

1. Assessment of Fiscal Stance

Key Messages

- A strong cyclical recovery and substantial consolidation effort, particularly in the early years of the crisis, has helped to improve Ireland's budgetary position. This has led to an important milestone in 2017: the achievement of the Medium-Term Objective (MTO) of a structural deficit of 0.5 per cent of GDP. From an economic perspective – and in terms of the technical application of the fiscal rules – the Government's budgetary position is currently close to balance.
- Ireland's government debt burden is still among the highest in the OECD and negative shocks will inevitably occur in future years. A further loosening of current plans as the economy and revenues improve risks missing the window of opportunity to return debt to safer levels and to make the public finances more resilient to shocks.
- Improvements on the budgetary front have slowed more recently even as the cyclical recovery continues and is reinforced by a number of favourable tailwinds. Non-interest spending has risen at essentially the same pace as buoyant cyclical tax revenue since 2015 and the structural position is likely to deteriorate in 2018. In recent years, spending drift has been allowed to absorb all of the unexpected revenue gains.
- The Government's current plans as set out in *SPU 2018* would be appropriate provided that these are followed through on. Yet improving the budget balance more than currently planned would be desirable, especially given the risks of overheating and the opportunity provided by favourable times. Any revenues arising from a faster-than-expected recovery in housing construction should therefore be used to build buffers. This could take the form of either additional contributions to the Rainy Day Fund or through faster debt reduction. This is all the more important when there are obvious downside risks over the medium term including those associated with Brexit, US trade policy and the international tax environment.

- For 2019, there is no case for additional fiscal stimulus. The appropriate policy would be to increase government expenditure broadly in line with the long-term potential growth rate of the economy plus inflation. This would imply an approximate limit of up to €3½ billion for spending increases or discretionary tax cuts (i.e., the “gross fiscal space”) as a starting point for budgetary plans for 2019. Anything more expansionary than this suggested maximum limit is not likely to be appropriate. Prudence is all the more important when there are obvious downside risks over the medium term, including those associated with Brexit and international tax policy.
- Given existing spending commitments and the planned contribution to the Rainy Day Fund, this reduces the scope for additional measures in Budget 2019. If additional priorities are to be addressed, these should be funded by additional tax increases or through re-allocations of existing spending. Any unexpected increases in tax revenues or lower interest costs should not be used to fund permanent budgetary measures.
- The Government needs a credible plan for the medium term. Focusing on the right budgetary stance and being prepared to be more cautious than the fiscal rules allow is the correct approach for the Government to follow. Yet there are a number of challenges to following such a policy as Ireland exits its latest crisis and there is no scope for complacency. In particular, there is a danger that the current policy framework is insufficiently equipped to prevent a return to procyclical fiscal policy. Sensible policy tools recently introduced need further development if they are to be effective. The Rainy Day Fund should operate more as a countercyclical tool, while the debt target and medium-term budgetary framework are not properly implemented. The shortening of the horizon in the government’s projections from five- to three-years-ahead is not conducive to the aim of achieving medium-term fiscal stability.

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

	2015	2016	2017	2018	2019	2020	2021
General Government							
Revenue ¹	41.0	38.5	37.9	37.2	36.9	36.6	36.5
Expenditure ¹	42.6	39.5	38.3	37.6	37.1	36.2	35.9
Balance ¹	-1.6	-1.0	-0.4	-0.4	-0.2	0.4	0.6
Interest Expenditure	4.0	3.3	2.9	2.5	2.3	2.2	2.0
Primary Expenditure ¹	38.7	36.2	35.4	35.1	34.8	34.0	33.9
Primary Balance ¹	2.3	2.3	2.5	2.1	2.2	2.6	2.6
Real Expenditure Net of DRMs (% Change) ²	5.9	-1.2	3.1	1.5	2.2	0.9	2.9
CAM Structural Balance (% GDP) ³	-1.5	-0.9	-0.5	-0.9	-0.4	0.1	0.3
Change in CAM Structural Balance (p.p.) ³	1.9	0.6	0.5	-0.4	0.5	0.5	0.2
CAM Structural Primary Balance (% GDP) ³	1.1	1.3	1.5	0.8	1.2	1.5	1.7
Change in CAM Structural Primary Balance (p.p.) ³	0.6	0.2	0.2	-0.7	0.3	0.3	0.1
Debt							
Gross Debt	116.6	106.0	100.1	96.9	93.6	88.9	86.8
Net Debt	99.8	92.8	86.7	83.0	80.6	78.7	76.3
Gross Debt (% GDP)	76.9	72.8	68.0	66.0	63.5	60.2	58.7
Net Debt (% GDP)	65.8	63.7	58.9	56.5	54.7	53.3	51.6
Gross Debt (% Revenue)	284.5	273.4	264.2	260.2	253.5	243.2	237.8
Net Debt (% Revenue)	243.5	239.3	228.9	222.9	218.2	215.3	208.9
Output							
Real GDP Growth (% Change)	25.6	5.1	7.8	5.6	4.0	3.4	2.8
Nominal GDP Growth (% Change)	34.7	5.2	7.5	5.6	5.4	4.7	4.3
Nominal GDP Level (€bn)	262.0	275.6	296.2	312.8	329.6	345.1	360.0
Nominal GNI* Growth (% Change)	11.9	9.4	6.3	5.9	5.0	4.5	4.2
Nominal GNI* Level (€bn)	172.9	189.2	201.2	213.0	223.6	233.6	243.5
Potential Output (% Change) ⁴	24.0	4.6	6.6	5.0	3.1	3.1	2.7
Output Gap (% Potential GDP) ⁴	-2.4	-2.5	-1.6	-1.0	0.3	0.8	0.9
Miscellaneous							
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

¹ One-offs/temporary measures excluded to get a sense of the underlying fiscal position are those assessed as being applicable by the Council. These comprise the AIB transaction in 2015 (€2.11 billion); an amount related to the EU Budget contribution for 2016 (€0.17 billion); the European Financial Stability Facility (EFSF) pre-paid margin in 2016 (€0.55 billion); and the cost of refunding water charges 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). It is non-interest spending growth net of any discretionary revenue measures (e.g., tax increases/cuts). Measures that lead to additional revenues allow equivalent increases in spending growth; measures that reduce revenues constrain the pace of spending growth allowed under the rules.

³ These are based on the latest supply-side estimates derived under the Commonly Agreed Methodology (CAM), which has a number of drawbacks that can lead to inappropriate estimates for Ireland (Box B and E, IFAC 2017e).

⁴ These estimates are based on the Department's preferred GDP-based alternatives to the CAM as in *SPU 2018*.

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 reflected in the *Stability Programme Update (SPU)* 2018.

The Council's assessment of the fiscal stance is informed by the extent of compliance with the fiscal rules, along with a complementary economic assessment. The economic assessment takes into account the state of the public finances, the stage of the economic cycle, and growth prospects for the economy.

1.2 The Recent Macroeconomic and Fiscal Context

Macroeconomic Context

The pace of the recovery in the Irish economy has been rapid since at least 2014, even when leaving aside the activities of foreign-owned companies and focusing on underlying Irish developments. This follows the steep contraction amid the financial crisis from 2008/2009 and a subsequent stagnation in growth up until as late as 2013.

