Assessment of the Fiscal Stance

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1. ASSESSMENT OF THE FISCAL STANCE

KEY MESSAGES

- Significant progress has been achieved in resolving Ireland's fiscal crisis. While debt levels remain extremely high, the debt-to-GDP ratio should now be on a declining path, underpinned by nominal GDP growth, record low interest rates and the move to a planned balanced budget by 2018. Although fragilities remain, the borrowing capacity of the State has been restored, with secondary-market bond yields falling to low levels.

- A positive legacy of the crisis has been the institutionalisation of a fiscal framework with complementary national and European elements. Provided it is observed and supported, the framework should help to smooth future boom-bust cycles. It should also support the reduction of debt to safer levels, and underpin the credibility of the Government's commitment to avoid default during the period that debt levels remain unavoidably high. Ultimately, the test of the fiscal framework will be whether it delivers sustainable, broadly based growth in incomes and employment.

- The *Stability Programme Update 2014* (*SPU 2014*) contained a strong commitment to respect the requirements of the new fiscal framework. In the short term, this requires that the necessary adjustments are undertaken so as to exit the Excessive Deficit Procedure (EDP) on schedule. Over the medium term, the framework requires meeting the national Budgetary Rule and the requirements of the preventive arm of the *Stability and Growth Pact (SGP)*.

- The Government should follow through on commitments to implement €2 billion of additional measures in *Budget 2015*. There are three main reasons for this recommendation: (i) to reduce risks to debt sustainability by putting the debt-to-GDP ratio on a firm downward path; (ii) to provide a reasonable probability that the requirement of a deficit of below 3 per cent of GDP is achieved in 2015; and (iii) to protect the hard-won credibility of Ireland's capacity to follow through on adjustment commitments.

- Medium-term fiscal adjustment plans imply a sustained fall in non-interest government spending as a share of GDP. Maintaining tight spending in the areas of government services, public investment and social payments will be difficult given demographic and other demand pressures and rigidities in certain areas of expenditure. In this context, care should be taken not to erode aggregate revenue-raising capacity through tax cuts without offsetting revenue measures.

1.1 Introduction

The *Fiscal Responsibility Acts 2012 and 2013* (*FRA*) requires the Council to assess the Government's fiscal policy stance, with reference to the requirements of the *SGP*. As this is the first assessment report since Ireland exited its programme of international financial assistance, Section 1.2 draws on the analyses of subsequent chapters to take stock of crisis-resolution developments and remaining risks. Section 1.3 then examines the important role played by an effective fiscal framework in guiding appropriate fiscal policy for the Irish economy, and Section 1.4 briefly reviews the European/national fiscal framework that has been put in place. Section 1.5 assesses the fiscal stance set out in *SPU 2014*. Section 1.6 concludes.

1.2 Crisis-Resolution: Strategy, Developments, and Risks

Crisis-Resolution Strategy

The collapse of Ireland's property/credit bubble set in motion a series of vicious feedback effects between the banking sector, the public finances and the real economy (see, IFAC, 2013b, Box D). The crisis reached an acute phase with the loss of creditworthiness of the banking system and the State itself in 2010, raising the spectre of a sovereign default that would have added a further twist to the feedback cycles. The chosen strategy to resolve the crisis included the continued adjustment of an unsustainable public finance position with transitional (and conditional) international financial assistance.[1]

The strategy was based on a number of broad premises. First, with the agreement of official funders, the strategy was based on a strong commitment to avoid a sovereign default. While the effects of sovereign defaults are unpredictable and vary with country circumstances, it was believed that defaults are associated with output losses, forced short-term austerity measures due to financing constraints, and more difficult future borrowing conditions.

Second, the strategy was based on the belief that the ambitious planned fiscal adjustment would be both politically and economically feasible. Political feasibility required that the Government would be able to implement what were extremely painful expenditure cuts and revenue increases over an extended period of time. Economic feasibility required that the fiscal measures taken would not contract domestic demand so much that they would be directly self defeating in the sense of actually worsening the public finances. Previous assessment reports have examined the impacts of the adjustments compared to a counterfactual no-adjustment scenario (see, e.g., IFAC, 2013b, Chapter 4).

[1] The public-finance elements of the crisis-resolution strategy were combined with reforms to stabilise the banking sector and structural reforms to improve the economy's growth potential.

