



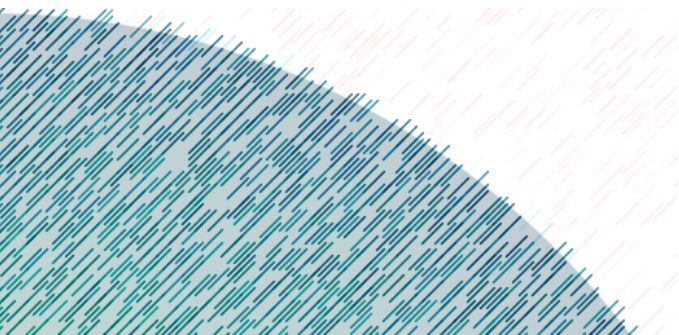
# **Irish Fiscal Advisory Council**

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## **Fiscal Assessment Report**

November 2018

Report Briefing,  
27th November 2018



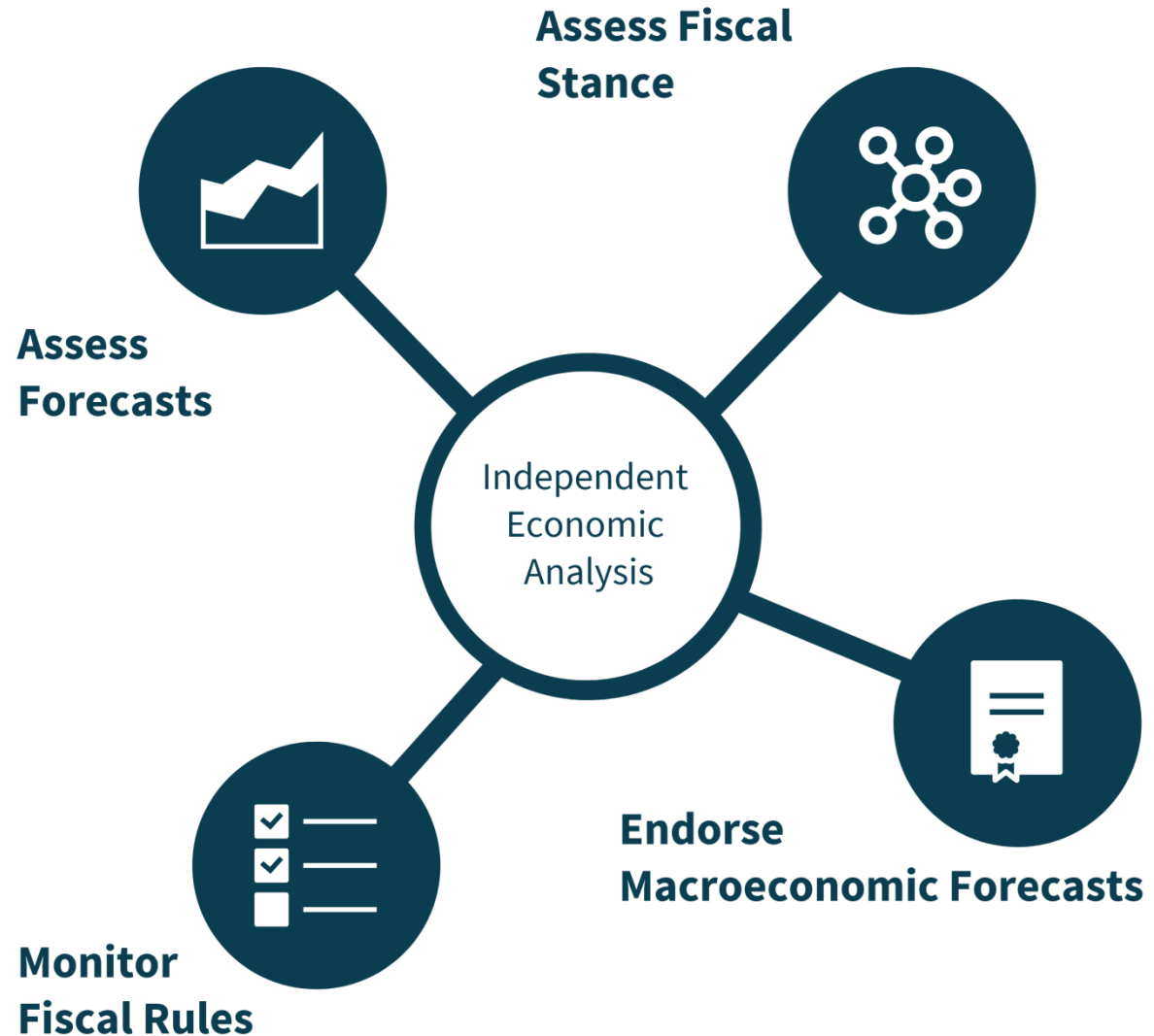
# **Some Background**

# The Fiscal Council

- First established in July 2011
- Five-Member Council
- Seven-Member Secretariat
- The Fiscal Assessment Report is the Council's main publication. The twice yearly report assesses the Government's budgetary plans through all elements of the Council's mandate. This is our 15<sup>th</sup> Fiscal Assessment Report.



# Our Mandate



# Key Messages

# Key messages

- Repeated failures to prevent unbudgeted spending increases leave public finances exposed.
- Budget 2019 plans are not conducive to prudent economic and budgetary management.
- Medium-term budgetary plans are not credible.
- While the short-term outlook for the Irish economy remains strong, a slowdown in coming years is inevitable.

# **(1) Repeated failures to prevent unbudgeted spending increases leave us exposed**

- Failures to prevent unplanned spending increases have meant long-lasting increases in spending that are difficult to reverse and that represent a repeat of the policy mistakes of the past.
- Instead, pressures in the health sector and elsewhere should be funded through sustainable tax revenues or decreases in spending categories elsewhere.
- These have left the public finances more exposed to adverse shocks, with the budget balance in deficit rather than in surplus.

## (2) 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—beyond the limit that the Council had assessed as appropriate.
- A prudent fiscal policy would see net policy spending rise in line with sustainable revenues.
- The Council deem budgetary plans as not conducive to prudent economic and budgetary management.
- Increases in spending in 2018 and in *Budget 2019* are higher than previously planned.
- Underlying improvements in the budget balance have stalled since 2015, despite the favourable environment.



### **(3) Medium-term budgetary plans are not credible**

- The current intention to run budget surpluses for the foreseeable future if conditions allow is vague.
- Medium-term spending forecasts are based on technical assumptions that look unrealistic.
- Previous commitments to outperform fiscal rules and to reduce debt to 55 per cent of GDP over the medium term—itself an insufficiently ambitious target and with no clear timing—are no longer referenced.
- The Government's three-year budget ceilings are not working, with repeated, procyclical, upward revisions.

## **(4) While the short-term outlook for the Irish economy remains strong, a slowdown in coming years is inevitable.**

- The Council assesses that the pick-up in growth since about five years ago has been driven by a cyclical recovery in demand.
- The economy appears to be operating close to its potential level, with overheating a possibility in coming years.
- Major positive risks (such as a stronger upturn in housing sector) and negative risks (such as harsher than assumed Brexit) are evident.

# More Detail

# Macro Context

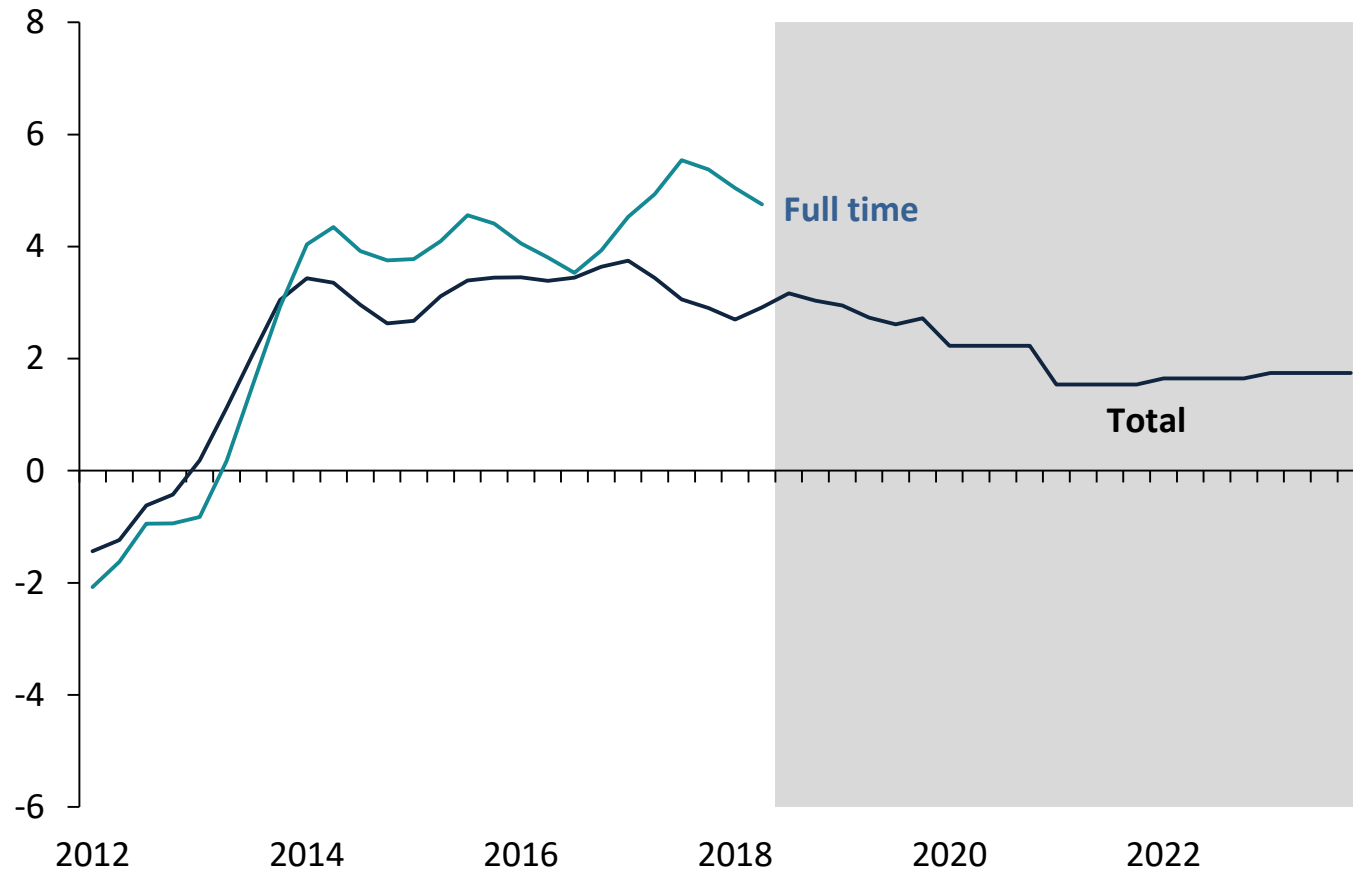
# The Macro Context

- The pick-up in growth since about five years ago has been driven by a cyclical recovery in demand.
- The Irish economy now looks to be operating close to potential in 2018, meaning that capacity and price pressures could begin to emerge.
- While the short-term outlook for the Irish economy remains strong, a slowdown in coming years is inevitable. The outlook is uncertain, with major risks evident in both directions.

