Chapter 1

Assessment of Fiscal Stance

1. Assessment of the Fiscal Stance

Key Messages

- The Government assumed a disorderly Brexit when planning *Budget 2020*. This approach was broadly appropriate from a budgetary perspective, given the associated risks and uncertainties at the time of planning. The budget documents also showed a deal scenario for the macroeconomic forecasts, yet they only contained one budgetary scenario, which was for a disorderly Brexit. This envisaged €1.2 billion of Brexit-related measures, some of which were temporary, and some long-lasting.

- The macroeconomic backdrop remains uncertain. Strong growth in the domestic economy has continued risking overheating in the near term. Yet it is also possible that a severe external shock could hit the economy leading to a slowdown or outright recession. This could arise from a more-adverse-than-assumed disorderly Brexit scenario, a wider global slowdown, further trade tensions, increased financial vulnerabilities, or changes to the international tax environment.

- Ireland's government debt burden is the sixth highest in OECD economies when measured as a share of a more appropriate measure of national income like GNI* and when allowing for liquid assets held by the Government. At end-2018, the net debt burden was equivalent to 90 per cent. Only France, Portugal, Italy, Japan and Greece are higher. The Government has increased spending at a fast pace in recent years so that, when allowing for the effects of the cycle and potentially temporary surges in corporation tax, the budgetary position has deteriorated since 2015.

- In 2019, the Government again relied on unexpected corporation tax receipts to fund additional spending. Using surprise corporation taxes to meet budget balance targets is risky. Corporation tax is more volatile and unpredictable than other sources of Government revenue and receipts are subject to potential reversals in future years, depending on firm-specific developments and changes to the global tax environment. By contrast, the expenditure increases funded by these receipts are likely to be long lasting.

- In 2019, spending slippages look set to continue. An overrun of €0.7 billion is now forecast compared to *Budget 2019* plans. Health overruns beyond the expected €0.3 billion overrun and an upward revision to social payments (to reflect higher-than-expected payments in 2018) could worsen the revisions.

- For 2020, the Government offset Exchequer slippages in 2019 with higher-than-planned revenue-raising measures in *Budget 2020*. This is a welcome step to prevent budgetary measures from drifting up with each spending overrun, although it requires spending to be controlled in 2020.

- However, upward revisions to spending outside of the Government's direct control of €0.9 billion (including by local Government and predominantly by housing bodies) undermine efforts to limit spending slippages continuing into 2020 from 2019. As a result, *Budget 2020* implies a net policy spending increase in 2020 of €4.6 billion overall: €2.1 billion higher than the Government planned as recently as in April. Within this, Brexit-related costs of about €1 billion are expected to arise only in a no-deal scenario.

- The fact that large spending overruns have occurred in areas outside the Exchequer is a concern as these impact the economy just as much as central spending and should be taken into account in budget planning. The Department needs to publish more information in budgetary publications on a general government basis including a comprehensive "walk" from Exchequer to general government data in gross terms (currently, this is only done on a net basis).

- For the medium-term (2021–2024), the Government should set a course for a prudent fiscal policy that ensures its net policy spending growth does not exceed sustainable growth in its revenues. To achieve this, the Government can reinforce its budgetary framework with three sets of reforms: (1) use the rainy day fund and a prudence account to save temporary receipts including unexpected corporation taxes; (2) use sustainable growth rates informed by alternative estimates of potential output to guide net policy spending growth and to aid in producing more realistic medium-term forecasts; and (3) establish meaningful debt ratio targets.

Table 1.1: Summary Table

% GNI* unless stated, general government basis (based on *Budget 2020* forecasts under a disorderly Brexit)

	2018	2019	2020	2021	2022	2023	2024
General Government							
Revenue [1]	41.5	42.5	43.5	43.7	44.0	44.5	45.1
Expenditure [1]	41.5	42.2	44.5	44.0	43.9	43.8	43.8
Balance [1]	0.0	0.3	-1.0	-0.3	0.1	0.7	1.3
Interest Expenditure	2.7	2.3	2.0	1.8	1.8	1.8	1.7
Primary Expenditure [1]	38.9	39.9	42.5	42.3	42.1	42.0	42.1
Primary Balance [1]	2.7	2.6	1.0	1.4	1.9	2.5	3.0
Revenue Growth (%) [1]	7.1	5.3	2.7	3.8	4.2	4.5	4.7
Primary Expenditure Growth (%) [1]	7.4	5.6	7.0	2.8	3.1	3.1	3.4
Real Net Policy Spending Growth (%) [2]	6.1	3.8	3.9	1.2	1.4	1.2	1.4
Structural Balance (% GDP) [3]	0.1	-0.4	-0.4	-0.5	-0.6	-0.6	-0.4
Structural Primary Balance (% GDP) [3]	1.7	1.0	0.7	0.5	0.4	0.4	0.6
Change in Structural Primary Balance (p.p.) [3]	-1.3	-0.7	-0.3	-0.2	-0.1	0.0	0.2
Debt							
Gross Debt (€bn)	206.0	203.6	198.5	205.8	207.1	213.2	218.5
Cash & Liquid Assets (€bn)	28.1	27.2	18.6	22.8	18.6	19.7	20.9
Net Debt (€bn)	177.9	176.4	179.9	183.0	188.5	193.5	197.6
Equity and Investment Fund Shares (€bn) [4]	37.0						
Gross Debt Ratio (% GNI*)	104.3	100.2	97.4	97.7	94.9	94.5	93.9
Net Debt Ratio (% GNI*)	90.1	86.8	88.3	86.9	86.4	85.8	84.9
Output							
Real GDP Growth (% Change)	8.2	5.5	0.7	2.5	2.8	2.7	2.6
Potential Output (% Change) [3]	5.3	4.0	2.0	1.6	2.1	2.0	2.4
Output Gap (%) [3]	-0.2	1.0	-0.3	0.5	1.3	1.9	2.1
Nominal GDP Growth (% Change)	9.1	5.9	2.4	3.9	4.2	4.1	4.1
Nominal GNI* Growth (% Change)	7.3	2.9	0.2	3.4	3.5	3.4	3.2
Nominal GDP Level (€bn)	324.0	343.2	351.4	365.2	380.7	396.5	412.6
Nominal GNI* Level (€bn)	197.5	203.3	203.7	210.7	218.1	225.6	232.8
One-offs							
Expenditure One-Offs (€m) [1]	213	0	0	0	0	0	0
Revenue One-Offs (€m) [1]	300	0	0	0	0	0	0
Net One-Offs (€m) [1]	87	0	0	0	0	0	0

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.

[1] One-offs considered relevant by the Council are excluded to assess the underlying fiscal position. For 2018 there is €300 million of corporation tax and €213 million for a settlement of pay arrears for medical consultants.

[2] This measure is outlined in Box A (Fiscal Council, 2018e). It represents total general government expenditure less interest, cyclical unemployment-related costs, and discretionary revenue measures.

[3] These estimates are based on the Department of Finance's preferred GDP-based alternatives.

[4] This comprises government holdings in equity (shares and other equity) and investment fund shares (F5), including the value of bank shares held by the State.

1.1 Introduction

The Council has a mandate under the *Fiscal Responsibility Act (FRA) 2012*, and with reference to the requirements of the *Stability and Growth Pact (SGP)*, to assess the Government's fiscal stance.

This chapter draws on analysis in the rest of the report in assessing the fiscal stance in *Budget 2020*. The Council's assessment is informed by: (1) an economic assessment that considers the state of the public finances, the stage of the economic cycle, and growth prospects for the economy; and (2) the extent of compliance with the fiscal rules.

1.2 The Macroeconomic Context

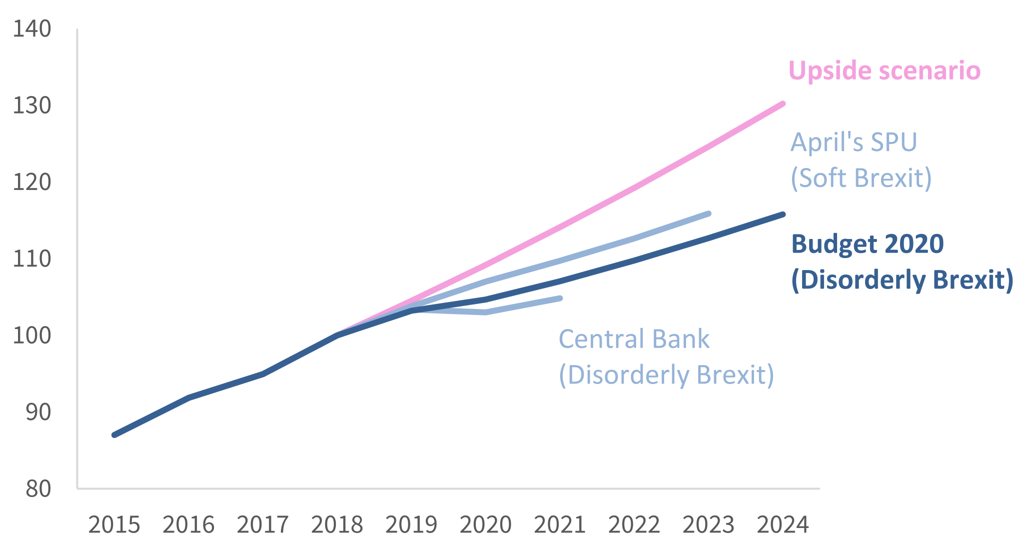
Domestic Economic Activity

Unusual uncertainty has clouded the outlook for the Irish economy in recent times. In particular, two starkly different scenarios for the near future can be thought of: (1) the recent strong growth in the domestic economy continues such that it risks overheating in the near term; and (2) a severe external shock hits the economy leading to a slowdown or outright recession.

