Preliminary Analysis of the Stability Programme Update 2019

PBO Publication 21 of 2019 – European Semester series

Introduction

The Government published the draft Stability Programme Update 2019 (SPU) on 16 April 2019 – this year’s SPU is a 71-page document set out in eight sections which include a total of sixty tables, figures, boxes and annexes. The SPU is Ireland’s national medium-term fiscal plan, and includes the Department of Finance’s updated economic and fiscal forecasts out to 2023. This document will be submitted to the European Commission by 30 April 2019 in accordance with the requirements of the European Semester.

A key fiscal policy objective outlined in the SPU is the pursuit of prudent budgetary policy in good economic times, in order to build-up fiscal buffers that can be relied upon in the event of a downturn. In addition, reducing the elevated burden of public debt remains a policy objective.

In this Note, the PBO identifies key issues arising from the SPU that can affect the Government’s fiscal policy objectives. It also summarises some of the main aspects of the SPU 2019 and focusses on key changes from the previous forecasts (i.e. those contained in Budget 2019).

SPU 2019 also contains a number of boxes, including information on: the inversion of the yield curve in the US, the possibility of a disorderly Brexit, and fiscal heat maps.

Key Issues as identified by the PBO

An appropriate fiscal stance is critical to counter the risk of overheating.

Estimates of the output gap, produced using the Department of Finance’s alternative approaches to the European Commission’s harmonised methodology, indicate that the Irish economy will be at risk of overheating beyond 2019.

The Irish economy experienced strong growth in 2018 (with a 6.7% annual increase in real GDP), and robust and broad-based growth is projected to continue into 2019 and 2020. The economy is approaching full employment and unemployment stands at 5.4% in March 2019. Skills shortages have also become apparent in certain sectors and are exacerbated by housing supply constraints, which inhibit the mobility of labour. These constraints place upward pressure on prices and wages, and risk contributing to overheating. Overheating could also be exacerbated by a stronger-than-expected housing supply response.

With Irish growth expected to outpace the euro area, it is unlikely that monetary policy will serve domestic interests and assist in dampening overheating pressures (the ECB has indicated that monetary policy normalisation is unlikely before 2020).

In light of this, the PBO continues to emphasise the importance of counter-cyclical fiscal policy in alleviating the pressures of overheating. On the basis of Finance’s estimates of the Structural Balance (based on its own output gap estimates), the fiscal stance can be assessed to be expansionary in 2018/2019 due to the dis-improvement in the Structural Balance (from 0.4% in 2018 to 0.1% in 2019). Over the period 2019-2023, annual average growth in General Government Expenditure (3%) is expected to be lower than average annual growth in General Government Revenue (4.1%). However, expenditure projections beyond 2019 may not be realistic, taking account of historical patterns of expenditure overruns, and revenue projections should be read in the context of revenue sustainability concerns (e.g. the volatility and sustainability of Corporation Tax receipts in particular).

The relatively high level of indebtedness limits the Government’s room for movement in the event of a future downturn. The pursuit of counter-cyclical fiscal policy would allow the Government to build-up fiscal buffers (e.g. using a rainy day fund) which could be deployed (subject to the constraints of the EU fiscal rules) in the event of a downturn.

A disorderly Brexit remains a possibility, but the likelihood of a no-deal has decreased in the short-term.

An orderly Brexit remains the central scenario underpinning the macroeconomic and fiscal forecasts included in SPU 2019. The short-term risk of a disorderly Brexit has subsided following the European Council summit in April (wherein the European Commission agreed to extend the Brexit deadline until 31 October 2019, at the latest), and it is now less likely that the UK will leave the EU without a deal before that date. Nevertheless, if a disorderly Brexit should transpire, this
could lead to lower than expected tax revenues for 2019 and beyond, and stronger than anticipated expenditure pressures.

Budget 2019 did not contain a sensitivity analysis of the likely impact of a disorderly Brexit on the Government’s fiscal forecasts. SPU 2019 does contain the results of an analysis by the ESRI/Department of Finance, detailing the impact of various Brexit scenarios on the economy and the General Government Balance. While this is a welcome development, a greater level of detail on the impact of a disorderly Brexit scenario on revenue and expenditure projections would facilitate greater budgetary oversight by the Houses of the Oireachtas.

