Assessment of Budgetary Forecasts

Key Messages

- The General Government deficit of 3.7 per cent of GDP for 2014 projected in *Budget 2015* is driven by buoyant tax revenues for the year to date and a higher level of nominal GDP than originally anticipated. This is a lower deficit than the 4.8 per cent forecast in *SPU 2014*. The improved outlook for 2014 and strong expected economic growth for 2015 lead to a forecast deficit of 2.7 per cent next year. This is outcome is expected to be achieved despite the turnaround in the planned fiscal stance to allow for the introduction of expansionary measures.

- *Budget 2015* does not include a well-specified plan for the public finances after 2015. Instead, it provides a set of revenue forecasts based on a no-policy change and an expenditure profile based on holding Voted Expenditure constant. These do not appear to represent the Government's best estimates of the level of revenues or expenditure in the coming years. Indeed, revenues will likely be impacted by announcements regarding an easing of the income tax burden in future Budgets and the *Comprehensive Expenditure Report 2015-2017* announces a different path for voted expenditure.

- Spending plans have been revised upward, including raising the expenditure ceilings for 2015 to 2017. Even so, expenditure pressures remain and the *Comprehensive Expenditure Report 2015-2017* does not detail what spending measures will be required to remain below ministerial ceilings. This a particular problem for departments reporting large cost pressures over 2015 to 2017.

- General Government debt should rise much more gradually in the medium term due to the rundown of cash balances and shrinking deficits. The debt-to-GDP should fall quite rapidly over the medium term if *Budget 2015*'s forecasts for economic growth materialise.

- While the budgetary projections for 2015 are assessed to be appropriate, significant uncertainties surround growth projections and the capacity to deal with expenditure pressures. The usual uncertainties are compounded for 2016-18 by the absence of a well-specified medium-term plan. Risks to the government's balance sheet, while still present, have subsided considerably in recent years as the outlook for both NAMA and the banking sector has improved and greater certainty was provided by recent bank stress tests.

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 2014 (Section 3.2); (ii) an assessment of the forecasts contained in *Budget 2015* (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 contains new analysis which decomposes the main drivers of the Department's forecasts for key tax revenues in 2015.

3.2 Department of Finance Budgetary Projections for 2014

Budget 2015 forecasts a deficit of 3.7 per cent in 2014, considerably lower than the 4.8 per cent forecast in *Budget 2014* and *SPU 2014.* Part of this change is due to statistical revisions to both the size of the deficit and the size of nominal GDP; these were required as part of an international movement from the ESA 95 standard to the ESA 2010 standard (see Analytical Note 6). Table 3.1 shows the evolving set of projections for 2014, as adjusted for statistical revisions required under ESA 2010.[1]

The outlook for General Government revenues in 2014 is almost €2 billion stronger in *Budget 2015* relative to *Budget 2014.* Within this, taxes make up the largest source of revision, some €1.2 billion stronger than anticipated. Social contributions (mainly Pay Related Social Insurance (PRSI)) and other non-tax revenue (mainly Central Bank surplus and dividends from semi-state companies) also contribute €0.7 billion in total. Total expenditure for 2014 has also risen in *Budget 2015.* An upward revision to government services was partially offset by a downward revision to interest payments.

The forecast for the size of the debt in 2014 in nominal terms is similar in *Budget 2015* to the level forecast in both the *SPU 2014* and in *Budget 2014*, as shown in Figure 3.1.[2] Although the projected size of the debt in nominal terms is largely unchanged compared to earlier forecasts, the debt ratio as a percentage of GDP is expected to be lower. This reflects the increase in the level of nominal GDP due to ESA 2010 changes as well as higher forecasts of nominal GDP growth in 2014. Removing the effect of ESA revisions from nominal GDP but allowing for improved economic growth, the *Budget 2015* estimate for debt-to-GDP would have been roughly 118 per cent.

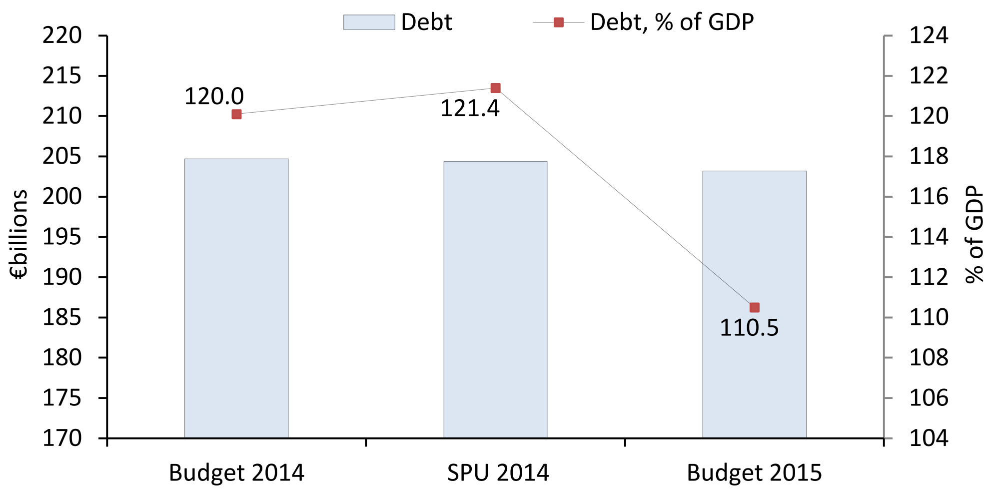
[1] The table is amended for the nominal impact of ESA 2010 revisions to each category. For items expressed as a percentage of 2014 GDP, nominal GDP for 2013 is revised to ESA 2010 and the forecasted GDP growth rate for 2014 is applied.

[2] The main ESA 2010 revisions to the nominal debt level, predominantly the treatment of Irish Bank Resolution Corporation (IBRC), have fallen out of the debt figures by 2014.

TABLE 3.1: DEPARTMENT OF FINANCE PROJECTIONS FOR 2014 (ADJUSTED FOR ESA 2010)[3]

€ Billions	*Budget 2014*	*SPU 2014*	*Budget 2015*
	Oct-13	Apr-14	Oct-14
General Government Balance	**-8.2**	**-8.0**	**-6.9**
General Government Balance, % of GDP	**-4.5**	**-4.6**	**-3.7**
Primary Balance, % of GDP	0.0	0.0	0.3
Revenue	61.9	62.0	64.0
Tax	44.6	44.7	45.9
Social Contributions	10.3	10.1	10.6
Other	7.0	7.1	7.6
Expenditure	70.1	70.0	70.9
Government Services	26.7	26.6	27.9
Social Transfers	28.2	28.2	28.1
Interest	8.2	8.0	7.5
Investment	2.6	2.7	2.8
Other	4.4	4.4	4.6
Primary Expenditure	61.9	62.0	63.4

FIGURE 3.1: EVOLVING DEBT PROJECTIONS FOR 2014



Source: Department of Finance.

