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SWD(2017) 518 final

COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Ireland

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Ireland

{C(2017) 8018 final}

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1. INTRODUCTION

Ireland submitted its Draft Budgetary Plan (DBP) for 2018 on 16 October in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Ireland is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO), a structural deficit of 0.5% of GDP. In 2017, it should achieve an annual fiscal adjustment of 0.6% of GDP or more towards the MTO. In 2018, it should pursue a substantial fiscal effort, taking into account the need to ensure the sustainability of Ireland's public finances. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal rate of growth of net primary government expenditure' which does not exceed 2.4% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP.

As its debt ratio was 76.9% of GDP in 2015, during the three years following the correction of the excessive deficit Ireland is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments according to the DBP, including an analysis of risks to their achievement based on the Commission forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis on the composition of public finances and with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017[1], including reducing the tax wedge. Section 6 provides a summary.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the DBP assumes that economic growth will remain robust, mostly in line with the April 2017 Stability Programme. The underlying domestic economy – that is excluding the volatile components of investment by multinationals – is expected to remain strong supported by solid growth in private consumption and investment in construction.

[1] Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Ireland and delivering a Council opinion on the 2017 Stability Programme of Ireland (OJ C 261, 9.8.2017, p. 26-30).

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The macroeconomic assumptions for 2017 in the DBP diverge marginally from the Commission 2017 autumn forecast, while they are more alike for 2018 and 2019. The DBP assumes a strong decline in investment in intangible assets in 2017, and therefore growth rates of total investment and related imports (as the intellectual property assets are being imported) are expected to be negative this year (Table 1). The Commission takes a more optimistic approach and assumes that intangible investment in the second half of 2017 will not decline. This implies a positive growth in headline investment and imports this year, though lower than expected in the Spring Forecast. Investment in construction is forecast to be strong in both the DBP and the Commission forecast. Likewise, abstracting from the high volatility of investment in intangible assets and aircraft, the growth of underlying domestic demand is expected to remain strong in both the DBP and the Commission forecast.

As regards HICP inflation, the DBP scenario and the Commission forecast are broadly in line. They both project a low inflation rate in 2017, given the outturn for the first nine months of the year, and expect an increase of 0.8 % in 2018 and above 1% in 2019. This is due to a waning of the deflationary trend in goods prices, while prices for services are projected to remain positive. Both the forecast and the DBP scenario expect sizeable employment growth further reducing the unemployment rate.

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Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	5.1	4.3	4.3	4.8	3.7	3.5	3.9
Private consumption (% change)	3.2	2.8	2.3	2.6	2.7	2.3	2.6
Gross fixed capital formation (% change)	60.8	-17.1	-3.7	3.5	5.4	6.1	5.6
Exports of goods and services (% change)	4.6	5.0	3.5	3.9	5.1	4.8	4.5
Imports of goods and services (% change)	16.4	-2.0	-1.0	2.2	5.3	5.5	4.7
Contributions to real GDP growth:							
- Final domestic demand	14.1	-3.7	-0.2	2.4	2.5	2.8	3.0
- Change in inventories	0.2	0.0	-0.6	0.0	0.0	0.1	0.0
- Net exports	-9.2	8.0	5.2	2.5	1.2	0.6	0.9
Output gap[1]	1.9	1.2	1.7	1.6	0.7	0.8	0.6
Employment (% change)	2.8	2.7	2.8	2.9	2.4	2.3	2.2
Unemployment rate (%)	7.9	6.4	6.3	6.1	5.8	5.7	5.5
Labour productivity (% change)	2.3	1.6	1.5	1.9	1.3	1.2	1.7
HICP inflation (%)	-0.2	0.6	0.2	0.3	1.2	0.8	0.8
GDP deflator (% change)	0.0	1.2	0.5	0.5	1.3	0.9	1.1
Comp. of employees (per head, % change)	2.0	3.2	2.8	2.6	3.4	3.1	2.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.5	10.9	3.0	1.2	10.4	2.0	0.9

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

Similarly to the Commission forecast, risks to the macroeconomic projections underlying the DBP are tilted to the downside. The most important sources of uncertainty relate to the outcome of negotiations between the United Kingdom and the EU, as well as potential changes to US tax and trade policies, to which Ireland is highly exposed as a small and very open economy.

Overall, therefore, the macroeconomic scenario underlying the DBP is plausible and broadly in line with the Commission 2017 autumn forecast.

