Fiscal Assessment Report

May 2022

Rising prices and an uneven recovery

Irish Fiscal Advisory Council

Foreword

The Irish Fiscal Advisory Council was established as part of wider reforms of Ireland's budgetary architecture. It was set up on an administrative basis in July 2011 and was formally established as a statutory body in December 2012 under the Fiscal Responsibility Act. The Council is a public body, with the terms of its funding set out in the Fiscal Responsibility Act.

The Council's mandate is to:

- endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- assess the official forecasts produced by the Department of Finance;
- assess government compliance with the Budgetary Rule;
- assess whether the Government's fiscal stance set out in each Budget and Stability Programme Update (SPU) is conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact.

The Council's Chairperson is Mr Sebastian Barnes. Other Council members are Prof. Michael McMahon, Ms Dawn Holland, Dr Adele Bergin, and Mr Alessandro Giustiniani. The Council's Secretariat consists of Dr Eddie Casey, Mr Niall Conroy, Mr Kevin Timoney, Mr Killian Carroll, Ms Karen Bonner, and Dr Elliott Jordan-Doak. The Council would like to acknowledge the kind help from staff at the CSO, Central Bank of Ireland, ESRI, PBO, and the NTMA.

The Council submits its Fiscal Assessment Reports to the Minister for Finance and within ten days releases them publicly. This report was finalised on 30 May 2022. More information on the Irish Fiscal Advisory Council can be found at [www.FiscalCouncil.ie.](http://www.FiscalCouncil.ie)

978-1-8381309-4-7

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Macroeconomic assessment

- **The Irish economy has continued to grow strongly despite global challenges, including the Covid-19 pandemic and the ongoing Russian invasion of Ukraine. But higher inflation, driven by energy prices, has reduced expectations for real economic growth.** Uncertainty is very high and this has reduced consumer and business confidence. However, high-frequency data on consumer spending, labour demand, and tax receipts have nonetheless remained robust in recent months. The economic recovery from the pandemic, while uneven, has been faster than anticipated in official projections.

- **Downside risks to the economy over the medium-term have increased.** Higher inflation due either to further rises in energy and food prices or second-round increases of domestic wages and prices could cause additional challenges for growth. Risks of a global downturn and tighter financial conditions have increased. Ireland has a high reliance on foreign multinationals as a driver of earnings growth. Brexit could cause further disruptions to trade if there is an unwinding of the current protocol between the UK and the EU related to Northern Ireland.

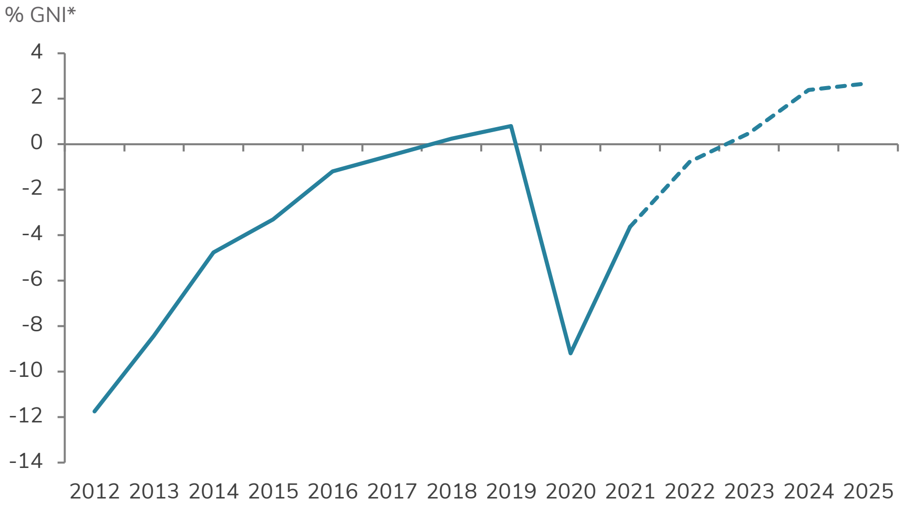
- **The *Stability Programme Update (SPU)* 2022 only projects three years ahead.** This is contrary to previous recommendations by the Council, and intentions expressed by the Department of Finance that it would lengthen the forecasting period to five years ahead. The Council believes that the parliamentary term should not affect the horizon of official macroeconomic and fiscal forecasts. Medium-term forecasting should always be undertaken to five years ahead.

Budgetary assessment

- **The Government forecasts a deficit of 0.8 per cent of GNI* in 2022.** The substantial narrowing of the deficit reflects strong revenue growth and lower one-off pandemic-related spending. The balance could ultimately be even more favourable than forecast in *SPU 2022*, with possible current and capital underspends and higher–than–forecast revenue likely, although further spending measures would tend to offset this.

- **Higher inflation means significant spending pressures exist.** Were the Government to fully offset price pressures by increasing wages and benefits, this would imply a higher level of spending than that currently forecast in *SPU 2022* both over the coming 18 months and further ahead.

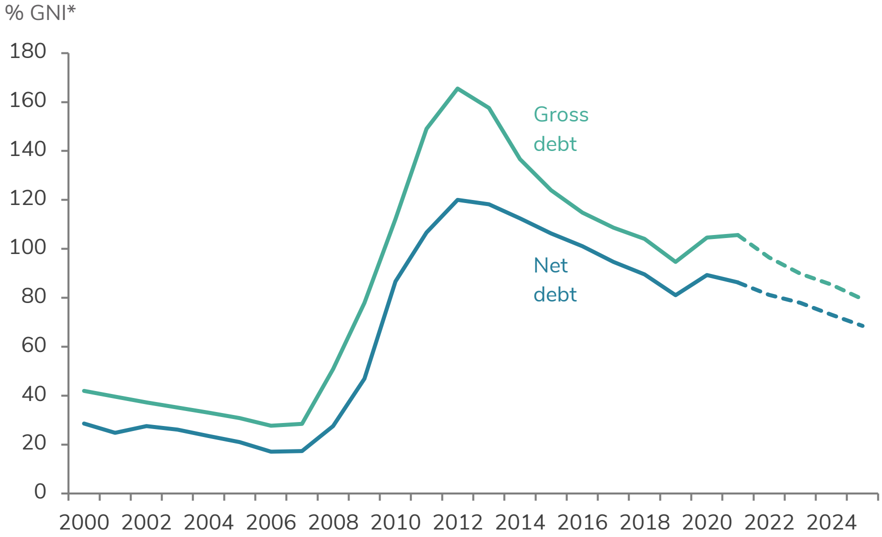
The Government's budget balance is forecast to reach surplus in 2023



- **Over the medium-term, the budget balance is set to reach a surplus in 2023 and to improve thereafter to reach a surplus of 2.7 per cent of GNI* by 2025.** This assumes that the economy continues to grow at a steady pace over the medium-term and that the Government follows its spending rule introduced in *Budget 2022* based on growing core spending in line with the underlying growth of the economy. To understand the trends in the public finances, we can compare the 2025 fiscal forecasts to 2019 to "look through" the Covid crisis. The substantial increase in public investment planned over this period is achieved while improving the budget balance due to strong growth of the economy, large corporation tax receipts, low interest costs and moderate increases in current spending, following the newly adopted spending rule.

- **Given low interest costs, strong growth and the improving general government balance, the government debt ratio is projected to fall significantly in the coming years.** By 2025, gross general government debt is forecast to be just under 80 per cent of GNI* (from 106 per cent in 2021).

Government debt is forecast to fall as a share of national income



- **Immediate risks to the public finances stem from costs associated with the war in Ukraine and spending pressures from a higher inflation environment.** Higher inflation could impact the public finances together with a slowdown in global growth and further measures to manage the higher cost of living. Of the €7 billion in contingencies for spending set out in *Budget 2022*, €2.5 billion remains unallocated. These may be spent on humanitarian assistance for Ukrainian refugees or further cost of living measures.

- **There are significant medium-term challenges**. The assumed path of government expenditure under the spending rule would allow very little room if at all for new policies. This assumes full indexation were implemented so that existing policies are maintained in real terms, though such an approach requires caution in the current high-inflation environment. Demographic change, Sláintecare reforms, costs in transitioning to a low carbon economy and defence spending are likely to be significant. Meanwhile the public finances are forecast to remain heavily reliant on Corporation tax receipts.

Fiscal Stance

- **The Government plans to stick to its 5% Spending Rule as set out in *Budget 2022*.** Core spending — excluding temporary supports, such as for Covid-19 — is set to be the same in cash terms as projected at Budget time last October. In effect, the rule is being followed such that the original allocations act as ceilings on the level of core spending.

- **Sticking to the spending rule should see the debt ratio fall at a steady pace.** Ireland entered the pandemic with a debt ratio that was already high by international and historical standards. With revenues recovering faster than expected, and the economy rebounding, sticking to the spending plans would see the Government's net debt ratio fall by about 4½ percentage points per annum on average over 2022 to 2025. Ireland's debt ratio still remains high by international standards — the ninth highest in the OECD. Reducing the debt ratio in line with these plans is appropriate to help to build a buffer so that future shocks could be cushioned by budgetary supports in a similar way to the response during the pandemic.

- **The risks around the path for the public finances are unusually wide.** Growth is highly uncertain with several downside risks, including from the war in Ukraine, Brexit, and the impact of price inflation on the domestic and global economy. In addition, further pressures to provide additional temporary fiscal supports are likely, given the sectoral impacts of both the pandemic and Russia's war on Ukraine. The space for funding new current spending initiatives on a sustainable basis without tax increases or spending reductions elsewhere is very limited.

- **The Government has some scope to introduce additional temporary measures this year.** Some €2.5 billion of the contingencies set out for 2022 remains unallocated. These may be used for supports for Ukrainian refugees and measures on the cost-of-living targeted at those on lower incomes and most severely affected by higher prices.

- **This year, the Government has some space to introduce spending increases and adjustments to wages and welfare rates to reflect unexpected inflation, but it will have to make some choices.** The unexpected inflation in 2022 is likely to mean cuts in real terms to the value of welfare payments, public sector pay, and to various public services. This is due to increases set out in last October's Budget not having anticipated the scale of wage and price rises. Allowing for full indexation — tracking price and wage rises with welfare and public sector pay rates — could require another €2 billion in core spending increases. If introduced in October's Budget, along with other planned increases, this would push spending increases beyond both the *SPU* 2022 plans and the Government's current ceiling. Recent underspends could create some additional space if these continue. Taken together, the Government may face difficult choices between maintaining the real value of public services and supports, sticking to its capital plans, increasing spending elsewhere, or raising additional revenues.

