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Analysis of the 2016 Draft Budgetary Plan of IRELAND

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of IRELAND

{C(2015) 8104 final}

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1. INTRODUCTION

Ireland submitted its Draft Budgetary Plan (DBP) for 2016 on 15 October 2015 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Ireland is currently subject to the corrective arm of the Stability and Growth Pact (SGP). The Council opened the Excessive Deficit Procedure (EDP) for Ireland in April 2009. On 7 December 2010, as part of the negotiations of the EU-IMF financial assistance programme, the Council adopted a revised recommendation under Article 126(7) of the Treaty, which required the country to correct its excessive deficit by 2015. Assuming the timely and durable correction of the excessive deficit in 2015, Ireland would be subject to the preventive arm of the SGP in 2016 and should ensure sufficient progress towards its medium-term budgetary objective (MTO). During the three years following the correction of the excessive deficit, Ireland would be also subject to the transitional debt rule.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2015 autumn forecast. Section 3 presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 against the obligations stemming from the SGP. Section 5 provides an analysis of implementation of reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The Irish economy is experiencing a much stronger-than-expected economic rebound. 2014 marked a turning point when GDP grew by 5.2% in real terms – compared to 1.4% a year earlier – topping growth league tables in Europe. Initially driven by exports, the recovery became increasingly broad-based and is now well anchored on domestic demand components across most economic sectors. While the volatility of Irish national accounts data might conceal the precise magnitude of economic growth, in the first half of 2015 real GDP accelerated to 7% compared to the same period last year. Subject to revisions of national accounts data, this exceptionally strong pace sets the ground for record average real GDP growth of at least 6% in 2015 and still strong, albeit more moderate, growth next year. Both domestic demand components and external demand are expected to contribute positively to GDP growth in 2016, as the Irish economy proves resilient to weaker global growth. Additional government spending of about €1.5 billion or 0.7% of GDP announced shortly ahead of the submission of the DBP adds to the already exceptional growth momentum. The Irish economy is witnessing the emergence of some supply constraints – for instance, in housing and infrastructure – that, if not resolved, could weigh on potential output growth going forward. Consumer price inflation is expected to be close to zero in 2015, on account of falls in energy prices, but to recover in 2016, driven primarily by wage developments.

The macroeconomic scenario underlying the DBP builds on the strong carry-over from the first six months of 2015 (5.7%) while discounting a likely downward correction in some of the more volatile components of aggregate demand in the second half of the year. This refers, for instance, to exceptionally strong growth of investment in the second quarter, explained by a single transaction in intellectual property by one of the multinationals established in Ireland. The scenario assumes that household consumption will experience strong and sustained growth of 3.5% in 2015 and 2016 each year while the contribution of net exports to GDP growth is assumed to peak at 2 pps. in 2015 and to become broadly neutral the year after.

Table 1. Comparison of macroeconomic developments and forecasts

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	5.2	4.0	6.2	6.0	3.8	4.3	4.5
Private consumption (% change)	2.1	2.4	3.5	2.9	2.5	3.5	2.5
Gross fixed capital formation (% change)	14.3	15.3	13.0	16.8	12.1	12.5	11.9
Exports of goods and services (% change)	12.1	7.6	11.9	12.7	4.8	6.9	7.0
Imports of goods and services (% change)	14.7	8.7	12.1	14.1	5.4	8.2	7.7
Contributions to real GDP growth:							
- Final domestic demand	4.1	3.7	4.3	5.0	3.5	4.2	3.9
- Change in inventories	0.5	-0.3	0.0	0.0	-0.2	-0.1	0.0
- Net exports	0.1	0.6	2.0	1.1	0.5	0.2	0.6
Output gap[1]	-1.1	1.1	1.5	1.2	1.1	1.4	1.3
Employment (% change)	1.7	2.2	2.8	2.0	2.2	2.4	1.5
Unemployment rate (%)	11.3	9.6	9.5	9.5	8.8	8.3	8.7
Labour productivity (% change)	3.4	1.7	3.4	4.0	1.5	1.8	2.9
HICP inflation (%)	0.3	0.2	0.1	0.3	1.1	1.2	1.4
GDP deflator (% change)	0.1	2.8	4.6	2.0	1.5	1.8	1.9
Comp. of employees (per head, % change)	1.8	2.3	2.1	3.2	2.9	2.4	2.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.7	n.a.	6.9	6.2	n.a.	6.2	6.0

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

Compared to the 2015 Stability Programme, the DBP presents a significantly revised macroeconomic scenario on account of both stronger domestic demand and net exports. As shown in Table 1, real GDP growth has been revised up by 2.2 pps. in 2015 and by 0.5 pp. in 2016. These revisions flow from the exceptionally high growth estimates for the first half of 2015, as reported in the quarterly national accounts release of 10 September 2015. However, these quarterly estimates should be read with some caution, as they are very volatile and are very likely to be revised as additional information becomes available. Overall, and taking also into account revisions to 2014 data, the level of nominal GDP presented in the DBP for 2015 and 2016 is around 7% higher than in the 2015 Stability Programme.

The macroeconomic outlook in the Commission 2015 autumn forecast is very close to the macroeconomic projections underpinning the DBP. The Commission expects private consumption to grow somewhat more moderately in 2015 and 2016, as household indebtedness remains high in Ireland. As for net exports, the Commission expects a more moderate contribution to GDP growth in 2015, assuming that multinationals will book additional imports towards the end of the year. Conversely, in 2016, the Commission expects net exports to contribute somewhat more sizeably to GDP, as imports would grow relatively less on account of our more moderate consumption outlook. The Commission also expects higher public consumption and investment than the DBP.

