Tithe an Oireachtais
Houses of the Oireachtas

An Oifig Buiséid Pharlaiminteach
Parliamentary Budget Office

Quarterly Economic and Fiscal Commentary

Q2 2018

Séanadh

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Introduction

This is the fourth Quarterly Economic and Fiscal Commentary produced by the Parliamentary Budget Office (PBO) of the Houses of the Oireachtas. The Parliamentary Budget Office was set up to assist Members of the Houses of the Oireachtas, and the Committee on Budgetary Oversight in particular, in their engagement with scrutiny of budgetary proposals both pre- and post-Budget.

The PBO's Quarterly Commentary updates Members on economic and fiscal developments, highlighting areas of interest and concern. In addition the PBO uses the Commentary to bring issues to the attention of Members.

In summary, the main macroeconomic indicators point to an economy still growing strongly. On the fiscal side tax revenue has grown strongly in the first half of the year and is over-profile. However, much of this is due to Corporation Tax receipts. On the expenditure side, overruns in Health and the Justice Group of Votes are a cause for concern.

In this issue the PBO has produced boxes on some macroeconomic issues including:

- Labour Force participation and employment rates – now that 'full' employment appears imminent, continued employment growth will depend on those outside the labour force and the activation policies that can be used to ensure they can participate in future.
- Oil price movements – Ireland's economy, as a large net energy importer, is influenced by oil price movements. Oil prices have increased in recent months well above forecasts and if they persist this may impact future economic growth and inflation.

In addition, this Commentary focuses on some important issues on the fiscal side. These include:

- Comparisons between fiscal forecasts 2014 and 2018 – It is interesting to compare where Ireland's public finances are currently relative to what was expected. This Box shows that the General Government non-interest expenditure is expected to be €14.4 billion higher in 2018 than anticipated just 4 years ago. Apart from showing how the economy has developed, there is also a warning; half of this expenditure is financed by unexpected increases in Corporation Tax revenue and decreases in Government debt interest payments.
- The composition of current expenditure – this box outlines the major areas of current Government Voted expenditure (Health, Education and Social Protection) and discusses the composition of it. Of the €55.9 billion in current expenditure only €15.2 billion is not accounted for by public sector pay, pensions and social protection payments.
- Demographics – new CSO projections of population growth and its structure will impact on Government finances in the years to come.
- The *Summer Economic Statement* – the *Summer Economic Statement* has outlined the Government fiscal stance and, notwithstanding the amount available for additional tax or expenditure measures under the fiscal rules, projects a small deficit of €330 million or 0.1% of GDP for 2019. Given the challenges in estimating 'fiscal space' for Ireland and the risk of overheating this seems to be a prudent economic and fiscal stance.

Annette Connolly

Director of the Parliamentary Budget Office

Summary

This is the fourth Parliamentary Budget Office (PBO) Quarterly Economic and Fiscal Commentary since the PBO's establishment in August 2017. The purpose of these Quarterly Commentaries is to draw together for Members of the Oireachtas, in a single accessible document, the latest information on:

- Trends in the Irish economy, and an analysis of these trends; and
- The most recent fiscal position.

This commentary is published in the context of the recent release of the Government's Summer Economic Statement. This laid out the Government's medium-term fiscal strategy. The Government intends to continue to increase expenditure, but not to the full degree allowed by the fiscal rules. The Government have indicated that they intend to only use €800 million of the net available fiscal space of €2.2 billion (after accounting for pre-commitments). This will leave a buffer of €1.4 billion of allowed expenditure unspent, €500 million of which is to be set aside in a 'Rainy Day Fund'.

In addition to the latest economic and fiscal commentary, this current publication includes a number of boxes on various issues to inform Members. These include:

- Labour Force participation and employment rates;
- Oil price movements;
- A comparison between Stability Programme Update 2014 and 2018;
- The composition of Current Voted Expenditure 2018;
- Demographic change to 2031; and
- The Summer Economic Statement.

Macro-economic developments

Unfortunately, at the time of publication, the Central Statistics Office (CSO) has not published the Quarterly National Accounts for Q1 2018. These were due to be published on 28 June, but have been postponed until 19 July. As such some of the data in this Commentary is the same as the previous PBO Quarterly Commentary.

The CSO's preliminary estimate for GDP growth in 2017 was 7.8%. This growth was mainly driven by a large increase in net exports linked to the activities of foreign owned multinational companies; however, the domestic economy also grew strongly.

The Department of Finance's forecast for GDP growth has been revised upwards in the Stability Programme Update, and is now expected to be 5.6% in 2018 and 4.0% in 2019, compared with 3.5% and 3.2% respectively in the previous forecast.

Other economic indicators such as employment, wages, services, and inflation for the first half of 2018 are consistent with strong economic growth. These indicators show a continued fall in unemployment, strong performance in the retail and services index (although the extreme weather conditions curtailed these somewhat) and an increase in average weekly earnings over the quarter.

While economic indicators are generally positive, there exists significant downside risk. Global economic uncertainty is high as the US Government has imposed tariffs on certain products and imports from China, Canada and the European Union. Their response has been to impose retaliatory tariffs. This will impact global trade and could lead to a further escalation.

In addition, Brexit remains a significant risk to the Irish economy, with the potential for a range of consequences including higher import costs if tariffs are imposed, lower demand for Irish goods and a depreciation in the value of Sterling compared to the Euro impacting Irish competitiveness. Domestically, housing supply pressures present challenges to Ireland's competitiveness and there is the persistent risk of overheating.

Fiscal developments

Revenue

Up to end-June 2018, overall revenue (excluding transactions with no general government impact) was €31.85 billion, which was €354 million or 1.1% **above** expectations:

- Tax revenues were just over €24.94 billion, or €168 million **above** profile;
- Appropriations in Aid were almost €5.84 billion, or €16 million **above** profile; and
- Non-tax revenue was €1,038 million, or €158 million **above** profile.

While tax revenues were up year-on-year they also overperformed against profile by €168 million (0.7%). This was mostly a result of overperformances in Corporation Tax and income tax. VAT, excise duties and stamp duties were below profile.

Non-tax revenue is significantly above profile (18%). This variance is driven by Central Bank Surplus Income due to the disposal of floating rate notes.

Expenditure

Up to end-June, overall expenditure (excluding transactions with no general government impact) equalled €35 billion, €346 million below profile but €2,611 million more than at the same point in 2017. This was made up of €27.51 billion in voted expenditure, €1.61 billion in non-voted expenditure and €3.88 billion in interest on the national debt.

Notable details underlying this expenditure balance are that:

- Gross Voted Current Expenditure was €68 million or 0.2% **above** profile;
- Gross Voted Capital Expenditure was €175 million or 8.2% **below** profile;
- Gross Non-Voted Current Expenditure was €165 million or 9.3% **below** profile; and
- Interest on National Debt was €74 million or 1.9% **below** profile.

With regard to Gross Voted Current Expenditure more Vote Groups are reporting an above profile expenditure at end Q2 2018 as compared to Q2 2017. Health expenditure is of particular concern – it was €168 million over profile.

Gross Voted Capital Expenditure was €175 million (or 8.2%) below profile, however the Department of Finance's *Fiscal Monitor* provides no commentary to explain this. This is distributed across many Votes and could indicate capacity issues in Government departments and/or the private sector in respect to capital projects. If so, this could be a concern in future with the increase in capital expenditure expected under the National Development Plan. The under-profile expenditure in Education and Skills may, in part, be as a result of building contractors going into liquidation or

examinership.

Overall balance

The Exchequer Balance (which includes financial transactions which do not impact on the General Government Balance) showed a deficit of €823 million at end Q2, which is €1,279 million lower than the expected deficit of €2,102 million. This was principally due to:

- significant above profile Central Bank receipts (€581 million above profile);
- below profile capital and non-voted expenditure; and
- better than expected overall tax receipts.

The fiscal rules are based on the General Government Balance, not the Exchequer Balance. The Stability Programme Update has projected a General Government Deficit of €540 million in 2018. The overall trends on revenue (1.1% over profile) and expenditure (1% below profile) in the *Fiscal Monitor* would suggest that this is achievable or could be bettered. However, there are concerns with expenditure in Health and that more Departments are over profile than at the same time in 2017.

In the *Summer Economic Statement* (see Box 6), the Government has stated that, notwithstanding the amount available under the fiscal rules, a small deficit of €330 million or 0.1% of GDP is the target for 2019.

Latest macro-economic developments

The resources available to facilitate Government expenditure are dependent on taxation and therefore on the state of the Irish economy. This section briefly outlines the latest macro-economic developments, and provides commentary on some of the main risks facing the economy in the short to medium term.

Economic growth

The Irish Economy, as measured by Gross Domestic Product (GDP), grew strongly in 2017. The Parliamentary Budget Office's (PBO) last *Quarterly Commentary* showed that the CSO's preliminary estimate for GDP growth in 2017 was 7.8%. This growth was mainly driven by a large increase in net exports linked to the activities of foreign-owned multinational companies. However, the domestic economy also grew strongly.

Unfortunately, at the time of publication of this Quarterly Commentary, the CSO has not published the first estimates of GDP growth for Q1 2018 (or the final estimates for 2017). These were due to be published on 28 June but have been postponed to 19 July. The PBO will publish a short Note later in July to inform Members of the results.

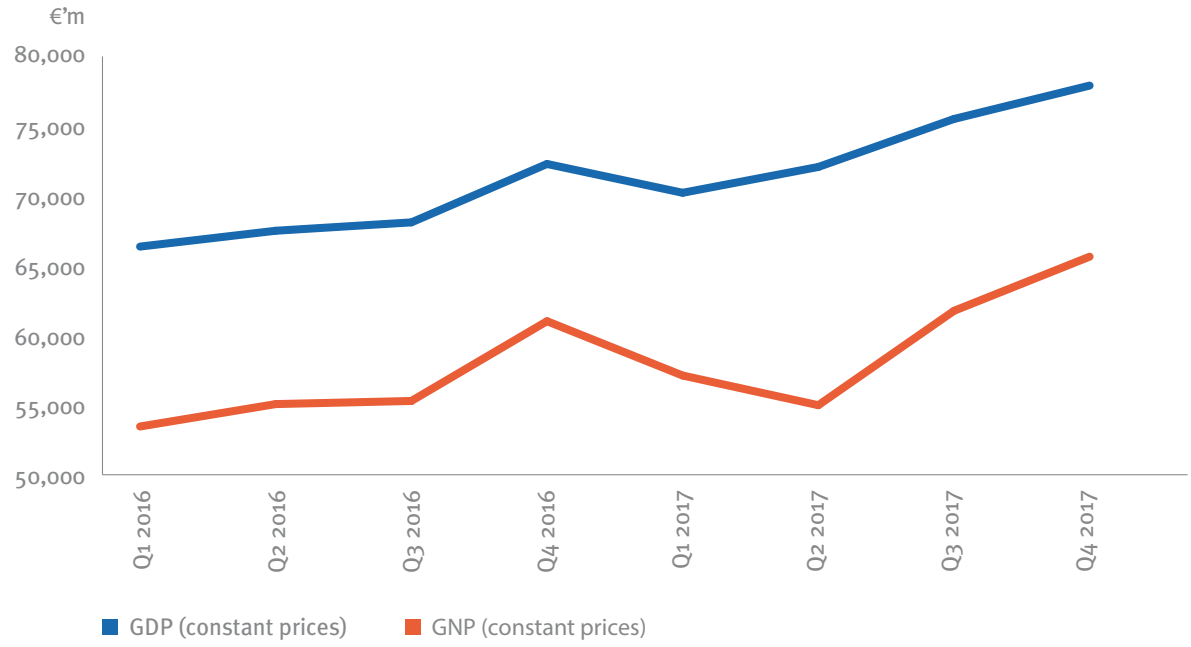
Alternative indicators of economic activity (such as employment, sales, trade etc.) can provide a measure of activity growth in specific areas, and when viewed in aggregate, give an indication of the performance of the overall economy in real time. Some of these indicators are discussed further in this publication. Based on the performance of such indicators, it is likely that strong economic growth has continued in the first half of 2018.

Latest quarterly economic growth statistics

Due to the rescheduling of the release of the Quarterly National Accounts by the CSO, we are unable to update some key economic indicators and so the data provided for some indicators will be the same as in the previous quarterly commentary.

