Fiscal Stance

The Government needs to deliver on its new strategy

3. FISCAL STANCE

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With *Budget 2022*, the Government stuck to the budgetary package of €4.7 billion that it had set out in the *Summer Economic Statement* published in July 2021. As the Council noted in its *Pre-Budget 2022 Statement*, this package looked to be at the limit of what is prudent. However, taking account of the improved growth outlook, the final tax package, and the forecast increases in broader general government spending, the overall pace of expansion is broadly in line with the underlying potential growth rate of the economy. This should help to ensure that the underlying (structural) deficit — once temporary factors are excluded — would remain broadly close to balance. In turn, this should help set the debt ratio on a steady path towards safer levels.

The Government stuck to the package set out in July

For the medium term, *Budget 2022* presents a clearer sense of the Government's plans for the coming years than in previous budgets. There are three key changes to budgetary plans set out in the *SES* and implemented in a Budget for the first time. First, the Government has provided more credible spending forecasts that allow for the cost of maintaining existing supports amid demographic and price pressures. Second, it has introduced a spending rule that seeks to limit permanent Exchequer spending increases to an average of 5 per cent annually, broadly in line with the economy's trend growth rate. Third, it has set out public investment plans to 2030 in a new National Development Plan, published in October. In addition, the Government has said that it aims to lower the debt ratio and not borrow to finance current spending over the medium-term.

Budget 2022 presents a clearer sense of the Government's plans with the 5% Spending Rule and more realistic spending forecasts

These changes have the potential to set the public finances on a prudent path. With revenues expected to recover strongly, the plans should allow the Government to respond to investment needs in the areas of housing and climate change, bring public investment to record levels, and maintain existing levels of services, without providing excessive stimulus to an already fast-growth outlook. In addition, they allow for a steady pace of debt reduction averaging close to 3 percentage points for the net debt-to-GNI* ratio annually over the medium term. This would bring the gross debt ratio to 89.5 per cent of GNI* by 2025 and the net debt ratio to 79.2 per cent.

These changes have the potential to set the public finances on a prudent path

However, Ireland has a poor track record of sticking to budgetary plans and there are still risks and unknown costs associated with large spending commitments. It remains unclear what the cost to the Government will be in halving Ireland's greenhouse-gas emissions by 2030. It is possible that budgeted amounts will fall short of what is required, particularly for current spending needs. In addition, commitments to major Sláintecare reforms in health are not budgeted for beyond next year. The space available for funding new current spending initiatives on a sustainable basis each year without raising taxes or scaling back other spending is very limited.

There is also a need to address the over-reliance on corporation tax receipts built up in recent years. The concentration of corporation tax receipts coupled with their ongoing volatility and vulnerability to international tax developments is a source of serious concern. To help to limit or reduce this over-reliance, the Government should allocate any further excess corporation tax receipts, including increases due to the rise in the minimum corporation tax rate to 15 per cent, to the Rainy Day Fund.

The Government needs to deliver on its plans and reinforce its new 5% Spending Rule

If the Government's strategy is to be realised, the Government will need to deliver on its plans. The fact that medium-term Departmental spending ceilings have yet to be published undermines the new rule (Section 4.1). To support the plans, the Government should also set its new spending rule on a stronger footing. This means giving it legislative backing, while also reinforcing the rule so that it (1) is backed by departmental spending ceilings; (2) is better aligned with sensible estimates of real potential output growth; (3) captures non-Exchequer spending and the impact of tax changes, which it currently does not; and (4) has a link to debt-to-GNI* targets. This would better align it with the EU spending rule, the Expenditure Benchmark, while correcting for distortions in GDP (see Section 1), measurement problems associated with potential output and possible sustained changes in inflation.

If the Government's medium-term spending plans exceed *Budget 2022* plans, tax increases or spending savings elsewhere may be needed to keep the public finances on a safer path. This would ensure that the Government's planned steady reduction in the debt ratio, averaging close to 3 percentage points of GNI* per annum, would be maintained. It would ensure that the Government's new 5% Spending Rule and Existing Level of Services initiatives continue to guide sound management of the economy and public finances.

If net spending exceeds *Budget 2022* plans, tax increases or spending savings elsewhere may be needed to keep the public finances on a safer path

The Council's assessment of the fiscal stance is informed by (1) a broad economic assessment that considers appropriate management of the cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with domestic and EU fiscal rules.

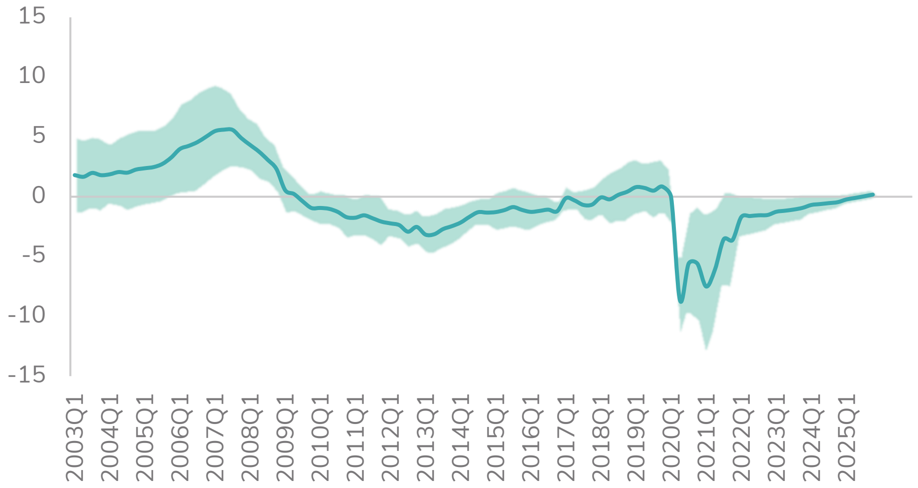
3.1 The fiscal stance in 2021

The pandemic led to a substantial contraction in the domestic economy, with domestic GVA falling by 8.7 per cent in 2020. Activity has rebounded since then, however, as restrictions have eased, and vaccinations progressed. This is corroborated by high-frequency data (Section 1).

Activity has rebounded

Figure 3.1: Ireland's economy fell well below its potential in 2020

% gap between actual and potential economic output (output gap)



Sources: Fiscal Council workings (based on *Budget 2022* forecasts). [Get the data.]
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's supply-side models (Casey, 2019) and the Department's forecasts. Given distortions to standard measures like GDP and GNP and the relative importance of domestic activity to the public finances, the measures focus on domestic economic activity, including quarterly Domestic GVA.

While there are risks around the path for growth, the *Budget 2022* estimates imply that the economy has been operating well below its capacity since the pandemic started. However, it is projected to recover most of its normal levels by mid-next year. At that time, the gap between actual and potential economic activity is estimated to be about –1½ per cent as compared to about –8½ per cent in Q2 2020. The projections imply a more gradual recovery thereafter, with the gap closing in 2025.

The uneven sectoral nature of the shock means there is uncertainty around long-term supply-side impacts that might hamper growth. Some sectors, such as tourism and hospitality, remain relatively depressed, and it is unclear to what extent activity will recover in these areas. The fact that domestic demand has recovered to its pre-crisis trend indicates the strength of the recovery elsewhere (Section 1). Targeted supports were appropriate in supporting the economy through the downturn.

Some sectors remain relatively depressed

The Council assesses that the Government was right to pursue a countercyclical fiscal policy in 2020 and 2021 — providing exceptional budgetary support amid the downturn. The scale of the government supports has been unprecedented in modern times. The fiscal supports introduced are estimated to have boosted economic activity, in real GNI* terms, by about 5 percentage points, halving the estimated contraction in real GNI* last year from what it might have been in the absence of these supports (Fiscal Council, 2020a).

Exceptional and targeted supports were appropriate

The Council therefore assesses that the Government's response to the crisis, in terms of the sizeable temporary supports funded by large deficits, was prudent and necessary to support the economy. The temporary supports provided in 2020 and 2021 were costly but they were reasonably well targeted. They helped to avoid lengthening and deepening the economic crisis that unfolded. The approach was also supported by monetary policy at the Euro Area level that kept interest rates at low levels.

While the Council assessed that the temporary supports were welcome, the Government also introduced large unfunded permanent increases in spending in *Budget 2021* — the size of these increases was not prudent. The increases reflected plans for large increases in public sector staff numbers and they were set out without long-term funding to offset them.

However, the scale of permanent increases in spending for 2021 now look set to be smaller than had been envisaged, while the spending increase in 2020 was also revised down. The downward revision in 2020 was mainly due to lower investment spending. The planned increase for 2021 is now also €3 billion less than had been set out previously. This is mainly driven by lower increases in current general government spending, now estimated to rise by €2.3 billion less than planned when excluding interest costs and one-offs such as Covid-related amounts. Public investment is projected to expand by €0.6 billion less than previously planned.

