Irish Fiscal Advisory Council

Fiscal Assessment Report

November 2018

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Foreword

The Irish Fiscal Advisory Council was established as part of a wider agenda of reform of Ireland's budgetary architecture as envisaged in the Programme for Government 2011. The Council was initially set up on an administrative basis in July 2011, and was formally established as a statutory body in December 2012 under the *Fiscal Responsibility Act* (*FRA*). The Council is a public body funded from the Central Fund. The terms of its funding are set out in the *FRA*.

The mandate of the Irish Fiscal Advisory Council is:

- To endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- To assess the official forecasts produced by the Department of Finance;
- To assess government compliance with the Budgetary Rule as set out in the FRA;
- To assess whether the fiscal stance of the Government in each Budget and Stability Programme Update (SPU) is conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact.

The Council is chaired by Mr Seamus Coffey (University College Cork). Other Council members are Mr Sebastian Barnes (Organisation for Economic Co-operation and Development), Dr Íde Kearney (Dutch Central Bank, De Nederlandsche Bank), Mr Michael G. Tutty and Dr Martina Lawless (Economic and Social Research Institute). The IFAC Secretariat consists of Eddie Casey, Niall Conroy, Kevin Timoney, Ainhoa Osés Arranz, Friederike Vogler, and Killian Carroll. The Council would like to acknowledge the help of the staff of the Central Statistics Office and of the NTMA.

The Council submits its Fiscal Assessment Reports to the Minister for Finance and within ten days releases them publicly. This report was finalised on 22 November 2018. More information on the Irish Fiscal Advisory Council can be found at www.FiscalCouncil.ie

Summary Assessment

Summary Assessment

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 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 Department of Finance's preferred estimates of the output gap indicate that the economy will be just above its potential in 2019 and growth is expected to exceed its potential in the next few years. Significant 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 handful of specialised areas, the global rise in protectionism, and 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. After a slowdown in improvements, the remaining deficit is expected to be closed in 2019.

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 since 2015: 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 opportunities to strengthen the budget balance during the upswing in the cycle are being missed.

A prudent fiscal policy would see net policy spending rise in line with sustainable revenues. The Irish debt burden is still among the highest in the OECD. Various stress scenarios considered in this report highlight how quickly the debt ratio could deteriorate under plausible scenarios. Given the fragility of the debt burden, strong cyclical growth, the risk of overheating in later years, and surging corporation tax receipts, there is no case for additional stimulus at this stage. The budget should be kept in balance in structural terms to ensure that debt ratios are on a steady downward path.

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. When compared to plans laid out in the *Stability Programme Update 2018* and the *Summer Economic Statement 2018*, the Government increased spending by a further €1.1 billion in 2018, €0.7 billion of which was attributable to the Health area. These overruns are likely to be long-lasting spending items. This increase 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 outlined in previous plans. The additional measures introduced on budget day imply a total package of tax and spending measures equivalent to €1.1 billion (€0.3 billion more than had been planned for the budget day package). When added to the within-year increases for 2018, this means a level of government spending €2.3 billion above what was set out in *SPU 2018*. While higher-than-planned tax increases will help to fund new spending, these cover only a part of the additional commitments. 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 would have been achieved much earlier had the unplanned, within-year spending drift not occurred in each of the years 2015–2017.

Repeated failures to prevent unbudgeted spending increases have left the public finances more exposed to adverse shocks, with the budget balance in deficit rather than in surplus. Failures to prevent unplanned spending increases has 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. Measures to increase taxes to support further spending are a welcome aspect of the budget as they allow for additional spending increases that are funded sustainably. However, the spending pressures that were accommodated in recent budgetary decisions are only partly

offset by discretionary revenue measures being approximately €1 billion higher than originally set out.

The Department of Finance has made substantial progress on macroeconomic forecasting. The Department has developed and published its own estimates of the supply-side of the economy, which means that better measures of medium-term economic growth and of the underlying state of the domestic Irish economy are being used to inform policy.

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 and 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 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.

The Department of Finance's own estimates suggest that Government plans will breach the fiscal rules for 2018 and 2019. The Medium-Term Objective (MTO) of a structural deficit of no more than 0.5 per cent of GDP is forecast to not be met in 2018 based on the Department's own estimates. The estimated deterioration in the structural balance—based on the commonly

agreed methodology—largely reflects changes to the estimated output gap that may be misleading. The MTO requirement is not forecast to be met in 2019 either, with an estimated structural deficit of 0.7 per cent of GDP. Net expenditure growth is expected to be within with the Expenditure Benchmark limits for 2018 and 2019. However, there are risks of slippage in 2019, which could worsen any breach of the MTO. For example, if Department of Health overruns or unbudgeted-for welfare increases were to be repeated.

The Council recommends at least meeting the Expenditure Benchmark based on the Department's alternative estimates of potential output and the output gap. As a minimum standard, this would help to ensure that spending growth is in line with sustainable and prudent budget management. The Council also assesses that an appropriate debt commitment would be helpful, taking into account sustainability concerns. The commitment should be well specified. It should be time limited with a specific date by which the objective should be achieved and it should be clearly specified whether the commitment would be a target or a ceiling.

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.

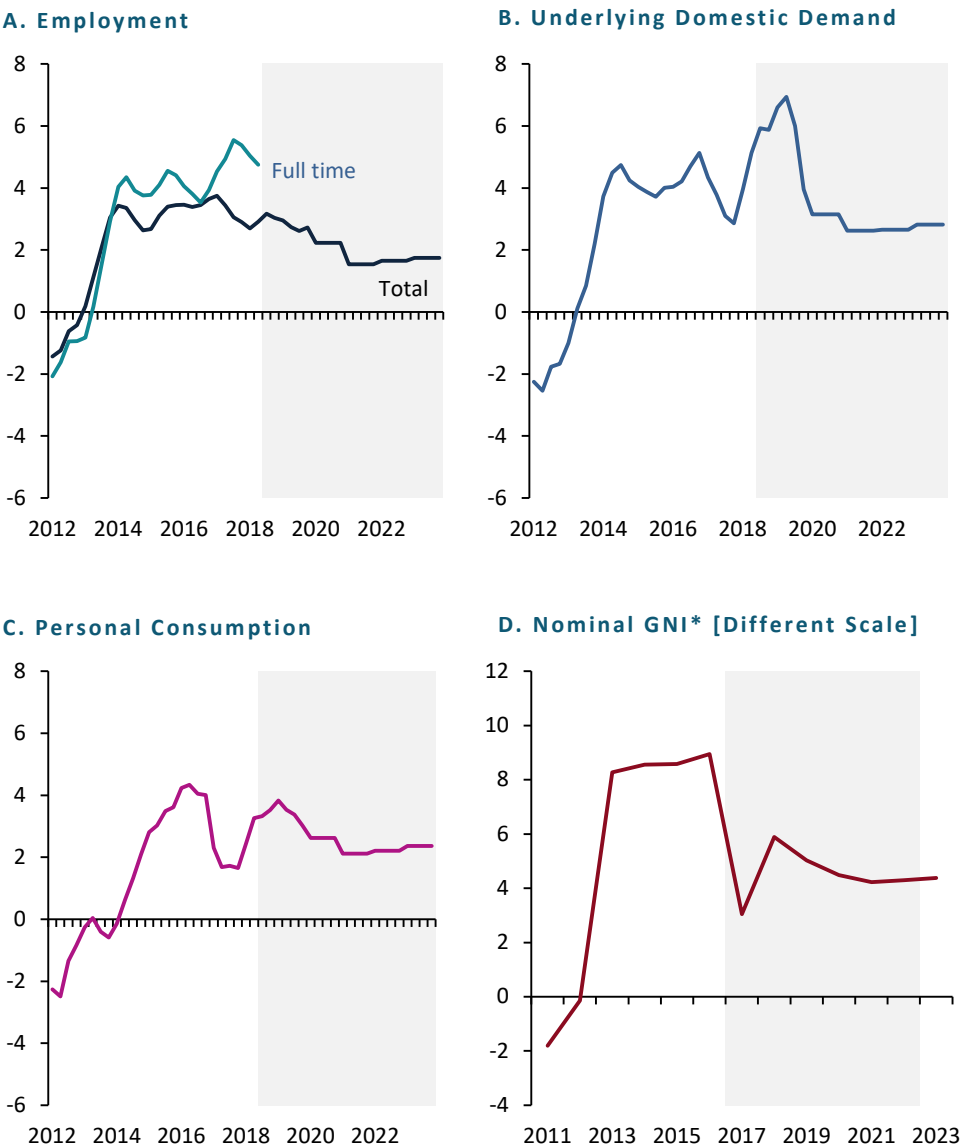
1.2 The Recent Macroeconomic Context

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*

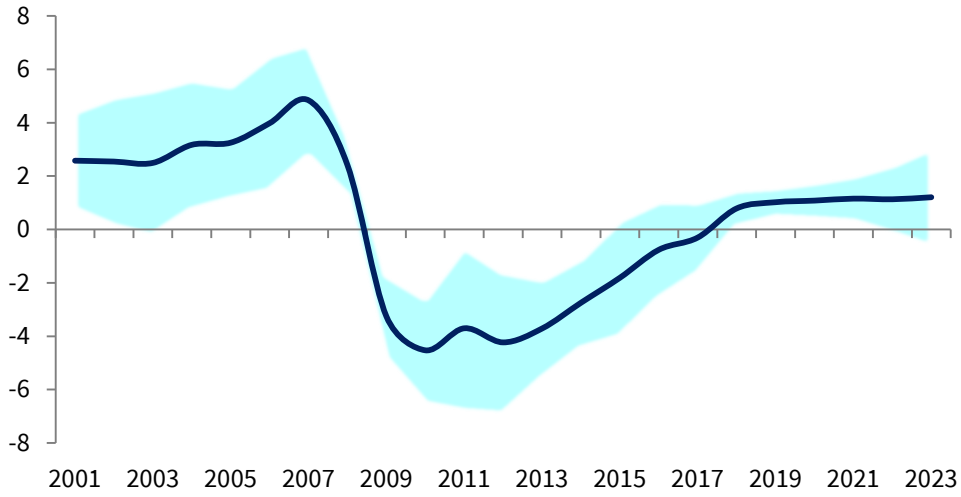
[1] Note the Department doesn't provide forecasts for full-time employment.

[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

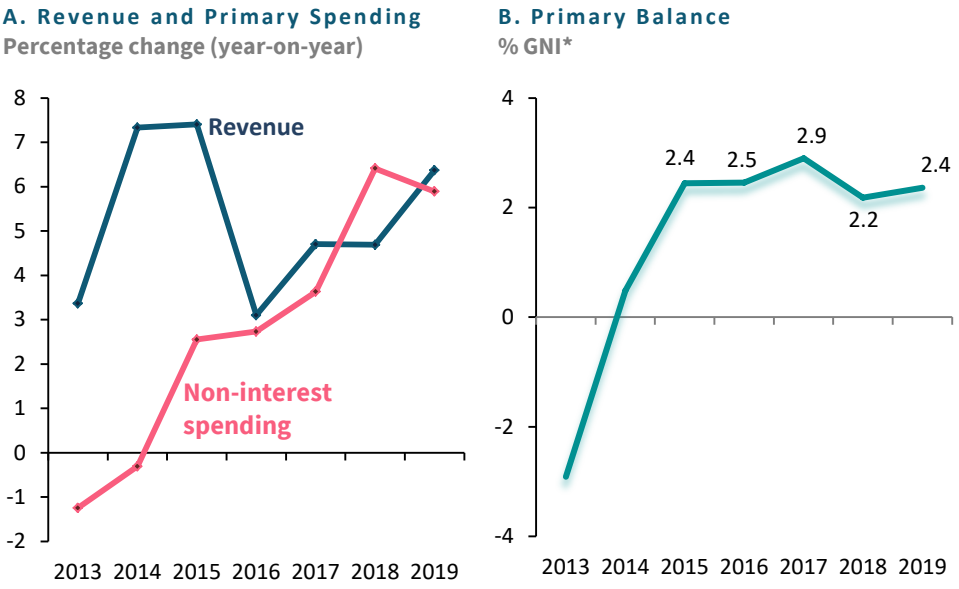
[3] An example of this is the labour intensity of UK demand for Irish exports. This is typically much greater than for an average Irish trading partner. In other words, exports to the UK tend to have a lower value attached to them, but a higher amount of worker hours involved (for example, agri-foods 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).

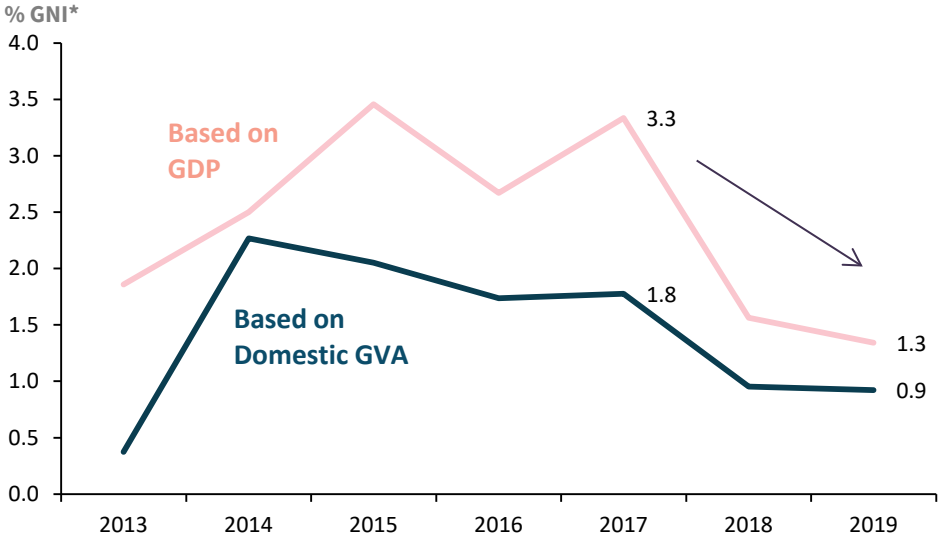
Figure 1.3: Improvements in the Primary Balance have Stalled



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

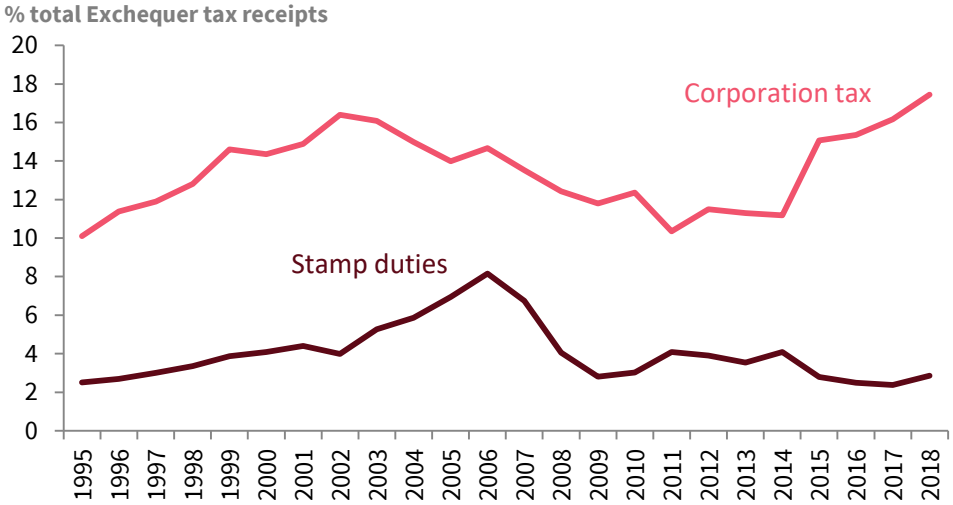


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data are adjusted for the cycle using the Department's alternative output gap estimates, which are based on GDP, and an assumed semi-elasticity to the output gap of 0.5275.

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



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.

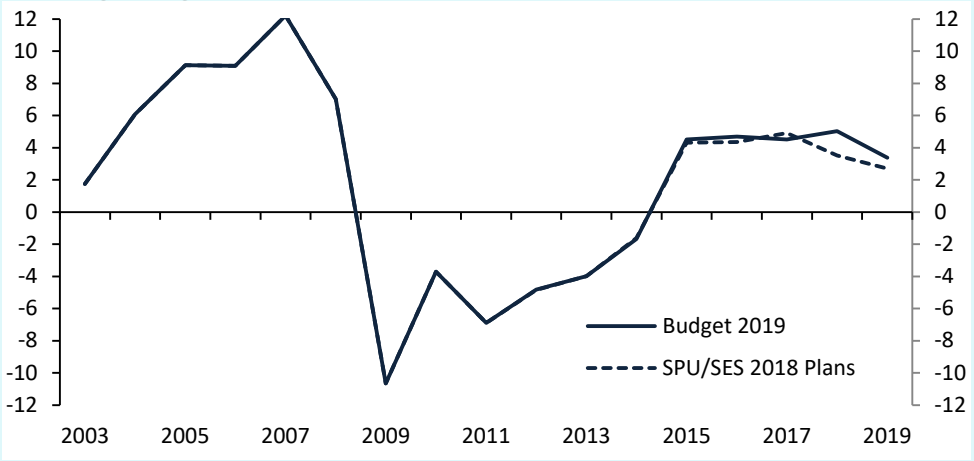
[9] Note that, as in the fiscal rules, this is compared with the actual unemployment rate to estimate the amount of cyclically unemployed individuals that exist, while average unemployment benefits per person are derived from the latest annual outturn for Eurostat data on unemployment expenditure (COFOG99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

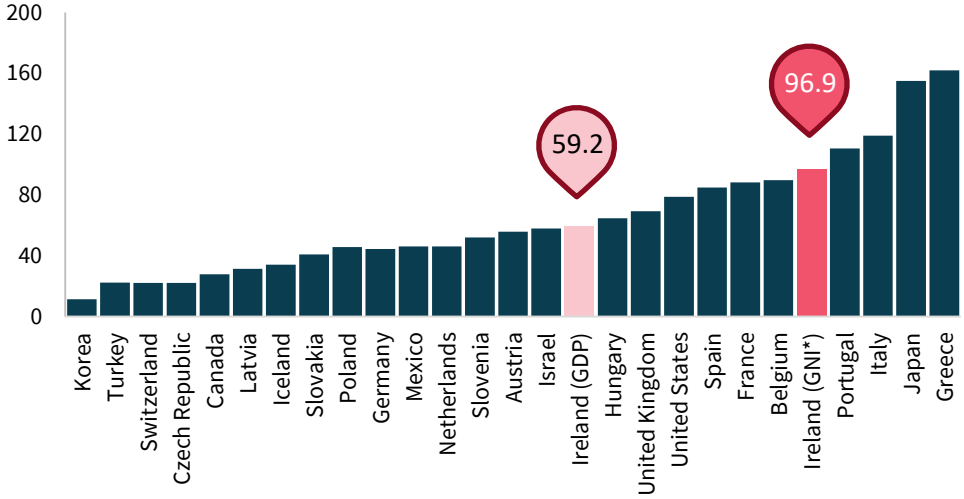


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Real Net Policy Spending = total general government expenditure less interest, one-offs, cyclical unemployment benefits, and discretionary revenue measures. It is HICP-deflated. Cyclical unemployment benefits are calculated on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

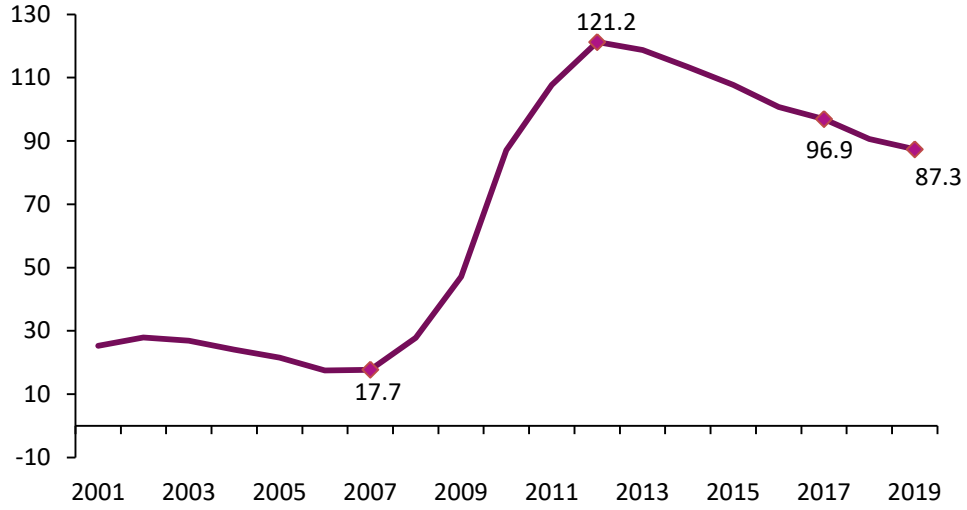
% GDP at end-2017 (% GNI* for Ireland), net general government debt



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



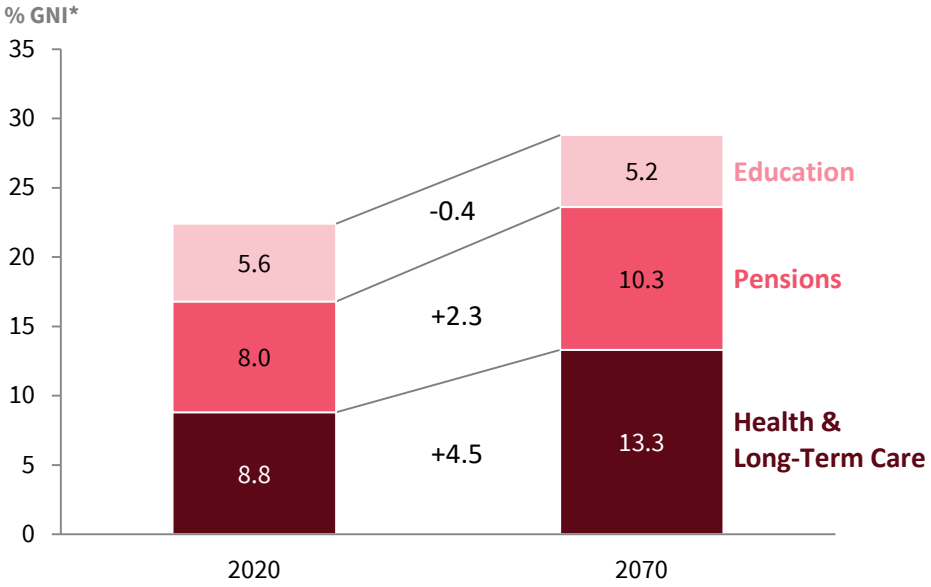
Sources: CSO; Department of Finance; and internal IFAC calculations.

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

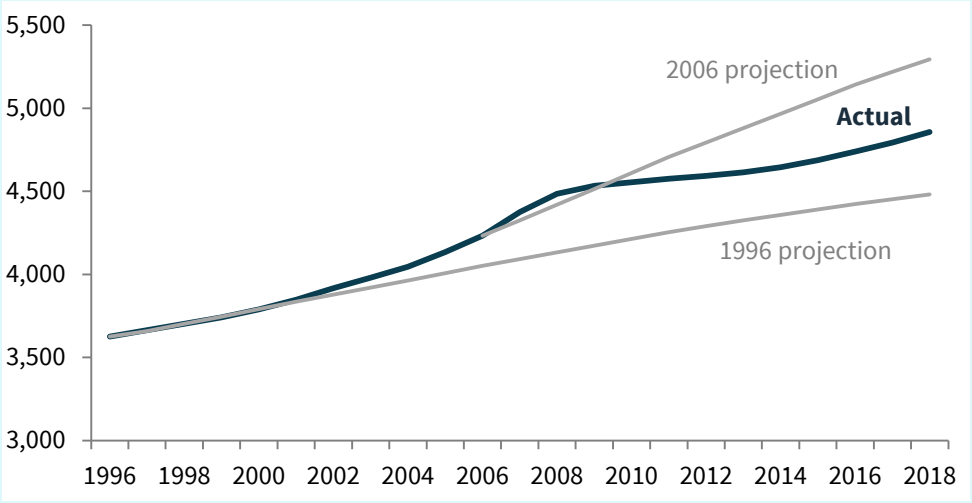
The Council is planning a special publication on the long-term sustainability of the public finances (30-40 years ahead) for next year. Demographics are a key driver of the public finances, which can directly impact relevant spending areas such as pensions, education and health. However, projections 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.

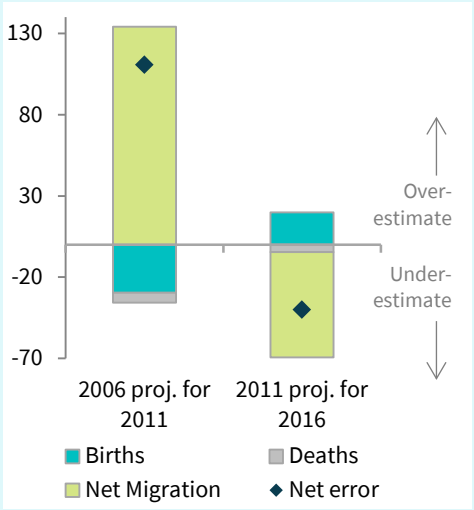
[11] For example, 1996 census projections list three total fertility scenarios: fertility rates (1) rise to 2 children per woman by 2001 and remain there, (2) decrease to 1.75 by 2011 and remain there and (3) decrease markedly to 1.5 by 2011 and remain there. Actual rates were around 1.9 for 1996–2006, 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.

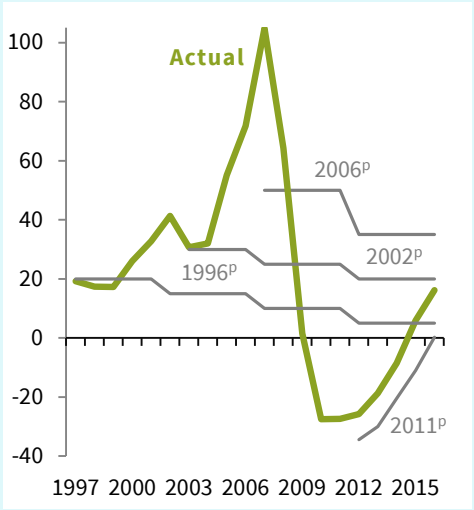
Figure B.2: A Closer Look at Errors on Projections

Population flows and population in thousands

A. Projection errors decomposed



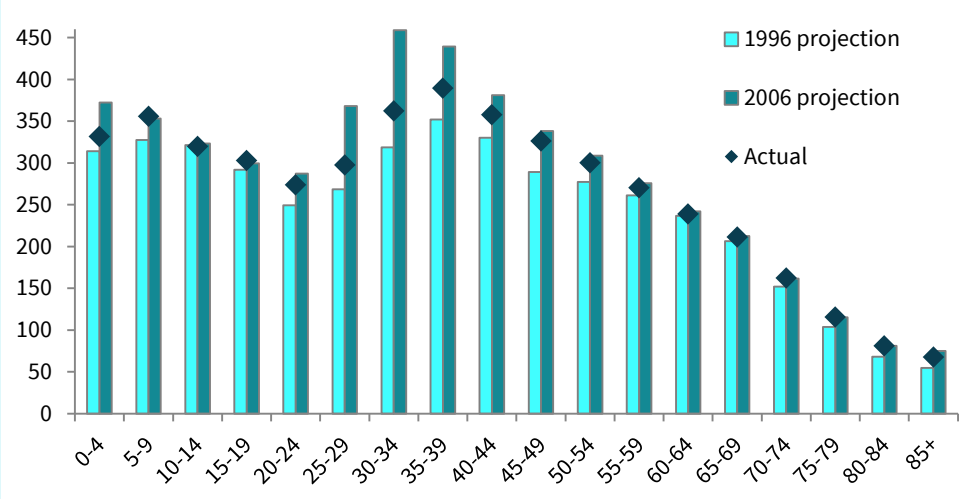
B. Actual and projected migration



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).

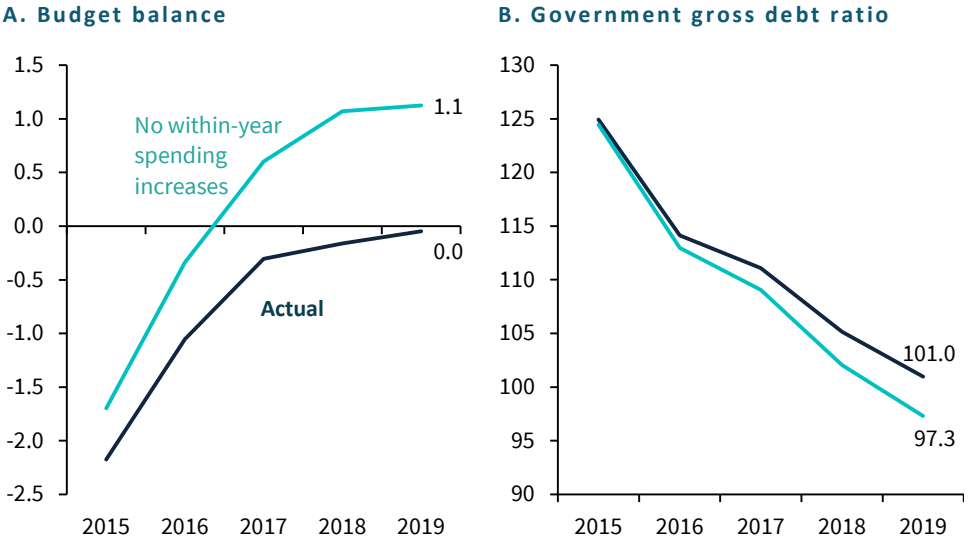
The delay to a return to surplus is not without its costs. It keeps debt higher than could have been achieved, leaves the public finances more exposed to adverse shocks in coming years, and provides an unnecessary stimulus to an already fast-growing economy. Using unexpected revenues to fund long-lasting 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.

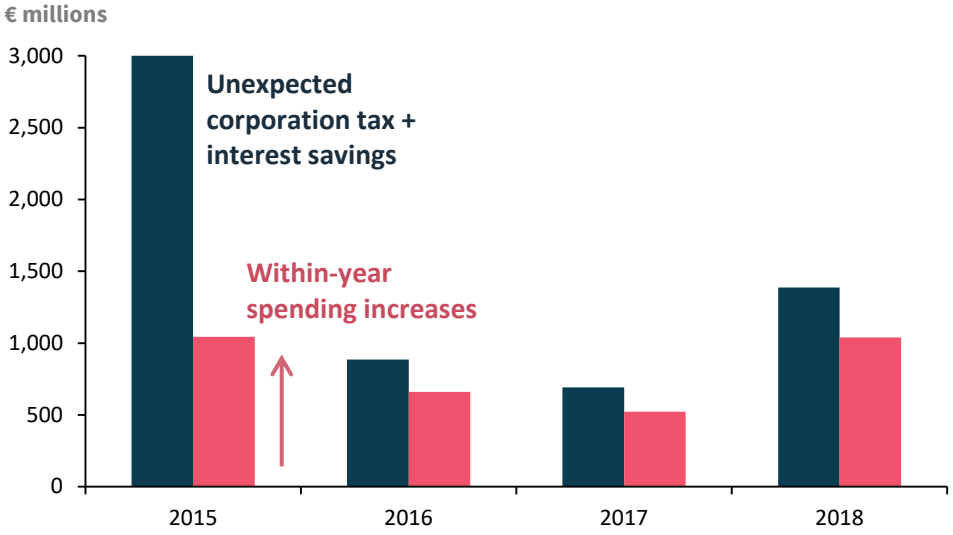
1.4 Assessment of the Fiscal Stance for 2018–2023

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*

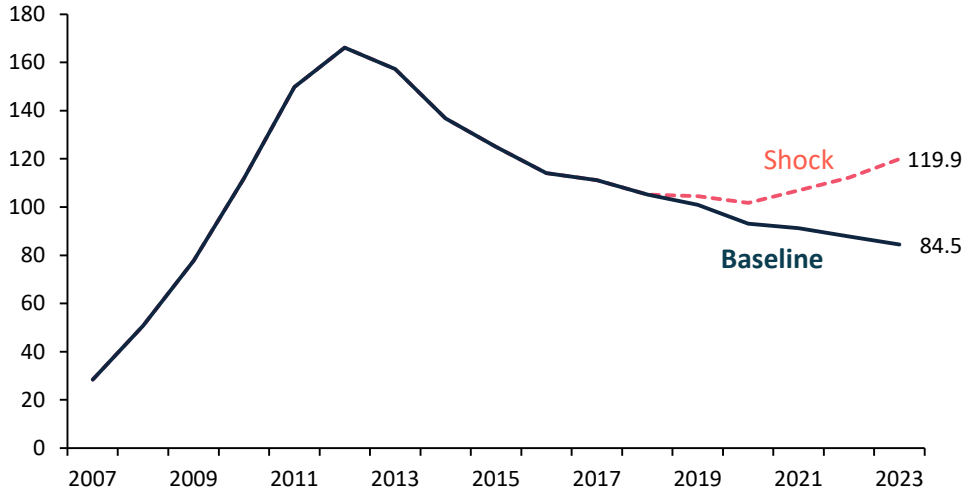
% GNI* (Non-interest spending, general government basis)

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.

Chapter 2

Endorsement and Assessment of the Macroeconomic Forecasts

2. Endorsement and Assessment of the Macroeconomic Forecasts

Key Messages

- The Council endorsed the *Budget 2019* macroeconomic forecasts for 2018 and 2019 produced by the Department of Finance, which expect the Irish economy to maintain its recent strong growth. This favourable performance is part of a cyclical recovery that has been ongoing for about five years. The Council's preferred estimate of real economic activity in Ireland is underlying domestic demand, which strips out components of domestic demand that are particularly affected by multinational enterprises. The Department of Finance forecasts this to grow by 4.9 per cent on average for 2018 and 2019.

- The Council welcomes the development and publication in *Budget 2019* of tables detailing the Department of Finance's estimates of potential output and the cyclical position of the economy. These estimates suggest that the Irish economy is currently operating close to potential, and that economic growth will outstrip the sustainable rate of around 3 per cent over coming years, leading to upward pressure on prices. Although these pressures imply upside risk to the near-term forecasts, they could also lead to the realisation of downside risks over the longer term. While a growth in new dwelling completions to meet demand has been included in the baseline projections, high levels of residential building activity often characterise the end of an economic cycle. As such, careful management of these risks by policymakers is necessary.

- The Irish economy remains heavily dependent on large, foreign-owned multinational enterprises to support growth in national income and tax revenues. Although near-term forecasts for some of Ireland's main trading partners remain favourable, much uncertainty surrounds the prospects for growth in the UK. The impact of Brexit on the Irish economy is particularly difficult to forecast, as standard models may not capture the extent of the two countries' closely integrated supply-chain networks, amongst other linkages.

- The presentation of relevant economic statistics for the Irish economy has improved considerably in recent years, in response to the distortions related to multinational enterprises. Further additions are needed in order to provide policymakers with a coherent and consistent picture of underlying economic conditions in Ireland. The Council, the Department of Finance and the Central Bank of Ireland in particular have emphasised these alternative measures in their forecast publications. The Council would welcome widespread adoption of available alternative estimates and statistical aggregates by forecasters from official and private-sector agencies.

2.1 Introduction

The Council monitors developments in the Irish economy on an ongoing basis. The identification of potential risks and economic imbalances requires careful and continuous analysis. The Council's 11th endorsement exercise assessed macroeconomic projections prepared by the Department of Finance reflected in *Budget 2019*. The timeline for this endorsement process is detailed in Appendix B.

A key focus of this chapter concerns the improvement in the range of relevant analysis and statistics available for the Irish economy, providing policymakers with a greater understanding of underlying activity and its effects on economic conditions. Some of these improvements are detailed in Box C. At the same time, ongoing efforts by the Council and Department of Finance have substantially improved the availability of relevant estimates of the potential output of the economy. Taken together, these developments have made inroads towards a coherent and consistent set of variables with which to describe economic activity in Ireland.

Box C: Underlying Measures of the Irish Economy

Issues with interpreting Irish economic data

Irish economic data has long been bedevilled by the effects of globalisation. Unlike many developed economies, gross national product (GNP) for Ireland is substantially lower than gross domestic product (GDP) as a result of activities by foreign companies that lead to large net factor income flowing back to the rest of the world. As a result, GDP is not a reliable proxy for the tax base as it is in many other countries.

For many years, contemporary understanding of Irish economic data held that transfer pricing and other factors related to globalisation resulted in a distorted flow of recorded exports sold by firms operating in Ireland, initially concentrated in goods and extending to services over time. To the extent that profits related to these export sales accrued to foreign-owned multinational firms, rather than to Irish firms, these profits could be expected to flow back out of Ireland – either through royalties payments (services imports) or net factor payments. GNP, which nets off income flows to foreigners, was used as a proxy for underlying Irish activity.

However, in recent years, some of the increases in exports have not been flowing back out of GNP, resulting in a distorted profile for GNP. The composition of gross product measures has been complicated by the move to measuring activity on an ownership basis. This change has also affected investment through higher recorded investment and imports, and the associated issue of contract manufacturing (FitzGerald, 2016). The impact of contract manufacturing has been discussed in previous Council publications, for example the June 2018 *FAR* (IFAC, 2018c). Further issues related to depreciation on intangibles and re-domiciled firms have provided additional challenges to the interpretation of trends in the national accounts.

Alternative indicators of activity, income and savings

Efforts to address many of these challenges have been ongoing in recent years. The CSO has

been implementing various changes to the presentation of national accounts data, in response to end-user suggestions and the findings of the Economic Statistics Review Group (ESRG). Table C.1 summarises the Council's preferred alternative indicators and the adjustments required in the derivation of these indicators.

Table C.1: Underlying measures of the Irish economy

2017 nominal € billion amount

Indicators and Adjustments	Modified nominal GNI	Modified current account	Domestic GVA	Modified domestic demand	Underlying domestic demand
Original aggregate	234.2	24.9	272.2	198.5	198.5
Less:					
Re-domiciled PLCs	-4.9	-4.9			
Depreciation on R&D service imports and trade in IP	-43.1	-43.1			
Depreciation on aircraft leasing	-5.1	-5.1			
Net aircraft activities related to leasing		6.6		-6.6	
R&D-IP imports		14.0		-14.0	
R&D-IP exports		-3.1			
R&D service imports		12.8			
Foreign GVA*			-107.2		
Planes and intangibles					-39.2
Underlying total	**181.2**	**2.2**	**165.0**	**177.9**	**159.3**

Source: CSO.
Note: * Foreign GVA corresponds to GVA by NACE sectors 20, 58-63, 18.2, 21, 26, 27 and 32.5.

Modified gross national income (GNI*) has gained some traction as a more relevant nominal indicator. As such, the use of GNI* has become more prevalent as a denominator for assessing trends in debt and deficit ratios, for example, which are understated when scaled by GDP or GNP. A top-down adjusted measure, GNI* subtracts certain items from gross national income. These adjustments are the factor income of re-domiciled firms (as Irish residents will not benefit from any resulting profit flows), and depreciation on each of research and development (R&D) service imports, trade in intellectual property (IP) and aircraft leasing (as the Irish employment does not depend on the savings required to replace these capital assets). At present, it is only available annually and as a current-prices series. Further planned developments include its publication as a constant-prices series, and to publish quarterly GNI* updates.