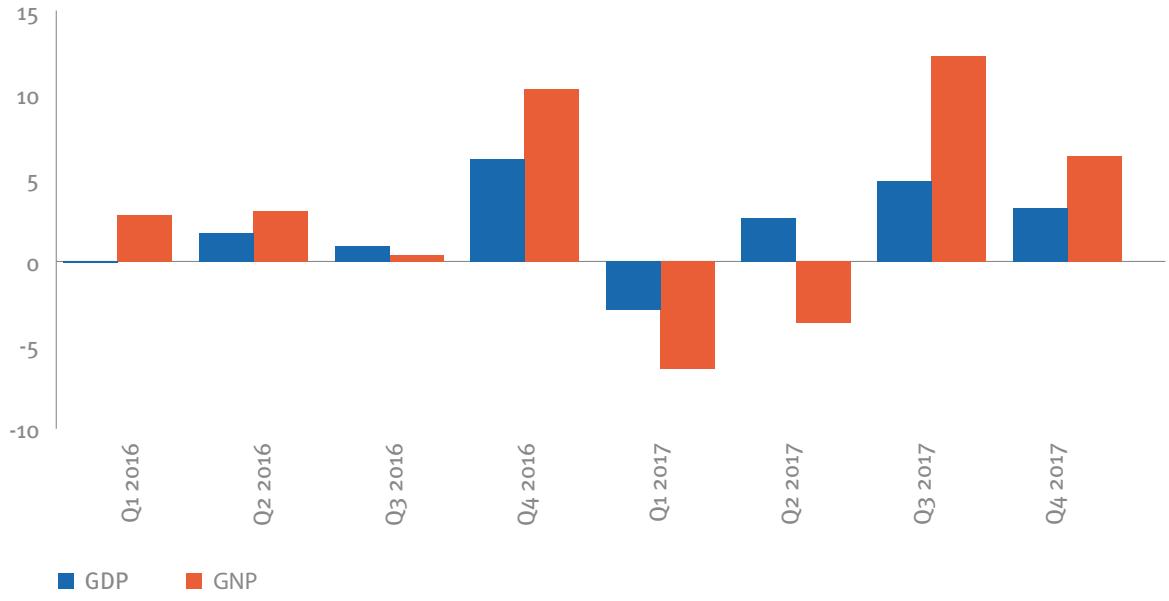
GDP, on a seasonally adjusted basis grew by 3.2% in Q4 2017 relative to Q3 2017, and was 7.8% higher compared with Q4 2016. Growth in Q4 was lower quarter on quarter, when compared with Q2 to Q3 growth of 4.8% (Figure 2). GNP grew by 6.3% from Q3 to Q4 2017, and 7.6% from Q4 2016 to Q4 2017.

Figure 1: Seasonally adjusted GDP and GNP at constant prices by quarter (2016 – 2018)



Source: CSO Quarterly National Accounts Quarter 4 2017.

Figure 2: GDP and GNP growth rates on previous quarter (% change)



Source: CSO Quarterly National Accounts Quarter 4 2017 Table 4.

Drivers of quarterly economic growth

Differences in quarterly GDP and GNP between Q3 2017 and Q4 2017 were driven by:

- Personal Consumption up 0.3% in the quarter;
- Investment (GFCF) up by 6.1% in the quarter; and
- Both exports and imports also experienced quarterly growth by 4.4% and 5.7% respectively.

GNP grew at 6.3% in the quarter compared to GDP growth of 3.3%, due to a small fall in net income sent abroad.

Modified domestic demand, an indicator from the CSO that strips out some activities of multinational companies (e.g. R&D and aircraft leasing) to get a better statistic on underlying spending and output in the domestic economy, decreased by 4.1% in Q4 2017. This compares to 2.9% growth in Q3 2017. The main driver of the fall in the quarter was lower investment (GFCF), which decreased by 10.3% in Q4 2017. This fall was driven by a large decrease in investment in intangible assets excluding R&D related intellectual property imports.

Economic growth forecasts for 2018 and 2019

Since the release of the Q1 2018 PBO *Quarterly Economic and Fiscal Commentary*, the Government's *Stability Programme Update* (SPU) for 2018 has become available. The PBO has released a *Note* (No. 6 of 2018) which presents the key components of the economic and fiscal forecast in SPU 2018, and compares them to the earlier forecasts from Budget 2018.

The forecast for GDP growth has been revised upwards in the SPU, and is now expected by the Department of Finance to be 5.6% in 2018 and 4.0% in 2019, compared with 3.5% and 3.2% respectively in the previous forecast.

Table 1: GDP Forecasts by forecasting institution and date of forecast release

	Recent Forecast			Previous Forecasts			Upwards Revision	
Forecasting Organisation	**Date**	**2018**	**2019**	**Date**	**2018**	**2019**	**Change 2018**	**Change 2019**
European Commission	May-18	5.7	4.1	Feb-18	4.4	3.1	1.3	1
Department of Finance	Apr-18	5.6	4.0	Oct-17	3.5	3.2	2.1	0.8
Central Bank of Ireland	Apr-18	4.8	4.2	Jan-18	4.4	3.9	0.4	0.3
IMF	Apr-18	4.5	4	Oct-18	3.4	3	1.1	1
ESRI	Mar-18	4.8	3.9	-	-	-	-	-
OECD	Mar-18	2.9	2.4	-	-	-	-	-

Source: Department of Finance (2018) Monthly Economic Bulletin May 2018 / IMF Article IV Staff Report 2018.

Table 1 shows the forecasts of the major institutions that estimate Irish economic growth. Table 1 shows that all the institutions have revised their forecasts for GDP growth upwards significantly. The most recent estimates for GDP growth range from 2.9% to 5.7% in 2018, and 2.4% to 4.2% in 2019. The OECD has the lowest growth figures and while only published in March 2018 seem very conservative in light of developments.

The relatively large revisions in the forecasts also highlight the volatility and accuracy of GDP forecasts in the Irish context and suggests that care be taken when using such forecasts as the basis of budgetary forecasts and decisions.

Other economic indicators

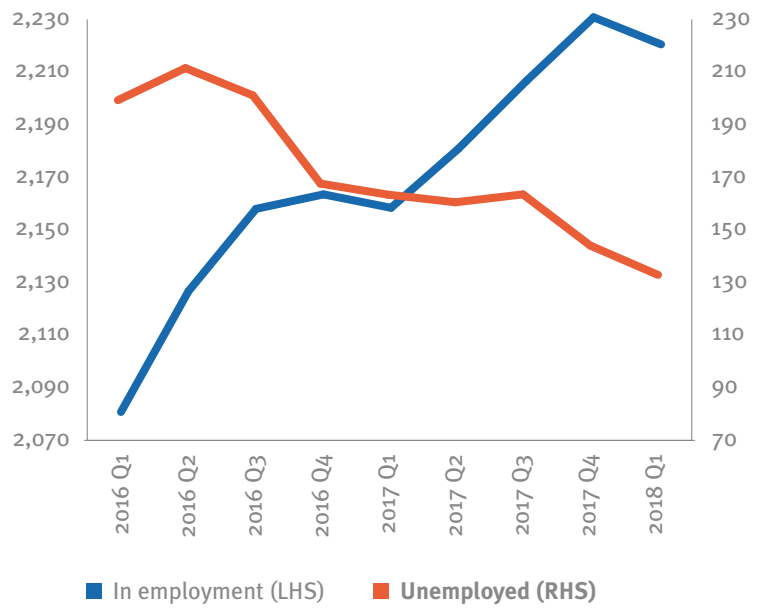
As is widely acknowledged, GDP and GNP are not always the optimal measures of the Irish economy, from which policy makers should base their decisions. To understand the trends and occurrences in the Irish economy more comprehensively, and to understand how economic performance affects Irish residents, analysis of other economic indicators is required. Such indicators are available more frequently and therefore can be used for a timelier analysis of recent economic developments than GDP, GNP, or GNI*.

Employment and unemployment statistics indicate if economic growth is translating into employment growth. Wages indicate potential purchasing power and increasing wage levels lead to stronger disposable income which positively affects consumption.

Consumer prices reflect inflation, and increased prices can indicate higher demand and is typically associated with economic growth. However, inflation can remain low during periods of substantial economic growth, as is the case with Ireland currently. An appreciating euro relative to sterling and dollar leads to lower prices for Irish imports, subduing inflation somewhat. Retail, services, and industrial production indices give us an indication of the performance of these specific sectors.

Due to the very open nature of the Irish economy and its dependence on trade, the level of exports, imports, and the balance of payments, are the key indicators of economic performance.

Figure 3: Number of Persons aged 15 and over in employment and unemployment (thousands)



Source: CSO Labour Force Survey Quarter 1 2018 Table 1.

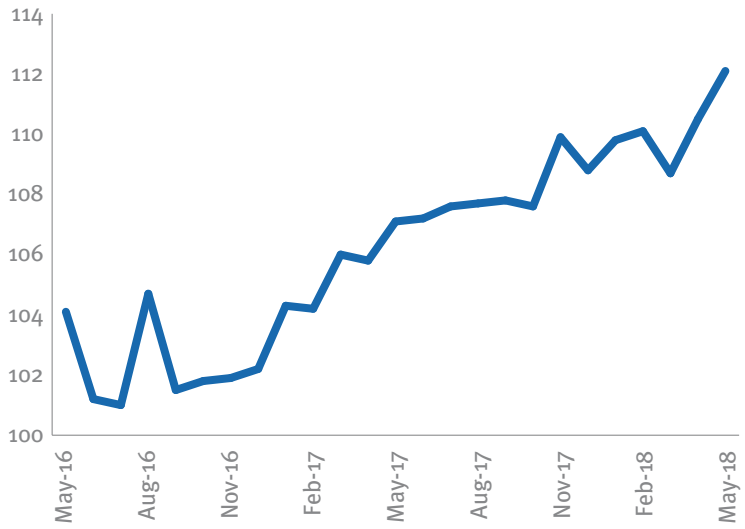
Employment and Unemployment

There were over 2.22 million people employed in the State in Q1 of 2018. The annual increase in employment was 2.9% (or 62,100 people), with an annual decrease in unemployed persons of 18.7% (or 30,500 people).

The unemployment rate in June 2018 was 5.1% which is the lowest recorded since October 2007 and indicates that 'full employment' has almost been reached.

It is expected that as the economy approaches full employment, the rate of employment creation could slow as there is a smaller pool of unemployed to become employed. This may be partially countered by inward migration or an increase in the participation rate (see Box 2), which could sustain a level of job creation not otherwise possible. In addition, the rate of change in unemployment might slow, or stop as the State approaches full employment. If employment demand increases faster than the supply of labour there will be upward pressure on wages and an increased risk of overheating.

Figure 4: Retail Sales Index (by volume excluding motor trades, seasonally adjusted)



Source: CSO Retail Sales Index May 2018.

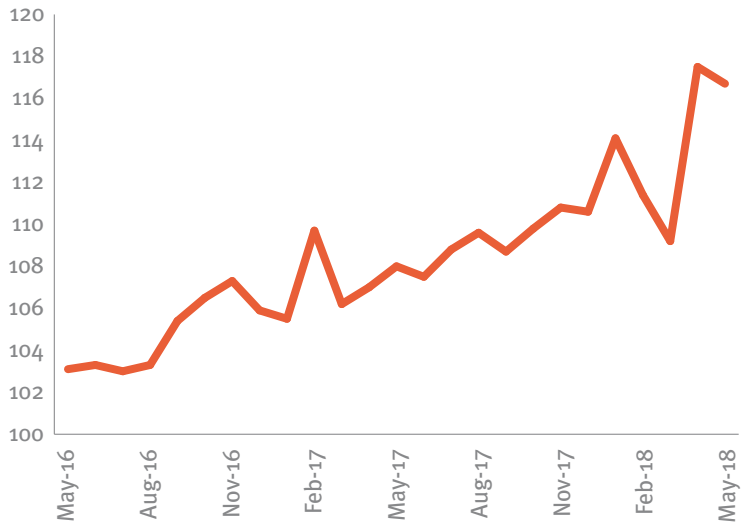
Retail sales

There was a 4.7% increase in the seasonally adjusted retail sales (excluding motor trades) volume in the year to May 2018. There was a month-on-month increase of 1.5% from April 2018.

This continued increase in retail activity indicates increasing domestic demand and disposable income as employment and wages grow, with retail prices showing only modest growth.

Sectors that saw particularly large increases in the volume of retail activity in the year to May 2018 were: hardware, paints and glass (12.6%), books, newspapers and stationery (9.8%), household equipment (9%), and electrical goods (8.4%).

Figure 5: Monthly Services Index (by value, seasonally adjusted)



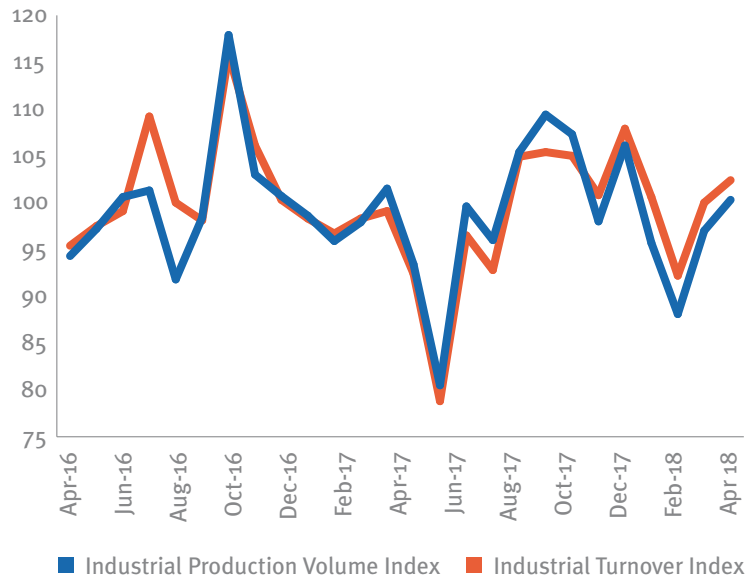
Source: CSO Monthly Services Index May 2018.

Services

The services index increased in the year to May 2018 by 8.1%, compared to an increase of 4.8% in the year to May 2017. There was a small decrease in May 2018 from April 2018 (0.7%).

