Irish Fiscal Advisory Council

Fiscal Assessment Report

November 2019

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This report can be downloaded at www.FiscalCouncil.ie

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Foreword

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

The mandate of the Irish Fiscal Advisory Council is to:

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

The Council is chaired by Mr Seamus Coffey (University College Cork). Other Council members are Mr Sebastian Barnes (Organisation for Economic Co-operation and Development), Mr Michael G. Tutty, Dr Martina Lawless (Economic and Social Research Institute), and Prof. Michael McMahon (Professor of Macroeconomics at the University of Oxford and Tutorial Fellow of St Hugh's College). The Council's Secretariat consists of Dr Eddie Casey, Mr Niall Conroy, Mr Kevin Timoney, Ms Ainhoa Osés Arranz, Ms Friederike Vogler, Mr Killian Carroll, and Ms Karen Bonner. The Council would like to acknowledge the kind help from staff at the CSO, Central Bank of Ireland, ESRI, and the NTMA. The Council would also like to thank Máire O' Dwyer for copy editing the report.

The Council submits its Fiscal Assessment Reports to the Minister for Finance and within ten days releases them publicly. This report was finalised on 25 November 2019. More information on the Irish Fiscal Advisory Council can be found at www.FiscalCouncil.ie

Non-Technical Summary

Non-Technical Summary

The Government based *Budget 2020* on a disorderly Brexit scenario. This was appropriate, given the uncertainties and risks involved. It outlined some €1.2 billion of disorderly Brexit contingent spending.

Developments since the budget suggest that a disorderly Brexit scenario is now less likely in the near term. However, even if the UK agrees a trade deal with the EU, this could be less favourable than free trade agreements previously envisaged.

The macroeconomic outlook remains unusually uncertain. Strong growth in the domestic economy has continued, risking overheating in the near term. Adverse risks include the possibility of a global slowdown, further trade tensions, increased financial vulnerabilities, or changes to the international tax environment.

Ireland's net government debt burden is the sixth highest in advanced OECD economies at 90 per cent of Modified GNI*: an appropriate measure of Ireland's national income. Only France, Portugal, Italy, Japan and Greece are higher.

Budget 2020 projects a budget surplus for 2019 and a return to deficit in 2020, even without disorderly Brexit-related spending. The position would have been more favourable if the Government had not allowed spending to drift upwards in recent years.

The pattern of within-year spending increases—that is spending increases beyond budgets—risks repeating past mistakes. New analysis in this report shows that three quarters of the upward spending revisions since *Budget 2017* are due to current spending. These include repeated health overruns, averaging €500 million annually in recent years, that are long-lasting and not matched by savings or revenues raised elsewhere. Health spending needs to be properly managed.

Large tailwinds worth €10–14 billion annually have not been used to improve the budget balance, with the deficit only improving by €3 billion over 2015–2018.

In particular, the Government has become increasingly reliant on corporation tax to fund spending. Almost one-in-every-five euro of tax collected by the Exchequer is from corporation tax. And some €2–6 billion of the €10 billion forecast for this year is estimated to be "excess". In other words, beyond what would be expected based on the economy's underlying performance and historical or international norms. This leaves the public finances exposed to potential reversals.

A prudent policy for *Budget 2020*—ignoring temporary Brexit-related measures—would have seen the Government stick to its plans for 2019 and 2020 as set out in the April Stability Programme.

For 2019, the Government did not stick to its plans and is again likely to rely on unexpected corporation tax receipts to fund spending overruns of about €0.7 billion.

For 2020, the Government adopted the welcome approach of offsetting overruns from 2019 in its *Budget 2020* package. The Government opted to incorporate overruns in 2019 in its budget package for 2020 and to introduce offsetting measures elsewhere on the Exchequer side. Steps like this are in line with the Council's advice in recent years.

However, upward revisions to spending outside of the Exchequer—where more transparency is needed—mean general government spending is forecast to expand more rapidly than previously planned. This includes planned spending by local government and by housing bodies, which should be fully incorporated into budgetary plans.

The increase in net spending planned for 2020 is now 4.4 per cent. This compares to 3.1 per cent growth set out in April and puts it right at the limit of what would be considered sustainable for next year. The Brexit contingency included in *Budget 2020*, if spent, would raise this further. The first annual payments to be made to the Rainy Day Fund in 2019 and 2020 were postponed.

The Government can ensure a prudent fiscal policy where net policy spending growth does not exceed sustainable growth in revenues. Three reforms would help to achieve this: (1) using the rainy day fund and a prudence account to save temporary receipts, including corporation tax; (2) guiding net spending with sustainable growth rates informed by alternative estimates of potential output; and (3) establishing meaningful debt ratio targets.

Summary Assessment

Summary Assessment

The Government based *Budget 2020* on a disorderly Brexit scenario. This was appropriate, given the uncertainties and risks involved. For the macroeconomic forecasts, two scenarios were considered: a "deal scenario" and a "disorderly Brexit". However, only one budgetary scenario was published, which was for a disorderly Brexit, and this envisaged €1.2 billion of disorderly Brexit contingent spending, some of which would be temporary and some long-lasting.

Developments since the budget suggest that a disorderly Brexit scenario is now less likely in the near term. Yet the macroeconomic outlook remains unusually uncertain. Even if the UK agrees a withdrawal agreement and a trade deal with the EU, this may be less favourable than free trade agreements previously envisaged. Strong growth in the domestic economy has continued, risking overheating in the near term. Adverse risks include the possibility of a global slowdown, further trade tensions, increased financial vulnerabilities, or changes to the international tax environment. While the *Budget 2020* disorderly Brexit scenario does result in an economic slowdown, there are strong downside risks to this assessment. Downturns typically have severe impacts on the domestic economy including significant falls in consumer spending, investment, wages, and employment.

Ireland's government debt burden is the sixth highest in OECD economies. This is when assessed as a share of an appropriate measure of national income like GNI* and allowing for certain liquid assets held by the government. At end-2018, Ireland's net debt burden was equivalent to 90 per cent of GNI*. Only France, Portugal, Italy, Japan and Greece have higher net debt burdens in the OECD.

***Budget 2020* projects a budget surplus for 2019 and a return to deficit in 2020, even without disorderly Brexit-related spending. The position would have been more favourable if the Government had not allowed spending to drift upwards in recent years.** The pattern of within-year spending increases—beyond what was budgeted for—risks repeating mistakes of the past. New analysis in this report shows that three quarters of the upward spending revisions since *Budget 2017* are due to current spending. Many of these increases are long-lasting in nature. This report also shows that recent health overruns have been largely driven by hospitals, where current spending—such as wages—dominates overall spending. Repeated overruns in the health budget, averaging around €500 million annually in recent years, are undermining the sustainability of the public finances and health spending needs to be properly managed.

In recent years, large tailwinds have not been used to improve the budget balance. Yearly tailwinds have risen to an estimated €10–14 billion. Yet the deficit has only improved by €3 billion between 2015 and 2018. The tailwinds include surges in corporation tax, the reduced interest bill, as well as higher revenues and lower unemployment-related costs associated with the economic cycle.

The Government has become increasingly reliant on the surge in corporation tax receipts to fund spending. Corporation taxes are forecast to account for more than €10 billion of tax revenue, almost one-in-every-five euro of tax collected by the Exchequer. A large portion of this corporation tax is "excess", in other words, beyond what would be projected based on the economy's underlying performance and based on historical or international norms. The excess is estimated to contribute €2–6 billion to the Government's yearly revenues (1–3 percentage points of modified GNI*). The reliance on these volatile receipts leaves the government vulnerable to changes to

the global tax environment, including the OECD's Base Erosion and Profit Shifting (BEPS) initiative. It also increases exposure to firm- and industry-specific factors, given that half of receipts are accounted for by only ten corporate groups.

A prudent policy for *Budget 2020* would have seen the Government stick to its plans for 2019 and 2020 as set out in the April Stability Programme. These allowed for substantial increases in net policy spending, but at a pace below sustainable revenue growth. Such prudence was needed given the risks associated with a potential disorderly Brexit, the reliance on corporation tax, possibilities of overheating, and the rapid rise in spending between 2017 and 2019. There was a case for even more caution with *Budget 2020* owing to the risks associated with Brexit and a worsening external outlook.

For 2019, the Government did not stick to its plans and is again likely to rely on unexpected corporation tax receipts to fund spending overruns. Overruns in 2019 are forecast to be €0.7 billion. This includes €0.3 billion in health spending and the Christmas Bonus. If health spending goes beyond its forecast €0.3 billion overrun or if social welfare spending is revised upwards to reflect higher-than-expected payments in 2018, this could worsen the upward revisions to spending for the year. The health overrun comes despite an extra €1.1 billion being allocated by the Government in last year's budget (an increase of 6.6 per cent). With the overrun, the health spending increase is likely to be more than 9 per cent.

The structural budget balance based on the Department of Finance's measure has deteriorated in recent years. It is now forecast to just meet the minimum requirement set out in the fiscal rules for 2019. However, the position is flattered by excess corporation tax receipts, which may prove unsustainable.

For 2020, the Government adopted the welcome approach of offsetting overruns from 2019 in its *Budget 2020* package. The Government opted to incorporate overruns in 2019 in its budget package for 2020 and to introduce offsetting measures elsewhere on the Exchequer side. Steps like this are in line with the Council's advice in recent years. The approach helps to prevent budgetary measures from drifting up with each spending overrun. Thanks to this approach, the Government broadly stuck to its 2020 plans on an Exchequer basis. It will require spending to be tightly controlled in 2020 to deliver this plan.

However, upward revisions to spending outside of the Exchequer—where more transparency is needed—mean general government spending is forecast to expand more rapidly than previously planned. This includes planned spending by local government and by housing bodies, which should be fully incorporated in budgetary plans. *Budget 2020* implies a net policy spending increase in 2020 of €4.6 billion overall in general government terms: this is €2.1 billion higher than the Government planned in April. Within this, Brexit-related costs of about €1 billion are expected to arise only in a no-deal scenario. However, a further €0.9 billion of higher spending arises outside of the Exchequer, including in local government and Approved Housing Bodies. This is a concern as these increases impact the economy just as much as central government spending and they should be considered in budget planning. To improve budgetary planning and oversight, the Department needs to publish more information and comprehensive projections in budgetary publications on a general government basis. This should include a comprehensive "walk" of all items from Exchequer to general government data in gross terms. Currently, this is only done on a net basis.

The overall nominal increase in spending (net of new tax measures) planned for 2020, excluding Brexit measures, is now 4.4 per cent. This compares to the 3.1 per cent growth rate set out in April and is right at the limit of what could be considered sustainable for 2020. The spending revisions in other areas of the general government have taken the Budget away from the original approach of increasing spending by less than a measure of sustainable revenue growth. This would have accounted for the uncertainties facing the Irish economy by keeping budgetary increases below this benchmark. Instead, *Budget 2020* plans remove the safety margin. This narrows the scope for budgetary policy to cushion adverse shocks without raising concerns of fiscal sustainability. It also adds to activity in an already fast-growing economy.

The Government included a disorderly Brexit contingency in *Budget 2020* and suspended the first annual payments to be made to the Rainy Day Fund in 2019 and 2020. A spending contingency was allocated for sectoral supports and other measures in a disorderly Brexit scenario. While temporary measures to address a severe short-term shock can be accommodated, permanent effects should be viewed within the overall budgetary package. If the contingency were to arise, it is important that the temporary measures do not lead to long-lasting levels of higher net spending. There is a case for suspending Rainy Day Fund payments in the event of a disorderly scenario, but the case for suspending payments without the risk materialising is less convincing.

For the medium term (2021–2024), the *Budget 2020* projections suggest a return to a surplus in 2021, which gradually rises to 1.3 per cent of GNI*. The Government's medium-term spending forecasts are more realistic than they have been recently. Yet, they still rely on arbitrary technical assumptions for spending rather than Government plans or

assessments of demographic and inflationary pressures, and they do not include any public sector pay agreement beyond 2020.

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. This should tackle the economic and budgetary risks associated with reliance of government revenues on excess corporation tax receipts. Successive governments have managed to bring a large deficit to balance and to put debt ratios on a downward path following the crisis. But progress has slowed since 2015 and a clear plan is needed for the medium term to limit the risk that hard-won gains might give way to a need for forced austerity yet again. The Government should develop and implement the proposals set out in the Department's "Fiscal Vulnerabilities Scoping Paper" to reinforce its budgetary framework. Three sets of reforms—which go beyond what the Department proposes—are needed. The Government needs to: (1) use the rainy day fund and a prudence account to save temporary receipts, including saving unexpected corporation tax receipts so that they cannot be used to finance overruns in other areas; (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.

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.

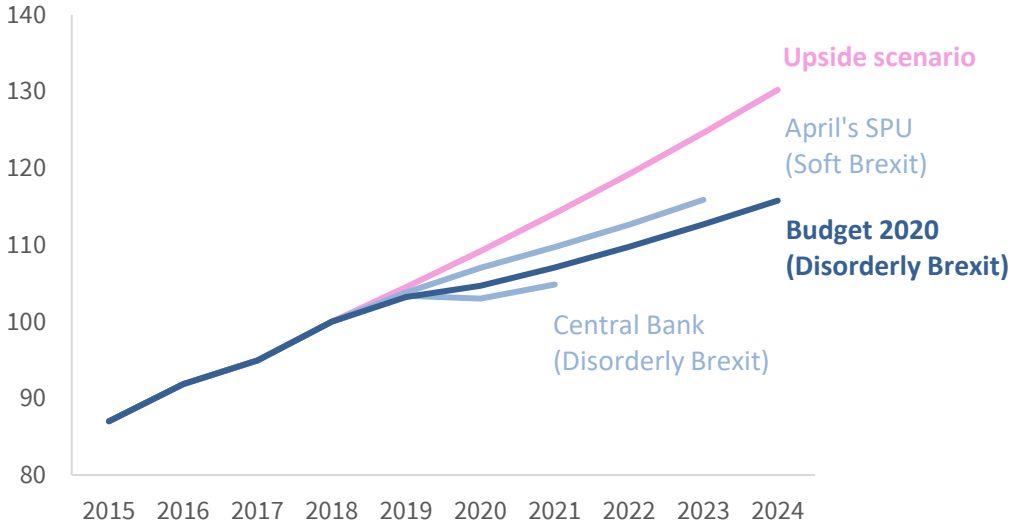
1.2 The Macroeconomic Context

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

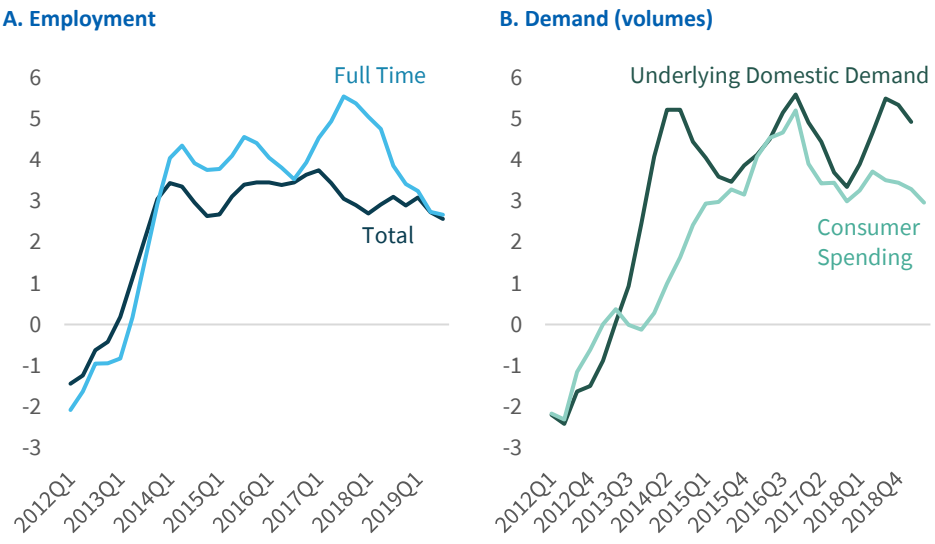
per cent higher over the long run if no Brexit were to have occurred relative to a situation where the UK leaves the EU in an orderly fashion, with a transition period, and with a free trade agreement (Bergin *et al.*, 2019; and Central Bank, 2019). The deal now being considered by the UK Government 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



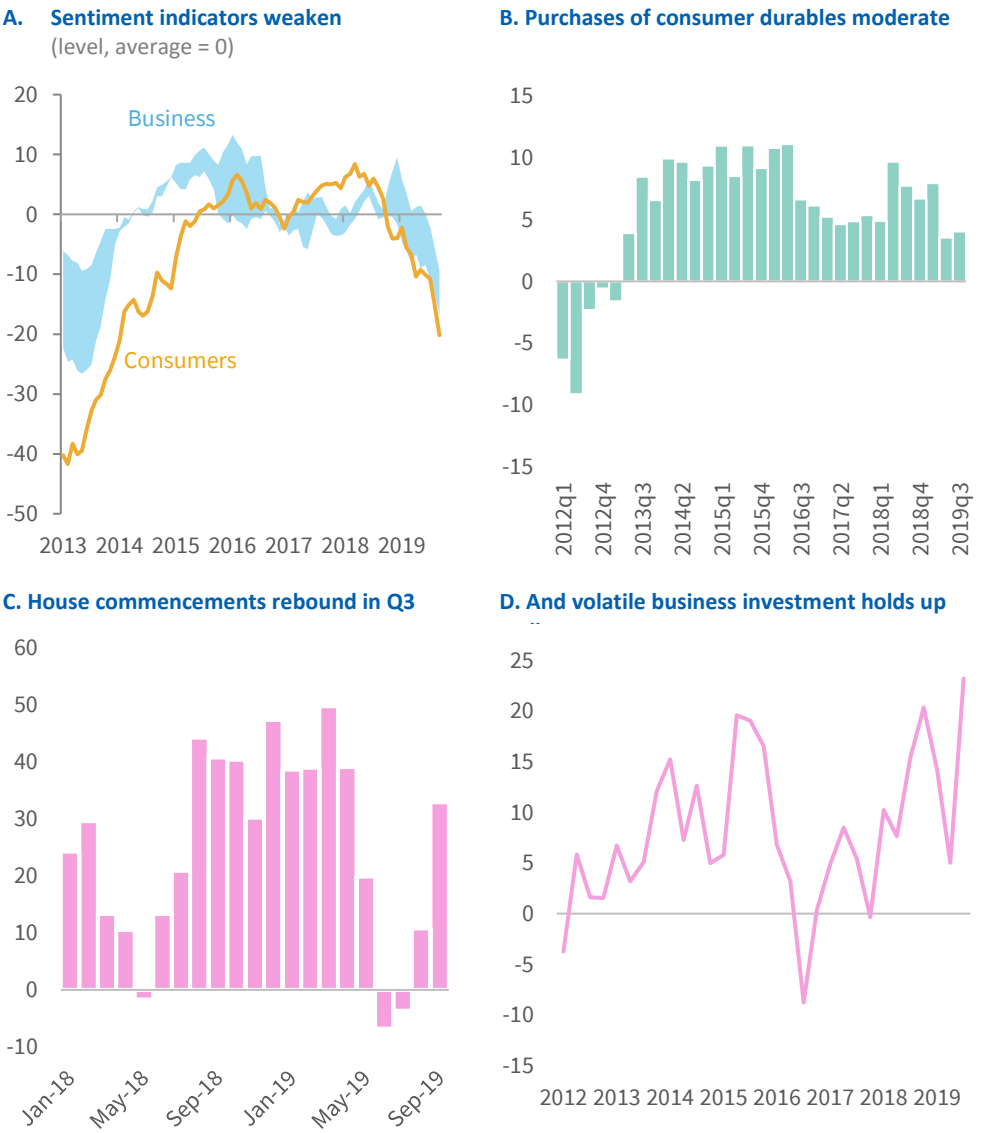
Sources: CSO; and Fiscal Council workings.
Note: Four-quarter moving averages are shown.

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



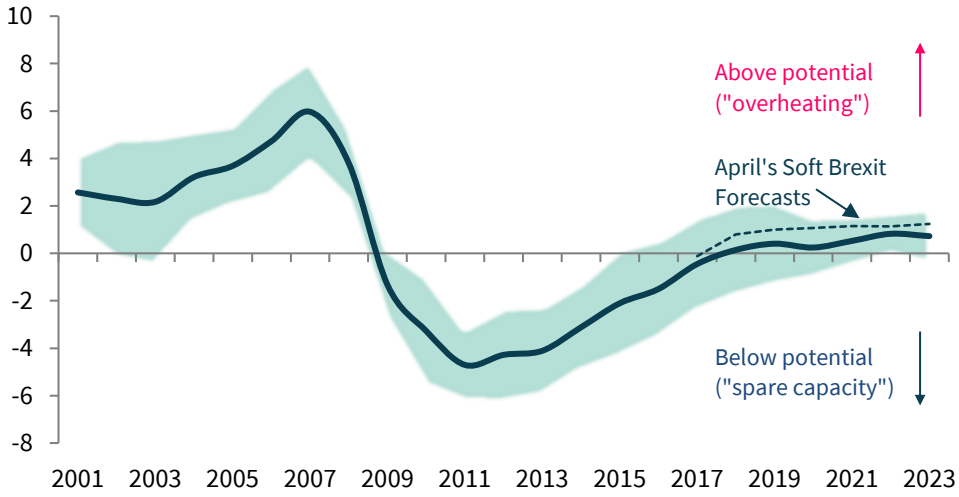
Sources: DGECFIN; KBC; Bank of Ireland; CSO; and Fiscal Council workings.
Note: Sentiment indicators are shown in terms of the difference with their four-year average (2015–2019). The "business" sentiment range uses DGECFIN Industry and Services confidence indicators as well as the Bank of Ireland business 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).

[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

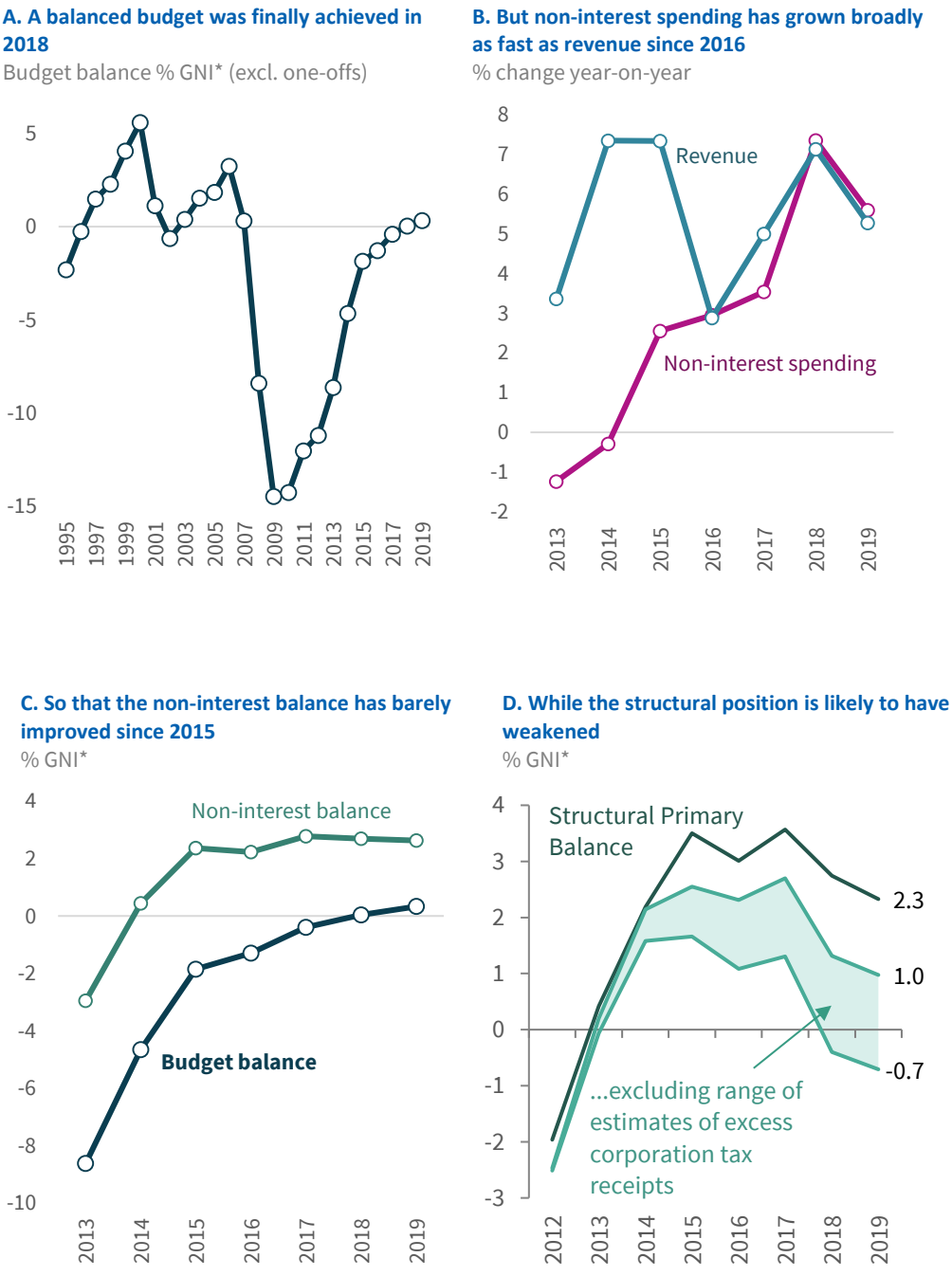
[3] Removing interest costs is useful when these: (i) reflect past decisions (i.e., the debt stock) rather than current policies; (ii) are volatile or unpredictable; (iii) are less important from an economic perspective (in Ireland's case, interest payments on government debt securities traditionally 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

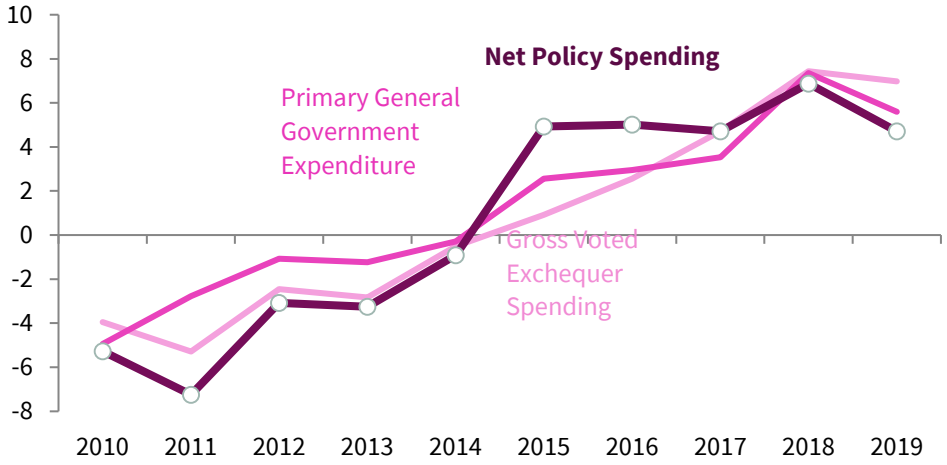


Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Revenue and non-interest spending growth and the budget balance in panel C as well as its improvement noted in panel D exclude one-offs.

[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

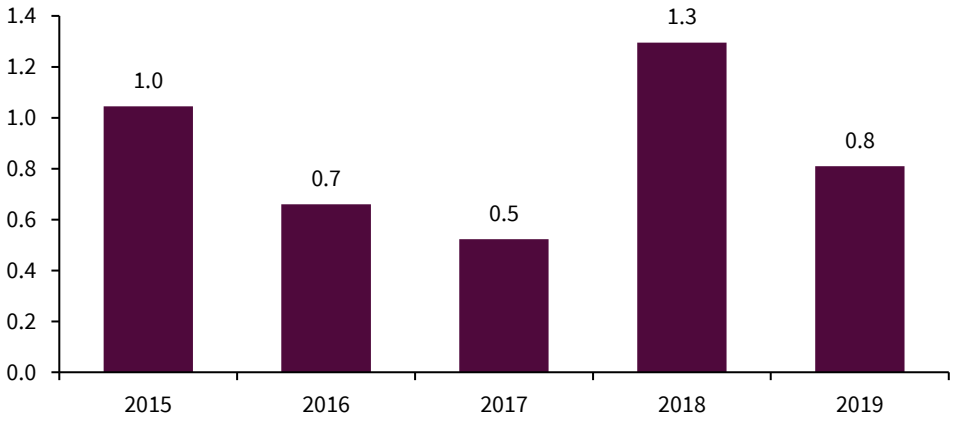


Sources: Department of Finance; and Fiscal Council workings.
Note: The estimated "excess corporation tax" receipts are the same as in Box B of the *June 2019 Fiscal Assessment Report* (Fiscal Council, 2019). Estimates are shown as a percentage of potential modified GNI*, which is obtained using the Department's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



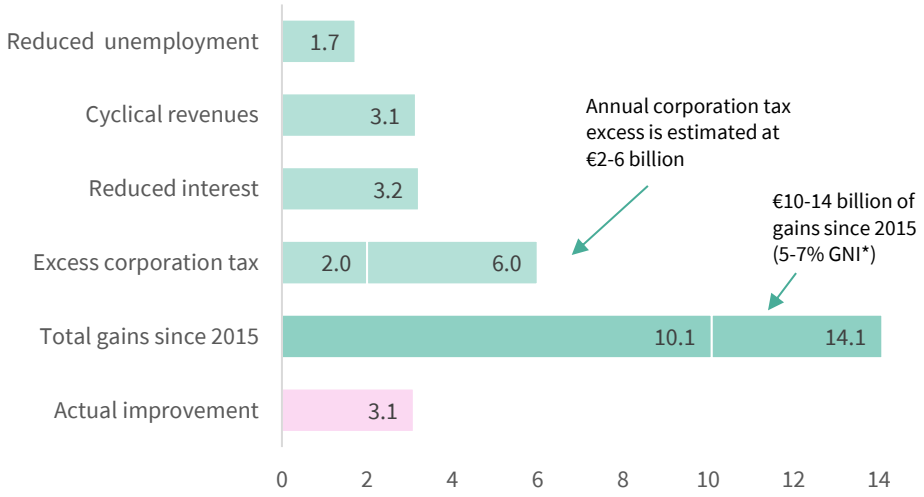
Sources: Department of Finance; and Fiscal Council workings.
Note: Within-year spending increases are based on gross voted spending outturns as compared to earlier vintages of estimates (*Budget 2015* for 2015; *Budget 2016* for 2016; *Budget 2017* for 2017; and *SPU 2018* for 2018, due to the reclassification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

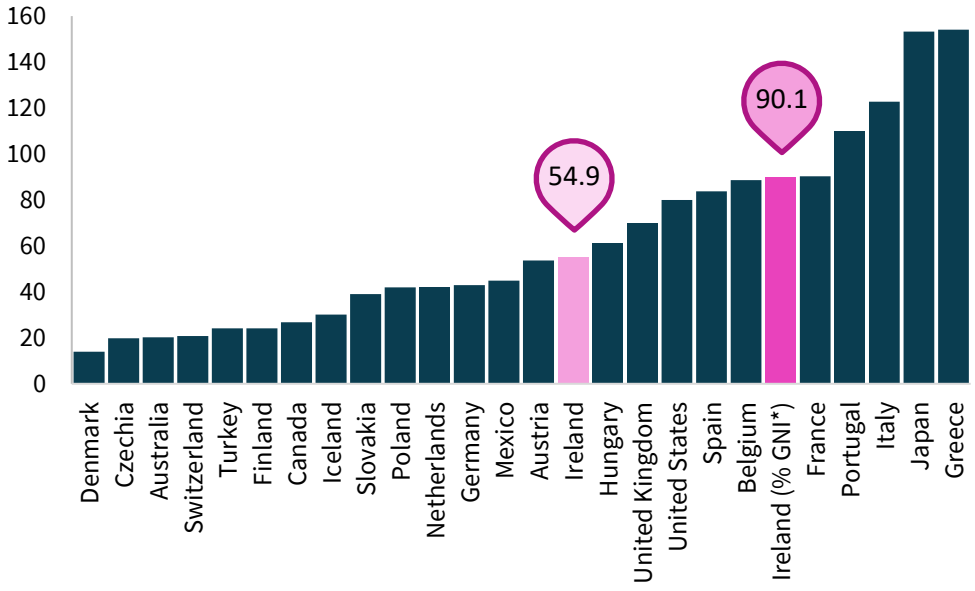
[7] Box G (June 2019 Fiscal Assessment Report) notes that revenue in 2018 was almost €6 billion higher than anticipated in *Budget 2015*. Almost €5 billion of this was due to corporation tax.

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.

[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).

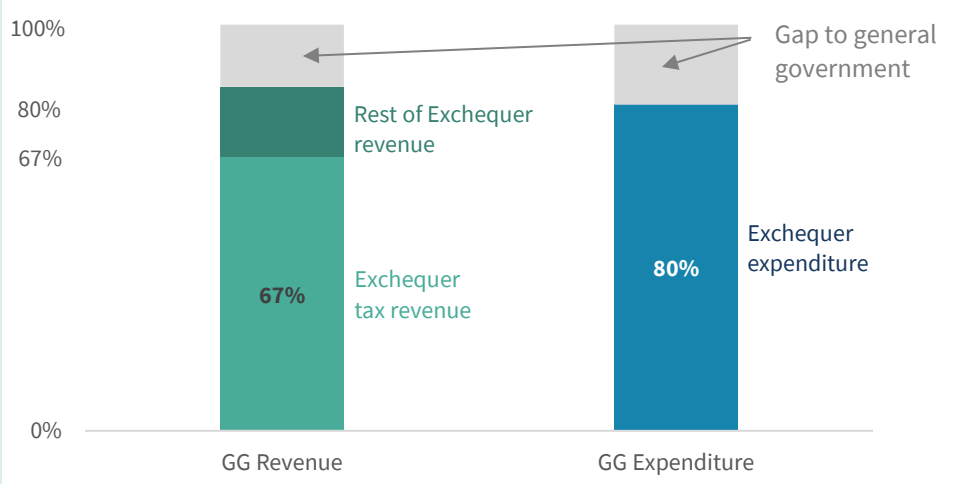
[11] Approved Housing Bodies are non-profits that provide affordable rented housing (Box L).

[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.

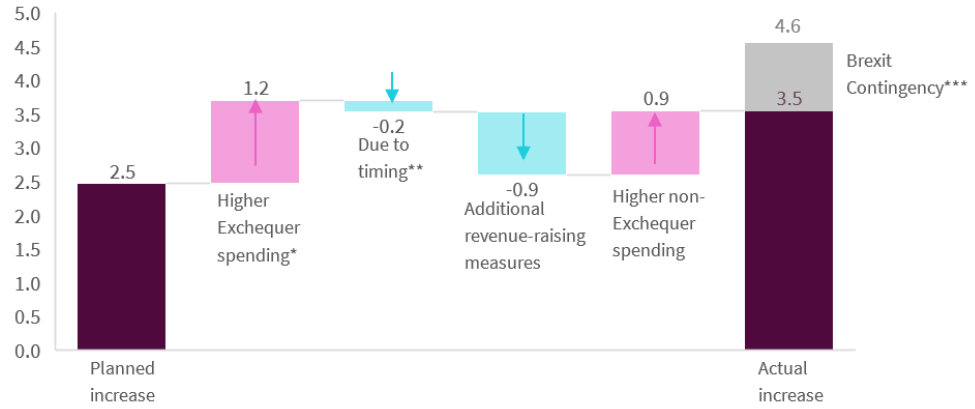
The Government's net policy spending plans for 2020 have been revised up substantially. The Government's plans for 2020 set out as recently as in April's *SPU 2019* pointed to a net policy spending increase of €2.5 billion in 2020. If the revised plans for spending in 2019 and 2020 are taken together (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.

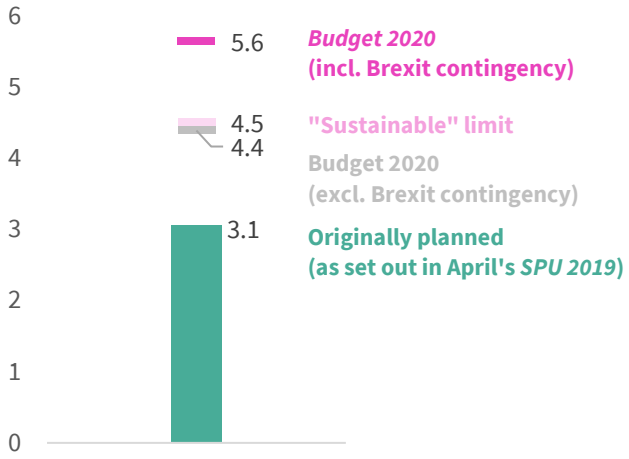
- Health spending overruns have been a common feature in recent years (averaging €0.5 billion since 2014). An overrun of €0.3 billion is expected for 2019 and there is a risk of a further overrun in 2020, given that weak planning and weak spending controls remain evident (Box I).

- 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

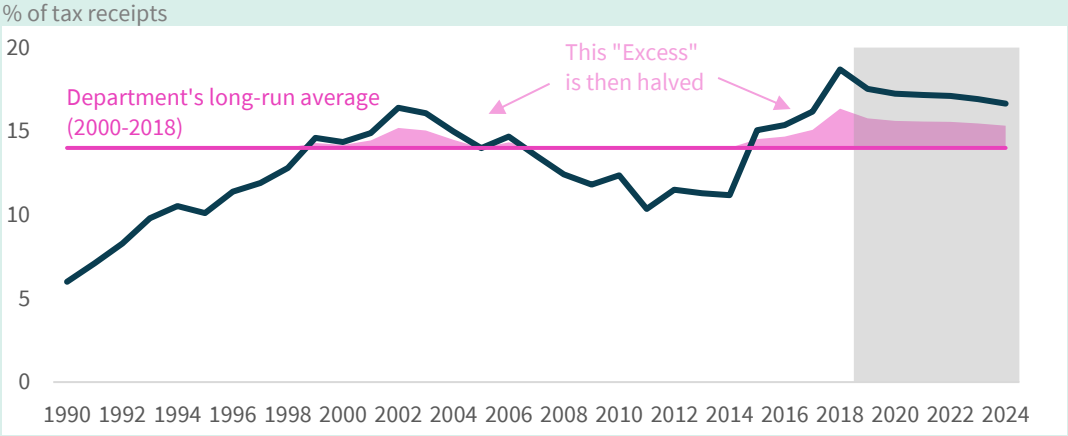
This box explores the Department of Finance's proposals to deal with vulnerabilities arising from an increased reliance on corporation tax.[22] At present, the corporation tax proposals set out by the Department are good in principle, but relatively modest in scale.

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.

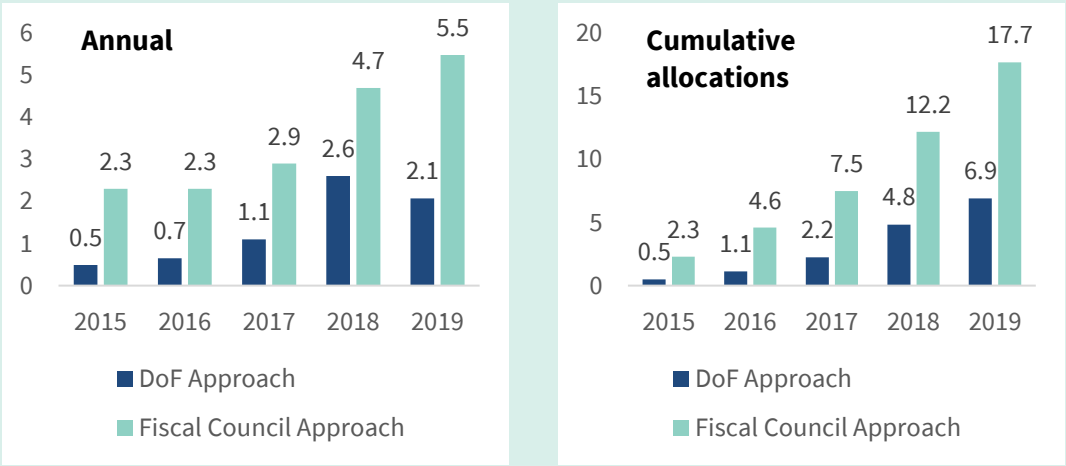
Comparison with the Council's proposals

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.