Risks to the macroeconomic projections in the DBP are broadly balanced for 2015. In effect, if national accounts estimates for the first half of the year are confirmed in full, Ireland could be looking at a real GDP growth rate in excess of 6% in 2015, also on account of the positive evolution of high frequency indicators in the third quarter of the year. As for 2016, the outlook for private consumption could turn out lower than assumed in the DBP given the still high stock of household debt. Yet, more dynamic growth in other domestic demand components, coupled with a more moderate deceleration in net exports, could lead to higher GDP growth than assumed in the DBP. Overall, therefore, the macroeconomic scenario underlying the DBP is plausible and broadly in line with the Commission 2015 autumn forecast.

Box 1: The macro economic forecast underpinning the budget in Ireland

The macroeconomic forecast in Ireland's DBP for 2016 was prepared by the Department of Finance. A detailed description of the economic forecast methodology is contained in section V of the Medium-Term Budgetary Framework (MTBF – July 2014)[1].

The task of assessing and endorsing the macroeconomic forecast underpinning the draft budget and the Stability Programmes was assigned to the Irish Fiscal Advisory Council (IFAC) in the Fiscal Responsibility Acts of 2012 and 2013.

The procedures underlying the endorsement process have been set out in a Memorandum of Understanding (MoU), which was agreed between the Department of Finance and IFAC. The latter is required to issue its view according to which the forecast either falls within an appropriate endorseable range (hence a letter of endorsement is issued to the Department of Finance and published subsequently by both the IFAC and the Department) or it may not be within endorseable range (triggering publication of explanations for non-endorsement by IFAC along with the Budget or Stability Programme). The IFAC also endorsed the macroeconomic forecasts underpinning the 2016 DBP; the letter of endorsement was published on 2 October. In its endorsement, the IFAC underlined that "*due to the difficulties associated with estimating supply-side variables* [for potential output and the output gap] *using the EU methodology, the Council's endorsement refers only to the actual demand-side projections*". IFAC noted that "*work is underway by the Department of Finance to develop an* [yet, unspecified] *alternative approach to estimating potential output and the output gap*".

The IFAC is an independent statutory body established by the Fiscal Responsibility Act with a mandate to independently provide an assessment of, and to comment publicly on, whether the government is meeting its own stated budgetary targets and objectives (in particular through assessments of annual budgets and the stability programmes). Its five board members are appointed based on competence and experience for a four-year term that can be renewed

[1] http://www.finance.gov.ie/sites/default/files/140718%20Medium%20Term%20Budgetary%20Framework%20-%20revised.pdf

once. The IFAC is granted "all such powers as are necessary for, or incidental to, the performance of its functions", which would include access to data and freedom of communication, which has been exercised in practice since its establishment.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP projects a general government deficit of 2.1% of GDP in 2015, slightly below the 2.3% of GDP in the 2015 Stability Programme and well within the 3%-of-GDP reference value in the Treaty. On the basis of the available information, the DBP confirms the commitment of the Irish government to correct the excessive deficit in a timely and durable manner by the recommended deadline of 2015.

The moderate improvement compared to the 2015 Stability Programme results from two opposing developments: (i) considerably better-than-expected tax revenues in the wake of the economic rebound, buoyed by rising domestic demand[2]; and (ii) additional permanent government expenditure for 2015 announced shortly ahead of the presentation of the DBP for 2016. The extra spending in 2015 of around 0.7% of GDP[3] comes at a time when economic growth is already exceptionally strong and ahead of general elections to be held not later than 8 April 2016. It also contrasts with previous EU policy guidance under the EDP and the CSRs to use windfalls to accelerate debt reduction. The additional spending goes on top of the tax cuts and spending increases included in the 2015 budget. Moreover, the extra spending is primarily financed by buoyant corporate tax receipts which, by experience, are fairly volatile (see chart below)[4].

The Commission 2015 autumn forecast projects a general government deficit for 2015 of 2.2% of GDP. The minor difference compared to the government's target of 2.1% of GDP is due to a slightly more conservative assumption for economic growth. Public finances are expected to improve further in 2016 and beyond on the back of still very robust, yet more moderate, economic growth.

For 2016, the DBP targets a general government deficit of 1.2% of GDP, half a percentage point lower than the target included in the 2015 Stability Programme. The new deficit target includes a comprehensive package of new measures worth around 0.7% of GDP consisting of tax cuts and spending increases. A detailed description of the new measures is provided in Section 3.3 below.

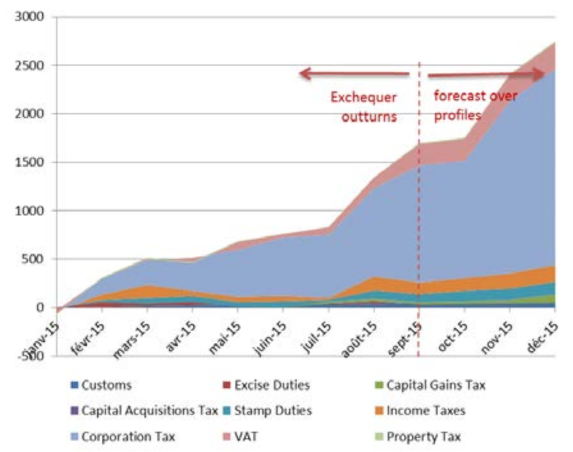
2 On account of the revised GDP growth assumptions in the DBP and the revised 2014 outturn, the level of nominal GDP in 2015 and 2016 is now expected to be nearly 7% higher than in the 2015 Stability Programme. Tax returns increased by 5.8% y-o-y in the first three quarters, exceeding the government's target in 2015 Budget by 0.8% of GDP. This was largely due to the remarkable performance of corporate tax receipts, which were up by 44% in the same period over 2014.

