Box H: The impact of Brexit on the public finances assumed in *Budget 2020*

This box examines the impact Brexit is forecast to have on the public finances. Forecasts in *Budget 2020* were made based on a central scenario of a no-deal Brexit. A disorderly no-deal Brexit is forecast to have a significant impact on the economy, with growth in 2020 of 0.7 or 0.8 per cent (GDP or modified domestic demand) as opposed to 3.1 or 3.0 per cent in the case of an orderly deal scenario (which was the assumption in *SPU 2019*).

A typical negative shock to the economy has obvious implications for the public finances. On the expenditure side, unemployment benefits would be higher than otherwise would be the case, leading to increased expenditure. On the revenue side, weaker income and employment growth would impact on income tax revenue. Lower consumption (due to both income and confidence/uncertainty effects) would impact on VAT receipts. Corporation tax receipts could also be impacted if firms became less profitable as a result.

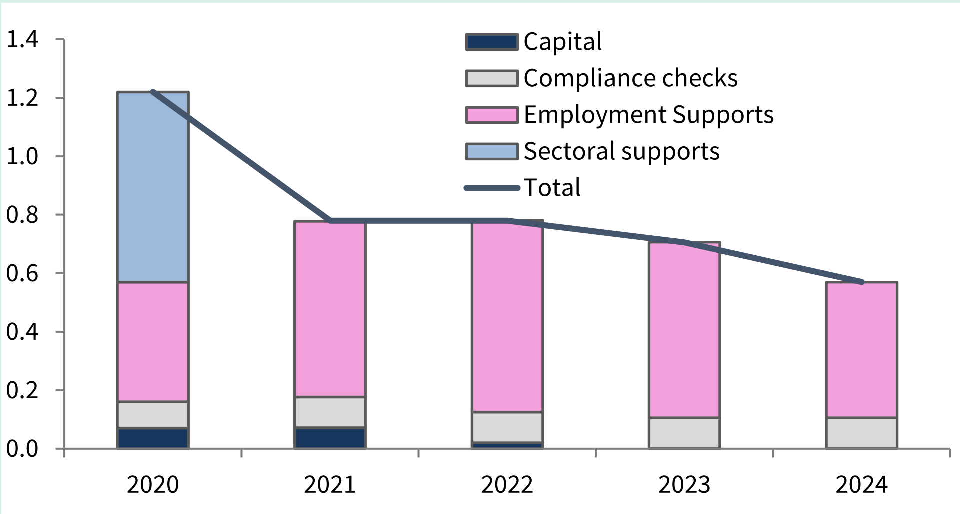
A hard Brexit is not a typical adverse economic shock, however. Additional fiscal costs over and above those arising from a standard economic shock may be expected. Compliance checks at the border and at ports would likely add to government expenditure (as well as adversely impacting trade).

Budget 2020 assumes a number of direct and indirect expenditure costs from a disorderly Brexit. This includes temporary sectoral support measures, employment supports and other measures. Additional expenditure of €1.2 billion in 2020 has been set aside for the event of a no-deal Brexit. If a no-deal Brexit does not occur then these funds are not to be spent elsewhere and hence have not been included in estimates for various departments or expenditure headings.

Of the €1.2 billion in funding for 2020, €650 million is for supporting sectors most adversely impacted by Brexit, such as Agriculture, Enterprise and Tourism. €410 million is allocated for employment supports (Figure H.1). The vast majority of this (€365 million) relates to social protection spending on items such as unemployment-related benefits. The remaining €45 million is for labour market activation supports. Capital costs of €70 million are expected to be incurred, with a further €90 million of current spending on compliance checks.

Figure H.1: No-deal Brexit-related expenditure

€ billion



Sources: *Budget 2020*; and Fiscal Council calculations.

Given the unique nature of this shock, it is not straightforward to assess these estimates of increased expenditure. The most straightforward perhaps are those relating to social protection payments associated with increased unemployment. Taking the *Budget 2020* forecasts of numbers unemployed in 2020, compared to *SPU 2019* forecasts, this implies approximately 17 thousand extra people would be unemployed. Dividing the €365 million of additional expenditure over the 17 thousand extra unemployed suggests an average cost per unemployed person of approximately €21,000. This is in line with estimates used for compliance with the fiscal rules. In addition, Carroll (2019) estimates the elasticity of unemployment-related expenditure with respect to the output gap. Applying this elasticity to the shock would also lead to estimates close to the €365 million provided for in *Budget 2020*.

The level of additional spending related to a no-deal Brexit falls to €0.8 billion in 2021 before eventually falling to €0.6 billion in 2024. The sector supports are assumed to be paid only in 2020, with no provision for them thereafter. It would appear unlikely that all supports for adversely affected sectors would be completely discontinued in 2021. There are risks that the underlying economic problems are longer-lived or that there will be political pressures to extend the supports. There is a significant upside risk that expenditure in this area could be higher and longer-lasting than assumed if a no-deal Brexit were to occur.

Unemployment-related supports are longer lasting, increasing somewhat in 2021 before levelling off and eventually falling in 2024. Expenditure related to compliance checks is assumed to be permanent, particularly the staffing costs (after the initial capital outlay on infrastructure).