Due to the recurrent pattern of expenditure overruns in recent years, spending projections may not be realistic.

The current projections do not include any provision for overspending in 2019. As noted in the PBO’s latest Quarterly Economic and Fiscal Commentary (Q1 2019), the data available so far in 2019 is relatively consistent with the position at the same time in 2018, which suggests that the pattern of expenditure overruns seen in 2018 may recur in 2019. This is of particular concern in relation to the Health Vote Group which had recourse to a very significant Supplementary Estimate in 2018 and expenditure in respect of which, at Q1 2019, is broadly in line with the position in Q1 2018. As the SPU notes therefore, it is “imperative that Departments continue to manage expenditure in-line with profile”. However, in the case of many Vote Groups, expenditure pressures typically increase in Q3 and Q4 and the current situation (where expenditure is close to profile) is therefore potentially a matter of concern.

The SPU 2019 also states that Voted expenditure over 2020-2023 is largely unchanged from Budget 2019 and that the gross current expenditure shows an average increase of 2.5% or €1.5 billion. Between 2001 and 2019 (which includes the period of the economic and fiscal crisis) the average growth rate of Gross Voted Expenditure was 5.3%.

Corporation Tax accounts for a higher share of tax revenue than in the history of the State.

Corporation Tax (CT) receipts have surged in recent years to become the third largest category of tax for the State (accounting for 18.7% of Exchequer tax receipts in 2018, and almost €10.4 billion). At end-March 2019, CT receipts were €267 million or 103.8% above profile, outweighing the cumulative below-profile performance of other tax heads in Q1 2019.

These receipts are inherently volatile and strongly impacted by external factors, making them harder to predict, which can complicate fiscal planning. Research from the PBO shows that forecasts of CT revenue have been the least accurate of the largest tax categories; receipts have tended to be above forecasts since 2012, showing the effect of positive revenue “surprises” or so-called “windfall” receipts.

The PBO has previously warned against the use of unexpected or windfall tax revenues to fund permanent expenditure or tax reductions. Prudential fiscal policymaking would instead involve using surprise revenues from a volatile tax head to capitalise a counter-cyclical fund that would then be used to fund expenditure when that volatile revenue fails to materialise in future years.

CT receipts are concentrated in a small number of foreign-owned multi-national corporations (MNCs), with data from the Revenue Commissioners indicating that (as of end-2017) ten tax-payers account for almost 40% of all receipts, and foreign-owned MNCs account for almost 80% of all receipts.

This level of concentration exposes a substantial proportion of Exchequer revenue to firm- and sector-specific shocks, and to international factors that are largely beyond domestic control (e.g. efforts to harmonise international CT policy such as BEPS 2, and tax competition from abroad). The Irish Fiscal Advisory Council (IFAC) report that just one large firm leaving Ireland would reduce revenues by over €330 million, due to the loss in CT alone.

As detailed in SPU 2019, the PBO would highlight that, of the €800 million over-performance in CT revenue for 2018, the decision was taken to include €500 million of this into the tax forecast for 2019 onwards.

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1 See PBO publication 2- of 2019, pp. 26-27.
2 Parliamentary Budget Office, Quarterly Economic and Fiscal Commentary – Q1 2019, April 2019.
3 Ibid.
Limited progress has been made in broadening the tax base, and revenue sustainability remains a key concern.

The economy faces a number of downside risks which, if they were to materialise, could have a severely negative fiscal impact (e.g. a disorderly Brexit, negative developments in the global economy etc.).

Prudential fiscal policy-making would suggest that it is desirable to have a broad tax base, focused on sustainable revenue sources. Not only is the Corporation Tax base heavily dependent on a small number of foreign-owned MNCs (as previously discussed), but their employees are also responsible for approximately 24% of all Income Tax/USC/PRSI revenue. Similarly, Income Tax shows a significant degree of concentration with 13% of total Income Tax units (those with gross income above €70,000) accounting for 64% of total Income Tax paid (including USC) in 2016.

