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An Oifig Buiséid Pharlaiminteach
Parliamentary Budget Office

Quarterly Economic and Fiscal Commentary

February 2020

Séanadh

Disclaimer

Contents

Overview

The Irish economy continues to grow at a rapid pace. In the first nine months of 2019 the economy grew by 5.9% and employment grew by 2.7% with 60,000 more people at work. However, growth in recent years has been heavily concentrated in certain sectors of the economy.

From 2016 to 2019 71.4% of growth was driven by sectors that are dominated by multinationals. The remaining sectors only accounted for 28.6% of growth. This contrasts with the last phase of growth during the 2000s. From 2004-2007 the majority of growth was driven by domestic sectors, while multinational sectors only accounted for a third of growth. These dynamics have changed the structure of the economy as multinational dominated sectors now account for 44% of output (GVA) up from 22.7% in 2008.

Exports continued to experience strong growth in 2019, however, this was also concentrated in certain sectors. In the first ten months of last year Ireland exported €12.4 billion more goods (11% higher). Chemical and pharmaceutical products accounted for 61% of this growth. It is likely that this growth is concentrated amongst a small number of firms as data from the CSO showed that in 2017, only 31 pharmaceutical firms accounted for 87% of pharmaceutical exports and 43.7% of total goods exports. Growth was also concentrated in certain markets. Irish exports to China almost doubled last year (up 96%) while exports to the US grew by 19%. Overall new exports to China and the US accounted for 75% of total export growth.

Looking out to 2020 risks remain on the horizon. While Ireland has been given some breathing space on Brexit, a hard Brexit is still a possibility. EU officials have expressed scepticism that a full trade agreement can be reached by the end of the transition period. The UK Prime Minister has indicated that no additional extension will be sought, while the Chancellor has indicated that there will be no regulatory alignment with the EU once the transition period has ended.

Other international risks also remain as global growth has showed signs of slowing. The IMF, World Bank and OECD have all revised growth figures downwards for 2019, by an average of 0.3 percentage points. Furthermore, while the US economy continues to grow, business investment (excluding intangibles) fell by 2% in Q3 2019. This could have knock on implications for Ireland as US companies played a significant role driving business investment here in recent years.

Fiscal Developments

Overall, Central Government revenue by source (excluding transactions with no General Government Balance impact such as inter-Government loan transactions) was €74.3 billion in 2019, which was €2.3 billion or 3.2% above expectations at the beginning of the year:

- Tax revenues were €59.3 billion, and €1.37 billion above profile;
- Appropriations-in-Aid were €13.3 billion, and €584 million above profile; and
- Non-tax revenue was €1.7 billion and €327 million above profile.

Overall, year-on-year revenue was up €4.5 billion or 6.5%. Corporation Tax revenue (€1.4 billion or 14.8% above profile) was the substantive driver of the increase in tax revenue in 2019. Issues around reliance on Corporation tax to fund long-term spending as well as the difficulty in accurately forecasting how much will be collected are ongoing.

2019 also saw an increase above profile in capital taxes – Capital Gains Tax and Capital Acquisitions Tax. In that context, the PBO would welcome an annual review of tax revenue forecasting for each tax head in order to facilitate more informed scrutiny of these forecasts.

Expenditure

At the end of 2019, overall Central Government expenditure (excluding transactions with no General Government Balance impact) equalled €75.3 billion, €277 million above profile and €3.5 billion (or 4.9%) more than in 2018. This was made up of €67.4 billion in Voted expenditure, €2.9 billion in non-Voted expenditure and €5 billion in interest on the National Debt:

- Gross Voted Current Expenditure was €757 million (1.3%) above profile; this was a significant change from end-November when Gross Voted Current Expenditure was 0.3% or €171 million under profile.
- Gross Voted Capital Expenditure was €24 million (0.3%) above profile; this has also deviated significantly since end-November, when capital expenditure was €387 million below profile.

These figures compare the Exchequer provisional outturn to the *Revised Estimates for Public Services 2019* (i.e. excluding Supplementary Estimates).[1] The Supplementary Estimates 2019 provided for an additional €780 million in gross Voted expenditure and thus the actual provisional outturn was €260 million less than the final amounts approved by Dáil Éireann for 2019.

Much of the increased spending is again, in effect, financed by the increased Corporation Tax receipts. However, while receipts from this tax head are prone to volatility, the types of spending being committed to are generally less so. In the Health and Education & Skills Votes (both of which received significant Supplementary Estimates), pay is the primary source of current day to day spending. Given the ongoing risks in the current domestic and international macroeconomic environment, the continuing reliance upon tax revenue that is highly volatile to fund increasing spending that may be more long term in nature poses a key challenge for management of the public finances.

Overall Balance

The Exchequer Balance shows a surplus of €647 million at the end of 2019. This is €3 billion better than was profiled. This improvement is a result of tax and non-tax revenue €2.3 billion higher than profiled, non-general government impacting revenue €1.1 billion higher than expected, offset by general government expenditure €0.3 billion and non-general government impacting spending €76 million higher than projected. The Government has indicated that the surplus in the Exchequer balance will translate to a surplus of €647 million in the General Government Balance.

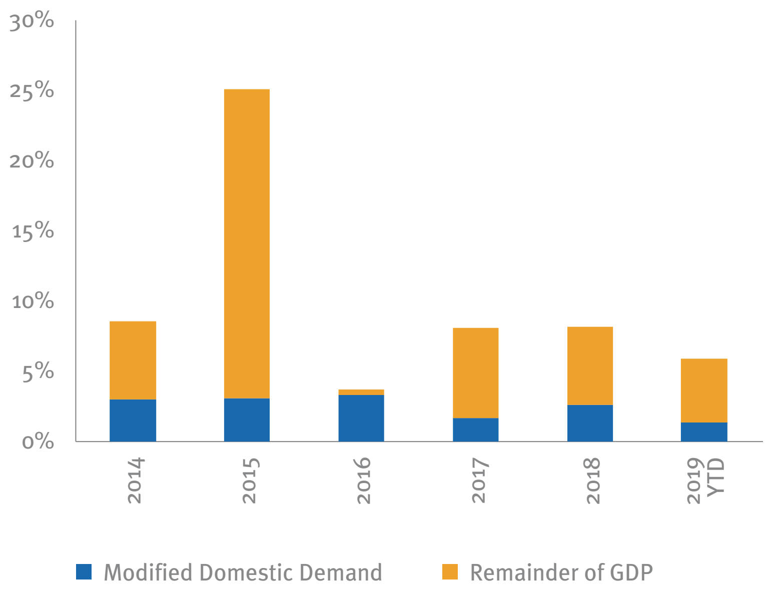
Government Debt

The National Treasury Management Agency (NTMA) forecasts that Gross General Government Debt was €203.6 billion at the end of 2019. This corresponds to 59.3% of GDP, against the target of below 60% set in the Treaty on the Functioning of the European Union. This is still very high however and gives little scope for extra borrowing if there was a downturn in the economy that impacts the public finances.

1 *See PBO publication 74 of 2019, PBO Analysis of the Supplementary Estimates for Public Services 2019.*

Macroeconomy

Figure 1: GDP growth



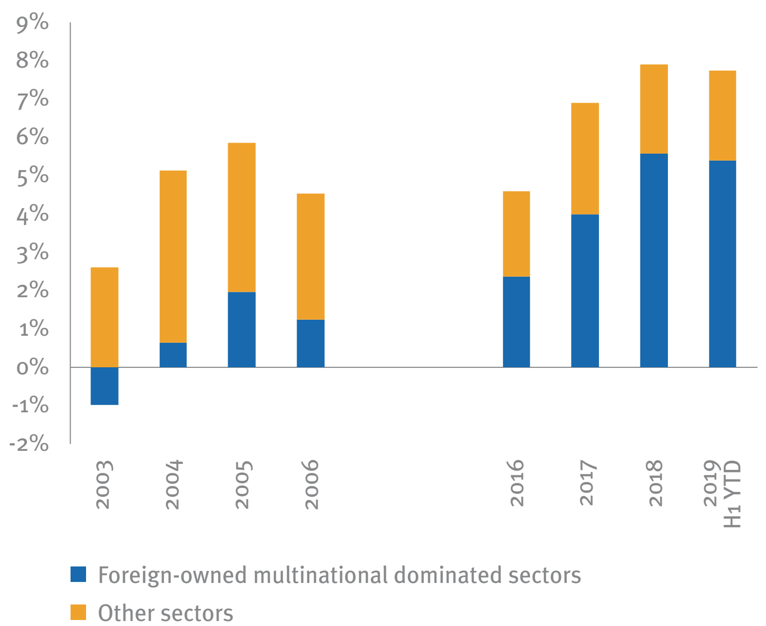
Source: CSO.

GDP experienced strong growth of 5.9% in the first nine months of 2019.

Modified domestic demand (which is a proxy for the domestic economy) grew by 2.5%.

The domestic economy played a minor role driving growth in recent years. In the last two years (Q3 2017-Q3 2019), modified domestic demand only accounted for roughly 20% of growth. The remainder of GDP growth was driven by exports and certain investments such as intellectual property imports.

Figure 2: GVA annual growth by sector



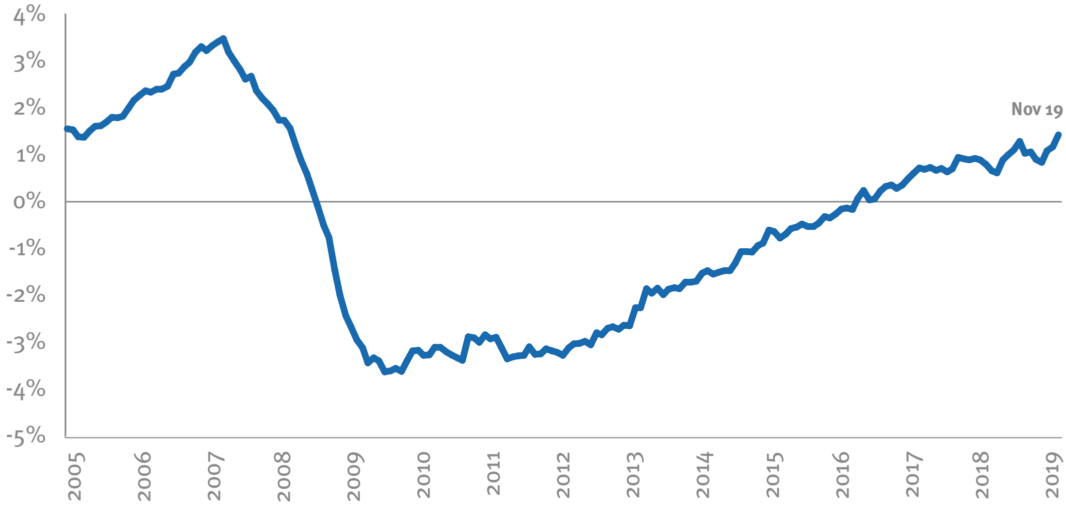
Source: CSO.

In the first half of 2019, multinational dominated sectors accounted for 44% of Gross Value added (GVA).

This share has grown significantly in recent years and is now double what it was in 2008. This has been due to significant growth in the multinational sectors in recent years.

From H1 2016-H1 2019 71.4% of growth was driven by multinational dominated sectors. This is significantly higher than the last economic expansion. From 2004-2007 only a third of growth was driven by multinational dominated sectors, the majority was driven by domestic facing sectors such as construction.

Figure 3: PBO's monthly cyclical indicator for the Irish economy



Source: PBO own analysis.

Note: Values above 0 indicate a potential risk of economic overheating, while estimates below 0 suggest that the economy is operating below capacity.

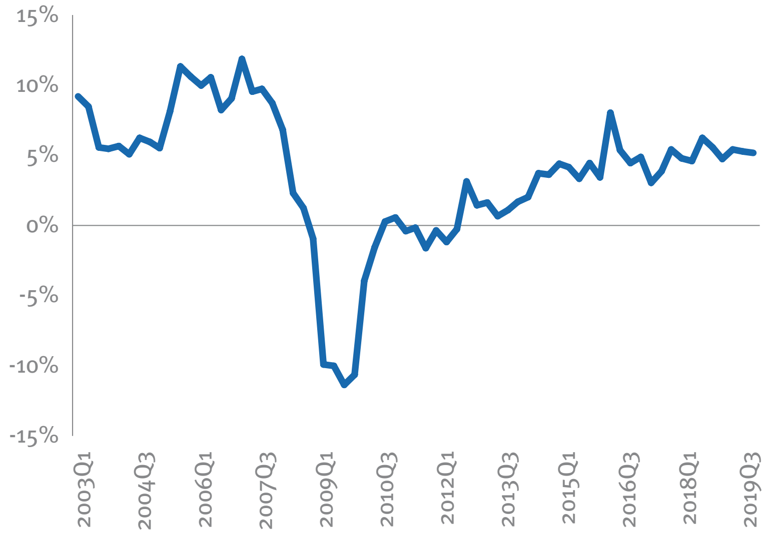
Continued underlying economic expansion is suggested by the PBO's cyclical indicator for the Irish economy (Ire-cyin) presented in Figure 3. This is an indicator that gives a real-time estimate (on a monthly basis) of the trend in economic activity. It is based on Principal Component Analysis (PCA)[2], and draws from developments in different areas of the economy including the labour market, consumer prices, consumer spending, house prices and financial markets.

