Rialtas na hÉireann
Government of Ireland

Summer Economic Statement

June 2019

Prepared by the Department of Finance and the Department of Public Expenditure and Reform

www.gov.ie

Summer Economic Statement
June 2019

Foreword

A decade ago, the Irish economy was at the coal-face of the most severe global economic recession in decades. The sharp decline in global economic activity exposed home-grown economic, budgetary and financial imbalances in Ireland that had been allowed to build up and which would ultimately lead to a loss of economic sovereignty.

We have come a long way in the intervening period, and our economy is now in a much healthier position. Living standards have recovered and measures of well-being have improved. The public finances finally returned to surplus last year. The level of employment has moved above the 2.3 million mark, its highest level ever. Involuntary emigration has been reversed and the unemployment rate is now below 4½ per cent.

The economic journey has been a difficult one and I am acutely aware that the scars of the crisis will remain for some time. This is why we must never allow these home-grown imbalances to emerge again. We must:

- increase budgetary surpluses and reduce public debt;
- deliver steady and sustainable increases in public services;
- continue to invest in our infrastructure;
- maintain our focus on the competitiveness of our economy; and
- sustainably improve living standards.

Turning to the short-term outlook, my Department's spring economic projections were set out in the *Stability Programme Update* (SPU), which was published in April. GDP is projected to expand by 3.9 per cent (modified domestic demand (MDD) growth – a better indicator of domestic living standards – of 4.0 per cent) this year; for next year, both GDP and MDD growth are projected at 3.3 per cent. The data-flow since April has been relatively strong, and the economy may be on the verge of over-heating.

Having said that, the near-term economic outlook is clouded with more uncertainty than normal. I am, of course, referring to the rising possibility of a disorderly exit of the UK from the European Union in the autumn. This would have a severe impact on many exporting sectors (including agri-food, indigenous manufacturing, tourism) as well as importing sectors, especially those characterised by just-in-time supply chains (notably parts of the retail sector).

Importantly, a disorderly Brexit is not the only potential source of stress for our economy at present. In many parts of the global economy external headwinds are picking up, with economic growth hitting a soft patch in many of our key export markets.

It is against this highly unusual backdrop that the Government must formulate budgetary policy. On the one hand, budgetary policy cannot add 'fuel to the flames' of an economy that is already performing at full capacity. In other words, budgetary policy must reflect very strong economic growth. On the other

hand, the possibility of a disorderly Brexit presents a clear and present danger to domestic living standards.

The overarching budgetary priority must be to protect domestic living standards, irrespective of the format that Brexit takes. This means building up our fiscal buffers so that, in the event of a disorderly Brexit, budgetary policy can respond accordingly.

Given heightened uncertainty, I am setting out two budgetary scenarios in this document. The first involves an orderly exit of the UK at end-2020 (as originally envisaged) while the second involves a disorderly exit in the autumn of this year.

The Budget 2020 framework involves a budgetary package of €2.8 billion for 2020, which includes €0.7 billion for additional investment on capital programmes. Under the orderly Brexit scenario, this is consistent with a 0.4 per cent of GDP headline surplus for next year. With current and capital expenditure commitments amounting to €1.9 billion, and an expenditure reserve of up to €0.2 billion being established in 2020 to accommodate funding requirements for the National Broadband Plan (NBP) and National Children's Hospital (NCH),this leaves €0.7 billion to be specifically allocated as part of the Budget. Under the disorderly Brexit scenario, this could involve a headline deficit in the region –½ to –1½ per cent of GDP for next year, depending on the magnitude of the economic shock. The wide range reflects the uncertainty surrounding the budgetary impact of such an unprecedented shock.

In September, the Government will decide – based on information available at the time – which scenario will form the basis for *Budget 2020*. Both eventualities involve choices.

Put simply, we face a difficult balancing act – steering the economy and the public finances through a potentially turbulent couple of years. We must avoid the excesses that characterised budgetary policy during the 2000s while, at the same time, navigate the economy through a potential disorderly UK exit from the EU. Such an outcome would dominate the Irish economy in the short- to medium-term, limiting the scope for new policy initiatives. I want to stress, however, that the Government would still be in a position to fund the rollout of the *National Development Plan* – involving investment of €116 billion over the 2018-2027 period – and to maintain and improve existing levels of public services, including honouring existing pay agreements.

Our revenue base has become progressively more reliant on corporation tax receipts in recent years. In view of growing uncertainty related to possible future changes in other jurisdictions, it is important to reduce the exposure of the public finances to this revenue stream. This is why I have widened the VAT base, increased stamp duties on commercial property and introduced a sugar tax. It is also one of the reasons why the Government has established the *Rainy Day Fund* which, by the end of this year, will have accumulated €2 billion in liquid assets.

Our corporation tax regime is an important – though far from only – part of Ireland's economic model. In this context, my Department will undertake and publish an assessment of the sustainability of receipts, in light of future multilateral policy changes in this area. This sustainability analysis will be published by March next year.

An additional source of fiscal vulnerability relates to the fiscal rules, which are clearly inappropriate for the Irish economy at this point in the economic cycle. This is why it is so important that budgetary policy is tailored to what is right for the economy rather than on the basis of one-size-fits-all rules that do not account for the unusual features of the Irish economy (such as the limited information content of traditional economic variables such as GDP).

Options include formulating the debt rule in GNI* terms, excluding parts of corporation tax receipts in assessing domestic compliance with the rules and using different estimates of potential growth. My Department will shortly publish an analysis setting out the shortcomings of the rules and outline proposals for improvements. My intention is to give consideration to some of these and to make recommendations to Government in the autumn.

High public indebtedness is also a challenge. My Department has calculated the ratio of debt to national income (as measured by modified Gross National Income) to be slightly above 100 per cent this year. On a per capita basis, this amounts to €42,500 for every person in the State, one of the highest figures in the developed world. The Government remains committed to reducing debt, including by using all windfall gains – as well as receipts from the resolution of the financial crisis – for debt reduction.

Finally, the *National Economic Dialogue* will take place on 26th and 27th June. The Dialogue facilitates an open and inclusive exchange on the competing economic and social priorities facing the Government. This year's theme is '*Building on Progress at a Time of Change*' and the Dialogue will further consider how we can achieve sustainable economic growth in a changing environment.

To conclude, the Government will continue to work to strengthen the resilience of the economy, to maximise opportunities and to prepare our economy for the challenges we face in the uncertain times ahead.

Paschal Donohoe T.D.
Minister for Finance and Public Expenditure and Reform

Contents

		Page
Foreword		**i**
Tables, Figures, Boxes and Annexes		**v**
Executive Summary		**vi**
1	**Economic Strategy**	**7**
1.1	Background	7
1.2	Economic strategy	8
2	**Economic Outlook**	**11**
2.1	Economic background	11
2.2	Recent developments	11
2.3	Economic Outlook: 2019	17
2.4	Economic Outlook: 2020 and the medium term	17
2.5	Risk to the outlook	18
3	**Then and Now**	**19**
3.1	Introduction	19
3.2	Structural Change	19
3.3	Budgetary cycle: enhancing transparency	21
4	**Budgetary Strategy**	23
4.1	Background	23
4.2	Fiscal developments to date in 2019	23
4.3	Budgetary strategy	24
5	**Public Expenditure Strategy**	**28**
5.1	Overview	28
5.2	Context for public expenditure	28
5.3	Current expenditure growth	29
5.4	Capital expenditure growth	30
5.5	2020 expenditure strategy	31
5.6	Medium tern perspective	32
5.7	Expenditure Reforms	33
5.8	Summary	34

Tables

Table 1	Macroeconomic growth and labour market forecasts 2018-2024	17
Table 2	Overheating pressure – 'then and now'	20
Table 3	Budget projections 2018-2024	23
Table 4	Orderly Brexit	25
Table 5	Disorderly Brexit	26
Table 6	Budget package consistent with Scenario A	27
Table 7	Fiscal space	27
Table A1	Expenditure benchmark approach to fiscal space	38

Figures[1]

Figure 1	Robust underlying growth in the economy	11
Figure 2	Robust labour market	12
Figure 3	Beveridge curve for Ireland, Q4 2008-Q1 2019	13
Figure 4	Participation rate 1999-2018	14
Figure 5	External sector	15
Figure 6	Total goods and services exports and imports to and from the US (2017)	16
Figure 7	SES: budgetary cycle – staging posts	22
Figure 8	Fiscal developments	24
Figure 9	Nominal growth in departmental gross voted expenditure	29
Figure 10	Current expenditure growth (real and nominal) 1999 – 2019	30
Figure 11	Gross Fixed Capital Formation as per cent of economic activity 1999 – 2019	31
Figure 12	Expenditure v revenue and economic growth 1998-2018	33

Boxes

Box 1	The beveridge curve	13
Box 2	Labour force participation rate	14
Box 3	Ireland's trading relationship with the US	16
Box 4	Building on progress in a time of change	22
Box 5	Fiscal space 2020-2024	27

Annexes

Annex 1	Expenditure benchmark approach to fiscal space	38

[1] In line with the Government's *Open Data Initiative* the data underpinning charts in this document are available on the Department of Finance website.

Executive Summary

Almost all of the available evidence points to an economy that is now operating at full capacity. The turnaround has been remarkable and best seen through the prism of the labour market: after peaking at 16 per cent in 2012, the unemployment rate is now below 4½ per cent.

At the same time, the faster-than-anticipated recovery has been associated with a building up of pent-up demand – perhaps most notably in the areas of housing and healthcare provision – and the Government has significantly increased resources to address these challenges.

From a policy perspective, the virtual attainment of full-employment means that **budgetary policy must lean against the wind, it must be counter-cyclical so that** mistakes of the past must be avoided. It is also critical that **budgetary policy is tailored to what is right for the economy** rather than on the basis of one-size-fits-all rules that do not account for Ireland's specific idiosyncrasies and needs.

Most important of all, **budgetary policy must be framed against the backdrop of a rising possibility of a disorderly exit of the UK from the European Union** in the autumn. A particularly sharp downturn would arise if a disorderly exit was accompanied by a slowdown in the wider global economy where, it is fair to say, momentum has slowed.

Careful management of the economy means that the Government is in a strong position to meet the challenges ahead. A *Rainy Day Fund* has been established and, by end-year, is budgeted to have accumulated €2 billion of assets. Ireland's fiscal credibility has been restored, evidenced by the fact that the risk premium vis-à-vis 'core' euro area borrowing costs is minimal. Capital spending has increased substantially as Government boosts the productive capacity of our economy, laying the foundations for future improvements in living standards.

In summary, the economy is caught between possible over-heating on the one hand and the very real possibility of a disorderly Brexit on the other hand. **The appropriate budgetary strategy must be to avoid further inflating the economy and, concurrently, build up resources which can be deployed in the event of the UK leaving the EU without a trade agreement** at end-October. Recognising and planning for the challenges of Brexit is the only sensible budgetary strategy and it is the one that the Government intends to follow.

Chapter 1
Economic Strategy

1.1 Background

On the back of another strong year for the Irish economy in 2018, a range of indicators (labour market, retail sales, tax receipts) suggest that momentum has continued – and may even have picked-up – in the first half of 2019. The economy is on course to grow by 3.9 per cent this year and recent data show the labour market is zeroing-in on full-employment.

However, there are significant challenges ahead that must be addressed, not least the risk of a disorderly Brexit, the possibility of a prolonged slowdown in global growth, and the increasing likelihood of over-heating on the domestic front. In light of these elevated risks, the over-arching economic strategy of the Government is the protection of domestic living standards, underpinned by prudent fiscal policy. This means that continued vigilance is required to ensure tax and revenue remain on a sustainable footing and that pro-cyclical budgetary policy is avoided.

The benefits of the rapid recovery since the crisis can be seen across the economy. The unemployment rate has fallen by over 11 percentage points since 2012. There are now over 2.3 million people at work, nearly 2.2 million of whom work outside of construction, a sign of the balanced nature of our labour market today. Involuntary emigration has been reversed, real average incomes have recovered, and there is a much-needed recovery in housebuilding, although clearly more needs to be done. Key well-being metrics such as per capita measures of both real disposable income and consumption are back at levels seen before the crisis.

The economy is now closing-in on full-employment. This is, of course, a welcome development but also one that brings challenges. In particular, it is imperative to avoid over-heating and the emergence of dangerous imbalances that characterised the Irish economy in the not-too-distant past. Policy – including budgetary policy – must be cognisant of this.

