Submission to the Committee on Budgetary Oversight in advance of Budget 2020

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Executive summary

- Overall, there is little evidence the economy was overheating in 2018. In this context, our view is that the structural balance was marginally in surplus in 2018 with a plausible range of 0.0% to 1.0% of potential output.
- The economy is likely to be overheating by the end of 2019 in the absence of a negative external shock such as a disorderly Brexit.
- Baseline average potential output growth of 4.5% is feasible over the 2020s. This sets a baseline for sustainable average annual nominal increases in public spending net of discretionary revenue measures.
- Ireland's per capita public spending and government revenue is below average compared to 'peer' high-income EU countries.
- Given increasing demand pressures, Ireland's position in the economic cycle, and the negative implications for inclusive growth and public services, it is our view that a package of discretionary revenue measures that reduces net government revenue would be an unwise course of action for Budget 2020.

1. Introduction

We will divide this brief submission into the four thematic areas identified as being of particular interest to the Committee.

- The overall fiscal position

[1] My responsibilities at the Institute include macroeconomic policy and fiscal policy. My PhD in Economics is from NUI Galway and was in relation to the sources of long-run economic growth and innovation policy. Paul Goldrick-Kelly and Ciarán Nugent contributed to this document.

- Matters which have a significant impact on the budgetary position or on the overall fiscal position
- Public expenditure policy
- Exchequer receipts policy

2. The Overall fiscal position

The overall fiscal position is reasonably solid, at least ostensibly, with a neutral headline General Government Balance (GGB) of 0.0% of GDP in 2018. The year-end gross debt ratio stood at 64.8% of GDP in 2018, while the net debt ratio was 55.8%. We expect that the headline GGB position will improve modestly in 2019 with a marginally positive surplus of close to 0.1% of GDP. The debt-to-GDP ratios should improve (i.e. decline) by 3 to 4 percentage points this year. In addition, the average interest on government debt will be a sustainable 2.3%.

Using GDP as a proxy for fiscal capacity is problematic in the case of Ireland. The CSO's Modified Gross National Income (GNI*) indicator is a better measure of Irish output activity and fiscal capacity. The gross debt-to-GNI* ratio was 107.3% in 2018 and will be close to 102% in 2019. Only three EU countries (Greece, Italy and Portugal) had a higher gross debt-to-GDP ratio in 2018 than Ireland's gross debt-to-GNI* ratio. In addition, Ireland's gross debt per capita is one of the highest in the world.

In order for us to better assess the fiscal position we need to estimate the structural balance. The structural balance takes into account the cyclical position of the economy and is, in theory, an indicator of the sustainability of the fiscal position. Unfortunately, we cannot observe the structural balance directly.

Our view is that the European Commission's official methodology for estimating the structural balance is unsuitable for use in Ireland. Their methodology generates an estimated structural deficit of 1.6% of potential GDP in 2018 and a smaller deficit of 1.1% of potential GDP in 2019. The Commission model describes an economy that is operating above capacity or 'overheating' (discussed on page 3).

The Department of Finance's alternative methodology generates estimates that are far more plausible. Their estimate of a 0.4% structural surplus in 2018 and a 0.1% surplus in 2019 is consistent with an economy that is approaching, albeit still below capacity in 2018, and then very marginally overheating by the end of 2019.

Our view, as expressed in numerous editions of the NERI's Quarterly Economic Observers (QEOs) is that the economy will reach capacity sometime in 2019 assuming the absence of a significant economic shock such as a disorderly Brexit.

We use a range of indicators to inform our view as to whether the economy is overheating:

- The **unemployment rate** (UR) is falling, and at 5.4% seasonally adjusted in March and again in April, was below the long-term average for Ireland. Even so, Ireland's UR was higher than 13 other EU countries in March, including Germany (3.2%) and the United Kingdom (3.8%). Ireland's UR was also worse than that of the United States (3.8%). In addition, Ireland's **job vacancy rate** is, at 0.9%, well below the EU average of 2.3%, and 4th weakest out of a group of 24 EU countries. Finally, while aggregate employment continues to grow strongly, Ireland's **employment rate** ranked just 16th out of 28 EU countries in 2018. Ireland's employment rate for people aged 20-64 was 74.1% compared to 78.2% for the United Kingdom and 81.8% for Sweden. Overall, it appears there was some remaining slack in the Irish labour market in 2018, notwithstanding labour shortages emerging in certain sectors. Net employment should increase by somewhere between 2% and 2.5% in 2019.

