1. Assessment of the Fiscal Stance

Key Messages

- Signals from a range of data sources point to solid growth in the economy this year, although there is evidence that the pace of growth may have slowed. Following strong growth in 2014 and 2015, along with falling unemployment, the Irish economy appears to be operating close to capacity in 2016. Ireland's level of debt remains elevated following the crisis and reducing it to safer levels must remain a key policy priority. This would help protect the public finances from numerous risks from Brexit and other internal and external sources.

- Across several measures, there is evidence of only marginal improvement in the public finances in 2016. The General Government deficit (excluding some financial sector measures) is projected to fall by just 0.1 percentage point of GDP. *Budget 2017* projects a 0.3 percentage point improvement in the estimated structural budget deficit in 2016, short of the 0.6 required under the fiscal rules. Excluding a technical one-off transaction involving AIB in 2015, the Expenditure Benchmark rule would also not be complied with in 2016. The failure to fully comply with the new budgetary framework is a source of concern, coming in the first year following the successful exit from the Excessive Deficit Procedure (EDP).

- The €3 billion package of new tax and expenditure measures for both 2016 and 2017, which has been announced over the course of 2016 to date, goes beyond the limit considered prudent by the Council. A smaller package in line with the *SES* plan would have been more appropriate given the need to eliminate the deficit and reduce the debt to safer levels. A repeat of the type of poor budgetary management evident in 2015 and 2016 over several years would not be conducive to prudent economic and budgetary management. The Government's projections indicate a breach of the Expenditure Benchmark rule in 2017. In 2018, the carry-over cost of measures introduced in *Budget 2017* is €650 million. This will absorb over half of the estimated fiscal space for 2018. This implies limited resources for new tax and spending initiatives without offsetting savings or new revenue raising measures.

- There has been an improvement in the medium-term budgetary forecasts presented by the Department of Finance. The projections for revenue, expenditure and the overall debt and deficit now include the use of the estimated fiscal space over the medium term. However, there are serious on-going problems with expenditure planning and management as the expenditure ceilings are not being implemented effectively. The persistent upward revisions to the ceilings represents a continuation of short-term year-to-year budgeting.

1.1 Introduction

The Fiscal Council has a mandate under the *Fiscal Responsibility Act 2012* to assess the Government's fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. The sections below draw on the analysis in later chapters in assessing the fiscal stance outlined in *Budget 2017*. The Council's assessment is informed by the extent of compliance with the fiscal rules along with a complementary economic assessment that takes into account the state of the public finances, the stage of the economic cycle and the growth prospects for the economy. Section 1.2 reviews the current cyclical position of the economy along with recent developments in the public finances. Section 1.3 reviews the short-run fiscal stance in 2016 and 2017 as set out in *Budget 2017,* while issues relating to the medium-term fiscal stance are discussed in Section 1.4.

1.2 The Macroeconomic and Fiscal Context for *Budget 2017*

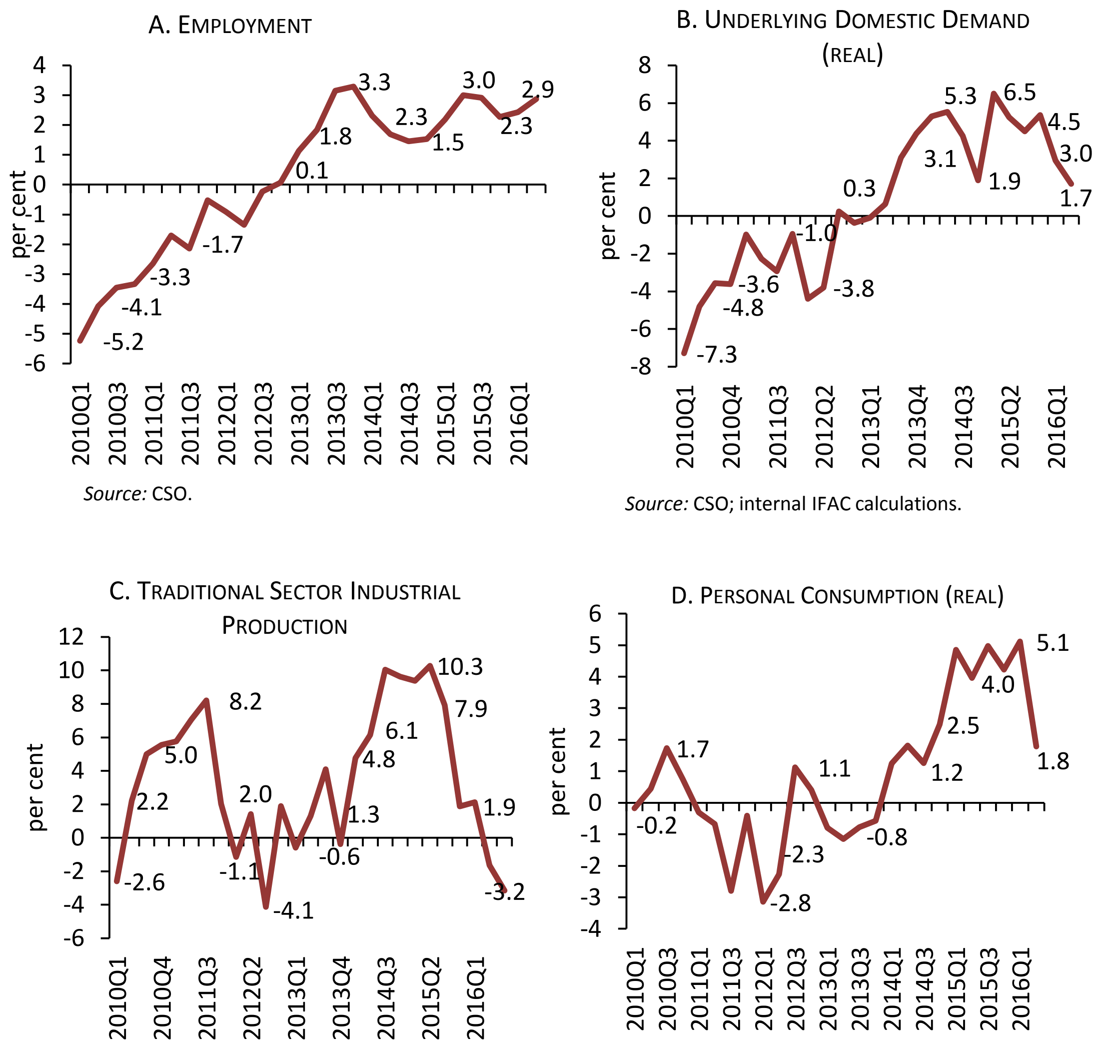
Table 1.1: Summary of Main Fiscal Aggregates in *Budget 2017* (General Government Basis)

% of GDP unless otherwise stated	2015	2016	2017	2018	2019	2020	2021
General Government Balance	-1.9	-0.9	-0.4	-0.3	0.2	0.7	1.1
General Government Balance (excluding financial sector measures)*	-1.0	-0.9	-0.4	-0.3	0.2	0.7	1.1
Interest expenditure	2.6	2.4	2.2	2.1	1.9	1.7	1.5
Primary Balance	0.7	1.4	1.8	1.8	2.1	2.4	2.6
Primary Balance (excluding financial sector measures)*	1.6	1.4	1.8	1.8	2.1	2.4	2.6
GDP growth (real annual % change)	26.3	4.2	3.5	3.8	3.6	3.0	2.8
Potential Output (% change, CAM-based)	24.6	4.0	4.2	4.5	3.7	3.2	3.0
Output Gap (CAM-based), % of potential GDP	1.6	1.8	1.1	0.5	0.3	0.2	0.0
Structural balance (CAM-based), % of potential GDP	-2.2	-1.9	-1.1	-0.5	0.0	0.6	1.1
*Change in Structural Balance***	*1.9*	*0.3*	*0.8*	*0.6*	*0.5*	*0.6*	*0.5*
Structural Primary Balance (CAM-based)	0.4	0.5	1.1	1.5	1.9	2.3	2.6
Change in Structural Primary Balance (p.p.)	*0.7*	*0.0*	*0.6*	*0.4*	*0.4*	*0.4*	*0.4*
General Government Debt	78.6	76.0	74.3	72.7	70.2	65.8	63.0

Source: Department of Finance (*Budget 2017*).
Notes: * The General Government balance and primary balance exclude the impact of some financial sector measures in 2015. In late 2015, the Government redeemed and converted its remaining preference shares in AIB to ordinary shares. The conversion of these preference shares is classified as an expenditure of government that increases the deficit in 2015.
**One-off factors are removed in calculating the change in the structural balance for the purposes of assessing compliance with the fiscal rules. For 2015, the Department of Finance estimates that one-off factors relevant for calculating the change in the structural balance amount to 0.5 per cent of GDP. Rounding may affect totals.