With the achievement of full employment, sustainable growth in living standards in the future will depend on, firstly, greater participation in the labour market by those currently outside, encouraging older workers to remain in the labour force for longer, and continuing to attract talent from the global labour pool, including those who previously left. Secondly, productivity improvements, particularly by Irish SMEs, have an important role to play in boosting living standards.

Turning to the traded sector of the economy, the extent of Ireland's integration into global value chains is no more evident than the €100 billion in exports recorded in the fourth quarter of 2018, the highest quarterly level ever. Having said that, the external environment is now clouded in uncertainty, with a slowdown in advanced economies that commenced in the latter half of 2018 now looking like it might be more prolonged than previously expected. Key indicators such as global trade in goods, container shipping volumes, new export orders, industrial production and investment have all disappointed of late.

The UK's forthcoming exit from the European Union casts a shadow over future prospects. Despite the extension of the article 50 period to end-October, the possibility of a 'cliff-edge' exit appears to have risen. From an economic perspective, this would entail a severe disruption to Irish-UK bilateral trade, with the impact magnified by deep, often 'just-in-time' supply-chain linkages and, in all likelihood, non-

tariff barriers and adverse exchange rate developments. The most affected sectors include those in the broad agri-food sector, where WTO tariffs are particularly high. In addition, non-tariff measures could affect all sectors, while loss of market access could severely affect trade in services.

On the public finance side, after a decade-long journey, the headline budget deficit was eliminated last year. At least part of this reflects the impact of the economic cycle so that it is probable that the headline balance is flattering the underlying budgetary position. At the same time, the ratio of debt-to-national income (where income is approximated by modified Gross National Income) is still too high, at around 100 per cent. Maintaining this ratio on a downward trajectory must be a key priority.

All Governments have to prioritise, and while doing so from a surplus position is preferable to the choices that had to be made in recent years, the need to plan for demographic pressures, remedy existing infrastructural bottlenecks and position our society for the challenges of the future (climate change, automation, post-Brexit trading environment), while also protecting the fiscal position from an adverse shock, means that not all demands can be met.

1.2 Economic Strategy

Against this general background, and in the context of an economy that is very close to full-employment, the key principles underpinning the Government's economic strategy are:

- Steady and sustainable improvements in living standards;
- Ensuring sustainable fiscal policy;
- Budgetary strategy that protects domestic living standards, irrespective of the Brexit outcome.

Steady and sustainable improvements in living standards

The Government is building on the gains made in recent years and ensuring Irish people enjoy higher standards of living and quality of life, both now and into the future. Several interconnected Government initiatives are underway to reinforce this. *Project Ireland 2040* provides the framework for making Ireland a great place to live - and do business - through integrated spatial and investment strategies. *Global Ireland* will boost our international relations so that we can better influence our place in the world and targets an ambitious doubling of our overseas impact. Complementing these initiatives, *Future Jobs Ireland*, launched earlier this year, will ensure our enterprises and workers are well placed to prosper in the rapidly changing global economy.

Looking ahead, the key to sustained increases in living standards, in the context of full employment, will be increased labour force participation and productivity improvements. Labour force participation features prominently in the *Future Jobs Ireland* strategy, particularly with respect to females and older workers. However, the participation rate has proven to be relatively static of late and remains one of the aspects of the labour market where progress is needed.

High levels of productivity allow higher wages without compromising competitiveness. Studies undertaken by the *Department of Finance* show that aggregate levels of productivity in Ireland are

heavily distorted by exceptionally high levels of productivity in a relatively small number of foreign-owned firms. On the other hand, productivity growth has been very modest elsewhere in the economy.

It is time to shift our enterprise and jobs focus to ensure quality jobs that will be resilient into the future. This is not just a question of more jobs, instead it is focused on enabling the creation of highly productive, sustainable jobs. It is also time to shift the way we work if we are to sustain and increase labour market participation. *Future Jobs Ireland* sets out core ambitions to improve productivity and participation - along with embracing innovation, enhancing skills and transitioning to a low carbon economy - each backed up by a set of specific deliverables.

Ensuring Sustainable Fiscal Policy

Decisive action in recent years has put the public finances on a sustainable path. A headline surplus was recorded last year for the first time in a decade, asset sales have been used to reduce debt and the Government has established a Rainy Day Fund. Ireland's fiscal credibility is evident from the fact that the cost of borrowing has fallen; indeed, the NTMA recently borrowed at negative interest rates. A fundamental lesson of the crisis, however, is that credibility is hard-won but easily lost.

Ireland's elevated public debt level weighs on the capacity of the public finances to respond to any economic downturn in the future. On the revenue side, as the *Department of Finance* has set out, receipts are highly concentrated with, for instance, the largest ten firms accounting for 45 per cent of corporation tax receipts. This creates a vulnerability for the Irish economy. At the same time, international tax reform, including discussions relating to revised profit allocation rules and global minimum tax rates as part of the OECD's new BEPS process, may have significant medium-term effects on our corporate tax revenue base.

Budgetary policy should be able to respond during a downturn, although this is contingent upon having sufficient room for manoeuvre. The highly unpredictable external environment at present illustrates the importance of 'fixing the roof when the sun shines'. Indeed, the need to rebuild fiscal buffers and the current cyclical position of the economy suggest the appropriate strategy is to run budgetary surpluses for a number of years in order to alleviate pressure on the domestic economy and to prepare for the future challenges.

This means incremental and sustainable increases in public expenditure over time and that changes to the taxation regime are sustainable. In particular, taxation changes must not lead to a narrowing of the taxation base. In practical terms, this means gradual increases in spending during 'good' times so that Government can avoid reversing these during 'bad' times. It also means using revenue surprises, be it through tax or non-tax windfalls (e.g. sales of State Assets, NAMA) to reduce our debt burden. The *Rainy Day Fund,* which is to be partially capitalised through a transfer from the ISIF, is an important policy response to mitigating over-reliance on revenue over-shoots, including corporation tax receipts.

Protect domestic living standards irrespective of the Brexit outcome

The macro-fiscal projections set out in the SPU are contingent upon a 'soft' exit of the UK from the EU. However, despite the decision of the European Council to extend article 50 until end-October, the probability of a disorderly, no-deal exit in late 2019 has, if anything, increased since the publication of the SPU.

Research undertaken jointly by the *Department of Finance* and the *Economic and Social Research Institute* (ESRI) shows that the impact of a disorderly exit would be to reduce the level of GDP by 5 per cent points (relative to baseline) over the longer term[2]. As set out in the SPU, the impacts of a disorderly Brexit would be most disruptive in the initial years, with the growth rate in the first year following exit close to 3 percentage points below what it would otherwise be.

The appropriate budgetary response is to allow the automatic stabilisers fully apply: higher unemployment-related expenditure and lower tax receipts would provide support for the economy. At the same time, targeted measures for the most affected sectors would need to be implemented in order to support the transition to the new equilibrium.

[2] https://www.gov.ie/en/publication/ca41b6-r/

Chapter 2
Economic Outlook

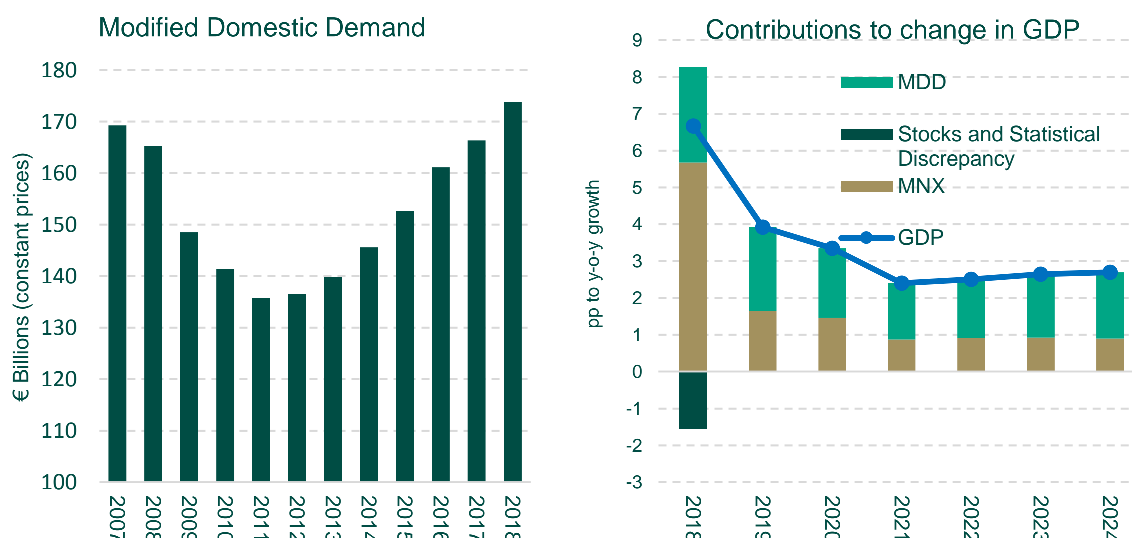
2.1 Economic Background

Continued economic momentum over the first half of 2019 is clearly evident across a range of high frequency indicators, most notably the first quarter labour market data, key 'bellwether' tax heads (income tax, VAT and excises) and retail sales. Recent developments in the labour market, with an unemployment rate of 4.4 per cent estimated for May, point to an economy that is close to, or even at, full-capacity, elevating the risks of over-heating in the near-term. At the same time, the global economic environment is particularly precarious at present, with the pace of growth in key trading partners having stalled of late and, despite the extension of the article 50 negotiating period, the possibility of a disorderly Brexit appears to have increased.

2.2 Recent developments

On the domestic front, modified domestic demand (MDD), i.e. domestic demand excluding investments in leased aircraft and 'on-shored' IP, has contributed significantly to growth in the economy in recent years and has now risen above its pre-crisis peak level (see figure 1a). The baseline scenario set out in the SPU assumes further strong growth in MDD next year (4.0 per cent) and over the medium term (averaging 2.8 per cent over 2021-2023).[3]

Figure 1: robust underlying growth in the economy



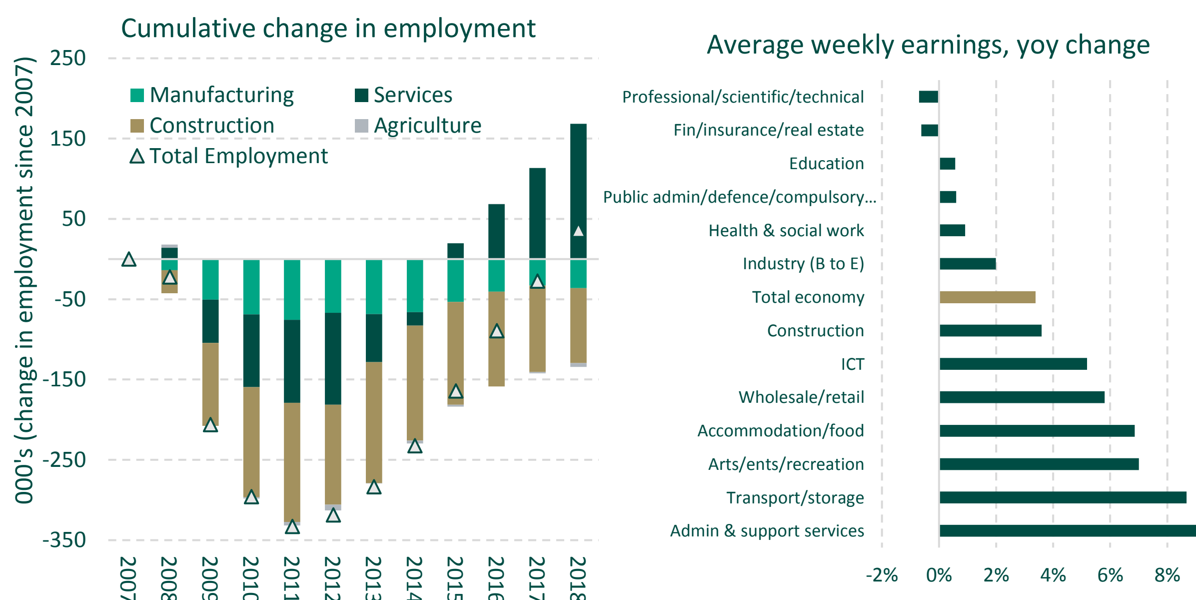
Source: CSO, Department of Finance
Modified domestic demand (MDD) represents the sum of private consumption, public consumption and investment excluding stocks, investments in aircraft by the leasing sector and net R&D imports. Modified net exports (MNX) is net exports (exports less imports) excluding investments in aircraft by the leasing sector and net R&D imports.