A **modified current account (CA*)** aims to provide a picture of underlying Irish savings with (or borrowing from) the rest of the world. It makes the same adjustments as GNI*, but further excludes net aircraft acquisitions related to leasing, R&D-related IP imports and exports, and R&D service imports. These adjustments result in a far more relevant profile for CA* than shown for the headline current account, which should represent a key sustainability measure for the economy.

The CSO has long published a decomposition of gross value added (GVA) between sectors that are dominated by foreign-owned multinational firms, and the remainder. The **domestic GVA** series provides a reasonably consistent profile for both nominal and real economic growth, but like GNI* it is only available annually, and the CSO has described the compilation of a quarterly version of the data as a "project in the medium term" (CSO, 2017).

The *Institutional Sector Accounts* also provide additional details on economic conditions in Ireland, particularly those facing households and non-financial corporations. Besides detailing the household savings ratio, a more recent inclusion is the breakdown of non-financial corporations into a top 50 group and all other firms (as ranked by GVA). Recommended by the ESRG, this decomposition is intended to provide a better understanding of indigenous economic activity (ESRG, 2016).

Alternative indicators of domestic demand

Domestic demand has previously been a relevant aggregate for assessing economic growth as explained by personal consumption, government consumption and gross domestic fixed capital formation. However, increased purchases of aircraft (outright or for leasing purposes), and onshoring of intellectual property assets by large foreign-owned multinational firms (depreciation on which are included as investment in the form of intangibles) have limited the relevance of headline domestic demand in recent years.

The CSO have begun publishing a quarterly **modified domestic demand** series, in both constant and current prices, which excludes aircraft for leasing and R&D-related IP imports. The constant-prices series performs reasonably well in terms of mirroring annual employment growth, and the Department of Finance has been using modified domestic demand as its preferred measure of core activity for the domestic economy. However, at a conceptual level, the Council prefers to exclude all aircraft investment and all intangibles, since they reflect activity in sectors which are dominated by foreign-owned multinational firms, with little value-added likely to accrue to Irish residents. This indicator is termed **underlying domestic demand**, and has been used extensively in Council publications in recent years.

Using the underlying measures in economic forecasts

The Council would welcome a more widespread adoption by official and private-sector forecasters of alternative measures of economic activity in Ireland, including those described above. This would help to focus forecasts on the most relevant developments for the Irish economy and make forecasts easier to communicate on a consistent basis by setting aside the most volatile components with weak connections to domestic developments.

Some publications have begun to include alternative measures – for example, the *Quarterly Bulletin* by the Central Bank of Ireland has included underlying domestic demand excluding stocks in its summary forecast table since the July 2018 update (Central Bank of Ireland, 2018), while the Department has lately emphasised modified domestic demand. However, many other forecasters continue to report the traditional components of GDP and an unmodified current account profile as a share of GDP or GNP. These provide very little relevant information to users.

Further planned enhancements to official economic statistics produced by the CSO should broaden the capacity of forecasters and policymakers to understand changes in economic conditions. Further progress should be a priority. The value of the data enhancements to users is reduced unless they are included prominently in the main tables of forecast publications by public- and private-sector forecasters.

2.2 Endorsement of *Budget 2019* Projections

This section describes the 11th endorsement exercise undertaken by the Council.[28] The macroeconomic forecasts contained in *Budget 2019* are assessed as being within an endorseable range for 2018 and 2019, taking into account the methodology and the plausibility of the judgements made.[29] There were modest changes of around 0.1 per cent of nominal GDP to the forecasts endorsed by the Council as a result of policies introduced in *Budget 2019*; these changes were concentrated in personal consumption (due to price effects) and government consumption (higher volume growth), and resulted in an upward revision of 2,000 to total employment in 2019.

The endorsement process entails three key aspects: the plausibility of the methodology used; the pattern of recent forecast errors; and comparisons with the Council's Benchmark projections and other forecasts.

Methodology

The Council is satisfied that the Department's approach to demand-side forecasting broadly conforms to that of other forecasting agencies. The Department has developed a set of supply-side estimates based on a relevant methodology for a small open economy, and consistent with their assessment of economic activity, and the Council welcomes this. The Department uses a suite-of-models approach, which draws on information from a range of models, and the output is included for the first time in the main tables of *Budget 2019*. The methodology is broadly similar to that of the Council, as described in Casey (2018).

Crucially, the new supply-side estimates of potential output and the output gap are more plausible, in the Council's view, than those based on the EU Commonly Agreed Methodology (CAM). This applies for historical series as well as for the near-term

[28] The statutory endorsement function is detailed in IFAC (2013) and IFAC (2014a). The Budget-related endorsement covers a shorter time range than the Stability Programme Update, which is the national medium-term fiscal plan. Benchmark projections prepared by the Secretariat form a key part of the endorsement process (see IFAC, 2013 and 2014a). An important input into the preparation of the Benchmark projections involves rounds of discussions with other external forecasters. For this round of forecasts, the Secretariat held discussions with economists and forecasters at the ESRI and Ulster Bank Capital Markets, and met with the CSO to gain further insights into recent data releases.

[29] In accordance with the *Fiscal Responsibility Act*, medium-term forecasts for 2020–2023 in *Budget 2019* are not subject to endorsement. These nonetheless provide useful information for policymakers and help with the assessment of the plausibility of the in-year and year-ahead forecasts.

forecast period. While potential output is not observable and is always estimated with considerable uncertainty, the Department's new estimates are more consistent with other indicators of the state of the economy, and the forces known to be affecting it, than the CAM. This is largely due to the use of a national-specific methodology whereas the CAM uses a relatively more harmonised EU-wide approach. Furthermore, the picture of an economy currently close to potential but growing faster than the sustainable medium-term rate of around 3 per cent is internally consistent with the Department's forecasts for activity, employment and prices. The Department's supply-side estimates show a similar picture to the Council's Benchmarks (see Appendix C), but diverge somewhat over the forecast horizon with a wider output gap opening up in the Budget estimates, albeit well within the margin of error of either approach.

The Department's models include the application of a Kalman filter to gross value added (GVA) of the domestic economy, and others derived from extended Hodrick Prescott filter models using GDP (which the Department considers as their preferred estimates). The midpoint series of these GDP-based results have been included in the 'Economic and Fiscal Outlook' of *Budget 2019* (reproduced in Figure 2.1A). The Council considers the GDP-based estimates to be conceptually weaker than those based on domestic GVA, given the large distortions to GDP in recent years. The profile of a widening output gap over the medium term is nonetheless plausible. While full details of the methodology underpinning these alternative estimates had not yet been published at the time of the endorsement, a preliminary draft of a forthcoming Department of Finance technical paper (including its underlying data and code) was made available to the Council Secretariat.

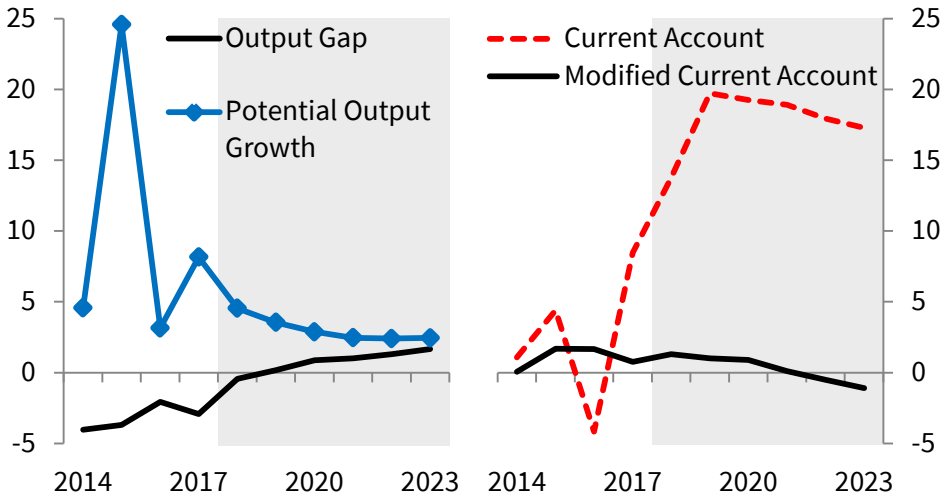
An additional series included in *Budget 2019* is the modified current account (CA*, see Box D for a description of the adjustments), presented as a share of modified gross national income (GNI*). As shown in Figure 2.1B, the modified current account provides a more plausible indication of the sustainability of economic activity in Ireland than the forecast path for the headline current account. The headline measure has been extremely volatile in recent years, showing a very high nominal surplus in recent quarters that does not reflect the economy's true saving behaviour

and its external relationship with the rest of the world, due to the influence of multinationals on recorded trade flows.[30, 31]

Figure 2.1: *Budget 2019* supply-side estimates and the current account (CA) compared to the modified current account (CA*)

A. Output gap and potential output
Percentage points of potential output and percentage change (year on year)

B. CA compared to CA*
Percentage of GNI*



Source: Department of Finance.
Note: The potential output growth estimate for 2015 of 24.6 per cent is clearly implausible and related to distortions in the MNC sector.

Both the publication of the alternative supply-side estimates and forecasts of CA* are welcome as important complements to other indicators of underlying economic activity (described in Box C). The inclusion of these new series in the Department's publications provides a coherent basis for understanding the sustainability and quality of forecast economic growth.[32] These developments complement ongoing improvements by the Central Statistics Office (CSO) in publishing more relevant and meaningful statistics of economic activity in Ireland. In summary, these innovations have enhanced Ireland's capacity to monitor economic performance and potential imbalances.

[30] From a sizeable deficit position in 2016, the current account as share of GDP returned to a large surplus in 2017. Data for the first half of 2018 point to another large increase in the position for the full year (forecast by the Department as 3.5 per cent of GDP), whereas CA* is only expected to increase modestly (by 0.1 per cent of GNI*).

[31] Although the CA* series was not available to the Council at the time of the endorsement, its expected path over time was nonetheless discussed with the Department.

[32] For example, the trajectory of the output gap is rising into positive territory, while potential output growth is forecast to moderate, with the modified current account declining into deficit. This suggests an internally consistent view of the economy over the medium term, reflecting an expectation for some degree of overheating.

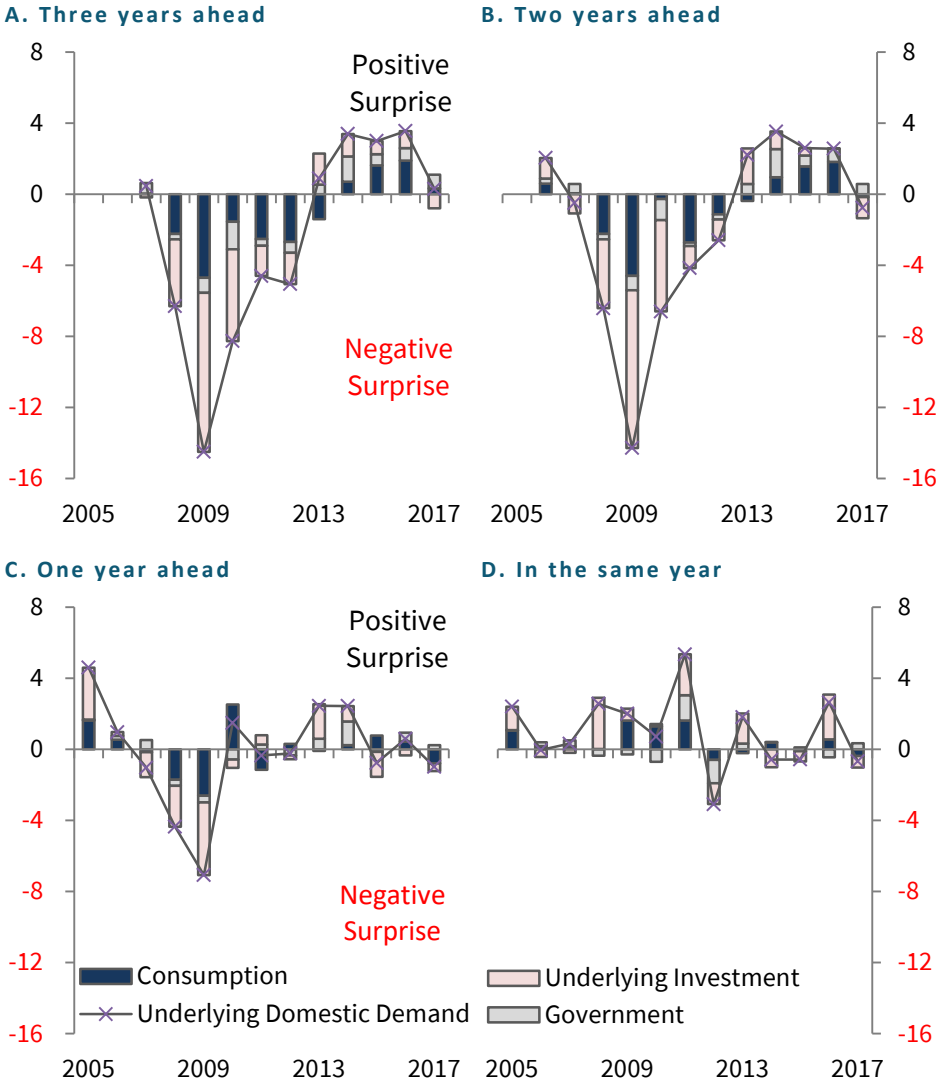
As in previous endorsements, the Council verified the application of the EU Commonly Agreed Methodology (CAM), which is required for the assessment of compliance with the fiscal rules. The CAM is prone to mismeasurement of the Irish economy's supply side (as discussed in Boxes B and E in IFAC, 2017e), and as such can provide misleading indications about the state of the economy.

Pattern of Recent Forecast Errors

A persistent pattern of forecast errors could indicate a deficiency with a chosen forecasting approach. The Council has found some recurrence in forecast errors by the Department. As described in Box C, the Council's preferred measure of activity in the domestic economy is underlying domestic demand. Figure 2.2 shows errors for four vintages of underlying domestic demand forecasts, and the contributions of its components: personal consumption, government consumption and underlying investment. The panels show that accuracy generally improves as the forecast horizon reduces, which is consistent with the principle that there is greater uncertainty around forecasts for periods that are further ahead. Underlying investment contributes the largest share of forecast errors in underlying domestic demand. In recent years, however, the Department's in-year forecasts and those made one year ahead (panels C and D) have been relatively accurate.

Figure 2.2: Forecast errors for underlying domestic demand

Percentage points (forecast error and contributions)



Sources: Department of Finance, various Stability Programme and Budget forecasts since 2004; CSO, various Quarterly National Accounts and National Income and Expenditure data releases since 2003; and internal IFAC calculations.

Note: Underlying domestic demand is calculated as domestic demand excluding stocks, aircraft and intangibles. Aircraft and intangibles are published as separate quarterly series and forecasts by the Department of Finance for these series are available since 2016. Before this, domestic demand excluding stocks is used a proxy.

The Council also notes that forecasts of real government net consumption made two and three years in advance have been persistently lower than outturns since 2013. A factor is the Department's use of technical assumptions to underpin its fiscal forecasts, which can result in a significant slowdown in government expenditure growth (as discussed in Chapter 3). More realistic outer-year forecasts would show higher planned expenditure increases, consistent with anticipated economic growth and the Department's projection for a positive output gap over the medium term. Such reliance on inconsistent technical assumptions partly explains how real

government net consumption outturns for each of 2015 and 2016 were higher than the comparable-basis Department forecasts three years earlier by over €4 billion.[33]

Comparison with Other Projections

Council's Benchmark Projections

For *Budget 2019*, the Department's forecasts are similar to the Council's latest Benchmark projections (detailed in Appendix C). Underlying domestic demand is forecast to grow by over 5.9 per cent in 2018, and close to 4 per cent in 2019. Although *Budget 2019* forecasts from 2020 onwards are not subject to formal endorsement, the Council's Benchmarks show a more moderate pace of expansion in underlying investment, mainly due to residential building and construction. Both *Budget 2019* and the Council's Benchmarks forecast a significant rise in new dwelling completions by 2023. The Benchmarks involve a more front-loaded increase in new dwellings completions, resulting in a smaller contribution to underlying investment growth over 2021–2023.

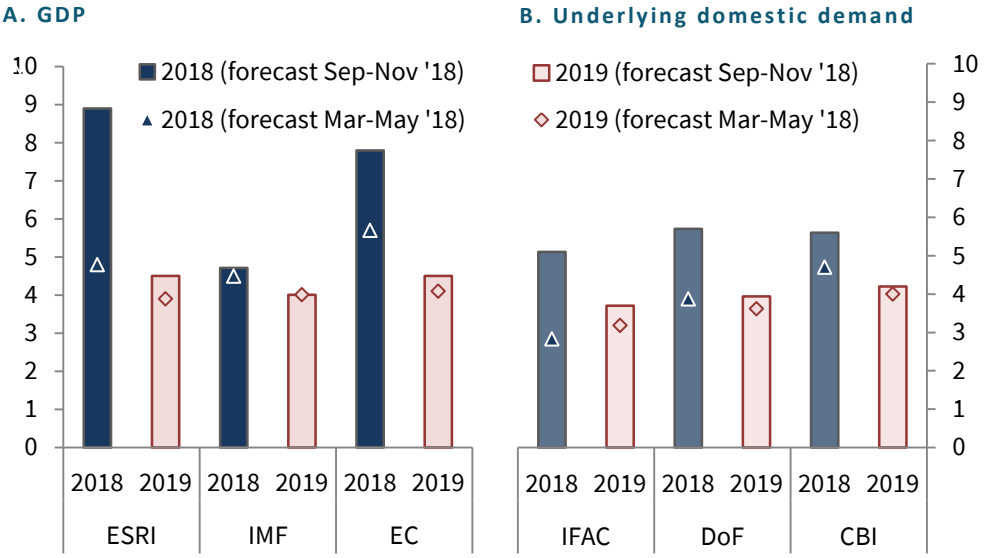
Short-Term Forecasts of Other Agencies

Preliminary CSO outturns show that the strong momentum in recorded GDP growth from the second half of 2017 has continued into the first half of 2018, resulting in upward revisions for both 2018 and 2019 by other forecasting agencies. However, where relevant forecast are available, the Council prefers to compare an aggregate that is not distorted severely by factors unrelated to domestic economic conditions, such as underlying domestic demand. Revisions to forecasts for 2018 and 2019 are depicted for six forecasting agencies in Figure 2.3; panel A shows forecasts for real GDP, while panel B shows real underlying domestic demand forecasts, where available. This compares expected economic growth rates from earlier in 2018 with updated forecasts from more recent months for the same agency.

[33] To ensure comparability between forecasts and outturns, actual real government net consumption is re-based to the base year applicable to the forecasts; e.g. forecasts for 2016 made in October 2013 (*Budget 2014*) were based on the latest CSO *National Income and Expenditure* release (*NIE 2012*, whose volume series are based in 2011 prices). The difference between the 2016 actual (€27.97 billion) and three-year-ahead forecast (€23.74 billion) real government net consumption was €4.23 billion, based in 2011 prices.

Figure 2.3: Forecasts of economic growth

Percentage change in volumes (year on year)



Sources: Economic and Social Research Institute, *Quarterly Economic Commentary* (Spring 2018 and Autumn 2018); International Monetary Fund, *World Economic Outlook* (April 2018 and October 2018); and European Commission, *European Economic Forecast* (Spring 2018 and Autumn 2018); Department of Finance, *SPU 2018* and *Budget 2019*; Central Bank of Ireland, *Quarterly Bulletin* (No.s 2 and 4 for 2018); and Irish Fiscal Advisory Council, *Fiscal Assessment Reports* from June 2018 and November 2018.

2.3 Assessment of the Macroeconomic Forecasts in *Budget 2019*

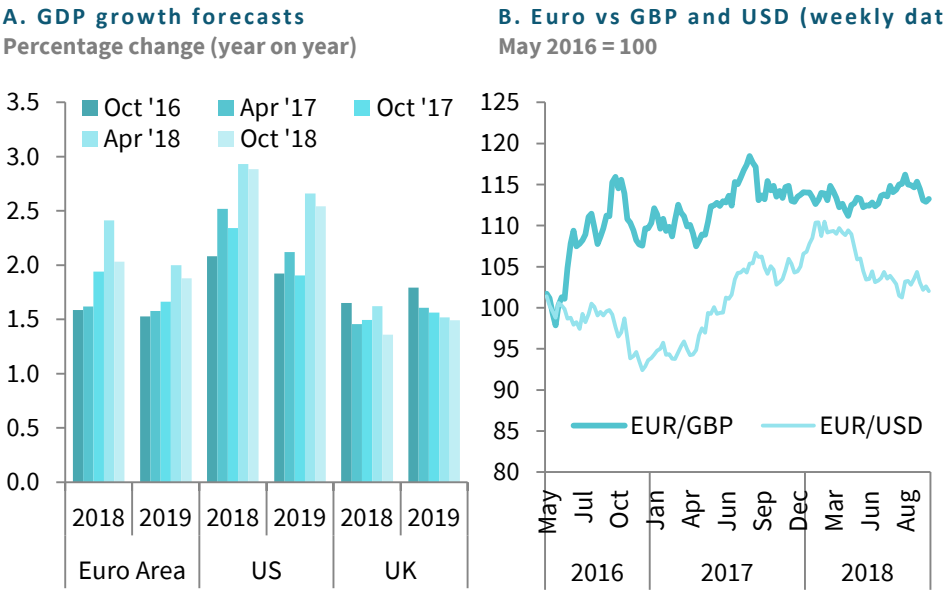
Macroeconomic Context

The Irish economy has continued to grow rapidly in 2018, with its robust cyclical recovery now ongoing for around five years. Employment growth remains strong at close to 3 per cent on average in the four quarters to June 2018; the unemployment rate has fallen from a peak of 16 per cent in early 2012 to 5.3 per cent by October 2018; and tax revenues including PRSI but excluding corporation tax are up by 6.2 per cent in the first ten months of the year. Despite an unexpected slowdown in recorded personal consumption growth in 2017, domestic demand is forecast to contribute meaningfully to economic growth in 2018 and 2019.

Output is close to its medium-term potential path, and capacity constraints have arisen across various sectors of the economy, in particular for housing. Hourly wage growth is expected to rise over coming years, and though still well below the pace seen in the early 2000s, it is forecast to reach 3.7 per cent by 2023. The growth in prices is similarly expected to increase, driven in part by a recovery in crude oil prices over the past year, rising from around $50 per barrel during 2017 to about $70 per barrel in 2018.

Prospects for external demand appear somewhat less favourable than at the time of *Stability Programme Update 2018* in April. Although GDP growth forecasts for the Euro Area and US this year and next have generally improved, as shown in Figure 2.4A, recent IMF forecasts have been revised downwards. Forecasts for the UK suggest that the economy is on a weaker growth trajectory, with slower consumption growth and subdued investment spending. This is likely to reflect a rise in uncertainty as the end-March 2019 date for Brexit draws nearer. In currency markets, the euro has continued on a relatively stable path during 2018 (Figure 2.4B). The euro-sterling exchange rate has been fairly steady for the past year, with sterling remaining close to 15 per cent weaker compared to May 2016 (before the Brexit vote took place). This continues to present a challenge to indigenous Irish exporting firms, whose exports rely heavily on UK-imported components (Lawless, 2018), although the relatively weaker inflation in Ireland compared to the UK has offset this effect to some extent.

Figure 2.4: Trading-partner growth forecasts and exchange rates



Sources: IMF World Economic Outlook and Datastream.

The assumptions in *Budget 2019* regarding the impact of Brexit on the Irish economy are essentially the same as in *SPU 2018*. The Department's baseline Brexit assumption is that the UK will leave both the EU customs union and single market for a free-trade agreement to be agreed in 2021, following a transition period beginning after the first quarter of 2019 and lasting until end-2020. As the forecast horizon in *Budget 2019* has been extended by two years to 2023, further information is now available regarding the Department's expectations for the impact of Brexit on the Irish economy. Relative to a scenario of no Brexit, the Department's baseline entails a level of GDP that is 2 per cent lower over 2021–2023 as a result of the less favourable trading conditions for Ireland under the assumed new free-trade agreement. With the end of the transition period expected from 2021 onwards, an increase in inflation is also forecast to coincide with the higher costs for businesses under the free-trade agreement.

Continued uncertainty has characterised the prospects for a transition arrangement since EU-UK negotiations progressed beyond their initial phase in December 2017. Indeed, *Budget 2019* acknowledges that estimates of the impact of Brexit on the Irish economy could be understated, even if the outcome is an orderly exit.[34] A

[34] Risks to the estimated effects that may not be adequately modelled include financial market effects and non-tariff barriers (i.e. regulatory divergence). Further issues relate to the strong assumption often applicable that a shock to growth in the UK is equivalent in terms of its impact on Ireland to a shock to an average trading partner.

disorderly outcome, however, could involve the imposition of large WTO tariffs from April 2019 onwards, which would pose a significant threat to Irish businesses. This is expected to result in a loss in the level of GDP between the first quarter of 2019 until 2023 of 3¼ per cent relative to a no-Brexit scenario – larger than the projected impact of a new free-trade agreement. Such estimates are helpful, but highly uncertain and the Department notes that the estimate for the "disorderly" Brexit scenario should be considered as a minimum likely impact of such a scenario.

Budget 2019 Short-Term Forecasts, 2018–2019

The key elements of the demand-side forecasts for 2018 and 2019 contained in *Budget 2019* are set out and assessed in this section. Rapid growth of 5.9 per cent is forecast for underlying domestic demand in 2018.[35] This measure of real growth is then expected to moderate to 4 per cent in 2019, supported by growth in underlying investment and personal consumption (as shown in Table 2.1). Employment is expected to continue its recent trend of strong growth, while the Department's GDP-based estimate of the output gap is projected to turn positive in 2019.

[35] *Budget 2019* forecasts growth in modified domestic demand of 5.2 per cent in 2018.

Table 2.1: *Budget 2019* macroeconomic forecasts (to 2019)

Percentage change in volume, unless stated

	2017[a]	2018	2019
Demand			
Underlying domestic demand[b]	2.9	5.9	4.0
GDP	7.2	7.5	4.2
…of which (contributions)			
Underlying domestic demand[c] (p.p.)	*0.5*	*3.6*	*2.1*
Underlying net exports[c] (p.p.)	*6.8*	*3.9*	*2.1*
Personal consumption	1.6	3.5	3.0
Government	3.9	3.5	2.9
Investment	-31.0	-8.9	7.1
Underlying investment[b]	6.2	16.5	7.7
Exports	7.8	7.0	5.6
Imports	-9.4	0.9	6.2
Underlying imports[b]	2.4	6.0	6.2
Supply			
Potential output	8.2	4.5	3.5
Output gap (% of potential output)	-2.9	-0.4	0.2
Labour Market			
Population	1.1	1.4	1.4
Employment	2.9	3.0	2.8
Unemployment rate (% labour force)	6.7	5.8	5.2
Prices			
HICP	0.3	0.7	1.5
Personal consumption deflator	1.4	1.5	2.0
GDP deflator	0.4	1.8	1.9
Other			
Nominal GNI*	3.0	8.1	6.1
Nominal GDP	7.6	9.3	6.2
Nominal GDP (€ billion)	294.1	321.6	341.5
Modified current account (% of GNI*)	1.2	1.3	1.0

Sources: CSO; Department of Finance; and internal IFAC calculations.
Notes: [a]Denotes latest outturns from the CSO. [b]Underlying domestic demand, investment and imports exclude other transport equipment (mainly aircraft) and intangibles; underlying domestic demand further excludes changes in inventories. [c]Underlying contributions to real GDP growth rates in percentage points – underlying domestic demand here includes the effect of changes in inventories, but like underlying net exports, it excludes the effect of investment in aircraft and intangible assets.

Domestic Demand

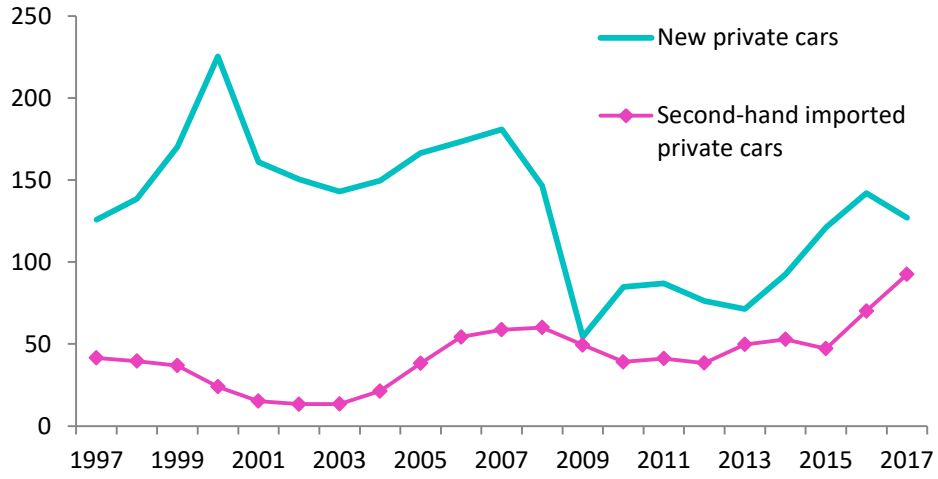
Personal consumption is set to grow 3 per cent in 2018 and 3.5 per cent in 2019 according to the *Budget 2019* projections. This is consistent with forecasts of sustained increases in employment income and a modest reduction in the savings rate as household balance sheets improve. However, recorded outturns for consumption

in 2017 surprised to the downside, expanding by just 1.6 per cent. This outturn would – if taken at face value – suggest a considerable slowdown in the growth of goods consumed compared to the previous three years, when growth averaged 5.6 per cent. However, a marked slowdown is not evident in the drivers of personal consumption. For example, the retail sales volume index and employment grew by 3.9 per cent and 2.9 per cent in 2017, respectively.[36] As such, a broader reading of available indicators suggests consumption volumes did grow fairly rapidly in 2017, lending plausibility to the continued strength in spending growth in 2018 and 2019.

The CSO has advised of the possibility that the volume of consumption of motor vehicles for 2017 may be revised, based on a new data source related to second-hand car purchases. As shown in Figure 2.5, second-hand imported private car sales almost doubled in 2017 compared to 2015. This is likely to be related to the negative exchange-rate shock to sterling since the Brexit vote, which has made used imported cars more attractive to Irish car buyers. The potential savings compared to equivalent domestic second-hand purchases is larger for more expensive vehicle brands and models. New information regarding such activity could have implications for estimates of the goods consumption deflator, which may not fully capture the composition of imported second-hand motor vehicles following the significant change in consumption patterns in 2017.

Figure 2.5: Private cars licensed for the first time in Ireland

Thousands of licences



Source: CSO.

[36] The volume growth for retail sales excluding motor trades accelerated from 4.9 per cent in 2016 to 5.8 per cent in 2017.

Real **government net consumption of goods and services** recorded growth of 3.9 per cent in 2017, more than double the rate expected at the time of *SPU 2018* (1.8 per cent), and a full 3.9 percentage points above the growth rate expected three years in advance, in *Budget 2015* (published in October 2014). Over the medium term, growth is forecast to fall back towards 1.8 per cent out to 2023. However, as discussed in Chapter 3, it is not clear how well this profile reflects anticipated growth in employment and population, which in turn facilitate growth in net government consumption.

Headline figures for **investment** have been extremely volatile in recent years, with levels doubling between 2014 and 2016, before falling by close to one third in 2017. However, the rate of growth in underlying investment (excluding aircraft and intangibles) has been more stable, increasing 6.2 per cent in 2017. *Budget 2019* forecasts a continuation of double-digit growth in residential construction in 2018 and 2019, reflected in annual output of new dwelling completions which is expected to reach 19,000 in 2018, rising to 49,000 by 2023.[37]

For 2018 and 2019, growth in non-residential construction activity is expected to slow to 7 per cent each year on average, although it would still contribute substantially to short-term growth in underlying investment. Further ahead, a gentle decline averaging −0.3 per cent annually is forecast for non-residential construction, as the Department anticipates substitution of activity from commercial into residential construction activities. However, there is a clear risk that the shift does not go as smoothly; there are potential upside risks to activity in the near term as a result, although there could also be a fall in non-residential construction before the predicted response in the supply of residential dwellings takes place, which represents a downside risk to the outlook for investment.

Finally, machinery and equipment excluding other transport equipment (mainly aircraft) has been growing particularly rapidly in the first half of 2018. It is not yet clear whether this represents a broad-based increase in activity, or one-off idiosyncratic developments. Forecast growth of 16 per cent on average for 2018 and 2019 could reflect some rebound in underlying capital formation, following a

[37] If sustained over the medium term, this output level would be at the upper range of estimates of housing supply required to achieve equilibrium in the market, as discussed in the June 2018 FAR (IFAC, 2018c).

decrease of close to 13 per cent in 2017. As discussed in the June 2018 *FAR* (IFAC, 2018c), certain foreign-multinational manufacturers whose investments entail a high content of imported machinery and equipment may explain some of this observed volatility.

Net Exports

Ireland's performance in net exports and international trade has become particularly difficult to analyse in recent years. As described in previous Council publications, CSO data in the national accounts for goods **exports** in the national accounts have been significantly affected by what is known as "contract manufacturing".[38] The monthly trade statistics published by the CSO do not include such activity. For the *Quarterly National Accounts* and *Balance of Payments* releases, broader definitions of exports and imports include the contract manufacturing of some firms, many of which are multinational enterprises. Growth in services exports is expected to slow in 2018 to just 2.6 per cent, reflecting weaker data for the first half of the year. In 2019 and 2020 however, it is projected to increase to above 5 per cent, and a long-running trend continues to favour services, comprising 45 per cent of total exports in 2017 (compared to close to 14 per cent twenty years previously).

Imports growth weakened in 2017, where the final outturns registered a 9.4 per cent decline. However, this profile is also significantly affected by aircraft (goods) and intangibles (services). Given the difficulty in predicting such components, it is more instructive to analyse underlying imports (excluding aircraft and intangibles), which grew by 1.7 per cent in 2017. For 2018, the growth rate in underlying imports is expected to fall back to zero, before returning to 1.3 per cent in 2019 and 1.4 per cent in 2020. Another cause of volatility for underlying imports is due to royalty payments (service imports), which have slowed considerably in recent quarters.

Aggregate Activity and Demand

Growth in real **underlying domestic demand** slowed in 2017, according to the most recent national accounts data – in large part due to a weak reading for goods consumption, as previously discussed. For 2018 and 2019, real underlying domestic demand is now forecast to grow quite rapidly, at 4.9 per cent on average (up from 3.7 per cent on average, according to *SPU 2018*).

[38] For example, see Box D of IFAC (2017e) and Box A in IFAC (2015b). For further detail see Connolly (2017).

Modified gross national income (GNI*) forecasts have been included in *Budget 2019*, although only as a technical forecast, moving in line with gross national product (GNP). For the latest Benchmarks, the Council derived a sum-of-parts forecast for GNI* starting with GNP and using forecasts of relevant investment components, combined with a relevant rate of depreciation and assumptions for other adjustments (including re-domiciled PLCs and EU taxes and subsidies).[39]

Table 2.2: Estimates of economic growth

Percentage change in volumes (year on year, unless stated) and percentage-point contributions

	2017[c]	2018	2019	2020	2021	2022	2023
Underlying domestic demand[a]	2.9	5.9	4.0	3.1	2.6	2.7	2.8
GNP	4.4	5.9	3.9	3.3	2.3	2.4	2.5
GDP	7.2	7.5	4.2	3.6	2.5	2.6	2.7
Of which…							
Underlying domestic demand[b]	*0.5*	*3.6*	*2.1*	*1.6*	*1.3*	*1.4*	*1.5*
Underlying net exports[b]	*6.8*	*3.9*	*2.1*	*1.9*	*1.2*	*1.2*	*1.2*
Nominal GNI*	3.0	8.1	6.1	5.2	4.2	4.3	4.4

Sources: CSO; and Department of Finance, *Budget 2019*.
Notes: [a]Underlying domestic demand excludes changes in inventories, investment in aircraft and intangible assets. [b] Underlying contributions to real GDP growth rates in percentage points (excludes the effect of investment in aircraft and intangible assets). Domestic demand contributions here include changes in inventories. Rounding can affect totals. [c] Denotes latest outturns from the CSO.

Forecasts of real **GDP** have been revised upwards for 2018, from 5.6 per cent at the time of *SPU 2018* to 7.5 per cent in *Budget 2019*, reflecting strong annual growth during the first half of the year. For 2019 onwards, there is some moderation expected over the forecast horizon, although the near-term expansion is expected to remain robust.

Budget 2019 Medium-Term Forecasts, 2020–2023

Forecast Horizon

The Council welcomes the return by the Department to forecasting out to five years ahead. However, as discussed in the June 2018 *Fiscal Assessment Report* (IFAC,

[39] The level of nominal GNI* for 2016 was revised down by the CSO in the most recent *National Income and Expenditure* release by close to €13.5 billion. In addition to a downward revision to GNP of €4.6 billion, depreciation on R&D service imports was broadened to include depreciation on trade in intellectual property. This resulted in the subtraction of a further €8.9 billion from GNI in the calculation of GNI*.

2018c), previous outlooks published by the Department have often reverted towards the three-year minimum required by the European Union, under the *Stability and Growth Pact* for each member's Stability Programme Update. The Council assesses that a horizon of at least five years ahead is appropriate to support a medium-term orientation for fiscal policy, and to ensure ongoing emphasis on identifying risks or potential economic imbalances in real time. The Department should not shorten the forecast horizon and should use realistic technical assumptions where needed, for example to forecast the public finances when the forecast horizon exceeds the length of the current parliamentary term.

Supply-Side Estimates

The Department's alternative estimates of the output gap and potential output, in conjunction with the modified current account, indicate an economy that is forecast to grow moderately faster than potential over the medium term. The GDP-based estimate of the output gap turns positive in 2019 and rises gradually to 1.7 per cent by 2023, as potential output growth reduces over time to 2.4 per cent from an estimated 4.5 per cent for 2018. The modified current account as a share of GNI* deteriorates slowly towards a deficit in 2022, reaching -1.1 per cent in 2023.