As discussed in the Council's September 2016 *Pre-Budget Statement* (IFAC, 2016b) and by the ESRI, Department of Finance and others, deciphering the pattern of growth in the Irish economy is difficult due to the distortions affecting Ireland's National Accounts data. This creates 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. Alternative presentations of existing data and/or the publication of new data by the CSO may help overcome some of the current difficulties in assessing the state of the economy. In the meantime, careful examination of a range of data sources must be used to help identify trends in domestic economic activity.

FIGURE 1.1: INDICATORS OF ECONOMIC ACTIVITY, YEAR-ON-YEAR PERCENTAGE CHANGE



Source: CSO. *Source:* CSO; internal IFAC calculations. *Source:* CSO; internal IFAC calculations. *Source:* CSO.

Figure 1.1 above shows a number of indicators of economic activity. Employment is a reliable indicator of economic developments currently and the latest QNHS data point to continued strong growth in the number at work in 2016 (Figure 1.1A). In the first half of 2016, employment has increased by 2.7 per cent, similar to the growth recorded in 2015. Other indicators suggest some slowdown in the pace of economic activity as 2016 has progressed. The year-on-year growth in underlying domestic demand is shown in Figure 1.1B. In 2015 this grew by 5.4 per cent following growth of 4.2 per in 2014. Led by consumption and building and construction domestic demand has continued to grow in 2016, but at a more moderate pace than in the previous two years. For the first half of 2016, underlying domestic demand is 2.3 per cent higher than for the same period in 2015.

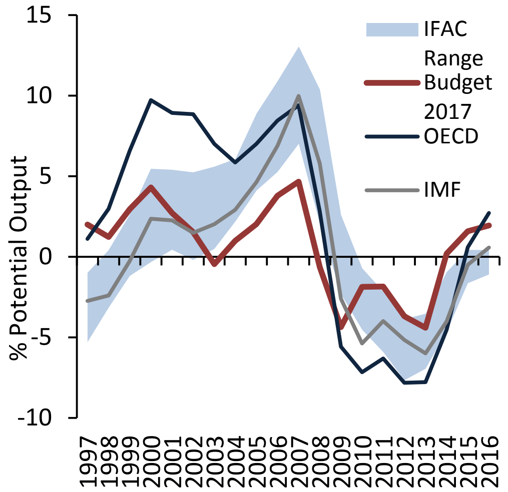
Figure 1.1C shows annual growth in output of the traditional sector (as defined by the CSO) which has slowed sharply since mid-2015, turning negative in the second quarter of this year. The UK is an important destination for the exports of this sector and the recent weakening in activity has coincided with the depreciation of Sterling against the Euro in 2016. This sector includes industries such as agriculture and food, which are particularly employment intensive. As the recent poor performance may partially reflect the impact of the UK vote to leave the EU, and given the continued weakness of Sterling against the Euro, it will be important to monitor whether the recent decline in output in the traditional sector persists over the coming months. Evidence of a loss in growth momentum can be seen in Figure 1.1D, which shows annual growth in real personal consumption expenditure. In 2015 consumption grew by 4.5 per cent, but annual growth has slowed to 3.5 per cent on average in the first half of 2016.[1]

Overall, while the data shown in Figure 1.1 present a somewhat mixed picture, the evidence suggests that the economy continues to grow in 2016 but with some signs of weakness as the year has progressed. The Council will continue to closely monitor the incoming data in the coming months for any signs of a more pronounced slowdown.

In assessing the fiscal stance, it is necessary to consider the implications of the recent economic growth for the estimated size of the economy's output gap. The output gap is defined as the difference between actual and potential GDP, expressed as a share of potential GDP. Estimates of the output gap are subject to much uncertainty as they require knowledge of the economy's potential growth rate, which is unobservable and must be estimated. The openness of the Irish labour market and the importance of migration mean that estimates of the output gap for Ireland are subject to particular uncertainty.

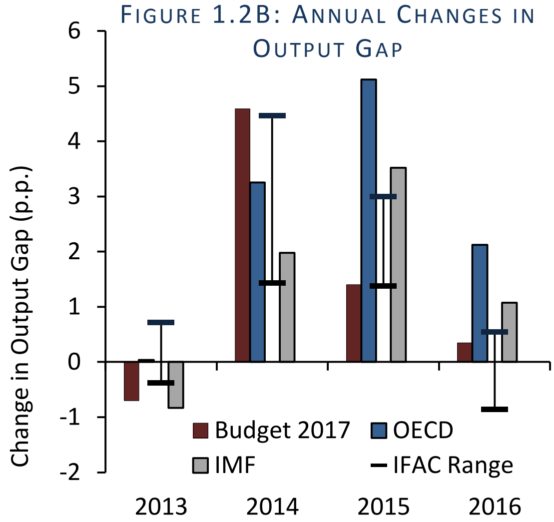
[1] Services consumption, as measures in the Quarterly National Accounts, has been weak in the first half of 2016 and is acting as a drag on overall consumption growth. As discussed in Chapter 2, the quarterly data for services consumption are prone to revision and should be interpreted with caution.

FIGURE 1.2A: OUTPUT GAP



Sources: Department of Finance, *Budget 2017;* IMF *WEO* (October 2016)*;* OECD *EO* (June 2016); internal IFAC calculations.

FIGURE 1.2B: ANNUAL CHANGES IN OUTPUT GAP



Sources: Department of Finance, *Budget 2017;* IMF *WEO* (October 2016)*;* OECD *EO* (June 2016); internal IFAC calculations.

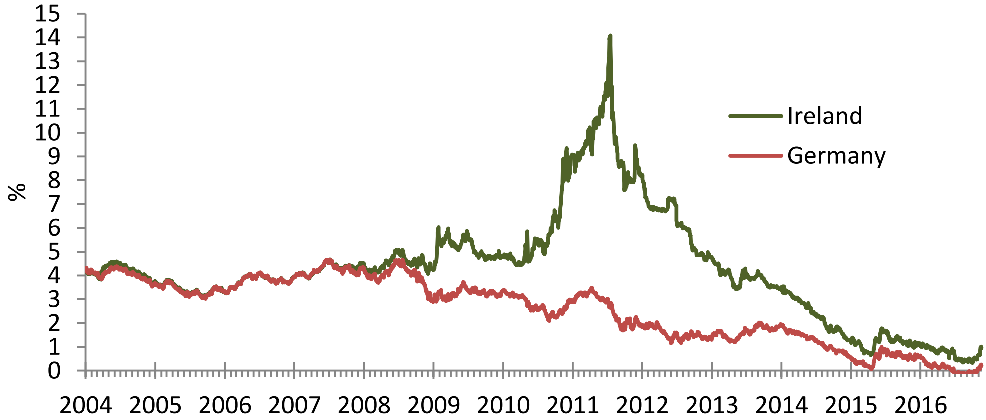
As illustrated in Figure 1.2A, a range of estimates indicate that a large negative output gap opened up from 2008 as the actual level of output in the economy fell well below what could be sustainably produced if all resources in the economy – human and capital – were fully utilised. Since 2013, the size of this negative output gap has reduced gradually due to the pick-up in economic growth (Figure 1.2B). Official estimates of the output gap based on the EU Commonly Agreed Methodology indicate a positive output gap of close to 2 per cent in 2016. This appears to overstate the size of any positive output gap and is inconsistent with other indicators of imbalances in the economy, such as the unemployment rate (see Chapter 2 and Appendix C). Other estimates from the IMF and based on models used by the Council, which exclude the activities of multinational enterprises so as to focus on the domestic economy, suggest that a small negative output gap may still exist in 2016, although it is closing quickly as shown in Figure 1.2A and Figure 1.2B.