[3] The SPU forecasts cover the period 2019-2023 and were endorsed by the Irish Fiscal Advisory Council. The projection for 2024 is included in this document in order to generate a five-year forecast.

The strong performance of the economy of late is possibly best reflected in the significant improvements seen in the labour market. Total employment is now in excess of 2.3 million, almost 100,000 above the previous peak level recorded in 2007. Importantly, this employment growth is broad-based across sectors and regions and is driven by gains in full-time positions. This rise in employment has led to a significant decline in unemployment, with the unemployment rate falling to 4.4 per cent in May, over 11 percentage points below its peak. Reflecting the positive momentum in the labour market, net migration turned positive in 2015 and has continued to increase since then.

Another consequence of a tighter labour market is the pick-up in earnings evident in recent quarters, after many years of sluggish growth. Average weekly earnings grew by 3.4 per cent in the first quarter, driven mainly by average hourly pay growth. Given the tightness of the labour market, an acceleration in the pace of earnings growth is expected over the medium term.

Figure 2: robust labour market



Source: CSO.

Overall, the labour market appears to be close to (or potentially past) a position of full-employment. This is evident from the low unemployment rate as well as a range of other broader labour market indicators, including trends in part-time under-employment, wider measures of potential labour supply, earnings growth and vacancy rates (see box 1).

Further increases in the labour force will depend on the 'natural' increase in the working age population, net inward migration and a pick up in the participation rate. This latter indicator, which features prominently in the *Future Jobs Ireland* strategy, particularly with respect to females and older workers, has proven to be relatively static of late and remains one of the aspects of the labour market where progress is needed (see box 2).

Box 1: The Beveridge Curve

The Beveridge curve, which plots the relationship between the job vacancy rate and the unemployment rate, provides useful information on developments in the labour market.

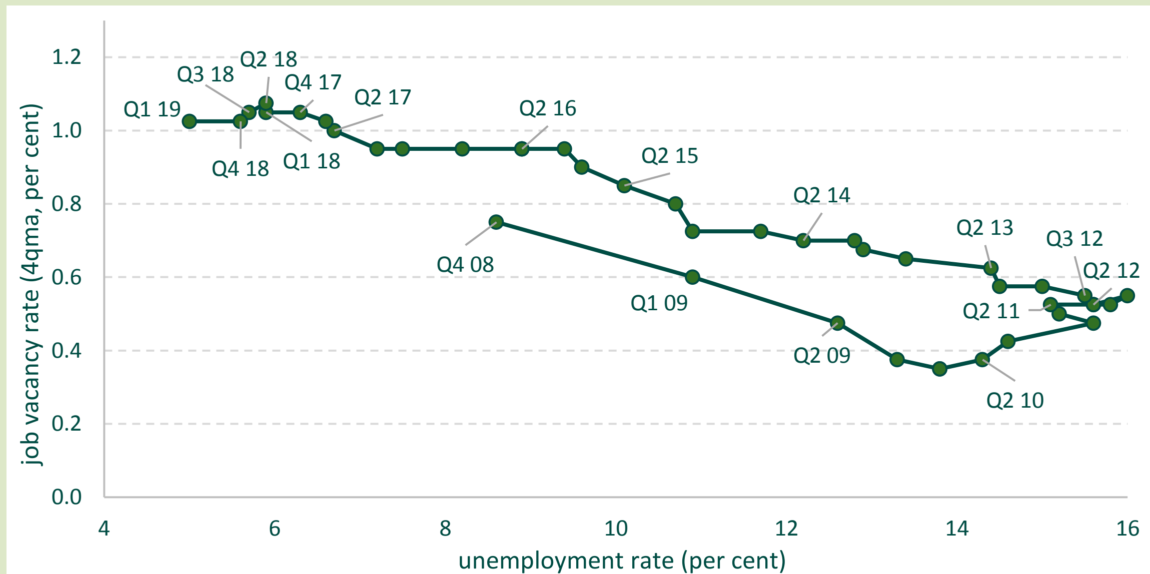
The Beveridge curve for Ireland is set out in figure 3 below. The data show a clear downward movement to the right from 2008-2010, with unemployment rising rapidly and vacancies falling as economic activity went into reverse.(i)

From 2010-2013, the curve shifted outwards with higher levels of vacancies for a given unemployment rate. This reflected an increase in skill and sectoral mismatches arising from the collapse of activity in previously over-extended sectors, e.g. construction.

As the recovery took hold over 2013-2015, vacancies increased while unemployment declined. From 2016, the Beveridge curve shifted inwards, reflecting a sustained fall in the unemployment rate despite the vacancy rate staying in the region of 1 per cent. This suggests that any significant mismatch between labour demand and labour supply was temporary.

From 2017-present, the vacancy rate has hovered above 1 per cent as the unemployment rate continued to decline. Interestingly, this inward shift has not been experienced to the same extent by other European countries suggesting that Ireland's labour market is relatively more efficient.

Figure 3: beveridge curve for Ireland, Q4 2008-Q1 2019



Source: CSO LFS and EHECS.

Notwithstanding the short time period for which the data are available, the vacancy rate is now at a relatively high rate. Moreover, certain sectors show vacancy rates significantly in excess of the average. In addition, the Central Bank of Ireland's Non-Employment Index suggest that the level of slack remaining in the labour market is now very close to that which prevailed before the crisis.(ii)

(i) Vacancy rates are from the CSO EHECS series, which is only available from 2008 onwards, and are calculated on a 4-quarter moving average basis in order to smooth quarterly volatility.

(ii) Box D, Quarterly Bulletin Q2 2019, Central Bank of Ireland.

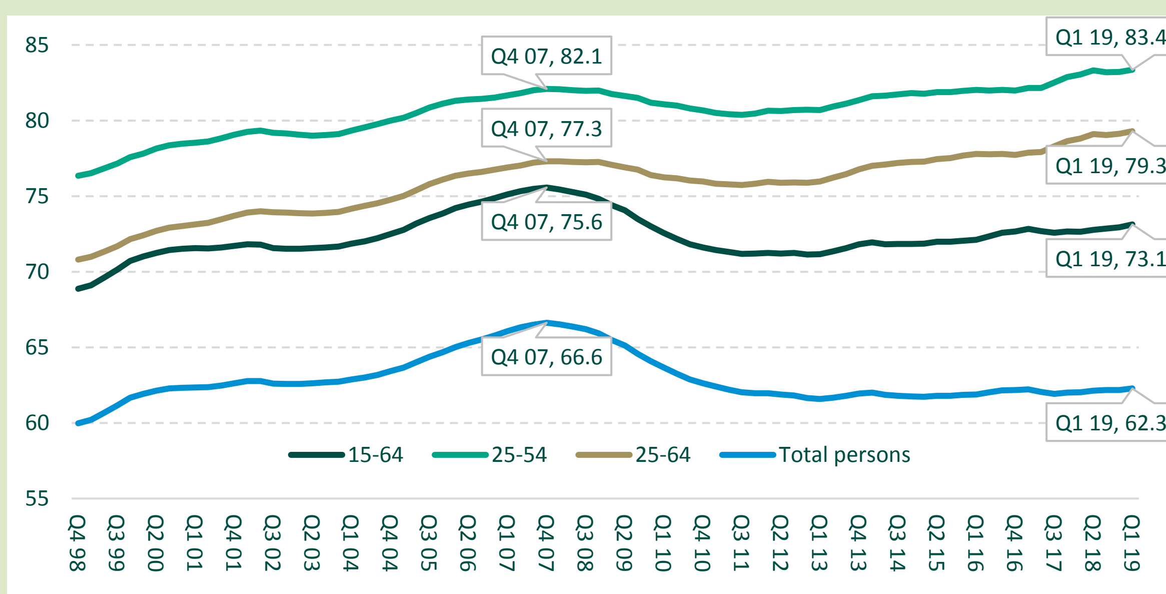
Box 2: Labour force participation rate

The participation rate – the number of people actively participating (working or seeking employment) in the labour market as a share of the working age population – is a key indicator and contains important information regarding the economic cycle.

Trends in the participation rate by age cohort since the beginning of monetary union are set out in the graph below. The overall participation rate (all persons aged 15 and over) peaked at 66.6 per cent in 2007, the aggregate participation rate fell to a low-point of 61.7 per cent in 2012. One of the surprising aspects of the recovery, is the static nature of this indicator which is relatively unchanged since 2011. International institutions tend to look at a slightly narrower age group, namely 15-64, for international comparisons.* Again this series remains below its previous peak though a modest up-tick is evident in recent years.

Part of the decline in labour force participation reflects the deterioration in labour demand during the crisis, which prompted a decline in participation among the more 'cyclically-sensitive' age-cohorts. For instance, the deep recession resulted in a sharp fall in participation among the younger age cohorts (15-25), particularly males, as many chose to stay on in education in order to boost their human capital. This greater investment in human capital should have a beneficial long-run impact for the economy by raising productivity.

Figure 4: participation rate 1999-2018 (4-quarter moving average, per cent)



Source: CSO.

When both younger (15-24) and older (65+) cohorts are excluded, the participation rates of the 'prime' working age population is actually above the pre-crisis level, with a 2 percentage point improvements in the 25-64 group. By way of international comparison the participation rate of the 25-54 year old group, at 83.4 per cent, is just over a percentage point higher than the equivalent rate in the United States^. However, demographic trends which will act as a drag on the 'prime group' in the years to come, as they approach retirement age, which illustrates the need for continued focus on labour force participation as a key policy priority.

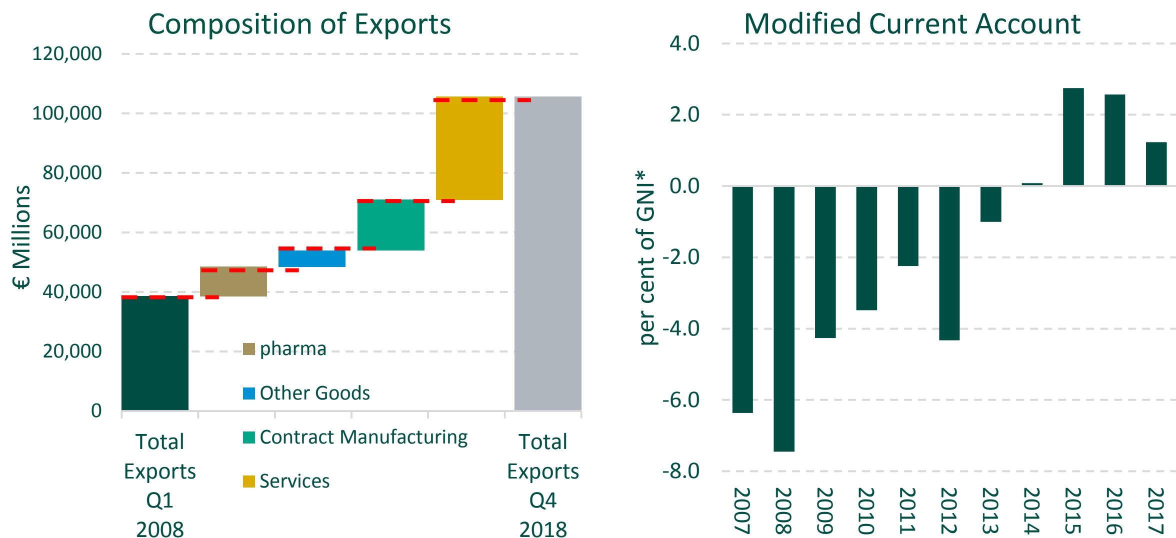
* See Box 1.1 Labour Market Dynamics in Selected Advanced Economies, IMF World Economic Outlook, April 2019

^ Source: FRED Economic Data, Federal Reserve Bank of Saint Louis.

