

Medium-Term Fiscal Statement

November 2012

Incorporating the Department of Finance's Autumn Forecasts

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Summary and Overview

Last November, in advance of *Budget 2012*, a *Medium-Term Fiscal Statement* covering the period 2012-2015 was published. That document set out the Government's medium-term fiscal strategy, the main aim of which is to restore order to the public finances by correcting the excessive deficit and putting our debt-to-GDP ratio on a downward trajectory. This is a necessary condition for a resumption of sustainable economic and employment growth.

The primary purpose of this document is to take stock, in advance of *Budget 2013*, of the progress made in the last year, to provide an update on the consolidation strategy over the period to 2015, and to highlight the significant challenges that remain. This document incorporates the *Department of Finance's Autumn 2012 economic and fiscal forecasts*.

It is important to note at the outset that the economic and fiscal projections set out in this document do not take account of any benefits that may flow from future developments that may result from the announcement, following the end-June euro area summit, that "*the situation of the Irish financial sector would be examined with the view of further improving the sustainability of the well-performing adjustment Programme*". Technical work is continuing in that regard.

Ireland is making good progress in terms of improving the sustainability of its public finances. On the basis of the latest information to hand, this year's General Government deficit is estimated at €13.5 billion or 8.3% of GDP. This is a marked improvement on the underlying deficit of €16.7 billion or 10.7% of GDP recorded in 2010. Importantly also, the 2012 deficit estimate is within the 8.6% of GDP limit set by the ECOFIN Council in December 2010.

To date, all quantitative fiscal targets set as part of the *EU/IMF Programme of Financial Support*, including the annual deficit target for 2011, have been achieved. The improvement in the public finances has come about mainly as a result of the implementation of consolidation measures to reduce expenditure and raise revenue but also through the return to economic growth in 2011 for the first time since 2007.

This progress and European commitments to provide further support to the Irish financial sector have helped rebuild market confidence. Yields on Irish Government bonds have fallen considerably in recent months and this assisted the State in making a welcome return to the market, for the first time since the autumn of 2010.

Notwithstanding this welcome progress, it is clear that a challenging road lies ahead. A large gap between the State's revenues and expenditures still exists, one which must be further closed next year and over the medium-term. While the economic recovery will contribute, part of the gap is structural in nature and requires that the consolidation and structural reform processes continue into the future. Continuing to run large deficits and thereby engaging in large volumes of borrowing is not a viable option. Devoting an ever-increasing share of revenue to debt servicing is a poor use of resources given the legitimate requirements for public service provision

The economic backdrop underpinning the consolidation strategy is one of continued modest expansion in the short-term, with the pace of growth gaining momentum thereafter. For next year, GDP is projected to expand by around 1.5%, the third

successive year of moderate growth. This represents a ¾ percentage point downward revision to the previously-published 2013 growth forecast from April last, and mainly reflects the deterioration in the external environment over the past six months or so. Assuming a pick-up in our main export markets during the second half of next year, then stronger exports should support an acceleration in the pace of GDP growth in Ireland in 2014-15.

Conditions in the labour market remain poor. Employment losses this year have been worse than expected, and the downward revision to the 2013 growth projection means that the most likely outcome is that the level of employment will effectively be flat next year. Having said that, net job creation is anticipated by the second half of the year, with further net gains projected thereafter.

As a result, the rate of unemployment is expected to fall over the forecast horizon, although it is likely to remain relatively high even by the mid-part of this decade. For this reason, addressing unemployment will remain the Government's main priority for the foreseeable future.

Based on the Department of Finance's current macroeconomic and fiscal assessment for the period 2013-2015, it is estimated that an adjustment package of just over €½ billion will be required over the forthcoming three-year period if annual deficit targets are to be achieved. Importantly, this aggregate volume of consolidation is unchanged from the estimate set out last year. This document re-states the year-by-year fiscal consolidation path published in the November 2011 *Medium-Term Fiscal Statement*, which remains broadly appropriate allowing for the updated macroeconomic and fiscal forecasts.

The Government notes that the *Irish Fiscal Advisory Council* has called for a strengthening of the consolidation effort and the targeting of a lower deficit by 2015. This is a reasonable view and one that has been considered carefully. On balance however the Government believes that the previously identified fiscal adjustment path remains appropriate, given the need to support the emerging economic recovery.

The Government remains fully committed to meeting fiscal targets and reducing the deficit to below 3% of GDP in 2015, not just because of the obligations imposed under the terms of the *EU/IMF Programme* and the *Stability and Growth Pact*, but because it makes sense to do so.

The ultimate aims of the *EU/IMF Programme* are to restore order to the public finances, return the economy to sustainable growth, and recapitalise and restructure the banking system, all of which would assist in returning the sovereign to market funding. Significant progress has been made in each of these areas and the Programme is on track.

There are significant hurdles to overcome but the strategy is reaping rewards and staying the course will help to ensure this remains the case.

In a new venture, this document also contains a number of policy papers written by Department of Finance officials. These papers cover the impact of the 9% VAT rate introduced as part of last year's *Jobs Initiative*, an economic assessment of the SME sector and an update on the *Common Consolidated Corporate Tax Base (CCCTB)*. It is the Department's intention to include further policy papers in future publications.

Main Macroeconomic and Fiscal Variables Forecasts 2012-2015

	2012	2013	2014	2015
<i>Macroeconomic Forecasts (% change, unless otherwise stated)</i>				
Real GNP	1.4	0.9	1.7	2.1
Real GDP	0.9	1.5	2.5	2.9
HICP	2.1	1.7	1.8	2.0
Employment	-1.2	0.0	0.9	1.3
Unemployment (% of labour force)	14.8	14.5	13.9	13.0
<i>Fiscal Forecasts (% of GDP, unless otherwise stated)</i>				
General Government Balance	-8.3	-7.5	-5.0	-2.9
General Government Debt	118	121	120	117
Exchequer Borrowing Requirement (€billion)	15.6*	15.3	11.2	7.5

Source: Department of Finance

Notes:

*Excludes the 2012 IBRC Promissory Note payment which was settled with a Government bond.

General Government Balance and Fiscal Consolidation Forecasts 2013 - 2015

	2013	2014	2015
		<i>% of GDP</i>	
General Government Balance limit – as set by ECOFIN Council	-7.5	-5.1	-2.9
Forecast General Government Balance (November 2012)	-7.5	-5.0	-2.9
		<i>€ billion</i>	
Estimated Fiscal Consolidation	3.5	3.1	2.0
Expenditure	2.25	2.0	1.3
➤ Current	1.70	1.9	1.3
➤ Capital	0.55	0.1	0.0
Revenue*	1.25	1.1	0.7
➤ New Measures	1.03	0.9	0.6
➤ Carry Forward	0.22	0.2	0.1

Source: Department of Finance & Department of Public Expenditure and Reform

Notes:

- Rounding may affect totals.

*While the aggregate annual consolidation amounts are consistent with the November 2011 MTFS the breakdown between new tax measures and the impact of carry forward from measures introduced previously has changed marginally. Budget 2013 will set out further detail in this regard, including in relation to estimates of the carry forward yield from measures introduced in previous years.

Chapter 1

Recent Developments and Emerging 2012 Economic and Fiscal Outlook

1.1 Recent Developments: Overview

Economy

The recent data-flow is consistent with a modest increase in the level of economic activity in Ireland this year. At this stage, GDP is projected to increase by 0.9%, a slight increase on the forecast published in the *April Stability Programme Update (SPU)*.

The shift in the composition of activity – away from domestic demand and into the exporting sectors – that has characterised developments in recent years is continuing. In particular, the unwinding of previously accumulated imbalances continues to weigh on domestic demand and on overall activity. Support for overall activity is coming from the exporting sectors, with services exports becoming an increasingly important engine of growth in recent quarters. This, in no small part, reflects the improvements in price and cost competitiveness that have been evident since the onset of the crisis.

The ongoing rebalancing of activity continues to have adverse implications for the labour market, given that the employment content of export-led activity is typically lower than that for activity driven by domestic demand. Employment has remained on a downward path in the first half of this year, with job losses being recorded in a majority of sectors. Notwithstanding this, unemployment has shown some tentative signs of stabilisation over the course of the year, albeit at levels that are too high.

Over the past few years, the weakness of domestic demand has helped keep a lid on inflationary pressures, thereby providing some support to household incomes in real terms. More recently, however, the rate of inflation has picked up somewhat, mainly on foot of external factors such as commodity prices.

Fiscal

The public finances continue to improve on foot of the implementation of adjustment measures and a return to modest GDP growth. Last year, the underlying General Government deficit – that is the deficit excluding the direct impact of banking support measures – improved to 9.1% of GDP, from an equivalent 10.7% of GDP outturn recorded in 2010. The 10.6% of GDP deficit limit for 2011 set under the terms of the ECOFIN Council decision of 2010 was therefore achieved by a significant margin.

On the basis of developments to end-October, the position looks set to improve further this year. Tax revenues have performed reasonably well so far in 2012 following their return to growth last year for the first time since 2007. While there are spending pressures evident in the Health and Social Protection areas, the aggregate position is that this year's 8.6% of GDP deficit limit looks likely to also be achieved. In addition, quarterly Exchequer primary balance and Central Government net debt targets set as part of the *EU/IMF Programme* continue to be met, most recently for end-September.

1.2 Emerging Economic Outlook 2012

Following a quarterly decline of 0.7% in the first quarter, the level of GDP stabilised in the second quarter of this year.

On the domestic side, consumer spending remained subdued in the opening half of the year reflecting falling real wages as well as relatively high rates of saving by households. However, high-frequency data provide tentative evidence of stabilisation in more recent months. For instance, core retail sales have stabilised in recent months, which is consistent with the modest improvement in consumer sentiment seen over the same period. Taking all of these developments into account, a decline of 2.0% in consumer spending is envisaged for this year.

Uncertainty regarding short-term prospects continues to weigh on business investment, with spending on machinery and equipment – excluding purchases of aircraft – remaining at low levels in the first half of the year. Falling housing investment continues to dampen overall building and construction investment, with housing start data consistent with a further reduction in the second half of the year. All-in-all, a decline of 3.8% in investment spending is projected for this year.

Turning to external developments, exports of goods and services increased at an annual rate of nearly 6% in the first quarter before slowing to just over 2% in the second quarter. Of particular interest is the near double-digit growth in services exports recorded in this period. While high-frequency data remained in broadly positive territory during the summer, there is now mounting evidence to suggest that external headwinds are gaining momentum. External demand has slowed in many of our main export markets with, for instance, GDP in the euro area set to contract in 2012. Accordingly, short-term growth projections for our main trading partners are being revised downwards, and this may well affect Ireland's export performance in the second half of the year. At this stage, an increase of 3.0% for the year as a whole is anticipated.

Imports of goods and services are projected to remain flat this year, following expected developments in final demand as well as imports in the first two quarters. As a result, and taking account of external price developments, the trade surplus is likely to expand once again this year, contributing positively to the current account of the balance of payments. Second quarter figures show a sharp increase in profit inflows to Ireland, significantly increasing the current account surplus and raising the growth rate of GNP relative to GDP.

Drawing all of these elements together, the emerging picture is one of modest growth in the second half of this year, with a positive contribution from net trade offsetting further weakness in domestic demand. At this juncture, GDP is projected to increase by 0.9% for the year as a whole. GNP growth is assumed to be somewhat stronger, at 1.4% in large part reflecting the increase in profit inflows recorded in the second quarter.

Data for the first half of the year confirm that employment losses in many sectors have not yet bottomed out. And while some sectors – mainly those closely associated with exports – are showing employment gains, a further decline in aggregate employment, estimated at 1.2%, is in prospect for this year.

Live register data for the first ten months of the year show some stabilisation in the rate of unemployment, which is forecast to average 14.8% this year. The stabilisation in unemployment at a time of falling employment is explained by the decline in labour supply, due to falling participation rates and, more importantly, demographic factors. In relation to the latter, net outward migration amounted to 34,000 in the twelve months to April of this year, a figure equivalent to around 0.7% of the population.

As measured by the harmonised index of consumer prices, inflation looks likely to average 2.1% this year (2.0% on a CPI basis). Allowing for *inter alia* a marginal deterioration in the terms-of-trade, a 1.7% increase in the GDP deflator – the widest measure of price developments in the economy – is projected for this year.

1.3 Emerging Fiscal Outlook 2012

The paragraphs that follow refer primarily to the Exchequer position as of end-October. Information regarding the Exchequer position is the most up-to-date information available on the performance of the public finances. The end-November Exchequer Returns will provide further information that will assist in forming an updated view in the context of *Budget 2013*.

End-October Exchequer Returns

Exchequer tax revenue of €28.35 billion was collected in the period to end-October 2012. When compared to the same period in 2011, tax receipts were up 6.3%. Adjusting for the impact of delayed corporation tax receipts and a PRSI/income tax reclassification issue, the year-on-year growth rate is lower, though still a robust 4.3%.

In aggregate terms, total tax revenues were 0.3% better than planned in the first ten months of 2012. However, the surplus against profile has narrowed since the mid-way point in the year, largely as a result of a very significant but not unexpected corporation tax shortfall in October. Weaker than expected PAYE and Universal Social Charge (USC) income tax and excise receipts in the four month period July – October have also been a factor.

In aggregate terms, income tax has performed well so far this year, recording a 0.6% surplus against profile in the period to end-October. It is up an estimated 8.6% year-on-year, on an adjusted basis. This is a strong performance, especially considering that there were no income tax increases introduced in *Budget 2012*. Much of this year-on-year growth is therefore attributable to carryover effects from measures introduced in *Budget 2011*.

The main sub-components of income tax are PAYE and the USC, which together account for over 80% of total income tax. While both were almost exactly in line with profile in the ten month period to end-October, there was a weakening of receipts in the third quarter. The main sub-components delivering the surplus in income tax in the year to date are Deposit Interest Retention Tax (DIRT) and Dividend Withholding Tax. The surplus in DIRT receipts may reflect the high savings rate prevalent in the Irish economy at present.

It is particularly encouraging that VAT receipts have performed better than expected following the two percentage point increase in the standard rate introduced in *Budget 2012*. For the year as a whole a 2.6% increase in VAT receipts was targeted. Receipts at end-October were 3.5% higher year-on-year and 1.3% ahead of profile. Notably, monthly targets have been achieved in three of the last four months and more significantly in both of the most recent VAT “due” months – July and September.

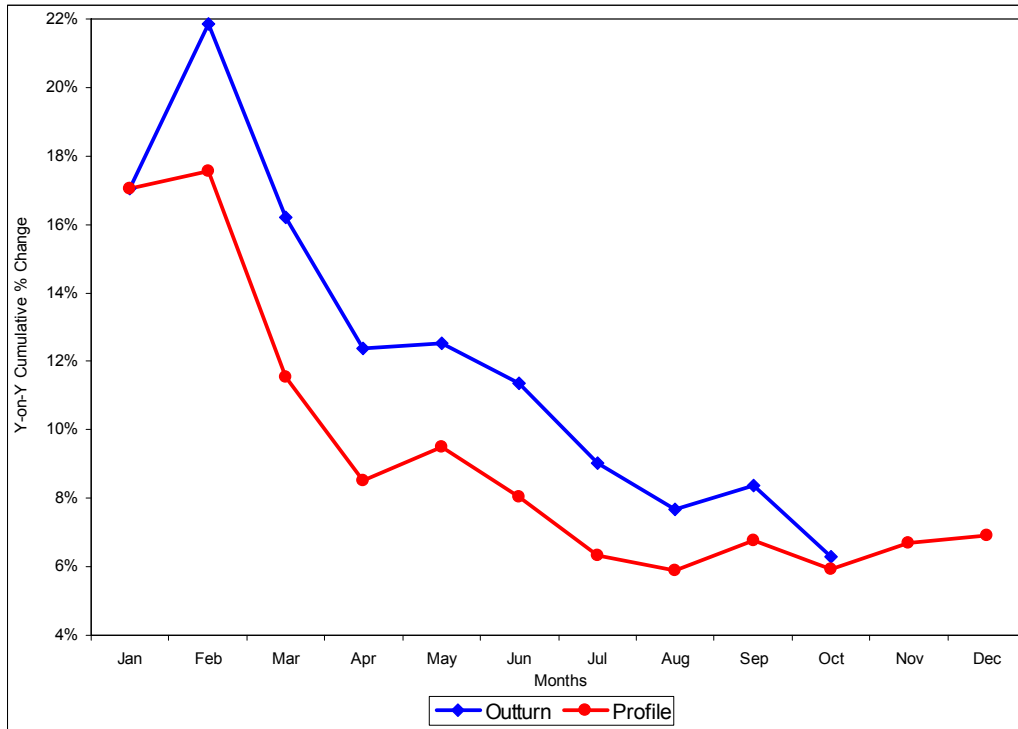
Excise receipts have weakened noticeably since mid-year and at end-October were 4.1% below profile. All of the main sub-components have recorded shortfalls against target so far this year. A shortfall for the year as a whole now seems highly likely.

The last of the “big four” tax-heads is corporation tax. November is the most important month of the year for corporation tax collection with 30% of the annual take (almost €1.2

billion) scheduled for collection in that month alone. Performance in November will be pivotal in determining the overall end-year tax revenue outturn. At end-October corporation tax revenues were 1% ahead of expectations. Receipts in the month of October itself were significantly down on profile but this was not unexpected based on advance information supplied to the Department of Finance by the Revenue Commissioners.

Figure 1.1 shows the cumulative performance of tax revenues in the first ten months of 2012 as compared to the revised profile published in early May.

Figure 1.1: End-October 2012 Cumulative Tax Revenue Outturn v Profile



Source: Department of Finance

Considering all of the above, the Department of Finance is of the view that tax revenues for the year as a whole will be broadly in line with profile, with the possibility of a marginal surplus, of the order of €0.2 billion (½%) being recorded. Much will depend on the performance of tax revenues in November. It is the most important month of the year for income tax and corporation tax and it is also the last VAT “due” month of the year. All told, €5.7 billion or close to 16% of the total tax expected this year is profiled for collection in the month. Good performances are required from each of these three taxes if the annual aggregate target for taxes is to be achieved.

As regard expenditure, total net voted expenditure at end-October, at €36.7 billion, was 0.8% lower year-on-year and 0.2% ahead of expectations. A significant voted capital expenditure shortfall of €336 million (14.2%) is almost completely offsetting a voted current spending overrun of €124 million (1.2%).

It must be acknowledged however that a large part of the voted current expenditure overrun is due to a shortfall in PRSI receipts, thereby necessitating a higher subvention to the Social Insurance Fund (SIF) from the Exchequer. Adjusting for this PRSI shortfall,

net voted current expenditure is around €135 million above the level planned. 13 of the 16 Vote Groups are managing current expenditure within allocations and this is a positive development in the context of deficit reduction.

Nonetheless, there are notable current spending pressures in the areas of Health and Social Protection in particular. Some of this pressure is caused by cyclical factors such as higher than expected numbers on the live register which is manifesting itself in a higher volume of *Jobseekers Allowance* expenditure. These overruns are a cause of significant concern and at this point it will be a significant challenge to bring overall voted expenditure in on target by end-year.

The large capital spending shortfall evident at end-October is driven primarily by timing issues and expenditure is expected to accelerate over the final two months of the year, thereby ending the year close to profile.

Taken as a whole, it is anticipated that voted expenditure in 2012 will be somewhat higher than anticipated in the *Revised Estimates for Public Services* published earlier this year, almost exclusively as a result of the pressures evident in the Health and Social Protection areas.

The current working estimate of the Exchequer deficit for 2012 is €5.6 billion¹. The improvement compared to the SPU is due largely to the treatment of this year's IBRC Promissory Note payment. Adjusting for this, the estimate is virtually unchanged at the aggregate level although there have been some compositional adjustments. Higher voted current expenditure is expected to be offset by a marginal tax revenue surplus and lower than expected cash debt interest expenditure.

Based on the Department of Finance's current macroeconomic and fiscal assessment, and consistent with this latest estimate of the Exchequer deficit, the emerging General Government deficit estimate, at 8.3% of GDP, is very much in line with the April SPU estimate. Importantly it is within the 8.6% of GDP limit. The nominal level of the deficit, at €3.5 billion is approximately €350 million worse than estimated at the time of the SPU, due primarily to the higher voted current expenditure referred to above. However this is offset by a higher GDP level which means the 8.3% of GDP SPU forecast remains unchanged.

¹ The April SPU Exchequer deficit estimate of €8.7 billion included, as part of non-voted capital expenditure, a €3.06 billion payment in respect of the IBRC Promissory Note. However this €3.06 billion payment was settled with a Government bond and the transaction is not included in Note 6 of the end-October Exchequer Statement (non-voted capital expenditure) due to the statutory payments basis of the Finance Accounts (with which the Exchequer Statement aligns) and the exceptional nature of the transaction in that regard. Therefore it is not accounted for as part of the Exchequer deficit in 2012 as the 2011 payment in respect of the IBRC Promissory Note was last year.

Chapter 2

Fiscal Consolidation Strategy

2.1 Background

Ireland has been engaging in a fiscal consolidation strategy since mid-2008. The process started because of the widespread recognition internally that the public finances were deteriorating very rapidly, so Ireland was “ahead of the curve” in that respect.

Expenditure reducing and revenue raising measures designed to save/yield approximately €25 billion (around 16% of 2011 GDP) have been implemented to date. This is a very significant level of consolidation by any measure. The revenue raising and expenditure reducing measures introduced have been wide-ranging and have had a significant impact on the living standards of all the citizens of the State.

The current strategy is gradually delivering on its principal aim of returning the public finances to a more sustainable position. All quantitative fiscal targets set so far under the *EU/IMF Programme* have been achieved and this year’s deficit, currently estimated at 8.3% of GDP, is on track to again come within the limit set, as was the case last year. It is also a marked improvement on the equivalent underlying deficit of 10.7% of GDP recorded in 2010.

This improvement has come about as a result of the difficult decisions that have been taken to reduce expenditure and raise revenue over the last number of years but also through a return to economic growth last year for the first time since 2007.

2.2 Rationale for Further Fiscal Consolidation

Notwithstanding the progress made, it is clear that there remains a very large gap between revenues and expenditure. This year that gap, in General Government expenditure and revenues terms is estimated to be €13.5 billion or 8.3% of GDP. This is likely to be one of, if not, the highest deficit in the EU.

At present this gap is being filled by large volumes of borrowing, the majority of it at very favourable interest rates from the *EU/IMF Programme*. Given the volume of borrowing required, the State’s debt-to-GDP ratio is set to rise further next year, as is the proportion of revenue that goes towards servicing that debt.

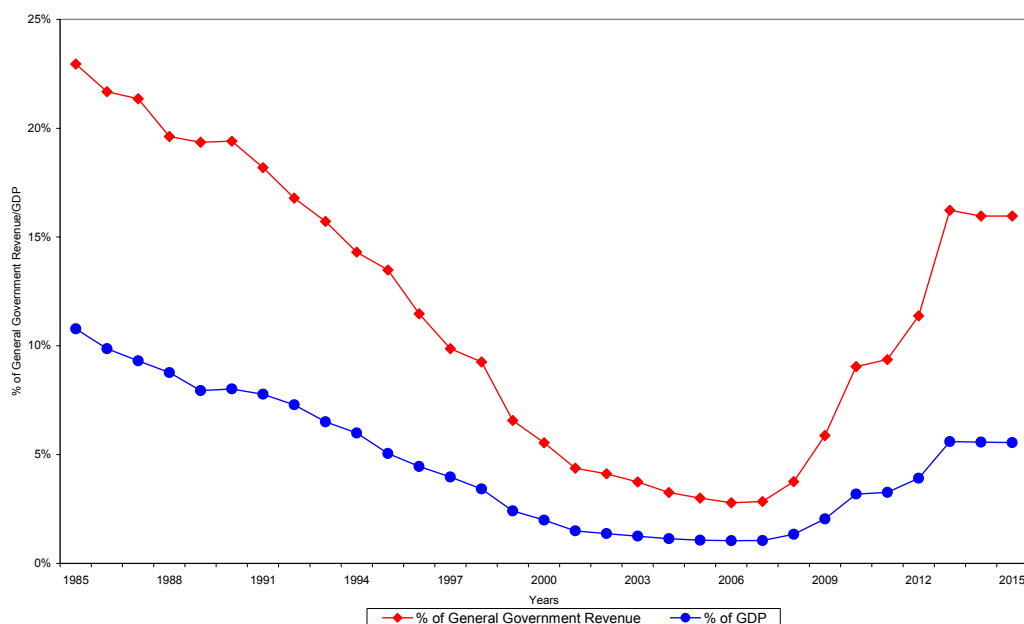
The Government remains steadfast in its commitment to continue meeting fiscal targets. It is very important to remain on a credible path of adjustment towards renewed fiscal sustainability. Moving towards a sustainable fiscal position is a necessary pre-condition for restoring the economy to robust growth and ensuring that the re-entry to international bond markets which took place over the summer can be sustained at competitive interest rates.

Consolidation is necessary to reverse the rapid increase in the debt-to-GDP ratio seen in recent years, thus ensuring that debt remains sustainable. Unless debt is reduced, the burden of debt servicing will continue to absorb an increasing proportion of the State’s resources. Revenue and expenditure must continue to be more closely aligned in the coming years. While improvements in the economy will help, higher levels of activity alone will not be sufficient to close the gap as part of the deficit is structural in nature. That is one of the reasons why the process of fiscal consolidation must continue.

As recently as 2007 the equivalent of just less than 3% of all General Government revenues (or 1% of GDP) were required to meet the State’s debt interest expenditure obligations. This year, the equivalent figures will be over 11% and close to 4% respectively. To put that 2012 interest expenditure figure in context, it is close to two-thirds of all the revenue the State will collect in VAT this year.

Notwithstanding the scale of the fiscal adjustment that has already been implemented, with additional measures to come in the years ahead, this interest/revenue ratio is forecast to rise further next year, before stabilising at around 16% in 2014 and 2015. The equivalent interest/GDP ratio in 2014 and 2015 is estimated at just over 5½%. These are certainly elevated ratios but importantly they are well below the levels seen in the mid-1980s when the equivalent figures were over 20% of revenue and close to 11% of GDP – see figure 2.1.

Figure 2.1: General Government Debt Interest Burden 1985-2015



Source: Eurostat, Central Statistics Office (CSO), Department of Finance & NTMA.

While fiscal consolidation does have negative economic implications, particularly so in the short-run, the Government will endeavour to implement the consolidation in a manner that balances the twin considerations of reducing the deficit in line with commitments and supporting the economic recovery. The Government will also aim to ensure that the necessary consolidation is implemented in as fair and equitable a manner as possible.

Under the terms of the corrective arm of the Stability and Growth Pact (SGP) Ireland is required to reduce the deficit below 3% of GDP by 2015. This 2015 deadline allows for the implementation of a phased consolidation strategy in a manner that should allow the economic recovery to strengthen. Based on current estimates, almost three quarters of the consolidation required to meet the 3% deficit target has already been implemented.