Budget 2019 contained no changes in carbon, fuel or motor taxes, with only a minor change related to Vehicle Registration Tax (VRT) on diesel cars. While these taxes do present an opportunity to broaden the tax base, they pose a long-term challenge for the stability of the revenue base. A significant fraction of tax revenues come from the transport sector (i.e. excise duty on fossil fuels, carbon tax, VRT, etc.). This is estimated to be nearly 10% of total tax revenues. This revenue is likely to decline over time, in line with behavioural changes and the adaption of green technologies, potentially leaving a sizeable gap in Exchequer revenue.

Furthermore, on the issue of broadening the tax base, the Minister for Finance announced on 3 April 2019 that the revaluation date for the Local Property Tax would be deferred by one year, from November 2019 to November 2020.

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Macroeconomic forecasts

The SPU sets out the Department of Finance’s updated economic forecasts for 2019-2023. IFAC has endorsed the Department of Finance’s macroeconomic projections as being within the range of appropriate forecasts. Real GDP is projected to be 3.9% in 2019 and 3.3% in 2020. These forecasts were revised downwards compared to Budget 2019 (from 4.2% and 3.6% respectively).

Table 1 overleaf some of the key macroeconomic and fiscal variables in the report. Some notable aspects of the economic forecasts include:

- **Employment** is projected to grow by 2.2% or 50,000 persons in 2019. This is down from 2.9% or 63,000 persons in 2018;
- **Unemployment** is plateauing, with the unemployment rate projected to fall to 5.4% in 2019 and 5.2% in 2020;
- **Personal consumption** is expected to increase by 2.7% in 2019 and 2.5% in 2020, revised downwards from Budget 2019 (from 3.0% in 2019 and 2.6% in 2020);
- **Investment** is expected to increase by 6.9% in 2019 and 5.5% in 2020, revised downwards from Budget 2019 (from 7.1% in 2019 and 5.7% in 2020);
- **Wage growth** (compensation per employee) is expected to be 3.0% in 2019 and 3.2% in 2020, generally in line with Budget 2019 projections;
- Since Budget 2019, growth forecasts for 2019 have been revised downwards by the Department of Finance and the ESRI (from 4.5% to 3.8%). Conversely, forecasts were revised upwards by the IMF, the European Commission (both from 4.0% to 4.1%), and the OECD (from 2.9% to 4.1%). The Central Bank of Ireland’s growth forecast was unchanged.

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7 For a more detailed analysis of these risks, see Parliamentary Budget Office, Quarterly Economic and Fiscal Commentary – Q1 2019, April 2019.
10 Edgar Morgenroth in Committee on Budgetary Oversight debate on ’Environmental Impact of Fiscal Instruments: Discussion’, Tuesday, 8 May 2018.
Table 1: Selected Macroeconomic Variables (% change unless stated)

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>6.7</td>
<td>3.9</td>
<td>3.3</td>
<td>2.4</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Real GNP</td>
<td>5.9</td>
<td>3.7</td>
<td>3.1</td>
<td>2.2</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Labour Market</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Employment ('000)</td>
<td>2,259</td>
<td>2,309</td>
<td>2,357</td>
<td>2,393</td>
<td>2,432</td>
<td>2,474</td>
</tr>
<tr>
<td>Unemployment (per cent)</td>
<td>5.7</td>
<td>5.4</td>
<td>5.2</td>
<td>5.3</td>
<td>5.2</td>
<td>5.1</td>
</tr>
<tr>
<td>Prices</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HICP</td>
<td>0.7</td>
<td>0.9</td>
<td>1.1</td>
<td>1.6</td>
<td>2.0</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: PBO based on Draft Stability Programme Update 2019

- Relative to the Government’s autumn forecast, Euro-area and US growth forecasts have been revised downwards in the short-to-medium term. For the UK, while short-term growth forecasts have been revised downward, medium-term growth forecasts are unchanged;

- Both inflation, as measured by the Harmonised Index Consumer Price (HICP) and core HICP (excluding the volatile components of unprocessed food and energy), for this year and for the short-to-medium period are lower than the figures projected in Budget 2019;

- The US dollar is projected to strengthen compared to Budget 2019 (€1 = $1.13 vs €1 = $1.16), as is UK sterling (€1 = £0.86 vs €1 = £0.89);

- Oil price projections (based on Futures’ markets) are lower than Budget 2019 forecasts ($65.3 vs $74.7);

- Trade balance figures are expected to contribute to GDP in 2019 and 2020 at a significantly lower rate than the Budget 2019 projections, due to a slowdown in global growth and expansion of domestic demand.