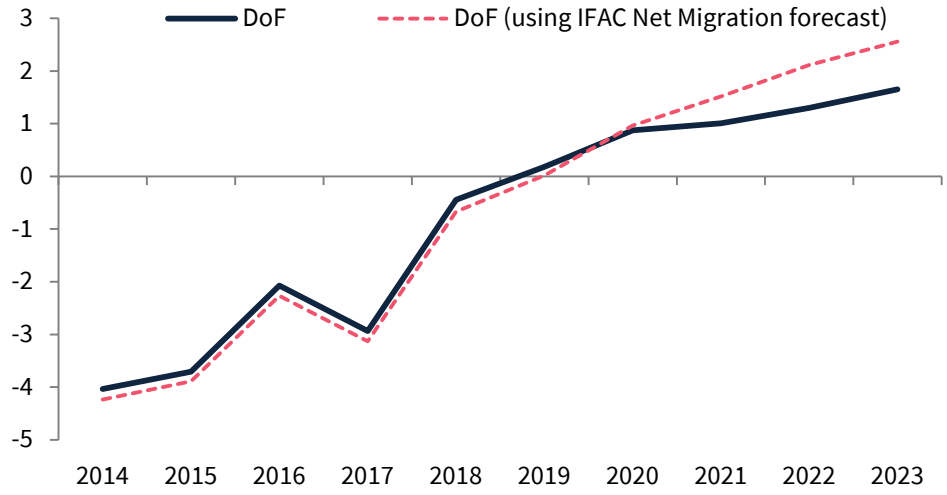
The alternative supply-side estimates represent a significant improvement on the EU CAM, especially for plausibility and representing the Department's view of the cyclical position of the economy at present and over the medium term. Forecasts tend to show output gaps closing over a period of time, even if this assumption is not imposed explicitly. While the Budget forecasts show the gap widening, financial variables could have a stronger effect on increasing the output gap than is assumed in the forecasts, especially if overheating were to take hold in a more serious way.

It is important to acknowledge that the alternative estimates are subject to considerable uncertainty. The severity of overheating signalled by the estimates changes substantially depending on the inputs assumed for key variables including, for example, net migration. Figure 2.6 shows a sensitivity analysis of the *Budget 2019* alternative GDP-based output gap estimates using the Council's Benchmark assumptions for net migration. The Council assumes that net migration rises continuously over the forecast horizon, whereas the Department's net migration forecast moderates over time. If the higher net migration estimates are incorporated, the output gap turns significantly more positive for 2021–2023. As

discussed in the Risks and Imbalances section, a more positive net migration forecast appears more consistent with other *Budget 2019* forecasts, in particular expectations for construction employment (see Figure 2.9).

Figure 2.6: Sensitivity analysis of alternative output gap estimates

Percentage points of potential output



Sources: Department of Finance, *Budget 2019*; and internal IFAC calculations.

2.4 Risks and Imbalances

Risks

This section considers various risks and imbalances that may affect the Department's central forecasts. They include the possibility of an unwinding of various favourable conditions evident since the recovery began. Table 2.3 reviews the short- and medium-term macroeconomic risks described by the Department in *Budget 2019*. Likelihood and impact factors are assessed, and a brief commentary describes the Council's own assessment of each risk. Besides the ten macroeconomic risks identified in *Budget 2019*, three additional risks are included by the Council: inappropriate monetary policy, inappropriate domestic policy and a potential volatility in food commodity prices.

Overall, the main risks relate to Brexit, strong reliance on highly concentrated foreign-owned activities, and domestic overheating. In the near term, there are upside risks from greater momentum in domestic activity (including construction) with negative risks related to other factors. Looking ahead, risks are mainly to the downside, including if overheating were to lead to a correction.

Table 2.3: Assessing the *Budget 2019* Macroeconomic Risk Matrix

Likelihood and Impacts from *Budget 2019*, unless stated: high in red; medium in pink; low in grey

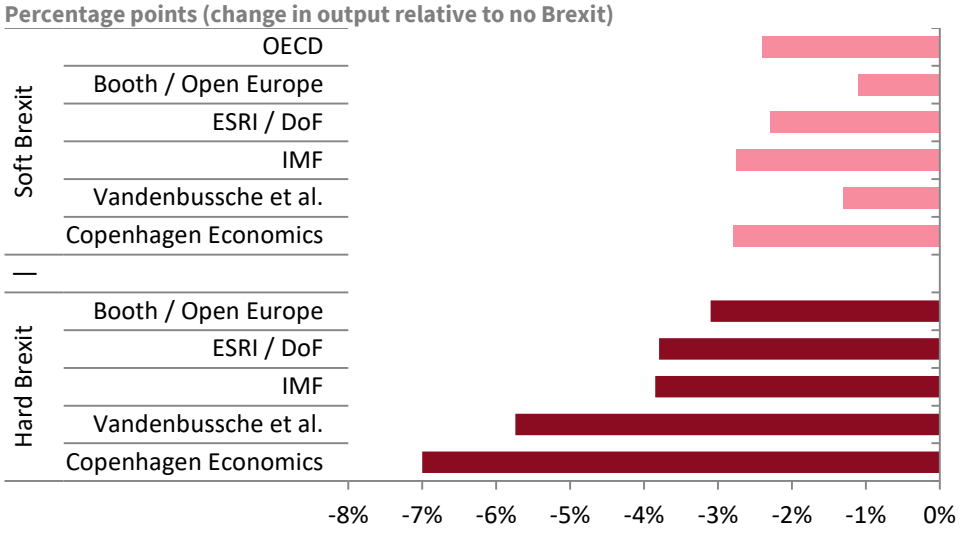
	Likelihood	Impact
"Disorderly Brexit" Risks of a WTO-style arrangement, impact on Irish-UK trade. Impact on medium-term growth prospects in Ireland. Severity and persistence of shock relative to estimates.		
External demand shock Strong current global economic growth context. Concern due to slowdown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

Medium-Term Impacts of Brexit on Ireland

Brexit remains a key source of risks to the medium-term outlook. More than two years after the referendum, the UK's ultimate trading relationship with the EU and the implications for Ireland still remain unclear. Moreover, the size and nature of potential impacts from various Brexit scenarios are highly uncertain (see estimated ranges under "soft" and "hard" scenarios in Figure 2.7). Standard models may not fully capture the extent of the two countries' closely integrated supply-chain networks, and other key channels may be more important than is assumed. Other risks stem from Ireland's reliance on a small range of specialised exporting activities, rising protectionism and potential changes in international tax policies.

Figure 2.7: Range of medium-term impacts of Brexit on Ireland

Percentage points (change in output relative to no Brexit)



Sources: As shown in chart legend.

Imbalances

The Council's modular approach to analysing the supply side of the Irish economy examines various indicators with the intention of identifying sources of economic imbalances in real time (see Box A in IFAC, 2015b). Motivations for the approach include the difficulty in producing a statistical estimate of the cyclical position of the economy, and monitoring specific economic data that may indicate the presence of potentially unsustainable positions relevant for the public finances, or developments that display procyclical tendencies. Appendix D presents indicators over the *Budget 2019* forecast horizon for four modules: the labour market and prices, investment and housing, external balances and credit conditions. The figures show outturns and *Budget 2019* forecasts (where available).

The Council has also developed a summary 'heat map' visualisation for monitoring potential imbalances in the Irish Economy, shown in Figure 2.8. Drawing on previous work by Byrne and Smyth (2016), the methodology and data sources used in this heat map are described further in Timoney and Casey (2018).

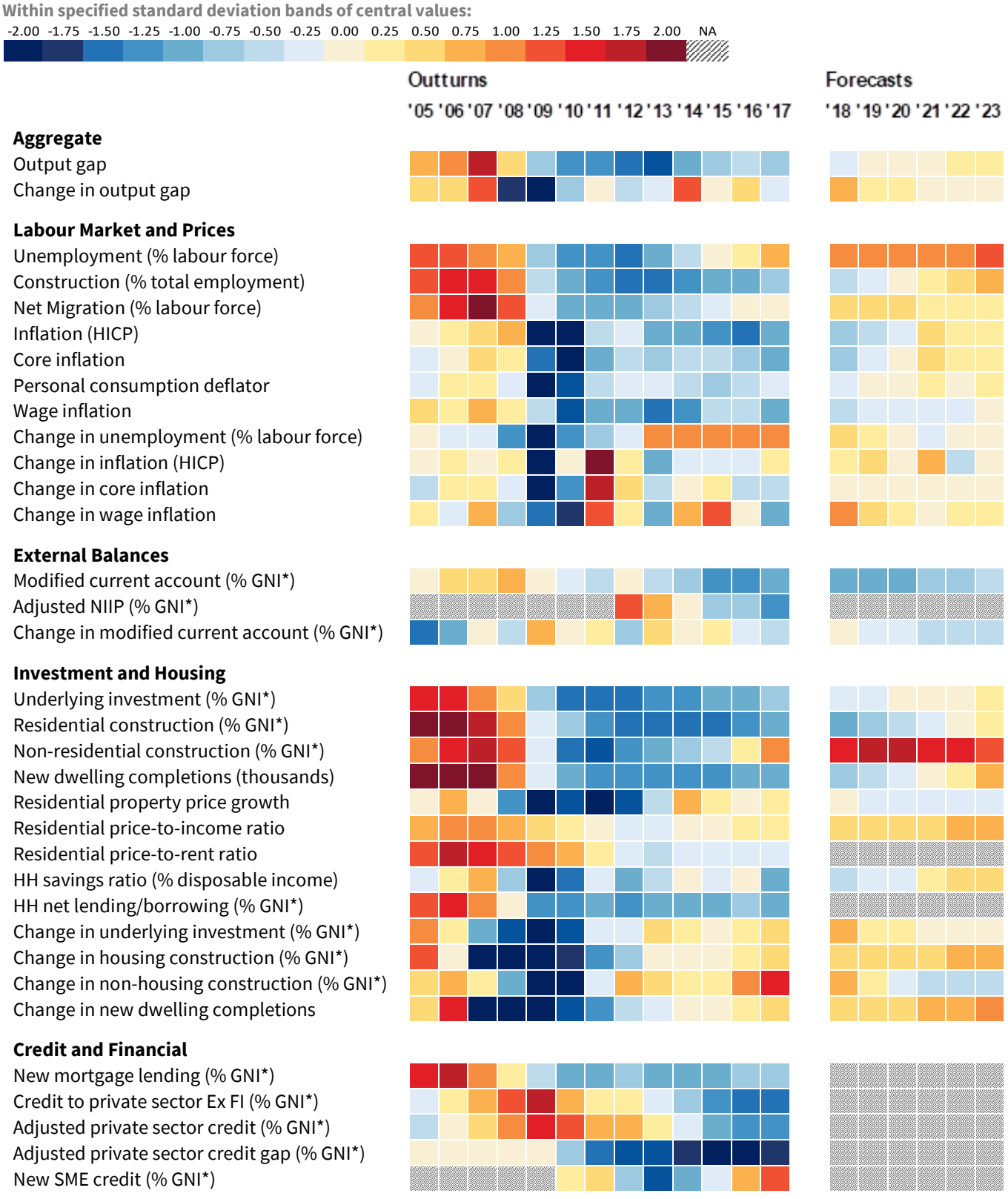
An important caveat to the signals of Figure 2.8 is that it includes forecasts of the Department, which may underestimate possible impacts of overheating.

Labour Market and Prices

Indicators for the labour market based on *Budget 2019* forecasts continue to suggest a relatively benign environment over the forecast horizon. Despite a rapid economic recovery since 2014 (fuelled by strong employment growth), inflation measures have remained muted in Ireland for several years. *Budget 2019* shows limited change to this outlook over the forecast horizon. Hourly wages – having returned to positive growth in 2015 – are expected to grow more rapidly to above 3 per cent from 2020, despite a surprisingly weak growth rate in 2017 of 0.1 per cent. The unemployment rate continues to decline and is forecast to stabilise between 5 and 5¼ per cent.

Forecasts for inward migration show moderation from a projected 1.6 per cent of the labour force in 2019, to a rate averaging 1.2 per cent for 2020–2023. Large migration flows have been evident previously as a feature of Ireland's very responsive labour supply when demand is strong. Analysis of recent flows suggests that a more highly educated and skilled profile of immigrants have been arriving in recent years, when compared with previous episodes of net inward migration for Ireland. Net migration has been closely associated with construction employment in the past (shown in Figure 2.9). Given that this relationship is not reflected in the *Budget 2019* forecasts, there may be upside risks to the Department's net migration forecast, as the additional construction employment does not appear to be facilitated by higher net inward migration. In practice, this demand tends to be met by rapid immigration flows.

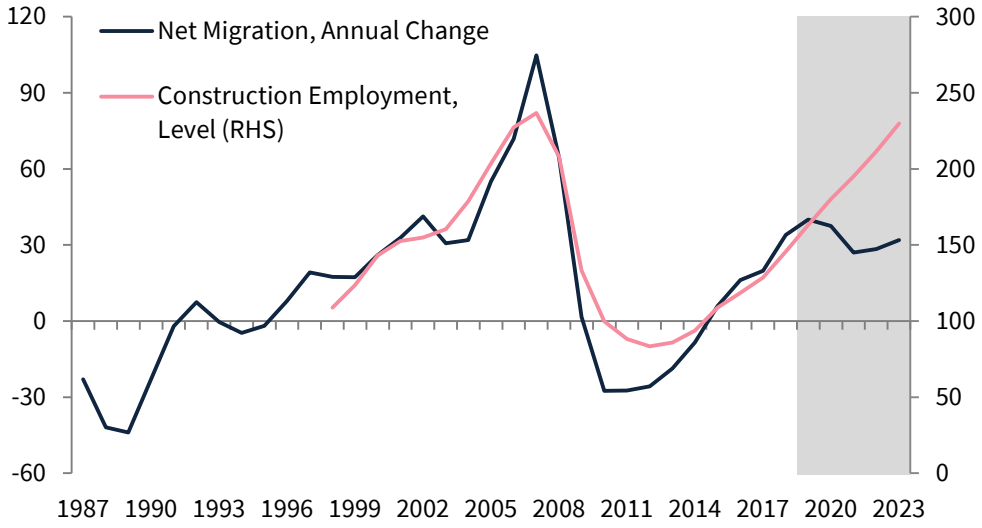
Figure 2.8: Heat map for monitoring potential imbalances in the Irish economy



Sources: CSO; Central Bank of Ireland; Department of Finance (*Budget 2019* forecasts); Department of Environment, Heritage and Local Government; ESRI/PTSB; European Commission (AMECO and CIRCABC); Residential Tenancies Board; and internal IFAC calculations.
Note: See Timoney and Casey (2018).

Figure 2.9: Net migration and construction employment

Thousands



Sources: Department of Finance, *Budget 2019* and *SPU 2018*.

External balances

The modified current account (CA*) measure reached a surplus of 2.8 per cent of GNI* in 2015, moderating to 1.2 per cent by 2017. The Department forecasts a reduction in this balance leading to a modest deficit of 1.1 per cent by 2023. Considering the sectoral balances at play, this declining path for the modified current account is supported by the Department's forecast for a gradual decline in the household savings ratio. However, the expected surplus of the general government would act against this, suggesting an increase in leverage of firms in the private sector is expected over the period.

An alternative measure for analysis of external balances is the net international investment position (NIIP). In order to avoid the distorting influence of sectors such as the International Financial Services Centre (IFSC) and volatile non-financial corporations, these are excluded from the measure. This adjusted NIIP improved from –€90 billion in 2012 to close to +€75 billion in 2017. This improvement reflects higher financial asset values and also the significant deleveraging that has taken place in the economy since 2012.

Investment and housing

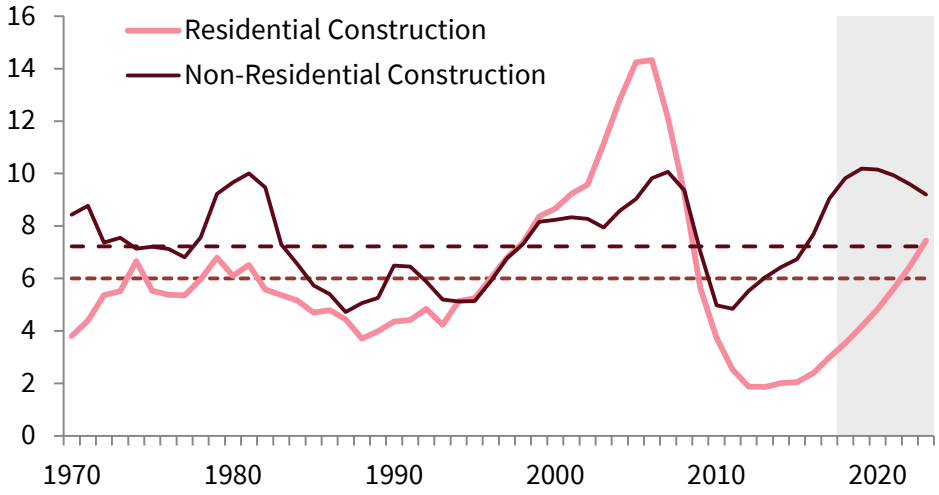
From a low base of activity, residential construction is expected to pick up steadily over coming years. Annual housing completions, officially estimated at close to 14,500 for 2017, are forecast by the Department to increase to close to 50,000 by

2023. This would be at the upper end of estimates of the appropriate medium-term level of housing completions consistent with demand. If the Department's forecasts are realised, this may help to address the undersupply of dwellings seen in recent years.

Figure 2.10 shows that *Budget 2019* forecasts imply residential construction will rise to over 7 per cent of GNI*, above its long-run average, over the forecast horizon, although well below its pre-crisis peak. This may create an imbalance in activity with a skew towards new dwellings construction. This activity is employment intensive and generates significant tax revenues, as well as attracting inward migration. It can therefore pose a wider risk if activity in construction of new dwellings adjusts downwards in future. For non-residential construction, there is also a positive deviation from a long-run average despite usual volatility, which is reflected by the red cells in the heat map. Construction activity should be monitored closely over coming years.

Figure 2.10: Residential and non-residential construction

Percentage of GNI*



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The pre-1995 nominal GNI* series is extended back to 1970 using nominal GDP growth rates. Long-run averages are shown as dashed lines; historically, non-residential building and construction has accounted for a higher average share of national output than residential.

Credit conditions

While credit growth has remained subdued in the aftermath of the previous decade's excesses, flows of capital to the private sector have shown signs of increasing. For small- and medium-sized enterprises (SMEs) overall, new lending has grown by 8.5 per cent in the year to June 2018, increasing by over €400 million to

€5.3 billion. However, core new lending to SMEs (which excludes loans to financial and property sectors), has been quite subdued in the ear to June 2018; at €3.4 billion, it was close to €170 million lower than for the same period in 2017. The increases in new lending to SMEs overall arise mainly due to property-related lending flows. The slowdown in new lending to core SME activity is consistent with recent trends in the Department's survey of SME credit demand, which did not show any increase in the share of firms requesting credit in most recent update (for April to September 2017).[40]

Household lending growth continues to be limited by the introduction of macroprudential rules, particularly aimed at avoiding the over-extension of credit for house purchases by limiting loan-to-value and loan-to-income ratios. Deleveraging has been ongoing, and while overall credit for house purchases has only recently returned to positive-growth territory in 2017, this has been held back by buy-to-let lending which has been in continuous decline since at least December 2011 (when data published by the Central Bank of Ireland begins). For credit advanced to households for principal dwelling purchases, this has been growing since the second quarter of 2016, and has since accelerated to 3.4 per cent as of the second quarter of 2018. Although beginning from a low base, persistent and excessive net growth in credit could destabilise wider economic growth. In particular, if credit growth causes a further acceleration in house-price growth, this could lead to a sudden correction.

[40] Available at https://www.finance.gov.ie/wp-content/uploads/2018/03/180306-SME-Credit-Demand-Survey-April-September-2017.pdf

Chapter 3

Assessment of Budgetary Forecasts

3. Assessment of Budgetary Forecasts

Key Messages

- The general government deficit (excluding one-off items) for 2018 is forecast at 0.5 per cent of GNI*, slightly deteriorating compared to 2017. This comes despite several favourable factors such as strong revenue growth, falling unemployment and declining interest payments. The deterioration in the budget balance is driven by non-interest spending growing at a faster pace (6.4 per cent) than total revenue (4.7 per cent).

- Spending in 2018 was higher than budgeted for, with overruns in the Department of Health and, to a lesser extent, the payment of the Christmas bonus (which had not been budgeted for) mainly responsible. For 2019, primary expenditure is forecast to increase by €4.5 billion. This is to be partially funded by discretionary tax changes.

- In recent years, there has been a persistent pattern of large overruns in health spending. These long-lasting pressures have been largely absorbed through temporary gains from sources like cyclical revenues, unexpected corporation tax receipts or interest savings. Unrealistic health spending forecasts have undermined the credibility of ceilings, leading to higher-than-planned spending.

- Corporation tax receipts as a share of tax revenue in 2018 are estimated to reach record levels, aided by €700 million one-off receipts. This tax head is very volatile and is strongly concentrated in a small number of companies. This, together with changes in the international tax environment, leaves government revenue exposed to shocks.

- For 2019–2023, the general government balance is forecast to improve very gradually, with a surplus of 0.5 per cent of GNI* in 2020, followed by increasing surpluses thereafter. The expenditure forecasts are based on technical assumptions, which are unlikely to reflect actual policy. These assumptions imply an implausible slowdown in expenditure growth and overstate the likely budget balance.

3.1 Introduction

This chapter assesses recent outturns and the latest set of fiscal forecasts produced by the Department of Finance in *Budget 2019*.

The general government balance is forecast to remain in deficit in 2018 and 2019. For 2018, the balance (excluding one-off items) is forecast to deteriorate by €465 million, after excluding once-off payments of €700 million in corporation tax receipts. Expenditure projections after 2019 are based on technical assumptions, the application of which leads to a significant slowdown in expenditure growth, which results in surpluses in later years. These assumptions are unlikely to reflect actual policy.

Strong general government revenue growth is forecast to continue in the coming years. Over 2019–2023, revenue (excluding one-off items) is projected to grow by 4.7 per cent on average, the same rate as in 2017 and 2018. However, primary expenditure (excluding one-off items) is forecast to grow even stronger than revenue in 2018 and 2019 (6.4 and 5.9 per cent, respectively).

The *Budget 2019* plans allocate €0.5 billion each year from 2019 to 2023 to a Rainy Day Fund (also known as the National Surplus Reserve Fund), along with an initial allocation of €1.5 billion from the Ireland Strategic Investment Fund (ISIF). Although these amounts will count as Exchequer spending, they will not impact the general government balance, because these are transfers that remain within the general government sector.

Table 3.1: Summary of Fiscal Outturns and Forecasts (2017–2023)

€ billion, unless stated

	2017	2018	2019	2020	2021	2022	2023
General Government Balance	-0.7	-0.3	-0.1	1.1	2.6	4.2	5.8
General Government Balance (excluding one- offs) [1]	-0.6	-1.0	-0.1	1.1	2.6	4.2	5.8
Total revenue	76.5	80.8	85.2	88.9	92.6	96.6	100.7
Total revenue excl. one-offs [1]	76.5	80.1	85.2	88.9	92.6	96.6	100.7
Total revenue excl. one-offs (% change) [1]	4.7	4.7	6.4	4.3	4.2	4.4	4.2
Total Expenditure	77.3	81.1	85.3	87.8	90.0	92.5	94.9
Total Expenditure excl. one-offs [1]	77.1	81.1	85.3	87.8	90.0	92.5	94.9
Total Expenditure excl. one-offs (% change) [1]	2.9	5.3	5.1	3.0	2.4	2.8	2.6
Interest Expenditure	5.8	5.3	5.0	4.7	4.5	4.8	5.1
Primary Expenditure	71.5	75.9	80.3	83.1	85.5	87.6	89.8
Primary Expenditure excl. one-offs [1]	71.3	75.9	80.3	83.1	85.5	87.6	89.8
Primary Expenditure excl. one-offs (% change)[1]	3.6	6.4	5.9	3.5	2.8	2.6	2.4
Primary Balance	5.1	5.0	4.9	5.8	7.2	9.0	10.9
Primary Balance excl. one-offs [1]	5.3	4.3	4.9	5.8	7.2	9.0	10.9
Nominal GNI* Growth (% change)	3.0	8.1	6.0	5.2	4.2	4.3	4.4

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: [1] One-off items/temporary measures are as assessed by the Council to be applicable, as per Table 1.1, Chapter 1. These one-offs are removed from variables to get a sense of the underlying fiscal position. Rounding can impact on totals. Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which may be unrealistic. Expenditure amounts in 2021 are adjusted to take account of a capital transfer expected to be reclassified to general government.

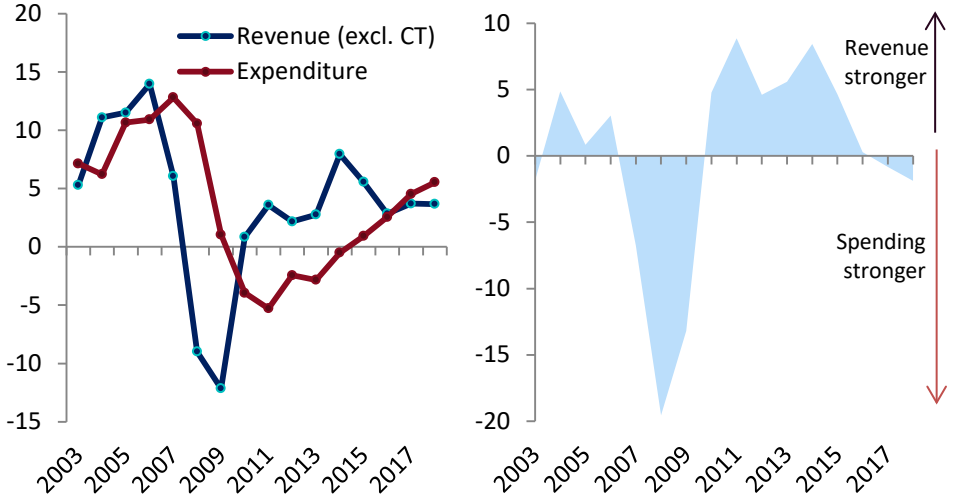
The figures in Table 3.1 differ somewhat from those presented in *Budget 2019*. After *Budget 2019*, Eurostat reviewed the classification of the Eircom No. 2 pension fund and concluded that it should be classified to the general government sector. As a result, a €1 billion capital transfer in 2021, which had been included in *Budget 2019* forecasts, is removed. Removing this distortion implies a smoother path for fiscal projections. As a result of this alteration, the general government surplus and primary surplus are €1 billion higher than presented in *Budget 2019*, as general government expenditure and primary expenditure is €1 billion lower than in *Budget 2019*. This capital transfer relates to pensions of employees of the disbanded Department of Posts and Telegraphs.

3.2 Outturns and Estimates in 2018

The **general government deficit** for 2018 is now forecast to be €0.3 billion, an improvement of €0.4 billion from 2017. However, excluding one-off payments of €0.7 billion in corporation tax, the deficit for 2018 is €1.0 billion and represents a deterioration of €0.5 billion from 2017. This comes despite strong cyclical revenue growth, declining unemployment, and falling interest payments (€0.5 billion lower than last year). The €0.7 billion one-off corporation tax receipts are driven by two elements. First, the adoption of new accounting standards, which affect the timing of the payments of the receipts. Second, non-recurring improvements in profitability / trading conditions from other Revenue clients.

Excluding one-off items, the deficit is €0.2 billion larger than forecast in *SPU 2018* in April. Forecasts of both revenue and expenditure have been revised up since *SPU 2018* (by 0.8 billion and €1.1 billion, respectively). These revisions are mainly due to: (i) higher-than-expected corporation tax receipts (even after a one-off payment is accounted for); (ii) overruns in health spending; and (iii) the payment of the Christmas bonus (which, once again, had not been budgeted for).

Figure 3.1: Revenue (Excluding Corporation Tax) and Expenditure



Sources: Department of Finance; and internal IFAC calculations.
Note: Expenditure is expressed in total gross voted terms; revenue is shown in Exchequer revenue terms excluding corporation tax. Figures for 2018 are as per *Budget 2019.*

Figure 3.1 shows underlying revenue and expenditure trends. In the past 15 years, Exchequer revenue growth—excluding the highly volatile corporation tax revenue—has generally outpaced gross voted spending. The two periods where this has not been the case are the crisis years (2007–2009) and the current period (2017–2018,

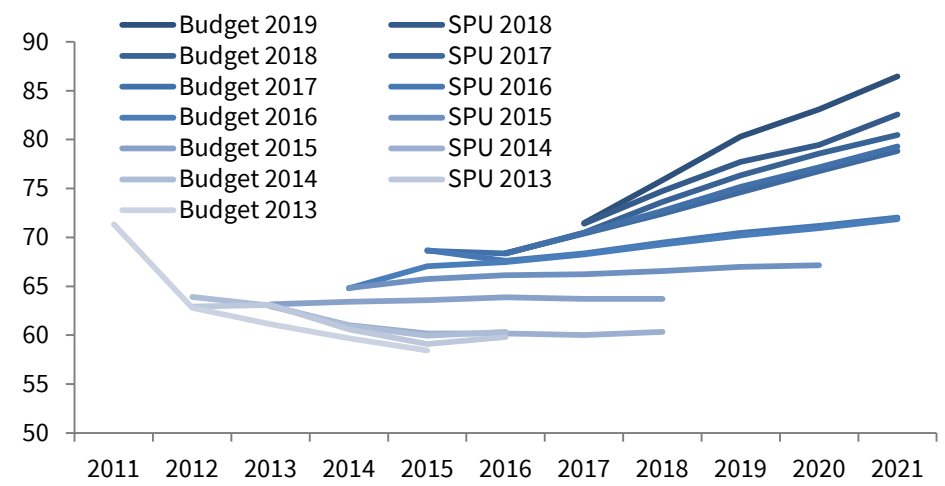
see Figure 3.1B). This does not seem to match a strong cyclical upswing in the economy in recent years. The lack of improvement in the budget balance in the last three years partly reflects the fact that expenditure growth has accelerated since 2016, while revenue growth (excluding corporation tax) has been relatively flat.

The **primary balance** (excluding one-off items) is forecast to deteriorate in 2018 (surplus of 2.2 per cent of GNI*) relative to 2017 (2.9 per cent of GNI*). This is a consequence of non-interest spending growing at a faster pace (6.4 per cent) than total revenue (4.7 per cent).

General government **primary expenditure** (excluding one-off items) is set to grow by €4.6 billion in 2018. The main items driving this growth are gross fixed capital formation (€1.4 billion), compensation of employees (€1.3 billion) and intermediate consumption (€1.1 billion). This estimated growth is faster than anticipated in *SPU 2018* forecasts, and is mainly accounted for by stronger growth in current spending. This upward revision to primary spending is consistent with the pattern of revisions to spending seen in recent years. Figure 3.2 shows various vintages of forecasts of primary spending; one can see there has been a tendency for spending to drift up as the cyclical recovery takes hold.[41]

[41] Forecasts for spending at the end of the forecast horizon may have been somewhat unrealistic (i.e., low) prior to *Budget 2016* which may exaggerate the extent of upward revisions somewhat.

Figure 3.2: Vintages of General Government Primary Spending



Sources: Department of Finance.
Note: Primary expenditure excludes interest payments. Prior to *Budget 2016*, spending forecasts were made on the unrealistic assumption of fixed nominal spending for most items. Since then, forecasts have been made on a realistic basis, and so upward revisions to spending more clearly show the upward drift in spending plans.

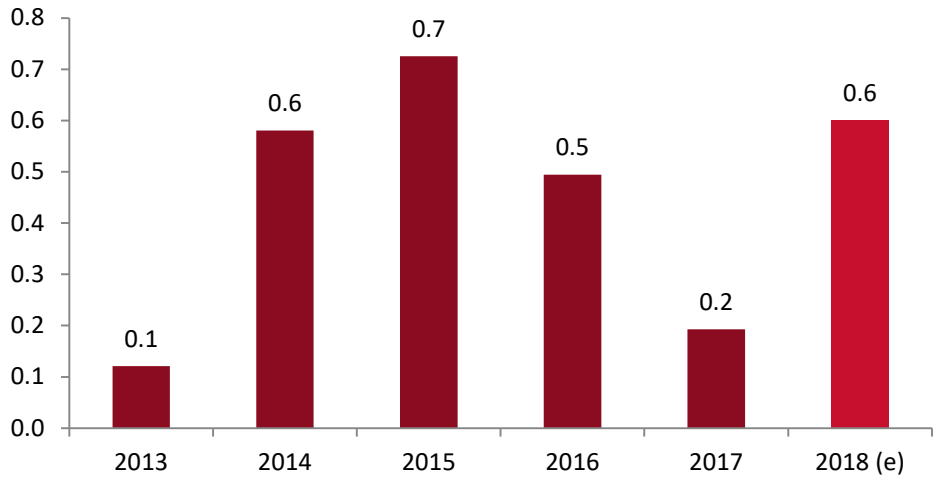
The main contributor to higher-than-expected expenditure in 2018 to date is current expenditure in the Department of Health. To the end of October, gross voted current spending in the Department of Health is €368 million above profile. On Budget day, the Minister confirmed that a €700 million supplementary estimate would be needed for the Department.[42,43] This comes in addition to an increase of €685 million for 2018 that had originally been budgeted for as part of *Budget 2018*. Higher-than-budgeted spending has been a recurring issue for the Department of Health, resulting in "within-year" increases and supplementary estimates (Howlin, 2015). A combination of unrealistic forecasting and an anticipated relaxation of health spending ceilings is likely to have reinforced the "soft budget constraint" (see Box D for more details). Figure 3.3 shows the persistent current spending overruns in the Department over the past six years. Of these, the expected €600 million overspend this year is among the largest in recent years (Figure 3.3).

[42] "This year I will allocate an additional €700 million by way of a supplementary estimate, bringing the total additional 2018 investment to €1.2 billion." As well as overspending, revenue from private patients is set to be lower than anticipated. Financial statement, available at: http://budget.gov.ie/Budgets/2019/Documents/Financial%20Statement_C.pdf

[43] As well as overspending, revenue from private patients is set to be lower than anticipated.

Figure 3.3: Health Overruns

€ billion



Sources: Department of Public Expenditure and Reform, Analytical Exchequer Statements; and internal IFAC calculations.
Note: Overruns are shown in terms of gross voted current spending and are derived from end-December Analytical Exchequer Statements outturns less profiles. The 2018 figure shows the expected overrun for the year.

Other than the Department of Health, current spending is broadly on profile for the first ten months of the year. Gross voted capital spending is €345 million lower than profile for the first ten months, with underspends in Housing, Planning and Local Government; Transport, Tourism and Sport; and Education and Skills mainly responsible for this underperformance.

Box D: Health Overruns

In recent years, there has been a persistent pattern of large overruns in health spending. A combination of unrealistic forecasts and repeated relaxation of ceilings have repeatedly led to uncontrolled increases in spending, which can put the public finances at risk. Over the period 2014–2017, these overruns have averaged €0.5 billion per year (in current spending terms). In 2018, the Government expects a health spending overrun of €0.6 billion, one of the largest overspends in recent years.[44] This implies that the 2018 outturn is now expected to be 9.3 per cent higher than the ceiling set in the previous Budget. In light of previous experience, the *Budget 2019* forecasts for 2019–2021 may not be realistic.[45]

This box highlights important issues with health overruns, namely: (i) the way these long-lasting increases in expenditure have been generally absorbed by unexpected, transient gains from the cycle; (ii) the budgetary implications of spending peaks taking place late in the year; and (iii) the underlying deficiencies that are driving this pattern of large overruns.

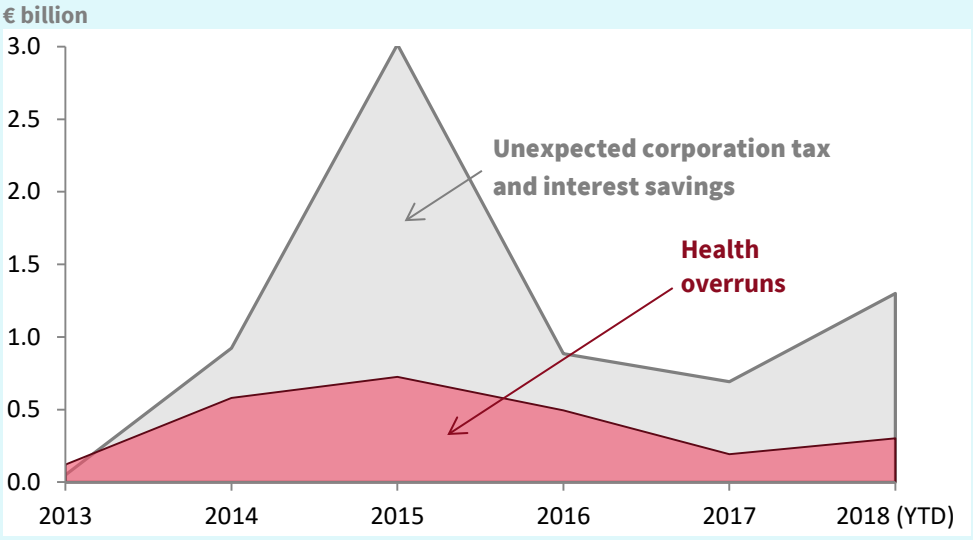
[44] The expected total overrun for 2018 is €0.7 billion, of which €0.6 billion relates to current spending, and the remaining €0.1 billion relates to capital expenditure and a shortfall in Departmental receipts.

[45] For 2019, the current health ceiling is forecast to growth by 5.8 per cent. For 2020–2021, current health spending is forecast to grow by less than 1.0 per each year, which appears too modest compared with the trends in the last years.

Long-lasting health pressures are being masked by temporary gains

Since 2013, the impact of health overruns on the deficit has been masked by unexpected gains from corporation tax and interest savings, both of which may well be temporary. Figure D.1 shows that, in 2013–2017, the current health overspends (averaging €0.4 billion per annum) were outweighed by unexpected corporation tax receipts (averaging €0.8 billion) and unexpected interest savings (averaging €0.3 billion).

Figure D.1: Health Overruns Masked by Unexpected Corporation Tax and Interest



Sources: Department of Finance, Analytical Exchequer Statements; and internal IFAC calculations.
Note: Overruns are shown in gross voted current spending terms. All figures are derived from the end-December Analytical Exchequer Statements outturns less profiles. 2018 shows data to end-October.

The volatility and strong concentration of corporation tax in Ireland—where the top 10 companies account for roughly 40 per cent of all corporation tax receipts—implies that unexpected revenues from this source should be deemed as transient.[46] Similarly, unanticipated interest savings over the last years are a result of changes in the external environment, which may prove temporary in nature.

To the extent that gains are temporary or cyclical, these should not be used to mask ongoing health overruns. Doing so risks a repeat of the pro-cyclical policy mistakes of the past. Instead, pressures in the health sector should be absorbed through sustainable tax revenues or decreases in spending categories elsewhere.