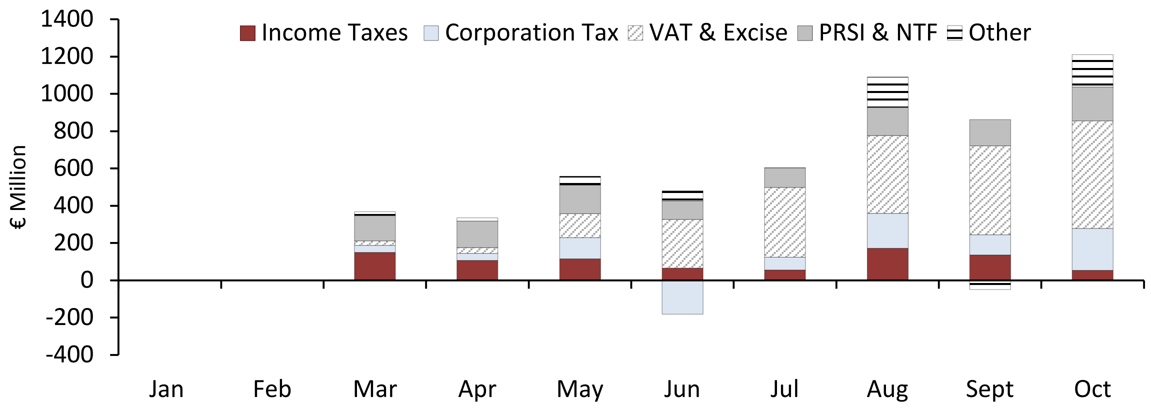
[3] This table summarises Department of Finance's forecasts for 2014 as amended by the statistical revisions contained in ESA 2010. This is carried out for comparison purposes. As such, there may be small differences between the numbers reported here and those contained in *Budget 2014* and *SPU 2014*.

Revenue Revisions

The biggest changes to the budgetary forecasts for 2014 relative to *Budget 2014* are those made to revenues, both tax and non-tax. This section analyses revenue revisions in greater detail.

The upward revision to taxes and social contributions is in the context of Exchequer numbers to end-October (Figure 3.2) being substantially ahead of expectations. Taxes and PRSI together were some €1.3 billion ahead of profile, driven by an unexpectedly large 8.2 per cent year on year increase in VAT, as well as strong performances in Excise Duty, Corporation Tax (CT), PRSI and Income Tax. While a portion of this strong performance is related to the pension fund levy, which will be substantially reduced in 2015, the majority of the overperformance appears to be based on an underlying improvement in revenues rather than one-off or temporary factors.

Figure 3.2: Taxes and PRSI Relative to Profile



Source: Department of Finance, internal calculations.

The Department of Finance forecast tax heads on the basis of a number of factors:

i. economic drivers;
ii. the estimated yield from policy changes; and
iii. other variables such as carryovers from previous years, one-offs and data provided by the Revenue Commissioners

A standard formula is used to estimate the impact of these factors, but the final forecast may include a judgement factor to adjust the formula's forecast up or down.[4] Based on this approach, the forecast revision for four of the main tax heads contained in *Budget 2015* can be divided into three categories: (i) revision to economic outlook, (ii) confirmation of the tax take in 2013 (referred to as the starting point error), and (iii) other errors which relate to judgement, estimation of

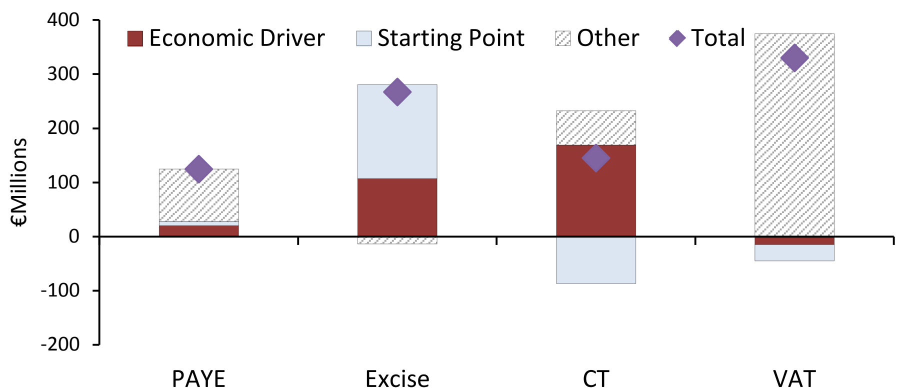
[4] See Analytical Note 3, June FAR 2014 for an explanation of this formula and the method of decomposing errors.

carryovers and one-offs and estimations of the policy yield (i.e., the impact of tax changes on the tax yield). Figure 3.3 shows the *Budget 2015* revision to estimates of the 2014 tax take split into these components.

For VAT, the 2014 outturn appears likely to be well-ahead of the 2013 estimate. While the starting point estimate for 2013 was slightly optimistic this was offset by a large revision stemming from other factors. Since no judgement was applied and as the size of adjustments for policy and one-offs was small, the bulk of the error is likely related to the elasticity of VAT receipts with respect to personal consumption growth having been higher than assumed by the forecasting formula. This could be because consumers are returning to more discretionary purchases, such as cars, that tend to be richer in VAT receipts.

For corporate tax, an upward revision to gross operating surplus[5] and a positive revision from other factors are partially offset by a negative starting point error. Judgement was used to scale down the forecast.

FIGURE 3.3: SOURCE OF BUDGET 2015 REVISION TO BUDGET 2014 FORECAST FOR 2014 TAXES



Source: Department of Finance and internal calculations.
Note: Graph splits error source into those arising from incorrect forecast of economic activity, mis-estimation of the tax take for 2013 and other.

Non-tax revenues have also been revised upwards. The Central Bank surplus for 2014, reflecting profits accruing in 2013, was underestimated by €222 million or 18.3 per cent. The estimate for dividends from semi-state enterprises also shows a very large underestimation of €176 million or 43.3 per cent due to special dividends received by the Exchequer

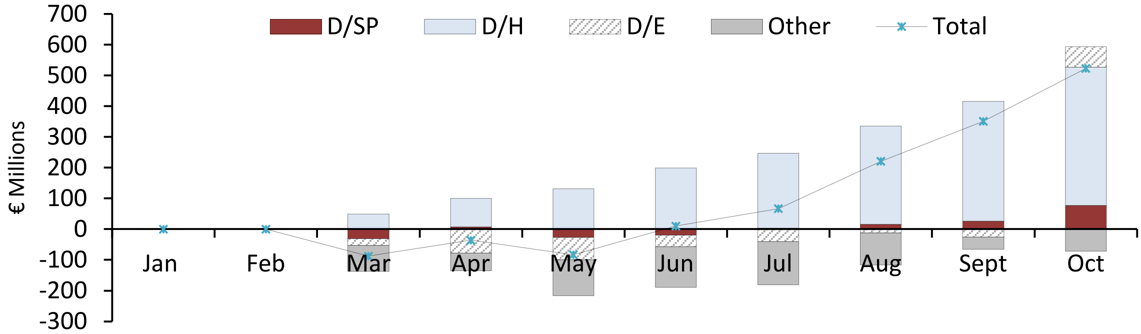
[5] Gross Operating Surplus is income earned by capital. Essentially, it is output less intermediate consumption less compensation of employees.

Expenditure Revisions

Total expenditure for 2014 has been revised upwards by €1.7 billion. As noted above, this mainly consists of an upward revision to Government Services (comprising Compensation of Employees and Intermediate Consumption) and Investment being offset by savings in Interest.