- Turning to prices, we see little evidence of overheating from the main indicators over the last few years, although recent data does suggest that a faster price and wage growth dynamic is starting to emerge. The **Consumer Price Index (CPI)** has been persistently rooted below the ECB target of 2% in recent years, and registered at below 1% annually for each of 2013 through to 2018. However, recent months have seen upward momentum and the CPI reached 1.7% in April. Even so, consumer prices increased just 2.2% in the seven years between April 2012 and April 2019. We are finally

seeing evidence of wage price inflation. **Average hourly wages** increased 3.8% between Q4 2017 and Q4 2018, including by 4% in the private sector. However, medium-term wage growth has been relatively sluggish with average hourly earnings increasing 7.2% in the five years to Q4 2018.

- Residential property prices continue to recover, growing 4.3% annually in February. Even so, the rate of growth is slowing and property prices are just 80% of peak prices. The fast rate of growth in property prices reflects the current lack of supply relative to demand. The mismatch between supply and demand is generating rapid growth in rents in the residential property market. We should understand this growth in rents as a particularised market failure rather than evidence of an overheating economy. Private sector credit growth is moderate with lending to households up 1.7% annually in March and lending to non-financial corporations up 4.2%.
- The gross savings rate of households was 10.8% of gross disposable income in 2017 and 11.7% in 2018. These rates are well above historical averages. Finally, the CSO modified current account balance (CA*) indicator was in surplus by €2.2 billion in 2017, equivalent to 1.2% of GNI*. Preliminary estimates from a CSO press conference in March suggest CA* was again in surplus in 2018. A trade surplus runs counter to the narrative of an overheating economy.

Overall, there is little evidence the economy was overheating in 2018. In this context, our view is that the public finances (cyclically adjusted) were marginally in surplus in 2018 with a plausible range of 0.0% to 1.0% of potential output.

While the economy may not have been be overheating, it did grow strongly in 2018 with the output gap continuing to close. Personal consumption grew 3% in 2018, underlying investment grew 6.9% albeit from a low base, and modified final domestic demand was 4.5%. We anticipate that labour productivity growth will fall below trend in 2020-2021 due to the rapid growth in the low productivity construction sector. Our view is that the economy will reach capacity in 2019 and that the structural balance will be very marginally in surplus.

If so, the government should be able to increase public spending year-on-year at a rate equivalent to the medium-term potential rate of the economy, net of discretionary revenue measures. Ireland's favourable demographics mean that its growth potential is higher than that of the EU. In nominal terms the baseline for potential growth should average close to 4.5% per annum over the 2020s (2.5% in real terms), with the potential growth rate declining slowly over the course of the decade.

3. Matters which have a significant impact on the budgetary position or on the overall fiscal position

The greatest source of uncertainty that relates to the budgetary position is the sustainability of corporation tax receipts. The surge in receipts in recent years caught policymakers and analysts by surprise. It may be the case that changes to the treatment of corporation tax at EU level will undermine the flow of revenue from this source at least at the Irish level. This suggests a more cautious fiscal stance is appropriate until we have greater certainty in relation to the future levels of revenue. In addition, the reliance on a small number of firms for a large portion of corporation tax receipts suggests that this source of revenue is vulnerable to sector specific slowdowns in the global economy.

The other major uncertainty relates to the type of Brexit that takes place. A hard Brexit will reduce output and employment growth in the short-run and cause a deterioration in the GGB. In addition, Brexit will marginally reduce potential output growth over the 2020s. In this context, it will likely impinge on the annual fiscal space available to government.

4. Public Expenditure Policy

GDP based comparisons of public spending are fundamentally problematic given the issues around the use of GDP as a measure of economic activity and fiscal capacity in Ireland. In response to the scale of GDP distortions the CSO have

developed a variant output measure for Ireland called modified GNI (GNI*). Table 1 compares public spending levels in Ireland to that of the EU. While Ireland's spending relative to GDP is very low we can see that Ireland's spending ratio is much closer to the EU average when using the GNI* basis (GDP for the EU). Even so, the difference of 3.1 percentage points of GNI* amounted to a spending gap of €5.6 billion in 2017.

Table 1 Public expenditure comparisons, Ireland and EU, (% GDP)

	2015	2016	2017
Total revenue			
Ireland	28.9	27.5	26.3
Ireland (GNI*)	47.0	42.7	42.7
European Union	46.9	46.2	45.8

Sources: Eurostat (2018), CSO (2018), NERI calculations
Notes: Rounding affects totals.