The downward revisions to spending increases set out for 2021 are entirely in areas outside of the Exchequer where there is virtually no transparency. These areas account for about one-fifth of overall general government spending. They include spending by local government (including approved housing bodies), non-commercial semi-state bodies (like Irish Rail, Irish Water, RTÉ, Solas, Tusla, the aggregate institutes of technology, etc), and

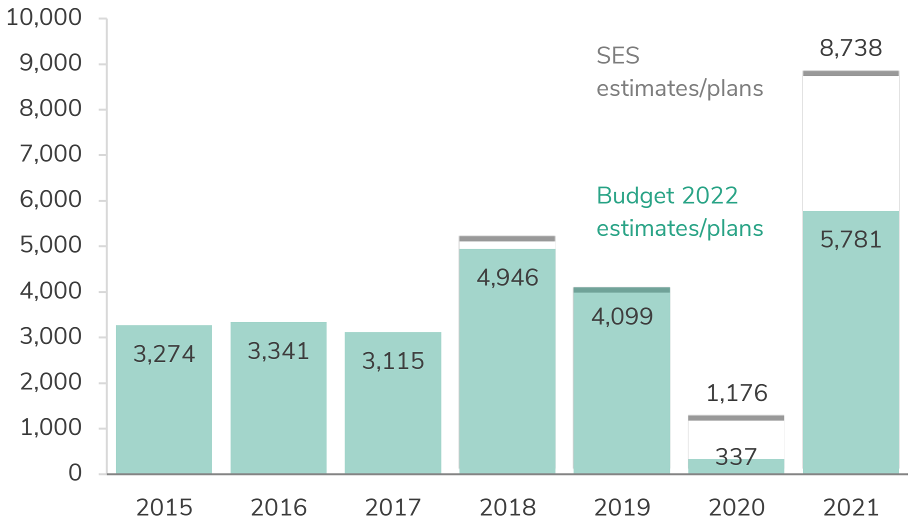
Extra-Budgetary Funds (such as the Irish Strategic Investment Fund). The Council has repeatedly called for more transparency to be shone on these areas in budgetary publications, but this has still not been addressed adequately. The Department of Finance has committed to providing more information on these areas in the forthcoming Stability Programme Update in April 2022 and this needs to be delivered on.

Downward revisions to spending lessen the risks to fiscal sustainability

The downward revisions to spending lessen the risks to fiscal sustainability. The scale of unfunded permanent spending increases set out in *Budget 2021* are large at €5.8 billion (Figure 3.2). These also came amid sizeable temporary spending measures for Covid. However, the impact on fiscal sustainability is moderated by the downward revisions to permanent spending increases for both 2020 and 2021. Moreover, part of the expansion in 2021 is likely to reflect a catch-up in spending that was supressed in 2020 due to logistical challenges associated with the pandemic. Taken together, the average €3.1 billion expansion over the two years, as compared to €5 billion previously set out, is now better aligned with sustainable increases in the economy and government revenues.

Figure 3.2: Permanent net spending increases smaller than first signalled

€ millions, net policy spending increases



Sources: CSO; Department of Finance (SES and Budget 2022); and Fiscal Council workings.
Notes: Net policy spending is a measure of spending that attempts to assess the Government's overall fiscal policy stance. It represents overall general government spending, excluding temporary factors like one-offs, and spending on unemployment benefits that are not likely to be long-lasting. It also recognises the role of tax changes; that is, a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts. Get the data.

3.2 The fiscal stance in 2022

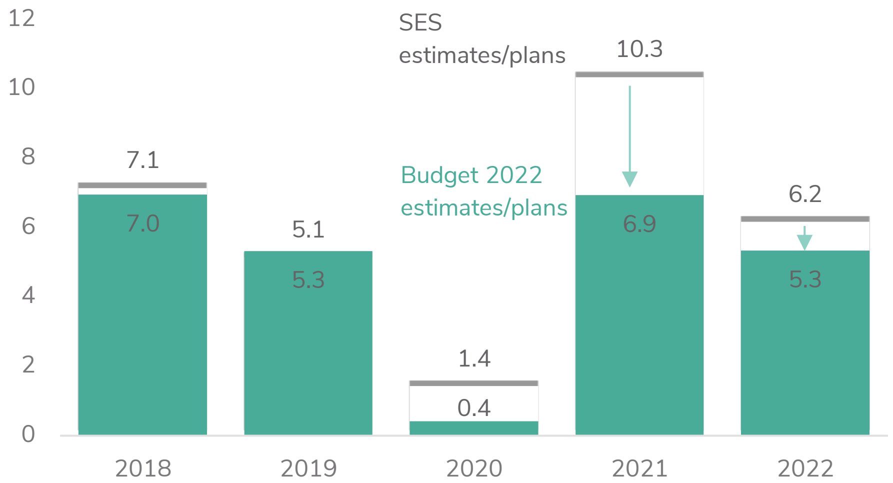
For 2022, the Government stuck to its planned €4.7 billion budgetary package as had previously been set out in the *Summer Economic Statement*. The package included €1.6 billion to maintain the existing level of public services, an increase of €1.1 billion in government investment, and an additional €1.45 billion in new current spending measures. The Government also raised tax allowances to take into account inflation and undertook a few other tax changes.

The overall expansion of net policy spending at 5.3 per cent is in line with the Government's 5% Spending Rule and estimates of the potential growth rate of the economy. In addition, a temporary spending amount of €4 billion of Covid contingency reserves was set out for 2022, which is prudent.

The overall expansion in net policy spending is in line with the new 5% Spending Rule and estimates of potential growth

Figure 3.3: Plans more moderate than previously thought

% change in net policy spending



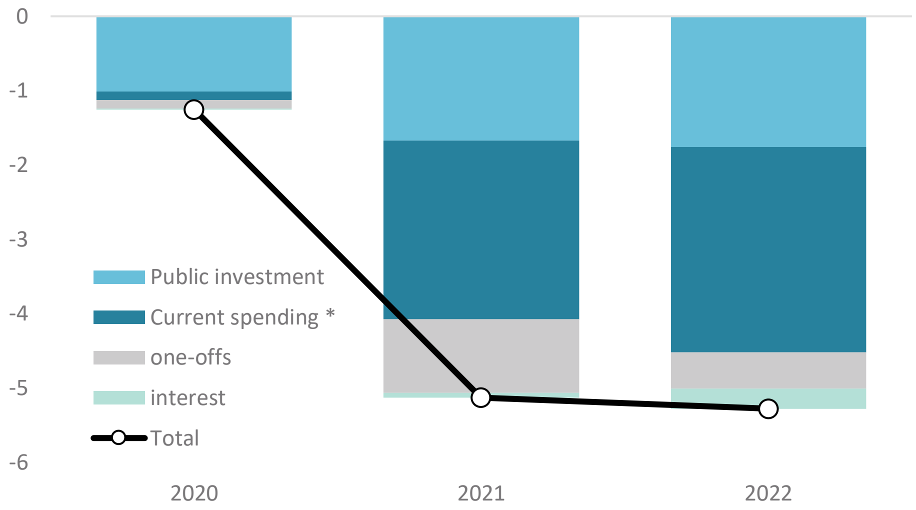
Sources: CSO; Department of Finance (SES and Budget 2022); and Fiscal Council workings.
Notes: Net policy spending is a measure of spending that attempts to assess the Government's overall fiscal policy stance. It represents overall general government spending excluding temporary factors like one-offs and spending on unemployment benefits that are not likely to be long-lasting. It also recognises the role of tax changes: that is, a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts. Get the data.

The budgetary expansion for 2022 is more moderate than was thought to be the case at the time of the *Summer Economic Statement*. In summer, the Government set out plans that indicated a permanent budgetary expansion at what appeared to be a rate of 6.2 per cent (Figure 3.3). This is when measured on the basis of net policy spending — a measure of underlying spending that attempts to assess the Government's overall fiscal policy stance by (a) excluding temporary items and (b) recognising the impact of tax cuts/increases. The Council had assessed this rate of expansion as being at the limit of what is prudent. However, the package set out on Budget Day amounts to an actual increase of 5.3 per cent, which is more in line with sustainable growth rates for the economy and government revenues. Moreover, updated estimates of government expenditure for 2020 and 2021 highlight that the rate of permanent spending increases in recent years have turned out to be less than was initially assessed (Section 3.1).

Spending for 2020 and 2021 was revised down and a more moderate budgetary expansion was introduced for 2022

Figure 3.4: Lower-than-expected spending

€ billions revisions to general government spending suggested by Summer Economic Statement



Sources: CSO; Department of Finance (SES and Budget 2022); and Fiscal Council workings.
Notes: This analysis shows the difference between the Council's estimates of spending projected using the incomplete data provided in the *Summer Economic Statement* with the more comprehensive estimates set out in *Budget 2022*. * Current spending here refers to total general government expenditure less gross fixed capital formation, interest and one-off items. Get the data.

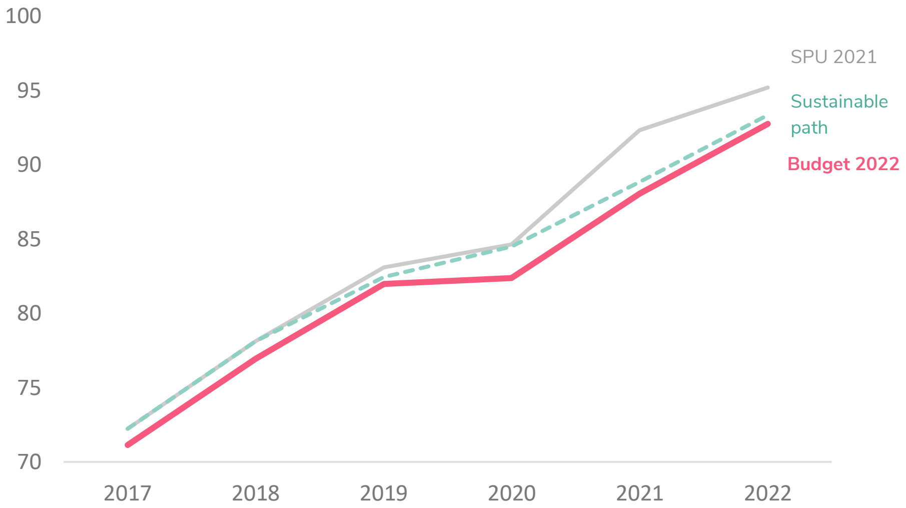
The lower-than-planned net policy spending in 2022 reflects two key factors. First, the spending base is lower due to underspends, mainly in 2021, both in current and capital spending (Figure 3.4). Second, the income tax policy changes for 2022 broadly matched the cost of indexing income tax bands and credits, but did not reduce revenues by much more, which the *Summer Economic Statement 2021* could have been interpreted as indicating. Third, current spending is projected to rise by slightly less in 2022 when assessed on a broader general government basis. That is, Exchequer increases are unchanged from SES indications, but the broader general government figures show a slightly slower pace of increase.