Taken together, while economic growth in 2016 is likely to be slower than in recent years, it follows very robust growth in 2014 and 2015. As a result, by the end of 2016 there is unlikely to be a significant demand shortfall in the Irish economy. In these circumstances, from a demand-management perspective, a stimulus from fiscal policy is not needed at this time.

The overall position of the public finances and the sustainability of the debt is a second important consideration in determining the appropriate fiscal stance. It is important to recognise that Ireland's debt sustainability position has improved considerably since 2010 due to a number of favourable developments. Reflecting Ireland's adherence to a credible fiscal adjustment programme as well as initiatives at a European level, such as the ECB's Outright Monetary

Transactions (OMT) and Public Sector Purchase programmes, the cost of borrowing for the State has fallen dramatically (Figure 1.3). This is reflected by the fact that although Ireland's stock of debt is almost five times larger than before the crisis, the State's cost of borrowing is at a historic low. This low interest rate environment has allowed the NTMA to finance new and maturing Irish debt at comparatively favourable rates.

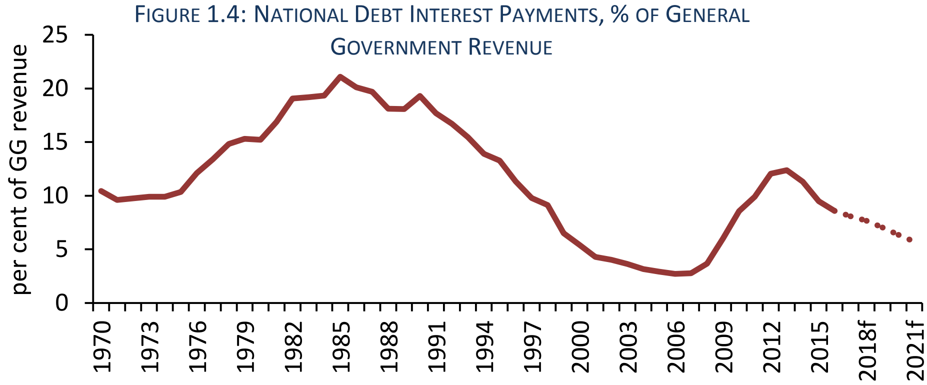
FIGURE 1.3: TEN-YEAR GOVERNMENT BOND YIELDS



Sources: Bloomberg, Datastream and internal IFAC calculations.
Notes: Ten-year Irish yields partly interpolated in 2011-2013.

Figure 1.4 shows national debt interest payments as a share of General Government revenue. Although the interest burden on Irish debt is lower now than during the fiscal crisis in the 1980s (Figure 1.4), it is still significant with interest costs amounting to just under one-tenth of government revenue in 2016. In addition, while the current low interest rates make the cost of servicing the government debt more manageable, Ireland's overall debt sustainability position remains fragile and vulnerable to numerous potential downside risks (see Chapter 3, Section 3.4). Interest rates are unlikely to remain at their current exceptionally low levels over the longer term and rates can be expected to eventually increase, even though there is uncertainty over when this will occur.

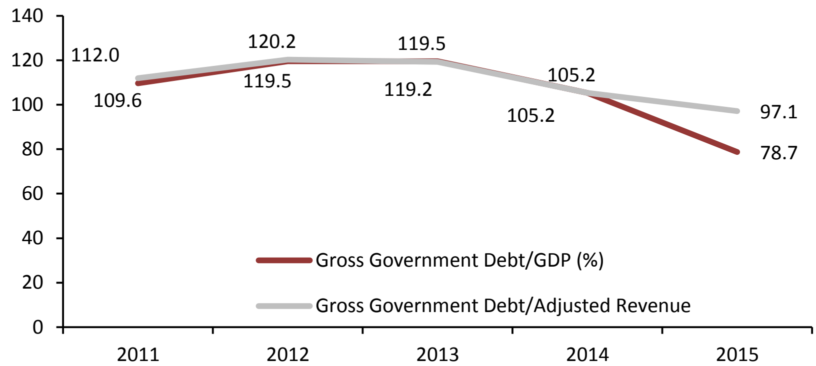
Figure 1.4: National Debt Interest Payments, % of General Government Revenue



Sources: CSO, *Budget 2017.*
Notes: Data from 2016-2021 (dotted line) are forecasts from *Budget 2017.*

Ireland's overall stock of government debt remains at an elevated level following the crisis. The well-known problems with Ireland's GDP figures mean that the debt ratios expressed as a share of GDP or GNP give a seriously distorted picture of the fiscal position. Until a better estimate of the size of the economy is published, as an interim response, the Council has found it useful to focus directly on fiscal ratios expressed as a share of General Government revenue. As discussed in the Council's September 2016 *Pre-Budget Statement,* this approach is not unproblematic as the ratio captures actual revenue (including the recent buoyant corporation tax receipts) rather than the potential revenue base. However, the ratios based on government revenue give a more informative picture of the fiscal position than those based on the distorted GDP data.

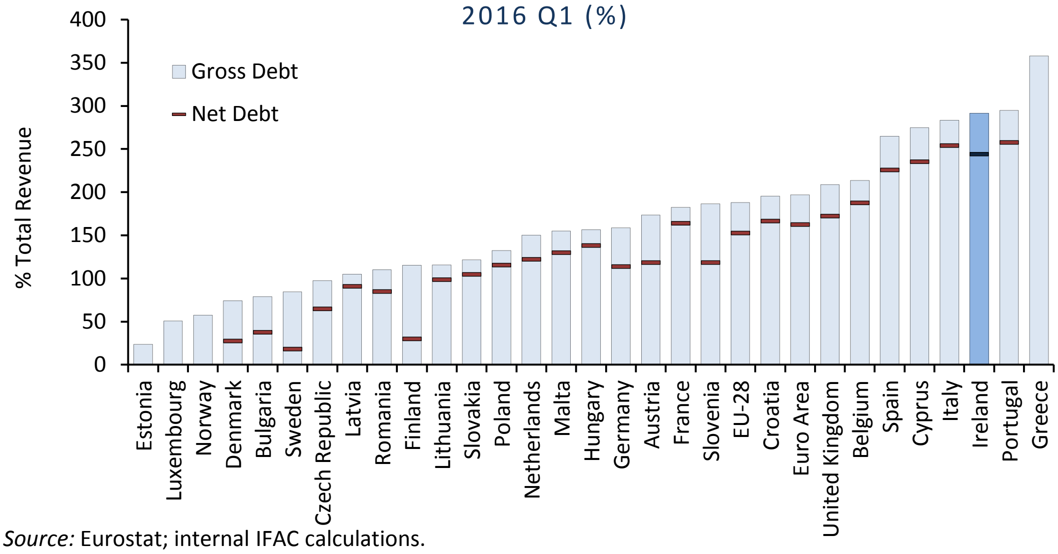
Figure 1.5: General Government Gross Debt to Scaled Revenue Base



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.