On the external side, Irish export growth once again exceeded import growth last year driven mainly by the pharma-chem and ICT sectors, with total exports exceeding €100 billion in the fourth quarter alone (see figure 5). As a result, the trade balance widened to reach its highest level ever at just under €100

billion for the year. While several factors distort Irish trade – in particular contract manufacturing, and trade in activities such as intellectual property and leased aircraft (see box 3 for a discussion on the impact on the Ireland-US bilateral position) – the underlying improvements over the last decade in the external sector are clearly seen in recent years in the dramatic turnaround of the 'modified' current account of the balance of payments (see figure 5).

Figure 5: external sector



Source: Department of Finance calculations based on CSO data.

The external trading environment is particularly precarious at present. Globally, growth in goods trade, container shipping and new export orders are either negative or close to zero, with the outlook particularly weak for the rest of the year. From an Irish perspective the pace of growth has slowed in key export markets, particularly the UK and the euro area. The full impact of US-China trade tensions has yet to be realised, with estimates from the IMF suggesting as much as a quarter of a percentage point could be wiped-off world GDP in the event of a 25 per cent tariff rate on bilateral trade

Box 3: Ireland's trading relationship with the US

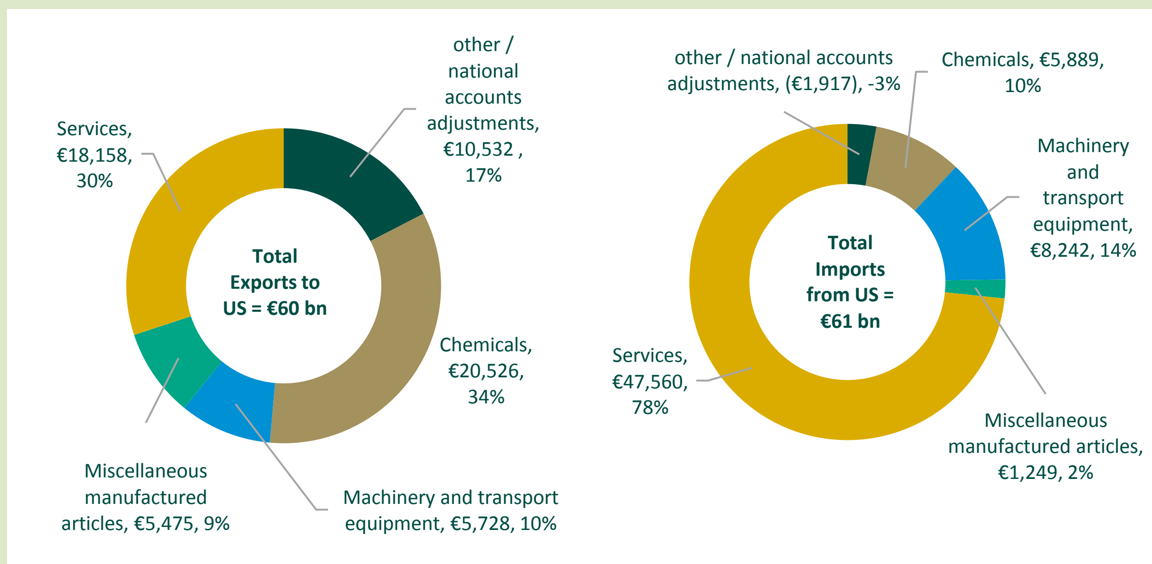
Trade linkages between the US and Ireland have intensified in recent years, reflecting the increasingly globalised nature of the Irish economy and the strong bilateral economic relationship between the two countries. While Ireland has consistently run a merchandise trade surplus with the US in recent years, this has largely been balanced out by a services trade deficit. In 2017, the latest year for which services trade data are available, Ireland had a small overall trade deficit of €600m with the US, comprising a goods surplus of €28.8bn and a services deficit of €29.4bn.

The figure below shows the composition of Ireland's exports and imports to and from the US. Goods exports are primarily driven by chemicals (pharmaceuticals), machinery and transport equipment (mostly related to aircraft leasing) and miscellaneous manufactured articles (e.g. medical devices). Ireland has a significant goods trade surplus in chemicals as well as in misc. manufactured articles, compared to a goods trade deficit in machinery and transport equipment.

The 2017 services deficit was largely driven by significant imports of research and development as well as royalties and licenses, i.e. the licensing fee paid by firms for the use of or outright purchase of intellectual property. The Irish economy is deeply embedded in global supply chains, with Irish exports heavily reliant on imports of intermediate goods and services such as raw materials and, in particular, intellectual property. Most of this activity relates to intra-firm trade by US multinationals located in Ireland. As such, the bilateral goods and services trade balance should be considered as a whole to account for both goods and services inputs in production processes.

It is also important to note that Ireland's goods surplus with the US is significantly distorted by contract manufacturing (i.e. off-shore production in third countries). Of the €28.8 billion goods surplus in 2017, around €12 billion relates to exports associated with contract manufacturing. If these are excluded, Ireland would have run an overall trade deficit of €12.5 billion with the US in 2017 (rather than the €0.6 billion deficit).

Figure 6: total goods and services exports and imports to and from the US (2017)



Source: CSO.
Note national accounts adjustments refers to statistical adjustments to move from the traditional goods exports definition to the national accounts 'economic ownership' definition of exports. It is largely accounted for by contract manufacturing, but also includes merchanting (whereby goods are bought and resold without entering the Irish border, and other conceptual (i.e. price) adjustments. The negative adjustment to imports is a national accounts adjustment whereby the export is valued net of transportation of insurance costs.

2.3 Economic Outlook: 2019[4]

Against a backdrop of slower global growth, growth in the Irish economy is expected to transition towards a more sustainable pace, with GDP expected to grow by 3.9 per cent this year (MDD growth of 4.0 per cent). This should continue to pay dividends in the labour market with strong employment growth already evident in the opening quarter of the year. Inflationary pressures in the economy are expected to remain subdued, with 'core' inflation (the harmonised measure excluding the volatile components of unprocessed food and energy) to average at just 0.9 per cent this year – the seventh consecutive year that inflation remains below 1 per cent.

2.4 Economic Outlook: 2020 and the medium term

Looking ahead, baseline GDP growth of 3.3 per cent is forecast for 2020, with broadly similar contributions from modified domestic demand and modified net exports. The economy is then expected to converge towards its 'potential' rate of growth, of around 2¼ per cent per annum over the medium term.

The central scenario underpinning the Department's projections assumes that a transition period will be agreed between the EU and the UK that extends or replicates existing frameworks until end-2020, i.e. the UK is assumed to remain in the single market and customs union during this period, with a free trade agreement operating thereafter. This form of agreement is assumed to reduce the GDP growth rate by ½ of a percentage point on average each year over the 2021-2024 period relative to a no-Brexit baseline. However, there is still considerable uncertainty in relation to the future path of trading arrangements between the UK and the EU. As set out in the SPU, a disorderly Brexit would reduce the level of GDP by almost 3 ½ per after 5 years compared to what it would otherwise be (and 5 per cent over the longer term), with the impacts substantially front loaded. Indeed, in the first year following a disorderly Brexit the growth rate would be almost 3 percentage points lower than currently projected.

Table 1: macroeconomic growth and labour market forecasts 2018-2024, per cent change

	2018	2019	2020	2021	2022	2023	2024
Economic Activity							
Real GDP	6.7	3.9	3.3	2.4	2.5	2.6	2.7
Real GNP	5.9	3.7	3.1	2.2	2.3	2.4	2.5
Labour Market							
Total Employment ('000)^	2,259	2,309	2,357	2,393	2,432	2,474	2,519
Employment	2.9	2.2	2.1	1.5	1.6	1.7	1.8
Unemployment (per cent)	5.7	5.4	5.2	5.3	5.2	5.1	5.0

^ Nearest 1,000.
Source: CSO for 2018 and Department of Finance.

[4] More detailed analysis is set out in the *Stability Programme, April 2019 Update*.

2.5 Risks to the outlook

Despite the relatively positive medium term outlook, the balance of risk is firmly tilted to the downside, with vulnerabilities on both external and domestic fronts.

External

First and foremost is the potential fallout from a disorderly Brexit. Second, risks from disruption to world trade remain elevated, given on-going trade tensions. Third, the modest growth in key export markets may be more prolonged, which would affect Irish exporters. Finally, changes in international tax rules that affect the competitiveness of Ireland's corporate tax regime could be damaging to Ireland's economic model.

Domestic

Domestically, the principal risk relates to potential overheating as the economy zeroes in on full-employment. While the baseline projections as published in SPU 2019 now assume that some overheating pressures will emerge over the medium-term, as the share of construction activity increases, overheating could be more significant than expected with the potential to generate dangerous imbalances over the coming years. This is why from a policy perspective, continued vigilance is required to ensure tax and revenue remains on a sustainable footing and that pro-cyclical budgetary decisions are avoided.

Chapter 3
Then and now

3.1 Introduction

A decade on from the onset of the crisis, the Irish economy is very different to that which prevailed on the eve of the crisis. This chapter documents some of the key changes in the structure of the economy and public finances and details the main alterations to the budgetary formulation process.

3.2 Structural change

The extraordinary recovery in the Irish economy in recent years, and the continued momentum into this year, raises two obvious questions. Firstly, where is the economy in the cycle? Secondly, how does the economy compare with the pre-crisis years?

Where is the economy in the cycle?

Estimating the position in the economic cycle is notoriously difficult for a small open economy such as Ireland. Having said that, there is mounting evidence to suggest that the economy is operating at, or even marginally beyond, full capacity. For instance, the unemployment rate now stands at below 4½ per cent, the lowest rate since early 2005, and below the average rate over the 2000-2007 period. As a result, there has been a pick-up in wages, with average weekly earnings in the private sector growing in excess of 4 per cent in the first quarter this year. More broadly, the *Department of Finance's* estimate of the output gap is projected to turn positive this year, and to continue to widen over the medium-term, indicating that the economy may be starting to produce above its sustainable level.

Having said that, it must be acknowledged that consumer price inflation remains muted, with 'core' inflation running at around 1 per cent. One possible explanation for this apparent conundrum is ongoing structural change *inter alia* due to globalisation and technology. These factors may mean that the signalling properties of consumer price inflation – regarding the amount of slack in an open economy – may be weaker than in the past.

How does the economy compare with the pre-crisis years?

Important indicators that were flashing red on the eve of the crisis are not suggestive of significant imbalances at this stage. During the period 2004-2008, wages per head and real personal consumption grew by approximately 5 per cent per annum, all significantly above the corresponding rates in more recent years. More tellingly, the extreme imbalances that characterised the bubble in the mid-2000s were, perhaps, most evident in the explosion in credit growth, which rose by approximately 25 per cent per annum in the run-up to the bursting of the bubble. In more recent years, credit growth has been largely flat, in part due to macro-prudential tools aimed at preventing excessive household leverage. In addition, the Central Bank has introduced counter-cyclical capital buffers to curtail pro-cyclical lending by the commercial banks.

During the bubble period, the mis-allocation of capital and labour from the exporting sectors to the construction sector resulted in a loss in our external competitiveness which, in turn, generated a large balance of payments deficit. The modified current account of the balance of payments reached more than 7 per cent of GNI* in the bubble period; the most recent data point to a small surplus in recent years.

Turning to balance sheets, household debt as a proportion of GNI* fell from 147 percent in 2009 to 77 percent in 2017, a level more in line with fundamentals, as shown in recent research by the *Department of Finance*.[5]

Another symptom of the bubble was an unbalanced labour market, where 10 per cent of the workforce were directly employed in construction activity. Today's labour market is more balanced, with growth seen in all sectors and regions. Of the record 2.3 million persons in employment, nearly 2.2 million are employed outside of construction, a level close to the total number of persons employed in 2007.

The same pattern of unsustainable growth during the 2000s was also evident in the public finances, where current spending increased at an average annual rate of 12½ per cent over 2004-2008. The equivalent figure over 2015-2019 is approximately 4 per cent. This represents an increase of €17.8 billion between 2004 and 2008, compared to a projected increase of €8.1 billion 2015 and 2019. Nowadays, the public finances have been reinforced by a range of initiatives designed to build up fiscal buffers, such as the *Rainy Day Fund* and commitments to use windfall gains for debt reduction.