Figure 1.1 illustrates the uncertainty that surrounded the pre-budget outlook based on various scenarios considered and on an illustrative upside scenario.

Figure 1.1: Economic outlook exceptionally uncertain for the budget

Index (2018 =100), real underlying domestic demand



Sources: CSO; Department of Finance; Central Bank of Ireland; and Fiscal Council workings.
Note: The "Upside" scenario assumes that growth stays constant at its average pace over 2014–2018 at 4.5 per cent per annum and that adverse Brexit impacts are limited.

In the months leading up to October's *Budget 2020*, the likelihood of a disorderly Brexit had risen. While renewed optimism about a deal was evident in September, the probability of a "no deal exit" remained high coming into the budget. This likelihood, and the severe risks associated with such an outcome, prompted a decision to base the macroeconomic forecasts underpinning the budget on a disorderly Brexit scenario, which was appropriate at the time (Chapter 2).

A disorderly Brexit would present severe risks to the Irish economy, yet even an outcome that includes a trade agreement has negative implications for future growth compared to a world in which no Brexit were to have occurred. The Irish economy might have been expected to see economy-wide output 0.6 per cent to 1.7

per cent higher over the long run if no Brexit were to have occurred relative to a situation where the UK leaves the EU in an orderly fashion, with a transition period, and with a free trade agreement (Bergin *et al.*, 2019; and Central Bank, 2019). The deal now being considered by the UK Government implies potentially worse outcomes for Ireland than the deal scenario that was previously assumed by the Department of Finance in *SPU 2019* and previous publications (Chapter 2).

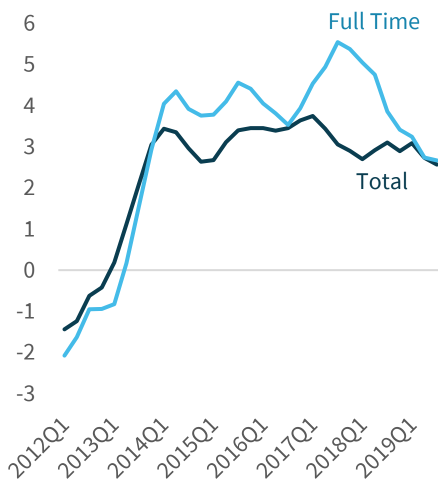
Notwithstanding Brexit-related developments, external conditions have deteriorated of late. Growth in US and Euro Area activity has slowed, and the outlook for global growth has been downgraded. This comes amid rising trade tensions, including between the US and China and the US and the EU. Manufacturing output and investment spending have weakened, while growth in global trade fell to 1 per cent in the first half of 2019: its weakest level since 2012 (IMF, 2019a).

The Irish economy has performed strongly in recent years. Short-term indicators of the domestic economy's performance highlight the pace of the cyclical upswing since about 2013 (Figure 1.2).

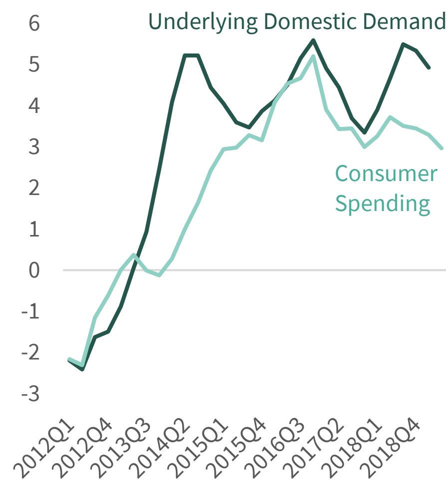
Figure 1.2: A cyclical upswing has been evident since about 2013

% change year-on-year

A. Employment



B. Demand (volumes)



Sources: CSO; and Fiscal Council workings.
Note: Four-quarter moving averages are shown.

More recently, there is evidence that soft data (such as business and consumer sentiment indicators) have weakened, though their relationship with real activity is mixed (Box E). Still, it is possible that uncertainty may have fed through to lower real

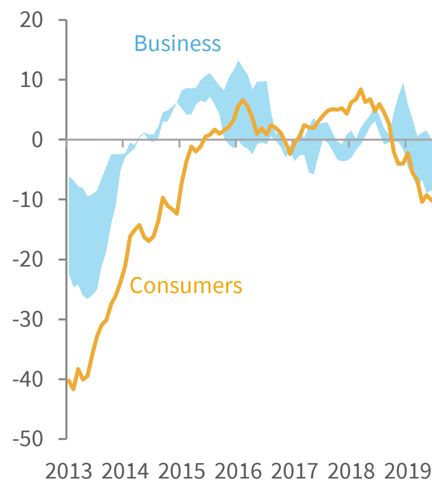
activity in some areas (if not, to more pessimistic assessments of future growth). For instance, growth in consumer durables purchases moderated slightly in the second and third quarters and housing starts slowed in the second quarter (Figure 1.3). Yet commencements rebounded in the third quarter and business investment—a key gauge of real impacts from economic uncertainty—has held up well.

Figure 1.3: Latest indicators show mild uncertainty effects

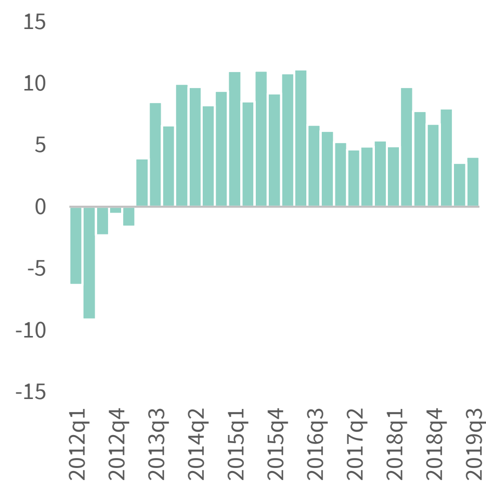
% change year-on-year unless stated

A. Sentiment indicators weaken

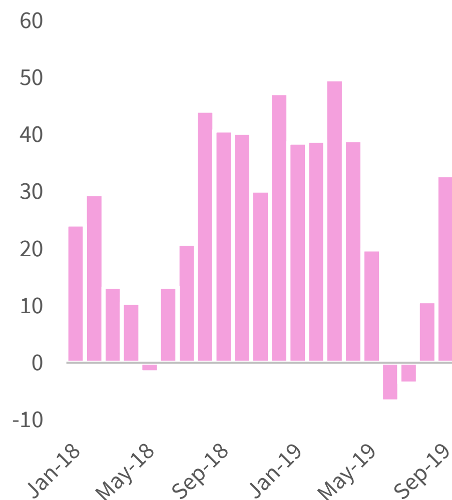
(level, average = 0)



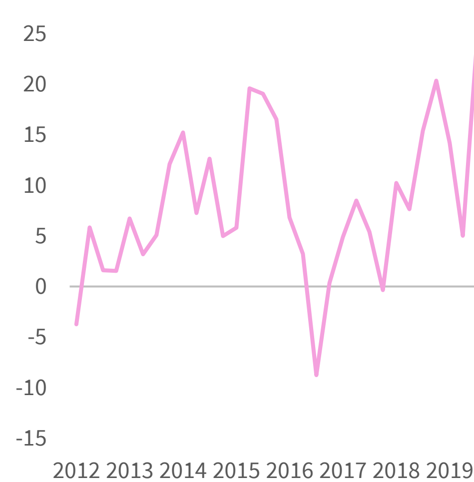
B. Purchases of consumer durables moderate



C. House commencements rebound in Q3



D. And volatile business investment holds up



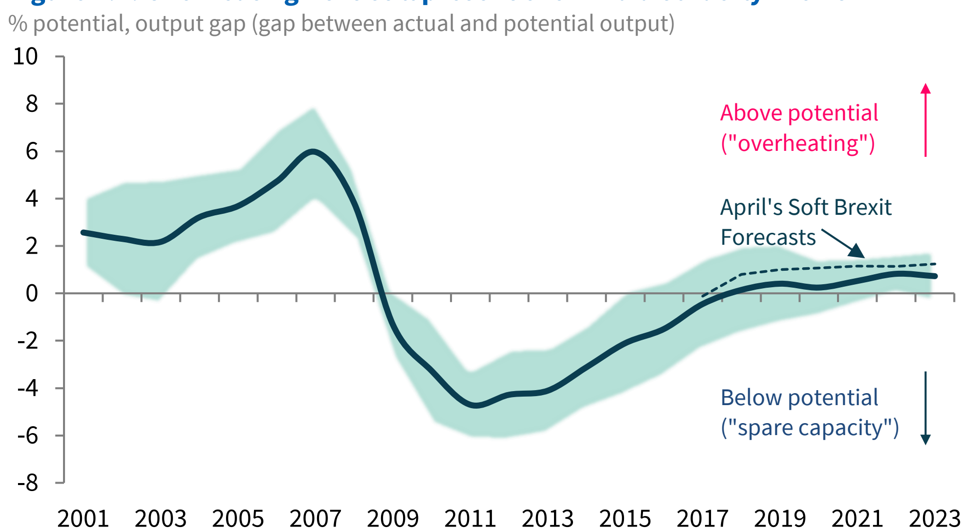
Sources: DGECFIN; KBC; Bank of Ireland; CSO; and Fiscal Council workings.
Note: Sentiment indicators are shown in terms of the difference with their four-year average (2015–2019). The "business" sentiment range uses DGECFIN Industry and Services confidence indicators as well as the Bank of Ireland business pulse indicator. Durables purchases are estimated based on CSO National Accounts weights (NIE Table 14) applied to Retail Sales data. The estimates are produced using a similar approach to Clancy, Cussen and Lydon (2014) as updated in Central Bank of Ireland's Quarterly Bulletin 4, 2019. Three-month moving averages are shown for housing unit commencements. The "business investment" indicator is based on annual percentage changes in quarterly merchandise imports data, with machinery and equipment imports adjusted to exclude planes, cars and processors.

