Budgetary Assessment

Deficit to improve as economy recovers

2. BUDGETARY ASSESSMENT
Deficit to improve as economy recovers

After a gradual narrowing of the deficit in the years up to 2019 (Section 2.1), budgetary developments remain dominated by the impact of the pandemic on government spending and revenue during 2021 (Section 2.2).

The medium-term budgetary outlook will be shaped by the recovery and policy decisions, as well as various spending and revenue pressures (Section 2.3). *SPU 2021* forecasts a deficit of 8.4 per cent of GNI* in 2021, narrowing to 5.0 per cent in 2022 and then 0.3 per cent by 2025, but this does not fully take into account the cost of maintaining existing policies.

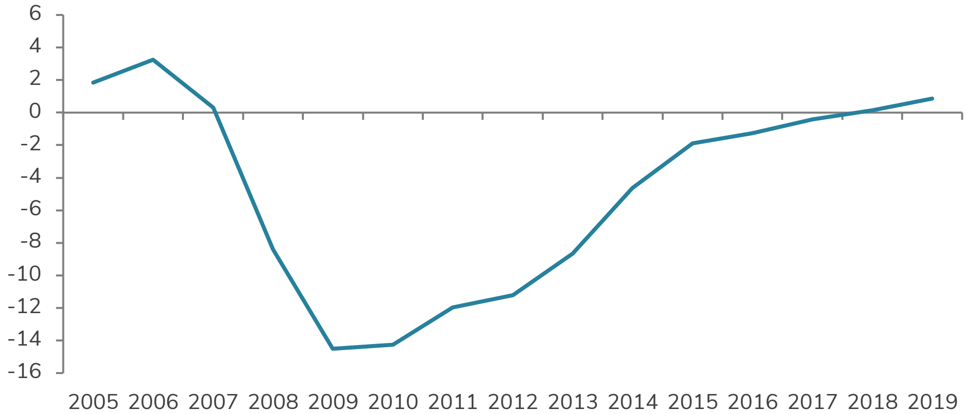
This section develops an adjusted *SPU 2021* budget balance, taking into the cost of on-going spending and correcting for apparent overestimation of capital spending and income receipts, which leaves the 2025 deficit at 1.2 per cent of GNI*. In both the short and medium term, there are substantial risks to the budgetary outlook (Section 2.4).

2.1 The recent budgetary context

Prior to the Covid-19 pandemic, the budget deficit had narrowed over many years, finally reaching a small surplus in 2018 and 2019 (Figure 2.1). As a result, the public finances were somewhat better placed to absorb the pandemic's impacts in 2020 and beyond. However, "excess" corporation tax receipts—unexplained by the performance of the domestic economy—have boosted the budgetary position since 2012. Last year, corporation tax receipts were €11.8 billion — up to €6.3 billion more than the level estimated by the Council to be in line with growth in the domestic economy (see section S9).

Figure 2.1: The Government's budget balance reached a surplus in 2018

% GNI*, excludes one-off items



Sources: CSO; and Fiscal Council workings.
Note: Data are adjusted to exclude one-offs as assessed by the Council. Get the data.

Current estimates suggest that a general government deficit of €18.4 billion (8.9 per cent of GNI*) was recorded in 2020. This marked a deterioration of €20.2 billion compared to 2019. This was driven by increased spending of €16.7 billion. About €13 billion of the spending increase can be attributed to policy measures — mainly related to supports for incomes and the health response (Table 2.1). Overall revenues were more stable, falling by €3.5 billion, of which about €1.4 billion reflects tax supports adopted. While receipts from many tax heads fell, others were remarkably resilient. The overall package of budgetary supports introduced in 2020 was about €14.5 billion, with automatic stabilisers playing a much smaller role by comparison.

Both revenue and expenditure outturns were more favourable than expected for 2020

Overall, tax revenue in 2020 was much more resilient than expected. Income and employment losses were sector specific and concentrated in the lower half of the income distribution, while pay increases agreed before the pandemic raised earnings for many. As a result, income tax receipts (when adjusted for warehousing as explained in the next section) grew in 2020 (see Box D). This outcome was far better than initially projected, largely because wages have been more resilient than expected.

Outcomes for 2020 were also better than expected even in *Budget 2021* in mid-October, despite the additional lockdown measures that were not factored in. General government revenue was €1.5 billion higher than in *Budget 2021*. Income tax was stronger than forecast in *Budget 2021* (€1.2 billion), while corporation tax was lower (€0.5 billion).

On the spending side, general government spending was €1.7 billion lower than forecast in *Budget 2021*. This was despite the unanticipated imposition of Covid restrictions in mid-October. *Budget 2021* forecasts assumed €16.7 billion of Covid-19 related spending in 2020. It appears that Covid-19-related spending was €14.9 billion (€1.8 billion lower).[23] This suggests that non-Covid-19-related spending was in line with *Budget 2021* forecasts.

Table 2.1: Policy supports in response to Covid-19 are very large

€ billions, reductions in revenue indicated by negative numbers

	2020	2021*
Total change in spending	16.7	4.4
Spending policy measures**	13.1**	12.0
Pandemic Unemployment Payment	5.0	0.6*
Wage subsidy schemes	3.8	1.2*
Health spending on Covid-19	2.0	1.9
ICT spending	0.8	
Restart Grants and Covid Restrictions Support Scheme	0.6	
Other enterprise supports	0.1	
Other	0.8	2.9
Contingency allocation		2.0
Recovery Fund		3.4
Total change in revenue	-3.5	4.8
Tax policy measures	-1.4	-0.7
Tax warehousing write-off	-0.5	-0.1
Loss relief	-0.6	
VAT cuts	-0.3	-0.5
"Stay and spend" and other schemes	-0.0	-0.1
Total change in deficit	20.2	-0.4
Total policy measures	14.5	12.7

Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: The Covid Restrictions Support Scheme is included here as an expenditure item in line with the CSO's classification (the Department classified it initially as a tax measure). Tax warehousing amounts refer to amounts of receipts warehoused and not expected to be repaid (25 per cent). Single asterisked (*) amounts refer to budgeted allocations as part of *Budget 2021/Revised Estimates 2021*; excesses over these amounts will be funded through Contingency allocations and the Recovery Fund. Double asterisked (**) amounts in 2020 differ from *SPU 2021* estimates of €14.9 billion but are in line with CSO estimates of Covid-specific spending. This, however, may be revised up in future vintages.

[23] *SPU 2021* lists Covid-19 related spending for 2020 of €14.9 billion. However, the CSO classified €13.1 billion of 2020 spending as Covid-19 related. This figure is subject to revision in future vintages. For now, the *SPU 2021* figure is used.

2.2 The short-term outlook

SPU 2021 forecasts the general government deficit to be almost unchanged in 2021 relative to 2020 (€18.1 billion or 8.4 per cent of GNI*). Both revenue and expenditure are forecast to grow by over €4 billion in 2021 as the economy recovers.

Spending is forecast to rise in 2021 despite Covid-19/one-off spending being forecast to fall by almost €3 billion. Permanent spending is forecast to rise by over €7.3 billion in general government terms following decisions in *Budget 2021*. This is an unusually large year-to-year change in core government spending, unrelated to the pandemic.

Spending forecasts in *SPU 2021* are made on the basis of temporary supports like the PUP and Employment Wage Subsidy Scheme (EWSS) ending as of end-June 2021, but contingencies were built into the overall Budget. These contingencies have broadly protected overall spending projections in *Budget 2021* from the impact of the unanticipated health-related restrictions in the first half of 2021. *SPU 2021* indicates that almost €12 billion of spending in 2021 is related to Covid support schemes, additional health spending, and additional unemployment payments.[24]

Forecasts of total general government expenditure in 2021 were revised down in *SPU 2021* by €0.6 billion relative to *Budget 2021*. This suggests that effectively all €5.4 billion of contingency spending, which was left unallocated in *Budget 2021* (made up of a Recovery Fund of €3.4 billion and a Covid-19 Contingency reserve of €2 billion) is now expected to be used. In other words, there is no unallocated spending in the *SPU 2021* fiscal projections.[25]

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[24] Income support schemes and social protection payments of €3.3 billion, a Recovery Fund of €3.4 billion, a Contingency allocation of €2 billion, and the remainder in departmental Covid-19 contingencies.

[25] Section S7 provides some insights into where much of the previously unallocated funding (€5.5 billion) appears to now be allocated.

Table 2.2: Fiscal forecasts from *SPU 2021*

€ millions unless otherwise stated

	2020	2021	2022	2023	2024	2025
General Government Revenue	**85,780**	**90,515**	**94,150**	**99,470**	**103,700**	**108,120**
Change in General Government Revenue	-3,488	4,735	3,635	5,320	4,230	4,420
General Government Expenditure	**104,200**	**108,575**	**105,765**	**104,790**	**106,835**	**108,920**
Covid/One-off Expenditure	14,916	11,960	5,275	975	700	500
Change in Covid/One-off Expenditure	14,916	-2,956	-6,685	-4,300	-275	-200
"Core" General Government Expenditure	89,284	96,615	100,490	103,815	106,135	108,420
Change in "Core" General Government Expenditure	1,794	7,331	3,875	3,325	2,320	2,285
General Government Balance	**-18,415**	**-18,060**	**-11,615**	**-5,320**	**-3,130**	**-805**

Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: Covid/one-off spending in 2022 is made up of €2.5 billion in Covid-19 supports, €1.5 billion in "Covid automatic stabilisers", €1.1 billion for the Brexit Adjustment Reserve Fund, and €0.2 billion for the National Recovery and Resilience Plan. One-off amounts for 2023 to 2025 are made up of Covid automatic stabilisers and the National Recovery and Resilience Plan. CSO estimates suggest Covid specific spending in 2020 was €13.1 billion. This estimate is subject to further revision, however, so the *SPU 2021* estimate of €14.9 billion is used.

