Chapter 1

Assessment of Fiscal Stance

1. Assessment of Fiscal Stance

Key Messages

- The Council assesses that the pick-up in growth has been driven by a cyclical recovery in demand for about five years. The economy now looks to be operating close to potential in 2018, meaning that capacity and price pressures could begin to emerge.

- The short-term outlook for the Irish economy remains strong, though a slowdown at some point in the future is inevitable. The Department's preferred estimates of the output gap indicate that the economy will have reached its potential in 2019 and growth is expected to exceed its potential in the next few years. Overheating pressures could build up if a faster-than-expected pick-up in housing construction materialises. On the other hand, Brexit may prove to be more costly than assumed. Other risks are posed by the concentration of Ireland's exporting sector in a small number of specialised areas, by the global rise in protectionism, and by possible future changes in the international tax environment.

- The large government deficit that emerged in 2008 was brought close to balance in 2017. The turnaround was achieved through substantial efforts to reduce spending and raise revenues in the period 2009 to 2015, coupled with a number of favourable factors: a stronger-than-expected cyclical recovery, low interest rates, and surging corporation tax receipts.

- However, underlying improvements in the budget balance have stalled since 2015, despite the favourable environment. There has been no improvement in the budget balance excluding interest costs: non-interest spending has been increased at essentially the same pace as government revenues. As much of the improvement in revenues may be cyclical or temporary, this suggests that the structural position has deteriorated. This is a worrying pattern as it means limited improvements in the headline balance from the upswing in the cycle.

- A prudent fiscal policy would see net policy spending rise in line with sustainable revenues, given that the Irish debt burden is still among the highest in the OECD, given strong cyclical growth, the risk of overheating in later years, and surging corporation tax receipts. There is no case for additional stimulus in these circumstances. The budget should be in kept balance in structural terms to ensure that debt ratios are on a steady downward path. However, the current Government plans go beyond the limit of what the Council had assessed as being prudent.

- For 2018, the Government decided to increase spending by a further €1.1 billion beyond what was originally envisaged just four months earlier (*SPU 2018*), €0.7 billion of which was attributable to the Health area. This is not consistent with prudent budgetary management.

- For 2019, the government has set out a level of government spending €2.3 billion above what was originally planned in *SPU 2018*. The additional measures introduced on budget day imply a total package of tax and spending measures worth €1.1 billion (€0.3 billion more than had been planned for the budget day package). When added to the additional within-year increases for 2018, this means a level of government spending €2.3 billion above what was set out in *SPU 2018*. It puts the total budget package beyond the limit of what the Council had assessed as being prudent based on an assessment of sustainable growth rates for the economy and government revenues. There are risks that further slippages will occur in 2019 should health spending overruns occur again, and provision should be made for the Christmas bonus.

- Taken together, the Budget 2019 plans are not conducive to prudent economic and budgetary management. The plans imply a government spending increase (net of tax measures) of €4.5 billion in 2019 compared to what was planned for 2018. This is a substantial increase and it goes beyond the limit of €3½ billion for spending increases or tax cuts for 2019 that the Council had assessed as appropriate prior to the budget on the basis of sustainable growth rates. The larger increase mainly reflects the fact that the budget plans for 2019 are built on the imprudent increase in spending in 2018. The overall increases also go beyond the Government's own plans set

out prior to the budget. With the now-higher base for 2018, the underlying increase in total expenditure (net of tax measures) from 2018 to 2019 is currently €1.4 billion beyond plans set out in *SPU 2018*. The Council estimates that a general government surplus of €1.1 billion (0.6 per cent of GNI*) would have been achieved in 2017 had the unplanned, within-year spending drift not occurred in each year from 2015–2018.

- The Department has made substantial progress on macroeconomic forecasting over the medium term. This includes the development and publication of its own supply-side estimates, and the use of better measures of the underlying state of the domestic Irish economy.

- However, the medium-term budgetary plans are not credible, and previous medium-term objectives have been effectively dropped. The current intention to run budget surpluses for the foreseeable future if conditions allow is vague. Previous commitments to outperform the requirements of the EU fiscal rules and to reduce debt to 55 per cent of GDP over the medium term—itself an insufficiently ambitious target with no clear timing—are no longer referenced. The Government's system of three-year budget ceilings is not working, with repeated, procyclical, upward revisions to ceilings taking place. Medium-term spending forecasts are based on technical assumptions that look unrealistic. The Council welcomes the introduction of the Rainy Day Fund (the "National Surplus (Exceptional Contingencies) Reserve Fund"). Though it is potentially useful, the current design is insufficient to offset higher-than-prudent growth allowed under the spending rule as applied.

- The Department of Finance's *Budget 2019* forecasts indicate that Government plans are not consistent with complying with the fiscal rules for 2018 and 2019. CAM-based estimates indicated that the Medium-Term Objective (MTO) of a structural deficit of no more than 0.5 per cent of GDP will not be met in either 2018 or 2019, with structural deficits of 1.2 per cent and 0.7 per cent, respectively. The Expenditure Benchmark looks set to be complied with in 2018 and 2019, despite fast spending growth. However, the limits have risen procyclically. Standard adjustments to the growth rates assessed also favour compliance, but may be inappropriate.

Table 1.1: Summary Table

% GNI* unless stated, general government basis (based on *Budget 2019* forecasts)

Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which are unrealistic (see Chapter 3).

	2017	2018	2019	2020	2021	2022	2023
General Government							
Revenue [1]	42.2	40.9	41.1	40.7	40.7	40.7	40.6
Expenditure [1]	42.5	41.4	41.1	40.2	39.5	39.0	38.3
Balance [1]	-0.3	-0.5	0.0	0.5	1.1	1.8	2.3
Interest Expenditure	3.2	2.7	2.4	2.2	2.0	2.0	2.1
Primary Expenditure [1]	39.3	38.7	38.7	38.0	37.5	36.9	36.2
Primary Balance [1]	2.9	2.2	2.4	2.7	3.1	3.8	4.4
Revenue Growth (%)	4.7	4.7	6.4	4.3	4.2	4.4	4.2
Primary Expenditure Growth (%)	3.6	6.4	5.9	3.5	2.8	2.6	2.4
Real Net Policy Spending Growth (%) [2]	4.5	5.0	3.4	1.4	0.9	-0.7	-0.1
Structural Balance (% GDP) [3]	1.4	-0.1	-0.1	-0.2	0.2	0.4	0.5
Structural Primary Balance (% GDP) [3]	3.3	1.6	1.3	1.1	1.4	1.6	1.8
Change in Structural Primary Balance (p.p.) [3]	0.7	-1.8	-0.2	-0.2	0.2	0.2	0.2
Debt							
Gross Debt (€bn)	201.3	205.9	209.6	203.3	207.7	208.4	209.4
Cash & Liquid Assets (€bn)	25.7	28.4	28.3	19.7	23.2	22.1	22.2
Net Debt (€bn)	175.6	177.5	181.3	183.6	184.5	186.3	187.2
Equity and Investment Fund Shares (€bn) [4]	42.6	–	–	–	–	–	–
Gross Debt Ratio (% GNI*)	111.1	105.2	101.0	93.1	91.2	87.8	84.5
Net Debt Ratio (% GNI*)	96.9	90.7	87.3	84.1	81.0	78.5	75.6
Output							
Real GDP Growth (% Change)	7.2	7.5	4.2	3.6	2.5	2.6	2.7
Potential Output (% Change) [3]	8.2	4.5	3.5	2.9	2.5	2.4	2.4
Output Gap (%) [3]	-2.9	-0.4	0.2	0.9	1.0	1.3	1.7
Nominal GDP Growth (% Change)	7.6	9.3	6.2	5.4	4.4	4.4	4.5
Nominal GNI* Growth (% Change)	3.0	8.1	6.0	5.2	4.2	4.3	4.4
Nominal GDP Level (€bn)	294.1	321.6	341.5	360.0	375.8	392.2	409.7
Nominal GNI* Level (€bn)	181.2	195.8	207.6	218.4	227.7	237.4	247.8
Miscellaneous							
Expenditure One-Offs (€m) [1]	178	0	0	0	0	0	0
Revenue One-Offs (€m) [1]	0	700	0	0	0	0	0
Net One-Offs (€m) [1]	-178	700	0	0	0	0	0

Sources: CSO; Department of Finance; and internal IFAC calculations.

Note: Expenditure amounts in 2021 are adjusted to take account of a capital transfer expected to be reclassified to general government (Chapter 3), but no information is yet available as to the likely impact of this adjustment on debt ratios.

[1] One-offs/temporary measures excluded to discern underlying fiscal position are those assessed as applicable by the Council. These comprise water charge refunds for 2017 (€178 million) and the €700 million of corporation tax received in 2018, which was judged to be one-off in the Minister's *Financial Statement to Budget 2019*.

[2] This measure is outlined in Box A and it represents total expenditure less interest costs, and estimated cyclical unemployment benefits, while discretionary revenue measures are netted off.

[3] These estimates are based on the Department of Finance's preferred GDP-based alternative estimates of the output gap as published in *Budget 2019*.

[4] This comprises the value of government holdings in equity (shares and other equity) and investment fund shares (F5), including the value of bank shares held by the State.

1.1 Introduction

The Council has a mandate under the Fiscal Responsibility Act (FRA) 2012, and with reference to the requirements of the Stability and Growth Pact (SGP), to assess the Government's fiscal stance.

This chapter draws on analysis in the rest of the report in assessing the fiscal stance in *Budget 2019*. The Council's assessment is informed by: (1) an economic assessment that takes into account the state of the public finances, the stage of the economic cycle, and the growth prospects for the economy; and (2) the extent of compliance with the fiscal rules.

