# Medium-Term Fiscal Statement

November 2011

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# SUMMARY

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# OVERVIEW

This *Medium-Term Fiscal Statement* provides an update, in advance of *Budget 2012* in December and the sequence of budget-related announcements that will be made in the coming weeks, of the Government's medium-term budgetary strategy. The primary aim of this strategy is to return the public finances to a sound position and thereby create a critical pre-condition for the attainment of strong sustainable employment growth.

Considerable progress has already been made towards stabilising the public finances. Taking account of the latest available information, this year's General Government deficit is now expected to be 10.3% of GDP. This is lower than the 10.6% of GDP target set for Ireland by the ECOFIN Council last December. It also marks a significant improvement vis-à-vis the 11.5% of GDP outturn for the underlying deficit in 2010. Achieving this progress has required a wide range of difficult decisions to cut spending and raise revenue and these will help to secure further improvements in the budgetary position in the years ahead.

However, all of this progress has to be seen in the context of the evolving situation in Europe. The announcement of the comprehensive strategy by euro area leaders on 26th October marked a new watershed in European cooperation, although subsequent developments in Greece have generated a new round of uncertainty. A credible solution to the Greek situation is key to restoring normality and is in the interests of all.

Moreover, it is clear that significant challenges remain for Ireland. The large gap that still exists between Government spending and revenue must be closed. Continuing to run big deficits and engaging in the large volume of borrowing required to fund them is simply not viable. To do so would result in an unsustainable stock of debt and long-term loss of sovereignty.

In any event, our international obligations under the *EU/IMF Programme of Financial Support* entered into in late 2010, and under the *Stability and Growth Pact*, require us to make measurable progress in reducing the budget deficit. Under the latter we must cut the deficit to less than 3% of GDP by 2015. It is currently estimated that to do so will necessitate adjustment measures amounting to a total of €12.4 billion over the 4-year period 2012-2015, the implementation of which is projected to arrest the rise in the debt/GDP ratio and bring about a 5 percentage point reduction between 2013 and 2015.

Based on the Department of Finance's current macroeconomic and fiscal assessment, this *Statement* sets out a year-by-year timetable of how this consolidation will be phased, starting with the €3.8 billion adjustment that is now planned for 2012, how it will be split between tax increases and spending cuts, and how the spending cuts in turn will be split between the current and capital budgets.

As far as phasing is concerned, the Government has decided to retain a degree of front-loading in order to underline its resolve to make swift progress in addressing the problem. However, the Government has not been persuaded by arguments for even greater front-loading, on the grounds that it is important to allow the shallow economic recovery that has commenced a chance to strengthen.

As to the composition of the adjustment, of the overall €12.4 billion consolidation now planned for the 2012-2015 period, it is intended that €7.75 billion will consist of expenditure reducing measures and €4.65 billion revenue raising measures. This mix reflects the analysis of international evidence by organisations like the European Commission, IMF and OECD which suggests that fiscal consolidations tend to be more successful when they rely more on spending cuts than tax increases. It also reflects the view that the scope for raising the overall tax burden in an economy as dependent on international trade and foreign direct investment as Ireland is limited by considerations of competitiveness, and the judgement that the late 1990s, a period of outstanding performance by the Irish economy, provides a useful benchmark in this regard.

Restoring the public finances to good health, much less restoring the economy to its full potential, will not be achieved by fiscal consolidation alone. Indeed, in the short term fiscal consolidation dampens economic activity. However, despite that dampening effect, the economy has started to expand again and real GDP is now expected to increase by 1% this year, propelled by relatively strong export growth.

At present, the only source of significant growth in the economy is exports. That being the case, safeguarding and expanding the economy's export base will remain a critically important objective of overall economic strategy. To that end, in tandem with the fiscal adjustment programme set out in this *Statement*, the Government will continue to develop and implement policies designed to improve the competitiveness of Ireland's internationally trading sectors and enhance Ireland's attractiveness as a place in which to set up and grow business.

However, it is also important that domestic demand recovers. Indeed, it is only when consumer spending and investment start increasing again, that appreciable, broadly-based employment growth will re-commence. In this context, the restoration of an adequate flow of credit is critical and is a central objective of Government policy in relation to the banking sector. Another pre-condition for renewed growth in domestic demand is the restoration of business and consumer confidence.

The Government can assist in the rebuilding of confidence by pursuing a budgetary strategy that dispels fears about the sustainability of Government debt, and by articulating that strategy in a way that provides clarity around the measures that will underpin it. It is the Government's intention to publish further details in the context of Budget 2012 in relation to the tax and spending measures planned for the 2012-2015 period to serve this purpose. Specifically, the framework of fiscal consolidation presented in this *Statement* will be translated on Budget Day into a published tax strategy and binding expenditure ceilings for each Government Department for the next three years.

This *Statement* contains a set of macroeconomic forecasts that has been prepared by the Department of Finance. The forecasts paint a positive picture of our economic prospects, though recent data have led to some downward adjustment of this, notably for 2012, compared with the last set of forecasts published by the Department in the *Stability Programme Update* (SPU) in April. GDP is now projected to grow by 1.6% in 2012 and at an average annual rate of 2.8% over the following three years. The corresponding SPU forecasts were 2.5% and 3% respectively. A key reason for the downward revisions is that the outlook for the global economy has deteriorated in the intervening period. In comparison, the most recent OECD forecasts for the euro area see GDP growth of 0.3% in 2012 and 1.5% in 2013.

The implications of this revised growth outlook for the labour market are a matter of particular concern. Employment is now projected to increase by around 65,000 by 2015 and the unemployment rate is forecast to have fallen only modestly, to 11.6%, by then. It must be stressed that these forecasts are necessarily predicated on policies that have been articulated at this stage, and cannot take into account policies that have not yet been designed or announced. As such, there is no sense in which the forecasts represent Government targets.

On the contrary, the macroeconomic forecasts, and especially those that pertain to employment and unemployment, provide one measure of the scale of the challenge that the Government faces. They underline the urgency of designing and implementing reforms that will enhance the economy's potential growth rate and its capacity to generate employment. In the context of the large fiscal adjustment that remains necessary, they also reinforce the Government's commitment to ensuring that the measures taken are as jobs-friendly as possible.

# CHAPTER 1

## Recent Developments

## Emerging 2011 Economic & Budgetary Outlook

## 1.1 Recent Developments

***Economy***

After a number of difficult years, the first half of 2011 saw a rebound in economic activity, thus bringing to an end the worst recession in Irish history and marking the start of what is expected to be a rather gradual recovery.

Recoveries of small open economies such as Ireland's are typically externally-driven, with a pick-up in exports feeding through to investment and employment that then spurs household spending. In recognition of this, the Government is working to create the conditions in which the internationally traded goods and services sector can grow and prosper. Key amongst these conditions are sound public finances, a banking system that is capable of meeting increased credit demand as it materialises and a reduced cost base. At the same time, the Government is pursuing an ambitious programme of structural reform, including a frontloading of measures to boost competitiveness and support domestic activity and job creation.

Recent developments suggest that this growth strategy is starting to gain traction. GDP expanded by 1.9% (quarter-on-quarter, seasonally adjusted) in the first quarter and by 1.6% in the second, while GNP was up by just over 1%. Real GDP is now back above its level of early 2009.

As expected, the traded sector is leading the nascent recovery. Exports of goods and services increased by over 6% on an annual basis in the first quarter and - notwithstanding softer activity in our main trading partners - by close to 5% in the second. Encouragingly, export growth is also broadening out to include parts of the indigenous traded sector, including agri-foods and tourism. That exports are now well in excess of pre-crisis levels owes much to the significant price and cost adjustments that have taken place in recent years. These, in turn, are a testament to the flexibility of the Irish economy.

Less positively, all components of domestic demand contracted in the first half of the year (on an annual basis). This was also anticipated. It will take time for export growth to filter through to investment and personal consumption. Moreover, with households, firms and the Government sector still working through the imbalances built up during the boom, such as excessive indebtedness and an over-reliance on construction, domestic demand is likely to respond only sluggishly to the impetus from the external side.

So, while economic activity is expanding again, and even surprised on the upside in the first half of the year, the export-led nature of growth means that the recovery is not being fully reflected in the labour market situation as of yet.

That said, labour-market conditions are moving towards stabilisation. The pace of job losses moderated in the first half of 2011, with the rate of decline easing in the second quarter to 0.2% (quarter-on-quarter, seasonally adjusted) and 8 of the 14 economic sectors actually creating jobs. The labour force also fell in the first half of the year, on account of lower participation and outward migration. The CSO estimates that around 34,000 people left the country in net terms in the year to April, similar to the 2010 number. The decline in labour supply was not sufficient to compensate for the loss in employment however, with the result that the unemployment rate rose to 14.2% in the second quarter. Data available for October show a further pick-up in the rate, albeit marginal. The increase in the number of long-term unemployed – which now accounts for more than half of the total out of work – is a particularly worrying trend and underlies the policy focus at Government level on up-skilling and training.

***Public Finances***

On the budgetary front, the underlying position - that is excluding the impact of State support for the banking sector - is showing signs of improvement after three very tough years. The text that follows refers to the position as of end-September. The Exchequer Returns for the period up to end-November will be assessed over the coming weeks with a view to forming an updated view on the likely end-year outturn in Budget 2012.

<u>End-September Exchequer Returns</u>

The end-September Exchequer Returns showed that an Exchequer deficit of €20.7 billion was recorded in the first nine months of 2011. On a headline basis there was an increase of €7.3 billion on the deficit in the corresponding period in 2010. However, this increase is the result of banking related payments, including €3.1 billion in Promissory Note payments to Anglo Irish Bank, Irish Nationwide Building Society (INBS) and Educational Building Society (EBS) and €7.6 billion in Exchequer funded payments relating to July's recapitalisation of the banking sector.

Excluding these payments, the underlying Exchequer deficit fell by over €3 billion in the first nine months of the year, evidence of the real progress that is being made in tackling the large deficit that exists and in restoring the public finances to a more sustainable position.

€24.1 billion in tax revenue was collected in the three quarters to end-September 2011. This represents an increase of just over €1.9 billion or 8.7% on the amount collected in the first nine months of 2010. This strong year-on-year growth rate owes much to the measures introduced in Budget 2011 - most notably the Universal Social Charge (USC) - but also the receipts from the temporary levy on private pension funds, which was introduced to fund the Government's *Jobs Initiative*.

Exchequer tax revenues are derived primarily from four main sources – the "big four" tax-heads. These are: income tax, VAT, excise duties and corporation tax and together they account for approximately 95% of total tax revenues.

On a cumulative basis, tax revenues at end-September were €160 million or 0.7% better than expected. However, this surplus was largely due to favourable timing factors relating to income tax and also receipts from the pension levy, which did not form part of the original tax revenue profile for 2011 which was published in early February.

Income tax has performed reasonably well in 2011 and at end-September was €147 million, or 1.6%, ahead of expectations. This stronger than profiled performance was largely due to earlier than expected payments of Deposit Interest Retention Tax (DIRT) in April and July. The payment schedule for DIRT was changed after the profile of tax revenues was published in early February. Nonetheless, the underlying performance of income tax can be viewed very positively, particularly in the context of such a large target being set as a result of the introduction of the USC and other Budget 2011 measures.

VAT receipts to end-September were €300 million or 3.6% behind profile. The trend in recent months in VAT receipts has been negative, reflecting continuing weak domestic demand. This shortfall is expected to grow somewhat over the final months of the year.

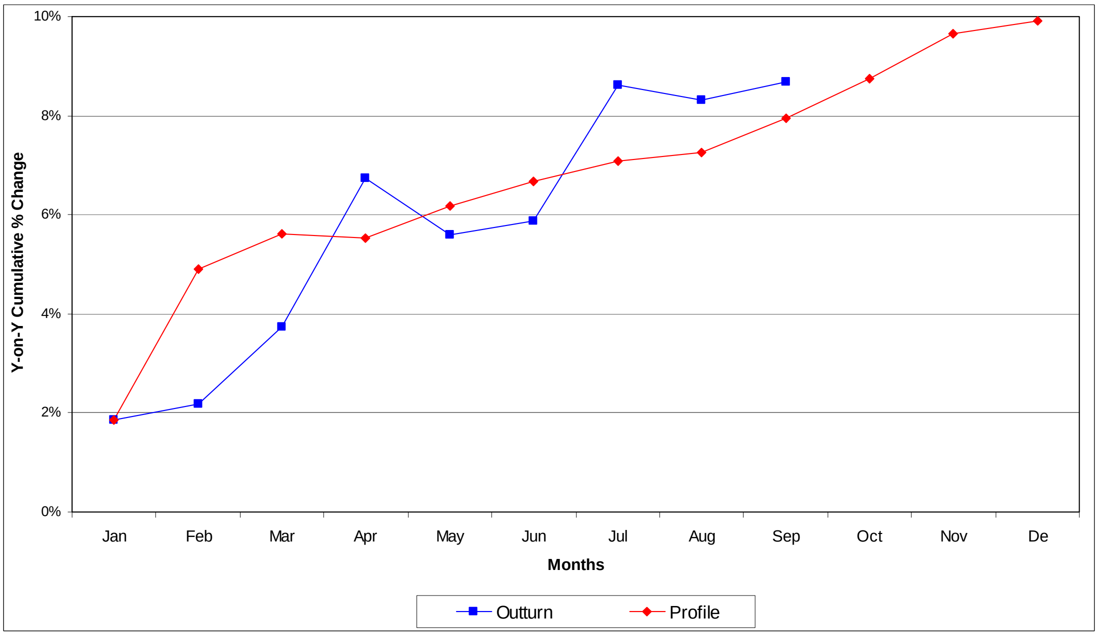
While excise duties recorded a €77 million or 2.3% shortfall against target in the period to end-September, this was due to a delay in the receipt of €112 million in revenues at the end of September. Although these revenues were proper to September, they did not reach the Exchequer account until the early days of October. This delay depressed the end-September position somewhat.

