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Séanadh

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Contents

Introduction	2
Summary	3
Latest macro-economic developments	5
Economic growth	5
Other economic indicators	6
Macroeconomic risks	7
Fiscal developments 2017	9
Taxation and other revenue	9
Overall expenditure	11
Overall balance	15
Commentary	16
Summary of Pre-Budget 2018 Commentary for the Committee on Budgetary Scrutiny	18

Introduction

This is the first quarterly Economic and Fiscal Commentary by the Parliamentary Budget Office (PBO) of the Houses of the Oireachtas. It is envisioned that, at the start of each new quarter, this publication will be used to update Members on the main macro-economic and fiscal developments that have emerged over the previous quarter. It will also indicate how these developments may affect the achievement of budgetary targets in the current and future years.

The PBO is in the initial stages of its establishment. It is envisioned that over the next few months additional staff will be recruited and the services that the PBO provides will be developed.

This first commentary is based on providing a general description and summary of recently published data by the Department of Finance, the Central Statistics Office and other relevant bodies. It is anticipated that, as the PBO is established additional analysis will be included in future quarterly commentaries and that the format may change accordingly.

The PBO produced a short commentary on Budget 2018 for Dáil Éireann's Committee on Budgetary Scrutiny as part of their pre-Budget 2018 deliberations. The full commentary produced for the Committee is available on the Oireachtas website at <http://www.oireachtas.ie/parliament/about/parliamentarybudgetoffice/>. A summary has also been included in this document.

Annette Connolly

Director of the Parliamentary Budget Office

5th October 2017

Summary

Macro-economic developments

The latest quarterly figures would suggest that the growth in the first half of 2017 is compatible with the current projections of GDP growth in respect of 2017 and 2018 made by various bodies. However, it should be noted that Quarterly GDP and GNP spiked in Q4 2016 (even adjusting for seasonal factors) and quarterly GDP and GNP in both quarters of 2017 are below Q4 2016 levels. Thus, strong quarterly growth in Q3 and Q4 will be required if the full year growth forecasts are to be met. Most other economic indicators for Ireland (employment, retail sales etc.) also show that the economy continues to perform strongly in 2017.

Notwithstanding that the Irish economy is growing at a reasonable rate and that most of the main economic indicators are performing strongly, this does not mean that the economy does not face risks. The main economic risks facing the economy can be categorised under:

- Brexit and associated exchange rate movements.
- Global economic demand.
- Domestic economic risks such as the housing market and competitiveness.

Fiscal developments

Revenue

Cumulative government revenue (excluding transactions with no general government impact) to end-Q3 was €43.8 billion which was €216 million or 0.5% under profile. Government revenue at end-Q3 2017 was €2.0 billion or 4.8% above the end-Q3 2016 figure.

There were a number of additional transactions which also contribute revenue to the Exchequer but do not impact the General Government Balance. These include the AIB share transaction of €3,434 million and other Central Bank of Ireland surplus income of €884 million.

Three of the main tax heads were significantly (in absolute terms) under profile at end-September:

- Income tax receipts of €13,605 million were 1.4% (€188 million) below profile.
- Excise duties' receipts of €4,216 million were 2.7% (€116 million) below target.
- Stamp duties are well below profile with a shortfall of €98 million or 11.9%.

On the other hand, cumulative Corporation Tax receipts at end-Q3 were 3.8% or €169 million above profile and up 12.3% (€511 million) in annual terms.

Expenditure

Gross expenditure (Voted Current, non-Voted Current, Voted Capital and interest on the national debt) was €47,539 million at end-Q3 2017 and €677 million below profile. However, gross expenditure is up €1,601 million or 3.5% over the same period in 2016.

Gross voted **current** expenditure of €39,149 million was €119 million (0.3%) below target up to end Q3 but up €1,435 million (3.8%) year-on-year. For most Government Departments gross voted current expenditure was below profile. The most notable Departments with below profile gross current expenditure for the year to end-Q3 (in absolute terms) were:

- Department of Social Protection, €67 million or 0.5% below profile;
- Department of Housing, Planning, Community & Local Government, €65 million or 10.7% below profile;
- Department of Children and Youth Affairs, €60 million or 6.2% below profile;
- Department of Defence, €27 million or 4.3% below profile.

The only exceptions were:

- Department of Health, €166 million or 1.6% ahead of profile; and
- Department of Justice & Equality, €22 million or 1.2% ahead of profile.

At end-Q3 year to date Gross voted capital expenditure of €2,517 million was €155 million (5.8%) below profile and €395 million (18.6%) ahead in year on-year terms.