Box 1: The macro economic forecast underpinning the budget in Ireland

The macroeconomic forecast in Ireland's DBP for 2018 was prepared by the Department of Finance. The task of assessing and endorsing the macroeconomic forecast underpinning the draft budget was assigned to the Irish Fiscal Advisory Council (IFAC), an independent statutory body also mandated to independently provide an assessment of, and to publicly

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comment on, whether the government is meeting its own stated budgetary targets and objectives.

The procedures underlying the endorsement process have been set out in a Memorandum of Understanding (MoU), which was agreed between the Department of Finance and IFAC. On 29 September the IFAC sent a letter to the Department of Finance on the macroeconomic forecasts of Department. It endorsed the set of macroeconomic projections underpinning the 2018 DBP for the years 2017 and 2018, as within the range of appropriate forecasts .

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP projects a general government deficit of 0.3% of GDP in 2017, slightly less than the 0.4% of GDP predicted both in the 2017 Stability Programme and in the Commission 2017 autumn forecast. The improvement compared to the 2017 Stability Programme is mostly due to the revised output projection, while the Commission deficit forecast reflects more conservative revenue estimates given shortfalls in the year through September cash returns.

For 2018, the DBP targets a general government deficit of 0.2% of GDP, slightly above the target of 0.1% of GDP included in the 2017 Stability Programme, prepared under no-policy-change assumptions. The new deficit target includes a comprehensive net budget package of around 0.2% of GDP consisting of revenue increasing measures, personal income tax cuts and spending increases. A detailed description of the new measures is provided in Section 3.3 below.

On the revenue side, the DBP projects total revenues at EUR 78.7 billion in 2018, up to 4.4% compared to the previous year and EUR 0.7 billion above the 2017 Stability Programme on the back of resilient economic growth and the announced revenue raising measures. The DBP projects income tax revenues to grow by 5.5% y-o-y despite the planned, yet moderate, tax cuts, the effect of which is partly offset by a range of tax compliance measures and the reform of corporate tax relief related to intangible assets. Similarly, taxes on production and imports are projected to increase by 4.5% y-o-y, as a result of a sustained growth of personal consumption and the increase in the rate of stamp duty on commercial property transactions.

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Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**26.4**	**26.8**	***26.1***	**26.0**	**26.5**	***26.1***	**25.9**	**-0.3**
of which:								
- Taxes on production and imports	8.5	8.8	*8.5*	8.5	8.7	*8.5*	8.6	0.0
- Current taxes on income, wealth, etc.	10.6	11.0	*10.8*	10.6	11.0	*10.9*	10.6	0.3
- Capital taxes	0.1	0.1	*0.1*	0.1	0.1	*0.1*	0.1	0.0
- Social contributions	4.4	4.5	*4.4*	4.4	4.4	*4.4*	4.4	0.0
- Other (residual)	2.8	2.4	*2.3*	2.4	2.3	*2.2*	2.2	-0.6
Expenditure	**27.1**	**27.2**	**26.4**	**26.4**	**26.6**	**26.3**	**26.0**	**-0.8**
of which:								
- Primary expenditure	24.8	25.1	24.4	24.3	24.6	24.4	24.2	-0.4
of which:								
Compensation of employees	7.0	7.2	7.1	7.1	7.1	7.0	7.0	0.0
Intermediate consumption	3.4	3.6	3.4	3.4	3.3	3.5	3.5	0.1
Social payments	10.3	10.3	10.0	9.9	9.8	9.6	9.6	-0.7
Subsidies	0.6	0.6	0.6	0.6	0.6	0.5	0.6	-0.1
Gross fixed capital formation	1.8	1.9	1.8	1.9	2.0	2.0	2.0	0.2
Other (residual)	1.6	1.5	1.5	1.5	1.8	1.8	1.5	0.2
- Interest expenditure	2.2	2.1	2.0	2.0	2.0	1.9	1.8	-0.3
General government balance (GGB)	**-0.7**	**-0.4**	**-0.3**	**-0.4**	**-0.1**	**-0.2**	**-0.2**	**0.5**
Primary balance	**1.6**	**1.7**	**1.7**	**1.6**	**1.9**	**1.7**	**1.7**	**0.1**
One-off and other temporary measures	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	-0.1
GGB excl. one-offs	**-0.8**	**-0.4**	**-0.2**	**-0.4**	**-0.1**	**-0.2**	**-0.2**	**0.6**
Output gap[1]	1.9	1.2	1.7	1.6	0.7	0.8	0.6	-1.3
Cyclically-adjusted balance[1]	-1.7	-1.1	-1.2	-1.3	-0.5	-0.6	-0.5	1.2
Structural balance (SB)[2]	**-1.9**	**-1.1**	**-1.1**	**-1.3**	**-0.5**	**-0.6**	**-0.5**	**1.3**
Structural primary balance[2]	0.4	1.0	0.9	0.8	1.5	1.3	1.3	1.0

