Box B: Dealing with the Economic and Fiscal Impact of Surging Corporation Tax Receipts

The Council has made repeated calls for caution in terms of how the recent surge in corporation tax receipts is treated by the Government. Corporation tax receipts more than doubled since 2014. Receipts rose to a record 18.7 per cent share of total tax receipts last year from just 10.3 per cent in 2011. This share is also high relative to international norms (Chapter 3 shows equivalent shares for OECD countries).

The concentration of corporation tax receipts is a further concern. Half comes from the top ten corporate groups and close to four-fifths of annual receipts are attributable to foreign-owned multinational enterprises. As an indication of its relative importance, the €10.4 billion of corporation tax raised last year is similar, for example, to the Government spend on Education and Skills.

The fact that a large share of corporation tax receipts is raised from foreign rather than domestic income sources means that much of this revenue is a net stimulus to the economy from fiscal policy: funds available to the government but without a counterpart in terms of taxes paid out of domestic activity.

How large is the surge in corporation tax receipts?

The first question to ask is just how much have corporation tax receipts surged? Another way of framing this is to ask, “how far have receipts departed from predicted levels or from normal levels?” We can examine a number of approaches.

Model projections: One approach is to take standard forecasting methods and apply these to levels that prevailed at an earlier period to see how much actual receipts have diverged from projected values. Figure B.1 adopts this approach drawing on the forecasting models outlined in Casey and Hannon (2016). Using standard parameters for linking corporation tax changes to economic growth and taking 2011 as a base year, it suggests that some €3 billion to €6 billion of annual receipts as of 2018 are unexplained by the performance of the domestic economy, around 30–60 per cent of the total in 2018 or 1½ to 3 per cent of GNI*.

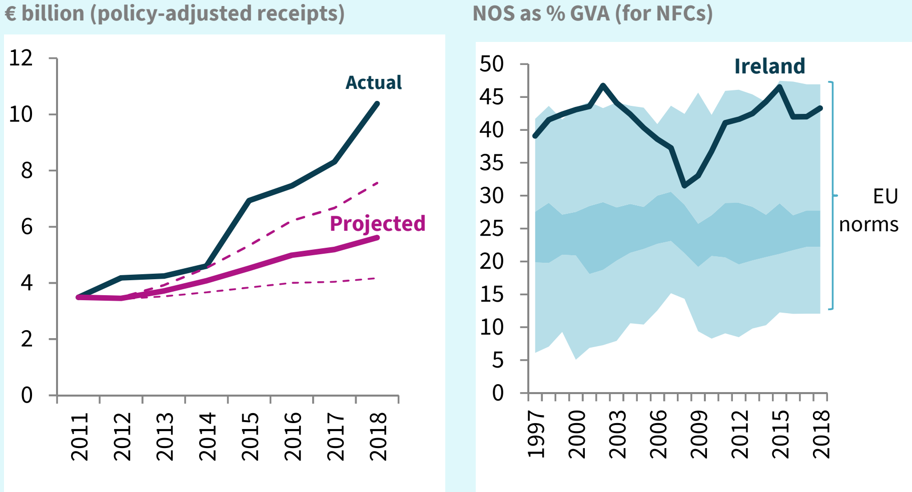
Official Forecasts: We can also consider the predicted performance of corporation tax versus where it actually is right now. In this respect, the earliest set of forecasts available for 2018 corporation tax receipts come from *Budget 2015.* Forecasts at that time suggested corporation tax receipts would be close to €5 billion for 2018, yet turned out to be twice that level at €10.4 billion. Taking this approach implies an excess performance in annual receipts of €5.4 billion (2.8 per cent GNI*): the upper range that we consider in our first exercise.

Historical Norms: If one were to assume that corporation tax receipts returned to their average long-run share of total receipts (12.5 per cent, 1990–2017), this would imply that 2018 receipts are €3½ billion (1.8 per cent GNI*) above expected levels.

