Pre-Budget 2019 Statement

September 2018

Irish Fiscal Advisory Council

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Key Messages

The Government should stick to its existing budget plans for 2019 of a budget-day package of €0.8 billion. This would increase government expenditure (net of tax measures) in line with the sustainable long-term growth rate of the economy. Various estimates would put this at approximately 3¼ per cent per annum. This combined with inflation would imply an approximate limit of up to €3½ billion for spending increases or tax cuts for 2019. There is no case for additional stimulus in 2019 beyond this.

The cost of previously announced measures, including sharp increases in public investment spending, means that the scope for new initiatives – over and above previous commitments – in *Budget 2019* is limited. If additional spending measures are to be addressed in 2019 beyond the quantity in the *Summer Economic Statement 2018*, these should be funded by additional tax increases or through re-allocations of existing spending.

An earlier move to a small budget surplus than planned would be warranted if cyclical growth and corporation tax receipts continue to exceed expectations. Any unexpected increases in tax revenues or lower interest costs that arise this year or in 2019 should not be used to fund budgetary measures beyond those currently planned. The risks of overheating and the narrowing window of opportunity provided by a favourable external environment would suggest that improving the budget balance by more than currently planned would be desirable. This would be especially warranted if revenues were to outperform expectations for factors that may be temporary. This includes higher corporation tax receipts or stronger-than-expected growth in the domestic economy. The Government should instead use these receipts to build buffers either through additional contributions to the Rainy Day Fund or through a budget surplus and faster debt reduction. Moreover, expenditure ceilings should not be allowed to continue to drift up as unexpected – and likely cyclical or transitory revenues – arise.

The economy looks set to continue to grow at a rapid pace. A number of indicators show that the Irish economy is still growing rapidly.

Forecasts assume that this pace of expansion in the domestic economy will only gradually moderate and the current outlook for Ireland’s main trading partners remains reasonably strong.

Most plausible estimates suggest that the domestic economy has been growing faster than its potential growth rate since 2014 and is now, in 2018, close to its potential. Central forecasts suggest that it will move beyond potential from 2019 onwards, with overheating emerging in later years.

It is inevitable that adverse shocks will occur in coming years. Further ahead, three major sources of potential downside risks to Ireland are apparent: Brexit, rising protectionism, and the international tax environment. The size and nature of potential impacts from various Brexit scenarios are highly uncertain. Standard models may not fully capture the extent of Ireland and the UK’s closely integrated supply-chain networks, and other key channels may be more important than is assumed. In terms of the international tax environment, the highly concentrated nature of Irish corporation tax receipts means that substantial reductions in government revenue could arise if even one large firm were to relocate its operations to elsewhere.

Efforts to stabilise the public finances since the crisis have proven successful, but improvements on the budgetary front have stalled since 2015. This comes despite a strong recovery in the economic cycle – both domestically and internationally – in addition to a supportive monetary policy environment. Non-interest spending has risen at essentially the same pace as tax revenue since 2015 so that the strong cyclical recovery and favourable external environment have not led to any notable improvement in the underlying budgetary position (excluding interest savings). It is clear that recent revenue growth has been supported by short-term cyclical developments and a possibly transient surge in corporation tax receipts. Looking through these effects, the underlying structural position would appear to have deteriorated since 2015.

Ireland's debt burden is still among the highest in the OECD. When set against a more appropriate measure of national income like GNI*, Ireland's net debt burden for 2017 is equivalent to 96 per cent, the fourth highest in the OECD behind only Portugal, Italy and Japan.

The Government should reinforce its medium-term plans to ensure that these are credible. Focusing on the right budgetary stance and being prepared to be more cautious than the fiscal rules allow is the correct approach for the Government to follow over the medium term. This is particularly true, given that the strict legal application of the current fiscal rules using the EU's Commonly Agreed Methodology for potential output estimation will not necessarily prevent a repeat of procyclical fiscal policy mistakes made in the past. In particular, the Rainy Day Fund – though potentially useful – is currently only half-formed and needs more development if it is to be effective. A better goal for the Fund would be to counteract some of the procyclical bias currently present in the fiscal rules and evident in policy in the lead-up to the last crisis. As it stands, the Rainy Day Fund is not countercyclical and is only envisaged as a fund that would deal with unexpected shocks or events.

Pre-Budget 2019 Statement

1. Introduction

The Council's mandate includes assessing the prudence of the Government's fiscal stance. The basis for the Council's assessment is twofold: first, the Council conducts an economic analysis, which assesses the appropriateness of the fiscal stance in terms of the principles of sound economic and budgetary management; second, the Council assesses whether the Government's fiscal plans are in line with the requirements of the budgetary framework.[1]

This *Pre-Budget 2019 Statement* reviews the fiscal stance in advance of *Budget 2019* in line with these aspects of the Council's assessment. Since the Council's *Fiscal Assessment Report June 2018*, the Government has published its *Summer Economic Statement 2018* (*SES 2018*) and the *Mid-Year Expenditure Report 2018*.

[1] The budgetary framework is a system of procedures and rules that are designed to set the public finances on a sustainable path. The framework includes the requirements outlined under the domestic Budgetary Rule (as set out in the *Fiscal Responsibility Act 2012*) as well as those covered by the EU's *Stability and Growth Pact* (*SGP*). The framework also gives an independent role in monitoring and assessment to the Council.

