Irish Fiscal Advisory Council

Fiscal Assessment Report

June 2019

Report Briefing,

10th June 2019

Some Background

The Fiscal Council

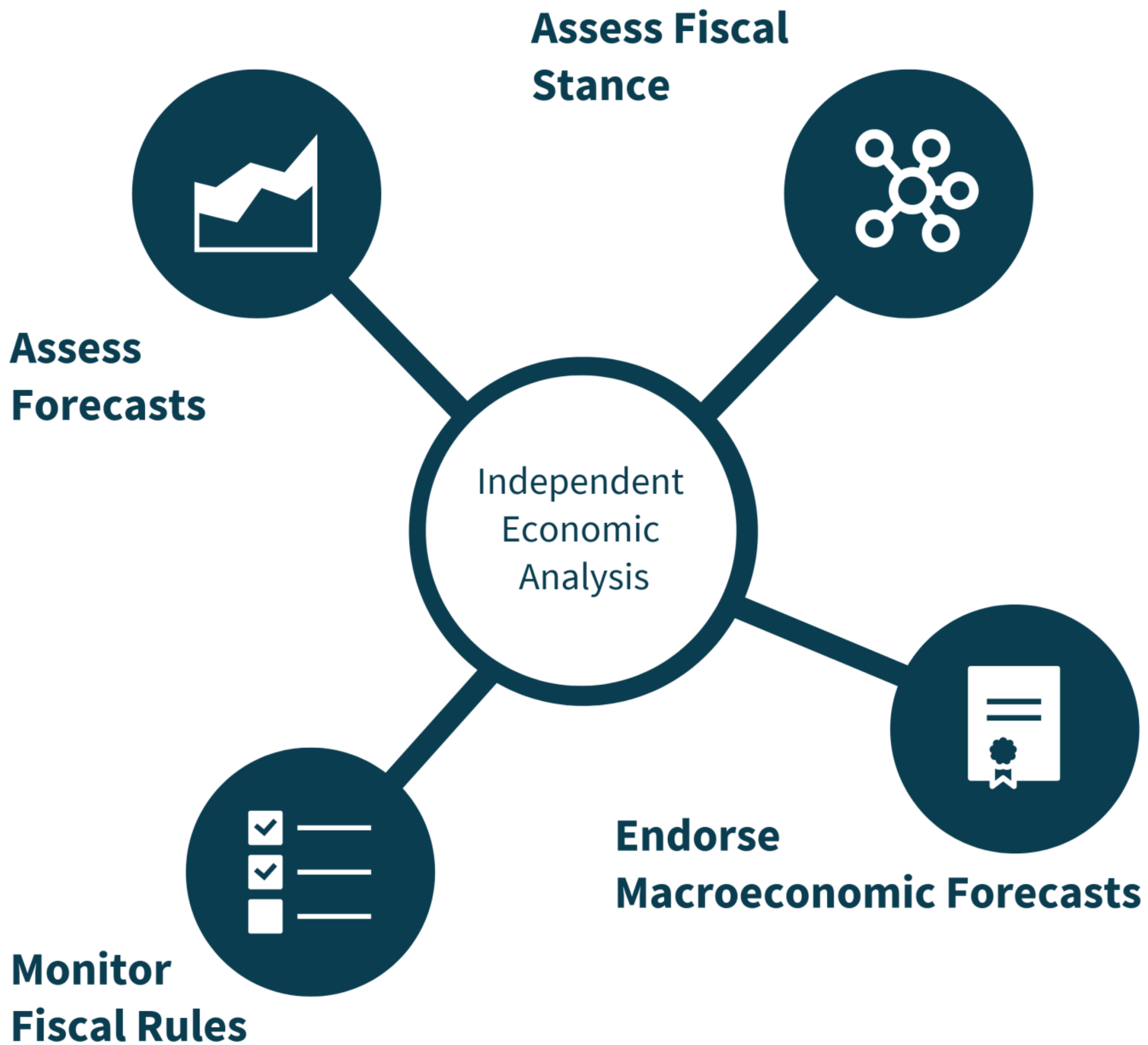
- First established in July 2011

- Five-Member Council

- Seven-Member Secretariat

- The Fiscal Assessment Report is the Council’s main publication. The twice yearly report assesses the Government’s budgetary plans through all elements of the Council’s mandate.

Our Mandate


Assess Fiscal Stance
Assess Forecasts
Independent Economic Analysis
Endorse Macroeconomic Forecasts
Monitor Fiscal Rules

Key Messages

Key Messages

1) The Government should be cautious and stick to its plans as set out in *SPU 2019.*

2) Growth is strong, but the outlook for the economy is unusually uncertain.

3) The public finances are still vulnerable and spending has been allowed to drift upwards in recent years beyond planned increases.

(1) Growth is strong, but outlook uncertain

- Continued strong growth means that the Irish economy has recovered from a deep crisis and is now operating near capacity.
- Yet the current outlook is unusually uncertain.
- The Government's forecasts assume the UK makes an orderly and agreed exit from the EU at the end of 2020.
- But this outlook is balanced between potential overheating on one side and an exceptional adverse shock in the form of a harder-than-assumed Brexit on the other.

(2) The public finances are still vulnerable

- Efforts to turn around a large budget deficit were successful, but little progress since 2015 and Ireland's net debt ratio remains 5th highest in OECD.
- The Government has allowed a pattern of spending drift in recent years: policy spending growth has risen from 4.5 per cent in 2015 to 6.7 per cent in 2018.
- Some €3 billion to €6 billion of the €10.4 billion corporate tax receipts received in 2018 could be considered above conventional levels.
- Still no credible medium-term strategy.

(3) The Government should be cautious and stick to its plans

- This reflects risks of a hard Brexit, reliance on corporation tax, possibilities of overheating, and the rapid rise in spending between 2017 and 2019.
- For 2019, it means no additional within-year increases without offsetting measures. For 2020, it entails some €2.8 billion of budgetary measures: amounts already earmarked for public investment, public sector pay, demographic pressures, and assumed tax cuts.
- Given previous announcements, this allows for minimal new tax/spending measures on budget day.
- If additional measures are to be taken, the Government should introduce revenue-raising measures or scale back spending/tax cuts elsewhere.

