



**Irish Fiscal
Advisory Council**

Pre-Budget 2017 Statement
September 2016

Irish Fiscal Advisory Council

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KEY MESSAGES

Distorted National Accounts data combined with uncertainty over the impact of Brexit and the sustainability of corporation tax receipts have created a challenging backdrop to the assessment of the appropriate fiscal stance for *Budget 2017*. Although calculated appropriately according to international rules, key National Accounts aggregates for Ireland are distorted by the activities of a small number of multinational enterprises (MNEs). Measures of growth based on headline aggregates such as GDP and GNP are detached from underlying developments in the Irish economy that determine the employment and incomes of Irish residents. Moreover, fiscal ratios based on these measures are not reliable indicators of the health of the public finances. This makes it challenging to assess the fiscal stance and means alternative macroeconomic and fiscal indicators must be relied on. Uncertainty has also increased in the wake of Brexit as the magnitude of this negative shock for the Irish economy and public finances in the coming years is still largely unknown.

The Irish economy is growing at a reasonably solid rate based on measures of underlying economic activity. Notwithstanding the fall in the headline debt-to-GDP ratio, government debt remains high, and reducing it to safer levels must remain a priority to protect the public finances against numerous risks. Domestic demand (excluding spending on aircraft and intangible assets) grew by just under 5 per cent in 2015 while employment growth has been strong. Continued fast growth in 2016 is likely to see the demand shortfall in the economy disappear in the near term. The headline debt-to-GDP ratio underestimates the size of the debt burden and overstates its rate of improvement last year. High debt levels leave the public finances uncomfortably exposed to domestic and international risks, one of which has already materialised in the form of the UK's vote to leave the EU.

A further loosening of the fiscal stance beyond the package of measures for *Budget 2017* already announced in the *Summer Economic Statement* would not be appropriate. The planned fiscal stance is more expansionary than implied by the intended use of the €1 billion of fiscal space for 2017 outlined in the *SES*. Previously announced new spending commitments for 2017 amount to a further €0.9 billion. Moreover, in June the Government announced an additional €0.5 billion increase in spending for 2016 that is carried into the expenditure base for next year. Taking 2016 and 2017 together, this gives a combined package of measures of €2.4 billion. The Council assesses that the resulting fiscal stance is at the limit of the range of prudent policies when the risks facing the economy and the high level of debt are considered. While an anomaly in the fiscal rules related to the AIB preference share transaction in 2015 could allow additional expansion in 2016, a further relaxation of the stance, as occurred in last year's budget through late supplementary expenditure estimates, would not be appropriate. The Government should take advantage of the current relatively strong growth in revenue to eliminate the remaining budget deficit and accelerate the reduction in the debt ratio.

Estimates of fiscal space over the medium term under the fiscal rules are highly uncertain and are sensitive to key assumptions, in particular related to the projected rate of economic growth in future years. The *Summer Economic Statement* contained new estimates of fiscal space over the medium term. Given the uncertainty around key parameters used to calculate fiscal space, such as the forecasts for the economy's actual and potential GDP growth, it is useful to consider a range of alternative scenarios. One development which could negatively impact the Irish economy is Brexit. In a relatively benign baseline scenario using the most recent post-Brexit forecasts for the UK economy from the National Institute for Economic and Social Research (NIESR) in the UK, estimates suggest that Irish growth could be lowered by around $\frac{3}{4}$ of a percentage point in 2017 with more limited effects thereafter. In this case, the estimated fiscal space out to 2021 would not be significantly reduced compared to the *SES*. However, it is possible that the eventual impact of Brexit could turn out to be more severe than this, resulting in a long-lasting reduction in the growth rate. A more adverse Brexit scenario resulting in a persistent growth shortfall of $\frac{1}{2}$ a percentage point per annum could see fiscal space reduced by around a quarter compared to the current *SES* estimates.

Recent surges in corporation tax receipts related to the activities of multinationals facilitated relaxations of the fiscal stance in 2015 and already in 2016. Given the uncertainty about the durability of the corporation tax surge, a further easing of the fiscal stance based on an assumed continuation of these revenues would not be appropriate. Corporation tax revenues are highly concentrated among a small number of company groups and the degree of concentration has increased. In 2015, 41 per cent of corporation tax was paid by ten company groups. Given the volatility of these receipts and the particular uncertainty around the sustainability of the recent increases, prudent economic and budgetary management argues against using potentially transient revenues to fund difficult to reverse expenditure increases and tax cuts. The Council notes the EU Commission ruling on Apple from 30 August 2016. At this stage, the EC decision has no immediate implications for the plans for *Budget 2017*, although the Council will continue to monitor the evolving developments closely.

The *Mid-Year Expenditure Report* is a welcome innovation to the budget process but progress is needed to address deficiencies in expenditure management and planning. As argued by the Council in previous reports, meaningful expenditure forecasts that take into account inflation and underlying service demand are needed to underpin improved expenditure planning and control. An inevitable implication of unrealistic expenditure forecasts is the continual revision of expenditure ceilings as the horizon shortens. Proposals to improve the current system, underpinned by realistic forecasts, are outlined in this Statement.

1.1 INTRODUCTION

The Council's mandate includes assessing the prudence of the Government's fiscal stance. The basis for the Council's assessment is twofold: first, the Council assesses whether the Government's fiscal plans are in line with the requirements of the budgetary framework; and second, a complementary economic analysis is carried out which assesses the compliance of the fiscal stance with the principles of sound economic and budgetary management.

This *Pre-Budget 2017 Statement* reviews the fiscal stance in advance of *Budget 2017* in line with these components of the Council's assessment. Since the publication of the Council's Fiscal Assessment Report in early June 2016 (IFAC, 2016a), the Government has published its *Summer Economic Statement (SES)* announcing a planned tax and expenditure package of €1 billion for *Budget 2017*, along with the *Mid-Year Expenditure Report* in July. Two important further developments have taken place since the publication of the *SES*: the result of the UK's referendum on membership of the European Union and the dramatic revisions to Ireland's National Accounts statistics published by the CSO in mid July. This Statement provides an updated assessment of the fiscal stance in advance of *Budget 2017* taking into account these developments and the latest available macroeconomic and fiscal data.

1.2 THE MACROECONOMIC AND FISCAL CONTEXT FOR *BUDGET 2017*

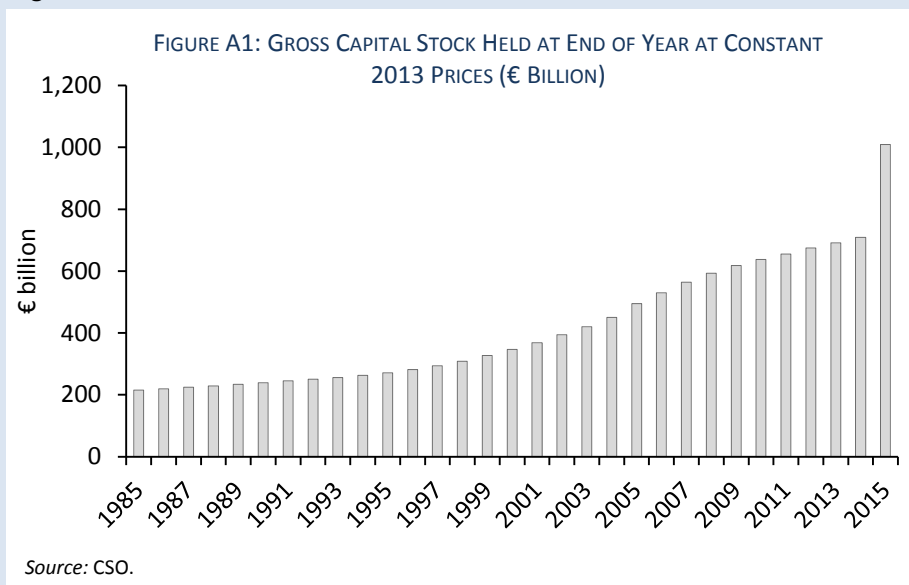
1.2.1 Macroeconomic Context

The National Income and Expenditure Accounts (NIE) and Quarterly National Accounts (QNA) contain data on key aggregates such as output by each sector of the economy – exports, imports, investment as well as an estimate of overall growth in economic activity as measured by GNP or GDP. These data typically provide the foundation for analysis of macroeconomic developments. In recent years and especially with the most recent data revision, difficulties interpreting Ireland's National Accounts statistics have become more severe. Some of the challenges were highlighted previously by FitzGerald (2015) and by the Council (IFAC, 2015b, 2016a).

The sharp revisions to key National Accounts aggregates published by the CSO on 12 July 2016 create challenges for the Council in respect of all elements of the mandate: endorsement of the Government's macroeconomic forecasts, assessment of the macroeconomic and budgetary forecasts, assessment of compliance with fiscal rules and assessment of the appropriateness of the fiscal stance. These challenges will be addressed in detail in the forthcoming November *Fiscal Assessment Report*. In advance of *Budget 2017*, an immediate issue is the assessment of the macroeconomic/fiscal position and the appropriate fiscal stance for 2017.

