate for the structural budget balance. Given that fiscal policy is now subject to rules set in terms of the structural balance, this is a serious gap in the information provided by the Department of Finance.[96]

Projections underlying *Budget 2014* - provided at the Council's request after the Budget - are consistent with compliance with the Budgetary Rule in 2013, 2014 and in each year out to 2016, when the projections end, as the Adjustment Path Condition of improving the structural balance by at least 0.5 percentage points of GDP would be complied with in all years (Table 3.1).[97]

[96] There is a formal EU requirement for this information to be published in Stability Programmes. While there is currently no such requirement for the Budget documentation, this is a key piece of information. The requirements of the "Two Pack" will mean that a draft budgetary plan must be published as part of the budgetary documentation from 2014. This draft budgetary plan would include an assessment of the cyclical position in line with that provided in the *Stability Programme Update*. Guidelines on the information to be included in draft budgetary plans are provided by the European Commission (See EC, 2013b). In a formal sense, compliance with the Budgetary Rule is assessed using data produced at the time of the *Stability Programme Update*. Nevertheless, if the rules are to provide a guide to policy, estimates are needed for each budgetary exercise (see April 2013, *Fiscal Assessment Report*).

[97] These structural balance projections were supplied to the Council on 24 October and made public in answers to a Parliamentary Question on 5 November 2013 (Numbers 151/152).

TABLE 3.1 SUMMARY OF MAIN FISCAL AGGREGATES[98]

	2013	2014	2015	2016
Main Aggregates, % of GDP				
General Government Balance	-7.3	-4.8	-2.9	-2.4
Structural Balance	-5.3	-3.6	-1.6	-1.1
Output Gap (% Potential GDP)	-3.3	-2.9	-2.7	-2.5
General Government Debt	124.1	119.9	118.3	114.5

The fiscal position is expected to remain over the projection horizon some distance from the two other conditions that would lead to compliance with the Budgetary Rule: the headline budget balance would remain in deficit, and the Medium Term Budgetary Objective (MTO) of a balanced budget in structural terms would not be achieved.

The projected improvement in the structural balance is at least one percentage point for all years from 2013 to 2015, considerably larger than the minimum required adjustment of 0.5 percentage points. Despite many uncertainties there is some margin to accommodate negative shocks without jeopardising compliance with the Budgetary Rule in the years to 2015.

In meeting the required structural adjustment, cyclical shocks should — by definition — have no effect on the structural balance. The main sources of risk to meeting the rules are structural deteriorations in the fiscal position. These could arise either because of unexpected changes in policy, such as higher than planned non-cyclical spending, or because of a measured deterioration in the structural balance resulting from differences between the anticipated and actual impact of the cycle and/or revised estimates of the output gap.[99]

The *Fiscal Responsibility Act* allows for deviations from the required adjustment path if this arises "…only as a result of exceptional circumstances and the failure does not endanger fiscal sustainability in the medium term" and is "consistent with the rules of the Stability and Growth

[98] Table shows the underlying General Government Balance as defined by the Department of Finance.

[99] Paradoxically, a key risk at Budget time for meeting structural balance targets for the same year is *higher* than anticipated output. Given that fiscal outturns for much of the year are already largely known and assuming potential output is fixed, a stronger than anticipated growth outturn implies that more of the gain in revenue is cyclical and less of the improvement in the budget balance is structural than anticipated (put another way, this outcome implies that the cyclical elasticity of revenue is revealed to be lower than assumed in the structural budget adjustment).

Pact (SGP)". The SGP allows for temporary deviations from the adjustment path which are not regarded as significant before applying EU procedures.[100,101]

Future Implications of the MTO

By 2015 and the scheduled closing of the Excessive Deficit Procedure (EDP), the structural balance is estimated to reach -1.6 per cent of GDP. Ireland's MTO for the structural balance was revised in 2013 from -0.5 per cent of GDP to a balanced budget in structural terms in line with EU procedures (Box H). The main reason for the stricter MTO resulting from this exercise is the higher debt-to-GDP ratio since the previous estimate was made in 2009 (based on data for 2008). This tightening in the required structural balance – other things equal – would require additional consolidation of close to €0.8 billion at some point to reach the new standard compared with the previous MTO.

Box H: The Medium-Term Budgetary Objective (MTO)

The Medium-Term Budgetary Objective (MTO) and progress towards it, is one of the conditions underpinning the Irish Budgetary Rule, as well as forming the cornerstone of the "preventive arm" of the EU Stability and Growth Pact. It is set at the EU-level for each country using a formula. This box provides an overview of how the MTO is set and how progress towards it is measured.

Setting The MTO

The MTO is set in terms of the structural budget balance (i.e. the cyclically-adjusted General Government balance net of one-off and temporary measures.)

MTOs are set for all countries in an EU-wide exercise at regular three year intervals, most recently in 2009 and then again in 2013. The MTO is determined by a formula taking into account a number of considerations as set out below. Until 2013, this formula was not made fully public.

The MTO can never be lower than a deficit of -1 per cent of GDP in structural terms for any Euro Area country. Countries, such as Ireland, that signed the EU Fiscal Compact have committed to MTOs no lower than -0.5 per cent of GDP until their debt ratio is significantly below 60 per cent of GDP and the risks in terms of long-term sustainability of public finances are low.

Subject to these constraints, the MTO is set to meet three objectives:

- A safety margin with respect to the 3 per cent of GDP deficit limit. This is based on

[100] Temporary deviations from the adjustment path of 0.5 percentage points in one year or cumulatively over two years from the MTO are allowed *ex post*.

[101] Exceptional circumstances are defined in the *Fiscal Responsibility Act 2012 and 2013* as "…a period during which an unusual event outside the control of the State has a major impact on the financial position of the General Government, or …a period of severe economic downturn".

achieving the lowest percentile of country-specific output gap estimates over the historical sample, given the estimated elasticity of the budget to the output gap.

- Ensure sustainability or rapid progress towards sustainability of public debt, taking into account the economic and budgetary impact of ageing. This is set as the sum of:
  - The budget balance needed to stabilise the debt-to-GDP ratio at 60 per cent given long-term growth and interest rate projections.
  - An additional 2.4 basis points for each additional percentage point by which the debt to GDP ratio exceeds 60 per cent.
  - One-third of the budget balance required to meet the present value of future age-related expenditure.[102]
- Allow room for budgetary manoeuvre, in particular taking into account public investment needs.

For Ireland, the upward revision to the MTO since it was previously set in 2009 (which tightened the MTO from a structural deficit of 0.5 per cent of GDP to balance) arises from a combination of the major changes of circumstances since the crisis, along with some minor methodological changes. The main driver is the higher debt-to-GDP ratio.

Measuring Progress Towards the MTO

Until the MTO is met, the EU rules require improvement in the structural balance each year with 0.5 per cent of GDP as a benchmark. A greater effort can be sought in good times with effort more limited in bad times. Progress is assessed on the basis of plans for the current and the next year (*ex ante* assessment) and also for the previous year (*ex post* assessment).

If there is "significant deviation" *ex post* from this path, this can open the way to a recommendation from the EU and sanctions.

Signification deviations are assessed using two complementary indicators:

- The size of the deviation in the structural balance from the adjustment path to the MTO.
- An expenditure benchmark that public spending grows below the medium-term potential growth rate of the economy (see Box I).

In both cases, a deviation of 0.5 percentage points of GDP in one year or 0.25 percentage points in each of two consecutive years is considered significant.

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[102] Formally, this can be expressed as:

$$\mathrm{MTO}^{*} = -\left({(60\% * \mathrm{g})}\Big/{(1+\mathrm{g})} \right) + (0.024\mathrm{b} - 1.24) + 0.3\dot{3} * \mathrm{S2E},$$

where *g* is the long-run nominal growth rate, *b* is the debt-to-GDP ratio and *S2E* is an EC indicator of future ageing costs.

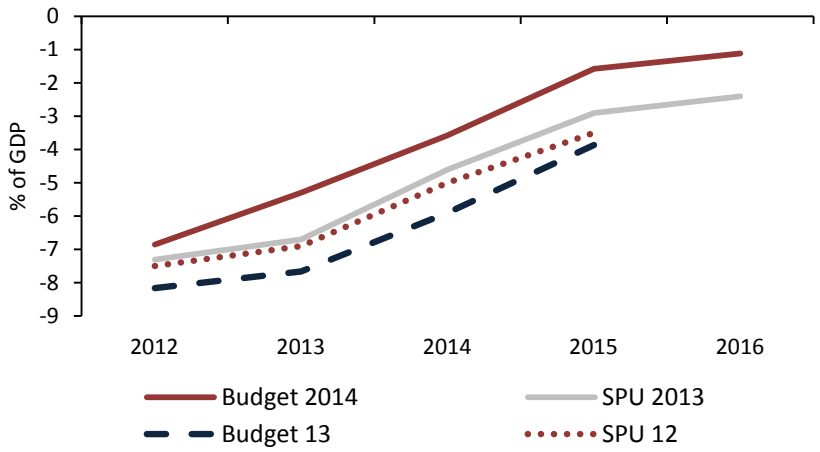
(***Note:*** *This footnote was amended 12 December 2013.)*

Given this new MTO, just over two more years of additional improvements in the structural balance at the minimum required pace of 0.5 percentage points would be required from 2016 to reach the MTO under the *Budget 2014* projections. As discussed in Chapter 4, this would allow for only small increases in nominal spending in the absence of measures to increase revenues. From an EU perspective, a faster rate of convergence than the minimum 0.5 percentage points may be expected given Ireland's high debt levels.[103]

However, measuring and projecting the structural balance is challenging. Estimating the output gap, forecasting the future path of potential GDP and adjusting the budget balances for the cycle remain uncertain and imprecise. Given this imprecision and that the MTO is not projected to be a met for a number of years, there is significant uncertainty about what the rules will ultimately require in terms of the total amount of consolidation.

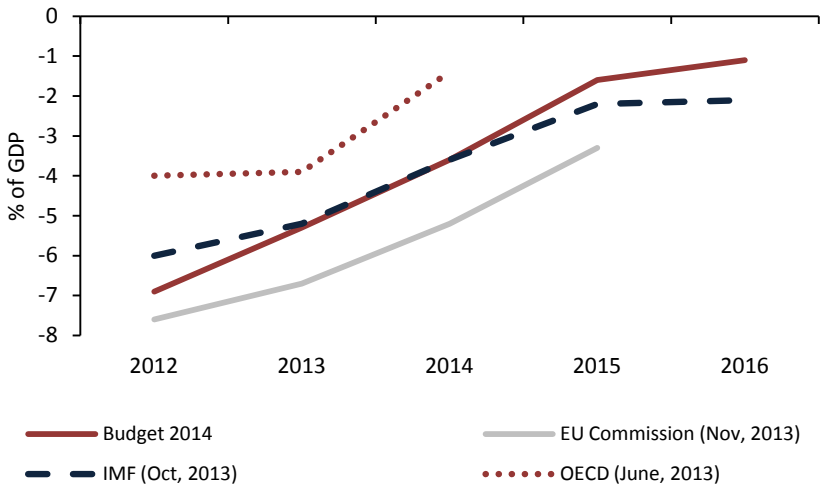
The difficulty in measuring the structural balance is highlighted by recent revisions to estimates by the Department of Finance. The estimates of the output gap and consequently the structural balance in *Budget 2014* have changed significantly since *SPU 2013*. The latest estimates for the structural balance are compared to previous estimates published by the Department of Finance in Figure 3.1 and to the latest estimates from other institutions in Figure 3.2.

FIGURE 3.1 COMPARISON OF DEPARTMENT OF FINANCE STRUCTURAL BALANCE ESTIMATES FOR IRELAND



[103] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), known as the Fiscal Compact, states in Article 3.1 (b) that "The Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks".

FIGURE 3.2 COMPARISON OF LATEST STRUCTURAL BALANCE ESTIMATES FOR IRELAND



The Department of Finance estimates of the structural budget balance are relevant to assessment of compliance with the Budgetary Rule as set out in the *FRA*, although the EU rules (and compliance with the preventative arm of the SGP) continue to be assessed relative to European Commission estimates, as discussed in the previous *Fiscal Assessment Report*.[104]

Efforts to improve the Department of Finance and EU methodologies are welcome. A more comprehensive set of methodologies is needed in Ireland to improve the understanding of the cyclical position of the economy and the public finances.

3.2.2 COMPLIANCE WITH OTHER IRISH AND EU FISCAL RULES

The Council has no formal mandate to monitor the Irish Debt Rule and EU fiscal rules.[105] However, it is required in its assessment of the fiscal stance to include "…reference to the provisions of the Stability and Growth Pact".

In terms of compliance with other Irish and EU rules:

- Ireland remains subject to an EU Excessive Deficit Procedure (EDP) as the General Government deficit exceeds the three per cent of GDP deficit criterion of the SGP. However, Ireland is

[104] See Chapter 3, Section 3 of April 2013 Fiscal Assessment Report.

[105] Independent monitoring of compliance with the Budgetary Rule is a requirement of the EU Fiscal Compact but this obligation does not cover the domestic Debt Rule.

complying with its obligations to bring down the deficit under the EDP and the Troika programme. *Budget 2014* projections show the headline deficit is expected to fall to 2.9 per cent of GDP by 2015, leaving almost no margin to accommodate negative shocks. The requirement of progress towards the MTO is effectively the same as under the Adjustment Path Condition of Budgetary Rule and would therefore be met. If the 3 per cent limit were to be breached, the European Commission would then assess whether "effective action" had been taken ("conditional compliance") using a range of criteria before making a recommendation to the EU Council for a decision.[106,107] The EU Council may extend the deadline for deficit correction, usually by one year. While such an extension is not automatic, and new nominal and structural targets may be introduced, a number of countries have had their EDP deadlines extended earlier this year. If effective action is judged not to have been taken, this will lead to a fine, typically of the order of 0.2 per cent of the previous year's GDP, payable to the ESM.[108]

- Debt remains higher than the "Debt Rule" and SGP debt criterion requirements of 60 per cent of GDP and the EU benchmark for convergence towards the debt criterion (see Annex I). These requirements do not apply while Ireland is subject to the EDP and this will be followed by a transition period of three years.

- The EU has an expenditure benchmark that real non-interest expenditure growth, net of certain components of expenditure (see Box I), should not exceed the growth in potential GDP plus the relevant GDP deflator, except if fully offset by discretionary revenue increases, less an additional margin to ensure that the structural budget balance converges to the MTO. As shown in Box I, the expenditure benchmark implies that this spending should fall by at least 0.7 per cent in real terms over each of the next three years. This would be met under current official projections out to 2016.

[106] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-07_council/2010-12-07_ie_126-7_council_en.pdf

[107] An analysis of effective action is undertaken by the European Commission and incorporates an assessment of the impact of forecast errors on the setting of the initial targets. This approach is formalised under the reforms to the SGP in 2011 (see section 2.3.2.1. of EC (2013c)). On finalising its assessment the European Commission will then make a recommendation to the EU Council.

[108] A fine may be cancelled on the grounds of exceptional economic circumstances or following a reasoned request from the country within 10 days of the EU Council decision.

- While the exact role of the expenditure benchmark is still somewhat unclear, the structural balance appears to take precedence over the expenditure benchmark in the assessment of progress towards the MTO. The differences in methodology between the MTO and the expenditure benchmark allow for a more thorough assessment of compliance with the rules and the particular factors that may lead to non-compliance. This may be especially important if the required MTO is not met. In this case, meeting the expenditure benchmark could help with compliance with EU requirements. There may also be differences between compliance with the expenditure benchmark and *ex post* compliance with MTO requirements if forecast errors or revisions in the structural balance mean that the MTO requirements are not met despite sufficient discipline in terms of spending.

BOX I: THE EU EXPENDITURE BENCHMARK

The assessment by the EU of progress towards the MTO uses the structural balance as a reference, but also includes an analysis of expenditure net of discretionary revenue measures. The expenditure benchmark is therefore not a "rule" in the same sense as other requirements but does need to be taken into consideration. It is considered by the European Commission to be a complementary indicator to the budgetary rule. Specifically, the expenditure benchmark is an important factor in the overall assessment of compliance with the preventive arm of the Stability and Growth Pact when a country is not at its MTO.[109]

The expenditure benchmark is also designed as a complementary measure to ensure countries stay at their MTOs by providing guidance about how expenditure should be set to fulfil the adjustment path condition and then maintain the structural budget balance at the MTO level thereafter. This is being applied in Ireland, where the expenditure benchmark is being used to inform the setting of the multi-year expenditure ceilings (see Chapter 2).