Counterfactual simulations based on realistic multiplier and buoyancy assumptions indicate that both the General Government deficit and debt would quickly have reached unsustainable levels.

Third, the strategy depended on the economy having reasonable underlying growth potential. Belief in this potential was based, in part, on Ireland's large export sector and strong base of multinational enterprises. Absent such potential, the required adjustments could have strained the adjustment capacity of the political and social system beyond breaking point.

And fourth, the strategy depended on reliable lender-of-last resort support. In particular, concerns that debt restructuring would be imposed as a condition of future support would have undermined investor confidence in the Government's capacity to avoid default. Such fears could easily have become self-fulfilling as the risk premium on Irish debt remained high and official lenders demanded a restructuring given poor prospects for market access. It was, therefore, important that the European Union's crisis-resolution tools were strengthened. Important developments included the instituting of the European Stability Mechanism (ESM) as a permanent fund and also the ECB's introduction of the Outright Monetary Transactions (OMT) programme as part of a commitment to do whatever it takes to preserve the euro.

Developments in Crisis Resolution

While the crisis has been exceptionally difficult for the Irish public, the crisis-resolution strategy has broadly succeeded in its aims. On the fiscal front, the primary deficit has been brought to projected balance this year from a peak of over 9 per cent of GDP in 2009 or nearly €15 billion (excluding banking-support measures). Moreover, the debt-to-GDP ratio is also estimated to have peaked last year at just under 124 per cent of GDP before falling to 107 per cent of GDP by 2018 according to the projections in *SPU 2014*. The projected reduction in the debt ratio is driven by a decline in accumulated cash balances, nominal GDP growth and the assumed movement of the General Government deficit towards balance by 2018. However, the ratio is projected to remain at high levels over the period. This resulting debt-sustainability challenge is revealed even more starkly when alternative measures of fiscal capacity are used (see Figure 1.1). The figure shows the projected evolution of alternative debt to fiscal capacity ratios: GDP (peaking at 124 per cent in 2013), GNP (147 per cent) and the Council's Hybrid (137 per cent) measure of fiscal capacity.[2]

[2] The hybrid measure of output is an intermediate measure of fiscal capacity between GDP and GNP. It puts differential weight on GNP and the excess of GDP over GNP, defined as: H = GNP + 0.4(GDP – GNP). For details see IFAC (2012b).

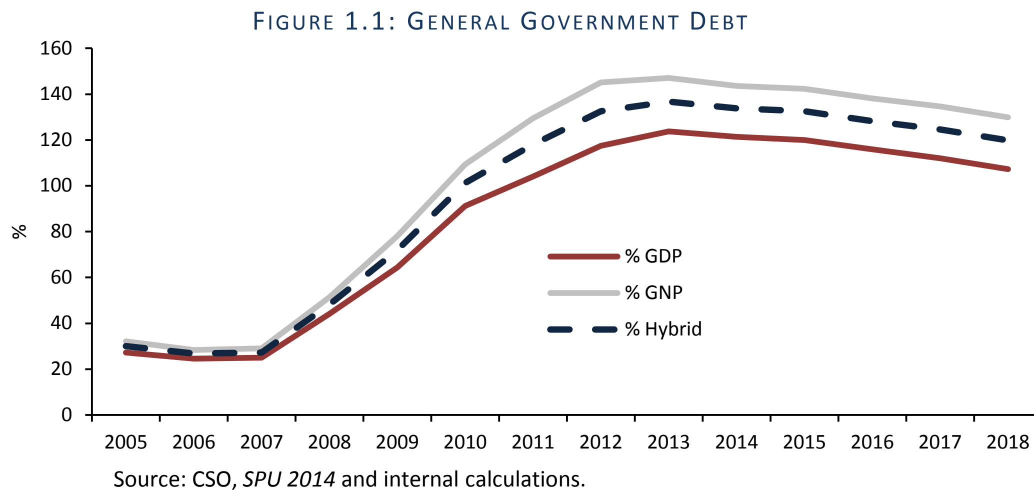


FIGURE 1.1: GENERAL GOVERNMENT DEBT

Source: CSO, *SPU 2014* and internal calculations.