2.3 Volume and Composition of Fiscal Adjustment 2013-2015

Given that a still significant level of further fiscal adjustment is required to reduce the deficit below 3% of GDP by 2015, a combination of both revenue raising and expenditure reducing measures must be implemented.

Last November's *MTFS* laid out a multi-annual fiscal consolidation strategy for the period to 2015. It showed the levels of consolidation deemed necessary to deliver upon annual deficit targets. It also showed the proposed split between expenditure and revenue measures and, within expenditure, between current and capital measures. The Government remains of the view that this consolidation path is broadly appropriate.

Table 2.1 Fiscal Consolidation Estimates and Breakdown 2013 - 2015

	2013	2014	2015
		<i>€ billion</i>	
Total Consolidation Amount	3.5	3.1	2.0
Expenditure	2.25	2.0	1.3
➤ <i>Current</i>	1.70	1.9	1.3
➤ <i>Capital</i>	0.55	0.1	0.0
Revenue*	1.25	1.1	0.7
➤ <i>New Measures</i>	1.03	0.9	0.6
➤ <i>Carry Forward</i>	0.22	0.2	0.1

Source: Department of Finance & Department of Public Expenditure and Reform

Notes:

- Rounding may affect totals

*While the aggregate annual consolidation amounts are consistent with the November 2011 *MTFS* the breakdown between new tax measures and the impact of carry forward from measures introduced previously has changed marginally. Budget 2013 will set out further detail in this regard, including in relation to estimates of the carry forward yield from measures introduced in previous years.

In designing a consolidation strategy it is important to consider whether a particular measure contributes to a closer alignment of revenue and expenditure or constitutes an improvement to the efficiency of fiscal structures. It is also important to bear in mind other considerations such as the characteristics of a small open economy like Ireland's which relies heavily on international trade and foreign direct investment, as well as the need to ensure fairness.

The Government remains committed to adhering to the 7.5% of GDP General Government deficit target set for 2013. The 2011 target set was achieved and the 2012 target is also on track to be delivered. The Government is determined to stay the course in this regard and to ensure continued adherence to fiscal targets.

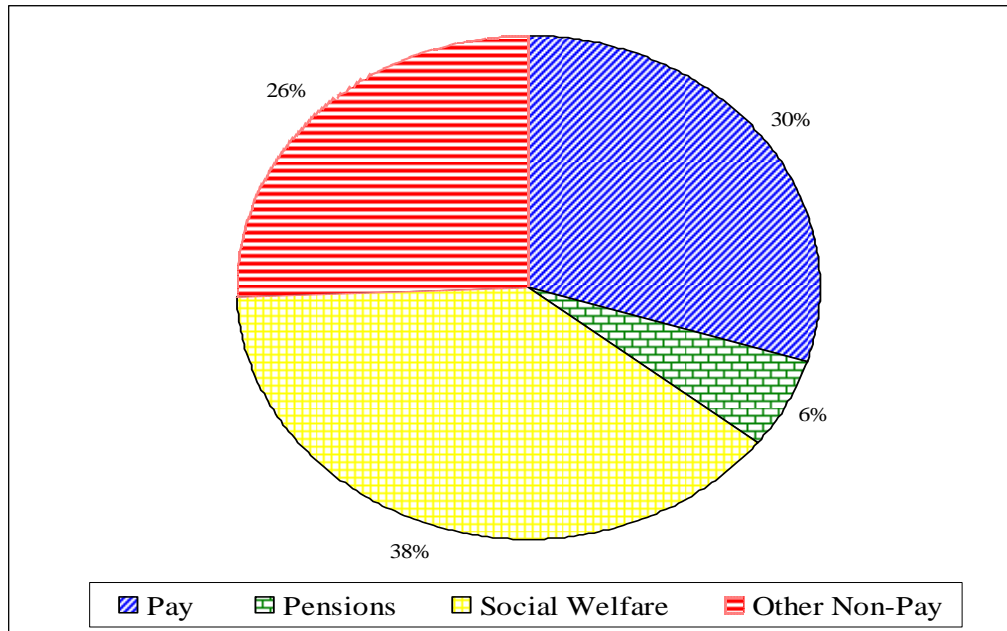
Analysis of the fiscal situation and targets, taking all relevant economic and fiscal factors into account, confirms that the consolidation parameters set out by the Government in last year's *MTFS* remain broadly valid at this time. The precise detail of the measures that are to be introduced next year will be set out in *Budget 2013*.

Future Expenditure Adjustment Measures

The *Comprehensive Expenditure Report 2012-2014 (CER)* introduced a range of budgetary reforms including a Medium Term Expenditure Framework (MTEF). The key features of the MTEF include fixed multi-year aggregate expenditure ceilings alongside fixed multi-annual Ministerial expenditure ceilings. The multi-annual dimension to the ceilings encourages a more focused approach to medium-term structural and strategic planning of expenditure within departments. The fixed nature of the multi-annual ceilings encourages Departments to adopt a more prudent approach to financial planning and allows Departments to take more direct responsibility with regard to managing expenditure within their allocations in a clear and transparent fashion. While the MTEF has been in place on an administrative basis throughout 2011, the recently published *Ministers and Secretaries (Amendment) Bill 2012* will put the Ministerial expenditure ceilings on a statutory footing.

The scale of consolidation required can only be achieved through contributions from all the main components of expenditure. All options are being considered and the 2013 package will include measures to ensure social expenditure reductions and reductions in the total pay and pensions bill. As can be seen from figure 2.2, social welfare spending and pay bill costs constitute the two largest portions of gross current expenditure.

Figure 2.2: Gross Pay, Pensions, Non-pay and Social Welfare as a % of Gross Current Expenditure in 2012



Source: Revised Estimates for Public Services 2012

In relation to the public service wage bill, recent overtime and sick pay reforms will continue to be progressed by targeting unjustified pay allowances for elimination, or medium-term restructuring. All options are under consideration in order to improve the sustainability of the public sector wage bill and achieve the envisaged current expenditure savings while protecting the delivery of public services.

To ensure that the level of expenditure on the social supports is contained and well-targeted, it will be necessary to examine the full range of social transfers, including universal benefits, in order to identify savings and efficiencies while protecting the most vulnerable and minimising work disincentives. This review will take into account the 2011 Comprehensive Review of Expenditure and the projected increase in age-related spending, as highlighted in the recent actuarial review of the SIF.

The consolidation strategy continues to be implemented with a view to supporting employment creation through a wide range of measures. The *Pathways to Work* scheme has recently launched its new unemployment support service, Intreo. The program aims to accelerate the profiling of job seekers and further increase engagement with unemployed individuals at both the group and individual level. Further to this, identifying and implementing measures to improve the business climate in 2013 and beyond remains a key priority with specific focus on promoting access to finance and investment by SMEs, supporting indigenous start-ups, and developing and deepening the impact of foreign direct investment.

The five year capital Exchequer framework was published in "*Infrastructure and Capital Investment 2012-2016: Medium Term Exchequer Framework*" in November 2011. This document identifies the Government's key capital strategic priorities for that five year period, emphasising investment which will provide the greatest economic return or which meets urgent social requirements.

Commencing in 2013, the Exchequer capital expenditure programme will be supplemented by €1.4 billion through public-private partnerships (PPPs) with the European Investment Bank (EIB), the National Pension Reserve Fund (NPRF), and private investors. Projects have been identified in education, transport, health care, and justice. The strategic disposal of state assets will proceed in 2013 as planned with at least half of the proceeds used to reduce public debt in due course. Once realised, the remaining proceeds will be reinvested in job-rich projects of a commercial nature, consistent with our fiscal targets.

On 17 November, 2011, the Government's *Public Service Reform Plan* was published, setting out an ambitious agenda for radical and sustainable reform of the Public Service.

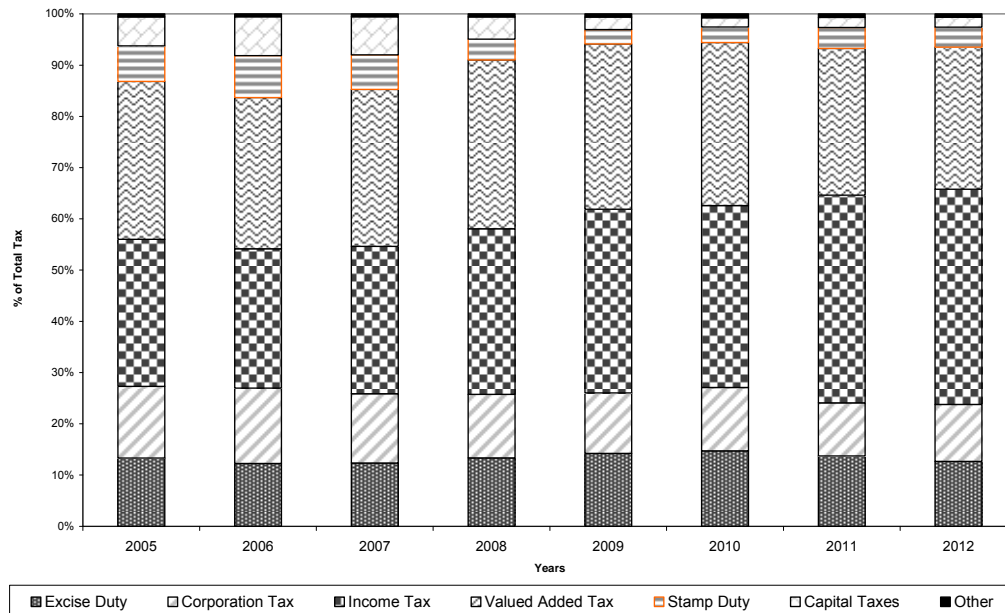
In a context of reduced public expenditure and significantly fewer public servants, reform of the Public Service is essential to ensure the provision of key public services, for which there is increasing demand. Many of these reforms will yield cost savings in the medium- and longer-terms, as well as improving efficiency, effectiveness and the integration of the Public Service. As set out in the *Progress Report* published on 6 September 2012, significant progress is being made across the wide range of central and sector specific initiatives set out in the *Public Service Reform Plan* and Sectoral Reform Plans.

Future Revenue Adjustment Measures

The strategic objective, when implementing future revenue consolidation measures, is to ensure that the burden is spread in a manner that is both fair and sustainable in the longer-term. The primary focus will continue to be on the taxation of immobile assets rather than employment.

In that context, the current Government policy is to maintain the current rates of income tax together with bands and credits, in keeping with the aim of re-invigorating the labour market. Much of the revenue adjustment thus far has come from income tax, which now accounts for around 42% of total tax revenue.

Figure 2.3: Composition of Exchequer Tax Revenue 2005-2012



Source: Department of Finance

Following through on this commitment will be dependent to a large extent on making further progress in implementing revenue changes in other areas so that the objective of meeting fiscal targets is achieved.

The Government is actively considering its options in terms of revenue raising measures but has already signalled its intention, including in the *EU/IMF Programme Memorandum of Understanding (MoU)* to bring forward the introduction of a value-based property tax next year. The precise details will be announced as part of *Budget 2013*.

The MoU also commits the Government to a further broadening of the personal income tax base. Such base broadening may include the curtailment, reduction or abolition of a variety of income tax reliefs and a broadening of the PRSI base generally.

Indirect taxation will also play a role and a restructuring of motor taxation and Vehicle Registration Tax (VRT) are important components of the overall revenue raising strategy.

Stability of the revenue base is key, hence the introduction of a property tax and continuing emphasis on base broadening generally rather than rate increasing. Tax revenues in the future must not be as susceptible to economic downturns as the capital taxes generated in the mid-part of the last decade were. Accordingly, recognition must be given to not just the “quantity” of revenue to be raised but also to the “quality” of measures adopted.

Budget 2013 will be presented on Wednesday, 5 December and will set out in further detail the nature of the revenue measures that are to be implemented.

2.4 Impact of Consolidation on Economic Growth

There can be no escaping the fact that fiscal consolidation has negative economic implications, particularly so in the short-run. While the short-run impact may see a reduction in economic output, over the medium-term positive effects are expected as the

fiscal deficit is reduced and increased investor confidence translates into a lower risk premium which allows public debt to be put on a declining path.

Recent IMF staff research² on the size of fiscal multipliers has attracted considerable attention. The research suggested that multipliers for many countries had been underestimated in recent years. It is important to point out that this result did not hold for Ireland, suggesting that multiplier estimates used by most forecasters remain appropriate.

The compliance shown with the requirements of the *EU/IMF Programme* and the consistent achievement of fiscal targets has restored a great deal of Ireland's reputation. This has helped lower the interest rate demanded by international investors, thereby facilitating the return of the State to the international bond markets. It will in turn assist in reducing, over time, debt service payment costs which have to be borne by the taxpayer.

The *Irish Fiscal Advisory Council* has called for a strengthening of the consolidation effort and the targeting of a lower deficit by 2015. The Council believes that it would be prudent for the Government to implement more consolidation than currently planned so as to achieve a deficit of 1.9% of GDP in 2015. The Council is of the view that this would require €1.9 billion in additional consolidation measures over what is currently planned. The Council's view is that this would result in a significantly improved debt trajectory. This is a reasonable view and one the Government considered carefully in its deliberations.

However, there is a balance to be struck between the size of consolidation and the need to support the emerging economic recovery. In this context, the Government believes that adhering to the commitment to reduce the deficit to below 3% of GDP by 2015 and continuing to deliver on the *EU/IMF Programme* commitments is the appropriate way of restoring the public finances to health. The approach is working and the view of Government is that it would be unwise to deviate from the current strategy at this point.

A more detailed response to the Council's September *Fiscal Assessment Report* can be found in chapter 6.

² IMF World Economic Outlook – October 2012

Chapter 3

Economic and Fiscal Outlook 2013-2015

3.1 2013 Economic Outlook

The external environment in which the Irish economy operates has deteriorated relative to earlier expectations, as some of the previously-identified risks to the global economy have materialised to some extent. In addition, recent developments suggest domestic demand remains soft. Against this general backdrop, a downward revision to previously published forecasts for economic growth appears warranted at this stage.

In the relation to the external situation, the pace of GDP growth in some of our key export markets has slowed and, in some cases, has moved into negative territory in recent months. The intensification of the euro area sovereign debt crisis in late-spring has been an important contributory factor, operating in part through the business and consumer confidence channels. That said, the announcement by the Eurosystem in early-September of the outright monetary transactions programme (OMTs) in the secondary market for euro area sovereign debt may help restore confidence, although it may be some time before this feeds through into activity in our major trading partners.

Fiscal consolidation is another factor weighing on aggregate demand in many regions, while relatively high oil prices – mainly due to supply-side developments – are reducing disposable incomes in many of our trading partners. All institutions which forecast the international economy are revising down the outlook for 2013 in Ireland’s trading partners compared with their view of late spring, in particular for the euro area and the UK. However the US recovery appears reasonably healthy at this juncture, notwithstanding the obvious downside risk from the ‘fiscal cliff’.

Finally, it is also worth highlighting the weaker outlook for many of the key emerging market economies, which have been important contributors to global economic expansion in recent years. Forecasts for the key external variables are presented in the table below and are taken from the IMF’s October World Economic Outlook, the most recent set of forecasts for Ireland’s trading partners out to 2015.

Table 3.1: External Assumptions

<i>% Change</i>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
External GDP Growth				
G20 countries	1.4	1.5	2.2	2.5
Advanced G20 countries	-0.4	1.1	2.2	2.6
United States	2.2	2.1	2.9	3.4
Euro Area	-0.4	0.2	1.2	1.5
United Kingdom	-0.4	1.1	2.2	2.6
Technical Assumptions				
Euro-Sterling Exchange Rate	0.81	0.80	0.80	0.80
Euro-Dollar Exchange Rate	1.28	1.28	1.28	1.28
Brent Crude (US \$ per barrel)	111.6	108.4	108.4	108.4
Brent Crude (€per barrel)	87.2	84.7	84.7	84.7

Sources: IMF World Economic Outlook October 2012 (growth outlook); Macrobond (oil and currency)

Notes:

- Exchange rate figures are Department of Finance technical assumptions involving the maintenance of unchanged rates from those in mid-November (10 day average).

- Oil price figures are based on market futures at mid-November (10 day average).

Against this external backdrop, the short-term outlook for the Irish economy has weakened. Export growth looks set to moderate next year relative to previous forecasts, given the softening of activity in both the euro area and the UK. An increase of 3.3% is now anticipated, with services exports assumed to lead the way.

Table 3.2: Macroeconomic Projections 2012-2015

<i>% change, unless otherwise stated</i>	2012	2013	2014	2015
Real GNP	1.4	0.9	1.7	2.1
Nominal GNP (rounded to nearest €25m)	130,850	133,900	137,775	142,325
Real GDP	0.9	1.5	2.5	2.9
Nominal GDP (rounded to nearest €25m)	163,150	167,725	174,100	181,400
Components of Real GDP				
Private Consumption	-2.0	-0.5	1.0	1.2
Government Consumption	-4.0	-2.7	-2.3	-1.5
Investment	-3.8	3.2	8.3	4.4
Exports	3.0	3.3	4.3	4.8
Imports	0.0	2.3	3.9	3.8
BOP Current Account (% of GDP)	3.4	4.3	4.2	4.3
Contributions to Real GDP Growth				
Domestic Demand (excluding inventories)	-2.1	-0.3	1.0	0.8
Changes in Inventories	-0.2	0.2	0.1	0.0
Net Exports	3.2	1.6	1.4	2.1
Price Developments				
HICP	2.1	1.7	1.8	2.0
GDP Deflator	1.7	1.3	1.3	1.3
Labour Market				
Employment	-1.2	0.0	0.9	1.3
Unemployment (% of labour force)	14.8	14.5	13.9	13.0

Source: Department of Finance

Rounding may affect totals

Domestic demand looks set to contract once again next year, for the fifth successive year. Personal consumer spending is projected to contract by 0.5%, reflecting a further decline in real disposable income of the household sector. In addition, the need for further balance sheet repair and continued uncertainty regarding future income prospects mean that households will likely maintain savings at elevated levels.

On the investment front, recent FDI announcements should provide some support to machinery and equipment spending, although continued uncertainty and corporate deleveraging are likely to remain features. House-building and other construction-related spending is assumed to remain at relatively low levels so that overall investment spending is projected to rise by a fairly modest 3.2%.

Government spending is forecast to decline by 2.7% next year, with declines likely over the medium term also, reflecting fiscal consolidation measures.

Lastly, imports are projected to increase broadly in line with final demand so that in overall terms, real GDP is forecast to grow by 1.5% next year (GNP by 0.9%). The continued rebalancing of activity will be reflected in our external payments position, with the current account of the balance of payments projected to record a surplus once again next year, increasing to 4.3% of GDP.

3.2 2013 Fiscal Outlook

Ireland is implementing an ambitious programme of fiscal consolidation and structural reforms to improve the sustainability of the public finances. This is the backdrop that has framed fiscal policy since mid-2008 and it will continue to be the overriding policy driver in the medium-term.

The current working estimate of the 2013 Exchequer deficit is €15.3 billion. This estimate assumes a €3.06 billion cash payment from the Exchequer in respect of the next instalment of the IBRC Promissory Note.

Favourable base effects from the estimated 2012 tax revenue outturn mean the current tax revenue forecast for 2013, at €38.4 billion, is virtually unchanged from the April SPU. This base effect largely offsets the negative impact from the ½ percentage point reduction in the forecast nominal GDP growth rate for 2013 compared to the SPU.

This tax revenue forecast is consistent with the implementation of a consolidation package designed to raise approximately €1 billion gross from new revenue measures next year. The precise breakdown of that adjustment is under consideration by Government presently and will be set out in *Budget 2013* on 5 December. As noted elsewhere in this document however, the *EU/IMF Programme* MOU provides a significant level of detail on the likely sources of the revenue adjustment next year.

Tax revenue growth is currently estimated at 5% next year on foot of this adjustment and nominal GDP growth of 2.8%.

This forecast will be subject to further updating in the context of *Budget 2013*, in light of the later information which becomes available in the coming weeks, most notably the tax revenue outturn for the key month of November but also the precise detail of the measures to be implemented next year.

As regards non-tax revenue, fees from the Bank Guarantee Schemes have played an important role in improving the fiscal position in recent years but receipts are forecast to drop off significantly next year, down some 60% in cash terms on the 2012 outturn. Revenues from the surplus income of the Central Bank are expected to remain significant next year. The second 10% dividend payment of some €300 million on the contingent capital provided to the Irish banking system in 2011 is also benefitting the fiscal position.

As regards expenditure in 2013, upward revisions to live register estimates and the associated labour activation scheme costs have been identified as putting upward pressure on expenditure. This is due to the downward revision of the economic outlook but is also likely to be due to unemployment being more structural in nature than previously believed.

Despite these pressures, the Government remains committed to achieving the fiscal targets set out in the consolidation strategy as per the *MTFS* published in November 2011. The underlying expenditure consolidation strategy remains unchanged as per the *Comprehensive Expenditure Review 2012-2014*.

Further to this, the Local Government sector will now be required to ensure that its finances are managed in balance over the medium-term and in particular to ensure a balanced budget is maintained in 2013. This requirement will involve the application of the financial management safeguards and requirements in place within the sector, and will

replace the existing provision for Local Government whereby a €200 million deficit is built into the budget each year.

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 7.5% of GDP in 2013. On the basis of the most up-to-date economic and fiscal data available, the deficit limit is viewed as being achievable on the basis of the implementation of the previously agreed €3.5 billion consolidation package.

The main reason for the relatively small improvement in the deficit next year, from an estimated 8.3% this year to 7.5%, is that the 2013 deficit forecast includes the impact of some €1.9 billion, or 1.1% of GDP, in interest on the Promissory Notes. In light of the interest holiday secured on the Promissory Notes for 2011 and 2012, there was no impact on the deficit in those years arising from this interest. However for 2013, this represents a significant additional General Government expenditure item. Excluding this impact, the 2013 deficit estimate would be 6.4% of GDP, along other things being equal, a 1.9% of GDP improvement on the estimated 2012 deficit.

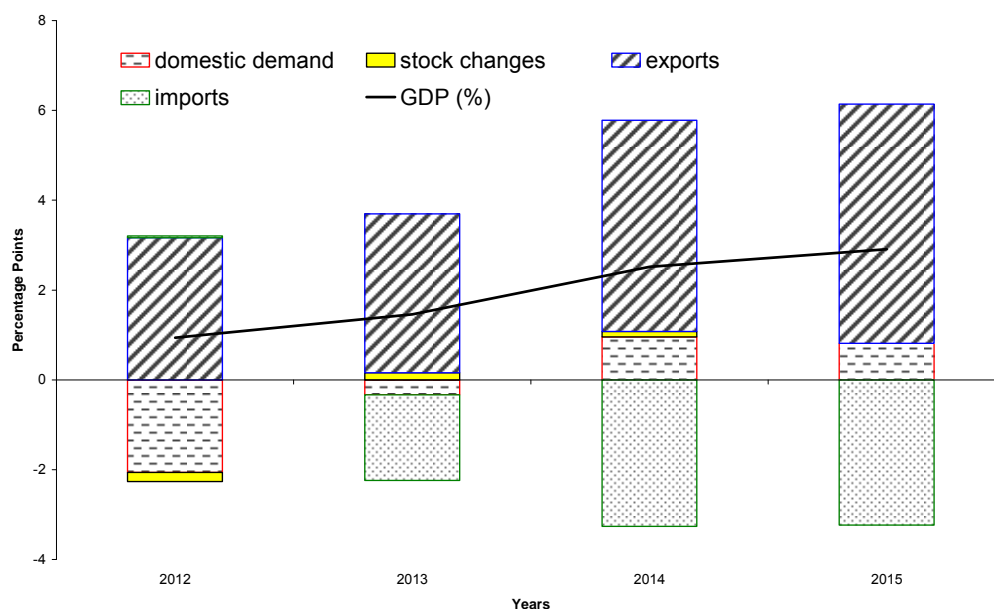
3.3 2014-2015 Economic Outlook

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 compared with previous expectations.

GDP is now projected to grow by 2.5% in 2014 (GNP by 1.7%), a downward revision of around ½ a percentage point compared to April's SPU, whereas growth of just under 3% is foreseen for 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 the second half of 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. Investment growth in 2013 and beyond has been revised up modestly to take into account the announcement in July of the Government's €2.25 billion stimulus plan.

Figure 3.1: Contributions to GDP Growth 2011-2015



Source: Department of Finance

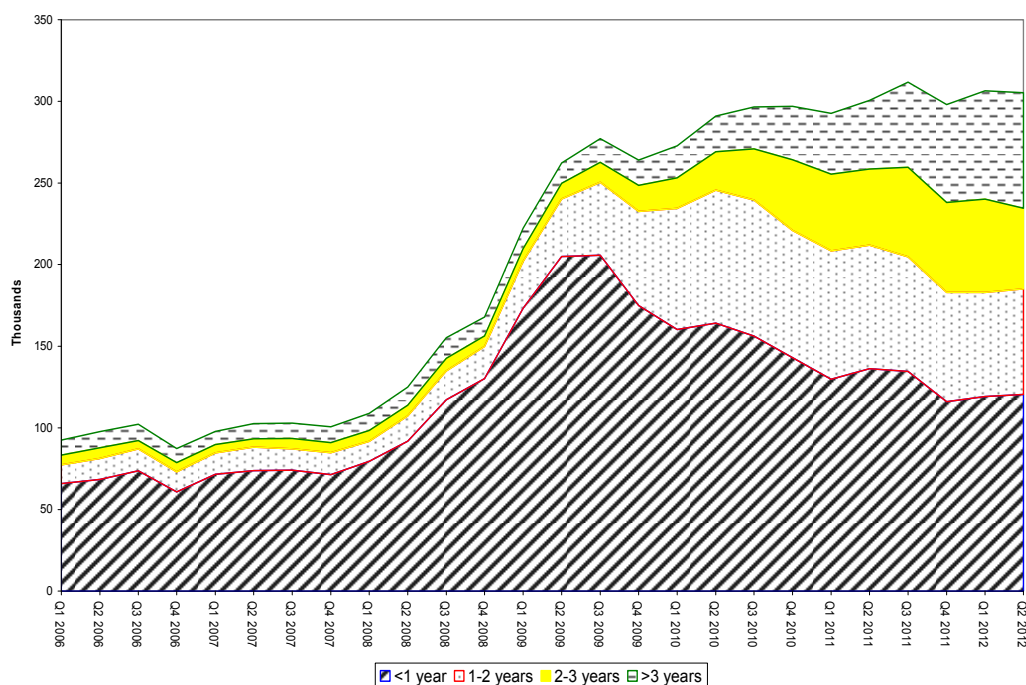
The Labour Market

The level of employment is projected to stabilise next year, following significant declines every year since 2008. A number of factors underpin this assessment. Firstly, the external sector will once again be the main source of growth next year; the capital-intensive nature of such production will limit the scope for significant employment gains. Secondly, the economy is still in the very early stages of recovery. In this phase, firms typically meet any increase in demand by employing their existing workforce more productively rather than risk employing additional staff and recent data in the shape of increases in hours worked support this view. Finally, sectoral trends suggest continued employment losses in a number of areas in the short-term.