THE EXPENDITURE BENCHMARK

The expenditure benchmark essentially says that annual expenditure growth should not exceed the medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. If expenditure increases in a given year at the medium-term reference rate of potential GDP, the benchmark ensures that there is no change in the structural budget balance.

For countries that have not reached their MTOs, an additional convergence margin is set for the appropriate growth rate of expenditure that is below the medium-term rate of potential GDP growth, as well as requiring that any discretionary tax cuts are financed through lower

[109] For example, in their assessment of the German Stability Programme Update for 2013, the European Commission states that "the growth rate of Government expenditure, net of discretionary revenue measures, will exceed the reference medium-term rate of potential GDP growth in 2013. However, the expenditure benchmark is not binding given that it is intended to underpin the necessary adjustment towards the MTO (which Germany plans to continue to comply with). Moreover, the programme foresees that the growth rate of Government expenditure will again be below the reference rate in 2014".

spending or higher non-tax revenues or both.

Expenditure is measured excluding interest, cyclical unemployment benefit spending and Exchequer co-financing of EU programmes, and investment costs are smoothed over a four year period.

To Calculate The Benchmark

The medium-term rate of potential GDP growth is calculated over a 10-year window, incorporating estimates for the past 5 years of data, the current year and forecasts for the next 4 years from the European Commission. This will be re-calculated every three years.

The convergence margin is subtracted from the medium-term growth rate. It is set so that the structural budget balance improves by 0.5 per cent of GDP as required under the adjustment path condition of the MTO.[110] The margin is higher if the public sector is smaller because a larger proportional change in spending is needed to achieve a given improvement in the budget balance as a share of GDP. For Ireland, the expenditure benchmark would require General Government expenditure to decline by 0.7 per cent each year. This reflects a low medium-term rate of 0.6 per cent less a convergence margin of 1.4 per cent.

Implications of The Benchmark

In principle, the expenditure benchmark is designed to achieve MTO-based requirements and therefore does not add additional constraints on policy, but rather shows what is needed to achieve requirements for the structural balance. It implies that real General Government expenditure will need to decline in nominal terms for some time. The scenarios shown in Chapter 4 develop the implications of the MTOs for expenditure more systematically.

There are, however, some cases where the expenditure benchmark and the MTO could give different signals:

- The expenditure benchmark excludes interest payments, while the MTOs are set in terms of the overall structural budget balance (including interest). This can lead to differences. For example if spending on interest payments falls as a share of GDP, the MTO could be achieved without meeting the expenditure benchmark.
- The expenditure benchmark uses a different (10 year average) measure of potential output than the assessment of progress towards the MTO in a given year, again creating possibilities of different signals. For example, the backward-looking element of the medium-term potential growth calculation in the expenditure rule could imply a weaker growth number than that used to derive the MTO and therefore the expenditure benchmark could require a more positive budget balance.
- The cyclical adjustment of the budget balance could be affected by measurement or forecasting errors, leading to a shortfall in the MTO despite compliance with the expenditure benchmark.
- The MTOs are set in structural terms and are net of one-off and other temporary

[110] It can be shown that, if revenues grow in line with potential nominal GDP and interest spending is constant as a share of GDP, the 0.5 percentage point adjustment can be achieved by a convergence margin of 50/(primary expenditure as a percentage of GDP).

measures. Such one-off adjustments are not applied to the calculation of the expenditure benchmark.

Given recent revisions to estimates of the output gap and potential output, the locking in of current expenditure benchmarks based on estimates in spring 2013 for three years may mean that expenditure growth is more constraining than necessary to fulfil the adjustment path conditions to the MTO than more up-to-date estimates would suggest.

Meeting the expenditure benchmark will not only be challenging during the adjustment to the MTO, but requires spending to be neutral with respect to the cycle thereafter. Given that the wage bill is a large share of Government spending, public sector wages may need to be decoupled from the cycle. This could be difficult to achieve. Alternatively, other forms of spending could be made more strongly counter-cyclical or discretionary tax increases could be made when the economy is growing faster than trend.

3.3 THE EU "TWO PACK"

The so-called "Two Pack" of new EU fiscal regulations came into force on 30 May 2013.[111] This section sets out the main features of these new rules and focuses specifically on the new endorsement function it adds to the Council's mandate.

The "Two Pack" largely deals with institutions and procedures to strengthen fiscal governance in the Euro Area and reduce fiscal and financial risks.

The main elements of this legislation are (EC, 2013b):

- All Euro Area countries will follow a common budgetary timeline with a draft Budget by 15 October and the Budget legislated by the end of the year. In Ireland, this has required moving the Budget process to earlier in the year. There is a new coordinated EU surveillance exercise in the autumn and new reporting requirements, allowing the Commission to submit an opinion on the draft budget.
- The macroeconomic forecasts underpinning the Budget and the Stability Programme Updates must either be made independently or endorsed by independent bodies. In Ireland, as discussed in Chapter 1, the Council has been assigned the role of endorsing the forecasts produced by the Department of Finance.

[111] Formally, (1) EU Regulation No 473/2013 on common provisions for monitoring and assessing draft budget plans and ensuring the correction of excessive deficit of the Member States in the Euro Area, and (2) Regulation No 472/2013 on the strengthening of economic and budgetary surveillance of Members States in the Euro Area experiencing or threatened with serious difficulties with respect to their financial stability.

- Independent bodies must monitor compliance with the domestic fiscal rules put in place under the EU Fiscal Compact.[112] In Ireland, the Council's mandate already included monitoring the Budgetary Rule, as well as a role in the operation of the automatic correction mechanism in the case that the rule is not met.
- The obligation for Euro Area countries that enter Excessive Deficit Procedures (EDP) in the future to submit an Economic Partnership Programme describing the structural reform measures that will contribute to exiting the EDP.
- Better coordination of national debt issuance plans through new reporting obligations.
- Stronger monitoring and surveillance procedures for Euro Area countries experiencing or threatened with serious financial stability difficulties.

[112] Treaty on the Stability, Coordination and Governance in Economic and Monetary Union (TSCG).

4. ASSESSMENT OF THE FISCAL STANCE

SUMMARY

- The planned fiscal stance for 2014 and 2015 is assessed to be conducive to "prudent economic and budgetary management". However, the Council remains of the view that the most appropriate policy for *Budget 2014* was to continue with the previously planned adjustment of €3.1 billion rather than the reduced amount of €2.5 billion. The main arguments in favour of the larger adjustment are the value of a margin of safety in meeting the key EDP deficit targets in a highly uncertain growth environment and the credibility gains that come with successfully delivering on previously announced adjustment plans.

- There should be no reduction in the previously announced discretionary adjustments of €2 billion for 2015. To reinforce credibility gains, any future upward revisions in growth projections should be used to provide a margin of safety to ensure that the key EDP deficit ceiling of 2.9 per cent of GDP for 2015 is complied with. Additional adjustments may be required to ensure the target is achieved if growth projections are reduced or other contingencies raise the projected deficit for 2015.

- The fiscal adjustment programme is working in terms of stabilising the public finances and restoring the creditworthiness of the State. Market perceptions of sovereign default risk have fallen sharply. Simulations indicate that in the absence of fiscal adjustment from 2008 to 2013, this year's deficit would have been close to 20 per cent of GDP with the debt ratio close to 160 per cent of GDP (and rising).

- Extended projections out to the end of the decade indicate that the most difficult phase of the adjustment – which has involved large annual nominal expenditure and revenue changes – should be broadly complete in 2015/2016. Modest increases in nominal expenditure should be feasible post-2016, while meeting all domestic and European fiscal rules. However, the extent of the tightness of the fiscal stance should not be underestimated, as the scope for real expenditure increases will be limited. Significant risks also surround this scenario given the length of the projection horizon.

- As well as fiscal adjustment, various "self-protection" strategies could be used to minimise the risks to future borrowing capacity. A precautionary credit line with reasonable terms and conditions would have provided valuable additional protection against renewed funding pressures as Ireland exits the EU/IMF assistance programme. Two further "self-protection" strategies are also examined: extending and smoothing the maturity profile of the debt and holding cash reserves. Each of these self-protection strategies involves costs as well as benefits, and the optimal approach is likely to have involved a mix of all three.

4.1 INTRODUCTION

The setting of fiscal policy during the crisis has required a difficult balancing of the need to support domestic demand/employment, the need to restore the State's creditworthiness and the need to put the public finances on a sustainable path. While the Government faces a trade-off between demand support and creditworthiness/sustainability in the short to medium term, reducing the perceived risk of default and unstable debt dynamics is critical to laying a stable foundation for longer-term growth and employment.[113]

This chapter takes up a number of issues relevant to the trade-off and thus the Council's identification of the appropriate fiscal stance. In the next section, we first assess the Government's planned fiscal stance out to 2015 as set out in *Budget 2014* and last April's *Stability Programme Update (SPU, 2013)*. As required under the *Fiscal Responsibility Act*, an assessment is provided as to whether the Government's fiscal stance is "...conducive to prudent economic and budgetary management". A number of broader issues relating to the conduct and prospects for fiscal policy over the next number of years are then taken up.

It is often claimed that "austerity is not working". If the definition of "working" is that fiscal adjustment is leading to faster short-term growth, then such claims are almost certainly justified.

[113] Much of the international discussion of the trade off between demand and creditworthiness/sustainability focuses on countries with an independent central bank and monetary policy, but facing a zero lower bound on nominal interest rates. The trade off is likely to be considerably more benign in the context of an independent monetary policy and a zero lower bound for two reasons. First, perceptions of default risk appear to be considerably lower where a central bank can print money to meet debt obligations in extremis. The ability to use quantitative easing type policies can also lower financing costs to the consolidated Government. The different level of bond market pressure faced by the United Kingdom during the crisis – which has a deficit and debt ratio not too dissimilar to Irelands – is a case in point. Second, the operation of an independent monetary policy gives the country the scope to offset the negative impact of fiscal tightening when the country is no longer constrained by the zero lower bound. This can create a significant asymmetry between the costs of fiscal tightening today (when the zero lower bound is binding) and later (when it is not), increasing the relative attractiveness of back-loaded fiscal adjustment. For a small country in a large monetary union, later monetary policy can largely be viewed as exogenous to its fiscal policy.

The available evidence on multipliers suggests that fiscal adjustment does slow the economy in the short term (IFAC, 2013a). However, the core instrumental purpose of the adjustment is to put the public finances on a sustainable path and ensure the borrowing capacity of the State. While the direct short-term effects on growth are likely to be negative, maintaining borrowing capacity – both from market and official sources – is essential:

- to allow the adjustment to be phased over time (forestalling the need for even greater adjustment),
- to avoid a disruptive State default,
- to support access to affordable funding for the banking system, and
- to underpin long-term sustainable growth.

In Section 4.3, the "self-defeating austerity" argument is examined using the Council's Fiscal Feedbacks model to compare the actual evolution of key fiscal and creditworthiness variables since Ireland's fiscal adjustment began with predicted outcomes under the counterfactual scenario of no adjustment.

Another worry concerning the current fiscal adjustment strategy is that it will be so prolonged that it is not economically or politically feasible. Such expectations of unending austerity sap confidence and also the credibility of the adjustment programme itself. Building on work done by the Department of Finance in *SPU 2013*, Section 4.4 looks ahead to the fiscal adjustments that are likely to be required to ensure compliance with all fiscal rules post-2015.

The revealed fragility of Ireland's creditworthiness within the monetary union is likely to be an enduring constraint on Irish fiscal policy making. Drawing in part on the experience of emerging markets that have faced "sudden stops" of capital inflows, Section 4.5 examines self-protection strategies – in addition to reducing the deficit and debt – that offer the potential to reduce the vulnerability of future market access.

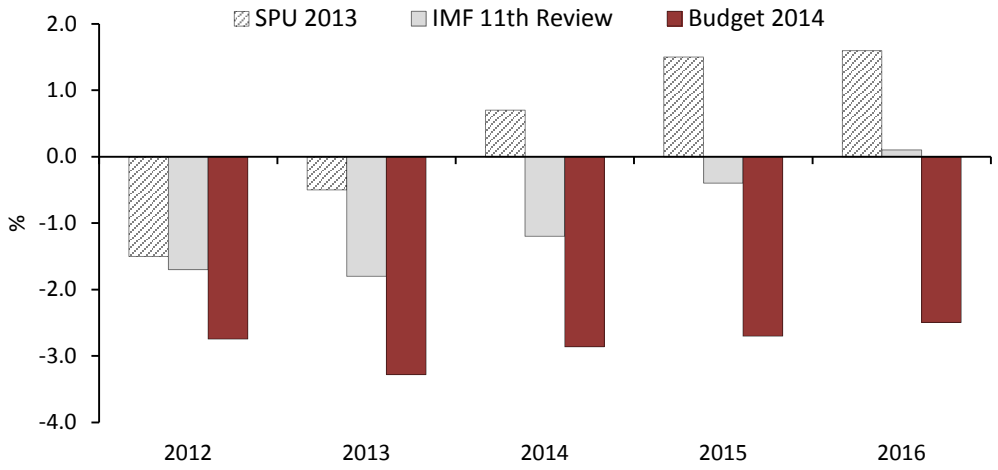
4.2 Review of the Fiscal Stance

In this section, recent developments affecting the demand/creditworthiness trade-off are first briefly reviewed. The appropriateness of the planned fiscal stance for 2014-2015 is then assessed.

The current official estimate of the output gap—the difference between actual and potential GDP expressed as a percentage of potential GDP—is -3.3 per cent for 2013 (see Chapter 3). As a result of changes to estimates of the underlying equilibrium unemployment rate (or non-accelerating wage rate of unemployment, NAWRU), the Department of Finance has significantly revised its estimates and projections of the output gap compared to those provided in *SPU 2013*.[114] Both sets of output gap numbers are shown in Figure 4.1 and were discussed in Chapter 3.

According to *SPU 2013* the output gap was projected to turn positive in 2014. As discussed in the last *Fiscal Assessment Report* (IFAC, 2013a, Chapter 3), the Council did not find these output gap estimates and projections to be plausible. One indication that the previous official numbers understated the size of the real GDP shortfall was the European Commission's projection that the NAWRU would rise to close to 16 per cent by 2017. This view was not shared by experts on the Irish labour market (see, e.g., ESRI 2013, *Medium-Term Review*). The Department of Finance had also itself expressed reservations about the estimated size of the current and projected output gap that results from the use of the EU methodology (see, e.g., *SPU 2013*).

Figure 4.1: Estimates and Projections of Ireland's Output Gap



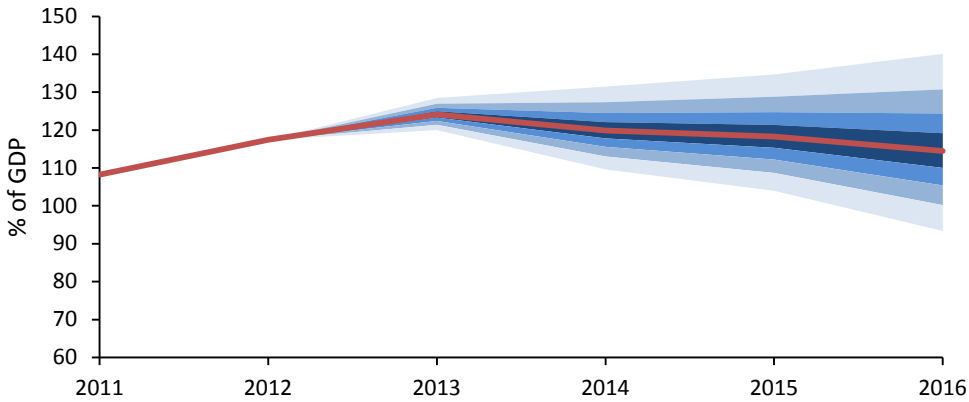
Note: A negative output gap indicates actual real GDP is below potential real GDP.

[114] The Department of Finance uses a common EU methodology in estimating potential output and the associated output gap.

The new Department of Finance output gap estimates and projections are now closer to those provided by the IMF, although they are more pessimistic (see Figure 4.1). They show an economy that is significantly underperforming relative to its potential, and is likely to continue to do so over the next number of years. The output gap is now projected to still be at a level of -2.5 per cent of potential GDP in 2016. This underperformance is in significant part due to weak domestic demand in the context of a balance sheet recession (see Chapter 1). Lacking a country-specific monetary policy instrument, standard demand management considerations would tend to favour a delay of fiscal adjustment measures in the absence of other constraints.