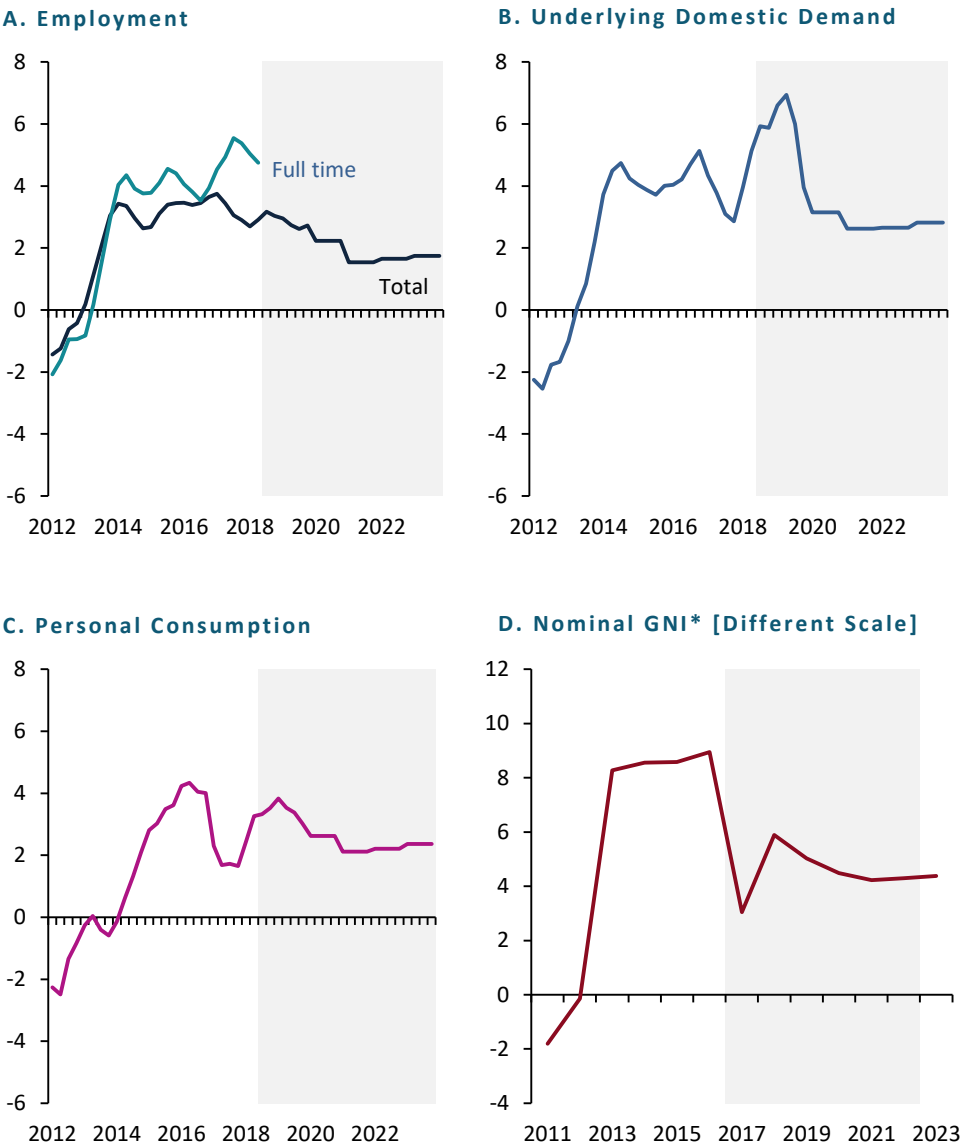
1.2 The Recent Macroeconomic Context

Domestic Economic Activity

The Irish economy has recovered from a deep recession. The Council assesses that the pick-up in growth since about five years ago has been driven by a cyclical recovery in demand. This has been supported by growing confidence, and falling household and non-financial business debt following the crisis, though debt levels remain high by international standards (Central Bank of Ireland, 2018).

Figure 1.1: Indicators of Domestic Economic Activity

Percentage change (year-on-year)



Sources: CSO; Department of Finance; and internal Irish Fiscal Advisory Council calculations.
Note: Figures show four-quarter moving averages (annual changes for GNI*). *Budget 2019* forecasts/estimates are demarked by grey shaded regions. As forecasts are in annual average terms, quarterly growth rates are extrapolated within year and identical for quarters in panels A, B and C. Underlying Domestic Demand strips out intangibles and aircraft investment in full as these are—in the main—imported, with little impact on real GDP aside from subsequent use of assets.

Indicators of domestic economic activity less prone to distortions from foreign-owned multinational enterprises show a resilient recovery. Figure 1.1 shows that year-on-year growth rates for employment (both full-time and total), underlying domestic demand, and personal consumption have been rapid since at least 2014. Employment, in particular, is growing by just over 3 per cent year-on-year (average for Q1 2013–Q2 2018). Full-time employment has averaged just over 4 per cent year-on-year. Though expected to moderate in coming years, the Department of Finance's central forecasts for these indicators suggest continued expansion.[1]

Modified Gross National Income (GNI*) is a better measure of national income growth (CSO, 2018). It is currently only available in nominal terms, yet this measure also reveals a sharp rebound in recent years. The Department's forecasts show nominal growth rates averaging 5.2 per cent per annum over the period 2019–2021.[2] Chapter 2 assesses *Budget 2019*'s macroeconomic forecasts in more detail.

The Cyclical Position

The short-term outlook for the Irish economy remains strong. Cyclical conditions should continue to be positive in the short run, supported by a relatively benign external backdrop, notwithstanding Brexit and other external uncertainties.

The Council assesses that the domestic economy now looks to be at its potential in 2018. This means that there is unlikely to be further scope for a rapid pace of expansion without price and wage pressures emerging. This is supported by labour market data. The unemployment rate has fallen to 5.5 per cent as of October 2018; numbers of long-term unemployed are one-quarter what they were at the worst point in the crisis; and inflation has started to pick up in a number of sectors. Ireland's external position has also improved, with the current account balance (adjusted for distortions) registering a small surplus in 2018. Taken together, this would suggest that there is limited scope left for further employment growth without contributing to rising wage pressures.

The Council welcomes the Department of Finance's decision to place its own estimates of potential output and the output gap in the main tables of the *Budget*

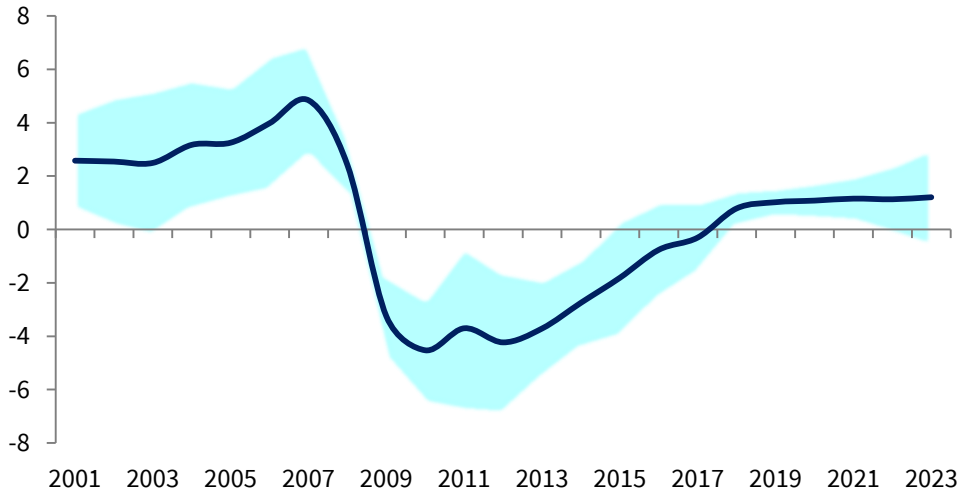
[1] Note the Department doesn't provide forecasts for full-time employment.

[2] The Department of Finance views the slowdown in 2017 as related to the timing of volatile profit outflows rather than an underlying slowdown.

2019 documentation. The new estimates offer a more plausible alternative to the estimates that had been previously published by the Department since 2003—those produced under the EU Commonly Agreed Methodology (CAM)—and are consistent with the demand-side projections. Chapter 2 discusses these estimates in more detail. Of note is the fact that the Department's preferred GDP-based estimates point to a potential output growth rate of 2.7 per cent over the medium term (2019–2023) and a positive output gap in the coming years. The Council's own estimates, which are based on similar methods, also point to a positive output gap (Figure 1.2), but with a higher potential output growth rate of 3½ per cent over the same period. The Council's estimates focus on Domestic GVA: a measure of the domestic economy that strips out the activities of sectors dominated by foreign-owned multinational enterprises.

Figure 1.2: The Economy is at its Potential and Risks Overheating

IFAC's Output Gap (gap between actual and potential output as % of potential)



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The IFAC range of output gap estimates shown is produced using a variety of methods. Given the distortions to standard measures like GDP and GNP and the relative importance of domestic activity to fiscal outcomes, the range currently focuses on measures produced by using measures of domestic economic activity, including Domestic GVA (see Casey, 2018).

Risks to the Outlook

Major risks could yet derail the Government's central forecasts. Near term, growth prospects are favourable, with upside risks dominating the outlook, whereas substantial downside risks are apparent over the medium term, and a slowdown is inevitable at some point in the future.

Overheating remains a realistic risk for the domestic economy over the forecast horizon. The Department's preferred output gap estimates suggest a positive output gap opening up from next year. As shown in the heat map that the Council developed to help assess macroeconomic imbalances (Chapter 2), significant overheating is not yet evident, despite recent declines in unemployment rates, non-housing construction levels, and the potential for a more rapid pick-up in consumer prices, wages and housing activity than currently forecast. The Department's forecasts do not signal clear signs of overheating across all indicators. However, an important caveat when using forecasts to inform the assessment is that macroeconomic forecasts of the demand side tend to be constructed to bring the economy to equilibrium over the forecast horizon, and so are likely to understate the prospects for overheating.

Further ahead—depending on how events develop—three major downside risks are apparent: Brexit, rising protectionism, and an evolving international tax environment.

Brexit is still a key source of risk to the medium-term outlook. The Government's central forecasts assume a transition arrangement is agreed to cover 2019–2020, which would then be followed by a new trading relationship in 2021. This new trading relationship would represent a "soft exit" involving "some form of bilateral trade agreement between the UK and EU27" (Department of Finance, 2018d). However, negotiations concerning the UK's future trading relationships have been fraught, and there is a reasonable probability that the transition agreement and final relationship assumed will not materialise.

The size and nature of potential impacts from various Brexit scenarios are highly uncertain. Central estimates of the medium-term impacts on Irish output are in the range of 1.1 per cent to 2.8 per cent for a so-called "soft Brexit" and 3.1 per cent to 7 per cent for a "hard Brexit" according to various studies (Chapter 2). Yet these are central estimates and standard models may fail to fully capture the extent of Ireland

and the UK's closely integrated supply-chains. Other key channels may also be more important than is assumed.[3]

The international tax environment presents a risk given Ireland's reliance on a small range of specialised exporting activities, including medical devices, pharmaceuticals, and information and communications technology. This reliance is particularly evident from the concentration of corporation tax receipts, which have grown rapidly in recent years and are now forecast to represent a record share of total Exchequer taxes this year. Corporation tax receipts are the most volatile of the major taxes, and two in every five euro paid are from just ten firms. This, together with changes in the international tax environment, leaves revenue exposed to shocks. The Council's *June 2018 Fiscal Assessment Report* (Box C) noted that the stylised direct impact of just one 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. A number of significant changes in the international tax environment are either already in process or mooted, including country-by-country reporting, and digital taxation proposals.[4] Changes to the tax environment may have a low probability of occurring in the near term, however, their potential impact is high (see Chapter 3's assessment of fiscal risks).

