1. Assessment of the Fiscal Stance

Key Messages

- Ireland is continuing to make progress following the crisis. It is likely that the Government will succeed in bringing the deficit to below 3 per cent in 2015. Meanwhile, creditworthiness has improved and a broad-based economic recovery appears to be taking hold.

- The Budget projects a deficit of 2.7 per cent of GDP in 2015 in line with requirements for exiting the Excessive Deficit Procedure. As set out in the June *Fiscal Assessment Report (FAR)*, the Council considers a fiscal stance that secures the scheduled exit from the EDP as being "conducive to prudent economic and budgetary management" within the terms of the *Fiscal Responsibility Act* (2012).

- *Budget 2015* represents a missed opportunity to decisively move the public finances into a zone of safety and to create a larger buffer to guard against adverse shocks. The stance in *Budget 2015* means that the deficit next year will be more than one percentage point higher than if previous plans had been adopted. All else equal, the larger deficits result in the debt level being roughly €10 billion higher in 2018 than if previous plans had been adopted.

- With the State having exited the EU-IMF Programme, Ireland's new budgetary framework should play an increasingly important role in helping to avoid the historic pattern of fiscal policy mistakes. If operated effectively, the framework can guard against pro-cyclicality in fiscal policy making which has contributed to damaging boom-bust cycles. To ensure public support, it will be essential for the Government to make a robust case for the national value of the newly strengthened budgetary framework.

- *Budget 2015* was marked by an absence of a well-specified plan for the public finances beyond 2015. Tax revenue profiles assume no change in policy in the medium-term despite Budget commitments. Moreover, the Budget spending profiles assume that spending will remain unchanged after 2015, despite higher figures in the *CER 2015-2017.* The *CER 2015-2017* does not adequately address how well-known expenditure pressures will be met in the coming years.

- The absence of a fully worked-out plan for the public finances beyond 2015 makes an assessment of the medium-term stance challenging. It was especially important that an updated medium-term plan be provided in *Budget 2015* due to the scale of the changes since *SPU 2014.*

It is crucial for the Government to provide credible medium-term fiscal projections in both the Budget and Stability Programme Updates.

1.1 Introduction

The Fiscal Council has a mandate under the *Fiscal Responsibility Acts 2012* and *2013* to assess the Government's fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. The sections below draw on the analysis in later chapters in assessing the fiscal stance in *Budget 2015*. With Ireland having exited the EU-IMF official support programme and likely to reduce the deficit to below the 3 per cent EDP ceiling in 2015, the new budgetary framework comprising domestic and European components will set the parameters for fiscal policymaking in the coming years. Section 1.2 outlines the importance of the framework in helping to avoid the pattern of pro-cyclicality in fiscal policymaking which has proven so damaging in the past. Section 1.3 provides an assessment of the fiscal stance in *Budget 2015*. A number of issues in relation to the lack of detail on the medium-term fiscal stance are set out in Section 1.4.

1.2 Ireland's New Budgetary Framework and Avoiding the Mistakes of the Past

Since 2011, fiscal policy decisions have been guided by the conditions of the EU-IMF programme and the Corrective Arm of the EU *Stability and Growth Pact* that required the Government to reduce the deficit to below 3 per cent of GDP by 2015. With the State now out of the EU-IMF Programme and with the 3 per cent ceiling likely to be met, a new phase of fiscal policy surveillance guided by other elements of Ireland's new budgetary framework will begin.[1] While significant progress has been made in repairing Ireland's public finances, the overall level of debt relative to the GDP is expected to be over 110 per cent in 2014. Reducing debt to safer levels can ease the State's vulnerability to shocks and underpin a return to sustainable growth in employment and incomes. The June *FAR* (2014a) outlined three key potential benefits of the budgetary framework that are summarised here:

i. *Taming the boom-bust cycle*

   The framework should help to tame the tendency of the Irish economy towards boom-bust cycles. For example, the expenditure rule that limits the growth in expenditure to the underlying potential growth of the economy places restraints on the extent to which wind-fall revenues are used to fund "permanent" increases in spending or reductions in tax burdens.