The State has also gone some distance to restoring its market creditworthiness. Figure 1.2 shows the evolution of the 10-year bond yields for Ireland and Germany. From a peak at over 14 per cent in July 2011, Ireland's 10-year yield has fallen to below 3 per cent. In large part, this is likely to have reflected a general downward trend in euro area yields following the autumn 2012 announcement of the OMT programme combined with a credible commitment to repair the public finances. Figure 1.3 shows a commonly used measure of implied default risk based on the observed yield spread between Irish and German bonds. While significant perceived default risk remains, the market perception of the likelihood of an Irish default has fallen back dramatically since reaching a peak of close to 90 per cent in mid-2011. Furthermore, the five main rating agencies all now rate Irish sovereign debt at investment grade.

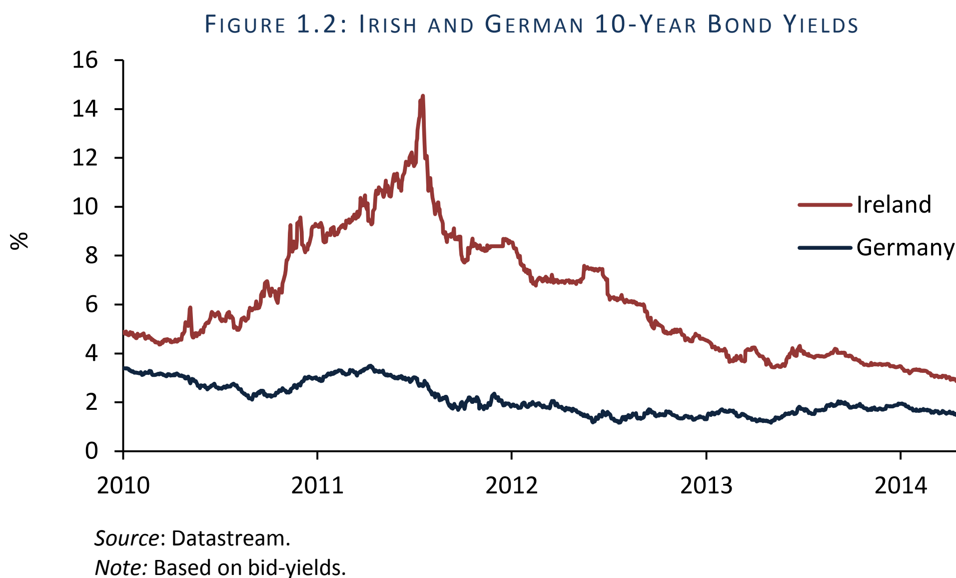
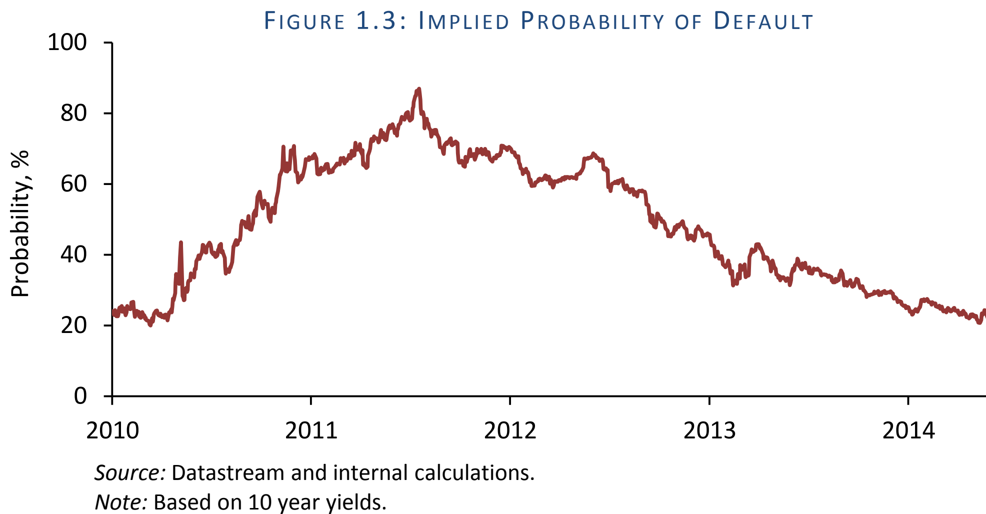


FIGURE 1.2: IRISH AND GERMAN 10-YEAR BOND YIELDS

Source: Datastream.
Note: Based on bid-yields.

