Budgetary Assessment

Significant spending pressures to arise in the coming years

2. BUDGETARY ASSESSMENT

Significant spending pressures ahead

The public finances are improving but pressures remain

SPU 2022 forecasts a general government deficit of 0.8 per cent of GNI* in 2022. This would represent an improvement of almost 3 percentage points of GNI*) from 2021, driven by stronger tax revenues from the economic recovery and lower than planned spending. While the Government has introduced new measures to address cost of living increases and supports for Ukrainian refugees, existing supports are within the overall envelope set out for Covid contingencies. The deficit could be smaller than projected, however, with possible upside to revenue forecasts, underspends on core spending, and the possibility of accommodating additional measures are within existing contingencies.

Under current spending plans and consistent with the newly introduced rule limiting core expenditure growth to 5 per cent per year, *SPU* 2022 projects the general government balance to improve over the medium term. Falling Covid spending is expected to be more than offset by an increase in core expenditure, which takes account of the National Development Plan. In addition, SPU spending plans already incorporate the impact of existing cost-of-living measures and humanitarian assistance for refugees. Yet, the continued recovery in revenues would result in a significant improvement in the budget balance over the coming years.

However, over the medium term (2023–2025), core current spending growth is forecast to fall short of the level required to maintain the real value of existing service levels. In other words, if full indexation of public sector pay and social benefits were to be applied, the spending limit would be binding and there would be no scope for new spending measures or improvements to service levels without other changes in policy. Furthermore, there are large uncertainties around the costs of major policy reforms such as Sláintecare and the costs of the Government's commitments to significantly reduce greenhouse gas emissions by 2030.

With interest costs set to remain low, economic growth and the improving general government balance, the government debt ratio is projected to fall in the coming years. By 2025, gross (net) general government debt is forecast to be 79.4 (68.5) per cent of GNI*.

2.1 2021 outturns and measures introduced since *Budget 2022*

The fiscal performance in 2021 was significantly better than expected in *Budget 2022* (Table 2.1). This was mainly driven by revenue overperformance, with corporation and income tax receipts as the largest contributors.[22] Lower-than-expected capital spending and intermediate consumption also contributed to a lower-than-forecast deficit.

2021 turned out better than expected

Table 2.1: 2021 saw an overperformance relative to *Budget 2022* forecasts

€ millions unless otherwise stated

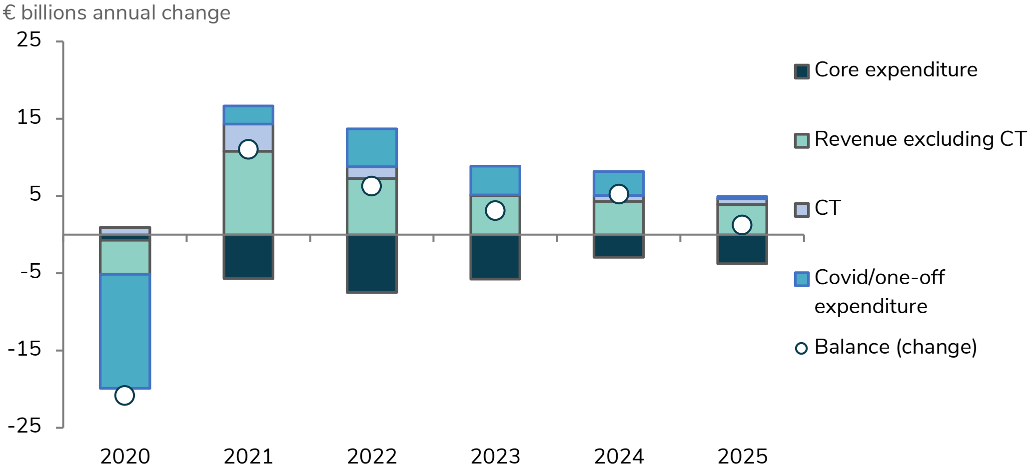
	November Budget	2021 Outturn	Forecast error
General Government Revenue	**93,110**	**96,961**	**3,851**
Corporation Tax	13,890	15,325	1,435
Income Tax	26,015	26,665	650
Capital Gains Tax	1,100	1,640	540
General Government Expenditure	**106,360**	**105,072**	**-1,288**
Of which: Capital Spending	9,430	8,498	-932
Of which: Intermediate Consumption	16,895	16,245	-650
General Government Balance	**-13,255**	**-8,111**	**5,144**
General Government Balance (% GNI*)	**-5.9**	**-3.6**	**2.3**

Sources: CSO, and Department of Finance. Get the data.
Notes: Corporation, income and capital gains tax are all on an exchequer (cash) basis, hence are not directly comparable to general government revenue. However, their forecast errors are shown here to illustrate some of the factors behind the forecast error for general government revenue.

The general government balance is forecast to improve further in 2022, with the deficit shrinking to just below €2 billion or 0.8 per cent of GNI*. Revenue is forecast to grow strongly this year (9 per cent), mainly driven by income tax and VAT receipts. Temporary/one-off spending is forecast to fall, with temporary spending measures introduced in response to the increased cost of living outweighed by reduced spending related to Covid-19 (Figure 2.1). However, this decline in temporary spending (€5.8 billion) is more than offset by the substantial planned increase in core spending forecast for this year (€8.6 billion) now needed to reach the level of core spending forecast in *Budget 2022* following underspends last year.

[22] General Government Revenue in 2021 was also boosted by a reclassification of revenue from 2020 into 2021. This occurred after *Budget 2022* forecasts were made, hence explaining some of the forecast error.

Figure 2.1: Improvements in the budget balance are driven by revenue increases and falls in Covid/one-off spending.



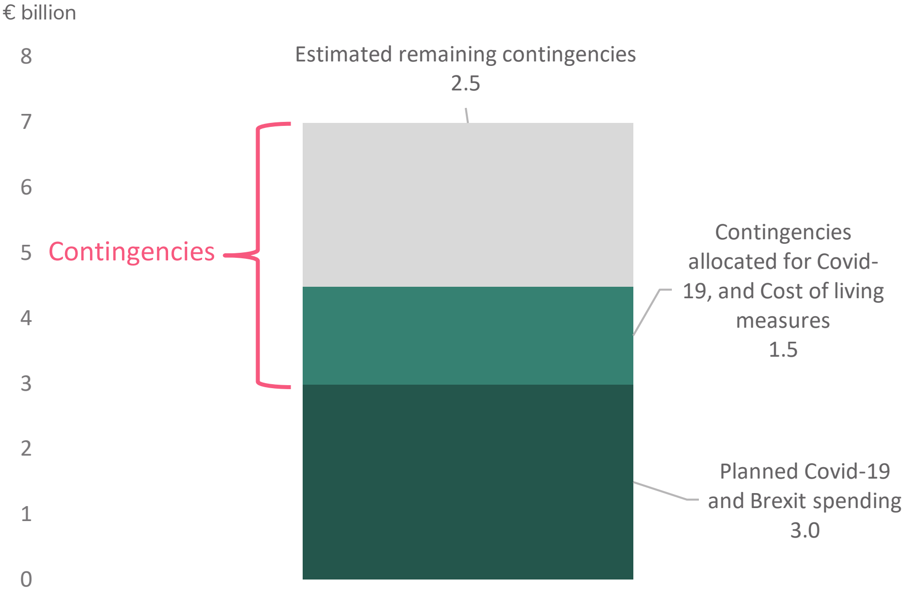
Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Changes in expenditure are recorded as their impact on the balance (i.e., expenditure increases are recorded as negative, as they worsen the balance). Covid/one-off expenditure as outlined in Table 2.3. CT = Corporation Tax.

SPU forecasts for revenue and spending in 2022 incorporate new measures introduced since *Budget 2022*. Many of these measures were intended to alleviate pressure on households and businesses facing higher energy prices. The main measures are listed in Table 2.2. Of the €7 billion in contingency spending included in *Budget 2022*, around €3.0 billion has been allocated to Government departments to finance planned Covid and Brexit spending.[23] The remaining €4.0 billion had been left as a contingency to deal with any further Covid-19 related spending.

Between *Budget 2022* and *SPU 2022*, around €1.5 billion of these contingencies were effectively committed to spending measures for Covid-19 and to address increases in the cost of living (Figure 2.2). This leaves around €2.5 billion remaining that could be used if further supports were introduced or if existing measures were extended. Any further measures, beyond the remaining €2.5 billion in contingencies, would increase spending relative to *SPU 2022* plans.

[23] Underspends in this area are possible, which would free up further funds for unforeseen spending on other areas such as cost of living measures or humanitarian assistance for refugees.

Figure 2.2: Sizeable contingencies remain for 2022 even after the introduction of cost of living measures



Sources: *Budget 2022*, *SPU 2022* and Fiscal Council workings. Get the data.
Notes: Approximately €1.5 billion of the €4 billion contingency has now been allocated to deal with Covid related spending and cost of living measures leaving €2.5 billion of funding unallocated for 2022.

Sizeable contingencies remain to respond to various crises

SPU 2022 outlines that Ukrainian humanitarian spending for 2022 is currently assumed to come from the remaining €2.5 billion contingency. Were the Government's Ukrainian humanitarian spending in 2022 greater than this level, this would raise spending beyond *SPU 2022* projections.[24] However, as elaborated in Box C, the current projections of Ukrainian humanitarian spending appear to be on the high side relative to experience to date and so these funds may not be fully used.

[24] Equally, were any combination of other spending measures totalling more than €2.5 billion to be introduced, this would raise spending beyond *SPU 2022* forecasts.

Table 2.2: Additional discretionary tax and spending measures introduced in 2022

€ millions

	Cost	Scheduled Expiry
Measures Since Budget 2022		
Pandemic Special Recognition Payment*	100	One-off
Additional Bank Holiday*	50	Permanent
Excise cuts	417	October 2022
Electricity Credit**	379	One-off
Public Transport Subsidy	54	End 2022
Fuel Allowance	86	One-off
VAT cut on gas & electricity	46	October 31
Haulier Support Scheme	18	One-off
Drugs Payment Scheme	17	Permanent
Tillage Support Scheme	12	One-off
Working Family Payment	4	Permanent
School Transport Subsidy	3	Permanent
Measures Since SPU 2022		
Inflation Co-operation Framework***	30-40	Not specified
Monthly payment to house refugees****	20-50	Uncertain
Extension of 9% VAT rate	250	End Feb 2023
Total	1,506	

Sources: Department of Finance and Fiscal Council workings.

Notes: *Estimated costs as of 10/5/2022 **Excludes VAT ***Costing is based on the estimated cost for Q1 2022, final costs would be higher if the payment is made again later in the year. The costs associated with this scheme are to be absorbed within the capital allocations as part of the NDP. ****Estimated annual cost.

Box C: Fiscal impacts of Ukrainian humanitarian spending

This box examines the potential fiscal impacts arising from the resettling of refugees from Ukraine. The macroeconomic and fiscal projections made in *SPU 2022* are based on an assumed inflow of 80-100 thousand refugees from Ukraine.

There is considerable uncertainty surrounding what the eventual inflow will be. Migration models would typically point to distance, common language and the existing stock of migrants of that nationality (commonly referred to as network effects) as being key factors. As highlighted in Section 1.1, each of these three factors would point towards Ireland being an unlikely destination for Ukrainian refugees, in the absence of an EU burden sharing resettlement agreement. With this in mind, it is possible that significantly less than 80,000 refugees could arrive in Ireland. At the time of writing over 33,000 Ukrainian refugees have arrived.

For 2022, a technical assumption is made in *SPU 2022* regarding spending on resettling refugees from Ukraine. Approximately €2.5 billion of Covid contingency reserve spending is yet to be allocated for 2022. For now, it is assumed that humanitarian spending could be met within this amount. If underspends in other areas were to occur, this would also free up funds for further spending in this area while remaining within the Government Expenditure Ceiling set out in *Budget 2022*.