2. The Macroeconomic Context for the Budget

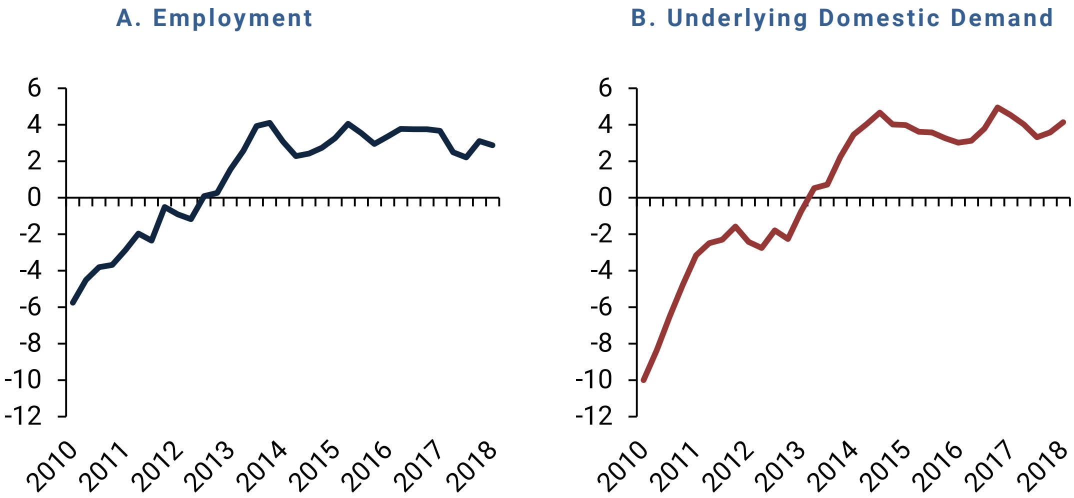
Recent National Accounts data confirm the Council's macroeconomic assessment (*Fiscal Assessment Report June 2018*) that the economy is continuing to undergo a rapid recovery.

Recent Domestic Economic Activity

The Irish labour market has proven a reliable indicator of domestic activity in recent years and has shown little sign of a slowdown in its recent recovery. Employment growth has averaged close to 2.5 per cent in year-on-year terms since 2013 and this has continued apace into 2018 (Figure 1A).

Figure 1: Indicators of Economic Activity

% change in volumes, year-on-year



Sources: CSO; and internal Irish Fiscal Advisory Council (IFAC) calculations.
Note: Annualised underlying domestic demand is an aggregate measure comprising consumer spending plus investment plus government consumption, which also excludes investment in intangibles and aircraft.

With aggregate national accounts measures still prone to a variety of distortions arising from the activities of foreign-owned multinational enterprises, it is worth considering other aggregates. Domestic Gross Value Added (GVA) strips out some of the larger volatile sectors whose activities are less integrated with the Irish economy (e.g., producers of pharma-chem products, various computer products, and medical devices). This aggregate has grown strongly since 2014 and, despite moderating in 2017, it is still growing at a pace above its previous two-decade average (3.8 per cent per annum over 1997–2016). Underlying domestic demand is another such useful aggregate, albeit one that excludes the traded sector. As shown in Figure 1B, this measure also points to a sustained recovery in the domestic economy over the last few years.[2]

The Cyclical Position

Economic developments are positive and most estimates would suggest that the economy is close to its potential. The Council's own range of estimates suggests that any remaining negative output gap will have closed this year. New alternative estimates from the Department of Finance would suggest that the output gap is set to become marginally positive in 2019 (+0.3 per cent) with some moderate overheating emerging in later years (+0.9 per cent by 2021).[3] Estimates available from other institutions suggest a more positive output gap at present, albeit that other signs of overheating pressures or growing imbalances are generally absent across most of the indicators typically used for such assessments.[4]

However, estimates of the economic cycle are subject to substantial uncertainty and revision. The various estimates produced by the Council range from -0.9 to +1.7 per cent for 2018. Notwithstanding the wide uncertainty surrounding estimates, the broad thrust in recent years has been towards an economy that is experiencing a strong cyclical recovery – one where actual economic growth has exceeded potential medium-term growth.

It is worth bearing in mind that the current cyclical recovery has been running since at least 2014. Economic cycles can have irregular durations and a better way to conceive the likelihood of a coming slowdown or recession may be in terms of the accumulation of various imbalances in

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[2] Underlying domestic demand is an aggregate measure comprising consumer spending plus investment plus government consumption, which also excludes investment in intangibles and aircraft, both of which have a high import content.

[3] These are new estimates that the Department has produced as alternatives to the estimates produced using the Commonly Agreed Methodology, which has tended to yield implausible results for Ireland. Box D of the *June 2018 Fiscal Assessment Report* discusses these in detail (IFAC, 2018). By way of comparison, the same new alternative models from the Department show an output gap of +6.9 per cent in 2007.

[4] OECD, IMF, and European Commission estimates suggest an already overheating economy. OECD estimates show an output gap of 2.6 per cent for both 2017 and 2018, while IMF estimates show an output gap of 1.8 per cent in both 2017 and 2018. European Commission estimates suggest that the output gap for 2017 was -0.5 per cent, rising to +0.7 per cent in 2018.

the economy or the probability of an external negative shock occurring (IFAC, 2018). In this respect, a number of sources of adverse shocks are currently foreseeable.

Risks to the Outlook

The Council assesses that risks to the Department's central forecasts are mixed. Near term, growth prospects continue to look favourable, and upside risks are apparent. In particular, supply pressures in the housing sector might lead to a faster-than-expected – though much-needed – pick-up in housing construction. There are already signs that the labour market is tightening. If the wider economy shows signs of overheating, the Government should introduce offsetting countercyclical fiscal policy measures.

Further ahead, depending on how events proceed, three major sources of potential downside risks to Ireland are apparent: Brexit, rising protectionism, and the international tax environment.

Brexit remains a key source of risks to the medium-term outlook. Two years after the referendum decision, the UK's ultimate trading relationship with the EU and the implications for Ireland still remain unclear. Moreover, the size and nature of potential impacts from various Brexit scenarios are highly uncertain. Estimates of "soft" and "hard" Brexit scenario impacts on Irish output still vary widely. While the range of estimated impacts on output is large, standard models may also not fully capture the extent of Ireland and the UK's closely integrated supply-chain networks, and other key channels may be more important than is assumed.

