

1. Assessment of Fiscal Stance

Key Messages

- The Council assesses the fiscal stance adopted by the Government in *Budget 2018* for next year to be conducive to prudent economic and budgetary management. The Government increased expenditure at a faster pace than the initial limit permitted under the rules by introducing revenue-raising measures to fund these initiatives. This meant that the Government followed through on plans to keep existing spending and tax plans within the available gross fiscal space for 2018 of around €1.7 billion. The Department of Finance's *Summer Economic Statement 2017* set out that plan, while the Council's *Pre-Budget 2018 Statement* recommended it be adhered to.
- Looking further ahead, the budget plans allow for a gradual pace of debt reduction; moderate increases in current expenditure; and a ramping up of public investment to rates that are among the highest in the EU, while also complying with the requirements of the fiscal rules.
- Over the medium term, there is a risk that the economy may experience overheating should a rapid – albeit necessary – response from the construction sector to persistent supply shortfalls arise, which is not offset by countercyclical measures elsewhere. Reflecting the fact that improvements in the public finances in such circumstances might primarily reflect cyclical or transient developments, it would be better to use any associated revenues to reduce debt at a faster pace or to build up buffers against future shocks. This is especially important when the economy is growing strongly and when large spending commitments (e.g., for pensions) are still outstanding. Additional risks stem from the fact that the fiscal rules and cyclical measurement under the Commonly Agreed Methodology (CAM) have a poor record of distinguishing between cyclical and sustainable developments.
- The Government should set out a credible plan for the medium term. A lack of clarity on how to deal with cyclical/transient revenues means that the current medium-term budgetary plans could be undermined, particularly if a procyclical pattern of budgetary increases occurs as has often been the case. There are a number of solutions that could help to achieve this: (i) make a firmer commitment to use the Expenditure Benchmark as an anchor for fiscal policy even when the Medium Term Objective (MTO) is met; (ii) strengthen the proposed design of the Rainy Day Fund; (iii) develop the Department's toolkit for assessing the cyclical position of the economy beyond the CAM; and (iv) adhere to a target for public investment spending over the medium term. These measures should help to alleviate known measurement issues and prevent an excessively expansionary fiscal stance from being followed as in previous cyclical upswings.

Table 1.1: Summary Table% GDP unless stated, general government basis (based on *Budget 2018* forecasts)

	2015	2016	2017	2018	2019	2020	2021
Revenue (% GNI*) ¹	40.8	38.1	39.6	39.6	39.3	39.3	39.4
Expenditure (% GNI*) ¹	42.5	39.3	40.1	39.9	39.4	38.9	38.1
Balance (% GNI*) ¹	-1.7	-1.2	-0.4	-0.3	-0.2	0.4	1.3
Interest Expenditure (% GNI*)	4.0	3.3	3.1	2.8	2.7	2.5	2.2
Primary Expenditure (% GNI*) ¹	38.5	36.1	37.0	37.0	36.8	36.4	35.8
Primary Balance (% GNI*) ¹	2.3	2.1	2.7	2.6	2.5	2.9	3.5
Real Expenditure Net of DRMs (% Change) ²	2.9	2.5	1.6	1.2	1.6	1.9	1.6
CAM Structural Balance ³	-2.2	-1.7	-1.1	-0.5	0.2	0.4	0.9
Change in CAM Structural Balance (p.p.) ³	1.6	0.5	0.6	0.6	0.7	0.3	0.5
CAM Structural Primary Balance ³	0.4	0.5	0.9	1.3	1.9	2.1	2.4
Change in CAM Structural Primary Balance (p.p.) ³	0.3	0.1	0.4	0.4	0.6	0.1	0.3
Gross Debt	76.9	72.8	70.1	69.0	67.1	63.5	61.2
Net Debt	65.8	63.7	61.2	59.6	57.7	56.6	54.6
Gross Debt (% GNI*)	116.6	106.0	106.5	104.7	101.8	96.4	93.1
Net Debt (% GNI*)	99.8	92.8	93.1	90.5	87.5	85.9	83.0
Gross Debt (% Revenue)	285.5	276.1	268.7	264.4	259.3	245.6	236.5
Net Debt (% Revenue)	244.3	241.7	234.7	228.5	222.9	219.0	210.9
Real GDP Growth (% Change)	25.6	5.1	4.3	3.5	3.2	2.8	2.6
Nominal GDP Growth (% Change)	34.7	5.2	4.9	4.4	4.4	4.1	4.1
Nominal GDP Level (€bn)	262.0	275.6	289.1	301.8	315.1	328.0	341.5
Nominal GNI* Growth (% Change)	11.9	9.4	0.6	4.5	4.5	4.0	4.0
Nominal GNI* Level (€bn)	172.9	189.2	190.2	198.9	207.7	216.0	224.6
CAM Potential Output (% Change) ³	23.6	5.6	4.5	4.5	4.4	3.6	3.1
CAM Output Gap (% Potential GDP) ³	2.2	1.7	1.6	0.7	-0.5	-0.4	-0.2
Expenditure One-Offs (€m) ¹	2,111	170	178	0	0	0	0
Revenue One-Offs (€m) ¹	0	554	0	0	0	0	0
Net One-Offs (€m) ¹	-2,111	384	-178	0	0	0	0

Sources: Department of Finance (*Budget 2018*); CSO; and internal IFAC calculations.

¹ One-offs/temporary measures are removed to get a sense of the underlying fiscal position. The one-off amounts removed here are those assessed by the Council to be applicable for 2015-2016, with Department of Finance one-offs used thereafter. The main one-offs assessed by the Council to be applicable include the AIB transaction in 2015 (€2.11 billion); an amount related to the contribution to the EU budget prompted by GNI revisions for 2016 (€0.17 billion) and the European Financial Stability Facility (EFSF) pre-paid margin in 2016 (€0.55 billion). The Department has included the cost of refunding water charges as a one-off expenditure item in its estimates for 2017 (€0.18 billion).

² This refers to the expenditure aggregate used for assessing the pace of growth in spending under the expenditure rule (Chapter 4) – in this case, one-offs are excluded for all years. It captures non-interest spending growth net of any discretionary revenue measures introduced (e.g., tax increases/cuts). Measures that lead to additional revenues allow equivalent increases in spending growth relative to the limit set under the fiscal rules, while measures that reduce revenues constrain the pace of spending growth.

³ These measures are based on the output gap estimates produced under the Commonly Agreed Methodology (CAM). The CAM has a number of drawbacks that can lead to inappropriate estimates for the Irish economy (Boxes B and E).

1.1 Introduction

The Council has a mandate under the *Fiscal Responsibility Act (FRA) 2012*, and with reference to the requirements of the *Stability and Growth Pact (SGP)*, to assess the Government's fiscal stance. This chapter draws on analysis in the rest of the report in assessing the fiscal stance in *Budget 2018*. 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 macroeconomic and fiscal context that serves as the backdrop to *Budget 2018*. Section 1.3 assesses the fiscal stance relevant to 2017 and 2018, while Section 1.4 discusses issues relating to the fiscal stance over the medium term.

1.2 The Macroeconomic and Fiscal Context

1.2.1 Cyclical Developments and Risks

A range of measures of economic activity suggest that the Irish economy is continuing to grow rapidly. Moreover, the pace of growth in recent years would appear to be above what is typically expected for the Irish economy and may be considered a strong cyclical rebound. The Department's forecasts show that this is set to moderate, though the Irish economy is notoriously volatile and there are risks to both the upside and downside.

Looking at indicators of economic activity that are less prone to distortions from the activities of foreign-owned multinational enterprises, it is clear that the sharp rebound in the economy is proving resilient. Figure 1.1 highlights some of these key aggregates (Chapter 2 assesses *Budget 2018*'s macroeconomic forecasts in more detail).

The sharp rebound in activity is evident from year-on-year growth rates for employment, underlying domestic demand and personal consumption.¹ Employment, in particular, is growing by 3 per cent year-on-year and 4.5 per cent when looking just at full-time employment. This follows the steep downturn amid the collapse of the property/credit bubble. The new modified Gross National Income measure (GNI*), which is currently only available in nominal terms, also shows the sharp rebound in recent years and the Department of Finance's forecasts show nominal growth rates averaging 4.2 per cent per annum over the period 2018 – 2021 (the Department of Finance have linked the expected slowdown in 2017 to timing effects related to volatile profit outflows).²