FIGURE 1.3: IMPLIED PROBABILITY OF DEFAULT



Source: Datastream and internal calculations.
Note: Based on 10 year yields.

Rates of economic growth in Ireland have been volatile – in part due to factors relating to its large multinational sector. However, the country is projected to be returning to a period of sustained growth (see Chapter 2). The strong recovery in employment growth since the latter part of 2012 has been a particularly welcome feature of the recovery.

Overall, these developments combined, allowed Ireland to exit its international assistance programme at the end of 2013.

REMAINING RISKS

Notwithstanding these successes, significant risks remain. The risks surrounding growth are discussed in Chapter 2; the knock-on risks in terms of the budgetary aggregates, as well as expenditure pressures, balance sheet and interest rate risks, are discussed in Chapter 3. We therefore only provide a brief preview here.

First, uncertainty still surrounds the prospects for growth. These risks are both domestic and external. On the domestic side, there remains uncertainty about the dynamics of the post-bubble recession and recovery. With balance sheets impaired across the economy, international experience provides cautions about the persistence of weak domestic demand, impaired credit flow and the risk of setbacks. On the external side, the high degree of openness of the Irish economy makes it unusually dependent on demand conditions in export markets. Recent international-agency forecasts have upgraded the prospects for some of Ireland's key export markets. However, international growth prospects are subject to a high degree of uncertainty. Given the importance of nominal GDP growth to the budgetary arithmetic, a particular concern relates to the ability of the Euro Area to avoid a low

inflation/deflation trap, under which the European Central Bank (ECB) is unable to maintain expectations of inflation at their target of "…below, but close to 2 per cent."[3]

Second, the extent of non-performing loans in the banking sector remains a fiscal risk. The recent Asset Quality Review (AQR) by the Central Bank has provided some reassurance on the capital positions of the main Irish banks, although a full assessment must await the EU-wide stress tests due in October 2014. Developments on a European banking union have also reduced the risk that the State will be called on to provide capital support beyond what is fiscally sustainable. Concerns relating to ultimate losses by NAMA have receded. However, the limited nature of the banking union, combined with the level of non-performing loans, means that explicit and implicit contingent liabilities associated with the banking sector remain a downside risk.

Third, current low risk premiums on riskier assets such as the sovereign bonds of high-debt countries might not be sustainable. Leading central banks have lowered short-term rates to close to zero levels and also targeted term premiums through quantitative-easing policies. One concern is that policies that lower the return on low-risk assets lead investors to "reach for yield" by purchasing higher risk assets to maintain the overall returns on their portfolios. International investors also appear to have shifted funds from some emerging markets given changes in risk perceptions relative to the Euro Area periphery. To the extent that Ireland and other crisis-affected economies have benefited from such portfolio effects, the normalisation of monetary policies – or a reassessment of relative risks – could lead to higher costs for new borrowing.[4]

Fourth, there is a risk of external policy shocks. One possibility is that a flare-up of a crisis in another Euro Area country leads to a broader reassessment of risk, or to European-level policy responses that reduce the creditworthiness of still-vulnerable member states. Even in the absence of such flare-ups, policy could evolve in ways that raise investor fears of future defaults. The recent German Constitutional Court review of the legal foundations of OMT provides a cautionary example of the potential for setbacks to the institutional and policy developments that have helped reduce fragility within the Euro Area.

[3] The recent monetary policy announcements by the ECB (i.e. a 10 basis point reduction in the main refinancing rate, targeted longer-term refinancing operations and negative deposit facility rates) signalled an intensification of efforts to counter such risks.

[4] This is mitigated by the long average maturity on outstanding debt (see Chapter 3, Section 3.4.3).

1.3 The Value of an Effective Fiscal Framework

One positive legacy of the crisis is a much strengthened fiscal framework comprising complementary European- and national-level elements. The framework has the potential to help Ireland avoid repeating past mistakes by fostering a more sustainable fiscal policy. It should also help reduce the remaining risks to a robust exit from the crisis that are noted above. This section elaborates on some high-level arguments for a strong fiscal framework: taming the boom-bust cycle; moving to safer levels of debt; and enhancing the credibility of Ireland's fiscal sustainability during the transition to those safer levels.