- **Over 2023 to 2025, the Government faces challenges addressing substantial price and wage pressures and achieving its medium-term policy objectives.** The Government's spending plans would allow it raise investment to record levels, provide sizeable temporary supports, and reduce the debt burden. Many of these increases are already committed to. However, the planned increases in current spending under the spending rule would not be sufficient to fully maintain existing supports and services in real terms or to allow for new spending initiatives. For later years, the shortfall is relatively small at about €0.5 billion per annum over 2023 to 2025 on average. Revenue-raising measures could be used to offset these additional costs or fund new spending measures. Alternatively, only partially tracking price and wage increases would create space for new projects. This approach would see spending increase without providing excessive stimulus to an already fast outlook for growth; it would help avoid the risk of second-round increases in prices and wages, potentially destabilising the economy and the public finances; and it would ensure the steady pace of debt reduction set out in the SPU.

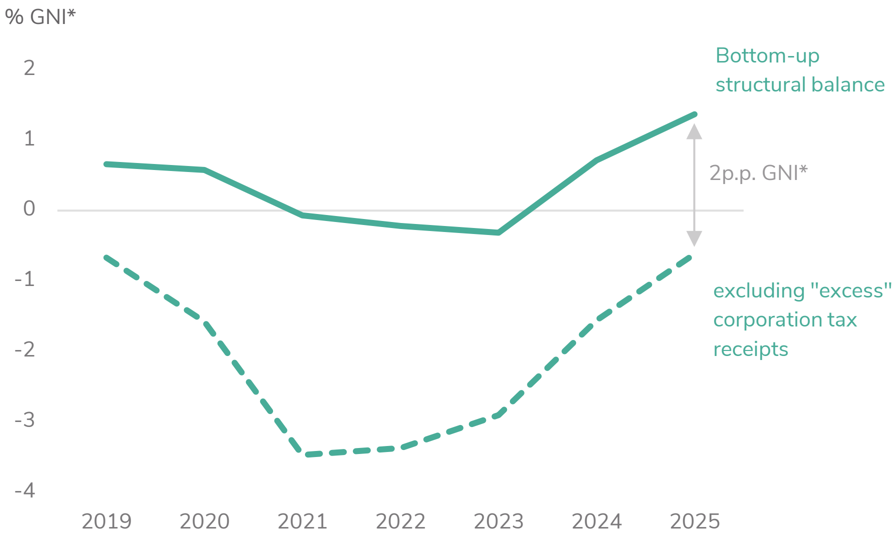
- **The Council assesses that the overall fiscal stance in *SPU* 2022 is conducive to prudent economic and budgetary management.** The stance set out in the SPU strikes an appropriate balance between managing the impact of higher inflation, avoiding cyclical imbalances, and supporting fiscal sustainability, although there remain significant gaps in the Government's short- and medium-term budgetary plans. This assessments rests on four elements:

- **First, the Government faces a delicate balancing act in protecting the economy and poorer households from higher energy and food prices, while avoiding adding to inflation through second-round effects.** A combination of carefully-calibrated temporary and targeted supports and permanent social welfare, wage and spending increases could help to achieve this.

- **Second, the Government should reinforce its 5% Spending Rule.** The rule is a welcome innovation that can help to set the public finances on a sustainable path. It is currently providing a useful signal about the balancing act the Government needs to achieve. However, it should be broadened to capture general government spending, have a link to debt targets, and recognise the impact of tax measures.

- **Third, the over-reliance on corporation tax should be gradually unwound.** Corporation tax receipts represent nearly one-in-every four euro of tax raised by the Exchequer, and the top-ten paying companies account for more than half of those receipts: up from a quarter in 2008. The Government does not currently have a strategy to reduce this over-reliance. The Council's assessment is that (1) the Government should clearly show the impact of excess corporation tax receipts on the budget balance, and (2) the Government should take measures to reduce its reliance on corporation tax. This includes capping the amounts of revenue from this source that are spent or gradually reducing spending that is reliant on this source. This could be achieved by making contributions to the Rainy Day Fund or running debt down more quickly. The Exchequer has benefited significantly from corporation tax receipts in recent years that could be considered "excess" — beyond what is explained by the performance of the domestic economy. By using these excess receipts to fund ongoing expenditure, the Government has potentially opted not to set aside some €22 billion in a Rainy Day Fund or to reduce net debt by a substantial amount.

Excess corporation tax receipts are flattering the budget balance



- **Fourth, major policy commitments need to be properly costed and factored into the Government's plans.** There are major medium-term challenges for which the Government has not set out credible plans. These pressures on public spending raise significant questions about how they will be accommodated within the Government's spending rule alongside existing policies. This would imply reductions in planned spending elsewhere or higher taxes. Providing an assessment of the costs of meeting these objectives needs to be addressed urgently. The Government is required to halve Ireland's greenhouse-gas emissions by 2030, but it has not factored in the full costs to the state of achieving this. Estimates from FitzGerald (2021) put the cost at an additional 1.7 to 2.3 per cent of GNI* on average over the years 2026 to 2030. The Government has also not costed its planned major healthcare reforms under "Sláintecare" beyond this year and there is no clarity on how much progress has been made to date in terms of the overall cost of the reforms. The Government has not responded to the Pensions Commission recommendations on how to address funding shortfalls in the pension system. Annual spending on pensions is set to rise by about 1½ to 2 per cent of GNI* by 2030 amid a rapidly ageing population. Despite these and other spending pressures, the Government has limited plans for raising new revenues to deal with potential costs.

Fiscal Rules

- **The general escape clause has been active since the Covid-19 pandemic began.** This flexibility in the fiscal rules has allowed for an appropriate fiscal response to the pandemic in 2020 and 2021. In 2022, it has facilitated a humanitarian response to the war in Ukrainian along with the introduction of a range of measures to mitigate the cost-of-living shock on households and firms. The European Commission has decided that current conditions warrant an extension of the clause for 2023.

- **In 2022 and throughout the forecast period, Government plans look set to comply with the fiscal rules.** While the exceptional circumstances clause applies, both the headline and structural deficits are in any case forecast to be below their respective limits of 3 per cent and 0.5 per cent of GDP this year and beyond to 2025. The balance is projected to turn positive in 2023.

- **The Government's medium-term Departmental expenditure ceilings are made on the basis of unrealistic technical assumptions.** There is a legal requirement to produce medium-term expenditure ceilings by Department, which would help to underpin the Government's overall spending 5% rule and the focus on medium-term planning. These ceilings were not published at Budget time and they are based on unrealistic technical assumptions.

- **The current unexpected inflation highlights some issues with the design of spending rules**. For 2022 and throughout the forecast period, the Government plans to stick to its 5% Spending Rule in levels. With spending for 2021 revised down, this would allow for a faster pace of growth in 2022 as the rule is based on the original allocations rather than outturns. This may help to accommodate price and wage pressures in the near-term if underspends are not fully unwound. Over the medium-term, higher inflation means that prioritising between maintaining the real value of service provision and other competing demands could be a challenge for policymakers.

Summary Table of SPU 2022 Economic and Budgetary Projections

% GNI* unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Macro forecasts							
Real GNI* growth (%)	2.6	-3.5	5.5	3.7	3.1	3.2	3.3
Nominal GNI* growth (%)	9.0	-3.4	7.3	8.5	6.0	5.6	5.4
Nominal GNI* (€bn)	216	208	223	242	257	271	286
Output gap (% of potential)	2.1	-1.8	-1.0	-0.5	-0.1	0.0	0.2
Potential output growth (%)	4.7	9.3	14.3	4.6	3.8	3.7	3.6
Budgetary forecasts							
Balance	0.8	-9.2	-3.6	-0.8	0.5	2.4	2.7
Balance (€ billion)	1.7	-19.1	-8.1	-1.9	1.2	6.5	7.7
Balance ex one-offs [1]	0.8	-1.6	2.0	2.5	2.0	2.6	2.8
Balance ex one-offs [1] (€ billion)	1.7	-3.3	4.4	6.2	5.0	7.2	8.1
Revenue ex one-offs [1]	40.8	40.2	43.5	43.9	43.2	42.8	42.2
Expenditure ex one-offs [1]	40.0	41.8	41.5	41.3	41.2	40.1	39.4
Primary balance ex one-offs [1]	2.9	0.3	3.4	3.9	3.3	3.9	3.8
Revenue growth ex one-offs [1] (%)	6.3	-4.8	15.9	9.6	4.3	4.6	4.0
Primary expenditure growth ex one-offs [1] (%)	6.0	1.9	7.4	8.3	5.7	3.0	4.0
Gross debt ratio (% GNI*)	94.6	104.7	105.6	96.5	89.9	85.4	79.4
Net debt ratio (% GNI*)	81.0	89.3	86.2	81.2	77.9	73.0	68.5
Gross debt (€ billion)	204	218	236	234	231	231	227
Cash & liquid assets (€ billion)	29	32	43	37	31	33	31
Net debt (€ billion)	175	186	193	197	200	198	196
Fiscal stance							
Structural primary balance[2]	2.8	2.3	1.4	0.8	1.1	1.9	2.5
- change (p.p.)		-0.5	-0.9	-0.6	0.3	0.8	0.5
Net policy spending growth (%)	5.3	0.1	7.4	8.3	5.2	2.6	3.6
Real net policy spending growth (%)	4.4	0.6	4.9	2.0	2.1	0.4	1.5
Change in net debt ratio (p.p.)	-8.5	8.3	-3.0	-5.0	-3.3	-4.9	-4.5
Fiscal rules							
Spending Rule	✓	xc	xc	xc			
Structural Balance Rule	✓	xc	xc	xc			
Overall Assessment	✓	xc	xc	xc			

Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: Output gaps and potential output estimates, including those used for the structural balances, are based on the Department of Finance's preferred alternative estimates. xc = Exceptional circumstances apply for these years, meaning that a temporary deviation from the requirements of the fiscal rules is allowed. [1] These figures exclude one-offs. One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. These include Covid-related expenditure and expenditure and revenue related to the EU funds for the Brexit Adjustment Reserve and the National Recovery and Resilience Plan). [2] This is based on the Council's own "bottom-up" estimates of the structural primary balance.

Macro Assessment

Continued growth despite global challenges

1. MACRO ASSESSMENT

Continued growth despite global challenges

The economy has been hit by several large shocks in recent years, but growth has proved resilient

Between Brexit, the Covid-19 pandemic, and the ongoing war in Ukraine, the Irish economy has been hit by significant negative shocks in recent years. In each case, there has been a great deal of uncertainty about the magnitude of the impact and how long its effects would remain.

However, despite the challenges, outcomes have been consistently stronger than expected. Official projections show that Ireland's economy (real GNI*) will have expanded by 3 per cent a year on average between 2017 and 2022, despite the contraction of 3.5 per cent in 2020 due to Covid-19. A relatively healthy Irish economy in the lead-up to the 2020s and favourable developments in the high-skill sectors, including pharmaceuticals and information/communication technology, as well as domestic factors, have contributed to the resilience of growth.

The war in Ukraine has led to a rapid increase in the costs of imported energy. This has caused a sharp increase in prices, and inflation has reached its highest rates in a generation. Projections for net inward migration have increased substantially due to continued expected arrivals of refugees from Ukraine. Uncertainty around future developments for growth and inflation remains high, and high energy prices are likely to drag on growth if they persist.