SPU 2021 forecasts are compiled on the basis that supports schemes such as the PUP and EWSS finish at the end of June 2021. The original allocations for these income support schemes were €0.6 billion and €1.2 billion respectively, with a further €1.4 billion made available for unemployment spending following the proposed closure of the PUP and EWSS in March 2021. Spending above these levels was to be supported through the Contingency and Recovery funds.[26]

The unexpected deterioration in the public health situation from last autumn has resulted in tighter restrictions and a significantly larger number of workers claiming the PUP than was expected in *Budget 2021*, and at higher rates of pay. Costs associated with the PUP and EWSS are now likely to be around €5.7 billion in total between January and June 2021.[27]

The costs of unexpected lockdowns have used up most contingencies, leaving little room for stimulus measures without additional funding

This will require fully drawing down the Covid-19 allocation for the Department of Social Protection, along with the entire Contingency Fund and some of the Recovery Fund. Further income supports provided for the rest of the year through extensions of these schemes or standard jobseeker's payments has been signalled by the Government and would require further drawdowns from the Recovery Fund, leaving little to no

[26] These figures are the higher, Revised Estimates released after the initial *Budget 2021* figures of €0.4 billion for the PUP and €0.9 billion for the EWSS.
[27] Based on details provided by the Department of Finance, excluding foregone PRSI through the EWSS.

funding for further stimulus efforts within the Government's €12 billion allocation for Covid-19-related expenditure in 2021.[28]

Budget 2021 planned for large permanent increases in spending, not related to Covid-19. In gross voted terms, permanent increases in spending of €5.4 billion are forecast. In general government terms, this increase is even larger. These remain part of the spending increases in *SPU 2021*.

Spending projections in *SPU 2021* do not take account of payment of the Christmas bonus in 2021 or beyond. Given the recent history that it has been paid in each of the past seven years, it should have been budgeted for by default (see Box B, Fiscal Council 2020d). In 2020, full payment of the Christmas bonus cost €0.3 billion.

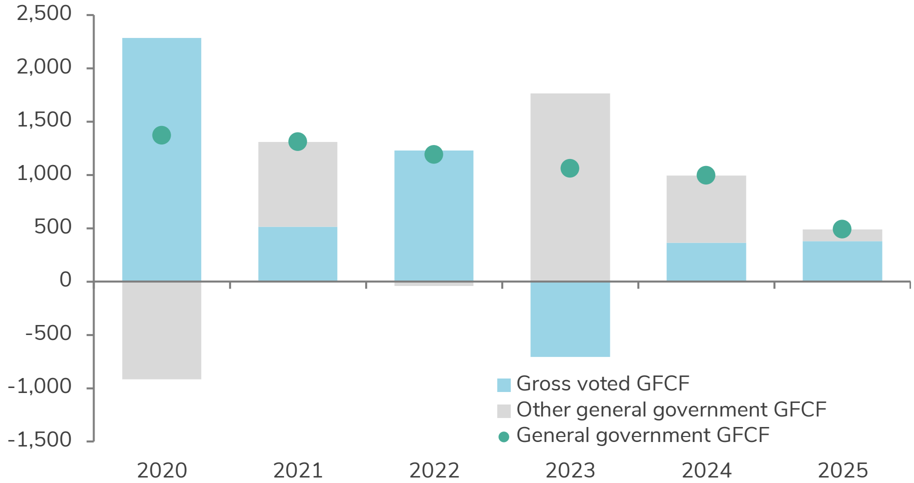
This is one part of the wider transparency issues around budgetary projections. For example, the only mention of Sláintecare in the Revised Estimates for 2021 came under the heading of "health care reform" and showed an associated amount of just €45 million for 2021. It was not until the publication of the *Sláintecare Implementation Strategy & Action Plan 2021–2023* in May that the actual costs associated with the reforms in 2021 were clarified as being some €1.2 billion of the 2021 health spending allocation.

General government capital spending is forecast to grow by €1.3 billion in 2021 (13.4 per cent). This is driven by both exchequer and non-exchequer bodies (Figure 2.2). Much of the forecast increase in capital spending after 2022 comes from non-Exchequer areas. Yet there is limited available information on spending in non-Exchequer areas. The Council had called in its previous Fiscal Assessment Report for more transparency to be provided on these areas. *SPU 2021* shows no major improvements from *Budget 2021* in this regard.

[28] While the government has indicated that these schemes are likely to continue beyond June, there are no official details on the form that they will take.

Figure 2.2: Capital spending increases driven by exchequer and non-exchequer bodies

€ millions, change year-on-year



Sources: CSO; *SPU 2021*. Get the data.

On the revenue side, *SPU 2021* forecasts general government revenue to increase by €4.7 billion in 2021. The level for 2021 has been revised up by €1.8 billion relative to *Budget 2021* forecasts. This is mainly driven by general government revenue being €1.5 billion higher in 2020 than forecast in *Budget 2021* (mainly due to income tax; see Figure S.8a). Box C outlines the impact of warehousing on Exchequer tax receipts.

Box C: The impact of warehousing on tax receipts

One of the measures introduced in response to the pandemic was the warehousing of some tax due in 2020 and 2021. Some income tax and VAT which were due to be paid in 2020 and 2021 were deferred, to be repaid over the period 2021–2023.

Overall, €2,253 million of receipts were warehoused (€1,900 million in 2020, €353 million in 2021). On an Exchequer basis, these receipts will not be included in the year they were originally due, but rather in the year they are eventually collected (cash basis). However, on a general government basis, these warehoused tax receipts are included in 2020 and 2021 (accrual basis) figures rather than over the period received (2021–2023).

Forecasts of income tax in *SPU 2021* are compiled on an Exchequer basis. These then are used as an input into forecasts of general government revenue (which are on an accruals basis). In 2020 and 2021, €1,026 million of income tax receipts were warehoused.[29] *SPU 2021* assumes a default rate of 25 per cent. This means that €770 million of income tax is expected to be recovered (over the period 2021-2023).

This default rate was arrived at by the Department after consultations with Revenue. Given the unusual nature of the scheme, there is significant uncertainty over the appropriate default rate to be assumed. Given this uncertainty, the Department used what it believed to be a relatively high default rate as a prudent assumption.[30]

Table C1: Income tax forecasts from SPU 2021

€ millions unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Exchequer income tax (cash basis)	22,934	22,711	24,305	26,130	28,470	30,385	32,305
Warehousing	0	649	121	0	0	0	0
Repayments	0	0	115	231	423	0	0
Net Warehousing impact	0	649	5	-231	-423	0	0
“Underlying” income tax (accruals basis)	22,934	23,360	24,310	25,899	28,047	30,385	32,305
Exchequer income tax growth (%)	8.0	-1.0	7.0	7.5	9.0	6.7	6.3
“Underlying” income tax growth (%)	8.0	1.9	4.1	6.5	8.3	8.3	6.3

Sources: SPU 2021.

Note: Of the €1,026 million of income tax receipts that were warehoused in 2020 (€865 million) and 2021(€161 million), *SPU 2021* forecasts assume that 75 per cent are repaid (€770 million). €649 million of this relates to income tax warehoused in 2020, with €121 million related to income tax warehoused in 2021. As a result, “underlying” income tax receipts for 2020 are €649 million higher than given by the Exchequer presentation. 2021 sees a mixture of some warehousing of receipts and some repayments of income tax warehoused in 2020. Conversely, “underlying” income tax receipts for 2022 and 2023 are lower than the Exchequer presentation.

The income tax forecasts in *SPU 2021* reflect this assumed impact of warehousing and subsequent repayment. Table C1 shows what “underlying” income tax receipts would look like under the *SPU 2021* forecasts. This adjustment attributes the recovered amounts of income tax to 2020 and 2021, rather than 2021-2023. After making this adjustment, “underlying” income tax receipts are forecast to grow by 4.1 per cent in 2021. This is much more modest that the headline 7 per cent growth rate, and closer to the growth of the non-agricultural pay bill.

As with income tax receipts, VAT receipts are also impacted by warehousing in 2020 and 2021, with payments due in subsequent years (Table C2). VAT receipts of €1,227 million were

[29] Almost all the warehoused income tax is PAYE, with self-employed income tax accounting for less than 5 per cent of warehoused income tax.

[30] In reporting the Government Finance Statistics, the CSO has accrued €874 million of income tax/VAT receipts into 2020. This implies a default rate of 54 per cent. This will be further reviewed as more data becomes available. See background notes, transactions of note 2020: https://www.cso.ie/en/releasesandpublications/er/gfsa/governmentfinancestatisticsapril2021/

warehoused over 2020-2021 and, as is the case with income tax, 75 per cent of the warehoused VAT is expected to be repaid over the period 2021–2023 (€920 million). On an underlying basis, VAT fell less severely in 2020 and is forecast to grow more modestly in 2021 (8.9 per cent).

Table C2: VAT forecasts from *SPU 2021*

€ millions unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Exchequer VAT (cash basis)	15,118	12,425	14,370	15,885	17,280	18,105	19,015
Warehousing	0	776	144	0	0	0	0
Repayments	0	0	138	276	506	0	0
Net warehousing impact	0	776	6	-276	-506	0	0
"Underlying" VAT (accruals basis)	15,118	13,201	14,376	15,609	16,774	18,105	19,015
Exchequer VAT growth (%)	6.2	-17.8	15.7	10.5	8.8	4.8	5.0
"Underlying" VAT growth (%)	6.2	-12.7	8.9	8.6	7.5	7.9	5.0

Sources: *SPU 2021*.

Note: Of the €1,227 million of VAT receipts that were warehoused in 2020 and 2021, *SPU 2021* forecasts assume that 75 per cent are repaid (€920 million, €776 million relating to 2020 warehousing, €144 million relating to 2021 warehousing). As a result, "underlying" VAT receipts for 2020 are €776 million higher than given by the Exchequer presentation. Conversely, "underlying" VAT receipts for 2022 and 2023 here are lower than the Exchequer presentation.

Forecasting income tax presents a number of challenges given the sharp changes in the composition of the forecast, which have changed the standard relationship between income and income tax receipts.

In addition to the complexities of warehousing, Section S.8 outlines some of the difficulties in forecasting income tax at a time of high volatility and with large differences in the situation of different taxpayers using the Department's methodology in this round. This has led to large amounts of judgement being applied to income tax forecasts in 2022 (see Figure S.8b). Box D outlines some of the challenges in forecasting income tax receipts.

Box D: The resilience of income tax in 2020

Income tax was surprisingly resilient in 2020, falling by just 1 per cent. It would have grown by 1.9 per cent if deferred, or "warehoused", tax receipts were included. This reflects how the total wage bill in Ireland was effectively flat in 2020, despite substantial lost earnings for some sectors. In each case, the performance in 2020 was far more benign than the Department of Finance projected in *SPU 2020* and in *Budget 2021*. This Box analyses the compositional issues affecting income tax as observed in 2020 due to the Covid-19 pandemic.