BOX A: IRELAND'S REVISED NATIONAL ACCOUNTS STATISTICS

The release of the National Accounts for 2015 saw large revisions, with GDP growth of 26.3 per cent now estimated for 2015. The previous estimate from the Quarterly National Accounts in March 2016 had been 7.8 per cent. Much of this revision is attributed to a €300 billion increase in the capital stock which can be seen in Figure A1 below. Although detailed data have not yet been published, some information is available on the drivers of this large increase.¹



Restructuring or relocation of company assets explains most of the measured increase in the capital stock in 2015. An explanatory note from the CSO states that “corporate restructuring both through imports of individual assets and also reclassifications of entire balance sheets in 2015 means that the level of capital assets in Ireland increased dramatically compared to 2014”.² It is worth noting that the scale of the increase in the capital stock is not reflected in the investment data for 2015, implying that the increase in the capital stock has mainly occurred by entire balance sheets being moved to Ireland.³ The counterpart to the transfer of assets to Ireland is a large increase in Ireland’s external debt liabilities as reflected in the revised Net International Investment Position (NIIP). Aircraft leasing activities also contributed to the increase in the capital stock in 2015, although the impact from these sources is not believed to be large.

¹ Due to statistical confidentiality rules reflecting the small number of firms involved, detailed data are not available from the CSO that explain the source of this increase in the capital stock.

² http://www.cso.ie/en/media/csoie/newsevents/documents/pr_GDPexplanatorynote.pdf

³ The CSO has explained that when there is a relocation of a company this is not counted as a “Transaction” in the statistical system, but as “Other volume changes”. Therefore the effects are seen in the balance sheet positions, for example the International Investment Position (IIP) and the Capital Stocks, but not as transactions in the Balance of Payments current account.

Table A1: Gross Value Added, current prices, € Millions

	2014	2015	Change, € million
Agriculture, forestry and fishing	4,154	4,135	-19
Industry (including building)	46,525	97,792	51,267
Distribution, transport, software and communication	47,107	48,846	1,738
Public administration and defence	7,161	7,430	269
Other services (including rent)	71,825	78,032	6,206
Statistical discrepancy	-1,913	155	2,068
Gross value added at factor cost	174,860	236,389	61,529
Net Taxes and Subsidies	18,299	19,426	1,126
Gross domestic product at current market prices	193,160	255,815	62,655

On the output side of the National Accounts (Table A1), the increase in GDP is driven by output in the industry sector, which more than doubled in 2015. The majority of the large increase in GVA in the industry sector is likely to have been driven by foreign-owned MNEs. Related to the large increase in industrial output was a 44 per cent rise in company profits in 2015 and a large increase in the provision for depreciation of over €30 billion as shown in Table A2. The increase in profits, mostly from MNEs, was matched by a similar change in net factor income outflows (Table A2) and therefore GNP is corrected for the impact of the higher MNE profits which accrue to foreign owners. However, although most of the increase in depreciation also accrues to foreign-owned MNEs, it is included in GNP as this is a gross measure of activity. Depreciation appears to have been relatively stable up to last year. The large-scale relocation of assets to Ireland in 2015 gave rise to a significant increase in the provision for depreciation accruing to foreign-owned MNEs, thereby boosting GNP.

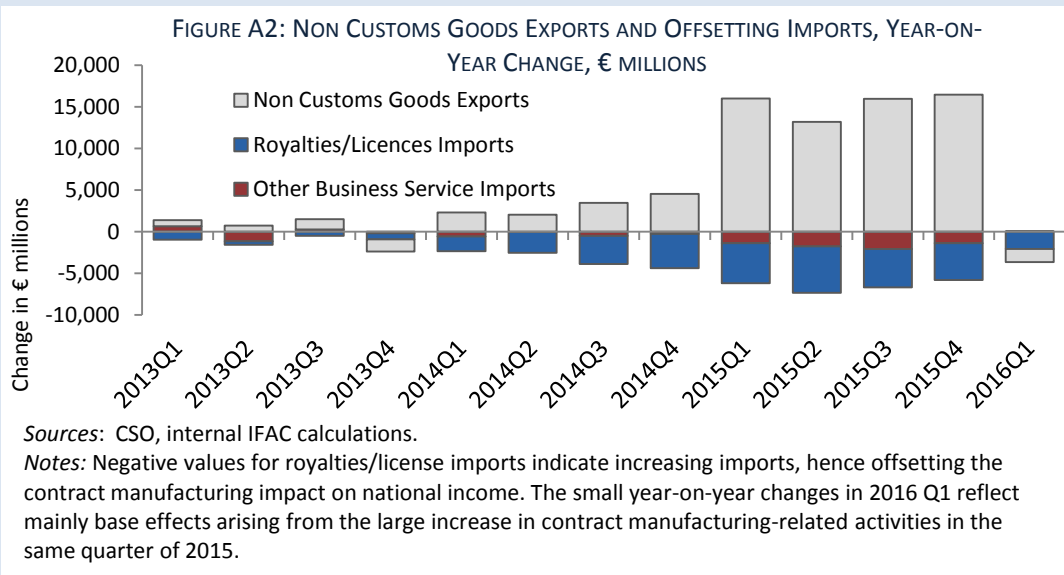
Table A2: Net Value Added, current prices, € millions

	2014	2015	Change, € million
Wages and salaries	68,333	72,083	3,750
Employers contribution to social insurance	5,817	6,211	394
Company trading profits before tax	52,302	75,398	23,096
Self employed earnings	7,361	7,927	566
Rent (actual and imputed)	9,221	10,415	1,195
Adjustment for stock appreciation	248	17	-231
Net Value Added at Factor Cost	143,969	174,831	30,862
Provision for depreciation	30,891	61,558	30,667
Net taxes and subsidies	18,299	19,426	1,126
GDP at market prices	193,160	255,815	62,655
Net factor income	-29,715	-53,173	-23,458
GNP	163,445	202,642	39,197

Looking at the expenditure side of the National Accounts, the increase in output is

reflected in a large rise in exports. While the National Accounts show a huge increase in exports of goods, this is not reflected in the monthly trade statistics. The gap between goods exports in the National Accounts and the monthly trade statistics is thought to be mainly due to contract manufacturing activities.⁴ While there have been large increases in contract manufacturing activities in previous years, these had been largely GDP neutral. This is because exports produced via contract manufacturing were offset by associated imports (particularly royalty payments for the use of intellectual property, see Figure A2 below). Due to the on-shoring of intellectual property in 2015, it appears that these payments are not being made and hence service imports are no longer increasing in line with exports produced via contract manufacturing (Figure A2). This results in contract manufacturing now having a material impact on measured GDP growth in the Irish National Accounts, because the intellectual property underpinning the products is located here even though the actual manufacturing activity takes place abroad through a third party.

To summarise, the latest NIE data for 2015 are seriously distorted by the activities of MNEs. The output and exports produced by these entities are adding to Irish GDP and GNP even though the production of the output takes place outside the state and no domestic labour is used in the production process. The current account of the balance of payments – an important indicator of imbalances in the economy – is also inflated. The latest data show an artificially high current account surplus of over 10 per cent of GDP for 2015. The scale of this surplus is not consistent with the trade performance of firms producing output in the Irish economy or with the savings and investment patterns of domestic residents. The distortions have also resulted in a large deterioration in Ireland’s NIIP that is not reflective of the economy’s true net foreign asset position.



⁴ The CSO (2015) note that reasons for adjustments to primary data sourced from the International Trade monthly series of imports and exports of goods usually relate to the recognition of changes in economic ownership. As well as for contract manufacturing, such adjustments may take place due to the recording of merchanting activities and due to conceptual adjustments relating to the valuation of goods, such as in cases where certain exports may be undervalued. See: <http://www.cso.ie/en/media/csoie/surveysandmethodologies/documents/pdfdocs/ContractManufacturingInformationNotice.pdf>

The new data mean that many key National Accounts aggregates no longer provide an informative picture of underlying developments in the Irish economy. Underlying in this context refers to economic activity carried out in Ireland using domestic labour and capital which has an impact on employment and incomes of Irish residents. To see this, it is sufficient to look only as far as headline real GDP and GNP, which in the latest data are estimated to have increased by 26.3 per cent and 18.7 per cent respectively in 2015. These growth rates are not in line with more reliable indicators such as employment or consumption (Table 1). The assessment of the fiscal position is also complicated by the revised data. Measures such as the General Government Deficit to GDP ratio and the General Government Gross Debt to GDP ratio have typically played a key role in assessing the fiscal position, facilitating both comparisons across countries and changes over time. There have, of course, been long-standing debates about the appropriateness of using GDP as a denominator for Ireland, which has led to the use of GNP or a hybrid of GDP and GNP (see, for example, IFAC, 2012).

TABLE 1: INDICATORS OF ECONOMIC ACTIVITY, REAL ANNUAL % CHANGE (UNLESS STATED)

Growth Indicator	2014	2015	2016f	2017f
Underlying Domestic Demand*	5.9	4.6	5.1	4.1
Private Consumption	1.7	4.5	2.7	2.4
Employment	1.7	2.6	2.6	2.3
Net National Product (nominal)**	6.5	6.5	-	-
GVA excluding Industry	8.7	6.6	-	-
Domestic GVA***	8.1	6.1	-	-
GDP	8.5	26.3	4.9	3.9
GNP	9.2	18.7	4.1	3.7

Source: Historic data for 2014 and 2015 are from the CSO. Forecasts for 2016 and 2017 are from the Department of Finance (SPU 2016).