The extent to which Brexit is a supply shock is important for some of the fiscal implications. For example, if this supply shock results in the natural rate of unemployment increasing, then this would have a long-lasting impact on expenditure. If the number of people unemployed is permanently increased, then all else being equal, the level of unemployment-related expenditure would be higher.

Similarly, a supply shock would lead to permanently lower income. This would naturally impact on income tax receipts, with second-order impacts on VAT receipts due to lower consumption. As noted in Chapter 1, it appears that in using the COSMO model, the Department of Finance is treating this shock as a supply shock.

In terms of risks to the forecast impact of Brexit on the public finances, there are a number of factors to consider. Firstly, the macroeconomic impact of Brexit could be very different to *Budget 2020* projections (see Chapter 2). Given the difficulty in modelling such a shock and the lack of similar events/case studies to compare to, errors/uncertainty over the impact are unusually large (keeping in mind Ireland is a volatile and difficult-to-forecast economy in “normal” times).

Second, a further difficulty related to quantifying the fiscal impacts is how the macroeconomic shock maps to revenue and expenditure. While an empirically estimated elasticity may often be a good guide for the relationship between government revenue headings and the macroeconomy, a large supply shock such as Brexit could cause a change in the relationship between these variables.

One obvious example of this is customs duties. Due to the assumed no-deal Brexit, significantly more customs tariffs are expected to be collected in 2020 (only 20 per cent of these revenues are kept by the collecting country). This is not due to stronger economic growth or stronger trade, but rather reflects the assumed status of imports from the UK having tariffs charged on them.

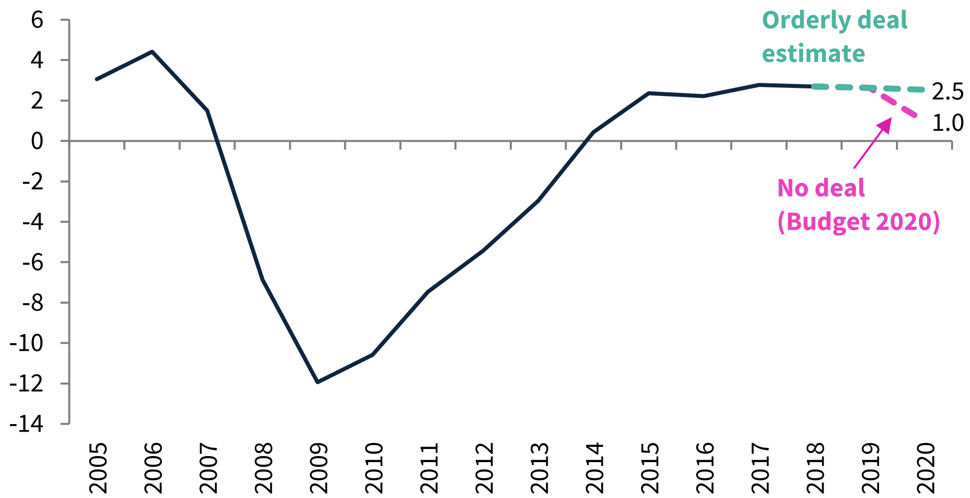
Combined income tax/USC has been revised down by €0.3 billion for 2020 compared to *SPU 2019* forecasts, a downward revision of just over 1 per cent. If one adjusts for smaller revenue-reducing policy changes in *Budget 2020* compared to assumptions in *SPU 2019,* this increases the downward revision to 2.7 per cent. This would be more in line with what one might expect given the scale of the shock to domestic activity and the resulting impact on household income.[48]

Given the macroeconomic scenario assumed, many of the effects forecast in *Budget 2020* seem broadly appropriate. However, the assumption that sector supports of €650 million would be paid in 2020, and then discontinued completely in 2021 may be unrealistic. This would appear to be a significant upside risk to expenditure forecasts in 2021 were a no-deal Brexit to occur. In addition, should the current proposed withdrawal agreement be passed, this could be followed by a free trade agreement which is much less comprehensive than current EU membership. In that scenario, sector supports may be sought in 2021. More generally, there are huge uncertainties surrounding the extent of the damage that could materialise from a no-deal Brexit.

With interest costs set to fall by a further €0.7 billion, the underlying primary balance is forecast to deteriorate in 2020 by €3.4 billion, relative to 2019 (in a no-deal Brexit scenario).[49] Under an orderly deal assumption, the primary balance could be expected to remain unchanged in 2020. Figure 3.7 shows the underlying primary balance over time. Improvements in the primary balance stalled in 2016 and have been largely unchanged since then. This is despite strong economic growth, falling unemployment and surprise corporation tax receipts.

Figure 3.7: Improvements in the primary balance have stopped since 2016

% GNI*, excluding one-off items



Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: The orderly deal line is calculated by applying the lower estimate of impacts from the SES to the *Budget 2020* forecasts.

[48] The *Budget 2020* forecast for income tax revenue in 2019 is unchanged from *SPU 2019*, so the revisions are not impacted by a change to the previous year's base.
[49] To estimate what this would look like in an orderly Brexit, one can apply the estimates from the *SES* on the impact on the general government balance (this assumes that the choice of Brexit scenario does not have a significant immediate impact on interest expenditure).