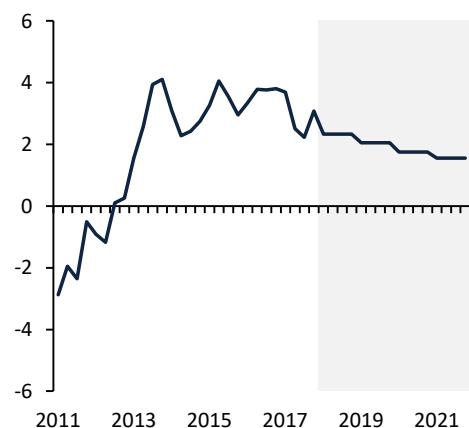
Looking across a number of indicators, the Irish economy still appears to be growing very fast. Figure 1.1 summarises some of the indicators that attempt to look through distortions arising from the activities of foreign-owned multinational enterprises (MNEs), which can often lead to a misleading picture of underlying activity (Chapter 2 assesses the *SPU 2018* macroeconomic forecasts in more detail).

Starting with the labour market, employment has risen by an average of just over 3 per cent year-on-year for five years now and has only recently moderated. Within this, full-time employment has surged as workers take up employment with longer working hours and move out of part-time employment. The rise in numbers in full-time employment is 5.8 per cent for 2017 – the fastest annual increase since 1999.

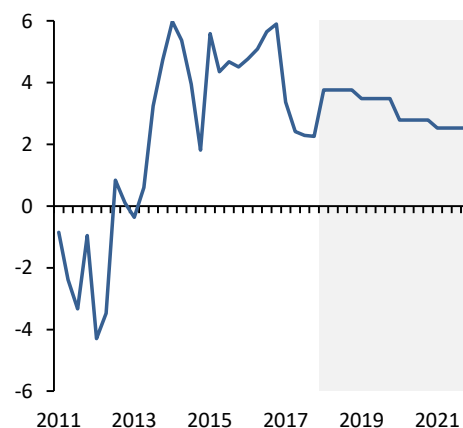
Figure 1.1: Indicators of Economic Activity

Percentage year-on-year change in volumes, unless otherwise stated

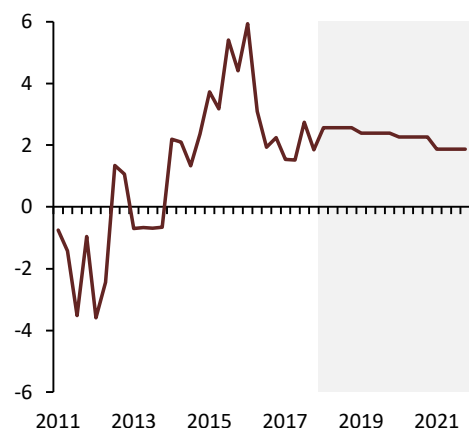
A. Employment



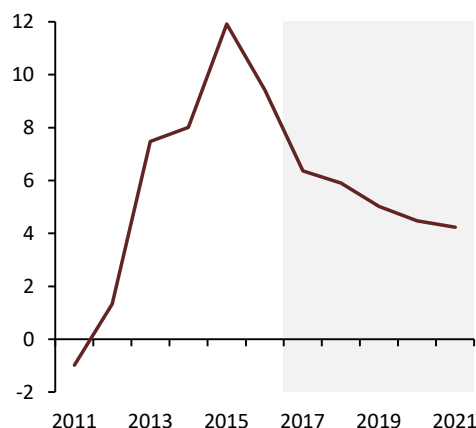
B. Underlying Domestic Demand



C. Personal Consumption



D. Nominal GNI* [Different Scale]



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

Note: SPU 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.

Turning to the national accounts, the recovery is also visible in various measures of domestic economic activity. Underlying domestic demand is one useful aggregate given its tax-rich nature and the relatively limited distortions arising from the MNE sector.¹ This has grown by just over 4 per cent per annum on average from 2013 to 2016. While the speed of expansion appeared to moderate to 2.6 per cent last year as business investment was scaled back, the recorded moderation of consumer spending is likely to be overstated. Upward revisions to the initial outturn, which seem likely, would also imply less of a slowdown in the pace of growth of underlying

¹ Underlying Domestic Demand strips out investment in intangibles and aircraft as these are, in the main, imported, with little impact on real GDP.

domestic demand during 2017 (Chapter 2). Nominal GNI* – an official measure designed to rid standard macroeconomic aggregates of MNE-related distortions – is estimated by the Department to have grown by 6.4 per cent last year.²

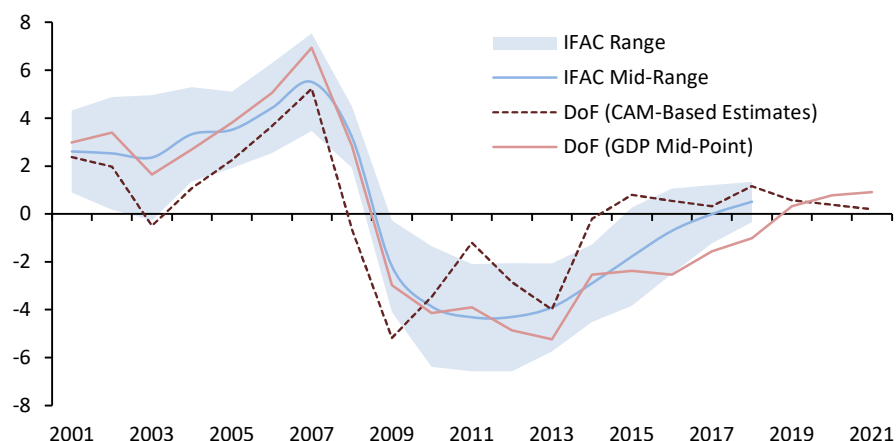
The forecasts in *SPU 2018* assume a continuation in the recent momentum in the domestic economy and incorporate a reasonably strong outlook for Ireland's main trading partners. Though the forecasts show that the recent pace of growth is set to moderate over the next three years, it will still remain strong compared to most advanced economies.

The pace of the recent recovery is supported by a cyclical upswing (Figure 1.2). Although there is much uncertainty, most coherent estimates suggest that domestic economic activity has been growing faster than the economy's potential growth rate since at least 2014. This is reflected in the Council's own suite of models of the output gap, which have closed from a negative position that opened up sharply after 2008. These estimates appear to show that the economy is producing close to its medium-term potential in 2018, while the Department's own preferred range of estimates – published for the first time in the current SPU – suggest that the economy will move beyond its potential in 2019.

The progress made by the Department towards developing new estimates of the output gap for Ireland is a significant step and is welcome (Box D). These estimates should form an essential part of the Department's toolkit for the purposes of producing well-founded medium-term forecasts in future. They should also help to provide a sounder basis for setting the economy and the public finances on a sustainable path. The Council also welcomes the intention of the Department to include these estimates in the headline table of macroeconomic indicators in future endorsement rounds, as well as in the headline tables of macroeconomic indicators for its future SPU and Budget publications. This would see the new alternatives replace those estimates that are based on the CAM, which are not regarded as reliable (but which are likely to continue to be used for fiscal surveillance).

² GNI* is an aggregate designed to more accurately capture Irish residents' national income compared to GDP. For Ireland, the standard GDP measure 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. Note that the nominal growth rate for underlying domestic demand in 2017 is estimated by the CSO to have been 5½ per cent – roughly one percentage point below the nominal GNI* growth rate. The CSO have not yet published a GNI* figure for 2017.

Figure 1.2: Ireland's Cyclical Recovery
Output gap estimates (percentage of potential output)



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

Note: The IFAC range is produced based on a variety of approaches. These are outlined in Casey (2018). 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 estimates shown here are based on a range of alternative GDP-based methods.

Both the Council's and the Department's estimates of the output gap are produced using a number of approaches that are more suited to the Irish economy than the standard Commonly Agreed Methodology employed by the European Commission. Moreover, the diversification afforded by applying a range of approaches is a sensible way of reinforcing the robustness of the estimates produced. This is particularly true as the relevance of any single-model paradigm may vary over time (e.g., with the financial crisis) and given that there are obvious limits to the informational content of individual approaches.