Rising protectionism represents a downside risk to Irish trade growth in coming years. Substantive tariffs are now being placed on imports between the US and China. These are certain to have a negative impact on global trade, with knock-on impacts for the Irish economy, given its high degree of openness.

1.3 The Recent Fiscal Context

Improvements on the budgetary front—namely in the primary balance—have stalled since 2015. This is despite a number of factors working strongly in the government's

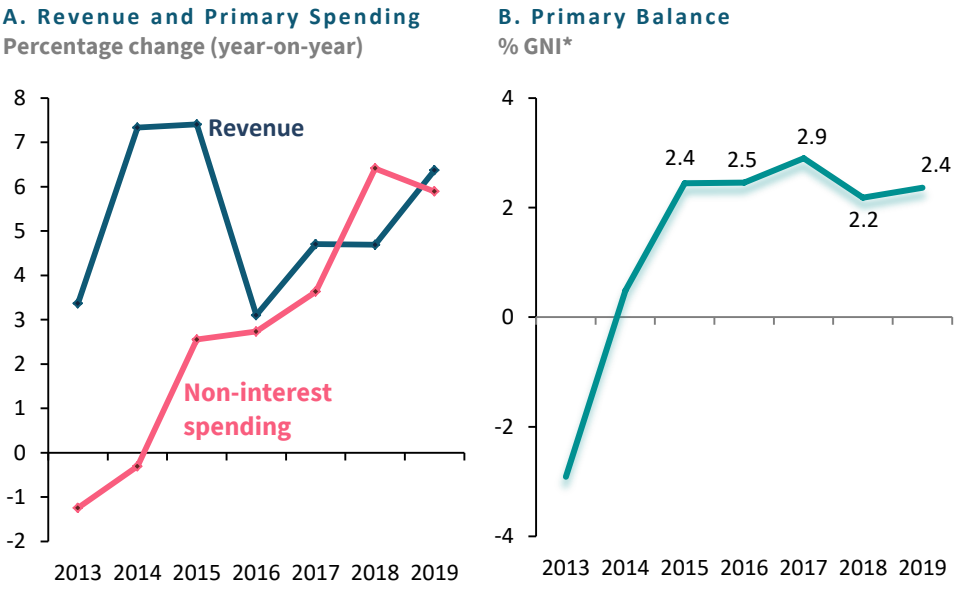
[3] An example of this is the labour intensity of UK demand for Irish exports. This is typically much greater than for an average Irish trading partner. In other words, exports to the UK tend to have a lower value attached to them, but a higher amount of worker hours involved (for example, agri-foods exports involve relatively large numbers of workers per value of exports). As models tend to weight UK demand simply by the value of exports, this can understate the importance of the UK to the Irish labour market (Lawless and Morgenroth, 2016).

[4] Some of the recent changes in the international tax environment seem to have worked in Ireland's favour, as illustrated by corporation tax receipts, over the past few years.

favour including a strong cyclical recovery; a surge in corporation tax receipts; reduced interest costs; and a low interest rate environment.

Some of these favourable factors might have been expected to contribute to a much stronger improvement in the underlying budgetary position, but they have not. Instead, non-interest spending has risen at essentially the same pace as strengthening cyclical tax revenues since 2015 (Figure 1.3A), and the primary balance has therefore been broadly unchanged over the same period (Figure 1.3B).

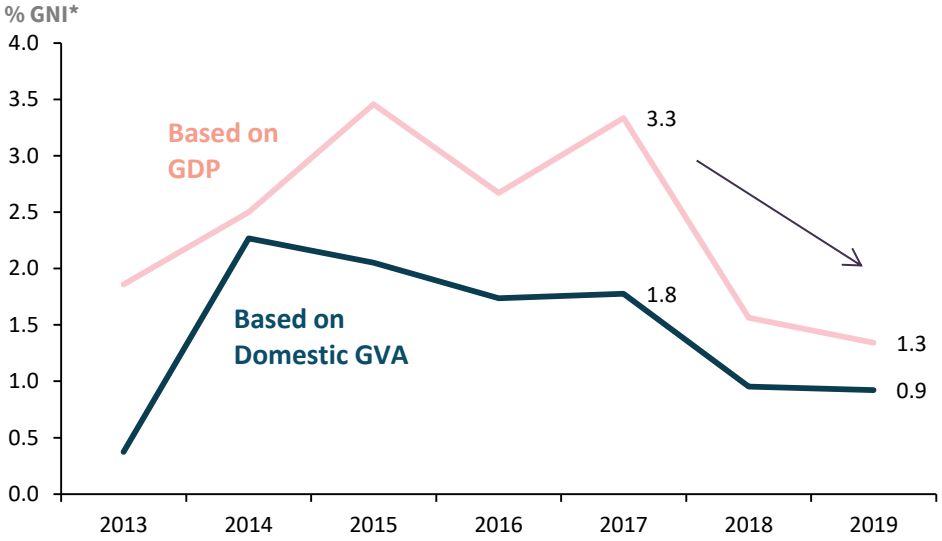
Figure 1.3: Improvements in the Primary Balance have Stalled



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data are on a general government basis and are adjusted to exclude one-offs as in Table 1.1. The primary balance is the balance of revenue and primary (non-interest) spending.

The structural position would appear to have deteriorated since 2015, when one allows for the estimated effects of the cycle. Using the Department's preferred estimates of the output gap (based on GDP), the structural primary balance looks set to have deteriorated from a surplus of 3.3 per cent in 2017 to a surplus of 1.3 per cent in 2019 (Figure 1.4). Estimates based on the Department's Domestic GVA-based output gap estimates also show a deterioration, albeit a less marked one (deteriorating from 1.8 per cent to 0.9 per cent over the two years).

Figure 1.4: Primary Balance Adjusted for Cycle is Deteriorating



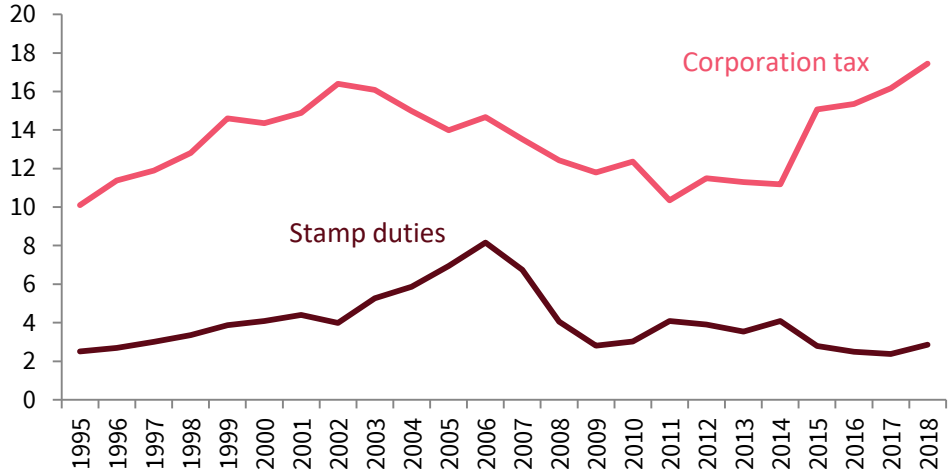
Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data are adjusted for the cycle using the Department's alternative output gap estimates, which are based on GDP, and an assumed semi-elasticity to the output gap of 0.5275.

The deteriorating structural primary balance means that fiscal policy is acting as a stimulus to the economy, and it has been accompanied by an upswing in cyclical revenues as well as by corporation tax receipts. Both factors are likely to prove temporary (Chapter 3 examines these in more detail). Moreover, the cyclical adjustments do not strip out the positive impact on the budget balance that has resulted from the recent surge in corporation tax receipts. A large share of corporation tax receipts are raised from foreign rather than domestic income. This means that changes in the adjusted primary balance (Figure 1.4) can also understate the stimulus that fiscal policy has given the economy.

Corporation tax receipts are expected to reach a record share (17.4 per cent) of total Exchequer tax receipts this year (Chapter 3). This has worrying echoes of the position that the public finances were in prior to the last crisis when the concentration of property-related taxes, such as stamp duties, rose to high levels (Figure 1.5). Unlike stamp duty revenues—which took money out of a booming domestic economy—spending corporation tax receipts adds demand to the domestic economy as the tax is primarily raised from the income of foreign-owned companies.

Figure 1.5: Reliance on corporation tax receipts a concern

% total Exchequer tax receipts



Sources: Department of Finance; and internal IFAC calculations.

The pace of net policy spending growth—a useful measure of the underlying budgetary stance—has been at the limit of, if not higher than, what might be considered sustainable in recent years (Box A). This measure saw nominal increases of €4.1 billion in 2018 and €3.7 billion in 2019. Moreover, this does not take into account the risks relating to the permanency of the revenues on which much of the recent spending increases have relied. It is also notable that the actual and planned spending growth rates are higher than indicated in the earlier *Summer Economic Statement 2018* and *SPU 2018* plans. Real increases of 3.5 per cent and 2.7 per cent were previously set out for 2018 and 2019, respectively, in these documents. Yet the current *Budget 2019* plans suggest growth rates of 5 per cent and 3.4 per cent for 2018 and 2019, respectively.

Box A: Measuring Government Stimulus using Net Policy Spending

To better understand how much stimulus the government is providing by way of its budgetary decisions, it is important to look at the sum impact of a government's budgetary decisions. This means focusing, not just on spending changes, but on tax changes too. This box explores a way to gauge the government's budgetary stance that relies on an adjusted measure of spending: "net policy spending". Based on the adjusted measure of net policy spending, the pace of annual budgetary increases in 2018 and 2019 looks to be fast, and beyond what can be deemed as prudent or sustainable.

What is Net Policy Spending?

Net policy spending measures total government spending, with some adjustments made to get a truer reflection of what is under the control of the government and to allow for offsetting tax changes. The measure is similar in many respects to what is considered under the spending rule (the Expenditure Benchmark's corrected expenditure aggregate), but there are a number of important differences.