Chapter 2

Endorsement and Assessment of the Macroeconomic Forecasts

2. Endorsement and Assessment of the Macroeconomic Forecasts

Key messages

- The Department of Finance's *Budget 2020* macroeconomic forecasts show a slowdown in economic activity in the short term, followed by a recovery towards long-run potential growth. While the Council assessed this forecast to be within an endorsable range, the outlook for the Irish economy remains unusually uncertain, with overheating still possible. The risk of a more adverse scenario following a disorderly Brexit has not entirely dissipated.

- The Budget forecasts were appropriately prepared on the basis of a disorderly UK exit from the EU, given the risks and potential impact. The forecasts were informed by simulations undertaken with the COSMO model of the macroeconomy. While this provides a good framework to assess the longer-term impact, the short-run scenario may not incorporate all disruptions and hence may be somewhat too benign. For example, following a disorderly Brexit, the unemployment rate is forecast to be 0.6 of a percentage point higher in 2020 relative to an orderly-deal scenario.

- Although the likelihood of a disorderly Brexit has reduced, the Council highlights that there could be considerable downside risks to the Budget's disorderly Brexit scenario due to several factors, including the labour-intensive nature of the trading relationship between the UK and Ireland. This chapter shows how economic downturns can be characterised by severe impacts on the domestic economy. Further analysis in this chapter assesses the relationship between falling consumer and business sentiment indices and relevant measures of real economic activity. However, the analysis shows that sentiment has a mixed track record as a leading indicator of future falls in economic activity.

- The forecasts for government consumption in *Budget 2020* rely on expenditure projections that are not well anchored to known pressures, including population growth and demographic changes. As a result, persistent positive forecast errors (outturns greater than forecast) have been noted in previous Council publications. There is also an inconsistency between how nominal and real spending are projected.

2.1 Introduction

The Council's endorsement exercise covered short-term macroeconomic forecasts prepared by the Department of Finance for 2019 and 2020 reflected in *Budget 2020*, based on the prudent and appropriate assumption of a disorderly UK exit from the EU. As the identification of risks to the economy requires careful and continuous analysis, the Council monitors developments in the Irish economy, and the economies of Ireland's main trading partners, on an ongoing basis.

Although the central scenario of a disorderly Brexit was not necessarily more likely than not to occur at the time of the endorsement, and its likelihood has diminished in the intervening period, the negative impacts of any form of Brexit—not only a disorderly Brexit—could be more severe than shown in *Budget 2020* forecasts. The historical experience of Ireland and comparable European countries with downturns presented in Box D provides context for a possible less-benign impact of a disorderly Brexit, and Box E considers the recent declines in consumer and business sentiment, and the possible implications for future activity. Box F at the end of this chapter briefly investigates the relative performance of the Council's Benchmark forecasts and a new methodology applying a large Bayesian vector autoregression (LBVAR) model.

2.2 Endorsement of *Budget 2020* Forecasts

The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in September 2019 (see Appendix B for the endorsement timeline details).[27] The short-term macroeconomic forecasts produced by the Department and contained in *Budget 2020* for 2019 and 2020 were judged as being within an endorseable range, taking into account the methodology and plausibility of the judgments made.

The endorsement process entails three aspects: the appropriateness of the methodology used, the pattern of recent forecast errors, and comparisons with the Council's benchmark projections and other forecasts. This section then concludes with an overview of macroeconomic risks that could contribute to divergence between the Budget's forecasts and eventual outturns.

Methodology

The Council is satisfied that the Department's approach to macroeconomic forecasting broadly conforms to that of other forecasting agencies. For the demand-side macroeconomic forecasts, the methodology continues to produce reasonably accurate short-term (in-year and year-ahead) forecasts of underlying domestic demand—that is, domestic demand excluding investments in aircraft and intangibles. This is shown in Figure 2.1 in the June 2019 *Fiscal Assessment Report* (Fiscal Council, 2019c).

However, Ireland's exports and imports are more difficult to forecast accurately, given the distortions to the data caused by multinational firms. Furthermore, the coherence of some aspects of the Department's forecasts, in particular over the medium term, could continue to be further improved. As discussed later in this chapter, the forecast of a fall in the savings ratio over 2021–2024 may not be consistent with higher precautionary savings resulting from a disorderly Brexit.

The Council has noted several issues regarding the *Budget 2020* forecasts for government net consumption. Over the medium term, the forecasts rely on

[27] The statutory function is detailed in Fiscal Council (2013) and Fiscal Council (2014a). Benchmark projections prepared by the Secretariat form a key part of the endorsement process. An important input into the preparation of the benchmark projections involves rounds of discussions with other external forecasters. The Secretariat met with the European Commission and statisticians from the CSO to gain further insights into recent data releases.

expenditure projections that are not well anchored to known spending pressures, such as a growing population and changes in the demographic profile. Furthermore, the Department forecasts growth in the government consumption deflator—which includes the effect of public sector wage growth—to turn negative for 2021–2024. This is highly implausible and appears to reflect a methodological issue arising from the use of inconsistent nominal and volume government consumption forecasts, whereby government spending volumes grow at a reasonable rate but nominal spending growth is implausibly low (1.2 per cent on average for 2021–2024).

Compared with April's *Stability Programme Update 2019* (*SPU 2019*), the Government made the decision to prepare *Budget 2020* based on assumption of a disorderly UK exit from the EU, without a withdrawal agreement. Although the Budget forecasts were finalised in September, the UK government and the EU later reached a new withdrawal agreement in mid-October. As the Budget occurred before the EU had granted a further Article 50 extension to end-January 2020 and at a time when UK policy was very uncertain, the Government's approach was prudent and appropriate given the likelihood and potential impact of a disorderly exit.[28]

Budget forecasts were formulated by first updating the *SPU 2019* figures based on no change in the assumption regarding Brexit—that is, assuming an orderly exit with a withdrawal agreement in place, including provisions for a transition period until end-2020. This scenario was then updated to reflect the output of ESRI/Department of Finance research (Bergin *et al.*, 2019), in which the impacts of a disorderly Brexit scenario were modelled using the ESRI's COSMO medium-term macroeconomic model of the Irish economy.

Bergin *et al.* (2019) include various caveats to their analysis, some of which are described in Table 2.1.[29] Overall, the Council assesses that these caveats imply a significant degree of downside risk for the estimated impact of a disorderly Brexit on the Irish economy, relative to the *Budget 2020* forecasts—if a disorderly Brexit occurs.

[28] The deal has not yet been passed in legislation and the UK general election in December could increase or decrease the likelihood that the UK parliament ratifies the new withdrawal agreement.

[29] The Department notes that the euro-sterling exchange rate is not the same as that shown in Table 2 of the *Budget 2020 Economic and Fiscal Outlook*, as the assumption of a disorderly Brexit "necessitat(es) an element of judgement when compiling the external demand assessment".

Table 2.1: Caveats to COSMO-based estimates of the potential impact of Brexit on the Irish economy

Caveat	Description
Trade	The timing and severity of changes in trade patterns may differ from the assumptions reflected in Bergin *et al.* (2019), and those reflected in *Budget 2020*, in the event of a disorderly Brexit. Non-UK trade flows could also be disrupted due to a disorderly Brexit.
Supply-chain effects	The absence of supply-chain effects from the model could mean the model underestimates the impact of a disorderly Brexit on the Irish economy.
Labour market	A disorderly Brexit could result in sharper declines in employment, as Brexit is modelled as a typical trade shock, whereas the labour intensity of UK demand is often greater than for an average trading partner. This reflects the relative importance of the UK market to Irish-owned firms involved in labour-intensive activities, such as agri-foods exports (Lawless and Morgenroth, 2019). A modest 0.6 percentage-point increase in the unemployment rate is forecast in 2020 in the event of a disorderly Brexit, compared to the deal-counterfactual scenario—this could prove too benign.
Fiscal policy	The model excludes any response to Brexit in terms of government spending. The inclusion in *Budget 2020* of "Brexit contingency" expenditure implies possible upside risk to short-term growth forecasts. Previous Council analysis (Fiscal Council, 2019c) using the Fiscal Feedbacks model that indicates a more severe negative impact of Brexit on the public finances could occur. This may result in more challenging trade-offs for the Government if large and persistent deficits occur, as a rising debt ratio implies a limited capacity for lasting fiscal support.
Potential growth	Brexit could negatively impact Ireland's potential growth rate. Estimated impacts on Ireland's output are presented as a level shock, and growth rates are not explicitly impacted over the long run. However, Brexit can also be viewed as representing a shock to long-run or trend growth rates (Fiscal Council, 2017e). This would be consistent with Irish exporters facing significant challenges in diversifying to other markets after Brexit, and the existence of a relationship between potential economic growth and an economy's openness to trade, capital and labour market flows.

Sources: Bergin et al. (2019); and Fiscal Council (2017e, 2018e).

Pattern of recent forecast errors

The Council notes a pattern of generally positive errors in forecasts of underlying domestic demand since 2013—that is, outturn growth rates have often been higher than those forecast. In Chapter 2 of the June 2019 *Fiscal Assessment Report* (Fiscal Council, 2019c), government net consumption has been identified as the one clear source of persistent positive forecast errors in underlying domestic demand. This highlights the need to use more realistic assumptions for government spending to present the most accurate forecast of future macroeconomic developments.

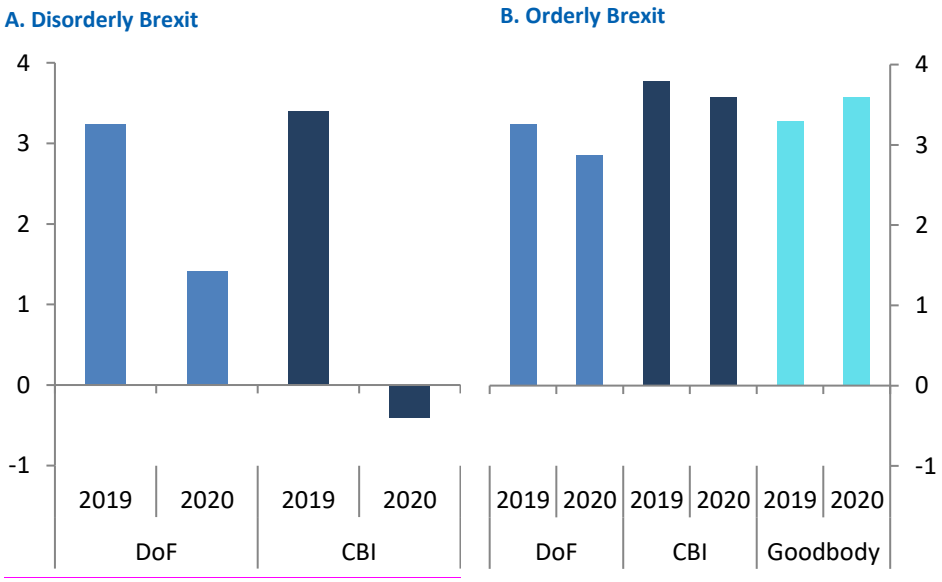
Forecasts of exports, particularly services exports, have also been lower than outturns over time, and by a considerable magnitude. For example, outturns for services exports have been 5.7 percentage points higher than in-year forecasts on average for the period 2014–2018 (12.8 per cent versus 7.1 per cent forecast), despite these forecasts taking place at Budget time in October of the forecast year. Data revisions to the quarterly national accounts explain some of this, and these components are inherently difficult to forecast given on-going structural changes.

Comparison with other projections

The Council's benchmark projections are presented in Appendix C. There are minor differences between the benchmark projections and the Department's macroeconomic forecasts. The benchmark projections anticipate a slightly slower growth rate than *Budget 2020* for 2020–2024; the average difference in underlying domestic demand growth is 0.3 of a percentage point, assuming a disorderly Brexit takes place. This difference includes broadly offsetting contributions of faster growth in personal consumption and slower growth in underlying investment.

Figure 2.1: Forecasts of underlying domestic demand

Year-on-year percentage change in volumes



Sources: Department of Finance, *Budget 2020*; Central Bank of Ireland, *Quarterly Bulletin No 4 2019*; Goodbody Stockbrokers, November 2019.

Figure 2.1 compares recent short-term forecasts for real underlying domestic demand in 2019 and 2020, for both disorderly Brexit (panel A) and orderly Brexit (panel B) scenarios. *Budget 2020* projects that a disorderly Brexit results in lower underlying domestic demand growth of 1.8 per cent. The Central Bank of Ireland

estimates a more severe impact with a decrease in growth of 4 percentage points, to −0.4 per cent.

Macroeconomic risks

The medium-term outlook for the Irish economy is unusually uncertain (see Chapter 1), with clear possibilities for both upside performance (due to overheating) and realisation of various downside risks. Besides the risk of a more adverse scenario under a disorderly Brexit, the current downside macroeconomic risks include continued escalation of protectionist measures involving the world's largest economies, the onset of a cyclical downturn in Ireland's main trading partners, and the possibility that continued easing in monetary conditions could lead to a build-up of financial vulnerabilities. Table 2.2 reviews the macroeconomic risks described by the Department in *Budget 2020*.

Table 2.2: Assessing the *Budget 2020* macroeconomic risk matrix

Likelihood (L) and Impact (M) are from *Budget 2020*, unless stated (red=high; pink=medium; grey=low)

L	M	
		Deeper global slowdown: Forecasts for global growth have been revised downward in 2019. A more protracted slowdown could negatively impact Ireland's exports, with potential implications for incomes and employment creation.
		Larger impacts of a disorderly Brexit: Although the Budget forecasts reflect a scenario involving a disorderly Brexit, such a unique shock to economic growth as Brexit is very difficult to accurately forecast, and the impacts on the Irish economy could be more severe than projected.
		Disruption to world trade: Related to the risk of a deeper global slowdown, an increased risk of protectionist trade policies may have a negative impact on worldwide trade flows. In 2019, Ireland has been impacted by tariffs as a result of a trade dispute between the EU and the US.
		Geopolitical factors: While geopolitical factors have little direct impact on Ireland, second-round effects of wider global tensions on world trade could be significant.
		Loss of competitiveness: Domestic sources of possible competitiveness losses include wage pressures and rising rents in commercial and residential properties. One possible external source of a loss in competitiveness is a shock to exchange rates.
		Inappropriate monetary policy (Fiscal Council risk): Monetary policy is set by the European Central Bank. If a disorderly Brexit is avoided, growth in Ireland is forecast to continue to outperform the euro area. This scenario could mean a looser monetary policy than would be ideal for Ireland. This could amplify the business cycle, as occurred prior to the last crisis.
		Housing supply pressures: A supply response would be expected to moderate price growth, and year-on-year price changes in Dublin began to decline in August 2019. Excess demand can be harmful for competitiveness and labour mobility, while a construction boom with output nearing potential could exacerbate the risk of overheating risk.
		Concentrated production base: The Irish production base is concentrated in a small number of sectors. As a result, sector- or firm-specific shocks could pose wider risks for the economy.
		Overheating risk: Overheating could occur in the Irish economy even without significant credit growth. A persistently strong economic growth rate when the economy is operating near its potential output means there is a risk of overheating if rapid growth rates continue.
		Inappropriate domestic policy (Fiscal Council risk): Ireland has fewer levers for managing the domestic economy. Two main domestic policy tools are fiscal policy and macroprudential policy. These may need to play an active role in preventing overheating, although they may also provide support to the economy in a downturn.

Sources: Department of Finance, *Budget 2020*; and Fiscal Council assessment.

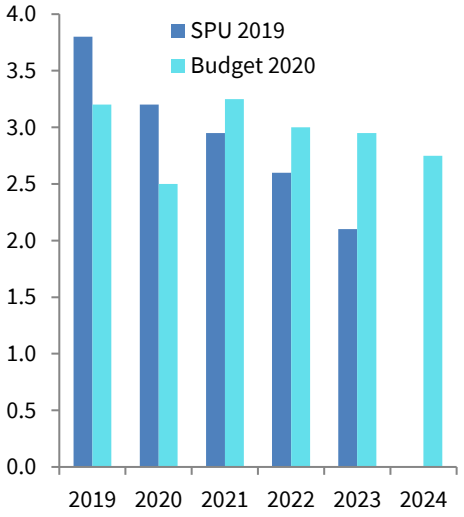
2.3 Assessment of the *Budget 2020* Macroeconomic Forecasts

Macroeconomic context

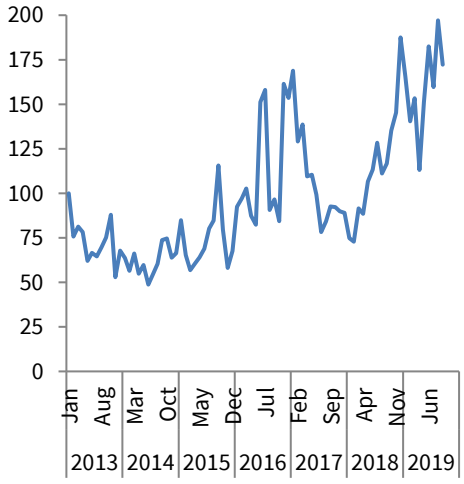
Budget 2020 forecasts incorporate an anticipated short-term weakening of demand in Ireland's main trading partners, as shown in Figure 2.2A. An increase in trading frictions and protectionist measures among the world's largest economies (US and China), in combination with the prospect of a disorderly UK exit from the EU, and uncertainty in monetary policy, are reflected in an elevated level of global economic policy uncertainty (Figure 2.2B). A slowdown in Euro Area manufacturing and services is suggested by high-frequency indicators such as purchasing managers' indices. This slowdown has also been evident in some quarterly macroeconomic data releases in recent months, although as of yet there has been no adverse impact on growth rates in employment or earnings.

Figure 2.2: World demand weaker with rising policy uncertainty

A. World demand forecasts
Year-on-year percentage change



B. Global economic policy uncertainty
January 2013 = 100



Sources: Department of Finance, *Budget 2020* Macroeconomic Outlook and Projections (Presentation to Irish Fiscal Advisory Council, slide 26); and www.policyuncertainty.com.

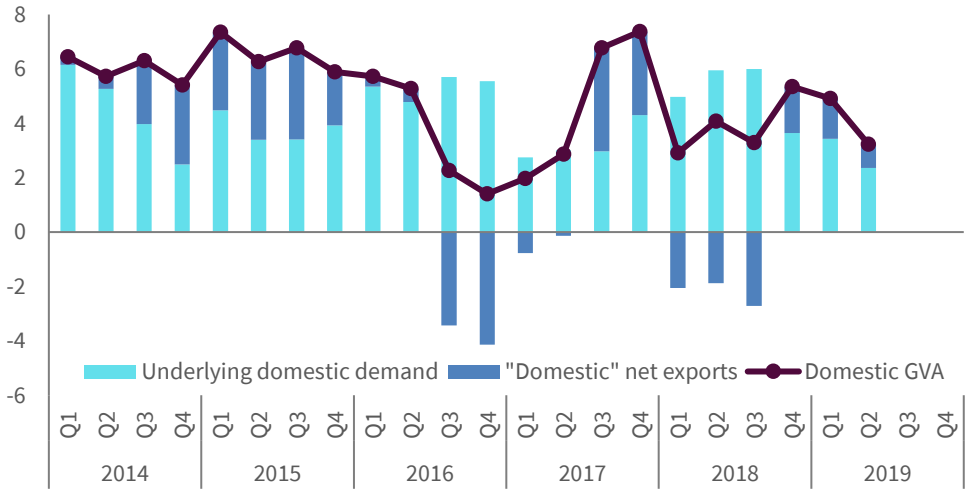
A slowdown in world demand could significantly affect the Irish economy given its strong dependence on trade—however, the current shock to global trade has so far been concentrated in activities where Ireland has lower exports exposure. Headline Irish exports increased by 10.4 per cent in 2018 and reached 201 per cent of modified gross national income, and the majority relate to sales by multinational firms whose strong performance has continued in 2019. For example, exports of computer services increased by close to one third in the first half of the year

compared with the same period in 2018, whereas pharmaceuticals exports (NACE codes 51 and 54) are 10.3 per cent higher for January–September. While many of these firms operate in industries which are less cyclically sensitive to global demand, domestic Irish exporters are generally far more exposed to such effects.

One way to estimate the contribution of net exports by domestic firms to economic growth is to subtract underlying domestic demand (excluding investments in aircraft and intangibles) from gross value added that is not dominated by multinational firms (whose turnover is over 85 per cent of a sector's total)—that is, "domestic" GVA. As shown in Figure 2.3, this highlights the part of domestic value added that is explained by underlying domestic activity and the part that is explained by "domestic" net exports. This measure of domestic net exports explains much of the variation in the growth of domestic production over recent years, including the slowdown in the second half of 2016—possibly in response to the UK voting to leave the EU—and acted as something of a drag on growth in 2018.

Figure 2.3: "Domestic" net exports have contributed less to economic growth since the Brexit vote in mid-2016

Year-on-year percentage change in volumes



Sources: CSO; and internal Fiscal Council calculations.
Note: "Domestic" net exports are estimated as the difference between non-multinational-dominated gross value added and underlying domestic demand (excluding investments in aircraft and intangibles). Council estimates of aircraft and intangibles are used for Q2 2019 as the data were not published in the Quarterly National Accounts due to confidentiality issues.

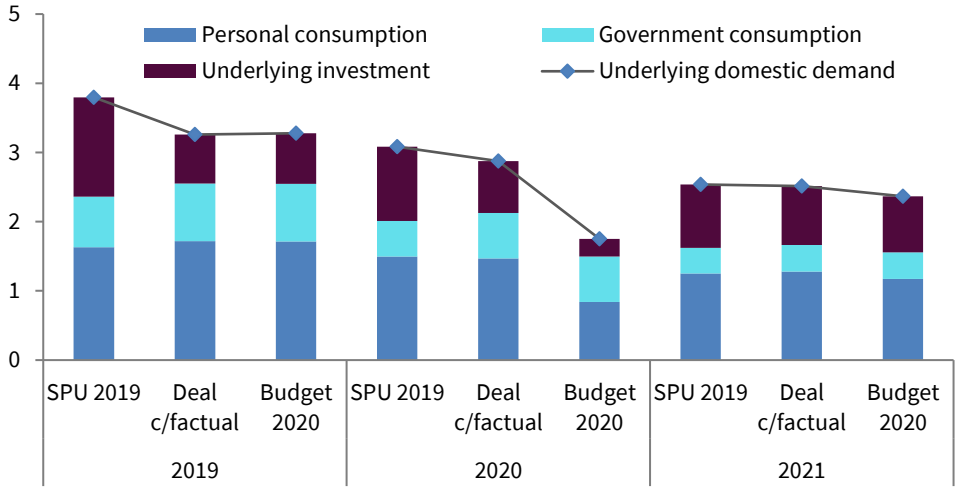
Budget 2020 short-term forecasts

In an orderly Brexit scenario, the underlying domestic demand growth projections in *Budget 2020* would have been slightly slower than in April's SPU. Figure 2.4 presents the changes to the *SPU 2019* forecasts reflected in *Budget 2020* for underlying domestic demand and its components. This shows the estimated

impacts to April's short-term outlook of updated forecasts reflecting a "deal-counterfactual" scenario, and of a disorderly Brexit.[30]

Figure 2.4: Changes to *SPU 2019* short-term forecasts for underlying domestic demand and its component contributions

Year-on-year percentage change and percentage points



Sources: Department of Finance; and internal Fiscal Council calculations.
Note: Underlying investment growth in 2021 is assumed unchanged compared to *SPU 2019*.

The impact of a disorderly Brexit is evident in a near-halving of the 2020 growth forecast for underlying domestic demand, to 1.8 per cent in *Budget 2020*. A far more modest reduction in growth as a result of a disorderly Brexit of 0.15 of a percentage point is forecast for 2021.[31]

Table 2.3 details the Budget's short-term forecasts with both orderly and disorderly Brexit scenarios included for 2020. A disorderly Brexit reduces personal consumption growth by 1 percentage point, and underlying investment growth by 2.4 percentage points, with downward revisions also for growth in employment and the labour force. Gross domestic product growth is forecast to slow to 0.7 per cent in 2020, down from 3.1 per cent in the deal-counterfactual scenario. This forecast is particularly affected by slower growth in exports of 0.9 per cent, driving a negative contribution to growth of underlying net exports. The shock is also reflected in a return to a negative estimated output gap in 2020, compared to output 0.8 per cent above potential as shown in April's SPU (see Figure 2.5).

[30] Although the "deal-counterfactual" scenario could prove to be a more likely outcome, a disorderly Brexit remains possible. Furthermore, the current deal reflects less favourable trading arrangements for Ireland than under the previous withdrawal agreement.
[31] 2021 was not included in the Council's endorsement exercise for *Budget 2020*.

Table 2.3: *Budget 2020* macroeconomic forecasts (to 2020)

Percentage change in volume, unless stated

	2018[a]	*2019*	Disorderly Brexit *2020*	Orderly Brexit *2020*
Demand				
Underlying domestic demand[b]	5.3	3.3	1.8	2.9
GDP	8.2	5.5	0.7	3.1
…of which (contributions)				
Underlying domestic demand[c] (p.p.)	*2.7*	*1.7*	*0.8*	*1.5*
Underlying net exports[c] (p.p.)	*5.5*	*3.7*	*−0.1*	*1.7*
Personal consumption	3.4	2.7	1.4	2.4
Government consumption	4.4	4.5	3.5	3.5
Investment	−21.1	50.4	−24.0	−22.4
Underlying investment[b]	13.0	3.8	1.3	3.9
Exports	10.4	10.2	0.9	4.2
Imports	–2.9	22.6	–6.5	–4.7
Underlying imports[b]	6.5	11.7	1.6	4.8
Supply				
Potential output	5.3	4.0	2.0	N/A
Output gap (% of potential output)[d]	−0.2	1.0	−0.3	N/A
Labour market				
Population	1.4	1.3	1.2	N/A
Labour force	1.8	1.8	1.4	N/A
Employment	2.9	2.4	0.8	1.7
Unemployment rate (% labour force)	5.8	5.2	5.7	5.1
Prices (year-on-year percentage change)				
HICP	0.7	0.9	1.3	1.2
Personal consumption deflator	1.8	1.7	1.7	N/A
GDP deflator	0.8	0.4	1.6	1.9
Other				
Nominal GNI*	7.3	2.9	0.2	N/A
Nominal GDP	9.1	5.9	2.4	5.2
Nominal GDP (€ billion)	324.0	343.2	351.4	364.0
Modified current account (% of GNI*)	6.6	5.2	2.4	N/A

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

Notes: [a] Denotes latest outturns from the CSO.

[b] Underlying (final) domestic demand, investment and imports exclude other transport equipment (mainly aircraft) and intangibles. For the orderly Brexit scenario in 2020, the growth rate in modified investment is used as a proxy for underlying investment.

[c] Underlying contributions to real GDP growth rates in percentage points. Underlying net exports include the effect of the change in inventories and exclude the effect of investment in aircraft and intangible assets.

[d] The output gap and potential output estimates used here are the Department's GDP-based alternative estimates.

Budget 2020 forecasts show continued growth in underlying domestic demand, despite the impact of a disorderly Brexit. However, the main risks to this outlook are

to the downside, as discussed in relation to the Department's methodology, and the caveats to the estimated impacts of a disorderly Brexit (Table 2.1).

Given the significant uncertainty surrounding the forecasts, it is important to consider the possible impacts of a less benign scenario due to a disorderly Brexit—or an orderly Brexit with less benign impacts than currently envisaged in the Budget forecasts. Box D analyses downturns in domestic economic activity in Ireland and comparable European countries over the past six decades, and finds that investment declines have been particularly severe manifestations of downturns in Ireland. Although a downturn is not forecast following a disorderly Brexit, the historical experience of downturns provides context for possible impacts on the domestic economy and labour market if a less benign scenario were to materialise.

With the decline in 2019 of high-frequency consumer and business sentiment indicators for Ireland, it is relevant to query whether sentiment can provide advance warning of a forthcoming slowdown in the economy. The analysis in Box E suggests that the relationship between sentiment indicators and real economic activity has historically not been very strong, with signals often mixed. For example, in contrast to the sentiment data, other indicators of economic activity such as the quarterly national accounts and retail sales have held up quite well so far in 2019. This matches findings elsewhere: for example, Stock and Watson (2003) find that US consumer confidence declined sharply before and during the 1990 recession, yet it maintained strength well into the 2001 recession.

Box D: Characterising downturns in Ireland's domestic economy

Budget 2020 forecasts a slowdown in economic growth for Ireland in 2020. However, as discussed in this chapter, a great deal of uncertainty surrounds short-term forecasts of economic growth in a disorderly Brexit. With a view to quantifying possible downside risks to the Budget forecasts, this box considers how downturns have historically manifested in relevant indicators of economic activity, for Ireland and comparable European countries.

Methodology

Downturn episodes in Ireland and a group of small European countries are analysed using 59 years of European Commission AMECO data (in volumes) for personal consumption, investment, employment, and (HICP-deflated) compensation of employees.[32] A standardised definition of a downturn episode in final domestic demand (excluding stocks) is taken as an

[32] Latest CSO data are used for Ireland, and investments in aircraft and intangibles are excluded from Ireland's gross fixed capital formation data since 1995, due to their high import content and association with activities of multinational enterprises.

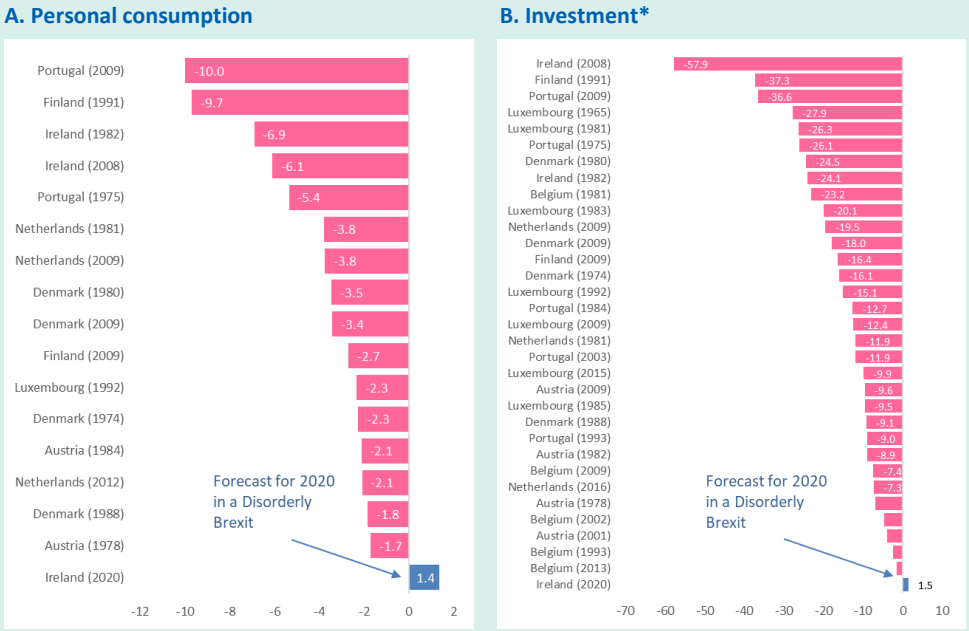
annual growth rate that is one standard deviation below the country-specific long-run average. Downturn impacts are then calculated as peak-to-trough falls in the four variables listed above for up to seven years around each downturn year—that is, from year *t-1* to *t+6* for a downturn in year *t*. This approach to assessing the impacts of downturns is very mechanical, however, and does not account for different causes of downturn episodes across countries.

What happens to personal consumption and investment in downturns?

Figure D.1 presents the performances of personal consumption and investment (gross fixed capital formation) during domestic downturns in Ireland and comparable European countries. The two panels show a typical feature of business cycles: investment is more sensitive to downturns than personal consumption, which is evident in both the relative size of the impacts and the relative number of episodes.

Figure D.1: Investment falls by more than consumption in downturns

Peak-to-trough percentage change in volume; country and first year of downturn episode



Sources: European Commission, AMECO database; CSO; and internal Fiscal Council calculations.
Notes: Downturns are defined as growth in final domestic demand (excluding stocks) one standard deviation below its long-run (1961–2018) average. Bars show peak-to-trough percentage change from years *t-1* to *t+6*, with a downturn occurring in year *t*.
*The latest CSO data are used for Ireland for 1995–2018, and underlying investment (excluding investments in aircraft and intangibles) is used instead of unadjusted gross fixed capital formation.

The most severe investment downturn in the sample took place in Ireland during the recent crisis period, when underlying investment fell 57.9 per cent between 2008 and 2012. Personal consumption in Ireland fell 6.9 per cent in 1982, which is its worst peak-to-trough decline since 1960, and later fell by 6.1 per cent during the recent crisis period (2009–2013).

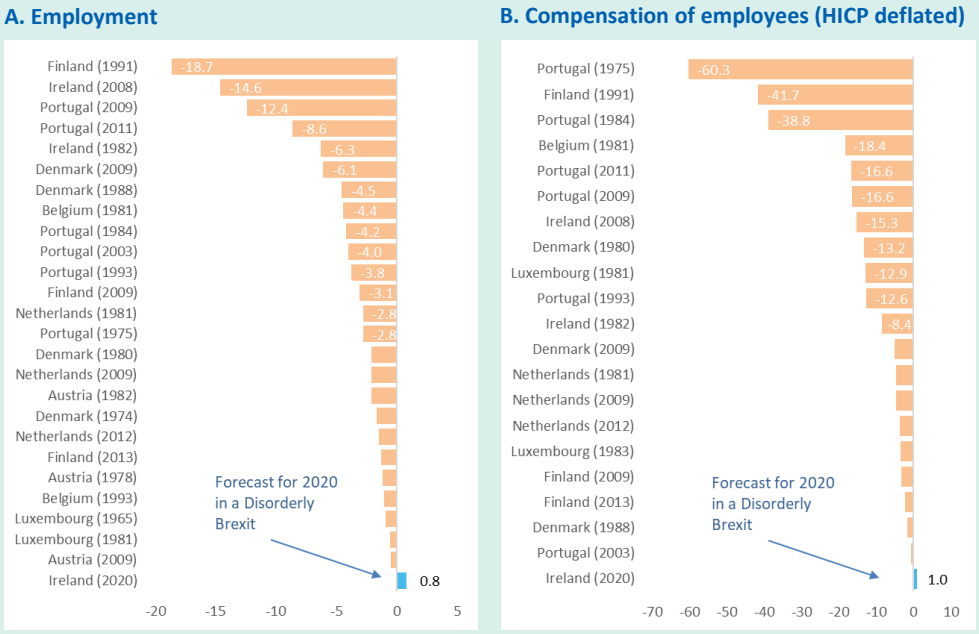
Despite the assumption of a disorderly Brexit, *Budget 2020* forecasts growth in underlying domestic demand in 2020 of 1.4 per cent. This does not meet the criteria for a "downturn" as defined in this box, as one standard deviation below the 1961–2018 average involves a fall of 0.5 per cent. However, the risk of a more adverse impact is illustrated by the range of episodes experienced in comparable European countries—based on which, the average reduction in personal consumption is 4.2 per cent, and 16.6 per cent for investment. As noted previously, this analysis does not attempt to account for differences in the causes of downturns across countries and over time, and instead mechanically compares episodes in a broader sense.

What happens to employment and employees' wages in downturns?

Figure D.2 shows corresponding labour-market impacts of downturns in Ireland and similar European countries. Ireland's largest downturns have severely impacted employment and real compensation of employees, although impacts have been worse elsewhere, for example in Finland (for employment) and Portugal (for wages). While *Budget 2020* does not forecast a downturn episode in 2020, the historical context shows an average impact across country downturn episodes of −4.5 per cent for employment and −15 per cent for real compensation of employees.

Figure D.2: Wages often fall by more than employment in downturns

Peak-to-trough percentage change in volumes, by country and first year of downturn episode



Sources: European Commission, AMECO database; CSO; and internal Fiscal Council calculations.
Notes: Downturns are defined as growth in final domestic demand (excluding stocks) one standard deviation below its long-run (1961–2018) average. Bars show peak-to-trough percentage change from years *t-1* to *t+6*, with a downturn occurring in year *t*. The latest CSO data are used for Ireland for 1999–2018.

Implications

These findings suggest that Ireland's downturns have been relatively severe, in particular for underlying investment. Although all downturn episodes are unique, the examples included in this box suggest that investment and real compensation of employees have been exposed to particularly large peak-to-trough falls of over one tenth in many cases. As such, if a disorderly Brexit causes a downturn to occur, there could be large downside risks to the Budget's forecasts for 2020.

Box E: How well do consumer and business sentiment correspond to real economic activity?

A number of surveys are used to measure consumer and firm assessments of their financial circumstances and their expectations for the general economy. Among these are the KBC consumer sentiment index, and the European Commission's indices for consumer and business sentiment (which includes sub-indices for industry and services).

Table E.1 shows the correlations between these sentiment indices and four measures of real economic activity: expenditure on personal consumption, underlying domestic demand, underlying investment, and gross domestic product. The highest correlations are between the consumer sentiment indices and underlying domestic demand, and a similarly strong relationship exists between these indices and personal consumption—the largest component of underlying domestic demand.

Table E.1: Consumer sentiment is more correlated with real economic growth than is business sentiment

Correlation coefficient: 1=perfectly correlated, –1=perfectly negatively correlated

	Consumer sentiment		Business sentiment	
	KBC	DGECFIN	DGECFIN (Industry)	DGECFIN (Services)
Personal consumption	0.80	0.81	0.52	0.61
Underlying domestic demand	0.81	0.83	0.62	0.69
Underlying investment	0.60	0.60	0.60	0.61
Gross domestic product	0.66	0.65	0.60	0.72

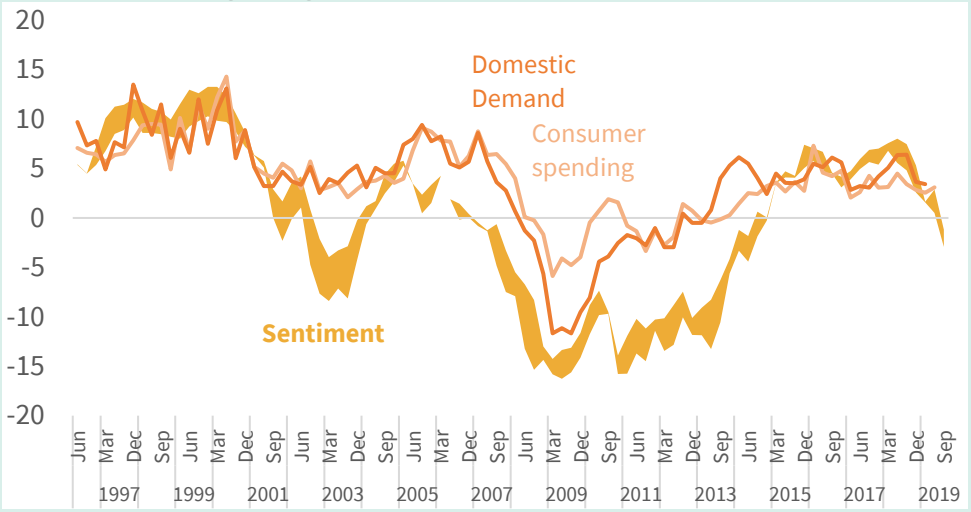
Sources: CSO; KBC Bank Ireland; European Commission; and internal Fiscal Council workings.
Note: The table shows correlations between year-on-year percentage changes for real economic activity—using quarterly data—and standardised sentiment, which is constructed by subtracting a long-run average from quarterly sentiment data, and scaling it by its long-run standard deviation.

Consumer sentiment indices

Consumer sentiment has a reasonable correlation with real activity, as shown in Figure E.1. But looking closely at the performance of sentiment indicators over time, their performance as leading indicators is relatively mixed.[33]

Figure E.1: Consumer sentiment indices are reasonably correlated with real activity, but have a mixed performance as leading indicators

Year-on-year percentage change and standardised consumer sentiment



Sources: CSO; KBC Bank Ireland; European Commission; and internal Fiscal Council workings.
Note: These data show year-on-year percentage changes for personal consumption and underlying domestic demand, using quarterly data. Standardised consumer sentiment is constructed by subtracting a long-run average from quarterly sentiment data, and scaling by its long-run standard deviation.

