Irish Fiscal Advisory Council

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CONTENTS

FOREWORD I

SUMMARY ASSESSMENT II

1. ASSESSMENT OF THE FISCAL STANCE 1

KEY MESSAGES 1

1.1 INTRODUCTION 2

1.2 IRELAND'S NEW BUDGETARY FRAMEWORK AND AVOIDING THE MISTAKES OF THE PAST 2

1.3 THE FISCAL STANCE IN *BUDGET 2015* 5

1.4 MEDIUM-TERM FISCAL STANCE 8

2. ASSESSMENT AND ENDORSEMENT OF MACROECONOMIC FORECASTS 11

KEY MESSAGES 11

2.1 INTRODUCTION 12

2.2 AN ASSESSMENT OF THE MACROECONOMIC FORECASTS IN *BUDGET 2015* 12

2.3 RISKS 23

2.4 ENDORSEMENT OF THE *BUDGET 2015* PROJECTIONS 26

3. ASSESSMENT OF BUDGETARY FORECASTS 29

KEY MESSAGES 29

3.1 INTRODUCTION 30

3.2 DEPARTMENT OF FINANCE BUDGETARY PROJECTIONS FOR 2014 30

3.3 ASSESSMENT OF *BUDGET 2015* FORECASTS 34

3.4 SENSITIVITY AND RISK ANALYSIS 46

4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES 50

KEY MESSAGES 50

4.1 INTRODUCTION 51

4.2 EXCESSIVE DEFICIT PROCEDURE EXIT 52

4.3 COMPLIANCE WITH THE BUDGETARY RULE 53

4.4 COMPLIANCE WITH OTHER IRISH AND EU FISCAL RULES 63

BOXES

Box A: What are Income Data Telling us? 15
Box B: Estimates of Car Sales 16
Box C: Weaknesses in 2013 Real GDP 23
Box D: Treatment of One-Off and Temporary Measures 57

APPENDICES

Appendix A: Fiscal Council Benchmark Projections 22 September 66
Appendix B: House Price Risks Update 68
Appendix C: Timeline for Endorsement of Budget 2015 Projections 70

GLOSSARY 71

BIBLIOGRAPHY 74

FOREWORD

The Irish Fiscal Advisory Council was established as part of a wider agenda of reform of Ireland's budgetary architecture as envisaged in the *Programme for Government 2011*. The Council was initially set up on an administrative basis in July 2011, and was formally established as a statutory body in December 2012 under the *Fiscal Responsibility Act (FRA)*. The Council is a public body funded from the Central Fund. The terms of its funding are set out in the *FRA*.

The mandate of the Irish Fiscal Advisory Council is:

- To endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- To assess the official forecasts produced by the Department of Finance;
- To assess government compliance with the budgetary rule as set out in the *FRA*;
- To assess whether the fiscal stance of the Government in each Budget and Stability Programme Update (SPU) is conducive to prudent economic and budgetary management, including with reference to the provisions of the *Stability and Growth Pact*.

The Council submits its *Fiscal Assessment Reports* to the Minister for Finance and within 10 days releases them publicly.

The Council is chaired by Professor John McHale, National University of Ireland, Galway. Other Council members are Mr Sebastian Barnes, Organisation for Economic Co-operation and Development; Professor Alan Barrett, Economic and Social Research Institute; Dr Donal Donovan, University of Limerick (formerly International Monetary Fund staff) and Dr Róisín O'Sullivan, Associate Professor, Smith College, Massachusetts.

The IFAC secretariat consists of Eddie Casey, Thomas Conefrey, Sarah Doyle, Andrew Hannon and John Howlin.

The Council would like to acknowledge the help of Jean Cassidy and Rónán Hickey (Central Bank of Ireland), David Purdue and Rossa White (NTMA), and the staff of the Central Statistics Office. Thanks to Deirdre Whitaker for her expert assistance with copy editing.

This report was finalised on 21 November 2014. More information on the Irish Fiscal Advisory Council can be found at www.fiscalcouncil.ie

SUMMARY ASSESSMENT

The Government will likely accomplish the important milestone of reducing the deficit to below the 3 per cent ceiling in 2015.

Strong progress has been made since 2008 in rectifying the public finances. The fruits of that effort are now becoming apparent with the deficit likely to fall below the 3 per cent Excessive Deficit Procedure (EDP) ceiling in 2015 and the debt to GDP ratio beginning to fall, albeit from a very high level. At the same time, economic recovery appears to be taking hold and risks to the Government's balance sheet have subsided considerably as the outlook for both NAMA and the banking sector has improved.

The Budget projects a deficit of 2.7 per cent of GDP in 2015 in line with requirements for exiting the Excessive Deficit Procedure.

As set out in the June *Fiscal Assessment Report*, the Council considers a fiscal stance that secures the scheduled exit from the EDP as being "conducive to prudent economic and budgetary management" within the terms of the *Fiscal Responsibility Act* (2012).

Nevertheless, Budget 2015 reflects a missed opportunity to move the public finances more decisively into a zone of safety by following through on previous plans.

In the short run, the stance in *Budget 2015* means that the deficit is projected to be more than one percentage point higher in 2015 than could have been achieved if previous plans had been implemented. An opportunity to create a larger buffer to guard against adverse near- and medium-term growth shocks has thus been missed. All else equal, the larger deficits result in the debt level being roughly €10 billion higher in 2018 than if previous plans had been adopted.

The new budgetary framework provides a potential bulwark against the repeat of past fiscal policy mistakes.

A positive legacy of the crisis has been the institutionalisation of a new budgetary framework comprising national and European elements. If operated effectively, the framework can guard against pro-cyclicality in fiscal policy making which has contributed to damaging boom-bust cycles in the past.

A serious weakness of Budget 2015 is the absence of a well-specified medium-term plan for the public finances.

Given the scale of the changes since the *Stability Programme Update 2014 (SPU 2014),* it was important for *Budget 2015* to provide an updated medium-term plan. Credible medium-term plans for the public finances are crucial to avoiding pro-cyclical fiscal policy and protecting fiscal sustainability. *Budget 2015* did not include a well-specified plan for the public finances. Published tax revenue

projections assume no change in policy in the medium term, despite Budget commitments to cut taxes in the coming years. Moreover, the Budget spending profiles assume that spending will remain unchanged after 2015, despite higher figures for expenditure being set out in the *Comprehensive Review of Expenditure 2015-2017 (CER 2015-2017)*. The *CER 2015-2017* also states that Departments are expected to stay broadly within the new ceilings, notwithstanding the scope for additional resources in 2016 and 2017.

Spending plans have been revised upwards each year since 2012, with Budget 2015 raising the expenditure ceilings for 2015 to 2017.

The almost continuous raising of the government's expenditure ceilings undermines the purpose of multi-annual expenditure planning, which is designed to protect against the type of pro-cyclical trend in government spending observed in the run up to the crisis. The *CER 2015-2017* does not adequately address how well-known expenditure pressures will be accommodated in the coming years. This a particular problem for departments such as Health and Education, reporting large demand pressures over 2015 to 2017, and given the current very low level of capital spending.

The recovery in the economy has gained momentum in 2014, although headline GDP growth may be flattered by contract manufacturing.

The underlying growth trajectory for the near-term appears strong. Exports have performed well in 2014 while domestic demand is recovering. Future developments in contract manufacturing are especially difficult to forecast and this compounds the usual uncertainties surrounding growth prospects. Taking into account these uncertainties, the Council assessed the *Budget 2015* macroeconomic forecasts for 2015 as within an endorsable range.

Budget projections imply compliance with the relevant fiscal rules in 2015 but following EDP exit, there is limited room for manoeuvre in 2016.

Under the Budget projections, the Budgetary Rule and the expenditure benchmark will be complied with in 2016 but with only a very small safety margin. Any significant expenditure increases or discretionary revenue reductions would likely lead to a breach of the Budgetary Rule and EU Expenditure Benchmark, leading to possible EU sanction procedures.

1. ASSESSMENT OF THE FISCAL STANCE

KEY MESSAGES

- Ireland is continuing to make progress following the crisis. It is likely that the Government will succeed in bringing the deficit to below 3 per cent in 2015. Meanwhile, creditworthiness has improved and a broad-based economic recovery appears to be taking hold.

- The Budget projects a deficit of 2.7 per cent of GDP in 2015 in line with requirements for exiting the Excessive Deficit Procedure. As set out in the June *Fiscal Assessment Report (FAR)*, the Council considers a fiscal stance that secures the scheduled exit from the EDP as being "conducive to prudent economic and budgetary management" within the terms of the *Fiscal Responsibility Act* (2012).

- *Budget 2015* represents a missed opportunity to decisively move the public finances into a zone of safety and to create a larger buffer to guard against adverse shocks. The stance in *Budget 2015* means that the deficit next year will be more than one percentage point higher than if previous plans had been adopted. All else equal, the larger deficits result in the debt level being roughly €10 billion higher in 2018 than if previous plans had been adopted.

- With the State having exited the EU-IMF Programme, Ireland's new budgetary framework should play an increasingly important role in helping to avoid the historic pattern of fiscal policy mistakes. If operated effectively, the framework can guard against pro-cyclicality in fiscal policy making which has contributed to damaging boom-bust cycles. To ensure public support, it will be essential for the Government to make a robust case for the national value of the newly strengthened budgetary framework.

- *Budget 2015* was marked by an absence of a well-specified plan for the public finances beyond 2015. Tax revenue profiles assume no change in policy in the medium-term despite Budget commitments. Moreover, the Budget spending profiles assume that spending will remain unchanged after 2015, despite higher figures in the *CER 2015-2017.* The *CER 2015-2017* does not adequately address how well-known expenditure pressures will be met in the coming years.

- The absence of a fully worked-out plan for the public finances beyond 2015 makes an assessment of the medium-term stance challenging. It was especially important that an updated medium-term plan be provided in *Budget 2015* due to the scale of the changes since *SPU 2014.* It is crucial for the Government to provide credible medium-term fiscal projections in both the Budget and Stability Programme Updates.

1.1 Introduction

The Fiscal Council has a mandate under the *Fiscal Responsibility Acts 2012* and *2013* to assess the Government's fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. The sections below draw on the analysis in later chapters in assessing the fiscal stance in *Budget 2015*. With Ireland having exited the EU-IMF official support programme and likely to reduce the deficit to below the 3 per cent EDP ceiling in 2015, the new budgetary framework comprising domestic and European components will set the parameters for fiscal policymaking in the coming years. Section 1.2 outlines the importance of the framework in helping to avoid the pattern of pro-cyclicality in fiscal policymaking which has proven so damaging in the past. Section 1.3 provides an assessment of the fiscal stance in *Budget 2015*. A number of issues in relation to the lack of detail on the medium-term fiscal stance are set out in Section 1.4.

1.2 Ireland's New Budgetary Framework and Avoiding the Mistakes of the Past

Since 2011, fiscal policy decisions have been guided by the conditions of the EU-IMF programme and the Corrective Arm of the EU *Stability and Growth Pact* that required the Government to reduce the deficit to below 3 per cent of GDP by 2015. With the State now out of the EU-IMF Programme and with the 3 per cent ceiling likely to be met, a new phase of fiscal policy surveillance guided by other elements of Ireland's new budgetary framework will begin.[1] While significant progress has been made in repairing Ireland's public finances, the overall level of debt relative to the GDP is expected to be over 110 per cent in 2014. Reducing debt to safer levels can ease the State's vulnerability to shocks and underpin a return to sustainable growth in employment and incomes. The June *FAR* (2014a) outlined three key potential benefits of the budgetary framework that are summarised here:

i. Taming the boom-bust cycle

The framework should help to tame the tendency of the Irish economy towards boom-bust cycles. For example, the expenditure rule that limits the growth in expenditure to the underlying potential growth of the economy places restraints on the extent to which wind-fall revenues are used to fund "permanent" increases in spending or reductions in tax burdens.

[1] The Framework document is available at: http://www.finance.gov.ie/what-we-do/public-finances/medium-term-budgetary-framework-legislation . This version has been updated since the June 2014 *Fiscal Assessment Report.*

ii. *Moving to safer debt levels*

Compliance with the Budgetary rule and the Debt rule[2] should be consistent with delivering the necessary primary budgetary balance to put the debt-to-GDP ratio on a declining path towards safer levels.

iii. *Enhanced Credibility*

The Government's credibility can be underpinned by a commitment to a well-designed fiscal framework, especially one that is widely shared across the political spectrum. Such a framework can help signal intentions with regard to medium-term debt-reduction goals, and can also raise the political costs of deviating from the planned path as crisis memories fade.

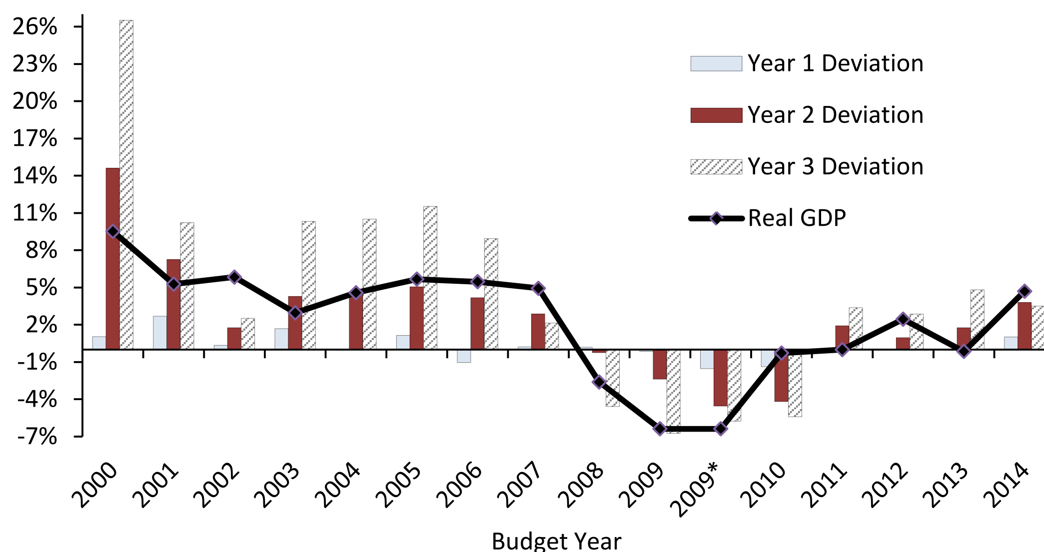
The new budgetary framework is sometimes portrayed in negative terms as an intrusion into domestic freedom of action and as implying the need for perpetual fiscal consolidation. It is important to recognise that debt markets can be much more demanding taskmasters in terms of the constraints on deficit and debt levels considered consistent with access to borrowing on affordable terms. In addition, as noted above, by encouraging prudent management of the public finances during good times, the budgetary framework can provide the Government with fiscal space for expansionary policy to cushion the impact of downturns.

A major weakness of Ireland's approach to fiscal policy prior to the crisis was that the annual budgetary process paid insufficient attention to multi-annual fiscal planning. Expenditure plans focused almost exclusively on the following year's spending plans with medium-term expenditure profiles seen as indicative and subject to change in later years. With spending determined on an ad hoc year-to-year basis, this inevitably contributed to pro-cyclicality in fiscal policy.

Figure 1.1 compares the three-year expenditure projections that were published in the annual Budgets for 2000 to 2014, to the actual outturns for expenditure in each of the three years. While the first year outturn typically came in close to the projected figure, large divergences between planned and actual spending were common in the second and third years from 2000 to 2007. This pattern has started to recur, coinciding with the return to growth in the economy.

[2] The Budgetary rule states that the budgetary position of general government must be in balance or surplus or, if it is not, that it is on the adjustment path towards its medium-term objective. The debt rule states that debt in excess of the 60 per cent debt to GDP ratio must be reduced by at least 1/20th per year on average.

FIGURE 1.1: GROSS CURRENT EXPENDITURE, % DEVIATION FROM FORECAST



Source: Department of Finance
Note: Bars show the deviation of actual expenditure from the three-year ahead expenditure projections published in each Budget since 2000. 2009* refers to the 2009 Supplementary Budget.

A core domestic budgetary reform introduced recently is the Medium-Term Expenditure Framework (MTEF),[3] according to which the government must provide multi-annual ceilings for expenditure for each department for the next three years. This is designed to avoid the type of expenditure management problems highlighted in Figure 1.1 and to guide the planning and delivery of structural reforms.

While the new budgetary framework is not without flaws, the complementary national and European elements provide a valuable structure to guide Irish fiscal policy. Rather than being viewed as something imposed on Ireland, it should be seen as a framework that is in the national interest in that it helps to create the conditions that underpin sustainable growth in Irish incomes and employment and also ensures the future fiscal capacity of the State.

For the framework to be implemented effectively, domestic ownership is essential. Ownership can partly be demonstrated by the provision of clear medium-term budgetary plans consistent with both the letter and the spirit of the new budgetary framework. If policymaking is only considered in the context of ensuring technical compliance with the rules, then its ability to address the structural flaws in Ireland’s fiscal policymaking will be lessened.

[3] The MTEF is set out in the Ministers and Secretaries (Amendment) Act 2013 and Departmental Circular 15/13.

Broad political support and advocacy of Ireland's budgetary framework will be vital if it is to act as an effective guide to sound management of the public finances. This is especially important now that the degree of direct external surveillance has eased with the ending of the Programme. The evidence from *Budget 2015* discussed below suggests that, while public awareness of, and political support for, the framework has increased, problems with implementation remain. To increase public support, it will be essential for the Government to make a robust case for the national value of the newly strengthened budgetary framework.

1.3 The Fiscal Stance in *Budget 2015*

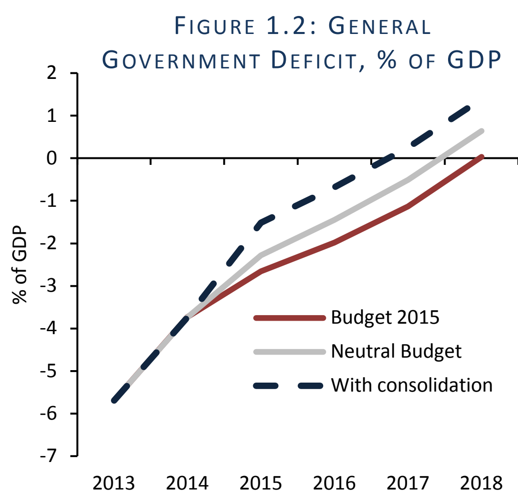
As the economy recovers, the benefits of actions to remedy the public finances between 2008 and 2013 have become evident. Concerns that such a large programme of fiscal consolidation could trip the economy into a deflationary spiral and even become "self-defeating" in budgetary terms have not come to pass. Instead, having peaked in 2009 at 11.5 per cent of GDP, the underlying general government deficit has fallen and is expected to measure around 3.7 per cent of GDP in 2014. While the consolidation measures negatively impacted domestic demand, the recovery in the Irish economy has gained momentum and is now being supported by improving domestic demand. It was against this comparatively more favourable backdrop that *Budget 2015* was framed.

An expansionary package amounting to just over €1 billion was announced in *Budget 2015*. This comprised €420 million of tax measures and an increase in expenditure of €630 million.[4] This easing of the fiscal stance represents a €3 billion reversal from the plan outlined in the *SPU 2014* when a package of tax increases and expenditure cuts of around €2 billion was envisaged. According to the Budget projections, the deficit as a percentage of GDP will fall to 2.7 per cent in 2015 (Figure 1.2); a neutral budget would likely have delivered a deficit of around 2.4 per cent in 2015, and estimates suggest that the implementation of €2 billion consolidation, as recommended by the Council, would have resulted in the deficit falling to around 1.5 per cent of GDP next year (see Figure 1.2). In this latter counterfactual scenario, €2 billion consolidation would have brought the government accounts close to balance by 2016 (deficit of 0.7 per cent); in the *Budget 2015* projections, the deficit does not fall to zero until two years later in 2018.

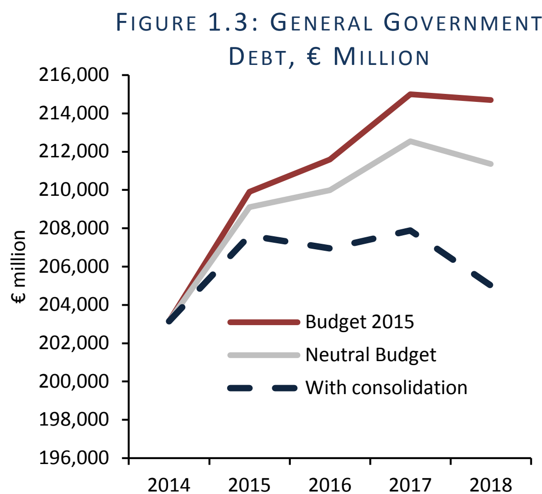
The higher deficits out to 2018 also result in a more unfavourable path for the overall level of debt than could otherwise have been achieved. Figure 1.3, based on the Council's fiscal feedback's

[4] In addition to the €630 million increase in expenditure, €400 million in savings from reductions in the Live Register in 2015 do not feed through to lower overall expenditure, with this saving being allocated to other expenditure. Savings from the fall in unemployment could be expected to contribute to the cyclical fall in the deficit rather than funding expenditure increases elsewhere.

model, shows that the debt is expected to peak at a level roughly €10 billion higher than would have occurred with an implementation of previous plans.



Source: Internal calculations.



Source: Internal calculations.

As noted in the Council's *Pre-Budget 2015 Statement*, improvements in the economy and in tax revenues, as well as the positive impact of statistical changes on fiscal aggregates (see *Analytical Note No. 6*), meant that as 2014 progressed, it became apparent that compliance with the 3 per cent deficit ceiling could likely be achieved with less consolidation than previously planned. The Government opted for an expansionary package of €1 billion in *Budget 2015* rather than the planned consolidation, thereby absorbing a substantial portion of the additional resources created by the improvements in fiscal aggregates evident up to end-September 2014.[5]

The Council has a responsibility under the FRA to assess whether "...the fiscal stance for the year or years concerned is....conducive to prudent economic and budgetary management" [*FRA* 8(4)(b)]. In the June 2014 *FAR*, the Council assessed that a budgetary policy to bring the projected deficit in line with the EDP limit of below 3 per cent of GDP in 2015, and then to follow the adjustment-path requirements of the preventive arm of the SGP and the national Budgetary Rule would meet the requirements as set out in the *FRA*. According to *Budget 2015*, these conditions are expected to be met over the forecast years.

[5] By end-September, the last available data prior to the Budget, the Exchequer data showed that taxes and PRSI were ahead of profile by €0.9 billion while non-tax revenues were €0.4 billion higher. This improved revenue performance up to end-September was only partially offset by a €116 million expenditure overrun relative to profile.

However, as noted in the Council's *Pre-Budget 2015 Statement*, the fiscal rules set a minimum standard for policy and there are circumstances where a more ambitious policy stance may be appropriate. By opting to depart from its previously announced plans in *Budget 2015*, the opportunity to embed a more favourable and prudent fiscal stance over the coming years - and thus to more decisively move the public finances into a zone of safety - has been missed. By choosing to comply with the most immediate target of the budgetary framework (correction of the excessive deficit) with a much tighter margin, meeting the requirements of the rules beyond 2015 becomes a more demanding task.

As shown in Figure 1.2, implementing the planned consolidation effort would have produced a deficit of 1.5 per cent in 2015 and would have moved the public finances into safer territory with a balanced budget position within reach. The opportunity to build in a more adequate margin of safety for 2015 has therefore been lost. *Budget 2015* projects a deficit of 2.7 per cent of GDP in 2015. The margin below the 3 per cent EDP ceiling is small relative to the scale of uncertainty at this stage about developments in 2015. This is illustrated by the analysis in Chapter 3 which shows that even a small negative shock which reduces nominal GDP growth in 2015 by 0.5 of a percentage point would, in the absence of offsetting policy measures, result in the 3 per cent EDP ceiling in 2015 being missed. Chapter 2 shows that a small weakening in the Euro Area economy could lead to a reduction in Irish growth of this magnitude. While there is scope to accommodate negative developments in 2015 to ensure that the target is met, for example by reducing spending during the year, such adjustments may be disruptive. Moreover, a smaller budget deficit in 2015 would put the public finances in a safer position relative to the considerable uncertainties regarding the medium-term outlook.

The Council's approach to assessing the fiscal stance is informed by the difficult trade-off between implementing fiscal consolidation to improve creditworthiness and debt sustainability and minimising the negative impact on demand and output. The implementation of a large programme of fiscal retrenchment during 2009 and 2010, when output was already falling and unemployment increasing, required that the negative impact of the consolidation measures on growth needed to be carefully balanced with the need to stabilise the public finances. As discussed in Chapter 2, although the headline rate of growth may be overstating the extent of the improvement in the economy this year, the forecasts from the Department of Finance and other agencies indicate that the economy is growing at a robust rate and this is projected to continue in 2015. The need for *Budget 2015* to provide an additional short-run stimulus in this context is reduced. On the other hand, the improved creditworthiness of the State and stabilisation of the debt to GDP ratio have reduced the urgency of further adjustment efforts. However, it remains the judgement of the

Council that completing the last phase of the adjustment plan to 2015, and then following the less demanding requirements of the Budgetary Rule and Preventive Arm of the *SGP*, would have been on balance the most appropriate fiscal stance.

1.4 Medium-Term Fiscal Stance

In the short run, it is likely that the Government could meet its objective of reducing the deficit to below the 3 per cent ceiling in 2015. However, *Budget 2015* raises a number of issues of concern in relation to the path of the public finances beyond 2015.

As discussed in Chapter 3, the post-2015 expenditure profiles provided in the Budget are based on a technical assumption that voted spending remains fixed at its 2015 level from 2016-2018. This is despite higher actual figures for expenditure being set out in the accompanying *CER 2015-2017.*[6] Moreover, the Budget figures for tax revenue do not take account of further tax changes post-2015 which have been signalled such as reductions in income tax and the universal social charge.[7] Consequently, *Budget 2015* lacks a well-specified plan for the public finances beyond 2015.