Figure D1 presents detailed data from recent Revenue analysis of PAYE receipts in 2020 (Collins and O'Rourke, 2021). This demonstrates that the sectors with the largest annual falls in income taxes paid in percentage terms tended to be those sectors that pay a small share of total PAYE receipts. In contrast, the top seven sectors — each with shares of at least 10 per cent of PAYE receipts — saw tax payments increase by 2.3 per cent (in weighted average terms) in 2020.

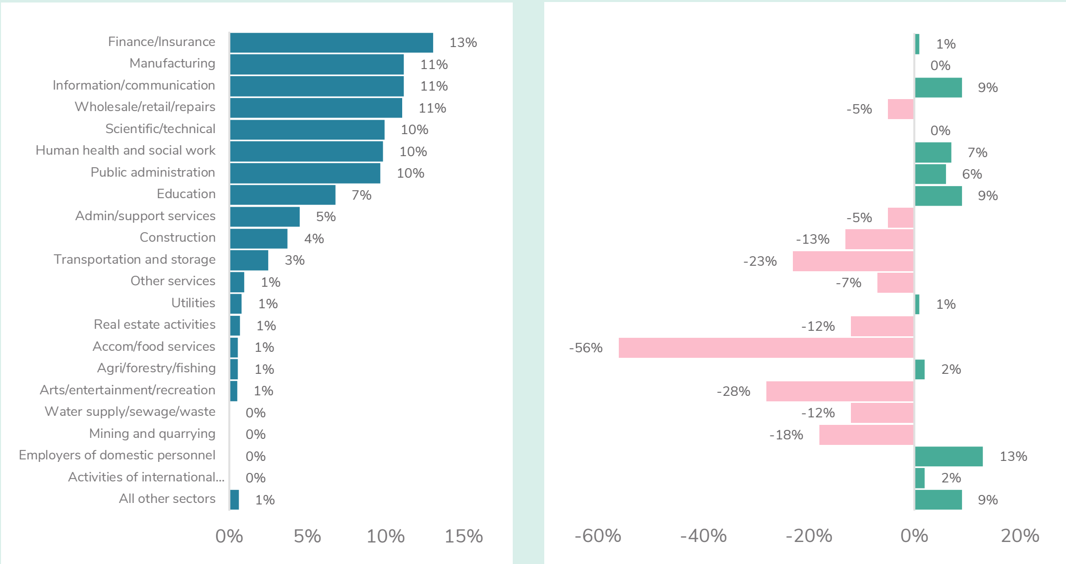
Overall decreases in PAYE receipts for sectors that declined amounted to approximately €650 million, whereas the increases for sectors that grew totalled €450 million. By far the largest decrease was in accommodation and food services (about €220 million), followed by other services (close to €120 million). The largest increase was for information and communication (about €130 million), followed by human health and social work (€100 million).

Figure D2 presents recent forecast vintages of income tax (panel A) and the average income tax rate (panel B). As discussed in Section 2.3, income tax (excluding the adjustment for warehousing) is forecast to recover gradually from a modest fall in 2020, with the level of receipts by 2023 back in line with pre-pandemic projections. The eventual reduction in 2020 receipts was far more benign than expected in *SPU 2020* or *Budget 2021*, reflecting the extreme uncertainty brought on by the pandemic.

Figure D1: Incomes held up in sectors paying the most income tax

A. PAYE receipts by sector
% total

B. PAYE growth rate by sector
% change year-on-year



Source: Collins and O'Rourke (2021).

Figure D2: Forecasts of sharp changes in effective income tax rates have proven inaccurate

A. Income tax vintages
€ billion

B. Average income tax rate vintages
Percentage of compensation of employees

Sources: Department of Finance (various forecasts); and Fiscal Council workings.

PAYE makes up the majority of income tax (70 per cent in 2020). Department of Finance forecasts of PAYE are made using two macroeconomic drivers: non-agricultural earnings per person and the numbers employed. An elasticity of 2.1 is applied to non-agricultural earnings per person, while an elasticity of 1 is applied to employment.[31] Due to the sector-specific nature of the pandemic, employment and average earnings per person employed diverged strongly. In 2020, employment fell, while average earnings per person still employed rose sharply due to the compositional changes.

Using the two elements of the wage bill (pay per person and employment) may be problematic in this case and this is best illustrated by examining the impact of macroeconomic drivers on 2022 forecasts. *SPU 2021* forecasts that in 2022, employment and labour market conditions will improve. The return of many lower paid employees means average pay per employee is forecast to fall in 2022. This is offset somewhat by employment rising. However, as a much higher elasticity (2.1 as opposed to 1) is applied to pay per employee, the overall "macro" effect on PAYE receipts is negative. This runs counter to the idea that a recovering labour market should boost income tax receipts.

Given the problems with the methodology, significant judgement is applied by the Department of Finance to arrive at the forecasts in *SPU 2021* (Section S.8). A simpler and possibly more robust alternative in this case would have been to use an alternative method, such as the elasticity of PAYE receipts to compensation of employees.

Corporation tax receipts are forecast to fall in 2021, due to payments under the Covid Restrictions Support Scheme (CRSS).[32] While recent outturns suggest that the cost of this scheme has been lower than anticipated, around €0.3 billion of corporation tax receipts this year have been redirected to impacted businesses through the CRSS.[33] The scheme is scheduled to

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[31] The same two macroeconomic drivers are used to forecast Universal Social Charge receipts. However, the elasticity used for earnings per person (1.2) is much closer to that applied to employment growth (1.0). As a result, the differing growth rates of these two variables is less problematic.

32 The CRSS is a direct cash payment scheme for firms forced to close as a result of public health restrictions, and was originally to be funded through the €3.4 billion Recovery Fund.

[33] Previous estimates were for CRSS payments to total around €0.16 billion per month under Level 3 restrictions. The introduction of the Covid-19 Business Aid Scheme worth €60 million has likely supported businesses that would have required some of the €0.16 billion monthly estimate.

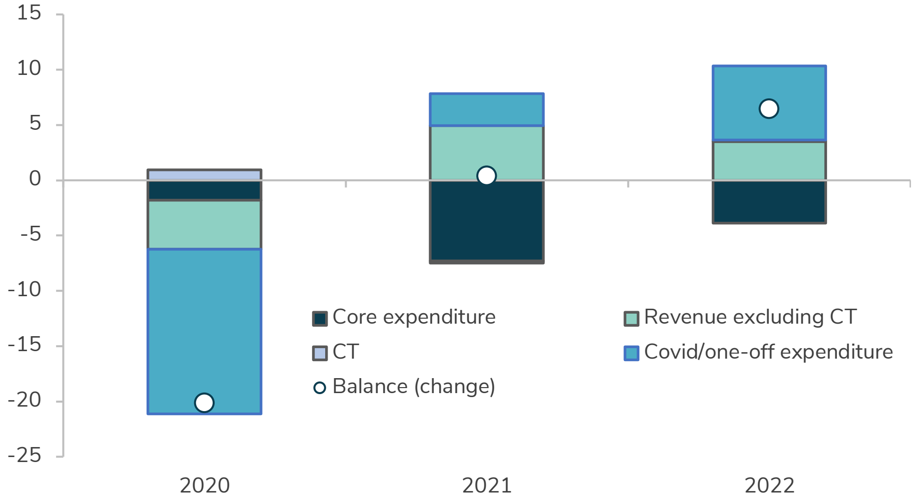
remain in place until the end of June, with indications it will be extended in some form.

Figure 2.3 shows the elements contributing to changes in the general government balance in 2021. Revenue growth in 2021 contributes to improvement in the general government balance, together with lower Covid/one-off spending. However, increases in core expenditure almost entirely offset these improvements. As a result, the balance is forecast to only marginally improve in 2021.

Falls in Covid-19-related spending and revenue increases in 2021 are offset by rising core spending

Figure 2.3: Improvements in the budget balance from revenue increases and falls in temporary spending are largely offset by increases in core spending

€ billion, annual change



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Changes in expenditure are recorded as their impact on the balance (i.e. expenditure increases are recorded as negative, as they worsen the balance). Covid/one-off expenditure as outlined in Table 2.2. CT = Corporation Tax. Get the data.

2.3 The medium-term outlook

Fiscal projections in *SPU 2021* go out to 2025. The Council welcomes this longer forecast horizon relative to *SPU 2020* and *Budget 2021* and would welcome a return to full 5-year ahead forecasts in the autumn.

However, *SPU 2021* spending projections over the period 2022-2025 are "technical" in nature in that they are not intended to reflect Government policy decisions.

This means that the *SPU 2021* forecasts do not aim to fully reflect the cost of continuing existing policies and do not take into account the commitments in the 2020 *Programme for Government*.

Temporary spending on Covid-19 remains in 2022, with technical assumptions of 3.5% spending growth relied upon thereafter in SPU 2021

Current spending projections for core voted spending from 2022 are based on the *ad hoc* assumption of 3.5 per cent growth per year, following a forecast increase of non-Covid related spending of 7.7 per cent in 2021.[34] As noted below, this level of spending growth would be insufficient to hold current service levels constant and index social payments. The assumed capital spending profile does not match the Capital Plan.

For 2022, there is €2.5 billion of spending set aside for Covid-19 spending/sectoral supports. This is presented as indicative of spending that may be required in certain sectors.[35] A further €1.5 billion in spending is related to automatic stabilisers (mainly jobseeker's payments). €1.1 billion of capital spending in 2022 is to be funded by the Brexit Adjustment Reserve Fund. These assumptions mean that Covid-19/one-off expenditure is forecast in *SPU 2021* to fall by €6.7 billion in 2022. This outweighs core spending growth of €3.9 billion, meaning general government expenditure is forecast to fall by €2.8 billion.

[34] *SPU 2021* forecasts nominal GNI* growth of 7.6 per cent in 2022.

