Chapter 1

Assessment of Fiscal Stance

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Key Messages

- The Council assesses that the outlook for Ireland's economy is unusually uncertain. The Government's forecasts assume a scenario in which the UK makes an orderly and agreed exit from the EU at the end of 2020. However, the outlook is balanced between potential domestic overheating on one side and an exceptional adverse shock in the form of a harder-than-assumed Brexit on the other as noted in *SPU 2019*. Other adverse risks are posed by the possibility of changes to the international tax environment; an escalation of protectionist measures; the onset of a cyclical downturn in major trading partners; and adverse financial developments (including those arising from Italy).

- The Government's debt burden is on a downward path as a share of national income, creditworthiness has improved, and the budget balance appears to be close to a balanced position when the effects of the cycle are accounted for. Notwithstanding the efforts by successive governments to get to this position, Ireland's net debt ratio remains the fifth highest in the OECD when measured appropriately, and creditworthiness is still vulnerable to rapid changes.

- Underlying improvements in the primary budget balance have stalled since 2015, despite a favourable upswing in the cycle and the surge in corporation tax receipts. There has been no improvement in the budget balance excluding interest costs: non-interest spending has increased at an accelerating pace of growth. As much of the recent improvement in revenues may be cyclical or temporary, this suggests that the structural position has deteriorated. Importantly, the budget balance is boosted by recent surges in corporation tax receipts, which are not likely to be permanent.

- Part of the reason for the lack of improvement since 2015 has been unplanned spending increases (beyond what was budgeted for). For 2018, the Government raised spending levels by €1.3 billion more than planned compared to *SPU 2018* last April. This was largely due to health overruns.

The Government expected spending overruns to be €1 billion in *Budget 2018*, but post-budget spending turned out to be a further €0.3 billion higher than planned again (in terms of gross voted spending). For 2019, there is a risk of further slippages. Health spending overruns could be repeated (averaging some €0.5 billion in recent years), and provision has again not been made for the Christmas bonus (€0.3 billion).

- New analysis in this report (Box B) suggests that corporation tax receipts in Ireland are now a long way from conventional levels and from what the underlying performance of the economy would imply. It finds that some €3 billion to €6 billion of the €10.4 billion of corporation tax receipts in 2018 could be considered "excess" (i.e., beyond what would be expected and beyond what historical and international norms would suggest). Unlike typical revenue windfalls, these gains might persist for a number of years before reversals could be expected. Yet the receipts remain volatile and vulnerable to change, possibly in line with the global business cycle. They also represent a net injection to the Irish economy, given that foreign-owned multinational enterprises contribute four-fifths of receipts. This is different from conventional tax receipts on domestic incomes, which are available to the government yet have a counterpart in taxes paid out of domestic activity. The Council therefore advises that further surprises in corporation tax receipts should not be used to finance additional government spending. This would protect the public finances from being vulnerable to future reversals and it would avoid adding further stimulus to the economy. The Government should also seek to gradually reduce the extent to which spending programmes are dependent on these receipts.

- One way to credibly commit to saving unexpected—and potentially risky—corporation tax receipts might be to have a fixed rule under which the government sets aside excess receipts above a certain threshold. An option would be to notionally set aside such receipts through in-year allocations to a "Prudence Account". Allocations could be based on the excess between actual and forecast corporation tax receipts. At year end, these notional amounts could then be turned over to the rainy day fund (the "National Surplus (Exceptional Contingencies) Reserve Fund") or used to reduce debt.

- For 2019, the Government should stick to its existing plans. This means that no additional within-year increases should be introduced without offsetting measures. To stem the increasing reliance on corporation tax receipts, any additional unexpected receipts should be allocated to a Prudence Account during the year and then to the rainy day fund or elsewhere (Box B).

- For 2020, the Government should be prudent with the budget. This reflects the risks associated with a hard Brexit, the reliance on corporation tax, possibilities of overheating, and the rapid rise in spending from 2017–2019. The risks posed by a disorderly Brexit are particularly severe (Box C shows how it could lead to a return to rising debt ratios). To limit the possibility of rising debt ratios, loss of creditworthiness, and a need for sizeable correction in the public finances, the Government should postpone any additional discretionary increases in expenditure or tax cuts beyond those already provided for in *SPU 2019*. This would allow for further support to be provided in the event of an adverse shock materialising, and would allow fiscal policy to cushion some of its effects. A smaller expansion than the €2.8 billion currently implied by *SPU 2019* would also be desirable, again, recognising risks posed by Brexit, the reliance on corporation tax receipts, and the risks of further overheating. This could include not using the €0.6 billion currently set aside for tax cuts and unallocated spending increases.

- For 2021–2023, the Government needs to develop a credible medium-term strategy. The Government's medium-term projections are based on technical assumptions that ignore likely policy decisions. A better approach could be built around four elements. First, it should start with a clear statement of the sustainable growth rate that net policy spending can grow at. Second, multi-year departmental expenditure ceilings should be framed in the context of this upper limit and more realistic forecasts for spending should be developed. Third, the debt ratio target should be restated as a percentage of modified GNI* with a clear timeframe; it should be clarified whether it is a steady-state target or a ceiling; it should have clear staging posts; and it should be lower to reflect Ireland's volatile growth rates. Fourth, the Government needs to gradually wean itself off the reliance on corporation tax receipts that has built up in recent years.

Table 1.1: Summary Table

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

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

	2017	*2018*	*2019*	*2020*	*2021*	*2022*	*2023*
General Government							
Revenue [1]	42.2	42.5	42.6	42.0	42.0	42.1	42.2
Expenditure [1]	42.6	42.5	42.3	41.4	40.8	40.4	40.0
Balance [1]	-0.4	0.0	0.3	0.6	1.2	1.7	2.2
Interest Expenditure	3.2	2.7	2.4	2.0	1.9	1.9	1.9
Primary Expenditure [1]	39.4	39.8	40.0	39.4	39.0	38.5	38.0
Primary Balance [1]	2.8	2.7	2.7	2.6	3.0	3.6	4.2
Revenue Growth (%) [1]	4.9	6.7	5.2	3.4	3.8	4.2	4.5
Primary Expenditure Growth (%) [1]	3.4	7.2	5.3	3.3	2.8	2.7	2.8
Real Net Policy Spending Growth (%) [2]	4.5	5.0	3.4	1.4	0.9	-0.7	-0.1
Structural Balance (% GDP) [3]	1.3	0.2	0.1	-0.1	0.2	0.2	0.4
Structural Primary Balance (% GDP) [3]	3.3	1.9	1.5	1.1	1.3	1.4	1.5
Change in Structural Primary Balance (p.p.) [3]	0.7	-1.4	-0.4	-0.4	0.2	0.1	0.2
Debt							
Gross Debt (€bn)	201.4	206.2	205.1	196.7	203.6	203.5	206.0
Cash & Liquid Assets (€bn)	25.5	28.6	27.8	19.2	24.4	23.3	24.4
Net Debt (€bn)	175.8	177.6	177.3	177.5	179.2	180.2	181.6
Equity and Investment Fund Shares (€bn) [4]	42.6	37.0					
Gross Debt Ratio (% GNI*)	111.1	107.3	101.7	93.0	92.7	89.1	86.7
Net Debt Ratio (% GNI*)	97.1	92.4	87.9	83.9	81.6	78.9	76.4
Output							
Real GDP Growth (% Change)	7.2	6.7	3.9	3.3	2.4	2.5	2.6
Potential Output (% Change) [3]	7.4	4.1	3.1	2.6	2.2	2.0	2.2
Output Gap (%) [3]	-2.9	-0.5	0.2	0.8	1.0	1.4	1.8
Nominal GDP Growth (% Change)	7.6	8.3	5.5	5.1	4.1	4.1	4.3
Nominal GNI* Growth (% Change)	3.0	6.1	4.9	4.9	3.9	3.9	4.1
Nominal GDP Level (€bn)	294.1	318.5	335.8	352.9	367.3	382.5	399.1
Nominal GNI* Level (€bn)	181.2	192.2	201.7	211.5	219.7	228.3	237.6
Miscellaneous							
Expenditure One-Offs (€m) [1]	178	213	0	0	0	0	0
Revenue One-Offs (€m) [1]	0	350	0	0	0	0	0
Net One-Offs (€m) [1]	-178	137	0	0	0	0	0

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

[1] One-off/temporary measures are excluded to obtain the underlying fiscal position and are those assessed as applicable by the Council. These comprise water charge refunds for 2017 (€178 million), €350 million of corporation tax received in 2018, and €213 million for a settlement of pay arrears for medical consultants.

[2] This measure is outlined in Box A (IFAC, 2018e). It represents total general government expenditure less interest costs and less estimated cyclical unemployment benefits, while discretionary revenue measures are also accounted for (that is, discretionary revenue-reducing measures raise the measured expenditure growth).

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

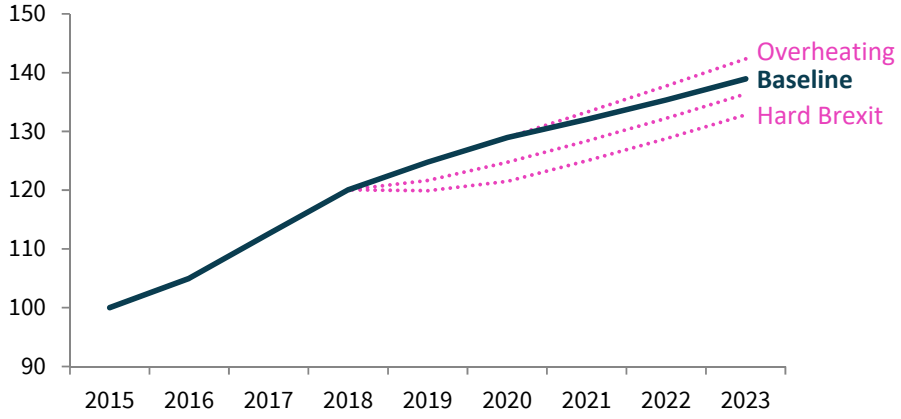
This chapter draws on analysis in the rest of the report in assessing the fiscal stance in *SPU 2019*. The Council's assessment is informed by: (1) an economic assessment that takes into account the state of the public finances, the stage of the economic cycle, and the growth prospects for the economy;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

1.2 The Macroeconomic Context

Domestic Economic Activity

Having recovered in the past five years from a deep recession, the current outlook for Ireland's economy is now unusually uncertain. The Government's forecasts assume a scenario in which the UK makes an orderly and agreed exit from the EU. However, this outlook is balanced between potential overheating on one side and an exceptional adverse shock posed by Brexit on the other as noted in *SPU 2019.* Figure 1.1 examines the uncertain outlook based on recent scenarios from other bodies and based on an illustrative assumption for overheating.