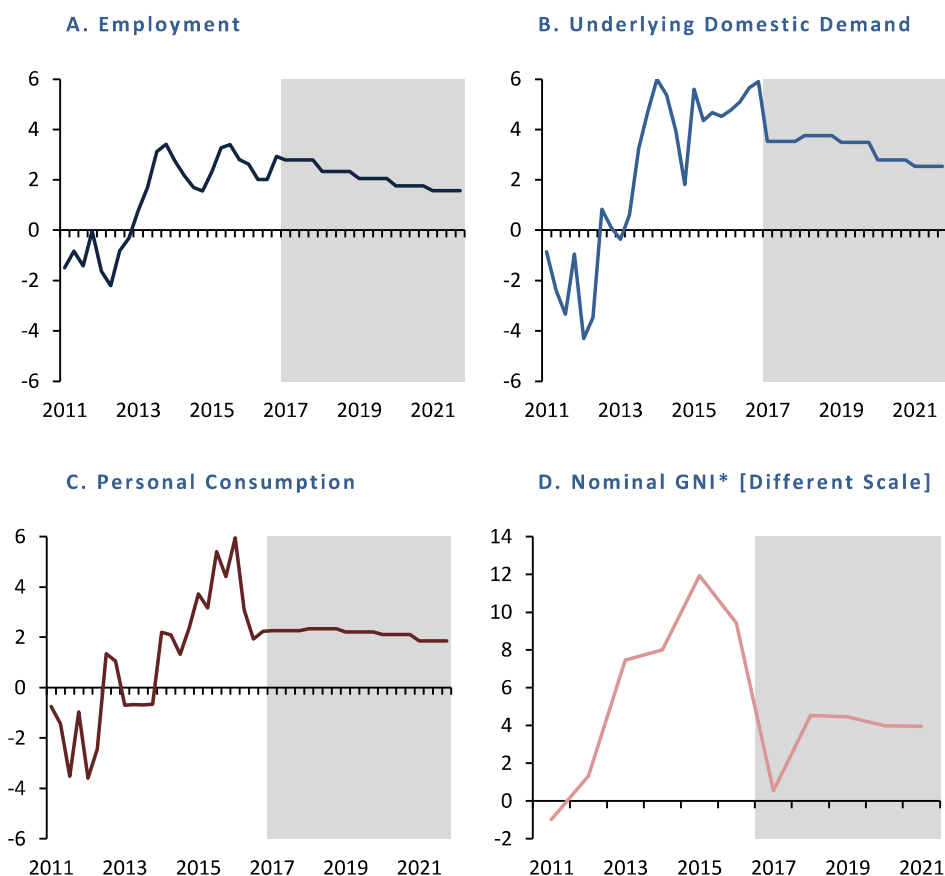
¹ Underlying domestic demand is an aggregate measure comprising consumer spending plus investment plus government consumption, and excludes investment in intangibles and aircraft, both of which have a high import content.

² GNI* is an aggregate that is designed to more accurately capture national income of Irish residents compared to GDP, given that GDP is prone to distortions from foreign-owned multinational enterprises. GNI* differs from actual GNI in that it excludes (i) the depreciation of foreign-owned, but Irish-resident, capital assets (specifically, intellectual property and aircraft-leasing assets) and (ii) the undistributed profits of firms that have re-domiciled to Ireland.

Each of the measures is forecast to continue to grow over the forecast period 2018–2021, albeit with growth rates moderating. Consumer spending and underlying domestic demand are expected to grow by 2.1 per cent and 3.1 per cent per annum, respectively (slower than their long-run averages and less than in recent years).³ Employment is forecast to rise by, on average, close to 2 per cent per annum. Again, this is less than its long-run average, and represents a moderation in the pace of growth from the resurgence seen in previous years.

Figure 1.1: Indicators of Economic Activity

Volumes (unless stated), percentage change, year-on-year



Sources: CSO; and internal Irish Fiscal Advisory Council (IFAC) calculations.

Note: Budget 2018 forecasts/estimates are demarked by grey shaded regions. As forecasts are in annual average terms, quarterly growth rates are extrapolated within year and presented as being identical for each quarter in panels A, B and C. Underlying Domestic Demand strips out intangibles and aircraft investment in full as these are, in the main, imported, with little impact on real GDP.

Risks

While the Department's forecasts are for a moderation in growth from the pace evident in recent years, there are risks that growth could be faster or slower than is currently expected. In the near-

³ The long-run averages for real annual growth in consumer spending and underlying domestic demand are 3.9 and 3.4 per cent, respectively (1996–2016), while recent years (2014–2016) have seen average growth rates of 3.2 per cent and 4.8 per cent, respectively.

term, upside risks are quite prominent. As shown in Chapter 2, several forecasting agencies have revised upwards the pace of expansion envisaged for 2018. This is notable in consumer spending forecasts for example, where the Department is forecasting growth of 2.3 per cent as compared to Central Bank of Ireland, ESRI and consensus forecasts of 2.7 per cent, 2.8 per cent and 2.8 per cent, respectively. In addition, there are upside risks in residential construction for the near-term. Price pressures associated with ongoing shortfalls in supply could ultimately lead to a very sharp supply response, which would likely manifest in an accelerated pick-up in housing completions. *Budget 2018* forecasts a steady, modest increase in completions of around 4,000 each year out to 2021, when completions are forecast to reach 35,000 units per annum. This level of annual completions is in line with estimates of what is needed to meet annual requirements for new housing. However, completions could increase more rapidly than this to meet any pent-up demand or cumulative backlog that has built up as a result of the ongoing shortfall in output.

With unemployment rates already forecast to fall to 5.5 per cent by late-2018, upside risks to domestic activity – if they materialise – could see unemployment continue to fall to lower levels. The Department views the 5.5 per cent unemployment rate as close to “full employment” (i.e., a rate of unemployment consistent with unchanged wage/price inflation).⁴ While such estimates are highly uncertain, it seems plausible that a rapid expansion of labour-intensive construction activities would lead to a period of above-normal levels of economy-wide activity so that unemployment rates may fall below what would be expected in a context of low/stable inflation and absent any other imbalances.⁵

For the long term, a number of key downside risks are apparent. In particular, the range of potential outcomes to Brexit negotiations adds to uncertainties about the future trend growth rates to which the Irish economy may revert in the long run. A hard Brexit – though forming the basis for the Department’s central forecast scenario – could have negative impacts that are more front-loaded, more severe, and more persistent than is assumed.⁶

⁴ This view is implied by comments in *Budget 2018* regarding how the economy is approaching full employment, for instance. The Department’s CAM-based estimate of the natural rate of unemployment is 5.2 per cent in 2021, but this closeness would appear to be a coincidence driven in part by the procyclicality of these estimates in the CAM framework and the fact that the forecasts of actual unemployment are close to the same level for most of the forecast years (i.e., for 2018–2021 actual unemployment averages 5.5 per cent). For a recent exploration of the interaction between wage growth and labour market conditions in the Irish context, see Linehan *et al* (2017).

⁵ It is possible, for example, that full employment is now consistent with higher unemployment rates should individuals who are long-term unemployed face difficulties in returning to employment following the crisis for structural reasons or otherwise (e.g., difficulties retraining, etc.). Adding to uncertainty in this regard are arguments that factors such as globalisation, changing labour market structures, and pent-up wage deflation may have weakened the usual Phillips curve relationship, which predicts a positive response in inflation to lower unemployment rates (see Yellen, 2014; Daly, Hobijn, and Lucking, 2012; and Iakova, 2007).

⁶ A hard Brexit could have impacts that are more frontloaded and more severe than is assumed, but the persistence of the impact is especially important for medium-term fiscal policy. In terms of how frontloaded the effects are, analysis by Morgenroth (2017) highlights how disintegrations can produce sharp negative impacts on trade in the years

Changes in US, UK and EU policies, particularly in relation to corporation tax, could also negatively impact on foreign direct investment (FDI) flows into Ireland. The Irish export base is highly concentrated (reflecting this, two-fifths of Irish corporation tax receipts in 2016 came from ten companies) and uncertainty about future tax policy (including a Common, Consolidated Corporate Tax Base in the EU and proposed changes to the US corporate tax regime) adds to risks concerning future investment decisions.

Other risks stem from Euro Area monetary policy, which could prove inappropriately loose for Ireland over the medium term. Accommodative monetary policy looks set to continue in the Euro Area at least in the short term, but quantitative easing is to be scaled back from next year.⁷ As growth in Ireland is forecast to continue to outperform the Euro Area, there is a risk that monetary policy could be looser than is optimal for Ireland in the coming years.⁸

The Cyclical Position of the Economy

Although the exact cyclical position of the economy is highly uncertain and clear signs of overheating are not evident as yet, circumstances can change rapidly. Given the relatively strong growth rates forecast and upside risks, there is a possibility that overheating could occur over the coming years. The range of estimates used by the Council suggests an output gap that would appear to be nearly closed in 2017. Figure 1.2 shows the Council's estimates of the cyclical position of the economy (the "output gap") as compared to the official estimates presented in *Budget*

immediately following break-ups. This would contrast with the view of a more gradual shock-adjustment where the economy then returns to a new steady-state level. In terms of severity, the labour intensity of UK demand is typically much greater than for an average Irish trading partner of Ireland reflecting, e.g., the relatively greater importance of the UK market to labour-intensive activities such as agri-foods exports (Lawless and Morgenroth, 2016). In terms of the persistence of the effects, Ireland's trend growth rate could also be negatively impacted by a hard Brexit. Estimates produced by the ESRI using COSMO present the impact on Ireland's output as a level shock (i.e., a shock where the level of output is permanently lower but growth rates are not impacted over the long run). However, one could also view a hard Brexit as representing a shock to long-run or trend growth rates. This would be consistent with the view that Irish exporters face significant challenges in diversifying to other export markets following a hard Brexit and that the openness of an economy to trade, capital and labour market flows is an important determinant of a country's long-run potential growth rate. As discussed in IFAC (2016b; 2017b), there are a number of possible channels (including trade, capital and labour market flows) through which UK potential output growth could be lowered as a result of Brexit. This could have knock-on consequences for Irish potential output growth rates. Lower potential output growth in the UK would bode poorly for the Irish economy's potential output growth if Irish exporters were unable to offset demand shortfalls by expanding into other markets and opening up to new markets can be challenging. Using gravity model approaches applied to Irish data, Lawless (2010) identifies strong negative effects on exports from geographical distance to markets, while a commonly shared language and well-developed communications infrastructures are factors found to be supportive of exports.