However, it may be more relevant to compare levels of public spending in different countries on a per capita basis. A meaningful comparison of this type can only be with similar high income countries. Per capita primary public spending in Ireland was 2nd lowest (€15,791) within the EU's group of 10 rich 'peer countries' in 2016 and 89.1% of the group's population weighted average (see Table 2). An important caveat is that the peer countries have different demographic profiles. Ireland's relatively young population means spending pressures are higher for education and child supports but lower for areas like pensions or healthcare.

Table 2 Per capita public spending excluding interest payments in 2018, €bn

Rank	Country	Population (000's)	Total	Per Capita (€)
1	Denmark	5,794.0	149.8	25,851
2	Sweden	10,175.2	230.6	22,658
3	Finland	5,516.2	122.1	22,129
4	Austria	8,844.0	180.8	20,444
5	Belgium	11,405.0	225.8	19,800
6	France	66,977.0	1,278.5	19,088
7	Netherlands	17,232.0	319.1	18,518
8	Germany	82,885.0	1,454.6	17,550
9	**Ireland (ROI)**	**4,860.7**	**76.8**	**15,791**
10	United Kingdom	66,466.0	918.4	13,817
	Peer Weighted Average (PWA)			17,725
	ROI as % PWA			89.1
	Gap scaled to Irish Population (€bn)		9.4	

Sources: AMECO (2019), NERI calculations
Notes: Rounding affects totals.

A more nuanced picture emerges when we consider spending by function (COFOG categories). The per capita 'underspending' trend is not universal to all 10 functional areas. On a per capita basis, Ireland underspends its peers on *defence, general public services, environmental protection, economic affairs* and *recreation, culture and religion*. The single largest deficit occurs under Social Protection, which accounts for close to 90% of the aggregate spending gap. On the other hand, Ireland outspends its peers on, *health*, *education*, *housing/community* (a quirk related to spending on water supply) and *public order and safety*. Great care is required when interpreting this data as there may be cross-country differences in classification by functional type most notably between health spending and social protection spending.

While Ireland does not underspend on education on a per capita basis, NERI research from McDonnell and Goldrick-Kelly (June 2017) estimated using 2013 data that Ireland spends well below the per pupil norm for advanced high-income economies. Of the 13 rich countries for which there was data, Ireland had the lowest level of public spending on tertiary education on a per pupil basis.

Table 3 Per capita public R&D spending, current prices, €

Country	2015	2016	2017
Belgium	266	281	319
Denmark	533	531	544
Germany	343	357	369
Ireland	**192**	**201**	**190**
France	261	262	250
Netherlands	357	348	354
Austria	344	375	390
Finland	361	360	381
Sweden	453	465	461
United Kingdom	215	191	179
Peer Weighted Average	298	298	299
ROI to PWA Gap	105	97	109
ROI as % PWA	64.6	67.5	63.4
Gap scaled to Irish Population (€ bn)	0.5	0.5	0.5

Sources: Eurostat (2019), AMECO (2019), NERI calculations
Notes: Rounding affects totals.

Perhaps the most notable underspend with an implication for long-run productivity, and therefore Ireland's potential growth, is the underspend on public R&D Table 3). Ireland had one of the lowest levels of public expenditure per capita of the 10 peer countries in 2015 through 2017. Ireland's average per capita spending on

R&D (€194) over the period averaged just 65.2% of the peer country average (€298) over the period. The 'gap' scaled over the population amounts to €0.5 billion per annum.

5. Exchequer Receipts Policy

In Goldrick-Kelly and McDonnell (October 2017) the NERI examined tax revenue and social contributions (SSCs) scaled according to contributions made per capita. They compare per capita receipts from taxes and SSCs in 2015 in 11 EU 'peer' countries with GDP per capita in excess of €30,000 and find that Ireland was the lowest of the comparators. The net difference between Ireland and the population-weighted average was €1,757 per person, close to €8.1 billion if scaled over the population. The difference was primarily a function of the lower SSCs on labour income in Ireland as well as lower receipts from capital stocks (i.e. property taxes, wealth taxes, inheritance taxes). Updated estimates for 2017 show Ireland in 10th place out of 11, above the UK, and with the difference between Ireland and the population-weighted average reduced to €1,260 per capita.