The *Stability Programme Update (SPU)* 2022 only projects three years ahead, contrary to previous Council recommendations and intentions expressed by the Department, and confirmed by the Minister, that it would lengthen the forecasting period to five years ahead. As discussed in Section 1.4, this limits the Council's ability to assess the consistency of the Department's forecasts between short-and medium-term developments and to develop a medium-term picture of the public finances. The Council believes that the parliamentary term should not affect the horizon of official macroeconomic and fiscal forecasts. Medium-term forecasting should always be undertaken to five years ahead.

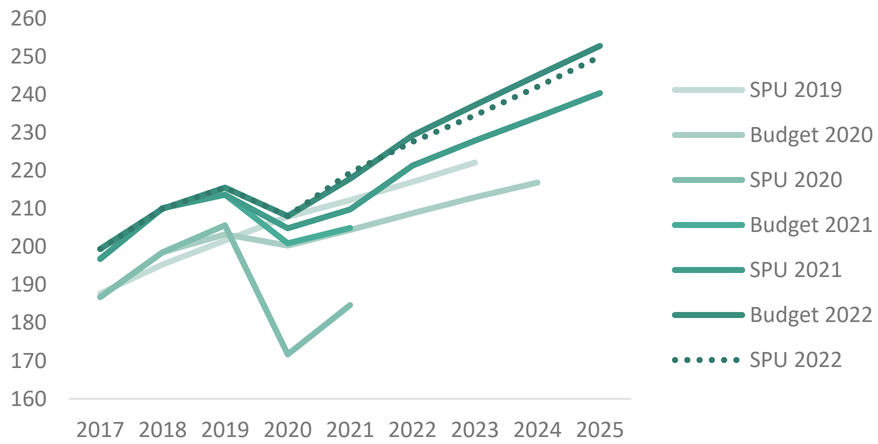
1.1 The short-term outlook

SPU 2022 shows a continued recovery from the Covid-19 pandemic and sustained growth in the medium-term, driven primarily by continued employment and wage growth and domestic factors.

Figure 1.1 presents successive forecasts for real modified gross national income (real GNI*) from successive Budgets and SPUs. Projections have been revised up strongly since 2020, as the economy-wide impact of Covid-19 has turned out less severe than anticipated. However, the latest projection in *SPU 2022* is somewhat lower than forecast in *Budget 2022*, reflecting the impact of the higher energy prices and increased uncertainty.

Figure 1.1: *SPU 2022* forecasts for the Irish economy remain more positive than a year ago, but somewhat lower than in *Budget 2022*

€ billion, real GNI* in 2019 constant prices



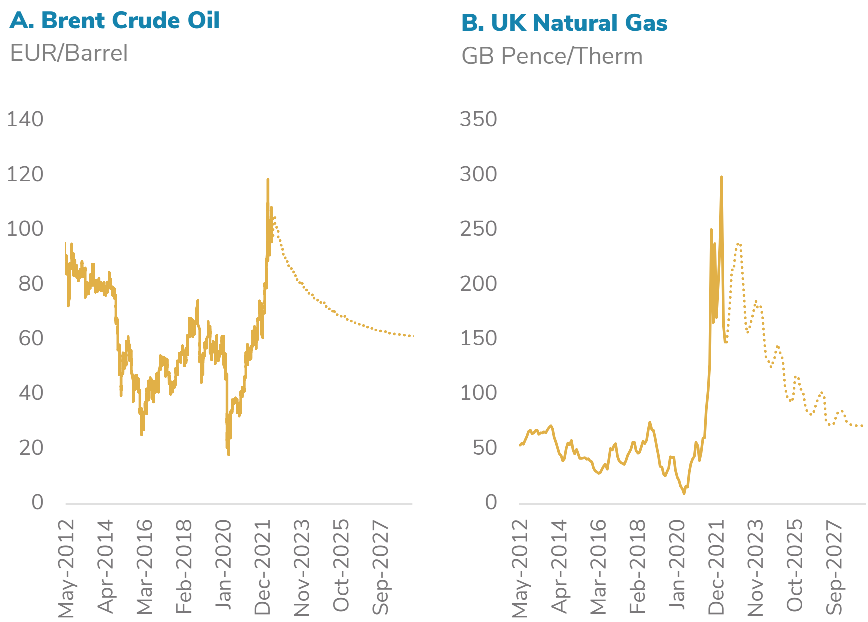
Sources: Department of Finance, Central Statistics Office (CSO), and Fiscal Council workings.
Notes: For *SPU 2019*, *Budget 2020*, and *SPU 2020*, the Department of Finance's forecasts for nominal GNI* are deflated with the GNP deflator to estimate real GNI*. Following *SPU 2020*, the CSO revised historical data for the level of GNI* upwards in its *National Income and Expenditure 2019* release, hence the upward shift in the level of historical real GNI* from *Budget 2021* onwards (a forecast for real GNI* has also been separately published since then). Get the data.

Since *Budget 2022*, there has been a major increase in prices and inflation. Higher inflation initially reflected a rebound in some prices as economies re-opened, driven by rising demand in goods market and labour shortages emerged in some activities. Higher rents have also continued to contribute to inflationary pressures in Ireland.

Price inflation has risen sharply

In February, Russia's invasion of Ukraine resulted in a further sharp rise in energy (Figure 1.2) and food prices. While the exposure of Irish exporters to the shock is generally limited, Ireland does rely on substantial imports of gas and oil. Higher prices internationally have raised the cost of living for households and the costs of production in some sectors, including agriculture and transport. The *SPU 2022* forecasts assume that prices of these goods will remain high and fall back only gradually, based on the assumption that the current sanctions regime remains in place and that alternatives to Russian oil and gas come on stream in the years ahead. With nominal wages already set in the near term based on much lower expectations of inflation, higher energy costs will capture an increasing share of household budgets, constraining consumer spending on other goods and services. Over the longer term, continued higher prices for imported energy would tend to reduce consumption and output.

Figure 1.2: Energy prices have increased and are forecast to remain high



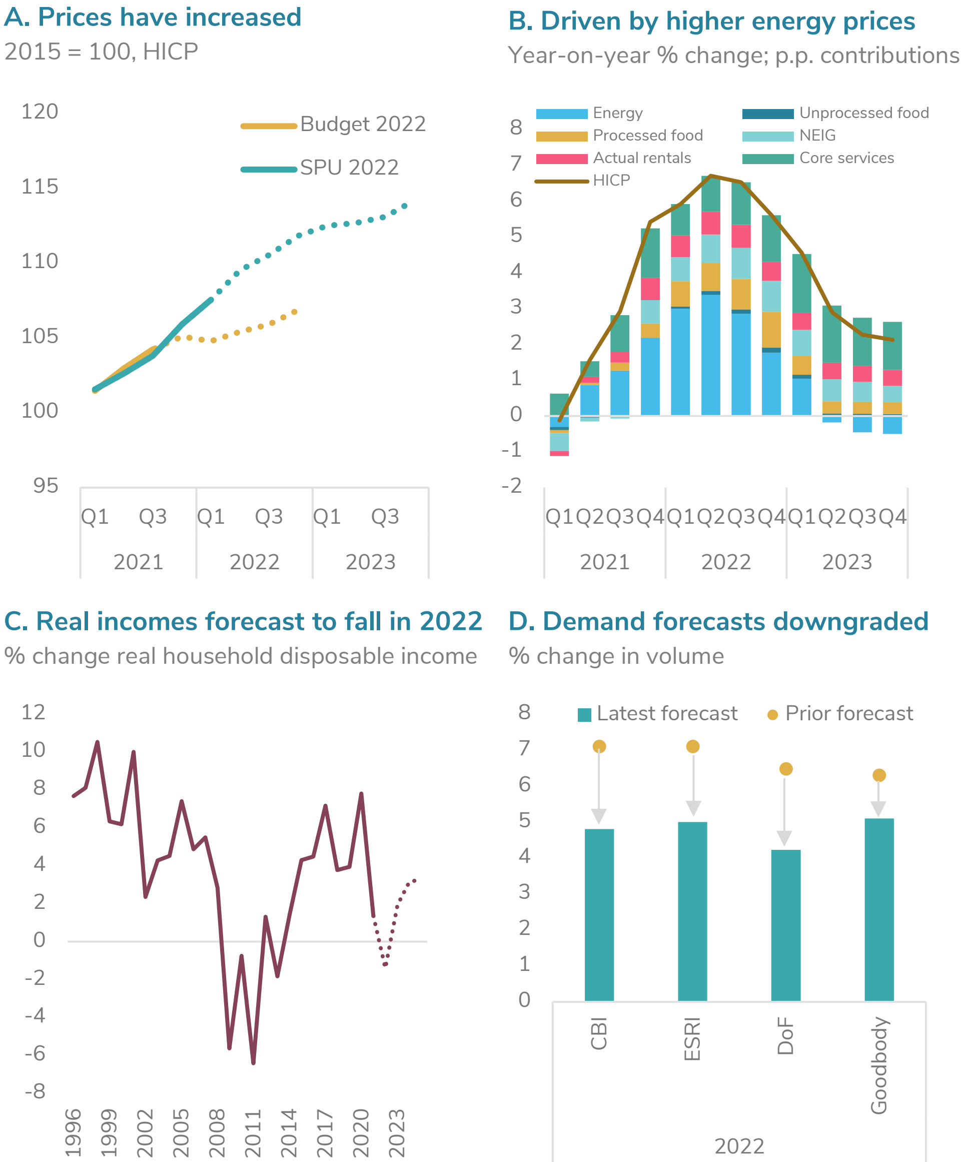
Source: Macrobond. Get the data.

Higher inflation has reduced forecasts of economic growth

The immediate effects of higher inflation for Ireland's economy are reflected in the *SPU 2022* projections for annual price inflation of 6.2 per cent for 2022 and 3 per cent in 2023 (Figure 1.3A). Higher inflation this year results in an expected reduction in real household disposable income (Figure 1.3C), and slower growth in modified domestic demand (Figure 1.3D). While the average inflation projection in *SPU 2022* until 2025 is 3.6 per cent, this follows a generally low-inflation decade (2012–2021) where price increases averaged just 0.6 per cent per annum.

The *SPU 2022* forecasts assume that much of the increase in prices has already taken place through higher energy prices (Figure 1.3B). Still, prices are forecast to continue to rise more rapidly than usual during the coming months of 2022. Some price increases feed through gradually, notably under household fuel prices, while other goods will require higher input prices through the supply chain in areas where energy is an input, such as a food and metals. Prices increases in the SPU are projected to slow to a more moderate pace from 2023 with only a modest acceleration in wage growth.