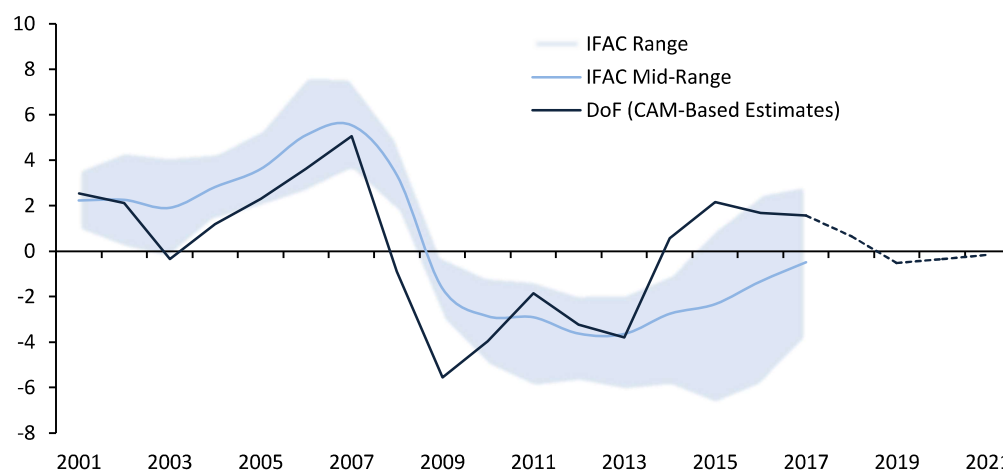
⁷ The ECB announced in October that it intended to start a gradual process of withdrawal of quantitative easing. This would see it, first, halving its bond-buying programme from €60 billion per month to €30 billion per month beginning in January 2018, with purchases continuing at that pace until end-September 2018. Plans could alter depending on the ECB Governing Council's views on the path of inflation (e.g., a less favourable outlook or financial conditions inconsistent with progress towards the inflation target could alter these plans).

⁸ One aspect of the previous boom that has been highlighted in subsequent research is the impact that inappropriate monetary policy can have in terms of amplifying the business cycle (e.g., Crowley and Lee, 2008), with low interest rates cited as one contributing factor in the lead-up to Ireland's crisis (Honohan, 2010). Others suggest that – in Ireland's case – the weight of blame is better placed on Irish domestic fiscal and regulatory policy (Whelan, 2013).

2018.⁹ The Council's estimates focus on measures of domestic economic activity – a focus warranted by the fact that domestic activities tend to be typically more tax-rich in nature and, hence, of greater significance for the setting of appropriate fiscal policy.¹⁰ The IFAC range for annual potential output growth rates averages 2½ to 4 per cent over the most recent five-year period (the implied mid-range is 3¼ per cent).¹¹

Figure 1.2: Ireland's Output Gap Estimates

Percentage of potential output



Sources: CSO; Department of Finance (*Budget 2018*); and internal IFAC calculations.

Note: The IFAC range is produced based on a variety of approaches. These are outlined in Box A of the *November 2015 Fiscal Assessment Report* and Box B of the *June 2015 Fiscal Assessment Report*. Since then a number of approaches have been added to the Council's toolkit for estimating potential output. Given the distortions to standard measures like GDP and GNP and the relative importance of domestic activity to fiscal outcomes, the range currently focuses on measures produced by using measures of domestic economic activity. The Department's estimate is based on the CAM which is known to have a number of shortcomings leading to inappropriate estimates for Ireland (Boxes B and E).

The differences in the levels of the output gap since 2014 as estimated under the CAM and in IFAC's mid-range are notable. CAM estimates imply that the economy moved to a position where it was operating above-capacity from 2014 onwards, with a large positive output gap of 1.6 per cent in 2017 – a position expected to ameliorate over the forecast horizon. Applying the standard interpretation of such measures to this rather odd profile would imply that the economy is currently overheating or that “excess” employment is evident so that a large portion of the unemployed are not regarded as likely to contribute to the productive potential of the economy

⁹ The output gap is a summary measure intended to provide an estimate of whether the economy is currently operating below, close to, or above its potential level. This has an important bearing on the perceived sustainability of economic developments and of tax revenues (e.g., a positive output gap might be said to indicate that the economy is overheating or that tax revenues might be temporarily higher than can be sustained).

¹⁰ An example of this is “Domestic GVA”, which tries to isolate domestic activity by ignoring sectors in the economy that are dominated by foreign-owned multinationals. Sectors are defined as being dominated by foreign owned-multinationals if they account for over 85 per cent of turnover in that sector.

¹¹ Recent estimates based on simulations using the ESRI's model COSMO (McQuinn *et al*, 2017) indicate that the potential growth rate of the aggregate economy is approximately 3.3 per cent (comprising 2.4 per cent for the non-traded sector and 3.9 per cent for the traded sector) and that the Irish economy will reach its potential level by 2018.

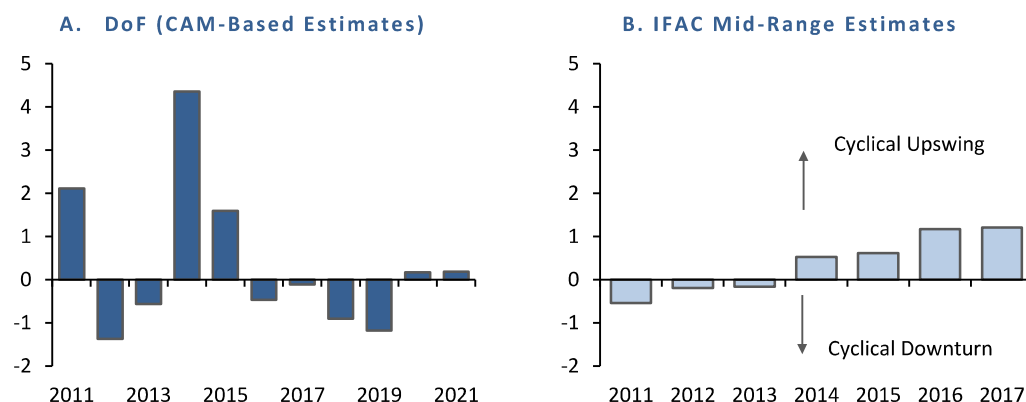
(Darvas, 2013). However, the IFAC mid-range points to a sustained negative output gap that only began to close from 2013 onwards so that by 2017 the economy is finally close to its potential level. The implications for an appropriate fiscal policy are strikingly different.

The Council supplements its analysis of summary output gap measures with a “modular approach” to assessing imbalances in the economy. This approach is intended to help with the assessment of cyclical developments in the economy (see Chapter 2 and Appendix C). The approach involves assessing key sources of imbalances that can help to discern whether or not the economy may have departed from normal levels of output, with a view to examining these “modules” in a more systematic manner.

The view that the economy is operating close to its potential is reinforced by a number of indicators. In particular, labour market indicators suggest that conditions are tightening, though evidence of price/wage pressures is relatively limited. Similarly, aggregate investment indicators signal levels of activity gradually returning to historical norms. By comparison, housing market conditions show greater evidence of supply shortages and credit conditions are still relatively subdued.¹² On balance these indicators would reinforce the view that, while the economy may not yet be overheating, it is likely to be operating close to its potential.

Figure 1.3: Changes in the Cyclical Position of the Economy

Estimates of the change in Ireland’s output gap (percentage points of potential output)



Sources: CSO; Department of Finance (*Budget 2018*); and internal IFAC calculations.

Notes: See notes to Figure 1.2. Positive changes in the output gap indicate cyclical upswings but do not give any information about the economy’s position with respect to its potential level (i.e., although the output gap may be becoming relatively more positive, the economy may still be operating below its potential such that overheating may not be a concern).

Assessing the estimated change in the output gap can give a sense of how cyclical conditions are evolving over time, notwithstanding uncertainties about its current level (Figure 1.3). The

¹² The Central Bank of Ireland’s latest Macro Financial Review (2017:1) shows that, while lending is increasing, year-on-year growth in credit to households and non-financial corporations remains negative as both sectors continue to deleverage. Gross new lending to SMEs, however, has been rising since early-2014, while some categories of household credit are showing positive growth, including non-mortgage credit and mortgage lending at fixed rates.

Department's official estimates based on the CAM show that the output gap has become less positive in 2016 and 2017, with this continuing in 2018 and 2019 (i.e., implying that the economy is "cooling" in relative terms). This view is implausible and does not fit with a broader assessment of economic information. The Council's view is that – notwithstanding the high degree of uncertainty involved – the recent pace of growth in the economy is more likely to imply that the output gap has been closing from a negative position. This is in contrast with the indications of CAM estimates. Consistent with this view, the IFAC mid-range estimates of the change in the output gap suggest that the output gap has become consistently less negative from 2014–2017 (Figure 1.3B). This pattern could be expected to continue, particularly if upside risks materialise.¹³

Should the recent pace of growth continue, then the economy might be expected to begin to operate above its potential soon. As Chapter 2 notes, one of the main upside risks to growth in the short- to medium-term is output from the construction sector. If the economy continues to grow rapidly, any remaining slack in the economy would be eliminated. From this position, a necessary rise in construction activity could boost growth further leading to a situation where output may exceed sustainable levels, and offsetting measures may be required.

1.2.2 Current Fiscal Context

Government Budget Balance

While interest and growth dynamics are important for debt developments (see Box H), a government has greater control over a third key driver: its budget balance. This represents the difference between the total annual revenue and expenditure of a government. Assessing a government's budget balance is complicated by factors such as one-off items (e.g., revenues that are unpredictable or not representative of the underlying position); the effects of the cycle (e.g., boom-time revenues); and spending outside of the government's control. With this in mind, the Council focuses on budgetary measures that may be considered useful indicators of how recent or envisaged policies will influence the fiscal stance and debt sustainability.