Other risks stem from Ireland's reliance on a small range of specialised exporting activities, rising protectionism and potential changes in international tax environment. Corporation tax receipts have already grown rapidly in recent years and could register a record share of Exchequer tax revenues this year if the current over-performance relative to forecasts is sustained. The high volatility and strong concentration of corporation tax receipts in few companies pose significant risks of sharp revenue falls. The Council's *June 2018 Fiscal Assessment Report* (Box C) noted that the stylised direct impact of a large firm leaving Ireland would be to reduce government revenues by over €330 million, close to half a per cent of total revenue in 2016. This would mostly arise due to lost corporation tax.

Imbalances and overheating can undermine the sustainability of the public finances. To monitor potential imbalances in the economy, the Council uses a "modular approach". This involves assessing four main areas: (1) the labour market and prices, (2) external balances, (3) housing and investment, and (4) financial indicators. Excessive levels or growth rates in these variables could signal imbalances and/or future corrections in the economy.

Figure 2 shows a newly-developed "heat map", a summary tool that the Council has developed in order to help with assessing potential imbalances in the economy. It relates historical outturns and forecasts for a number of variables to their long-run levels. Possible instances of overheating, or above-average readings, are shown as deepening shades of red, while below-average readings register in deepening shades of blue. The "heat map" summarises a range of relevant data and provides an assessment of the position at a point in time relative to historic norms. It is important to note that this is only one input into the Council's assessment of risks.[5]

Forecasts contained in *SPU 2018* suggest potential contributions to overheating over the forecast horizon in the unemployment rate and non-housing construction levels as a percentage of GNI*. Consumer prices, wages and housing activity do not signal any risk of overheating in the Department's central forecasts, though there are clear upside risks related to pent-up demand for housing and a tightening labour market. An important caveat when using forecasts to inform the assessment is that macroeconomic forecasts tend to be constructed to bring the economy to equilibrium over the forecast horizon and so are likely to understate the prospects for overheating.

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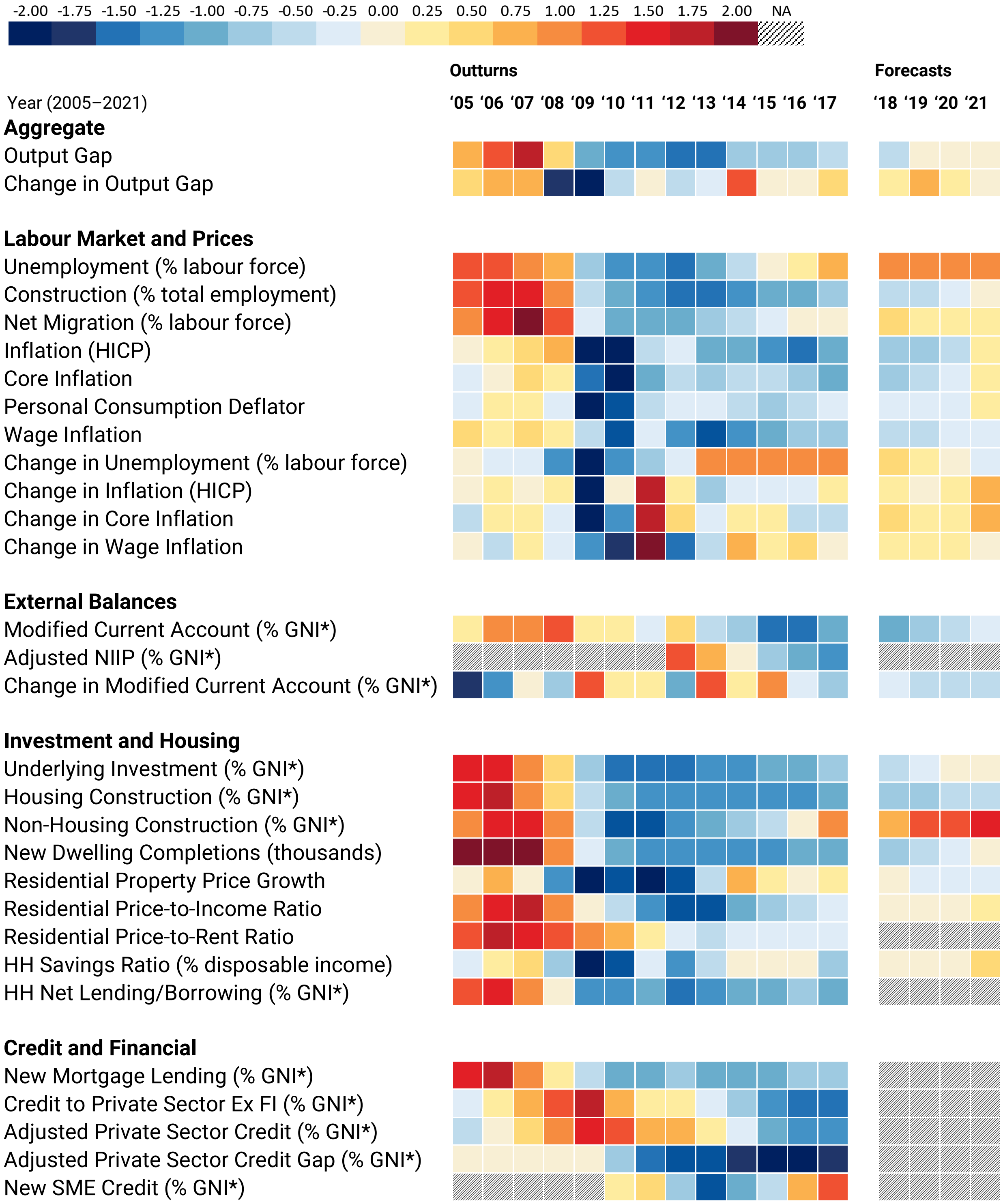
[5] It is also worth noting that the heat map is very mechanical in nature and it may fail to adequately account for structural shifts. A particular challenge with the approach is that of identifying appropriate equilibria for each of the indicators included.