3 Additional allocations mainly go to health and social protection.

4 Without these additional expenditures, the deficit would have declined to around 1½% of GDP.

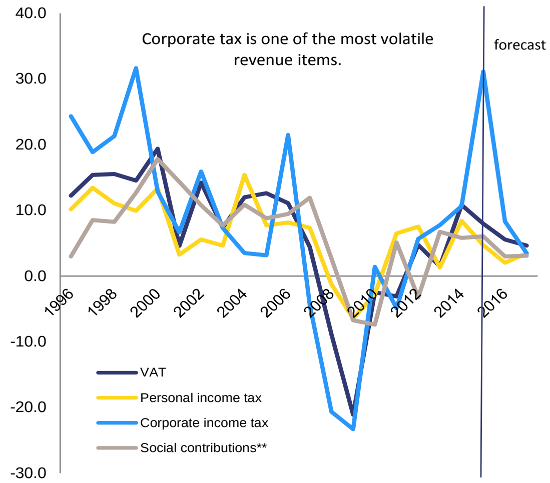
Figure 1. Fiscal developments

2015 tax receipts: diff. between outturn and plan



Source:Ireland Department of Finance, European Commission

Main tax receipts: y-o-y percentage change



Source: Ireland Department of Finance, European Commission

On the revenue side, the DBP projects total revenues at €71.3 billion in 2016, €2.0 billion up from the 2015 Stability Programme, on the back of the economic upswing. The DBP estimates income tax revenues to grow by 4.5% y-o-y despite planned tax cuts, the effect of which is partly offset by the decision of non-indexing the income tax bands (€0.3 billion); a similar increase, by 5.0% y-o-y, is foreseen for taxes on production and imports on foot of the expected recovery of household income and personal consumption. Conversely, non-tax revenues, calculated as the difference between total revenue and the tax burden, are expected to decrease by -14% y-o-y to €6.5 billion in 2016 on account of a reduction in the Central Bank surplus income following the partial cancellation of floating rate bonds.

Turning to the expenditure side, the DBP projects primary expenditure to reach €67.5 billion in 2016, nearly €1.4 billion above the targets presented in the 2015 Stability Programme. On a year-on-year basis, primary expenditure increases by 0.6% driving the expenditure-to-GDP ratio down to 33.2% in 2016, 2 pps. lower than in 2015. Interest expenditure is projected to be more than €163 million lower than in the 2015 Stability Programme, reflecting more favourable market conditions.

The Commission 2015 autumn forecast projects a general government deficit of 1.5% of GDP in 2016, 0.3 pp. higher than the DBP, on account of a less-tax-rich composition of GDP and a somewhat more dynamic forecast for government expenditure, motivated by recurring overspending compared to government plans in the past several years.

Risks associated with DBP and Commission budgetary projections mainly relate to the sustainability of the currently very favourable economic outlook and to the actual size of the recurring spending overruns. The upcoming elections may also imply a certain degree of uncertainty in relation to the implementation of 2015 budget.

On the basis of the information provided in the DBP, the recalculated structural deficit[5] is estimated at 2.8% of GDP in 2015 (down from 3.2% of GDP in 2014) and only slightly lower compared to the estimate derived from the 2015 Stability Programme (3.0% of GDP). The Commission 2015 autumn forecast estimates the structural deficit at 3.0% of GDP in 2015, mainly on account of the underlying higher deficit forecasts. In 2016, the recalculated structural deficit is estimated at 1.9% of GDP based on the DBP, slightly lower than the estimate in the Commission forecast of 2.1% of GDP.

[5] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**34.4**	**34.3**	***33.0***	**34.0**	**33.2**	***31.9***	**32.8**	**-2.4**
of which:								
- Taxes on production and imports	11.2	11.2	*10.6*	11.0	11.1	*10.5*	10.9	-0.7
- Current taxes on income, wealth, etc.	13.2	13.1	*12.9*	13.2	12.9	*12.7*	12.8	-0.5
- Capital taxes	0.2	0.2	*0.2*	0.2	0.2	*0.2*	0.2	0.0
- Social contributions	5.8	5.7	*5.5*	5.7	5.4	*5.3*	5.5	-0.4
- Other (residual)	4.1	4.1	*3.8*	4.0	3.6	*3.3*	3.4	-0.8
Expenditure	**38.2**	**36.6**	**35.1**	**36.2**	**34.9**	**33.2**	**34.3**	**-5.1**
of which:								
- Primary expenditure	34.3	33.1	31.9	32.9	31.7	30.2	31.3	-4.0
of which:								
Compensation of employees	9.8	9.7	9.3	9.6	9.3	8.9	9.2	-0.9
Intermediate consumption	4.6	4.9	4.6	4.8	4.6	4.3	4.5	-0.3
Social payments	14.9	13.9	13.4	13.8	13.2	12.6	12.9	-2.3
Subsidies	1.0	1.0	0.9	1.0	1.0	0.9	0.9	-0.1
Gross fixed capital formation	2.0	1.8	2.0	2.0	1.8	1.9	2.0	-0.1
Other (residual)	2.0	1.8	1.7	1.8	1.8	1.7	1.8	-0.3
- Interest expenditure	4.0	3.5	3.2	3.3	3.2	3.0	3.0	-1.0
General government balance (GGB)	**-3.9**	**-2.3**	**-2.1**	**-2.2**	**-1.7**	**-1.2**	**-1.5**	**2.6**
Primary balance	**0.1**	**1.1**	**1.1**	**1.1**	**1.5**	**1.7**	**1.5**	**1.6**
One-off and other temporary measures	-0.1	0.1	-0.1	0.1	0.1	-0.1	-0.1	0.0
GGB excl. one-offs	**-3.8**	**-2.4**	**-2.0**	**-2.4**	**-1.8**	**-1.1**	**-1.4**	**2.6**
Output gap[1]	-1.1	1.1	1.5	1.2	1.1	1.4	1.3	2.5
Cyclically-adjusted balance[1]	-3.3	-2.9	-2.9	-2.9	-2.3	-2.0	-2.2	1.3
Structural balance (SB)[2]	**-3.2**	**-3.0**	**-2.8**	**-3.0**	**-2.4**	**-1.9**	**-2.1**	**1.3**
Structural primary balance[2]	0.8	0.5	0.5	0.3	0.8	1.1	0.9	0.3