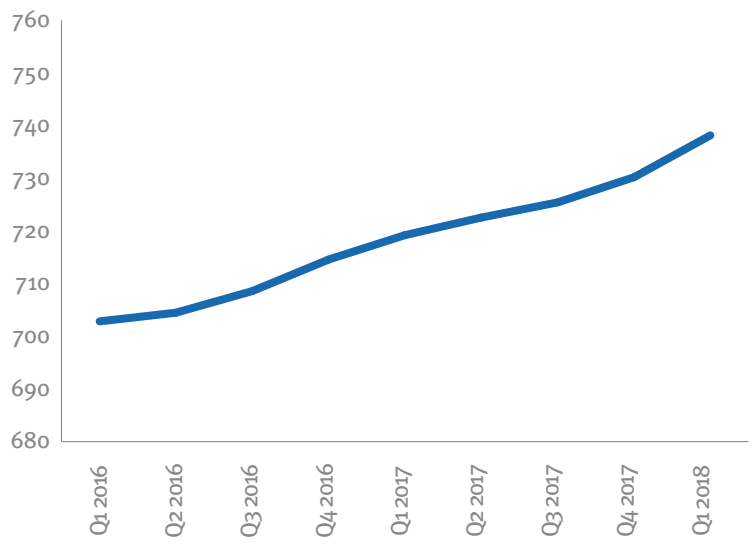
The service sectors showing the strongest year-on-year growth were administrative and support service activities (increased 31%), information and communication (increased 14.5%), accommodation and food services (increased 11.9%), wholesale and retail (increased 9.1%), and transportation and storage activities (increased 7.4%).

Figure 6: Industrial Production and Industrial Turnover in Manufacturing Industries (seasonally adjusted)



Source: CSO Industrial Production and Turnover May 2018.

Figure 7: Average Weekly Earnings (€)



Source: CSO Earnings and Labour Costs Q4 2017 (Final) Q1 2018 (Preliminary Estimates).

Industrial Production and Turnover

As measured by the CSO, industrial production volume in manufacturing industries increased by 7.4% in the year to May 2018, and increased by 3.4% in the month of May 2018. This compares to a 3.9% decrease in the year to May 2017.

Industrial turnover increased substantially by 10.8% in the year to May 2018, with an increase of 2.4% in the month of May 2018. These figures compare to a decrease in industrial turnover in the year to May 2017 of 5.2%.

Due to the effect of increased contract manufacturing (where firms outsource the manufacture of their products) the industrial production volume and turnover indices are particularly volatile, and not as tightly related to the domestically located manufacturing activity as previously.

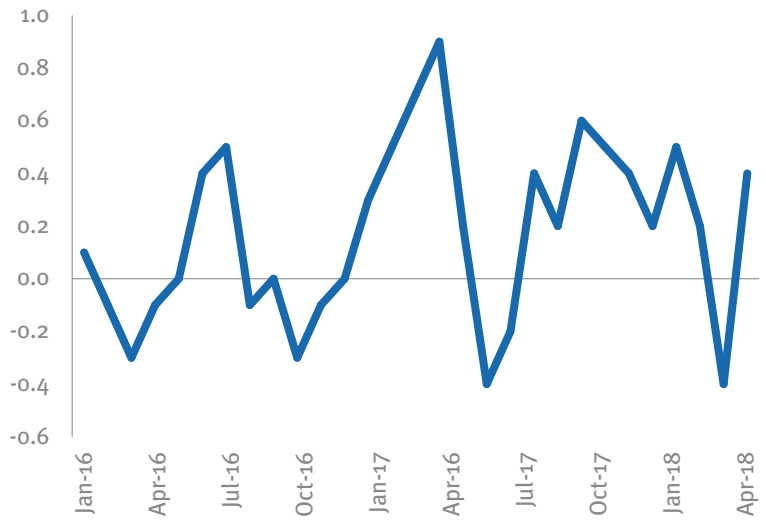
Average earnings

Seasonally adjusted average weekly earnings in Q1 2018 were €738.14, an increase of 1.1% from the previous quarter and up 2.6% compared to Q1 2017.

The economic sectors that saw the highest unadjusted earnings increase in the year to Q1 2018, were the information and communication sector (7.6% increase from €1,096.27 to €1,179.97), and the financial, insurance and real estate activities sector (4.9% increase from €1,172.03 to €1,229.13). The administrative and support service activities sector was the only reported sector to see a weekly earnings decrease over this period, from €552.03 to €545.90 (1.1% decrease).

This average weekly earning increase is particularly impactful on real disposable income as inflation (as measured by CPI) is low.

Figure 8: Consumer Price Index (CPI) percentage change over previous 12 months



Source: CSO Consumer Price Index May 2018.

** % change based on previous 12 months*

Inflation

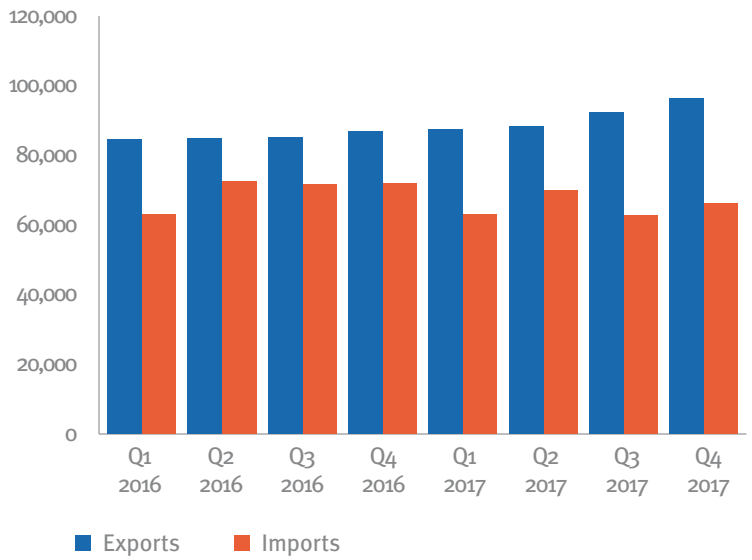
The change in the Consumer Price Index is a measure of inflation, which estimates inflation based on the market price of a basket of consumer goods and services purchased by households.

There have been only modest increases in consumer prices in recent months, with an increase of 0.4% in the year to May 2018. The low level of inflation is partially due to the Euro's relative appreciation against sterling and the dollar, decreasing the costs of imports.[1] Consumer prices are expected to grow as the effect of Euro appreciation fades and domestic demand increases.

The main drivers of inflation in the 12 months to May 2018 were housing, water, electricity, gas and other fuels (which increased by 5.5%), restaurant and hotels (increased 2.4%), and transport (increased 1.4%). Prices in miscellaneous goods & services decreased by 3.6%, in food and non-alcoholic beverages decreased by 2.3%, and in furnishings, household equipment and routine household maintenance decreased by 4%.

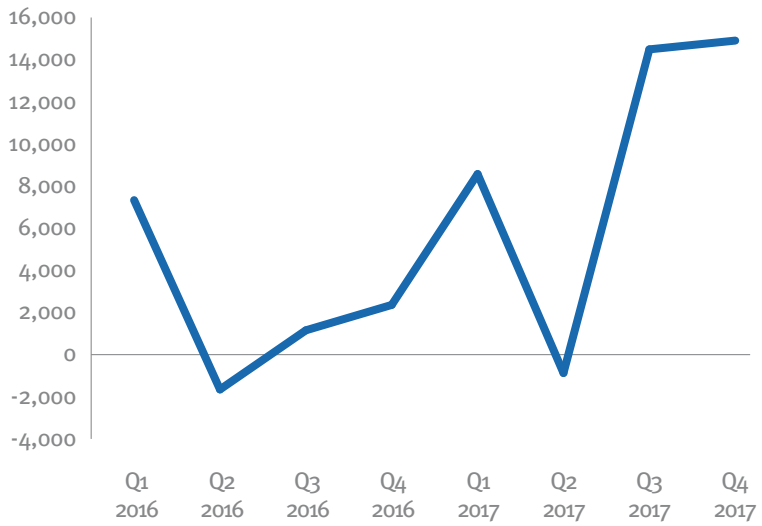
1 *Central Bank of Ireland (2018) Quarterly Bulletin April 2018.*

Figure 9: External Trade in Goods and Services (€ million)



Source: CSO Quarterly National Accounts Quarter 4 2017 Annex 1B.

Figure 10: Balance of Payments – Current Account (€ million)



Source: CSO Balance of Payments Table 1.

External trade

Exports of goods and services in Q4 2017 were up 4.4% compared to Q3 2017 and up 11.2% compared to Q4 2016. Approximately 49% of goods exported in 2017 were destined for non-EU markets, 13% went to the UK and 38% were destined for other EU markets. Imports of goods and services increased by 5.7% in Q4 from Q3, however on a year-on-year basis imports were down 8%. Similar to exports, imports from non-EU markets made up the largest proportion of goods imported followed by other EU markets and the UK.

The figures for external trade in services are not yet available for Q1 2018. However, the figures for external trade in goods are available on a monthly basis. These figures show goods exports continuing to grow in excess of imports in Q1 2018.

Balance of Payments

Ireland's Current Account balance was in surplus by €14.9 billion at end 2017. This was an increase of 3% in Q4 relative to Q3, while there was a rise of 84% compared to Q4 2016. The CSO have noted that there are significant distortions caused to Irish current account data by the activities of large multinational firms.

Ireland's Current Account Balance in Q4 2017 was largely driven by positive income from net merchandise trade (€30.0 billion) with a deficit in services trade (€2.1 billion) and outflows of primary (€11.8 billion) and secondary (€1.1 billion) income.[2]

Overall, the Current Account balance shows aggregate income inflows into Ireland though these are mainly driven by trade by multinational companies.

2 *Primary income includes wages and investment income going to and from Ireland while secondary income is mainly related to Third World aid programmes operated by non-governmental organisations and transfers related to non-life insurance businesses.*

The above indicators indicate a robust level of economic growth for the first half of 2018. Higher employment and increases in average earnings, along with moderate levels of inflation, will help spur domestic consumption. Though affected by abnormal weather conditions in March, improving retail sales volume and strong services sales also provide a supporting indication for increases in domestic consumption. The overall increase in tax revenue (especially income tax) in the six months to June also indicate strong growth.

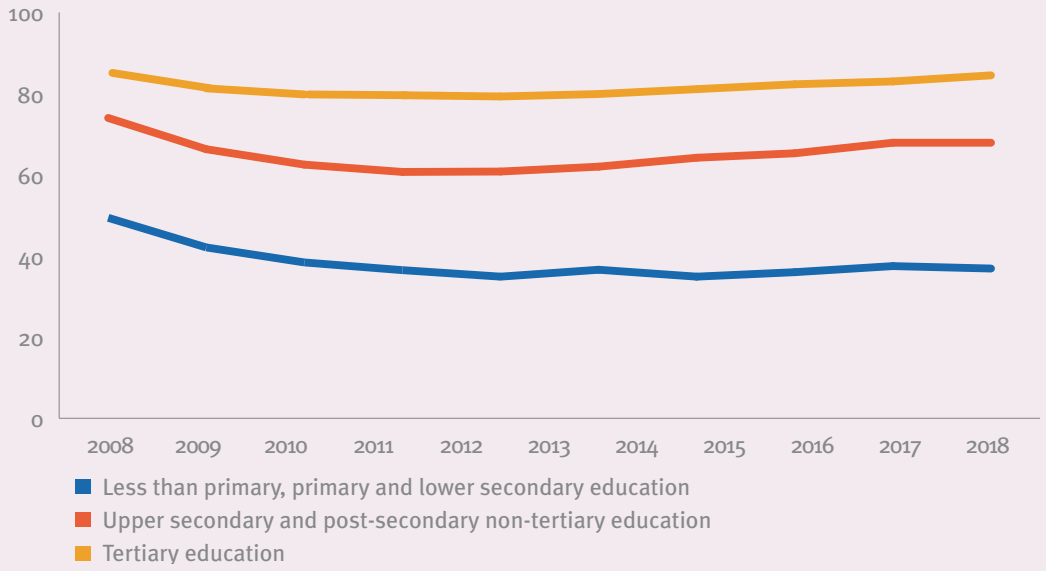
Though the industrial production and turnover indices provided more mixed results for Q1 2018's economic performance, the expectation for strong economic growth is supported by the range of economic indicators discussed.

Box 1: Labour Force participation and employment rates

The Labour Force Participation Rate is the percentage of people of working age who are engaged in employment or are actively seeking employment. Ireland's labour force participation rate in *Q1 2018* was 61.5%, below its peak of 64% in 2007. The employment rate[3] in *Q1 2018* was 68.1%, marginally above the EU28 average of 68%. Of those not in the labour force, the absolute number classified as being inactive and with the potential to work was estimated by the CSO to be 119,200 in Q1 2018.

At present, there is a recognised risk of overheating in the Irish economy. The *Stability Programme Update* for 2018 forecasts an increase in the number of people in employment of 60,000 (2.7 per cent) this year. As the economy approaches full employment, demand for labour will need to be met by an expanded labour force, either through immigration or labour market activation if the effects of overheating (such as upward pressure on wages) are to be avoided. Employment rates are notably low among those with only primary or secondary education levels (Figure 11), and most pronounced among young people within this cohort.

