Economic Research

Irish Budget 2016 13 October 2015

The 2016 Budget was the last delivered by the current Administration and the first for Ireland under EU fiscal rules that impose constraints on Government expenditure. In previous budgets the requirement was to get the fiscal deficit below 3% of GDP (the '*Corrective arm*') and that has been achieved , with the forecast for 2015 at 2.1%, so attention now switches to the '*Preventive arm*', designed to move the Budget to a balanced position, when adjusting for the economic cycle. The accompanying limits on expenditure will be a feature of Irish fiscal policy for some time, regardless of the political hue of the next Government. For 2016, the permitted increase in expenditure (net of any discretionary tax changes) was €1.2bn and the Government chose to use all this 'Fiscal space' although some have argued that the economy is growing very strongly (by over 6% in 2015) and already operating well above potential (according to the Government's own forecast) so a stimulus was not required.

The Government had flagged that it was going to use €700mn of the available fiscal space to reduce the direct tax burden and that duly emerged, with most of the figure (€600mn) directed to income tax, via a reduction in USC rates. Income tax bands and credits were unchanged ,however, and as average pay is forecast (by the Department of Finance) to rise by 2.4% this non-indexation results in a €300mn increase in tax receipts. 'Compliance' measures are deemed to deliver another €75mn, which alongside an additional €230mn as a result of tax buoyancy reduces the net tax cut to just €85mn. Consequently, the post-Budget tax revenue forecast was almost identical to that published pre-Budget. The latter projected a General Government deficit of 0.8% of GDP and the post-Budget forecast of 1.2% is due to changes on the spending side.

So the net effect of the 2016 Budget is not as stimulatory as appears at first glance on the tax side, although spending was also boosted by a strong base effect. This arose as a result of the decision by the Government to increase current expenditure this year by some €1.5bn above the planned figure, funded by the forecast €2.3bn overshoot in tax receipts. As a result the expenditure base in 2015 is now higher than assumed earlier in the year.

The Government expects real GDP to grow by 4.3% next year (from 4.2% pre-Budget) with a nominal increase of 6.2% taking the figure to €223bn. That pace of growth alongside a forecast primary surplus (i.e. revenue exceeds non-debt spending) of 1.8% of GDP results in a further reduction in the projected debt ratio to 92.8% from an estimated 97% this year, which would be around the euro average. On a cyclical basis the economy is assumed to be operating at 2.5% above potential in 2016 which would produce a budget surplus equivalent to 1.3% of GDP. The actual fiscal balance forecasts is a deficit of 1.2% so Ireland is deemed to be running a structural budget deficit of 2.5% of GDP. This represents a fall from the 2015 estimate of 3.2%, which is enough to pass EU scrutiny. Overall, then, a Budget in which Exchequer spending is higher than though likely a few months ago and one which includes up-front tax concessions which are largely offset by non-indexation and tax buoyancy.

The Pre-Budget deficit was forecast at 0.8% of GDP...The Irish budgetary process is unusual in that the Government publishes fiscal projections on an unchanged policy basis for the coming year a few days before the Budget is presented. For 2016, the General Government deficit was forecast to fall to 0.8% of GDP from an estimated 2.1% this year, against a backdrop of a 6.1% expansion in nominal GDP (4.2% real and a 1.9% rise in the deflator) and a forecast 5.8% rise in tax receipts. The 2015 deficit might have been down at around 1% of GDP, with carry-over effects into next year, thanks to a €2.3bn overshoot in tax receipts , but in the event the authorities have decided to boost current sending by an additional €1.5bn in the final three months of the year, so limiting the fall in the deficit, although it is still well below the original 2.7% forecast.

… **the current budget is still set for a modest surplus**...The pre-Budget projections included a €1.3bn surplus on the current budget, thanks to broadly unchanged spending and a forecast €2.6bn increase in tax receipts. The Minister announced a gross tax package of €700mn, largely due to a €600mn cut is the USC component of income tax , although the net effect was under €100mn when account is taken of tax buoyancy (€230mn) , the non-indexation of bands and credits (€300mn) and compliance measures (€75mn), so leaving the revenue forecast largely unchanged. Current spending emerged some €800mn higher with the result that the current budget is still expected to be in surplus, albeit at €0.5bn.

(€bn.)	2015	2016	change
Current Spending	49.2	49.9	0.7
-Voted	39.5	40.1	0.6
-non Voted	9.7	9.8	0.1
Revenue	48.0	50.4	2.4
- Tax	44.6	47.2	2,6
- Other	3.4	3.2	-0.2
Current Budget Balance	-1.2	0.5	1.7
Capital Budget Balance	-1.7	-2.1	-0.4
Exchequer Balance	-2.8	-1.7	1.1
General Government Balance	-4.4	-2.8	1.6
% of GDP	(-2.1)	(-1.2)	(0.9)

..**with the General Government deficit at €2.8bn**...On the capital side net spending was left as previously announced at €4.6bn, which with receipts of €2.4bn gave a capital deficit of €2.1bn. The overall Exchequer deficit was therefore €1.7bn , or €0.8bn above the pre-Budget projection, and is the modest cash sum that the NTMA will have to fund in 2016.. The projected General Government deficit is higher , at €2.8bn, and emerges at 1.2% of projected GDP. The latter is now expected to rise by 6.2%, including a 4.3% rise in volume terms.

..**the structural deficit is higher..**.The strength of economic activity in the first half of the year has prompted an upward revision to the consensus growth forecast for 2015 and the Department of Finance now expects real GDP to expand by 6.2%. That will leave the economy operating at well above potential, according to Finance, with a positive output gap of 2.3%. Potential output growth of 4.1% has been assumed for next year, but this means that the output gap rises further, to 2.5%, given that GDP is forecast to grow by 4.3%. The output gap is not observable and may seem arcane but it is important in terms of the EU's fiscal rules, as the *'preventive arm'* concentrates on the Structural deficit, which is the actual deficit adjusted for the economic cycle. In this case a 2.5% output gap is deemed to be consistent with a budget surplus of 1.3% of GDP, so if one takes that cyclical component into account, the actual deficit of 1.2% implies that the structural deficit is higher, at 2.5% of GDP. The estimate for 2015 is 3.2% so on that basis the forecast improvement in 2016 is 0.8%, which is better than the 'above 0.5%' mandated by the EU.

...**the debt burden is falling rapidly**… Ireland's debt burden soared from 2008 , reflecting the cost of the bank bailout and the impact of the recession on tax receipts and the underlying fiscal position. The level of debt peaked in 2013 at €215bn, equivalent to 120% of GDP, and fell to €203bn in 2014, with a similar figure now expected for this year. The debt ratio has fallen sharply, however, reflecting very strong growth in nominal GDP (the denominator) with a 11% rise forecast in 2015. As a consequence the debt ratio is expected to end this year at 97%. The nominal debt figure is forecast to rise modestly in 2016, to €207bn, but again a strong rise in GDP (of 6.2%) will result in a further decline in the debt ratio, to a forecast 92.8%, taking it down to the euro average. The ratio is still along way from the 25% seen before the recession but the pace of decline has been much faster than most if any expected, highlighting yet again the importance of economic growth in transforming a nation's debt burden.