Against this general background, job losses are assumed to broadly offset job gains in 2013 with employment likely to be broadly flat relative to this year. However, supported by the Government's various labour market policy initiatives including the stimulus package, the economy is expected to record net employment growth by the second half of next year, with conditions improving thereafter as economic recovery gains momentum and a modest pickup in domestic demand takes hold. A modest fall in the labour force is anticipated for next year, due to a small decline in participation as well as continued net outward migration. With employment effectively flat, the unemployment rate is projected to fall slightly. In 2014 and 2015 a modest pick-up in employment growth is assumed. However labour supply will likely increase in response to the increase in employment so that unemployment will only fall gradually over the forecast horizon.

The composition of unemployment has changed considerably since 2006 (see figure 3.2 below), with long-term unemployment increasing from 29% in the first quarter of 2006 to 61% in the second quarter of 2012. Inflows to unemployment were particularly large in 2008 and 2009, as a result of the sharp contraction in employment at the time. A considerable share of this cohort remains unemployed, with unemployment of over two years duration now at 39% and over three years duration at 23%. This level of persistence suggests that unemployment is becoming increasingly structural in nature.

Figure 3.2: Unemployment by period of continuous duration 2006 – 2012 (Q2)



Source: Department of Finance using CSO data

Price Developments

During 2012, the main upward price pressures have come from elevated energy prices, higher indirect taxes and the impact of administered price hikes. Nevertheless, continued weakness in the domestic economy has kept underlying or “core” inflation muted.

For 2013, annual HICP inflation is forecast to decline somewhat, averaging 1.7% as energy price increases fall out of the annual comparison. Core inflation should remain subdued as domestic demand continues to be held back by a weak labour market and continued fiscal consolidation measures.

Over the medium-term, as the recovery in domestic demand gains momentum during 2014-2015, HICP inflation is expected to pick-up but remain close to 2.0%.

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 remain positive again next year – in the region of 1.3% – on the back of a stabilisation in the terms-of-trade and increases in consumer prices also. Over the medium-term, a gradual firming of the deflator is expected which, in turn, will support a strengthening of nominal GDP growth and the tax revenue base.

3.4 2014-2015 Fiscal Outlook

Over the period 2014-15 nominal GDP growth is forecast to average 4%. In tandem with the implementation of further, though reducing levels of adjustment, growth in tax revenues is expected to strengthen further, averaging around 6¼% over that period.

Economic growth will continue to be predominantly export-driven in the coming years. This type of growth does not generate the same level of tax revenues as growth which is

more domestically-driven and as such tax revenues, even by 2015, are still expected to be some 8% below their 2007 peak level.

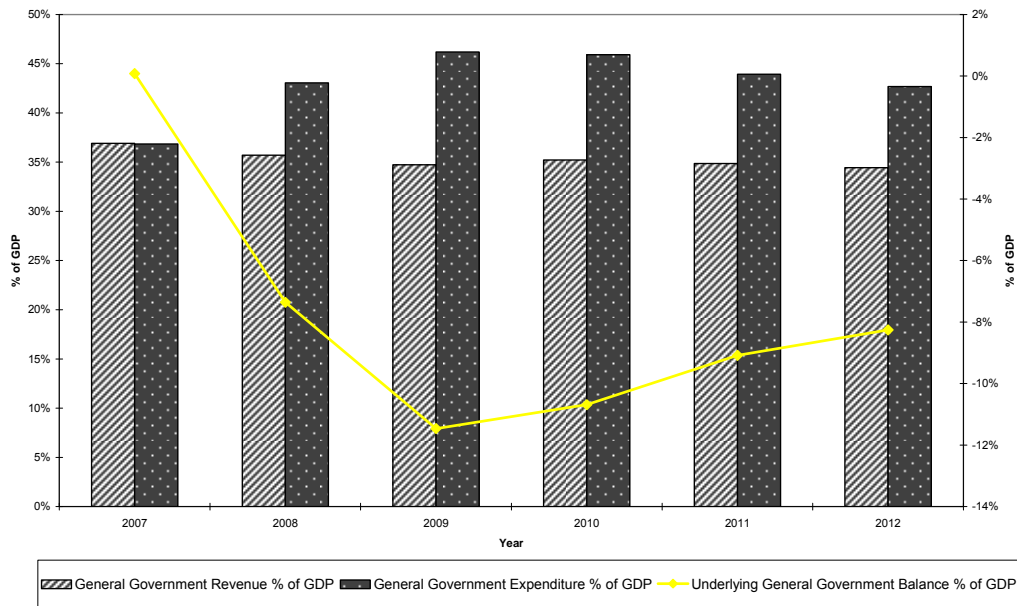
This serves to highlight the unprecedented collapse in tax revenues that took place over the period 2008-2010 and reflects the position that a substantial proportion of the transitory tax revenues derived from the booming construction sector in the early to mid part of the last decade will not return.

Tax revenues are now estimated at €36.6 billion this year, still close to one quarter below their 2007 peak. In contrast, the gross voted current expenditure of Government Departments will have grown by around 7½% in that period, despite the consolidation implemented. This largely reflects the impact of automatic stabilisers stemming from the very significant increase in unemployment seen over the period.

Importantly the figures in the previous paragraph indicate that the gap between revenue and expenditure is closing. As recently as 2010 for example, tax revenues were one third below their 2007 peak whereas gross voted current spending in 2010 was up nearly 12% compared to 2007. These figures also show however that the gap remains large and must be closed further.

As nominal GDP has also fallen significantly since its 2007 peak (down around 14%), total General Government revenue, which in addition to tax revenue, also includes PRSI receipts and non-tax revenues, has remained fairly constant as a percentage of GDP – see figure 3.3. In contrast, even when the impact of banking-related payments is excluded, General Government expenditure as a percentage of GDP continued to grow up to 2009. This mainly reflected increased debt interest (non-voted) costs and unemployment-related (voted) social expenditure.

Figure 3.3: General Government Revenue v Expenditure* 2007-2012



Source: Department of Finance & CSO

Notes:

*Reflects underlying expenditure i.e. expenditure excluding the direct impact of bank support measures

As outlined in chapter 2, the tax system is being restructured so that it is based on more substantive, and therefore less cyclical, sources of tax revenue. Coupled with a return to more robust economic growth over the coming years, Exchequer tax revenues are projected to account for around 24% of GDP by 2015, almost in line with the equivalent 2007 ratio. Including PRSI, the 2015 ratio is estimated to be around 28%.

On foot of further consolidation, discretionary Government spending will continue to fall so that aggregate expenditure is more closely aligned with revenue.

The fiscal projections in Table 3.3 show the steady improvement in the General Government deficit over the coming years. Annual deficit limits, as set by the ECOFIN Council in December 2010 are expected to be met and the deficit is projected to be below 3% of GDP by 2015.

Table 3.3: Fiscal Forecasts 2012-2015

<i>€ millions</i>	2012	2013	2014	2015
CURRENT BUDGET				
Expenditure				
Gross Voted Current Expenditure	52,300	50,915	49,030	47,640
Non-Voted (Central Fund) Expenditure	<u>8,195</u>	<u>9,750</u>	<u>10,265</u>	<u>10,750</u>
Gross Current Expenditure	60,495	60,660	59,300	58,385
less Expenditure Receipts and Balances	<u>10,800</u>	<u>10,675</u>	<u>10,865</u>	<u>11,115</u>
Net Current Expenditure	49,695	49,990	48,435	47,275
Receipts				
Tax Revenue	36,595	38,420	41,005	43,320
Non-Tax Revenue	<u>2,765</u>	<u>2,040</u>	<u>1,775</u>	<u>1,725</u>
Net Current Revenue	39,360	40,460	42,785	45,050
CURRENT BUDGET BALANCE	-10,330	-9,530	-5,650	-2,225
CAPITAL BUDGET				
Expenditure				
Gross Voted Capital	3,960	3,375	3,255	3,255
Non-Voted Expenditure	<u>3,325</u>	<u>4,755</u>	<u>4,260</u>	<u>3,915</u>
Gross Capital Expenditure	7,290	8,130	7,515	7,165
less Capital Receipts	<u>325</u>	<u>315</u>	<u>315</u>	<u>305</u>
Net Capital Expenditure	6,960	7,815	7,200	6,865
Capital Resources	1,690	2,030	1,610	1,625
CAPITAL BUDGET BALANCE	-5,275	-5,785	-5,590	-5,240
EXCHEQUER BALANCE	-15,605	-15,315	-11,245	-7,465
EXCHEQUER PRIMARY BALANCE	-9,880	-8,040	-3,480	710
GENERAL GOVERNMENT BALANCE	-13,470	-12,645	-8,770	-5,345
<i>% of GDP</i>	-8.3	-7.5	-5.0	-2.9
GENERAL GOVERNMENT PRIMARY BALANCE	-7,080	-3,250	930	4,730
<i>% of GDP</i>	-4.3	-1.9	0.5	2.6
Nominal GDP (rounded to nearest €5m)	163,150	167,725	174,100	181,400

Source: Department of Finance, Department of Public Expenditure & Reform & NTMA

Notes:

- Figures rounded to nearest €5 million except for GDP

- Rounding can affect totals

- The technical fiscal forecasts for the years 2013-2015 set out in table 3.3 have been prepared largely on the basis of the consolidation as set out in Budget 2012 and the April 2012 SPU. The precise nature of the consolidation measures to be introduced will be outlined as part of Budget 2013 in December.

- Government decisions with regard to the precise nature of the measures to be introduced will impact these economic and fiscal forecasts and revised forecasts will be published as part of Budget 2013, in light of those decisions and in light of more up-to-date economic and fiscal data that becomes available over the coming weeks, most notably tax revenue collection data for the key month of November.

- For an explanation of the "walk" from Exchequer Balance to General Government Balance, see table 2 in the Supplementary Tables section at the end of this document.

Chapter 4

Debt Analysis and Sustainability and Funding Position

It is important to note that the debt forecasts in this chapter take no account of any benefits that may flow from future developments which may result from the announcement, following the end-June euro area summit, that “*the situation of the Irish financial sector would be examined with the view of further improving the sustainability of the well-performing adjustment Programme*”. Technical work is continuing in that regard.

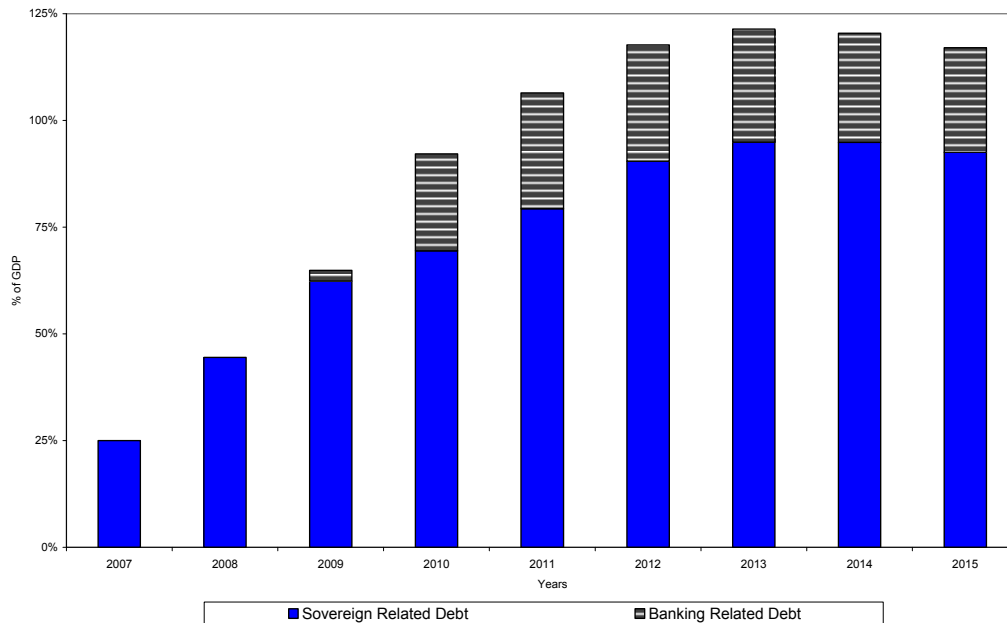
4.1 Recent Trends

Ireland has run large budget deficits since 2008. These are primarily the result of:

- the collapse in revenues and significant increase in cyclical unemployment and debt servicing related expenditure arising from the sharp contraction in economic activity;
- the structurally high level of expenditure, and
- the very substantial level of State support provided to the banking sector.

Figure 4.1 shows that of the estimated €192 billion General Government debt level at end-2012, almost 30% of it relates directly to support provided by the sovereign to the banking sector. Excluding that support, the end-2012 debt-to-GDP ratio would be of the order of 90%. This is a level viewed as being a significant marker in terms of debt. Below it, a State’s debt level is generally seen to be a safe one, whereas a debt ratio above 90% is generally viewed as one that is an impediment to economic growth.

Figure 4.1: General Government Debt 2007-2015



Source: Department of Finance & CSO

Notes:

- “Banking related debt” relates to the direct, gross impact on General Government debt of measures taken to support the Irish banking system through the Exchequer and Promissory Notes.

- No allowance is made for any revenues flowing from the banking sector such as from fees for the Bank Guarantee, interest on contingent capital notes, dividends from the Central Bank to the State as a result of ELA provision or the proceeds from the sale of part of the NPRF Commission shareholding in Bank of Ireland in 2011.

- Similarly, the figures do not take account of the €20.7 billion gross in support provided directly from the NPRF, the Exchequer support provided to the credit union sector or the debt servicing costs of the associated Exchequer borrowing.

Budget deficits have continued to accumulate despite the implementation of a succession of fiscal consolidation packages since mid-2008.

When focusing on the level of debt in Ireland, there are two separate measures which can be referenced. These are National debt and General Government debt. National debt is the net debt incurred by the Exchequer after taking account of cash balances and other related assets.

However the more important measure is General Government debt, which is the total gross debt of the State. It is the measure used for comparative purposes across the European Union and as such is the one to which financial markets pay closest attention. It is calculated as follows:

- add to National debt any cash balances and other related assets;
- add the outstanding Promissory Notes provided to financial institutions as a means of providing State support to these institutions;
- add the amount of coinage in circulation, and
- add the liabilities of non-Exchequer entities, such as Local Government, which are within General Government.

General Government debt increased from €47 billion at end-2007 to €169 billion at end-2011. Over the same period, the debt-to-GDP ratio increased from 25% to 106%.

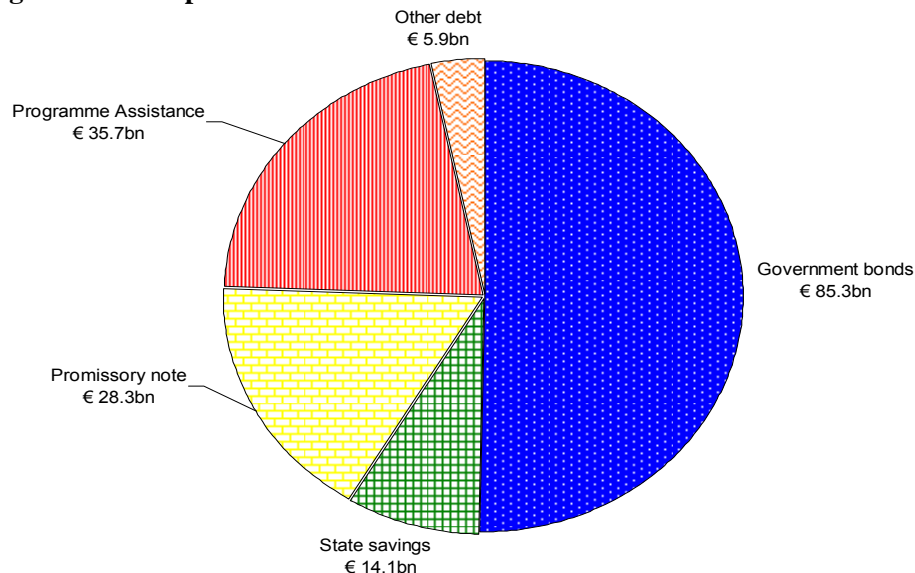
Until 2008, movements in both National debt and General Government debt were closely correlated, as the former would typically have accounted for the vast majority of movement in the latter. However in recent years there have been significant divergences between the measures and there are two primary factors behind this development.

- The first was a result of the strategic accumulation of liquid assets by the NTMA, with an increase in 2008 alone of almost €8 billion. While these liquid assets were used to part fund the Exchequer deficits in recent years, the Exchequer continued to hold balances at an elevated level at end-2011.
- The second factor is the issuance by the Government in 2010 of Promissory Notes to Anglo Irish Bank and Irish Nationwide Building Society (INBS) (now jointly known as Irish Bank Resolution Corporation or IBRC) and the Educational Building Society (EBS). The Promissory Notes increased the level of General Government debt by almost €31 billion in 2010 alone. However, they only add incrementally to National debt as the annual instalments are paid.

The stock of General Government debt outstanding at end-2011 was €169 billion or 106% of GDP. Figure 4.2 shows the composition of that debt. It consists of:

- €85.3 billion of Government bonds;
- €35.7 billion of EU/IMF Programme borrowings;
- €28.3 billion in Promissory Notes outstanding;
- €14.1 billion State Savings; and
- €5.9 billion of other Government debt.

Figure 4.2: Composition of General Government debt at end-2011



Source: Department of Finance, NTMA & CSO

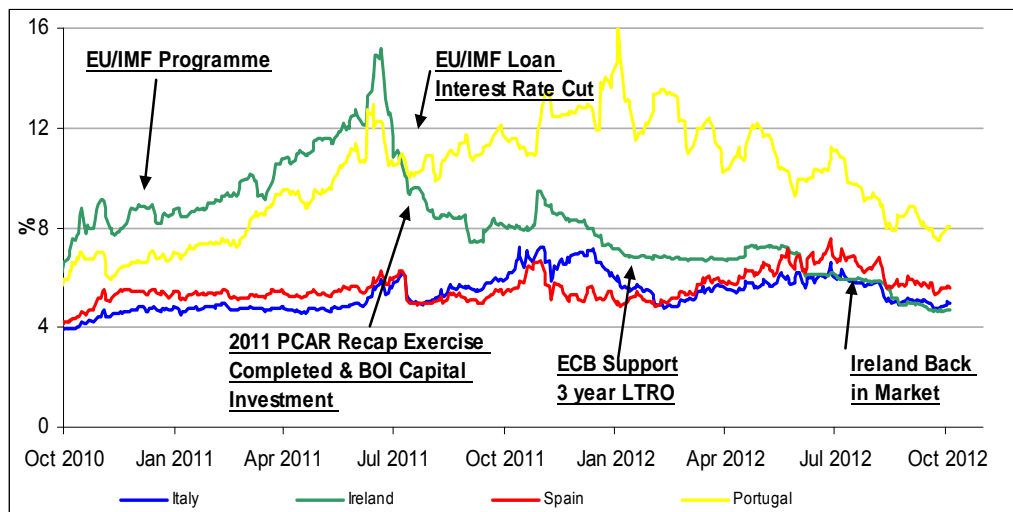
4.2 2012 General Government Debt Estimate

The State's gross General Government debt level is now expected to reach €192 billion or 118% of GDP this year. While the debt-to-GDP ratio estimate is virtually unchanged from the time of the April SPU, owing to a higher estimate of the GDP level for 2012, the nominal level of debt is some €5.3 billion in excess of the SPU estimate.

This is predominantly due to the return by the NTMA to the bond markets in 2012 and in particular during the summer of 2012. While this had the effect of increasing the stock of debt, it reduced significantly the January 2014 "funding cliff", from what had at one point been €1.9 billion. Most of the new debt raised resulted from a significant operation in July in which €4.2 billion of new money was committed by investors into long-term Government bonds. The sale, in August, of €1 billion in new amortising bonds, which are designed to meet the needs of the Irish pensions industry, is also a factor behind the increase in the debt level.

Yields on Irish Government bonds have continued to fall since the summer (see figure 4.3), reflecting improved market sentiment, as well as continuing *EU/IMF Programme* compliance and achievement of fiscal targets.

Figure 4.3: Selected Euro Area 10* year Sovereign Yields



Source: Bloomberg (Department of Finance)
*9 year yield for Ireland

2012 Net Debt Position

As outlined previously in this chapter, General Government debt is a gross measure that does not allow for the offsetting of cash balances and other related assets. A recent IMF paper³ suggests that although gross debt of General Government should be globally adopted as the headline indicator, it should be supplemented by other measures of government debt for risk-based assessments of the fiscal position. The paper suggests that net debt is one such indicator that could be considered and net debt is certainly a variable worth examining in an Irish context.

³ "What Lies Beneath: The Statistical Definition of Public Sector Debt – An overview of the coverage of public sector debt for 61 countries" by Robert Dippelsman, Claudia Dziobek and Carlos A. Gutierrez (IMF Staff Discussion Note - July 2012)

Netting-off the estimated €18.5 billion in cash and deposits held by the Exchequer at end-2012, net Government debt would be of the order of 106% of GDP at end-2012. This is still an elevated level but one which is significantly below the gross debt ratio.

4.3 Projected Debt Levels 2013-2015

Notwithstanding the significant budgetary consolidation measures that are to be implemented over the period 2013-2015, a sizeable, though declining Exchequer Borrowing Requirement (EBR) will still be a feature of the public finances.

The cumulative EBR over the period 2013-2015 is forecast to amount to €34 billion. This implies a further increase in General Government debt, as indicated in table 4.1.

The elevated peak debt ratio is also due in part to the specific policy decision taken by the NTMA to maintain cash reserves sufficient to cover 12 to 15 months of Exchequer funding requirements, including maturing medium- and long-term debt. Exchequer cash balances are projected to be approximately €7.1 billion at end-2013. This is somewhat in excess of what might, in normal circumstances, be considered a long-term level but it is designed to boost market confidence in the sovereign as it emerges from the *EU/IMF Programme*.

The debt-to-GDP ratio is expected to increase further in 2013 but at a slower pace than in previous years. It is also projected to begin declining in the years thereafter. This is due to a combination of factors, including:

- the achievement of a General Government primary surplus – that is an excess of revenues over expenditure excluding debt interest expenditure – by 2014 through the implementation of further fiscal consolidation, and
- strengthening nominal GDP growth as a result of the implementation of further growth-enhancing policy measures.

Furthermore, the debt ratio is expected to decline due a stock-flow adjustment in 2014 and 2015. This is the result of a run-down of cash balances in those years, meaning part of the annual EBR is funded without recourse to additional borrowing and is instead funded through resources already to hand.

Table 4.1 presents General Government debt estimates over the period 2011-2015, based primarily on the EBR. Table 3 in the *Supplementary Tables* section at the back of this document sets out an alternative presentation of the General Government debt forecasts, one which is based primarily on the movement in the GGB.

Table 4.1: Projected Gross General Government Debt 2012-2015

<i>€ billion</i>	2011	2012	2013	2014	2015
Opening General Government Debt	144.2	169.2	192.0	203.6	209.6
EBR	24.9	18.7*	15.3	11.2	7.5
Promissory Note Repayment of Principal**	-2.5	-3.1	-2.6	-1.2	-1.3
Change in Cash Balances & Related Assets	1.9	6.0	-1.4	-3.9	-3.2
Net Lending of Local Government & NCSSBs	-0.1	0.5	0.0	-0.2	-0.2
EFSF Pre-Paid Margin	0.5	0.0	0.0	0.0	0.0
Other***	0.3	0.7	0.2	0.1	0.0
Closing General Government Debt	169.2	192.0	203.6	209.6	212.3
GDP	159.0	163.2	167.7	174.1	181.4
General Government Debt-to-GDP Ratio	106	118	121	120	117

Source: Department of Finance, CSO & NTMA

Notes:

- Rounding may affect totals

*The 2012 IBRC Promissory Note payment was settled with a Government bond and as such is not reflected as part of the Exchequer deficit (or EBR) in the end-October 2012 Exchequer Returns. For simplicity however it is counted as part of the 2012 EBR in table 4.1.

**Interest due on the Promissory Notes is accounted for as part of General Government debt each year.

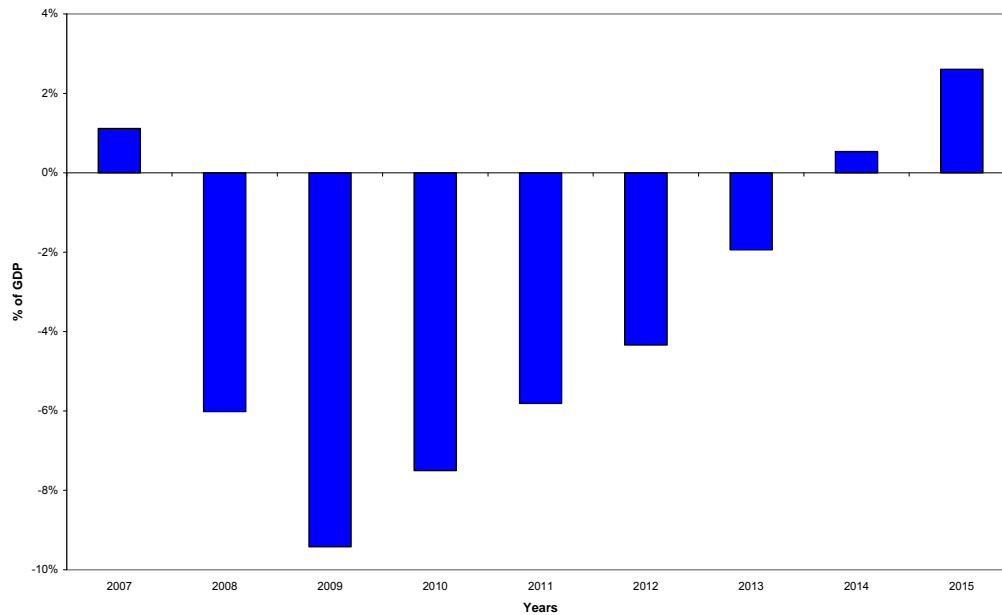
***Includes the effect of issuance and cancellation of debt above or below par.

4.4 Debt Sustainability

Debt sustainability is a key issue for investors' perception of Ireland at this time given the rapid rise in the State's debt level in recent years. Debt levels have increased sharply in recent years for a number of reasons outlined elsewhere in this chapter, including the significant level of support provided by the State to the banking sector. Stabilising the debt is one of the Government's key objectives and so it is implementing policies which both consolidate the fiscal position and foster economic growth.

There is no one rule that says debt above a particular level is unsustainable. Debt sustainability is achieved if there is a credible path to stabilise the debt-to-GDP ratio and then reduce it over time. The projected trajectory of the debt ratio depends on the primary balance (that is the difference between revenues and expenditure excluding debt interest expenditure), the nominal rate of economic growth and the interest rates on Government debt – both the stock outstanding and new debt issued. In a situation where the interest rate exceeds the nominal GDP growth rate, a primary surplus must be run in order to prevent the debt ratio from rising. Achieving a debt stabilising primary balance is a key determinant of sustainability.