Table 2: over-heating pressures – 'then and now'

	2004-2008	2015-2019[1]
Consumption [2]	5.0	3.1
Monthly Average Inflation Rate	2.6	0.3
Wage per head growth	5.1	2.0
Monthly average annual household credit growth	24.2	-0.9
Average Quarterly Construction Employment % Total Employment	10.0	5.7
	2007	**2019Q1**
Total Employment	2,221,350	2,301,900
Construction	236,725	144,600
Non-Construction Employment	1,984,625	2,157,300

1. 2019 figure incorporates the latest available outturn data
2. Figure relates to the period 2015-2018

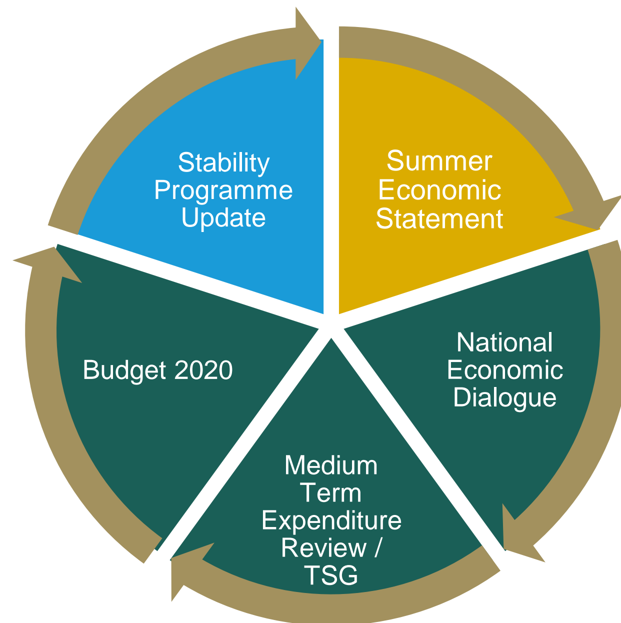
[5] https://www.gov.ie/en/publication/e41a53-analysis-of-private-sector-debt-in-ireland/

3.3 Budgetary cycle: enhancing transparency

In recent years, considerable reforms have been made to the Budgetary framework intended to permit a more open and transparent budgetary process, allow stronger dialogue with *Dáil Éireann* on key elements and facilitate the continued central role of Government in the development of budgetary proposals, consistent with the maintenance of stable public finances. Reforms include:

- Publication of the **Summer Economic Statement** which sets out the broad parameters for the budget.
- The **National Economic Dialogue** which facilitates an open and inclusive exchange on the competing economic and social priorities facing Government.
- Publication of the **Mid-Year Expenditure Report** which sets out the baseline for Departmental expenditure and provides the starting point for examination of budgetary priorities by the Oireachtas.
- Publication of the outputs of the **Spending Reviews** for the years 2017 to 2019 which is intended to give greater oversight of the policy options available to Government in setting the estimates for the following year.
- Publication of the **Tax Strategy Group** papers in advance of the Budget to facilitate informed discussion.
- Establishment of the **Irish Fiscal Advisory Council** in 2012 as an independent body to provide independent budgetary advice.
- To enhance the role of the Oireachtas in the Budget process, the **Select Committee on Budgetary Oversight** was established in July 2016 to review the macro-economic and fiscal issues that form part of the Budget considerations.
- Establishment of the **Parliamentary Budget Office** in 2017 to facilitate the Oireachtas in engaging with the Budget process.
- The **Performance Budgeting Initiative** continues to evolve, and now incorporates the Public Service Performance Report, the aim of the latter being to strengthen focus on what is being delivered with public funds.
- The Revised Estimates Volume 2018 saw the roll-out of a pilot programme of **Equality Budgeting**, and this is being expanded in 2019 to further develop the gender budgeting elements as well as broadening its scope to other dimensions of equality including poverty, socioeconomic inequality and disability.
- As a first step in implementing **Green Budgeting**, the Department of Public Expenditure and Reform has attempted to identify Exchequer climate-related expenditure in REV 2019.

Figure 7 SES: budgetary cycle – staging posts



Source: Department of Finance.

Box 4: National Economic Dialogue 2019 – Building on progress at a time of change

The *National Economic Dialogue 2019* will take place on 26 - 27 June in Dublin Castle. The aim of the Dialogue is to foster discussion on how to best sustain and strengthen the economy, while addressing the many competing economic and social priorities within the limited resources available. The theme of this year's Dialogue is "Building on progress at a time of change".

The global economy has entered a period of growing uncertainty. At the same time, sector-specific factors have dented growth in parts of Europe, geo-political tensions are weighing on economic sentiment, and vulnerabilities in several emerging market economies have been exposed.

Beyond these short-term, largely cyclical challenges, more fundamental challenges lie ahead. The previously shared consensus on progressive economic integration is being challenged and some of the building blocks that have underpinned the international trade architecture are creaking. Most importantly from an Irish perspective, the scheduled departure of the UK from the EU in the autumn presents an enormous challenge.

Other structural challenges include an ageing population, the rising importance of automation and, crucially, the need to transition to a (net) zero carbon economy.

So we are living in a time of unprecedented change and, in all likelihood, the pace of change will, if anything, accelerate in the years ahead.

The forthcoming Dialogue will consider what these changes mean for policy, both in the short-term and over the medium-term. A shared understanding of the challenges ahead will better equip us to respond to future change and opportunities.

Chapter 4
Budgetary Strategy

4.1 Background

As outlined earlier, the context for the forthcoming budget is an economy that is juxta-positioned between the possibility of overheating on the one hand and a disorderly UK exit from the European Union on the other hand.

The overarching objective of budgetary policy must be the protection of domestic living standards irrespective of the format that Brexit takes. Ultimately, this means a budget that 'leans against the wind' to firstly, avoid overheating the economy and, secondly, to build up appropriate buffers so that budgetary policy can support the economy in the event of a disorderly exit.

4.2 Fiscal developments to date in 2019

Exchequer tax revenues in 2019 are projected at €58.4 billion, a 5.2 per cent increase relative to last year. The within year performance is consistent with this: in the year to end-May, taxation receipts were 5.7 per cent ahead of the same period last year.

Non-tax revenue to end-May 2019 amounted to €2.7 billion, up €0.3 billion on the same period of 2018, in part due to Central Bank surplus income. Capital receipts at end-May are up by €0.3 billion relative to the same period last year, mainly due to a receipt from the IBRC.

Table 3 below sets out the key fiscal metrics consistent with SPU 2019.

Table 3: budgetary projections 2018-2024, € millions

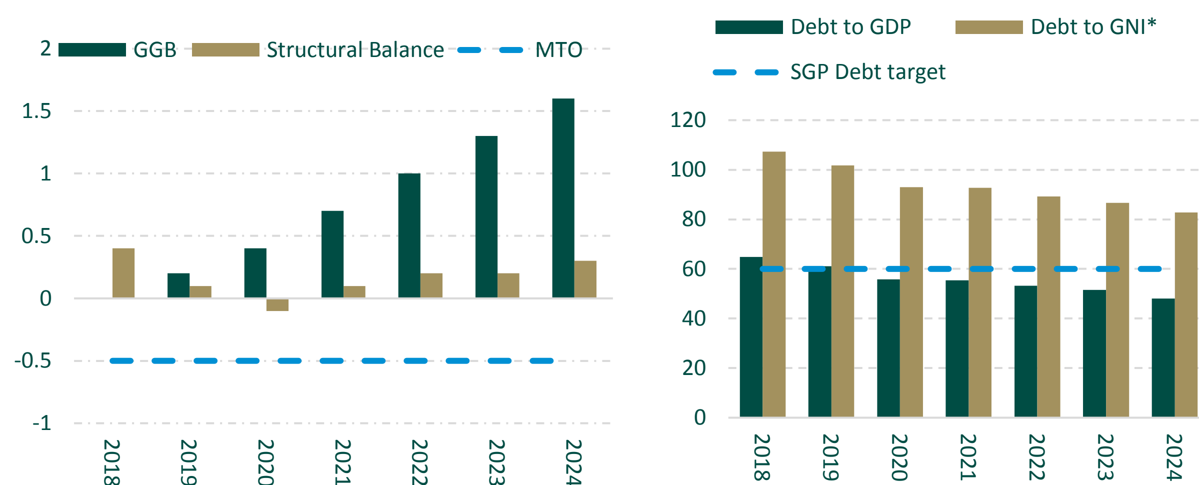
	2018	2019	2020	2021	2022	2023	2024
Exchequer Balance	105	-2,095	445	615	-220	600	1,700
General Government Balance	45	610	1,235	2,530	3,785	5,345	6,620
GGB, per cent of GDP	0.0	0.2	0.4	0.7	1.0	1.3	1.6
Structural Balance*per cent of GDP	0.4	0.1	-0.1	0.1	0.2	0.2	0.3
GG debt, per cent of GDP	64.8	61.1	55.8	55.4	53.2	51.6	48.1
GEC**	63,060	66,630	68,805	70,840	72,670	74,730	76,935

Source: Department of Finance
* Output gap measures based on Department of Finance's GDP based alternative methodology.
**Projected GEC (Government Expenditure Ceiling 2019-2021) as approved by Government. 2022 – 2024 is a technical assumption.
Note: Fiscal forecasts are presented on an *ex-post* basis. Figures are rounded to the nearest €5 million and may affect totals.

Total gross voted expenditure to end-May 2019 was €26.1 billion, broadly in line with expectations and an increase of €2.0 billion (8.2 per cent) in year on year terms. The increase in gross voted expenditure was composed of a 6.7 per cent increase in current spending and a 31.8 per cent increase in capital spending. Specifically in relation to Health expenditure, gross current expenditure of €6.9 billion is €0.6 billion or 8.9 per cent higher than the same period in 2018. This is compared to the rate of 5.8 per cent budgeted for the full year and illustrates the challenge and the need for staffing and savings measures to be proactively manged by the Department of Health if the requirement for a Supplementary Estimate in the sector is to be avoided this year. Regarding this, as is outlined in Chapter 5 of this document, enhanced monitoring arrangements have been put in place regarding the scale of Health expenditure this year.

Non-voted expenditure, excluding debt servicing costs, of €3.3 billion, was up €0.3 billion in year-on-year terms, mainly on foot of an increased EU budget contribution (mainly a timing-related issue).

Figure 8: fiscal developments, per cent of GDP/GNI*



Note: Structural balance calculations based on Department of Finance's GDP based alternative methodology.
Source: Department of Finance (SPU 2019)

4.3 Budgetary Strategy

Given ongoing uncertainty regarding the form that Brexit will take, two budgetary scenarios are presented below. Both are indicative: unprecedented levels of uncertainty means that there are many possible economic and budgetary outcomes. The Government will decide in September – based on additional information – which is the more likely scenario and anchor the October budget on this. Scenario A sets out the environment relating to an orderly Brexit, with scenario B outlining an alternative situation in the case of a disorderly Brexit.

Given the cyclical position of the Irish economy, the focus of the expenditure strategy out to 2024 under scenario A is on maintaining sustainable annual increases in spending at a level below the projected growth rate of the economy. Table 4 includes the impact on the general government balance of annual

increase of 3¼ per cent in current expenditure, post-2020. This compares with a 2½ per cent increase assumed in the SPU.

Scenario A: "Orderly" Brexit

In the event of an orderly exit – which entails a transition period until the end of next year – the Irish economy is projected to expand by 3.3 per cent next year. This scenario would essentially entail an economy operating at full capacity, and necessitates a budgetary strategy that does not add fuel to the flames.

The appropriate budgetary strategy in these circumstances is as set out in the *Stability Programme Update* and involves targeting a headline surplus of 0.4 per cent of GDP for next year. This would be consistent with:

- €0.7 billion increase in capital expenditure;
- €0.3 billion carryover costs associated with measures introduced this year;
- €0.4 billion in public sector pay increases; and
- €0.5 billion for demographic costs.

In addition, the Stability Programme Update provides for an additional €0.3 billion current public expenditure (as yet unallocated) and for €0.6 billion for taxation changes.

In the SES an expenditure reserve of up to €0.2 billion is being established in 2020 to accommodate funding requirements for the National Broadband Plan and Children's Hospital. This is reflected for 2020 in Scenario A (Table 6) below.