Figure 11: Employment Rates by Education Level in Ireland

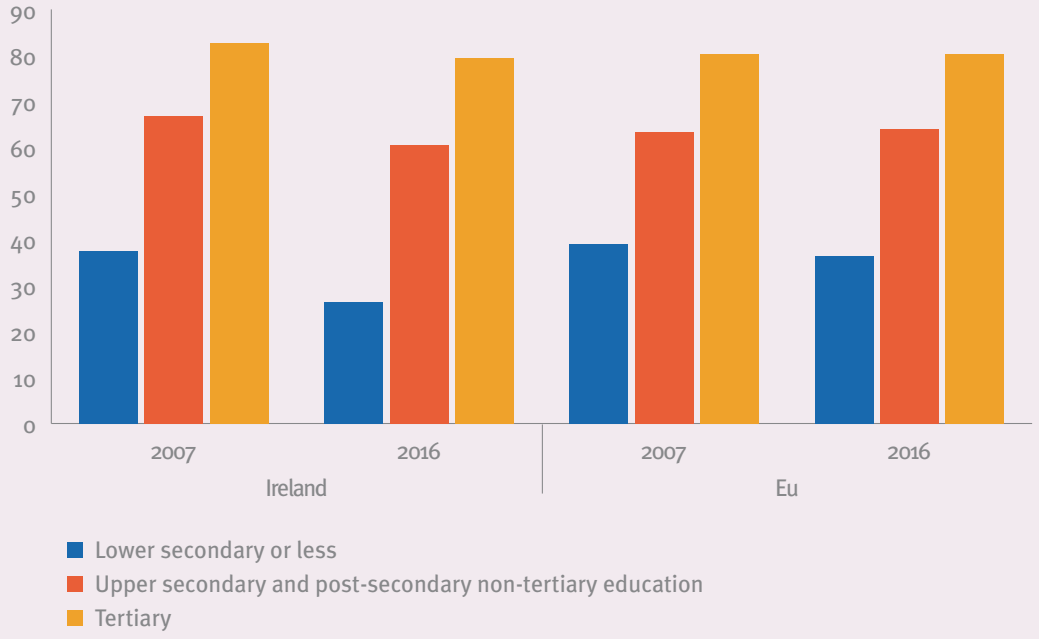


Source: Eurostat, Employment Rates by sex, age and educational achievement.

3 *The Employment Rate is the number of employed aged 15 to 64 expressed as a percentage of the total population aged 15 to 64 and is the standard measure used by the EU, OECD and the International Labour Organization.*

In particular, women with low-educational attainment are more likely to be outside the workforce than those with high levels of educational attainment (Figure 12). Women with secondary education or less were found to have an employment rate of 24.8% in 2016 compared to 78.4% of those tertiary educated. Across all three broad education categories, Irish female employment rates remain 2 to 12 percentage points lower than in other EU countries and, significantly, 4 to 10 percentage points lower than 2007 levels.

Figure 12: Female Employment Rate (%) 2007/2016 by Educational Attainment



Source: Eurostat, Employment Rates by sex, age and educational achievement.

The European Commission noted in its *2018 Country Report* that Ireland's persistent inactivity rates remain a challenge. Successive Country Specific Recommendations since 2015 have noted the impact of these factors on Irish economic activity, recommending the use of Active Labour Market Policies[4] to broaden the tax base (i.e. decrease the inactive population and increase the number of people employed and paying income tax) and to reduce the number of jobless households. It was further recommended to reduce the cost of childcare to facilitate increasing female participation in the workforce. The *2018 draft Country Specific Recommendations*[5] have stressed the need to focus on the upskilling and reskilling of the workforce, a recommendation which was echoed in a recent *paper by the Department of Business, Enterprise and Innovation* on the impact of Brexit on Irish businesses.

4 *The PBO will be publishing a paper on Active Labour Market Policies in due course.*

5 *See PBO Note 11 of 2018 - 2018 European Semester: Draft Country Specific Recommendations for Ireland, May 2018.*

Macroeconomic risks

As discussed above, the Irish economy appears to be performing well, with most of the main economic indicators performing strongly. However, this does not preclude adverse effects from downside risks facing the economy. The SPU 2018 outlines a number of risks to the macroeconomic position and the Government's evaluation of them. The SPU includes the danger of a 'tit-for-tat' trade war, a 'cliff edge' Brexit and pressures from an overheating economy and housing market among the risks to the Irish economy.

While the recent global economic environment has been broadly positive, there are a number of risks slanted to the downside for the Irish economy in the external economic environment. Economic growth in Q1 in the US and EU was relatively strong, however, growth disappointed in the UK. Forecasts are broadly optimistic but there are significant risks to the global economic environment and the Irish economy. These relate to uncertainty surrounding Brexit, geopolitical and economic risks and risks present in global financing conditions.

The IMF published the *Staff Report* of their 2018 Article IV Consultation[6] with Ireland in June. This was broadly positive on the Irish economy, noting that growth and other economic indicators have been strong. However, the report also highlighted a number of risks to the Irish outlook. Domestically, they noted that risks are emerging related to the economy reaching full capacity, with the possible re-emergence of 'boom-bust' dynamics. Externally, the report notes the risks posed by an escalation in protectionism, a 'hard' Brexit and changes in the international tax landscape.

External risks

Brexit

Brexit remains a threat to the economic outlook. In the event of a 'hard' or 'no deal' Brexit, where the UK leaves the EU without a free trade or transitional agreement in place, trade with the UK will take place under WTO rules. This will impose significant barriers to trade, with implications for Irish and UK growth. Even if a trade agreement is put in place, it will likely still erect new barriers to trade. The nature and severity of these will depend on the nature of the agreement between the EU and the UK.

While the UK will leave the EU on 29 March 2019, a transition period has been proposed until the end of 2020. This would broadly preserve the *status quo* immediately after the UK leaves the EU. However, it is contingent on a Withdrawal Treaty being agreed and ratified before 29 March 2019. As such, the risk of a 'hard' Brexit cannot be discounted given the numerous areas requiring progress on this treaty; including the avoidance of a hard border between Ireland and Northern Ireland.

Brexit presents Ireland with a number of national and regional risks. The threat to Irish trade will present a challenge to economic growth at a national level. Regionally, these impacts have the potential to affect the border and rural regions disproportionately and exacerbate existing regional inequalities.

6 *International Monetary Fund, Article IV Consultation Staff Report, June 2018.*

Global financial market and monetary policy conditions

A number of international bodies raised concerns with respect to risks in the financial system. Due to historically low interest rates, global debt levels are currently exceptionally high. If the access to credit was to be tightened in a disorderly manner, heavily indebted firms and governments could struggle to access credit at affordable rates. This could cause further disruptions to financial markets, with implications for global financial stability and the real economy, including the Irish banking sector.

In a fiscal context, Ireland currently benefits from low interest rates set by the European Central Bank (ECB). As such, interest payments have been below the forecasts of the Department of Finance in previous years.[7] As the euro area economy begins to see stronger growth, it is likely that the ECB will move to raise interest rates. This will increase the cost of financing for the Exchequer, impacting on the capacity of the Government to increase spending.

Global economic demand and related developments

Ireland has a small, open economy. As such it is vulnerable to external developments that interfere with global trade. Currently, there is a significant risk of restrictions on the global flow of trade with the potential to cause an economic downturn resulting in lower demand for Irish goods and services. This, if it occurred, has the potential to negatively impact Irish growth and employment.

International commentary suggests that the global economy is currently experiencing robust growth. Ireland's major trading partners expect to see growth in the near future, although that of the UK is weaker than growth in other partners. (See Table 2 for further details.)

Table 2: Growth forecasts for main Irish Trade Partners

	2018	2019
Euro Area	2.2%	2.1%
United Kingdom	1.4%	1.3%
United States	2.9%	2.8%

Source: OECD (2018) Interim Economic Outlook May 2018.

A global downturn has the potential to significantly impact Ireland's economic prospects. A slowdown in the global markets will exert downwards pressure on Irish economic forecasts and should be considered as a factor when using forecasts.

The OECD's May 2018 *Interim Economic Outlook* is broadly positive regarding the global economy, forecasting 4% global growth in 2018 and 2019 and growth in the OECD area at 2.5% per annum. The report highlights a number of risks which could endanger this positive outlook. Increases in interest rates could impact on access to funds by governments and by firms and citizens and the increase in borrowing encouraged by low rates could leave the financial system more exposed to shocks. The Outlook also highlighted new uncertainties in trade policy. Since the publication of the report, these have worsened.

7 *In the 2015 SPU, the Department of Finance forecast interest payments of almost €7 billion in 2018. The 2018 SPU forecasts interest payments of €4.9 billion. In addition to lower interest rates, the restructuring of debt and a lower absolute amount of debt are also responsible for lower interest payments.*

The IMF's *World Economic Outlook* broadly reflects similar concerns to the OECD's *Economic Outlook*. While global growth is strong, there are a number of risks in the medium term. The IMF raises concern with regard to vulnerability in the global financial system, increased support for protectionist measures and geopolitical and climate shocks. The report also notes that these risks are likely to be interlinked (i.e. if one takes place it could act as a catalyst for others).

The World Bank's *Global Economic Prospects* report notes that while global growth has eased somewhat, it remains robust. The report identifies risks as being tilted towards the downside, to the degree that some are becoming acute. The report concurs with the consensus that risks to the financial system, global trade and geopolitical threats are the main challenges to the outlook forecasted for the short to medium term.

A common theme in international commentary has been concern over moves by the US Government to impose tariffs on steel and aluminium imports. This has provoked the imposition of 'tit-for-tat' tariffs on US goods by Canada and the European Union. The US Government has threatened to respond to these tariffs with further retaliatory measures. If these were to escalate to a full blown trade war, Ireland would be very exposed. The *2018 Globalisation Report* prepared by Bertelsmann Stiftung finds Ireland to be the most globalised country in the world and the most exposed to a potential trade war. The nature of Irish trade between the rest of the European Union and the high level of investment by American companies in Ireland is another avenue through which a trade war could damage the Irish economy.

Box 2: Oil price movements

In the last decade there have been severe swings in the price of oil. Immediately prior to the 'Great Recession', oil prices had achieved historic highs. This was followed by a sharp correction during the immediate crisis and a steep climb to levels close to pre-crisis levels. However, since late 2014 oil prices have been at significantly lower levels. This has supported growth in the Irish and global economies. In recent months, the price of oil has begun to climb, although it is still far from its pre-2011 peak (over $100 a barrel).

Explanations for the recent increase in oil prices may include instability in the Middle East and Venezuela, cuts by oil exporting nations in the amount of oil produced and strong growth in the global economy. While OPEC have agreed to increase production, this may only serve to slow the rate of growth if production is not maintained in other regions which are continuing to suffer instability.

Figure 13: Brent Crude oil, $ per barrel

Source: U.S. Energy Information Administration, Crude Oil Prices: Brent - Europe [DCOILBRENTEU], retrieved from FRED, Federal Reserve Bank of St. Louis.

Department of Finance oil price forecasts

The price of oil is an important input in to Department of Finance models used to estimate growth. The price of oil used in these models is based on the futures market for the time period in question. The Department's record in this area has historically been relatively close to prevailing oil prices.[8] However, the Budget 2018 estimate has proven to be significantly lower than the outturn. The Budget 2018 estimates were based on oil prices of approximately $53 to $55 per barrel between 2018 and 2021. This has proven to be overly optimistic for 2018. Oil prices are currently between $70 and $75 per barrel. While the SPU, when updating the Government's economic forecasts, adjusted for the higher price of oil, its estimate is still below current market prices. The SPU forecasts oil prices of $65 per barrel in 2018, falling to $58.1 per barrel by 2021.

Ireland's economy, as a large net energy importer, is influenced by oil price movements. Oil prices have increased in recent months well above what was forecast and if they persist this may impact future economic growth and inflation.

8 *Jim Power Economics, Evaluation of the Department of Finance's Macroeconomic and Fiscal Forecasts 2013-2016.*

Domestic economic risks

As discussed earlier the Irish economy is broadly performing well. Economic indicators, such as employment and the retail and services sales indexes suggest that there has been robust economic growth and the OECD has noted that the recovery has now broadened to include the domestic economy. However, there are particular domestic risks to the economy which must be considered alongside any forecast of Irish economic growth. The SPU highlights concerns over housing supply pressures, the economy overheating and the potential to lose competitiveness as threats to Ireland's economy.

Economic overheating

Overheating refers to an economy that has an output above its potential output (i.e. the sustainable level of output). This can be unsustainable and threatens the health of the economy in the medium to long term. The negative consequences of an overheating economy include unsustainable price pressures as different elements of the economy compete intensely for resources such as labour, property or services. This increases the overall price level in the economy, harming competitiveness and making exports relatively expensive.

The Irish Fiscal Advisory Council's (IFAC) June 2018 *Fiscal Assessment Report*[9] suggests that while the Irish economy is not currently overheating, it is now close to its medium-term potential and may move past it next year. In particular, the report notes the strong growth forecast for the construction sector in the next three years and states that this has the potential to contribute to overheating unless offsetting measures are taken elsewhere in the economy.

Housing supply pressures

Beyond the human cost of an undersupply of housing, the housing sector has the potential for severe macroeconomic consequences in a number of fields.

The SPU highlights the damaging impact of high housing costs on Ireland's competitiveness as the higher cost of living will see workers demand higher pay. This will make Ireland a less attractive destination for investment and make Ireland's exports relatively more expensive. A constrained housing market will also harm the economy through limiting the mobility of workers. Workers with secure housing will be slower to move to jobs that may be more lucrative over fears of not being able to secure suitable housing or people seeking work are disincentivised from moving into areas where jobs are more plentiful due to the restricted supply of housing.

The housing market also has the potential to contribute to the overheating of the wider economy. In their June 2018 *Fiscal Assessment Report*, IFAC highlight that Government expect housing completions to almost double between 2017 and 2021. While this is a positive development, it is taking place in a context of an economy at, or near, full capacity. Therefore, care must be taken that this expansion in construction activity does not push the economy into overheating.

9 *Irish Fiscal Advisory Council, Fiscal Assessment Report, June 2018.*

Fiscal developments

This section outlines the main fiscal developments in Q2 2018, based on the end of June Exchequer Returns from the *Fiscal Monitor: June 2018*. Appendix 1 and 2 of this Commentary reproduce Appendix II of the *Fiscal Monitor* – the *Analytical Exchequer Statement*. This is the source, along with Appendix V of the *Fiscal Monitor*, of much of the fiscal data used below.