Figure 2: Heat Map for Monitoring Potential Imbalances

Within specified standard deviation bands of central values:



Sources: CSO; Central Bank of Ireland; Department of Finance (*SPU 2018* forecasts); Department of Environment, Heritage and Local Government; ESRI/PTSB; European Commission (AMECO and CIRCABC); Residential Tenancies Board; and internal IFAC calculations.

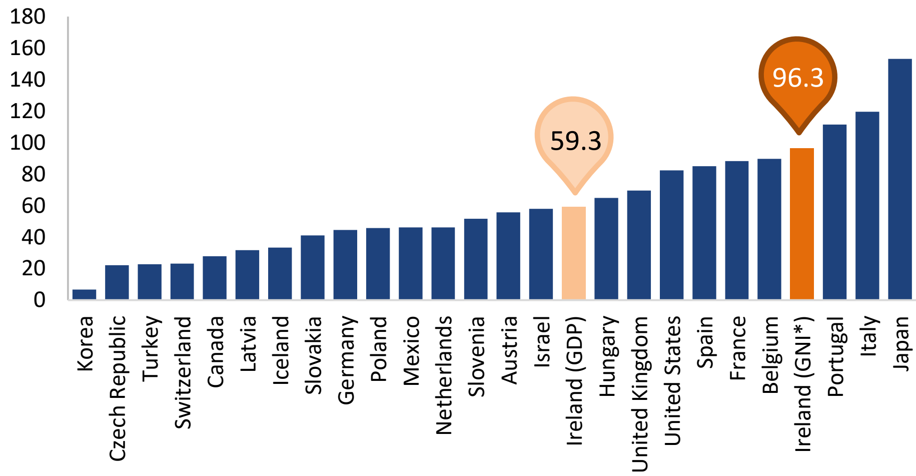
3. The Fiscal Context for the Budget

Ireland's government debt burden remains among the highest in the OECD, and improvements in the gap between non-interest spending and total government revenue have stalled since 2015.

Government Debt

Ireland's net debt burden is the fourth highest in the OECD behind only Portugal, Italy and Japan when set against a more appropriate measure of national income like GNI*. Ireland's net debt burden for end-2017 is equivalent to 96 per cent on this basis (Figure 3).[6]

Figure 3: The 25 Largest Net Debt Burdens in the OECD
% GDP (incl. % GNI* for Ireland), end-2017 net general government debt



Sources: IMF (April 2018 WEO); CSO; Eurostat; and internal IFAC calculations. Greece is excluded due to the absence of net debt data.

Government Balance

Having brought a substantial government deficit that emerged during the crisis to below 3 per cent of GDP in 2015, the pace of improvement in the budget position has since stalled as shown by the deficit excluding interest costs (the primary balance). This lack of improvement comes despite a strong recovery in the economic cycle, both domestically and

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[6] Note that the *Stability and Growth Pact* criterion of a 60 per cent ceiling for government debt is set in gross terms rather than in net terms. It is also worth noting that the net debt measure does not include the State's bank investments.

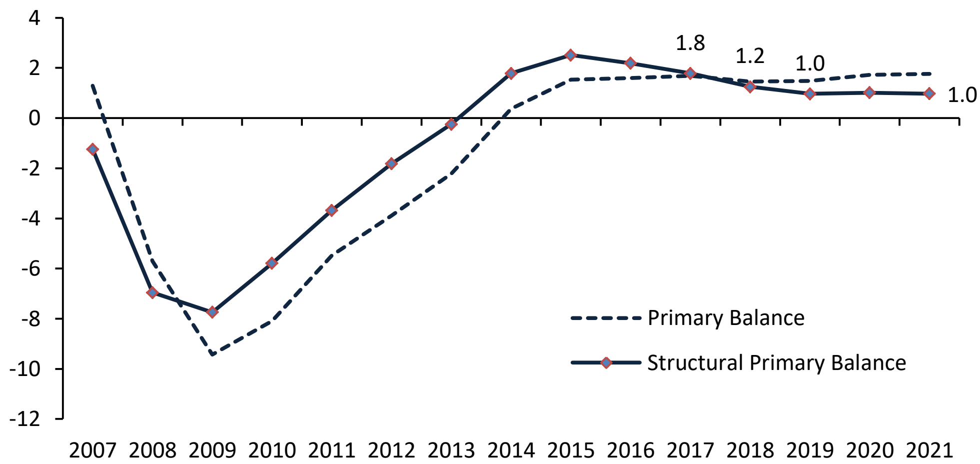
internationally, in addition to a supportive monetary policy environment, as well as largely unanticipated increases in corporation tax revenues.

Budget and within-year spending increases have meant that non-interest spending has risen at essentially the same pace as tax revenue since 2015. In recent years, a pattern of "spending drift" has been allowed to absorb all of the unexpected revenue gains. This has seen the Government loosen its planned budgetary policy over time as economic and revenue growth turns out to be better than expected. Within-year spending increases – though individually small – are cumulative and long-lasting.

Reflecting the strong pace of expenditure increases in recent years, the primary balance (excluding one-offs) has barely improved despite favourable economic conditions (Table 1).[7] It is clear that recent revenue growth has been supported by short-term cyclical developments and a (possibly transient) surge in corporation tax receipts. Looking through the cyclical effects, the underlying structural position – as shown by the structural primary balance – would appear to have deteriorated since 2015 (Figure 4).

Figure 4: A Deteriorating Structural Primary Balance

Percentage change (year-on-year)



Sources: CSO; Department of Finance (*SPU 2018*); and internal IFAC calculations.
Note: The structural primary balance strips out one-offs from the headline primary balance (expressed as a share of GDP) and the cyclical component is subtracted as 0.53 × the level of the Council's mid-range output gap estimate (the same approach as adopted for CAM-based estimates).

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[7] Note that historical data have been updated since the publication of the *SES 2018* to reflect revised national accounts and public finances data. This should lead to revisions to *SES 2018* forecasts for *Budget 2019*.