Figure 1.3: Inflation has accelerated mainly due to higher energy prices, and recent economic forecasts have been revised down



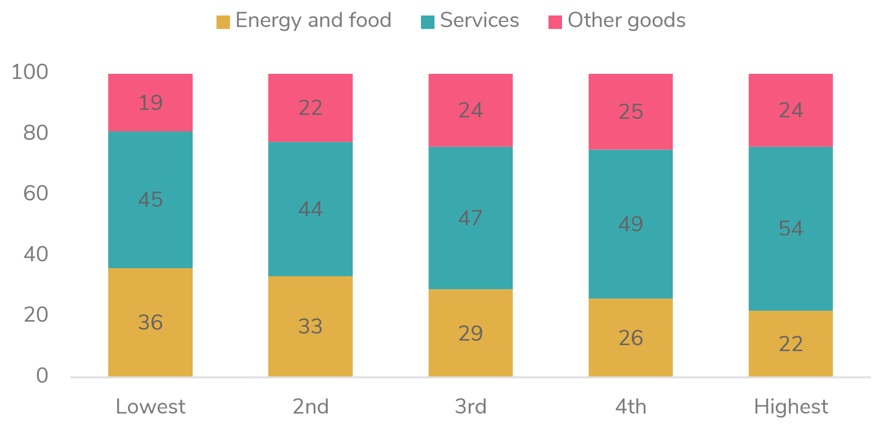
Sources: Eurostat; CSO; Various forecasting bodies. Get the data.
Notes: Dotted lines show official forecasts. Panel C shows total disposable income deflated with the harmonised index of consumer prices (HICP). Panel D shows forecasts for volume growth rates in modified domestic demand. CBI prior and latest forecasts are the Q1 and Q2 2022 Quarterly Bulletins. ESRI prior and latest forecasts are the Winter 2021 and Spring 2022 Quarterly Economic Commentaries. DoF (Department of Finance) prior and latest forecasts are Budget 2022 and *SPU 2022*. Goodbody prior and latest forecasts are Q4 2021 and Q1 2022 *Health Checks*.

However, uncertainty is high around these projections. Firstly, energy prices could change significantly, for example if there are disruptions to the supply of gas from Russia or if efforts to substitute away from Russian energy are more challenging than assumed. Low-income households spend more than a third of disposable income on energy and food (Figure 1.4), implying a greater degree of vulnerability to price increases, Second, workers and firms may look to raise wages and prices more than projected to maintain their purchasing power and margins. These second-round effects could in turn feed back into higher and more persistent inflation than *SPU 2022* assumes.

Low-income households are more vulnerable to energy and food price increases

Figure 1.4: Low-income households spend more than a third of disposable income on energy and food

Expenditure weights by quintile of net disposable household income



Sources: Lydon (2022), CSO, and Fiscal Council workings. Get the data.

If inflation remains high and feeds into higher wage growth internationally, there may be a faster pace of monetary policy tightening that could slow growth or even lead to recession in advanced economies. Slower momentum going into 2023 would result in weaker demand for Irish exports. As a small open economy, Ireland is particularly sensitive to investment decisions and trade spillovers from its main trading partners. However, Ireland currently has favourable exposures to high-skill sectors, including those with less cyclical tendencies such as information and communication technologies and pharmaceuticals, which have shown resilience during challenging periods for the global economy. As a result, it is possible that the Irish economy is relatively well placed to weather a downturn in economic activity abroad.

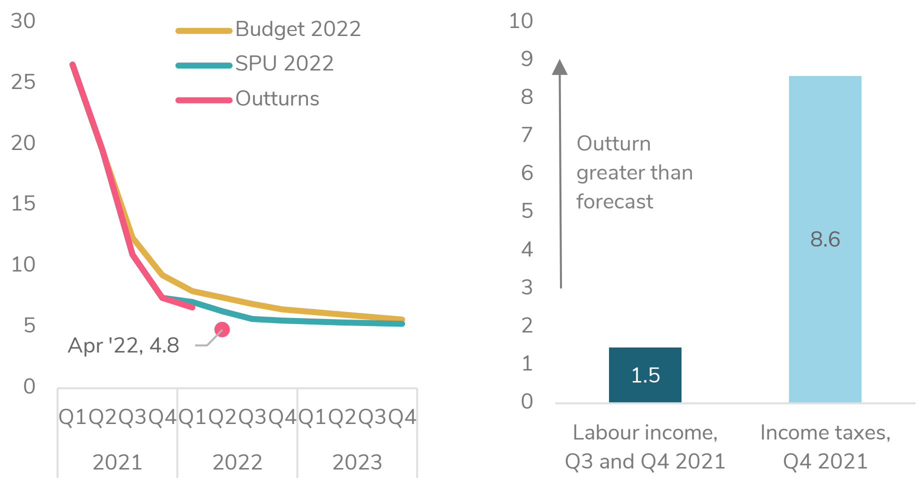
Despite the negative headwinds, recent short-term macroeconomic indicators point to a continued strong recovery from the pandemic. The unemployment rate has fallen faster than projected and was 4.8 per cent in April (Figure 1.5A) — well below the *SPU 2022* projection for this year of 6.2 per cent. These trends have positively impacted government revenues, and reflect a stronger employment outcome.[1] Labour income for the second half of 2021 was €0.8 billion (1.5 per cent) stronger than forecast, and income taxes for Q4 2021 came in €0.65 billion (8.6 per cent) ahead of last October's Budget (Figure 1.5B).

Yet the economy has continued to perform well in recent months

Figure 1.5: The recovery in the labour market has been faster than expected

A. Unemployment rate
% of labour force

B. Labour income and income taxes
% difference from *Budget 2022* projections



Sources: CSO; Department of Finance (SPU 2022) projections. Get the data.
Note: Panel A shows Covid-adjusted unemployment rates. The Q1 2022 outturn is the average of the CSO's monthly Covid-19 adjusted unemployment rates for January and February, and the March monthly unemployment rate, since the ending of pandemic unemployment payments from 25th March onwards.

In 2021, personal consumption grew by 6 per cent, but somewhat underperformed the Department's *Budget 2022* forecasts, due in part to additional Covid-19 restrictions at the end of the year. However, underlying investment in machinery and equipment excluding aircraft grew by over 40 per cent. This reflects a combination of stronger investment by domestic firms in software and equipment for employees working from home, but also activity of multinational firms — including new equipment for data centres, whose electricity usage increased dramatically last year.[2]

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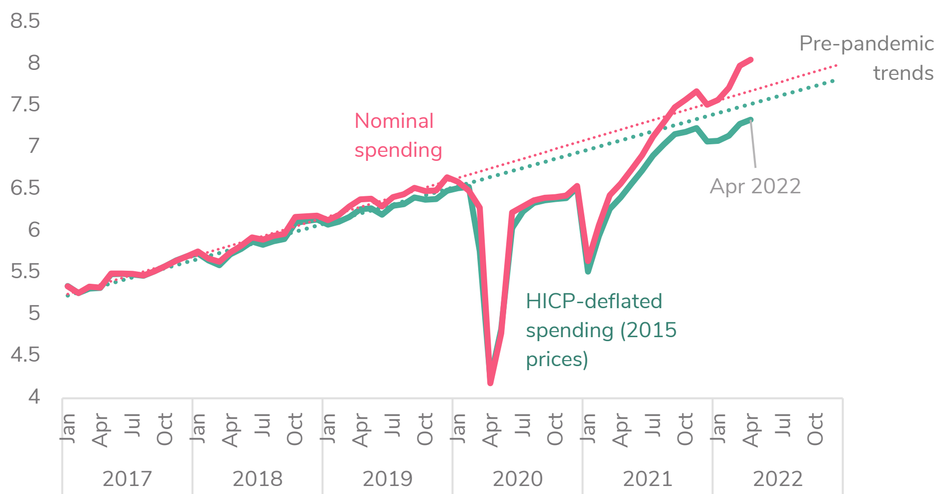
[1] In terms of actual hours worked, this recovery was reflected broadly across sectors, but especially by high-earning sectors: information and communication, financial and insurance, real estate activities, education, and professional, scientific, and technical activities. These are the 'High 5' sectors described in Timoney (2022), and in the second half of 2021, actual hours worked increased by 10.6 per cent. This was a faster increase than for the 'Middle 6' (6.1 per cent) or for the 'Low 5' (7.4 per cent), despite the minor impact of the pandemic on the 'High 5'.

[2] For details, see: https://www.cso.ie/en/releasesandpublications/ep/p-mec/meteredelectricityconsumption2021/

Indicators of consumption including monthly data for card spending and ATM withdrawals have performed strongly in recent months, even when deflated by higher-than-expected consumer prices. Figure 1.6 shows that, relative to pre-pandemic trend, a small gap remained by April 2022 for HICP-deflated spending (in green), whereas nominal spending had again exceeded its trend level.

Figure 1.6: Cards spending and ATM withdrawals remain close to trend



Sources: Central Bank of Ireland, and Fiscal Council workings.
Notes: Monthly spending on cards and ATM withdrawals are deflated with HICP and seasonally adjusted with Tramo-Seats. The linear trend is based on a sample period of 2015–2019. April 2022 is based on daily card spending and ATM withdrawals, and subject to revision when full-month data become available. Get the data.

High-frequency indicators of real consumer spending remain strong, despite rising prices

The inflow of refugees from the Ukraine could have a significant impact on the Irish economy. The official projections now anticipate over 100,000 net migrants to Ireland in 2022 and 2023 combined, compared to just 40,000 expected in *Budget* 2022. The difference amounts to an increase of around 1 per cent of Ireland's population. This will lead to additional government spending and demand for services, including housing. Over time, it may also increase the supply of labour. However, by late May, just over 33,000 Ukrainian refugees had arrived in Ireland, close to 7,000 higher than by late April.[3] The expected number of Ukrainian refugees arriving in Ireland is very hard to evaluate as it depends on developments in Ukraine and the choices refugees make. However, the official projections may overestimate the outcome.

[3] https://www.cso.ie/en/releasesandpublications/fp/p-aui/arrivalsfromukraineinirelandseries1/

1.2 The medium-term outlook

SPU 2022 projects that the Irish economy will expand slightly faster than trend growth rates of 3 per cent per annum until 2025 due to export growth, rising consumption, and construction. The central scenario is that a small positive output gap will emerge, signalling strong growth but not significant overheating. Given the assumptions that energy prices will tend to ease gradually rather than increase, growth in compensation of employees and inflation pressures are expected to ease with a return towards normal trend rates from 2024. Table 1.1 presents key *SPU 2022* macroeconomic forecasts for the Irish economy.

Table 1.1: *SPU 2022* key macroeconomic forecasts

Year-on-year percentage change in volumes, unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Modified gross national income (GNI*)	2.6	-3.5	5.5	3.7	3.1	3.2	3.3
Underlying domestic demand (UDD)	3.3	-4.9	5.9	4.2	3.9	3.5	3.6
Personal consumption	3.3	-10.4	5.7	6.0	3.6	3.5	3.4
Underlying investment	-0.4	-3.6	7.3	5.5	6.8	5.1	5.6
Compensation of employees (nominal)	7.1	0.5	8.2	9.8	7.5	6.8	6.6
Employment[a]	2.9	-16.8	11.0	14.9	2.1	1.7	1.7
Unemployment rate[a] (% labour force)	5.0	19.2	15.9	6.2	5.4	5.2	4.9
Inflation (HICP)	0.9	-0.5	2.5	6.2	3.0	2.2	2.1
Savings ratio (% disposable income)	10.2	25.2	19.9	13.6	11.7	11.0	10.7
Modified current account (% GNI*)	9.4	11.5	9.8	8.5	7.3	6.7	6.2
Output gap (% potential GDP)	2.1	-1.8	-1.0	-0.5	-0.1	0.0	0.2

Sources: Department of Finance, and Fiscal Council workings.
Note: [a] The unemployment rate and employment growth shown for 2020–2022 inclusive are based on the CSO's "upper bound" Covid-19 unemployment data.

