Ireland

Irish Fiscal Advisory Council

Country note, July 2019

Key messages:

- **The outlook is unusually uncertain:** The recovered economy could overheat, but risks of a no-deal Brexit have intensified.
- **Fiscal risks:** Repeated overruns in spending and reliance on highly concentrated corporation tax are key risks.
- **Medium-term budget plans are not credible:** Government's spending projections are implausibly low.
- **IFAC has adopted a "principles-based approach" for assessing the fiscal rules:** This shows a breach for 2018.
- **Fiscal Stance:** Government should stick to budgetary plans as set out in *Stability Programme Update 2019* for 2019–2020.

Macroeconomic outlook

As a result of continuing strong growth, the Irish economy has recovered from a deep crisis and is now operating near capacity. Yet the current outlook is unusually uncertain. Government forecasts assume that the UK makes an orderly and agreed exit from the EU at the end of 2020. However, this outlook is balanced between potential overheating on one side and an exceptional adverse shock in the form of a harder-than assumed Brexit on the other (Chart 1). Further adverse risks are posed by the possibility of changes to the international tax environment; an escalation of protectionist measures; the onset of a cyclical downturn in major trading partners; and adverse financial developments (including those arising from Italy).

Short-term fiscal outlook

With the public finances still in a relatively vulnerable position, the Government has allowed a pattern of spending drift in recent years. Despite a favourable upswing in the cycle and the surge in corporation tax receipts to €10.4 billion in 2018 (of which IFAC estimates between €3–6 billion may be considered excess), there has been no improvement in the budget balance excluding interest costs since 2015. The Government has increased non-interest spending rapidly in recent years and it grew faster than revenue in 2018 (Chart 2). As much of the recent improvement in revenues may be cyclical or temporary, this suggests a deteriorated structural position. Any additional unexpected corporation tax receipts should be allocated to a Prudence Account during the year and then to the rainy day fund or elsewhere. For 2019 the Government should stick to its existing plans, and for 2020 it should be cautious with the budget. This reflects the possible overheating and hard Brexit risks, reliance on corporation tax, and the rapid rise in spending in recent years.

Medium-term fiscal outlook

The Government's medium-term plans are not credible. The projections in the *Stability Programme Update 2019* show a budget balance that is set to improve, with rising surpluses every year. Yet the spending forecasts are not credible, implying an implausible slowdown in spending growth. They do not reflect likely future policies or the future cost of meeting existing commitments. For 2021–2023, the Government needs to develop a credible medium-term strategy. This would help to avoid routinely procyclical fiscal policy in Ireland (Chart 3). A disorderly Brexit would have severe consequences for the public finances. The shock to the economy, revenues, and cyclical spending could mean that debt ratios begin to rise again. Trade-offs would be far worse than under a relatively more benign Brexit, and the Government might need to cut spending or raise taxes to prevent debt ratios from rising indefinitely.

Fiscal framework and national fiscal rules

IFAC has adopted a new "principles-based approach" for assessing the fiscal rules. The European Commission assesses EU fiscal rules based on their own operational approach and based on estimates of the cycle that have tended to be implausible for Ireland. IFAC has therefore adopted a principles-based approach that makes the assessment simpler and more robust, including using the Department of Finance's alternative measures of the cycle. On this basis, the Medium Term Objective of a structural balance of no less than –½ per cent of GDP was achieved in 2018, with the structural balance estimated as +0.2 per cent. However, there was a substantial deterioration in the structural balance and government spending breached the Expenditure Benchmark limit in 2018. Net spending is forecast to grow at the limit for 2019, but there is a risk of a repeat of large spending overruns.

Chart 1: Unusually uncertain outlook

Index (2015=100), real GDP volumes

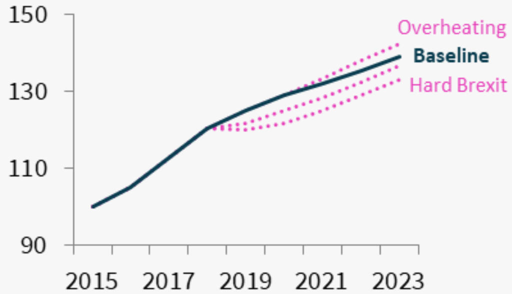


Chart 2: Accelerating primary spending growth

Annual % change, general government basis, excludes one-offs

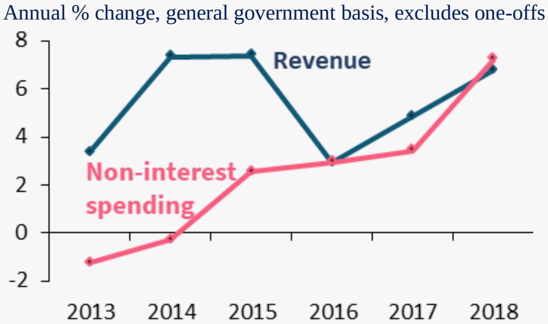
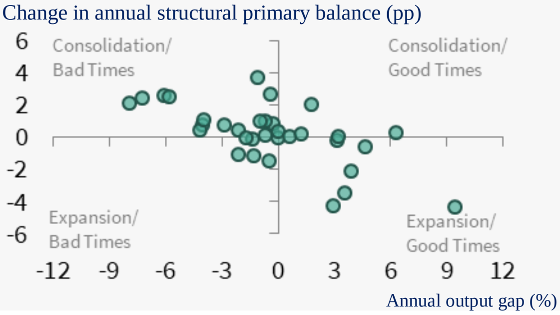


Chart 3: Procyclical fiscal policy in Ireland, 1986–2018

Change in annual structural primary balance (pp)



Key indicator forecast

		2017	2018 f	2019 f	2020 f	2021 f	2022 f	2023 f	Source
Real GDP growth rate	% y-to-y	7.2	6.7	3.9	3.3	2.4	2.5	2.6	1
Output Gap (DoF GDP-based estimate)	%	-2.1	-0.5	0.2	0.8	1.0	1.4	1.8	1
GG balance	% of GNI*	-0.5	0.0	0.3	0.6	1.2	1.7	2.2	1
GG gross debt	% of GDP	68.5	64.8	61.1	55.7	55.4	53.2	51.6	1
GG gross debt	% of GNI*	111.1	107.3	101.7	93.0	92.7	89.1	86.7	1
GG structural balance (CAM)	% of potential GDP	-1.1	-1.7	-1.4	-0.5	0.1	0.7	1.3	1
GG structural balance (DoF)	% of potential GDP	1.5	0.4	-0.2	-0.1	0.1	0.1	0.3	1
Adjusted real GG expenditure growth	% y-to-y	2.9	4.0	3.2	0.5	1.4	1.5	1.1	2
Discretionary revenue measures	% of GDP	0.0	0.3	0.3	0.1	0.0	0.0	0.0	1

Sources:

1 - Department of Finance (DoF) estimates; output gap used is an alternative approach and not the EU approach; the Council deems 2020–2023 expenditure forecasts unrealistic, hence the grey font.

2 – IFAC estimates; Commonly Agreed Methodology (CAM), General Government (GG)

f - forecast

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