While the central scenario depicted in the Department's forecasts is relatively benign, the prospects for the Irish economy are uncertain and there are very different plausible scenarios both on the upside and downside. Chief among these is the risk that Brexit turns out to have a worse-than-expected impact on the Irish economy. A second key risk is that changes to the international tax environment could lead to a slowdown in foreign direct investment or even a potential exit of some large corporate groups that are resident in Ireland. Domestically, a substantive upside risk relates to the burgeoning pressures in the residential construction market where persistent undersupply has been evident. This could well lead to a rapid uptick in housing output. In turn, this could prompt overheating in the economy, where levels of unemployment are already falling steadily.

While the timing of any future slowdown or downturn is hard to predict, it is inevitable that – at some point in future years – the state of the economy will become less favourable than it is today. Box A notes that post-war expansions in employment and output have tended to last around 4½ –6 years on average. The Department’s latest forecasts suggest that employment will continue to expand nine years on from its most recent contraction, which ran from 2008 to 2012. Age (or duration) is a poor predictor of turning points, yet there are foreseeable risks and potential imbalances in the economy that should be monitored closely.

Quantifying the impact of the downside risks is difficult given the relatively limited historical precedent for such events. It is therefore important that the Government develops more robust scenario analyses building on potentially more-adverse-than-assumed outcomes relative to its central forecasts. Box C in Chapter 2 examines some of the avenues that should be explored in relation to the possible impact of a large, foreign-owned multinational firm exiting Ireland.

Box A: The Duration of Cycles: Death by Illness, Not by Age

This box examines cycles in economic output and employment to give a sense of how long these typically last.

In the US, the National Bureau of Economic Research (NBER) acts as the official arbiter of the business cycle. It provides timings of peaks and troughs in economic activity. Its definition of recessions is broad and comprises an assessment of many measures of broad activity including real GDP, employment and real income. Correspondingly, expansions are recorded as periods outside of recessions (i.e., between a trough and a peak in output).

Table A.1 shows the typical duration of expansions in output as documented by the NBER. For the longest available period of data up to the financial crisis (1854–2009), the typical length of an expansion in real GDP in the US has been just over three years, with contractions lasting close to 1½ years on average. Looking at the post-war period (1945–2009), the NBER shows that the average expansion duration lengthened to almost five years, with typical contractions shortening to just under one year.

Table A.1: Durations of Expansions in Output and Employment

Country	Source	Sample	No. of Cycles	Contraction (years)	Expansion (years)
Output Cycles					
US	NBER	1854–2009	33	1.5	3.2
US	NBER	1945–2009	11	0.9	4.9
US	IFAC Workings	1948–2009	9	0.5	5.8
Employment Cycles					
US	IFAC Workings	Q1 1948–Q1 2009	10	0.8	4.7
UK	IFAC Workings	Q2 1960–Q1 2009	8	1.0	5.2
Ireland	IFAC Workings	1960–2009	7	2.5	4.4

Sources: NBER; and internal IFAC calculations.

Notes: Durations are taken as an average of the Bry and Boschan (1971) and Markov-Switching model except in the case of Ireland where the latter fails to converge.

Table A.1 also replicates some approaches that are commonly used to identify business cycle durations. First, the Bry and Boschan (1971) dating algorithm is used, which is commonly applied to examine business cycle peaks and troughs. Second, a Markov-Switching model similar to that of Hamilton (1989) is implemented.³ The average durations from the two approaches are shown (these typically correspond quite closely). For US output, the durations of expansions are similar to those identified by the NBER, albeit a little longer (expansions are estimated as closer to six years whereas contractions are estimated to typically last half a year).

Applying the approaches used for US output to employment, we can derive estimates of employment cycles. The approaches suggest that for the US, expansions in the employment cycle typically last close to five years, with contractions lasting close to one year (very similar to those for output). UK data show virtually the same durations as the US. For Ireland, employment expansions are estimated to average close to 4½ years.

Imbalances and Rigidities Are More Important

While the typical length of expansions and recessions is somewhat informative, it is important to note that these historical averages are drawn from relatively small samples and they may not be good predictors of when an expansion might end. The end of any individual expansion may be said to have more to do with the build-up of imbalances and rigidities in the economy than it has to do with age itself. In other words, the fact that an expansion has lasted for a long time does not tell us very much about the likelihood of a coming recession.

Rudebusch (2016) uses a survival analysis akin to actuarial assessments for people’s expected lifespan to assess the end of US expansions historically. The findings suggest that since the 1940s, US expansions into their 80th month (6th year) have the same probability of ending as expansions in their 40th month (3rd year).

Recognising the importance of assessing imbalances in the economy so as to understand the sustainability of the budgetary position, the Council uses a “Modular Approach” (Chapter 2). The Modular Approach involves assessing a broad range of indicators of potential imbalances in the economy. This approach can help to deal with the fact that macroeconomic models tend to have a poor track record in terms of identifying turning points. There are also obvious risks of these occurring over the medium term. In particular, Brexit negotiations could lead to more adverse outcomes for Ireland than expected, while further risks are posed by international tax policy.

Fiscal Context

Against a backdrop of high debt levels, improvements on the budgetary front have slowed in recent years even as the cyclical recovery continues and is reinforced by a number of favourable tailwinds. Non-interest spending has risen at essentially the same pace as buoyant cyclical tax revenue since 2015. This means that the budget balance excluding interest and one-offs has remained close to 2–2½ per cent of GNI* over the period 2015–2017 and it is forecast to stay around this level out to 2021.

Assessing the government’s budget balance is complicated by factors such as one-off items; the effects of the cycle; and spending outside of the government’s control.

³ As noted in Owyang *et al.* (2005), a key shortcoming of the BB approach relative to the MS approach is that the magnitude of growth rates needed to trigger a regime shift does not change from state to state, instead remaining constant over time.

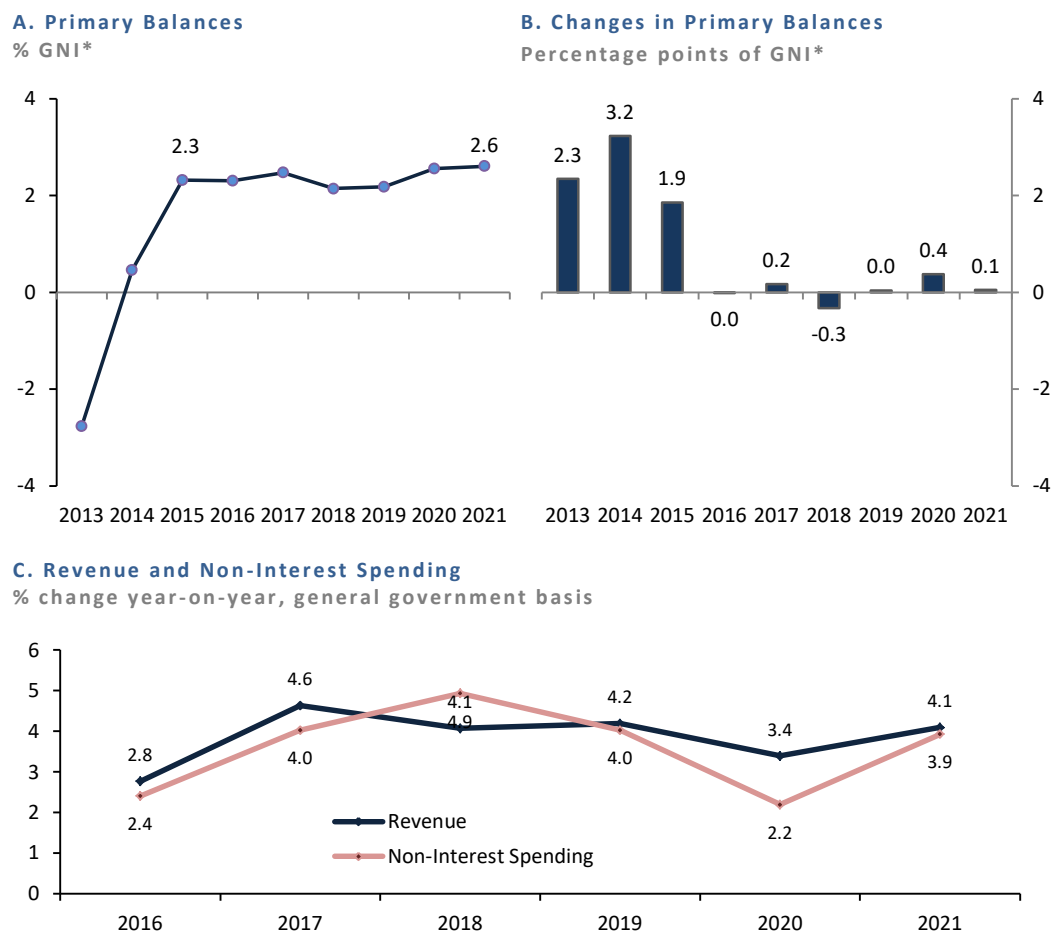
With this in mind, the Council focuses on fiscal aggregates that may be considered useful indicators of how recent or envisaged policies will influence the fiscal stance and debt sustainability.