The Cyclical Position

The 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, although this assessment is inevitably uncertain. Based on the Department of Finance's latest forecasts, it is expected to continue to run close to but somewhat above its potential over the period 2020–2024 (Figure 1.4). A modest degree of overheating might be sustainable for a time. Yet more significant overheating could carry greater risks and would be more likely absent an adverse demand shock.

Figure 1.4: Overheating risks still present even in a disorderly Brexit

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



Sources: CSO; Department of Finance; and Fiscal Council workings.
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). "April's Soft Brexit forecasts" draw on the official *SPU 2019* forecasts, which were set on the assumption of a soft Brexit scenario.

This also raises the question as to the extent to which a disorderly Brexit would represent a short-run demand shock as opposed to a long-run supply shock. As modelled with COSMO (Bergin *et al.*, 2019), the bulk of the effects are long-lasting: output remains 5 per cent below a no-Brexit scenario ten years later and growth remains at a similar pace to its baseline thereafter meaning the estimated effects are permanent. Though the links between productivity growth (the key determinant of long-run growth) and trade are well documented, it is, however, possible that Irish exporters could overcome challenges (including language, geographical, and legal barriers) to find new markets. It is also possible that foreign direct investment

and the supply of labour (through migration) might be boosted by Brexit, hence offsetting some of the negative supply-side effects over the longer term.

Risks to the Outlook

Major risks continued to surround the economic outlook. *Budget 2020* assumes—in its central scenario—that a disorderly Brexit occurs. An obvious upside risk is that an orderly Brexit outcome arises. Yet there is also the risk that a disorderly Brexit could be far worse than assumed (Box D). There are also other risks in both directions.

One upside risk is that overheating could be much more severe in coming years if growth does not moderate as expected. If an expansion in housing construction—both necessary and welcome—turns out to be faster than expected, this could lead to more severe overheating. If this happens, space should be made elsewhere in the economy to accommodate this activity (for example, by dampening demand in other areas). Annual housing completions increased by an average of 9,000 units per annum at peak over 2003–2006, whereas the Department now forecasts increases of just under 5,000 per annum (2020–2024).[1] Overheating can manifest in a variety of ways: rising wage and price pressures, rising debt, deteriorations in the current account balance, and faster inflows of labour and foreign capital.[2] A key aspect of overheating is that any further growth in incomes and government revenues above normal rates would not be expected to be sustainable.

There are also a number of adverse risks. The global economic outlook is weaker, and advanced economies are already well into a cyclical upswing. International tax changes (including those under the OECD's Base Erosion and Profit Shifting initiative) could affect foreign investment in Ireland and corporation tax receipts. Protectionist measures by the US and other nations could escalate further, weakening global trade. And adverse financial developments could spill over to the Irish economy. If monetary policy were to be loosened further to combat these risks, this could unintentionally contribute to a further build-up of financial vulnerabilities internationally (IMF 2019b).

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[1] Previous studies have estimated that each additional 10,000 units of housing completions typically adds one percentage point to GNP growth (see Duffy, 2005; and Bergin *et al.*, 2013).

[2] See Box A, *June 2019 Fiscal Assessment Report* for a broader discussion of overheating.

1.3 The Recent Fiscal Context

With successive governments making efforts to turn around a large deficit, the gap between government spending and revenue was closed for the first time in eleven years in 2018 (Figure 1.5A). However, improvements in the budgetary position have been more limited since 2015 after the target of a deficit smaller than 3 per cent of GDP was achieved. This reflects the fact that the growth of non-interest spending has risen to a fast pace since 2015, similar to the pace of growth in total revenue (Figure 1.5B).

A useful, if not perfect, way to assess the Government's fiscal stance is by examining the budget balance excluding one-offs and interest costs (the "underlying primary balance").[3] This measure has barely improved since 2015 (Figure 1.5C). The structural primary balance, the budget balance that is adjusted for one-offs and the estimated effects of the cyclical upswing on revenue and expenditure, is likely to have weakened from a surplus of 3.5 per cent of GNI* in 2015 to 2.3 per cent in 2019.[4] Excluding the estimated 'excess' in corporation tax—beyond what fundamentals would suggest (Box B, *June 2019 Fiscal Assessment Report*)—the structural primary balance is likely to be weaker again and as low as a surplus of 1 per cent or a deficit of 0.7 per cent (Figure 1.5D).

The fast pace of spending growth in recent years is evident across a number of measures, but most notably in the Council's "net policy spending" measure (Figure 1.6). Net policy spending examines spending growth net of tax measures and represents one good measure against which to assess the sustainability of fiscal policy.[5] Between 2015 and 2018, net spending growth, on the basis of this measure, rose at a nominal pace of 5.4 per cent per annum on average (it accelerated to 6.9 per cent in 2018). Sustainable growth rates would have been closer to a range of

[3] 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 less 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).

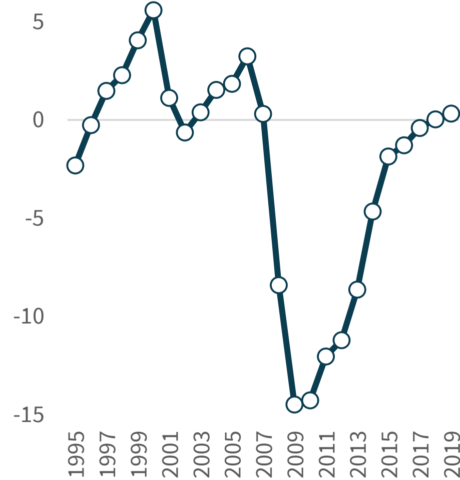
[4] Using the Department's preferred output gap estimates.

[5] The measure is outlined in Box A, *November 2018 Fiscal Assessment Report*. It is total general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment and it takes account of the impact of discretionary revenue measures (for example, net revenue-raising measures reduce the measured growth rate).

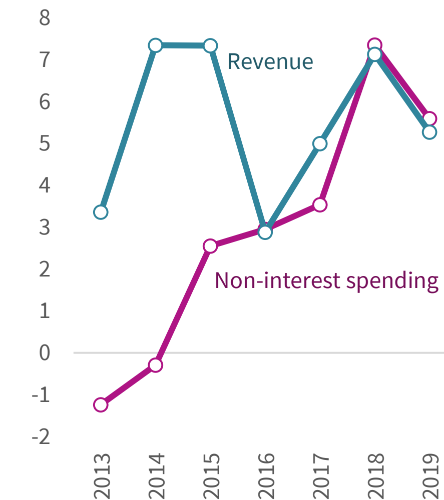
2½–4 per cent over this period.[6] While spending growth looks set to decelerate in 2019, it is still fast relative to the economy's potential.

Figure 1.5: Underlying budgetary improvements have stalled since 2015

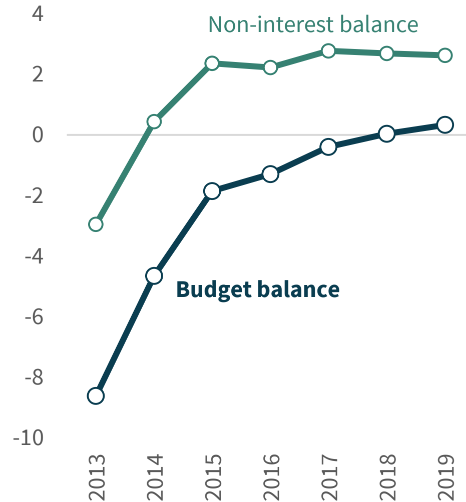
A. A balanced budget was finally achieved in 2018
Budget balance % GNI* (excl. one-offs)



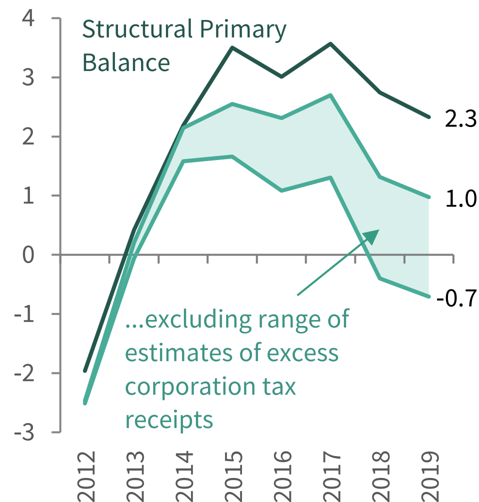
B. But non-interest spending has grown broadly as fast as revenue since 2016
% change year-on-year



C. So that the non-interest balance has barely improved since 2015
% GNI*



D. While the structural position is likely to have weakened
% GNI*

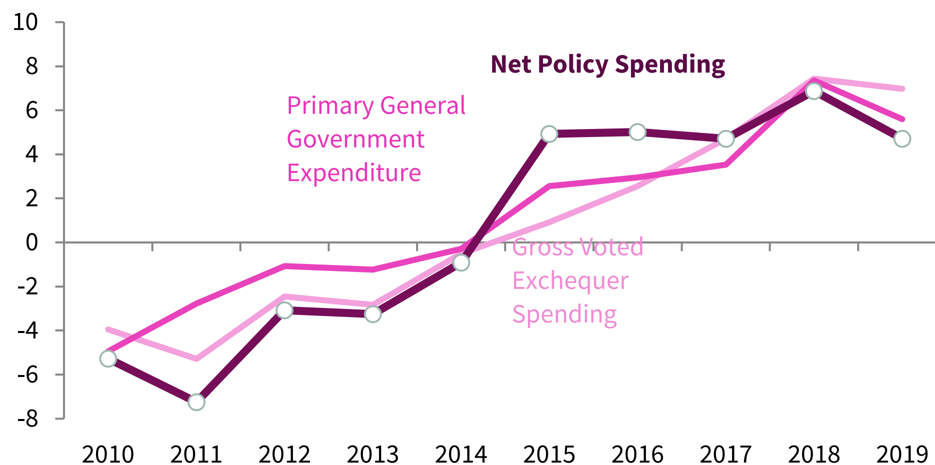


Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Revenue and non-interest spending growth and the budget balance in panel C as well as its improvement noted in panel D exclude one-offs.

