1. ASSESSMENT OF THE FISCAL STANCE

KEY MESSAGES

- The recovery in the Irish economy has gathered momentum with stronger growth and lower unemployment benefitting the public finances. With positive Exchequer tax data for the early months of 2015, it is likely that the Government will succeed in bringing the deficit to below 3 per cent in 2015 and exit the Excessive Deficit Procedure (EDP).

- Ireland's new budgetary framework can help avoid a repeat of past mistakes which aggravated the impact of the crisis. The framework supports the maintenance of sound public finances and should help to tame the tendency of the Irish economy towards boom-bust cycles.

- *SPU 2015* forecasts indicate that the fall in the structural budget deficit in the Government's plan is insufficient to meet the requirements of the Budgetary Rule in 2016. Compliance with the Expenditure Benchmark (EB) would also be called into question if tax buoyancy arising from the proposed budgetary package for 2016 is excluded. The inclusion of such buoyancy appears to go against the letter and spirit of the EB rule. Rather than a plan that falls short of the requirements, adjustment in line with the minimum improvement required under the rules would have been appropriate in 2016 in light of Ireland's high debt levels and improved cyclical conditions.

- Beyond 2016, there is an inconsistency in *SPU 2015* between the projections for the public finances that imply large annual improvements in the structural deficit and the stated Government policy intention to target minimum rule compliance. The budgetary position over the coming years would be less favourable if the Government's projections are adjusted to reflect stated policy intentions and a likely higher level of expenditure than envisaged in current plans.

- The Budgetary Frameworks Directive requires the Government to provide medium-term projections of each major expenditure and revenue item based on unchanged policies as well as on the basis of envisaged policies. *SPU 2015* falls short of these requirements. Tax forecasts assume no change in policy after 2016 while spending profiles do not adequately take account of underlying expenditure pressures. Providing detailed budgetary projections as envisaged in the Frameworks Directive is a more demanding task relative to current practice. However, such projections are essential to provide a realistic and comprehensive framework for medium-term budgetary planning.

1.1 Introduction

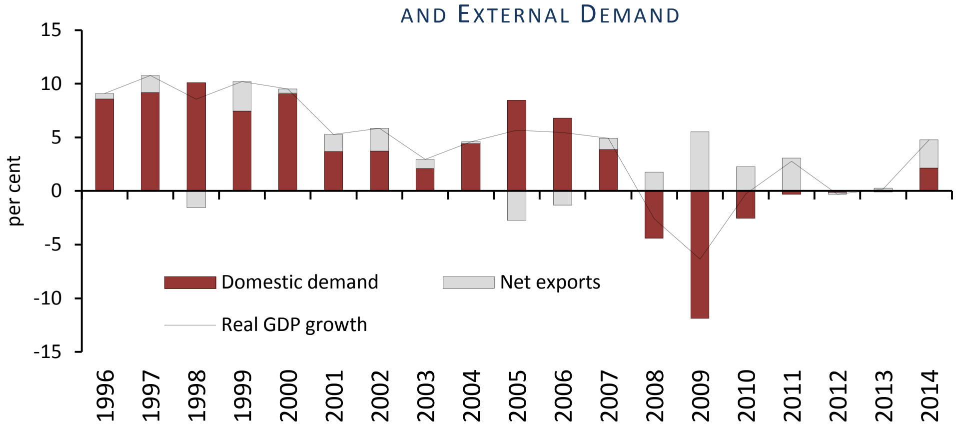
The Fiscal Council has a mandate under the *Fiscal Responsibility Acts 2012* and *2013* to assess the Government's fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. This chapter draws on the analysis in later chapters in assessing the fiscal stance in *SPU 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 should set the parameters for fiscal policymaking in the coming years.

Section 1.2 provides an overview of recent macroeconomic developments that provided the backdrop to *SPU 2015*. Section 1.3 outlines how the new budgetary framework supports basic principles of sound budgetary management. Section 1.4 provides an assessment of the fiscal stance in 2016 and over the medium-term as set out in *SPU 2015,* drawing attention to weaknesses in the implementation of Ireland's new budgetary framework.