Overruns late in the year imply higher carryover costs

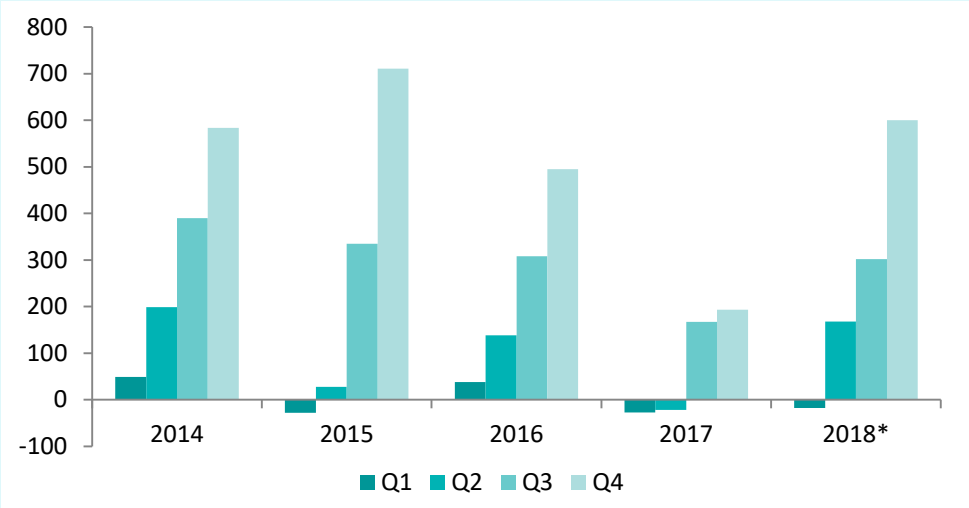
Recent trends have shown health spending ramping up in the second half of the year, especially in the last quarter (Figure D.2). This is the case, yet again, in 2018, when half of the expected current spending overrun in 2018 is to take place just in the last quarter.[47] However, it is worth noting that the later the overrun occurs within the year, the less time there is to adjust spending in the remainder of the year. This also triggers larger spending carryovers in the following year.

[46] The June 2018 *Fiscal Assessment Report* (IFAC, 2018c) provided a stylised scenario on the direct impact of a large firm leaving Ireland. This exit was estimated to trigger a reduction of government revenues by over €330 million, close to half a per cent of total revenue in 2016 (and higher than the current health overspend of 2017).

[47] While the first three quarters of 2018 have seen an overrun of €0.3 billion in current terms, the expected overrun for the last quarter is €0.3 billion.

Figure D.2: Health Overspends Tend to Ramp Up Late in the Year

€ million (cumulative), per quarter



Sources: Department of Finance Analytical Exchequer Statements; and internal IFAC calculations.
Note: Overruns are shown in terms of gross voted current spending and are derived from the monthly Analytical Exchequer Statements outturns less profiles. * The 2018 figure for Q4 is an IFAC estimate.

A key driver of this pattern in the timing of overspends is related to staff recruitment. As noted in Connors (2018a), recruitment in each of the last quarters of 2015–2017 by the Health Service Executive has averaged 1,432. This represents 40 per cent of the annual increase in employment over just a three-month period. As in previous years, an important part of the 2018 overrun is likely to be unplanned increases in staff.[48] As new recruits have commenced work at different stages in 2018, the full-year cost of employing them will only be realised in full in 2019. This means that the overrun will imply carryover costs into 2019, more so because of the late timing. The Department currently estimates that these carryover costs into 2019 will amount to €0.3 billion, implying a €1.1 billion full-year cost of the overruns this year.

These timing effects, if not accounted for properly, can have important implications. For example, the 2018 carryover costs narrow the budgetary resources available for 2019. This is partly reflected in the increased ceiling forecast for 2019 since July's *Mid-Year Expenditure Report 2018* (estimated at €15.0 billion) relative to the latest ceiling established in *Budget 2019* (€16.4 billion, in gross current terms). This implies a revision in the ceiling of €1.4 billion for next year in just three months.

Health budgets should be well-founded and credible

The budget overruns in recent years largely reflect significant deficiencies in health spending management, including:

1. **Weak planning**: spending plans are not accurately accounting for increasing cost pressures and demand for health services; and
2. **Weak spending controls:** day-to-day health spending is not sufficiently constrained throughout the year.

[48] Connors (2018b) notes that the Health Service Executive is required to produce a Pay and Numbers Strategy every year including detailed information on the number of staff to be hired along the year. However, these reports have tended to be submitted very late in the year. For example, a revised version of the document for 2016 was submitted in December 2016, which looked to significantly increase the end-2016 staffing number. This was done despite not having the resources to undertake such increases. In 2017 and 2018, submissions took place in November and August, respectively.

The combination of weak planning and weak spending controls has led to a "soft budget constraint" problem. That is, providers of health services anticipate that yearly spending ceilings will be relaxed at a later stage with little opposition, and this weakens the incentive to stay within initial spending targets (Howlin, 2015). When this happens persistently, it can lead to uncontrolled increases in spending and budget plans can lose credibility. If spending overruns are likely to be long-lasting (e.g., when permanent staff are unexpectedly recruited), but are funded by temporary revenues, the sustainability of public finances can be put at risk. When temporary revenues disappear, the long-lasting spending overruns will remain and will lead to deteriorations in the government balance, unless those costs are offset by new tax-raising measures or savings elsewhere.

Turning to **general government revenue** for 2018, this is estimated to amount to €80.8 billion. This is €1.5 billion higher than in *SPU 2018*, largely driven by taxes on income and wealth arising from higher-than-expected corporation tax receipts. In light of recent revenue growth, it is worth exploring what has driven growth in general government revenue.

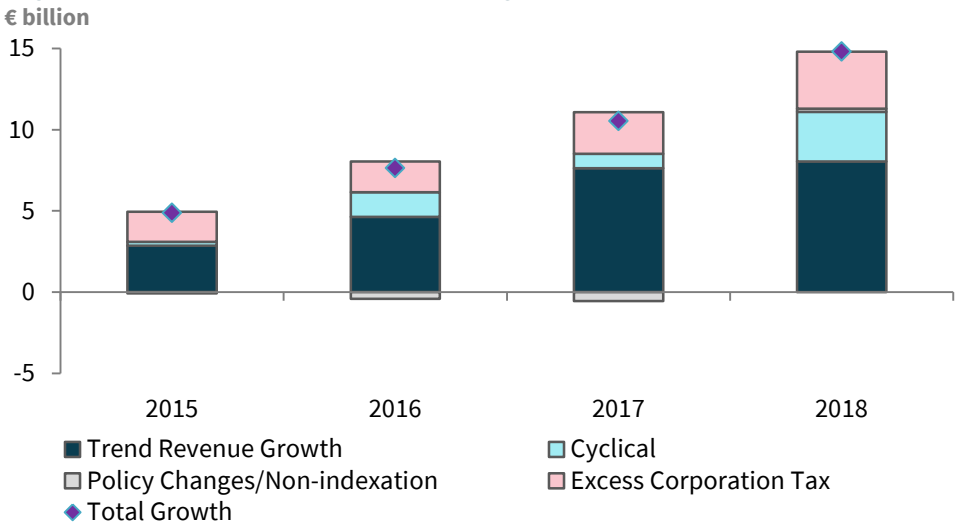
Examining the sources of recent changes in revenue

As an illustrative example, Figure 3.4 attempts to quantify the various contributors to revenue growth since 2014. *Budget 2019* forecasts of general government revenue for 2018 are almost €15 billion above 2014 levels. The increases in revenue are broken into four categories:

1. Trend revenue growth: this refers to increases in revenue driven by normal trend growth, rather than cyclical growth, corporation tax surprises or tax policy changes. It is calculated as a residual after accounting for the three other factors described below.
2. Cyclical revenue: this refers to the extra revenue collected due to the growth in activity associated with the cyclical upturn experienced over these years. This is calculated using the Department's preferred alternative output gap estimate.
3. Policy changes/non-indexation: this refers to the direct impact of tax policy changes on revenue over these years. Estimates are taken from Budget documentation. This also includes non-indexation of tax bands and credits, which increases revenue relative to a scenario where these bands and rates are raised in line with inflation.
4. Excess corporation tax: this refers to corporation tax in excess of what might have been anticipated. To calculate what might have been

anticipated, the 2014 outturn is taken as given, with the subsequent years assumed to grow in line with nominal GNI*.

Figure 3.4: Contributions to Changes in Revenue since 2014



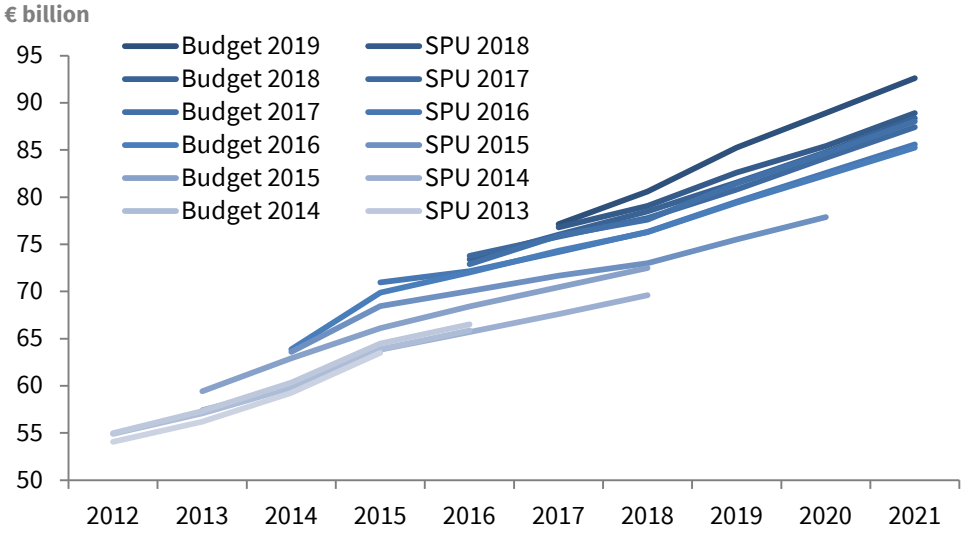
Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Cyclical revenue is calculated using changes in the output gap. Policy changes/non-indexation reflects tax policy changes introduced over the period, as described in Budget documentation as well as the extra revenue generated from not indexing tax bands and credits. Excess corporation tax is measured as corporation tax receipts minus what would be expected if they were to grow in line with GNI*.

The €15 billion revenue increase from 2014 to 2018 can be attributed to the following components. Trend growth in revenue accounts for just over half of the overall change in revenue (€8 billion). Cyclical revenues contribute €3 billion, with excess corporation tax receipts contributing €3.5 billion to revenue growth. Policy changes/non-indexation contributed positively (€0.2 billion) to revenue also over the period. So while trend growth has accounted for over half of the change in revenue in this period, there have been significant contributions from the cyclical upturn and surprise corporation tax receipts. Tax policy changes made a small positive contribution to revenue over the period.

One concern is that estimates of medium-term revenue get revised procyclically as revenue comes in. This implies that revenue forecasts get revised up in good times. But correspondingly, it implies that revenue forecasts would be revised down in bad times. Looking at budget and SPU publications in recent years, there is evidence of general government revenue forecasts being revised up (Figure 3.5) as cyclical conditions improve and as surprise corporation tax receipts are received. For 2019, revenue projections—adjusted for discretionary revenue changes—are now some

€9.7 billion stronger than first forecast in *SPU 2015*. Even for 2021, revenue projections are around €7 billion higher than forecast in *Budget 2016*. This underlines the likely cyclical characteristics of some part of forecast revenue growth.

Figure 3.5: Vintages of General Government Revenue



Sources: Department of Finance; and internal IFAC calculations.
Note: Data are adjusted to account for discretionary tax policy changes (not including the impact of non-indexation of tax bands and credits).

Exchequer Tax Revenue and PRSI Developments

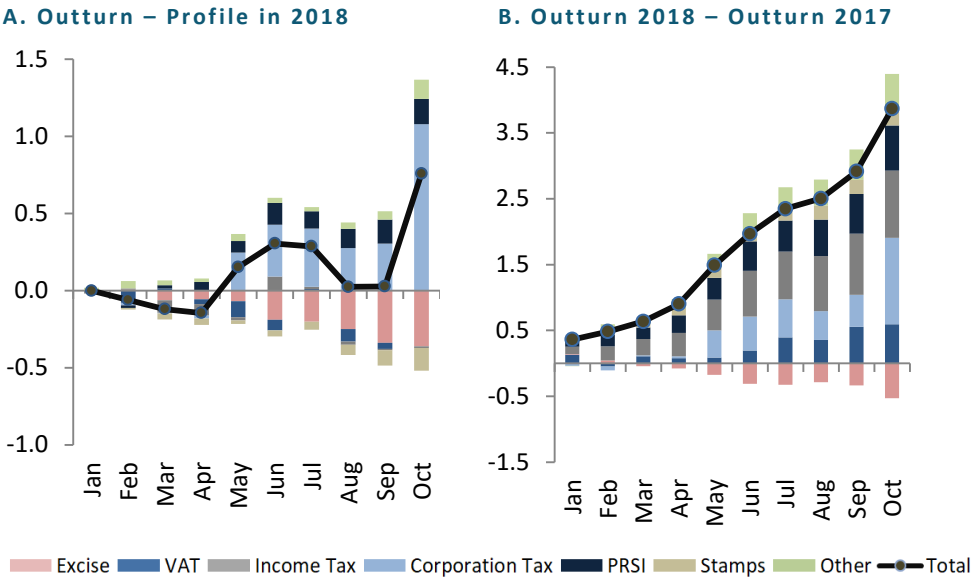
In terms of **Exchequer tax revenue**, this is estimated at €55.1 billion in 2018, €0.9 billion higher than estimated in *SPU 2018.* This boost arises from the substantial overperformance of corporation tax revenue, mainly driven by unexpected one-off receipts of €0.7 billion. Separately, **PRSI** contributions, which are paid into the Social Insurance Fund, are expected to amount to €10.2 billion in 2018.

For the first ten months of the year, cumulative receipts including PRSI are €0.8 billion above target (Figure 3.6A). The main drivers of this outperformance are corporation tax and PRSI contributions, which have more than offset underperforming excise duties and stamp duties. Figure 3.6B shows that the outturns for the year to end-October are cumulatively €3.9 billion higher than in end-October 2017, with excise duties being the only tax head with annual negative growth.[49]

[49] The main driver of this annual increase is corporation tax (+1.3 billion), followed by income tax (+€1.0 billion), PRSI (+€0.7 billion) and VAT (+€0.6 billion).

Figure 3.6: Tax Revenue and PRSI

€ billion (cumulative)



Sources: Department of Finance; and internal IFAC calculations.
Note: Data as per the monthly Analytical Exchequer Statements. Other includes capital taxes, motor tax and other unallocated tax receipts.

For the year to October, **corporation tax** receipts are €1.1 billion (or 19.1 per cent) higher than previously forecast, and €1.3 billion (or 24.3 per cent) higher than in the same period last year. For the end of 2018, *Budget 2019* projects an overperformance of €1.1 billion in corporation tax receipts (relative to *Budget 2018* and *SPU 2018*). This is cited as being driven by one-off receipts (€700 million) and other unexpected, yet recurring, receipts related to improved profitability / trading conditions (€400 million). The one-off revenue is mainly related to two components: (i) timing issues in some payments, particularly in relation to the adoption of new accounting standards by some firms (€300 million); and (ii) non-recurring improved profitability / trading conditions from other Revenue clients (€400 million).[50,51]

If the projections for 2018 materialise, corporation tax receipts as a share of total Exchequer tax revenue will be at a record level of 17.4 per cent in 2018. As shown in Figure 3.7, this is well above the previous peak of 16.4 per cent in 2002. However, the Council notes that receipts from this tax head are very volatile and highly

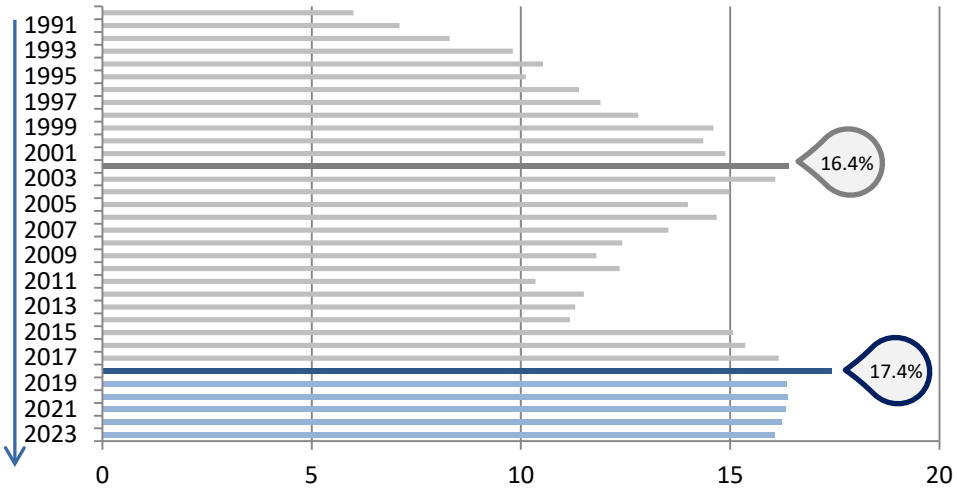
[50] The new accounting standards relate to the International Financial Reporting Standard (IFRS 15). Over time, the impact is expected to be cash-neutral (i.e., the surge in revenues in 2018 is expected to be offset by lower revenues in future). Of the cumulative outperformance to date, €0.3 billion relates to the IFRS 15 received in May.

[51] Receipts for the month of October are €773 million higher than profiled, which the Department of Finance attributes to improvements in profitability / trading conditions.

concentrated in a small number of companies. This, together with changes in the international tax environment, can leave government revenues exposed to shocks.

Figure 3.7: Corporation Tax (% Revenue) in 2018 at Record Levels

% of total Exchequer tax revenue (horizontal axis)



Sources: Department of Finance; and internal IFAC calculations.
Note: The shares for 2018–2023 are based on *Budget 2019* estimations/projections.

Income tax receipts to end-October are cumulatively strong in annual terms—higher than in 2017 by €1 billion or 6.7 per cent—and are broadly in line with *Budget 2018* forecasts. In terms of **PRSI**, receipts since March are higher than initially forecast (+€163 million in cumulative terms to end-October). This reflects a strong labour market, where employment and earnings growth are estimated to amount to 3.0 per cent and 2.4 per cent, respectively, this year.[52] Compared to the first ten months of 2017, PRSI contributions are now €688 million (8.1 per cent) higher. Since last year, PRSI revenue has been higher than forecast for almost all months.

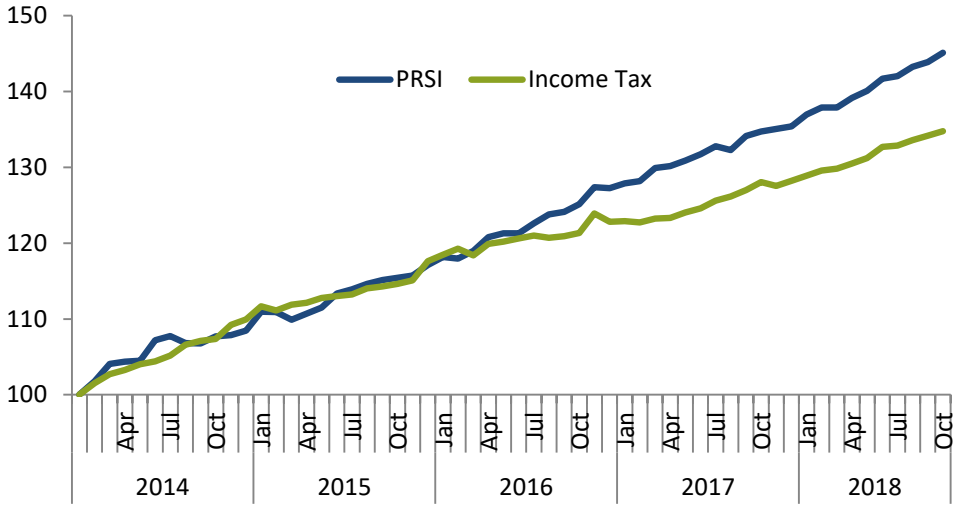
Figure 3.8 shows that the gap in growth between PRSI and income tax has widened since mid-2016. Income tax is comparatively weaker given a number of recent discretionary changes (including rate cuts and changes in tax bands), which have triggered revenue being foregone from this tax head.[53] As a result of this, PRSI gives a better indication of the recent strength in the labour market.

[52] Employment growth for 2018 has been revised up from 2.7 per cent in *SPU 2018* to 3.0 per cent in *Budget 2019.* Compensation per employee, however, showed more moderate growth in *Budget 2019* (2.4 per cent) relative to *SPU 2018* (2.6 per cent).

[53] In *Budget 2019*, the new measures include an increase of €750 in the income tax standard rate band for all earners, from €34,550 to €35,300 for single individuals and from €43,550 to €44,300 for married one earner couples. In addition, an increase in the Home Carer Tax Credit has been

Figure 3.8: PRSI Growth Outstripping Income Tax Growth

Index of 12-month-rolling sum, January 2014 = 100

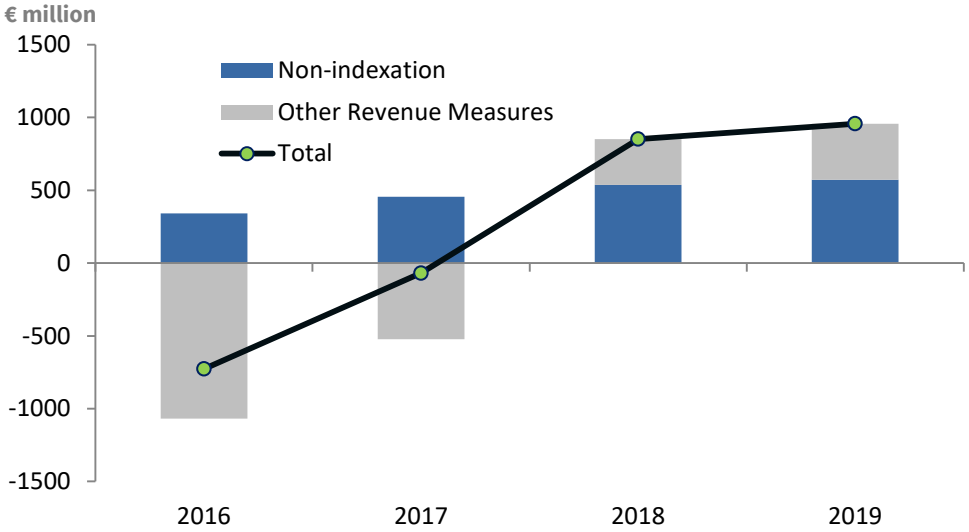


Sources: Department of Finance; and internal IFAC calculations.
Note: Data shown up to end-October 2018.

Recent years have seen a number of policy measures introduced on the revenue side. These include: (i) non-indexation of tax thresholds (additional tax revenues that are generated as people move into higher rate bands); and (ii) other measures. Figure 3.9 shows that the net impact of such measures reduced revenue in 2016 (by €700 million), while the figures for 2018–2019 show that these measures will increase revenue (by €850 million and €960 million, respectively). While the positive contribution of non-indexation has remained relatively stable at roughly €500 million since 2016, the impact of other discretionary revenue measures only became positive in 2018. This positive impact of discretionary revenue measures other than non-indexation is also projected to remain in 2019.

introduced from €1,200 to €1,500, together with an increase in the Earned Income Credit from €1,150 to €1,350.

Figure 3.9: The Impact of Revenue Policy Measures



Sources: Department of Finance; and internal IFAC calculations.
Note: Non-indexation reflects the increase in tax revenues due to tax thresholds not being indexed so that, as income rises, additional tax revenues are generated. Other Revenue Measures shown include both discretionary revenue measures introduced that year as well as the carryover impact of measures introduced in previous years. The 2018 estimate and 2019 projections are as per *Budget 2019*.

Excise duty receipts to end-October are €361 million (or 7.6 per cent) lower than expected, and 10.7 per cent lower than in the same period last year. This is, in the main, driven by previously anticipated purchases of tobacco products in advance of the introduction of the plain-packaging in 2017.[54] This poor performance has triggered a €0.2 billion downward revision in *Budget 2019* relative to *SPU 2018.*[55]

Figure 3.10A shows how excise duty forecasts have compared to actual outturns since 2005. The two most recent peaks, in 2016 and 2017, are related to new packaging regulations on tobacco products. The 2016 boost largely reflects EU requirements to modify the design of tobacco packages to discourage tobacco consumption.[56] Stocks were built up in anticipation of the measure, which explains the downward trend that followed after that (Figure 3.10). After this measure, the Domestic Plain-Packaging Initiative was introduced in end-September 2017.[57]

[54] To a lesser extent, the Department of Finance also attributes this shortfall to lower-than-expected excise duties arising from a decreasing petrol demand. This is partly the result of improved efficiencies in cars and an increased demand of hybrid or electric cars.

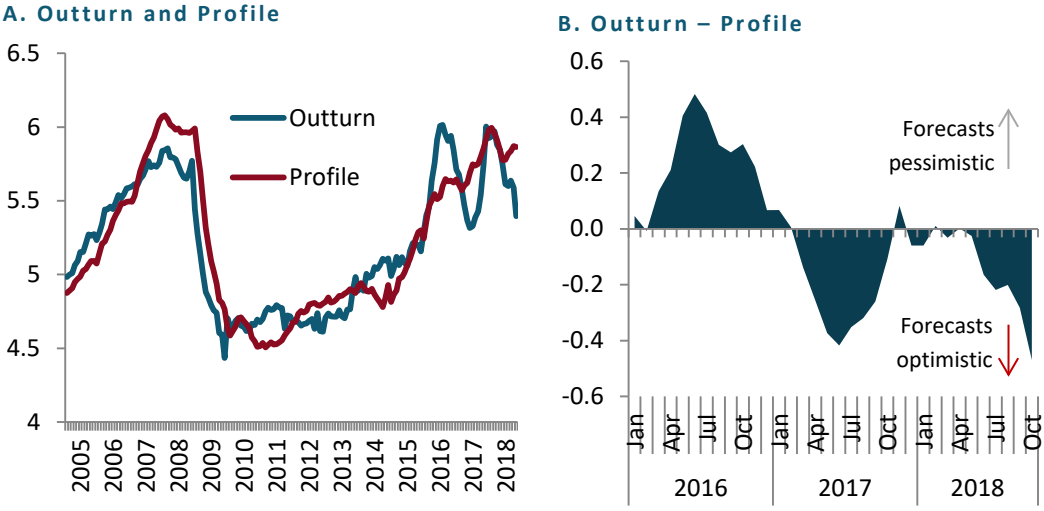
[55] It is worth noting that the downward revision since *SPU 2018* is lower than the cumulative underperformance to end-October. This relies on the Department of Finance's assumption that lower-than-expected receipts to date, mainly related to tobacco products, will unwind by the end of the year.

[56] This refers to the EU Tobacco Warning Directive. While this regulation came into force in May 2016, manufacturers and retailers had one year to replace non-compliant stock items.

[57] This measure established that non-plain tobacco products could be marketed for a period of one year (i.e., until 30th September 2018).

Purchases of tobacco products then followed a similar pattern as in 2016, with excise duties reaching roughly the same amount as in the 2016 peak (see 12-month-rolling sum outturns in Figure 3.10A). After this, forecasts for the vast majority of 2017 and 2018 to date have been overly optimistic (in full-year rolling-sum terms). Figure 3.10B suggests that forecasts for 2018 did not capture the similar behavioural patterns that had been seen in 2016 and in part of 2017.

Figure 3.10: Excise Duties
€ billion (12-month-rolling sum)



Sources: Department of Finance; and internal IFAC calculations.
Note: Data shown up to end-October 2018.

VAT receipts are broadly in line with expectations for the year to end-October. In year-on-year terms, solid growth of 5.3 per cent (or €592 million) has been recorded for the first ten months of the year. This reflects strong personal consumption expenditure, estimated to grow at 5.1 per cent in 2018 in nominal terms (see Appendix E).

Stamp duties have performed substantially worse than forecast. The cumulative underperformance to end-October amounts to €149 million (or 10.9 per cent), with monthly receipts being persistently lower than profile. This largely reflects the overoptimistic yield expected to take place in 2018 as a result of a measure introduced in *Budget 2018* to increase the stamp duty rate on non-residential property. The Department of Finance notes that the "non-linear" nature of this tax source—where delays in completing major transactions such as property sales or merger and acquisitions have an impact on the timing of the receipts within the year—hinders the accuracy of the monthly forecasts. While the year-on-year

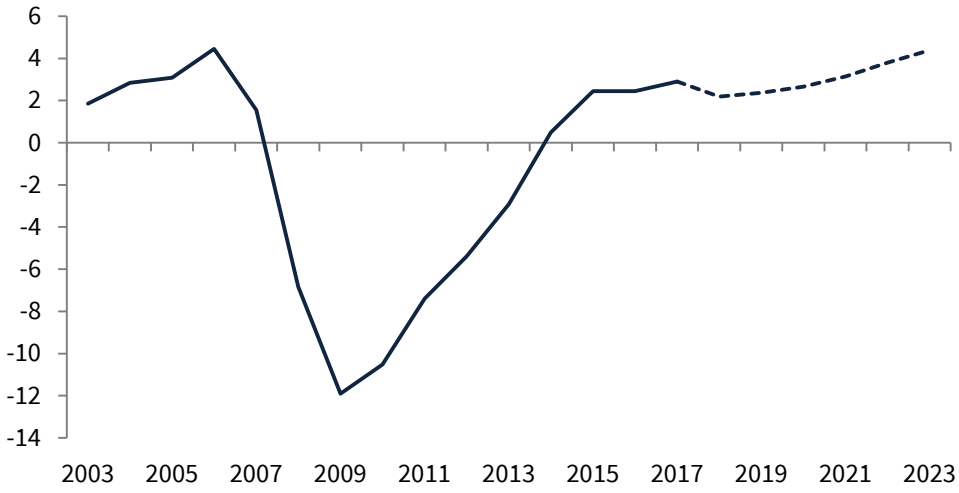
performance is very strong (23.3 per cent higher than for the same period last year), there is a revenue shortfall. As previously signalled by the Council, well-founded costing analysis should serve as the basis of realistic forecasts, and these should be subject to independent scrutiny.

3.3 Forecasts for 2019–2023

2019 – 2023 general government balance

Budget 2019 forecasts the general government balance to improve in 2019 (by €240 million in headline terms, and €940 million after correcting for one-off items). This improvement is aided by falling interest payments (down by €305 million compared to 2018). However, the underlying primary balance forecast for 2019 (2.4 per cent of GNI*) is the same as in 2015 (Figure 3.11). This comes despite several factors which would typically lead to an improvement in the intervening years, with strong recent economic growth set to continue, and with the unemployment rate forecast to fall further in 2019.[58] Rapid growth in expenditure—only partially funded by revenue-raising tax changes and the non-indexation of tax bands and credits—is mainly responsible for the lack of improvement in the budget balance in recent years.

Figure 3.11: Primary Balance
Percentage of GNI*, excluding one-off items



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Dashed line indicates forecasts from *Budget 2019*.

In the later years of the projections (2020–2023), the general government balance and the primary balance are projected to improve significantly. However, this is based on expenditure figures which rely on technical assumptions. These assumptions are unlikely to reflect actual policy and are described below. Revenue forecasts for the same years are much more informative as they are based on continuing existing policies in a way that is likely to broadly reflect reality.

[58] *Budget 2019* forecasts indicate the unemployment rate will fall by 0.6 percentage points in 2019.

Based on these assumptions, the general government balance is projected to move into surplus in 2020 (€1.1 billion), with increasing surpluses thereafter. Forecasts of the general government surplus in 2020 and 2021 have been revised up slightly since *SPU 2018*. Both revenue and expenditure have been revised up for 2019–2021 relative to *SPU 2018*, both in terms of levels and growth rates.

2019 expenditure

In 2019, general government expenditure is forecast to increase by €4.2 billion. This comes despite interest payments falling by €0.3 billion. This means that primary expenditure (i.e., expenditure net of interest payments) is forecast to grow by €4.5 billion (5.9 per cent). In addition to this very large increase in planned expenditure, there are factors which could push this figure even higher than forecast. For example, health spending has exceeded expenditure forecasts for the past number of years. While significant increased funding has been provided for in the latest set of forecasts, previous experience suggests overruns are likely (see Box D).[59]

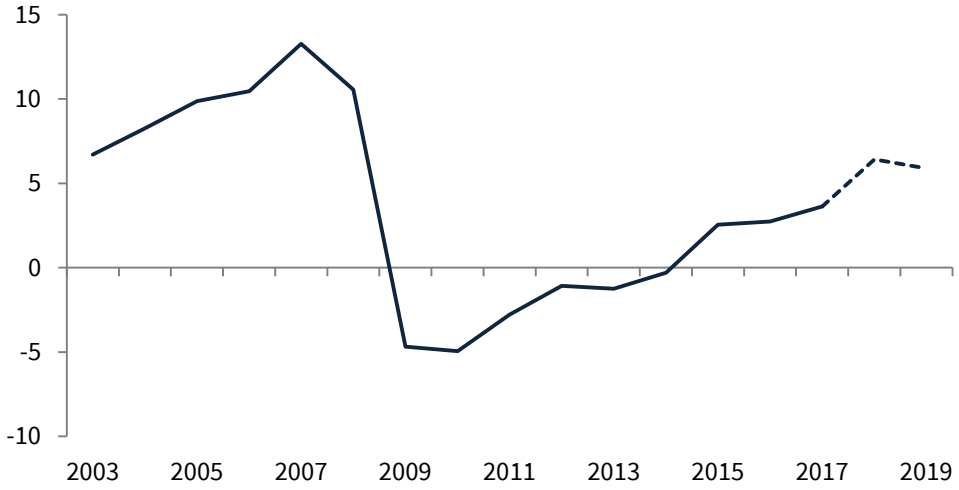
The Christmas bonus has, again, not been budgeted for in 2019, despite this payment having been made to varying degrees over the past five years. Throughout this period, the payment has not been budgeted for, with a decision on the scale of the payment being made late in the year. This year, the bonus is to be paid for a full week, with a cost of €265 million. In the interest of good budgetary planning and to avoid a pattern of spending decisions based on cyclical developments (as occurred in the past), budget estimates should account for the payment of the bonus unless the Government genuinely does not intend to pay it.

Compensation of employees is set to increase by €1.1 billion in 2019, driven by increased headcount and pay increases. Intermediate consumption (€1.9 billion) and public gross fixed capital formation (€0.9 billion) are both set to contribute strongly to expenditure growth next year.

[59] The latest gross current expenditure ceiling for the health group in 2019 is €896 million higher than the 2018 figure, which itself has been revised up by €666 million due to the anticipated supplementary estimate.

Figure 3.12: Primary Expenditure Growth

Percentage change (year-on-year), excluding on-off items



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Primary expenditure equals total expenditure less interest repayments on government debt and one-offs. One-offs are those defined by the Council as applicable.

Strong expenditure growth forecast for 2019 comes after substantial increases forecast for 2018. Primary expenditure growth is set to be 12.4 per cent higher in 2019 than in 2017. Gross fixed capital formation is forecast to record the strongest growth (44.5 per cent), and large contributions from intermediate consumption (30.6 per cent) and compensation of employees (11.4 per cent) are also projected. Figure 3.12 shows primary expenditure growth accelerating in recent years, getting closer to rates last seen in the early 2000s.

2020 – 2023 Expenditure

For the years 2020–2023, expenditure forecasts in *Budget 2019* are based on the following technical assumptions. Voted current expenditure is assumed to grow by 2.5 per cent per annum for 2020–2023. Previously, the Department of Finance had improved its medium-term expenditure forecasts by moving from simply assuming no nominal growth in spending to a more realistic basis that was consistent with stated government policy. *Budget 2019* took a step backwards in this regard, by assuming a fixed (and implausibly low) growth rate in the outer years with little basis. Non-voted current expenditure is forecast to grow by only 1.2 per cent on average over the period, mainly due to falling interest costs. There is limited information value in these forecasts as they are based on assumptions rather a medium-term policy path or the costs of sustaining existing policies.

Forecasts for voted capital expenditure are in line with the National Development Plan, with growth averaging more than 6.5 per cent over 2020–2023. As this is part of stated policy, this forecast is more informative than the other assumptions for spending forecasts.

Table 3.2: General Government Expenditure Forecasts (2018–2023)

Percentage change year-on-year, unless otherwise stated

	2018	2019	2020	2021	2022	2023
General Government Expenditure	5.0	5.1	3.0	2.4	2.8	2.6
Compensation of Employees	6.2	4.9	1.7	1.0	0.1	0.1
Intermediate Consumption	11.0	17.6	3.0	3.1	2.6	-0.5
Social transfers	0.3	1.8	1.9	1.1	0.3	0.5
Interest Expenditure	-8.9	-5.8	-5.0	-4.2	6.8	5.0
Subsidies	0.7	-0.3	1.1	-0.5	-2.4	4.5
Gross Fixed Capital Formation	27.0	13.8	3.2	4.4	4.4	6.8
Capital transfers	-8.6	13.3	15.1	8.9	9.9	3.5
Other	19.7	-4.9	8.9	3.7	2.6	3.0
Primary Expenditure	6.1	5.9	3.5	2.8	2.6	2.4
Primary Expenditure, % of GNI*	38.7	38.7	38.0	37.5	36.9	36.2
Resources to be allocated, € billion	0.0	0.0	0.6	1.3	2.4	3.6

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which may be unrealistic. Expenditure amounts in 2021 are adjusted to take account of a capital transfer expected to be reclassified to general government. Resources to be allocated represents expenditure which is yet to be allocated to a specific item, with a decision as to where this is to be allocated to be made closer to the time.

In IFAC (2018b), IFAC presented the Stand-Still scenario, which estimates the cost of maintaining today's level of public services and benefits (in real terms) over the medium term. A preliminary update to these estimates suggests that these costs are relatively unchanged since May. Including unallocated spending, the level of non-interest spending assumed in *Budget 2019* marginally exceeds the updated Stand-Still estimate for the period 2020–2023. This means that the assumed level of expenditure could accommodate demographic and price pressures, assuming no change in policy or macro drivers. The implication is that there would be no room for other improvements in public services or additional welfare increases based on these projections, unless there were significant efficiency gains. In a growing economy, this is likely to be extremely challenging.

The technical nature of the projections means that some expenditure items show limited growth. Compensation of employees sees a significant slowdown in growth

in 2020 and 2021, and is projected to remain flat in 2022 and 2023. Given the likely increases in staff numbers and wage growth in the economy, it would seem highly unlikely that compensation of employees would stay almost constant in 2022 and 2023. IFAC Stand-Still estimates would indicate that if public sector pay rates were to increase in line with agreed pay deals and private sector wages thereafter, this would imply cost pressures of over €600 million per year.

The Department has left a significant amount of unallocated expenditure in the forecasts. A better practice would be to give an indication of where these resources would be employed.

Budget 2019 saw a return to forecasting fiscal and macroeconomic variables five years ahead. The Council welcomes this and highlights that the practice ought to continue as part of multi-annual budgeting. The Alternative Presentation in the Budget, setting out spending and revenue forecasts in a disaggregated way over a five-year horizon, would be a potentially useful tool but is undermined by the implausible assumptions used for Departmental spending.