Starting with general government Total Expenditure (TE), we deduct interest costs (i), one-off expenditure items ($oneoffs$), and estimated cost/savings on unemployment benefits arising from the cycle ($cyclical\_benefits$).[5] Removing interest costs is useful when these: (i) reflect past decisions rather than current policies (i.e., depend on the stock of debt); (ii) are volatile or unpredictable; (iii) are important from an economic perspective (Ireland's interest payments traditionally flow more to non-resident than resident holdings); and (iv) reflect the inflation–interest nexus (high interest costs in times of high inflation may overstate the extent of the deficit that would prevail in a low-inflation environment, especially when real interest rates diverge from real growth rates). Investment could be treated differently, as in the "Golden Rule". However, both investment and current spending contribute to demand, both impact the wider government balance sheet, and certainty on the supply-side benefits would be needed to treat investment differently. Also, public investment levels are planned to ramp up from low levels so that the increase in the level is likely to persist rather than to be the result of temporary increases, which might warrant smoothing.

When considering the growth rate of this measure in a given year, we also recognise the efforts made by a government to offset spending increases with new tax measures. We do so by

[5] General government data is broader than the Exchequer data often given more domestic focus. General government data include the Social Insurance Fund and expenditure of all arms of government, whereas the Exchequer represents only a portion of total government.

including a further adjustment for Discretionary Revenue Measures ($DRMs$) in the current year "t", and by comparing this against the same measure without the DRM adjustment in the previous year "t–1". Broadly speaking, these DRMs are the total tax-raising or tax-reducing measures that a government may introduce, at its discretion, in a given year.[6] The adjustment for DRMs means that we are considering *net* spending by a government rather than just one side of the government's budget.[7]

The measure is given by:

$$Net\ Policy\ Spending = TE - i - oneoffs - \ cyclical\_benefits\ [-DRMs]$$

where DRMs are deducted in year t but not in year t–1 when obtaining growth rates. Total expenditure and interest costs are obtained from the CSO, but one-offs, cyclical benefits and DRMs are all Department of Finance estimates.[8]

The measurement of cyclical benefits also deserves careful consideration. The Expenditure Benchmark estimates this item of spending on the basis of estimates of the natural rate of unemployment, which are highly procyclical and implausible (Casey, 2018). A better way to get at changes in these costs is to assume that the natural rate of unemployment does not change so frequently from year to year. While this assumption may be inappropriate for the medium to long term, it is a reasonable assumption for assessing short-run developments. We therefore consider a natural rate of unemployment that is constant at 5.5 per cent—the level that the Department of Finance often assumes the economy will converge to over the medium term.[9] In sum, the measure considered here uses the one-offs assessed as applicable by the Council, cyclical benefits calculated on the basis of an unchanged natural rate of unemployment, and DRMs as estimated by the Department of Finance.

Net policy Spending Increases in Recent Years

The real net policy spending measure shows a pace of spending increases in recent years at rates of 3½ –5 per cent each year (Figure A.1). In 2015—when large within-year spending increases were introduced—the growth rate was 4.5 per cent. The pace of spending growth was similar in 2016 and 2017 before climbing to 5 per cent in 2018 and a currently forecast growth rate of 3.4 per cent for 2019. This compares to planned real increases of 3.5 per cent and 2.7 per cent in 2018 and 2019, respectively, based on the earlier *Summer Economic Statement 2018* and *SPU 2018* plans. Note that the faster pace of primary expenditure growth in recent years is dampened by revenue-raising measures that are included in the net policy spending measure.

[6] The impact of non-indexation is included from 2014 onwards, but not for previous years.

[7] Bedogni and Meaney (2017) also consider the government budgetary stance in terms of the growth in corrected expenditure using the Expenditure Benchmark adjustments. However, they do not alter the treatment of estimates of cyclical unemployment, which is important given that these tend to be estimated in a procyclical manner, nor the smoothing of public investment.

[8] The Council assesses the Department's one-offs and DRMs, e.g., Box H (IFAC 2017c). The full-year DRM impact is used here and is typically larger than the estimated first-year cost (e.g., due to the timing of a measure's introduction meaning a shorter window in the first year). A notable inclusion in DRMs often ignored is "non-indexation": the additional revenue raised by government from individuals who see their tax bill increase as they drift into higher tax bands when incomes rise. Both one-offs and DRMs form a key part of the calculations of the fiscal rules, and are thus prone to "fiscal gimmickry". Alt *et al.* (2014) and Koen and Van den Noord (2005) explore how numerical fiscal rules can create incentives for governments to use one-off items strategically. Box D (IFAC, 2014b) explores one-offs in detail.

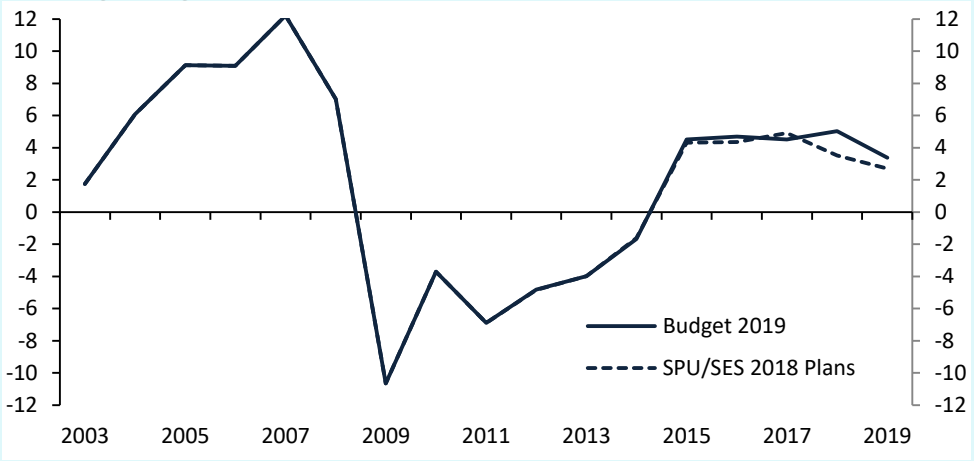
[9] Note that, as in the fiscal rules, this is compared with the actual unemployment rate to estimate the amount of cyclically unemployed individuals that exist, while average unemployment benefits per person are derived from the latest annual outturn for Eurostat data on unemployment expenditure (COFOG99 item GF1005) and Labour Force Survey data on numbers unemployed.

Sustainable Budgetary Increases

One way to gauge whether budgetary decisions are sustainable or not is to compare the growth in this net primary spending measure against what can be deemed "sustainable" over the medium to long term. The estimates of potential output growth rates developed by the Department of Finance and the Council indicate central estimates of 2.5 per cent and 3.5 per cent, respectively using the same demand-side forecasts. Assuming a one-to-one relationship between domestic economic growth and revenue growth, this would imply sustainable growth rates in the region of 2.5 to 3.5 per cent per annum on a real basis. Compared to this range, the recent annual real net policy spending increases averaging approximately 4.2 per cent in 2018 and 2019 look to be outside of what might be deemed as prudent. This could spell risks for the sustainability of these spending increases, especially if the pattern is repeated over a number of years.

Figure A.1: Real Net Policy Spending Increases in Recent Years

Percentage change (year-on-year)

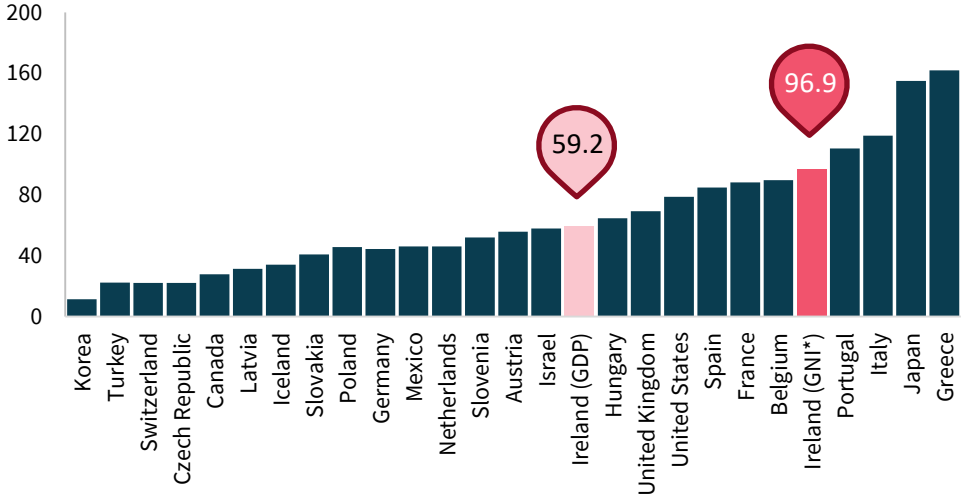


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Real Net Policy Spending = total general government expenditure less interest, one-offs, cyclical unemployment benefits, and discretionary revenue measures. It is HICP-deflated. Cyclical unemployment benefits are calculated on the assumption of an unchanged natural rate of unemployment of 5.5 per cent.

Against the backdrop of fast increases in spending and a deteriorating structural primary balance, Ireland's debt burden remains high following the crisis. When Ireland's net debt ratio is considered—a broad measure of government debt less liquid assets—the burden stands out as the fifth highest among OECD countries (Figure 1.6). While the debt ratio is falling steadily, it is likely to remain high by historical standards in coming years (Figure 1.7).

Figure 1.6: The Largest 25 Net Debt Ratios in OECD Countries

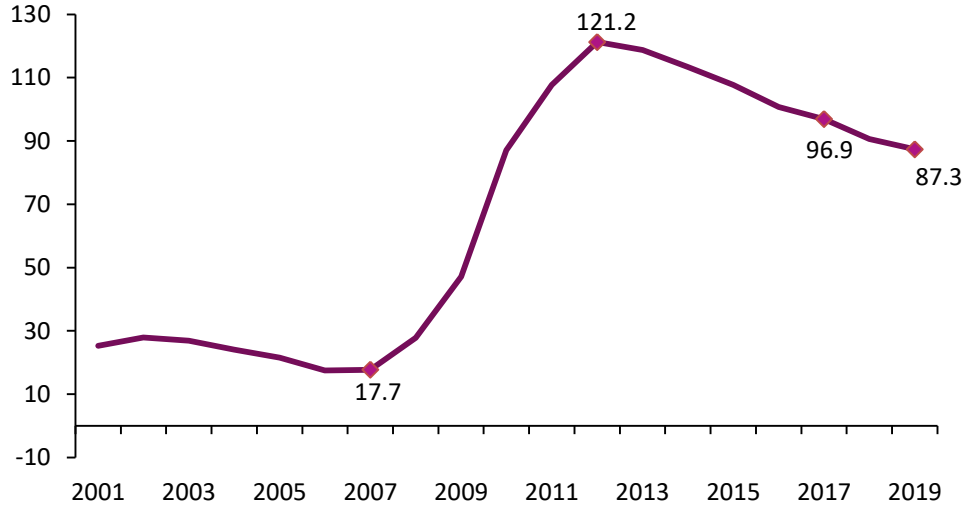
% GDP at end-2017 (% GNI* for Ireland), net general government debt



Sources: CSO; Eurostat; IMF World Economic Outlook (October 2018) and internal IFAC calculations.
Note: CSO data are used for Ireland; IMF data for Turkey, Switzerland, Canada, Korea, Iceland, Mexico, Israel, US, and Japan, while Eurostat data are used for remaining countries.

