9th October 2018

Budget 2019
Public Finances in Balance

The Irish economy has performed strongly in recent years, boosting tax revenues. Corporation tax receipts have jumped in particular. Meanwhile, debt interest costs have fallen quite sharply, helped by QE and negative ECB interest rates. As a result, the budget deficit declined at a much quicker than expected pace for much of this decade, although progress has slowed in the past couple of years as public spending picked up. The Government is forecasting that the deficit in 2018 will equate to 0.1% of GDP compared to 0.2% last year and 0.5% in 2016.

This trend is set to continue in 2019, with the Government aiming for a balanced budget. The ESRI has advised that a neutral budget is the most appropriate fiscal stance, pointing to the need to tackle large infrastructure deficits in areas like housing. The budget does provide for a large rise in capital spending. It is essentially a 'tax and spend' budget, with tax hikes and some large spending increases, but little relief for highly taxed, middle income earners. The Government is projecting that the public finances will move into surplus from 2020.

Budget 2019: The Key Points

- **The budget deficit has been virtually eliminated in 2018.** It is forecast at 0.1% of GDP compared to 0.2% last year and 0.5% in 2016. The deficit was as high as 8% of GDP as recently as 2012. In absolute terms, the 2018 general government deficit is forecast at €0.3bn, down from €0.7bn in 2017 and €1.5bn in 2016. It stood at €14bn in 2012. **The public finances are expected to be in balance next year and move into surplus from 2020.**

- The expected deficit outturn for 2018 is slightly lower than last year's budget day forecast of €0.5bn, thanks to higher than expected corporation tax receipts. **The projections underpinning the 2019 budget look reasonable and our best judgement is that the outturn will be close to target again next year**. GDP is forecast by the Dept. of Finance to grow by 4.2% in 2019, which is broadly in line with most other forecasts.

- The so-called gross fiscal space for 2019 is put at €3.9bn by the Dept. of Finance. However, much of this was already pre-committed, in particular for capital spending. As a result, there was around €800m at play in today's budget. The Minister announced some **significant tax raising measures today,** amounting to €715m, which increased his room for manoeuvre. Thus, he was able to announce **additional spending of €1.4bn** and some very modest income tax cuts of just €0.3bn, with no indexation of tax credits or bands for wage inflation. **In essence, this is a tax and spend budget,** containing some significant tax hikes and a big rise of 23.5% in capital spending in particular.

- EU fiscal rules largely determine the Government's scope for changes to the public finances. **Notably, the Minister chose not to use all of the fiscal space available in today's budget,** opting for a more prudent approach. This would seem appropriate given the still high very level of public debt, strength of economic activity and doubts about the sustainability of the marked jump in corporation tax receipts in recent years.

- **Ireland's general government gross debt/GDP ratio has been in marked decline since 2013** when it stood at 120%. It is expected to fall to 64% at end 2018 and 56.5% by 2020. However, it should be noted that inflated GDP figures since 2015 overstate the rate of improvement. A better ratio is government net debt to GNI* (modified Gross National Income). We put this ratio at over 90% at end 2018, falling to circa 80% by end 2020.

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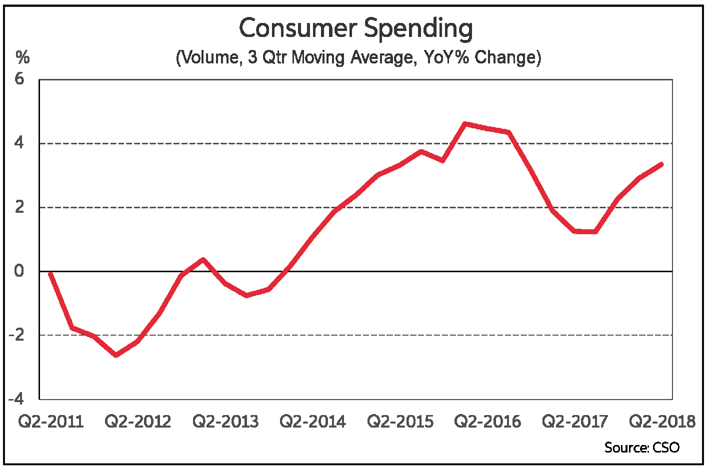
Robust Growth Continues in 2018

- **The past number of years have seen a strong recovery by the Irish economy that has surpassed all expectations**. This was initially led by robust export growth, but there has been strong growth in domestic demand in recent years also, including business investment, construction and consumer spending.