Figure 1.1: The Economic Outlook is Exceptionally Uncertain
Index (2015=100), real GDP volumes



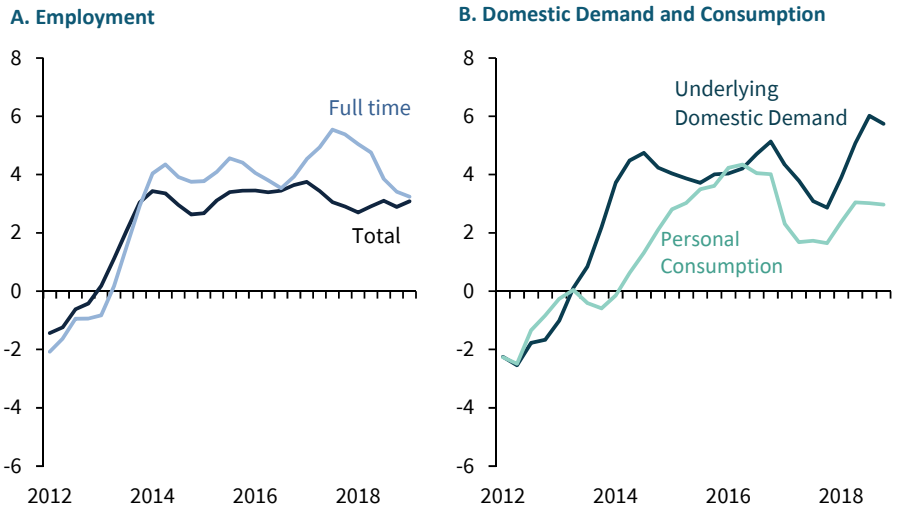
Source: Internal IFAC calculations; CSO; Central Bank of Ireland; and ESRI.
Notes: The "Overheating" scenario is one in which growth does not slow from its pace in the baseline after 2020. The two "Hard Brexit" scenarios shown are based on the ESRI (Bergin et al., 2019) and Central Bank of Ireland (2019) scenarios for a disorderly Brexit.

Short-term indicators of the domestic economy's performance highlight the pace of the cyclical turnaround since about 2013. Figure 1.2 shows that year-on-year growth rates for underlying domestic demand, employment (both full-time and total), and personal consumption have been rapid. Employment growth has averaged close to 3 per cent year-on-year and is still growing at this pace. Full-time employment has moderated a little having grown at an even faster pace. Other useful indicators of domestic activity such as Modified Gross National Income (GNI*) and Domestic Gross Value Added (GVA) also reinforce the strength of the rebound in recent years.[1]

[1]Modified GNI* is a better measure of national income growth than GDP and GNP, but it is currently only available in nominal terms and only becomes available for the previous year when the National Accounts are published (CSO, 2018). Domestic GVA is a measure of the domestic economy that strips out the activities of sectors dominated by foreign-owned multinational enterprises.

Figure 1.2: Indicators of Domestic Economic Activity

% change (year-on-year), four-quarter moving averages



Sources: CSO; and internal Irish Fiscal Advisory Council calculations.
Note: Figures show four-quarter moving averages. 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.

Though growth is expected to moderate in coming years, the Department of Finance's baseline forecasts for these indicators nevertheless suggest continued expansion (Table 1.2).

Table 1.2: Official Baseline Forecasts for the Irish Economy

% change year-on-year, volumes unless stated

	2019	2020	2021	2022	2023
Underlying Domestic Demand	3.8	3.1	2.5	2.7	2.9
Personal Consumption	2.7	2.5	2.1	2.3	2.5
Employment	2.2	2.1	1.5	1.6	1.7
Modified GNI* (nominal)	4.9	4.9	3.9	3.9	4.1
Output Gap (% potential) [1]	0.2	0.8	1.0	1.4	1.8

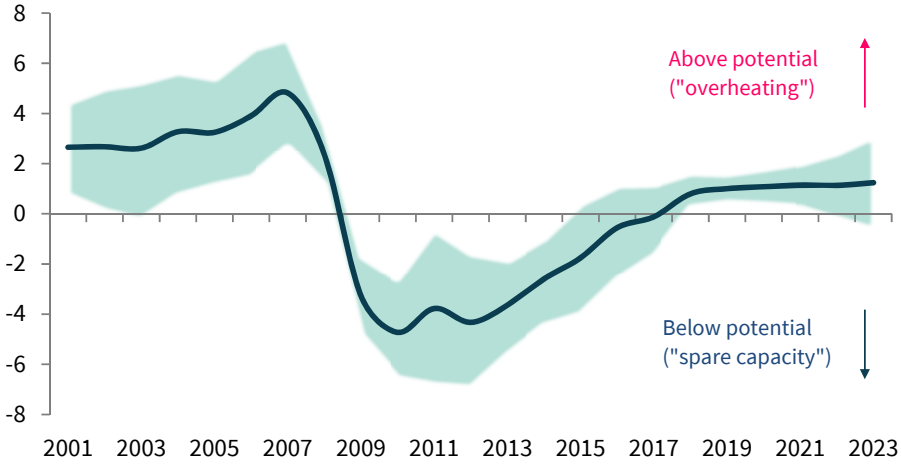
Sources: Department of Finance; and internal IFAC calculations.
[1] This is the Department of Finance's preferred measure of the output gap, which is based on GDP.

The Cyclical Position

Best-available estimates of where the economy is relative to "normal" levels of activity (its potential) suggest that the economy is currently operating at or above its potential in 2019 and is expected to continue to run somewhat above potential for the period 2020–2023 (Figure 1.3). This modest degree of overheating may be sustainable for some time, but a more significant overheating would carry greater risks. In the absence of Brexit-related effects, it is likely that the Irish economy would be forecast to be on a path to more significant overheating.

Figure 1.3: The Economy is Forecast to Overheat

% potential, output gap (gap between actual and potential output)



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The figure shows a range of output gap estimates (the shading) and the mid-range estimates (the line). Estimates are produced using a variety of methods based on the Council's models and Department forecasts. 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).

It is important to note that macroeconomic forecasts of demand tend to be constructed in such a way as to assume that the economy reverts to its equilibrium over the medium term. This means that the Department's forecasts could well understate the degree of overheating possible over the medium-term. Chapter 2 examines a series of plausible alternative scenarios where the output gap becomes more positive if net inward migration continues to rise, consistent with overheating, and if credit and prices pressures are less subdued than the Department expects.

Risks to the Outlook

While the outlook remains reasonably strong, major risks are evident in both directions and a slowdown is inevitable.

Overheating could be much more severe in coming years if the pace of growth in the domestic economy does not moderate as expected. The Department of Finance's baseline forecasts already assume that the economy will be above its potential this year and that overheating will accentuate over the coming years. It is possible that this overheating could be further fuelled by a necessary and welcome rise in housing construction: one that is faster than the Department currently expects (unless space is made in the economy to accommodate this additional activity). For comparison, annual housing completions increased by an average of 9,000 units per

annum at peak over 2003–2006, whereas the Department forecasts increases of 6,000 per annum (2019–2023).

Based on Ireland's previous experiences as a member of the Euro Area, overheating could coincide with rising wage and price pressures, rapidly rising debt, a deterioration in Ireland's current account balance, and/or faster inflows of labour from abroad (Box A). It is possible that new factors that coincide with overheating could include inflows of foreign capital into the Irish construction and property sectors and the injection of foreign-company sourced Corporation Tax receipts into domestic demand. Importantly, any above-potential growth in incomes and government revenues during this period would not be expected to be sustainable.

Adverse risks also confront the outlook for the economy, chief among them a hard Brexit. Estimates of the medium-term impacts on Ireland's real output are 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 (IFAC, 2018e). Other risks include changes to the international tax environment; the possibility that protectionist measures adopted by the US and other nations escalate further, thus dampening global trade; the possible onset of a wider cyclical downturn in Ireland's major trading partners; and adverse financial developments (including related to Italy).

Box A: Sustainable Growth

"Sustainable growth" in economic activity is a challenging concept to pin down. It is typically defined as an economy's medium-term potential output growth, but this definition is fraught with measurement problems and potential output growth rates may not adequately reflect an economy's sustainable pace of growth. In light of the importance of such a concept to fiscal policy and to identify an appropriate pace at which net Government spending should grow over the medium term (absent policy changes), this Box explores the concept of sustainable growth more closely.

A key question when discerning the sustainable growth rate of an economy is the basis on which this is founded. There are three standard approaches: (1) those based on purely statistical approaches; (2) those based on Phillips curve concepts that identify potential output with reference to states where inflationary pressures are non-existent or unchanging; and (3) production function approaches that appeal to Phillips curve concepts as well as to the growth rates that would prevail given full usage of factor inputs like capital and labour and the efficiency with which they can be combined (total factor productivity).

Each of these definitions is subject to a number of overlapping shortcomings, which can weaken their value in terms of determining measures of sustainable output growth. First, small and open economies that are converging on more advanced economies' level of infrastructure and technology may experience potential output growth rates that prove to be temporarily higher than the stable growth path that they eventually tend toward. Second,

unsustainable booms in investment (such as that which happened in Ireland in the mid-2000s) can contribute to inflated measures of potential output growth if the definition of potential is determined by the full use of capital in the economy (as in the Commonly Agreed Methodology). Third, credit expansions can also lead to faster growth rates that are above the sustainable rate for a prolonged period of time and can inflate measures of potential output if the financial cycle is not adequately controlled for. Fourth, statistical tools typically used to identify trend or potential growth rates can exhibit tendencies toward "end-point bias" meaning that the most recent actual or forecast growth rates may exert undue influence on the potential growth rates being estimated (leading to procyclical bias: an especially dangerous feature for the purposes of determining appropriate fiscal policy). Fifth, forecast bias might further aggravate end-point bias. This can happen if, for example, it is assumed that recent momentum in the economy will continue over the forecast horizon. Sixth, a serious issue with small open economies with mobile factors of production is the possibility of multiple equilibria (multiple states in which the economy may stabilise).

A better definition of sustainable output growth for fiscal policy

For the purposes of assessing potential output in a monetary union a different conceptualisation may be warranted, especially for the purpose of assessing fiscal sustainability. A monetary union like the Euro Area may have different macroeconomic dynamics relevant for potential output, given the presence of a fixed exchange rate and the openness to trade—both of which are important for price changes—and given the increased mobility of capital and labour.

