3. ASSESSMENT OF BUDGETARY FORECASTS

KEY MESSAGES

- A General Government deficit of 4.8 per cent of GDP is likely for this year based on data to end-May. This outlook coupled with the planned €2 billion package of tax and expenditure measures in the forthcoming Budget should see the deficit just below 3 per cent of GDP in 2015 in line with Excessive Deficit Procedure (EDP) commitments.

- The General Government debt ratio is projected to remain unavoidably high in the near term at close to 120 per cent of GDP. The improving budgetary outlook, robust nominal GDP growth and the use of existing cash balances, however, should see a steady decline in the debt ratio over the period to 2018.

- While the budgetary projections in the *Stability Programme Update (SPU) 2014* are assessed to be appropriate, a number of risks remain including uncertainties surrounding growth prospects and significant challenges on the expenditure side.

- Medium-term fiscal adjustment plans indicate that government non-interest spending will have to fall by just over 8 percentage points of GDP between 2013 and 2018, reaching very low levels historically. These budgetary plans imply considerable pressures on government services, public investment and social payments.

- The prolonged tight spending plans will be difficult to achieve, given demographic and other pressures. The forthcoming *Comprehensive Review of Expenditure* (due October 2014) should be used to identify appropriately detailed expenditure plans and associated policies underpinning *SPU 2014*'s expenditure path. This would help to promote informed public debate and enhance the credibility of budgetary projections over the medium term.

- Budgetary outturns in recent years have been helped by much lower than expected interest and investment expenditures and higher than expected non-tax revenues.

3.1 INTRODUCTION

This chapter assesses the latest set of budgetary forecasts produced by the Department of Finance. This involves a number of steps: (i) a review of the accuracy of Department of Finance forecasts for 2013 (Section 3.2); (ii) an assessment of the forecasts contained in *SPU 2014* (Section 3.3); 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 3.4). This chapter also takes a closer look at the expenditure projections underlying *SPU 2014.* A number of sources of pressure are highlighted as is the need for detailed plans to be set out in the forthcoming *Comprehensive Review of Expenditure*. Finally, two Analytical Notes provide further background to this Chapter covering the topics of: (3) Tax Forecasting Error Decomposition; and (4) DIRT Forecasting Methodology.

3.2 DEPARTMENT OF FINANCE BUDGETARY PROJECTIONS FOR 2013

A General Government deficit of 7.2 per cent of GDP was recorded in 2013. This was a full percentage point lower than the 2012 outturn.[65] The ratio of General Government debt to GDP stood at 123.7 per cent at end-2013, up from 117.4 per cent in 2012.

Forecasts for the General Government deficit were revised downwards throughout the course of the year (Table 3.1). The end-year deficit was €0.3 billion lower than had been envisaged in *Budget 2014* and €0.8 billion lower than foreseen in both *Budget 2013* and *SPU 2013*.

The lower than expected 2013 outturn largely reflected stronger receipts from social contributions and "other sources" of revenue. The latter is a broad category that includes dividend income, including the Central Bank surplus and miscellaneous capital and current receipts. Taxes ended the year in line with expectations and very close to the outlook in *Budget 2014.* New analysis by the Council contained in Analytical Note 3 of this report examines the sources of tax forecasting errors.[66]

[65] The 2013 outturn for the public finances was published in the April Maastricht returns. These returns contain official estimates for the levels of the General Government balance and General Government debt for the preceding four years as well as forecasts for the current year. They are compiled by the Department of Finance and the Central Statistics Office and submitted to Eurostat by each Member State twice a year, at end-March and end-September.

[66] A caveat to this finding however is the movement in timing of the Budget from December to October. This could affect the accuracy of tax forecasts going forward. For more details see Box E, pp.32-33 of IFAC, 2013b.

TABLE 3.1: DEPARTMENT OF FINANCE PROJECTIONS FOR 2013 AGAINST OUTTURN

€ billions	*Budget 2013*	*SPU 2013*	*Budget 2014*	*Outturn*
	Dec-12	Apr-13	Oct-13	Apr-14
General Government Deficit	**12.7**	**12.6**	**12.1**	**11.8**
General Government Deficit, % of GDP	**7.5**	**7.5**	**7.3**	**7.2**
Structural Deficit, % of GDP[67]	7.7	6.7	5.3	6.2
Primary Deficit, % of GDP	2.0	2.6	2.7	2.5
Revenue	57.6	58.7	58.6	58.9
Tax	41.2	41.9	41.4	41.4
Social Contributions	9.7	9.8	9.9	10.2
Other	6.7	7.1	7.2	7.3
Expenditure	70.4	71.3	70.7	70.6
Government Services	27.2	27.3	27.0	26.7
Social Payments	26.2	28.2	28.4	28.6
Interest	9.3	8.2	7.6	7.7
Investment	3.1	3.2	3.0	2.7
Other	4.6	4.4	4.6	4.9
Primary Expenditure	61.1	63.1	63.0	63.0
Debt	203.5	207.0	205.9	202.9
Debt, % of GDP	121.3	123.3	124.1	123.7
Nominal GDP	167.7	167.9	165.9	164.1
Nominal GDP, % growth	2.8	2.6	1.2	0.1

Sources: Department of Finance, CSO and internal calculations.

The outturn for General Government expenditure was broadly in line with forecasts produced during the course of 2013. Gross departmental spending ended the year marginally below its allocation, despite expenditure overruns in the Health sector (discussed in more detail below). Forecasts for interest spending were reduced as the year progressed. This has been a feature of recent Department of Finance forecasts and has been noted previously by the Council (IFAC, 2013b). See Box B for more details.

[67] The methodology for estimating potential output has changed over the past year resulting in changes to the estimates for the structural budgetary balance. (See *SPU 2014*, Box 1, pp 23).

Although overall government revenues came in ahead of profile and expenditure was broadly on track, a weaker than expected level of nominal GDP meant that the General Government deficit to GDP ratio at 7.2 per cent was only marginally lower than the *Budget 2014* forecast.

There were also a number of one-off factors that added 0.4 per cent of GDP to the deficit in 2013. This mainly reflected exceptional payments associated with the liquidation of Irish Bank Resolution Corporation (IBRC) (0.7 per cent of GDP), although this was partly offset by mobile licence fees (see Chapter 4, Box C for more details).

The General Government debt to GDP ratio ended the year slightly above forecast due in part to revisions to nominal GDP. The actual level of debt was less than had been foreseen earlier in the year reflecting a lower level of borrowing in the latter part of 2013. The most noteworthy debt development in 2013 was the change in the composition of debt as the promissory notes were replaced by long-term government bonds.[68]

Box B: A Closer Look at General Government Deficit Forecast Errors[69]

The Council has a mandate to assess the accuracy of budgetary forecasts. In this Box, we take a look back at the accuracy of forecasts for the General Government deficit from 2011 to 2013 from successive Budgets. We examine the one year ahead forecasting error – the difference between the outturn for the deficit in 2013 relative to the forecast in *Budget 2013* (we do the same for *Budget 2011* and *Budget 2012*).

Decomposition of General Government Deficit Forecasts

In the Tables below, we compare Department of Finance estimates for key General Government aggregates (including nominal GDP) with actual outturns. For example, in *Budget 2013*, the Department of Finance estimate for General Government Revenue in 2012 was €55.7 billion. The outturn was €56.6 billion. All else equal, the starting point is therefore better than was envisaged in *Budget 2013*. We apportion the forecast error in the deficit into an error due to these data revisions and a residual error. Negative numbers indicate a lower than forecast deficit.[70]

[68] The promissory note transaction resulted in a switch of €25 billion from promissory note debt to government bonds. As of end-2013, 55 per cent of General Government debt was in the form of government bonds (€111 billion), with EU/IMF programme assistance loans accounting for a third (€67 billion) according to *SPU 2014*. The Government's holding of liquid assets (which leads to a corresponding increase in gross debt) amounted to €24 billion (of which €18.5 billion was in the form of Exchequer cash and deposits) at end-2013.

[69] The calculations behind these tables can be downloaded from www.fiscalcouncil.ie.

[70] Exceptional payments to the financial sector are excluded from the analysis.