[35] The Minister for Finance suggested that these funds may be required "to support semi-state companies, the continuation of social distancing within public transport and some of the measures that are in place in our schools". See https://www.oireachtas.ie/en/debates/debate/committee_on_budgetary_oversight/2021-04-27/2/

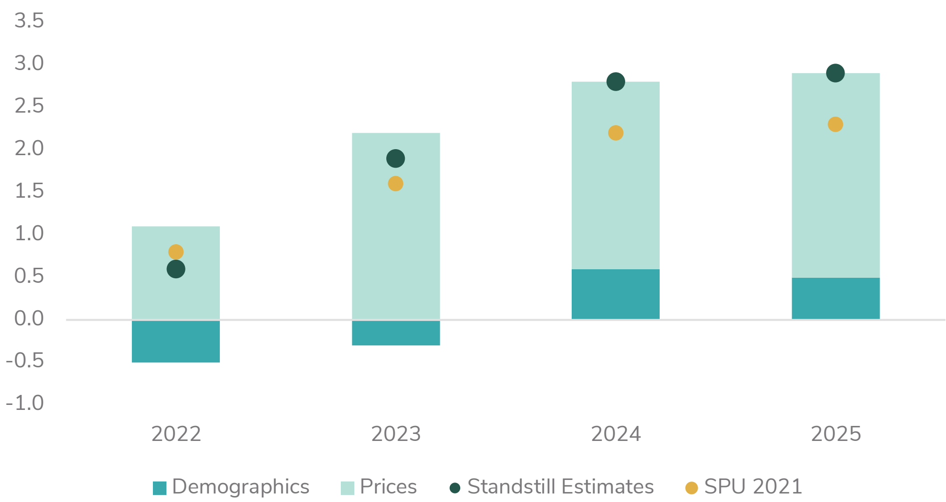
For the medium term, a better methodology to forecast spending is based on the “Stand-Still costs” of maintaining existing public services and value of welfare payments, taking into account inflation, wages increases and the costs of ageing, and any envisaged policy changes which have implications for spending. In assessing this, the Council is not recommending indexation. These increases would be realistic to expect as (1) they would be in line with past patterns and (2) they would be required to maintain their relative real value (such that that public sector wages and welfare payments would increase in line with economy-wide wages). This approach provides the best anchor for understanding the consequences of policy changes relative to existing commitments.

Estimating Stand-Still costs associated with price and demographic pressures allows for a more realistic projection of future spending

Section S11 outlines the Council’s Stand-Still cost estimates. These indicate the costs of maintaining current government service levels and indexing social welfare payments to account for demographic and price pressures. This includes adjusting for the estimates of Covid and unemployment-related supports, which are expected to fall as the economy recovers.

Figure 2.4: Stand-still costs exceed medium-term gross voted spending allocations

Annual change in € billion (gross voted current spending)



Source: SPU 2021, Revised Estimates 2020, CSO, Department of Expenditure and Reform, HIPE, HSE, and Fiscal Council workings. Get the data.

The Stand-Still estimates imply that spending would need to increase by approximately €2.1 billion each year on average (for 2022-2025) to maintain existing commitments (see section S11). These pressures are largely driven by price effects but with some impact from ageing in the later years (Figure 2.4).

Stand-Still costs of €2.1 billion per year are higher than the €1.7 billion annual average increase in gross voted current spending from 2022-2025 in *SPU 2021*. This cumulates to €1.2 billion over the period. This implies that core spending increases projected in *SPU 2021* would be insufficient to maintain current service levels and index social payments. The gap between the Department's current spending forecasts and the Stand-Still estimates remains the same, even if changes in social benefits owing to lower numbers unemployed are removed from the analysis. This is before any new policy priorities are considered or any upside risks to spending in areas such as health are realised.[36]

Expenditure levels in *SPU 2021* are not credible when compared with Stand-Still costs

This suggests that the medium-term spending plans are not credible as they do not appear consistent with on-going spending plans yet alone additional policy priorities set out in the Programme for Government. At the same time, the lack of detailed foundations to these SPU projections makes it difficult to understand what is driving the projections. While the assumption of 3.5 per cent growth in spending is likely to be more realistic than some projections in some past years, which assumed flat spending in nominal terms. It appears both unfounded and unrealistic.

This highlights the limitations of using unrealistic technical assumptions to forecast medium-term spending. A better methodology would be to forecast spending based on a bottom-up assessment of demographic and price pressures, as with the Stand-Still estimates, and any envisaged policy changes which have implications for spending. This would provide a more realistic projection and provide a better way of articulating the factors impacting the public finances.

Interest costs are projected to stay relatively stable over the medium term. Gross financing needs are projected to be below 10 per cent of GNI*, which would limit the immediate impact of an increase in the marginal interest rate. *SPU 2021* forecasts of interest costs in 2021 are lower than those in *Budget 2021*, repeating a recent pattern of downward revisions.

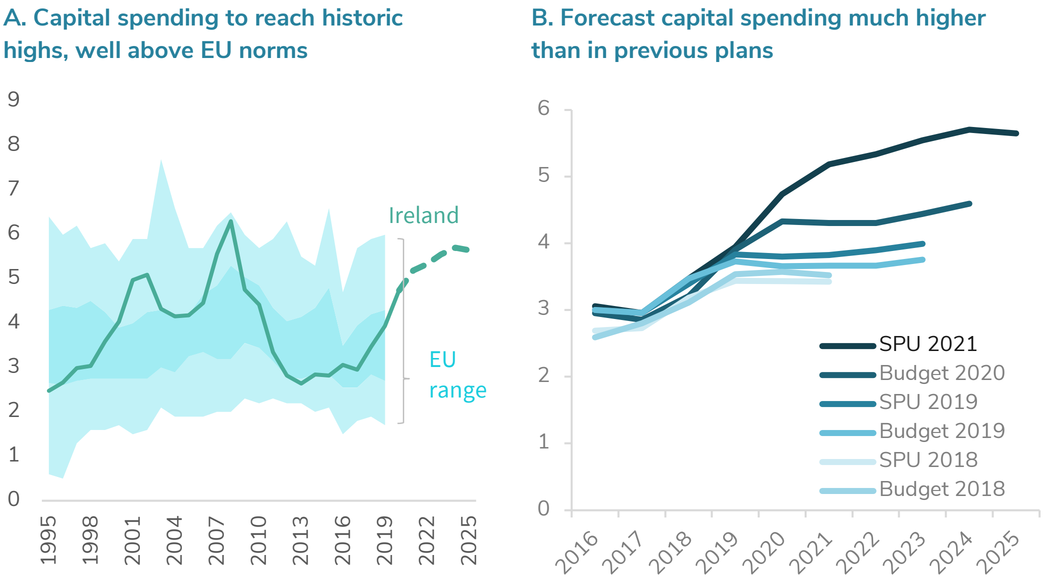
[36] See Box E for an overview of how costs associated with the government's climate change policies are likely to add to spending pressures over the coming years.

One area of spending that *SPU 2021* forecasts to grow rapidly over the forecast horizon is capital spending.[37] General government capital expenditure is forecast to exceed 5.5 per cent of GNI* from 2023 onwards. This would put Ireland well above current EU averages for public investment as a share of national income (Figure 2.5, Panel A). Previous forecasts of public investment in Ireland showed much lower levels of investment planned for the later years of the forecast horizon (Figure 2.5, Panel B). Much of the increase in general government capital spending in the later years is focused in non-exchequer areas (Figure 2.2).

Ireland's capital spending as a share of national income is forecast to become one of the highest in Europe

Figure 2.5: Capital spending to increase as a share of national income.

% GNI*



Sources: CSO and Department of Finance.
Note: Dashed line in Panel A indicates forecasts from *SPU 2021*. The EU range shows the minimum and maximum levels of public investment as a share of national income in EU countries (GDP for all countries apart from Ireland). The darker shaded area shows the inter quartile range of EU levels of investment. Darker lines in Panel B represent more recent forecasts. *SPU 2020* and *Budget 2021* are excluded due to their short forecast horizons. Get the data.

The upward revision to planned increases in investment is substantial and might be difficult to achieve. It is possible that the Government might not have the capacity to ramp up public investment to the extent that is now planned meaning that the public investment forecasts set out in the *SPU 2021* could be too optimistic.

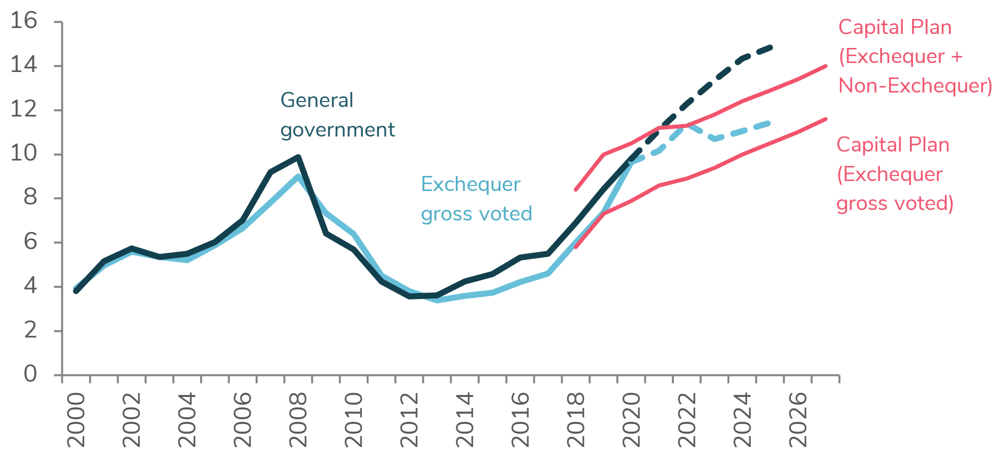
Ambitious capital spending plans will require careful planning to achieve targets

Furthermore, the planned increase in investment is higher in than in the Government's capital plan: the "National Development Plan". Figure 2.6 shows that the ramp up would see general government investment

[37] *SPU 2021* indicates that €1.1 billion of capital spending in 2022 is to be funded by the Brexit adjustment reserve fund.

spending exceed the capital plan's allocation for both Exchequer and non-Exchequer areas by almost €2 billion. It is also notable that there is a lack of detail in *SPU 2021* in terms of what areas this investment is targeted at. While the Revised National Development Plan is to be released in the coming months, it is impossible to determine if the allocations made in *SPU 2021* are consistent with this upcoming publication and whether they capture costs of major policies envisaged such as meeting climate change targets, housing priorities or Sláintecare reforms.