# Domestic economy continues to grow strongly

## Employment Growth

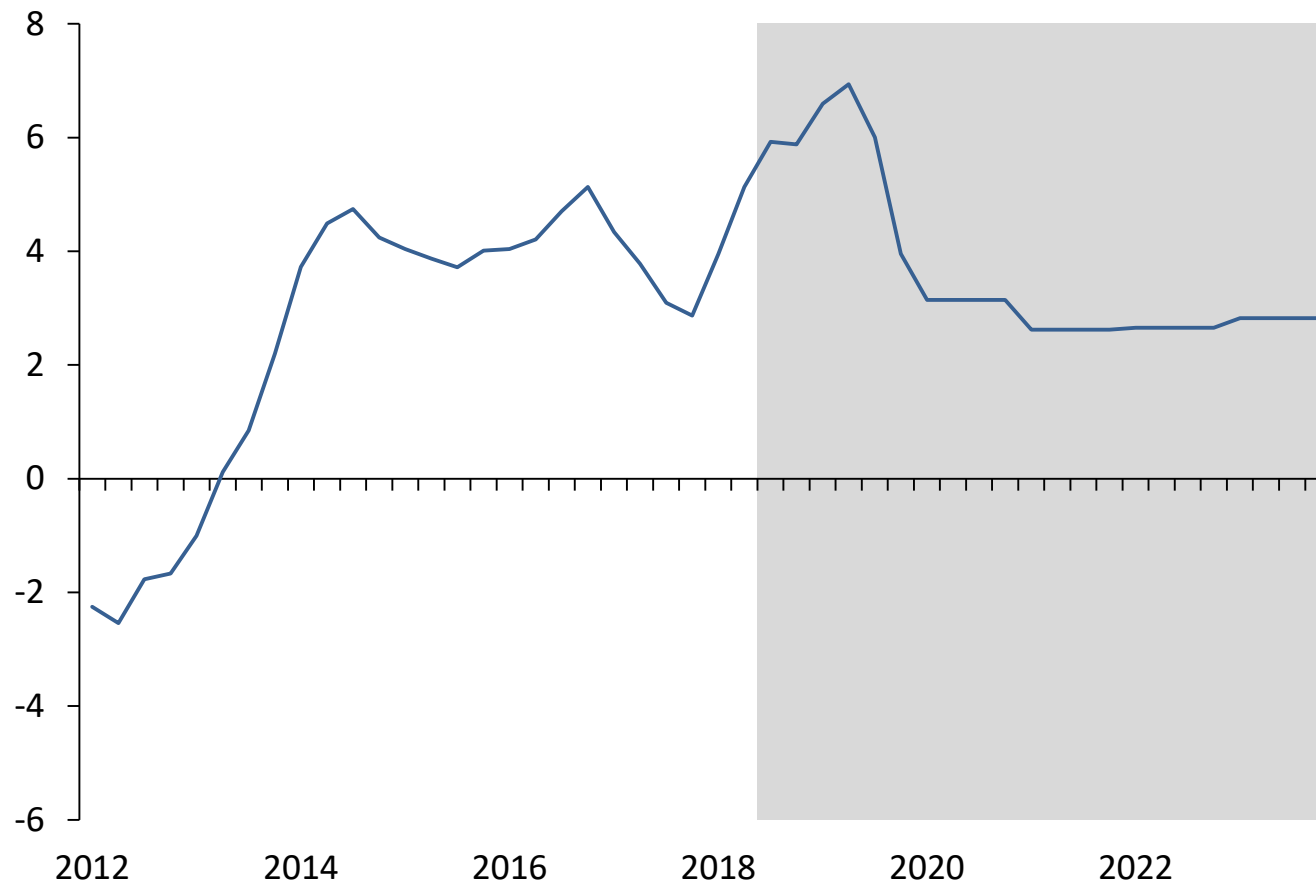
Percentage change (year-on-year)



# Domestic economy continues to grow strongly

## Underlying Domestic Demand

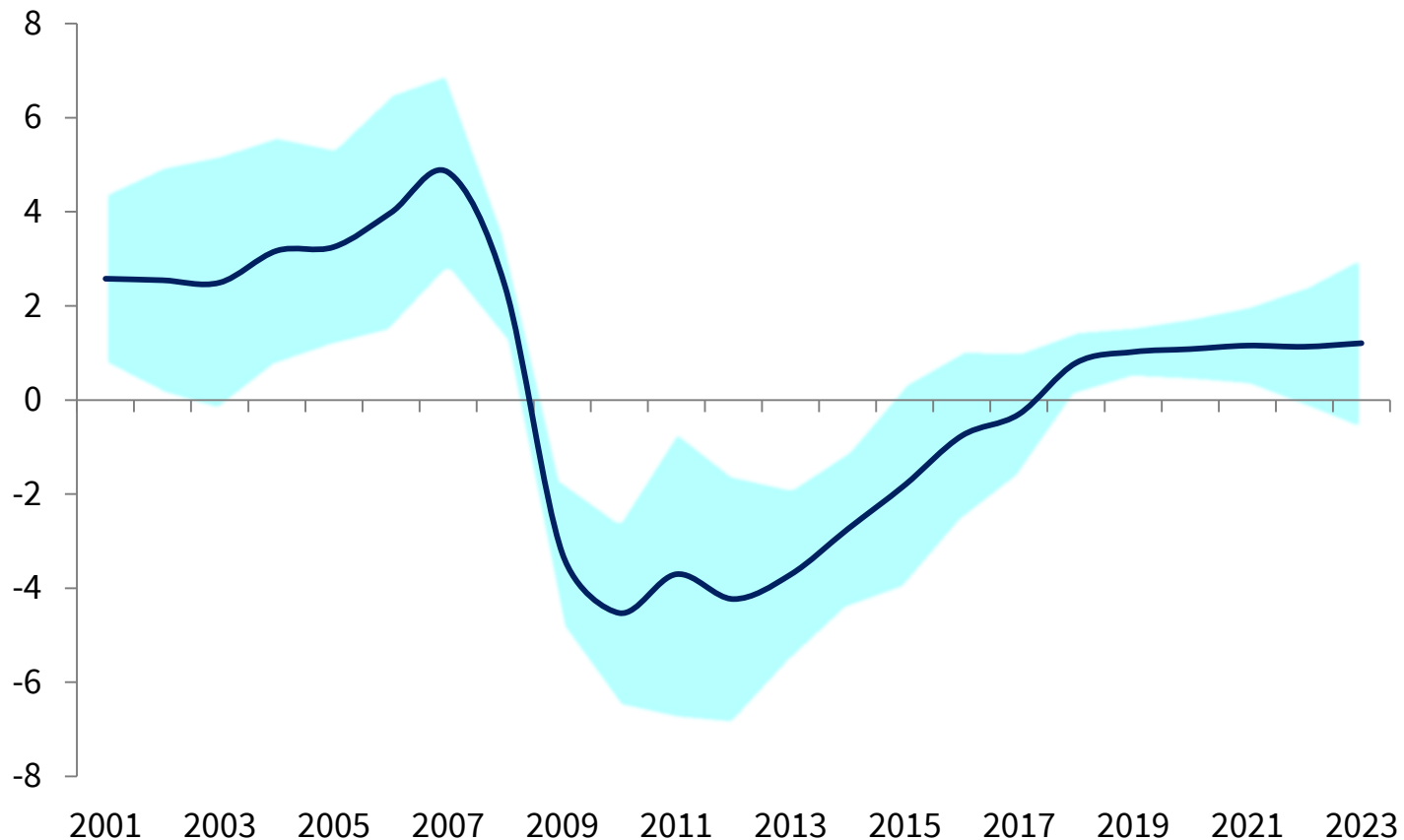
Percentage change (year-on-year)



# Domestic economy now looks to be at its potential in 2018

## IFAC's Output Gap Estimates

gap between actual and potential output as % of potential





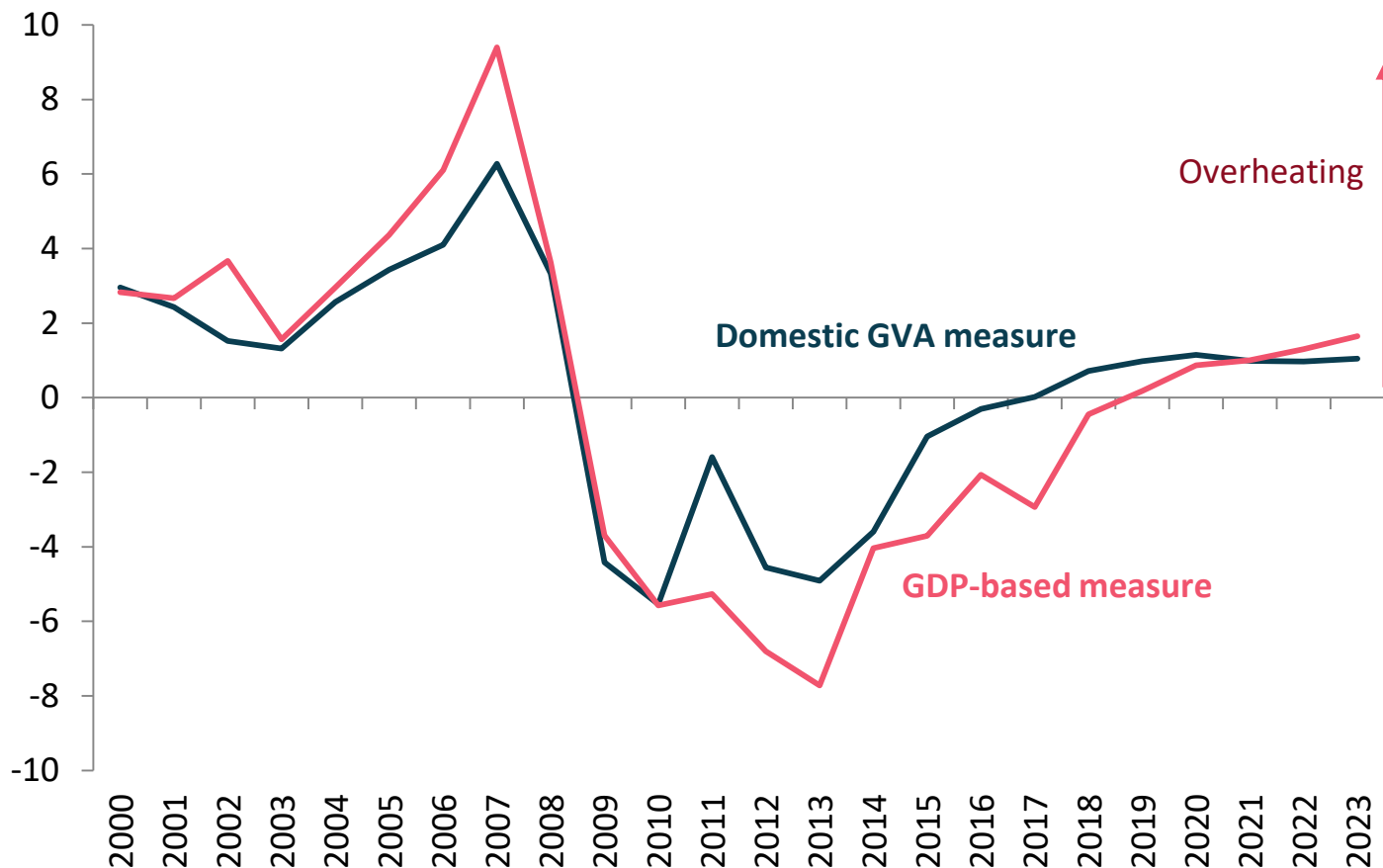
# Department of Finance has developed new estimates of potential and of the cycle

- The Department of Finance has made substantial progress on macroeconomic forecasting.
- It has developed and published its own estimates of medium-term economic growth and of the underlying state of the domestic Irish economy to inform policy.