International Norms: Another way to examine the exceptional performance of corporation tax receipts is to look at international norms. One way to do this is to consider the taxable base and how large it has become relative to wider economic activity. Comparing the closest equivalent measure of taxable corporate profits (Net Operating Surplus) against Gross Valued Added from the sector and focusing on non-financial corporations, we can see that Ireland’s taxable base has departed from the middle 50 per cent of EU countries shares and is at the upper end of the all-Member State range. If Ireland were to return to the 75th percentile (i.e., the top of the middle 50 per cent range), then this would imply excess receipts in 2018 of €3.4 to €4.3 billion (1.8 to 2.2 per cent of GNI*).[5]

[5] This assumes an average effective tax rate of 10–12.5 per cent.

Figure B.1: Corporation Tax Receipts Unexplained by Underlying Economy and Profits are Exceptional



Sources: Department of Finance; Eurostat; and internal IFAC workings.
Notes: Panel A takes the best-performing approach to modelling corporation tax from Casey and Hannon (2016); it forecasts "Projected" corporation tax receipts adjusted for policy measures from 2012 onwards; and it uses the underlying economic driver as growth rates for the domestic economy (domestic GVA and nominal modified GNI*) rather than GDP. A 95 per cent confidence interval is shown with dashed lines around the Projected level. These estimates can be interpreted as the level of corporation tax receipts that would have been expected to prevail had distortions related to foreign-owned multinational enterprises, which also showed up in GDP, not contributed to a higher tax base from 2012. Panel B looks at Net Operating Surplus (NOS) as a share of Gross Value Added (GVA) for Non-Financial Corporations (NFCs) in Ireland. It gives a sense of the profits compared to total value added to identify whether or not the current levels observed in Ireland are operating above EU norms. Shaded bands represent the EU min to max range and the middle 50 per cent of EU countries.

What are the risks?

The fact that Ireland is receiving higher inflows of foreign capital and higher tax receipts is something to be welcomed from a public finance perspective and it highlights the fact that Ireland continues to be considered an attractive destination for global activities.

The risks relate to how these receipts are used by Irish governments and in terms of correctly interpreting their impacts on the economy. An obvious risk is that these receipts might reverse in coming years. This could be due to idiosyncratic reasons (like changes in the profitability of firms paying receipts or their individual location decisions) or due to changes in the international tax environment that make Ireland less attractive for companies. Corporation tax receipts are also statistically the most volatile and unpredictable of the four main taxes (Box H). These features warrant caution with how receipts are used, even if it does not imply risks of a permanent reduction in average medium-term receipts. If a government relies too much on these receipts for recurrent spending, then the risk is that any inevitable reversal would imply weaker budget balances, absent any policy response.

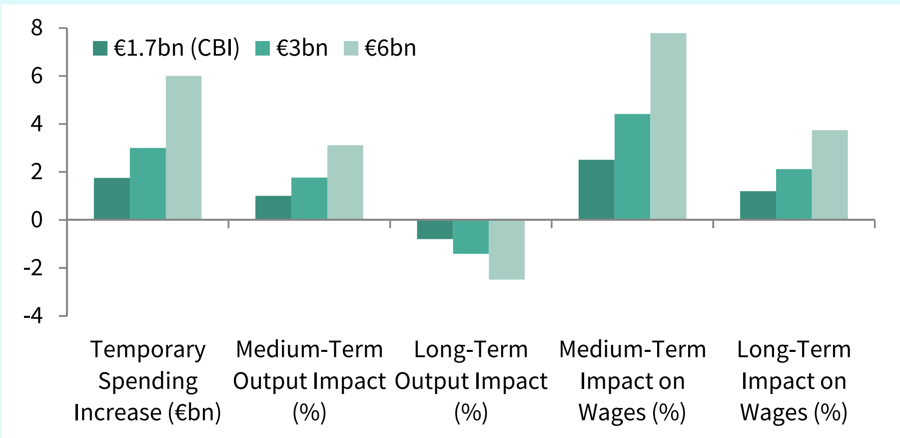
In terms of macroeconomic effects, the excess corporation tax receipts serve to make the current account balance (both headline and underlying measures) look more favourable than they otherwise would. This can complicate assessments of the sustainability of the current economic position and should be accounted for.

Recent work by Conefrey, O' Reilly and Walsh (2019) explores the impact on Irish output growth from saving €1.7 billion additional fiscal gains (mainly corporation tax receipts) over three years as compared to using it to fund additional expenditure.