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

Box 2: Impact of the current low interest rate environment on compliance with the SGP

Identifying an interest rate windfall/shortfall for 2016

Sovereign bond yields have fallen sharply since end-2013 and reached historical lows in the first half of 2015, before increasing somewhat during the summer. After hitting a low of 0.66% in April, the yield on the 10-year Irish bond was still at about 1.15% in mid-October 2015, while the 10-year spread over German bonds remained near 60 basis points. Following bond issuances of a total €10.25 billion in the first six months of 2015, including a new 30-year euro benchmark bond at a yield of 2.08%, the National Treasury Management Agency (NTMA) raised €2.75 billion in three 15-year bond issuances with yields ranging from 2.2% in June to 1.6% in October.

As a result of the lower market rates, benefitting new issuances, and the early repayment of IMF loans, total interest payments by the general government have decreased over the last few years. Interest expenditure in Ireland equalled €7.2 billion (4.1% of GDP) in 2012. It peaked at €7.7 billion (4.3% of GDP) in 2013 and is expected to fall to €6.7 billion (3.4% of GDP) in 2015 and to decrease further next year to €6.6 billion (3.1% of GDP), based on the information provided in the DBP. The fall in debt servicing costs vis-à-vis 2015 reflects the full-year impact of the repayment of the IMF loans and lower cost of funding on other programme related loans. These projections are in line with the Commission autumn forecast.

Prospects and vulnerability

The sovereign's financing situation remains comfortable given the long maturity profile and moderate interest rates payable. The average maturity of debt is close to 13 years, having improved by nearly one year following the replacement of IMF loans with longer-dated bonds. The residual balance on the IMF loan now stands at SDR 3.8 billion (€4.7 billion) and is subject to the SDR interest rate plus a margin of 1%. This balance is due to be amortised over the period 2021-2023.

In addition, the extension of loans from the European Financial Stability Mechanism (EFSM), agreed in 2013, is due to further improve the maturity profile and interest rate expenditure for the sovereign. These loans will be extended on request as they approach their maturity dates. In July 2015, Ireland requested the extension of a EUR 5 billion EFSM loan due in December. The funding benefit is estimated at around EUR 375 million over 10 years. The NTMA does not expect Ireland to refinance any EFSM loan through market issuances before 2027.

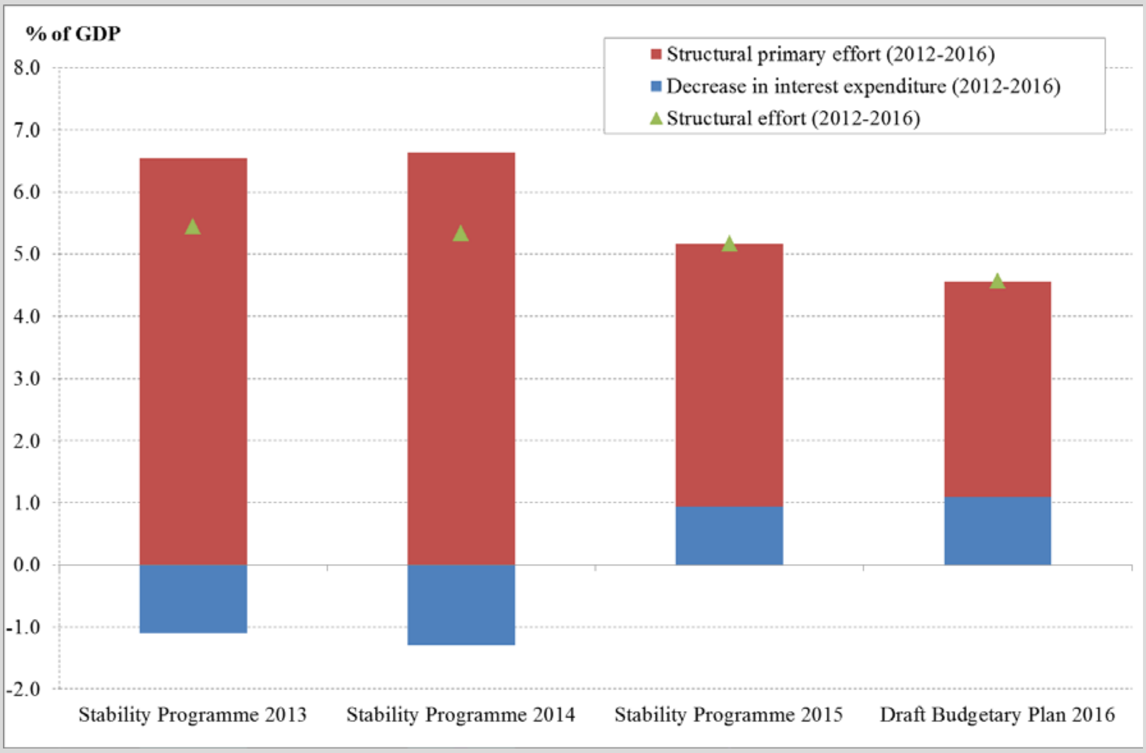
The Exchequer Borrowing Requirement (EBR) is narrowing and is projected to drop to just over €1.7 billion next year. However, the current outstanding balance of treasury bonds maturing in April 2016 is €8.1 billion. Looking further ahead, bond redemptions are significant over the medium term. The current outstanding balance on the six benchmark bonds maturing over the period 2017-2020 is around €50 billion.