1.2 Macroeconomic Context for *Stability Programme Update 2015*

Preliminary National Accounts estimates from the CSO indicate that economic activity as measured by GDP expanded by 4.8 per cent in 2014. On a GNP basis, the economy is estimated to have grown by 5.2 per cent last year following a solid expansion in 2013. The data for 2014 indicate that a broad-based recovery in the economy has commenced after the severe recession that followed the financial crisis and the collapse of the domestic property market bubble. As shown in Figure 1.1, and discussed further in Chapter 2, a notable aspect of the recovery in the economy in 2014 was the expansion in domestic demand, the first such increase since 2007. This was driven by a rise in investment by households and firms. Looking ahead, Department of Finance forecasts expect balanced economic growth to continue over the medium term.

Figure 1.1: Contributions to Real GDP Growth, Domestic and External Demand



Sources: CSO, internal IFAC Calculations.

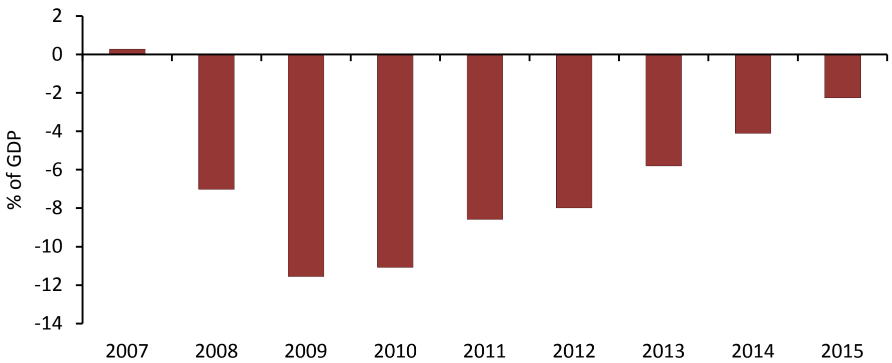
TABLE 1.1: SUMMARY OF MAIN FISCAL AGGREGATES

	2014	2015	2016	2017	2018	2019	2020
Main Aggregates, % of GDP							
General Government Balance	-4.1	-2.3	-1.7	-0.9	-0.1	0.7	1.7
Official measure of the Structural Balance (SB)	-4.0	-2.6	-2.3	-1.3	-0.3	0.8	2.1
Change in the SB	*0.0*	*1.4*	*0.3*	*1.0*	*1.0*	*1.1*	*1.3*
Official measure of the Output Gap (% of Potential GDP)	-0.9	0.4	1.0	0.7	0.4	-0.2	-0.8
General Government Debt	109.7	105.0	100.3	97.8	93.6	89.4	84.7

Sources: CSO and Department of Finance.
Notes: The estimates of the output gap and the structural deficit shown in this table are those published by the Department of Finance using the official harmonised methodology of the European Commission.

Assisted by the resumption of strong economic growth and the impact of the consolidation measures implemented since 2008, the underlying general government deficit fell from a peak of 11.6 per cent in 2009 to 4.1 per cent in 2014. The deficit is expected to fall to well below the 3 per cent Excessive Deficit Procedure (EDP) ceiling in 2015 (Table 1.1 and Figure 1.2).

FIGURE 1.2: GENERAL GOVERNMENT BALANCE, % of GDP



Source: SPU 2015.
Note: Chart shows the underlying general government balance net of banking related transfers. 2007 to 2014 are actual outturns. 2015 is a forecast from *SPU 2015.*

Given the magnitude of the crisis, it was not always obvious that a recovery pattern of the type now being observed - with a strong rebound in growth and a falling deficit – would come to pass. While the main objective of fiscal policy since 2008 has been on reducing the deficit and restoring the state's creditworthiness, we are now entering an important phase where fiscal policy must be used to ensure that a sustainable pattern of growth is established for the medium term.

1.3 Ireland's New Budgetary Framework

A positive legacy of the economic crisis has been the introduction of a new budgetary framework in Ireland comprising both domestic and European elements. While Ireland was subject to the conditions and related surveillance under the EU-IMF Programme, many of the provisions of the new budgetary framework were effectively in abeyance as the targets under the bailout programme superseded the requirements under the new framework. Now that the state has exited the EU-IMF programme and is due to exit the EDP later this year, normal operation of the new budgetary framework has commenced.