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

Turning to the expenditure side, the DBP projects primary expenditure to reach EUR 73.6 billion in 2018, nearly EUR 1.2 billion above the targets presented in the 2017 Stability Programme, reflecting the new spending initiatives and the recently agreed public pay increases. On a year-on-year basis, primary expenditure is projected to increase by 4.4% in line with the expected increase in nominal GDP. The slight decline in the total expenditure-to-

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GDP ratio (26.3% of GDP, 0.1 % of GDP. below the level in 2017) is mostly due to the reduction in interest expenditure, reflecting more favourable market conditions.[2]

The Commission 2017 autumn forecast projects the general government deficit to fall to 0.2% of GDP in 2018, in line with the DBP estimates. Risks associated with the DBP and the Commission budgetary projections are on the downside and mainly relate to uncertainties surrounding the macroeconomic outlook and the volatility of some sources of government revenues. In particular, the majority of revenue raising measures (i.e. reduction in capital allowances for intangible assets; increase stamp duty on non-residential property transactions; increased compliance efforts) is biased towards highly volatile, highly pro-cyclical, highly uncertain tax bases. This raises concerns on the revenue sustainability over the medium-term.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Ireland currently standing at 0.57%[3]. In Ireland, as of end of September, EUR 15 billion have been raised in 2017 at a weighted average yield of 0.9% and with a weighted average maturity of just over 12 years. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBP, interest expenditure in Ireland is expected to fall from 2.2% of GDP in 2016 to 2.0% in 2017 and is projected to decrease further next year, to 1.9% of GDP, well below the 4.2% recorded back in 2012 at the peak of the euro area sovereign debt crisis. This is broadly confirmed by the Commission forecast.

On the basis of the information provided in the DBP, the structural deficit[4] is estimated at 1.1% of GDP in 2017 and 0.6% in 2018, broadly in line with the estimate derived from the 2017 Stability Programme. The Commission 2017 autumn forecast estimates the structural deficit at 1.3% of GDP in 2017 and 0.5% in 2018.[5] The structural effort in 2018 is supported by the estimated position of Ireland in the economic cycle, with the positive output gap[6] expected to be fully closed by 2018.

Against the background of falling interest expenditure, the projected improvement in the structural balance in 2017 and 2018 (by 0.8% and 0.5% of GDP, respectively) is accompanied by a less pronounced improvement in the structural primary balance (0.6% and 0.4% of GDP, respectively).

3.2. Debt developments

Ireland's general government debt-to-GDP ratio is projected to continue declining, having peaked at just below 120.0% in 2012. The DBP estimates gross debt to fall to 70.1% of GDP in 2017 and to reach 69.0% in 2018, contingent on still robust GDP growth and the realisation of primary budget surpluses. The improvement (by 2.8 and 2.2 % of GDP, respectively) compared to the projections in the 2017 Stability Programme is primarily due to a

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[2] The DBP projects interest expenditure in 2018 at EUR 5.6 billion, near EUR 400 million lower than in the 2017 Stability Programme.

[3] 10-year bond yields, 6 November 2017. Source: Bloomberg

[4] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the DBP, using the commonly agreed methodology

[5] Discrepancies between structural balance estimates can also arise from the longer time-horizon of the Commission forecast routine compared to the one used in the recalculated DBP estimates.

[6] The output gap, which measures the cyclical position of an economy, is defined as the difference between actual and potential output. The latter is estimated by the Commission using a production function method, endorsed by the ECOFIN Council on 12 July 2002, which allows identifying the different components of potential output.