The estimate, based on information available up until November 2019, indicates that the Irish economy is operating above "normal" capacity, implying that if current trends persist and negative risks do not materialise, the economy may experience imbalances in the short-to-medium term.

2 *This is a dimension-reduction statistical technique that can allow for the construction of an aggregate indicator best representing the information set from multiple economic variables. The indicator is based on the first principal component; namely, a linear combination of economic indicators explaining the greatest amount of information common to all variables. Variables included are standardised i.e. expressed as the number of standard deviations from the average value.*

Consumer Spending

Figure 4: Annual Consumer spending growth nominal



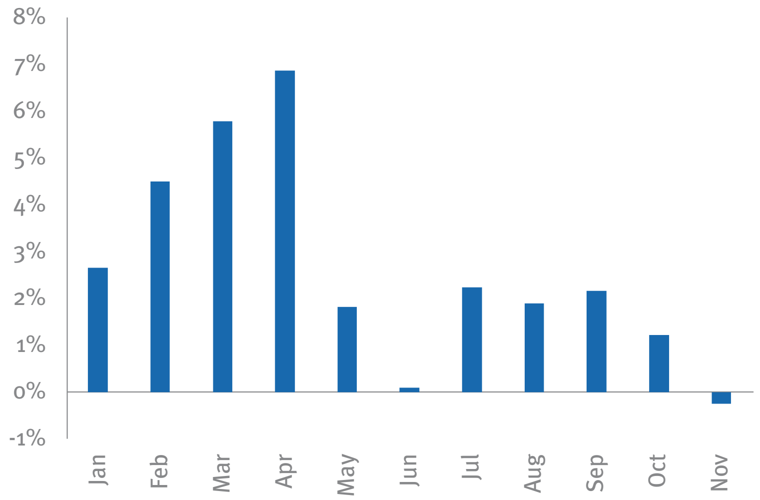
Source: CSO.

Consumer spending continues to grow at a steady pace.

In the first nine months of 2019 consumer spending was 5.3% higher than the same period in 2018. This is consistent with the trend experienced from 2014 onwards.

However, this is lower than growth experienced during 2005-2007 when consumer spending grew by 9.5% annually on average.

Figure 5: Annual growth in core retail sales 2019



Source: CSO.

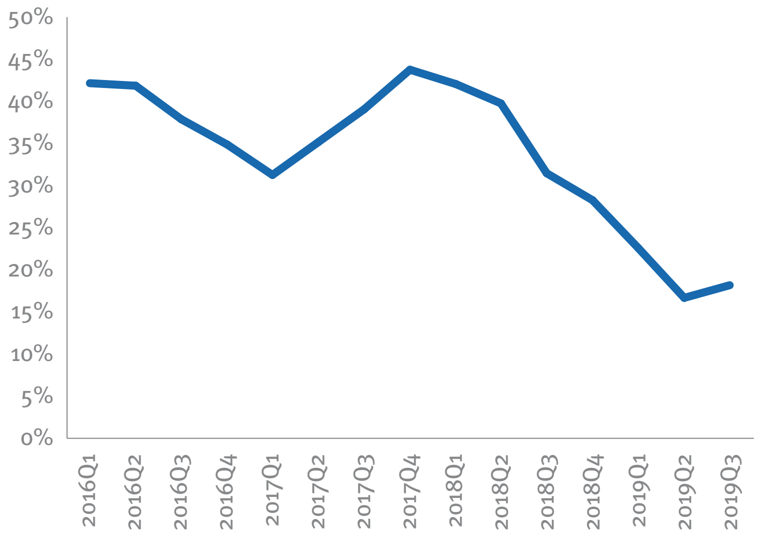
Core Retail sales (excluding cars and bars) showed strong growth in the first four months of 2019.

However, growth slowed in the following months. The fastest growing sectors were household durables (furniture (6.8%), hardware (5.2%) and electrical goods (4.5%) likely driven by the strong growth in residential construction.

In November, retail sales fell by 0.2%. November is now a key month for Christmas shopping and this weak performance suggests that Christmas 2019 may have been a difficult period for retailers. However, it could also be the case that the Black Friday sales failed to attract the same number of customers as they did in previous years.

Investment and Exports

Figure 6: Investment in housing



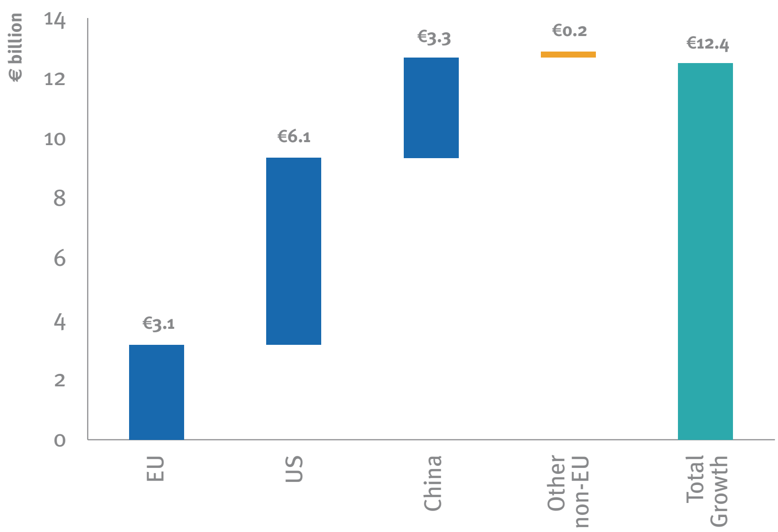
Source: CSO.

Investment in housing experienced strong growth in recent years.

In 2017, total investment in housing grew by 42%. Since then growth has slowed, although it is still strong. In the first nine months of 2019 housing investment was 18% higher than the same period in 2018.

This strong growth in housing investment has translated into higher house completions. The number of houses built in 2019 was 18% higher than the same period in 2018.

Figure 7: Goods exports Oct YTD growth



Source: Eurostat.

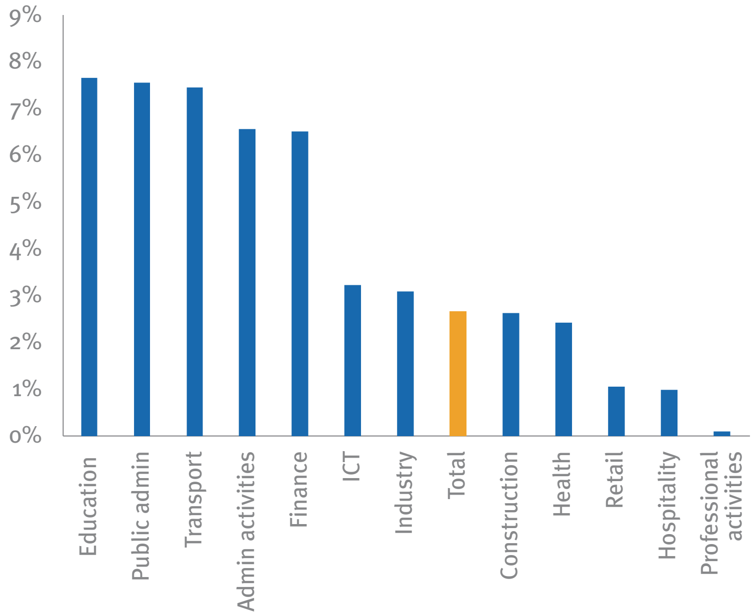
Ireland's goods exports experienced strong growth of 11% (€12.4bn more goods) in the first ten months of 2019.

China and the US accounted for 75% of this growth. Exports to the US grew by 19% (€6.1 bn) while exports to China almost doubled (96% higher). Growth was concentrated in certain sectors such as Chemical and pharmaceutical products which accounted for 61% of this growth.

It is also likely that this growth is concentrated amongst a small number of firms as data from the CSO showed that in 2017, only 31 pharmaceutical firms accounted for 87% of pharmaceutical exports and 43.7% of total goods exports.

Labour Market

Figure 8: Employment Sep YTD



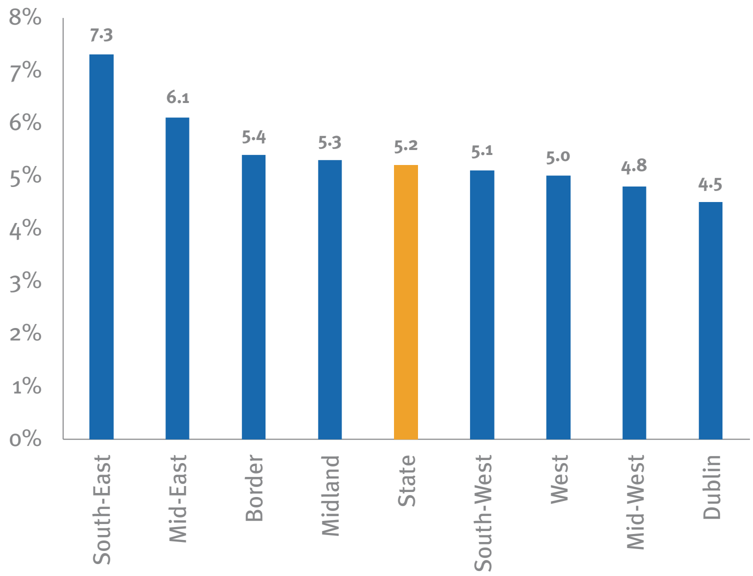
Source: CSO.

The number of people working in Ireland continues to grow.

In the first nine months of 2019 there were 60,000 more people working in Ireland compared to the same period in 2018 (2.7%). This brings the total number of people working in Ireland to 2.3 million.

Education (7.7%) and public administration (7.6%) experienced the strongest growth. The sectors which experienced the weakest growth were hospitality (1%), retail (1.1%) and professional activities (0.1%).

Figure 9: Unemployment rate Q3 2019



Source: CSO.

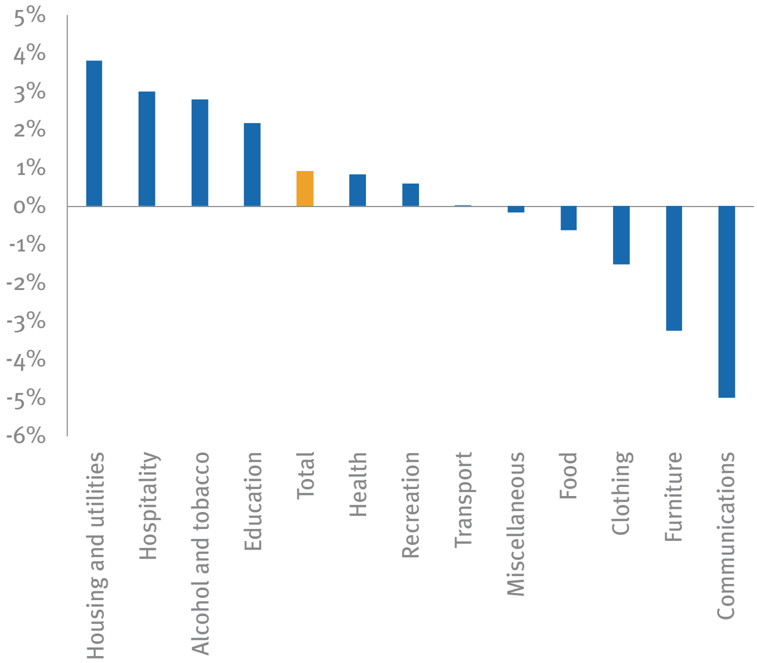
In the first nine months of 2019 employment growth ranged from 0.2% in the South West to 5.2% in the Mid-East.

As the labour force survey is based off where people live, as opposed to where they work the strong growth in the Mid-East may reflect a larger number of people commuting to work in Dublin.

The unemployment rate is now 5.2%. It is lowest in Dublin (4.5%) and is highest in the South-East (7.3%).

Inflation and Wages

Figure 10: CPI Nov YTD



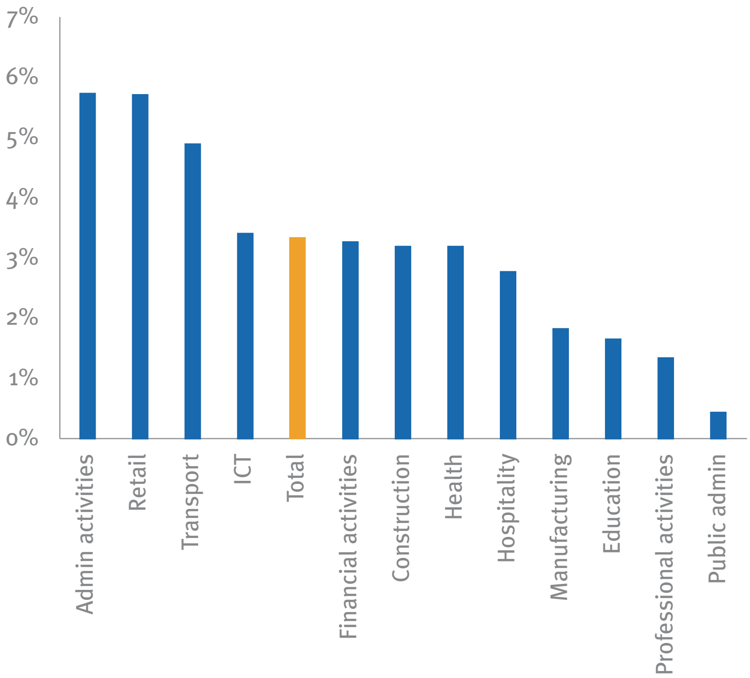
Source: CSO.