When the revisions to past years are considered together with the slightly less expansive measures for 2022, the overall trajectory for the public finances measures is more sustainable (Figure 3.5). The Council therefore assesses the budgetary plans to be conducive to prudent economic and budgetary management.

For 2022, targeted supports may need to continue to support a transition away from areas that might never recover previous levels of demand. However, the benefits and costs of any such measures need to be carefully assessed in the light of the recovery.

Figure 3.5: Net spending path better aligned with sustainable increases

€ billion, policy spending



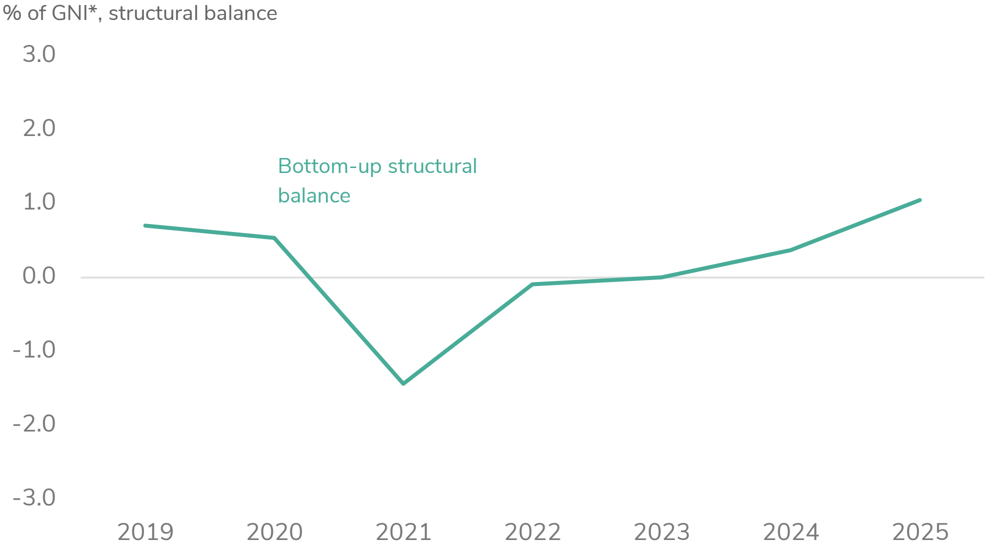
Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: Policy spending is general government expenditure less interest costs, one-offs, and the estimated costs associated with cyclical unemployment. The "sustainable" increases assume that spending grows in line with potential output and actual price inflation. Get the data.

The less expansive measures for 2022 leaves the estimated structural balance position — the underlying budget balance when corrected for temporary factors — better off. Ireland entered the pandemic with a structural balance that was reasonably close to balance. With a moderate expansion in 2022 now planned, the structural position should remain broadly balanced (Figure 3.6).

The Government's plans set the public finances on a more sustainable path, but high debt ratios mean there remains a high degree of uncertainty

In turn, this should help set the public finances on a more sustainable path for beyond 2022. The net debt ratio should stabilise this year and start to fall steadily after 2022. However, with debt ratios already high, there remains a high degree of uncertainty around the path for debt.

Figure 3.6: The underlying budgetary position is close to balance



Sources: CSO; Department of Finance; and Fiscal Council workings. [Get the data.]
Note: Figure shows the Council's bottom-up estimate of the structural balance. Potential output is assumed to grow at 3 per cent over 2021 to 2025. Inflation forecasts are based on the Department of Finance's *Budget 2022* forecasts. See Box I of the May 2021 *Fiscal Assessment Report* for further details.

3.3 The Government's medium-term fiscal stance

The Government's overarching budgetary strategy, as stated in *Budget 2022*, is to slow the pace at which debt is accumulated so that the debt ratio is put on a downward path over the medium term. This is a more ambitious and welcome approach than the objective set out three months earlier with the *Summer Economic Statement*, when it was noted that the objective was "to stabilise, and reduce slightly, the debt-income ratio in the coming years". It is also more consistent with the original commitments set out in the *Programme for Government*. Given the high level of government debt, this move towards reducing it is welcome and should help to ensure the sustainability of the public finances and maintain scope to run countercyclical policy in future downturns. Longer term challenges, including aging pressures, remain, which will put pressure on deficits and debt ratios.

Budget 2022 sets out plans to reduce debt ratios to safer levels helped by the new "5% Spending Rule" and more credible spending forecasts

The more ambitious approach to reducing the debt ratio is a consequence of the Government keeping its medium-term spending plans broadly unchanged in line with its new 5% Spending Rule. As a result, the faster pace of economic growth and the growth in revenues forecast in *Budget 2022* is planned to be used to reduce the debt ratio at a quicker pace than was set out in previous plans. While the Council assessed in September's *Pre-Budget Statement* that the Government's plans to run significant deficits during a period of strong growth was risky, sticking to the spending rule achieves a more prudent fiscal stance.

The Government has made significant steps towards developing a credible fiscal plan as first committed to in the Programme for Government one year ago. Compared to April's *SPU*, it has set out more realistic medium-term spending forecasts that allow for the costs of maintaining public supports and services in real terms; it commits to the new 5% Spending Rule; and it shows some evidence that the fiscal rules are likely to be complied with. As Table 3.2 shows, these steps have led to a more favourable assessment by the Council as regards the quality of the Government's medium-term plans. Previously, its plans were assessed as having made marginal or no progress overall, but now the overall assessment is of some progress and certain key areas have clearly been improved on.

However, it is unclear what costs of Sláintecare and climate change are and whether budget plans factor them in

However, there is an urgent need for the Government to outline the costs of meeting its health and climate objectives. It is still not clear how the Government's budgetary plans address major policy commitments such as the costs of Sláintecare reforms in health and measures required to achieve climate change objectives. While the new National Development Plan appears to cover significant capital spending needs, there may be significant additional costs to the State, particularly in encouraging the switch to electric vehicles and improving home energy efficiency. More detail is required on future plans and their expected impact and cost.

Table 3.2: Significant steps towards credible fiscal plans have been made

Objective	Budget 2022	Council calling for this since	Progress
Present five-year-ahead forecasts	Four-years-ahead	Nov-17	Mostly there
Base projections on realistic spending plans	Much more realistic than previous rounds, and Budget 2022 accommodates Stand-Still costs	Jun-16	Mostly there
Commit to medium-term fiscal objectives	With the spending rule, more formal numerical targets introduced, but need development	Nov-17	Mostly there
Consider measures to strengthen fiscal framework	Spending Rule and Existing Level of Services are excellent initiatives but can be improved further	Nov-17	Some
Provide transparent costings of major policy changes	Still not clear if Major Programme for Government policies including Sláintecare are factored in	Dec-20	Some
Show how rules will be complied with	Document sets out structural balances that appear compliant, but some areas are overlooked	Dec-20	Some
Indicate how taxes would be adjusted if needed	No information on this, but Tax and Welfare Commission established	Dec-20	Limited
Make non-Exchequer forecasts more transparent	Marginal improvement in transparency shown	Nov-19	Marginal/none
Clarify how the Rainy Day Fund will be used in future	No mention of it	Jun-16	Marginal/none
Overall progress			**Some**

Notes: Diagonal shading shows how the Council's past May 2021 Fiscal Council (2021a) assessment was revised up.

The spending rule could be developed along the lines set out in the Council's Pre-Budget Statement (Box B). Three key areas to improve on for the spending rule are to:

Improve coverage

Include non-Exchequer spending

Recognise tax cuts

Improve calibration

Set the 5% limit wth reference to potential output

Clarify relationship to debt rule

Give statutory footing

Set in legislation and link to Department spending ceilings

The Government could make substantial progress with its medium-term planning with these reforms.

First, by giving the rule a strong statutory footing and setting it in legislation, the Government could ensure that the 5% Spending Rule becomes a cornerstone of fiscal policy. The rule could be added to the *Fiscal Responsibility Act 2012*, with a comply and explain requirement, aligning it with the approach for other fiscal rules. In the recent past, Irish governments have developed debt rules that have unfortunately been consigned to history shortly after being introduced. In those cases, legislative underpinnings were missing and the rules were soon forgotten. The legislative requirement would both mean that the rule has to be specified more clearly and also that it would be harder to ignore, although ultimately the Government could legislate to get rid of it.

The medium-term plans could be reinforced by developing the new 5% Spending Rule

Second, widening the spending rule to recognise tax changes and non-Exchequer spending, currently not included, would help to ensure a sustainable path for the public finances. Assessing it on a general government basis would be more appropriate. It would also prevent other budgetary measures outside the scope of the spending rule undermining it as an effective anchor.

Third, considering the 5 per cent limit with respect to potential output and debt targets as the Council has previously recommended would also improve its foundations and avoid locking in unsustainable policies. These changes should rely on modified GNI (GNI*) as a denominator and the Department's preferred estimates of the cycle adjusting for issues with the denominator (Section 1).