Unfortunately, other constraints are present. One constraint is the need to ensure that the debt to GDP ratio is on a sustainable path. Under the extended projections out to the end of the decade from *SPU 2013*, this ratio is expected to peak this year and then begin to fall. However, given the volatility of Irish growth and resulting high forecast errors, there is no guarantee that debt is on a sustainable path. Figure 4.2 reproduces the debt ratio fan chart from Chapter 2. Each band represents 10 per cent of the distribution. The chart indicates that there is a 1-in-3 probability that the debt ratio will fail to stabilise by 2015 under current fiscal plans.

FIGURE 4.2: DEBT TO GDP RATIO FAN CHART



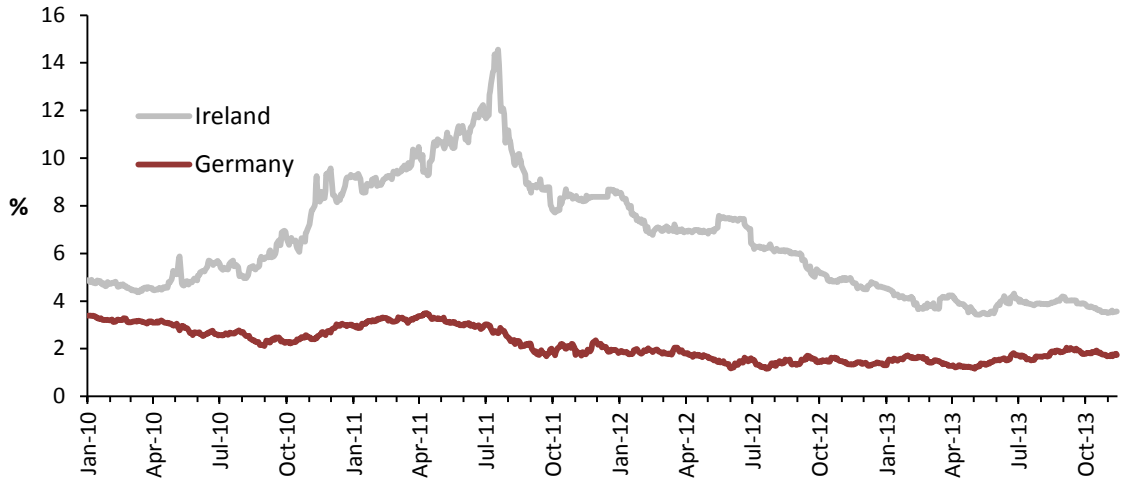
Even the reasonable likelihood of a stable or declining debt ratio under fiscal plans might not be sufficient to ensure the creditworthiness and consequent borrowing capacity of the State. This can reflect doubts about the Government's capacity to avoid a future default.[115] This in turn may

[115] This is an example of the well known time-inconsistency of optimal Government plans (see Kydland and Prescott, 1977, for the classic exposition). A Government may state its intention to pursue fiscal policies that will ensure the avoidance of default. If such plans are credible, expectations of default will be low and allow the Government to borrow

necessitate a tighter fiscal stance than would be warranted by purely demand-management considerations in order to underpin the credibility of the State's capacity to avoid default. The difficult trade-off between demand and sustainability/creditworthiness has made fiscal policy making in recent years extremely challenging.

In Ireland's case, market perceptions of default risk rose steadily from 2010 through the first half of 2011 (see Figure 4.3). However, successful implementation of fiscal adjustment efforts combined with improvements in official supports have substantially lowered the yield spread between Irish and German bonds. As a result, market perceptions of sovereign risk default have fallen sharply. The policy challenge now is to sustain the improvement in creditworthiness and borrowing capacity while limiting the contractionary drag caused by tight fiscal policies in a balance-sheet recession.

FIGURE 4.3: IRISH AND GERMAN 10-YEAR BOND YIELDS



Source: Datastream.

at low interest rates. However, the later fiscal adjustment policies required to avoid default could be highly costly, and the Government might choose subsequently to default, even where the costs of the default are themselves high. Recognising this later incentive, the announced plans may not be credible. To reduce expectations of default the Government can attempt to change the expected *ex post* costs and benefits of default. Putting the debt ratio on a lower trajectory can reduce the expected benefits of a default. Taking difficult actions now can also help signal the Government's strong intention – and political capacity – to take the difficult fiscal actions required to avoid default. Other actions that the Government can take to change perceptions of the later cost-benefit calculation include putting the Government's reputation as a no-default Government firmly on the line (thus raising the political costs of default), putting in place a fiscal framework of strong fiscal rules and institutions that raise the political costs of weak fiscal policies, and choosing a debt structure that is costly to restructure.

In previous *Fiscal Assessment Reports*, the Council argued for the importance of meeting targets under the Excessive Deficit Procedure (EDP), and in particular for attaining a deficit at or below the EDP ceiling of 2.9 per cent of GDP in 2015. This is a requirement for exiting the EDP, which is part of the corrective arm of the Stability and Growth Pact (SGP). To enhance the credibility of the fiscal stance, and recognising the uncertainty surrounding economic growth and other contingencies, an argument was made for providing a margin of safety relative to just meeting the target under the central growth forecasts. The credibility of the stance should further be enhanced by following through on planned discretionary adjustments. These discretionary adjustments are closely related to adjustments in the structural deficit, which are a key focus of both the European Commission and the IMF.

In response to an improvement in forecasts for the General Government deficit, partly as a result of the promissory notes transaction (see IFAC, 2013a, and Barnes and Smyth, 2013), the Government made the decision in *Budget 2014* to reduce the €3.1 billion in previously planned adjustment to €2.5 billion. The Council in its most recent report had urged that the target of €3.1 billion be retained. Based on the growth forecasts from *Budget 2014* – which have been endorsed by the Council (see Chapter 1) – the planned adjustment set out in the Budget is consistent with keeping the deficit at the EDP deficit ceiling of 2.9 per cent of GDP in 2015, and thus consistent with meeting this criterion for exit from the EDP. However, the Council is of the view that the likely benefit from reducing the planned adjustment for *Budget 2014* in terms of improved short-term growth (estimated to be approximately 0.2 percentage points of GDP) is unlikely to have been worth the cost in terms of the elimination of the margin of safety and lessened credibility. Overall, however, given that the EDP deficit target for 2015 is expected to be met, the Council continues to assess that the planned fiscal stance is "...conducive to prudent economic and budgetary management".

Even though the planned fiscal stance is consistent with meeting the EDP deficit ceiling for 2015 under the *Budget 2014* forecasts, it leaves limited room for adverse growth shocks (as was outlined in Chapter 2). The Government should implement the €2 billion in adjustments previously announced for 2015. Given the importance, from a credibility viewpoint, of meeting the deficit ceiling for 2015, increased adjustments would likely be required if there is any material deterioration in the growth forecasts or other deficit/debt-affecting contingencies. Moreover, any upward revisions to growth forecasts should be used to restore a valuable margin of safety in

relation to the 2015 EDP deficit ceiling and to ensure that the debt-GDP ratio remains on a sustainable path.

4.3 Has Fiscal Adjustment Worked to Stabilise the Public Finances and Restore Creditworthiness?

As discussed above, the choice of fiscal stance in current circumstances involves a difficult balancing act of supporting domestic demand and credibly stabilising the public finances. Although it is often stated that there is a trade-off between "growth and austerity", discretionary fiscal adjustment – austerity – is better viewed as the instrument available to policymakers to move along the domestic demand and sustainability/creditworthiness trade-off.

Much discussion of appropriate fiscal strategy has essentially amounted to a denial that this trade-off exists. The denials have taken two quite different forms: the expansionary fiscal contraction (EFC) hypothesis and the self-defeating fiscal adjustment hypothesis. Under the EFC hypothesis, discretionary fiscal contractions are assumed to increase growth. This might happen, for example, because fiscal adjustments reduce interest rates or reduce fears of a disruptive State default. Discretionary adjustments would then lead to improved fiscal performance both directly and also indirectly through improved growth performance. In the previous *Fiscal Assessment Report* (IFAC, 2013a), available evidence on the size of short-term fiscal multipliers was reviewed. Although there is evidence that short-term multipliers are lower when debt to GDP ratios are high, or the country is in a debt crisis, the weight of the evidence does not support the EFC hypothesis.

The second way in which the trade-off might not exist is if discretionary fiscal adjustments are not working in terms of improving the fiscal situation and ultimately the State's creditworthiness. Under such "self-defeating austerity", discretionary efforts to curb the deficit would result in both lower growth and a worsening in the key fiscal aggregates. The remainder of this section examines possible evidence of self-defeating fiscal adjustment in the Irish context. It considers the post-2008 evolution of key variables: the underlying primary deficit (i.e., the primary deficit excluding banking-related recapitalisation costs); the underlying General Government deficit; the debt to GDP ratio; and the 10-year bond yield.

An obvious drawback of this approach is that the counterfactual – that is, how these variables would have evolved in the absence of fiscal adjustment – is not observable. The Council's Fiscal

Feedbacks model is thus used to examine how the fiscal variables are likely to have evolved in the absence of discretionary adjustment.[116]

Figures 4.4a to 4.4c show the actual/predicted evolution of the four variables between 2009 and 2013. (Figure 4.3 previously showed the evolution of market assessments of creditworthiness). The prediction for the fiscal variables for 2013 is taken from *Budget 2014*. Despite significant non-austerity related growth headwinds, the underlying primary deficit has fallen from 9.2 per cent of GDP in 2009 to a projected 2.7 per cent of GDP in 2013. The underlying actual deficit has fallen from 11.2 per cent of GDP to a projected 7.3 per cent of GDP over the same period. Given that the Government was running a primary deficit over this period and the nominal interest rate has exceeded the nominal growth rate, it is not surprising that the debt to GDP ratio has increased over the period. The increase in the debt to GDP ratio has also reflected substantial supports to the banking system and increases in the State's cash reserves. In terms of secondary market bond yields, the implied 10-year bond yield increased steadily until mid-2011, but has fallen dramatically over the last two years.

As noted, the more interesting question is what would have happened to these variables in the absence of fiscal adjustments. The total discretionary adjustments undertaken between 2009 and 2013 add up to approximately €28 billion. For the fiscal variables, a useful counterfactual scenario can be run assuming that no discretionary adjustments were undertaken. It should be stressed that this scenario assumes that growth would have evolved in the same way as under the actual scenario other than through the effects of the discretionary fiscal adjustment on growth given the assumed deficit multiplier. The simulations also assume that the interest rate on outstanding debt would not have been affected by the absence of fiscal adjustment. These two assumptions mean that the simulations are likely to underestimate the levels these fiscal variables would have reached in the absence of the discretionary adjustments. Of course, it is highly unlikely that such a "no-adjustment" path would have been feasible.

Figures 4.4a to 4.4c also show the predicted counterfactual evolutions for the three fiscal aggregates in the absence of fiscal adjustment. The underlying primary deficit would have risen to a

[116] These simulations assume a reduced form deficit multiplier of 0.5 and an automatic stabiliser coefficient of 0.5, where the latter is based on new European Commission estimates of this coefficient (Mourre *et al.* 2013).

projected 14 per cent of GDP in 2013.[117] The underlying actual deficit would have risen to 20 per cent of GDP. Finally, the debt to GDP ratio would have risen to a projected 158 per cent. Taken together, these results indicate that, even under what could be viewed as rather optimistic assumptions, the fiscal adjustment effort has not been self defeating in terms of improving the key underlying fiscal aggregates.[118]

Absent a credible model of perceived creditworthiness, it is not possible to conduct a defensible counterfactual simulation of market assessments of default risk based on underlying bond spreads.[119] However, the sharp reduction in the secondary market bond yield does not suggest that the fiscal adjustment effort has been self-defeating on this measure either. The combination of the demonstrated capacity to gain control of the public finances, together with developments in European-level official support policies (which are themselves conditional on fiscal effort), appears to have supported a sharp fall in perceived default risk.

Overall, the evidence indicates that the fiscal adjustments pursued since the crisis erupted in 2008 are working to stabilise the public finances and to restore the creditworthiness of the State.

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[117] Figures 4.4a and 4.4b show the underlying primary and General Government deficits, that is, the deficits excluding the effect of capital injections into financial institutions as defined by the Department of Finance.

[118] One possible objection to these counterfactual simulations is that the effects of discretionary fiscal adjustment could be non-linear, with possibly larger multiplier effects at the margin. In the context of the Fiscal Feedbacks model, it should be noted that discretionary adjustments improve the underlying primary balance for any chosen (positive) deficit multiplier. However, for large enough multipliers, discretionary adjustments could lead to a higher debt to GDP ratio for a period of time if the adverse effects on the denominator through reduced growth offset the positive effect on the numerator through an improved primary deficit. It is useful, then, to ask how large the multiplier would have to be for additional discretionary adjustment in year t to actually lead to a larger debt to GDP ratio in year t+1. We again use the Fiscal Feedbacks model to examine how large the reduced-form multiplier would have to be for an additional €1 billion in adjustments in 2014 to lead a higher debt to GDP ratio in 2015, all else equal. The multiplier would have to be 1.8 or larger – values that are in excess of any available estimate for Ireland's deficit multiplier given the openness of the economy.

[119] Some empirical models of the risk premium postulate a simple linear relationship between the risk premium and current and/or lagged values of fiscal variables such as the deficit as a share of GDP and the debt to GDP ratio. However, bond market investors are likely to adopt a more forward looking approach, and in particular to form expectations of how fiscal variables will evolve in the future in an uncertain economic and political environment. Another complication, further discussed in Section 4.5.2, is that the risk premium may be subject to multiple expectations-based equilibria. This can lead to discontinuous jumps in the premium, even with limited changes in contemporaneous fiscal variables. The experience of a rapidly rising risk premium between mid-2010 and mid-2011 is a case in point, as is the subsequent fall. Although a reliable predictive model is thus difficult to estimate, an understanding of the broad forces leading to a "good" equilibrium do point to the importance of the credibility of the planned deficit- and debt-reduction stance and perceptions of the Government's commitment to avoid default. In Section 4.5.2 we discuss further policies that could increase the robustness of an equilibrium with low perceived default risk.