Figure 4.4 – Underlying General Government Primary Balance 2007-2015



Source: Department of Finance & Eurostat

The underlying primary balance in 2009 was -9.4% of GDP. This year's primary balance is now estimated at -4.3% of GDP, a significant improvement of over 5 percentage points of GDP since 2009. By further reducing the gap that exists between revenues and expenditure through additional consolidation, together with the implementation of policy measures that will assist in boosting economic growth, a primary surplus of 0.5% of GDP is forecast to emerge in 2014, strengthening to 2.6% the following year.

Reducing the Debt Level and Enhancing Sustainability

A continuation of the extent of the increases seen in the debt ratio since 2007 is not sustainable. It is vital that the debt ratio is stabilised and returned to lower, safer levels as quickly as possible, bearing in mind the need to protect the emerging economic recovery.

As already outlined in this chapter, the achievement of a primary surplus by 2014 will be key. Fostering and enhancing policies that can help in returning the economy to robust growth will also be an important determinant in returning the debt to a more sustainable level. Higher growth means that the primary balance required to stabilise the debt ratio is lower than it would otherwise be. It should also lead to higher tax revenues and it means a larger denominator, and therefore a lower ratio.

The State's debt dynamics were improved by the interest rate reduction on Programme funding and the lengthening of maturities on Programme loans secured last year. This lengthening of maturities means there is less pressure on the State to borrow to refinance maturing debt in the short-to-medium term, giving the State valuable breathing space to continue with the process of returning the economy to health and the public finances to a more sustainable path.

Of course sovereign support for the banking sector has been responsible for a significant part of the sharp increase in the debt level seen over recent years. Recognising this, it was announced following the end-June 2012 euro area summit that the "*situation of the Irish financial sector would be examined with the view of further improving the sustainability*

of the well-performing adjustment Programme”. This is a positive development for Ireland and one that could have beneficial impacts for the debt outlook. Technical work is continuing in that regard.

Chapter 6 also outlines how EU Member States with a debt-to-GDP ratio above 60%, such as Ireland, will be required to reduce that part of the debt above the 60% threshold by 1/20th annually. The Fiscal Responsibility Bill published in July and currently being debated by the Oireachtas provides for this rule.

It is important to note that while stabilisation of the debt ratio is perhaps the key condition for sustainability, the level at which it stabilises is also of significance, for several reasons:

- the higher the debt ratio, the greater the proportion of government resources that must be directed towards servicing the debt, thereby reducing available funds for productive growth enhancing measures such as government capital spending;
- the higher the debt ratio, the greater the exposure of the public finances, and, by extension, the economy to negative domestic and external shocks, and
- elevated debt-to-GDP ratios are likely to be reflected in lower credit ratings and possibly higher bond yields.

The level at which Ireland’s debt ratio is forecast to peak is high relative to the threshold commonly cited as being an impediment to economic growth. Research by economists Reinhart and Rogoff⁴ suggests that a debt ratio above 90% could have negative implications for economic growth. By 2015, two years after the debt ratio is forecast to peak, Ireland’s debt ratio is still forecast to be well in excess of this threshold, at 117%, although crucially it will be on a downward path.

4.5 Debt Servicing Costs

As recently as 2007 the equivalent of around 3% of General Government revenues (or 1% of GDP) was required to meet the State’s debt interest expenditure obligations. This year, the equivalent figures are estimated at close to 11½% and close to 4% respectively. To put that 2012 figure in context, it is almost two-thirds of all the revenues the State will collect in VAT this year.

Notwithstanding the scale of the fiscal adjustment already implemented, with additional measures to come in the years ahead, this interest/revenue ratio is forecast to rise further next year, driven to a large extent by the ending of the interest holiday on the IBRC Promissory Note secured for 2011-2012 and the resulting €1.9 billion or 1.1% of GDP in deficit worsening interest expenditure which is accrued to 2013. The interest/revenue and interest/GDP ratios are then expected to stabilise at around 16% and 5½% respectively in 2014 and 2015. These are certainly elevated figures but importantly they are below the equivalent levels seen in the mid-1980s when interest expenditure accounted for over 20% of revenue and nearly 11% of GDP.

⁴ “Growth in a Time of Debt” – Reinhart, C. and Rogoff, K. (NBER Working Paper No. 15369, 2010)

Table 4.2: Projected General Government Interest Expenditure 2012-2015

<i>€ millions</i>	2012	2013	2014	2015
National Debt Cash Interest	5,725	7,270	7,760	8,170
<i>% tax revenue</i>	<i>15.6</i>	<i>18.9</i>	<i>18.9</i>	<i>18.9</i>
<i>% of GDP</i>	<i>3.5</i>	<i>4.3</i>	<i>4.5</i>	<i>4.5</i>
National Debt Interest Accruals	480	100	20	85
Consolidation and Grossing Adjustments	65	15	25	30
Accrued Promissory Note Interest	15	1,890	1,780	1,685
Other	105	115	115	105
Total Interest on ESA95 basis	6,390	9,395	9,700	10,075
<i>% total General Government revenue</i>	<i>11.4</i>	<i>16.2</i>	<i>16.0</i>	<i>15.9</i>
<i>% of GDP</i>	<i>3.9</i>	<i>5.6</i>	<i>5.6</i>	<i>5.6</i>

Source: Department of Finance & NTMA

Notes:

- Rounding may affect totals

- Figures rounded to nearest €5 million

4.6 Funding

Ireland's funding requirements in the coming years will be met through a combination of the remaining *EU/IMF Programme* funding, the utilisation of the substantial cash resources available to the Exchequer, as well as through market funding by the NTMA.

Since its commencement at end-2010, Ireland has drawn down a nominal €4½ billion under the *EU/IMF Programme* to end-October 2012, leaving a further €13 billion of external funding to be drawn down over the remainder of 2012 and 2013.

At end-October 2012 the Exchequer held cash reserves of €2½ billion, an increase of around €0.3 billion since end-2011. As explained elsewhere in this chapter, as General Government debt is measured on a gross basis, this increase in cash balances explains a large part of the increase in debt this year. These reserves are expected to be used in part over the 2013-2015 period to assist in meeting Ireland's ongoing funding needs, which include some large bond maturities.

The NTMA returned to international capital markets in January 2012 offering terms that were accepted by investors to switch €3.5 billion of bond debt maturing in 2014 into a new bond maturing in 2015. Bond operations continued in the summer when the NTMA raised a total of €4.2 billion in new funding, through the sale of two longer-term bonds maturing in 2017 and 2020. A further €1 billion in holdings of shorter-dated 2013 and 2014 bonds were switched by investors into the longer-term 2017 and 2020 bonds.

The NTMA also resumed Treasury bill issuance in early July of this year. Further Treasury Bill auctions took place in September, October and most recently on 13 November. Furthermore, in late August the NTMA issued €1 billion worth of amortising bonds which are designed to meet the needs of the Irish pensions industry.

It is expected that the NTMA will continue to extend its market presence in order to meet the funding requirements of the State which include a €5.6 billion Government bond maturity in April 2013. The first of the *EU/IMF Programme* borrowings are due for repayment in 2015.

Chapter 5

Risks to the Economic and Fiscal 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. The range of forecast outcomes is comparatively tighter than in the past. All are agreed that the economy will expand again in 2013, with the negative contribution to domestic demand offset by net export growth; and that unemployment is set to remain in the 14% - 15% range. The Department of Finance's economic forecast is towards the middle of the range, which comprises both domestic and international institutions.

Table 5.1: Comparative Macroeconomic Forecasts 2013

	<u>D/Finance</u> <u>(Nov)</u>	<u>Central</u> <u>Bank</u> <u>(Oct)</u>	<u>ESRI</u> <u>(Sept)</u>	<u>IMF</u> <u>(Oct)</u>	<u>EC</u> <u>(Nov)</u>	<u>Reuters</u> <u>Consensus</u> <u>(end-Oct</u> <u>poll)*</u>
GDP	1.5	1.7	2.1	1.4	1.1	1.5
Employment	0.0	0.1	-0.2	0.4**	0.0	N/A
HICP	1.7	1.3	N/A	1.0	1.3	1.5
BOP (% of GDP)	4.3	3.4	2.0	2.7	3.4	N/A
Unemployment (% of labour force)	14.5	14.5	14.6	14.4**	14.7	14.3

Notes:

*Annual average except for the Reuters Consensus which is an end-year figure. (year-on-year % change unless otherwise stated)

**Employment and unemployment taken from IMF August forecast as these variables not presented in October WEO

The International Monetary Fund produced a forecast out to 2015 in August of this year. Their view of the macroeconomic outlook in 2014 and 2015 is for a pick-up to growth of close to 3%. Net exports continue to drive growth with domestic demand turning positive but providing only a small contribution to growth. Unemployment is set to decline slowly to above 13% by 2015 with inflation remaining below 2% for the period. A return to positive growth in the GDP deflator (which drives tax revenue) is forecast as well and the outlook for nominal GDP is close to the Department of Finance's view.

Table 5.2: Comparative Macroeconomic Forecasts 2014-2015

	<u>D/Finance</u> <u>(Nov)</u>	<u>IMF</u> <u>(Aug)</u>	<u>Reuters</u> <u>Consensus (end-Nov poll)</u>
	<i>% change, average per annum</i>		
Consumption	1.1	1.5	-
Exports	4.5	4.5	-
GDP	2.7	2.6	2.8
Employment	1.2	1.6	-
HICP	1.9	1.5	-
	<i>% of GDP, average per annum</i>		
BOP	4.3	3.8	-
	<i>% of labour force, average per annum</i>		
Unemployment	13.4	13.4	-

The relationship between forecast and actual outcomes for Irish economic variables is historically low across all institutions which forecast the Irish economy. First, the unusually open nature of the Irish economy means that both labour supply and capital flows are considerably more volatile than in larger economies leading to difficulty in estimating potential output and deviation from it. Second, revisions to historical GDP data in Ireland are generally of a greater magnitude than elsewhere meaning the starting base for forecasting changes in advance of the outturn. Third, the export sector is dominated by a few firms and comprises over 100% of GDP. Firm-specific decisions can have an appreciable impact on growth in a given year. Finally, the unprecedentedly large fall in Irish output in the 2008 – 2010 period due to the collapse of the construction sector far exceeded even the most pessimistic of forecasts in advance.

These structural features point to the difficulty in forecasting trends in the Irish economy with certainty. Recent estimates by Bermingham and Weymes (Economic Letter Vol. 2012 No.9) of the Central Bank of Ireland estimate a probability distribution surrounding a baseline estimate of GDP to 2015 based on past Central Bank forecast errors and econometric forecasting models. At the 90% confidence level simulated GDP in 2015 has a range of €162 billion to €206 billion relative to a baseline estimate of €184 billion (close to the Department's estimate of €181 billion). This would mean the difference between 0.6% and 6.8% compound annual nominal growth in the 2012 to 2015 period, with a central estimate of 3.7% per annum. A range of this magnitude points to the considerable uncertainty surrounding any forecast for the medium-term.

5.2 Risks to the Macroeconomic Outlook

The primary risk to the forecast stemming from international events is the continuing crisis in the euro area. This is dampening growth in Ireland's main trading partners, both the UK and elsewhere in Europe. A further downturn resulting in negative growth in either the UK or the euro area in 2013 or beyond would reduce demand for Irish exports pushing down growth. 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 1.4% in 2013 and by 1.6% further out. A positive (if undoubtedly less likely) risk is that trading partner growth responds to recently announced monetary policies at European level seeing demand for Irish exports increasing above levels assumed in the forecast over the horizon. These HERMES results are broadly symmetric – a 1% increase in world growth would raise the level of GDP by 1.4% in 2013 and by 1.6% in 2015 – demonstrating how sensitive the extremely open Irish economy is to global economic conditions.

With regard to sector-specific issues, a notable risk is from developments in the pharmaceutical sector. A number of drugs which are manufactured in Ireland are in the process of coming off patent, and this could pose a downside risk to industrial production and exports if global demand declines significantly in the post-patent environment. Nonetheless, the potential remains for new products and generic manufacturing to offset any potential declines in patented production. In terms of labour market impact, the sector is quite capital-intensive in nature.

Turning to domestic demand, the main downside risk is the need for both the household and corporate sectors to deleverage in the light of the high indebtedness built up during the boom. Loans to the household sector in Ireland measured 207% of household income in the year to second quarter with the private savings rate at over 12% in the same period. Although household indebtedness is on a declining path, any further acceleration in deleveraging by households presents a downside risk to the consumption profile outlined

in the Department's forecast. The HERMES model estimates that a sustained 1 percentage point increase in the savings rate would reduce the real level of GDP by 0.4% in 2013 and 0.3% further out. Again, the effects are broadly symmetric.

Table 5.3 summarises the results of the sensitivity analysis.

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

<i>(% change from base)</i>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Baseline real GDP growth	+1.5	+2.5	+2.9
Change in baseline real GDP growth estimate			
1% change in world growth	+/-1.4	+/-1.6	+/-1.6
GDP range	0.1 to 2.9	0.9 to 4.1	1.3 to 4.5
1% point change in savings rate	+/-0.4	+/-0.3	+/-0.3
GDP range	1.1 to 1.9	2.2 to 2.8	2.6 to 3.2

Source: Department of Finance calculations on the basis of the ESRI's macroeconomic model

On the domestic side the main upside risk is growth from the very low levels of investment currently taking place. Obviously, investment is set to remain weak over the medium term and is forecast to increase gradually from an all-time low of 9.4% of GDP in 2012 to 10.3% of GDP in 2015. On the supply side, heavy public and private investment in the years to 2008 has left an overhang in some sectors of the economy that remains to be utilised to full capacity. On the demand side, households have reduced investment both in order to deleverage and adjust to reduced demand, particularly firms in the non-traded sector. Economy-wide investment in Ireland only slightly exceeded depreciation in 2011, implying a stabilisation in the size of the capital stock which is highly unusual in an advanced economy. By comparison, euro area average investment is forecast considerably higher at nearly 19% of GDP by the European Commission in 2012, despite the continued economic uncertainty. Historically, investment averaged about 21% in Ireland during the period 1998-2008. Any return to more normal levels of investment (both comparatively and in relation to historical experience) could see upside risk to the Department's current forecast. Turning to sector-specific developments, the impact of the July 2012 stimulus announcement has been built into the forecast. However there is also potential for some upside if loan finance provided by NAMA to meet medium-term supply shortages in the commercial and residential sectors stimulates investment above the baseline forecast.

Turning to GNP, the export-led nature of the forecast recovery means that GNP growth is assumed lower than GDP growth over the forecast horizon. This is due to the growth in net factor outflows, essentially the repatriation of profits made in Ireland to parent companies abroad. These factor flows can be heavily influenced by specific decisions made by individual firms which cannot be predicted with much certainty. As such, there is a wider degree of uncertainty around GNP growth and level forecasts both in the short- and medium-term.

Finally, it is worth pointing out that in assessing the Department's macroeconomic forecasts, the Irish Fiscal Advisory Council, in its September 2012 *Fiscal Assessment Report* noted that the Department's forecasts "do not exhibit evidence of optimism bias".

5.3 Risks to the Fiscal Outlook

The most obvious risk to the fiscal outlook is that related to the economic outlook. If the downside macroeconomic risks outlined in this chapter were to materialise, there would most likely be consequential negative implications for the public finances.

Table 5.4 outlines estimates of how the budget deficit would be affected by (i) 1% lower/higher world growth and also (ii) a 1 percentage point higher/lower household savings rate, than assumed in the baseline forecast.

Lower world growth would translate into lower domestic growth and would on the basis of the technical estimates set out in table 5.4, increase the budget deficit by 0.5% of GDP in 2013, and by 0.5-0.6% of GDP in each of the subsequent years. These accumulated deficits would add to the stock of debt, meaning it would peak at a higher level than the 121% of GDP currently forecast. The effects are broadly symmetrical in that higher world growth would reduce the budget deficit and by extension the debt level quicker, through its positive effects on output and employment and therefore revenue. Of course these are just technical estimates. As can be seen this year, real GDP growth below original expectations does not necessarily mean a higher budget deficit.

It is estimated that a higher household savings rate would increase the annual budget deficit by 0.2% of GDP each year. Again, the results are broadly symmetrical.

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

<i>(% change from base)</i>	2013	2014	2015
Baseline GGB	-7.5	-5.0	-2.9
1% change in world growth	+/-0.5	+/-0.6	+/-0.5
GGB range	-7.0 to -8.0	-4.4 to -5.6	-2.4 to -3.4
1% pt change in savings rate	+/-0.2	+/-0.2	+/-0.2
GGB range	-7.3 to -7.7	-4.8 to -5.2	-2.7 to -3.1

Source: Department of Finance calculations on the basis of the ESRI's macroeconomic model

Another risk to the public finances is that tax revenues in the month of November – the key month of the year in terms of revenue collection – do not perform in line with expectations. €5.7 billion or close to 16% of total tax revenue for the year is profiled for collection in November. It is the most significant month of the year in terms of income tax (€2.5 billion or 16% of total) and corporation tax (€1.2 billion or 30%) and is also the final VAT “due” month of the year (€1.4 billion). Were revenues to underperform, this could have negative implications not just for 2012 fiscal targets but also the base upon which the 2013 tax revenue forecast is built.

It is also possible that in the context of making a sustainable return to market funding the premium required by investors may be higher than allowed for in the fiscal forecasts. This would make the achievement of deficit targets more challenging. The recent improvement in yields means that this now appears less likely. Related to this is the impact that any credit rating downgrades would have on the cost of borrowing and the associated implications for the public finances. However it must be acknowledged that Ireland maintained its credit rating amidst downgrades for a number of other euro area countries earlier this year, in recognition of the commitment to fiscal consolidation and structural

reforms and the success in achieving all of its objectives and fiscal targets required under the *EU/IMF Programme*. The last downgrade in Ireland's rating came in July 2011.

There are also some potential upside risk factors to the fiscal forecasts, most notably from the announcement, following the end-June euro area summit that "*the situation of the Irish financial sector would be examined with the view of further improving the sustainability of the well performing adjustment Programme*". As a result, the burden of debt arising from the significant costs associated with the State support to the banking sector may be reduced somewhat and this could have potential positive implications for the fiscal position.

Chapter 6
Budgetary Reform
and
Response to Irish Fiscal Advisory Council's September 2012
Fiscal Assessment Report

6.1 Context

Actions 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 have been implemented administratively. These are in line with clear commitments in the Government Programme to reform our national budgetary process and will be given statutory effect before the end of this year.

Both the Department of Finance and the Department of Public Expenditure and Reform have been working on budgetary reform for some time, as evidenced by the jointly published Discussion Document entitled *Reforming Ireland's Budgetary Framework* in March last year. However, to a large extent, developments at European level have superseded the work that had been underway.

These developments included reform of the *SGP* and other processes of EU economic governance through the adoption of the so-called "six-pack" of measures in this area and the *Treaty on Stability, Coordination and Governance* (the "*Fiscal Compact*"), which was approved by the people of Ireland in a referendum held on 31 May 2012.

Other European developments are nearing completion. The "two-pack" of proposed EU regulations, which is currently being negotiated, will have direct implications for domestic budgetary processes. These implications, which are discussed further below, include a common timeline for budgetary processes in all EU Member States. In addition, the President of the European Commission has stated that there will be further proposals in the area of economic governance in the coming months.

The reforms, referred to above, that were introduced on an administrative basis include the establishment of the *Irish Fiscal Advisory Council* (the Council) and the introduction of medium-term ministerial expenditure ceilings. Legislation, which is described below, has been drafted to put these reforms on a statutory basis.

Finally, a host of other improvements have been made in terms of the reporting and presentation of budgetary information on both a multi-annual and annual basis and work to introduce further improvements continues.

6.2 Fiscal Responsibility Bill 2012

Following the endorsement of the *Fiscal Compact* by the Irish people in the referendum held on 31 May 2012, the *Fiscal Responsibility Bill 2012 (FRB)* was published on 18 July 2012, and is progressing through the Oireachtas at present. The purpose of the *FRB* is to provide for the implementation of Articles 3 and 4 of the *Fiscal Compact* in domestic Irish law.

The *FRB* imposes a duty on the Government to ensure that the budgetary rule and the debt rule, which are provided for in the *FRB*, are complied with. The budgetary rule requires that the budgetary position of General Government must be either:

- in balance or in surplus and that this will be satisfied if the annual structural balance is at the medium-term budgetary objective (MTO); or
- the annual structural balance of General Government is complying with the adjustment path toward the MTO as set in accordance with the SGP; unless
- a failure to achieve the MTO or remain on the adjustment path towards it is permitted if exceptional circumstances, as defined under the SGP, apply.

If there is a failure to comply with the budgetary rule and the deviation from the MTO or the adjustment path is more than 0.5% of GDP and exceptional circumstances do not apply, then the Government will be required to implement a correction mechanism. The provisions of this correction mechanism have been drafted in light of the Common Principles adopted by the European Commission.⁵

The FRB also provides for the implementation of the debt rule in line with the requirements of the SGP. The debt rule requires that General Government debt in excess of 60% of GDP must be reduced by one twentieth of the excess over this limit each year. In Ireland's case, the debt rule will apply in full three years after it has exited its current EDP in 2015.

The FRB will put the Council on a statutory basis and assign it the monitoring and assessment functions required of an independent national institution under the *Fiscal Compact*. The provisions ensuring the independence of the Council comply with the European Commission's Common Principles footnoted above. The functions already assigned to the Council on an administrative basis are also included in the FRB. These functions include assessing the official spring and autumn macroeconomic and budgetary forecasts produced by the Department of Finance and, in relation to annual budgets and stability programme updates, the fiscal stance for the year or years concerned.

6.3 Medium-term Expenditure Framework

In the *Comprehensive Expenditure Report 2012-2014* (CER) published in December 2011, the various elements of the Government's new Medium-term Expenditure Framework (MTEF) were outlined. One key element was the introduction of "Ministerial expenditure ceilings," which are three-year allocations of current expenditure to each Minister / Department. This innovation is intended to put the planning and management of current expenditure onto the same footing as capital expenditure, which has been managed on a multi-year basis since 2004.

The 2013 Ministerial expenditure ceilings were introduced on an administrative basis in the CER and now form the basis upon which the detailed 2013 expenditure allocations are being decided by the Government. In keeping with an *EU/IMF Programme* commitment in this regard, the administrative ceilings are to be put on a statutory footing, which will ensure that this reform measure becomes a permanent structural feature of Ireland's budgetary framework. The necessary legislative change is included in the *Ministers & Secretaries (Amendment) Bill 2012*, which was published on 28 September⁶. In essence, the Bill provides for the power of the Government to set out an overall ceiling for

⁵ COM(2012) 342 final

⁶ Available at: <http://www.oireachtas.ie/viewdoc.asp?DocID=21814&&CatID=59>

aggregate current expenditure for each of the following three years (on the basis of a proposal from the Minister for Finance), and for the aggregate ceilings to be apportioned into Ministerial expenditure ceilings (on the basis of a proposal from the Minister for Public Expenditure & Reform). The annual Estimates of Expenditure must, in turn, not exceed the overall limits set out by the Government.

The CER also instigated the new ‘whole of year budgeting’ process that is currently underway. All Dáil Select Committees now have the opportunity to participate in the annual Estimates process in an *ex ante* fashion with Departments. This process introduces an important new dimension of accountability which will enhance the role and the policy relevance of the Select Committees of the Oireachtas. Meetings have been ongoing over recent weeks between Ministers and the various relevant Committees concerning the prospective Estimates for 2013, framed within the context of the expenditure ceilings set out in the CER.

In order to gauge the efficiency and effectiveness of Departmental expenditure management in terms of delivering upon public service objectives, “performance budgeting” has now been introduced for almost all Government Offices and Departments. The Book of Estimates now presents the spending allocations grouped by strategic programme. For the most part, these are the same as the High Level Objectives in the departmental Statements of Strategy, and bring a new streamlining and clarity to the overall processes within each organisation. Alongside the spending allocations, performance indicators – both outputs and outcomes – are set out clearly. This allows for Dáil Committees to know precisely what public service outputs and outcomes are being delivered with public funds. This approach emphasises the need to focus on what is being *achieved* with the money that is being spent and not just the *amount* of money that is being spent.

Building on the performance budgeting agenda, a new public-facing web platform called *Ireland Stat* has recently been launched in pilot mode (see www.irelandstat.gov.ie). This initiative aims to deliver a whole-of-Government performance measurement system which will measure success in delivering on the Government’s objectives, linking the high level goals with associated outcomes and outputs. It will allow the public to observe how well the Government and the system of public administration as a whole is delivering upon public service policy objectives. It will also allow for a far richer and deeper level of information to be presented online than is possible in printed form. This initiative is one part of the Government’s overall narrative of performance, delivery and results.

The finalisation of detailed Estimates allocations remain a major challenge for the Government over the period ahead, given the scale of fiscal correction that must be accomplished. However, the range of structural budgetary reforms set out above will allow for the budgetary decisions to be informed by a considered analysis of options and impacts, in keeping with the more sustained focus upon evaluation and evidence-based policy-making that underlies the Government’s budgetary reform agenda.

6.4 European Developments

The SGP was reformed by measures included in a set of five regulations and one directive adopted in November 2011, which were known as the “six-pack”. As EU regulations have immediate legal effect in Member States, budgetary policy preparation has been carried out in accordance with the reformed SGP. These reforms strengthened the preventative and corrective arms of the Pact. With regard to the directive, this concerns the

requirements for budgetary frameworks in Member States and it must be transposed into domestic law by the end of 2013.

In addition to the “six-pack”, the European Commission proposed two further regulations which are known as the “two-pack”. These draft regulations concern:

- common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficits in euro area Member States; and
- the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area.

These draft regulations have been considered and agreed separately by Member States in the Council and the European Parliament. At present, negotiations to reach a common position between the Council and the European Parliament are underway with the assistance of the European Commission and it is expected that these regulations will be finalised in the next few months.

Although, as outlined above, the “two-pack” has not yet been finalised, it is clear from the positions reached separately by the Council and the European Parliament that the regulations will impact our current budgetary process. One objective is to bring in a common budgetary timeline. This will be achieved through requiring draft budgets for Central governments and the main parameters of the draft budgets for all other sub-sectors of General Government to be made public no later than the 15th of October each year.

In Ireland’s case, this means that much of the existing budgetary process, which normally is completed in the first week of December, will have to be finalised much earlier. This will pose challenges, particularly in relation to information on tax performance in the current year because a significant portion of Ireland’s tax revenues is collected in November each year. Notwithstanding these difficulties, Ireland will take effective action to ensure that we remain in full compliance with the requirements of EU budgetary coordination and governance.