- The **latest National Accounts data show that GDP grew by over 9% year-on-year in the first half of 2018.** However, this is partly due to base effects and annual GDP growth is likely to slow sharply in H2 2018 - GDP actually contracted in the first half of last year but then rose by close to 7% in H2 2017. **In seasonally adjusted terms, GDP grew at a 4% annualised rate in the first half of this year.**

- **GDP also continues to be distorted by the activities of some multi-national companies.** We are forecasting that GDP will grow by around 6.5% in 2018. However, there are a wide range of forecasts, reflecting the distortions in the data. The ESRI is now forecasting 9% GDP growth for 2018, double its previous estimate, while the Dept. of Finance is at 7.5%. **Modified final domestic demand** is a better measure of underlying activity. It is **likely to grow by 5% or slightly above this year**.



- **Exports have continued to perform strongly in 2018,** rising by close to 9% year-on-year in H1, although again the data can be distorted by the activities of some multi-nationals. Meanwhile, the first half of the year saw strong growth in all the major components of domestic demand. **Consumer spending was up by 3.7%,** broadly in line with the trend in retail sales**.** This follows a weak performance in 2017, when consumer spending rose by just 1.6%.

- **Investment grew strongly in H1 2018**. **Construction** has continued to pick up, rising by 11% yoy. There was particularly strong growth in house building, which was up by 32% yoy. **Business investment,** which can be very volatile, rebounded in H1 2018 after declining in 2017, rising by 40% yoy.

- **Labour market data remain strong,** with employment up 3.2% year-on-year in H1 2018. Meanwhile, the **unemployment rate had declined to 5.4% by September,** down from 6.6% a year ago and 6.2% at end 2016. The rate of decline in unemployment has slowed in the past year, reflecting a pick-up in net inward migration and a rise in the participation rate. As a result, growth in the labour force has accelerated.

DEPT OF FINANCE ECONOMIC FORECASTS

(%)	2016	2017	2018(f)	2019(f)	2020(f)
GDP	**5.0**	**7.2**	**7.5**	**4.2**	**3.6**
GNP	11.5	4.4	5.9	3.9	3.3
Private Cons	4.0	1.6	3.5	3.0	2.6
Gov Expd.	3.5	3.9	3.5	2.9	1.9
Fixed Inv.	51.7	-31.0	-8.9	7.1	5.7
Exports	4.4	7.8	7.0	5.6	4.8
Imports	18.5	-9.4	0.9	6.2	5.3
HICP	-0.2	0.2	0.7	1.5	1.7
Employment	3.7	2.9	3.0	2.8	2.2
Unemploy. Rate	8.4	6.8	5.8	5.2	5.0

- Overall then, **the economy has continued to perform very well this year** despite the considerable on-going uncertainty over Brexit. Employment continues to grow by over 3%, as has been the case since 2013, while both consumer spending and investment have regained momentum after subdued performances in 2017.