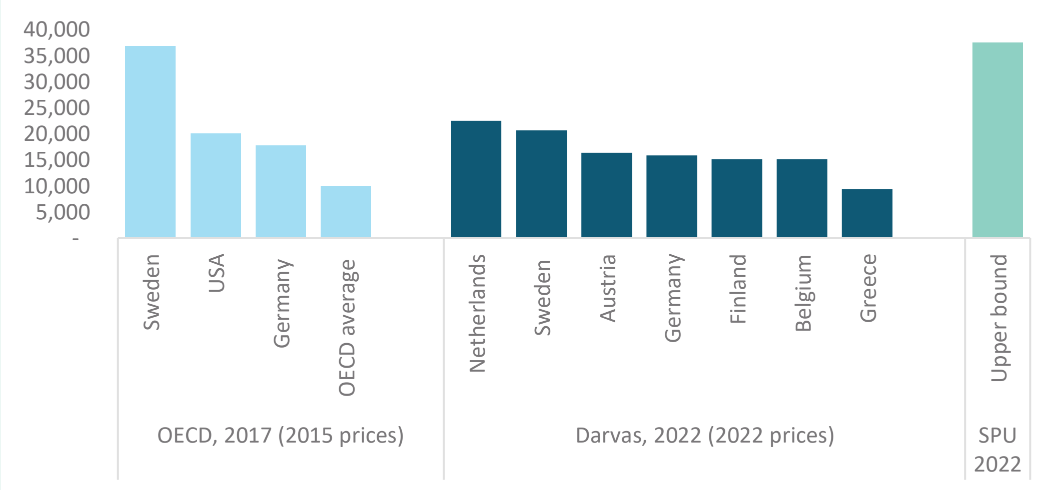
Some €3 billion has been set aside for Ukrainian humanitarian spending in 2023. With 100,000 refugees assumed to arrive in Ireland, the level of spending in 2023 per refugee would be approximately €30,000.[25] Historical estimates of the cost per refugee vary across countries. Recent estimates of the cost associated with the 2015-16 refugee inflows in Europe, by Darvas

[25]Based on 80,000 refugees arriving in Ireland, this figure would be €37,500 per refugee.

(2022), put the cost per refugee in the range of €9,000–€25,000 (Figure C1). Estimates by OECD (2017) indicate a broader range, with the costs per refugee in Sweden reaching over €36,800 (2015 prices). However, OECD (2017) finds that on average across the main recipient European countries, the costs for processing and accommodating a refugee was estimated to be €10,000 in the first year. However, this estimate increases if integration support is provided.

Figure C1: Estimates of cost per refugee vary

€ per refugee



Sources: Department of Finance; OECD (2017), Darvas (2022).
Notes: Only select estimates of the cost per refugee from OECD (2017) are included here. Get the data.

In addition, the higher the proportion of vulnerable groups that arrive, like unaccompanied minors, the higher the costs of humanitarian support will tend to be. Irish-specific factors might also have a bearing. Housing market pressures were already evident before this population inflow, resulting in accommodation costs which could be higher than what other countries have experienced in the past.

Having said that, the costs assumed by the Department are on the upper bound of the spectrum, broadly in line with the experience of Sweden. Under lower assumptions, the contingency might provide considerable scope to manage an even larger number of refugees.

However, there is no provision for further spending related to Ukrainian refugees in 2024 or 2025 in the SPU projections. It would seem more likely that some level of expenditure would be required after 2023. In addition, while the Department do not assume a large labour force participation of these refugees, should they remain here for an extended period, their participation rates may exceed the Department's assumptions leading to an upside to tax revenue forecasts such as income tax.

2.2 Upside risks for the budget balance in 2022

Upsides to the budget balance

There is potential upside to the Budget balance forecast for 2022 even without factoring in the potential for contingencies not being used in full, as revenue has continued its strong performance and there are likely underspends in key areas.

Tax and PRSI receipts at the end of April 2022 were €5.7 billion greater than the same period last year. The improved performance was broad based, but Income tax, VAT and Corporation tax accounted for the majority of the growth relative to last year. The improved performance relative to 2021 reflects, in part, the lower receipts in the early part of last year due to Covid-19 restrictions.

Revenue could overperform relative to forecasts

PRSI receipts at end-April 2022 are up €320 million relative to the profiles which were based on *Budget 2022* forecasts. In *SPU* 2022, PRSI forecasts for 2022 have been revised up by €490 million relative to *Budget 2022* forecasts. Given the limited forecast revisions compared to the overperformance to date, it is likely that PRSI receipts will overperform SPU forecasts for the year as a whole.

No tax profiles for 2022 were published based on *Budget 2022* forecasts.[26] This makes it difficult to assess the year-to-date performance of various taxes relative to official forecasts. However, tax profiles are now available for the remainder of the year based on *SPU 2022* forecasts.

Income tax so far this year is up over 19 per cent relative to the same period last year. This reflects in part the Covid-19 restrictions in place in the early part of last year, but also the robust labour market. Income tax receipts are expected to end the year 10.6 per cent higher than 2021. Receipts so far this year have been strong, and there are further upside risks to the income

[26] PRSI profiles are compiled by the Department of Social Protection. Tax profiles are compiled by the Department of Finance.

tax forecasts given the strong labour market momentum, and the unusually low level of receipts assumed in the forecast profile for November.[27, 28]

Corporation tax is forecast to grow by 10 per cent in 2022. At end-April, corporation tax was up sharply on the same period last year. For the most part, this reflects unexpectedly large payments in March. The performance of corporation tax to date explains the entirety of the 10 per cent growth expected for the full year. Indeed, for the remaining eight months of the year Corporation tax receipts are expected to be 1.2 per cent lower than the corresponding months last year. While part of this reflects one-offs received in October last year, on an underlying basis (excl. last year's one-offs of €780 million), corporation tax receipts are forecast to grow by 4.3 per cent for the remaining eight months of the year.[29] Receipts in November are forecast to be 8 per cent lower than November 2021.[30] Given the muted forecast for corporation tax receipts for the remainder of the year, there is the prospect that receipts may over perform, especially if the large payments in March were repeated again in August.[31]

VAT for the remaining eight months of the year is forecast to grow by 8.5 per cent relative to the same period last year. However, since *SPU* 2022, the Government have announced an extension of the 9 per cent VAT rate on hospitality into next year. The extension of the reduced VAT rate on hospitality is expected to cost €250 million in total but would only reduce

[27] Over 2013-2019, income tax receipts at the end of April accounted for on average 31.2 per cent of the total income tax for the year. The current forecasts are for receipts at the end-April 2022, to account for 32.3 per cent of total income tax in 2022. This forecast is for a higher proportion of receipts by end-April than any point over 2013-2019, despite Covid-19 restrictions being in place at the start of this year. Given the strong receipts to date, there is likely upside to the forecast for the remainder of the year.

[28] Self-assed income tax is typically paid in November. As a result, November typically sees the largest income tax payments. Over 2013-2019, November accounted for on average 15.3 per cent of income tax receipts in a given year. November 2022 is forecast to account for just 13.4 per cent of income tax receipts.

[29] The one-offs were due to tax settlements.

[30] Due to the timing of corporation tax payments, much of the receipts in November are linked to the receipts in June. Typically, large companies pay preliminary corporation tax in the 6th month of their financial year and the 11th month of their financial year. In the 6th month of their financial year, companies pay either 50% of the CT liability in the previous year or 45% of the CT liability for the current year. In the 11th month of their financial year, they pay a further instalment of tax, bringing the tax paid up to 90% of the current year's liability. In this instance, June is the 6th month, and November is the 11th of the financial year. Receipts in June are forecast to grow by 6 per cent. It would be odd for receipts in June to be up 6 per cent, and receipts in November down 8 per cent.

[31] The current forecast for August receipts of €1.2 billion. This compares to receipts last August of €1.0 billion, and receipts in March of €1.6 billion. Receipts in March and August are linked. See footnote 25 for an explanation as to why these are linked.

the VAT receipts for the current year by approximately €170 million relative to SPU forecasts.[32] While this presents downside risks to the budget balance forecast for 2022, consumer spending may be stronger than forecast in cash terms and any unexpected further inflation could see VAT receipts stronger than forecast.[33]

Underspends look likely in 2022

Turning to the expenditure side, *Budget 2022* forecast gross voted core spending to be €75.9 billion in 2021. However, Gross voted core spending ended up being €1.8 billion lower.[34] Despite the lower level of core spending that transpired last year, the forecast for core spending in 2022 has not been revised down since Budget time.

Core current spending in 2021 was €1.5 billion lower than forecast in *Budget 2022*. Of this, underspends in Health and Social Protection made up €1.3 billion.

Core current spending in Health was approximately €900 million below what was forecast in *Budget 2022*. Despite this underspend, the forecast for spending in Health for 2022 has not been revised down. Current spending in health so far this year is roughly on profile, despite the Covid-19 surges in the earlier part of this year.[35] The HSE has also indicated that it is unlikely to meet its recruitment targets for 2022.[36] This raises the prospect of underspends in core current Health recurring in 2022.

Core Social Protection spending in 2021 was €0.4 billion below the forecast in *Budget 2022*. Spending was lower than forecast across a number of schemes, including jobseekers' payments. At the end of April 2022, current Social Protection spending was just €260 million above profile, despite additional spending on PUP and EWSS which had not been anticipated.[37] To date, there has been a limited impact of the ending of the PUP in March, on live register figures with only 177,000 people on the live register in April

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[32] The reduced VAT rate is extended until the end of February 2023. The figure for the cost in 2022 is estimated on a pro-rata basis.

[33] See Box E for the implications of inflation on the government revenue.

[34] The Department have indicated that the "core" expenditure figures for 2021 are preliminary at this stage and there may be spending which is subject to reclassification at a later date.

[35] The spending profiles do not incorporate any of the €4 billion contingency spending. The profile did incorporate €750 million of planned covid-19 related spending.

[36] See minutes of the Health Budget Oversight Group meeting, January 2022: https://www.gov.ie/en/collection/31f5d3-hbog-finance-subgroup-minutes/.

[37] Also, to a limited extent, additional spending on accommodating Ukrainian refugees.

up from 163,000 in February. While the ending of the EWSS may have an impact on the number of people on the live register, to date the numbers on the live register are well below those assumed at budget time.[38, 39] As a result, there could be a repeat of the underspend on Jobseeker's Payments that were seen last year.

Relative to *Budget* 2022 forecasts, gross voted capital spending in 2021 came in €0.5 billion under budget.[40] In reality, the amount spent on capital was lower further €0.8 billion as this amount was included in the December 2021 gross voted capital figures but reflects an amount carried over into next year to fund capital spending in 2022, that was planned to take place in 2021.[41]

While the lockdown in the construction sector in early 2021 was certainly a factor for this underspend on capital last year, capacity constraints may also limit the ability to meet capital spending plans.

At the end of April, gross voted capital spending was €390 million, or 20 per cent under profile. This is despite an additional €109 million being included in the amount spent to date, associated with the cost of the electricity credit, which had not been accounted for in the spending profiles.[42]

Given the underspend to date, it is probable that capital spending will come in under forecast for 2022, and that there will be a further carryover of capital spending into 2023.

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[38] See Hickey (2021) for the Department's forecast for the number of people on the live register.

[39] The EWSS is scheduled to end on 31st May 2022.

[40] This was also €175 million under the *Budget 2021* forecast. The forecast for 2021 was revised up in *Budget* 2022.

[41] If there is an underspend on capital in the current year, Departments can carryover up to 10 per cent of their capital allocation into the following year.

[42] The electricity credit is estimated to cost €379 million. Only €270 million of this cost was included in the spending profiles.

2.3 Medium-term spending pressure

Forecasts are for only 3 years ahead

Fiscal projections in *SPU 2022* end in 2025, only three years ahead. The Council has previously highlighted the importance of five-year-ahead forecasts to support a medium-term orientation for fiscal policy. This also obscures the role of key medium-term developments that will impact the public finances, including an ageing population and automatic enrolment in pension schemes. All projections should have a horizon of at least 5 years.