Taming the Boom-Bust Cycle

The Irish economy has been susceptible to severe boom-bust cycles throughout much of its post-independence history. This has partly reflected the inherent volatility of a small open economy, especially one with highly mobile capital and labour. However, the volatility has also reflected policy mistakes (see, e.g., Honohan and Walsh, 2002). Such mistakes were apparent in the run up to the most recent crisis, especially in relation to financial regulation. See e.g., Donovan and Murphy (2013), McHale (2012) and Whelan (2013).

Pro-cyclical fiscal policy has contributed to this volatility – a phenomenon not unique to Ireland – even if fiscal policy was not the main force behind the pre-crisis property boom. See e.g., Calmfors and Wren-Lewis (2011) and DeBrun and Kumar (2007). The pro-cyclicality involves an expansionary bias in good times, although the underlying "deficit bias" can be temporarily hidden by unsustainable revenue windfalls (Lane, 2010). The pro-cyclicality then continues in bad times through fiscal contractions, typically forced by the need to ensure debt sustainability and preserve borrowing capacity.

A well-designed fiscal framework should help to tame this tendency towards boom-bust cycles. For example, an expenditure rule that limits the growth in expenditure to the underlying potential growth of the economy places limits on the extent to which windfall revenues are used to fund "permanent" increases in spending or reductions in tax burdens. Of course, fiscal policy has not been the only source of pro-cyclical bias. Excessive credit growth was a more fundamental driver of Ireland's unsustainable property-driven boom. Even so, in addition to new frameworks for micro- and macro-prudential regulation of credit markets, a fiscal framework that prevents the build up of actual (or hidden) structural deficits should help support a more sustainable growth pattern for the Irish economy.

Moving to Safer Debt Levels

The crisis has left the Irish economy with a legacy of high State debt. From a low of under 25 per cent in the third quarter of 2007, Ireland's debt-to-GDP ratio reached almost 124 per cent in 2013. This increase reflected both the large deficits that opened up as windfall property-related revenues evaporated as the economy contracted and the costs of bailing out the banking system. Such a high debt level leaves the economy vulnerable to shocks that bring debt sustainability and creditworthiness into question.

Ostry *et al*. (2010) identify a country's "fiscal space" as the gap between its current debt-to-GDP ratio and the ratio that leads to unsustainable debt dynamics taking into account such factors as the capacity to run primary surpluses and growth potential. The smaller this gap the greater the risk that adverse shocks will put the economy beyond the critical threshold. Nearness to the threshold also leads investors to demand a risk premium to hold the country's debt and raises the risk of self-fulfilling confidence crises relating to country's chances of avoiding default.

While the process of regaining fiscal space should be phased over time, prudence requires that Ireland pursues a path to a safer debt level. A well-designed fiscal framework should be consistent with delivering the large primary surpluses that need to be run for a number of years to put the debt-to-GDP ratio on a declining path.

Credibility

Recognising the need for a phased reduction in the debt-to-GDP ratio, it will take time before a reasonably safe level of this ratio is achieved. The credibility underlying the economic and political capacity to make the necessary adjustments will be critical during the transition, and indeed essential to ensure that a phased transition is feasible. This credibility can be underpinned by a commitment to a well-designed fiscal framework, especially one that is widely shared across the political spectrum. Such a framework can help signal the political system's intentions with regard to medium-term debt-reduction goals, and can also raise the political costs of deviating from the planned path as crisis memories fade. While rules can constrain the ability to follow an "optimal" policy at all times, a credible framework can give policymakers more flexibility when temporary shocks cause deviations from the planned path. Moreover, when such shocks occur, a credible framework can give policymakers more flexibility to follow a less pro-cyclical path without damaging confidence in its ultimate capacity to deliver a low and sustainable debt level.

1.4 Ireland's Fiscal Framework

Ireland's new fiscal framework is designed to help to temper future boom-bust cycles and to guide debt to safer levels, while providing fiscal credibility. It focuses on avoiding excessive deficits/debts, achieving a budget balance in structural terms, and ensuring that expenditures are underpinned by stable revenues.

The framework is a combination of European-level elements under the reformed *Stability and Growth Pact (SGP)* and national-level elements that are designed to complement and extend the European rules. The Department of Finance has usefully brought the various elements together in its *Medium-Term Budgetary Framework* (MTBF) document (Department of Finance, 2013e).