While the Department of Finance has previously signalled to the Council its intention to forecast to five years ahead, the SPU projections are only to three years ahead. This limits the Council's ability to assess the consistency of the Department's forecasts between short-and medium-term developments.

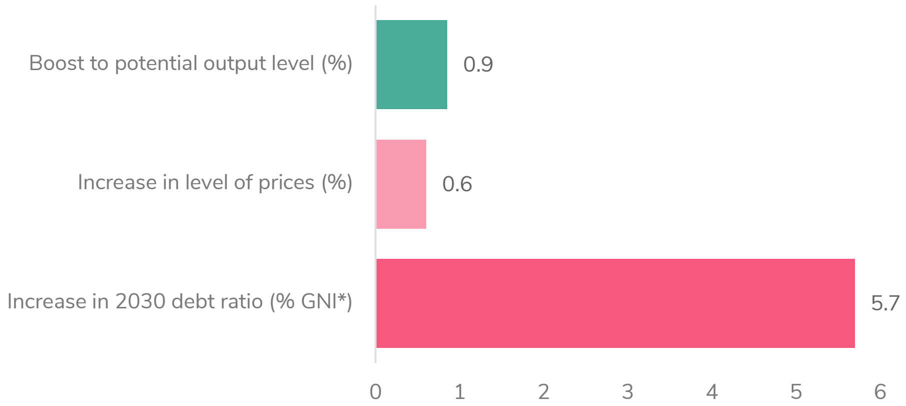
Although *SPU 2022* includes downward revisions to public expenditure on gross fixed capital formation, the Government still plans a substantial increase in public investment in the coming years. This will drive up short-term activity and increase the total size of Ireland's capital stock, raising the potential for economic activity over the long term. Analysis by Conroy, Casey and Jordan-Doak (2021) shows that the additional public investment outlined in the *National Development Plan (2021–2030)* could boost the overall level of activity by around 1 per cent over the long run (Figure 1.7).

Higher public investment should boost economic activity

However, the additional activity would also add to inflation pressures — prices across the economy are expected to increase by an estimated 0.6 per cent. The research also shows that the National Development Plan would require 180,000 construction workers, which is some 21,000 workers above Q1 2022 levels. With limited numbers of unemployed construction workers domestically, and risks of a mismatch between the skill set of migration flows and the needs of the construction sector, it could prove challenging to achieve this increase in construction employment and meet the targets of the Plan.

Figure 1.7: Public investment ramp-up to lift output, prices, and debt

Estimated impacts of additional public investment by 2030



Sources: Conroy, Casey and Jordan-Doak (2021). Get the data.
Notes: The estimated boost to real potential output shown is the median estimate from a variety of approaches. The increase in prices is for HICP levels by 2030. All estimates are compared to a scenario where public investment is held constant at its 2021 rate of 4.1 per cent of GNI*.

The savings ratio remained elevated in 2021 at 21 per cent according to the most recent CSO estimates, as household incomes grew strongly during the pandemic (helped by the Government's income supports) but opportunities to spend were restricted. The SPU projects that this will gradually reduce to around 11 per cent by 2025. This is close to the level in 2017–2018 but higher than in the preceding years.

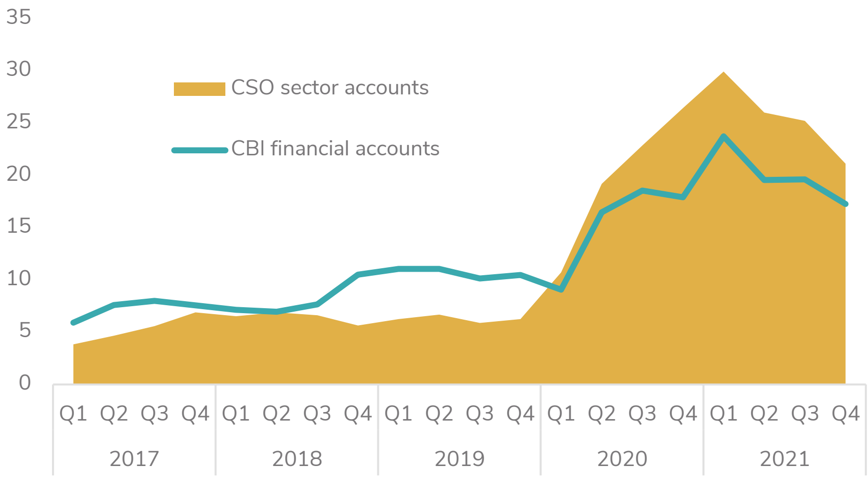
The persistently high level of savings forecast in *SPU 2022* is somewhat puzzling. It is also possible that the 2021 level of consumption is understated by the current CSO estimates, or that consumption will recover more fully than projected by 2025. This could imply a stronger level of consumption over the forecast horizon than projected in *SPU 2022* and a lower savings rate all other things equal.

The relatively slow recovery to date in household consumption expenditure according to Ireland's national accounts for 2020 and 2021 is not well supported by a number of other data sources, including spending on cards and ATM withdrawals (Figure 1.6), value-added taxes, and the implied level of household net lending in the Central Bank of Ireland's *Quarterly Financial Accounts*.

As shown in Figure 1.8, the Central Bank's data on net lending has typically been higher than in the CSO's *Institutional Sector Accounts*. These series rely on different sources and approaches to estimation, but since the Covid-19 pandemic began in early 2020, this relationship between the two net lending sources has reversed.

Figure 1.8: The *Quarterly Financial Accounts* could imply higher household consumption than the CSO's national accounts show

€ billion, net lending by the household sector, four-quarter moving sum



Sources: CSO, Central Bank of Ireland, and Fiscal Council workings. [Get the data.]
Notes: Data are shown for households and non-profit institutions serving households. Net lending captures leftover resources after paying for consumption and investment from income. Gross savings is the outcome of the current account, mainly relating to disposable income less consumption. Net lending in the sector accounts additionally accounts for transactions in the capital account, including gross capital formation and capital transfers, whereas net lending in the financial accounts is determined from all net financial transactions recorded in bank ledgers.

The gap in these series in Q4 2021 was close to €4 billion. If the pre-pandemic relationship held (with the CBI estimate above the CSO estimate of net lending), this would likely imply an upward revision beyond €4 billion to household consumption, since net lending is residually determined in the national accounts.[4]

In terms of the balance between domestic and foreign demand, Ireland's modified current account (CA*), which has registered a large surplus of

[4] Gross capital formation by households could also explain smaller aspect of this difference, given it is less than one-tenth the size of household final consumption.

around 10 per cent of GNI* in recent years, is likely to narrow in response to the higher costs of imported energy and declining household savings rate.[5] Weaker international economic activity will likely reduce Ireland's exports from sectors with greater relevance to GNI*. At the same time, a strong underlying rate of domestic growth, in combination with high energy prices and pressures on global supply, is likely to increase Ireland's nominal spending on imports. In terms of sectoral balances, the increase in savings due to a rising general government balance over the medium term (see Section 2) would be more than offset by higher consumption spending and investment.

[5] In the absence of modified measures of exports and imports with relevance to Ireland's real economy, it remains challenging to assess Ireland's modified current account (CA*) from an expenditure perspective.

1.3 Risks to the outlook

Downside risks have increased, but recent performance has surprised to the upside

Risks to the outlook in *SPU 2022* are described as being "firmly tilted to the downside". There are significant and unusually large risks both to inflation and to economic activity, including those associated with the war in Ukraine. At the same time, there are some upside risks and Ireland's recent economic performance has generally been better than anticipated in recent years, as discussed in Section 1.2.

As a small open economy, Ireland's economy has the capacity to be significantly affected by global risks, such as energy shortages or a large financial shock. Current developments regarding supply-chain disruptions in China as a result of Covid-19 restrictions, and potential energy shortages for EU Member States arising from both existing and prospective restrictions on imports from Russia, have greatly increased risks emanating from the global economy.

Price inflation has already proven to be considerably higher than previously expected (see Figure 1.3A) and remains high. Risks to the outlook due to second-round effects of inflation on further price and wage increases are central, but difficult to evaluate given the prolonged period of low inflation experienced in the recent past. Knock-on demands for higher wages may reduce Ireland's competitiveness and exports depending on relative changes in Ireland's trading partners. As noted in the December 2021 *Fiscal Assessment Report* (Fiscal Council, 2021b), domestic capacity constraints could be an issue in the coming years, with the risk that these could constrain growth and raise price pressures. There are continued signs of tightness in areas such as construction, which the expanded public investment programme will most likely add to (Conroy, Casey and Jordan-Doak, 2021). While Ireland has often relied on inward flows of migration to respond to tightening labour market conditions, migration flows could respond more slowly to higher post-pandemic demand, or migrants may lack the skill sets needed to meet short-term needs of the labour market. However, a more favourable scenario relates to the possibility that inflation recedes more rapidly than currently suggested in both market-based projections and official forecasts. Although the likelihood of this more benign scenario appears remote at present, energy prices have long been volatile, and they could revert to a lower level over coming years.

Given Ireland's reliance on foreign multinationals to drive labour demand and earnings growth, a key downside risk is the potential for lower foreign direct investment from the multinational national sector in response to international tax reforms or other factors. Besides the effect on future corporation taxes, this could reduce earnings in high-pay sectors of the economy with further effects to wider demand and the public finances.

An ongoing risk relates to the possible unwinding of Brexit's current trading agreement between the UK and the EU related to Northern Ireland, which would lead to disruptions to trade. Northern Ireland has remained within the EU's customs union and single market, but the free trade agreement's adverse effects could be larger than assumed.[6] The UK has further postponed the introduction of checks on incoming goods, delaying the potential impact of some frictions on Irish trade. In addition, the risks of a disruptive change of trading conditions remains, particularly if UK access to the EU market were to change amid continued uncertainty over the Northern Ireland Protocol.

On the positive side, there continues to be a number of reasons why both short- and medium-term growth might be higher than assumed. Ireland's relatively resilient performance during the large shock represented by the Covid-19 pandemic is instructive for understanding its prospects over the coming years. Although vaccines, government supports, and adaptation by firms were crucial factors in the Irish economy's recovery from the pandemic, the relatively healthy economy in 2019, with favourable sectoral exposures to high-skill activities, was also very important. From a sectoral perspective, the drivers of growth in the Irish economy have been concentrated in sectors with the highest hourly wages, as discussed in a separate analytical note by Timoney (2022). If hourly wages or hours worked perform stronger than projected, the growth of earnings could again exceed official projections, as has been typical in recent forecasts (see Figure 1.13).