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combination of the carry-over effect of higher nominal GDP in 2016 and a lower-than-previously-expected absolute level of debt at end of 2017. However, due to the increasing impact of multinational companies on Ireland's GDP and GNP, these macro-aggregates tend to overstate the actual size of the domestic economy. A range of other metrics, including a debt-to-modified[7] GNI ratio, shows that Ireland's stock of public debt remains high by historical and international standards.[8]

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**72.8**	**72.9**	**70.1**	**69.9**	**71.2**	**69.0**	**69.1**
Change in the ratio	-4.1	0.1	-2.7	-2.9	-1.7	-1.1	-0.9
Contributions[2] :							
1. Primary balance	**-1.6**	**-1.7**	**-1.7**	**-1.6**	**-1.9**	**-1.7**	**-1.7**
2. "Snow-ball" effect	**-1.5**	**-1.7**	**-1.4**	**-1.6**	**-1.5**	**-1.0**	**-1.5**
Of which:							
Interest expenditure	2.2	2.1	2.0	2.0	2.0	1.9	1.8
Growth effect	-3.8	-3.0	-3.0	-3.3	-2.6	-2.4	-2.6
Inflation effect	0.0	-0.8	-0.4	-0.3	-0.9	-0.6	-0.7
3. Stock-flow adjustment	**-1.1**	**3.5**	**0.4**	**0.4**	**1.7**	**1.7**	**2.3**
Of which:							
Cash/accruals difference		0.3	0.30		0.3	0.30	
Net accumulation of financial		-0.4	-1.60		-0.2	-0.30	
of which privatisation proceeds		0.0			0.0		
Valuation effect & residual		0.0			0.0		

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

The debt projections in the 2018 DBP are broadly in line with the Commission 2017 autumn forecast. Overall, government financing has benefitted from the low interest rate environment and supportive bond market conditions. Any change to this favourable situation could have an adverse impact on debt projections. However, as most of the outstanding stock of debt is at fixed rates, risks to debt projections mainly relate to changes to the economic outlook.

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7 The Modified Gross National Income (also known as GNI*), recently provided by the Irish statistical authorities, more accurately reflects the income standards of Irish residents than GDP. It differs from actual GNI in that it excludes inter alia the depreciation of foreign-owned, but Irish-resident, capital assets (most notably intellectual property and assets associated with aircraft leasing) and the undistributed profits of firms that have re-domiciled to Ireland.

8 A fuller assessment of debt dynamics is set out in the Department's Annual Report on Public Debt in Ireland, June 2017 available at http://www.finance.gov.ie/wp-content/uploads/2017/07/annual-debt-report-2017.pdf

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On the other hand, the planned early repayment of EUR 5.5 billion in EU-IMF Programme loans from the IMF, Sweden and Denmark has the potential to generate interest savings while providing an opportunity to further smoothen and extend the debt maturity profile.[9]

3.3. Measures underpinning the draft budgetary plan

The DBP for 2018 includes some reduction to personal income tax of around 0.1% of GDP, mainly through cuts in the Universal Social Charge (USC) rates[10], an income tax band change[11] and increases on certain tax credits[12], as well as new spending initiatives of more than 0.4% of GDP. These giveaways will be partly financed by several revenue raising measures including an increase in stamp duty for commercial property purchases, a reduction in capital allowances for intangible assets, an increase in excise duties on tobacco products, the introduction of a tax on sugar-sweetened beverages, and by a range of tax compliance initiatives, which reduce the overall net impact of the budgeted measures to nearly -0.2% of GDP.

On the expenditure side, the bulk of the current expenditure increases are directed towards social protection (around 0.1% of GDP)[13], health (nearly 0.1% of GDP)[14], housing (0.05% of GDP)[15] and education (0.05% of GDP). The government's capital allocation for 2018 of EUR 5.3 billion represents an increase of more than 17% compared to the previous year's capital expenditure. Half of the increase has already been allocated following the mid-term review of the Capital Plan 2016-2021 to address shortages in social housing.[16] The DBP for 2018 allocates the remaining additional resources towards areas of priority need such as continued building of new schools, health care facility modernisation, transport networks, flood defences and business support measures.[17]

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[9] These early repayments require agreement from the European lenders to waive the proportionate early repayment clauses in the respective loan agreements as well as parliamentary approval processes in some Member States.

[10] The 5% USC rate, applicable on income between EUR 19 300 and EUR 70 000, will be cut by 0.25 percentage point and the 2.5% rate, applicable on income between EUR 12 000 and EUR 19 300, will drop to 2%.

[11] The income threshold to the highest personal income tax rate will be raised by EUR 750 to EUR 34 500.