Table 4: orderly Brexit, per cent of GDP

	2020^	2021	2022	2023	2024
(i) SPU baseline GGB~	0.4	0.7	1.0	1.3	1.6
(ii) Expenditure developments #	0.0	-0.1	-0.2	-0.3	-0.4
(iii) Revised GGB (SES 'orderly' baseline)	0.4	0.6	0.8	1.0	1.2

^Includes expendiure reserve for 2020.
~ Post-current Dáil term to 2021, technical assumptions are made to GEC for 2022 – 2024
# This incorporates the GGB impact of NBP and 3¼ per cent y-o-y current spending growth from 2021 onwards.
Note: rounding may affect totals.

In total, therefore, this would be consistent with a total budgetary package of €2.8 billion for next year. Decisions in relation to the allocation between tax and expenditure of the total unallocated amount of €0.7 billion will be made during the budgetary process.

Scenario B: "Disorderly" Brexit

A disorderly Brexit would have a severe impact on the Irish economy with output and employment adversely affected, especially in the short-term. Come September, if this was the most likely scenario, then the budgetary strategy for 2020 would be anchored upon the baseline budgetary parameters as in the orderly (A) scenario and then also involve:

- allowing the automatic stabilisers[6] provide counter-cyclical support; and
- temporary, targeted funding for the sectors most affected.

Since the precise impact upon the economy, and on particular sectors and overall employment, cannot be projected within the normal levels of certainty the indicative GGB is presented with a likely indicative range.

The magnitude of the deterioration to the nominal general government balance is set out below.

Table 5: disorderly Brexit, per cent of GDP

	2020	2021	2022	2023	2024
Revised GGB (SES 'orderly' baseline)	0.4	0.6	0.8	1.0	1.2
Brexit Impact	-1	-1	-1	-1	-¾
Indicative GGB^	-½ to -1½	-½ to -1	-¼ to -¾	-¼ to ¼	0 to ½
Nominal deterioration in GG balance €bn	c.-6½	c.-6	c-6	c.-5	c-5

^Figures are presented in ranges given the uncertainty associated with an unprecedented event such as a disorderly Brexit.
Note: rounding may affect totals.

[6] The automatic stabilisers refer to the automatic counter-cyclical support that the public finances provide to the economy through, for instance, welfare payments due to higher unemployment numbers and, on the revenue side, lower tax collections which helps cushion aggregate demand.

Box 5: Fiscal space 2020-2024

The appropriate budgetary strategy is as set out in the arithmetic underpinning the SPU, adjusted for the impact of additional spending in later years (outlined in scenario A). This involves a baseline budgetary package of €2.8 billion, consistent with the achievement of a headline surplus of 0.4 per cent of GDP next year. Of this, €0.7 billion is unallocated, with decisions in terms of the distribution to be made at the time of the Budget.

Table 6: budget package consistent with Scenario A, *(delivering an improving headline surplus)* € billion

	2020	2021	2022	2023	2024
a. Indicative nominal budgetary package*	**2.8**	**3.2**	**2.9**	**3.3**	**3.4**
b. Pre committed	*1.9*	*1.3*	*0.7*	*1.0*	*1.1*
c. Expenditure reserve for 2020 ^	*0.2*	*-*	*-*	*-*	*-*
d. Unallocated (a-b-c)	*0.7*	*1.9*	*2.2*	*2.2*	*2.3*
Revised GGB (SES 'orderly' baseline) (per cent)	**0.4**	**0.6**	**0.8**	**1.0**	**1.2**
Nominal GGB (€ billions)	**1.4**	**2.2**	**3.1**	**4.0**	**5.0**

Note: The projections for 2024 are for illustrative purposes, necessarily based on technical assumptions.
* From 2021 onwards, includes NBP and annual current spending growth of c.3¼ per cent.
^ An expenditure reserve of up to €0.2 billion is being established in 2020 to accommodate funding requirements for the National Broadband Plan and National Children's Hospital.
Figures may not sum to totals due to rounding.
Source: Department of Finance.

Any tax and spending measures that went beyond this would not be consistent with prudent budgetary policy and would worsen both the headline and structural budgetary positions. Table 6 is consistent with an orderly Brexit (i.e. consistent with table 4). In the event of a disorderly Brexit, an update of this table will be provided.

Purely for completeness, indicative estimates of 'fiscal space' over the five-year (2020-2024) horizon are set out in the table below. Gross fiscal space is the amount of (net) expenditure permitted under minimum compliance with the expenditure rule set out in the Stability and Growth Pact; net fiscal space is the available amount once account is taken of pre-commitments (such as providing for demographic factors).

It is important to note that net fiscal space represents *additionality*, i.e. further tax and expenditure measures to those set out in the budget package, which will worsen the headline position. As previously highlighted the concept of 'fiscal space' is increasingly inappropriate for Ireland given the pro-cyclicality of the expenditure rules (a point also emphasised *inter alia* by the Irish Fiscal Advisory Council). The Minister for Finance has highlighted the importance of budgetary policy in managing the economy rather than a literal application of the expenditure rule.
The latter approach would put Ireland on a deficit-increasing trajectory which would be **completely inappropriate** for the Irish economy at present and simply represent a repeat of past mistakes

Table 7: fiscal space, € billion

	2020	2021	2022	2023	2024	cumulative
Gross fiscal space	2.9	5.3	5.3	5.2	5.0	23.7
Net fiscal space^	0.2	2.8	2.6	2.7	2.6	11.0
Implied GGB (limit of fiscal rules), per cent of GDP	0.4	-0.1	-0.3	-0.6	-0.8	n.a.
Nominal GGB (limit of fiscal rules)	1.3	-0.3	-1.3	-2.4	-3.4	n.a.

Note: The amount for 2024 is based on no-policy change technical assumptions. The detailed calculation of gross and net fiscal space is set out in Annex 1.
^This does not take account of the Rainy Day Fund.
Source: Department of Finance.

Chapter 5
Public Expenditure Strategy

5.1 Overview

Taking a twenty year view of the evolution of public expenditure, large increases in public expenditure were seen in the period leading to the economic and fiscal crisis, which ultimately proved unsustainable. This was followed by significant expenditure consolidation, and succeeded in recent years by moderate growth in expenditure on day-to-day services and a focus on increased capital investment in order to address bottlenecks in social and economic infrastructure.

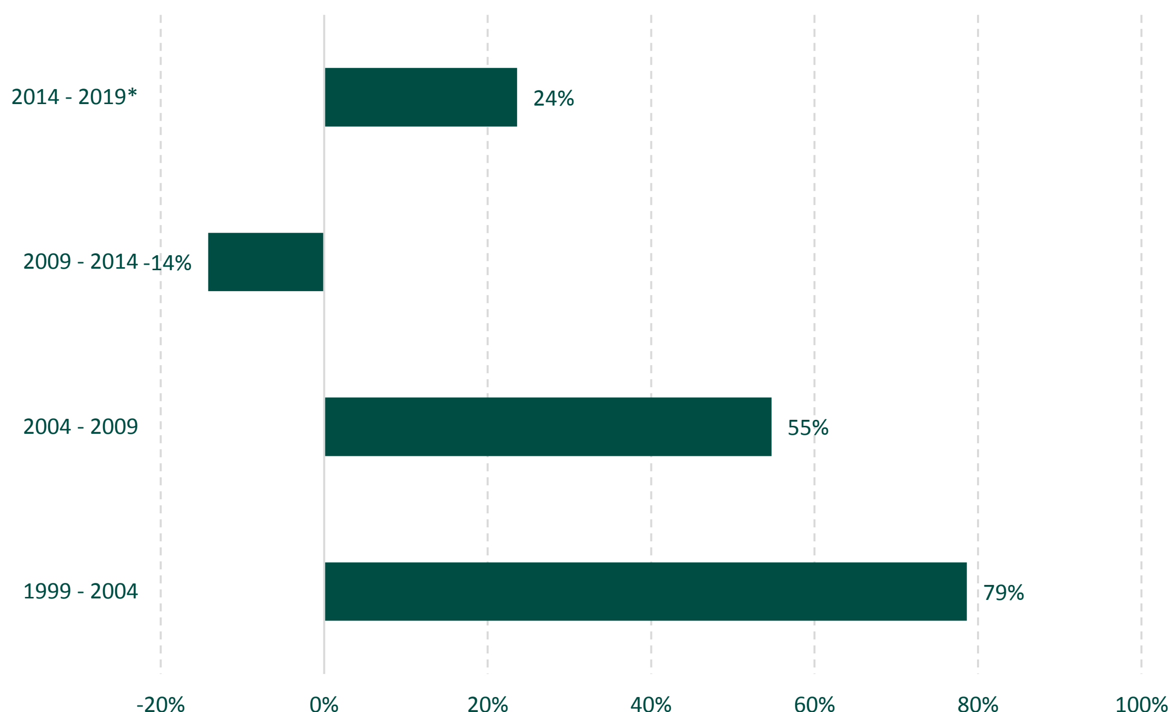
While recent increases in expenditure have impacted broadly across all sectors, a particular focus has been placed on ensuring the areas of Health, Housing, Education and Social Protection are sufficiently funded to support the Government's social goal for a fairer and more inclusive society.

Given the risks in the external environment, the key challenge is to ensure that expenditure increases are affordable both today and in the future. A pattern of unsustainable increases followed by significant expenditure consolidation, as seen in the crisis period, puts economic and social well-being at risk. In this context, and taking into account the experience of the last twenty years, it is important that in the period ahead the Government adopts a cautious approach and continues to plot a sustainable path for public expenditure.

5.2 Context for Public Expenditure

Figure 9 below illustrates the evolution of public expenditure over the last twenty years. In the period leading up to the economic and fiscal crisis, there were significant increases in expenditure funded by high growth in tax revenue from a rapidly growing economy. This growth came to a halt in 2008 with tax revenues reducing from €47 billion in 2007 to €33 billion in 2009, while at the same time gross voted expenditure increased from €56.4 billion in 2007 to €63.1 billion in 2009. Significant tax and expenditure consolidation was implemented over the period 2009 to 2014 with gross voted expenditure reducing from €63.1 billion to €54.1 billion in 2014. Since the end of 2014, it has been possible to grow expenditure at a pace below the growth in the economy. Consequently, the General Government Balance which stood at a deficit of €7.1 billion in 2014 returned to balance in 2018. Over this five year period to the end of 2019, capital expenditure will have almost doubled, following the reductions made during the crisis period, and current expenditure is projected to grow at a moderate rate of an average of just under 4 per cent per annum.

Figure 9: Nominal Growth in Departmental Gross Voted Expenditure, five-year intervals



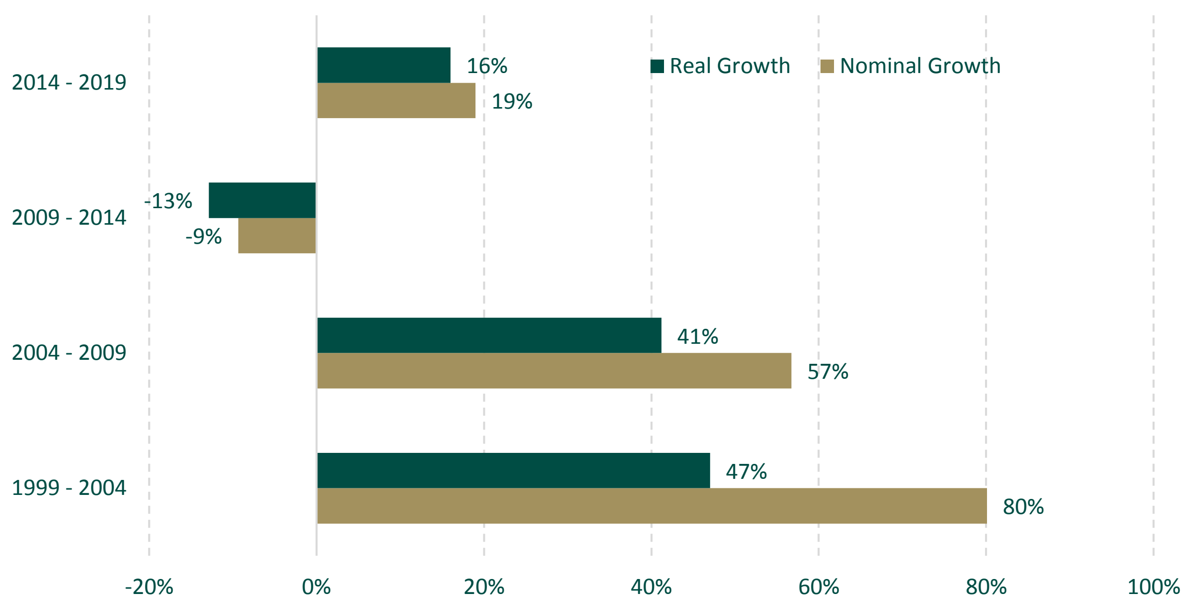
*Adjusted to reflect the dis-establishment of HSE Vote and Water Service Act 2017.
Source: DPER databank and DPER calculations.