6.5 Improving Fiscal Reporting

As part of the process of enhancing fiscal reporting, the Departments of Finance and Public Expenditure & Reform published for the first time, as part of the end-September Exchequer Returns, an alternative, analytical presentation of the Exchequer position. The main purpose of the alternative presentation is to show voted expenditure on a *gross* basis, including expenditure by Departments and also from the Social Insurance Fund (SIF) and the National Training Fund (NTF).

The monthly outturn for Appropriations-in-Aid (A-in-As) – Departmental receipts which need not be paid directly into the Exchequer but which may be retained to defray the expenses of the Vote to which they refer – is also now shown separately.

This alternative format also removes the distinction between the current and capital accounts and instead shows all revenues (including A-in-As) on the one hand, and all expenditures (including gross voted current and capital expenditure) on the other.

An advantage to this alternative format is that it allows for a clearer analysis of the key underlying drivers of both expenditure and revenue. For example, under the traditional presentation, variations in PRSI receipts affect the *net* expenditure of the Social Protection Vote and can make it more difficult to track the management of actual programme expenditure in *gross* terms. The new format is also in keeping with other reforms, such as the proposed introduction of fixed, multi-year Ministerial expenditure ceilings as provided for in the recently published *Ministers & Secretaries (Amendment) Bill 2012* referred to in section 6.3.

Both Departments are committed to working together to further refining and improving fiscal reporting.

6.6 Response to Irish Fiscal Advisory Council's September 2012 Fiscal Assessment Report

Since the Council was established on an administrative basis in June 2011, it has published three fiscal assessment reports, in addition to work on fiscal frameworks. The first report was in advance of *Budget 2012*, and assessed the fiscal stance that had been set out in the April 2011 SPU, taking into account the intervening macroeconomic and fiscal developments. This was a timely contribution in advance of the November 2011 *MTFS* and *Budget 2012*.

In advance of the publication of the April 2012 SPU, the Council published its second *Fiscal Assessment Report*, commenting on the macroeconomic and fiscal projections set out by the Government in *Budget 2012*, including the appropriateness of the overall fiscal stance over the period to 2015. The report also considers the longer-term implications of compliance with the fiscal rules in the *FRB*. The Council suggested that a further €400 million in consolidation measures would be necessary to meet the 8.6% of GDP General Government deficit target for 2012, and an additional €2.8 billion in consolidation over the period to 2015. At the time, the Minister for Finance suggested that the additional consolidation may not be necessary, noting that Ireland remained on track based on the first quarter's Exchequer Returns and stated that the situation would be monitored closely. The most recent Exchequer Returns show that Ireland remains on track to achieve the deficit target for 2012, without the need for additional measures.

The third *Fiscal Assessment Report* of the Council was published in September 2012. It assessed the macroeconomic and fiscal projections set out by the Government in the April 2012 SPU, and in advance of *Budget 2013*, the appropriateness of the fiscal stance over the period to 2015. The *Fiscal Assessment Report* has been considered in the preparation of this document.

The Council does not produce its own forecasts, but it assessed the Government's current fiscal stance and budgetary and economic projections as set out in April's SPU. The assessment of the Council also considers the longer-term implications of compliance with the fiscal rules in the *FRB*.

In summary, the Council is largely supportive of the current policy of fiscal adjustment and considers that the deficit targets set out in the SPU are largely appropriate. While noting that risks to the macroeconomic environment are tilted to the downside, they consider that the SPU forecast for a deficit of 8.3% of GDP in 2012 is achievable.

However, the Council believes that it would be prudent for the Government to implement more consolidation than currently planned so as to achieve a deficit of 1.9% of GDP in

2015. This would require €1.9 billion in additional consolidation over what is set out in the SPU for the period 2014-2015 but would result in a significantly improved debt trajectory. The Council suggested that there be no additional consolidation in 2013, but further consolidation of €0.4 billion in 2014 and €1.5 billion in 2015. The Council suggests that this could provide additional fiscal sustainability, by front-loading the consolidation necessary to meet the 2015 General Government deficit target.

While the Council suggests that it would be prudent to undertake additional consolidation in 2014 and 2015, it states that the additional adjustment is not recommended lightly given the existing pressures on domestic demand and the high burden of unemployment.

The Government is very conscious of the potential impact this could have on economic activity. In striving to restore sustainability to the public finances, it is necessary to also be mindful of protecting the emerging economic recovery and seek to strike the right balance between the two. This balancing act is difficult but the Government view is that a reasonable balance has been achieved. The consolidation completed to date has been achieved with remarkable social cohesion, and the adjustment path is supported by the European Commission, ECB and IMF. The fact that the Council sees Ireland achieving its deficit targets on the basis of the already committed adjustments reinforces this view in that regard. However, we will continue to closely monitor economic developments and will take the measures necessary to meet our targets.

In their report, the Council suggest that debt sustainability remains fragile. As discussed earlier in the report, stabilising the debt is one of the Government's key objectives and it is implementing policies which both consolidate the fiscal position and foster economic growth.

As part of its September 2012 *Fiscal Assessment Report*, the Council also discussed the case for the use of a hybrid GNP/GDP measure as an appropriate measure of fiscal capacity.

The Council states that the motivation for the use of such a measure originates from the inherent weaknesses of using either GDP or GNP as a proxy for debt sustainability in a small open economy. While in most countries the difference between GDP and GNP is marginal, significant differences can emerge between the two measures in the case of a small open economy like Ireland.

The view of the Council is that GDP is susceptible to overstating Ireland's measure of fiscal capacity, due primarily to the large profits generated by multinationals. Using GNP however does not allow for any potential revenue from the excess of GDP over GNP, an excess that is primarily derived from multinationals and the significant levels of corporation tax they generate for the Exchequer.

The Council's hybrid measure attempts to overcome these constraints. The measure assigns a differential weight on the fiscal capacity of GNP and the GDP excess over GNP.

As discussed in chapter 4, the General Government debt-to-GDP ratio is the most commonly used indicator of debt sustainability in international analysis. It is the measure used for comparative purposes across the EU and as such it is the measure to which financial markets pay closest attention. In that context the Department of Finance, while noting the views of the Council, will continue to present General Government debt forecasts in percentage of GDP terms.

Section 3 of the report was devoted to assessing the appropriateness of the economic and budgetary forecasts of the Department of Finance. As the Council notes, economic and budgetary forecasts are subject to a degree of uncertainty and this is reflected in the wide range of projections and ongoing revisions. However, the findings of the Council are that the forecasts produced within the Department of Finance show no sign of optimism bias. This is one of the key conclusions of the report, and is clearly stated.

The Council notes that forecasts of the timing and magnitude of the recovery have been revised down by the Department of Finance in recent years, but also notes that similar revisions have been made by all institutions which forecast the Irish economy. The recovery in the global economy – on which Ireland relies for an acceleration of export growth – has, in recent years, proved weaker than initial expectations of a number of international forecasting agencies such as the IMF and OECD.

Similar comments were made by the March 2011 report on *Strengthening the Capacity of the Department of Finance*, which recognised that the Department's forecasting record was as good as any other institution engaged in the process. Nonetheless, the Department of Finance has taken steps over the last eighteen months to improve its capacity in the economics field. New graduate staff with economics qualifications to Masters level have been recruited and a separate Economics Division has been established.

The Council urges that comprehensive and timely explanations be provided publically on methodological changes and data revisions that impact on fiscal outturns or official forecasts, or sources of major modifications to forecasts and on the components of non-tax revenues. This is the policy of the Department of Finance as part of a move towards a more transparent and open system, and can be seen in recent publications. Such explanations can be seen in the April SPU, for example, which explained the realignment of the Department of Finance data with the outturn ESA95 tables sent to Eurostat by the CSO. Notes to the Supplementary Tables at the end of this document explain methodological revisions since the April SPU.

A further step towards this can be seen in the enhanced Exchequer reporting piloted in the end-September Exchequer Returns. The Department of Finance, in co-ordination with the Department of Public Expenditure and Reform will be taking this forward next year, including profiling non-tax and other revenue in addition to the already profiled tax revenue forecasts and voted expenditure returns.

Section 5 of the *Fiscal Assessment Report* provided forecasts with regard to Ireland's path towards complying with the budgetary rule and debt rule, based on SPU data. This was a helpful and useful contribution, providing an example path running past the official forecast period. The Council concludes that, on the basis of assumptions set out in the report the current MTO would be reached around 2019.

It notes that the debt rule will not be a requirement until after 2018 and that compliance with the budgetary rule means that the debt rule will also be complied with.

While the Council supports the exploration of financing mechanisms such as loans from the EIB and well-structured PPPs to finance capital expenditure set out in the main programme, it has significant reservations regarding the appropriateness of the separate-stimulus approach under current conditions. The Council is of the opinion that any policy action should be in the context of the main adjustment programme and furthermore that

the total amount of Government spending set out in the fiscal stance underlying SPU 2012 should not be increased without explicit revenue-raising offsets.

Regarding the fiscal stimulus package, it should be noted firstly that it is not the case that it is to be funded by a run down of NPRF assets. The NPRF would provide loan funding (in addition to funding from other private sector sources) to the PPP Consortia which will be repaid to the NPRF based on a commercial rate of return.

The primary rationale for pursuing the PPP approach as a procurement option (assuming there is a sound rationale for pursuing the project) is on the basis of appropriate risk sharing between the public and private sectors and where it offers value for money. The balance sheet status of the project is not the main driver in the appraisal/selection of the PPP option. However, the potential balance sheet implication of the funding of PPPs is taken into account during the appraisal process. The PPP guidance includes a note on the accounting treatment of capital projects for accounting purposes. There is ongoing consultation with the CSO to ensure that the guidance fully reflects the EUROSTAT rules on the compilation of National Accounts.

Policy Papers

There are three policy papers in this section, all of which have been written by current Department of Finance officials.

1. Measuring the Impact of the Jobs Initiative: Was the VAT Reduction Passed On and Were Jobs Created?

This paper was written by Brendan O'Connor, a senior economist in the Fiscal Section of the Department of Finance's Economics Division. An earlier draft was submitted to the Tax Strategy Group. The author thanks colleagues in the economics and fiscal division as well as members of the tax strategy group for helpful comments.

2. Economic Assessment of SME Sector in Ireland

This paper was written by Terence Hynes. Terence is also an economist working in the Fiscal Section of the Department of Finance's Economics Division. An earlier draft was submitted to the Tax Strategy Group. This paper was completed in June 2012.

3. Common Consolidated Corporate Tax Base (CCCTB): An Update

This paper was co-authored by Declan Kelly (Fiscal Attaché, Permanent Representation of Ireland to the EU) and Gary Tobin (Principal, Business Tax Team, Tax Policy Unit, Fiscal Division, Department of Finance). It originally appeared as an article in the September edition of the *Irish Tax Review* and is reproduced here with their permission.

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Measuring the Impact of the Jobs Initiative: Was the VAT Reduction Passed On and Were Jobs Created?

The Jobs Initiative

In May 2011 the Government announced a *Jobs Initiative* which involved a series of measures to boost employment. A key aspect of the *Jobs Initiative* involved a reduction in the rate of VAT which was targeted mainly at labour intensive goods and services relating to tourism. In this context, a new temporary second reduced rate of VAT at 9% was introduced with effect from 1 July 2011 until end-December 2013.

The 9% rate applies to the following categories which had previously been subject to VAT at 13.5%:

- The supply of food and drink (excluding alcohol and soft drinks) in the course of catering or by means of a vending machine;
- Hot take-away food and hot drinks;
- Hotel lettings, including guesthouses, caravan parks, camping sites etc;
- Admissions to cinemas, theatres, certain musical performances, museums, art gallery exhibitions;
- Amusement services of the kind normally supplied in fairgrounds or amusement park services;
- The provision of facilities for taking part in sporting activities by a person other than a non-profit making organisation;
- Printed matter e.g. newspapers, brochures, leaflets, programmes, maps, catalogues, printed music (excluding books); and,
- Hairdressing services.

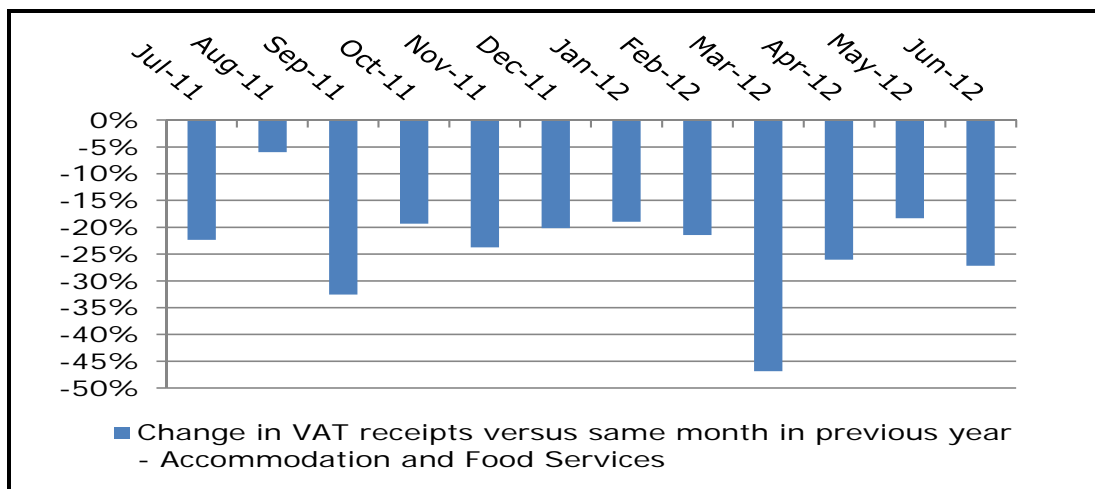
The exact items from these categories which are included in the CPI basket are set out in the Annex to this paper.

This measure was estimated to cost €120 million in 2011 and €350 million in a full year.

All other goods and services to which a reduced rate had applied remained subject to the 13.5% rate. In addition, the Finance Act 2012 provided that admissions to historic houses, open farms and built & natural heritage facilities became subject to the 9% VAT rate from 1 January 2012. However, as these services had formerly been exempt from VAT, they are not part of the services being analysed in this study.

As a result of the VAT reduction, VAT receipts in the '*Accommodation and Food Services*' economic sector have trailed their level in the same month in the preceding year for each of the months in which the 9% VAT rate has applied. This is shown in Figure 1.

Figure 1: Change in VAT receipts versus same month in previous year, Accommodation and Food Services



June 2011=100

Source: The Revenue Commissioners

The reduction in VAT targeted from the tourism sector is consistent with the economic literature which suggests that the price elasticity of demand for tourism related goods is relatively elastic.⁷ This means that consumer demand increases by proportionately more than the percentage reduction in prices in the tourism sector. It was hoped that this demand side stimulus would increase the demand for jobs in the sector through consumer responses to lower prices and by sustaining employer margins.

The Minister for Finance announced in his Jobs Initiative speech that to ensure that the tourism sector is delivering added employment from the 9% rate of VAT, the effects of the changes will be assessed and the measures reviewed before the end of 2012 in the context of preparing Budget 2013.

One of the means of testing the effectiveness of the stimulus would be an examination of rate of pass through of the VAT reduction to lower consumer prices. Data limitations mean that a study of employer level margins is not possible.

A full year of monthly price data has been provided by the CSO for the affected goods and services. It is therefore timely to analyse the price trends that have emerged.

The Data

The CSO publishes monthly changes in the consumer price index relative to a base year price (currently December 2011). The CSO ordinarily publishes changes in twelve sub-indices (food and non-alcoholic beverages, clothing and footwear, etc.) which are further disaggregated on the CSO databank. The published sub-indices do not correspond to the categories for which the 9% VAT rate was introduced.

On foot of a special request from the Department, the CSO in consultation with the Revenue Commissioners constructed price series that match with the goods and services

⁷ Durbarry, R. (2008). Tourism Taxes, Implications for Tourism Demand in the UK. *Review of Development Economics*, 12(1), 21-36.

at the reduced 9% rate. In all, an index of prices has been constructed for each of the eight reduced VAT categories as well as an overall series that covers all of the 9% VAT rate items. The relevant items and their respective series are listed in the Annex to this paper.

Employment data is available from the CSO quarterly national household survey (QNHS). The level of aggregation of activities only permits a meaningful analysis of the employment impact in food and accommodation services (NACE economic sector I). All other categories for which the 9% reduced VAT rate applies are small components of wider economic sectors in the context of the QNHS. Whilst it is not possible to analyse the employment impact for these other activities, accommodation and food services account for over 70% of expenditure on the 9% items and can thus be considered a reasonable proxy for the overall employment impact of the 9% items.

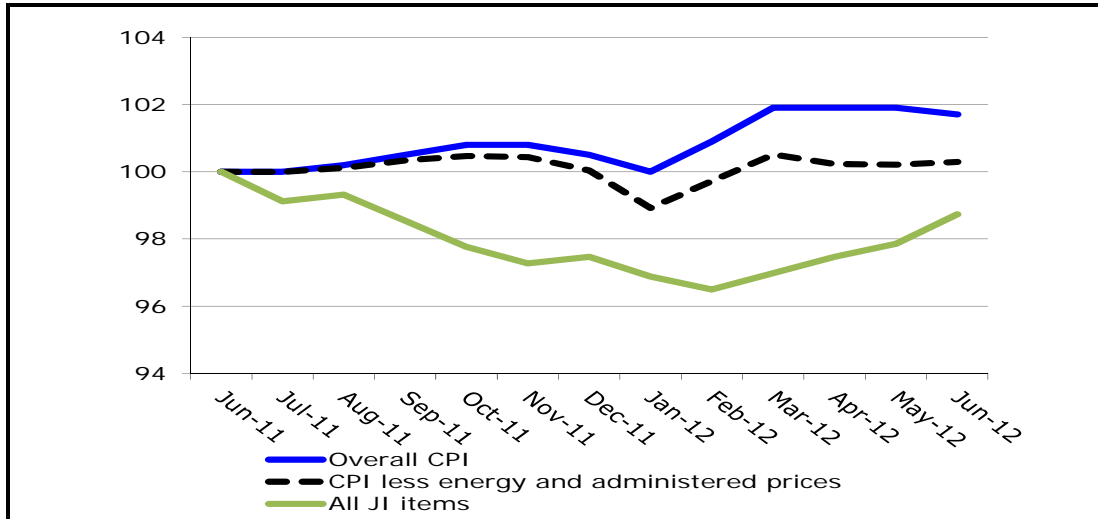
VAT rate pass through

The price level for each series in June 2011 – the month prior to the VAT rate reduction – has been set as a base for this analysis. The trends in prices are compared to this month. Price data are available up to June 2012.

Between June 2011 and June 2012 overall economy wide inflation increased by 1.7%, whereas aggregate inflation for the sectors covered by the VAT reduction fell by 1.5%.

It should be noted that the headline inflation rate as measured by the CPI was influenced by higher than headline rates of inflation in energy and administered prices. To get an understanding of underlying inflation in the economy an inflation series excluding these two categories has been constructed. This series recorded a 0.3% price rise over the same period. The reduction in price in the affected sectors following the VAT reduction is still favourable when compared to underlying inflation.

Figure 2: Inflation June 2011 to June 2012, overall inflation, underlying inflation, and Jobs Initiative items



June 2011=100

Source: Central Statistics Office

Whilst overall prices covered by the VAT reduction fell compared with economy wide headline and underlying inflation, different rates of inflation occurred in the various categories covered by the Jobs Initiative.

For example clear evidence of pass through occurred in the following series:

- Meals out;
- Hairdressing;
- Admissions to cinemas, theatres, musicals, museums and art galleries; and,
- Newspapers.

Significant price volatility occurred in the ‘hotels and other accommodation’ series which fell by 13% from July 2011 to January 2012, and recovered to within 1% of the June 2011 price level by June 2012. This is driven by the cyclical nature of hotel prices which peak in mid-year and decline thereafter. Another series impacted by seasonality is hairdressing services with a clear ‘December effect’ causing a temporary spike in prices around the Christmas period.

The price changes in each of the series are summarised in Table 1. For convenience, the price changes for June-December 2011 and January-June 2012 are separately identified as well as the overall June 2011-June 2012 price change.

Table 1: Rates of Inflation June 2011 – June 2012

Category	June-December 2011	January – June 2012	June 2011 – June 2012
Cinemas, theatres, musicals, museums, art galleries	-2.8%	2.4%	-0.6%
Hairdressing services	3.5%	-4.3%	-1.6%
Hot take away foods and hot drinks	-0.4%	-0.4%	-0.5%
Hotels and other accommodation	-10.2%	13.6%	-0.9%
Meals out including rail car dining	-1.3%	0.1%	-1.3%
Newspapers	-1.7%	-0.5%	-2.2%
Sport	0.0%	-4.5%	-4.5%
All 9% items	-2.5%	1.9%	-1.3%
Headline CPI	0.5%	1.7%	1.7%
Underlying CPI	0.0%	1.4%	0.3%

Source: Central Statistics Office

The only sector where prices actually rose in the first six months following the VAT reduction was in hairdressing services, although this increase was a seasonal effect around the Christmas period and a price reduction was observed either side of the Christmas increase (see Figure 11).

No price change was observed for sporting facilities in the first six months after the reduction. This reflects annual pricing by sporting facilities and club memberships (e.g. gyms and sports clubs). Full pass-through was observed for this sector from January 2012.

Prices for the remaining items all fell during June-December 2011. For some categories this represented a reversal of earlier increases and for others it represented an acceleration of an existing downward trend.

For the period January – June 2012 an upward trend was observed for ‘cinemas, theatres, musicals, museums, and art galleries’ and for ‘hotels, and other accommodation’ with a 13.6% rise experienced in the latter series. The overall effect of the increase in the ‘hotels and other accommodation’ category was to restore the prices in this category back to within 1% of the June 2011 level. This is reflective of the seasonality of hotel and accommodation pricing which increase during the first half of a calendar year with a mid-year peak and price reductions thereafter (see Figure 7).

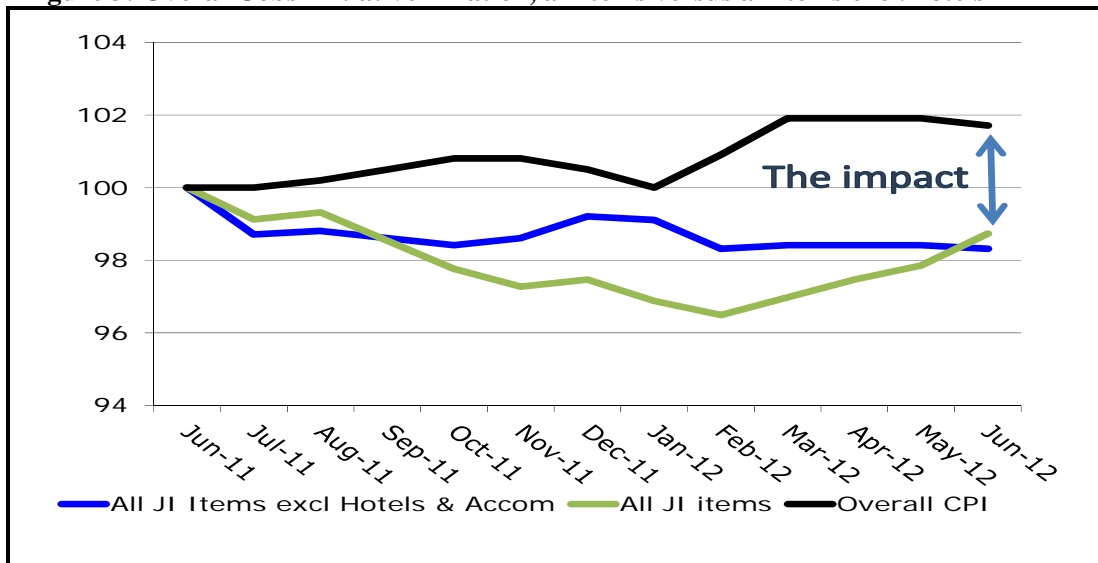
Looking at the 9% VAT rate items as a group, it is interesting that following a 2.5% price reduction in the first six months, prices increased by 1.9% in the second six month period, resulting in an overall price reduction of 1.3% by June 2012 compared with June 2011. It is also noteworthy that the rate increase in the second six month period outpaced both headline and underlying inflation. This rate rise was however accounted for mainly by seasonally driven price increases in ‘hotels and other accommodation’ in the first half of 2012.

The cyclical nature of pricing in hotels and other accommodation overstated the decline in the overall Jobs Initiative series in the final six months of 2011 and similarly overstated the price increase in the overall series in the first six months of 2012. By excluding hotels and other accommodation from the overall Jobs Initiative series a more modest decline in prices of just under 2% relative to June 2011 can be observed for most of the period with

the exception of a slight increase around Christmas 2012 which was largely accounted for by seasonal hairdressing prices driven by supply and demand factors in that sector. Controlling for the impact of this “Christmas effect” on hairdressing prices, the overall pass-through of close to 2% held consistently since the 9% reduced VAT rate came into existence. This suggests that close to half of the VAT reduction has been passed through to consumer prices.

Given that headline inflation ran at close to 2% for the full period it is likely that some of the gap between the actual price decrease in the affected sectors and the rate reduction is accounted for by economy wide inflation.

Figure 3: Overall Jobs Initiative inflation, all items versus all items excl. hotels



June 2011 = 100

Source: Central Statistics Office

Employment Impact

The CSO releases employment data quarterly through the QNHS. The most recent QNHS release was in respect of Q2 2012. The 9% reduced VAT rate came into existence at the start of Q3 2011. Thus there are four quarters of out-turn data on the employment impact available, including the quarter in which the rate change occurred.

The QNHS data are published by reference to NACE REV 2 economic sectors. Based on the data that are publicly available from the CSO the most relevant economic sector that is mainly accounted for by 9% VAT rate items is NACE sector I – ‘accommodation and food services’. All other 9% VAT rate items form small parts of broader economic sectors and an analysis of these sectors would not be informative in terms of the specific impact of the 9% reduced VAT rate.

Whilst it therefore not possible to look at the impact of the Jobs Initiative across every 9% VAT rate category, the food and accommodation services covers 70% of the Jobs Initiative basket according to expenditure data provided by the CSO as part of its price series. It is therefore reasonable to analyse the food and accommodation services economic sector as proxy for the overall impact.