# Department of Finance alternative estimates of the cycle show economy overheating

## Output Gap

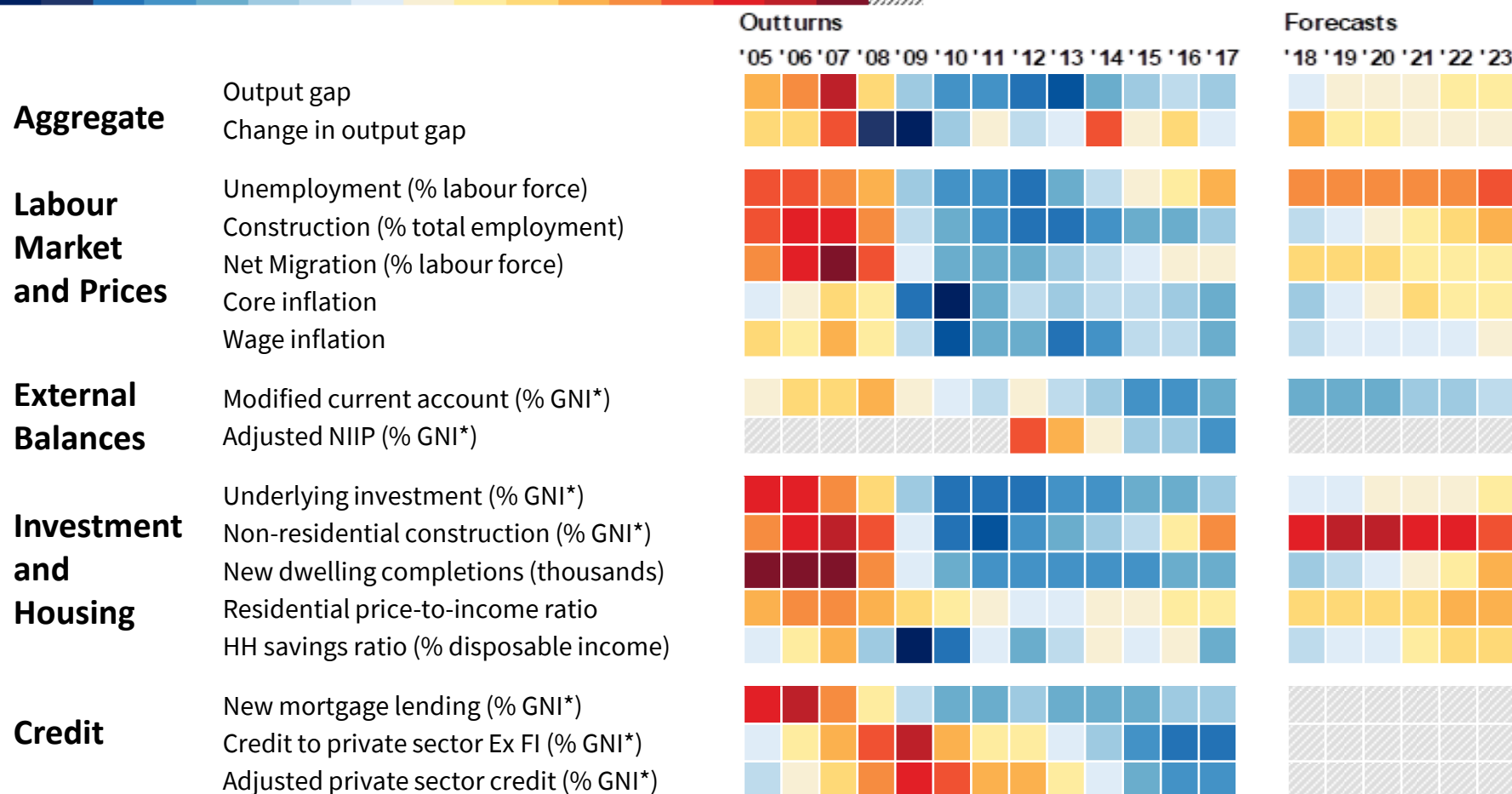
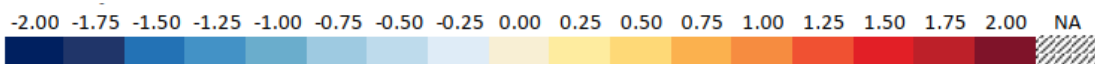
gap between actual and potential output as % of potential



# Significant overheating not yet evident looking across a range of indicators

## Heat map for monitoring potential imbalances

Within specified standard deviation bands of central values



## But numerous risks in both directions

|   | Likelihood | Impact |
|---|------------|--------|
| <b>“Disorderly Brexit”</b>  |            |        |
| Risks of a WTO-style arrangement, impact on Irish-UK trade. Impact on medium-term growth prospects in Ireland.                          |            |        |
| <b>External demand shock</b>  |            |        |
| Strong current global economic growth context. Concern due to slowdown in global trade and prospective trade wars.                      |            |        |
| <b>Geopolitical risks</b>   |            |        |
| Limited direct impact, second-round impacts could be more significant.  |            |        |
| <b>Disruptions to world trade</b>   |            |        |
| Protectionism risk: possible negative impact on global trade flows.   |            |        |
| <b>Loss of competitiveness</b>  |            |        |
| Domestic sources: wage pressures, rising commercial/residential rents. External source: exchange rates.                                 |            |        |
| <b>Inappropriate monetary policy (IFAC risk)</b>  |            |        |
| Growth in Ireland is forecast to continue to outperform the Euro Area; risk of looser monetary policy than would be ideal for Ireland.  |            |        |
| <b>Overheating economy</b>  |            |        |
| Could occur without significant credit growth. Strong growth when currently near potential output risks overheating.                    |            |        |
| <b>Housing supply pressure</b>  |            |        |
| Supply response expected to moderate price growth. Excess demand: harmful for competitiveness and labour mobility.                      |            |        |
| <b>Food commodity prices (IFAC risk)</b>  |            |        |
| Weather-related increases of recent years expected to unwind. Potential to disrupt dairy profits, crucial for regional economic growth. |            |        |
| <b>Global financial market conditions</b>   |            |        |
| Low interest rates/“search for yield”: financial stability concerns. Normalisation of monetary policy: impact on borrowers.             |            |        |
| <b>Concentrated production base</b>   |            |        |
| Production base concentrated in a small number of sectors. Sector- or firm-specific shocks could pose wider risks for the economy.      |            |        |
| <b>Inappropriate domestic policy (IFAC risk)</b>  |            |        |
| Monetary policy is set by the European Central Bank (ECB). Ireland has fewer levers for managing the domestic economy.                  |            |        |

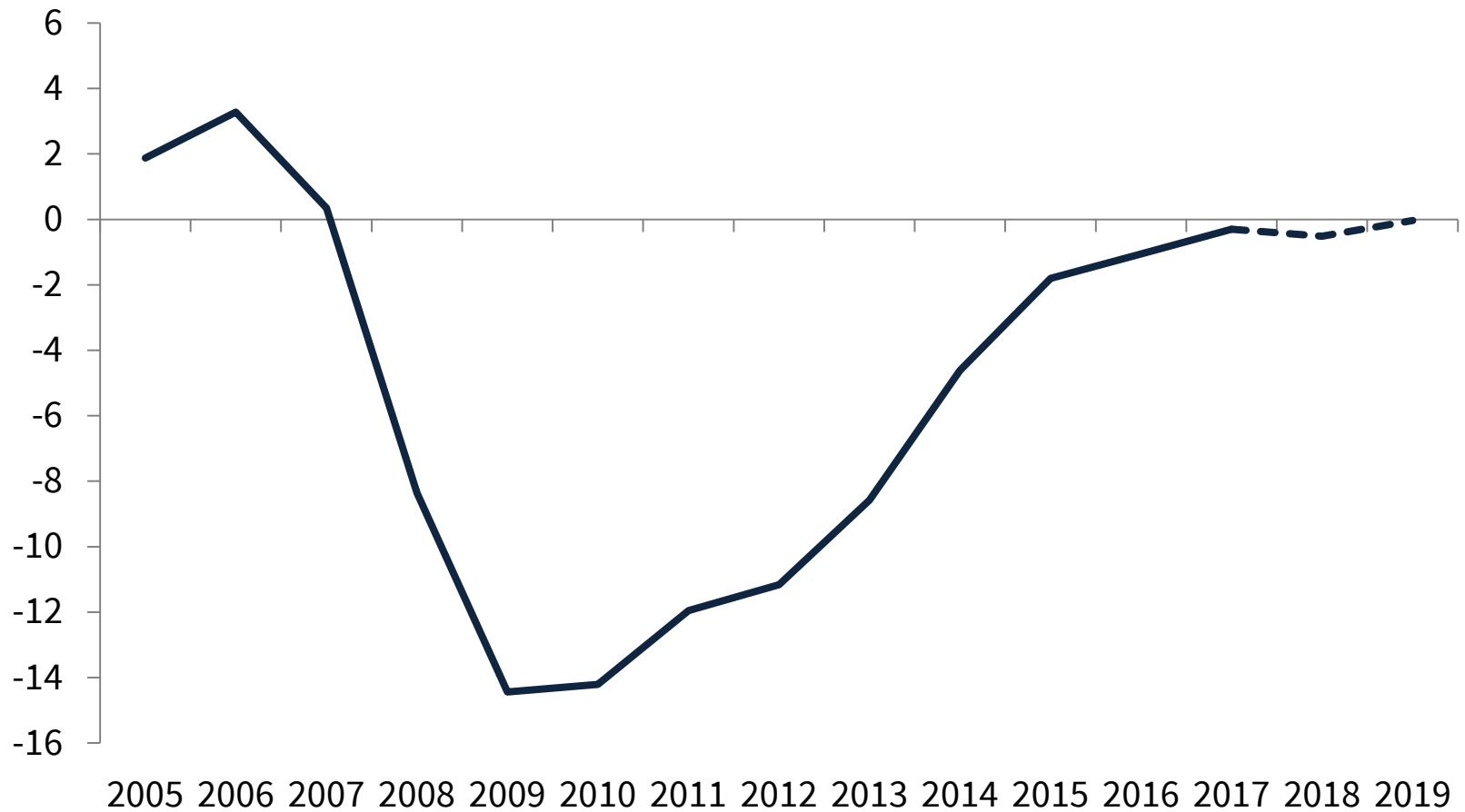
# Fiscal Context

# Fiscal Context

- There has been no improvement in the budget balance excluding interest costs since 2015.
- Non-interest spending has been increased at essentially the same pace as government revenues.
- Much of the improvement in revenues may be cyclical or temporary. Suggests structural position has deteriorated.
- This is a worrying pattern as it means opportunities to strengthen the budget balance during the upswing in the cycle are being missed.