Fourth, giving clear timeframes, such as annual targets would allow for a more meaningful debt target. As it stands, the debt objective is only vaguely defined.

Fifth, the rule should be backed by projections for consistent departmental ceilings. Such ceilings were not included with *Budget 2022* in what was a bad start to how the rule is operationalised. This is at odds with past practice, over 2013 to 2019, when these ceilings would have been published with the Budget itself rather than in late-December as happened last year.

The combination of the new 5% Spending Rule and the allowance for maintaining "Existing Levels of Services" helps to make budgeting more credible. This responds to the Council's recommendations that "Stand-Still" costs — the costs of maintaining public services and supports in real terms, recognising demographic and price pressures — are accommodated.

However, there may be too little allocated specifically for maintaining Existing Levels of Services in the medium term and information is lacking (Section 2). This means that more of the unallocated amounts for current spending increases set out in line with the 5% Spending Rule may be absorbed by the costs of standing still. The Government needs to get the balance right between what it budgets for maintaining existing spending in real terms and what is available for new current spending measures.

There are several other areas where the Government can improve its medium-term planning. First, a clear sense of how taxes would be adjusted if needed would help to safeguard future plans. The Commission on Taxation and Welfare does not report until July 2022, but its recommendations will be important in this regard and outcomes will depend on whether or not their recommendations are followed through on. Second, the Government should improve transparency on non-Exchequer areas.[32] Third, the Government should deliver on the commitment to full 5-year-ahead medium-term forecasts and revert to this horizon in future publications.

Implications of the medium-term fiscal stance

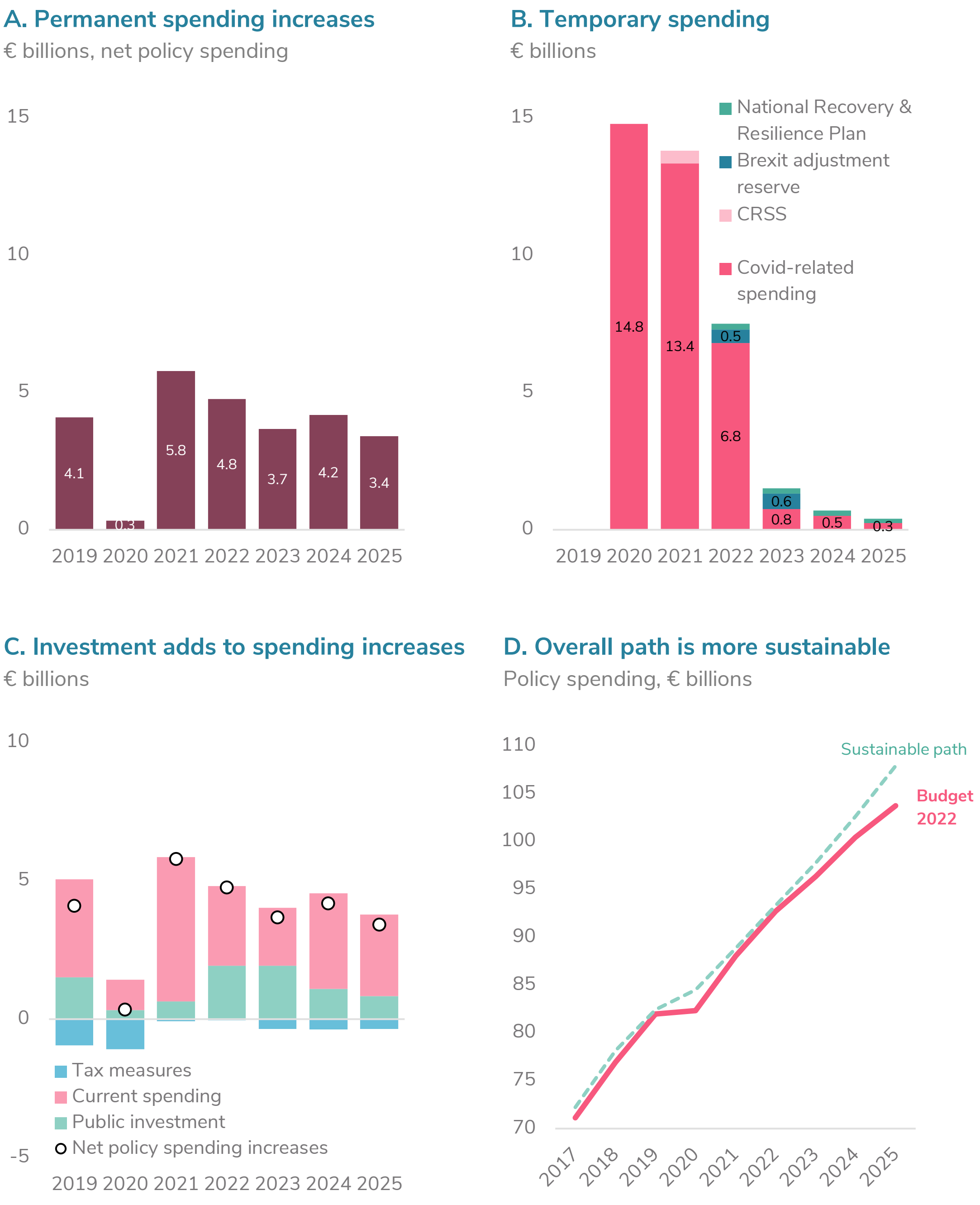
The Government plans to increase net policy spending by nearly €3.8 billion annually on average from 2023 to 2025 (Figure 3.7A). This is well aligned with sustainable growth rates in the economy and revenues. Temporary spending associated with the pandemic is also set to fall sharply in the coming two years — down from €13.4 billion in 2021 to €0.8 billion in 2023 (Figure 3.7B). This will help the deficit almost fully close by 2023 and will help to reduce the debt ratio at a steady pace (Figure 3.7D).

Plans for net spending over the medium term are well aligned with sustainable growth rates

[32] The Expenditure Report for *Budget 2022* showed more detail on capital spending among non-government bodies. However, this was for just two years (2021 and 2022) and tables on local and other government areas outside of the Exchequer were dropped. For example, Table A8 of *Budget 2021*'s Economic and Fiscal Outlook showed estimates of local government income and expenditure for 2021 but this table was absent from *Budget 2022* documentation. However, the Department has indicated to the Council that it is making progress on these areas including on developing a "gross walk" which is planned to be published with *SPU 2022*.

In terms of the impact on the economy, running a budget close to balance in the years ahead means that the Government will broadly be taking in as much revenue from the private sector as it pays out in wages, interest, welfare payments and other expenses. This is appropriate, given that the economy will be growing strongly.

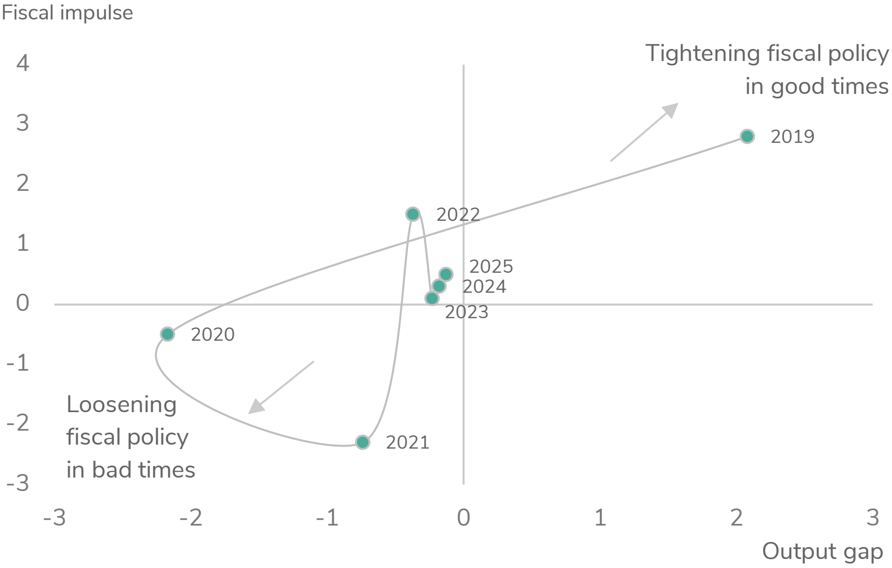
Figure 3.7: Moderate expansions and fewer temporary measures



Sources: CSO; Department of Finance (Budget 2022); and Fiscal Council workings.
Notes: The tax measures in panel C include the carbon tax increases, the €500 million tax cuts and the estimated yield from non-indexation yield. The "sustainable path" in panel D shows what policy spending would look like if it grew from 2019 in line with 3 per cent potential output plus the rate of HICP inflation (1.6 per cent on average). Get the data.

Another useful way to assess the change in the Government's fiscal stance is by looking at its "fiscal impulse". That is, the change in the structural primary balance given cyclical conditions in the economy as measured by the output gap. Figure 3.8 uses the Department's preferred measure of the output gap and the Council's bottom-up structural primary balance. The move towards loosening policy sharply in 2020 and 2021 is visible in the bottom left of the panel. By contrast, the indicator suggests that the direction of policy in 2022 is to reduce the expansionary measures adopted in recent years, while the measure implies the fiscal impulse is minimal in the years ahead.