Despite its complexity and imperfections in some areas, the budgetary framework with complementary European and national elements provides a valuable structure to guide Irish fiscal policy. The national components of the fiscal framework are set out in detail in the *Medium-Term Budgetary Framework (MTBF)*. Core components are the Budgetary Rule set out in the *Fiscal Responsibility Act 2012* and the *Medium-Term Expenditure Framework* set out in the Ministers and Secretaries (Amendment) Act 2013. Taken together the rules and enforcement mechanisms are designed to be consistent with the requirements of the Preventive Arm of the SGP. Consistency between the national and EU frameworks allows the two sets of formal rules and enforcement procedures to reinforce each other: the monitoring, peer pressure and financial-sanction procedures of the SGP helps give credibility to the national rules; the monitoring and enforcement procedures of the national rules – including roles for both the Dáil and the Fiscal Advisory Council – provide a degree of domestic oversight and ownership of the overall rules framework.

The framework should help ensure that three basic principles of sound budgetary management are followed:

i. *Counter-Cyclicality*

Fiscal policy has the potential to play an important stabilising role in the face of macroeconomic shocks. This occurs through the operation of automatic stabilisers – e.g., expenditures such as unemployment benefits increase and most revenues decrease in a recession – or through discretionary policies that "lean against the wind" of the economic cycle. Unfortunately, Irish fiscal policy has in the past been predominantly pro-cyclical.[1] This pattern of pro-cyclical fiscal policy has been a major contributor to the severe boom-bust cycles to which the Irish economy has been susceptible over the last half a century.

[1] See Kearney (2012).

The use of counter-cyclical fiscal policy as a macroeconomic policy instrument can differ depending on the cyclical position of the economy. When the economy is operating above its long-run potential, as was the case in Ireland during the property bubble, tight fiscal policy can be used to counter overheating. By allowing the automatic stabilisers to work and through discretionary fiscal policy actions to stimulate the economy, counter-cyclical fiscal policy can also be used to help close the output gap when the economy is operating below its potential.

The counter-cyclical role of fiscal policy is especially important where monetary policy is not available as a demand management tool. Given the sluggish recovery in the euro area relative to the Irish economy, interest rates are expected to remain at low levels over the medium term. Since interest rates in future years could be inappropriately low given the cyclical position of the Irish economy, this enhances the role of fiscal policy in managing the economic cycle.[2]

Without a strong framework, there is a risk that as crisis memories fade support for sound fiscal policy will fade too. Political pressures related to the electoral cycle could result in budgetary policy moving in an overly expansionary and therefore pro-cyclical direction, despite the damage this has caused in the past.

ii. Sustainability

A basic condition for fiscal sustainability is that the debt-to-GDP ratio is stable at an appropriate level or can reasonably be expected to become so in the future. Concerns about sustainability lead to reduced creditworthiness and higher borrowing costs.

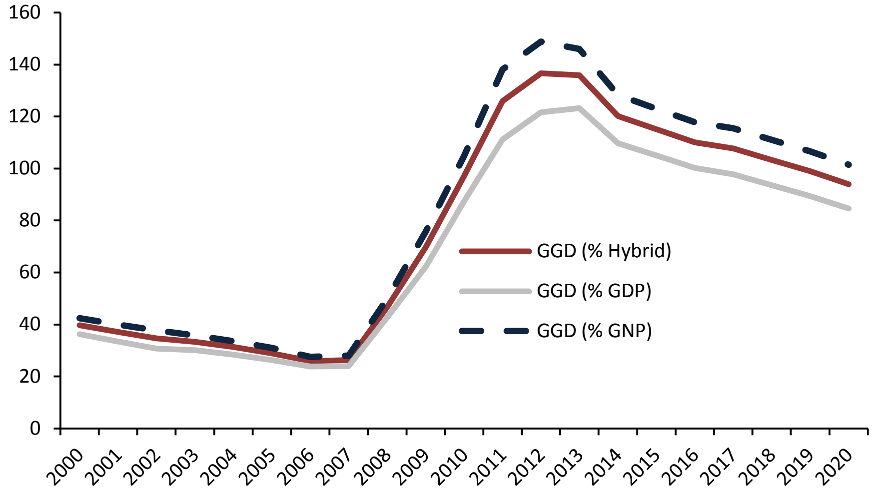
The economic and financial crisis has left Ireland with a legacy of high debt levels. The gross debt to GDP ratio peaked at just under 124 per cent before declining to 110 per cent in 2014. Although projected to decline steadily over the coming years, the ratio is expected to remain at high levels over the period to 2020. The debt-sustainability challenge appears more arduous when alternative measures of fiscal capacity are used (see Figure 1.3). The figure shows the projected evolution of alternative debt to fiscal capacity ratios: GDP (peaking at 124 per cent in 2013), GNP (149 per cent) and the Council's Hybrid (147 per cent) measure of fiscal capacity.[3]