The Tables highlight that the lower than expected deficit outturns in recent Budgets to a large extent reflected a favourable (tax and non-tax) revenue performance and lower than expected interest payments.[71] This helped to compensate for expenditure pressures in 2012 and 2013.

TABLE B1: DECOMPOSITION FORECAST ERROR IN 2013

Contributions, % of GDP	Due to 2012 Revision	Due to Residual Error	Combined
Nominal GDP	0.0	+0.2	+0.2
Revenue	-0.6	-0.2	-0.8
Primary Expenditure	+0.7	+0.4	+1.1
Interest	-0.2	-0.7	-1.0
Total Forecast Error	**-0.1**	**-0.3**	**-0.4**

TABLE B2: DECOMPOSITION FORECAST ERROR IN 2012

Contributions, % of GDP	Due to 2011 Revision	Due to Residual Error	Combined
Nominal GDP	-0.4	+0.1	-0.2
Revenue	-0.7	-0.3	-1.0
Primary Expenditure	0.0	+1.3	+1.2
Interest	0.0	-0.5	-0.5
Total Forecast Error	**-1.1**	**+0.6**	**-0.4**

TABLE B3: DECOMPOSITION FORECAST ERROR IN 2011

Contributions, % of GDP	Due to 2010 Revision	Due to Residual Error	Combined
Nominal GDP	0.0	0.0	-0.1
Revenue	+0.4	+0.6	+1.1
Primary Expenditure	-1.5	-0.1	-1.6
Interest	+0.2	-0.2	-0.1
Total Forecast Error	**-0.9**	**+0.3**	**-0.6**

EXAMPLES OF ERRORS IN SPECIFIC FORECAST COMPONENTS

To get a sense of the magnitude of some of the revisions to General Government aggregates, in Figure B we plot successive forecasts for three specific cases:
- interest expenditure
- investment spending and
- other revenues (General Government revenue less taxes and social contributions).

There has been a pattern of downward revisions to forecasts for interest and investment spending with other revenues underestimated. These patterns have previously been noted by

[71] Some of the factors causing revisions to interest expenditures were discussed in previous *Fiscal Assessment Reports* (IFAC, 2013b) – these relate to the extension of maturities on official loans, lower interest rates, borrowing activity by the National Treasury Management Agency and the promissory note transaction.

the Council (IFAC, 2013a).

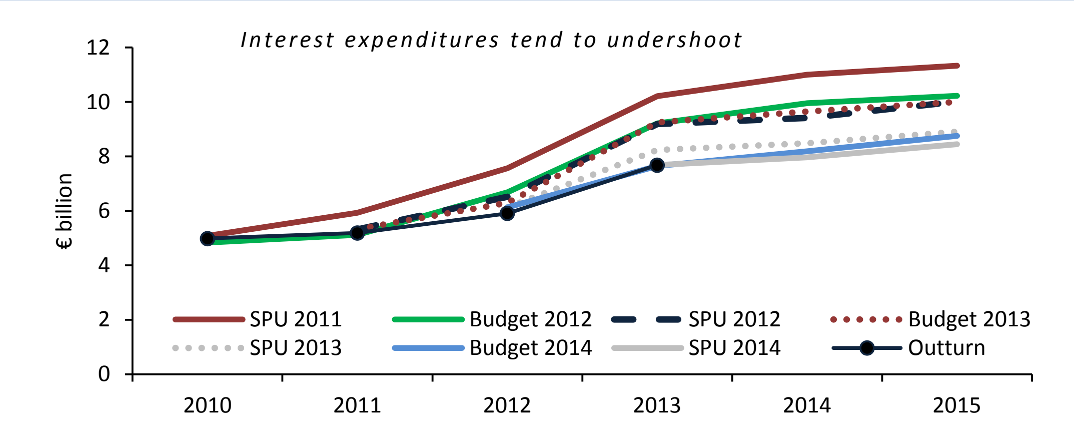
Forecasts for interest spending are provided to the Department of Finance by the NTMA. The Council acknowledges that the task of forecasting interest payments has been more difficult of late due to the substantial changes that have occurred in Ireland's debt profile. For example, the decision to replace the promissory note with long-term government bonds generated interest savings from 2013 as did the extension of maturities on official loans. These developments could not have been foreseen in the budgetary projections.

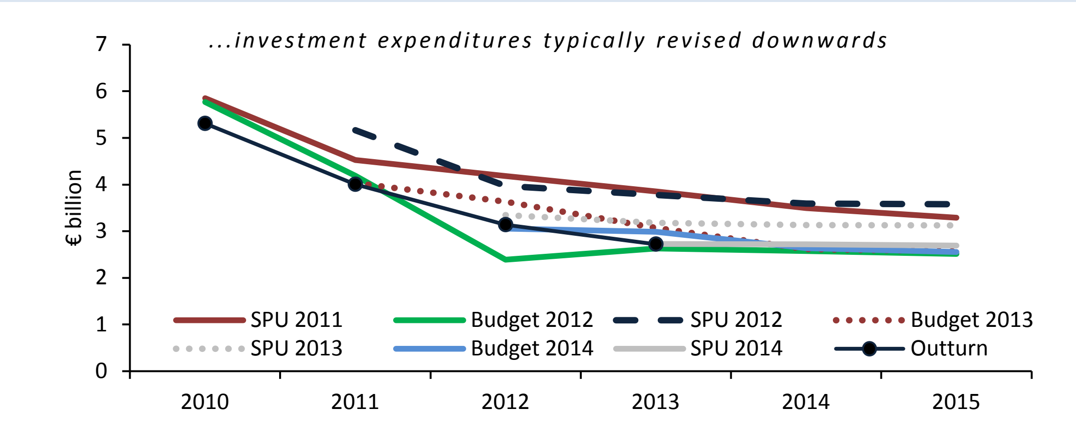
General Government investment spending has tended to be periodically revised downwards. This has also been evident from Exchequer data in recent years, with voted capital expenditure (including the capital carryover) coming in below profile.

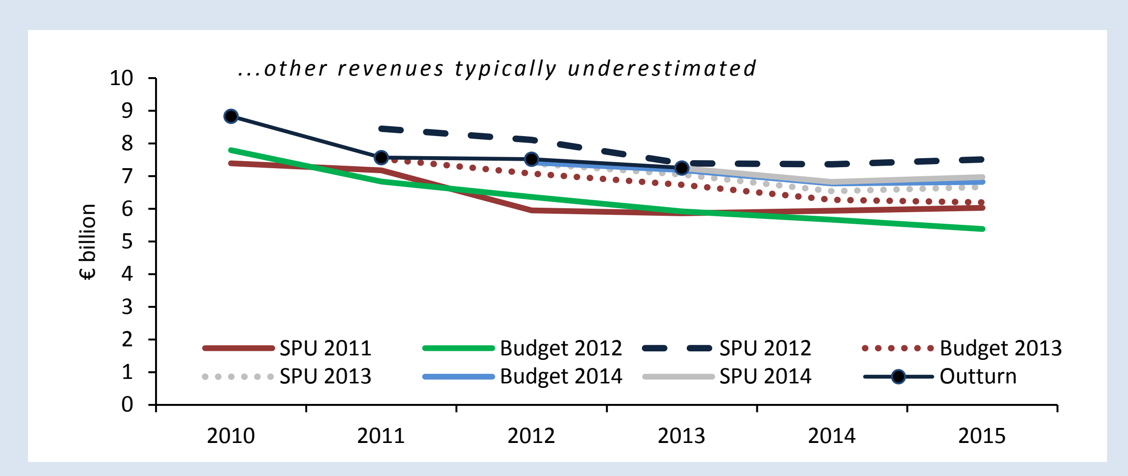
In relation to "other revenues", the Department of Finance has noted that much of the error relates to fees associated with the Eligible Liabilities Guarantee Scheme (ELG) and Central Bank Surplus Income. The latter category is forecast by the Central Bank. Other differences arise from the timing (and recording) of the sale of national lottery and Universal Mobile Telecommunications System (UMTS) licences.

It would be beneficial if the Department of Finance provided more information on the underlying assumptions behind forecasts of these aggregates in future publications.