Notes: * Underlying domestic demand consists of consumption, investment (excluding that in aircraft and intangible assets), stock changes and government consumption. ** Net National Product is in nominal terms and excludes the impacts of depreciation and net factor income on the National Accounts, unlike GDP and GNP. *** Domestic GVA excludes MNE-dominated parts of industry as well as the IT sector. See note 2 to Figure 1 below.

In time the CSO may expand the current range of macroeconomic statistics or devise complementary presentations of the existing data.⁵ In the meantime, to assess the macroeconomic and fiscal position on an underlying basis, i.e. to assess developments which impact employment

⁵ In September 2016, the CSO will publish data for 2015 providing a breakdown of Gross Value Added for the multinational and domestic sectors of the economy. A consultative group has been established by the CSO to examine the potential for the development of supplementary statistical series that may enhance understanding of the Irish economy. Council member Seamus Coffey and Thomas Conefrey from the IFAC secretariat are two members of this group.

and living standards in Ireland, it is necessary to look beyond the standard National Accounts aggregates and to use alternative indicators. A range of indicators of economic activity for 2014 and 2015, along with Department of Finance forecasts for 2016 and 2017 are shown in Table 1. As shown in the Table, using these indicators necessarily involves a trade-off between the use of distorted data and the alternative indicators which provide a less distorted picture of underlying economic activity but are partial and do not fully capture all relevant economic activity.

Looking at the expenditure side of the National Accounts, it is clear that the traded sectors have been most heavily affected by the recent data revisions, with net exports now estimated to have doubled and exports growing by 34 per cent last year. With this in mind, domestic indicators may give a better picture of actual economic activity in Ireland. Figure 1A shows the year-on-year changes in underlying domestic demand.⁶ The chart illustrates that the domestic part of the economy grew by 4.6 per cent in 2015.

Looking at the output side of the accounts, most of the growth in the unadjusted CSO data was concentrated in the broad industrial sector. If this sector is excluded, a very crude measure of output growth excluding the volatile industrial sector can be calculated.⁷ As shown in Figure 1B, from this measure it is apparent that there was real growth in 2013 (2.9 per cent), 2014 (8.7 per cent) and 2015 (6.6 per cent).

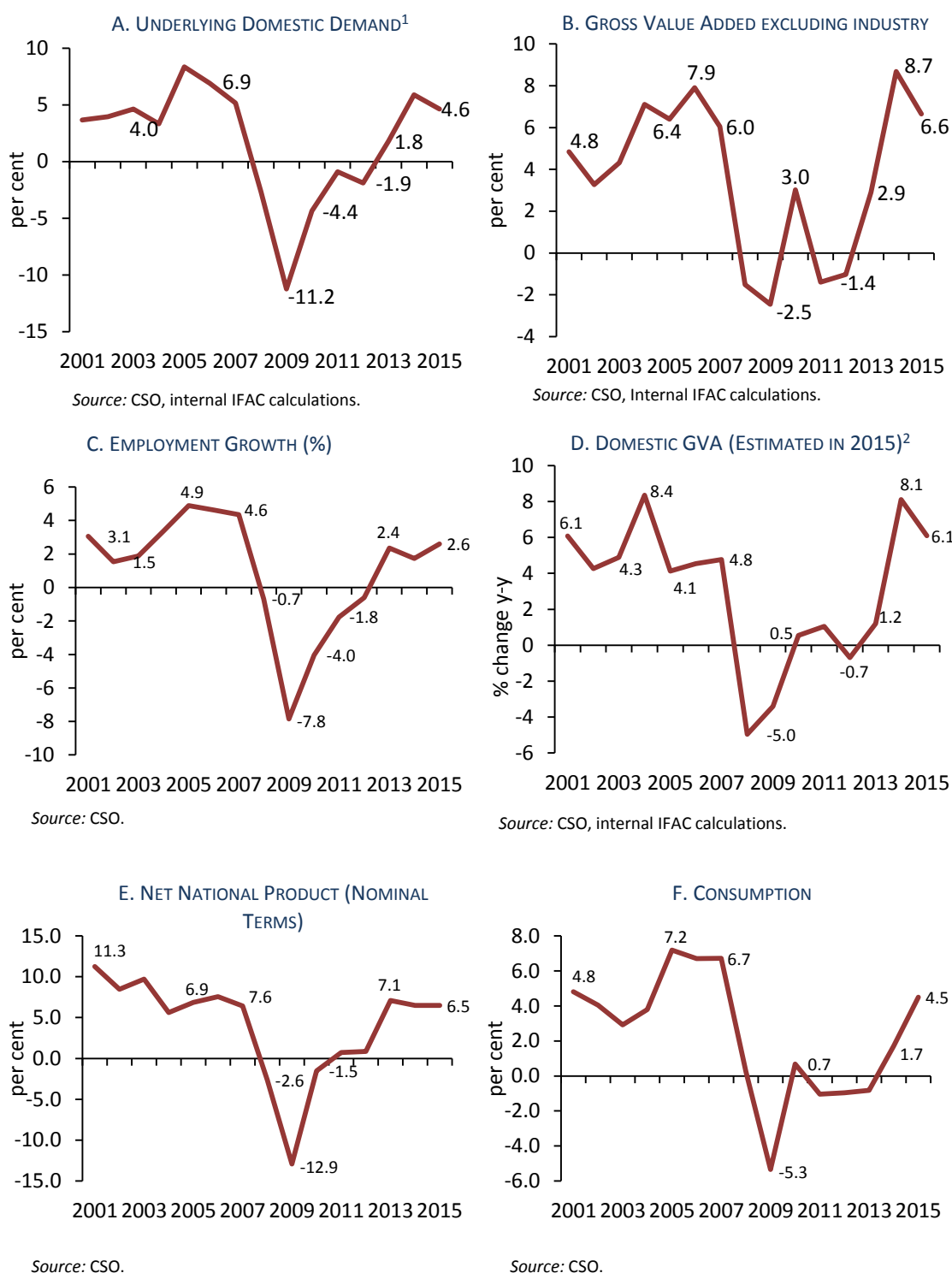
Another metric that can be reliably used to examine the health of the Irish economy is employment growth. Employment data are more stable and subject to smaller revisions than many National Accounts based measures. In 2015 there was further steady employment growth, building on earlier improvements in the labour market. The number at work increased by 2.6 per cent in 2015 and employment growth continued at a strong pace in the first half of 2016 (Figure 1C).

Tax revenues also grew strongly in 2015. Overall Exchequer tax and PRSI revenue grew by 10.5 per cent in 2015; excluding corporation tax, revenues increased by 5.6 per cent. Tax revenues have continued to increase on an annual basis in 2016, although the pace of growth has weakened in recent months. Exchequer returns for August 2016 show VAT and income tax lower than forecast by the Department of Finance in *Budget 2016*.

⁶ This is given by adding personal consumption, government consumption, stock changes and underlying investment (which exclude investment in aircraft and intangible assets).

⁷ The industry sector accounted for 23 per cent of overall GVA in 2014.

FIGURE 1: ALTERNATIVE INDICATORS OF ECONOMIC GROWTH, ANNUAL % CHANGE



Source: CSO; internal IFAC calculations.

¹ Underlying domestic demand strips out investment in intangibles and aircraft from headline investment.

² GVA ex MNE-dominated industry and software uses the historical relationship between industrial production data for the traditional sector and Gross Value Added excluding chemicals and pharmaceuticals, computers and instrument engineering, and medical and dental instruments and supplies to construct estimates of growth in the latter for 2015 based on available data for 2015 traditional sector industrial production. All remaining sectoral GVA (other than industry and software) is then added to this to approximate GVA excluding MNE-dominated sectors.

A fourth metric that can be considered is the growth rate in the Gross Value Added (GVA) of sectors other than those where foreign-owned multinational enterprises (MNEs) are dominant. The CSO produce estimates of this, but unfortunately these are not yet published for 2015. It is, however, possible to approximate new estimates for 2015 based on available traditional sector industrial production data and its historical relationship with GVA for certain non-MNE dominated sectors of industry. Using these estimates, it would appear that GVA excluding MNE-dominated sectors grew by 6.1 per cent last year (Figure 1D).⁸

Overall, it is evident from these indicators that while the headline figures overstate recent growth, there has been a significant expansion in economic activity since 2012. Based on an estimate of growth in domestic demand, real growth in 2015 measured around 5 per cent and this pick-up is also reflected in the improving labour market.

Turning to implications for the cyclical position of the economy, although recent underlying growth has been strong, there are no obvious signs of overheating at present. While subject to a large degree of uncertainty, a range of formal estimates of the output gap reported in the Council's June 2016 *Fiscal Assessment Report* (IFAC, 2016a) suggested that the economy is operating close to potential in 2016. Updating these model estimates is complicated due to the problems with the National Accounts data noted above. The Council's assessment of the economy's cyclical position also takes into account a range of other indicators of economic imbalances. An adjusted measure of the current account prior to the most recent data release indicated that the current account was close to balance in 2015. Wage growth (measured by compensation per employee) picked up slightly to 2.7 per cent in 2015 but remains modest. Credit growth to both households and Non-Financial Corporations (NFCs) continues to be subdued with Irish banks holding more household deposits than household loans at end-July 2016.⁹

Overall, the available evidence is not indicative of overheating in the economy at present. It is important to note, however, that there is significant uncertainty around this assessment and the position could change over the next number of years. In particular, the level of house building remains well below the estimated annual requirement. A pick-up in public and private house completions in 2017/2018 to the levels targeted in the Government's new housing plan (*Rebuilding Ireland*) would add significantly to investment and domestic demand growth, meaning the economy would require careful management to avoid potential overheating. While not of

⁸ Mac Coille (2016) adopts a similar approach.

