On balance, the Council views the fiscal stance set out in *Budget 2013* as broadly appropriate, and therefore "conducive to prudent economic and budgetary management". With the recommended margin of safety achieved through the recent favourable developments, the Council does not see a case at this time for the additional measures it had proposed earlier. However, the Council's assessment is that the planned adjustments of €3.1 billion in 2014 and €2.0 billion in 2015 should not be reduced. Budget-impacting developments will have to be monitored closely, with particular attention to potential growth shortfalls and the effective implementation of planned adjustment measures.

Box F: Identifying the Appropriate Medium Term Fiscal Stance: Some Considerations

The economic crisis has led to a large increase in the General Government deficit. Although there is disagreement on the precise measurement of the structural deficit (see Chapter 3), there is general agreement that much of the remaining deficit is structural in nature, and so will not disappear as the economy returns to its underlying potential. The requirements of long run fiscal sustainability, the national Budgetary Rule and the rules of the *Stability and Growth Pact* (*SGP*), mean that there is no choice but to correct the structural deficit over the medium to long run.

Notwithstanding this imperative, the Government does face a decision on how fast to correct the structural deficit. Of course, the room for policy choice is restricted by the conditions of the external assistance programme and the related commitments under the Excessive Deficit Procedure (EDP). Under the EDP, the maximum deficits are specified in nominal (i.e., that actual deficit as a share of GDP) rather than structural terms. A central requirement is to bring the General Government deficit to below 3 percent of GDP by 2015, with intermediate targets of 7.5 percent for 2013 and 5.1 percent for 2014. The structural balance as a share of GDP must also improve at a minimum rate of 0.5 percentage points of GDP per year.

With these constraints in place, the operational question for the Government in setting its medium term fiscal stance is whether to aim for lower nominal and structural deficits than allowed under the EDP and national Budgetary Rule given central projections for economic growth.

Competing considerations can be framed in terms of arguments for backloading the adjustments – which effectively means planning for no greater adjustments than are required to meet the targets under the central growth projections – and arguments for frontloading the adjustments by aiming at lower deficits than the maximum allowed.

In the international debate, the main argument advanced for backloading is that fiscal multipliers are likely to be larger in a recession. This means that the growth and employment loss from any given total adjustment in the structural primary balance (i.e., the structural balance excluding interest costs) is likely to be larger if it is concentrated when the economy is already in recession. The debate about the size of fiscal multipliers in the current recession has been given impetus by recent IMF analysis that suggests that current multipliers are larger than they had previously believed, an underestimation that led them in turn to underestimate the negative effects of consolidation on growth. However, the IMF does not believe the multiplier has been underestimated for Ireland. We review the multiplier debate in Section 4.3.

Given Ireland's struggle to regain access to bond markets at affordable interest rates, a core argument for frontloading relates to creditworthiness. Under current conditions, Ireland's creditworthiness depends to a significant extent on perceptions that it would be able to meet conditions required for future official support – if needed – without funders demanding a restructuring of privately held Government debt. Uncertainty surrounding growth prospects leads to uncertainty over the capacity to meet nominal deficit targets and targets for stabilising the debt to GDP ratio without greater than planned adjustments.

Figures 2.5a and b in Chapter 2 show the uncertainty that surrounds projections for the General Government deficit and debt ratios given underlying uncertainty surrounding growth over the period to 2015. These figures assume no change to planned adjustments over this period. Figure 2.5c shows the uncertainty surrounding the additional nominal discretionary adjustments that would be required to meet the nominal targets. In the event of bad outcomes on growth, potential investors will be concerned that the required adjustments would not be politically feasible. This in turn leads to a "fear of default" that can put upward pressure on interest rates throughout the economy – including the cost of funding to the banking system – and harm domestic confidence. These effects would themselves slow growth in the short term.

Adjustments that are greater than required under central growth projections can then be viewed as providing a cushion should growth disappoint. This should help in the process of restoring creditworthiness. This effect could be reinforced by the further positive signal sent relating to Ireland's capacity to make difficult adjustments, although Ireland's reputation is already strong in this regard given the recent record.

A second argument for frontloading the adjustment is that it reduces domestic household and business uncertainty about the form the inevitable fiscal adjustments will take. This uncertainty could increase households' precautionary saving and lead businesses to hoard cash and delay planned hiring and investments until the fiscal picture becomes clearer.

Putting aside the issue of the size of near term adjustments, the effects of uncertainty about the form a given fiscal adjustment could take might also affect household and business spending plans in the near term. Rather than an argument for frontloading the adjustment, this could provide a case for supplying as much advance information as possible on the form the future planned adjustments will take. A counter argument is that although people have a general sense that further adjustments are coming, explicit announcements would make these effects more salient, leading to cutbacks in spending. Another counter argument is that by announcing the detailed adjustments in advance, it will allow affected groups to better organise to lobby against the planned adjustments.

Other arguments for frontloading include limiting the extent to which the burden of adjustment is pushed onto younger generations and empirical evidence that large debt overhangs directly act as a drag on longer run growth.

Summing up, the decision on whether to frontload adjustments beyond the minimum necessary to meet nominal deficit targets under the central growth projections involves balancing the costs to near term growth and employment against the benefits of enhanced creditworthiness, intergenerational fairness and longer term growth prospects.[87]

4.3 The Fiscal Multiplier Debate

The international economic and financial crisis has led to a resurgence of interest in the size of fiscal multipliers. In the early stages of the crisis, much of the interest was in potential impacts of fiscal stimulus measures, at least for countries that had the "fiscal space" to pursue expansionary policies. As governments have moved to correct large deficits and rising debt levels, attention has turned more to the negative growth and employment effects of fiscal adjustment measures.

The economics literature on fiscal multipliers has responded rapidly to the greater policy interest, with significant output of both theoretical and empirical work. A general (though not universal) thrust of the recent work is to revise up estimates of fiscal multipliers, especially in the context of a financial crisis. A further theme has been how multipliers vary over time and across countries, depending on such factors as economic openness, exchange rate regimes, debt levels and economic conditions. Despite the surge in research, there remains considerable uncertainty about the size of multipliers that apply under current conditions (see Appendix E).

[87] The foregoing arguments have taken the nominal deficit targets imposed by official lenders and the EDP as given. However, the broader rules under the *SGP* allow for flexibility based on the state of the economy. In other words, the targets are specified in cyclically-adjusted terms. The benefits outlined above in terms of improved creditworthiness could potentially also be attained by specifying the conditions for official support in cyclically-adjusted terms. This would limit the requirement to scale up fiscal adjustments when growth disappoints. To the extent that potential investors in Irish debt doubt the capacity to push through even larger required adjustments in a weak growth environment, this is likely to also negatively affect creditworthiness. While retaining ambitious adjustment targets under central growth forecasts, the trade off between growth and creditworthiness could thus be improved by specifying targets in cyclically-adjusted terms. The challenges associated with measuring the cyclically-adjusted balance are discussed in Chapter 3.