[6] These estimates are based on nominal potential output growth—the economy's estimated growth rate when it is in its steady state—for the domestic economy.

Figure 1.6: Expenditure growth has been fast

% change year-on-year, general government basis

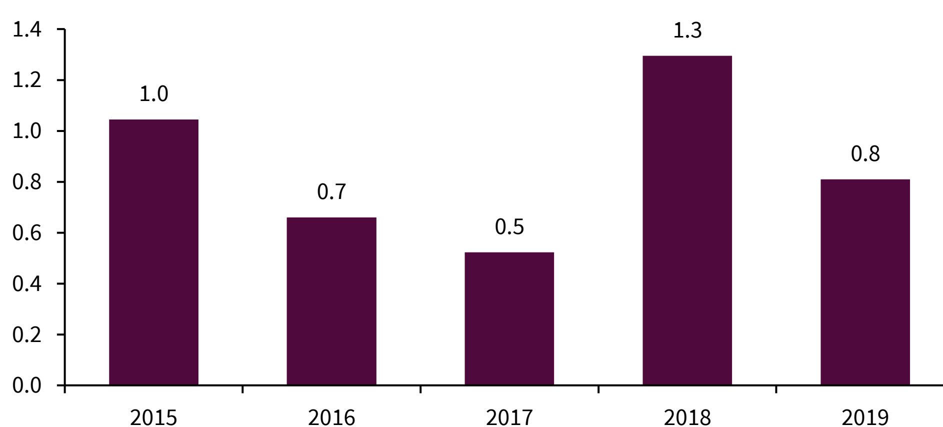


Sources: Department of Finance; and Fiscal Council workings.
Note: The estimated "excess corporation tax" receipts are the same as in Box B of the *June 2019 Fiscal Assessment Report* (Fiscal Council, 2019). Estimates are shown as a percentage of potential modified GNI*, which is obtained using the Department's preferred output gap estimates.

Unplanned within-year spending increases have contributed to a fast pace of spending growth in recent years. These include frequent health spending overruns (averaging €0.5 billion since 2014) and regular payments of the Christmas bonus (close to €0.3 billion). These increases—over and above what was budgeted—are expected to occur again in 2019, with the health overrun estimated at €335 million this year. Overall, within-year increases could add a further €0.8 billion to spending in 2019 (Figure 1.7). Absent these, the primary surplus would have been 1.6 percentage points of GNI* higher by 2019, based on the Council's Fiscal Feedbacks Model.

Figure 1.7: Within-year spending increases have added to spending plans

€ billion



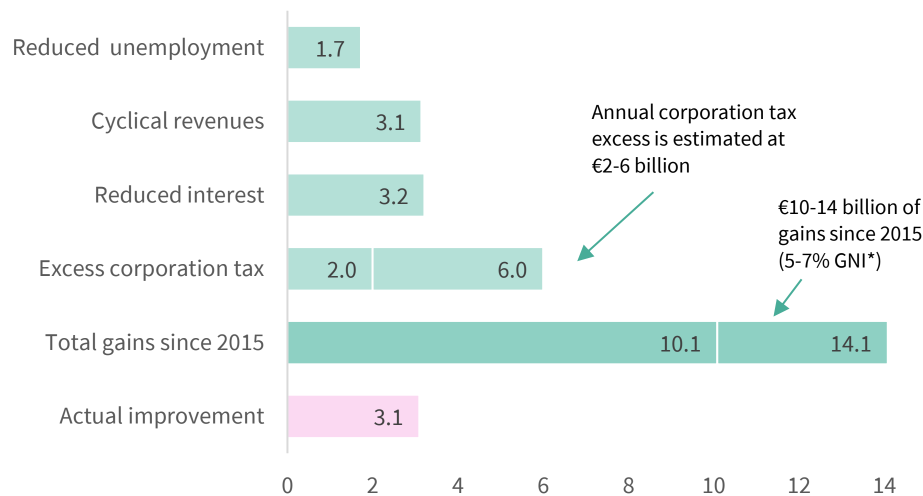
Sources: Department of Finance; and Fiscal Council workings.
Note: Within-year spending increases are based on gross voted spending outturns as compared to earlier vintages of estimates (*Budget 2015* for 2015; *Budget 2016* for 2016; *Budget 2017* for 2017; and *SPU 2018* for 2018, due to the reclassification of spending on water services into the Department of Housing; *Budget 2019* for 2019).

The within-year increases imply a looser fiscal stance, a weaker-than-planned underlying budgetary position (ignoring temporary gains) and they can contribute to the build-up of potential overheating pressures.[7]

Figure 1.8 highlights how the Government has used unexpected tailwinds since 2015 to raise spending such that the actual improvement in the budget balance is much lower than it would have been if the original spending plans had been followed. Annual corporation tax receipts are estimated to be some €2–6 billion beyond what various fundamentals would suggest they would be, interest costs are €3.2 billion lower than expected, unemployment costs have fallen by €1.7 billion as a result of the recovery, and revenues have been boosted by some €3 billion due to the upswing in the economy. The combined effect of these gains of €10–14 billion has not resulted in a large budgetary improvement. Instead the budget balance has improved by just over €3 billion over the same period.

Figure 1.8: Various gains have been used to increase spending

€ billions (estimated annual gains since 2015)



Sources: CSO; Eurostat; Department of Finance; and Fiscal Council workings.
Notes: "Excess corporation tax" estimates are based on updates of Box B (*June 2019 Fiscal Assessment Report*). Interest gains are based on the difference between the *Budget 2015* forecast of interest and the actual outturn. Unemployment-related cost gains are based on the Council's principles-based approach (Chapter 4) and relate to the estimated reduction in associated expenditure due to the recovery in the cycle. Cyclical revenue gains are based on the Department's preferred estimate of the output gap and the elasticity of revenue to the output gap as outlined in Carroll (2019). Actual improvement is based on the change in the actual budget balance excluding one-offs between 2015 and 2018.

[7] Box G (June 2019 Fiscal Assessment Report) notes that revenue in 2018 was almost €6 billion higher than anticipated in *Budget 2015*. Almost €5 billion of this was due to corporation tax.

Recent surges in corporation tax receipts boost government revenues, but they also boost the economy in other ways. For instance, Ireland’s strong current account surplus is inflated by the surges as four-fifths of receipts are due to foreign-owned firms. Activities associated with these receipts are also likely to be reflected in terms of the higher profits and large contributions of net exports to growth in headline GDP seen in recent years. Moreover, the corporation tax receipts themselves represent a net injection to the Irish economy (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. As Chapter 2 notes, this can make the current account balance look more favourable than it otherwise would.

In the context of looser-than-planned spending, it is important to remember that Ireland’s government debt burden remains high after the crisis. When set against a more appropriate measure of national income like GNI*, Ireland’s net debt burden for end-2018 was equivalent to 90 per cent (Figure 1.9). This places it as the sixth highest in OECD countries behind France, Portugal, Italy, Japan and Greece.

Figure 1.9: The largest 25 net debt ratios in OECD countries

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

Sources: IMF (October 2019 WEO); CSO; Eurostat; and Fiscal Council workings.

Notes: The Stability and Growth Pact criterion of a 60 per cent ceiling for government debt is set in gross terms rather than in net terms. Net debt does not include the State’s bank investments.

1.4 Assessment of the Fiscal Stance for 2019–2024

The economy is now close to its potential and risks to the outlook are visible in both directions. Weighing up the uncertain macroeconomic outlook, the risks on the horizon, and the still vulnerable fiscal position, the Council assesses that caution is appropriate.

The Council's previous advice for 2019 and 2020 was that the Government should deliver on its spending plans (net of new tax measures) and offset additional Brexit-related costs that are avoidable and/or clearly not temporary in nature with budgetary measures elsewhere. It argued that there was a case for more caution owing to the risks associated with Brexit, the Government's increased reliance on risky corporation taxes and the worsening external outlook (Fiscal Council 2019b, 2019c).

Fiscal Stance in 2019

In 2019, the Government looks set to repeat its recent pattern of within-year spending increases. It expects to raise underlying spending by €0.7 billion more than planned this year.[8] Yet this is likely to only impact overall spending levels by €0.4 billion, with some €0.3 billion of additional offsetting interest savings expected.

There is a risk that slippages in 2019 could turn out even higher than *Budget 2020* suggests. Health spending overruns—currently estimated at €0.3 billion for the year—could end up closer to their €0.5 billion average of recent years. Social payments on a general government basis could also be higher than expected as the Department opted not to revise up its 2019 forecasts to fully account for higher-than-forecast payments last year (Chapter 3).