These projections show core spending levels unchanged in cash terms relative to *Budget 2022* for each year of the forecast.[43] This is a reflection of the Government's new spending rule being applied as growth rates on original allocations, rather than outturns. This means that the actual growth rate in spending can fluctuate around the 5 per cent 'target' and yield the same levels of spending as initially planned. For example, as a result of a lower outturn for 2021, this year core spending would grow by 8.1 per cent to reach the same initially planned level.

Consistent with the aim of meeting the expenditure rule exactly (see Section 3), the implied spending limits could be difficult to achieve if higher inflation were to persist.

Table 2.3: Fiscal forecasts from *SPU 2022*

€ billions unless otherwise stated

	2020	2021	2022	2023	2024	2025
General Government Revenue	82.6	97.0	105.8	110.9	116.0	120.6
Change in General Government Revenue	-5.4	14.3	8.8	5.2	5.1	4.6
General Government Expenditure	101.8	105.1	107.7	109.7	109.5	113.0
Covid/One-off Expenditure	14.8	12.4	7.5	3.8	0.7	0.4
Change in Covid/One-off Expenditure	14.8	-2.4	-4.9	-3.7	-3.1	-0.3
"Core" General Government Expenditure	87.0	92.7	100.2	105.9	108.8	112.6
Change in "Core" General Government Expenditure	0.7	5.7	7.5	5.8	2.9	3.7
General Government Balance	-19.1	-8.1	-1.9	1.2	6.5	7.7

Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: For 2020, €14,762 million of general government spending is considered to be pandemic related, as per CSO estimates. 2023 includes a €3 billion contingency for Ukrainian humanitarian spending. These estimates of Covid/one-off expenditure are consistent with those used by the Council in calculating net policy spending (see Section 3).

[43] This excludes temporary measures associated with Covid-19, cost-of-living initiatives, and spending arising from the fallout of the war in Ukraine.

An important factor in assessing the credibility of budgetary projections is whether they are consistent with maintaining existing levels of services and implementing government policies.

Progress made in Budget 2022 but more details needed

Budget 2022 made progress in this regard by outlining for the first time the assumed costs for maintaining the existing levels of services in 2022. However, there were only indicative allocations made on the basis of technical assumptions for 2023-2025 (Box D). These costs were estimated as being an increase of around 3 per cent of total gross voted core current spending in each year. These assumptions are unchanged as part of *SPU 2022* projections, despite the much higher price level and higher wages in the economy assumed in the macroeconomic forecasts. This is a significant gap in the budgetary projections, although it does not necessarily distort overall planned spending if other spending increases were to be adjusted in an offsetting way. Furthermore, the Government may choose not to fully increase wages and welfare rates in line with inflation.

The Council's Stand-Still estimates aim to project the level of spending required to maintain current levels of services in real terms, accounting for demographic, wage and price rises. As noted in Section 3, those on lower incomes may face even higher inflation than suggested by the headline rate, as a larger share of their income is spent on food and energy.[44] As a result, Stand-Still estimates may be viewed as a lower bound on the costs of maintain the purchasing power of welfare recipients.

Inflation is increasing to cost of maintaining services

Taking into account the revised higher forecast for prices and wages as part of *SPU 2022*, the Council estimates that total spending would be around €2.3 billion higher than the Government's own projections for these Existing Level of Services (ELS) costs over the years 2023-2025.This reflects the unexpected jump in inflation in 2022 being recovered by spending in 2023, with a cost of over €2 billion. Meanwhile, Stand-Still costs in 2024 and 2025 are estimated to be around €1.6 billion higher on average that ELS allocations. This assumes that government costs rise in line with inflation and that wages and social welfare rates increase at a somewhat faster pace over the next two years in line with expected economy-wide developments. To the extent that the Government does not fully uprate these payments,

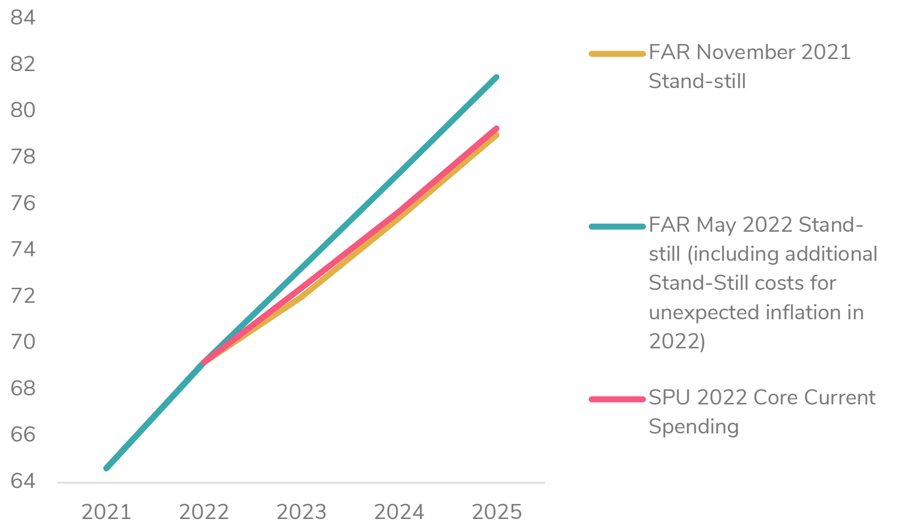
[44] Lydon (2022) calculates that inflation for the lowest 20 per cent of earners in December 2021 was 6.1% as opposed to 5.3% for the top 20 per cent

reducing their value relative to the economy-wide average, this would lower the costs.

Importantly, the higher Stand-Still costs would take government spending above the total gross voted current spending levels projected in *SPU 2022* (Figure 2.3).[45] Stand-Still estimates over the forecast period are on average, €0.5 billion above these amounts. This implies that *SPU 2022* forecasts of spending are now lower than the level required to stand still i.e., fully offsetting inflation with increases in public sector pay and social welfare rates.

Figure 2.3: Higher inflation leads to spending pressures

Gross voted core current spending, € billion



Sources: Department of Finance and Fiscal Council workings. Get the data.
Notes: The estimates derived as part of the November 2021 Stand-Still above employ the contemporaneous drivers (e.g., *Budget 2022* forecasts of unemployment and inflation) but retain the 2022 spending base as detailed in *SPU 2022*.

The excesses of Stand-Still costs illustrate that the Government's new spending rule might be difficult to adhere to over the forecast period without other changes in spending or allowing changes in the real value of existing services (see Box I for a more comprehensive discussion of the impact on inflation on the rule). With the space available for new measures estimated to be low even at the time of *Budget 2022*, the current estimates show that even this is likely to be consumed by Stand-Still costs.

An illustrative example of this dynamic is taking the rate of social protection payments like unemployment assistance and pensions. As the Government

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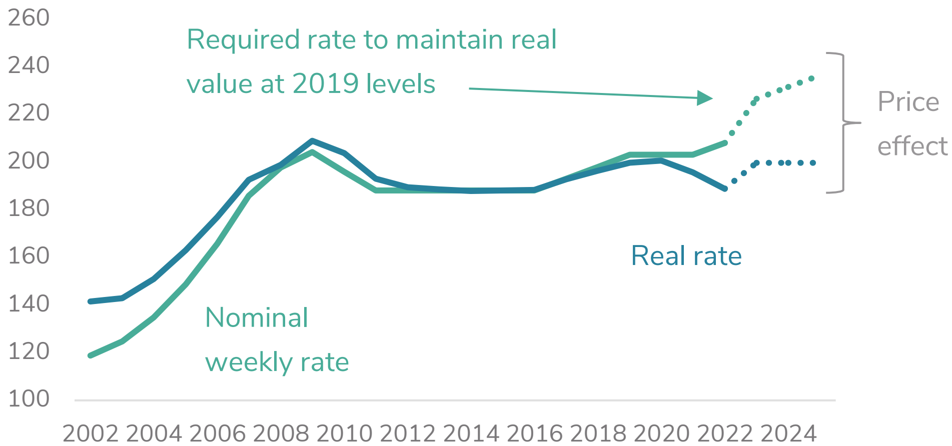
[45] This assumes that core spending in 2022 is as forecast in *SPU 2022*. As Section 2.2 highlights, there may be underspends.

policy in this area is to implement discretionary changes rather than have payments automatically follow the path of wages or consumer prices in the economy, the real value of payments would be eroded by inflation in the absence of an explicit policy decision.

A simple exercise below illustrates this point, where nominal jobseeker's rates would have to increase by around 13.7 per cent between now and 2025 under the Department's projections of HICP inflation to recover to their 2019 real level in terms of the aggregate consumer price index. While the real rate of payment has been maintained since the financial crisis against inflationary developments, if indexed to wage developments in the economy the nominal rate would need to rise even further (Figure 2.4).

Figure 2.4: Illustrating Stand-Still costs – indexing social welfare payments to inflation

€ weekly, jobseeker's allowance rate



Source: Department of Finance; and Fiscal Council workings. [Get the data.]

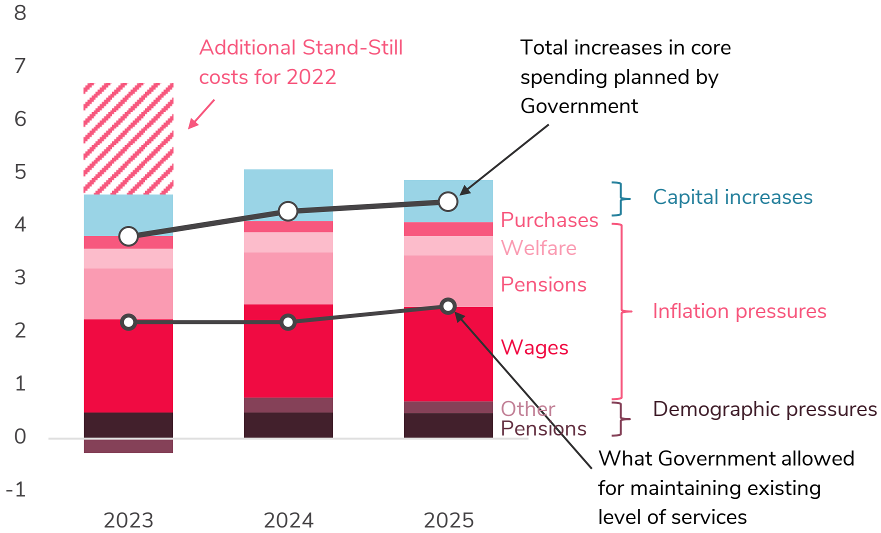
Notes: Nominal weekly rates are deflated using the HICP index.

While a full indexation of spending to inflation or wages remains a policy choice for Government and needs to be carefully considered in the context of the rise in energy prices, this exercise shows that spending pressures are likely to mount over the forecast period to maintain existing living standards for lower-income households. See Figure 2.5 for a more detailed breakdown of these pressures in areas like social welfare and public pay for example.[46]

[46] From a forecasting perspective, having this assumption would have allowed for more realistic projections of expenditure in previous years.

Figure 2.5: Spending Pressures are broad based over the medium-term

€ billion, year-on-year changes



Source: *SPU 2022* and Fiscal Council workings. Get the data.

Notes: The chart shows the disaggregated costs derived from the Council's Stand-Still analysis, planned increases in core capital investment, the implied ELS allocations from the Government's technical assumptions on these costs over the medium-term, and the total annual change in planned core spending in line with the spending rule. The green bar for 2023 shows the costs that would come from restoring the real value of services and payments by Government to account for the unexpected inflation in 2022, this is calculated as the cost of the difference between forecasts of inflation in *Budget 2022* and *SPU 2022*, with these costs added on to 2023 levels.

These dynamics are illustrated in Figure 2.5, where a more granular breakdown of the spending pressures facing Government over the medium-term is presented. Price pressures across both pensions payments and the public sector wage bill would make the largest contributions towards the increases in spending if some form of across-the-board indexation were to take place.

This would significantly reduce the room for manoeuvre within the Government's spending limits implied by the expenditure rule, while it would also represent a considerable injection of cash into the economy at a time of rising prices. The Government could still achieve the same budgetary targets and accommodate these Stand-Still costs if it reduced other spending programmes or raised taxes elsewhere. However, fully indexing parts of current spending — as the Stand-Still approach implies — would require some caution as it would potentially contribute to further price and wage rises in the economy

Figure 2.5 shows the role for planned capital increases in the overall expenditure limits generated by the spending rule. If these yearly increases in core capital spending were to be scaled back, this would create more space for other spending but risks tackling issues like housing or climate change, and should be avoided, particularly so as rising prices are already likely.