The last of the "big four" tax-heads is corporation tax. Receipts from this source at end-September were €31 million or 1.5% behind profile. Corporation tax payments can vary notably from month to month and payments from, and repayments to, large firms can very often impact considerably upon collection figures. Receipts were well above target in the months of March and July but fell significantly short of target in May and September, thus highlighting the very considerable month-to-month volatility that can arise. November is the most important month of the year for corporation tax collection with just over a quarter of the annual receipts scheduled for collection in that month. Performance in November will go a long way to determining the overall end-year tax revenue outturn.

In terms of the smaller tax-heads, stamp duty receipts were a notable €384 million or 51.9%, ahead of target at end-September, due to receipts from the levy on pension funds, introduced to fund the *Jobs Initiative*.

Graph 1.1 shows the cumulative performance of tax revenues in the first nine months of 2011 as compared to the published profile.

**Graph 1.1: Tax Revenue Cumulative Outturn v Profile to end-September 2011**




Turning to voted expenditure, at €33.4 billion, total net voted expenditure at end-September was €184 million, or 0.6%, higher on a year-on-year basis. However, adjusting for the technical accounting issue around the reclassification of health levy receipts to form part of the USC, it is estimated that total net voted expenditure fell 3% year-on-year in underlying terms.

Importantly, net voted expenditure was €749 million, or 2.2%, below target at end-September. To some degree, this position reflects favourable timing factors on some votes, as well as stronger-than-anticipated PRSI receipts which reduce net Exchequer outlay on the Social Protection vote.

In addition, while most votes are being managed tightly within the allocated amount, there are significant pressures arising on current expenditure in some areas. In particular, the Live Register will be significantly higher than the average of 405,000 previously forecast for 2011. An average in the range of 440,000-445,000 for the year as a whole is now foreseen. This upward revision partly reflects weaker than expected labour market developments during the year. There are also underlying spending pressures in the Justice area, particularly in the area of Garda overtime in connection with the State visits earlier in the year; and within the Health Service Executive (HSE), where the pressures are being managed proactively in coordination with the Department of Health.

Likewise, capital spending was €278 million, or 11.3%, below profile at end-September. This was primarily due to timing issues and it is expected that capital expenditure will return to profile over the latter part of the year.

Taken as a whole, it is anticipated that voted expenditure in 2011 will be brought in at or below the overall allocation.

The end-October Exchequer Returns were published on Wednesday, 2nd November, showing that net voted expenditure was held at €941 million or 2.5% below target. While the timing factors and underlying pressures outlined above are still relevant, this overall position lends further assurance to the end-year position being delivered within the allocation.

The end-October Exchequer figures, and indeed the end-November Exchequer Returns will continue to be further assessed over the coming weeks in the context of forming an updated view on the end-year position. This will be set out in Budget 2012.

### 1.2 Emerging Economic Outlook 2011

While the Irish economy performed better than expected in the first half of 2011, our assessment of its performance in the second half of the year must take account of some less benign aspects of the economic environment.

On the domestic front, high-frequency data suggest that weak demand conditions have persisted into the third quarter. Household spending in particular looks to be under pressure - temporary supports such as the car scrappage scheme have come to an end, while uncertainty continues to weigh on consumer confidence and keep the savings rate at an elevated level. With retail sales and the consumer sentiment indicator continuing to disappoint, it seems that the previously identified downside risks to personal consumption have materialised somewhat. Uncertainty is also having a dampening effect on business investment, while housing start data are consistent with a further fall in completions.

**Table 1.1: External Assumptions**

| *% Change* | 2011 | 2012 | 2013 |
|---|---|---|---|
| **External GDP Growth** | | | |
| G20 countries | 3.9 | 3.8 | 4.6 |
| Advanced G20 countries | 1.5 | 1.5 | 2.2 |
| United States | 1.7 | 1.8 | 2.5 |
| Euro Area | 1.6 | 0.3 | 1.5 |
| | | | |
| **Technical Assumptions** | | | |
| Euro-Sterling Exchange Rate | 0.87 | 0.87 | 0.87 |
| Euro-Dollar Exchange Rate | 1.40 | 1.39 | 1.39 |
| Brent Crude (US $ per barrel) | 111 | 106 | 101 |
| Brent Crude (€ per barrel) | 79 | 76 | 73 |

Source: External growth projections are taken from the OECD release of 31st October; exchange rate figures are Department of Finance technical assumptions involving the maintenance of unchanged rates from those at end-October (10 day average); oil price figures are based on market futures at end-October (10 day average).

Moreover, uncertainty surrounding global growth prospects has increased over the course of the summer and into the autumn. While emerging and developing economies are still growing strongly, in advanced economies the data-flow has been weaker than expected. Recent months have also seen the sovereign debt crisis in the euro area enter a new phase, with negative spill-over effects spreading to parts of the European banking system. On foot of these developments, international organisations are in the process of revising down their short-term macroeconomic projections. The OECD, for instance, expects growth in advanced G20 countries to be relatively subdued over the period 2011-12 and has scaled back its projections for Ireland's main trading partners, though it still foresees modest growth in these economies.

Weighted by their share in Irish exports, GDP in our main trading partners is now projected to increase by around 1% next year. This compares to a figure of roughly 2% at the time of the SPU.

While the significant competitiveness improvements that have taken place in recent years and the acyclical nature of some Irish exports will have a mitigating effect, this weaker external environment will hold back export growth somewhat. Indeed, mirroring soft momentum at the global level, recent readings of the new export orders components of the Purchasing Managers' Indices have been weak and point to slower export growth in the second half of the year.

Drawing these elements together, the picture emerging for the latter part of the year is one of moderating growth. The relatively strong performance in the first half is set to more than offset this, however, implying a marginal upward revision to growth for 2011 as a whole compared with the SPU forecasts. The economy is now projected to expand by 1% in GDP terms and by 0.4% on a GNP basis. The composition of growth has also altered slightly, with the contribution of domestic demand revised down and the contribution of net exports revised up.

While GDP is set to grow once more in real terms – for the first time since 2007 – nominal GDP is expected to decline again this year. This follows from developments on the price side, where a negative terms-of-trade effect (i.e. import prices are rising faster than export prices) is weighing on the GDP deflator. Consumer price inflation, on the other hand, is projected to turn positive on the back of a sharp rise in commodity prices, increases in some administered prices and, in the case of the CPI, interest rate hikes[1]. Encouragingly, the current account of the balance of payments is likely to show a small surplus again this year, meaning that as a nation, Ireland is paying its way.

As recoveries in hiring tend to lag those in activity, further job losses are foreseen for the second half of 2011, although the pace of the decline should continue to ease. For the year as a whole, employment is expected to contract by 1.8%, well below the 4.2% fall recorded in 2010. The unemployment rate is forecast to average 14.2%, up from 13.6% last year.

### 1.3 Emerging Budgetary Outlook 2011

On the tax revenue side, it is the case that there is an underlying weakness in some taxes, most notably VAT. November is by far the most important month of the year in terms of tax revenue collection, with large targets set for income tax, corporation tax and VAT. Tax revenues in November will go a long way to determining the annual outturn. Notwithstanding the un-profiled additional revenues collected from the *Jobs Initiative* pension levy, it is now viewed that there is a downside risk attaching to the Budget day tax revenue target of €34.9 billion and an overall shortfall of some €450 million is being worked into the estimated end-year budgetary position.

In the context of voted expenditure, while there are some compositional changes, the aggregate net allocation published in the July *Revised Estimates Volume* remains the aggregate net spending target for 2011. The stronger than expected performance of PRSI receipts is expected to offset gross expenditure pressures in some areas.

The current working estimate of the Exchequer deficit for 2011 is €25.4 billion. While this is significantly in excess of the estimate contained in April's SPU[2], this is largely due to the €7.6 billion in banking recapitalisation payments funded from the Exchequer in July. A further €10 billion from the National Pensions Reserve Fund (NPRF) has also been used to fund banking recapitalisation payments this year. No further banking-related payments from the Exchequer, above those which occurred in July, have been factored into the current working Exchequer deficit estimate.

The current working estimate of the underlying Exchequer deficit – that is the deficit excluding the banking recapitalisation payments – is €17.9 billion, which is some €300 million better than the SPU estimate and close to the original estimate set out in Budget 2011.

The improvement compared to the SPU is due largely to the €1 billion in proceeds from the sale of part of the State's shareholding in Bank of Ireland, higher than estimated fees from the Bank Guarantee Schemes, and lower debt interest expenditure as a result of the interest rate reductions secured at the 21st July Heads of State or Government (HoSG) meeting. However these improvements are offset to some extent by the anticipated shortfall in tax revenues, the requirement for the Exchequer to provide funding for the credit union sector and an advance to the Insurance Compensation Fund – amounts of €250 million and €280 million are being factored in for 2011 respectively – and the now

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[1] While around half of all mortgage holders are on tracker rates, the CPI only takes account of variable rate mortgages. As such, the impact of margin increases on the CPI may be overstated.

[2] The April SPU Exchequer deficit estimate of €18.2 billion for 2011 did not allow for Exchequer funded banking recapitalisation payments. However, the 2011 estimate of the General Government debt/GDP ratio prudently assumed €10 billion in Exchequer funded banking recapitalisation payments.

likely non-realisation this year of revenues from the sale of State assets and the auctioning of the Spectrum mobile telephony licence.

Based on the Department of Finance's current macroeconomic and fiscal assessment, the emerging General Government deficit estimate, at 10.3% of GDP, is within the 10.6% target set by the ECOFIN Council in December 2010. This estimate is based on this year's banking recapitalisation payments being classified as financial transactions which means they are not counted as part of the General Government deficit measure. This provisional classification will continue to be assessed in the coming months in light of on-going discussions between the Department of Finance, the CSO and Eurostat[3].

[3] The ECOFIN Council target would not be affected in the event that these payments were reclassified as capital transfers and therefore counted as part of the General Government deficit measure.

# Chapter 2

Budgetary Consolidation

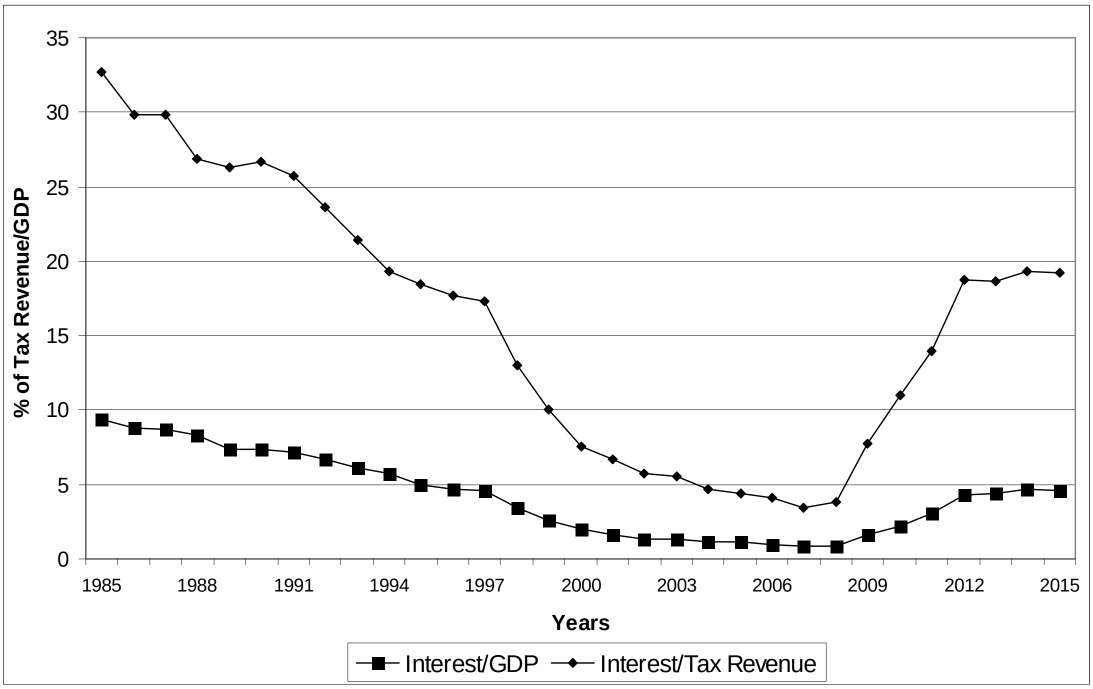
## 2.1 Rationale for Budgetary Consolidation

It is clear that, notwithstanding the improvements that have been made to the underlying budgetary position, there remains a very large gap between receipts and spending which is currently being filled by borrowing. This gap must be closed over the coming years – while improvements in the economy will help, higher levels of activity alone will not be sufficient to close the gap – and that is why the process of budgetary consolidation has to continue. It will be done in a manner which balances the need to narrow the deficit with the need to support the emerging economic recovery. Having said that, it is vital that the State continues to show the seriousness of its intent to tackle the deficit in the public finances and bring a halt to the increase in the debt to GDP ratio as soon as possible.

If the State does not continue with the process of consolidation, the debt burden will rise more rapidly and to a higher level, making the sustainability of that debt all the more difficult.