The European elements have been extensively described in previous *Fiscal Assessment Reports* (see also Chapter 4). A detailed description of the workings of the *SGP* is also provided in the European Commission's *Vade Mecum* on the pact (EC, 2013a).

The national components of the fiscal framework are set out in detail in the MTBF. Core components are the Budgetary Rule set out in the *FRA* and the *Medium-Term Expenditure Framework* set out in the *Ministers and Secretaries (Amendment) Act 2013*.[5] Taken together the rules and enforcement mechanisms are designed to be consistent with the requirements of the preventive arm of the *SGP*. The framework also follows the growing international practice in giving a role to an independent fiscal council in monitoring and assessment. See e.g., DeBrun and Kindra (2014).

A key feature of the *FRA* is that the Government is answerable to the Dáil for failures to meet the Budgetary Rule. Article 6(1) states:

> If the Commission addresses a warning to the State under Article 6(2) of the 1997 surveillance and coordination Regulation or if the Government consider that there is a failure to comply with the budgetary rule which constitutes a significant deviation for the purposes of Article 6(3) of that Regulation, the Government shall, within 2 months, prepare and lay before Dáil Éireann a plan specifying what is required to be done for securing compliance with the budgetary rule.

Furthermore, if the Government does not accept the Fiscal Council's assessment of compliance with the Budgetary Rule – including compliance with any correction plan put in place to meet the rule – the Minister shall, within 2 months of being given a copy of the Council's assessment, provide a statement to the Dáil on the reasons for why it has not been accepted.

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[5] The Budgetary Rule is discussed in detail in Chapter 4. See IFAC (2013b, Chapter 2) for a discussion of the *Medium-Term Expenditure Framework*.

Consistency between the national and European frameworks allows the two sets of formal rules and enforcement procedures to reinforce each other: the monitoring, peer pressure and financial-sanction procedures of the *SGP* helps give credibility to the national rules; the monitoring and enforcement procedures of the national rules – including roles for both the Oireachtas and the Fiscal Advisory Council – provide a degree of domestic oversight and ownership of the overall rules framework.

One weakness of the European Rules framework involves the harmonised methodology for estimation and measurement of the structural budget balance. This measurement is based on the measures of the output gap, discussed in Chapter 2, which are in turn based on measures of potential output using a harmonised production-function framework. This method may lead to quite pro-cyclical measures of potential GDP, with potential GDP following actual GDP quite closely. This tends to limit the size of measured output gaps and, therefore, leads to relatively small differences between the actual and structural deficit. In a downturn, this relatively close correspondence constrains the countercyclical scope of fiscal policy. Moreover, in a period of unsustainable growth (say driven by an unsustainable property boom financed by international capital inflows), the harmonised method may fail to signal the true size of the underlying imbalances in the public finances.[6]

It is doubtful that the harmonised methodology provides an adequate signal of the cyclical position of the Irish economy. It is probably better viewed as an attempt to temper the potential pro-cyclicality of the rules, while also ensuring that member states' budget deficits remain low; and, where deficits do open up, are closed in a reasonably fast time frame. It is important that alternative measures of the potential output of the Irish economy are developed to better identify the cyclical position of the economy and inform decisions about the appropriate policy stance. The development of credible alternative measures could also help inform the debate about improvements to the harmonised methodology. It is important to recognise, however, that applications of the *SGP* rules are based on the Commission's use of the harmonised methodology even if the Government has significant disagreements with the structural-balance measurements it produces.

[6] One potential problem with the harmonised method is that it can miss the impact of low-frequency "financial cycles" (see Borio *et al*, 2013). The upswing of a financial cycle is associated with high property-price growth and unusual credit expansion financed by capital inflows and an associated current account deficit. However, given a strong supply response – in Ireland's case facilitated by large net inward migration – this upswing can be associated with relatively muted overall inflationary pressure. To the extent the harmonised methodology relies on signs of inflationary pressure to signal a positive output gap, the unsustainable nature of the output expansion may be missed. Similarly, following a downturn in the financial cycle, a too-negative view of underlying potential may emerge. Thus, conventional measures of the output gap and structural balance need to be augmented by measures that take better account of the implications of low-frequency financial cycles (see Bergin and FitzGerald (2014) for a recent analysis using the ESRI's *HERMES* model).