[33] McQuinn (2019) finds that while Irish consumer sentiment has a statistically significant relationship with economic activity, this model has performed relatively poorly since 2018.

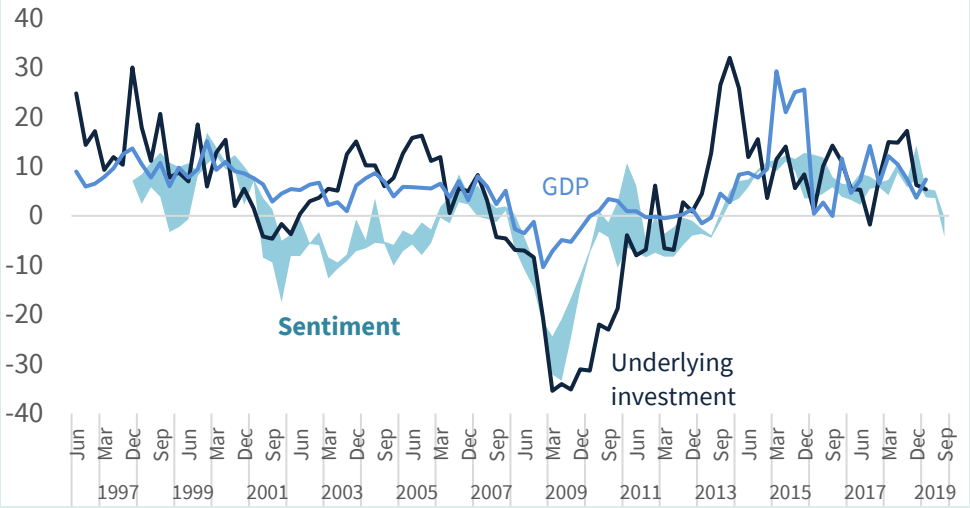
For instance, in the early 2000s around the time of the "dot-com bubble" and 9/11, the sentiment indices weakened substantially. Though real activity did moderate during this period, they held up quite well regardless of the declines in sentiment. This moderation also partly reflected the ending of a catch-up (or "convergence") period as opposed to an underlying weakening in economic conditions. By contrast, in the financial crisis period, weaknesses in consumer sentiment did appear to pre-sage contractions in real activity as far out as four to six quarters ahead.

Business sentiment indices

Business sentiment data tend to have a weaker correlation with real activity compared to consumer sentiment indicators (Figure E.2). Looking more closely at their performance as leading indicators, we can see that it is—as with consumer sentiment—quite mixed.

Figure E.2: Business sentiment indices show weaker correlation with real activity

Year-on-year percentage change and standardised consumer sentiment



Sources: CSO; European Commission; and internal Fiscal Council workings.
Note: These data show year-on-year percentage changes for personal consumption and underlying domestic demand, using quarterly data. Standardised consumer sentiment is constructed by subtracting a long-run average from quarterly sentiment data, and scaling by its long-run standard deviation.

The early 2000s again saw business sentiment indices weakening, though real activity (underlying investment and GDP) held up quite well. The contraction in investment in 2001 was short-lived relative to the ongoing weaknesses in sentiment. At the time of the financial crisis, underlying investment contracted before sentiment turned. While sentiment seemed to recover its pre-crisis levels by 2011, investment continued to contract.

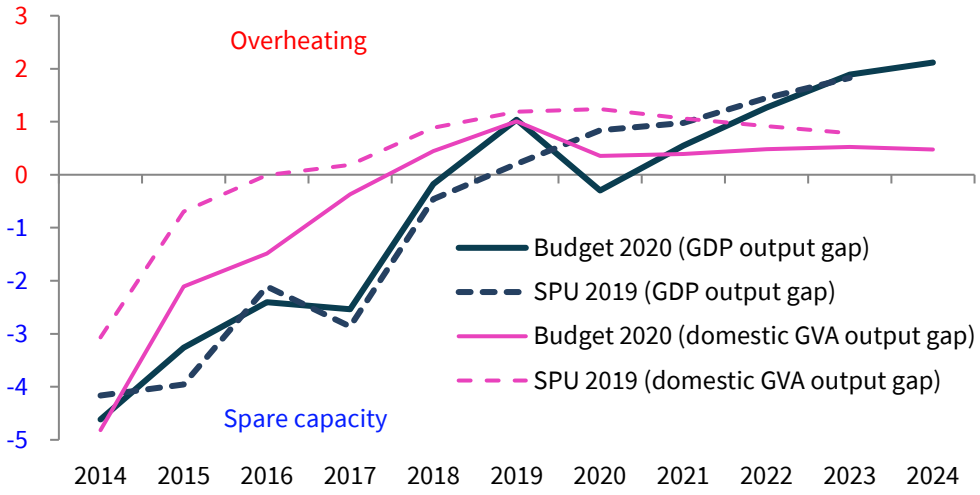
Budget 2020 medium-term forecasts

Over the medium term, underlying domestic demand forecasts in *Budget 2020* show growth of close to 2½ per cent per year for 2021–2024, while employment growth is forecast to recover gradually after falling to 0.8 per cent in 2020, towards 2 per cent by 2024. The unemployment rate is forecast to increase only modestly to 5.9 per cent in 2021 before recovering to 5½ per cent by 2024. Compared to an orderly Brexit, the unemployment rate is forecast to increase by just 0.6 of a percentage point in 2020 and 0.8 of a percentage point in 2021 as a result of a disorderly Brexit.

The impact of a disorderly Brexit is concentrated in an expected fall in underlying net exports in 2020, resulting in a slower forecast for GDP growth. The effects are largely treated as a level shock to demand, rather than as a supply shock affecting long-term growth rates. This results in a modestly negative impact on the Department's preferred output gap estimate in 2020—the most recent GDP-based and domestic GVA-based alternative estimates are shown in Figure 2.5, with *SPU 2019* figures also included for comparison. Although April's SPU forecasts were prepared assuming an orderly Brexit, it is noteworthy that compared to a prior 0.2 per cent, the most recent estimate of the output gap in 2019 has been revised up to 1 per cent—in line with current and prior estimates based on domestic GVA. The revision reflects a higher GDP outturn for 2018 in July's *National Income and Expenditure 2018*.

Figure 2.5: Alternative output gap estimates

Percentage points of potential output



Sources: Department of Finance, *SPU 2019* and *Budget 2020*.

Over the medium term, the GDP-based measure suggests that the output gap will turn positive and continue to widen over the forecast horizon to reach around 2 per cent by 2024, consistent with some overheating. However, as the Council has previously noted, the GDP-based estimates are conceptually weaker than those based on domestic GVA, given the large distortions to GDP in recent years (Fiscal Council, 2018e). Alternative estimates provided by the Department of Finance point to a smaller but still positive output gap in the coming years. Overheating is fairly likely if the economy remains on a steady course. An increasingly positive output gap may be less likely in a disorderly Brexit scenario, although growth could be unbalanced between Brexit-impacted traditional sectors and other activities.

However, the coherence of some of the trends in key economic sustainability indicators over the medium term is weaker in some areas than others. Whereas the savings ratio forecast in April's SPU was just over 12 per cent on average for 2021–2023, the profile in *Budget 2020* (based on a disorderly Brexit) shows a fall in the savings ratio of 3.6 percentage points over 2020–2024. This is despite the Budget's forecasts for slower household consumption and faster personal disposable income on average over the medium term compared to April's SPU. Furthermore, this may not be consistent with possibly higher precautionary savings under a disorderly Brexit scenario.

Imbalances

The Council's modular approach examines possible sources of economic imbalances—see Appendix D for details. The approach seeks to address the difficulty of producing a summary statistical estimate of the cyclical position of the economy, and to monitor specific economic data that may indicate the presence of potentially unsustainable positions of relevance to the public finances, or developments that display procyclical tendencies. The four modules examined are the labour market and prices, external balances, dwellings and investment, and credit conditions.

Figure 2.6 (overleaf) shows the Council's "heat map" visualisation. As the crisis years approached, the mainly red-coloured ("hot") indicators corresponded to activity that was more than one standard deviation above its central value. These indicators abruptly turned blue for much of the time since 2009, and more recently have become more neutral (yellow) as the recovery progressed. Preliminary 2019 data show an increasing number of orange and red indicators, in particular for the labour market and investment—hourly wages grew by 3.6 per cent in the first half of 2019, the fastest pace since 2008, and far faster than 0.6 per cent in the Euro Area.

The labour market and prices

Budget 2020 forecasts a relatively benign labour-market environment. Despite strong employment growth in recent years, price inflation in Ireland remains muted. The unemployment rate is forecast by the Department to return to 5½ per cent by 2024 after modest increases in 2020 and 2021 as a result of a disorderly Brexit. The Budget projects net immigration above 1 per cent of the labour force over the medium term, broadly unchanged compared to April's SPU.

Figure 2.6: Heat map for monitoring potential imbalances in the Irish economy

Within specified standard deviation bands of central values:

-2.00 -1.75 -1.50 -1.25 -1.00 -0.75 -0.50 -0.25 0.00 0.25 0.50 0.75 1.00 1.25 1.50 1.75 2.00 NA

'00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17 '18 '19

Aggregate

Output gap

Change in output gap

Labour Market and Prices

Unemployment (% labour force)

Construction (% total employment)

Net migration (% labour force)

Inflation (HICP)

Core inflation

Personal consumption deflator

Hourly wage inflation

Real hourly wage inflation

Relative hourly wage growth (Ireland / Euro Area)

Change in unemployment (% labour force)

Change in inflation (HICP)

Change in core inflation

Change in wage inflation

External Balances

Modified current account (% GNI*)

Adjusted NIIP (% GNI*)

Change in modified current account (% GNI*)

Investment and Housing

Underlying investment (% GNI*)

Residential construction (% GNI*)

New dwelling completions (thousands)

Non-residential construction (% GNI*)

Residential property price growth

Residential price-to-income ratio

Residential price-to-rent ratio

Household savings ratio (% disposable income)

Household net lending/borrowing (% GNI*)

Change in underlying investment (% GNI*)

Change in residential construction (% GNI*)

Change in new dwelling completions

Change in non-residential construction (% GNI*)

Credit and Financial

New mortgage lending (% GNI*)

Credit to private sector Ex FI (% GNI*)

Adjusted private sector credit (% GNI*)

New SME credit (% GNI*)

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

Note: 2019 data included above show year-to-date outturns, and the *Budget 2020* forecast for GNI* is used. For other calculation details, see Timoney and Casey (2018).

External balances

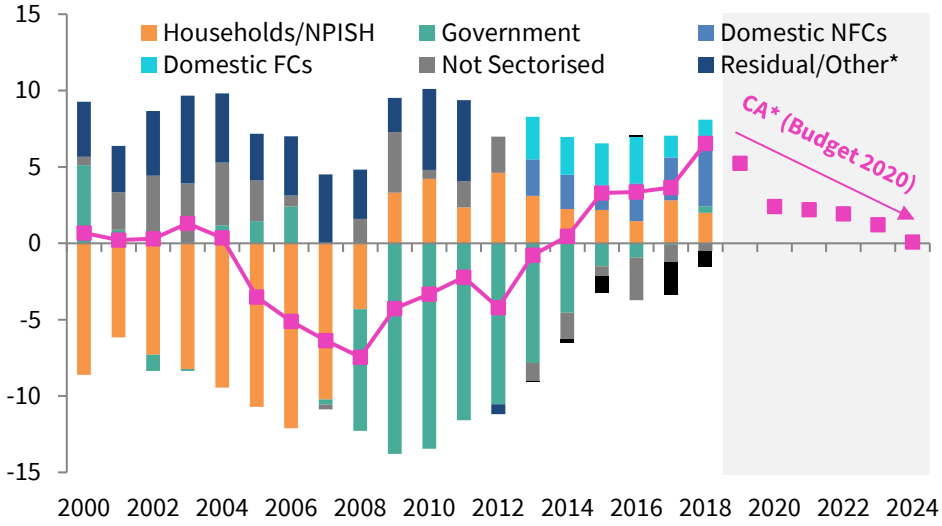
The modified current account (CA*) can be analysed based on the net financial balances of institutional economic sectors. This is approximated using the balance of gross savings less gross capital formation by households/non-profit institutions serving households (NPISH), government, domestic financial corporations and non-financial corporations (data available from 2013), non-sectorised activity, and a residual category including domestic firms prior to 2012.

Large unexpected corporation tax receipts in recent years have contributed to the current account balance over time. These receipts represent a net injection to the Irish economy, as foreign-owned multinational enterprises contribute four-fifths of receipts. These are 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. It can therefore complicate assessments of the sustainability of the current economic position and should be accounted for. Underlying measures of the current account—if adjusted for the surges in corporation tax (Box B, *June 2019 Fiscal Assessment Report*) as well as the impact of multinational activities more generally—would likely show a surplus of closer to 2.3–4.3 per cent of GNI* for 2019, rather than 5.2 per cent as forecast in *Budget 2020*.

The sectoral balances of the Irish economy are shown in Figure 2.7. Factoring in gross savings and gross capital formation, the figures now suggest the domestic non-financial corporation sectoral balance improved by €2.3 billion in 2018, and all sectors of the economy (besides "Not Sectorised" and a residual category) contributed positively to the CA* surplus of close to €13 billion. The Department forecasts a sharp decrease in CA* in 2020, reflecting weaker expected net exports mainly due to the disorderly Brexit assumption, leading to an assumed reduction in the contribution of non-financial corporations to the CA* balance. Following this, the Department projects a more gradual decrease over the medium term. However, the CA* level is projected to retain a €2.7 billion surplus by 2023, whereas *SPU 2019* forecasted a deficit of €3.2 billion for the same year. This is despite the higher forecast for the household savings ratio in April's SPU. The SPU and Budget forecasts for CA* imply very different prospects for the medium-term health of the economy—if CA* remains in surplus over time, this suggests a greater degree of sustainability for economic activity than other relevant indicators, especially the positive and widening output gap.

Figure 2.7: Domestic balances were all positive in 2018

Percentage of GNI*



Sources: CSO; and internal Fiscal Council calculations.
Note: Net-financial-balance components of the modified current account are calculated as gross savings less gross capital formation of households/NPISH, government, domestic financial corporations, domestic non-financial corporations, not sectorised, and a residual category which includes domestic financial and non-financial corporations prior to 2013.

Dwellings and investment

From a low base of activity, residential construction is forecast by the Department to continue to rise over coming years. Annual housing completions, officially estimated at 17,995 for 2018, are forecast by the Department to increase to 45,000 by 2024. This would approach the upper end of estimates of the appropriate medium-term level of new-dwelling completions consistent with demand, and could prove challenging to achieve without a rapid increase in apartments completions—of which just 3,132 were completed in the four quarters to Q3 2019. While it is necessary to address the undersupply of new housing, particularly if a disorderly Brexit is avoided, there is a risk that the associated construction activity in an economy already close to full employment will create imbalances in demand and a skew towards new-dwelling construction. Residential construction is an employment-intensive activity and generates significant tax revenues, as well as typically attracting inward migration—which in turn can further increase the required supply of new dwellings. As previously highlighted in Council publications (Fiscal Council, 2019c), the level of activity in non-residential construction continues to be projected to remain above its long-run average share of GNI* over the medium term. Allowing for usual volatility, this level of activity reaches close to two standard deviations above its long-run average in the early 2020s, suggesting either that the

forecasts are overoptimistic or the risk of possible resource over-concentration in non-residential construction in the coming years.

Credit conditions

The stock of credit owed by households and enterprises (excluding financial intermediation) has been in continuous decline for over ten years, beginning in the fourth quarter of 2008. More recently, the pace of reduction in the stock of private-sector credit has slowed. Net credit flows to private-sector enterprises (excluding financial intermediation) returned to growth in 2018. For household lending, net flows of credit advanced for principal dwelling purchases have been growing since the second quarter of 2016, and have remained close to 4 per cent as of the second quarter of 2019. This growth has occurred despite the impact of macroprudential limitations on lending, which could be contributing to a recent slowdown in national residential property price growth. With new-dwelling completions forecast to increase steadily over the medium term, there is potential for rapid growth in net flows of credit for house purchases. It is essential that developments in credit are closely monitored and anticipated, to enable policymakers and regulators to take corrective actions where necessary.

Box F: Using a Large Bayesian VAR for short-run forecasting of Ireland's macroeconomy

As part of the Council's endorsement function, the Council prepares benchmark forecasts of Ireland's macroeconomy to allow for a comparison with the forecasts of the Department of Finance.[34] The Council adopts a suite of modelling approach (having multiple models), to forecast each individual macroeconomic indicator.[35] This box gives a brief summary of an additional forecasting tool the Council has developed—Large Bayesian Vector Auto-Regression (LBVAR)—for forecasting Ireland's underlying macroeconomy.

Given the large range of dynamics that can affect the economy in the short-run, modelling the macroeconomy in a system requires a large number of inputs. Often historical data availability is limited. This can give rise to a large number of parameters that need to be estimated with only a limited data set. For instance, in a Vector Auto-Regression (VAR) with P lags and N variables there are $N^2 \times P + N$ parameters that need to be estimated. Therefore, adding additional variables to a conventional VAR can significantly reduce the degrees of freedom. This can lead to in-sample overfitting and large out of sample forecast errors.

Following the work of Bańbura *et al*. (2010), LBVARs offer a solution to this problem. LBVARs apply Bayesian shrinkage to the parameters of the model, which allows for the use of large information sets to forecast the macroeconomy. LBVARs have been shown to have superior forecasting performance to that of smaller VARs, smaller Bayesian VARs, Factor-Augmented VARs and small DSGE models (Bańbura *et al*., 2010; Gupt & Kabundi, 2010).

The basic intuition behind an LBVAR is to start with a standard VAR model and take a prior belief, typically a so called "Minnesota prior", which is a belief that each equation in the model is centred around a random walk with drift:

$$Y_t = c + Y_{t-1} + u_t$$

Where Y_t is the variable of interest, c is a constant and u_t is a normally distributed error term. This is equivalent to a prior belief that the variable depends on its own lagged value (the coefficient of Y_{t-1} is equal to 1) and not on other variables (the coefficient on the lags of other variables is 0). The overall tightness of the prior distribution around this central estimate is then controlled by a hyper-parameter, λ. The idea behind an LBVAR is to increase the overall tightness of the prior distribution around the central estimates as the number of variables increases, thus reducing overfitting that occurs in larger conventional VARs and reducing the impact of omitted variable bias that smaller VARs are prone to.

Comparing the historical forecasting performance of the Large Bayesian VAR with the Council's other models

This section provides a brief analysis of the forecasting performance of the LBVAR. Forecasts from the LBVAR are compared with the forecasts produced by two models, one for employment growth, and one for personal goods consumption growth, currently in use by the Council. The LBVAR was estimated using a dataset of 47 variables from Q1 2000 to Q4 2018. Figure F.1A shows the outturn for employment growth alongside the one-year-ahead forecast of employment growth from the LBVAR and from one of the Council's benchmark models for forecasting employment.[36] Both models perform relatively similar. The average absolute forecast error for the LBVAR of 0.78 versus 0.80 for the benchmark model. The relative mean

[34] The Council's mandate includes endorsing, as it considers appropriate, the official macroeconomic forecasts of the Department of Finance that are the basis for Budgets and SPUs.

[35] See Conroy & Casey (2017) for an outline of the Council's Suite of Models approach.

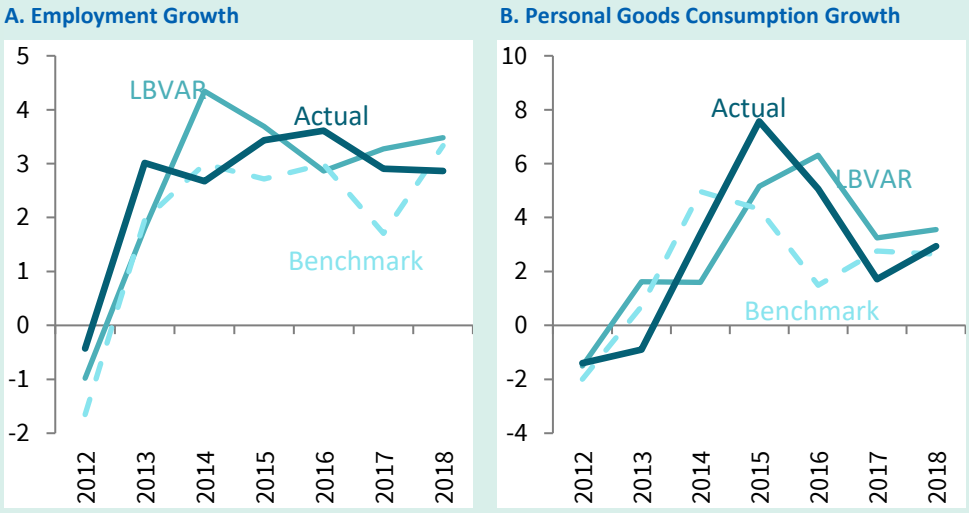
[36] The benchmark model for forecasting employment growth is an error correction model with Underlying Domestic Demand as the macro-driver.

squared forecast error is 1.08, indicating that the benchmark model performs slightly better over this time horizon.[37]

A similar exercise is carried out for personal goods consumption growth (Figure F.1B).[38] Again, both models' performance is relatively similar; however, the LBVAR outperforms the benchmark model in terms of the average absolute forecast error and the relative mean squared forecast error. The average absolute forecast error is 1.46 and 1.71 for the LBVAR and the benchmark model respectively. The relative mean squared forecast error is 0.66 over this horizon, indicating that the LBVAR has a superior forecasting performance.

Figure F.1: Comparison of LBVAR forecasts with the Council's benchmarks

Year-on-year percentage change



Sources: CSO; and Internal Fiscal Council calculations.

Note: Left Panel: Data shows the one-year ahead forecasted employment growth rate for the LBVAR and the benchmark model, as well as the actual employment growth for that year (as of the March 2019 release of the Quarterly National Accounts (QNA)). Right panel: Data show the one-year-ahead forecasted personal goods consumption growth rate for the LBVAR and the benchmark model, as well as the actual personal goods consumption growth rate for that year (as of the March 2019 release of the QNA).

What is the LBVAR currently forecasting?

Table F.1 shows the LBVAR's forecasts for 2019 and 2020 for employment growth and personal goods consumption. The LBVAR forecasts are purely model based with no judgement applied. These forecasts are shown alongside the Council's benchmark forecasts for these variables. For 2019, the LBVAR forecasts employment growth to be 2.6 per cent and personal goods consumption to be 2.7 per cent, relatively close to the benchmark forecast of 2.4 per cent and 2.5 per cent respectively. For 2020, the forecasts for employment growth are only marginally different, with the LBVAR forecasting a growth rate of 1.4 per cent, while the benchmark forecast is 1.5 per cent. There is however, a slight divergence in the forecasts for personal consumption growth for 2020, with the LBVAR forecasting growth of 2.4 per cent, while the benchmark forecast is 2.0 per cent.

[37] That is, the mean squared forecast error of the LBVAR divided by the mean squared forecast error of the benchmark model. Values below one, indicate that the LBVAR has superior forecasting performance relative to the benchmark model.

[38] The benchmark model for forecasting personal consumption growth is an error correction model with personal disposable income in the long-run equation, and both personal disposable income and household wealth in the short-run equation.

Table F.1: LBVAR statistical forecasts

Year-on-year percentage change

	2019	2020
LBVAR employment growth	2.6	1.4
Benchmark employment growth	2.4	1.5
LBVAR personal goods consumption growth	2.7	2.4
Benchmark personal goods consumption growth	2.5	2.0

Sources: CSO; and internal Fiscal Council calculations.

Note: Forecasts are based on data up to Q2 2019. Figures for the benchmark correspond to those in Appendix C relating to the orderly Brexit scenario. The benchmark figures in this table are based on the suite of models for each variable, of which the models outlined above constitute one of the models in the suite for each variable. The benchmark figures may include some element of judgement.

While the analysis above gives a brief outline of the LBVAR and its forecasting performance, a forthcoming working paper will provide a more detailed description of the model estimation and a more comprehensive analysis of its forecasting performance for a wider range of variables.

Chapter 3

Assessment of Budgetary Forecasts

3. Assessment of Budgetary Forecasts

Key Messages

- For 2019, the general government surplus (excluding one-off items) is forecast to be 0.3 per cent of GNI*, a slight improvement compared to 2018. Overruns in health expenditure are likely to be masked by higher-than-anticipated corporation tax receipts.

- The *Budget 2020* fiscal forecasts are presented solely on the basis of a no-deal Brexit, with a front-loaded impact assumed to take place in 2020. For 2020, the general government balance (excluding one-off items) is forecast to deteriorate to a deficit of €2.0 billion. This is mainly driven by higher expenditure on unemployment-related benefits and sector-specific supports in an assumed no-deal Brexit. Under an orderly deal scenario, estimates suggest that this would lead to a surplus of around €1.1 billion.

- There are risks that spending could be higher in 2020, with the Christmas bonus again not budgeted for and a possible repeat of persistent health overruns. The fiscal costs associated with a no-deal Brexit could also be higher and more long-lasting than currently forecast in *Budget 2020*.

- Corporation tax as a share of tax revenue in 2018 reached record levels of 18.7 per cent and is forecast to remain elevated in the coming years. This tax head is volatile and is strongly concentrated in a small number of companies. This, together with potential changes in the international tax environment, leaves government revenue particularly exposed to shocks.

- From 2021 onwards, the expenditure forecasts in *Budget 2020* are based on technical assumptions, rather than likely future policies or the future cost of meeting existing commitments. These technical assumptions have been revised to make them somewhat more realistic, with faster forecast expenditure growth than previously assumed. Other than for corporation tax, revenue forecasts as a whole have been reasonably accurate in recent years. However, the unique nature of a shock like a hard Brexit might imply lower revenue than is currently assumed by the Department of Finance.

3.1 Introduction

This chapter assesses recent data from the Central Statistics Office, Fiscal Monitors, and the latest set of fiscal forecasts produced by the Department of Finance in *Budget 2020*. In 2019, the general government balance (excluding one-off items) is forecast to reach a surplus of €0.7 billion, an improvement of €0.6 billion relative to 2018 (Table 3.1). Both revenue and expenditure forecasts for 2019 have been revised up since *SPU 2019*. For 2020, a deficit is expected to re-emerge, mainly due to the assumed impact of a no-deal Brexit on the public finances.

Budget 2020 forecasts are made on the basis of an assumed no-deal Brexit. While a no-deal Brexit is a possible outcome, uncertainty remains and hence there are many possible outcomes. Given the scale and nature of such a shock, the fiscal forecasts would look very different if they were prepared on the basis of an orderly deal scenario (as was the case in *SPU 2019*). While macroeconomic projections were prepared for both a deal and a no-deal scenario, fiscal forecasts have been prepared only on a no-deal basis. This makes it quite difficult to interpret how the budgetary position would be expected to evolve under an orderly deal scenario. This chapter will assess the Department's forecasts produced on the basis of a no-deal Brexit, but it will also consider the impacts arising from this assumption so as to give a sense of how the public finances would evolve under a relatively more benign outcome.

Table 3.1: Summary of fiscal outturns (2018) and forecasts (2019–2024) under an assumed no-deal Brexit

€ billion, excluding one-offs, unless stated

	2018	2019	2020	2021	2022	2023	2024
General Government Balance	0.1	0.7	-2.0	-0.7	0.2	1.5	3.1
Total Revenue	82.0	86.4	88.7	92.1	95.9	100.3	105.0
… % change	7.1	5.3	2.7	3.8	4.2	4.5	4.7
Total Expenditure	82.0	85.7	90.7	92.8	95.7	98.8	101.9
… % change	6.0	4.6	5.8	2.3	3.2	3.2	3.1
Interest Expenditure	5.2	4.7	4.0	3.7	3.9	4.0	3.9
Primary Expenditure	76.7	81.0	86.7	89.1	91.9	94.7	98.0
… % change	7.4	5.6	7.0	2.8	3.1	3.1	3.4
Primary Balance	5.3	5.4	2.0	3.0	4.1	5.5	7.0
Nominal GNI* growth (% change)	7.3	2.9	0.2	3.4	3.5	3.4	3.2

Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: One-offs are removed from variables to get a sense of the underlying fiscal position. One-off items/temporary measures are as assessed by the Council to be applicable, as per Table 1.1, Chapter 1. Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which are unlikely to reflect future developments. Rounding can impact on totals.

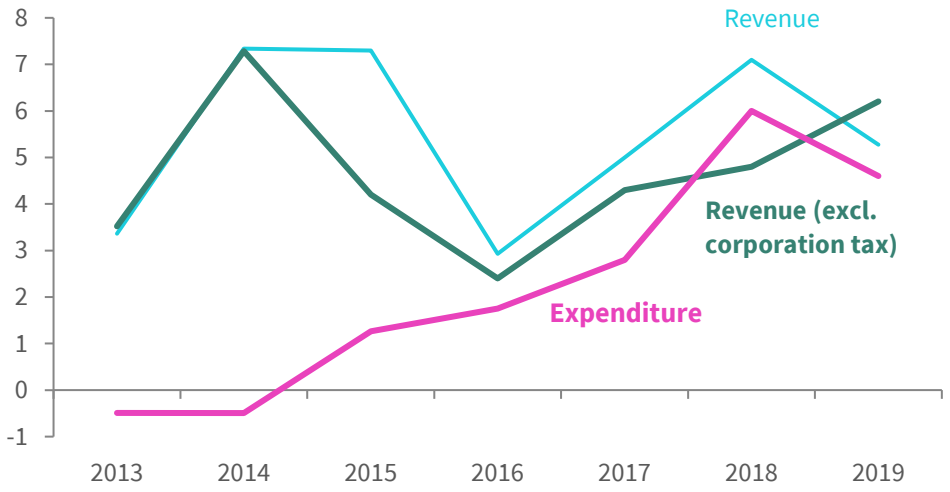
3.2 Assessment of 2019 Outturns and Estimates

Balance, 2019

Budget 2020 forecasts an underlying **general government surplus** for 2019 (excluding one-offs) of €0.7 billion, an improvement on 2018 (when an underlying surplus of €0.1 billion was recorded).[39] This improvement is aided by strong cyclical revenue growth, declining unemployment and falling interest payments (forecast to be €0.6 billion lower than in 2018). Figure 3.1 shows underlying revenue and expenditure trends. General government expenditure growth accelerated from 2013 to 2018. In 2018, it outstripped revenue growth (excluding the highly volatile corporation tax revenue) for the first time in recent years. For 2019, non-corporation tax revenue growth is estimated to be higher than expenditure growth, though risks are highlighted below.

Figure 3.1: Expenditure growth has accelerated since 2013, matching strong revenues

% growth, year on year



Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: Revenue and expenditure are in general government terms. They exclude one-offs assessed by the Council as applicable. The 2019 figures are based on *Budget 2020* forecasts.

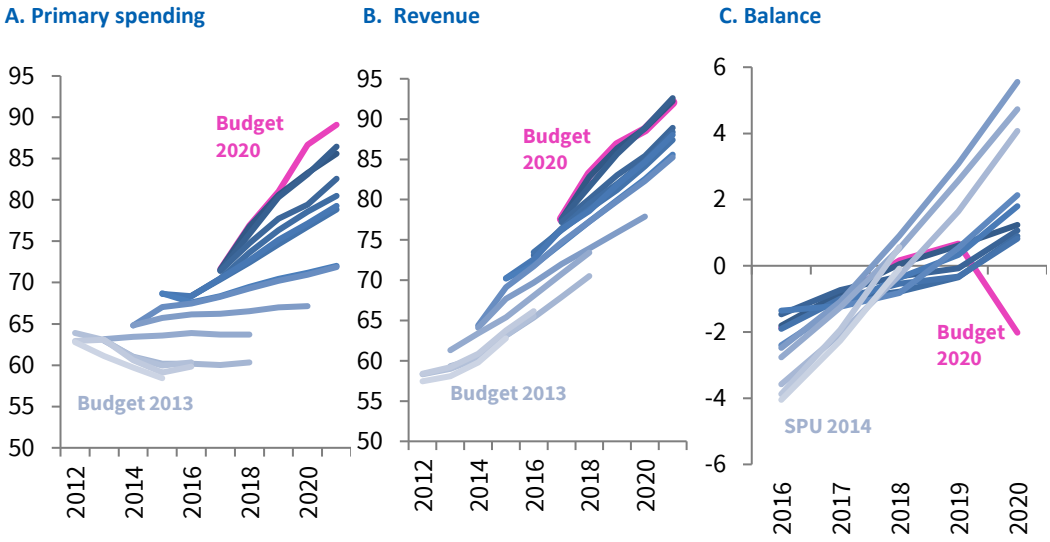
The **primary balance** (excluding one-off items) is forecast to be €5.4 billion in 2019, almost unchanged relative to 2018. Non-interest spending and revenue are both set to grow by over 5 per cent in 2019 (excluding one-off items). Figure 3.2 shows how the forecast pace of improvement in the general government balance has been

[39] The headline surplus in 2018 was €0.2 billion. This difference was caused by one-off receipts of €0.3 billion in corporation tax and €0.2 billion in expenditure in 2018.

revised down over time. This reflects how spending has been revised up by more than revenue over successive forecasts (also shown in Figure 3.2).

Figure 3.2: Vintages of general government primary spending, revenue and balance forecasts

€ billion (light blue = **older vintages**; darker blue = **more recent vintages**)



Sources: CSO; and Department of Finance.

Note: Primary expenditure excludes interest payments. Prior to *Budget 2017*, spending forecasts were made on the unrealistic assumption of fixed nominal spending for most items. Since then, forecasts have been made on a more realistic basis, and so are a more significant signal of upward spending drift. General government revenue data are adjusted to account for discretionary tax policy changes (not including the impact of non-indexation of tax bands and credits). The slope of the general government balance lines shows the expected improvement in the public finances. Older vintages generally show a more rapid improvement in the balance.

Expenditure, 2019

General government **primary expenditure** (excluding one-off items) is forecast to grow by €4.3 billion in 2019. The main items driving this growth are intermediate consumption (€2.2 billion), gross fixed capital formation (€1.6 billion) and compensation of employees (€0.8 billion). Underlying primary expenditure growth accelerated up to last year and is forecast to be 5.6 per cent in 2019, a moderation compared to 2018 (7.4 per cent).

CSO data for the first half of 2019 shows intermediate consumption to be €0.2 billion higher than the first half of 2018. This means that *Budget 2020* forecasts imply rapid growth in the second half of 2019. The supplementary estimates for the Department of Health may contribute to stronger growth in the second half of the year. Although the Fiscal Monitor does not show an overrun in the Department of Health as of end-October 2019, the HSE performance reports do show a deficit (Box K explores this). Gross fixed capital formation also shows much slower growth for the first half of the

year (5.2 per cent) compared to that forecast in *Budget 2020* for the full year (25.3 per cent). This may be a downside risk to expenditure in 2019. Overspends of €0.4 billion in the areas of health, justice and education were accounted for in *Budget 2020* forecasts (almost all of which are expected to recur).

For 2018, social payments ended up €1 billion higher than was forecast in *Budget 2019*. Yet the 2019 forecast has only been revised up by €0.5 billion following the higher-than-expected outturn last year. As a result, social payments are now forecast to fall in 2019 relative to 2018, which seems highly unlikely. The only significant policy change between *Budget 2019* and *Budget 2020* has been the decision to pay the Christmas bonus in full this year (at a cost of €0.3 billion), which increases social payments in 2019. Preliminary data for the first half of this year suggests that social payments have grown by 2.1 per cent in the first half of 2019. Taking all of this into account, it would appear likely that social payments will be higher in the CSO outturn for 2019 than the *Budget 2020* forecast.

Primary spending in 2018 was €1.1 billion higher than forecast in *Budget 2019*. This was mainly driven by higher-than-expected social payments. Primary spending in 2019 is now forecast to be €0.7 billion higher than forecast in *Budget 2019*.[40] Given the scale of the upward revision to 2018 spending, one might have expected a bigger upward revision to forecasts of 2019 spending.

The upward revision to primary spending in 2019 is consistent with the pattern of revisions to spending seen at budget times and within-year in recent years. Figure 3.2 shows various vintages of forecasts of primary spending; one can see there has been a tendency for spending to drift up as the cyclical recovery takes hold.[41] Box G highlights how this spending drift has been predominantly accounted for by current primary spending, which is expected to be long-lasting, rather than capital spending.

[40] Primary spending for 2019 was revised up by €0.3 billion in *SPU 2019* compared to *Budget 2019*. *Budget 2020* forecasts were then revised up by a further €0.4 billion compared to *SPU 2019.*
[41] Forecasts for spending at the end of the forecast horizon may have been somewhat unrealistic (i.e., low) prior to *Budget 2017*, which may exaggerate the extent of upward revisions.

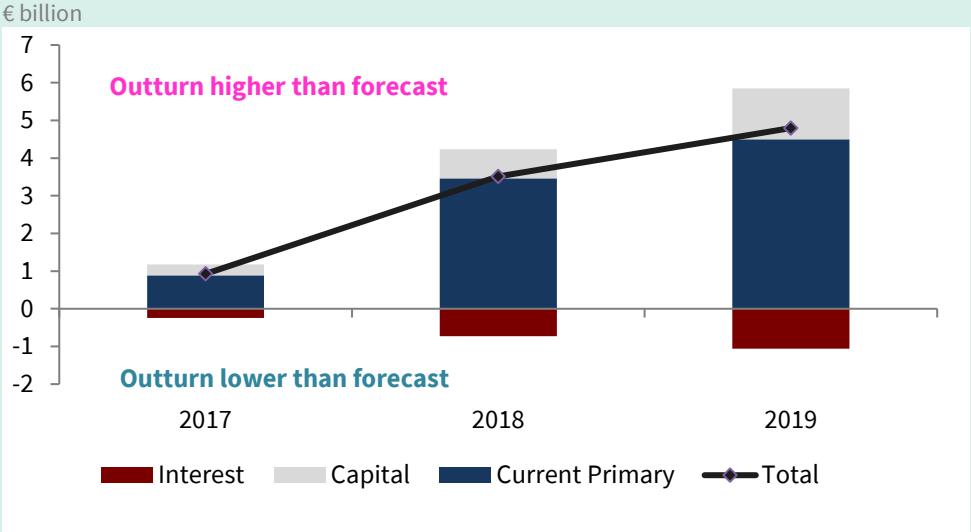
Box G: Current primary spending is the main driver of spending drift in recent years

Previous Fiscal Assessment Reports have highlighted that expenditure has increased relative to plans in recent years (Fiscal Council, 2019c, 2018e and 2018c). This box examines the specific components of expenditure which have contributed to this higher-than-planned expenditure.

Three categories of expenditure are considered: (1) current primary spending (current expenditure minus interest); (2) interest expenditure; and (3) capital expenditure. Figure G.1 shows how the level of expenditure has been revised from plans in *Budget 2017* to the latest outturns from CSO data (2017 and 2018) and *Budget 2020* forecasts (2019).[42] This shows that current primary spending and capital spending have been higher in each of these years compared to *Budget 2017* plans. In addition, interest expenditure has been lower than forecast for each year.

By 2019, *Budget 2020* forecasts of general government spending are €4.8 billion higher than forecast in *Budget 2017*. Of this, €4.5 billion is due to higher current primary spending and €1.4 billion is due to higher capital spending, while interest spending is €1.1 billion lower than anticipated. If capital spending had not been revised up from previous plans, expenditure would still be much higher than planned. This is because current primary expenditure has been the main driver of this higher-than-planned expenditure.

Figure G.1: Spending overruns compared with *Budget 2017* plans have been largely driven by current primary spending



Sources: *Budget 2017*; CSO; *Budget 2020*; and Fiscal Council calculations.