Unless it is reduced, the burden of servicing a high level of debt will continue to absorb an increasing proportion of the State's tax revenues. To put the rapid increase in debt servicing costs into perspective, as recently as 2007 the equivalent of just under 3½% of all tax revenues were required to fund the interest expenditure on our national debt. This year, the equivalent figure will be around 14%. To put that figure in context, it is around half of all of the revenues the State collects in VAT. Notwithstanding the scale of the budgetary adjustment that has already been undertaken, with more to come in the years ahead, this ratio is forecast to continue to rise, albeit at a reducing pace – see Graph 2.1. This issue is also discussed in more detail in Chapter 4.

**Graph 2.1: Debt Interest Burden 1985-2015**




Moving towards a balanced budgetary position is a key condition for restoring the economy to sustained economic/employment growth. Continuing with the process of tackling the budget deficit is essential in order to engender international confidence in the State's ability to meet its commitments. The benefit of meeting targets is evident in the reduction in the notional cost of borrowing for the State. In mid-July spreads on 10-year Irish Government bond yields compared to the German benchmark had risen to around 1,200 basis points. As of mid-October, they had dipped below 600 basis points, with the successful implementation of the EU/IMF Programme and the meeting of commitments and quantitative fiscal targets under the Programme cited as the primary reasons. Reflecting recent financial market turbulence, the spread has widened somewhat.

Bridging the gap that currently exists in the public finances is important for other reasons also. Failure to consolidate further could potentially jeopardise future foreign direct and indeed domestic investment in the economy. Consolidation, if designed with an eye to further improving the efficiency of the public sector, could also lead to a further improvement in the competitiveness of the economy.

Ireland's membership of the euro area obliges us to adhere to the Stability and Growth Pact and bring the General Government deficit back below 3% of GDP. The deadline for bringing the deficit back below that ceiling was extended to 2015 in December of last year. It is currently estimated that an adjustment of some €12.4 billion over the four-year period 2012-2015 will be sufficient to achieve this target.

### 2.2 Composition of Budgetary Adjustment 2012-2015

Given the magnitude of the adjustment required over the four-year period to 2015, it cannot be achieved by exclusive reliance on either tax increases or expenditure cuts. In determining the appropriate balance between the two, the Government has been guided by the lessons from our past as well as the experience of other countries that have found themselves in similar circumstances. Much of the international evidence that exists in this area, as analysed by organisations such as the IMF, the European Commission and the OECD, suggests that budgetary adjustments tend to be more successful in reducing deficits and stabilising debt ratios when they rely more on reducing expenditure than increasing taxes.

Of course, the specific circumstances of the country concerned must be taken into account in designing a programme of fiscal consolidation. For Ireland, as a small open economy that relies heavily on international trade and foreign direct investment, the competitiveness of the exposed sectors and the country's attractiveness as a place in which to work and set up business are critical to the restoration of sustainable growth in output and employment.

This suggests that the overall burden of taxation should be an important consideration in determining the shape of fiscal adjustment. Although it is not possible to provide a definitive answer to the question of what is an optimal tax burden for Ireland, some broad guidance in this regard is offered by past experience. In the late 1990s, for example, the economy enjoyed robust but balanced growth, driven by a highly competitive internationally trading sector. This suggests that the policy settings (including the overall tax burden) at that time were broadly appropriate.

Of course, tax burdens (as measured by the ratio of tax receipts to GDP) amongst our main trading partners and competitors for FDI have not remained constant in the intervening period. Indeed, on the basis of current plans, most EU Member States will, by 2014, have tax/GDP ratios lower - and in many cases considerably lower - than in the late 1990s.

Currently, compared with the late 1990s, Ireland's tax/GDP ratio is somewhat lower and its tax/GNP ratio is about the same. This and the trends underway in other EU Member States have informed the Government's decision to rely rather less on tax increases than on expenditure cuts in designing the fiscal consolidation strategy for the 2012-15 period.

The Government is fully committed to adhering to the 8.6% of GDP General Government deficit target set for 2012 by the ECOFIN Council in December 2010. It has agreed to the implementation of a budgetary adjustment of €3.8 billion to achieve that target. Of the total adjustment, just less than 60% will be on the expenditure side of the account with the remainder of the adjustment being implemented through revenue measures. Within the expenditure measures, the adjustment will be split approximately 2:1 between current and capital. While the overall level of adjustment required is slightly greater than was previously anticipated, it is necessary to ensure compliance with the agreed deficit target[4]. It is vital that this target is adhered to.

The bulk of the adjustment implemented thus far, approximately 60%, has come on the spending side and all areas of spending have been affected. Notwithstanding that the majority of the future adjustment will come on the spending side also, it must be borne in mind that very significant and wide-ranging revenue raising measures have been introduced over the last three years.

In terms of total taxes on income, for example, marginal tax rates have increased across the board and the numbers paying tax have been increased significantly. Tax on capital gains/inheritance has increased by a quarter and tax on interest from savings has been increased by a third. An annual property charge on second homes has been introduced. A comprehensive Carbon Tax has been introduced. Tax relief associated with private pension provision has been dramatically curtailed and a programme of termination of tax expenditures has been set in train. Further significant adjustments to revenue will be implemented in the coming years as part of the consolidation process.

The Irish Fiscal Advisory Council in its first Fiscal Assessment Report sees a strong argument for strengthening the consolidation effort and targeting a General Government deficit of 1% of GDP by 2015.

While cognisant of the views of the Council - and indeed others, who have called for an acceleration of the consolidation process - on balance, the Government is of the view that adhering to its commitment to reduce the deficit to below 3% of GDP by 2015 and delivering on the EU/IMF Programme commitments will be sufficient to engender confidence in the country's ability to restore the public finances to health.

In terms of the split between revenue and expenditure measures for the forecast period as a whole, a broadly similar split to that applying in 2012 is envisaged with just under two-thirds of the measures currently expected to be implemented on the spending side.

The precise detail of the measures that are to be introduced in 2012 will be set out over the coming weeks in a series of announcements which will be made in the context of the current and capital spending reviews and, of course, Budget 2012, which will set out the revenue measures that are to be implemented.

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[4] The views of the Irish Fiscal Advisory Council were also considered in the context of the scale of the adjustment to be implemented.

In addition, and as outlined in the Programme for Government, progress on deficit reduction will be reviewed in the context of preparation for Budget 2013 with a view to achieving the objective of reducing the deficit to below 3% of GDP by 2015.

**Expenditure Measures**

In the context of decisions regarding future expenditure measures, the Government has announced, as part of its new approach to the budgetary process that a *Medium-Term Capital Investment Plan* will be published on Thursday, 10th November. This will set out the capital envelopes for each Department for 2012-2016 in light of the outcomes of the Capital Review.

Following that, on Thursday, 17th November, a *Public Service Reform Programme* will be published, setting an ambitious agenda of public service wide reform and re-structuring measures that have been developed in the context of the Comprehensive Review of Expenditure (CRE). This is consistent with the Government's determination that reductions in administrative overhead and bureaucratic costs must make a significant contribution to the overall fiscal consolidation effort.

Finally, the spending decisions for 2012 will be published in the first week of December on the basis of the high-level outcomes of the CRE. As part of the expenditure reform process, multi-annual expenditure ceilings will be laid down for each Department for 2012-2014 alongside the detailed Budget Estimates for 2012. All of the background CRE documents will also be made available online.

**Revenue Measures**

The Programme for Government states that, as part of the Government's fiscal strategy, the Government will maintain the current rates of income tax together with bands and credits. This is based on the view that the primary focus has to be on job creation and, as far as possible, taxes on employment should be kept to a minimum.

Budget 2011 substantially increased income taxes through changes in the tax credits and bands and introduced the Universal Social Charge.

Therefore, it is the Government's objective not to make any further substantial changes in income tax in Budget 2012. This will require that other areas of taxation deliver the revenue increase consistent with the overall budgetary targets.

Income Tax (including the USC) now accounts for 40% of Exchequer tax receipts. Maintaining the current bands, credits and rates in the years 2013-2015 will be dependent on making progress on expenditure reductions and tax changes in other tax areas to ensure that the overall budgetary targets for the period are met.

Proposals in the area of VAT, excise duties and carbon tax are being examined to see how indirect taxes can assist the Government in meeting commitments under the EU/IMF Programme. This will be done in the context of the Programme for Government commitment that any increase in VAT will limit the standard rate of VAT to 23%. In addition, carbon taxes and excise duties on energy products are being examined with a view to protecting revenues, while encouraging behavioural change and reducing our greenhouse gas emissions.

Budget 2012 will be presented to Dáil Éireann on Tuesday, 6th December and will set out in detail the nature of the revenue measures that are to be implemented over the coming years.

Table 2.1 is a technical table showing the General Government deficit targets set by the ECOFIN Council in December 2010 as well as the current estimate of the consolidation required to meet those targets. It is based on the current view of the economy and public finances and will be subject to revision in light of more up-to-date information that becomes available.

**Table 2.1 – Technical General Government Deficit Projections and Amount of Consolidation Required to Achieve Targets**

| | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|
| | | *% of GDP* | | |
| General Government Deficit Target – *as set by ECOFIN Council* | 8.6 | 7.5 | 5.1 | 2.9 |
| Projected General Government Deficit | 8.6 | 7.5 | 5.0 | 2.9 |
| | | *€ billions* | | |
| Total Consolidation Amount | 3.8 | 3.5 | 3.1 | 2.0 |
| Expenditure | 2.2 | 2.25 | 2.0 | 1.3 |
| ➢ *Current* | *1.45* | *1.70* | *1.9* | *1.3* |
| ➢ *Capital* | *0.75* | *0.55* | *0.1* | *0.0* |
| Tax | 1.6 | 1.25 | 1.1 | 0.7 |
| ➢ *New Measures* | *1.0* | *0.95* | *0.9* | *0.4* |
| ➢ *Carry Forward* | *0.6*[5] | *0.30* | *0.2* | *0.3* |

Source: Department of Finance and Department of Public Expenditure and Reform
*Rounding may affect totals*

The Government will seek, insofar as is practically possible, to implement the measures in a fair and equitable manner that will not unduly hamper the economic recovery that is underway.

[5] The Universal Social Charge is also expected to deliver an additional €0.4 billion in revenues in 2012. While this is not part of the €3.8 billion consolidation package, it is captured in the budgetary projections.

# <u>Chapter 3</u>

Economic & Budgetary Outlook 2012-2015

## 3.1 2012 Economic Outlook

The nascent recovery of the Irish economy is expected to gain ground next year, with GDP forecast to grow by 1.6% and GNP by 1%[6].

**Table 3.1: Macroeconomic Projections 2011-2015**

| *% change, unless otherwise stated* | **2011** | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|---|
| Real GNP | 0.4 | 1.0 | 1.7 | 2.3 | 2.3 |
| Nominal GNP (rounded to nearest €25m) | 126,450 | 128,525 | 132,100 | 136,850 | 142,050 |
| Real GDP | 1.0 | 1.6 | 2.4 | 3.0 | 3.0 |
| Nominal GDP (rounded to nearest €25m) | 155,250 | 158,875 | 164,525 | 171,600 | 179,400 |
| *Components of Real GDP* | | | | | |
| Private Consumption | -2.5 | -1.0 | 0.0 | 1.0 | 1.2 |
| Government Consumption | -3.0 | -2.2 | -2.2 | -2.3 | -2.1 |
| Investment | -11.0 | -0.8 | 3.2 | 4.6 | 4.8 |
| Change in Inventories (% of GDP) | 0.2 | 0.3 | 0.3 | 0.3 | 0.2 |
| Exports | 4.6 | 3.8 | 4.5 | 4.8 | 4.8 |
| Imports | 1.6 | 1.9 | 2.8 | 3.4 | 3.5 |
| BOP Current Account (% of GDP) | 0.5 | 1.5 | 2.4 | 3.2 | 3.5 |
| *Contributions to Real GDP Growth* | | | | | |
| Domestic Demand (excl. inventories) | -3.1 | -1.0 | 0.0 | 0.6 | 0.7 |
| Changes in Inventories | 0.7 | 0.1 | 0.0 | 0.0 | 0.0 |
| Net Exports | 3.4 | 2.5 | 2.5 | 2.4 | 2.3 |
| *Price Developments* | | | | | |
| HICP | 1.2 | 1.2 | 1.5 | 1.6 | 1.8 |
| GDP Deflator | -1.5 | 0.8 | 1.1 | 1.3 | 1.5 |
| *Labour Market* | | | | | |
| Employment | -1.8 | -0.2 | 0.8 | 1.2 | 1.6 |
| Unemployment (% of labour force) | 14.2 | 14.0 | 13.4 | 12.8 | 11.6 |

Source: Department of Finance
*Note that rounding can affect totals*

While continuing to drive the recovery, export growth is set to slow in 2012. Further competitiveness gains and the acyclicality of certain goods and services notwithstanding, the openness of the economy means that it will not escape unscathed from what is happening overseas. With activity in our main trading partners remaining soft, especially in the euro area – which accounts for about two-fifths of Irish exports – export growth is projected to ease to 3.8% next year, from 4.6% this year.

Headwinds facing the domestic economy also remain significant and domestic demand is set to fall once more in 2012. Prospects for both investment and private consumption appear weaker now than they did in the spring.

On the investment front, uncertainty and corporate deleveraging are likely to continue weighing on machinery and equipment investment during 2012, though the impetus from the external side, albeit relatively weak, should provide some support. With the drag from the house building component at an end, overall investment spending is projected to fall next year by a fairly modest 0.8%.