FIGURE B: GENERAL GOVERNMENT AGGREGATES: FORECAST VINTAGES, *SPU 2011 – SPU 2014*







3.3 An Assessment of SPU 2014 Forecasts

3.3.1 Overview of Budgetary Outlook to 2018

Short-Term Forecasts, 2014 to 2015

The budgetary outlook from *SPU 2014* is summarised in Table 3.2. The General Government deficit is projected to improve to 4.8 per cent of GDP in 2014.[72] This improvement reflects a forecast €2 billion increase in revenues partly arising from tax measures introduced in *Budget 2014* as well as carryover effects from past tax changes and the impact of growth.[73] The 2014 deficit is also lowered by one-off factors (notably national lottery licence sales) amounting to approximately 0.2 per cent of GDP.

Expenditure savings of €1.6 billion as a result of *Budget 2014* measures underlie the expenditure forecast. As outlined in the previous assessment report (IFAC, 2013b), the bulk of this adjustment is apportioned to the two largest spending departments – Social Protection and Health. The outlook for interest expenditures has improved relative to *Budget 2014* reflecting lower interest payments in the early part of the year.

The latest Exchequer developments are summarised in Figure 3.1. By end-May, the Exchequer deficit at €3.5 billion was €1.2 billion lower than the profile for the year. Exchequer taxes at €15.6 billion were up 5.6 per cent year-on-year and were 2.9 per cent (€446 million) ahead of Department of Finance expectations. All tax heads with the exception of capital gains tax were ahead of target. In particular, income taxes were up 7.8 per cent year-on-year and were 1.8 per cent ahead of profile. This robust performance reflects the upturn in employment and the effect of past tax changes.

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[72] This forecast is largely unchanged from the outlook in *Budget 2014*.

[73] One of the main tax measures in *Budget 2014* involved changes to Deposit Interest Retention Tax (DIRT). This is expected to generate additional receipts of €105 million in 2014, while the capping of tax relief of medical insurance is expected to generate €94 million in 2014 – see Analytical Note 4 for more details).

On the expenditure side, current departmental spending at €21 billion was 0.4 per cent (€82 million) below profile to end-May. Nearly all government departments with the exception of Health have kept within budget. Current primary expenditure at €22.5 billion was down 5.4 per cent in the year. Capital expenditure (voted) at €0.8 billion was 6.9 per cent behind its expected profile.

TABLE 3.2: *SPU 2014* PROJECTED CHANGES IN GOVERNMENT REVENUE AND EXPENDITURE

	2014	2015	2016	2017	2018
Main Aggregates, % of GDP					
General Government Deficit[74]	4.8	2.9	2.2	1.2	0.0
Primary Balance	-0.1	+1.8	+2.6	+3.7	+4.8
Structural Deficit	4.7	2.8	2.1	1.2	0.0
General Government Debt	121.4	120.0	115.9	112.0	107.2
Nominal GDP Growth, %	2.6	3.6	4.3	4.7	4.7
Projected Changes in Government Revenue and Expenditure, € billions					
Total Revenue	**2.0**	**2.5**	**1.6**	**2.0**	**2.8**
Tax	2.5	2.1	1.8	2.0	2.5
Social Contributions	-0.1	0.2	0.3	0.4	0.3
Other	-0.4	0.1	-0.5	-0.4	0.0
Total Expenditure	**-1.7**	**-0.4**	**0.4**	**0.3**	**0.6**
Compensation of Employees	-0.2	-0.3	0.0	0.0	0.0
Intermediate Consumption	-0.1	-0.1	0.2	0.4	0.1
Social Payments	-0.6	-0.8	-0.2	-0.5	0.2
Interest	0.3	0.5	0.4	0.4	0.3
Other	-1.1	0.4	0.0	-0.1	0.0
Primary Expenditure	**-1.9**	**-0.9**	**0.0**	**-0.2**	**0.3**

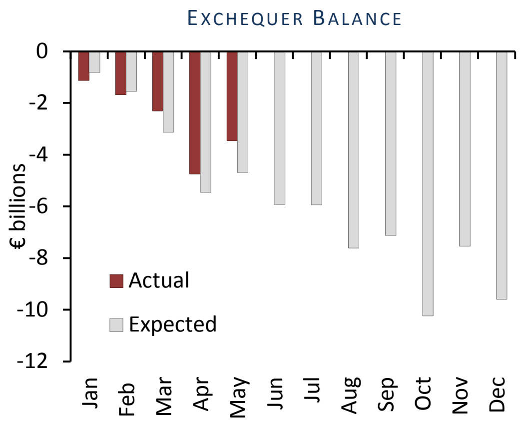
Note: Numbers rounded to one decimal place.

The Department of Finance now publishes monthly General Government data (with a lag of one month). The figures to end-April report a General Government deficit of €4.8 billion – reflecting the Exchequer deficit and the balances on the Social Insurance Fund and Local Government sector. The publication of monthly General Government data marks a further significant achievement in terms of fiscal transparency and follows a series of improvements to Exchequer releases over the past year or so (see IMF, 2013b and IFAC, 2013b).

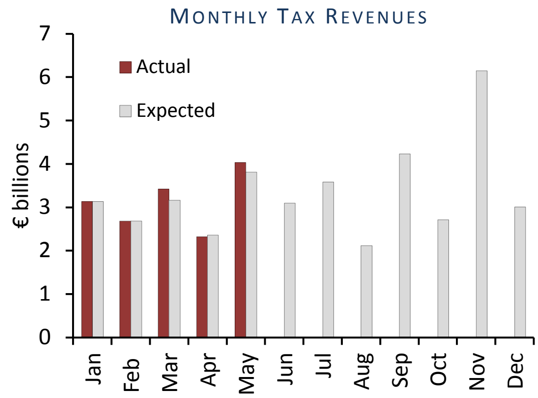
[74] The deficit ceiling for Ireland under the Excessive Deficit Procedure (EDP) is 5.1 per cent of GDP in 2014 and 2.9 per cent in 2015. The deficit here refers to the deficit less deficit increasing financial sector measures. The latter are estimated at €50 million in 2014 and €100 million in both 2015 and 2016.

Figure 3.1: Emerging Fiscal Outlook: Outturn Vs Profile to May 2014

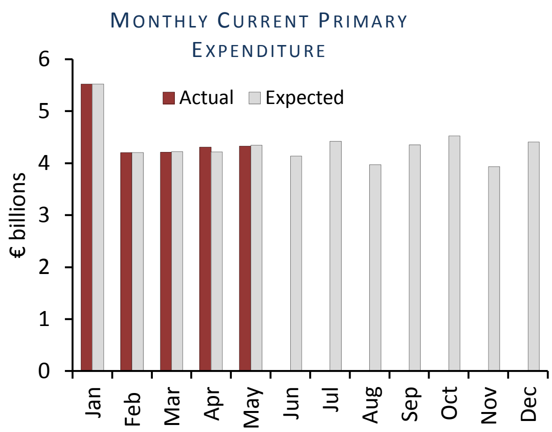
Exchequer balance ahead of Budget 2014 profile...



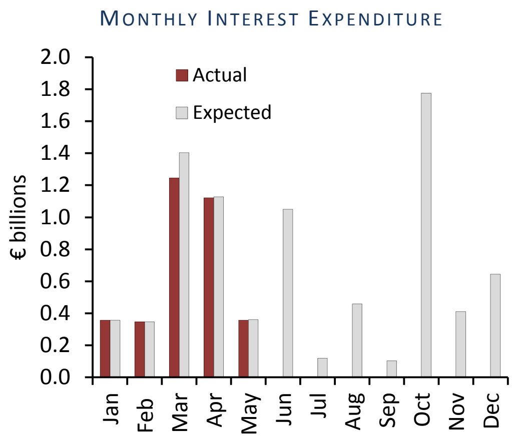
...while taxes continue to outperform



Primary expenditure on track...



...while Interest savings are again apparent



Source: Department of Finance.

These data and the macroeconomic outlook for the remainder of 2014 mean that it is likely that a General Government deficit to GDP ratio of 4.8 per cent will be achieved. This outcome could also be helped by a possible upward revision to the level of nominal GDP (see Chapter 2).

The General Government debt ratio is projected to decline by over 2 percentage points of GDP to 121.4 per cent by end-2014 due to a lower deficit and the use of precautionary cash balances.[75] This would mark the first decline in the debt ratio since 2006.