Figure 3.8: Moderate reversals in loose fiscal policy



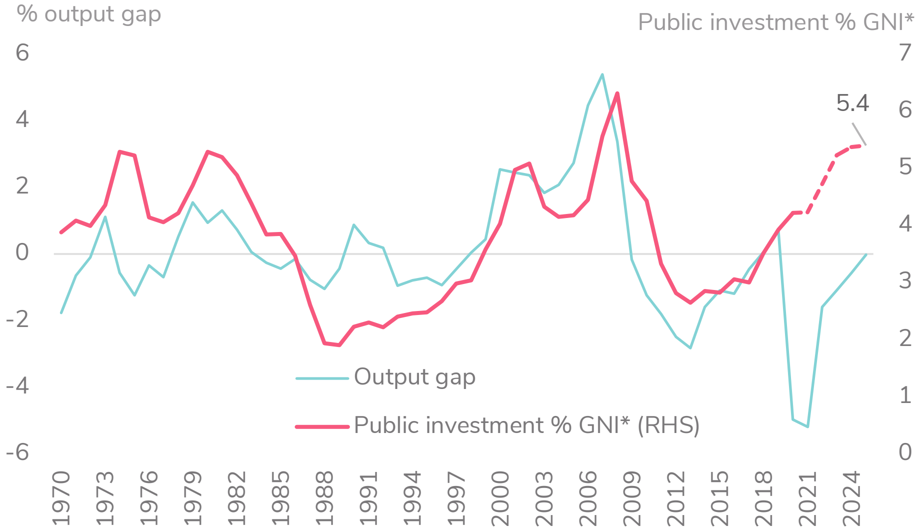
Sources: CSO; Department of Finance; and Fiscal Council workings. [Get the data.]
Notes: The "fiscal impulse" is defined as the change in the structural primary balance (percentage points), with the Council's bottom-up estimates used and the Department's preferred estimates of the output gap.

Public investment is set to make up an increasing amount of spending in the coming years and risks need to be managed carefully. The Government plans to expand public investment to about 5½ per cent of national income. This is unusually high both by historical and international standards. Conroy, Casey and Jordan-Doak (2021) estimate that this additional investment could boost the level of economic activity by one per cent over the long term. However, prices across the economy would also be expected to rise by about 0.6 per cent and the government debt ratio would be higher by about 5.7 percentage points of GNI* compared to a scenario in which public investment rates remained at 4.1 per cent of GNI* as in 2021.

Public investment spending is set to ramp up sharply and needs to be managed carefully

Ireland's public investment has fluctuated over the past two decades with booms and busts in the economy (Figure 3.9). There are risks, especially as the economy recovers, that a tight labour market and low productivity in construction could potentially lead to lower value for money. It is therefore important that the Government safeguards the value of its investments while fostering greater productivity in the sector.

Figure 3.9: Public investment set to rise to unusually high levels



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Public investment is general government gross fixed capital formation. The output gap estimates are the Council's own produced using Department of Finance demand-side forecasts for 2021–2025.

The Department of Public Expenditure and Reform could usefully develop its capacity as a coordinator and gatekeeper of public investment in this regard. Conroy, Casey and Jordan-Doak (2021) highlight three avenues through which this could be achieved, drawing partly on the IMF's (2017) Public Investment Management Assessment:

There may be further scope to improve how capital projects are assessed

1) **Building up the Department's in-house expertise**: The Department could continue to develop its use of analytical techniques such as cost-benefit analyses and reference class forecasting as well as producing more analysis on costs of maintaining existing assets. It could alleviate potential optimism bias by using more conservative scenarios for higher cost inflation in the construction sector over the coming years.

2) **Improving transparency**: The Department could develop a register of existing assets and further develop its tracker of capital projects.

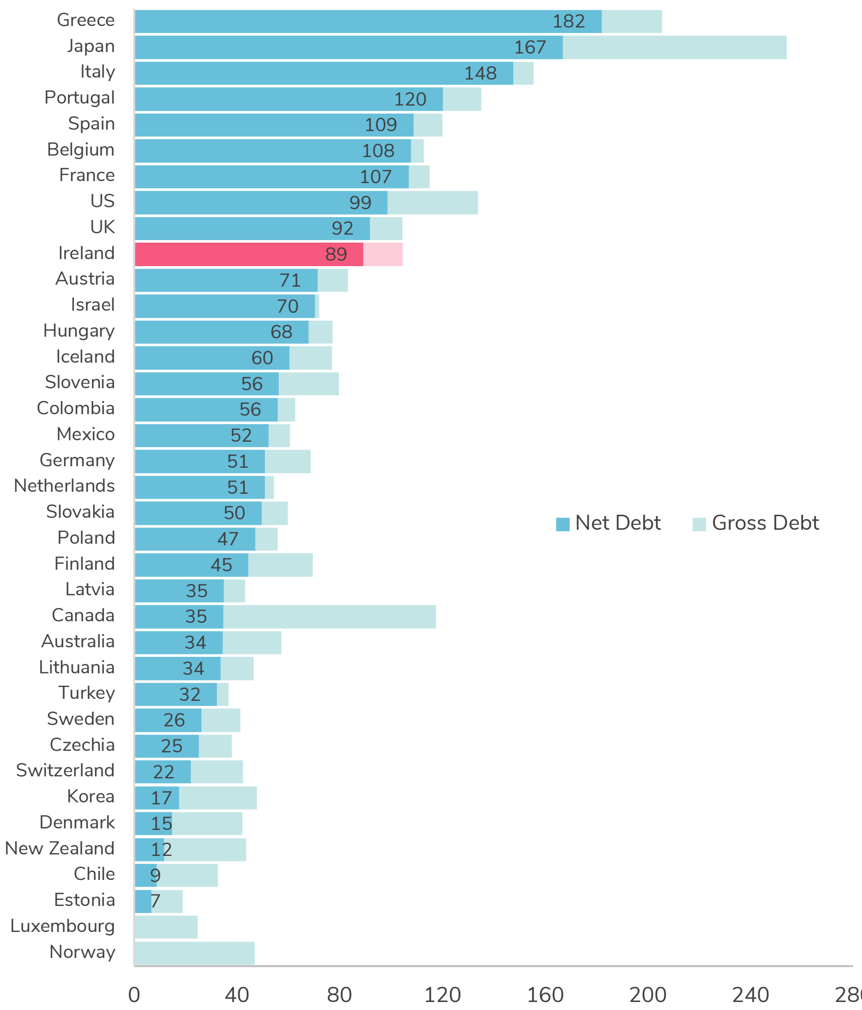
3) **Learning from past experiences:** The Department could strengthen assessments of major past projects; encourage the Comptroller and Auditor General to audit major capital projects; and produce summaries of government-wide lessons based on reviews of the 10 largest projects every two years.

Ireland's net debt ratio was already high entering the pandemic. At the end of 2020, with other countries seeing their levels of output fall and debt rise, Ireland was tenth highest out of 37 OECD countries for which data are available. Ireland's net debt ratio at the end of 2020 was 89 per cent of GNI*. This also marks Ireland out as an outlier as having one of the highest net debt ratios for a small economy in the OECD (Figure 3.10).

Ireland's debt ratio remains high, especially for a small open economy

Figure 3.10: Ireland has a high debt ratio

% GDP (% GNI* for Ireland), general government basis, end-2020



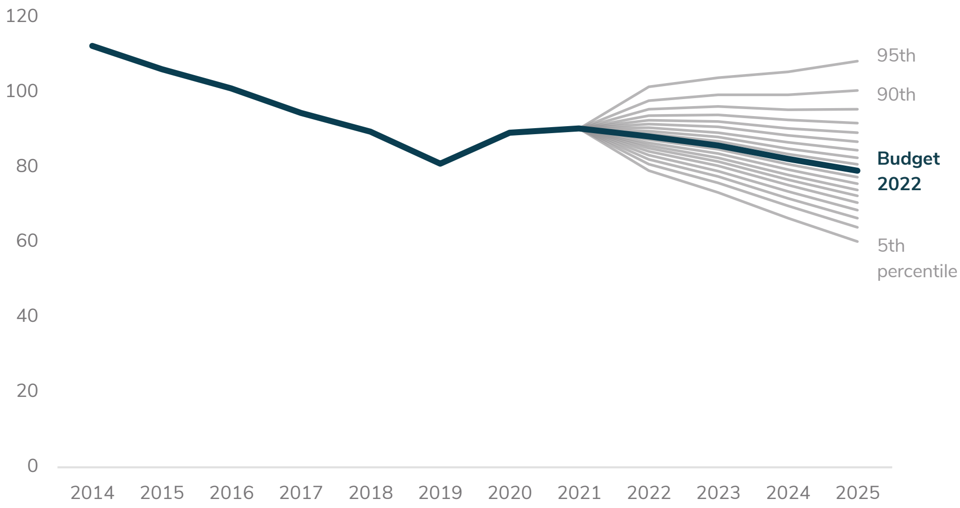
Sources: Eurostat; CSO; IMF (October 2021 Fiscal Monitor); and Fiscal Council workings. Get the data.
Notes: All OECD countries are shown aside from Costa Rica. Net debt is gross debt of general government excluding assets held by the state in the form of currency and deposits; debt securities; and loans. The 60 per cent ceiling for government debt set out in the Stability and Growth Pact (SGP) is set in gross rather than net terms. Net debt does not include the State's bank investments.

While the pace of budgetary expansion set out in *Budget 2022* is prudent, with Ireland carrying such a high level of debt, risks remain. The Council estimates using its Maq model — a structural econometric macro-fiscal model of the Irish economy — that there is a one-in-four risk that current policies could lead to a debt path whereby the debt ratio fails to fall, or even rises, from current high levels (Figure 3.11). While the Government has set out a more prudent path for the medium term, this analysis highlights the uncertainties and risks around the path for the debt ratio when the starting point is a high debt level. In other words, the planned path for the public finances is safer than had been signalled in the summer, but it is not yet safe.