Spending slippages in 2019 are likely to be masked by higher-than-expected corporation tax receipts. In recent years, within-year spending overruns—particularly in current spending (Box G) and most notably in health (Box I)—have been masked by increasing corporation tax receipts. This is likely to be repeated in

[8] This is assessed based on a net policy spending basis (i.e., general government spending adjusted for one-offs, interest, and cyclical unemployment costs) and relative to *Budget 2019*. Exchequer revisions broadly match the general government revisions observed for 2019 (for instance, compared to *Budget 2019* forecasts, Exchequer gross voted and non-voted current spending plus gross voted capital spending—adjusted for interest, one-offs, and cyclical unemployment costs—is expected to be revised up by €0.7 billion.

2019, with strong receipts in the key month of June providing an early sign that November's receipts will also outperform forecasts (Chapter 3).

The reliance on corporation tax to fund slippages in spending is highly risky, given the considerable uncertainty around these receipts. Corporation tax is the most volatile and least predictable of the Government's main taxes (Casey and Hannon, 2016). Receipts are concentrated in a handful of companies though the composition of the top ten does change from year to year (close to a half is from ten corporate groups) and the receipts are prone to changes in the international tax environment. New research using a suite of models to capture corporation tax movements highlights that typically about one-third of the annual variability (R-squared) in receipts is explained by preferred models (McGuinness and Smyth, 2019).

Fiscal Stance in 2020

On a general government basis, *Budget 2020* shows upward revisions in spending plans of €0.7 billion for 2019 that widen to €1.1 billion in 2020, even when allowing for tax-raising measures and the possibility that costs associated with a disorderly Brexit do not materialise.[9]

The additional slippage in 2020 is somewhat surprising. The measures introduced on budget day appeared relatively limited compared to other years and the Government made welcome efforts to limit the impact of the 2019 slippages on long-run spending by offsetting measures planned for 2020 in areas it controls directly with higher-than-planned revenue-raising measures. Indeed, on an Exchequer basis, the 2019 overruns were offset.[10] Such an approach is welcome as it avoids budgetary plans drifting up with each overrun.

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[9] This is measured on the basis of comparing Budget 2019 plans with Budget 2020 plans. Considering policy spending (total general government spending less one-offs, interest, and cyclical unemployment costs), the revision relative to Budget 2019 plans is €3.2 billion. This is offset or explained by (1) the Brexit contingency adjusted for the revision to cyclical unemployment costs (€0.9 billion), (2) higher-than-planned discretionary revenue-raising measures (€0.9 billion), and (3) timing-related costs linked to the 2020 leap year (€0.2 billion), which should have already been factored in to the plans.

[10] On an Exchequer basis, using the same adjustments for interest, one-offs, cyclical and unemployment costs, and recognising amounts explained or offset by the Brexit contingency, timing-related costs, additional revenue-raising measures, and the impact of higher EU budget contributions linked to Brexit, the underlying upward revision is €0.4 billion relative to *Budget 2019* and €0.2 billion relative to *SPU 2019.*

Most of the slippages relative to previous plans for 2020 are set to arise in areas of spending outside of the direct control of central Government (including by local Government and by Approved Housing Bodies).[11] These 2020 slippages are sizeable. They potentially add to activity in an already fast-growing economy and they could imply an overall pace of spending growth that is not conducive to prudent economic and budgetary management.[12]

The large upward revisions to spending forecast in general government areas outside the Exchequer should be incorporated in budget plans. These impact the economy just as much as central spending and should be taken account of, with plans set on a general government basis. The Department needs to publish more information in budgetary publications on a general government basis so that government policies and compliance with fiscal rules can be comprehensively assessed. An essential starting point is to make a more comprehensive "walk" from Exchequer to general government data in gross terms available in budgetary publications (currently, this is only done on a net basis). As Box A notes, a fifth of activity tends to be missed by focusing on traditional Exchequer definitions.

Box A: The Department should improve its general government accounting

There has been a longstanding tradition that the Department of Finance focuses primarily on "Exchequer" figures when it comes to the public finances rather than on the wider "general government" figures. This box argues that the Department needs to move further towards general government accounting.

The traditional focus on the Exchequer rather than the broader measure of general government is partly a result of institutional and historical factors. The Department of Finance has traditionally had more oversight of Exchequer activities, compared with other areas of general government such as local government and non-Exchequer bodies.

Exchequer vs general government

Exchequer data have many limitations. They cover only about four-fifths of wider government spending and revenue (Figure A.1).

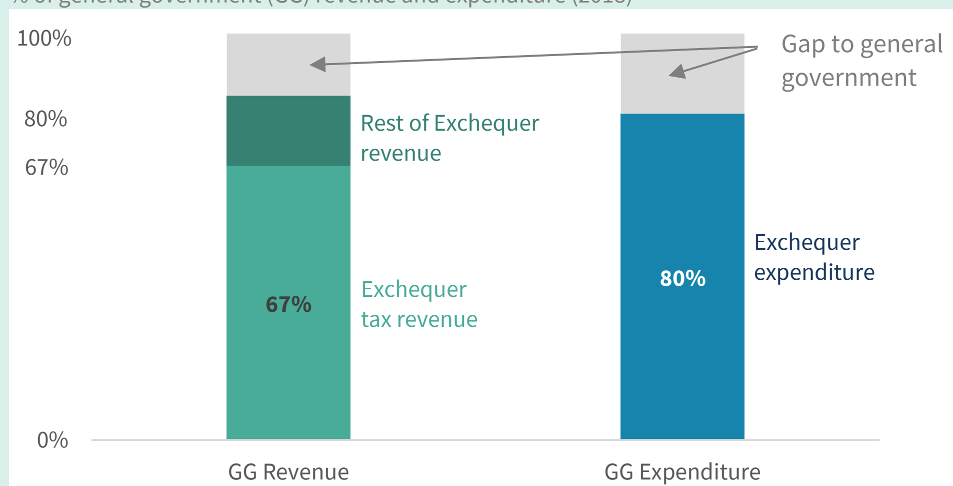
[11] Approved Housing Bodies are non-profits that provide affordable rented housing (Box L).

[12] At present, policies set out in *Budget 2020* offset a large portion of the Exchequer slippages seen in 2019, but this is only part of the picture. In Exchequer terms, just €0.4 billion of the €0.7 billion slippage in 2019 remains into 2020. Therefore, about half of the previous year's slippage can be said to have been reversed in the budget. This approach is to be welcomed. If the slippages were not reversed, then they would have added to long-lasting spending increases without being matched by any changes to sustainable sources of revenue. While aspects of the Government's approach to Exchequer spending revisions and plans for 2020 are to be welcomed, the Council's assessments of budgetary policy and its monitoring of compliance with the fiscal rules are on the basis of wider government spending (beyond the traditional Exchequer definition).

In many cases, the Department only refers to Exchequer tax receipts, which cover even less (two-thirds in the case of revenue).[13] The Exchequer data is not consolidated (so that transactions may be double-counted when including different levels of government). Exchequer data refers to cash amounts and so costs and receipts are not measured as taking place in the period they actually relate to.[14] Exchequer data are not cleaned of financial transactions that do not impact the states' financial position (for example, if assets are converted from cash to other liquid assets, such as bonds, then they show up as impacting the Exchequer data but not the general government data).

Figure A.1: Exchequer data miss a portion of government

% of general government (GG) revenue and expenditure (2018)



Sources: CSO; Department of Finance; and Fiscal Council workings.

A more comprehensive definition of the government and a budgetary measure preferred by the Council is based on the general government sector accounts. General government data conform to the main internationally recognised governmental accounting standards. They are much broader measures that cover revenue and expenditure of all arms of government, as well as many state-owned independent bodies. They are compiled on a mixed cash and accruals basis.

The general government can be characterised as consisting of both Exchequer and non-Exchequer revenue and expenditure. In terms of revenue, the non-Exchequer parts included in general government data are mainly represented by PRSI contributions to the Social Insurance Fund and other fund receipts. In terms of expenditure, the non-Exchequer parts are mainly related to local government spending (including Approved Housing Bodies).

What is the problem with Exchequer accounting?

Less comprehensive: By focusing predominantly on Exchequer measures and by providing less detail on general government data, there is a risk that analysis of the public finances is less comprehensive and that large parts of government activity is not given adequate focus. Using the narrower measure creates a risk that activities in other parts of government go unnoticed.

Less clarity on policy: Transactions—important from a policy perspective—may be outside of the Exchequer so that there is less clarity on actual policy. There can also be an incentive to move things outside of the Exchequer so that it gets less focus.

[13] By "wider" here, we mean general government expenditure and general government revenue.

[14] Accrual accounting involves recognising the economic events at the time at which they occur, regardless of when the related cash receipts and payments take place (OECD, 2019). Accrual accounting also recognises all stocks of assets and liabilities in balance sheets.

Fiscal rules: In addition, the focus on Exchequer measures does not allow for clear assessments of the fiscal rules, which are set on a general government basis.

What can be done?

The Government has recently agreed to ambitious reforms to how it presents its budgetary data. This is based on OECD recommendations (OECD, 2019) and builds on similar recommendations in the IMF's (2013) Fiscal Transparency Assessment of Ireland. The OECD roadmap for reforms include introducing accruals accounting and upgrading financial reporting systems across departments. The OECD report notes that practices in Ireland lag behind other countries due to (1) limited accrual information, (2) narrow institutional coverage, and (3) long time lags for publishing information.

The Minister has said that the reforms recommended by the OECD would be introduced progressively, and that stakeholders and financial managers across the public service would be consulted. This is a welcome development. It is important that the Government makes progress in relation to these reforms as a priority.