[6] Compared to the SPU however, this represents a downgrading of the 2012 outlook (by around 1 percentage point), reflecting the changed external environment and weaker domestic demand conditions.

Similarly, private consumption is expected to contract by 1%, somewhat less than the 2.5% decline foreseen for this year, but still significant. Given households' need to repair balance sheets and general uncertainty on their part, the savings rate looks like it will remain at a fairly high level. At the same time, real disposable incomes are projected to decline. As a result, 2012 is set to become the fifth year in which personal spending falls.

Government spending is also forecast to decline next year by 2.2%, and indeed for some time to come, as budgetary adjustment proceeds.

Lastly, imports are projected to increase broadly in line with final demand so that in overall terms, real GDP is forecast to grow by 1.6% in 2012 (GNP by 1%). As growth will again be externally-driven, the current account position is expected to improve further. This is encouraging, as is the anticipated increase in nominal GDP - the first since 2007.

### 3.2 2012 Budgetary Outlook

The current working estimate of the 2012 Exchequer deficit is €17.3 billion, which is largely unchanged from the SPU. This is significantly lower than the emerging Exchequer deficit for 2011, the main reason being that there is no banking-related Exchequer expenditure expected in 2012, other than the previously committed to Promissory Note payments.

The composition of the overall deficit is noticeably different from that set out in the SPU however.

On the plus side, the reduced debt interest expenditure arising from the July 21st HoSG decision has a substantial positive impact on the budgetary position.

Similarly, higher than expected non-tax revenue receipts, primarily from the fees collected under the Bank Guarantee Schemes, and the surplus income of the Central Bank together with a 10% dividend payment of some €300 million on the contingent capital provided to the Irish banking system, are expected to have a beneficial impact on the budgetary position.

On the other hand, lower nominal economic growth, combined with a lower base as a result of the expected shortfall in 2011, has negative implications for tax revenue generation. This means that tax revenues in 2012 are now projected at almost €1.3 billion below the SPU forecast. Nonetheless tax revenue growth is still projected at over 5% for 2012 presently. This forecast will be subject to further updating in the context of Budget 2012 and, in light of the later information which becomes available in the run-up to the Budget, most notably the tax revenue outturn for the key month of November. In addition, increased numbers on the Live Register in 2011 lead to a substantial upward revision to the projected Live Register average for 2012.

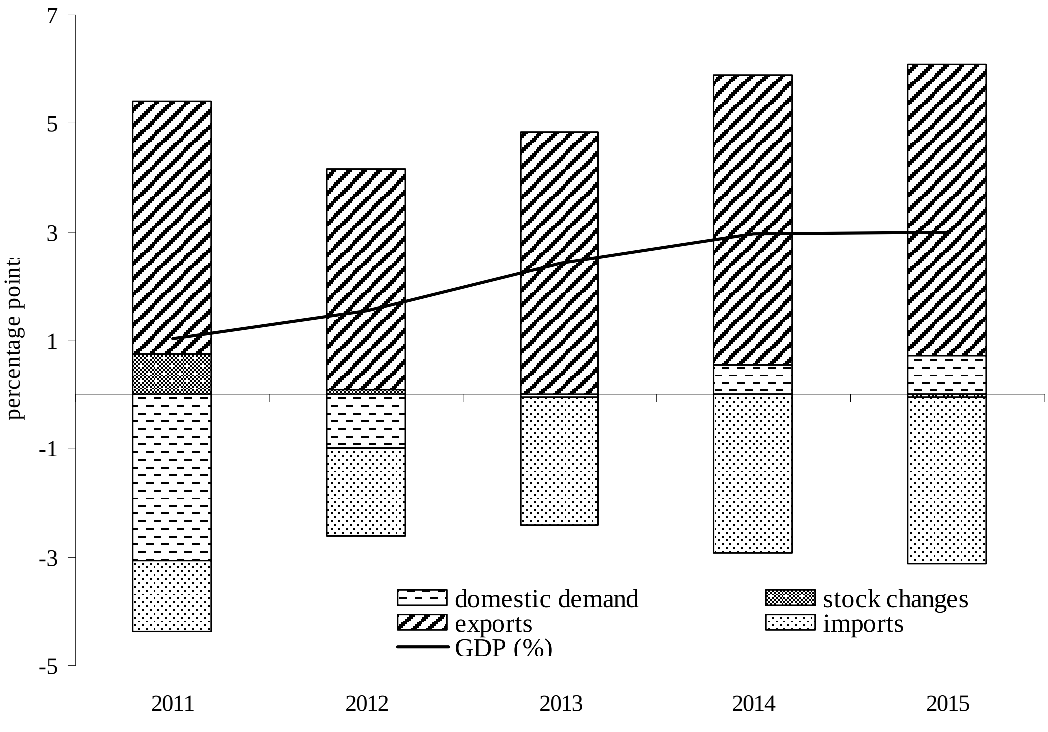
Under the revised Excessive Deficit Procedure (EDP) Recommendation issued by the ECOFIN Council in December 2010, the State's General Government deficit must not exceed 8.6% of GDP in 2012. The General Government deficit in 2012 is currently projected at 8.6% of GDP, based on the implementation of a budgetary adjustment package of €3.8 billion – see Chapter 2 for more detail on the composition of the adjustment for 2012 and later years.

### 3.3 2013-2015 Economic Outlook

In keeping with the typical recovery path of a small open economy, a gradual firming and broadening out of economic activity is expected over the medium term. With external headwinds adding to those on the domestic front however, momentum is set to be softer than previously expected, and the economy's return to robust growth is likely to be delayed somewhat. GDP is now projected to grow by 2.4% in 2013 (GNP by 1.7%), a downward revision of around ½ a percentage point compared to the SPU, whereas growth of 3% is still foreseen for 2014 and 2015. These projections take account, in so far as possible for an economy such as Ireland's, of the trend growth rate and the amount of slack in the economy.

On the demand side, a number of forces are set to shape developments further out the forecast horizon. While fiscal consolidation and ongoing deleveraging will dampen domestic activity, the assumed strengthening of external demand bodes well for the traded sector and export growth. With a stronger export performance feeding through to investment and employment from 2013 on - and the banking system providing support as needed - confidence is expected to return and the household savings rate should start to unwind somewhat. Even so, it will likely be 2014 before personal spending rebounds and domestic demand contributes positively to GDP growth.

**Graph 3.1: Contributions to GDP Growth 2011-2015**




Source: Department of Finance calculations

***The Labour Market***

While the pace of economic activity is set to pick up next year, the composition of growth – driven by the less labour intensive external sector – coupled with the tendency for firms to meet extra demand through productivity increases in the early stages of a recovery will weigh on job creation.

A marginal contraction in employment is forecast for 2012 as a whole, although a small decline in the labour force – reflecting once again net outward migration and weaker labour force participation – should see the unemployment rate fall to 14%. Supported by the measures set out in the Government's *Jobs Initiative,* the economy is, however, expected to be creating jobs on a net basis by the end of next year, with an annual increase foreseen for 2013. Hiring is set to strengthen in subsequent years as the recovery gains traction and starts to broaden out.

While it is expected that around 65,000 jobs will be created over the period 2013-2015, the number of people out of work will remain at a relatively high level – even though a gradual decline in the unemployment rate is projected over the medium-term, it is still expected to average 11.6% in 2015.

***Price Developments***

On the nominal side, annual HICP inflation is forecast to average 1.2% next year, as is CPI inflation. While the steep rally in oil and other commodity prices, which began in mid-2009, has largely petered out of late on foot of softening global growth, the ongoing pass-through of previous increases in energy prices and future rises already announced, will put upward pressure on headline inflation in 2012. Weak domestic demand and considerable spare capacity in the economy mean that underlying or 'core' inflation should remain muted, however.

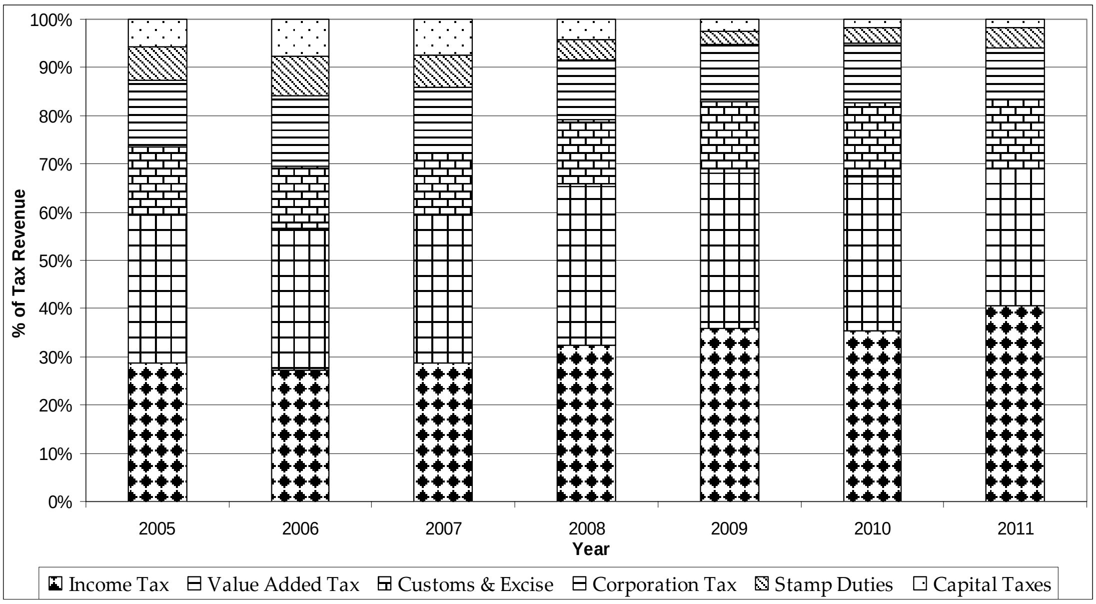
Over the period 2013-2015, HICP inflation is expected to pick up slightly, though with consumer prices in many of our trading partners projected to increase at a faster pace, further competitiveness gains are foreseen.

The GDP deflator takes account of price changes in all components of demand, and so is the widest measure of price developments in the economy. This is projected to turn positive again next year - in the region of 0.8% - on the back of an improvement in the terms-of-trade. The latter follows, in part, from an assumed more favourable euro-dollar exchange rate (on the basis of the technical assumptions set out earlier). Over the medium-term, a gradual firming of the deflator is expected which, in turn, will support a strengthening of nominal GDP growth.

## 3.4 2013-2015 Budgetary Outlook

Over the period 2013-15 nominal economic growth is forecast to average around 4.1% per annum (in GDP terms). Boosted by the implementation of further budgetary adjustments on the revenue side, growth in tax revenues is expected to average just over 6% per annum over this period.

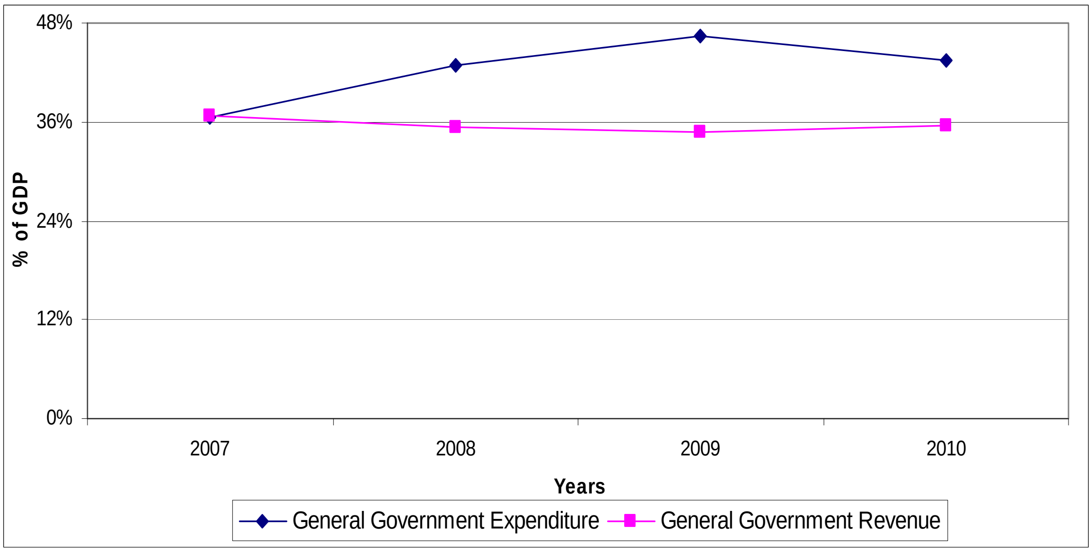
**Graph 3.2: Composition of Tax Revenue 2005-2011**




Economic growth will be predominantly export-driven in the early years of the forecast period. As this is not as tax-rich as domestically-driven growth, tax revenues even by 2015 are currently forecast at €43.3 billion, still €3.9 billion, or 8%, below their 2007 peak. This highlights the unprecedented collapse in tax revenues that took place over the period 2008-2010 and reflects the position that a substantial proportion of the transitory tax revenues derived from the booming property sector of the early and middle part of the last decade will not return. Exchequer tax revenues peaked at €47¼ billion in 2007. In 2010, tax revenue amounted to just €31¾ billion, a fall of one-third in just three years. In contrast, the gross voted current expenditure of Government departments increased by close to 12% between 2007 and 2010.