Figure 1.7: Ireland's net debt levels

% GNI*, general government basis



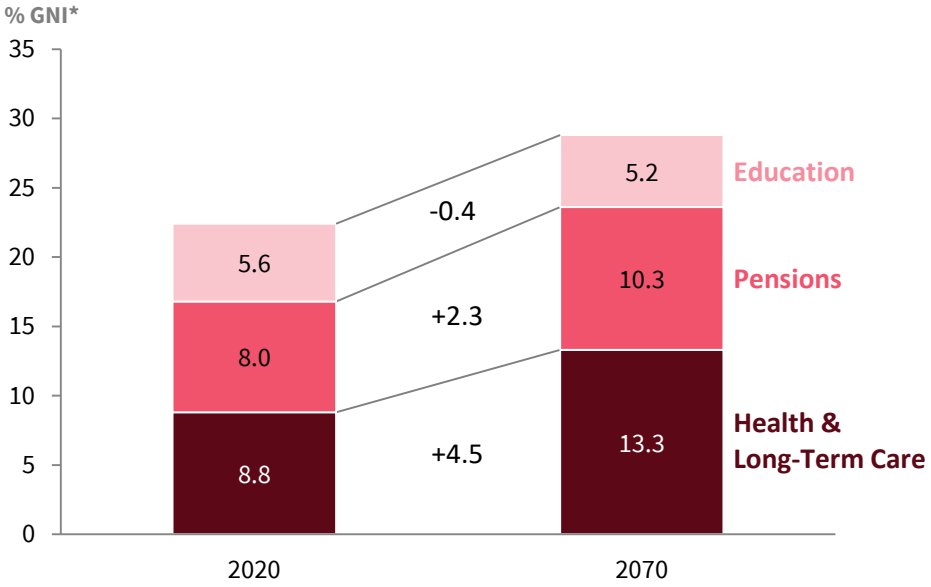
Sources: CSO; Department of Finance; and internal IFAC calculations.

Long-term costs for public spending associated with ageing are expected to rise over the coming decades. The Department (2018e) shows that—related to ageing—annual government spending on pensions, health and long-term care, and education is expected to rise by almost 7 percentage points of GNI* by 2070, when compared to 2020. Within this, Ireland's ageing population is estimated to contribute to a rise in annual health and long-term care costs worth 4.5 per cent of GNI* by 2070 as compared to 2020, while pension costs are expected to add 2.3 percentage points (Figure 1.8). These increases reflect a near doubling of the old-

age dependency ratio (the percentage of retirement age population as a share of the working age population) from 23 per cent in 2020 to 41 per cent by 2070. The Department shows that the impact of this rise in age-related costs would be to add about 70 percentage points of GNI* to the debt ratio by 2070 from 2020 levels, absent any policy response.

A notable aspect of long-term expenditure forecasting is that it can be biased by the effects of the cycle at the starting point of the projection period. If population estimates are boosted due to a cyclical upswing at the start of the projection period, then subsequent estimates of the population (taking average net migration contributions) may be unduly influenced by the temporarily high base. This can be especially important for migration, for example, where economic performance is associated with the relative attractiveness of the Irish labour market and migrant decision-making (Box B).

Figure 1.8: Annual Ageing and Health Costs Expected to Rise from 2020–2070



Sources: Department of Finance (2018e).

Box B: Demographic Change and Public Finances

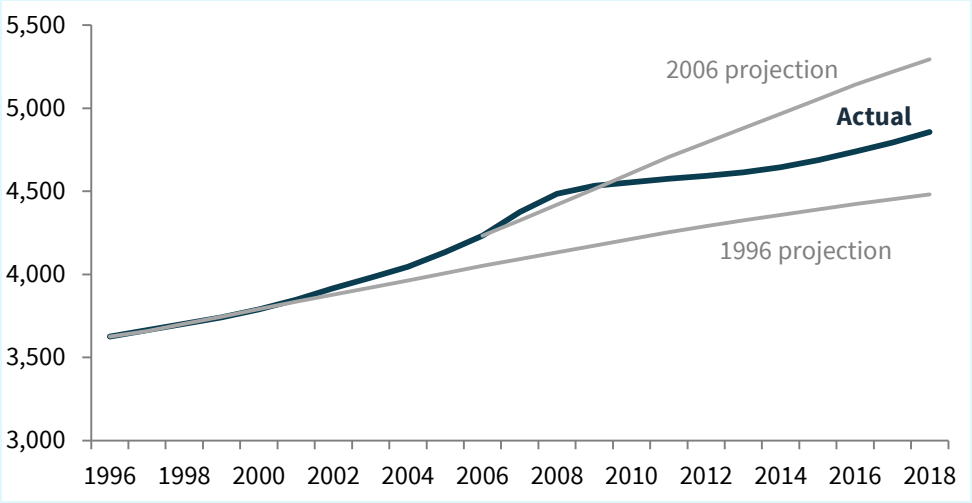
The Council is planning a special publication on the long-term sustainability of the public finances (30-40 years ahead) for next year. Demographics are a key driver of the public finances, which can directly impact relevant spending areas such as pensions, education and health. However, projections around these are challenging given the amount of uncertainty involved, as this box aims to outline.

To illustrate how errors on demographic projections can accumulate, we compare past projections from the CSO against actual census outcomes.[10] The CSO usually provides scenarios for different fertility and migration assumptions. In this analysis, we only consider the scenario that has been the most accurate up to 2016 for each projection.[11]

Looking at the CSO projections, we can see that a shorter projection window does not necessarily give more precise results. Figure B.1 compares actual population outturns from 1996–2018 with projections based on the 2006 and 1996 censuses. For 2016—the most recent census year—the 20-year-ahead projections underestimated the population by almost 317,000, while the ten-year-ahead projection of 2006 overestimated it by 354,000.

Figure B.1: Comparison of Actual and Projected Population

Population in thousands



Sources: CSO annual population estimates and CSO population projections 1996/2006 census based.
Note: The scenarios displayed are M1F1 for 1996 and M2F1 for 2006. Data after 2016 is preliminary.

Net migration tends to be the key source of error for population projections. This is evident for the five-year-ahead projections for 2006 and 2011 (Figure B.2, Panel A). Panel B shows that actual net migration varied greatly during the last 20 years. Importantly, it largely mirrored the economic cycle, whereas each set of projections tended to be quite linear and informed by

[10] It is important to note that the population projections produced by the CSO are not attempts at forecasting the future, rather presentations of how the population could evolve under different scenarios. The scenarios are agreed by an expert group in conjunction with the CSO. Assumptions are informed by historical and recent migration, mortality and fertility trends, and also by the prevailing economic and social conditions at the time of the projection.

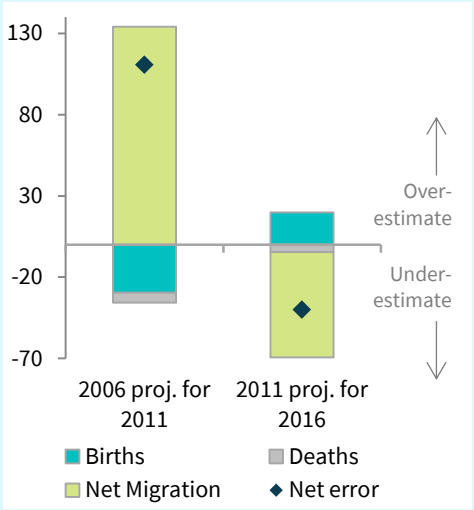
[11] For example, 1996 census projections list three total fertility scenarios: fertility rates (1) rise to 2 children per woman by 2001 and remain there, (2) decrease to 1.75 by 2011 and remain there and (3) decrease markedly to 1.5 by 2011 and remain there. Actual rates were around 1.9 for 1996–2006, before rising to 2.0 for 2007–2011 and then falling to just over 1.8 until 2016. From what we know today, the 1996 "high" fertility assumption (F1) was the most accurate assumption for 2016.

recent migration. This is also reflected in the relatively large projection errors for middle age groups (25-44) as well as for young ages (0-4) of the 2016 population (Figure B.3). The total number of births typically depends on fertility rates as well as on the number of women in middle age groups. As such, they may be indirectly affected by migration. Projections of deaths, on the other hand, have been the most consistent over all recent timeframes. IFAC is working on modelling migration explicitly in order to refine population projections.