The planned path for the public finances is safer but not yet safe

Figure 3.11: Current policies suggest one-in-four risk of unsustainable debt path

Net debt ratio, % GNI*



Sources: Fiscal Council workings. Get the data.
Notes: Each line shows a path for debt dynamics at various probability levels or "percentiles". The *Budget 2022* projections are treated as the central or most likely scenario. The estimates are based on the Council's Maq model (Casey and Purdue, 2021).

The one-in-four risk assessment is a source of concern, though not necessarily alarming, as several factors mitigate the risks. The debt sustainability risk assessment is based on current medium-term policies and it implies that there is a non-negligible probability that fiscal adjustment might be required to ensure debt sustainability. However, the risks of an outright recession being imminent seem relatively low for the coming years. Risks are also tempered by the fact that policies can adjust. For instance, a large portion of the rise in public spending in the coming years will be due to exceptional levels of investment to help address shortfalls in climate change and housing areas. There may be a strong case for this investment to be unusually high for a period. If high levels of public investment spending are sustained for a period and then returned to more normal levels in later years, the budget balance would be expected to improve along with the debt path. There are also some upside risks to revenue (Section 2).

A welcome feature in *Budget 2022* that helps to frame sustainability assessments is that it places more emphasis on using GNI* as the denominator for assessing fiscal sustainability. This is something the Council continues to assess as appropriate (Box C).

Box C: Department of Finance now making greater use of GNI* when assessing budgetary sustainability and real economic activity

The Department of Finance has moved to using modified Gross National Income (GNI*) in its budgetary documents as a key measure for assessing both fiscal sustainability and real economic activity. This aligns with the Fiscal Council's view that GNI* is a more appropriate measure for assessing the sustainability of the public finances and for gauging economic activity relative to other countries' estimates of GDP.

This box explains why the Council assesses GNI* to be an appropriate measure. In particular, it shows that the ability of GNI* to explain and predict taxes and real economic activity is far superior to GDP.

How does GNI* differ from GNI?

When moving from GNI to GNI*, the CSO makes the following adjustments:

1) Depreciation on intellectual property and on leased aircraft: Some assets held in Ireland by foreign-owned companies add significantly to GNI due to the addition of high amounts for depreciation. However, these amounts have little relation to production here, and if they are used in production, the profits all flow overseas to foreign owners. This is true of patents needed for manufacturing pharmaceuticals and of planes leased by foreign-owned companies. Yet the impact of these planes and patents on domestic output and employment is limited. The cost of depreciation on these assets is also borne by the owner overseas. For these reasons, the CSO excludes this depreciation.

2) Redomiciled PLCs: Redomiciled PLCs are companies with permanent offices in Ireland, but usually a small staff and little or no real activity. Management, leadership and other productive activity are mainly carried out overseas. While a lot of their profits from subsidiaries elsewhere are sent on to shareholders as dividends, some profits remain as net income inflating GNI. Recognising that they have little interaction with the Irish economy, the CSO subtracts out this net income from GNI*.

Why GNI* is a useful measure

1) Informed by expert assessments

After Ireland's GDP growth spiked in 2015, an expert group was set up to provide recommendations to the Central Statistics Office on how to address distortions in the national accounts. The idea was to convene experts and wide-ranging stakeholders to provide insights as to how best meet user needs for greater insight into Irish economic activity. Specifically, the group sought to account for measurement challenges associated with the highly-globalised nature of the Irish economy and the role of large foreign-owned multinational enterprises.

It its recommendations, the Economic Statistics Review Group (ESRG) proposed GNI* as a reliable level indicator of the size of the Irish economy. This was designed to be suitable for fiscal planning and for assessing the sustainability of public and private debt.

A substantial amount of evidence went into the ESRG assessment drawing on inputs from FitzGerald (2016); Honohan (2016); the Central Bank of Ireland (2016); Revenue (2016); and the Head of National Accounts at the OECD, Van de Van (2016). The report was finalized in 2016. Subsequent analysis by Lane (2017) and FitzGerald (2020) corroborates the move to GNI* as an appropriate measure of Ireland's economy. Lane looks at the need for countries such as Ireland where globally active firms play an important role to have an appropriate accounting framework. Two principles are sought: (1) a stable measure of overall economic performance robust to alternative accounting approaches; (2) a sensible measure robust to alternative mechanisms by which returns to foreign investment are paid out. As with the ESRG, he concludes that GNI* represents a suitable measure of domestic resources. FitzGerald (2020) similarly assesses that GDP, the traditional measure of national output and income, is no longer a good measure of the economic welfare of those living in Ireland and shows how detailed measures consistent with GNI* provide a more informative breakdown of economic growth over recent years.

2) More useful for assessing public finances and sustainability

As well as being statistically better able to explain historical year-to-year movements in taxes, GNI* is far superior for predicting future taxes.

Using error correction models, we assess a variety of government revenue measures and their relationship with both GDP and GNI*. The short-run equations for the models are of the form:

$$\Delta log(tax_t) = \alpha + \beta\, \Delta log(activity_t) + EC_{t-1}$$

with tax activity being represented by a variety of revenue measures; activity represented by either nominal GDP or nominal GNI*; and the Error Correction (EC) term representing the lagged residual from a long-run equation of the form:

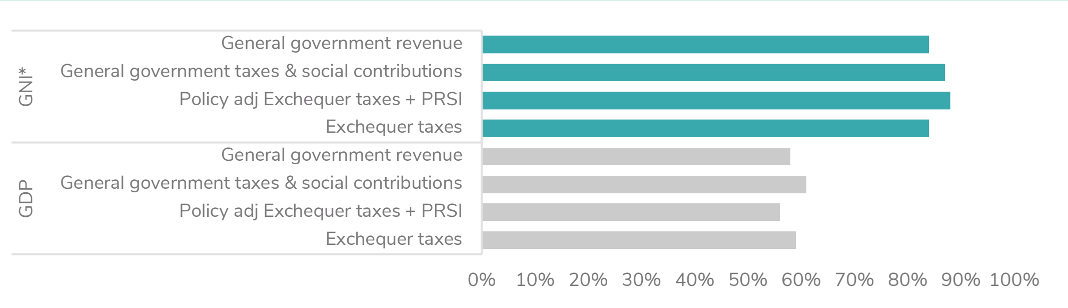
$$log(tax_t) = \alpha + \beta\, log(activity_t)$$

On average, models that use GNI* are able to explain about 86 per cent of annual variation in government revenues as compared to just 59 per cent with GDP (Figure C1). This points to the better ability of GNI* to explain how the public finances evolve with economic activity.

Using GNI* also leads to a better forecasting performance. On average, using GNI* almost halves the forecast errors compared to GDP. The errors using GDP would average 7.9 percentage points for annual growth rates as compared to 4.3 percentage points if using GNI* (Figure C2).

Figure C1: GNI* is better at explaining taxes

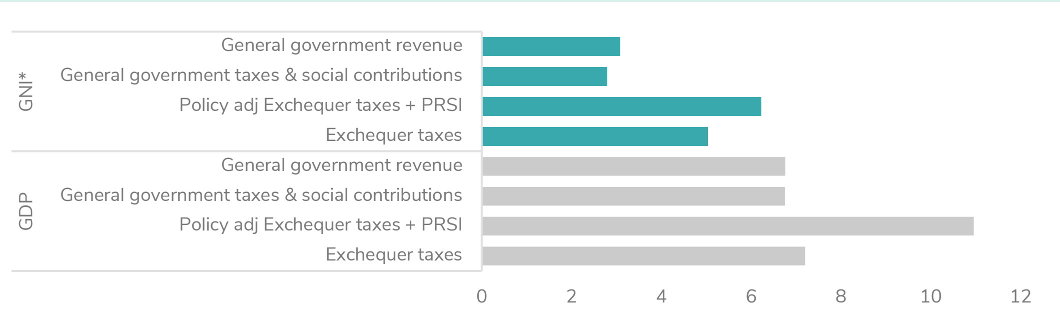
Explanatory power for error correction models estimating revenues



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: The chart compares the explanatory power (adjusted R-squared) of error correction models that rely on nominal GNI* as compared to nominal GDP. The estimation window is 1995–2019 using annual data.

Figure C2: GNI* is better at forecasting revenues

Annual percentage point forecast errors



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: The chart compares the forecast errors (the root mean squared error of annual percentage changes) of forecasts produced by error correction models that rely on nominal GNI* as compared to nominal GDP. The estimation window is 1995–2005 and the out-of-sample forecast window is 2006–2019 using annual data.

3) More aligned with the real economy

Another sense check on whether GNI* provides useful insights into the domestic economy is how it relates to growth in employment — a common measure of the performance of the "real economy".