As the revenue-to-GDP ratio was reasonably constant at 33-34 per cent between 2011 and 2014, the revenue-based debt ratio can be adjusted to make it more comparable to standard GDP ratios based on the revenue share in 2014.[2] Figure 1.5 shows the adjusted 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.[3] Thus the adjusted data point to a continuing reduction in the State's debt burden, although the overall level of debt remains high. An international comparison of gross and net debt-to-government revenue is shown in Figure 1.6. As of Q1 2016, Ireland's gross debt ratio based on this measure was the third highest in the EU.

FIGURE 1.6: GENERAL GOVERNMENT DEBT-TO-REVENUE RATIOS, 2016 Q1 (%)



Source: Eurostat; internal IFAC calculations.
Note: Net debt from Eurostat Government Finance Statistics calculated as Gross Consolidated Debt less EDP debt instrument assets (F2: Currency and Deposits; F3: Debt securities; and F4: Loan assets). Total General Government Revenue = 4 quarter sum.

Ireland's elevated debt level means that the public finances are more exposed to an adverse shock that could trigger debt sustainability concerns and threaten the State's access to market funding at affordable rates. As discussed further in Chapter 2 and Chapter 3, while the central projections for the economy contained in *Budget 2017* are positive, numerous risks surround the outlook for Irish growth, including those related to Brexit and the concentrated nature of production in the Irish economy. If one or more of these risks were to materialise, the economy could be derailed from the current favourable growth trajectory with lower GDP growth and higher unemployment than

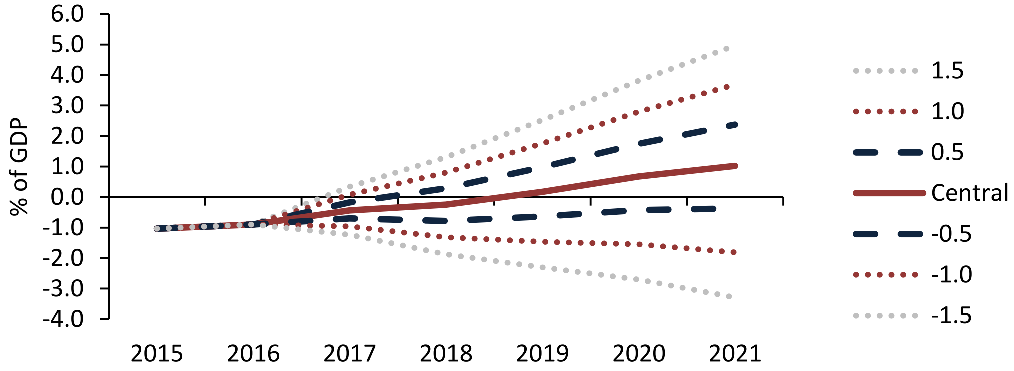
[2] The ratio of GDP to General Government revenue in 2014 was 2.94. The adjusted revenue base is calculated by multiplying actual General Government revenue by this ratio in each year. The nominal deficit and debt are then divided by this scaled revenue base to arrive at the adjusted debt and deficit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

[3] 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 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 nominal 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.

forecast in *Budget 2017*. A weaker growth performance than currently projected would result in a higher deficit and debt ratio (either debt-to-GDP or debt-to-revenue) and there is a risk that the debt ratio could start rising again.

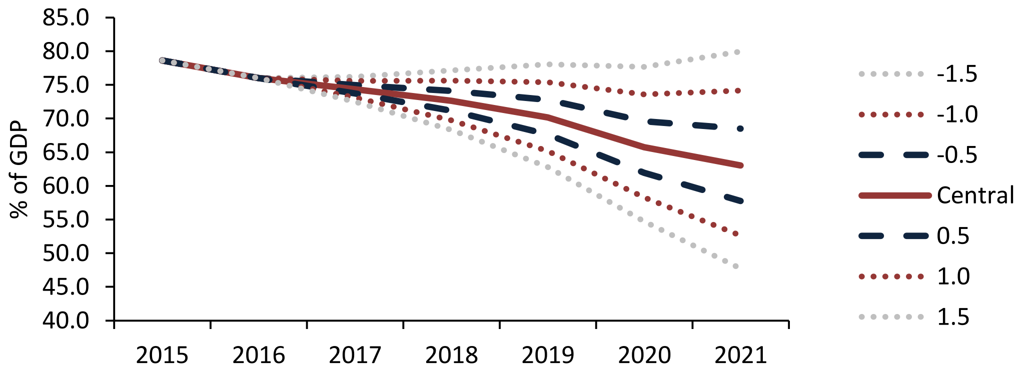
As shown in Figure 1.7 and Figure 1.8, a negative shock which lowered GDP growth by 1.5 percentage points below the *Budget 2017* baseline each year would result in the deficit being over 4 percentage points of GDP higher by 2021. All else being equal, this means that the public finances would remain in deficit out to 2021, compared to *Budget 2017* forecast of a 1.1 per cent budget surplus. The debt-to-GDP ratio would stagnate at its current high level before rising by the end of the decade, in the absence of corrective policy action. A shock of this magnitude would not be exceptional given the historic volatility of Irish GDP growth.

FIGURE 1.7: GENERAL GOVERNMENT BALANCE PATHS



Source: Internal IFAC calculations using Fiscal Feedbacks Model.
Note: Lines depict how far the deficit would be pushed away from the *Budget 2017* forecast for the General Government balance under different shocks to growth in each year. The solid red line ("Central") corresponds to the forecast from *Budget 2017.* The scenarios assume no change to the fiscal policy stance as set out in *Budget 2017.*

FIGURE 1.8: GENERAL GOVERNMENT DEBT PATHS



Source: Internal IFAC calculations using Fiscal Feedbacks Model.
Note: Lines depict how far the debt would be pushed away from the *Budget 2017* forecast for the General Government debt under different shocks to growth in each year. The solid red line ("Central") corresponds to the forecast from *Budget 2017.* The scenarios in the chart assume no change to the fiscal policy stance as set out in *Budget 2017.*

As discussed further in Chapter 2, output in the Irish economy is highly concentrated in a small number of sectors such as IT and pharmaceuticals. This leaves the economy and the public finances particularly exposed as an idiosyncratic shock impacting one of these sectors has the potential to significantly reduce growth in the Irish economy. The concentration of output in these highly globalised sectors means there is large uncertainty around forecasts for growth in the Irish economy. This provides another reason for exercising caution in framing budgetary policy.

To sum up, a cross-check of the analysis of the current cyclical position of the economy with the debt sustainability considerations confirms the need to prioritise reducing Ireland's high debt to safer levels over using an expansionary fiscal stance to stimulate an economy with solid growth and falling unemployment.

1.3 Assessment of the Fiscal Stance in 2016 and 2017

The Council's assessment of the fiscal stance in *Budget 2017* covers the years 2016 and 2017. The package of measures announced in *Budget 2017* on Tuesday, 11 October contained a number of changes compared with the Government's earlier plans as published in the April 2016 *Stability Programme Update (SPU)* and the July 2016 *Summer Economic Statement (SES)* and *Mid-Year Expenditure Report.* For 2016, additional current and capital spending of €0.3 billion was announced compared to estimates in the *Mid-Year Expenditure Report.* This followed the €0.5 billion increase in spending for the Health and Justice areas announced in June. For 2017, the Budget contained an overall package of tax reductions and expenditure increases amounting to €1.3 billion. As shown in Table 1.2, when the previously announced spending increases for 2016 and 2017 are added in, this gives a total package of fiscal measures of €3 billion. As discussed in Chapter 3, the expenditure and tax measures introduced in *Budget 2017* have a full-year carryover cost of just under €0.7 billion. Adding in the full-year cost of the *Budget 2017* measures increases the overall cost of the package to €3.7 billion.