Interest expenditure

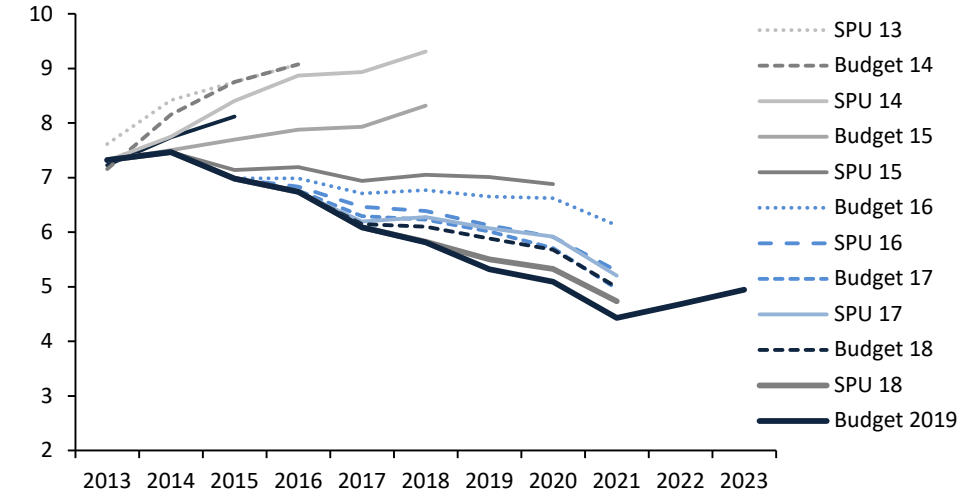
Interest costs on government debt have declined in recent years, and this is forecast to continue until 2021. Figure 3.13 shows the improvement in forecast and actual interest costs due to: (i) low global interest rates; (ii) agreed reductions in interest rates on official borrowing; (iii) expansionary monetary policy by the ECB, including the Public Sector Purchase Programme; and (iv) the early repayment of IMF loans and other debt restructuring. *Budget 2019* has once again seen a fall in expected interest payments over the period 2018–2021. Interest costs are forecast to rise somewhat after 2021, due to a forecasted rising average interest rate and a rising level of debt (in absolute terms). The average interest rate is forecast to rise because the bonds due to be refinanced in 2022 have very low rates; hence they are expected to be refinanced at higher rates.

Budget 2015 forecasts suggested interest expenditure of close to €8.5 billion and corporation tax receipts of close to €5 billion for 2018. The latest forecasts suggest interest expenditure will be just over €5.5 billion and corporation tax receipts of close to €10 billion in 2018. This is a positive swing approaching €8 billion for the public finances which was not forecast four years ago. Despite this, the general

government balance is now forecast to be in deficit in 2018, compared to a surplus forecasted in *Budget 2015.*

Figure 3.13: Revisions to National Debt Cash Interest Payments

€ billion



Sources: Department of Finance.

2019–2023 revenue

The outlook for 2019 points to **general government revenues** of €85.2 billion, with annual growth forecast at 5.4 per cent (Table 3.3). The main drivers of a total increase of €4.4 billion are social contributions (€1.4 billion), followed by taxes on production and income, and current taxes on income and wealth (€1.3 billion each).[60] Over 2020–2023, revenue is projected to average €94.7 billion, representing an average increase of €3.9 billion per year (or 4.3 per cent).[61] As a share of GNI*,

[60] Compared to *SPU 2018,* general government revenue for 2019 has been revised up. In particular, *Budget 2019* includes revisions of +€1.0 billion in social contributions; +€0.9 billion in current taxes on income and wealth; and +€0.5 billion in other. Over the medium term (2020–2023), growth is forecast at a slower average rate of 4.3 per cent per year, with current taxes on income and wealth being the main contributor to this increase.

[61] For 2020–2021, *Budget 2019* has included upward revisions of social contributions (averaging €1.3 billion each year); current taxes on income and wealth (+€1 billion per year); and other (averaging +€0.9 billion per year). The revision in social contributions is predominantly due to the latest estimates of PRSI receipts in the Social Insurance Fund and the National Training Fund. The revision of current taxes on income and wealth partly reflects the fact that the €0.6 billion income tax reductions included on an indicative basis in earlier forecasts is not to be fully utilised in 2019 (which impacts 2019 and subsequent years).

general government revenue is projected to be over 41 per cent in 2019, and 40.7 per cent on average in 2020–2023 (Table 3.3).[62]

Table 3.3: General Government Revenue Forecasts
€ billion, unless stated

	2018	2019	2020	2021	2022	2023
General Gov. Revenue	80.8	85.2	88.9	92.6	96.6	100.7
Taxes on production and imports	25.2	26.5	27.6	28.6	29.6	30.6
Current taxes on income, wealth	34.2	35.6	37.4	39.2	41.2	43.5
Capital taxes	0.5	0.5	0.5	0.5	0.5	0.6
Social Contributions	13.3	14.7	15.5	16.3	17.1	17.9
Property income	1.5	1.5	1.3	1.1	1.1	1.0
Other	6.2	6.6	6.7	6.9	7.1	7.1
Macro indicators						
% GNI*	41.3	41.1	40.7	40.7	40.7	40.6
% GDP	25.1	25.0	24.7	24.6	24.6	24.6

Sources: Department of Finance; and internal IFAC calculations.

Exchequer tax revenue for 2019 is forecast to amount to €57.9 billion, 5.2 per cent higher than in 2018. Strong income tax and VAT revenues are expected to account for the highest part of this increase (Table 3.4 and Figure 3.14). Separately, **PRSI** contributions are forecast to reach €11.2 billion in 2019.

In terms of **income tax**, growth of 6.8 per cent reflects "the assumed continuation of strong employment and earnings growth" in 2019 (projected at 2.8 per cent and 3.0 per cent, respectively). Relatedly, the unemployment rate is forecast to remain low at 5.2 per cent in 2019. *Budget 2019* notes that the full €0.6 billion that had been previously included on an indicative basis to income tax measures in 2019 was not fully used in this Budget (see Figure 3.15 and Appendix E). This gave space for additional spending measures beyond the level previously set out.

Another expected source of income tax revenue for 2019 relates to a compliance measure introduced in *Budget 2019*. This refers to Revenue's updated PAYE system, which is projected to bring in a yield of €50 million. An analysis of compliance measures introduced in *Budget 2017* was included with the budget documentation (Revenue Commissioners, 2018b). This is welcome, and it is important that

[62] This higher share for 2019–2021 relative to *SPU 2018* (where the last projected year is 2021) is the result of an upward revision of general government revenue—averaging +€1 billion—and a downward revision of GNI*—averaging –€16 billion (see Chapter 2).

estimated yields from revenue measures are based on sound and detailed forecasts, as also highlighted in the *November 2017 Fiscal Assessment Report* (Box F). The Revenue analysis of compliance measures indicates that the compliance target established in *Budget 2017* for 2017 was exceeded. However, the document notes that it is not possible to clearly identify how much is raised from compliance measures due to the improved efforts at tax compliance as opposed to from general economic activity or behavioural changes. While this breakdown might not be easy to undertake, it is crucial that a robust analysis is made to evaluate the impact of such measures.

Table 3.4: Tax Revenue and PRSI Forecasts
€ billion, unless stated

	2018	2019	2020	2021	2022	2023
Tax Revenue	55.1	57.9	61.0	63.8	66.8	70.2
Income tax	21.4	22.9	24.2	25.6	27.1	28.8
VAT	14.1	15.1	16.0	16.7	17.5	18.4
Corporation tax	9.6	9.5	10.0	10.4	10.8	11.3
Excise duties	5.6	5.9	6.1	6.3	6.4	6.6
Stamp duties	1.6	1.7	1.8	1.8	1.8	1.9
Other	2.7	2.8	2.9	3.0	3.1	3.2
PRSI	10.2	11.2	11.9	12.5	13.2	14.0

Sources: Department of Finance; and internal IFAC calculations.
Note: Tax revenue in Exchequer terms. Other includes motor tax, customs, capital gains tax and capital acquisitions tax.

As regards **VAT**, a strong yield for 2019 is supported by a solid growth of personal consumption volume (3.0 per cent) and of the personal consumption deflator (2.0 per cent), as covered in the "macro" driver of Appendix E. In addition, a policy impact is estimated by the Department of Finance to further support an increasing VAT yield for 2019. This refers to an increase of VAT rate on "tourism" activities—though this goes beyond what can be strictly considered as "tourism", e.g., an increase of VAT in restaurants affects both tourists and non-tourists—expected to bring in a yield of €560 million for the full year (€466 million for 2019).[63,64]

[63] The measure applies to goods and services related to tourism activities, with the exception of newspapers and sporting facilities. The increased rate will be applied from January 1st 2019 onwards. The reason why the full-year yield is higher than the 2019 yield is because VAT is paid in arrears. In January 2019, businesses will pay VAT for sales made in November and December 2018, which for the tourism sector will be at the 9 per cent rate. The next November and December's sales will be at the 13.5 per cent rate, but the VAT will not be paid until January 2020.

[64] The "Review of the 9% VAT Rate" (Department of Finance, 2018b) notes that an increase in the VAT rate is not expected to trigger a fall in the demand of goods and services, "given the positive

A simple cross-check, using accommodation and food service activities data from the CSO, suggests that this estimate is reasonable. The rationale for choosing this category is that it covers information related to both tourists and non-tourists, who are also liable for this measure. Assuming a 2-per-cent growth of accommodation and food services per annum (close to the long-term average growth, and still substantially lower than the recently observed growth) and assuming no further behavioural changes suggests that increasing the rate to 13.5 per cent might bring in a yield of around €500 million from these specific sectors in 2019.[65]

In terms of **corporation tax**, the 2019 projections point to slightly lower receipts than in 2018 (1.3 per cent lower), largely due to a base-year effect as a consequence of the 2018 windfall. In particular, Appendix Figure E1 shows that this negative growth is the result of the one-off impact that has taken place in 2018, which is not expected to be offset by the strong gross operating surplus forecast for 2019.[66] However, after accounting for the one-off revenue of €0.7 billion, the Department of Finance still expects strong growth of 6.5 per cent for 2019. Corporation tax as a percentage of Exchequer tax revenue is forecast to amount to 16.4 per cent in 2019. This is equal to the second highest peak of the last decades, reached in 2002 (see Figure 3.7 in Section 3.2), but still lower than the expected record share of 2018.

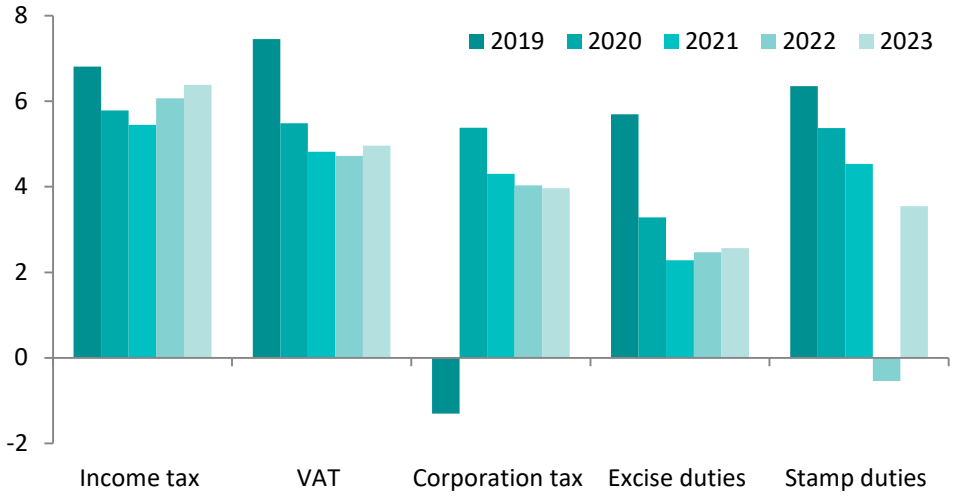
outlook for both household incomes and consumer demand […] and given that demand is considerably more sensitive to changes in income than price".

[65] This exercise is shown on an indicative basis. The elasticity of changes in demand to this modified rate should be properly accounted for in order to provide a more accurate estimate.

[66] In particular, the gross operating surplus projected for 2019 is 6.1 per cent, the highest rate of the whole projection horizon.

Figure 3.14: Tax Forecasts

Percentage change (year-on-year)



Sources: Department of Finance; and internal IFAC calculations.

Excise duties are forecast to grow by 5.7 per cent in 2019. This relies on the assumption that the distortionary impact from tobacco health measures will unwind by 2019. The excise duty projection for 2019 partly reflects an expected policy impact of €90.4 million (Appendix E) related to three tax-raising policy measures introduced in *Budget 2019*: (i) tobacco products tax (€48.9 million); (ii) betting tax (€39.5 million); and (iii) raise in the minimum excise duty on cigarettes (€2.0 million).

In relation to the tobacco products tax, the Revenue Commissioners' estimates (which attempt to partially reflect the change in behaviour of smokers to higher prices) suggest that an equivalent increase should yield between –€44 million to +€57 million (Revenue Commissioners, 2018). While the analysis notes that the upper limit of these estimates is likely to be most accurate, choosing this rather than the mid-point of estimates (€6.5 million, in this case) is an unusual statistical practice. The assumptions underpinning this range of estimates are not referenced, which is paramount for assessing the adequacy of this estimate.

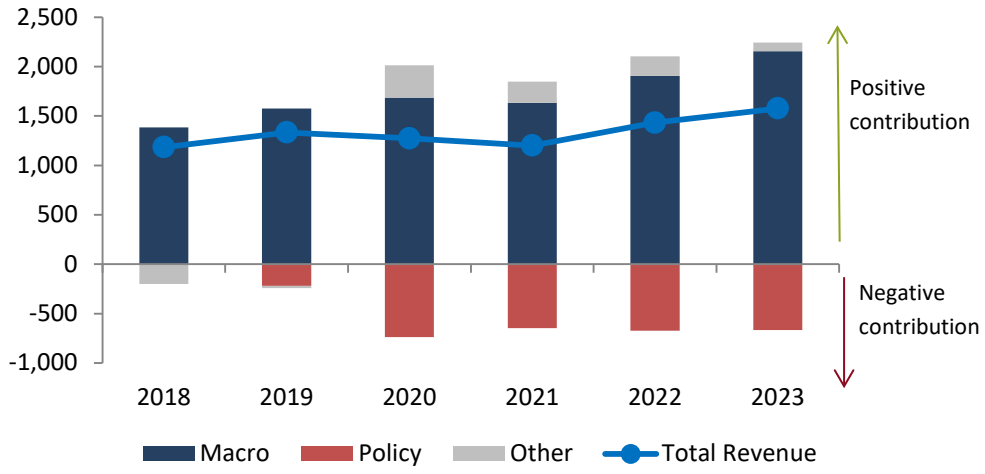
Stamp duties are expected to follow relatively strong growth of 6.3 per cent in 2019 to moderate thereafter and become negative in 2022, before again turning positive in 2023. The expected drop in 2022 is because the banking levy is due to cease after 2021, hence triggering a structural fall in revenues for 2022.

Over **2020–2023**, Exchequer tax is forecast to average €65.4 billion. This implies strong growth of 4.9 per cent, on average, annually. Income tax is expected to

register the strongest growth of all the main tax heads, averaging 5.9 per cent over this period.

Figure 3.15 and Appendix E identify the factors that contribute to the annual changes in USC and PAYE forecasts of income tax produced by the Department of Finance. Both USC and PAYE are expected to grow strongly, aided by strong non-agricultural earnings and employment prospects—as covered in the "macro" driver—but policy changes will partly mitigate this. These policy impacts largely reflect the assumption that an income tax package of over €0.6 billion will be allocated each year between 2020 and 2023. This is a technical assumption, which will depend on the Government in advance of each respective Budget. Another important source of revenue is PRSI, which is not often recognised in revenue analyses. Receipts from this source are forecast to be equivalent to almost half of income tax revenues over the whole period 2020–2023.

Figure 3.15: Income Tax (USC and PAYE) Forecasts Decomposed
€ million, year-on-year change



Sources: Department of Finance; and internal IFAC calculations.
Note: Graphs show the Pay-As-You-Earn (PAYE) and Universal Social Charge (USC) components of income tax (see Appendix E for more detail on the calculations). Other includes carryover effects, one-offs and other factors/judgement applied by the Department of Finance.

VAT and corporation taxes are also forecast to grow strongly (5.0 and 4.4 per cent on average, respectively), while the growth of excise duties will remain more moderate (averaging 2.7 per cent). The growth in corporation tax is fully driven by relatively strong macroeconomic forecasts (gross operating surplus is projected to grow by 4.4 per cent on average over 2020–2023). In terms of VAT, solid forecasts of personal consumption expenditure and of the deflator support an average VAT growth of over €800 million per annum. Regarding excise duties, the estimated yields over

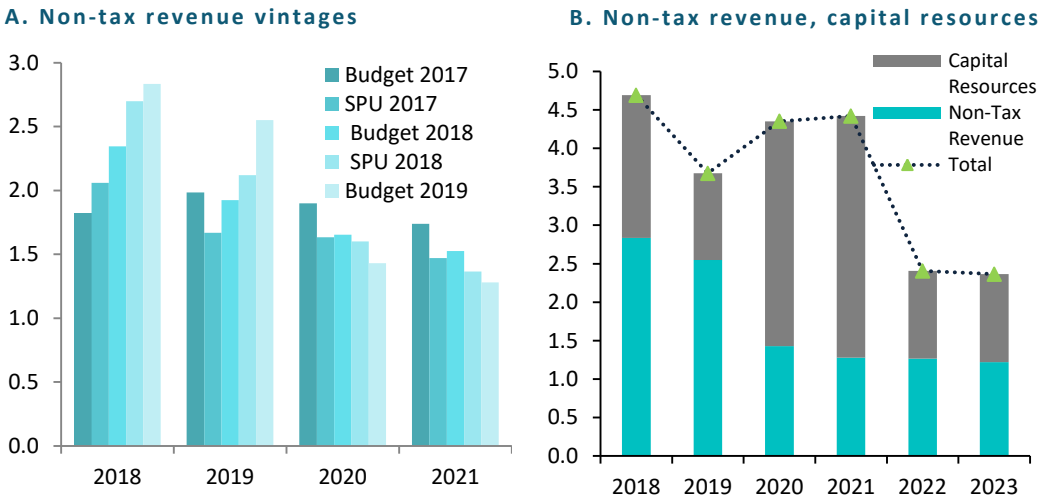
2020–2023 are partly the result of strong macro drivers, including personal consumption expenditure (excluding cars), the projected increase in the price of new cars, and, to a lesser extent, the volume of new car sales (with average growth projected to slightly moderate relative to 2018–2019).

Non-tax revenues are projected to reach €2.6 billion in 2019 (Figure 3.16). This is €0.7 billion higher than the *SPU 2018* forecast and is mainly driven by expectations of increased non-tax revenue through higher Central Bank of Ireland surplus income, as well as other dividend income. Taking previous forecasts, this is the highest yield projected for 2019, as shown in Figure 3.16A. For 2020–2021, non-tax revenues are assumed to decrease to €1.4 billion and €1.3 billion respectively. These lower estimates arise from an assumption of decreased Central Bank surplus income payable to the Exchequer.[67] For 2022 and 2023, non-tax revenue (largely arising from the Central Bank surplus income, besides dividend income) is forecast to remain relatively stable at roughly to €1.2 billion (Figure 3.16B). It is worth noting that, over the whole projection horizon, around half of total non-tax revenues (on average) will have no general government impact, although they will impact the Exchequer position.

[67] Given the current negative interest rate environment, the Central Bank charges credit institutions for holding their deposit balances and receives income which, in more normal times, would represent a cost of holding such funds. As interest rates turn positive, the Central Bank will have to pay to hold such balances and the profit outlook reflects this as part of a general assumption that post-crisis conditions continue to normalise. This, combined with expected increases in operating costs, is expected to reduce the Central Bank's profit and surplus payable to the Exchequer.

Figure 3.16: Non-Tax Revenues and Capital Resources

€ billion



Sources: Department of Finance; and internal IFAC calculations.
Note: Almost all of the revenue from capital resources is estimated to not impact the general government balance (since it is treated as a financial transaction under current accounting rules), while the Exchequer cash position will be impacted. For non-tax revenue, this is the case only for half of the yearly revenue over 2019–2023.

Capital resources for 2019 are expected to amount to €1.1 billion before increasing to roughly €3 billion in 2020 and 2021. This boost results from the distribution of a €3.5 billion surplus of the winding-down of the National Asset Management Agency (NAMA) in this period.[68] Capital resources in 2022–2023 are projected to decline due to the cessation of the NAMA.[69] While impacting the Exchequer position, almost all of the projected capital resources (95 per cent, on average) are neutral from a general government perspective.[70]

General government debt

The gross debt-to-GDP ratio has fallen substantially since 2012. Two factors have played a significant role. The first is related to the high level of measured GDP growth in 2015. The second involves the liquidation of the IBRC, which led to lower liabilities being measured on the Government's balance sheet (in 2011, this had led to an increase in government liabilities of €20.9 billion; stripping out these liabilities, gross debt to GDP would have been 4 per cent lower annually). While the Stability

[68] Of the €3.5 billion surplus, €1.5 billion is expected to take place in 2020, and the remaining €2.0 billion, in 2021.

[69] *Budget 2019* notes that these proceeds—along with others related to the resolution of the financial crisis—are to be directed to debt reduction. This aims to "help ensure fiscal sustainability and to reduce the debt servicing burden, particularly as we face a number of potential external challenges, including Brexit".

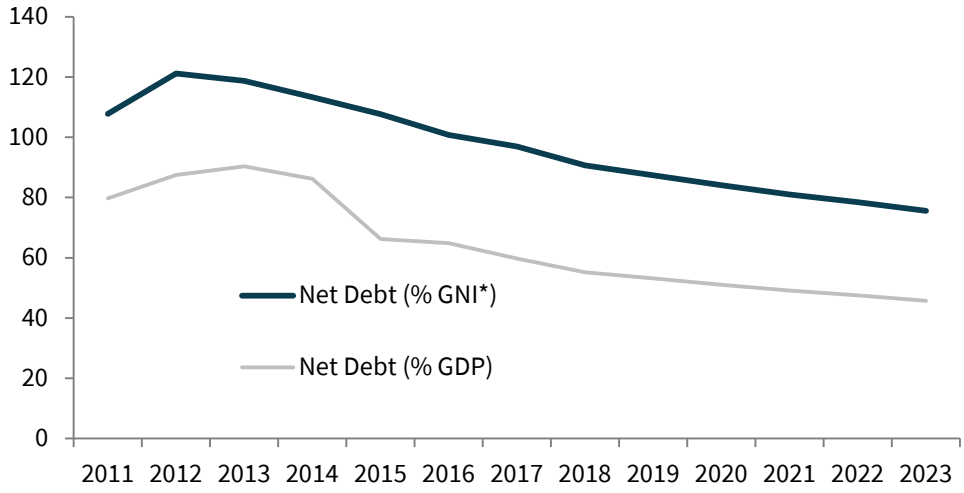
[70] According to the ESA2010 accounting rules, this income is treated as a financial transaction, hence not impacting on general government balance.

and Growth Pact reference value of 60 per cent is set in terms of debt-to-GDP, it is worth remembering that for Ireland this 60 per cent of GDP reference value would be equivalent to 97.4 per cent of GNI* (using 2017 nominal outturns for both variables).[71] Using GNI* or revenue as a denominator, government debt remains high relative to other OECD countries (see Figure 1.6 in Chapter 1). Given some of these distortions and the relatively high cash balances run by the NTMA, net debt to GNI* is a more informative measure. Using this metric, the decline in debt levels is more gradual since 2012, and debt is expected to fall to 90.7 per cent in 2018 before falling to 75.6 per cent in 2023 (Figure 3.17).

The increasing surpluses in 2020–2023—driven by unrealistic forecasts of expenditure growth—contribute to a reduction in the debt burden in those years. Higher forecasts of expenditure in those years would lead to a slower pace of debt reduction in those years.

Figure 3.17: General Government Debt

Percentage of GDP/GNI*



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data for the period 2018–2023 are projections as per *Budget 2019*.

[71] Gross general government debt is forecast to fall below 60 per cent in 2020.

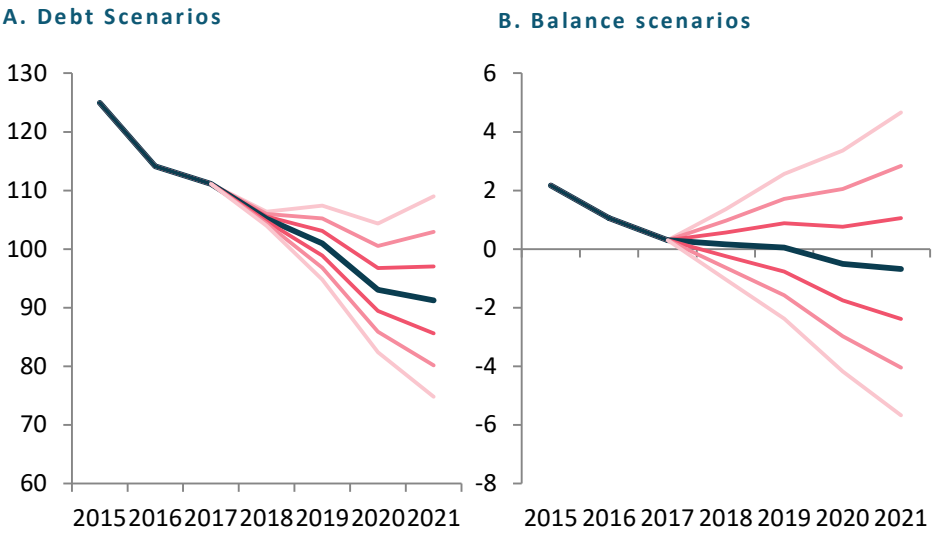
3.4 Risks

While *Budget 2019* forecasts continuing improvements in the macroeconomic and fiscal outlook, substantial risks to the public finances remain. One of the most prominent risks continues to be uncertainty in relation to the external environment. Volatile bond market conditions as seen recently in Italy and possible changes to the international corporation tax environment could pose significant fiscal risks.

The reliance on potentially transient sources of revenue to fund permanent expenditure increases is a significant fiscal risk. Corporation tax is set to record its highest share of tax revenue in the last decades in 2018 (Figure 3.7). These unexpected corporation tax receipts are being partially used to fund permanent increases in health expenditure and the payment of the Christmas bonus.[72]

Figure 3.18: Debt and Budget Balance Paths under Different Growth Scenarios

%GNI*, general government basis



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Central line depicts the central forecasts from the Department of Finance. The outer lines depict how far the budget balance as a percentage of GNI* would be pushed away from the central forecasts under different shocks to real GDP growth in each year. The outer lines, as one moves further away from the central forecast, are for positive/negative growth shocks of 0.5, 1.0, and 1.5 percentage points, respectively. Positive shocks raise the balance; negative shocks reduce it.

Figure 3.18 shows how shocks to growth would impact on the general government balance and general government debt. A shock to GNI* growth of 1.5 percentage

[72] The Department of Finance has already stated that €700 million of corporation tax receipts are likely to be one-off receipts. In the financial statement as part of *Budget 2019*, the Minister for Finance stated that a €700 million supplementary estimate for the Department of Health would be required in 2018.

points relative to *Budget 2019* forecasts each year from 2018 to 2023 would result in the general government balance being 5.3 percentage points of GNI* lower by 2023. All else being equal, this means that the public finances would remain in deficit out to 2021, as compared to a central scenario of a surplus of 0.7 per cent of GNI*. In the same scenario, the currently high gross government debt-to-GNI* ratio would remain close to current levels, in the absence of corrective policy action. A shock of this magnitude would not be exceptional given the historic volatility of Irish national income growth, for which a typical current year forecast error is close to 2 percentage points.

Table 3.5: Assessing the *Budget 2019* Fiscal Risk Matrix

Likelihood and Impacts from *Budget 2019* , unless stated:
high in red; medium in pink; low in grey

	Likelihood	Impact
Health overruns (IFAC risk)		

Recent years have seen a persistent pattern of large overruns in health spending. A combination of unrealistic forecasts and a repeat of relaxation of ceilings have recurrently led to uncontrolled increases in spending, which can put the public finances at risk. Over the period 2014–2017, current spending overruns have averaged €0.5 billion per year, and are expected to amount to €0.6 billion in 2018 (of the total estimated supplementary estimate of €0.7 billion, the remaining €0.1 billion relates to capital expenditure and a shortfall in Departmental receipts).

EU climate change and renewable energy targets

Ireland seems unlikely to meet its 2020 emissions targets without purchasing more allowances, which could cost between €148 million and €455 million per year (Deane, 2017). Costs associated with missing later targets (2030) could be substantially higher (Curtin, 2016 estimates €2.7 to €5.5 billion).

Corporation tax concentration risks

Corporation tax revenue is forecast to be double its 2014 value this year. Given how quickly this revenue source has grown, there is a significant risk it could fall rapidly also. *Budget 2019* has revised corporation taxes by +€1.1 billion relative to forecasts in *SPU 2018.* Corporation tax (as a share of Exchequer tax revenue) will be at record levels of the last decades (estimated at 17.4 per cent). Given the high volatility and strong concentration of this tax head in very few companies, the Council assesses that a high impact would be more appropriate.

Budgetary pressures

This pressure refers to the risk of public expectations exceeding budgetary policy. Budgetary pressures may also arise due to demographics, eligibility factors and other demand side pressures. In-year spending increases would also exacerbate the problem. The political cycle may also increase near-term budgetary pressures. Given the pattern of overruns in the Department of Health and having not budgeted for the payment of the Christmas bonus in 2019, the Council assess a high likelihood to be more appropriate.

Reliance on transient revenues (IFAC risk)

Failure to recognise the transient nature of certain sources of revenue could, if repeated, reduce the stability of tax revenues. This is particularly risky if transient revenue resources are used to fund long-term expenditure. For example, in 2018, higher-than-expected corporation tax revenue and interest savings, both of which might be deemed as temporary, are largely devoted to funding the high health overrun for the year (see Box D).

Sharper-than-expected growth in tax-rich sectors (IFAC risk)

Pent-up demand in the housing sector is forecast to lead to strong growth in the construction sector. Given the tax-rich nature of housing output, due to its labour intensity, and capacity for tax collection on new homes and housing transactions, rapid growth could imply a substantial increase in revenue.

	Likelihood	Impact
EU Budget contributions		

There is continuing uncertainty surrounding the impact Brexit will have on the contributions to the EU budget.

Changes to tax "drivers"

Tax forecasts are dependent upon macroeconomic projections and other components. For example, corporation tax forecasts are driven by forecasts around the Gross Operating Surplus (GOS), and the elasticity associated with this. The GOS forecasts are subject to a high degree of uncertainty, namely that related to international trading conditions and currency markets. Hence, changes in the composition of those macroeconomic components can have important impacts on the tax forecasts.

Litigation risk

This risk refers to an adverse or unexpected outcome of litigation against the State, leading to increased expenditure. Bova *et al.* (2016) estimate that the contingent liability realisations could have an average fiscal cost of 6.1 per cent of GDP.

Tax forecast and payment timeline asymmetry

Timing in relation to certain tax receipts can lead to variation throughout the year. Another concern is posed in the estimation of the cost of tax measures. Although there is a risk of underestimation of the impacts of tax cuts, there is also a risk that estimated yields accruing from revenue-raising measures may be overly optimistic.

Statistical classifications

Ireland's compliance with the EU fiscal rules is measured under the ESA 2010 statistical framework. When statistical revisions take place, or decisions are made around guidance and classification of different items, including Eurostat, this might pose fiscal risks.

Unexpected one-off revenues (IFAC risk)

This risk refers to large, unexpected one-off government revenues being received. A recent example relates to Apple, which was ordered to pay €13 billion (plus €1.3 billion interest) to an escrow account related to unpaid taxes in Ireland. This is equivalent to 6.6 per cent of GNI* in 2018. Since the announcement, the Minister for Finance stated that this liability "should be taken off the national debt rather than spent on day-to-day expenditure". Given that this one-off receipt is not budgeted for, it represents a positive fiscal risk.

Receipts from resolution of financial sector crisis

The budgetary projections in *Budget 2019* do not include any assumed proceeds relating to disposals of the State's shareholding in a number of financial institutions. This provides an upside risk to the fiscal forecasts.

Dividend payments

Budget 2019 identifies risks in relation to lower-than expected payments of dividends from the State's shareholding in banks and commercial semi-state companies. Such dividends are a function of business performance and outlook, over which the State has little control. If some of these assets are sold, then associated revenue streams would fall.

	Likelihood	Impact
Bond market conditions		
The long maturities and relatively fixed nature of debt (with 94 per cent of gross national debt being at fixed interest rates in June 2017) should insulate the public finances from a typical shock to interest rates on sovereign borrowings. At high debt levels, external shocks such as a harder-than-expected Brexit could lead to self-reinforcing fears in bond markets.		
Contingent liabilities		
Contingent liabilities continued to fall in 2017. Given their reduced level, the Council assesses a low impact to be more appropriate.		

Sources: Department of Finance; and internal IFAC assessment.

Chapter 4

Assessment of Compliance with Fiscal Rules

4. Assessment of Compliance with Fiscal Rules

Key Messages

- The Department of Finance's *Budget 2019* forecasts indicate that Government plans were not consistent with complying with the fiscal rules for 2018 and 2019. Based on estimates presented in *Budget 2019*, the Medium-Term Objective (MTO) of a structural deficit of no more than 0.5 per cent of GDP will not be met in 2018 following a sizeable deterioration in the CAM-based estimate of the structural balance, now forecast to deteriorate to a deficit of 1.2 per cent of GDP. This largely reflects changes to the estimated output gap, and the volatility of the current estimates, with the output gap estimated to increase by 2.6 percentage points in 2018.

- The MTO requirement would not be met in 2019 either, with a structural deficit of 0.7 per cent of GDP. Revisions to the CAM output gap and further risks of slippage (including overruns in spending) might worsen the forecasted breach of the MTO.

- The MTO was achieved, for the first time, in 2017. Significant revisions to the CAM output gap estimates contributed to an improvement of the structural balance for 2017. This resulted in a structural surplus of 0.4 per cent of GDP for 2017.

- Net expenditure growth for 2018 is likely to be below the Expenditure Benchmark limit. In 2019, net expenditure growth is expected to be 4.3 per cent, which is below the 5.9 per cent increase allowed under the Expenditure Benchmark. However, there are risks of slippage and the Expenditure Benchmark limit may be breached if expenditure overruns occur, e.g. Department of Health overruns or unbudgeted welfare increases (like the Christmas Bonus).

- The Council welcomes the Department of Finance's alternative estimates of potential output. The Council recommends at least meeting the Expenditure Benchmark based on these estimates as a minimum standard.

This would help to ensure that spending growth is in line with sustainable and prudent budget management.

- Estimated compliance with the rules can reflect volatility in the CAM estimates of the output gap between years. The estimates have been revised significantly over the past year. Yet the rules do point towards the lack of progress in the underlying budgetary position in recent years, despite favourable growth. There has been a consistent pattern of upward revisions to expenditure ceilings in recent years, which echoes mistakes of the past.

- The Council assess that setting an appropriate debt commitment would be helpful, taking into account sustainability concerns. The commitment should be well specified. It should be time limited with a specific date by which the objective should be achieved and it should be clearly specified whether the commitment would be a target or a ceiling.

4.1 Introduction

The Council's mandate includes assessing compliance with Ireland's Domestic Budgetary Rule as set out in the *Fiscal Responsibility Act 2012* and the EU fiscal rules as set out in the *Stability and Growth Pact*. This chapter examines the consistency of the projections contained in *Budget 2019* with the Preventative Arm of the *Stability and Growth Pact*. In particular, it examines compliance in relation to the Medium-Term (Budgetary) Objective (MTO), the Expenditure Benchmark and the Debt Rule.[73]

The assessment of the rules in this chapter is based on the Department of Finance's estimates in *Budget 2019* using the EU Commonly Agreed Methodology (CAM) and considering the Council's own assessment of one-off/temporary measures. [74,75] *Budget 2019* included a one-off windfall of €0.7 billion for corporation tax in 2018 and this is incorporated in the Council's assessment of the fiscal rules.[76] Table 4.1 provides a summary assessment of compliance with the fiscal rules.

[73] The Debt Rule is due to come into force in full, for Ireland, in 2019, after the end of the three year transition period from 2016-2018. See Section 4.4 and Box F for details.

[74] A number of issues make the CAM output gap less plausible for Ireland. See Box E of the November FAR (IFAC, 2017e) for details. As a result, the Department of Finance recently developed alternative models of potential output, which appear more plausible, on which the Department base their budgetary figures. However, the legal requirement for assessment of the fiscal rules is based on the EU Commonly Agreed Methodology.

[75] Since the publication of *Budget 2019*, the European Commission have deemed that additional adjustments to the methodology for producing estimates of the CAM potential output would be necessary for Ireland. These adjustments are reflected in the Commission's Autumn 2018 forecasts, but are not reflected in the Department's *Budget 2019* forecasts. The assessment of the fiscal rules in this chapter is based on the forecasts presented in *Budget 2019.*

[76] The treatment in this chapter differs to that of the Department of Finance, presented in the documents for *Budget 2019*. The Council assesses that an adjustment should be made to account for the one-off nature of the windfall in order to arrive at the underlying structural balance.

Table 4.1: Assessment of Compliance with the Fiscal Rules[1, 2, 3]

% GDP unless stated, deviations: negative=non-compliance

	2017	2018	2019
Corrective Arm			
General Government Balance Excl. One-Offs	-0.2	-0.3	0.0
General Government Debt	68.4	64.0	61.4
1/20th Debt Rule Limit	81.9	71.5	67.7
Debt Rule met?	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule			
Structural Balance Adjustment Requirement			
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**
CAM Structural Balance	0.4	-1.2	-0.7
MTO met?	Y	N	N
Minimum Change in Structural Balance Required	**-**	**-**	**-**
Change in CAM Structural Balance	0.6	-1.5	0.5
1yr Deviation (€bn)	-	-4.9	1.6
1yr Deviation (p.p.)	-	-1.5	0.5
2yr Deviation (€bn)	-	-	-1.6
2yr Deviation (p.p.)	-	-	-0.5
Expenditure Benchmark			
(a) Reference Rate of Potential Growth (% y/y)	-	3.4	4.5
(b) Convergence Margin	-	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	-	3.4	4.5
GDP Deflator used	-	1.3	1.3
Limit for Nominal Net Expenditure Growth (% y/y)	**-**	**4.8**	**5.9**
Net Expenditure Growth (% y/y)	4.5	3.9	4.3
Net Expenditure Growth (Corrected for one-offs) (% y/y)	4.2	4.1	4.3
1yr Deviation (Corrected for one-offs) (€bn)	-	0.4	1.2
1yr Deviation (Corrected for one-offs) (% GDP)	-	0.1	0.3
2yr Deviation (Corrected for one-offs) (€bn)	-	-	0.8
2yr Deviation (Corrected for one-offs) (% GDP)	-	-	0.2
Limit for Nominal Net Expenditure Growth (€bn)	**-**	**3.4**	**4.4**
Net Expenditure Increase (€bn)	3.0	2.7	3.2
Net Expenditure Increase (Corrected for one-offs) (€bn)	2.8	2.9	3.2
Current Macroeconomic Aggregates			
Real GDP Growth (% y/y)	7.2	7.5	4.2
CAM Potential GDP Growth (% y/y)	7.4	4.6	4.5
CAM Output Gap	-1.0	1.6	1.3
GDP Deflator Used (% y/y)	1.2	1.3	1.3

Notes:

[1] Assessments examine the *Budget 2019* revenue and expenditure plans, using the Department of Finance's CAM estimates of potential output and considering the Council's views on one-off/temporary measures. A new one-off windfall of €0.7bn in corporation tax revenue for 2018 is included in the Council's assessment of the structural balance. The treatment here differs to that applied in the "Assessment of Compliance with the Domestic Budgetary Rule in 2017" (IFAC, 2018a), which used the Commission's Spring 2018 output gap estimates for the structural balance as these are the basis of *ex-post* assessments of compliance. The outlier for "CAM Potential GDP Growth" for 2015 is replaced by the average of the 2014 and 2016 rates in the expenditure benchmark, as discussed in the *June 2017 FAR* (IFAC, 2017c).