In 2015, the General Government deficit is projected to fall just below 3 per cent of GDP in line with EDP commitments (Table 3.2). This forecast is premised on a package of tax and expenditure measures of €2 billion in *Budget 2015* and nominal GDP growth of 3.6 per cent.[76] *SPU 2014* contained no additional details on the specific taxation and expenditure measures planned in *Budget 2015*.[77]

General Government revenues are projected to remain broadly unchanged as a share of GDP in 2015 (at 36.3 per cent). The contributions from the main components of Government revenue are shown in Figure 3.2A.[78]

The share of primary (non-interest) spending in GDP is forecast to decline by 1.8 percentage points to 34.6 per cent in 2015. A significant proportion of the fall in spending reflects the improved outlook for the labour market, savings arising from the Haddington Road Agreement, the impact of past expenditure measures and further planned adjustments in the forthcoming budget (Figure 3.2B).

Projections in *SPU 2014* show the Government just meeting its EDP commitments in 2015. While this outlook is assessed to be appropriate, a number of risks could endanger it, principally uncertainties surrounding growth prospects and significant challenges on the expenditure side. These are outlined below.

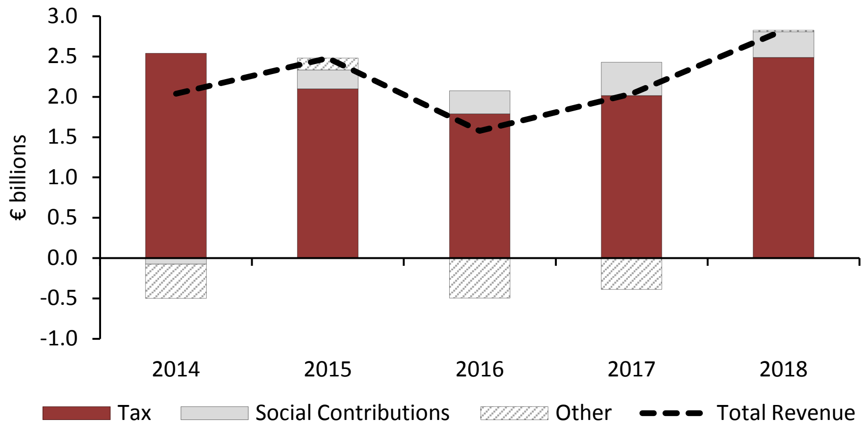
[75] The *SPU 2014* projections for General Government debt show a €7.1 billion decline in Exchequer deposits (against an expected Exchequer deficit of €8.7 billion) in 2014. These liquid assets provide an important buffer in respect of short-term funding needs.

[76] The stability programme signalled that the actual consolidation effort would depend on developments up to Budget day and also following the conclusions of the *Comprehensive Review of Expenditure* (CRE) and a review of tax reliefs and incentives, both of which are expected in October.

[77] The lack of detail on the planned measures for 2015 was also noted in the recent European Commission assessment of *SPU 2014* (European Commission, 2014e).

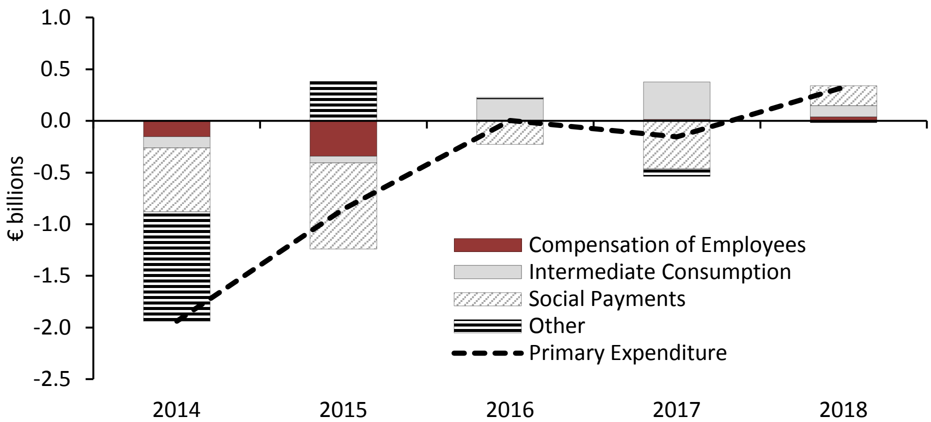
[78] There has been a downward trend in “other revenues” reflecting the ending of bank guarantee income. The increase in 2015 reflects the introduction of Uisce Éireann.

FIGURE 3.2a: *SPU 2014* PROJECTED CHANGES IN GOVERNMENT REVENUE TO 2018



Source: SPU 2014.

FIGURE 3.2b: *SPU 2014* PROJECTED CHANGES IN GOVERNMENT PRIMARY EXPENDITURE TO 2018



Source: SPU 2014.

MEDIUM-TERM FORECASTS, 2016 TO 2018

The budgetary projections from 2016 to 2018 are premised on average annual nominal GDP growth of 4.6 per cent. The forecasts for General Government revenues and expenditures out to 2018 are set so that the structural budget converges to a balanced position in line with Ireland's Medium-Term Budgetary Objective (MTO) (for more details see Chapter 4).

Government revenues are forecast to increase cumulatively by €6.4 billion over the three-year period to 2018 on foot of a sustained upturn in economic activity. Overall tax revenues are forecast to grow broadly in line with nominal GDP (at a rate of 4.4 per cent *per annum*).

On the expenditure side, continued restraint is envisaged with primary spending declining by 4.3 per cent of GDP from 2016 to 2018. Most of this will be driven by savings in social payments, compensation of employees and broader public services (including intermediate consumption). These forecasts are supported by the forecast fall in the unemployment rate. Over the three year period to 2018, the unemployment rate declines by 2.5 percentage points to 8.0 per cent. In Live Register terms, this can be approximated as a cumulative fall of 75,000 persons.[79]

Investment is set to remain at a stable nominal level while declining as a share of output. Debt interest costs are projected to increase further adding to an already sizable interest burden.

Overall, the medium-term fiscal adjustment plans set out in *SPU 2014* imply a sizable and sustained fall in non-interest spending. These budgetary plans imply considerable pressures on government services, public investment and social payments. This is discussed in more detail in the next section.

3.3.2 Expenditure Challenges

The *SPU 2014* projections for expenditure are set within the parameters of the domestic and European rules (see Chapter 4). Primary expenditure as a share of GDP is forecast to decline by just over 8 percentage points between 2013 and 2018. Figure 3.3A shows that this leaves the primary expenditure share of economic output (at 30.2 per cent of GDP) at a very low level historically.[80] Under the existing fiscal framework, there is limited scope for primary expenditure to increase above this ratio in the absence of discretionary revenue-raising measures.[81]

Achieving the envisaged expenditure adjustments will be challenging. Given rising prices, fixed nominal spending would imply a falling volume of public expenditure and a reduction in public services in the absence of productivity gains. A further challenge will arise from demographic pressures as the demand for public sector services increases (principally in education and healthcare).[82]

The plans for Ireland also appear challenging in an international context. In Figure 3.3B, the share of primary spending in GDP is compared across a range of advanced economies with relatively high debt

[79] These calculations are based on *SPU 2013* estimates for the relationship between the Live Register and the unemployment rate.

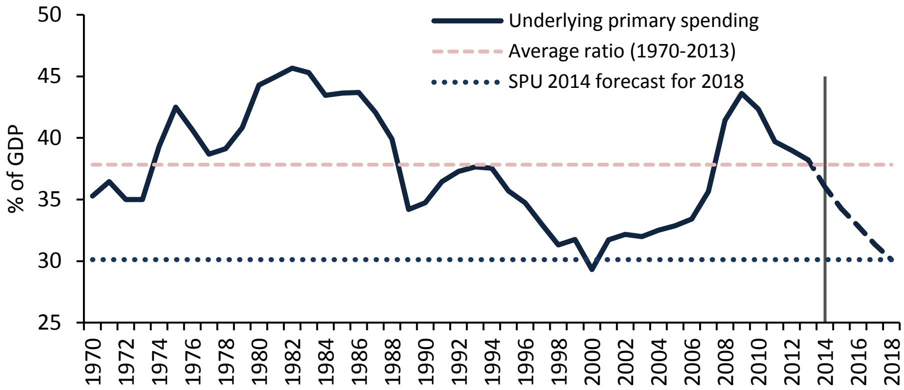
[80] A breakdown of expenditure by category is shown in Figure 3.4A.