---

[2] See FitzGerald *et al.* (2010).

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

FIGURE 1.3: GENERAL GOVERNMENT DEBT



Source: Department of Finance; internal IFAC calculations.

Notwithstanding the exceptionally low level of interest rates recently observed, events in the euro area have shown how susceptible states can be to self-fulfilling crises of confidence. States without their own independent monetary policy are especially vulnerable. Sound fiscal management requires achieving and sustaining safe debt levels, including a margin to allow for unanticipated macroeconomic shocks. Compliance with the Budgetary Rule and the Debt Rule[4] 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. *Stability*

Economic theory points to the value of stable tax rates over time. For a given profile of government spending, economic efficiency is enhanced by stable rates. This is because economic distortions associated with taxation tend to rise in a non-linear way with the tax rate. Total tax-related distortions are then lower with a stable tax rate than with one that fluctuates. With the profile of government spending likely to rise given demographic pressures, stable tax rates could require a period of surpluses to reduce debt or accumulate assets in advance of higher spending needs.

Unfortunately, the principles of sound budgetary management can sometimes pull in different directions. For example, the setting of fiscal policy during the crisis has required a difficult balancing of the need to support domestic demand/employment and the need to put the public

[4] 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.

finances on a sustainable path. With the economy underperforming relative to potential in recent years, the principle of counter-cyclicality would have favoured an easing of the fiscal stance to offset weak demand in the absence of other constraints. Unfortunately, the constraints imposed by Ireland's high debt levels and the need to restore creditworthiness meant that the principle of sustainability required that the deficit be reduced and the debt moved to lower levels.

With the economy now recovering strongly, new considerations come into play in assessing how best to balance the principles. Estimates produced using the harmonised methodology indicate that Ireland will have a small positive output gap in 2015, suggesting that the economy is operating above potential this year. The Council is of the view that, although the output gap has narrowed since 2012, the economy may still be operating somewhat below potential in 2015. Department of Finance projections envisage strong GDP growth averaging 3.6 per cent per annum from 2015 to 2018. If realised, growth rates of this magnitude could see output returning to close to potential in the near term.

While there is likely to be some spare capacity in the economy currently, the need to provide an additional stimulus from fiscal policy in the current context is weak. At the same time, debt levels remain high following the crisis and there is still a deficit in the government accounts. Balancing these factors, the Council assesses that a policy of following minimum compliance with the rules in 2016 is appropriate.

The new budgetary framework represents a step forward in strengthening budgetary planning and could help narrow the gap between sound and actual fiscal policies. However, as discussed in the next section, the budgetary plans set out in *SPU 2015* fall short of meeting what is required under the new budgetary framework in some key respects.

1.4 The Path of the Public Finances in *SPU 2015*

Under its mandate, the Council is required to assess the appropriateness of the Government's fiscal stance with reference to the requirements of the SGP. It is also required to assess compliance with the Budgetary Rule of the *Fiscal Responsibility Act 2012*. The *Stability and Growth Pact (SGP)* includes both a Corrective Arm – operationalised through the Excessive Deficit Procedure (EDP) – and a Preventive Arm, which is focused on attaining a structural budget balance over the medium term. The headline general government deficit is expected to fall to below 3 per cent of GDP in 2015 meaning that the requirements of the Corrective Arm of the *SGP* will have been complied with.

After 2016, the public finances will be subject to the provisions of the Preventive Arm of the *SGP*[5,6].The Preventive Arm aims to ensure that a country follows appropriate fiscal policies, through monitoring and surveillance. Under the Preventive Arm, the Government is required to ensure that the budgetary position is at, or moving at a sufficient pace towards, the Medium-Term budgetary Objective (MTO). Ireland's MTO is for a balanced budget in structural terms.