Capital expenditure in the Department of Housing, Planning, Community and Local Government is €96 million (26.1%) ahead of profile, driven by increased spending on the housing programme.

By its nature, capital expenditure can be irregular and it can be difficult to profile correctly. However, there are also a large number of Departments where capital expenditure is significantly below profile and it is unclear whether or not this is significant in terms of whether or not projects will be completed to plan.

Overall, the Exchequer balance at end-Q3 (excluding transactions with no General Government impact) showed a €506 million improvement over profile.

The Irish Fiscal Advisory Council (IFAC) has advised that additional in-year spending measures for 2017 would not be advisable and has warned that, “considering that the rules already risk being breached this year, a further relaxation of the stance for 2017 would not be appropriate.”

However, there appears to be a risk that additional in-year spending measures for 2017 will collectively increase the overall level of Voted expenditure, notwithstanding underspends in specific Votes. The main areas where the risk of additional expenditure could arise and lead to that situation include the Department of Health and the Department of Housing, Planning and Local Government.

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, as well as providing 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 by 5.2% in 2016. The globalised nature of the Irish economy means that GDP is less useful as a measure of domestic economic activity. However, other measures of economic activity such as Gross National Product (GNP), Gross National Income (GNI) and the new modified Gross National Income (GNI*) also grew strongly in 2016.

The CSO's *Quarterly National Accounts Quarter 2 2017* were published on 15 September 2017. The most notable developments in this release include:

- GDP increased by 1.4% in Q2 2017 (over Q1 2017) on a seasonally adjusted basis.
- GNP decreased by 4.6% over the same period.
- GDP increased by 5.8% year-on-year (GNP was 1.4% lower year-on-year).
 - Personal consumption was up 1.7% year-on-year.
 - Investment was down 8.8% year-on-year.
 - Exports were up 3.2%.
 - Imports were down 3.6%.
 - Net payments to the rest of the world (net factor income outflows) were up 41.3% which accounts for the difference between year-on-year GDP growth and the fall in GNP.
 - Strong year-on-year growth in the quarter was recorded for the Agriculture, Forestry and Fishing (+15.7%) and the Information and Communication (+21.0%) sectors.
- Modified domestic demand, an indicator from the CSO that strips out some activities of multinational companies (R&D and aircraft leasing) to get a better statistic on underlying spending and output in the domestic economy grew at 4.5% in the quarter. This was a recovery from the -5.6% recorded in Q1 (though much of the difference is due to the value of physical changes in stocks rather than changes in personal consumption, Government consumption, or investment).

Table 1: Current forecasts of GDP growth

GDP Forecasts	Date	2017	2018
European Commission	May 2017	4.0	3.6
Department of Finance	Apr 2017	4.3	3.7
Central Bank of Ireland	Jul 2017	4.5	3.6
IMF	Jun 2017	3.9	3.3
ESRI	Oct 2017	5.0	4.0
OECD	Jun 2017	3.7	2.5

Source: Department of Finance (2017) Monthly Economic Bulletin September 2017.

Table 1 shows the current projections of GDP growth by various bodies for 2017 and 2018. The latest quarterly figures would suggest that the growth in the first half of 2017 is compatible with these projections. However, quarterly GDP and GNP spiked in Q4 2016 (even adjusting for seasonal factors) and quarterly GDP and GNP in both quarters of 2017 are below Q4 2016 levels. Thus, strong quarterly growth in Q3 and Q4 will be required if the full year growth forecasts are to be met.

The Department of Finance will publish updated forecasts with Budget 2018. It is these forecasts, which were endorsed by the Irish Fiscal Advisory Council (on 4 October), that the Budget is based on.

Other economic indicators

Most economic indicators for Ireland show that the economy continues to perform strongly in 2017. A non-exhaustive list of relevant indicators includes:

- **Employment:** The Quarterly National Household survey showed that in Q2 2017 the total number employed increased to 2,063,000, an increase 48,100 (or 2.4%) over Q2 2016.
- **Unemployment rate:** In September 2017 the monthly unemployment rate was estimated at 6.1%, with 133,200 persons classified as unemployed. This was 31,600 fewer persons unemployed than a year earlier.
- **Retail sales:** Retail sales, in volume terms, excluding the motor trade increased 6.7% year-on-year terms in August.
- **Services index:** The seasonally adjusted monthly services value index fell by 6.3% in August 2017 when compared with July 2017, while in the year to August 2017 there was a decrease of 1.9%. The fall was driven by a contraction in the Information and Communication sector.
- **Industrial production index:** The seasonally adjusted volume of industrial production for Manufacturing Industries for June to August 2017 was 1.6% lower than in the preceding three month period. The Turnover index was down 3.1% over the same period.
- **Average earnings:** In Q2 2017 the preliminary estimates for average weekly earnings were 2.2% higher than in the same period in 2016.
- **Inflation:** Ireland's inflation rate in August measured both by the Consumer Price Index and the Harmonised Index of Consumer Prices was 0.4% up year-on-year.