Taxation and other revenue

Figure 14 (over) shows Central Government revenue by source (excluding transactions with no General Government Balance impact such as inter-Government loan transactions). Up to end-June 2018, overall revenue was €31.85 billion, which was €354 million (1.1%) **above** expectations:

- Tax revenues were just over €24.94 billion, €168 million **above** profile;
- Appropriations-in-Aid were €5.84 billion, €16 million **above** profile; and
- Non-tax revenue was €1,038 million, €158 million **above** profile.

Overall Exchequer revenue increased by €1,495 million (4.9%) year-on-year; driven by large increases in income taxes, VAT, Corporation Tax, and stamp duties.

Taxation

Tax revenues were up €1,525 million (6.5%) year-on-year, and were slightly above profile by €168 million (0.7%). Overall, tax revenue is on target but this is mainly due to additional Corporation Tax receipts cancelling out the large fall in excise duties receipts. While most taxes displayed positive year-on-year changes excise duties were down €312 million (11.2%) compared to the same period in 2017. Some notable variations include:

- Income taxes are €92 million (1%) **over** profile;
- VAT is €69 million (1%) **below** profile;
- Excise duties are €188 million (7.1%) **below** profile;
- Corporation Tax is €335 million (9.1%) **over** profile; and
- Stamp duties are €38 million (5.8%) **below** profile.

Income taxes, which had been below profile by €80 million (1.7%) in Q1, are now €92 million (1%) over profile; and well up on the same period in 2017 (by €698 million or 7.7%). This probably reflects the strong labour market. No explanation is provided as to why VAT is €69 million (1%) below profile.

Notwithstanding increases in stamp duty for non-residential properties in Budget 2018, stamp duties are €38 million (5.8%) below profile – albeit having increased €160 million (34.5%) year-on-year. The Department of Finance have stated that the shortfall in stamp duties reflects "in part, the non-linear nature of this heading".[10] Stamp duty on commercial property in Budget 2018 represented the major revenue raising element of the Budget and the PBO remains concerned[11] that the projected additional yield for 2018 of €376 million from changes to stamp duty may not be fully achieved.[12]

10 *Fiscal Monitor: June 2018 (July 2018) p.3.*

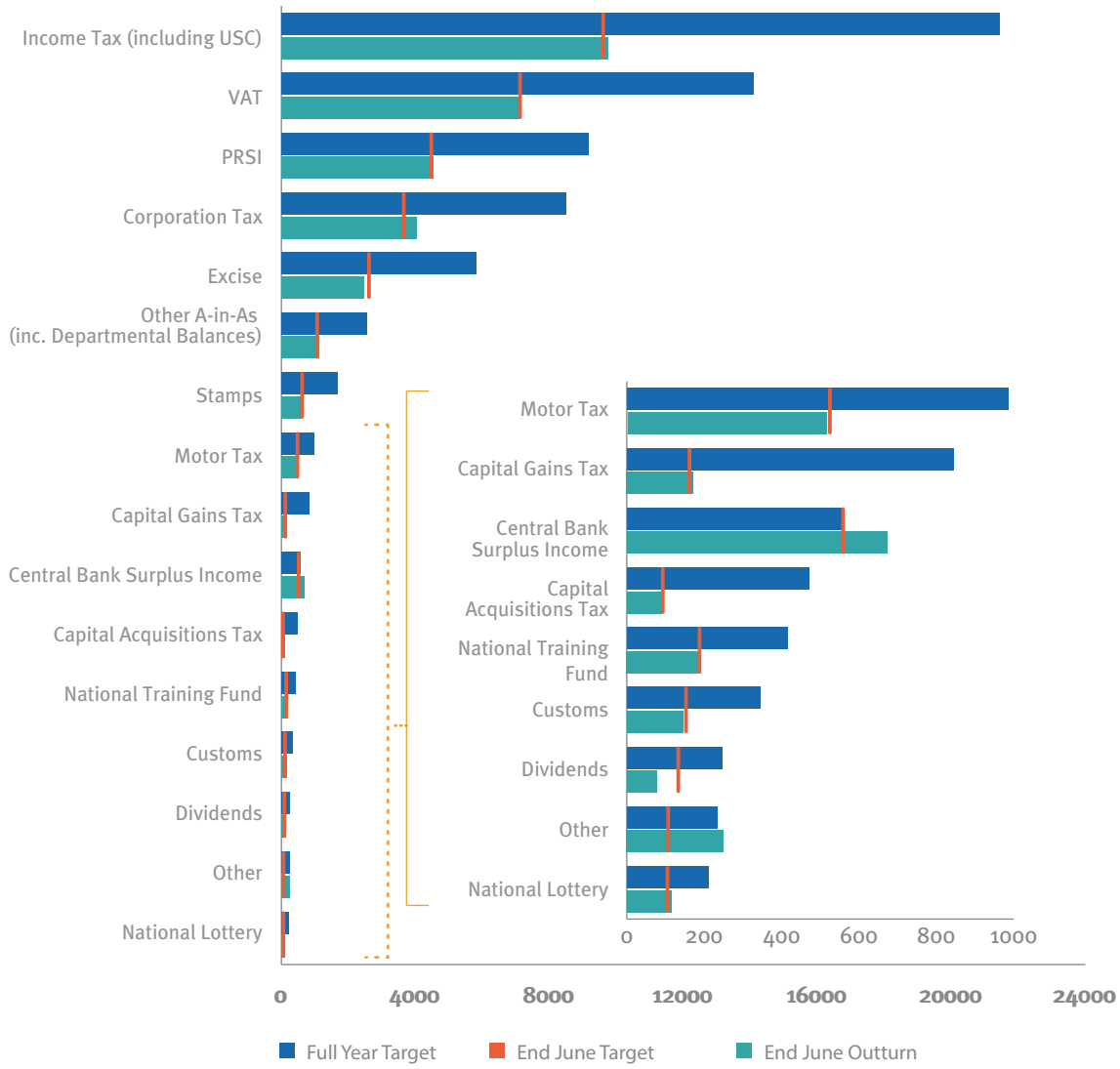
11 *PBO, Quarterly Economic and Fiscal Commentary: Q1 2018 (April 2018) p.24.*

12 *Budget 2018: Tax Policy Changes (2017) p.7.*

The PBO notes, in particular, that excise duties are €188 million (7.1%) below profile – a significant deterioration from their position in Q1 at €62 million below profile. Notwithstanding an increase to Tobacco Products Tax and the introduction of the Sugar Sweetened Drinks Tax (SSDT) in April 2018, Excise duties are €312 million (11.2%) down year-on-year. This warrants further explanation; however, the *Fiscal Monitor* does not elaborate on this issue.

Corporation Tax is up 14.6% year-on-year and is 9.1% above profile at end-June 2018. This is a continuation of trends in unexpected Corporation Tax receipts that are discussed in Box 3.

Figure 14: Taxation and other Central Government revenue 2018 (€ millions)



Source: Parliamentary Budget Office based on Department of Finance Fiscal Monitor: June 2018.

Box 3: Comparison between Stability Programme Update 2014 and 2018.

The *Stability Programme Update 2018* (SPU) shows a higher level of both General Government (GG) revenue and expenditure for 2018 when compared with the revenue and expenditure forecast in previous SPUs, such as 2014. In addition, the comparison also shows a lower level of interest expenditure in SPU 2018 than was forecast in SPU 2014[13] (See Table 3).

Table 3: Comparison between forecasts of general government aggregates 2018 from SPU 2014 and SPU 2018.

General Government (GG)	SPU 2014 forecast	SPU 2018 forecast	Difference
(All figures in € millions)	**2018**	**2018**	
GG Revenue	69,830	79,295	9,465
GG Expenditure	69,915	80,080	10,165
GG Balance	-85	-780*	-695
GG Interest expenditure	9,570	5,350	-4,220
GG Expenditure less interest	60,345	74,730	14,385

*Source: Stability Programme Update 2018, Stability Programme Update 2014. *Rounding affects totals.*

The comparison shows that general government expenditure is €10.2 billion higher than forecast in 2014 with general government revenue €9.5 billion higher. This means that the 2018 deficit is approximately €700 million higher than it was forecast to be in 2014.

Seamus Coffey, Chairperson of the IFAC and lecturer in UCC[14] has pointed out two unexpected factors have made the increase in expenditure possible without dramatically increasing the deficit. These are the fall in government debt interest payments and the rise in Corporation Tax revenue.

Government debt interest payments were forecast (in 2014) to reach €9.6 billion in 2018. However, they are now expected to be €5.4 billion in 2018 (a difference of €4.2 billion). The means that general government expenditure less interest in 2018 is €14.4 billion higher than forecast in 2014 (Table 3). This is a 24% increase in non-interest expenditure from what had been expected. This represents significant additional resources for public services over what had been expected.

In 2014 Corporation Tax revenue (on an Exchequer basis) was €4,617 million. If it had grown in line with other general government revenue over the period 2014 to 2018 (i.e. at 15.3% rather than at 84%) it would have been €5,323 million in 2018. This is approximately €3.2 billion lower than what the Government forecast Corporation Tax revenue will be in 2018.

13 *SPU 2014 was chosen as it was the earliest Government publication with fiscal forecasts for 2018.*

14 *Irish Independent (2018) Chairman, Fiscal Advisory Council: 'There's been a very strong recovery - we are now living within our means' 18/01/2018.*

Corporation Tax has also increasingly become a larger fraction of total tax revenue, being 10.3% of Total Tax Revenue in 2011, and 16.2% of Total Tax Revenue in 2017. Corporation tax receipts are a strongly cyclically linked source of revenue and are also particularly exposed to exogenous shocks due to their concentration in a small number of multinational enterprises (MNE). For instance, the IMF estimates that the cut in the US corporate income tax (CIT) tax rate and investment expensing could reduce Irish CIT tax revenue by approximately 10%, or 0.25% of GDP (approximately €750 million).[15]

It is likely that approximately half of the €14.4 billion in additional non-interest expenditure is financed by unexpectedly high Corporation Tax receipts and unexpectedly low interest payments. Expanding expenditure commitments on the basis of higher levels of Corporation Tax revenue and lower interest payments leaves the Exchequer exposed in the event of outside factors changing the present trends. This suggests a need for prudence in Irish fiscal policy making.

Appropriations-in-aid

Appropriations-in-aid are €16 million above profile. The variations are as follows:

- Receipts from PRSI are €13 million above profile;
- Receipts from the National Training Fund are €4 million above profile; and
- "Other" Appropriations-in-aid are €1 million below profile.

The PBO previously noted that performance above or under profile in relation to "Other" Appropriations-in-aid is obscured.[16] However, there has been significant improvement in performance against profile in this heading since Q1 – it was €62 million below profile at end-March 2018, and now is only €1 million below profile.

Non-tax revenue and Capital Receipts

Non-tax revenue is €158 million (18%) above profile. The variance is largely under Central Bank Surplus Income (€114 million), "Other" (€90 million), and Dividends (-€55 million). The Department of Finance state that year-on-year growth in Central Bank Surplus Income "is mainly due to an increase in the surplus income from the Central Bank as it continues to reduce its holding of floating rate notes."[17] The PBO previously noted that the National Treasury Management Agency (NTMA) redeemed €1 billion more in Floating Rate Notes than originally envisioned in 2017; as a result of which, revenue from the Central Bank of Ireland would increase in 2018 but would fall in future years.[18]

Year-on-year, dividends at end-June are down €33 million, and are under profile by €55 million (41.2%). However, dividend returns from State companies are generally higher at end-June 2018 than at end-June 2017 with the exception of the Electricity Supply Board (ESB). Dividends from the ESB are currently €52.8 million less than their level at the same point in 2017. Given that ESB outturn against profile accounts for the majority of the performance of dividends it would appear that a timing issue may be responsible for this under profile receipt.

15 *IMF (2018) Ireland: Selected Issues, Country Report No. 18/195, June 2018).*

16 *PBO, Quarterly Economic and Fiscal Commentary: Q1 2018 (April 2018) p.26.*

17 *Fiscal Monitor: June 2018 (July 2018) p.7.*

18 *PBO, Note on Central Bank of Ireland Surplus Income (March 2018).*

Capital Receipts (excluding capital receipts with no General Government Balance impact) are €35 million. This is made up mostly by European Regional Development Fund (ERDF) payments (over €32 million), and some receipts under the Carbon Fund Act 2007 and other miscellaneous receipts.

Non-General Government Balance impacting revenue

There are three main elements of revenue with no General Government Balance impact in the Exchequer Statement to date:

- Payments received from the European Commission for implementation of the European Agricultural Guarantee Fund and European Agricultural Fund for Rural Development. This revenue was €740 million.
- Repayments of advances to the Supply Account were €193 million. These are repayments made to the Exchequer for advances that were made to the Paymaster General's Supply Account to ensure there was sufficient money in the account for Departments to meet expenditure demands. These payments are not included when calculating the general government balance, and have no impact on the outturn figures for the fiscal rules.
- Central Bank Surplus Income (with no general government impact) of €1,428 million is €467 million (48.6%) over-profile at end-June 2018. This is also attributable to the accelerated redemption of floating rate notes by the NTMA.