[12] These refers to the increase in the Home Carer Tax Credit from EUR 1 100 to EUR 1 200 and to the increase of the Earned Income Credit for self-employed from EUR 950 to EUR 1 150.

[13] Spending on social protection includes a EUR 5 per week increase in pension payments and in working age income supports. On the other hands, the continuing improvement in the number of unemployed has resulted in additional resources from the Live Register related savings. The DBP estimates savings of around EUR 400 million in 2018.

[14] Expenditure measures in the health area mainly relate to commitment to improve waiting times for patients, to address a range of acute hospital services pressures, to expand primary care interventions and to ensure more accessible and effective mental health services.

[15] This mainly refers to an increase in the Housing Assistance Payment Scheme.

[16] http://www.per.gov.ie/wp-content/uploads/Capital-Plan-Review-2016-2021.pdf.

[17] Further details on the allocation of the additional funding available for public investment over the period 2018-2021 are set out in the *Outcome of the Mid-Term Review of the Capital Plan: Exchequer Envelopes 2018-2021*.

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Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and imports	0.0	0.2	0.0
Current taxes on income,	-0.2	-0.1	0.0
Capital taxes	0.0	0.0	0.0
Social contributions	0.0	0.0	0.0
Property Income	n.a.	n.a.	n.a.
Other	0.1	0.1	n.a.
Total	-0.1	0.2	0.0

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0.1	0.1	0.1
Intermediate consumption	0.0	0.1	0.0
Social payments	0.2	0.1	0.0
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	0.0	0.0
Gross fixed capital formation	0.1	0.1	0.0
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
Total	0.4	0.4	0.1

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan for 2018

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Following the correction of the excessive deficit in 2015, Ireland is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its MTO. Ireland is also subject to the transitional debt rule in 2016-2018. Box 2 reports the latest country-specific recommendations in the area of public finances.

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Box 2. Council recommendations addressed to Ireland

On 11 July, the Council addressed recommendations to Ireland in the context of the European Semester. In particular, in the area of public finances, the Council recommended to Ireland to: (i) pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which translates into a substantial fiscal effort for 2018; (ii) use any windfall gains, such as proceeds from asset sales, to accelerate the reduction of the general government debt ratio; (iii) limit the scope and the number of tax expenditures and broaden the tax base.

4.1. Compliance with the debt criterion

Following the correction of the excessive deficit in 2015, Ireland is subject to a three year transition period as regards the debt criterion. This implies that, during the period 2016-2018, Ireland is required to make sufficient progress towards compliance with the debt criterion – as defined by the minimum linear structural adjustment (MLSA) – and comply with the debt benchmark at the end of the transition period.

Table 5. Compliance with the debt criterion

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	72.8	72.9	70.1	69.9	71.2	69.0	69.1
Gap to the debt benchmark [1,2]							
Structural adjustment [3]	0.2	0.3	0.8	0.6	0.6	0.5	0.8
To be compared to:							
Required adjustment [4]	-0.1	n.a.	n.a.	-0.4	n.a	n.a	-2.0

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:
Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

The DBP does not include sufficient information to assess compliance with the transitional arrangement for the debt reduction benchmark. According to the Commission 2017 autumn forecast, the change in the structural balance is expected to exceed the required MLSA in both 2017 (projected change of 0.6% of GDP vs. required change of -0.4% of GDP) and 2018 (projected change of 0.8% of GDP vs. required change of -2.0% of GDP). Therefore, Ireland is expected to make sufficient progress towards compliance with the debt criterion in both 2017 and 2018.

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4.2. Compliance with the adjustment towards the MTO

In 2017, according to the information provided in the DBP, the recalculated improvement of the structural balance (0.8% of GDP) is above the 0.6% of GDP required to ensure sufficient progress towards the MTO. Conversely, the expenditure benchmark points to a deviation of 0.2% of GDP from the requirement of a real rate of growth of net primary government expenditure that does not exceed 1.2%. This calls for an overall assessment. The structural balance pillar is positively impacted by decreasing interest expenditure and by the underlying higher point estimate for potential GDP growth (compared with the medium-term potential GDP growth used in the expenditure benchmark pillar). In general, given the very open nature of the Irish economy and the volatility of potential GDP estimates, the expenditure benchmark pillar is considered to reflect more appropriately the underlying fiscal effort. In turn, the two-year average deviation based on the expenditure benchmark is above the applicable significant deviation threshold of 0.25% of GDP.[18]