[81] Conversely, any discretionary revenue reductions would require expenditure to be reduced below the level set out in *SPU 2014*.

[82] More broadly, Baumol's "cost disease argument" contends that the size of government can increase while maintaining a set level of services due to the cost of government services tending to rise faster than average prices in the economy.

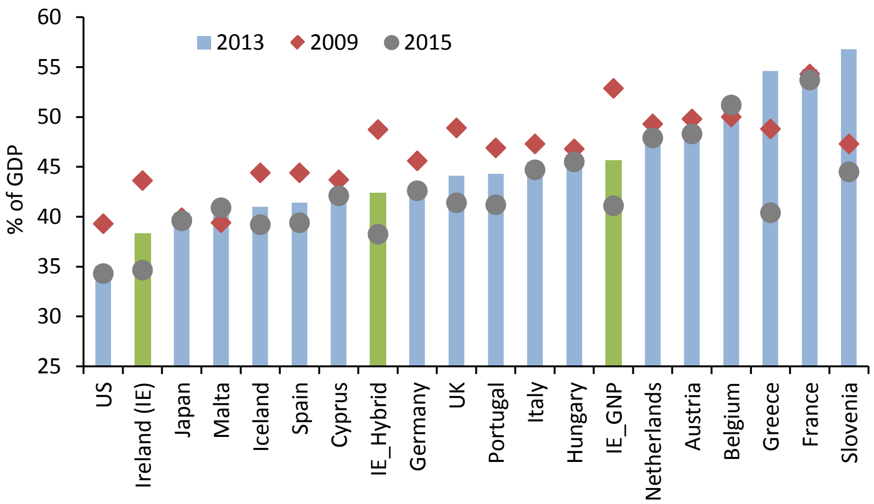
to GDP ratios. Primary spending in Ireland is already at the lower end of the spectrum with the expected change in the ratio between 2009 and 2015 being particularly stark.[83, 84] In Figure 3.3C, the burden imposed by a high level of debt in Ireland is also apparent when interest costs (relative to revenue) are compared across countries.

FIGURE 3.3a: PRIMARY SPENDING, 1970 TO 2018



Source: Internal calculations based on CSO and Department of Finance data.
Note: Underlying primary expenditure excludes exceptional payments to the banking sector.

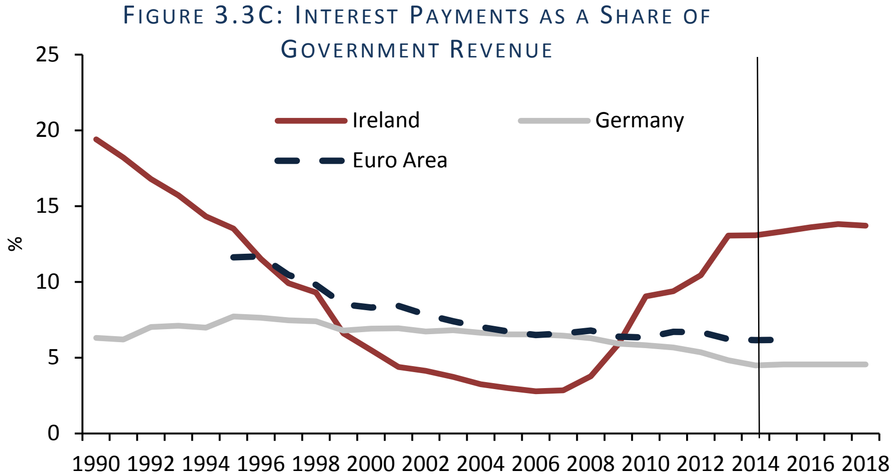
FIGURE 3.3b: CROSS-COUNTRY COMPARISON, PRIMARY EXPENDITURE



Source: Internal calculations, *SPU 2014* and EC Spring 2014 forecasts.

83 For comparative purposes, ratios relative to GNP and the Council's Hybrid measure of output are also shown.

84 While the focus of this section is on expenditure, it is worth noting that the ratio of General Government revenue to GDP in Ireland remains well below the Euro Area average. In 2013, these ratios were 35.9 per cent and 46.8 per cent respectively, based on data from Eurostat.



Source: SPU 2014, Eurostat and German Stability Programme 2014 Update.

THE COMPOSITION OF GOVERNMENT SPENDING

The composition of government spending underpinning *SPU 2014* is shown in Figure 3.4A, with the envisaged adjustments depicted in Figure 3.4B. Most of the main primary expenditure categories are projected to decline as a share of nominal GDP over the forecast horizon.

SOCIAL PAYMENTS

Social payments is the largest category of government spending, accounting for approximately 40 per cent of the total. It includes unemployment related expenditures as well as a range of other areas of spending (e.g., pensions, child benefit, disability payments, allowances, etc). The subcomponents within social spending are easier to assess using Exchequer data (Figure 3.4C). While a significant proportion of social welfare expenditure has remained stable as a share of GDP, pension expenditure has grown at a faster rate, while unemployment-related spending grew significantly as a result of the crisis.

The budgetary projections in *SPU 2014* assume a €2 billion decline in social payments over the period to 2018. Most of this decline is accounted for by the forecast fall in the unemployment rate. However, it is not clear how the remainder of the savings in social payments (up to a third) will be achieved.[85] In addition, the costs of demographic and other pressures have to be met.

The costs associated with population change and an increasing dependency ratio will also put upward pressure on social welfare related spending (Figure 3.4D).[86] Spending on pensions, health, education

[85] This figure is based on a Department of Finance method for estimating unemployment. See Annex 3 of *SPU 2013.*

[86] The projections are based on European Commission estimates.

and long-term care are projected to increase by 2½ percentage points of GDP between 2014 and 2020.[87] All else being equal, this has the potential to crowd out other areas of spending.

There are also other sources of pressure on social expenditure. For example, in the area of healthcare, technological developments, drug costs and incomes all play a large role in determining costs. In addition, institutional and legal arrangements can also influence the incentive structures facing physicians and patients and hence the availability and take-up of services and the final cost to the State.[88] In this context, the proposed reforms to the healthcare system in Ireland must be carefully costed to assess the impact of changing incentive structures on costs.[89]

Compensation of Employees

SPU 2014 envisages a 2.6 per cent reduction in the public sector pay bill to 2016 supported by the Haddington Road Agreement (HRA). Thereafter, the pay bill increases on average by 0.2 per cent *per annum* in the two year period to 2018. The recent *Revised Estimates for Public Services 2014* shows an estimate of public service employees for 2014 broadly unchanged from the 2013 level. If this level is maintained, this implies that savings arising from public service number reductions will not make a significant contribution to expenditure savings from 2014.[90] Without offsetting staffing reductions, these forecasts provide limited scope for pay increases in the post-HRA period.[91]

In the absence of either further productivity increases or per capita pay reductions, the overall cost base will rise in line with any demand increases. While it may be possible, and potentially desirable, to meet these demand pressures without direct hiring, there will nonetheless be a cost to the State.[92]

Investment

The decline in government investment spending has been a notable feature of the budgetary adjustment process since 2008. *SPU 2014* shows government investment is expected to average 1.5 per cent of GDP over the period to 2018, well below the current Euro Area average of approximately 2 per cent. While there is no single measure of government capital, Figure 3.4E shows estimates for the

[87] These projections assume no policy changes and are informative in highlighting the challenges posed by population ageing.

[88] These arrangements include the role of GPs as a ‘gatekeeper’ and the nature of system financing.

[89] These reforms include the introduction of Universal Health Insurance, a ‘money follows the patient’ model of funding hospital care, universal primary care and the introduction of hospital groups as a transition step to independent hospital trusts.

[90] Some savings may arise from the replacement of existing employees with employees on the lower end of pay scales.