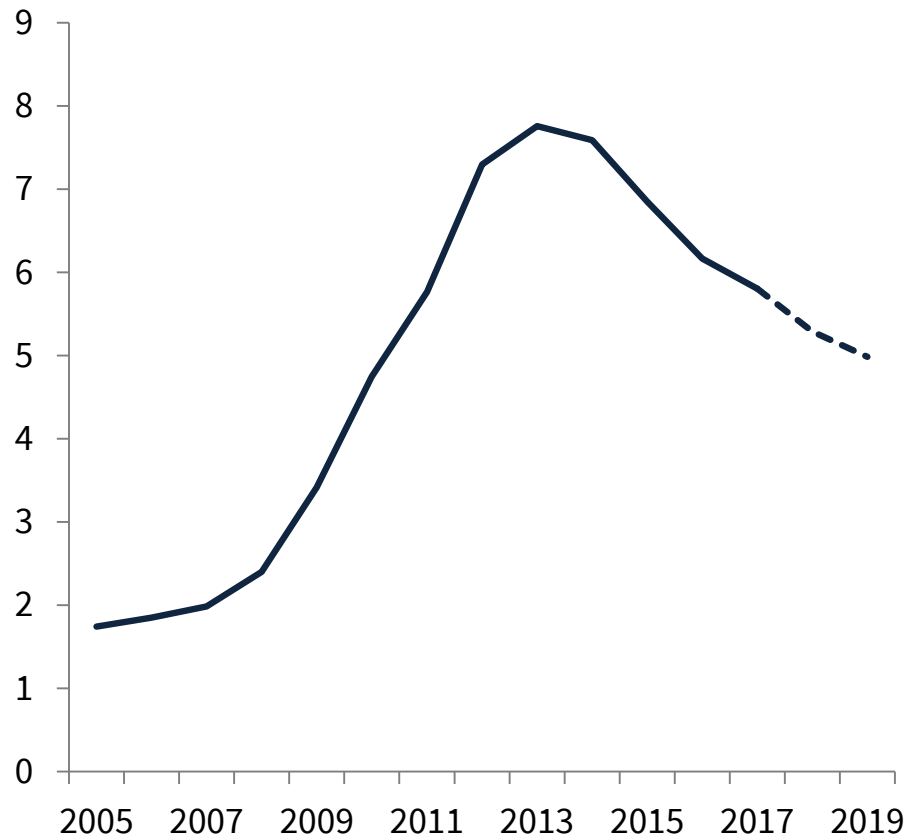
# Improvements have stalled

**General Government Balance**  
% GNI\* excluding one-offs

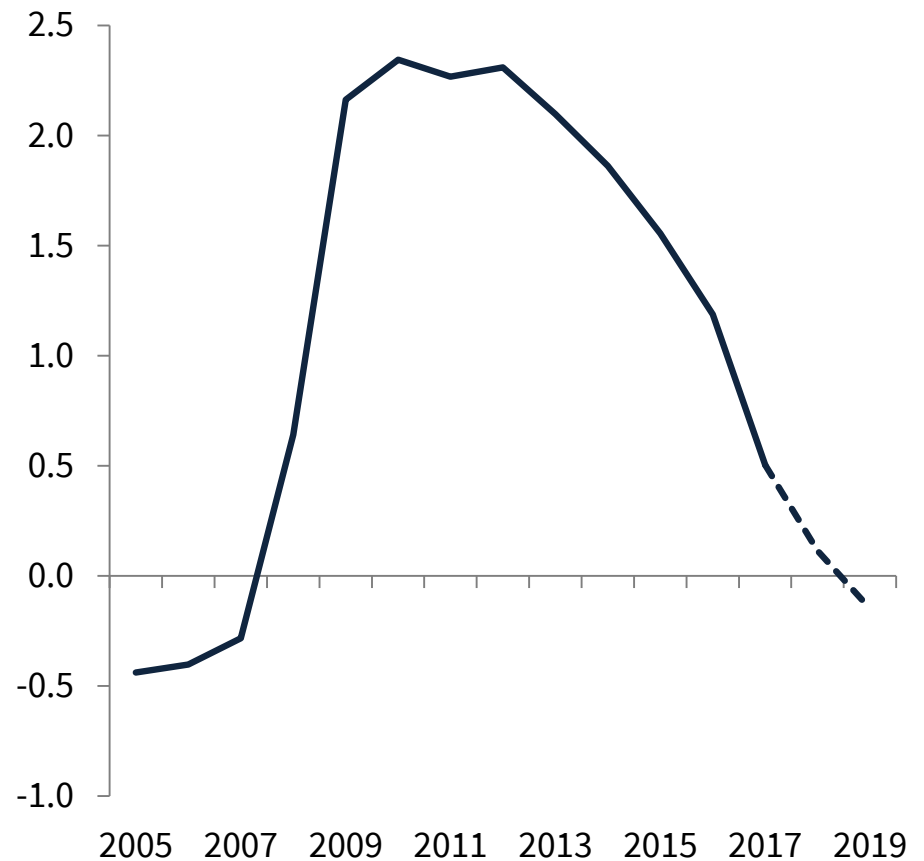


# Fiscal tailwinds - Expenditure

**A. Interest expenditure**  
€ billions

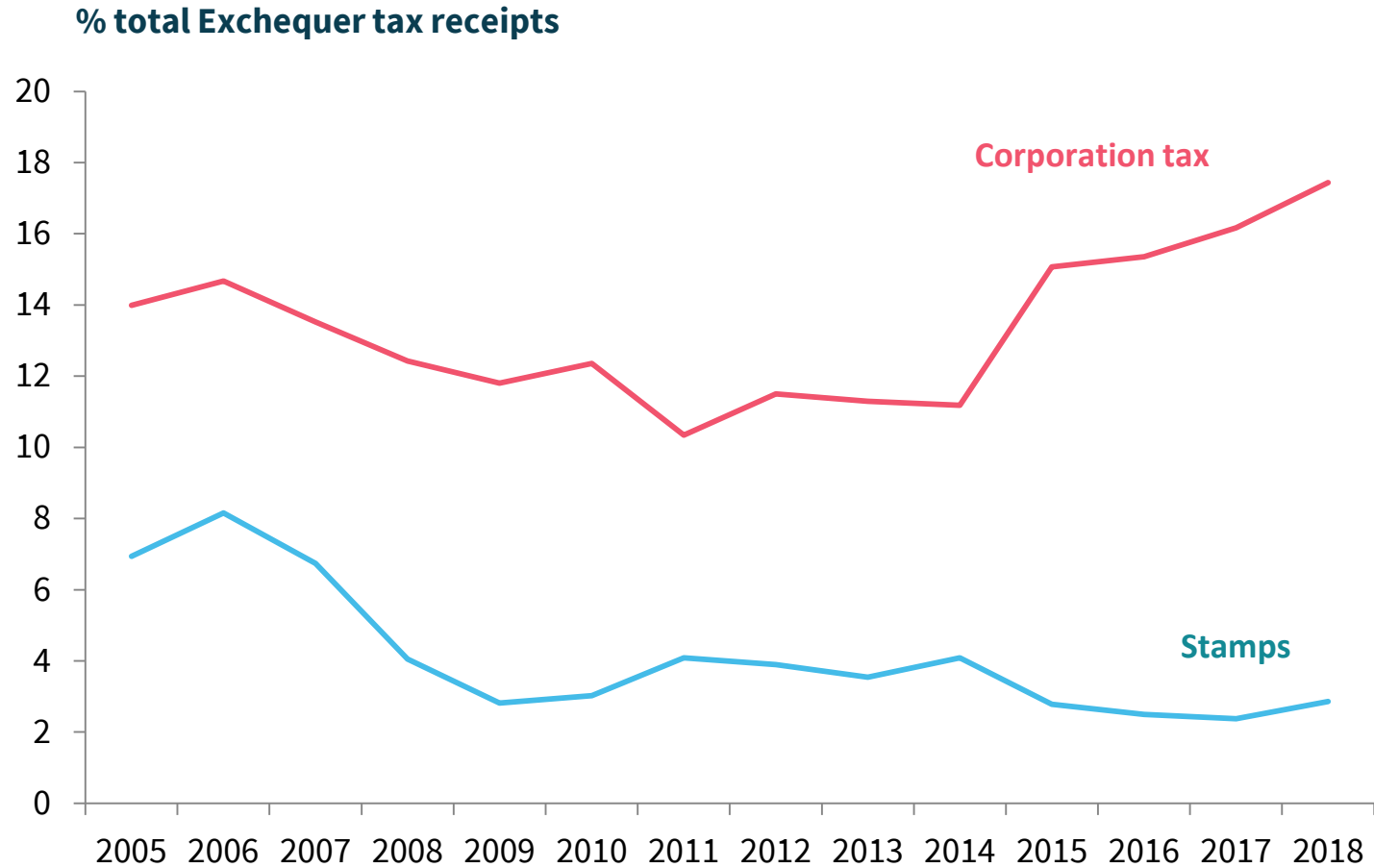


**B. Cyclical unemployment expenditure**  
€ billions



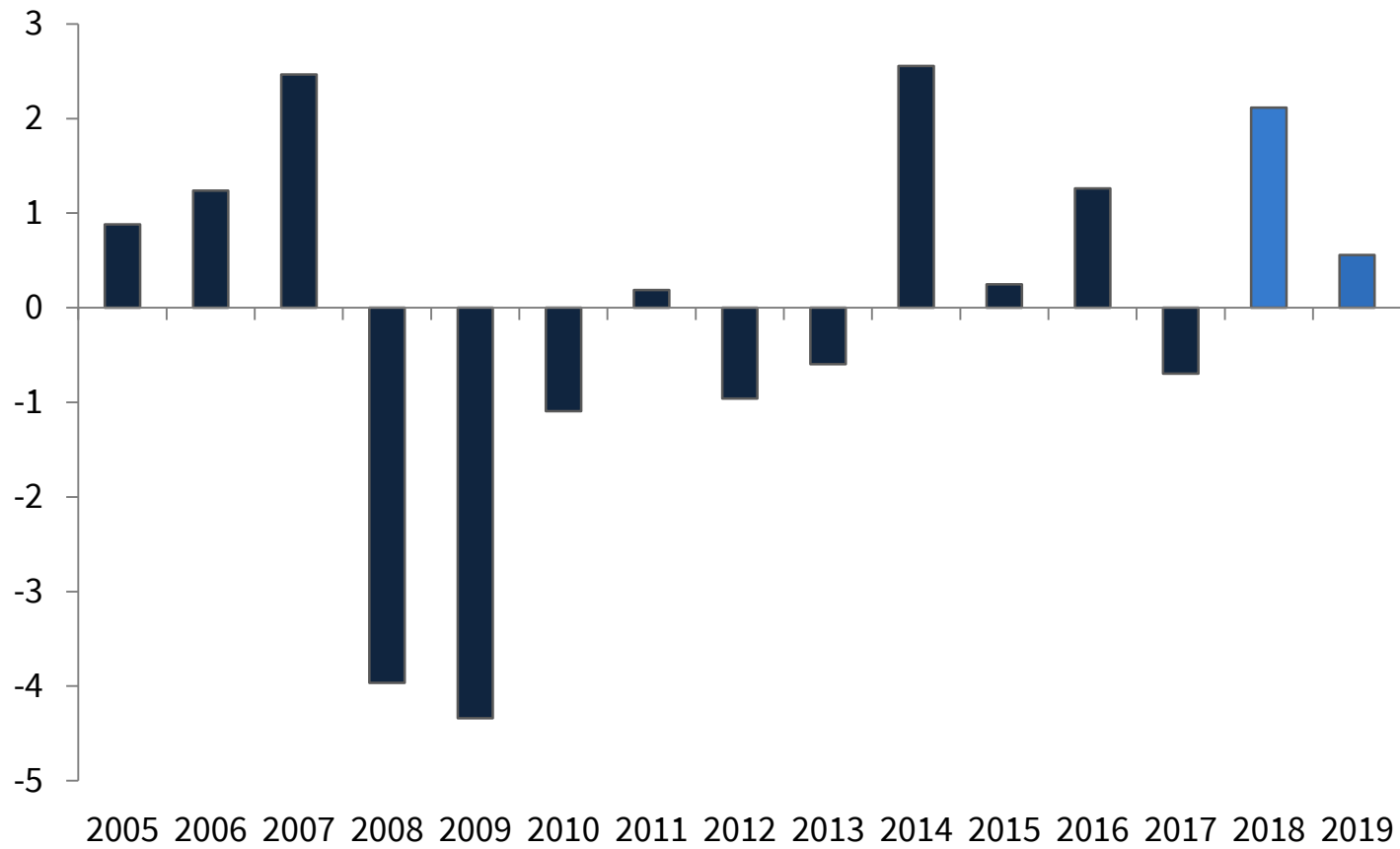


# Fiscal tailwinds - Revenue



# Fiscal tailwinds - Revenue

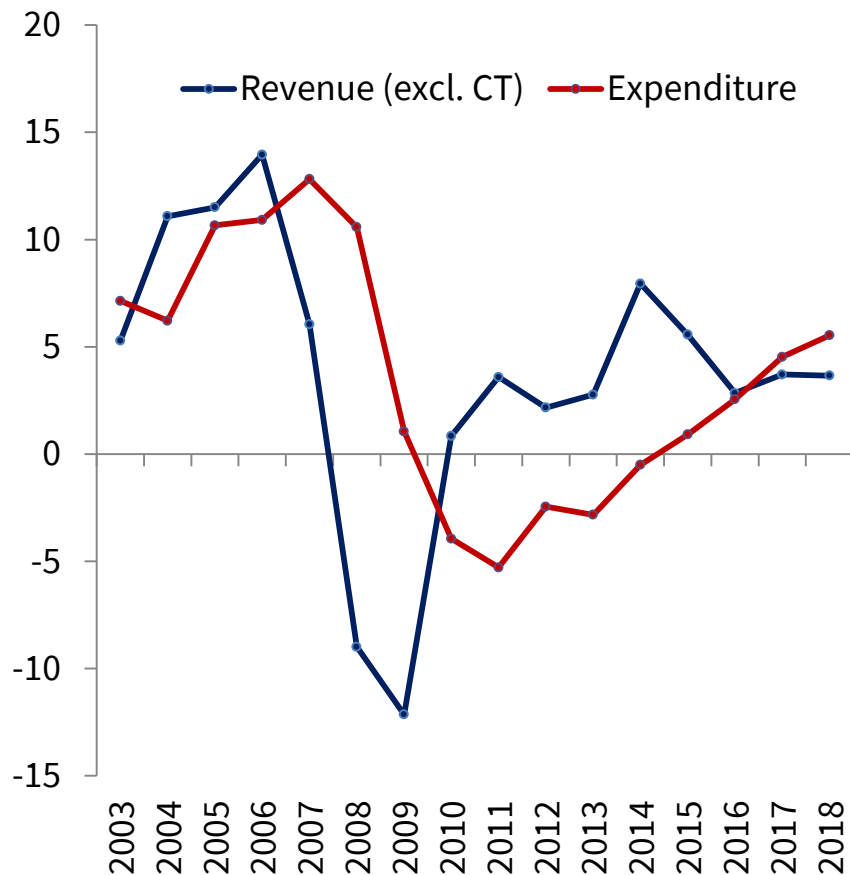
Cyclical tax revenue  
€ billions



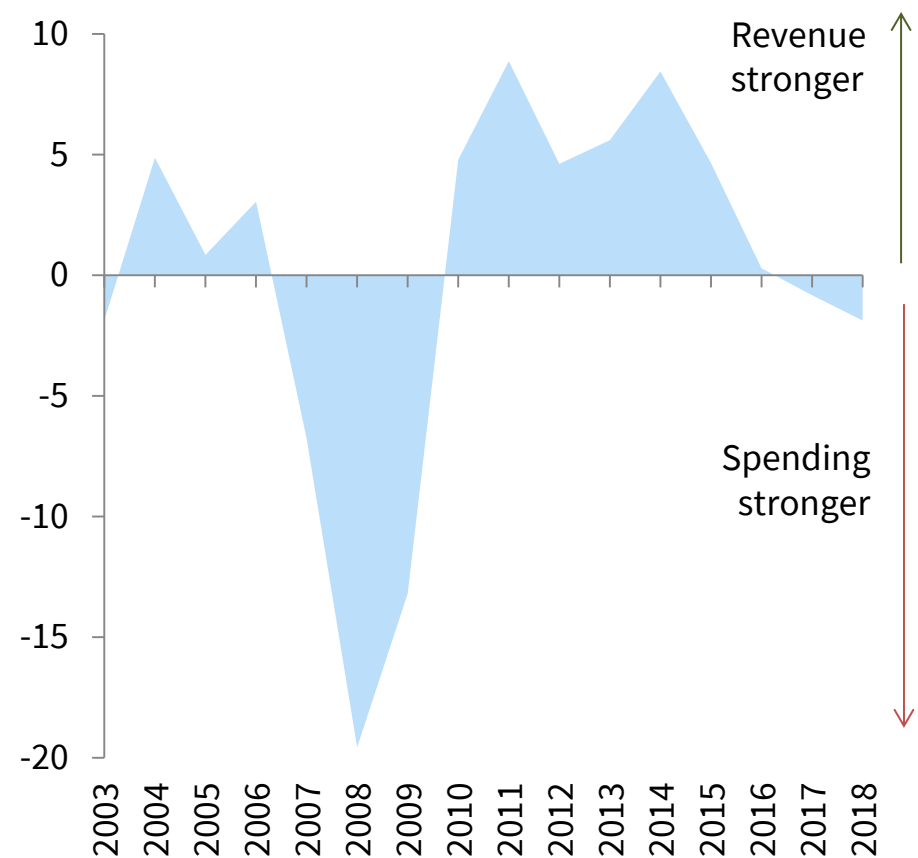