Macroeconomic risks

As described above the, Irish economy is growing at a reasonable rate and most of the main economic indicators are performing strongly. However, this does not mean that the economy does not face risks. The Government, in the *Stability Programme Update 2017* and the *National Risk Assessment 2017*, outline the main economic risks facing the economy. A number of these risks are commented upon below.

Brexit and associated exchange rate movements

The impact of Brexit on Ireland is difficult to quantify as the nature of the post-Brexit relationship between the UK and the European Union is unclear. The main channel through which Brexit will impact the economy is trade. Different sectors will be affected differently and the prospects of tariffs, divergent regulations and exchange rate uncertainty will weigh on business decisions.

The ESRI¹ has estimated that a ‘hard’ Brexit whereby World Trade Organisation (WTO) tariffs are introduced post-Brexit would result in a permanent loss of approximately 4% of Irish GDP (compared to a no-Brexit scenario). However, the ESRI’s analysis did not differentiate between industrial sectors and there is evidence and commentary that indigenous sectors which are more labour intensive such as food manufacturing could be more affected than others. The ESRI analysis also suggested that the General Government Balance would be 1% of GDP lower than it would have otherwise been (i.e. if the Government balance were to be in deficit, that deficit would be 1% of GDP higher) following a ‘hard’ Brexit. This would be due to rises in unemployment and associated social welfare payments and falls in taxation revenue.

The euro-pound exchange rate is one of the key factors in the evolution of trade between Ireland and the UK. The Department of Finance’s economic projections (from March) are based on the technical assumption that the 2017 and future years’ exchange rate is €1 = £0.87. The average exchange rate for the first 9 months of 2017 was €1 = £0.8725.²

Global economic demand

The OECD’s latest Economic Outlook (September 2017) has projected that global growth will be higher in 2017 than in 2016, with a further increase expected in 2018. However, the OECD cautions that strong, sustainable, and inclusive medium-term growth is not assured.

The OECD expects the Euro area to grow by 2.1% of GDP in 2017 and 1.9% in 2018. This represents an upward revision from its previous projections and is driven by stronger growth in key European countries. The revised projections reflect stronger than expected performance in the first half of 2017, in the context of rising employment rates, accommodative monetary policy and reduced political uncertainty. The upswing is also driven by stronger consumption growth and investment, as well as healthy export growth.

¹ Bergin et al. (2016) *Modelling the Medium to Long Term Potential Macroeconomic Impact of Brexit on Ireland* available from <http://www.esri.ie/pubs/WP548.pdf>.

² Based on the average of monthly exchange rates as published on the Central Bank of Ireland website.

In the United States, growth is estimated at 2.1% in 2017 and 2.4% in 2018, supported by stronger consumer spending and business investment. The UK is projected to grow by 1.6% in 2017 and 1% in 2018. The depreciation of sterling has improved export prospects modestly. However, that has also pushed up inflation and while the unemployment rate in the UK has fallen to below 4.5%, weak productivity and real wage growth persist.

The above forecasts for the US and UK are in line (i.e. within 0.2 percentage points) with the Department of Finance's expectations (based on EU Commission and IMF forecasts) at the time of the last published economic forecasts (March 2017). However, the OECD Euro area economic growth projections for 2017 are higher (by 0.5 percentage points) than the Government's. Revised economic forecasts will be published with the Budget.

The OECD's economic projections would suggest a relatively benign global economic outlook for the rest of 2017 and 2018. However, the OECD cautions that while unemployment is falling wage growth remains weak in its member countries. They also highlight trade imbalances, financial market issues (including the normalisation of interest rates) and vulnerabilities in some emerging markets as risks to economic growth.

Domestic economic risks

The Governments' *Stability Programme Update* identifies a small number of domestic economic risks. These are:

- Concentrated industrial base – Ireland's industrial base is highly concentrated in a small number of high-tech sectors, with the result that output and employment are exposed to firm- and sector-specific shocks.
- Loss of competitiveness – as a small and open economy, Ireland's business model is very much geared towards export-led growth, which, in turn, is sensitive to the evolution of cost competitiveness.
- Private sector deleveraging – notwithstanding recent improvements, levels of household and Non-financial corporation's debt remain high in Ireland, which may prompt stronger-than-assumed deleveraging over the medium term.
- Housing supply pressures – supply constraints in the housing sector.