1.4.1 The Fiscal Stance in 2016

Based on estimates of the structural deficit using the EC harmonised methodology, Ireland is currently above its MTO of a balanced budget in structural terms. The country must meet a required minimum adjustment path to the MTO in terms of an annual reduction in the structural deficit of greater than 0.5 percentage points of GDP.[7] The structural deficit refers to that part of the deficit which will not be eroded by the cyclical upswing in economic growth. To support this requirement, the Preventive Arm places limits on the rate of growth of government spending through the Expenditure Benchmark. The Expenditure Benchmark essentially says that annual expenditure growth should not exceed the medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.

In its *Analytical Note* published in April, the Council drew attention to an anomaly in the calculation of the Expenditure Benchmark in 2016. Subsequently, changes were agreed at an EC level which allowed for the existing Expenditure Benchmark calculation for 2016 to be updated and also introduced changes to the process of setting the Benchmark in later years (see Chapter 4).

The tax and expenditure forecasts in *SPU 2015* include the impact of a budgetary package of €1.2 billion in 2016, split evenly between expenditure increases and tax cuts. Turning first to the Budgetary Rule, the solid red line in Figure 1.4 shows the projected annual change in the structural deficit from *SPU 2015.* The broken line shows the required 0.6 per cent improvement under the Budgetary Rule and the Preventive Arm. For 2016, the projected improvement in the structural

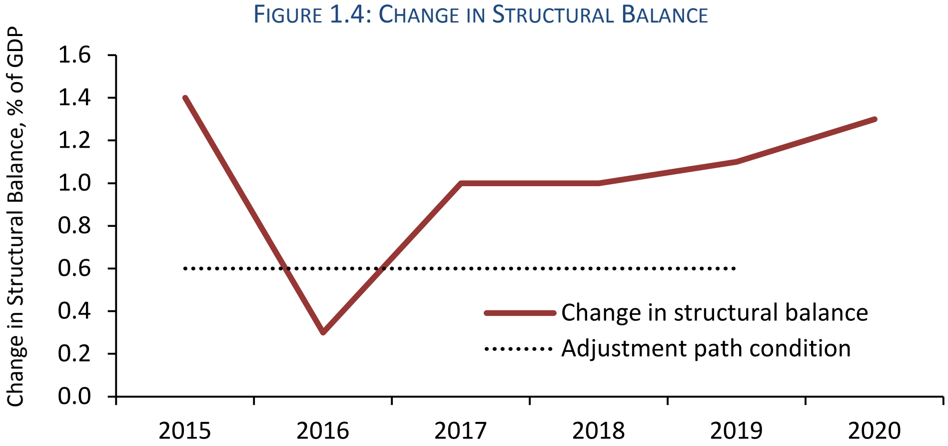
[5] The Department of Finance has usefully brought the various elements together in its Medium-Term Budgetary Framework (MTBF) document. The document is available at: http://www.finance.gov.ie/sites/default/files/131219%20Medium%20Term%20Budgetary%20Framework%20-%20FINAL%20REV.pdf.

[6] The procedures and policies for implementing the SGP are presented in the EC's *Vade Mecum* (EC, 2013) available at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp151_en.pdf

[7] As Ireland has a debt ratio of greater than 60 per cent of GDP, under the terms of the *SGP*, the annual change in the structural balance must be greater than 0.5 percentage points of GDP to comply with the Adjustment Path condition. It has been decided at EC level that 0.6 percentage points of GDP is an appropriate minimum pace of adjustment.

deficit is 0.3 percentage points of GDP and, therefore, the *SPU* projections fall short of meeting the requirements of the Government's Budgetary Rule in 2016.[8]

FIGURE 1.4: CHANGE IN STRUCTURAL BALANCE



Note: Medium-Term Budgetary Objective for Ireland is a structural balance. This is planned to be achieved in 2019 and consequently the Adjustment Path condition does not apply in 2020.
Source: SPU 2015, Department of Finance.