Inflation picked up slightly in 2019, from 0.5% in 2018 to 0.9%.

While still low, this is the largest increase since 2012. This has been driven by higher housing and utilities prices (3.8%), hospitality prices (3%), alcohol and tobacco products (2.8%) and education (2.2%).

Prices for other items such as food (-0.6%) fell. Communications experienced the largest fall (-5%), which was driven by lower phone service prices.

Figure 11: Wages Sep YTD



Source: CSO.

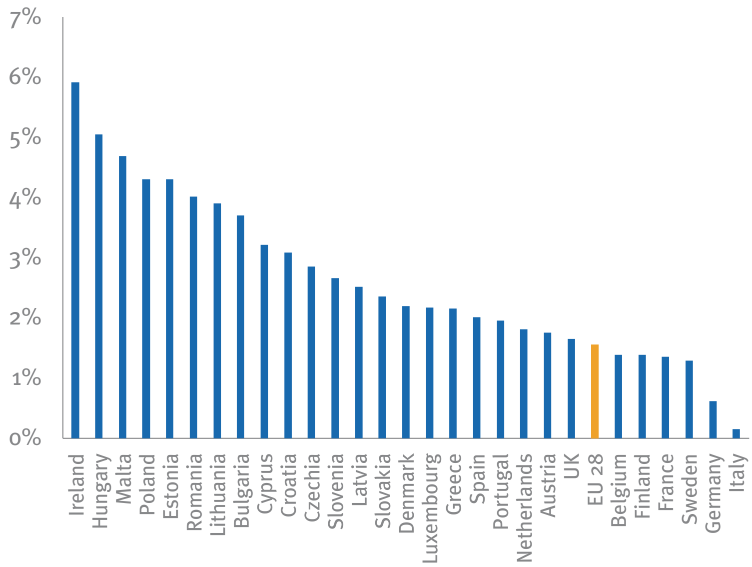
Hourly wages in Ireland continue to grow at a steady pace.

In the first nine months hourly wages were 3.3% higher than the same period in 2018. The sectors which experienced the strongest increases were administrative activities (5.8%) and retail (5.7%).

This is amongst the highest in the EU and is happening at a time of relatively low inflation.

International Economies

Figure 12: European GDP Growth Sep YTD



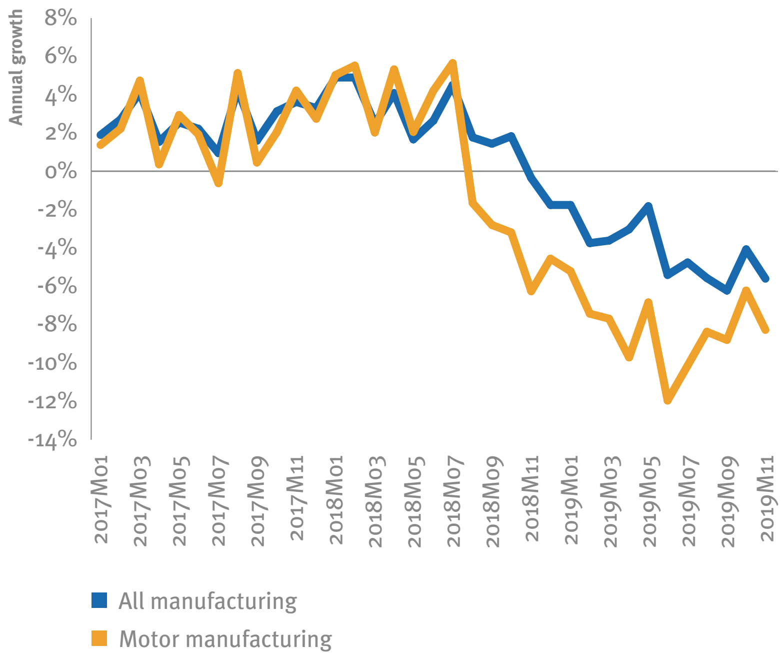
Source: Eurostat.

The EU economy grew by 1.6% in the first nine months of 2019.

This was slightly weaker than previous years (annual growth averaged 2.2% from 2016 to 2018).

This slowdown was driven by larger economies (Italy and Germany) that experienced weaker growth in 2019 (see more on Germany below). However, many countries experienced strong growth, with ten economies growing by more than 3%.

Figure 13: German Industrial Output, 4 month moving average



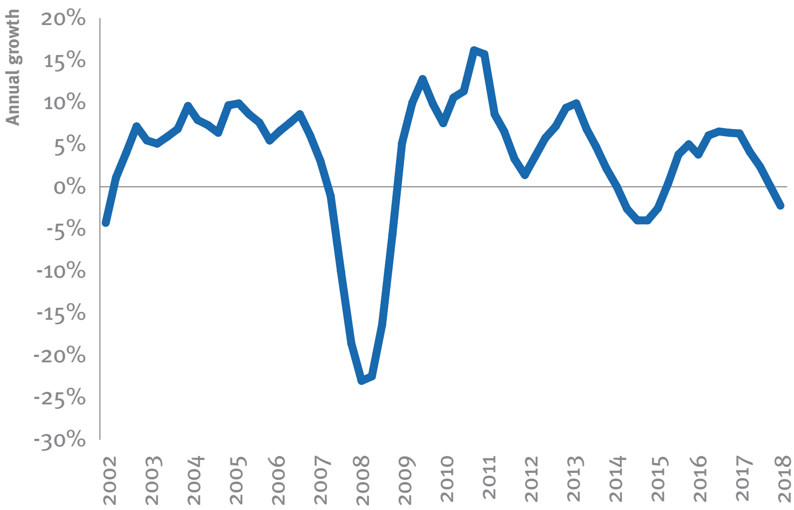
Source: Eurostat.

The German economy slowed in 2019 as GDP grew by only 0.6% in the first nine months.

This weak performance was driven by a contraction in the manufacturing sector. In the first 11 months of 2019, manufacturing output fell by 4.6%.

This was largely driven by the motor sector which saw output fall by 9.2%. The motor sector was affected by new emission rules for cars and a shift to electric vehicles. Overall growth remained positive due to higher consumer and government spending. However, if the manufacturing sector continues to decline, it is likely that this will spill over and have a negative impact on consumer spending.

Figure 14: Business Investment (excluding intangibles) US



Source: BEA.

The US economy continues to grow. GDP grew by 2.1% in Q3 2019.

However, in recent months business investment has fallen. In the third quarter of 2019 business investment fell by 2.2%. This might signal a fall in confidence in the US as companies anticipate lower demand for their goods in the future.

It could also be driven by political uncertainty in advance of the 2020 presidential election. This could have an impact on business investment in Ireland as a large component of this investment is undertaken by US multinationals.

Box 1: An update on budgetary forecasts over 2019-2025 under an 'orderly' Brexit scenario

On the 9th of January, Minister Donohoe published an updated version of the Budget 2020 macroeconomic and fiscal forecasts. The main changes are as follows:

- **The new forecasts are based on an 'orderly' Brexit scenario**, i.e. a free-trade agreement between the EU and UK that follows existing arrangements is put in place or an extension of the transition period is agreed, beyond the current deadline of January 2021. The central scenario underpinning Budget 2020 was a 'disorderly' (or no-deal) exit of the UK from the European Union in October 2019.
- **An adjustment to tax revenue from 2022 onwards is made to account for the estimated reduction in Corporation Tax receipts arising from BEPS changes.** This consists of a flat annual reduction of €500 million (€2 billion cumulatively by 2025).

For the economic indicators (GDP and labour market), the main changes affect the short-term forecasts (2020-2021).

- GDP growth is revised up from 0.7% to 3.9% in 2020 and from 2.5% to 3% in 2021. Medium-term forecasts are essentially unchanged and anchored to the estimated potential growth rate of the economy (2.5%).
- Employment growth is revised upward to 1.8% from 0.8% in 2020 and to 1.7% from 1.1% in 2021. Forecasts for the unemployment rate suggest that the labour market has approached full employment, with forecasts approximately 1 percentage point lower compared to 'no-deal' forecasts.

On the public finances, tax revenue is forecast to increase by 7.1% (to €63.5 billion) in 2020 in a deal scenario vs 4.3% under a 'no-deal' scenario, and by 4.7% in 2021 (vs 4.1% in no-deal). In the medium term (2022-2024), tax revenue is expected to grow at a lower rate (annual average growth rate of 3.8%) compared to Budget 2020 forecasts (annual average growth of 4.6%). While a full break down of tax revenue by tax head has not been published, it is likely that lower tax revenue growth overall is explained by the estimated BEPS impact on Corporation Tax.

Figure 15a-15d: Medium-Term Fiscal forecasts: updated orderly vs disorderly Brexit

Source: PBO based on Department of Finance and Budget 2020: Economic and Fiscal Outlook.

Under a deal Brexit scenario, the government expects a budget surplus in 2020 (0.7% of GDP), that will improve over time (to 1.3% of GDP in 2025). These improvements in the general government balance will directly affect the estimates of the structural budget balance, with the Medium-Term Objective expected to be maintained over the forecast horizon. Conversely, in a 'no-deal' scenario, the government would run a budget deficit until 2022.

The document also gives an estimate of the total unallocated amount of financial resources that are available for future budgets (based on the current budgetary strategy), while still complying with the fiscal rules. This is estimated at €11 billion from 2021-2025. Over 2021-2024, this amount remains unchanged from the estimate in a Brexit deal scenario included in the Summer Economic Statement 2019 (€8.6 billion).

Current expenditure pre-commitments are estimated at €1 billion in 2021 (demographics (€0.5 billion); PSSA (€0.3 billion); Budget 2020 carryover (€0.2 billion)) and kept flat at €0.5 billion thereafter (2022-2025) to accommodate for the estimated increase in public spending due to demographic changes.

Figure 15e: Total Unallocated Fiscal Resources

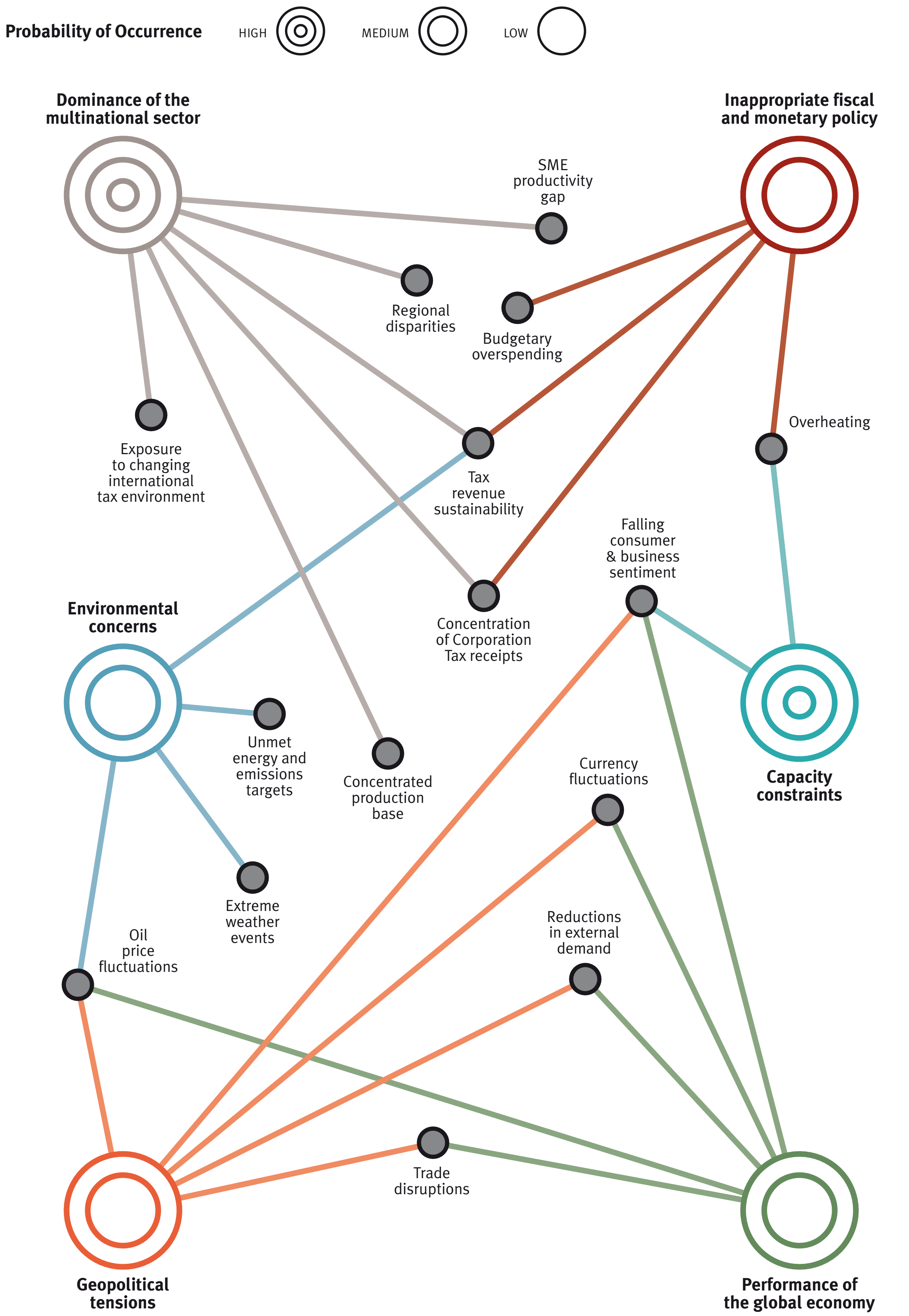
Source: Department of Finance.