TABLE 1.2: DISCRETIONARY MEASURES IMPACTING THE FISCAL STANCE IN 2016 AND 2017

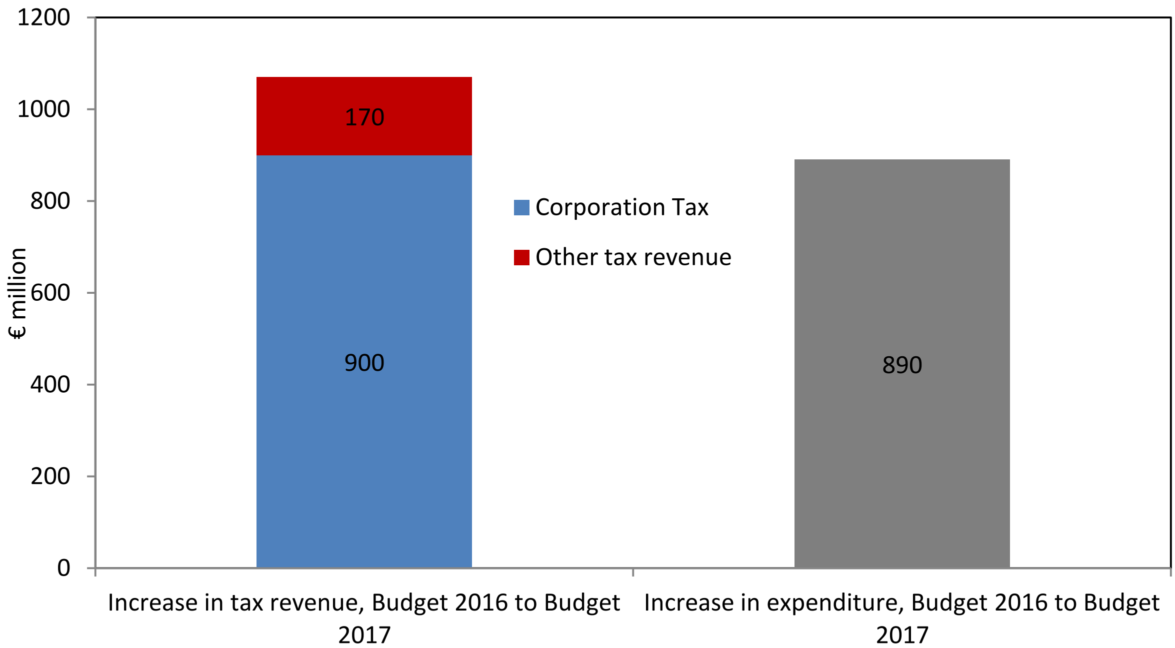
Measure	Date and Publication	Details	Amount (€bn)
Pre-Committed Expenditure for 2017	April 2016, *SPU 2016*	Before any changes in *Budget 2017,* gross voted current and capital spending is projected to increase by around €0.9 billion in 2017. This pre-committed spending includes provisions for demographic pressures (€0.4 billion), the Lansdowne Road Agreement (€0.3 billion), the Public Capital Programme (€0.2 billion) and certain other policies.	0.9
Additional Voted Spending for 2016	June 2016, *SES*	April's *Stability Programme Update* 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
Additional spending for 2016	October 2016, *Budget 2017*	An additional €300 million in expenditure for 2016 was announced in *Budget 2017,* on top of the €0.5 billion announced in June 2016. €200 million of the additional expenditure was allocated to capital with current spending increased by €100 million. The additional current spending is to cover part of the cost of the payment of the Christmas bonus in 2016.	0.3
New measures announced in *Budget 2017*	October 2016, *Budget 2017*	*Budget 2017* contained a package of measures for 2017 of €1.3 billion, comprising tax reductions of €0.3 billion and expenditure increases of €1 billion (€0.8 billion in current and €0.2 billion in capital).	1.3
Total (new measures in 2016 and 2017)			**3.0**
Full-year cost of *Budget 2017* measures in 2018	October 2016, *Expenditure Report 2017* and *Budget 2017*	According to the *Expenditure Report 2017* (Table 9, page 36), spending measures for 2017 introduced in *Budget 2017* have a full-year carryover cost of just under €0.5 billion in 2018. In addition, the carryover cost of the tax cuts in *Budget 2017* is approximately €0.2 billion in 2018. The total full-year cost (€0.7 billion) will have to be met from the available net fiscal space in 2018, currently estimated at €1.2 billion.	0.7
Total			**3.7**

Sources: Department of Finance and Department of Public Expenditure and Reform *Summer Economic Statement* (2016), *Stability Programme Update* (2016) and *Budget 2017.*
Notes: Data are on an Exchequer basis. Rounding may affect totals.

In June 2016, the Government revised up its forecast of tax revenue for 2016 by €1 billion compared to its *Budget 2016* forecast, and the Department of Finance maintained this June forecast in *Budget 2017*. If this additional revenue materialises as forecast by the Department of Finance, it will not contribute to a significant reduction in the deficit as additional spending increases for 2016 detailed in Table 2 will absorb the majority of the additional tax revenue (Figure 1.9). This repeats what occurred in 2015 when the Government announced a €1.5 billion increase in spending for 2015, in line with an upward revision to corporation tax of close to the same amount.

Using unexpected revenues to fund increases in expenditure goes against the spirit of the new budgetary framework and is reminiscent of past fiscal policy errors made in Ireland. The use of positive revenue surprises to fund permanent spending increases carries particular risks when the revenue surprise is largely due to a single, and relatively uncertain, revenue stream – in this case corporation tax. Instead of using the additional corporation tax revenue for permanent expenditure, a more appropriate policy would have been to use this revenue to reduce the deficit. As the sustainability of recent corporation tax increases has yet to be verified, this would have left the public finances less exposed in the event of a reversal in corporation tax receipts in the coming years. Based on the Council's Fiscal Feedbacks Model, had all of the unexpected CT revenue in 2015 and 2016 been used for deficit reduction, the budget would have been close to balance in 2016 and the government accounts would move into surplus in 2017, two years earlier than projected by the Government in *Budget 2017.*

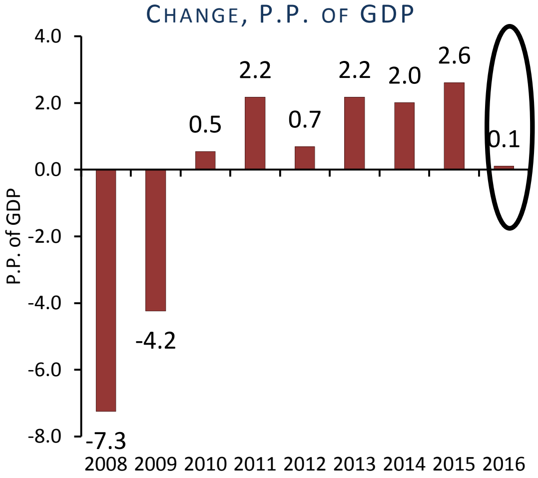
FIGURE 1.9: REVISIONS TO EXCHEQUER EXPENDITURE AND TAX REVENUE FOR 2016



Source: Department of Finance and internal IFAC calculations.
Note: The increase in expenditure between *Budget 2016 and Budget 2017* (right-hand column) refers to total gross voted current and capital expenditure on an Exchequer basis. Tax revenue (left-hand column) is the sum of Exchequer tax revenue plus PRSI.