Table 1: Summary of Key Aggregates
% GNI* unless stated, general government basis

Year	2016	2017	2017	2018	2019	2020	2021
Source	CSO	CSO	DoF	DoF	DoF	DoF	DoF
Public Finances (% GNI* unless stated)							
Revenue [1]	41.6	42.2	37.9	37.2	36.9	36.6	36.5
Expenditure [1]	42.6	42.7	38.3	37.6	37.1	36.2	35.6
Balance [1]	-1.0	-0.5	-0.4	-0.4	-0.2	0.4	1.0
Interest Expenditure	3.5	3.2	2.9	2.5	2.3	2.2	2.0
Primary Expenditure [1]	39.1	39.5	35.4	35.1	34.8	34.0	33.5
Primary Balance [1]	2.5	2.7	2.5	2.1	2.2	2.6	3.0
CAM Structural Balance (%GDP) [2]			-0.5	-0.9	-0.4	0.1	0.6
Change in CAM Structural Balance (p.p. GDP) [2]			0.5	-0.4	0.5	0.5	0.5
CAM Structural Primary Balance (% GDP) [2]			1.5	0.8	1.2	1.5	1.9
Change in CAM Structural Primary Balance (p.p. GDP) [2]			0.2	-0.7	0.3	0.3	0.4
Gross Debt	114.1	111.1	100.1	96.9	93.6	88.9	86.8
Net Debt	100.0	96.1	86.7	83.0	80.6	78.7	76.3
Output/Demand							
Real GDP Growth (% y/y)	5.0	7.2	7.8	5.6	4.0	3.4	2.8
Nominal GDP Growth (% y/y)	4.1	7.6	7.5	5.6	5.4	4.7	4.3
Potential Output (% change) [3]			6.6	5.0	3.1	3.1	2.7
Output Gap (% potential) [3]			-1.6	-1.0	0.3	0.8	0.9

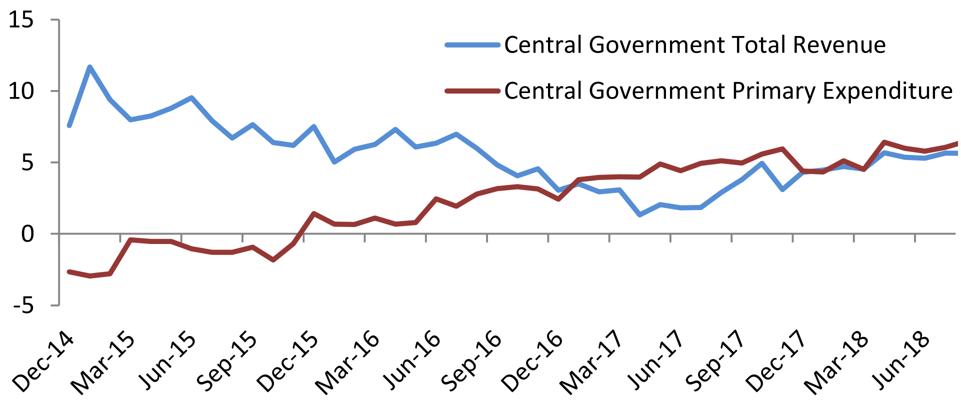
Sources: CSO; Department of Finance (DoF); and internal IFAC calculations.
Note: A break is shown in the table to reflect the fact that CSO data have been updated for 2017, including a downward revision to nominal GNI*, since the Department of Finance forecasts were published.
[1] One-offs/temporary measures are removed from fiscal aggregates to get a sense of the underlying fiscal position and are as assessed by the Council to be applicable for 2015-2017 (IFAC, 2018), with Department of Finance one-offs used thereafter.
[2] These are based on the latest supply-side estimates derived under the Commonly Agreed Methodology (CAM), which has a number of drawbacks that can lead to inappropriate estimates for Ireland (Box B and E, IFAC 2017).
[3] Department of Finance preferred alternative estimates of potential based on GDP.

Budgetary Outturns to end-August 2018

Exchequer developments thus far in 2018 indicate that revenue is broadly in line with expectations apart from corporation tax, with spending somewhat below forecast levels apart from in Health. If these trends continue, the budget balance is likely to be broadly on target. However, one scenario is that higher overall spending, for example on health, could then be accommodated based on revenues not foreseen a few months ago. This should be avoided given the likely transitory nature of the unexpected revenues, which should therefore be saved. Primary expenditure growth has been accelerating in recent times. This has resulted in faster growth in non-interest spending (6.5 per cent for the twelve months to August 2018) when compared to total revenue growth (5.6 per cent) since the beginning of 2017 (Figure 5). More generally, expenditure has increased by more than originally planned since Ireland achieved a 3 per cent of GDP deficit in 2015 (as higher-than-expected corporation tax and lower interest expenditure arose).

Figure 5: Central Government Total Revenue and Primary Expenditure

% change year-on-year (12-month moving sum)



Sources: Department of Finance (Analytical Exchequer Statements); and internal IFAC calculations.
Note: Transactions that do not impact the general government position are excluded. Total Revenue comprises Exchequer tax revenue, appropriations-in-aid, non-tax revenue and excess capital resources. Primary Spending is current primary and capital Exchequer expenditure minus national debt interest. Receipt of Central Bank Surplus moved from April to May in 2016 for consistency with other years.

Exchequer tax revenue is below expectations by €101 million or 0.3 per cent for the year-to-end-August. Several items have performed below expectations on a cumulative basis, notably excise duties, VAT and stamp duties (Table 2).

By contrast, corporation tax receipts have been significantly higher than expected to date in 2018 (€276 million or 6.7 per cent). While welcome, corporation tax receipts in Ireland are highly concentrated, volatile, have large forecast errors, and are acutely prone to external risks such as changes in international tax environment (Casey and Hannon, 2016). [8,9,10] In 2018, corporation tax revenue looks likely set to account for 16 per cent of total Exchequer tax revenue, a share that is fairly close to the highest peak reached in recent decades.[11] PRSI receipts are also ahead of expectations (€125 million or 1.9 per cent in cumulative terms), reflecting strong labour market developments.