# Improvements have stalled

## Expenditure and Revenue excluding Corporation Tax (CT)

### A. Percentage change (year-on-year)

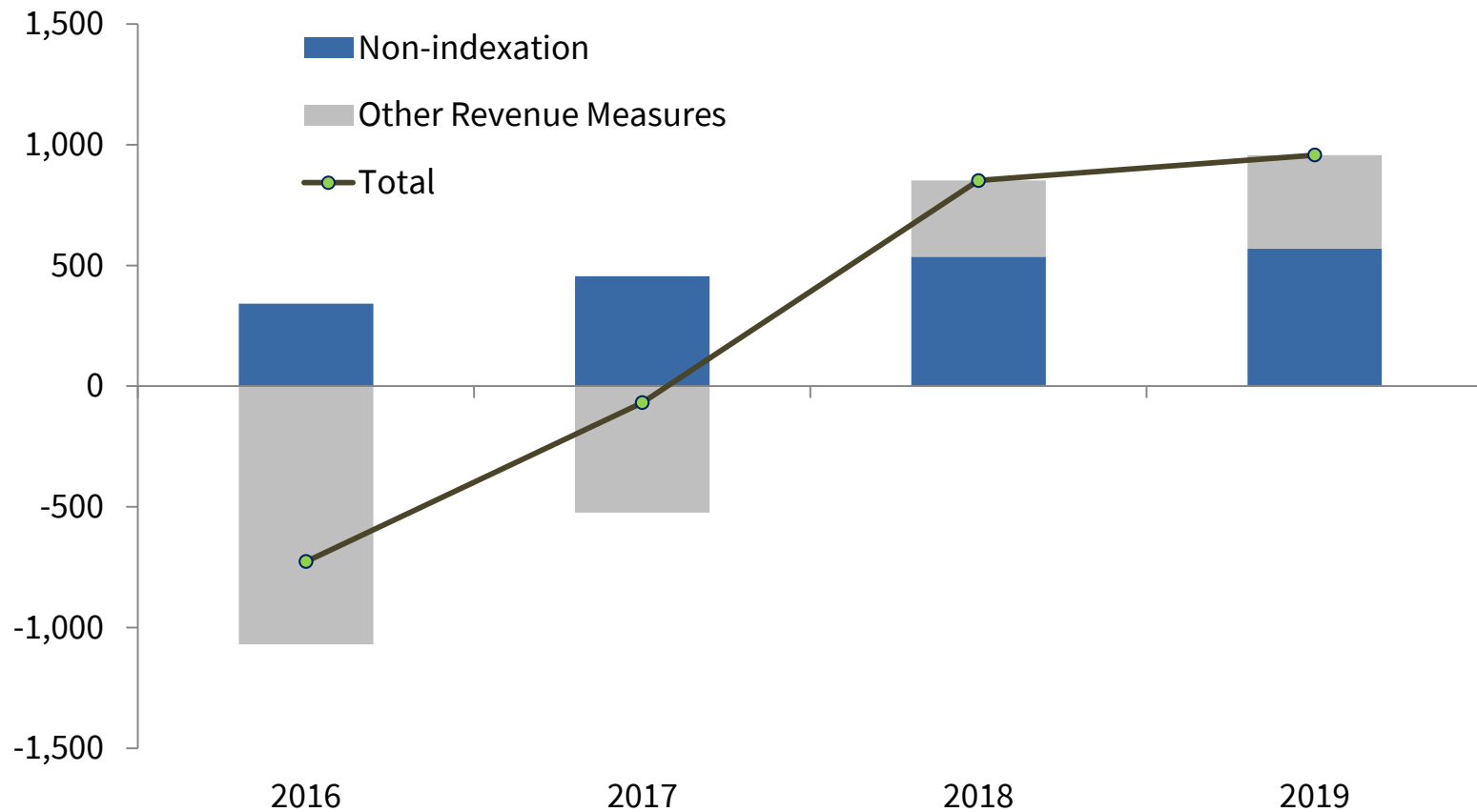


### B. Growth Differential



# Recent policy measures have raised revenue

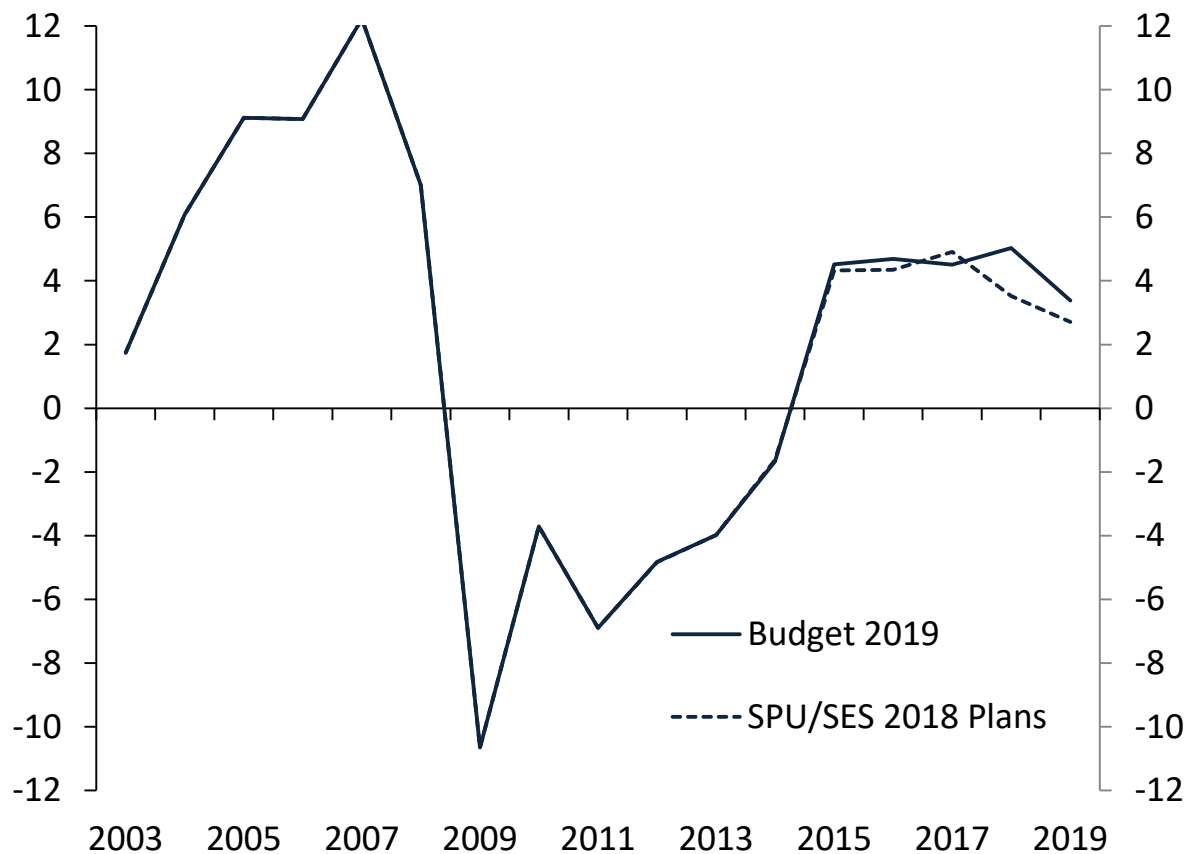
Impact of Revenue Policy Measures  
€ million



# Real spending increases have been fast in recent years

## Real net policy spending \*

Percentage change (year-on-year)



**\*“Real Net Policy Spending” is:**

Total general government expenditure

– interest costs

– estimated costs/savings on unemployment benefits due to cycle

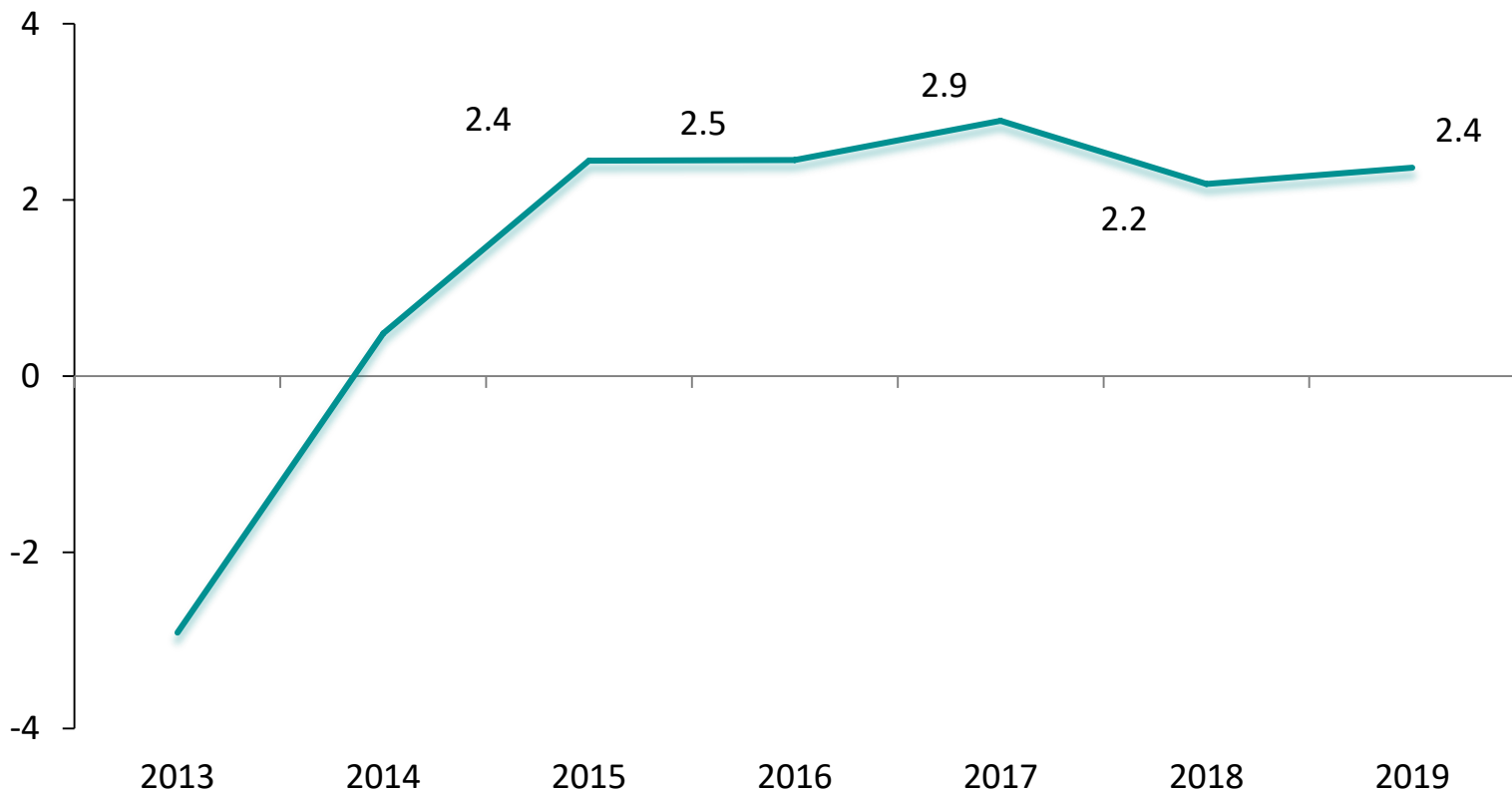
– discretionary revenue measures.