The Council's June 2014 *FAR* highlighted that the sharp decline in government spending as a ratio of GDP over a prolonged period envisaged in the *SPU 2014* would be difficult to achieve given demographic and other pressures. In this context, the report urged that the *CER 2015-2017* would set out comprehensive and detailed plans on how expenditure savings will be delivered. However, this has not occurred.

[6] *Budget 2015* (p. C23) states that "...the spending aggregates in this [Budget book] Table differ from the 2016 and 2017 details set out in the Expenditure Report. Priorities, which have been outlined in the Budget, and included in the ceilings in the Expenditure Report, will be addressed in subsequent Budgets when there is technical clarity around the quantum of fiscal space".

[7] In relation to taxes, Minister Noonan stated in his Financial Statement: "This is the first instalment of a plan to progressively reduce the 52% tax rate on low and middle income earners in a manner that maintains the highly progressive nature of the Irish tax system…We will continue to ease the burden on those in the middle in a targeted manner without giving disproportionate benefits to those on highest incomes. The 52% marginal tax rate will be lowered further while ensuring those on higher incomes continue to pay their fair share".

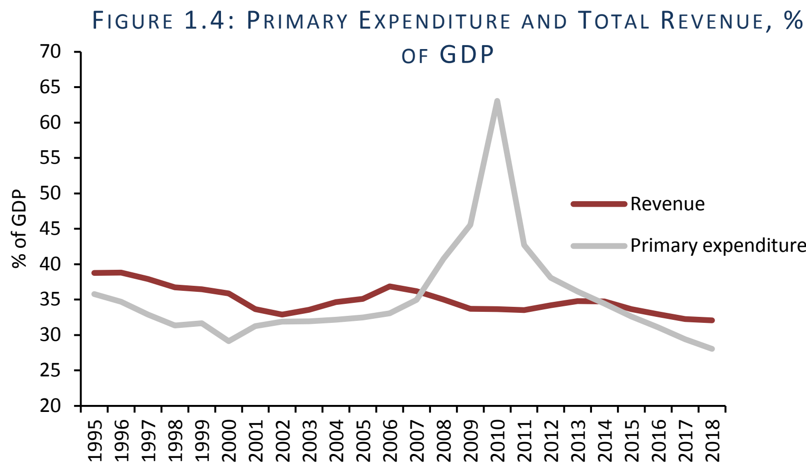


FIGURE 1.4: PRIMARY EXPENDITURE AND TOTAL REVENUE, % OF GDP

Source: Department of Finance , Central Statistics Office (CSO), internal calculations.
Notes: Data are on a general government ESA 2010 basis.

The projected expenditure figures shown in Figure 1.4 are based on the *CER 2015-2017* and imply a steep fall in the ratio of primary expenditure to GDP, similar to that contained in the *SPU 2014*.[8] The CER has raised these expenditure ceilings for 2015-2017 but does not contain detailed information on how pressures arising from demographic changes, investment needs and demands for public sector pay increases have been incorporated into medium-term spending plans. If the expenditure path shown in Figure 1.4 makes allowance for these pressures, it is not clear from the *CER* where savings are to be made elsewhere to free up resources for increased spending to meet these demands, or the extent of these savings.

The raising of the expenditure ceilings discussed in Chapter 3 undermines the purpose of multi-annual expenditure planning. The shift to a multi-annual approach to expenditure planning is a key element of the new budgetary framework and is designed to protect against the type of pro-cyclical trend in government spending observed in previous years. The Government's revised *Medium-Term Budgetary Framework (MTBF)* states that multi-annual expenditure planning is designed to "...facilitate a more strategic approach to resource allocation by emphasising prioritisation of key services over reaction to day-to-day pressures..." (*MTBF,* 2014). However, as outlined in Chapter 3, every expenditure report since 2012 has contained upward revisions to the expenditure ceilings. Furthermore, in this context, the current *CER 2015-2017* states that

[8] The *CER* published on Budget day sets out the expenditure ceilings for each department for the years 2015 to 2017. These expenditure figures were not used in Table 11 (page C.24) of the Budget Book. Instead, as explained in further detail in Chapter 3, the expenditure projections in the Budget are based on the technical assumption that voted expenditure remains fixed at its 2015 level from 2016 to 2018. In order to show a path for expenditure which more realistically reflects actual government spending plans, Figure 1.4 uses the projections from the *CER* rather than the Budget figures.

Departments are expected to stay broadly within the new ceilings, notwithstanding the scope for additional resources in 2016 and 2017.

The lack of detail and clarity around the expenditure plans as well as the upward revisions to expenditure ceilings in recent years raises doubts as to the meaningfulness of the current projections for government spending in the medium term. As explained in Chapter 3, expenditure ceilings have been revised upwards since 2012 with the upward revision in the most recent *CER 2015-2017* measuring 3 per cent. [9] If this pattern of upward revisions exhibited in earlier years was to be repeated then the budget deficit from 2016 would be higher than is currently projected.

The ratio of tax revenue to GDP is forecast to fall over the projection horizon (Figure 1.4) and by 2018 the ratio is expected to be over 4 percentage points lower than in 2000. These projections in the Budget are based on the technical assumption of no easing of the tax burden after 2015 and likely overstate the level of government revenue in the medium-term. The likely level of resources which will be available to fund government spending out to 2018 thus remains unclear.

Taken together the lack of detail underpinning the Government's medium-term projections for both expenditure and revenue means in turn that considerable uncertainty surrounds the overall projected path for the general government deficit. This is expected to decline to 2.7 per cent in 2015 with further projected improvements leading to a small surplus being recorded by 2018. However, with both government revenue and expenditure expected to differ from the path outlined in *Budget 2015*, it is unclear what the likely underlying path of the deficit will be over the medium term.[10] Moreover, the lack of a well-anchored medium term plan raises the risk that incoming cyclical revenues will be spent rather than saved, leading to unsustainable spending levels.

[9] This figure is calculated by comparing the expenditure projections in the *CER 2015-2017* to the 2014 *Expenditure Report.*

[10] The European Commission Autumn forecast projects that the deficit would rise from 2.9 per cent of GDP in 2015 to 3 per cent in 2016 on a no-policy change basis.

2. Assessment and Endorsement of Macroeconomic Forecasts

Key Messages

- The Council endorsed the *Budget 2015* macroeconomic forecasts to 2015. Taking into account the uncertainties and judgemental elements involved, it was satisfied that these forecasts were within an endorsable range.

- The macroeconomic forecasts endorsed by the Council were prepared on the basis of no budgetary adjustment, though final forecasts in the Budget Book take account of €1 billion of measures subsequently announced. While the Department's reconciliation section provides some information explaining the reasons for the forecast changes, additional detail would help to identify precisely the factors driving changes to the macroeconomic forecasts between Endorsement and Budget day, particularly on the implied marginal propensities to consume and import content related to any changes.

- Aggregate GDP forecasts in *Budget 2015* covering 2014 and 2015 appear plausible. However, as before with the *SPU 2014*, domestic demand is assumed to be stronger than in Benchmark projections prepared by the Council's Secretariat, with net exports weaker. Medium-term real GDP growth rates for 2016 to 2018 forecast at 3.4 per cent may be at the relatively optimistic end of the range and are slightly higher than in the April 2014 *SPU*.

- The underlying growth trajectory for the near term appears strong, with evidence that the recovery is beginning to broaden out across different sectors of the economy. However, the recent sharp acceleration in real GDP growth may be flattered by contract manufacturing activities. This activity is unlikely to be associated with any significant domestic employment and its contribution to the tax base is unclear. Its impact also increases the degree of uncertainty around projections for net exports.

- While the economy appears to have turned a corner of late, chances that growth may disappoint remain high. The discussion in *Budget 2015* is dominated by downside macroeconomic risks. Concerns over the health of the Euro Area economy intensified in recent months. A prolonged slump would threaten the prospects for an export-led recovery in Ireland. Domestically, the pace of labour market improvements also appeared to slow in early 2014. Budget documentation should provide an assessment of the Department's view on the balance of these risks as recommended by the Council and as included in some past Budgets.

2.1 Introduction

This third endorsement exercise undertaken by the Council covers *Budget 2015* and a shorter horizon of forecasts (2014-2015) than in the *SPU 2014*.[11] The timeline for the endorsement process is detailed in Appendix C. As with previous exercises, the Department of Finance provided high levels of cooperation in all of their interactions with the Council.

As part of the ongoing development of the "suite of models" approach, the Secretariat has continued to develop its set of tools for short-term forecasting. Since July, new models of consumption and incomes have been added and the Council has undertaken further work to improve its understanding of the volatility underlying quarterly releases of macroeconomic data.[12]

Section 2.2 discusses the *Budget 2015* forecasts and puts these in context relative to forecasts of other agencies, while Section 2.3 provides an assessment of the uncertainty and risks surrounding the economic outlook. Section 2.4 concludes by outlining the endorsement process as it applied to the *Budget 2015* projections. Three boxes are included: the first assesses data available on Irish household incomes; the second examines the prospects for private vehicle spending in the near term. A third box looks at the causes of weaknesses in 2013 GDP growth. *Analytical Note No. 6* provides further background to this Chapter in describing recent statistical revisions to Irish macroeconomic data.

2.2 An Assessment of the Macroeconomic Forecasts in *Budget 2015*

2.2.1 Short-Term Forecasts, 2014-2015

Budget 2015 envisages a considerable pick-up in economic activity after last year's disappointing 0.2 per cent increase in real GDP. Strong growth of 4.7 per cent is anticipated for 2014 followed by a 3.9 per cent rise in 2015. There is evidence pointing to robust underlying growth for the short term, but specific trade developments magnify the usual forecast uncertainties.

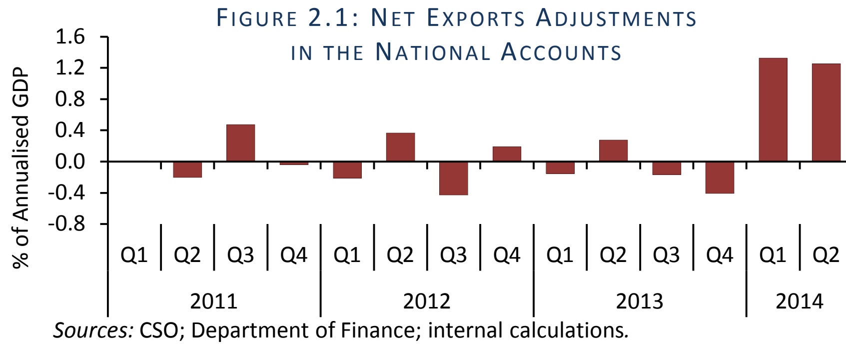
The underlying increase in activity for 2014 may be flattered by highly concentrated increases in exports arising from offshore production activities, which are referred to as contract manufacturing.[13] It is uncertain whether these activities will continue to improve overall figures,

[11] The endorsement function is outlined in detail in IFAC, (2013b) and in IFAC, (2014a).

[12] In addition to discussions with Council members, an important input into the preparation of the Benchmark projections involves a round of discussions with other external forecasters, coming from a wide variety of different perspectives. For this round of forecasts, the Secretariat held discussions with economists and forecasters at the EU Commission, the NTMA, Central Bank of Ireland, Investec and Bank of Ireland. The Secretariat also met with the CSO to gain further insights into recent changes in the *National Income and Expenditure Accounts* and *Balance of Payments* data.

[13] These activities are also referred to as 'contracted production' and are expanded on in Box 1 of *Budget 2015*. They can occur when an Irish-resident firm (not necessarily Irish-owned) contracts a manufacturer abroad to produce a good for supply to an end-client abroad. The sale of the good is recorded as an Irish export of goods, while the contracted production is considered a service import.

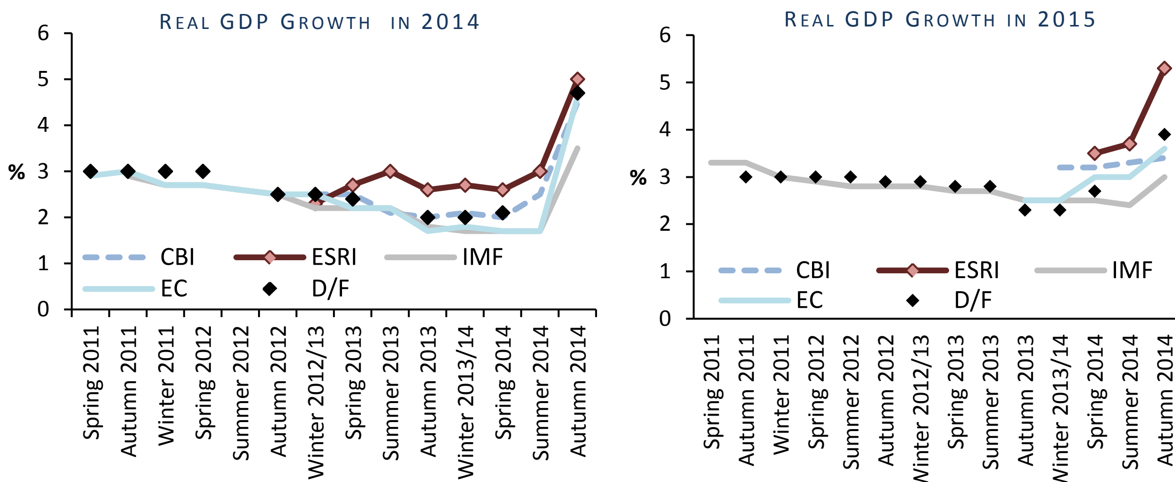
whether they will represent a once off boost to real GDP growth or whether they will actually unwind over coming quarters thereby weakening overall activity. As contract manufacturing appears to be related to only a small number of firms, sector- and product-specific developments may well have a disproportionate impact on subsequent GDP outturns. Given the unusual uncertainties related to this activity, forecasts of the outturns for 2014 and 2015 are subject to potentially greater margins of error.



Sources: CSO; Department of Finance; internal calculations.

Figure 2.1. shows the adjustments related to contract manufacturing since 2011 that are made in the Irish *National Accounts*. The adjustments are made to trade data, which are based on physical movements of goods across the border. Having typically been negative or near balance in previous years, the adjustment became strongly positive in the first half of 2014, equating to some 2.5 per cent of GDP. *Budget 2015* contains a Box explaining the impact of this phenomenon on the *National Accounts*. It also importantly notes that this activity involves "...very little employment effect or second-round impact on the wider economy".

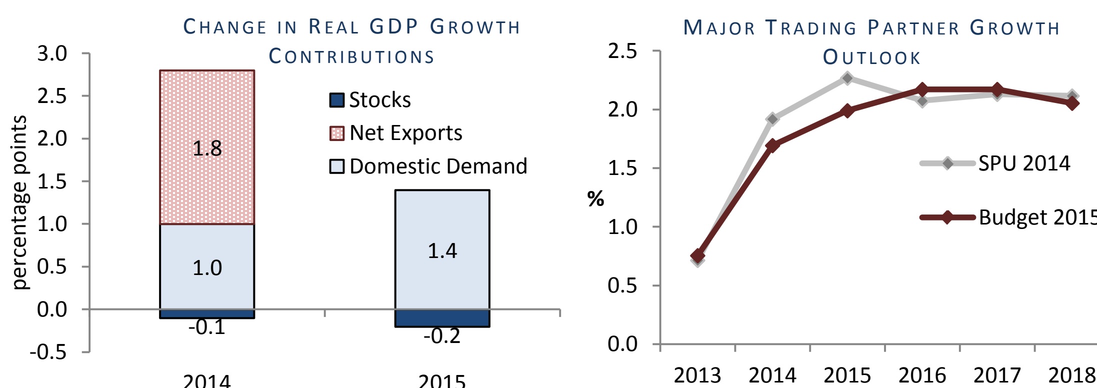
FIGURE 2.2: COMPARATIVE REAL GDP FORECAST VINTAGES (% CHANGE YEAR-ON-YEAR)



Sources: Department of Finance (D/F); European Commission; International Monetary Fund (IMF); Central Bank of Ireland (CBI) and the Economic and Social Research Institute (ESRI).

The Department of Finance and other agencies have revised upwards their projections since the time of the *SPU 2014* (Figure 2.2). This is due in large part to the boost from contract manufacturing activities and the Department now expect net exports to contribute an additional 1.8 percentage points to the overall growth rate compared to *SPU 2014* projections. The contribution to growth in 2015 is unchanged. The improvement in 2014 is not matched by a pick-up in external demand. Indeed, near-term prospects for trading partners have worsened marginally in the interim (Figure 2.3).

FIGURE 2.3: *BUDGET 2015* COMPARED TO *SPU 2014*



Sources: Department of Finance (D/F); internal calculations.
Note: Trading partner forecasts are trade-weighted OECD/IMF forecasts used by D/F for UK; US and Euro Area.

Stripping out the effects of contract manufacturing, the underlying trajectory for growth is still predicated on a solid recovery in domestic demand, with consumer spending and underlying investment (i.e., excluding planes) contributing to an expansion both this year and next. Exports are expected to grow more in line with export markets in 2015 and the drag on goods exports from patent expiries is expected to recede.

TABLE 2.1: *BUDGET 2015* MACROECONOMIC FORECASTS (TO 2015)

% change unless otherwise stated	2012	2013	2014	2015
Real GDP	-0.3	0.2	4.7	3.9
GDP Deflator	1.3	1.0	0.4	1.3
Nominal GDP	1.0	1.2	5.2	5.3
Real GNP	1.9	3.3	4.1	3.6
Consumption	-1.2	-0.8	1.7	2.7
Investment	5.0	-2.4	14.6	12.7
Government	-2.1	1.4	4.8	2.3
Exports	4.7	1.1	8.3	4.8
Imports	6.9	0.6	8.8	5.3
Current Account (% of GDP)	1.6	4.4	4.9	4.4
Employment	-0.6	2.4	1.8	2.4
Unemployment Rate	14.7	13.1	11.4	10.2
Inflation (HICP)	2.0	0.5	0.5	1.1
Nominal GDP (€ billions)	172.8	174.8	183.8	193.5

Sources: CSO and Department of Finance (*Budget 2015*).

Box A: What are Income Data Telling us?

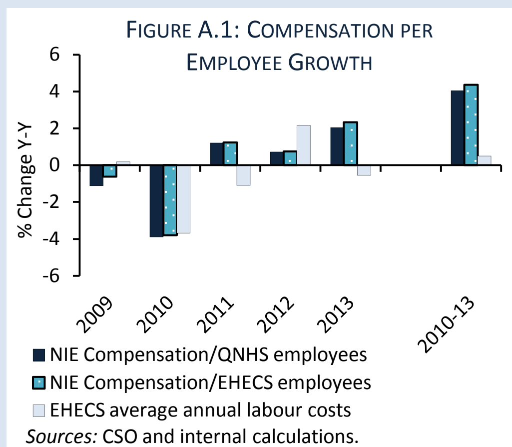
Personal consumption, equating to roughly half of GDP, has an important bearing on growth projections. Previous FARs highlighted a tendency for Department of Finance forecasts to over-estimate consumption growth (IFAC, 2013a). A key problem arises from understanding income developments which are crucial variables when forecasting consumer spending. In this Box, we highlight some of the issues with available income data.

Irish Income Data Sources Compared

The *National Income and Expenditure (NIE)* results published in the Summer following the most recent full year provide an official estimate of earnings growth. The latest release published in July 2014 covers 2013 and indicates that earnings rose by close to 2 per cent last year – better than the Department's 1.5 per cent forecast. The Council had assumed much weaker wage developments in line with high frequency quarterly data releases, known as the *Earnings, Hours and Employment Costs Survey (EHECS)*. These indicated an average decline of some 0.5 per cent for 2013.

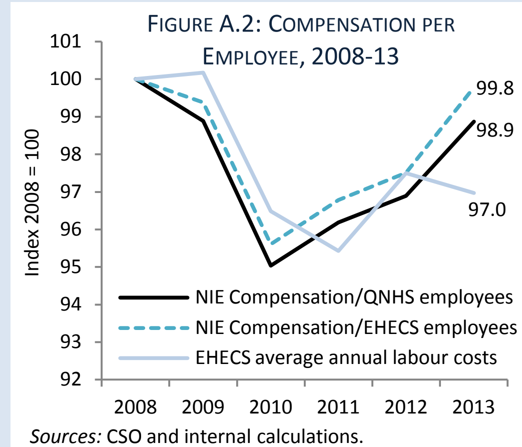
The divergence between the EHECS and the NIE is not a new issue, but it widened last year. Figure A.1 shows two NIE-based estimates alongside EHECS-based estimates.[14] Cumulatively, the EHECs data suggest that compensation per employee was relatively unchanged since 2010. The NIE data show that compensation per employee rose by roughly 4-4½ per cent depending on the estimates of employee numbers used.[15]

Figure A.1: Compensation per Employee Growth



Sources: CSO and internal calculations.

Figure A.2: Compensation per Employee, 2008-13



Sources: CSO and internal calculations.

The profile for earnings developments in the NIE also looks quite different to that portrayed by the EHECS dataset. NIE-based estimates show a more pronounced fall in earnings in 2010 with a steadily increasing pattern since then. Having bottomed out in 2010, they have recovered to close to their 2008 levels by 2013. The EHECS, however, would appear to suggest that compensation has recovered little since 2010. This suggests some problems for forecasters as the only hard data available in between annual NIE estimates are those provided by the EHECS. The differing narratives around earnings can also give rise to very different forecasts of consumption as well as for projections of income-related tax revenues. It would, therefore, be helpful if high-frequency earnings data could be improved.

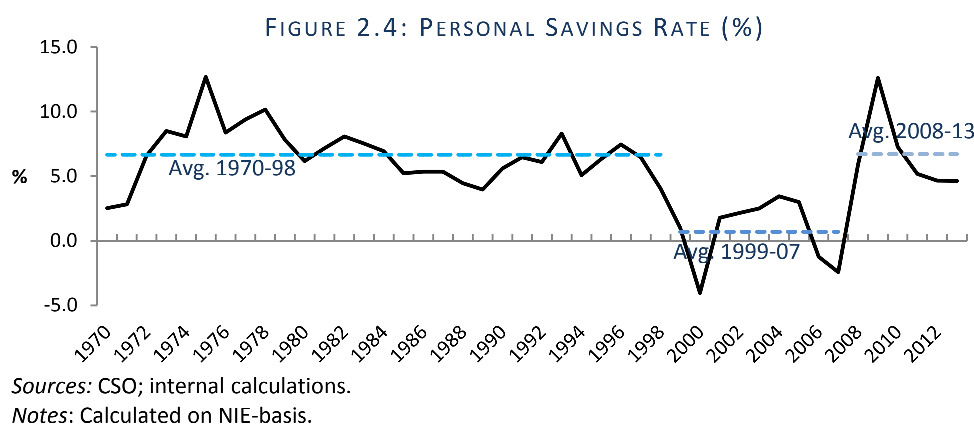
[14] The EHECS data here is the average hourly labour costs series which captures earnings data (regular earnings irregular earnings, bonuses, etc.) as well as non-labour costs (employers' PRSI, other social costs, benefit in kind etc.).

[15] Employee estimates can be taken from the EHECs dataset or from the *Quarterly National Household Survey (QNHS)* dataset. The former is a survey of employers and excludes certain sectors covered in the *QNHS* such as "activities of households as employers of domestic personnel"; "...undifferentiated goods- & services-producing activities of private households for own use..."; and "...activities of extraterritorial organisations and bodies...". It typically gives an estimate of employment that is ½-1½ per cent lower than the QNHS equivalent.

After three years of contraction, **personal consumption** is likely to show a rebound in 2014 (see Table 2.1 forecast summary). Income data present a mixed picture of recent trends in earnings. Annual data from the NIE showed strong income growth in 2013, but other CSO data suggest an annual decline in labour costs during 2013 and on into early 2014 (Box A).

Consumer spending growth is projected to accelerate in 2015, though headwinds remain. The pace of employment growth slowed during 2014 and a continuation of this trend could result in weaker earnings growth than projected. This could dampen consumer spending along with the ongoing negative drag from household deleveraging. In addition, CSO data on savings rates released after the endorsement suggest that savings rates have already descended from recent high levels.[16] Unless these converge on 1999-2007 levels (Figure 2.4), there may be limited space for reduced savings rates to further fuel consumption growth.

FIGURE 2.4: PERSONAL SAVINGS RATE (%)



Sources: CSO; internal calculations.
Notes: Calculated on NIE-basis.

BOX B: ESTIMATES OF CAR SALES

Roughly 3 per cent of annual consumption relates to the purchase of private transport equipment. Having contracted for several years, newly licensed private cars expanded by 30 per cent in the first eight months of 2014. An analysis of the determinants of vehicle purchases can help to shed light on whether or not car sales are likely to continue to improve in the coming years.

MODELLING THE STOCK OF CARS IN THE ECONOMY

Hennessy and Tol (2011); FitzGerald *et al*. (2002) and DKM (1998) suggest that convergence to a "saturation rate" forms a central part of forecasting the stock of cars likely to be in the economy at a given point in time. This saturation rate can be crudely understood as the number of cars per 1,000 of the population at which point demand for new vehicles

[16] The data on the savings rate were released on 9th October after the endorsement had taken place. Note that while NIE measured savings rates are shown here, the CSO's *Institutional Sector Accounts* provide another measure of household saving that includes depreciation, CGT and net non-life insurance premiums/claims. The latter series is only available from 2002 onwards and hence the long-run average is distorted by the Celtic Tiger period.