Furthermore, the recovery of sectors severely affected by the pandemic has already been strong, and the transition out of unemployment to employment

[6] Various studies put estimates of the medium-term impacts on Ireland's real output of Brexit as 1.1 per cent to 2.8 per cent for a so-called "soft Brexit" and 3.1 per cent to 7 per cent for a "hard Brexit" (Fiscal Council, 2018a). However, the impacts of Brexit are likely to have been dampened by the transition period and are also, to an extent, masked by the coinciding effects of the pandemic.

in those sectors with high demand for labour has been rapid, suggesting limited scarring over the medium term at an aggregate level. Demand for services that had been restricted has been especially high, and firms in sectors such as hospitality have been facing shortages of labour supply and rising costs. As discussed in the June 2021 *Fiscal Assessment Report* (Fiscal Council, 2021a), these sectors tend to attract less imports and have higher domestic multiplier effects, so that increases in consumer spending in these areas could lead to larger-than-usual growth impacts.

1.4 Endorsement of the Department of Finance's macroeconomic projections

The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in March and April 2022.

The Council assessed that the Department's forecasts for 2022 to 2025 were within an endorseable range, taking into account the methodology and plausibility of the judgments made. This section explores the key issues that arose in this latest endorsement exercise.

The Council's assessment of the Department's macroeconomic forecasts resulted in particular scrutiny relating to the forecast horizon, the outlook for personal consumption, compensation of employees, and income taxes.

Background

The Department's provisional macroeconomic forecasts were completed on 24th March 2022 (see table S1a in the Supporting information section for details of the endorsement timeline). The Council and Secretariat discussed the forecasts with Department staff on 1st April.

The Department has expanded its use of underlying economic measures that focus on the domestic economy, including GNI* (see Lennon and

Power, 2021). This is a welcome development, given the distortions that affect many headline indicators in Ireland due to multinational enterprises.[7]

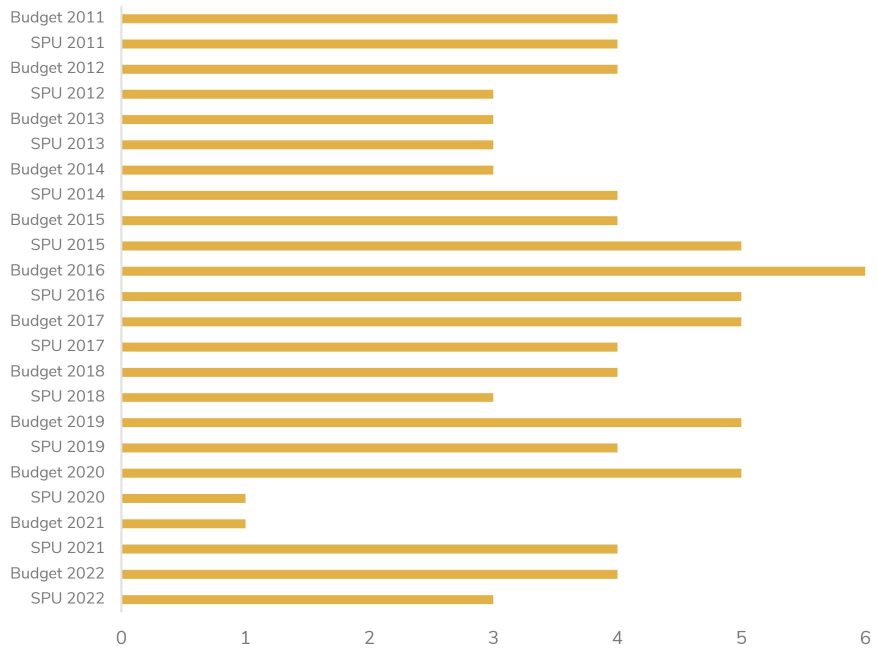
Forecast horizon

SPU 2022 only forecast three years ahead, less than in some previous forecasts and too short a horizon to provide a full picture of medium-term prospects. Figure 1.9 shows that the horizons in official forecasts have only rarely stretched to five years or beyond, but the three-year horizon used in *SPU 2022* is nonetheless unusually short.

SPU 2022 only forecasts to three years ahead

Figure 1.9: *SPU 2022* only forecasts to three years ahead

Years



Sources: Department of Finance, and Fiscal Council workings. Get the data.
Note: Budgets are labelled as "Budget t+1", but published in year t; for example, *Budget 2023* will be published in October 2022, meaning its forecast for 2022 is an in-year forecast (for year t).

The Department has previously signalled to the Council its intention to forecast to five years ahead. This limits the Council's ability to assess the consistency of the Department's forecasts between short-and medium-term developments — especially in respect of supply-side variables such as the output gap and potential output growth, and the return of key ratios such as the unemployment rate and savings rate towards medium-term norms. This also obscures the role that ageing, climate change, implementation of

[7] Unfortunately, many agencies and private bodies forecasting the Irish economy continue to focus on GDP. The Council's view is that a wider move towards forecasting underlying measures would provide more meaningful and relevant projections, and would help to strengthen the overall macroeconomic debate in Ireland.

international tax reforms and automatic enrolment could have on the economy.

The Council has previously noted this issue (Fiscal Council, 2018b), and its concern that the parliamentary term should not affect the horizon of official macroeconomic and fiscal forecasts.[8] Medium-term forecasting should always be undertaken out to five years ahead.

Taxes, labour income, and personal consumption

A recurrent issue in recent Government forecasts has been the consistency between consumption, labour income and income taxes. These have been unusually difficult to forecast because of the impact of the pandemic and structural changes in the economy. Consistency checks between different elements of the forecast, such as the savings ratio that links spending and disposable incomes, or the effective tax rate, can be a useful help to evaluate the internal consistency and coherence of forecasts.

The Council endorses the macroeconomic rather than the budgetary projections, but some fiscal measures are nonetheless present in macroeconomic data. For example, taxes on income and wealth are a key determinant of households' disposable income, which feeds into consumption and savings.[9]

Box A highlights some inconsistencies between the macroeconomic forecasts for net social transfers to households and the corresponding fiscal forecasts for social transfers. Net social transfers, together with income taxes form a key component of household disposable income. Ensuring accurate macroeconomic forecasts of these variables is a pre-requisite for accurate fiscal forecasts, and it is important that there is a consistent picture between these fiscal quantities and the macroeconomic forecasts, given their relevance to understanding budgetary developments.

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[8] See, for example, the November 2018 *Fiscal Assessment Report* (Fiscal Council, 2018b): "The Council assesses that a horizon of at least five years ahead is appropriate to support a medium-term orientation for fiscal policy, and to ensure ongoing emphasis on identifying risks or potential economic imbalances in real time. The Department should not shorten the forecast horizon and should use realistic technical assumptions where needed, for example to forecast the public finances when the forecast horizon exceeds the length of the current parliamentary term."

[9] Note that "taxes on income and wealth" is a broader category than income tax examined in Box B and Section 2. The measure examined here includes not just income tax, but also capital gains tax, motor tax (on household cars), and the TV licence.

Box A: Household income and Macro-Fiscal (in)consistency

The Department of Finance aims to have its macroeconomic forecasts, such as its household income forecasts, consistent with its fiscal forecasts. In practice however, there are challenges to achieving this. The fiscal forecasts typically do not assume social benefits (pension payments and unemployment benefits) are uprated as this requires a formal budgetary decision, even if history suggests this is likely. But for the Department's forecasts of consumer spending and household savings to be realistic, some recognition of these likely changes are needed. In practice, achieving realistic macroeconomic forecasts in this context can lead to inconsistencies with less realistic fiscal forecasts. The Council has highlighted credibility issues with the Government's expenditure forecasts on numerous occasions. This box examines the macro-fiscal consistency of the Departments *SPU 2022* forecasts.

Macroeconomic forecasts

As part of the Council's endorsing of the Department's macroeconomic forecasts, the Department sends the Council its projections of household income. These include "net transfers": mainly social benefits received less social contributions paid.

Households receive social benefits mostly from the government, but also from the financial sector (in the form of pensions for example) and from overseas. Households pay social contributions to both the government and the financial sector.

The bulk of social benefits households receive (82 per cent) and contributions they pay (68 per cent) are from/to the government. As a result, the social benefits households receive should move broadly in line with the social payments paid by the Government. Likewise, social contributions received by the Government should move broadly in line with social contributions paid by households.

Forecast revisions point to inconsistencies

The *SPU 2022* forecasts saw potentially significant inconsistencies between the macro and fiscal parts of the forecasts. The macroeconomic forecasts in *SPU 2022* signal large downward revisions to net transfers to households compared to at Budget time. By 2025, the SPU has net transfers received revised down by €5 billion (Table A1). In other words, households are now forecast to receive substantially less benefits than the contributions it would pay out. However, the fiscal forecasts show the opposite.[10] Transfers from the government to households are revised up by €3.2 billion relative to *Budget 2022* forecasts.[11]

These revisions do not appear consistent with each other. And the difference is large by 2025 at €8.2 billion (5.3 per cent of personal disposable income). For this to be consistent, it would have to imply that households pay substantially more net contributions to the financial sector by 2025, compared to the Budget forecasts. This seems implausible.[12, 13]

What does this disparity mean? It means that either Budget 2022 forecasts were inconsistent, SPU 2022 forecasts are inconsistent, or both. Whether *Budget 2022* forecasts were inconsistent

[10] Since the Department compiled their macroeconomic forecasts, which used the latest national account and institutional sector account data, there have been some revisions to the data based on the latest Government Financial Statistics release. However, these revisions do not meaningfully alter the analysis in this box.

[11] Social transfers in kind (via market producers) (D.632), does not form a part of household disposable income so is removed here to ensure a direct comparison with the figures from the macroeconomic forecasts. An example of a social transfer in kind (via market producers) would be a payment under the housing assistance payment scheme.

[12] The Department did not incorporate the impact of the proposed auto enrolment scheme into their macroeconomic forecasts.

[13] Alternatively, a steep increase in "net" other current transfers paid would have to explain the difference. The largest component of other transfers is net non-life insurance premiums/claims. The extent of the increase necessary would be implausible.

is hard to say. The Department did not provide the Council with the gross flows that underly their "net transfers" figure in the macroeconomic forecasts from Budget 2022.