** Estimate based on current budgetary strategy.*

Quarterly Economic and Fiscal Commentary

PBO Macro-Fiscal Risk Network

The **PBO's Macro-Fiscal Risk Network** aims to show the PBO's assessment in respect of the core macroeconomic and fiscal risks facing the economy (in the short to medium-term) and their probability of occurring. It further explores the linkages between these risks and details their implications for the domestic economy (grey shaded circles). In this edition of the *Quarterly*, the PBO identifies **six key risk factors** (separated by colour).



Macroeconomic and Fiscal Risks

Dominance of the multinational sector

Probability: High

Impact: SME productivity gap; Tax revenue sustainability; Regional disparities; Concentration of Corporation Tax receipts; Concentrated production base; Exposure to changing international tax environment

Implications for: General government balance; Current account balance; Economic output

The concentration of economic activity and tax revenue around a few highly productive multinational corporations (MNCs), represents a key systemic risk. The geographic concentration of highly productive firms exacerbates regional disparities, and an SME wage and productivity gap persists.

The dominance of MNCs exposes output, employment, and tax revenue to firm- and sector-specific shocks, and to global factors that are beyond domestic control.[3] As of 2017, foreign-owned MNCs account for:

- 22% of employments;
- 34% of gross earnings;
- 77% of Corporation Tax receipts, with almost half of all Corporation Tax coming from the top ten tax-payers; and,
- 25% of all Income Tax (PAYE) and USC receipts.

This concentration of activity is particularly concerning in the context of international tax reform. The actions underpinning the OECD's BEPS 2.0 poses a significant threat to the sustainability of Corporation Tax receipts, adding uncertainty to an already volatile and difficult to predict revenue stream.[4]

The Government estimates that BEPS will reduce Corporation Tax revenue by €500 million in 2022, rising by an additional €500 million in each of 2023 to 2025.[5] If a single large MNC were to exit the State, the PBO estimates that Exchequer revenue would fall by around €440 million (capturing the impact on both direct and indirect taxation), with a 2% reduction in Gross Value Added (GVA).[6]

In addition, a productivity gap persists between foreign-owned MNCs and domestic firms, with MNCs continuing to outperform in terms of productivity and wages (including on a within sector basis). As of Q2 2019, almost half of all GVA (45%) comes from MNCs.[7] The productivity of MNCs is also rising at a faster rate, compared to domestic firms. Since Q2 2018, GVA for foreign-owned MNCs has increased by an average of 3.2% per quarter, versus 0.9% for domestic firms. In Q2 2019, GVA for foreign-owned MNCs was 12% higher than in Q2 2018 (versus a 4% increase over the same period for domestic firms). This productivity gap is larger in Ireland than in other OECD countries,[8] and exacerbating the issue, knowledge and productivity spill-overs have been shown to be limited between MNCs and domestic firms (Di Ubaldo, Lawless and Siedschlag; 2018).[9]

3 *Pre-Budget 2020 PBO Commentary, 1 October 2019.*

4 *BEPS 2.0 seeks to create international consensus on a framework for taxation, and could lead to a readjustment in the balance of tax rights and the allocation of profits, between jurisdictions where assets are owned and where consumers are based.*

5 *Medium-Term Fiscal Strategy, Government of Ireland, 9 January 2020.*

6 *Pre-Budget 2020 PBO Commentary, 1 October 2019.*

7 *CSO National Accounts Quarterly, January 2020.*

8 *Compendium of Productivity Indicators, OECD, 2019.*

9 *M. Di Ubaldo, Lawless, M., and Siedschlag, I. 2018. "Productivity spillovers from multinational activity to indigenous firms in Ireland", ESRI, Working Paper 587.*

The geographic concentration of the production base in certain areas is also contributing to regional disparities, with MNCs concentrating their activities in key urban regions (e.g. Dublin and other urban centres).[10] There is also considerable sectoral concentration in export activity: 61% of exports come from the chemicals and pharmaceuticals industries, while 40% of goods exports ship to the UK (11%) and the US (28%).

The PBO emphasises the need to pursue policies that seek to address the imbalances highlighted above, by, among other things, targeting and improving the productivity of relatively less productive industries and firms, particularly domestic SMEs.[11]

Inappropriate fiscal and monetary policy

Probability: Medium

Impact: Overheating; Tax revenue sustainability; Budgetary overspending; Concentration of Corporation Tax receipts

Implications for: General government balance; Domestic demand

Pro-cyclical fiscal policy increases the risk of overheating, particularly in the context of an extraordinarily accommodative monetary policy regime. Appropriate (counter-cyclical) fiscal policy will be crucial to manage this risk in the short term, especially in the absence of a disorderly Brexit.

Persistent spending overruns in recent years (particularly in Health) have weakened the budgetary position, contributing to a deterioration in the general government balance. The Supplementary Estimates[12] for 2019 total €960 million; the supplementary for Health alone was €383 million (and was €645 million in 2018, with this amount forming part of the expenditure base for 2019). In addition, soft budget constraints in respect of capital projects, paired with inaccurate cost estimates, have facilitated sizeable overruns (e.g. in relation to the National Broadband Plan and the National Children's Hospital).[13]

The use of windfall revenues to fund permanent spending, and to meet cost overruns, is an ongoing concern. Since 2015, unexpected Corporation Tax receipts have improved the headline fiscal position. As detailed in Box 3 of this publication, this unexpected (or windfall) revenue risks masking unsustainable spending increases (by distorting the estimated structural balance). Corporation Tax continues to overperform expectations; receipts were €10.9 billion in 2019 (an historic high), which was €1.4 billion ahead of what was anticipated at the time of Budget 2019.[14]

Volatile and unexpected revenue streams should instead be set aside, to preserve the sustainability of the public finances should this volatile revenue fail to materialise in future years. As part of Budget 2020 (which was based on a disorderly Brexit), the planned allocation of €500 million to the Rainy Day Fund for 2019 and 2020 was suspended. As the immediate risk of a disorderly Brexit has subsided, these allocations to the Rainy Day Fund should be reconsidered.

10 *Country Report Ireland, European Commission, 2019.*

11 *Ireland's Competitiveness Challenge 2019, National Competitiveness Challenge, December 2019.*

12 *PBO Analysis of the Supplementary Estimates for Public Services 2019, PBO Publication 74 of 2019, 6 December 2019.*

13 *Summer Economic Statement, Department of Finance, June 2019.*

14 *DPER Databank, January 2020.*

In terms of monetary policy, interest rates remain exceptionally accommodative, and are unlikely to rise through 2020. The governing council of the ECB voted (in December 2019) to maintain the record low deposit rate of -0.5% (introduced in September 2019).[15] This means that monetary policy cannot be relied upon to ease domestic demand in the short-term, and places greater emphasis on the role of prudent fiscal policy in managing the risk of overheating.

While an interest rate cut can stimulate growth (by increasing household disposable income and investment spending), persistently low rates can contribute to financial instability (damaging bank profitability and incentivising investors to seek out riskier investments in search of returns). However, it is worth noting that there is little evidence of reduced policy rates being passed on to Irish consumers or businesses (the interest rate on both personal and corporate loans is relatively high in Ireland compared to other countries in the Euro Area).[16]

Capacity constraints

Probability: High

Impact: Overheating; Falling consumer & business sentiment

Implications for: General government balance; Domestic demand

Unemployment is at 5.2%, implying that the economy is at (or approaching) full employment. This means that additional demand for labour must be met from outside the existing labour force. However, capacity constraints persist in housing, health and childcare, making it harder to attract workers from abroad.

The tightening labour supply, and issues of housing availability, could continue to place upward pressure on prices and wages. This could undermine Ireland's competitiveness, increase domestic demand and strengthen the risk of overheating.

Residential property price growth has slowed through 2019. Dublin experienced negative price growth in the year to November (-0.7%, with negative growth recorded for the 12 months to August, September and October also). This compares to relatively robust growth of 5.1% over the same period in 2018. While remaining positive, price growth has slowed nationally (excluding Dublin), with growth of 3.6% in the 12 months to November (relative to 9.2% over the same period in 2018).[17]

This slowdown is likely the result of a combination of factors, including Brexit-related uncertainty weighing on consumer sentiment, and the effect of the Central Bank's macro-prudential lending rules constraining access to credit. In addition, on the supply side, the number of new dwellings increased by 22% in Q3 2019 over Q3 2018 (with completions 18% higher in the first 9 months of 2019 relative to the same period in 2018).[18] The ESRI estimates the total number of completions for 2019 to be 21,500 units (and 24,500 units for 2020).[19]

15 *Monetary policy decisions, ECB Press Release, 12 December 2019.*

16 *Quarterly Economic Commentary, Winter 2019, ESRI, December 2019.*

17 *CSO House Prices, January 2020.*

18 *CSO New Dwelling Completions, January 2020.*

19 *Quarterly Economic Commentary, Winter 2019, ESRI, December 2019.*

The Department of Finance forecasts that completions will increase to almost 50,000 by 2023.[20] However, with the economy approaching full employment, skills shortages are manifesting (e.g. in hospitality, health and construction) which could slow the pace of residential construction over the medium-term. Beyond residential construction, these capacity constraints can also negatively impact on corporate investment and expansion decisions.

Labour market activation remains a feature of the European Commission's Country Specific Recommendations (CSRs) for Ireland. Specifically, the 2019 CSRs identify the scope for more integrated and targeted labour market activation policies.[21] The participation rate for 25 to 44 year olds remains below the EU average for both men and women, despite improvements in recent years. In addition, the gender participation gap in Ireland is above the EU average, with high childcare costs weighing on labour market participation rates.[22] Ireland has been found to have the highest childcare costs among high income countries,[23, 24] and the ESRI have found evidence of unmet need for childcare in Ireland, with affordability cited as a key concern.[25]

Performance of the global economy

Probability: Medium

Impact: Reductions in external demand; Trade disruptions; Currency fluctuations;
Oil price fluctuations; Falling consumer & business sentiment

Implications for: Current account balance; Domestic demand; General government balance.

Global growth remains subdued, albeit with a slight recovery expected in 2020. However, growth projections are underpinned by key downside risks related to a continuation of the policy uncertainty seen throughout 2019. Should these risks materialise, the emphasis must be placed on sound financial management, and prudent fiscal policy-making, to preserve the public finances.

The IMF,[26] World Bank[27] and OECD[28] have all revised growth figures downwards for 2019, by an average of 0.3 percentage points. These bodies predict, on average, growth of 2.8% for 2019. A downward revision of the same magnitude was made to growth projections for 2020, with forecasts now averaging 2.9%. Should trade tensions ease through 2020, a modest pickup in global trade growth (estimated to be 1.3% in 2019 but rising to 2.2% in 2020) is expected.

20 *Stability Programme Update 2019, Department of Finance, April 2019.*

21 *Country Specific Recommendations, European Commission, 2019.*

22 *Childcare in Ireland: An Analysis of Market Dynamics, Public Programmes and Accessibility, PBO Publication 70 of 2019, 14 November 2019.*

23 *Starting Strong, OECD, 2017.*

24 *Country Report Ireland, European Commission, 2019.*

25 *Access to Childcare and Home Care Services across Europe, ESRI, September 2019.*

26 *World Economic Outlook, IMF, October 2019.*

27 *Global Outlook, World Bank, January 2020.*

28 *Economic Outlook, OECD, November 2019.*

These growth forecasts are subject to sizeable downside risks. Potential risk factors include the possibility of a reescalation in trade tensions (specifically between the US and China and the US and EU), as well as geopolitical fragilities, and the very limited room for additional monetary stimulus should growth prove weaker than expected (with global interest rates already at unprecedented lows).

Strong headline indicators persist in the US, buoyed by the remnant effects of fiscal stimulus. Unemployment is at record lows, with strong growth in real wages driving personal consumption. However, activity is slowing as the effects of fiscal stimulus begin to subside. Further, weak global growth and the threat of an escalation in trade tensions are weighing on US growth. Forecasts for 2019 and 2020 average 2.3% and 2% respectively.

The outlook for the UK remains highly uncertain, notwithstanding the period of relative stability that followed the outcome of the general election in December 2019 (which facilitated the passage of the Withdrawal Agreement Bill through Parliament, and the exit of the UK from the EU on 31 January). Growth is projected to remain relatively flat in 2019 and 2020, at 1.2%. Investment levels remain weak, and sentiment indicators suggest that this trend will continue. Beyond 2020, growth prospects depend heavily on the nature of any EU trade deal that is ultimately agreed.

The ECB has made minor positive revisions to Euro Area growth forecasts for 2019 and 2020 (of 0.1 percentage point), with growth now expected to be 1.2% and 1.1% respectively. Sluggish global growth continues to weigh on net exports. Personal consumption is driving growth, and this trend will likely continue through 2020, on the back of strong labour market conditions and rising real wages.[29]

Of concern, is the extent to which the Irish public finances are insulated against negative developments in the global economy. With limited room for additional stimulus via monetary policy and the lack of a fiscal buffer, the emphasis will be on sound financial management and prudent fiscal policy-making should downside external risks materialise.