As nominal GDP also fell significantly over that period, total General Government revenues, which include not just tax revenue but PRSI receipts and non-tax revenues also, remained fairly constant as a percentage of GDP, as Graph 3.3 shows. Even when the impact of banking-related payments is excluded, General Government expenditure as a percentage of GDP continued to grow, however, up to 2009. This mainly reflected increased debt interest and unemployment-related social expenditure.

**Graph 3.3: General Government Revenue v Expenditure[7] 2007-2010**




The tax system must therefore be redesigned so that it is based on more substantive - less cyclical - forms of tax revenue. Significant structural adjustments to the tax system, including the introduction of the new Universal Social Charge, are underway and the impact of that, in the context of the volume of income tax receipts collected in the first three quarters of the year can be seen.

The discretionary spending of Government, as set out under the voted current and capital headings in Table 3.2, will continue to fall as is necessary to bring about renewed sustainability to the public finances.

Reflecting the increasing debt burden, non-voted Central Fund expenditure will continue to rise over the forecast period, although the proportion of tax revenues required to service the interest on the national debt is forecast to stabilise at just below 20%.

The budgetary projections in Table 3.2 show the steady improvement in the Exchequer position from a forecast deficit of €17.3 billion in 2012 to €7 billion in 2015. Based on the current assessment, this is viewed as sufficient to bring the General Government measure of the deficit below the 3% of GDP target by 2015.

[7] Excludes impact of €4 billion capital injection to Anglo Irish Bank in 2009 and impact of €30.85 billion in Promissory Notes to Anglo, INBS and EBS in 2010.

**Table 3.2: Budgetary Forecasts 2011-2015**

| *€ millions* | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| **CURRENT BUDGET** | | | | | |
| **Expenditure** | | | | | |
| Gross Voted Current Expenditure | 53,240 | 51,745 | 50,400 | 48,690 | 47,280 |
| Non-Voted (Central Fund) Expenditure | 6,815 | 9,255 | 9,785 | 10,670 | 11,065 |
| **Gross Current Expenditure** | **60,055** | **61,000** | **60,185** | **59,360** | **58,345** |
| less Expenditure Receipts and Balances | 11,355 | 11,165 | 11,240 | 11,560 | 11,835 |
| **Net Current Expenditure** | **48,700** | **49,835** | **48,945** | **47,800** | **46,510** |
| | | | | | |
| **Receipts** | | | | | |
| Tax Revenue | 34,450 | 36,260 | 38,860 | 41,465 | 43,325 |
| Non-Tax Revenue | 2,565 | 2,410 | 1,630 | 1,640 | 1,525 |
| **Net Current Revenue** | **37,015** | **38,670** | **40,490** | **43,105** | **44,850** |
| | | | | | |
| **CURRENT BUDGET BALANCE** | **-11,685** | **-11,165** | **-8,455** | **-4,695** | **-1,660** |
| | | | | | |
| **CAPITAL BUDGET** | | | | | |
| **Expenditure** | | | | | |
| Gross Voted Capital | 4,640 | 3,940 | 3,375 | 3,255 | 3,255 |
| Non-Voted Expenditure | 11,970 | 4,350 | 4,165 | 4,160 | 4,175 |
| **Gross Capital Expenditure** | **16,610** | **8,290** | **7,540** | **7,415** | **7,430** |
| less Capital Receipts | 335 | 345 | 345 | 320 | 320 |
| **Net Capital Expenditure** | **16,275** | **7,945** | **7,195** | **7,095** | **7,110** |
| | | | | | |
| **Capital Resources** | **2,530** | **1,795** | **1,850** | **1,935** | **1,795** |
| | | | | | |
| **CAPITAL BUDGET BALANCE** | **-13,745** | **-6,150** | **-5,345** | **-5,160** | **-5,315** |
| | | | | | |
| **EXCHEQUER BALANCE** | **-25,430** | **-17,315** | **-13,800** | **-9,855** | **-6,975** |
| | | | | | |
| **GENERAL GOVERNMENT BALANCE** | **-15,950** | **-13,595** | **-12,400** | **-8,610** | **-5,125** |
| *% of GDP* | -10.3 | -8.6 | -7.5 | -5.0 | -2.9 |
| **Nominal GDP** **(rounded to nearest €25m)** | 155,250 | 158,875 | 164,525 | 171,600 | 179,400 |

Source: Department of Finance & Department of Public Expenditure & Reform
*Figures rounded to nearest €5 million*
*Note that rounding can affect totals*

Notes to Table 3.2:

1. The technical budgetary forecasts set out in the table above have been prepared largely on the basis of the consolidation as set out in April's SPU for the years 2012-2015.

2. The precise nature of the budgetary measures to be introduced will be set out in the coming weeks in a series of announcements which will be made in the context of the current and capital spending reviews and Budget 2012.

3. Government decisions with regard to the precise nature of measures will impact both the economic and budgetary forecasts set out in this document and revised forecasts will be prepared for Budget 2012, in light of those decisions but also in light of more up-to-date economic and budgetary data that becomes available over the coming weeks, most notably tax revenue collection data for the key month of November.

# <u>**Chapter 4**</u>

Debt Analysis & Sustainability

Funding Position

## 4.1 Revision to end-2010 General Government Debt Level

In relation to the calculation of the 2010 General Government debt it has recently been made public that an error inadvertently led to the double-counting of a sum of €3.6 billion. This error arose due to an incorrect accounting treatment of the Housing Finance Agency's funding needs. This had implications for the calculation of the 2010 General Government debt. Consequently, the previously published 2010 General Government debt figure of €148 billion (94.9% of GDP) has been revised downwards and now stands at €144.4 billion, or 92.6% of GDP. The CSO has informed Eurostat of the error, and the figures shown in respect of Ireland's gross debt and associated debt/GDP ratio will be corrected in future releases relating to Government debt. Similarly the forecasts in this document take account of this revision to the 2010 General Government debt.

## 4.2 Recent Trends

Ireland has run a succession of very large budget deficits since 2008. These deficits mainly reflect two sets of factors:

- the effects, especially on tax revenues but also on social spending arising from a sharp contraction in economic activity, and
- the heavy cost to the State of supporting a gravely damaged banking system.

The very significant fall in nominal GDP from €190 billion in 2007 to €156 billion in 2010 has also impacted the debt/GDP ratio.

These large deficits have accumulated despite the implementation of a series of very large budgetary consolidation packages between July 2008 and December 2009 (Budget 2010) that were designed to yield/save almost €15 billion or 9½% of GDP.

There are two measures of debt which are generally cited. The first – National debt – is essentially the debt of the Exchequer. The second – General Government debt – is the standard measurement of gross indebtedness used for comparative purposes within the EU. It includes the National debt as well as Local Government debt, Promissory Notes and some other minor liabilities of Government. Unlike National debt, it is a gross measure which does not allow for the offsetting of cash balances. This is an important consideration in the Irish case and is discussed below.

As General Government debt is a cross-country measure which allows for comparative analysis, it is the measure that financial markets tend to pay closest attention to when assessing debt levels.

General Government debt, which totalled €47.4 billion at end-2007, rose to stand at €144.4 billion at end-2010. Over this period the debt/GDP ratio rose from 25% to 93%.

The change in what is defined as the net National debt from year to year largely reflects the annual Exchequer Borrowing Requirement (EBR) or Exchequer deficit. Ordinarily, changes in the National debt would account for most of the change in General Government debt also, but in recent years this has not been the case. There are two main explanations for this.

The first relates to the tactical build up of a large amount of liquid assets by the NTMA in 2008. These were increased by almost €18 billion in 2008. There was some use of these liquid assets in 2009 and 2010 to part-fund the budget deficits in those years but the greater part of what had been accumulated in 2008 and earlier years remained in place at end-2010. The second explanation is the issuance by the Government of Promissory Notes to Anglo Irish Bank, Irish Nationwide Building Society (INBS) and Educational Building Society (EBS). This boosted the level of General Government debt outstanding by almost €31 billion in 2010.

## 4.3 Projected Debt Levels 2012-2015

Despite the substantial packages of budgetary adjustment measures that Government will implement in the coming years, a large, though declining, EBR will remain.

It is projected that the cumulative EBR over the period 2012-2015 will amount to approximately €48 billion. This implies a further increase in the level of General Government Debt, as indicated in Table 4.1. Allowing for principal payments in respect of the Promissory Notes and expected changes in Exchequer deposits, it is projected that General Government debt will be close to €204 billion by end-2015.

Importantly however, with nominal GDP growth expected to accelerate, the achievement of a primary surplus by 2014 and an assumed run-down in cash balances in 2014 and 2015, which means that a part of the EBR can be funded without recourse to additional borrowing in those years, the debt/GDP ratio is projected to peak in 2013 and to fall thereafter.

**Table 4.1: Projected Gross General Government Debt 2011-2015**

| *€ billions* | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Previous Year Outturn | 144.4 | 163.8 | 181.8 | 194.6 | 200.8 |
| EBR | +25.4 | +17.3 | +13.8 | +9.8 | +7.0 |
| Promissory Note Repayment of Principal[8] | -2.5 | -3.1 | -2.6 | -1.2 | -1.3 |
| Change in Exchequer Deposits | -4.8 | +3.3 | +1.3 | -2.8 | -2.8 |
| Other | +1.3 | +0.4 | +0.3 | +0.3 | +0.1 |
| **Current Year Debt Forecast** | **163.8** | **181.8** | **194.6** | **200.8** | **203.8** |
| ***Forecast Debt/GDP Ratio*** | ***105.5*** | ***114.3*** | ***118.3*** | ***117.0*** | ***113.5*** |

Source: Department of Finance
*Note that rounding can affect totals*

## 4.4 Debt/Deficit Dynamics

The debt/GDP ratio is a key measure of the burden of debt, and its level and rate of change are key indicators of debt sustainability. Whether the ratio rises or falls depends on the evolution of the following variables:

- the nominal growth rate of GDP;
- the average interest rate on the stock of debt, and
- the primary budget balance – the budget balance excluding interest payments.

In general, and ignoring the complications introduced by stock-flow adjustment, if the interest rate exceeds the growth rate, the debt ratio will continue rising unless the Government runs a primary surplus of sufficient size.

In each of the years 2012 through 2015, the projected average interest rate on the debt exceeds the forecast growth rate in nominal GDP. Thus, abstracting from the matter of

[8] In light of further technical work since the SPU forecasts, it has been confirmed, following discussions with the CSO, that the interest due on the Promissory Notes should be accounted for as part of General Government debt each year. This is reflected in Table 4.1.

stock-flow adjustment, a primary budget surplus would be required to stabilise the debt ratio in any one of these years. For example, for 2013 nominal GDP growth is forecast at 3.6%, but the average interest rate on the debt is projected to be 5.2% which, taken together with the previous year's debt ratio of 114%, implies that a primary surplus of 1.8% of GDP would be required to prevent the debt ratio from increasing further. Instead, a primary deficit of 1.7% of GDP is projected for that year with the result that the debt ratio continues to rise to 118%.

**Table 4.2: Evolution of Projected General Government Debt/GDP Ratio**

| *% of GDP* | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| General Government Debt | 105.5 | 114.3 | 118.3 | 117.0 | 113.5 |
| Change in General Government Debt (=1+2+3) | 13.0 | 8.9 | 3.9 | -1.3 | -3.4 |
| *Contributions to change in debt ratio* | | | | | |
| 1. General Government Deficit | 10.3 | 8.6 | 7.5 | 5.0 | 2.9 |
| 2. Stock-flow adjustment | 2.2 | 2.7 | 0.3 | -1.4 | -1.2 |
| 3. Nominal GDP | 0.4 | -2.4 | -3.9 | -4.9 | -5.0 |
| *Composition of GGB* | | | | | |
| 4. General Government Balance | -10.3 | -8.6 | -7.5 | -5.0 | -2.9 |
| 5. Interest expenditure | -3.5 | -4.5 | -5.8 | -6.0 | -5.8 |
| 6. Primary balance ( = 4 - 5 ) | -6.8 | -4.1 | -1.7 | 1.0 | 2.9 |
| *Composition of stock-flow adjustment* | | | | | |
| 7. Change in Exchequer deposits | -3.1 | 2.1 | 0.8 | -1.6 | -1.5 |
| 8. Interest adjustments | -0.3 | -0.2 | -1.0 | -0.2 | -0.1 |
| 9. Net banking recapitalisation | 4.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| 10. Accrual adjustments | 0.2 | 0.3 | 0.2 | 0.1 | 0.1 |
| 11. Impact of NPRF | 0.4 | 0.2 | 0.2 | 0.2 | 0.2 |
| 12. Other | 0.8 | 0.4 | 0.2 | 0.1 | 0.2 |
| *Memorandum item:* | | | | | |
| Average interest rate (% of previous year's debt) | 3.7 | 4.4 | 5.2 | 5.3 | 5.2 |
| Nominal GDP growth | -0.5 | 2.3 | 3.6 | 4.3 | 4.5 |

Source: Department of Finance
*Note that rounding can affect totals*

However, the combination of nominal GDP growth, the interest rate and the primary balance envisaged for 2015 is consistent with the debt ratio falling that year. Indeed, the ratio is projected to decline in 2014 and 2015, and by more than the interaction of these variables would indicate. The reason is that, over this period, it is intended that the budget deficit will be funded in part by the running down of Exchequer deposits by €2.8 billion per annum. This is reflected in the 'stock-flow adjustment' factor in the table above and still leaves a relatively healthy cash balance at the end of the forecast period.