[1] The Framework document is available at: http://www.finance.gov.ie/what-we-do/public-finances/medium-term-budgetary-framework-legislation . This version has been updated since the June 2014 *Fiscal Assessment Report.*

ii. *Moving to safer debt levels*

Compliance with the Budgetary rule and the Debt rule[2] should be consistent with delivering the necessary primary budgetary balance to put the debt-to-GDP ratio on a declining path towards safer levels.

iii. *Enhanced Credibility*

The Government's 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 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.

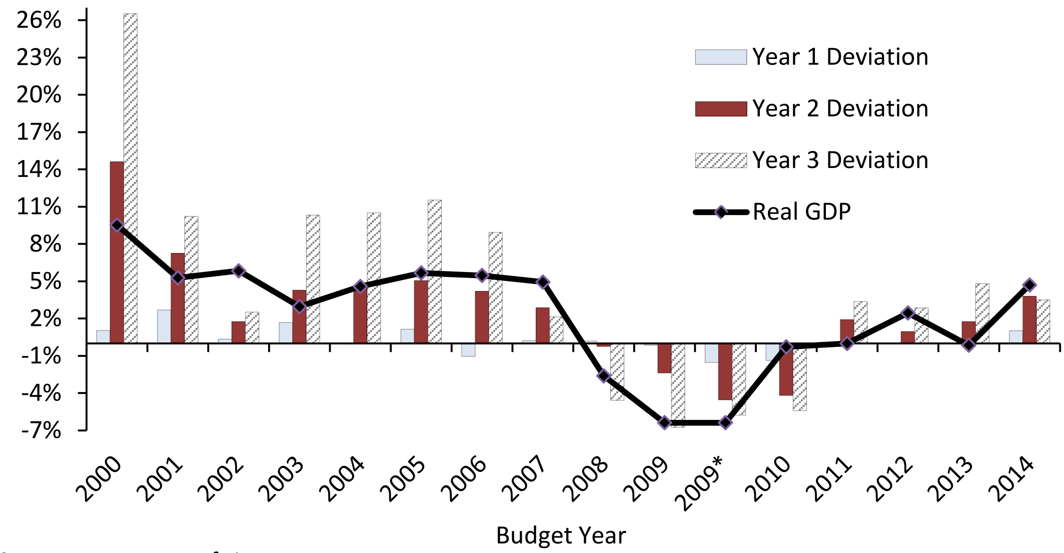
The new budgetary framework is sometimes portrayed in negative terms as an intrusion into domestic freedom of action and as implying the need for perpetual fiscal consolidation. It is important to recognise that debt markets can be much more demanding taskmasters in terms of the constraints on deficit and debt levels considered consistent with access to borrowing on affordable terms. In addition, as noted above, by encouraging prudent management of the public finances during good times, the budgetary framework can provide the Government with fiscal space for expansionary policy to cushion the impact of downturns.

A major weakness of Ireland's approach to fiscal policy prior to the crisis was that the annual budgetary process paid insufficient attention to multi-annual fiscal planning. Expenditure plans focused almost exclusively on the following year's spending plans with medium-term expenditure profiles seen as indicative and subject to change in later years. With spending determined on an ad hoc year-to-year basis, this inevitably contributed to pro-cyclicality in fiscal policy.

Figure 1.1 compares the three-year expenditure projections that were published in the annual Budgets for 2000 to 2014, to the actual outturns for expenditure in each of the three years. While the first year outturn typically came in close to the projected figure, large divergences between planned and actual spending were common in the second and third years from 2000 to 2007. This pattern has started to recur, coinciding with the return to growth in the economy.

[2] The Budgetary rule states that the budgetary position of general government must be in balance or surplus or, if it is not, that it is on the adjustment path towards its medium-term objective. The debt rule states that debt in excess of the 60 per cent debt to GDP ratio must be reduced by at least 1/20th per year on average.

FIGURE 1.1: GROSS CURRENT EXPENDITURE, % DEVIATION FROM FORECAST



Source: Department of Finance

Note: Bars show the deviation of actual expenditure from the three-year ahead expenditure projections published in each Budget since 2000. 2009* refers to the 2009 Supplementary Budget.