With this in mind, the Network of EU Independent Fiscal Institutions (2018) has developed a useful working definition that considers an economy's potential as the:

> *maximum level of output sustainable in the medium to long run, where "sustainable" implies that output, when at its potential, is not unduly influenced in any particular direction by imbalances in the economy, be they external, internal or financial.*

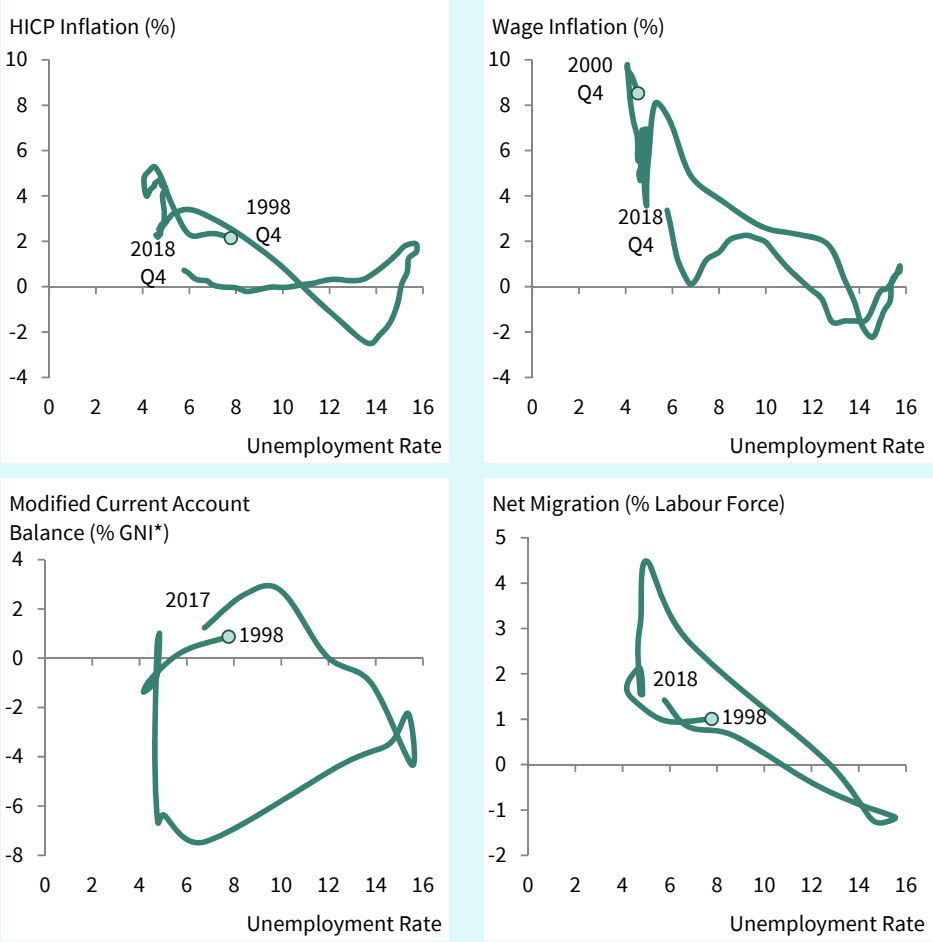
This working definition of potential output has certain advantages over alternative definitions. First, it recognises that standard approaches may not adequately incorporate important information. This could relate to absorption cycles, the financial cycle, and/or any other temporary phenomena that inflate or depress growth conditions but which are not captured sufficiently by production functions or other standard approaches. Second, this definition accepts that multiple disequilibria can coexist in an economy. In other words, a boom in commercial property spurred by external capital might inflate potential output growth, but this might be offset by weaker-than-normal domestic credit conditions. It thereby forces the user to consider current economic conditions more broadly, recognising that there are multiple drivers of overall economic imbalances that can distort current output growth relative to its potential. Third, it moves beyond purely inflation-dependent concepts of potential output, which may be less useful outside of a central-banking context and for small open economies, especially where migration flows, for instance, can dampen the relationship between labour usage and inflationary pressures.

One motivation for moving to beyond-inflation concepts of potential output is given by the pre-crisis experiences in Ireland and Spain (Cuerpo, Cuevas, and Quilis, 2018), among others. While it is now widely accepted that the run-up to the crisis was characterised by highly unsustainable growth rates, this was not reflected to a similar extent in corresponding price pressures. One explanation for this is that—in a monetary union—other channels can matter more, including the current account balance (a measure of an economy's net exports, income and transfer flows with the rest of the world) and net migration flows. Figure A.1 highlights this feature by plotting unemployment rates against general inflation and hourly wages, but also against the current account balance and net migration. In Ireland's case, the relationship between unemployment rates and general HICP inflation has been relatively muted since 1998. Wage inflation—though high in the mid-2000s—was not especially different to earlier

rates (in part due to convergence). This meant that, as the economy strengthened prior to the crisis, the usual expectation underpinning many definitions of potential output that price pressures would emerge proved incorrect. By comparison, accumulating imbalances were clearly evident from a deepening current account deficit, and growing net migration inflows.

The failure of standard definitions of potential output to capture unsustainable growth developments prior to the last crisis is one reason why the Council favours broader assessments of sustainable growth like that formulated by the Network of EU Independent Fiscal Institutions. It is also one reason why the Council favours a "suite of models" approach to estimating potential output rather than reliance on any single estimation approach. And it is a reason why the Council emphasises the importance of a "modular" approach to assessing the economy. This involves a systematic examination of a range of economic indicators for signs of economic imbalances including in the labour market; housing and investment; credit; and external balances.

Figure A.1: How the Cycle Relates to Prices and External Channels



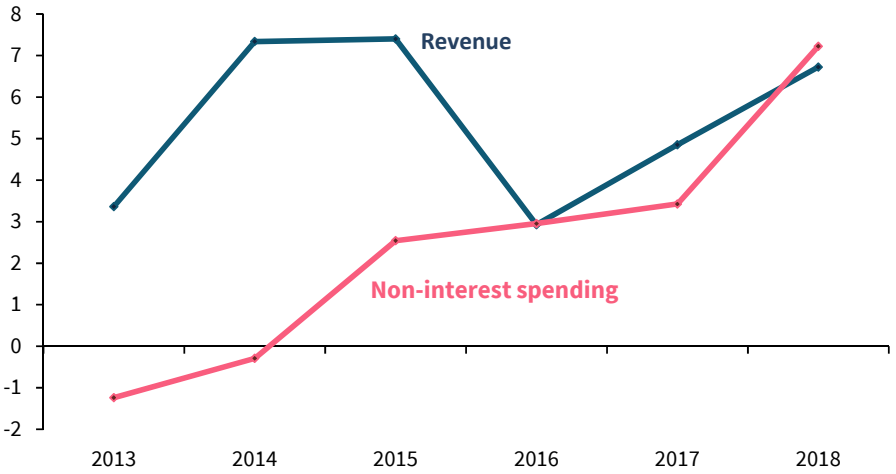
Sources: CSO, internal IFAC calculations.
Notes: Wage inflation is hourly wage inflation and is based on the National Accounts data for "compensation of total employees", combined with the LFS definitions of employees and average weekly hours.

1.3 The Recent Fiscal Context

A useful—though imperfect—measure of the budget stance is the balance excluding interest costs (the "primary balance") and one-offs.[2] On this measure, progress toward improving the budgetary position has stalled since 2015. This is despite a number of factors working in the government's favour including a strong cyclical recovery boosting revenues and reducing unemployment-related expenditure and surges in corporation tax receipts.

These favourable factors should have resulted in a stronger improvement in the underlying budgetary position. Instead, stronger cyclical tax revenues, surging corporation tax receipts, and interest cost savings have been offset by faster-than-planned increases in government spending. Government spending (excluding spending on interest payments) has been accelerating in recent years and in 2018 exceeded the strong growth rate of revenue (Figure 1.4).

Figure 1.4: Spending is Rising as Fast as Strong Revenues
% change year-on-year in revenue and non-interest spending



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 Department of Finance tends to refer to spending growth in terms of central government gross voted cash spending. This measure of spending is less robust than general government measures. The gross voted measure ignores close to one quarter (almost €20 billion) of total spending. About half of this is non-voted

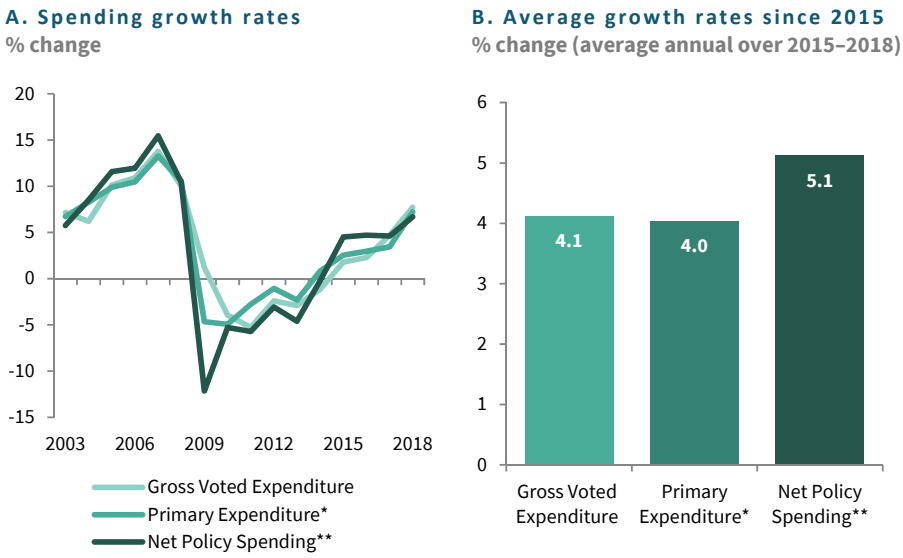
[2] Removing interest costs is useful when these: (i) reflect past decisions (i.e., the debt stock) rather than current policies; (ii) are volatile or unpredictable; (iii) are important from an economic perspective (in Ireland's case, interest payments on government debt securities traditionally flow more to non-residents than residents); and (iv) might be overstated in times of high-inflation compared to low-inflation environments (given prevailing interest rates).

spending in parts of central government, with the rest split between spending by various non-commercial State bodies and by local government.

Despite the differences in coverage, the gross voted measure has risen at a similar pace (4.1 per cent per annum on average since 2015) to primary expenditure in recent years (Figure 1.5). Primary expenditure growth has risen from a pace of growth of 2.5 per cent in 2015 to 7.2 per cent in 2018.

However, governments can also expand fiscal policy through tax cuts. And tax cuts can, in effect, be considered somewhat equivalent to spending increases when it comes to using fiscal resources. If the impact of discretionary tax changes since 2015 are considered together with spending changes, then the net growth rate is faster again at an average of 5.1 per cent per annum (albeit that recent budgets have had large revenue-raising measures).[3]

Figure 1.5: Government Spending Growth is Rising



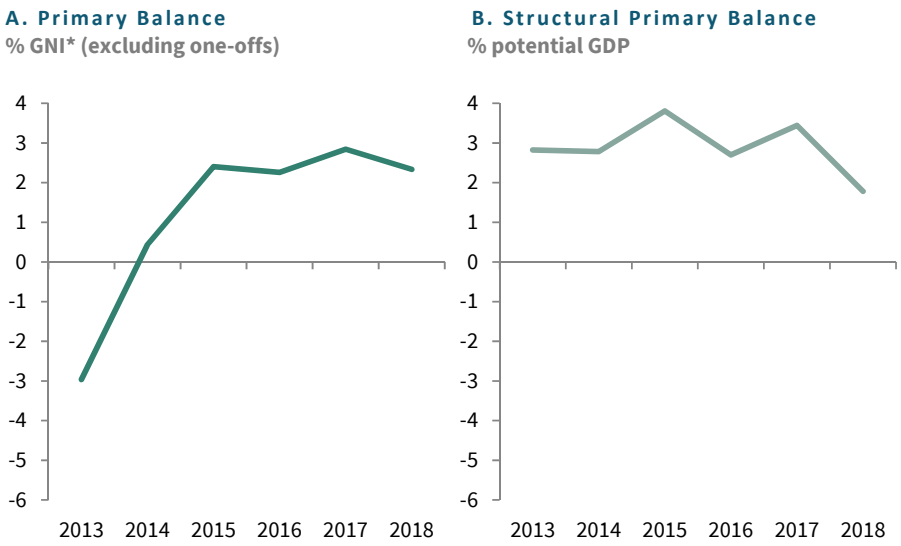
Sources: CSO; Department of Finance; and internal IFAC calculations.
Notes: * Primary Expenditure is total general government expenditure less interest costs. ** Net Policy Spending is a measure of spending growth that tries to get a truer reflection of what is under the control of governments and to allow for offsetting tax changes (Box A, IFAC 2018e). Net Policy Spending = total general government expenditure less interest, one-offs, cyclical unemployment benefits, and discretionary revenue measures. Unemployment benefits are calculated on the assumption of an unchanged natural rate of unemployment of 5.5 per cent.