Most of the revision to Government Services will likely be accounted for by departmental current spending which is being revised up by €499 million. Figure 3.4 shows the evolution of the overrun relative to expectations up to October. In previous years, large aggregate overruns have been avoided as overspends in the Health area were offset by savings in other departments. In the year to date, however, an overrun in Health of some €450 million is being added to by overruns in the other large departments of Education and Social Protection. These combined overruns are only being partially offset by small under-spending in most other departments. Overruns in Health are a persistent and serious problem, as underlined in previous FARs.

Figure 3.4: Gross Current Voted Expenditure Relative to Profile



Source: Department of Finance

On the Non-Voted side, there was an unprofiled €310 million transfer to the Local Government Fund, as well as an unprofiled capital transfer to Irish Water of €185 million.

3.3 Assessment of *Budget 2015* Forecasts

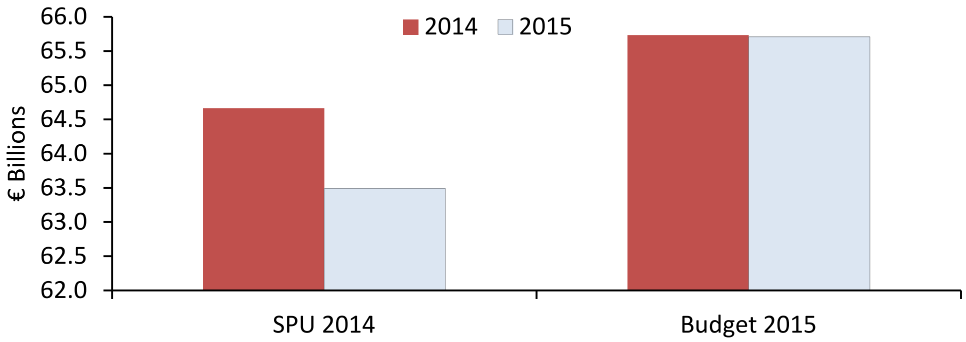
3.3.1 Forecasts for 2015

Budget 2015 introduced expansionary measures of €1 billion or 0.5 per cent of GDP, compared with the €2 billion consolidation previously planned. On foot of a stronger starting position for 2014, Budget decisions and forecasts for nominal GDP growth of 5.3 per cent in 2015, the General Government deficit is projected to fall to 2.7 per cent of GDP in 2015. The expansionary measures of €1 billion include €0.4 billion in tax cuts and a €0.6 billion increase to the 2014 expenditure ceiling set in *Budget 2014.*

It should be noted that while the forecast General Government deficit for 2015 is 2.7 per cent, this excludes part of the €1.4 billion in revenues flowing to the Exchequer from the Central Bank surplus. Of these, €0.3 billion has been excluded from the General Government deficit calculation as it relates to a capital gain on financial assets, which are not counted as deficit reducing. The extra funds will, however, be used to lower the Exchequer Borrowing Requirement, thereby lowering the debt.[6]

Figure 3.5 shows the revisions to expenditure plans and 2015 compared with previous plans. Under the plan outlined in *SPU 2014* this April, total expenditure in 2015 had been projected to fall by €1.2 billion from its 2014 level. However, *Budget 2015's* estimate for spending in 2015 is some €2.2 billion higher and no change in total expenditure is now expected between 2014 and 2015.

FIGURE 3.5: TOTAL EXPENDITURE



Source: Department of Finance.
Note: Graph compares total expenditure on an Exchequer basis.

The revenues from the introduction of water charges had been expected to improve the public finances. The saving would come about as water charges paid to Irish Water were expected to remove the full cost of water services from Local Government, allowing the Exchequer to reduce the subvention to Local Government. However, the start-up costs being incurred by Irish Water in 2015 as well as investment in infrastructure mean that there is no reduction in the Exchequer subvention to the local government fund. The overall net gain to the general government accounts from the eventual introduction of water charges is now likely to be lower than previously anticipated. *Budget 2015* contains an increase in the subvention for next year.

Interest expenditure has been revised down considerably, from €8.5 billion in *SPU 2014* to €7.4 billion in *Budget 2015*, reflecting a fall in the average interest rate from 4.1 per cent to 3.5 per cent.

[6] The Exchequer Borrowing Requirement is the amount needed to fund the Exchequer deficit in a given year.

In part, the revision reflects the more favourable interest environment and its effects on floating rate bonds as well as debt management activities. It also incorporates the assumed early repayment of IMF Programme loans in late-2014 and 2015.

A detailed analysis of the potential savings related to any refinancing of the IMF loans is outlined in a joint EU Commission, IMF, ECB and ESM note for the Economic and Financial Committee (2014). The refinancing of IMF credit is estimated to yield non-discounted savings of up to €2.1 billion (1.2 per cent of 2013 GDP) relative to the original profile of payments which were due to be repaid in full by end-2023.[7] The bulk of these savings relate to the period 2015-17, during which savings equivalent to 0.8 per cent of GDP are expected to materialise. Savings estimates are sensitive to the interest rate at which repayments are assumed to be refinanced. Early repayment may also result in a lengthening of the average maturity of government debt, thus reducing roll-over risks. If replaced with new 10-year bonds, the average maturity of the outstanding IMF credit would extend from 3.9 years at end-2015 to 7.5 years at end-2015.

The expenditure measures include an increase of €0.6 billion to the Health expenditure ceiling. This ceiling has been consistently breached. As noted earlier, the overruns in Health have not been offset by under-spending in other departments as has occurred in previous years.

Figures 3.6 A-D show the forecast source of change for the major tax heads from 2014 to 2015. For PAYE, projected improvements in economic conditions in the form of growing employment and rising pay will be partially offset by policy decisions for 2015. When the carryover related to the full-year effects of policy in previous years and other adjustments are taken account of, PAYE is forecast to grow by €188 million (1.7 per cent).

Strong growth in gross operating surplus of 5.5 per cent is projected to lead to a rise in CT revenue. However, a combination of policy effects and adjustments for one-offs works to offset a large amount of this. A small amount of positive judgement is applied to scale up the forecast.

VAT revenues are expected to rise by 6.4 per cent due to nominal personal consumption growth. Some upward judgement is applied to VAT due to the strong over-performance relative to the

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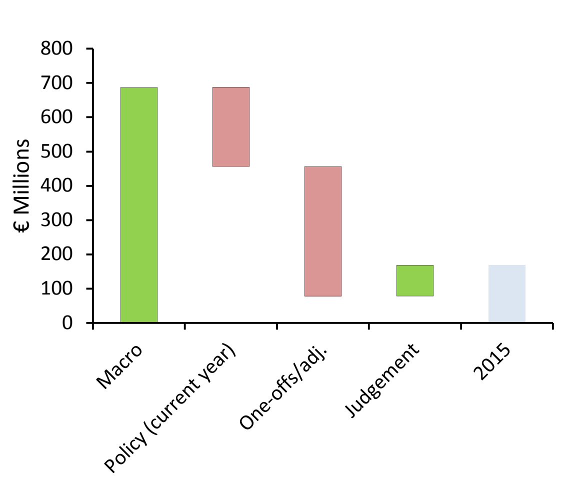
[7] A number of assumptions underpin the estimates produced in the joint note. Repayments were assumed to take place in three tranches: the first payment occurring in end-2014, the two other payments in mid-2015 and mid-2016, respectively. All bonds are assumed to mature in 2024 and €18.3 billion of the €22½ billion IMF credit is repaid early between the end of 2014 and end of 2015. Costs of hedging IMF credit are assumed to be stable over time in the analysis. Early repayment of IMF credit is not assumed to impact on the medium-term level of cash balances targeted by Ireland. The average interest rate on the new bonds is assumed to be 1.88 per cent (the average yield on Irish 10-year government bonds over the 30 days up until 10 September 2014) as compared to an all-in rate of just below 5 per cent on IMF credit in 2014 (including costs of hedging of exchange rate and interest rate risks). Relevant exchange rates are assumed to remain at current levels.