Overall, while the fiscal framework is not without flaws and needs to be augmented by robust domestic analysis, the complementary European and national elements provide a valuable structure to guide Irish fiscal policy. Rather than being viewed as something imposed on Ireland, or even simply an act of shared sovereignty with other Euro Area members to make monetary union work, it should be seen as a framework that is in the national interest to the extent it underpins sustainable growth in Irish incomes and employment.

1.5 Evaluation of the Fiscal Stance

As in previous reports, in assessing the fiscal stance the Council recognises the trade off between ensuring borrowing capacity/debt sustainability and the direct output costs of fiscal adjustment measures. Owing to the precarious financial position of the State, in earlier reports the Council recommended the need for a margin of safety to ensure that fiscal targets were met given investor doubts about Ireland's adjustment and growth capacity and the likely costs of default. With improvements in the fiscal position and creditworthiness, it should now be sufficient to meet the requirements of the fiscal framework. This requires that the EDP targets are met in the short term, and the national Budgetary Rule and preventive arm of the *SGP* are respected over the medium term.

The Government's fiscal stance was set out in the *SPU 2014* (Department of Finance, 2014, p. 1)

> [T]he Government recognises that sustainable public finances are a necessary condition for economic recovery. The immediate fiscal policy objective, therefore, remains the correction of the excessive deficit by next year. Thereafter, fiscal policy will be set in line with the requirement to move towards Ireland's medium-term budgetary objective, which is for a balanced budget in structural terms.
>
> It is worth highlighting the institutional reforms that have taken place in the fiscal area in recent years. The establishment of the Irish Fiscal Advisory Council (IFAC) on a statutory basis, the placing of fiscal rules on a higher legal basis, and improvements to the budgetary process, all represent important enhancements to fiscal policy formulation and help further underpin confidence in the evolution of the public finances in Ireland. On foot of these developments, Ireland is now fully compliant with all of the fiscal governance reforms that have been initiated in recent years.

The statement adds (p.3):

> [T]he Government's firm commitment to correct the excessive deficit by 2015 remains the cornerstone of near-term fiscal policy. On present estimates, this should be achieved with the previously announced policy of a package of tax and expenditure measures of €2.0 billion. However, the actual consolidation effort required to meet the deficit objective will be based on the most up-to-date economic and fiscal data on Budget day. The specific measures will be announced in the Budget in October 2014, and will take on board the conclusions of the Comprehensive Review of Expenditure (CRE) and other ongoing reviews.

The Council welcomes the clear statement of intent to meet the requirements under Ireland's fiscal framework. It assesses that a budgetary policy to bring the projected deficit in line with the EDP limit of a deficit below 3 per cent of GDP in 2015, and then to follow the adjustment-path requirements of the preventive arm of the *SGP* and the national Budgetary Rule, meets the requirement set down in the *FRA*. This requirement is that "... the fiscal stance for the year or years concerned is, in the opinion of the Fiscal Council, conducive to prudent economic and budgetary management".

Under current projections, the stated policy should put the debt-to-GDP ratio on a firm downward path and support the credibility gains that have underpinned the restoration of the State's market creditworthiness.

The Council recommends that the previously planned measures of €2 billion should be followed through on in *Budget 2015*.

There are three main reasons for this recommendation. First, while significant progress has been made in repairing Ireland's public finances, the gap between General Government expenditure and revenue is still projected to be close to €8 billion in 2014. Slowing the pace of deficit and debt reduction would leave the public finances more exposed to shocks that create unsustainable debt dynamics.

Second, even with the encouraging recent fiscal performance (see Chapter 3), the *SPU 2014*'s central projections indicate no margin of safety around the EDP deficit ceiling for 2015. Recognising the high level of uncertainty surrounding the level and composition of growth (see Chapter 2), reducing the planned adjustments would increase the probability of missing the target and put the EDP exit in jeopardy.[7]

Third, the dramatic reduction in the risk premium on Irish debt has reflected, amongst other factors, the increasing credibility of Ireland's capacity to make necessary fiscal adjustments. While the relatively small reduction in planned consolidation in *Budget 2014* does not appear to have harmed Ireland's credibility, a second year of scaled-back adjustment effort – especially one closely following the ending of Ireland's programme of official assistance – could raise doubts about the political capacity to make necessary adjustments outside of a formal external programme.