The budget balance excluding interest costs (the primary balance) and excluding various one-off or temporary items has therefore been broadly unchanged over the same period (Figure 1.6). Recognising the increased revenues that are likely to have

[3] Note that discretionary tax measures here include the impact of non-indexation.

arisen from the cyclical upswing as well as from surging corporation tax receipts, the structural primary budget balance is likely to have worsened over the last three years, particularly in 2018. This is reflected in Figure 1.6B where standard adjustments for the cycle are made and where the Department's preferred alternative output gap estimates are used.[4]

Figure 1.6: No Improvement in Underlying Balance Since 2015

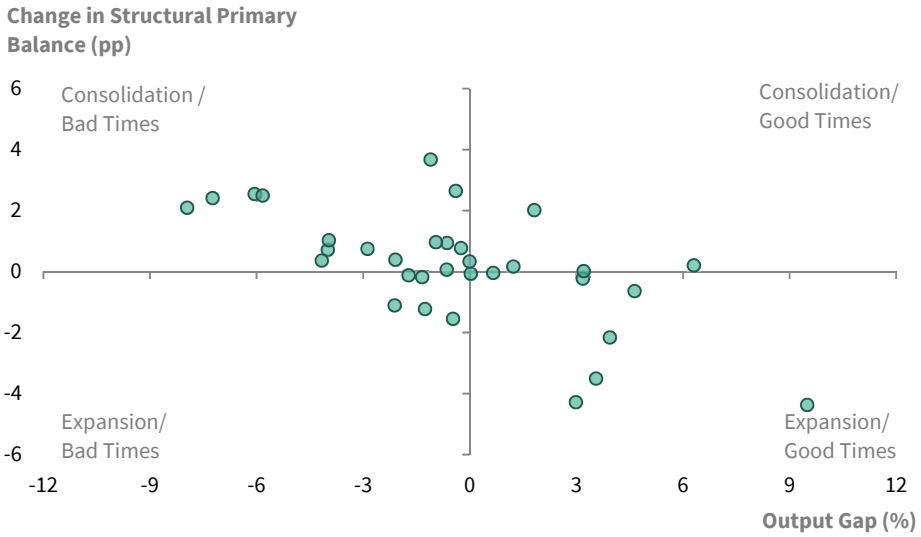


Sources: CSO; Department of Finance; internal IFAC calculations.
Notes: The primary balance is the general government balance less interest costs and it excludes one-offs assessed by the Council (e.g., see Table 1.1). The structural primary balance is the same but with a correction for the effects of the cycle. It uses the Department's preferred GDP-based output gap to measure the cyclical position under an assumed semi-elasticity of 0.588.

Ireland has a poor track record in terms of running a countercyclical fiscal policy. Instead, budgets have tended to follow the cycle: expanding in good times and contracting in bad times. This has stoked pressures in the economy at times when it is overheating and has exacerbated subsequent downturns. Specifically, it means that measures to increase spending or reduce taxation in good times have needed to be reversed in bad times. Figure 1.7 plots the Government's structural primary balance (the budget balance excluding interest costs, one-off items and cyclical effects) against the cyclical position of the economy. It shows that there are few occasions when policy has been unambiguously countercyclical (i.e., expansionary in bad times or contractionary in good times).

[4] A budgetary semi-elasticity of 0.588 for how the deficit responds to changes in the output gap is used as estimated in IFAC Analytical Note 12.

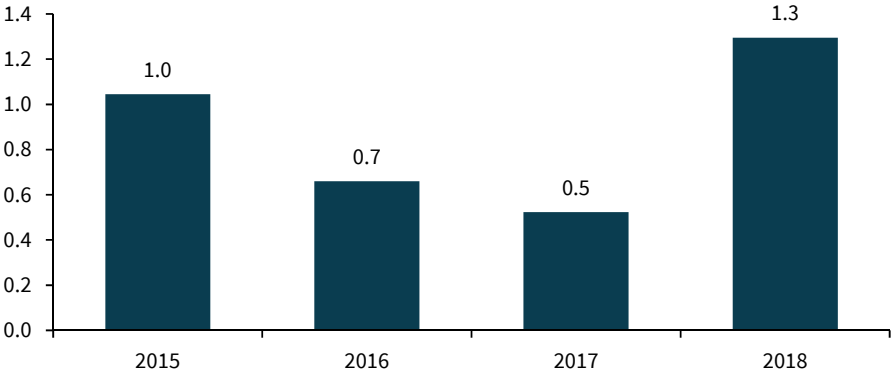
Figure 1.7 Irish Fiscal Policy has been Routinely Procyclical (1986–2018)



Sources: Department of Finance; CSO; internal IFAC calculations.
Notes: The figure shows the change in the structural primary balance and the output gap (using the Department's preferred output gap estimates for 2000–2018 and the Council's own estimates for earlier years in both cases). Observations in the top-left and bottom-right quadrants can be said to be consistent with procyclical fiscal policy.

Recent years have seen a recurring pattern of within-year increases in spending as the cycle has recovered (Figure 1.8). Such within-year changes have also demonstrated a procyclical bias in the past.

Figure 1.8: Within-Year Spending Increases in Recent Years



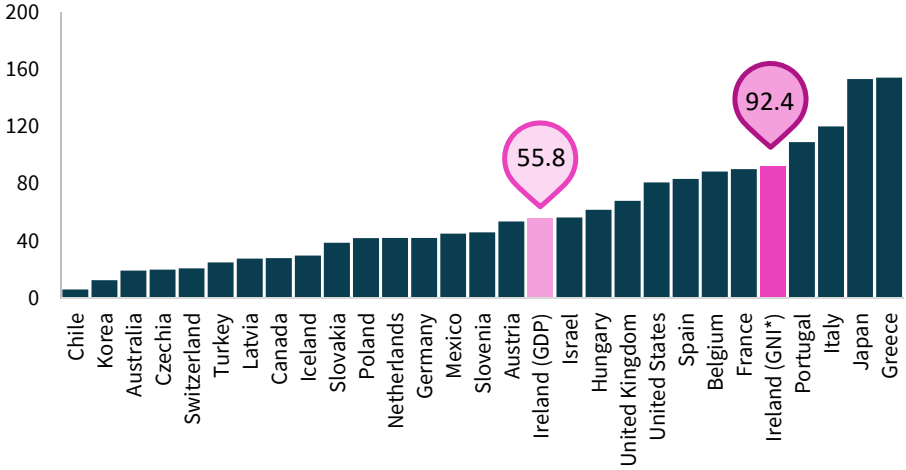
Sources: Department of Finance; and internal IFAC calculations.
Note: Within-year spending increases are based on gross voted spending outturns as compared to earlier vintages of estimates (*Budget 2015* for 2015; *Budget 2016* for 2016; *Budget 2017* for 2017; and *SPU 2018* for 2018, due to the reclassification of spending on water services into the Department of Housing, having previously been funded by a mix of local government, non-voted spending, and Irish Water borrowings).

Against this backdrop of poor budgetary management, Ireland's debt burden remains high. When Ireland's end-2018 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 1.9). While the debt ratio is falling steadily (Figure 1.10), it is likely to remain high by historical and international standards in coming years.

Figure 1.9: The Largest Net Debt Ratios in OECD Countries

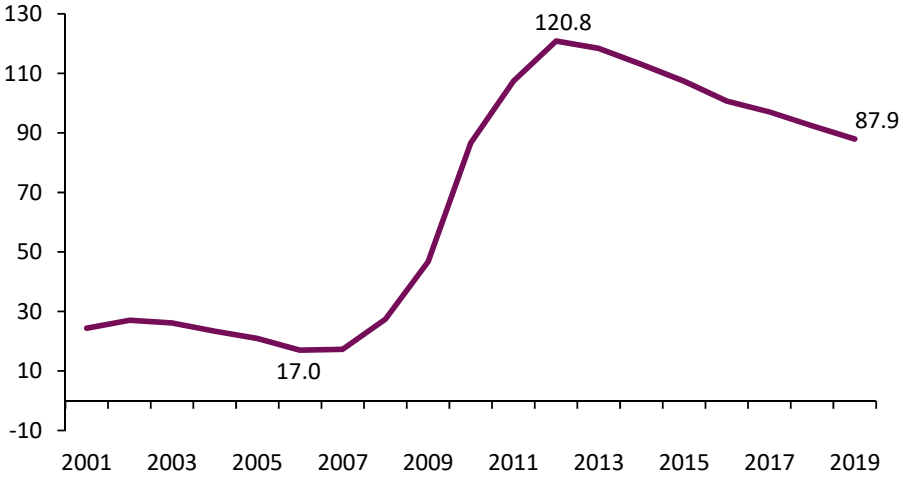
% GDP at end-2018 (% GNI* for Ireland), net general government debt



Sources: CSO; Eurostat; IMF World Economic Outlook (April 2019); 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 1.10: Ireland's Net Debt Burden

% GNI*, general government basis



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

Box B: Dealing with the Economic and Fiscal Impact of Surging Corporation Tax Receipts

The Council has made repeated calls for caution in terms of how the recent surge in corporation tax receipts is treated by the Government. Corporation tax receipts more than doubled since 2014. Receipts rose to a record 18.7 per cent share of total tax receipts last year from just 10.3 per cent in 2011. This share is also high relative to international norms (Chapter 3 shows equivalent shares for OECD countries).

The concentration of corporation tax receipts is a further concern. Half comes from the top ten corporate groups and close to four-fifths of annual receipts are attributable to foreign-owned multinational enterprises. As an indication of its relative importance, the €10.4 billion of corporation tax raised last year is similar, for example, to the Government spend on Education and Skills.

The fact that a large share of corporation tax receipts is raised from foreign rather than domestic income sources means that much of this revenue is a net stimulus to the economy from fiscal policy: funds available to the government but without a counterpart in terms of taxes paid out of domestic activity.