Table 2: Exchequer Revenue, Cumulative Performance to end-August 2018

€ million, unless otherwise stated

	Outturn	Forecast	Difference	Difference (%)
Exchequer Tax Revenue	32,422	32,523	-101	-0.3
Income Tax	13,051	13,072	-21	-0.2
VAT	9,382	9,463	-81	-0.9
Corporation Tax	4,366	4,090	276	6.7
Excise Duty	3,475	3,724	-249	-6.7
Stamp Duty	870	937	-67	-7.2
Other Taxes	1,278	1,237	41	3.3
PRSI Receipts	6,798	6,673	125	1.9
Other Revenues	3,046	2,768	278	10.0
NTF and Other A-in-A's	1,871	1,803	68	3.8
Non-Tax Revenues and Capital Resources	1,175	965	210	21.8
Total Central Government Revenue	42,266	41,964	302	0.7

Sources: Department of Finance Analytical Exchequer Statement; and internal IFAC calculations.
Note: Other Taxes include Capital Taxes, Motor Tax and Other. PRSI and NTF receipts include their excess over expenditure as indicated in the memo items.

Stamp duty receipts are lower than projected thus far in 2018 (7.2 per cent). This raises questions about the yield from the higher rate of stamp duty introduced in *Budget 2018* that was estimated at the time of the

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[8] The top ten companies are responsible for nearly 40 per cent of the total corporation tax receipts.

[9] Box C of the June 2018 Fiscal Assessment Report provides a scenario analysis for direct macroeconomic, labour-market and budgetary effects of an exit from Ireland by a stylised large, foreign-owned multinational enterprise.

[10] Uncertainty about the effects of the US corporation tax reform and the path of EU and UK fiscal policy are some of the risks that surround the future of corporation tax receipts in Ireland.

[11] In 2017, corporation tax grew fastest of all tax headings and reached its second highest share of Exchequer tax revenue in recent decades.

budget, albeit this tax is lumpy by nature and could yet achieve the expected revenue.[12] It is important for realistic forecasts that costings and estimates of yields from tax changes are well-founded and subject to independent scrutiny.

In terms of expenditure, total gross voted spending to end-August 2018 is 7.9 per cent (or €2.9 billion) higher than for the same period last year. This is, however, broadly in line with previous forecasts (slightly lower than forecast by €152 million or 0.4 per cent). Current spending is slightly ahead of forecasts (€209 million), with annual growth of €2.4 billion (6.8 per cent) in the first eight months of the year. This strong growth is largely driven by increased spending in Health (+€826 million), followed by Housing (+€399 million), Education (+€356 million), and Social Protection (+€352 million). In terms of significant overruns, the Department of Health's current expenditure is above forecast levels by €313 million (3.1 per cent), and is significantly higher (8.7 per cent) compared to the same period in 2017.

[12] In the Response of the Minister for Finance and Public Expenditure and Reform to the June 2018 Fiscal Assessment Report, this is attributed to the "non-linear nature [of stamp duty receipts], with over three quarters of this heading based on property and share transactions, which themselves can be 'lumpy' in nature". It is also noted that "…in preparing the yield costing for the Budget 2018 commercial stamp duty measures, the base was prudently adjusted for previous large 2016 transactions".

4. Assessing the Fiscal Stance for *Budget 2019*

The Council's approach to assessing the prudence of the overall fiscal stance involves: (1) a broad economic assessment that considers appropriate management of the cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with the legislated domestic and EU fiscal rules.

Official forecasts for 2018–2021 indicate that economic growth is likely to remain strong even if moderating somewhat; the debt ratio will continue to fall at a steady pace; the headline primary balance will remain unchanged; and interest costs should be relatively insulated from changing monetary conditions.

The Council assesses that the plans in the *Summer Economic Statement 2018* for 2019 are in line with prudent economic and budgetary management and should be followed through on. For 2018, the government should avoid a continuation of the recent spending drift that has led to additional expenditure increases being introduced within the year, which go beyond already-budgeted-for increases.

A feature of budgetary policy in Ireland in the past few decades has been one of procyclicality: fiscal policy expanding too fast in good times, resulting in forced budgetary contractions in bad times. This has had a destabilising effect on the economy and too loose a budgetary policy in good times has left the public finances more fragile on occasions when the cycle turned.

The fiscal rules are designed to address procyclicality. The Council sees the fiscal rules as a minimum standard for sustainability and continues to recommend that the Government commit to adhering to these. However, the systematic mismeasurement of the cycle means that the fiscal rules – as applied – are insufficiently equipped to prevent a repeat of past mistakes by themselves.

Focusing on the right budgetary stance and being prepared to be more cautious than the fiscal rules allow is the correct approach for the

Government to follow. This is especially important during presently favourable economic times so as to allow greater scope for a fiscal response in the event of a future downturn.

Identifying the Appropriate Stance for *Budget 2019*

An appropriate stance for *Budget 2019* would be to increase government spending in line with the sustainable long-term growth rate of the economy. This is consistent with the Council's assessment that the economy is close to its potential and that the budget deficit (excluding one-off items) is almost closed so that the structural budgetary position is also near balance. This would suggest that little further adjustment is required in structural terms to close an underlying deficit or to enable a steady pace of reduction in the debt ratio. To maintain this position, it is essential that spending rises or revenue reducing measures are introduced at a sustainable pace.

Various estimates would put the sustainable growth rate of the economy at around 3¼ per cent per annum. As Table 3 shows, this implies an approximate limit of up to €3½ billion for spending increases or tax cuts for 2019 compared to 2018 (i.e., the "gross fiscal space").[13] Anything more expansionary than this suggested maximum limit would not be appropriate.