5.3 Current Expenditure Growth

The high levels of growth in expenditure in the years leading up to the fiscal and economic crisis was largely due to substantial additional resources being directed towards key priority areas such as Health, Social Protection and Education. Day-to-day spending on Health increased from c. €4.5 billion in 1999 to almost €15.5 billion in 2009. Social Protection expenditure increased from just over €6 billion in 1999 to over €20 billion 10 years later, driven by increased recipients and substantial real increases in rates.

Growth in current expenditure in the last five years has been more moderate. This reflects the Government's commitment to provide for increases in expenditure that are sustainable into the future and supports the overall expenditure strategy of targeted investments that deliver on the Government's social and economic goals of improving living standards for all. Taking into account the low levels of inflation over this period, most of this nominal growth translates into increases in real terms. The challenge ahead is to ensure that improvements in services continue to be provided in a manner that are fiscally sustainable, in particular taking into account the risks in the external environment.

Figure 10: Current Expenditure Growth (Real and Nominal) 1999 – 2019, five year intervals



Source: DPER databank and DPER calculations, CSO (CPI Deflator Base Year 1998).

5.4 Capital Expenditure Growth

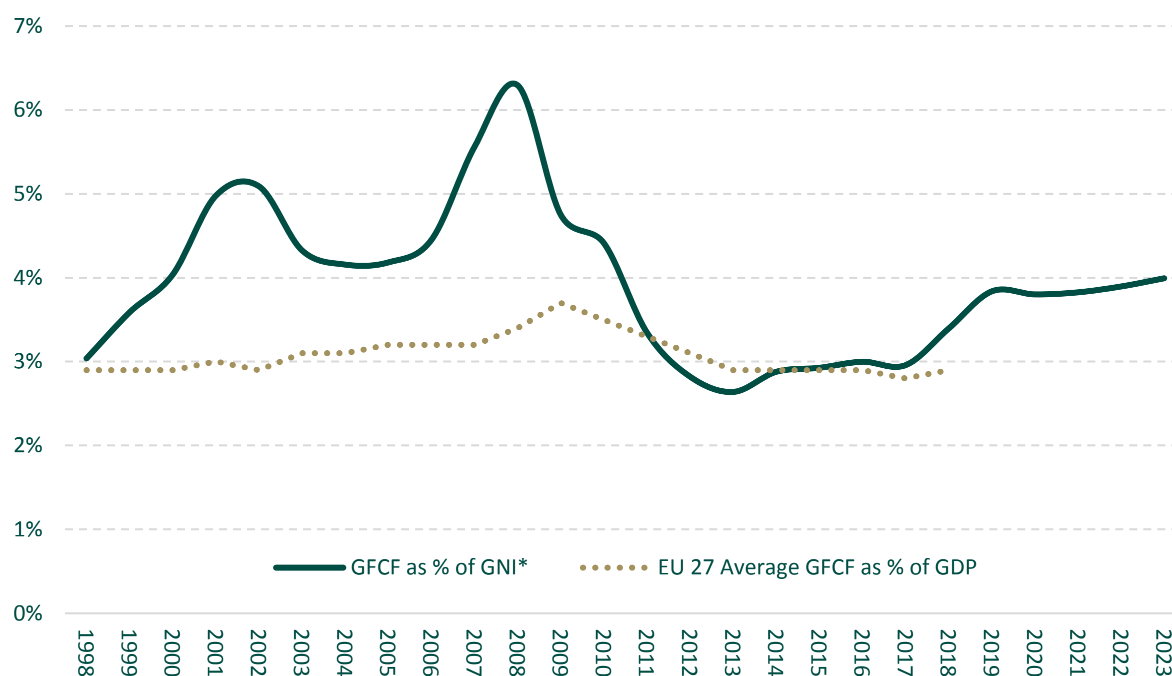
Gross voted capital expenditure increased significantly in the years leading up to the economic crisis, growing from €3 billion in 1999 to just over €9 billion in 2008. However, the consolidation effort in the following years resulted in marked reductions in the capital budget, which reached a low of €3.4 billion by 2013. However, recent years have seen increased capital investment with an allocation of €7.3 billion provided in 2019.

Similar to current expenditure, an examination of these allocations shows that the increases have predominantly been targeted at the delivery of key infrastructure areas considered essential for delivering on the Government's social and economic goals. As such, significant investments have been made in the areas of Housing, Transport, Health and Education.

As outlined in the National Development Plan[7], over the period 1995 to 2015, Gross Fixed Capital Formation (GFCF) as a share of Gross Domestic Product (GDP) in Ireland was in the region of 3 per cent, equating to the average for the EU15 over the same period. This indicates that a value of 3 per cent of an appropriate measure of national income can be considered as a suitable target for the long-term average level of public capital spending for Ireland. Under the National Development Plan, it is projected that public capital investment as measured by Gross Voted Capital Expenditure will reach c. 4 per cent of national income as measured by GNI* by 2024, with sustained investment averaging 4 per cent on an annual basis over the period 2022 to 2027. This commitment demonstrates that this Government recognises the important role sustainable and targeted improvements in key infrastructural projects will play in delivering a higher standard of living for all citizens in the State.

[7] Project Ireland 2040 National Development Plan 2018-2027

Figure 11: Gross Fixed Capital Formation as per cent of economic activity 1999 – 2019



Source: DPER databank and DPER calculations, CSO.

5.5 2020 Expenditure Strategy

As set out in Expenditure Report 2019 and the recently published Stability Programme Update, the expenditure policy for 2020 is a 2.5 per cent increase in current expenditure and just under 10 per cent increase in capital investment, reflective of the Government policy set out in the National Development Plan. This Strategy is consistent with expenditure positions set out in previous Summer Economic Statements since 2016. Looking at the increases in expenditure over this period 2017 to 2019, the average annual rate of growth in overall spending is projected to be 5.4 per cent, with current spending increasing at an average of 4.4 per cent and capital spending growing at an annual rate of 16 per cent. Compared to the expenditure forecast set out in the 2016 Summer Economic Statement, there have been a number of variations. These variations have largely been driven by policy decisions, such as the provision of additional funding for our Health Service and increased investment in public capital infrastructure. In addition, over this period decisions have been made by the Government to allocate additional resources for spending increases through the introduction of revenue raising measures and the redistribution of some resources allocated for taxation measures.

Looking at Budget 2020, it is important that the Expenditure Strategy adopted is guided by the wider economic climate, from both a global and domestic perspective. In light of these risks, set out previously, a cautious approach to Government expenditure is required next year. As set out in the SPU, pre-committed current expenditure for 2020 amounts to €1.2 billion. This is inclusive of:

- Demographics - €0.5bn in the areas of Health, Social Protection and Education
- The Public Service Stability Agreement - €0.4bn

- Carryover costs of certain Budget 2019 current expenditure measures amounting to €0.3bn in the areas of Health, Housing, Justice, Education and Social Protection.

Allocating these amounts to Departments allows for additional teachers to be recruited to meet demographic demands, therefore protecting the pupil-teacher ratio. It allows for funding to meet the cost of additional State Pension recipients, as well as to cover the carryover impact of measures such as Social Welfare rate increases and the additional Social Housing units provided under the HAP scheme in 2019. In addition, a further unallocated amount of €0.3 billion is available to fund programmes that support the delivery of the Government's core social and economic goals. Any decision to increase expenditure in excess of this amount will require the reallocation of resources between tax and expenditure measures, as has occurred in recent Budgets, to ensure that the Government's fiscal targets are achieved.

The increase provided in respect of capital investment next year reflects the Government's policy as set out in the National Development Plan. As part of the Budget 2020 estimates process, consideration will be given to the funding of additional costs in relation to the National Children's Hospital and the National Broadband Plan reflecting the most up-to-date position relating to capital spending at the time An expenditure reserve of up to €0.2 billion is being established in 2020 to accommodate funding requirements for the National Broadband Plan and National Children's Hospital.

As outlined in Chapter 4, under Scenario B - disorderly Brexit - there will be an impact of c. 1 to 1½ per cent on the General Government Balance. On the expenditure side, as the automatic stabilisers take effect, there will be a requirement for additional income supports. Further to this, there will be a requirement for a number of targeted temporary supports for sectors most affected, particularly in the areas of Agriculture and Enterprise.

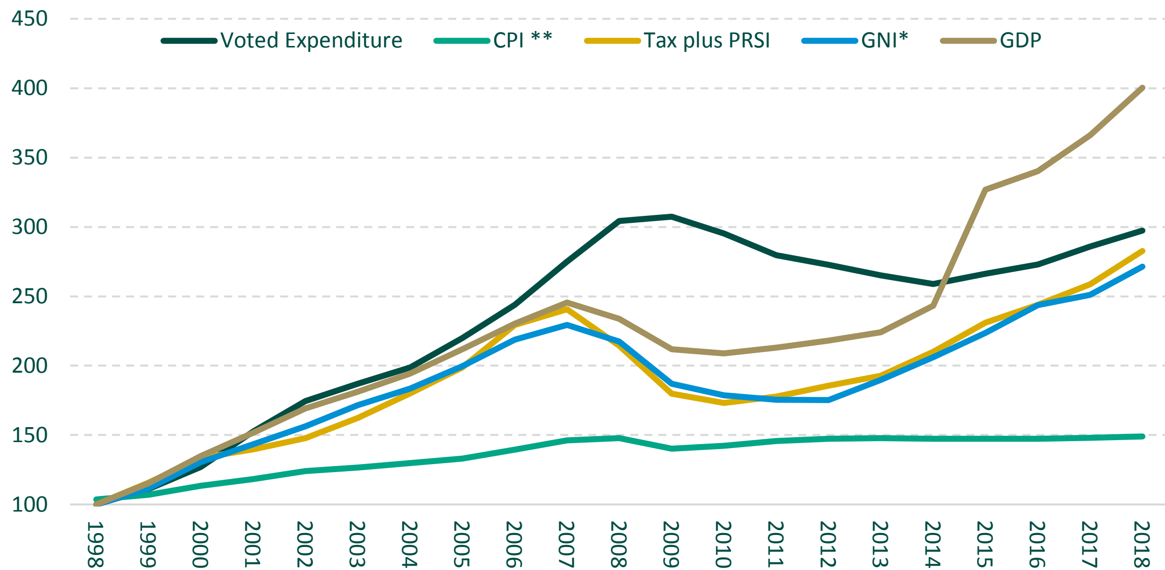
5.6 Medium Term Perspective

As noted, recent expenditure policy has been guided by the requirements of Preventive Arm of the SGP including the Expenditure Benchmark. However, while the Expenditure Benchmark is designed to ensure that spending growth is limited to the potential growth rate of the economy, the evidence is that it can produce pro-cyclical outcomes. This is an important observation in looking beyond next year's Budget. Indeed, cognisant of the current risks of potential overheating in the Irish economy, adopting a different fiscal anchor that better mitigates against the medium term risk of the pro-cyclical expenditure policies may be more appropriate.

This position is demonstrated in Figure 12 below which takes a twenty year view of expenditure, revenue, and economic growth. Looking at the growth in revenues and expenditure compared to growth in the economy, GNI* tracks revenue growth better than GDP. Indeed, the compound average annual growth in overall voted expenditure over the last twenty years was 5.6 per cent. This is only marginally higher than the annual compound average growth in the size of the economy of 5.1 per cent, as measured by GNI*. The strategy set out under scenario A outlined earlier reflects the general

government balance impact of a 3¼ per cent annual increase in current expenditure post-2020 and the Government's commitment to the National Broadband Plan. This would allow for an annual increase in expenditure below the growth rate of the economy as represented by GNI*. This is appropriate given the uncertainties arising in the external environment and the current position of the State in the economic cycle.

Figure 12: expenditure v revenue and economic growth 1998-2018, 1998=100



Source: CSO and DPER databank

5.7 Expenditure Reforms

A number of reforms to the overall budgetary process have been introduced in recent years to enhance the quality of the public finances. Taking into account proposed changes to the expenditure pathway outlined above, it is appropriate to consider how further reforms can support the sustainability of expenditure.