Figure 2.6: Public investment is forecast to exceed the Capital Plan



Sources: National Development Plan; CSO; and Department of Finance forecasts.
Note: While the gross voted measures shown are comparable, the capital plan (National Development Plan) did not present public investment plans on a general government basis, which makes things difficult to compare in this respect. The Exchequer + Non-Exchequer amounts set out in the plan would include routine maintenance and repairs, for example, but this would be excluded from the general government measure, which only counts major investments. Get the data.

The implementation of policy priorities from the 2020 Programme for Government such as emissions reductions, the provision of housing, and Sláintecare, in particular, appear to present upside risks to spending over the medium term as they are not explicitly factored into *SPU 2021* and the amounts projected for current spending are insufficient to maintain existing activities in real terms.

Sláintecare represents a significant spending risk, given the scale of its ambition and the lack of detail on costings

At the same time, it remains unclear how the large permanent increase in spending from *Budget 2021* is being allocated relative to the Government priorities. While we now know that some €1.2 billion of the €1.9 billion of permanent increases in health spending for 2021 are actually allocated to the implementation of Sláintecare, there remains no clear guidance as to how far these costs go towards implementing the Sláintecare reforms in full. This was estimated in May 2017 at €3 billion. In other areas of current spending, it is unclear how Government objectives will be funded.

More generally, there is a lack of detail and transparency in recent budgetary documentation. For example, the expenditure report released as part of *Budget 2021* detailed large and permanent increases to health spending, but with no clear information provided on how these costs related to plans of delivering Sláintecare.[38]

Income tax forecasts in SPU 2021 imply growth rates that are stronger than expected for wages

On the revenue side, "Underlying" income tax is forecast to grow strongly over 2022-2025 (7.4 per cent on average). This is faster growth than growth for the non-agricultural wage bill (5.1 per cent on average over 2022-2025).[39] This suggests that the average effective tax rate is increasing (Figure 2.7b).

While not explicitly stated in the documentation, *SPU 2021* projections appear to have been based on income tax bands and credits not being indexed after 2021. This means that the average effective tax rate increases due to inflation and higher wages as more taxpayers move into the higher tax bands and as the real value of thresholds fall. The Programme for Government committed to income tax bands and credits being indexed from *Budget 2022* onwards.[40] As a result, *SPU 2021* projections do not incorporate a significant government policy commitment that would substantially reduce revenue is later years.

If a policy of indexing income tax bands and credits were to be pursued over the period 2022-2025, that would result in 2025 receipts being between €1 and €2 billion lower. As a result, approximately half of the increase in the income tax to compensation of employee's ratio can be attributed to the yields from non-indexation.[41]

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[38] The only mention of Sláintecare in the Revised Estimates for 2021 came under the heading of "health care reform" and showed an associated amount of just €45 million for this year. It was not until the publication of the *Sláintecare Implementation Strategy & Action Plan 2021–2023* in May that the actual costs associated with the reforms in 2021 were clarified as being some €1.2 billion of 2021 health spending allocation.

[39] This would imply an elasticity of 1.5. This is larger than the range of policy-adjusted estimates (1.3 to 1.4) found in Conroy (2020). These policy-adjusted elasticities did not account for the yield from non-indexation, so can be considered an upper bound.

[40] "From Budget 2022 onwards, in the event that incomes are again rising as the economy recovers, credits and bands will be index linked to earnings. This will be done to prevent an increase in the real burden of income tax". See https://www.gov.ie/en/publication/7e05d-programme-for-government-our-shared-future/

[41] Were income tax to remain at its 2019 share of non-agricultural wages, then that would imply income tax being €3.2 billion lower than the level forecast in *SPU 2021*.

The remaining increase in the income tax to compensation of employee's ratio implies an elasticity of income tax (with respect to compensation of employees) above one. This could occur if jobs and incomes are moving towards higher income categories, which are more heavily taxed under the progressive income tax system. Were indexation assumed after 2020 and a lower elasticity was applied, receipts in 2025 could be up to €2 billion lower than projected in *SPU 2021*.

Income tax indexation does not appear to have been clearly factored into *SPU 2021* forecasts, leading to difficulties in assessment and inconsistencies with the Programme for Government

While *SPU 2021* income tax projections appear to be too strong given the assumptions used, income tax receipts could indeed be as high as projected in *SPU 2021*. This could arise if wages and incomes are stronger than forecast in *SPU 2021* (Section 1). In other words, a macroeconomic forecast error could offset a fiscal forecasting error.

Figure 2.7: Income tax forecast to grow much more rapidly than the non-agricultural wage bill

A. Income tax forecast to grow rapidly
Index 2018 = 100

B. Income tax share of wage bill
Income tax as a percentage of the non-agri wage bill

Sources: CSO and *SPU 2021*.
Note: Both panels use "underlying" income tax receipts, which adjusts for the impact of warehousing over the years 2020-2023 (see Box C). Dashed line in Panel B shows the ratio implied by *SPU 2021* forecasts of income tax and the non-agricultural wage bill. The sharp increase in 2011 is due to the introduction of the universal social charge. Get the data.

While the forecast of income tax receipts might be an overestimate, the projection of PRSI revenue might be underestimated in *SPU 2021*. Given the sector specific nature of changes in the labour market, changes in PRSI may not mirror changes in aggregate income. PRSI receipts fell significantly in 2020 (8.3 per cent), despite aggregate income being broadly flat. This may be because employment losses in 2020 were focused in low paying sectors, who were previously paying PRSI contributions. By contrast, many

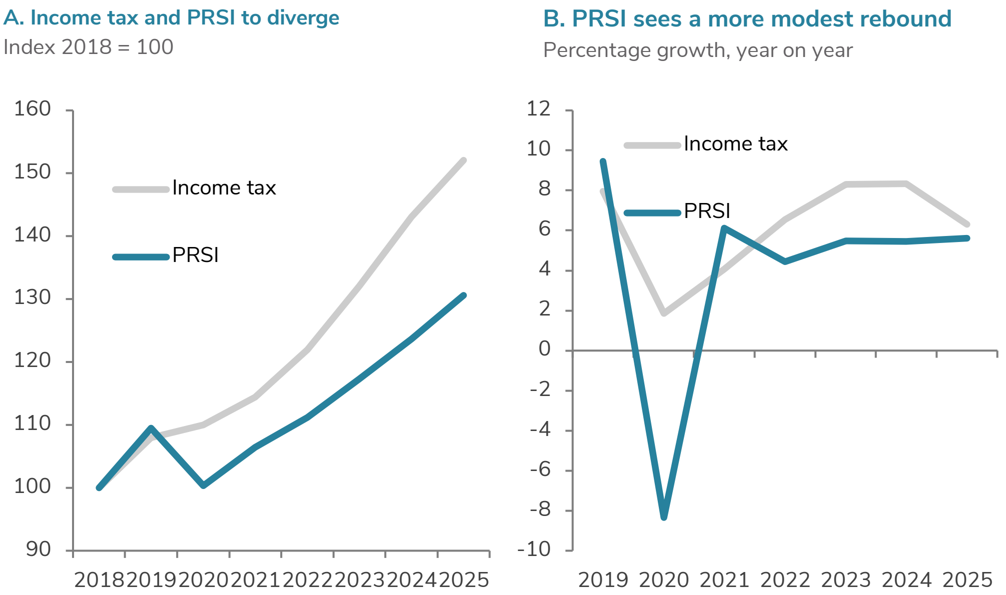
PRSI is forecast to grow at a modest pace relative to income tax

of these lower paid employees may not have been paying any income tax, which grew on an underlying basis in 2020.

As a result of this compositional factors, when employment in these lower paying sectors returns, one would expect PRSI receipts to grow faster than aggregate income. *SPU 2021* forecasts PRSI to grow slightly faster than income in 2021, and broadly in line with income thereafter. It would appear more likely that PRSI receipts would grow faster than aggregate income when employment is growing in 2022 and 2023, before reverting to mirroring aggregate income growth. Hence there could be an upside risk to PRSI forecasts in *SPU 2021*.

Figure 2.8 shows how forecasts of PRSI and underlying income tax differ greatly. Having fallen more severely in 2020, PRSI sees more moderate growth than income tax (apart from 2021).

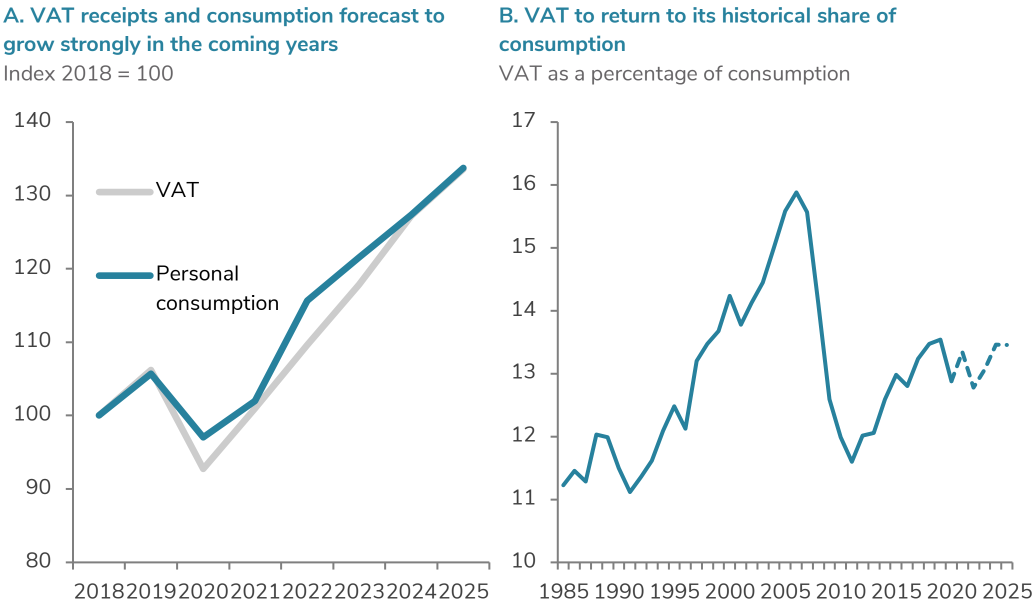
Figure 2.8: PRSI forecast to grow much more slowly than the income tax



Sources: CSO and SPU 2021.
Note: Both panels use "underlying" income tax receipts, which adjusts for the impact of warehousing over the years 2020-2023 (see Box C). Get the data.