As well as addressing how government departments report, there should also be more detail provided on general government forecasts in budgetary publications. An ongoing problem is that the Department does not provide estimates in budgetary publications of how it moves from its Exchequer figures to the wider general government figures other than in net terms (the so-called "walk"). That is, it only shows the move from the Exchequer balance to the general government budget balance. It does not show the gross spending or gross revenue amounts making up the gap between the two measures. This is poor as regards transparency, especially when the implications of government policy actions can differ across the two measures — as happened with *Budget 2020*. Reforms to how forecasts and policies are presented would also help to improve wider transparency for the public finances.

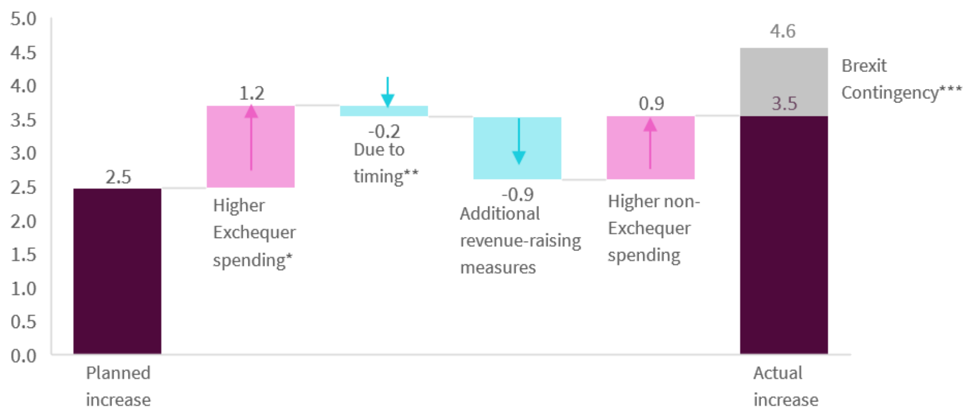
The Government's net policy spending plans for 2020 have been revised up substantially. The Government's plans for 2020 set out as recently as in April's *SPU 2019* pointed to a net policy spending increase of €2.5 billion in 2020. If the revised plans for spending in 2019 and 2020 are taken together (as in, if the original *SPU 2019* plans for 2019 are compared against the new *Budget 2020* plans for 2020), the increase is now closer to €4.6 billion — a €2.1 billion upward revision. This implies a fast pace of increase equivalent to growth of 5.6 per cent year-on-year that is beyond the sustainable growth rate of the economy.

The Government incorporated some of the upward revisions to Exchequer spending in its budgetary plans for 2020, but these measures are outweighed by higher non-Exchequer spending and the potential cost of the Brexit contingency. As Figure 1.10 shows, Exchequer spending increases—beyond what was planned in April's *SPU 2019*—were mostly offset by €0.9 billion of additional revenue-raising measures. The revenue-raising measures were mainly made up of an increase in stamp duty on non-residential property from 6 per cent to 7.5 per cent, a carbon tax increase, and

some compliance measures. A further €0.2 billion of the increase is temporary and arises due to timing-related issues arising from extra payment dates in the 2020 leap year. While the Brexit contingency may not be required, and some of this could prove temporary even if it is used, the additional higher-than-expected spending in areas outside of the Exchequer drives up spending increases by a further €0.9 billion relative to earlier plans.

Figure 1.10: Net increase in 2020 €1 billion higher even before Brexit spending

€ billions (net policy spending increases)



CSO; Department of Finance; and Fiscal Council workings.

Note: Net policy spending is general government expenditure less one-offs, interest, and discretionary revenue measures. The figure compares the original *SPU 2019* plans for spending in 2019 with *Budget 2020* estimates for 2020 to capture the impact of within-year spending revisions in 2019. * Exchequer spending is gross voted current and capital spending plus non-voted current spending (adjusted for the higher EU budget contribution arising from Brexit-related customs duties, which is general government neutral). ** Timing-related costs arise due to extra payment dates in the 2020 leap year. *** The Brexit contingency is adjusted for the estimated cost of cyclical unemployment benefits already removed from net policy spending.

The Council had previously assessed that the Government should offset slippages in core spending with budgetary measures elsewhere in 2019 or in 2020. The Government did offset additional within-year spending revisions expected for 2019 with revenue-raising measures elsewhere on the Exchequer side. This is a welcome approach, which has been recommended by the Council and one that breaks from recent patterns. It limits the extent to which overruns contribute to budgetary measures drifting upwards in subsequent years.

Yet the Council's assessments and the requirements of the *FRA* and *SGP* refer to broader general government spending (which include items outside of the traditional Exchequer definition). This is the most relevant measure for assessing how the Government's activities impact the economy. On this basis, upward revisions to spending in 2019 are likely to have widened further in 2020.

There are risks of even further underlying slippages arising in 2020 in addition to what is already forecast:

- The Government's Brexit-related supports to specific sectors (such as tourism and agriculture) amount to €0.65 billion and are intended to be temporary but could persist. Although the budget forecasts assume that these supports would last for only one year, if introduced, it is plausible that such supports may be difficult to reverse in future (Box H).

- The Christmas Bonus, which has been paid out to varying degrees in each of the past six years, is, again, not budgeted for in 2020. The Government took late decisions to make full payments in 2018 and in 2019. If this happens again in 2020, it will add a further €0.3 billion to spending.

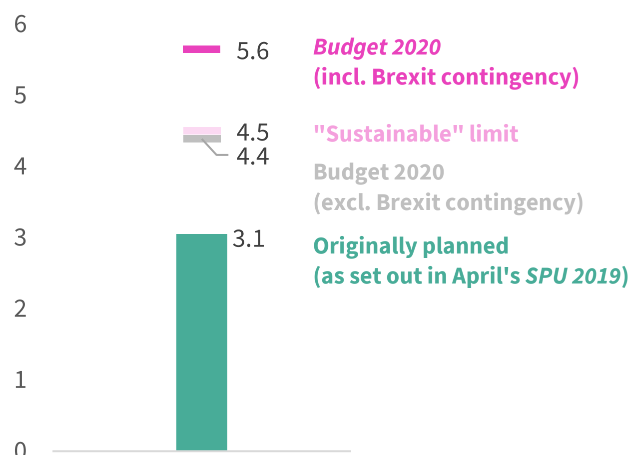
- Health spending overruns have been a common feature in recent years (averaging €0.5 billion since 2014). An overrun of €0.3 billion is expected for 2019 and there is a risk of a further overrun in 2020, given that weak planning and weak spending controls remain evident (Box I).

- Revenue-raising measures introduced in *Budget 2020* to fund additional spending may not raise what was stated. Revenue-raising measures were €0.9 billion (in net terms) more than was planned in April's *SPU 2019*. However, some of the assumptions behind the three largest measures (accounting for €0.3 billion) could be questioned in terms of the assumptions used to estimate their yields and in terms of whether these can ever be verified (Box J).

The Council assesses that the repeat in 2019 of a recent pattern of within-year spending increases has the potential to undermine the public finances. The Government attempted to offset the within-year spending increases in 2019 by introducing additional revenue-raising measures in *Budget 2020*. This is the right approach, but it was undermined by higher-than-planned spending increases in areas outside of the Government's direct control (including in local authorities and predominantly in housing bodies). The combination of within-year increases in 2019 and undirected increases in 2020 leads to a fast pace of spending growth and is not conducive to prudent economic and budgetary management.

Figure 1.11: Plans were for more moderate net spending growth in 2020

% growth in net policy spending for 2020



Source: CSO; Department of Finance; and Fiscal Council workings.
Note: "Sustainable" limit refers to the growth rate implied by potential output over the medium term (3 per cent) and forecast inflation for 2020 of 1.5 per cent.

A prudent fiscal policy at present, with the structural position relatively near to a balanced budget, would see net policy spending rise no faster than the growth rate of sustainable revenues. At the time of the Council's Pre-Budget Statement, this was estimated to imply a growth rate of 4½ per cent for 2020.[15] The Government's *SPU 2019* plans for 2020 as set out in April were within this growth rate at an estimated 3.1 per cent. Being cautious and sticking to the plans set out in *SPU 2019* would have helped to limit the possibility of rising debt ratios, loss of creditworthiness, and a need for sizeable correction in the public finances. In particular, it would have allowed more room for further support to be provided in the event of an adverse shock without raising concerns of fiscal sustainability, hence allowing fiscal policy to cushion some of its effects. Yet the actual *Budget 2020* plans imply growth in net policy spending of 4.4 per cent for 2020 — right at the limit of what is considered sustainable. If the Brexit contingency is included, which may happen if it proves not to be one-off in nature, this growth rate for 2020 rises to as much as 5.6 per cent (Figure 1.11). This is on the basis of comparing original plans for 2019 as set out in *SPU 2019* with the revised 2020 plans set out in *Budget 2020*.

The Irish debt burden is still among the highest in the OECD. Various stress scenarios considered in Appendix A highlight how quickly the debt ratio could deteriorate

[15] This is based on an estimated potential output growth rate of 3 per cent (using the Council's suite of potential output models) and inflation of 1½ per cent (updated inflation forecasts from *Budget 2020* if combined with the same potential output growth rate would imply a similar limit).

under plausible scenarios. Given the high debt burden, strong cyclical growth, risks to the economic outlook, and surging corporation tax receipts, there is no case for additional stimulus at this stage. The budget should be kept in balance in structural terms to ensure that debt ratios are on a steady downward path.[16]

Two annual €500 million contributions that were planned for the Rainy Day Fund in both 2019 and 2020 have been cancelled. This means that the Rainy Day Fund—first proposed as part of the Government's programme in May 2016—will not have any *annual* contributions made to it until 2021 at the earliest: five years after it was first proposed. This ignores the planned €1.5 billion transfer of cash assets from the Irish Strategic Investment Fund to the Rainy Day Fund, which has no impact on the State's net asset position. Suspending the transfers to the Rainy Day Fund may have made sense in a disorderly Brexit, hence reducing refinancing requirements, though the need for this is not clear in an orderly scenario. Box B reviews the history of the Rainy Day Fund in the context of the cancelled transfers.