Table C1: GNI* is also better at explaining and predicting employment

Independent variable	Dependent variable	Explanatory power	Out-of-sample forecast errors (p.p.)
Real GDP	Employment	43%	3.34
Real GNI*	Employment	86%	1.59

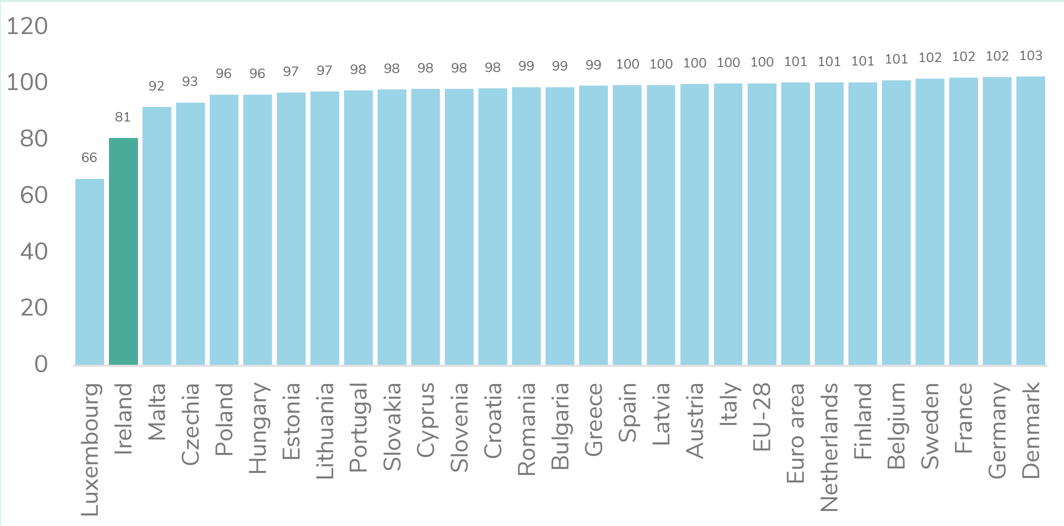
Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: The explanatory power (adjusted R-squared) is shown for error correction models that rely on real GNI* as compared to real GDP when modelling employment. The forecast errors refer to the root mean squared error of annual percentage changes with a smaller estimation window of 1995–2005 and an out-of-sample forecast window of 2006–2019.

4) GNI tends to align well with GDP elsewhere

For most countries, GNI aligns very closely with GDP. Over the 10 years 2010 to 2019, for instance, nominal GNI averaged within 2 per cent of GDP for 15 EU countries. It was within 4 per cent for all but 4 countries, while Czechia was 6.6 per cent below on average, and Malta 8.2 per cent below. However, Ireland was a clear exception with GNI, on average, 19.2 per cent below GDP. Only Luxembourg, at 33.6 per cent below, showed a greater gap to GDP (Figure C3).

Figure C3: GNI tends to align well with GDP internationally

GNI as a % of GDP



Sources: AMECO. Get the data.
Notes: Figure shows the average for nominal gross national income (not modified gross national income) as a share of nominal gross domestic product over 2010 to 2019.

For these four reasons, the Council tends to use GNI* as a more meaningful measure of the Irish economy — one that reduces the statistical distortions linked to globalized activities that have less of a bearing on fiscal and real-economy developments.

3.4 Medium-term challenges

Ireland faces several medium-term challenges. The Government needs to spell out how priorities and challenges will be met.

Ireland still faces challenges on ageing, climate, and the overreliance on corporation tax receipts. The Government needs to spell out how these challenges will be addressed

Sláintecare reforms could put additional pressure on health spending but basic detail is lacking. Commitments to major Sláintecare reforms in health are not budgeted for beyond next year. Moreover, essential information on costs and progress associated with Sláintecare thus far is severely lacking (Casey and Carroll, 2021). It appears that a cumulative amount of €2.1 billion of recurrent spending has been allocated to the reforms as of end-2022. Total costs were estimated at €2.8 billion per annum in 2017, but these estimates appear to be highly outdated and do not seem to include subsequent price and wage pressures. A mechanical estimate, using wage and price pressures in the interim, would suggest that costs could prove to be upwards of €3½ billion by 2027 to implement the reforms. To gauge progress and potential future costs, updated costings, which factor in these pay and price pressures, should be carried out to better inform policy and planning.

Table 3.1: Gaps in knowledge on major spending commitments

Climate action plan	No costings of economic/fiscal impacts are available outside of NDP amounts (Transport + Environment ~€40 billion; Housing ~€40 billion). Spending on green measures remains unclear. The Council estimated potential costs of €7 billion per annum based on a scaling up of previous NDP plans and this is similar to IMF (2021) estimates.
Sláintecare reforms	Sláintecare costs were estimated to add €2.8 billion to annual public spending by 2027 back in 2017 (Oireachtas, 2017). Estimates have not been updated since then. Wage and price pressures have since risen. The outlay as of 2022 appears to be €2.1 billion. No allocation is budgeted beyond then. Mechanical estimates would suggest costs upwards of €3½ billion by 2027.

Transitioning to a low-carbon economy will also have substantial costs. The Government has detailed the additional actions that will be required across both the public and private sectors to achieve the 2030 ceiling for levels of greenhouse-gas emissions as legally required by the Climate Act.[33] The target is a 51 per cent reduction in Ireland's overall greenhouse-gas

[33] These legally binding objectives are set out in the Climate Action and Low Carbon Development (Amendment) Act 2021. The carbon budgets and sectoral ceilings will be adopted by Government in the coming months after being considered by the Oireachtas.

emissions from 2021 to 2030, and net-zero emissions by no later than 2050.

However, there is little clarity on the potential costs to the state of achieving the transition. Some €125 billion of total costs to meet the new objectives to 2030 are outlined in the Climate Action Plan 2021 (Department of Environment, Climate and Communications, 2021). Annually, this equates to an additional €14 billion per annum, on average. But it is unclear how much is to be spent by the private and public sectors. The Climate Action Plan 2021 notes that 40 per cent (about €50 billion or €5½ billion annually) of the total investment costs required are unlikely to have positive returns so that the State may have to make some financial intervention to incentivise these.

The recently published NDP had a cumulative total public investment of €165 billion over 2021 to 2030. It's possible—assuming the spread across departments is similar after 2026—that about €40 billion is for transport and environment, with another €40 billion on housing. But there is no clear indication how much relates to green measures within these areas. It is possible that if these investments end up being more focused on green initiatives, then sticking to currently budgeted spending levels would still be achievable while also meeting any additional pressures that arise from climate objectives.

The only clear information in the Climate Action Plan 2021 on amounts committed is that about €8.5 billion will be public spending:

- There will be at least €8 billion of public spending on residential retrofit to 2030 by the Government. Part funding is the €5 billion of the €9.5 billion in carbon tax receipts planned to be raised by 2030, which are to be used to increase capital spending on energy efficiency (supporting residential retrofit).
- €0.5 billion of the National Recovery and Resilience Plan (NRRP) amounts are to be allocated towards decarbonising measures such as retrofitting, ecosystem resilience and regeneration, climate mitigation and adaptation, and green data systems.

Sources of revenue, including excise, vehicle registration tax, motor tax and carbon tax, are likely to be affected as behaviour changes in response to climate change mitigation policies. The process of adapting the economy to lower carbon emissions may have positive effects on employment and investment. However, it may also carry costs for both growth and the public finances as firms transition to new technologies.

As with other long-term fiscal challenges, delaying adjustment in respect of climate change targets would ultimately prove more costly.

The Government's overreliance on volatile and concentrated corporation tax receipts has grown in recent years. Receipts have become more concentrated: just 10 corporate groups accounted for 56 per cent of all corporation tax receipts last year. Efforts by various international organisations and stakeholders to facilitate a global minimum corporation tax rate and sharing of profits from global digital activities could see Ireland collect lower levels of corporation tax. The Budget assumes that a gradual €2 billion reduction in corporation tax receipts will result from major changes to the global tax environment (reducing by €1 billion in 2023 and €500 million per year in 2024 and 2025).

The Rainy Day Fund has been absent in recent budget publications but could play an important role in reducing the Government's current over-reliance on corporation tax receipts. The Fund was proposed in 2016 and the first planned savings to be allocated to the fund were to take place in 2019 and 2020.[34] However, these planned savings were first scaled back and eventually abandoned. An amount of €1.5 billion was transferred to the Fund from another arm of the State (the Irish Strategic Investment Fund) but was withdrawn for *Budget 2021* as part of the response to the pandemic.

The excess corporation tax receipts that have been collected in recent years can be thought of as an unusual and persistent windfall, somewhat like the proceeds from oil discovered in the North Sea by Norway. The Norway Oil Fund was set up in the 1990s to shield the economy from ups and downs in oil revenue, to act as a financial reserve, and as a long-term savings plan so that both current and future generations get to benefit from the proceeds of its oil wealth.[35] While oil revenue has been very important for Norway, the thinking was that one day it would run out. The aim of the fund is to ensure

[34] See Box B of the November 2019 Fiscal Assessment Report for a discussion of the Rainy Day Fund's usage in Ireland.

[35] More detail on the Norway Oil Fund is available at: https://www.nbim.no/en/the-fund/about-the-fund/

that funds received from oil are used responsibly, with a long-term vision for safeguarding the future of the Norwegian economy.[3]

In some ways, Ireland's corporation tax receipts have become a persistent windfall akin to Norway's oil. Much like oil, corporation tax revenues have proven volatile, exceptionally difficult to forecast, and prone to idiosyncratic factors outside of Ireland's control disconnected from the rest of the domestic economy. Continuing to fund a large part of Ireland's recurrent spending using a resource like this would be highly unwise.

The Council assesses that the Government should allocate any further excess corporation tax receipts — beyond what is forecast — and potentially any increase in revenue due to the rise in the minimum corporation tax rate to 15 per cent to the Rainy Day Fund. This would help to limit, and potentially reduce, the over-reliance on corporation tax receipts that has currently built up.

The Council previously recommended that a "Prudence Account", related to the Rainy Day Fund, be operated.[36] The Council's proposal for a Prudence Account is one way in which unexpected surges in corporation tax receipts could be saved so as to help to prevent long-lasting spending increases being tied to possibly temporary revenue sources.