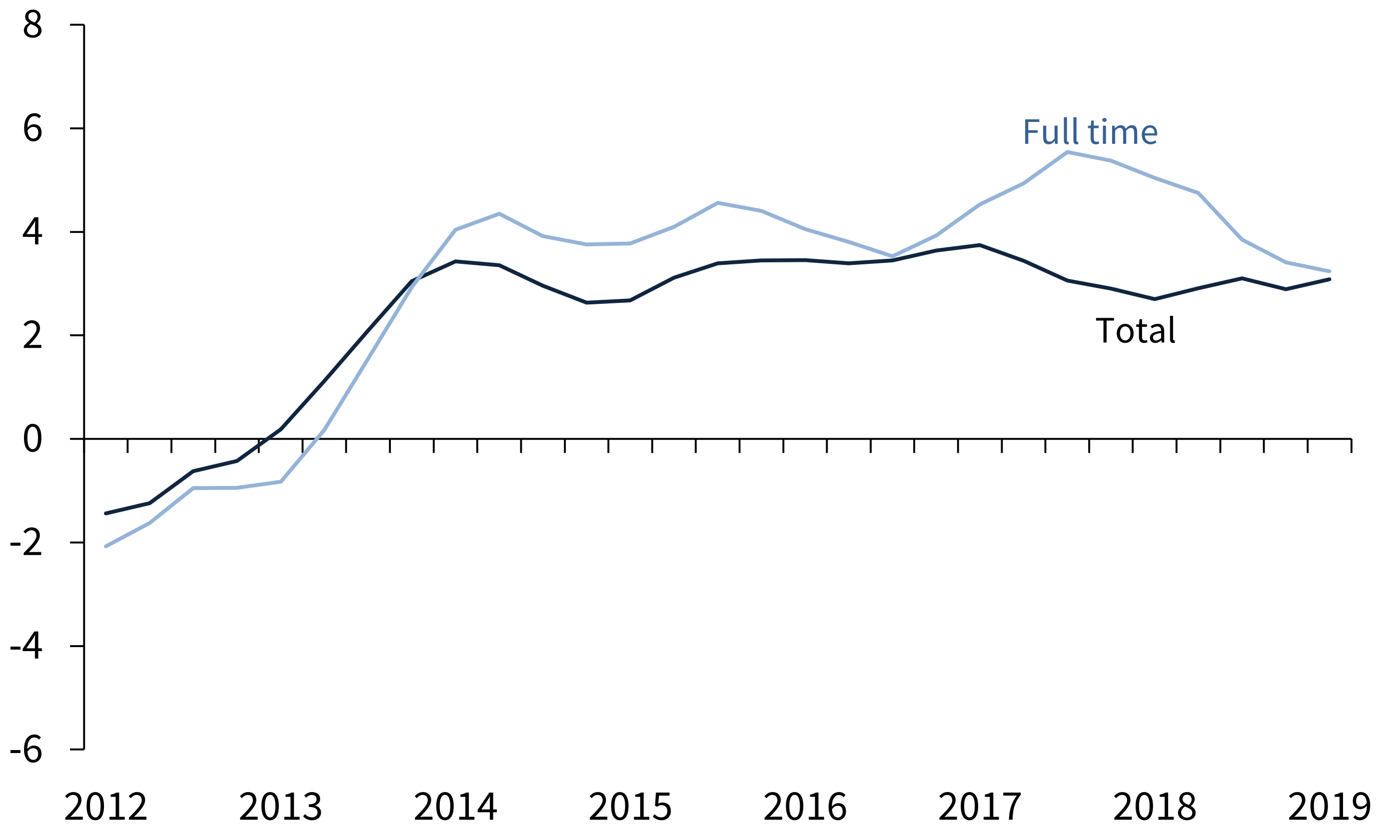
More Detail

Macro Context

The domestic economy has shown continuing strong growth

Employment Indicators

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

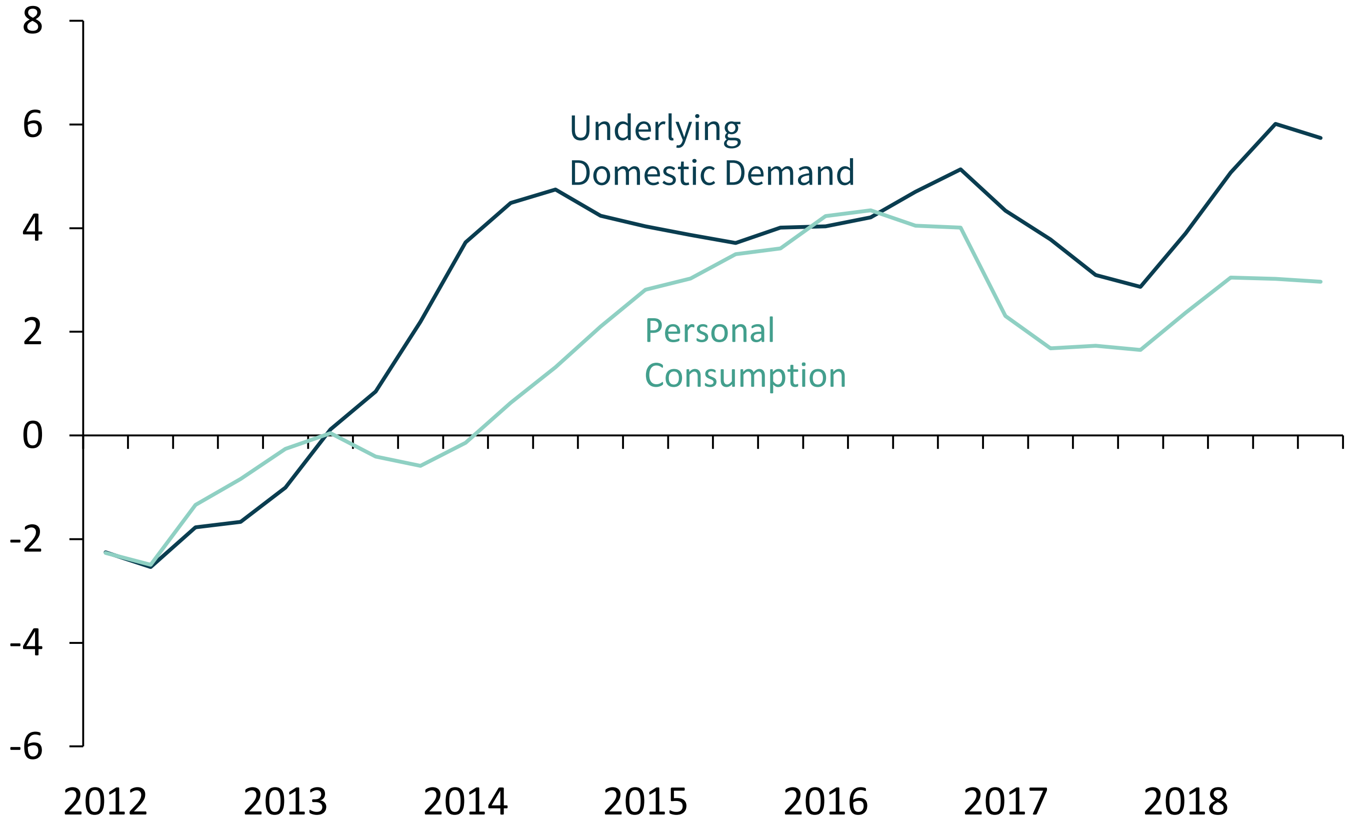


Irish Fiscal Advisory Council

The domestic economy has shown continuing strong growth

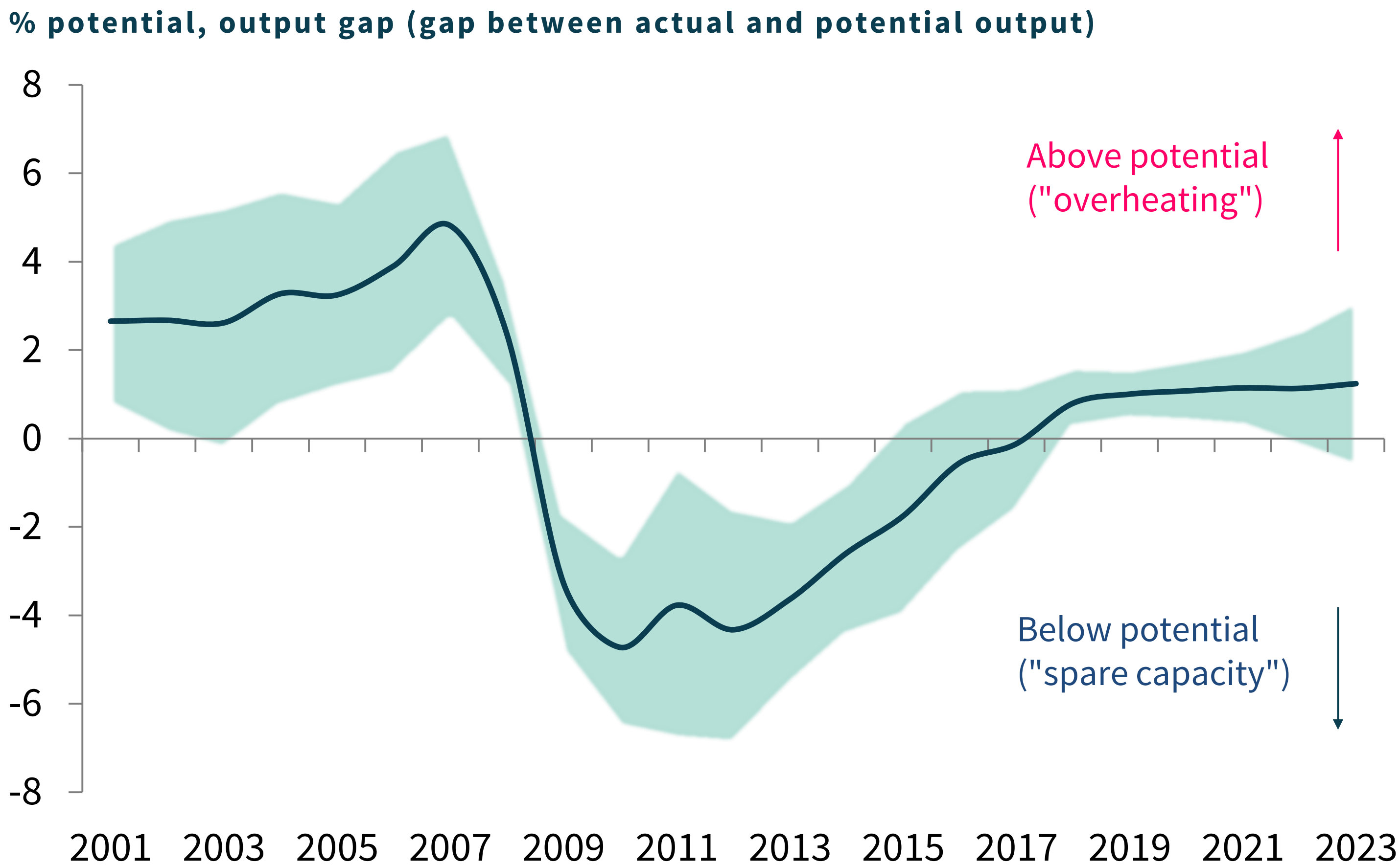
Indicators of Domestic Economic Activity

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



Note: 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.

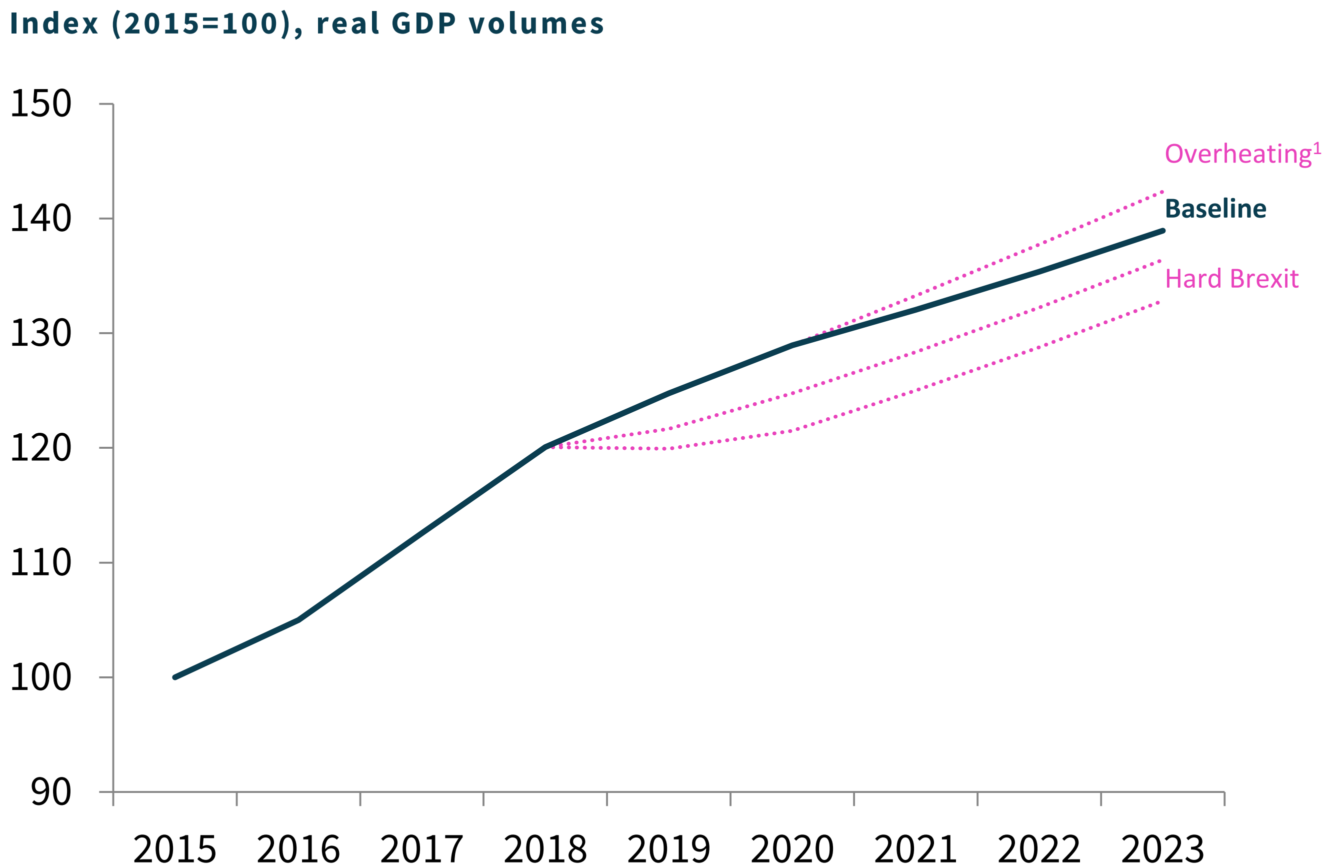
And the economy is now forecast to overheat



Note: Figure shows range of output gap estimates (the shading) and mid-range estimates (the line). Estimates are produced using a variety of methods based on the Council's models and Department *SPU 2019* forecasts. The range currently focuses on measures produced by using measures of domestic economic activity, including Domestic GVA.