⁹ The household loan-to-deposit ratio was 92 per cent at end-July 2016.

immediate concern given the lack of obvious signs of excess demand in the economy, this will be an important consideration in framing fiscal policy post *Budget 2017*.

1.2.2 Fiscal Context

Turning to an assessment of the fiscal position, the problems with the official estimates of GDP and GNP require the use of alternative fiscal ratios. The choice of a suitable denominator for fiscal ratios such as the debt and deficit requires the identification of an appropriate revenue base for the Irish economy. For example, the Council previously used a hybrid measure which reflected the likelihood that the revenue potential of GNP is different to the excess of GDP over GNP. However, with the measures of both GDP and GNP now being overstated, these traditional denominators risk giving a seriously distorted picture of the underlying fiscal position. For example, the debt-to-GDP ratio is measured to have fallen from 105 per cent in 2014 to just over 78 percent in 2015 (Figure 3b). This gives a misleading view of the true improvement in the debt position.

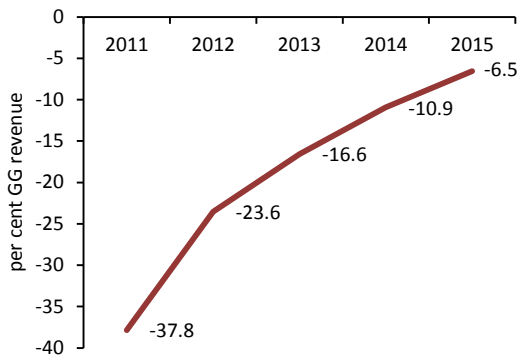
As an interim response, in this report the Council has found it more useful to focus directly on fiscal ratios expressed as a percentage of actual General Government revenue. This is not unproblematic as the ratios capture actual tax revenue rather than the size of the potential tax base. Nevertheless, the ratios based on government revenue are likely to give a more informative and transparent picture of changes in the fiscal position over time than those based on the distorted GDP data. The General Government deficit and gross debt as a proportion of General Government revenue are shown in Figure 2A and Figure 2B. The charts show a steady reduction in the deficit since 2011. According to this measure, the debt-to-revenue ratio peaked in 2012 and 2013 but declined both in 2014 and 2015.

As the revenue-to-GDP ratio was reasonably constant at 33-34 per cent between 2011 and 2014, these revenue-based ratios can be adjusted to make them more comparable to standard GDP ratios based on the revenue share in 2014.¹⁰ Figures 3A and 3B show the adjusted ratios. The implied improvement in the debt ratio between 2014 and 2015 is now strikingly different to a naïve use of the standard debt-to-GDP ratio. The adjusted debt ratio improves from 105 per cent in 2014 to 97 per cent in 2015, a fall of eight percentage points compared to the 27 percentage point fall in the unadjusted debt-to-GDP ratio.¹¹ Thus the adjusted data point to a continuing gradual reduction in the State's debt burden, although the overall level of debt remains high.

¹⁰ The ratio of GDP to General Government revenue in 2014 was 2.94. The adjusted revenue base is calculated by multiplying actual General Government revenue by this ratio in each year. The nominal deficit and debt are then divided by this scaled revenue base to arrive at the adjusted debt and deficit ratios shown in Figure 5a and Figure 5b.

¹¹ Taking the range of alternative indicators of economic activity discussed in this section and shown in Figure 1 and Table 1, a plausible estimate of the real growth in the economy in 2015 is around 6 per cent - excluding distortionary

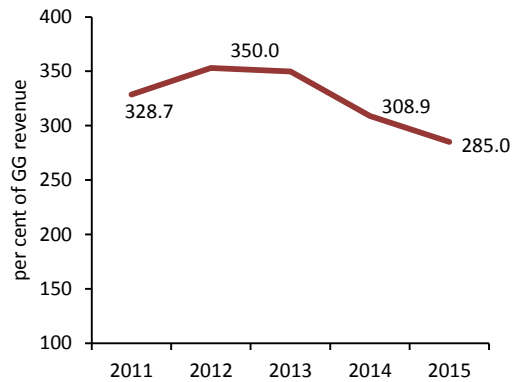
FIGURE 2A: GENERAL GOVERNMENT BALANCE TO REVENUE BASE (%)



Source: CSO.

Notes: Chart shows the GG balance expressed as a proportion of GG revenue.

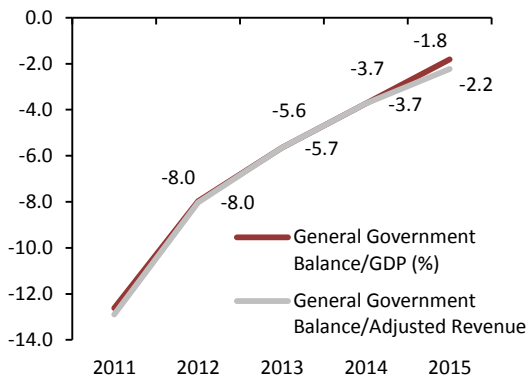
FIGURE 2B: GENERAL GOVERNMENT GROSS DEBT TO REVENUE BASE (%)



Source: CSO.

Notes: Chart shows the GG gross debt expressed as a proportion of GG revenue.

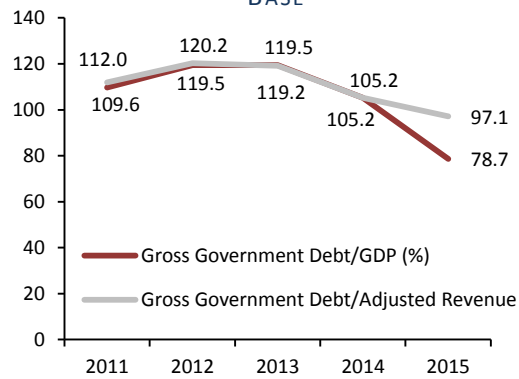
FIGURE 3A: GENERAL GOVERNMENT BALANCE TO SCALED REVENUE BASE



Source: CSO.

Notes: Chart shows the GG balance expressed as a proportion of a scaled GG revenue base. The scaled base is calculated by multiplying the actual GG revenue by the ratio of GDP to revenue in 2014.

FIGURE 3B: GROSS GOVERNMENT GROSS DEBT TO SCALED REVENUE BASE



Source: CSO and internal IFAC calculations.

Notes: Chart shows the GG gross debt expressed as a proportion of a scaled GG revenue base. The scaled base is calculated by multiplying the actual GG revenue by the ratio of GDP to revenue in 2014.

factors related to MNEs. Assuming growth in the GDP deflator of 2 per cent, this gives assumed nominal GDP growth of 8 per cent for 2015, instead of the 32 per cent growth in the official CSO data. Based on 8 per cent nominal GDP growth in 2015, the debt ratio would have been 96.5 per cent last year, similar to the 97 per cent figure based on the adjusted debt-to-government revenue ratio and higher than the 78 per cent number based on the distorted GDP data.

1.3 ASSESSMENT OF THE FISCAL STANCE IN ADVANCE OF *BUDGET 2017*

The Council's standard approach to assessing the prudence of the overall fiscal stance examines compliance with the fiscal rules, cross-checked by an economic assessment to confirm appropriate consideration of cyclical demand management and debt sustainability issues.

TABLE 2: ANNOUNCED DISCRETIONARY MEASURES IMPACTING THE FISCAL STANCE IN 2016 AND 2017

Measure	Details	Amount (€bn)
Additional Voted Spending in 2016	<i>April's Stability Programme Update</i> signalled potential spending pressures, which were addressed by including an additional €540 million voted expenditure in the 2016 Revised Estimates Volume published in June 2016. This allocated an additional €500 million for Health and €40 million to the Department of Justice. This additional expenditure is carried forward into the expenditure base for 2017.	0.5
Pre-Committed Expenditure for 2017	Before any changes in <i>Budget 2017</i> , gross voted current and capital spending is projected to increase by around €0.9 billion in 2017. This pre-committed spending includes provisions for demographic pressures (€0.4 billion), the Lansdowne Road Agreement (€0.3 billion), the Public Capital Programme (€0.2 billion) and certain other policies.	0.9
Fiscal Space Estimate for 2017	The <i>Summer Economic Statement</i> estimated fiscal space of €1 billion is available for 2017. The Government has indicated that it intends to use this fiscal space for additional expenditure increases and tax reductions in <i>Budget 2017</i> .	1.0
Total		2.4

Sources: Department of Finance *Summer Economic Statement* (2016b) and *Stability Programme Update* (2016a).

Notes: Data are on an Exchequer basis. Rounding may affect totals.