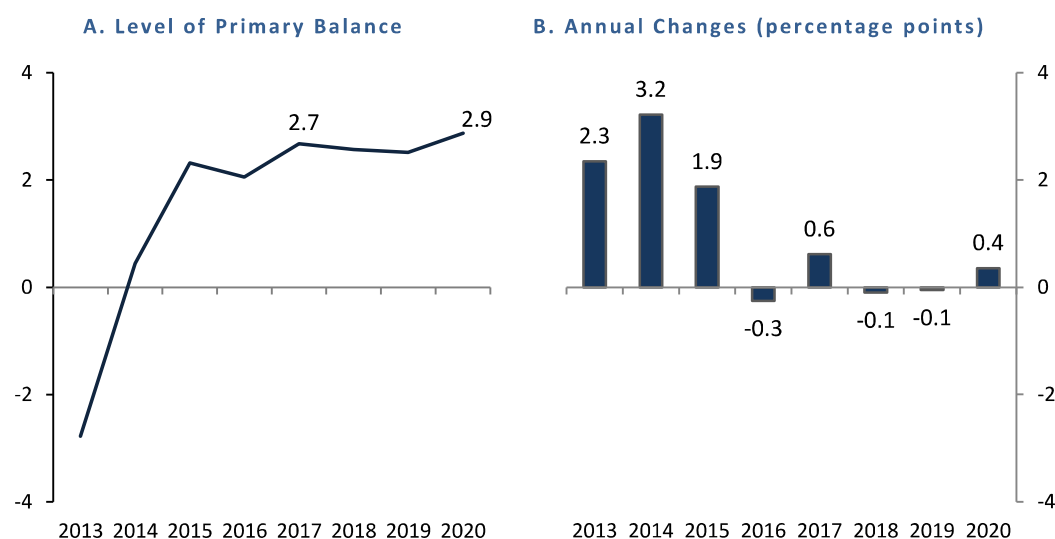
One useful – though not perfect – measure of the fiscal stance is the primary balance excluding one-off items. This represents the balance of general government revenue and non-interest spending where one-off items are removed. Removing interest costs may be considered useful when: (i) costs are typically the result of past decisions rather than current policies (i.e., they depend on the stock of debt, which depends on past deficits); (ii) interest costs are volatile or unpredictable – in this case the approach can provide a more stable alternative for assessing the fiscal stance (this is evident in Ireland post-crisis with sharp changes in global interest rates, Irish

¹³ As the output gap estimates produced by the Council rely on variables for which no forecasts are available, estimates only run to 2017 in Figure 1.2. However, models for which forecasts are available would suggest an output gap that becomes slightly positive over the period to 2021 (using the Department's central scenario).

risk premia, and official lending); (iii) interest costs are important from an economic perspective (in Ireland's case, interest payments on government debt securities traditionally flow more to non-resident holdings than to resident holdings); and (iv) considering the inflation–interest nexus (high interest rates paid on government debt during times of high inflation may overstate the extent of the deficit that would prevail in a low-inflation environment – this matters more where real interest rates diverge from real growth rates).¹⁴

Figure 1.4: Changes in Primary Balance Slowing

% of GNI*, general government basis



Sources: CSO; Department of Finance; and internal IFAC calculations.

Note: Data are adjusted to exclude one-offs identified by the Department of Finance and assessed as applicable by the Council (see Table 1.1).

While the path for the primary balance in the early forecast years is relatively stable, there are questions as to how realistic the planned improvements for 2019 onwards are. As a share of GNI*, the primary balance for 2017 is expected to be 2.7 per cent, and is set to remain broadly at that level for the next few years (Figure 1.6). It deteriorates marginally in 2018 and 2019 before rising to 2.9 per cent in 2020 (forecasts for 2021 show the primary balance picking up more rapidly to 3.5 per cent in 2021, but forecasts for the years 2019 onwards are predicated on the basis of unused fiscal space, which may be an unrealistic scenario – see Chapter 3).

In contrast to the slow pace of improvement in the primary balance for the period 2017–2020,

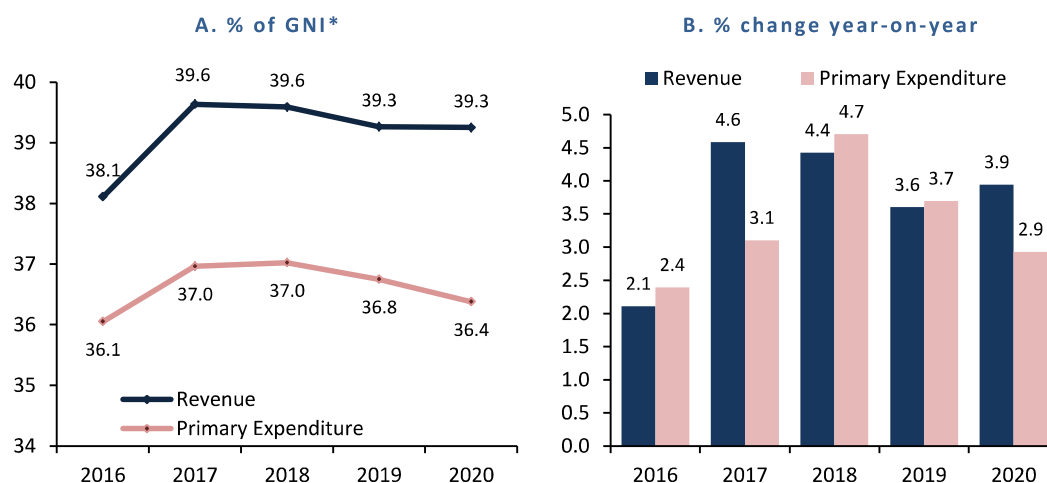
Budget 2018 plans show that the overall balance improves by some 0.8 percentage points of GNI*

¹⁴ Andritzky (2012) offers a useful international examination of holdings of government bonds based on residency. Central Bank of Ireland holdings accumulated through the ECB's Public Sector Purchase Programme have increased the domestic share of Irish Government bonds in recent years, but non-resident holdings still represented 55 per cent of total medium- and long-term debt as of end-2016. The CSO publish estimates of interest flows specifically. For 2016, they show that total interest payments were €6.2 billion, of which €3.9 billion (63 per cent) was payable to non-residents (Table 4, CSO *Government Finance Statistics*).

over the forecast horizon. This would suggest that expected interest savings equivalent to 0.6 percentage points of GNI* would be used to fund additional expenditure. With interest rates already at multi-century lows, the use of such a large a proportion of these savings to fund additional expenditure raises questions about its sustainability.

An improving underlying fiscal position is suggested by estimates of the change in the CAM-based structural primary balance, but these are prone to mismeasurement. The CAM suggests that cyclical deteriorations in coming years will imply a primary balance that is improving by more than the unadjusted measure when accounted for the cycle. The CAM-based structural measure rises by an average of +0.4 percentage points each year over 2017–2020 (Table 1.1). This is clearly a surprising indication and is largely the result of the CAM's implicit view that the economy was already overheating between 2014 and 2017, but will experience a cyclical downturn in coming years – a view completely at odds with what is implied by other indicators (Section 1.2.1). A more plausible path for the period after 2018 – assuming that the Department's forecasts for average real GDP growth of 3 per cent per annum materialise – would be that the economy experiences a very moderate cyclical upswing in future years. This would imply that a more appropriate measure of the structural primary balance would look more like the unadjusted measure (i.e., showing limited improvements out to 2020), in effect assuming that the economy remains close to potential.

Figure 1.5: Government Revenue and Primary Expenditure
General government basis



Sources: CSO; Department of Finance; and internal IFAC calculations.

Note: Data are adjusted to exclude one-offs identified by the Department of Finance and assessed as applicable by the Council.

For the period 2017–2020, *Budget 2018* plans show revenue growth broadly in line with growth in nominal GNI*, while non-interest spending growth is marginally slower. As a result, non-interest expenditure falls from 37 per cent of GNI* in 2017 to 36.4 per cent in 2020, while revenue levels

average close to 39.5 per cent of GNI* (2017–2020). Importantly, the plans are predicated on the suggestion that spending growth will broadly keep pace with revenue growth for 2017–2019, but will slow to a pace below revenue growth thereafter (Chapter 3).

The lower primary expenditure levels in 2019–2021 reflect unused gross fiscal space as assumed in the budgetary projections (Chapters 3 and 4). This is partly explained by allocations to the Rainy Day Fund, but also by unrealistically low forecasts for certain areas of spending (Chapter 3).

It is worth questioning just how realistic the expenditure forecasts are for later years. The Government has previously indicated a policy of minimum compliance with the fiscal rules, but *Budget 2018* forecasts would appear to imply an additional unused fiscal space in 2019, 2020 and 2021 of just over €1 billion per annum, separate to the Rainy Day Fund allocations. Setting aside some unused fiscal space is a sensible approach when there are reasons to believe that the rules may allow overly procyclical budgetary increases, but a credible plan is needed to ensure that such increases do not occur. There has been a consistent pattern of upward revisions to expenditure ceilings in recent years, while plans for the Rainy Day Fund have already been scaled back (Box A). This might suggest that even minimum compliance could be a stretch to assume, let alone the *Budget 2018* plans for over-compliance.