Overall Exchequer expenditure

Up to end-June, overall Central Government expenditure (excluding transactions with no General Government Balance impact) equalled €35 billion, €346 million below profile but €2,611 million more than at the same point in 2017. This was made up of €27.51 billion in voted expenditure, €1.61 billion in non-voted expenditure and €3.88 billion in interest on the National Debt.[19]

Notable details underlying this expenditure are that:

- Gross Voted Current Expenditure was €68 million (0.2%) above profile;
- Gross Voted Capital Expenditure was €175 million or (8.2%) below profile;
- Gross Non-Voted Current Expenditure was €165 million (9.3%) below profile; and
- Interest on National Debt was €74 million (1.9%) below profile.

The main reason that Gross Non-Voted Current Expenditure is below profile is that Ireland's contribution to the EU budget is €135 million below what was profiled. However, it is €259 million above its level at the same point in 2017.

Gross voted current expenditure

Gross voted current expenditure was profiled at €27,483 million up to end-June 2018. With outturn of €27,551 million, it is €68 million (0.2%) over profile. End-June 2018 outturn is €1,629 million or 6.3% more than for the same period in 2017. The Justice and Health Vote Groups are over profile by a combined €210 million.

Figure 15 (over) shows the Q2 outturn for gross voted current expenditure compared to its profile and the overall level of expenditure for the year (as presented in the *Revised Estimates for Public Services 2018*)[20] for each Departmental Vote Group.

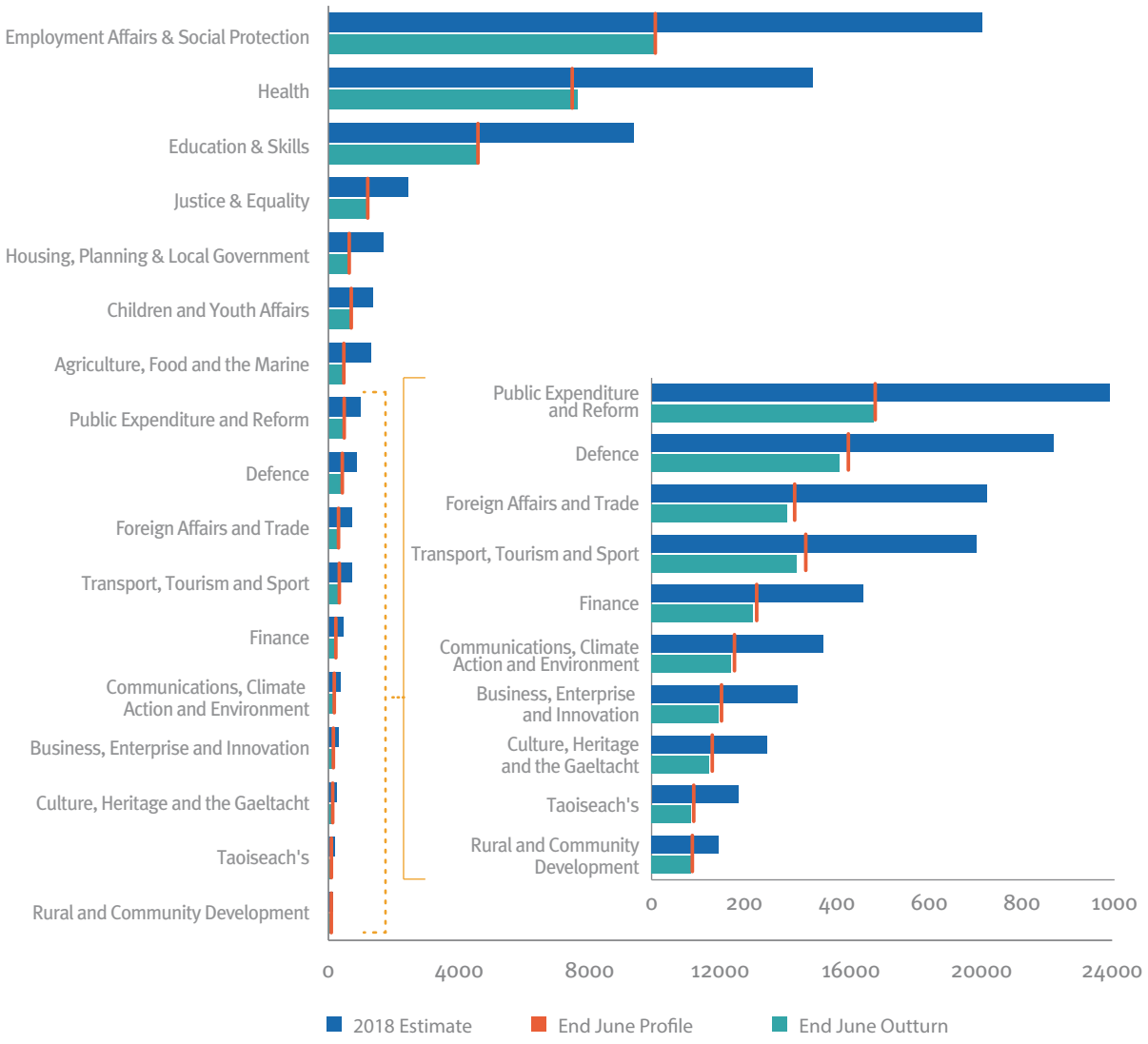
19 *Fiscal Monitor: June 2018, p.15.*

20 *The PBO prepared a Briefing Paper on the Revised Estimates for Public Services 2018 which is available here.*

The most notable aspects for the comparison of gross voted current expenditure to profile include:

- Health is €168 million (2.3%) over profile. This is a deterioration over its Q1 position of €18 million (0.5%) under profile;
- Justice and Equality is €42 million (3.5%) over profile. This is a deterioration over its Q1 position of €3 million (0.5%) over profile;
- Expenditure in Education and Skills and Employment Affairs and Social Protection were essentially on profile with a deviation of €8 million (0.1%) and €16 million (0.3%) respectively;
- The significant under profile expenditure in Housing, Planning and Local Government identified in Q1 has reduced;[21] however, it remains €37 million (5.7%) under profile; and
- Under profile expenditure of €40 million (8.6%) in Agriculture, Food and the Marine. The *Fiscal Monitor* makes it clear that this is "mostly due to a timing issue of an EU receipt".[22]

Figure 15: Gross Voted Current Expenditure by Department Vote Group 2018 (€ millions)



Source: Parliamentary Budget Office based on Department of Finance Fiscal Monitor: June 2018.

21 *PBO, Quarterly Economic and Fiscal Commentary: Q1 2018 (April 2018) p.26.*

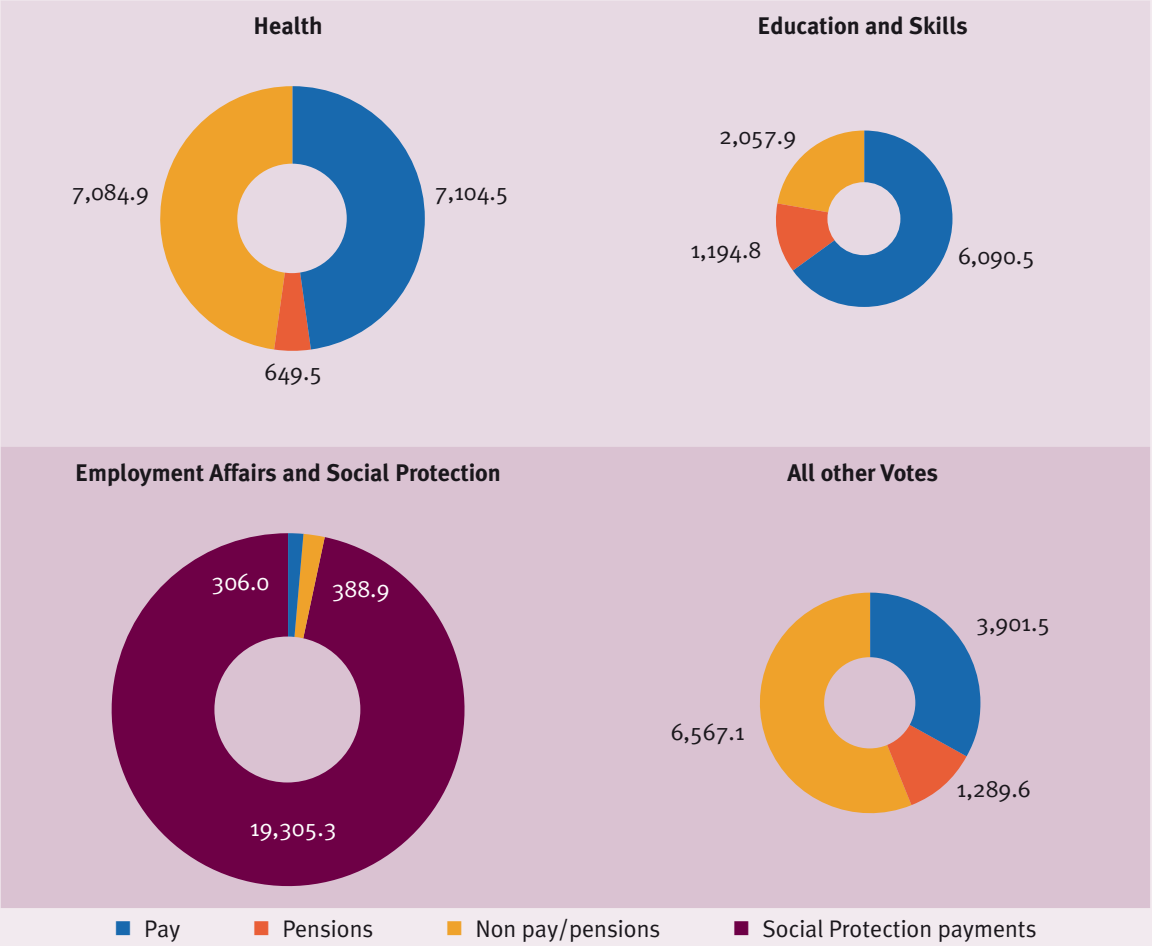
22 *Fiscal Monitor: June 2018 (July 2018) p.19.*

Box 4: Composition of Gross Voted Current Expenditure 2018

As shown in *PBO Infographic 3 of 2018*, most public expenditure, on a General Government basis (€61.8 billion or 78% of €79.3 billion), is set out in the *Revised Estimates for Public Services 2018*. This €61.8 billion of Gross Voted Expenditure (including the estimated expenditure from the Social Insurance Fund (SIF) and the National Training Fund (NTF)) is distributed across 42 Votes composed of programmes and sub-programmes. Of this amount, €55.9 billion relates to current services and €5.8 billion relates to capital.

This Box analyses the €55.9 billion in current expenditure in order to illustrate to what extent the Government has flexibility in re-prioritising or reducing expenditure. Figure 16 below shows this expenditure divided between the three largest Votes which constitute 79% of gross voted current expenditure (Health, Education and Employment Affairs and Social Protection) and all other Votes. The figure also displays the division between public sector gross pay, pensions & non pay/pensions expenditure. In addition for the Employment and Social Protection Vote the social insurance and welfare payments to (or on behalf of) individuals are displayed separately.

Figure 16:Gross Current Expenditure by largest Votes (€ million)



Source: Revised Estimates for Public Services 2018, Tables 3, 5 and 6 and Employment Affairs and Social Protection Estimate.

It should also be noted that the monies allocated to 'pay' in the Revised Estimates relate only to the public sector employees identified within each Vote, i.e. a proportion of the non pay/pensions expenditure is ultimately used to pay public service employees (and retirees) not directly paid by the Exchequer – in certain agencies, non-commercial semi-state bodies, etc.

Some issues that Figure 16 illustrates include:

- Non pay/pension expenditure accounts for €15.2 billion of the €55.9 billion current expenditure.
- The primary driver of expenditure in Education and Skills is the pay of current employees with pay responsible for almost half of Health's current expenditure.
- Pensions, i.e. the legacy cost of the employment contracts of previous public sector employees is also significant (€3.1 billion). Public service pension payments have two dedicated Votes (Vote 12 – Superannuation and Retirement Allowances and Vote 35 – Army Pensions) but are also a feature of 16 other Votes. It should be noted that public services can only be provided by the current cohort of employees (i.e. pensions represent the ongoing cost of providing public services in the past).
- Of the €7.08 billion in non pay/pensions in Health the largest expenditure items are: Primary Care Reimbursement Services and Community Demand Led Schemes (€2.83 billion – mostly medical cards and drugs), HSE non-pay (€2.61 billion), long-term residential care (€961 million) and the State Claims Agency (€274 million). All other non pay/pensions current Exchequer expenditure in Health amounts to approximately €400 million.
- Of the €2.06 billion in non pay/pensions for Education and Skills the largest expenditure items are €438 million for capitation grants to schools, €407 million for student grants, €413.5 million for National Training Fund programmes and €190 million for school transport services. All other non pay/pensions current Exchequer expenditure in Education amounts to approximately €611.5 million.
- Approximately 99.5% of the Employment Affairs and Social Protection Vote (including the Social Insurance Fund) goes towards social insurance/welfare payments to or on behalf of individuals. This expenditure is driven within the different schemes by policy decisions in relation to means testing, payment rates, eligibility etc. and by demographics.
- Of the €6.6 billion in non pay/pensions in the other Votes, the largest sub-programmes include Irish Water (€600 million), Local Authority Housing (€550 million), Child and Family Agency (non-pay) (€461 million), Bilateral co-operation and humanitarian assistance(€374 million), ECCE Pre-school year programme (€349 million), Transport - Public Service Provision Payments (€282 million), Agri-environmental schemes (€233 million), Areas of Natural Constraint Scheme (€227 million) and the Grant to RTÉ for Broadcasting licence fees (€191 million).