Rather than a plan that falls short of the requirements, greater adjustment in line with the minimum 0.6 per cent structural improvement required under the fiscal rules would be appropriate in 2016. Such an approach would deliver a lower headline deficit for 2016 and, by complying with the Budgetary Rule, signal the Government's commitment to the new budgetary framework.[9]

The requirements under the Preventive Arm of the *SGP* are also assessed on the basis of the Expenditure Benchmark. Under the Benchmark, increases in expenditure are permitted if fully offset by discretionary revenue-raising measures, for example, an increase in tax rates or another structural revenue-raising measure. Increases in revenue due to tax buoyancy[10] from the economic cycle cannot be used to fund higher expenditure. As explained in Chapter 4, in calculating the allowable fiscal space under the Expenditure Benchmark, *SPU 2015* includes the impact of tax buoyancy as a result of the assumed budget package for 2016.

[8] As discussed in Chapter 4, this difference between the planned improvement of 0.3 per cent and the 0.6 per cent requirement is not large enough to be deemed a "significant deviation" under the EU rules.

[9] In relation to 2016, the statement published by the IMF in May 2015 following the Third Post-Programme Monitoring Discussion states that: "IMF staff estimate that the implied structural primary adjustment is modest, at about ¼ percent of GDP. (These estimates use a different potential output methodology than the EU). Stronger adjustment, of ½ percent of GDP, is appropriate in view of Ireland's high public debt and strong growth, implying a deficit target of about 1.5 percent of GDP." See: http://www.imf.org/external/np/ms/2015/050115.htm

[10] An example of tax buoyancy is the increase in revenues from stamp duty and capital gains taxes which accrued from the construction boom of the 2000s.

The treatment of tax buoyancy arising from the budget package as a discretionary revenue raising measure in *SPU 2015* would appear to go against the letter and spirit of the Expenditure Benchmark. The point of the Expenditure Benchmark is to ensure that expenditure growth is linked to sustainable revenue growth, which is in turn linked to growth in potential output and discretionary tax changes. Revenue growth based on the temporary demand effects of an expansionary fiscal package does not meet this criterion. Furthermore, no provision for the use of "buoyancy" appears in the formal descriptions of the working of the Expenditure Benchmark rule.

Given the planned fall in the structural budget deficit is insufficient to meet the requirements of the Budgetary Rule in 2016*,* it is especially important that the Expenditure Benchmark is complied with in 2016. On the basis of current calculations, the scope for any further increases in expenditure or discretionary reductions in revenues beyond the €1.2 billion package set out in the *SPU* is limited, even allowing for the inclusion of buoyancy. As discussed in Chapter 4, excluding the tax buoyancy effect in 2016 there is a considerable risk of non-compliance with the EB based on the *SPU 2015* projections.

The Council has a responsibility under the Fiscal Responsibility Act to assess whether ". . . the fiscal stance for the year or years concerned is . . . conducive to prudent economic and budgetary management" [*FRA* 8(4)(b)]. The requirements for EDP exit are likely to be complied with in 2015 thereby meeting this prudence test. Post EDP exit, the Council's assessment of the fiscal stance will be informed by compliance with the Budgetary Rule and the Preventive Arm of the Stability and Growth Pact (SGP). A decision on the prudence of the fiscal stance for 2016 will be made in the next *Fiscal Assessment Report* following the publication of *Budget 2016*.

1.4.2 Medium-Term Fiscal Stance in *SPU 2015*

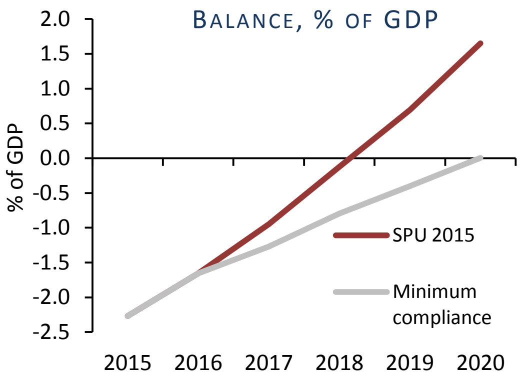
A realistic projection for the medium-term budgetary position is essential for setting the fiscal stance. As discussed in Chapter 3, the budgetary projections in *SPU 2015* do not take full account of the likely costs of demographic ageing and cost pressures in delivering existing programmes, as well as not taking into account explicit Government commitments to reduce taxes. The illustrative scenario in Chapter 3 shows that, based on certain assumptions, fully accommodating ageing and cost pressures would see a higher level of government spending than contained in the Government's plan. This would imply a less favourable budgetary position over the coming years than shown in the *SPU 2015* projections.