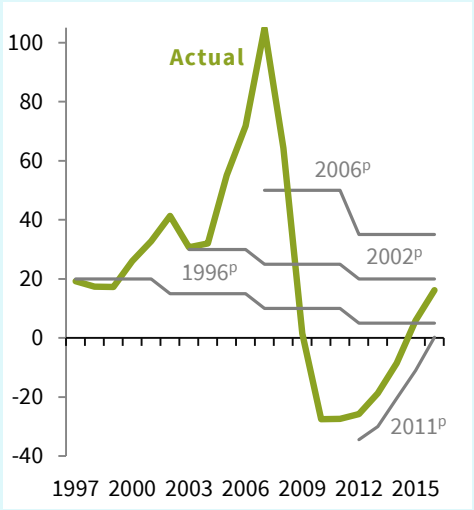
Figure B.2: A Closer Look at Errors on Projections

Population flows and population in thousands

A. Projection errors decomposed



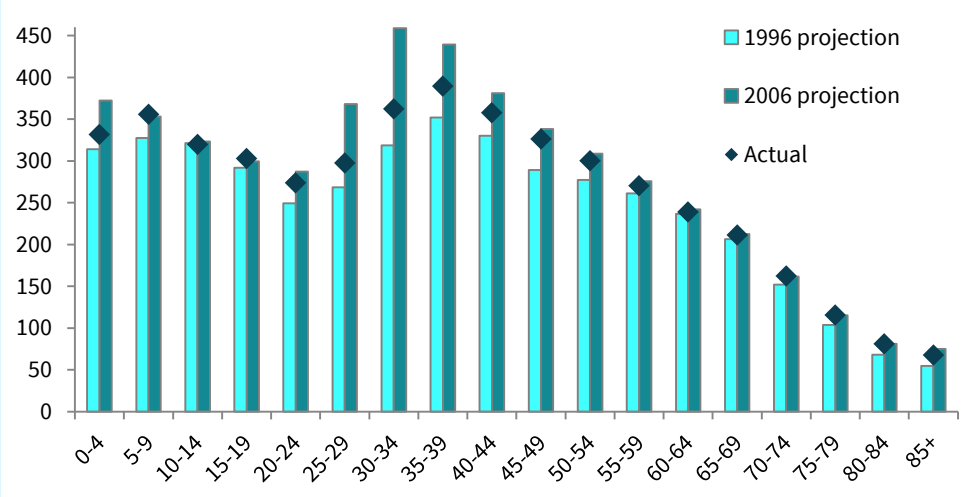
B. Actual and projected migration



Sources: CSO population estimates and 2016 census results; CSO population projections based on 1996, 2002, 2006 and 2011 censuses.
Note: Scenarios are M1F1 (1996); average of M1/M2, F1/F2 (2002); M2F1 (2006); M1F2 (2011). "p" = projection.

Figure B.3: Actual vs Projected Population 2016 by Age Group

Population in thousands by 5 year age groups



Sources: CSO 2016 census and CSO population projections based on censuses 1996/2006.
Note: The scenarios displayed are M1F1 for 1996 and M2F1 for 2006.

Fertility, migration and deaths can impact the public finances differently, depending on, for example, net impacts on the labour force, contributions, and transfers. They may also have economic implications, including on housing. Further research could explore migrants' fertility, schooling demand, retirement intentions, and long term care requirements.

Spending Drift

For the years 2015–2018, a major driver of the rapid pace of spending growth has been within-year spending increases. This pattern of "spending drift"—a tendency for spending to increase within the year beyond already-budgeted-for increases—has been a notable feature of budgetary policy since 2015.

Spending in the health area has been a key driver of the recent spending drift. A dangerous feedback loop has been allowed to develop in health spending: unrealistic spending plans are followed by weak expenditure controls and an eventual upward revision of spending ceilings. This interaction has led to a "soft budget constraint": those responsible for spending decisions know that spending limits will be relaxed and, hence, do not perceive these limits as credible. This means that incentives to stay within spending limits are weakened. The danger now is that this pattern will continue unless the Government makes serious efforts to arrest it. Connors (2018b) highlights failures in management and planning practices that may have led to budget overruns, including incomplete service plans and assessments of available resources.[12]

As Box D shows, the overruns in health have averaged €0.5 billion per year over 2014–2017. Recent trends have shown health spending ramping up in the second half of the year, especially in the last quarter, with staff recruitment being a key driver. This implies large carryover costs into the subsequent year, when new staff are paid on a full-year basis. While such spending increases have long-lasting effects on overall expenditure, their deficit impact has been masked by temporary gains elsewhere.

A notable aspect of health spending is the inadequacy of currently available data. The Government should seek to develop and publish more data on health expenditure than is currently provided, including monthly in-year forecasts of the expected annual outturn for health expenditure. Monitoring expenditure by

[12] For example, Connors (2018b, p.15) notes that "as set out in the legislation, the [National Service Plan] NSP should also outline the number and type of staff the HSE expect to recruit throughout the year within the Budget available. Since 2013, the NSP has made no reference to the number of staff the HSE expect to recruit throughout the year and the associated cost of these staff." With staff costs accounting for close to half of all health expenditure, failures to plan and manage staffing requirements are a key potential driver of overruns. Furthermore, the authors add that "the approach to workforce planning[…]makes little or no reference to available resources. There is no consideration of what current resources are being spent on or what can be delivered in the future…".

functional classification in a timely manner throughout the year should be a first step to assessing and controlling potential overruns. This would be helped by a move to a timelier, audited, and consolidated general government accounting system for all departments.

Had spending growth based on initial plans for 2015–2018 been followed, the Government would now be running a surplus.[13] Using the Council's Fiscal Feedbacks Model, it can be estimated that a general government surplus of €1.1 billion (0.6 per cent of GNI*) would already have been achieved in 2017—three years earlier than now planned—if within-year increases in spending that were not planned for had not occurred in each of the years during 2015–2018 (Figure 1.9).[14] Furthermore, the budget would have been on track to record its third year in surplus, with a positive balance of 1.1 per cent of GNI* for 2019, and the debt ratio would have been 3.7 percentage points of GNI* lower (approximately €8 billion lower).

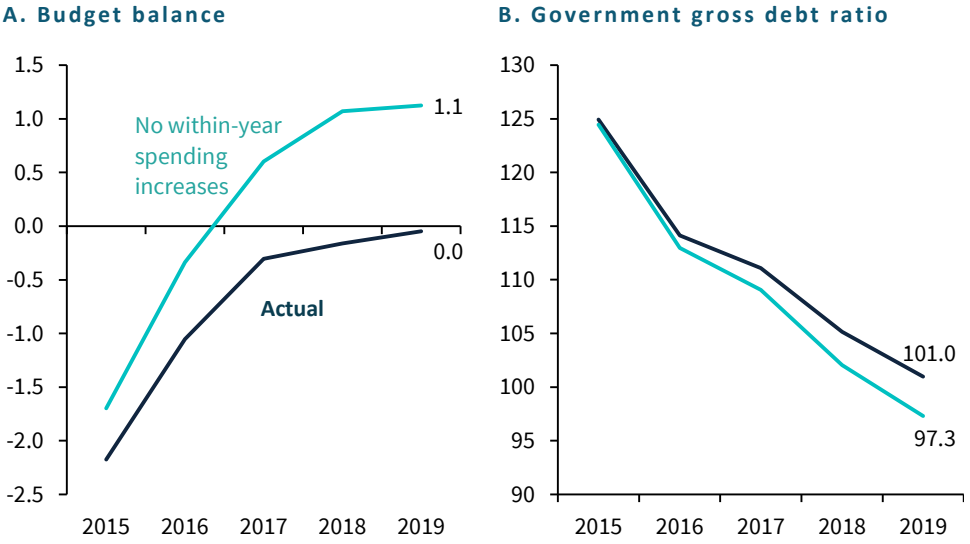
The delay to a return to surplus is not without its costs. It keeps debt higher than could have been achieved, leaves the public finances more exposed to adverse shocks in coming years, and provides an unnecessary stimulus to an already fast-growing economy. Using unexpected revenues to fund long-lasting spending increases when economic growth is already strong also has worrying echoes of mistakes made prior to the last crisis, when a surge in property-related windfalls temporarily improved the public finances. By comparison, ten of the eleven years from 1997–2007 saw underlying budget surpluses being run, with an average surplus of 1.8 per cent of GNI*.

[13] This assumes that the expenditure base is reduced in each subsequent year accordingly.

[14] This counterfactual would be consistent with nominal net policy spending growth of 4.0 per cent per annum over the period 2015–2019 rather than the 4.9 per cent now likely, with total general government spending lower by €3.3 billion in 2019 compared to current *Budget 2019* plans.

Figure 1.9: Estimated Budget Balance and Debt had Within-Year Spending Increases Been Avoided

% GNI*, general government basis



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Within-year spending increases are based on gross voted spending outturns as compared to earlier vintages of estimates (*Budget 2015* for 2015; *Budget 2016* for 2016; *Budget 2017* for 2017; and *SPU 2018* for 2018 – note that we use *SPU 2018* rather than *Budget 2018* to allow for the reclassification impact of a significant technical adjustment relating to funding of water services following the enactment of the *Water Services Act 2017*). The 2018 outturn estimates are preliminary and are based on *Budget 2019* estimates.

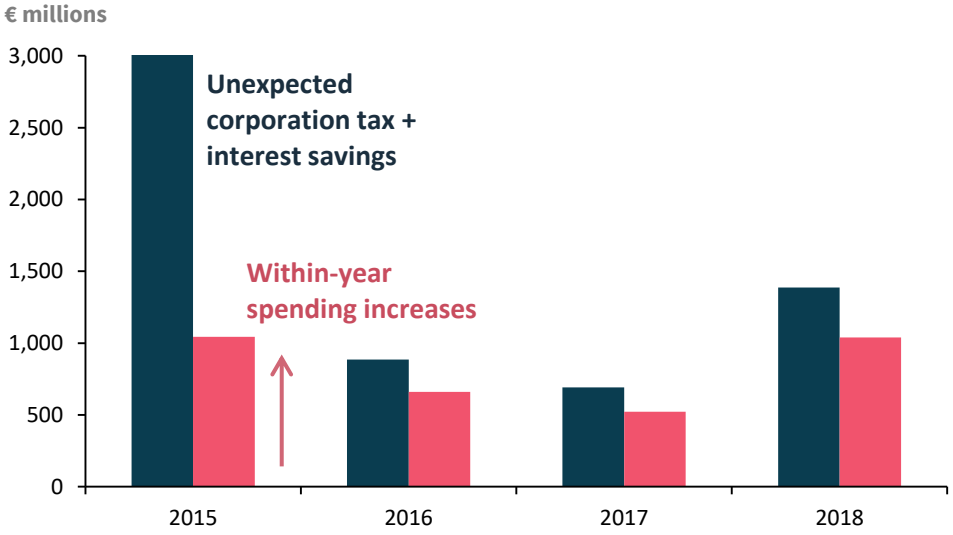
1.4 Assessment of the Fiscal Stance for 2018–2023

Fiscal Stance in 2018

Previous Government plans for 2018 were prudent, but were not followed through (IFAC 2018d). In the *November 2017 Fiscal Assessment Report*, the Council assessed that the fiscal stance adopted by the Government in *Budget 2018*, for this year—based on growing spending around the potential growth rate of the economy—was conducive to prudent economic and budgetary management. However, Government spending this year is now set to be increased at a faster pace than originally envisaged, with the increases likely to be long-lasting.