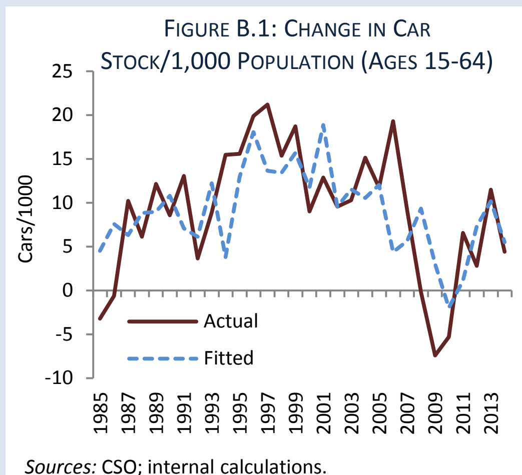
stabilises. At this point, the increase in the total stock of cars is deemed to be directly proportional to the changes in the population or demographic components. FitzGerald *et al.*[17] (2002) estimate the following model of the Irish car stock for a given saturation rate of 0.80

$$\Delta \ln \frac{0.8}{Cars_t/Pop_t - 1} = 0.286 - 3.17\mathrm{E}^{-05}\frac{Y_t}{Pop_t} - 0.155\ \ln \frac{0.8}{Cars_{t-1}/Pop_{t-1} - 1} - 1.63\mathrm{E}^{-05}\frac{Y_{t-1}}{Pop_{t-1}}$$

where Y is the level of disposable income and Pop is the population aged 15-64 years. The model adopts a logistic functional form[18] with an error correction procedure used to predict the car stock per member of the critical 15-64 age group at time t ($Cars_t/Pop_t$). Using the approach in FitzGerald et al. (2002), we re-estimate the model for the period 1985-2013:

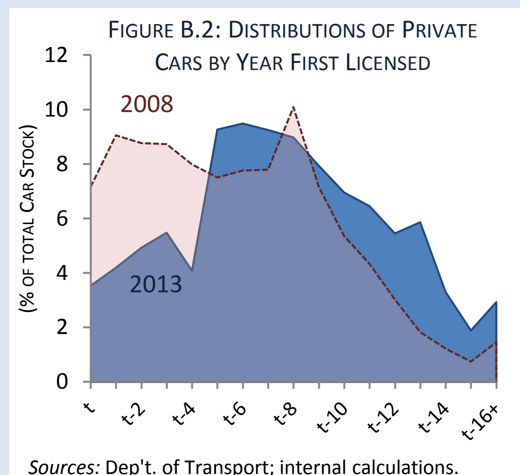
The coefficients we find (shown above) are similar to those on the lagged dependent variable, albeit are of a smaller order of magnitude for the income variables compared to previous studies. The signs are identical to previous studies and all coefficients are significant.

Figure B.1: Change in Car Stock/1,000 Population (Ages 15-64)



Sources: CSO; internal calculations.

Figure B.2: Distributions of Private Cars by Year First Licensed



Sources: Dep't. of Transport; internal calculations.

The model estimates fit the data reasonably well as can be seen in Figure B.1, with the change in the actual car stock per 1,000 of the population (aged 15-64) overshooting that estimated during the pre-bubble period and undershooting it in the early-crisis period 2008-2010. Since then, developments have been more aligned with the model's predictions. The stock bottomed out in 2011 in line with real incomes. Income growth in the last two years then contributed positively to the expansion in the car stock. Based on current income expectations, this should continue beyond 2015.

Other Factors: Ageing Fleet and Convergence on EU Norms

There is further evidence to suggest that an expansion in car stocks could be expected to continue. In addition to support offered by models of car stocks and income expectations, the necessity of replacing an ageing car fleet and a likely convergence on international levels of ownership suggest further potential growth in 2015. The proportion of private cars aged over 10 years old is nearly twice as high as in 2008 (Figure B.2) – this will necessitate new purchases if the stock is to be maintained. Also, the share of cars per 1,000 persons in Ireland is below that of the assumed saturation level and below that of other European economies (Figure B.3).

[17] This saturation rate is determined based on a consideration of international experience.

[18] This functional form allows for an 'S-Shaped' curve where demand for vehicles slows as the saturation point is converged on.

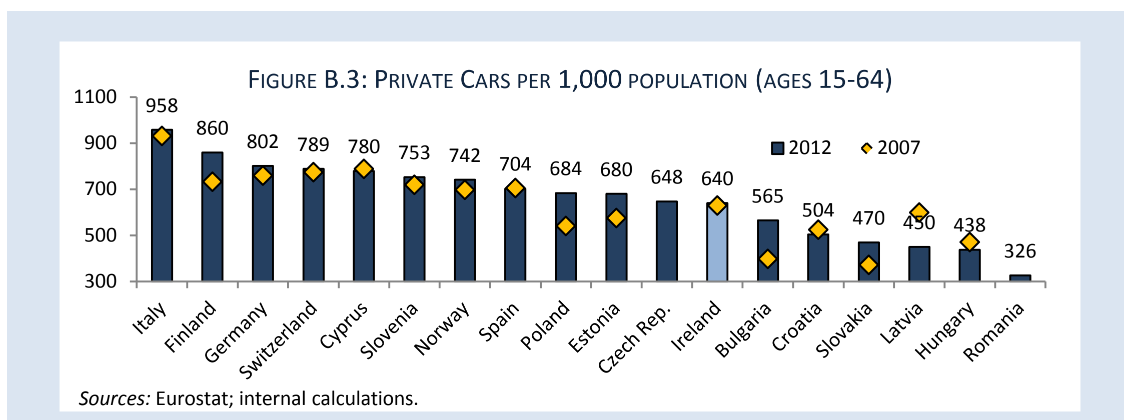


FIGURE B.3: PRIVATE CARS PER 1,000 POPULATION (AGES 15-64)

Sources: Eurostat; internal calculations.

Domestic demand is expected to be boosted by an increase in **government consumption** in 2014 and 2015. This is largely technical in nature, with the statistical treatment of longer public service hours worked under the Haddington Road Agreement having a greater measured impact than expected.[19] Measures introduced in *Budget 2015* contribute modestly to the increase next year as does a fall in offsetting receipts related to the banking system guarantee.[20]

Investment spending is expected to continue to expand robustly as a lagged response of the building and construction sector to supply shortages in certain areas provides further impetus. Underlying investment (i.e., excluding planes and intangibles) was running at a rate of 20 per cent year-on-year in the first half of 2014. A negative base effect is expected in the second half of the year following strong machinery and equipment investment in late 2013, but the strength of forward-indicators such as PMIs and commencements data augurs well for housing investment in the quarters ahead.

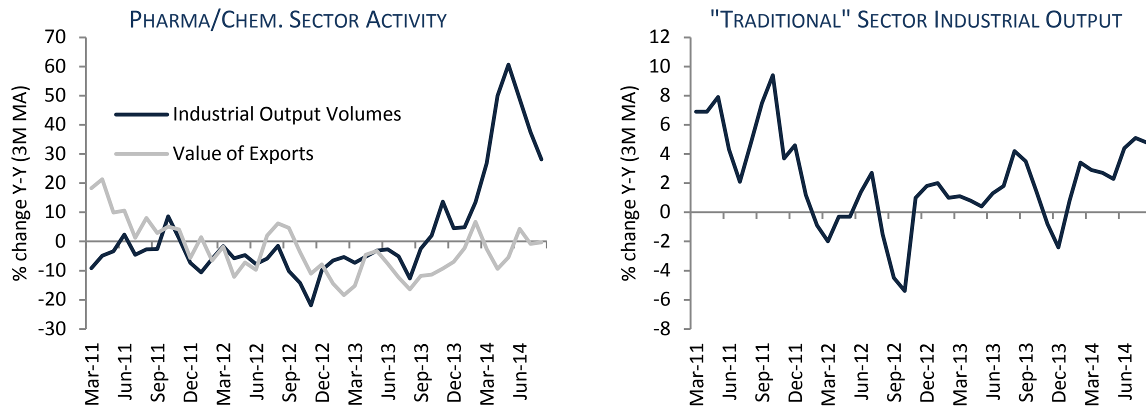
Aside from idiosyncratic developments related to contract manufacturing, **exports** are likely to benefit from recovering demand in the UK and US markets and an unwinding of the patent cliff (Figure 2.5). A recovery in exporting sectors that are less dominated by multinationals was apparent in 2013. This appears set to continue with "traditional sector" industry output also higher in 2014.[21] Services' exports also remained strong in the first half of 2014. This was reflected on the output-side by solid expansions in distribution and software and other services, though data for this sector can be volatile.

[19] The measured volume increase in government consumption is greater than before, but the price deflator registers a sharper decrease. These movements offset each other to some extent. The net impact of both entails an upward revision in nominal terms of the order of 0.2 percentage points of GDP excluding the impact of new measures in *Budget 2015* and revisions to the base year (2013).

[20] Receipts related to the Eligible Liability Guarantee scheme are netted against government consumption in the *National Accounts* treatment.

[21] The "traditional" sector classification includes some large multinationals also. It comprises all industries (NACE 05-35) aside from those sectors typically classified as "modern", namely: pharma/chem. (NACE 20-21); computer, electronic, optical and electrical equipment; reproduction of recorded media; and medical and dental instruments and supplies.

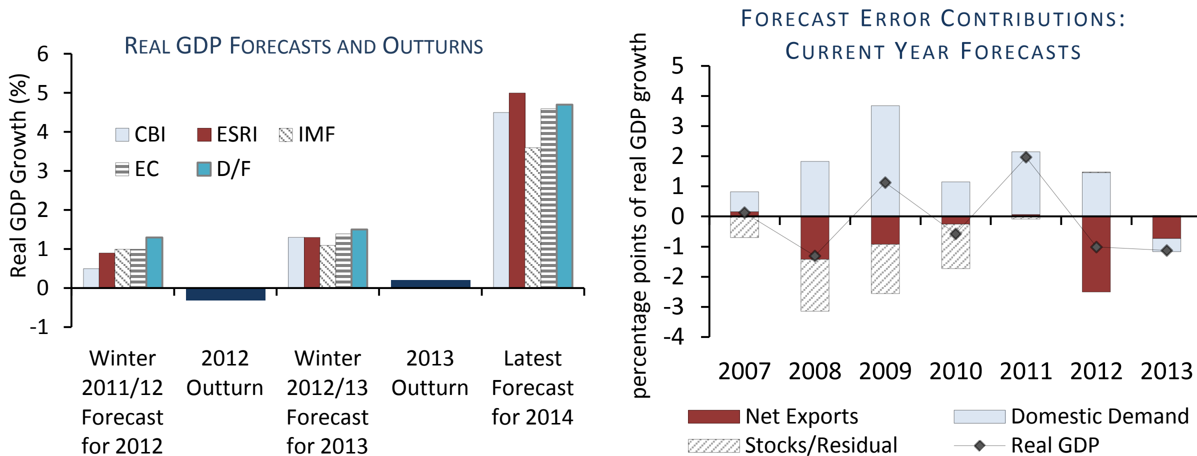
FIGURE 2.5: SECTORAL PERFORMANCE IN GOODS EXPORTS



Source: CSO.

Nominal GDP for 2014 is largely influenced by real growth given relatively subdued economy-wide inflation. The GDP deflator is expected to grow faster next year, particularly as a weaker euro vis-à-vis the dollar benefits Irish exports priced in US dollars. A substantial boost to historical nominal GDP results from the adoption of new international standards for economic statistics (Analytical Note No. 6).

FIGURE 2.6: REAL GDP GROWTH FORECASTS, OUTTURNS AND ERRORS



Sources: CBI; ESRI; IMF; EC and CSO.

Source: Department of Finance; CSO and internal calculations.

The bulk of the Department's recent forecast errors for real GDP growth came from over-optimistic projections with respect to the traded sector. In 2012 and 2013, net exports reduced growth by 2.5 and 0.7 percentage points, respectively, relative to early-year expectations. These revisions reflected in part similar downward revisions to trading partner growth from official IMF, OECD or European Commission forecasts and patent expiries in the volatile pharma/chemicals sector.[22] The

[22] Since forecasts for demand in Ireland's major trading partners are taken as exogenous inputs from other international forecasting agencies, any errors in these forecasts can translate into errors in trade forecasts for Ireland also.

outturn for consumer spending in 2013 was again weaker than had been projected by the Department although this was offset by stronger investment and government consumption. Up to recently, a pattern of downward revisions to official forecasts was observed. This should caution against complacency in interpreting the most recent projections. Official 2013 forecasts – having begun the year at close to 1½ per cent – were gradually revised down towards an outturn of just 0.2 per cent as the year progressed (Figure 2.6). Similarly, early forecasts for 2012 anticipated real GDP growth of roughly 1 per cent. The actual outturn ended up negative at -0.3 per cent. October's *NIE* tables suggest the weak 2013 outturn reflected, in part, developments in sectors dominated by multinationals (Box C).

2.2.2 Reconciliation Tables

On Budget day, a set of reconciliation tables was provided to the Council outlining differences between the endorsed draft forecasts and the final projections in *Budget 2015*. The published reconciliation tables showed the difference between the endorsed macro forecasts and the final Budget figures but did not provide detailed information explaining how specific budgetary measures impacted the macroeconomic projections. The Council recommends improvements to the level of detail provided in the reconciliation table to make clear the rationale for and drivers of revisions to the macroeconomic projections resulting from Budget day measures. Specifically, useful additions would be the implied marginal propensities to consume that underpin any modifications as well as the import content related to any changes in expenditure components.[23]

The fiscal package announced in *Budget 2015* boosted overall real GDP for 2015 by an additional 0.3 percentage points compared to the draft forecasts. At an aggregate level, this increase – most of which comes through in the form of additional consumer spending – appears reasonable although the provision of greater detail on the precise impact of individual Budget measures would allow for a more thorough assessment.[24]

2.2.3 Medium-Term Forecasts, 2016-2018

As in the *SPU 2014*, *Budget 2015* forecasts economic activity to be driven by domestic demand initially, with a more balanced composition in 2016 and 2017. By 2018, net exports are projected to take up the mantle from domestic activity. Although the focus of *Budget 2015* was on the short-term horizon, the medium-term outlook envisaged may be at the relatively optimistic end of the range. Estimates of potential real GDP growth rates were revised up further from *SPU 2014* by roughly ½ percentage point per annum to close to 4 per cent over 2017-18 (Table 2.2).

[23] These will be discussed in the context of the review of the *Memorandum of Understanding* between IFAC and Department of Finance to be completed in 2014.

[24] An overall import elasticity of 0.47 was assumed.

Table 2.2: Real GDP Growth Rate Forecasts

	% change	2014	2015	2016	2017	2018
Budget 2015	Real GDP Growth	4.7	3.9	3.4	3.4	3.4
	Nominal GDP Growth	5.2	5.3	5.1	5.2	5.2
	Potential GDP Growth	2.1	2.7	3.4	3.8	3.9
SPU 2014	Real GDP Growth	2.1	2.7	3.0	3.5	3.5
	Nominal GDP Growth	2.6	3.6	4.3	4.7	4.7
	Potential GDP Growth	1.5	2.2	2.9	3.3	3.5

Source: Department of Finance.

A hand-over from domestic demand-driven growth to an environment in which the traded sector carries more weight is assumed in the Department's projections. While feasible, this may be difficult to achieve, especially if the recovery in the Euro Area does not gather pace. Competitiveness gains needed to support export driven growth, in particular, will likely be challenging to bring about. *Budget 2015* forecasts consumer prices near those for the Euro Area; stronger labour market developments; and employee compensation growing more robustly than previously assumed (2.6 per cent per annum on average for 2015-18 compared to 2 per cent in *SPU 2014*). Furthermore, the assumed shift to net-exports-driven growth by 2017 may be difficult to realise given the possible drag on productivity growth arising from a compositional shift to relatively low-productivity sectors. A full analysis of the medium-term outlook will be provided as part of the Council's endorsement and assessment of the Department's *Stability Programme Update 2015* scheduled for release in April next year.

2.2.4 Forecasts of Other Agencies

The consensus among other forecasting agencies is for real GDP growth to accelerate sharply in 2014, with growth rates pencilled in at close to 5 per cent for this year. However, there is some divergence of opinion as to the pace of growth that can be expected for 2015.

The Central Bank (2014b) is forecasting a deceleration to 3.4 per cent real GDP growth in 2015, but the ESRI (2014) expect a considerable portion of this year's momentum will carry through into next year. This appears to reflect an assumption of some reversion in net export growth on the part of the Central Bank and the EC, bringing it in line with external growth for 2015, whereas the ESRI appear to imply some continuation of the recent trade performance. The wider range around recent forecasts for next year likely reflects uncertainties tied to the traded sector and contract manufacturing in particular.[25]

[25] IMF forecasts were not updated at the time of writing to reflect the latest QNA data.

Table 2.3: Medium-Term Macroeconomic Forecasts to 2018

% change unless otherwise stated	2014	2015	2016	2017	2018
Budget 2015					
GDP	4.7	3.9	3.4	3.4	3.4
Employment	1.8	2.4	1.9	1.9	1.9
Productivity	2.8	1.4	1.4	1.4	1.4
ESRI (*MTR*: Recovery Scenario)					
GDP	3.0	4.0	4.1	4.2	3.7
Employment	0.9	2.3	2.9	1.9	2.2
Productivity (implied)*	2.1	1.7	1.2	2.3	1.5
IMF (*12th Review*)					
GDP	1.7	2.5	2.5	2.5	2.5
Employment	1.5	1.2	1.2	1.7	1.7
Productivity (implied)*	0.2	1.3	1.3	0.8	0.8
OECD (*May 2014*)					
GDP	1.9	2.2	3.3	3.3	3.0

Sources: SPU 2014; ESRI *(Medium-Term Review 2013);* IMF *(12th Review);* OECD (*Economic Outlook,* May 2014).
* Implied productivity is simply GDP growth less employment growth.

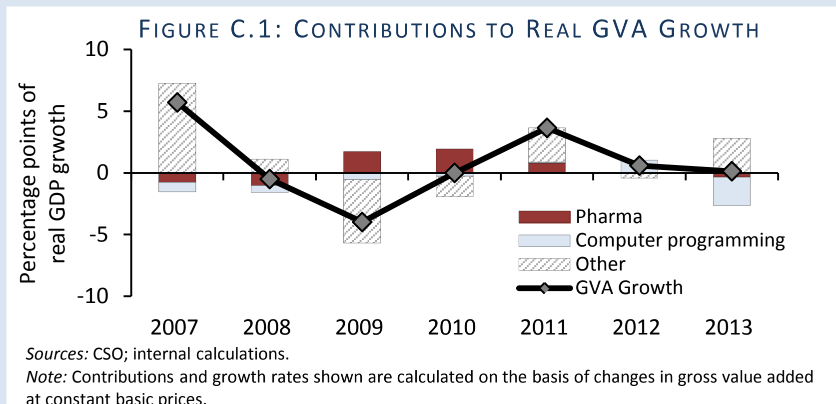
As at the time of the last *FAR*, the Department's forecasts were weighted more towards domestic demand relative to other agencies. In 2015, growth is dominated by the contribution from the domestic economy in the Department's forecasts (contributing 3.6 percentage points to the 3.9 per cent growth rate), whereas other agencies envisage a broadly balanced contribution from the traded and domestic sectors.

In contrast to forecasts for potential GDP, real GDP forecasts for the medium term are essentially unchanged since the time of the last *Assessment Report*, with the latest *Budget 2015* projecting average real GDP growth of 3.4 per cent over 2016-18 (Table 2.3). This is still in excess of the IMF baseline averaging 2.5 per cent, yet close to the OECD average (3.2 per cent) and below that projected in the ESRI's "recovery" scenario for the medium term (4 per cent).

Box C: Weaknesses in 2013 Real GDP

New data from the CSO indicate that the overall weakness of real GDP in 2013 was due to developments in the multinational-dominated sectors.[26] Domestically-oriented sectors of the economy appear to have performed strongly in 2013. 'Computer programming' and 'pharma' activities exerted a combined drag on the volume of output last year of the order of 2½ percentage points.[27] The vast bulk of this related to a contraction in computer programming, though estimates for the latter could be subject to revision. Looking at Gross Value Added (GVA) rather than GDP (Figure C.1), we can see that a large negative contribution from the computer programming sector offset much of the improvement in other sectors last year.[28]

Figure C.1: Contributions to Real GVA Growth



Sources: CSO; internal calculations.
Note: Contributions and growth rates shown are calculated on the basis of changes in gross value added at constant basic prices.

The weaknesses in 2013 real GDP growth appear to stem from Information Communication Technology (ICT)-related sectors rather than weaknesses related to the patent cliff as had been expected prior to the October NIE release. Two factors are relevant in this context: first, on the basis of current data – which may be revised – the pharma sector does not show as substantial a contraction in output volumes as had been expected.[29] Second, imports of a relatively larger number of patents among ICT sectors were recorded in 2013. This resulted in a large reduction in gross value added in the sector by raising intermediate consumption. The increase in the latter largely related to substantial rises in offsetting imports of royalties.[30]

2.3 Risks

The substance of the *Budget 2015* discussion of risks is relatively unchanged from that presented in *SPU 2014*. In a written response to the concerns raised in the previous *FAR*, the Minister for Finance noted that "...a statement on the overall balance of risks can be provided in future". The

[26] The new release published on 16 October provides data on Gross Value Added for Foreign-owned Multinational Enterprises and Other Sectors of the economy.

[27] The 'computer programming' sector is a broad sector comprising computer programming, consultancy and related activities as well as information service activities (NACE codes 62-63). Pharmaceuticals here specifically refer to basic pharmaceutical products and pharmaceutical preparations (NACE 21).

[28] A further breakdown from the CSO in the new 'Gross Value Added for Foreign Multinational Enterprises and Other Sectors Annual Results' release suggests this dynamic corresponds to a similar dynamic in the domestic/foreign split of GVA. In effect, the data show that a large positive contribution from more domestically-oriented sectors to GVA growth last year was offset by a contraction in sectors dominated by foreign-owned multinationals.

[29] This may be revised with the 2014 NIE release as annual Revenue data for 2013 become available.

[30] Note that while the fall in volume was substantial (-57 per cent), this was more than offset by an implied improvement in output prices compared to intermediation consumption prices. The relative price improvement was large enough to mean that the overall *value* of the sector actually expanded by some 20 per cent.

Council considers this to be a useful and important element of the analysis; however, no such balance of risks was included in *Budget 2015*, although it was included in some earlier Department of Finance publications.

TABLE 2.4: MACROECONOMIC RISKS COVERED IN *BUDGET 2015*

Risk	Direction	Details
Euro Area Growth	Downside	Increased probability of contraction in Euro Area could lead to weaker-than-expected export demand
Euro Area Deflation	Downside	Deflation could raise real interest rates and depress aggregate demand
Geopolitical Risks	Downside	Any acceleration in tensions could pose downside risks for growth
FDI-Dependence	Downside	Inward FDI is vulnerable over medium term to lost competitiveness gains; shifts in demand for products; changes in global tax regime
Household Debt	Downside	Unanticipated interest rate rises could dampen near-term private consumption growth
Debt Sustainability	Downside	Although peaking in 2013, government debt remains very high by historical standards
Investment	Upside	Any faster-than-anticipated pick-up in investment from current low levels could boost domestic demand

Source: Budget 2015.
Note: The direction of risk is inferred from but not specified in *Budget 2015*. Additional risks listed in *Budget 2015* – almost exclusively downside in nature – are extracted from the Draft *National Risk Assessment*, but are omitted here.

Downside risks dominate the discussion in *Budget 2015* (summarised in Table 2.4). There are six sources of primarily downside risks listed in the main risk discussion, with one upside risk. Added to the list of forecast risks and the sensitivity tables is a brief discussion of April's Draft "*National Risk Assessment*" publication.[31] The main additions are risks relating to a re-emergence of the Euro Area sovereign debt crisis; vulnerabilities in the banking system; and 'human capital' risks (i.e., skills shortages in areas such as ICT).

A welcome area of improvement is seen in the efforts made to bring together previously fragmented risk analyses.[32] Where relevant risks remain pertinent – such as those documented in the *National Risk Assessment* – it would be more useful to incorporate these into a single risk discussion that gives a more comprehensive sense of risk exposure.

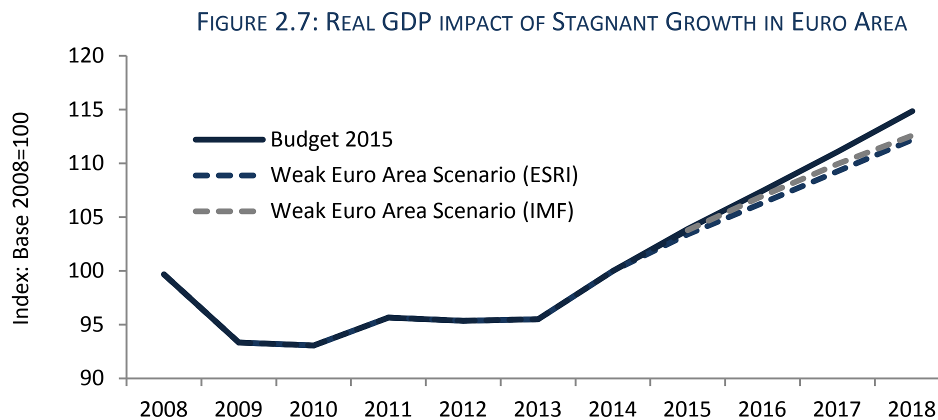
The Council broadly agrees with the array of macroeconomic risks outlined in *Budget 2015*, but some areas are overlooked. The issue of contract manufacturing – while covered in Box 1 in *Budget 2015* – is absent from the risk discussion. There is an acknowledgment in *Budget 2015* that such activities could "...unwind or accelerate with potentially large impacts on measured GDP". The net

[31] Available here: http://www.taoiseach.gov.ie/eng/Publications/Draft National Risk Assessment 2014.pdf

[32] This problem is highlighted in the IMF (2013) *Fiscal Transparency Assessment* and is in part addressed by the inclusion of a discussion of contingent liabilities and links to various reports in *Budget 2015*.

impact is shown to contribute in the region of 2½ percentage points to real GDP growth in the first half of 2014, which – if it were to unwind – would imply a sizeable impact on forecast assumptions.

