Summary of Pre-Budget 2018 Commentary

As its first publication, the new Parliamentary Budget Office (PBO) of the Houses of the Oireachtas produced a short commentary on Budget 2018 for Dáil Éireann's Committee on Budgetary Scrutiny. This commentary is available on the Oireachtas website www.oireachtas.ie.

Medium Term Budgetary Objective (MTO), Expenditure Benchmark and Fiscal Space

Ireland has targets and objectives to meet under European and domestic fiscal rules. One of these is the Medium Term Budgetary Objective (MTO). The MTO is a budgetary target, set by EU Member States and agreed with the European Commission, for the underlying Government Budget position, exclusive of cyclical or temporary tax receipts/expenditure (i.e. in structural terms). For Ireland, the MTO is to achieve a structural budget balance at or below -0.5% of GDP. To meet the MTO in 2018, Ireland must make a fiscal effort of +0.7% of potential GDP. The Government is committed to achieving the MTO in 2018.

However, the structural budget balance is calculated based on an estimation of the (cyclically adjusted) output gap. The **output gap** is the difference between actual and potential economic output as measured by GDP. **Potential GDP** is defined as the level of output an economy can produce at a constant inflation rate. It is widely acknowledged that the European Commission's Common Agreed Methodology (CAM) for the calculation of the output gap is not particularly suitable for Ireland. The Department of Finance bases fiscal policy on its own calculation of the output gap using the CAM. The Department of Finance in the *Stability Programme Update* estimates the output gap for Ireland in 2017 at 1.4% of potential GDP.

If a country is **not** at its MTO, the Expenditure Benchmark (which limits the growth of Government expenditure as part of the EU fiscal rules) includes a convergence margin which reduces the flexibility available to the Government for new taxation and expenditure measures. This flexibility is known as the **Fiscal Space**.

The calculation of the output gap is central to the amount available as Fiscal Space in 2018. Other bodies such as the IMF and OECD use alternative methodologies to that employed by the European Commission and have widely different estimates of the output gap. ***If*** Ireland ***was*** at its MTO, the convergence margin of the Expenditure Benchmark would ***not*** apply and permitted expenditure growth would be 4.7%, not the 2.4% set out in the Government's *Summer Economic Statement*. This would imply a gross fiscal space of €3.3 billion (not €1.7 billion) and net fiscal space of €2.9 billion (not €1.3 billion).

Overheating

While few commentators (with the exception of the OECD) suggest that the economy is overheating, various economic commentators including the Economic and Social Research Institute (ESRI) and the Irish Fiscal Advisory Council (IFAC) have suggested that Ireland should, in effect, have a neutral budget in 2018.

Use of Fiscal Space

The *Summer Economic Statement* estimates that the gross Fiscal Space in 2018 will be €1.7 billion. However, when certain pre-commitments and carryover costs are provided for, there is approximately €530 million of fiscal space uncommitted. This does not include the cost of the new Public Service Stability Agreement 2018–2020 which is estimated at €180 million in 2018.

The Government has stated that it wishes to reduce the tax burden on middle income earners. It has focussed on widening the income tax bands. Currently, approximately €220 million in fiscal space is apportioned to taxation measures. The Revenue Commissioners have calculated that increasing the single person standard rate band by €1,000, with a similar increase for married couples (both one and two earner couples), would cost €175 million in the first year and €202 million in a full year. Those currently on the lower rate of income tax would not benefit.

Contingency Reserve/Rainy Day Fund

The Government announced a Contingency Reserve and Rainy Day Fund (two related but different concepts) in the *Summer Economic Statement 2016*.

The Contingency Reserve would appear to constitute a 'current account', which can be drawn upon in-year and, if not drawn down or not drawn down in its entirety, would be 'deposited' in the Rainy Day Fund for use in future years as appropriate. A balance would accumulate in the fund, the scale of which would depend upon what amount is ultimately set aside as a contingency each year and how much of that is ultimately deposited in the fund at year-end.

The size of the contingency (to be implemented in 2019) was reduced from €1 billion per annum to €500 million in the *Summer Economic Statement 2017*. There is little other information on how the Contingency Reserve and Rainy Day Fund will work and no proposed legislation establishing such a Fund appears in the Autumn legislative programme. However, the Minister for Finance, and Public Expenditure and Reform confirmed to the Committee on Budgetary Oversight on 27th September 2017 that a consultation paper in relation to the Rainy Day Fund will be sent to the Oireachtas shortly.

Exchequer pay bill

The exchequer pay bill is expected to increase sharply over the next few years. If the rate of increase in staff numbers continues to be in the region of 2% per annum, and pay increases are implemented as set out in the public service agreements, the overall pay bill could increase by 4%-6% per annum over the period 2018 to 2020. This would be in the region of €650 million to €1 billion per annum. How this projected increase is sustainable in the medium term without countervailing measures is open to question.

Corporation Tax receipts

The recently published Review of *Ireland's Corporation Tax Code*, undertaken by Mr Seamus Coffey (the 'Coffey Report'), acknowledges that Corporation Tax receipts may be sustainable at a new higher level at least in the medium term to 2020. However, the inherent volatility of Corporation Tax receipts will remain and some of the factors that led to the 2015 level shift could unwind individually. In this context the report advises caution in terms of introducing permanent increases in spending or reductions in taxation.

Contribution to the EU Budget

In the medium-term Ireland is likely to increase its contribution to the EU Budget. This is a result of Brexit and other factors such as the increase in Gross National Income (which determines a large share of a country's contribution). There is limited information available on how Ireland's contribution to the EU Budget will evolve in the medium term but the increase in Ireland's net contribution is likely to be significant.

Comprehensive Review of Expenditure

A Spending Review of current expenditure has been carried out in advance of Budget 2018. The economic and fiscal backdrop has changed since the two previous reviews of expenditure in the current round were conducted. The purpose of the review has therefore now progressed from making fiscal reductions to improving efficiency and effectiveness by evaluating the bulk of Government expenditure. Budget 2018 will be an opportunity to examine if the lessons from the Spending Review are incorporated into Government expenditure decisions.

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