Consequences for public finances

Comparing the interest expenditure projections across different vintages of Stability Programmes and the 2016 DBP shows that interest expenditure still dragged on the planned structural effort over the 2012-1016 period until the 2014 Stability Programme. The contribution of debt-servicing costs to the overall structural effort started to be positive with the 2015 Stability Programme. Using data from the 2016 DBP, interest expenditure savings are estimated to contribute by 1.1% of GDP to the overall planned structural effort over the period 2012-2016. The size of the (unexpected) interest windfall since the fall in market interest rates could be estimated of around 2% of GDP[6] which appear to have been used to replace the reduction of the overall structural primary effort.

It has to be noted that the improvement of market conditions for the sovereign is largely due to the fiscal adjustment and structural reforms that Ireland has undertaken, including during the EU-IMF finance assistance programme, in addition to the impact of the ECB's expanded asset purchase programme. Conversely, the low inflation environment appears to play a minor role.

Structural effort and decrease in interest expenditures between 2012 and 2016 based on government plans



Source: Stability programmes, Draft Budgetary Plan 2016 and AMECO

3.2. Debt developments

Ireland's general government debt-to-GDP ratio is expected to continue to fall after having peaked at 120% in 2013. The DBP estimates gross debt to fall below GDP level in 2015 (97.0% of GDP) and to reach 92.8% in 2016.

The improvement compared to the projections in the 2015 Stability Programme results from the combined effect of better-than-expected economic growth, lower interest rates and larger primary surpluses. As regards the stock-flow adjustment, from 2015 the liquidation of the

[6] Note that, while it is likely that revisions in the interest expenditure projections across different vintages primarily reflect changes in interest rates, other factors such as debt dynamics, the maturity profile of debt and statistical reclassifications (e.g. the switchover to the ESA 2010 standard of national accounts) may also have played a role.

Irish Banking Resolution Corporation (IBRC) is no longer having a significant impact on debt reduction[7].

The debt projections in the 2016 DBP are broadly in line with the Commission 2015 autumn forecast. Whereas divergences in 2015 mostly relate to different inflation estimates, dissimilarities in 2016 debt projections mainly stem from the different general government deficit expectations.

Table 3. Debt developments

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**107.5**	**105.0**	**97.0**	**99.8**	**100.3**	**92.8**	**95.4**
Change in the ratio	-12.5	-2.5	-10.5	-7.7	-4.7	-4.2	-4.3
Contributions [2] :							
1. Primary balance	**-0.1**	**-1.1**	**-1.1**	**-1.1**	**-1.5**	**-1.7**	**-1.5**
2. "Snow-ball" effect	**-2.1**	**-3.4**	**-7.3**	**-4.7**	**-2.1**	**-2.6**	**-2.9**
Of which:							
Interest expenditure	4.0	3.4	3.2	3.3	3.2	3.0	3.0
Growth effect	-5.9	-4.0	-6.0	-6.0	-3.8	-3.9	-4.2
Inflation effect	-0.2	-2.8	-4.5	-2.0	-1.5	-1.7	-1.8
3. Stock-flow adjustment	**-10.3**	**2.2**	**-1.8**	**-1.8**	**-1.0**	**0.2**	**0.2**
Of which:							
Cash/accruals difference		0.3	0.4		0.2	0.4	
Net accumulation of financial assets		n.a.	-0.6		n.a.	-1.1	
Valuation effect & residual		n.a.	n.a.		n.a.	n.a.	

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

As regards the sensitivity of the debt projections forecast to interest rate shocks, while there is some floating rate exposure, it should be noted that most of the outstanding stock of gross debt is at fixed rates. Therefore, risks to the budgetary forecast are more likely to arise from

[7] Other less significant debt developments contribute reducing the debt position in 2015. These include the cancellation of €1.0 billion (0.5% of GDP) of the floating rate bonds purchased from the Central Bank of Ireland, about €0.5 billion (0.3% of GDP) from the sale of contingent capital notes and equity in Permanent TSB (PTSB), and the transfer of €1.6 billion (0.9% of GDP) from the National Pension Reserve Fund (NPRF) due to the redemption of Bank of Ireland (BOI) preference shares. In 2016, the planned receipts from the redemption of the Allied Irish Banks (AIB) contingent convertible capital notes of €1.6 billion (0.8% of GDP) will contribute to the decline in gross debt.

specific events or from changes to the economic outlook. Over the longer term, there are also some risks arising from the potential under-achievement of legally binding climate change targets[8] which will require Ireland to purchase carbon credits until targets have not been reached. Upsides to the baseline debt scenario are related to the potential sales of shares the government still retain in the three major domestic banks AIB (99.8%), Bank of Ireland (13.9%) and PTSB (74.9%) which are valued in the region of €15 billion.

3.3. Measures underpinning the Draft Budgetary Plan

The DBP for 2016 includes new measures of around 0.7% of GDP consisting of tax cuts and spending increases. Projections also account for a buoyancy second-round effect of around 0.1% of GDP on revenue receipts arising from the package of measures.

On the tax side, the bulk of measures (around 0.4% of GDP) focus on reducing income taxes through cuts of the Universal Social Charge (USC). The marginal tax rate for middle-income earners is expected to decline to 49.5% from 51%. Other tax measures include changes to tax credits for self-employed and home carers, a cut in capital gains tax for entrepreneurs, a higher threshold for capital acquisition tax on inheritances, a reduction of the motor tax for commercial vehicles and an increase of excise duties on cigarettes.

As already announced in the 2015 Budget, the 2016 DBP introduces a so-called "Knowledge Development Box". This measure offers a reduced corporate tax rate of 6.25% for qualifying incomes arising from certain types of intellectual property, such as patents and copyrighted material, including software, which are the result of R&D carried out in Ireland. The measure is taken in response to the to the OECD Base-Erosion and Profit-Shifting (BEPS) initiative.