[91] The cessation of certain measures under the HRA will also place upward pressure on pay costs, e.g., the return of annual increment payments.

[92] For example, the use of external agency staff for hospitals.

Government's net acquisition of non-financial assets. This shows that depreciation exceeded investment in 2013, implying a marginal decline in the Government's stock of capital. This appears likely to continue out to 2018 under the projected investment rates. This highlights the risk that current low levels of investment will lead to a decline in the public capital stock, impairing the ability to deliver public services while supporting economic growth. It also highlights the limited room for further reductions in the capital budget.[93]

Expenditure Planning

As well as highlighting the limited room for manoeuvre on the expenditure side, the preceding sections underline the implications of "top-down" expenditure planning. By "top-down", we refer to an approach where expenditure aggregates or ceilings are set so as to meet the requirements of the fiscal rules. [94]

There is a risk that forecasts of key expenditure (and revenue) components become overly mechanistic and do not adequately reflect 'bottom-up' pressures.[95] Any failure to take account of these pressures can lead to difficulties in the budget delivery stage.[96] With this in mind, the forthcoming *Comprehensive Review of Expenditure* (October 2014) will be key to effective expenditure planning. [97] It should set out clear and detailed plans on how planned expenditure savings will be delivered. This would also help to underpin the credibility of the budgetary projections over the medium term.

In the absence of further reforms to public spending, it may be difficult to achieve these expenditure reductions without impairing public policy objectives. Furthermore, any reductions in discretionary revenues can only be made in parallel with policy measures to reduce expenditure. In setting the

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[93] Recent announcements in relation to both the Strategic Investment Fund and a €0.2 billion infrastructural stimulus package financed from the proceeds of the sale of State assets help to somewhat allay these concerns.

[94] See the Department of Finance's (2013e) *Medium-Term Budget Framework* for a description of how medium-term expenditure ceilings are set.

[95] The *SPU 2014* forecasts assume tax revenue grows in line with nominal GDP, with expenditure constrained to ensure compliance with the fiscal rules. In practice, additional expenditure would be permitted under the rules if additional discretionary revenue-raising measures are introduced. Conversely, a discretionary reduction in revenue would require offsetting reductions on the expenditure side

[96] See Ljungman, G. (2009), "Top-Down Budgeting – An Instrument to Strengthen Budget Management", IMF Working Paper.

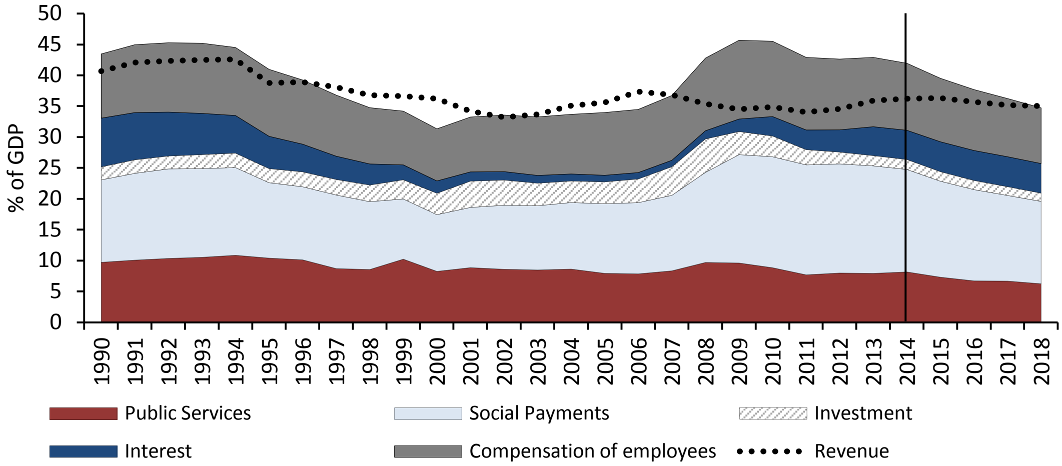
[97] The 2014 *Medium Term Economic Strategy* (MTES) notes (p24) "The next Comprehensive Review of Expenditure will be undertaken in advance of Budget 2015. This will again allow for a detailed examination of current expenditure across all areas of Government, and it will build on the knowledge and experience gained from previous reviews and other evaluations. It will examine spending trends and pressures, and help to identify ways of addressing the challenges arising in the context of fiscal policy. The purpose of the CRE will be to inform Government decisions on future budgetary matters and allow for the Government's recalibration of ministerial expenditure ceilings in light of changing priorities and evaluations of expenditure."

expenditure ceilings, the Government must be mindful not only of the overall fiscal stance but also of the demand pressures and rigidities already built in by existing policies.

Taken together, this suggests that there is limited room for increases in expenditure without offsetting adjustments in other areas. Given this, all adjustment margins should be kept open and under close review.

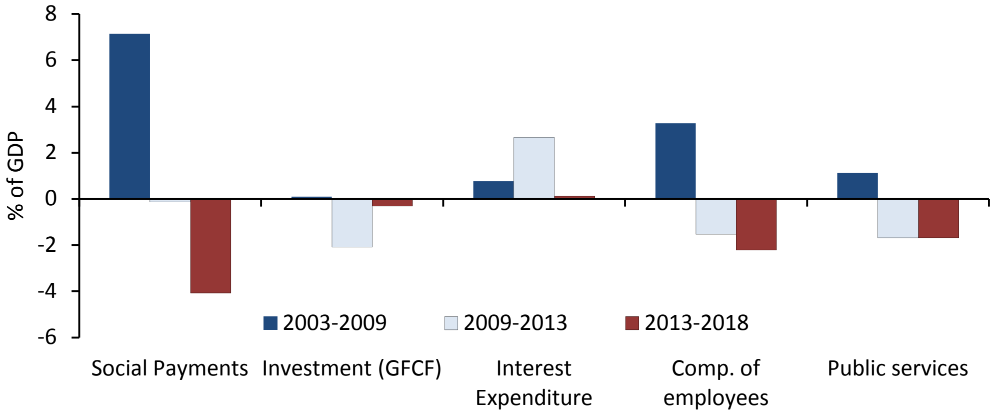
Figure 3.4: Challenges in Expenditure Management

Figure 3.4A: Composition of Government Expenditure



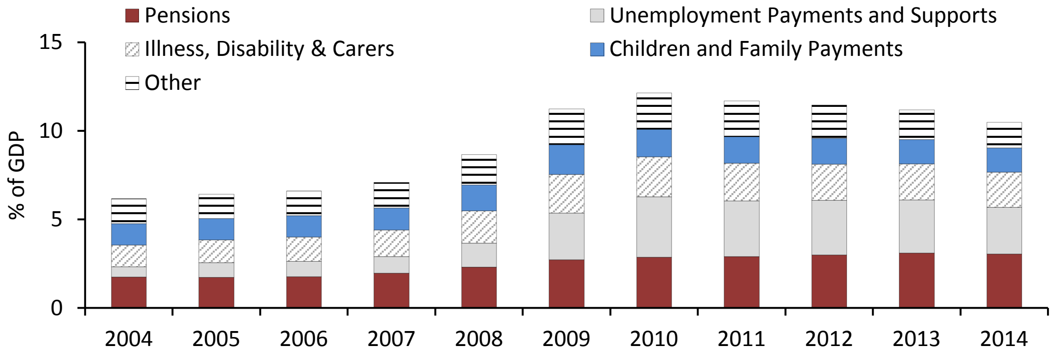
Source: CSO; *SPU 2014.*
Note: The 'Public Services' category includes items such as intermediate consumption, subsidies and capital transfers.

Figure 3.4B: Change in Expenditure



Source: SPU 2014.
Note: The 'Public Services' category includes items such as intermediate consumption, subsidies and capital transfers.