According to the QNHS there were 114,500 people employed on a seasonally adjusted basis in the accommodation and food services economic sector in Q2 2012, compared with 108,300 in Q2 2011, the quarter that immediately preceded the introduction of the 9% rate. This represented a net increase in the sector of 6,200 jobs (+6%).⁸

Figure 4: Accommodation and food service activities – total employees (seasonally adjusted)

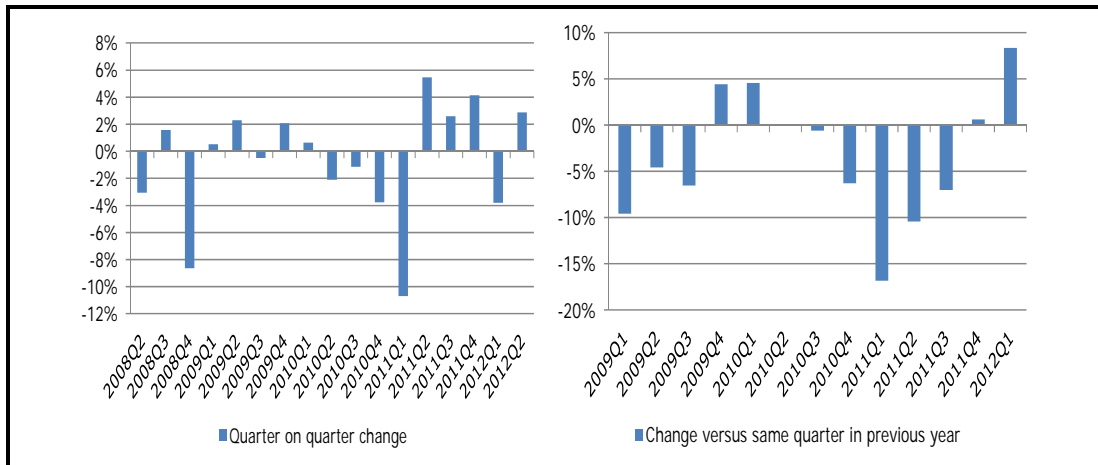


Source: Central Statistics Office
QNHS NACE Rev 2 Economic Sector I

Quarterly increases in employment in this sector were recorded in Q2 2011 (+5%), Q3 2011 (+3%), Q4 2011 (4%) and Q2 2012 (3%) with a quarterly fall in Q1 2012 (-4%).

⁸ The unadjusted employment series increased by 6,300 during the same period.

Figure 5: Accommodation and food service activities – quarterly employment changes



Source: Central Statistics Office
 QNHS NACE Rev 2 Economic Sector I

While a lag would normally be expected between a policy change and an impact on the labour market, there appears to be reasonable evidence of the desired employment impact in the accommodation and food services sector.

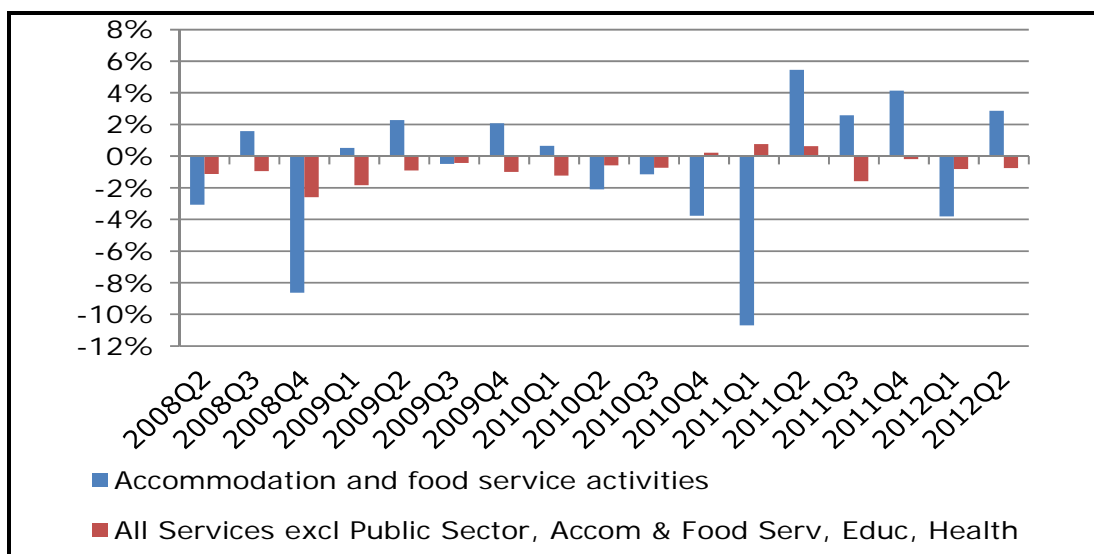
It is worth comparing the observed employment impact with a counterfactual. While the theoretical counterfactual would be the impact on employment and food services over the same period at the old 13.5% rate, this obviously cannot be observed. A counterfactual must therefore be formed from observable outcomes, for instance the employment outcomes in comparable sectors.

One possible comparable sector is overall economy-wide employment which fell by 2% over the same period. However this contains construction, manufacturing and public sector jobs which may not be relevant for this analysis. Another possible sector is overall services employment which also fell by 2% over the same period. However the overall services series includes accommodation and food services as well as public sector employment.

A useful comparison may therefore be overall services excluding accommodation and food services and public sector employment (including health and education). This series, which captures employment in market services excluding accommodation and food services, fell by 3% over the same period. The quarterly changes in accommodation and food services and this counterfactual series are graphed overleaf.

Compared with the range of possible counterfactuals discussed above, there has been a net employment growth differential of 8%-9% since the introduction of the 9% VAT rate with the reference series growing by 6% and the counterfactual series falling by 2%-3%.

Figure 6: Quarterly employment changes



Source: Central Statistics Office
 QNHS NACE Rev 2 Economic Sector I

Whilst there were 6,200 additional employees in the sector in Q2 2012 relative to Q2 2011, given that an upward trend was in existence in Q2 2011 (+5%) it is possible that some of the increases were due to reasons other than lower VAT rate. However given the clear evidence of price pass through in food services categories, and similar though less conclusive evidence in accommodation services, the evidence appears to support the view that the 9% reduced VAT rate has had the desired employment impact.

It should also be noted that this analysis is by its nature backward looking and is not an indication of sustained or further employment growth in the future. It is therefore not possible to state whether the employment response is likely to have been temporary or permanent. It should also be noted that a substitution effect may have drawn consumer demand away from other sectors and towards accommodation and food services as a result of consumer price reductions.

Detailed analysis of price pass through

The various 9% VAT rate categories are discussed individually below. A chart accompanying each category is presented with each chart comparing the out-turn inflation in the category - with the price in June 2011 set to 100 – against a counterfactual or ‘modelled’ series in which the VAT reduction is immediately passed through and the rate of inflation thereafter is assumed to move forward in line with underlying inflation – i.e. headline inflation less energy prices and administered prices. This facilitates a comparison not only of the speed of pass through but the general price trend in each category against underlying inflation in the economy.

Hotels and other accommodation

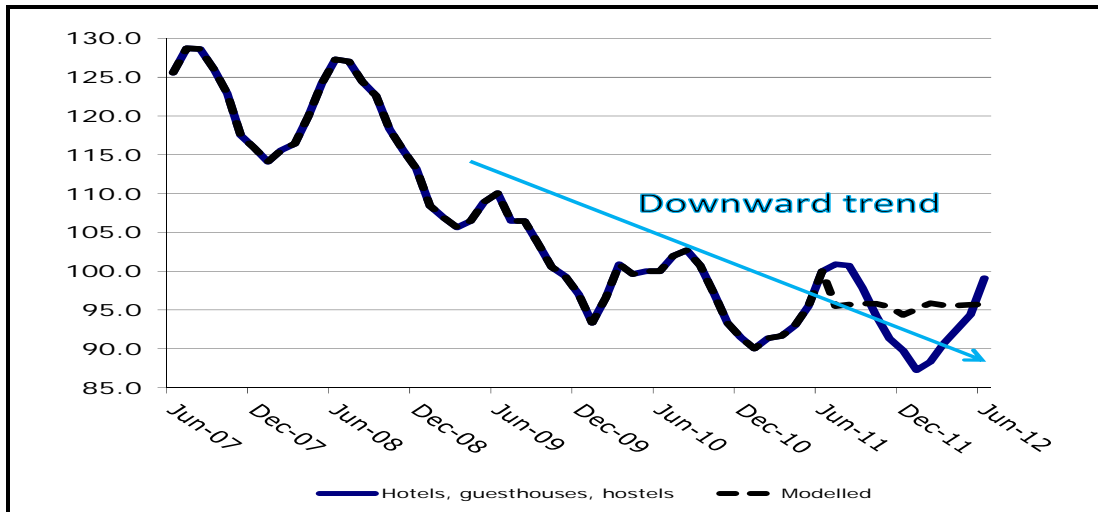
Following the July 2011 VAT reduction a slight increase in prices occurred that month followed by a decrease of 10% in the period to December 2011 compared with June 2011 levels. Prices continued to fall in January 2012 with the price index for the hotels and other accommodation series reaching a level 13% below that of June 2011.

The reduced price levels of 2011 were reversed in 2012 with prices approaching their June 2011 levels by June 2012. This increase is consistent with a cyclical pattern of prices in this sector with prices tending to increase in the first half of each year towards a mid-year peak and reduce in the second half.

The trend in hotel prices since June 2007 is presented below with the counterfactual or ‘modelled’ series included from June 2011. It is clear that a downward trend in prices has been occurring since 2007, though with a deceleration in the rate of reduction in recent years. The cyclicity in prices is clearly evident with very obvious mid-year peaks and year end troughs occurring annually. The low-point in the post Jobs Initiative price cycle occurred in January 2012 and was just under 2% below the January 2011 level, while the June 2012 price level is within 1% of the price level in June 2011.

The evidence of pass through in the hotels and other accommodation sector is not conclusive. On the one hand the price decreases throughout the second half of 2011 could be interpreted as the continuation of an existing trend. Alternatively it could be interpreted as evidence of pass through given that the January and June 2012 prices are below the equivalent levels in 2011. Ultimately it is impossible to know what would have happened to the price trend in the absence of the VAT reduction.

Figure 7: Hotels and other accommodation – actual and counterfactual ‘modelled’ inflation



June 2011=100

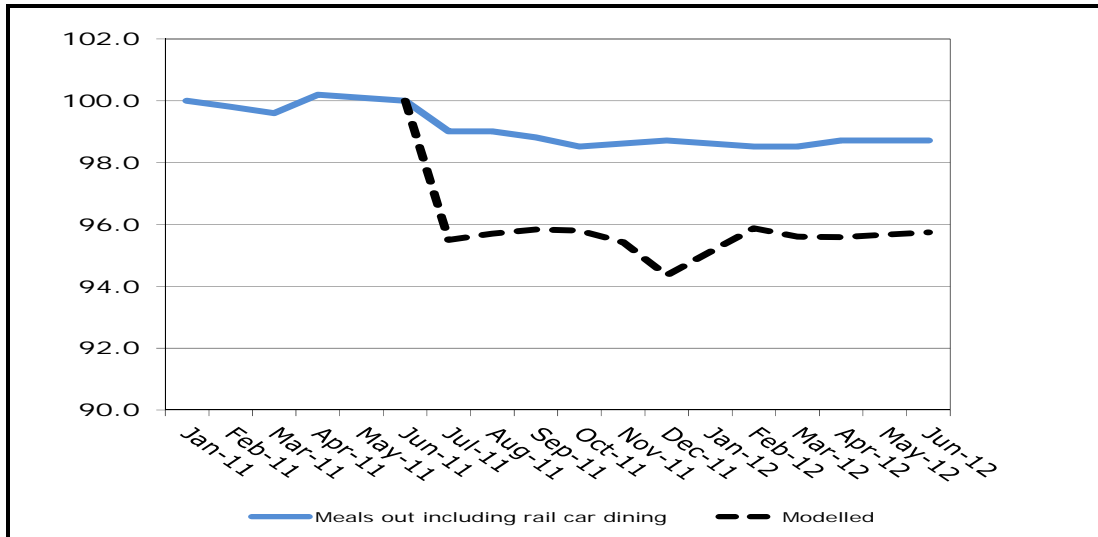
The modelled series represent a counterfactual in which the full 4.5 percentage point VAT reduction was passed through in July 2011 and projects forward in line with underlying inflation

Source: Central Statistics Office

Meals out

The meals-out category experienced an overall price reduction of 1.3% for the period. There was an immediate pass through of 1.5% in the first six months following the rate reduction with prices largely static thereafter.

Figure 8: Meals Out – actual and counterfactual ‘modelled’ inflation



June 2011=100

The modelled series represent a counterfactual in which the full 4.5 percentage point VAT reduction was passed through in July 2011 and projects forward in line with underlying inflation

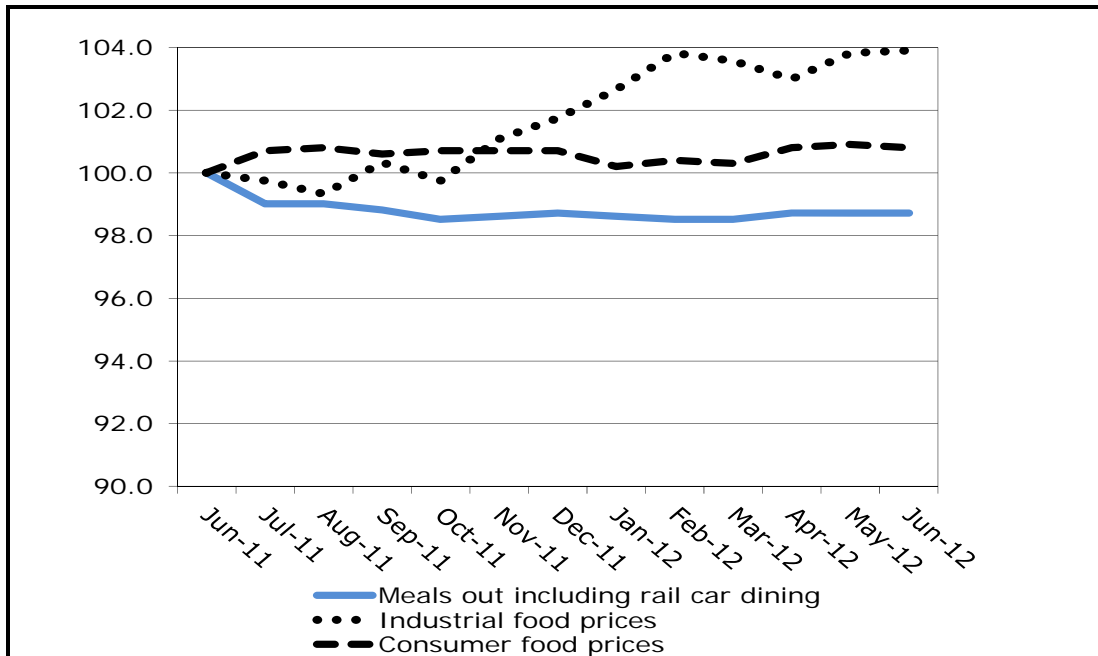
Source: Central Statistics Office

While the full VAT reduction does not appear to have been passed-through in its entirety, it should be noted that food prices, a key input into this activity, can have volatile levels of inflation.

By way of comparison, the diagram overleaf compares the inflation rate for the meals out category against prevailing food price inflation as measured by both upstream industrial (wholesale) price inflation for food items and downstream consumer food prices from the CPI. It is clear that the inflation rate for meals out is less than the rate of consumer and industrial price inflation for food items generally.

This suggests that the partial pass through could have been reflective of the interaction between upward cost pressure due to rising food prices and pass through of the lower VAT rate. It appears that some of the rate reduction was offset by higher input food prices.

Figure 9: Meals Out – comparison with industrial and consumer prices for food items



June 2011=100

Source: Central Statistics Office

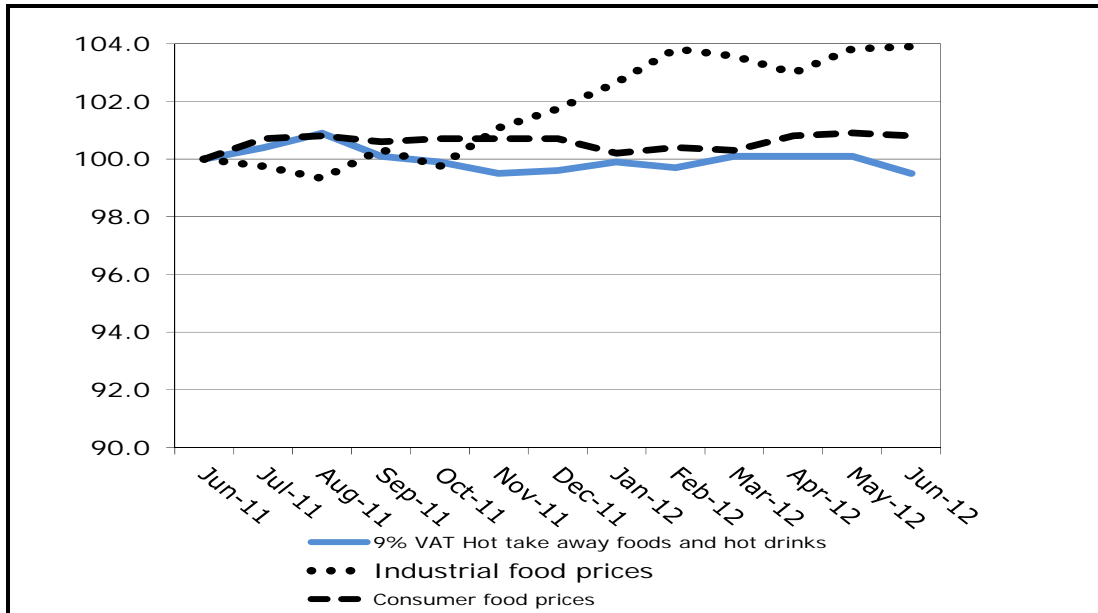
Hot take away food

After a slight increase in the first two months following the VAT reduction the price series for ‘hot food and take away’ trended around the June 2011 price level until June 2012. This suggests limited evidence of pass through for this item. However as with the meals out category it should be noted that there has been inflation in wholesale and consumer prices for food items.

As evidenced in Figure 10 there has been a lower rate of inflation in the hot take away food series than in the wholesale and consumer food price series. The wholesale food price series is of particular interest given that this is an input cost to vendors of hot take away food.

It appears that the VAT reduction has largely been absorbed by increases in wholesale food prices.

Figure 10: Hot takeaway food, comparison with wholesale and consumer food prices indexes



June 2011=100

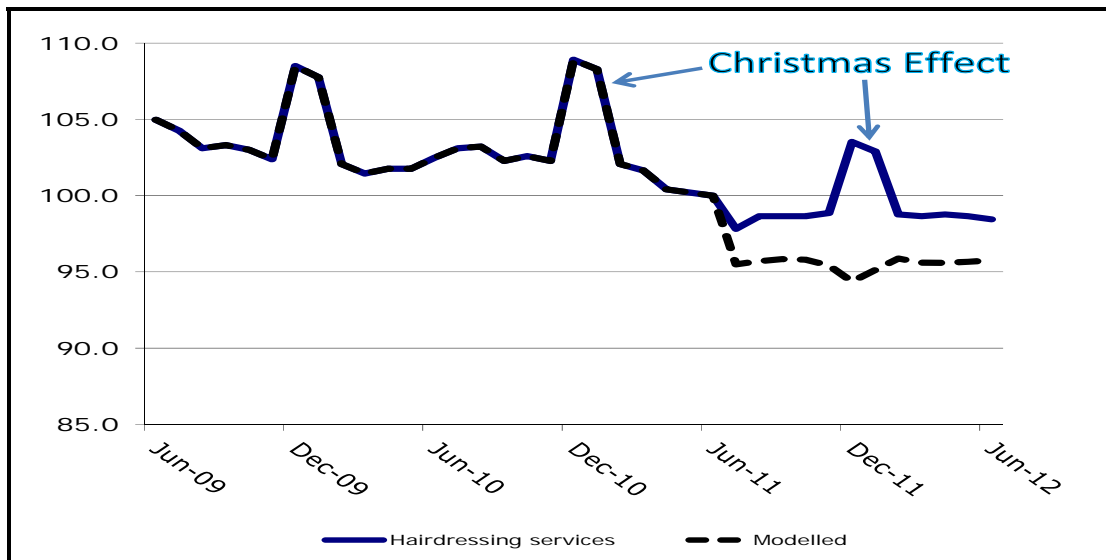
Source: Central Statistics Office

Hairdressing services

The price index for hairdressing services was on a downward trend for the first 6 months of 2011. After the VAT reduction an immediate pass-through of approximately 2% was observed. This was maintained for most of the following six months with a sharp increase in December 2011 which brought the series to a level close to 4% above June 2011 prices. This increase is consistent with a regularly occurring “Christmas effect” caused by seasonal demand increases in the sector at that time of year. The “Christmas effect” was reversed in early 2012 with the price series returning to that prevailing up to November 2011.

Figure 11 sets out the price path for hairdressing services since June 2009. The “Christmas effect” can clearly be seen each year. While an existing downward trend in 2011 should be acknowledged there is clear evidence of pass through in this sector.

Figure 11: Hairdressing services – actual and counterfactual ‘modelled’ inflation



June 2011=100

The modelled series represent a counterfactual in which the full 4.5 percentage point VAT reduction was passed through in July 2011 and projects forward in line with underlying inflation

Source: Central Statistics Office

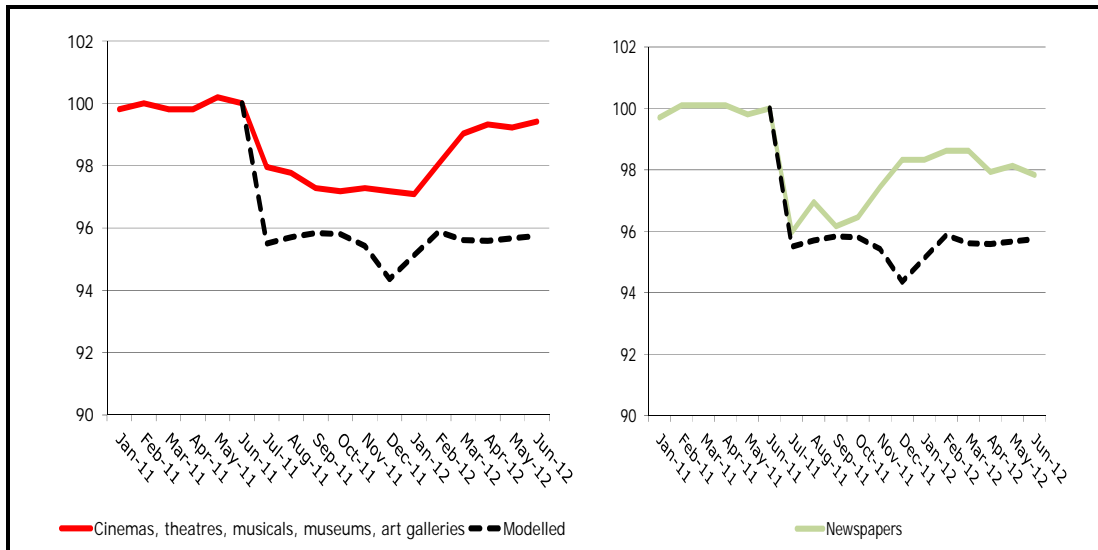
Cinemas, theatres, musicals, museums, art galleries

The full 4.5 percentage point VAT reduction appeared to have been passed through by November 2011 but this has been reversed in 2012 with the price series trending back towards the level seen in June 2011, the month prior to the rate reduction. This series has experienced price increases in 2012 in excess of underlying inflation. This series is presented in Figure 12.

Newspapers

The newspaper series experienced full and immediate pass through of the VAT reduction with the price level falling to 95.5 in July 2011 relative to the base of 100 in June 2011. A trend increase which began in October 2011 has brought the series back to with 2% of its June 2011 one year later. This series is presented in Figure 12.

Figure 12: cinemas and other cultural admissions, newspapers – actual and counterfactual ‘modelled’ inflation



June 2011=100

The modelled series represent a counterfactual in which the full 4.5 percentage point VAT reduction was passed through in July 2011 and projects forward in line with underlying inflation

Source: Central Statistics Office

Sporting facilities

There was a six month lag for the pass through of prices for sporting facilities with full pass through occurring in January 2012. This is reflective of annual subscription charges for the use of sports facilities and the admission to sports clubs and societies where clubs and other membership subscriptions are determined at the start of a calendar year and only change in the following membership year. This is the only series where full pass through occurred and remained persistent.

Conclusion

The 9% reduced VAT rate appears to have had the desired impact both in terms of price pass through and by contributing to employment gains, with an additional 3,000 jobs in quarter 1 2012 relative to quarter 2 2011 in the labour intensive food and accommodations services sector of the economy.

When considered as an overall group there is evidence of pass through of the VAT rate reduction, though not the full amount, with an aggregate reduction of 1.3% recorded between June 2011 and June 2012 and 1.7% when the highly seasonal hotel price series category is excluded. This compares favourably with economy wide inflation which increased by 1.7% over the same period on a headline basis and underlying inflation which increased by 0.3%.

The evidence in respect of pass through in the hotels and other accommodation sector is inconclusive. Whilst the price level for this sector in June 2012 was below the level of June 2011 it may be attributable to either a Jobs Initiative effect or a continuation of a multi-year trend of falling prices.

The evidence is clearer in respect of the two food categories with meals out falling by 1.3% and hot take away food falling by 0.5% relative to June 2011 despite inflationary pressures in wholesale and consumer food prices.

There is some evidence of pass through to consumer prices in all of the other reduced rate categories.

It is likely that the VAT rate reduction on some of the categories acted as a temporary employment stimulus, either through direct pass through or by enabling the retention or expansion of labour demand without offsetting reductions in firm margins.

Annex: List of Jobs Initiative items at new 9% VAT rate

Jobs Initiative list of items	CPI sub-index	CPI BASKET Items (Base: December 2011=100)
The supply of food and drink (excluding alcohol and soft drinks) in the course of catering or by means of a vending machine	9% VAT Meals out including rail car dining	<ul style="list-style-type: none"> ▪ Chips - small single ▪ Lunch ▪ Dinner ▪ Fast food meal ▪ Meal in ethnic restaurant ▪ Canteens ▪ Rail catering ▪ Tea/coffee - eat-in (hot) ▪ Sandwich/wrap/roll/bagel - eat-in
Hot take-away food and hot drinks	9% VAT Hot take away foods and hot drinks	<ul style="list-style-type: none"> ▪ Hot deli foods ▪ Take-away meal ▪ Chicken - cooked whole ▪ Tea/coffee - take-away (hot)
Hotel lettings, including guesthouses, caravan parks, camping sites etc	9% VAT Hotels, guesthouses, hostels	<ul style="list-style-type: none"> ▪ Guest houses and B&Bs ▪ Hotels ▪ Hostels
Admissions to cinemas, theatres, certain musical performances, museums, art gallery exhibitions	9% VAT Cinemas, theatres, musicals, museums, art galleries	<ul style="list-style-type: none"> ▪ Cinema
Amusement services of the kind normally supplied in fairgrounds or amusement park services		NO RELEVANT ITEM IN BASKET
The provision of facilities for taking part in sporting activities by a person other than a non-profit making organisation	9% VAT Sport	<ul style="list-style-type: none"> ▪ Sports participation ▪ Club & society subscriptions
Printed matter e.g. newspapers, brochures, leaflets, programmes, maps, catalogues, printed music (excluding books)	9% VAT Printed matter - newspapers, comics, magazines	<ul style="list-style-type: none"> ▪ Newspapers ▪ Comics ▪ Magazines
Hairdressing services (Note: beauty treatments:- for example, facials, massages, nail treatments, tanning or sunbed services etc., remain liable at the 13.5% rate)	9% VAT Hairdressing services (beauty treatments are excluded - remain at 13.5%)	<ul style="list-style-type: none"> ▪ Gents - dry haircut ▪ Gents - wash, cut & blowdry ▪ Ladies - shampoo & set ▪ Ladies - wash, cut & blowdry ▪ Ladies - perm/bodywave ▪ Ladies - hair colour & highlights

Economic Assessment of SME Sector in Ireland

This paper sets out the size and structure of the small and medium-sized enterprise sector in Ireland taking into account its contribution to the economy in terms of employment, Gross Value Added and Turnover. It also outlines the main challenges facing the sector today in the form of low credit supply and weak domestic demand. Substantial data and commentary for this paper were taken from both Business in Ireland 2009 and SMEs in Ireland: Stylised facts from the real economy and the credit market produced by the CSO and the Central Bank respectively, and as such can be used for further reference. The key points to note from this paper are set out below.