On the expenditure side, spending increases focus on public sector pay rises (around 0.1% of GDP) and social protection (around 0.1% of GDP). The main changes in social protection include a €3 per week increase in pension payments, a €5 per month rise in child benefit and an increase of the carer's support grant. Government investment expenditure, which was significantly reduced during the post-2007 consolidation process, continues to be subdued with the level of gross voted capital expenditure 1.4% lower than the latest estimates for 2015.

Following the phasing out of the so-called "double Irish" with the 2015 budget, by changing the residency rules to require all companies registered in Ireland to also be tax resident in Ireland, the government introduced a measure for country-by-country reporting by multinationals in line with the approach agreed as part of the BEPS project[9]. No other measures have been taken to broaden the tax base, and little progress has been made in enhancing the growth and environmental friendliness of the system. Notably, the revaluation of self-assessed property values, used to calculate local property tax (LPT) liabilities, has been

[8] Under the EU Effort Sharing Decision, which covers the period 2013 -2020, Ireland is obliged to achieve a 20% Greenhouse Gas emissions reduction (compared to 2005 levels) in certain sectors. At the moment, the EPA is estimating that Ireland's emissions are not in line with this reduction.

[9] The measure requires an Irish resident parent company of large Multinational (MNE) groups to provide annually, and for each tax jurisdiction in which they do business, a country-by-country report to the Revenue Commissioners. The requirement begins for fiscal years commencing on or after 1 January 2016. The report is required to contain details of the MNE group's revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in. The country-by-country report is based on guidance published by the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) on 5 October 2015.

delayed by two years to November 2018. Residential property prices have increase substantially since the first self-assessment such that this decision represents a lost opportunity to broaden the tax base. The impact of new announced “Petroleum Production Tax”, the purpose of which is to ensure that discoveries made under future exploration licenses will result in an increased financial return to the State and at an earlier point in time, has still to be fully assessed.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	**2016**	**2017**
Taxes on production and	0.0	0.0	-0.1
Current taxes on income,	0.0	-0.4	-0.1
Capital taxes	n.a.	n.a.	n.a.
Social contributions	n.a.	n.a.	n.a.
Property Income	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
Total	0.0	-0.4	-0.2

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2016

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	**2016**	**2017**
Compensation of employees	0.0	-0.1	-0.1
Intermediate consumption	n.a.	n.a.	n.a.
Social payments	0.0	-0.1	0.0
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	n.a.	n.a.
Gross fixed capital formation	n.a.	n.a.	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
Total	0.0	-0.2	-0.1

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2016

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Ireland is currently subject to the corrective arm of the SGP and is recommended to correct its excessive deficit by 2015. Box 3 recalls the main features of the EDP opened by the Council on 27 April 2009 and the latest CSRs in the area of public finances.

Box 3. Council recommendations addressed to Ireland

On 27 April 2009, the Council adopted a decision under Art. 126(6) of the Treaty according to which, for the first time, an excessive deficit existed in Ireland, and recommended the country, under Art. 126(7) of the Treaty, to correct its excessive deficit by 2013. A number of additional steps in the procedure were taken between April 2009 and July 2010 (for more detail see Ireland's 2012 Stability Programme). On 7 December 2010, as part of the EU-IMF financial assistance programme, the Council adopted revised recommendations to Ireland and extended the deadline for correcting the excessive deficit to 2015. The December 2010 recommendations were essentially three-fold. The first requirement was for Ireland to implement fiscal measures to ensure that the annual general government deficit (excluding direct support for the banking sector under the programme) was at or below pre-determined annual ceilings over the 2011-2015 period. Secondly, in order to achieve these nominal targets, the Council recommended an improvement in the structural balance of at least 9½% of GDP over 2011-2015 and to seize opportunities, including from better economic conditions, to accelerate reducing the gross debt ratio towards the 60%-of-GDP reference value in the Treaty. Finally, the Council recommended various institutional reforms in order to limit risks to the fiscal adjustment. The Council requested the Irish authorities to report on the implementation of these recommendations in each of its annual Stability Programmes between 2011 and 2015.

On 14 July 2015, the Council also addressed recommendations to Ireland in the context of the European Semester. In particular, in the area of public finances the Council recommended to Ireland to ensure a durable correction of the excessive deficit in 2015 and to achieve a fiscal adjustment of 0.6% of GDP towards the medium-term objective (MTO) in 2016. Ireland is also expected to: i) use windfall gains from better-than-expected economic and financial conditions to accelerate the deficit and debt reduction; ii) limit the existing discretionary powers to change expenditure ceilings beyond specific and predefined contingencies; iii) broaden the tax base and review tax expenditures, including on value-added taxes.

4.1. Compliance with EDP recommendations

For 2015, the DBP projects a general government deficit of 2.1% of GDP in 2015, well below the 3.0%-of-GDP reference value in the Treaty. Similarly, the Commission 2015 autumn forecast expects Ireland to bring its general government deficit well below the 3%-of-GDP reference value in the Treaty. The correction of the excessive deficit is currently projected to be durable. In effect, the DBP targets a deficit of 1.2% of GDP in 2016, broadly in line with the Commission's view. For 2017, the general government deficit target in the DBP is also well below the 3%-of-GDP reference value in the Treaty, consistent with the Commission 2015 autumn forecast.

According to the Commission 2015 autumn forecast, over 2011-2015 – i.e. the EDP correction period – both the unadjusted and the adjusted average changes in the structural balance fall short of the recommended average annual fiscal effort of 1.9% of GDP by respectively 0.7% and 1.3% of GDP. Moreover, the estimated yield of permanent consolidation measures taken under the EU-IMF financial assistance programme and thereafter is below the required level of 9½% of GDP.