FIGURE 4.4a: PRIMARY DEFICIT,
ACTUAL AND COUNTERFACTUAL SCENARIO

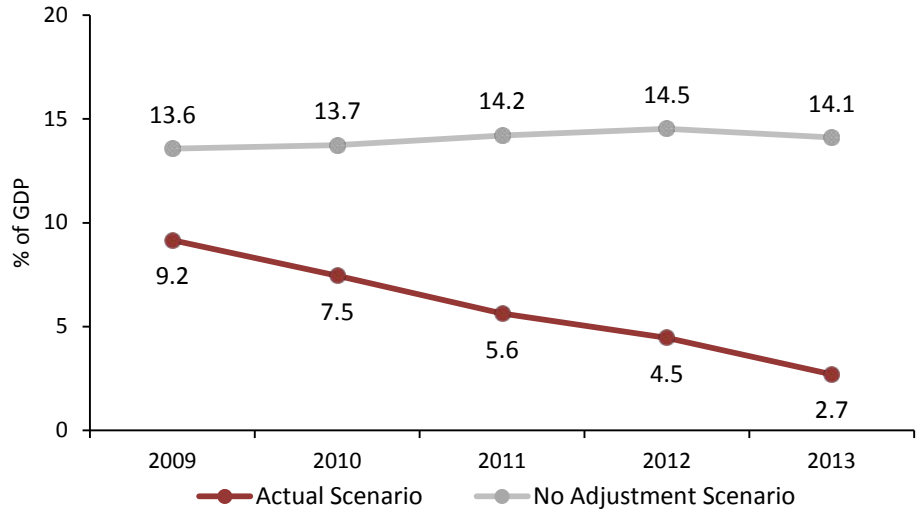


FIGURE 4.4b: GENERAL GOVERNMENT DEFICIT,
ACTUAL AND COUNTERFACTUAL SCENARIO

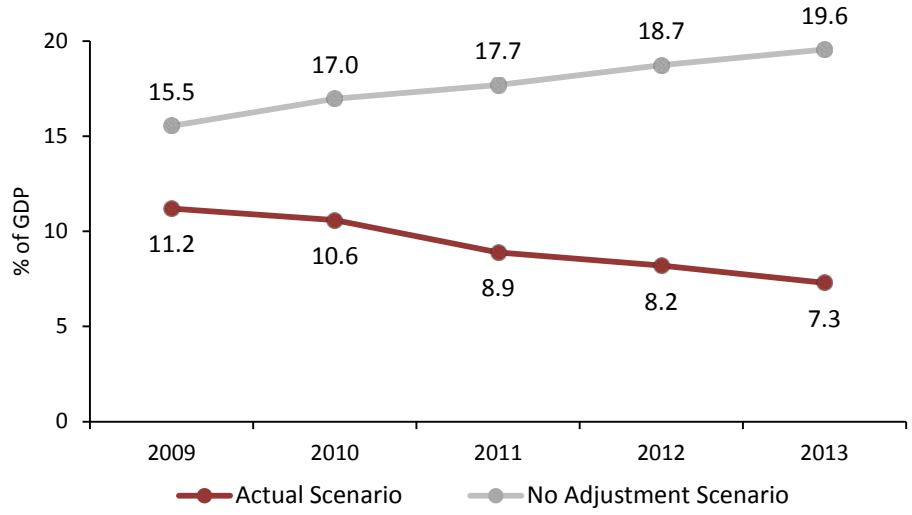
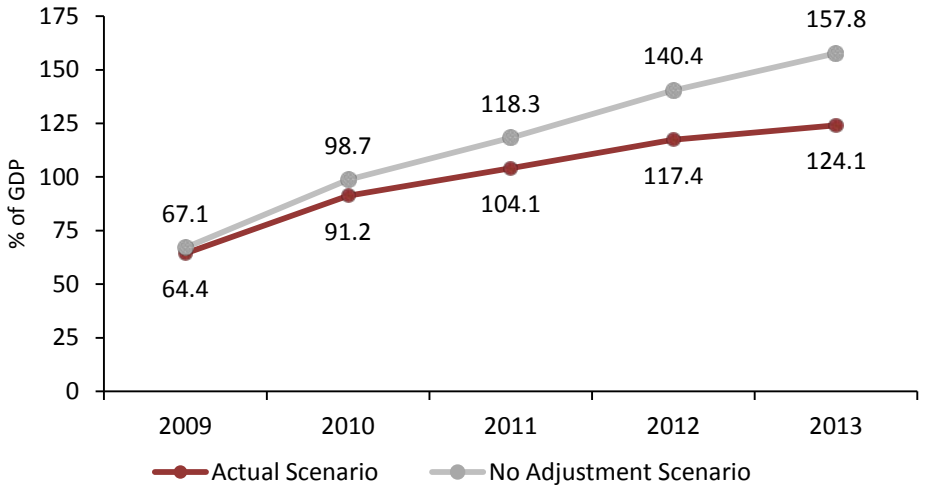


FIGURE 4.4C: GENERAL GOVERNMENT DEBT TO GDP RATIO, ACTUAL AND COUNTERFACTUAL SCENARIO



4.4 BEYOND 2015: POLICY REQUIREMENTS AND EXTENDED FISCAL PROJECTIONS

The requirement to bring the deficit to below 3 per cent of GDP by 2015 has been the focus of much recent fiscal policy discussion.[120] As 2015 nears and as the Programme ends, it will be increasingly important for the Government to set out its medium-term fiscal plans for 2016 and beyond. This would provide additional credibility for future policy actions, helping to support creditworthiness as the Government returns to the market, and greater certainty to consumers, businesses and the Government sector about future prospects.

The domestic and European fiscal rules provide a minimum standard for future policy, but it would be useful for the Government to articulate whether more ambitious goals should be set and what meeting these standards would actually imply in terms of policy. Of course, the actual size of required future measures will depend on such factors as future growth, interest rates and any realised costs associated with contingent liabilities. These risk factors were discussed in Chapter 2.

The *SPU 2013* outlined an illustrative scenario for key fiscal and economic variables to 2019. The authors of the scenario stressed that the policy assumptions underlying the scenario were purely illustrative and did not reflect policy decisions. The illustrative scenario assumed no discretionary tax changes (and thus tax revenues growing at the same rate as nominal GDP) and voted nominal

[120] This is a requirement under the Excessive Deficit procedure (EDP), which is part of the corrective arm of the SGP.

expenditure growing at an average of one per cent per annum, compared to assumed positive inflation of between one and two per cent. Key fiscal and economic outcomes associated with this scenario are reproduced in Annex J.

The scenario considered in *SPU 2013* would be consistent with compliance with all fiscal rules. In particular, in 2019 the structural budget balance is projected to show a surplus of one per cent of GDP (which compares with the Medium Term Objective (MTO) of a balanced structural budget), the General Government deficit shows a surplus of 0.8 per cent of GDP (well below the deficit ceiling for the corrective arm of the SGP), and the debt to GDP ratio is below the backward-looking benchmark of the SGP's new debt rule (see Chapter 3 for details on these rules).[121]

This section takes the Department of Finance's illustrative scenario as a baseline and then examines the implications of alternative policy stances using the Council's Fiscal Feedbacks model.[122]

One feature of the Department's scenario in *SPU 2013* is that it involves a quite uneven adjustment of the structural balance across different years, and also leads to overachievement of the required structural balance under the MTO set for Ireland under the preventive arm of the SGP and the domestic Budgetary Rule.[123]

Two alternative policy scenarios associated with a smoother adjustment path for the structural balance are examined: improvements of 0.5 percentage points of GDP per year and 0.75 percentage points of GDP per year. The results are recorded in Figure 4.5 and Figure 4.6. An adjustment of 0.5 percentage points per year in the structural balance would still leave an estimated structural deficit of roughly 1 per cent of GDP in 2019 (and thus fail to meet the MTO).

[121] It should be noted that the Department of Finance has recently revised its estimates and projections for the output gap, which will have implications for estimates and projections of the structural budget balance (see Chapter 3). As a revised longer-term scenario is not yet available, this section uses the *SPU 2013* illustrative scenario as a baseline. Recognising that the revised output gap estimates will, all else equal, lower the projected structural deficit, the requirement to achieve a structural budget balance would be achieved earlier than in the illustrative scenario. All else equal, this would raise the feasible expenditure increases in the later years of the scenario under the assumption of minimal compliance with all fiscal rules.

[122] The Fiscal Feedbacks model implicitly assumes an exogenous path for the GDP deflator (or equivalently no output gap term in the Philips curve for GDP deflator inflation), so that changes in the nominal growth rate are equal to changes in the real growth rate.

[123] The illustrative scenario in the *SPU 2013* projects that the structural balance will improve by 0.5 percentage points of GDP in 2016, 0.7 percentage points of GDP in 2017, 1.3 percentage points of GDP in 2018, and 1.4 percentage points of GDP in 2019.

An adjustment of 0.75 percentage points per year would bring the structural deficit to roughly zero. The 3 per cent deficit limit and the debt rule are complied with under both policy scenarios.

Figures 4.5 and 4.6 also show the level of nominal discretionary budgetary adjustments required to meet the target for the adjustment in the structural budget deficit (see panel f in each figure). For the illustrative scenario in *SPU 2013*, the required discretionary adjustment is equal to the increase in nominal primary expenditure (excluding unemployment benefit costs) given the assumption of no change in tax rates.[124] For the other policy scenarios, the additional discretionary adjustment required to reach the alternative targets for the change in the structural balance is calculated using the Fiscal Feedbacks model.[125]

In the three scenarios considered, required discretionary adjustments generally turn negative in 2016. In other words, the simulations suggest that modest increases in nominal discretionary expenditure are feasible post-2015 consistent with compliance with the fiscal rules. However, the extent of the tightness of the fiscal stance should not be underestimated given the assumed positive inflation of between 1 and 2 per cent per year over the period 2016 to 2019.

On the assumption that tax rates remain unchanged, we can calculate the implied feasible percentage increases in nominal and real primary expenditure (excluding cyclical unemployment benefit expenditures).[126] These are shown in Table 4.1. It must be underlined that the results are based on specific assumptions relating to growth and other contingencies. However, if these assumptions are met, these scenarios indicate that the most difficult phase of the fiscal adjustment should be broadly complete in 2015/2016.

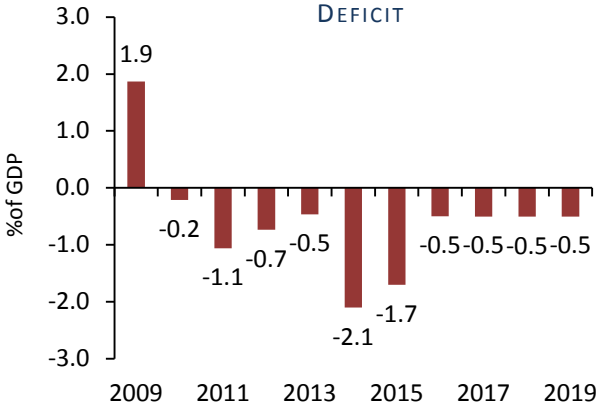
[124] This assumes that there is no feedback other than through the cost of unemployment benefits from the state of the economy to the level of primary expenditure. In other words, the actual change in primary expenditure (excluding unemployment benefits) is assumed to be equal to the discretionary change in primary expenditure (excluding unemployment benefits).

[125] The required discretionary adjustment under each alternative policy scenario is equal to the required adjustment under the baseline in *SPU 2013* and any additional adjustment (potentially negative) due to the change in policy assumption relative to the baseline.

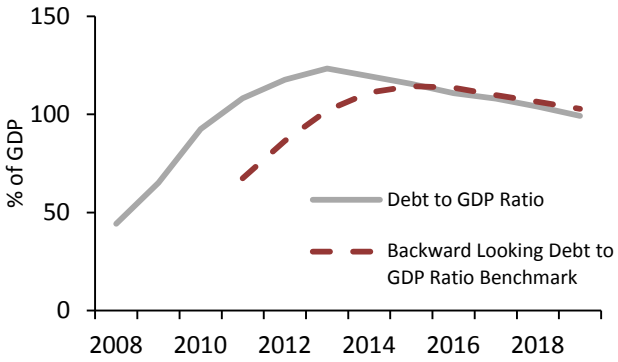
[126] The GDP deflator is used to infer projected increases in real expenditure. Projections of the inflation rate (as measured by the consumer price index) out to 2019 were not provided in *SPU 2013*.

FIGURE 4.5: ASSUMED ANNUAL ADJUSTMENT IN STRUCTURAL DEFICIT = 0.5 PERCENTAGE POINTS, 2016 – 2019. ALL OTHER ASSUMPTIONS ARE AS IN *SPU 2013* ILLUSTRATIVE SCENARIO

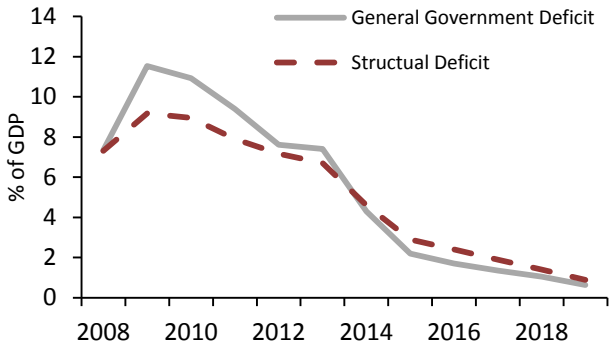
a. CHANGE IN STRUCTURAL BUDGET DEFICIT



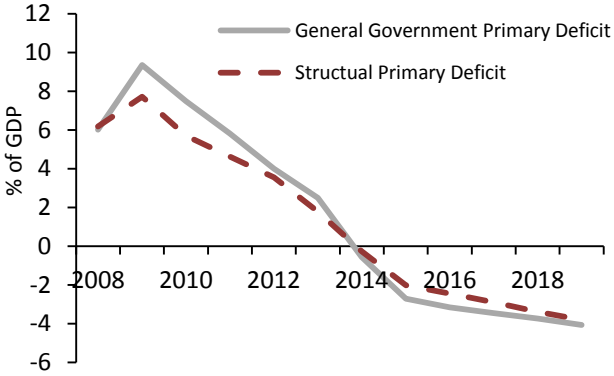
b. DEBT TO GDP RATIO



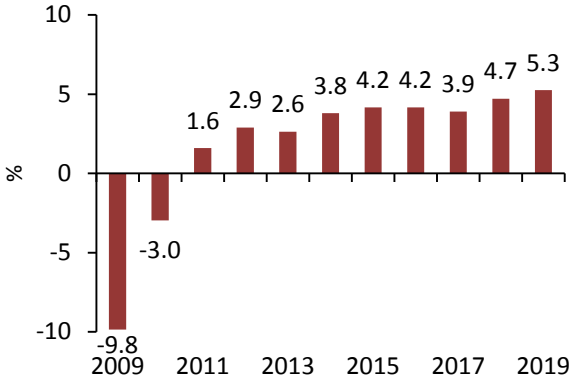
c. ACTUAL AND STRUCTURAL DEFICIT



d. ACTUAL AND STRUCTURAL PRIMARY DEFICIT



e. NOMINAL GROWTH RATE



f. REQUIRED DISCRETIONARY ADJUSTMENT

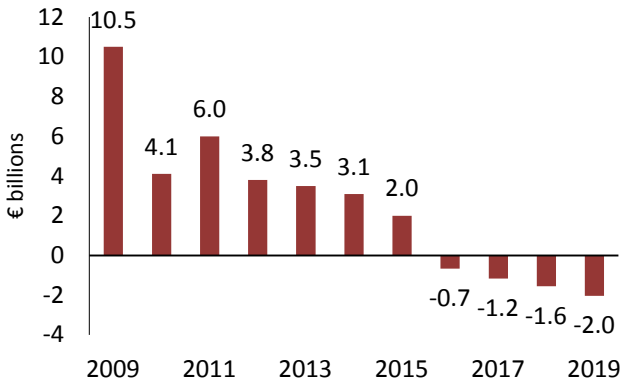
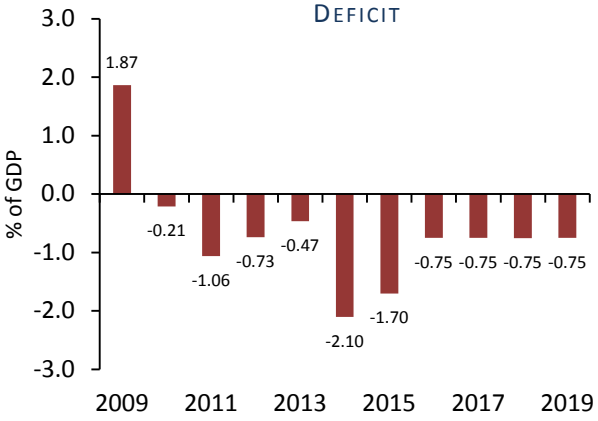
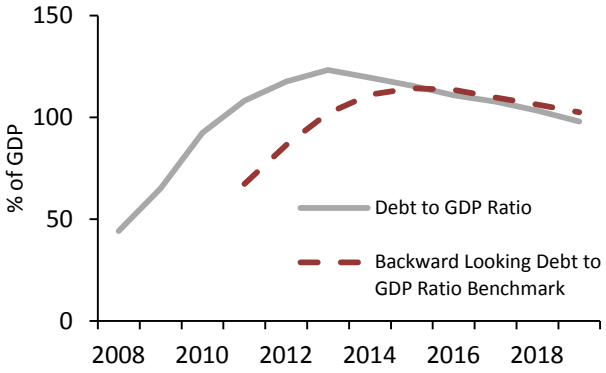


FIGURE 4.6: ASSUMED ANNUAL ADJUSTMENT IN STRUCTURAL DEFICIT = 0.75 PERCENTAGE POINTS, 2016 – 2019. ALL OTHER ASSUMPTIONS ARE AS IN *SPU 2013* ILLUSTRATIVE SCENARIO