Box B: Contributions to the Rainy Day Fund suspended before they start

This box reviews the operation of Ireland's Rainy Day Fund in light of the suspension of the first annual allocations to the Fund, which were planned for 2019 and 2020.

A brief history of Ireland's Rainy Day Fund

The Rainy Day Fund was first proposed as part of the Government's programme in May 2016.[17] Few details were given at that time, but the proposal came under the objective of securing "sound public finances and a stable and broad tax base".

At the time, the Council welcomed the initiative as a useful way to improve Ireland's budgetary framework.[18] The view was that—provided it was designed and managed appropriately—such a fund would have three advantages:

1) It could provide a way for the Government to sustain budget surpluses in good times, withstanding political pressures to loosen budgetary policy when tax revenue is growing strongly. In this way, the Fund could act as a counterweight to the problem of "deficit bias": that is, the tendency for governments to run deficits and allow debt levels to rise over time.
2) While allocating some resources to the fund in good times would imply a tighter fiscal stance than would otherwise be the case, the Fund could help to protect the

[16] This is a minimum objective in the context of the fiscal rules. One reason in favour of this approach is that output gaps tend to be revised up, particularly for cyclical upswings.

[17] See the Programme for a Partnership Government available at: https://www.merrionstreet.ie/MerrionStreet/en/ImageLibrary/Programme_for_Partnership_Government.pdf

[18] See Box B, *June 2016 Fiscal Assessment Report.*

Government against a need for forced austerity in the event of a loss of market confidence and inability to borrow at low interest rates in future.

3) The Rainy Day Fund would also provide the Government with access to useful financial assets in the event of a crisis.

As part of *Budget 2017*, the Minister for Finance announced plans to set aside €1 billion every year in a Rainy Day Fund starting in 2019. This reflected the "need to build up a safety buffer".

The Council saw the proposed Rainy Day Fund as a potentially useful tool for reacting to changing economic conditions. In particular, it noted that fiscal policy would have to play an important role in "leaning against the wind" in coming years should the domestic economy begin to overheat.[19] The Rainy Day Fund was one option that could help to achieve this.

In 2017, plans for the Rainy Day Fund were scaled back. The planned contributions to the Fund were halved from €1 billion per year to just €0.5 billion per year. In October, a consultation paper on how the Fund would operate was released by the Department of Finance (2017).[20] While it outlined some aspects of how the Fund would work, the Council noted that three key issues still had to be addressed: (1) how the fund was intended to help limit procyclical fiscal policies from arising; (2) how the fund would interact with the EU fiscal rules; and (3) how governance procedures were to be designed.

In particular, the Council noted that the fund envisaged by the Department did not appear to function as a countercyclical tool for fiscal policy (it would not act in a manner that would lessen past tendencies to ramp up spending and cut taxes during a cyclical upswing). Instead, the proposed design was one that involved pre-determined limits (€0.5 billion each year) on how much would be allocated to the fund (in other words, not dependent on how the cycle actually evolved); total allocations would be capped over the life of the fund (at €8 billion); and the Fund would address only "specific events or shocks rather than the impact of the cycle". These features ran contrary to the original purpose of the Fund and suggested that it would contribute little to improving fiscal policy.

The Council further developed its views on how the Rainy Day Fund could address shortcomings in Ireland's budgetary framework in subsequent reports and research (Barnes and Casey, 2019; Fiscal Council, 2018; Casey *et al.,* 2018).

In June 2019, the "National Surplus (Reserve Fund for Exceptional Contingencies) Bill 2018" passed into legislation, establishing the Rainy Day Fund. Its establishment provided for assets up to the value of €2 billion to be transferred to it from the Ireland Strategic Investment Fund—a State fund that operates on a commercial basis to support economic activity and employment in Ireland—but the Government's intention was always to transfer €1.5 billion. The Bill also provided that the Minister for Finance would transfer €500 million to the Rainy Day Fund each year from 2019 to 2023. The first payments into the fund were to take place later in 2019.

With a disorderly Brexit forming the backdrop to *Budget 2020*, the first transfer to the Rainy Day Fund of €500 million was suspended. The Minister noted in his *Budget 2020* speech:

> *"My original intention was to transfer €500 million to the Rainy Day Fund from the Exchequer this year, with an additional €1.5 billion being transferred from the Ireland Strategic Investment Fund. While I am committing that this €1.5 billion will be transferred to the Rainy Day Fund, given that a No Deal Brexit is more likely, I have decided not to transfer the additional €500 million from the Exchequer this year. This is the appropriate response to the more challenging economic environment we may*

[19] *June 2017 Fiscal Assessment Report*.

[20] Department of Finance, (2017d).

be facing. It will ensure that we have in place the right supports so that our economy is protected from the impacts of Brexit and it ensures that Government can continue to protect our public services in the years ahead."

What now?

The decision to suspend the first transfer means that the Rainy Day Fund has not been allocated any resources as yet. A transfer of €1.5 billion of cash assets from one arm of the State (the Irish Strategic Investment Fund) to another (the Rainy Day Fund) is, however, expected to take place later this year. This will have no impact on the State's net asset position. It is possible, however, that the funds might be used for different purposes. If they were to have stayed in the Irish Strategic Investment Fund, for instance, these resources may have eventually been used to support economic activity and employment in Ireland on a commercial basis. In the Rainy Day Fund, their ultimate use is unclear, given how the Fund interacts with the fiscal rules.

At this point, the limitations of the Fund noted by the Council are still valid. The Fund will not operate in a countercyclical manner. Its stated purpose is only to deal with specific events or shocks. The €8 billion cap and the pre-determined transfer amounts undermine any countercyclical objective. And its scope to be used in a downturn remains unclear (due to the question over its interaction with the EU fiscal rules not being adequately resolved). These are the key areas to be developed if the Fund is to fulfil its potential as a tool for improving budgetary outcomes in Ireland.

Fiscal Stance in 2021–2024

To ensure that the public finances follow a sustainable path in coming years and that debt ratios are steadily reduced from high levels, the Government needs to develop better strategies for managing the public finances.

Currently, the Government's medium-term plans show real net policy spending growth of between 1 and 1½ per cent over 2021–2024 — below most estimates of potential output for the Irish economy. While such a growth rate would be well within what the government is likely to be able to fund sustainably, there are questions over the plausibility of medium-term forecasts. Chapter 3 notes that the Department of Finance has moved towards more plausible estimates of medium-term spending growth for current spending, yet these are still based on arbitrary technical assumptions rather than bottom-up assessments of price and service pressures. Chapter 4 highlights how medium-term spending ceilings have been repeatedly revised up as the economy fares better than expected.

The objective for the medium-term should be to set a course for a prudent fiscal policy that ensures net policy spending rises in line with sustainable revenues. That means using the Rainy Day Fund to help build resources in good times so that forced

austerity can be avoided in bad times; reducing the over-reliance on corporation tax receipts; anchoring medium-term plans to better measures of Ireland's sustainable growth rate; and guiding policy with more appropriate debt targets. To achieve this, the Government could reinforce its budgetary framework with three sets of reforms:

Reform 1. Save temporary receipts through the Rainy Day Fund and a Prudence Account

Recent years have seen the Government use revenues from the economic recovery as well as surges in corporation tax to fund long-lasting spending increases. A risk is that temporary revenues may disappear so that the underlying budgetary position is weaker than it might have been had sustainable revenue sources been used to fund additional government services and supports.

The Council has argued for use of the Rainy Day Fund as a countercyclical tool as a way to mitigate these risks. This means saving temporary revenues associated with good times in the economic cycle rather than spending them so that they can, instead, be used in bad times. This would help to avoid the need for the forced austerity that has happened in the past.

The reforms to the Rainy Day Fund that are needed are relatively clear. First, it should operate in a countercyclical manner. Second, it should not be capped nor should amounts allocated be pre-determined as this undermines countercyclical objectives. Third, its scope to be used in a downturn should be clarified in the context of the EU fiscal rules through greater engagement with the European Commission.

Related to the Rainy Day Fund is the operation of a "Prudence Account". The Council's proposal for a Prudence Account is one way in which unexpected surges in corporation tax receipts could be saved so as to help to prevent long-lasting spending increases being tied to possibly temporary revenue sources. The Department has set out some proposals in this regard, which are welcome. Box C notes that the Department's plans are good in principle, but that they are relatively modest in scale.

One area of tax reform that has potential to cause reversals in corporation tax in future years is the OECD Base Erosion and Profit Shifting (BEPS) initiative. The timeline on the OECD initiative, approved by the G20 will depend on how discussions proceed (the timing of when plans could be enacted spans the next decade). The impact on Irish corporation tax receipts is unclear, though it is expected to be quite negative. There are two pillars of reforms, both of which could have negative impacts. Estimates of the potential impacts are likely to be published in coming months. Pillar 1 currently involves looking at where corporation taxes should be paid, on what basis they should be paid, and what portion should be based on the location of users. Pillar 2 looks at potential minimum effective corporate tax rates that could apply to all countries.