FIGURE 2.7: REAL GDP IMPACT OF STAGNANT GROWTH IN EURO AREA



Source: CSO; ESRI; IMF; Department of Finance; internal calculations.
Note: Low Euro Area growth scenario assumes real GDP growth or real import growth one standard deviation below baseline EC forecasts for 2015-18 . Shock coefficients are taken from ESRI (2013) and Nkusu (2013).

A more substantive discussion of the external risks in the Budget would have been worthwhile. If fragilities related to the external recovery were to see demand in the Euro Area slow to one standard deviation below that assumed in *Budget 2015*, then yearly real GDP growth rates for Ireland would be expected to average around half a percentage point lower over 2015-2018 (Figure 2.7).[33] The IMF (2014) currently estimate a near 40 per cent probability of a recession in the Euro Area over the next twelve months, with the probability of deflation estimated at 30 per cent.[34] By contrast, upside risks could materialise if EU policy actions prove decisive in arresting weak activity levels.

A third risk that warrants further discussion is the slowdown in employment growth observed in early 2014 and the wider uncertainties surrounding the likely prospects for the labour market in the medium term.

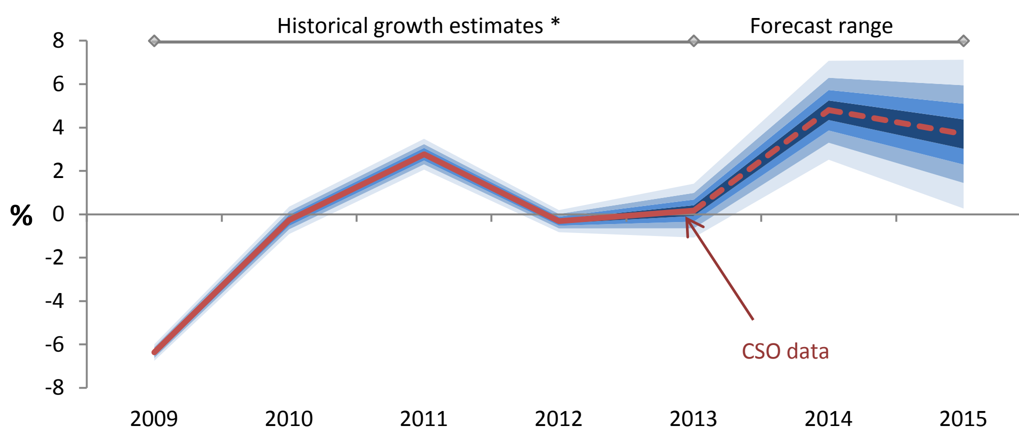
Other risks to be considered relate to possible cost pressures related to recent rapid house price increases (Appendix B) and the ability of credit institutions to support the recovery. Ongoing global demand shortfalls could also impede growth if policies designed to promote activity in major trading partners fail to overcome weak international demand conditions and sluggish productivity advancements.

[33] Based on VAR model elasticities.

[34] Deflation here is defined as two consecutive quarters of falling consumer prices over the next 12 months.

Irish economic developments are relatively volatile compared with other countries, having one of the largest absolute forecast errors for GDP in the EU (IMF, 2013b). In addition, Irish macroeconomic data are subject to some of the largest historical revisions in the OECD, contributing to the difficulties of making accurate forecasts.[35] Uncertainty surrounding current growth estimates related to contract manufacturing is likely to mean that uncertainty around GDP at present may be higher than represented in the fan chart. Figure 2.8 shows the fan chart surrounding the Department's growth forecasts to 2016 based on past errors along with the range related to expected data revisions for the historical period.

FIGURE 2.8: REAL GDP FAN CHART BASED ON *BUDGET 2015* PROJECTIONS (TO 2015)



Sources: CSO, Department of Finance, internal calculations.
* Distributions or 'fans' around historical growth estimates are based on previous revisions to real GDP data. Both forecast errors and revisions are based on 1999-05 sample.

2.4 ENDORSEMENT OF THE *BUDGET 2015* PROJECTIONS

This section details the third endorsement exercise undertaken by the Council covering *Budget 2015* and is intended to outline the Council's considerations around the time of the endorsement (Appendix C details the timeline). Data available at the time may differ from that available for the purposes of the assessment documented in previous sections. The forecasts for the endorsement were predicated on a no policy change basis (i.e., a neutral *ex ante* discretionary budget adjustment).

The Council endorsed the *Budget 2015* macroeconomic forecasts to 2015. It was satisfied that these were within its endorsable range, taking into account the methodology and the plausibility of the judgements made.

[35] This is true even when relatively high historical growth rates in an international context are controlled for.

The endorsement process focuses on several key dimensions: the plausibility of the methodology used; the pattern of recent forecast errors; and comparisons with Benchmark and other projections.

First, focusing on the methodology used by the Department of Finance, the Council is satisfied that this is broadly in line with standards set by other forecasting agencies both internationally and domestically. The Department has made available the models used in the development of its forecasts for assessment by the Council and has explained in detail its approach in various meetings. The Council also welcomes the recent uptake by the Department of the Council's recommendations for carry-over analyses and the production of quarterly profiles. Quarterly data in Ireland are volatile and prone to revision, yet this volatility represents an integral aspect of the dynamics of the economy and understanding the nature of the volatility can yield important insights. Furthermore, an understanding of quarterly dynamics and any patterns to data revisions is necessary to make accurate predictions for annual *National Accounts* variables.[36]

The projected quarterly profile for net exports in 2014 and 2015 was examined as part of the endorsement. In light of the strong net export outturn for the first half of 2014, the expected profile of goods exports and services imports - particularly that relating to contract manufacturing - bears considerable influence over real GDP assumptions for the forecast period. Quarterly profiles produced by the Department suggested that net exports would weaken in the second half of this year, before rebounding in 2015. Another plausible scenario could see imports rise such that any gross value added arising from associated activities was less pronounced for the year as a whole. The absence of detailed information on what appeared to be largely firm-specific developments made it very difficult to determine the likely outcome for the traded sector.

Second, in terms of the pattern of errors in recent Department of Finance forecasts, the Council has previously highlighted forecast errors related to the domestic and external split of aggregate demand. This issue was raised in previous *Fiscal Assessment Reports* and it represented a key focus of the endorsement process.[37] The Council continues to monitor the Department's forecast errors. With respect to 2013, it was evident that forecast errors related to consumption were offset by other positive surprises in domestic activity, while specific issues related to multinational-dominated sectors resulted in weaker-than-forecast net exports. Examining the balance of domestic activity in the overall composition of the macroeconomic projections formed an

[36] The relationship between annual growth rates and quarterly growth profiles is explored in more detail in Box C of the November 2013 *FAR*.

[37] See the Decomposition of Forecast Errors in Box A of the April 2013 *Fiscal Assessment Report* for more detail.

important part of the Council's endorsement, especially given that domestic activity is typically more tax-rich in nature.

Third, comparisons with the Benchmark projections and other forecasts drew further attention to the strength of consumer spending assumed in the Department's forecasts. These were less of a concern for 2014 given the strength of supporting high-frequency data even though the assumed growth was stronger relative to Benchmark projections (Appendix Table A.1) and some other agency projections.[38] Retail sales volume growth had been largely positive and, notwithstanding some tendency to overstate actual measured personal consumption outturns, the 2014 projection appeared attainable.

The plausibility of the assumed continuation of strong consumer spending into 2015 was less clear-cut. The forecasts were driven by much weaker growth in taxes and stronger pre-tax income growth such that nominal personal disposable incomes are expected to rise by 3.5 per cent. This forecast relied on the strength of income growth in 2013 as reported in the *National Accounts* data. Exchequer data – while not formally linked to wage growth – appeared consistent with some strengthening in incomes. Income growth could be reasonably expected to continue to recover into 2015 if supported by other factors: a continued – albeit potentially more gradual – recovery in employment, sustained low interest rates and additional improvements in consumer sentiment. These factors provided further grounds for additional momentum in earnings over coming quarters.

[38] Benchmark projections form a key part of the endorsement process (see IFAC, 2013b and 2014a).

3. Assessment of Budgetary Forecasts

Key Messages

- The General Government deficit of 3.7 per cent of GDP for 2014 projected in *Budget 2015* is driven by buoyant tax revenues for the year to date and a higher level of nominal GDP than originally anticipated. This is a lower deficit than the 4.8 per cent forecast in *SPU 2014*. The improved outlook for 2014 and strong expected economic growth for 2015 lead to a forecast deficit of 2.7 per cent next year. This is outcome is expected to be achieved despite the turnaround in the planned fiscal stance to allow for the introduction of expansionary measures.

- *Budget 2015* does not include a well-specified plan for the public finances after 2015. Instead, it provides a set of revenue forecasts based on a no-policy change and an expenditure profile based on holding Voted Expenditure constant. These do not appear to represent the Government's best estimates of the level of revenues or expenditure in the coming years. Indeed, revenues will likely be impacted by announcements regarding an easing of the income tax burden in future Budgets and the *Comprehensive Expenditure Report 2015-2017* announces a different path for voted expenditure.

- Spending plans have been revised upward, including raising the expenditure ceilings for 2015 to 2017. Even so, expenditure pressures remain and the *Comprehensive Expenditure Report 2015-2017* does not detail what spending measures will be required to remain below ministerial ceilings. This a particular problem for departments reporting large cost pressures over 2015 to 2017.

- General Government debt should rise much more gradually in the medium term due to the rundown of cash balances and shrinking deficits. The debt-to-GDP should fall quite rapidly over the medium term if *Budget 2015*'s forecasts for economic growth materialise.

- While the budgetary projections for 2015 are assessed to be appropriate, significant uncertainties surround growth projections and the capacity to deal with expenditure pressures. The usual uncertainties are compounded for 2016-18 by the absence of a well-specified medium-term plan. Risks to the government's balance sheet, while still present, have subsided considerably in recent years as the outlook for both NAMA and the banking sector has improved and greater certainty was provided by recent bank stress tests.

3.1 Introduction

This chapter assesses the latest set of budgetary forecasts produced by the Department of Finance. This involves a number of steps: (i) a review of the accuracy of Department of Finance forecasts for 2014 (Section 3.2); (ii) an assessment of the forecasts contained in *Budget 2015* (Section 3.3); and (iii) an examination of the sensitivity of the main budgetary aggregates to changes in the economic outlook as well as a broader assessment of risks (Section 3.4). This chapter contains new analysis which decomposes the main drivers of the Department's forecasts for key tax revenues in 2015.

3.2 Department of Finance Budgetary Projections for 2014

Budget 2015 forecasts a deficit of 3.7 per cent in 2014, considerably lower than the 4.8 per cent forecast in *Budget 2014* and *SPU 2014.* Part of this change is due to statistical revisions to both the size of the deficit and the size of nominal GDP; these were required as part of an international movement from the ESA 95 standard to the ESA 2010 standard (see Analytical Note 6). Table 3.1 shows the evolving set of projections for 2014, as adjusted for statistical revisions required under ESA 2010.[39]

The outlook for General Government revenues in 2014 is almost €2 billion stronger in *Budget 2015* relative to *Budget 2014.* Within this, taxes make up the largest source of revision, some €1.2 billion stronger than anticipated. Social contributions (mainly Pay Related Social Insurance (PRSI)) and other non-tax revenue (mainly Central Bank surplus and dividends from semi-state companies) also contribute €0.7 billion in total. Total expenditure for 2014 has also risen in *Budget 2015.* An upward revision to government services was partially offset by a downward revision to interest payments.

The forecast for the size of the debt in 2014 in nominal terms is similar in *Budget 2015* to the level forecast in both the *SPU 2014* and in *Budget 2014*, as shown in Figure 3.1.[40] Although the projected size of the debt in nominal terms is largely unchanged compared to earlier forecasts, the debt ratio as a percentage of GDP is expected to be lower. This reflects the increase in the level of nominal GDP due to ESA 2010 changes as well as higher forecasts of nominal GDP growth in 2014. Removing the effect of ESA revisions from nominal GDP but allowing for improved economic growth, the *Budget 2015* estimate for debt-to-GDP would have been roughly 118 per cent.

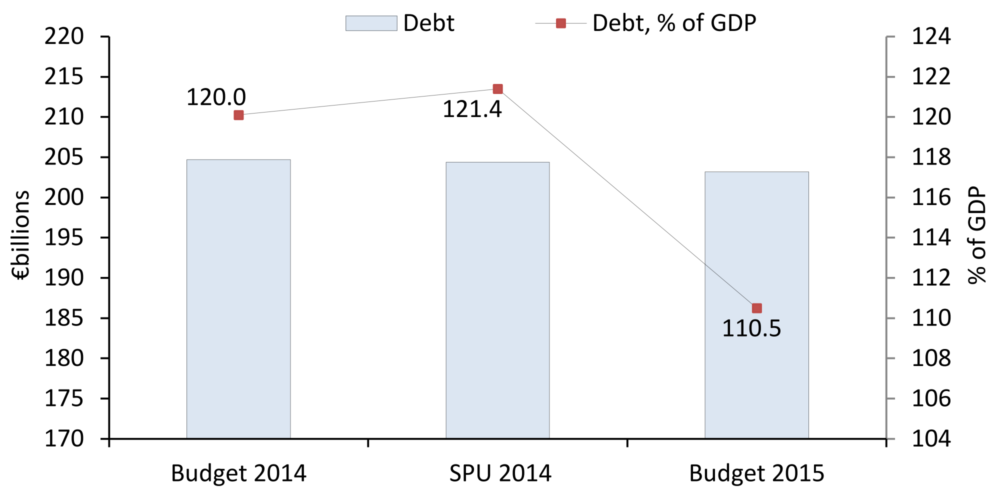
[39] The table is amended for the nominal impact of ESA 2010 revisions to each category. For items expressed as a percentage of 2014 GDP, nominal GDP for 2013 is revised to ESA 2010 and the forecasted GDP growth rate for 2014 is applied.

[40] The main ESA 2010 revisions to the nominal debt level, predominantly the treatment of Irish Bank Resolution Corporation (IBRC), have fallen out of the debt figures by 2014.

TABLE 3.1: DEPARTMENT OF FINANCE PROJECTIONS FOR 2014 (ADJUSTED FOR ESA 2010)[41]

€ Billions	*Budget 2014*	*SPU 2014*	*Budget 2015*
	Oct-13	Apr-14	Oct-14
General Government Balance	**-8.2**	**-8.0**	**-6.9**
General Government Balance, % of GDP	**-4.5**	**-4.6**	**-3.7**
Primary Balance, % of GDP	0.0	0.0	0.3
Revenue	61.9	62.0	64.0
Tax	44.6	44.7	45.9
Social Contributions	10.3	10.1	10.6
Other	7.0	7.1	7.6
Expenditure	70.1	70.0	70.9
Government Services	26.7	26.6	27.9
Social Transfers	28.2	28.2	28.1
Interest	8.2	8.0	7.5
Investment	2.6	2.7	2.8
Other	4.4	4.4	4.6
Primary Expenditure	61.9	62.0	63.4

FIGURE 3.1: EVOLVING DEBT PROJECTIONS FOR 2014



Source: Department of Finance.

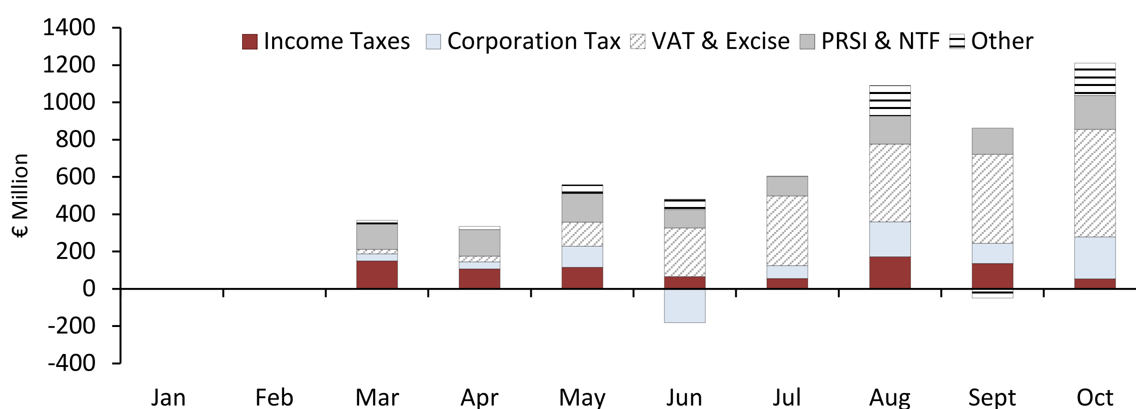
[41] This table summarises Department of Finance's forecasts for 2014 as amended by the statistical revisions contained in ESA 2010. This is carried out for comparison purposes. As such, there may be small differences between the numbers reported here and those contained in *Budget 2014* and *SPU 2014*.

Revenue Revisions

The biggest changes to the budgetary forecasts for 2014 relative to *Budget 2014* are those made to revenues, both tax and non-tax. This section analyses revenue revisions in greater detail.

The upward revision to taxes and social contributions is in the context of Exchequer numbers to end-October (Figure 3.2) being substantially ahead of expectations. Taxes and PRSI together were some €1.3 billion ahead of profile, driven by an unexpectedly large 8.2 per cent year on year increase in VAT, as well as strong performances in Excise Duty, Corporation Tax (CT), PRSI and Income Tax. While a portion of this strong performance is related to the pension fund levy, which will be substantially reduced in 2015, the majority of the overperformance appears to be based on an underlying improvement in revenues rather than one-off or temporary factors.

Figure 3.2: Taxes and PRSI Relative to Profile



Source: Department of Finance, internal calculations.

The Department of Finance forecast tax heads on the basis of a number of factors:

i. economic drivers;
ii. the estimated yield from policy changes; and
iii. other variables such as carryovers from previous years, one-offs and data provided by the Revenue Commissioners

A standard formula is used to estimate the impact of these factors, but the final forecast may include a judgement factor to adjust the formula's forecast up or down.[42] Based on this approach, the forecast revision for four of the main tax heads contained in *Budget 2015* can be divided into three categories: (i) revision to economic outlook, (ii) confirmation of the tax take in 2013 (referred to as the starting point error), and (iii) other errors which relate to judgement, estimation of

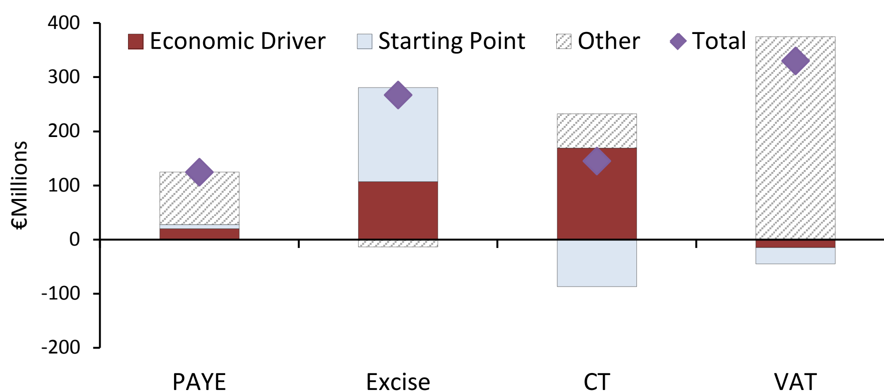
[42] See Analytical Note 3, June FAR 2014 for an explanation of this formula and the method of decomposing errors.

carryovers and one-offs and estimations of the policy yield (i.e., the impact of tax changes on the tax yield). Figure 3.3 shows the *Budget 2015* revision to estimates of the 2014 tax take split into these components.

For VAT, the 2014 outturn appears likely to be well-ahead of the 2013 estimate. While the starting point estimate for 2013 was slightly optimistic this was offset by a large revision stemming from other factors. Since no judgement was applied and as the size of adjustments for policy and one-offs was small, the bulk of the error is likely related to the elasticity of VAT receipts with respect to personal consumption growth having been higher than assumed by the forecasting formula. This could be because consumers are returning to more discretionary purchases, such as cars, that tend to be richer in VAT receipts.

For corporate tax, an upward revision to gross operating surplus[43] and a positive revision from other factors are partially offset by a negative starting point error. Judgement was used to scale down the forecast.

FIGURE 3.3: SOURCE OF BUDGET 2015 REVISION TO BUDGET 2014 FORECAST FOR 2014 TAXES



Source: Department of Finance and internal calculations.
Note: Graph splits error source into those arising from incorrect forecast of economic activity, mis-estimation of the tax take for 2013 and other.

Non-tax revenues have also been revised upwards. The Central Bank surplus for 2014, reflecting profits accruing in 2013, was underestimated by €222 million or 18.3 per cent. The estimate for dividends from semi-state enterprises also shows a very large underestimation of €176 million or 43.3 per cent due to special dividends received by the Exchequer

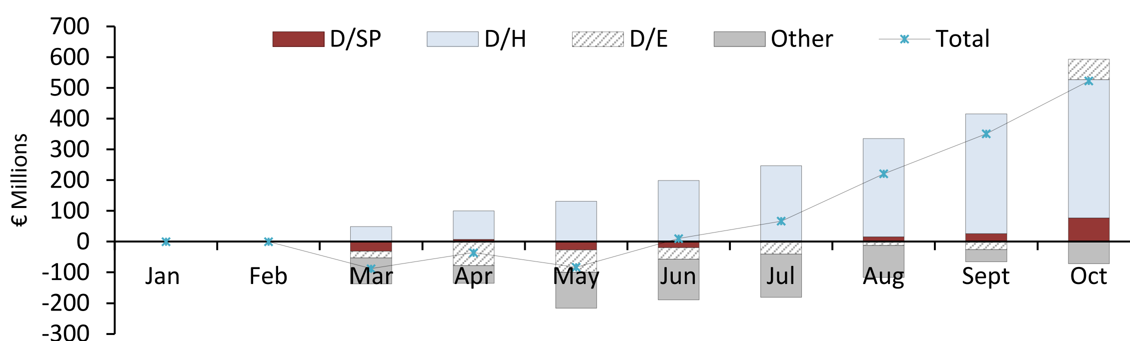
[43] Gross Operating Surplus is income earned by capital. Essentially, it is output less intermediate consumption less compensation of employees.

Expenditure Revisions

Total expenditure for 2014 has been revised upwards by €1.7 billion. As noted above, this mainly consists of an upward revision to Government Services (comprising Compensation of Employees and Intermediate Consumption) and Investment being offset by savings in Interest.

Most of the revision to Government Services will likely be accounted for by departmental current spending which is being revised up by €499 million. Figure 3.4 shows the evolution of the overrun relative to expectations up to October. In previous years, large aggregate overruns have been avoided as overspends in the Health area were offset by savings in other departments. In the year to date, however, an overrun in Health of some €450 million is being added to by overruns in the other large departments of Education and Social Protection. These combined overruns are only being partially offset by small under-spending in most other departments. Overruns in Health are a persistent and serious problem, as underlined in previous FARs.

Figure 3.4: Gross Current Voted Expenditure Relative to Profile



Source: Department of Finance

On the Non-Voted side, there was an unprofiled €310 million transfer to the Local Government Fund, as well as an unprofiled capital transfer to Irish Water of €185 million.

3.3 Assessment of *Budget 2015* Forecasts

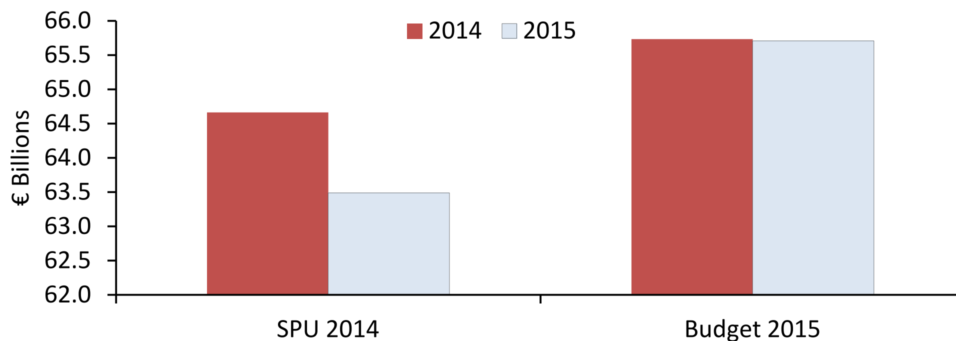
3.3.1 Forecasts for 2015

Budget 2015 introduced expansionary measures of €1 billion or 0.5 per cent of GDP, compared with the €2 billion consolidation previously planned. On foot of a stronger starting position for 2014, Budget decisions and forecasts for nominal GDP growth of 5.3 per cent in 2015, the General Government deficit is projected to fall to 2.7 per cent of GDP in 2015. The expansionary measures of €1 billion include €0.4 billion in tax cuts and a €0.6 billion increase to the 2014 expenditure ceiling set in *Budget 2014.*

It should be noted that while the forecast General Government deficit for 2015 is 2.7 per cent, this excludes part of the €1.4 billion in revenues flowing to the Exchequer from the Central Bank surplus. Of these, €0.3 billion has been excluded from the General Government deficit calculation as it relates to a capital gain on financial assets, which are not counted as deficit reducing. The extra funds will, however, be used to lower the Exchequer Borrowing Requirement, thereby lowering the debt.[44]

Figure 3.5 shows the revisions to expenditure plans and 2015 compared with previous plans. Under the plan outlined in *SPU 2014* this April, total expenditure in 2015 had been projected to fall by €1.2 billion from its 2014 level. However, *Budget 2015'*s estimate for spending in 2015 is some €2.2 billion higher and no change in total expenditure is now expected between 2014 and 2015.