Growth To Remain Strong, Assuming a Soft Brexit

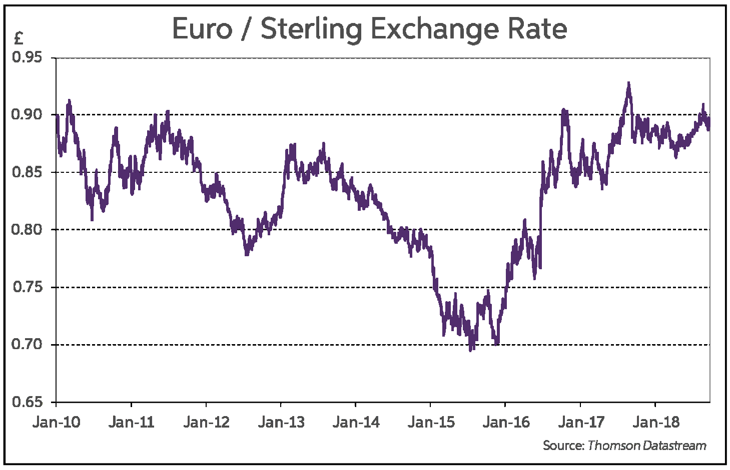
- The studies carried out by the ESRI, Central Bank and Copenhagen Economics suggest that **Brexit will have a dampening impact on the growth rate of the Irish economy,** with activity obviously being far more negatively affected by a hard than a soft Brexit. The impacts are also front-end loaded, being mainly felt in the years following Brexit.

- **There are a number of factors, though, which should be supportive of activity in the next couple of years. The external environment is expected to remain reasonably favourable.** Global growth has picked up momentum in the past couple of years and it is expected to remain solid in 2019-2020.

- **Meanwhile, on the fiscal front, public spending is on the rise. Interest rates have fallen to record low levels** and the ECB is guiding that rates will remain very low over the next couple of years. **Real incomes are also increasing,** with wage growth picking up and continuing good growth in employment anticipated in 2019/20. Inflation is expected to remain quite low at below 2%. We expect the **construction sector to continue to make a significant contribution to economic growth** over the next couple of years, in particular house building activity, which is continuing to recover from very low levels of output. Ireland should also continue to benefit from sizeable inflows of FDI, which are likely to be also boosted by Brexit.

COMPARATIVE ECONOMIC FORECASTS 2019/2020

%	AIB	Dept. of Finance	ESRI	Central Bank
2019				
GDP	**4.0**	**4.2**	**4.5**	**4.2**
GNP	3.7	3.9	4.7	4.0
Private Cons.	2.5	3.0	2.5	2.5
Gov. Expd.	3.0	2.9	4.5	2.0
Fixed Inv.	7.0	7.1	9.8	9.0
Exports	4.5	5.6	5.2	4.3
Imports	4.5	6.2	6.0	4.6
2020	**AIB**	**Dept. of Finance**	**IMF**	
GDP	**3.5**	**3.6**	**3.5**	
GNP	3.2	3.3	n.a.	
Private Cons.	2.5	2.6	2.5	
Gov. Expd.	3.0	1.9	1.4	
Fixed Inv.	6.0	5.7	5.9	
Exports	4.3	4.8	4.3	
Imports	4.5	5.3	4.6	



Source: *Thomson Datastream*

- **As the table above shows, all the forecasts are for the economy to continue to grow strongly in the next two years.** GDP growth is forecast by the D/Finance, ESRI, Central Bank and AIB at 4.0-4.5% in 2019. The IMF and EC are predicting 4% GDP growth for next year. Turning to 2020, the available forecasts are for GDP growth to slow slightly to circa 3.5%.

- **There are downside risks to the above growth forecasts, in particular from Brexit**. A no-deal hard Brexit in March 2019 cannot be ruled out. It would deliver a major shock to key indigenous sectors of the Irish economy that rely heavily on the UK market, most notably the agri-food industry. The problems would be added to by a likely further marked weakening in sterling. Meanwhile, as the IMF and OECD have pointed out, downside risks have risen for the world economy, including problems in some large emerging economies and tensions over global trade. However, if a soft Brexit materialises, then Irish growth could again surprise to the upside, as has been the case in recent years.