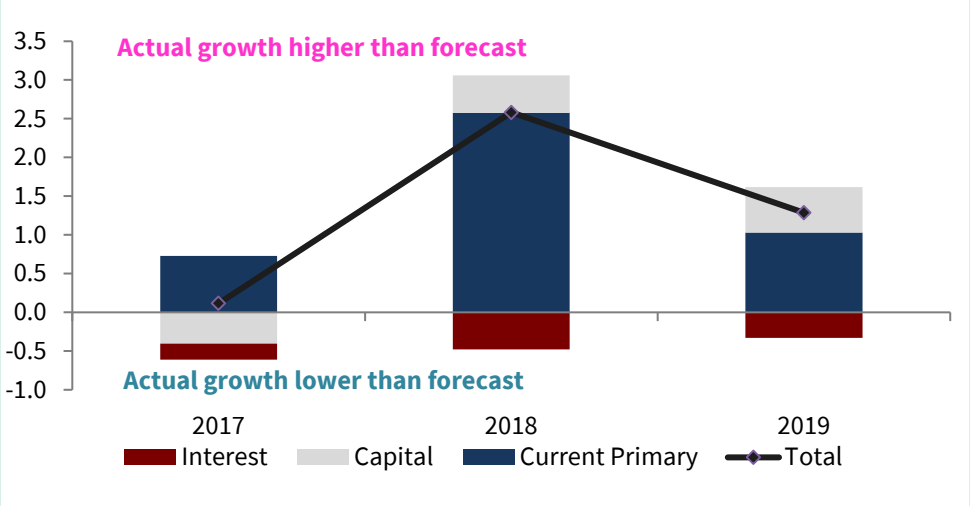
There is a possibility that spending outturns may be higher than forecast due to factors other than policy decisions. For example, statistical reclassifications or revisions to previous data can be a source of such changes. With this in mind, Figure G.2 compares the amount each of these expenditure items was expected to change by in each year, compared to the outturn/latest forecasts. For example, total general government expenditure in 2018 was expected to increase by €2.1 billion in *Budget 2017*, whereas the latest outturn suggests an

[42] *Budget 2017* is used as a comparison as these expenditure forecasts were more realistic than previous vintages. *Budget 2017* forecasts took account of the planned use of available fiscal space over the medium term, as opposed to the previous assumption of flat nominal amount of expenditure in the later years.

increase of €4.7 billion.[43] The €2.6 billion gap is shown in Figure G.2. Of this gap, faster-than-anticipated growth in current primary spending accounted for €2.6 billion. The faster-than-expected growth in capital spending (€0.5 billion) was offset by interest costs falling faster than anticipated.

Figure G.2: Annual spending growth since 2017 has been higher than forecast, largely driven by current primary spending

€ billion, year-on-year growth



Sources: *Budget 2017*; CSO; *Budget 2020*; and Fiscal Council calculations.

Looking at either the levels of planned spending or the year-to-year growth, the same pattern emerges. Expenditure has been higher and has grown faster than earlier plans anticipated. This has been driven mainly by current primary expenditure. Capital expenditure has contributed also, but to a far lesser extent. Interest spending has been lower and has fallen faster than anticipated.

Revenue, 2019

For 2019, **general government revenue** is forecast to be €4.3 billion (or 5.3 per cent) higher than in 2018, excluding one-offs. This is €410 million better than expected in April's SPU forecasts, despite the *Budget 2020* incorporating the impact of a disorderly exit of the UK from the EU from 31 October 2019. The upward revision is driven by (1) increases in current taxes on income and wealth (+€320 million)—mainly arising from higher-than-expected corporation tax revenue—and (2) increased projections on social contributions (+€240 million).

[43] *Budget 2017* forecast an increase of €2.1 billion. This was increased to €2.9 billion in *Budget 2018*, further revised up to €3.9 billion in *Budget 2019* and revised again in *SPU 2019* (€4.6 billion). The latest data (reflected in *Budget 2020*) shows an increase of €4.7 billion.

Strong **tax** growth is expected in *Budget 2020* for 2019: +5.6 per cent over the year (excluding one-offs).[44,45] Income tax is estimated to grow by 7.9 per cent, VAT by 6.4 per cent, and excise duties by 8.0 per cent. An exception is corporation tax, which *Budget 2020* expects to fall in 2019, given its high base in 2018 (partially due to a one-off payment).

For the year to end-October, **PRSI** and corporation tax are the main drivers of the revenue overperformance (Figure 3.3). PRSI is €267 million above profile to end-October. Forecast growth of PRSI has almost doubled since *SPU 2019* (from 5.7 to 10.8 per cent) given the ongoing strong performance of PRSI for the year.[46]

Corporation tax revenue is €660 million (or 10.6 per cent) higher than forecast to end-October, and €148 million (or 2.2 per cent) higher than last year, which was already a substantially large outturn. However, the annual growth in corporation tax receipts to end-October declined compared to end-September. This is largely because the October 2018 receipts were €773 million (or 96 per cent) higher than forecast for that month alone (as a result of higher-than-expected payments from large companies and the adoption of new accounting standards by some companies).

Corporation tax has accounted for an increasing share of total Exchequer tax revenue, especially since 2015 (Figure 3.4). In 2018, it reached a record share of 18.7 per cent of total Exchequer tax revenue, and this is expected to remain high as per *Budget 2020* projections for 2019 and the outer years (averaging 17.1 per cent, Figure 3.4). *Budget 2020* provides a review of fiscal vulnerabilities (Department of Finance, 2019c), which questions the sustainability of the "level shift" of corporation tax receipts seen since 2015. It highlights that the concentration of these receipts within a small number of companies entails additional exposure for the public finances.

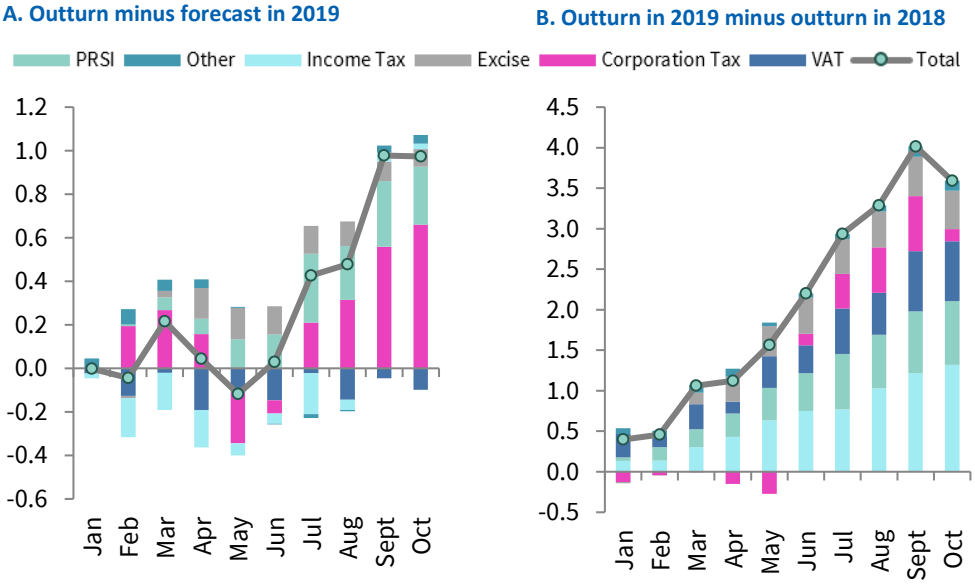
[44] Compared to *SPU 2019*, the total Exchequer tax estimate for 2019 is slightly higher (+€180 million). This is due to upward revisions of corporation tax revenues (+€300 million), which are expected to more than offset downward revisions of excise duties (–€85 million) and stamp duties (–€65 million).

[45] This excludes the customs payments on behalf of the EU assumed under a no-deal Brexit in 2019.

[46] The PRSI forecast for 2019 is €11.6 billion in *Budget 2020*, compared to €11.1 billion in *SPU 2019*.

Figure 3.3: Tax revenue and PRSI are outperforming to end-October 2019

€ billion (cumulative)

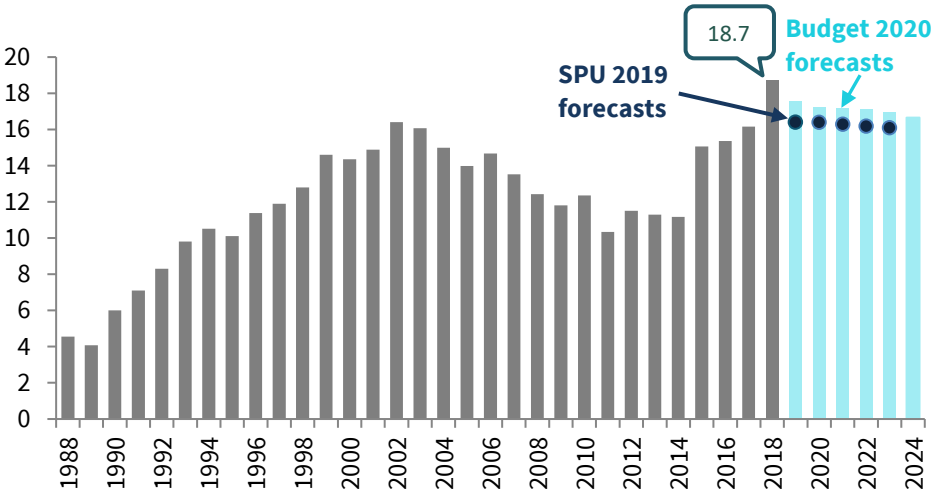


Sources: Department of Finance; and Fiscal Council calculations.

Note: Data as per the monthly Fiscal Monitor. Other = capital taxes + motor tax + other unallocated tax receipts. PRSI includes the excess over expenditure as indicated in the memo items.

Figure 3.4: Corporation tax (% tax revenue) is projected to remain high

% of total Exchequer tax revenue



Sources: Department of Finance; and Fiscal Council calculations.

3.3 Forecasts for 2020 in *Budget 2020*

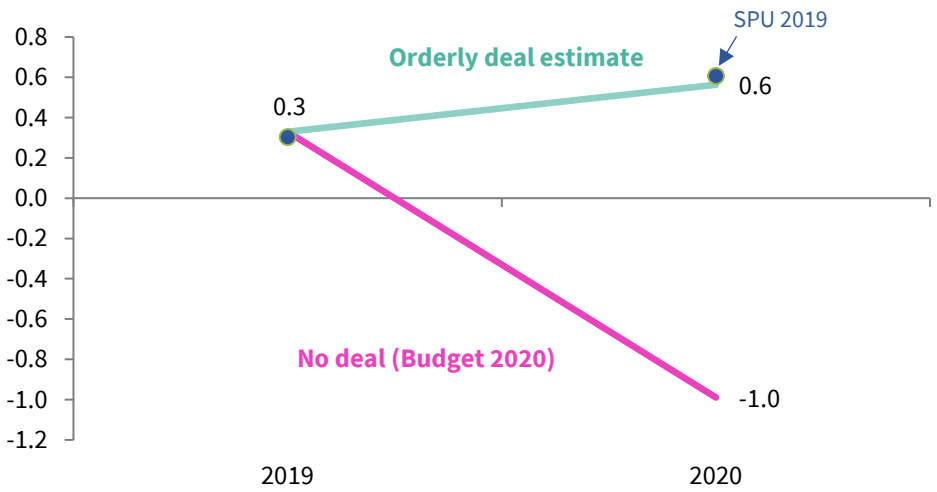
Budget balance, 2020

Budget 2020 forecasts the **general government balance** to deteriorate in 2020 by €2.7 billion under a no-deal Brexit scenario. This would move the general government balance from a position of surplus (€0.7 billion) to deficit (€2.0 billion).

The fiscal forecasts in *Budget 2020* are provided only based on an assumed no-deal Brexit. The *Summer Economic Statement* (*SES*) (Department of Finance, 2019c) provided estimates of the impact of a no-deal Brexit relative to an orderly deal scenario. Using this, one can get an estimate of what budget balance might have been forecast under an orderly Brexit scenario. The impacts for 2020 ranged from 1.6 to 3.1 per cent of GNI*. Comparing the *Budget 2020* forecasts of the balance in 2020 compared to forecasts in *SPU 2019* and the *SES*, it would appear that lower end of Brexit impacts was used. Applying these impacts to the forecasts presented in *Budget 2020* would suggest a general government surplus of 0.6 per cent of GNI* (Figure 3.5) in 2020 in the event of an orderly deal. This is in line with *SPU 2019* forecasts and the Department's latest estimate of a surplus of 0.5 per cent of GDP in 2020 under an orderly Brexit scenario.[47]

Figure 3.5: General government balance under different Brexit assumptions

% of GNI*



Sources: Department of Finance; and Fiscal Council calculations.
Note: Orderly deal estimates are calculated using the lower estimate of impacts given in the SES. This estimated impact of a no-deal Brexit is then applied to the *Budget 2020* forecasts to show what these forecasts would have looked like had an orderly deal Brexit been assumed.

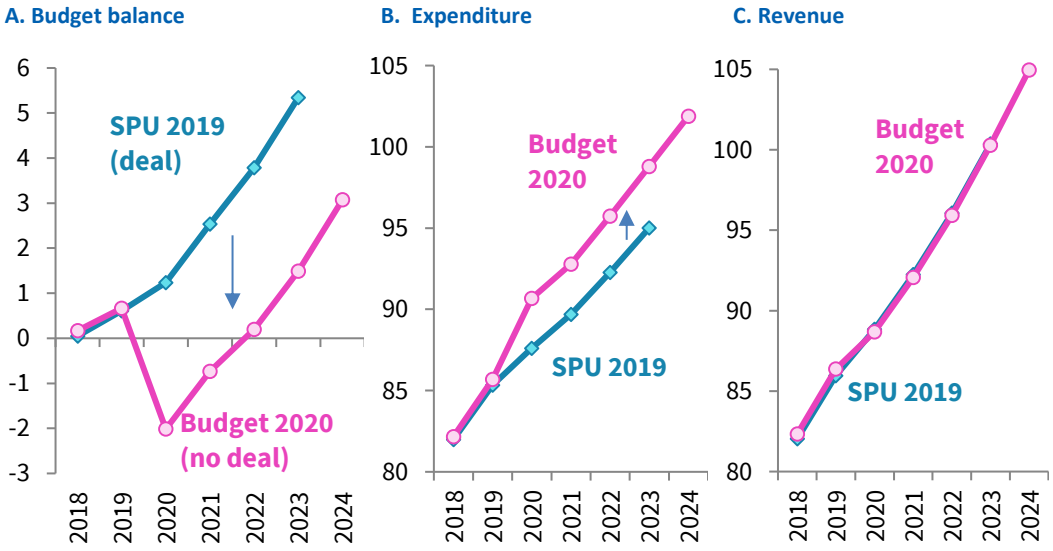
[47] The Minister noted this estimate in the Budget Oversight Committee (12 November 2019).

Since the SPU and SES, the proposed withdrawal agreement of the UK from the EU has changed somewhat. The latest proposals could see a less comprehensive free trade agreement negotiated after a transition period. This could result in a more negative impact on the Irish economy (and public finances), particularly in 2021 (if the new arrangement is agreed within that timeframe). There have been no published estimates of how these impacts, on Ireland, would compare to other proposed arrangements.

Compared to *SPU 2019*, the deterioration in the general government balance mostly comes from higher spending (Figure 3.6), with reductions in the revenue forecasts being comparatively very small. This is largely due to the fact that positive revenue-raising measures in *Budget 2020* are expected to offset some of the negative revenue impact of the no-deal Brexit scenario.

Figure 3.6: The balance is projected to be worse than in *SPU 2019*, driven by higher spending, while revenue is expected to remain broadly unchanged

€ billion (general government basis)



Sources: Department of Finance; and Fiscal Council calculations.
Note: Revenue has remained broadly unchanged since *SPU 2019*, but this is largely due to the fact that the revenue-raising measures introduced in *Budget 2020* are expected by the Department to offset some of the negative revenue impact of the no-deal Brexit scenario.

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.

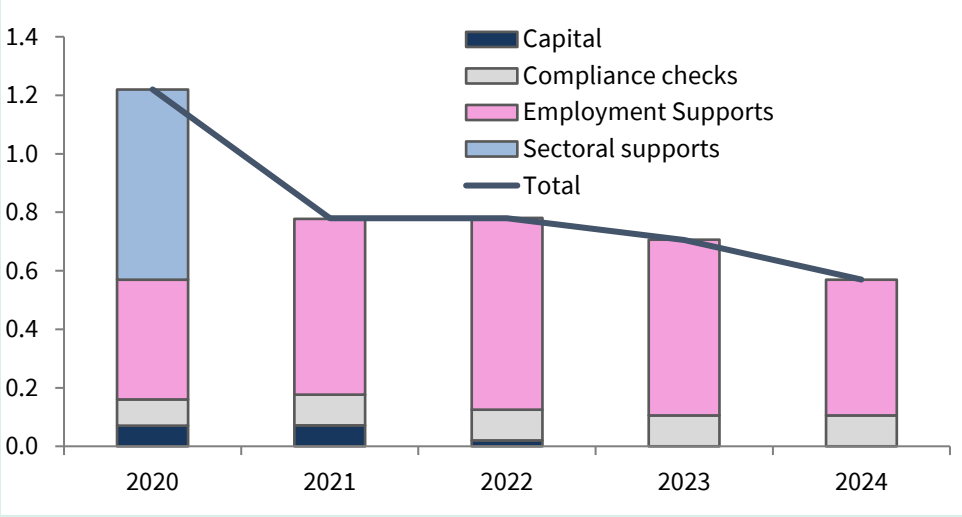
A hard Brexit is not a typical adverse economic shock, however. Additional fiscal costs over and above those arising from a standard economic shock may be expected. Compliance checks at the border and at ports would likely add to government expenditure (as well as adversely impacting trade).

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

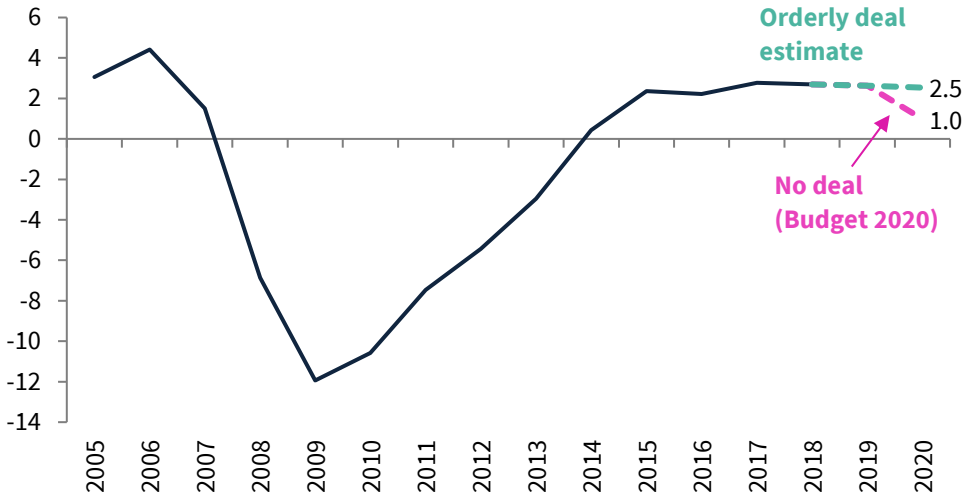
given the scale of the shock to domestic activity and the resulting impact on household income.[48]

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).

Expenditure, 2020

In 2020, general government expenditure is forecast to increase by €5.0 billion. With interest costs set to fall by €0.7 billion, primary spending is set to increase by €5.7 billion (7.0 per cent). As outlined in Box H, expenditure specifically related to a no-deal Brexit in 2020 amounts to €1.2 billion. As a result, underlying primary expenditure would be forecast to grow by €4.4 billion (5.5 per cent, Figure 3.8) in an orderly deal scenario. While this would be considered very strong expenditure growth, it is lower than the growth recorded in 2018 (7.4 per cent) and forecast for 2019 (5.6 per cent). This is to be partially funded by revenue-raising measures.

Budget 2020 forecasts suggest most expenditure headings will see substantial increases in 2020 (irrespective of the Brexit scenario assumed). Intermediate consumption (+€1.0 billion) and compensation of employees (+€0.7 billion) are forecast to contribute to expenditure growth in 2020. Even after excluding the Brexit contingency funds allocated to unemployment-related expenditure and labour market activation supports, social payments are forecast to increase by €1.0 billion in 2020.

Gross fixed capital formation is forecast to grow by €0.9 billion in 2020, much of which is believed to be due to increased activity of Approved Housing Bodies (Box L).[50] Expenditure by these bodies is not included in Exchequer spending but is part of general government spending. Capital transfers are forecast to increase by €0.6 billion in 2020, due to an increase in capital grants and the inclusion of transfers by the new Land Development Agency.

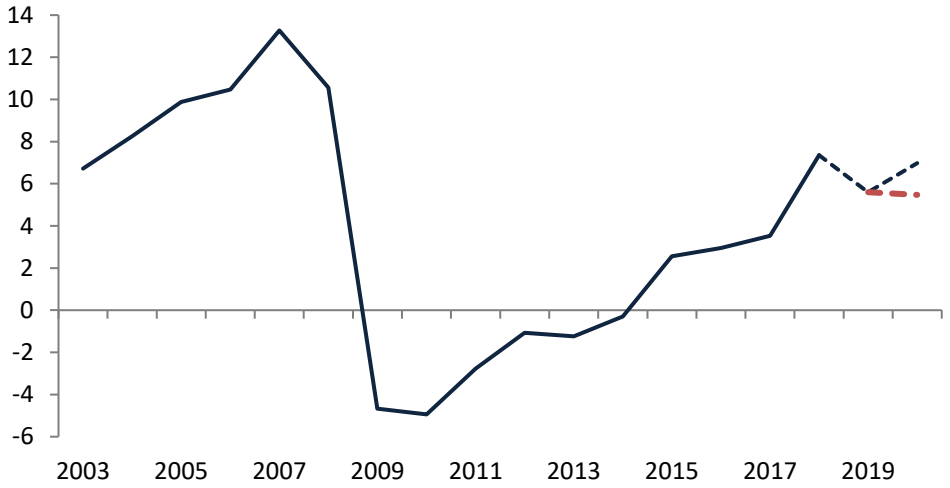
Budget 2020 forecasts of general government spending in 2020 are €3.1 billion higher than in *SPU 2019*. If one excludes the €1.2 billion of Brexit-related contingency, this falls to €1.9 billion. Intermediate consumption (€1.1 billion), gross fixed capital formation (€0.8 billion) and social payments (€0.6 billion) have seen the largest upward revisions. The upward revision to intermediate consumption may be partially related to the overrun in health in 2019, leading to a higher base. The upward revision to capital expenditure appears to be due to the assumed increase in activity by Approved Housing Bodies. The upward revision to social payments may be related to the base of expenditure being higher in 2018 (even though this

[50] Expenditure by these bodies is not included in Exchequer spending but is a part of general government.

has not been incorporated into 2019 forecasts, as described earlier). Some partially-offsetting revenue-raising measures were introduced as part of *Budget 2020*.

Figure 3.8: Primary expenditure growth

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



Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: Primary expenditure equals total expenditure less interest repayments on government debt and one-offs. One-offs are those defined by the Council as applicable. Dashed line indicates forecasts from *Budget 2020*. The red dashed line indicates underlying primary spending growth excluding no-deal Brexit-related spending (€1.2 billion).

The most likely reason for expenditure to be lower than currently forecast in 2020 is that a no-deal Brexit does not occur, and hence the €1.2 billion of additional spending does not take place. There are also significant upside risks to forecasts of primary expenditure in 2020. Health spending has exceeded expenditure forecasts for the past number of years, with overruns averaging €500 million per annum. While significant increased funding has been provided for in the latest set of forecasts, previous experience suggests health overruns are likely (Box I).[51] Further public sector pay increases in 2020 outside of the current agreement, which ends in 2020, are also an upside risk to expenditure forecasts. Given the uncertainty surrounding its impact, Brexit-related expenditure could also be higher than currently budgeted for in 2020 were a no-deal outcome to occur.[52]

[51] The latest gross current expenditure ceiling for the health group in 2020 is €701 million higher than the 2019 figure, which itself was €335 million higher than originally forecast.

[52] In 2020 there is a timing-related cash cost of €169 million. This arises as there are 53 Social Welfare payment dates and 27 pay periods for fortnightly paid Public Service workers within the calendar year. This is broken into: €95 million for the Department of Employment Affairs and Social Protection, €57 million for the Department of Education and Skills and €17 million for the Department of Justice and Equality. As there are 53 Fridays in 2021, there is a cost of €125 million from an additional weekly payment of the state pension. After 2021, these costs do not arise in the forecasts.

The Christmas bonus has, again, not been budgeted for in 2020, despite this payment having been made to increasing degrees over the past six years and in full for 2018 and 2019. Throughout this period, the payment has not been budgeted for, with a decision on the scale of the payment being made late in the year. This year, the bonus is to be paid for a full week, with a cost of €279 million. In the interest of good budgetary planning and to avoid a pattern of spending decisions based on cyclical developments (as occurred in the past), budget estimates should account for the payment of the bonus unless the Government genuinely intends not to pay it.

Budget 2020 plans no allocation in 2019 and 2020 to the National Surplus Reserve Fund (also known as the Rainy Day Fund) from the Central Fund (Box B). Contributions of €500 million per year are now planned to start from 2021. Although annual contributions would count as Exchequer spending (non-voted capital expenditure), they would not impact the general government spending or the balance, because these are transfers that remain within the general government sector. A transfer of €1.5 billion from the Ireland Strategic Investment Fund is to be made this year. Box B reviews the operation of the Rainy Day Fund and how planned contributions have evolved over time.

Box I: Health overruns in recent years: magnitude and main drivers

This box examines health overruns in recent years in terms of their magnitude relative to the allowed yearly increases and the main drivers of such overruns.

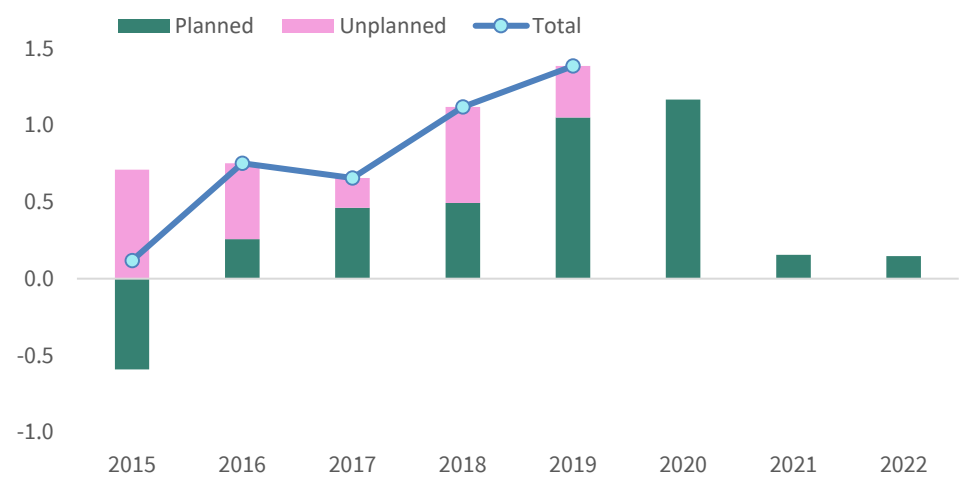
Unplanned health overruns have been large despite planned growth

Over the last few years, health overruns have been substantial. In the period 2014–2018, these have amounted to an average of €500 million per annum. This can have important implications for the public finances, especially when these expenditure overruns are covered by potentially transient revenue sources.

One way to look at the incidence of the overruns is to analyse their impact relative to the spending growth initially budgeted for. For example, the planned increase in health spending in 2017 and 2018 was, in both cases, close to €500 million (Figure I.1). But the magnitude of the overruns differed significantly: around €200 million in 2017, and €625 million in 2018. For 2019, the Government had budgeted for high year-on-year growth in health spending, amounting to €1.1 billion. This is lower than the actual growth in 2018, but it represents the largest planned increase since 2015. Despite this, an overrun for the year is expected. In particular, the Expenditure Report (Department of Finance, 2019d) included a supplementary estimate of €335 million for the Department of Health. For 2020, the planned increase is the largest since 2015, but it is still lower than the expected increase for 2019. After 2020, the planned increases are low and risk a repeat of significant overruns.

Figure I.1: Health overruns since 2016 have been large despite planned growth

€ billion: **planned** growth (forecast$_t$ – outturn$_{t-1}$) + **unplanned** growth (outturn$_t$ – forecast$_t$) = actual **total** growth (outturn$_t$ – outturn$_{t-1}$)



Sources: Department of Finance (Analytical Exchequer Statements and Fiscal Monitors); and Fiscal Council calculations.

Note: Data shown in Exchequer gross voted current spending terms. The2019 overrun is an estimate based on the supplementary estimate of the Expenditure Report 2020 (Department of Finance, 2019d). The forecasts for 2020–2022 are based on the Expenditure Report 2020. The 2015 growth takes into account the transfer from the HSE to Tusla (the Children and Family Agency) that took place in 2014.

HSE overruns are largely driven by hospital spending

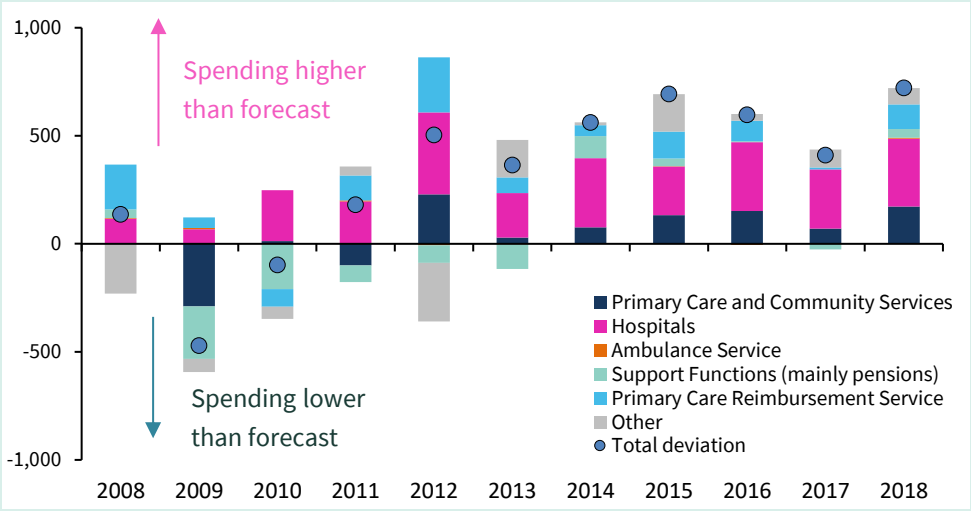
The most persistent driver of overspends in the HSE sector relates to hospital overspending, followed by overspends in Primary Care and Community Services and in the Primary Care Reimbursement Service (PCRS) (Figure I.2).[53]

[53] The PCRS is responsible for making payments to healthcare professionals (e.g., GPs, dentists or pharmacists) for the free or reduced costs of the services provided to the public.

In every year between 2008 and 2018 hospital spending has exceeded initially budgeted spending, averaging over €240 million per annum. However, most of these overruns should be analysed in a context were the planned annual increases were either negative (2009–2016) or almost zero (2017–2018), which may not be realistic (Figure I.3). As outlined in Howlin (2015), a failure to stay within initially forecast hospital spending arises from an underestimation of: (1) the demand for hospital services; (2) the efficiency of service delivery; (3) the impact of cost containment measures; and (4) the combination of these three factors. An important feature of hospital spending is that around 70 per cent of total expenditure relates to pay. This includes wage payments to hospital staff, which has recently exceeded initially planned budgets, especially due to the unplanned hiring of new staff by the end of the year.

Figure I.2: Overruns in the HSE have been largely driven by hospital spending

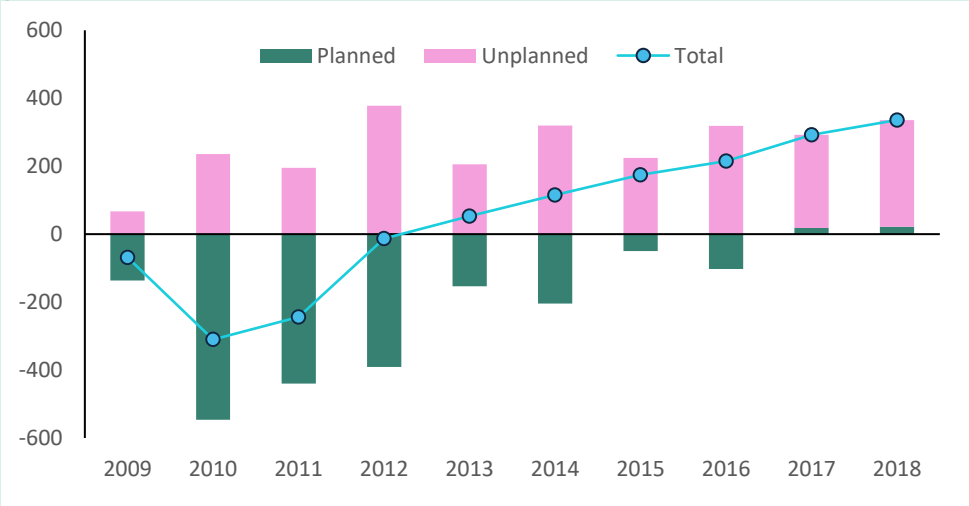
€ million (outturn minus forecast)



Sources: HSE Monthly Performance Reports; Howlin (2015); and internal Fiscal Council calculations.
Note: Forecasts taken from the end-January Performance Reports; outturns taken from end-December. In 2012, the performance of "primary care and community services" and "other" is impacted by a re-allocation between primary care for older people and the "Fair Deal" (within the "other" category) (see Howlin, 2015).

Figure I.3: Hospital spending increases have been achieved through overruns rather than planned spending

€ million: **planned** growth ($forecast_t - outturn_{t-1}$) + **unplanned** growth ($outturn_t - forecast_t$) = actual **total** growth ($outturn_t - outturn_{t-1}$)



Sources: HSE Monthly Performance Reports; Howlin (2015); and internal Fiscal Council calculations.

Failures in health management have been repeatedly highlighted by a number of institutions, including the European Commission (2019b), which notes that "budget management is weak across all levels of the health system" and that "[…] comprehensive planning and funding models are either non-existent, poorly functioning or unconnected locally and regionally".

The persistent health overruns that have taken place over the last few years have been the result of weak planning and weak spending controls, which has led to a "soft budget constraint" problem. That is, the budget allocations are not seen as credible by the health managers, which can lead to unplanned increases in spending. If these overruns are long-lasting (for example, the unexpected recruitment of permanent stuff), but are funded with temporary revenues (for example, temporary corporation tax windfalls), the sustainability of the public finances can be put at risk (Box D, Fiscal Council 2019e).

Revenue, 2020

The Government's revenue forecasts reflect the impact of a no-deal Brexit, with the sharpest slowdown in revenue growth taking place in 2020. **General government revenue** is projected to moderate its growth to €2.3 billion (or 2.7 per cent) in 2020 (Table 3.2), which compares to an expected growth of €4.3 billion (or 5.3 per cent) in 2019. The revenue growth for 2020 in *Budget 2020* is lower than in an orderly Brexit scenario in *SPU 2019*, which projected this to be 3.4 per cent. The moderation in 2020 projected in *Budget 2020* is driven by assumed slowdowns in (1) taxes on production and imports (mostly VAT, excise and stamp duties); (2) current taxes on income and wealth (largely income tax); and (3) social contributions (predominantly PRSI).[54]

In terms of **Exchequer revenue**, the underlying projections for 2020 (and outer years) are only moderately lower than at SPU time. This is driven by lower tax revenue projections. This is despite the move from an orderly Brexit scenario in *SPU 2019* to a disorderly Brexit in *Budget 2020*. On a headline basis, the Exchequer revenue projections are higher than in April's SPU, but this is largely driven by the assumption that a no-deal Brexit will imply that goods traded with the UK will be subject to customs duty payments, which has an insignificant impact on the Exchequer balance. In particular, 80 per cent of these would be collected on behalf

[54] Appropriations-in-Aid have been revised up by roughly €500 million for 2020–2023 since *SPU 2019*. This is based primarily on increased projections of the SIF, with PRSI projections being higher than in *SPU 2019* for all the period 2020–2023.

of the EU, while the remaining 20 per cent would be retained in the Irish Exchequer accounts.[55]

Table 3.2: General government and Exchequer revenue forecasts under an assumed no-deal Brexit

€ billion, excluding one-offs

	2018	2019	2020	2021	2022	2023	2024
General Gov. Revenue	82.0	86.4	88.7	92.1	95.9	100.3	105.0
Taxes production and imports	25.5	26.6	27.2	28.1	28.8	29.7	30.8
Current taxes on income, wealth	34.3	36.2	37.5	39.1	41.0	43.1	45.4
Capital taxes	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Social contributions	13.5	15.1	15.6	16.4	17.2	18.2	19.3
Property income	1.3	1.7	1.3	1.2	1.2	1.3	1.3
Other	7.0	6.2	6.6	6.8	7.1	7.4	7.7
Exchequer Tax and PRSI	65.8	69.9	72.2	75.3	78.6	82.4	86.7
Exchequer Tax Revenue *	55.3	58.3	60.1	62.6	65.3	68.3	71.7
PRSI	10.5	11.6	12.1	12.7	13.4	14.1	15.0

Sources: Department of Finance; and internal Fiscal Council calculations.
Note: *From 2019 onwards, the customs forecasts included in Exchequer tax revenue exclude the contribution to the EU budget due to the baseline assumption of a no-deal Brexit (as this is almost neutral in terms of the Exchequer balance, and it is not reflected in the general government accounts). For PRSI, the gross figures including the excess over expenditure are shown. For 2020–2024, PRSI refers to the total Social Insurance Fund figures, which in recent years have been around €100 million to €200 million greater than gross PRSI including excess expenditure. Rounding can impact on totals.

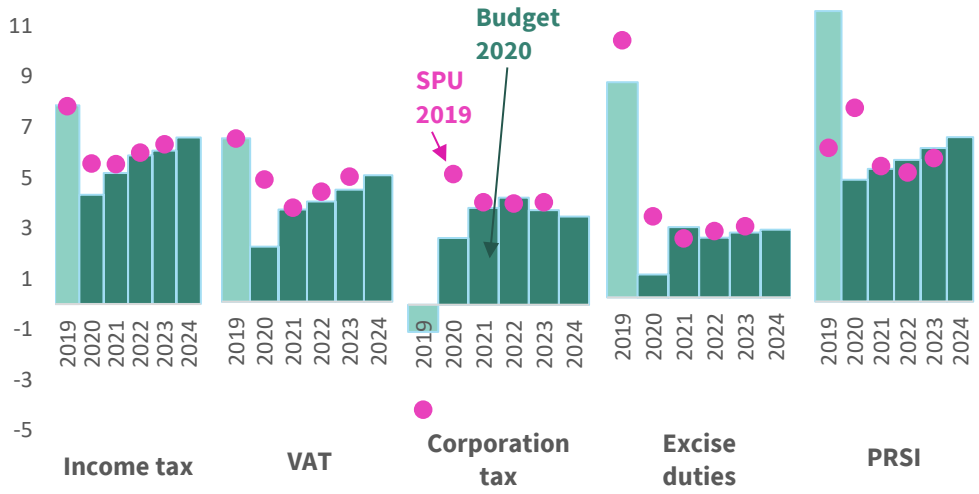
Focusing on **Exchequer tax revenue**, *Budget 2020* forecasts a slowdown in growth to 3.1 per cent in 2020, compared to 5.6 per cent estimated for 2019 (Table 3.2).[56] The front-loaded impact of a hard Brexit assumed by the Department in 2020 for the main tax heads (and PRSI) is reflected in Appendix E, and Figures 3.9 and 3.10.

[55] While this inflates Exchequer revenue—which jumps by €1 billion in 2020, and above that in 2020–2024—it is also translated into higher non-voted expenditure, making the net impact on the Exchequer balance relatively small, as noted in *Budget 2020* (Box 7). The custom duties arising from this assumption do not impact the general government accounts. More broadly, the EU contributions (including customs) are expected to increase substantially as a result of the UK existing the EU and the growth of GNI in the next few years. The Taoiseach noted that Ireland's contributions will increase by about 45 per cent between 2021 and 2027. The full explanation is available at: https://www.oireachtas.ie/en/debates/debate/dail/2019-10-23/23/#spk_301

[56] This excludes the expected customs received and subsequently paid to the EU as a result of an assumption of a hard Brexit (as customs tariffs would apply to goods imported from the UK).