FIGURE 3.5: TOTAL EXPENDITURE



Source: Department of Finance.
Note: Graph compares total expenditure on an Exchequer basis.

The revenues from the introduction of water charges had been expected to improve the public finances. The saving would come about as water charges paid to Irish Water were expected to remove the full cost of water services from Local Government, allowing the Exchequer to reduce the subvention to Local Government. However, the start-up costs being incurred by Irish Water in 2015 as well as investment in infrastructure mean that there is no reduction in the Exchequer subvention to the local government fund. The overall net gain to the general government accounts from the eventual introduction of water charges is now likely to be lower than previously anticipated. *Budget 2015* contains an increase in the subvention for next year.

Interest expenditure has been revised down considerably, from €8.5 billion in *SPU 2014* to €7.4 billion in *Budget 2015*, reflecting a fall in the average interest rate from 4.1 per cent to 3.5 per cent.

[44] The Exchequer Borrowing Requirement is the amount needed to fund the Exchequer deficit in a given year.

In part, the revision reflects the more favourable interest environment and its effects on floating rate bonds as well as debt management activities. It also incorporates the assumed early repayment of IMF Programme loans in late-2014 and 2015.

A detailed analysis of the potential savings related to any refinancing of the IMF loans is outlined in a joint EU Commission, IMF, ECB and ESM note for the Economic and Financial Committee (2014). The refinancing of IMF credit is estimated to yield non-discounted savings of up to €2.1 billion (1.2 per cent of 2013 GDP) relative to the original profile of payments which were due to be repaid in full by end-2023.[45] The bulk of these savings relate to the period 2015-17, during which savings equivalent to 0.8 per cent of GDP are expected to materialise. Savings estimates are sensitive to the interest rate at which repayments are assumed to be refinanced. Early repayment may also result in a lengthening of the average maturity of government debt, thus reducing roll-over risks. If replaced with new 10-year bonds, the average maturity of the outstanding IMF credit would extend from 3.9 years at end-2015 to 7.5 years at end-2015.

The expenditure measures include an increase of €0.6 billion to the Health expenditure ceiling. This ceiling has been consistently breached. As noted earlier, the overruns in Health have not been offset by under-spending in other departments as has occurred in previous years.

Figures 3.6 A-D show the forecast source of change for the major tax heads from 2014 to 2015. For PAYE, projected improvements in economic conditions in the form of growing employment and rising pay will be partially offset by policy decisions for 2015. When the carryover related to the full-year effects of policy in previous years and other adjustments are taken account of, PAYE is forecast to grow by €188 million (1.7 per cent).

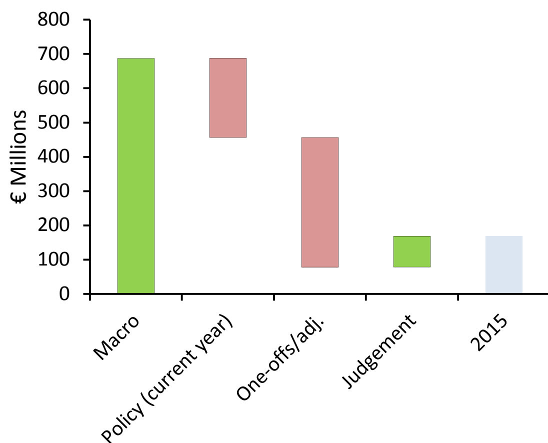
Strong growth in gross operating surplus of 5.5 per cent is projected to lead to a rise in CT revenue. However, a combination of policy effects and adjustments for one-offs works to offset a large amount of this. A small amount of positive judgement is applied to scale up the forecast.

VAT revenues are expected to rise by 6.4 per cent due to nominal personal consumption growth. Some upward judgement is applied to VAT due to the strong over-performance relative to the

[45] A number of assumptions underpin the estimates produced in the joint note. Repayments were assumed to take place in three tranches: the first payment occurring in end-2014, the two other payments in mid-2015 and mid-2016, respectively. All bonds are assumed to mature in 2024 and €18.3 billion of the €22½ billion IMF credit is repaid early between the end of 2014 and end of 2015. Costs of hedging IMF credit are assumed to be stable over time in the analysis. Early repayment of IMF credit is not assumed to impact on the medium-term level of cash balances targeted by Ireland. The average interest rate on the new bonds is assumed to be 1.88 per cent (the average yield on Irish 10-year government bonds over the 30 days up until 10 September 2014) as compared to an all-in rate of just below 5 per cent on IMF credit in 2014 (including costs of hedging of exchange rate and interest rate risks). Relevant exchange rates are assumed to remain at current levels.

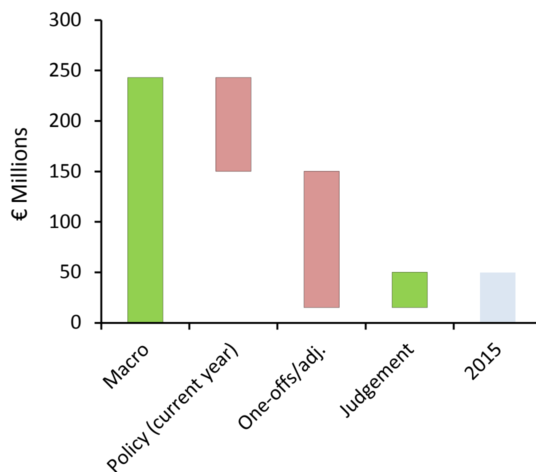
forecast for 2014, which was based on the standard formula. Given that VAT has grown at a rate of 8.2 per cent in the year to date, a growth slowdown to 6.4 per cent appears reasonable given the projections for key drivers. Excise is forecast to grow 3.2 per cent, on the back of solid consumption growth and a rebounding car market. It is also helped by policy changes as extra excise was levied on tobacco and betting activities. As with VAT, Excise is scaled up with the application of judgement.

FIGURE 3.6A: PAYE



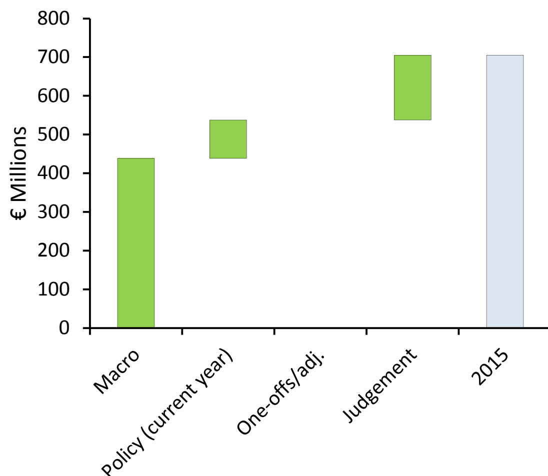
Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

FIGURE 3.6B: CORPORATION TAX



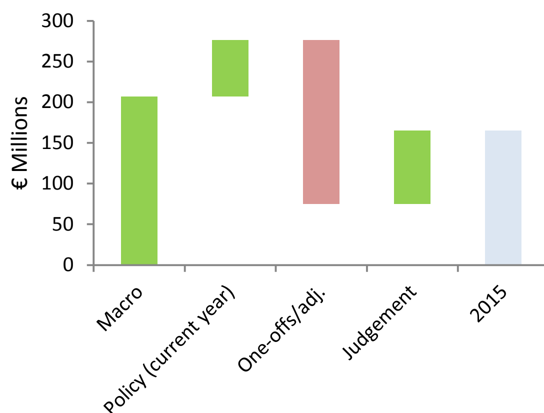
Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

FIGURE 3.6C: VAT



Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

FIGURE 3.6D: EXCISE



Source: Department of Finance and Internal Calculations
Note: Chart shows how sources of change add up to overall change for 2015.

Overall the forecasts appear driven mainly by the expected economic developments. Some judgement is applied to those tax heads expected to come in above profile in 2014. The possibility that the elasticity of certain tax heads to macroeconomic variables may differ from the long run

average elasticity used in the formula, as appears to have occurred with VAT revenue in 2014, means that this could act as a source of error in 2015.

TABLE 3.2: *BUDGET 2015* PROJECTED CHANGES IN GOVERNMENT REVENUE AND EXPENDITURE

	2014	2015	2016	2017	2018
Main Aggregates, % of GDP					
General Government Balance	-3.7	-2.7	-1.9	-0.9	0.3
Primary Balance	0.3	1.1	1.9	2.9	4.0
Structural Balance	-4.4	-3.4	-2.5	-1.2	0.2
General Government Debt	110.5	108.5	104.0	100.5	95.4
Nominal GDP Growth, %	5.2	5.3	5.1	5.2	5.2
Projected Changes in Government Revenue and Expenditure, € billions					
Total Revenue	**3.2**	**1.6**	**2.0**	**2.2**	**2.9**
Tax	3.4	1.5	1.9	2.2	2.6
Social Contributions	0.3	0.3	0.4	0.0	0.1
Other	-0.5	-0.1	-0.3	0.0	0.2
Total Expenditure	**0.1**	**0.1**	**0.6**	**0.2**	**0.4**
Compensation of Employees	0.0	0.1	0.0	0.0	0.0
Intermediate Consumption	0.9	-0.4	0.2	0.0	0.1
Social Payments	-0.5	-0.2	-0.2	-0.2	-0.1
Interest	-0.2	-0.1	0.3	0.4	0.4
Other	-0.2	0.6	0.3	0.0	0.0
Primary Expenditure	**0.3**	**0.2**	**0.3**	**-0.2**	**0.0**

3.3.2 FORECASTS FOR 2016-2018

Budget 2015 did not provide a well-specified medium-term plan for the deficit path. Policy-based forecasts for revenue and expenditure were only provided for 2015, while 2016 to 2018 figures were on the basis of 'technical assumptions'. The reason given for this effective reversion to one-year budgeting was that there are "...uncertainties with regard to interpretation and implementation of fiscal rules...".[46]

The assumption for revenue for 2016 onwards is that no tax measures are introduced after 2015. This is despite the announced intention of the Government to adjust income tax in the next

[46] *Budget 2015* page C.23.

Budget.[47] On the expenditure side, the technical assumption is that departmental ('voted') expenditure does not change at all from 2015 to 2018. It is unclear why this assumption was made since the *Comprehensive Expenditure Report 2015-2017* (*CER 2015-2017)* includes ceilings for voted expenditure out until 2017. This raises the question of whether the ceilings outlined in the *CER 2015-2017* will be subject to change in future Budgets when the uncertainties on the fiscal rules referred to in *Budget 2015* are cleared up. Given a number of statements in both the Budget and CER 2015-2017, the possibility of further changes in the ceilings cannot be ruled out.[48]

As noted by the June 2014 *FAR*, the *SPU 2014* timeframe for achieving a structural budget balance appeared to go beyond what EU rules required for converging on Ireland's Medium-Term Objective (MTO). This was a result of following a calendar of convergence agreed with the European Commission that no longer has to be adhered to. It had been hoped that a new path would have been supplied in *Budget 2015.* Unfortunately, since the plan does not incorporate policy changes in revenue and the plan for expenditure may be subject to change, there is a large degree of uncertainty as to how fast the Government intends to converge toward a balanced budget.

Budget 2015 suggests that the medium-term path for the deficit is likely to be worse than that implied by these technical assumptions as their effect is to apply all available fiscal space to deficit reduction. Figure 3.7 shows the source of changes in the deficit until 2018. Almost all of the change is derived from projected revenue increases given that expenditure is projected to be unchanged. Under a no policy change scenario, revenues are expected to grow by €7.1 billion or 10.8 per cent between 2015 and 2018. Taxes make up most of this, increasing by €6.6 billion. This improvement relative to *SPU 2014* reflects, in part, the stronger macroeconomic forecasts underlying *Budget 2015.* The projections suggest that revenue will fall as a percentage of GDP, from 34.8 per cent in 2013 to 32.3 per cent by 2018; as such, the forecasts appear credible if the projected economic growth occurs. Since expenditure is assumed to be broadly unchanged over the forecast horizon, its size as a percentage of GDP falls quite sharply from 38.6 per cent to 32.1 per cent.

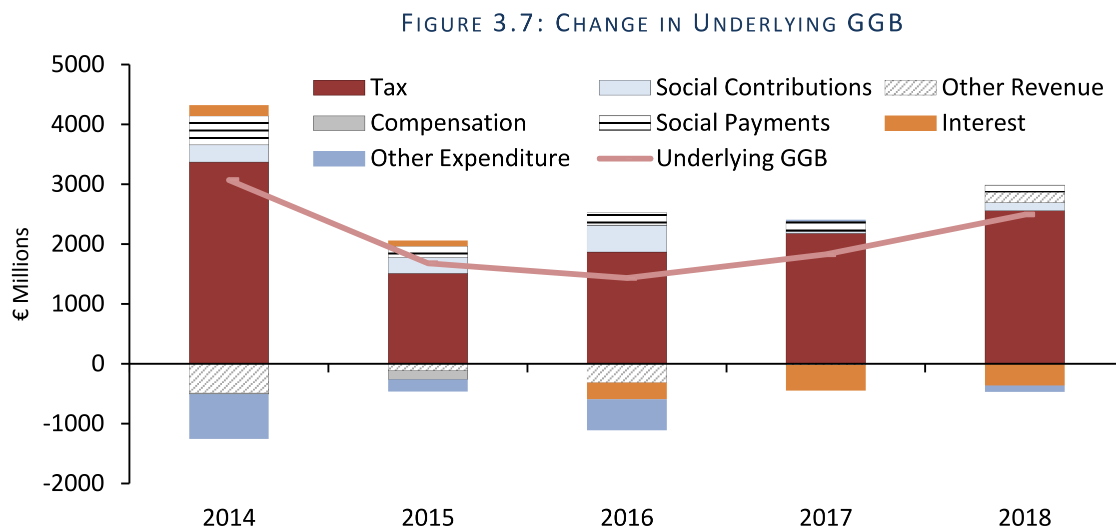
[47] Minister Noonan stated in his Financial Statement: "We will continue to ease the burden on those in the middle in a targeted manner without giving disproportionate benefits to those on highest incomes. The 52% marginal tax rate will be lowered further while ensuring those on higher incomes continue to pay their fair share."

[48] The *CER 2015-2017* states that, with regard to the ceilings, "Departments are expected to stay broadly in line with these parameters, notwithstanding the scope for additional resources in 2016 and 2017". *Budget 2015* goes on to state: "Priorities, which have been outlined in the Budget, and included in the ceilings in the Expenditure Report, will be addressed in subsequent Budgets when there is technical clarity around the quantum of fiscal space". This statement appears to suggest that when clarity on the amount of fiscal space becomes available, priorities included in the ceilings will be changed in subsequent Budgets, with the potential consequence that ceilings will need to change to accommodate these revisions.

Figure 3.8 shows the General Government Balance (GGB) that results from *Budget 2015*'s assumptions. It also shows the GGB excluding the impact of ESA 2010 statistical revisions. This illustrates the one-off benefit to the recorded deficit that results from new statistical guidelines but has no real impact on required borrowing or debt levels. Without this one-off statistical change, the GGB for 2015 would have been 3.1 per cent, above the EDP ceiling. The difference gradually declines over 2016-2018.

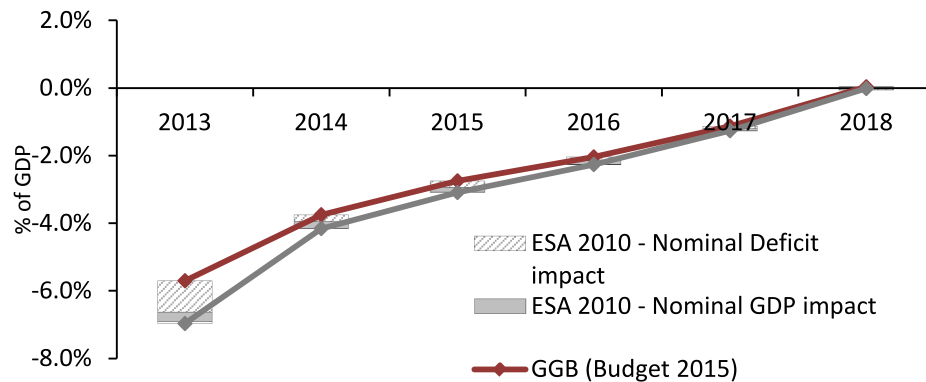
Under the *Budget 2015* scenario, debt-to-GDP falls from 108.5 per cent in 2015 to 95.4 per cent in 2018. This is a considerable improvement relative to *SPU 2014* when it was estimated that debt would still be at 107.2 per cent of GDP in 2018. However, the improvement is entirely due to revisions to the level of nominal GDP by 2018 as the nominal level of debt is forecast to be marginally higher at €214.7 billion. The statistical revisions to nominal GDP have the effect of making debt ratios appear less onerous in the context of the historical understanding of relative debt burdens. Furthermore, in the absence of specific moves to raise revenues from the newly measured areas, the revisions do not necessarily reflect any additional capacity to finance what remain high deficits and high debt levels.

FIGURE 3.7: CHANGE IN UNDERLYING GGB



Source: Department of Finance.
Note: Contribution to change in Underlying GGB.

Figure 3.8: Impact of ESA 2010 Revisions on the General Government Balance



Source: Department of Finance and Internal Calculations
Note:

3.3.3 Comprehensive Review of Expenditure

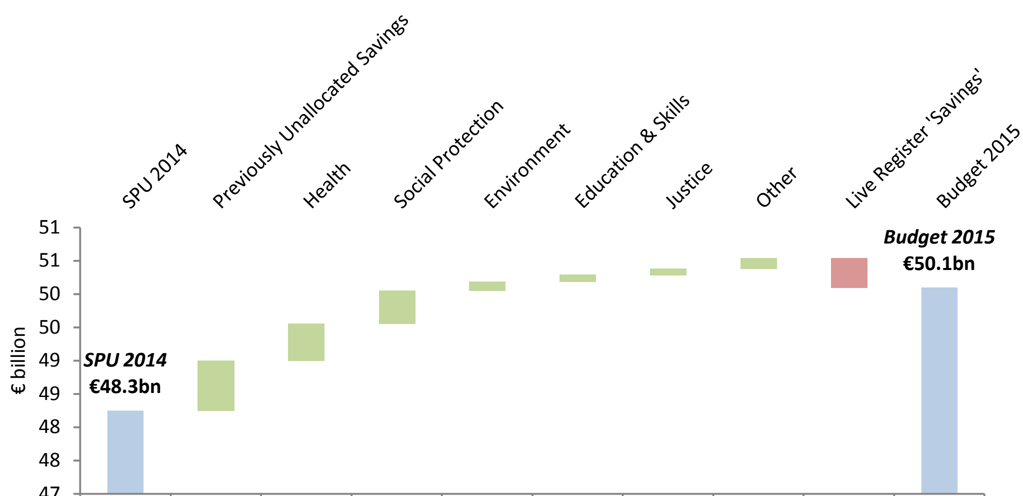
Overview

The *CER 2015*-2017 raised the voted expenditure ceiling for 2015 by €2.1 billion, resulting in it being €639 million higher than the 2014 ceiling. This is the expenditure expansion reported in *Budget 2015*. As it is estimated that the 2014 ceiling will be breached by €499 million, this would represent an €30 million decline in spending compared with the estimated 2014 outturn.

Of the €2.1 billion increase to the 2015 ceiling (as previously set out in *Expenditure Report 2014*), €1.8 billion is voted current expenditure and €0.3 billion is voted capital expenditure. Figure 3.9 shows how the increase to the Voted Current Expenditure Ceiling is allocated. Firstly, there had been a plan to obtain an extra €0.8 billion in savings across departments; this will not now occur. Secondly, savings of €0.4 billion from a cyclical reduction in unemployment will be used to partly fund a structural increase in spending.[49] Thirdly, ministerial ceilings are raised across all departments. The Health ceiling for 2015 is increased by €0.6 billion. This is €0.3 billion above its 2014 ceiling. However, since Health spending appears certain to overrun its 2014 ceiling, its 2015 ceiling is likely to be very similar to 2014 spending. Given the pressures identified in Health (discussed further below) maintaining 2015 spending at a similar level as in 2014 could be challenging . The Department of Social Protection also sees an increase of €0.2 million for new services and €0.3 million to offset pressures. Most other departments receive moderate increases to ceilings with the *CER* stating that the additional expenditure is required to support the delivery of existing services.

[49] *Budget 2015* uses the harmonised methodology to estimate how much of the savings from falling unemployment is cyclical. Unfortunately, due to problems in the estimation of the Non-accelerating Wage Rate of Unemployment (NAWRU) this method tends to understate the cyclical component of the savings.

FIGURE 3.9: ADJUSTMENT TO GROSS CURRENT EXPENDITURE CEILING FOR 2015



The 2016 ceiling is revised up by €1.7 billion compared to *Expenditure Report 2014* and a new 2017 ceiling is introduced. Within these ceilings, the Health ceiling increases by €0.2 billion in 2016 and €40 million in 2017. Social Protection falls by €70 million each year (possibly due to unemployment reductions) and there is a marginal rise in the Education ceiling. The other departments are expected to keep to the same ceilings as 2015. With expenditure pressures and inflation, this will require cost saving measures from the remaining departments. No measures are proposed or suggested in *CRE 2015-2017.*

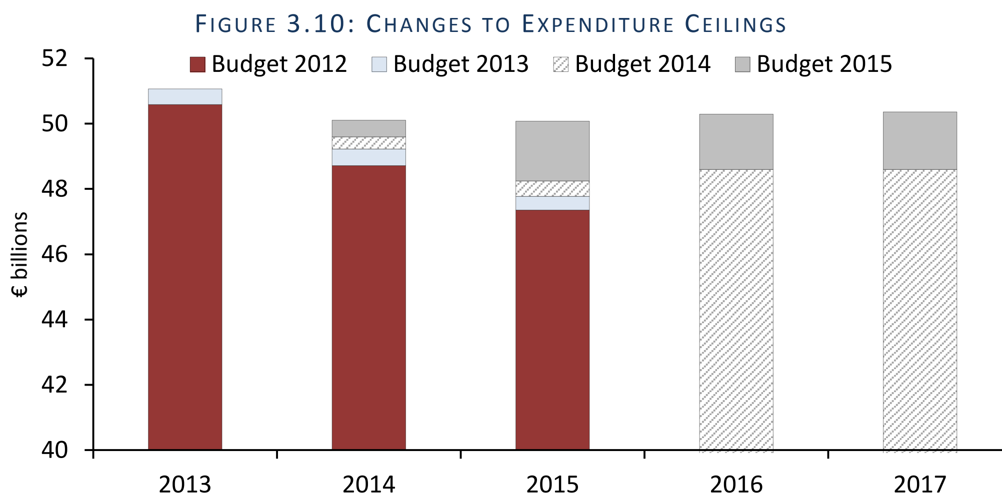
There is no contingency between the aggregate Voted Current Expenditure Ceiling and the sum of the Ministerial Voted Current Expenditure Ceilings. This implies that if any costs not currently factored into the published ceilings arise between 2015 and 2017, meeting them will require finding additional savings elsewhere or breaching the ceiling. In this context, what happens to public sector pay and staffing levels post-Haddington Road Agreement will be an important factor in determining whether the current ceilings can be adhered to.

On the capital side, the expenditure ceilings for 2015 and 2016 were increased by €300 million and €350 million respectively. The Government was due to publish a Capital *Expenditure Review* along with *CER 2015-2017* as occurred with the last expenditure review. This has not happened. In the last *Capital Expenditure Review*, the Government outlined its rationale for cutting public capital expenditure. Given that investment has now been cut to a level where it is barely sufficient to cover the costs of depreciation, and with economic growth recovering, it may now be time to revisit this rationale. While drastic cuts to capital spending are easier to achieve in the short run, in the long run, holding investment at such low levels would be expected to lead to an infrastructure deficit, restricting potential growth and thereby potentially harming the fiscal metrics that spending cuts seek to protect.

EXPENDITURE PLANNING

Revisions to expenditure forecasts have been common and usually in an upward direction. During the initial years of the downturn, government expenditure was less than proposed in the initial medium-term plans. Since 2011, however, a pattern of persistent upward revisions to planned expenditure has re-emerged. This is despite the implementation of a Medium-Term Expenditure Framework (MTEF) which should work to anchor policymakers' planning. Figure 3.10 shows how the ceilings for expenditure have developed since the first *Comprehensive Review of Expenditure 2012-2014* (*CER 2012*-2014) in 2012 set out the initial multi-annual ceilings. Originally, expenditure was set to fall by over €3 billion by 2015; it is now expected to fall by just over €1 billion. Every expenditure report since 2012 has contained upward revisions to ceilings. The *CER 2015-2017* saw the largest revision to the expenditure projections for 2014 to 2017, with the increase averaging 3 per cent. The earlier revisions were in the region of 1 per cent. If this trend continues, the eventual ceiling for 2017 could be as high as €51.8 billion or 3 per cent higher than the current 2017 ceiling and almost 4 per cent higher than the 2015 ceiling.

FIGURE 3.10: CHANGES TO EXPENDITURE CEILINGS



Source: Department of Finance.
Note: Bars show how annual expenditure allocations to a given year rise as the forecast year approaches.

In introducing the MTEF, the first *CER 2012-2014* and the subsequent *Expenditure Reports*, outlined the intention to move away from the "old-fashioned" approach of expenditure being determined by "...demands and bids from the spending Ministries ... with little regard to medium-term plans or constraints upon overall allocations" [50] to a multi-annual approach that "...provides clarity about the resources Departments will have available over a number of years and reinforces fiscal

[50] *Comprehensive Expenditure Report 2012-2014*, page 78

discipline".[51] It was thought that this would "...facilitate a more strategic approach to resource allocation by emphasising prioritisation of key services over reaction to day-to-day pressures".[52] While multi-annual ceilings should not be entirely inflexible to developing needs, consistent upward revisions to the overall expenditure ceilings reduces the incentive for individual Ministries to identify and implement savings. A pattern of annual upward revisions to ceilings suggest that extra resources could be available the following year. In addition, incremental increases in spending can reduce the incentive to think strategically about where the substantial new resources are needed, and where there is scope to scale back spending.