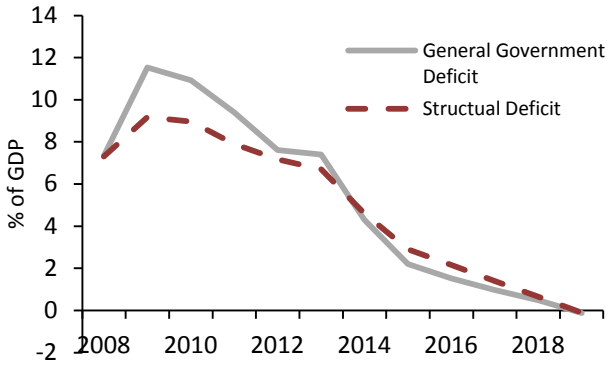
a. CHANGE IN STRUCTURAL BUDGET DEFICIT



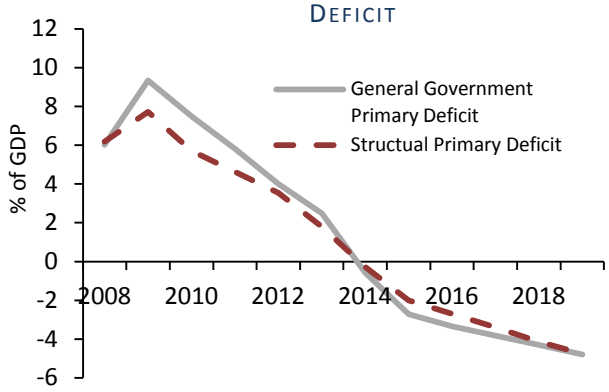
b. DEBT TO GDP RATIO



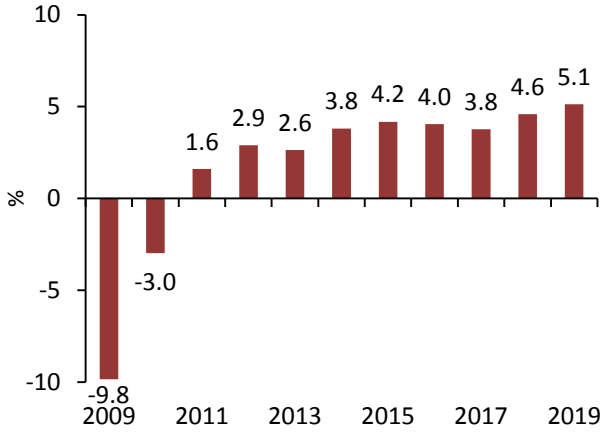
c. ACTUAL AND STRUCTURAL DEFICIT



d. ACTUAL AND STRUCTURAL PRIMARY DEFICIT



e. NOMINAL GROWTH RATE



f. REQUIRED DISCRETIONARY ADJUSTMENT

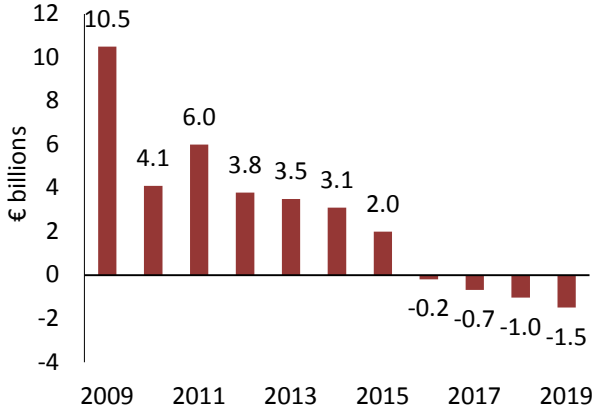


TABLE 4.1: FEASIBLE PRIMARY EXPENDITURE INCREASES FOR 2016-2019: STABILITY PROGRAMME UPDATE 2013 ILLUSTRATIVE SCENARIO AND ALTERNATIVE POLICY SCENARIOS

Feasible Primary Expenditure Growth, Percentage Changes (Excluding cyclical unemployment benefit costs)	2016	2017	2018	2019
SPU 2013 "Illustrative Scenario" Baseline				
Nominal	1.1	1.3	-0.1	0.1
Real	-0.3	-0.2	-1.4	-1.2
0.5 Percentage Point Per Annum Reduction in Structural Balance				
Nominal	1.1	2.0	2.6	3.3
Real	-0.3	0.5	1.3	2.0
0.75 Percentage Point Per Annum Reduction in Structural Balance				
Nominal	0.3	1.1	1.7	2.5
Real	-1.1	-0.4	0.4	1.2

Source: SPU 2013 and IFAC calculations.

Note: Calculations do not reflect post-SPU revisions to projected structural balances (see Chapter 3). These revisions suggest that, all else equal, a structural budget balance (Ireland's Medium-term Objective) will be achieved earlier than projected in *SPU 2013*. This could allow for larger feasible percentage expenditure increases in the later years of the projection period than identified above.

4.5 BEYOND THE BAILOUT: REDUCING THE FRAGILITY OF IRELAND'S CREDITWORTHINESS

4.5.1 INTRODUCTION

As Ireland's programme of official funding assistance nears its end, and the recent success in issuing bonds at affordable yields indicates a return to market access, attention has turned to what needs to be done to ensure that the return to market access is sustained. The background to this policy discussion includes the revealed fragility of creditworthiness for countries with high deficits and debts within the EMU. The absence of a domestic central bank capable of acting as lender of last resort to Government has been shown to leave a country's capacity to borrow from market sources quite vulnerable (see, e.g., DeGrauwe, 2011). Ireland's recent return to market access has resulted from a positive interaction between its demonstration of economic and political capacity to adjust an unsustainable fiscal stance – including meeting the conditions for official funding support – together with improvements in systems for providing that support. These improvements include the establishment of a permanent Euro Area bailout fund (the European Stability Mechanism (ESM)) and a weakening of demands for official-creditor seniority. Indications are that

the ECB's introduction of its Outright Monetary Transactions (OMT) programme has further underpinned market confidence.

This section briefly reviews the components of a possible strategy to help ensure robust market access given current official support systems. (Policies to strengthen these support systems – for example, the introduction of some form of Eurobonds or a debt redemption fund – are not considered, although such policies could further reduce fragility.) It must be recognised that self-protection strategies involve both benefits and costs. The main benefit is the reduced susceptibility to funding crises and a brief discussion of the susceptibility to self-fulfilling funding crises is first provided. The nature of the costs will depend on the self-protection approach pursued. Three elements of a possible strategy to support robust market access are then discussed.

4.5.2 Self-Fulfilling Funding Crises: The Problem of Multiple Equilibria

Much of the recent literature on the fragility of creditworthiness within the Euro Area has focused on the possibility of multiple expectations-based equilibria (see, e.g., DeGrauwe, 2011; and Corsetti and Dedola (2013)). The classic "bad equilibrium" story focuses on the effects of fears of default on interest rates and consequent debt dynamics. Fears of default lead to a large risk premium on Government borrowing; the resulting high interest rate then worsens the country's debt dynamics, and validates the initial fears (see Calvo, 1988, for the classic multiple-equilibria model).

In Ireland's case, the relatively long average maturity of outstanding debt should have provided a degree of protection against a sudden shift to a bad equilibrium in 2010. However, another channel seems to have been at work. Fears that the country would enter a bailout programme, and that such a programme could come with a forced restructuring of privately held debt (with official lender seniority), made it difficult to access new borrowing, which itself would be subject to losses in the event of restructuring. Although there were real concerns about fundamental insolvency – in part due to the costs of the banking-system bailout – the concerns about the implications of a bailout for restructuring may have made fears of a bailout self-fulfilling in late 2010. Indeed, in Ireland's case, concerns relating to a forced restructuring appear to have grown over the first half of 2011 even as the average interest cost remained low due to access to official funding. A similar dynamic may have been present for Portugal, with the country losing market access in 2011 and also requiring a bailout programme. From mid-2011 onwards, perceptions of the nature of the evolving bailout/bail-in regime began to change, with the likelihood of a forced restructuring receding for countries that seemed capable of stabilising their debt dynamics. This stabilisation has

been reinforced by the announcement of the OMT programme by the ECB. Overall, there has been a dramatic fall in Irish yields as programme conditions have been consistently met.

4.5.3 Self-Protection Against Funding Crises: Elements of a Strategy

Although the evolving European lender-of-last resort regime should be less susceptible to the multiple equilibria problem than was the case in 2010/11, the uncertain domestic and international macroeconomic environments – and lingering doubts about the strength of the Euro Area's lender of last resort function – are likely to keep creditworthiness fragile. This raises the question of what countries can do in addition to stabilising their public finances to self-protect against a bad equilibrium.

A similar question was widely debated in emerging market economies following a series of crises that included Mexico (1994), East Asia (1997-98), Russia (1998), Brazil (1999) and Argentina (2002). A common feature of these crises was the existence of large amounts of short-term debt in foreign currency relative to foreign-currency reserves. This led to susceptibility to roll-over crises, where investors worried about the willingness of other investors to roll over loans, leading to a "run" on the country and a "sudden stop" of capital inflows. In the aftermath of these crises, many emerging market Governments adopted self-protection strategies to protect against such roll-over crises (Feldstein 1999; Chang and Velasco, 1999).

Three possible elements of a self-protection strategy against self-fulfilling liquidity crises in a Euro Area context can be considered.[127] In assessing the appropriate mix of elements, it is important to recognise that each element is costly, and the marginal cost of additional protection along each dimension is likely to rise with the level of protection already secured. The optimal strategy is therefore likely to involve a mix of the elements.

(i) Extend and Smooth the Maturity Structure of Outstanding Debt

It has long been recognised that a short and/or bunched maturity structure can increase the risk of a roll-over crisis (see, e.g., Alesina *et al.* 1990; and Giavazzi and Pagano, 1990). The basic idea is that the probability of falling into the type of bad equilibrium discussed above increases when a large amount of debt has to be refinanced in a short period of time, potentially quickly raising the average interest rate on outstanding debt. However, extending the maturity structure can also be

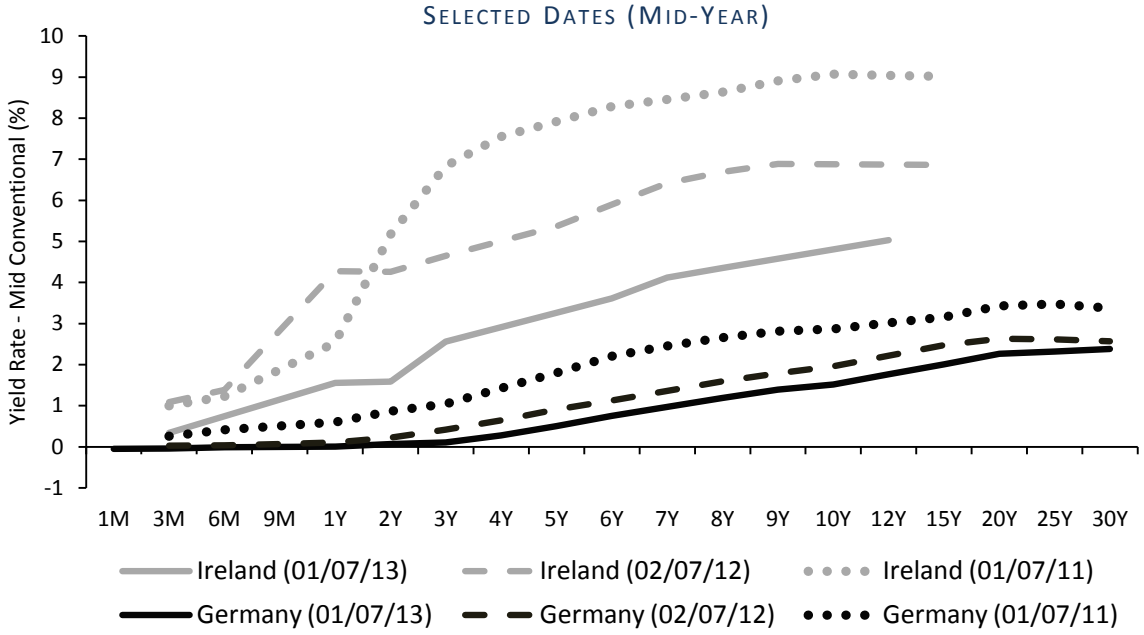
[127] Although Ireland borrows mainly in Euro, it shares with the crisis-affected emerging markets the fact that it is borrowing in a currency it does not control.

costly where the Government faces a term premium on longer-maturity debt (see Figure 4.7 for the Irish and German yield curve at selected points in time.)[128] One element of a strategy to reduce fragility is then to extend and smooth out the maturity structure, and also to limit the amount of debt that is maturing in the short to medium run, during which time funding markets are likely to remain volatile.[129] (See Figure 4.8 for the maturity structure of long-term and official debt following the June 2013 extension of EFSF loans). The marginal benefits of this self-protection strategy (reduced susceptibility to roll-over crises) must be weighed against the marginal costs (higher overall funding costs), and also compared to other available options for self protection.

[128] Different explanations have been given for the existence of such a term premium and the consequent relative costliness of longer-term debt. A term premium may simply result from investor preferences. Particular investors may have a preference – or "preferred habitat" – for a given part of the yield curve. This can lead to a segmented market with yields that are sensitive to relative supplies at different maturities. Increasing the relative supply of longer-maturity debt would then steepen the yield curve. In the context of bank funding, Diamond and Rajan (2001) emphasise the positive incentive effects of having a fragile short-maturity structure that must be rolled over frequently. Jeanne (2009) applies this idea of a short maturity structure as a commitment device to sovereign debt. Effectively, Governments on such a "short leash" have a stronger incentive to pursue fiscal policies that lowers investor risk. The term premium may rise as the Government deviates further from the optimal maturity structure from an incentive perspective. Another interesting explanation for a term premium is given by Alfaro and Kanczuk (2006). In the context of a model with imperfect information on the Government's type, they note that, conditional on the Government being viewed as a low-default type at present, the probability of the Government continuing to be a low-default type is higher in the near term than in the more distant future. This is based on the assumption that the probability of the current Government being in power is higher in the short term. This would again lead to a term premium and a consequent cost advantage to short-term debt.

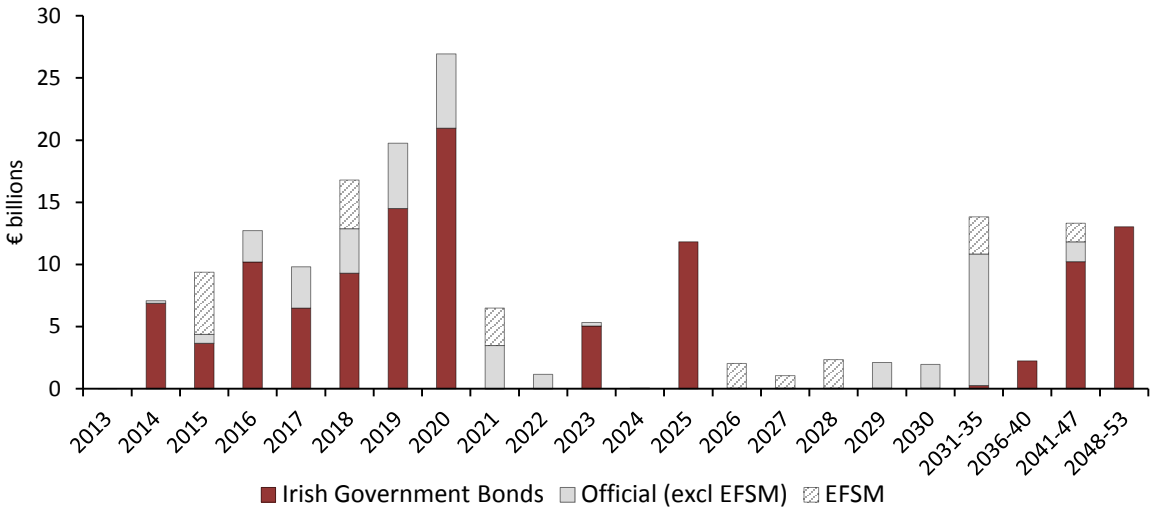
[129] It should be noted that an upward sloping yield curve does not necessarily imply the existence of a term premium. If it is expected that short-term rates will rise, the yield curve with slope upwards even without a term premium. The ECB is presently keeping short-term rates very low in the context of liquidity trap conditions. Although it has stated its expectation that short-term rates will remain low for some time under its new forward-guidance policy, short-term rates should rise as Euro Area economic conditions eventually normalise.

FIGURE 4.7: SOVEREIGN YIELD CURVES, IRELAND AND GERMANY, SELECTED DATES (MID-YEAR)



Source: NTMA and IFAC Calculations.

FIGURE 4.8: LONG-TERM AND OFFICIAL DEBT MATURITY[130]



Source: NTMA, end-October 2013.