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 transient items assessed by the Council as unrepresentative of the underlying picture are removed (Table 1.1 provides these one-off items).

Figure 1.3 shows that since 2015, there has been barely any improvement in the primary balance when one-offs are stripped out. The lack of improvement is somewhat surprising considering the ongoing cyclical recovery, which has been supported by a number of favourable tailwinds including an exceptionally loose monetary policy environment; reasonably strong external demand growth; and strong corporation tax receipts.

Chapter 3 highlights how the slowing improvements in the deficit have been partly due to spending drift: the Government has loosened its planned budgetary policy over time as growth turns out to be better than expected. Growth in underlying domestic demand was more than twice the pace that was initially expected over 2015–2017 (taking *Budget 2015* forecasts). At the same time, upward revisions to spending plans across a broad range of non-interest areas over this period amounted to a cumulative €17.8 billion – more than offsetting the higher-than-expected revenues that came in (€17.2 billion). The only expenditure item which was lower than anticipated was interest payments (€4.3 billion) – the driver of the improvement in the headline budget deficit. This would imply that essentially all of the gains from the faster-than-expected recovery over this period, aside from lower interest payments, may have been used for spending increases.

Figure 1.3: The Primary Balance Has Barely Improved Since 2015



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

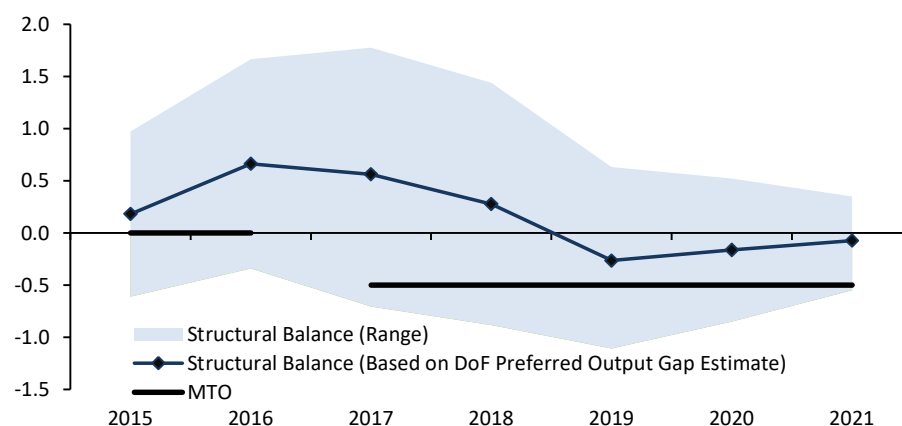
Note: Data are adjusted to exclude one-offs as assessed by the Council (Table 1.1). In 2021, a capital transfer of €900 million boosts spending growth from 2.8 per cent to 3.9 per cent (Chapter 3).

An important milestone in attaining the Medium-Term Objective (MTO) of a structural deficit of 0.5 per cent of GDP was attained last year. This achievement has been helped to a large extent by a fall in interest costs over the past three years. Interest costs have fallen by 1.1 percentage points of GNI* from 2015 to 2017, while the budget balance and structural balance have improved by almost exactly the same amount (Table 1.1). From an economic perspective – and in terms of the technical application of the fiscal rules – the Government’s budgetary position is close to balance. With the output gap believed to be almost closed, the headline deficit would remain close to its level when adjusted for the cycle. However, there are risks that this position could deteriorate in coming years and a reliance on savings on interest costs could prove unwise.

Using the Department's preferred estimates of the output gap to assess the structural balance would also suggest that the MTO is likely to have been achieved in 2017. On this basis, the structural balance estimates range from -0.7 to $+1.8$ per cent of GDP as compared to the MTO requirement of -0.5 per cent for 2017 (Figure 1.4).

Figure 1.4: The Achievement of the MTO (assessment using alternative output gap estimates)

Percentage of GDP



Sources: Department of Finance; and internal IFAC calculations.

Note: The range is based on the Department's preferred range of alternative estimates of the output gap used in *SPU 2018* (i.e., those based on GDP). The same semi-elasticity of the deficit to the output gap is used as for the CAM. The MTO is the targeted level of the structural balance.

Ireland's net government debt burden remains among the highest in the OECD and is understated by standard GDP comparisons. When set against a more comparable measure of national income like GNI*, the net debt burden is equivalent to 86.7 per cent, the sixth highest behind only Italy, Portugal, Belgium, France and Japan (Figure 1.5).⁴ A similar picture emerges when it is compared to revenue (Ireland's is the fifth highest ratio of annual government revenue at 228 per cent).⁵

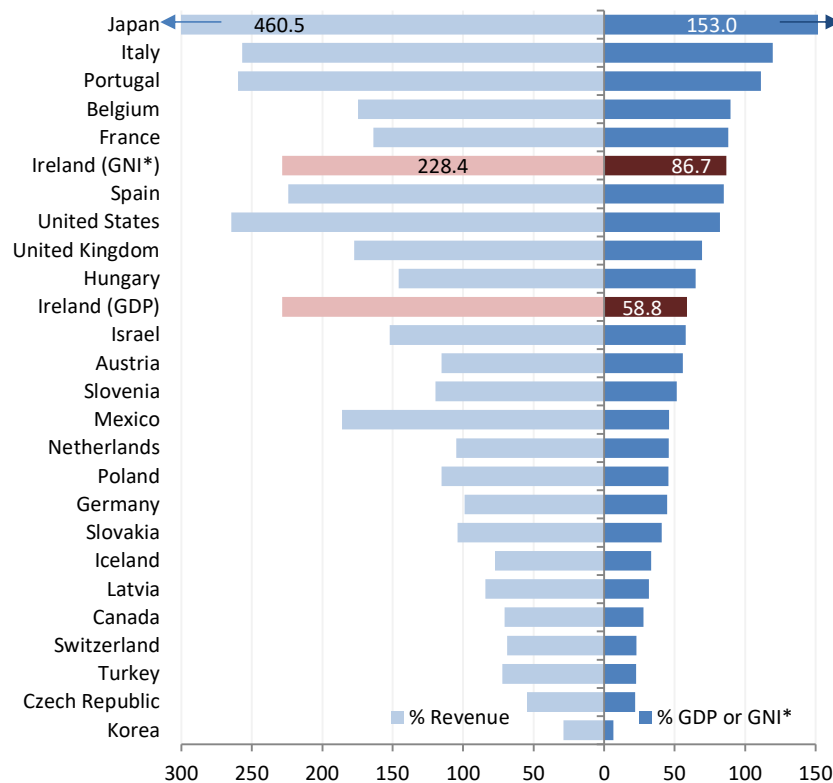
The Government's current plans envisage a steady pace of debt reduction from its current high levels. Figure 1.6 highlights the steep rise in debt ratios post-crisis as sharp losses in transient revenue streams associated with the property/credit bubble coincided with costly banking support measures. The *SPU 2018* plans suggest that net debt levels will fall steadily from 86.7 per cent of GNI* at end-2017 to 76.3 per cent by end-2021, helped by economic growth; low interest costs; and a primary surplus.