The same conclusion can be drawn on the basis of the Commission 2017 autumn forecast. While the structural balance is expected to be in line with the recommended fiscal effort, the expenditure benchmark points to a risk of significant deviation. However, it does not capture the additional revenue linked to the continued non-indexation of income tax bands, which is considered to be of a permanent nature. Taking this into consideration, the expenditure benchmark pillar would point to a deviation below 0.5% of GDP in 2017. Nonetheless, the average deviation over 2016 and 2017 taken together would still be well above the applicable significant deviation threshold of 0.25% of GDP. Therefore, the overall assessment points to a risk of a significant deviation over 2016 and 2017 taken together.

In 2018, Ireland is projected to have a structural balance of -0.6% of GDP, slightly less than the MTO of -0.5%, based on the Draft Budgetary Plan and achieve it based on the Commission forecast. The recalculated change in the structural balance indicates some minor deviations of 0.1% of GDP while the nominal growth rate of government expenditure, net of discretionary revenue measures, is expected to be slightly below the expenditure benchmark[19], leading to a positive gap of 0.1% of GDP. In turn, over 2017 and 2018 taken together, the average deviation based on the expenditure benchmark pillar points to some deviation.

Based on the Commission 2017 autumn forecast, conclusions for 2018 are broadly the same. The projected improvement in the structural balance of 0.8% of GDP is above the recommended fiscal effort. However, the growth of government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark, leading to a deviation of 0.2% of GDP. As for 2017, decreasing interest expenditure and a higher point estimate for potential GDP growth largely explain the

[18] The Irish authorities have repeatedly contested what they consider to be the retroactive application to the 2016 budgetary assessment of the recently agreed systematic exclusion of one-offs from the expenditure benchmark calculation. Not adjusting for one-offs, the two-year assessment would point to some deviation.

[19] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

The expenditure benchmark for Ireland reflects an adjustment to correct for a distortion to the 10-year reference rate of potential growth caused by the exceptionally high surge in real GDP growth in 2015. For more information see Box 2 of the Commission's assessment of the 2017 Stability Programme for Ireland.

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divergence between the two pillars. As above, the expenditure benchmark pillar is considered to reflect more appropriately Ireland's underlying fiscal effort.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	-0.5		-0.5	
Structural balance[2] (COM)	-1.9	-1.3		-0.5	
Structural balance based on freezing (COM)	-1.7	-1.1		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6	0.6		0.6	
Required adjustment corrected[5]	0.6	0.6		0.6	
Change in structural balance[6]	0.3	0.8	0.6	0.5	0.8
One-year deviation from the required adjustment[7]	-0.3	0.2	0.0	-0.1	0.2
Two-year average deviation from the required adjustment[7]	EDP in 2015	0.0	-0.1	0.1	0.1
Expenditure benchmark pillar					
Applicable reference rate[8]	0.1	1.2		2.4	
One-year deviation adjusted for one-offs[9]	-0.5	-0.2	-0.6	0.1	-0.2
Two-year average deviation adjusted for one-offs[9]	EDP in 2015	-0.3	-0.6	-0.1	-0.4
PER MEMORIAM: One-year deviation[10]	0.5	-0.4	-0.8	0.1	-0.2
PER MEMORIAM: Two-year average deviation[10]	EDP in 2015	0.1	-0.1	-0.2	-0.5
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	EDP in 2015	Overall assessment	Overall assessment	Overall assessment	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source:

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

Over 2017 and 2018 taken together, while the structural balance pillar is expected to be in line with the required fiscal effort, the expenditure benchmark pillar suggests that Ireland is at risk of a significant deviation from the requirements (0.4% of GDP). When the additional revenue from the continued non-indexation of income tax bands in 2017 and 2018 is taken into consideration, the average deviation based on the expenditure benchmark pillar would be below but close to the applicable significant deviation threshold of 0.25% of GDP. The impact of non-indexation of the income tax system is estimated at around EUR 550 million in a full year, or around 1.9% of GDP. Therefore, the overall assessment points to a risk of some deviation from the required structural adjustment path over 2017 and 2018 taken together.

The Commission Communication on the 2017 European Semester of May 2017[20] stated that the Commission stands ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment is particularly significant. The country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. However, in light of the fact that Member State is not found at risk of a significant deviation in 2018, such a qualitative assessment does not need to be carried out at this stage.