It is worth recalling that the 2010 EDP recommendation asks Ireland to seize opportunities, including from better-than-expected economic and financial conditions, to accelerate the deficit and debt reduction.

Table 5. Compliance with the EDP recommendation

(% of GDP)	2014	2015	
	COM	**DBP**	**COM**
Headline balance			
Headline budget balance	-3.9	-2.1	-2.2
EDP requirement on the budget balance	-5.1	-2.9	
Fiscal effort - change in the structural balance			
Change in the structural balance[1]	1.1	0.5	0.2
Average cumulative change[2]	1.4	1.2	1.2
Average required change from the EDP recommendation	1.9	1.9	
Fiscal effort - adjusted change in the structural balance			
Adjusted average cumulative change in the structural balance[3]	0.9	-	0.6
of which: *correction due to change in potential GDP estimation (α)*	-2.5	-	-2.5
correction due to revenue windfalls/shortfalls (β)	0.2	-	-0.3
Cumulative adjusted change [2]		-	
Average required change from the EDP recommendation	1.9	1.9	
Fiscal effort - calculated on the basis of measures (bottom-up approach)			
Fiscal effort (bottom-up)[4]	n.a.		
Cumulative fiscal effort (bottom-up)[2]			
Requirement from the EDP recommendation			
Cumulative requirement from the EDP recommendation			

Notes

[1] Structural balance = cyclically-adjusted general government balance excluding one-off measures. Structural balance based on DBP is recalculated by the Commission on the basis of the Draft Budgetary Plan scenario using the commonly agreed methodology. Change compared to t-1.

[2] Average since the first year for correction in the lastest EDP recommendation.

[3] Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendation.

[4] The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.

Source :

Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

4.2. Compliance with the debt criterion

Assuming a timely correction of the excessive deficit by 2015, Ireland would benefit from a three-year transition period as regards compliance with the debt criterion[10], during which it should ensure sufficient progress towards compliance with the debt criterion. Over this period (2016-2018), the structural balance is expected to adjust in order to ensure that the debt reduction benchmark is met at the end of the transition period.

Table 6: Compliance with the debt criterion

	2016		
	SP	**DBP**	**COM**
Gross debt ratio	100.3	92.8	95.4
Gap to the debt benchmark [1,2]			
Structural adjustment [3]	0.6	0.9	0.8
To be compared to:			
Required adjustment [4]	0.1	n.a.	-0.1

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

The DBP does not include sufficient information to assess compliance with the transitional arrangements for the debt reduction benchmark. According to the Commission 2015 autumn forecast, the structural effort is higher than the required minimum linear structural adjustment (MLSA) in 2016 (0.8% of GDP vs. required -0.1% of GDP).

[10] Members States in EDP/transition period should respect simultaneously the two conditions below:
(i) First, the annual structural adjustment, ensuring compliance with the debt rule at the end of the transition period, should not deviate by more than ¼ % of GDP from the required linear structural adjustment;
(ii) Second, at any time during the transition period, the remaining annual structural adjustment should not exceed ¾ % of GDP.

4.3. Compliance with the adjustment towards the MTO

Assuming a timely and durable correction of the excessive deficit in 2015, Ireland will be subject to the preventive arm from 2016 onwards.

The recalculated improvement of the structural balance in 2016 (0.9% of GDP) is above the 0.6% of GDP required to ensure sufficient progress towards the MTO and the DBP foresees net expenditure growth in 2016 to be in line with the expenditure benchmark.

Table 7: Compliance with the requirements of the preventive arm

(% of GDP)	2016	
Initial position[1]		
Medium-term objective (MTO)	0.0	
Structural balance[2] (COM)	-2.1	
Structural balance based on freezing (COM)	-	
Position vis-a -vis the MTO[3]	Not at MTO	
(% of GDP)	**2016**	
	DBP	**COM**
Structural balance pillar		
Required adjustment[4]	0.6	
Required adjustment corrected[5]	0.6	
Change in structural balance[6]	0.9	0.8
One-year deviation from the required adjustment [7]	0.3	0.3
Two-year average deviation from the required adjustment [7]	n.a. (in EDP in 2015)	
Expenditure benchmark pillar		
Applicable reference rate[8]	0.1	
One-year deviation [9]	0.0	-0.4
Two-year average deviation [9]	n.a. (in EDP in 2015)	
Conclusion		
Conclusion over one year	Compliance	Overall assessment
Conclusion over two years	n.a. (in EDP in 2015)	

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

Based on the Commission 2015 autumn forecast, the structural balance is projected to post a similar improvement of 0.8% of GDP in 2016, more than the required 0.6% of GDP. Conversely, the growth rate of government expenditure, net of discretionary revenue measures, is expected to exceed the expenditure benchmark by 0.4% of GDP in 2016, on account of a more dynamic expenditure forecast and one-off factors. Therefore, an overall assessment is warranted.

The difference between the two indicators chiefly stems from the fact that the annual potential GDP growth rate used to estimate the improvement of the structural balance in 2016 is significantly higher than the recently updated medium-term rate used in the calculation of the expenditure benchmark (derived from the Commission 2015 spring forecast). In the case of Ireland, the medium-term reference rate used for the computation of the expenditure benchmark is a more stable and prudent estimate of the medium-term growth potential at the current juncture. Because of the very open nature of the Irish economy, the estimates of annual potential growth are subject to considerable, often pro-cyclical variations due to frequent and sizeable data revisions of Irish national accounts and factors impacting on the supply side of the economy notably migration, the real effective exchange rate or energy prices.

In conclusion, following an overall assessment, there is a risk of some deviation from the required adjustment path towards the MTO in 2016.