Irish Fiscal Advisory Council

But the economic outlook is unusually uncertain



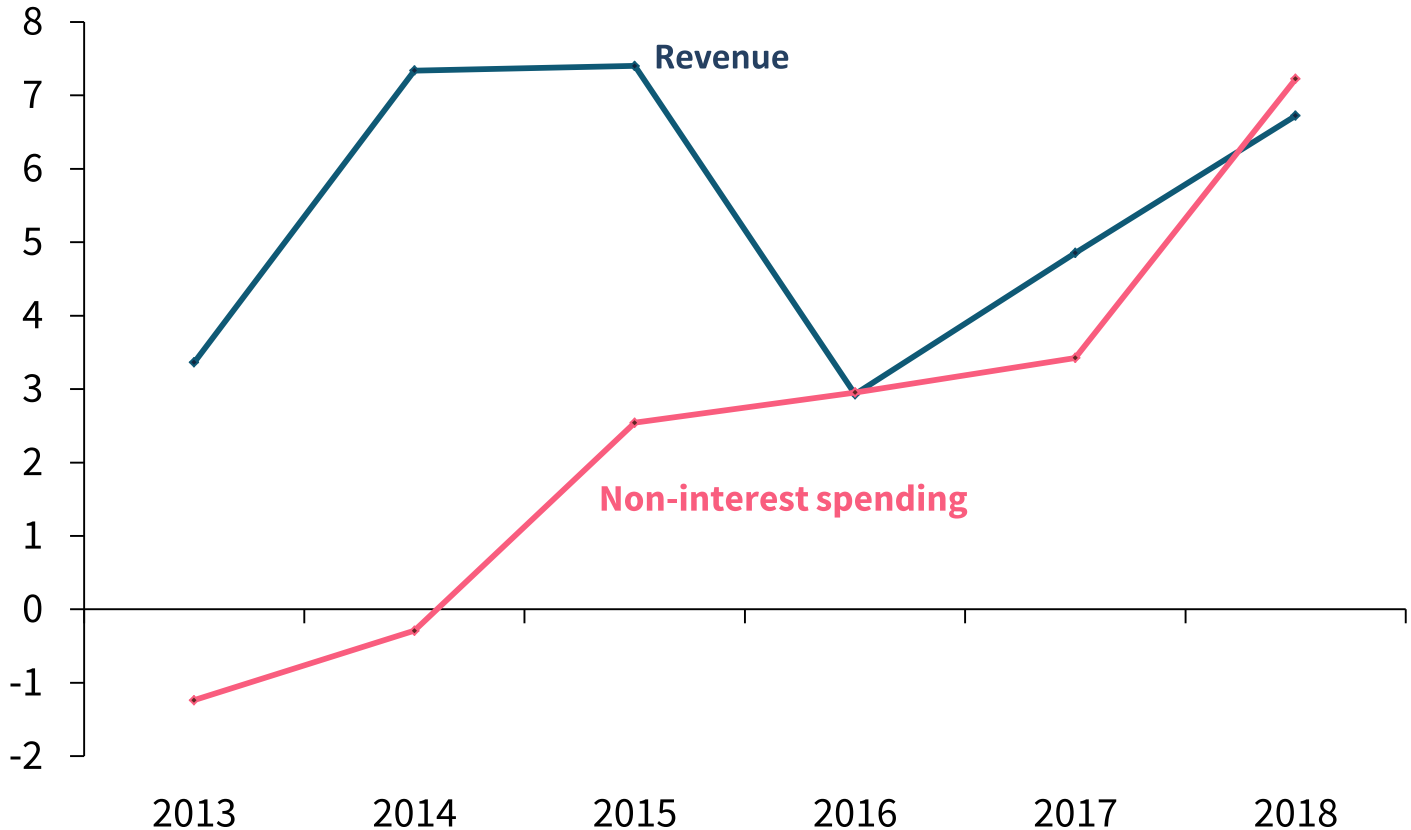
The "Overheating" scenario is one in which growth does not slow from its pace in the baseline after 2020. The two "Hard Brexit" scenarios shown are based on the ESRI (Bergin et al., 2019) and Central Bank of Ireland (2019) scenarios for a disorderly Brexit.

Fiscal Context

Spending in 2018 rose faster than strong revenues

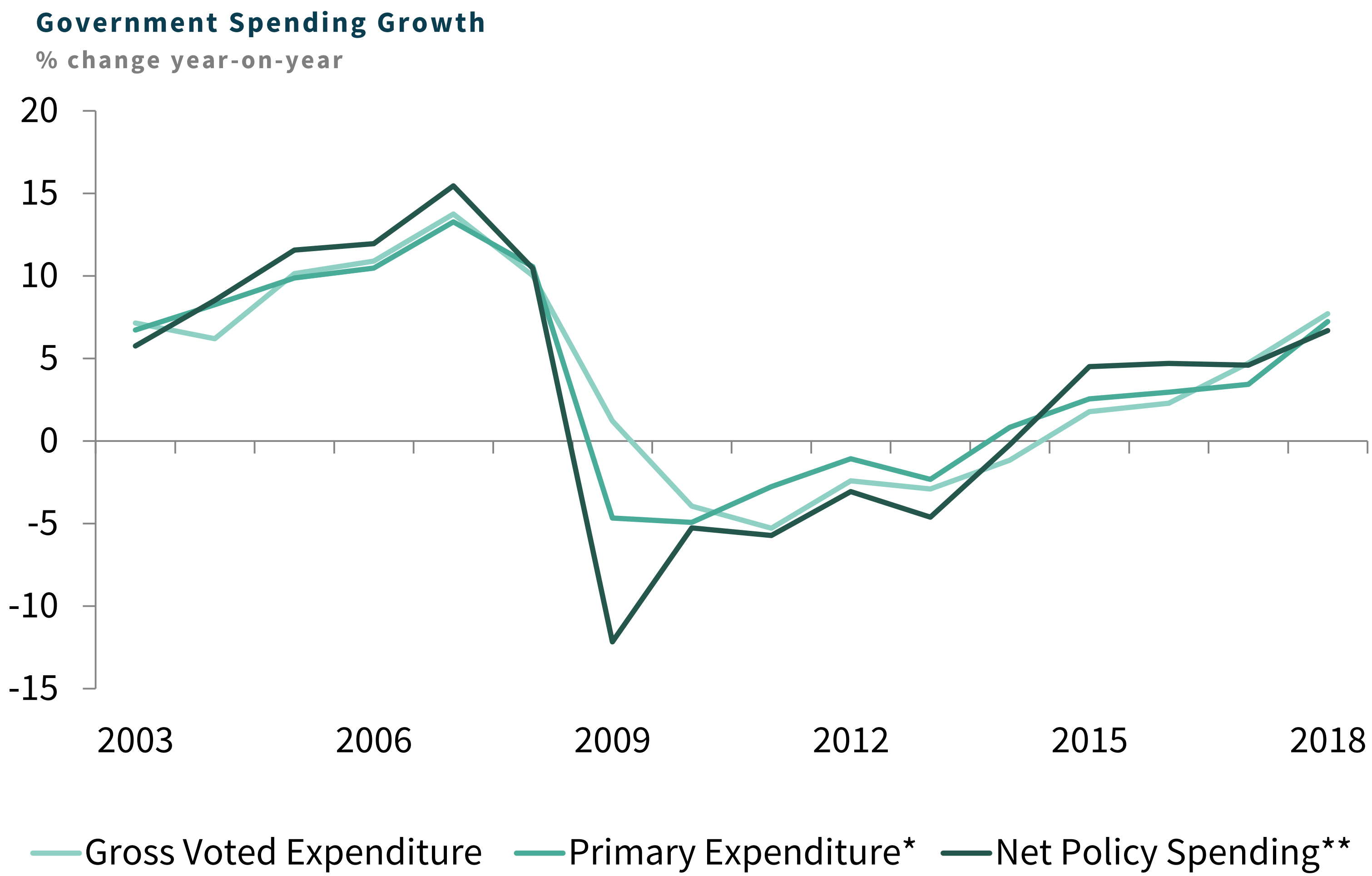
Revenue and non-interest spending

% change year-on-year



Note: Data are on a general government basis and are adjusted to exclude one-offs as in Table 1.1.