- SMEs make up the substantial proportion of the enterprise economy, with over 99% of businesses in this sector and almost 70% of people employed by them. Despite this SMEs make up only 52% of both turnover and gross value added in the economy.
- Despite Ireland's reputation as one of the world's most globalised economies, 64 percent of private sector workers are employed by indigenous non-exporting firms, with 56 per cent working for indigenous, non-exporting SMEs. These numbers highlight the importance of domestic demand for sustaining and generating employment, and suggest that an export orientated growth policy may not have as large an impact on number of people employed as might be expected.
- Large firms pay substantially more than SME's; in the manufacturing sector it can be up to 25-30% more. In establishing the importance of the SME sector to Ireland, the above outlined issues point to the need to understand the extent to which SMEs economic weight as evidenced through their large employment numbers and majority ownership of GVA and Turnover are as a result of large exporting companies.
- The dependence of SME's on domestic demand given their largely non-exporting structure is significant in light of high savings rates, poor consumer sentiment and retail sales index figures all pointing towards a flagging domestic economy.⁹
- Lending to non-financial, non-property related SMEs by Irish resident credit institutions declined by €17 million (0.8 per cent), over the quarter to March 31st, and €1.7 billion over the year ending Q1 2012 (6.3 per cent). This follows an annual decline of 6.2 per cent in 2011.
- Both the Retail Sales Index and the Consumer Sentiment Index are at historically low levels resting at 90 and 61 which are half their 2005 levels.

⁹ As of late August CSO figures show domestic demand has risen 1.5% though retail sales continue to fall.

Introduction

SMEs form by far the majority of the business community in Ireland. As a largely indigenous, employment-intensive sector that relies primarily on domestic demand, SMEs are particularly responsive to changes in domestic policy. In view of the high proportion of people employed by SMEs in Ireland they are especially relevant to addressing the country's unemployment concerns.

SMEs have fared particularly badly when viewed against larger enterprises i.e. those above 250 employees, as a result of the poor economic climate over the last few years. Since larger companies and multinationals have access to funding from international sources, domestic financial sector difficulties which have resulted in tighter lending policies have greater implications for SMEs.

They also are more dependent on demand in the domestic economy which is continuing to experience the historic lows in consumer sentiment, retail sales and, the corollary, high savings rates maintained by consumers.

Role of SMEs in the Irish Economy

Business Demography

The data presented in this section is based on the Business Demography statistics taken from the CSO Central Business Register. The Business Register is a register of all enterprises that are active in the State and is based on enterprises that are registered with the Revenue Commissioners.

In 2009, there were over 199,000 active enterprises in the business economy with over 1.3 million persons engaged. Table 1 below represents the number of people employed and people engaged in each of the 5 areas Industry, Construction, Distribution, Services and Financial & Insurance Activities. These represent the business economy according to the NACE Rev. 2 classifications of economic activity which leave out Agriculture, Forestry & Fishing, Public Administration & Defence, Education and Health.

Table 1: Total Number of Enterprises by Sector

	Industry	Construction	Distribution	Services	Financial & Insurance Activities	Total Enterprise Economy
Active Enterprises	14,273	44,970	44,143	90,799	5,056	199,241
Persons employed	216,527	124,774	340,012	527,377	93,392	1,302,082
Employees	211,243	96,350	317,601	471,337	92,632	1,189,163

Source: Business in Ireland 2009

Using the Business Demography data, it is possible to break down the number of active enterprises and the number of persons engaged into employment size classes. The majority of enterprises in the business economy at 90.4% were micro enterprises with less than 10 persons engaged. A further 8.0% were other small enterprises with between 10 and 49 persons engaged. Medium-sized enterprises with between 50 and 250 and large enterprises with greater than 250 persons engaged made up 1.3% and .2% respectively. In total SMEs accounted for 99.7% of the enterprise economy in Ireland. Persons engaged include employees as well as proprietors and family members.

Table 2: Number of Active Enterprises and Persons Engaged by Size Class 2009

Class Size	Total Business Economy			
	Active enterprises	Percentage of Active Enterprises by Class Size	Persons Engaged	Percentage of Persons Engaged by Class Size
Micro <10	180,199	90.4%	350,533	26.9%
Small 10-49	15,990	8.0%	305,296	23.4%
Medium 50-249	2,571	1.3%	245,123	18.8%
Large >250	481	0.2%	401,130	30.8%
Total	199,241	100.0%	1,302,082	100.0%
SME	198,760	99.76%	900,952	69.19%

Source: *Business in Ireland 2009*

Business Operations Data

The following data is taken from the main structural business surveys which cover the enterprise economy in Ireland.¹⁰ Though the Industrial Survey which covers NACE sectors B, C, D and E is missing data on micro businesses with 2 or less people it still represents adequate coverage of the sector.

Data relates to NACE rev 2 categories B to N, less 642 (excluding activities of holding companies), and excludes NACE rev 2 categories A (agriculture, fishing & forestry) and categories O to U (which includes public admin, education, health & social work, arts, entertainment & recreation, and a number of other smaller activities). The Financial & Insurance Activities sector (NACE Sector K) was not included in this analysis due to the unavailability of persons engaged data on the relevant survey forms.

The following financial variables of turnover and gross value added are analysed in terms of the employment size classes using the business survey data. Turnover comprises the totals invoiced by the enterprise during the reference period and Gross Value Added is the gross income from operating activities after adjusting for operating subsidies and indirect taxes.

Large enterprises were dominant in terms of both turnover and gross value added. Large enterprises accounted for 48.1% of turnover and 48.9% of gross value added. In contrast to the employment data seen above, micro enterprises were not as significant in terms of turnover and gross value added. Micro enterprises accounted for just 11.4% of turnover and 14.7% of gross value added while other small enterprises accounted for 19.0% of turnover and 15.8% of gross value added. Overall, SMEs contributed 52% both to turnover and gross value added which is much lower than their percentage of persons engaged contribution of 69%.

¹⁰ Census of Industrial Production (CIP), Building & Construction Inquiry (BCI), Annual Services Inquiry (ASI)

Table 3: Turnover and Gross Value Added Broken Down by Sector and Size Class 2009

Class Size	<u>Total Business Economy</u>			
	Turnover €m	Percentage of Turnover by Class Size	Gross Value Added €m	Percentage of Gross Value Added by Class Size
Micro <10	35,756	11.4%	12,406	14.7%
Small 10- 49	59,570	19.0%	13,325	15.8%
Medium 50-249	67,533	21.5%	17,323	20.6%
Large >250	151,130	48.1%	41,207	48.9%
Total	313,989	100.0%	84,261	100.0%
SME	162,859	51.87%	43,054	51.10%

Source: Business in Ireland 2009

An important point to note from the above outlined statistics is that while SMEs are responsible for the majority of employment in the economy it is large firms who generate a disproportionate amount of turnover and gross value added. This perhaps reflects the concept of large companies creating demand for large numbers of indirect jobs in the economy which are supplied by SME's.

Also of interest, is a breakdown of companies, by their size, ownership nationality and export orientation. Data taken from the Census of Industrial Production (2009) and Annual Services Inquiry (2008) (Note: omitting the construction sector) is displayed in the tables 4, 5, and 6 below. This data does not include sole traders and firms with fewer than three employees in the manufacturing sector, and so under represents micro enterprise's contribution in the economy.

Table 4 identifies the Services and Manufacturing share of employment by national and non-national owned SMEs as well as their export status. Note that the table now breaks down by employment in the non-construction, non financial private sector. SMEs are shown to account for 72 per cent of employment in the private sector, while they account for 82 per cent of the people employed in the indigenous economy. Of note is the fact that, despite Ireland's reputation as one of the world's most globalised economies, 64 percent of private sector workers are employed by indigenous non-exporting firms, with 56 per cent working for indigenous, non exporting SMEs. These statistics highlight the importance of domestic demand for sustaining and generating employment, and suggest that an export orientated growth policy may not have as direct impact on number of people employed as might be expected.

Table 4: Services and Manufacturing, Share of Employment by Ownership, Export Status and Size

Class Size	Irish Non-Exporter	Irish Exporter	Foreign Non-Exporter	Foreign Exporter	Total
Micro<10	23.4%	0.6%	0.4%	0.1%	24.5%
Small 10-49	20.3%	3.1%	1.0%	0.7%	25.2%
Medium 49-250	12.7%	4.1%	2.3%	2.9%	21.9%
Large >250	7.5%	6.6%	7.4%	6.9%	28.4%
Total	63.9%	14.3%	11.1%	10.7%	100.0%
SME	56.4%	7.8%	3.7%	3.7%	71.6%

Source: Irish SMEs: Stylised facts from the real economy and credit market

Table 5 below outlines the share of Gross Value Added by class size, export status and nationality. It's clear that in terms of this measure of output, neither SMEs nor indigenous non-exporters are as important as they are for employment. Multinational exporters, accounting for 11 per cent of employment, make up 38 per cent of GVA. Indigenous non-exporters, on the other hand, while accounting for 64 per cent of employment, appear much less important in GVA, with 33 per cent of the total. The SME total of 52 per cent of GVA is also significantly lower than their 72 per cent share in employment.

Table 5: Services and Manufacturing, Share of Gross Value added by Ownership, Export Status and Size

Class Size	Irish Non-Exporter	Irish Exporter	Foreign Non-Exporter	Foreign Exporter	Total
Micro <10	11.2%	0.8%	1.0%	0.3%	13.3%
Small 10-49	10.6%	2.7%	4.0%	1.0%	18.3%
Medium 50-249	6.3%	4.0%	2.7%	7.4%	20.5%
Large >250	4.7%	9.0%	5.2%	29.0%	48.0%
Total	32.9%	16.5%	12.9%	37.7%	100.0%
SME	28.1%	7.5%	7.7%	8.7%	52.1%

Source: Irish SMEs: Stylised facts from the real economy and credit market

Table 6 below sets out the sources of aggregate investment. Similar to GVA, SMEs are shown to account for 52 per cent of total investment in the private sector. The non-exporting sector in Ireland accounts for 59.9 per cent of aggregate investment. This suggests that flat domestic demand is likely to be having a large impact on aggregate investment, regardless of the performance of the exporting sector.

Table 6: Services and Manufacturing, Share of Investment, by Ownership and Export Status and Size

	Irish Non-Exporter	Irish Exporter	Foreign Non-Exporter	Foreign Exporter	Total
Micro <10	10.9%	0.1%	0.7%	0.0%	11.7%
Small 10-49	9.2%	2.4%	11.0%	0.6%	23.2%
Medium 50-249	8.4%	3.5%	2.4%	3.2%	17.4%
Large >250	10.7%	18.0%	6.6%	12.3%	47.6%
Total	39.2%	24.1%	20.6%	16.2%	100.0%
SME	28.5%	6.0%	14.1%	3.8%	52.3%

Source: Irish SMEs: Stylised facts from the real economy and credit market

Table 7 displays information on average wage of firms of different class size and nationality. It shows that firms that are larger tend to pay more, with foreign firms paying more than Irish firms. This information could be viewed as a proxy for the value of generating a job in a large company versus a small or medium sized enterprise. Combined with the knowledge that large firms have much higher GVA with lower amounts of persons engaged, it seems likely that a given amount of jobs in a large firm are worth much more to the economy as a whole than the same amount in SMEs on average.

Table 7: Average wages in €000s in Manufacturing and Services by nationality

	<u>Manufacturing</u>		<u>Services</u>	
	Irish	Foreign	Irish	Foreign
Micro	35	42	30	65
Small	36	51	32	62
Medium	41	52	31	56
Large	48	63	36	41
SME	37	48	31	61

Note relatively large wage in Micro/Small foreign firms could be a result of small sample size allowing some high-end foreign producers to push up the wage average. Also, the average wage for SME is a simple average. The relatively high number of employees in micro firms with lower wages would pull down the average even further if weighted.

Source: Irish SMEs: Stylised facts from the real economy and credit market

Challenges facing the industry

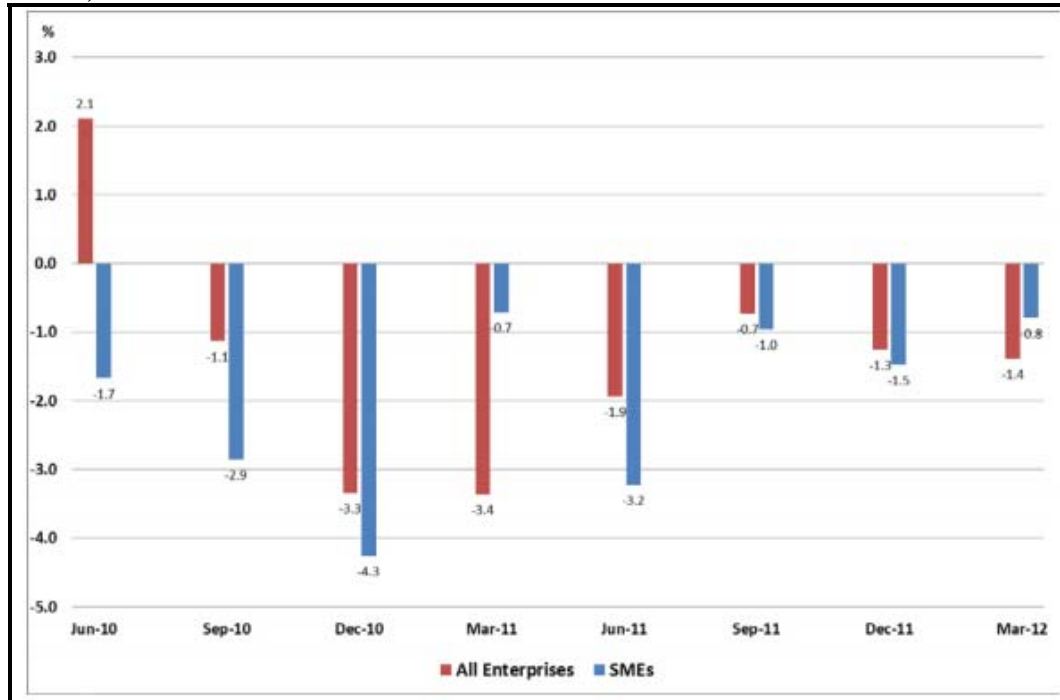
Access to Credit

Research conducted by the Central bank has shed light on the difficulties SME's face in accessing credit. They have found evidence that as a consequence of economic conditions, many foreign banks are exiting the Irish lending market leaving a smaller pool of lenders supplying credit to meet demand (especially so for SMEs), with less competition between those lenders.

The Central Bank's research shows that while there has been a small fall in SMEs demanding credit there has been a large rise in rejection rates independent of the productivity or growth rate of the firm. They also indicate the likelihood that banks' lending decisions are likely to display credit rationing implying that viable businesses aren't receiving funds they would have in years gone by or they are receiving them at higher interest rates.

Figure 1 below shows changes in credit advanced to all enterprises in the economy and SMEs. Lending to non-financial, non-property related SMEs by Irish resident credit institutions declined by €217 million (0.8 per cent), over the quarter to March 31st, and €1.7 billion over the year ending Q1 2012 (6.3 per cent). This follows an annual decline of 6.2 per cent in 2011. Figure one below shows declining overall lending to all enterprises in the economy with lending to SME's losing a greater amount of credit each in many quarters than all enterprises taken together.

Figure 1: Quarterly Rates of Change in Credit Advanced to All Private-Sector Enterprises and SMEs (Excluding Financial Intermediation and Property-related sectors)¹¹

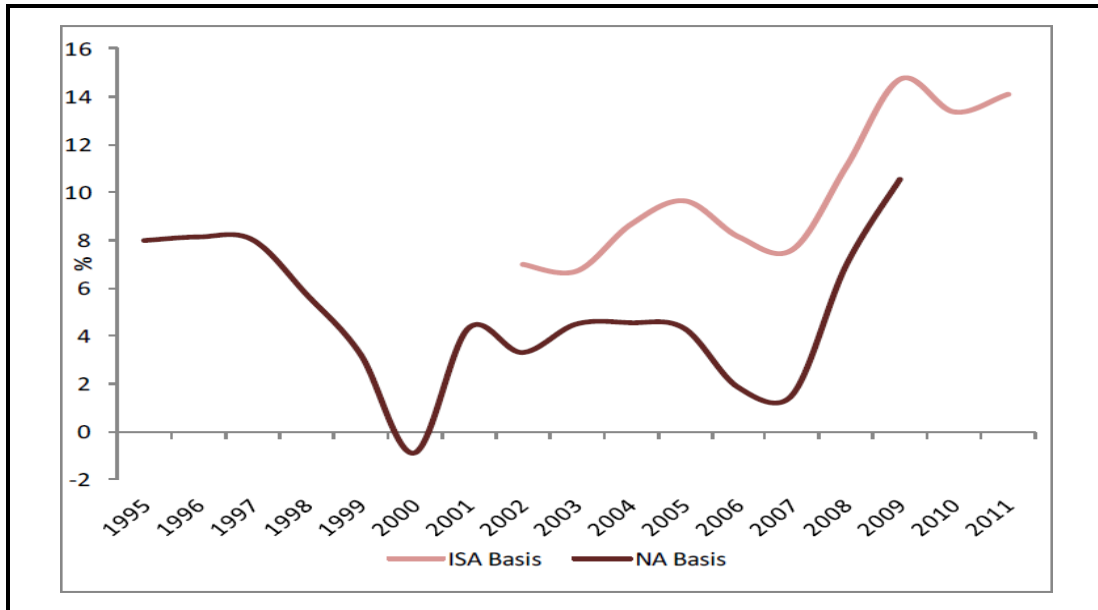


¹¹

http://www.centralbank.ie/polstats/stats/cmab/Documents/2012q1_ie_trends_in_business_credit_and_deposits.pdf

Flagging Domestic Demand

Figure 2: Savings rate in Ireland 1995-2011



Source: *The savings rate during the recession-ESRI Paper12*

The data from the National Accounts and the Institutional Sector Accounts displayed in Figure 2 above, tell the same story; the level of the savings rate during the period 1998-2007 was low relative to those estimated for earlier periods and were associated with significant increases in the level of real household consumption, with the National Accounts Data averaging 6.3 per cent from 1997-2007. The negative savings rate in 2000 was associated with a volume increase in consumption of 10.5 per cent between 1999 and 2000. In 2008 and 2009 the savings rate increased to 6.9 per cent and 10.5 per cent respectively from a level of 1.5 per cent in 2007 and these increases were associated with a decline in real household spending. This reservoir of savings contributes to the poor domestic climate faced by the SME sector but is worthy of hope if fundamentals of the economy increasing consumer sentiment. In this environment consumers may be encouraged to draw down savings which will support SME's going into the future.

The Retail Sales Index (RSI) and the Consumer sentiment Index (CSI) going back to 2005 are graphed in Figure 3 below. The Retail Sales Index is the official short-term indicator of changes in the level of consumer spending on retail goods. It measures the trend in the level of average weekly sales for each month, after allowances are made for calendar composition. The Consumer sentiment index records details on consumers' attitudes towards trends in the economy.

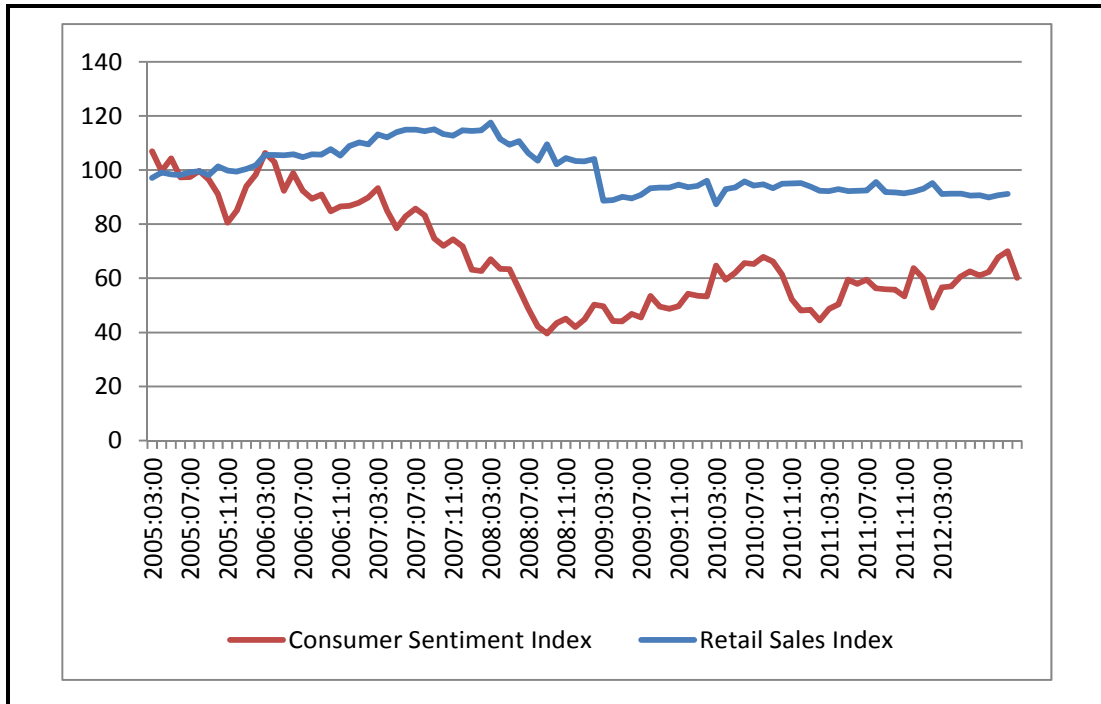
Both indexes have fallen substantially from 2005 onwards and remain low historically.

These indexes reflect the poor performance of the domestic economy which, as demonstrated earlier in the paper, is highly relevant for SMEs in the economy. The CSI declined from 70.0 in August to 60.2 in September. This compares to a reading in September of last year of 53.3. It is now down 44% from the peak in January 2005. The 3-month moving average also weakened, to 66.0 from 66.7 in August.

¹² http://www.esri.ie/publications/latest_publications/view/index.xml?id=3563

For the RSI, August figures show the volume of retail sales (i.e. excluding price effects) increased by 0.4% in August 2012 when compared with July 2012 while there was an annual decrease of 0.6%. It is now down 33% from its peak in January 2008.

Figure 3: Retail Sales Index and Consumer Sentiment Index from 2005 to May 2012 and April 2012 respectively



Source: CSO Statbank

Common Consolidated Corporate Tax Base (CCCTB): An Update

Introduction

After almost ten years of consultation, drafting and discussion, the European Commission published its eagerly anticipated proposal for a Common Consolidated Corporate Tax Base (CCCTB) on 16 March 2011¹³. The proposal generated much commentary and controversy, even before its publication. Our intention in this article is to provide an overview of the CCCTB proposal, where it currently stands and what will happen next.

What Is the CCCTB?

The draft Directive contains 136 Articles and is divided into 18 Chapters. As this proposed legislation falls into the direct taxation field, it is covered by Article 115 of the Treaty on the Functioning of the European Union (TFEU), which obliges the Council to act unanimously in accordance with the special legislative procedure and after consulting the European Parliament and the European Economic and Social Committee.

The CCCTB proposal is intended to provide a single set of rules that companies operating within the EU could use to calculate their taxable profits. Essentially, the intention is that a group of companies¹⁴ operating within the EU would have to comply with only one system for the calculation of its taxable income. The Commission has proposed that the CCCTB would be optional for companies to join.

According to the proposal by the Commission, the CCCTB would make it possible for groups of companies to consolidate all profits and losses across the EU. The single consolidated tax return would be used to report the consolidated base of the group, after which all Member States in which a group company is active would be entitled to tax a certain portion of that base, according to a specific formula based on three equally weighted factors (assets, labour and sales by destination). This work would all be done through the tax authorities of the group's principal Member State in what the Commission calls a "one-stop-shop" approach. The Commission argues that a Directive is needed to tackle the tax obstacles that are barriers to the completion of the Single Market and that place additional costs on businesses that trade across borders. It is worth reiterating that the focus of the CCCTB proposal is on the corporate tax base rather than on corporate tax rates, although this is the subject of some contention. Ireland would not support any proposals on the harmonisation of corporate tax rates.

Recent Developments Involving the CCCTB at Political Level

The European Council conclusions of 24/25 March 2011 created the Euro Plus Pact for Stronger Economic Policy Coordination for Competitiveness and Convergence. This pact, which was endorsed by all euro area members, plus Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania, includes commitments on tax policy coordination. The Pact states that:

“developing a common corporate tax base could be a revenue neutral way forward to ensure consistency among national tax systems while respecting national tax strategies, and to contribute to fiscal sustainability and the competitiveness of European Business.”

¹³ Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2011) 121 final – 2011/0058 (CNS).

¹⁴ For CCCTB purposes, a company will form a group with its permanent establishments in other Member States.

It goes on to say that “the Commission has presented a legislative proposal for a common consolidated corporate tax base”. The Pact is somewhat ambiguous, perhaps unintentionally, as it appears to support the development of a Common Corporate Tax Base (without the consolidation element) rather than endorsing or developing further the work of the Commission’s CCCTB.

Further developments at the political level took place in July 2011, when as part of the overall package of measures to ensure the financial stability of the euro area agreed by Heads of State or Government of the euro area at their meeting of 21 July 2011, Ireland indicated a:

“willingness to participate constructively in the discussions on the Common Consolidated Corporate Tax Base draft directive (CCCTB) and in the structured discussions on tax policy issues in the framework of the Euro+ Pact framework.”¹⁵

After this meeting, both Chancellor Merkel and former President Sarkozy met to discuss the ongoing financial stability issues in the euro area. In their joint letter of 17 August 2011 to President Van Rompuy, a specific reference is made to the CCCTB where both leaders seek a commitment from Member States:

“to finalize the negotiation on the Commission’s proposal on ‘a common consolidated corporate tax base’ before end 2012. Euro area member states should be ready to consider enhanced cooperation for further progress on tax coordination.”¹⁶

The CCCTB featured again in the conclusions of the European Council of 23 October and the euro area summit of 26 October 2011. In the context of the Euro Plus Pact, tax policy coordination and the CCCTB will become a more regular reporting feature of the European Council, meaning that each Presidency will have to ensure that these files are given adequate attention in the Council Working Party on Tax Questions.