Overall, the short-term outlook is positive, however the balance of risk is firmly tilted to the downside over the medium-term.

Fiscal Developments

The Exchequer balance is expected to deteriorate by €2.2 billion between 2018 and 2019, from a €0.1 billion surplus to a €2.1 billion deficit. The Stability Programme Update states that this is “due inter alia to the continued expansion of capital investment under the 2018-2027 National Development Plan and the project €0.5 billion contribution from the Exchequer to the Rainy Day Fund this year.” However, this is a simplification of the development of the Exchequer Balance between 2018 and 2019, as a wide range of areas impact upon the changing Exchequer position in 2019:

- Voted Current Expenditure is expected to rise by €2.2 billion;

- Voted Capital Expenditure is expected to increase by €1.3 billion;

- The replacement of Irish Water’s commercial debt with state funded debt will cost €1.1 billion (Non-Voted Capital Expenditure); and

- The foregoing expenditure growth is offset by a €2.8 billion increase in Exchequer Revenue.

Table 2 shows the changes in the General Government Revenue, Expenditure and Balance from Budget 2019 in the Draft Stability Programme Update 2019. Changes to General Government Revenue and General Government Expenditure have an inverse impact on the Balance: increases in Revenue improve the Balance, while increases in Expenditure cause it to deteriorate and vice versa. One of the key changes in General Government Revenue between the two documents is the decision to include €500 million (of €800 million over-performance) in Corporation Tax in the tax base for 2019. This revision is described as a “technical upward revision”, however it results in an increase in tax revenue of €500 million in 2019, and remains (substantially) in the base from 2020 onwards, as shown in Table 2.

12 Ibid, p. 22.
In the medium-term, the SPU projects that General Government Revenue will rise significantly year-on-year out to 2023. However, General Government Expenditure is not expected to rise at the same rate, which leads to a significant improvement in the General Government Balance by 2023. Between 2019 and 2023, General Government Revenue is projected to grow by 4.1% on average, while General Government Expenditure is projected to grow by 3% on average. Under Voted Expenditure specifically, the SPU 2019 states that it will have “an average annual increase of 2.5 per cent”. However, between 2001 and 2019 (which includes the period of the economic and fiscal crisis) the average growth rate of Gross Voted Expenditure was 5.3%.

In addition, the pre-committed costs include an allocation for demographics, the existing projections for which are being reviewed as part of Spending Review 2019.

Structural budget balance

As Table 3 below shows, there have been large changes to the estimated Output Gap since Budget 2019, and this has the effect of changing the path of the Structural Balance significantly. According to the European Commission’s methodology, the Structural Balance worsens in almost all years within the forecast window, with the achievement of the MTO still projected for 2020. However, the MTO (-0.5%) is expected to be achieved with a margin of 0.1% of GDP, which leaves the achievement of the MTO exposed to Voted expenditure pressures (which were equal to 0.4% of GDP in 2018).

The Structural Balance is estimated differently by the Department of Finance, who assess Ireland to already be at the MTO (on the back of lower estimates of the Output Gap). However, for assessment of compliance with the EU fiscal rules, the Commission’s own estimates are used.

Government Debt

The Draft Stability Programme Update 2019 revises the projections for the General Government Debt. The Debt-to-GDP ratio is projected fall under the 60% threshold during 2020, and remain below the threshold level out to 2023. However, while the absolute level of debt is decreased from 2018 to 2020, it is projected to return to 2018 levels by 2023. The debt burden remains high; the GNI* projections imply a ratio of 107.3% in 2018, declining to 86.7% by 2023.