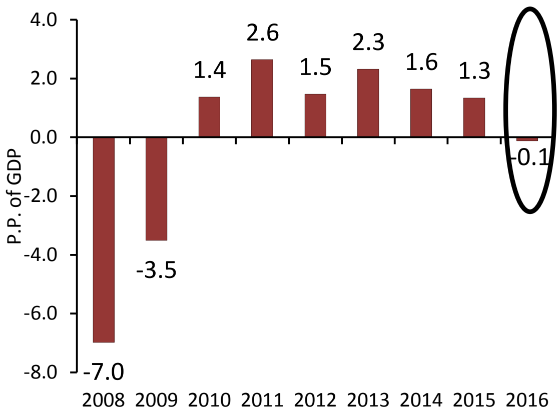
Looking at 2016 more broadly, the *Budget 2017* projections show that progress in reducing the deficit in 2016 is likely to stall despite strong economic growth and savings from falling unemployment and debt interest costs. Figure 1.10A and Figure 1.10B show the estimated change in the General Government balance and primary balance respectively, excluding some financial sector measures.[4] The improvement in the General Government balance is projected to be just 0.1 percentage points of GDP in 2016. This improvement is aided by a fall in national debt interest payments. The primary balance, the General Government balance excluding debt interest payments, deteriorates by 0.1 percentage points of GDP in 2016, the first worsening since 2009. This results in an unwinding of some of the improvements made between 2013 and 2015 and reduces the level of the overall primary surplus to 1.4 per cent in 2016. Given the relatively favourable economic conditions in 2016, this marks a missed opportunity to continue to move the budget towards balance.

FIGURE 1.10A: GENERAL GOVERNMENT BALANCE, ANNUAL CHANGE, P.P. OF GDP



Source: Department of Finance; internal IFAC calculations.
Note: The General Government balance excludes the impact of financial sector measures.

FIGURE 1.10B: GENERAL GOVERNMENT PRIMARY BALANCE, ANNUAL CHANGE, P.P. OF GDP



*Source:*Department of Finance; internal IFAC calculations.
Note: The General Government primary balance excludes the impact of financial sector measures.

The fiscal stance in the *Fiscal Responsibility Act (FRA)* 2012 is defined in terms of the change in the structural primary balance. The structural primary balance is an appropriate measure of the fiscal stance as it provides an estimate of the budget surplus or deficit adjusting for the cyclical position of the economy. While there is uncertainty around the level of the structural primary deficit or surplus at a point in time, estimates of the change in this measure provides a more robust indicator of changes in the fiscal position. Consistent with the signals from the overall General Government balance and primary balance measures, the projections in *Budget 2017* indicate no improvement in the structural primary balance in 2016 (Table 1.1).

As discussed in Chapter 4, the Preventive Arm of the *SGP* applies to Ireland from 2016. Under the Preventive Arm, the Government is required to ensure that the budgetary position is at, or moving

[4] The General Government balance and primary balance data in Figure 1.10A and Figure 1.10B are adjusted for the impact of financial sector measures such as the AIB preference share transaction in 2015.

at a sufficient pace towards, the Medium-Term Budgetary Objective (MTO). Ireland's MTO is for a General Government deficit of 0.5 per cent of GDP in structural terms.

Based on estimates of the structural deficit using the EU Commonly Agreed Methodology (CAM), Ireland is currently not meeting its MTO of a budget deficit of 0.5 per cent of GDP in structural terms. The structural deficit refers to that part of the deficit which will not be eroded by the cyclical upswing in economic growth. The forecasts in *Budget 2017* indicate that the MTO will be reached in 2018. Until then, the country must meet a required minimum adjustment path to the MTO in terms of an annual reduction in the structural deficit which for 2016 has been set at 0.6 percentage points of GDP.[5] To support this requirement, the Preventive Arm of the *SGP* 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.[6]

Compliance with the fiscal rules is consistent with reducing the budget deficit and gradually lowering the debt to safer levels. Strong adherence to the framework can help avoid a repeat of past mistakes when fiscal policy was strongly pro-cyclical. To avoid undermining the integrity of the new framework, the Council is strongly of the view that the plan outlined in the budget should be consistent with meeting all of the rules in 2016 and later years.

In this context, the Council is concerned by planned breaches in the fiscal rules in both 2016 and 2017 signalled in *Budget 2017*. As discussed in detail in Chapter 4, the expected improvement in the structural balance in 2016 of 0.3 percentage points of GDP falls short of the 0.6 percentage point of GDP improvement required. The Expenditure Benchmark is complied with in 2016 but only with the inclusion of a technical one-off transaction involving AIB in 2015. This transaction is explicitly treated as a one-off for the purpose of calculating compliance with the structural balance pillar but an anomaly in the fiscal rules means that the same transaction is not deemed a one-off in assessing compliance with the Expenditure Benchmark. Excluding the AIB transaction, the spending limit set by the Expenditure Benchmark would also be exceeded in 2016. As 2016 is the first year the *SGP* Preventive Arm and domestic Budgetary Rules apply following the closing of the Excessive Deficit Procedure, the failure to fully comply with all rules is a source of concern.

[5] 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. As discussed in Chapter 4, the current projected deviation from the required structural balance adjustment in 2016 would not be considered "significant" under the rules.

[6] For countries not at their MTO, a convergence margin is applied when setting the EB to ensure that expenditure growth is kept in line with the required change in the structural balance.

Potential compliance issues are also signalled in the Government's projections for 2017. The *Budget 2017* forecasts show compliance with structural balance rule; however, the forecasts indicate a breach of the Expenditure Benchmark.

It is important for the credibility of the budgetary process that the Government's fiscal plans show full compliance with the domestic and EU fiscal rules based on the Department of Finance's own estimates of the structural improvement. The Council's *ex post* assessment of the fiscal stance will take into account whether the Government has met both the structural balance and Expenditure Benchmark requirements. In a scenario where the Government complies with one rule (for example, the structural balance rule) but shows limited compliance or fails to comply with another (for example, the Expenditure Benchmark), the Council will examine the particular reasons causing the differing signals as well as the amount of structural fiscal effort undertaken by the Government.[7] In circumstances where the Government set out in advance a plan which envisages non-compliance with one of the two rules, this could make it difficult to demonstrate *ex post* that sufficient fiscal effort had been undertaken to merit an overall conclusion of compliance.

The Council has a responsibility under the *Fiscal Responsibility Act (2012)* to assess whether "...the fiscal stance for the year or years concerned is....conducive to prudent economic and budgetary management" [*FRA* 8(4)(b)]. This assessment covers both 2016 and 2017. As stated in the Council's *Pre-Budget Statement*, the strong pace of economic growth in 2016 which is projected to continue in 2017, along with falling unemployment, meant that there was a limited economic case for a larger budgetary package than was planned by the Government in its July *SES*. Moreover, the debt level remains high leaving the economy more vulnerable to numerous domestic and external risks.

Despite these considerations, the Government went beyond the plan outlined in the *SES* with additional expenditure in 2016 and 2017 bringing the overall package of tax cuts and expenditure increases to €3 billion. The additional expenditure in 2016 – two upward revisions to spending within the same year – means there is almost no improvement in the deficit in 2016 when the one-off AIB transaction in 2015 is excluded. Using better than expected incoming revenues to increase spending within the same year goes against the spirit of the rules and has echoes of the poor fiscal management evident in Ireland prior to the crisis. Funding permanent spending increases from volatile and potentially reversible corporation tax receipts could undermine the sustainability of the public finances. In addition, the Department of Finance forecasts show expected non-

[7] This is in line with the approach under the Preventive Arm whereby, in the event of conflicting signals from the structural balance and Expenditure Benchmark rules, an "overall assessment" is carried out. This assessment examines the reasons for non-compliance as well as the amount of structural effort undertaken by the Government.

compliance with the structural balance rule in 2016 and the EB would also not be complied with in 2016 except for the inclusion in the 2015 expenditure base of a technical AIB transaction.

Putting these different elements together, the combined €3 billion package of tax reductions and expenditure increases for 2016 and 2017 goes beyond the limit considered prudent by the Council. Compared to the plan outlined in the July 2016 *SES*, the fiscal stance in *Budget 2017* leaves the public finances more exposed to risks than would have been the case if earlier plans had been adhered to. In 2016, unexpected corporation tax revenue was again used to fund within-year increases in expenditure, a recurrence of the actions seen in 2015. Viewed in isolation, the deviation from what could be considered a prudent stance in *Budget 2017* is not large but a repeat of the type of poor budgetary management evident in 2015 and 2016 over several years would not be conducive to prudent economic and budgetary management. As the current projections for 2017 already imply a breach of the Expenditure Benchmark in 2017, the scope for any further slippage is limited.