Table 4 shows aggregate revenue comparisons for the 2007 to 2016 period. Ireland's revenue ratio in 2016 was 23.3 per cent of GDP and 36.2 per cent of GNI*. In comparison, the revenue ratio in the EU was 38.9 per cent of GDP. Ireland's revenue ratio declined marginally on a GNI* basis between 2007 and 2016, while the EU's increased marginally on a GDP basis. Ireland relied upon taxes on consumption, which are principally VAT and Excise Taxes, for 33.6 per cent of its total tax take in 2016. This was higher than the 28.5 per cent in the EU as a whole. Ireland, at 24.7 per cent, also had a higher Implicit Tax Rate (ITR)[2] on consumption than the EU's 20.6 per cent. Capital taxation was 24.3 per cent of total taxation in Ireland, which was higher than the 21.7 per cent share in the EU.

[2] The ITR is the ratio of receipts to the potential tax base. We can therefore think of it as a measure of how heavily we tax something.

Table 4 Tax Revenue Comparisons, Ireland and EU, (% GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total revenue										
Ireland	30.8	29.0	28.1	27.8	28.0	28.3	28.7	29.0	23.4	23.3
Ireland (GNI*)	36.7	34.7	35.4	36.2	37.8	39.2	37.7	38.1	38.1	36.2
European Union	38.0	37.8	37.1	37.2	37.7	38.3	38.7	38.7	38.5	38.9
By type										
Indirect taxes										
Ireland	13.2	12.1	10.9	10.9	10.5	10.6	10.8	11.0	8.7	8.7
Ireland (GNI*)	15.7	14.5	13.7	14.2	14.2	14.7	14.2	14.5	14.2	13.5
European Union	13.1	12.7	12.6	13.0	13.2	13.4	13.5	13.6	13.6	13.6
Direct taxes										
Ireland	13.4	12.4	12.0	11.8	12.3	12.9	12.9	13.0	10.8	10.7
Ireland (GNI*)	16.0	14.8	15.1	15.4	16.6	17.9	16.9	17.1	17.6	16.6
European Union	13.4	13.3	12.4	12.3	12.5	12.9	13.2	13.1	13.2	13.3
Social Contributions										
Ireland	4.1	4.4	5.2	5.0	5.3	4.8	5.0	4.9	3.9	3.9
Ireland (GNI*)	4.9	5.3	6.6	6.5	7.2	6.6	6.6	6.4	6.3	6.1
European Union	11.5	11.8	12.2	12.0	12.1	12.1	12.2	12.1	11.9	12.1
By function										
Consumption										
Ireland	11.0	10.5	9.8	9.9	9.5	9.5	9.8	9.9	7.8	7.8
Ireland (GNI*)	13.1	12.6	12.3	12.9	12.8	13.2	12.9	13.0	12.7	12.2
European Union	10.6	10.3	10.4	10.7	10.9	10.9	11.0	11.0	11.0	11.1
Labour										
Ireland	10.7	11.2	12.2	12.0	12.8	12.8	12.8	12.8	9.9	9.8
Ireland (GNI*)	12.7	13.4	15.4	15.6	17.3	17.7	16.8	16.8	16.1	15.2
European Union	18.4	18.8	19.2	19.1	19.1	19.4	19.6	19.4	19.1	19.3
Capital										
Ireland	9.2	7.3	6.1	5.9	5.8	6.0	6.1	6.3	5.8	5.7
Ireland (GNI*)	11.0	8.7	7.7	7.7	7.8	8.3	8.0	8.3	9.4	8.9
European Union	9.0	8.5	7.6	7.5	7.7	8.0	8.1	8.2	8.4	8.4