The measure is then HICP-deflated.

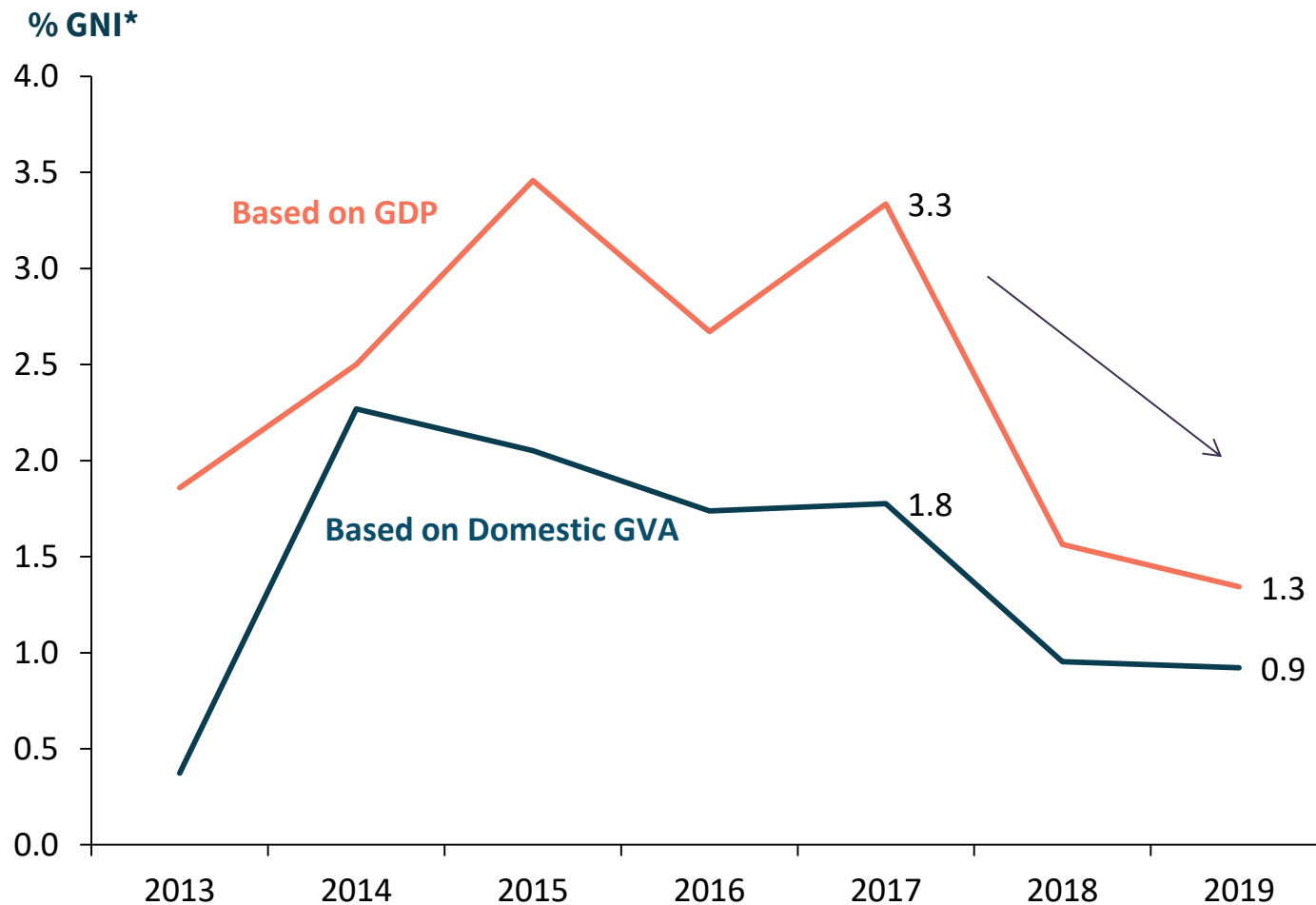
# Primary balance relatively unchanged since 2015

## Primary Balance

% GNI\*



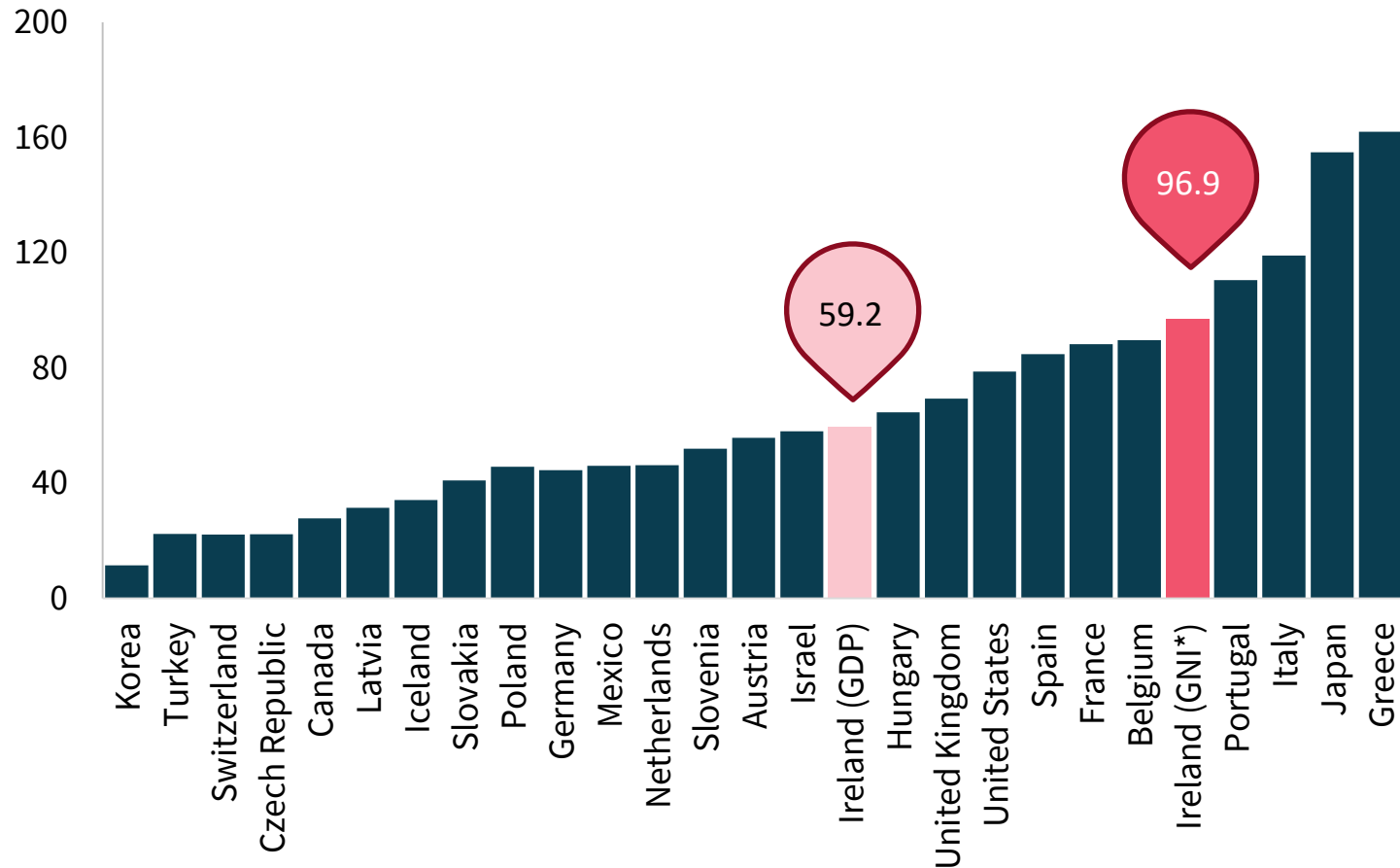
# Primary Balance Adjusted for Cycle is Deteriorating