Government Debt

A legacy of the crisis is that Ireland's debt burden is still comparatively high, with this burden understated by standard comparisons against GDP. Ireland's government debt levels, when set against a more comparable measure of national income like GNI*, would suggest that debt was among the highest in the OECD as of end-2016 (Figure 1.6). On this basis, Ireland's net debt burden ranks as the fourth highest in the OECD with only Portugal, Italy and Japan showing higher net debt burdens.¹⁵ While the GNI* measure is not available for other countries, a similar picture emerges when it is compared against alternative ratios like net debt as a percentage of total general government revenue (Ireland's ratio is fifth highest in the OECD).¹⁶ On this basis, Ireland's net debt burden is just over 240 per cent of annual government revenue as of end-2016.

Under the Government's current plans, Ireland's net debt levels are expected to decline at a steady pace. Figure 1.7 highlights the steep rise in debt ratios for Ireland over the crisis period as sudden losses in transient revenue streams associated with the property/credit bubble materialised and as costly banking support measures were introduced. It also shows the projected path for net debt to

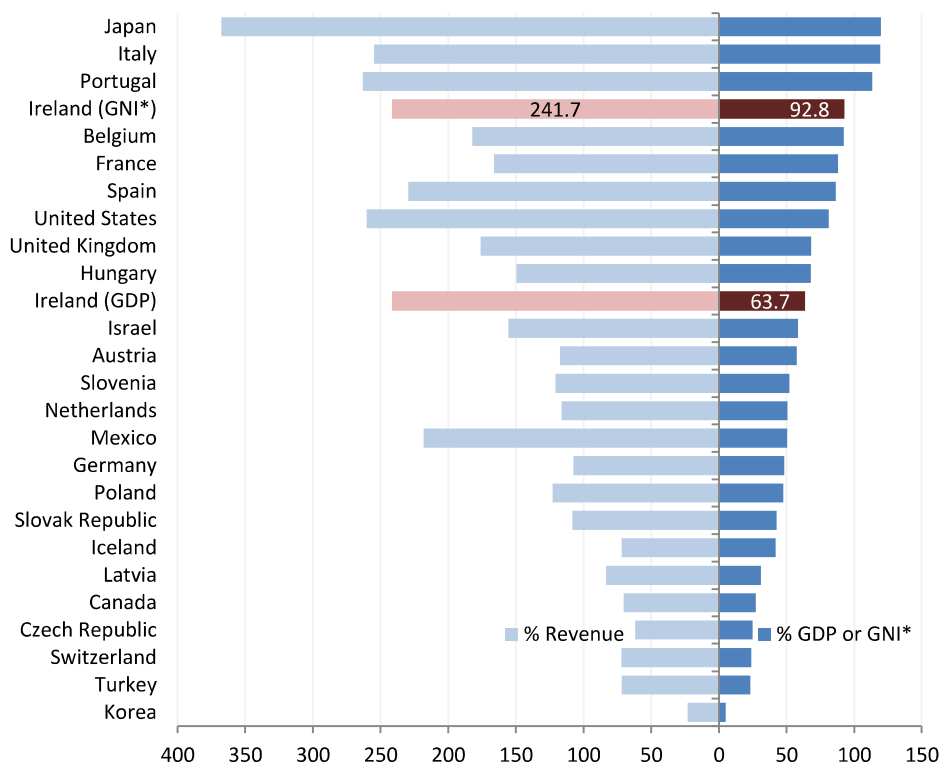
¹⁵ Note that net debt data are not available for Greece.

¹⁶ Debt-to-revenue ratios are somewhat problematic 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 are those based on distorted GDP data, and such ratios are on a like-for-like basis when comparing with other countries.

2021 under the plans outlined in *Budget 2018*. The *Budget 2018* plans would suggest that net debt levels will fall steadily from 93 per cent of GNI* at end-2017 to 83 per cent by end-2021.

Figure 1.6: OECD Countries Net Government Debt (Top 25 Countries)

End-2016 net general government debt as % revenue (LHS); and as % GDP or GNI* (RHS)

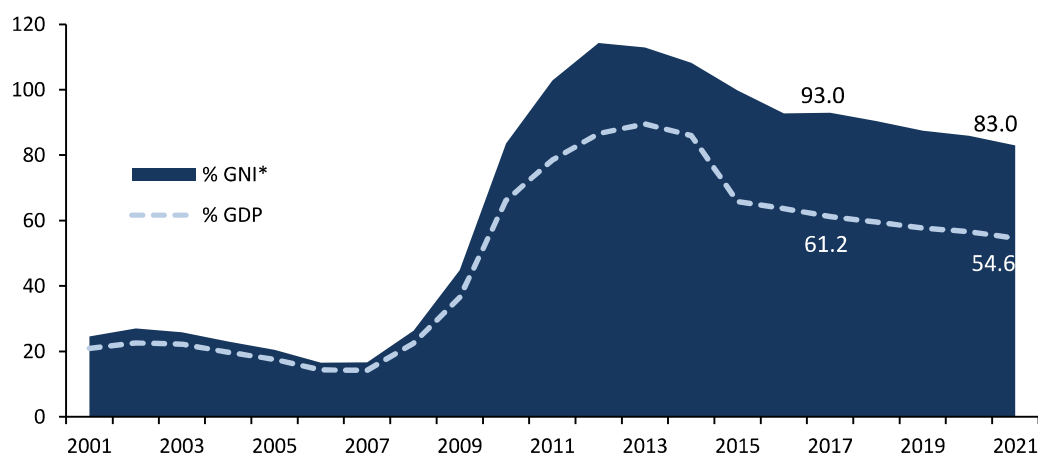


Sources: CSO; Eurostat; IMF World Economic Outlook (October 2017) and internal IFAC calculations.

Note: CSO data are used for Ireland; IMF data for Turkey, Switzerland, Canada, Korea, Iceland, Mexico, Israel, US, and Japan, while Eurostat data are used for remaining countries.

Figure 1.7: Ireland's Net Government Debt Levels

% GNI* and % GDP, General Government basis



Sources: CSO; Department of Finance; and internal IFAC calculations.

The Government has identified a medium-term debt ratio target of 45 or 55 per cent of GDP as a basis for steering fiscal policy. Such targets – if well specified, time-bound, and set against an appropriate denominator – can be useful. However, the Government’s target does not meet any of these criteria. It is set against the distorted GDP denominator, which *Budget 2018* acknowledges has less information content for Ireland.¹⁷ It is predicated on vaguely specified time commitments, which potentially would only be met over a very long period (e.g., *SPU 2017* applied the target for the “mid-to-late 2020s”, while *Budget 2018* suggests the 45 per cent target will apply “once the major capital projects have been completed”).¹⁸ It is not clear if the targets are levels to be achieved (hard targets) but not exceeded (ceilings) or whether these will account for cyclical developments in any way. Furthermore, there does not appear to be a very strong commitment to the debt target. Within the space of six months, the targets have already been revised up to 55 per cent (*Budget 2018*) from an original 45 per cent target (*SPU 2017* and *Budget 2017*).

More importantly, the level of the proposed 55 per cent target cannot be considered low or particularly prudent. IFAC (2017b) showed that using 2016 data, a 55 per cent debt-to-GDP target would be broadly equivalent to an 80 per cent debt-to-GNI* ratio (similarly, a 45 per cent debt-to-GDP ratio would equate to over 65 per cent of GNI*). This is still high, compared with pre-crisis levels when debt-to-GNI* ratios were closer to 20-25 per cent, and when compared with international norms.

The 55 per cent target appears to be anchored in terms of *SGP* commitments (which are specified as a percentage of GDP). The argument follows that, while a ceiling for the debt ratio in the *SGP* is set as 60 per cent of GDP, a 55 per cent ratio is more prudent because it is 5 percentage points lower than this. These arguments do not withstand much scrutiny, given the GDP distortions already specified. The Department acknowledges in *Budget 2018* that GNI* “more accurately reflects the income standards of Irish residents than GDP”, yet the distorted GDP denominator is still used as the basis for setting the Government’s debt targets.

There are additional reasons why a prudent debt ceiling for Ireland – even if more appropriately defined in terms of GNI* – might be lower than the 60 per cent ceiling in the *SGP*. First, the ceiling is exactly that – a maximum ceiling, not a target – so that staying close to this does not necessarily represent a prudent approach. Second, as Box H shows, Ireland has a volatile history in terms of its debt dynamics, which would argue for setting a debt ceiling below the *SGP* limits (these are

¹⁷ The use of GDP as a denominator could become increasingly less meaningful over time should a continued onshoring of intellectual property products further inflate its level in coming years, especially when associated activities tend to be less tax-rich in nature.

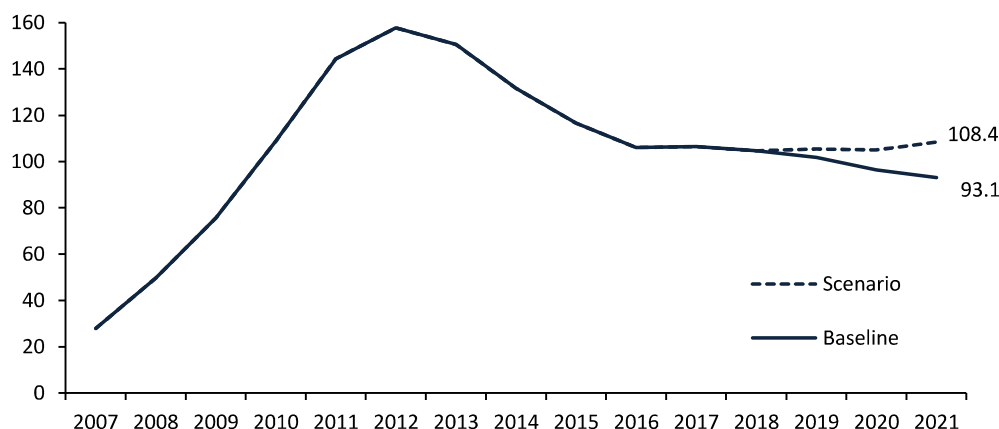
¹⁸ The Department’s *Annual Report on Public Debt in Ireland June 2017* sets out some long-term debt forecasts, but it is not clear that these are intended as targets.

primarily set with larger EU Member States in mind).¹⁹ Third, additional considerations might lead one to conclude that an appropriate debt level is more prudent when account is taken of the government's wider balance sheet, long-term expenditure pressures and pension commitments.