And spending growth has been accelerating

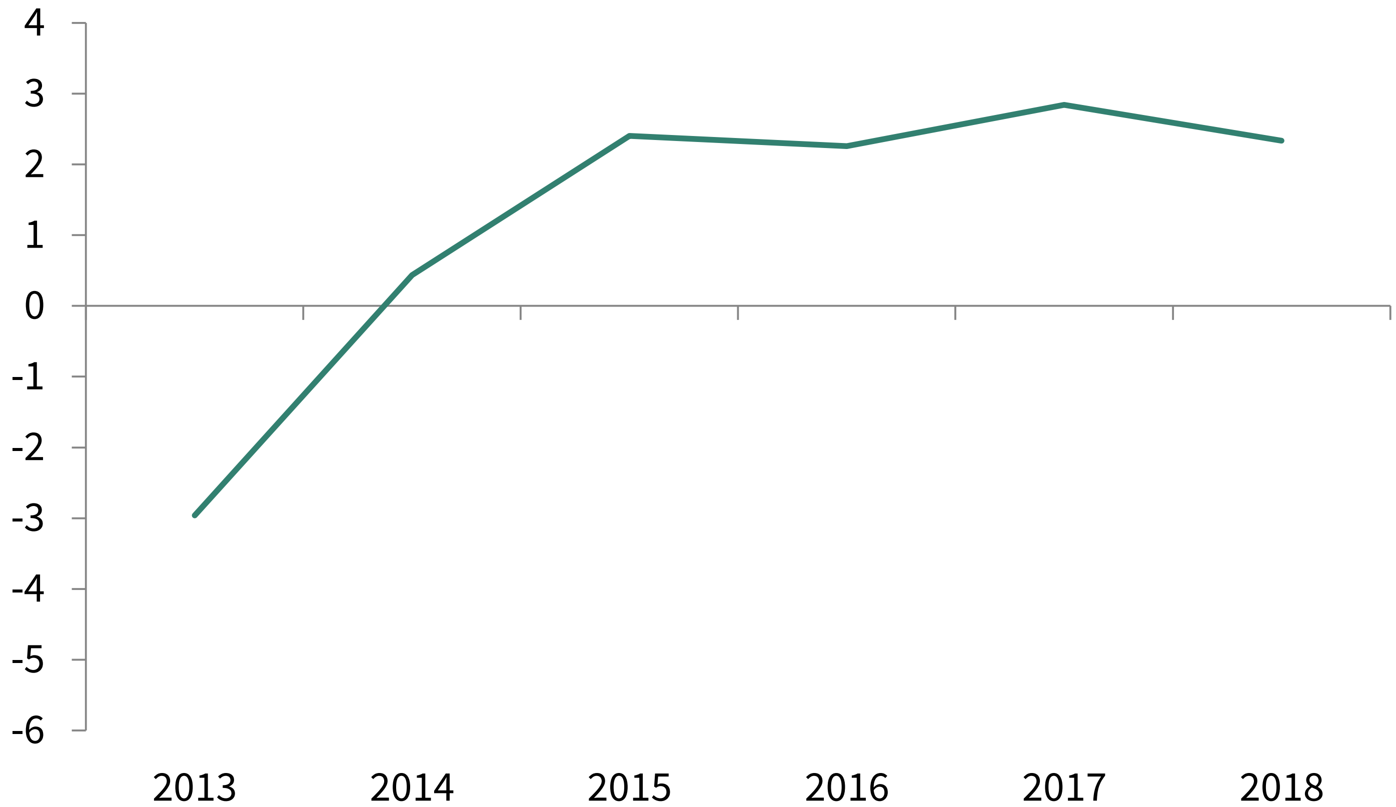


Notes: * Primary Expenditure is total general government expenditure less interest costs. ** Net Policy Spending is a measure of spending growth that tries to get a truer reflection of what is under the control of governments and to allow for offsetting tax changes (Box A, IFAC 2018e). Net Policy Spending = 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.

With the result that the primary balance (budget balance excl. interest costs) is flat

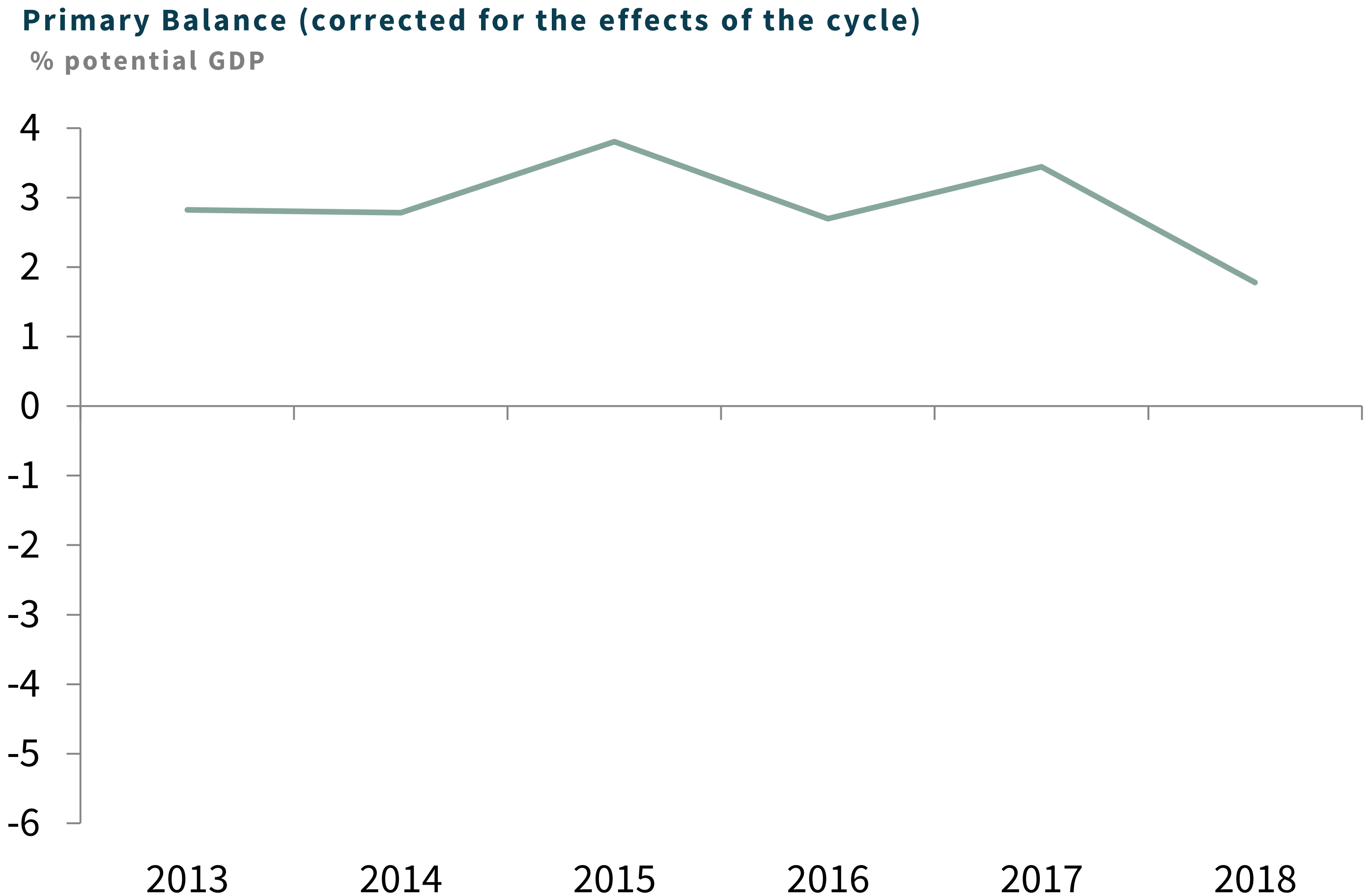
Primary Balance

% GNI* (excluding one-offs)



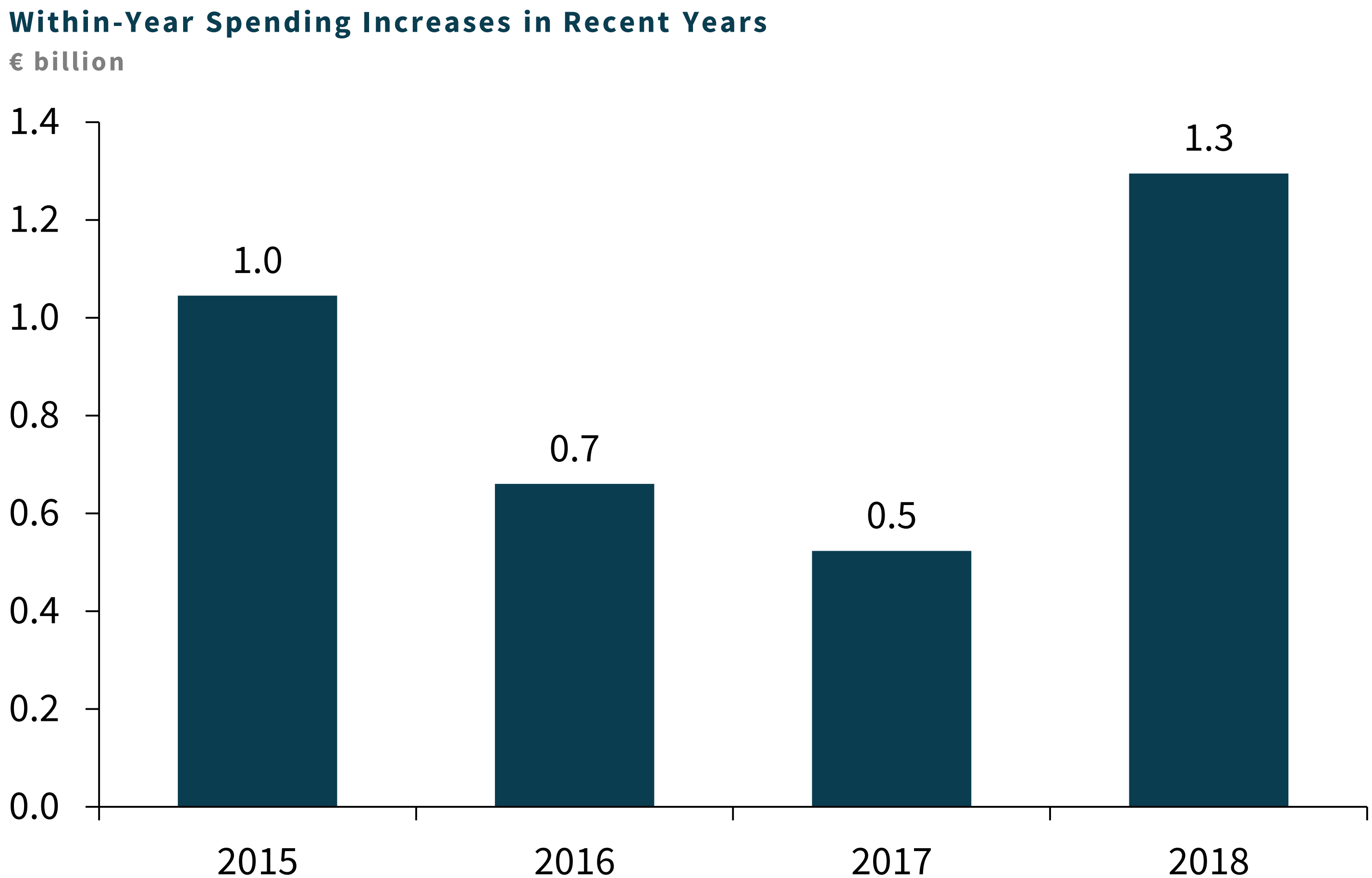
Notes: The primary balance is the general government balance less interest costs and it excludes one-offs assessed by the Council.