The OECD, in its most recent Economic Outlook³, stated that, "the high level of private indebtedness leaves Ireland sensitive to a rise in interest rates." The EU Commission has also highlighted domestic financial institutions as an economic risk as they may not be in a position to lend.

The OECD goes on to state that, "property prices might rise more strongly than projected, which would support construction activity in the near term, but might also sow the seeds of another bubble." Related to this, the ESRI and the IFAC have highlighted the risk of the economy overheating due to increased activity in the construction sector. Conversely, others including IBEC have suggested that capacity constraints in the construction sector may restrict growth.

The issues in the housing market are leading to higher housing prices and higher rents. The effects of the rent price controls introduced early in 2017 are unclear. Higher housing costs can feed into pressures for higher wages which, if granted, could affect Ireland's competitiveness. The loss of competitiveness is identified by the Government as a risk to Ireland's continued economic growth.

3 <http://www.oecd.org/eco/outlook/economic-forecast-summary-ireland-oecd-economic-outlook-june-2017.pdf>.

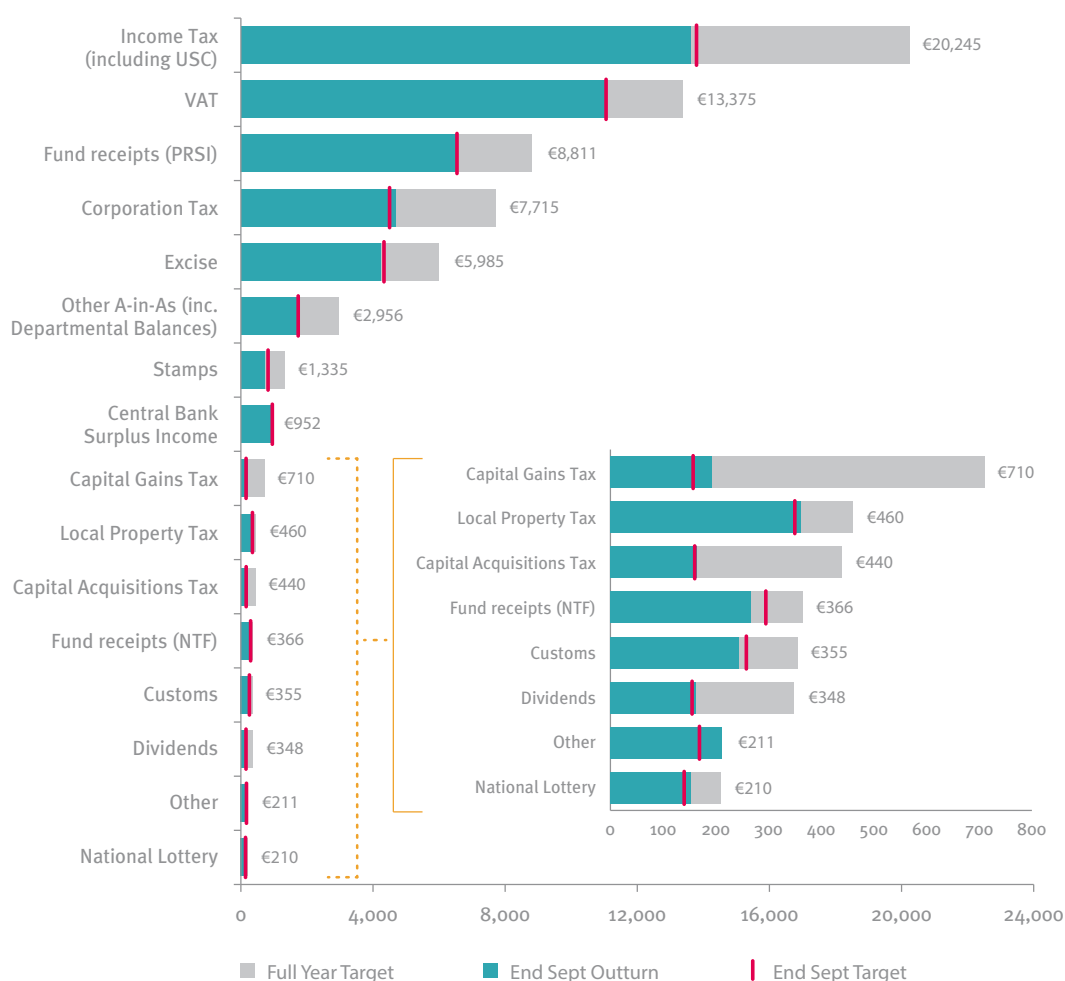
Fiscal developments 2017

This section briefly outlines the latest fiscal developments in 2017, as well as providing commentary on some of the main risks facing the achievement of the 2017 fiscal goals.