How large is the surge in corporation tax receipts?

The first question to ask is just how much have corporation tax receipts surged? Another way of framing this is to ask, "how far have receipts departed from predicted levels or from normal levels?" We can examine a number of approaches.

Model projections: One approach is to take standard forecasting methods and apply these to levels that prevailed at an earlier period to see how much actual receipts have diverged from projected values. Figure B.1 adopts this approach drawing on the forecasting models outlined in Casey and Hannon (2016). Using standard parameters for linking corporation tax changes to economic growth and taking 2011 as a base year, it suggests that some €3 billion to €6 billion of annual receipts as of 2018 are unexplained by the performance of the domestic economy, around 30–60 per cent of the total in 2018 or 1½ to 3 per cent of GNI*.

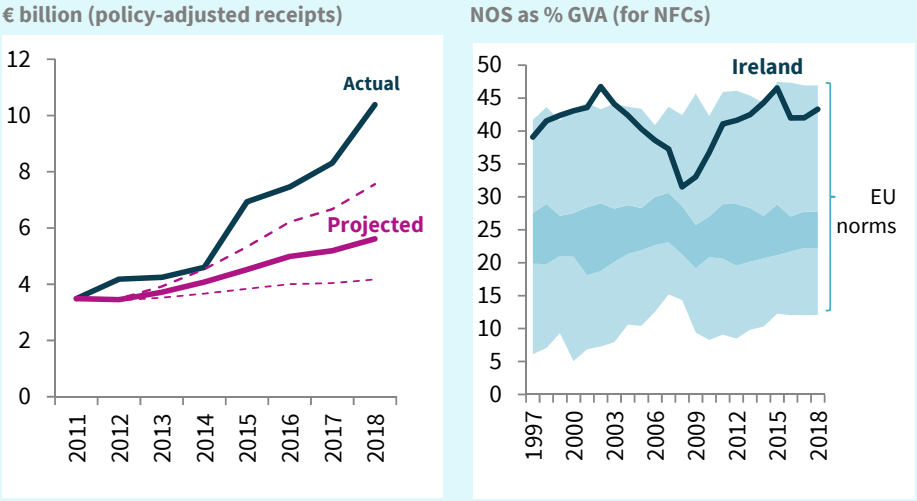
Official Forecasts: We can also consider the predicted performance of corporation tax versus where it actually is right now. In this respect, the earliest set of forecasts available for 2018 corporation tax receipts come from *Budget 2015.* Forecasts at that time suggested corporation tax receipts would be close to €5 billion for 2018, yet turned out to be twice that level at €10.4 billion. Taking this approach implies an excess performance in annual receipts of €5.4 billion (2.8 per cent GNI*): the upper range that we consider in our first exercise.

Historical Norms: If one were to assume that corporation tax receipts returned to their average long-run share of total receipts (12.5 per cent, 1990–2017), this would imply that 2018 receipts are €3½ billion (1.8 per cent GNI*) above expected levels.

International Norms: Another way to examine the exceptional performance of corporation tax receipts is to look at international norms. One way to do this is to consider the taxable base and how large it has become relative to wider economic activity. Comparing the closest equivalent measure of taxable corporate profits (Net Operating Surplus) against Gross Valued Added from the sector and focusing on non-financial corporations, we can see that Ireland's taxable base has departed from the middle 50 per cent of EU countries shares and is at the upper end of the all-Member State range. If Ireland were to return to the 75th percentile (i.e., the top of the middle 50 per cent range), then this would imply excess receipts in 2018 of €3.4 to €4.3 billion (1.8 to 2.2 per cent of GNI*).[5]

[5] This assumes an average effective tax rate of 10–12.5 per cent.

Figure B.1: Corporation Tax Receipts Unexplained by Underlying Economy and Profits are Exceptional



Sources: Department of Finance; Eurostat; and internal IFAC workings.
Notes: Panel A takes the best-performing approach to modelling corporation tax from Casey and Hannon (2016); it forecasts "Projected" corporation tax receipts adjusted for policy measures from 2012 onwards; and it uses the underlying economic driver as growth rates for the domestic economy (domestic GVA and nominal modified GNI*) rather than GDP. A 95 per cent confidence interval is shown with dashed lines around the Projected level. These estimates can be interpreted as the level of corporation tax receipts that would have been expected to prevail had distortions related to foreign-owned multinational enterprises, which also showed up in GDP, not contributed to a higher tax base from 2012. Panel B looks at Net Operating Surplus (NOS) as a share of Gross Value Added (GVA) for Non-Financial Corporations (NFCs) in Ireland. It gives a sense of the profits compared to total value added to identify whether or not the current levels observed in Ireland are operating above EU norms. Shaded bands represent the EU min to max range and the middle 50 per cent of EU countries.

What are the risks?

The fact that Ireland is receiving higher inflows of foreign capital and higher tax receipts is something to be welcomed from a public finance perspective and it highlights the fact that Ireland continues to be considered an attractive destination for global activities.

The risks relate to how these receipts are used by Irish governments and in terms of correctly interpreting their impacts on the economy. An obvious risk is that these receipts might reverse in coming years. This could be due to idiosyncratic reasons (like changes in the profitability of firms paying receipts or their individual location decisions) or due to changes in the international tax environment that make Ireland less attractive for companies. Corporation tax receipts are also statistically the most volatile and unpredictable of the four main taxes (Box H). These features warrant caution with how receipts are used, even if it does not imply risks of a permanent reduction in average medium-term receipts. If a government relies too much on these receipts for recurrent spending, then the risk is that any inevitable reversal would imply weaker budget balances, absent any policy response.

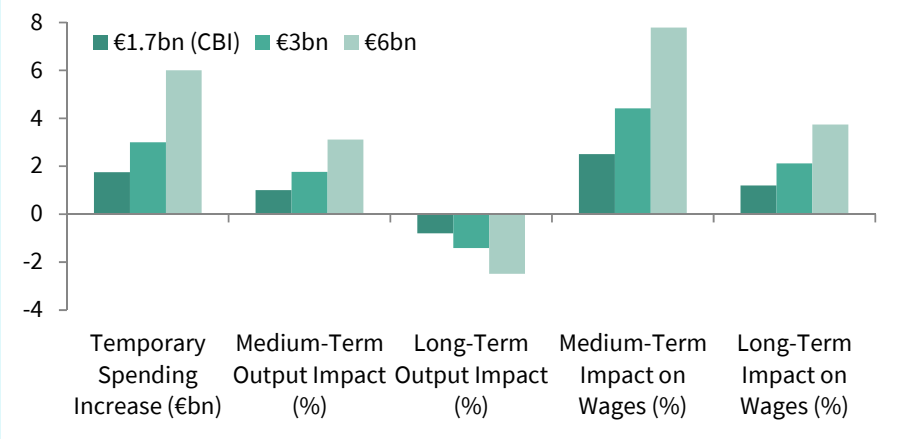
In terms of macroeconomic effects, the excess corporation tax receipts serve to make the current account balance (both headline and underlying measures) look more favourable than they otherwise would. This can complicate assessments of the sustainability of the current economic position and should be accounted for.

Recent work by Conefrey, O' Reilly and Walsh (2019) explores the impact on Irish output growth from saving €1.7 billion additional fiscal gains (mainly corporation tax receipts) over three years as compared to using it to fund additional expenditure.

Scaling up these results using the range of estimates for the excess corporation tax receipts (€3–6 billion) set out in this Box would suggest that spending rather than saving the receipts would imply an additional boost to economic output of some 2 to 3 per cent relative to baseline over the medium term in the context of an economy already at capacity (Figure B.2). Such spending would be expected to boost short-run growth. But if the economy is already at capacity (such as with low unemployment), this would be expected to contribute to overheating risks (including those related to wage pressures, and export competiveness losses).

Figure B.2: Short-Run Macroeconomic Impacts of Spending vs Saving any Excess Corporation Tax

€ billion and % deviation from baseline of temporarily spending excess fiscal gains



Sources: Conefrey, O' Reilly, and Walsh (2019); internal IFAC workings.
Notes: The "CBI" (Central Bank of Ireland) estimates are taken from Conefrey, O' Reilly and Walsh (2019). They show the impact of €1.7 billion excess receipts being used to fund additional government expenditure, and are scaled up linearly to produce the impacts for €3 billion and €6 billion use of excess receipts.

How can Ireland mitigate these risks?

Some policy responses have been considered in terms of how excess corporation tax receipts might be set aside. The Minister for Finance, Public Expenditure and Reform has on several occasions noted two solutions. First, that some of the corporation tax surge are being excluded from tax revenue projections and, accordingly, will "not feed into the expenditure base". Second, that some of the historically high levels of corporation tax are to be set aside in the Rainy Day Fund.[6]

These solutions make sense in principle, but it is difficult for the Government to commit to them and, indeed, it has not done so thus far. Excluding some receipts from revenue projections does not preclude the Government from ultimately spending these receipts when they come in or when forecasts are exceeded. If anything, the repeated within-year upward revisions to spending suggest that much of the unexpected receipts are being used to fund additional expenditure rather than being set aside. The Rainy Day Fund solution could work in principle, but the annual amounts to be set aside in the fund have in fact halved from their original target of €1 billion (*Budget 2017*) to €0.5 billion, whereas annual corporation tax receipts are now far higher than they were expected to be when the original commitments were made. The fixed payment amounts also fail to allow for saving of additional cyclical revenues.

Kydland and Prescott's (1977) "time-inconsistency" problem shows that policymakers who

[6] See, for example, the Minister's responses to the June 2018 and November 2018 Fiscal Assessment Reports.

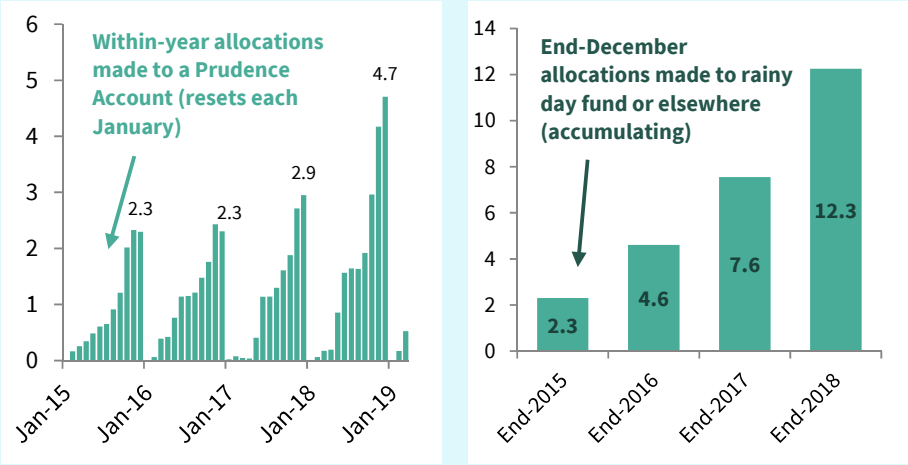
have complete discretion at every moment in time in terms of how they use resources available to them might not obtain the best possible long-term outcome. In other words, their actions later on might prove to be inconsistent with policy commitments made at an earlier stage. A key conclusion is that one can improve outcomes by limiting future discretion. This would help to preserve earlier commitments.