Increased Spending the Key Feature of Budget

- The so-called fiscal space is defined as the projected amount of resources available to the Government for additional expenditure and/or tax reductions, while ensuring compliance with EU fiscal rules. **The Dept. of Finance has put the gross fiscal space available in 2019 at €3.9 billion. However, much of this was already pre-committed before today's budget.** Spending increases are required to cover carry-over costs from previous budgets, demographic pressures, public sector pay increases and in particular, higher capital spending, mainly for housing. On top of this, **the Government is setting aside €0.5bn in a new Rainy Day Fund**, as well as providing a €0.9bn allocation as a "margin of compliance" with the fiscal rules. These latter two elements, amounting to €1.4bn, mean **that the Government decided not to use all the fiscal space available for next year under the budgetary rules.**

- The result is that the amount available to the Minister to allocate in today's budget was circa €800m. The Minister did **increase a number of taxes today, though, which will bring in an additional €715m in revenue in 2019. This gave the Minister the room for additional spending totalling €1.4bn and some very modest tax cuts amounting to €365m.**

- There was only a slight **easing of the income tax burden**. The 4.75% USC rate was cut by 0.25%, with a widening of the standard income tax band by €750 to €35,300 . Thus, marginal income tax rates still remain very high for middle income workers in Ireland, at 48.5% on earnings between €35,300 and €70,044 and 52% on income above €70,044. There was no indexation of income tax credits or bands in the budget.

- There were **some significant tax hikes announced in the budget**, with an increase in excise duty on cigarettes, while the VAT rate that applies to the hospitality sector was brought back up to 13.5% from the special low rate of 9% that has applied in recent years - this hike will bring in €560m in a full year. The tax on betting is to be doubled to 2%. The National Training Fund levy paid by employers rises by 0.1% from 0.8% to 0.9%. Overall, Government tax revenue is set to rise by €715 million as a result of the tax changes announced today.

- **Additional current spending totalling €1.4bn was announced in today's budget**, including increases in areas such as housing and health. Social welfare benefits are being increased by €5 per week from March. Overall, **total gross voted government current spending will rise by €2.4bn to €59.3 billion** next year from €56.9 billion in 2018, an increase of over 4%. Meanwhile, **gross voted Exchequer capital spending is projected to rise by €1.4bn or 23.5%, to €7.3bn,** with the biggest rise coming in housing- it gets an extra €422m.

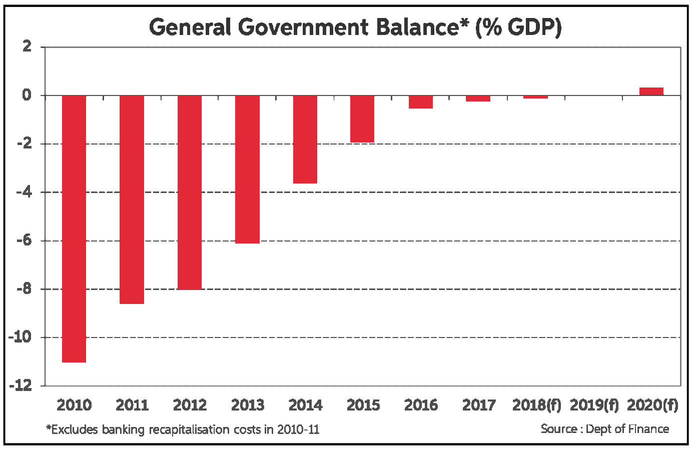
- Overall, **this was very much a tax and spend budget,** with a €3.8bn or 6% increase in gross voted spending next year, partly financed by taxes hikes in the budget. The biggest spending increases are in health (€1.1bn), housing (€0.7bn), education (€0.5bn) and social protection (€0.5bn).

BUDGETARY PROJECTIONS : 2018 - 2020

(€ bn)	2018	2019	2020
Net Current Expenditure	53.4	55.0	56.3
Net Current Revenue	57.9	60.5	62.4
Current Budget Balance	**4.5**	**5.5**	**6.1**
Capital Budget Balance	**-5.0**	**-7.3**	**-6.3**
EXCHEQUER BALANCE*	-0.5	-2.3	-0.7
GEN GOV BALANCE	**-0.2**	**-0.1**	**1.1**
% of GDP			
Gen Gov Balance	-0.1	0.0	0.3
Interest Expd	1.6	1.5	1.3
Primary Balance	1.5	1.5	1.6