In the context of Budget 2019 and the usual focus on the additional expenditure it is useful to have an overview of the €55.9 billion expenditure. This Box shows that re-prioritising or reducing expenditure in some areas in effect means making difficult choices – the bulk of Government current expenditure goes on pay/pensions and social insurance/welfare payments. The large areas of other non pay/pension expenditure (such as grants to schools, medical cards, drug payments, HSE non-pay, Irish Water, etc.) are not easily cut without significant reforms and/or impacts on individuals.

A final lesson from this analysis is that it not possible to determine with certainty at subhead level (from an examination of the *Revised Estimates*) the division between pay/pensions and non-pay in many cases. The lack of clarity, as to which subheads have a mixture of pay, pensions, and non pay/pensions, means that there can be a lack of transparency as to the expenditure drivers within a Vote.

Gross voted capital expenditure

Gross voted capital expenditure was profiled at €2,143 million up to end-June 2018. With an outturn of €1,968 million, it is €175 million (8.2%) below profile. The end-June 2018 outturn is €445 million or 29.2% higher than at end-June 2017.[23]

The year-on-year increase in capital expenditure of €445 million is largely attributable to four Vote Groups which represent 88.5% of the year-on-year increase:

- Housing, Planning and Local Government up €212 million (67.9%) year-on-year;
- Transport, Tourism and Sport up €79 million (24%) year-on-year;
- Health up €61 million (56.7%) year-on-year; and
- Education and Skills up €42 million (14.9%) year-on-year.

Most Vote Groups are reporting below profile expenditure. The notable variances reported in Q2 are:

- Education and Skills is €38 million (10.6%) below profile;
- Housing, Planning and Local Government is €22 million (4%) below profile;
- Rural and Community Development is €17 million (71%) below profile;
- Transport, Tourism and Sport is €17 million (3.9%) below profile; and
- Business, Enterprise and Innovation is €16 million (8.2%) below profile.

The *Fiscal Monitor* provides no commentary to explain under profile capital expenditure. Capital expenditure in Education and Skills may, in part, be under profile as a result of building contractors going into liquidation or examinership processes.[24]

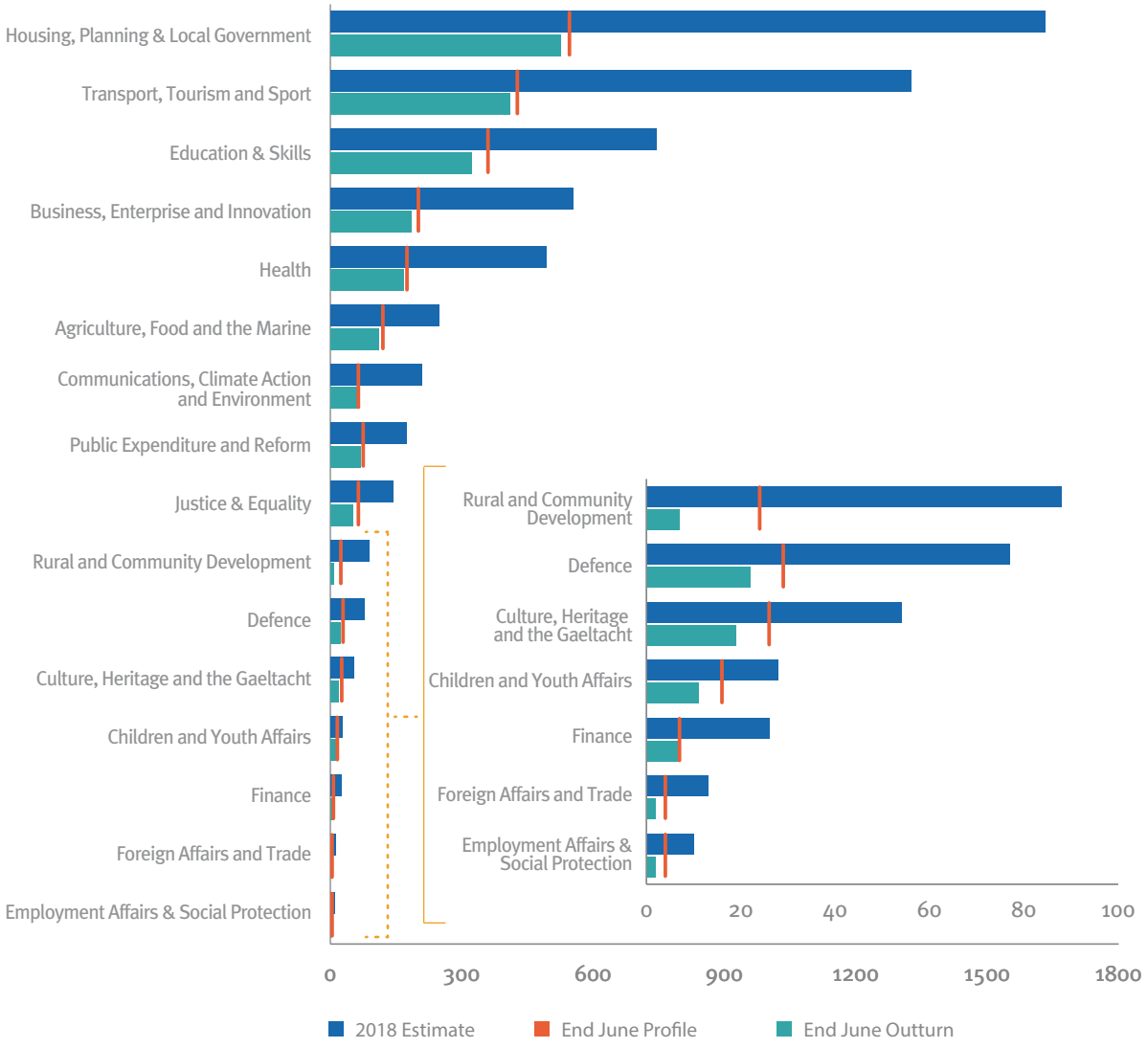
Housing, Planning and Local Government is €22 million (4%) below profile; however, this represents expenditure at closer to profile than in Q1. The Q1 shortfall, €50 million (30.3%) below profile, was attributed to a delay by Irish Water in drawing down payments.[25] It would appear that this process has been rectified.

23 *When considering direct year-on-year comparisons of capital expenditure account should be taken of the change of the treatment of Irish Water within the Revised Estimates of Public Services.*

24 *Minister for Education and Skills, Written Answer to Parliamentary Question [27045/18] (20 June 2018).*

25 *Fiscal Monitor: March 2018 (April 2018) p.8.*

Figure 17: Gross Voted Capital Expenditure by Departmental Vote Group 2018 (€ millions)



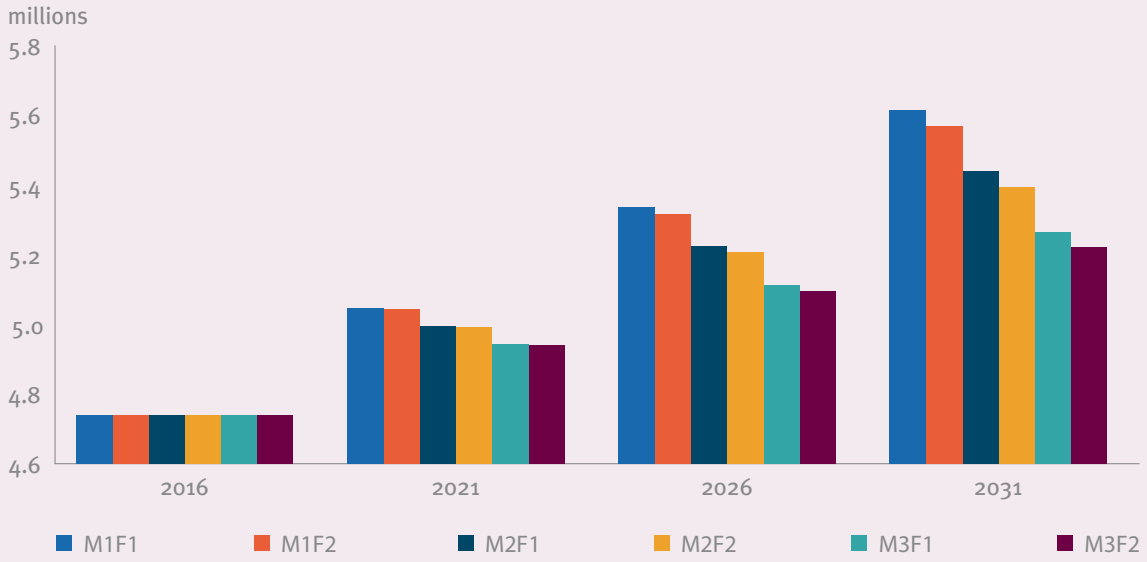
Source: Parliamentary Budget Office based on Department of Finance Fiscal Monitor: June 2018.

Box 5: Demographic change to 2031

The CSO's *Population and Labour Force Projections 2017-2051* (June 2018) sets out six projections of Ireland's population to 2051. These projections are based upon two primary contributory factors – migration (M) and fertility (F). Fertility assumptions underpin the natural increase in the population (births minus deaths) and migration assumptions determine the number (and age) of persons entering and exiting the State. The CSO uses combinations of three migration assumptions and two fertility assumptions to project changes to the size and age profile of the population and use M1F1, M2F2, etc. to represent each projection.

The CSO's projections illustrate that even in the short-to-medium term that Ireland's population may grow significantly from 4.74 million to between 5.22 million and 5.61 million in 2031. Figure 18 illustrates this potential growth from 2016 to 2031.

Figure 18: CSO population projections (2016-2031)



Source: CSO, PEC16 (June 2018).

The CSO's projections signal the demographic changes which will drive increased demand for public services. In the period 2016-2031 these include:

- Overall population growth of 10% to 18%; and
- The number of persons aged 65 years and older is likely to grow by almost 60%.

An increased population will use more resources (such as water and electricity), will require more services (such as healthcare and education), and may require additional capital investment (such as housing and transport infrastructure). Growth in the population, specifically the working-age population, can generate economic activity and therefore revenue for the State; whereas, growth in younger and older cohorts can increase demand for services without generating comparable revenue for the State.

The total support ratio (dependency ratio) is the ratio of dependants (those aged under 16 and over 64) to the working-age population. It is expressed as a % of the working-age population. The total support ratio has increased from 49.3% in 2011 to 52.7% in 2016.[26] The CSO's projections suggest that this may rise to 55.5% by 2031.[27] This suggests that in the short-to-medium term that the State should have the capacity to generate revenue through taxation of the working age population which should facilitate expenditure driven by demographic change without much change to existing policy. However, in the long-term the total support ratio is expected to grow less favourable, potentially growing to between 66.9% and 75.2% by 2051 and increasing pressure on the working age cohort. The bulk of this increase is due to the increase in the older cohort and will put pressure on the health and pension systems.

Later this year the PBO will publish a paper which will address demographic pressures and their potential impact on Government expenditure.

Expenditure commentary

The end-June gross voted expenditure performance against profile gives an indication of expenditure trends for the year. There are causes for concern in relation to both current and capital expenditure.

At end Q2 2017 gross voted current expenditure was €265 million (1%) under profile; however, by end-December expenditure was €436 million (0.8%) over profile. At end Q2 2018 gross voted current expenditure is €68 million (0.2%) over profile. Should similar performance to profile occur in the second half of 2018 as in 2017 there is potential for significant end-of-year over profile expenditure.

Comparing the performance against profile across Vote Groups to the same period in 2017 shows that outturn above profile is more common in 2018. In 2017 only the Justice Vote Group had exceeded profile (€19 million by end June; however, in 2018, five Vote Groups have gross voted current expenditure in excess of profile.

Total variance (above and below profile expenditure) at end-June 2017 was €303 million compared to €410 million at end-June 2018; however, cumulatively, variance in June 2017 was €265 million under profile; whereas, at end-June 2018 the cumulative variance was €68 million over profile.

26 CSO, *'Census of Population 2016 - Profile 3 An Age Profile of Ireland'* (July 2017).

27 CSO, *'PEC 15'* (June 2018).

Notwithstanding a year-on-year increase in profiled gross voted current expenditure of €416 million in Health, at end-June 2018, Health is €168 million over profile. Should this continue Health may run significantly over-profile by year-end. *The Revised Estimates for Public Services 2018* set out gross voted current expenditure of almost €14.84 billion for Health, an increase of €491.6 million (3.4%) over 2017 (thus 85% of the increase authorised by Dáil Éireann has been effectively spent by end-June). If Health expenditure over profile remains at its current level of 2.3% this would equate to over profile expenditure of €341.3 million at year-end.

It is not clearly understood what has driven the significant over profile expenditure in Health in the first half of the year; however, it is noted that over profile Health expenditure was not apparent until Q3 of 2017, although performance to profile improved in Q4. The PBO notes that expenditure over profile this early in the year, and of such significant quantum, may indicate potential for significant over profile expenditure by year end.

The Justice Vote Group gross voted current expenditure was €11 million (1%) over profile at end-June 2017. At the same point in 2018 it was over profile by €42 million (3.5%). As previously noted by the PBO, An Garda Síochána has required a Supplementary Estimate "every year since at least 2004 [...] [largely] to accommodate pay and overtime requirements."[28] Vote 20 Garda Síochána, within the Justice Vote Group, specifically required a Supplementary Estimate of €44.2 million in 2017.[29] There is significant potential as of end-June 2018 for a Supplementary Estimate in respect of the Justice Vote Group in 2018.