Taxation and other revenue

Figure 1 shows Central Government revenue by source (excluding transactions with no general government impact such as the AIB share sale) for the period January 2017 to end September 2017 – along with the target for end year. Overall revenue in this period was €43.8 billion which was €216 million or 0.5% under profile. Revenue at end-Q3 2017 was €2.0 billion or 4.8% above the end-Q3 2016 figure.

Figure 1: Taxation and other Central Government revenue 2017 (millions)



Source: Parliamentary Budget Office based on Department of Finance Fiscal Monitor September 2017.

Some notable details include:

- Income tax receipts at end-Q3 of €13,605 million were 1.4% (€188 million) below profile, but up 5% (€652 million) in year-on-year terms. This reflects a narrowing in the shortfall since Quarter 2.
- VAT receipts are -0.3% (€36 million) below profile. This is in contrast to the end-Q2 outturn which showed VAT returns €202 million above profile. However, it should be noted that at end-Q3 cumulative VAT receipts were up 8.1% or €827 million year-on-year.
- Pay Related Social Insurance (PRSI) receipts at €6,535 million are 0.1% (or €7 million) below profile.
- Cumulative Corporation Tax receipts at end-Q3 were 3.8% or €169 million above profile and up 12.3% (€511 million) in annual terms.
- On a cumulative basis, Excise Duty receipts of €4,216 million at end-Q3 were 2.7% (€116 million) below target. Much of this is due to a monthly shortfall of €65 million in August. This under-performance is across a range of excise components.
- Stamp duties are well below profile with a shortfall of €98 million or 11.9%.
- Other appropriations-in-aid (i.e. direct receipts to Government departments) were €1,766 million or €32 million ahead of profile.
- Capital Gains Tax was €35 million ahead of profile.

Non-General Government impacting revenue

In addition to the above revenue, there were a number of additional transactions which contribute revenue to the Exchequer but do not impact the General Government Balance. These include the AIB share transaction of €3,434 million and other Central Bank of Ireland surplus income of €884 million. In addition, there are receipts of €770 million from the European Agricultural Guarantee Fund (EAGF) and the European Agricultural Fund for Rural Development (EAFRD) (replacing the FEOGA – *(Fonds Europeen d’Orientation et de Garantie Agricole)* which the Department of Agriculture, Food and the Marine administers on behalf of the European Union.