As part of the CRE process, individual departments provided submissions to the Department of Public Expenditure and Reform (DPER). These documents, along with an assessment from DPER were usefully published online. It is noteworthy that in certain cases there is a large mismatch between spending pressures reported by individual departments and the level of extra resources awarded to meet these pressures. This suggests that either the departments are likely to find it difficult to remain within the ceiling and meet all of these pressures, or that the size of the pressures may have been mis-estimated. For instance, the submission from Department of Education and Skills (DES) indicated considerable cost pressures of €0.5 billion relative to the 2014 base for each of the years 2015-2017. The actual ceiling for 2015 published in the *CER 2015-2017* contained an increase of just €60 million relative to the 2014 base. The *CER 2015-2017* does not discuss the reasons for the discrepancy between the additional €500 million sought by DES and the actual final allocation of €60 million. In this instance, because it is not clear what expenditure would be in a no policy scenario, it is difficult to know how much savings, if any, will be required to come within the ceiling.

The June 2014 *FAR* noted several areas of expenditure that face challenges in the coming years. In this respect, it was noted that expenditure planning should be informed not only by the fiscal stance, but also by the expenditure constraints and pressures faced by the various areas of Government spending.[53] There is the potential for tension between 'top-down' expenditure planning – informed largely by fiscal constraints and rules – and 'bottom-up' expenditure pressures arising from demographic pressures, investment needs and demands for increases to public sector pay. If this tension is not resolved by careful 'bottom-up' expenditure management, it will result in persistent overruns and revisions of ministerial ceilings and a lack of credibility in the medium-term

[51] *Expenditure Report* 2014, page 90.

[52] *Medium-Term Budgetary Framework*, page 21.

[53] June 2014 *FAR* noted challenges related to maintaining the planned path for investment, social payments and compensation of employees.

expenditure framework.[54] Successful bottom-up planning should make ceilings resistant to demographic pressures that can be anticipated over a three-year horizon.

Ideally, the *CER 2015-2017* would have established the level of spending in each department under a no-policy change scenario for the years 2015-2017, taking account of the impact of demographic changes and all other foreseeable changes to costs, including compensation of employees. These bottom-up costings would then be compared to the required ceiling as determined by top-down concerns. The gap, if any, is where new policies could play a role.

For example, in its submission to the review process, the Department of Social Protection (DSP) provided a costing for most of its programmes for every year to 2018. This showed that under a no-policy change, the Department would come within the previously outlined ceiling. It was decided to increase the ceiling for 2015 to accommodate new policies, all of which were costed for that year. However, no costing for the impact of these new policies is provided for 2016 or 2017.

By contrast, there is no exact costing of the Department of Health's expenditure on a no policy change except that the Department estimate that they will be subject to increased demands of the order of €200 million per annum from 2015-2017.[55] The Health submission then indicates that in order to comply with its original 2015 ceiling, which was to be €213 million less than the 2014 ceiling, it would have to introduce just €213 million in new measures. This appears to greatly understate the level of savings that would need to be achieved. This is because the Department estimate that Health spending would increase by €200 million on a no-policy basis and in addition there is currently a large overrun relative to the 2014 ceiling. In this instance, a lack of clarity on what the Health service will cost in 2015-2017 without new policy measures has led to confusion over what level of savings would have been required to comply with the 2015 ceiling. In the event, the 2015 Health ceiling was raised so that it is €305 million above the 2014 ceiling. If the current 2014 overrun of €450 million is maintained and 2015 sees additional pressures of €200 million, the new 2015 ceiling still implies considerable savings are required. *CER 2015-2017* does not outline any new savings measures.[56]

[54] The 'soft budget constraint' is relevant in this context. Where the consequences of imposing an expenditure ceiling are severe, the department may anticipate that the ceiling is likely to be relaxed. The constraint is not seen as credible and this may limit its impact on expenditure control behaviour.

[55] It is not clear whether this additional €200 million in 2015 is relative to the 2014 ceiling or to the 2014 spending, which is currently overrunning by €450 million.

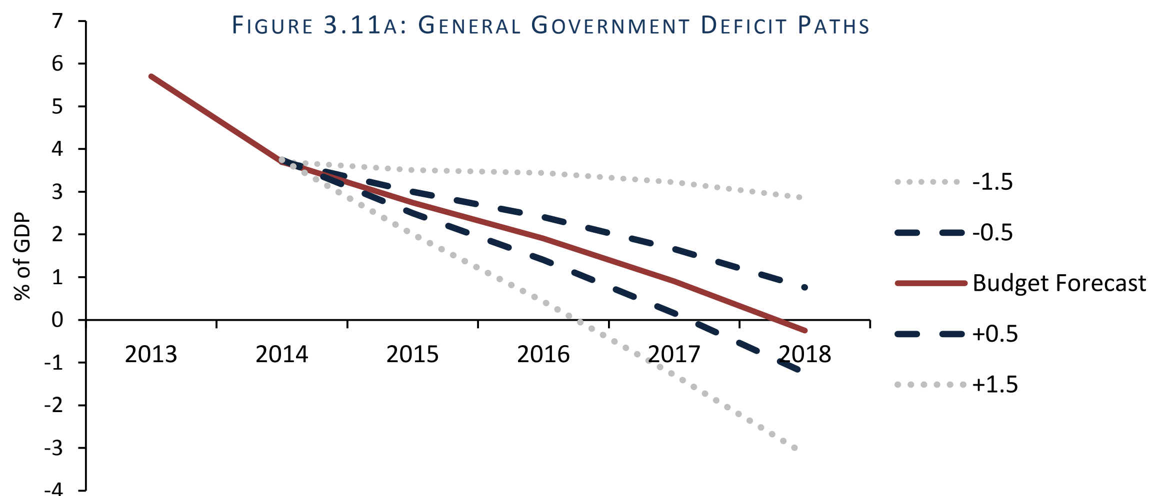
[56] Where an overrun is persistent, the Government faces a number of options. A decision could be made to address the source of the overrun, reprioritise funding from other departments or areas or fund a higher level of spending through increased taxation or borrowing. Addressing the problem at the source would require either the identification of areas where efficiencies can allow the delivery of the anticipated level of services. Alternatively, structural reforms could be

3.4 Sensitivity and Risk Analysis

3.4.1 Growth Risks

The attainment of a deficit of 2.7 per cent remains dependent on economic growth forecasts (and potentially the composition of growth) among other factors. With the Department of Finance's past growth forecast errors, the Council's Fiscal Feedbacks Model is used to estimate a range of possible deficits and debt levels (Figures 3.11A and 3.11B). The graphs below assume that no offsetting fiscal policy measures are undertaken in the alternative growth scenarios. However, being forced into unplanned policy measures – such as cancelling or delaying capital projects – are likely to be undesirable. Thus, negative growth shocks can lead to undesirable outcomes even if the relevant fiscal targets are met.

Figure 3.11A: General Government Deficit Paths



Source: Department of Finance and internal calculations.
Note: The figure shows alternative projections of the deficit ratio based on GDP growth forecasts that deviate from Budget projections by 0.5 and 1.5 percentage points in either direction.

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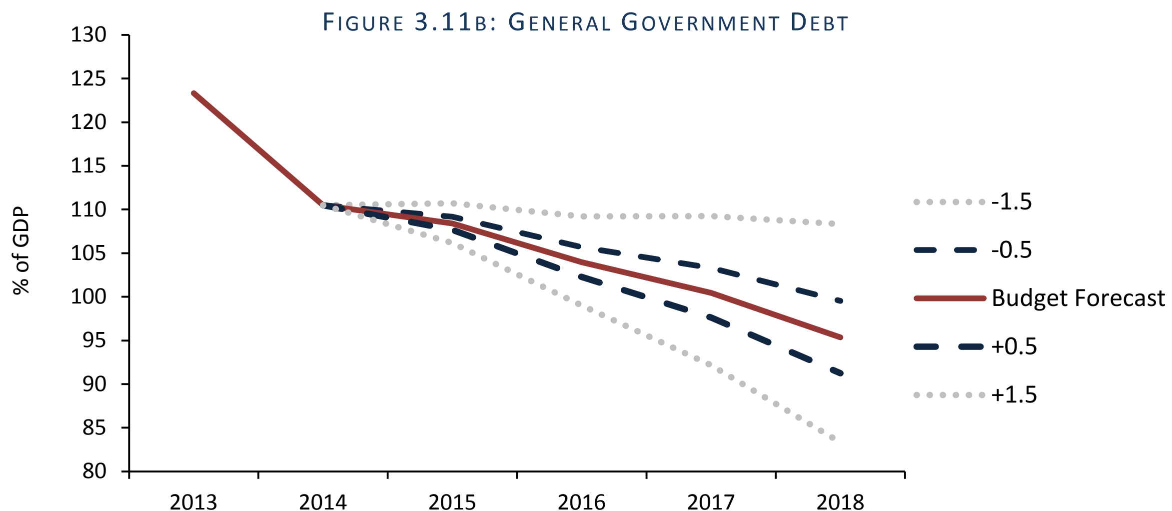
introduced that take into account that the desired level of service provision will be difficult to maintain with the budgetary constraints and priorities the government faces.



Source: Department of Finance and internal calculations.
Note: The figure shows alternative debt ratios based on GDP growth forecasts that deviate from Budget projections by 0.5 and 1.5 percentage points in either direction.

If growth disappoints by as little as 0.5 percentage points in 2015, then the 3 per cent deficit ceiling could be in danger of being breached. The Typical error around the Department of Finance's nominal GDP growth is 2.1 per cent.[57] If growth were to disappoint by as much as 1.5 per cent, the deficit would not fall in 2015. While the outer years of 2016-2018 do not represent a policy-based plan for the deficit, they do represent what the Government believes will occur if expenditure is held constant and taxes are unchanged. This path is dependent on real GDP growth of over 3 per cent. As discussed in Chapter 2, there are some risks to this outlook. Nominal GDP growth could be lowered as a result of low inflation. HICP is forecast to rise from 0.5 per cent in 2013 and 2014 to 1.1 per cent in 2015 and 1.4 per cent in 2016, but this rise might not come to pass in the context of sustained below target inflation in the Euro Area.

If medium-term real growth is closer to 2 per cent out to 2018, the path for the deficit and debt would, all else being equal, be declining at a much more gradual pace than that set out in *Budget 2015*. The effect on the debt-to-GDP ratio would be that it declines more slowly from current high levels. This scenario of debt stagnating at over 100 per cent of GDP would leave Ireland extremely vulnerable to any future economic shocks.

3.4.3 Interest Rate Risks

Interest rates are currently at historically low levels. The yield on Irish 10-year bonds has fallen below 2 per cent. This represents a dramatic reversal of the situation in 2011 when bond yields

[57] The typical forecast error refers to the Root Mean Square Error of the Department's forecast.

peaked at over 14 per cent. This should highlight the extreme volatility that the country's bond yields can be subject to, even as the economy's fundamentals change much more slowly. A re-emergence of the Euro Area sovereign debt crisis or other negative shock could lead to a renewed period of high interest rates. Downward revisions to projected interest costs have been a consistent feature of recent budgets. This suggests upside risk of interest expenditure coming in below profile in 2015. *Budget 2015* revised down projections of interest expenditure by over €1 billion for 2015 onward to account for the likely refinancing of IMF loans, indicating that some of the potential benefits from lower interest rates have already been factored in to the Government's forecasts.

3.4.4 Balance Sheet Risks

Balance sheet risks have diminished considerably over the last number of years. Nonetheless, the government still faces a number of risks from items both on and off balance sheet. *Budget 2015* reports that Contingent Liabilities have fallen to €32.1 billion in 2014 down from €66.9 billion in 2013. A large portion of this fall is accounted for by the closure of the ELG scheme to new entrants in March 2013 and the ending of Exceptional Liquidity Assistance.

NAMA

NAMA represents an important off-balance sheet liability. NAMA issued €30.2 billion of senior bonds guaranteed by government but has already repaid €15.1 billion or 50 per cent of that. It was originally planned for NAMA to reach this milestone by 2016. By end-2016, NAMA now aims to have paid down 80 per cent of the senior bonds it issued, a cumulative €24 billion. On the basis of the performance to date, the risk that this contingent liability would crystallise appears to have fallen significantly.

Banking

The risks emanating from the banking sector generally appear to be receding. Impairments at Allied Irish Bank, Bank of Ireland and Permanent TSB fell slightly at end-June 2014. The ending of the ELG scheme had no significant affect on deposit retention and deposits now account for around two-thirds of bank funding. All three covered banks have returned to market funding and have reduced reliance on Eurosystem facilities.

The main source of uncertainty had been the results of the ECB stress tests. AIB and Bank of Ireland both passed the tests but PTSB was found to have a capital shortfall of around €800 million in the stress scenario. It has raised 80 per cent of this shortfall in the year to date and intends on raising a further €100-€200 million from the market in the near future. At this stage, the risk that the State

will be called on to provide extra capital appears low and the amounts involved, while not inconsequential, would not pose a systemic risk.

Other Off-Balance Sheet Risks

Other sources of risk not on balance-sheet and not included in contingent liabilities include Public Private Partnerships (PPPs). The contractual capital value of all PPPs held off-balance sheet was €5.2 billion as at March 31st 2014. Finally, the capital contribution that could be called upon by international organisations (ESM, EFSF, IMF, etc.) when needed is another risk to State finances. The need to pay more than the paid-in level of capital for one of these organisations could arise, for instance, if another country in receipt of bailout funds from that organisation were to default.

Irish Water

Uncertainty over whether Irish Water will remain outside of General Government or not constitutes a risk to reported deficit and debt while the entity represents a potential contingent liability. In order to be classified as outside of General Government, at least 50 per cent of Irish Water's production costs must be financed by sales. Of total revenue, at least 50 per cent must derive from private sources. Were Irish Water to fail this test, its borrowing would be added to the General Government Deficit in 2015. If this borrowing were greater than €0.6 billion, it could lead to the forecast deficit of 2.7 per cent being pushed above the 3 per cent Excessive Deficit Procedure ceiling.

4. ASSESSMENT OF COMPLIANCE WITH FISCAL RULES

KEY MESSAGES

- In the short term, the primary aim of fiscal policy continues to be the successful correction of the excessive deficit in 2015. Under the most recent projections for a deficit of 2.7 per cent of GDP in 2015, Ireland remains on track to formally exit the EDP in 2016. However, as highlighted in earlier chapters, significant risks to meeting the deficit ceiling of 3 per cent remain.

- Following EDP exit, there is limited room for manoeuvre if the Budgetary Rule and the Expenditure Benchmark are to be respected in 2016. Any significant expenditure increase or discretionary revenue reduction would likely lead to a breach of these rules and the possible introduction of sanction procedures.

- When discretionary revenue changes are factored in, the upward revisions to expenditure ceilings introduced in *Budget 2015* mean that real expenditure is planned to grow at a faster pace in 2015 and 2016 than permitted under the Expenditure Benchmark. While not meeting the test of a 'significant deviation' from the allowable rate of expenditure growth, any further upward revision to expenditure, or further discretionary reductions in revenues, risks possible sanctions under the preventive arm of the SGP.

- Despite clarification that the Medium term Budgetary Objective (MTO) deadline of 2018 no longer applies, it appears that this target remains for *Budget 2015*. This requires a large structural cumulative adjustment of over 2½ percentage points of GDP between 2016 and 2018.

- The expected improvement in the general government balance as a share of GDP between the budget and latest outturn for the last two years is driven in part by changes in the estimation of one-off and temporary measures. Much of the remaining improvement arises from revisions to the forecast of nominal GDP. As the date for EDP exit approaches, transparency on the classification of one-off factors is increasingly important.

4.1 Introduction

The Council's mandate includes reporting on compliance with the Budgetary Rule and also monitoring compliance with the full range of EU fiscal rules as part of a broader assessment of the fiscal stance. *Budget 2015*, the *Draft Budgetary Plan* and the *Comprehensive Expenditure Report 2015-2017 (CER 2015-2017)* update the Government's fiscal forecasts for the period to 2018, relative to those published in the *SPU 2014*, (Table 4.1). The figures used in this chapter adjust the general government deficit for the period 2016 to 2018 published in *Budget 2015* to account for the domestic expenditure ceilings published in the *CER 2015-2017*, which are not included in the published Budget figures. This chapter examines the consistency of this plan with the fiscal rules and discusses some of the key operational elements of the fiscal framework at both the domestic and European levels, with reference to the impact of the recent ESA 2010 statistical revisions. This chapter also includes a box on the identification and treatment of one-off and temporary measures in the structural balance.

Table 4.1: Summary of Main Fiscal Aggregates adjusted for Expenditure Ceilings

	2013	2014	2015	2016	2017	2018
Main Aggregates, % of GDP						
General Government Balance	-5.7	-3.7	-2.7	-2.0	-1.1	0.0
Structural Balance (SB)	-4.4	-4.4	-3.4	-2.7	-1.4	-0.1
Change in the SB	*3.1*	*0.0*	*1.0*	*0.7*	*1.2*	*1.4*
Output Gap (% of Potential GDP)	-2.4	-0.1	1.0	1.0	0.7	0.1
General Government Debt	123.3	110.5	108.5	104.2	100.9	96.0

In assessing the compliance of fiscal plans with individual rules, the status of these rules within the broader fiscal framework must be borne in mind. At the European level, fiscal rules are set within the two pillars of the Stability and Growth Pact (SGP): a Preventive Arm that operates in 'normal' times; and a Corrective Arm that operates when significant fiscal imbalances need to be rectified. Ireland is currently in an Excessive Deficit Procedure (EDP) within the Corrective Arm of the SGP. While there is no explicit legal provision stating that the Corrective Arm takes precedence over the Preventive Arm, this is implicit in the operation of the European fiscal framework.[58] Consequently,

[58] In the Preventive Arm, fiscal policy guidance is given in the Country Specific Recommendations (CSRs) approved by the EU Council. In the Corrective Arm, the EU Council issues an EDP recommendation, which replaces any guidance in the former. For a country that has an EDP recommendation, the fiscal part of the CSR simply recommends that this be implemented. Ireland's latest CSR following *SPU 2014* requires, "...the correction of the excessive deficit in a sustainable manner by 2015 through underpinning the budgetary strategy with additional structural measures while achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. After the

while all rules are assessed in this chapter for the period to 2015, the fiscal rule that must be adhered to in this period is the correction of the excessive deficit in 2015 and the successful exit of the EDP.[59] As part of the wider assessment of the fiscal stance the other fiscal rules that would apply in the absence of an EDP are also monitored and reported by the Council for the period to 2015. We begin our assessment of compliance with an analysis of where Ireland stands in relation to its exit from the EDP.

4.2 EXCESSIVE DEFICIT PROCEDURE EXIT

On the basis of the *Budget 2015* forecast deficit of 2.7 per cent of GDP for next year, the EDP ceiling of an underlying general government deficit of 3 per cent of GDP will be complied with. In the event of the 3 per cent ceiling not being met in a sustainable manner, the EC would undertake an assessment of effective action.[60] In their decision on Ireland's EDP, the EU Council recommended a structural balance improvement ("fiscal effort") of at least 9½ per cent of GDP be achieved over the period 2011 to 2015.[61] On the basis of a 'top-down' analysis of the structural balance estimate in *Budget 2015*, the structural deficit is expected to be reduced by 6.4 percentage points between 2011 and 2015. The EC's "adjusted fiscal effort" measure of "effective action" also shows a shortfall against the required 9½ percentage point improvement.[62]

As noted in the June *FAR*, the analysis of fiscal effort should: (i) reference the achievement of expenditure plans; (ii) the implementation of discretionary revenue measures; (iii) the composition of growth; and (iv) the tax richness of economic growth. A simple 'bottom-up' analysis of *ex ante* discretionary consolidation undertaken in the June *FAR* indicated some 9.2 percentage points of GDP has been undertaken between 2011 and 2014. A similar analysis in *SPU 2014* estimated the discretionary consolidation adjustment at 9½ percentage points over the same period. However, neither analysis factors in the expansionary measures contained in *Budget 2015*. In addition, both assessments are conducted on the *ex ante* measures as announced in previous budgets. A detailed

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correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0,5 % of GDP each year...".

[59] The Council's current understanding is that the Budgetary Rule will not be in effect until the excessive deficit has been corrected. The Council will be seeking legal clarification of this position prior to the next report.

[60] The latest EC Autumn 2014 forecasts show a general government deficit of 2.9 per cent of GDP in 2015 and, under a no-policy-change assumption, a 3.0 per cent of GDP general government deficit in 2016. This gives an indication of the uncertainty around the sustainability of the correction of the excessive deficit, which is required for a successful EDP exit.

[61] The EU Council also recommended that, "Irish authorities should seize opportunities, including from better economic conditions, to accelerate reducing the gross debt ratio towards the 60%-of-GDP reference value." (7 December 2010, 17210/10).

[62] This method attempts to take into account forecast errors that have become apparent since the EU Council EDP Recommendation. In order to do this it accounts for (i) revisions to potential output growth, (ii) the impact of revisions to the revenue elasticity arising from composition of economic growth or of revenue windfalls/shortfalls and (iii) the possible impact of other unexpected events.

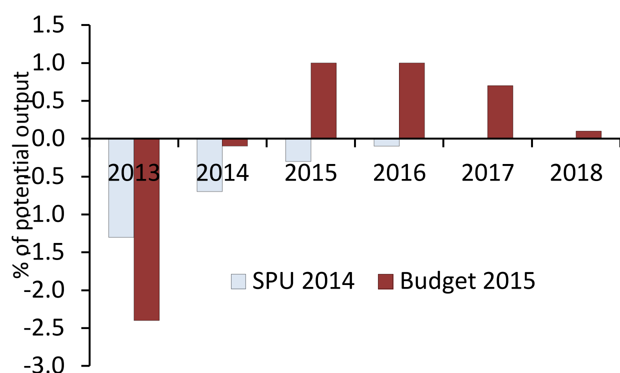
ex post assessment of individual measures would be required to determine if the planned revenue increases and expenditure reductions have been delivered in full and meet the adjustment recommended by the EU Council. The most recent assessment by the EC from June this year estimates that a discretionary fiscal effort of 9.9 per cent of GDP has been made between 2011 and 2014 on a 'bottom-up' basis. This analysis will be updated in the forthcoming EC opinion on Ireland's Draft Budgetary Plan.

4.3 COMPLIANCE WITH THE BUDGETARY RULE

EU MEASURE OF THE STRUCTURAL BUDGET BALANCE

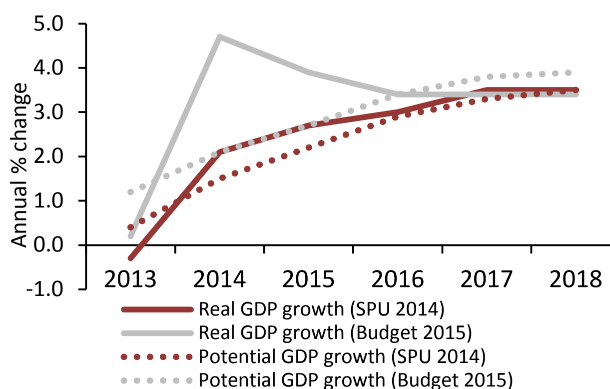
Compliance with the Budgetary Rule has been significantly impacted by statistical revisions related to the move to the *European System of Accounts 2010 (ESA 2010)*. These revisions have a direct deficit- to-GDP reducing impact, as the nominal deficit is reduced and nominal GDP increases (Chapter 3 and Analytical Note 6).

FIGURE 4.1A: COMPARISON OF OUTPUT GAP ESTIMATES



Source: Stability Programme Update 2014 and Budget 2015.

FIGURE 4.1B :COMPARISON OF REAL AND POTENTIAL GDP GROWTH



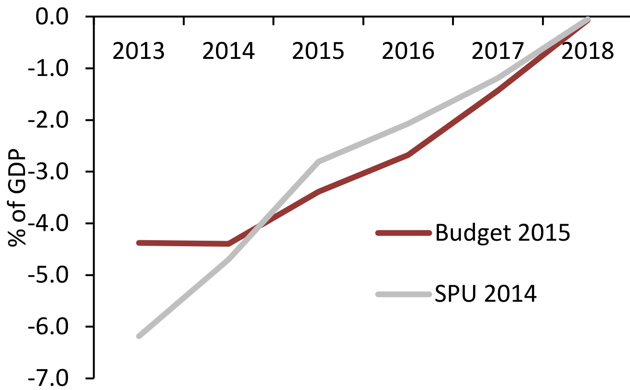
Source: Stability Programme Update 2014 and Budget 2015.

There is also an indirect impact through the effect of these revisions on the estimation of the output gap and the implied proportion of the change in the headline balance due to changes in the business cycle. Figure 4.1 shows that the revised Department of Finance macroeconomic forecasts - which also reflect ESA 2010 revisions - leads to significant changes to the output gap from *SPU 2014*.