The space being afforded by the fiscal rules is becoming increasingly larger and less sustainable. This predominantly reflects mismeasurement of the cycle and of Ireland's potential growth rate in the methodology used for the legal application of the fiscal rules (the Reference Rate used in the *Summer Economic Statement 2018* is 4.5 per cent for 2019). The fact that the measures are rising as the cycle recovers provides further evidence of the procyclicality of the application of the rules themselves.[14] While the Council assesses that an appropriate upper limit for the gross fiscal space would be around €3½ billion in 2019, minimum compliance with the fiscal rules

[13] Note that this approach to estimating gross fiscal space is different to the approach taken by the Department of Finance, which relies on estimates of potential output taken from the Commonly Agreed Methodology. The Commonly Agreed Methodology has a number of drawbacks that can lead to inappropriate estimates for Ireland (IFAC, 2018).

[14] See Box B of the *November 2017 Fiscal Assessment Report* (IFAC, 2017).

using the Commonly Agreed Methodology would allow €3.9 billion. The issue of procyclicality is also acknowledged in the *Summer Economic Statement 2018 (p.ii)*, where the Minister notes that a "full and literal application of the fiscal rules would involve the adoption of pro-cyclical policies not remotely appropriate to our position in the economic cycle".

Table 3: Identifying the Appropriate Gross Fiscal Space

Estimates of Average Potential Growth 2019–2021 (%)	
IFAC	3.25
ESRI	3.3
DoF (GDP-Based Alternative)	3.0
Forecasts of Inflation for 2019 (%)	
GDP Deflator	1.3
Core HICP	1.2
HICP	1.0
Reference Rate (%)	
Potential Growth Rate + Inflation	c.4.5
Gross Fiscal Space - Expenditure Benchmark Basis (€bn)	
Total General Government Expenditure in 2018	80.1
Less Interest Expenditure	-5.3
Less EU co-financed current spending	-0.5
Less Public Gross Fixed Capital Formation	-6.8
Plus four-year average of Public GFCF	+5.5
Less Cyclical Unemployment Expenditure	-0.2
Less One-Off Expenditure Items	-0.0
Corrected Expenditure Aggregate	= 73.2
× Reference Rate of 4.5%	3.4

Sources: ESRI (McQuinn *et al.*, 2017); Department of Finance (*SPU 2018*); and internal IFAC calculations.

The Council assesses that the Government should stick to its existing budget plans for 2019 and stay within an approximate limit for spending increases or tax cuts of up to €3½ billion as assessed in the *June 2018 Fiscal Assessment Report* (IFAC, 2018). There is no case for additional stimulus in 2019 beyond this. If additional priorities are to be addressed, these should be funded by additional tax increases or through re-allocations of existing spending. This approach was broadly taken in

Budget 2018 when new tax-raising measures such as stamp duty rate increases and corporation tax changes were introduced to allow scope for further tax and expenditure measures beyond what the fiscal rules already allowed for. However, it is essential that new measures are appropriately costed and the Council has previously raised concerns about the reliability of the estimated yield from stamp duties changes introduced in *Budget 2018* (IFAC, 2017).

Current Government Plans for the Allocation of Gross Fiscal Space

The cost of previously announced measures – including sharp increases in public investment spending – means that the scope for new initiatives in *Budget 2019* will be limited in the absence of additional revenue-raising measures.

Table 4: Department Estimates of Fiscal Space for 2019
€ billion, in terms of fiscal space

	€bn
Starting Point	
Gross Fiscal Space	3.9
+ Non-Indexation of Tax System	0.6
	4.5
Use of Fiscal Space	
Pre-Commitments	2.3
Rainy Day Fund	0.5
Margin of Compliance	0.9
Available to be Allocated	0.8

Sources: *Summer Economic Statement 2018*; and internal IFAC calculations.

Table 4 shows how the gross fiscal space estimated by the Department is expected to be allocated. The starting point for *Budget 2019* (i.e., the gross fiscal space) is €3.9 billion. As noted, this starting point is based on a strict application of the rules and is higher than is considered appropriate by the Council. Non-indexation of the tax system boosts the scope for spending or tax measures in *Budget 2019* by €0.6 billion, giving an allowable expansion of €4.5 billion. The Department notes in the *Summer Economic Statement 2018* that a large amount of the €4.5 billion is already allocated. Some €2.3 billion has already been allocated, for example, to various pre-committed expenditure increases for 2019. Table 5 – which is shown in nominal terms rather than in terms of the use of fiscal space – shows that these pre-commitments are mainly related to planned increases in public investment.

A further €1.4 billion of fiscal space is also allocated in the *Summer Economic Statement 2018*: €0.5 billion to the Rainy Day Fund and an additional €0.9 billion as a "margin of compliance" with the fiscal rules.

The allocation to the Rainy Day Fund and the margin of compliance allocations represent, in effect, a decision to not use all of the fiscal space available under one of the fiscal rules: the Expenditure Benchmark. The Department reasons that using the margin of compliance, for example, would (1) worsen the headline balance by 0.3 per cent of GDP; (2) involve additional borrowing in the absence of any offsetting revenue-raising measures; and (3) risk non-compliance with the fiscal rules in 2019.[15] This approach – though differently framed – is consistent with the Council's advice of setting an appropriate fiscal stance for 2019 on the basis of an approximate limit for spending increases or tax cuts of up to €3½ billion. The €3½ billion limit is lower than would be allowed under the strict application of the fiscal rules, yet the non-usage by the Government of available fiscal space leads to a similar planned expansion for 2019.

Table 5: Pre-Committed Expenditure Measures
€ billion, nominal terms

	€bn
Voted Exchequer Spending	
Carryover cost of previous budget measures	0.3
Public sector pay increases	0.4
Demographic costs	0.4
Capital spending increases (public investment)	1.5
Total	2.6

Sources: Department of Finance (*Summer Economic Statement 2018*); and internal IFAC calculations.
Notes: [1] The total of €2.6 billion differs from the total of €2.3 billion for pre-commitments outlined in Table 4. This reflects differences in the treatment of expenditure under the rules including for capital spending, for example, where the smoothing of capital spending is allowed for to recognise its lumpy spending nature from year to year.