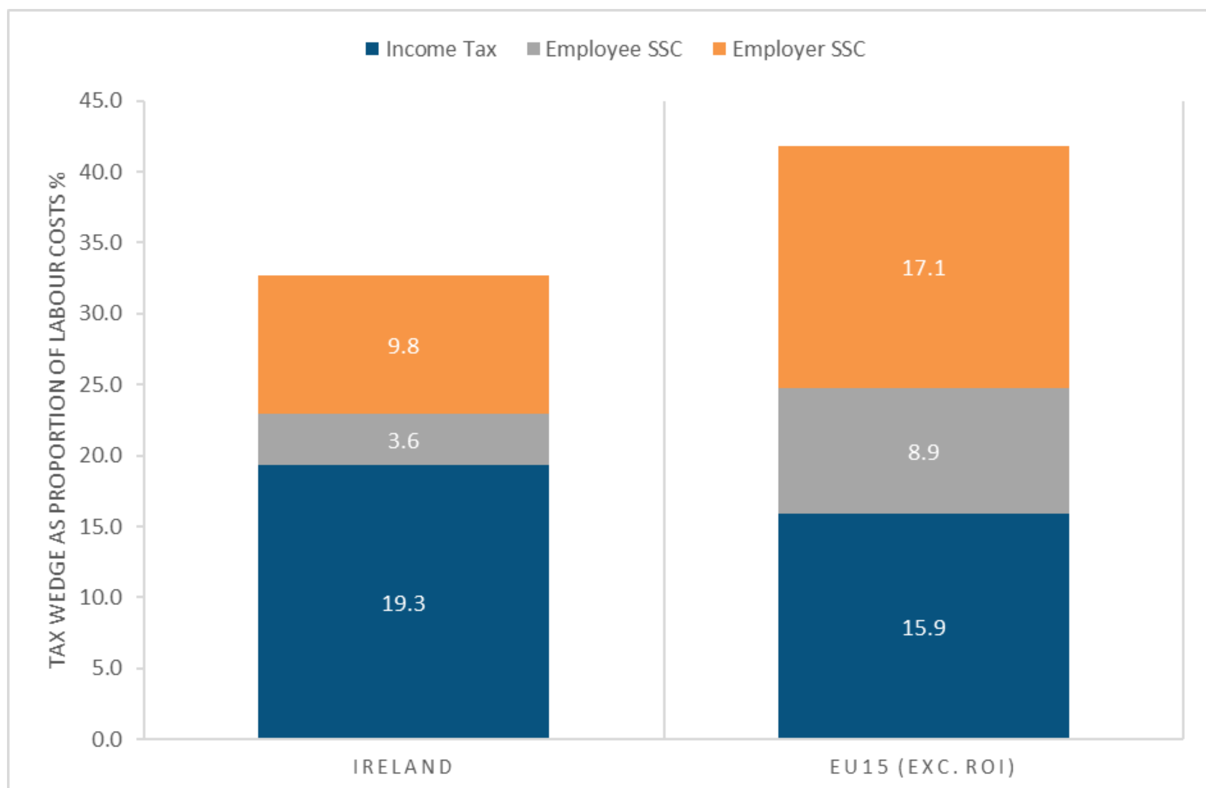
Sources: Eurostat (2018), CSO (2018), NERI calculations

Notes: Rounding affects totals. As of 2016, Irish GNI* (€175.827 billion) was 64.3 per cent of Irish GDP (€273.238 billion). The same ratio was 84.0 per cent in 2007._
The relative gap in total revenue in 2016 between Ireland (GNI* basis) and the mean for the EU28 (GDP basis) amounts to €4.75 billion

Conversely, the EU relies upon taxes on labour income (49.8 per cent of total taxation) much more than Ireland does (42.1 per cent) – a gap of 7.7 percentage points. The ITR on labour is also higher in the EU than it is in Ireland – 36.1 per cent compared to 32.7 per cent. The divergence is mainly a function of the differences in the taxation of income from employment paid by employers and the non-employed (i.e. the self-employed). Revenue from employment income paid by employers comprised 19.5 per cent of total taxation in the EU but just 11.0 per cent of total taxation in Ireland. More strikingly, revenue from employment income paid by non-employed was 5.0 per cent of total taxation in the EU but just 0.5 per cent in Ire-

land. OECD data shows that the total employee tax wedge (i.e. income tax, USC and employee PRSI) for a single person on the average wage expressed as a percentage of gross wage earnings is one of the lowest in the EU15. Chart 1 shows that this is driven by low rates of taxation levied as social contributions. This is especially pronounced compared to the EU15 average (excluding Ireland) for employer contributions, which would have to increase by approximately three quarters to reach the average.

Chart 1: Decomposition of the tax wedge, single person, average wage, 2018



Sources: Taxing Wages 2019 (OECD), NERI calculations

Notes: The OECD defines the tax wedge as "the sum of the employee personal income tax and social contributions paid by employees and employers, minus cash benefits, as a proportion of the labour costs for employers" (OECD,2019).

Overall, there is no evidence that the Irish tax system is onerous in comparison to other high-income European states. In light of this, and in the context of substantial areas of under-spend, the case for further tax cuts is extremely weak. Indeed, there is a strong argument for increasing revenues given the need for additional state support in areas such as housing and childcare. Strong candidates for increases include employer PRSI, property taxes, inheritance and gift taxes and carbon taxes.