In the *Summer Economic Statement* published on 21 June 2016, the Government announced a planned package for *Budget 2017* of €1 billion comprising expenditure increases amounting to around €670 million and tax cuts of €330 million. In addition to the €1 billion figure, other expenditure increases are planned for both 2016 and 2017 (Table 2). First, the *SES* contained an increase in expenditure for 2016 of €0.5 billion compared to the initial Revised Estimates for 2016 published last December.¹² This increase in spending will be carried into the expenditure base for 2017. Second, the Government's baseline fiscal projections for 2017 already allow for an increase in current spending due to commitments under the Lansdowne Road Agreement and for demographics. Along with some pre-committed capital spending, total voted current and capital spending is forecast to rise by around €0.9 billion in 2017.¹³ Taking the announced use of the €1

¹² €500 million of this has been allocated to the Health area with €40 million allocated to the Department of Justice.

¹³ Additional costs may arise in 2017 if Ireland's contribution to the EU budget is higher than expected. Member State contributions to the EU budget are based on a formula which includes Traditional Own Resources (customs duties), a VAT-based payment and a component based on each Member State's share of EU Gross National Income (GNI). As a result of the upward revision to Ireland's GNI in the National Accounts data released by the CSO in June, the

billion fiscal space and adding in the €0.5 billion increase in spending in 2016 (which carries forward to 2017) as well as the €0.9 billion of pre-committed spending gives an overall package of measures amounting to around €2.4 billion (Table 2).

The parameters and inputs used to calculate the estimate of €1 billion additional fiscal space (under national and EU fiscal rules) for 2017 have already been “frozen” based on the European Commission’s Spring 2016 forecasts and the April 2016 *Stability Programme Update* from the Department of Finance. Since then, the Central Bank and others have revised down their forecasts for economic growth in 2016 and 2017.¹⁴ This raises the question of whether the current estimate of fiscal space for 2017 would change if more up-to-date forecasts were used in the calculation. Re-estimating fiscal space for 2017 based on updated post-Brexit forecasts indicates that the current €1 billion figure based on the Spring data would not change materially. Over the medium-term, however, estimates of fiscal space are sensitive to the economy’s projected growth path and could be impacted by shocks such as Brexit as discussed in detail in Section 1.3.

While ascertaining the precise pace of growth in the economy is difficult, a range of indicators of economic activity discussed in Section 1.2 above suggests that the economy is currently growing at a reasonably strong rate. The unemployment rate has fallen and there was net inward migration in the year to April 2016 for the first time since 2009. As the demand shortfall in the economy is likely to be small and disappearing quickly, the economic case for a more expansionary stance than already planned by the Government through the €2.4 billion of measures outlined above is weak.

Turning to debt sustainability considerations, the government debt level when measured relative to government revenue remains high (Figure 3B). Although the current interest rate environment is favourable, the experience of recent years has demonstrated how quickly market sentiment can change. The State’s high level of debt means the overall fiscal position is still fragile and an adverse shock could cause the debt ratio and deficit to start rising again.

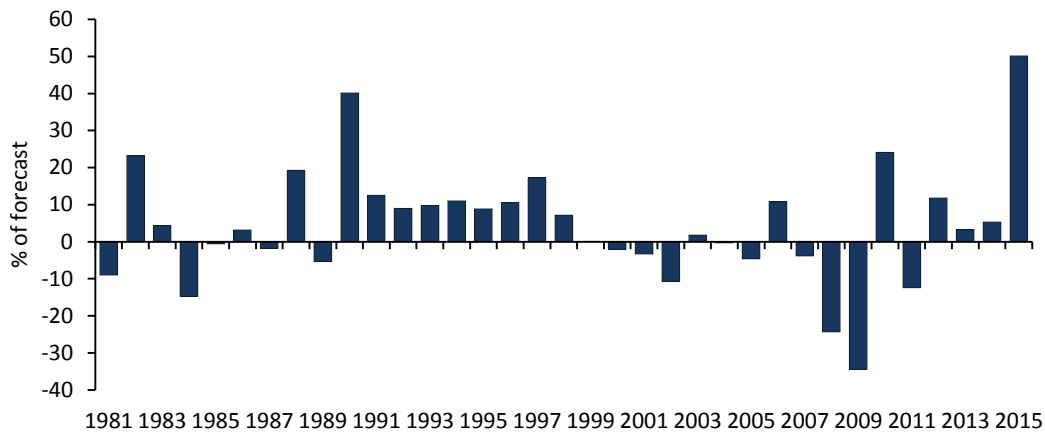
Moreover, in the wake of Brexit the risks facing the Irish economy have heightened since the publication of the Council’s last assessment in June. While it is possible that the eventual impact of Brexit on the Irish economy and public finances will be modest and along the lines described in the Baseline Scenario in the next Section, there is much uncertainty and a more severe outcome is also possible. Apart from the immediate risk posed by Brexit, other risks to the public finances stem

Department of Finance estimate that this could lead to an overall increase in Ireland’s EU budget contribution for 2017 of around €280 million compared to the forecast in the *SES*, after some offsetting factors have been taken into account. A more concrete estimate of the final figure should be available in November 2016. See PQ 22880/16 [here](#).

¹⁴ In *Quarterly Bulletin No. 3 2016*, the Central Bank revised down its 2016 GDP growth forecast by 0.2 percentage points and its 2017 forecast by 0.6 percentage points.

from the highly concentrated nature of the Irish export base which leaves overall export and GDP growth vulnerable to sector-or firm-specific shocks. To protect the public finances against these and other possible risks, the Government should take advantage of the current relatively strong growth in the economy to eliminate the remaining budget deficit and reduce the debt level. This would leave the Government in a stronger position to protect the economy and the public finances from adverse shocks.

FIGURE 4: CORPORATION TAX FORECAST ERRORS (1981-2015)

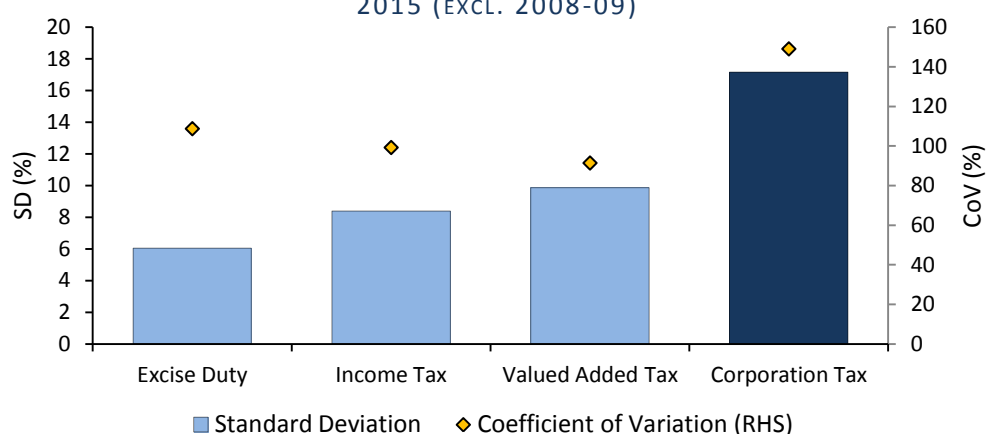


Source: Department of Finance (forecasts from various Budget documents).

Notes: Errors relate to Budget-day forecasts for the following year.

A distinctive feature of recent budgetary performance has been surging corporation tax revenues. Figure 4 shows the growth in corporation tax revenue relative to forecasts in recent years. Although corporation tax makes up around 15 per cent of overall Exchequer tax revenue, it accounts for a larger fraction of the total tax revenue outperformance relative to the Department of Finance’s forecasts in 2015 and 2016. As discussed in the Council’s Analytical Note (Casey and Hannon, 2016), corporation tax is the most volatile of Ireland’s main tax headings (Figure 5). This raises the important question of how corporation tax surges should affect broader tax, expenditure and deficit decisions. A central part of the background is that public debt for the Irish economy remains at unsafe levels (see Section 1.2), which is compounded by new Brexit-related uncertainties. Regardless of the sustainability of recent increases in corporation tax, this argues for using windfalls to lower debt to a safer level, in particular given the costs of alternative means of reducing the deficit through expenditure cuts and tax increases.

FIGURE 5: VOLATILITY OF ANNUAL TAX REVENUE GROWTH: 2000-2015 (EXCL. 2008-09)



Source: Department of Finance tax revenue data. Internal IFAC calculations.
Notes: Standard deviation of growth rates = SD; Coefficient of Variation = CoV.

However, even if there was not a need to lower debt to safer levels, care would still need to be taken in using such revenue surges to fund permanent (or at least difficult to reverse) spending increases and tax cuts. One issue is the expected persistence of the recent revenue outperformance. Although the latest National Accounts data and analysis by the Revenue Commissioners (Tancred, 2016) gives some insight into the reasons for the outperformance, its relationship to the asset and tax management decisions of a small number of multinational corporations gives reason to be cautious about its sustainability. Moreover, when underlying revenues are volatile, prudent budgetary management suggests that buffers should be built up to protect against potential reversals, especially where it is costly to reverse expenditure increases and tax cuts.