For 2018, the Government decided to increase spending limits by a further €1.1 billion (0.53 per cent of GNI*) beyond what was contained in official plans just four months earlier.[15] This meant that net policy spending rose by 5.7 per cent for the year as compared to previous plans for an increase of the order of 4.1 per cent.[16]

Figure 1.10: Within-Year Spending Increases Masked by Unexpected Gains



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Within-year spending increases are based on gross voted spending outturns as compared to earlier vintages of estimates (*Budget 2015* for 2015; *Budget 2016* for 2016; *Budget 2017* for 2017; and *SPU 2018* for 2018 – note that we use *SPU 2018* rather than *Budget 2018* to allow for the reclassification impact of a significant technical adjustment relating to funding of water services following the enactment of the *Water Services Act 2017*). The unexpected corporation tax receipts and interest savings are derived from end-December Analytical Exchequer Statements outturns less profiles. The 2018 outturns are preliminary and are based on *Budget 2019* estimates.

[15] However, the Minister noted in a meeting with the Budget Oversight Committee after the *Summer Economic Statement 2018* was published that a supplementary of some form was expected: "A 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."

[16] Previous plans as contained in the *Summer Economic Statement 2018* and *SPU 2018*.

The bulk of the 2018 within-year increase was due to an additional €0.7 billion rise in health spending beyond already-planned-for increases. The pace of growth in health spending in recent years is likely to be at an average rate of just over 6 per cent per annum from 2016–2019. Chapter 3 examines the health overrun in 2018 and previous years in more detail.

The Government revised up its expectations for 2018 tax receipts to include an unexpected and temporary surge in corporation tax receipts. An over-performance in corporation taxes worth an expected €1.1 billion was forecast in *Budget 2019* for 2018. The Department also noted that it expected a large portion of this (some €0.7 billion) to be "one-off" in nature.[17] Separate "company / sector-specific developments" were cited as driving the remainder of the corporation tax outperformance.[18] Further unexpected interest savings of €0.3 billion also mask the impact of the higher within-year spending increases for 2018. This pattern of unexpected corporation tax receipts and interest savings is one that has been evident in recent years as the economy has recovered (Figure 1.10).

The Council assesses that the additional expenditure increases introduced in 2018 were not conducive to prudent economic and budgetary management. To the extent that budgetary gains are temporary, these should not be used to facilitate ongoing overruns. Failure to address the pattern of overspending in health areas, and the use of temporary, highly volatile, and unpredictable revenue sources to offset these means that the procyclical policy mistakes of the past are being repeated. This approach leaves the public finances more vulnerable than they otherwise would be to inevitable, adverse shocks.

The Department of Finance's own estimates, based on the CAM, suggest that Government plans will breach the fiscal rules for 2018. The two key rules that apply assess the structural balance and the pace of spending growth (note Chapter 4 covers the assessment of the fiscal rules in detail):

[17] This partly reflects the adoption of new accounting standards by some firms: the International Financial Reporting Standard (IFRS 15). Over time, the impact is expected to be cash neutral (i.e., the surge in revenues in 2018 is expected to be offset by lower revenues in future).

[18] There was also a downward revision to Excise Duty so that the net change in underlying tax revenues was limited.

Structural Balance: A deterioration in the structural deficit for 2018 to 1.2 per cent of GDP means that the Medium-Term Objective of a structural deficit of no more than 0.5 per cent of GDP is not forecast to be met.[19] The estimated deterioration in the structural balance largely reflects changes to the estimated output gap that may be misleading. Yet, even more plausible estimates of the output gap indicate that the structural position has deteriorated rather than being kept at the same level in 2018 (Figure 1.4 and Chapter 4).

Spending Growth (Expenditure Benchmark): Net spending growth is expected to be within with the Expenditure Benchmark limit for 2018, notwithstanding the fast pace of expansion in net policy spending (Box A). This partly reflects how two key adjustments to the spending growth rate assessed are made. One adjustment allows for temporary fluctuations in public investment spending increases by smoothing through recent levels (to recognise the lumpy nature of public investment spending). However, the Government's plans are to ramp up public investment spending to high levels (i.e., the increases are not temporary increases, but trend increases). A second key adjustment tries to capture how cyclical improvements in the labour market effect unemployment benefit costs. Both adjustments give misleading signals in 2018, which benefit compliance relative to more appropriate adjustments (Chapter 4). Moreover, the limits for real net spending growth allowed under the Expenditure Benchmark are climbing to high levels, given how procyclically the measure as applied is (Chapter 4).

[19] Note that this assessment uses the one-off items assessed as applicable by the Council.

Fiscal Stance in 2019

In the lead up to *Budget 2019*, the Council assessed that the Government should stick to its existing budget plans for 2019 (IFAC, 2018d). This would have amounted to a budget-day package of €0.8 billion, allowing nominal net policy spending to rise by 4½ per cent.

Table 1.2: Use of Fiscal Space is Higher than Expected

€ millions unless stated

	Pre-Budget		Now (Post-Budget 2019)	
	2018	2019	2018	2019
Total Expenditure	80,080	82,965	81,145	85,310
Less Interest	5,346	5,225	5,346	5,225
Less EU co-financed current spending	470	500	470	500
Less Public Investment (GFCF)	6,790	7,690	6,805	7,745
Plus four-year avg of Public Investment	5,489	6,267	5,540	6,296
Less Cyclical Unemployment Expenditure	126	-84	114	-149
Less One-Off Expenditure Items	0	0	0	0
Corrected Expenditure Aggregate (a)	72,837	75,901	73,950	78,284
Less DRMs for 2019 (b_t)		33		958
Use of Fiscal Space = (a_t - b_t) - a_{t-1}		3,031		3,377
Unplanned increase for 2019				€0.35bn
Unplanned increases for 2018 & 2019				€1.4bn

Sources: Department of Finance; internal IFAC calculations.
Note: DRMs are Discretionary Revenue Measures. Note that the cyclical unemployment expenditure amounts used are based on an assumed natural unemployment rate of 5.5 per cent, which the Department tends to assume the economy converges to over the medium term.

As it turned out, the actual budget package introduced for 2019 was a further €0.3 billion (0.15 per cent of GNI*) larger than previously planned (Table 1.2). Moreover, it took the higher base for 2018 due to the unplanned within-year increases as its starting point. The budget day package incorporated total tax increases of €0.35 billion (tax cuts of €0.365 billion, and tax increases of €0.715 billion). Added to non-indexation, which raised a further €0.6 billion, this meant an overall net revenue-raising package of €1 billion. This compares to original plans, which were for a net tax package of €0.0 billion (€0.6 billion tax cuts offset by €0.6 billion non-indexation). Expenditure increases of €1.4 billion entailed a €1.1 billion package of tax and spending measures (ignoring indexation).[20] Factoring in the higher starting point, this means that total spending in 2019 is €2.3 billion above what was planned

[20] A further €0.6 billion raised from not indexing the income tax system was already planned for prior to the budget and is included in the Discretionary Revenue Measures.

in *SPU 2018*, with larger-than-planned discretionary revenue measures (€0.958 billion) only partly offsetting the increase.

The Council previously assessed that there was no case for additional fiscal stimulus beyond a package of €3.5 billion (Chapter 2 notes the additional demand impact that the budget had). It also noted that, given the various adverse risks on the horizon, there were good reasons to introduce a budget that was below an upper limit of €3½ billion for spending increases or tax cuts for 2019. The upward revision of €0.35 billion to plans for 2019 contained in *Budget 2019*, coupled with the within-year increases in 2018, puts it beyond the upper limit assessed by the Council. For 2019, total use of fiscal space is set to be €3.4 billion as compared to initial plans to use closer to €3 billion, but this is in addition to the within-year spending increases introduced in 2018. Furthermore, there is a risk that this type of slippage could occur again in coming years.

Taken together, the plans for both 2018 and 2019 are not conducive to prudent economic and budgetary management. The plans imply a government spending increase (net of tax measures) of €4.5 billion in 2019 compared to what was planned for 2018. Repeated failures to prevent unbudgeted-for increases of this kind leave the public finances more exposed to adverse shocks, which are inevitable in coming years. They also lead to spending increases that are long-lasting and difficult to reverse, and they represent a repeat of the policy mistakes of the past. Instead, pressures in the health sector and elsewhere should be absorbed through sustainable tax revenues or decreases in spending categories elsewhere.

There is a high likelihood that these types of increases in spending beyond current plans will occur again. In particular, some of the budgetary estimates for 2019 lack credibility:

- **Health estimates**: As Box D shows, current health overruns have amounted to an unexpected €0.5 billion additional spending per year (or 0.3 per cent of GNI*) over 2014–2017. The total (current + capital) health overrun for 2018 is now expected to cost another €0.7 billion. While the increase in spending now budgeted for in 2019 is large at €1.05 billion (+6.6 per cent), there is little reason to suggest that wider problems in planning and monitoring/controlling spending have been resolved.

- **No provision for Christmas Bonus**: no funding has been provided for the Christmas Bonus beyond 2018 yet again. Some form of payment of the Christmas Bonus has been made in each of the past five years, despite not having been budgeted for. Notwithstanding this, the Government continues to maintain that this is at its discretion based on prevailing conditions. Basing budgetary decisions on "prevailing conditions" is not an advisable approach to take with the public finances. If the full bonus is paid again in 2019—as in 2018—then close to €0.3 billion will be added to the budgeted-for increases in spending for 2019.

- **Estimates of tax yields**: Several yield estimates for measures introduced in *Budget 2019* and in the previous budget lack a strong evidence base. While the large VAT increase looks to have been costed accurately, smaller measures are more questionable. For example, the 50 cent increase on tobacco products in the budget are projected to yield additional excise taxes of €50 million (excluding VAT) in 2019. Yet Revenue's estimates, which attempt to partially reflect the change in behaviour of smokers to higher prices, suggest that an equivalent increase could yield in the range of –€44 million to +€57 million (a midpoint of €6.5 million).[21] Previous work by the Council has pointed to issues with the quality of costings in *Budget 2018* including the stamp duty rate increase on non-residential property (see Chapter 3 and Box F, IFAC 2017e).

The potential for further within-year increases in 2019 and beyond is a serious concern and should be avoided. An argument that has been used to justify unbudgeted increases in these areas has been that the increases are needed to "improve public services and support economic growth" following a period of significant expenditure consolidation.[22] Improvements in public services are to be

[21] Revenue (2018) note that "variations in receipts from tobacco in recent years suggest that the use of the range is appropriate but also that the higher end of the range is likely the most suitable to use when undertaking costings." Taking the upper end of a range of estimates rather than the midpoint is an unusual statistical practice.