Overall expenditure

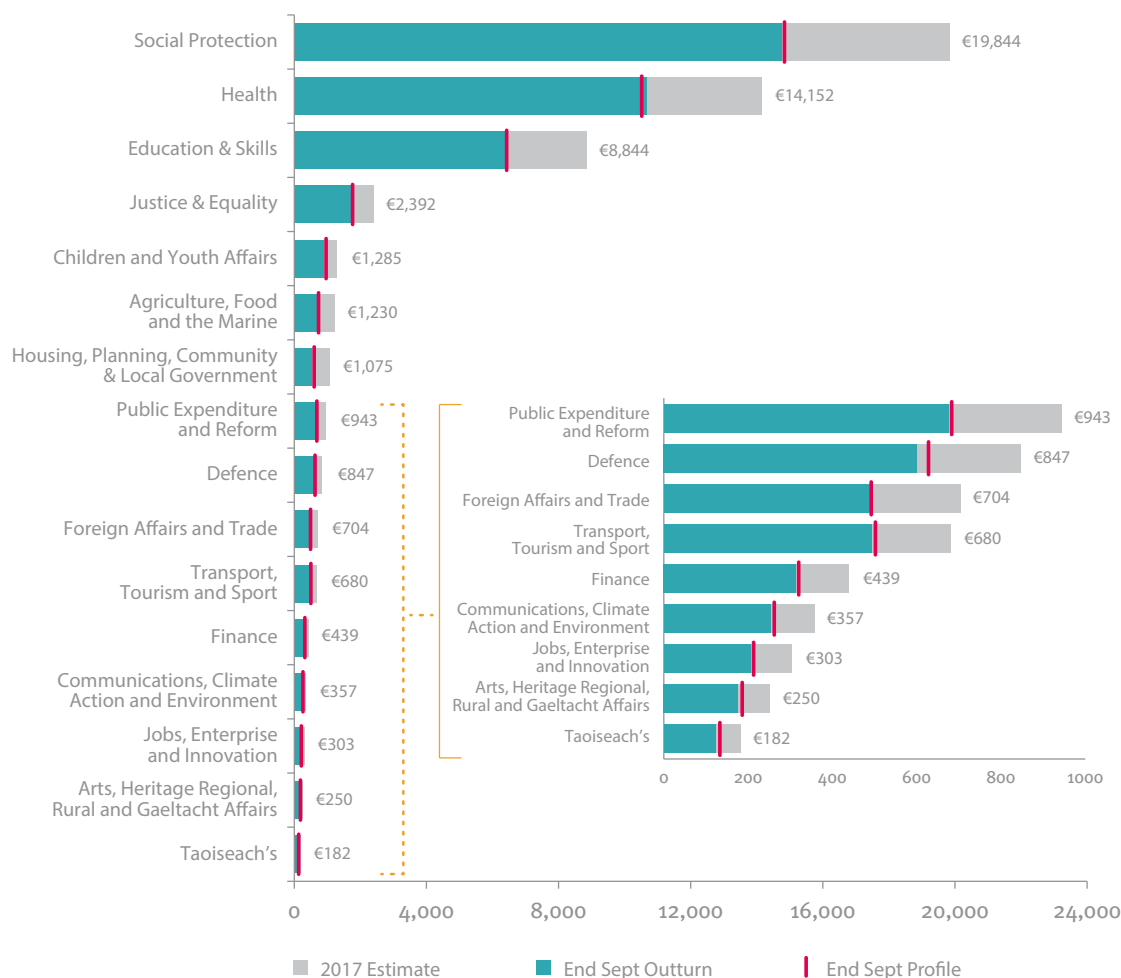
The Department of Finance's *Fiscal Monitor September 2017* showed that gross expenditure (Voted Current, non-Voted Current, Voted Capital and interest on the national debt) was €47,539 million at end-Q3 and €677 million below profile. This €677 million is broken down as follows:

- Voted current expenditure was €119 million below profile (see below for more details).
- Non-Voted current expenditure was €252 million below profile mainly due to a below profile EU budget contribution of €219 million. However, due to the high level of economic growth in recent years the EU Budget contribution is €331 million higher to date in 2017 than in 2016.
- Voted Capital Expenditure at €2,517 million is €155 million below profile (though up €395 million from 2016) (see below for more details).
- Interest on the national debt is €151 million below profile mainly due to the continued favourable market interest rate environment.

Overall expenditure is €1,601 million or 3.5% above the same period in 2016.

Gross voted current expenditure

Gross voted current expenditure of €39,149 million was €119 million (0.3%) below target up to end Q3 but up €1,435 million (3.8%) year-on-year. Figure 2 breaks this down by Departmental Vote Group with a comparison with the full year expected expenditure and the end-Q3 profile.

Figure 2: Gross Voted Current Expenditure by Departmental Vote Group 2017 (millions)⁴

Source: Parliamentary Budget Office based on Department of Finance Fiscal Monitor September 2017.

For most Departments gross voted current expenditure was below profile. The only exceptions were:

- Department of Health, €166 million or 1.6% ahead of profile; and
- Department of Justice & Equality, €22 million or 1.3% ahead of profile.

The most notable Departments with gross current expenditure below profile for the year to end-Q3 (in absolute terms) were:

- Department of Social Protection, €67 million or 0.5%;
- Department of Housing, Planning, Community & Local Government, €65 million or 10.7%;
- Department of Children and Youth Affairs, €60 million or 6.2%;
- Department of Defence, €27 million or 4.3%.