The Expenditure Benchmark (EB) – which links spending growth to the economy’s underlying potential growth rate – is explicitly designed to prevent increases in expenditure being funded from temporary or cyclical revenue surges. However, a series of anomalies in the implementation of this rule mean that in practice the EB may be looser than is appropriate. For example, in 2015, the fact that Ireland was in the Corrective Arm of the Stability and Growth Pact (SGP) – also called the Excessive Deficit Procedure – meant that the Expenditure Benchmark was not applied. The surging corporation tax revenue meant that Ireland was easily able to meet the target for the nominal budget deficit of 3 per cent of GDP, which created room for increases in spending through the supplementary estimates process late in the year. For 2016, the statistical treatment of the AIB preference share transaction in 2015 loosened the EB for this year and allowed the Government to announce the additional €540 million in expenditure for 2016 without formally breaching the rule. Due to the AIB transaction which raised the expenditure base for 2015, a further increase in

spending in 2016 through supplementary estimates could take place while still technically complying with this rule.¹⁵

While adherence to the Expenditure Benchmark provides valuable long-term protection against the type of policy mistakes that preceded the economic crisis, good policy making also requires recognising anomalies in its implementation to ensure that actual policy follows the principles of prudent risk management. In this context, a further relaxation of the fiscal stance in 2016 based on volatile and uncertain corporation tax revenues would go against the spirit of the rules and would not be appropriate in the current circumstances.

At the time of the Council's June 2016 *Fiscal Assessment Report*, the estimated fiscal space for 2017 was €0.9 billion, marginally below the current estimate. The Council's preliminary assessment in June 2016 was that a budget package of this magnitude, on top of a similar amount already pre-committed, would be consistent with prudent economic and budgetary management. The Council also stated that within-year increases in expenditure in 2016 as occurred in 2015 should not be repeated.

Since the publication of this preliminary assessment, the Government has announced the additional increase in spending of €540 million for 2016 noted above and the estimated fiscal space has been revised upwards marginally to €1 billion. Taken together, these changes mean that the Government's fiscal stance for 2016 and 2017 is now more expansionary than earlier indicated.

Choosing the appropriate short-run fiscal stance involves a balancing of counter-cyclical and risk management objectives. Brexit has further complicated the trade-off facing policy makers. On the one hand, to the extent that the Brexit-related shock has lowered growth, a pro-cyclical response through a tighter fiscal stance should be avoided from a demand management perspective. One of the objectives of post-crisis fiscal policy should be to avoid pro-cyclical policy responses to shocks. On the other hand, Brexit has increased the macroeconomic and fiscal risks facing the Irish economy at a time when debt sustainability and creditworthiness remain vulnerable due to the post-crisis legacy of high debt. Good risk management argues against moves to loosen the fiscal stance which would slow the progress towards safer deficit and debt levels. Following prudent

¹⁵ The AIB reclassification impact in 2015 means that the total and corrected expenditure aggregates relevant for the EB in 2015 are both €2.1bn higher than they otherwise would be. This results in net fiscal space of €0.94 billion for 2016 under the Expenditure Benchmark given current expenditure plans (i.e., the revised SES plans for 2016). By contrast, if the €2.1bn was not added to corrected expenditure in 2015, this would mean a deviation of €1.2 billion (0.5pp GDP) in 2016 on the basis of current plans.

policy now can also help ensure that the Government has scope for actions to mitigate the impact of future adverse shocks on the economy and the public finances.

Weighing up these considerations, the Council assesses that the Government's current plans for a €1 billion package in *Budget 2017*, on top of a combined €1.4 billion of expenditure increases already committed for 2016 and 2017, is at the limit of the range of prudent policies. Any further relaxation of the fiscal stance in 2016 or 2017 beyond the current plans would not be appropriate given the strong pace of underlying economic activity, falling unemployment and the need to bolster the resilience of the public finances to adverse shocks. This means that current plans for 2016 and 2017 should be adhered to even in the event of tax revenue outperforming current forecasts by the end of 2016.

1.4 POTENTIAL IMPACT OF BREXIT ON FISCAL SPACE

The UK vote to leave the EU occurred after the publication of the Council's June report and the release of the Government's *SES*. Given the extent of the trade links between Ireland and the UK, the referendum result has the potential to significantly affect the Irish economy in the coming years. At present, however, the ramifications of the referendum result for the UK economy and for Ireland are still largely unknown. In the longer term, the ultimate impact of the UK decision will depend on many factors, including the nature of the post-Brexit trade arrangements that the UK eventually negotiates to replace its current rights as an EU member.

In the short run, there are a number of Brexit-related developments that can be expected to have an influence on the Irish economy. First, prior to the Brexit referendum, the value of sterling fell substantially against the euro and has averaged around 0.85 pence since the referendum result in late June. This represents a 16.5 per cent depreciation compared to sterling's average value versus the euro in 2015. The scale of this depreciation damages Ireland's external competitiveness and could result in a decline in exports to the UK.¹⁶ Second, all official forecasts for the UK economy published post Brexit have contained a downward revision to growth for both 2016 and over the medium term (IMF, 2016; Bank of England, 2016; NIESR, 2016b). While there is obviously a considerable degree of uncertainty attached to these projections, they all point to weaker growth in the UK economy than previously envisaged. By reducing external demand for Irish exports, a slowdown in UK growth will negatively impact the Irish economy, in particular the employment intensive "traditional" sector (as defined by the CSO) for which the UK is an important export

¹⁶ The value of merchandise exports to the UK in the first six months of 2016 was €6.18 billion, down 5 per cent from €6.5 billion in the first half of 2015.

destination. A slowdown in growth would reduce tax revenues and increase the budget deficit and debt in the absence of offsetting developments.

The Government's *SES* published prior to the Brexit result estimated the availability of a cumulative €11.3 billion of net fiscal space from 2017 to 2021. These fiscal space estimates were calculated on the basis of the Expenditure Benchmark rule. The calculation of fiscal space under this rule is dependent on a number of key inputs and other assumptions. Two of these are: a ten-year average of the economy's potential growth rate (called the "reference rate") and the year Ireland is expected to reach its Medium-Term Budgetary Objective.¹⁷

Fiscal space is calculated based on the economy's estimated potential rather than actual GDP growth and therefore should be less sensitive to temporary business cycle fluctuations. At this point, however, it is unclear whether Brexit will result in a mild slowdown in the Irish economy or whether a more severe permanent effect on the economy's potential growth will materialise. Two possible scenarios are explored below to illustrate how the economy and public finances could be affected by Brexit. In the first scenario, the possible impact of Brexit is assessed taking the most recent forecasts for the UK economy published after the referendum result. The second scenario considers a more adverse outcome where the Irish economy's potential output is assumed to be permanently lower.

1. Baseline Brexit Scenario

In attempting to model the effect of Brexit on Irish growth (and potential growth), a number of channels need to be examined. The most direct impact of Brexit on Irish growth is likely to be through reduced external demand, due to lower growth in the UK. Given that almost 17 per cent of overall Irish goods and services exports go to the UK,¹⁸ changes in economic growth in the UK have a significant impact on external demand for Irish exports. While the direct trade links are strong, there are also significant indirect trade links.¹⁹

The other main channel through which Brexit could impact the Irish economy is via depreciation of sterling. This would have negative implications for Ireland's competitiveness, as Irish goods would be more expensive in the UK and imports from the UK would be relatively cheaper. Due to the close trading relationship between the two countries, exchange rate movements could have

¹⁷ Ireland's MTO is a structural budget deficit of -0.5 per cent of GDP.

¹⁸ This figure is based on data for goods exports from the CSO Merchandise Trade Statistics. The data measure physical trade through Irish ports. Data for services exports come from the annual Balance of Payments statistics.

¹⁹ For example, a reduction in UK growth could reduce US growth, which consequently would further reduce demand for Irish exports.

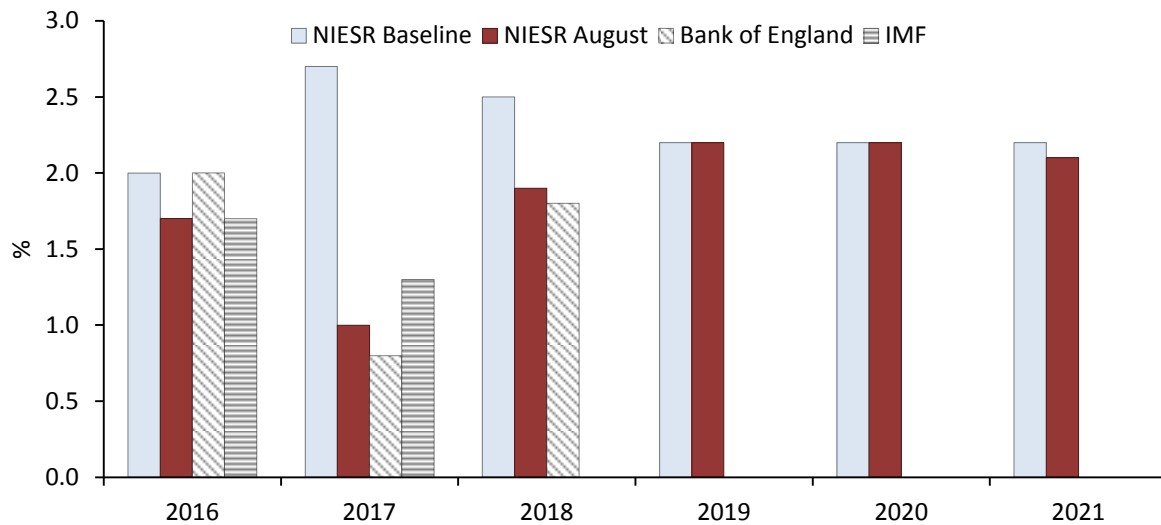
significant implications for Irish growth prospects. The analysis in this Section examines the sensitivity of the macroeconomic forecasts published in the *SES* to changes in the external environment due to Brexit.