# Against a backdrop of still high debt

## The Largest 25 Net Debt Ratios in OECD Countries

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

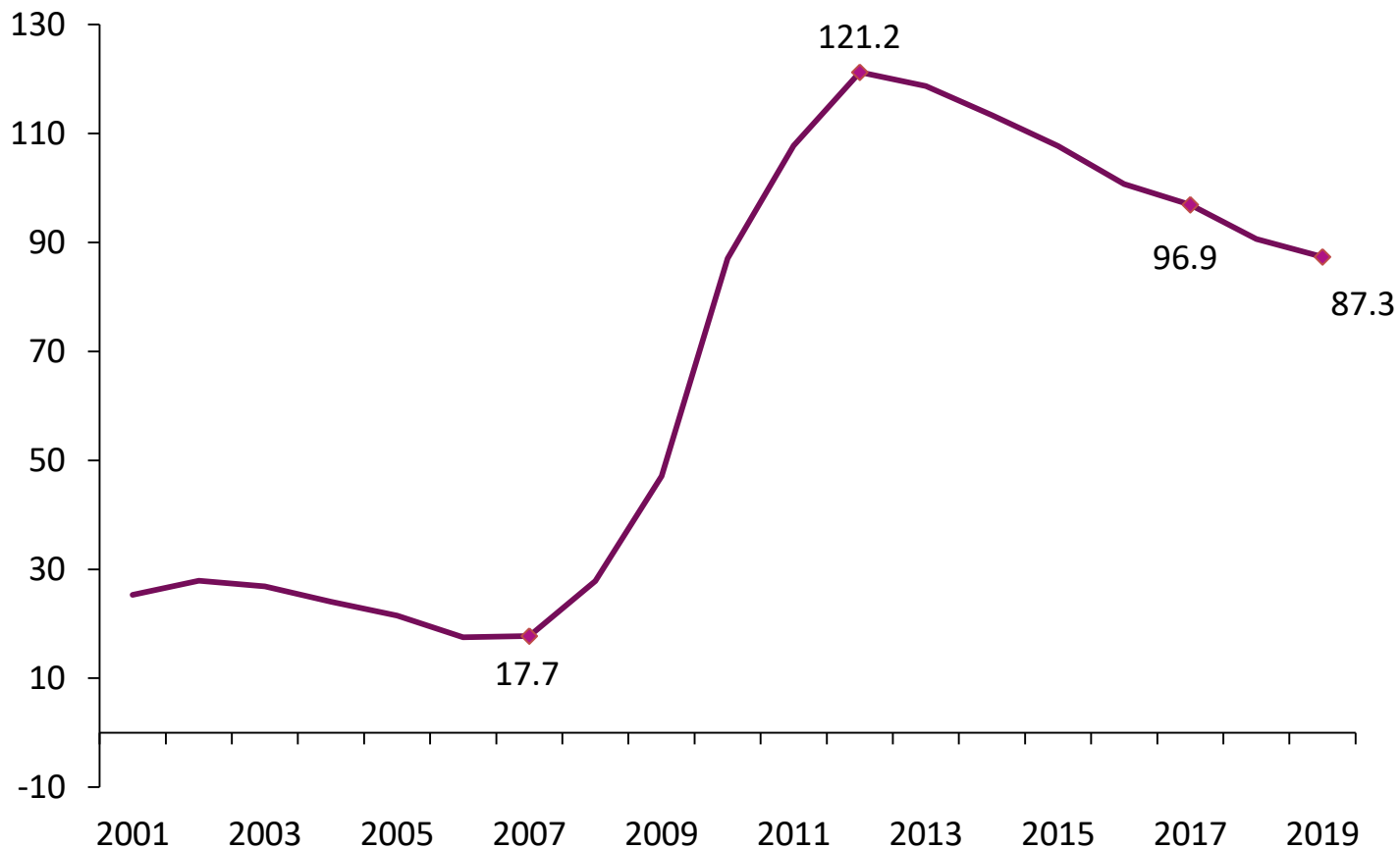




# Debt is likely to remain high by historical standards in coming years

## Ireland's net debt levels

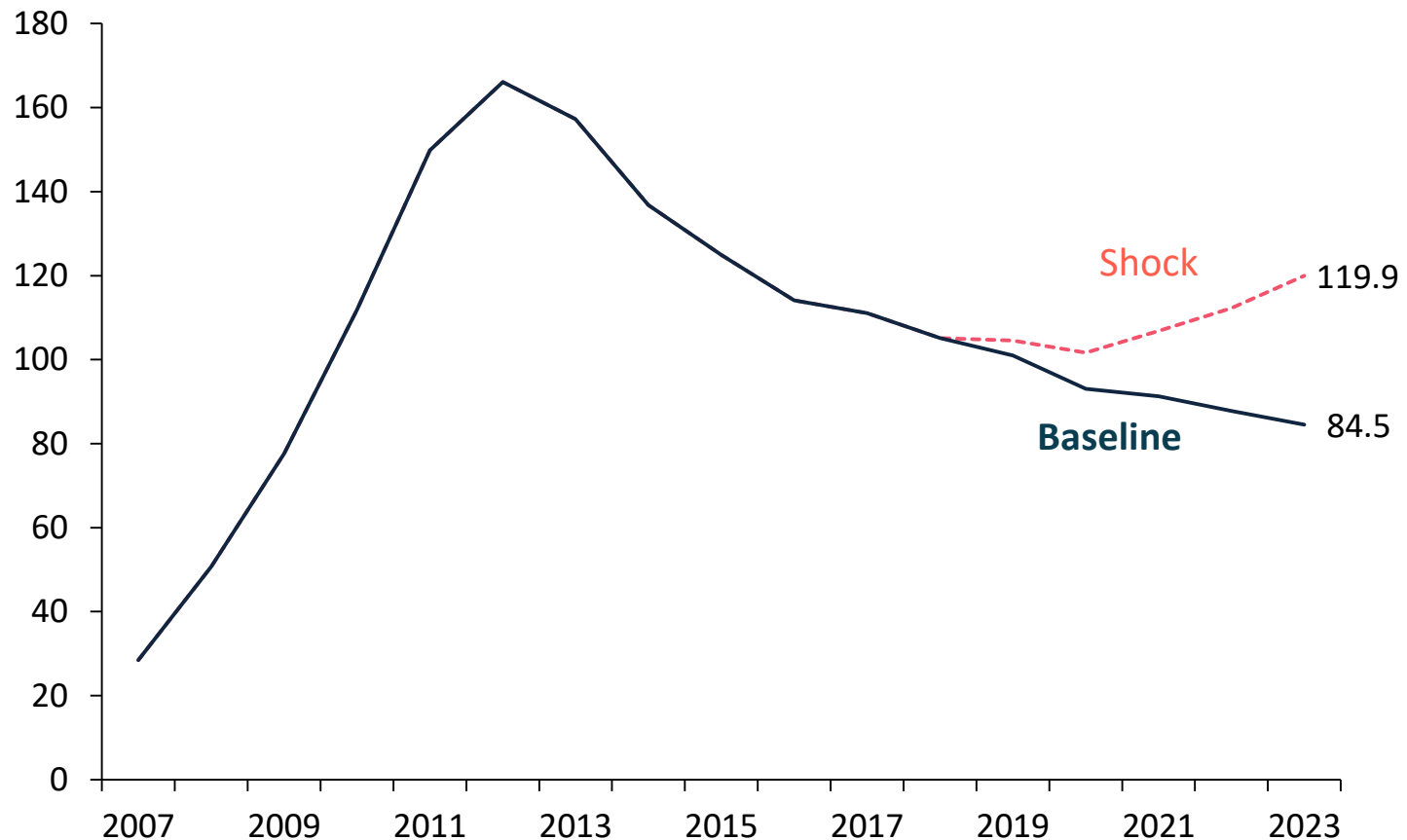
% GNI\*, general government basis



# Debt is also fragile and vulnerable to a number of external shocks

**Figure 1.12: Illustrative Debt Shock from 2019 Onwards**

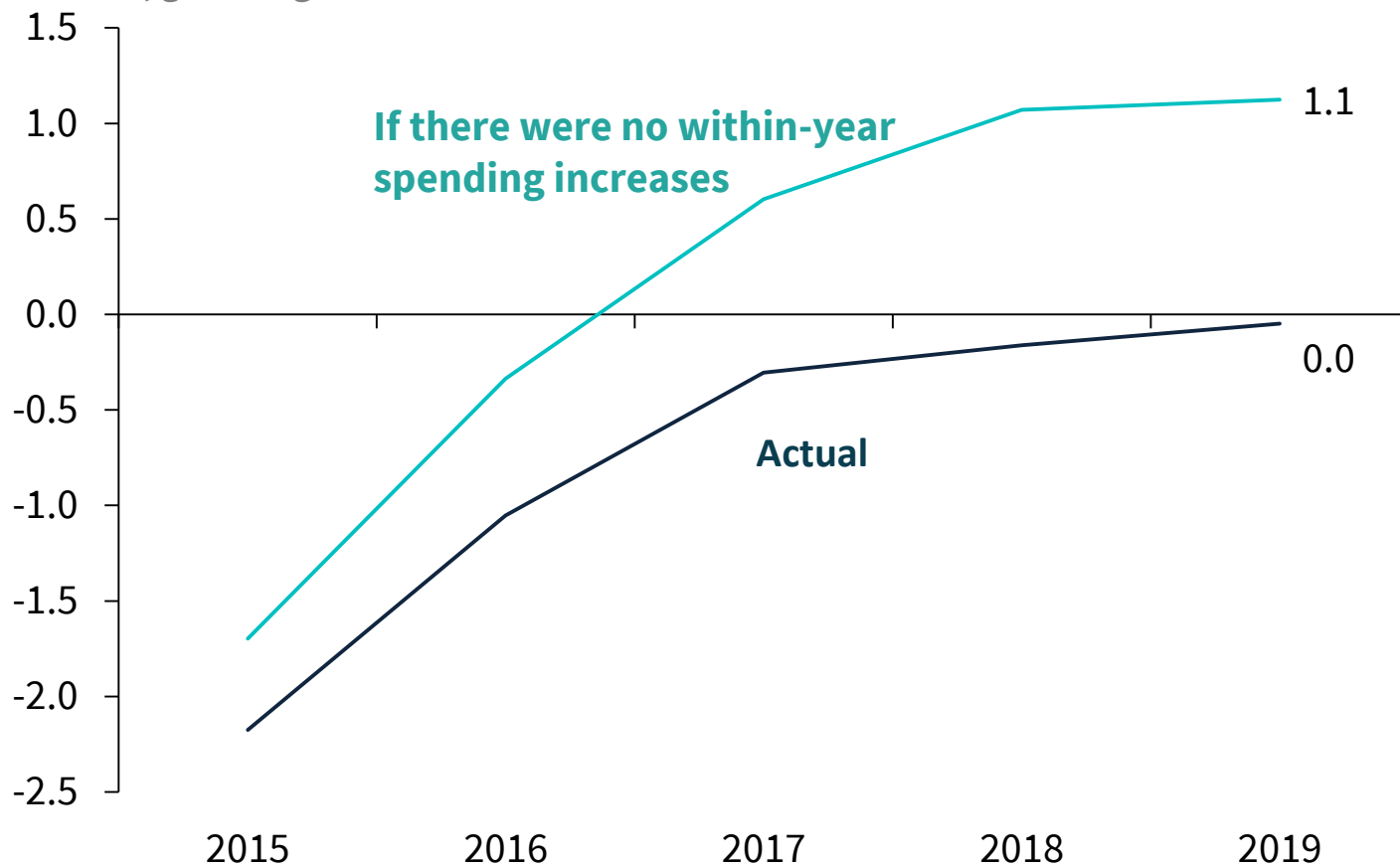
Gross debt as % of GNI \*, general government basis



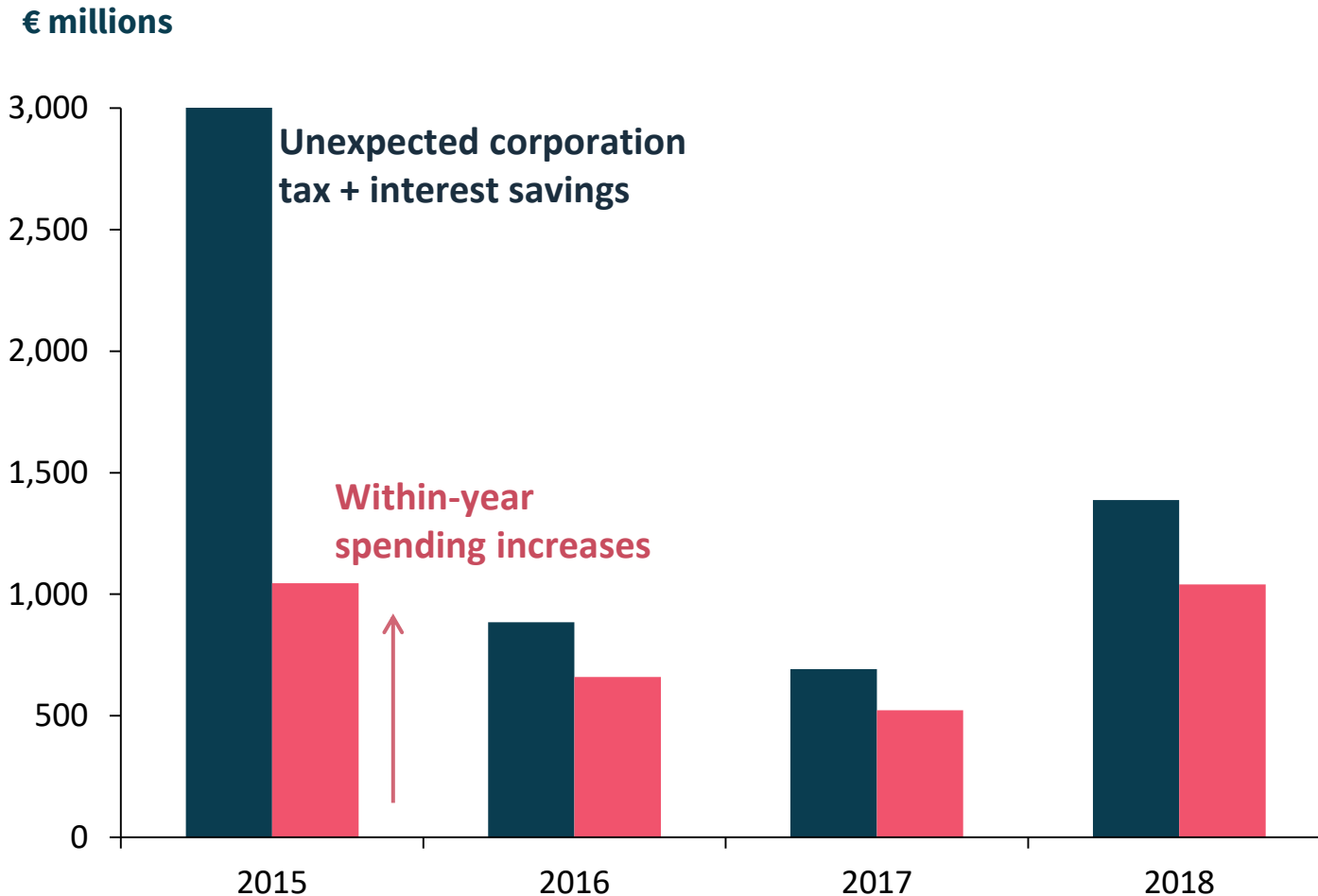
# Within-year spending increases could have been avoided/funded giving a surplus