Proposal for a Prudence Account

To make a commitment to saving unexpected—and potentially temporary—receipts such as those from corporation tax more credible, it might be desirable to have a clear policy framework that supports this by constraining what can be done in future when those receipts arrive. Ideally there would be a fixed rule under which the Government sets aside excess receipts above a certain threshold. One option would be to notionally set aside in-year allocations to a "Prudence Account". These allocations could be based on the excess between actual and forecast corporation tax receipts (i.e., using the Exchequer profiles set out for corporation tax receipts after the previous year's budget and adjusting the base). Allocating these excess receipts to the Prudence Account as they come in could remove them from the budgetary calculus. It could reduce the scope for spending these funds as they come in, as has occurred in recent years, because the headline Exchequer position would not be impacted by these inflows. At year end, these notional amounts could then be turned over to the rainy day fund (the "National Surplus (Exceptional Contingencies) Reserve Fund") or set aside some other way.[7] The baseline for the following year would be based on the initial forecasts so that the overrun would not be locked into the base.

Figure B.3: How a Prudence Account Might have Operated

€ billion



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Allocations of above-profile corporation tax receipts to the Prudence Account would be made over the course of the year, and then turned over to the rainy day fund or set aside elsewhere. The base for next year's corporation tax receipts forecasts would be adjusted for unexpected receipts in the previous year.

Figure B.3 shows how the Prudence Account might have worked. It sets out what would have happened had the Government set aside the excess corporation tax receipts relative to forecasts (profile) since 2015. It adjusts for the surprise receipts in full when forecasting receipts for the year ahead. An approach like this would have implied some €2.3 billion being set aside at the end of both 2015 and 2016, a further €2.9 billion or receipts at end-2017, and €4.7 billion at the end of 2018. The cumulative amount of funds transferred to a rainy day fund or elsewhere would have been some €12.3 billion at the end of last year.

[7] Casey *et al.* (2018) shows how the rainy day fund could be used more actively to alleviate unsustainable expenditure increases on the basis of cyclical and other temporary revenues.

Had the Prudence Account been used as suggested here, then a larger Exchequer deficit would have been recorded in recent years. It would not have been masked by surprise corporation tax receipts. Table B.1 illustrates what the headline Exchequer Balance could have looked like in recent years had a Prudence Account worked as suggested. The Exchequer balance would have been in deficit by €4.6 billion in 2018 instead of recording a marginal surplus. Given the allocations made to a Prudence Account each year, the cumulative rainy day fund resources would have risen to just over €12 billion at end-2018. If the sustainability of such resources became clearer over time, their use could be gradually reconsidered.

Table B.1: Prudence Account and Exchequer Balance (Counterfactual)
€ billions

	2015	2016	2017	2018
Projected Corporation Tax	4.6	5.0	5.3	5.7
Actual Corporation Tax	6.9	7.4	8.2	10.4
Unexpected Corporation Tax → Prudence Account	2.3	2.3	2.9	4.7
Rainy day fund resources from Prudence Account	2.3	4.6	7.6	12.3
Exchequer Balance	-0.1	-1.0	1.9	0.1
Exchequer Balance with a Prudence Account	-2.4	-3.3	-1.0	-4.6

Sources: CSO; Department of Finance; and internal IFAC calculations.
Notes: Corporation tax receipts are projected using the same approach as in Figure B.1, but starting from the year 2015 as a base year. The Exchequer Balance with a Prudence Account Within-year allocations to the Prudence Account are assumed to transfer to the rainy day fund at the end of the year. These resources are assumed to accumulate in the fund. Note that this does not assume any macroeconomic impact from the additional borrowings implied to fund expenditure that took place in these years alongside the allocations to the Prudence Account.

An important consideration is what base year should be used. Too early a start date would mean that resources set aside would necessarily be larger. Too late a start date would mean that risks would only be stemmed from becoming much greater. But this would not mitigate the risks associated with today's level of receipts. At minimum, the Government should stem further risks from being built up in terms of a reliance on corporation tax receipts in future years. Given the risks posed, it should seek to gradually reduce reliance on existing receipts.

This exercise illustrates the extent to which excess corporation tax receipts have boosted the public finances in recent years. The analysis is something that the Council intends to update on a regular basis to show the implications for the Exchequer balance.

1.4 Assessment of the Fiscal Stance for 2019–2023

The economy is now close to its potential and there are risks of overheating absent major adverse shocks. The debt burden remains high though its ratio to income is declining steadily; creditworthiness has improved but is vulnerable to rapid changes; and the structural balance appears to be close to a balanced position (albeit that this might be artificially supported by recent surges in corporation tax receipts, which are not likely to be permanent).

Weighing up the uncertain macroeconomic outlook, the risks on the horizon, and the current fiscal position, the Council assesses that the Government should be cautious for the year ahead. For 2019, the Government should not allow within-year increases in spending, as in recent years, and any unexpected corporation tax receipts should be allocated to a Prudence Account (Box B) and then to a rainy day fund or used for debt reduction. For 2020, a prudent Budget is needed given Brexit risks, high reliance on corporation tax receipts, overheating risks, and the rapid spending increase over 2017–2019. There is room to increase spending to maintain the current level of services and planned investment increases, but any additional fiscal measures should be matched by tax increases or lower spending in other areas. This implies sticking to plans as implied by *SPU 2019* and allowing net spending to rise at a speed not quite as fast potential growth.

For the medium term, assuming that no major shocks materialise, the Government should—at maximum—grow net policy spending on the basis of sustainable growth rates, while continuing to manage risks related to corporation tax reliance. Any further tax or spending measures beyond this amount should be funded by sustainable revenue-raising measures or savings made elsewhere. Second, a credible medium-term framework needs to be developed to support budgetary planning. Third, the Government should gradually reduce the reliance it has built up in recent years on volatile and potentially reversible corporation tax receipts. These receipts have been used to mask the impact of the unplanned increases in expenditure on the headline balance in recent years.

Fiscal Stance in 2019

The fiscal stance initially planned for 2019 (as set out in *SPU 2018*) signalled an expansion in line with the economy's potential and inflationary pressures, but the Government ramped up spending beyond original plans. For 2018, the Government raised gross voted spending levels by €1.3 billion more than planned (compared to *SPU 2018*).[8] This was largely due to health overruns (IFAC, 2018e). At budget time, a €1 billion overrun was expected for 2018, but post-budget spending turned out to be a further €0.3 billion more than planned again. The overruns are evident even more so in general government data.[9, 10] For 2019, policy was also loosened relative to earlier plans. The net impact of the tax and spending measures announced on budget day meant a package of €1.1 billion. The 2018 *Summer Economic Statement* indicated that a package of €0.8 billion would be introduced. These repeated revisions to plans undermine the credibility of the budgetary process.

The unplanned increases meant that the Government went well beyond the limit of €3½ billion for spending increases or tax cuts that the Council had assessed as appropriate for introduction by the end of 2019 based on the figures in *SPU 2018*. This recommendation was made prior to the 2019 budget on the basis of sustainable growth rates. The larger increase mainly reflected the fact that the plans for 2019 were built on the imprudent and unplanned increase in spending in 2018.[11] The Council's assessments of the fiscal rules—which show breaches of the Expenditure Benchmark in recent years—reinforce the view that the increases in recent years have not been conducive to prudent economic and budgetary management (Chapter 4).

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[8] Note, we use *SPU 2018* rather than *Budget 2018* as the point of comparison 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. Adjustments between *Budget 2018* and *SPU 2018* to gross voted spending were relatively minor otherwise.

[9] In terms of non-interest general government spending, the spending increases for 2018 relative to 2017 have been revised upwards repeatedly. As of *Budget 2018*, the annual increase was to be €2.2 billion; *SPU 2018*: €3.3 billion; *Budget 2019*: €4.5 billion; and the outturn now €5.4 billion.

[10] The general government spending revision upwards relative to *SPU 2018* is €1.9 billion. Of this, €0.2 billion was a one-off consultants' pay settlement that is not expected to recur and €0.1 billion relates to a reclassification of pension payments from Eircom and Coillte pension funds. These payments were reclassified retroactively in the sector of general government (CSO, 2019). However, the remaining €0.5 billion—above the estimated *Budget 2019* overrun—appears to be driven by (1) anticipated underspends in non-health areas not having materialised (these were factored into the budget day estimates for 2018), and (2) higher-than-estimated social payments including health service, housing assistance, and other social protection schemes.

[11] The Council's assessment in November was based on a 2018 general government expenditure increase that was €0.5 billion lower than shown by the CSO outturn data (when one-offs are excluded).

There is a risk that recent slippages could be repeated. Department of Health overruns remain a possibility in 2019 and provision has once again not been made for the Christmas bonus.[12] Health spending increases budgeted for in 2019 are large at €1.05 billion (+6.6 per cent). Yet there is no clear evidence to suggest that wider problems in planning and monitoring/controlling spending have been resolved. Higher-than-budgeted spending has been a recurring issue for the Department of Health (current spending overruns average €0.5 billion over 2013–2018). And the dangerous feedback loop between unrealistic forecasting and an anticipated relaxation of spending ceilings in health areas is likely to have reinforced the problem of a "soft budget constraint" (Box D, IFAC 2018e).[13] Moreover, recent failures in budget forecasts and controls are now evident on the capital side of the budget, with the National Children's Hospital showing substantial cost increases (Box F).

Why are the recent within-year spending increases problematic? First, the decision to loosen spending further—beyond already-budgeted-for increases—means that government debt remains higher than it otherwise would have been. Delaying a return to safer debt levels means that risks, such as a harder-than-expected Brexit, present more severe threats than would otherwise be the case. Carrying greater amounts of debt now means that there is less scope to respond to future downturns through government-led stimulus. Second, the faster-than-planned increases add additional stimulus to an economy that is already close to full employment, which can contribute to potential overheating in the economy. Third, the use of unexpected corporation tax receipts—largely a net injection of funds into the Irish economy—puts the public finances at risk of sudden reversals in receipts, and also contributes to the overheating risks.

Recognising these risks, the Government should stick to existing plans for 2019. This means that no additional within-year increases should be introduced without

[12] The Christmas Bonus has been paid in each of the past five years in some form, yet the Government refuses to budget for any payments. Instead, the Government maintains that this is at its discretion and will be decided based on prevailing conditions. Basing budgetary decisions on "prevailing conditions" in this sense implies a clear procyclical bias and is a poor approach to managing the public finances. If the full bonus is paid in 2019 as in 2018, then some €0.3 billion will be added to spending increases forecast for 2019. If it is not funded by additional revenue measures, then the underlying budgetary position will weaken by a corresponding amount.