Figure 3.9: The hard Brexit impacts on tax and PRSI growth are mostly reflected in 2020

% change (year-on-year)



Sources: Department of Finance; and Fiscal Council calculations.

Growth in the main tax heads is projected to slow to 2.5 per cent in 2020. This is driven by (1) weaker macroeconomic forecasts, which incorporate the impacts of a no-deal Brexit, and (2) further negative judgement related to Brexit (other than that included in the macro drivers) in most of the cases (i.e., excluding corporation tax forecasts):

- For income tax, the slowdown in 2020 is almost fully driven by downward judgement related to Brexit (–€240 million), and weaker growth in the macroeconomic drivers (namely, earnings and employment growth) than in 2019. However, the implied year-on-year growth for income tax in 2020 is projected at 4.3 per cent, which might seem strong given the assumed slowdown in employment growth projected by the Department and the potential magnitude of a shock like a disorderly Brexit. As noted in Box H, there is considerable uncertainty over the fiscal impact a no-deal Brexit would have.

- Similarly, the assumed slowdown in VAT growth for 2020 is the result of negative Brexit-related judgement (–€240 million) and a slowdown in personal consumption growth to 1.4 per cent in 2020 (in contrast to an estimated 3.1 per cent in 2019). The implied year-on-year growth in *SPU 2019* was 4.8 per cent for 2020, in sharp contrast with the *Budget 2020* implied growth of 2.1 per cent.

- Corporation tax is forecast to grow by 2.5 per cent in 2020, in contrast to the negative growth estimated for 2019. This is because the negative judgement

which was applied to the 2019 forecast is no longer assumed to impact 2020. Compared to *SPU 2019,* corporation tax forecasts have somewhat increased for 2020 and later years in absolute terms (with an upward revision of €60 million per annum, on average), despite the move to a no-deal Brexit scenario in *Budget 2020*.[57] Focusing on the corporation tax growth for 2020, the low growth forecast by the Department is almost entirely driven by moderations in Gross Operating Surplus (forecast at 1.6 per cent for 2020, as opposed to the estimate of 6.1 per cent in 2019). However, if the 2019 receipts prove higher than currently forecast, this will mean that the *Budget 2020* forecasts for 2020 are made on the basis of a low starting point (2019). This might lead to underestimations of the yield for 2020, though this might be balanced with uncertainties arising from Brexit and the international tax environment, as well as the intrinsically uncertain nature of corporation tax receipts, especially in the past few years.

- Excise duties for 2020 are forecast to substantially moderate their growth compared to 2019 given a decline in the macro drivers and, more notably, negative Brexit judgement of €200 million. Of this, €150 million relates to a negative adjustment in vehicle registration tax to reflect the estimated impact of Brexit on second hand car imports from the UK; and the remaining €50 million reflects the assumed impact of a disorderly Brexit, including the introduction of duty-free shopping. This is partly offset by the increase in excise duties on tobacco products introduced in *Budget 2020*. Box J examines the methodology underpinning the expected yield from this measure, as well as some other measures introduced in *Budget 2020.*

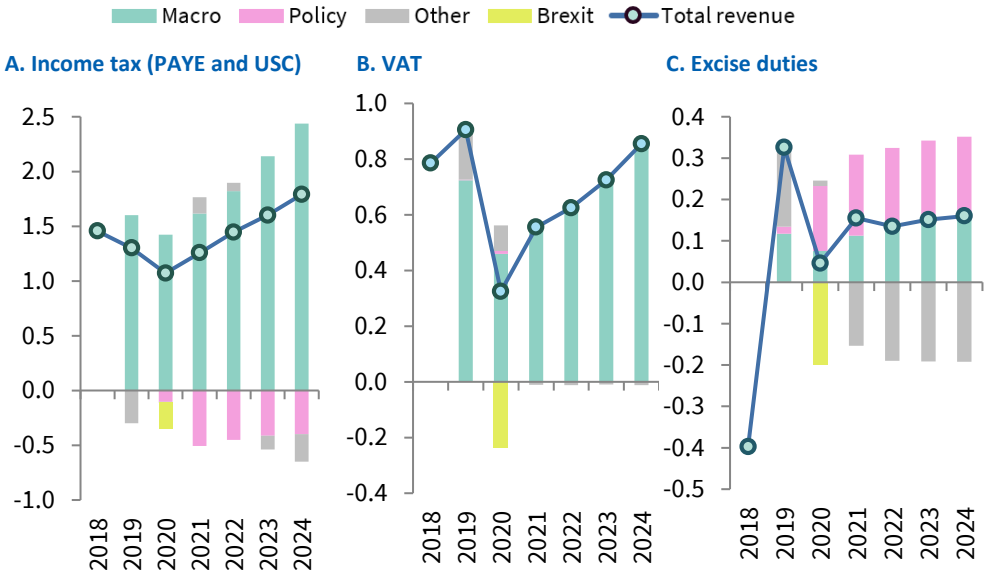
Stamp duty receipts are projected to grow by just €35 million in 2020 relative to 2019. This is despite a policy change to increase the rate of stamp duty on non-residential property, which the Department projects to yield €141 million in 2020. The gap that explains this difference relates to lower receipts from share-trading activity, which the Revenue Commissioners already note to be a driver of the stamp duty's underperformance for the year to date. The *Budget 2020* forecasts

[57] Although Figure 3.12 shows that the assumed corporation tax growth for 2020 is lower in *Budget 2020* than in *SPU 2019*, this is entirely driven by the upward revision in the 2019 base estimated in *Budget 2020*. In absolute terms, the 2020 forecast is higher in *Budget 2020* than in *SPU 2019*.

assume a continuation of this trend, particularly in the context of an assumed no-deal Brexit, where a fall-off in share-trading activity with the UK is expected to negatively impact stamp duty revenue in 2020.[58]

Figure 3.10: Slowdowns in tax growth in 2020 caused by lower macro drivers and further Brexit judgement

€ billion change year-on-year



Sources: Department of Finance; and internal Fiscal Council calculations.
Note: "Other" reflects other factors/judgement applied by the Department of Finance and carryover impacts from previous policy measures. See Appendix E for more detail.

Box J: Assessing the discretionary revenue measures introduced in *Budget 2020*

This box examines the three largest revenue-raising measures contained in *Budget 2020*. The box updates some of the analysis undertaken in Box F of the *November 2017 Fiscal Assessment Report* (Fiscal Council, 2017e).

(1) Stamp duties on non-residential construction

The largest revenue-raising measure contained in the Budget relates to a further increase in stamp duties on non-residential construction from 6 per cent to 7.5 per cent. This measure is expected by the Department to yield €141 million in 2020.

In *Budget 2018,* the rate of stamp duty on non-residential property increased from 2 to 6 per cent. This was estimated to yield an extra €374 million in 2018, which proved overly optimistic: the actual yield might be close to €289 million. The assumptions underpinning the projected yield were based solely on activity levels evident in 2016 and early-2017. This shortfall from forecasts suggests that the elasticity of changes in stamp duty to commercial activity might have been overestimated in *Budget 2018.* In *Budget 2020,* the Revenue Commissioners state that the expected yield for 2020 is calculated on the basis of the full-year receipts in 2018, as well as the expected yield in 2019. But Table J.1 shows that, in essence, the assumptions

[58] For 2022, the negative growth in stamp duties projected by the Department is the result of the cessation of the bank levy, which accounts for approximately for €150 million in annual revenue.

underpinning this yield for 2020 are the same as at the time of *Budget 2018.* In particular, *Budget 2018* implied that each additional percentage point increase in stamps would bring in an extra €93.5 million for 2018. *Budget 2020* implies the exact same assumption.

In addition, as shown in Figure J.1, the reference period considered for the Revenue Commissioners' forecasts might correspond to an exceptional period of activity. In recent years, commercial property turnover has been substantially higher than at the pre-crisis peak. This poses concerns in terms of the sustainability of the revenue arising from this measure.

Table J.1: The forecast yield of the increased stamp duty is made on the same basis as in *Budget 2018*, which proved over-optimistic

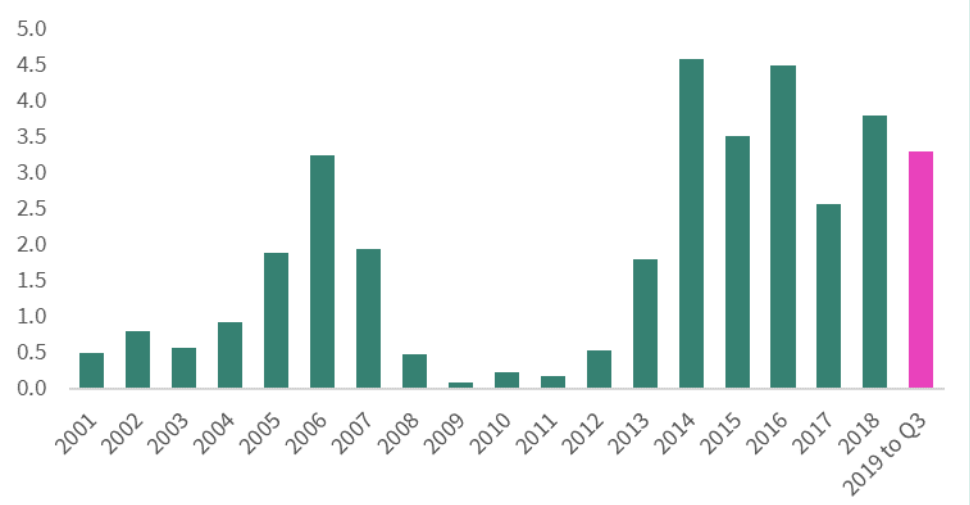
€ millions unless stated

	$\Delta Rate$ (pp)	Forecast yield	For a 1pp increase, the implied forecast yield is …
Budget 2018 (2% to 6%)	4.0	+374	+93.5
Budget 2020 (6% to 7.5%)	1.5	+141	+93.5

Sources: Department of Finance; and Fiscal Council calculations.
Note: The last column is calculated as column 2 divided by column 1.

Figure J.1: Irish commercial property investment turnover

€ billion



Sources: CBRE Research.

(2) Excise duties on tobacco products

The tax on tobacco products has been increased by €0.50 (including VAT) on every pack of 20 cigarettes, with pro-rata increases on other tobacco products. The Department of Finance forecasts this measure to bring in a yield of €57.1 million for 2020. This is equivalent to the yield estimated at the time of *Budget 2019* for the same measure.

Prior to the *Budget 2020* publication, the Revenue Commissioners (2019b) published the Ready Reckoner report, which included the expected yield arising from an increase in the tobacco products tax. For an increase of €0.50 per pack of 20, the Revenue Commissioners estimated a yield that ranges from –€42million to +€57 million. The analysis notes that the upper limit of these estimates is likely to be most accurate.

Previous analysis made by the Revenue Commissioners (2011) in "Modelling the Market for Cigarettes in Ireland" finds that an increase in the price of cigarettes triggers a reduction in cigarette consumption. It shows that a Laffer-type of curve is likely to exist in Ireland, which suggests that beyond a certain level of taxation, tax revenue will start to fall. Although the

proposed Laffer curve does not prove significant, it could serve as a guideline for illustrative purposes. The peak of the curve is found at a tax rate of below 79 per cent. With the current tax rate being nearly 80 per cent, this analysis would imply that the revenue collected from this measure might be negative.

For *Budget 2020,* the limited amount of data makes it difficult to understand the drivers of this yield proposed by the Revenue Commissioners. For example, it would be helpful to know whether the methodology takes on board behavioural changes that can have important implications for the revenue collected from this measure. For example, as a result of the increased tax, people might choose to reduce their tobacco consumption; or they might switch to alternative modes of tobacco products that are less heavily taxed (e.g., vaping); or they might resort to other markets where the tobacco products are either taxed at a lower rate (including duty-free purchases) or not declared (i.e., the black market). The 2011 report by the Revenue Commissioners echoed the importance of such behavioural changes. It noted that the reduced consumption of tobacco arising from an increase in prices was largely explained by smokers switching to substitute cigarettes, such as cigarettes not taxed in Ireland.

(3) Compliance measures

Budget 2020 includes a compliance measure that is projected to yield a revenue of €80 million in 2020. This refers to an increase in the Dividend Withholding Tax (from 20 per cent to 25 per cent), which applies to dividend payments and other profit distributions made by Irish resident companies.[59] As this measure relates to an increase of a tax rate, there are doubts as to whether this should be categorised as a "compliance" measure. The Department of Finance has stated that the estimated yield is based on assumptions from payments in 2018 and 2019 to date on the basis of "prudency". Again, it would be helpful to have details about the specific methodology underpinning the yield, which is currently unclear.

[59] When the Dividend Withholding Tax was introduced in 1999, the USC did not exist and this tax had not been updated to take account of the introduction of the USC. The new rate at 25 per cent is close to the combination of the standard 20 per cent rate of income tax and the most common rate of USC of 4.5 per cent.

3.4 Medium-term forecasts (2021–2024) in *Budget 2020*

Budget balance, 2021–2024

In the later years of the projections (2021–2024), the general government balance and the primary balance are both projected to improve significantly. The improvement in 2021 is partially due to Brexit-related expenditure falling (from €1.2 billion to €0.8 billion), which may be unrealistic (Box H). Revenue growth is forecast to pick up after the slowdown in 2020 (reflecting a pickup in economic growth after a no-deal Brexit having a big impact on 2020 growth). In a deal scenario, it may be the case that growth is stronger than a no-deal case in 2020, but lower in 2021. The extent of the reduction in growth in 2021 would be contingent on the nature of the free trade agreement to be negotiated (which could be significantly less comprehensive than current EU membership). It is also worth noting that the currently proposed withdrawal agreement is likely to be more damaging to economic growth than what was assumed previously (in *SPU 2019*, for example).

The expenditure figures from 2021–2024 rely on technical assumptions, as has previously been the case, albeit that the revised assumptions may prove somewhat more realistic (as described below). Revenue forecasts for the same years are based on continuing existing policies in a way that is likely to broadly reflect reality. Based on these assumptions, the general government balance is projected to move into surplus in 2022, with larger surpluses thereafter. If an orderly deal were to be assumed, the general government balance would be forecast to feature increasing surpluses over the forecast period, in line with what was shown in *SPU 2019*.

Macroeconomic and fiscal forecasts in *Budget 2020* went out to year T+5 (in this case 2024), a move that was committed to in *SPU 2019* and which the Council welcomes. The Council assesses that a horizon of at least five years ahead is appropriate to support a medium-term orientation for fiscal policy, and to ensure ongoing emphasis on identifying risks or potential economic imbalances in real time.

Expenditure, 2021–2024

For 2021, gross voted current spending is forecast to grow by 3.0 per cent. For the years 2022–2024, expenditure forecasts in *Budget 2020* are based on technical assumptions that do not reflect either current government policy or likely future policies. Gross voted current expenditure is assumed to grow by 3.25 per cent per annum for 2022–2024. This approach is a change from *Budget 2019* and *SPU 2019,* where the Department assumed that gross voted current expenditure would grow by 2.5 per cent.[60] For context, this measure has grown by 3.9 per cent annually, on average, over 2016–2018, so the new forecasts are closer to historical experience and may be more realistic.

While the approach in *Budget 2020* of assuming a higher growth rate in the later years may be more likely to match the eventual outturn, forecasts based on a medium-term policy path or the costs of sustaining existing policies would be more informative.

Gross voted capital forecasts are in line with the National Development Plan, with growth averaging over 6.1 per cent over 2021–2024. These forecasts also incorporate commitments relating to the National Children's Hospital and the National Broadband Plan. As noted in Fiscal Council (2019c, Box F), large capital investment projects in Ireland (and internationally) tend to overrun initially-set budgets.

As outlined earlier, *Budget 2020* forecasts assume that Brexit contingency spending is forecast to fall after 2020. It may be unrealistic assume that sectoral supports would be completely discontinued after 2020.

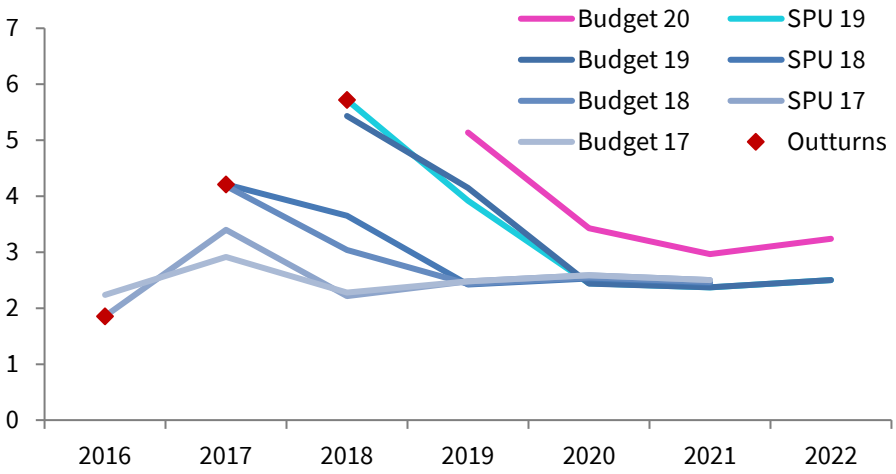
Figure 3.11 shows various forecast vintages of gross voted current expenditure. In recent rounds, there has been a pattern of forecasting a slowdown in expenditure growth, generally down towards some assumed medium-term growth rate. This significant slowdown to such a rate is yet to occur.[61]

[60] On a general government basis, this is mainly reflected by higher intermediate consumption in these later years.

[61] Gross voted current spending grew by 4.2 per cent in 2017 and 5.7 per cent in 2018 and is forecast to grow by 5.1 per cent in 2019.

Figure 3.11: Vintages of gross voted current expenditure forecasts

Percentage change



Sources: Department of Finance; and Fiscal Council calculations.

Table 3.3: General government expenditure forecasts under an assumed no-deal Brexit

% change year-on-year, unless otherwise stated

	2019	2020	2021	2022	2023	2024
General Gov. Expenditure	4.3	5.8	2.3	3.2	3.2	3.1
Compensation of Employees	3.7	3.0	1.7	0.2	-0.4	-0.1
Intermediate Consumption	20.3	7.5	2.1	10.0	10.4	11.3
Social transfers	-0.2	3.3	1.2	0.6	0.2	0.4
Interest Expenditure	-10.6	-14.2	-7.8	4.6	4.5	-2.7
Subsidies	-15.5	-8.6	-0.7	0.3	1.7	2.7
Gross Fixed Capital Formation	25.3	11.1	2.8	3.5	6.8	6.7
Capital transfers	3.8	33.3	18.4	11.4	13.1	9.5
Other	-7.1	12.0	0.5	0.9	3.4	3.4
Resources to be allocated, € billion (included in total expenditure above)	0.0	1.2	1.9	2.3	2.3	2.2
Of which: Brexit Contingency	0.0	1.2	0.8	0.8	0.7	0.6
Of which: Other unallocated	0.0	0.0	1.1	1.5	1.6	1.6
Primary Expenditure	5.3	7.0	2.8	3.1	3.1	3.4
Primary Expenditure (% GNI*)	39.9	42.5	42.3	42.1	42.0	42.1

Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which may be unrealistic. Resources to be allocated represents expenditure which is yet to be allocated to a specific item, with a decision as to where this is to be allocated to be made closer to the time. It is not included in "other" expenditure listed above. Primary expenditure is calculated as total expenditure minus interest payments. As a result, it includes resources to be allocated (some of which are Brexit contingency funds).

The technical nature of the medium-term spending projections implies that many expenditure items show limited growth (Table 3.3). Compensation of employees is forecast to remain relatively flat after the expiration of the current public sector pay

agreement (2020). Given the likely increases in staff numbers and wage growth in the economy, it would seem highly unlikely that compensation of employees would stay nominally constant from 2021 to 2024. Fiscal Council "Stand-Still" estimates would indicate that if public sector pay rates were to increase in line with agreed pay deals and in line with private-sector wages thereafter, this would imply additional cost pressures of approximately €850 million per year.[62, 63]

The Department has left a significant amount of unallocated expenditure, spending which is not identified to specific purposes, in the forecasts (even apart from the no-deal Brexit contingency expenditure). A better practice would be to give an indication of where these resources would be employed, even if this might be adjusted by subsequent policy decisions.

Two alternative illustrative scenarios for general government spending and the resulting balance assuming the same tax policies as the Budget are presented in Table 3.4.[64] The two scenarios both show similar results, with higher spending resulting in a lower general government balance than forecast in *Budget 2020*.

[62] The Fiscal Council "Stand-Still" scenario estimates the cost of maintaining today's level of services and social benefits (in real terms) over the medium run.
[63] In addition, estimates from the spending review (Walker and Ryan, 2019) suggest that absent policy changes, the public sector pay bill could increase by 8 per cent per annum out to 2022. This is calculated by taking the difference between the 2018 outturns and the projected 2022 level.
[64] In both cases, general government revenue is adjusted to account for the increased levels of expenditure (relative to *Budget 2020* forecasts). This is done using the Council's Fiscal Feedbacks Model.

Table 3.4: Alternative scenarios for general government expenditure, revenue and balance

€ billion

	2019	2020	2021	2022	2023	2024
Expenditure						
Budget 2020	85.7	90.7	92.8	95.7	98.8	101.9
Alternative: grow in line with GNI*	85.7	90.7	93.3	96.6	99.8	102.8
Alternative: Stand Still	85.7	90.7	92.9	96.4	N/A	N/A
Revenue						
Budget 2020	86.4	88.7	92.1	95.9	100.3	105.0
Alternative: grow in line with GNI*	86.4	88.7	92.2	96.1	100.5	105.2
Alternative: Stand Still	86.4	88.7	92.1	96.1	N/A	N/A
Balance						
Budget 2020	0.7	-2.0	-0.7	0.2	1.5	3.1
Alternative: grow in line with GNI*	0.7	-2.0	-1.1	-0.4	0.7	2.4
Alternative: Stand Still	0.7	-2.0	-0.8	-0.3	N/A	N/A

Sources: CSO; *Budget 2020*; and Fiscal Council calculations.
Notes: Two scenarios are considered in this exercise. The "Alternative: grow in line with GNI*" scenario shows general government expenditure which would arise from growing spending (apart from the Brexit contingency funds) in line with nominal GNI*, using GNI* forecasts from *Budget 2020*. The "Alternative: Stand Still" scenario shows the general government expenditure which would arise when adding in the additional Fiscal Council Stand-Still costs for demographics and price pressures over the pre-commitments for these items, carryover costs and unallocated resources in *Budget 2020* forecasts. Figures in grey indicate that the Council assesses these forecasts as largely the result of technical assumptions on expenditure, which may be unrealistic.

The first alternative scenario shows how general government expenditure would evolve were it to grow in line with GNI*.[65] For this scenario, the no-deal Brexit contingency funds are left as forecast in *Budget 2020*, with the remainder of expenditure assumed to grow in line with GNI*. *Budget 2020* forecasts of nominal GNI* are used for 2021–2024, with growth averaging 3.4 per cent. This first alternative scenario shows higher levels of expenditure in the years 2021–2024. This is because non-Brexit spending is forecast (in *Budget 2020*) to grow slower than nominal GNI* over the period 2021–2024. In this illustrative alternative scenario, a deficit remains until 2022 before improving to a surplus thereafter. The surpluses in the later years are also smaller than those presented in *Budget 2020*.

[65] Although 2020 expenditure is a forecast rather than an outturn, it is used as the starting point here. This is because most of the policy decisions for expenditure in 2020 have already been made. In addition, starting from 2020 ensures consistency with the Stand-Still approach, which is also used as an alternative scenario for expenditure in Table 3.4.

As a second illustrative scenario, we use the Fiscal Council Stand-Still scenario to arrive at alternative spending projections.[66] As Department of Public Expenditure and Reform estimates of the expenditure related to demographic costs have only been provided out to 2022, the Stand-Still analysis can only be conducted for 2021 and 2022. The results for this scenario are similar to those obtained in the GNI* scenario for these two years, with higher spending meaning a deficit in 2022.

As highlighted above, public sector pay increases are not factored in beyond 2021. The unallocated resources in *Budget 2020* (excluding the no-deal Brexit contingency funds) are not enough to cover the Fiscal Council estimates of pay and non-pay price pressures in 2021 and 2022.

Revenue, 2021–2024

For the medium term (2021–2024), the growth of general government revenue is projected to average 4.3 per cent per annum, similar to the medium-term forecasts projected in *SPU 2019,* when the baseline scenario was more benign. Overall, the main components of the revenue forecasts have not been revised significantly since April's forecasts. This means that the shock in revenue growth assumed by the Department is rather front-loaded, with the most significant slowdown in growth forecast to take place in 2020.

The growth of the main tax revenue sources is projected to recover after the assumed shock in 2020. Although the Department does not provide a detailed counterfactual of an orderly/disorderly Brexit by tax head—and, more broadly, on the budgetary front—the forecasted medium-term revenue growth rates are also similar to those in *SPU 2019* (Figure 3.9). This reflects that the nature of Brexit is assumed to have relatively little impact at these longer horizons, reflecting the profile of impacts on activity and incomes. Income tax and VAT are both projected to grow substantially: by 2024, they are expected to reach an annual growth of 6.6

[66] This is calculated as the difference between Fiscal Council Stand-Still estimates of the costs associated with demographic change and price pressures (pay and non-pay) and the pre-committed amounts and unallocated resources (not including the no-deal Brexit contingency funds) in *Budget 2020* expenditure forecasts. This difference is then added to the *Budget 2020* projections for general government expenditure. The budget pre-commitments used for this exercise include allocations for demographics, public sector pay and carryover costs.

and 4.9 per cent, respectively. Corporation tax growth is projected to stabilise to an average of around 3.6 per cent over the medium term (2021–2024).

Given the unique nature of a shock like a disorderly Brexit, the assumed macro drivers of the revenue forecasts might be lower than currently assumed in *Budget 2020* over the medium term. Separately, there is an upside risk that corporation tax might yield higher-than-forecast outturns, as has been the case over the past few years. However, there is a significant downside risk that part of the corporation tax receipts might prove temporary in nature, which poses concerns about its sustainability, as also noted by the Department of Finance (2019d).

Box K: The way health spending is reported can lead to different conclusions about its performance

This box examines the differences in how health spending performance is reported.

Accounting differences. Two main publications show the monthly performance of health spending, but these differ in content and in the accounting standards they adopt. The HSE Performance Reports show expenditure based on accrual accounting: spending is recorded at the time at which it occurs, regardless of when the related cash payments take place. In contrast, the Central Government's Fiscal Monitor covers cash inflows and outflows. It comprises the total (current and capital) health vote including the HSE.[67]

Figure K.1 shows the difference between the monthly outturns and forecasts (the "overruns" or "underruns") by publication. This is shown on a net basis, looking at current spending only, to ensure comparability. For 2017 and 2018, the HSE Performance Reports showed higher overruns than the Fiscal Monitor publications for most of the year, before the Fiscal Monitor "catches up" by the end of the year. Yet a substantial gap in performance remains. One would expect that the divergence is therefore due to accruals and/or coverage differences.

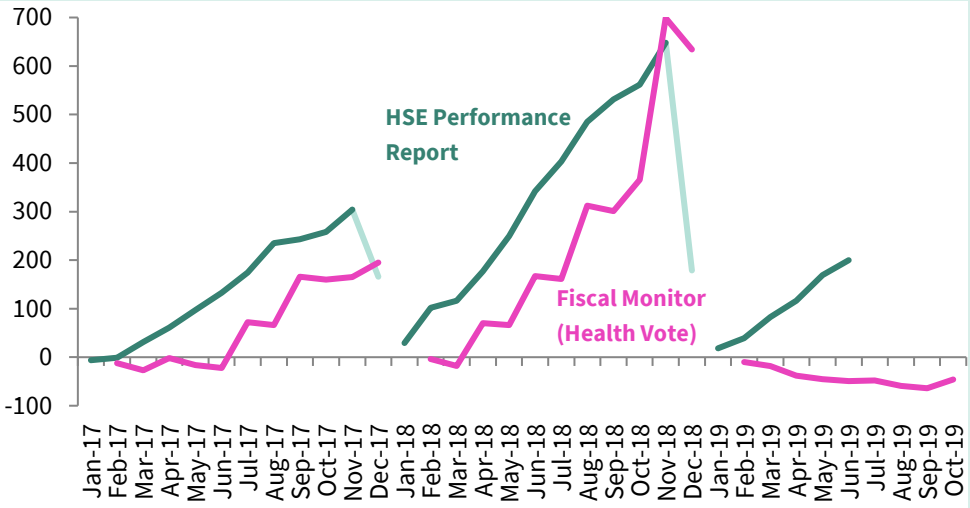
Is this year different? While the latest HSE figure of June 2019 shows an overrun of expenditure of around €200 million, the Fiscal Monitor reports underruns in every month, cumulating to almost €100 million as of end-October 2019.

The underrun shown in the Fiscal Monitor is attributed by the Department of Health to the financial improvement of the HSE, which has not required any cash in addition to the original allocation. In contrast, the overrun shown in the HSE Performance Report might be partly explained by an unusual transaction related to the settlement of pay arrears with medical consultants in 2018. The CSO dated €213 million of the settlement to central government expenditure in Q2 2018, the time of the court settlement (CSO, 2019). However, some payments are due in 2019 as well as 2020. Any impact on overruns is uncertain, as it is unclear how much of the total has been accrued and paid at different stages of the year so far.

[67] The HSE Performance Report is net of HSE income and covers only current spending. The Fiscal Monitor reports net expenditure (net of appropriations-in-aid).

Figure K.1: Health overruns/underruns differ by report

€ million (outturn minus profile), net current expenditure



Sources: Fiscal Monitors 2017–2019; HSE Performance Reports (Finance section) 2017–2019.
Note: January Fiscal Monitors do not include a comparison of Vote outturns to profiles. In December 2017/2018, the overrun reported in the HSE Performance Report fell. This is likely due to revisions in the monthly forecasts throughout the year but particularly at year's end. In contrast, the Fiscal Monitor profiles are not revised within the year.

Box L: What are Approved Housing Bodies?

Approved Housing Bodies are non-profit entities that provide affordable rented housing. We explored these in more detail in Box F of the *June 2018 Fiscal Assessment Report*, but this box gives a quick recap of some of the key elements.

In 2017, the CSO conducted a review of the classification of the largest Approved Housing Bodies in Ireland. It concluded that these bodies should be classified as part of the local government sector and, hence, part of the wider general government sector. This means that spending and revenues associated with the bodies were to be recognised as part of government activity. The rationale for why bodies become recognised as part of general government follows three key principles related to (1) the extent of government or local authority control, (2) the degree of autonomy in decision making and other aspects of institutional independence from government, and (3) the degree to which its services or goods are "non-market" — that is to say the extent to which prices charged for these are "economically significant" according to set criteria (CSO, 2018c).

The classification of Approved Housing Bodies into general government added about €0.6 billion to government investment spending in 2018. On the revenue side, "sales of goods and services" saw relatively more modest increases of just under €0.1 billion. The reclassification of these bodies into general government had a relatively small impact on general government debt (increasing it by around €0.1 billion). This reflected the fact that much of the Approved Housing Bodies' debt had already been included in general government statistics as it was obtained via the Housing Finance Agency, which is already included in the general government sector.

Investment spending by Approved Housing Bodies had been expected to rise as part of *Rebuilding Ireland*, the Government's housing plan, as the bodies acquired or developed newly built housing. Approved Housing Bodies are expected to "deliver approximately one third of

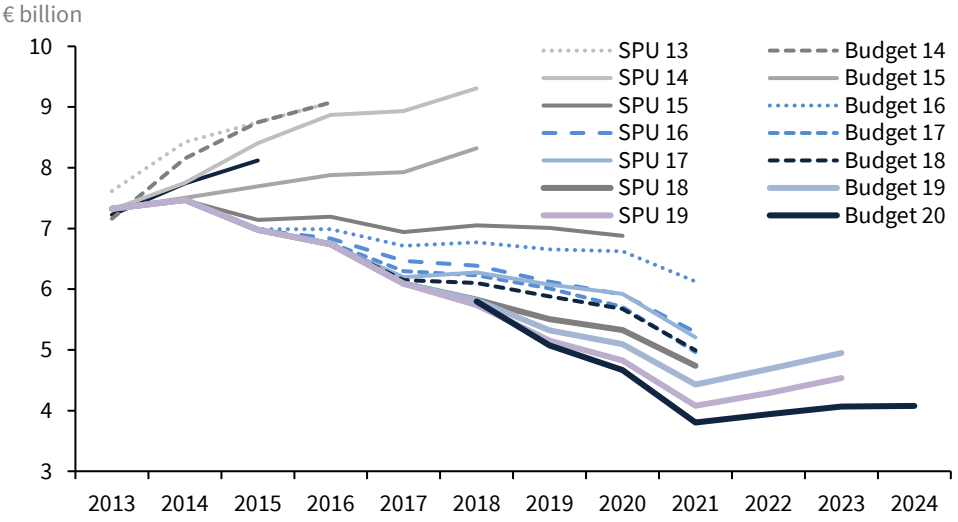
the targets for the remaining years of *Rebuilding Ireland*".[68] There is limited data on the previous levels of aggregate activity of these bodies, and hence it is difficult to assess if they are likely to increase activity as rapidly as is reflected in *Budget 2020* forecasts.

Interest expenditure

Interest costs on government debt have declined in recent years, and this is forecast to continue until 2021. Figure 3.12 shows the reduction in forecast and actual interest costs due to: (1) low global interest rates; (2) agreed reductions in interest rates on official borrowing; (3) expansionary monetary policy by the ECB, including the Public Sector Purchase Programme; and (4) the early repayment of IMF loans and other debt restructuring. Figure 3.12 also shows that interest costs have been consistently lower than forecast for a number of years.

Budget 2020 has seen a further downward revision to expected interest payments over 2019–2023. Interest costs are forecast to rise somewhat after 2021, due to a forecasted rising average interest rate and a rising level of debt (in nominal terms). The average interest rate is forecast to rise because the bonds due to be refinanced in 2022 have very low rates; hence they are expected to be refinanced at higher rates.[69]

Figure 3.12: Revisions to national debt cash interest payments



Sources: Department of Finance.

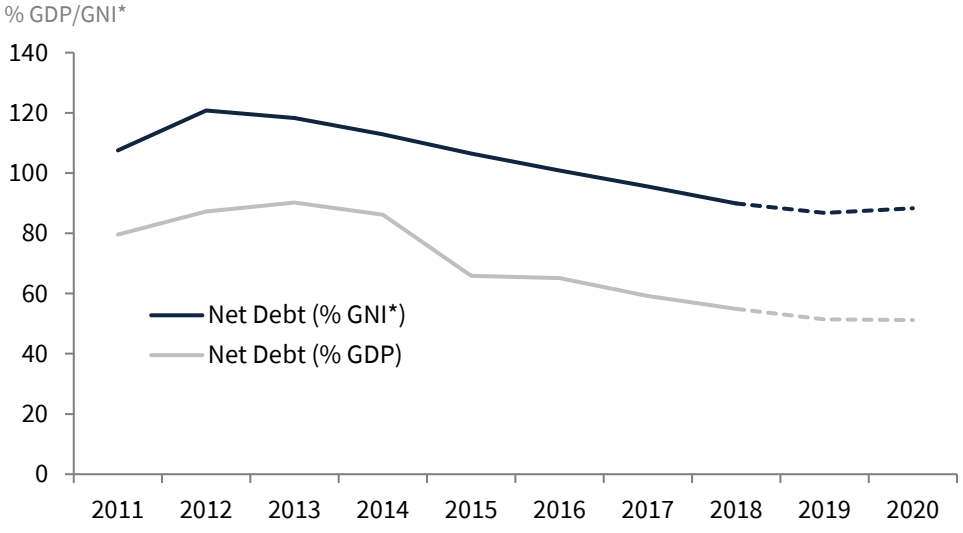
[68] Response from the Minister of State at the Department of Housing, Planning and Local Government. The full debate is available here: https://www.oireachtas.ie/en/debates/question/2019-02-20/25/

[69] Given that forecasts of interest costs have fallen since SPU, it appears a no-deal Brexit is not assumed to have a significant impact on Irish interest costs or the risk premium.

General government debt

The gross debt-to-GDP ratio has fallen substantially since 2012. Two factors have played a significant role. The first is related to the high level of measured GDP growth in 2015. The second involves the liquidation of the IBRC, which led to lower liabilities being measured on the Government's balance sheet (in 2011, this had led to an increase in government liabilities of €20.9 billion; stripping out these liabilities, gross debt to GDP would have been 4 per cent lower). While the *Stability and Growth Pact* reference value of 60 per cent is set in terms of debt-to-GDP, it is worth remembering that for Ireland this 60 per cent of GDP reference value would be equivalent to 98.5 per cent of GNI* (using 2018 nominal outturns for both variables).[70] Using GNI* or revenue as a denominator, government debt remains high relative to other OECD countries (see Figure 1.9 in Chapter 1). Given some of these distortions and the relatively high cash balances run by the NTMA, net debt to GNI* is a more informative measure. Using this metric, the decline in debt levels is more gradual since 2012, and net debt is expected to fall to 86.8 per cent in 2019 (Figure 3.13). The projections imply a steady reduction in the debt/GNI* ratio in the later years, although this is based on technical assumptions for spending. The decline in the debt ratio would be shallower if higher expenditure were forecast in the later years (Table 3.4 shows two alternative scenarios).

Figure 3.13: General government debt



Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: Data for the period 2019–2020 are projections as per *Budget 2020*.

[70] Gross general government debt is forecast to fall below 60 per cent of GDP in 2019.

Budget 2020 highlights the need for a more comprehensive picture of public sector net wealth. Public sector balance sheets are a good way of getting such an overview. The Department of Finance is said to be working with the CSO to develop a public sector balance sheet for Ireland. The Council welcomes this development and looks forward to seeing a time series of published estimates.

3.5 Risks

While *Budget 2020* forecasts incorporate what previously would have been a downside risk (no-deal Brexit), substantial risks to the public finances remain. As has been well documented, for any given Brexit scenario there is huge uncertainty around how that would translate into macroeconomic and fiscal impacts for Ireland. So while *Budget 2020* forecasts have incorporated an adverse Brexit scenario, there is a chance that modelling work may have underestimated the impacts of such a scenario on the Irish economy. Naturally, there is now an upside risk to macroeconomic and fiscal projections if a softer Brexit occurs or if there is a further extension to UK membership of the EU.

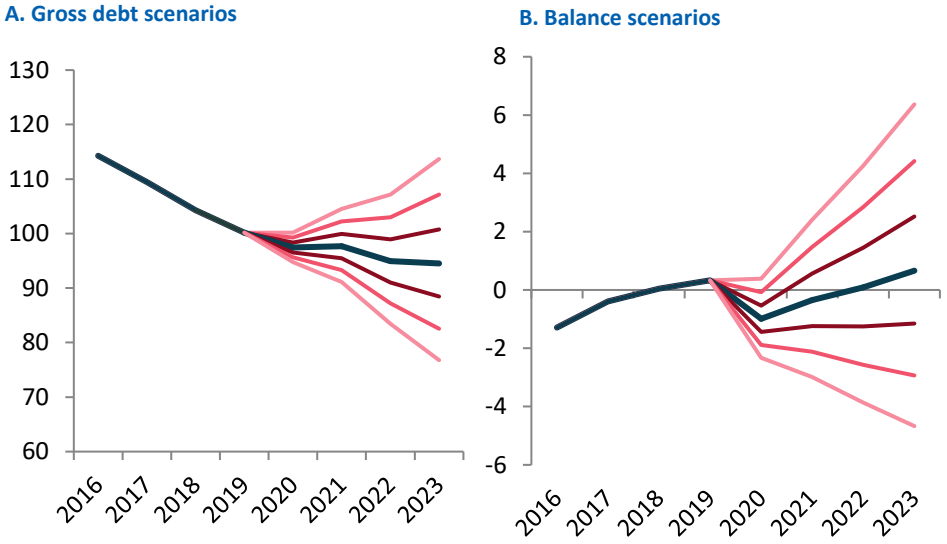
Other aspects of the external environment pose risks to the forecasts. In particular, possible changes to the international corporation tax environment could pose significant fiscal risks.