Figure 3.4C: Social Welfare Expenditure

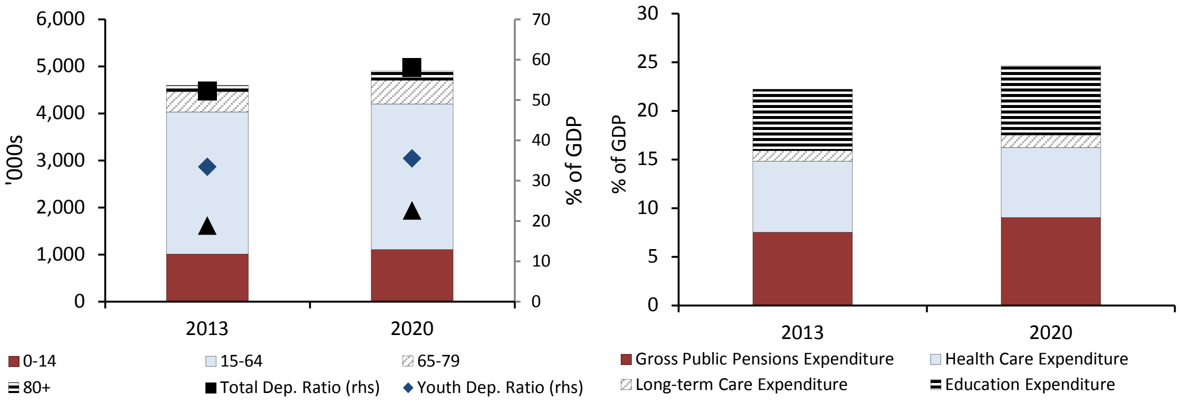


Source: Internal calculations

Figure 3.4D: Implications of Projected Demographic Changes to 2020[98]

(i) Demographic Changes

(ii) Cost Estimates of Demographic Change



Source: *The 2012 Ageing Report,* European Economy 4/2011.

Source: European Economy, Occasional Papers 162, October 2013.

Figure 3.4E: Net Acquisition of Non-Financial Public Assets

Source: CSO.

[98] The total dependency ratio is the ratio of the population aged under 15 and over 64 as a percentage of those aged 15 to 64.

3.4 Sensitivity and Risk Analysis

The stability programme contained a limited discussion on risks. This included sensitivity analysis (using the ESRI *HERMES* model) to quantify the effect of changes in output, interest rates and savings rates on the fiscal ratios. Risks associated with the banking sector or other broader contingent liability risks, however, were not considered.[99] The Council's assessment of fiscal risks updates analysis in earlier reports but also draws particular attention to risks on the expenditure side. Three main classes of risk are considered in Table 3.3.

Table 3.3: Risks to the Budgetary Outlook

Source of Risk	Nature of Risk
(a) Nominal GDP Outlook	- Historical volatility of Irish growth and susceptibility to conditions in the international economy - Uncertainty surrounding the persistence of the balance sheet recession and deleveraging effects on domestic demand - A period of sustained weakness in prices
(b) Expenditure	- Challenges posed by expenditure pressures in key sectors
(c) Other risks	- Balance sheet risks - Interest rates and funding requirements

3.4.1 Sensitivity to Growth Shocks

The Council's Fiscal Feedbacks model can be used to highlight the uncertainty surrounding the budgetary outlook in *SPU 2014*. The fan charts generated by the model are based on historical forecast errors. These suggest that there remains a 1-in-2 probability that the deficit to GDP ratio would be above the 2.9 per cent EDP ceiling in 2015 in the absence of further offsetting adjustments (Figure 3.5A).[100, 101] There is also an estimated 1-in-3 probability that the debt to GDP ratio will have failed to stabilise by end-2015 unless there are other positive surprises or further policy measures beyond those currently planned are taken (Figure 3.5B).[102]

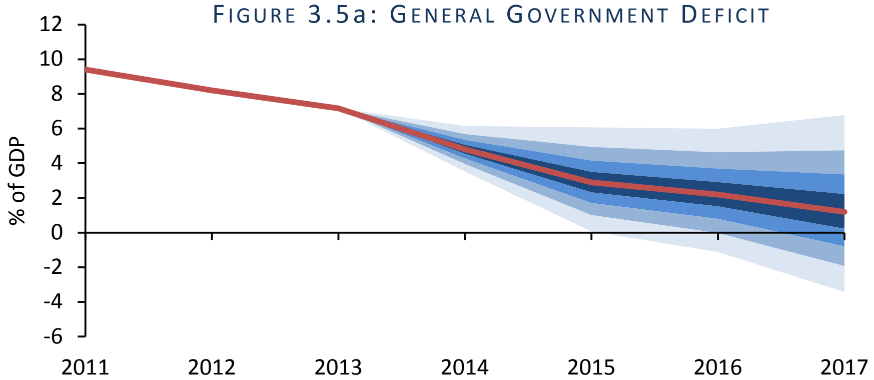
[99] The Council notes the publication of the draft National Risk Assessment in April. This sets out a very broad range of risks and marks a promising step in improving risk analysis.

[100] For a discussion on the use of fan charts, see IFAC (2012c) and (2013a).

[101] Additional sensitivity analysis suggests that if growth turns out to be one percentage point weaker/stronger per annum over the forecast period relative to the *SPU 2014* baseline, then the General Government deficit would be approximately half a percentage point higher/lower by 2015.

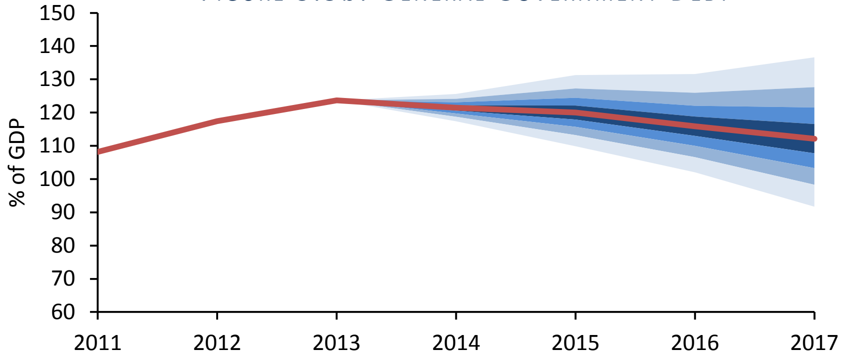
[102] These probabilities are broadly unchanged relative to the Council's previous assessment based on *Budget 2014.*

FIGURE 3.5a: GENERAL GOVERNMENT DEFICIT



Source: Internal calculations.

FIGURE 3.5b: GENERAL GOVERNMENT DEBT



Source: Internal calculations.

A comparison of *SPU 2014* projections with other agencies also highlights the uncertainty in the budgetary outlook (see Annex C). While all agencies expect that the deficit will fall to below 5 per cent of GDP in 2014, there are diverging views on the macroeconomic and budgetary outlook in 2015. [103] The OECD, for example, projects that the 3 per cent deficit ceiling in 2015 will be breached (albeit by a very small margin). The European Commission are forecasting a deficit of 4.2 per cent of GDP, on a no policy change basis – i.e., excluding the planned €2 billion adjustment in *Budget 2015*. This would suggest the need for adjustments of the order of 1½ per cent of GDP in *Budget 2015* (approximately €2½ billion – (see EC, 2014e)).

[103] The OECD forecast real GDP growth of 1.9 per cent in 2014 and 2.2 per cent in 2015. The European Commission's forecasts are for growth of 1.7 per cent and 3.0 per cent over the same period. These compare with forecasts of 2.1 per cent and 2.7 per cent respectively in *SPU 2014*.

3.4.2 Expenditure Pressures

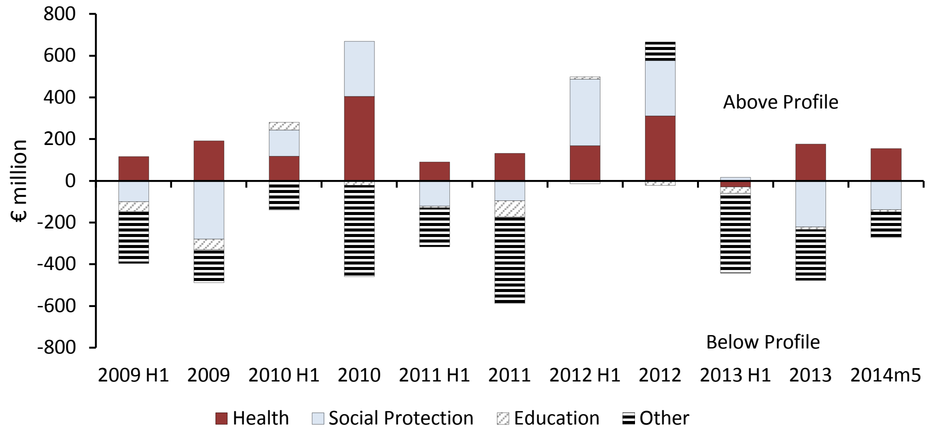
In Section 3.3.2, we outlined the challenges facing the Government in planning expenditure within the parameters of the fiscal rules. This highlighted the limited room for manoeuvre due to various inbuilt rigidities in the system (both economic and social).