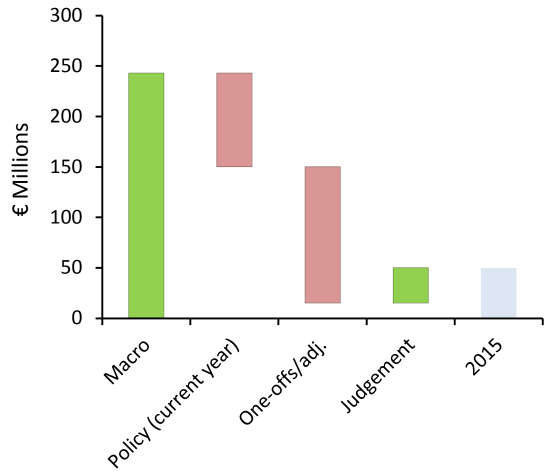
forecast for 2014, which was based on the standard formula. Given that VAT has grown at a rate of 8.2 per cent in the year to date, a growth slowdown to 6.4 per cent appears reasonable given the projections for key drivers. Excise is forecast to grow 3.2 per cent, on the back of solid consumption growth and a rebounding car market. It is also helped by policy changes as extra excise was levied on tobacco and betting activities. As with VAT, Excise is scaled up with the application of judgement.

FIGURE 3.6A: PAYE



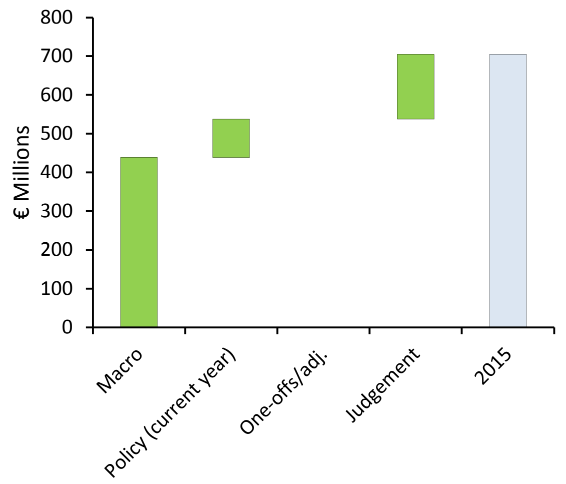
Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

FIGURE 3.6B: CORPORATION TAX



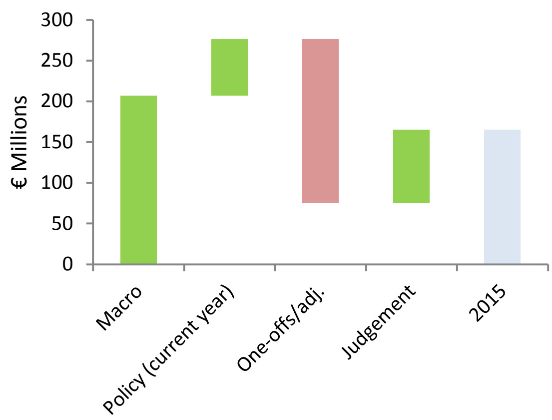
Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

FIGURE 3.6C: VAT



Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

FIGURE 3.6D: EXCISE



Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

Overall the forecasts appear driven mainly by the expected economic developments. Some judgement is applied to those tax heads expected to come in above profile in 2014. The possibility that the elasticity of certain tax heads to macroeconomic variables may differ from the long run average elasticity used in the formula, as appears to have occurred with VAT revenue in 2014, means that this could act as a source of error in 2015.

TABLE 3.2: *BUDGET 2015* PROJECTED CHANGES IN GOVERNMENT REVENUE AND EXPENDITURE

	2014	2015	2016	2017	2018
Main Aggregates, % of GDP					
General Government Balance	-3.7	-2.7	-1.9	-0.9	0.3
Primary Balance	0.3	1.1	1.9	2.9	4.0
Structural Balance	-4.4	-3.4	-2.5	-1.2	0.2
General Government Debt	110.5	108.5	104.0	100.5	95.4
Nominal GDP Growth, %	5.2	5.3	5.1	5.2	5.2
Projected Changes in Government Revenue and Expenditure, € billions					
Total Revenue	**3.2**	**1.6**	**2.0**	**2.2**	**2.9**
Tax	3.4	1.5	1.9	2.2	2.6
Social Contributions	0.3	0.3	0.4	0.0	0.1
Other	-0.5	-0.1	-0.3	0.0	0.2
Total Expenditure	**0.1**	**0.1**	**0.6**	**0.2**	**0.4**
Compensation of Employees	0.0	0.1	0.0	0.0	0.0
Intermediate Consumption	0.9	-0.4	0.2	0.0	0.1
Social Payments	-0.5	-0.2	-0.2	-0.2	-0.1
Interest	-0.2	-0.1	0.3	0.4	0.4
Other	-0.2	0.6	0.3	0.0	0.0
Primary Expenditure	**0.3**	**0.2**	**0.3**	**-0.2**	**0.0**

3.3.2 FORECASTS FOR 2016-2018

Budget 2015 did not provide a well-specified medium-term plan for the deficit path. Policy-based forecasts for revenue and expenditure were only provided for 2015, while 2016 to 2018 figures were on the basis of 'technical assumptions'. The reason given for this effective reversion to one-year budgeting was that there are "...uncertainties with regard to interpretation and implementation of fiscal rules...".[8]

The assumption for revenue for 2016 onwards is that no tax measures are introduced after 2015. This is despite the announced intention of the Government to adjust income tax in the next

[8] *Budget 2015* page C.23.

Budget.[9] On the expenditure side, the technical assumption is that departmental ('voted') expenditure does not change at all from 2015 to 2018. It is unclear why this assumption was made since the *Comprehensive Expenditure Report 2015-2017* (*CER 2015-2017)* includes ceilings for voted expenditure out until 2017. This raises the question of whether the ceilings outlined in the *CER 2015-2017* will be subject to change in future Budgets when the uncertainties on the fiscal rules referred to in *Budget 2015* are cleared up. Given a number of statements in both the Budget and CER 2015-2017, the possibility of further changes in the ceilings cannot be ruled out.[10]

As noted by the June 2014 *FAR*, the *SPU 2014* timeframe for achieving a structural budget balance appeared to go beyond what EU rules required for converging on Ireland's Medium-Term Objective (MTO). This was a result of following a calendar of convergence agreed with the European Commission that no longer has to be adhered to. It had been hoped that a new path would have been supplied in *Budget 2015.* Unfortunately, since the plan does not incorporate policy changes in revenue and the plan for expenditure may be subject to change, there is a large degree of uncertainty as to how fast the Government intends to converge toward a balanced budget.