The reliance on potentially transient sources of revenue to fund permanent expenditure increases is a significant fiscal risk. Corporation tax rose to a record share of tax revenue in the last decades and particularly last year (Figure 3.4). These unexpected corporation tax receipts were partially used to fund permanent increases in expenditure over the last number of years.[71]

[71] Almost all of the €0.4 billion overruns this year from the Departments of Health, Education and Skills and Justice and Equality are believed to be recurring.

Figure 3.14: Debt and budget balance paths under different growth scenarios

%GNI*, general government basis



Sources: CSO; Department of Finance; and Fiscal Council calculations.
Note: Central line depicts the central forecasts from the Department of Finance (based on a no-deal Brexit). The outer lines depict how far the budget balance as a percentage of GNI* would be pushed away from the central forecasts under different shocks to real GDP growth in each year. The outer lines, as one moves further away from the central forecast, are for positive/negative growth shocks of 0.5, 1.0 and 1.5 percentage points, respectively. Positive shocks raise the balance; negative shocks reduce it.

Figure 3.14 shows how shocks to growth would impact on the general government balance and general government debt. A shock to GDP growth of 1.5 percentage points relative to *Budget 2020* forecasts each year from 2020 to 2023 would result in the general government balance being 5.3 percentage points of GNI* lower by 2023. All else being equal, this means that the public finances would show increasing deficits over the period 2020 - 2023 as compared to a surplus of 0.7 per cent of GNI* in 2023. In the same scenario, the currently high gross government debt-to-GNI* ratio would rise by over 13 percentage points, in the absence of corrective policy action. A shock of this magnitude would not be exceptional given the historical volatility of Irish national income growth, for which a typical current-year forecast error is close to 2 percentage points.

Table 3.5: Assessing the *Budget 2020* Fiscal Risk Matrix

Likelihood (**L**) and Impact (**M**) are from *Budget 2020*, unless stated (**red=high**; **pink=medium**; **grey=low**)

L	M	
		Health overruns (Fiscal Council risk): Health spending overruns average €0.5 billion yearly (2014–2018). Unrealistic forecasts and weak ceilings reinforce these risks.
		Climate change and renewable energy targets: Ireland's 2020 emissions targets are unlikely to be met, implying costs of €148 million–€455 million per year (Deane, 2017). Missing later (2030) targets could cost €2.7–€5.5 billion (Curtin, 2016).
		Corporation tax concentration risks: Corporation tax doubled from 2014 to 2018 and hit a record 18.7 per cent of total tax in 2018. It is volatile, concentrated in few companies, and is vulnerable to global tax changes, meaning it could fall rapidly. The OECD's Base Erosion and Profit Shifting (BEPS) proposals would include firms paying taxes wherever they have significant consumer-facing activities and generate profits. The timeline on the BEPS implementation, approved by the G20, will depend on how discussions proceed, and could span a decade.
		Overruns on large projects (Fiscal Council risk): Large capital projects have experienced a number of overruns (the National Broadband Plan's current expected overrun is €2.5 billion and the National Children's Hospital's is about €1 billion). These unplanned costs need to be funded through revenue increases, savings elsewhere or more borrowing.
		Public sector pay (Fiscal Council risk): The current public sector pay agreement is set to expire in 2020. Forecasts in *Budget 2020* do not allocate significant increases in Compensation of Employees after 2020. Even if some of the "Resources to Be Allocated" were used on this item, the forecast growth would still be implausibly low, which poses a risk to the public finances.
		Budgetary pressures: This refers to the risk of public expectations exceeding budgetary policy. Budgetary pressures may also arise due to demographics, eligibility factors and other demand side pressures. In-year spending increases would also exacerbate the problem. The political cycle may also increase near-term budgetary pressures. Given the pattern of overruns in the Department of Health and the payment of the Christmas bonus not having been budgeted for in 2019, ***the Council assesses a high likelihood to be more appropriate***.
		Reliance on potentially transient improvements to the public finances (Fiscal Council risk): The use of temporary revenues could reduce the stability of tax revenues. This is particularly risky if they are used to fund long-term spending. For example, in 2018, higher-than-expected corporation tax revenue and interest savings—both of which might prove temporary—largely funded health overruns. And this is likely to be repeated in 2019.
		Sharper-than-expected growth in tax-rich sectors (Fiscal Council risk): Pent-up demand in the housing sector is forecast to lead to strong growth in the construction sector. Given the tax-rich nature of housing output, due to its labour intensity and the capacity for tax collection on new homes and housing transactions, rapid growth could imply a substantial increase in revenue.
		EU Budget contributions: There is continuing uncertainty surrounding the impact Brexit will have on the contributions to the EU Budget. In addition, statistical reclassifications impacting on measured Gross National Income in Ireland could impact on EU Budget contributions. Taking these considerations into account, ***the Council assesses a high likelihood to be more appropriate***.
		Changes to tax "drivers": Tax forecasts are dependent upon macroeconomic projections and other components. For example, corporation tax forecasts are driven by forecasts around the Gross Operating Surplus (GOS), and the elasticity associated with this. The GOS forecasts are subject to a high degree of uncertainty, namely that related to international trading conditions and currency markets. Hence, changes in the composition of those macroeconomic components can have important impacts on the tax forecasts.
		Forecasts of yields from tax measures (Fiscal Council risk): Although there is a risk of underestimation of the impacts of tax cuts, there is also a risk that estimated yields accruing from revenue-raising measures may be overly optimistic. This is particularly acute when transaction-based taxes are concerned (Box J).
		Statistical classifications: Ireland's compliance with the EU fiscal rules is measured under the ESA 2010 statistical framework. When statistical revisions or reclassifications of different items take place, this might pose fiscal risks.
		Unexpected one-off revenues (Fiscal Council risk):This risk refers to large, unexpected one-off government revenues being received. A recent example relates to Apple, which was ordered to pay €13 billion (plus €1.3 billion interest) to an escrow account related to unpaid taxes in Ireland.

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		This is equivalent to 7.9 per cent of GNI* in 2017. Given that this one-off receipt is not budgeted for, it represents a positive fiscal risk.
		Receipts from resolution of financial sector crisis: The budgetary projections in *Budget 2020* do not include any assumed proceeds relating to disposals of the State's shareholding in a number of financial institutions. This provides an upside risk to the fiscal forecasts.
		Dividend payments: *Budget 2020* identifies risks in relation to lower-than expected payments of dividends from the State's shareholding in banks and commercial semi-state companies. Such dividends are a function of business performance and outlook, over which the State has little control. If some of these assets are sold, then associated revenue streams would fall.
		Bond market conditions: The long maturities and relatively fixed nature of debt (with 94 per cent of gross national debt being at fixed interest rates in June 2017) should insulate the public finances from a typical shock to interest rates on sovereign borrowings. More severe events in Italian or euro area bond markets could be more impactful, however. At high debt levels, external shocks such as a hard Brexit could lead to self-reinforcing fears in bond markets.
		Contingent liabilities: These continued to fall in 2018, with the final Eligible Liabilities Guarantees expiring and the National Asset Management Agency redeeming the final €500 million of senior debt in 2017. Given their reduced level, ***the Council assesses a low impact to be more appropriate***.
		Litigation risk: This refers to an adverse or unexpected outcome of litigation against the State, leading to increased expenditure. Bova *et al.* (2016) estimate that the contingent liability realisations could have an average fiscal cost of 6.1 per cent of GDP. Taking this into account, ***the Council assesses a medium impact to be more appropriate***.

Sources: Department of Finance; and Fiscal Council assessment.

Chapter 4

Assessment of Compliance with the Fiscal Rules

4. Assessment of Compliance with the Fiscal Rules

Key Messages

- A substantial deterioration of the structural balance occurred in 2018, and this trend continued into 2019. The structural balance for 2019 is now forecast to be -0.4 per cent of GDP marginally above the Medium-term Budgetary Objective (MTO) of a structural balance of no less than –0.5 per cent of GDP. Conditional on a no-deal Brexit and considering the proposed expenditure on sectoral supports to be temporary, the structural balance is forecast to improve slightly to -0.2 per cent of GDP for 2020. However, the compliance with the MTO is, again, flattered by excess corporation tax receipts that may prove unsustainable. Excluding some of these receipts from the assessment, the MTO would not be achieved in 2019 and 2020 (Box N).

- Net expenditure is currently forecast to grow by 3.6 per cent in 2019, below the Expenditure Benchmark limit of 3.9 per cent for 2019. In 2020, net expenditure is currently forecast to grow by 4.5 per cent, below the Expenditure Benchmark limit of 5.1 per cent.

- The debt ratio is currently forecast to fall below the 60 per cent of GDP threshold set in the Stability and Growth Pact (SGP). However, this is largely as a result of distortions in Ireland's GDP figures relating to the activities of multinationals. Were the Debt Rule based on a more appropriate ratio of debt-to-GNI*, as opposed to GDP, there is a possibility that non-compliance would occur over the medium-term.

- Over the medium-term, there is a risk of non-compliance with the MTO. Forecasts for 2021–2023 show the structural balance fails to achieve the MTO. Furthermore, the Expenditure Benchmark is forecast to be breached in 2024. This is despite the fact that expenditure figures for later years, 2021–2024, are based on technical assumptions that may not be realistic.

4.1 Introduction

The Council's mandate includes assessing compliance with Ireland's Domestic Budgetary Rule, as set out in the Fiscal Responsibility Act 2012 (FRA), and the EU fiscal rules as set out in the *Stability and Growth Pact* (SGP). This chapter assess the consistency of the projections laid out in *Budget 2020* with Ireland's Domestic Budgetary Rule and with the preventive arm of the SGP. In particular it examines compliance with the Medium-term Budgetary Objective (MTO), the Expenditure Benchmark and the Debt Rule.

The assessment in this chapter examines compliance with Ireland's Domestic Budgetary Rule based on the Council's "principles-based approach" to the budgetary rule, using the Department of Finance's GDP-based estimates of potential output in *Budget 2020* and considering the Council's own assessment of one-off/ temporary measures.[72] While legal compliance with the EU fiscal rules is assessed based on the Vade Mecum on the Stability & Growth Pact—using the EU's Commonly Agreed Methodology (CAM) for estimating the output gap—the Council and the Department of Finance have identified a number of shortcomings with this methodology. Therefore, the Council has opted to base its assessment of the Domestic Budgetary Rule on a framework that is more appropriate for Ireland.[73]

As *Budget 2020* was framed on the basis of a no-deal Brexit, which would be a permanent shock to the economy, this necessitates a discussion around the classification of the proposed supports to affected sectors, be they permanent or temporary, and how these impact on the assessment of the fiscal rules. Box H of the June 2017 FAR outlines what is required for a measure to be considered a one-off/temporary measure (Fiscal Council, 2017c):

> "Deliberate policy actions that increase the deficit do not, as a rule, qualify as one-offs. In order to give policymakers the right incentive to fully

[72] See Appendix F for a summary of the Council's "principles-based approach". For a more detailed outline of the Council's "principles-based approach" to the Domestic Budgetary Rule, and the Council's reasoning for taking this approach, see Box A of Ex-Post Assessment of Compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a).

[73] For an outline of some of the shortcomings of the EU's CAM for estimating the output gap and potential output, see among others, Box B and Box E of the November 2017 Fiscal Assessment Report (Fiscal Council, 2017e) and Barnes & Casey (2019).

> recognise permanent budgetary impacts, there is a strong presumption that deliberate policy actions that increase the deficit are of a structural nature. These measures should only exceptionally be classified as one-offs, in cases where it can be unambiguously demonstrated that they have an intrinsic temporary nature."

On the basis of information provided by the Department of Finance, the above definition, and the exceptional and exogenous nature of a no-deal Brexit, the Council is of the view that €0.65 billion of Brexit sectoral supports can be classified as one-off/temporary measures and should therefore be excluded from the Council's assessment of compliance with the fiscal rules. However, this classification is preliminary and is subject to change in the *ex-post* assessment of 2020 should these supports—if introduced—not prove temporary, or alternatively, should more supports prove to be temporary.

Table 4.1 provides a summary assessment of compliance with the Domestic Budgetary Rule and the Debt Rule. *Budget 2019* incorporated a one-off windfall of €0.3 billion for corporation tax in 2018, relating to a change in International Financial Reporting Standards, and this continues to be incorporated in the Council's assessment of the fiscal rules. Additionally, *SPU 2019* incorporated a one-off expenditure of €0.2 billion for 2018 relating to the payment of arrears to medical consultants following the settlement of a court process.

Table 4.1: Assessment of compliance with the fiscal rules[1, 2, 3]

Per cent of GDP unless stated. For deviations, negative values = non-compliance

	2018	2019	2020	2021	2022	2023	2024
Corrective Arm							
General Government Balance Excl. One-Offs	0.0	0.2	-0.4	-0.2	0.1	0.4	0.7
General Government Debt	63.6	59.3	56.5	56.4	54.4	53.8	53.0
1/20th Debt Rule Limit	71.4	67.4	60.0	60.0	60.0	60.0	60.0
Debt Rule met? (Y/N)	Y	Y	Y	Y	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule							
Structural Balance Adjustment Requirement							
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
Structural Balance	0.1	-0.4	-0.2	-0.5	-0.7	-0.7	-0.5
MTO met? (Y/N)	Y	Y	Y	N	N	N	Y
Minimum Change in Structural Balance Required	**–**	**–**	**–**	**–**	**0.0**	**0.2**	**0.2**
Change in Structural Balance	-1.1	-0.5	0.2	-0.3	-0.2	0.0	0.2
1yr Deviation (€bn)	–	–	–	-1.1	-0.7	-0.9	0.0
1yr Deviation (p.p.)	–	–	–	-0.3	-0.2	-0.2	0.0
2yr Deviation (€bn)	–	–	–	-0.2	-0.9	-0.8	-0.5
2yr Deviation (p.p.)	–	–	–	-0.1	-0.2	-0.2	-0.1
Expenditure Benchmark							
(a) Reference Rate of Potential Growth (% y/y)	3.3	3.4	3.4	3.3	3.2	3.2	2.6
(b) Convergence Margin	0.0	0.0	0.0	0.0	0.1	0.8	1.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	3.3	3.4	3.4	3.3	3.1	2.4	1.6
GDP Deflator used (% y/y)	0.8	0.4	1.6	1.4	1.4	1.4	1.4
Limit for Nominal Net Expenditure Growth (% y/y)	**4.2**	**3.9**	**5.1**	**4.8**	**4.5**	**3.8**	**3.0**
Net Expenditure Growth (% y/y)	6.0	3.4	5.3	3.6	3.8	3.1	3.4
Net Expenditure Growth (Corrected for one-offs) (% y/y)	6.0	3.7	4.5	4.4	3.8	3.1	3.4
1yr Deviation (Corrected for one-offs) (€bn)	-1.3	0.2	0.5	0.3	0.6	0.6	-0.3
1yr Deviation (Corrected for one-offs) (% GNI*)	-0.7	0.1	0.2	0.2	0.3	0.3	-0.1
2yr Deviation (Corrected for one-offs) (€bn)	-0.8	-0.6	0.3	0.4	0.5	0.6	0.1
2yr Deviation (Corrected for one-offs) (% GNI*)	-0.4	-0.3	0.2	0.2	0.2	0.3	0.1
Limit for Nominal Net Expenditure Growth (€bn)	**2.9**	**2.9**	**4.0**	**4.0**	**3.9**	**3.4**	**2.8**
Net Expenditure Increase (€bn)	4.2	2.5	4.2	3.0	3.3	2.8	3.2
Net Expenditure Increase (Corrected for one-offs) (€bn)	4.2	2.7	3.5	3.7	3.3	2.8	3.2
Current Macroeconomic Aggregates							
Real GDP Growth (% y/y)	8.2	5.5	0.7	2.5	2.8	2.7	2.6
Department's alternative Potential GDP Growth (% y/y)	5.3	4.0	2.0	1.6	2.1	2.0	2.4
Department's alternative GDP Output Gap	-0.2	1.0	-0.3	0.5	1.3	1.9	2.1
GDP Deflator Used (% y/y)	0.8	0.4	1.6	1.4	1.4	1.4	1.4

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

Notes: [1] All figures are presented on a General Government basis. Assessments examine the Budget 2020 revenue and expenditure plans, using the Council's principles-based approach to the Domestic Budgetary Rule and considering the Council's views on one-off/temporary measures. Deviations from the Expenditure Benchmark are assessed on the basis of GNI* instead of GDP (a significant deviation from the benchmark is 0.5 per cent of GNI*, on a one-year basis, and 0.25 per cent of GNI* on a two-year basis). For the rationale behind assessing deviations on the basis of GNI* see Box M. For more information about the Council's principles-based approach see Appendix F of this report and Box A of Fiscal Council's *Ex-post* assessment of compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a). A one-off windfall of €0.3bn in corporation tax revenue for 2018 is included in the Council's assessment of the structural balance as well as a one-off expenditure of €0.2 billion, in 2018, due to a settlement in relation to pay arrears for medical consultants. For 2020, Brexit sectoral supports of €0.65 billion are considered temporary measures by the Council and are therefore excluded from the assessment. The outlier for Potential GDP Growth for 2015 is replaced by the average of the 2014 and 2016 rates in the Expenditure Benchmark, as discussed in the June 2017 FAR (Fiscal Council, 2017c). [2] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress toward the reference value of 60 per cent of GDP. A transition period applied until the end of 2018. [3] Figures in red indicate a significant deviation from the limit. Figures in amber indicate some deviation from the limit.

4.2 In-year assessment of 2019

This section assesses whether the Department's plans for 2019, based on forecasts in *Budget 2020*, are compliant with the fiscal rules. However, a brief recap of the assessment of 2018 is warranted at this point given the nature of fiscal policy in 2018.[74] The estimated structural balance deteriorated by 1.1 percentage points in 2018 to 0.1 per cent of GDP. Net expenditure in 2018 grew by 6.0 per cent, above the Expenditure Benchmark limit of 4.2 per cent. This was a deviation of €1.3 billion over the limit set by the Expenditure Benchmark. It is given this context that the in-year assessment of 2019 is carried out.

The Debt Rule will apply in full for the first time in 2019, following the end of a three-year transition period from 2016–2018.

The MTO is forecast to be achieved for 2019; however, there is minimal room for slippage in 2019 and this achievement of the MTO is heavily reliant on excess corporation tax (see Box M). Net expenditure is forecast to grow below the Expenditure Benchmark for 2019 and the debt-to-GDP ratio is currently forecast to fall below 60 per cent of GDP for the first time since 2008.

MTO and Structural Balance Adjustment Requirements

As the MTO was achieved for 2018, there was no adjustment requirement for 2019. A structural balance of -0.4 per cent of GDP is now forecast for 2019, above the MTO of a structural balance of no less than -0.5 per cent of GDP (Figure 4.1).[75] However, the structural balance is forecast to deteriorate by 0.5 percentage points in 2019 and any further slippage in 2019 would put the achievement of the MTO at risk.

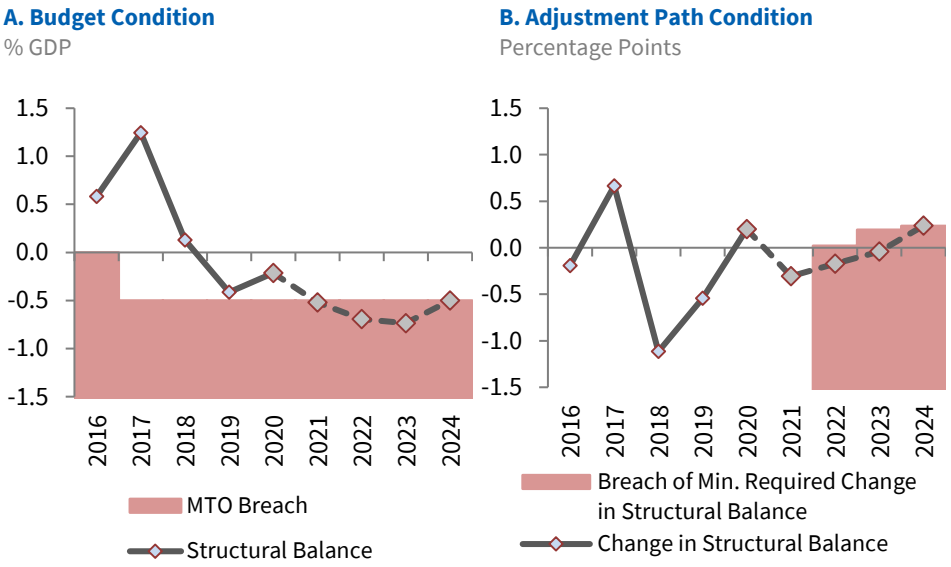
There was an upward revision to the estimate of the output gap for 2019 of approximately 0.9 percentage points relative to *SPU 2019* (Figure 4.2). As the structural balance adjusts for the effects of the cycle on the general government balance, an upward revision to the output gap makes the estimated structural

[74]The Council's formal assessment of 2018 was carried out in *Ex-post assessment of compliance with the Domestic Budgetary Rule 2018* (Fiscal Council, 2019a).

[75] On budget day, the Department of Finance published the paper "*Addressing Ireland's Fiscal Vulnerabilities*" which highlighted the fact that if the formula used to calculated the MTO was adjusted for the distortions in Irish GDP figures by using GNI* instead of GDP, the minimum required MTO for Ireland would instead be a structural balance of 0.5 per cent instead of –0.5 per cent (Department of Finance, 2019c).

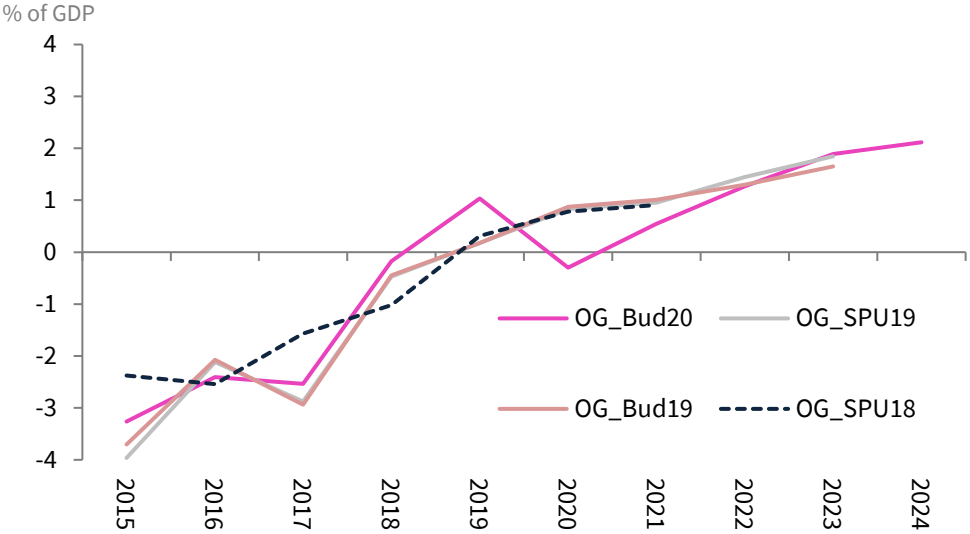
balance more negative (cyclical budgetary component, Figure 4.3). The forecast improvement in the general government balance is not of a sufficient magnitude to prevent a deterioration in the structural balance.

Figure 4.1: Assessment of compliance with the Budgetary Rule



Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Notes: The MTO for 2017–2022 for Ireland is set at –0.5 per cent of GDP. When the MTO is achieved the adjustment path condition is not assessed, so no breach can occur.

Figure 4.2: Vintages of the Department's GDP-based output gap



Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: The Department's GDP-based estimates of the output gap are based on the mid-point of its suite of GDP-based models. The *SPU 2018* vintage of the output gap for the Department's GDP-based estimates was at the early stage of the development of these estimates and included an additional model not included in the Department's suite of models in subsequent vintages.

Expenditure Benchmark

The Council recommends that the Expenditure Benchmark should be considered as an upper limit, and may, sometimes, be beyond what the Council would deem appropriate. While the Expenditure Benchmark has its flaws (see, for instance, Barnes & Casey, 2019), it can provide a better indication of the prudence of fiscal policy than the structural balance.

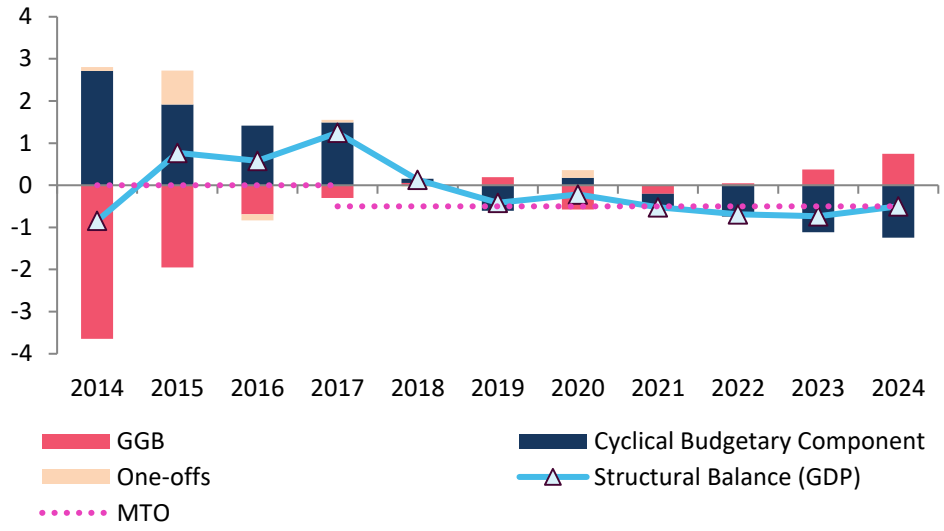
Based on *Budget 2020* forecasts, net expenditure is set to grow by 3.6 per cent in 2019, below the limit of 3.9 per cent growth. However, further expenditure overruns in 2019, and a potential underestimation of social payments for 2019 (see chapter 3), could jeopardise compliance with the Expenditure Benchmark.

Based on current forecasts, taking 2018 and 2019 together and, assessing deviations from the Benchmark using GNI* (see Box M), there is a risk that a significant deviation will occur over the two years (expenditure of more than 0.25 per cent of GNI* above the Benchmark limit). This is largely as a result of a significant deviation occurring in 2018, on a one-year basis (0.5 per cent of GNI* from the Benchmark), and no corrective measures being taken in 2019.[76]

[76] However, this is based on the Council's principles-based approach, which was not in place at the time policy was set and as such, the Government could not have formulated policy in order to be compliant with this limit. The Council adopted its principles-based approach to the Domestic Budgetary Rule in May 2019 (Fiscal Council, 2019a). However, the expenditure limit that was in place at the time policy was set was also breached in 2018 (See Appendix G).

Figure 4.3: Structural balance decomposition

% of GDP



Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: GGB is the General Government Balance. The cyclical Budgetary Component is estimated as: -0.588 × output gap, where the output gap is the Department of Finance's GDP-based output gap.

Box M: Using GNI* to assess compliance with the Expenditure Benchmark

The Council has recently begun assessing Ireland's Domestic Budgetary Rule using its principles-based approach.[77] This new approach makes the assessment simpler and more appropriate for Ireland, including by measuring potential output using the Department of Finance's alternative method rather than the EU's Commonly Agreed Methodology (CAM). This Box outlines a further innovation to the Council's principles-based approach, and that is to assess the severity of deviations from the Expenditure Benchmark using Modified Gross National Income (GNI*) instead of using GDP.[78]

Under the EU fiscal rules, what constitutes a significant deviation from the Expenditure Benchmark is assessed on the basis of GDP. The Vade Mecum on the Stability & Growth Pact states that a "*significant deviation on each indicator* [Structural Balance and Expenditure Benchmark] *will look at whether the difference between the two is forecast/planned to be equal to or more than 0.5% of GDP for the year under consideration, or will result in an average deviation of 0.25% of GDP over two years.*"[79]

While GDP is an appropriate estimate of the size of the domestic economy in most EU countries, due to well-documented issues relating to the multinational sector, GDP is not an appropriate measure of the size of Ireland's domestic economy.[80] Figure M.1 shows the ratio of

[77] See Appendix F for a summary of the Council's "principles-based approach". For a more detailed outline of the Council's "principles-based approach" to the Domestic Budgetary Rule, and the Council's reasoning for taking this approach, see Box A of Ex-Post Assessment of Compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a).

[78] GNI* is an indicator produced by the CSO designed to "exclude globalisation effects that are disproportionally impacting the measurement of the size of the Irish economy". It excludes from gross national income, factor income from redomiciled companies, depreciation on aircraft leasing and depreciation on R&D service imports and trade in IP. More information available here: https://www.cso.ie/en/releasesandpublications/ep/p-nie/nie2017/mgni/.

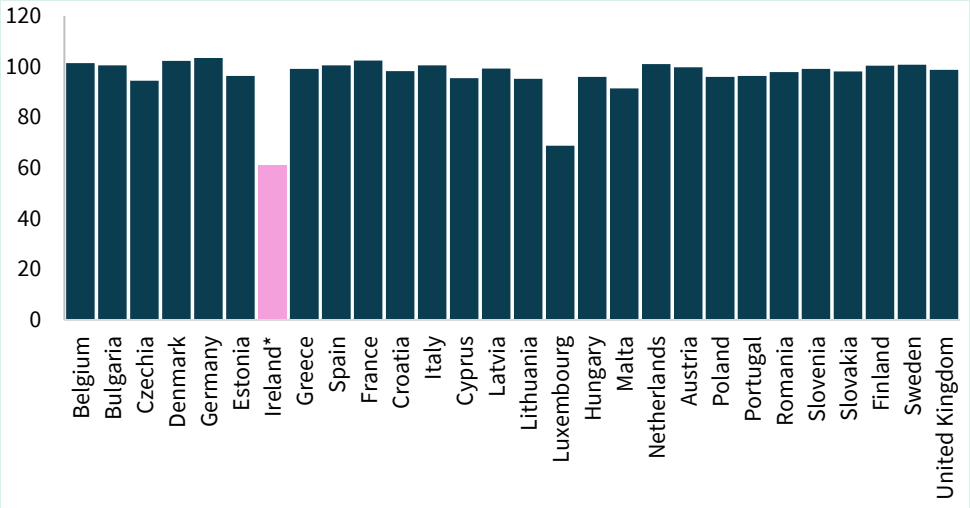
[79] https://ec.europa.eu/info/publications/vade-mecum-stability-and-growth-pact-2019-edition_en

[80] See, for instance, Box D of the June 2017 Fiscal Assessment Report (Fiscal Council, 2017c).

GNI (GNI* for Ireland) to GDP for EU countries in 2018. For most EU countries, the ratio is close to 100 per cent of GDP, whereas for Ireland, the ratio of GNI* to GDP was 61 per cent in 2018.

Figure M.1: Ratio of GNI (GNI* for Ireland) to GDP in 2018 for EU countries

Per cent of GDP

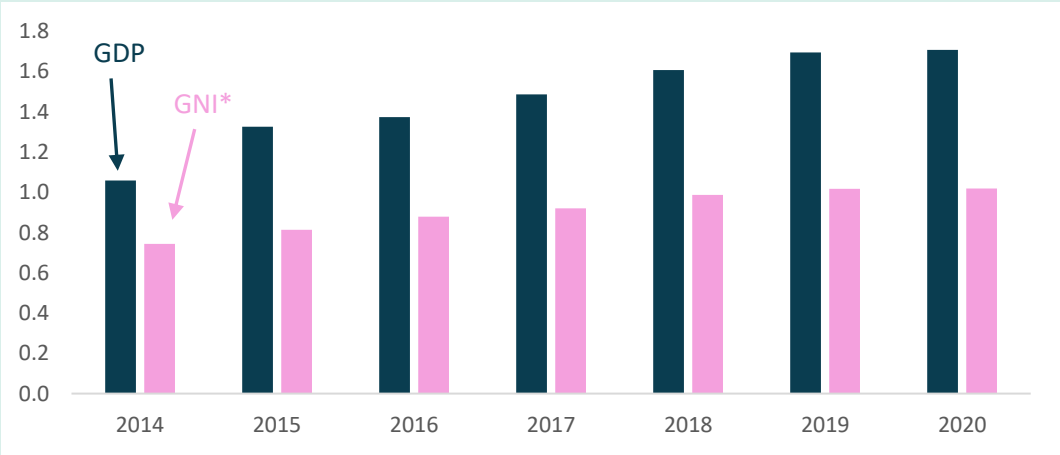


Sources: Eurostat for GDP; AMECO for GNI; CSO for GNI*; and internal Fiscal Council calculations.

As the disparity between national income and GDP for Ireland is so large, assessing what is a significant deviation from the Expenditure Benchmark on the basis of GDP would not be appropriate for Ireland. A more appropriate figure from which to assess a deviation from the Expenditure Benchmark is GNI*. Figure M.2 shows the amount of spending—measured as 0.5 per cent of GDP or GNI* for each year—in excess of the Expenditure Benchmark that would have to occur in order to be considered a significant deviation. The disparity between the amounts beyond which a significant deviation occurs has increased in recent years – particularly since the level shift in GDP in 2015. For 2020, if assessed against GDP, spending of €1.7 billion over the Expenditure Benchmark would have to occur before a deviation would be considered significant, whereas, if assessed against GNI*, the corresponding figure would be €1 billion.

Figure M.2: Spending in excess of the Expenditure Benchmark that would result in a significant deviation

€ billion



Sources: CSO; and internal Fiscal Council calculations.

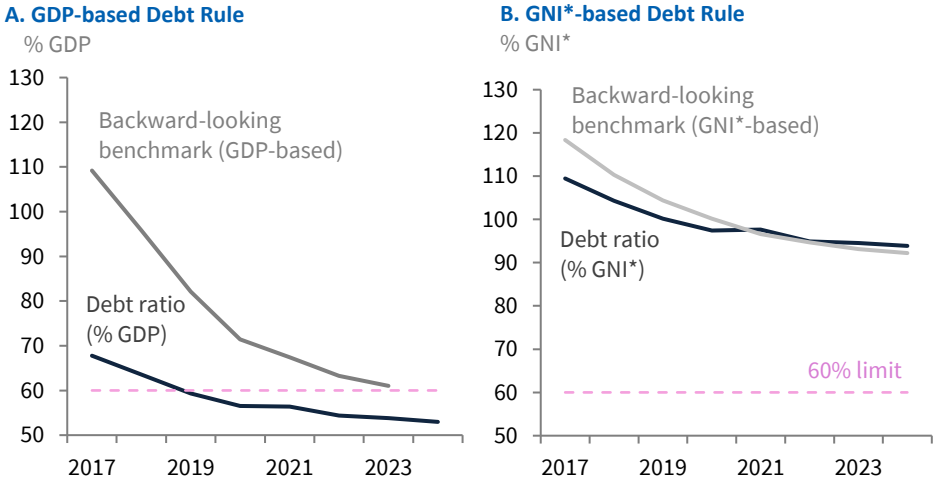
As GNI* is a more appropriate indicator to measure Ireland's underlying macroeconomy and its fiscal capacity, the Council has decided to assess deviations from the Expenditure Benchmark on the basis of GNI* instead of GDP.

Debt Rule

The Debt Rule applies in full for the first time in 2019, following the end of a three-year transition period (2016–2018) since Ireland exited the SGP Corrective arm based on 2015 outturns. The debt-to-GDP ratio is the formal basis for the Council's assessment of compliance with the Debt Rule, as specified in the *FRA 2012*. The Debt Rule requires Ireland's debt-to-GDP ratio to be below 60 per cent of GDP or reducing by, on average, 1/20th of the gap above 60 per cent.

Forecasts in *Budget 2020* show the debt ratio falling below 60 per cent of GDP at the end of 2019 (Figure 4.4A). However, the recent fall in the debt ratio is largely as a result of level shifts in GDP, the denominator. The distortions in GDP, mainly relating to the globalisation activities of a small number of large multinational firms, mean that the debt-to-GDP ratio is not an appropriate indicator of the sustainability of Ireland's debt levels. The sustainability of Ireland's debt levels should be judged against more appropriate metrics, like a debt-to-GNI* ratio.

Figure 4.4: Compliance with the Debt Rule: backward-looking benchmark



Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: The left panel shows the Debt Rule based on GDP, which is the legal requirement for compliance. The right panel shows compliance with the Debt Rule were it to be based on GNI*.

The debt-to-GNI* ratio is forecast to be above 100 per cent of GNI* at the end of 2019 (Figure 4.4B). Were the Debt Rule to be formulated as a per cent of GNI*, instead of GDP (as specified in the FRA), this would be above the 60 per cent limit. However, in this case, the Debt Rule would be complied with as the pace of reduction in the debt ratio would be below the backward-looking benchmark for 2019 (Figure 4.4B).[81]

[81] The backward-looking benchmark requires that the debt ratio falls by, on average one-twentieth 1/20th the excess between the actual debt ratio and 60 per cent.

4.3 *Ex-ante* Assessment of 2020

Budget 2020 was framed on the basis of a no-deal Brexit. As such, €0.65 billion of proposed sectoral supports have—for the time being—been classified as temporary measures and are not forecast to recur in 2021. However, this classification is subject to change, should these measures—if introduced—prove to be permanent, or alternatively, should more supports prove to be temporary.

As the debt-to-GDP ratio is forecast to fall below 60 per cent of GDP in 2019, the legal requirement for the Debt Rule (under the FRA and the SGP) for 2020 is to maintain a debt-to-GDP ratio below 60 per cent.

The structural balance is forecast to meet the MTO for 2020. Net expenditure (corrected for one-offs) is forecast to grow by 4.5 per cent, below the limit set by the Expenditure Benchmark for 2020. There is a risk of further expenditure slippage in 2020 with the Christmas bonus again not budgeted for and a possible repeat of persistent health spending overruns (see Chapter 3).

MTO and Structural Balance Adjustment Requirements

As the MTO is forecast to be achieved in 2019, there is no adjustment requirement for 2020. A structural balance of -0.2 per cent of GDP is forecast for 2020. This is above the MTO of a structural balance of no less than -0.5 per cent of GDP.

Further slippages in expenditure and revenue shortfalls for 2020, potentially arising from a more severe impact of a no-deal Brexit than currently forecast, could jeopardise the achievement of the MTO. Revisions to the output gap could also impact on the assessment of compliance with the MTO for 2020. In addition, the recent surge in corporation tax flatters the estimated structural balance and these revenues may prove unsustainable. Box N shows the structural balance that would have transpired if corporation tax remained at its long run share of tax revenue. If excess corporation tax receipts were removed, the MTO would not be achieved in 2020.

Expenditure Benchmark

Net expenditure for 2020 is set to grow by 4.5 per cent, below the limit of 5.1 per cent set by the Expenditure Benchmark for 2020 (Table 4.2). Were the expenditure

on the proposed sectoral supports arising from a no-deal Brexit to be classified as permanent, and not a one-off, net expenditure would grow by 5.3 per cent, above the Expenditure Benchmark (also shown in Table 4.2).

Notably also, the annual change in public investment in 2020 is now below the change in its four-year average (Table 4.2). While previously the annual change in public investment was greater than the change in its four-year average—and as a result this would have reduced the assessed growth rate figure under the Expenditure Benchmark for 2018 and 2019—this is no longer the case.

Table 4.2: Contributions of adjustments to net expenditure Growth

% of Net Expenditure

		2018	2019	2020	2021
Walk to Net Expenditure Growth (Net of one-offs)					
ΔGGE	**General Government Expenditure Growth**	**6.7**	**4.7**	**6.3**	**2.5**
-ΔInt	Change in Interest	0.9	0.7	0.8	0.4
-ΔEU	Change in EU Co-Financed Current Spending	-0.1	-0.1	0.0	0.0
-ΔGFCF	Change in Public Investment (GFCF)	-1.5	-2.1	-1.1	-0.3
+ΔavGFCF	Change in Four-Year Avg of Public Investment	0.7	1.1	1.2	1.1
-ΔUC	Change in Cyclical Unemployment Expenditure	0.7	0.4	-0.3	-0.1
-DRMs	DRMs	-1.2	-1.3	-1.6	0.0
	Net Expenditure Growth	**6.0**	**3.4**	**5.3**	**3.6**
-ΔOOE	Change in One-Off Expenditure Items	-0.1	0.3	-0.8	0.8
ΔNE	**Net Expenditure Growth (Net of one-offs)**	**6.0**	**3.7**	**4.5**	**4.4**
	Limit for Net Expenditure Growth (% y/y)	**4.2**	**3.9**	**5.1**	**4.8**

Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: Rounding may affect totals. All figures are in nominal terms and are expressed as a percentage of the previous year's net expenditure (less adjustment for DRMs), unless otherwise stated. Δ indicates the change in the variable from year t-1 to year t. Limits presented here are based on the Council's principles-based approach to the Domestic Budgetary Rule.