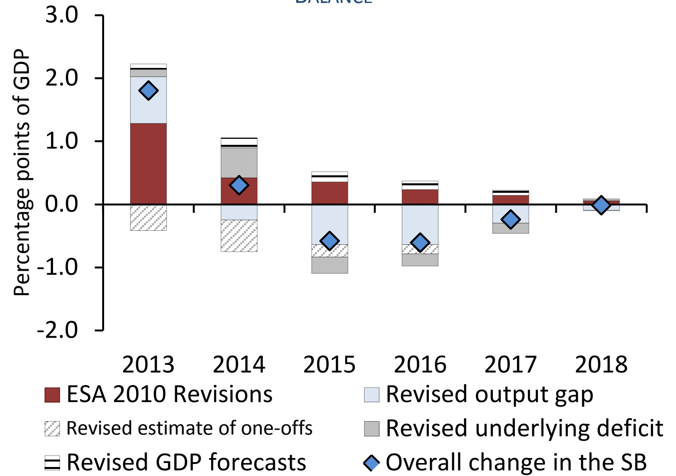
The revisions to the estimated path of the structural balance since the last official estimates in *SPU 2014* are shown in Figure 4.2A. The size of the revisions highlight the practical challenges involved with applying rules based on the structural balance to guide fiscal policy. Figure 4.2B expands this analysis and shows the main sources of the revision. These also include revised estimates of one-off and temporary measures and the forecast net impact of policy decisions on the underlying balance

in later years. The revisions to the 'underlying balance' show the positive effect of the over-performance of taxes in 2014 and the negative impact of *Budget 2015* policy measures from 2015.

FIGURE 4.2A: REVISION TO THE ESTIMATED STRUCTURAL BALANCE



FIGURES 4.2B: DECOMPOSITION OF DIFFERENCE IN THE STRUCTURAL BALANCE



Note: Positive changes in the components result in a reduced structural deficit. The changes to the cyclical adjustment include changes resulting from the ESA 2010 revisions to data.

Source: Budget 2015, SPU 2014, IFAC calculations. The fiscal forecasts in *Budget 2015* assume constant Departmental expenditure from 2016 to 2018. The above figures are adjusted to fully reflect the Ministerial Expenditure ceilings published in the *CER 2015-2017*. 2013 figures are based on the latest CSO data, *SPU 2014* data and unpublished output gap estimates. ESA 2010 revisions include revisions to both the nominal general government and nominal GDP.

On the basis of current data the change in the structural balance to 2013 is consistent with the requirements of the Budgetary Rule.[63] The Department of Finance estimates a structural deficit of 4.4 per cent of GDP for 2013, which does not meet the MTO for Ireland of a structural balance (see Figure 4.3). However, the reduction in the structural deficit of 3.1 percentage points of GDP between 2012 and 2013 more than meets the Adjustment Path condition, which requires an annual improvement in the structural balance exceeding 0.5 percentage points for Ireland (see Figure 4.3).[64]

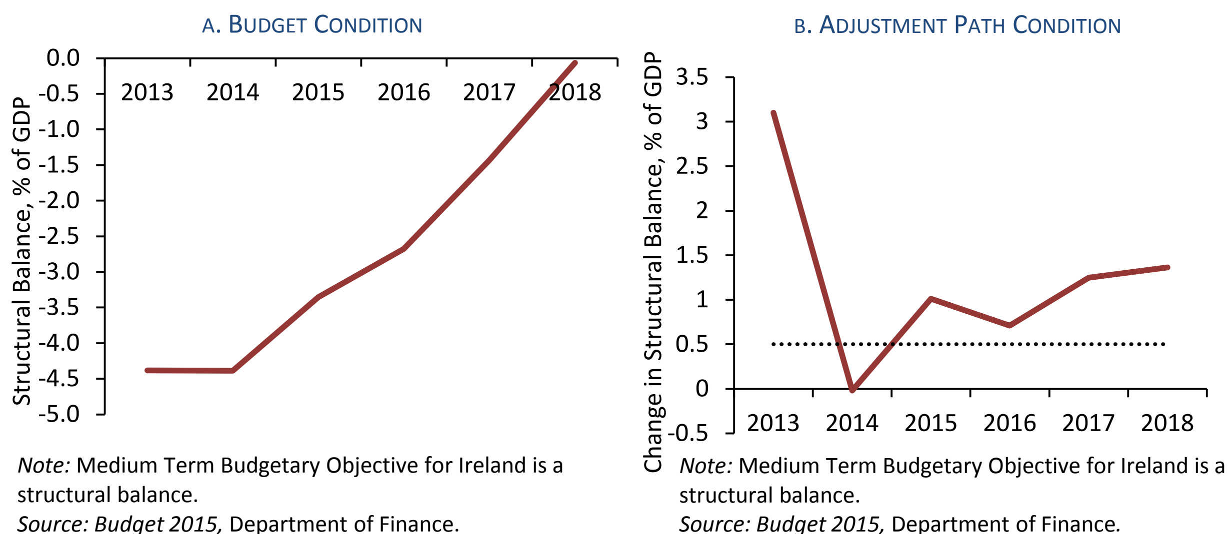
The estimated structural balance improvement is almost double that reported for 2013 in the *SPU 2014*. Most of the improvement comes directly from the ESA 2010 revisions as well as positive contributions from a change in the output gap (see Figure 4.2b). While these impacts are somewhat offset by revisions to estimated one-off and temporary measures in 2013, the combined

[63] This includes Government Finance Statistics data from the CSO and information provided by the Department of Finance.

[64] As Ireland has a debt ratio of greater than 60 per cent of GDP, under the terms of the SGP, the annual change in the structural balance must be greater than the 0.5 percentage point benchmark to comply with the Adjustment Path condition. Discussions at EU level are continuing as to what complies with "greater than 0.5%" in this context.

effect is to reduce the estimated structural deficit in 2013 from 6.2 per cent in *SPU 2014* to 4.4 per cent.

FIGURE 4.3: ASSESSMENT OF COMPLIANCE WITH THE BUDGETARY RULE



Note: Medium Term Budgetary Objective for Ireland is a structural balance.
Source: Budget 2015, Department of Finance.

Note: Medium Term Budgetary Objective for Ireland is a structural balance.
Source: Budget 2015, Department of Finance.

The estimated structural deficit-to-GDP ratio for 2014 remains flat at the 2013 level of 4.4 per cent based on the data in *Budget 2015*. In addition to not meeting the MTO requirement, this also indicates an insufficient annual improvement in the structural balance for compliance with the Adjustment Path condition.[65] However, this reduced annual change to 2014 does not reflect a reduced 'fiscal effort' in 2014. The more modest reductions in the headline balance in 2014 as compared to 2013 are offset by the treatment of 'one-offs' and the re-estimated very sharp reduction in the output gap, which implies that much of the improvement in the general government balance is measured as cyclical in nature. The Budgetary Rule will be assessed on an *ex post* basis for 2014 in the Council's 2015 reports.

EX ANTE ASSESSMENT OF 2015 TO 2018

While the Council's formal requirement to assess (*ex post*) compliance with the Budgetary Rule is backward-looking in nature, the mandate of the Council to assess the fiscal stance suggests considering compliance on a forward-looking basis. The fiscal position for 2015 is driven by the requirement to run an underlying general government balance of below 3 per cent of GDP for successful exit of the EDP. *Budget 2015* also implies a sufficient reduction in the structural balance to comply with the Budgetary Rule in 2015.

[65] The latest EC estimates of the structural balance (*European Economic Forecast-Autumn 2014*) show a reduction from -4.8 per cent of GDP to -3.8 per cent of GDP between 2013 and 2014.

As was the case in *SPU 2014*, the Government's last published fiscal plan, *Budget 2015* plans for the MTO to be met in 2018. However, the path to meeting the MTO has been adjusted, with both technical and policy factors playing a part (see Figure 4.2B).

The statistical ESA 2010 revisions that improved the structural balance estimates for 2013 and 2014 also impact in later years, albeit with a reduced effect. In addition, planned changes to underlying taxes and expenditure under *Budget 2015* are deficit increasing for all subsequent years.[66]

The Government's medium-term fiscal plan set out in *SPU 2014* was determined by the 2018 deadline to meet the MTO proposed by the EU Commission in 2013 (in the 'calendar of convergence'). In the June *FAR*, the Council assessed that meeting the MTO of a balanced budget in structural terms in 2018 appeared to go beyond the minimum requirements of the fiscal rules as the 2013 calendar of convergence no longer applied. In his response to the FAR published in June 2014 the Minister for Finance stated:

> Following discussions on the necessary consistency between the fiscal compact and the *Stability and Growth Pact (SGP)*, and as part of a discussion on the 2014 Country Specific Recommendations, the European Commission has clarified that the deadline for MTO achievement is not fixed but the required annual improvement in the structural balance is. Consistent with *SGP* rules, Member States not at their MTOs must improve their structural balance by at least 0.5 per cent of GDP per annum.[67]
>
> Minister for Finance, Letter to the Irish Fiscal Advisory Council (22 July 2014)[68]

All other things being equal, this would allow the Government to loosen the fiscal stance in the period post-2015 relative to *SPU 2014*, while still complying with the required change in the structural balance.

In 2016, there is limited room for further fiscal slippage following *Budget 2015* while still complying with the Adjustment Path condition. However, as shown in Figure 4.3, the change in the structural balance remains significantly in excess of that required for minimum compliance with the rules for 2017 and 2018 given that 2018 appears to remain as the government's deadline for achieving

[66] The over-performance in tax revenues in 2014 leads to an improved structural balance in 2014, however, this increase in taxes is more than offset by other policy changes in taxation and expenditure for later years.

[67] As a high debt country the adjustment for Ireland is greater than 0.5 per cent per annum.

[68] This letter is available on the Fiscal Council website:

http://www.fiscalcouncil.ie/wp-content/uploads/2012/08/Response-from-Minister-to-IFAC-June-2014-FAR.pdf

structural balance.[69] The bulk of the structural adjustment to meet MTO in 2018 has been back-loaded into 2017 and 2018. The plan to out-perform the requirement of the EU rules and to make greater efforts in 2017 and 2018, without a clear justification appears to reflect the use of technical assumptions rather than a well developed and detailed medium-term fiscal plan for 2016 to 2018. This issue is discussed in Chapters 1 and 3.

Box D: Treatment of One-Off and Temporary Measures

A key tool in assessing the fiscal stance is the structural balance. This represents the position of the public finances if the economy were to be operating at full potential and when one-off and temporary measures are excluded. A common approach to identifying the structural balance is to adjust the general government balance to remove non-structural elements, particularly those revenues and expenditures driven by the position of the business cycle. There has been much discussion, particularly in Ireland, concerning the problems with identifying the cyclical element of the balance through the estimation of potential output. However, it is also important to analyse the impact of one-off or temporary measures and transactions on the headline balance.[70]

In recent years, one-off and temporary measures have played a significant part in obscuring the movements of the headline deficit position in Ireland and elsewhere. The impact of this is most obvious in the exclusion of one-off and temporary measures in support of the financial system from the assessment of compliance with the EDP. Figure D.1 extends this analysis to exclude all one-off and temporary measures. It is notable that while there is an improvement in the general government balance as a share of GDP in 2013 and 2014 - between budget and outturn - this is driven in part by changes in the estimation of one-off and temporary measures, with much of the remainder from revisions to the forecast of nominal GDP.

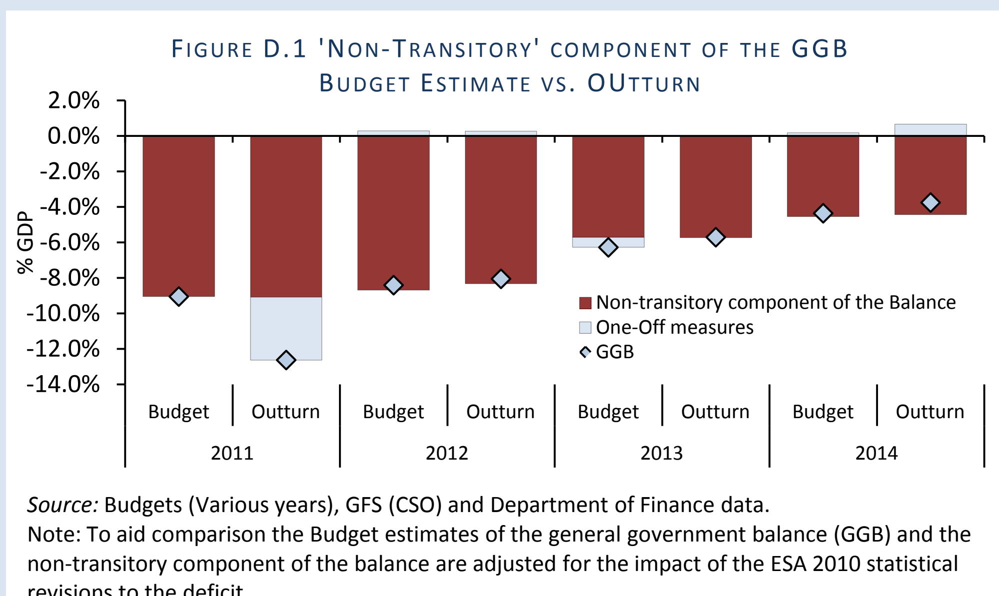


Figure D.1 'Non-Transitory' component of the GGB Budget Estimate vs. OUtturn

Source: Budgets (Various years), GFS (CSO) and Department of Finance data.
Note: To aid comparison the Budget estimates of the general government balance (GGB) and the non-transitory component of the balance are adjusted for the impact of the ESA 2010 statistical revisions to the deficit.

[69] The Budget states: "Profiled structural adjustment for 2016-2018 exceeds the minimum correction path prescribed by the Council of the EU" (Ireland's *Draft Budgetary Plan*, Table 7a; CSR Recommendations).

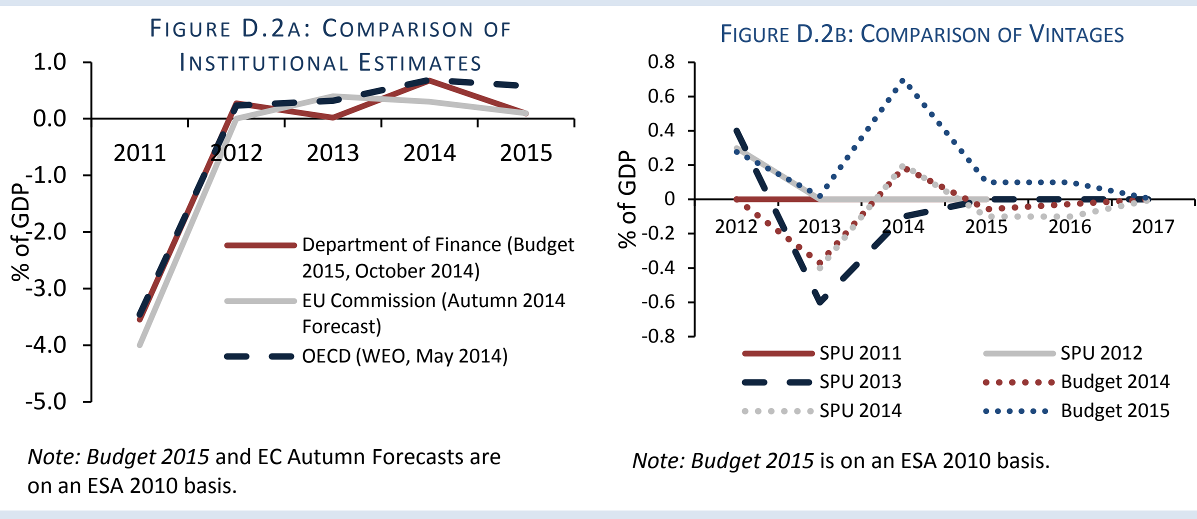
[70] One-off measures typically involve "...large, non-recurrent operations, whose impact on fiscal balance usually falls predominantly in the year when the related operations are recorded with no sustained change in the inter-temporal budget position and hence no implications for fiscal sustainability" (Bornhurst *et al*, 2011).

Figure D.1 uses one-offs as identified by the Department of Finance. However, the identification of one-offs and temporary measures can be somewhat subjective. For example, in Budgets 2011 and 2013 a temporary increase in dividends to the State was identified as part of the consolidation package, however, these increases were not classified as one-off. Part of the problem in this instance may be due to the difficulty in identifying the temporary element of on-going transactions.[71]

IDENTIFICATION OF ONE-OFF MEASURES

In identifying one-off or temporary measures, both the EU Commission and the IMF employ a 'bottom-up' method, identifying items and adjusting for individual transactions, similar to the Department of Finance. This approach can, however, suffer from information asymmetries between monitoring institutions and the national authorities and requires detailed guidelines on classification.[72]

The OECD takes a more 'top down' approach and identifies the presence of one-offs and temporary transactions through deviations in trend net capital transfers (Joumard *et al.*, 2008).[73] This method ensures consistency of treatment across countries. It is transparent as data are freely available in the National Accounts and hence allows for easier review of any *ex post* changes. However, it may omit one-off transactions outside net capital transfers For example, for Ireland it would not account for the treatment of the pension fund levy.[74] Figures D.2A and D.2B compare the latest international estimates for Ireland with those of the Department of Finance and compares different vintages of Department of Finance estimates. The 'bottom-up' method to estimating one-off and temporary measures applied by both the Department of Finance and the EC can lead to differing estimates of the structural balance. However, it is the EC estimate that is ultimately used when assessing compliance with the European rules.



Note: Budget 2015 and EC Autumn Forecasts are on an ESA 2010 basis.

Note: Budget 2015 is on an ESA 2010 basis.

[71] Similarly, the reduction in the VAT rate on accommodation, restaurants, and certain cultural activities was not included as a temporary measure despite being identified as such when introduced in 2011. However, as it is a deficit increasing measure, it may have been excluded on this basis as these are typically not accounted for as one-off or temporary under the principles applied by the EC.

[72] See Larch and Turrinni (2009) and Bornhurst *et al.* (2011) for an overview of the EC and IMF guidance on the identification of one-off and temporary measures.

[73] The trend is derived using a HP filter approach. The use of this method also raises the issue of the end-point bias in HP filtered estimates.

[74] Such one-offs could be adjusted for individually while preserving the core approach.

Forecasting one-off and temporary measures into the medium term can be challenging. While one-off transactions can arise or change in scale without prior warning, the nature of transactions can also be revised as the ending of a scheme or policy comes close, e.g. the changed treatment of the pension fund levy as a temporary measure in *Budget 2015*.

The use of one-offs transactions in fiscal policy is particularly relevant in Ireland at present given the renewed importance of the budgetary framework. There is evidence that the introduction of a fiscal rules framework based on numerical targets for the headline balance can create an incentive for governments to circumvent it using so-called accounting stratagems, including the use of one-off measures.[75] Consequently, adjustments that may normally be viewed as technical can take on a more strategic role in the budget framework.[76] Koen and Van den Noord (2006) demonstrate that as deficit rules tend to become more binding, recourse to one-offs and other fiscal stratagems is more likely. In the European context, the EU Commission has shown that while in theory one-off adjustments should be both deficit increasing and decreasing, on average they have tended to be deficit-reducing. This analysis also examined the size and incidence of one-offs measures and shows that there is a tendency across Euro Area countries for there to be more - and larger - one-offs when members state are close to the 3 per cent deficit ceiling that applies to the Corrective Arm of the SGP.

While the scope to use one-off and temporary measures will be more limited under both the preventive arm of the SGP and the national Budgetary Rule, the degree of judgement involved in identifying such transactions implies that they require ongoing scrutiny. Even though not all one-off and temporary transactions are under the direct control of Government, there is still sufficient scope for discretionary actions to flatter movements even in key structural fiscal indicators. Given the importance of identifying one-off and temporary measures for both the Corrective and Preventive Arms, a more transparent approach should be taken by both the EC and the Department of Finance. While both institutions have shared their detailed estimates with the Council, these estimates should be published as a matter of course.

Expenditure Benchmark

The EU Expenditure Benchmark (EB) limits growth in general government expenditure, excluding a number of factors.[77,78] As the EB sets a limit on the real growth of this adjusted expenditure aggregate a GDP deflator is used to adjust the nominal growth rate of the aggregate. A further adjustment is made where there is a discretionary change to revenues being collected. This change is symmetrical: a discretionary decrease (increase) in revenues effectively reduces (increases) the growth in the expenditure aggregate that complies with the EB.[79] As the EB forms part of the

[75] These incentives are reinforced in electoral periods (Buti *et al.*, 2006).

[76] This tendency has been associated with Goodhart's law, which is normally formulated as "When a measure becomes a target, it ceases to be a good measure".

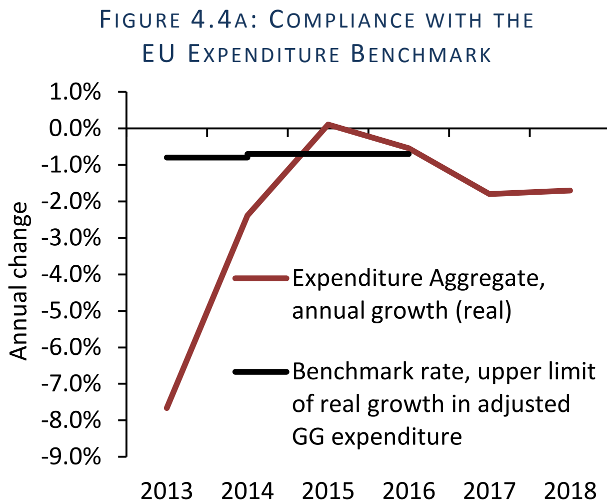
[77] The expenditure aggregate used in the assessment of the EB is calculated as general government expenditure excluding interest, cyclical unemployment benefit spending and certain spending on EU programmes and adjusted for exceptional investment costs relating to infrastructure.

[78] While ESA 2010 impacts on general government expenditure, this is mainly a level effect and does not change the annual growth rate substantially of the measured expenditure aggregate.

[79] In relation to the EB, Article 5 of EU Regulation 1466 states, "... the Council and the Commission shall assess whether the growth path of government expenditure, taken in conjunction with the effect of measures being taken or planned on the revenue side, is in accordance with the following conditions [...](c) for Member States that have not yet reached

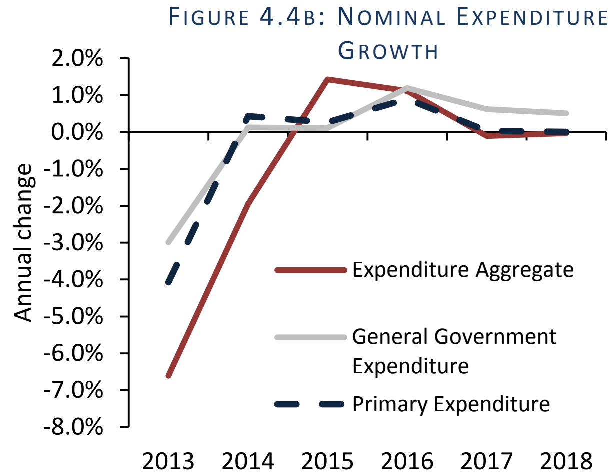
Preventive Arm of the SGP, it will only fully come into force for Ireland in 2016, following the expected correction of the excessive deficit in 2015.

FIGURE 4.4A: COMPLIANCE WITH THE EU EXPENDITURE BENCHMARK



Source: Budget 2015.

FIGURE 4.4B: NOMINAL EXPENDITURE GROWTH



Source: Budget 2015.

On the basis of *Budget 2015* estimates, the expenditure aggregate assessed under the EU Expenditure Benchmark (EB) is estimated to have fallen by just below 8 per cent and 2½ per cent in 2013 and 2014 respectively.[80,81] This compares to a reference rate of real growth of -0.8 per cent in 2013 and -0.7 per cent in 2014 under the EB (see Figure 4.4a). It therefore meets the requirements in both years.

The changes announced in *Budget 2015* led to the previously identified domestic Government Expenditure Ceiling and individual Ministerial Expenditure ceilings being broken. This significant upward revision to the Government Expenditure Ceiling, combined with the discretionary reduction in revenues, means the EB is not complied with in 2015.[82] However, as the deviation is less than 0.5 per cent of GDP it is not considered "significant" under the SGP. Figure 4.5 shows that in the absence of discretionary revenue reductions the EB would have been complied with. This

their medium-term budgetary objective, discretionary reductions of government revenue items are matched either by expenditure reductions or by discretionary increases in other government revenue items or both".

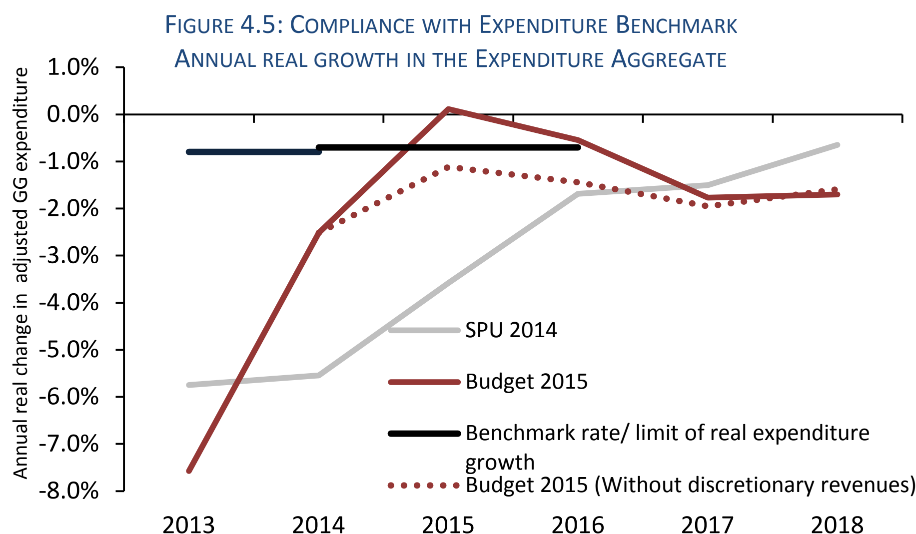
[80] The figures used in the assessment of compliance with the expenditure benchmark are contained in Table 5(b) of *Ireland's Draft Budgetary Plan* for 2015. For the following years, figures are taken from table A7 of *Budget 2015*, with the exception of discretionary revenues, which are taken from Table A6.