Box D: The Stand-Still approach and the Government's medium-term spending estimates

In recent forecasting rounds, there has been progress on the methodologies employed by the Department of Finance to project spending by Government departments.

The Department of Finance has made welcome progress towards more accurately incorporating the costs of maintaining existing levels of service in real terms, something the Council had recommended for many years. Such an approach is broadly in line with that the Council itself has developed with its Stand-Still methodology.

This box outlines in broad terms both the methodology used by the Council and the available details on the "Existing Level of Service" (ELS) approach used by the Department, noting where improvements to the latter could be introduced.

The Stand-Still approach of the Council

In 2018, the Council developed an approach to projecting medium-term spending pressures it named the Stand-Still scenario. This was motivated by the necessity to produce realistic estimates of the cost of maintaining the prevailing level of public services and benefits in real terms over the medium-term that would allow for expected price, wage and demographic pressures.

The Council's approach as part of its Stand-Still analysis makes explicit assumptions regarding the path of government spending through channels such as public sector pay increases, the indexation of benefits such as jobseeker's allowance and pensions payments, and the costs to the government of providing services like healthcare (Table D1). These assumptions allow for a full passthrough of price pressures to government spending and offer an illustration of the extent to which maintaining the real value of government spending can use much of the perceived fiscal space generated by growth in the economy.

The "ELS" approach

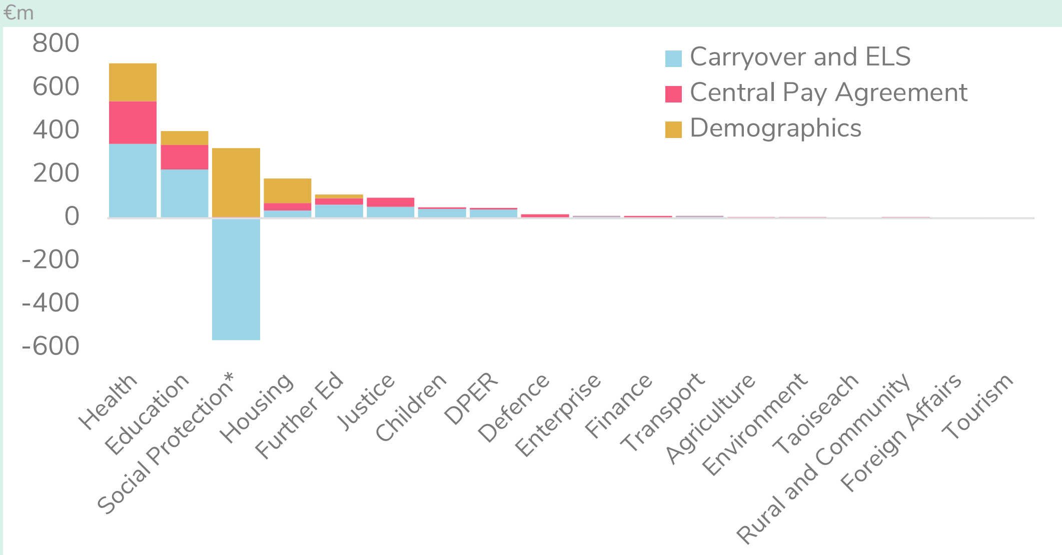
After years in which medium-term forecasts for government spending were based on arbitrary growth rate assumptions, following repeated calls from the Council to move towards a Stand-Still methodology, the Government has recently adopted a new approach, which it refers to as the "ELS". This approach, which is similar in principle to the Council's Stand-Still, provides disaggregated accounts for the year ahead of the factors affecting the provision of the same levels of services; public sector pay increases, costs associated with changing demographics, and 'existing levels of services' along with annual amounts carried over (Figure D1).

Table D1: Select drivers of the Stand-Still approach

	Demographic	Price
Health spending	Cohort-specific projections for service use	Wage growth / GNP +1%
Pensions payments	Projections for cohort age 66+	Wage growth
Unemployment benefits	Unemployment levels	Wage growth

Notes: The Council's current Stand-Still approach forms part of its broader Long-term model. Details on the wider methodology employed can be found here. The above table is not an exhaustive list of the modelled costs as part of the Long-Term Model and is provided here only to illustrate the generalised way in which costs are modelled,

Figure D1: Departmental ELS, demographics, and public pay allocations for 2022 in Budget 2022



Source: *Budget 2022*
Notes: *The decrease in carryover and ELS costs associated with social protection spending reflects the projected fall in unemployment in 2022.

This approach is useful by providing clarity on the expected real levels of spending, disaggregated overall spending at the Government level, and more realistic expectations of the growth rate of spending to harmonise with the Government's new spending rule.

Greater detail on the medium-term path for ELS spending is required

While *Budget 2022* outlined the assumed costs for maintaining the Existing Levels of Services (ELS) in 2022, there were only indicative allocations showing total "allocated" and "unallocated" amounts based on technical assumptions for 2023-2025. This supported a projection for overall spending in line with the Government's 5% rule and broadly sufficient to cover Stand-Still costs in total, although the "allocated" part was less than the Stand-Still estimates imply.

While this is an improvement, without details on the assumed costs of the main spending drivers, there is little sense as to the Government's policy priorities over the medium term, including the extent of indexation in areas such as pensions payments and unemployment benefits. These factors also have important implications for the effective implementation of the new spending rule, explored in greater detail in Box I. Moreover, for consistency, the results of the ELS approach should be incorporated into the broader macro forecasts over the medium-term. Further moves towards institutionalising the budgetary framework in this regard would also shed light on the assumed costs of major drivers of public spending over the medium term and help improve focus on medium-term budgeting.

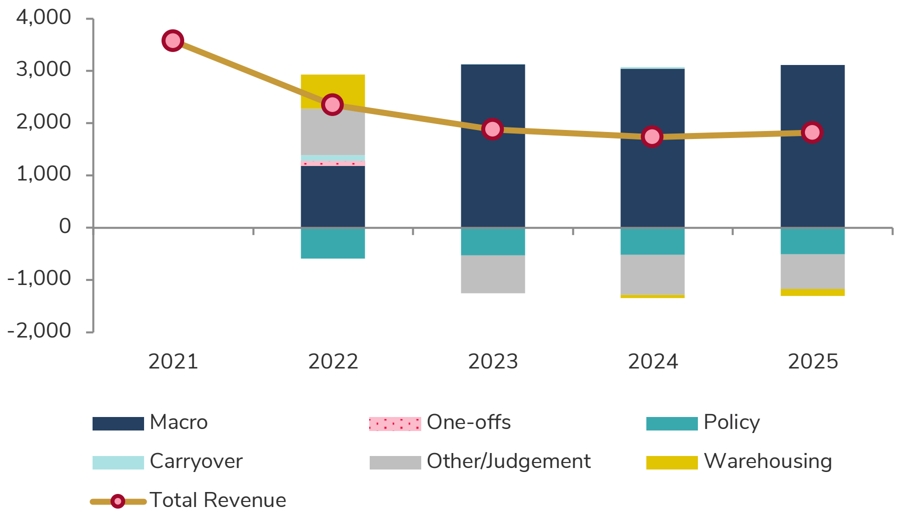
2.4 Tax forecasts

In general, forecasts of tax receipts have been revised up since *Budget 2022*. Much of this is due to the higher inflation environment. Box E examines the impact higher nominal levels of macroeconomic drivers could have on government revenue in the coming years.

Tax forecasts can be decomposed into several factors, growth in macroeconomic drivers, policy changes, one-off effects, and judgement applied to the forecasts. Supplementary information section S5 shows a breakdown of the various factors contributing to *SPU 2022* forecasts of tax receipts.

Figure 2.6 Income tax forecasts assume a permanent upward shift from 2022

€ million, year-on-year change



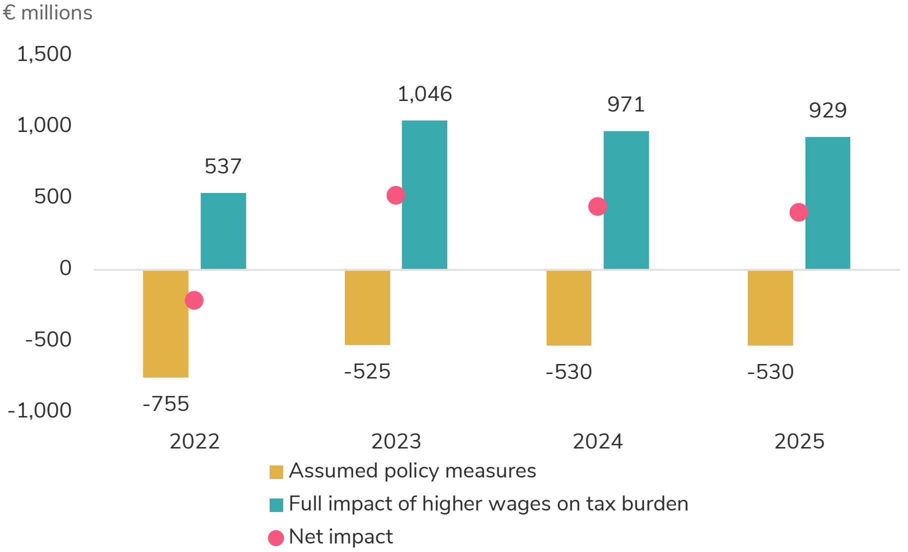
Sources: Department of Finance; and Fiscal Council workings. Get the data.
Notes: This chart shows the decomposition of combined USC and PAYE receipts, which makes up more than 84 per cent of income tax receipts

Income tax forecast to perform strongly

Income tax receipts are projected to grow strongly, driven by the macroeconomic environment (see Figure 2.6). Strong growth in hourly pay and employment will lead to an increase in receipts over the forecast period. Nonetheless, income tax receipts for this year have been scaled up by €800 million (positive judgement) in order to take into account changes in labour income composition. This is reversed in the later years, with approximately €700 million of negative judgement applied in each year. Box B and Timoney (2022) use a bottom-up sectoral approach to income tax forecasting that suggests that the current strength of income tax would continue if the higher paid sectors continue to do relatively well.[47]

A partial indexation of income tax bands and credits is assumed for SPU forecasts. This equates to around €500 million in policy changes for each year. This would have the effect of mitigating the tax burden as incomes grow (Figure 2.7).[48] If nominal wages were to increase more rapidly due to high inflation, this would imply a larger increase in effective tax rates as more income moves into higher tax brackets unless more significant policy changes were made.

Figure 2.7: Assumed Income tax policy changes would mitigate the increase in the tax burden through partial indexation



Sources: Department of Finance; and Fiscal Council workings. Get the data.
Notes: A net impact greater than zero indicates that assumed policy changes are less than the assumed yield from not indexing income tax bands and credits. As a result, income tax revenue would be higher than if full indexation of the income tax system were assumed. The cost of indexation for 2022 is given by Department of Finance estimates. 2023-2025 figures are derived using Revenues "ready reckoner", alongside Department of Finance forecasts of hourly earnings growth.

Forecasts of corporation tax have been subject to some negative judgement. The projection for this year has been trimmed by about €300 million, under the assumption that the extra profits associated with the pandemic are unlikely to be repeated.

[47] A further motivation for this judgement is to keep the income tax to compensation of employee's ratio from rising further.
[48] SPU 2022 forecasts of hourly nominal wage growth are used to calculate cost of fully indexing income tax bands and credits.

Some one-off factors are influencing forecasts for 2022 and 2023.[49] Over the 2023-2025 period, negative judgement is applied reflecting the impact of the changing international corporation tax landscape. This is assumed to amount to €1 billion in 2023, with a further €500 million in 2024 and 2025, although no detailed explanations were given as to how these figures were arrived at.