And the balance is deteriorating when accounting for the economic upswing



Notes: The primary balance is the general government balance less interest costs and it excludes one-offs assessed by the Council. The primary balance (corrected for the effects of the cycle) is the same but it uses the Department's preferred GDP-based output gap to measure the cyclical position under an assumed semi-elasticity of 0.588.

Large part of this is due to unplanned spending increases within the year

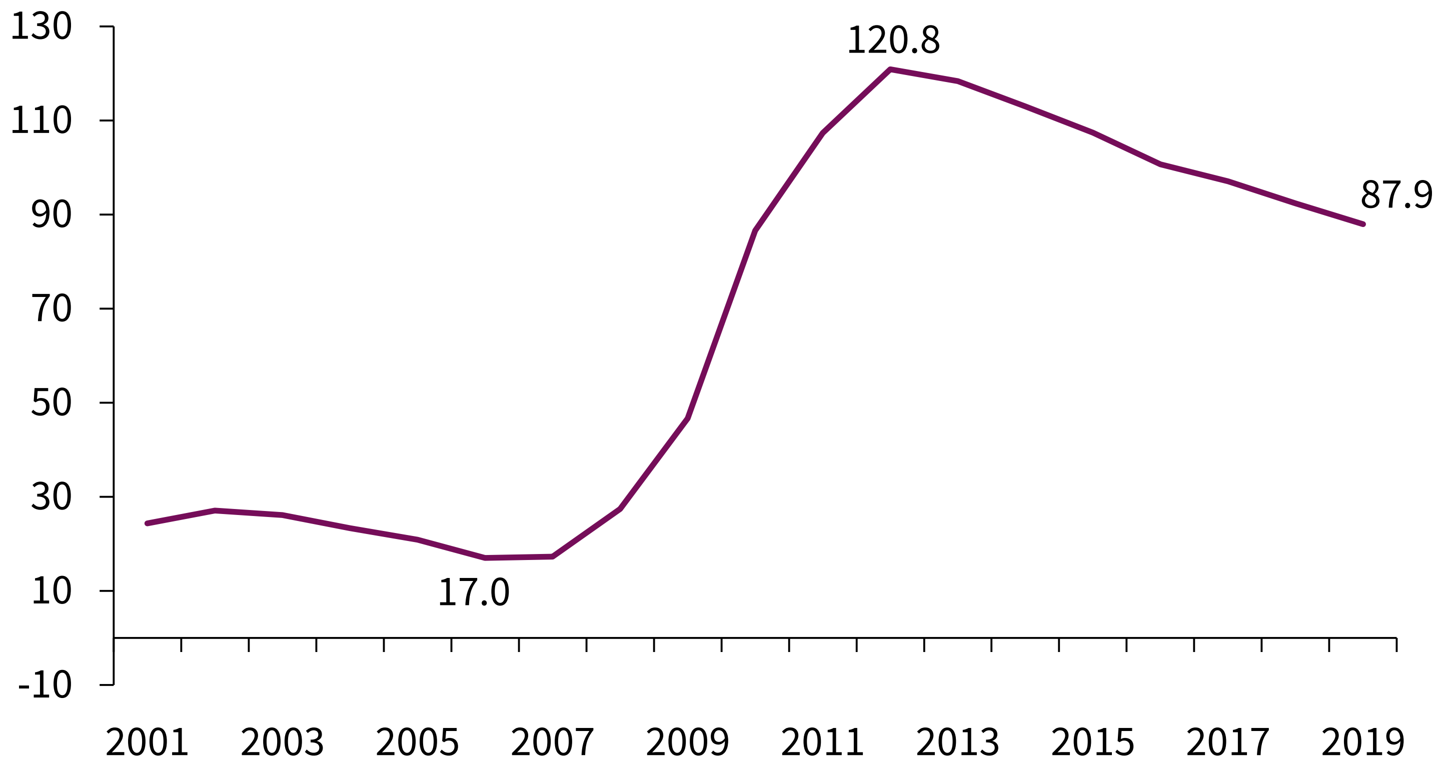


Notes: Within-year spending increases are based on gross voted spending outturns as compared to earlier vintages of estimates (Budget 2015 for 2015; Budget 2016 for 2016; Budget 2017 for 2017; and SPU 2018 for 2018, due to the reclassification of spending on water services into the Department of Housing,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

Though Ireland’s debt burden is steadily falling…

Ireland’s Net Debt Burden

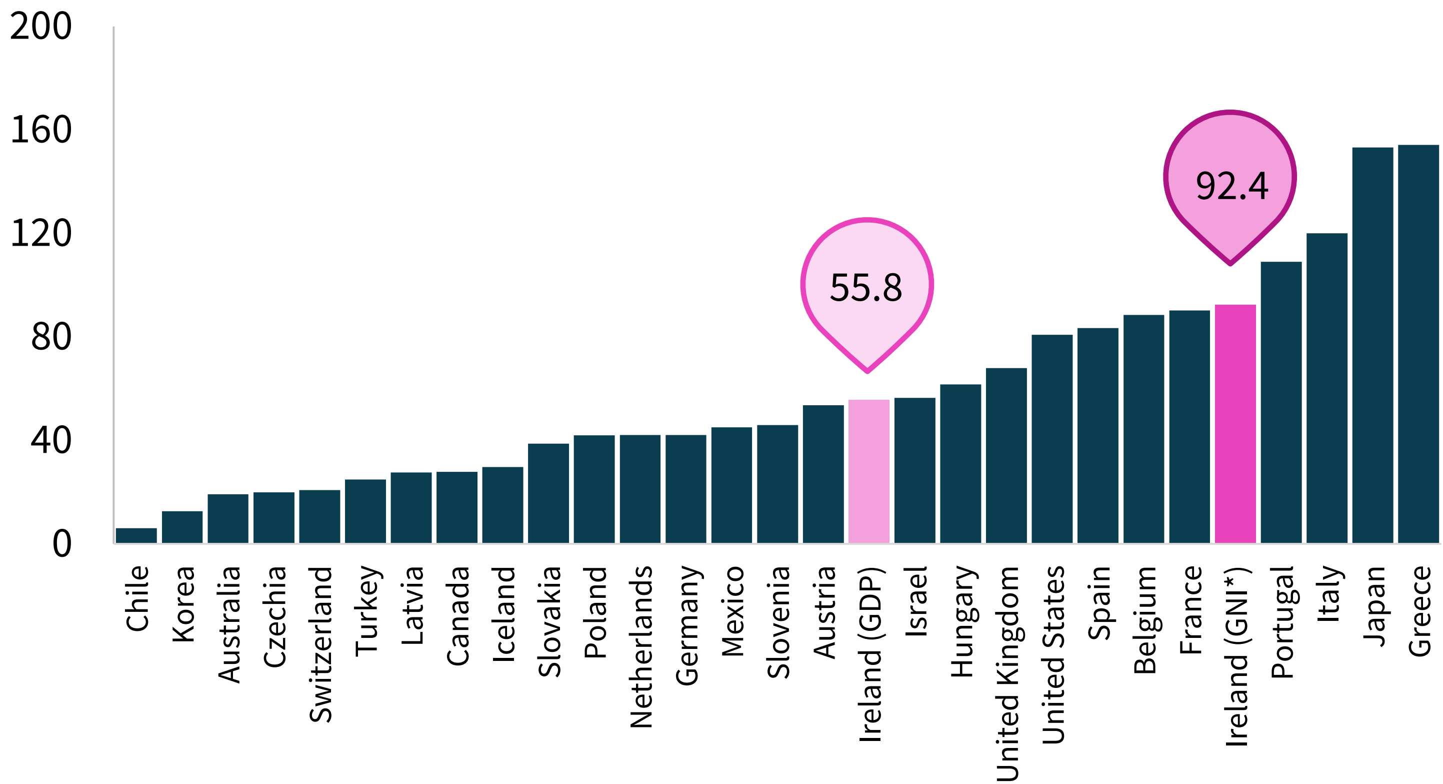
% GNI*, general government basis



…Ireland's debt remains high

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.