Otherwise, the Rainy Day Fund itself should be reinforced in a number of ways: (1) removing the €8 billion cap; (2) making allocations flexible to the economic cycle; and (3) clarifying how drawdowns would work under the fiscal rules. These changes would help to establish the Rainy Day Fund as a meaningful tool to support the economy in future downturns.

The Irish population is rapidly ageing. This will put pressure on pensions and health spending. The Council estimated that the growing number of pension recipients would add some €370 million annually to pension costs on average over 2021 to 2025. This was even before the legislated-for

[36] The Prudence Account is outlined in Box B of the *June 2019 Fiscal Assessment Report*. Essentially, the idea is to notionally set aside the excess between actual and forecast corporation tax receipts as in-year allocations to a "Prudence Account". This would remove the excess receipts from the budgetary calculus; reduce the scope for spending these funds as they come in; and, at year end, these notional amounts could then be turned over to the Rainy Day Fund or set aside some other way. The baseline corporation tax forecast for the following year would then be based on the initial forecasts so that the outperformance would not be locked into the base.

increase in Ireland's pension age to 67 this January was deferred. In its Long-term Sustainability Report (Fiscal Council, 2020), the Council estimated that the deferral would raise annual expenditure by some €575 million in 2021, with costs rising over time. Increases in average payments to allow for price increases in the economy would push this upwards. Under current policies, combined spending on pensions and healthcare is projected to increase from 16 per cent of GNI* in 2019 to almost 25 per cent in 2050, with costs rising more rapidly after 2030.

Ageing will also lead to a shrinking labour force, while Ireland's productivity growth rates are likely to moderate further in future. This is expected, given the tendency for high-productivity regions internationally to exhibit slower rates of productivity growth.

The Report of the Commission on Pensions, published in October, drew on the Council's *Long-term Sustainability Report*. The Commission's report was clear that measures to improve the fiscal sustainability of the state pension were required. It noted that costs associated with the state pension (contributory) would increase by 65 per cent by 2030 and that State pension spending would consume the entire Social Insurance Fund by 2040 if policy did not adjust. Addressing the fiscal sustainability challenges faced, the Commission set out a preferred package of reforms comprising changes to social contributions, pension age increases and additional Exchequer contributions. Box D reviews these reforms.

Box D: Pensions Commission recommends substantial reforms to ensure sustainability of the pension system

The Commission on Pensions was established in November 2020 under a Programme for Government commitment to "examine sustainability and eligibility issues ... and outline options for the Government to address issues including qualifying age, contribution rates, total contributions and eligibility requirements". Its work was completed this October with the publication of a substantial report highlighting the sustainability challenges facing the pensions system.

This box sets out the main recommendations proposed by the Commission and assesses their potential impact.

Main recommendations

The Commission's main recommendation was that a package of measures be undertaken to ensure sustainability of the pension system. Increases in social contributions, the pension age and additional Exchequer contributions were the key features.

Reform and share of pensions costs shortfall met by it	Nature of specific reforms
Social contributions increases (40%)	Increase self-employed PRSI rates from 4% to 10% by 2030. Increase higher Class A Employer rate by 2.4 percentage points by 2040 and by 0.1 percentage points by 2050. Increase employer and employee rates both by 1.35 percentage points by 2040 and 0.1 percentage point by 2050.
Pension age increases (38%)	Increase the pension age by three months each year from 2028 to reach 67 in 2031. Then increase by 3 months every 2 years from 2033 to reach 68 in 2039.
Exchequer contribution increases (13%)	Allocate the equivalent of 10% of State Pension Contributory spending to pension spending annually.
Moving fully to a "Total Contributions" approach (9%)	Currently, people availing of the state pension can choose between the most favourable option based on a "Yearly Average Approach" or a "Total Contributions" approach. This reform would see the former option abolished and a full move to the total contributions approach, whereby 40 years of contributions (including credits) are required for a full pension.

The reforms are expected to address the shortfall primarily through the social contribution and pension age increases (Figure D1).

Reforms suggest a need for tax increases

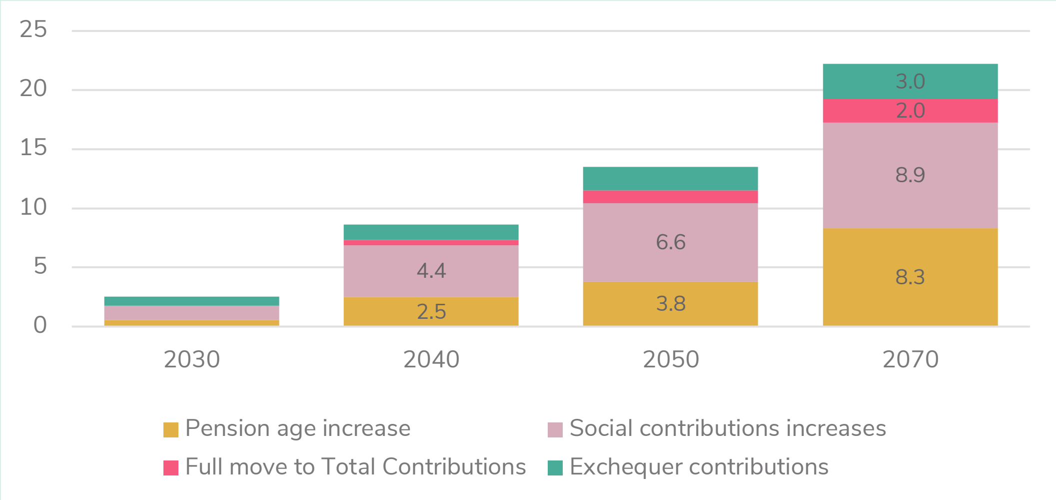
The choice to use taxes to fund much of the costs is reasonable, though it raises questions about the willingness of governments, both current and future, to raise PRSI contributions on this scale. The proposed increase in Exchequer contributions to 2030 (€790 million) would, if funded by taxes, roughly correspond to a further 1 percentage point rise in the standard 20 per cent income tax rate (€744 million full-year impact in 2022 — see Section S10). Relying on a rise in taxes over the longer term is not that credible without clear commitments to follow through on such an approach. To be credible, the Government should plan and legislate for these measures, acting sooner rather than leaving for another government term.

Increasing the pension age as the Commission proposes would mean that the gap between the pension age and the expected age of death, given life expectancy at age 65, will remain broadly fixed at about 20 years (Figure D2). The more gradual phasing is likely to make the changes easier to implement, avoiding large step changes.

However, the proposals recommend postponing increases in the pension age, which locks in a longer average retirement period. It also means higher costs than would be incurred by beginning to apply the same changes earlier, and it means that the full costs of an ageing population will need to paid for between now and 2028.. It is not clear what the rationale for recommending a delay in the pension age increases was. However, the Commission's report notes that "public concern [in relation to the originally planned pension age increase to 67] endures and was borne out in subsequent surveys and in many submissions to the Commission".

Figure D1: How the reform package addresses pension cost shortfalls

€ billions, cumulative funding raised by source

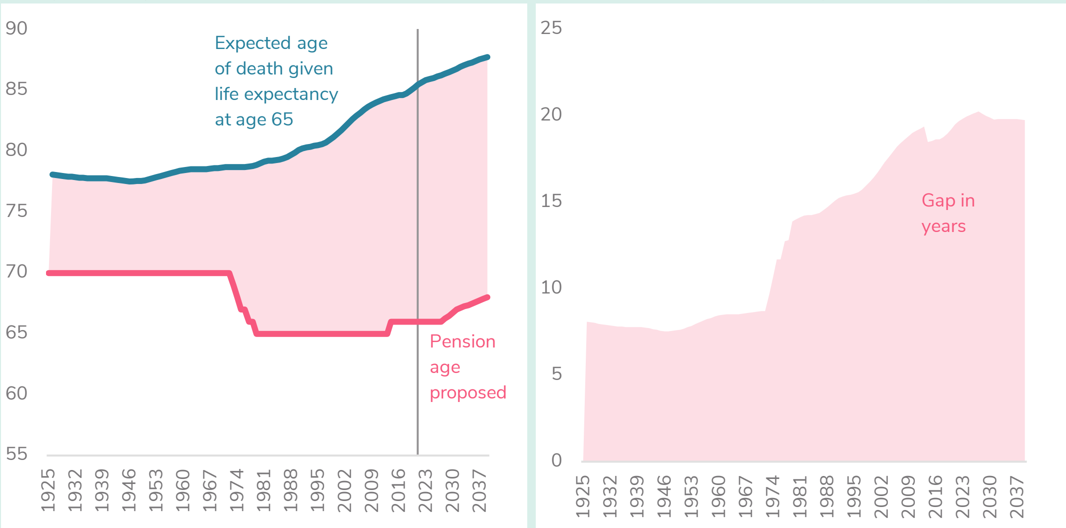


Source: Commission on Pensions (2021). Get the data.

Phasing the increase in the pension age as the Commission proposes will mean that the gap between the pension age and the expected age of death given life expectancy at age 65 will remain broadly fixed at about 20 years (Figure D2).

Figure D2: Expected years of retirement to stay broadly fixed at 20 years

Age (left panel); and gap in years between life expectancy at age 65 and pension age (right panel)



Sources: CSO Life Tables; Pensions Commission Report; and Fiscal Council workings.
Notes: Life expectancy at age 65 is interpolated from CSO Life Tables; projections are from the Council's Long-term Sustainability Report (2020); the pension age rises in line with the Pensions Commission's recommendations. Get the data.