Budget 2015 suggests that the medium-term path for the deficit is likely to be worse than that implied by these technical assumptions as their effect is to apply all available fiscal space to deficit reduction. Figure 3.7 shows the source of changes in the deficit until 2018. Almost all of the change is derived from projected revenue increases given that expenditure is projected to be unchanged. Under a no policy change scenario, revenues are expected to grow by €7.1 billion or 10.8 per cent between 2015 and 2018. Taxes make up most of this, increasing by €6.6 billion. This improvement relative to *SPU 2014* reflects, in part, the stronger macroeconomic forecasts underlying *Budget 2015.* The projections suggest that revenue will fall as a percentage of GDP, from 34.8 per cent in 2013 to 32.3 per cent by 2018; as such, the forecasts appear credible if the projected economic growth occurs. Since expenditure is assumed to be broadly unchanged over the forecast horizon, its size as a percentage of GDP falls quite sharply from 38.6 per cent to 32.1 per cent.

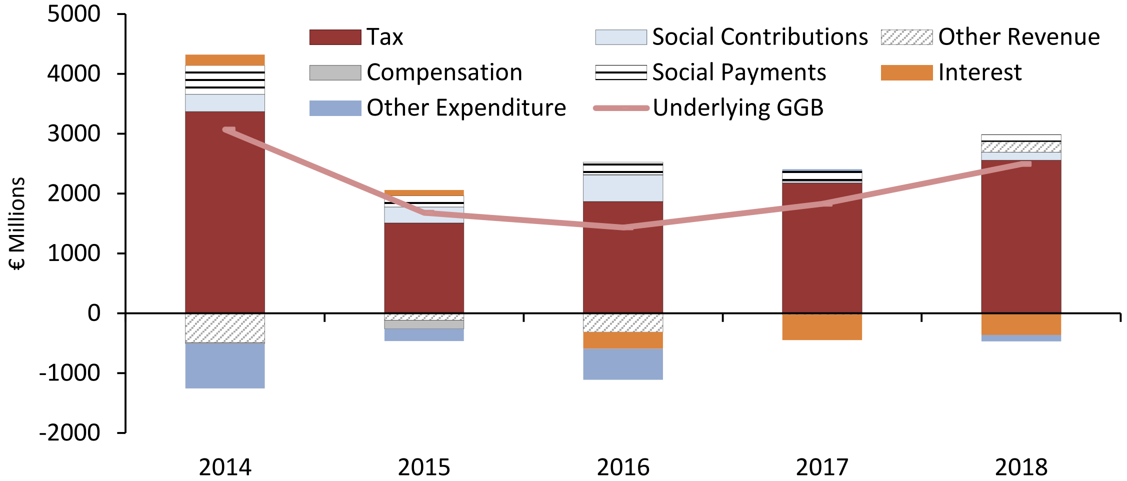
[9] Minister Noonan stated in his Financial Statement: "We will continue to ease the burden on those in the middle in a targeted manner without giving disproportionate benefits to those on highest incomes. The 52% marginal tax rate will be lowered further while ensuring those on higher incomes continue to pay their fair share."

[10] The *CER 2015-2017* states that, with regard to the ceilings, "Departments are expected to stay broadly in line with these parameters, notwithstanding the scope for additional resources in 2016 and 2017". *Budget 2015* goes on to state: "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". This statement appears to suggest that when clarity on the amount of fiscal space becomes available, priorities included in the ceilings will be changed in subsequent Budgets, with the potential consequence that ceilings will need to change to accommodate these revisions.

Figure 3.8 shows the General Government Balance (GGB) that results from *Budget 2015*'s assumptions. It also shows the GGB excluding the impact of ESA 2010 statistical revisions. This illustrates the one-off benefit to the recorded deficit that results from new statistical guidelines but has no real impact on required borrowing or debt levels. Without this one-off statistical change, the GGB for 2015 would have been 3.1 per cent, above the EDP ceiling. The difference gradually declines over 2016-2018.

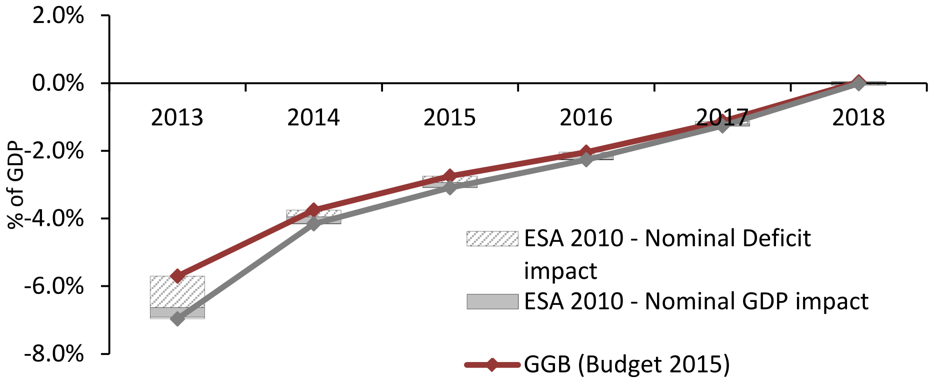
Under the *Budget 2015* scenario, debt-to-GDP falls from 108.5 per cent in 2015 to 95.4 per cent in 2018. This is a considerable improvement relative to *SPU 2014* when it was estimated that debt would still be at 107.2 per cent of GDP in 2018. However, the improvement is entirely due to revisions to the level of nominal GDP by 2018 as the nominal level of debt is forecast to be marginally higher at €214.7 billion. The statistical revisions to nominal GDP have the effect of making debt ratios appear less onerous in the context of the historical understanding of relative debt burdens. Furthermore, in the absence of specific moves to raise revenues from the newly measured areas, the revisions do not necessarily reflect any additional capacity to finance what remain high deficits and high debt levels.

FIGURE 3.7: CHANGE IN UNDERLYING GGB



Source: Department of Finance.
Note: Contribution to change in Underlying GGB.

FIGURE 3.8: IMPACT OF ESA 2010 REVISIONS ON THE GENERAL GOVERNMENT BALANCE



Source: Department of Finance and Internal Calculations
Note:

3.3.3 COMPREHENSIVE REVIEW OF EXPENDITURE

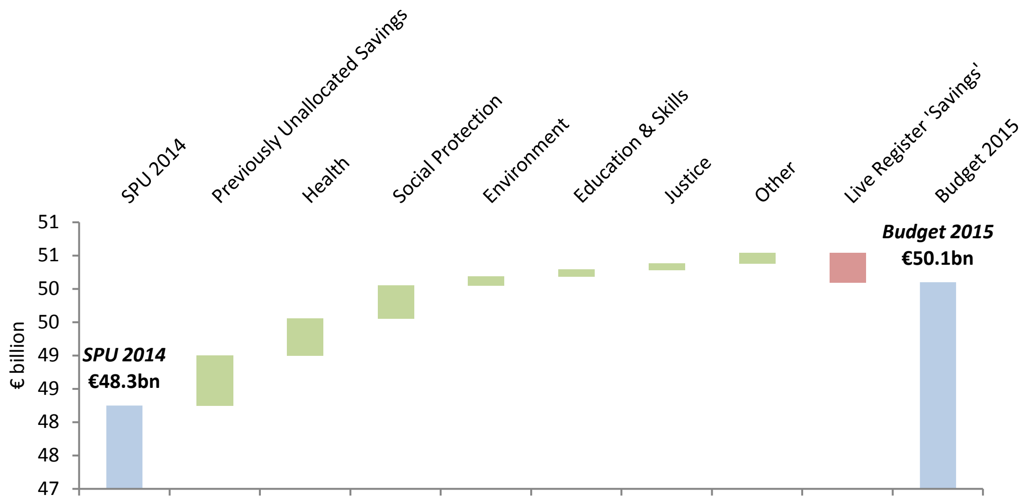
OVERVIEW

The *CER 2015*-2017 raised the voted expenditure ceiling for 2015 by €2.1 billion, resulting in it being €639 million higher than the 2014 ceiling.   This is the expenditure expansion reported in *Budget 2015*. As it is estimated that the 2014 ceiling will be breached by €499 million, this would represent an €30 million decline in spending compared with the estimated 2014 outturn.