The steady pace of debt reduction in *Budget 2018* is broadly appropriate, but there are risks to the trajectory, particularly from growth. In considering the appropriate fiscal stance for the coming period, it is important to bear in mind the sensitivity of the debt trajectory to alternative assumptions. One scenario could see a sharp and sustained reduction in growth rates relative to *Budget 2018* forecasts from 2019 onwards. This could happen if a Brexit-related shock were much harder than currently envisaged, or if the scale of the multinational enterprise sector operating in Ireland were to shrink, reducing Corporation Tax receipts and output. Assuming a typical forecast error for each of the years 2019, 2020 and 2021, the debt-to-GNI* ratio could stagnate at high levels, rising from 106.5 per cent at end-2017 to 108.4 per cent by end-2021, in the absence of any policy response. This compares to a fall to the 93.1 per cent ratio implied by budget figures. In a situation where debt is already at high levels, the impact of such shocks on creditworthiness can be more pronounced. There are also upside risks, and one scenario is that overheating could occur in coming years. In such a scenario, it would be wiser to use any additional cyclical revenues to reduce debt at a faster pace or to build up buffers against future shocks. The Rainy Day Fund could have a useful role in supporting this (Box A).

Figure 1.8: Illustrative Shock Scenario from 2019 Onwards

Gross Debt as % of GNI*, general government basis



Sources: CSO; Department of Finance (*Budget 2018*); and internal IFAC calculations.

Note: Using the Council's Fiscal Feedbacks Model, the scenario shows the debt ratio path for an illustrative shock equivalent to a typical forecast error on nominal GDP growth (–2 p.p. relative to baseline growth rates) in each of the years 2019, 2020 and 2021. Nominal GNI* is assumed to have an elasticity with respect to nominal GDP of 1.0, which is applied only to the deviation in nominal GDP from its baseline. The pace of debt reduction from 2011–2016 is distorted by the liquidation of the IBRC such that lower liabilities were measured on the government's balance sheet.

¹⁹ As Box H shows, while larger Member States tend to have interest-growth differentials where half of the observations are within a range of less than two percentage points, Ireland's span over a much wider range of 8 percentage points.

1.3 Assessment of the Fiscal Stance in 2017 and 2018

Given the macroeconomic and fiscal context, this section assesses the fiscal stance adopted in *Budget 2018*.

The Council assesses the fiscal stance adopted by the Government in *Budget 2018* for next year to be conducive to prudent economic and budgetary management. As recommended in the Council's *Pre-Budget 2018 Statement*, the Government followed through on plans to keep net spending and tax plans within the available gross fiscal space for 2018 of around €1.7 billion. This was consistent with the Department's initial estimates of the available scope for tax and spending changes in 2018 if the fiscal rules were fully met (i.e., the "gross fiscal space"). The estimate of €1.7 billion was based on the required 0.6 percentage point-of-GDP improvement in the structural balance as Ireland moves towards its medium-term budgetary objective.

As Table 1.2 shows, the Government increased expenditure at a faster pace than the initial limit permitted under the rules by introducing revenue-raising measures to fund these initiatives. Starting with the €1.7 billion gross fiscal space that was first estimated as available in the *SES 2017*, the nominal resources available for new measures in 2018 were reduced to €0.65 billion once a number of non-budget-day measures were accounted for. These included measures already committed to by the Government (–€0.9 billion), carryover costs from *Budget 2017* (–€0.65 billion), and offsetting revenues arising from not indexing tax bands and credits (+€0.5 billion).

Table 1.2: Gross Fiscal Space and Budgetary Measures

€ billions

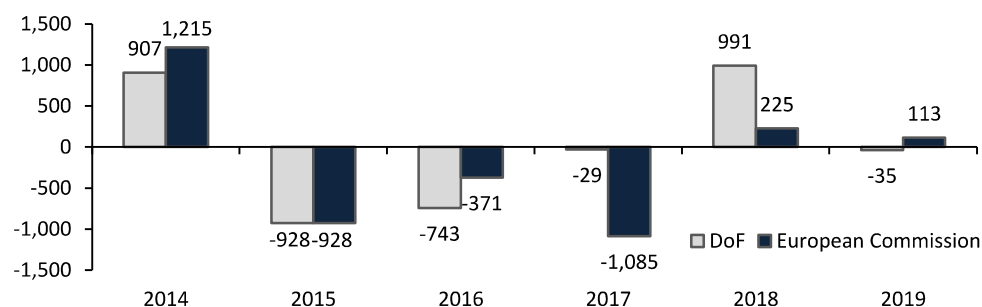
	Yield	Cost	Total
Starting Point			
Gross Fiscal Space			1.7
Pre-Committed Spending		-0.9	
Carryover Costs of <i>Budget 2017</i>		-0.65	
Non-Indexation of Tax System	+0.5		
Nominal Resources for New Measures Prior to Budget 2018			0.65
Budget Package			
New Current Expenditure		-0.87	
New Capital Expenditure		-0.22	
USC		-0.18	
Income Tax		-0.16	
Stamps	+0.38		
Corporation Tax	+0.15		
Compliance	+0.10		
Other	+0.20		
Total Budget 2018 Package	+0.83	-1.43	-0.60

Sources: Department of Finance (*Budget 2018*); and internal IFAC calculations.

On budget day, €1.1 billion of spending measures were introduced (€0.87 billion current spending and €0.22 billion capital spending) along with €0.34 billion of tax cuts.²⁰ These measures were offset by €0.83 billion of discretionary revenue-raising measures. This meant a net package of €0.6 billion as compared to the original estimated scope of €0.65 billion for new measures prior to the Budget (IFAC 2017b).

At face value, the Budget appears broadly consistent with initial plans for tax and spending changes, but there may be some questions over the quality of revenue-raising measures introduced under the Budget (Box F). The discretionary revenue-raising measures introduced in *Budget 2018* marked a departure from recent budgets where tax cuts outweighed revenue-raising measures (Figure 1.9). For 2018, the Department estimates the impact of discretionary revenue measures at close to €1 billion (0.5 per cent of GNI*) when non-indexation of the tax system is included. However, there are uncertainties around projected yields and the accuracy of these costings has an important bearing on compliance with the fiscal rules and the actual fiscal stance.²¹

Figure 1.9: Estimated Impact of Current Discretionary Revenue Measures
€ million



Sources: Department of Finance (*Budget 2018*); and European Commission (Autumn 2017).

There are questions over whether some of the revenue-raising measures introduced in *Budget 2018* will be able to deliver the anticipated revenue gains, particularly over the longer term. Revenue-raising measures should reflect estimated yields that can be considered sustainable over the long run so that these can be expected to support long-lasting expenditure increases. This would also be in keeping with the spirit of the new budgetary framework. However as Box F notes,

²⁰ These amounts include the impact of the new public sector pay agreement (Table 9, Economic and Fiscal Outlook, *Budget 2018*).

²¹ European Commission (2017b) estimates indicate a much lower impact at just €0.2 billion or 0.1 per cent of GNI*. Some €0.5 billion of the difference is attributable to non-indexation amounts not (yet) included by the Commission, while the remainder relates to different views about the impact of various discretionary revenue measures. As noted in the Commission's assessment of the *Stability Programme Update 2017*, differences in the appraisal of the discretionary revenue measures were related to fact that "the stability programme includes, among them, the non-indexation of income tax bands". While the initial Commission assessments of the expenditure benchmark in spring 2017 did not reflect the additional revenues linked to the continued non-indexation of income tax bands, a subsequent overall assessment did. It is expected that, while the Autumn 2017 estimates do not currently capture these additional revenues associated with non-indexation of the tax system for 2018, the overall assessment will again include them in much the same way that the spring assessment did.

the yield from the increase appears to have been estimated at a high point in the cycle. This casts doubt on whether or not the measure will yield the anticipated receipts on an ongoing basis. In particular, the Government should take care to avoid building an increased reliance on transient or cyclical revenue streams given the lessons of the last crisis.

Following the budget, there is a risk that the fiscal rules could still be breached in 2017 and 2018, albeit current plans suggest that any breach is unlikely to be by a sufficient margin to risk potential sanctions. Unexpected savings in certain departments mean that limited over-runs together with public sector wage increases in 2017 are unlikely to lead to a breach of the fiscal rules that is sufficient to trigger potential sanctions. For 2018, given that budget plans are consistent with the required adjustment in the structural balance as estimated in the *SES 2017*, the risks of a breach in the fiscal rules are relatively limited though questions over the sustainability of some revenue-raising measures introduced in the Budget are important in this context (Chapter 3 and 4).

1.4 The Medium-Term Fiscal Stance (2019-2021)

There are greater challenges in terms of setting and executing an appropriate fiscal stance over the medium-term. The budget plans allow for a gradual pace of debt reduction; moderate increases in current expenditure; and a ramping up of public investment to rates among the highest in the EU, while also complying with the requirements of the fiscal rules. An important milestone in attaining the Medium-Term Objective of a structural deficit of 0.5 per cent of GDP also looks within reach for 2018. However, key challenges face the Government as Ireland recovers from its latest fiscal crisis.