Scaling up these results using the range of estimates for the excess corporation tax receipts (€3–6 billion) set out in this Box would suggest that spending rather than saving the receipts would imply an additional boost to economic output of some 2 to 3 per cent relative to baseline over the medium term in the context of an economy already at capacity (Figure B.2). Such spending would be expected to boost short-run growth. But if the economy is already at capacity (such as with low unemployment), this would be expected to contribute to overheating risks (including those related to wage pressures, and export competiveness losses).

Figure B.2: Short-Run Macroeconomic Impacts of Spending vs Saving any Excess Corporation Tax

€ billion and % deviation from baseline of temporarily spending excess fiscal gains



Sources: Conefrey, O' Reilly, and Walsh (2019); internal IFAC workings.
Notes: The "CBI" (Central Bank of Ireland) estimates are taken from Conefrey, O' Reilly and Walsh (2019). They show the impact of €1.7 billion excess receipts being used to fund additional government expenditure, and are scaled up linearly to produce the impacts for €3 billion and €6 billion use of excess receipts.

How can Ireland mitigate these risks?

Some policy responses have been considered in terms of how excess corporation tax receipts might be set aside. The Minister for Finance, Public Expenditure and Reform has on several occasions noted two solutions. First, that some of the corporation tax surge are being excluded from tax revenue projections and, accordingly, will "not feed into the expenditure base". Second, that some of the historically high levels of corporation tax are to be set aside in the Rainy Day Fund.[6]

These solutions make sense in principle, but it is difficult for the Government to commit to them and, indeed, it has not done so thus far. Excluding some receipts from revenue projections does not preclude the Government from ultimately spending these receipts when they come in or when forecasts are exceeded. If anything, the repeated within-year upward revisions to spending suggest that much of the unexpected receipts are being used to fund additional expenditure rather than being set aside. The Rainy Day Fund solution could work in principle, but the annual amounts to be set aside in the fund have in fact halved from their original target of €1 billion (*Budget 2017*) to €0.5 billion, whereas annual corporation tax receipts are now far higher than they were expected to be when the original commitments were made. The fixed payment amounts also fail to allow for saving of additional cyclical revenues.

Kydland and Prescott's (1977) "time-inconsistency" problem shows that policymakers who

[6] See, for example, the Minister's responses to the June 2018 and November 2018 Fiscal Assessment Reports.

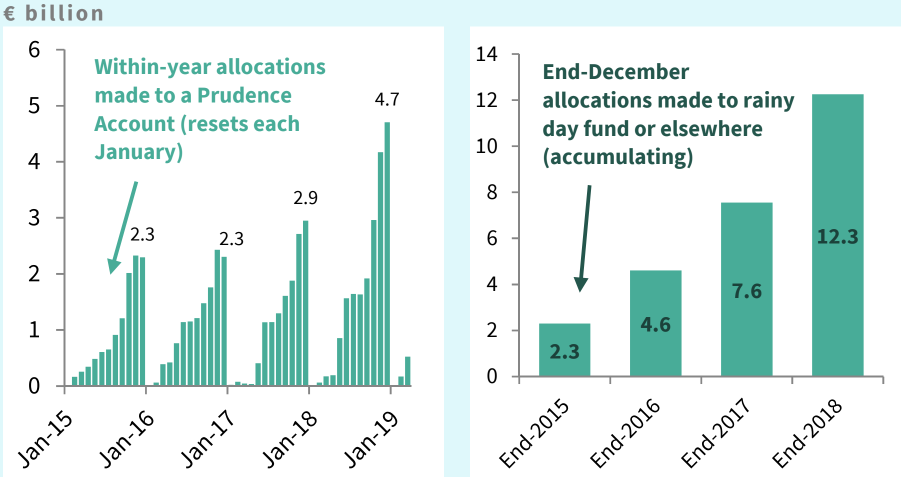
have complete discretion at every moment in time in terms of how they use resources available to them might not obtain the best possible long-term outcome. In other words, their actions later on might prove to be inconsistent with policy commitments made at an earlier stage. A key conclusion is that one can improve outcomes by limiting future discretion. This would help to preserve earlier commitments.