As stated in the *SPU*, the Government's intention is to comply with the minimum requirements to achieve its MTO of a balanced budget in structural terms. This would suggest some room for spending increases in nominal terms to fund the likely expenditure needs identified in Chapter 3, but tight spending constraints and strong cost pressures would continue to constrain public services, pay and welfare payments. Any discretionary tax cuts would further increase the need to squeeze public spending over the coming years.

The *Spring Economic Statement (SES)* states that the Government intends to move towards the MTO at the minimum rate of greater than 0.5 per cent of GDP rather than at the faster rate envisaged in the SPU projections. This would imply annual adjustments from 2017 around half as large as is contained in the *SPU*. *SPU 2015* does not provide deficit and debt projections consistent with this stated policy intention. The document notes that that the difference between the SPU projections and what is required for minimum rule compliance indicates the availability of considerable fiscal space after 2016.

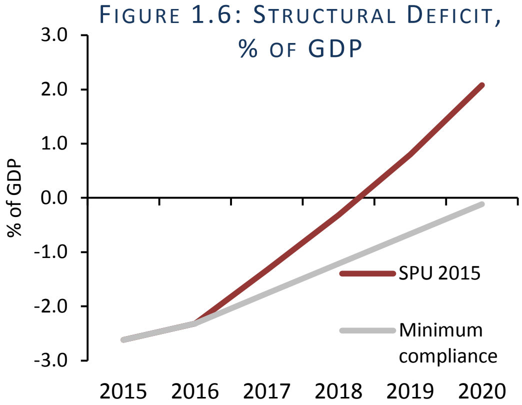
Assuming the Government implements its stated policy of limiting fiscal adjustment to the minimum required under the rules, Figure 1.5 and Figure 1.6 show the path of the actual and structural deficits compared to the projections in *SPU 2015.* Assuming that fiscal policy is set in accordance with stated policy of meeting minimum rule compliance, there would be larger deficits over the 2017 to 2019 period and the government accounts would be broadly in balance by 2020 compared to the large surplus contained in the *SPU* projections. The scenarios for the structural deficit are shown in Figure 1.6. Under the *SPU* forecasts, the Government would meet its MTO (of a balanced budget in structural terms) by 2018. Assuming smaller structural adjustments are actually implemented after 2017, the MTO would not be reached until two years later in 2020.

FIGURE 1.5: GENERAL GOVERNMENT BALANCE, % OF GDP



Sources: SPU 2015; internal IFAC calculations.

FIGURE 1.6: STRUCTURAL DEFICIT, % OF GDP



Sources: SPU 2015; internal IFAC calculations.

In providing medium-term projections for the public finances, the Government should ensure that these reflect actual Government policy intentions along with the Department's best assessment of the actual likely future path of deficit. This is essential if the forecasts contained in the *SPU* are to provide a meaningful anchor for medium-term budgetary planning.

As part of the “six-pack” of EU fiscal governance reforms, the Budgetary Frameworks Directive requires that member states put in place Medium-Term Budgetary Frameworks (MTBFs). These frameworks are required to include, inter alia, procedures for providing medium-term budgetary projections on both a no-policy-change and policy-change basis. The Statutory Instrument implementing the framework in Irish law [11] states that the framework shall include procedures for establishing the following:

(i) projections of each major expenditure and revenue item of the general government with more specifications on the central government and social security level, for the budget year and beyond, based on unchanged policies;

(ii) a description of medium-term policies envisaged with an impact on general government finances, broken down by major revenue and expenditure item, showing how the adjustment towards the medium-term budgetary objectives is achieved compared to projections under unchanged policies.

As outlined above and discussed in detail in Chapter 3, the medium-term projections for expenditure and tax revenue in *SPU 2015* do not fully meet the requirements of a medium-term fiscal plan as envisaged in the Budgetary Frameworks Directive.

[11] http://www.irishstatutebook.ie/pdf/2013/en.si.2013.0508.pdf