Table A1: How net transfers to households were revised in SPU 2022

€ million, *SPU 2022 – Budget 2022*

	2021	2022	2023	2024	2025
Macroeconomic forecast revisions	-2,449	-3,099	-4,057	-4,576	-4,992
Fiscal forecast revisions	672	3,111	3,893	2,845	3,177

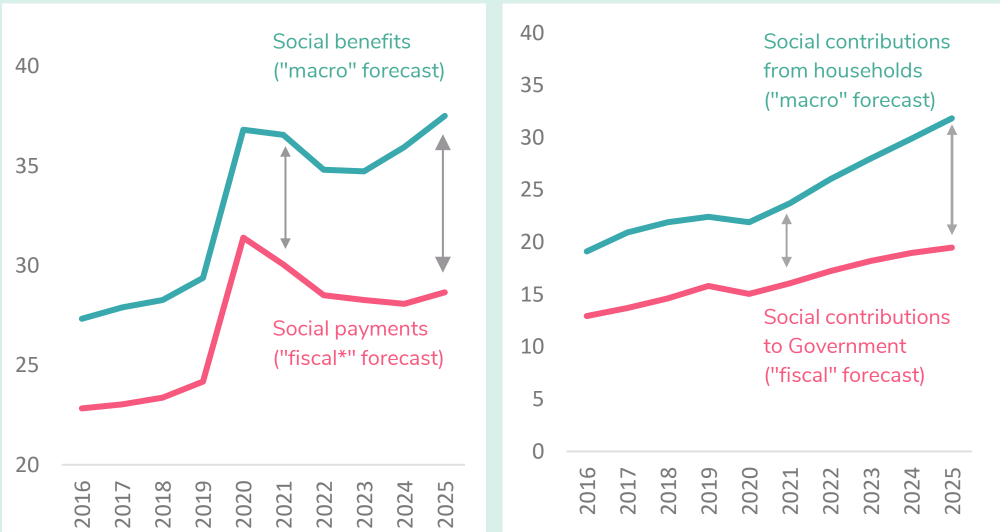
Source: Department of Finance.
Notes: The fiscal forecasts show the net revisions of social contributions (D.61) and social payments (D.62 + D.632) from Table 12 in SPU 2022 relative to Table 10 of Budget 2022's Economic and Fiscal outlook, together with the revision to social transfers in kind (via market producers) (D.632). Social transfers in kind (via market producers) is derived from the Department's macroeconomic forecasts for Personal Consumption Expenditure and Final Consumption Expenditure of households, which the Department assume grow at the same rates.

However, the Department did provide the gross flows of their macroeconomic forecasts as part of their *SPU 2022* forecasts. Figure A1 shows these gross flows alongside some of the SPU's corresponding fiscal forecasts.

Figure A1: Households social benefits and social contributions SPU forecasts

A. Social benefits households receive
€ billion

B. Social contributions households pay
€ billion



Sources: CSO; and Fiscal Council workings.
Notes: The green lines are from the macroeconomic forecasts. The pink lines are from the fiscal forecasts. *The pink line in panel A is constructed using both the fiscal forecasts for social payments and the macroeconomic forecasts for final consumption expenditure. It is derived from subtracting the social payments in kind (via market producers) (D.632). The forecasts of social payments in kind (via market producers) are obtained from the Department's macroeconomic forecasts for personal consumption expenditure and final consumption expenditure of households. Get the data.

Two things are apparent from comparing the SPU's macroeconomic and fiscal forecasts.

First, the forecasts suggest an increasing gap between the benefits households receive and the payments made by the Government to them (Figure A1.A). This implies that the share of benefits to households from the financial sector and overseas, is increasing rapidly. This could be a reasonable way to make the macroeconomic forecasts more realistic if the fiscal forecasts for social payments from government are unrealistically low. The social payments from government is falling in both 2023 and 2024 by close to €200 million, before rising by €580 million in 2025. The Council's Stand-Still scenario points to Social Protection demographic costs (including the effect of the fall in unemployment) falling by only €65 million in 2023, then rising by €470 million in 2024 and €395 million in 2025. This is without factoring in likely increases to the rates of pay of these benefits.

Second, the comparison of contributions paid by households with contributions to the Government similarly shows a gap emerging over time. This, again, implies a much larger share of contributions going to the financial sector (Figure A1.B). Total social contributions paid by households, which includes contributions to government and the financial sector, are forecast to rise at a sharp rate over the forecast horizon: up 7.7 per cent on average over 2022–2025, whereas the contributions to government are growing by 5 per cent.[14, 15]

How might inconsistencies be avoided?

In compiling the macro-fiscal forecasts, the first best outcome is that the macroeconomic and fiscal forecasts are both realistic and fully consistent with each other. However, in the absence of realistic fiscal forecasts that consider demographic pressures and the likely uprating of benefits and tax bands, some adjustments should be made to the macroeconomic forecasts. At a minimum, these adjustments would ensure that the macroeconomic forecasts are realistic. This can be done by compiling the macroeconomic forecasts on a "most likely" outcome basis, using Stand-Still-like spending pressures as an input. That is, recognising the likelihood that benefits would be uprated in line with historical precedent. This would prevent unrealistic fiscal forecasts impacting on the realism of other areas of the macroeconomic forecasts like the forecasts for consumer spending.[16]

In 2021, household taxes grew more than twice as fast as employees' labour income, leading to a sharp increase in the ratio of taxes to labour income. This outcome reflected a combination of factors. Firstly, there was an ongoing weakness in incomes for sectors worst affected by the pandemic, which typically contribute less to income taxes — see Box D in the May 2021 *Fiscal Assessment Report* (Fiscal Council, 2021a). Secondly, tax receipts were unexpectedly strong from sectors less affected by the pandemic (see Box B).

While the tax-income ratio has typically been stable over time, the Council has noted that a number of previous forecasts have shown rising ratios. The average tax rate increased rapidly in 2021 and *SPU 2022* shows that this is

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[14] Of the contributions to government, PRSI receipts are forecast to grow by an average of 7.4 per cent over 2022–2025, broadly in line with Compensation of employees. This means that the social contributions from government employees and the government's imputed pension contribution for these employees are forecast to fall by an average of 2.5 per cent over 2022–2025.

[15] While PRSI may grow in line with compensation of employees (with an elasticity of 1, see Conroy, 2020), in the recent past total social contributions from households has grown at a slower rate than compensation of employees. For instance, over 2013–2021, compensation of employees grew by an average of 5.2 per cent, whereas total social contributions grew by 4 per cent.

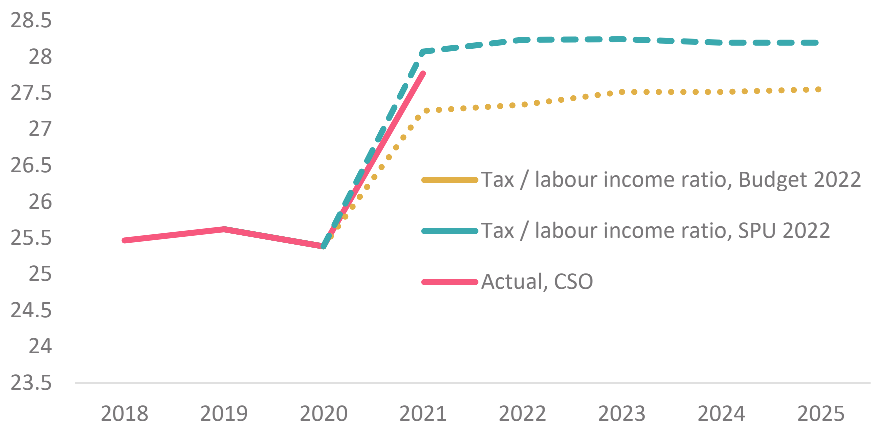
[16] If the realism of consumption forecasts are affected, this can impact on the accuracy of VAT receipts, and by extension the budget balance.

expected to persist, even as the economy recovers (Figure 1.10).[17] This implies that taxes will remain well above the 2019 share of income. There are a few potential explanations for such a forecast. As wages rise, fewer workers may become exempt from income tax over time; more people might fall into the higher tax bracket; or a larger share of earnings could be taxed at the higher rate. However, it is also possible that a return to work of employees with lower hourly pay or part-time jobs, whose employment was most acutely affected by the pandemic, could lead to a return to a lower tax-income ratio.

The Department's forecasts implied an elevated effective income tax rate until 2025

Figure 1.10: *SPU 2022* shows a level-shift projection for the ratio of household taxes to labour income

Taxes as a share of labour income



Sources: CSO, Department of Finance, and Fiscal Council workings. [Get the data.](#)
Notes: The dashed lines represent forecasts at the time of the Budget or SPU's publication. The measure of taxes on income and wealth is broader than just income tax, and also includes capital gains tax, motor tax (on household cars), and the TV licence. Actual (CSO) reflects the Q4 outturn for taxes, which was €0.3 billion weaker than expected in *SPU 2022*'s macroeconomic projections.

Box B uses sectoral data for employee taxes, wages and salaries, and hours worked to assess the *SPU 2022* forecasts for income tax. Based on a recent analytical note by Timoney (2022), the analysis suggests that a bottom-up projection of income taxes align with official forecasts, conditional on the composition of employee earnings in *SPU 2022*. The strength of hourly earnings in high-earning sectors is shown to be especially relevant to the prospects for employee taxes, which could prove even stronger over the medium term. However, caution is warranted given the recent nature of this shift.

Strong wages in high-pay sectors could increase the average effective tax rate on labour income, but caution is warranted

[17] Although *Institutional Sector Accounts* for Q4 2021 had not been published by the time of the endorsement decision, compensation of employees by sector has recently been included in the CSO's *Quarterly National Accounts*. Figure 1.8 reflects the Q4 outturn for taxes, which was €0.3 billion weaker than expected in *SPU 2022*'s macroeconomic projections.

Box B: A bottom-up assessment of income tax forecasts across sectors

Income tax receipts were exceptionally strong in 2021, despite significant restrictions on activity due to Covid-19. As a share of labour income, the effective tax rate (ETR) increased by two percentage points to 24 per cent between 2020 and 2021. This followed a stronger outturn for income tax receipts in 2020 compared to official forecasts.

The *Stability Programme Update (SPU)* 2022 projects a higher ETR to remain for 2022–2025. To assess the plausibility of the aggregate income tax forecasts contained in *SPU* 2022, this box generates a bottom-up estimate of income tax forecasts across sectors, summarising the findings of a recent analytical note by Timoney (2022).