High debt levels and risks to the growth trajectory suggest that complacency should be avoided. Debt levels are still among the highest in the OECD and there are notable risks to the growth trajectory outlined in *Budget 2018* plans. A harder-than-expected Brexit and tax policy-related risks could negatively impact on long-term growth rates making debt reduction more difficult over the long term. Upside risks are also evident depending on the response of the residential construction sector to persistent supply shortfalls in housing. The resulting employment and income growth would be expected to add substantially to cyclical tax revenues. It may be necessary to counteract any resultant overheating through offsetting measures elsewhere. The Government should be conscious that revenues from an expansion in housing output to above-normal levels (i.e., where upside risks to housing completions relative to the central scenario in *Budget 2018* materialise) would likely be transient in nature.

The budgetary plans for 2019–2021 show a degree of over-compliance with the spending rule, which it would be sensible to stick to (Chapter 3). The only explicit commitment for the medium term has been one of minimum compliance with the fiscal rules.²² This coupled with a pattern of

²² *Budget 2017* noted that: “the medium-term fiscal projections outlined here reflect the Government’s stated policy intention to use of available fiscal space”. It also stated that forecasts would be updated to reflect changes in estimates

overruns and breaches of the fiscal rules in recent years could – if continued – undermine the current budget plans. The current fiscal context and outlook underline the need to restore the capacity to withstand future shocks and to ensure that the economy does not overheat, thus avoiding repeats of past policy mistakes. Given the risk of overheating and the fact that the Budget plans are consistent with ramping up capital spending, meeting demographic and price pressures, and achieving other budgetary aims, it would be wise to refrain from adjusting budgetary plans upwards to a substantial degree over the medium term. A better use of resources from any cyclical upswing or favourable revenue conditions, such as strong corporation tax receipts, would be to use revenues to build buffers (as in the Rainy Day Fund) or to reduce debt at a faster pace.

Avoiding a return to procyclical fiscal policy is paramount over the medium term. To mitigate this risk, a number of steps should be taken. First, the Government should make a firmer commitment to following the spending rule; second, the Department should develop its toolkit for assessing the cyclical position of the economy beyond the CAM; third, the proposed design of the Rainy Day Fund should be strengthened; and fourth, a proposed investment rule should be pursued.

i. **The Government should make a firmer commitment to following the spending rule (the**

Expenditure Benchmark) after the MTO is reached. The Expenditure Benchmark is designed to ensure that spending growth does not follow a procyclical pattern. While it is meant to be consistent with the structural balance rule, differences in its calculation provide some safeguards around measurement issues. In particular, since the rule uses a ten-year average of potential output growth rates to determine “sustainable” real expenditure growth rates, this leaves it less exposed to annual volatility in CAM-based estimates of the output gap (which determine structural balance estimates).

However, following the Expenditure Benchmark is not a panacea. While the spending rule is less susceptible to measurement issues compared to the structural balance, it could still imply an inappropriately loose fiscal stance for later years. As such other initiatives are also required.

ii. **The Department should develop its toolkit for assessing the cyclical position of the economy beyond the CAM.** The CAM is the method that is used to set a “sustainable” pace of growth for expenditure in the fiscal rules (net of any discretionary revenue measures) and to identify the underlying balance, abstracting from temporary or cyclical factors (the structural balance). However, there are known issues with procyclicality underpinning the

of the available fiscal space: “aggregate expenditure forecasts now include the planned level of Government expenditure out to 2021...based on the current economic forecasts and the existing estimates of available fiscal space. As we move forward, the economic forecasts will vary and estimates of fiscal space will change as the relevant economic indicators used in the calculation change. As this happens, the fiscal forecasts for both revenue and expenditure will change too.”

CAM (Boxes B and E). Given that future improvements in the public finances might primarily reflect cyclical factors, there is a risk that any cyclical upswing could feed through to higher estimates of potential growth in a procyclical fashion (i.e., with estimates unduly chasing revisions to outturns/forecasts as the cycle evolves). To help ensure that temporary or cyclical revenues are recognised as such, the Department should develop its toolkit for assessing the cyclical position of the economy in keeping with its recent commitments.²³

- iii. **The proposed design of the Rainy Day Fund should be strengthened.** Pressures to increase government spending and cut taxes in an unsustainable manner might be expected in future years. Current budgetary plans look set to deal with a lot of known pressures; however, the procyclicality of the fiscal rules could result in an excessively loose fiscal stance being permitted while compliance with the fiscal rules is observed. Future pressure to loosen the fiscal stance further relative to current plans could be mitigated by allocating cyclical or transient revenues to other purposes and the Rainy Day Fund represents a useful tool for achieving this.

As Box A argues, the proposed design of the Rainy Day Fund can be strengthened in a number of ways. If the fund is to function meaningfully, annual allocations should give some consideration to cyclical conditions, while upper limits on allocations should not be imposed. Furthermore, the Department should engage with the European Commission further on developing a sensible basis for how the Rainy Day Fund can operate in conjunction with fiscal rules. The proposal suggests availing of one-offs, the unusual events clause and the structural reforms/investment clauses. These triggers, applicable only to very specific circumstances, may not prove effective in allowing the withdrawal of resources from the Rainy Day Fund as and when these resources are needed.

- iv. **Adhering to a target for public investment spending over the medium term would provide a sensible approach for guiding fiscal policy.** As Box G shows, public investment spending has been an area of government spending that has exhibited a markedly procyclical pattern in recent decades and it is set to ramp up again quite rapidly in coming years. Adhering to a targeted ratio of expenditure to GNI* (as suggested in the *Review of the Capital Plan 2016–2021*) would help to prevent forced cuts to public investment in future downturns and excessive expansions in good times.

²³ IFAC Endorsement Letter April 2017: <http://www.fiscalcouncil.ie/wp-content/uploads/2017/04/IFAC-Endorsement-Letter-04-04-2017-accessible.pdf>

Box A: Rainy Day Fund

This box discusses the Government's planned Rainy Day Fund. The Council assess that the Rainy Day Fund could be a potentially very useful countercyclical tool to ensure more sustainable growth and prudent management of the public finances. It welcomes the publication of a Consultation Paper on how the Fund might operate (Department of Finance, 2017d). Yet key issues have still not been addressed adequately, and the Fund envisaged in the Consultation Paper appears to be have been scaled back from initial plans. The Council identifies three key issues still to be addressed: (i) countercyclicality; (ii) interaction with the fiscal rules; and (iii) governance procedures.²⁴

(i) Countercyclicality

The fund envisaged by the Department of Finance does not appear to function as a countercyclical tool for fiscal policy (i.e., it does not act in a manner that would lessen past tendencies to ramp up spending and cut taxes during a cyclical upturn). The paper appears to indicate that part of the reason for this is that the *SGP* is "for the most part, designed to smooth 'normal' cyclical conditions". However, as Boxes B and E emphasise, there are good reasons to suggest that the *SGP* will fail to identify the cycle accurately and an additional tool is needed to manage the public finances in a manner that would help to avoid any procyclical bias evident in the fiscal rules.

Rather than responding to cyclical developments, it would appear that the fund, as proposed, would be set with pre-determined allocation limits that are applicable for a pre-determined period of time. Allocations are set at a maximum of €500 million annually over the three-year period 2019–2021 and there is no clear basis for how allocations are expected to vary within this limit. The Consultation Paper notes that the fund will be used to address "only specific events or shocks rather than the impact of the cycle". This runs contrary to the original purpose of the fund and it would contribute little to improving fiscal policy when the State already holds large reserves of liquid assets.

The prospect of a cap on total cumulative allocations to the fund is also outlined. This, again, would appear to be inconsistent with the idea of a countercyclical tool. If, for example, an upturn is strong and persists over a prolonged period of time, then allocations to the fund should be allowed to expand accordingly without constraints on its capacity to dampen the boom–bust cycle. Correspondingly, if a cyclical downturn were to ensue, then having pre-committed to making allocations to the fund would not be wise, nor would it be consistent with the principle of counteracting the cycle.

Plans for the fund have already exhibited a procyclical pattern whereby proposed allocations have been reduced as economic prospects have improved. Allocations to the Rainy Day Fund have been twice scaled back from original plans. As part of *Summer Economic Statement 2016* and *Budget 2017*, it was announced that €1 billion annual allocations would be made in 2019, 2020 and 2021. Yet the *Summer Economic Statement 2017* noted that these allocations would be halved to €500 million. Following this, *Budget 2018* noted that the €500 million allocations would instead be a maximum limit rather than a target for annual allocations. Over this time, real GDP growth forecasts produced by the Department of Finance for 2017 and 2018 have been revised upwards by 0.8 and 0.1 percentage points, respectively, such that – all else equal – the cyclical position of the economy would be more positive than assessed when the Rainy Day Fund was first proposed. Moreover, risks to the macroeconomic outlook are now assessed by the Department as broadly balanced, whereas at the time of *Budget 2017* they were viewed as firmly tilted to the downside. Against the backdrop of these reduced allocations, a decision was taken in *Budget 2018* to move €1.5 billion of existing liquid assets held by the Ireland Strategic Investment Fund to the Rainy Day Fund.