Underlying VAT is projected to grow strongly over the medium term (7.3 per cent on average over 2022-2025). This mirrors nominal consumption growth and would keep the VAT to consumption ratio broadly constant (Figure 2.9). Were some upside risks to consumption realised, VAT receipts could be stronger than *SPU 2021* projections (see Box A).

Figure 2.9: VAT and personal consumption forecast to grow at similar rates after 2021



Sources: CSO and SPU 2021.
Note: In both panels VAT receipts are adjusted for the impact of warehousing over the period 2020-2023 (Box C). Dashed line in Panel B shows the ratio implied by SPU 2021 forecasts of VAT and nominal personal consumption. Get the data.

Reforms to the global tax environment are expected to reduce corporation tax receipts over the coming years

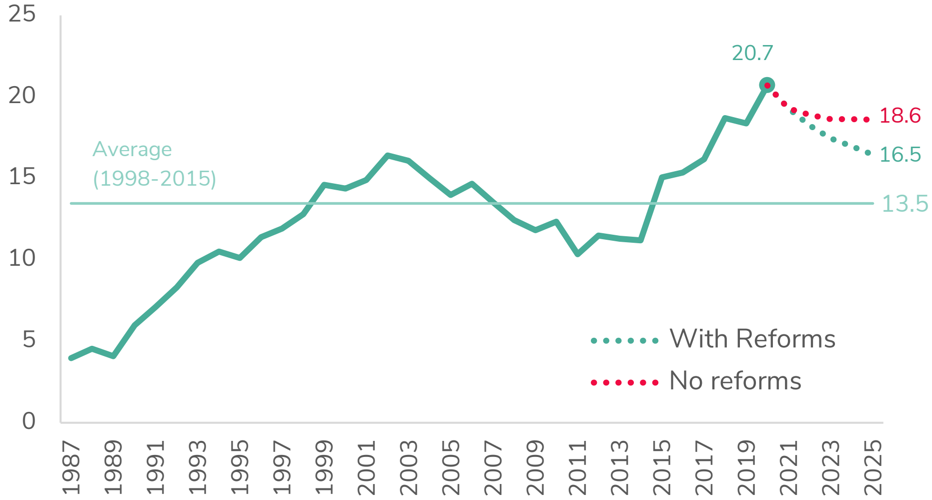
SPU 2021 forecasts suggest modest growth in corporation tax beyond 2021 as growth in the economy is offset by the assumed negative impact of a changing international tax environment. This mainly reflects the OECD's Base Erosion and Profit Shifting (BEPS) process. Payments by domestic firms may be reduced in the years ahead due to the carry-forward of losses during the pandemic or due to Brexit.

From 2022 to 2025, the assumed impact of a changing international environment is €500 million per year (see judgement in Section S.8). As a result, corporation tax receipts in 2025 are forecast to be €2 billion lower than would be the case in an unchanged international environment.[42] Box F further explores the several risks to Irelands corporation tax receipts, including a changing international tax environment. As a result of more modest growth, corporation tax as a share of Exchequer tax revenue is forecast to fall over the forecast horizon. Were these impacts not assumed, then the corporation tax share of Exchequer tax revenue would fall somewhat in 2021 and stay relatively stable thereafter (Figure 2.10).

[42] While an impact of €2 billion is significant, Fiscal Council estimates of "excess" corporation tax receipts are up to €6 billion.

Figure 2.10: Corporation tax to fall as a share of Exchequer tax revenue

Corporation tax (per cent share of Exchequer tax revenue)



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: The "with reforms" series shows how the corporation tax share is forecast to evolve in *SPU 2021* (which incorporates impacts from Base Erosion and Profit Shifting (BEPS) reforms). The "no reforms" series shows how the forecast would differ were these impacts not assumed and the forecasts were otherwise as in *SPU 2021* (hence increasing CT and total tax receipts relative to *SPU 2021* forecasts). Get the data.

The impact of increased carbon taxes has not been included in SPU 2021, but is likely to be deficit neutral

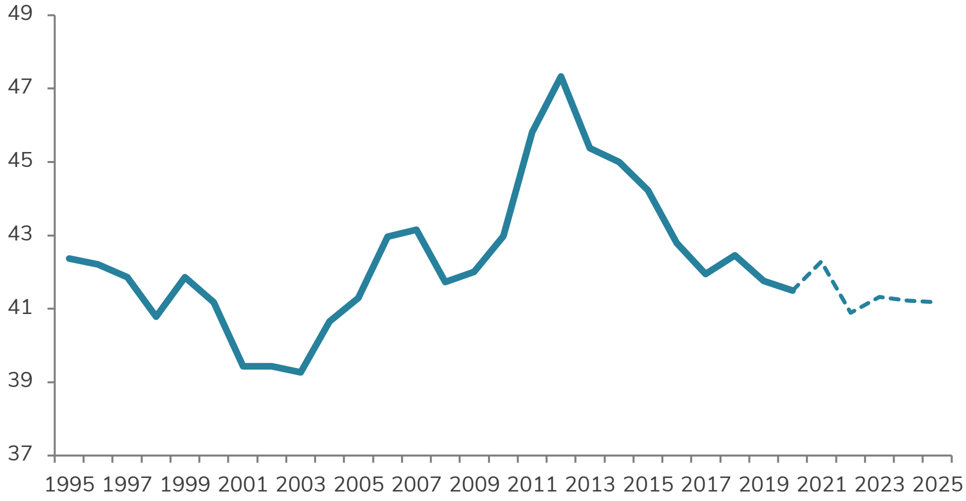
While increases in the rate of carbon tax out to 2030 were legislated for in *Budget 2021*, the additional yield (approximately €147 million per annum) from increases beyond 2021 has not been incorporated into *SPU 2021* projections of excise receipts. However, as the increased revenue from the tax has been hypothecated for new climate-related expenditure, this is likely to be neutral to the balance. Were the increases in the carbon tax included (along with assumed expenditure), this would lead to higher levels of revenue and expenditure.[43]

Overall, *SPU 2021* forecasts suggest general government revenue will grow at a slower pace (4.5 per cent) than GNI* (5.3 per cent) over 2022-2025. The rapid growth of income tax assumed almost entirely offsets the negative judgement applied to corporation tax. As a result, the general government revenue-to-GNI* ratio is broadly flat over this period and is slightly below its 2019 levels (Figure 2.11).

[43] If one assumed no major behavioral changes in response to the tax increases, revenue and hence expenditure would rise by approximately €147 million per annum out to 2030.

Figure 2.11: Overall revenue grows in line with GNI* in later years

General government revenue (per cent share of GNI*)



Sources: CSO and *SPU 2021*.

Note: Dashed line indicates *SPU 2021* forecasts. Get the data.

SPU 2021 projections of revenue and expenditure result in an improving balance over 2022-2025 to reach a deficit of €0.8 billion or 0.3 per cent of GNI* by 2025. While this outcome is possible, some of the technical assumptions underlying *SPU 2021* fiscal projections may be unrealistic. For example, the rapid growth in both income tax and investment spending.

The Council assesses that a better-founded and more useful projection for the budget balance can be made using an adjusted projection of the budget balance. Table 2.3 presents the adjusted projection together with an alternative "upside scenario" for the general government balance for 2025.

Revising current spending upwards, relative to SPU 2021 provides a more realistic view of the public finances

The "adjusted SPU" projection aims to show the budget balance that would arise based on current government policies and spending commitments based on the SPU's macroeconomic projects. On the spending side, this assumes the current primary spending is €1.2 billion higher in 2025 than *SPU 2021* projections to cover Stand-Still costs. Capital spending is assumed to reach 4.9 per cent of GNI*, which is consistent with Exchequer and non-Exchequer spending outlined in the National Development plan. This is lower than the level of investment projected in *SPU 2021*.

On the revenue side, two adjustments are made to *SPU 2021* forecasts. First, income tax is reduced by €1.5 billion, largely reflecting the costs of indexing income tax bands and credits. Second, corporation tax receipts are assumed to be lower by €1.5 billion bringing the impact on receipts assumed by the Department more in line with the lower end of the Council's estimates of excess corporation tax receipts.[44] This entails an impact on corporation tax receipts equivalent to about 30 per cent of its 2020 level.

Overall, the changes to the revenue and spending projections result in a larger deficit — €2.2 billion wider than projected in *SPU 2021*.

Table 2.3: Alternative general government spending, revenue, and balances for 2025

€ billions

	SPU 2021	Adjusted SPU	Upside scenario
Current Primary Spending	90.6	91.8	93.4
Interest Spending	3.4	3.4	3.4
Capital Spending	14.8	12.9	13.2
General Government Expenditure	108.9	108.1	110.0
Income tax	32.3	30.8	32.3
Corporation tax	12.5	11.0	12.5
Other General Government Revenue	63.3	63.3	64.9
General Government Revenue	108.1	105.1	109.7
General Government Balance	-0.8	-3.0	-0.3

Sources: *SPU 2021* and Fiscal Council workings.

Second, an "Upside scenario" is also presented, reflecting upside risks to growth set out in Section 1. This scenario assumes that the long run loss in output from the pandemic (or "scarring") is half of that incorporated in *SPU 2021* projections (take to imply 2.5 per cent scarring on GNI* rather than 5 per cent). As a result of the stronger economy, income tax in 2025 reaches the levels projected in *SPU 2021* (i.e. the positive macroeconomic error offsets a negative fiscal error). Corporation tax is assumed to be unaffected by further losses than those assumed in the *SPU* and to be unaffected by the reduced scarring, as receipts are largely detached from the performance of the domestic economy. Other general government revenue is assumed to be 2.5 per cent higher than projected in *SPU 2021* (implying an elasticity of one). Overall, this leads to general government revenue being €4.6 billion higher than on the "adjusted SPU" measure, (or €1.6 billion higher than *SPU 2021* projections).

In the "upside scenario", current primary spending is increased by €1.2 billion (relative to *SPU 2021*) to cover higher Stand-Still costs. In addition, the positive macroeconomic shock (relative to *SPU 2021*) would be expected to lead to additional Stand-Still costs reflecting the impact of higher growth and wages. It is assumed that half of the revenue gains

[44] This is in addition to the €2 billion of negative judgement applied in *SPU 2021* forecasts.