The Department's estimated overall impact of €2 billion due to the reforms is unchanged since January 2020. In the meanwhile, corporation tax receipts have grown by €4.4 billion (41 per cent). As a result, the €2 billion impact is a much smaller share of corporation tax receipts than was the case when it was originally estimated. €2 billion was 18.4 per cent of 2019 receipts, it is 13.1 per cent of 2021 receipts. While it remains unclear whether the global reforms will pass and how the international tax environment may change, it now seems likely that reforms will not be until 2024, rather than 2023.

More detail is need on the economic and fiscal impact of corporation tax reforms

Moreover, the size of the policy-induced adjustment applied by the Department is much lower than Council estimates of "excess" corporation tax receipts of €6-9 billion (see Box G). This implies that most of the recent growth in corporation tax is expected by the Department to carry over through the entire forecast period.

On the other hand, *SPU 2022* does not include any extra revenue from an increased rate of corporation tax.[50] If the tax base were to remain unchanged, the gain could be substantial. However, the higher rate could prompt greater efforts to avoid the tax. Furthermore, this could impact the tax base of the multinational sector on a much larger scale if firms were able to shift profits elsewhere. Nonetheless, given that Ireland's corporation tax rate will remain relatively low, including relative to the various rates currently applied to the income of US multinationals, it is not clear that firms would have a strong incentive to repatriate these activities.

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[49] Overall, one-off factors are deemed to have no impact on the growth of corporation tax receipts in 2022. The level of 2021 receipts were boosted by €330 million (+€780 million from one-off settlement payments and -€450 million in CRSS payments). 2022 receipts are also forecast to be boosted by a one-off payment (€300 million). As a result, growth in CT receipts in 2023 is lower as this falls out of the base.

[50] As part of *Budget 2022*, a new corporation tax rate of 15 per cent for firms with a global annual turnover in excess of €750 million. It is expected that this change will take effect from 1 January 2023.

Excise receipts are forecast to grow strongly, driven by two factors. Firstly, strong consumption growth. Secondly, the rate of carbon tax is assumed to increase throughout the forecast horizon. This contributes an additional €155 million in revenue each year on average over 2023-2025.

Box E: The impact of inflation on government revenue

This box examines the impact the of revisions to projections of inflation and real growth would imply for government revenue. The box focuses on three main (nominal) macroeconomic drives: personal consumption, compensation of employees, and Building and Construction activity (B&C). Forecasts published in *SPU 2022* give updated forecasts of these variables in nominal and real terms. Hence, the revisions compared to *Budget 2022* represent the shock we use to estimate the potential impacts on three main tax aggregates, namely Income tax, Social Contributions, and VAT. Table E1 shows the revisions to nominal growth rate forecast for each of these variables.

Table E1: Forecasts of nominal growth and inflation have been revised up significantly

Revisions to annual percentage growth rates (*SPU 2022* – *Budget 2022*)

	2022	2023	2024	2025
Nominal compensation of employees	3.8	1.9	1.0	0.7
Nominal personal consumption	-0.4	1.1	0.3	-0.1
Nominal building and construction	8.1	1.6	1.2	-0.5
HICP inflation rate	3.8	1.1	0.1	-0.1

Sources: Department of Finance and Fiscal Council workings.
Notes: Revisions are clalculated as *SPU 2022* forecast growth rate - *Budget 2022* forecast growth rate.

This exercise focuses on the nominal growth rates for these variables, as that is what is relevant for forecasting government revenue. Forecasts of nominal variables combines forecasts of real rates of growth, along with forecasts of inflation. While forecasts of inflation have been revised up, some real growth rates have been revised down at the same time. For example, personal consumption inflation is generally higher and nominal consumer spending is higher in most years, apart from 2022 when the contractionary effect on real consumption more than offsets the upward revision to inflation

For this exercise, to isolate the impact of inflation on revenues, it is assumed that no policy changes occur in response to the inflation shock. For example, there is no widening of income tax bands or credits to offset the higher tax burden associated with increasing nominal levels of pay.

As can be seen in Table E1, growth in the nominal compensation of employees has been revised up since *Budget 2022*. This stronger nominal growth leads to higher income tax and social contributions. The elasticities used for income tax, VAT and social contributions are in line with those estimated in Conroy (2020). For income tax an elasticity of 1.4 is assumed, while for social contributions (PRSI) an elasticity of 1 is used. VAT receipts respond to changes in the nominal growth of consumption (with an elasticity of 0.8) and B&C activity (with an elasticity of 0.2).

Table E2 shows the government revenue implications of the upward revisions to nominal growth of the relevant macroeconomic variables. The main impacts from higher nominal macroeconomic drivers would come through income taxes and social contributions. Smaller impacts are seen through indirect taxes (VAT). Overall, the stronger nominal growth implies higher government revenue. These estimates suggest that government revenue would be between 0.8 and 1.9 percentage points higher as a share of national income due to the higher inflation under the assumption that there are no changes in tax policy, including no indexation of income tax bands. However, the Programme for Government commits to indexation if wages are growing. The *SPU*

2022 forecasts incorporate a partial indexation of the income tax system, which entails some mitigation of the income tax burden over the forecast horizon.

Table E2: Higher inflation and real growth yields increased government revenue

€ million unless otherwise stated

	2022	2023	2024	2025
Nominal impact:				
Income Tax	1,425	2,345	3,008	3,601
Social contributions	613	984	1,232	1,441
VAT	202	425	546	552
Total	2,024	3,526	4,559	5,365
Total (% GNI*)	0.8	1.4	1.7	1.9

Sources: Department of Finance and Fiscal Council workings.

Notes: Real compensation of employees is defined here as nominal CoE deflated by HICP.

In *SPU* 2022, official forecasts of government revenue have been revised upwards compared to Budget 2022. Table E3 shows the revisions to the three main tax headings considered. These figures have been adjusted for the better-than-expected 2021 outturn. The reported results look broadly in line with estimates given in Table D2 above.

Table E3: Government projections of revenue have been revised up

SPU 2022 forecast minus *Budget* 2022 forecast (adjusted for 2021 outturn), € million

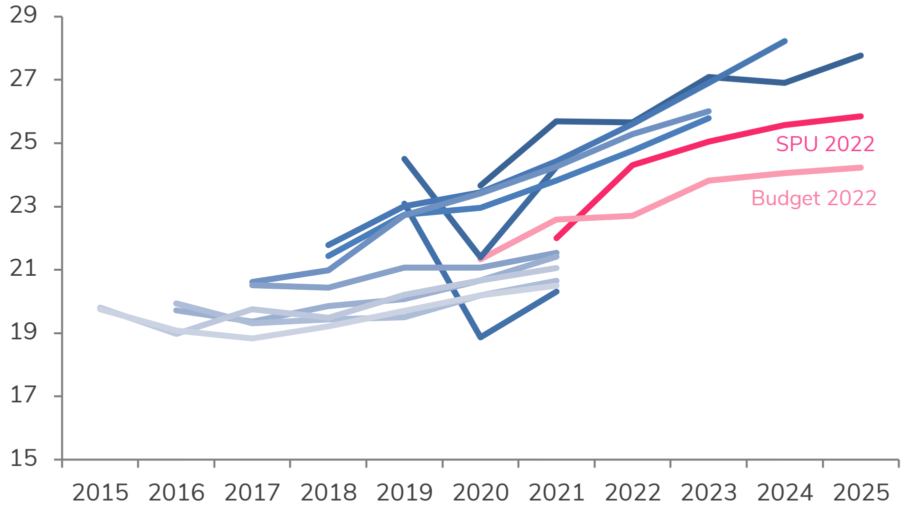
	2022	2023	2024	2025
Income Tax	1,325	1,790	1,935	2,205
Social contributions	509	769	1,379	1,639
VAT	835	910	750	685
GG Revenue (excluding CT)	3,859	3,649	3,994	4,099
GG Revenue (excluding CT) (% GNI*)	1.6	1.4	1.5	1.4

Sources: Department of Finance and Fiscal Council workings.

Notes: Outturns for 2021 were higher than forecast, which leads to a higher level when forecasting 2022. As a result, this table shows the upward revision, excluding the impact of the higher starting point (2021). The values given are the revision (i.e. SPU – Budget) minus the overperformance in 2021 relative to Budget 2022 forecasts. This is equivalent to SPU 2022 – Budget 2022 –(Outturn 2021-Budget forecast of 2021).

Figure 2.8: The level of non-tax GG revenue has been revised up since Budget 2022

€ billion



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

Notes: Non-tax General government revenue here is defined as General Government Revenue minus General government taxes. General government taxes are made up of Taxes on production and imports, Current taxes on income and wealth and Capital taxes.

The factors driving the upward revision in the forecast of non-tax revenue remains unexplained. The Government receives around 23 per cent of revenues from non-tax sources. Figure 2.8 shows various vintages of projections of non-tax general government revenue. *SPU 2022* projections are significantly higher than those made in *Budget 2022*. As was highlighted in Fiscal Council (2021b), the *Budget 2022* projections looked low relative to previous projections. It was also highlighted that “This is an area where there is limited detail in budgetary projections”. Unfortunately, this remains the case, and hence it is difficult to explain why the forecast level has been revised back up.

2.5 Capital spending

Capital spending has been revised down

As outlined in Section 2.3, capital spending in 2021 was lower than forecast in *Budget 2022*. In general government terms gross fixed capital formation in 2021 was €932 million lower than forecast in *Budget 2022*.[51] On a general government basis, capital spending fell slightly compared to 2020.

Conroy et al. (2021) highlighted that there may be challenges in ramping up public capital spending as quickly as is projected in the National Development Plan. While some pandemic restrictions may be responsible for spending shortfalls in the past couple of years, more general issues around capacity constraints (particularly in the construction sector) may be playing a key role.[52]

Table 2.4: Government projections of capital spending revised down

General government gross fixed capital formation, € million

	2021	2022	2023	2024	2025
SPU 2022	8,498	10,630	11,820	12,695	13,815
Budget 2022	9,430	11,365	13,300	14,395	15,225
Revision	-932	-735	-1,480	-1,700	-1,410
Revision (% GNI*)	-0.4	-0.3	-0.6	-0.7	-0.6

Sources: Department of Finance and Fiscal Council workings. Get the data.

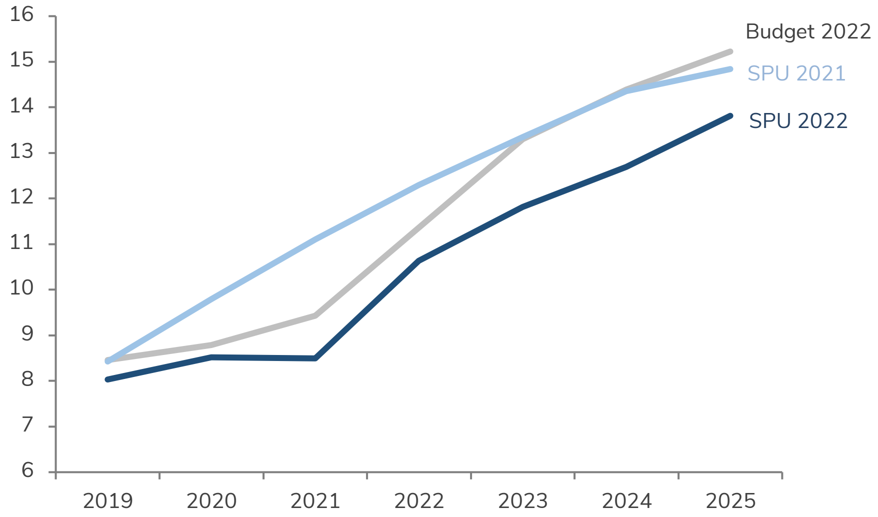
The shortfall in capital spending recorded in 2021 is projected to widen over the medium term (Table 2.4). However, these downward revisions are not mirrored in the projections of gross voted capital spending for 2023-2025, which are unchanged from *Budget 2022* forecasts. This suggests that non-exchequer capital spending is now expected to rise more slowly. Given the long-term nature of the capital plan, it is surprising that such large revisions are occurring in the Government investment projections at relatively long horizons.