### 4.5 Sustainability Analysis

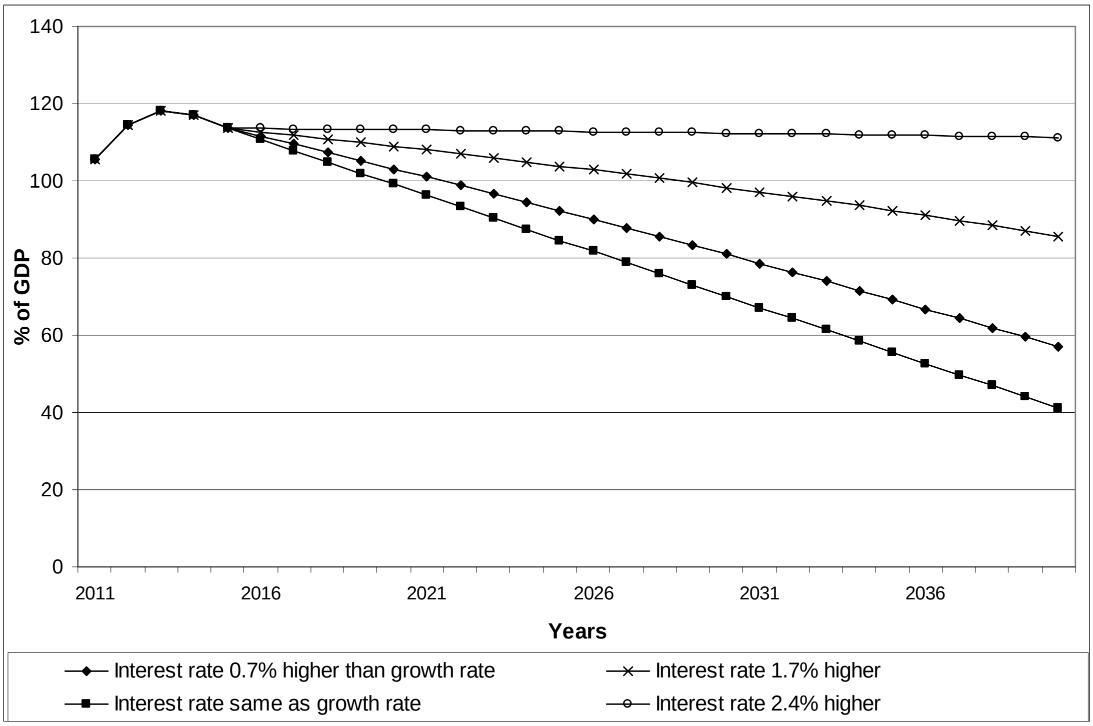
In order for the burden of Government debt to be sustainable, it is necessary that it stop rising relative to the Government's revenue base as proxied by GDP. As indicated by the analysis just described, this condition is met in 2014, and by end-2015 the debt/GDP ratio is projected to be 113.5%, almost 5 percentage points below its end-2013 peak.

Some of this fall (about 3 percentage points) is attributable to the running down of cash deposits and to that extent does not reflect the combination of fundamental factors in place in 2014-15. It is worth considering what margin of comfort that combination of fundamentals provides. The 2015 forecast of 4.5% nominal GDP growth and an average interest rate of 5.2% on the debt implies that a primary surplus of 0.8% of GDP would stabilise the debt ratio, without the assistance of a favourable stock-flow adjustment. In the event, a primary surplus of 2.9% of GDP is projected for that year. This suggests a modest margin of comfort; the primary surplus would have to be about 2 percentage points of GDP lower than projected in order to prevent the debt ratio from falling in 2015.

Stabilisation of the debt ratio is a necessary condition, but is not a sufficient condition for sustainability. The reason has to do with the level at which the ratio stabilises. In this regard, the level at which the Irish ratio peaks is very high relative to the kind of threshold that is commonly regarded as signalling the likelihood of damage to economic growth. In this connection, research conducted by Reinhart and Rogoff[9] suggests a threshold value of 90%. Even by 2015, two years after it is projected to have peaked, Ireland's debt/GDP ratio is significantly above this level.

This being so, it is important to consider how quickly the ratio might fall to a safe level after it has peaked. Taking as a scenario, the combination of GDP growth and the interest rate projected for 2015, and assuming that this combination could be maintained thereafter, maintaining a primary surplus at its projected 2015 level of 2.9% of GDP would result in the ratio falling by around 2 percentage points per annum. This would allow a ratio of 90% to be reached by 2026 and a 60% ratio to be reached by 2039.

**Graph 4.1: Alternative Trajectories for Debt/GDP Ratio**




The accompanying graph illustrates a number of additional long term scenarios, looking beyond 2015, corresponding to different assumptions about the gap between the interest rate and growth rate and assuming that the primary surplus is maintained at its projected 2015 level of 2.9% of GDP. For example, if the interest rate were on average to remain 0.7 percentage points above the nominal GDP growth rate, the debt ratio would decline to

[9] Reinhart, C. and Rogoff, K. (2010): "Growth in a Time of Debt", NBER Working Paper No. 15369

about 57% by 2040. In contrast, if on average the interest rate were to exceed the growth rate by a 1 percentage point more than this, either because growth was more sluggish and/or borrowing costs were higher, the debt ratio would decline at a slower pace and would be about 86% by 2040.

It is worth noting that, provided a primary surplus of 2.9% of GDP were maintained, the debt/GDP ratio would decline as long as the interest rate did not exceed the growth rate by more than 2.4 percentage points. It is also worth noting that the maintenance of a primary surplus larger than 2.9% of GDP would, all other things being equal, permit the debt ratio to fall faster than indicated.

The Irish Fiscal Advisory Council in its first Fiscal Assessment Report sees a strong argument for strengthening the consolidation effort and targeting a General Government deficit of 1% of GDP by 2015, as compared to the target of having a deficit below 3% by that year. It is the view of the Council that this would have important favourable effects on the State's creditworthiness and would improve debt dynamics.

While cognisant of the views of the Council, and indeed others who have called for an acceleration of the consolidation process, on balance the Government is of the view that adhering to its commitment to reduce the deficit to below 3% of GDP by 2015 and delivering on the EU/IMF Programme commitments will be sufficient to engender confidence in the country's ability to restore the public finances to health. Such confidence is already returning, with the meeting of Programme commitments and quantitative fiscal targets cited as the main reasons.

In forming its view, the Government is also mindful of the impact on growth of an additional €4 billion of adjustment which is what is viewed by the Council as being necessary to achieve the 1% deficit target.

The Government has also noted the Council's view that retaining the current SPU deficit targets as a percentage of GDP comes "within the range of appropriate courses of action".

### 4.6 Projected Debt Interest Expenditure

Another indicator of debt sustainability that is worth noting is the burden of debt service, which may be measured by the ratio of interest payments to tax revenue or to GDP. Relevant data for the 2011-15 period are presented in Table 4.3.

Cash interest expenditure was as low as €1.6 billion or 3.4% of tax revenues and just 0.9% of GDP as recently as 2007. This year those figures are projected to be €4.8 billion[10], 14.0% of tax revenues and 3.1% of GDP respectively. Notwithstanding the very welcome and significant reduction in the average interest rate on funding under the EU/IMF Programme, these ratios are projected to rise further.

[10] €4.2 billion in Exchequer interest and €0.6 billion in funds from the Capital Services Redemption Account (CSRA).

**Table 4.3: Projected Interest Payments 2011-2015**

| *€ billions* | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Cash Interest (includes CSRA) | 4.8 | 6.8 | 7.2 | 8.0 | 8.3 |
| *% tax revenue* | *14.0* | *18.7* | *18.6* | *19.3* | *19.2* |
| *% of GDP* | *3.1* | *4.3* | *4.4* | *4.7* | *4.6* |
| Promissory Note Interest | 0.0[11] | 0.0 | 1.9 | 1.8 | 1.7 |
| Accrued Interest Payments | 0.4 | 0.3 | 0.3 | 0.5 | 0.3 |
| Other | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| **General Government Interest** | **5.4** | **7.2** | **9.5** | **10.4** | **10.4** |

Source: Department of Finance & NTMA
*Note that rounding can affect totals*

It is worth putting the burden of debt service in a historic context. Graph 2.1 in Chapter 2 tracks interest payments relative to tax revenue and GDP for the period since the mid-1980s.

## 4.7 Funding

Table 4.4 is a technical table and is purely for illustrative purposes only. It shows that the State has sufficient funding under the EU/IMF Programme to cover all its financing requirements until the end of 2013. It remains the stated intention of the NTMA to return to the debt markets before this point and as soon as market conditions permit.

The draw-down of funds under the EU/IMF Programme is of course subject to strict policy conditionality.

**Table 4.4: Technical Table - Estimated Funding Requirement & Sources 2011-2013 (For Illustrative Purposes Only)**

| | **2011-2013** |
|---|---|
| **Estimated Funding Requirement** | |
| Exchequer Deficits (excluding net banking recapitalisation) | 50.0 |
| Current Expectation of Net Banking Recapitalisation | 16.5 |
| Maturing Long-Term Debt | 16.5 |
| Maturing Short-Term Debt | 7.0 |
| **TOTAL** | **90.0** |
| | |
| **Funding Sources** | |
| **EU/IMF Programme** | **67.5** |
| *- EU including Bilateral loans* | *45.0* |
| *- IMF* | *22.5* |
| **Retail Funding (to end-September 2011)** | **1.2** |
| | |
| **Use of Ireland's Own Resources** | |
| *- NPRF* | *10.0* |
| *- Exchequer Cash Resources* | *11.3* |
| **TOTAL** | **90.0** |

Source: Department of Finance & NTMA
*Note that rounding can affect totals*

[11] A very minor amount of interest in respect of the EBS Promissory Notes impacts the General Government deficit in 2011 and 2012.

In an extreme case where no new market funding is available between 2011 and 2013, taking account of the EU/IMF programme funding and the liquid reserves available to the NTMA, it is estimated that all of Ireland's funding needs until late 2013 are met. For the purpose of this exercise, it is assumed that the Exchequer's cash reserves are almost completely depleted. This would not be a prudent course of action for several reasons, one of which is the need to refinance a large maturing bond in early 2014.

The State also has at its disposal the remaining unencumbered assets of the NPRF which amount to some €5 billion. These assets are not taken into account in the scenario described above.

# **Chapter 5**

Risks to the Economic & Budgetary Outlook

## 5.1 Context

The latest available macroeconomic forecasts for 2012 from a number of agencies, both domestic and international, are set out in Table 5.1. There are appreciable differences between the agencies; the forecasts for GDP growth span the range from 1% to 2.3% while the employment forecasts range from a further small decline to a modest increase. However, all forecasters are agreed that domestic demand will contract again, that the current account of the balance of payments will produce a sizeable surplus, that inflation will remain subdued and that the unemployment rate will remain in the order of 14%.

It is worth noting that the Department of Finance's forecast of GDP for 2012 is towards the middle of the range.

**Table 5.1: Comparative Macroeconomic Forecasts 2012**

| | Central Bank (Oct) | ESRI (Sept) | D/Finance (Oct) | OECD (Oct) | Troika* (Sept) | Reuters Consensus (end-Sept poll) |
|---|---|---|---|---|---|---|
| | | | *% change* | | | |
| GDP | 1.8 | 2.3 | 1.6 | 1.0 | 1.9 | 1.7 |
| Employment | 0.1 | 0.7 | -0.2 | - | -0.1 | - |
| HICP | 0.7 | 1.0 | 1.2 | 0.9 | 0.6 | 1.2 |
| | | | *% of GDP* | | | |
| BOP | 2.0 | 1.6 | 1.5 | 1.7 | 2.7 | - |
| | | | *% of labour force*** | | | |
| Unemployment | 14.0 | 14.5 | 14.0 | 14.2 | 13.8 | 13.8 |

*Source: European Commission – Economic Adjustment Programme for Ireland Summer 2011 Review (Published September 2011).

**Annual average except for the Reuters Consensus which is an end-year figure.

To date, very few detailed forecasts have been published that cover the 2013-2015 period. Those that are available – from the Department of Finance and the Troika – are summarised in Table 5.2. The picture painted by the two sets of forecasts is similar. There is a shared expectation that overall economic growth will accelerate gently, reaching 3% by 2014-2015, that the recovery in domestic demand - consumer spending in particular - will be shallow, that employment growth will be modest, that unemployment will remain high and that inflation will stay in very low single digits.

The fact that there is broad agreement amongst forecasters does not mean that the forecasts will prove to be correct, however. While forecasting attempts to utilise all available information to illuminate future trends, it is an inherently uncertain exercise. That being the case, it is important to identify the principal risk factors and to try to indicate what would be the consequences if these risks were to crystallise.

**Table 5.2: Comparative Macroeconomic Forecasts 2013-2015**

| | D/Finance (Oct) | Troika* (Sept) | Reuters Consensus (end-Sept poll) |
|---|---|---|---|
| | | *% change, average per annum* | |
| Consumption | 0.7 | 1.3 | - |
| Exports | 4.7 | 4.9 | - |
| GDP | 2.8 | 2.8 | 2.8 |
| Employment | 1.2 | 1.3 | - |
| HICP | 1.6 | 1.6 | - |
| | | *% of GDP, average per annum* | |
| BOP | 3.0 | 4.0 | - |
| | | *% of labour force, average per annum* | |
| Unemployment | 12.6 | 12.5 | - |

*Source: European Commission – Economic Adjustment Programme for Ireland Summer 2011 Review (Published September 2011)

An analysis of the generality of forecasts of the Irish economy over the past 10-15 years highlights some interesting features that have implications for the assessment of the risks that attach to the current set of forecasts. The most important of these is that the exceptionally steep recession of 2008-2010 was associated with a marked deterioration of the forecasting record because the depth of the recession was greatly in excess of what was forecast. This, in turn, is because the collapse in the property market and the accompanying banking and fiscal crises triggered responses by households and firms that are poorly understood and not adequately dealt with in standard forecasting models.