Of the €2.1 billion increase to the 2015 ceiling (as previously set out in *Expenditure Report 2014*), €1.8 billion is voted current expenditure and €0.3 billion is voted capital expenditure. Figure 3.9 shows how the increase to the Voted Current Expenditure Ceiling is allocated. Firstly, there had been a plan to obtain an extra €0.8 billion in savings across departments; this will not now occur. Secondly, savings of €0.4 billion from a cyclical reduction in unemployment will be used to partly fund a structural increase in spending.[11] Thirdly, ministerial ceilings are raised across all departments. The Health ceiling for 2015 is increased by €0.6 billion. This is €0.3 billion above its 2014 ceiling. However, since Health spending appears certain to overrun its 2014 ceiling, its 2015 ceiling is likely to be very similar to 2014 spending. Given the pressures identified in Health (discussed further below) maintaining 2015 spending at a similar level as in 2014 could be challenging . The Department of Social Protection also sees an increase of €0.2 million for new services and €0.3 million to offset pressures. Most other departments receive moderate increases to ceilings with the *CER* stating that the additional expenditure is required to support the delivery of existing services.

[11] *Budget 2015* uses the harmonised methodology to estimate how much of the savings from falling unemployment is cyclical. Unfortunately, due to problems in the estimation of the Non-accelerating Wage Rate of Unemployment (NAWRU) this method tends to understate the cyclical component of the savings.

FIGURE 3.9: ADJUSTMENT TO GROSS CURRENT EXPENDITURE CEILING FOR 2015



The 2016 ceiling is revised up by €1.7 billion compared to *Expenditure Report 2014* and a new 2017 ceiling is introduced. Within these ceilings, the Health ceiling increases by €0.2 billion in 2016 and €40 million in 2017. Social Protection falls by €70 million each year (possibly due to unemployment reductions) and there is a marginal rise in the Education ceiling. The other departments are expected to keep to the same ceilings as 2015. With expenditure pressures and inflation, this will require cost saving measures from the remaining departments. No measures are proposed or suggested in *CRE 2015-2017.*

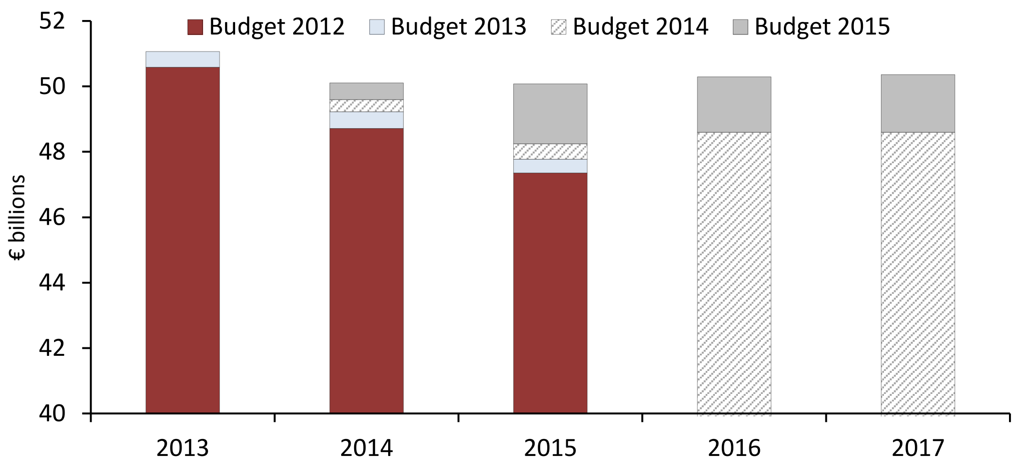
There is no contingency between the aggregate Voted Current Expenditure Ceiling and the sum of the Ministerial Voted Current Expenditure Ceilings. This implies that if any costs not currently factored into the published ceilings arise between 2015 and 2017, meeting them will require finding additional savings elsewhere or breaching the ceiling. In this context, what happens to public sector pay and staffing levels post-Haddington Road Agreement will be an important factor in determining whether the current ceilings can be adhered to.

On the capital side, the expenditure ceilings for 2015 and 2016 were increased by €300 million and €350 million respectively. The Government was due to publish a Capital *Expenditure Review* along with *CER 2015-2017* as occurred with the last expenditure review. This has not happened. In the last *Capital Expenditure Review*, the Government outlined its rationale for cutting public capital expenditure. Given that investment has now been cut to a level where it is barely sufficient to cover the costs of depreciation, and with economic growth recovering, it may now be time to revisit this rationale. While drastic cuts to capital spending are easier to achieve in the short run, in the long run, holding investment at such low levels would be expected to lead to an infrastructure deficit, restricting potential growth and thereby potentially harming the fiscal metrics that spending cuts seek to protect.

Expenditure Planning

Revisions to expenditure forecasts have been common and usually in an upward direction. During the initial years of the downturn, government expenditure was less than proposed in the initial medium-term plans. Since 2011, however, a pattern of persistent upward revisions to planned expenditure has re-emerged. This is despite the implementation of a Medium-Term Expenditure Framework (MTEF) which should work to anchor policymakers' planning. Figure 3.10 shows how the ceilings for expenditure have developed since the first *Comprehensive Review of Expenditure 2012-2014* (*CER 2012*-2014) in 2012 set out the initial multi-annual ceilings. Originally, expenditure was set to fall by over €3 billion by 2015; it is now expected to fall by just over €1 billion. Every expenditure report since 2012 has contained upward revisions to ceilings. The *CER 2015-2017* saw the largest revision to the expenditure projections for 2014 to 2017, with the increase averaging 3 per cent. The earlier revisions were in the region of 1 per cent. If this trend continues, the eventual ceiling for 2017 could be as high as €51.8 billion or 3 per cent higher than the current 2017 ceiling and almost 4 per cent higher than the 2015 ceiling.

Figure 3.10: Changes to Expenditure Ceilings



Source: Department of Finance.
Note: Bars show how annual expenditure allocations to a given year rise as the forecast year approaches.

In introducing the MTEF, the first *CER 2012-2014* and the subsequent *Expenditure Reports*, outlined the intention to move away from the "old-fashioned" approach of expenditure being determined by "...demands and bids from the spending Ministries ... with little regard to medium-term plans or constraints upon overall allocations" [12] to a multi-annual approach that "...provides clarity about the resources Departments will have available over a number of years and reinforces fiscal

[12] *Comprehensive Expenditure Report 2012-2014*, page 78

discipline".[13] It was thought that this would "...facilitate a more strategic approach to resource allocation by emphasising prioritisation of key services over reaction to day-to-day pressures".[14] While multi-annual ceilings should not be entirely inflexible to developing needs, consistent upward revisions to the overall expenditure ceilings reduces the incentive for individual Ministries to identify and implement savings. A pattern of annual upward revisions to ceilings suggest that extra resources could be available the following year. In addition, incremental increases in spending can reduce the incentive to think strategically about where the substantial new resources are needed, and where there is scope to scale back spending.