Sticking to Plans for 2018

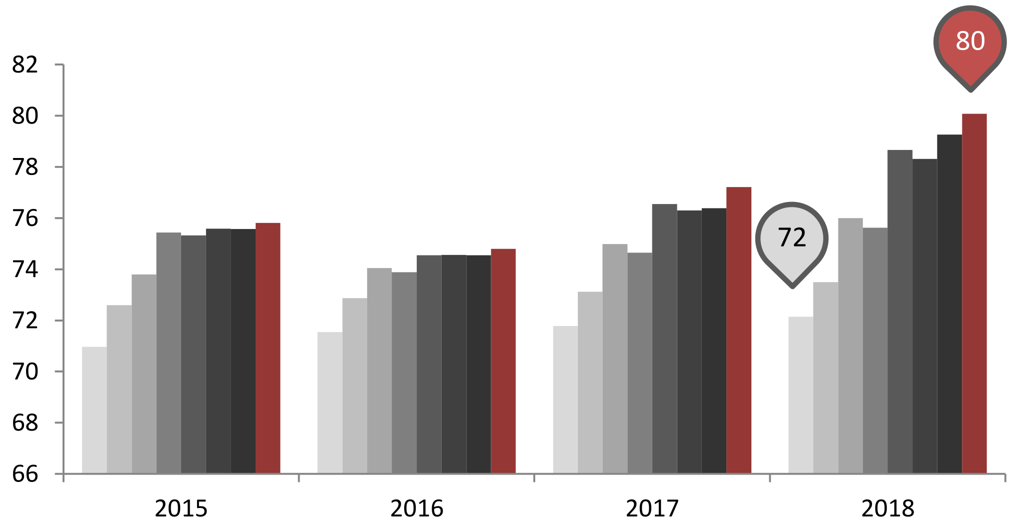
For 2018, the Government should stick to its original plans to increase underlying net expenditure by €1.7 billion (the gross fiscal space identified

[15] Specifically, the Medium-Term Objective of a structural deficit of 0.5 per cent of GDP is planned to be marginally met in 2019 with a structural deficit of 0.4 per cent of GDP. Using the margin of compliance amount of €0.9 billion, for instance, would disimprove the deficit by 0.3 per cent of GDP, thus increasing the risk of non-compliance in 2019 on the basis of the other pillar of the fiscal rules: the structural balance.

for 2018). In particular, it should seek to avoid the kind of within-year increases in spending that were introduced in 2015–2017 to ensure that mistakes of past cycles are not repeated.

In recent years, spending drift has been allowed to absorb all of the unexpected gains that have arisen. These include revenues from a better-than-expected cyclical recovery; a surge in corporation tax receipts; and unexpected interest savings (Figure 6). Growth in underlying domestic demand was more than twice the pace that was initially expected over 2015–2017 (taking *Budget 2015* forecasts). At the same time, upward revisions to non-interest spending across a broad range of areas more than offset higher-than-expected revenues. This meant that the only driver of the improvement in the headline budget deficit was lower-than-expected interest payments.

Figure 6: Spending Drift over 2015–2018
€ billion, general government expenditure over different forecast vintages



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Lighter grey bars indicate older forecasts; red bars indicate current estimates. Note that forecasts of expenditure produced prior to *Budget 2017* were not on a so-called “ex-post” basis. This means that the Department did not include expenditure increases that would have been allowable under the fiscal rules as part of their initial forecasts. Therefore, the extent of spending drift relative to more realistic plans is overestimated.

Had unexpected cyclical revenues, corporation tax receipts and interest savings been used for deficit reduction, rather than to part-fund within-year spending increases, the budget would have been already in balance in 2016 (IFAC 2017). This would have been roughly three years earlier than is now projected by the Government.

Health spending for 2018 looks set to exceed the level of planned increases set out at budget time yet again. For the first eight months of 2018, health spending has been higher than forecast, and a supplementary estimate is expected for the Department of Health yet again this year. The likely need for a supplementary is noted in the *Mid-Year Expenditure Report 2018* and in the Minister stated during his appearance before the Budgetary Oversight Committee in July 2018 that some form of "additional funding will be needed for the Department of Health at some point this year. That has been the case in previous years and I will have to work on that later in the year." Staff recruitment costs are cited as driving the expected overrun but should have been planned for.

The Department of Health has experienced numerous overruns historically (Howlin, 2015) and the problem of unrealistic forecasts coupled with a "soft budget constraint" has undermined the credibility of expenditure ceilings. To ensure that the overall level of spending increase for 2018 does not go beyond existing planned increases, and to ensure that the pattern of spending drift does not continue into 2018, it is important that pressures in the Department of Health budget should be absorbed elsewhere.

Making Medium-Term Budgeting more Credible

To help ensure that medium-term plans are credible and to avoid a repeat of procyclical policy mistakes, the Government should reinforce the design of the Rainy Day Fund. This initiative – though potentially useful – is only half-formed and needs more development if it is to be effective.

A better goal for the Rainy Day Fund would be to counteract some of the procyclical bias currently present in the fiscal rules and evident in policy in the lead-up to the last crisis (Casey, *et al.* 2018). The Rainy Day Fund is not countercyclical and is only envisaged as a fund that would deal with specific shocks or events. By restricting the fund to fixed contributions that are set out in advance, the fund will not be able to respond flexibly to cyclical conditions as they change. Furthermore, limiting the size and timeline for contributions also constrains the extent to which the fund can operate countercyclically.

A further issue that needs to be resolved is how exactly reserves accumulated in the Rainy Day Fund are expected to be used without leading to potential breaches of the fiscal rules. One avenue considered by the Department is the use of the exceptional circumstances provided for under the fiscal rules. However, this clause has rarely been activated, it is typically limited to relatively small amounts, and there are no guarantees that it will be considered applicable in future cyclical downturns. The Council's own recommendations in this regard stress the need for an automatic exemption of expenditure increases funded by Rainy Day Fund resources provided that these correspond to foregone expenditure increases allowed under the fiscal rules in preceding periods (Casey, *et al.* 2018).

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