A core domestic budgetary reform introduced recently is the Medium-Term Expenditure Framework (MTEF),[3] according to which the government must provide multi-annual ceilings for expenditure for each department for the next three years. This is designed to avoid the type of expenditure management problems highlighted in Figure 1.1 and to guide the planning and delivery of structural reforms.

While the new budgetary framework is not without flaws, the complementary national and European elements provide a valuable structure to guide Irish fiscal policy. Rather than being viewed as something imposed on Ireland, it should be seen as a framework that is in the national interest in that it helps to create the conditions that underpin sustainable growth in Irish incomes and employment and also ensures the future fiscal capacity of the State.

For the framework to be implemented effectively, domestic ownership is essential. Ownership can partly be demonstrated by the provision of clear medium-term budgetary plans consistent with both the letter and the spirit of the new budgetary framework. If policymaking is only considered in the context of ensuring technical compliance with the rules, then its ability to address the structural flaws in Ireland’s fiscal policymaking will be lessened.

[3] The MTEF is set out in the Ministers and Secretaries (Amendment) Act 2013 and Departmental Circular 15/13.

Broad political support and advocacy of Ireland's budgetary framework will be vital if it is to act as an effective guide to sound management of the public finances. This is especially important now that the degree of direct external surveillance has eased with the ending of the Programme. The evidence from *Budget 2015* discussed below suggests that, while public awareness of, and political support for, the framework has increased, problems with implementation remain. To increase public support, it will be essential for the Government to make a robust case for the national value of the newly strengthened budgetary framework.

1.3 The Fiscal Stance in *Budget 2015*

As the economy recovers, the benefits of actions to remedy the public finances between 2008 and 2013 have become evident. Concerns that such a large programme of fiscal consolidation could trip the economy into a deflationary spiral and even become "self-defeating" in budgetary terms have not come to pass. Instead, having peaked in 2009 at 11.5 per cent of GDP, the underlying general government deficit has fallen and is expected to measure around 3.7 per cent of GDP in 2014. While the consolidation measures negatively impacted domestic demand, the recovery in the Irish economy has gained momentum and is now being supported by improving domestic demand. It was against this comparatively more favourable backdrop that *Budget 2015* was framed.

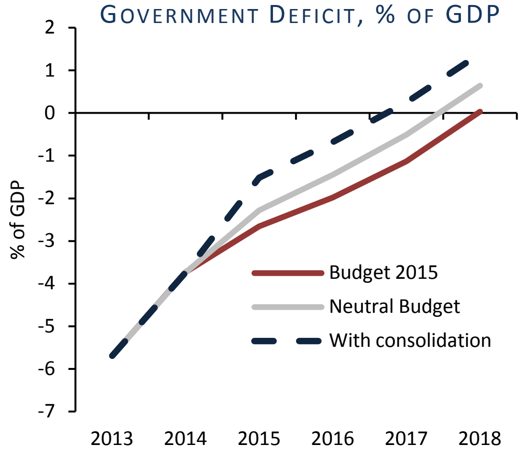
An expansionary package amounting to just over €1 billion was announced in *Budget 2015*. This comprised €420 million of tax measures and an increase in expenditure of €630 million.[4] This easing of the fiscal stance represents a €3 billion reversal from the plan outlined in the *SPU 2014* when a package of tax increases and expenditure cuts of around €2 billion was envisaged. According to the Budget projections, the deficit as a percentage of GDP will fall to 2.7 per cent in 2015 (Figure 1.2); a neutral budget would likely have delivered a deficit of around 2.4 per cent in 2015, and estimates suggest that the implementation of €2 billion consolidation, as recommended by the Council, would have resulted in the deficit falling to around 1.5 per cent of GDP next year (see Figure 1.2). In this latter counterfactual scenario, €2 billion consolidation would have brought the government accounts close to balance by 2016 (deficit of 0.7 per cent); in the *Budget 2015* projections, the deficit does not fall to zero until two years later in 2018.