As part of the CRE process, individual departments provided submissions to the Department of Public Expenditure and Reform (DPER). These documents, along with an assessment from DPER were usefully published online. It is noteworthy that in certain cases there is a large mismatch between spending pressures reported by individual departments and the level of extra resources awarded to meet these pressures. This suggests that either the departments are likely to find it difficult to remain within the ceiling and meet all of these pressures, or that the size of the pressures may have been mis-estimated. For instance, the submission from Department of Education and Skills (DES) indicated considerable cost pressures of €0.5 billion relative to the 2014 base for each of the years 2015-2017. The actual ceiling for 2015 published in the *CER 2015-2017* contained an increase of just €60 million relative to the 2014 base. The *CER 2015-2017* does not discuss the reasons for the discrepancy between the additional €500 million sought by DES and the actual final allocation of €60 million. In this instance, because it is not clear what expenditure would be in a no policy scenario, it is difficult to know how much savings, if any, will be required to come within the ceiling.

The June 2014 *FAR* noted several areas of expenditure that face challenges in the coming years. In this respect, it was noted that expenditure planning should be informed not only by the fiscal stance, but also by the expenditure constraints and pressures faced by the various areas of Government spending.[15] There is the potential for tension between 'top-down' expenditure planning – informed largely by fiscal constraints and rules – and 'bottom-up' expenditure pressures arising from demographic pressures, investment needs and demands for increases to public sector pay. If this tension is not resolved by careful 'bottom-up' expenditure management, it will result in persistent overruns and revisions of ministerial ceilings and a lack of credibility in the medium-term

[13] *Expenditure Report* 2014, page 90.

[14] *Medium-Term Budgetary Framework*, page 21.

[15] June 2014 *FAR* noted challenges related to maintaining the planned path for investment, social payments and compensation of employees.

expenditure framework.[16] Successful bottom-up planning should make ceilings resistant to demographic pressures that can be anticipated over a three-year horizon.

Ideally, the *CER 2015-2017* would have established the level of spending in each department under a no-policy change scenario for the years 2015-2017, taking account of the impact of demographic changes and all other foreseeable changes to costs, including compensation of employees. These bottom-up costings would then be compared to the required ceiling as determined by top-down concerns. The gap, if any, is where new policies could play a role.

For example, in its submission to the review process, the Department of Social Protection (DSP) provided a costing for most of its programmes for every year to 2018. This showed that under a no-policy change, the Department would come within the previously outlined ceiling. It was decided to increase the ceiling for 2015 to accommodate new policies, all of which were costed for that year. However, no costing for the impact of these new policies is provided for 2016 or 2017.

By contrast, there is no exact costing of the Department of Health's expenditure on a no policy change except that the Department estimate that they will be subject to increased demands of the order of €200 million per annum from 2015-2017.[17] The Health submission then indicates that in order to comply with its original 2015 ceiling, which was to be €213 million less than the 2014 ceiling, it would have to introduce just €213 million in new measures. This appears to greatly understate the level of savings that would need to be achieved. This is because the Department estimate that Health spending would increase by €200 million on a no-policy basis and in addition there is currently a large overrun relative to the 2014 ceiling. In this instance, a lack of clarity on what the Health service will cost in 2015-2017 without new policy measures has led to confusion over what level of savings would have been required to comply with the 2015 ceiling. In the event, the 2015 Health ceiling was raised so that it is €305 million above the 2014 ceiling. If the current 2014 overrun of €450 million is maintained and 2015 sees additional pressures of €200 million, the new 2015 ceiling still implies considerable savings are required. *CER 2015-2017* does not outline any new savings measures.[18]

[16] The 'soft budget constraint' is relevant in this context. Where the consequences of imposing an expenditure ceiling are severe, the department may anticipate that the ceiling is likely to be relaxed. The constraint is not seen as credible and this may limit its impact on expenditure control behaviour.

[17] It is not clear whether this additional €200 million in 2015 is relative to the 2014 ceiling or to the 2014 spending, which is currently overrunning by €450 million.

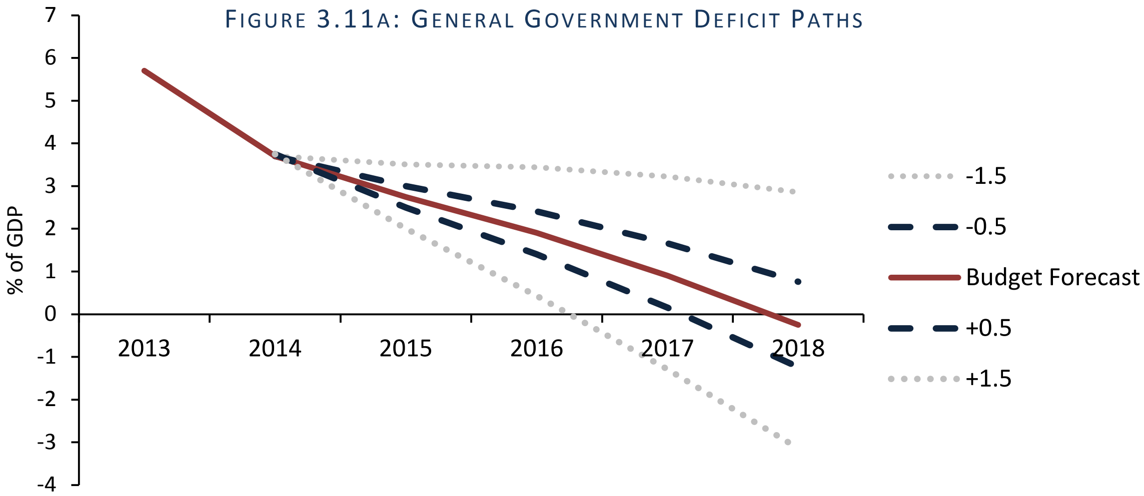
[18] Where an overrun is persistent, the Government faces a number of options. A decision could be made to address the source of the overrun, reprioritise funding from other departments or areas or fund a higher level of spending through increased taxation or borrowing. Addressing the problem at the source would require either the identification of areas where efficiencies can allow the delivery of the anticipated level of services. Alternatively, structural reforms could be

3.4 Sensitivity and Risk Analysis

3.4.1 Growth Risks

The attainment of a deficit of 2.7 per cent remains dependent on economic growth forecasts (and potentially the composition of growth) among other factors. With the Department of Finance's past growth forecast errors, the Council's Fiscal Feedbacks Model is used to estimate a range of possible deficits and debt levels (Figures 3.11A and 3.11B). The graphs below assume that no offsetting fiscal policy measures are undertaken in the alternative growth scenarios. However, being forced into unplanned policy measures – such as cancelling or delaying capital projects – are likely to be undesirable. Thus, negative growth shocks can lead to undesirable outcomes even if the relevant fiscal targets are met.