From 2017 onwards, the Government's projected fiscal stance and intention to comply with the EU fiscal rules is consistent with the deficit and debt remaining on a downward path. Provided the economy is growing at a sustainable rate, the use of the available fiscal space as envisaged in the current forecasts would be consistent with prudent policy. As discussed in Chapter 3, the growth in government spending (excluding interest expenditure) in nominal terms is expected to average around 3 per cent per annum from 2018-2021, which is below the estimated nominal potential growth rate of the economy.

1.4 The Medium-Term Fiscal Stance

1.4.1 Medium-Term Expenditure Planning and Management

A recurring theme in the Council's *Fiscal Assessment Reports* has been the need to improve the quality of the medium-term projections for the public finances presented in the budget and Stability Programme Update. It is important to recognise that some progress has been made in improving the quality of the medium-term budgetary forecasts. In particular, in the *Summer Economic Statement 2016* and in *Budget 2017,* the Department of Finance published forecasts for overall revenue, expenditure, the deficit and the debt that include the planned use of the estimated fiscal space. These forecasts are more meaningful and realistic than the medium-term projections published previously which were purely technical and did not show the path of the public finances consistent with the Government's stated policy intention to use the available fiscal space. Box A describes recent changes to the budgetary process in Ireland and the presentation of budgetary data.

As noted previously by the Council, Article 9 of the Directive on Medium-Term Budgetary Frameworks (MTBF) requires that Member States provide forecasts for major items of expenditure based on unchanged policies and on the basis of policies envisaged. The publication of the *ex post* forecasts in the *SES* and *Budget 2017* go some way towards meeting this latter requirement. The fiscal forecasts in *Budget 2017* improve on the previous purely technical projections by showing the path of the main budgetary aggregates consistent with the Government's intended policy of following minimum compliance with the fiscal rules.

While there has been some progress, the Government's medium-term fiscal projections still fall short of fully meeting the requirements of the Directive.[8] By providing forecasts on the basis of both unchanged policies and on the basis of intended policies, this would facilitate an assessment of the long-term impact of envisaged policies on the sustainability of the public finances. An expenditure scenario which estimates the cost of maintaining the current level of public services and benefits in real terms in future years would be one useful input into the process of producing the type of expenditure forecasts envisaged under the Directive.

This is the idea behind the Council's stand-still scenario developed and published in recent reports. It is important to stress that this estimate is not intended as a forecast of future government expenditure but is instead designed to provide an estimate of the future path of spending allowing for demographic pressures and the cost of maintaining the real value of public services and benefits over the medium term. There is no suggestion from the Council that automatic indexation of future expenditure should be followed. The purpose of the stand-still expenditure estimate is not to recommend automatic indexation but rather to provide an illustrative estimate of the cost of maintaining the real value of public services and benefits in an environment where the Department of Finance is forecasting increases in inflation over the medium term, albeit at a modest rate.

[8] Article 9 of the Directive on Medium-Term Budgetary Frameworks (MTBF) states that Member States must adopt MTBFs that provide for a fiscal planning horizon of at least three years and that these multiannual frameworks should include the following: (a) comprehensive and transparent multiannual budgetary objectives in terms of the General Government deficit, debt and any other summary fiscal indicator such as expenditure, ensuring that these are consistent with any numerical fiscal rules as provided for in Chapter IV in force; (b) 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; (c) 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; (d) an assessment as to how in the light of their direct long-term impact on General Government finances, the policies envisaged are likely to affect the long-term sustainability of the public finances.

The Council's stand-still scenario is updated in Chapter 3 from the June 2016 *Fiscal Assessment Report.* On top of some pre-committed spending, the Government has allocated a total of €4.4 billion of the estimated net fiscal space from 2017 to 2021 to current expenditure increases. The analysis in Chapter 3 shows that accommodating estimated demographic pressures and the cost of maintaining real public services and benefits would absorb almost the full amount currently budgeted for current expenditure increases from 2017-2021. An estimate of the cost of standing still is an important input into good expenditure planning as it helps inform policymakers of the scope for new spending or tax initiatives, in the absence of efficiency gains or cuts to real benefits. Along with the approach developed by the Council, alternative methodologies could be used to estimate a stand-still scenario.

Related to this, it is worth noting that the overall amount of net fiscal space available for expenditure increases, tax reductions and the proposed Rainy Day Fund from 2018-2021 was revised down by €1 billion in *Budget 2017* compared to *SES 2016* published in June (see Box F in Chapter 4 for a discussion of the concept of fiscal space as used by the Department of Finance). The downward revision to the estimated net fiscal space was mainly caused by lower forecasts for the economy's potential growth rate over the medium term in *Budget 2017*. Despite the reduction in overall net fiscal space of €1 billion in *Budget 2017,* the expenditure allocations in the Budget are set relative to the higher fiscal space estimates from the *SES.* Similarly, the amount of fiscal space allocated to the proposed Rainy Day Fund is also unchanged from the *SES.* This would imply that the effect of the overall €1 billion reduction in net fiscal space in *Budget 2017* has been to reduce the amount of resources available for tax reductions.

TABLE 1.3: ESTIMATES OF NET FISCAL SPACE: *BUDGET 2017* AND *SES 2016*, € BILLION

Net Fiscal Space	2018	2019	2020	2021	Total
SES 2016	1.2	3.0	3.1	3.0	10.3
Budget 2017	1.2	2.7	2.7	2.7	9.3
Difference (*Budget 2017 - SES 2016*)	0.0	-0.3	-0.4	-0.3	-1.0

Sources: Department of Finance, *SES 2016* and *Budget 2017.*Rounding may affect totals.

As discussed in Chapter 3 and Chapter 4, on-going problems with expenditure planning and management are evident again in the *Expenditure Report 2017.* If properly implemented, the Medium-Term Expenditure Framework should work to provide an anchor for policymakers' planning. Since 2011, however, a pattern of persistent upward revisions to planned expenditure has become established. Every expenditure report since 2012 has contained upward revisions to ceilings. In 2016, the expenditure ceilings in the *Mid-Year Expenditure Report* published in July were revised up in the space of four months with the publication of higher ceilings in the *Expenditure Report 2017* released on Budget day. Repeated upward revisions undermine the usefulness of the expenditure ceilings as a tool for medium-term expenditure planning and management and increase the risk that incoming cyclical revenues will be spent rather than saved, potentially undermining the sustainability of the public finances over the medium term. The operation of the Medium-Term Budgetary Framework is discussed in more detail in Chapter 4.

1.4.2 Managing Demands on the Public Finances with Finite Resources

As noted above and in Chapter 3, in 2017 and 2018 the available resources for tax reductions and/or expenditure increases is very limited while complying with the fiscal rules. The estimated fiscal space for 2018 in *Budget 2017* is €1.2 billion. Deducting the cost of funding the expenditure increases and tax cuts introduced in *Budget 2017* on a full year basis in 2018 reduces the fiscal space for any new initiatives or maintaining the real value of public expenditure to below €600 million.

In framing future budgets, the reality of the relatively limited resources available for new measures under the fiscal rules in the short term will have to be reconciled with the many competing demands for additional pay and non-pay expenditure across a range of areas. The projections in *Budget 2017* show the budget deficit being eliminated in 2018 with the budget moving into a small surplus in 2019. This path for the public finances is consistent with minimum compliance with the fiscal rules. Accepting that this overall target for the deficit is appropriate in the coming years, it is worth noting a simple reality of budgetary arithmetic. Higher expenditure in one area means fewer resources are available for additional spending in another area, unless savings or new revenue raising measures are identified. Similarly, discretionary tax cuts limit the room for expenditure increases.