[13] That is, providers of health services anticipate yearly spending ceilings will be relaxed at a later stage with little opposition, thus weakening incentives to stay within spending targets (Howlin, 2015).

offsetting measures. To help stem an even greater reliance of government spending on services and income supports on corporation tax receipts, the Government should allocate unexpected corporation tax receipts compared to profile to a Prudence Account during the year and then to a rainy day fund or elsewhere (Box B).

Fiscal Stance in 2020

The Council assesses that the Government should be prudent with its budget for 2020 and that it should stick to its plans as implied by *SPU 2019*. The potential scale of an adverse shock from a hard Brexit could be severe (see Box C). Postponing the introduction of further budgetary increases would allow for further support to be provided in the event of an adverse shock materialising, while cushioning some of its effects.

The scope to respond to an adverse shock like a hard Brexit is currently quite limited. Monetary policy may not be much more accommodative than it already is (other Euro Area members are less exposed than Ireland is to UK developments). The euro exchange rate is unlikely to adjust favourably to support Irish exports after any exit and it could move adversely. The scope to use Irish fiscal policy to support the economy against negative shocks—beyond allowing the budget balance to fluctuate with tax receipts as an automatic stabiliser—is limited by the fact that the government debt burden remains high after the crisis (when appropriately measured as a share of modified GNI*). Fiscal multipliers tend to be weaker in Ireland due to its highly open nature (much of the stimulus flows abroad in the form of higher imports).[14]

In the event of a negative shock such as a hard Brexit, the response of fiscal policy would need to be balanced against the economy starting from a position of operating near capacity, with unemployment at low levels already, and against how well various sectors of the economy actually perform. A hard Brexit would at least partly reflect a permanent shock to Ireland's supply-side that policy would not be possible to alleviate indefinitely. This suggests that any adverse impacts from a hard Brexit might be challenging to mitigate through available policy levers. There could also be unforeseen financial impacts arising from a disorderly Brexit. In particular,

[14] A recent IFAC working paper, Ivory *et al.* (2019), examines Ireland's spending multipliers in detail.

adverse income and employment impacts could transmit to lower bank profitability and to lower credit quality of loans (Central Bank of Ireland, 2018).

There are two policy implications worth thinking about in the context of a hard Brexit scenario. First, a relatively more benign hard Brexit scenario (like the ESRI/DoF-based scenario) might be one where letting the automatic stabilisers operate—as assumed in the simulation in Box C—might be sensible. This would allow a small rise in the debt ratio with limited need for more active policy measures to stabilise the debt path. Second, however, a disorderly Hard Brexit like that considered in the Central Bank of Ireland modelling has much more severe consequences for the public finances. Trade-offs here would be far worse, given the starting position, and the Government might need to cut spending or raise taxes to prevent debt ratios from rising again. Long-term levels of output would be worse in any such scenario rather than simply being an issue of temporary disorder in the economy. Should a more adverse shock materialise, the policy response would need to be carefully assessed. However, the Government should in principle act to support the economy in so far as possible during any period of unusually weak demand.

Given the risks, the Government should stick to the plans implied by *SPU 2019*. This would benefit the economy and public finances by avoiding the need for more substantial tightening to stabilise the debt burden in the event of a severe hard Brexit scenario materialising. Any further adjustments to policy should be deferred until there is reasonable clarity as to the precise nature of the shock. While the sustainable long-term growth rate of the economy would imply €3½ billion as a limit for spending increases or tax cuts in 2020, a prudent approach to the budget would use less of the space than this.[15]

Sticking to the plans implied by *SPU 2019*, as the Council assesses, would mean some €2.8 billion of budgetary measures for 2020. These amounts are already

[15] This is based on various estimates which would put the economy's sustainable growth rate at up to 3½ per cent, while inflation forecast for 2020 is close to 1 per cent. The Department's preferred GDP-based models show potential output growth averaging 2¼ per cent over the period 2020–2023. The Council's own suite of models suggest that potential is closer to 3½ per cent. Simulations using the ESRI's model COSMO (McQuinn et al., 2017) indicate that the economy's potential growth rate is approximately 3.3 per cent (2.4 per cent for the non-traded sector and 3.9 per cent for the traded sector). The impact of a harder-than-expected Brexit could well be to reduce potential output growth rates by impacting on Ireland's potential future exporting performance, hence lowering long-run productivity growth.

earmarked for increases in public investment, public sector pay, provision to cater for demographic changes, and for planned tax cuts in 2020. Public investment alone is forecast to be more than double its level six years ago (€8 billion in 2020 as compared to €3.5 billion in 2013). If additional discretionary measures are to be taken beyond the *SPU 2019* plans, then the Government should introduce additional revenue-raising measures to preserve overall sustainability or it should scale back planned spending increases and tax cuts elsewhere.

A smaller expansion than the €2.8 billion currently implied by *SPU 2019* plans would also be desirable recognising the severe risks posed by Brexit, the reliance on corporation tax receipts, and the risks of further overheating. This could include not using the €0.6 billion that is currently set aside for assumed tax cuts and unallocated spending increases.

In the context of potential adverse fiscal outcomes, it is worth noting that recent reforms to the European Stability Mechanism could entail greater scope to absorb shocks across all Euro Area Member States including Ireland. Of course, this insurance mechanism carries costs too (Box D).

Fiscal Stance over the Medium Term (2021–2023)

The Government needs a credible strategy for the medium term. Operating fiscal policy on the basis of the correct "budgetary stance" and being willing to be more prudent than the current fiscal rules allow is the correct approach to take. A better approach to budgetary planning could be built around four elements:

1) **A better approach to medium-term budgeting would start with a clear statement of the sustainable growth rate that net policy spending can grow at.** This could be informed by the Department's alternative estimates of potential output, but any approach should try to correct for the risks of procyclical bias present in such estimates. As it stands, the fiscal rules—owing to their procyclicality—are not proving a helpful anchor for sustainable spending growth (net of tax measures). The limits for real net spending growth allowed under the Expenditure Benchmark are climbing to high levels, given how procyclical the measure used is (Casey *et al.*, 2018).

2) **Departmental three-year expenditure ceilings should be reframed around this medium-term growth rate and forecasts should be more realistic.** The current ceilings are not working. 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 to ensure that aggregate spending increases are sustainable. In practice, recent years have seen overruns, especially in health spending, that have not been absorbed by other areas.

   To address this, forecasts should be more realistic (accounting for obvious pressures) and should be anchored to more sustainable growth rates. The budgetary surpluses currently forecast to be run over the medium term are unlikely to materialise (Chapter 3).

   The Department of Public Expenditure and Reform views its current ceilings as (a) the best way to generate efficiencies (allowing for general price inflation is viewed as raising the effective floor for negotiations with line departments); and (b) as a way to allow the Government to address emerging, unforeseen social/economic pressures as they arise. The current approach to medium-term spending ceilings might therefore be better understood as an attempt to impose commitment mechanisms, rather than efforts to realistically forecast expenditure. The problem with the approach is that it lacks credibility. Upward revisions to ceilings are frequent and the ceilings fail to function as an effective tool for controlling spending. This is also problematic for the macroeconomic forecasts (Chapter 2), with forecast aggregate demand slightly lower than it otherwise would be in a situation where government consumption forecasts were more realistic.

3) **The debt ratio target should be lower to reflect Ireland's volatile growth rates; it should be restated as a percentage of modified GNI*; it should be clarified as either a ceiling or target; and it should have clear staging posts.** The current debt ratio target of 55 per cent of GDP—though not referenced in *Budget 2019*—is not a particularly low or prudent debt ratio considering the distortions to GDP and given Ireland's typical debt

dynamics.[16] A better approach would be to define a lower ratio to reflect this. It should also be clarified as either a ceiling or a target and to define it in terms of a more appropriate measure of national income like modified GNI*. Ideally, a debt objective should also incorporate a broader assessment of long-term spending pressures. In addition, there are no clear staging posts for when the debt ratio should be achieved. 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.

4) **A budgetary position less reliant on corporation tax receipts should be an overarching principle guiding fiscal policy in coming years.** A key policy challenge for the State in coming years will be to stem its dependency on corporation tax revenues for supporting long-lasting expenditures on income supports and public services. Box B explores the risks involved and how this reduced reliance could be achieved. Reducing the dependency should—at minimum—mean that any future surges in corporation tax receipts are not used to fund permanent expenditure increases as in recent years. Ideally, the Government should attempt to reduce its dependency on corporation tax receipts by growing spending by less than is implied by sustainable growth rates in future years, while also implementing something like a Prudence Account (Box B).

[16] As Box H of the November 2017 Fiscal Assessment Report (IFAC, 2017e) shows, Ireland has a volatile history in terms of its debt dynamics, which would argue for setting a debt ceiling below the SGP limits (these are primarily set with larger EU Member States in mind).

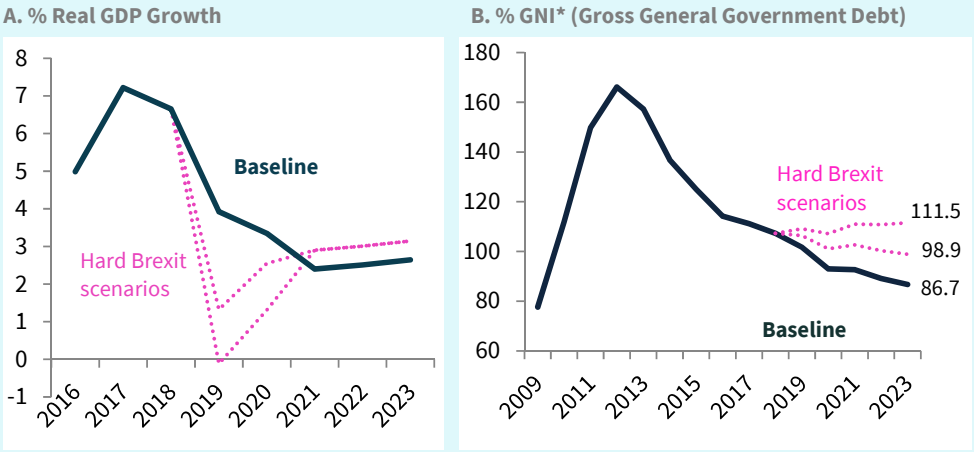
Box C: Fiscal Impacts of Hard Brexit Scenarios

This box considers the fiscal impacts from alternative scenarios of how the economy might evolve in coming years, given the uncertain outlook.

Alternative Scenarios

The two alternative "Hard Brexit" scenarios considered are based on the ESRI/DoF (Bergin *et al.*, 2019) and Central Bank of Ireland (2019) scenarios for a disorderly Brexit. Figure C1.A shows the implied growth rates under each scenario relative to the baseline.

Figure C1: Alternative Growth and Debt Ratio Scenarios



Source: Internal IFAC calculations based on CBI and ESRI/DoF; CSO.
Note: The baseline is taken as *SPU 2019* estimates. CBI shock is initially the more adverse of the two "Hard Brexit Scenarios". ESRI scenario is based on Box 1, McQuinn *et al.* (2019). Scenario growth rates are higher in later years to allow for the fact that the *SPU 2019* forecasts already incorporate a soft Brexit after 2020 leading to a free trade agreement between the UK and EU. As noted in Chapter 3, the baseline debt ratio projections over the medium term may be unrealistic due to the technical nature of expenditure forecasts.