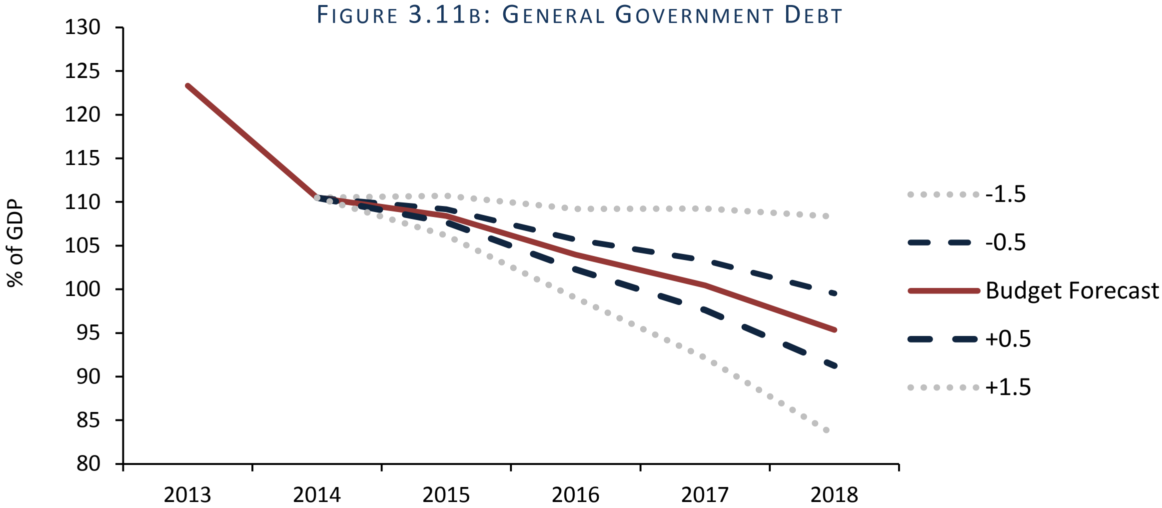
Figure 3.11A: General Government Deficit Paths



Source: Department of Finance and internal calculations.
Note: The figure shows alternative projections of the deficit ratio based on GDP growth forecasts that deviate from Budget projections by 0.5 and 1.5 percentage points in either direction.

introduced that take into account that the desired level of service provision will be difficult to maintain with the budgetary constraints and priorities the government faces.

FIGURE 3.11B: GENERAL GOVERNMENT DEBT



Source: Department of Finance and internal calculations.
Note: The figure shows alternative debt ratios based on GDP growth forecasts that deviate from Budget projections by 0.5 and 1.5 percentage points in either direction.

If growth disappoints by as little as 0.5 percentage points in 2015, then the 3 per cent deficit ceiling could be in danger of being breached. The Typical error around the Department of Finance's nominal GDP growth is 2.1 per cent.[19] If growth were to disappoint by as much as 1.5 per cent, the deficit would not fall in 2015. While the outer years of 2016-2018 do not represent a policy-based plan for the deficit, they do represent what the Government believes will occur if expenditure is held constant and taxes are unchanged. This path is dependent on real GDP growth of over 3 per cent. As discussed in Chapter 2, there are some risks to this outlook. Nominal GDP growth could be lowered as a result of low inflation. HICP is forecast to rise from 0.5 per cent in 2013 and 2014 to 1.1 per cent in 2015 and 1.4 per cent in 2016, but this rise might not come to pass in the context of sustained below target inflation in the Euro Area.

If medium-term real growth is closer to 2 per cent out to 2018, the path for the deficit and debt would, all else being equal, be declining at a much more gradual pace than that set out in *Budget 2015*. The effect on the debt-to-GDP ratio would be that it declines more slowly from current high levels. This scenario of debt stagnating at over 100 per cent of GDP would leave Ireland extremely vulnerable to any future economic shocks.

3.4.3 INTEREST RATE RISKS

Interest rates are currently at historically low levels. The yield on Irish 10-year bonds has fallen below 2 per cent. This represents a dramatic reversal of the situation in 2011 when bond yields

[19] The typical forecast error refers to the Root Mean Square Error of the Department's forecast.

peaked at over 14 per cent. This should highlight the extreme volatility that the country's bond yields can be subject to, even as the economy's fundamentals change much more slowly. A re-emergence of the Euro Area sovereign debt crisis or other negative shock could lead to a renewed period of high interest rates. Downward revisions to projected interest costs have been a consistent feature of recent budgets. This suggests upside risk of interest expenditure coming in below profile in 2015. *Budget 2015* revised down projections of interest expenditure by over €1 billion for 2015 onward to account for the likely refinancing of IMF loans, indicating that some of the potential benefits from lower interest rates have already been factored in to the Government's forecasts.

3.4.4 Balance Sheet Risks

Balance sheet risks have diminished considerably over the last number of years. Nonetheless, the government still faces a number of risks from items both on and off balance sheet. *Budget 2015* reports that Contingent Liabilities have fallen to €32.1 billion in 2014 down from €66.9 billion in 2013. A large portion of this fall is accounted for by the closure of the ELG scheme to new entrants in March 2013 and the ending of Exceptional Liquidity Assistance.

NAMA

NAMA represents an important off-balance sheet liability. NAMA issued €30.2 billion of senior bonds guaranteed by government but has already repaid €15.1 billion or 50 per cent of that. It was originally planned for NAMA to reach this milestone by 2016. By end-2016, NAMA now aims to have paid down 80 per cent of the senior bonds it issued, a cumulative €24 billion. On the basis of the performance to date, the risk that this contingent liability would crystallise appears to have fallen significantly.

Banking

The risks emanating from the banking sector generally appear to be receding. Impairments at Allied Irish Bank, Bank of Ireland and Permanent TSB fell slightly at end-June 2014. The ending of the ELG scheme had no significant affect on deposit retention and deposits now account for around two-thirds of bank funding. All three covered banks have returned to market funding and have reduced reliance on Eurosystem facilities.

The main source of uncertainty had been the results of the ECB stress tests. AIB and Bank of Ireland both passed the tests but PTSB was found to have a capital shortfall of around €800 million in the stress scenario. It has raised 80 per cent of this shortfall in the year to date and intends on raising a further €100-€200 million from the market in the near future. At this stage, the risk that the State will be called on to provide extra capital appears low and the amounts involved, while not inconsequential, would not pose a systemic risk.

Other Off-Balance Sheet Risks

Other sources of risk not on balance-sheet and not included in contingent liabilities include Public Private Partnerships (PPPs). The contractual capital value of all PPPs held off-balance sheet was €5.2 billion as at March 31st 2014. Finally, the capital contribution that could be called upon by international organisations (ESM, EFSF, IMF, etc.) when needed is another risk to State finances. The need to pay more than the paid-in level of capital for one of these organisations could arise, for instance, if another country in receipt of bailout funds from that organisation were to default.

Irish Water

Uncertainty over whether Irish Water will remain outside of General Government or not constitutes a risk to reported deficit and debt while the entity represents a potential contingent liability. In order to be classified as outside of General Government, at least 50 per cent of Irish Water's production costs must be financed by sales. Of total revenue, at least 50 per cent must derive from private sources. Were Irish Water to fail this test, its borrowing would be added to the General Government Deficit in 2015. If this borrowing were greater than €0.6 billion, it could lead to the forecast deficit of 2.7 per cent being pushed above the 3 per cent Excessive Deficit Procedure ceiling.