Risks to Public Finances

Irish Fiscal Advisory Council

There are two major risks to public finances

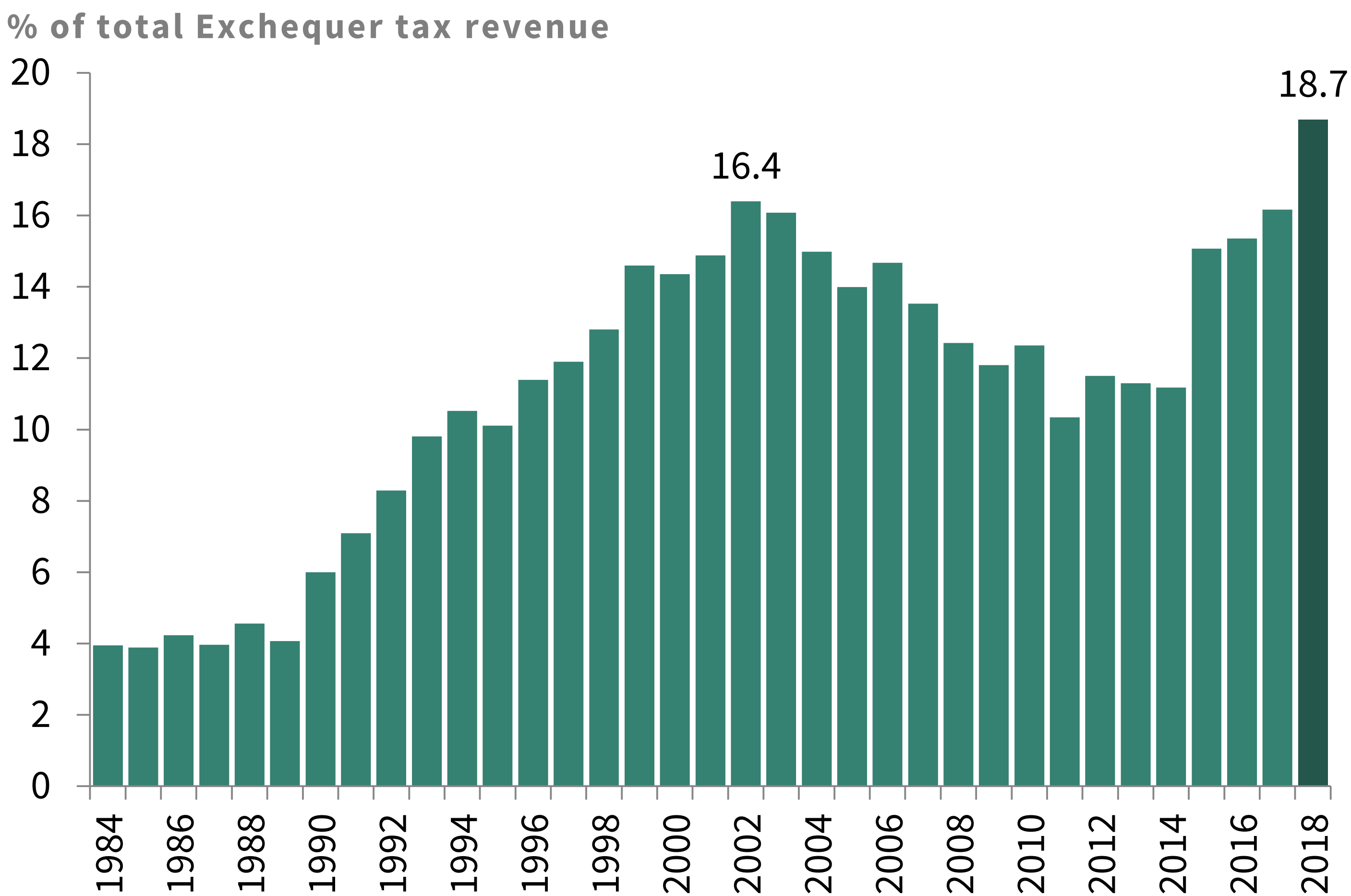
- This report looks in detail at two major risks to the Irish public finances:

  1) The risk of a reversal in corporation tax receipts, which are now far above conventional levels

  2) The impact of a disorderly Brexit

Irish Fiscal Advisory Council

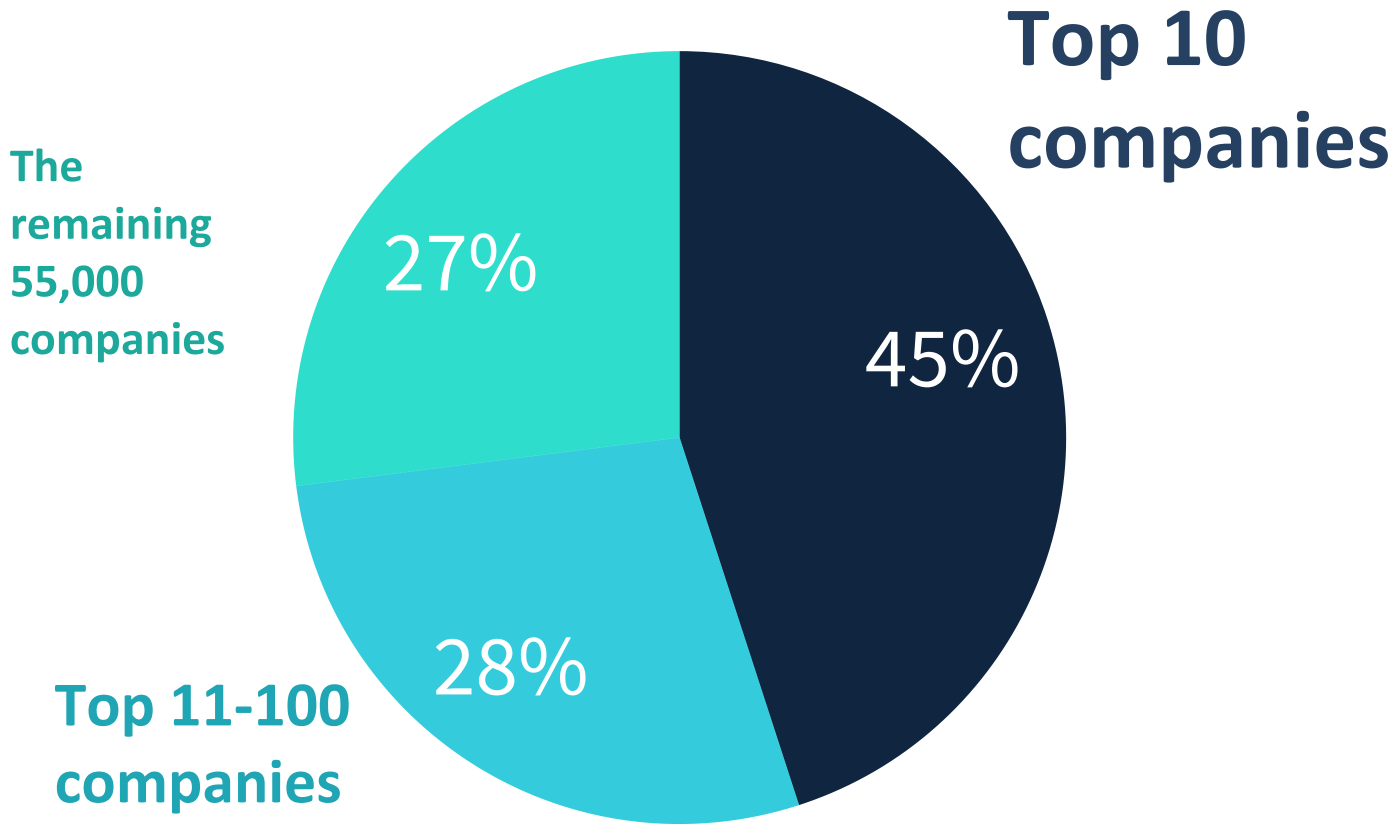
Corporation tax at highest share of tax revenue ever



Irish Fiscal Advisory Council

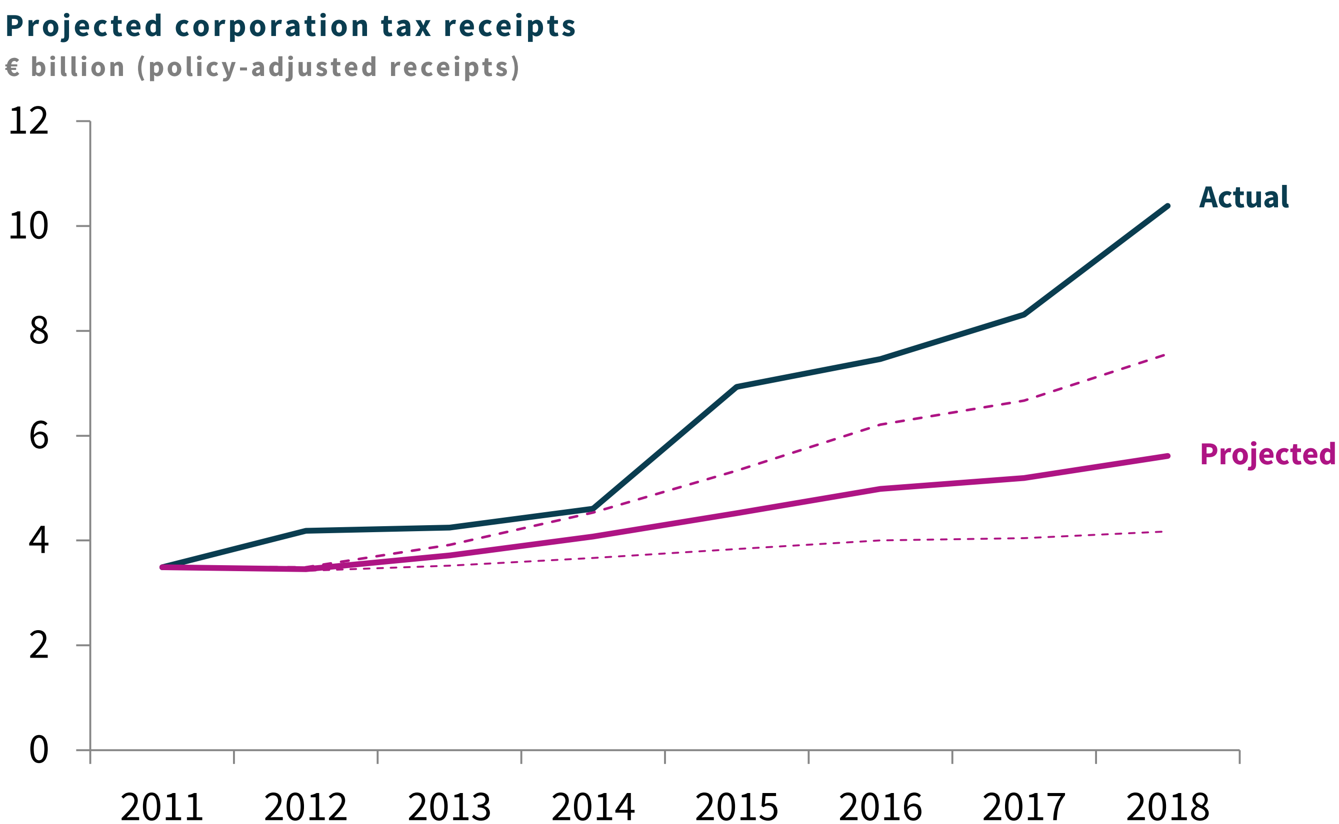
Corporation tax receipts are concentrated in relatively few companies

% of total corporation tax receipts



Sources: Revenue Commissioners (2019); and internal IFAC calculations.