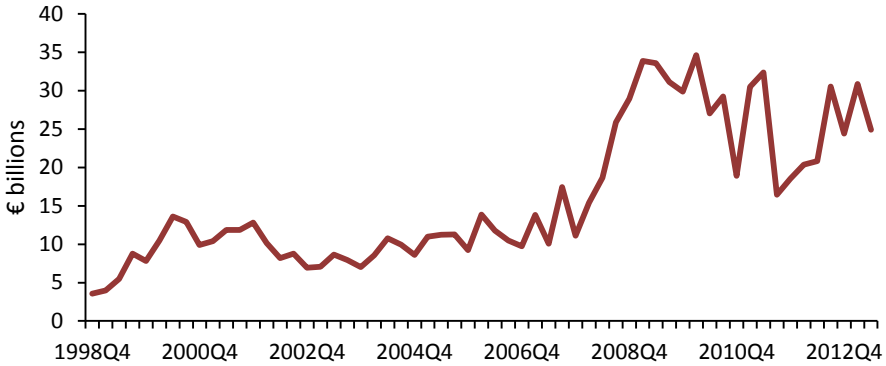
[130] Note: this figure reflects EFSM loan original maturity dates. As with EFSF loans, EFSM loans are also subject to a 7 year extension. While the revised maturity dates of individual EFSM loans will only be determined as they approach their original maturity dates, it is not expected that Ireland will have to refinance any of its EFSM loans before 2027.

(ii) Accumulate Cash Reserves

Rodrik (2006) documents the large increases in reserves held by emerging market economies following the sequence of crises of the 1990s and early 2000s. He also reviews evidence on the role that such reserve accumulation can play in crisis mitigation and prevention.

In preparation for a return to full market access, the NTMA has already accumulated significant cash reserves (see Figure 4.9). Compared to other European economies, these reserves are at a high level as a share of total financing requirements over the period to 2015 (see Figure 4.10).[131] Of course, such cash reserves come with a cost to the extent that the marginal interest rate on new borrowing is above the return on investments in the cash-like assets in which the reserves are held. The marginal cost of reserve accumulation is also likely to rise with the level of reserves to the extent that the interest spread on the resulting higher debt and the liquid assets worsens underlying debt dynamics.

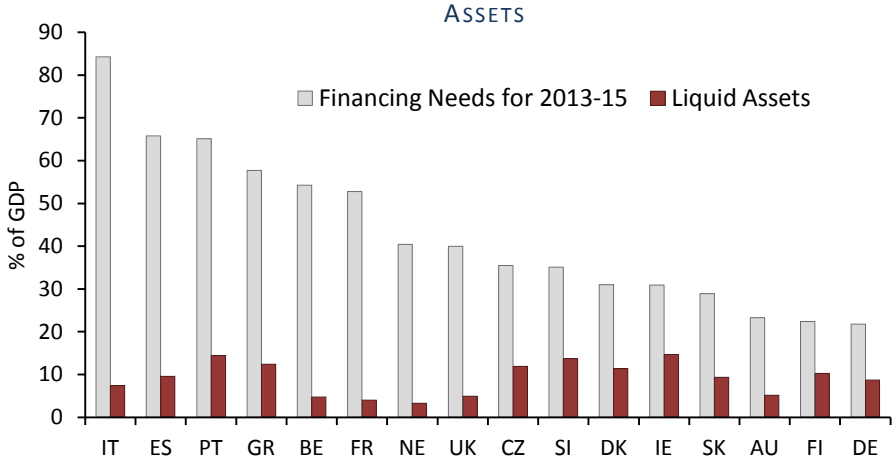
Figure 4.9: Government "Cash" Reserves: Currency and Deposits 1998Q4 to 2013Q2



Source: Eurostat, Quarterly Financial Accounts for General Government.

[131] It should be noted that Ireland has a significant amount of maturing debt post-2015. According to the NTMA, €86 billion of long-term and official debt matures between 2016 and 2020 (see footnote 130 regarding EFSM maturities).

FIGURE 4.10: MATURING DEBT AND LIQUID GOVERNMENT ASSETS



Source: Internal Calculations based on Eurostat and IMF data.

However, the existence of such balances also means that the Government should have more time to demonstrate its fundamental solvency before having to enter a programme that could involve restructuring privately held debt. This gives protection against sudden shifts in market sentiment, following, say, from contagion from a crisis flare-up in another Euro Area country. The current plan is to accumulate large cash reserves to ease the difficult transition back to full market access. However, the ongoing fragility of creditworthiness may mean that significant reserve holdings would be needed for a period of time, although the size of the optimal holdings will depend on the other elements of the self-protection strategy and macroeconomic developments.

(iii) NEGOTIATE PRECAUTIONARY FUNDING LINES WITH OFFICIAL LENDERS

The final potential element is access to a pre-arranged precautionary (conditional) credit line. The basic idea is that, provided the country is pursuing appropriate policies, official lenders agree in advance to meet specified funding needs if market access is lost. As discussed above, an important feature for such a credit line to be successful in avoiding a bad equilibrium is that a country meeting its conditions would not be forced to restructure existing privately held debt; or, at least, such restructuring would be subject to a high trigger.

The extent to which this self-protection strategy can be used is likely to be limited by the size of available credit lines. The marginal cost of such protection may also rise with the level of protection to the extent that larger lines come with higher fees and/or more conditions. Again, given a rising

marginal cost, such advance provision for liquidity support is likely to be just one element of an optimal diversified self-protection strategy.

As regards potentially available precautionary credit lines from official lenders, the ESM offers two precautionary facilities: the Enhanced Conditions Credit Line (ECCL) and (with more stringent qualifying conditions) the Precautionary Conditioned Credit Line (PCCL).[132] In addition to its Stand-By Arrangement (SBA),[133] the IMF also offers two precautionary credit lines: the Precautionary and Liquidity Line (PLL)[134] and (again with more stringent qualifying conditions) the Flexible Credit Line (FCL).[135]

Precautionary facilities would have come with conditions and monitoring. However, the conditions would have been likely to be broadly in line with commitments already in place under national and European fiscal rules. The Government is also planning to put in place a medium-term strategy to maintain reform momentum after the current programme ends. The elements of this strategy could have overlapped with any additional conditionality. Moreover, post-programme monitoring by the EU is set to take place in any case until 75 per cent of their programme loans have been repaid, with similar arrangements in effect with respect to IMF loans.[136]

Given a fragile international financial environment, the Council would thus have supported an application for a precautionary credit line as part of a broader self-protection strategy. Provided it had come with reasonable terms and conditions, such a facility would have provided valuable additional protection against any renewed funding pressures as Ireland exits the EU/IMF assistance programme. The Government announced its decision not to seek such a facility on November 14.

[132] For details, see: http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20precautionary%20financial%20assistance.pdf.

[133] For details, see: http://www.imf.org/external/np/exr/facts/sba.htm.

[134] For details, see: http://www.imf.org/external/np/exr/facts/pll.htm.

[135] For details, see: http://www.imf.org/external/np/exr/facts/fcl.htm.

[136] Confidence in Ireland's capacity to achieve sustained bond market access could further be reinforced through ECB commitments to support secondary market bond yields through its Outright Monetary Transactions (OMT) programme. A precautionary programme from the European Stability Mechanism (ESM) is one of the requirements for access to the OMT programme.

ANNEX A: FISCAL COUNCIL BENCHMARK PROJECTIONS 24 SEPTEMBER

As part of the endorsement process, the Council's Secretariat produced a set of benchmark projections in advance of its meetings with the Department of Finance. The benchmark projections were finalised on 24 September 2013 and are summarised in Annex Table A.1.

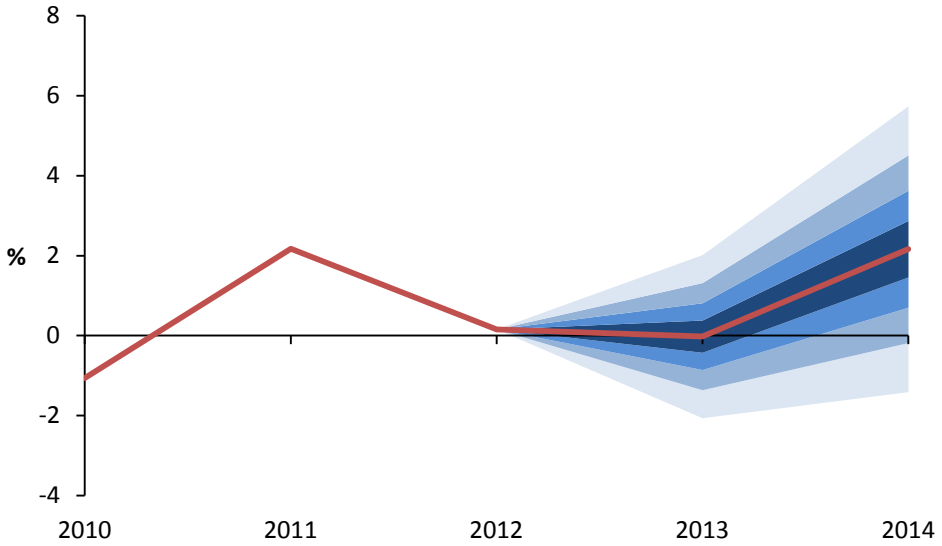
ANNEX TABLE A.1: BENCHMARK PROJECTIONS FOR 2013 AND 2014

% change unless otherwise stated	2013	2014
Real GDP	0.0	2.2
Consumption	-0.4	0.4
Investment	6.4	5.4
Government	-2.0	-2.0
Stock change (% of GDP)	0.1	0.0
Exports	0.6	4.3
Imports	0.9	3.4
Current Account (% GDP)	3.1	3.5
Employment	1.9	1.5
Unemployment Rate (%)	13.8	13.3
HICP	0.8	1.1
GDP Deflator	0.9	1.4
Nominal GDP (€ billions)	165.4	171.4
Nominal GDP	0.9	3.6

Note: Benchmark projections were finalised on 24 September 2013.

The Council's endorseable range is informed by, but not mechanically linked to, the uncertainty captured in fan chart analysis. For context, Annex Figure A.1 shows the benchmark projections with the standard fan chart constructed around it.

ANNEX FIGURE A.1: REAL GDP FAN CHART BASED ON BENCHMARK PROJECTIONS[137]



[137] Fan chart range based on historic forecast errors over the period 1990-2012. For more discussion on fan charts, see IFAC, 2012b, "Annex A Fan Charts to Represent Forecast Uncertainty", available at: http://www.fiscalcouncil.ie/wp-content/uploads/2012/09/AnnexA4.pdf

ANNEX B: MACROECONOMIC FORECASTS ENDORSED BY THE COUNCIL

ANNEX TABLE B.1: DEPARTMENT OF FINANCE *BUDGET 2014* PROVISIONAL FINAL FORECASTS

% change unless otherwise stated	2013	2014
Real GDP	0.2	1.8
Consumption	-0.2	1.1
Investment	4.9	6.8
Government	-0.9	-1.9
Stock change (% of GDP)	0.4	0.3
Exports	-0.6	1.9
Imports	-0.4	1.4
Current Account (% GDP)	4.4	4.1
Employment	1.6	1.4
Unemployment Rate (%)	13.5	12.6
HICP	0.7	1.5
GDP Deflator	0.9	0.9
Nominal GDP (€ billions)	165.9	170.4
Nominal GDP	1.2	2.7

ANNEX C: MACROECONOMIC FORECAST TABLES

ANNEX TABLE C.1: DEPARTMENT OF FINANCE MACROECONOMIC FORECASTS FOR 2012 VERSUS THE OUTTURN FOR 2012

% change unless otherwise stated	*Budget 2013*	*SPU 2013*	*Budget 2014*	Outturn
	Dec 2012	Apr 2013	Oct 2013	CSO
Real GDP	0.9	0.9	0.2	0.2
Real GNP	1.4	3.4	1.8	1.8
Consumption	-2.0	-0.9	-0.3	-0.3
Investment	-3.8	1.2	-1.0	-1.0
Government	-4.0	-3.7	-3.7	-3.7
Exports	3.0	2.9	1.6	1.6
Imports	0.0	0.3	0.0	0.0
Current Account (% GDP)	3.4	4.9	4.4	4.4
Employment	-0.7	-0.6	-0.7	-0.6
Unemployment Rate (%)	14.9	14.7	14.7	14.7
HICP	2.1	2.0	2.0	2.0
GDP Deflator	1.7	2.0	0.6	0.6
Nominal GDP (€ billions)	163.2	163.6	163.9	163.9
Nominal GDP	2.6	2.9	0.8	0.8
Nominal GNP (€ billions)	130.9	NA	132.7	132.6
Nominal GNP	3.0	NA	1.5	1.5

ANNEX TABLE C.2: DETAILED MACROECONOMIC FORECASTS FOR 2013

% change unless otherwise stated	*Budget 2014*	ESRI	CBI	IMF	EC	OECD
	Oct 2013	Oct 2013	Oct 2013	Oct 2013	Nov 2013	Nov 2013
Real GDP	0.2	0.5	0.5	0.6	0.3	0.1
Real GNP	1.0	2.0	0.1	0.3	NA	NA
Consumption	-0.2	0.2	-0.4	-0.3	-0.6	-1.1
Investment	4.9	0.7	1.6	2.0	2.9	-7.8
Government	-0.9	-0.7	-1.5	-0.6	-1.0	-0.9
Exports	-0.6	0.0	0.8	1.1	0.5	0.1
Imports	-0.4	-0.1	0.4	0.6	0.2	-0.3
Current Account (% GDP)	4.4	5.6	4.5	2.3	4.1	4.3
Employment	1.6	1.9	1.1	0.6	1.2	1.4
Unemployment Rate (%)	13.5	13.6	13.6	13.7	13.3	13.6
HICP	0.7	0.9	0.6	1.0	0.8	0.6
GDP Deflator	0.9	1.3	1.2	1.0	0.7	NA
Nominal GDP (€ billions)	165.9	166.9	166.7	166.6	165.6	NA
Nominal GDP	1.2	1.8	1.7	1.6	1.0	NA

ANNEX TABLE C.3: DETAILED MACROECONOMIC FORECASTS FOR 2014

% change unless otherwise stated	*Budget 2014*	ESRI	CBI	IMF	EC	OECD
	Oct 2013	Oct 2013	Oct 2013	Oct 2013	Nov 2013	Nov 2013
Real GDP	2.0	2.6	2.0	1.8	1.7	1.9
Real GNP	1.7	2.7	1.2	1.3	NA	NA
Consumption	1.8	1.5	0.4	0.5	0.5	0.8
Investment	6.8	4.2	6.6	4.0	4.4	5.9
Government	-1.9	-1.3	-2.8	-2.8	-2.8	-1.9
Exports	1.9	4.6	4.0	2.9	2.5	3.7
Imports	1.5	4.0	3.1	1.9	1.4	2.5
Current Account (% GDP)	4.0	6.7	5.0	3.0	4.6	3.9
Employment	1.5	1.3	1.2	0.9	1.3	0.5
Unemployment Rate (%)	12.4	13.1	13.0	13.3	12.3	13.2
HICP	1.2	1.6	0.7	1.2	0.9	0.8
GDP Deflator	0.8	1.2	1.2	1.2	0.8	NA
Nominal GDP (€ billions)	170.6	173.4	172.2	171.6	169.7	NA
Nominal GDP	2.9	3.9	3.3	3.0	2.5	NA

ANNEX TABLE C.4: DETAILED MACROECONOMIC FORECASTS FOR 2015

% change unless otherwise stated	*Budget 2014*	IMF	EC	OECD
	Oct 2013	Oct 2013	Nov 2013	Nov 2013
Real GDP	2.3	2.5	2.5	2.2
Real GNP	1.7	2.0	NA	NA
Consumption	1.2	1.0	1.0	0.7
Investment	5.9	5.0	5.4	5.9
Government	-1.5	-2.5	-2.5	-1.5
Exports	2.7	4.0	3.7	3.9
Imports	2.1	3.0	2.7	3.4
Current Account (% GDP)	3.8	3.1	4.9	3.4
Employment	1.3	1.7	1.3	1.4
Unemployment Rate (%)	11.8	12.8	11.7	12.3
HICP	2.0	1.4	1.2	1.0
GDP Deflator	1.4	1.4	1.1	NA
Nominal GDP (€ billions)	177.0	178.4	175.9	NA
Nominal GDP	3.7	4.0	3.6	NA

ANNEX TABLE C.5: DETAILED MACROECONOMIC FORECASTS FOR 2016

% change unless otherwise stated	*Budget 2014*	IMF
	Oct 2013	Oct 2013
Real GDP	2.8	2.5
Real GNP	2.1	2.1
Consumption	1.1	1.3
Investment	5.1	6.0
Government	0.2	0.3
Exports	4.2	4.1
Imports	3.5	3.9
Current Account (% GDP)	3.7	3.3
Employment	1.3	1.7
Unemployment Rate (%)	11.4	12.4
HICP	2.0	1.6
GDP Deflator	1.5	1.6
Nominal GDP (€ billions)	184.7	185.8
Nominal GDP	4.4	4.1

ANNEX D: DEPARTMENT OF FINANCE BUDGETARY FORECASTS IN 2012

In October 2013, the CSO published updated annual figures for the Government finances up to 2012. The General Government deficit in 2012 was revised up to €13.5 billion (from €12.5 billion) mainly on account of a change in the recording of sales of mobile telephone licences.[138]

In Table D.1, the revised General Government data are shown relative to recent Department of Finance forecasts. The budget deficit was revised significantly between *Budget 2013* and *SPU 2013* mainly on account of upward revisions to the main revenue headings. The Council in its previous *Fiscal Assessment Report* had signalled the fact that Government revenues in 2012 had been consistently underestimated by the Department (IFAC, 2013a).