Proposal for a Prudence Account

To make a commitment to saving unexpected—and potentially temporary—receipts such as those from corporation tax more credible, it might be desirable to have a clear policy framework that supports this by constraining what can be done in future when those receipts arrive. Ideally there would be a fixed rule under which the Government sets aside excess receipts above a certain threshold. One option would be to notionally set aside in-year allocations to a "Prudence Account". These allocations could be based on the excess between actual and forecast corporation tax receipts (i.e., using the Exchequer profiles set out for corporation tax receipts after the previous year's budget and adjusting the base). Allocating these excess receipts to the Prudence Account as they come in could remove them from the budgetary calculus. It could reduce the scope for spending these funds as they come in, as has occurred in recent years, because the headline Exchequer position would not be impacted by these inflows. At year end, these notional amounts could then be turned over to the rainy day fund (the "National Surplus (Exceptional Contingencies) Reserve Fund") or set aside some other way.[7] The baseline for the following year would be based on the initial forecasts so that the overrun would not be locked into the base.

Figure B.3: How a Prudence Account Might have Operated

€ billion



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: Allocations of above-profile corporation tax receipts to the Prudence Account would be made over the course of the year, and then turned over to the rainy day fund or set aside elsewhere. The base for next year's corporation tax receipts forecasts would be adjusted for unexpected receipts in the previous year.

Figure B.3 shows how the Prudence Account might have worked. It sets out what would have happened had the Government set aside the excess corporation tax receipts relative to forecasts (profile) since 2015. It adjusts for the surprise receipts in full when forecasting receipts for the year ahead. An approach like this would have implied some €2.3 billion being set aside at the end of both 2015 and 2016, a further €2.9 billion or receipts at end-2017, and €4.7 billion at the end of 2018. The cumulative amount of funds transferred to a rainy day fund or elsewhere would have been some €12.3 billion at the end of last year.

[7] Casey *et al.* (2018) shows how the rainy day fund could be used more actively to alleviate unsustainable expenditure increases on the basis of cyclical and other temporary revenues.

Had the Prudence Account been used as suggested here, then a larger Exchequer deficit would have been recorded in recent years. It would not have been masked by surprise corporation tax receipts. Table B.1 illustrates what the headline Exchequer Balance could have looked like in recent years had a Prudence Account worked as suggested. The Exchequer balance would have been in deficit by €4.6 billion in 2018 instead of recording a marginal surplus. Given the allocations made to a Prudence Account each year, the cumulative rainy day fund resources would have risen to just over €12 billion at end-2018. If the sustainability of such resources became clearer over time, their use could be gradually reconsidered.

Table B.1: Prudence Account and Exchequer Balance (Counterfactual)
€ billions

	2015	2016	2017	2018
Projected Corporation Tax	4.6	5.0	5.3	5.7
Actual Corporation Tax	6.9	7.4	8.2	10.4
Unexpected Corporation Tax → Prudence Account	2.3	2.3	2.9	4.7
Rainy day fund resources from Prudence Account	2.3	4.6	7.6	12.3
Exchequer Balance	-0.1	-1.0	1.9	0.1
Exchequer Balance with a Prudence Account	-2.4	-3.3	-1.0	-4.6

Sources: CSO; Department of Finance; and internal IFAC calculations.
Notes: Corporation tax receipts are projected using the same approach as in Figure B.1, but starting from the year 2015 as a base year. The Exchequer Balance with a Prudence Account Within-year allocations to the Prudence Account are assumed to transfer to the rainy day fund at the end of the year. These resources are assumed to accumulate in the fund. Note that this does not assume any macroeconomic impact from the additional borrowings implied to fund expenditure that took place in these years alongside the allocations to the Prudence Account.

An important consideration is what base year should be used. Too early a start date would mean that resources set aside would necessarily be larger. Too late a start date would mean that risks would only be stemmed from becoming much greater. But this would not mitigate the risks associated with today's level of receipts. At minimum, the Government should stem further risks from being built up in terms of a reliance on corporation tax receipts in future years. Given the risks posed, it should seek to gradually reduce reliance on existing receipts.

This exercise illustrates the extent to which excess corporation tax receipts have boosted the public finances in recent years. The analysis is something that the Council intends to update on a regular basis to show the implications for the Exchequer balance.