The Minister noted that corporation tax receipts are likely to fall at some point in a recent Oireachtas appearance, stating that:

> *"I believe we will see corporation tax receipts increase again this year as I indicated in my statement to the committee. It is very likely that they will increase again next year. I believe our corporation tax receipts will plateau and then decline at some point. That could be for any one of a number of reasons, but I will highlight three. First, the phase of corporate profitability many large companies are going through could begin to change in the future. The second is the effect of OECD measures on our share of global tax profits. The third is that we could see other countries begin to adopt more competitive attitudes towards corporation tax rates".*[21]

Reform 2. Guide policy with sustainable growth rates

To better guide medium-term net policy spending, the Government can use the alternative estimates of potential output that it has developed to inform more appropriate growth rates.

[21] Opening Statement to the Budgetary Oversight Committee by the Minister for Finance and Public Expenditure and Reform, Paschal Donohoe, T.D. 12th November 2019. Available at: https://www.oireachtas.ie/en/debates/debate/committee_on_budgetary_oversight/2019-11-12/3/

This would see the Government, first, set out a clear statement of the sustainable rate that net policy spending can grow at over the medium term (for example, the term of government). Second, multi-year departmental expenditure ceilings should be framed in the context of this upper limit. Third, more realistic forecasts for spending should be developed recognising these limits. These should take account of bottom up spending pressures (both from demographics and inflation, though they do not have to imply automatic indexation).

Reform 3. Establish meaningful debt ratio targets

In 2017, the Government set out a debt target of 45 per cent of GDP (since revised up to 55 per cent of GDP). The debt target, in principle, is a good idea, in particular as it can be a relatively transparent benchmark against which to assess budgetary policy, but it needs to be developed if it is to be a meaningful guide for fiscal policy over the medium term. The debt target needs to be restated as a percentage of modified GNI*. It needs a clear timeframe (currently, this timeframe is vaguely defined around the idea of when capital spending meets some unidentified level). It should have clear staging posts so that performance can be assessed. The Government should clarify whether the debt target is a steady-state target or a ceiling. And the target should be lower to reflect Ireland’s volatile growth rates.

Chapter 4 and Box N assess the Government’s plans on the basis of its proposed reforms, which are outlined in a document accompanying *Budget 2020* (Department of Finance, 2019d) and which address some elements of the reforms that the Council proposes.

Box C: The Department of Finance's proposals to address corporation tax risks

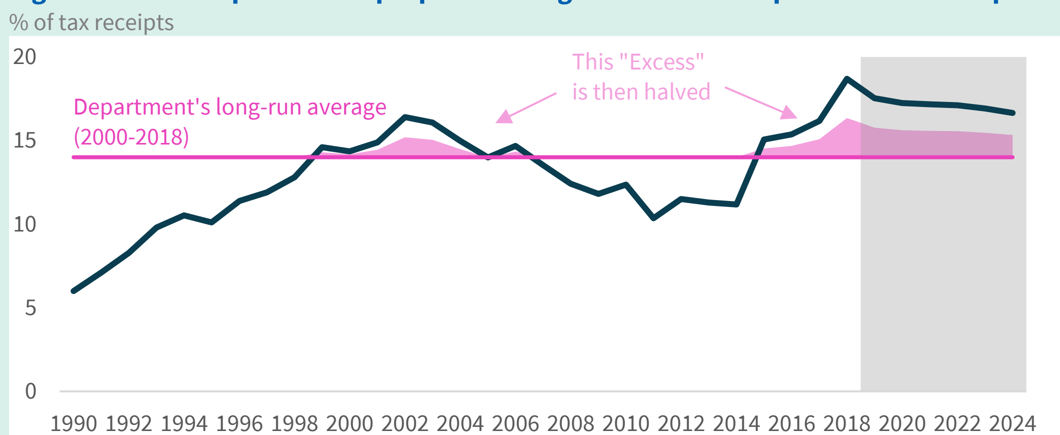
This box explores the Department of Finance's proposals to deal with vulnerabilities arising from an increased reliance on corporation tax.[22] At present, the corporation tax proposals set out by the Department are good in principle, but relatively modest in scale.

Modest proposals

The Department's proposal is to reduce the Government's exposure to reversals in potentially temporary corporation tax receipts by ring-fencing a portion of these (the example it gives is on the basis of an excess relative to the long-run average share of tax). The idea is that a portion of corporation tax would be set aside in the Rainy Day Fund so that it is not used to finance long-lasting spending increases or tax cuts.[23]

Figure C.1: The Department's proposal to ringfence excess corporation tax receipts

% of tax receipts



Source: Department of Finance; and Fiscal Council workings.
Notes: "Excess" defined as % total tax accounted for by corporation tax receipts beyond 2000–2018 average.

In principle, the Department's approach is a good one. Yet there are a few reasons why the Department of Finance proposals seem modest.

First, the proposals are based on one of the lower estimates of excess receipts that the Department of Finance calculates: the long-run average. This gives an excess of €2 billion. By contrast, its scenario where receipts return to 2014 levels suggests a €6 billion excess. This puts its proposals to ring-fence a portion of excess receipts for investment in the Rainy Day Fund at the lower end of the €2–6 billion range cited and below the €3–6 billion range assessed by the Council as potentially excess.[24, 25]

Second, the proposals are based on a 2000–2018 long-run average. Using this time period suggests that 14 per cent of total tax receipts are typically accounted for by corporation tax. More generally, relying on an average share to assess fundamental levels of corporation tax receipts is inevitably a crude and somewhat arbitrary approach. The average falls as more of the earlier observations are included and as more of the years where surges were evident are dropped. However, it could be argued that the modern corporate tax system has applied only

[22] The Fiscal Vulnerabilities Scoping Paper (Department of Finance, 2019d) examines corporation tax overperformance and sets out policy options to help to ensure the sustainability of the public finances.

[23] The details of the proposal are set out in Table 3 of the Department of Finance (2019d) Fiscal Vulnerabilities Scoping Paper.

[24] The Department (2019, p.iv) notes that "scenario analysis based on extreme, though far from implausible, assumptions suggests that, in the absence of corrective measures, a permanent budgetary gap of the order of €2 – €6 billion could potentially open up."

[25] The Council's range of estimates are set out in Box B of the *June 2019 Fiscal Assessment Report*.

since about 1998 at the earliest (when Ireland's 12.5 per cent corporation tax for trading income was introduced, though this was not fully commenced until 2003 and the 10 per cent rate for financial services (IFSC) companies expired only in 2005).

Third, the Department's proposals halve the excess but do not provide a justification for this.

Fourth, the proposals consider only the period 2018–2024. And there are no plans to build savings to account for excess corporation tax receipts received prior to now. Of course, it may be difficult to adjust the public finances for these past excess returns. But it is important to note that a further excess of €2¼ billion would have been evident for 2015–2017 (comparing shares of corporation tax receipts against the 14 per cent level). The Department forecasts that the share of total receipts accounted for by corporation tax will fall back towards the long-run average of 14 per cent in coming years. The planned allocations are therefore lower than they might otherwise be should higher-than-expected receipts persist.

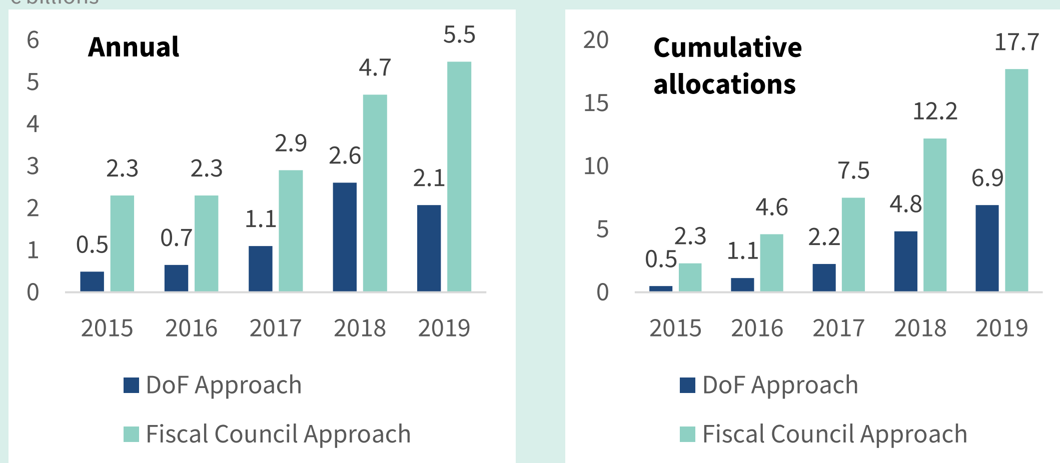
Comparison with the Council's proposals

The Council set out an approach for a "Prudence Account" in its last report (Box B, Fiscal Council, 2019). The Prudence Account was a mechanism to commit the Government to saving unexpected—and potentially temporary—tax receipts such as those from corporation tax as they arise. This approach would overcome the time inconsistency problems that can arise.[26] Allocations would 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).

Comparing the Department's proposals for ringfencing excess corporation tax receipts with the Prudence Account approach that the Council set out, we can see that the amounts involved are drastically different. The Council's proposals would have entailed annual allocations close to €5 billion in 2018 and 2019—more than double the Department's. In terms of cumulative amounts ringfenced, the Council's proposal would have amounted to €17.7 billion by end-2019—more than €10 billion more than the Department's proposals had they applied from 2015 onwards.

Figure C.2: The Department's proposed corporation tax savings are relatively modest

€ billions



Source: Department of Finance; and Fiscal Council workings.
Notes: The "excess" is defined as the share of total tax accounted for by corporation tax receipts in excess of the 2000–2018 average.

[26] Kydland and Prescott's (1977) time-inconsistency problem shows that policymakers with complete discretion at every point in time might not use resources available to them in the best way possible. In other words, good policy commitments made at an earlier stage might not be followed through on at a later stage. A key conclusion is that one can improve long-run outcomes by limiting future discretion so as to preserve earlier commitments.