General Government expenditure in 2012 was relatively close to Department of Finance forecasts. However, this masked divergences within categories with interest and investment expenditures overestimated with social payments underestimated.

Over the course of 2012, the forecast for the level of the General Government debt was revised upwards by just under €6 billion reflecting borrowing by the NTMA in the bond markets and subsequent accumulation of liquid assets. Headline deficit and debt ratios were helped by an upward revision to nominal GDP.

[138] Initially (in April 2013), the CSO had recorded sales of mobile phone licences in 2012. Following clarification from Eurostat, sales of €723 million were moved from 2012 into 2013. See *CSO 2013, Government Finance Statistics*, October.

Annex Table D.1: Department of Finance General Government Projections for 2012

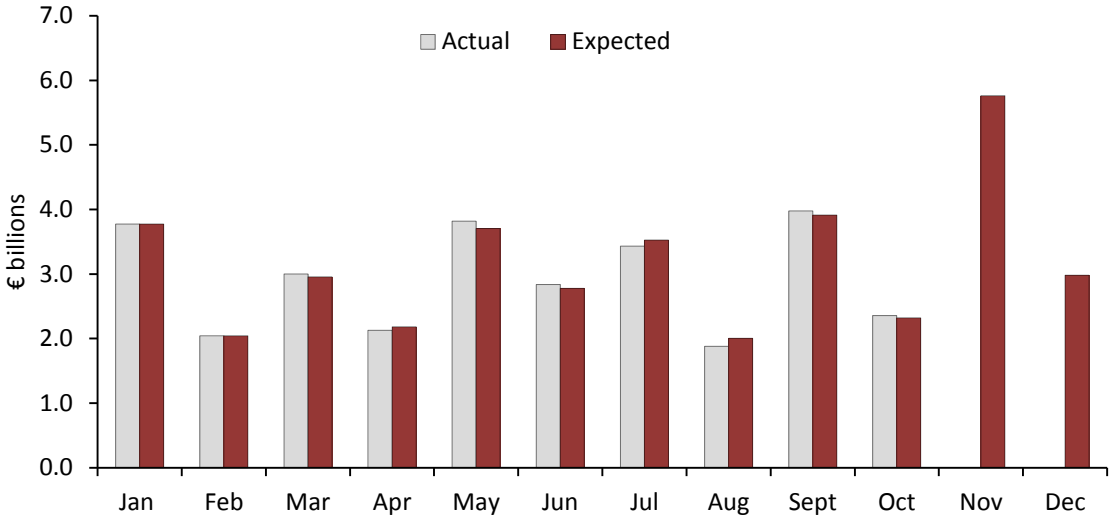
€ Billions	*SPU 2012*	*Budget 2013*	*SPU 2013*	*CSO Outturn*
	Apr 2012	Dec 2012	Apr 2013	Oct 2013
General Government Deficit	**13.1**	**13.3**	**12.5**	**13.5**
General Government Deficit, % of GDP [139]	**8.3**	**8.2**	**7.6**	**8.2**
Revenue	56.9	55.7	56.6	56.5
Taxes	38.9	39.3	39.7	39.5
Social Contributions	9.9	9.3	9.5	9.7
Other	8.1	7.1	7.4	7.3
Expenditure	70.1	69.1	69.1	69.8
Government Services	26.5	27.6	27.3	27.2
Social Payments	27.5	27.0	28.7	29.0
Interest	6.5	6.3	6.1	5.9
Investment	4.0	3.6	3.3	3.1
Other	5.6	4.5	3.6	4.7
General Government Debt	186.7	191.9	192.5	192.5
General Government Debt, % of GDP	117.5	117.6	117.6	117.4
Nominal GDP	158.9	163.2	163.6	163.9

Sources: SPU 2012, Budget 2013, SPU 2013 and CSO.

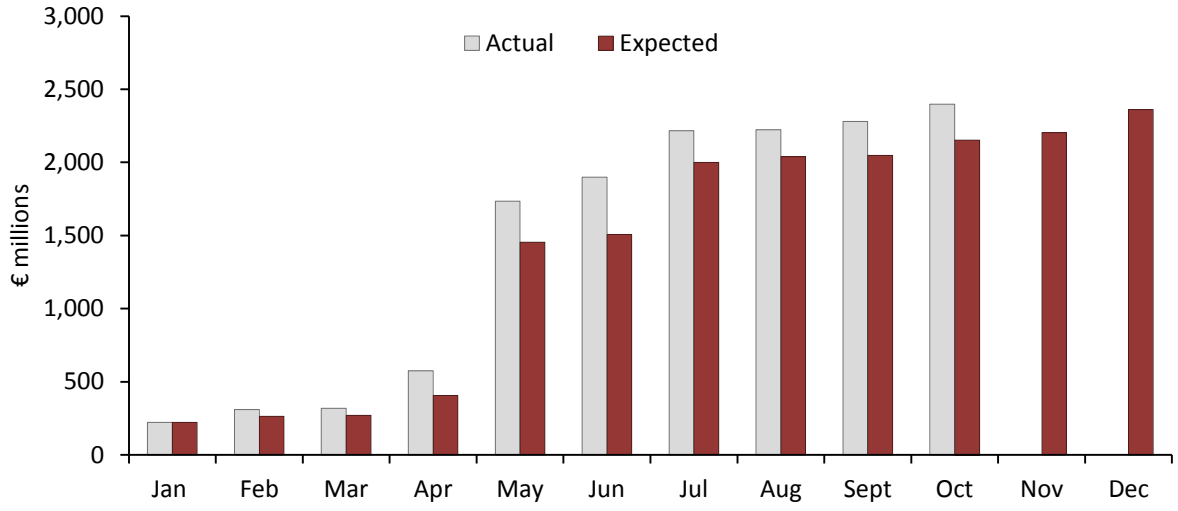
[139] The Excessive Deficit Procedure (EDP) General Government deficit ceiling for Ireland in 2012 was 8.6 per cent of GDP.

ANNEX E: EXCHEQUER DATA IN 2013

ANNEX FIGURE E.1: MONTHLY TAX REVENUE PROFILE IN 2013: EXPECTED VS ACTUAL



ANNEX FIGURE E.2: EXCHEQUER NON-TAX REVENUE



ANNEX F: DEPARTMENT OF FINANCE BUDGETARY OUTLOOK TO 2016

ANNEX TABLE F.1: DEPARTMENT OF FINANCE GENERAL GOVERNMENT PROJECTIONS FOR 2014

€ Billions	*Budget 2013* Dec 2012	*SPU 2013* Apr 2013	*Budget 2014* Oct 2013
General Government Deficit	**8.9**	**7.5**	**8.2**
General Government Deficit, % of GDP	**-5.1**	**-4.3**	**-4.8**
Structural Deficit, % of GDP	**5.9**	**4.6**	**3.6**
Primary Deficit, % of GDP	**-0.6**	**-0.5**	**0.0**
Revenue	**60.3**	**61.4**	**60.9**
Tax	44.0	44.8	43.8
Indirect Taxes	19.3	19.9	19.2
Direct Taxes	23.9	24.1	23.6
Capital Taxes	0.8	0.8	1.0
Social Contributions	10.1	10.1	10.3
Other	6.3	6.5	6.8
Expenditure	**69.4**	**69.1**	**69.1**
Government Services	26.5	26.2	26.6
Compensation of Employees	18.2	17.8	18.4
Intermediate Consumption	8.3	8.4	8.1
Social Transfers	25.7	27.8	27.9
Interest	9.7	8.5	8.2
Subsidies	0.5	0.4	1.3
Capital Transfers			1.1
Investment	2.6	3.1	2.6
Other	4.4	3.1	1.4
Primary Expenditure	59.7	60.6	60.9
General Government Debt	**209.2**	**208.2**	**204.7**
General Government Debt, % of GDP	**120.2**	**119.5**	**120.0**
Nominal GDP	**174.1**	**174.3**	**170.6**
Nominal GDP Growth, %	**3.8**	**3.8**	**2.8**
Average Interest Rate	**4.8**	**4.1**	**4.0**

ANNEX TABLE F.2: DEPARTMENT OF FINANCE GENERAL GOVERNMENT PROJECTIONS FOR 2015

€ Billions	*Budget 2013* Dec 2012	*SPU 2013* Apr 2013	*Budget 2014* Oct 2013
General Government Deficit	**-5.4**	**-4.0**	**-5.3**
General Government Deficit, % of GDP	**-3.0**	**-2.2**	**-3.0**
Revenue	**63.1**	**64.0**	**63.3**
Tax	46.6	47.1	46.0
Indirect Taxes	19.9	20.8	20.3
Direct Taxes	25.8	25.9	25.2
Capital Taxes	0.9	0.4	0.5
Social Contributions	10.3	10.2	10.6
Other	6.2	6.7	6.8
Expenditure	**68.4**	**68.0**	**68.7**
Government Services	25.7	25.1	26.4
Compensation of Employees	17.8	16.8	18.1
Intermediate Consumption	7.8	8.3	8.4
Social Transfers	25.5	27.5	26.6
Interest	10.0	8.9	8.8
Subsidies	0.4	0.4	1.3
Capital Transfers			1.1
Investment	2.6	3.1	2.6
Other	4.3	3.0	1.9
Primary Expenditure	58.4	59.1	59.9
General Government Debt	**211.9**	**209.7**	**209.7**
General Government Debt, % of GDP	**116.8**	**115.5**	**118.5**
Nominal GDP	**181.4**	**181.6**	**177.0**
Nominal GDP Growth, %	**4.2**	**4.2**	**3.7**
Average Interest Rate	**4.8**	**4.3**	**4.3**

ANNEX TABLE F.3: DEPARTMENT OF FINANCE GENERAL GOVERNMENT PROJECTIONS FOR 2016

€ Billions	*SPU 2013* Apr 2013	*Budget 2014* Oct 2013
General Government Deficit	**-3.2**	**-4.4**
General Government Deficit, % of GDP	**-1.7**	**-2.4**
Revenue	**65.8**	**65.2**
Tax	48.7	47.8
Indirect Taxes	21.2	20.9
Direct Taxes	27.0	26.4
Capital Taxes	0.4	0.4
Social Contributions	10.4	10.8
Other	6.7	6.6
Expenditure	**69.0**	**69.6**
Government Services	25.5	26.6
Compensation of Employees	16.9	18.1
Intermediate Consumption	8.6	8.6
Social Transfers	27.6	26.8
Interest	9.2	9.2
Subsidies	0.4	1.3
Capital Transfers		1.1
Investment	3.3	2.6
Other	3.1	2.0
Primary Expenditure	59.8	60.4
General Government Debt	**209.5**	**211.6**
General Government Debt, % of GDP	**110.8**	**114.6**
Nominal GDP	**189.1**	**184.7**
Nominal GDP Growth, %	**4.2**	**4.4**
Average Interest Rate	**4.4**	**4.4**

ANNEX G: FISCAL TRANSPARENCY

The degree of fiscal transparency in Ireland is of central importance to IFAC's statutory roles of assessing official forecasts and the appropriateness of the fiscal stance. This annex provides details on important recent developments in this regard: the first section summarises the main findings from a pilot fiscal transparency assessment carried out by the IMF as part of the revision of its Fiscal Transparency Code while the second section documents recent key improvements in Ireland's fiscal reporting that address some of the concerns raised in the IMF report.

THE IMF'S FISCAL TRANSPARENCY ASSESSMENT FOR IRELAND

In July 2013, the IMF published the outcome of a pilot *Fiscal Transparency Assessment for Ireland*. The objective of the assessment was to "...evaluate Ireland's fiscal reporting, forecasting and budgeting, and fiscal risks analysis and management practices against the standards set by the IMF's newly revised Fiscal Transparency Code." Following substantial improvements in recent decades, Ireland scores well on fiscal reporting and forecasting but is weaker in terms of fiscal risk disclosure. Key findings of the report are summarised below along with some of its recommendations.

FISCAL REPORTING

- Fiscal reporting in Ireland is relatively frequent, reliable and comprehensive, independently produced and subject to external audit.
- Although there is a high degree of disclosure, Ireland's fiscal reporting suffers from fragmentation. Issues include differences between in-year and annual fiscal reports in terms of institutional coverage, accounting basis (cash versus accrual) and classification standards (only annual reports are ESA-95 based).
- Coverage of institutions and public sector assets and liabilities is found overall to be good, although public corporations are not included in the Finance Accounts and fiscal statistics and fiscal reports include relatively little consolidated balance sheet information.
- Key recommendations focus on expanding the coverage of fiscal reports, both in terms of the institutions included and the assets and liabilities recognised, and increasing the use of accrual accounting and modern classification standards.

FISCAL FORECASTING AND BUDGETING

- Fiscal forecasting and budgeting practices are found to either be good or advanced in most areas. Budget documentation sets out clearly the impact of new policies and contains detailed distributional analysis.
- There is a lack of comprehensiveness in the annual budget documentation that focuses on Exchequer cash revenues and expenditures, however, resulting in activities of entities such as the National Pension Reserve Fund (NPRF) not being included in the budget estimates laid before Parliament.
- While the budget documentation provides a reconciliation between the Exchequer Balance and the General Government Balance, no such information is provided on the relationship between Exchequer and General Government revenue and expenditure aggregates. This is particularly relevant in terms of compliance with the medium-term expenditure rule introduced in the *Fiscal Responsibility Act*s 2012 and 2013.
- The macroeconomic forecasts behind the fiscal forecasts are presented clearly in the Budget documentation, and while macro forecast errors have tended to be large, they are relatively unbiased.
- Expenditure discipline appears to have benefited from the introduction of a medium-term expenditure framework following the crisis.
- While there is some reconciliation on the expenditure side between the fiscal forecasts provided at different points in time, no such breakdown is provided on the revenue side or for the overall balance.
- Comprehensive long-term fiscal projections are not published and analysis of long-term fiscal stability is lacking. This is particularly worrying given Ireland's demographic profile and relatively high Government debt levels.
- Key recommendations highlight the need for regularly published long-term fiscal projections and detailed reconciliation of changes to fiscal forecasts.

FISCAL RISK ANALYSIS AND MANAGEMENT

- Fiscal risk analysis and management meets only the basic standards of the Fiscal Transparency Code for most principles.
- The importance of fiscal risk analysis and management in Ireland is underscored by relatively large fiscal risks and lack of room to accommodate shocks given the high level of Government debt.
- The value of the information published on fiscal risks is diluted by the fact that it is fragmented – published in many separate documents across many agencies. Moreover, much of the information is reported by agencies other than the Departments responsible for fiscal management (Department of Finance and the Department of Public Expenditure and Reform).
- Analysis of macroeconomic risks is reported to meet advanced practice when the analysis published in reports by Department of Finance and IFAC is considered jointly. The analysis of specific risks, such as those relating to contingent liabilities, the values of the Government's assets and liabilities and particular factors such as the impact of the "patent cliff" on tax revenues, meets only the basic standard.
- Small amounts for contingencies are included in Ireland's Budget but there are no published criteria for their use.
- The NTMA publishes information on the risks associated with Government liabilities, a strategy for managing the financial assets of the NPRF and the currency composition and maturity profile of the national debt. However, there is no report that publishes consolidated information on the assets and liabilities managed by the NTMA, risk analysis of that portfolio and a strategy for their management.
- The main recommendations relating to fiscal risk analysis and management are the publication of an annual comprehensive statement on fiscal risks as part of budget documentation and an annual report on the Government's strategy for managing its portfolio of assets and liabilities.