The higher deficits out to 2018 also result in a more unfavourable path for the overall level of debt than could otherwise have been achieved. Figure 1.3, based on the Council's fiscal feedback's

[4] In addition to the €630 million increase in expenditure, €400 million in savings from reductions in the Live Register in 2015 do not feed through to lower overall expenditure, with this saving being allocated to other expenditure. Savings from the fall in unemployment could be expected to contribute to the cyclical fall in the deficit rather than funding expenditure increases elsewhere.

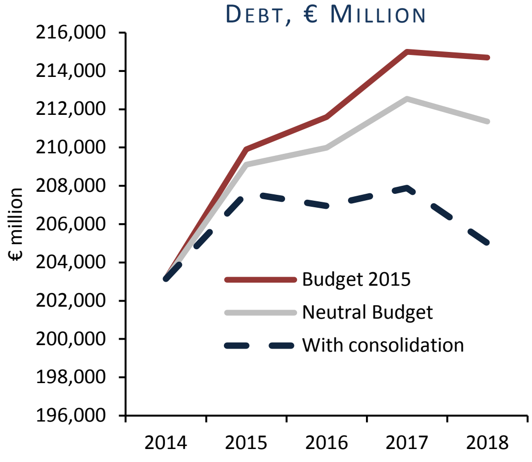
model, shows that the debt is expected to peak at a level roughly €10 billion higher than would have occurred with an implementation of previous plans.

Figure 1.2: General Government Deficit, % of GDP



Source: Internal calculations.

Figure 1.3: General Government Debt, € Million



Source: Internal calculations.

As noted in the Council's *Pre-Budget 2015 Statement*, improvements in the economy and in tax revenues, as well as the positive impact of statistical changes on fiscal aggregates (see *Analytical Note No. 6*), meant that as 2014 progressed, it became apparent that compliance with the 3 per cent deficit ceiling could likely be achieved with less consolidation than previously planned. The Government opted for an expansionary package of €1 billion in *Budget 2015* rather than the planned consolidation, thereby absorbing a substantial portion of the additional resources created by the improvements in fiscal aggregates evident up to end-September 2014.[5]

The Council has a responsibility under the FRA to assess whether "...the fiscal stance for the year or years concerned is....conducive to prudent economic and budgetary management" [*FRA* 8(4)(b)]. In the June 2014 *FAR*, the Council assessed that a budgetary policy to bring the projected deficit in line with the EDP limit of 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 would meet the requirements as set out in the *FRA*. According to *Budget 2015*, these conditions are expected to be met over the forecast years.

[5] By end-September, the last available data prior to the Budget, the Exchequer data showed that taxes and PRSI were ahead of profile by €0.9 billion while non-tax revenues were €0.4 billion higher. This improved revenue performance up to end-September was only partially offset by a €116 million expenditure overrun relative to profile.

However, as noted in the Council's *Pre-Budget 2015 Statement*, the fiscal rules set a minimum standard for policy and there are circumstances where a more ambitious policy stance may be appropriate. By opting to depart from its previously announced plans in *Budget 2015*, the opportunity to embed a more favourable and prudent fiscal stance over the coming years - and thus to more decisively move the public finances into a zone of safety - has been missed. By choosing to comply with the most immediate target of the budgetary framework (correction of the excessive deficit) with a much tighter margin, meeting the requirements of the rules beyond 2015 becomes a more demanding task.

As shown in Figure 1.2, implementing the planned consolidation effort would have produced a deficit of 1.5 per cent in 2015 and would have moved the public finances into safer territory with a balanced budget position within reach. The opportunity to build in a more adequate margin of safety for 2015 has therefore been lost. *Budget 2015* projects a deficit of 2.7 per cent of GDP in 2015. The margin below the 3 per cent EDP ceiling is small relative to the scale of uncertainty at this stage about developments in 2015. This is illustrated by the analysis in Chapter 3 which shows that even a small negative shock which reduces nominal GDP growth in 2015 by 0.5 of a percentage point would, in the absence of offsetting policy measures, result in the 3 per cent EDP ceiling in 2015 being missed. Chapter 2 shows that a small weakening in the Euro Area economy could lead to a reduction in Irish growth of this magnitude. While there is scope to accommodate negative developments in 2015 to ensure that the target is met, for example by reducing spending during the year, such adjustments may be disruptive. Moreover, a smaller budget deficit in 2015 would put the public finances in a safer position relative to the considerable uncertainties regarding the medium-term outlook.