Debt Rule

As the debt ratio is forecast to fall below 60 per cent of GDP in 2019, the legal requirement for 2020 is to remain below the 60 per cent debt-to-GDP ratio. This is forecast to be the case for 2020, with a debt-to-GDP ratio of 56.5 per cent.

4.4 *Ex-ante* assessment of 2021–2024

This section assesses compliance with the fiscal rules based on the Department's forecasts for 2021–2024 contained in *Budget 2020*. Based on current forecasts, the MTO will not be achieved in 2021–2023, and will only be achieved by a small margin in 2024. The Expenditure Benchmark will be complied with over 2021–2023, but based on current projections, it will be breached in 2024. This comes despite expenditure forecasts for outer years being based on technical assumptions that may not be credible (see Chapter 3).

MTO and Structural Balance Adjustment Requirements

The MTO of a structural balance of no less than -0.5 per cent of GDP will not be met for 2021–2023 based on current forecasts.[82] The structural balance for 2021 is marginally below the MTO but deteriorates further to a structural balance of -0.7 per cent of GDP by 2023 as the output gap turns increasingly positive and is not offset by improvements in the headline balance.

As the MTO will not be met for 2021–2023, there will be an adjustment requirement for 2022–2024. Based on current forecasts, this requirement will not be met in 2022 and 2023. The adjustment requirement will be met in 2024, as the structural balance returns marginally above the MTO.

Expenditure Benchmark

As the MTO is forecast not to be achieved in 2021–2023, there will be a convergence margin applied to the Expenditure Benchmark for 2022–2024. This will reduce the rate by which expenditure is allowed grow at under the Expenditure Benchmark. Based on *Budget 2020* forecasts, the Expenditure Benchmark will be complied with for 2021–2023. The Expenditure Benchmark is forecast to be breached in 2024. This is largely as a result of a convergence margin being applied for 2024, reducing the allowable growth under the Expenditure Benchmark.

This is despite the expenditure forecasts for 2021–2024 being based on technical assumptions that may not be credible. If plausible expenditure forecasts were used,

[82] In *SPU 2019* the MTO was set for 2020-2022 as a structural balance of no less than -0.5 per cent of GDP. As the MTO is currently not set for 2023-2024 it is assumed constant for these years as a structural balance of no less than -0.5 per cent of GDP.

this may have resulted in the structural balance being further away from the MTO than is currently forecast, which would necessitate a larger convergence margin being applied, as well as a higher assessed expenditure growth rate. It is worrying that an Expenditure Benchmark breach is forecast on the basis of expenditure forecasts that typically understate expenditure considerably.

Debt Rule

The Debt Rule is forecast to be complied with over the horizon 2021–2024. The debt ratio is forecast to continue on a downward trajectory and is forecast to be 53.0 per cent of GDP in 2024.

However, if the Debt Rule were based on the more appropriate debt-to-GNI* ratio, then the Debt Rule would not be complied with in 2021–2024. The pace of reduction in the debt-to-GNI* ratio would be close to but marginally above what the backward-looking benchmark requires for these years (Figure 4.4B).

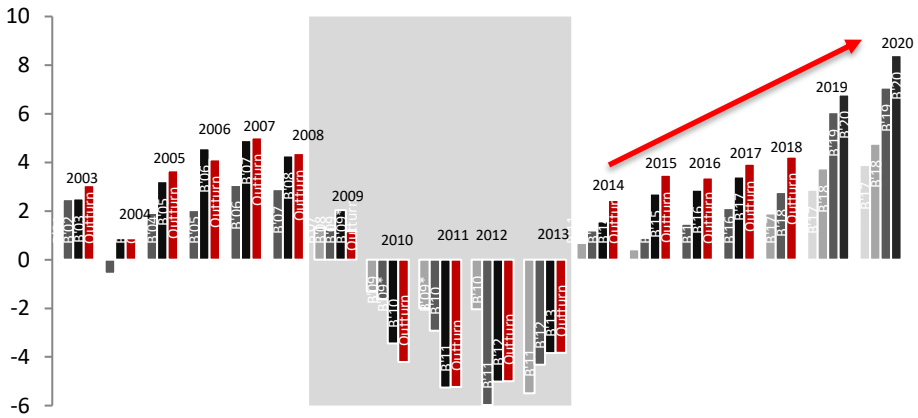
4.5 Medium-term Expenditure Framework

The Medium-term Expenditure Framework (MTEF) was a reform introduced in the Ministers and Secretaries (Amendment) Act 2013 to provide a better mechanism to control spending over the medium-term and to ensure the Expenditure Benchmark is complied with. The MTEF requires that the Government set limits for overall expenditure for the medium-term and that ministerial ceilings be set so that aggregate expenditure stays within the overall limits.

While the goal of the MTEF—to place a constraint on expenditure over the medium-term—is desirable, the MTEF is not working in practice. Procyclical increases in the expenditure ceilings risk repeating the mistakes of the past (Figure 4.5).

The MTEF, as currently instituted, is not a credible framework. The pattern of increases in the expenditure ceilings since 2014 indicates that these ceilings are, in practice, being treated as starting points in Departmental negotiations for resources and are not being used as intended (see Appendix H for graphs of the ceiling revisions for the four largest departments).

Figure 4.5: Change in gross expenditure ceiling relative to initial ceiling
€ billions



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

Box N: Fiscal vulnerabilities: assessing compliance with the Department of Finance's suggested alternative fiscal rules

The Department of Finance published, alongside the Budget, a paper assessing Irish fiscal vulnerabilities (Department of Finance, 2019c). The paper highlights the use of potentially temporary windfall corporation tax (CT) receipts to fund permanent expenditure as a key vulnerability. It also outlines an alternative fiscal framework for Ireland. The paper suggested four possible alternative fiscal rules for Ireland:

1) A target for the general government balance that excludes some of the excess CT receipts, which then feeds into structural balance targets;
2) A debt rule stated in terms of a ratio to GNI*;
3) Assessment of the achievement of the MTO on the basis of the Department's preferred estimate of the output gap; and
4) Use of alternative estimates of potential growth rates to determine the maximum permissible expenditure growth.

Under the Council's principles-based approach, the Council has already opted to assess compliance with Ireland's Domestic Budgetary Rule using both the third and fourth recommendations outlined above. The Council has repeatedly called for a more appropriate debt target (second recommendation).[83]

This box assesses the historical and forecasted compliance of the structural balance with the MTO when some of the excess CT receipts are excluded (first recommendation). This has some parallels with the Council's proposal to introduce a Prudence Account, which would address the same issue of possibly excess CT receipts by setting aside excess receipts at the point at which they occur and saving them (Box B, Fiscal Council, 2019c).

Taking the fiscal vulnerabilities paper's definition of excess CT receipts as the receipts above its long-run share of tax revenue (14 per cent), Figure N.1 shows the structural balance for 2015–2024 if the excess CT receipts were excluded.[84] Up to 2017, the difference between the actual structural balance and the structural balance excluding excess CT was relatively small (ranging from 0.2-0.4 percentage points). However, due to the level shift in CT receipts in 2018, the difference more than doubles to 0.8 percentage points in 2018. Had the excess CT been excluded, this would have resulted in a structural balance of –0.6 per cent of GDP in 2018, which would have been a breach of the MTO of a structural balance of no less than –0.5 per cent of GDP. This is compared to an actual structural balance of 0.2 per cent of GDP in 2018. Based on *Budget 2020* forecasts, if excess CT were excluded, the structural balance would not be at the MTO from 2019–2024 either.

Given the difference in the two structural balance estimates in Figure N.1 and the risks posed by funding permanent expenditure by means of potentially temporary tax receipts, setting budgetary targets that excludes excess CT receipts would be a prudent approach to formulating fiscal policy in Ireland. This could be complemented by the use of a prudence account, which sets aside the excess CT receipts so that they cannot be used to fund permanent expenditure.[85]

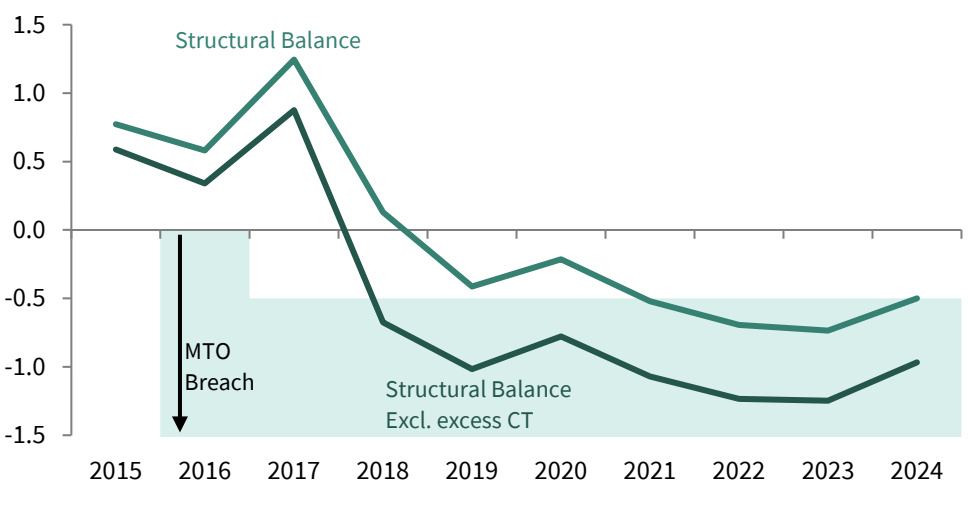
[83] See, for instance, the November 2018 Fiscal Assessment Report (Fiscal Council, 2018e)

[84] The Department of Finance's definition of excess CT receipts, used in the fiscal framework section of the paper, is more modest than the Council's analysis suggests. The Council has estimated that some €3-6 billion of CT can be considered excess (Box B, Fiscal Council, 2019c). The Department has estimated that approximately €2 billion can be considered excess.

[85] For an outline of how a prudence account would work, see Box B of the June 2019 Fiscal Assessment Report (Fiscal Council, 2019c).

Figure N.1: Excluding excess corporation tax receipts from the structural balance would result in non-compliance with the MTO for 2018–2024

Per cent of GDP



Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: Estimates are based on Budget 2020 forecasts. CT receipts in excess of the 14 per cent of total tax revenue are considered excess and are excluded from the structural balance estimate.

Appendices

Appendix A: Debt Sustainability Analysis

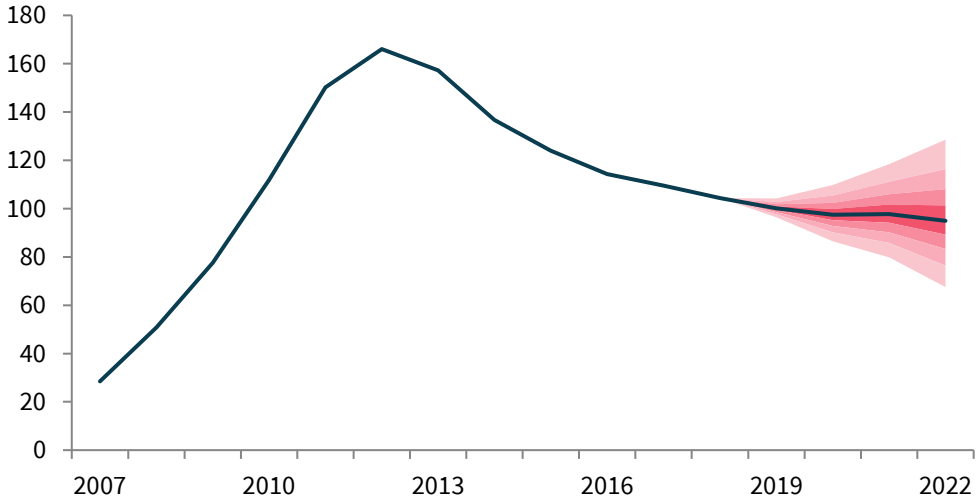
This appendix looks at the sustainability of Irish debt by considering (1) the probability range for debt outcomes based on historical forecast errors, and (2) a number of common stress scenarios. Estimates are produced using the Council's Fiscal Feedbacks Model (Fiscal Council, 2012) and the baseline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

Probability Distribution for Debt Forecasts

A useful way to illustrate uncertainty and the impact of alternative growth paths on the government debt ratio is through the use of a fan chart. Figure A1 takes the Department of Finance's latest debt forecasts as the central line. The width of the fan represents the range of possible outcomes for the debt-to-GNI* ratio based on the Department's past observed forecast errors.[86] For example, according to this, there is an estimated 40 per cent probability that the debt ratio would not fall below current levels by 2022, in the absence of offsetting policy adjustments (this is on the basis of the Department's forecasts, which assume a disorderly Brexit scenario).

Appendix Figure A1: Probability Outcomes for Government Debt

% GNI*, gross debt (general government basis)



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

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

Stress Scenarios

Another useful way to examine debt sustainability is by exploring a number of common stress scenarios (see IMF 2018, for example). All scenarios assume that policy settings are not adjusted in response to the shock. We consider six stress scenarios and their impact on the forecast debt ratios (Figure A2) and annual gross funding requirements (Figure A3) below:

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

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

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

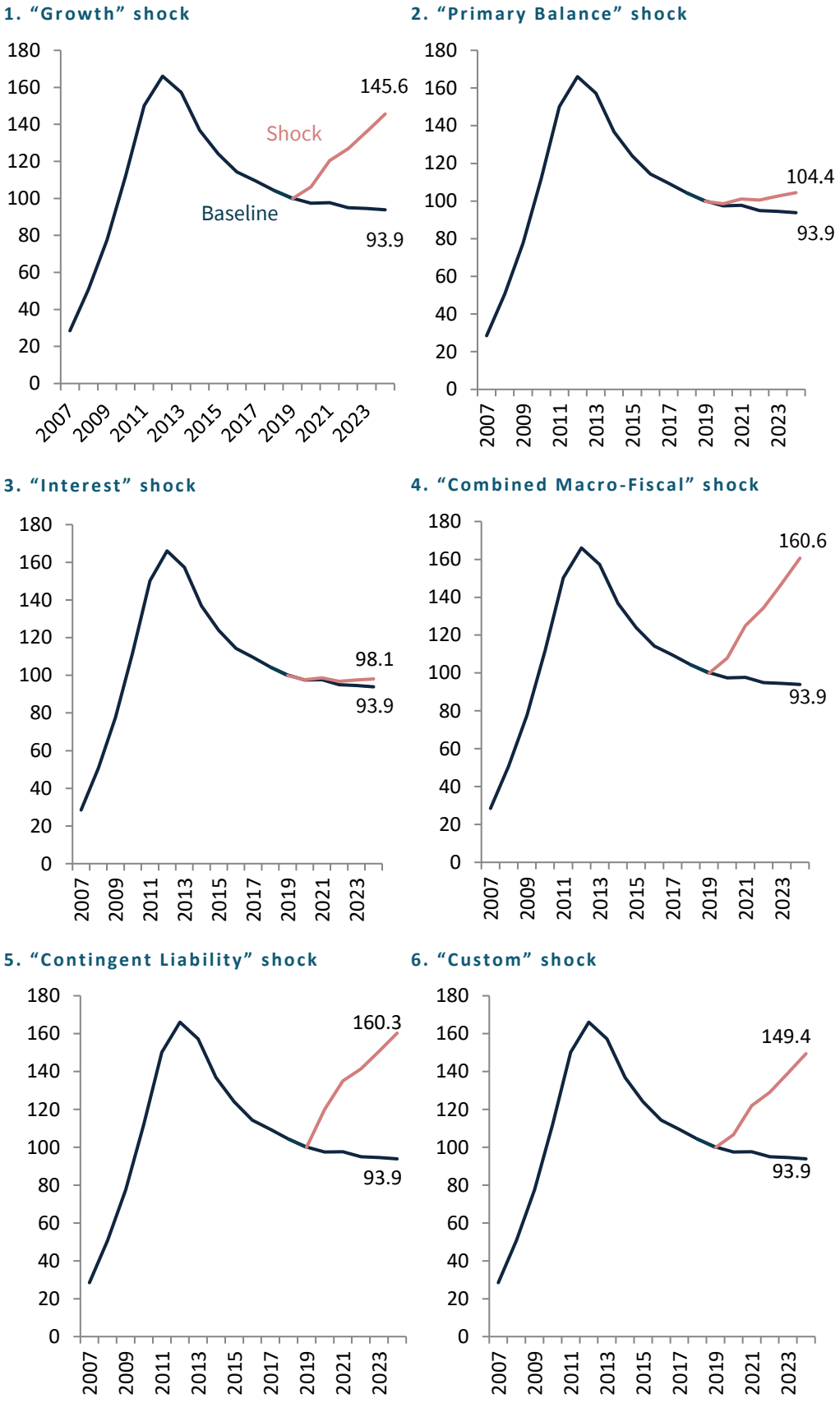
4. **"Combined Macro-Fiscal" shock**: Combines the three shocks above.

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

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

Appendix Figure A2: Stress Scenarios for Government Debt

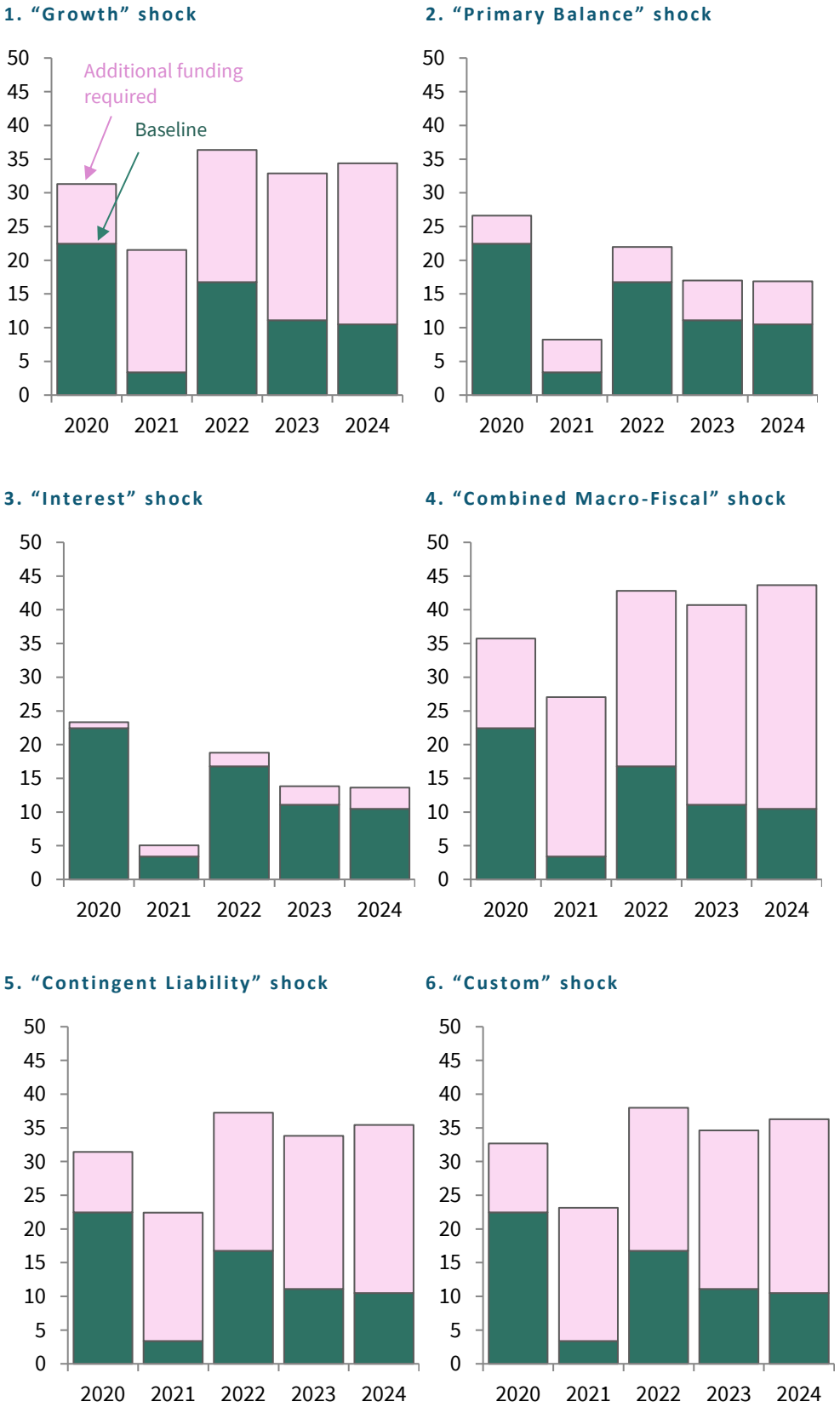
% GNI*, gross debt (general government basis)



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

Appendix Figure A3: Stress Scenarios for Funding Requirements

€ billions, estimated annual gross funding requirements



Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Notes: Gross funding requirements estimated as rollovers plus Exchequer borrowings.

Appendix B: Timeline for Endorsement of *Budget 2020* Projections

Date	
13 September	CSO releases *Quarterly National Accounts* estimates for Q2 2019.
16 September	The Secretariat and Department of Finance met the CSO to clarify technical details of latest *Quarterly National Accounts* estimates.
20 September	The Secretariat received Department of Finance technical assumptions underpinning *Budget 2018* forecasts.[87]
24 September, AM	After consideration by the Council, Benchmark projections were finalised by the Secretariat prior to receiving preliminary forecasts from the Department of Finance.
23 September, PM	The Council received preliminary forecasts from the Department in line with *Memorandum of Understanding* requirements. These were not viewed by the Secretariat until after the Council's Benchmark projections were finalised.
24 September	The first endorsement meeting took place with the Department of Finance presenting their forecasts to the Secretariat. A number of clarifications of a factual nature were requested.
26 September	The Council received final forecasts from the Department in line with *Memorandum of Understanding* requirements.
26 September	The Council met to discuss the Department of Finance forecasts.
27 September	Department of Finance staff met with the full Council and Secretariat to present their latest forecasts and to answer questions. The Council then finalised a decision on the endorsement.
30 September	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *Budget 2020*.
8 October	The Department's forecasts are published in *Budget 2020.*

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

Appendix C1: The Council's Benchmark Projections, assuming an orderly-deal Brexit (as of the morning of 24 September 2019)

Benchmark projections for 2019–2024

% change in volumes unless otherwise stated

	2019	2020	2021	2022	2023	2024
Demand						
Underlying domestic demand[a]	3.4	2.4	2.3	2.3	2.7	2.7
GDP	5.3	3.9	2.8	3.3	3.2	3.0
…of which (p.p. contributions)						
Underlying domestic demand[b] (p.p.)	1.3	1.3	1.1	1.2	1.3	1.3
Underlying net exports[b] (p.p.)	4.0	2.6	1.7	2.1	1.9	1.7
Consumption	3.2	2.4	2.5	2.5	2.6	2.4
Government	4.5	3.4	2.0	2.0	2.0	2.0
Investment	51.4	-13.1	6.0	-0.7	1.3	1.6
Underlying investment[a]	3.0	1.6	1.6	2.1	3.6	4.4
Exports	8.9	4.4	2.4	3.8	3.6	3.6
Imports	20.8	-1.4	2.9	2.5	2.9	3.1
Underlying imports[a]	9.2	3.8	1.7	3.6	3.6	3.8
Supply						
Potential output	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Output gap (% potential output)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour Market						
Labour force	1.8	1.4	1.4	1.8	1.5	1.8
Employment	2.4	1.5	1.8	1.9	1.9	2.0
Unemployment rate (% labour force)	5.3	5.3	5.0	4.9	4.6	4.5
Prices						
HICP	0.8	1.0	2.0	2.5	2.7	2.9
Personal consumption deflator	1.9	1.7	2.6	3.0	3.1	3.3
GDP deflator	1.7	1.3	1.6	1.9	2.1	2.3
Other						
Nominal GNI*	9.8	1.3	3.6	3.4	3.7	3.5
Nominal GDP	7.1	5.2	4.5	5.2	5.4	5.4
Nominal GDP (€ billion)	346.9	365.1	381.5	401.4	423.0	445.9
Modified current account (% GNI*)	8.1	6.7	5.8	4.8	3.5	1.9

Sources: CSO; and internal Fiscal Council calculations.
Notes: [a]Underlying (final) domestic demand, underlying investment, and underlying imports exclude "other transport equipment" (mainly aircraft) and intangibles. [b]Underlying contributions to real GDP growth rates in percentage points—here underlying net exports includes the effect of changes in inventories, and excludes the effect of investment in aircraft and intangible assets.

Appendix C2: The Council's Benchmark Projections, assuming a disorderly Brexit (as of the morning of 24 September 2019)

Benchmark projections for 2019–2024

% change in volumes unless otherwise stated

	2019	2020	2021	2022	2023	2024
Demand						
Underlying domestic demand[a]	3.0	0.4	1.3	2.6	3.0	2.7
GDP	4.8	1.9	1.9	3.6	3.5	3.0
…of which (p.p. contributions)						
Underlying domestic demand[b] (p.p.)	1.0	0.2	0.7	1.3	1.5	1.3
Underlying net exports[b] (p.p.)	3.8	1.7	1.2	2.3	2.0	1.7
Consumption	2.7	0.4	1.6	2.8	2.9	2.4
Government	4.5	3.4	2.0	2.0	2.0	2.0
Investment	51.0	-14.4	5.5	-0.6	1.4	1.6
Underlying investment[a]	2.2	-2.7	-0.3	2.7	4.2	4.4
Exports	7.9	-0.2	0.3	4.5	4.3	3.6
Imports	19.7	-6.3	0.7	3.1	3.6	3.1
Underlying imports[a]	7.9	-2.5	-1.2	4.5	4.4	3.8
Supply						
Potential output	4.7	4.2	2.2	3.1	3.2	3.3
Output gap (% potential output)	0.4	0.1	0.8	0.9	0.9	0.7
Labour Market						
Labour force	1.7	0.7	1.1	1.9	1.6	1.8
Employment	2.0	-0.4	0.9	2.1	2.2	2.0
Unemployment rate (% labour force)	5.5	6.4	5.5	4.8	4.4	4.5
Prices						
HICP	0.8	1.0	2.0	2.5	2.7	2.9
Personal consumption deflator	1.9	1.8	2.6	3.0	3.1	3.3
GDP deflator	1.8	1.5	1.6	1.9	2.1	2.3
Other						
Nominal GNI*[d]	9.2	-1.7	2.0	3.8	4.2	3.3
Nominal GDP	6.7	3.4	3.5	5.5	5.7	5.3
Nominal GDP (€ billion)	345.7	357.4	370.0	390.5	412.6	434.6
Modified current account (% GNI*)	8.0	5.5	3.8	2.9	1.7	-0.1

Sources: CSO; and internal Fiscal Council calculations.

Notes: [a]Underlying (final) domestic demand, underlying investment, and underlying imports exclude "other transport equipment" (mainly aircraft) and intangibles. [b]Underlying contributions to real GDP growth rates in percentage points—here underlying net exports includes the effect of changes in inventories, and excludes the effect of investment in aircraft and intangible assets.

Appendix D: Imbalance Indicators

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

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

(i) the labour market and prices;

(ii) external balances;

(iii) investment and housing;

(iv) credit conditions.

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

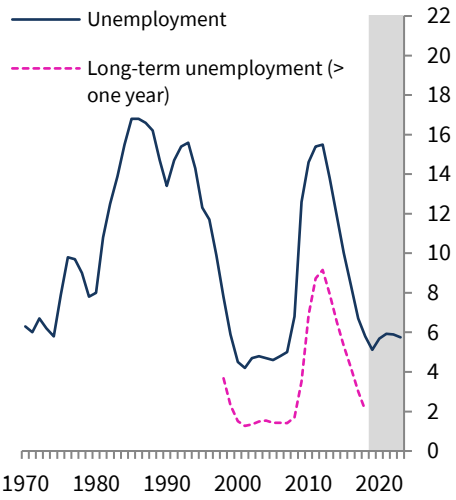
Appendix Figure D1: Labour market and prices indicators

A. Private sector job vacancy rates[1]

Per cent of private sector employment

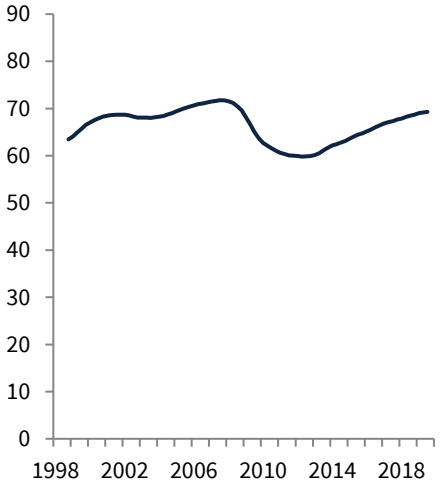
B. Unemployment rates[2]

Per cent of labour force

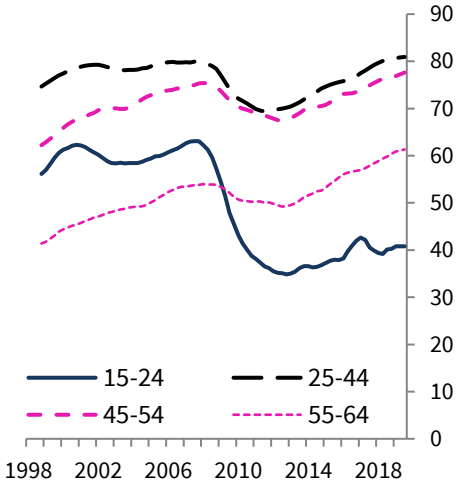


C. Employment rate (age 15–64)[3]

Per cent of population

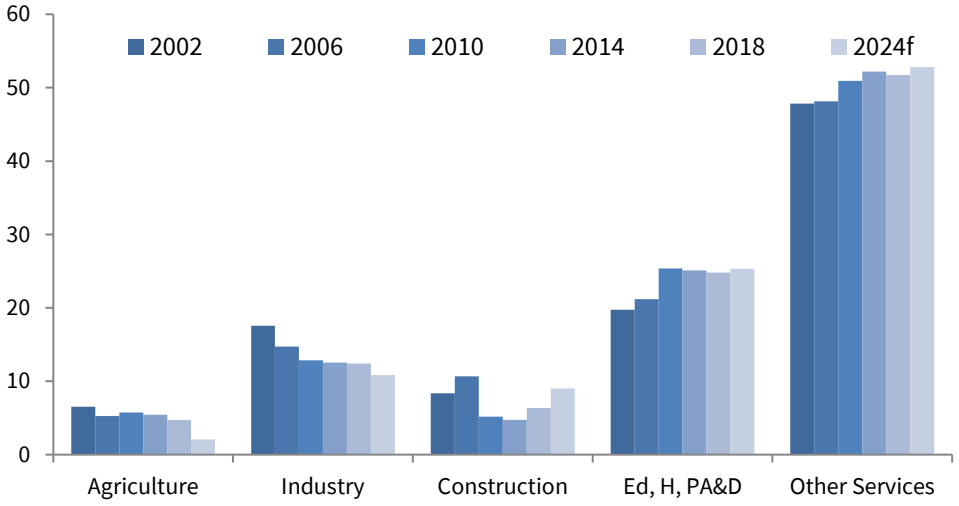


D. Employment rates by age[3]



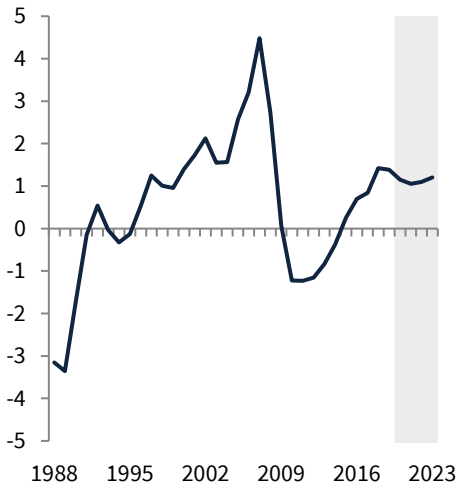
E. Sectoral employment concentration[4]

Per cent of total employment



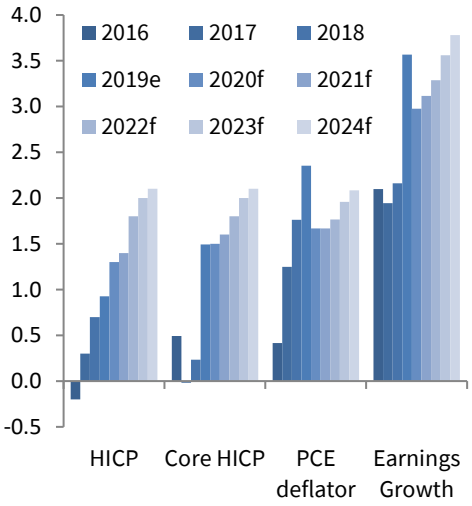
F. Net migration[4]

Per cent of labour force



G. Inflation measures[5]

Year-on-year percentage change



Sources: CSO; Department of Finance; European Commission, AMECO; and internal Fiscal Council calculations.

Notes:

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

[2] Combined historical data from AMECO and CSO, including latest outturns for 2019 and *Budget 2020* forecasts for 2020–2024.

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

[4] Positive net migration indicates immigration exceeded emigration. Figure F includes the latest outturns for 2019 and *Budget 2020* forecasts for 2020–2024.

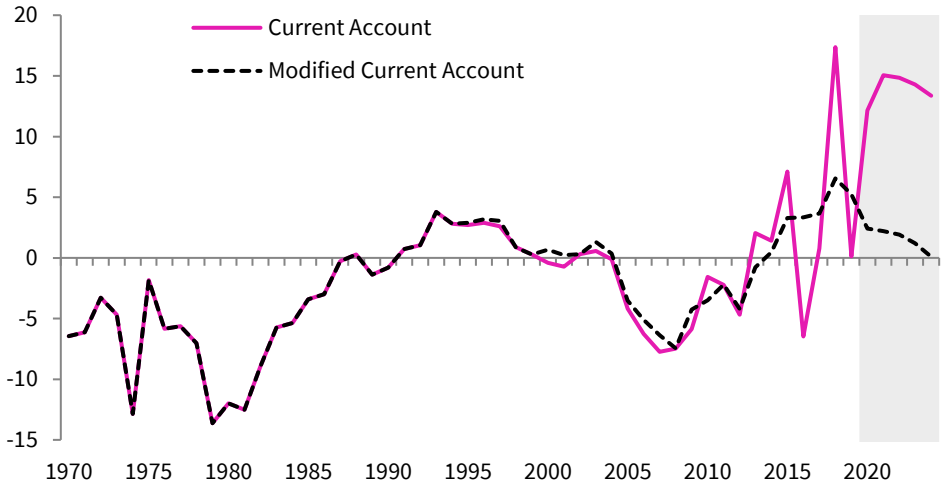
[5] Earnings growth shown is a per-hour national accounts measure, based on compensation of employees and annualised employee hours. The latest outturns for 2019 and *Budget 2020* forecasts for 2020–2024 are included.

[5] Earnings growth shown is a per-hour national accounts measure, based on compensation of employees and annualised employee hours. The latest outturns for 2019 and *Budget 2020* forecasts for 2020–2024 are included.

Appendix Figure D2: Indicators of External Balances

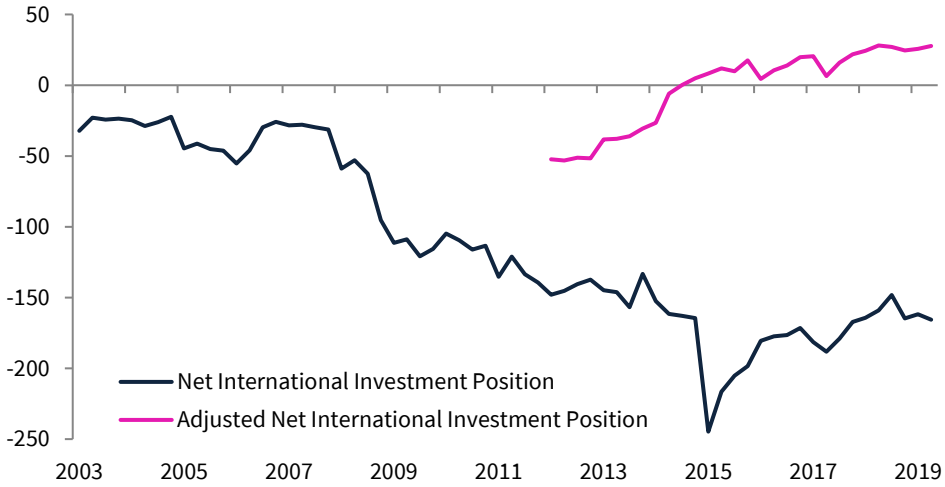
A. Current account and modified current account balances

Per cent of GNI*



B. Net international investment position

Per cent of GDP

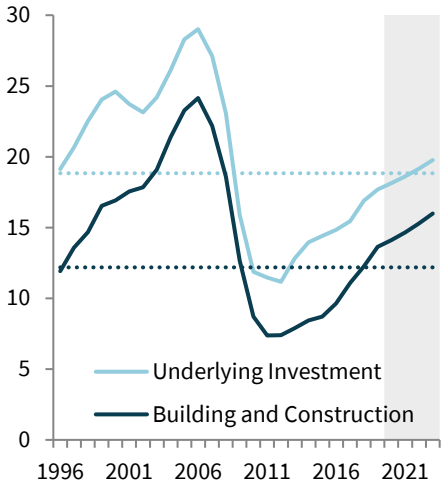


Sources: CSO; Eurostat and internal Fiscal Council calculations.
Note: The modified current account balance excludes the estimated impact of redomiciled PLCs, depreciation on research & development related intellectual property (IP) imports, depreciation on aircraft leasing, imports of R&D services by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

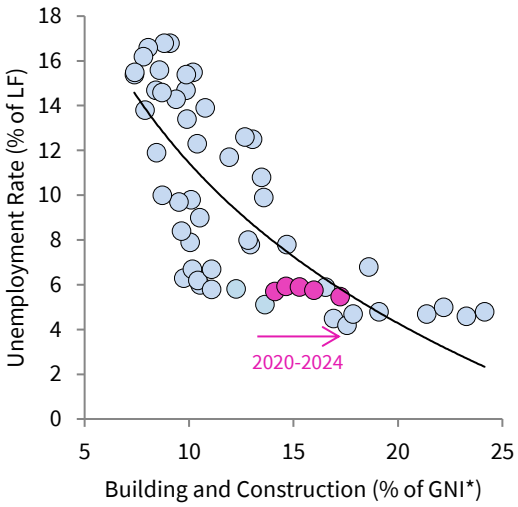
Appendix Figure D3: Investment and Housing Indicators

A. Investment

Per cent of GNI*



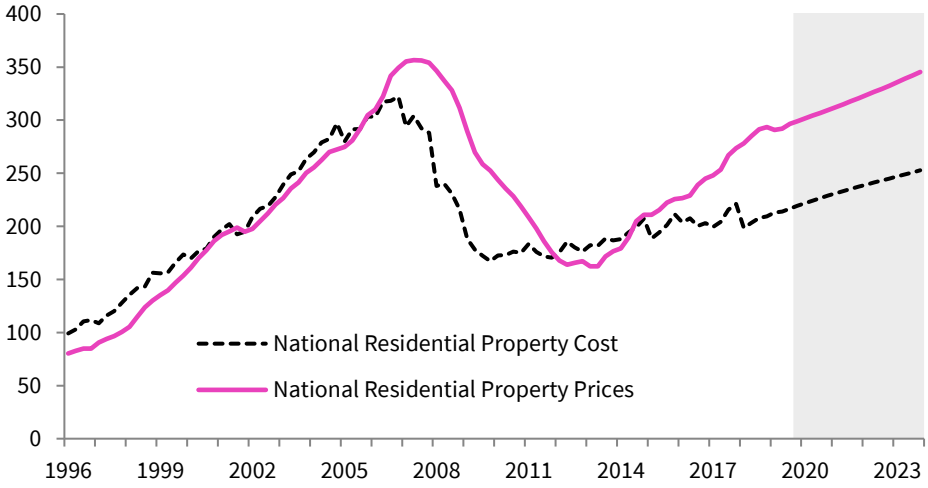
B. Construction activity and employment



Sources: CSO; AMECO; Department of Finance; and Fiscal Council workings.
Notes: Historical averages for investment ratios for 1970–2018 shown as horizontal lines in Panel A. In panel B, the latest outturn for 2019 is used, and forecasts (2020–2024) are shown in purple.