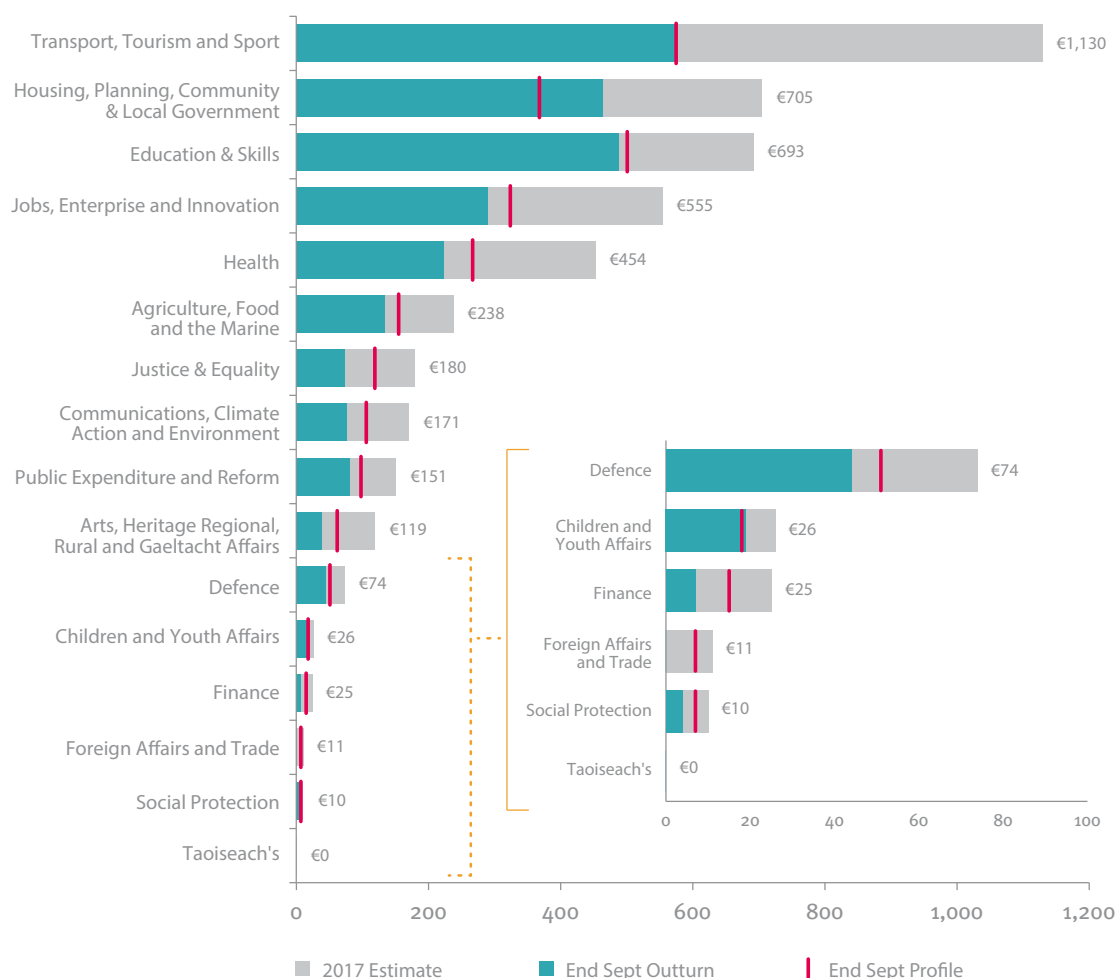
4 The Departmental Vote Groups presented here are as listed in the Fiscal Monitor.

Gross voted capital expenditure

At end-Q3 2017 Gross voted capital expenditure of €2,517 million was €155 million (5.8%) below profile and up €395 million (18.6%) in year on-years terms.

Capital expenditure in the Department of Housing, Planning, Community and Local Government is €96 million (26.1%) ahead of profile, driven by increased spending on the housing programme. The Department of Children (whose capital budget is low) was the only other Department with expenditure ahead of profile at end-Q3. The Department of Transport, Tourism and Sport's capital expenditure which had been significantly ahead of profile for most of the year had by end Q3 matched its profile.

Figure 3: Gross Voted Capital Expenditure by Departmental Vote Group 2017 (millions)⁵



Source: Parliamentary Budget Office based on Department of Finance Fiscal Monitor September 2017.

⁵ The Departmental Vote Groups presented here are as listed in the Department of Finance's Fiscal Monitor. The Government has made changes to Departments that will require Dáil Éireann to vote on further Revised Estimates to meet the financial requirements of the new arrangements.

At end-Q3 gross capital expenditure was below profile in all other Departments or Department Vote Groups (with the exception of Taoiseach's where no capital expenditure was expected). The most notable Departments with gross capital expenditure below profile for the year to end-Q3 (in absolute terms) were:

- Justice & Equality under profile by €45 million or 37.5%;
- Health under profile by €44 million or 16.4%;
- Jobs, Enterprise and Innovation under profile by €33 million or 10.3%;
- Communications, Climate Action and Environment under profile by €30 million or 28.1%;
- Arts, Heritage, Regional, Rural and Gaeltacht Affairs under profile by €25 million or 39.5%;
- Agriculture, Food and the Marine under profile by €21 million or 13.5%;
- Public Expenditure and Reform under profile by €16 million or 16.5%.