⁴ Note that net debt data are not available for Greece.

⁵ Debt-to-revenue ratios are problematic as they capture *actual* tax revenue rather the *potential* tax base. Nevertheless, the ratios based on government revenue are likely to give a more informative and transparent picture of changes in the fiscal position over time than those based on distorted GDP data and they are on a like-for-like basis when comparing with other countries.

Figure 1.5: OECD Countries' Net Government Debt

End-2017 net general government debt as % revenue (LHS); and as % GDP or GNI* (RHS)

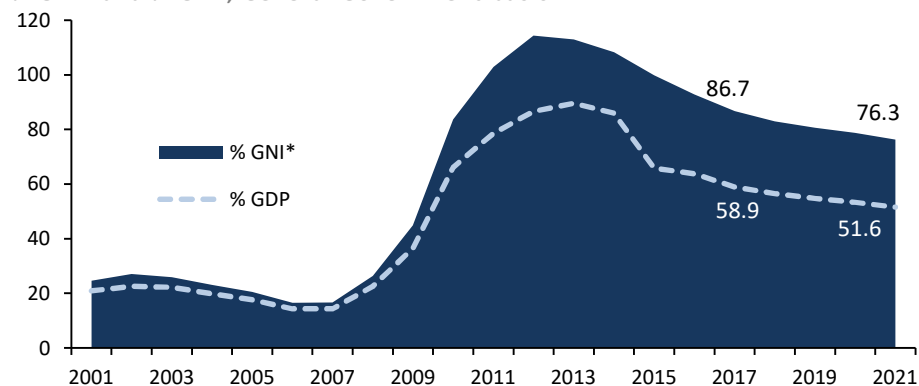


Sources: CSO; Eurostat; IMF (October 2017); and internal IFAC calculations.

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 1.6: Ireland's Net Government Debt Levels

% GNI* and % GDP, General Government basis



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

If the average pace of debt reduction envisaged over 2019–2021 were to remain constant from 2021, falling by 2.2 percentage points per annum, the debt-to-GNI* ratio would still remain high by the end of the next decade (i.e., between 50 and 60 per cent), and would be more difficult to achieve if any adverse shocks occurred.

1.3 Assessment of the Fiscal Stance for 2018–2021

Considering the prospects for the economy and the fiscal context, this section assesses the Government’s planned fiscal stance for the forecast years.

Fiscal Stance in 2018

Starting with 2018, it would appear that there is a slight deterioration in the underlying fiscal position. The Department’s preferred estimates of the output gap show a cyclical upturn in 2018, with the economy growing faster than its potential. The Council’s own estimates paint a similar picture. Given the cyclical upturn, the lack of improvement in the headline balance excluding interest costs would appear to mask an underlying disimprovement if one were to look through temporary cyclical effects. Based on the Department’s estimates, the structural primary balance (i.e., the budget balance excluding interest costs, one-offs, and the effects of the cycle) looks likely to deteriorate this year by about half a percentage point of GDP – similar to Council estimates (Figure 1.7).

The disimprovement in 2018 reflects non-interest spending being increased at a faster pace (4.9 per cent) than forecast government revenues (4.1 per cent). Non-interest spending increases amount to €3.3 billion over the year. These are mainly reflected in higher public investment (+€1.3 billion in 2018); increased spending by government on goods or services for the purposes of providing their own services (intermediate consumption is +€0.9 billion); and an increase in the overall public sector pay bill (+€0.7 billion). Notably, the increase in public investment in 2018 – at 23.5 per cent – is now forecast to be faster than had been anticipated at budget time, largely as a result of the additional spending outlined in the capital plan and the reclassification of Approved Housing Bodies (Chapter 3).⁶

Fiscal Stance in 2019–2021

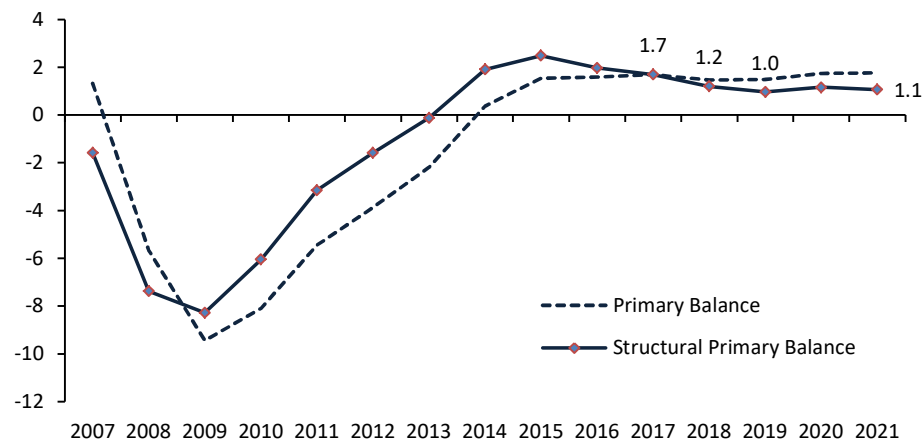
The budget balance is currently planned to improve to 0.6 per cent of GNI* in 2021 from –0.4 per cent in 2018 – an improvement of 1 percentage point. However, falling interest costs account for 0.5 percentage points of the improvement. Furthermore, a continued cyclical upswing is expected after this year: the output gap is expected to rise by close to 1 percentage point between 2018 and 2021 based on the Council’s mid-range estimates. This would imply that the continued

⁶ *Budget 2018* forecasts suggested public investment spending of €6.2 billion in 2018, whereas for *SPU 2018*, which incorporates the new capital plan, public investment spending is forecast at €6.8 billion.

cyclical upturn explains the rest of the improvement in the balance over 2019–2021 so that the structural position is broadly unchanged (Figure 1.7).⁷

Figure 1.7: Primary Balance

% GDP, General Government basis



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

Note: The structural primary balance strips out one-offs from the headline primary balance (expressed as a share of GDP) and the cyclical component is subtracted as $0.53 \times$ the level of the Council's mid-range output gap estimate (the same approach as adopted for CAM-based estimates).

However, the fiscal rules would allow a further easing of policy as a result of mismeasurement of the cycle, as happened in the 2000s. A key shortcoming of supply side estimates underpinning the fiscal rules is that they are prone to mismeasuring the cycle. This mismeasurement can exhibit a procyclical pattern whereby the allowed pace of growth in spending rises in good times, and falls in bad times. For Ireland, this is obvious from the allowed growth rates for real net spending that would have applied historically (Figure 1.8). It is also visible in other economies, albeit to a lesser extent, which partly reflects the volatility of real GDP growth in Ireland.