Geopolitical tensions

Probability: Medium

Impact: Reductions in external demand; Currency fluctuations;
Falling consumer & business sentiment; Trade disruptions; Oil price fluctuations

Implications for: Current account balance; Domestic demand; General government balance

The immediate risk of a disorderly Brexit has subsided, following a period of heightened uncertainty in the run-up to the initial Brexit deadline of October 2019. The political situation in the UK has stabilised, and following the passage of the Withdrawal Agreement Bill through parliament, the UK formally exited the EU on 31 January.

This means that, while the UK is no longer a Member State of the EU, EU rules will continue to apply until January 2021 (i.e. a “transition period” applies following the UK’s exit). The Department of Finance has updated[30] its growth forecast for 2020, taking account of the latest Brexit extension. Growth is expected to average 3 per cent over 2020 to 2025, assuming a Free Trade Agreement is reached (or the transition period is extended).

29 *Macroeconomic Projections, European Central Bank, December 2019.*

30 *Medium-Term Fiscal Strategy, Government of Ireland, 9 January 2020.*

However, while the immediate risk has subsided for now, a hard Brexit is still a possibility. EU officials[31] (and analysts)[32] have expressed scepticism that a full trade agreement can be reached by the end of the transition period. In addition, the UK Prime Minister has indicated that no additional extension will be sought,[33] while the Chancellor has indicated that there will be no regulatory alignment with the EU once the transition period has ended.[34]

The first phase of a trade agreement was signed by the US and China on 15 January 2020. This gives some certainty in the short term following an escalation in trade tensions throughout 2019. The agreement includes a cut to tariff rates imposed by the US on China, and an increase in Chinese imports of US goods over the next two years. This could, in turn, adversely affect the level of Chinese imports of non-US goods.

Geo-political tensions are high following an air-strike by the US on an Iranian military official. However, concerns about future oil supply, and the implications for oil prices of an escalation in tensions, are being offset by the subdued level of global growth (particularly the moderation of growth in China).[35,36]

Environmental concerns

Probability: Medium

Impact: Unmet energy and emissions targets; Tax revenue sustainability;
Extreme weather events; Oil price fluctuations

Implications for: General government balance

A failure to meet energy and emissions targets by 2020 and 2030 will require the purchase of costly allowances, negatively impacting the general government balance. Furthermore, revenue sourced from carbon related taxes will decline over time, in line with the transition to a lower carbon economy, potentially leaving a sizeable gap in the public finances.

Estimates of the cost of compliance vary considerably, ranging from a combined €3 billion to €6 billion in respect of both 2020 and 2030 targets.[37] The actual cost associated with missing later targets (in 2030) will depend on the extent of climate action taken in the intervening period.

In his 2018 annual report, the Comptroller and Auditor General (C&AG)[38] estimates that up to *€124 million* will be required to ensure compliance with energy and emissions targets (this is in addition to the €121 million already spent on acquiring carbon credits).

31 *"Full Brexit deal by end of year 'just not possible', EU trade chief says", The Independent, 16 January 2020.*

32 *Getting Brexit done – What happens now?, Institute for Government, 10 January 2020.*

33 *"Boris Johnson accused of 'brinkmanship' by EU trade chief", Financial Times, 16 January 2020.*

34 *"Forget staying close to EU after Brexit, chancellor tells business", Financial Times, 17 January 2020.*

35 *Oil Market Report – January 2019, International Energy Authority, January 2019.*

36 *Monthly Oil Market Report, OPEC, 17 January 2019.*

37 *J. Curtin, 2016, How much of Ireland's "fiscal space" will climate inaction consume?, IIEA blog, September 2016.*

38 *2018 Annual Report – Chapter 9, Comptroller and Auditor General, September 2019.*

Approximately one third of Ireland's acquired credits were retired in compliance with targets in the first commitment period of the Kyoto Protocol (from 2008 to 2012). The remainder can be carried forward for compliance in the second commitment period (from 2013 to 2020), however this is unlikely to suffice. The Department of Communications, Climate Action and Environment estimates that the cost to Ireland of purchasing the additional credits to make up the likely shortfall, is in the range of *€2 million* to *€14 million*.[39]

For renewable energy, Ireland has a mandatory target for at least 16% of gross final energy consumption to come from renewable sources by 2020. SEAI projections indicate that this target will be missed, which could result in costs of up to *€110 million*.

In addition, revenue from environmental taxes derives largely from vehicles and is linked to CO_2 emissions (e.g. Motor Tax and Vehicle Registration Tax). As Ireland transitions to a low carbon economy, revenues sourced from these taxes will diminish over time, leaving a sizeable gap in the Exchequer and worsening the general government balance, unless offsetting measures are implemented.[40, 41]

Box 2: OECD BEPS 2.0 Update

Base Erosion and Profit Shifting (BEPS) describes the efforts by a company to erode taxable income and ultimately reduce the amount of tax it is liable to pay, including the movement of profits away from a high tax jurisdiction to a relatively low tax jurisdiction. An OECD report (2017) estimates that revenue forgone under BEPS activity amounts to $100bn to $240bn per annum.

BEPS is the acronym of the OECD project to tackle this tax avoidance activity. This is an international collaboration led by the OECD Secretariat between 135 countries to agree to significant changes in tax policies and practices to tackle tax avoidance by multi-national companies, improve the coherence of international tax rules and ensure a transparent tax environment

The OECD produced the BEPS Programme of Work in 2019. It outlines a number of options and approaches that could be adopted. The working plan consists of **two main pillars**:

- The **first pillar concerns changes to profit allocation rules**. Specifically, this involves reallocating a share of profits from where a company is based to where sales or users are located;
- The **second pillar concerns the implementation of a global minimum effective tax rate** and a tax on base eroding payments.

The final report is expected to be published in 2020.

39 *Ibid.*

40 *PBO Pre-Budget 2019: Energy and Environmental Tax Issues and Options, Summary of Tax Strategy Group Paper, 18 September 2018.*

41 *An Analysis of the Sustainability of Vehicle Registration and Motor Tax, PBO Publication 50 of 2019.*

Impact on Ireland

Ireland benefitted from the first OECD BEPS initiative as it aimed to align company profits with the location of economic activity.

The second round of BEPS could pose a risk to Corporation Tax (CT) revenue. If CT is paid where a company's sales or users are located, it would benefit larger markets that are net-importers. Small export intensive economies such as Ireland would lose a portion of its tax base as a larger proportion of profits would be allocated to larger countries.

The current working programme does not specify a level for the global minimum effective tax rate. It also isn't clear whether it would be set globally or on a jurisdiction-by-jurisdiction basis. However, there is a strong possibility (depending on how it is designed) that it would undermine Ireland's competitive advantage in attracting foreign direct investment and the effectiveness of the R&D tax credit.

The Department of Finance has produced projections of the impact of BEPS on corporation tax revenue. From 2022 to 2025 Corporation tax receipts will fall by €500 million per year. This means that CT receipts will be €2 billion lower in 2025. There is significant uncertainty regarding this figure however, given that the OECD proposals are still developing and will need to be negotiated by OECD member states.

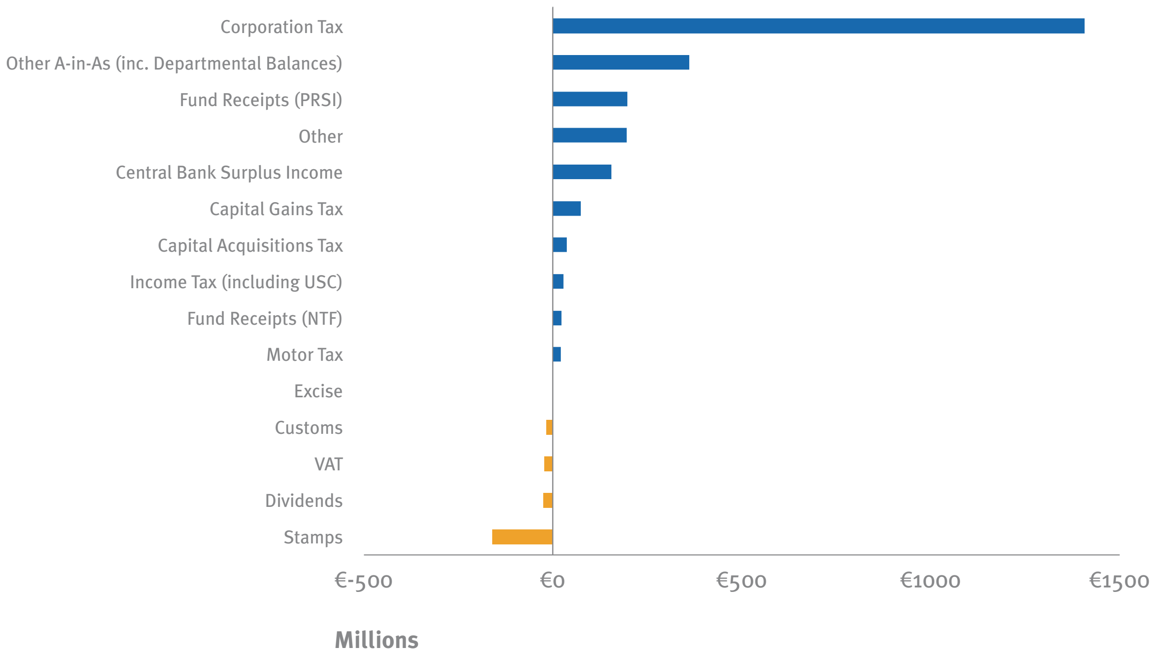
Fiscal Developments

This section briefly outlines the main fiscal developments in Q4 2019. It concentrates on the end of December Exchequer returns.[42]

Figure 16 shows Central Government revenue by source. It excludes transactions with no General Government Balance impact such as inter-Government loan transactions.

Taxation and Other Revenue

Figure 16: Taxation and other Central Government Revenue 2019 – Variance from Profile



Overall, **revenue** was **€74.3 billion**, which was **€2.3 billion** or **3.2% above** expectations at the beginning of 2019:

- Tax revenues were **€59.3 billion**, and almost **€1.37 billion above** profile;
- Appropriations-in-Aid were **€13.3 billion**, and **€584 million above** profile; and
- Non-tax revenue was **€1.7 billion** and **€327 million** above profile.

Year-on-year revenue was up **€4.5 billion or 6.5%**.

42 *Based on the Fiscal Monitor December 2019 (published January 2020). Unless otherwise stated, that edition of the Fiscal Monitor is the source of the fiscal data used here.*

Taxation

Taxation, overall, was €1.37 billion above profile for the year. While the variance is 2.4% above profile, individual taxes experienced significant variance both above and below profile. The following taxes exceeded profile (see Figure 16):

- Corporation Tax was **€1.4 billion or 14.8% above** profile;
- Capital Gains Tax was **€75 million or 7.5% above** profile; and
- Capital Acquisitions Tax was **€38 million or 7.7% above** profile.

However, receipts were below profile in a number of taxes, including:

- Stamp Duties were **€160 million or 9.6% below** profile; and
- Customs were **€16 million or 4.5% below** profile.

Corporation Tax receipts were therefore the substantive driver of the increase in tax revenue in 2019.

Despite twice revising the forecast for Corporation Tax revenue in 2019 (rising from €9.4 billion in January 2019, to €10 billion in the SPU, and finally to €10.3 billion in Budget 2020) the final outturn in December 2019 was €1.4 billion ahead of the original profile. It was also nearly €0.6 billion ahead of the Budget 2020 forecast. **The difficulty in accurately forecasting Corporation Tax revenue highlights the inherent volatility of this tax (in the Irish context, in particular), and emphasises the need for caution when using these receipts to fund increases in current spending.**[43]

The PBO's *Pre-Budget 2020 Commentary (October 2019)* highlighted its concern that, in 2018, a small number of multinational companies (MNCs) were responsible for over 45% of all Corporation Tax receipts. Clearly, the reliance on a small group of companies for a large amount of tax revenue can pose substantial threats to the public finances given the implications were one or more of these companies to transfer their operations out of Ireland. A PBO model within the same publication estimated that a "typical large MNC exiting Ireland would reduce revenue by approximately €440m (in terms of reduced Corporation Tax, Income Tax, USC, employer's PRSI and the VAT paid by the firm)" with around €323m of this lost revenue being in Corporation Tax receipts alone.

The PBO notes that, had Corporation Tax receipts come in on profile, overall revenue would have been below profile by €34 million. On this basis, the PBO welcomes statements from the Minister for Finance indicating that surplus revenues will not be used to fund permanent spending.[44]

2019 saw an increase above profile, and year-on-year, in capital taxes (Capital Gains Tax and Capital Acquisitions Tax, i.e. inheritance and gift tax), which may suggest a continued buoyancy in the economy based on certain asset classes increasing in value. Both returns are above their 2019 profiles (7.5% and 7.7%, respectively) and 2018 outturns (8.2% and 2%, respectively).

Stamp Duty saw a significant underperformance against profile of €160 million or 9.6% which may indicate a softening of the property market in terms of residential sales which were 3% lower than 2018.[45] Despite this shortfall, Stamp Duty receipts in 2019 outperformed the 2018 outturn by €62 million (a year on year increase of 4.2%).