## Budget Balance

% GNI\*, general government basis



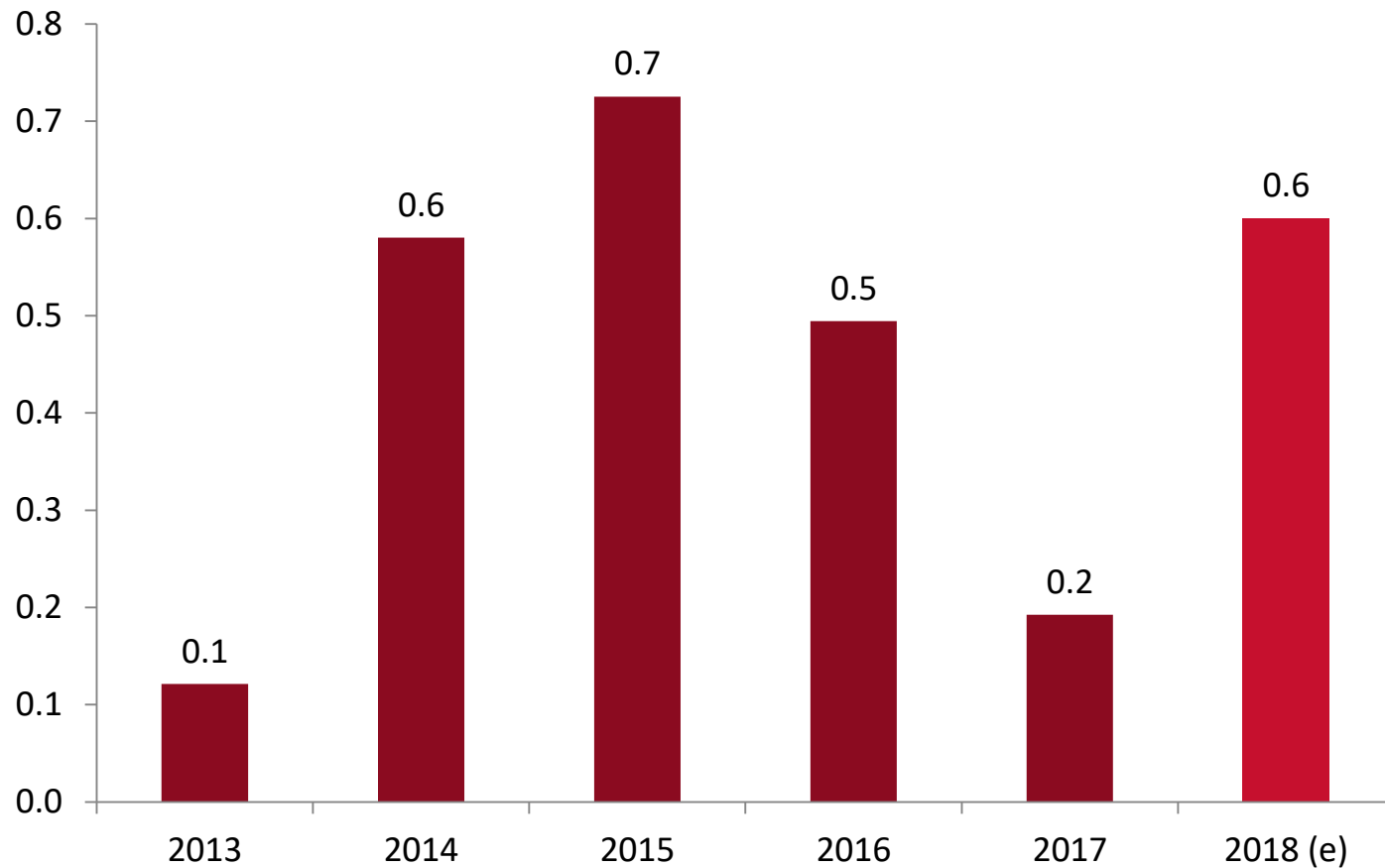
# Repeated within-year spending increases have been masked by unexpected gains



# Overruns are a regular feature in Health

## Health Overruns

€ billion



# Fiscal Stance

# Fiscal Stance Advice from the Council's *Pre Budget 2019 Statement*

- A prudent fiscal policy would see net policy spending rise in line with sustainable revenues.
- This implies an approximate limit of up to €3½ billion for spending increases or tax cuts for 2019 (based on an assessment of sustainable growth + inflation).
- If additional spending measures are to be addressed in 2019 beyond amount in *Summer Economic Statement 2018*, these should be funded by additional tax increases or through re-allocations of existing spending.
- The Government should reinforce its medium-term plans to ensure that these are credible.

# Fiscal Stance Assessment 2018

- For 2018, the Government decided to increase spending by a further €1.1 billion beyond what was originally envisaged just four months earlier, largely due to health overruns.
- Government increased spending by a further €1.1 billion in 2018, €0.7 billion attributable to Health.
- These are likely to be long-lasting spending items. This increase is not consistent with prudent budgetary management.



# Fiscal Stance Assessment 2019

- A prudent fiscal policy would see net policy spending rise in line with sustainable revenues.
- Budget 2019 plans are not conducive to prudent economic and budgetary management. 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 before budget on basis of sustainable growth rates.
- Also represents an increase of intended budget package (from €0.8bn to €1.1bn)

# Fiscal Stance Assessment

## 2020 →

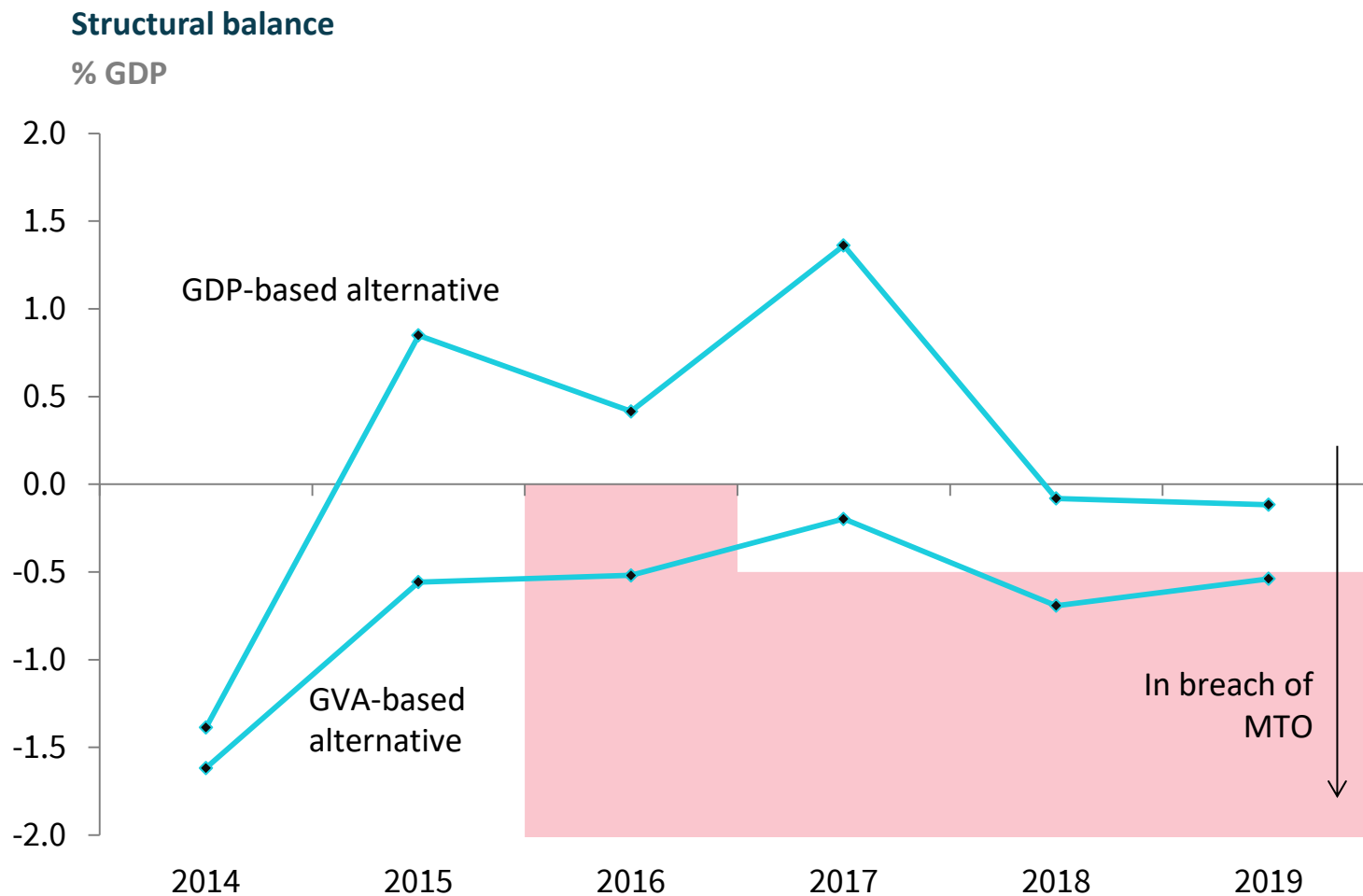
- While Department has made substantial progress on macroeconomic forecasting, budgetary plans are lacking.
- Medium-term budgetary plans are not credible, and previous medium-term objectives have been effectively dropped.
- Previous commitments to outperform the requirements of the EU fiscal rules and to reduce debt to 55 per cent of GDP over the medium term—itsself an insufficiently ambitious target and with no clear timing—are no longer referenced.

# Fiscal Stance Assessment

## 2020 →

- Government's system of three-year budget ceilings is not working, with repeated, procyclical, upward revisions to ceilings.
- Medium-term spending forecasts are based on technical assumptions that look unrealistic.
- Rainy day fund ( "National Surplus (Exceptional Contingencies) Reserve Fund") welcome. Potentially useful, but design is insufficient to offset faster-than-prudent growth rates allowed under the spending rule as applied. Annual allocations to the Fund have been lowered from previously planned amounts, despite a surge in corporation tax receipts.

# Reaching structural deficit objective (the “MTO”) depends on how the cycle is measured



# Department's own estimates of government plans showed breaches of fiscal rules for 2018 and 2019

Breaches circled in red

Department of Finance *Budget 2019 Economic and Fiscal Outlook*

**Table 1: summary – main economic and fiscal variables, per cent change (unless stated)**

|                      | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|----------------------|------|------|------|------|------|------|------|
| Structural balance^^ | 0.4  | -1.0 | -0.7 | 0.0  | 0.2  | 1.0  | 1.4  |

^^ on a 'harmonised' basis.

Source: CSO and Department of Finance.

**Table 13: comparison of expenditure benchmark compliance, per cent of GDP**

|                                   | 2018 |        | 2019 |        |
|-----------------------------------|------|--------|------|--------|
|                                   | SES  | Budget | SES  | Budget |
| One year assessment (year t)      | -0.1 | -0.4   | 0.4  | 0.2    |
| Two year average (year t-1 and t) | -0.3 | -0.4   | 0.2  | -0.1   |

Note: a negative indicates a breach of the expenditure benchmark. The threshold for a significant deviation is at least 0.5 per cent of GDP in a single year or cumulatively in two consecutive years.

Source: Department of Finance

Source: Budget 2019, Economic and Fiscal Outlook

# Recap of Key Messages

- (1) Budget 2019 plans are not conducive to prudent economic and budgetary management
- (2) Repeated failures to prevent unbudgeted spending increases leave us exposed
- (3) Medium-term budgetary plans are not credible
- (4) While the short-term outlook for the Irish economy remains strong, a slowdown in coming years is inevitable.