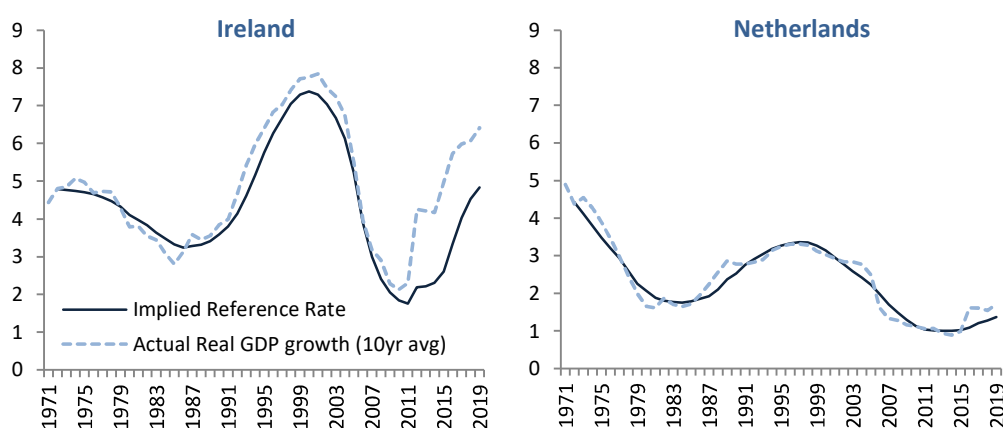
The procyclical application of the fiscal rules means that the allowed pace of growth in net spending is beginning to expand as the cyclical recovery continues. Already, the estimates of “sustainable growth” rates that underpin the fiscal rules have risen to close to 4½ per cent in 2018 even before inflation is considered – the upper range of estimates of potential output growth for the Irish economy – and they are rising from one vintage to the next. This results in rising amounts of fiscal space being estimated as allowable over time.

⁷ Note that this assumes that the responsiveness of the deficit to the Department's new output gap estimates is the same as estimated for the CAM.

The government has correctly set out a budgetary stance that is more cautious than the fiscal rules. While some of the expanded fiscal space has been allocated to additional investment spending (as outlined in the capital plan), other amounts remain unallocated. The unallocated amounts of fiscal space under the government's plans are back-loaded to the later years of the forecast horizon. Given recent spending drift and likely spending pressures in later years (see Chapter 3), it may be challenging to pursue these policies.

Figure 1.8: Procyclicality of Allowed Real Spending Growth Rates Under the Fiscal Rules

% change year-on-year



Sources: European Commission (Autumn 2017 estimates); internal IFAC calculations.

Note: Data show the implied allowed real spending growth rates based on ten-year averages of the estimated potential output growth rates derived using the Commonly Agreed Methodology.

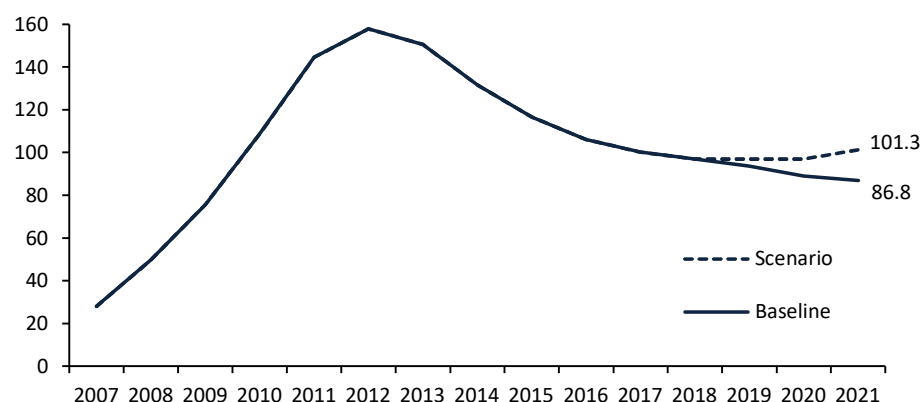
There are good reasons why a loosening in current fiscal plans in coming years should be avoided. With debt levels high and large downside risks on the horizon, revenues arising from any short-run cyclical upturn would be better used to build safeguards against adverse shocks in future. In particular, Brexit and potential changes to the international tax environment would caution against current plans being loosened further. Such shocks could have sustained negative effects on the economy that could make debt reduction more challenging over the long term. Should these risks materialise, this would imply that expenditure would need to adjust to a lower path or tax would need to rise. The Council's advice is intended to avoid the need for any such retrenchment.

The steady pace of debt reduction in *SPU 2018* is broadly appropriate, but there are risks to the trajectory, especially from growth. One scenario could see a sharp and sustained reduction in growth rates relative to *SPU 2018* forecasts. 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 (Box C). Assuming a typical forecast error for each of the years 2019, 2020 and 2021, the debt-to-GNI* ratio could stagnate at levels above 100 per cent of GNI*, absent any policy response. This compares to a planned reduction to 86.8 per cent (Figure 1.9). With debt at high levels, the impact of such shocks on creditworthiness can be more pronounced.

Figure 1.9: Illustrative Shock Scenario from 2019 Onwards

Gross debt as % of GNI*, general government basis



Sources: CSO; Department of Finance (*SPU 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 (-2pp 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.

There are also important upside risks to the forecasts in the next couple of years. In particular, these relate to the potential response of the residential construction sector to persistent supply shortfalls. The resulting employment and income growth would be expected to add substantially to cyclical tax revenues, while the economy already looks to be operating close to its potential. It may be necessary to counteract any associated overheating through offsetting measures elsewhere. The Government should take account of the fact 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 *SPU 2018* materialise) would not necessarily be permanent in nature.

A better use of resources from any cyclical upswing would be to use such revenues to build additional buffers (as in the Rainy Day Fund) or to reduce debt at a faster pace.

This is also true of potentially unsustainable revenue sources such as higher-than-expected corporation tax receipts.

Statements from the Minister for Finance and Public Expenditure and Reform have emphasised the importance of focusing on the “right budgetary stance” rather than on the amount of fiscal space available under the rules.⁸ Focusing on the right budgetary stance and taking a view that is broader than the limits allowed under a technical application of the fiscal rules is the correct approach for the Government to follow. One way to assess this over time would be to establish whether current plans are followed through on rather than being loosened in later years. This follow-through will prove challenging should a stronger-than-expected economic performance and higher revenues materialise as pressures for further spending increases emerge.

Savings on interest costs should not be relied on to generate improvements in the budget balance. Whereas the primary balance shows minimal changes under *SPU 2018* plans, the overall balance is forecast to improve by a full percentage point of GNI* over the period 2017–2021. This primarily reflects the fact that interest costs are forecast to fall by an amount equivalent to 0.9 percentage points of GNI*. With interest rates already at multi-century lows, this raises questions about the long-term sustainability of these improvements.

An appropriate starting point for next year’s budget – and for all budgets – is a consideration of what is sustainable. This should be informed by appropriate estimates of Ireland’s long-term potential growth, the expected government balance and the cyclical position of the economy. The government is close to running a balanced budget, the economy is experiencing rapid growth, and it is close to its potential level of output.

In such circumstances, the case for additional fiscal stimulus is weak and the appropriate policy would be to increase government expenditure broadly in line with the long-term potential growth rate of the economy. This could be the Department’s preferred estimates of real potential output growth, which average close to 3 per cent per annum over the forecast period 2019–2021. These are similar to the Council’s

⁸ See, for example, *Budget 2018* Statement of the Minister for Finance and Public Expenditure and Reform Mr. Paschal Donohoe T.D. 10 October 2017 p.4.

own estimates of 3¼ per cent as well as recent estimates produced by the ESRI.⁹ Considering the forecast for economy-wide inflation (1.3 per cent), estimates such as these would imply a sustainable nominal growth rate for government spending net of tax measures of – at maximum – 4½ per cent for 2019. One can translate this growth rate into an approximate limit of up to €3½ billion for spending increases or discretionary tax cuts (i.e., the “gross fiscal space”) as the starting point for any budgetary plans for 2019.¹⁰

Anything more expansionary than this suggested maximum limit is not likely to be appropriate. Recognising the strong growth in the economy, the risks to the macroeconomic outlook, and the vulnerability of the public finances to shocks, consideration could also be given to a tighter policy.