5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The 2018 DBP (specifically in Table 7a) contains a summary of the main country-specific recommendations the Council addressed to Ireland in the context of the European Semester on 12 July 2017 and (in Table 7b) actions to meet the targets set by the European Union's Strategy for Growth and Jobs. Table 7a offers a short description of the on-going efforts to implement structural reforms, listing initiatives and legislative proposals which have been adopted or are planned in the near future.

With regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017, and notwithstanding the required fiscal adjustment towards the medium-term budgetary objective (see section 4), the Commission welcomes the use of income from the sale of government's shares in state-owned-banks to reduce the debt. By the same token, the recent redemption by the National Asset Management Agency (NAMA) of the final EUR 500 million of the government-guaranteed debt, three years ahead of the target, marks another important step toward restoring full financial market confidence in the Irish sovereign. The redemption eliminates a contingent liability on the sovereign which dates from the height of the financial crisis that led to the nationalisation of Ireland’s banks.

As for the policy recommendation to limit the scope of the number of tax expenditures and broaden the tax base, the assessment of measures outlined in the DBP for 2018 is mixed. The increases to tax credits for self-employed and home carers, the creation of a stamp duty refund scheme for residential land, the reduction from seven to four years of the holding period to qualify for the capital gains tax exemption on certain property assets, the tapered extension of mortgage interest relief for the remaining recipients, the fiscal incentive for certain types of share-based remunerations, or the decision to extend the USC relief for medical card holders for a further two years, do not contribute to expanding the tax base. Conversely, the reduced

[20] COM(2017) 500

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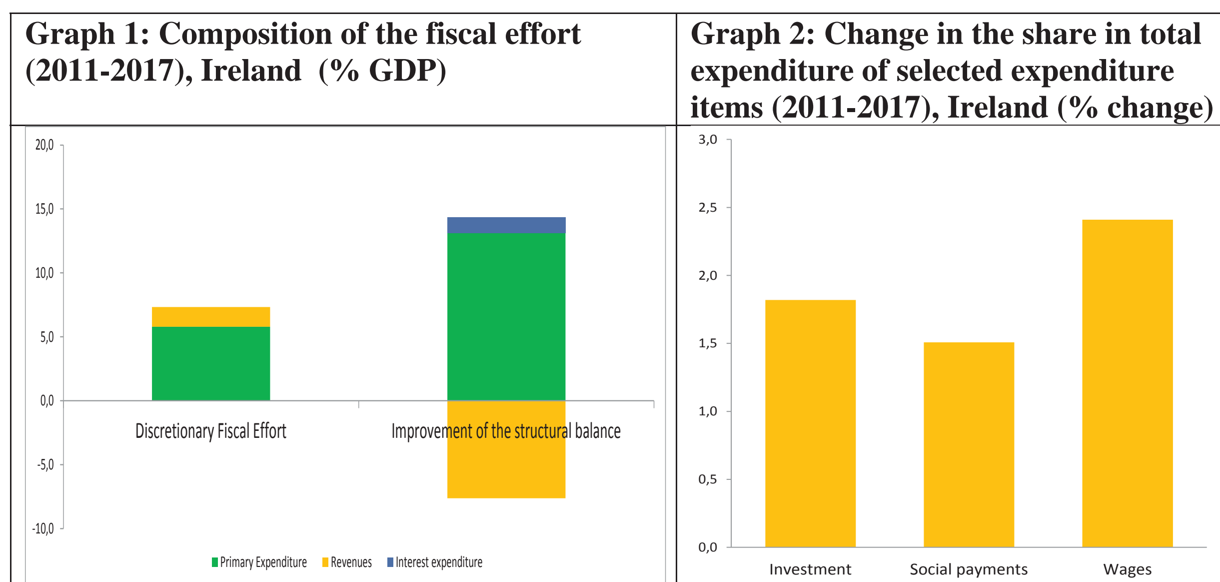
cap of 80% on the amount of capital allowances for intangible assets[21] and the introduction of a new tax on sugar-sweetened drinks can potentially broaden the tax base.