Level of corporation tax received annually is unexplained by underlying economy

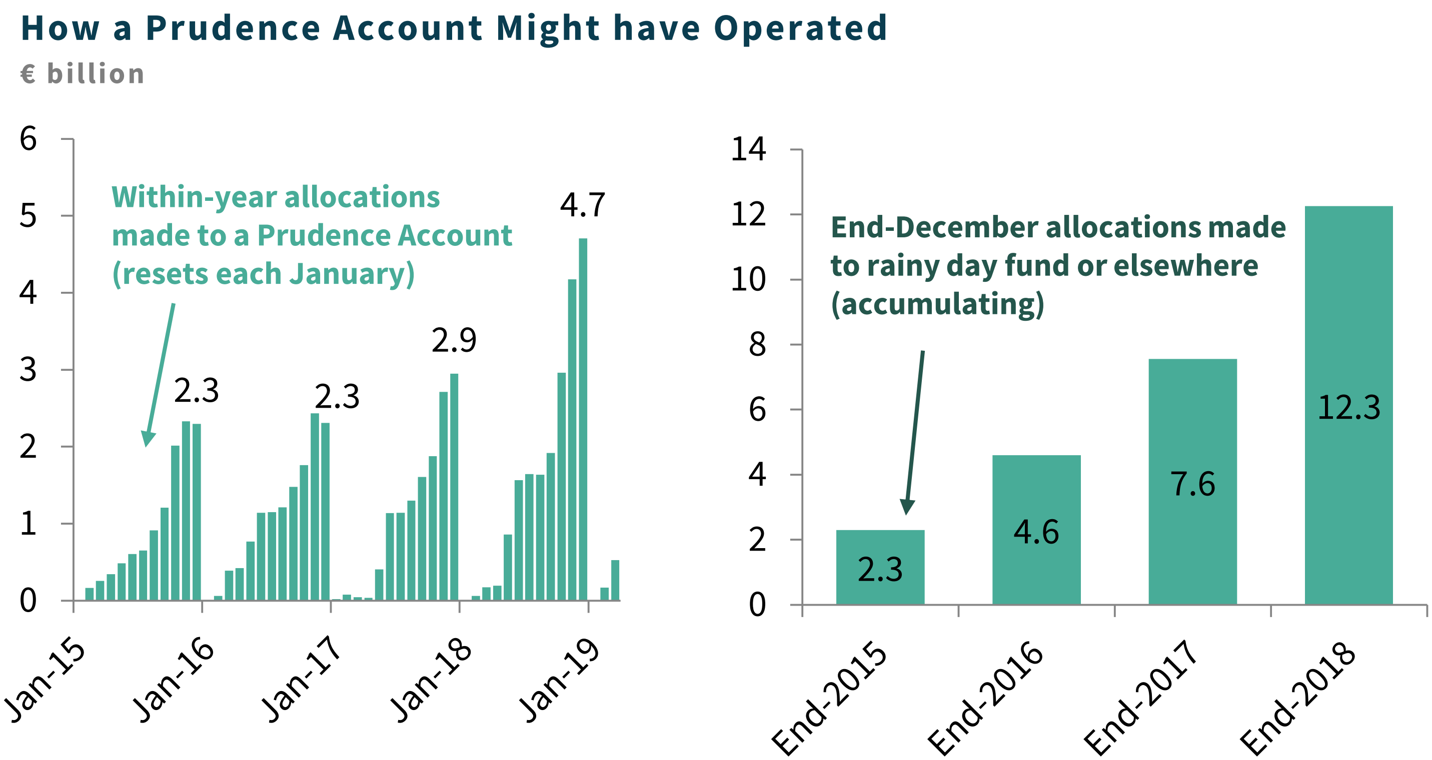


Note: Projected corporation tax receipts are based on the best-performing approach to modelling corporation tax from Casey and Hannon (2016). It forecasts “Projected” corporation tax receipts adjusted for policy measures from 2012 onwards; and it uses the underlying economic driver as growth rates for 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.

Four ways to look at current annual corporation tax receipts

- **Model projections:** some €3-€6 billion of annual receipts as of 2018 unexplained by domestic economy.
- **Official Forecasts:** Forecasts at time of Budget 2015 would have suggested corporation tax receipts would be €5 billion lower for 2018.
- **Historical Norms:** Assuming return to long-run share of tax receipts, corporation tax would fall by €3½ billion.
- **International Norms:** If Ireland returned to EU norms (75th percentile) for taxable corporate profits against Gross Valued Added, would imply excess receipts in 2018 of €3.4-€4.3 billion.

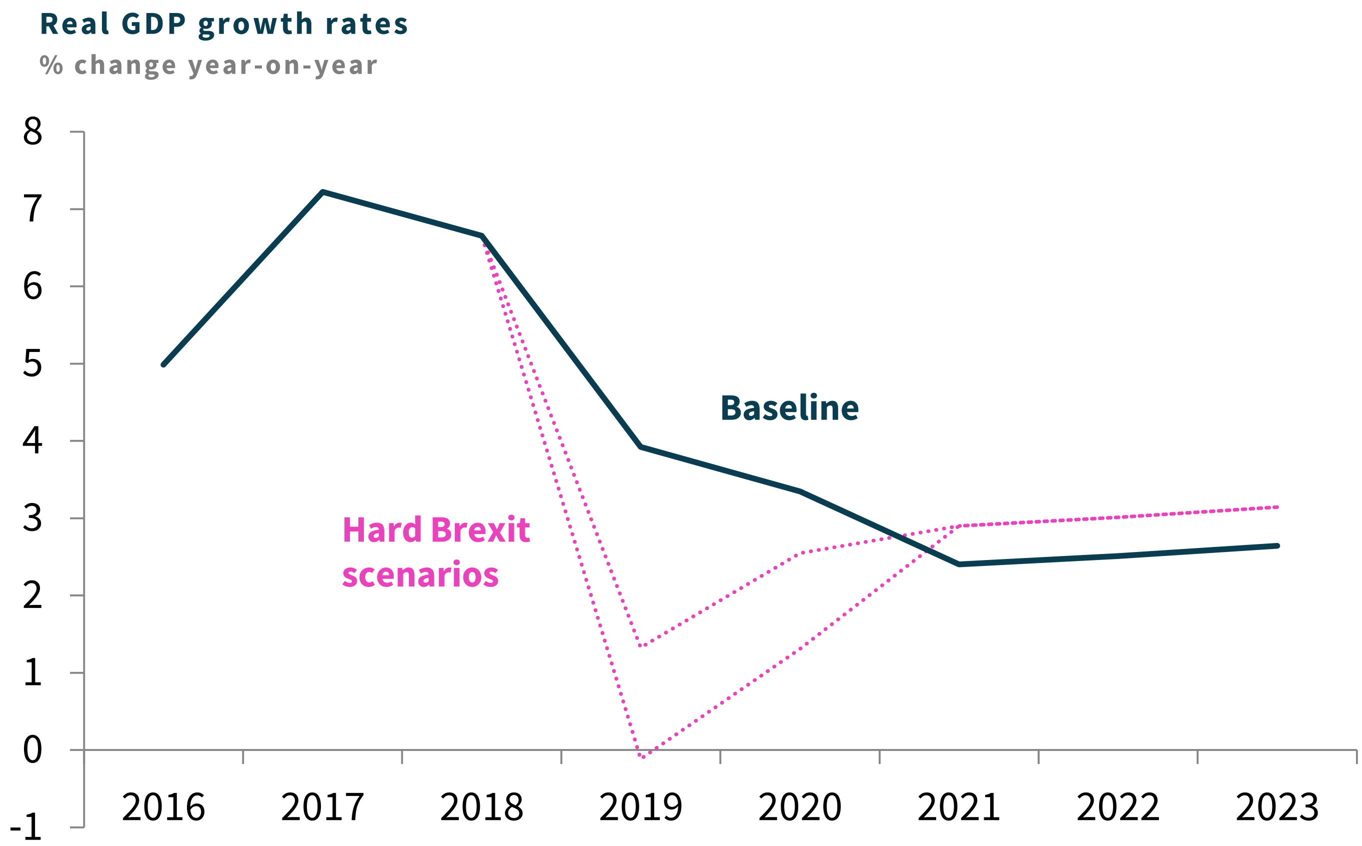
Council's "Prudence Account" Idea to avoid building up reliance on corporation tax