[2] As the Council assesses the MTO as achieved in 2017, no adjustments to the structural balance are assumed required in 2017 and 2018. However, it is expected that the European Commission will retain their requirements until a final spring 2019 assessment of 2018. In spring 2019, it is anticipated that there will be a negative convergence margin applied for 2018, due to the over achievement of the MTO in 2017. The Council assesses compliance without this. The adjustment requirement for 2019 is frozen by the European Commission at zero meaning a negative convergence margin for 2019. The Expenditure Benchmark limits presented here therefore differ to those presented in the budget documents and in the European Commission's opinion on Ireland's Draft Budgetary Plans.

[3] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress towards the reference value of 60 per cent of the GDP. A transition period applies until the end of 2018.

4.2 In-year assessment for 2018

Analysis based on the Department's latest available estimates indicates that the MTO was achieved for 2017 (see Appendix F for a review of the *ex-post* assessment of 2017). The adjustment requirements and spending limits for 2018 were set by the European Commission in spring 2017, when this achievement was not anticipated.[77] The Commission will not formally lift these requirements until spring 2019. In spring 2019, it is anticipated that the European Commission will assess the MTO as having been met for 2017, as a result, there will be no formal requirement for 2018, other than adherence to the MTO.

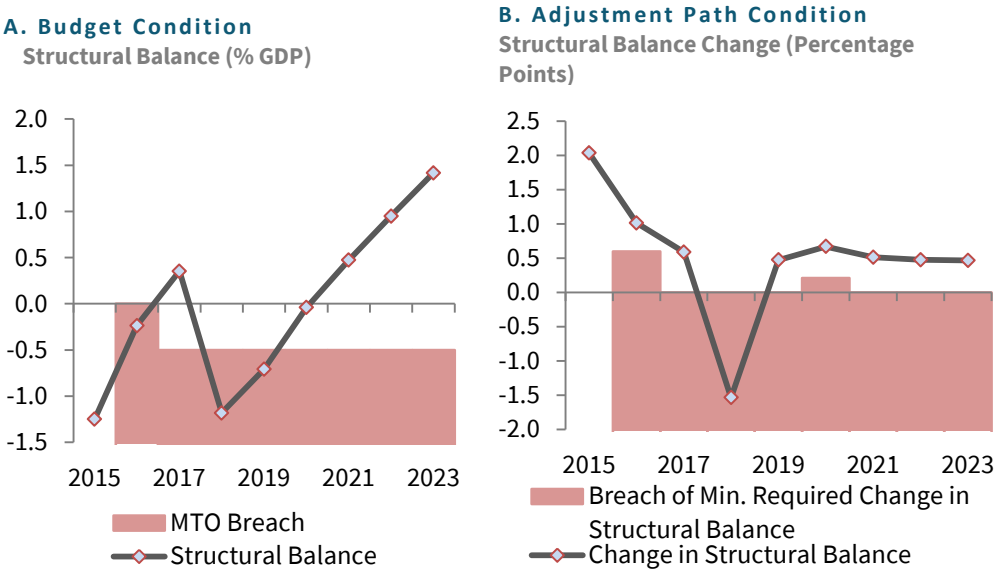
MTO and Structural Balance Adjustment Requirements

The structural balance is forecast to deteriorate to a deficit of 1.2 per cent of GDP for 2018 (Figure 4.1a); this represents a deterioration of 1.5 per cent of GDP compared with 2017 (Figure 4.1b). The MTO of a structural deficit of 0.5 per cent of GDP will therefore not be achieved in 2018 based on the Department's CAM-based estimates and the Council's assessment of one-off items. As the MTO was achieved in 2017, the only requirement was to ensure the continued adherence to the MTO. The deviation of 0.7 per cent of GDP from the MTO is classified as a significant deviation from the MTO.[78]

[77] The requirements for 2018 could only be reset on two occasions, Autumn 2017 or Spring 2019 for the *ex-post* assessment.

[78] The *Vade Mecum* (EC, 2018a) states that "For Member States at their MTO, a significant deviation is assessed with respect to a requirement of 0% of GDP, which is usually reflected in the first recommendation of the CSR [Country Specific Recommendation] as 'ensure that the medium-term budgetary objective continues to be adhered to' or 'avoid deviating from the medium-term budgetary objective'".

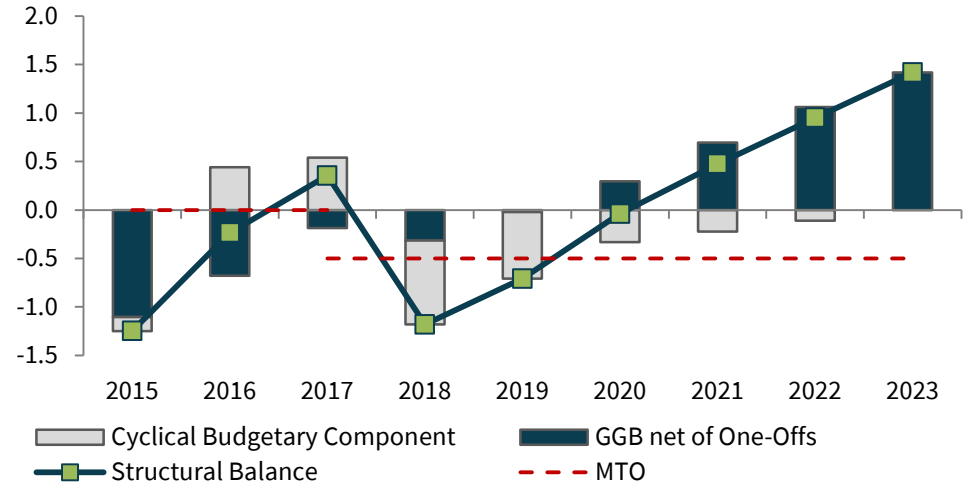
Figure 4.1: Assessment of Compliance with the Budgetary Rule



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The minimum MTO for Ireland 2017-2019 is set at -0.5 per cent of GDP. This was achieved in 2017 and so the 2018 adjustment path condition is expected to be 0.0 per cent of GDP once requirements are re-examined in 2019. Based on the Commission's latest estimates it is anticipated that there will be no adjustment requirement for 2019 when this requirement is re-examined. Required changes are calculated based on the previous year's structural balance.

Figure 4.2: CAM Structural Balance Decomposition

% GDP



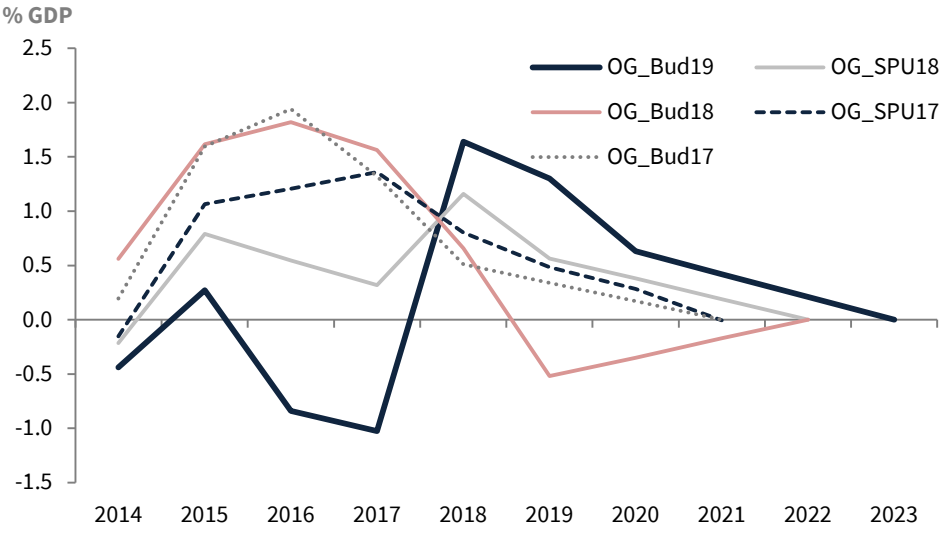
Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The cyclical budgetary component is estimated as: -0.5275 × output gap, where the output gap is the Department of Finance's CAM-based estimate. The CAM-based estimate of the output gap involves closure of the output gap over the medium-term. The MTO is due to be updated in 2019, for 2020-2022. This update was unavailable at the time of writing and the MTO is assumed constant at -0.5 per cent of GDP.

The deterioration of the structural balance between 2017 and 2018 is predominantly due to the estimated cyclical budgetary component, with the nominal general government balance largely unchanged across the two years once adjusted for one–offs (Figure 4.2). The large swing in the cyclical budget component is a result of the

large and implausible swing in the CAM output gap between 2017 and 2018 (Figure 4.3): the output gap for 2017 is estimated to be -1 per cent of GDP and +1.6 per cent of GDP in 2018. The output gap estimated for 2017, at the time of *Budget 2018*, was + 1.6 per cent of GDP, while the estimates of the output gap from *Budget 2019* show an output gap of –1.0 per cent of GDP for 2017. This significant swing in the estimated output gap over a short period of time is not plausible, and is another example of the poor results of the CAM output gap in relation to Ireland.[79]

However, as shown in Box E, the structural balance based on the Department of Finance's alternative estimates of the output gap also point to a deterioration of the structural balance in 2018. The GVA-based estimate of the structural balance shows a deterioration of 0.5 per cent of GDP for 2018, while the GDP-based estimate of the structural balance shows a deterioration of 1.4 per cent of GDP for 2018. All indications are that there was a significant deterioration in the structural balance in 2018.

Figure 4.3: CAM Output Gap Vintages



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The CAM-based estimate of the output gap involves closure of the output gap over the medium–term. As a result, the output gap declines towards zero at the end of each forecast horizon. The European Commission deemed that an adjustment to estimates of potential output for 2017 would be appropriate in response to higher-than-expected growth outturns in 2017. However, the exact implementation differed from what the Department had anticipated. Consequently, the changes in estimates of the output gap between *SPU 2018* and *Budget 2019* are partially as a result of the Department subsequently adopting the European Commission's approach.

[79] See Box E of the November FAR (IFAC, 2017e).

Box E: Fiscal Rules under Department of Finance's Alternative Output Gap Estimates

This box assesses the implications for the fiscal rules if they were applied using the Department of Finance's alternative estimates of the output gap rather than the EU's Commonly Agreed Methodology (CAM).

The CAM–based estimates of the output gap have a number of shortcomings and can lead to implausible estimates of the output gap, particularly for small, open economies such as Ireland. Consequently, the Department has recently developed a new suite of supply–side models of the Irish economy to estimate the output gap. The Department's preferred estimate of the output gap is the mid–point of a suite of GDP–based estimates of the output gap, yet they also produce a suite of Domestic GVA-based estimates. Below, adherence with the MTO and the Expenditure Benchmark is assessed on the basis of both of the alternative estimates of the output gap.[80]

MTO and Structural Balance Adjustment Requirements[81]

The MTO is designed to provide a safety margin with respect to the headline deficit limit of 3 per cent of GDP and to allow for debt ratios to converge towards prudent levels. It also gives consideration to the stage of the economic cycle, and the economic and budgetary impact of ageing populations. It is designed to allow room for budgetary manoeuvre, in particular taking into account public investment needs. The MTO for Ireland is currently set at a structural deficit of no greater than 0.5 per cent of GDP.

A comparison of structural balance estimates using the different alternative output gap estimates is shown in Figure E.1. Estimates of the structural balance based on the Department's GDP–based output gap (see Chapter 2, Figure 2.1.A) show that the MTO would have been achieved as early as 2015 had it applied, though estimates using the Department's other alternative (based on Domestic GVA) only show compliance from 2017. CAM–based estimates show that the MTO was achieved in 2017.

All of the estimates show deterioration in the structural balance from 2017 to 2018. The most severe deterioration is shown by the CAM-based estimates, where the closing of the negative output gap is more pronounced. This reflects strong real GDP growth, which is distorted by the activities of foreign-owned multinational enterprises. More plausibly, the Domestic GVA-based estimates would show a smaller closing of the output gap over the same period. Both sets of alternative estimates would suggest that, while there have been improvements in the cyclical position of the economy, it would appear that there has not been a comparable improvement in the headline budget balance.

By way of illustration, Figure E.2 shows the decomposition of the structural balance from 2014 to 2019 for the GDP–based alternative output gap estimates. The structural balance remains relatively unchanged from 2018 to 2019, with a minor negative cyclical budget component being offset by improvements in the General Government balance. The cyclical budgetary component arising from the alternative estimates is less erratic than the CAM–based equivalent (Figure 4.2) and is consistent with the output gap closing in 2018 and turning positive in 2019. The alternative GDP-based estimates show the MTO being adhered to over the

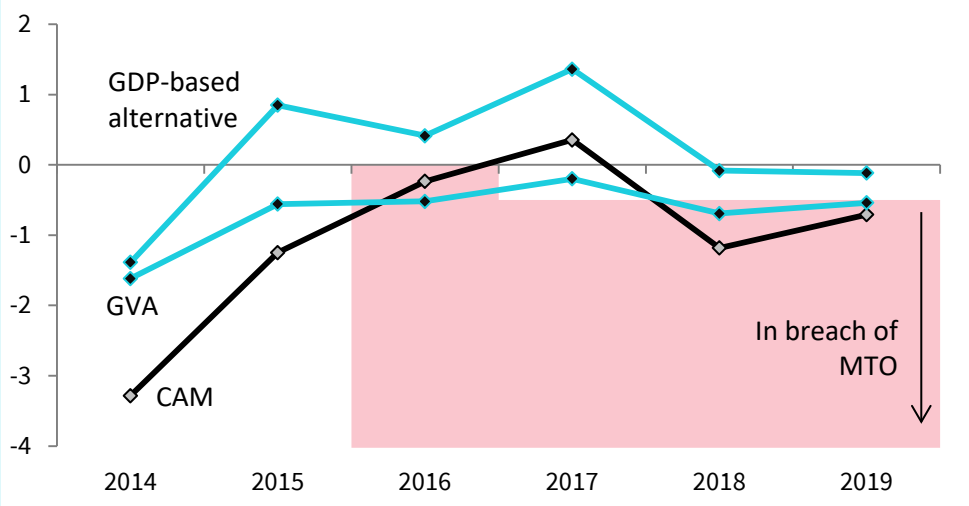
[80] Assessments of the Debt Rule based on the backward and forward looking benchmarks are independent of the estimates of the output gap. Assessment of compliance with the cyclically–adjusted Debt Rule, which is based on estimates of the output gap, only comes into effect if both the backward–looking and forward–looking benchmarks are breached. As a result, compliance with the Debt Rule, based on the alternative estimates of the output gap, is not assessed in this box. See Box F for details on the Debt Rule.

[81] Consistent with the rest of Chapter 4, the one–off of €0.7 billion in corporation tax in 2018 is included in the structural balance.

period 2015–2019. As the MTO would be adhered to on the basis of these estimates, there would be no adjustment requirements for these years.

Figure E.1: Structural Balance Estimates with Alternative Output Gaps

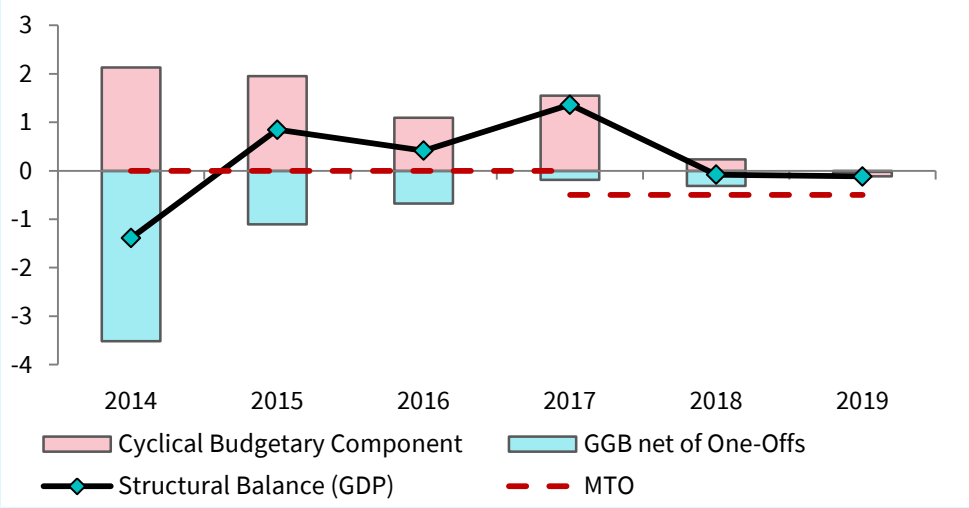
% GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The structural balance is derived on the basis of estimate of the output gap using the CAM; the Department's preferred GDP-based alternative; and the Department's GVA-based alternative. The cyclical budgetary component is estimated as: –0.5275 × output gap in each case and is added to the general government balance less one-off items.

Figure E.2: Structural Balance Decomposition Based on the Department's GDP Estimate of the Output Gap

% GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The cyclical budgetary component is estimated as: –0.5275 × output gap, where the output gap is the Department of Finance's GDP–based estimate.

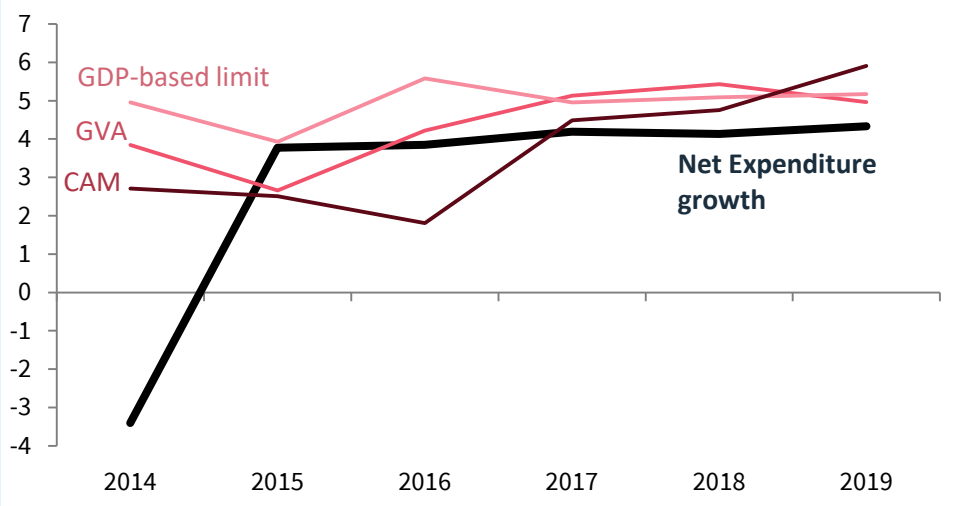
Expenditure Benchmark

The second pillar of the fiscal rules is the Expenditure Benchmark. Figure E.3 shows a comparison of the Expenditure Benchmark based on the Department's CAM-based estimates and the Department's two alternative sets of estimates of potential output over the period 2015–2019.

Net expenditure growth would have been below the limit set by the Department's GDP–based estimates of the Expenditure Benchmark for all years in the forecast horizon. Calculations of the Expenditure Benchmark limit using the Department's GDP-based estimates of potential are less volatile than the CAM–based estimates over this period, and provide a more plausible path for expenditure growth over the medium–term, than the CAM–based estimate, although there are a number of issues with the operation of the Expenditure Benchmark (see below, and section 4.2).

Figure E.3: Spending Growth and Alternative Expenditure Limits

Percentage change (year–on–year)



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Net expenditure growth is an adjusted measure that is net of discretionary revenue measures. The CAM–based limit includes reference rates that have been frozen by the European Commission. Consistent with the Council's assessment, these limits do not incorporate a negative convergence margin though the rules as applied by the Commission allow for this to happen (i.e., if a Member state overachieves its MTO in year *t-1*).

While the Expenditure Benchmark is excessively pro–cyclical (Casey *et al.* 2018), the Council recommends at least meeting the Expenditure Benchmark, without the application of a negative convergence margin — as a minimum standard — based on the Department's GDP–based estimate of potential output as these provide a more stable growth path for expenditure.[82] However, it is clear from recent years that the limits being set by the Expenditure Benchmark are still quite high, and that the adjustments made under the Expenditure Benchmark are serving to produce actual spending growth rate estimates that are lower than might otherwise be the case if measured appropriately. This is particularly true in relation to adjustments made for increases in public investment. While the rules smooth recent increases to allow for temporary fluctuations, increases in public investment in Ireland in recent years are part of a trend increase intended to bring investment levels to a higher steady state level.

[82] However, the legal requirement for compliance with the Expenditure Benchmark is based on the CAM–based estimate of potential output.

Expenditure Benchmark

The Expenditure Benchmark is used a measure of progress towards the MTO. Under the fiscal rules, once the MTO has been achieved the Expenditure Benchmark is not formally binding, although it is considered as part of an overall assessment.[83]

Net expenditure in 2018, less one-off expenditure measures, is forecast to increase by 4.1 per cent year-on-year. This is below the Expenditure Benchmark of 4.8 per cent year-on-year increase and so the Expenditure Benchmark will not be breached in 2018. However, due to the adjustments used to arrive at the net expenditure figure, this rule gives an inappropriate signal for 2018.[84]

Below is an outline of how the Net Expenditure Aggregate — used for assessing compliance with the Expenditure Benchmark — is arrived at:

$$Net\ Expenditure\ [Net\ of\ oneoffs]_t = GGE_t - Int_t - EU_t - (GFCF_t - avGFCF_t) - UC_t - DRM_t - [OOE_t]$$

Where GGE_t is general government expenditure at time t, Int_t is interest payments at time t, EU_t is funds matched by EU co–financing at time t, $GFCF_t$ is government gross fixed capital formation at time t, $avGFCF_t$ is the average government gross fixed capital formation for years $t-3$ to year t, UC_t is the cyclical unemployment expenditure at time t, and DRM_t is the discretionary revenue measures at time t.[85],[86] A further correction is made to adjust for one-offs in expenditure spending, OOE_t, at time t.

Shown in Table 4.2 are the contributions of each component to the net expenditure growth figure. As can be seen from the table, were it not for the adjustments from

[83] Member States are not expected to over-achieve the MTO. Therefore if the structural balance has exceeded the MTO in year t and budgetary plans do not jeopardise the MTO, deviations are not considered. However, the Expenditure Benchmark may still form part of the overall assessment of compliance with the fiscal rules (European Commission, 2018a).

[84] The European Commission's application of the fiscal rules allows for a negative convergence margin, in year *t,* if the MTO has been overachieved in year *t-1.* This allows more room for manoeuvre under the Expenditure Benchmark as the limit is then set higher than would otherwise be the case. The use of a negative convergence margin in the application of the Expenditure Benchmark is not something that the Council uses in its assessment.

[85] Cyclical unemployment expenditure is estimated using the CAM NAWRU.

[86] When calculating growth rates of net expenditure for year *t,* the previous year's net expenditure figure does not include the adjustment for DRMs.

GFCF and DRMs reducing the net expenditure figure, the Expenditure Benchmark would not have been adhered to for 2018 and 2019. If public investment (GFCF) is starting from a low level and there is a trend increase in investment (i.e., non-temporary increase)— as is the case for Ireland, where significant increases in public investment have occurred or are planned in 2018 and 2019—then, due to the nature of the adjustments made to arrive at the net expenditure figure, the Expenditure Benchmark may allow more-than-prudent increases.

Table 4.2: Contributions of Each Component to Net Expenditure Growth

Per cent of Net Expenditure

		2017	2018	2019
Walk to Net Expenditure Growth				
ΔGGE	**General Government Expenditure Growth**	**3.2**	**5.5**	**5.6**
-Δ Int	Interest	0.5	0.7	0.4
-ΔEU	EU co-financed current spending	-0.1	0.0	0.0
-ΔGFCF	Public Investment (GFCF)	-0.1	-2.1	-1.3
+ΔavGFCF	Four-year avg of Public Investment	0.6	0.9	1.0
-ΔUC	Cyclical Unemployment Expenditure	0.3	0.0	-0.1
-DRMs	DRMs	0.1	-1.2	-1.3
	Net Expenditure Growth	**4.5**	**3.9**	**4.3**
-ΔOOE	**One-offs**	-0.3	0.3	0.0
ΔNE	**Net Expenditure Growth [Net of one-offs]**	**4.2**	**4.1**	**4.3**
	Limit for Net Expenditure Growth (% y/y)	**-**	**4.8**	**5.9**

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Rounding may affect totals. All figures are in nominal terms and are expressed as a percentage of the previous year's net expenditure (less adjustment for DRMs), unless otherwise stated. Δ Indicates the change in the variable from year *t-1* to year *t*. Limits presented here do not incorporate a negative convergence margin when over achievement of the MTO has occurred in year *t-1*.

Table 4.3: Other Net Expenditure Aggregates

Per cent of Net Expenditure

	2017	2018	2019
Net Expenditure (NE)	4.2	4.1	4.3
NE (NAWRU = 5.5)	5.0	4.8	4.8
NE (No GFCF smoothing)	3.6	5.3	4.5
NE (NAWRU = 5.5, No GFCF smoothing)	4.4	5.9	5.0
Expenditure Benchmark Limit	**-**	**4.8**	**5.9**

Note: The table shows the percentage net expenditure growth, less one-offs, in all cases. All figures are in nominal terms and are expressed as a percentage of the previous year's corresponding net expenditure (less adjustment for DRMs), unless otherwise stated. The NAWRU of 5.5 per cent is the Department of Finance's stated belief about the natural rate of unemployment. Limits presented here do not incorporate a negative convergence margin when over achievement of the MTO has occurred in year *t-1*.

Table 4.3 shows alternative formulations of the net expenditure aggregate (less expenditure one-offs). When a more plausible natural rate of unemployment (NAWRU) is used, the Expenditure Benchmark limit would have been breached in 2018, although this breach would have been only marginal.[87] Without the adjustment for public investment (GFCF), net expenditure would have been above the limit set by the Expenditure Benchmark in 2018. These alternative aggregates, taken together with the net policy spending measure in Box A, all suggest that there was an imprudent increase in spending in 2018 above sustainable levels.

[87] The CAM NAWRU has a number of flaws; it is procyclical, and is highly correlated with actual unemployment.

4.3 Ex-Ante Assessment for 2019

This section assesses the Department's plans for compliance with the fiscal rules for 2019 based on *Budget 2019* forecasts. The Debt Rule will apply in full from 2019 onwards after the end of the three-year transition period from 2016–2018 but it is unlikely to be a binding constraint on fiscal policy for the foreseeable future (see Box F for a detailed explanation of the Debt Rule).

Based on the Department's estimates, the structural balance is currently forecast not to meet the MTO requirement in 2019. Net expenditure growth is forecast to be below the limit set by the Expenditure Benchmark for 2019. However, there are further risks of slippage for 2019.

MTO and Structural Balance Adjustment Requirements

A structural deficit of 0.71 per cent of GDP is expected for 2019, which will not meet the MTO requirement of a structural deficit of no more than 0.5 per cent of GDP (based on the Department's estimates under the CAM). However, the structural balance is within the European Commission's "margin of tolerance" of 0.25 per cent of GDP from the MTO. In this case, the MTO would be deemed — by the Commission — to be achieved for 2019.[88] The "margin of tolerance" is used to alleviate some of the uncertainty involved in the calculation for the structural balance and formulating fiscal policy in order to be compliant with the upper limits of the "margin of tolerance" is not prudent budget management. As the structural balance is set to be at the upper limit of the "margin of tolerance", based on the Department's estimates, there is a risk that the MTO would be deemed, by the Commission, not met for 2019. This could happen if expenditure overruns occur, revenue does not meet targets, or revisions to the output gap occur.[89]

There is no adjustment requirement for 2019.[90]

[88] Section 4.3 discusses scenarios where this might not be the case.

[89] A recent IGEES analytical note found that average annual absolute revision to the output gap for Ireland was almost 1 percentage point over the period 2003–2016 (Bedogni and Meaney, 2018). Upward revisions to the output gap would have a detrimental effect on the structural balance.

[90] The updated requirement is as a result of latest estimates by the European Commission, showing adherence to the MTO for 2018. This update to a no adjustment requirement is reflected in this chapter. However, the use of a negative convergence margin under the Expenditure Benchmark is not reflected in this chapter.

Expenditure Benchmark

Net expenditure for 2019 is expected to grow below the limit set by the Expenditure Benchmark. Net expenditure is forecast to grow by 4.3 per cent year-on-year in 2019, which is less than the 5.9 per cent limit set by the Expenditure Benchmark. The Department's forecasts based on the CAM show that the MTO will not be met for 2019. There are also risks that the Commission will deem the MTO as not being achieved. In such cases, the Expenditure Benchmark may be used in an overall assessment of compliance with the fiscal rules. Over the medium term, the Council recommends at least adhering to the Expenditure Benchmark, without a negative convergence margin, based on more plausible estimates of potential output for Ireland. This would help to ensure spending growth is in line with sustainable and prudent budget management.[91]

Scenario Analysis of Expenditure Benchmark and Structural Balance

This section provides a scenario analysis of the Expenditure Benchmark and structural balance based on a scenario which accounts for continued overruns in health and a payment of the Christmas bonus (which persistently has not been budgeted for). The average overrun in health over the last six years (including the forecast for 2018) was €466 million. [92] While the Christmas bonus is expected to cost €265 million in 2018. We assume the Christmas bonus will cost in the region of €270 million for 2019, due to increases in social welfare payments included in *Budget 2019*. Based on these two additional expenditures, Table 4.4 details how these would affect compliance with the Expenditure Benchmark when they are included for 2019, and assuming no offsetting factors.

[91] The Expenditure Benchmark based on CAM estimates of the potential output exhibits pro-cyclical tendencies which may not provide a good foundation for sustainable spending increases. The use of a negative convergence margin exacerbates these tendencies. See Box E for details of the Expenditure Benchmark based on the Department of Finance's preferred estimates for potential output.

[92] See Box D for details.

Table 4.4: Scenario Analysis of the Expenditure Benchmark

% GDP unless stated, deviations: negative=non-compliance

	2017	2018	2019
Expenditure Benchmark			
(a) Reference Rate of Potential Growth (% y/y)	-	3.4	4.5
(b) Convergence Margin	-	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	-	3.4	4.5
GDP Deflator used	-	1.3	1.3
Limit for Nominal Net Expenditure Growth (% y/y)	**-**	**4.8**	**5.9**
Net Expenditure Growth (% y/y)	4.5	3.9	5.3
Net Expenditure Growth (Corrected for one-offs) (% y/y)	4.2	4.1	5.3
1yr Deviation (Corrected for one-offs) (€bn)	-	0.4	0.4
1yr Deviation (Corrected for one-offs) (% GDP)	-	0.1	0.1
2yr Deviation (Corrected for one-offs) (€bn)	-	0.3	0.4
2yr Deviation (Corrected for one-offs) (% GDP)	-	0.1	0.1
Limit for Nominal Net Expenditure Growth (€bn)	**-**	**3.4**	**4.4**
Net Expenditure Increase (€bn)	3.0	2.7	4.0
Net Expenditure Increase (Corrected for one-offs) (€bn)	2.8	2.9	4.0

Note: Data are adjusted to include an overspend of €466 million in health and a Christmas bonus of €270 million in 2019. Limits presented here do not incorporate a negative convergence margin when over achievement of the MTO has occurred in year *t-1.*

The scenario above indicates that expenditure growth would increase by a further 1 percentage point year-on-year, if these measures were to occur in 2019. This would lead expenditure to be close to the limit of 5.9 per cent year-on-year growth set by the Expenditure Benchmark, leaving little room (€400 million) for any further slippage in expenditure.

Based on the expenditure scenario above, and under the assumption that 50% per cent of the overrun in expenditure (€368 million) is returned to general government in the form of increased tax revenue, a scenario analysis is carried out for impact on the structural balance.[93] In this scenario the structural balance for 2019 would no longer be considered, by the Commission, to be at the MTO as the structural balance of -0.82 per cent of GDP would be outside their "margin of tolerance" from the MTO (Table 4.5).

[93] The assumption of 50% of the expenditure being returned to the exchequer as tax revenue would be considered a favourable scenario in terms of adherence to the fiscal rules. The Christmas bonus has historically been paid in the first week of December. As a result, it is unlikely that there would be significant revenue return in the financial year arising from this payment.

Table 4.5: Scenario Analysis of the Structural Balance

% GDP unless stated, deviations: negative=non-compliance

	2017	2018	2019
Structural Balance Adjustment Requirement			
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**
CAM Structural Balance	0.4	-1.2	-0.8
MTO met?	Y	N	N
Minimum Change in Structural Balance Required	**-**	**-**	**-**
Change in CAM Structural Balance	0.6	-1.5	0.4
1yr Deviation (€bn)	–	-4.9	1.2
1yr Deviation (p.p.)	–	-1.5	0.4
2yr Deviation (€bn)	–	–	-1.8
2yr Deviation (p.p.)	–	–	-0.6

Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Data are adjusted to include an overspend of €466 million in health, a Christmas bonus of €270 million, and an increase in revenue of €368 million in 2019.

As the MTO would not be met and net expenditure growth would be close to the limit set by the Expenditure Benchmark for 2019, should this scenario arise, there is a risk of failure to comply with the fiscal rules for 2019.

Debt Rule

The requirements for the Debt Rule will come into effect in full from 2019, following the conclusion of the three-year transition period from 2016–2018. See Box I for details on the Debt Rule and how it is applied. In essence, the Debt Rule requires that the debt-to-GDP ratio be reduced by an average of at least 1/20th per year of the gap above 60 per cent of GDP. The debt ratio for 2019 is forecast to fall to 61.4 per cent of GDP, which is below the 1/20th Debt Rule limit. Due to the nature of the distortions in the GDP figures for Ireland, the 60 per cent ceiling value measured relative to GDP is more easily attained than in other economies for a given capacity of the domestic economy to support the debt; measured relative to GNI*, the debt ratio is approximately 40 percentage points higher than the ratio based on GDP.[94] Based on Government forecasts, the debt ratio is due to fall below the 60 per cent of GDP level in 2020 (Appendix H Table H.1). Once this occurs, the requirement is to maintain a debt-to-GDP ratio below the 60 per cent of GDP ceiling. This is forecast to be the case for 2021–2023.

[94] The forecast for GNI* for 2019 is taken from the Department of Finance's forecast, which is based on a purely technical assumption that GNI* moves in line with GNP.

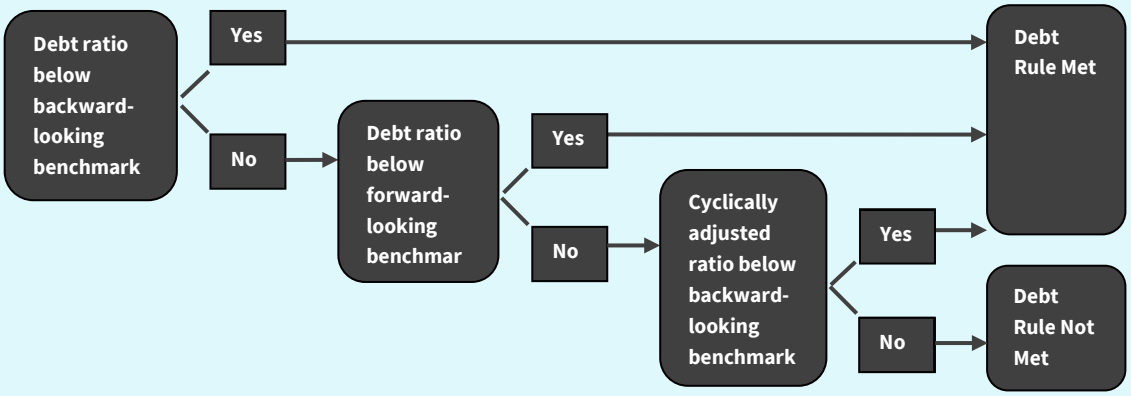
Box F: Introductory Guide to the Debt Rule

This Box outlines how the Debt Rule will apply once it becomes fully applicable to Ireland in 2019. The Debt Rule is one of the EU fiscal rules set out in the *Stability and Growth Pact* and is part of the "six-pack" of reforms implemented in 2011. The Debt Rule came into force in Ireland with the adoption of the *Fiscal Responsibility Act 2012.* Following the exit of the *Excessive Deficit Procedure* (EDP) in 2015, Ireland entered into a transition period from 2016-2018, which limited the legal requirements for adherence to the Debt Rule. From 2019 onwards, the Debt Rule will apply in full.

The Debt Rule in Operation

The core of the Debt Rule effectively requires that the debt-to-GDP ratio be below 60 per cent of GDP or sufficiently falling towards this upper limit. In essence, if the debt-to-GDP ratio is above 60 per cent of GDP, the rule requires that the ratio falls by, on average one-twentieth of the excess between the actual debt-to-GDP ratio and 60 per cent of GDP. This requirement is expressed as a benchmark debt-to-GDP ratio.

There are three criteria used when assessing progress towards the 60 per cent of GDP ceiling value, with the least stringent of these criteria being used to assess compliance with the Debt Rule. The three criteria are: (1) the backward-looking benchmark, (2) the forward-looking benchmark, which is compared to $t + 2$ forecast of the debt-to-GDP ratio, and (3) a cyclically adjusted debt-to-GDP ratio, which is compared to the backward-looking benchmark. The criteria are applied sequentially, as outlined in the flow chart below:



Formally, these are calculated as:

$$Backward\ looking\ Benchmark$$

$$= 60\% + \left(\frac{0.95}{3}\right)(b_{t-1} - 60\%) + \left(\frac{0.95^2}{3}\right)(b_{t-2} - 60\%) + \left(\frac{0.95^3}{3}\right)(b_{t-3} - 60\%)$$

$$Forward\ looking\ Benchmark$$

$$= 60\% + \left(\frac{0.95}{3}\right)(b_{t+1} - 60\%) + \left(\frac{0.95^2}{3}\right)(b_t - 60\%)$$

$$+ \left(\frac{0.95^3}{3}\right)(b_{t-1} - 60\%)$$

$$Cyclically\ Adjusted\ ratio = \frac{B_t + \sum_{j=0}^{2} C_{t-j}}{Y_{t-3} \prod_{h=0}^{2}(1 + y_{t-h}^{pot})(1 + p_{t-h})}$$

where b_t is the debt-to-GDP ratio at time t, B_t is the nominal debt level at time t, C_t is the cyclical component of the budget balance at time t, Y_t is the nominal GDP at time t, y_t^{pot} is the potential output at time t, and p_t is the price deflator at time t.[95]

In the event that the Commission deems that the debt-to-GDP ratio is in breach of all three criteria, the Commission will prepare a report, which takes a number of factors into account before coming to a conclusion as to whether the debt criterion has been breached, which can in turn lead to the Commission recommending the launch of an *Excessive Deficit Procedure*.[96,97]

Once the debt-to-GDP ratio falls below the 60 per cent of GDP ceiling value, this limit becomes the binding criteria. Breaching the 60 per cent of GDP ceiling limit from below automatically triggers a report from the Commission, unless the debt-to-GDP ratio returns below the ceiling value over the Commission's forecast horizon.[98]

Compliance with the Debt Rule over the forecast horizon

Figure F.1 shows the forecasted compliance with the backward-looking and forward-looking benchmark. Over the period 2014–2023, both the backward-looking benchmark and the forward-looking benchmark were complied with. The debt-to-GDP ratio is forecast to fall below the 60 per cent of GDP ceiling in 2020 (Figure F.1A), for the first time since 2008.