[51] General government GFCF for 2020 was also revised down, but by a lesser amount (€269 million). Gross voted capital expenditure for 2021 was €505 million lower than forecast in *Budget 2022*.

[52] Section 1 highlights labour supply as a potential constraint in the construction sector.

Figure 2.9: Capital spending revised down in cash terms

€ billions, General Government GFCF

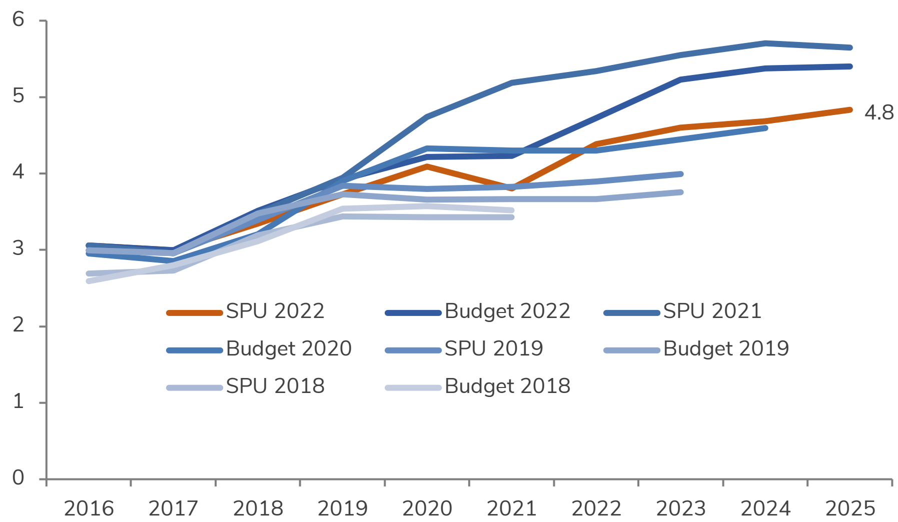


Source: Department of Finance. Get the data.

Despite the downward revisions, SPU capital spending plans as a share of national income are high by historic and international standards (Figure 2.10). As outlined in Conroy et al. (2021), in OECD countries, public investment has tended to range between 3 and 4 per cent of national income.

Figure 2.10: Capital spending revised down as a share of national income

Percentage of GNI*



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

Gross voted capital spending is a measure of capital spending used by government Departments. It is a looser definition of capital spending than

Gross Fixed Capital Formation — the definition in the National Accounts which is compiled by the CSO.[53] While the latter definition refers to the acquisition of assets to produce goods, the essential principle underlying gross voted capital spending is that this spending contributes to the "built environment". However, recent practice has highlighted deficiencies in what is considered capital expenditure under this heading. For instance, the recent €200 electricity credit paid by the Department of the Environment, Climate and Communications has been classified as gross voted capital spending, despite the fact that this measure does not contribute to the enhancement of any infrastructure, either for households or the government.

In response to a question the Council had on why the €200 electricity credit was included as gross voted capital expenditure, the Department of Public Expenditure and Reform said the following:

> "While the credit is not associated with the initial development of infrastructure by energy companies, the grant contributes to the built environment through supporting households to access the benefits of the related infrastructure."

This reasoning appears too broad. Many other transfers to households would fit this definition but would not normally be considered capital spending.[54]

[53] For further information on Gross fixed capital formation, see: https://www.cso.ie/en/interactivezone/statisticsexplained/nationalaccountsexplained/capitalformationandfixedassets/. Gross voted capital expenditure is looser in terms of what spending is considered capital. In addition, it is not a measure that covers the entirety of general government capital spending. For instance, capital spending that local authorities undertake, that is not funded by voted government grants, is not included.

[54] For instance, the Fuel Allowance, or the Housing Assistance Payment also support "households to access the benefits of the related infrastructure". These are not classified as capital spending but would appear to fall under the scope of this definition.

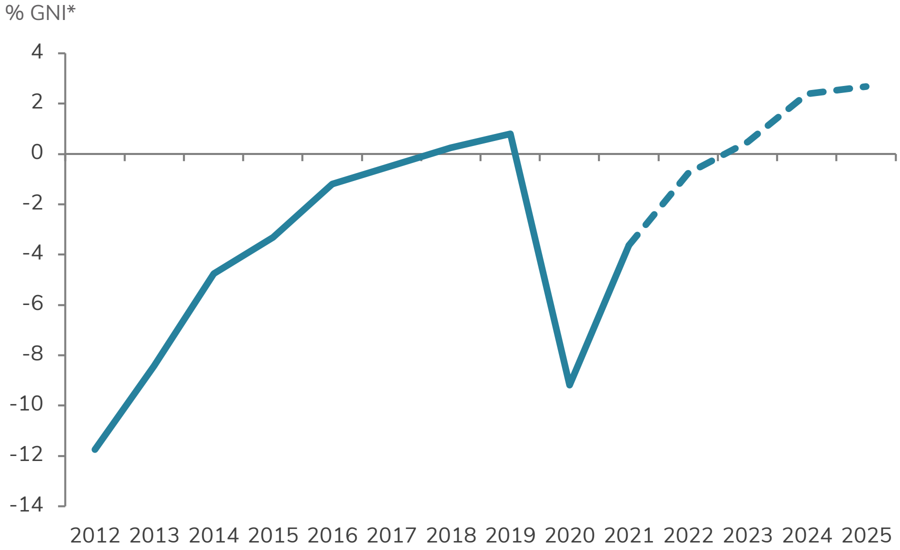
2.6 How the public finances are forecast to evolve

Public finances set to improve

To give a perspective on the underlying dynamics of the public finances over the medium term, Table 2.5 below compares the *SPU 2022* forecast of the level of several fiscal variables in 2025 to the last outturns before the pandemic (2019) as way of "looking through" the impact of the pandemic.

Overall, the general government balance is projected to improve significantly (Figure 2.11). From 2019 to 2025, a €5.9 billion improvement is forecast (1.9 per cent of GNI*). Strong tax growth and falling interest payments more than offset increases in public investment and current spending.

Figure 2.11: The Government's budget balance is forecast to reach surplus in 2023



Sources: CSO and SPU 2022 projections. [Get the data.]
Note: Dashed line indicates SPU 2022 forecasts.

The main feature over this period is the 72 per cent growth in public investment spending (rising by 9.5 per cent annually, on average). The nominal increase in public investment amounts to €5.8 billion, thus uplifting its share in national income to almost 5 per cent.[55] Despite this push in public investment, overall spending is expected to fall as a share of national income. Interest spending is forecast to decrease in nominal terms (and hence even more so as a share of national income). Current primary

[55] While this increase is large, it is noted earlier in the Section that this is a more modest increase than was forecast in *Budget 2022*.

spending is forecast to grow at an average annual rate of 4.6 per cent, which leads to a slight fall as a percentage of national income.[56]

Table 2.5: Comparing 2019 and 2025

Difference 2025 – 2019

	p.p change in GNI*	€ billion change	% Change	Annualised growth rate
GG Revenue	1.4	32.6	37.1	5.4
Tax Revenue	3.7	29.8	50.3	7.0
Non-tax revenue	-2.3	2.8	9.8	1.6
Income tax	1.8	12.7	55.4	7.6
Corporation tax	1.4	7.5	69.1	9.1
VAT	0.5	6.3	41.5	6.0
Other tax revenue	0.0	3.3	32.0	4.7
GG spending	-0.5	26.7	31.0	4.6
Gross Fixed Capital Formation	1.1	5.8	72.0	9.5
Interest	-1.1	-1.6	-35.3	-7.0
Current primary spending	-0.5	22.6	30.7	4.6
GG Balance	1.9	5.9		
Level of GNI*		70.2	32.6	4.8

Sources: CSO, and *SPU 2022*. Get the data.

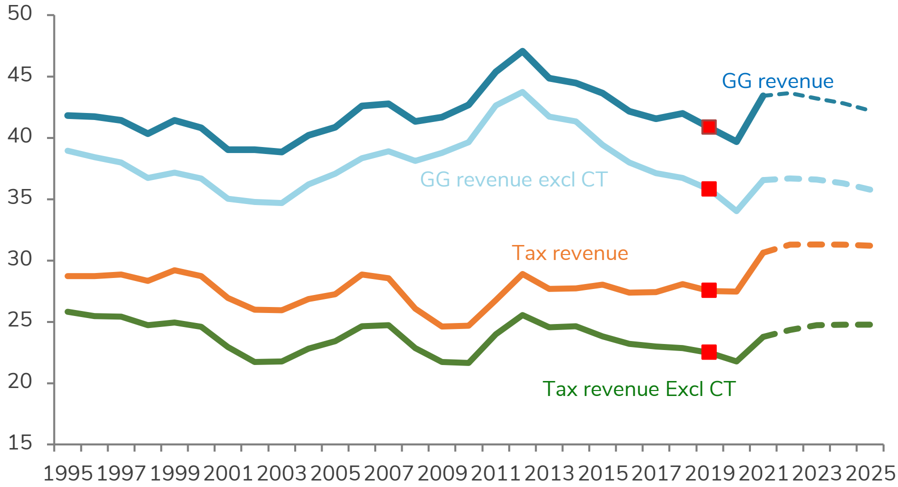
Notes: Changes are in the format 2025 level minus 2019 level. As a result, positive values indicate a variable increasing over the period or taking up a larger share of GNI* than was the case in 2019. The annualised growth rate shows what rate of growth applied for every year from 2019 would yield the 2025 level forecast in *SPU 2022*.

On the revenue side, tax revenues would rise primarily because of strong nominal growth, but some tax headings are forecast to grow even faster than GNI*. Income tax sees the biggest increase both in nominal terms (€12.7 billion) and as a share of national income (1.8 percentage point increase in GNI*). Timoney (2022) addresses sectoral and compositional issues surrounding income tax. Corporation tax contributes over 20 per cent of the total revenue increase, a large share from an uncertain source. The corporation tax increase is larger than the increase in public investment. By 2025, general government revenue is expected to climb above its 2019 share of national income (Figure 2.12). However, if corporation tax were excluded, the two shares would be equivalent.

[56] The most significant spending pressures due to an ageing population are likely to arise after 2025 (Fiscal Council, 2020).

Figure 2.12: GG Revenue to remain above its 2019 share of GNI*

Revenue as a share of nominal GNI* (per cent)



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

Notes: Red dots show the 2019 levels.

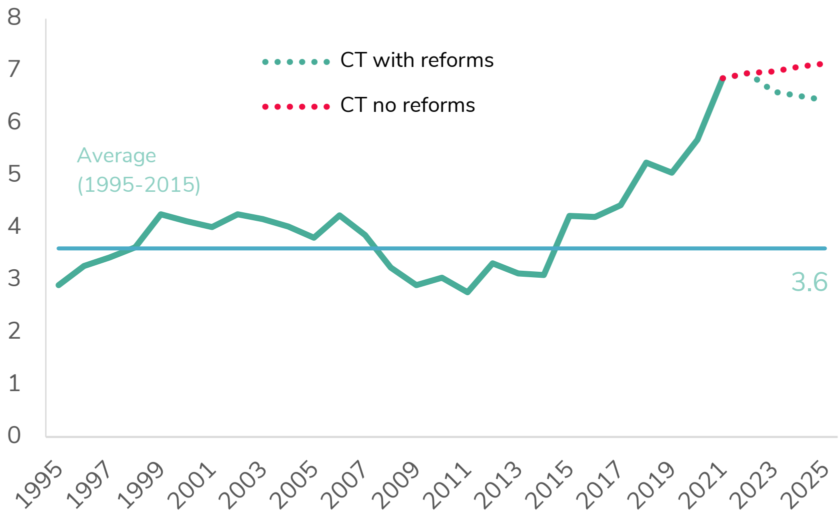
2.7 Increasing reliance on Corporation Tax

Corporation tax revenue has grown substantially in recent years. Corporation tax revenue is now almost 7 per cent of national income, roughly twice its long-term average of 3.6 per cent (Figure 2.13). As recently as 2011, corporation tax was only 2.8 per cent of national income.