(€1.54 billion out of €3.08 billion) are offset by further increases in Stand-Still costs due to stronger growth.[45]

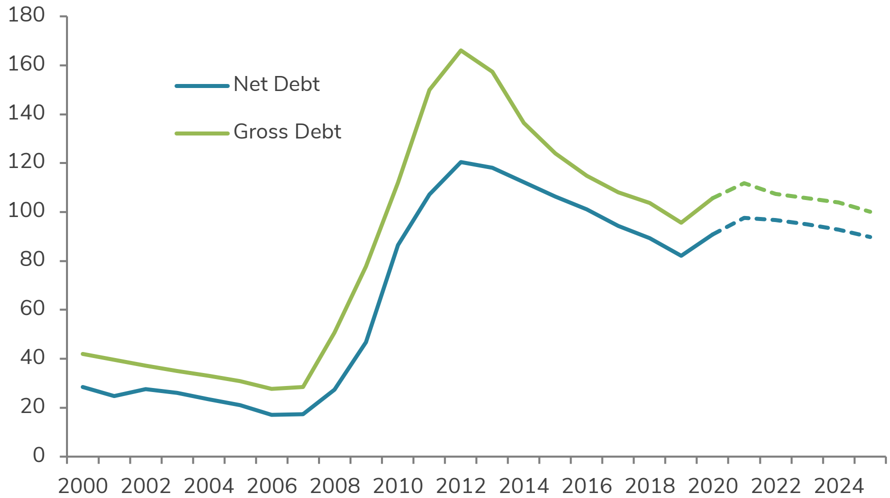
Capital spending in the "upside scenario" is again assumed to be 4.9 per cent of GNI*. However, as GNI* is larger than in the "adjusted SPU" scenario, this implies additional spending relative to that scenario. Overall, the "upside scenario" sees a slightly smaller general government deficit for 2025 compared to *SPU 2021*.

The scenarios are illuminating. They suggest that the deficit could be wider than is depicted in the SPU, given how alternative assumptions for key areas of uncertainty and more realistic spending profiles might impact the public finances. However, the scope for a wider deficit could be offset if the scarring on the economy caused by the economy is less than presumed and if outcomes on corporation tax receipts are more benign.

Gross and net debt-to-GNI* ratios are expected to remain at very high levels over the forecast horizon, even based on the *SPU 2021* budgetary projections (Figure 2.12). Section S12 illustrates how different adverse scenarios could lead to much higher debt ratios.

Figure 2.12: Debt ratios to remain at high levels

Gross and Net General Government Debt to GNI*



Sources: CSO and SPU 2021.
Note: Dashed lines indicate forecasts from SPU 2021. Get the data.

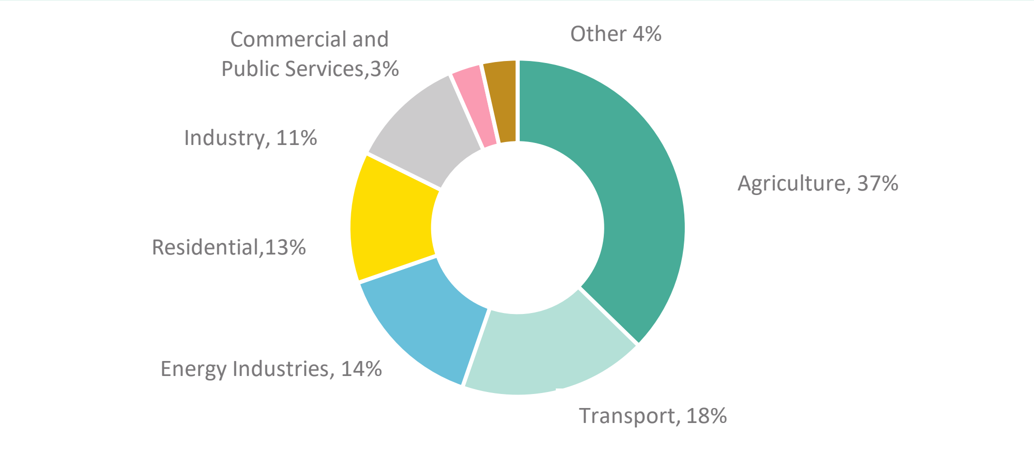
[45] Increased corporation tax receipts are assumed to have no impact on Stand-Still costs, hence only the increase in income tax and other general government revenue are considered here. Overall, primary spending is €2.74 billion higher than in *SPU 2021*. €1.2 billion of this is due to Stand-Still costs using SPU 2021 macroeconomic projections. The further €1.54 billion is due to assuming stronger growth in the upside scenario relative to *SPU 2021*.

Box E: The Government's new climate change targets need clear costings

Changing political dynamics and the Covid-19 crisis has brought the impact of climate change under increased focus both in Ireland and internationally. As part of the Government's efforts to reduce carbon emissions, it introduced the *Climate Action Plan* in 2019. This plan detailed Ireland's efforts towards supporting the broader EU goal of net-zero emissions by 2050. In March, the Government moved toward giving the targets legislative underpinnings through the *Climate Action Bill* 2021. This in line with the *Programme for Government*, which effectively aims to legally enshrine the target of carbon neutrality in Ireland by 2050.

Figure E1: Reducing emissions will require strong collective action

% of Total Emissions in Ireland in 2020



Source: Environmental Protection Agency

As part of this goal, ambitious targets have been set for annual reductions in carbon emissions over the next three decades in the country. While the costs of inaction on this front are high, the adjustment process will require a fundamental reorientation of how the economy operates, incurring heavy claims on the governments resources and requiring careful planning. This box explores some of the potential fiscal implications of achieving these targets and in the context of medium-term planning, discusses where greater budgetary clarity is required to estimate the overall impact on the public finances.

Meeting reduction targets requires immediate and substantial adjustments

The costs associated with meeting reduction targets could be substantial. The Climate Action Plan (2019) set out how emissions could be cut by a fifth to meet 2030 targets. It showed National Development Plan measures contributing to a reduction in emissions of 16.4 of the total 102 $MtCO_2eq$ reduction planned. But more than half (58 $MtCO_2eq$) of the overall reduction was unspecified. That is more than 3½ times the reduction achieved by the National Development Plan measures, which cost just over €20 billion over ten years (€2 billion per annum and about 1 per cent of GNI*).[46]

Another striking feature of the overall emissions reduction targets is how much the adjustments required to achieve the 2030 targets are now likely to be frontloaded, with a 51 per cent emissions reduction to be achieved by this time.[47] This frontloading means the government will target a 7 per cent annual reduction in emissions over the full period to 2030, up from the 3.5 per cent average in the Climate Action Plan (2019).[48]

[46] These cost estimates are set out in the National Development Plan (p.22), while the Climate Action Plan 2019 (p.26) sets out the policy assumptions on the NDP's contribution to overall emissions reductions.

[47] Relative to a 2018 emissions benchmark.

[48] The 2019 plan had targeted a 7 per cent annual reduction after 2030.

To date, the government has provided little detail on either the costs of reaching these revised targets or the ways in which it will do so, although a new *National Development Plan* scheduled to be released this year should provide greater detail. As can be seen in Figure E1, overall reductions in emissions will require collective action across a broad range of stakeholders, and with the Government committed to a “Just Transition”, this is likely to incur significant costs.

Competing priorities are exerting pressures on the public finances

While the ambitious targets are necessary to mitigate climate change, it comes at a time when there are several substantial demands on the public finances. In the short term, the implementation of Sláintecare and resources required to ensure the post-Covid-19 economic recovery will command high costs, while population ageing will reduce long term growth and increase healthcare and pension costs substantially in the coming decades. Furthermore, the *Programme for Government* rules out increases to large sources of the Exchequer tax take, increasing pressures on the revenue side.

More transparency is required to understand the path to implementation

These pressures, along with generalised risks to the outlook, and the potential for bottlenecks under the already increased ‘core’ capital expenditures, underscore the importance of careful budgetary planning to meet these competing demands. With the forecasts in *SPU 2021* containing only technical assumptions, and little indication of the full set of costs associated with the implementation of the *Climate Action Bill*, the implications of the new targets for fiscal policy are unclear.

While carbon tax increases will generate revenues in the short run, at least 20 per cent of these intakes will likely be redistributed in targeted social protection, while the overall tax take will likely diminish as households and businesses adapt, moving their behaviour away from using carbon intensive activity in the first place. Furthermore, with the *Programme for Government* ruling out increases to major tax sources, and estimates of Stand-Still costs running over current allocations, it is difficult to see how these ambitious targets will be achieved under current spending assumptions set out in *SPU 2021*. One possibility is that any spending impacts may come through on the capital side, which would help to explain the upward revisions in spending relative to the capital plan.

While climate change mitigation is of paramount concern, the government must outline not only the costs associated with its revised emissions targets, but also both the ways in which funding will be generated to meet these demands and also the implementation strategy over the medium term.

2.4 Risks to the outlook

In the short term, the macroeconomic and public health environments pose major risks to fiscal projections in *SPU 2021*. Were public health restrictions required again, that would imply higher levels of spending for longer, as well as depressing revenue. The main fiscal risks are listed in Section S4, which contains a fiscal risk matrix outlining potential likelihoods and impacts.

Short term risks to spending and revenues stem from Covid-19-related uncertainty

Further out in the forecast horizon, significant risks to the fiscal forecasts in *SPU 2021* arise both on the revenue and spending sides. On the revenue side, growth outturns and how they translate into revenues are important uncertainties. On the spending side, there is a risk that some of the recent spending increases which are assumed to be non-recurring turn out to be more long lasting. This could be the case in the health area, for example, which showed a rapid increase in spending and persistent overruns in the years prior to the pandemic.

As outlined earlier, expenditure increases allocated in *SPU 2021* fall short of what would be required to maintain current service levels and to index social payments. As a result, simply holding present service levels and indexing social payments would imply higher expenditure than forecast in *SPU 2021*.

Spending pressures from ambitious policy priorities represent medium term risks.

Any new policy measures or service improvements including those set out in the Programme for Government, such as Sláintecare, could imply significantly higher levels of expenditure. If these were funded by tax increases or spending restraint elsewhere, this would not impact the overall public finances. However, it remains unclear how such measures will be implemented and funded.