It is important to note that a key reason for the relatively constrained budgetary position in the near term is that Ireland is still adjusting its budget deficit downwards towards its medium-term objective. This requires that spending growth, net of discretionary revenue measures, is kept below the potential growth of the economy. Once the medium-term objective is achieved – a structural deficit of less than 0.5 per cent of GDP is reached – spending growth (again, net of discretionary revenue measures) is allowed under the rules to grow at the underlying potential growth rate of the economy. This will allow more resources to be available to meet important societal needs. Moreover, in both the near and longer terms, there is no restriction on faster spending growth provided that the necessary additional revenues are raised.

An issue which has raised considerable debate in recent years, not least in view of historically low global interest rates, is the treatment of investment under the fiscal rules and the question of whether the fiscal rules are too constraining on capital investment. The issue has been especially prominent in Ireland given the very low level of capital spending in recent years as documented in Kennedy (2016). In addressing this issue, it is worth noting at the outset the objectives which the current fiscal rules are trying to achieve. One of the objectives the current rules try to achieve is to avoid "deficit bias" – the tendency of governments to allow deficit and public debt levels to increase – and procyclicality in fiscal policymaking. Procyclicality has been a particular problem in Ireland in the past when in good times, with strong economic growth and revenue surges, tax cuts and spending increases were introduced which were very difficult to reverse once the revenue surges reversed. There is a risk of this re-occurring with corporation tax. One aspect of the fiscal rules that is very beneficial in potentially helping to avoid temporary revenue surges being used for permanent spending increases is the Expenditure Benchmark (EB). The Expenditure Benchmark is designed to ensure that overall expenditure growth, net of discretionary tax changes, is in line with the underlying sustainable growth rate of the economy. Fiscal rules also serve the function of initiating corrective action when the deficit is getting too large or debt levels are too high, helping to move the public finances on to a more sustainable path for the long term.

A concern exists, however, that the treatment of investment in the current fiscal rules may not be satisfactory. As discussed in Mintz and Smart (2006), a potential concern with the rules is that they reduce the incentive for public investment since capital expenditure tends to provide benefits in the future. Faced with binding fiscal rules, governments may be more reluctant to invest in capital which yields longer-term benefits versus the immediate gains attainable from current spending. Various studies have proposed a "golden rule" which would exclude net investment – the part of investment over and above estimated depreciation that increases the capital stock – from the overall calculation of the deficit target (see Blanchard and Giavazzi, 2003). At a European level, there have been discussions to examine possible modifications of the rules to exclude at least certain categories of net investment. The current fiscal rules make some allowance for possible lumpiness in capital spending by smoothing investment costs over a four-year period in calculating allowable spending growth under the Expenditure Benchmark.

It is possible that modifications that may be agreed in future at a European level could result in a more satisfactory treatment of public investment in the current fiscal rules. At the same time, even if the rules were to make more of a distinction between current and capital spending, it is necessary to ask whether a higher overall deficit path than currently being projected in *Budget 2017* to accommodate higher investment would be appropriate given the expected cyclical position of the economy and the public finances, even taking into account potential long-run benefits for potential output and the government's stock of physical assets.[9] In this context, it is also important

[9] See Barnes and Smyth (2013) for an analysis of the Government's balance sheet.

to consider that Ireland has a very high gross debt which needs to be brought down to safer levels. A key step in reducing the debt is to lower the deficit towards a balanced budget position. As noted earlier, this is what is projected in the current Department of Finance forecasts which envisage a balanced budget by 2018. Moreover, based on current forecasts, a looser fiscal stance over the medium term than already planned by the Government would not be warranted given the economy is likely to be operating close to capacity in 2016 and with further solid growth forecast for 2017 and later years.

Therefore, even though there may be concerns that the rules overly constrain capital spending, the current forecasts for the overall budget balance are likely to be close to what should be targeted in the coming years, given the need to bring the debt down and to provision for future demographic pressures. To address the concern that capital spending could be squeezed in the process of achieving the objectives for the overall budget balance, one solution is to supplement the main fiscal rule with a separate target for public investment (See Portes and Wren Lewis, 2015). For example, the Government could aim to achieve an overall level of public investment equal to a certain percentage of economic output. A separate target for public investment could help ensure that viable public investment projects with positive long-term effects are undertaken, while preserving the advantages of the current fiscal rules in helping to avoid deficit bias and procyclicality in setting budgetary policy.

Box A: The Evolution of the Budgetary Process

A number of innovations to the budgetary process have been introduced in Ireland in recent years. The reforms are designed to enhance Oireachtas engagement with the budgetary process and aim to address some of the shortcomings identified in the OECD *"Review of Budgetary Oversight by Parliament in Ireland"* published in 2015. In addition to the budget (published in October) and Stability Programme Update (published in April), the Government has published a *Spring/Summer Economic Statement s*ince 2015. In 2016, reflecting the fact that negotiations on the formation of Government were on-going at the time of the *SPU* publication in April, the *Summer Economic Statement* was published in June 2016 rather than at the same time as the *SPU*. The *SES* provides the macroeconomic and fiscal context for the discussions at the National Economic Dialogue held in June.

The *Summer Economic Statement 2016* saw a change to the way key budgetary data are presented compared to previous publications. *SES 2016* contained forecasts for key fiscal aggregates (revenue, expenditure, the deficit and the debt) on both an *ex ante* and *ex post* basis:

- The *ex ante* forecasts mirrored the purely technical projections contained in previous budgets and *SPUs*. For example, the medium-term expenditure projections made provision for pure demographic pressures and the impact of the Lansdowne Road Agreement until 2018. The use of the available fiscal space under the domestic and EU fiscal rules for tax reductions and expenditure increases was not factored into the *ex ante* forecasts.

- The *ex post* medium-term forecasts for overall tax revenue and expenditure and other main fiscal aggregates include the allocation of fiscal space for revenue and expenditure measures over the medium term.

The *ex post* forecasts are more realistic than the technical *ex ante* projections published previously as they show the path of the public finances over the medium term consistent with the Government's stated policy to use the estimated fiscal space for tax cuts and spending increases. *Budget 2017* also published forecasts on an *ex post* basis. This is an improvement on past practice as the forecasts take into account more of the known information about the Government's likely future fiscal stance, in contrast to the purely technical projections published previously.

The first *Mid-Year Expenditure Report (MYER)* was published in July 2016. This report contained details on expenditure trends to end-June 2016 across spending programmes and a revised end-year outturn. The revised end-year outturn for 2016 in the *MYER* included the additional €540 million expenditure for the Department of Health and Department of Justice that was previously included in the estimate for 2016 presented to the Dáil in June.

Another new development in the budgetary process in 2016 was the hearings held by the Oireachtas Budgetary Oversight Committee. Although the work of the Committee was truncated for *Budget 2017*, the Committee took evidence from a number of witnesses including the Minister for Finance and Minister for Public Expenditure and Reform, Central Bank, ESRI, IFAC and others. The Committee published a report in advance of the Budget outlining some of the common themes that emerged during the hearings.

If used effectively to provide relevant information for fiscal planning, including detailed medium-term fiscal projections, the new additions to the annual budget cycle such as the *Summer Economic Statement* and *Mid-Year Expenditure Report* have the potential to enhance the budgetary process and increase transparency. As the new budgetary process becomes embedded, however, it will be important to ensure that the *SES* and *MYER* are not viewed as opportunities to make incremental within-year adjustments to the Government's spending plans as announced in the previous October's budget. If this scenario materialised, it could undermine the budgetary process and further weaken the system of expenditure ceilings.

One practical step which would facilitate consistency between the Government's fiscal plans would be to align the timing of the *SPU* with the *SES* as was the case with the first *SES* published in 2015. This would avoid the scenario where one medium-term fiscal and macroeconomic plan announced in April (the *SPU*) is superseded by a new plan published two months later in June (the *SES*).