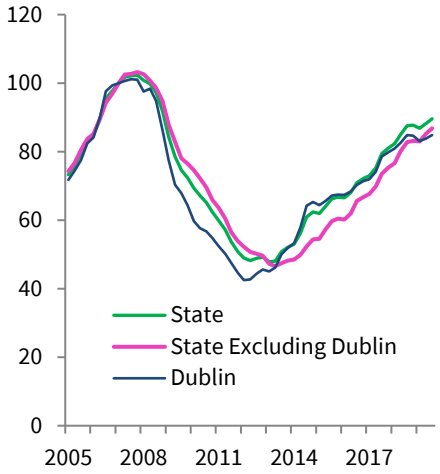
C. Irish residential property: prices and implied production costs

Euro, thousands

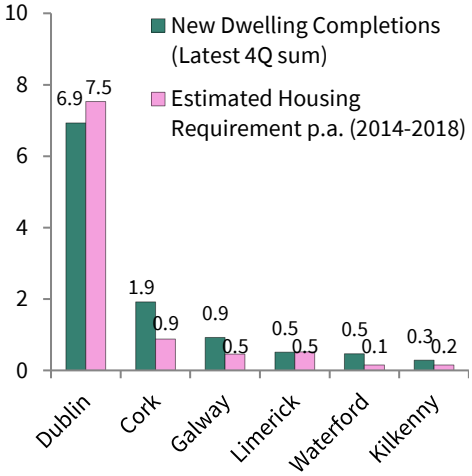


Sources: CSO; Society of Chartered Surveyors of Ireland; and internal Fiscal Council calculations.

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

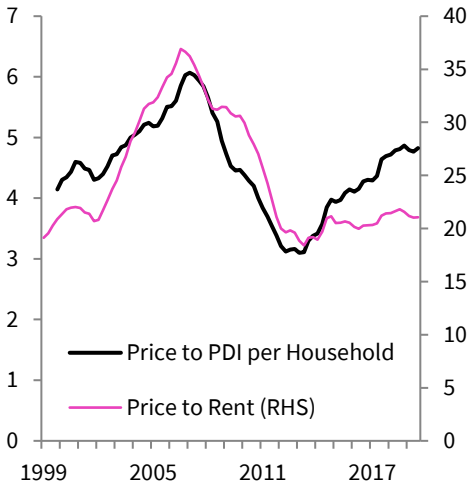


E. Estimated housing requirements and completions
Thousands

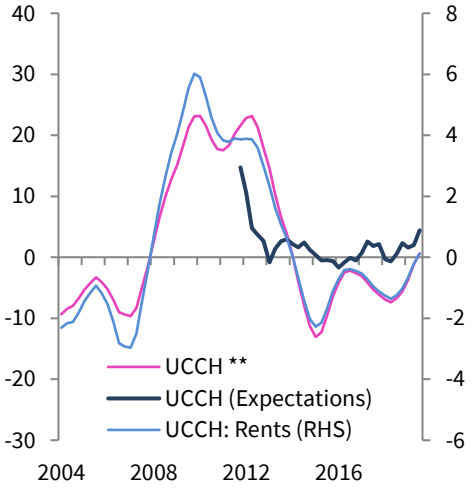


Sources: CSO, ESRI/PTSB, Housing agency estimates and Department of Housing, Planning, Community and Local Government; and internal Fiscal Council calculations.

F. Housing valuation ratios
Ratio

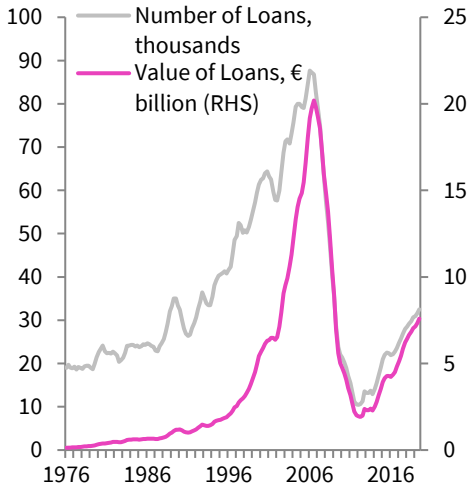


G. User cost of capital for housing (UCCH)



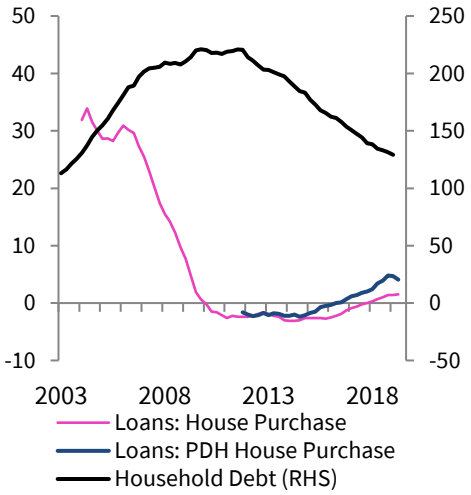
Sources: CSO, *Residential Property Price Index*; ESRI/PTSB *House Price Index*; RTB, *The RTB Rent Index Quarter 4 2018*; Housing agency estimates and Department of Housing, Planning, Community and Local Government; and internal Fiscal Council calculations. PDI = Personal Disposable Income.

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



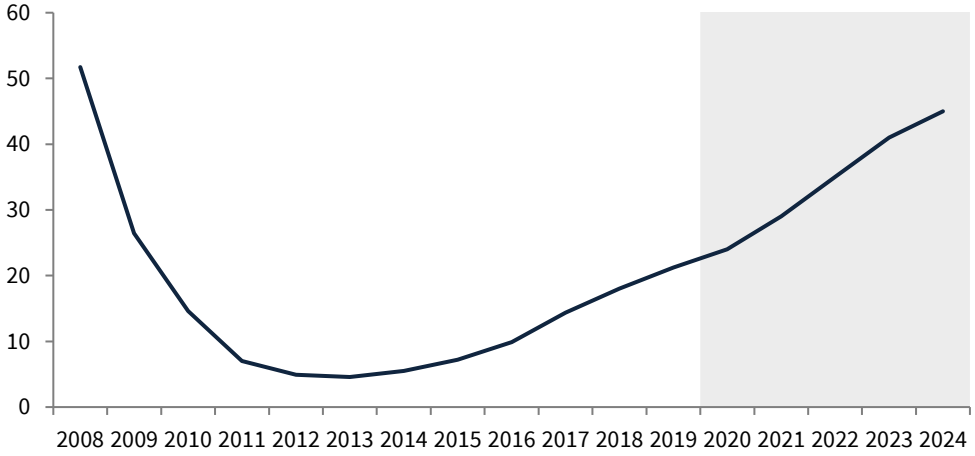
I. Loans to Irish households for house purchase

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



J. Housing completions

Thousands

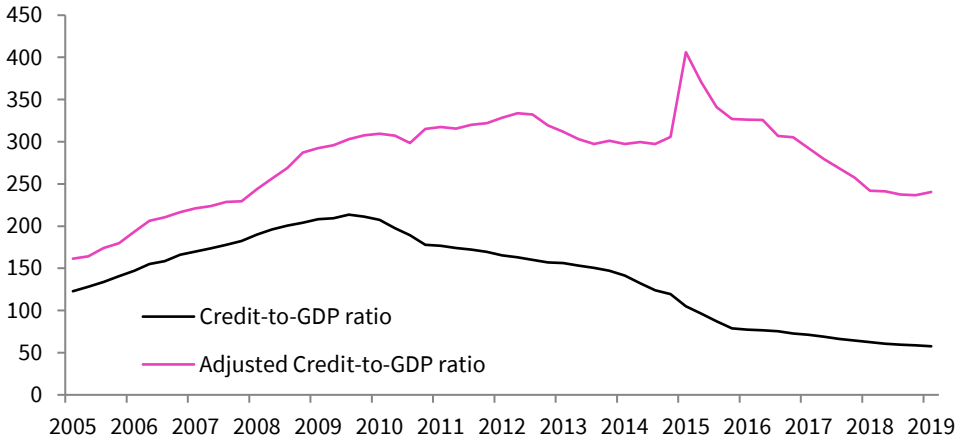


Sources: CSO, ESRI/PTSB, Central Bank of Ireland, BPFI Mortgage Market Profile, Department of Housing, Planning, Community and Local Government; and internal Fiscal Council calculations.
Note: Price to disposable income per household corresponds to average house prices divided by moving 4-quarter sum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

Appendix Figure D4: Credit Indicators

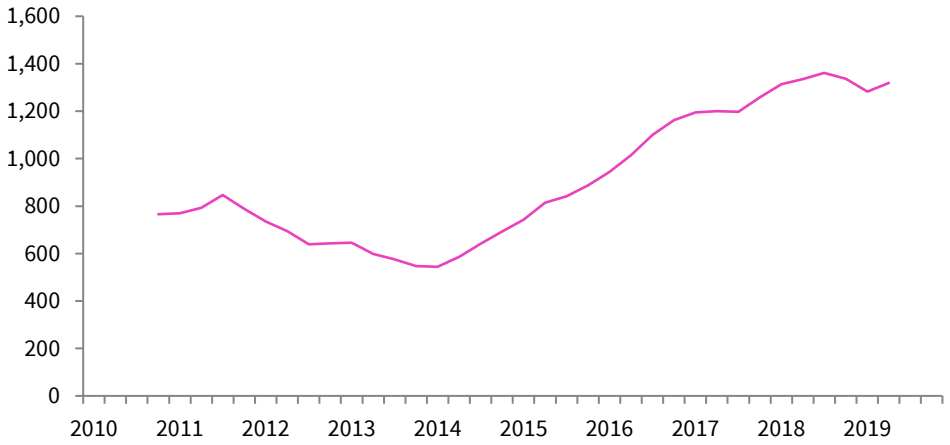
A. Private sector credit-to-GDP ratios

% GDP



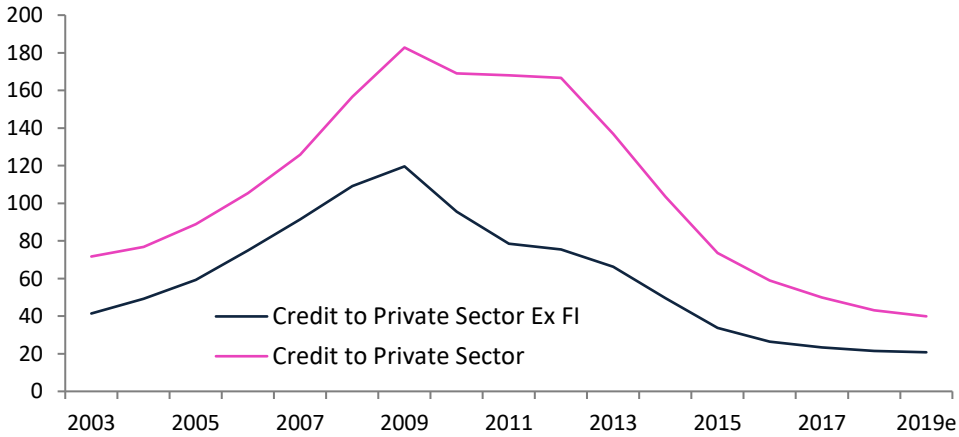
B. New credit advanced to Irish resident small- and medium-sized enterprises

€ billion (excluding financial intermediation, four-quarter sum)



C. Credit advanced to Irish resident private-sector enterprises

% GNI*



Sources: CSO; Central Bank of Ireland; and internal Fiscal Council calculations.
Notes: "FI" = Financial Institutions.

Appendix E: Tax Forecasts Decomposed

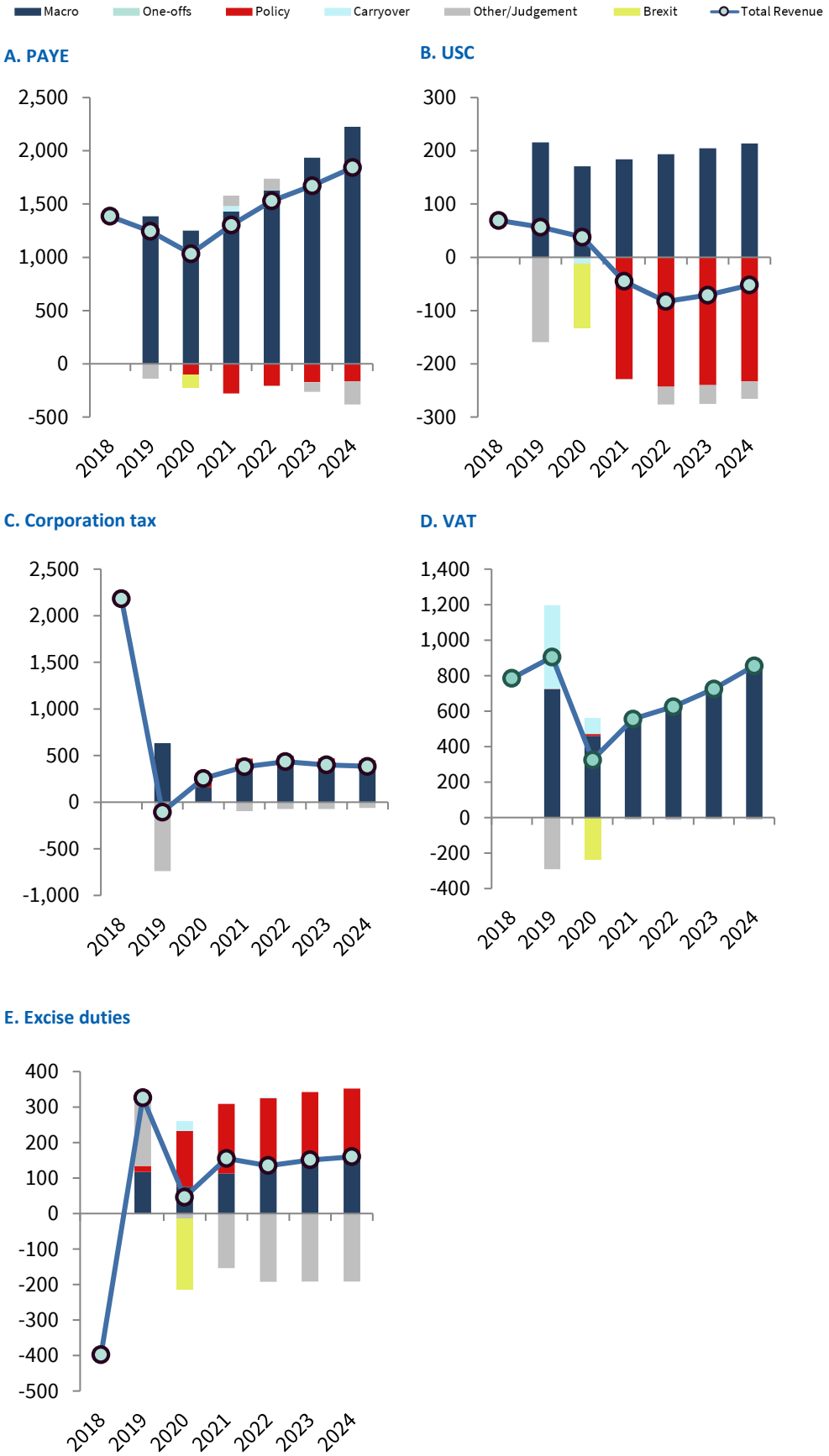
This appendix examines the latest tax revenue forecasts produced by the Department of Finance in *Budget 2020* for the projection horizon 2019–2024. In particular, it shows the yearly changes in the forecasts of VAT, corporation tax, excise duties, and the PAYE and USC components of income tax (see Appendix Figure E1).[88] For a detailed description of the Fiscal Council's forecast replication model, see Hannon (2014).

The changes on the tax forecasts (year-on-year) are attributed to a number of components: (1) "**macro**" is the part of the forecast driven by the growth in the relevant macro driver (e.g. wage growth and its corresponding elasticity when analysing income tax); (2) "**one-offs**" refer to non-recurring items that impact on expected tax receipts; (3) "**policy**" impacts account for the estimated impacts from policy changes in a given year (e.g., discretionary tax cuts); (4) "**carryover**" effects account for policy impacts carried over from previous years; (5) "**Brexit**" refers to the explicit no-deal Brexit-related judgement applied by the Department of Finance, other than that reflected in the "macro" driver; and (6) "**other**" represents potential elements affecting the forecasts (calculated as the difference between the Fiscal Council's internal forecasting exercise and that carried out by the Department of Finance), including judgement applied by the Department of Finance.

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

Appendix Figure E1: Tax forecasts decomposed

€ million, year-on-year change



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

Appendix F: Summary of the Council's Principles-Based Approach to the Budgetary Rule

Table F.1: Outline of the Council's principles-based approach to the Budgetary Rule

Criteria	Fiscal Council (New Approach)	Fiscal Council (Approach prior to May 2019)	European Commission Approach
Potential Output and the Output Gap	The Department's GDP-based estimates of potential output and the output gap.	The Department's CAM-based estimates of potential output and the output gap were used in all *Fiscal Assessment Reports* prior to May 2019. For the *ex-post* Assessment, the European Commission's own CAM-based estimates were used.	The European Commission's own CAM-based estimates of potential output and the output gap.
Reference Rate for Expenditure Benchmark	Based on the Department's latest estimates of GDP-based potential output growth (i.e. not frozen).	Reference rate frozen by the Commission in spring of year *t-1*, for assessment of year *t.* The same reference rate is used for the *ex-post* assessment. For later years (e.g. years *t+2* onwards) Fiscal Council uses the Department's CAM-based estimates of potential output.	Based on the European Commission's CAM-based estimates of potential output, frozen in spring of year *t-1.* No reference rate is set for *t+2* or later years.
Deflator for Expenditure Benchmark	Based on the Department's latest estimates of the demand-side GDP deflator (i.e. not frozen).	Based on the European Commission's estimates of the GDP deflator, frozen in spring of year *t-1.*	Based on the European Commission's estimates of the GDP deflator, frozen in spring of year *t-1.*
Adjustment Requirement and Convergence Margin	Based on the latest estimates of distance from the MTO in year *t-1* (i.e. not frozen). No negative convergence margin applied.	Compliance assessed based on the most favourable of the adjustment requirements and convergence margins in the spring or autumn of year *t-1*, or spring of *t+1* for the *ex-post* assessment (all based on the Commission's estimates of the output gap). No negative convergence margin applied.	Based on the European Commission's estimates of distance from the MTO that are frozen in either spring or autumn of year *t-1* (whichever is more favourable). For ex-post assessment, requirements can be unfrozen in spring of year *t+1* if these are more favourable in terms of compliance. Negative convergence margin allowed.
NAWRU	Assumed constant at 5.5%.	The Department's latest CAM-based estimates of the NAWRU.	The Commission's latest CAM-based estimates of the NAWRU.
Margin of Tolerance	No margin of tolerance.	No margin of tolerance.	0.25% of GDP from the MTO.
Significant Deviation from the Expenditure Benchmark	0.5% and 0.25% of GNI* for 1-year and 2-year assessment respectively.	0.5% and 0.25% of GDP for 1-year and 2-year assessment respectively.	0.5% and 0.25% of GDP for 1-year and 2-year assessment respectively.
Budgetary Semi-Elasticity	0.588	0.522	0.522

Note: For a full explanation of the Council's Principles-based Approach (PBA) to the Domestic Budgetary Rule see Box A of Ex-post assessment of compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a) and Box M of this report.

Appendix G: Assessment of the Budgetary Rule under the EU Methodology[89]

This appendix examines the consistency of the forecasts in *Budget 2020* with the preventive arm of the SGP. In particular, it examines compliance in relation to the Medium-term Budgetary Objective (MTO) and the Expenditure Benchmark.

The assessment in this appendix is based on the Council's interpretation of the *Vade Mecum* using the Department's CAM-based estimates of potential output and the output gap and considering the same one-off items as outlined in Chapter 4. As the assessment in this appendix is based on, among others, different estimates of potential output and the output gap, the assessment in this appendix may at times give contradictory signals about compliance with the Budgetary Rule when compared to the assessment in Chapter 4. It is the assessment that is presented in Chapter 4—not the assessment in this appendix—that represents the Council's view on compliance with the Budgetary Rule. Table G.1 provides a summary of the assessment of the compliance with the fiscal rules.[90]

[89] See Appendix F for a comparison of the EU methodology with the Council's principles-based approach.

[90] This assessment is in line with Column 3 (Fiscal Council Old Approach) of Appendix F, Table F.1.

Appendix Table G.1: Assessment of fiscal rules under the EU methodology[1, 2, 3, 4]

Per Cent of GDP, unless stated. For deviations, negative values = non-compliance

	2018	2019	2020	2021	2022	2023	2024
Corrective Arm							
General Government Balance Excl. One-Offs	0.0	0.2	-0.4	-0.2	0.1	0.4	0.7
General Government Debt	63.6	59.3	56.5	56.4	54.4	53.8	53.0
1/20th Debt Rule Limit	71.4	67.4	60.0	60.0	60.0	60.0	60.0
Debt Rule met? (Y/N)	Y	Y	Y	Y	Y	Y	Y
Preventive Arm & EU Budgetary Rule							
Structural Balance Adjustment Requirement							
MTO for the Structural Balance	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.5**
CAM Structural Balance	-1.2	-1.3	-0.6	-0.3	0.0	0.3	0.7
MTO met? (Y/N)	N	N	N	Y	Y	Y	Y
Minimum Change in Structural Balance Required	**0.4**	**–**	**0.3**	**0.1**	**0.0**	**0.0**	**0.0**
Change in CAM Structural Balance	-0.2	-0.1	0.7	0.3	0.3	0.4	0.4
1yr Deviation (€bn)	-1.8	-0.3	1.3	0.6	1.1	1.5	1.7
1yr Deviation (p.p.)	-0.6	-0.1	0.4	0.2	0.3	0.4	0.4
2yr Deviation (€bn)	–	-1.1	0.5	1.0	0.9	1.3	1.6
2yr Deviation (p.p.)	–	-0.3	0.1	0.3	0.2	0.3	0.4
Expenditure Benchmark							
(a) Reference Rate of Potential Growth (% y/y)	3.4	4.5	4.7	4.3	4.2	3.9	3.3
(b) Convergence Margin	1.7	0.0	1.2	0.4	0.0	0.0	0.0
(a-b) Limit for Real Net Expenditure Growth (% y/y)	1.8	4.5	3.5	4.0	4.2	3.9	3.3
GDP Deflator used (% y/y)	1.3	1.3	1.9	1.4	1.4	1.4	1.4
Limit for Nominal Net Expenditure Growth (% y/y)	**3.1**	**5.9**	**5.4**	**5.5**	**5.6**	**5.3**	**4.7**
Net Expenditure Growth (% y/y)	5.3	3.0	5.2	3.7	3.9	3.1	3.4
Net Expenditure Growth (Corrected for one-offs) (% y/y)	5.2	3.2	4.4	4.5	3.9	3.1	3.4
1yr Deviation (Corrected for one-offs) (€bn)	-1.5	2.0	0.8	0.8	1.5	2.0	1.2
1yr Deviation (Corrected for one-offs) (% GDP)	-0.5	0.6	0.2	0.2	0.4	0.5	0.3
2yr Deviation (Corrected for one-offs) (€bn)	-0.6	0.2	1.4	0.8	1.2	1.8	1.6
2yr Deviation (Corrected for one-offs) (% GDP)	-0.2	0.1	0.4	0.2	0.3	0.5	0.4
Limit for Nominal Net Expenditure Growth (€bn)	**2.2**	**4.5**	**4.3**	**4.6**	**4.9**	**4.8**	**4.4**
Net Expenditure Increase (€bn)	3.8	2.2	4.1	3.1	3.4	2.8	3.2
Net Expenditure Increase (Corrected for one-offs) (€bn)	3.7	2.5	3.4	3.7	3.4	2.8	3.2
Current Macroeconomic Aggregates							
Real GDP Growth (% y/y)	8.2	5.5	0.7	2.5	2.8	2.7	2.6
CAM Potential GDP Growth (% y/y)	7.3	4.9	3.2	2.6	2.3	2.4	2.5
CAM Output Gap	2.3	2.8	0.4	0.2	0.2	0.1	0.0
GDP Deflator Used (% y/y)	1.3	1.3	1.9	1.4	1.4	1.4	1.4

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

Note: [1] All figures presented on a General Government basis. Assessments examine *Budget 2020* revenue and expenditure plans using the Department of Finance's latest CAM estimates of potential output and considering the Council's views on one-off/temporary measures. A one-off windfall of €0.3bn in corporation tax revenue for 2018 is included in the Council's assessment of the structural balance as well as a new expenditure one-off of €0.2 billion, in 2018, due to a settlement in relation to pay arrears for medical consultants. For 2020, Brexit sectoral supports of €0.65 billion are considered temporary measures by the Council and are therefore excluded from the assessment. The treatment here differs to that applied in the appendix of "Assessment of Compliance with the Domestic Budgetary Rule in 2019" (Fiscal Council, 2019a), which used the Commission's Spring 2019 output gap estimates for the structural balance as these are the legal basis of ex-post assessments of compliance. The outlier for "CAM Potential GDP Growth" for 2015 is replaced by the average of the 2014 and 2016 rates in the expenditure benchmark, as discussed in the June 2017 FAR (Fiscal Council, 2017c).[2] The adjustment requirement for 2018 was reset to 0.4 per cent of GDP, based on the Commission's Spring 2019 estimates of the output gap. The Council assesses compliance with the Expenditure Benchmark without the use of a negative convergence margin. The adjustment requirement for 2019 is frozen by the European Commission at zero meaning the Commission will apply a negative convergence margin for 2019.The Expenditure Benchmark limits here therefore differ to those in the European Commission's opinion on Ireland's Draft Budgetary Plans. The adjustment requirement and convergence margin for 2020 were set on the basis of the Commission's Autumn 2019 forecasts. [3] The 1/20th Debt Rule requires that the debt-to-GDP ratio make annual progress towards the reference value of 60 per cent of GDP. A transition period applies until end-2018. [4] Figures in red indicate a significant deviation from the limit. Figures in amber indicate some deviation.

G.1 In-year Assessment for 2019

MTO and Structural Balance Adjustment Requirements

Based on the Department's CAM-based output gap, the MTO of a structural balance of -0.5 per cent of GDP will not be achieved in 2019. The structural balance is currently forecast to be -1.3 per cent of GDP in 2019 (Appendix Table G.1). This is a 0.2 percentage point decrease in the structural balance forecast in *SPU 2019*. This is as a result of an upward revision in the CAM output gap for 2019, as the forecast for the general government balance is largely unchanged since *SPU 2019*.

The adjustment requirement for 2019 was set in autumn 2018 based on the European Commission's Autumn 2018 forecasts, which – at the time – forecast that the MTO would be achieved for 2018.[91] This means that there will be no adjustment requirement for 2019, despite the MTO no longer being shown to be achieved for 2018.

Expenditure Benchmark

The limit set under the Expenditure Benchmark for 2019 was a growth rate for net expenditure of no more than 5.9 per cent.[92] Based on *Budget 2020* forecasts, net expenditure is currently forecast to grow by 3.4 per cent, below the limit set by the Expenditure Benchmark. The Expenditure Benchmark was breached in 2018, which resulted in a larger base for 2019. This larger base results in a lower growth rate for 2019 than would otherwise be the case.

As the MTO is forecast not to be achieved for 2019, the Expenditure Benchmark will be assessed by the Commission as part of an overall assessment of compliance with the fiscal rules.

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[91] Adjustment requirements for year *t* are set in spring of year *t-1*. These requirements can only be reset in autumn of year *t-1* or spring of year *t+1*, provided that these vintages imply a more favourable adjustment requirement in terms of compliance. The Commission's Autumn 2018 forecasts showed a structural balance of -0.2 per cent of GDP for 2018. As this vintage showed the structural balance was at the MTO for 2018, there is no adjustment requirement for 2018.

[92] The European Commission have set the Expenditure Benchmark limit for 2019 at 7 per cent. The difference between the Council's limit and the European Commission's limit was as a result of the European Commission applying a negative convergence margin for 2019, as the MTO was forecast to be overachieved in 2018 at the time the Expenditure Benchmark limit was set. The Council does not deem it prudent budgetary management to apply a negative convergence margin and as such, assesses the Expenditure Benchmark limit without it.

G.2 Ex-Ante Assessment of 2020

MTO and Structural Balance Requirements

Based on the Department's CAM-based estimates of the structural balance, the MTO of a structural balance of no less than -0.5 per cent of GDP, will not be achieved for 2020. The structural balance is currently forecast to be -0.6 per cent of GDP.

As the MTO is forecast not to be met in 2019, there will be an adjustment requirement for 2020. The adjustment requirement for 2020 is 0.3 per cent and was set based on the European Commission's Spring 2019 forecasts. Based on current Department of Finance forecasts, this adjustment requirement will be met. However, fiscal risks such as health overruns and the payment of the Christmas bonus may jeopardise compliance further (see chapter 3).

Expenditure Benchmark

As there is an adjustment requirement for 2020, a convergence margin also applies. The convergence margin reduces the Expenditure Benchmark limit by 1.2 percentage points, to 5.4 per cent. Net expenditure is currently forecast to grow by 4.4 per cent, below the Expenditure Benchmark limit.

G.3 Ex-Ante Assessment of 2021–2024

MTO and Structural Balance Requirements

The MTO is set for 2021–2022 as a structural balance of no less than -0.5 per cent of GDP. Assuming that the MTO will be kept constant for 2023 and 2024, the MTO is currently forecast to be achieved for 2021–2024. However, structural balance estimates for 2022–2024 are based on CAM-based output gap estimates that involve mechanical closure of the output gap over this horizon, and are not realistic.

Expenditure Benchmark

For 2021–2024, net expenditure is forecast to grow below the Expenditure Benchmark limit, but these forecasts for expenditure are largely based on technical assumptions that may be unrealistic.

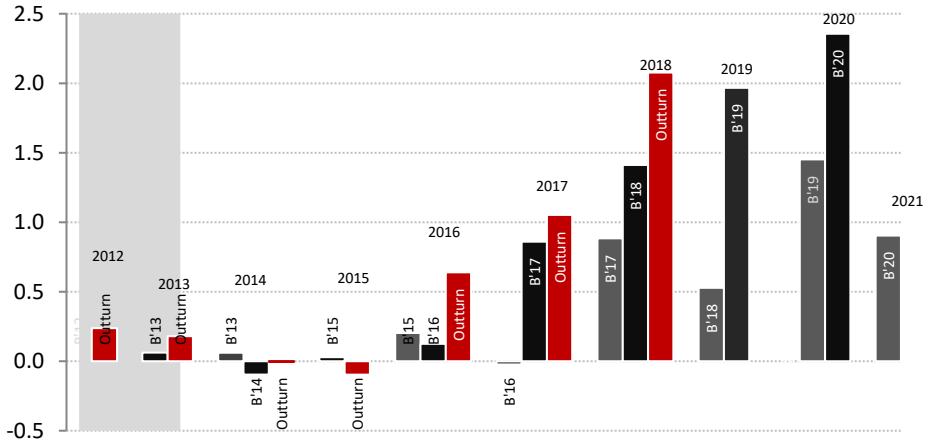
Appendix H: Gross Current Expenditure Revisions in Selected Departments

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

In particular, the Department of Health has had particularly large increases in ceilings in recent years, with the change from the original ceiling (set out in *Budget 2018*) for 2020 increasing by almost €2.5 billion. Given the recent patterns of overruns in the Department of health, the outturn for 2020 could be even higher.

Appendix Figure H.1: Change in gross current expenditure ceilings: Department of Health[93]

€ billion

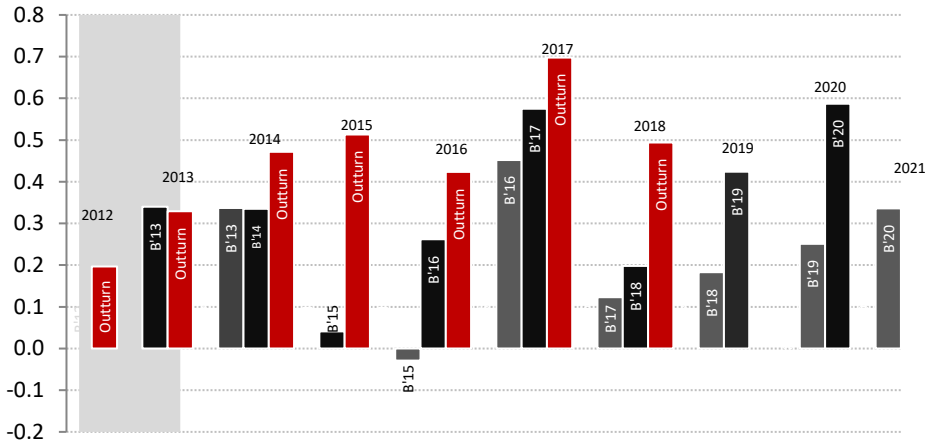


Sources: CSO; Department of Finance; and internal Fiscal Council calculations.
Note: Bars show the change in forecasts from various budgets followed by outturns, versus the earliest budget forecast for that year (e.g., B'15 = expenditure forecasts in Budget 2015 minus the earliest forecast for the specified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

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

Appendix Figure H.2: Change in gross current expenditure ceilings: Department of Employment Affairs & Social Protection Group

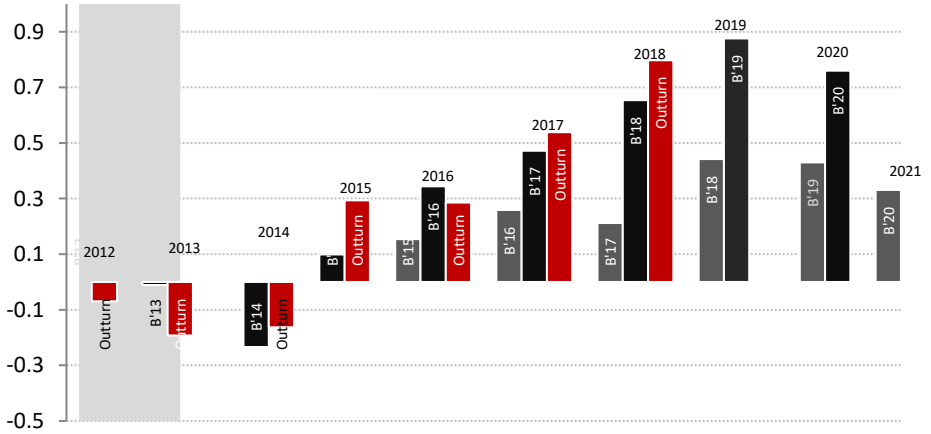
€ billion



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

Appendix Figure H.3: Change in gross current expenditure ceilings: Department of Education and Skills

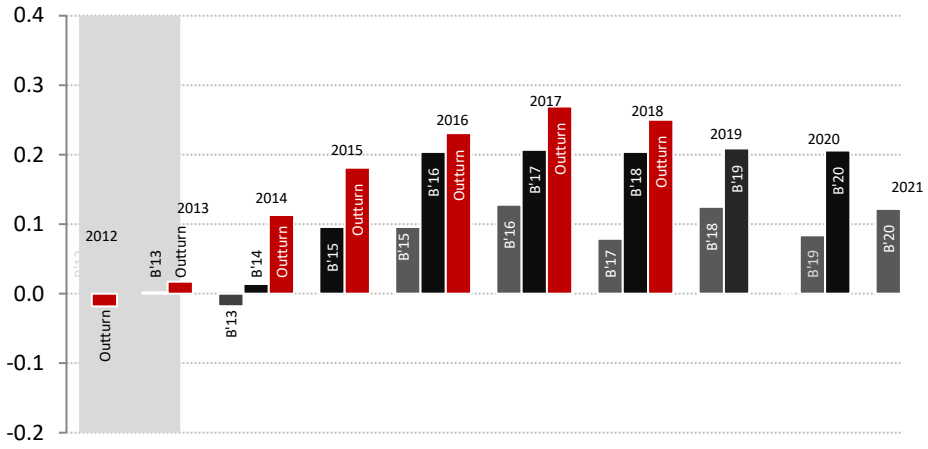
€ billion



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

Appendix Figure H.4: Change in gross current expenditure ceilings: Department of Justice

€ billion



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

Glossary

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

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

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

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

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

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

Exchequer: The Central Fund of Ireland. It is the Irish central government's main treasury account and it is recorded on a cash basis. The Exchequer represents only a portion of the total government financial position. Receipts into the Central Fund consist of Exchequer tax and non-tax revenues, EU receipts and other capital receipts. Central Fund expenditure includes Departmental spending, wages and pensions of the President, the C&AG, and the judiciary, running costs of the Oireachtas, debt servicing costs, and EU Budget payments.

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

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

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

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

Medium-Term Budgetary Framework: An institutional fiscal device that lets policymakers extend the horizon for fiscal policymaking beyond the annual

budgetary calendar (typically 3-5 years). Targets can be adjusted under Medium-Term Budgetary Frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

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

Modified current account balance (CA*): The current account balance adjusted to subtract (1) net factor income of re-domiciled PLCs, as well as depreciation of R&D imports, traded intellectual property, and leased aircraft; and (2) to add back the cost of imported investment in net aircraft related to leasing, R&D-related intellectual property, and the imports of R&D services. The adjustments in (1) apply to net primary income, whereas those in (2) affect net exports of merchandise and services. The idea is to better reflect domestic activities/resources rather than those related to foreign-equity owners. Depreciation of foreign-owned domestic capital is an operating cost of foreign-owned firms, and therefore does not affect the resources generated by domestic residents.

Modified gross national income (GNI*): Gross national income (gross domestic product less net factor income from the rest of the world, and taxes net of subsidies) adjusted for foreign-owned primary income in the balance of payments, which affects net factor income from the rest of the world. The adjustments to primary income subtract the impact of net factor income of re-domiciled PLCs (as this income reflects future dividend payments to foreign-equity owners that will not accrue to Irish residents); depreciation of R&D-related service imports and trade in intellectual property; and depreciation of aircraft for leasing (depreciation of foreign-owned domestic capital is an operating cost of foreign-owned firms, and therefore does not affect the resources generated by domestic residents).

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

Net Policy Spending: A measure of government expenditure which reflects the level of spending that is under the control of government, and which takes into account any offsetting tax changes (be they discretionary revenue-raising or revenue-decreasing measures). Interest spending, cyclical unemployment spending, and one-off and temporary measures (as assessed by the Council), are all largely considered to be beyond the control of government.

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

Output gap: The difference between actual output and estimated potential output.

Potential output: The maximum level of economic output that is sustainable in the medium to long run, where “sustainable“ implies that output, when at its potential, is not unduly influenced in any particular direction by imbalances in the economy, be they external, internal or financial. An alternative definition, often used by Central Banks, is that potential output is the level of economic output that is

consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

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

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

Principles-based approach: The approach that the Council takes when assessing compliance with Ireland's domestic Budgetary Rule. The principles-based approach differs to the European Commission's approach to assessing compliance with the EU fiscal rules across a number of strands (removing some layers of complexity; availing of the Department of Finance's alternative method for estimating potential output and the output gap; and drawing on the latest available information to a greater extent).

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

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

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

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

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

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

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