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

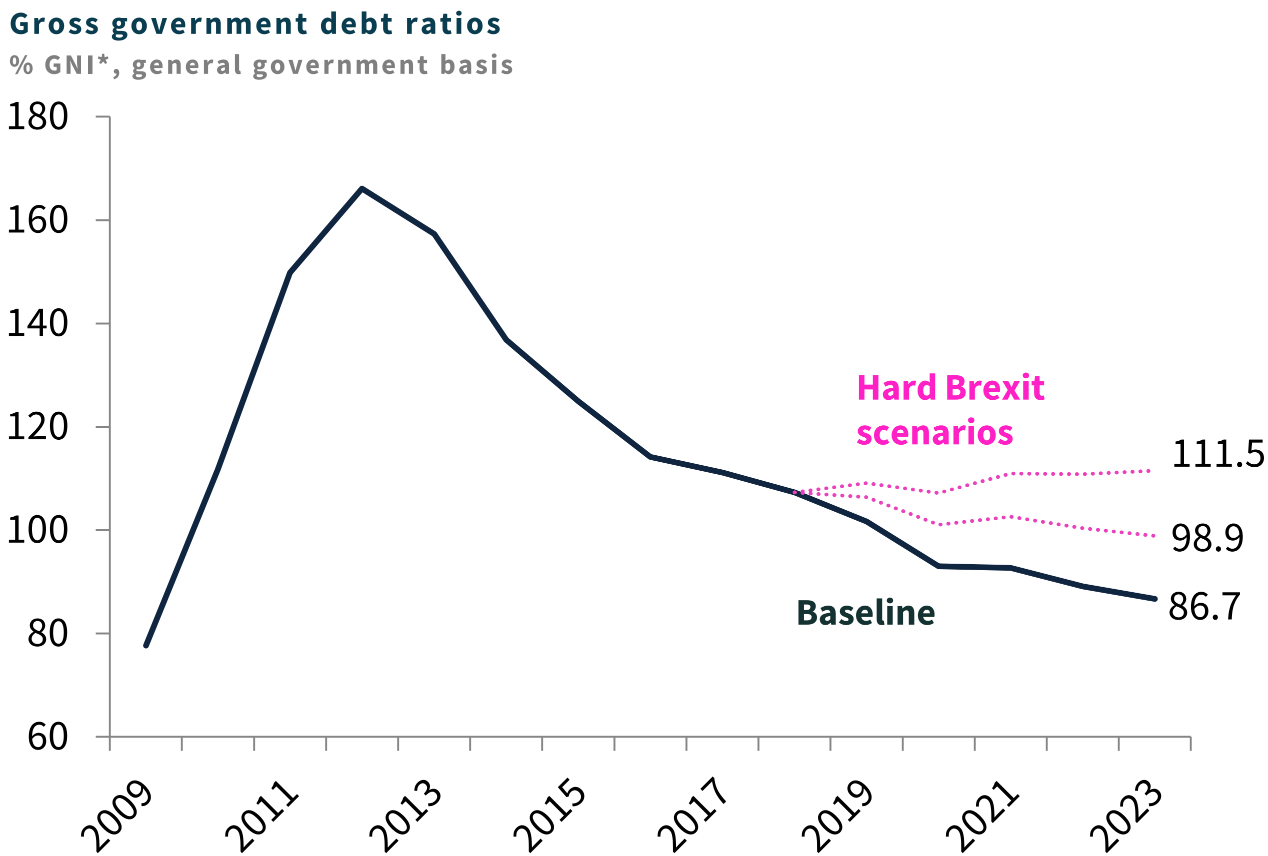
Note: Allocations of above-profile corporation tax receipts to the Prudence Account would be made over the course of the year, and then turned over to the rainy day fund or set aside elsewhere. The base for next year's corporation tax receipts forecasts would be adjusted for unexpected receipts in the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

A disorderly Brexit could lead to a sharp economic impact



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.

With severe consequences for the public finances



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.

Estimated fiscal outcomes in Brexit scenarios

% 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.

Implications of a disorderly Brexit

- If it materialises, the shock to the economy, revenues, and cyclical spending from a disorderly Brexit could mean that debt ratios could begin to rise again.
- More benign Brexit might suggest policy should allow small rise in debt ratio with limited efforts to stabilise debt path.
- But, a disorderly Brexit would have much more severe consequences. Trade-offs would be far worse. Government might need to cut spending or raise taxes to prevent debt ratios from rising indefinitely.
- Should a more adverse shock materialise, policy response would need to be carefully assessed. However, Government should in principle act to support the economy as much as possible during any period of unusually weak demand.

Fiscal Stance

Fiscal Stance Assessment 2019

- For 2019, Government should stick to its existing plans in *SPU 2019* meaning no additional within-year increases without offsetting measures.
- The planned stance for 2019 was an expansion in line with sustainable growth + inflationary pressures. But Government ramped up spending beyond plans.
- For 2018, it increased spending by €1.3 billion beyond a planned €3.2 billion increase (largely in health). In addition, budget package for 2019 was €0.3 billion more than planned.
- Much of these unplanned increases were masked by possibly temporary surge in corporation tax receipts.
- Any further unexpected corporation tax receipts should be allocated to a Prudence Account to stem reliance.

Fiscal Stance Assessment 2020

- For 2020, Government should be cautious with its budget.
- This reflects hard Brexit, reliance on corporation tax, overheating risks, and rapid spending rise over 2017-2019.
- To limit possibility of rising debt ratios, lost creditworthiness, and need for sizeable correction in public finances, Government should stick to its plans in *SPU 2019,* allowing for support to be provided in the event of an adverse shock.

Fiscal Stance Assessment 2020

- Sticking to *SPU 2019* plans would entail some €2.8 billion of budgetary measures for 2020: amounts already earmarked for increases in public investment, public sector pay, demographic pressures, and assumed tax cuts in 2020.

- This would allow minimal new tax and spending measures on budget day, taking into account previous announcements. Further measures should be funded by revenue-raising measures to preserve overall sustainability or by scaling back planned spending increases and tax cuts elsewhere.

Fiscal Stance Assessment 2021 → 2023

- The Government's medium-term plans are not credible.
- The projections show surpluses increasing in every year, but the spending forecasts underpinning these projections are not credible. They imply an implausible slowdown in spending growth based on technical assumptions, which do not reflect likely future policies or the future cost of meeting existing commitments.
- The Government needs a credible medium-term strategy.
- A better approach to budgetary planning could be built around four elements…

Irish Fiscal Advisory Council

Official projections show implausible slowdown in spending growth based on technical assumptions

Note: The scenario shows general government expenditure held constant at its share of GNI* in 2018 as compared to actual official projeciions. At the Budgetary Oversight Committee, the Minister for Finance, Public Expenditure and Reform said that "my view is that as future budgets are done, regardless of whether I or other Ministers have the opportunity to do them, the share of Government expenditure as a percentage of GNI* will at least stay constant, if not grow, and taxation decisions will have to be made in order to do that or decisions will have to be made not to do other things". Committee on Budgetary Oversight, Wednesday 16 January 2019.

The Government Needs a Medium-Term Strategy

#01 Debt Target

The debt ratio target should: (a) be lower to reflect Ireland's volatile growth rates; (b) be restated as a percentage of modified GNI*; and (c) have clear staging posts.

#02 Speed Limit

A better approach to medium-term budgeting would start with a clear statement of sustainable growth rate limits for net policy spending.

#03 Ceilings

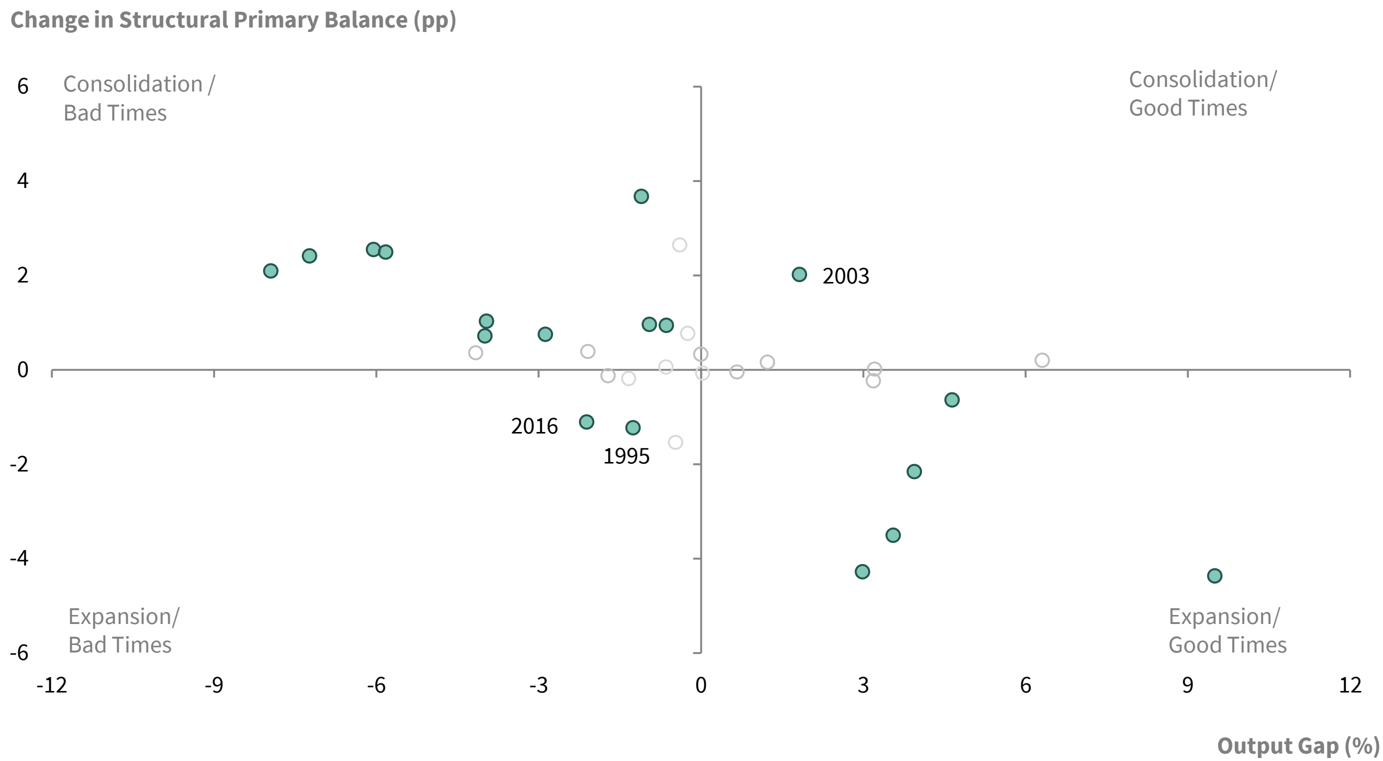
Departmental three-year expenditure ceilings should be framed in the context of the sustainable growth rate limit for spending, and more realistic forecasts should be developed.

#04 Corporation Tax

A budgetary position less reliant on corporation tax receipts should be an overarching principle guiding fiscal policy in coming years. This could be achieved through use of a "Prudence Account".

Procyclicality already exists (no need to reinforce it)

Procyclicality of Irish Fiscal Policy (1986-2018)



Sources: Department of Finance; CSO; own workings.
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.

Recap of Key Messages

1) The Government should be cautious and stick to its plans as set out in *SPU 2019.*

2) Growth is strong, but the outlook for the economy is unusually uncertain.

3) The public finances are still vulnerable and spending has been allowed to drift upwards in recent years beyond planned increases.