[95] For legal compliance with the Debt Rule, assessment of compliance with the forward-looking benchmark is based on European Commission forecasts of future debt-to-GDP ratios based on unchanged policies. Similarly, assessment of compliance with the cyclically adjusted ratio is based on the Commission's CAM estimates of potential output.

[96] The factors taken into account include among others, an assessment of the overall economic environment, adherence to the MTO, or adjustment path towards it, implementation of structural reforms and pension reforms, the expected timeline for compliance with the debt rule and the contribution of stock-flow adjustments to the breach.

[97] Should the European Council adopt the Commission's recommendation to launch an EDP, this would involve a requirement to adhere to annual targets for the nominal and structural deficits so that the by the end of the correction period, the debt-to-GDP ratio is compliant with the Debt Rule. Non-compliance with the EDP may lead to a sanction of a non-interest bearing deposit of maximum 0.2 per cent of GDP being lodged with the Commission. Further non-compliance with the EDP may lead to suspension of commitments — or payments — of the European Structural and Investment funds and/or fines of up to 0.5 per cent of GDP, which may be supplemented by the European Investment Bank reconsidering its investment policy towards the Member State.

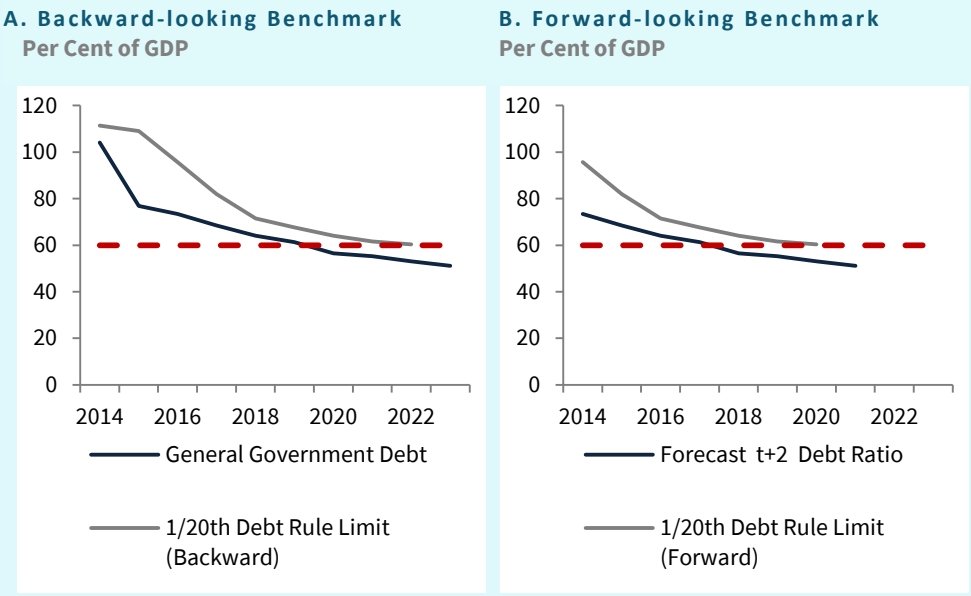
[98] In addition to the factors outlined above, one of the relevant factors that the Commission take into account when coming to a conclusion as to whether or not to recommend launching an *Excessive Deficit Procedure*, when the 60 per cent of GDP ceiling value is breached from below, is the cyclically adjusted debt-to-GDP ratio.

Implications of the Debt Rule for Ireland

The Debt Rule as currently formulated has a number of flaws. Essentially, the Debt Rule requires significant frontloading of consolidation, if the debt-to-GDP ratio is substantially above 60 per cent of GDP, or it imposes minimal fiscal effort, if the debt-to-GDP ratio is relatively close to the 60 per cent of GDP ceiling value (Barnes *et al.,* 2016).

In addition, due to the nature of the distortions in the GDP figures for Ireland, relating to the multinational sector, this rule is not expected to be a binding constraint on medium-term fiscal policy for Ireland. The sustainability of Ireland's debt levels should not be assessed on the basis of the debt-to-GDP ratio due to these distortions. Sustainability of Ireland's debt levels should be judged on a more appropriate measure of national income than the GDP figures, like GNI*.[99]

Figure F.1: Compliance with the Debt Rule



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The figures show the Department of Finance's forecasts of the debt ratio from *Budget 2019.* Legal compliance with the forward-looking benchmark is assessed on the basis of the European Commission forecasts.

The Council assesses that a more appropriate debt commitment should be chosen by the Government. The commitment should better reflect sustainability concerns — like a debt-to-GNI* ratio, rather than a debt-to-GDP ratio — and should be time limited with a specific date by which the objective should be achieved.[100] It should be clearly specified whether the commitment would be a target or a ceiling. Further, it should be specified whether it is a steady-state debt target to be achieved on average over the cycle or whether it is intended to be maintained permanently.

[99] See Box A of the June 2017 FAR (IFAC, 2017c) for details on ratios other than the debt-to-GDP ratio to assess sustainability on.

[100] The Government previously set a debt target of 55 per cent of GDP. This target was not well specified, not time-bound and was not set against an appropriate denominator. As a result, this was not an appropriate target.

4.4 *Ex-ante* Assessment for 2020–2023

Appendix H Table C.1 provides a summary of assessment of the fiscal rules for 2020–2023. However, the forecasts for expenditure in these later years are unrealistic (see Chapter 3).

MTO and Structural Balance Adjustment Requirements

The MTO for 2020-2023 is due to be set by the Government in 2019. Under the assumption that the same MTO, of a deficit of 0.5 per cent of GDP, will be set for these years, it is forecast that the MTO will be adhered to over this horizon.

The adjustment requirement for the structural balance for 2020 would be 0.2 per cent of GDP based on current forecasts, but this requirement will be formally set by the European Commission in spring 2019. It is forecast that this will be achieved in 2020 and that the structural balance would exceed the MTO by an increasing margin from 2020 to 2023. As a result, no adjustment requirement is expected to apply over this period. However, these are not reliable estimates of the structural balance, and are likely to change due to revisions to the CAM estimates of the output gap and expected higher expenditure than is currently planned (Chapter 3).

Expenditure Benchmark

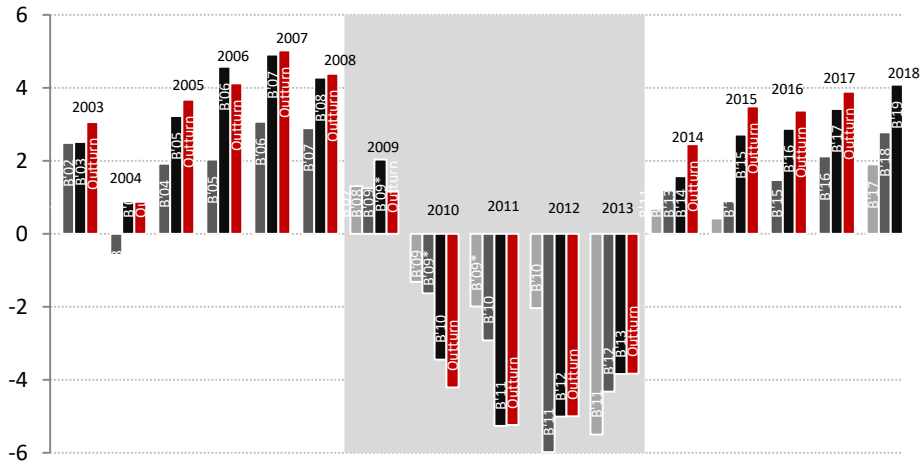
Based on *Budget 2019* forecasts the Expenditure Benchmark would be adhered to for the period 2020-2023. However, these forecasts are not credible and may be unrealistically low for a number of reasons (see Chapter 3).

4.5 Medium-Term Expenditure Framework

The Medium-term Expenditure Framework (MTEF) is a reform introduced after the crisis years and is legislated for in the *Ministers and Secretaries (Amendment) Act 2013.* The MTEF was introduced to provide a better mechanism of managing expenditure over the medium-term and ensures that the Expenditure Benchmark is adhered to. The MTEF requires the Government to set limits to overall public expenditure for the following three years, while Ministerial expenditure ceilings are established to ensure aggregate expenditure remains within overall limits.

Figure 4.4: Change in Gross Current Expenditure Forecasts

€ Billions



Source: Department of Finance; internal IFAC calculations.
Note: Bars show the change in forecasts from various Budgets followed by outturns, versus the earliest Budget forecast for that year (e.g., B'15 = expenditure forecasts in *Budget 2015* minus the earliest forecast for the specified year). Grey shaded region covers crisis period 2009-2013. Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above.

Figure 4.4 shows the revisions to current expenditure forecasts since 2003. There is a clear cyclical pattern to the revisions to expenditure forecasts that has continued in 2018. During the crisis years, there was a pattern of consistent downward revisions to expenditure plans. In recent years, we have witnessed a return to upward revisions to both expenditure forecasts and expenditure outturns. The pattern of upward revisions to the expenditure ceilings undermines the credibility of the ceilings and indicates that they are seen by government departments as a "soft budget constraint". In the last number of years, upward revisions to the expenditure ceilings have been quite significant in the four largest departments (Appendix G). In-year increases for 2018 were particularly large for the Department of Health, the Department of Education and Skills, and the

Department of Employment Affairs and Social Protection. The continued upward revisions to expenditure forecasts risks undermining the fiscal position of the state, risks repeating the mistakes of the past, and reduces the ability of public finances to absorb negative shocks in the future.

Appendices

Appendix A: Debt Sustainability Analysis

This appendix looks at the sustainability of Irish debt by considering (1) the probability range for debt outcomes based on historical forecast errors, and (2) a number of common stress scenarios. Estimates are produced using the Council's Fiscal Feedbacks Model (IFAC, 2012) and the baseline scenario is taken to be that produced in the Department's latest set of forecasts. It is intended that this appendix will be extended to assess other variables relevant for debt sustainability in future reports.

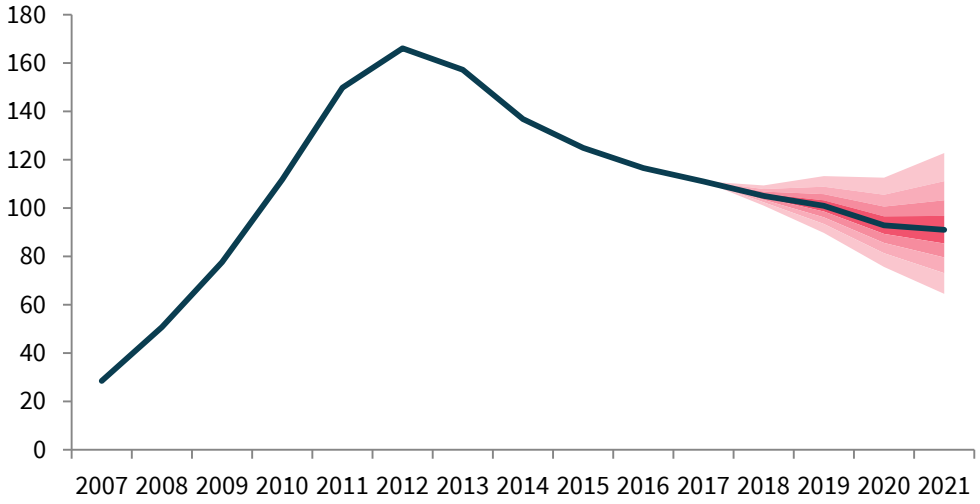
Probability Distribution for Debt Forecasts

A useful way to illustrate uncertainty and the impact of alternative growth paths on the government debt ratio is through the use of a fan chart.

Figure A1 below takes the Department of Finance's latest debt forecasts as the central line. The width of the fan represents the range of possible outcomes for the debt-to-GNI* ratio based on past forecast errors.[101] For example, according to this, there is an estimated 20 per cent probability that the debt ratio would not fall below current levels by 2021, in the absence of offsetting policy adjustments.

Appendix Figure A1: Probability Outcomes for Government Debt

% GNI*, general government basis



Source: Department of Finance; internal IFAC calculations.
Note: Line shows outturns and central forecasts, while bands show 20 per cent, 40 per cent, 60 per cent, and 80 per cent likelihood ranges, respectively, as one moves outward from the central forecasts. Forecast errors based on 2001–2007; 2011–14 sample of Department of Finance forecast errors.

[101] While there are some limitations with these charts, as described in Annex A of IFAC (2012), they do serve to highlight the uncertainty surrounding the fiscal position.

Stress Scenarios

Another useful way to examine debt sustainability is by exploring a number of common stress scenarios (see IMF 2018, for example). All scenarios assume that policy settings are not adjusted in response to the shock. We consider six stress scenarios and their impact on the forecast debt ratios in Figure A2 below:

1. **"Growth" shock**: A shock equivalent to one standard deviation of the historical nominal GDP growth rate over the period 2000–2017 (excluding 2008–2009 and 2015) is considered for two consecutive years (-4.6 percentage points per annum relative to baseline).

2. **"Primary Balance" shock**: A shock to the primary balance equivalent to half of the historical standard deviation of the underlying primary balance in per cent of GDP over the period 2000–17 (excluding 2008–2009 and 2015) is considered for the full forecast period (-2.4 percentage points). An increase in average effective interest rates of 0.25 percentage points is assumed for every 1 per cent of GDP worsening in the primary balance.

3. **"Interest" shock**: A standard 2 percentage point shock is applied to the marginal interest rate on government debt over the entire forecast period.

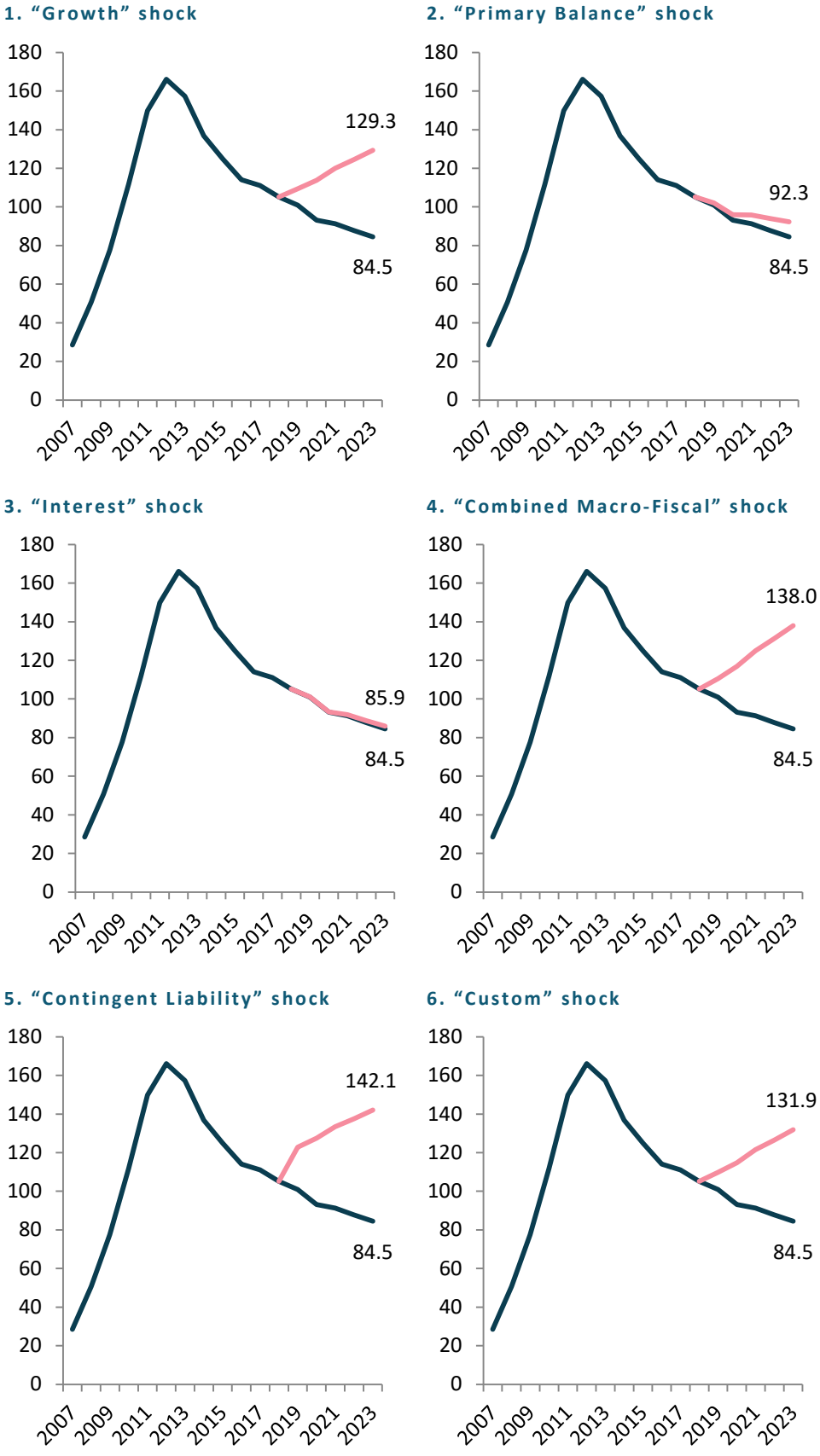
4. **"Combined Macro-Fiscal" shock**: Combines the three shocks above.

5. **"Contingent Liability" shock**: This extends the "Growth" shock above with a one-off increase in public spending equal to 10 per cent of domestic bank assets (i.e., the "Irish-Headquartered Group" of credit institutions as defined by the Central Bank of Ireland). This can be considered a tail risk as domestic banks have strengthened their capital buffers.

6. **"Custom" shock**: This draws on the analysis outlined in Box C of IFAC (2018a) and assumes that five large, foreign-owned multinational enterprises exit Ireland at the same time. A primary balance deterioration of €1.7 billion is assumed along with the "Growth" shock above.

Appendix Figure A2: Stress Scenarios for Government Debt

% GNI*, general government basis



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

Appendix B: Timeline for Endorsement of *Budget 2019* Projections

Date	
13 September	CSO releases *Quarterly National Accounts* estimates for Q2 2018.
17 September	The Secretariat and Department of Finance met the CSO to clarify technical details of latest *Quarterly National Accounts* estimates.
18 September	The Secretariat received Department of Finance technical assumptions underpinning *Budget 2018* forecasts.[102]
19 September	After consideration by the Council, Benchmark projections were finalised by the Secretariat prior to receiving preliminary forecasts from the Department of Finance.
20 September	The Council received preliminary forecasts from the Department in line with *Memorandum of Understanding* requirements.
24 September	The first endorsement meeting took place with the Department of Finance presenting their forecasts to the Secretariat. A number of clarifications of a factual nature were requested.
26 September	The Council received final forecasts from the Department in line with *Memorandum of Understanding* requirements.
27 September	The Council met to discuss the Department of Finance forecasts.
28 September	Department of Finance staff met with the full Council and Secretariat to present their latest forecasts and to answer questions. The Council sought information regarding a number of forecast components and assumptions used in models for alternative supply-side estimates. The Council then finalised a decision on the endorsement.
2 October	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *Budget 2019*.
9 October	The Department's forecasts are published in *Budget 2019.*

[102] These included assumptions related to oil prices, exchange rates, net expenditure by central and local government on current goods and services, and sources of forecasts for the growth of major trading partners.

Appendix C: The Council's Benchmark Projections (as of 19 September 2018)

Benchmark projections for 2017–2023

% change in volumes unless otherwise stated

	2017	2018	2019	2020	2021	2022	2023
Demand							
Underlying domestic demand[a]	3.2	5.1	3.7	2.8	2.5	2.4	2.4
GDP	7.2	6.6	4.2	3.3	2.7	2.5	2.4
…of which (p.p. contributions)							
Underlying domestic demand[b] (p.p.)	*0.6*	*3.6*	*1.9*	*1.5*	*1.3*	*1.3*	*1.2*
Underlying net exports[b] (p.p.)	*6.6*	*3.0*	*2.2*	*1.9*	*1.4*	*1.2*	*1.2*
Consumption	2.2	3.0	2.6	2.5	2.4	2.6	2.7
Government[c]	3.9	3.4	2.5	1.9	1.8	1.8	1.8
Investment	-31.0	-9.0	4.3	2.5	2.0	1.5	1.3
Underlying investment[a]	6.2	14.0	8.1	4.5	3.5	2.6	2.2
Exports	7.8	5.4	5.4	4.9	4.5	4.4	4.2
Imports	-9.2	0.1	5.1	4.8	4.9	4.9	4.7
Underlying imports[a]	2.6	4.7	5.8	5.3	5.4	5.4	5.2
Supply							
Potential output	6.7	5.5	4.0	3.3	2.6	2.5	2.4
Output gap (% potential output)	-0.2	0.8	1.0	1.0	1.1	1.1	1.1
Labour Market							
Population	1.1	1.4	1.5	1.5	1.6	1.7	1.7
Employment	2.9	2.7	2.5	2.1	2.0	1.9	1.9
Unemployment rate (% labour force)	6.7	5.6	4.9	4.6	4.6	4.5	4.5
Prices							
HICP	0.3	1.7	2.3	2.4	2.5	2.7	2.8
Personal consumption deflator	0.9	1.3	2.3	2.6	3.1	3.2	3.2
GDP deflator	0.4	1.4	1.7	1.5	1.6	1.6	1.8
Other							
Nominal GNI*	3.1	6.2	5.1	4.4	4.6	4.5	4.7
Nominal GDP	7.6	8.1	5.9	4.9	4.3	4.2	4.3
Nominal GDP (€ billion)	294.1	317.9	336.8	353.2	368.5	383.8	400.5
Modified current account (% GNI*)	1.2	0.9	0.3	-0.1	-0.5	-0.9	-1.1

Sources: CSO; and internal IFAC calculations.
Note: CSO outturn data for 2017 based on the *National Income and Expenditure* have been adjusted in anticipation of an upward revision to real goods consumption, which would also increase real goods imports. [a]Underlying domestic demand, underlying investment, and underlying imports exclude "other transport equipment" (mainly aircraft) and intangibles; underlying domestic demand further excludes changes in inventories. [b]Underlying contributions to real GDP growth rates in percentage points – here underlying domestic demand includes the effect of changes in inventories, but like underlying net exports excludes the effect of investment in aircraft and intangible assets. [c]As discussed in Chapter 3, the *Budget 2019* forecasts for the growth in volume of government consumption over the medium term may be too low.

Appendix D: Imbalance Indicators

As part of its toolkit for examining the cyclical position of the economy, the Council uses a "modular" approach. While estimates of the output gap and potential output are useful summary measures, there is a danger that they may not reflect all available economic information which may point to possible imbalances in the economy. Specifically in response to the financial crisis, Borio *et al.* (2014) developed methods of estimating potential output using financial indicators, which capture the effect of the financial sector on the business cycle. This approach can be applied to other variables which may provide useful information on the cyclical position of the economy.

This appendix assesses some indicators of potential imbalances in the Irish economy. Within each module, a number of indicators are examined. Forecasts from *Budget 2019* are also included, where available. Four modules are shown here, namely:

(i) the labour market and prices;

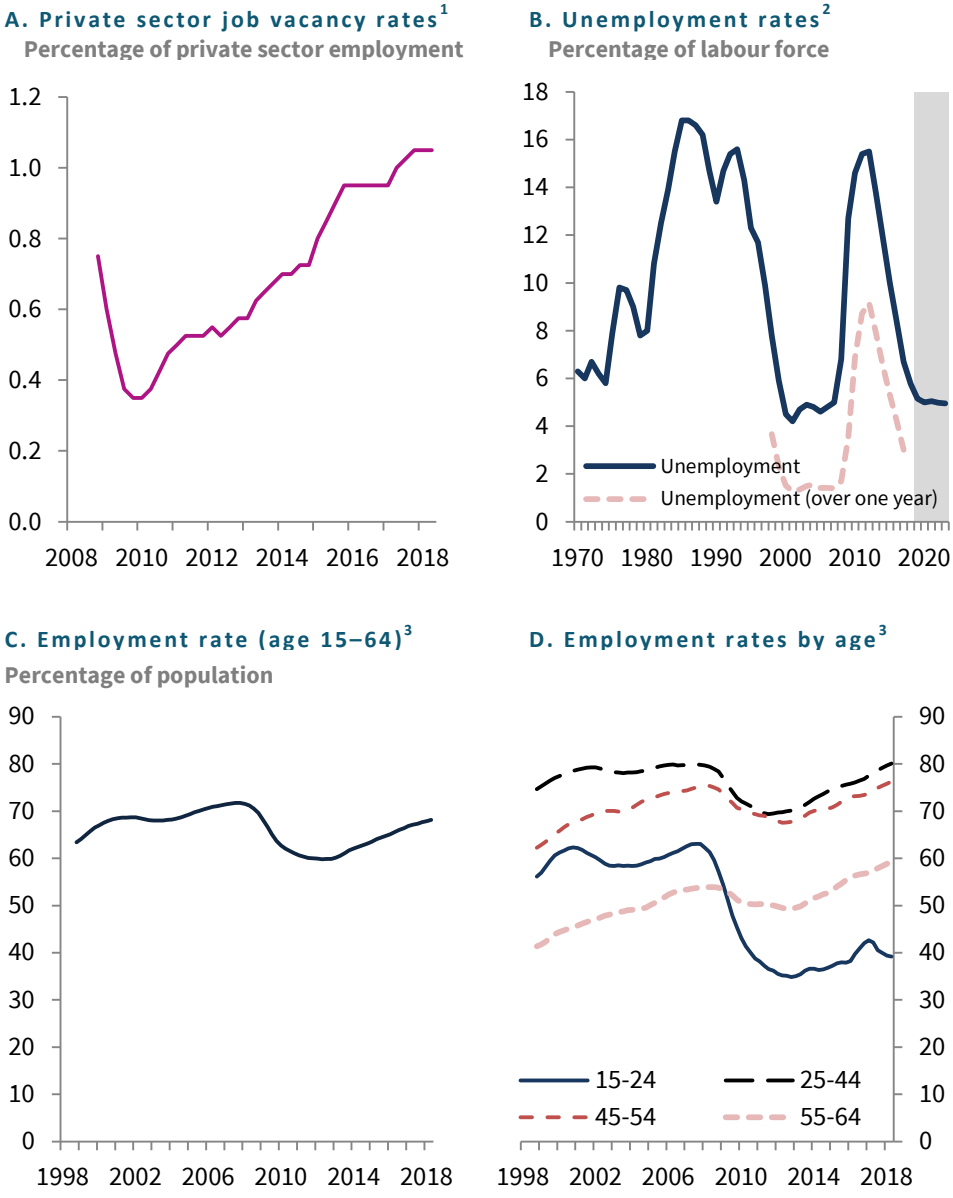
(ii) external balances;

(iii) investment and housing;

(iv) credit conditions.

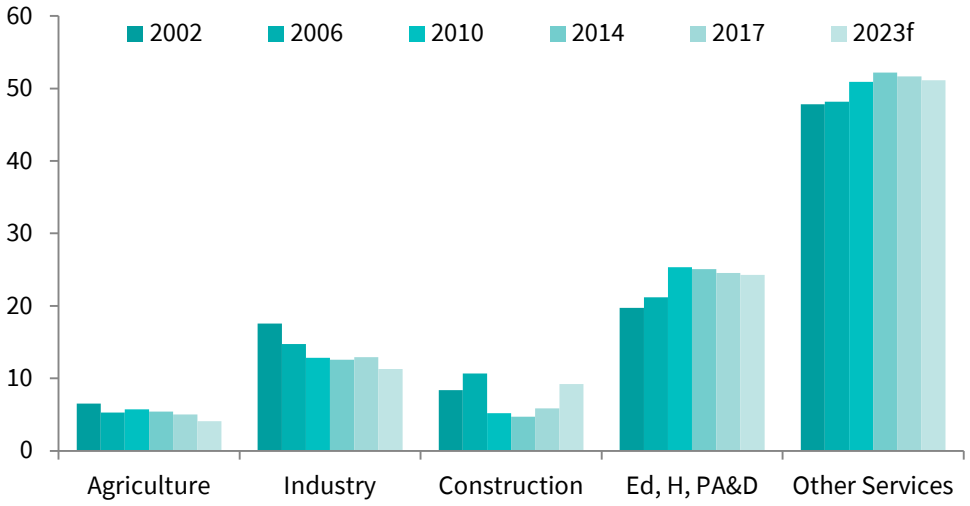
While this modular approach ensures that many potential sources of imbalance are examined, there are difficulties in assigning/estimating the relative importance (or weights) to attach to each of these imbalance indicators. Historical data may be a good guide to variables that explain previous business cycles, but not necessarily current or future ones.

Figure AD.1: Labour market and prices indicators



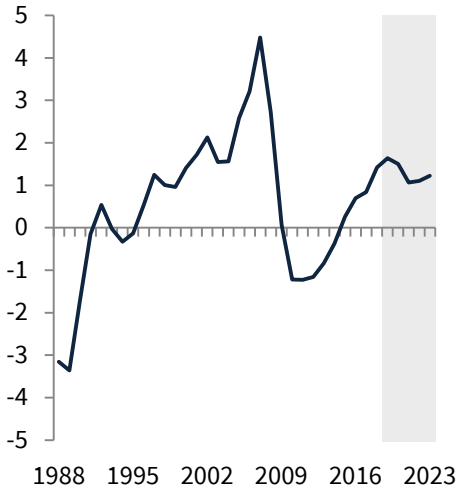
E. Sectoral employment concentration[4]

Percentage of total employment



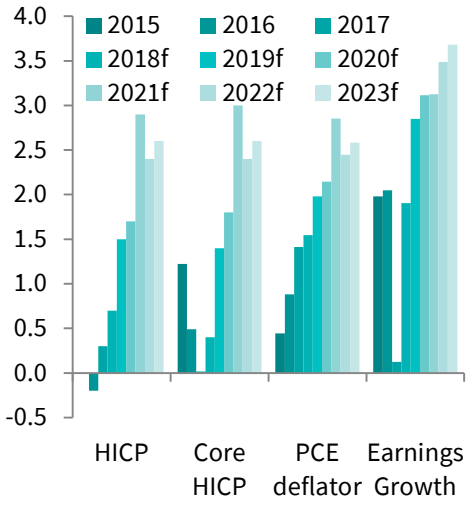
F. Net migration[4]

Percentage of labour force



G. Inflation measures[5]

Percentage change (year on year)



Sources: Central Statistics Office; Department of Finance; European Commission, AMECO.

Notes:

[1] Rates show the four-quarter moving average percentage of vacancies.

[2] Combined historical data from AMECO and CSO, including *Budget 2019* forecasts for 2018–2023.

[3] A four-quarter moving average is shown for employment rates. Employment rates by age grouping for 15-24 years, 25-44 years and 55-64 years are calculated as an average of quarterly employment rates (by five- or ten-year age groups), weighted by annual population estimates by corresponding age group.

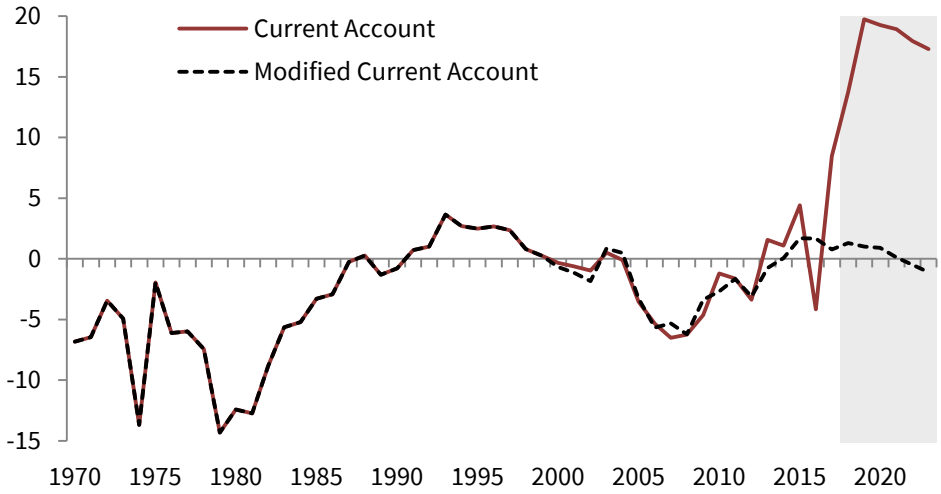
[4] Positive net migration indicates immigration exceeded emigration. Figures E and F include *Budget 2019* forecasts for 2018–2023.

[5] Earnings growth shown is a per-hour national accounts measure, based on compensation of employees and annualised employee hours. *Budget 2019* forecasts for 2018–2023 are included.

Figure D.2: Indicators of External Balances

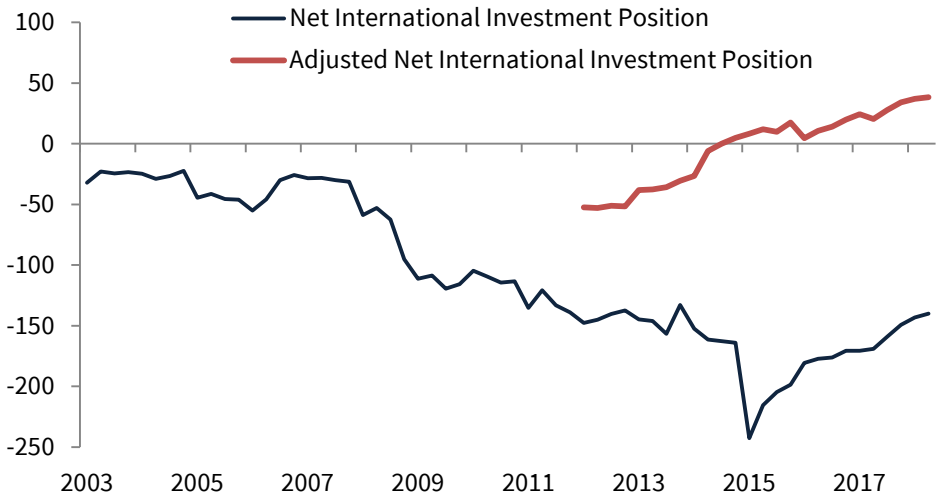
A. Current account and modified current account balances

Percentage of GNI*



B. Net international investment position

Percentage of GDP

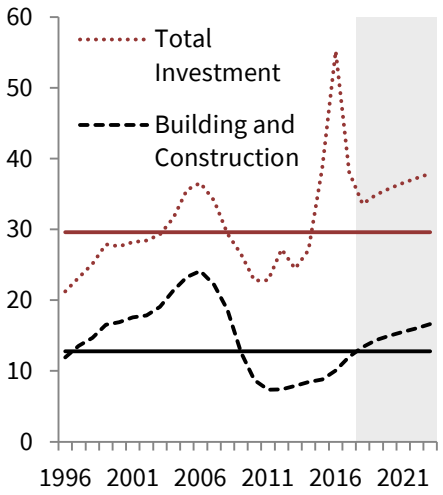


Sources: CSO; Eurostat and internal IFAC calculations.
Note: The modified current account balance excludes the estimated impact of redomiciled PLCs, depreciation on research & development related intellectual property (IP) imports, depreciation on aircraft leasing, imports of R&D services by foreign owned MNCs, and acquisitions of IP assets and aircraft for leasing. Adjusted measure of net international investment position excludes activities of the International Financial Services Centre and Non-Financial Corporations.

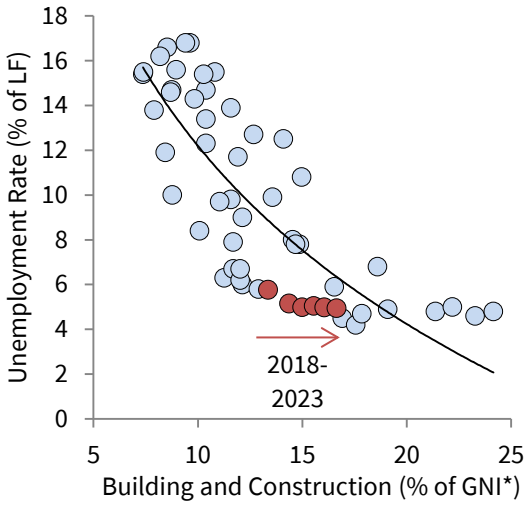
Figure D.3: Investment and Housing Indicators

A. Investment

Percentage of GNI*



B. Construction activity and employment

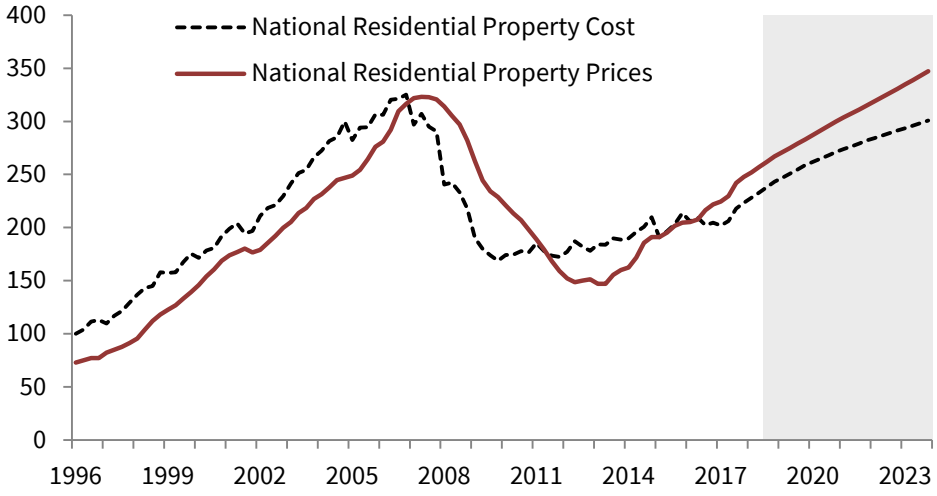


Sources: CSO; AMECO; Department of Finance; internal IFAC calculations.

Notes: Historical averages for investment ratios for 1970–2017 shown as horizontal lines in Panel A. In panel B, forecasts (2018–2023) are shown in red.