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43 *For a discussion of the implication of tax volatility and its policy implications see PBO Working Paper Series. No. 1 of 2019, Examining the Volatility of Ireland's Tax Base in the Paradigm of Modern Portfolio Theory.*

44 *Department of Finance (2019) Press Release: Minister Donoghue welcomes strong November Tax Performance, December 2019.*

45 *Source: https://statbank.cso.ie residential property sale executions for 2018 and 2019 (PBO calculations).*

When the slowdown in residential property sales is taken into account this outperformance, year-on-year, may be the result of greater returns from commercial property stamp duty, the rate for which increased in Budget 2018 from 2% to 6% with an estimated full year yield of €376 million.

The under performance against profile highlights the point made in the PBO's Post-Budget 2020 Commentary in relation to facilitating more informed scrutiny of revenue forecasts. In that Commentary, the PBO made the point that there have been sizeable forecast errors in recent years for more cyclical taxes.

The PBO also welcomes the *report* of the Tax Forecasting Methodological Review Group, published in December 2019 (the third of its kind). The report finds the overall forecasting performance to be robust. However, the PBO would further welcome an annual publication by the Department of Finance, examining the source of any forecast errors or deviations from profile over the preceding 12-month period. This would facilitate more informed scrutiny of revenue forecasts. There have been sizeable forecast errors in recent years for more cyclical taxes (Corporation Tax and Capital Taxes). The publication of an assessment by the Department of the source of any forecast errors (e.g. identifying issues relating to the underlying macro-driver used to predict receipts, or the inaccurate costing of policy changes), would facilitate greater scrutiny of revenue forecasts.

Excise Duty came in exactly on profile at €5.9 billion, up €523 million or 9.6% on 2018. It would appear that Excise forecasting has stabilised following a period of distortion likely resulting from the impact of the introduction of plain tobacco packaging in 2017.

The largest tax receipt categories, Income Tax and VAT, were €29 million above and €22 million below profile respectively. These represent deviations from profile of only 0.1% and -0.1%, respectively. Both categories of tax have seen sizeable growth year on year (Income Tax 8%, and VAT 6.2%) suggesting continued strong economic performance in 2019.

Box 3: Ongoing implications of windfall Corporation Tax revenue for the assessment of the underlying fiscal position

The structural balance is one of the main pillars of the EU fiscal rules. Unlike the actual budget balance (which is affected by cyclical changes in tax revenues and public spending)[46], the structural balance[47] is intended to account for the effects of economic fluctuations, to give policymakers certainty when setting fiscal policy (Bedogni and Meaney, 2017)[48]. As a result, "revenue buoyancy" (i.e. the response of tax revenue to changes in the macroeconomic environment), would in principle be accounted for by the structural balance, which is a proxy for the underlying condition of the public finances.

46 *For example, in a recession the fiscal balance will deteriorate due to lower revenues and increased public spending on unemployment payments. However, these effects tend to be of cyclical nature as they will dissipate over time when the economy recovers and returns to growth.*

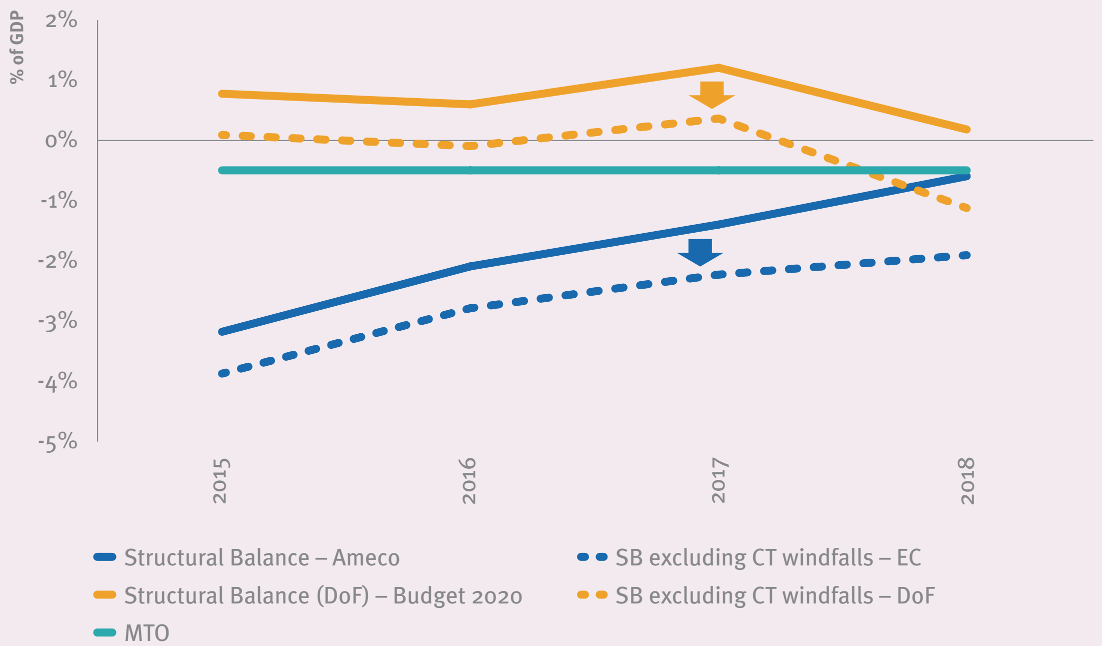
47 *The Government Budget Balance (GBB) adjusted for the impact of cyclical or temporary tax receipts and expenditure (Cyclical Budgetary Component – CBC (output gap x budgetary elasticity)), and one-off measures such as bank recapitalisations.*

48 *Bedogni, J. and K. Meaney, (2017). EU Fiscal Rules and International Expenditure Rules. Irish Government Economic and Evaluation Service, 2017. Dublin.*

In the case of Ireland, one limitation of the EU fiscal rules is that the unprecedented levels of Corporation Tax (CT) receipts collected from 2015, which might reflect both permanent and temporary factors, have affected estimates of the structural balance. Indeed, in the calculation of the structural balance there is no correction for the portion of CT receipts that cannot be explained by economic developments (i.e. the adjustment for the output gap in the economy).

In this Box, we analyse the implications of estimated windfall CT revenue for the assessment of Ireland's underlying fiscal position.

Figure 17: Ireland's underlying fiscal position 2015-2018 adjusted for CT windfalls



Source: PBO own analysis, AMECO and Department of Finance (DoF).

Note: CT windfalls are estimated as the difference between the actual growth of CT revenues and the CT revenue growth expected according to the growth rate of nominal GNI, with an elasticity of 1. Based on this approach, we estimate windfalls of approximately: €1.8 bn for 2015 (0.7% of GDP); €1.9 bn for 2016 (0.7% of GDP); €2.5 bn for 2017 (0.8% of GDP); and €4.3 bn for 2018 (1.3% of GDP).*

Figure 17 presents two sets of estimates for the structural balance (SB): the structural balance estimated by the EU Commission (AMECO data) and SB estimates by the Department of Finance based on their alternative methods for estimating the output gap (DoF). Overall, DoF estimates assess that Ireland over-achieved its Medium-term budgetary objective (MTO) – a structural balance of -0.5% of GDP – over 2015-2018, while CAM-based estimates present a worse situation for the underlying balance.

When we account for estimated windfall CT revenue, the distance between the revised structural balance and the MTO increases for the EU-CAM estimates, as the underlying fiscal position dis-improves by the amount of subtracted CT revenue windfalls. According to DoF estimates, the structural balance for 2018 falls short of the MTO requirement once €4.3 bn of CT windfalls are subtracted.

Revenue windfalls (that portion of revenue that is in excess of economic fundamentals (e.g. GDP) distort the estimated structural balance and therefore improve Ireland's compliance with the structural balance rule. When a Member State is at its MTO, compliance with the spending rule is not assessed. Because of this, revenue windfalls may mask unsustainable spending increases. The risks are magnified by the fact that for Ireland the Expenditure Benchmark (the spending rule) is not binding in 'good times', as it is based on pro-cyclical estimates of potential GDP growth.[49]

The reform of the six-pack highlighted the role of revenue windfalls in fiscal surveillance. If a Member State has overachieved its MTO, the occurrence of a deviation from the expenditure benchmark is not considered in the assessment of the existence of a significant deviation, unless significant revenue windfalls are assessed to jeopardise the MTO.

Revenue windfalls are deemed to be significant when they explain the entire overachievement of the MTO, in a way that a reversal of these windfalls in the future would put the MTO at risk (European Commission, 2019)[50]. However, in the fiscal surveillance framework there is no quantitative criteria to identify when revenue windfalls are significant. The Commission applies case-by-case judgment, particularly they attempt to identify cases in which these revenues are used to fund permanent expenditure.

This is an issue that has not been raised for Ireland so far, given broad achieved compliance with the expenditure benchmark. However, due to some of the shortcomings of the fiscal rules for Ireland, policy makers should be aware of the extent to which windfall CT revenue give a misleading positive impression of the underlying fiscal position.

This already happened in the past with housing-related tax receipts distorting the underlying fiscal position (and masking unsustainable expenditure developments) in the pre-crisis period. However, it must be noted that this time the underlying factors are different. The period of economic overheating in the 2000s, was mostly due to domestic factors fuelled by exceptional credit growth, while current developments in CT are largely dependent on external factors. In conclusion, prudence should be applied regarding how these excess funds are used.

49 *For an analysis of this issue see PBO Briefing Paper "Potential Output, the Output Gap and Associated Key Issues for Fiscal Policy-making in Ireland, page 14".*

50 *European Commission (2019). Report on Public Finances in EMU 2018. Institutional Paper 095, January 2019. Brussels.*

Appropriations-in-Aid

Appropriations-in-Aid were **€584 million** above profile in **2019** with receipts from **Pay-Related-Social-Insurance (PRSI) €198 million** or **2%** over profile. 'Other' Appropriations-in-Aid including Departmental Balances were **€362 million** or **14.3%** above profile. The PBO cannot ascertain, from the data presented in the Fiscal Monitor, what is driving this increase in 'other' Appropriations-in-Aid.

Non-Tax Revenue and Capital Resources

Non-tax revenue is, as in 2018, significantly above profile – by **€327 million** or **23.5% in 2019**. Contributing factors include:

- Central Bank surplus income of **€720 million** was **€155 million** or **27.4%** above profile; and
- 'Other' revenue excluding Capital Resources was **€240 million** or **52.1%** above profile.

Income from dividends was **€25 million** or **8.6%** below profile and overall income from dividends was just **€1 million** ahead of such income in **2018**. The ESB, DAA, Shannon Foynes Port, and Port of Waterford paid dividends to the state in 2019 that were in excess of their 2018 payments.

Capital Resources were €44 million or 59.3% below profile, representing a reduction on the 2018 figure of €63 million or 67.6%. This underperformance is driven by a substantial decrease in receipts from the European Regional Development Fund (ERDF) which is down **€65 million on 2018**.

Non-General Government Balance Impacting Revenue

There are four main elements of revenue with no General Government Balance impact in the Exchequer Statement (see Appendix 2):

- Payments of €725 million received from the European Commission for implementation of the European Agricultural Guarantee Fund (EAGF) and European Agricultural Fund for Rural Development (EAFRD);
- Repayments of advances to the Supply Account were €330 million;[51]
- Central Bank Surplus Income of €1,665 million is €427 million (34.5%) over-profile;[52] and
- 'Other' Capital Resources – this amounted to above profile receipts of €675 million.

51 *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.*

52 *An explainer on the drivers of Central Bank Surplus Income can be found in PBO Note 5 of 2018.*

Overall Exchequer Spending

At the end of 2019, overall Central Government expenditure (excluding transactions with no General Government Balance impact) equalled **€75.3 billion**, €277 million **above** profile and €3.5 billion (or 4.9%) more than in 2018. This was made up of €67.4 billion in Voted expenditure, €2.9 billion in non-Voted expenditure and €5 billion in interest on the National Debt:

- Gross Voted **Current** Expenditure was **€757 million** (1.3%) **above** profile; which is a significant change even from the end of November when Gross Voted Current Expenditure was 0.3% or €171 million under profile;
- Gross Voted **Capital** Expenditure was **€24 million** (0.3%) **above** profile. This is a significant deviation from the end of November, when capital expenditure was **€387 million below** profile;
- As at year end 2019, Gross Non-Voted Current Expenditure was **€229 million** (7.4%) below profile; and
- Interest on the National Debt was **€275 million** (5.2%) below profile, again as at year end 2019.

The €504 million in below-profile expenditure under Gross Non-Voted Current Expenditure (which includes the Interest on the National Debt) occurred in areas where Government has limited ability to impact expenditure in the short term.[53] This means that voted current and capital expenditure convey a more meaningful evaluation of the soundness of public financial management.