[81] The deflator used in this calculation is the average of the forecast deflators produced by the Department of Finance in their *SPU 2013* and *Budget 2014* forecasts for 2013 and the average of the *SPU 2014* and *Budget 2015* forecasts for 2014.

[82] Note that the estimated increase in 2014 expenditure increases the base and consequently reduces the annual growth rate in 2015.

highlights the importance of balancing expenditure demands with tax measures that erode the revenues when setting fiscal policy.

FIGURE 4.5: COMPLIANCE WITH EXPENDITURE BENCHMARK
ANNUAL REAL GROWTH IN THE EXPENDITURE AGGREGATE



Source: Budget 2015, SPU 2014, and internal calculations.

Furthermore, the Council has previously noted that the method used in estimating the cyclical component of unemployment benefit expenditure can flatter compliance with the EB.[83] *Budget 2015* estimates unemployment related payment savings of over €400 million in 2015.[84] However, as a significant element of these reduced costs is assumed to be structural, the difference can be used to fund increased structural expenditure without adversely affecting compliance with the EB.[85]

In 2016, the forecast growth of -0.5 per cent in adjusted expenditure does not comply with the minimum requirements (-0.7 per cent) of the EB. This takes into account the planned increases to expenditure in the *CER 2015-2017* and the additional carryover impact of revenue measures introduced in *Budget 2015*. While the deviation in 2016 would not be considered 'significant' it leaves very limited scope for any further increases to expenditure or discretionary reductions in revenues.[86] A significant deviation from the EB could lead to the imposition of sanctions.

[83] This is derived by applying a projected cost per person employed to an estimate of the unemployment gap (i.e., difference between the actual and structural unemployment rates). The latter is the estimated NAWRU consistent with the harmonised EU methodology. This method of estimating structural unemployment underestimates the unemployment gap (FAR, 2014a). As a consequence, this method tends to attribute less of the fall in unemployment related spending to changes in the cycle than may be appropriate.

[84] This saving is against the last forecast for 2015 rather than a year-on-year reduction.

[85] The Non-Accelerating Wage Rate of Unemployment (NAWRU) for 2015 estimated by the Department of Finance is 10.7 per cent of the labour force.

[86] Under the SGP, a significant deviation arises where there is a deviation of 0.5 per cent of GDP from the required growth rate in any given year, or an average deviation of 0.25 per cent of GDP over two consecutive years.

Furthermore, the average deviation over 2015 and 2016 is 0.2 per cent of GDP, which leaves an even narrower margin. Any changes to expenditure ceilings in *Budget 2016* must fully comply with Department of Public Expenditure and Reform Circular setting out the rules and procedures for Ireland's Medium-Term Expenditure Framework.

The EB for the period after 2016 has not been formalised, but the real growth rate in the expenditure aggregate is estimated by the Council to be -2.0 per cent and -1.8 per cent in 2017 and 2018.[87] The EC have indicated the benchmark for these years will be estimated in late 2015.[88] A concern in this regard is the EC method of extending their forecasts into the medium term, which tends to place significant weight on recent historical data observations. This can lead to the EC forecasts for growth and unemployment displaying a pro-cyclical pattern: during downturns, the methodology produces very low estimates of future growth while forecasting high unemployment. As growth recovers, and crisis period data points are followed up with stronger realised figures for growth and unemployment, this can result in significant upward revisions to the medium-term outlook using the EC methodology.[89.] Using the latest EC Autumn forecasts implies an EB of 0.3 per cent for the period 2017-2019; an estimate based on the *Budget 2015* would give a limit of just under 1 per cent.

The European and domestic budgetary framework can play a vital role in ensuring the sustainability of the public finances over the medium-term. Following EDP exit all aspects of the Preventive Arm of the SGP will apply and will have a key role in the setting of domestic fiscal policy. Both the EC and the Department of Finance must ensure there is clarity and transparency around the setting and assessment of the fiscal rules. Moreover, the mechanisms established in recent years to manage the public finances, specifically the medium-term expenditure framework (MTEF), must be respected if fiscal plans are to be successfully executed.

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[87] This includes the impact of the increase in expenditure ceilings in the *Comprehensive Expenditure Report 2015-2017*.

[88] For a country not yet at their MTO the EU EB rate of growth is calculated as follows:

$(\sum_{t-5}^{t+4} g_t) - (C_t)$, where g_t is the potential growth in t, and C_t is the convergence margin to ensure an annual adjustment of 0.5 percentage points of GDP per annum towards the MTO and is stated as $C_t \cong \frac{50}{e_t}$, where e_t is primary expenditure as a share of GDP. A higher adjustment effort – through a larger convergence margin – is required for when a country is considered to be in economic good times, whereas the effort might be more limited in economic bad times. The ESA2010 upwards revisions to both nominal GDP and general government expenditure have a relatively limited impact on the setting of the EB through changes to e_t. The exact impact on the forecasts for 2016 is not available but on the basis of the adjustments for 2014, the estimated effect is to increase the EB by up to 0.2 percentage points.

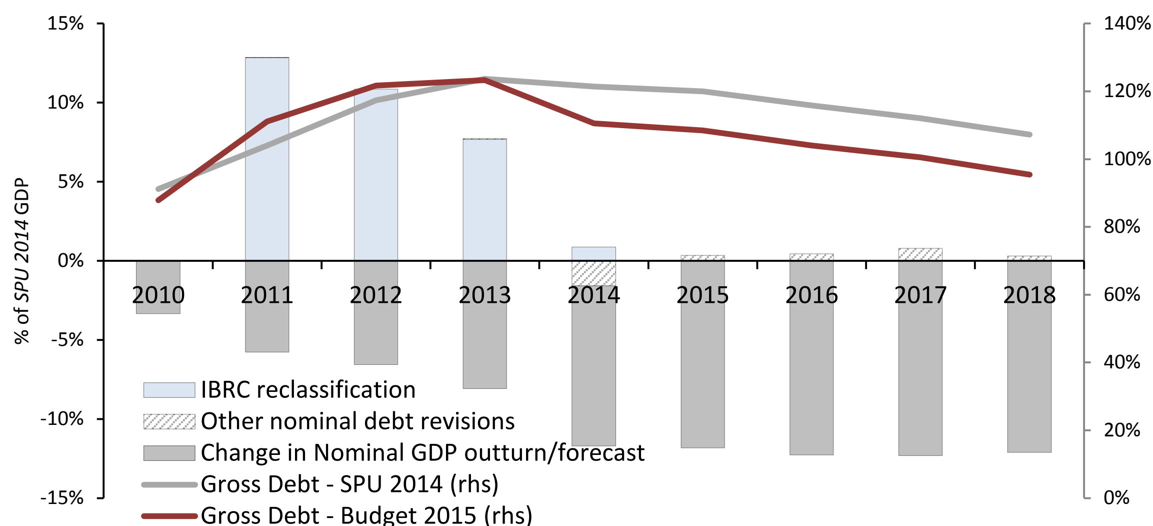
[89] See Analytical Note 2 (FAR 2014a)

4.4 Compliance with other Irish and EU Fiscal Rules

The Debt Rule

Both the level and the path of the debt-to-GDP ratio are affected by the revised treatment of IBRC and the impacts on nominal GDP (see Figure 4.6 and *Analytical Note No. 6*).

Figure 4.6: Revision to the Debt-to-GDP Ratio
SPU 2014 to *Budget 2015*



Source: CSO, *SPU 2014* and *Budget 2015*

Following the correction of the excessive deficit next year Ireland will be subject to transition arrangements under the Debt Rule.[90] These arrangements apply to countries which were in an EDP when the 2011 six-pack amendments to the SGP were adopted. The purpose of these arrangements is to give these countries a period of adjustment to adapt their structural adjustments to a level needed to comply with the reformed debt criteria, while still progressing towards compliance. During those three years, the debt requirement will be judged according to whether the countries in question make sufficient progress towards compliance. Sufficient progress towards compliance is defined by the two-pack Code of Conduct as the minimum linear structural adjustment ensuring that – if followed – Member States will comply with the debt rule at the end of the transition period.

Due to the construction of the benchmark criteria under the Debt Rule, the ESA 2010 revisions also impact the target debt levels. However, as the full debt benchmarks need only be complied with in 2019 the major volatility from ESA 2010 will have fallen out of the arithmetic. The reductions required by the revised debt criteria are matched by the lower path of the debt ratio. The

[90] The transition period begin with the correction of the deficit which will typically take place in the year before the EDP is formally ended or 'abrogated'.

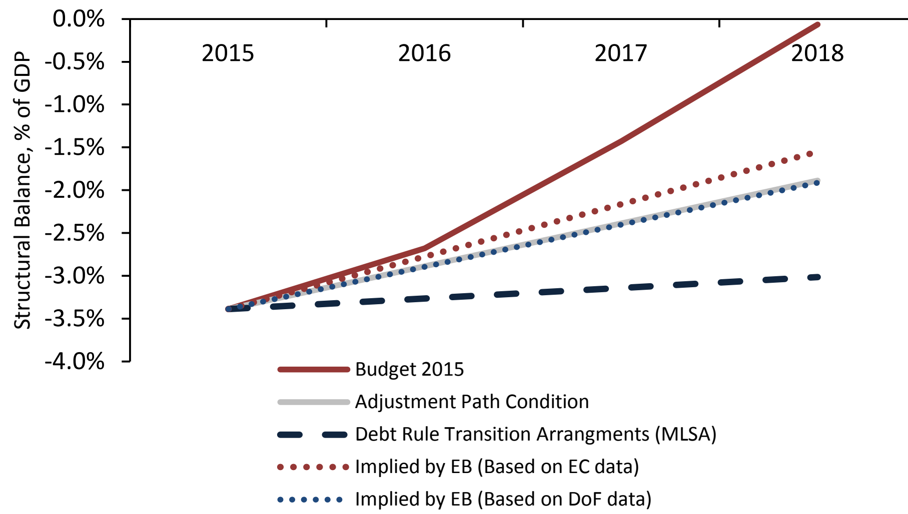
structural adjustments between 2016 and 2018 required under transition arrangements are broadly unchanged.

COMPARISON OF FISCAL RULES

As the Debt Rule is expressed as an annual change in the structural balance for the period to end-2018 when transition arrangements apply to Ireland, it is possible to directly compare the relative structural deficit position to the minimum requirements under the Budgetary Rule and to the planned path in *Budget 2015*. It is further possible to express the EB as a change in the structural balance given the assumption that nominal tax revenues grow at the same rate as nominal GDP.[91] The inclusion of the EB should be seen as largely illustrative. For the purpose of the stylised comparison in Figure 4.7, two alternative scenarios are estimated. The first holds the real rate of growth in the expenditure aggregate held at +0.3 per cent for 2017 and 2018 (equivalent to the EB under EC potential output and primary expenditure forecasts), while the second assumes it is +0.9 per cent (the Department of Finance potential output forecast). Depending on the choice of EB used, it is shown to be more binding than, or equally as binding, as the Adjustment Path condition of the Budgetary Rule over the period to 2018. In any case, based on currently available data, the structural deficit path for 2017 and 2018 is shown to be steeper than required under any of the rules.

[91] The structural balance consistent with minimum compliance under the EU EB is calculated by applying the maximum real expenditure growth under the benchmark to the expenditure aggregate calculated for 2015. This is then deflated using the forecast GDP deflators. This is repeated for all years to 2018. A general Government balance figure is estimated by adding cyclical unemployment costs, EU payments, a capital expenditure adjustment and debt interest (adjusted for the impact of the change in expenditure). This general government expenditure figures are then used to re-estimate the general government balance. By applying the cyclical adjustment and estimates for one-off and temporary measures the structural balance can be estimated. The required change in this structural balance consistent with compliance with this EB is expressed linearly over the period for comparison with the other rules.

FIGURE 4.7: ILLUSTRATIVE COMPARISON OF ALTERNATIVE RULES
STRUCTURAL BALANCE PATH



Source: Internal calculations
Note: The Adjustment Path condition is based on an annual improvement of 0.5 percentage points in the structural balance.

Appendix A: Fiscal Council Benchmark Projections 22 September

As part of the endorsement process, the Council's Secretariat produced a set of Benchmark projections in advance of its meetings with the Department of Finance. The Benchmark projections were finalised on 22 September 2014 and are summarised in Appendix Table A.1.

Appendix Table A.1: Benchmark Projections for 2014 and 2015

% change unless otherwise stated	2014	2015
Real GDP	4.8	3.7
Consumption	1.1	1.3
Investment	13.8	12.5
Government	-0.9	0.0
Stock change (% of GDP)	0.5	0.4
Exports	9.0	4.4
Imports	8.5	4.3
Net Exports (p.p. contribution)	2.3	1.0
Domestic Demand (p.p. contribution)	2.5	2.7
Stock Changes (p.p. contribution)	0.0	0.0
Current Account (% GDP)	4.5	4.9
Employment	1.6	1.9
Unemployment Rate (%)	11.4	10.3
HICP	0.4	0.9
GDP Deflator	0.2	1.3
Nominal GDP (€ billions)	183.6	192.8
Nominal GDP	5.0	5.0

The Council's "endorsable range" is informed by, but not mechanically linked to, the uncertainty captured in fan chart analysis. Note that this time around, the Council has applied the fan chart approach retrospectively also so that uncertainty around outturn revisions can also be graphically represented (Figure 2.8).

The fan chart bands for the historical period effectively show the typical scale of revisions applying to historical estimates of real GDP growth over a five year period.[92] As can be seen these are quite wide for the most recent yearly outturns, but gradually pare off over time.

The construction of the fan chart for the historical period can also vary depending on the number of iterations already released (i.e., the number of releases published with estimates of the yearly

[92] Quill (2008) notes that in practice CSO data beyond five years rarely changes materially except for methodological reasons.

outturn in question). As detailed in Casey and Smyth (*forthcoming*), typical confidence intervals surrounding estimates for the latest annual outturn are not especially narrower than that for the current forecast year.[93] While this source of uncertainty narrows after the *NIE* release in Summer, large uncertainties around the most recent annual outturns can still remain.[94]

It is important to note that the fan chart for the forecast period is symmetric by construction even though the Council may interpret the balance of risks to be weighted in a certain direction at a given point in time.

[93] Revisions for the latest full-year of data are typically large, especially when it comes to the first estimate of real GDP growth (i.e., with the release of the fourth quarter QNA results). A typical root mean squared error (RMSE) value of 1.6 for the previous full year of data compares to a RMSR of 1.8 for the current year's forecast. This means that the uncertainty surrounding the current forecast year is a little less than that of the previous year for which four quarters of data are available. The RMSR for the previous year narrows to 0.9 after the release of the NIE in the Summer of each year, but remains relatively large.

[94] The fan chart shown here is based on the typical scale of revisions that can be expected after the NIE release (i.e. after the second vintage of estimates for the previous annual outturn) and is, therefore, more aligned with the information available at the time of the budgetary endorsement exercise.

Appendix B: House Price Risks Update

The Council continues to monitor various indicators with respect to housing market trends given the attendant risks to both economic activity and to the public finances. This section updates previous analyses (IFAC, 2014a) using the latest available data.

The summary analysis in Figure AB.1 highlights the upturn in valuations from low levels as well as the recent reductions in user costs.[95] Such pressures appear to be fuelled by supply issues in particular.[96] In the absence of an appropriate supply response, there is a risk that price rises become entrenched in expectations and consequently self-reinforcing. The Central Bank (2014) proposed macroprudential measures to enhance the resilience of the banking sector and households to housing market developments.

Policy measures in *Budget 2015* that increase social housing provision are a useful means of tackling housing stock shortages, but are unlikely to be sufficient in the absence of increased private sector provision also. More sustainable solutions to shortages might seek to address barriers to construction responses in the form of regulations and associated costs as highlighted by Lyons (2014).

As noted in the previous *FAR*, risk assessment of the housing market would be well served if more regional analyses were routinely produced as migration and other assumptions evolve. Data availability with respect to regional household numbers and current and projected housing stocks could also be improved on. This would further help to limit risks of price growth expectations becoming dislodged from fundamentals.

[95] The recent four-quarter average is used here and assumes price growth of 9.6 per cent over the next twelve months. Third quarter survey price expectations by Daft.ie are for a 12 per cent rise in Dublin and 6 per cent outside of Dublin.

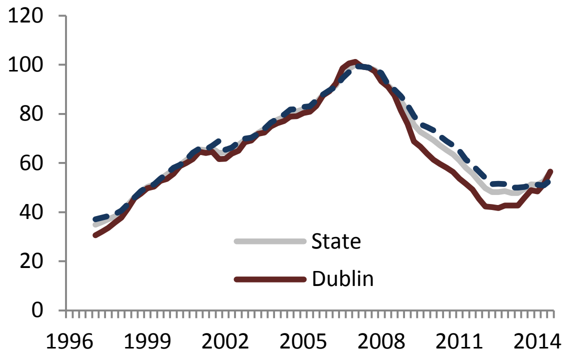
[96] A recent report commissioned by the Society of Chartered Surveyors Ireland (SCSI, 2014) examines the capacity of Dublin's zoned residential sites to meet projected demand over 2014-2018.

FIGURE AB.1: IRELAND: HOUSING DEVELOPMENTS

Even with recent increases, real prices are more than 40 per cent below peak levels on average

Real Residential Property Prices (HICP adj.)

Index: Q1 2007=100

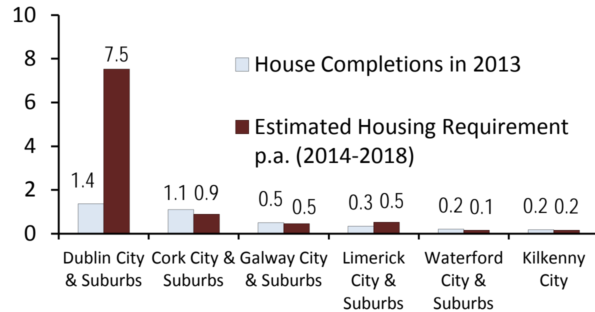


Sources: ESRI/PTSB; CSO.

...and supply issues remain a concern, particularly in Dublin.

Estimated housing requirements/completions

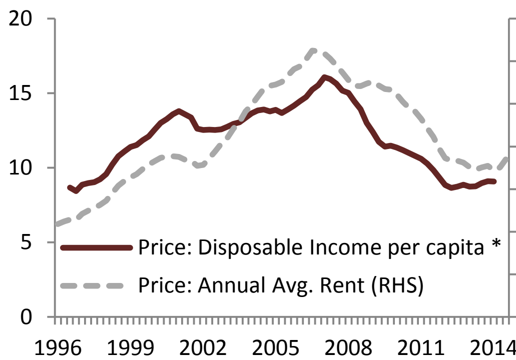
Units (000s)



Sources: Housing Agency; DoECLG.
Note: Completions cover rural + urban settlements; requirements only cover urban settlements of 1,000+ persons

Valuations have begun to pick up from low levels partly due to supply pressures in certain areas

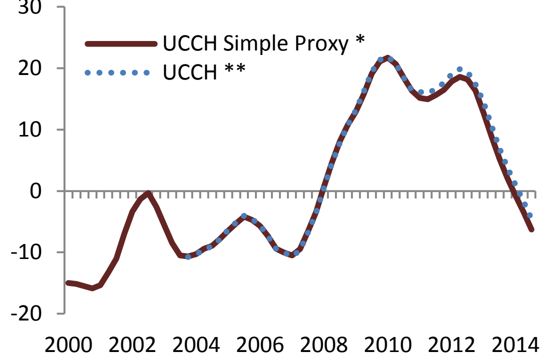
Housing Valuation Ratios



Sources: ESRI/PTSB; CSO.
*Average house prices divided by moving 4-quarter sum of adjusted personal disposable income per capita.

...and rising price expectations are fuelling a return to negative user costs.

User Cost of Capital for Housing (UCCH)

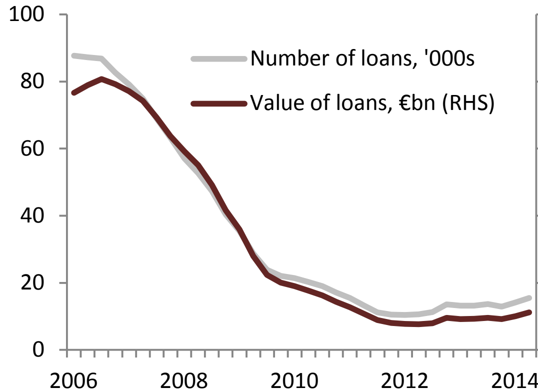


Sources: Central Bank of Ireland; CSO; ESRI/PTSB.
* New mortgage rates less annual price change for past 4Qs.
**Includes first-time buyer taxes/subsidies; down-payments; depreciation / maintenance.

Loan volumes and amounts have begun to pick up from a very low base

Annualised Residential Mortgage Lending

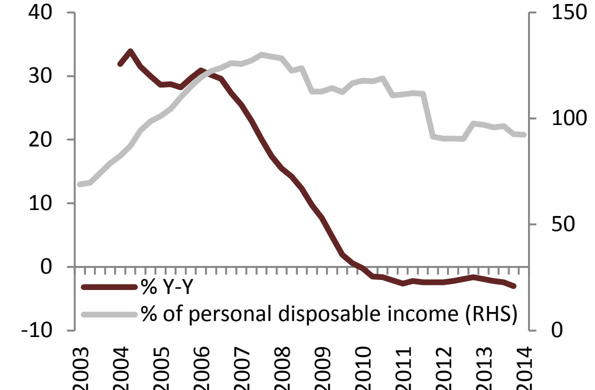
First-time buyer and mover purchaser loans



Source: IBF/PwC Mortgage Market Profile.

...although – in net terms – negative loan growth continues to reflect household deleveraging.

Loans to Irish Households for House Purchase



Sources: Central Bank of Ireland; CSO.

Appendix C: Timeline for Endorsement of *Budget 2015* Projections

Date	
18 September	CSO release *Quarterly National Accounts* estimates for Q2 2014.
19 September	The Secretariat received Department of Finance technical assumptions underpinning *Budget 2015* forecasts.[97]
24 September	Benchmark projections were discussed by the Council and finalised by the Secretariat prior to receiving preliminary forecasts from the Department of Finance.
	The Secretariat and Department of Finance met the CSO to clarify technical details of latest *Quarterly National Accounts* estimates.
	The Council received preliminary forecasts from the Department in line with *Memorandum of Understanding* requirements.
25 September	The first endorsement meeting took place with the Department of Finance presenting their forecasts to the Secretariat. A number of clarifications of a factual nature were requested.
26 September	The Secretariat submitted a number of queries to the Department in relation to the forecast set.[98]
29 September	The Department provided more details to IFAC in response to the queries received.
	The Council received a set of provisional final forecasts from the Department. Changes to several components were included and the forecast level of nominal GDP was slightly higher for 2015 in the newer forecast set reflecting higher public consumption estimates.
30 September	The Department provided additional details to IFAC in response to previous queries received.
2 October	The Council met to discuss the Department of Finance forecasts. Following this, Department of Finance staff met with the full Council and Secretariat to present their latest forecasts and to answer questions. The Council sought additional information regarding a number of forecast components.[99]
3 October	The Council met to discuss the Department of Finance forecasts in detail and to finalise a decision on the endorsement.
6 October	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *Budget 2015*.
7 October	The endorsement decision is announced at a presentation of the Department's forecasts at an Oireachtas Committee meeting. Subsequent to this, the endorsement letter is published.
14 October	*Budget 2015* published a reconciliation exercise between final and endorsed forecasts provided by the Department with qualitative explanations of changes to estimates.
15 October	Draft *2015 Budgetary Plan* for 2015 was formally submitted to the EC.

[97] These included assumptions related to oil prices, interest rates, exchange rates and sources of forecasts for major trading partners.

[98] Mainly covering quarterly profiles, income assumptions and the breakdown of investment forecasts.

[99] Primarily concerning the composition and expected profile of net exports, but also assumptions for incomes, the evolution of contract manufacturing activities, savings rates, building and construction assumptions, the neutral budget assumption underpinning fiscal assumptions and the employment growth slowdown in early 2014.

GLOSSARY[100]

Automatic stabilisers: Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Budget balance: The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses general government aggregates.

Cyclical component of budget balance: That part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap.

Discretionary fiscal policy: Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of automatic stabilisers.

Excessive Deficit Procedure (EDP): A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State.

Expenditure rules: A subset of fiscal rules that target (a subset of) public expenditure.

Fiscal consolidation: An improvement in the budget balance through measures of discretionary fiscal policy, either specified by the amount of the improvement or the period over which the improvement continues.

General Government: As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the excessive deficit procedure, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

[100] These definitions are taken directly from the European Commission. See European Economy, Occasional Papers 151, May 2013, *Vade Mecum* on the *Stability and Growth Pact*.

Maastricht reference values for public debt and deficits: Respectively, a 60 per cent General Government debt-to-GDP ratio and a 3 per cent General Government deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union.

Medium-term budgetary framework: An institutional fiscal device that lets policy-makers extend the horizon for fiscal policy making beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under medium-term budgetary frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-term budgetary objective (MTO): According to the reformed *Stability and Growth Pact*, stability programmes and convergence programmes present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms.

Minimum benchmarks: The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the medium-term budgetary objectives (MTO).

One-off and temporary measures: Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position.

Output gap: The difference between actual output and estimated potential output at any particular point in time.

Potential GDP: The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

Primary budget balance: The budget balance net of interest payments on general government debt.

Primary structural budget balance: The structural budget balance net of interest payments.

Pro-cyclical fiscal policy: A fiscal stance which amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the cyclically-adjusted budget balance unchanged over the economic cycle but lets the automatic stabilisers work.

Public debt: Consolidated gross debt for the general government sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Sovereign bond spread: The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

***Stability and Growth Pact (SGP)*:** Approved in 1997 and reformed in 2005 and 2011, the *SGP* clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The *SGP* consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997).

Stability programmes: Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*.

Stock-flow adjustment: The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance: The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance.

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