Corporation tax now accounts for more than a fifth of all tax receipts

Figure 2.13: Corporation tax to remain high as a share of national income

Corporation tax (per cent share of GNI*)



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Note: The "with reforms" series shows how the corporation tax share is forecast to evolve in *SPU 2022* (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 2022* (hence increasing CT relative to *SPU 2022* forecasts).

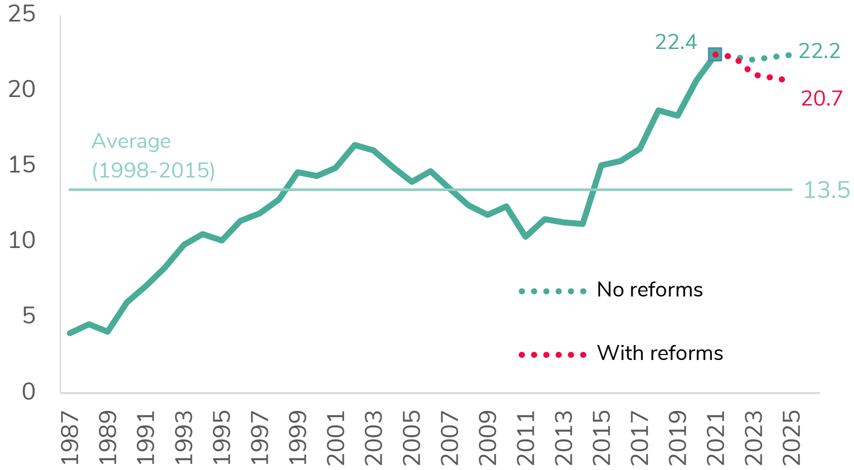
As a result, the reliance on corporation tax receipts used to fund recurring spending has also grown. In 2011, corporation tax accounted for 10.3 per cent of exchequer tax revenue, but this has risen to 22.4 per cent by 2021 (Figure 2.14).

The Department of Finance assumes a cumulative €2 billion hit to corporation tax receipts due to the BEPS reforms over 2023-2025. However, as discussed above, this estimate is surrounded by a high degree of uncertainty.

Yet, despite this downward revision, the overreliance on corporation tax is set to continue (Figure 2.14). The share of corporation tax in exchequer revenue is expected to remain above 20 per cent over 2023-2025. This is over 7 percentage points above its long run average.

Figure 2.14: 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. Get the data.

Note: The "with reforms" series shows how the corporation tax share is forecast to evolve in *SPU* 2022 (which incorporates impacts from 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* 2022 (hence increasing CT and total tax receipts relative to *SPU* 2022 forecasts).

While current forecasts do predict some reduction in reliance on corporation tax receipts, there are risks that Ireland's reliance on these receipts may continue to grow. A delay in implementing BEPS Pillar one reforms could see upside risks to the short-term forecasts for corporation tax. A further potential upside to the current corporation tax forecasts is the increase in corporation tax rate from 12.5 per cent to 15 per cent under BEPS Pillar two reforms.[57] The Department have not yet factored in any impact of this reform into its forecasts for corporation tax revenue.

However, this over-reliance on corporation tax receipts entails increasing risks.[58] As Box G notes, corporation tax receipts are highly volatile and concentrated. Moreover, a large proportion of receipts cannot be explained by underlying economic activity in Ireland. Box G also highlights how this overreliance on corporation tax can be reduced overtime.

[57] Based on figures from the Revenue Commissioners, 61 corporate groups in Ireland in 2018 had worldwide revenue greater than €750 million, which is the qualifying threshold to be liable for this 15% rate (Revenue, 2022).

[58] As a recent Fiscal Council analytical note points out, these large increases in corporation tax receipts have been used to fund overruns in health spending (see Casey and Carroll, 2021)

2.8 Debt ratio to fall quickly despite higher interest rates

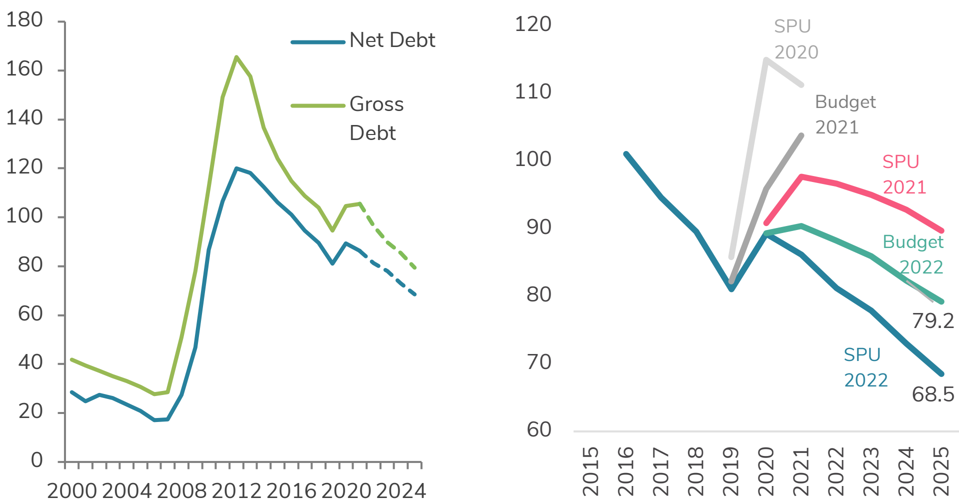
Debt dynamics are favourable over the medium term

The gross debt-to-GNI* ratio peaked at 105.6 per cent of GNI* at the end of 2021 (Figure 2.15). For 2022, it is expected to fall by 9.1 percentage points due to high nominal growth, despite the forecast deficit. The gross debt ratio is forecast to fall steadily in the following years by on average 5.7 percentage points over 2023-2025. By 2025, the gross debt ratio is expected to be below 80 per cent of GNI*.

Figure 2.15: Debt to fall as a share of national income

A. Debt on a downward trajectory
General government debt (% GNI*)

B. Downward revisions to net debt
% GNI*



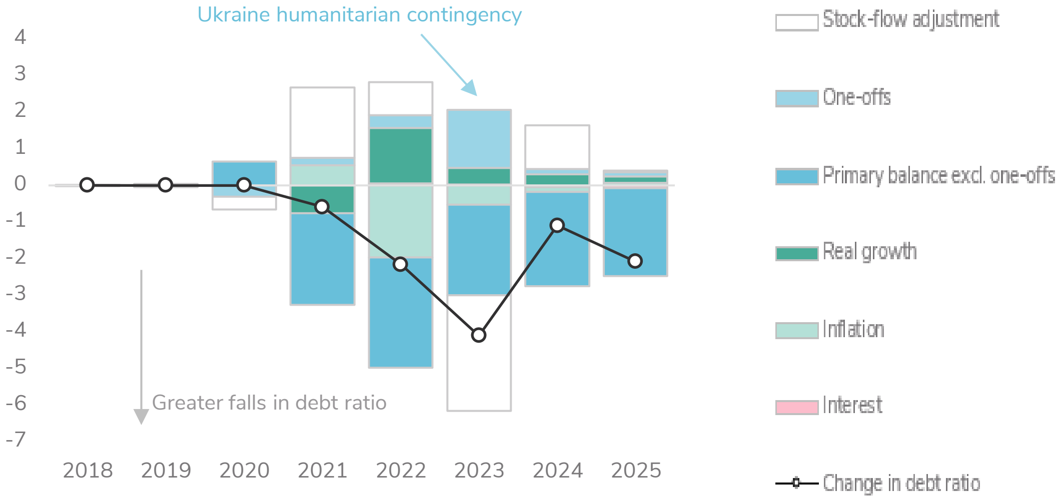
Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.

The net debt ratio has been revised down over the course of recent forecasts (Figure 2.15B). A year ago, *SPU 2021* forecast a net debt ratio of 89.7 per cent by 2025. This was revised down to 79.2 per cent by budget time, and further revised down to 68.5 per cent in the most recent *SPU 2022* forecast.

Compared to Budget time, the debt dynamics have improved (Figure 2.16). This is mainly due to the better primary balance now expected. Otherwise, the debt-reducing effect of higher inflation is offset by weaker real growth and the impact of stock-flow changes largely balances out over time.

Figure 2.16: Revisions to gross debt due to larger surpluses

GNI* p.p., decomposition of *revisions* to the gross debt ratio since Budget 2022



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: The right-hand panel shows a decomposition of the changes in the gross debt ratio since Budget time. It is not possible to fully isolate each of the underlying factors of the changes in the debt ratio, such as inflation, interest payments, growth, and the primary balance, into a clean additive decomposition (the interest and inflation terms are not independent). This decomposition is based on the following equation: $d_t - d_{t-1} = \frac{i_t}{1+n_t} d_{t-1} - \frac{\pi_t}{1+n_t} d_{t-1} - \frac{g_t}{1+g_t} d_{t-1} - p_t + sf_t$, where d_t is the debt ratio, i_t is the average nominal interest rate on the government debt, g_t is the real growth rate of GNI*, n_t is the nominal growth rate of GNI*, π_t is the GNI* deflator, p_t is the primary balance as a share of GNI*, and sf_t is the stock-flow adjustment as a share of GNI*.

Interest rates on government bonds have risen rapidly in past months, up from around zero per cent last year to around 1.5 per cent now, reflecting higher inflation and expectations of a tighter monetary policy by the ECB. The spread compared to other higher-rated euro area government debt has increased modestly alongside many other countries. While this will lead to higher interest costs over the medium-term, the Irish public finances are relatively well insulated from the direct effect of these increases. Of the €31.5 billion of fixed rate bonds due to mature by end of 2025, €26.5 billion worth of bonds have a coupon payment of 3.4 per cent or more. This means that the NTMA could roll over this debt by issuing bonds with marginally lower coupon payments, and interest costs would still fall.[59] In addition, as highlighted in Box F, Ireland has large cash balances on hand so does not need to roll over the full amount of this debt. However, interest costs will

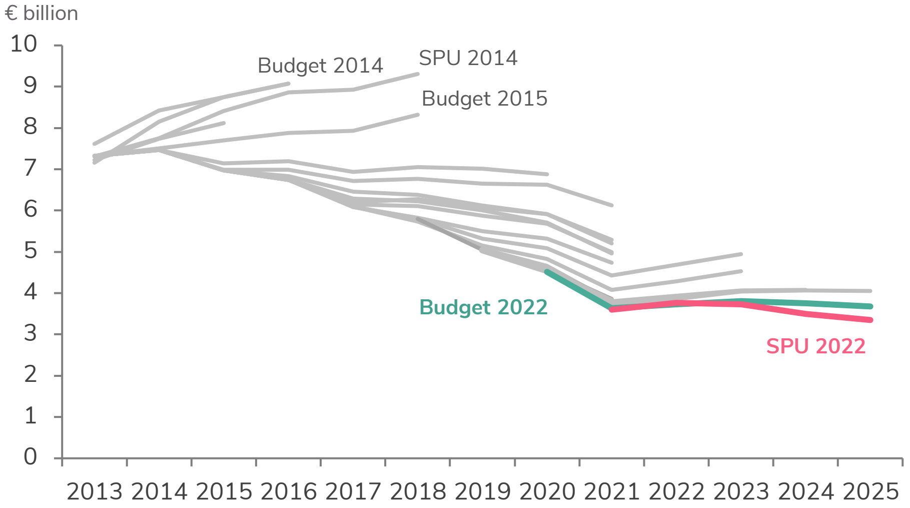
[59] While not due to mature in this timeframe, Ireland also has €1.1 billion in inflation linked bonds, and €4.5 billion in floating rate bonds outstanding. The interest payments associated with these outstanding bonds will rise the higher inflation or interest rates go, respectively. The interest rate payments for the inflation linked bonds rise in line with HICP (excluding tobacco). While the interest rate payments associated with the floating rate bonds rise in line with the Euribor rates.

still be higher than they otherwise would have been had we not seen this rise in interest rates.