Fiscal Impacts

The shock impacts from the scenarios are taken and modelled through the Council's Fiscal Feedbacks Model (IFAC, 2012). The model applies the difference in real GDP growth rates under each scenario relative to the Department's baseline macroeconomic forecasts as the basis for a growth shock. It models the cyclical impact on the primary balance (lower tax revenues and higher cyclical unemployment spending) and the feedback to nominal GDP growth from this. This is consistent with a situation in which the automatic stabilisers are allowed to work. The model does not take into account any change in marginal borrowing costs on Irish government debt, or changes in the exchange rate (which might dampen nominal growth), or possible direct costs related to Brexit, such as infrastructure costs or support to specific sectors. Furthermore, it assumes an average response whereas actual effects may be quite different to a standard shock. Lastly, the model assumes that shocks are permanent (i.e., that there are no offsetting responses in later years to the initial shock to the level of economic activity).

The scenarios highlight just how sensitive Ireland's public finances are to alternative outcomes. We can see that the hard Brexit scenarios considered would imply debt-to-GNI* ratios remaining close to 100 per cent by 2023 or rising to almost 112 per cent (assuming no policy response). The effects come about from much bigger deficits being run and also from less favourable GDP growth.

The budget balance and funding costs would also be affected (Table C1). The baseline scenario sees the budget balance rise gradually to 2.3 per cent by 2023 (albeit that this is based on

unrealistic expenditure assumptions as noted in Chapter 3). The hard Brexit scenarios paint a much more adverse picture. The ESRI/DoF scenario would see the budget balance swing back to deficit rapidly (-1.9 per cent in 2019 with a deficit persisting out to 2022). Funding requirements would be estimated to average 8.1 per cent of GNI* per annum (for context, advanced economy median requirements are around 6 per cent on average over 2019–2021).[17] The CBI scenario shows even more adverse outcomes, given a deeper growth shock early on.

Table C1: Estimated Fiscal Outcomes

% GNI*

	2019	2020	2021	2022	2023
Budget Balance					
Baseline	0.3	0.6	1.2	1.7	2.3
Hard Brexit (ESRI/DoF)	-1.9	-2.3	-1.4	-0.4	0.5
Hard Brexit (CBI)	-3.2	-4.7	-3.8	-2.8	-2.1
Gross Debt Ratio					
Baseline	101.7	93.0	92.7	89.2	86.7
Hard Brexit (ESRI/DoF)	106.4	101.1	102.6	100.3	98.9
Hard Brexit (CBI)	109.1	107.2	111.0	110.8	111.5
Funding Requirements					
Baseline	7.2	9.9	1.2	5.8	3.8
Hard Brexit (ESRI/DoF)	9.6	13.2	3.8	8.0	5.7
Hard Brexit (CBI)	11.0	15.8	6.2	10.6	8.4

Source: Internal IFAC calculations based on CBI and ESRI/DoF; CSO.
Notes: Budget balance and gross debt ratio are in general government terms. Funding requirements are estimated as the Exchequer borrowing requirement + maturing debt + anticipated buybacks of floating rate bonds.

Stabilising Debt Ratios

A common response to adverse shocks is to allow revenue to temporarily decline and cyclical spending to rise. However, in a situation where the debt ratio might begin to climb on an unsustainable trajectory, more active measures to stabilise debt ratios might be warranted. The growth shock based on the ESRI/DoF Hard Brexit scenario implies a debt ratio that remains relatively stable. By contrast, the shock based on the CBI estimates would see debt rising over the medium term.

A question worth considering is what level of adjustment to the structural primary balance would be required to stabilise the debt ratio. This can be considered in the Fiscal Feedbacks Model by exploring the required additional discretionary adjustments that would be needed to keep debt ratios at or below end-2018 levels over the medium term (107 per cent of GNI*). Based on the model, this could be achieved with a front-loaded adjustment of almost €4 billion in 2020 or with a cumulative adjustment of €5 billion phased evenly over the three years 2020–2022.

Caveats to the Analysis

There are several final caveats to note. First, the analysis here is based on an assumed deficit multiplier of 0.5, which is consistent with recent research based on SVAR-based approaches and COSMO estimates that assume no endogenous policy responses (Ivory *et al.*, 2019; Carroll, 2019). This gives different results to those produced in the ESRI/DoF analysis, which implies a lower sensitivity to growth shocks (at peak, the general government balance in the latter is

[17] This is based on the IMF's April 2019 Fiscal Monitor, which takes "total financing needs" as maturing debt + budget deficits. It includes the refinancing of short-term debt outstanding. By comparison, the Council's estimates for Ireland refer solely to medium- and long-term maturing debt rollovers + Exchequer borrowing requirements.

assumed to worsen by 0.9 percentage points relative to the baseline scenario, whereas the medium-term five-year impact is 0.5 percentage points). The lower sensitivity in the latter reflects two aspects: (1) lower sensitivity of the deficit to growth shocks in general in the model, and (2) moderate wage, and hence income tax, responses in a Brexit scenario (higher import prices lead to higher consumer prices, which offsets the downward pressure on wages). Second, the Council's scenario is based solely on a growth shock aggregated to the economy-wide level so that the exact nature of impacts from the hard Brexit scenarios on tax headings, cyclical expenditures, and economic behaviour is not considered. Third, the model assumes that the shock takes place in 2019, though the effects could obviously be assumed to take place over the course of 2019–2020, given the current timing.

Box D: Reforms to the European Stability Mechanism (ESM)

Last December, euro area heads of state and government endorsed a set of proposals that may have fiscal implications for Ireland. The goal of the reforms is to enhance the ESM's capacity as a crisis resolution fund—a provider of emergency support programmes—to help the euro area to withstand future crises (ESM, 2018).

The ESM

The ESM is a lender of last resort for countries that lose market access, or are close to losing market access. This is a function that did not exist before the recent crisis and the lack of which was considered a key failing in terms of how quickly and efficiently euro area institutions could respond (Baldwin and Giavazzi, 2015). The ESM was set up in October 2012, has a maximum lending capacity of €500 billion, and finances its activity by issuing bonds and other debt instruments. Its creditworthiness is supported by €705 billion of support from euro area member states: €80.55 billion paid-in capital, and €624.25 billion of callable capital. The callable capital serves as an additional buffer that the ESM can call on member states to contribute as and when necessary. It reinforces the ESM's creditworthiness further should a borrower of ESM funds have to default on a loan payment and should paid-in capital and other reserves prove insufficient to cover losses.

A common backstop to the Single Resolution Fund (SRF)

A key reform to how the ESM operates is the implementation of a common financial backstop for the Single Resolution Fund (SRF) so that it has enough cash to deal with a very big crisis from 2024 at the latest. The SRF is an EU fund for resolving failing banks and is financed by bank contributions. The backstop should mean that the ESM would be able to lend necessary funds to the SRF should the SRF's bank-provided resources prove insufficient to avert major bank failures in future.[18]

It is expected that the SRF bank-provided resources will be around €60 billion (or 1 per cent of deposits covered in the Banking Union) by 2024, while ESM loans available would be about the same size. If the ESM loans were to be used, the SRF would be required to pay back the ESM loan with money from bank contributions within three years (subject to an extension of up to two years). This means that it is intended to be fiscally neutral over the medium term.

The common backstop has several fiscal implications for Ireland:

There are obvious benefits to Ireland arising from the euro area architecture being made more robust. A common concern relating to the last crisis was that individual Member States—by

[18] Loans would have to be mutually agreed by the ESM's Board of Directors, consisting of euro area finance ministry officials, but the plan is that approvals could be made swiftly (in as little as 12 hours).

giving up monetary independence—had stripped away their central banks' role as lender of last resort (De Grauwe and Yuemei, 2013). A lack of guarantees of support from member states allowed liquidity crises to emerge in downturns among crisis countries. These crises were marked by large outflows of liquidity; difficulties in funding debt rollovers at reasonable interest rates; and limited capacity to allow automatic stabilisers to support the economy.

By providing insurance against the extent to which the costs of bank failures are borne by individual Member States, the reform could mean lower risk premia for Ireland, and hence lower government debt interest costs. It could provide further scope to allow automatic stabilisers to operate in a downturn (by alleviating pressure to consolidate). And it could also limit the likelihood of systemic crises in future (including sovereign-bank doom loops).

The reforms are not costless. A series of large bank bailouts in future could entail requirements for additional capital to be paid into the ESM to shore up the ESM's creditworthiness (hence preserving its capacity to borrow funds and lend to crisis countries). Ireland's paid-in capital currently amounts to €1.3 billion of the €80.5 billion total reflecting its 1.59 per cent contribution key (ESM, 2012). Ireland has also committed a further €9.8 billion of the ESM's €624 billion of callable capital. Bank losses in the last crisis were exceptionally large in some cases and so the risk of these funds being required is not negligible.[19] While financial crises occur infrequently (about once every 24 years on average), the realisation of contingent liabilities tend to be highly correlated during crises (IMF, 2016). Macroeconomic downturns tend to trigger other shocks, including financial sector crises, bailouts of state-owned enterprises and subnational governments, and other contingent liabilities. A risk is that future crises require Ireland to commit some of these callable amounts, if not more. It is plausible that such requirements might also entail adverse external economic conditions for Ireland. Spillovers from deteriorating financial conditions elsewhere might be expected to reduce Irish exports, domestic demand, and possibly even to transmit to weaker financial conditions domestically. Finally, to the extent that moral hazard problems exist—as with any insurance mechanism—risks of future bailouts might be aggravated by the reforms.

Other reforms

Other reforms will see the ESM's financial assistance tools developed. These include making eligibility for the ESM's precautionary lending more transparent and predictable, thus increasing its accessibility during liquidity crises. So-called "Single-limb Collective Action Clauses" are to be introduced by the ESM by 2022. These will allow a supermajority of bondholders to agree to debt restructurings that are legally enforceable on all bondholders, making debt restructuring smoother when needed (avoiding holdouts).

In addition, there is an agreement between the ESM and the European Commission on cooperation between the two institutions. This would cover partaking in missions related to economic policy coordination and budgetary monitoring; eligibility assessments; debt sustainability assessments; financing needs; financial stability risks; policy conditionality (e.g., goals and expected impacts of reform measures in relation to the financing needs to help Member States financial situation and refinancing capacity); and compliance and post-programme monitoring.

[19] Most notably, Germany's Hypo Real Estate was provided with guarantees of €145 billion between 2008 and 2010, while Dexia in 2008 was backed by French, Belgian and Luxembourg state guarantees amounting to €135 billion (Bruegel, 2018). In terms of adjustment programmes during the financial crisis, some €480 billion of external support was required for five euro area countries during the period 2010 – 2018 (Greece, €289 billion; Ireland, €67.5 billion; Portugal €76 billion; Spain, €41 billion; and Cyprus, €7 billion), which is more than the ESM's current lending capacity.