Nevertheless, the DBP for 2018 appears to fall short on the overall policy goal of reducing revenue volatility. In particular, the increase of the stamp duty rate on commercial property purchases amplifies the reliance on transaction-based taxes which, in the recent past, proved to be an unstable and highly pro-cyclical source of government revenue. Similarly, the reduction in capital allowances for intangible assets, although it might help smoothing the corporate tax revenue over time, can be hardly seen as a stable funding source. When these revenues are used to finance permanent current expenditure, risks to fiscal sustainability heighten. Apart from a fiscal incentive in the benefit-in-kind on electric vehicles, the DBP does not include changes to the environmental taxation.

The DBP for 2018 benefitted from a new spending review process which, in its first three-year cycle, has focussed on specific critical spending areas, representing around 30% of current government expenditure, such as drug costs in the health sector, disability and employment programmes in the area of social protection, and public transport. While expenditure ceilings now include demographic pressures and carry-over effects of previously announced measures, at least in the most critical areas, it is still too early to assess whether the new spending review may also improve the reliability of the multiannual spending plan.

Compared to the fiscal effort planned in the DBP for 2018, in 2011-2017 it relied on primary and interest expenditure savings. The share of revenue in GDP contracted, albeit with net discretionary revenue effort being positive (Graph 1). The analysis of the composition of public expenditure shows that investment, social payments and wages are all above, as a share in total expenditure, their levels in 2011 (Graph 2).



Note: Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

[21] The cap was reintroduced in line with the recommendation of the "Review of Ireland's Corporation Tax Code". The report recommended the reintroduction of the cap on the basis of ensuring some smoothing of corporation tax revenues over time.

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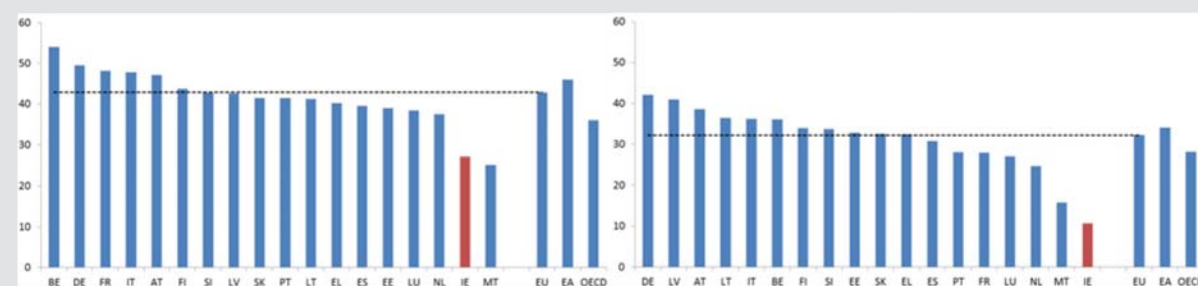
A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2018 Country Report.

Box 3. Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Ireland for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Ireland at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

The DBP for 2018 includes some measures aimed at further relieving the tax burden on labour, mainly through a moderate reduction in personal income taxes. As for the Universal Social Charge (USC), the 5% rate, applicable on income between EUR 19 300 and EUR 70 000, is being cut by 0.25 percentage point and the 2.5% rate, applicable on income between EUR 12 000 and EUR 19 300, drops to 2%. By the same token, the income threshold to the highest personal income tax rate rises by EUR 750 to EUR 34 500. The DBP also increases tax relief for the self-employed. The measures would contribute to further decrease the tax burden for all income categories, particularly low wage earners. The Department of Finance estimates that the cost to the exchequer in 2017 will be approximately EUR 333 million. Conversely, the DBP for 2018 has increased the employer contribution to the National Training Fund Levy, which, *ceteris paribus*, will increase the tax wedge. The DBP includes materials and tables showing the impact of those measures on several categories of income earners. The measures would contribute to further decrease the tax wedge for all income categories, particularly low wage earners.

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6. OVERALL CONCLUSION

Following an overall assessment of the DBP, there is a risk of a significant deviation in 2017 and a risk of some deviation in 2018 from the required adjustment path towards the MTO according to the two-year average rule. The same conclusion can be drawn on the basis of the Commission 2017 autumn forecast. The overall assessment relies on the expenditure benchmark, which in the case of Ireland provides a more stable yardstick of prudent fiscal policy. The expenditure benchmark for 2018 reflects the agreed adjustment to correct for a distortion to the 10-year reference rate of potential growth caused by the exceptionally high surge in real GDP growth in 2015.

Based on the Commission 2017 autumn forecast, Ireland is making sufficient progress towards complying with the debt rule in both 2017 and 2018.

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