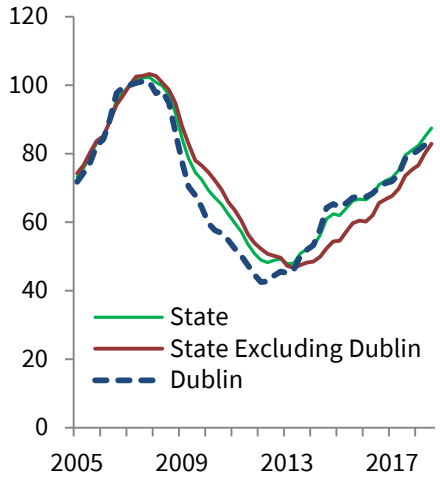
C. Irish residential property: prices and implied production costs

Euro, thousands

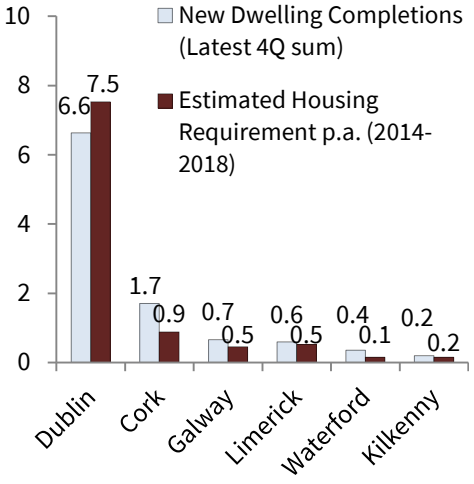


Sources: CSO; Society of Chartered Surveyors of Ireland; and internal IFAC calculations.

D. Real residential property prices (HICP adjusted)
Q1 2007 = 100

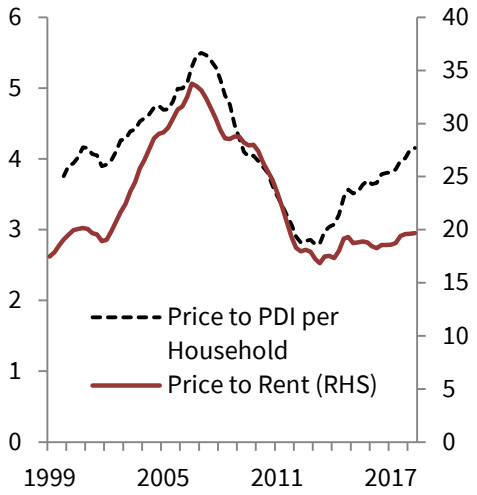


E. Estimated housing requirements and completions
Thousands

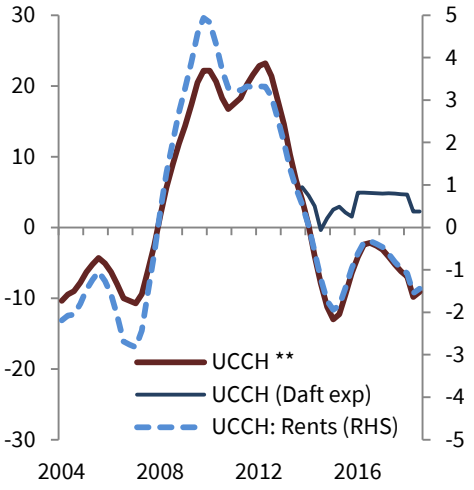


Sources: CSO, ESRI/PTSB, Housing agency estimates and Department of Housing, Planning, Community and Local Government; and internal IFAC calculations.

F. Housing valuation ratios
Ratio

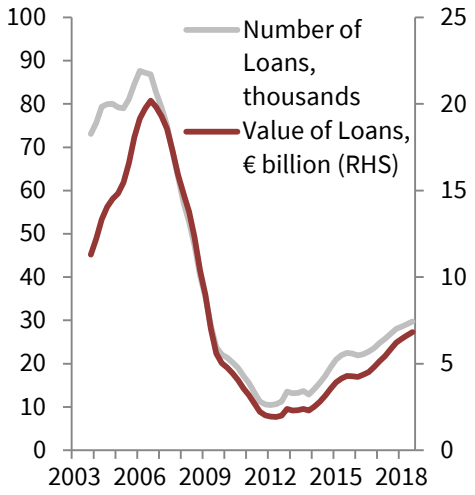


G. User cost of capital for housing (UCCH)



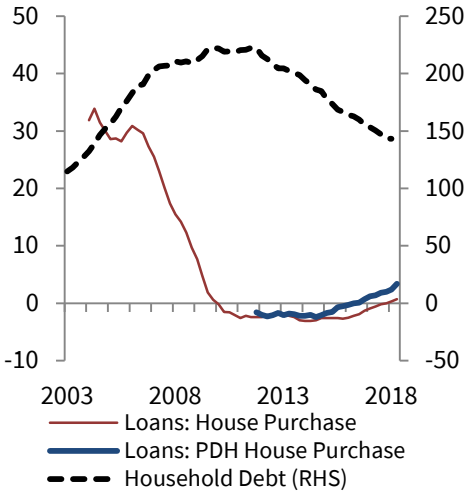
Sources: CSO, *Residential Property Price Index*; ESRI/PTSB *House Price Index*; RTB, *The RTB Rent Index Quarter 4 2017*; Housing agency estimates and Department of Housing, Planning, Community and Local Government; and internal IFAC calculations.

H. Annualised residential mortgage lending (first-time buyer and mover purchase loans)



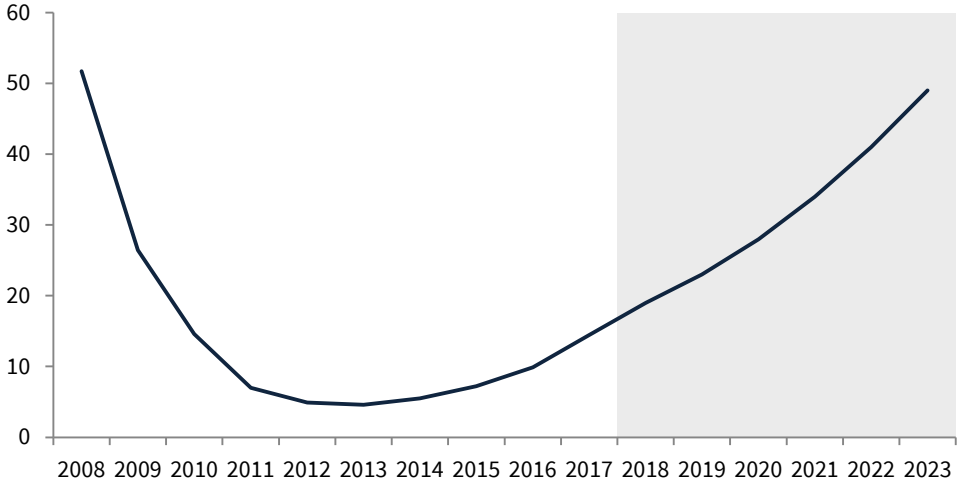
I. Loans to Irish households for house purchase

Percentage change (LHS) and percentage of gross disposable income (RHS)



J. Housing completions

Thousands

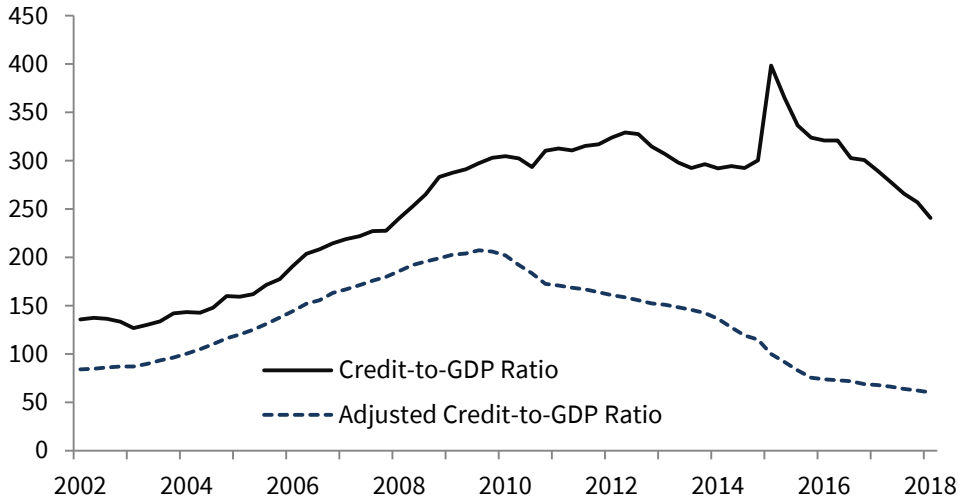


Sources: CSO, ESRI/PTSB, Central Bank of Ireland, IBF Mortgage Market Profile, Department of Housing, Planning, Community and Local Government; and internal IFAC calculations.
Note: Price to disposable income per household corresponds to average house prices divided by moving 4-quarter sum of adjusted personal disposable income per household – households are forecast based on population growth and assuming a constant share of households relative to population from Q1 2016 onwards. UCCH simple proxy corresponds to new mortgage rates less annual price change for the past 4 Qs. UCCH** includes first-time buyer taxes/subsidies; down-payments; depreciation/maintenance. UCCH (Daft exp) uses Daft.ie 12 month price expectations. Housing stock is proxied by Long-term loans; ESA-95 basis pre-2012.

Figure D.4: Credit Indicators

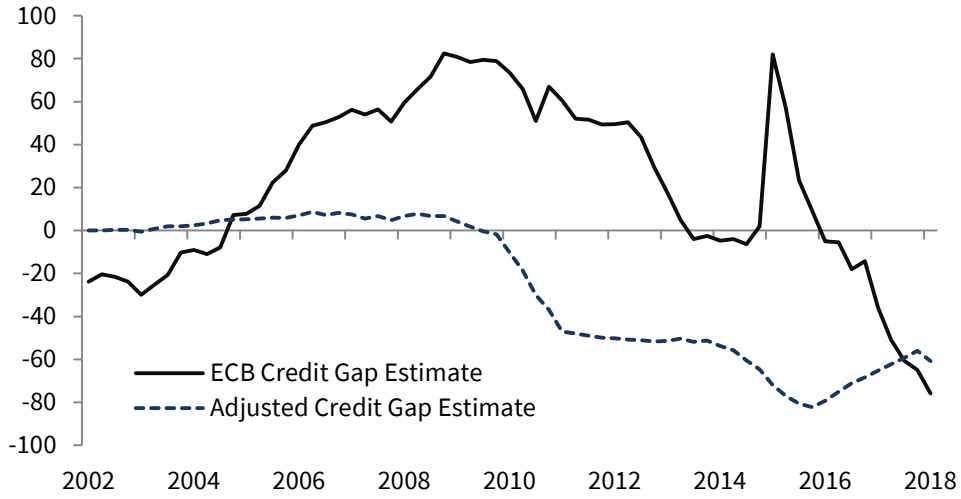
A. Private sector credit-to-GDP ratios

Per cent of GDP



B. Private sector credit-to-GDP gaps

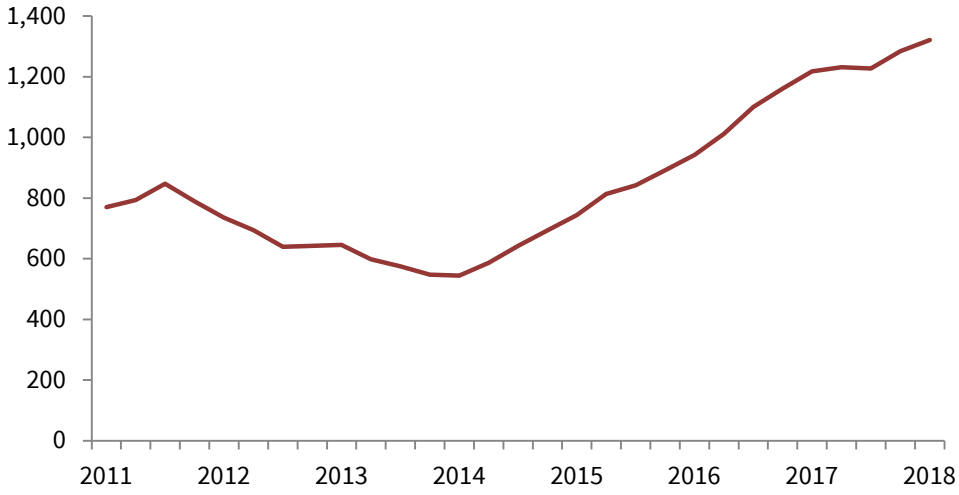
Per cent of GDP



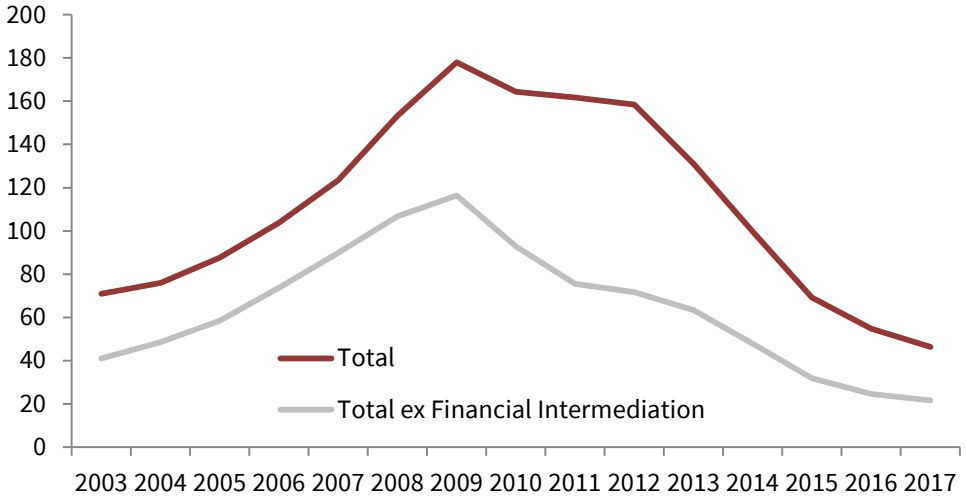
Sources*:* CSO; Central Bank of Ireland and internal IFAC calculations.

Notes*:* Adjusted ratios are constructed as Irish resident private sector enterprise credit (excl. financial intermediation) plus total loan liabilities of Irish households to adjust for the impact of multinational non-financial corporations given that associated credit is often sourced outside of Ireland (e.g., Box 6: Macro-Financial Review 2015:I, Central Bank of Ireland). A similar methodology to that in ESRB recommendation (18/06/2014) on guidance for countercyclical buffer rates is used to specify a credit ratio as: $(CREDIT_t / (GDP_t + GDP_{t-1} + GDP_{t-2} + GDP_{t-3})) \times 100\%$. A recursive Hodrick-Prescott filtered trend ratio is specified, with smoothing parameter lambda = 400,000 to capture the long-term trend in the behaviour of the credit-to-GDP ratio. The credit-to-GDP gap is given by: $GAP_t = RATIO_t - TREND_t$.

C. New credit advanced to Irish resident small- and medium-sized enterprises
€ billion (excluding financial intermediation, four-quarter sum)



D. Credit advanced to Irish resident private-sector enterprises
Per cent of GNI*



Sources: CSO; Central Bank of Ireland and internal IFAC calculations.

Appendix E: Tax Forecasts Decomposed

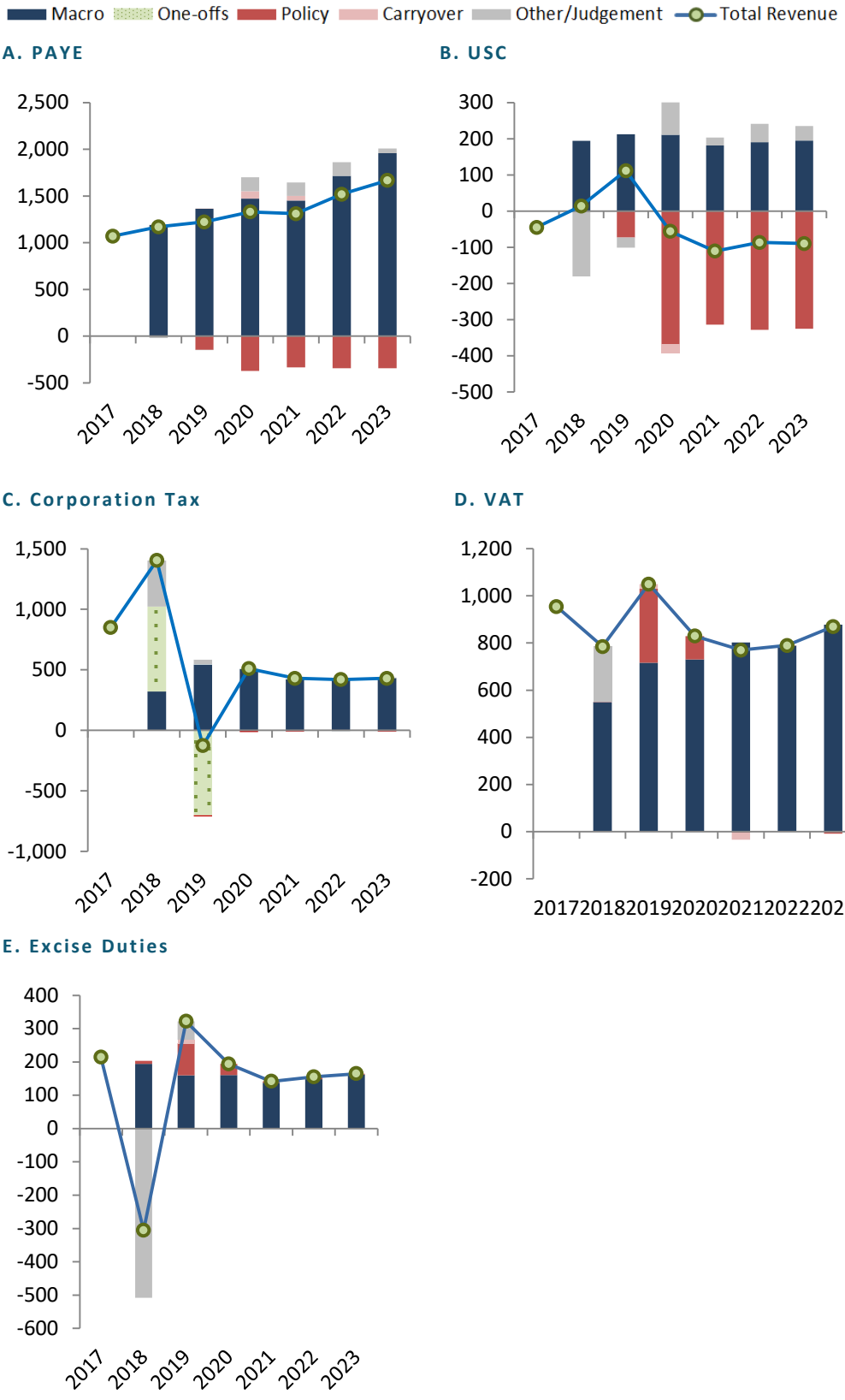
This appendix examines the latest tax revenue forecasts produced by the Department of Finance in *Budget 2019* for the projection horizon 2018–2023. In particular, it shows the yearly changes in the forecasts of VAT, corporation tax, excise duties, and the PAYE and USC components of income tax (see Appendix Figure E1).[103] For a detailed description of the IFAC's forecast replication model, see Hannon (2014).

The changes on the tax forecasts (year-on-year) are attributed to a number of components: (i) "**macro**" is the part of the forecast driven by the growth in the relevant macro driver (e.g. wage growth and its corresponding elasticity when analysing income tax); (ii) "**one-offs**" refer to non-recurring items that impact on expected tax receipts; (iii) "**policy**" impacts account for the estimated impacts from policy changes in a given year (e.g., discretionary tax cuts); (iv) "**carryover**" effects account for policy impacts carried over from previous years; (v)"**other**" represents potential elements affecting the forecasts (calculated as the difference between IFAC's internal forecasting exercise and that carried out by the Department of Finance), including judgement applied by the Department of Finance.

[103] The generic formula applied by the Department of Finance to forecast revenue is given by: $\mathrm{Rev}_{t+1} = (\mathrm{Rev}_t - \mathrm{T}_t) * (1 + \mathrm{B}_{t+1} * \mathrm{E}) + \mathrm{T}_{t+1} + \mathrm{M}_{t+1} + \mathrm{M}_t + \mathrm{J}_{t+1}$,
where revenue forecasts (Rev_{t+1}) depend on their lag stripped of one-off items (T_t), one-off items in the current period (T_{t+1}), the macro drivers (B_{t+1}) and their associated elasticity (E), current policy (M_{t+1}) and carryover policy impacts (M_t), and judgement (J_{t+1}). See Hannon (2014) for a discussion of this approach. Rewriting the formula in terms of annual changes yields: $\Delta\mathrm{Rev}_{t+1} = \mathrm{Rev}_t * \mathrm{B}_{t+1} * \mathrm{E} - \mathrm{T}_t * \mathrm{B}_{t+1} * \mathrm{E} + \Delta\mathrm{T}_{t+1} + \mathrm{M}_{t+1} + \mathrm{M}_t + \mathrm{J}_{t+1}$. In this way, yearly revenue changes for each tax head are attributed to the addition of: (i) the macro driver, which covers the parts of the formula affected by B_{t+1}; (ii) changes in one-off items, as shown in ΔT_{t+1}; (iii) current and previous policy changes ($M_{t+1}$and M_t, respectively); and other adjustments, mainly judgement, as covered in the component J_{t+1}.

Appendix Figure E1: Tax Forecasts Decomposed

€ million, year-on-year change



Sources: Department of Finance; and internal IFAC calculations.

Appendix F: *Ex-Post* Assessment for 2017

This appendix provides a review of the Council's May 2018 *Ex-post compliance with the Domestic Budgetary Rule for 2017* (IFAC, 2018a). Figures relating to the structural balance presented in *Budget 2019* reflect new estimates of the CAM-based output gap as compared to *SPU 2018*.[104] In particular, the output gap has been revised down from 0.3 per cent of GDP in *SPU 2018* to -1.0 per cent of GDP in *Budget 2019* (Figure 4.3). This revision resulted in an improvement of the estimated structural balance for 2017 — however, the legal assessment of adherence to the rule is frozen for 2017 and based on the European Commission's *Spring 2018* (European Commission, 2018b) estimates. [105]

F.1 MTO and Structural Balance Adjustment Requirements

The European Commission set the minimum MTO for Ireland as a structural balance of -0.5 per cent of GDP for the period 2017-2019. Using the Department's latest CAM output gap estimates to assess the structural balance shows that the MTO was achieved in 2017 with a structural balance of 0.4 per cent of GDP (Table 4.1). As the MTO was achieved in 2017, the adjustment requirement no longer applies.

F.2 Expenditure Benchmark

The Expenditure Benchmark acts as a guide for EU Member States to ensure that Member States remain at their MTO or on an appropriate path towards their MTO. As the MTO was achieved in 2017, the Expenditure Benchmark no longer applies.

[104] The European Commission deemed that an adjustment to estimates of potential output for 2017 would be appropriate in response to higher-than-expected growth outturns in 2017. However, the exact implementation differed from what the Department had anticipated. Consequently, the changes in estimates of the output gap between *SPU 2018* and *Budget 2019* are partially as a result of the Department subsequently adopting the European Commission's approach.

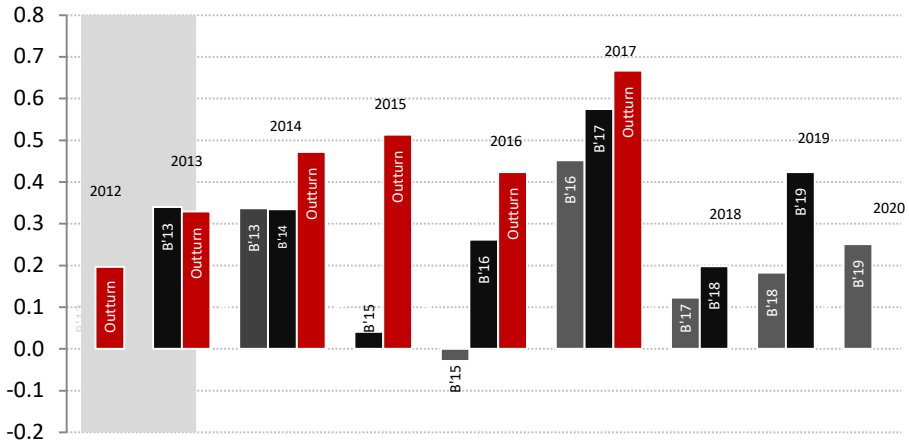
[105] See Box I of the November 2017 FAR (IFAC, 2017e) for a description of technical aspects of the Council's assessment of compliance with the fiscal rules.

Appendix G: Gross Current Expenditure Forecast Revisions in Selected Departments

This appendix shows the change in the forecast gross current expenditure by the four largest departments by current expenditure (the Department of Employment and Social Protection, the Department of Health, the Department of Education and Skills and the Department of Justice). Significant upward revisions have occurred in expenditure ceilings in recent y ears, for each of the four largest departments.

Appendix Figure G.1: Change in Gross Current Expenditure Forecasts: Department of Employment Affairs & Social Protection Group[106]

€ Billions

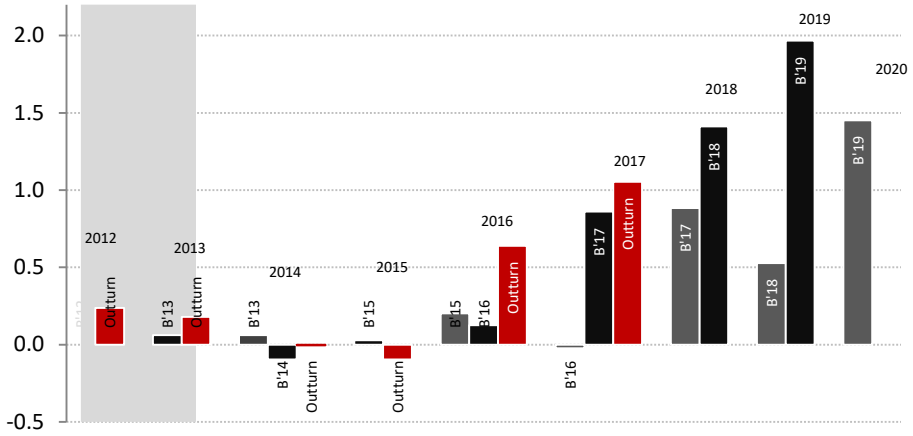


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Bars show the change in forecasts from various Budgets followed by outturns, versus the earliest Budget forecast for that year (e.g., B'15 = expenditure forecasts in *Budget 2015* minus the earliest forecast for the specified year). Grey shaded region covers crisis period up to 2013. Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above.

[106] Formerly known as the Department of Social Protection.

Appendix Figure G.2: Change in Gross Current Expenditure Forecasts: Department of Health[107]

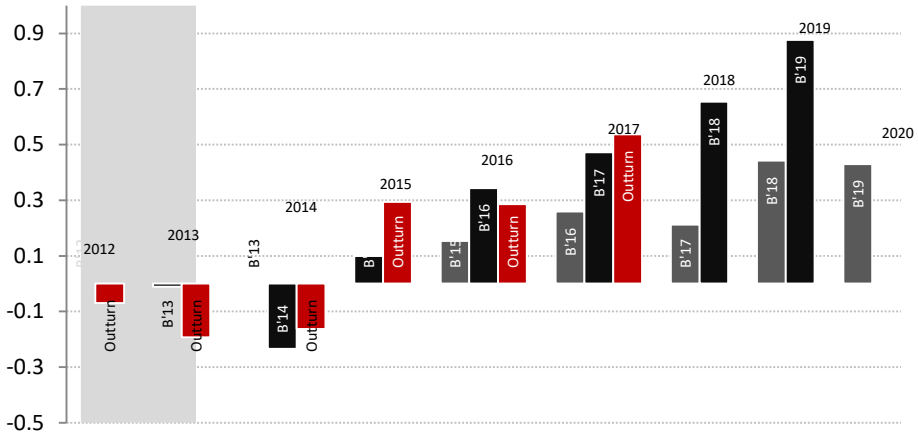
€ Billions



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Bars show the change in forecasts from various Budgets followed by outturns, versus the earliest Budget forecast for that year (e.g., B'15 = expenditure forecasts in *Budget 2015* minus the earliest forecast for the specified year). Grey shaded region covers crisis period up to 2013. Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above.

Appendix Figure G.3: Change in Gross Current Expenditure Forecasts: Department of Education and Skills

€ Billions

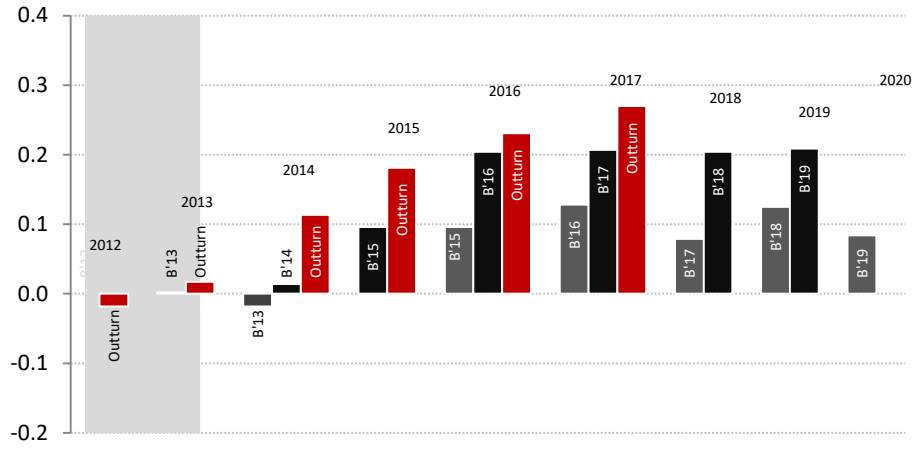


Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Bars show the change in forecasts from various Budgets followed by outturns, versus the earliest Budget forecast for that year (e.g., B'15 = expenditure forecasts in *Budget 2015* minus the earliest forecast for the specified year). Grey shaded region covers crisis period up to 2013. Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above.

[107] Between *Budget 2014* and year-end 2014, more than €500 million was transferred from the Health vote to the Children and Youth Affairs vote. As the bars in the graph indicate the change from the earliest budget forecast to the outturns, this transfer means that the outturns shown for 2014, 2015 and 2016 are approximately €500 million lower than would otherwise be the case.

Appendix Figure G.4: Change in Gross Current Expenditure Forecasts: Department of Justice[108]

€ Billions



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Bars show the change in forecasts from various Budgets followed by outturns, versus the earliest Budget forecast for that year (e.g., B'15 = expenditure forecasts in *Budget 2015* minus the earliest forecast for the specified year). Grey shaded region covers crisis period up to 2013. Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above.

[108] Formerly known as the Department of Justice and Equality.

Appendix H: Assessment of Compliance with the Fiscal Rules 2017–2023

% GDP unless stated, deviations: negative=non-compliance

	2017	2018	2019	2020	2021	2022	2023
Corrective Arm							
General Government Balance Excl. One-Offs	-0.2	-0.3	0.0	0.3	0.7	1.1	1.4
General Government Debt	68.4	64.0	61.4	56.5	55.3	53.1	51.1
1/20th Debt Rule Limit	81.9	71.5	67.7	64.1	60.0	60.0	60.0
Debt Rule met?	Y	Y	Y	Y	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule							
Structural Balance Adjustment Requirement							
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
CAM Structural Balance	0.4	-1.2	-0.7	0.0	0.5	1.0	1.4
MTO met?	Y	N	N	Y	Y	Y	Y
Minimum Change in Structural Balance Required	**-**	**-**	**-**	**0.2**	**0.0**	**0.0**	**0.0**
Change in CAM Structural Balance	0.6	-1.5	0.5	0.7	0.5	0.5	0.5
1yr Deviation (€bn)	-	-4.9	1.6	1.7	1.9	1.9	1.9
1yr Deviation (p.p.)	-	-1.5	0.5	0.5	0.5	0.5	0.5
2yr Deviation (€bn)	-	-	-1.6	1.6	1.8	1.9	1.9
2yr Deviation (p.p.)	-	-	-0.5	0.5	0.5	0.5	0.5
Expenditure Benchmark							
(a) Reference Rate of Potential Growth (% y/y)	-	3.4	4.5	4.6	4.3	4.1	3.6
(b) Convergence Margin	-	-1.1	-1.1	0.9	0.0	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	-	4.5	5.6	3.6	4.3	4.1	3.6
GDP Deflator used	-	1.3	1.3	1.8	1.8	1.7	1.7
Limit for Nominal Net Expenditure Growth (% y/y)	**-**	**5.8**	**7.0**	**5.5**	**6.2**	**5.9**	**5.4**
Net Expenditure Growth (% y/y)	4.5	3.9	4.3	3.4	3.0	3.0	2.3
Net Expenditure Growth (Corrected for one-offs) (% y/y)	4.2	4.1	4.3	3.4	3.0	3.0	2.3
1yr Deviation (Corrected for one-offs) (€bn)	-	1.2	2.0	1.6	2.6	2.4	2.7
1yr Deviation (Corrected for one-offs) (% GDP)	-	0.4	0.6	0.5	0.7	0.6	0.7
2yr Deviation (Corrected for one-offs) (€bn)	-	-	1.6	1.4	2.1	2.5	2.6
2yr Deviation (Corrected for one-offs) (% GDP)	-	-	0.5	0.4	0.6	0.7	0.6
Limit for Nominal Net Expenditure Growth (€bn)	**-**	**4.1**	**5.2**	**4.3**	**5.1**	**4.9**	**4.7**
Net Expenditure Increase (€bn)	3.0	2.7	3.2	2.7	2.4	2.5	2.0
Net Expenditure Increase (Corrected for one-offs) (€bn)	2.8	2.9	3.2	2.7	2.4	2.5	2.0
Current Macroeconomic Aggregates							
Real GDP Growth (% y/y)	7.2	7.5	4.2	3.6	2.5	2.6	2.7
CAM Potential GDP Growth (% y/y)	7.4	4.6	4.5	4.3	3.5	3.2	3.3
CAM Output Gap	-1.0	1.6	1.3	0.6	0.4	0.2	0.0
GDP Deflator Used (% y/y)	1.2	1.3	1.3	1.8	1.8	1.7	1.7

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

[1] Assessments examine the *Budget 2019* revenue and expenditure plans, using the Department of Finance's CAM estimates of potential output and Council's views on one-off items. A new one-off windfall of €0.7 billion in corporation tax revenue for 2018 is included in the Council's structural balance assessment. After *Budget 2019*, the Department indicated that a capital transfer of €1 billion previously included as expenditure in 2021 will now be classified as in general government (Chapter 3). Expenditure in 2021 is adjusted to take account of this capital transfer. No information is available yet as to the impact of this adjustment on debt ratios, so these are unchanged. The treatment here differs to that applied in the "Assessment of Compliance with the Domestic Budgetary Rule in 2017" (IFAC, 2018a), which used the Commission's Spring 2018 output gap estimates for the structural balance as

these are the basis of ex-post assessments of compliance. The outlier for "CAM Potential GDP Growth" for 2015 is replaced by the average of the 2014 and 2016 rates, as discussed in the *June 2017 FAR* (IFAC,2017c).

[2] The Council assesses the MTO as achieved in 2017, so that no adjustments to the structural balance were required in 2017 and 2018. However, the Commission will maintain some requirements fixed until the final assessment in Spring 2019. In Spring 2019, it is anticipated that there will be a negative convergence margin applied for 2018, due to the over achievement of the MTO in 2017, however, the Council assesses compliance with the Expenditure Benchmark, without a negative convergence margin (i.e., instead using a zero convergence margin). In addition, the adjustment requirement for 2019 is currently frozen by the Commission at zero. This means that the Commission will also apply a negative convergence margin for 2019. These updated requirements are reflected in the figures presented in the table above. As a result, the Expenditure Benchmark limits presented here differ to those presented in the budget documents and those presented in the Commission's opinion on Irelands Draft Budgetary Plans. The MTO is due to be updated for 2020-2022. This update was unavailable at the time of writing and the MTO is kept constant at -0.5 per cent.

[3] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress towards the reference value of 60 per cent of the GDP. A transition period applies till the end- 2018.

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

Glossary

Automatic stabilisers: Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Budget balance: The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses General Government aggregates.

Cyclical component of budget balance: That part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap.

Discretionary fiscal policy: Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of automatic stabilisers.

Discretionary Revenue Measures (DRMs): The estimated current year impact of any discretionary revenue raising/decreasing measures (e.g., tax increases/cuts).

Excessive Deficit Procedure (EDP): A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State.

Expenditure rules: A subset of fiscal rules that target (a subset of) public expenditure.

Fiscal consolidation: An improvement in the budget balance through measures of discretionary fiscal policy, either specified by the amount of the improvement or the period over which the improvement continues.

General Government: As used by the EU in its process of budgetary surveillance under the Stability and Growth Pact and the excessive deficit procedure, the General Government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Maastricht reference values for public debt and deficits: Respectively, a 60 per cent General Government debt-to-GDP ratio and a 3 per cent General Government deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union.

Medium-Term Budgetary Framework: An institutional fiscal device that lets policymakers extend the horizon for fiscal policymaking beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under Medium-Term Budgetary Frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-Term Budgetary Objective (MTO): According to the reformed Stability and Growth Pact, stability programmes and convergence programmes present a Medium-Term Objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as

well as of fiscal risks to the sustainability of public finances, and is defined in structural terms.

Minimum benchmarks: The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the Medium-Term Budgetary Objectives (MTO).

One-off and temporary measures: Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position.

Output gap: The difference between actual output and estimated potential output at any particular point in time.

Potential GDP: The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

Primary budget balance: The budget balance net of interest payments on General Government debt.

Primary structural budget balance: The structural budget balance net of interest payments.

Pro-cyclical fiscal policy: A fiscal stance which amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the cyclically-adjusted budget balance unchanged over the economic cycle but lets the automatic stabilisers work.

Public debt: Consolidated gross debt for the General Government sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Significant Deviations: "Significant deviations" are defined in the EU framework as referring to any deviation in structural balance adjustments toward MTO where the deviation is equivalent to at least 0.5 percentage points of GDP in a single year or at least 0.25 percentage points on average per year in two consecutive years. The same thresholds apply for the Expenditure Benchmark (i.e., for deviations in expenditure developments net of discretionary revenue measures impacting on the government balance). When assessed, significant deviations can lead to a Significant Deviation Procedure, which itself can result in sanctions.

Sovereign bond spread: The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt -service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP): Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions

and the Member States and two Resolutions of the European Council in Amsterdam (June 1997).

Stability programmes: Medium-term budgetary strategies presented by those Member States that have already adopted the Euro. They are updated annually, according to the provisions of the Stability and Growth Pact.

Stock-flow adjustment: The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance: The actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance.

Underlying Budget Balance: The general government budget balance with one-off items removed. The one-offs are those assessed by the Council as being applicable.

Underlying Current Account Balance: The balance of payments current account balance less the impact of re-domiciled PLCs; depreciation of intellectual property; and leased aircraft; research and development imports; net purchases of intellectual property products; and investment into intellectual property assets and aircraft leasing.

Underlying Domestic Demand: An aggregate measure comprising consumer spending plus investment plus government consumption, and excludes investment in intangibles and aircraft, both of which have high import content.

Underlying Net Exports: A measure comprising the difference between exports and imports, excluding those related to intangibles and aircraft, both of which have high import content.

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