**Source: D/Finance (Rainy Day fund adds €0.5bn to Exchequer deficit in 2019/20)*

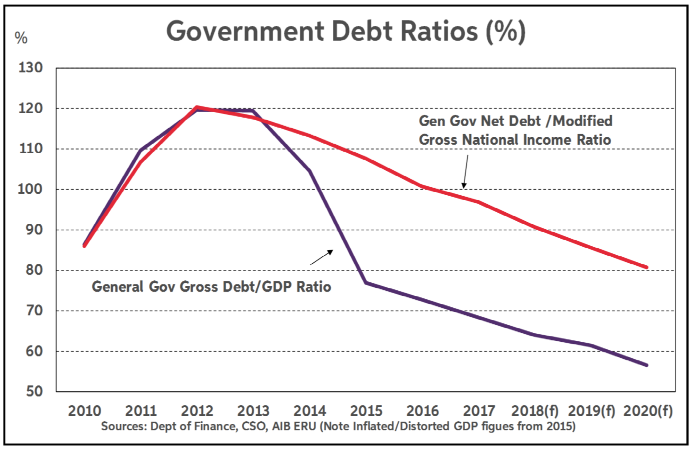
- There is **a rising current budget surplus, which is forecast at €5.5bn next year**, double its level in 2017. This should ease some concerns about an over reliance on corporation tax receipts. On the other hand, there is a growing capital budget deficit as the Government ramps up infrastructure spending after big cuts were made to the Public Capital Spending Programme during the financial crisis. The **Minister has been able to aim for a balanced General Government budget in 2019, with a surplus of just over €1bn forecast for 2020**. There is still an Exchequer deficit of €2.3bn next year, but it will fall sharply in 2020 when the NAMA surplus starts to be transferred to the Exchequer account.



- **The structural budget deficit will fall from 1% of GDP this year to 0.7% in 2019** according to the latest Dept. of Finance projections. This means that the Government still has to meet **the so-called Medium Term Budgetary Objective** of a structural deficit of 0.5% of GDP. It should be achieved in 2020.

- The **primary budget balance** (i.e. excluding debt interest) moved into a small surplus in 2014 for the first time since 2007. The surplus is **put at 1.5%** of GDP in 2018 and is forecast to remain around this level in 2019-2020

- While the level of government debt is still very high, **debt interest payments by the Exchequer are falling as a percentage of GDP.** They fell to 2% of GDP last year and are estimated at 1.6% in 2018 and projected at 1.5% in 2019. This is much lower than in the 1980s, when interest costs hit 9% of GDP.



- The **greatest uncertainty around the Dept.'s budget projections is generally in relation to tax receipts.** Corporation tax receipts have been stronger than expected in recent years, more than offsetting weakness in some other areas. A cautious approach to tax forecasts is warranted given the uncertainty attached to the economic outlook. Furthermore, there is also the on-going question about whether the surge in corporation tax receipts since 2015 will prove sustained.

- Nominal GDP is forecast to rise by 6.2% next year, while underlying tax receipts, (i.e. excluding the one-off corporation tax boost this year), are projected to increase by 5.5%, before today's budget changes. As always, it is difficult to say where the balance of risk lies with regard to the 2019 tax forecasts, especially **corporation tax**. Overall, the projections appear reasonable. **Overruns on health spending** have become a perennial feature of the public finances. We assume any such overruns in 2019 will be offset by savings elsewhere or possibly some higher than expected revenues. Overall, the **budget outturn should be close to target**.

- **Ireland's general government gross debt/GDP ratio has been in marked decline since 2013** when it hit 120%. It is forecast to fall to 64% by end 2018, 61.5% by end 2019 and 56.5% in 2020. However, inflated GDP figures since 2015 overstate the rate of improvement and underestimate the size of the actual debt burden. A better measure is General Government net debt to GNI* (modified Gross National Income). We estimate this ratio will be slightly above 90% at end 2018, falling to circa 80% by end 2020.