[22] See the *Response of the Minister for Finance to the June 2017 Fiscal Assessment Report* (Minister for Finance, 2017). This argument is also availed of by the Department of Public Expenditure and Reform when describing the unsustainable spending increases that occurred prior to the last crisis: "The pre-crisis period saw large increases in expenditure. These increases helped address key infrastructure deficits and provided the resources for significant improvements in public services and social supports. However, the increases were ultimately unsustainable…"Mid-Year Expenditure Report, July 2017 (p.29).

welcomed. However, if these are not supported by sustainable revenue increases, then forced cuts to spending at a later time become inevitable, with an ensuing deterioration of public services.

The Department of Finance's own estimates, based on the CAM, suggest that Government plans will breach the fiscal rules for 2019:

Structural Balance: The Department forecasts a structural deficit of 0.7 per cent of GDP in 2019 as compared to a required structural deficit of no more than 0.5 per cent of GDP.

Spending Growth (Expenditure Benchmark): In 2019, net expenditure growth is expected to be 4.3 per cent, which is below the limit allowed under the Expenditure Benchmark.

The risks of further slippage in 2019 could worsen the forecast breach of the MTO. In particular, this could arise if expenditure overruns were to occur, e.g. Department of Health overruns or unbudgeted welfare increases (like the Christmas Bonus).

Fiscal Stance in 2020–2023

The Government's plans for 2020–2023 lack credibility, and there is no clear anchor for spending and the public finances over the medium term. As Chapter 3 shows, the plans for 2020 and beyond are formulated on technical assumptions for departmental ceilings.

Aside from some allowances for demographics, and a ramp-up in public investment, departmental ceilings are largely flat for later years. This implies implausibly large and sustained decreases in non-interest spending as a share of GNI*, which seem unrealistic based on the pattern of recent years. From 2019 to 2023, non-interest spending is forecast to fall from 38.7 per cent of GNI* to 36.2 per cent (Figure 1.11).

Figure 1.11: Government spending forecasts imply unrealistic falls as a share of GNI*

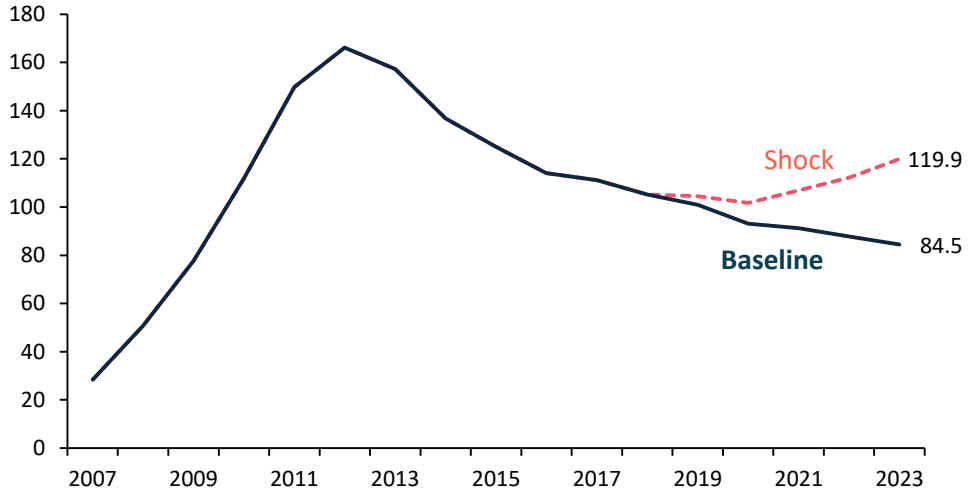
% GNI* (Non-interest spending, general government basis)

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data are adjusted to exclude expenditure one-offs as assessed by the Council.

A more plausible scenario is that spending increases at a faster pace than currently set out for these years, and more in line with cost of providing existing public services and welfare payments in a growing economy. This would imply that the surpluses which are shown in the *Budget 2019* documents for the period after 2019 are unlikely to occur and that debt levels will be higher than *Budget 2019* forecasts suggest.

Figure 1.12: Illustrative Debt Shock from 2019 Onwards

Gross debt as % of GNI *, general government basis



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Using the Council's Fiscal Feedbacks Model, the scenario shows the debt ratio path for an illustrative shock equivalent to a typical forecast error on nominal GDP growth (–2 p.p. relative to baseline growth rates) in each of the years 2019, 2020, 2021, 2022, and 2023. Nominal GNI* is assumed to have an elasticity with respect to nominal GDP of 1.0, which is applied only to the deviation in nominal GDP from its baseline.

With the Government's debt burden still high and vulnerable to shocks, medium-term spending plans should be well-founded. As Figure 1.12 shows, a standard forecast error on economic growth over the period from 2019 onwards could lead to a rising debt-to-GNI* ratio back to levels as high as 120 per cent by 2023 in the absence of offsetting policy tightening. This could happen if a Brexit-related shock were to be sharper than currently expected, if the international tax environment changed with negative consequences for the Irish economy, or if multinational enterprises operating in Ireland were to shift their operations elsewhere. To ensure that the debt burden is reduced to safer levels at a steady pace, the Government's medium-term budgetary plans should be more credible. A new Appendix A examines a number of other debt sustainability stress scenarios considered relevant by the Council. These highlight the uncertainty and fragility of the debt trajectory.

Previous statements by the Minister had referred to an emphasis on the "budgetary stance" rather than simply using all of the available fiscal space under the rules. This is the correct approach to follow, but it is not being pursued in budget decisions or in medium-term plans. *Budget 2019* saw this language largely abandoned. The commitment to run surpluses, if possible, in the foreseeable future is vague and inadequate.

The Government needs to develop a clear anchor for spending plans if it is to avoid repeating mistakes of the past. Three tools that are potentially useful for medium-term budgeting are (1) the spending ceilings; (2) the debt target; and (3) the Rainy Day Fund. These need to be developed further if they are to help to reinforce medium-term spending plans.

Spending Ceilings: The Government's three-year budget ceilings are not working. As Chapter 3 shows, forecasts for expenditure are unrealistic and control problems have repeatedly led to higher-than-forecast expenditure. This is underscored by the fact that a pattern of procyclical increases in spending has been evident since 2013/2014 (Chapter 4). A better approach would see more realistic spending plans set out in advance, and a strengthening of subsequent spending controls and monitoring. In principle, the spending ceilings should work by making offsetting cuts in other areas or clawbacks in subsequent years when overruns arise in one area. This would ensure that expenditure increases on aggregate are sustainable. In practice, recent years have seen aggregate overruns, especially in health spending, that have not been absorbed by other areas.

The Debt Target: The Government has in the past stated a debt target of 55 per cent of GDP, although this was not referenced in *Budget 2019*. This is not a particularly low or prudent debt ratio and there are no clear staging posts for when the debt ratio should achieve this target.[23] To help guide the debt burden to safer levels, the Government should publish debt ratio targets for individual years so that these can be assessed over time. The medium-term debt target itself should also be developed further. It should be set against a more appropriate measure of national income like GNI*; it should be lower; it should be specified clearly as either targets (e.g., a steady state position to be met on average) or as ceilings/limits; and it should incorporate a broader assessment of long-term spending pressures.

Rainy Day Fund: Legislation to establish the Rainy Day Fund has now been introduced. The Fund is to be called the "National Surplus (Exceptional Contingencies) Reserve Fund" and its introduction is a welcome step towards making fiscal policy in Ireland more countercyclical. The Fund will be established in

[23] The Department's Annual Debt Report, 2019 only shows an illustrative forecast as opposed to yearly targets. This is despite the fact that the Annual Debt Report in 2018 suggested the need for such staging posts.

2019 and a contribution will be made to it next year. Notwithstanding the name of the Fund, there is no planned surplus to put into the Fund in 2019.

Though potentially useful, the Fund has a number of major limitations:

- Most importantly, its design is insufficiently countercyclical to offset faster-than-prudent growth rates as allowed under the application of the spending rule (based on estimates of potential or "sustainable" output that are derived from the Commonly Agreed Methodology). This is something that could have been considered in the design of the Fund and it will be a key issue in coming years as the rules become looser following the cyclical upswing (Casey *et al.,* 2018; Department of Finance, 2018b).[24]

- A second key limitation of the Fund is the fact that contributions are largely fixed and do not respond to windfalls or cyclical revenues. Corporation tax have repeatedly been higher than expected in recent years, with levels now set to be at a record share of total tax receipts. Yet the allocation to the Fund has not increased from a previously stated allocation of €0.5 billion, despite the fact that the Government has stated that it will set aside some of the historically high levels of corporation tax for the purpose of capitalising the RDF. In fact, the €0.5 billion contribution is half the originally planned €1 billion contribution first set out two years earlier.[25] The €0.5 billion allocations are described as "prescribed amounts" in the proposed legislation meaning that, if the government spends money in a year on unforeseen costs related to natural disasters or other disasters, then a lower than prescribed amount may be paid into the Fund.[26] Payment of any additional amounts would have to be passed by a resolution by Dáil Éireann.

[24] A key shortcoming of supply side estimates underpinning the fiscal rules noted by both the Council and the Department is that they are prone to mismeasuring the cycle. This mismeasurement can exhibit a procyclical pattern whereby the allowed pace of growth in spending rises in good times, and falls in bad times

[25] The proposed allocations to the Rainy Day Fund were originally set at €1 billion each year in *Budget 2017* (p.12)*:* "the projections provide for a €1 billion per annum contribution from 2019 onwards to a rainy day fund or contingency reserve".

[26] Available at: https://www.finance.gov.ie/wp-content/uploads/2018/10/B11618D.pdf

- A third limitation is that the Fund is to be capped at €8 billion in size. Predicting the nature of a future cyclical downturn and/or exceptional events and their associated costs is virtually impossible.[27] It would be wise to remain agnostic about this. Instead of setting policy on the basis of what costs are expected to be, the Rainy Day Fund should be flexible to allowing cyclical developments and windfall revenues from corporation tax and elsewhere be allocated to the Fund. The ultimate size of the Fund should therefore be flexible too.

- A final limitation is that drawdowns from the Fund depend, in the main, on the Minister being satisfied that "exceptional circumstances" are occurring. This means (a) a period during which an unusual event outside the control of the State has a major impact on the financial position of the general government, or (b) a period of severe economic downturn within the meaning of the Stability and Growth Pact. Exceptional circumstances are events that have rarely occurred in the context of the EU definition, and there is no guarantee that the definition used by the Minister will be the same as assessed by the European Commission. Differences of opinion could mean that the use of the Fund could breach the fiscal rules, if existing plans are already only minimally complying.

[27] Box B of the *June 2018 Fiscal Assessment Report* explores a potential 12-year cycle for Ireland and finds that this could be consistent with a fund size of €8 billion.