The Council's approach to assessing the fiscal stance is informed by the difficult trade-off between implementing fiscal consolidation to improve creditworthiness and debt sustainability and minimising the negative impact on demand and output. The implementation of a large programme of fiscal retrenchment during 2009 and 2010, when output was already falling and unemployment increasing, required that the negative impact of the consolidation measures on growth needed to be carefully balanced with the need to stabilise the public finances. As discussed in Chapter 2, although the headline rate of growth may be overstating the extent of the improvement in the economy this year, the forecasts from the Department of Finance and other agencies indicate that the economy is growing at a robust rate and this is projected to continue in 2015. The need for *Budget 2015* to provide an additional short-run stimulus in this context is reduced. On the other hand, the improved creditworthiness of the State and stabilisation of the debt to GDP ratio have reduced the urgency of further adjustment efforts. However, it remains the judgement of the

Council that completing the last phase of the adjustment plan to 2015, and then following the less demanding requirements of the Budgetary Rule and Preventive Arm of the *SGP*, would have been on balance the most appropriate fiscal stance.

1.4 Medium-Term Fiscal Stance

In the short run, it is likely that the Government could meet its objective of reducing the deficit to below the 3 per cent ceiling in 2015. However, *Budget 2015* raises a number of issues of concern in relation to the path of the public finances beyond 2015.

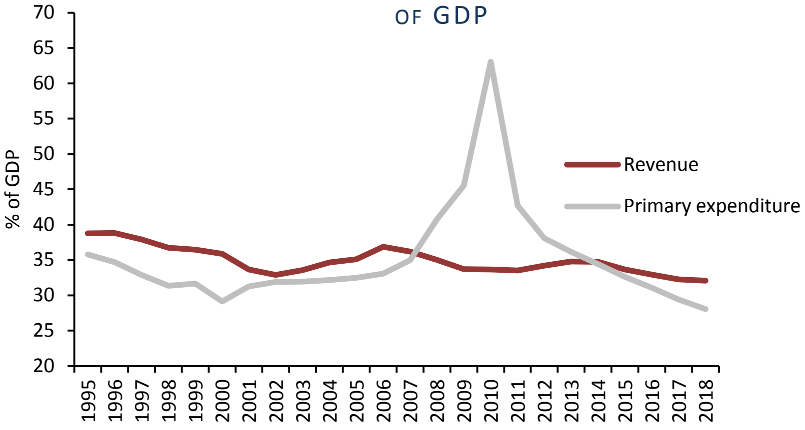
As discussed in Chapter 3, the post-2015 expenditure profiles provided in the Budget are based on a technical assumption that voted spending remains fixed at its 2015 level from 2016-2018. This is despite higher actual figures for expenditure being set out in the accompanying *CER 2015-2017.*[6] Moreover, the Budget figures for tax revenue do not take account of further tax changes post-2015 which have been signalled such as reductions in income tax and the universal social charge.[7] Consequently, *Budget 2015* lacks a well-specified plan for the public finances beyond 2015.

The Council's June 2014 *FAR* highlighted that the sharp decline in government spending as a ratio of GDP over a prolonged period envisaged in the *SPU 2014* would be difficult to achieve given demographic and other pressures. In this context, the report urged that the *CER 2015-2017* would set out comprehensive and detailed plans on how expenditure savings will be delivered. However, this has not occurred.

[6] *Budget 2015* (p. C23) states that "...the spending aggregates in this [Budget book] Table differ from the 2016 and 2017 details set out in the Expenditure Report. Priorities, which have been outlined in the Budget, and included in the ceilings in the Expenditure Report, will be addressed in subsequent Budgets when there is technical clarity around the quantum of fiscal space".