Notwithstanding ongoing reductions in unemployment,[30] Employment Affairs and Social Protection expenditure at end-June 2018 is largely on profile at just €8 million over profile (0.1%). At the same point in 2017 Employment Affairs and Social Protection was €56 million (0.6%) under profile. In previous years under profile expenditure in this Vote has been used to fund the payment of the Social Protection 'Christmas Bonus'; however, such 'savings' have not materialised as of yet in 2018. This increases the likelihood that a Supplementary Estimate may be required to fund the payment of the Christmas Bonus in December 2018.

Overall gross voted capital expenditure is under profile by €175 million (8.2%) at end-June 2018. Notwithstanding a year-on-year increase in capital expenditure of €445 million at end-June 2018, it is not clear that additional capacity to progress capital projects exists. A range of constraints in both the public and private sectors such as planning processes, shortages of appropriately skilled construction sector workers, project managers in Government Departments, etc. may contribute to capital projects progressing more slowly than envisaged. If capacity issues are responsible for the under-profile capital expenditure to end-June, it is a cause of concern in the context of the increased expenditure envisioned in future years under the National Development Plan.

28 PBO, *Revised Estimates for Public Services 2018* (February 2018) p.41.

29 *Supplementary Estimates for Public Services* (2017).

30 CSO, *'MUM01'* (July 2018).

Overall balance

The Exchequer Balance (which includes financial transactions which do not impact on the General Government Balance) showed a deficit of €823 million at end Q2, which is €1,279 million lower than the expected deficit of €2,102 million. This was principally due, as detailed above, to significant above profile Central Bank receipts (€581 million above profile), coupled with below profile capital and non-voted expenditure and better than expected overall tax receipts. In addition, there was an unexpected loan repayment that does not impact the General Government Balance.

A more balanced picture is provided by comparing revenue and expenditure excluding transactions with no General Government Balance impact (such transactions affect the Exchequer Balance but not the General Government Balance upon which the fiscal rules are based).

When such transactions are excluded the balance was a deficit of €3,160 million at end Q2 2018, an improvement of €699 million on expectations, however, the deficit was €1,116 million higher than at the end of Q2 2017.

The final outturn of the General Government Balance in 2017 was a deficit of €1,014 million or 0.3% of GDP. The SPU has projected a General Government Deficit of €540 million in 2018. The overall trends on revenue (1.1% over profile) and expenditure (1% below profile) in the *Fiscal Monitor* would suggest that this is achievable or could be bettered. However, there are concerns with expenditure in Health and that more Departments are over profile than at the same time in 2017.

In addition, the continued dependence on above profile Corporation Tax receipts and Central Bank surplus income to achieve deficit targets could suggest that additional expenditure is financed by volatile revenue streams.

The Government in the *Summer Economic Statement* (see Box 6) has stated that notwithstanding the amount available under the fiscal rules a small deficit of €330 million or 0.1% of GDP is the target for 2019.

Box 6: Summer Economic Statement

The 'fiscal space' is the level of financial resources available for additional public expenditure increases and tax reductions in the Budget under EU Fiscal Rules. Revised figures for the fiscal space for 2019 were given in the *Summer Economic Statement 2018* (SES). The fiscal space is derived using the EU Expenditure Benchmark. The Expenditure Benchmark (EB) is a spending rule which limits year-on-year real growth in government expenditure to the medium-term potential growth rate of the economy. A convergence margin is subtracted if a Member State is not at its Medium-Term Budgetary Objective (MTO). For Ireland this is a Structural Balance of -0.5 % of GDP. Discretionary revenue-raising measures (DRM) can be used to increase expenditure growth above the limit set by the EB. The use of an expenditure rule has the potential to mitigate against risks of uncontrolled expenditure increases and/or tax reductions arising in good economic times.

In a very short-time frame, Ireland has transitioned from a situation where the fiscal space was very restricted, to the current situation where the Government has decided not to use all the available fiscal space permitted under the fiscal rules.

The Government's fiscal policy stance was set out in the SES 2018. The Government stated that the use of all available fiscal space (i.e. minimum compliance with the EB) would increase the risk of overheating the economy and it would represent a very pro-cyclical fiscal stance given the current performance of the Irish economy. Consideration was also given to the difficulty of measuring the cyclical position of the economy i.e. the extent to which the economy is overheating, the elevated debt burden and the potential threats to the global economy. As a result, of the €2.2 billion of net fiscal space available (i.e. after accounting for pre-committed expenditure):

- €800 million will be used for new expenditure and tax measures;
- €500 million will be set aside for the Rainy Day Fund;
- €900 million of additional fiscal space will not be used.

As planned in the SES, this fiscal stance will leave €1.4 billion of the fiscal space not spent. The use of all the available fiscal space would increase the deficit by 0.3% of GDP and it would postpone the achievement of the MTO to 2021.

In its *Briefing Paper 6 of 2018*,[31] the PBO highlighted that in the near future the Expenditure Benchmark will stop being a binding rule and it could fail to sufficiently constrain expenditure in good economic times. This is due to pro-cyclical estimates of potential GDP growth feeding into the calculation of the EB and the non-application of the convergence margin (from 2020), given that Ireland is projected to reach its MTO in 2019.

Given that public debt is still high and that the economy is operating close to full capacity and that a looser fiscal stance may cause the economy to overheat, not using all the fiscal space available would seem to be a prudent fiscal and economic stance. Additionally, the PBO notes that a part of the additional available fiscal space is due to increased estimates of Irish potential GDP in the previous year. Given the known distortions in Irish GDP figures (which are used in the calculation of potential GDP), it may not be prudent to fully utilise fiscal space that is calculated using this data.

31 *Potential Output, the Output Gap and Associated Key Issues for Fiscal Policy-making in Ireland.*

Government debt

The National Debt is the net debt incurred by the Exchequer after taking account of cash balances and other financial assets. According to the *National Treasury Management Agency (NTMA)* gross National Debt at the end of June 2018 was €213.42 billion, with the National Debt at €187.49 billion.

The Department of Finance in the 2018 SPU projected that Ireland's gross General Government Debt (GGD) would be €206.3.6 billion or 66.0% of GDP at end-2018. The SPU forecasts significant reductions in the debt-to-GDP ratio over its forecast period and that Ireland's debt-to-GDP ratio will fall below the 60% of GDP threshold of the Debt rule in the preventative arm of the Stability and Growth Pact by 2021.

However, as outlined in previous PBO commentaries, GDP is not an accurate measure of domestic output for the Irish economy and other measures of debt sustainability should supplement the debt-to-GDP ratio. A previous *PBO Quarterly Commentary* has discussed some of these measures in more detail.

Approximately €8.9 billion of Irish Government bonds are due to mature in October 2018. The NTMA has raised €8.34 billion through bond issuance to end-June 2018 with bond auctions due in July and September. Overall, in 2018 the NTMA is expected to borrow between €14 and €18 billion through bond issuance.

Appendix 1: Exchequer Statement (excluding non General Government Balance Impacting transactions) (€ millions)

€m REVENUE	End-June 2018 Outturn	End-June 2018 Profile	Outturn v Profile €m	Outturn v Profile %	End-June 2017 Outturn	Y-on-Y €m	Y-on-Y %
Tax Revenue and Appropriations-in-Aid							
Income tax	9,743	9,651	92	1.0%	9,045	698	7.7%
VAT	7,101	7,170	-69	-1.0%	6,906	195	2.8%
Excise duties	2,471	2,659	-188	-7.1%	2,783	-312	-11.2%
Corporation tax	4,033	3,698	335	9.1%	3,520	513	14.6%
Stamp duties	624	663	-38	-5.8%	464	160	34.5%
Motor Tax	514	525	-11	-2.1%	0	514	n/a
Local Property tax	0	0	0	n/a	299	-299	-100.0%
Customs	146	153	-6	-4.1%	151	-5	-3.3%
Capital gains tax	172	162	11	6.7%	132	40	30.7%
Capital acquisitions tax	93	93	0	0.4%	90	3	3.1%
Other	42	0	42	n/a	25	17	68.2%
PRSI receipts	4,534	4,520	13	0.3%	4,324	209	4.8%
National Training Fund receipts	192	188	4	2.1%	158	34	21.3%
Other Appropriations-in-Aid (including Departmental Balances)	1,111	1,112	-1	-0.1%	1,136	-25	-2.2%
Total Tax Revenue and Appropriations-in-Aid	**30,778**	**30,593**	**185**	**0.6%**	**29,034**	**1,744**	**6.0%**

€m	End-June 2018 Outturn	End-June 2018 Profile	Outturn v Profile €m	Outturn v Profile %	End-June 2017 Outturn	Y-on-Y €m	Y-on-Y %
Non-tax Revenue							
Central Bank Surplus Income	673	559	114	20.4%	952	-279	-29.3%
National Lottery	114	105	9	8.1%	115	-1	-1.2%
Dividends	78	133	-55	-41.2%	111	-33	-29.8%
Other	173	83	90	109.2%	130	43	32.7%
Capital Resources	35	24	11	44.5%	13	22	175.4%
Total non-tax revenue and capital resources	**1,073**	**904**	**169**	**18.7%**	**1,322**	**-249**	**-18.8%**
(A) Total REVENUE	**31,851**	**31,497**	**354**	**1.1%**	**30,356**	**1,495**	**4.9%**
EXPENDITURE							
Gross Voted Current							
Employment Affairs and Social Protection	10,019	10,011	8	0.1%	9,880	139	1.4%
Health	7,634	7,466	168	2.3%	7,028	606	8.6%
Education and Skills	4,596	4,580	16	0.3%	4,281	314	7.3%
Other	5,302	5,426	-124	-2.3%	4,732	570	12.0%
Total Gross Voted Current	**27,551**	**27,483**	**68**	**0.2%**	**25,922**	**1,629**	**6.3%**

€m	End-June 2018 Outturn	End-June 2018 Profile	Outturn v Profile €m	Outturn v Profile %	End-June 2017 Outturn	Y-on-Y €m	Y-on-Y %
Non-Voted Current Primary							
Debt management expenses	91	111	-21	-18.4%	72	19	26.3%
Oireachtas Commission	57	59	-2	-3.2%	53	4	7.8%
EU Budget Contribution	1,397	1,532	-135	-8.8%	1,137	259	22.8%
Other	68	75	-7	-9.3%	56	12	21.7%
Total Non-Voted Current Primary	**1,612**	**1,777**	**-165**	**-9.3%**	**1,318**	**295**	**22.4%**
Gross Voted Capital							
Transport, Tourism and Sport	410	427	-17	-3.9%	330	79	24.0%
Education and Skills	322	360	-38	-10.6%	280	42	14.9%
Housing, Planning and Local Government	524	546	-22	-4.0%	312	212	67.9%
Other	712	810	-98	-12.1%	600	112	18.7%
Total Gross Voted Capital	**1,968**	**2,143**	**-175**	**-8.2%**	**1,523**	**445**	**29.2%**
Interest on National Debt	**3,879**	**3,953**	**-74**	**-1.9%**	**3,637**	**241**	**6.6%**
(B) Total EXPENDITURE	**35,010**	**35,356**	**-346**	**-1.0%**	**32,400**	**2,611**	**8.1%**
(C) = (A-B) Balance excluding transactions with no general government impact	**-3,160**	**-3,859**	**699**	**18.1%**	**-2,044**	**-1,116**	**-54.6%**

Note: The main transactions with no general government impact are not listed in this table. Their removal allows better visibility of the day-to-day receipts into and expenditure from the Exchequer account. See Appendix 2 for these transactions. Comparisons of revenue between 2017 and 2018 are affected by making Motor Tax an Exchequer tax in 2018 with Local Property Tax going directly to the Local Government Fund.

Appendix 2: Exchequer transactions with no General Government Balance Impact (€ millions)

€m	End-June 2018 Outturn	End-June 2018 Profile	Outturn v Profile €m	Outturn v Profile %	End-June 2017 Outturn	Y-on-Y €m	Y-on-Y %
(A) Balance excluding transactions with no general government impact	**-3,160**	**-3,859**	**699**	**18.1%**	**-2,044**	**-1,116**	**-54.6%**
Central Bank Surplus Income (No GG impact)	1,428	961	467	48.6%	884	544	61.6%
Feoga	740	780	-40	-5.1%	770	-30	-3.9%
Loan Repayments	193	20	173	866.4%	181	13	6.9%
AIB Share Sale Receipts	0	0	0	-	2,986	-2,986	-100.0%
Other	1	1	0	-35.7%	9	-9	-93.6%
(B) Revenue	**2,362**	**1,762**	**600**	**34.1%**	**4,830**	**-2468**	**-51.1%**
Transfer of LPT receipts to Local Government Fund	12	0	12	n/a	293	-281	-95.8%
Other	9	2	7	324.7%	2	7	400.0%
(C) Expenditure – Non Voted Current	**21**	**2**	**19**	**909.8%**	**295**	**-274**	**-92.9%**
Other	4	2	2	82.7%	6	-1	-25.9%
(D) Expenditure – Non Voted Capital	**4**	**2**	**2**	**82.7%**	**6**	**-1**	**-25.9%**
(E) = (A + B – C – D) EXCHEQUER BALANCE	**-823**	**-2,102**	**1,279**	**60.8%**	**2,485**	**-3,308**	**-133.1%**

Contact: *PBO@oireachtas.ie*
Go to our webpage: *www.Oireachtas.ie/PBO*
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Houses of the Oireachtas
Leinster House
Kildare Street
Dublin 2
D02 XR20

www.oireachtas.ie
Tel: +353 (0)1 6183000 or 076 1001700
Twitter: @OireachtasNews

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