The fiscal response from the government has included significant outlays on loan schemes, credit guarantees, and tax deferrals, resulting in the accumulation of contingent liabilities. Losses from these schemes could arise if firms become insolvent and fail to repay. Similarly, if firms default at a higher-than-assumed rate on warehoused tax liabilities, then that would adversely impact fiscal forecasts in *SPU 2021*. Conversely, the Department's assumptions regarding losses arising from warehoused VAT and income tax liabilities could fail to materialise, presenting an upside risk to revenues. In addition, were some of the upside macroeconomic risks highlighted in Section 1 to materialise, this would provide an upside risk to *SPU 2021* fiscal projections.

Reforms to the global corporation tax environment also represent a further potential risk to tax revenues in the coming years. Efforts by various international organisations and stakeholders to facilitate both a global minimum corporation tax rate, along with plans to address the digitalisation of profits could see Ireland collect lower levels of corporation tax in the coming years if introduced. Against this uncertain backdrop, *SPU 2021* fiscal projections are based on the assumption that these factors will reduce corporation tax receipts by €500 million per year from 2022. It has been indicated that these losses may be higher. One risk is that a downward adjustment takes place suddenly, rather than gradually as assumed, complicating the budgetary position in specific years more severely.

Reforms to the global tax environment represent a risk to corporation tax intake

Box F: Corporate tax reforms could reduce revenues

Ireland has benefited enormously from attracting large foreign-owned multinationals to set up operations on its shores. As well as generating substantial corporation tax receipts for the Government, this policy has attracted significant employment. In turn, this contributes to higher tax receipts being received from employee earnings and from wider economic activity more generally.

However, it has been recognised for some time that the reliance on tax receipts associated with these large multinationals poses risks. Recent efforts to reform the international corporation tax landscape have now gained impetus with the Biden administration’s tax proposals. This adds to the concerns around the sustainability of Irish corporation tax receipts.

This box looks at the risks around corporation tax, new reform proposals, and it explores a stylised scenario of what could happen should a number of large multinationals exit Ireland.

Over-relying on corporation tax is a risk to funding spending

The Government’s reliance on corporation tax has risen in recent years such that almost 21 per cent of Exchequer taxes come from corporation tax as compared to a long-run average of about 13.5 per cent. There are three risks in particular:

1) **Volatility** — corporation tax receipts are more volatile than other taxes. This also means that forecasts for corporation tax are prone to much larger errors than other taxes. Funding permanent spending on the back of volatile receipts is especially risky. It could entail a widening of deficits or a need to adjust spending downwards at a later stage should receipts fall rather than rise to ensure the public finances are on a sound footing.

2) **Concentration** — corporation tax receipts are heavily concentrated in a handful of companies. In 2019, ten corporate groups accounted for 56 per cent of net receipts. This concentration exposes the Government to risks around firm-specific profitability and various other idiosyncratic risks.

3) **Sudden reversals** — there is a risk that changes in policy regimes and circumstances globally lead to decisions for some firms to relocate. in some cases, companies may be relatively footloose meaning that they have relatively limited physical presence (workers or factories)

and can easily shift activities from one location to another. This could expose the government of the day to a large reversal of corporation tax receipts.

Assessing the risks involved with corporation tax receipts needs to reflect the full range of negative impacts that could occur, including the macroeconomic and labour-market impacts as well as the budgetary effects.

Even just five large multinationals leaving could have big impacts

Building on previous work (Box C of the *June 2018 Fiscal Assessment Report*), this box considers a scenario whereby five stylised large, foreign-owned multinational enterprises exit Ireland.

Revenue produces detailed information on large corporation taxpayers in Ireland by different groupings. Using this information, we can estimate how much tax is paid by a typical large foreign-owned multinational: about €99 million in 2019 for the top 99, rising to €456 million for the top 10 payers. Table F1 estimates a stylised large foreign-owned multinational firm based on the available Revenue data.

For the purposes of illustrating a potential shock associated with five major foreign firms exiting Ireland, we build on the stylised firm in Table F1 and assume:

- direct corporation tax losses of €3 billion (about a quarter of all corporation tax and 3.5 per cent of total government revenue);
- a shock to real GNI* of 1 per cent. As noted in FitzGerald (2015), in terms of their impact on the real economy, most of the output of foreign firms in Ireland is confined to the wage bill and the corporation tax paid on the profits; the rest of the profits are repatriated. We therefore calibrate the shock based on estimates of (1) the direct wage bill losses arising from the firm exits and (2) the indirect wage bill losses from local jobs supported. This analysis would suggest that the real economy effects would be relatively small even though the impact on tax receipts would be substantial.[49]

Table F1: Large multinationals account for significant jobs and taxes

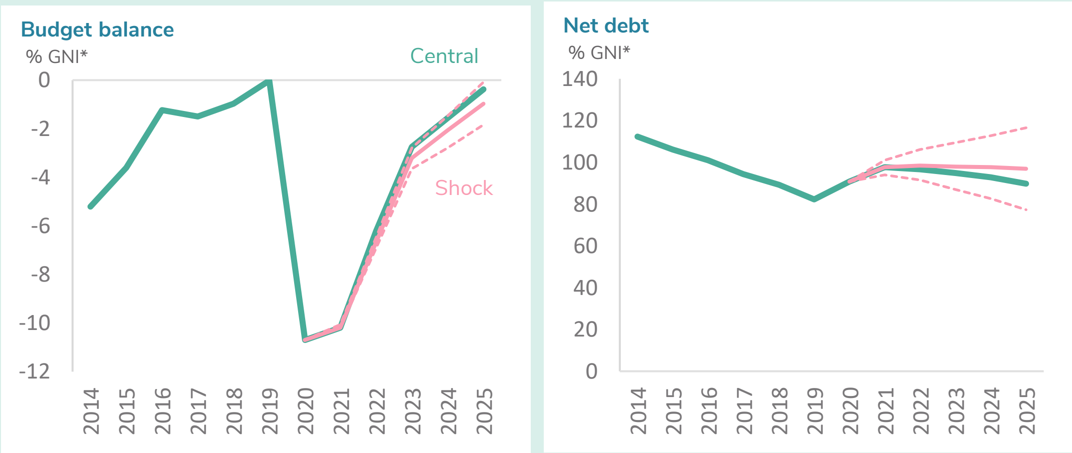
	All	Top 10	A stylised firm (estimated)
No. of Companies	99	10	1
Employments	103,822		1,049
Total staff earnings	€4,203,000,000		€42,454,545
Average wage	€40,483		€40,483
Corporation tax liability	€6,813,000,000	€6,072,000,000	€607,200,000

Source: Revenue (2021); and Fiscal Council workings.
Notes: This table looks at the larger foreign-owned multinational enterprises contained in Revenue data.

The results (Figure F1) suggest that the deficit could be wider by 0.6 to 1.4 per cent of GNI* by 2025, with the result that the net debt ratio would be on a flatter path in later years (2023–2025), falling by just 0.5 percentage points per annum as compared to 2.3 percentage points in the central scenario.

[49] Specifically, we assume 5,000 direct job losses and 15,000 indirect job losses based on Brady (2019) multiplier estimates for local jobs created. Of the direct job losses, we considered between 10–25 per cent translate to higher unemployment, 20–50 per cent to higher emigration, and the remainder re-employed at the median wage. This would suggest that a 1 per cent shock to domestic income is a reasonably conservative estimate.

Figure F1: Exits of foreign firms would widen deficits and slow debt reduction



Sources: CSO; Department of Finance; and Fiscal Council workings.

Biden and BEPS proposals are expected to reduce future FDI and taxes

Discussions on reforms of international tax rules have been ongoing under the OECD/G20 Inclusive framework on Base Erosion and Profit shifting (BEPS). As part of the BEPS 2.0 proposals, there are two 'pillar' reforms that change the global corporation tax environment. Pillar one relates to changing a share of tax collection from where firms have physical presence to where the firm's market or user is located. Pillar two relates to the establishment and enforcement of a global minimum corporation tax rate.

The Biden administration has given renewed impetus to the implementation of these reforms through recent corporate tax proposals of its own.[50] Aligning most closely with Pillar two, the Biden proposals include raising the current US Global Intangible Low-Taxed Income (GILTI) tax to a minimum of 21 per cent on profits of US corporations on a country-by-country basis and removing certain key exemptions, namely the exemption for Qualified Business Asset Investment (QBAI). The current GILTI system includes a global minimum corporate tax rate of 10.5 per cent and also allows for the higher profits paid in one jurisdiction to offset the lower profits paid in another jurisdiction, so that globally the 10.5 per cent rate is met. In addition, the proposals signal a shift from digitally-targeted tax reforms to ones that focus primarily on the largest companies.

However, the proposals will ultimately have to be passed by US congress, so their final form is uncertain. Similarly, the final form of the OECD BEPS reforms are also uncertain. As a result, it is difficult to gauge their impacts on both the macroeconomy and the public finances.

There are a number of channels through which revenues may be reduced. The location of profit booking is an important consideration for Ireland, with the shifting of profits from Irish domiciled firms naturally reducing corporation tax primarily. If firms have incentives to relocate these profits elsewhere, corporation taxes may be lower going forward.

There are also risks around the location of 'real' multinational activity in the event of changes to the global corporation tax environment. Reduced inflows of such activity in Ireland would have clear spillovers into other sectors of the economy and would impact Exchequer revenues more broadly and to a more significant extent. However, it may not have a significant impact on the current level of investment by multinational firms who already have a presence here.

The Department has estimated that some €2 billion in revenue will be lost over 2022-2025 as a result of the BEPS reforms. While tax rates are one of a number of factors multinational firms would consider when deciding where to invest, any reduction still has important implications for

[50] See the White House fact sheet on the American Jobs Plan for further details of the Biden administration's proposals: https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/.

the provision of public services and the implementation of policy priorities in the coming years. Ultimately, both pillars of the OECD's framework would reduce the relative attractiveness of Ireland as a place for new US FDI, and potentially reduce direct profitability. With corporation taxes largely representing an exogenous inflow into the Irish economy, their use to fund current spending in recent years requires careful consideration in the context of a changing global taxation environment.

In addition to risks posed by the OECD and US proposals, the EU is also exploring other avenues for corporate taxation reforms. These are contained in its May 2021 communication on "Business Taxation for the 21st century" (European Commission, 2021). The proposals include new approaches to allocating taxable profits between Member States. The European Commission is also expected to set out proposals for a digital levy this summer.