[7] In relation to taxes, Minister Noonan stated in his Financial Statement: "This is the first instalment of a plan to progressively reduce the 52% tax rate on low and middle income earners in a manner that maintains the highly progressive nature of the Irish tax system…We will continue to ease the burden on those in the middle in a targeted manner without giving disproportionate benefits to those on highest incomes. The 52% marginal tax rate will be lowered further while ensuring those on higher incomes continue to pay their fair share".

FIGURE 1.4: PRIMARY EXPENDITURE AND TOTAL REVENUE, % OF GDP



Source: Department of Finance , Central Statistics Office (CSO), internal calculations.
Notes: Data are on a general government ESA 2010 basis.

The projected expenditure figures shown in Figure 1.4 are based on the *CER 2015-2017* and imply a steep fall in the ratio of primary expenditure to GDP, similar to that contained in the *SPU 2014*.[8] The CER has raised these expenditure ceilings for 2015-2017 but does not contain detailed information on how pressures arising from demographic changes, investment needs and demands for public sector pay increases have been incorporated into medium-term spending plans. If the expenditure path shown in Figure 1.4 makes allowance for these pressures, it is not clear from the *CER* where savings are to be made elsewhere to free up resources for increased spending to meet these demands, or the extent of these savings.

The raising of the expenditure ceilings discussed in Chapter 3 undermines the purpose of multi-annual expenditure planning. The shift to a multi-annual approach to expenditure planning is a key element of the new budgetary framework and is designed to protect against the type of pro-cyclical trend in government spending observed in previous years. The Government's revised *Medium-Term Budgetary Framework (MTBF)* states that multi-annual expenditure planning is designed to "...facilitate a more strategic approach to resource allocation by emphasising prioritisation of key services over reaction to day-to-day pressures..." (*MTBF,* 2014). However, as outlined in Chapter 3, every expenditure report since 2012 has contained upward revisions to the expenditure ceilings. Furthermore, in this context, the current *CER 2015-2017* states that

[8] The *CER* published on Budget day sets out the expenditure ceilings for each department for the years 2015 to 2017. These expenditure figures were not used in Table 11 (page C.24) of the Budget Book. Instead, as explained in further detail in Chapter 3, the expenditure projections in the Budget are based on the technical assumption that voted expenditure remains fixed at its 2015 level from 2016 to 2018. In order to show a path for expenditure which more realistically reflects actual government spending plans, Figure 1.4 uses the projections from the *CER* rather than the Budget figures.

Departments are expected to stay broadly within the new ceilings, notwithstanding the scope for additional resources in 2016 and 2017.

The lack of detail and clarity around the expenditure plans as well as the upward revisions to expenditure ceilings in recent years raises doubts as to the meaningfulness of the current projections for government spending in the medium term. As explained in Chapter 3, expenditure ceilings have been revised upwards since 2012 with the upward revision in the most recent *CER 2015-2017* measuring 3 per cent. [9] If this pattern of upward revisions exhibited in earlier years was to be repeated then the budget deficit from 2016 would be higher than is currently projected.

The ratio of tax revenue to GDP is forecast to fall over the projection horizon (Figure 1.4) and by 2018 the ratio is expected to be over 4 percentage points lower than in 2000. These projections in the Budget are based on the technical assumption of no easing of the tax burden after 2015 and likely overstate the level of government revenue in the medium-term. The likely level of resources which will be available to fund government spending out to 2018 thus remains unclear.

Taken together the lack of detail underpinning the Government's medium-term projections for both expenditure and revenue means in turn that considerable uncertainty surrounds the overall projected path for the general government deficit. This is expected to decline to 2.7 per cent in 2015 with further projected improvements leading to a small surplus being recorded by 2018. However, with both government revenue and expenditure expected to differ from the path outlined in *Budget 2015*, it is unclear what the likely underlying path of the deficit will be over the medium term.[10] Moreover, the lack of a well-anchored medium term plan raises the risk that incoming cyclical revenues will be spent rather than saved, leading to unsustainable spending levels.

[9] This figure is calculated by comparing the expenditure projections in the *CER 2015-2017* to the 2014 *Expenditure Report*.

[10] The European Commission Autumn forecast projects that the deficit would rise from 2.9 per cent of GDP in 2015 to 3 per cent in 2016 on a no-policy change basis.