For 2019, this means that an appropriate stance would be for the Government to stick to its existing spending plans. Given existing spending commitments and the planned contribution to the Rainy Day Fund, this means more limited scope for additional measures in Budget 2019. The Department estimates that spending pre-commitments of €2.6 billion have already been made for 2019.¹¹ This isn’t necessarily the correct estimate to compare against the approximate limit of up to €3½ billion but it does highlight that there is limited scope in the next budget. Any further expenditure increases should be funded by revenue-raising measures or real efficiency gains that are sustainable over the long run. Any positive surprises to revenue or unexpected savings should go to improving the budget balance.

A repeat of both the recent and historical loosening of budgetary plans in good times must be avoided. In recent years, there has been a consistent pattern of upward revisions to expenditure ceilings observed (Chapter 4). This is similar to what happened in the 2000s, albeit that the scale is relatively smaller. The next section sets

⁹ Simulations using the ESRI’s model COSMO (McQuinn *et al.*, 2017) also 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).

¹⁰ The Expenditure Benchmark sets a limit for annual spending growth while allowing for the impact any tax measures introduced. To overcome mismeasurement issues related to the cycle, one can use preferred alternative estimates of the economy’s potential growth rate such as those developed by the Department – provided that these are formed on reasonable basis. It can also be assumed that the change in cyclical unemployment benefits is given by the difference between forecast unemployment rates and the Department’s view of the natural rate of unemployment (5.5 per cent) rather than the difference with the CAM-based NAWRU.

¹¹ See the Response to the Select Committee on Budgetary Oversight available at: <https://www.finance.gov.ie/wp-content/uploads/2018/05/respopnse-to-BOC-expend.pdf>

out some solutions for dealing with the challenges of running the right budgetary stance over the medium term.

1.4 Setting an Appropriate Fiscal Stance for Beyond 2021

A number of key challenges remain as Ireland exits its latest crisis and the Government needs a credible plan for the medium term to deal with these. In particular, there is a danger that the current policy set is not adequately equipped to prevent a return to procyclical fiscal policy.

Sensible policy tools set up to help with medium-term budgeting are only half-formed and need more consideration if they are to be effective. Two useful innovations in the Government's armoury are the Rainy Day Fund (RDF) and the medium-term debt target. Both were set up with a view to pursuing a more prudent budgetary stance and helping to avoid a repeat of past policy mistakes. These should be helped by the progress that the Department has made on developing its own alternative estimates of potential output. Yet the designs of the RDF and the debt target are lacking in many key respects and need closer attention.

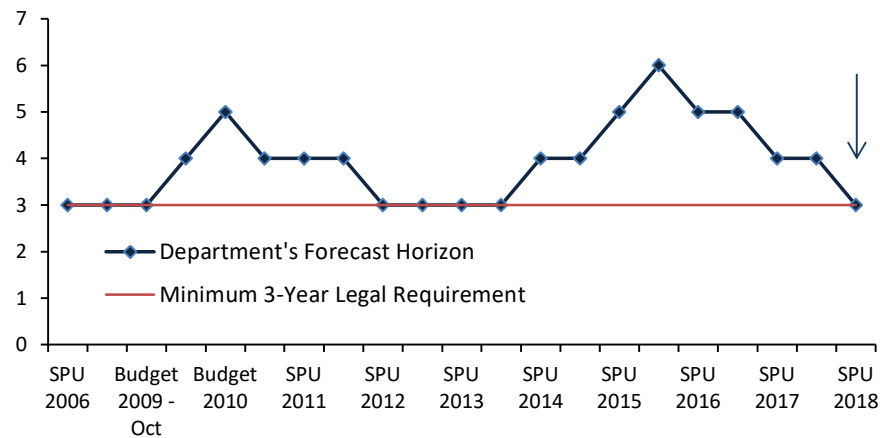
There are a number of solutions that should be pursued:

- First, the Government should make an explicit commitment to adhere to what it sees as a sensible medium-term path for spending growth (net of discretionary revenue measures). This could be operationalised on the basis of – at a minimum – following the spending rule (the Expenditure Benchmark) even after the MTO is met and it should be informed by the Department's own medium-term estimates of potential output growth.
- Second, the proposed design of the Rainy Day Fund should be strengthened. The Rainy Day Fund should be foremost a truly countercyclical fund – one that dampens swings in the cycle and alleviates procyclicality in the rules rather than just allocating fixed contributions regardless of this. A recent IFAC working paper outlines how relatively modest changes in the fiscal rules would help to achieve this (Casey *et al.*, 2018), and Box B examines the implications of this approach in terms of the potential size of the fund.
- Third, the forecasting horizon should always be at least five years to maintain a medium-term focus. The Department has narrowed its outlook by

shortening the horizon over which it forecasts. It has opted not to extend its medium-term plans in 2½ years. As such, it is now forecasting only three years ahead, to 2021 (the bare minimum in terms of EU legal requirements). For context, *Budget 2016*, which was released in October 2015, was forecasting as far ahead as 2021: the same endpoint as for current plans (Figure 1.10). This risks complacency seeping into medium-term planning and future publications should extend the horizon back to a five-year-ahead basis.

Figure 1.10: The Department Narrows its Outlook

Forecast Horizon in Years



Sources: CSO; Department of Finance (various publications); and internal IFAC calculations.

- Fourth, the Government's medium-term debt target, which aims for a debt level of 55 per cent of GDP over an unspecified timeframe, would be better specified if it were: (1) clearly time-bound; (2) set against a more appropriate denominator than GDP; (3) set as a ceiling rather than as a target; (4) committed to in a credible manner; and (5) actually set at a low or prudent level. As it stands, the Government's debt target has a number of shortcomings. It is set against the distorted GDP denominator, which the Department acknowledges is inappropriate. It is predicated on vaguely specified time commitments, which potentially would be met only over a very long period.¹² It is also not clear if the targets are hard targets or ceilings or whether these will account for cyclical developments in any way.¹³ The idea that staying close to a 55 per cent target is more prudent than 60 per cent does not stand up to much scrutiny. Well-documented distortions to GDP in

¹² For example, *SPU 2017* applied the target for the "mid-to-late 2020s", while *Budget 2018* suggests the 45 per cent target will apply only "once the major capital projects have been completed".

¹³ The 60 per cent ceiling in the *SGP* is also a maximum ceiling, not a target. It is also worth noting that the Government's original targets were not very credible (lasting only six months before being revised up from an original 45 per cent target in *Budget 2017* to 55 per cent in *Budget 2018*).

Ireland, Ireland's economic volatility, the government's wider balance sheet, long-term expenditure pressures and pension commitments might lead one to conclude that a lower debt level would be more prudent.¹⁴

Box B: The Appropriate Size of the Rainy Day Fund

This box examines the design of a Rainy Day Fund in terms of what is proposed in Casey *et al.* (2018). Specifically, it looks at one possible scenario for the potential size of the fund if it were to be operated on an appropriately countercyclical basis.

If the Rainy Day Fund is to be a truly countercyclical fund, it would need to be able to smooth through the changes in allowed spending growth rates over time. As noted in Casey *et al.* (2018), allowed spending growth under the fiscal rules tends to exhibit an excessively procyclical pattern: allowing growth rates that are too fast in good times, and too slow in bad times. If compared to the economy's long-term trend growth, this means that government spending is allowed to increase at an excessive pace in expansions, potentially leading to forced retrenchments in downturns (resulting in, for example, much slower spending growth or cuts to spending and tax increases).