The Council is of the view that annual allocations to be made to the fund should give some consideration to cyclical conditions and that upper limits on allocations should not be imposed if it

²⁴ Many of these issues were highlighted by the Council prior to budget day in its *Pre-Budget 2018 Statement* (IFAC, 2017c).

is to function meaningfully. An example would be to link contributions to measures that track the underlying performance of the economy such as labour market data (Box B of IFAC, 2016b); underlying domestic demand; and/or wage inflation. Distortions are common in Irish economic data, and any single measure is unlikely to prove consistent and sensible basis for calibrating annual allocations to a countercyclical fund. A role for external monitoring could be considered in terms of the timing of allocations. One option would be to include a provision that suggests that allocations should be made to the fund whenever unemployment is below the Department's estimate of what is consistent with full employment (e.g., a non-CAM-based NAWRU estimate) with an explanation being required when this is not pursued.

Restricting the countercyclical nature of the fund runs the risk that transient revenues could – as in previous crises – be used to fund long-lasting expenditure increases. This is a possibility that is exacerbated by the procyclicality of the estimates of Irish potential output underpinning the fiscal rules (Box B) – an issue which a well-designed Rainy Day Fund can serve to mitigate.

(ii) Interaction with the Fiscal Rules

A key aspect of the Rainy Day Fund that still needs to be addressed is how it might interact with the fiscal rules. The Consultation Paper notes that withdrawals from the fund could be complicated by the fact that increasing spending funded by drawing on resources built up in the fund could ultimately breach the domestic and EU fiscal rules. For instance, the spending rule (the Expenditure Benchmark) sets a limit on real spending growth net of interest costs and new tax measures, while the domestic government expenditure ceilings are designed to set ceilings for aggregate departmental spending. Using the fund to increase spending over and above what is already permitted under the rules or ceilings could lead to breaches of the fiscal rules – especially if budgetary plans are set on the basis of assumed minimum compliance.

More options should be considered for how withdrawals from the Rainy Day Fund can operate without running the risk of breaching the fiscal rules. The Consultation Paper notes that the unusual event clause, the one-off classification, and the structural reform/investment clauses are avenues that could be used to enable withdrawals while still complying with the rules. These flexibilities are not designed for such mechanisms; they may not permit the envisaged scope for temporary departures from the rules; and the procedures governing when the clauses may be triggered may not be sufficiently well-defined to suit the purposes intended. A better approach would be to engage with the European Commission on means through which the rules could be adapted to ensure that Member States employing tools such as the Rainy Day Fund are not treated in a punitive manner.

(iii) Governance Procedures

Specific procedures governing how the Rainy Day Fund is to operate should be examined in more detail. As noted in the Consultation Paper, there is a risk that if resources are not properly safeguarded, these could be used to fund ongoing expenditure overruns. The safeguards which will be put in place to prevent such actions need to be robust and key to this process will be defining the reasons for which resources may be drawn from the fund.

In addition, greater consideration should be given to whether other structural issues (such as addressing the accrued liability of public service occupational pensions) will also be addressed by this fund or by other funds.

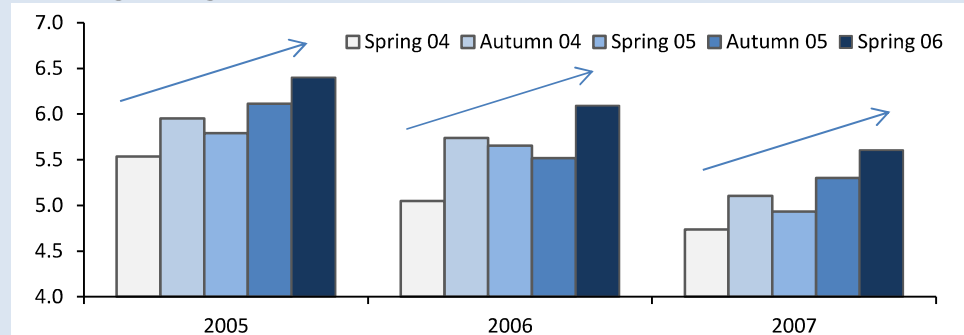
Box B: “Strong and Stable” – The Procyclicality of the CAM

This box highlights how the Commonly Agreed Methodology (CAM) used to estimate potential output for Ireland is prone to producing estimates that are very much procyclical (i.e., where estimates increase as cyclical recoveries ensue, and decline as downturns take hold).

This procyclicality is partly an issue caused by the methodology as applied to Ireland, but can also be a feature evident in many approaches to estimating potential output.²⁵ It is partly exacerbated by the regional nature of the Irish economy. In particular, sizeable labour market flows into and out of the country through migration can result in periods of self-reinforcing growth.²⁶

One way to demonstrate the procyclical nature of CAM estimates for Ireland is through the nature of revisions to estimates. Figure B1 shows the estimates of potential output for each of the years 2005, 2006, and 2007 as estimated in real-time over a number of forecast exercises (these exercises run from *Spring 2004* to *Spring 2006*). The estimates evolve in a way that moves procyclically (i.e., such that revisions to potential output estimates chase upward revisions to actual growth rates as the cycle improves). This is in part a consequence of (i) newly available “first” estimates of real GDP; (ii) new forecasts of real GDP for years ahead; and (iii) revisions to historical real GDP estimates.

Figure B1: Upward Revisions to Potential Output Growth Rate Estimates
Percentage Change, Year-on-Year



Sources: European Commission (CIRCA); and internal IFAC calculations.

Table B1 shows that this procyclicality is driven by expanding contributions from the net capital stock and from labour inputs. As the property/credit bubble took hold in the mid-2000s, rising construction activity contributed to greater levels of capital accumulation, while falling unemployment rates and rising participation rates led to greater contributions from the labour market. Both features led to rising estimates of potential output growth as the estimates failed to sufficiently account for what would ultimately prove to be transient developments.

Looking more closely at the determinants of labour inputs to potential output over the same expansionary period (2005-2007), we see that all of these inputs evolve in a way that contributes to higher estimates of potential output growth rates (Table B2). The estimated natural rate of unemployment in 2005 (the “NAWRU”) falls by half a percentage point between the *Spring 2004* and *Spring 2006* vintages. As such, the view of “full employment” as implied by the CAM becomes

²⁵ The European Commission also acknowledges issues with procyclicality in the same Production Function (PF) approach. Mc Morrow *et al* (2015), for instance, note that “revisions to the PF’s output gap estimates in the pre-crisis period were roughly five times greater than those of the post-crisis, 2009–2014, period...a particularly humbling statistic given that one of the EU’s primary motivations in 2002 for moving away from the HP filter to the PF approach was the expectation of reduced levels of procyclicality (especially in the upswing stage of cycles)”. For useful explorations of the procyclicality issue in a wider context, see Borio *et al* (2014); Heimberger and Kapeller (2017); and Kuusi (2017).

²⁶ There is a tendency for Ireland to demonstrate characteristics more like those of a regional economy than a typical national economy. This is in part a reflection of its small and open nature. Behaviours such as periods of self-reinforcing growth may be evidenced, for example, when inward migration supports scale economies and incomes, thus attracting further inward flows.

one that is consistent with much lower unemployment rates than initially implied by the method. In addition, the expected trend participation rate for the labour force in 2005 rises by 2.7 percentage points over the successive forecast rounds, while the working age population is seen to grow at a pace that is 1.2 percentage points faster than first estimated. While the latter reflects newer historical information and population projections, the trend participation rates and NAWRU estimates are unobservable variables where procyclicality is in part a feature of the estimation process.

Table B1: Revisions to Contributions to Potential Output Growth Rates

Changes in contributions, percentage points of potential output growth rates
(*Spring 2006 minus Spring 2004 forecast exercise*)

	Labour	Capital Stock	TFP
2005	0.2	1.0	-0.4
2006	0.4	1.1	-0.5
2007	0.3	1.1	-0.5

Sources: European Commission (CIRCA); and internal IFAC calculations.

Notes: TFP refers to the estimated contribution from growth in trend Total Factor Productivity.

Table B2: Revisions to Labour Input Determinants

Changes in percentage points (*Spring 2006 minus Spring 2004 forecast exercise*)

	NAWRU (% Labour Force)	Working Age Population (% change year-on-year)	Trend Participation Rates (% working age population)
2005	-0.5	1.2	2.7
2006	-0.2	1.3	3.0
2007	0.0	1.0	3.2

Sources: European Commission (CIRCA); and internal IFAC calculations.

Notes: Changes show revisions for each year's estimates between the *Spring 2004* vintage and the *Spring 2006* forecast exercise.

The problem of procyclicality suggests that potential output estimates under the CAM could evolve in future years in a way that is unduly determined by actual real GDP outturns. Upside risks to many of the determinants of potential output estimates are foreseeable in the near future. One plausible scenario for the coming years might see a sharper-than-expected construction recovery take hold as pent-up demand in housing supply is addressed. Should this scenario materialise, it could well see even higher estimates of potential output growth as measured under the CAM compared to the central scenario in *Budget 2018*. This could arise if increased labour force participation, higher inward migration flows and stronger capital accumulation arise in response to stronger residential construction activity.

How potential output growth rates evolve over time will be important for the reference rates that determine “sustainable” growth rates for government spending under the spending rule (the Expenditure Benchmark). The Department’s forecasts envisage Ireland’s medium-term annual growth rate as tending towards 2½ per cent by 2021 – an estimate that is largely influenced by the modelled impact of a hard Brexit on long-run growth rates. This compares to the reference rate implied by a ten-year average of potential output estimates produced under the CAM of 3.8 per cent for 2021. An issue arises if a gap of this size were to persist and if all of the space allowed under the spending rule were to be availed of. Such a policy could result in a divergence emerging over time between “sustainable” spending levels (as informed by CAM-based estimates) and “actually sustainable” spending levels (as more appropriately measured).