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[7] As discussed in Chapter 4, a failure to meet the nominal deficit target would lead to an evaluation of "effective action" in relation to structural budgetary adjustment. Failure to meet both the nominal target and a judgement of non-effective action could lead to the imposition of financial sanctions under the *SGP*. At this stage, there is uncertainty as to whether Ireland would be judged to have met the requirement for effective action given the divergent signals from "top-down" assessments of changes in the structural balance and "bottom-up" assessments based on adjustment measures undertaken. The risk of a negative judgement would increase if adjustments are reduced below the committed level of €2 billion, which would follow the reduction in previously committed adjustments of €0.6 billion in *Budget 2014*.

With a successful EDP exit, the post-2015 fiscal stance should follow the requirements of the preventive arm of the *SGP* and the national Budgetary Rule. For a high-debt country, the minimum annual adjustment of the structural balance for a country not at its Medium-Term Objective (MTO) has been identified as greater than 0.5 per cent of GDP. However, as discussed in Chapter 4, a more ambitious adjustment path for the structural balance is set out in *SPU 2014*, which leads the MTO of a structural balance being reached in 2018. With a credible commitment to the new fiscal framework, it should not be necessary to overachieve on the minimum adjustment path. Where targets are set in excess of the minimum requirements, a clear rationale should be provided.

A further reason that care should be exercised in setting targets for the post-EDP period relates to the significant medium-term expenditure challenges Ireland faces. Under current growth projections, the most difficult phase of the fiscal adjustment should be complete in 2015. However, under the EU Expenditure Benchmark, real expenditure growth must be kept below the growth rate of real potential GDP along the adjustment path to a structural budget balance (unless there are offsetting adjustments on the revenue side).[8]

Ireland is therefore facing a relatively restrictive fiscal stance until a structural budget balance is achieved – currently projected for 2018. As discussed in detail in Chapter 3, the combination of underlying spending pressures and rigidities in certain spending areas will make expenditure control challenging over the next number of years. In this context, it will also be important not to erode aggregate revenue-raising capacity through tax cuts without offsetting revenue measures. The forthcoming *Comprehensive Review of Expenditure* needs to be used to identify appropriately detailed expenditure plans. This would help to promote informed public debate and enhance the credibility of budgetary projections over the medium term.

[8] Under the Expenditure Benchmark, higher real expenditure growth than the reference rate for potential output growth adjusted for a “convergence margin” to ensure convergence to the MTO would have to be financed by additional revenue-raising measures.

1.6 CONCLUDING COMMENTS

Given the precarious financial position of the Irish State in recent years, the progress in stabilising the public finances and restoring borrowing capacity at affordable interest rates has been significant. One positive legacy of the crisis has been the instituting of a strong fiscal framework combining European and national elements. This framework should help to smooth future boom-bust cycles, guide debt to safer levels, and underpin the credibility of the State's ability to avoid default during the period that debt levels remain high and the international environment volatile. But for the framework to be an effective bulwark against instability, it is important that it has broad public understanding and support.

In assessing the constraints imposed by the new fiscal framework, the constraints that are also imposed by debt markets on fiscal policies should not be forgotten. As experienced by Ireland in 2010, debt markets can be even more demanding in terms of the fiscal policies viewed as consistent with access to funding to cover deficits and rollover debts. A credible commitment to a framework that ensures debt sustainability can, therefore, expand rather than narrow the room for fiscal manoeuvre.

In the short term, implementing the framework requires following through on adjustment commitments to ensure the scheduled exit from the EDP. Over the medium term, meeting the requirements of the national Budgetary Rule and the preventive arm of the *Stability and Growth Pact* should underpin the reduction in debt levels and secure the State's borrowing capacity at affordable interest rates, while reducing the fiscal drag on growth. Given the costs involved, care should be taken in pursuing an adjustment path that is more ambitious than required under the rules.

There is no denying that meeting the requirements of the framework will be demanding. This is especially evident in the pressures for expenditure restraint at a time of demographically related spending pressures and other demands. Any reduction in aggregate revenue-raising capacity would need to be carefully considered in this context. Ultimately, the test of the fiscal framework will be whether it delivers sustainable, broadly based growth in incomes and employment.