Budgetary execution is also important and perhaps most relevant for the Department of Health as there has been a persistent tendency for this department to exceed its budget (Figure 3.6). This was also noted in the 2012 Annual Report by the Comptroller and Auditor General. These problems have again resurfaced in 2014. Based on Exchequer data to end-May, current spending in Health was €156 million (or 3.1 per cent) ahead of profile. Historically, these overruns tend not to be corrected in the second half of the year as reported by the Council in a previous *Fiscal Assessment Report* (IFAC, 2012b).

The Department of Health's estimates for expenditure savings in *Budget 2014* (specifically in relation to medical card probity) further affirms the Council's concerns with expenditure control in that Department. A recent HSE (2014) report noted a deficit of €80 million in the first quarter of 2014 largely due to pressures in the acute hospital sector.

The inability to meet expenditure ceilings in key spending departments such as Health may also reflect the presence of a soft-budget constraint (where it is anticipated that the constraint will be relaxed). The November 2013 *Fiscal Assessment Report* pointed to the challenges posed by weak incentive structures (IFAC 2013b, Box G).

Figure 3.6: Cumultive Overruns in Net Current Expenditure: Mid-Year Vs End-Year



Source: Department of Finance.

3.4.3 Other Risks

Balance Sheet Exposures

The Government's balance sheet contains a wide range of assets and liabilities as well as important off-balance sheet (contingent and implicit) liabilities (for more details see Barnes and Smyth, (2013)).[104] Over the past year balance sheet exposures have fallen significantly. According to the CSO's Government Finance Statistics, contingent liability exposures declined to €73 billion last year, down from €121 billion in 2012.[105] This fall largely reflected the closing of the Eligible Liabilities Guarantee Scheme (ELG) to new liabilities in March 2013. [106]

Aside from the ELG scheme, exposures relating to NAMA have also declined reflecting the repayment of €7.5 billion in senior bonds. Furthermore, the Department of Finance announced in April that the proceeds from the sale of Irish Bank Resolution Corporation (IBRC) assets will be sufficient to discharge the outstanding debt owed to NAMA. The State is likely to gain from this transaction although the precise General Government implications are as yet unknown.[107]

Other downside risks relating to the banking sector appear to have receded as evidenced by a continued decline in the usage of ECB facilities by Irish banks and also by a gradual return to market funding by the three covered banks.[108, 109] However, the prospects for the banking sector are heavily dependent on the forthcoming 2014 EU wide stress test.

In terms of other sizable off balance sheet liabilities, a recent report on public sector pensions estimated that the total accrued liability was €98 billion in 2013.[110] This figure was revised downwards from the previous estimate of €116 billion in 2009 mainly due to pay and pension reductions. The other main off-balance sheet liability of Government is Public Private Partnerships (PPPs). These were valued at €5.7 at end-2013.

[104] 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.

[105] According to the CSO, the value of contingent liability guarantees declined to €68 billion in 2013.

[106] At end-March 2013, the total amounts guaranteed under the Scheme amounted to €75 billion (see NTMA for more details).

[107] As part of the liquidation of IBRC and the ending of the promissory notes, NAMA was required to issue €12.9 billion of Government guaranteed NAMA bonds to the Central Bank in exchange for IBRC debts under the ELA Facility Deed. This debt is now expected to repaid in full with the remaining proceeds available to remaining creditors.

[108] A recent Department of Finance (2014c) report noted that utilisation of ECB facilities by banks in Ireland amounted to approximately €31.4 billion at end-April 2014, the lowest level since the introduction of the Bank Guarantee in September 2008.

[109] See NTMA Presentation for Institutional Investors, May 2014.

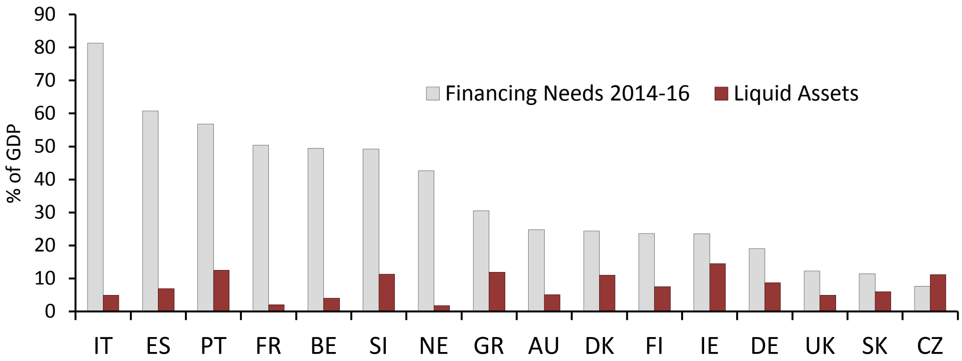
[110] This represents the present value of pension costs of all current public sector staff/pensioners. The CSO reports these liabilities in the Government Financial Statistics.

INTEREST RATES AND FUNDING REQUIREMENTS

The previous assessment report (IFAC, 2013b) examined the sensitivity of the General Government deficit and debt ratios to interest rate shocks. The effects were found to be relatively modest in the short term.[111] The yields on Irish Government bonds have also declined further over the past six months (see Chapter 1).

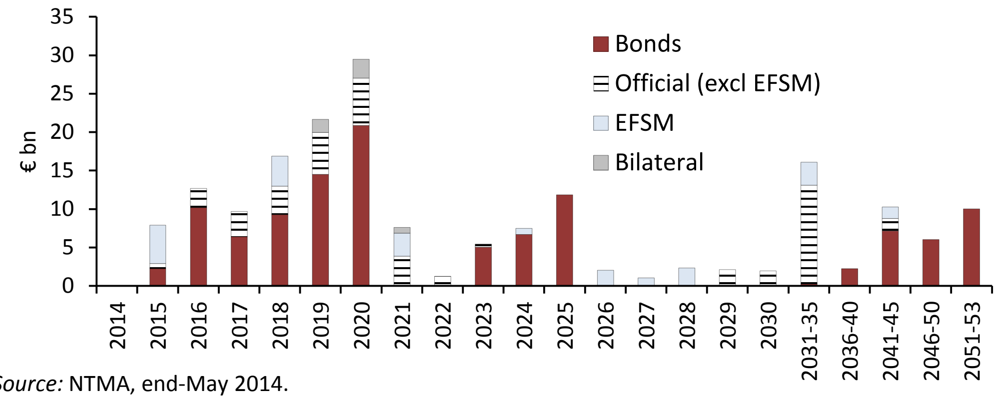
Funding requirements over the period to 2016 have been helped by a combination of strong cash balances and the activities of the NTMA.[112] Compared to other European economies, Irish liquid reserves are at a high level (Figure 3.7). As noted in Section 3.3, the *SPU 2014* projections assume that cash reserves will be run down significantly in 2014. However, Ireland also has significant funding requirements post-2018 as existing bonds mature and as official EU/IMF programme loans are repaid (Figure 3.8).

FIGURE 3.7: FINANCING NEEDS AND LIQUID GOVERNMENT ASSETS



Source: Internal calculations based on Eurostat and IMF data data.

FIGURE 3.8: LONG-TERM AND OFFICIAL DEBT MATURITY



Source: NTMA, end-May 2014.

[111] In the November *Fiscal Assessment Report*, it was estimated that a 150 basis point increase (decrease) in rates over three years would add (subtract) approximately half a percentage point of GDP to the deficit ratio.

[112] According to the projections in *SPU 2014*, the Government will need to raise approximately €13 billion per annum over the period 2015 to 2018, though much of the 2015 requirement has been pre-funded by the NTMA.