While most studies examining the possible impact of Brexit on the Irish economy published to date consider these conventional trade and exchange rate effects, it is possible that Brexit could influence the Irish economy through other channels. In their modelling of the short-run impact of Brexit on the UK economy, the UK Treasury (HMT, 2016) take into account a possible reduction in UK growth due to what is termed “the uncertainty effect”. This effect could materialise if businesses and households postpone or cancel spending or investment decisions until the nature of the UK’s new trading arrangements and relationship with the EU become clearer. Given the lack of clarity over this presently and the importance of the UK market for some sectors of the Irish economy, it is possible that similar uncertainty effects could impact Irish households and firms, reducing demand in the economy. The possible magnitude of this uncertainty effect is more difficult to estimate than the trade and exchange rate channels but it could nonetheless be an important conduit through which Brexit impacts the Irish economy. As a result, the Baseline Scenario includes an estimate of the reduction in consumption and investment due to uncertainty, drawing on the analysis for the UK.

The Baseline Scenario uses the most recent forecasts for the UK economy from the National Institute of Economic and Social Research (NIESR) published on 3rd August 2016. These forecasts are in line with NIESR’s Brexit scenario for the UK economy published prior to the referendum (NIESR, 2016a). The forecasts indicate a slowdown in the pace of economic growth to just 1 per cent in 2017 and 1.9 per cent in 2018. Prior to the referendum result, NIESR expected growth to measure 2.7 per cent and 2.5 per cent in 2017 and 2018 respectively (Figure 6). This NIESR forecast is somewhat more benign than others (such as the UK Treasury analysis on the impact of Brexit published before the referendum), mainly due to the exchange rate movements assumed. The NIESR forecasts assume an exchange rate of €1 = £0.84, which leaves the pound over 15 per cent lower than its average value against the euro in 2015. This results in a less severe drop in economic growth, due to the associated competitiveness gains for the UK. While this exchange rate movement is significant, it is somewhat mitigated by the fact that inflation²⁰ is higher in the UK as a result (mainly due to the higher cost of imports). This means the real effective exchange rate does not move as strongly as the depreciation of sterling would imply.

²⁰ For the scenario chosen it is assumed that the Bank of England does not engage in tighter monetary policy in response to the higher inflation.

FIGURE 6: FORECASTS FOR THE UK ECONOMY



Sources: NIESR Prospects for the UK economy, May 2016 and August 2016. Bank of England Inflation Report, August 2016. IMF, World Economic Outlook Update, July 2016.

Based on the IFAC forecasting models that are used to produce the Council’s Benchmark forecasts, the effect of these changed external conditions can be simulated to illustrate how Irish economic growth could be affected as a result of Brexit.²¹ The main channel through which this operates is trade, with service exports most heavily affected. There are also some modest negative impacts on investment, as expected future export demand is lower, thus reducing the need for firms to invest in extra capacity. As a result of these trade and exchange rate effects, GDP growth would be reduced by around ½ a percentage point in 2017 with a smaller impact in 2016 and 2018.²²

In addition to the trade channel, GDP growth in the Baseline Scenario is assumed to be reduced as a result of heightened uncertainty. Given the absence of empirical estimates on the effect of uncertainty on the consumption and investment decisions of Irish households and firms, an element of judgement is required to incorporate this effect into the Baseline Scenario. In the UK Treasury analysis, a one standard deviation increase in uncertainty is found to reduce business investment by 5 per cent cumulatively after two years and consumption by 1.5 per cent. For illustrative purposes, the scale of the uncertainty effect for Ireland in the Baseline Scenario is assumed to be half of the UK estimates, with most of the reduction in consumption and investment occurring in 2017.²³ Combining the negative trade impact with the reduction in demand due to uncertainty, overall GDP growth in the Brexit scenario is reduced by around 0.7 of a percentage

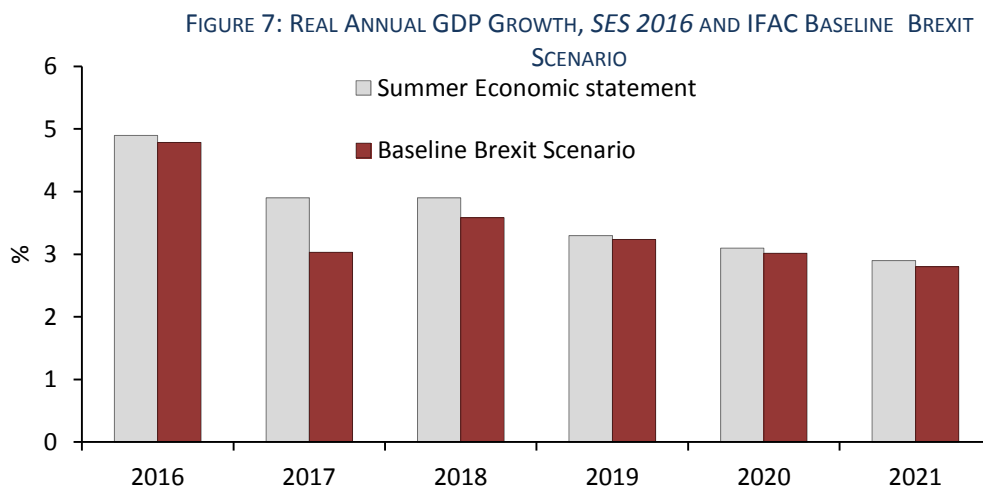
²¹ The two variables which are shocked are external demand and the real effective exchange rate.

²² These figures are similar to estimates published by the Central Bank in its July 2016 *Quarterly Bulletin*, see Box B.

²³ It is possible that consumption and investment expenditure that is delayed in 2016 and 2017 could take place at a later date offsetting the earlier decline, once the uncertainty effects diminish. For the purposes of constructing the Baseline Scenario, this deferred spending is assumed not to occur before 2021.

point in 2017 and 0.3 in 2018 compared to the *SES/SPU 2016* baseline (Figure 7). Reflecting the projections for UK growth after 2018 in the NIESR forecast, there is a limited impact on Irish GDP growth from Brexit after 2018 in this scenario.

As the Baseline Scenario implies a temporary reduction in Irish growth through mainly demand-side channels, it is therefore not expected that the economy’s long-run potential growth rate would be damaged in this scenario. However, the Commonly Agreed Methodology (CAM), used by the EC for assessment of compliance with the fiscal rules, suffers from the weakness that its estimates of potential growth tend to follow actual GDP growth quite closely. Running the Baseline Brexit Scenario through the CAM, estimated potential GDP growth is reduced but only marginally, mirroring the relatively modest impacts on actual medium-term growth rates. Given that the reference rate used for the purposes of calculating fiscal space in a given year is based on a ten-year average of potential growth, the Baseline Scenario would only result in a marginal adverse effect on fiscal space. However, in addition to the modest reduction in the reference rate, there is a risk under the Baseline Brexit scenario that achievement of the MTO could be delayed by one year (for example, if weaker government revenues led to larger estimates of the structural deficit). As illustrated in Figure 8 below, this could reduce the cumulative estimated fiscal space from 2017-2021 to below €10 billion.



Source: Department of Finance and Internal IFAC calculations.

Note: The forecasts for real GDP growth in Table 1 of *SES 2016* are the same as those set out in *SPU 2016*.

2. Adverse Brexit Scenario

There is significant uncertainty around the ultimate impact of Brexit on the Irish economy and a more severe outcome than the relatively benign short-run effects simulated in the Baseline Scenario is possible. For illustrative purposes, it is useful to consider the impact on fiscal space if

Brexit was to have a more lasting impact on the Irish economy than in the Baseline Scenario. Such a scenario could transpire if the UK's potential output growth is reduced by Brexit with knock-on consequences for the Irish economy. The exercise is not intended as a forecast of the possible impact of Brexit, but rather is designed to illustrate how fiscal space could dissipate if the economy performs significantly worse than currently forecast in the years ahead.