5. IMPLEMENTATION OF REFORMS IN THE AREA OF FISCAL GOVERNANCE

The 2016 DBP (specifically in Table 7a) contains a summary of the main CSRs the Council addressed to Ireland in the context of the European Semester on 14 July 2015 and (in Table 7b) actions to meet the targets set by the European Union's Strategy for Growth and Jobs. Table 7a offers a very short description of the on-going efforts to implement structural reforms, listing initiatives and legislative proposals which have been adopted or are planned to address the 2015 CSRs.

Concerning the recommendations in the area of fiscal governance, and notwithstanding the goal to correct the excessive deficit by 2015 (see Section 4), the DBP confirms Ireland's commitment to a reliable fiscal adjustment strategy towards achieving a continued reduction in the structural budget deficit. The estimated structural adjustment for 2016 exceeds the minimum correction required by the preventive arm of the SGP. At the same time, the new tax cuts and expenditure increases included in the DBP combined with the government's decision to allocate additional expenditure in 2015 are not in line with the CSR asking Ireland to use windfall gains form better-than-expected economic and financial conditions to accelerate the deficit and debt reduction.

No changes have been made regarding the need to ensure the binding nature of the government expenditure ceiling including by limiting the statutory scope for discretionary changes. Although the Ministers and Secretaries (Amendment) Bill (MSAA) in 2013 extended and put on a statutory footing the “ministerial expenditure ceilings” set within the triennial Comprehensive Expenditure Report, upward revisions have been a constant feature of the Irish multiannual planning system, with the larger revisions occurring in conjunction with upside economic surprise. The extra spending deliberated at the end of 2015 and the new expenditure increases in budget 2016 are notable cases in point.

While not specifically listed in the Tables 7a of the DBP, measures implementing the international agreed efforts to reduce tax avoidance are likely to contribute to broadening the tax base. No other measures have been taken to broaden the tax base, and little progress has been made in enhancing the growth and environmental friendliness of the system. Conversely, the changes to the Universal Social Charge and the introduction of further tax credits with budget 2016 are likely to further narrow the tax base. In addition, the revaluation of self-assessed property values, used to calculate local property tax (LPT) liabilities, has been delayed by two years to November 2018. This decision represents a lost opportunity to broaden the tax base given the substantial increase of residential property prices since the first self-assessment.

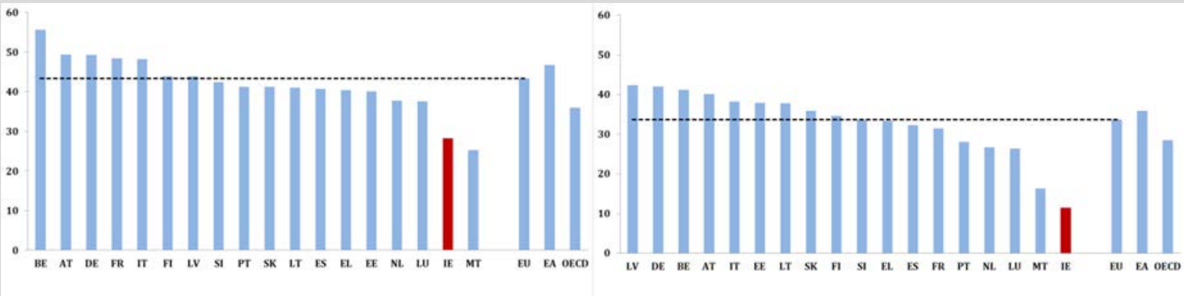
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

Box 4 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to screen euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Ireland for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Ireland at the average wage and a low wage (2014)



Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

This screening is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Most of the measures included in the Ireland's DBP aims at reducing personal income taxes mainly through changes to the Universal Social Charge (USC). The USC rates were cut in each of the three lowest bands, from 1.5% to 1%, from 3.5% to 3% and from 7% to 5.5%. The Budget also increased the entry threshold of the USC from €12,012 to €13,000, removing approximately 42,500 workers from the scope of the charge, while the middle threshold was also increased by over €1000 to €18,668. According to the authorities, the downward revision of the USC is primarily aimed at low and middle income families and is designed to support employment and job creation. Moreover, it will lower the marginal tax rate for middle-income earner to 49.5%. The Department of Finance estimate that the cost to the exchequer in 2016 will be approximately €561 million.

The DBP includes materials and tables showing the impact of those measures on several categories of income earners. The measures would contribute to further decrease the tax wedge for all income categories, particularly low wage earners.

6. OVERALL CONCLUSION

The DBP plans a correction of the excessive deficit by 2015, which is confirmed by the Commission 2015 autumn forecast. Both the DBP and the Commission 2015 autumn forecast project the general government deficit to remain well below the 3%-of-GDP reference value in the Treaty in the two years ahead. According to the Commission 2015 autumn forecast, both the unadjusted and the adjusted average improvement in the structural balance in 2011-2015 fall short of the recommended average annual improvement of 1.9% of GDP. Moreover, the estimated yield of the permanent consolidation measures is also below the recommended cumulative adjustment.

Although current forecasts are consistent with a timely correction of the excessive deficit, the additional permanent government expenditure for 2015 of around 0.7% of GDP announced in October comes at a time when the economy is already experiencing an exceptionally strong rebound. It also contrasts with policy guidance included in both the 2010 Council Recommendation under the EDP and the most recent CSR asking Ireland to use windfall gains from better-than-expected economic and financial conditions to accelerate the deficit and debt reduction.

Assuming a timely correction of the excessive deficit by 2015, Ireland would be subject to the preventive arm of the SGP from 2016 onwards. Based on data presented in the DBP, recalculated according to the commonly agreed methodology, progress towards the MTO is in line with the requirements of the preventive arm of the Pact. However, the Commission forecast points to a risk of some deviation from the expenditure benchmark requirement. In conclusion, based on an overall assessment, there is a risk of some deviation from the adjustment path towards the MTO.

Based on the Commission 2015 autumn forecast, Ireland is making sufficient progress towards complying with the debt rule in 2016.