By its nature capital expenditure can be irregular and it can be difficult to profile correctly. However, there are a number of Departments where capital expenditure is significantly below profile and it is unclear whether or not the projects planned will be completed by year end.

Overall balance

The Exchequer Balance (which includes financial transactions which do not impact on the General Government Balance) showed a surplus of €2,344 million at end-Q3 compared to an expected deficit of €1,771 million. This was in the main due to the sale of AIB shares.

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

Excluding such transactions at end-Q3, revenue was €45,245 million and expenditure was €47,539 million with a balance of -€2,294 million. The profile was expected to show a balance of -€2,800 million. Thus, there was an improvement in the balance compared to the profile of €506 million. As detailed above, this improvement is due to below profile expenditure.

Commentary

As shown above three of the main tax heads were significantly (in absolute terms) below profile at end-Q3.

- Income tax – the below profile outturn in this tax head may be due to estimation difficulties rather than any underlying issues with the labour market. The Department of Finance has acknowledged that their methodology for calculating the effect of income rises on USC revenue may have been over optimistic and have corrected this for future years. In addition, earlier in the year the Department indicated that Deposit Interest Retention Tax and Life Assurance Exit Tax⁶ were both significantly below profile⁷ and if this has continued may also be contributing to the below profile outturn.
- Excise duties – The Department of Finance has stated that the under-performance in this tax head is across a range of excise components. Much of the shortfall only arose in August (€65 million of the overall €116 million shortfall) and it may be too early to tell what, if anything this signifies. The Department of Finance states that some of the shortfall is due to the introduction of plain packaging for tobacco products and how companies have reacted to this (including anticipatory product stockpiling in 2016).
- Stamp duties – This subhead is one of two tax subheads to show a year-on-year decrease in revenue and is 11.9% below profile at end-Q3. It is unclear what is driving the under performance in this tax sub-head. In terms of revenue, stamp duties mainly come from residential and non-residential property, share transfers, insurance levies and credit/ATM/Debit cards and cheques.

The Irish Fiscal Advisory Council (IFAC) has advised that additional in-year spending measures for 2017 would not be advisable and has warned that, “considering that the rules already risk being breached this year, a further relaxation of the stance for 2017 would not be appropriate.”

There appears to be a risk that additional in-year spending measures for 2017 will collectively exceed the currently approved level of Voted expenditure – notwithstanding underspends in other areas. The main areas where the risk of additional Voted expenditure could arise are:

- Department of Health – the *Fiscal Monitor September 2017* showed voted current gross expenditure in the Health Vote was €166 million or 1.6% above profile. It was almost €460 million above the level at end-September 2016. Media reports suggest that the Health Service Executive (HSE) faces a deficit of €300 million by the end of the year.
- Garda pay – In November 2016 a Labour Court Recommendation on Garda pay was accepted by the Government. This was estimated to cost approximately €50 million. This is likely the cause of the ahead of profile current expenditure in the Justice Vote Group. It is unlikely at this stage that expenditure in this area will come in on profile by year end.

⁶ Both these taxes are included in the Income Tax sub-head.

⁷ In evidence to the Committee on Budgetary Oversight on 5 April 2017 see transcript available at <http://oireachtasdebates.oireachtas.ie/Debates%20Authoring/DebatesWebPack.nsf/committeetakes/CBO2017040500002?opendocument#Boo100>.

- Water charges – the Cabinet has recently approved a Bill which, amongst other matters, allows for the repayment of water charges paid by households to Irish Water in 2015 and 2016. The estimated cost of this is €178 million. Provision must be made for this.
- Department of Employment and Social Protection - The annual 'Christmas Bonus' for social welfare recipients is not currently included in Voted expenditure as any decision on it must be made by the Government. In 2016 the cost of a 85% 'Christmas Bonus' was €221 million.

Other areas of spending pressure in 2017 include:

- Department of Housing, Planning and Local Government – capital expenditure in this Department is 25.9% ahead of profile at end-September. While timing issues with regard to completion of major projects could be responsible, it is likely that this Vote will need an additional allocation by year end.
- Public sector pay – a revision to the Lansdowne Road Agreement brought forward a pay rise from 1 September 2017 to 1 April 2017 at an estimated cost of €120 million. This cost is distributed across all Vote groups and appears in most cases to have been absorbed within the profiled expenditure.
- Donegal flooding – Donegal County Council has estimated the cost of repairing road infrastructure after the recent flooding at approximately €15 million.

Summary of Pre-Budget 2018 Commentary for the Committee on Budgetary Scrutiny

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. The full commentary is available on the Oireachtas website www.oireachtas.ie. A summary of the commentary is presented below.

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.

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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