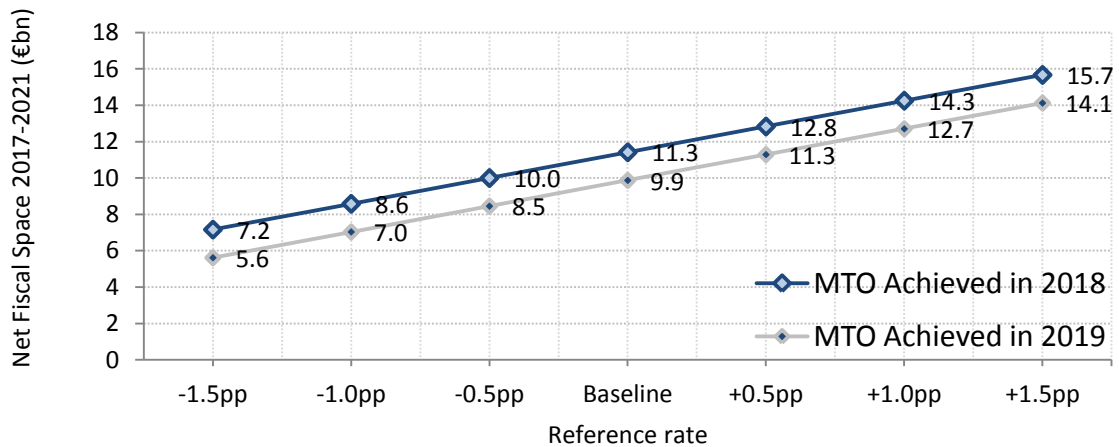
There are a number of possible channels through which potential output could be lowered as a result of Brexit. As part of the EU, the UK has access to a single market with free movement of labour, capital, goods and some trade in services. Following the referendum result, there is uncertainty over the trade and investment arrangements that will be put in place between the UK and its EU and non-EU trading partners, and the timing of these arrangements. As discussed in the Bank of England's August Inflation Report, research suggests that the degree of openness of an economy to trade, capital and labour market flows is an important determinant of a country's long-run potential growth rate.

Openness is particularly important for Foreign Direct Investment (FDI). Research shows that FDI can encourage the adoption of new technologies and practices that boost domestic firms' productivity (Haskel et al., 2007). Reduced openness post-Brexit could limit firms' opportunities to increase productivity by learning new processes and practices through trade and competition with foreign competitors. A reduction in the size of the market available to UK firms could also hinder firms' ability to exploit areas of comparative advantage, lowering aggregate productivity. Furthermore, potential growth could be reduced through the labour supply channel. This is because the size of the labour force is impacted by migration, the outlook for which is uncertain following Brexit.

The impact of Brexit on FDI flows is highly uncertain and there could be significant positive or negative effects on Ireland. Barrett et al. (2015) examined the FDI-related implications of Brexit. The study found that following Brexit the UK would be less attractive to FDI because of uncertainty and reduced EU market access. This could translate into lower productivity growth and lower potential growth in the UK through the channels noted above. The study observes that Ireland may attract additional FDI projects including some relocation of FDI from the UK. However, on the basis of patterns of the location choice of new FDI projects in Europe over the past ten years, the ESRI research finds that the expected additional attractiveness of Ireland to new FDI projects is likely to be small. Corporate tax reforms in the UK are likely to increase the attractiveness of the UK to FDI while the magnitude of their negative impact on Ireland's attractiveness would not be significant. The report finds that, even with a more competitive corporation tax system, the UK's attractiveness to FDI is likely to be negatively impacted by Brexit.

Permanently lower UK output growth as a result of reduced FDI would be expected to give rise to persistently lower demand for Irish exports in the absence of offsetting activity in other markets.²⁴ This would in turn reduce Irish potential growth rates. In addition, smaller trade flows between Ireland and the UK could reduce potential supply in the Irish economy by lowering aggregate productivity through similar channels to those discussed above. For illustrative purposes, assuming a reduction in Ireland’s potential growth rate of ½ a percentage point, fiscal space could be reduced by around a quarter to €8.5 billion if attainment of Ireland’s MTO was also delayed by a year (Figure 8). A ½ a percentage point shock would also not be exceptional when compared to the typical variation of the annual change in Irish potential GDP growth.²⁵

FIGURE 8: SENSITIVITY OF NET FISCAL SPACE TO REFERENCE RATE ASSUMPTIONS
(CUMULATIVE AMOUNT €BN, 2017-2021)



Notes: Estimates are calculated on the basis of compliance with the Expenditure Benchmark only, though Structural Balance adjustment requirements may differ. Amounts are not assumed to compound (i.e., available fiscal space is not assumed to be used in any given year such that a higher starting expenditure base would enable larger increases each year). Estimates of fiscal space assume that the non-achievement of MTO results in a convergence margin applying wherein a 0.6pp GDP adjustment to the structural balance is required.

Drawing on the Council’s stand-still expenditure estimate from the June 2016 *Fiscal Assessment Report*, allowing for increases in expenditure in line with projected inflation and demographic pressures would absorb the majority of the estimated fiscal space in the illustrative adverse scenario. This would mean the availability of very limited additional fiscal space after the cost of demographic pressures and maintaining the value of current public services in real terms out to 2021 is factored in.

²⁴ Challenges facing Irish exporters in diversifying to other export markets are evident from research applying gravity model approaches to Irish data (Lawless, 2010). Strong negative effects on exports are evident for geographical distance to markets, while a commonly shared language and well developed communications infrastructures are both factors found to be supportive of exports.

²⁵ The standard deviation of the change in Irish potential GDP growth over the period 1968 to 2014 is 0.8 per cent.

1.5 MEDIUM-TERM EXPENDITURE PLANNING AND CONTROL

As part of the new budgetary process, a welcome innovation is the publication of a *Mid-Year Expenditure Report* (see Department of Public Expenditure and Reform, 2016). This report sets out the medium-term Ministerial Expenditure Ceilings (MECs). The report follows the publication of fiscal space estimates in the *Summer Economic Statement* and the proposed allocation of that space between expenditure measures, revenue measures and allocations to the proposed rainy day fund.

In setting out the Ministerial Expenditure Ceilings, allowance is made in the Mid-Year Expenditure Report for demographic and unemployment developments and also for commitments under public-sector wage agreements. Beyond that, the report notes that “. . . holding non-pay expenditure broadly flat in nominal terms is the best option to support the achievement of efficiencies in non-pay expenditure” (p. 21). Thus no allowance is made for the cost of maintaining the real value of public services and benefits in an environment where prices are changing. The Council welcomes the statement in the Mid-Year Expenditure Report that work is underway to develop a framework for modelling government spending that goes beyond the current analysis of demographic drivers. The report states that the new methodology will “separately model the evolution of volume / demand and price impacts”. As the Council has argued in previous *Fiscal Assessment Reports*, realistic expenditure forecasts that take into account both volume and price effects are important to underpin effective expenditure planning and control.

Importantly, the medium-term MECs do not take into account a portion of the estimated net fiscal space that is targeted for expenditure increases. The use of the relevant fiscal space for the following year – but not for subsequent years in the medium-term planning horizon – is to be announced at budget time.

The Council is of the view that this approach to the setting of medium-term expenditure ceilings compromises medium-term expenditure planning and control. An inevitable implication is the continual revision of Ministerial Expenditure Ceilings as the horizon shortens. Good expenditure planning – especially where reforms involve upfront investments to yield later efficiencies – requires the best possible forecasts of the budgets that will be available. Moreover, where initial ceilings are set at unrealistic levels, it can be extremely hard to enforce hard budget constraints ex post. A negative feedback loop between unrealistic plans and poor expenditure control has been especially evident in the Health area in recent years (IFAC, 2015a). Unrealistic allocations are initially set out making longer-term reform initiatives difficult to plan, but the budget constraint is subsequently softened as expenditure pressures bite. With this cycle repeated, managers anticipate the soft budget constraint, undermining incentives for short-run expenditure control.

With the Government forced to soften the budget constraint they respond with even tighter ex ante expenditure allocations. The result can be a damaging combination of both poor planning and poor control with ad hoc annual adjustments – often within year adjustments – to expenditure ceilings.

The Council suggests an alternative broad approach that builds on the recent reforms to budgetary process:

Step 1. Estimate the available net fiscal space over the medium-term planning horizon and allocate a portion of this space to increases in the MECs.²⁶ Table 3 of the *SES* set out projections for expenditure that include the amount of fiscal space allocated to expenditure increases from 2017 to 2021. However, the medium-term MECs in the *Mid-Year Expenditure Report* do not incorporate the fiscal space allocated to expenditure increases in the *SES*.

Step 2. Estimate the portion of this space that would be required to continue to deliver the current level of public services and maintain the purchasing power of social protection benefits. This is the basis of the Council's stand-still spending estimate as reported in the June 2016 *Fiscal Assessment Report*. This would inform planners of the scope for new initiatives absent efficiency gains or cuts to real benefits. There is no suggestion here that automatic indexation should be followed; however, an expenditure forecast that estimates the cost of maintaining the current level of real public services and benefits should be an important input into expenditure planning.

Step 3. Set realistic MECs that reflect policy priorities while putting in place reasonable buffers that take account of the uncertainty related to the fiscal space estimates given the annual updating of the Expenditure Benchmark.

Step 4. Incentivise good expenditure planning and control through a strong accountability framework for senior managers with clearly specified consequences for failing to meet agreed performance targets within budget. (Such an accountability framework has recently been initiated for senior managers in the HSE.)

Implementing a reformed approach to expenditure management along these lines is a more demanding task than current practice and aspects of the suggested approach, for example how the

²⁶ The MECs in the Mid-Year Expenditure Report make provision for demographic pressures in Health, Education and Social Protection and the Lansdowne Road Agreement. Net fiscal space is the amount available for expenditure increases and tax cuts after these pre-committed expenditure increases have been allowed for.

buffers in Step 3 would ideally be set and operate, require further analysis. The Council plans to publish an *Analytical Note* in the coming months that will describe in more detail how the proposed approach outlined here could be implemented.

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