The report concludes that Ireland is "...approaching international best practice in fiscal reporting and meets the basic requirements for fiscal risk disclosure under the IMF's Fiscal Transparency Code". The Government's ambitious plans to make further improvements are acknowledged and it is noted that, given the existing high degree of fiscal disclosure, much progress can be made at

relatively low cost by consolidating and publishing existing information into a comprehensive set of public sector financial statements.

Improvements in Fiscal Reporting in 2013

In parallel with the preparation of the IMF report, a number of important developments in fiscal reporting have taken place in Ireland over the past twelve months. These developments go some way in addressing concerns raised by the IMF report as well as in previous *Fiscal Assessment Reports* by the Council.

Traditionally, the monthly Exchequer statement published by the Department of Finance was the main source of regular information on the public finances. This data relates to receipts and expenditures of central Government, with data recorded on a cash (as opposed to accruals) basis. The Exchequer statements showed net spending by Government Departments (gross spending less appropriations-in-aid (A-in-As)).

In October 2012, the Departments of Finance and Public Expenditure and Reform began publishing the Analytical Exchequer Statement (AES) in conjunction with the normal monthly release. The AES shows expenditure (and revenue) on a gross basis as well as expenditure by the Social Insurance Fund (SIF) and National Training Fund (NTF). It also shows the monthly outturn for A-in-As.

The AES groups (current and capital) revenue and expenditure items, in determining the monthly Exchequer balance. Finally, the AES presents a more detailed breakdown of non-tax revenue items (actual and expected revenues). The Council had previously called for more information to be provided on the sources of non-tax revenues (IFAC, 2012b). The main advantage of the AES is that it provides a clearer picture of the gross Exchequer spending and revenues.

From 2014, under the requirements of the EU “Six Pack”, the Department of Finance plans to publish monthly cash based General Government data.

In April 2013, the CSO published two new statistical releases relating to annual and quarterly Government Finance Statistics. These show the main components of the General Government deficit and debt from 1990 to 2012 (annual) and from 1999 to 2012 (quarterly). They also presented for the first time the official calculation of both net General Government debt and the total net worth of Government. As a result, detailed information on Government financial assets,

liabilities as well as non-financial assets was provided. This included data on the value of public-private-partnership contracts and Government guarantees. (For details see Barnes and Smyth 2013).

The quarterly release makes it easier to monitor developments in the key General Government aggregates throughout the course of the year. Prior to these publications, there were just two official releases (EDP Maastricht returns in October and April).

ANNEX H: THE MEDIUM-TERM EXPENDITURE FRAMEWORK

The introduction of a Medium-Term Expenditure Framework (MTEF) (see also Box F) for Departmental expenditure goes some way to addressing previous weaknesses in the multi-annual budgetary planning process in Ireland.[140] The MTEF has been further strengthened this year with:

(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.[141]

These arrangements also explicitly link the setting of ceilings to the overall EU fiscal structures. As part of the wider EU fiscal reforms, the so-called "Six Pack" introduced a complementary measure to the core Budgetary Rule measure known as the expenditure benchmark (EB). The role of the EB within the wider reforms of the Stability and Growth Pact is discussed in more detail in Box I, however, in the Irish context it is also specified as the mechanism through which an upper limit on General Government expenditure is determined. In effect the EB has been adopted as an expenditure growth rule for Ireland. The aggregate Government Expenditure ceiling (GEC) and the individual Ministerial ceilings then both operate as mechanisms to control Exchequer expenditure with this upper limit. Both the GEC and individual Ministerial ceilings are set on a nominal, three

[140] 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.

[141] http://circulars.gov.ie/pdf/circular/per/2013/15.pdf

year rolling basis. The more detailed arrangements for the operation of the MTEF are discussed below.

COVERAGE

The definition of 'Government expenditure' as set out in the *Ministers and Secretaries (Amendment) Act 2013* is equivalent to the gross voted total expenditure aggregate shown in the Budget and Estimates documentation. The GEC covers current and capital expenditure by Departments funded by the Exchequer and through appropriations-in-aid and the expenditure of the Social Insurance Fund and the National Training Fund. Consequently, the GEC does not include (i) debt interest costs or other non-voted expenditure financed directly from the Central Fund or (ii) non-Central Government expenditure including the Local Government sector. In addition, while cyclically related payments, specifically unemployment related costs, and EU co-funded expenditure are included within the ceilings, the Circular specifies that these items be treated differently.[142]

In its most recent assessment, the European Commission point to the inconsistency between the coverage of the GEC and the expenditure benchmark, which applies to the general Government sector but explicitly excludes interest expenditure, non-discretionary changes in unemployment benefit expenditure and discretionary expenditure increases fully offset by discretionary revenue increasing measures.[143]

The Local Government, while included in the EB ceiling on General Government expenditure, is not included within the GEC. Instead, the Circular refers to a protocol to control and monitor the local authorities contribution to the General Government Balance. However, a deficit-based arrangement allows scope for the Local Government Sector to increase expenditure on the basis of buoyant, non-discretionary, receipts and consequently cause either a breach of the EB or require a change to the GEC, all other things being equal. To avoid this, clear restrictions should be put in place around Local Government expenditure, explicitly expanding the protocol to include expenditure restrictions.

[142] The Circular specifies that these payments be re-visited each year and where the final outturn for the year is less than the allocated amount on these payments, the difference will automatically accrue to the benefit of the Exchequer, rather than be transferred across to fund the expansion of other services.

[143] http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp162_en.pdf

Revision of Ceilings/"Escape Clauses"

Three circumstances, or "escape clauses", are specified under which the aggregate GEC can be revised:

(i) under exceptional circumstances as defined under the *Fiscal Responsibility Act* 2012 and 2013;[144]

(ii) through the introduction of compensatory revenue measures; and

(iii) special arrangements for cyclically related unemployment spending and certain expenditure funded through EU receipts.

There are six circumstances identified whereby the apportionment of funding to Departments can be revised, including:

(i) an increase in the GEC;

(ii) policy change arising from the outcome of a Comprehensive Review of Expenditure;

(iii) for "good and pressing reasons of public policy" or a change in the division of functions between Departments;

(iv) as a result of a potential breach in ceilings requiring a Supplementary Estimate;

(v) arising from the arrangements in place for unforeseen variations in cyclical and EU co-funded expenditure; or

(vi) arising from the application of carryover savings or as the result of sanctions.

While the number of instances in which the GEC can be altered is now relatively limited, the capacity of Government to adhere, and be seen to adhere, to these restrictions has not been established. Where the GEC is revised, the specific provision under which it is being adjusted must be specified in the accompanying documentation.

Control Mechanisms

The control mechanisms for Departments are broken into three escalating levels of sanction, with the application of each automatically requiring a proposal to Government for decision by the Minister for Public Expenditure and Reform as part of the normal monthly reporting process to Government. The initial level is triggered where a Department's gross expenditure is above the

[144] In this context exceptional circumstances are (i) a period during which an unusual event outside the control of the State has a major impact on the financial position of the General Government, or (ii) a period of severe economic downturn.

published monthly profile for two consecutive months or can be triggered by the Department of Public Expenditure and Reform if felt necessary. The imposition of these sanction arrangements is semi-automatic as they escalate a decision to Ministerial/Governmental level but require decisions by Government to implement the sanctions at each stage. The transparent linking of sanctions to the public profiles is important as any failure to implement the controls will be evident. The sanctions range from more intense reporting and monitoring arrangements, to a formal external expenditure review with a requirement to implement recommendations, to the repayment of excess expenditure from future ceiling(s).

Carryover of Current Savings

Similar to the mechanism in place under the capital expenditure envelopes, the MTEF permits the carryover of current expenditure savings from one year into the next under varying arrangements depending on the level of savings as a proportion of the ceiling. It is specified explicitly that any savings carried over must be in compliance with the GEC and overall fiscal rules and may not be used to create an ongoing liability to the Exchequer.[145]

Reconciliation of Ceilings

The Circular commits that any changes to ceilings will be reconciled fully. Reconciliation tables were included in the recent *Expenditure Report 2014* for the GEC and Ministerial expenditure ceilings.

Periodic Reviews of Expenditure

Approximately every three years a comprehensive review of expenditure will be conducted. This allows for re-prioritisation between Ministerial ceilings while respecting the overall GEC. It also guards against a return to a 'bottom-up' incremental approach and should lead to an increased focus on evaluation of existing programmes and schemes.

Departmental Continuity Reserves

Continuity reserves are referenced in the Circular but have not yet been formally introduced. These reserves should provide Departments with individualised buffers within their Ministerial ceiling to allow modest budget deviations to be managed in a routine manner without requiring the imposition of sanctions. The causes and consequences of larger deviations should be assessed and a direct policy response considered if necessary. The introduction and operation of these reserves

[145] A limitation on the carryover of savings is that the increase in the following year's Ministerial ceilings arising from carried over savings cannot cause a breach of the GEC. Accordingly, provision would have to be made when setting Ministerial ceilings to allow 'space' between the GEC and the aggregate of the Ministerial ceilings.

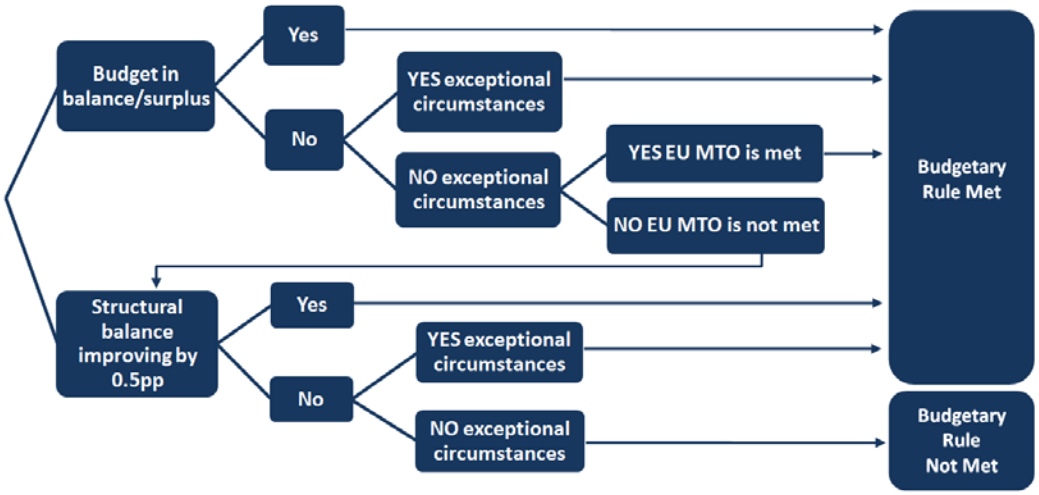
should be considered carefully, particular the impact on the incentive structure under the existing sanction/carryover mechanisms. Another important consideration is whether an aggregate reserve or individual Departmental reserves are more appropriate. While an aggregate reserve would allow flexibility for Government to address exceptional circumstances as they arise, it could lead to 'gaming' on the part of Departments to obtain additional funding.

ANNEX I: FISCAL RESPONSIBILITY ACT AND EU FISCAL RULES

The *Fiscal Responsibility Act* (FRA) and EU fiscal rules are complex, both individually and taken together, as set out in previous *Fiscal Assessment Reports*. There are three basic requirements:

- The FRA Budgetary Rule sets a norm of a headline budget balance or surplus for the General Government, while the EU SGP requires a deficit of less than 3 per cent of GDP.
- The FRA Budgetary Rule and EU SGP require the structural budget balance to meet an EU-agreed country-specific Medium Term Budgetary Objective (MTO), which is currently for a balanced budget in structural terms. If this condition is not met, a 0.5 percentage point improvement in the structural budget balance is required under the Budgetary Rule (Adjustment Path Condition) and EU rules.[146]
- The FRA Debt Rule and EU SGP require that a General Government debt-to-GDP ratio in excess of 60 per cent of GDP should be reduced according to a formula that requires approximately a 1/20th reduction of the excess over 60 per cent per year.

The conditions for meeting the FRA Budgetary Rule can be represented using a flow diagram:[147]



[146] It is important to note that the FRA Budgetary Rule and MTO are not identical to the extent that the FRA Budgetary Rule could be met by a headline budget balance, even if there were a structural deficit larger than the MTO. This could arise, for example, with an output gap greater than two percentage points.

[147] There is more than one way of presenting the rules in terms of a flow diagram. This broadly follows the order in which the conditions are specified in the text of the *FRA 2012*.

ANNEX J: ILLUSTRATIVE SCENARIOS IN *SPU 2013*

ANNEX TABLE J.1: *SPU 2013* ILLUSTRATIVE SCENARIO 2016-2019

Budgetary Plans	2016	2017	2018	2019
1. General Government Balance	-1.7	-1.2	-0.3	0.8
2. Structural Balance	-2.4	-1.7	-0.4	1.0
3. Cyclical Budgetary Component	0.8	0.5	0.1	-0.2
4. One-offs and Other Temporary Measures	0.0	0.0	0.0	0.0
5. General Government Balance	-1.7	-1.2	-0.3	0.8
6. Total Revenues	34.8	34.5	34.2	33.9
6.a. Total Revenues at Unchanged Policy from 2012	n.a	n.a	n.a	n.a
7. Total Expenditure	36.5	35.8	34.5	33.1
Amounts To Be Excluded from the Expenditure Benchmark				
7.a. Interest Expenditure	4.8	4.8	4.8	4.7
7.b. Expenditure on EU Programmes Fully Matched by EU Funds Revenue	0.2	0.2	0.2	0.2
7.c. Cyclical Unemployment Benefit Expenditure***	-0.4	-0.5	-0.5	-0.4
7.d. Effect of Discretionary Revenue Measures	n.a	n.a	n.a	n.a
7.e. Revenue Increases Mandated By Law	0.0	0.0	0.0	0.0
8. Tax Burden*	31.5	31.3	31.2	30.9
9. Gross Debt**	110.8	107.9	103.6	97.9

Source: Irish Stability Programme April 2013 Update.

ANNEX TABLE J.2: *SPU* 2013 ILLUSTRATIVE SCENARIO: MACROECONOMIC ASSUMPTIONS, 2016-2019

	2016	2017	2018	2019
1. Real GDP Growth	2.7	2.3	3.0	3.5
2. Nominal GDP Growth	4.2	3.8	4.3	4.8
3. GDP Deflator Growth	1.4	1.5	1.3	1.3
Potential GDP Growth	2.6	2.9	3.7	4.1
Output Gap	1.6	1.0	0.3	-0.3
Employment Persons (000s)	1.4	1.5	1.5	1.5
Hours Worked	0.6	0.6	0.6	0.6
Unemployment Rate	12.3	11.5	11.0	11.0
Gross Fixed Capital Formation	4.5	7.0	8.0	10.0
Compensation Per Employee	3.3	3.2	3.7	3.7

Source: Department of Finance Calculations, *Irish Stability Programme April 2013 Update.*
Note: Figures may not sum due to rounding.

GLOSSARY[148]

Automatic stabilisers: Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Budget balance: The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses general government aggregates.

Cyclical component of budget balance: That part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap.

Discretionary fiscal policy: Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of automatic stabilisers.

Excessive Deficit Procedure (EDP): A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State.

Expenditure rules: A subset of fiscal rules that target (a subset of) public expenditure.

Fiscal consolidation: An improvement in the budget balance through measures of discretionary fiscal policy, either specified by the amount of the improvement or the period over which the improvement continues.

General Government: As used by the EU in its process of budgetary surveillance under the Stability and Growth Pact and the excessive deficit procedure, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Maastricht reference values for public debt and deficits: Respectively, a 60 per cent General Government debt-to-GDP ratio and a 3 per cent General Government deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union.

[148] These definitions are taken directly from the European Commission. See European Economy, Occasional Papers 151, May 2013, Vade medum on the Stability and Growth Pact.

Medium-term budgetary framework: An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO): According to the reformed Stability and Growth Pact, stability programmes and convergence programmes present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms.

Minimum benchmarks: The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the medium-term budgetary objectives (MTO).

One-off and temporary measures: Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position.

Output gap: The difference between actual output and estimated potential output at any particular point in time.

Potential GDP: The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

Primary budget balance: The budget balance net of interest payments on general government debt.

Primary structural budget balance: The structural budget balance net of interest payments.

Pro-cyclical fiscal policy: A fiscal stance which amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the cyclically-adjusted budget balance unchanged over the economic cycle but lets the automatic stabilisers work.

Public debt: Consolidated gross debt for the general government sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Sovereign bond spread: The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP): Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997).

Stability programmes: Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the Stability and Growth Pact.

Stock-flow adjustment: The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance: The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance.

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