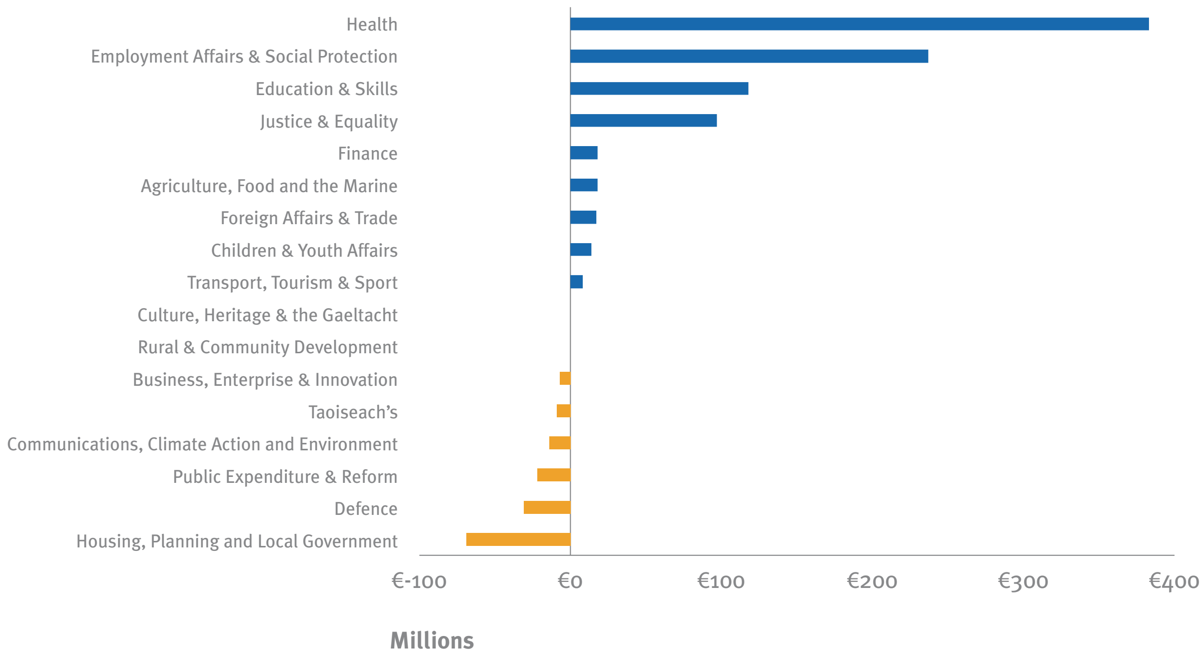
Another issue that arises is the recurrence of below profile spending in non-voted current expenditure. As government is not in a position to directly dictate this expenditure within-year, this recurrence may suggest that the profiles for non-voted current expenditure were too high.

53 *For more detail see PBO Publication 26 of 2019, General Government Expenditure: How its composition constrains decisions about government spending.*

Gross Voted Current Expenditure

As noted above, overall gross Voted current expenditure is **€757 million** (1.3%) above profile. This position is driven by **above profile** spending totalling €892 million in nine Vote Groups (see Figure 18).

Figure 18: Gross Voted Current Expenditure by Department Vote Group 2019 – Variance from Profile



- Health is **€383 million** (2.3%) above profile;
- Employment Affairs and Social Protection is **€237 million** (1.2%) above profile;
- Education & Skills is **€118 million** (1.2%) above profile;
- Justice & Equality is **€97 million** (3.8%) above profile;
- Agriculture, Food and the Marine is **€18 million** (1.3%) above profile;
- Finance is **€18 million** (3.7%) above profile;
- Foreign Affairs and Trade is **€17 million** (2.1%) above profile;
- Children and Youth Affairs is **€14 million** (0.9%) above profile; and
- Transport, Tourism and Sport is **€8 million** (1%) above profile.

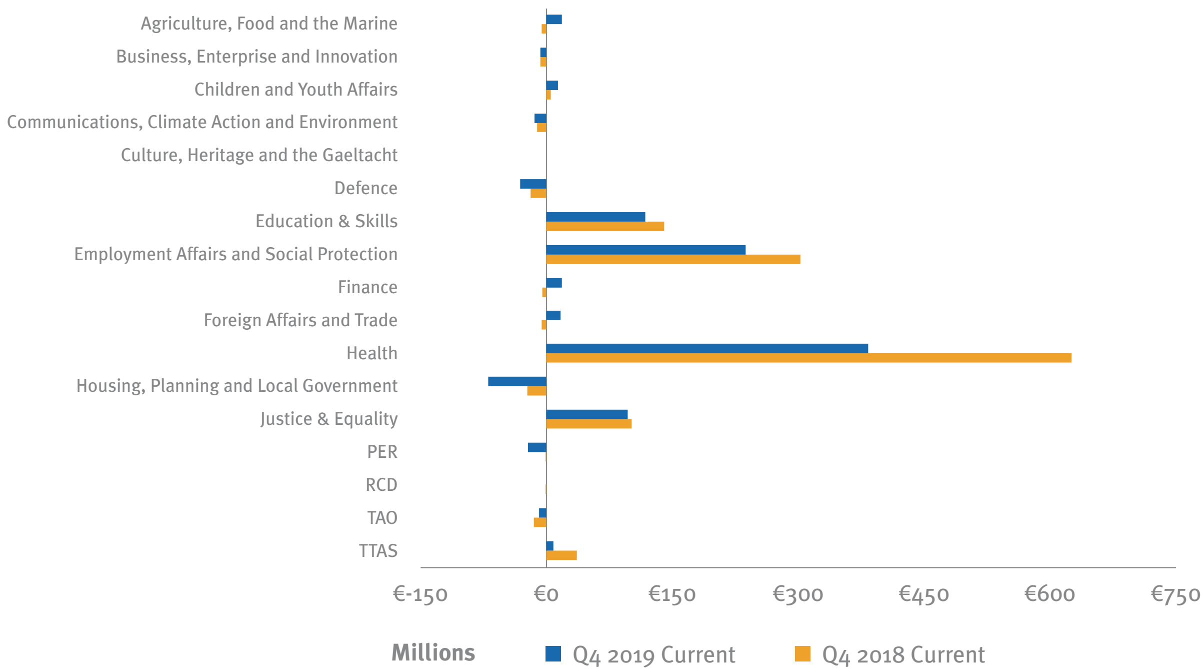
The total underspend in Vote groups where expenditure is below profile is **€152 million** compared to above profile expenditure of **€910 million** in Vote groups where expenditure exceeds profile. Taken together, this results in the **€757 million** aggregate spend above profile in gross Voted current expenditure.

The largest underspend by absolute value is **€69 million** in Housing, Planning & Local Government, equating to 3.6% of the overall estimate for 2019. Proportionally, the largest underspend is **4.7%** (or €9 million) in Taoiseach's Vote Group.

Alternatively, when compared to the final Estimates for 2019 i.e. including the Supplementary Estimates (as published in the *Revised Estimates for Public Services 2020*), [54] twelve Vote Groups are below their 2019 allocation, one is slightly ahead of its allocation (Foreign Affairs & Trade: €3 million), and four Vote Groups have spent their exact allocation. Of these four, Health and Justice & Equality spent the entirety of their allocation, including the whole of their Supplementary Estimates. The largest variance by absolute value is **€84 million** (4.3%) in Housing, Planning & Local Government, while the largest proportionally is Taoiseach's, which is below allocation by **7.6%** (€15 million).

Figure 19 sets out the variance from profile by Vote Group if we compare 2018 with 2019. This shows, for example, that the Education & Skills, Employment Affairs & Social Protection and Health Vote Groups spent substantially in excess of what was profiled in both 2018 and 2019 but to a lesser extent in the latter year.

Figure 19: Current Expenditure by Vote Group – Variance from Profile (2018 v 2019)

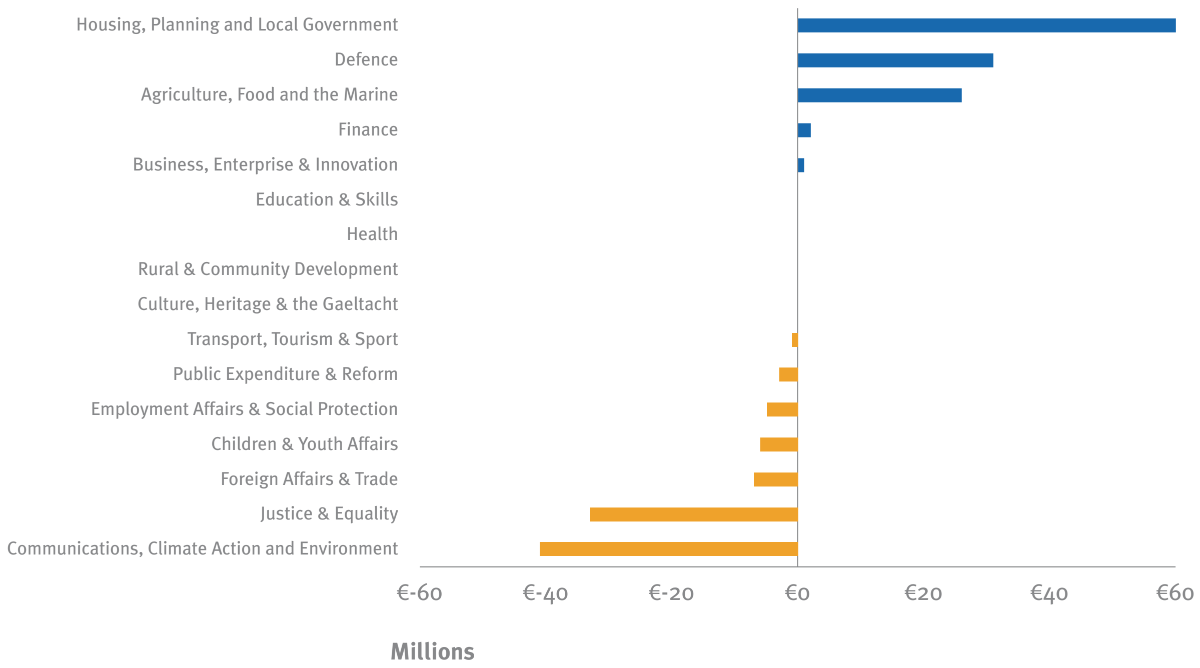


54 *That is to say, the spending profiles set out in the Fiscal Monitor do not reflect the Supplementary Estimates sought in November/December 2019.*

Gross Voted Capital Expenditure

As with 2018, during the first 11 months of 2019 capital expenditure was consistently below profile. Again, as in 2018, this trend reversed in December, resulting in capital expenditure coming in **€24 million** (0.3%) above profile. Figure 20 provides an overview for 2019 capital expenditure against profile.

Figure 20: Gross Voted Capital Expenditure by Department Vote Group 2019 – Variance from Profile



Five Ministerial Vote Groups have above profile spending at end-2019:

- Housing, Planning and Local Government: **€60 million** (2.8%);
- Defence: **€31 million** (29.2%);
- Agriculture, Food and the Marine: **€26 million** (10.2%);
- Finance: **€2 million** (9.3%); and
- Business Enterprise and Innovation: **€1 million** (0.2%).

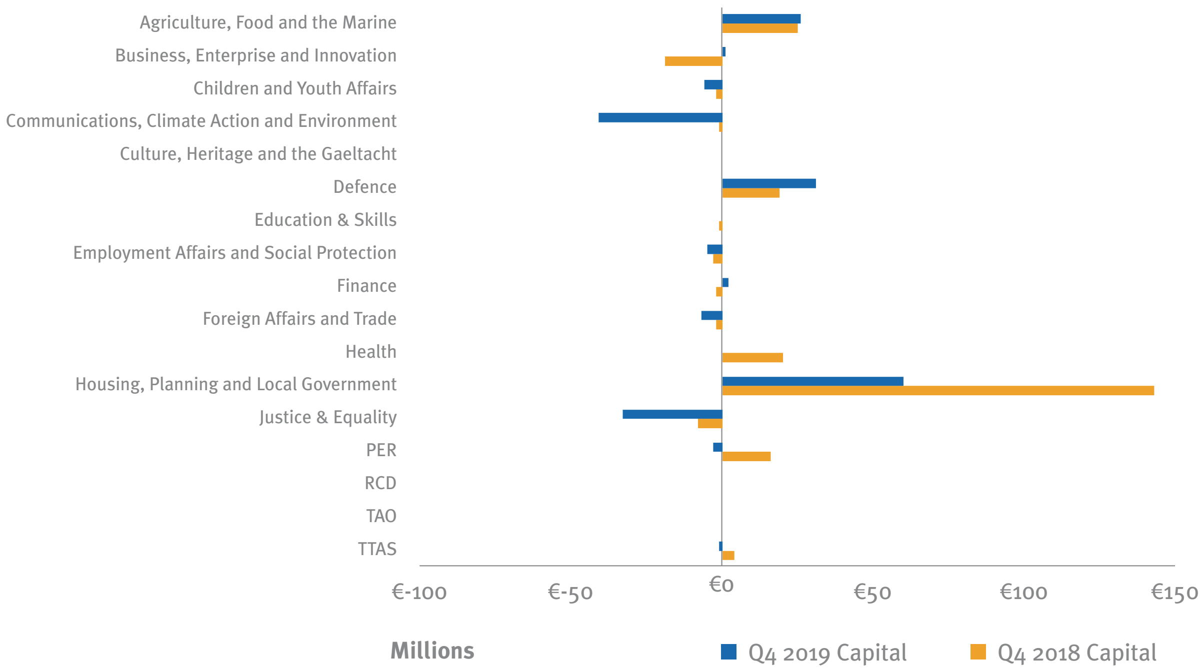
The three largest Vote Groups (by overspend) above also came in ahead of profile at end December 2018. From a forecasting viewpoint, the PBO notes that at end-November 2019 all Vote Groups (with the exception of Housing) were significantly under profile on Capital Spending. This trend has been noted in previous years and may be the result of intentional invoicing practices or accounting methods being employed within Departments. **From the perspective of parliamentary scrutiny it would be useful for the Department of Finance to provide a brief explanation with the Fiscal Monitor when such trends emerge in 2020.**

Three Vote Groups ended 2019 having spent exactly their profiled allocations with the remaining seven Vote Groups coming in below profile. The underspends range from €1 million to €41 million, with a total underspend of €96 million.