Interest costs set to fall despite rising interest rates

Ireland's interest costs have been falling for years (Figure 2.17). In 2014, cash payments for interest were €7.5 billion. By 2021, interest payments were €4 billion lower at €3.5 billion. Over 2014-2021 the cumulative saving in interest payments, relative to an annual payment of €7.5 billion, is €13.5 billion. The forecasts for interest payments have continued to be revised down, with interest payments in 2025 now expected to be €330 million lower than at Budget time.

Figure 2.17: Interest payments continue to be revised down



Sources: Department of Finance. Get the data.

Notes: Figures show National debt cash interest.

Box F: Recent increases in cash balances

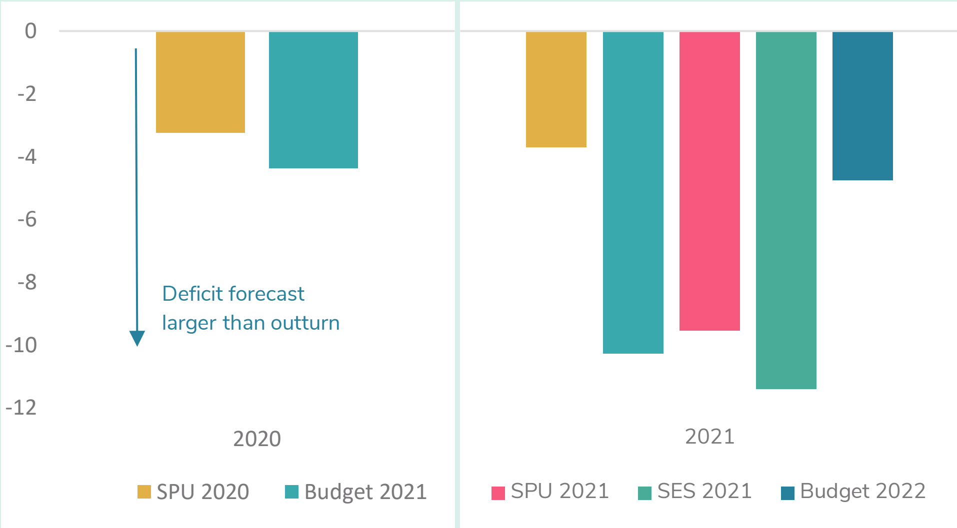
At end-March 2022, the exchequer had €29 billion cash on-hand, equivalent to 13 per cent of 2021 GNI*. This is partly due to the NTMA's strategy of prefunding future bond redemptions but also due to the Department overestimating past borrowing requirements. The larger-than-expected cash balances can be helpful in an environment of greater uncertainty and rising interest costs. However, these benefits should be weighed against the costs of maintaining these balances too.

Figure F1 shows the forecast errors for the exchequer deficit for 2020 and 2021. For 2020, the *Budget 2021* forecast was less accurate than the *SPU 2020* forecast. Despite just three months remaining in the year, the forecast error was €4.4 billion. For 2021, the *SES 2021* forecast performed the worst. Despite only having 6 months of data to forecast, the error was over €11 billion. The forecast error in *Budget 2022*, was €4.75 billion.

There has been enormous uncertainty around the forecasts over the past two years, meaning some forecast error is understandable. While the overperformance of revenue has played a significant role, the failure to revise down expenditure forecasts, both current and capital, in a timely fashion to reflect most recent data has contributed to these forecasts being inaccurate. As highlighted in Section 2.2, this failure has continued into 2022, with expenditure levels forecast to be the same as in *Budget 2022*, despite the level of "core" expenditure being €1.8 billion lower in 2021. This could lead to further forecast errors for this year's borrowing requirement.

Figure F1: Forecast for Exchequer borrowing requirement much larger than transpired

€ billion, forecast – outturn



Sources: Department of Finance; and Fiscal Council workings. Get the data.
Notes: The figure shows the forecast for the exchequer balance minus the actual outturn for the exchequer balance.

The implication of these forecast errors is that the NTMA ultimately ends up borrowing more than it would otherwise have, had the forecast been more accurate. Borrowing more than necessary ultimately comes with a cost. In particular, it leads to higher interest payments than would otherwise be the case.

The NTMA typically provides guidance on bond issuance to investors based on the government forecasts for the exchequer balance, taking into account the need for liquidity in the sovereign bond market and the current maturity profile of outstanding debt, amongst other factors. For instance, the NTMA gave bond issuance guidance for 2022 in the range of €10-14 billion based on the exchequer borrowing requirement forecast for 2022 in *Budget 2022*, of €7.7 billion. *SPU 2022* has now revised this exchequer borrowing requirement to €1.1 billion in 2022.

The flipside of borrowing more than necessary is that the Government ends up with more cash on hand. The downward revision to the exchequer borrowing requirement in the SPU resulted in the NTMA cancelling a planned bond auction in June, so that it now only plans to issue debt at the lower end of its range and does not further increase its cash balances. Despite that, there will now be more cash on hand at the end of 2022, than was planned at budget time. As highlighted above, there remains the further possibility that the borrowing requirement for 2022 turns out to be lower still than *SPU 2022* forecasts suggest.

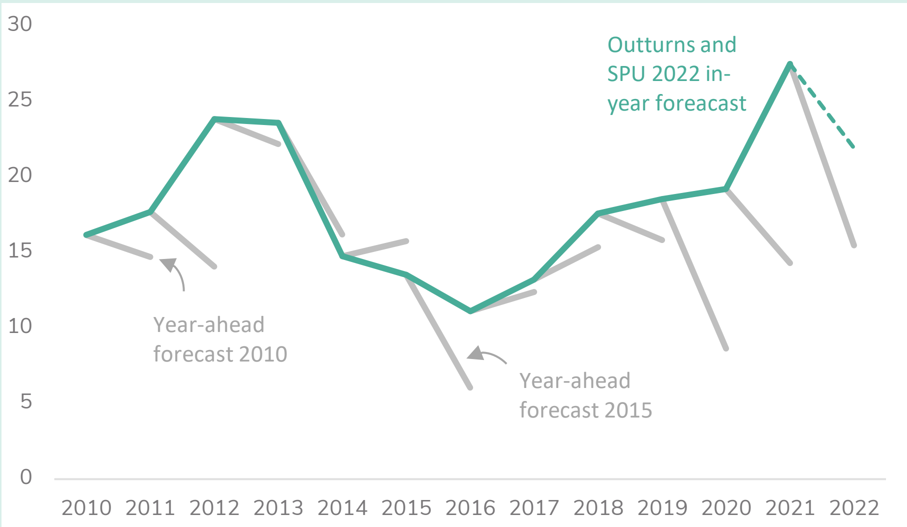
As shown in Figure F2, this additional borrowing has contributed to a run up in cash assets. The result of which is there is an almost 20 percentage point difference in the gross debt-to-GNI* ratio, which was 105.6 per cent, and the net debt ratio, which was 86.2 per cent.

There can be good reason for maintaining large cash balances during periods of uncertainty. It can also be beneficial in the face of rising interest costs. Of course, this must be weighed against the costs associated in obtaining this cash.

In the absence of large bond redemptions, unwinding large cash balances can take time. As Figure F2 shows, cash balances have been forecast to fall for some time. At end-March 2022, cash on hand was €29 billion. This compares to €31.5 billion of fixed rate bonds maturing between end-March 2022 and end 2025. With the exchequer forecast to return to surplus next year, the surpluses and the cash on hand more than cover these redemptions. However, for operational reasons, the NTMA typically needs to issue several billion euros worth of new debt each year to maintain liquidity in the market, maintain relationships with primary dealers and ensure that there is an appropriate spread of bond maturities to price the yield curve. Ireland looks set to maintain an elevated level of cash balances over the medium-term.

Figure F2: Cash balances have been higher than forecast for some time

€ billion, exchequer cash balances



Sources: CSO; NTMA, and Fiscal Council workings. Get the data.

Notes: Figures show the budget forecasts of exchequer cash balance for the following year (grey lines), relative to the outturn for cash balances (green line).

2.9 Risks to the outlook

Higher inflation, and impacts of the ongoing war pose risks to the public finances

As noted in Section 1, the ongoing war in Ukraine poses an immediate risk to the macroeconomic outlook. Higher inflation and lower real growth would have obvious negative implications for the public finances. Faster inflation does have some positive fiscal impacts via higher revenue (as shown in Box E). However, many items of government spending are also impacted by higher inflation. In addition, the government has introduced several measures to mitigate the impact of higher energy prices on households and firms.

Regarding the costs of assistance for Ukrainian refugees, there are fiscal risks in both directions. For 2023, the assumed costing of €3 billion is likely to be a conservative upper bound (Box C). However, in the opposite direction, no spending has been set aside for 2024 or 2025. While costs in these years are likely to be lower than those in 2023, there are likely to be non-negligible.

As a result of the higher inflation, policy interest rates are likely to increase significantly. While the impact on Irish government borrowing costs may be limited (due to low financing needs in the coming years), households are likely to be impacted.

Combining lower growth and higher interest rates might lead to a less favourable debt dynamics. While the consequences of these factors might be contained in the short-run, debt is still forecast to remain high in the coming years. As a result, significant changes in the interest-growth rate differential might derail the foreseen path of Irish public debt.

Any reintroduction of public health restrictions due to further waves of Covid-19 would have obvious negative implications for the public finances. Were pandemic related schemes such as the PUP, to be reintroduced, that would lead to higher expenditure.

Medium to long-term spending pressures are high

Moreover, there a number of pre-existing long-term issues that continue to pose significant risks to the Irish public finances. The costs and implementation of major policy commitments on health and climate change remain a key risk and an area of major uncertainty.

Regarding healthcare, the fiscal implications of Sláintecare remains unclear. As part of *Budget 2021*, over €1.1 billion was made available to fund the implementation of the programme, but this detail was released only several months following the publication of the Budget. Casey and Carroll (2021) outline several areas where information on health spending and planning is lacking. There is no more additional information on the remaining costs of implementing this reform.

On climate spending, detail on the economic and budgetary impact remains lacking. Several of the temporary measures which have recently been introduced could conflict with medium-term goals in transitioning from fossil fuels. These temporary measures could increase the long-term costs of transitioning to a lower-carbon economy.

While the infrastructure investments necessary to mitigate climate change appear to have included into the NDP (particularly with energy investments), other spending needs have not been addressed. This comprises current spending for incentives for encouraging changes in consumer behaviour and home energy efficiency. There is also little detail on the extent to which behavioural changes from the public are required to meet emissions targets. Should this fall short of Government expectations, further costs may be incurred. In addition, compensation may be needed for people and activities that are hit by the climate transition.

Another medium-term pressure on government spending comes from demographic change. An ageing population will increase health and pension costs (Fiscal Council, 2020). The Government's proposed auto-enrolment scheme for pensions should alleviate some of the fiscal burden from demographic change. Postponing planned increases in the pension age implies higher future spending, which will have to be met by increased taxation or reduced spending in other areas.

A key fiscal risk in the coming years is the extent to which temporary measures, particularly related to the pandemic and cost of living measures, might become permanent. Much of the improvement in the headline public finances is due to the unwinding of many temporary measures introduced to protect public health and support the economy through the pandemic. However, there are risks that these measures become permanent. For instance, the HSE has already indicated the intention to convert some temporary Covid spending into long-term spending in its budget.[60] Should these measures become permanent, and the pattern repeated across other Departments, the costs for the public finances could be substantial. Similarly, "temporary" cuts to VAT rates have proven to be quite long lasting.[61]

The Council's Stand-Still analysis shows that significant costs would arise were the Government to fully index public sector pay and social benefits. *SPU 2022* projections of spending would not be sufficient to cover these costs in full. Even if the Government decides to not fully index pay and social benefits, there is likely to be little room for new measures while remaining within the spending forecasts in *SPU 2022*.

The risks surrounding Corporation Tax receipts to the public finances in the coming years are discussed in detail in Section 2.7 and Box G.

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[60] See minutes of the Health Budget Oversight Group meeting, January 2022: https://www.gov.ie/en/collection/31f5d3-hbog-finance-subgroup-minutes/.

[61] A VAT cut to the hospitality sector was due to last two years beginning in 2011. The cut lasted just over 7 years.