This highlights the fact that forecasts of Ireland's economic performance at this juncture are not only subject to what might be called the perennial risks that attach to movements in exchange rates, interest rates and commodity prices and to the growth of international trade, but also to risks that arise from the unusual circumstances that currently prevail. The latter type of risks are sourced both domestically and externally. Those that have a domestic source relate to the availability of credit, the fragility of household and corporate balance sheets and the severe fiscal adjustment that is underway. Those that are external in origin concern the euro area sovereign debt and banking crisis, and include the risk that ongoing financial market instability generated by that crisis will further dampen economic growth in Europe and beyond, and potentially lead to contagion through higher interest rates and tighter credit supply.

A second feature of the forecasting record relates to serial correlation in the forecasting error. Thus, in the boom years in the middle of the last decade there was a tendency for growth forecasts to be pitched too low, while in the years since the onset of the crisis there has been a tendency for growth forecasts to be overly optimistic. However, this latter tendency has become weaker. Indeed, the Department of Finance's own forecast of 2010 GDP growth in the Pre-Budget Outlook (PBO) published in November 2009 was too pessimistic (-1½% compared with an outturn of -0.4%).

## 5.2 Risks to the Macroeconomic Outlook

The recovery in the Irish economy has, to date, been characterised by a dichotomy between the domestic and external sectors. The forecasts presented in Chapter 3 see this dichotomy continuing through 2012 and into 2013 as domestic demand growth remains constrained by fiscal consolidation and the ongoing need for balance sheet repair on the part of households and firms, while modest rates of export growth are sustained by a combination of competitiveness gains and external demand. Thereafter, the forecasts envisage a strengthening of domestic demand as the household savings rate starts to unwind somewhat and investment picks up, while the growth of exports accelerates on the back of assumed stronger growth in our main trading partners.

Broadly speaking, there are two sets of risks to these forecasts, one pertaining to exports, the other to domestic demand. Turning to exports first, a clear risk - highlighted by the recent downward revisions to expectations of international growth - is that the global economy (the economy of the euro area in particular) remains weaker and demand for Irish exports grows more slowly than expected over the forecast period. Were this to happen, the trajectory for GDP would be reduced, all other things being equal. Using the ESRI's macroeconomic model (HERMES), it is estimated that a 1% reduction in world growth would lower the real level of Ireland's GDP by 0.9% in the first year and by 1.3% in the fifth.

These results are broadly symmetric - a 1% increase in world growth would raise the level of GDP by 0.9% in year one and by 1.3% in year five - and demonstrate how sensitive to global economic conditions the extremely open Irish economy is.

Turning to domestic demand, an obvious (and, at the present juncture, heightened) source of uncertainty in the forecasts relates to the future spending behaviour of households and firms.

In this regard, a significant risk to the forecast is that household savings remain elevated for longer than assumed. Of course, it is also possible that the savings rate will fall sooner and/or to a lower level than assumed: the 9% projected for 2015 is still very high by historical standards. The HERMES model estimates that a sustained 1% point increase in the savings rate would reduce the real level of GDP by 0.3% both on impact and after five years. Again, the effects are broadly symmetrical.

Table 5.3 summarises the results of the sensitivity analysis just described.

**Table 5.3: Effect on the Level of Real GDP of Changing Assumptions**

| *(% change from base)* | **2011** | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|---|
| 1% change in world growth | +/-0.9 | +/-1.5 | +/-1.7 | +/-1.5 | +/-1.3 |
| 1% pt change in savings rate | +/-0.3 | +/-0.3 | +/-0.3 | +/-0.3 | +/-0.3 |

Source: Department of Finance

Another feature of the forecast recovery that is worth noting is the behaviour of investment which, following an estimated cumulative decline of 57% in real terms between 2007 and 2011, is projected to rise by a cumulative rate of around 12% from 2012 through 2015. The expectation of such an unusually tepid performance by investment in the context of an overall economic recovery follows from a combination of (i) the planned contraction in Exchequer-financed capital spending because of the pressures of fiscal consolidation; (ii) the likely slow recovery of house building in circumstances of a large supply overhang, and (iii) the more general expectation that capital formation by the corporate sector will be inhibited to some degree by balance sheet constraints.

Still, there may well be more upside than downside risk to the investment forecasts which see the ratio of investment to GDP remaining below 10% throughout the period to 2015. This is low by historical standards and also by reference to the EU average which is estimated at close to 19% for 2011 and averaged almost 20% in the period 1993-2010.

## 5.3 Risks to the Budgetary Outlook

Obviously, if the downside macroeconomic risks analysed above were to eventuate, the consequences for the public finances would be negative. All other things equal, the lower levels of output and employment consistent with these scenarios would raise the trajectories for the budget deficit and the stock of Government debt. Table 5.4 provides estimates of how the budget deficit would be affected by (i) 1% lower/higher world growth and (ii) a 1 percentage point higher/lower household savings rate, than assumed in the base scenario.

Lower world growth would increase the budget deficit by 0.3% of GDP in the first year, by 0.5-0.6% of GDP in each of the subsequent four years and by a cumulative 2.5% of GDP over five years. The latter figure is a rough estimate of the effect on the debt/GDP ratio after five years. As in the exercise described above, the effects are broadly symmetrical: faster growth in the world economy would reduce the budget deficit through its positive effects on output and employment.

It is estimated that a higher household savings rate would increase the budget deficit by 0.2% of GDP each year, or by a cumulative 1% of GDP over five years. Again, these results are broadly symmetrical.

**Table 5.4: Effect on Budget Deficit (% of GDP) of Changing Assumptions**

| *(change from base)* | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| 1% change in world growth | +/-0.3 | +/-0.5 | +/-0.6 | +/-0.6 | +/-0.5 |
| 1% pt change in savings rate | +/-0.2 | +/-0.2 | +/-0.2 | +/-0.2 | +/-0.2 |

Source: Department of Finance

There are risks to the budgetary outlook other than those that arise from the general behaviour of the macroeconomy. One such risk has to do with the responsiveness of tax revenue to economic activity. The fiscal projections set out in Chapter 3 envisage average annual tax revenue growth of 5.9% in the years 2012-2015. This allows for the effect of new tax measures amounting to a cumulative €4.05 billion over the period.

Excluding this amount, the underlying annual rate of tax revenue growth is projected at 3.3%. This compares with projected annual nominal growth rates of 3% and 3.7% for GNP and GDP respectively. The implied elasticity with respect to GDP is just 0.9; the implied elasticity with respect to GNP a little over unity. These are low elasticities by historical standards. The Tax Forecasting Methodology Group in its 2008 report, for example, found that over the 1996-2006 period, the implied average tax-to-GDP elasticity averaged 1.1, notwithstanding the significant variance from year-to-year. However, the low elasticity assumed for the period ahead seems warranted, given the slow growth in consumer spending and the low rate of wage inflation forecast for the period.

In any event, it would take a rather large departure of the actual tax elasticity from what has been assumed to generate significant differences in terms of the budgetary arithmetic for the forecast period. For example, an average tax elasticity relative to nominal GDP 0.1 above or below what has been assumed (that is, an average elasticity of 1.0 or 0.8) would produce annual tax revenues €140 million higher/lower than projected and would, all other things equal, result in the 2015 budget deficit being about 0.3 percentage points of GDP higher/lower than forecast.

### 5.4 Risks to Debt Sustainability

The projections set out in Chapter 4 show the debt/GDP ratio peaking at just over 118% in 2013 and falling by almost 5 percentage points over the subsequent two years. This trajectory for the debt ratio is a function of three sets of factors:

- the pace of budgetary adjustment, represented by the evolution of the primary balance;
- the rate of increase in nominal GDP, and
- the average interest rate on the stock of debt

Each of these is a risk factor as far as the debt ratio is concerned. All other things being equal, a slower pace of budgetary adjustment, a slower rate of growth of nominal GDP and/or a higher average interest rate on the debt would result in a trajectory for the debt ratio higher than that projected. It is also the case that these risks are mutually reinforcing. For example, slower nominal GDP growth would, unless additional adjustment measures were put in place, result in a larger primary deficit/smaller primary surplus than otherwise because of weaker tax revenues and higher Government spending on unemployment payments. In other words, to preserve a given trajectory for the primary balance in circumstances of slower economic growth would require a greater fiscal consolidation effort. This would in turn put further downward pressure on economic activity.

Of the risk factors to debt sustainability, the most important and the one that is most worth exploring, at least over the period covered by this document, is economic growth. As far as interest rates are concerned, the fact that interest payments on a high proportion of the debt are fixed, and the fact that Ireland is in an external assistance programme and does not need to directly access bond markets until 2014 (notwithstanding the objective of policy which is to re-enter markets before the end of 2012), together provide a measure of insulation from interest rate risk but do not eliminate it.

As far as GDP growth is concerned, the debt/GDP projections presented in the previous chapter are predicated on average annual GDP growth of 3.7% in nominal terms for the years 2012 through 2015, comprising average real growth of 2.5% and an average increase of 1.2% in the GDP deflator. To explore the downside risks here, we simulate the effects of nominal GDP growth 1 percentage point and 2 percentage points, respectively, lower than in the central case. In each of these scenarios the purely technical assumption is made that the Government does not attempt to offset the effect of lower growth on the primary balance; in other words, it is assumed that the same overall adjustment package (a cumulative €12.4 billion) is implemented over the 2012-2015 period.

The results of this exercise are presented in Table 5.5. In the scenario where nominal GDP growth is reduced by 1 percentage point, the debt ratio still begins to fall in 2014, albeit marginally and from a higher level than in the central case. However, in this scenario the Government’s commitment to achieve a budget deficit below 3% of GDP by 2015 is not met.

**Table 5.5: Debt Sensitivity Analysis 2012-2015 – Lower Growth**

| *(% of GDP)* | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|
| **Base case** | | | | |
| General Government Debt | 114.3 | 118.3 | 117.0 | 113.5 |
| General Government Balance | -8.6 | -7.5 | -5.0 | -2.9 |
| **Nominal growth 1% lower** | | | | |
| General Government Debt | 116.1 | 122.1 | 123.4 | 123.0 |
| General Government Balance | -9.1 | -8.7 | -6.7 | -5.0 |
| **Nominal growth 2% lower** | | | | |
| General Government Debt | 117.7 | 126.1 | 130.1 | 132.9 |
| General Government Balance | -9.7 | -9.9 | -8.4 | -7.3 |

Source: Department of Finance

In the scenario where nominal GDP growth is reduced by 2 percentage points per annum, the debt ratio continues rising throughout the period to 2015 and reaches a level of 133% by the end of that year.

It should be stressed that a scenario where nominal GDP growth is 2 percentage points below the central case is well outside the range of what is considered likely. It would mean virtual stagnation of economic activity for the next four years.

It is also worth making the point that more robust growth than is forecast in the central case is possible and that if this were to transpire, the deficit and the debt would decline more quickly, all other things equal. In the interests of symmetry and balance, the results of simulating nominal growth rates 1% and 2% higher than projected in the base case are presented in Table 5.6. Again, the purely technical assumption is made that the Government would pursue the same consolidation programme as in the base case.

**Table 5.6: Debt Sensitivity Analysis 2012-2015 – Higher Growth**

| *(% of GDP)* | **2012** | **2013** | **2014** | **2015** |
|---|---|---|---|---|
| **Base case** | | | | |
| General Government Debt | 114.3 | 118.3 | 117.0 | 113.5 |
| General Government Balance | -8.6 | -7.5 | -5.0 | -2.9 |
| **Nominal growth 1% higher** | | | | |
| General Government Debt | 112.8 | 114.6 | 110.8 | 104.5 |
| General Government Balance | -8.0 | -6.4 | -3.4 | -0.8 |
| **Nominal growth 2% higher** | | | | |
| General Government Debt | 111.2 | 110.9 | 104.7 | 95.9 |
| General Government Balance | -7.4 | -5.3 | -1.8 | +1.3 |

Source: Department of Finance

# **Chapter 6**

Budgetary Reform

## 6.1 Context

The Government Programme includes a number of clear commitments to reform our national budgetary process. The objectives of this reform agenda are to ensure greater openness and accountability in the annual processes of budgetary scrutiny and to introduce an effective multi-annual dimension to the fiscal process, so that the objective of sound public finances can be more effectively pursued.

The Department of Finance and the Department of Public Expenditure and Reform jointly published in March of this year a Discussion Document entitled *Reforming Ireland's Budgetary Framework* with a view to stimulating debate and setting out a range of potential policy options in this important area. The document sets out the policy background for these commitments and some specific approaches for implementation, including draft Heads of a Fiscal Responsibility Bill. Much of what is discussed in this chapter is consistent with the proposals set out in that discussion document. Final decisions on what is appropriate will be the subject of further consideration by Government.

The Stability and Growth Pact and other processes of EU economic governance have also recently been strengthened in a number of significant ways, culminating in agreement on the so-called 'six-pack' of measures in this area. All of these new measures have implications for Ireland's budgetary processes and institutions.

In keeping with the Government Programme commitments, and taking account of the EU developments, the Government has already taken action, or is planning to take further initiatives, in the following areas:

- the establishment of the Irish Fiscal Advisory Council (the Council), to provide an independent expert assessment of the official forecasts and of the Government's proposed fiscal policy stance;

- the preparation of a Fiscal Responsibility Bill which will establish new "fiscal rules" to ensure that the public finances are managed in a prudent and sustainable manner from year to year, and to put the Council on a formal statutory footing; and

- a range of reforms to the processes for setting and overseeing public expenditure.