Again, when we compare the Exchequer provisional outturn to the final Estimates for 2019 from the *Revised Estimates for Public Services 2020* (which includes the Supplementary Estimates), Housing, Planning & Local Government, and Defence are both above their final approved allocation, with a variance of €60 million and €31 million, respectively. While for Housing this equates to a relatively small proportionate increase of 2.8% above the original estimate, the Defence overspend is proportionately much larger at 29%. Sizeable underspends on the current side of their budgets have been used to fund overspends on the capital side in these two areas.

Figure 21 compares the variance from profile for 2019 with that for 2018 and shows that Housing, Planning & Local Government spent more than profiled in both years although to a lesser extent in 2019 (by €60 million). Agriculture, Food & the Marine has spent more than profiled in both years and to nearly the same extent. Communications, Climate Action & Environment on the other hand spent effectively to profile in 2018 but substantially underspent in 2019.

Figure 21: Capital Expenditure by Vote Group – Variance from Profile (2018 v 2019)



Quarterly Economic and Fiscal Commentary

Expenditure Commentary

In the PBO's Gross Expenditure Monitor covering up to end-September 2019,[55] it was predicted that, given spending profiles to date, it was likely that Supplementary Estimates would be required in a number of Vote Groups later in 2019. This was despite the Department of Finance's September Fiscal Monitor showing that the majority of Vote Groups, particularly Health, had spent less than their profiled allocations.

In addition to Health, the PBO highlighted, for example, that the potential need for a Supplementary Estimate in the Justice Vote Group was evident inasmuch as the Garda Commissioner's September 2019 report to the Policing Authority had referred to a "range of capital and current expenditure adjustments" required by the end of 2019. This was not, however, reflected in the spending outturns of the Justice Vote Group in the Fiscal Monitor.[56]

The PBO subsequently expressed its concern that, at a time when requests for Supplementary Estimates totalling €0.6 billion were being scrutinised by the Dáil Select Committees, that the latest Fiscal Monitor (November 2019) was showing that Net Voted spending was €0.7 billion below what was profiled to be spent. For the Fiscal Monitor to be an effective tool for monitoring in-year spending, it should include accurate financial data for each Vote as well as each Vote Group with actual spending levels being presented wherever possible.

A significant component of the spending being committed to is long-term day to day while additional revenue such as Corporation Tax is more volatile. The three largest overspends by Vote Groups in 2019 were all on the current side with the Education & Skills and Health Votes again being driven by increases in pay.[57] While Current Expenditure in the Employment Affairs & Social Protection Vote was above profile, this was in part due to the decision in Budget 2020 to again award a Christmas Bonus.

Overall Balance

The Exchequer Balance shows a surplus of €647 million at the end of 2019. This is €3 billion better than was profiled. This improvement is a result of tax and non-tax revenue (€2.3 billion higher than profiled) and non-general government impacting revenue (€1.1 billion higher than expected). This increased revenue is offset by Exchequer expenditure (€0.3 billion) and non-general government impacting expenditure (€76 million) higher than projected.

Excluding non-general government impacting transactions, a number of factors affected the Exchequer balance:

- Tax Revenues are €1.37 billion over profile, which is the result of €1.4 billion in unexpected Corporation Tax receipts;
- Appropriations-in-Aid (including PRSI) are €584 million above profile; and
- Other Revenues are €327 million above profile.

55 *PBO Publication 56 of 2019, Gross Expenditure Monitor: January to September 2019.*

56 *The Justice Vote Group is composed of a number of Votes, the most fiscally significant of which is the Garda Síochána Vote – see PBO Publication 2 of 2020 for an infographic representation of the Vote Groups and Votes and which Committees of Dáil Éireann scrutinise them.*

57 *For an analysis of how the composition of voted expenditure constrains decisions about Government spending, see PBO publication 26 of 2019.*

Taken together, the Exchequer revenues (excluding non-general government impacting transactions) are almost €2.3 billion above profile. However, overruns in spending totalling €0.35 billion (particularly in Health current expenditure), means that the Exchequer position (excluding non-general government impacting transactions) has improved by €2 billion above profile.

There are a number of savings that improve the Exchequer balance including:

- €275 million in reduced cost of managing and financing the national debt; and
- €143 million less in EU budget contributions than profiled.

The Exchequer has seen a more substantial surplus in 2019 than in 2018 (€647 million forecast v. €99 million).[58] While this is welcome, the profiled forecast for end 2019 was for a deficit in the Exchequer Balance of €2.4 billion. The fact that there was ultimately a surplus of €3 billion ahead of profile would call into question the accuracy of the forecasting models being used. It also highlights the country's mounting reliance on sources of revenues which are proving difficult to accurately forecast.

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 November 2019 was €211.8 billion, with the National Debt at €185.4 billion.[59]

Budget 2020 projected that Ireland's Gross General Government Debt (GGD) would be €203.6 billion by the end of 2019, corresponding to 59.3% of GDP.[60] In the medium term, the ratio of Gross GGD is projected to continue falling, to 53% by 2024, though in real terms Gross GGD is estimated to increase to €218.5 billion in the same period. This ratio is relevant, as it sets the threshold (60%) under the preventative arm of the Stability and Growth Pact (the framework for ensuring sound public finances in the European Union and Eurozone).

The PBO has previously commented on the problems inherent in measuring the performance of Ireland's economy by GDP. The use of GDP tends to overestimate both the size and the performance of Ireland's economy and the use of the "debt-to-GDP ratio gives a flattering impression of the burden of General Government Debt upon the sustainability of public finances."[61] Alternate measures such as GNI* present a more accurate profile of Ireland's economic performance and, as such, debt and deficit ratios should use GNI* as a denominator. However, GNI* is also not directly comparable to GDP ratios in other countries. The 2019 SPU estimates that gross debt as a rate of GNI* will be 101.7% in 2019, falling to 93.0% in 2020.

A forthcoming publication by the PBO will re-examine this area in more detail.

58 *The CSO produces the statistics on the General Government Balance and the preliminary estimates are expected in April.*

59 *NTMA, Composition of Debt end of November 2019.*

60 *Budget 2020: Economic and Fiscal Outlook (October 2019), p. 33.*

61 *See PBO, General Government Debt: Key Issues to Consider (November 2018) p. 4.*

Box 4: A Primer on Revenue Hypothecation

As part of Budget 2020, the Government introduced a €6 increase in the Carbon Tax, increasing the levy to €26 per metric tonne of carbon emissions. It was also announced that the additional revenues raised from this increase would be "ring-fenced" to help fund climate-related policies.[62] Approximately €431 million was raised from Carbon Tax in 2018.[63] While revenue figures for 2019 are not yet available, this increase is expected to yield an additional €90 million in 2020 (or €130 million in a full year).

In light of the commitment by Government to ring-fence the additional revenue raised from the increase in the Carbon Tax (i.e. €90 million), this Box provides a primer on the idea of tax revenue hypothecation. It defines what revenue hypothecation is and sets out the arguments for and against the practice. It concludes with an (non-exhaustive) overview of some examples of hypothecation in practice in Ireland.

What is revenue hypothecation?

Revenue hypothecation is a policy tool for 'ring-fencing' specific tax receipts to fund a particular policy area, often linked to the tax itself. This differs from the usual government practice in which tax receipts are consolidated in the Central Fund, from which government spending is drawn. While hypothecation prescribes that the ring-fenced revenue must be used for a specific purpose, it does not suggest that revenue from other sources cannot also be spent in the same way (or on the same policy area). Though the practice is not a regular feature of Irish fiscal policy, it is commonly used among US states, with approximately 24% of all state-level revenues earmarked. It is most prevalent in infrastructure, where fuel taxes and highway fees are regularly earmarked to fund road maintenance, public transit and new infrastructure, such as bridges.[64]

The case for revenue hypothecation

The case for revenue hypothecation rests on the idea that, from the perspective of the electorate, there is a tenuous link between the level or nature of public spending and the amount of taxes paid.[65] Furthermore, in contexts in which there has been a historic misuse or diversion of public funds, this can result in apathy among the electorate and/or public opposition to new tax measures.

Earmarking can serve to improve public support for new taxes, by re-affirming the conceptual link between taxes paid and public spending. It can also address the informational asymmetry between the public and the State, by elucidating the "money in versus money out" relationship between tax and spending. Furthermore, the hypothecation of revenue can act as a constraint mechanism, to bind political decision makers to a specific course of action and may restrict the ability of future governments to alter policies.[66]

62 *Statement of the Minister for Finance and Public Expenditure and Reform on Budget 2020, October 8th 2019.*

63 *Revenue Commissioners (2019) Excise Receipts by Commodity.*

64 *Jackson, J (2013) 'Tax Earmarking, party politics and gubernational veto: theory and evidence from US states' Public Choice Vol.155(1), pp.1-18.*

65 *Jacobs, A. M & J.S Matthews (2017), 'Policy Attitudes in Institutional Context: Rules, Uncertainty, and the Mass politics of Public Investment' American Journal of Political Science Vol.61(1) pp. 194-207.*

66 *Jackson, J (2013) 'Tax Earmarking, party politics and gubernational veto: theory and evidence from US states' Public Choice Vol.155(1), pp.1-18.*

The case against revenue hypothecation

The process of earmarking revenues for specific uses may constrain spending decisions, reducing flexibility and distorting resource allocations. This can result in less desirable or inefficient policy outcomes.

Hypothecation also ties a portion of spending to the volatility of the revenue base. This is especially relevant when the revenue is sourced from a tax designed to induce a behavioural change (such as the Plastic Bag Levy or Carbon Tax). In this case, the tax take will likely fall over time. This will result in revenue shortfalls negatively impacting the programme of spending for which the revenue was intended.

On the other hand, for particularly buoyant (or pro-cyclical) sources of revenue, surpluses may exceed the demands of the spending programme for which receipts have been earmarked. In that case, it may be desired to spend the excess funds elsewhere. The hypothecation of pro-cyclical revenues might also mean that these revenues are unavailable for spending when they are needed most (e.g. revenues aimed at providing targeted support to social welfare recipients).

Depending on how the hypothecation rules are designed, they may prove difficult to alter in future.

Forms of revenue hypothecation

There are several ways in which revenue can be ringfenced for specific uses. This can be through formal means by statute, with the establishment of a dedicated fund (as is the case with Pay Related Social Insurance (PRSI) contributions, and the National Training Fund Levy).[67] This is considered a ‘strong’ form of hypothecation, which creates a clear link between revenue and expenditure.

Alternatively, government can commit to assigning funds of an equal value to that generated from a particular tax or levy, to a general policy area. This is generally considered a ‘weak’ form of hypothecation. It allows for greater flexibility, as decision-making is not bound formally by statute, however earmarked funds may be re-appropriated.

Notable examples of revenue hypothecation in Ireland include:

- **Pay Related Social Insurance (PRSI) and the National Training Fund Levy**

  PRSI contributions are one example of revenue hypothecation in Ireland. The revenue generated is used to capitalise the Social Insurance Fund (SIF), from which social insurance entitlements are paid.[68] An additional employment levy is charged to certain employers at a rate of 0.9% (to increase to 1% in 2020). This is used to capitalise the National Training Fund (NTF) for use in funding programmes aimed at re-skilling or upskilling those in employment, as well as jobseekers.

67 *An examination of the National Training Fund can be found in PBO Note 22 of 2018.*

68 *For a detailed review of PRSI and the Social Insurance Fund see PBO Note 8 of 2018.*

- **Local Property Tax**

  Since 2017, an amount equivalent to the revenue collected from the Local Property Tax (LPT) is paid into the Local Government Fund by the Revenue Commissioners. Local authorities generally have discretion regarding how to spend their specific LPT allocations, although in certain cases a portion of this funding must be used for housing and road programmes.[69]

- **Carbon Tax**

  Much of the recent debate on revenue hypothecation relates to the revenues collected through carbon and environmental taxes. The reasons in favour of hypothecating these revenues include the need to safeguard climate change expenditures and to generate buy-in for these measures among the electorate. There is evidence to suggest that public support for carbon taxes is higher when the use of the proceeds is clearly specified.[70] The Climate Change Advisory Council advocates for the hypothecation of revenues raised from the Carbon Tax. The Council proposes using this revenue to: compensate those on lower incomes who might otherwise carry a disproportionate share of the additional tax burden, promote investment in dealing with climate change, and return residual income to households.[71]

69 *For more information on the Local Property Tax, see PBO Briefing Paper 2 of 2018.*

70 *Carattini, S. Carvalho, M. and FankHauser, S. (2017) "How to make carbon taxes more acceptable" Grantham Research Institute on Climate Change and the Environment London School of Economics and Political Science (LSE): London.*

71 *Opening Statement to Oireachtas Committee on Budgetary Oversight, John FitzGerald, 18 June 2019.*

Notes

Notes

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Go to our webpage: *www.Oireachtas.ie/PBO*
Publication date: *5 February 2020*

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