Before the December 2011 European Council, Chancellor Merkel and former President Sarkozy wrote jointly to President Van Rompuy with proposals for stabilising the euro and additional measures that should be invoked to improve the functioning of the internal market. Included in these measures was a reference to a “convergence and harmonisation of corporate tax base”.¹⁷ It is clear that the issue of a common harmonised corporate tax base remains on the agenda of European politics.

The March 2012 European Council introduced a new reporting requirement relating to certain specific tax dossiers. Each Presidency must now report to the European Council progress in relation to the proposals on energy tax, savings tax, financial transaction tax and the CCCTB. The Council stated that “work and discussions should be carried forward on the Commission proposals”.¹⁸ This new reporting requirement was implemented in June 2012.

¹⁵ Statement by the Heads of State or Government of the Euro Area and EU Institutions, 21 July 2011, para. 10.

¹⁶ Letter to President Van Rompuy from Chancellor Merkel and President Sarkozy, 17 August 2011, http://www.elysee.fr/president/root/bank_objects/lettre_english_final_version.pdf.

¹⁷ Letter to President Van Rompuy from Chancellor Merkel and President Sarkozy, December 2011, <http://www.reuters.com/article/2011/12/07/us-eurozone-france-letteridUSTRE7B612Y20111207>.

¹⁸ European Council Conclusions 1/2 March 2012, <http://register.consilium.europa.eu/pdf/en/12/st00/st00004-re02.en12.pdf>.

CCCTB and Subsidiarity

All Member State parliaments are entitled to scrutinise European Union legislation in accordance with the principle of subsidiarity. The Dáil Select Committee on Standing Order 103 examined the CCCTB in May 2011 and following its examination, the Committee determined that the CCCTB was in breach of the principle of subsidiarity, which, in short, requires that any legislation from the EU only be enacted if the benefits of acting at the level of the EU outweigh the benefits of individual Member States acting to address a specific problem.¹⁹ The Committee concluded that:

- The EU failed to provide sufficient detail that would allow national parliaments to assess fully the impact of the CCCTB.
- The Commission had not established that EU legislation was justified as the best way to meet the broader objectives of the proposals, and actions by individual Member States alone could suffice.
- The plan would introduce a second, parallel tax system within each Member State. This would not improve the simplicity and efficiency of EU corporate tax systems.
- There was a concern that the proposal may suit larger Member States more and did not adequately address the needs of start-up SMEs.

Nine Member States, with a total of 13 votes,²⁰ voted that the CCCTB breached the principle of subsidiarity. However, this fell short of the Treaty requirement of 18 votes, which would have forced the Commission to re-examine whether the CCCTB was in conformity with the principle of subsidiarity. The Commission subsequently replied to all Member State parliaments that had raised a concern on subsidiarity.²¹

Ireland's Position on the CCCTB

Ireland's position on the CCCTB is one of scepticism, but it is constructively engaging in the policy and technical debate. As outlined above, the 21 July summit formally set out Ireland's position and participation in the CCCTB dossier. Ireland is not alone among Member States that are sceptical about the CCCTB proposal, but all Member States are participating in the technical debate on the dossier. As the Minister for Finance has stated on a number of occasions, despite Ireland's scepticism on the merits of the proposal, the Government's view is that it is vital that Ireland is represented in the debate, because only by actively engaging in the process can we ensure that we bring all of the issues of concern to the table. Ireland's approach to translating constructive engagement into practice has involved a number of different aspects.

Firstly, before the publication of the CCCTB, the Department of Finance commissioned a study on the budgetary and economic impact of the CCCTB on the European Union, which was published in January 2011 and is available on the Department's website (www.taxpolicy.gov.ie). A second study – on compliance costs – was commissioned by the Irish Tax Institute, IBEC and the Irish Banking Federation. The aim of this analysis

¹⁹ <http://www.oireachtas.ie/parliament/mediazone/pressreleases/title-2179-en.html>.

²⁰ Each Member State has two votes.

²¹ <http://www.ipex.eu/IPEXL-WEB/dossier/document.do?code=COM&year=2011&number=121&extension=FIN>.

was two-fold: to assess the potential impact of the proposal on the Exchequer and to examine whether the proposal is rigorous enough to stand up to the requirements of a modern corporate tax system. The analysis of the impact assessments provides important evidence-based material for use by Irish officials at the European Council Working Party on Tax Questions and justifies a sceptical but constructive approach in the discussions.

Secondly, Irish officials are engaging in the Working Party on Tax Questions as appropriate and when necessary. As the discussions on the CCCTB are still in the early stages, the interventions have focused on posing detailed questions and observations to the European Commission. As the work on the dossier advances, it will be necessary to consider new text for inclusion in the draft proposal.

Thirdly, the Irish approach is to engage with Irish business representatives and our EU partners on the dossier and ascertain their opinions on how the CCCTB proposal may impact on them. Engagement with our EU partners allows us to build a pan-European picture of the potential impact of the current proposal and areas where there may be some difficulties. This last aspect will be important in the run-up to and during the Irish Presidency of the European Council from 1 January 2013.

Current State of Play at the Technical Level

The proposal is currently being examined in the European Council Working Party on Tax Questions. Further meetings are at the discretion of the rotating EU Presidencies. Currently, Cyprus holds the Presidency of the European Council. There were four meetings during the Danish Presidency, which preceded that of Cyprus.

The work by Denmark focused on the calculation of the common corporate tax base from the perspective of a single taxpayer; also presented was a first proposal for compromise text, on certain specific elements of the proposal. It is important to emphasise that all Member States are engaged in the discussions, but the technical examination in the Council is still at the early stages. No political decisions have been taken by ECOFIN on the work on the dossier. The European Parliament and the European Economic and Social Committee examined the CCCTB in parallel to the discussions in the Council, but as taxation falls under the principle of unanimity, as laid down in the Treaty on European Union, the role of these two institutions is limited to consultation only.

Franco-German Bilateral Initiative on Corporate Tax Harmonisation

Entirely separate to the CCCTB proposal, but relevant nonetheless, the German and French Governments have indicated a desire to examine the possibilities for more closely aligning their corporate tax regimes with each other and have established a technical working group to do this. It is likely that whatever emerges from this process will feed into the wider consideration of the Commission proposal.

What Will Happen Next?

At the time of writing, Cyprus has assumed the Presidency of the European Council. It has indicated that it will continue work on the technical issues on the CCCTB proposal. If, at some point in the future, whenever technical discussions on the proposal have been completed, agreement cannot be reached by all 27 Member States acting unanimously, it is possible that the enhanced cooperation procedure, as provided for in the Treaty on European Union, could be considered for the CCCTB, which would mean that a smaller group of EU Member States might decide to move forward with the proposal among themselves. However, in the short term, the work during the Cypriot Presidency and the subsequent Irish Presidency will be to finish a first reading of the proposal, giving

Member States an opportunity to air their initial technical views and concerns. From Ireland's perspective, the engagement with the CCCTB is ongoing, and examination of this complex proposal is still at the early stages.

Annex

EU/IMF PROGRAMME OF FINANCIAL SUPPORT

Background

The previous Government agreed on 28 November 2010 to enter an €85 billion EU/IMF Programme of Financial Support of Ireland. 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:

- €2.5 billion from the European Financial Stabilisation Mechanism (EFSM);
- €2.5 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
- €2.5 billion from the IMF.

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 - have direct impact on all Departments.
3. **Financial Sector Reforms:** These concern supervision, recapitalisation and deleveraging of the banking sector and are 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 legislation on a medium-term expenditure framework to provide for binding multi-annual ceilings on expenditure.

To date, Ireland is meeting its Programme commitments and Table 1 below shows the number of conditions met, and those identified for subsequent quarters (as of November 2012).

Table 1: Action Required Under the EU/IMF Programme

Category Description	Actions Required/ Completed Q4 2010- Q2 2012	Actions Required/ Completed Q3 2012	Total Actions Completed to Date	Actions Required Q4 2012	Actions Required (Q1 2013 – Q4 2013)	Total Actions Required Q4 2010 – Q4 2013
Permanent Conditions – Apply for the Duration of the Programme	(6-10)	(11)	(11)			
Fiscal Consolidation	12		12	5		17
Financial Sector Reform	83	18	101	16	47	164
Structural Reform	31	11	42	8	10	60
Structural Fiscal Reform	6	4	10	0	1	11
Total*	132	33	165	29	58	252

Source: Department of Finance

Notes:

Permanent conditions are ongoing and are not included in quarterly completion totals.

* There is an element of overlap and repetition in some of the tasks enumerated.

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 – there are a number of repeat actions – for example, progress on bank restructuring and deleveraging.

The above table shows that over 160 actions have been completed (excluding permanent conditions which are ongoing). 87 Programme conditions remain to be completed over the remainder of the programme.

Quantitative Performance Criteria (QPC) and Indicative Targets (IT) are defined in the MEFP tables for each quarter. The period covered in the August Programme documentation is from end-September 2012 to end-June 2013 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 9 targeted deliverables.

Ireland continues to meet all its commitments under the Programme.

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 their quarterly missions to Ireland. During these 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 seventh quarterly review in July 2012. The eighth quarterly review mission took place in October 2012.

Loan Disbursements

At the end of October 2012, Ireland's nominal borrowings under the EU/IMF Programme amounted to €5.29 billion.

The net amount received into the Exchequer was €4.61 billion. This represents 81% of the total funds available from the Troika. This differs from the figure above because of foreign exchange translation effects, adjustments for below par issuance and the deduction of a refundable prepaid margin of €0.53 billion by the EFSF.

The euro area Heads of State or Government (HOSG) agreed on 21 July 2011 to lengthen the maturity of future EFSF loans to Greece to the maximum extent possible from 7.5 years to a minimum of 15 years and up to 30 years with a grace period of 10 years. This was also applied to Portugal and Ireland. Ireland's EFSF loans will have an overall weighted average life of 15 years at the time of the final disbursement. The EFSF has also moved to a pooled interest rate charging structure which means that all programme countries will pay the same interest rate on loans issued under that structure.

In October 2011, the EU Council of Ministers approved an EU Commission proposal to increase the maturity of individual tranches of lending to Ireland and Portugal from 15 years up to 30 years. As a result the overall average original maturity of the EFSM loans to these countries will increase from the initial 7.5 years to up to 12.5 years.

The weighted average life of all programme loans drawn down to date is 10.4 years. Repayment will commence in 2015.

The following table provides details of the net amount drawn down to date from the three main lenders and bilateral loans from the UK, Sweden & Denmark.

Table 2: EU/IMF Programme Loans drawn by Ireland – as of 31 October 2012

Funding Mechanism	Currency	Currency	Net*
		Principal	Drawdown
		€bn	€bn
European Financial Stability Facility (EFSF)	EUR	12.74	12.16
European Financial Stabilisation Mechanism (EFSM)	EUR	21.70	21.62
International Monetary Fund (IMF)	SDR**	15.79	18.12
UK Bilateral Loan	GBP	2.02	2.46
Denmark Bilateral Loan	EUR	0.10	0.10
Sweden Bilateral Loan	EUR	0.15	0.15
TOTAL	EUR		54.61

Source: NTMA

Notes:

* The net euro drawdown figures are net of deductions including the prepaid margin on the first EFSF disbursement and discounts applied for below par issuance and also reflect the effect of foreign exchange transactions

** IMF Loans are denominated in Special Drawing Rights (SDRs), an international reserve asset which is composed of a basket of currencies consisting of the euro, Japanese yen, pound sterling, and U.S. dollar.

SUPPLEMENTARY TABLES

Table 1: General Government Balance (GGB) Estimates 2011-2015

	ESA	2011	2011	2012	2013	2014	2015
		€m	% of GDP				
<i>Net lending (EDP B.9) by sub-sector</i>							
1. General government (=6-7)	S.13	-21,256	-13.4	-8.3	-7.5	-5.0	-2.9
2. Central government	S.1311	-21,259	-13.4	-8.1	-7.5	-5.0	-2.9
4. Local government	S.1313	10	0.0	-0.1	0.0	0.0	0.0
5. Social security funds	S.1314	-8	0.0	0.0	0.0	0.0	0.0
<i>General government (S.13)</i>							
6. Total revenue	TR	55,414	34.9	34.4	34.5	34.8	34.8
7. Total expenditure	TE	76,672	48.2	42.7	42.0	39.8	37.7
8. Net lending/borrowing (=6-7)	B.9	-21,257	-13.4	-8.3	-7.5	-5.0	-2.9
9. Interest expenditure	D.41	5,325	3.3	3.9	5.6	5.6	5.6
10. Primary balance (= 1 + 9)		-15,932	-10.0	-4.3	-1.9	0.5	2.6
11. Bank Recapitalisation		-6,824	-4.3				
<i>Selected components of revenue</i>							
12. Total taxes (12=12a+12b+12c)		37,627	23.7	24.3	25.0	25.5	25.8
12a. Taxes on production and imports	D.2	17,682	11.1	11.0	11.1	11.0	10.8
12b. Current taxes on income, wealth etc.	D.5	19,238	12.1	12.8	13.4	14.0	14.5
12c. Capital taxes	D.91	707	0.4	0.5	0.5	0.5	0.5
13. Social contributions	D.61	10,251	6.4	5.8	5.7	5.6	5.5
14. Property income	D.4	2,000	1.3	1.4	1.4	1.4	1.3
15. Other		5,536	3.5	2.9	2.4	2.3	2.1
16. (=6) Total revenue (=12 to 15)	TR	55,414	34.9	34.4	34.5	34.8	34.8
p.m.: Tax burden		48,309	30.4	30.4	30.9	31.5	31.7
<i>Selected components of expenditure</i>							
17a. Compensation of employees	D.1	19,113	12.0	11.6	11.2	10.6	10.0
17.b Intermediate consumption	P.2	8,891	5.6	5.3	5.0	4.5	4.1
18. Social payments (18 = 18a+18b)		27,618	17.4	16.6	15.7	14.7	13.9
18a. Social transfers in kind	D.63	3,812	2.4	2.3	2.2	2.0	1.9
18b. Social transfers other than in kind	D.62	23,806	15.0	14.3	13.5	12.7	12.0
19=9 Interest expenditure	D.41	5,325	3.3	3.9	5.6	5.6	5.6
20. Subsidies	D.3	639	0.4	0.3	0.3	0.2	0.2
21. Gross fixed capital formation	P.51	4,033	2.5	2.2	1.8	1.7	1.6
22. Other		11,053	7.0	2.7	2.4	2.5	2.4
23=7 Total expenditure (=17 to 22)	TE	76,672	48.2	42.7	42.0	39.8	37.7
Nominal GDP (rounded to nearest €25m except 2011)	B.1*g		158,993	163,150	167,725	174,100	181,400

Source: Department of Finance, Department of Public Expenditure and Reform, CSO & NTMA.

Notes to Table 1:

- Rounding may affect totals.

- Table 1 sets out the General Government Balance (GGB) for the years 2011 to 2015 in terms of selected components of general government receipts and expenditures. Ireland's headline GGB in 2011 was -13.4 per cent of GDP (see item 1). A significant amount of this deficit (4.3 percentage points of GDP, see item 11) arises from capital injections into financial institutions that took place in July last year. Ireland's underlying deficit (which excludes banking recapitalisation) fell by 1.6 percentage points to 9.1% of GDP in 2011, well below the Programme limit of 10.6%.

- Item 1: Net lending by general government is identical with the general government balance.

- Item 9 & 19: Interest expenditure by general government is calculated on an accruals basis. In Ireland's case this includes interest payable on the promissory note paid to financial institutions in 2010. (There is an interest holiday where no general government interest is due on the promissory notes in 2011 and 2012.)

- Item 12a: Taxes on production and imports include VAT, customs, excise and stamp duty, local authority rates and the non-household part of motor tax.

- Item 12b: Current taxes on income and wealth comprise income tax, capital gains tax and corporation tax, the household part of motor tax and of television licences and the household charge.

- Item 12c: Capital taxes comprise capital acquisitions tax and the pension funds levy.

- Item 13: Social contributions consist mainly of contributions to the Social Insurance Fund. Imputed social contributions are also included.

- Item 14: Property income is made up of investment or dividend income.

- Item 15: Other receipts include miscellaneous receipts such as Departmental receipts (appropriations in aid), rents and receipts from abroad, receipts by non-commercial State sponsored bodies and miscellaneous capital receipts.

- Item 17a: Compensation of Employees includes wages and salaries as well as an estimate of the amount that would have to be contributed if public sector pensions were actually funded schemes.

- Item 17b: Intermediate consumption is current spending on goods and services by government units.

- Item 19: Social transfer payments include pensions, child benefit, payments for medical goods, transfers to the rest of the world and other unrequited payments to households. Social transfers in kind include such items as free travel on public transport and fuel allowances.

- Item 22: Gross fixed capital formation is acquisitions less disposals by government of capital formation such as construction and machinery.

- Item 23: In 2011 other expenditure includes €6.8 billion deficit increasing capital transfer into Irish banks. This item also includes transfer payments to non-government bodies such as higher education and capital grants. It also includes acquisitions less disposals of non-produced assets such as royalties and mobile phone licences.

Methodological Changes in the table since April 2012 SPU

Since the last publication of this table in the April 2012 SPU, there have been two changes in classification of entities that affect the composition of the receipt and expenditure items. Very little change to the general government balance results from these classification changes:

Secondary Schools

Secondary schools are now classified within the government sector in National Accounts. Previously, payments from the Education Vote to secondary schools were classified as transfer payments in "other expenditure". Under the new classification system, the costs of secondary schools are classified mostly as compensation of employees, intermediate consumption and capital formation.

Radio Teilifís Éireann (RTÉ)

RTÉ is now classified within the government sector and licence fees are now recorded as a tax in National Accounts. The receipts and expenditures of RTÉ are now therefore part of the receipts and expenditures of general government.

Table 2: Movement (“Walk”) from Exchequer Balance to GGB

<i>€millions</i>	2012	2013	2014	2015
(a) Exchequer balance	-15,605	-15,315	-11,245	-7,465
(b) Non-cash payment in 2012 of IBRC promissory note	-3,060	0	0	0
(c) Exclude equity and loan transactions	2,300	825	365	10
(d) Exclude repayment of promissory notes issued to financial institutions	3,085	3,085	3,085	3,085
(e) Include prom note interest accrual	-15	-1,890	-1,780	-1,685
(f) Adjust for national debt interest accrual	-480	-100	-20	-85
(g) Adjust for tax accruals	-110	185	190	155
(h) Adjust for other accruals	115	-30	-75	-85
(i) Impact of NPRF	555	595	600	595
(j) Transactions between government bodies	25	-105	-35	-20
(k) Net borrowing/lending of non-commercial State sponsored bodies	-85	100	145	145
(l) Net Surplus of the Social Insurance Fund	0	0	0	0
(m) Net (Borrowing)/Surplus of Local Government	-200	0	0	0
(n) General Government balance (= a to m)	-13,470	-12,645	-8,770	-5,345
(p) General Government balance as % of GDP	-8.3	-7.5	-5.0	-2.9
(q) Nominal GDP (rounded to nearest €25m)	163,150	167,725	174,100	181,400

Source: Department of Finance

Notes:

- Rounding may affect totals

- Table 21a of the CSO National Income and Expenditure (September 2012) publications shows the movement from the Exchequer Balance to the General Government Balance for the period 2006-2011.

- Any GGB worsening expenditure for credit union resolution and/or restructuring, such as from the Credit Institutions Resolution Fund (CIRF) is, for the purposes of EDP GGB targets, treated in the same manner as GGB worsening banking related expenditure. It is excluded in assessing adherence to EDP targets and therefore any such expenditure which may occur in the years 2013-2015 is not shown in the table.

- The GGB measures the fiscal performance of all arms of Government, i.e. Central Government, Local Authorities, Vocational Education Committees and non-commercial State sponsored bodies, as well as funds such as the SIF and the NPRF which are managed by Government agents. It thus provides an accurate assessment of the fiscal performance of a more complete ‘Government’ sector.

- The GGB does not reflect the position of commercial State sponsored bodies as these agencies are classified as being outside the general government sector. The GGB is calculated in accordance with ESA95, a consistent standard developed by the EU to facilitate budgetary comparisons between EU Member States in accordance with their obligations under the Maastricht Treaty.

a. The Exchequer Balance is the traditional domestic budgetary aggregate which measures the net surplus or deficit position of the Exchequer account. It is the difference between total receipts into and total expenditure out of the Exchequer account of the Central Fund.

b. In 2012 the annual promissory note payment to IBRC was made with a government bond.

c. Equity and loan transactions are excluded from the GGB on the basis that they affect the composition but not the level of assets and liabilities.

d. This item reflects the amounts committed in Promissory Notes to IBRC and EBS in 2010. These amounts are paid in equal instalments of 10% of the principal sum. The full GGB effect of the Promissory Notes principal sum was shown in 2010, and as the Exchequer pays this money to the financial institutions, the effect of this is removed from the GGB in subsequent years.

e. This refers to the accrued interest payable on Promissory Notes issued to financial institutions and a Eurostat ruling that there would be no interest payable on these Promissory Notes for the years 2011 and 2012, except for a minor amount in respect of the Educational Building Society (EBS) Promissory Note.

f. This adjustment reflects the accruals of National Debt interest.

g. & h. These adjustments are required in respect of certain transactions recorded on an accruals basis in calculating the GGB. These include tax accruals, Departmental balances, EU transfers, and the impact of the capital carryover.

i. This is the net lending/borrowing of the NPRF. This fund is within the General Government sector and transactions within the sector do not have an impact on the GGB.

j. Transfers between units within the General Government sector do not affect the GGB.

k, l & m. These adjustments add the net lending/borrowing of other government bodies and local government to arrive at a full concept of general government.

Table 3: Evolution of Forecast General Government Debt/GDP Ratio

(% of GDP)	2011	2012	2013	2014	2015
Gross debt	106.4	117.7	121.4	120.4	117.0
Change in gross debt (= 1 + 2 + 3)	14.0	11.3	3.7	-1.0	-3.3
<i>Contributions to change in gross debt ratio:</i>					
1. General Government Deficit	13.4	8.3	7.5	5.0	2.9
2. Stock-flow adjustment	2.4	5.7	-0.6	-1.6	-1.4
3. Nominal GDP contribution to Δ in debt ratio	-1.7	-2.7	-3.2	-4.5	-4.8
<i>Composition of GGB:</i>					
4. General Government Balance	-13.4	-8.3	-7.5	-5.0	-2.9
5. Interest expenditure	-3.3	-3.9	-5.6	-5.6	-5.6
6. Primary balance (= 4 - 5)	-10.1	-4.3	-1.9	0.5	2.6
<i>Composition of stock-flow adjustment:</i>					
7. Change in liquid assets	1.2	3.7	-0.8	-2.3	-1.8
8. Interest adjustments	-0.4	-0.3	-0.9	0.0	0.0
9. Equity transactions	3.0	1.4	0.5	0.2	0.0
10. Accrual adjustments	0.6	0.0	0.1	0.1	0.0
11. Impact of NPRF	-2.7	0.3	0.4	0.3	0.3
12. EFSF prepaid margin	0.3	0.0	0.0	0.0	0.0
12. Other	0.4	0.6	0.1	0.0	0.0
<i>Memorandum item:</i>					
Implied average interest rate (%)	3.6	3.8	4.9	4.8	4.8

Source: Department of Finance

Notes:

- The implied average interest rate is calculated by dividing General Government interest expenditure in year t (see table 4.2, chapter 4) by the stock of General Government debt outstanding at the end of year $t-1$ (see table 4.1, chapter 4). The sharp increase in the implied average interest rate in 2013 primarily reflects the impact of the ending of the Promissory Note interest holiday which applied in 2011 and 2012.

- Item 9: Equity transactions in 2011 include a €4.5bn equity purchase in respect of AIB, BOI and ILP.

- Item 11: In 2011, this reflects the impact of a €3.7bn GGB-impacting injection from the NPRF into AIB.

Table 4a: Promissory Notes (debt outstanding)

Year (€billion)	Annual Promissory Note payment	Interest Paid	Promissory Note Debt Outstanding
2010		-	30.85
2011	3.09	0.57	28.33
2012	3.09*	0.01	25.26
2013	3.09	0.51	22.68
2014	3.09	1.85	21.44
2015	3.09	1.76	20.12
2016	3.09	1.66	18.69
2017	3.09	1.56	17.17
2018	3.09	1.45	15.53
2019	3.09	1.33	13.77
2020	3.09	1.20	11.89
2021	3.09	1.06	9.87
2022	3.09	0.91	7.69
2023	3.09	0.75	5.36
2024	2.12	0.58	3.82
2025	0.93	0.45	3.33
2026	0.91	0.39	2.81
2027	0.91	0.33	2.23
2028	0.91	0.26	1.58
2029	0.91	0.19	0.86
2030	0.91	0.10	0.05
2031	0.05	0.01	0.00

Source: Department of Finance

Notes:

- Rounding may affect totals

- The figures reflect the €30.6bn in Promissory Notes issued to Anglo Irish Bank and Irish Nationwide Building Society (INBS) – now known collectively as Irish Bank Resolution Corporation (IBRC) – as well as the €250m EBS Promissory Note.

* In 2012 the €3.06bn IBRC Promissory Note payment was settled with a Government bond.

Table 4b: Promissory Notes (impact on GGB of initial contract and interest accrued)

Year (€billion)	Initial Promissory Note	Accrued Interest	Total GGB Impact
2010	-30.85	-0.56	-31.41
2011		-0.01	-0.01
2012		-0.01	-0.01
2013		-1.90	-1.90
2014		-1.79	-1.79
2015		-1.68	-1.68
2016		-1.58	-1.58
2017		-1.47	-1.47
2018		-1.36	-1.36
2019		-1.23	-1.23
2020		-1.09	-1.09
2021		-0.95	-0.95
2022		-0.79	-0.79
2023		-0.62	-0.62
2024		-0.48	-0.48
2025		-0.41	-0.41
2026		-0.35	-0.35
2027		-0.28	-0.28
2028		-0.20	-0.20
2029		-0.12	-0.12
2030		-0.03	-0.03
2031		-0.00	0.00

Source: Department of Finance

Notes:

- Rounding may affect totals.

- The purpose of table 4b is to show the initial impact on the 2010 GGB of the €30.85bn in Promissory Notes issued to Anglo Irish Bank and INBS – now known collectively as IBRC – and the EBS, as well as the impact on the GGB of the accrued interest. It is only these two impacts which are taken account of in the table.

- No account is taken of the dividends being paid to the State for ELA provision related to the Promissory Notes, which are GGB benefitting, or of the interest costs associated with borrowing to fund the annual Promissory Note payments, which negatively affect the GGB.