Table 2: Change in General Government Position, Budget 2019 to SPU 2019, (€ millions)

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Government Revenue</td>
<td>+1,205</td>
<td>+720</td>
<td>-65</td>
<td>-365</td>
<td>-580</td>
<td>-315</td>
</tr>
<tr>
<td>Corporation Tax</td>
<td>+780</td>
<td>+500</td>
<td>+475</td>
<td>+445</td>
<td>+435</td>
<td>+435</td>
</tr>
<tr>
<td>General Government Expenditure</td>
<td>+840</td>
<td>+35</td>
<td>-240</td>
<td>-1,285</td>
<td>-200</td>
<td>150</td>
</tr>
<tr>
<td>General Government Balance</td>
<td>+360</td>
<td>+685</td>
<td>+170</td>
<td>+915</td>
<td>-380</td>
<td>-460</td>
</tr>
</tbody>
</table>

Source: Department of Finance, Draft Stability Programme Update 2019 and Budget 2019: Economic and Fiscal Outlook.

Table 3: Structural Indicators, Budget 2019 to SPU 2019 (% GDP unless stated).

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structural balance (SPU 2019)</td>
<td>-1.6</td>
<td>-1.1</td>
<td>-0.4</td>
<td>0.2</td>
<td>0.7</td>
<td>1.3</td>
</tr>
<tr>
<td>Output Gap (p.p. change)</td>
<td>+1.9</td>
<td>+1.2</td>
<td>+1.0</td>
<td>+0.6</td>
<td>+0.3</td>
<td>-</td>
</tr>
<tr>
<td>Structural budget balance (p.p. change)</td>
<td>-0.6</td>
<td>-0.4</td>
<td>-0.4</td>
<td>-</td>
<td>-0.3</td>
<td>-0.1</td>
</tr>
</tbody>
</table>

Source: Department of Finance, Draft Stability Programme Update 2019 and Budget 2019: Economic and Fiscal Outlook.

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13 Department of Finance, Draft Stability Programme Update 2019, p. 25.
14 PBO Calculation based on Department of Public Expenditure and Reform Databank.
Macro-Fiscal Risks

The SPU contains virtually no change to the risks identified in Budget 2019; though global financial market conditions are no longer included as a macroeconomic risk, while tax forecast and payment timeline asymmetry is no longer included as a fiscal risk. In addition, the impact of an overheating economy has been revised upward, from medium to high (while the probability is unchanged).

Brexit, and the surrounding political uncertainty in the UK in Q1 2019, have contributed to renewed volatility in the euro-sterling exchange rate. The SPU notes that as the rate approaches parity (the rate as of end-March 2019 was €1 = £0.86), this poses serious disruption for the economy, with UK-bound exports becoming more expensive, resulting in negative effects on output and employment (particularly for sectors involved in agri-food, tourism, and cross-border trade).

The risk presented by an external demand shock has been updated to acknowledge the greater than expected slow down in global growth. The SPU’s sensitivity analysis predicts that a 1% deterioration in global demand would reduce Irish growth by 1% after five years, relative to current demand (with knock-on effects for employment and the debt-to-GDP ratio).

In terms of macroeconomic imbalances, the SPU identifies: the large current account surplus, the net international investment position, and private sector debt, as potential imbalances in the Irish economy. However, it notes that all three measures are distorted by the activities of MNCs, and when these activities are accounted for, may be less significant than expected.

Table 4: Government Debt Projections

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross debt (€ billions)</td>
<td>206.2</td>
<td>205.1</td>
<td>196.7</td>
<td>203.6</td>
<td>203.5</td>
<td>206.0</td>
</tr>
<tr>
<td>Debt ratio (% GDP)</td>
<td>64.8</td>
<td>61.1</td>
<td>55.8</td>
<td>55.4</td>
<td>53.2</td>
<td>51.6</td>
</tr>
<tr>
<td>Debt ratio (% GNI*)</td>
<td>107.3</td>
<td>101.7</td>
<td>93.0</td>
<td>92.7</td>
<td>89.2</td>
<td>86.7</td>
</tr>
</tbody>
</table>

Source: Department of Finance, Draft Stability Programme Update 2019

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