The first two measures are outlined below; the last measure (expenditure reforms) will be set out by the Minister for Public Expenditure and Reform over the coming weeks.

## 6.2 Irish Fiscal Advisory Council

Following the agreement of the Government in June, the Council was established as part of the wider agenda of reform of Ireland's budgetary architecture envisaged in the Programme for Government.

The Council is an independent body whose role it is to provide an assessment of, and comment publicly on, performance in relation to Government's budgetary targets and objectives.

The specific mandate of the Council, as decided by Government, is as follows:

- to provide an assessment of the soundness of the economic and budgetary projections and forecasts set out by the Government in the annual Budget and the SPU;

- to provide an assessment of the appropriateness of the fiscal stance set out by the Government in the Budget and SPU, including the Government's stated medium-term budgetary objective, with particular regard to whether they are conducive to prudent economic and budgetary management, including by reference to the provisions of the European Union Stability and Growth Pact;

- to provide an assessment of whether the budgetary plans set out in the Budget and the SPU are consistent with the fiscal rules which it is proposed to publish as part of a Fiscal Responsibility Bill, and

- to perform such other functions, including an assessment of the implications of budgetary plans for economic growth, investment and employment, as may be assigned by the Minister for Finance.

In carrying out its role, the Council is to maintain within its structures a technical ability to provide an informed assessment and critique of the official macroeconomic forecasts.

The members of the five-person Council are:

- Mr Sebastian Barnes – OECD
- Professor Alan Barrett – TCD (on secondment from the ESRI)
- Dr Donal Donovan – University of Limerick (formerly IMF staff)
- Professor John McHale (Chair) – Head of Economics, NUI Galway
- Dr Róisín O'Sullivan – Associate Professor, Smith College, Massachusetts

The standard tenure of members will be three years. The first appointments to the Council are being staggered by arrangement with the members. One member will be appointed for two years, two members will be appointed for three years and two members will be appointed for four years.

The Council will publish at least three reports each year and all reports will be laid before the Oireachtas. The Council has recently submitted its first Fiscal Assessment Report to Government and this was a timely contribution in advance of this Statement and the forthcoming Budget.

Furthermore, the Council will be consulted on the Fiscal Responsibility Bill which will, inter alia, establish the Council on a statutory basis.

The proposals for reform mentioned above take account of, and dovetail with, fiscal governance reforms at EU level. The "six-pack" adopted by ECOFIN consists of one directive and five regulations that strengthen economic and budgetary surveillance. In particular, the directive on budgetary frameworks requires Member States to establish a medium-term budgetary framework and to introduce country specific numerical fiscal rules. Key elements of the directive will be transposed into Irish law by the Fiscal Responsibility Bill.

It should be noted that as part of the EU/IMF Programme of Financial Support, Ireland agreed to the implementation of two structural benchmarks, the first being the establishment by mid-year of a Fiscal Advisory Council, which has been met. The second is the bringing forward of legislation in a Fiscal Responsibility Bill by end-March 2012 to reform the budgetary framework.

### 6.3 Fiscal Responsibility Bill

Under the Bill, a reformed fiscal framework will operate within a new legal context and be underpinned by new administrative arrangements. Options for inclusion in the Bill were set out in the Discussion Document "Reforming Ireland's Budgetary Framework" published earlier this year.

Fiscal rules will be designed to underpin the credibility of Ireland's system of budgetary management, by ensuring that minimum rules of good practice are observed throughout the economic cycle.

Three specific rules were set out in the Discussion Document:

- Public Finances Correction Rule: this would govern the pace of budgetary correction in circumstances where the public finances are in breach of one or both of the EU Treaty limits for the budget deficit (3% of GDP) or General Government debt (60% of GDP). The rule would require that the primary budget balance be improved by a defined minimum percentage each year, 1.5% as long as the debt exceeds 90% of GDP and 0.75% otherwise.

- Prudent Budget Rule: this would assist in maintaining budgets at a balanced position over the medium-term, as required under the SGP. This rule would specify a minimum improvement in the structural primary budget balance of 0.5% of GDP until the medium-term budgetary objective had been reached. The minimum annual improvement would be expressed in cyclically-adjusted terms.

- Sustainable Expenditure Growth Rule: this rule, which would apply in 'good economic times', would limit expenditure growth to the ability of the economy to generate resources, as measured by the underlying rate of economic growth. Higher rates of expenditure growth would need to be financed through additional taxation, thereby forging a direct and immediate link between spending choices and revenue raising.

The Fiscal Responsibility Bill will also provide a statutory basis for some of the expenditure reforms to be announced by the Minister for Public Expenditure and Reform in the coming weeks.

***Progress***

Much technical work in drafting this Bill has been done, in consultation with the Office of the Attorney General and work is progressing well to ensure that the Bill will be published by the end of the first quarter of 2012. This is in line with the EU/IMF Programme commitments.

# <u>Annex</u>

## EU/IMF Programme of Financial Support

## 1.1 Background

The previous Government agreed on 28th November 2010 to the provision of a €85 billion financial support programme for Ireland in the context of an EU/IMF Programme of Financial Support. Dáil Éireann approved the Programme by a motion passed on 15 December 2010. The State's contribution to the programme is €17.5 billion through a combination of funds from the National Pensions Reserve Fund (NPRF) and Exchequer cash balances, with the external support element therefore amounting to €67.5 billion.

The external assistance available comprises of the following:

- €22.5 billion from the European Financial Stabilisation Mechanism (EFSM);
- €22.5 billion made up of €17.7 billion from the European Financial Stability Facility (EFSF) and bilateral loans from the UK (€3.8 billion), Sweden (€0.6 billion) and Denmark (€0.4 billion), and
- €22.5 billion from the IMF.

## 1.2 Programme Conditions

The provision of funding under the programme is conditional on compliance with the conditions and reporting requirements set out in the Programme documents. These include the:

- Letters of Intent issued to the EU and to the IMF;
- Memorandum of Economic and Financial Policies (MEFP);
- Memorandum of Understanding on Specific Economic Policy Conditionality;
- Technical Memorandum of Understanding (TMU), and
- Confidential side letter dated 9 December 2010.

These documents are collectively referred to as the Memorandum of Understanding (MoU).

The conditions are defined in a series of quarterly targets. A number of these, which are considered to be of particular importance, are described as structural benchmarks.

For monitoring purposes, the actions are being monitored under five categories:

1. Permanent Conditions: These are continuing conditions relating to monitoring of public finances, monitoring financial markets for opportunities to return to them and a commitment to consult with the European Commission, the ECB and the IMF on the adoption of policies that are not consistent with this Memorandum.

2. Fiscal Consolidation: Mainly implemented by the Department of Finance and the Department of Public Expenditure and Reform in Budgets 2011 to 2013. However, the expenditure actions in these Budgets - including expenditure levels/ceilings and numbers ceilings - will directly impact on all Departments.

3. Financial Sector Reforms: These primarily concern supervision and deleveraging of the banking sector and will be implemented by the Department of Finance and the Central Bank.

4. Structural Reforms: These aim to improve the competitiveness of the economy through reforming the labour market, reform of unemployment benefits, pensions

and enhanced competition in sectors such as health, the legal sector, the retail sector and by reforming the personal debt regime.

5. Structural Fiscal Reforms: The key element of this will be a fiscal responsibility law providing for an independent budget advisory council and a medium-term expenditure framework with binding multi-annual ceilings on expenditure.

To date, Ireland has met all of its conditions under the Programme. Table 1 below shows the number of conditions met, and those identified for subsequent quarters (as of October 2011).

**Table 1.1: Action Required Under the EU/IMF Programme**

| Category Description | Actions Required/ Completed (Q4 2010 – Q1 – 2011) | Actions Required/ /Completed Q2 2011 | Actions Required/ Completed Q3 2011 | Total Actions Completed to Date | Actions Required Q4 2011 – Q4 2013 | Total Actions Required Q4 2010 – Q4 2013 |
|---|---|---|---|---|---|---|
| Permanent Conditions – Apply for the Duration of the Programme | N/A | (6) | (6) | (6) | (6) | (6) |
| Fiscal Consolidation | 7 | 1 | 1 | 9 | 5 | 14 |
| Financial Sector Reform | 24 | 16 | 12 | 52 | 54 | 106 |
| Structural Reform | 4 | 3 | 6 | 13 | 6 | 19 |
| Structural Fiscal Reform | 0 | 1 | 3 | 4 | 2 | 6 |
| Total* | 35 | 21 | 22 | 78 | 67 | 145 |

**There is an element of overlap and repetition in some of the tasks enumerated.*
*Permanent conditions are ongoing and are not included in quarterly completion totals.*

It is important to note that the number of actions does not always indicate the magnitude of the task involved. In the case of Fiscal Consolidation – the tasks relate mainly to the annual budgets which require substantial fiscal adjustments. In the case of the Financial Sector – a number of the actions are repetitive – for example, monitoring and reporting on PCAR/PLAR updates.

The above table shows that a total of 78 actions has been completed (excluding permanent conditions which are ongoing). As of October 2011, 67 conditions remain to be completed over the remainder of the programme.

Quantitative Performance Criteria (QPC) and Indicative Targets (IT) are defined in the Memorandum for Economic and Financial Policies (MEFP) Tables for each quarter. The period covered in the July Programme documentation is from end-September 2011 to end-June 2012 for each of the cumulative Exchequer primary balance (which is a QPC) – the Exchequer balance excluding Exchequer debt interest expenditure – the ceiling on the accumulation of new arrears on external debt (a QPC) and the ceiling on the stock of Central Government net debt (an IT) – a total of 12 targeted deliverables.

All of our deliverables have been met for each of the periods end-December 2010, end-March 2011, end-June 2011 and end-September 2011.

**1. 3 Quarterly Programme Reviews**

There are quarterly reviews of the Programme, and the disbursement of funding is conditional on the successful completion of these reviews.

Ireland is also required to provide a quarterly report to the Programme partners on implementation of the Programme actions in preparation for quarterly missions to Ireland by the Programme partners. During these quarterly missions the programme commitments and targets are reviewed and revised to incorporate additional or more detailed conditions and deadlines for future quarters.

The most recent set of documents available on the Department of Finance website was agreed in the aftermath of the third quarterly review in July. The fourth quarterly review has just been successfully completed and the Memorandum of Understanding and other related documents emanating from that review are being finalised.

**1.4 Interest Rate on Programme Funding**

***Initial Interest Rate***

When the programme was initially agreed in late 2010, the average interest rate on the €67.5 billion available to be drawn down from the external sources was estimated to be 5.82% on the basis of market rates at the time of the agreement.

The actual cost depends on the prevailing market rates at the time of each drawdown. The average life of the borrowings, which will involve a combination of longer and shorter dated maturities, under each of these sources was initially set at 7.5 years.

***Interest Rate Reductions Proposed and Agreed***

The euro area HoSG agreed on 21st July to reduce the cost of the EFSF facility to a level similar to that for the EU Balance of Payments facility – that is it should be close to funding cost, allowing for some element to cover the EFSF's costs.

In addition, amendments to the EFSF framework have replaced the need for cash buffers with an enhanced guarantee structure and the credit enhancement measures it uses to ensure its Triple A rating will therefore no longer be required. These changes remove the interest rate margin on EFSF funds, and were approved by all euro area Member States in October 2011. These changes were incorporated into a new legal agreement on 27 October in which the interest rate margin is now defined as zero. The agreement incorporates a guarantee commitment fee of 0.10% per annum and a service fee to cover the cost of operations of the EFSF. It is now estimated that the overall net reduction in Ireland's EFSF interest rate margin and other charges will be in the range of 2.7% to 2.8%. The EFSF's cost of funds depends on the interest rate it pays for its market issuance when raising funds for programme countries.

Also in October, the EU Council of Ministers approved an EU Commission proposal to eliminate the margin of 2.925% on the EFSM facility. This change was incorporated into an amendment to the existing legal agreement on 28th October and the margin is now defined as zero. This will apply to EFSM borrowings back to the date upon which they were issued.

The UK also agreed to reduce the margin it will charge on its bilateral loan – currently 2.29%. The precise figure has yet to be finalised.

Given these changes, figures provided by the NTMA show that the total savings on the original EU facilities with an average life of 7.5 years is about €9 billion, or approx 5.7% of 2011 estimated GDP.

In addition, the cost of our IMF loans will reduce as a result of recent and forthcoming increases in our IMF quota. The NTMA has calculated the overall benefit of this interest rate reduction at some €1.9 billion. Some €30 million of this arises in 2012 and is included in the overall estimate of €900 million of interest savings for next year. In the case of the IMF loans, the estimated savings take account of a quota increase which will not come into effect before autumn 2012 at the earliest. These expected savings may change either upwards or downwards in the light of future quota revisions.

For 2012, the changes in the EU and bilateral loans amount to some €875 million. When the impact of IMF quota changes is taken into account, the savings amount to some €900 million on a General Government basis.

**1.5 Drawdown of Funding**

The timing of the drawdown of the available funding will be determined by the Department of Finance in consultation with the NTMA, and will take account of funding requirements for Exchequer purposes and available cash balances.

The total draw downs to date (14th October 2011) amount to €27.5 billion and are broken down as follows:

- EFSF €4.2 billion.
- EFSM €13.9 billion.
- IMF €8.9 billion.
- UK Bilateral loan €0.5 billion.