Illustrative Size of the Rainy Day Fund

The Rainy Day Fund represents a good opportunity to promote a more countercyclical policy in Ireland. If run effectively, its size would primarily depend on the nature of the cycle. A longer or more pronounced expansion phase would – all else equal – imply larger reserves being accumulated in the fund, whereas a shorter or less pronounced expansion phase would mean much lower reserves being accumulated.

Predicting the nature of a future cycle is virtually impossible and it would be wise to remain agnostic about this. In any case, the design of the Rainy Day Fund proposed in Casey *et al.* (2018) looks through this issue. Instead of setting policy on the basis of what the cycle is expected to look like, the Rainy Day Fund should be flexible to how the cycle actually evolves. The proposal put forth suggests that a government take some – not necessarily the correct – view on what sustainable growth rates for the economy are likely to be over the long term and grow spending at this “desired” pace. Fluctuations in the “allowed” pace of spending growth can then be smoothed through, with contributions made to the Rainy Day Fund when the allowed pace exceeds the desired pace. Correspondingly, withdrawals can be made from it when the allowed pace falls below the desired pace.

To illustrate this, and to give a relatively realistic sense of the potential size of such a fund, Figure B1 shows how the proposal would look over a potential 12-year cycle for Ireland.¹⁵ An expansion phase is assumed to start in the first year (year *t*); a recession follows in years 5 and 6 (*t*+5 and *t*+6); before an expansion begins again. Spending begins at €80 billion – close to the level currently forecast for 2019 (corrected for the standard adjustments made under the spending

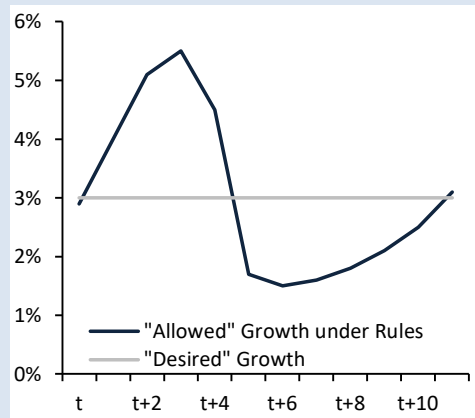
¹⁴ Using 2016 data, a 55 per cent debt-to-GDP target is broadly equivalent to 80 per cent of GNI*. This is still high, compared with pre-crisis levels when debt-to-GNI* ratios were closer to 20-25 per cent, and compared with international norms. Moreover, it is anchored in terms of *SGP* commitments specified on the basis of GDP. Ireland has a volatile history in terms of its debt dynamics as shown in Box H (IFAC 2017c), which would argue for setting a debt ceiling below *SGP* limits (these are primarily set with larger EU Member States in mind). 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, implying far more volatile debt dynamics from year-to-year.

¹⁵ Durations are broadly similar to standard business cycles as documented in Box A.

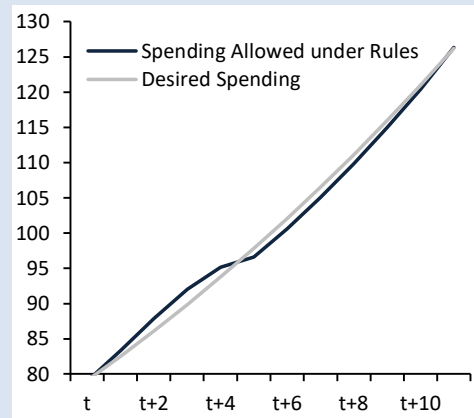
rule) and it is assumed that the Rainy Day Fund starts with reserves of €2 billion.¹⁶ The typical range of allowed real growth rates for spending in Ireland over a long time period is quite large. Current estimates show it falling to as low as 1.8 per cent in the recent downturn and rising to as high as 7.4 per cent at the start of the 2000s. These rates were likely distorted by the financial crisis as well as by the convergence and bubble periods pre-crisis. Both phases may have been unusual in an historical context and are unlikely to be repeated again in the medium term. We therefore examine a narrower range of 1.5 per cent to 5.5 per cent. Inflation, given by the GDP deflator, is assumed constant at 1.3 per cent per annum. The desired spending growth rate is assumed as the average of allowed growth rates over the 12 years (3 per cent).

Figure B.1: Illustrative Scenario for a Countercyclical Rainy Day Fund (RDF)

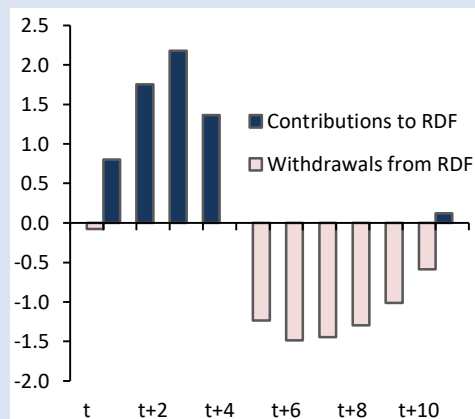
A. Spending Growth Rates Assumed
Percentage change y/y



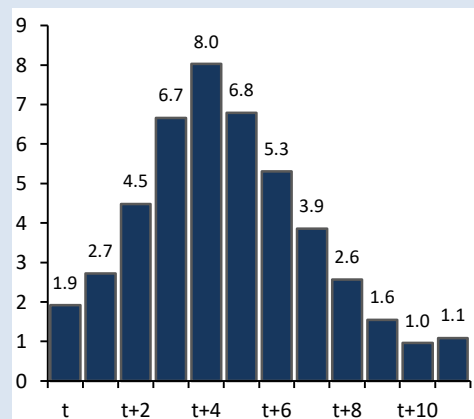
B. Levels of Actual Spending
€ billion



C. RDF Contributions and Withdrawals
€ billion



D. Accumulated Reserves in the RDF
€ billion



Sources: Internal IFAC calculations.

Note: This is an illustrative exercise. The actual level of reserves that would be accumulated in the Rainy Day Fund under the proposal in Casey *et al* (2018) would vary according to the depth and duration of any cyclical upturn and downturn and according to the pace of desired spending growth set out.

The scenario is summarised in Figure B.1. Panel A shows that allowed growth rates under the rules fluctuate around the assumed desired growth rate: rising above it in the expansion phase, and falling below it during and after the recession. Panel B shows the levels of spending

¹⁶ These corrections include one-offs; interest costs; government expenditure on EU programmes which is fully matched by EU funds revenue; the smoothing of public investment spending; and the estimated cyclical cost of unemployment benefits.

consistent with both growth rates. It is possible to see how spending allowed under the rules rises above the desired level during the expansion phase and is forced below it during and after the recession.

Panel C shows how the Rainy Day Fund would operate during this period. As allowed spending growth rises to a higher-than-desired pace, increasing contributions are made to the Rainy Day Fund to offset this. Similarly, as allowed spending growth falls, withdrawals are made to bring spending back up to the desired level. Panel D shows what this means for accumulated reserves in the fund. Starting at a level of €2 billion, the fund expands with the cyclical upturn and rises to €8 billion at the peak of the boom. When the recession hits, withdrawals are made and reserves are run down to €1 billion before additional contributions are made in the ensuing expansion.

It is important to note that this is just one scenario and there are a host of plausible scenarios for any given cycle. The €8 billion of resources at peak in this illustration could rise to levels a lot higher if the cycle is more pronounced and more persistent than assumed. Correspondingly, it could be lower if the next cycle is more muted or short-lived. To deal with the associated uncertainties, the design of the fund should be flexible to how the cycle evolves, as demonstrated in this approach.