Spending Review 2019

2019 is the third and final year of the current Spending Review. The purpose of the Spending Review is to shift the emphasis away from the incremental nature of the annual Estimates process to instead focus on assessing the effectiveness of the totality of existing expenditure programmes.

The Spending Reviews in 2017 and 2018 culminated in the publication of over 50 analytical papers which highlighted several important themes across a number of spending programmes. This work has also provided an important evidence base for Estimates discussions and decisions in the past two years.

Given the centrality of the Government's objective for responsible and moderate expenditure increases focused on Government priorities, the Spending Reviews in 2019 will seek to emulate the progress that has been made in the past two years.

However, in a change from the first two years, the approach adopted in 2019 has been to focus the analysis on areas of strategic importance more broadly rather than focusing on covering a particular level of expenditure. Within this, enhanced scope have been provided to authors and analysts to focus on providing the evidence base for reform efforts across Departments and the wider public service and to spotlight areas of innovation and good practice, both in programme design and service delivery, that may be of wider interest and applicability.

As the analysis is currently still ongoing, further detail on the 2019 Review will be set out in the Mid-Year Expenditure Report in July and alongside Budget 2020 in October.

It is intended to progress the Spending Review process beyond 2019. The details and themes of the next cycle will be developed further in the second half of this year. As part of this process, an independent external review has been established to investigate the design, conduct and implementation of the Spending Review 2017-2019. It is intended that the findings and recommendations from the review, which will be published with Budget 2020, will inform the approach to future Spending Reviews.

Public Spending Code – Capital Investment

The approach to increased public capital spending as reflected in the National Development Plan works to avoid contributing to economic instability and exacerbating any risks of unbalanced and inflationary growth. Taking into account trends in non-residential construction costs, with the SCSI[8] reporting a rise in construction tender prices of 7.7 per cent in 2018, a key challenge will be to ensure that Government projects are delivered in a manner that is in line with this approach set out in the National Development Plan, particularly in circumstances where there is a high degree of uncertainty regarding the cyclical position of the economy and the risk of overheating.

As part of the ongoing reform of Ireland's capital management systems, the Department of Public Expenditure and Reform is reviewing the Public Spending Code. The purpose of this review is to strengthen the existing guidance to better align with the realities of project delivery and with a particular focus on improved appraisal, cost estimation and management. The Office of Government Procurement is conducting a review of construction procurement which will align with the updated Public Spending Code.

The following reforms will be considered and implemented as part of the review:

- Strengthen and harmonise capital appraisal guidance;
- Greater clarity on governance and roles and responsibilities, particular in terms of who is the Sanctioning Authority and who is the Sponsoring Agency for major projects;

[8] Society of Chartered surveyors Ireland Tender Price Index March 2019

- Introduce new mechanisms to improve the accuracy of cost estimates;
- Improve project life cycle to better reflect the realities of project delivery; and
- Complement the Project Ireland 2040 Capital Tracker in monitoring projects and costs.

The revised central elements of the Public Spending Code relating to the appraisal and management of public capital projects will be published before the end of the summer. Further technical guidance building upon these central elements will follow in the second half of 2019 and in 2020.

The Construction Sector Group (CSG) has been established in order to ensure regular and open dialogue between Government and the construction sector. The group is focusing on issues that may impact on the successful delivery of Project Ireland 2040 and to consider wider developments in the construction sector. Its remit includes:

- Working with industry and government bodies to (a) benchmark and improve productivity and environmental sustainability and (b) to modernise public works delivery.
- Considering opportunities to introduce reforms within the sector that will help in controlling construction price inflation, improving efficiency and delivering value for money for investment.
- Assessing the supply of necessary skills and measures enhancing capacity (including potential use of overseas contractors, for example through joint ventures with local contractors).
- Issues arising from inadequate or ineffective regulation, poor performance and systemic poor quality.
- In 2019, the CSG is undertaking an ambitious work programme, looking at a number of key themes. These include increased technology adoption across the industry, greater use of prefabrication and offsite construction and the establishment of a central hub for learning and development in Building Information Modelling (BIM).
- In line with the principles of openness and transparency, the Construction Sector Group operates under the guidelines set out in the Transparency Code. This means that the group's membership, work programme, and the minutes and agendas of all meetings are published on gov.ie.

Financial Management and Corporate Governance

The effective implementation of a sustainable expenditure framework would entail the need to maintain expenditure within the agreed growth rate over the medium-term. This highlights the need for Departments to manage effectively within the allocations agreed by Government and voted by the Dáil each year in order to ensure the effective implementation of a managed multiannual expenditure pathway. Given that the key risk in this regard arises from expenditure overruns in the Health sector, a number of enhanced reporting requirements are in place for the Department of Health including:

- The creation of a new oversight group chaired by the Department of Public Expenditure and reform, to monitor spending and act as an early warning mechanism
- Monthly spending reports to be submitted to the Cabinet Committees in a timely manner
- A quarterly financial management memo to Government.

These measures are complemented by the Health Service Executive (Governance) Bill 2018, which provides for the establishment of a Board in the HSE.

Ministerial Expenditure Ceilings

The current practice which is retained in the Departmental current expenditure ceilings published out to 2021 in Expenditure Report 2019 is that the Health, Social Protection and Education ceilings reflect changes driven by demographic factors only, with all other Departmental ceilings essentially remaining flat. In relation to pay rates, the Departmental ceilings are adjusted to reflect any public service pay and pensions agreements decided by Government.

The non-application of price increases (de-indexation) is a mechanism that can be utilised to generate efficiency dividends and promote productivity where State bodies are effectively challenged to maintain the existing level of service with less resources. Automatically linking particular areas of spending to price rises can also 'crowd' out other areas of spending where more efficient policies could be pursued. Furthermore, adopting this approach addresses the risk that expenditure ceilings become floors for budgetary discussions and create increased expectations in relation to available expenditure increases, particularly so in an environment where in-year expenditure increases are provided.

Budget Transparency

Access to timely, objective and accurate information is a precondition for citizens to understand how public resources are being managed, participate in informed debate, and hold government properly to account. In recent years, there have been increased efforts internationally to enhance fiscal transparency and promote more effective public participation in budgetary decisions. These principles are reflected in the IMF Code of Good Practices on Fiscal Transparency which recommends that fiscal forecasts and budgets should be presented in a way that facilitates policy analysis and accountability.

Mirroring this international trend, recent reforms to our domestic budgetary framework have sought to achieve greater openness, transparency and public accountability in relation to public expenditure. More information than ever before is now published in relation to how public resources are allocated and utilised. In addition to the myriad of information that is published throughout the budgetary cycle, new publications have been made available to promote more engagement with public expenditure. For example, the Public Service Performance Report is a dedicated publication that focuses on what is being delivered with public funds. Information has also been presented in a more interactive format, for example, www.whereyourmoneygoes.gov.ie is a graphical, easy-to-use tool for examining government expenditure over a period of ten years.

Building upon the existing commitment to budget transparency, it is proposed to further enhance the accessibility and availability of budget information tailored towards the general public. At budget time this year, a dedicated citizen's guide to the budget will be published to explain the key decisions in clear non-technical language. The guide will be an objective, self-contained document that focuses on the

objectives and content of the budget presented in a concise and accessible format. It is intended to foster greater understanding of public finances and policy choices and ensure that people are better equipped to assess the impact of budgetary decisions on their lives.

5.8 Summary

The budgetary strategy outlined in Chapter 4 is predicated on the continuation of sustainable increases in public expenditure. Taking into account the current position of the Irish economy, the expenditure strategy discussed in this Chapter, with an expenditure growth rate slightly lower than the growth rate in the economy measured by GNI*, is appropriate. This strategy allows for continued and increased investment in public infrastructure as outlined in Project Ireland 2040, continued investment in public services to meet demographic pressures in the key areas of Health, Social Protection and Health and targeted measures to enhance the delivery of services. This strategy is supported by the continued close monitoring and reporting of Department spending with a requirement that Departments manage effectively within the expenditure allocations agreed by Government and voted by Dáil Éireann.

Recent budgetary reforms, including the introduction of the spending review process, are tools to facilitate effective budgetary management through the consistent evaluation of existing expenditure commitments. Helping Departments and the Government to identify areas of existing expenditure that could be spent more efficiently and have greater benefit to citizens.

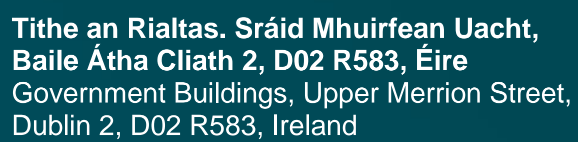
As in recent years the Mid-Year Expenditure Report will be published in July of this year. Primarily the report will review the ongoing 2019 expenditure position, outlining emerging trends at that stage and examining the risks to budget sustainability this year. In addition to this, the report will also look at the implications on medium term expenditure ceilings of the fiscal strategy proposed in this document and outline the key outputs from the 2019 spending review process.

Annex 1

Table A1: expenditure benchmark approach to fiscal space, € billions unless stated

	2020	2021	2022	2023	2024
a. Reference rate,[1] per cent	4.7	4.6	4.5	4.2	3.7
b. Convergence margin, percentage points	2.9	0.0	0.0	0.0	0.0
c. Applicable benchmark, per cent [a-b]	1.8	4.6	4.5	4.2	3.7
d. GDP deflator, per cent	1.9	1.8	1.7	1.7	1.7
e. Permitted expenditure growth, per cent [100*((1+c/100)*(1+d/100)-1)]	3.7	6.5	6.2	6.0	5.5
f. Corrected expenditure aggregate (year t-1)	78.8	81.9	84.8	87.8	90.8
g. **Gross fiscal space under EB** [e*f/100]	**2.9**	**5.3**	**5.3**	**5.2**	**5.0**
h. Discretionary revenue raising measures	0.6	0.6	0.6	0.6	0.6
i. Adjusted fiscal space [g+h]	3.5	5.9	5.9	5.8	5.6
j. Pre-committed fiscal space for Voted expenditure[2]	2.3	1.8	1.1	0.9	0.9
j. (i) demographics	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*
j. (ii) public service stability agreement	*0.4*	*0.3*	*0.0*	*0.0*	*0.0*
j. (iii) carryover of Budget 2019 measures	*0.3*	*0.0*	*0.0*	*0.0*	*0.0*
j. (iv) capital/NDP (smoothed)	*1.1*	*1.1*	*0.7*	*0.5*	*0.5*
k. Other[3]	1.1	1.4	2.2	2.2	2.0
k. (i) unallocated current expenditure (within GEC)	*0.3*	*1.3*	*1.6*	*1.6*	*1.7*
k. (ii) expenditure reserve for 2020	*-0.2*	*-*	*-*	*-*	*-*
k. (ii) tax reductions	*0.6*	*0.6*	*0.6*	*0.6*	*0.6*
k. (iii) other (non-voted and gg)	*0.3*	*-0.5*	*0.0*	*0.0*	*0.3*
l. Net fiscal space under EB [i-j-k]	**0.2**	**2.8**	**2.6**	**2.7**	**2.6**
m. Rainy day fund	0.5	0.5	0.5	0.5	0.5
n. Margin of compliance with EB[4] [l-m]	**-0.3**	**2.3**	**2.1**	**2.2**	**2.1**

Note: Rounding may affect totals. This table is consistent with assumptions in tables 4 and 7.
1. Reference rate values from 2017 onwards using an interpolated linear average for 2015 (not the 25 per cent potential growth figure for 2015).
2. Pre-committed expenditure covering voted expenditure (including demographics) and capital commitments.
3. Other includes non-voted expenditure, other general government commitments, GEC increases and negatives DRMs. The fiscal projections include indicative tax reductions of €0.6 billion, to be allocated in the context of the Budget.
4. This represents additionality, not included in the current fiscal projections.
Source: Department of Finance, Department of Public Expenditure and Reform.



Tithe an Rialtas. Sráid Mhuirfean Uacht,
Baile Átha Cliath 2, D02 R583, Éire
Government Buildings, Upper Merrion Street,
Dublin 2, D02 R583, Ireland

T:+353 1 676 7571
@IRLDeptFinance
www.gov.ie/finance