Three groups are used in presenting the bottom-up projections, based on the ranking of 16 sectors of the economy according to their hourly wages in 2019, and they are called 'High 5', 'Middle 6', and 'Low 5'.[18]

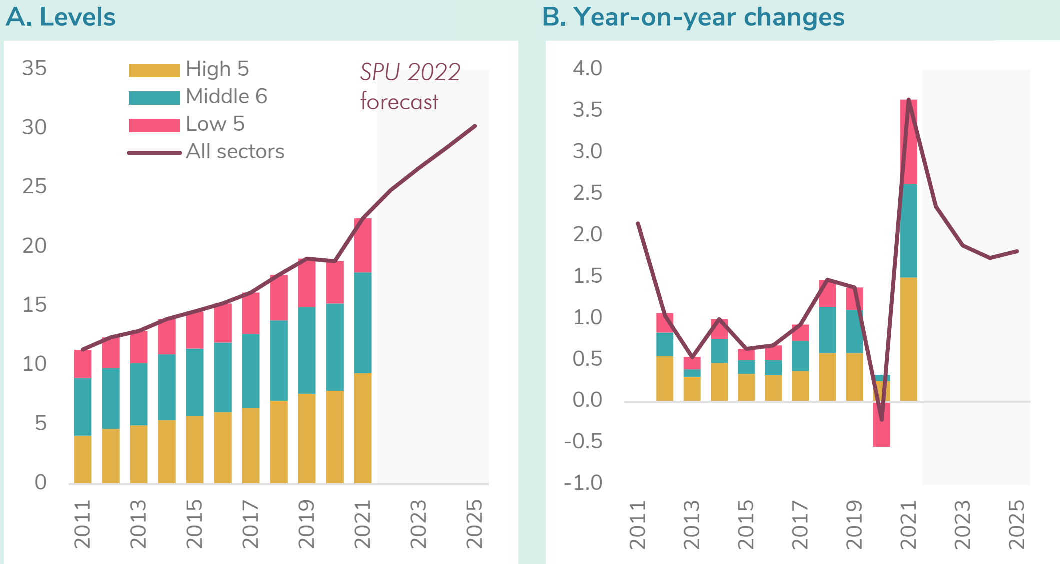
The first section of the box presents background data on employee taxes and hourly wages across sectors. The second section uses decompositions of hours worked and hourly wages to forecast wages and salaries across sectors, consistently with total wages and salaries in *SPU* 2022. The final section forecasts ETRs and employee taxes by sector.

Employee taxes and hourly wages across sectors

The main components of income taxes are employee taxes — that is, "pay as you earn" (PAYE) and universal social charge (USC, which replaced the income levy in 2011) — and they are presented in Figure B1, with *SPU* 2022 forecasts for 2022–2025 also included. In 2021, employee taxes recovered strongly for all sector groups following a weaker 2020 as a result of Covid-19.

Figure B1: Employee taxes grew across all sector groups in 2021

€ billion



Sources: Revenue Commissioners, Department of Finance, and Fiscal Council workings. Get the data.
Notes: Income tax mainly comprises "pay as you earn" (PAYE), universal social charge (USC, which replaced the income levy in 2011), and self-assessed income taxes. It also includes life assurance exit tax, deposit interest retention tax, professional services withholding tax, dividend withholding tax, and miscellaneous income tax.

[18] 'High 5': information/communication (J), real estate (L), professional/scientific/technical (M), financial/insurance (K), and education (P). 'Middle 6': mining/utilities (B, D and E), human health/social work (Q), administrative/support (N), manufacturing (C), public administration/defence (O), and other activities (R–T). 'Low 5': wholesale/retail (G), transport/storage (H), construction (F), accommodation/food services (I), and agriculture/forestry/fishing (A)

Table B1 summarises the pre-pandemic shares of employee taxes, wages and salaries, and hours worked in 2019 for the three sector groupings introduced above. The differences among these shares illustrate the progressivity of employee taxes.

Table B1: Employee taxes, wages and salaries, and hours worked in 2019

Percentage of total for employees in all sectors

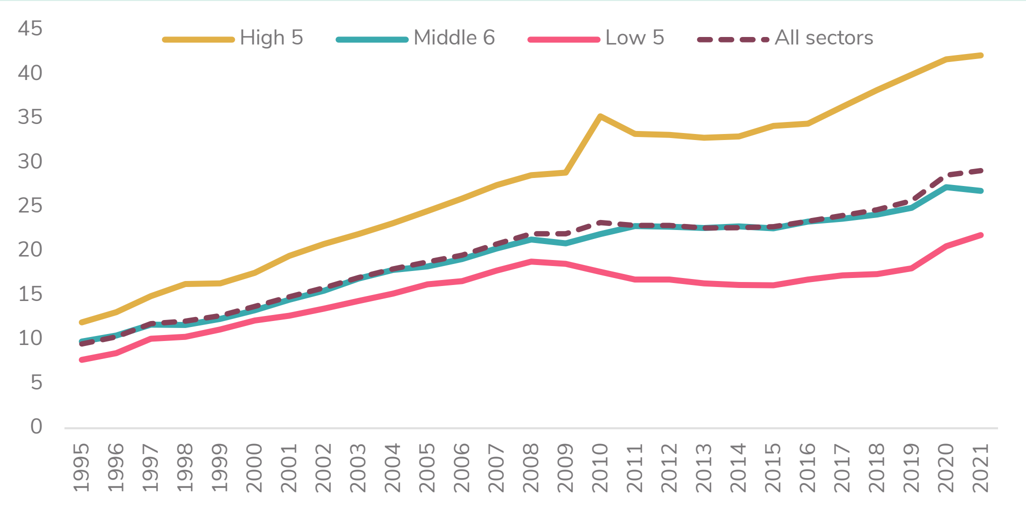
	High 5	Middle 6	Low 5
PAYE and USC	40	38	22
Wages and salaries	33	42	25
Hours worked	22	43	36

Sources: Eurostat; and Fiscal Council calculations.
Note: The sector groupings are based on a ranking of 2019 hourly employee wages for NACE Rev 2 sectors.

Figure B2 presents data for 1995–2021 for employees' hourly wages in the Irish economy. This shows that the 'High 5' sector grouping has seen considerably faster hourly wage growth over time compared to the 'Middle 6' and 'Low 5'. For the two groups with lower wages, the pandemic resulted in an increase in average hourly wages in 2020 and 2021, since job losses were concentrated among workers with the lowest wages.

Figure B2: Employee hourly wages have grown rapidly for the five sectors with the highest 2019 hourly wages

€ per hour worked



Sources: Eurostat, CSO, and Fiscal Council workings. Get the data.
Notes: The sector groupings are based on a ranking of 2019 employee wages per hour worked for NACE Rev 2 sectors.

This also shows that there has been a long-standing trend divergence between the higher-paid and other sectors in terms of the hourly wage. This reflects stronger productivity growth in the higher pay sectors. By contrast, average hourly wages have barely increased in cash terms since the Great Recession in the lowest paid sectors, implying a decline in real wages.

Forecasting wages and salaries by sector (consistent with SPU 2022 projections)

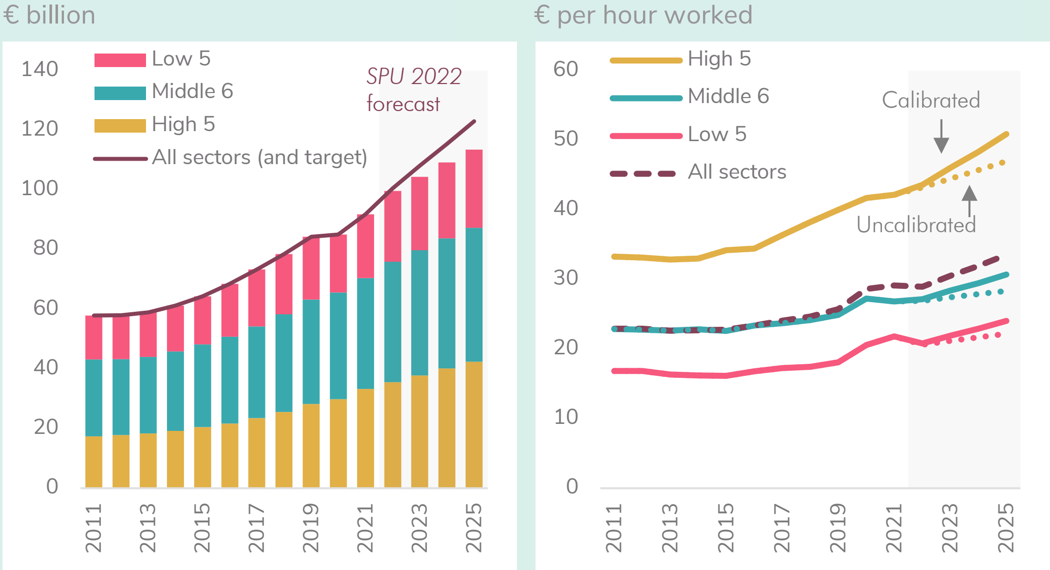
The slow-changing nature of hours worked shares across sectors provides a simple basis for forecasting the share of each sector using linear trend extensions. The sample period used is from ten-year trends for sectoral shares (2012–2021).[19] Multiplying the implied projections for hours worked with ten-year trends in hourly wages results in a preliminary, "uncalibrated" projection for employee wages and salaries. As shown in Figure B3.A, this approach is insufficient to explain the official forecasts for wages and salaries, falling short by €9.5 billion (7.7 per cent) in 2025.

To match this, a "calibrated" version of the estimates is constructed by allocating the differences for the total each year in proportion to each sector's share of total wages and salaries. This raises the level of the average hourly wage by about €2.50 (8 per cent) for 2025. Using these "calibrated" data for wages and salaries allows for the derivation of the implied employee hourly wage rates over the forecast horizon in terms of the bottom-up picture (Figure B3.B).

Figure B3: Calibrating hourly wages and salaries

A. Uncalibrated projection for employee wages, and target

B. Employee hourly wages



Sources: Revenue Commissioners; Eurostat; Department of Finance; and Fiscal Council workings. Get the data.
Notes: In panel A, the uncalibrated wages and salaries projections come from multiplying the hours worked decomposition by the ten-year linear trend extensions of employee hourly wages (dotted lines in panel B).

Forecasting effective tax rates and employee taxes by sector

To forecast income taxes across sectors, one approach is to use projected hourly wages derived in the previous section and to match them to expected sectoral effective tax rates (ETRs). The idea is that higher wage sectors will have higher ETRs and so a shift in income towards them will raise the economy-wide average tax rate.[20]

Using available data, the average elasticity of tax revenue to income growth over 2011–2021 is calculated across sectors as 1.3 for 'High 5', 0.8 for 'Middle 6', 0.9 for 'Low 5', and 1.1 for all

[19] Employee hours worked data from Eurostat are used up to 2019, but extended forward for 2020 and 2021 using actual hours worked data published by the CSO. This is to reflect the impact of the pandemic on hours worked more accurately, since standard ILO labour market data included many Pandemic Unemployment Payment recipients as employed. For 2022–2025, the series for employee hours worked is extended using the *SPU 2022* forecasts for the growth rate in total hours worked.

[20] However, compositional effects can affect these results. For example, if a sector experiences a shift towards part-time workers instead of full-time workers, along with no change in its hours worked or employee wages, then the ETR for that sector is likely to decline — owing to a lower average tax burden on part-time workers relative to full-time workers. This scenario would not imply a positive elasticity of the sector's ETR with respect to its hourly pay.

sectors. The elasticity of around 1 for total income suggests that the ETR is relatively constant, and in line with other estimates of the relationship between income tax and wages.[21]

This reflects the fact those the income gains of those in the 'High 5' sectors have been driven by wages taxed at the higher marginal tax rates and that starting salaries are high. By contrast, the elasticity is less than 1 in the other sectors, possibly reflecting the greater role of increases in the number of jobs in these sectors where people tend to start at a low marginal tax rate and more part-time work.

Using these elasticities, and the derived hourly wages by sector, estimated employee taxes paid by sector can be calculated with the following equation:

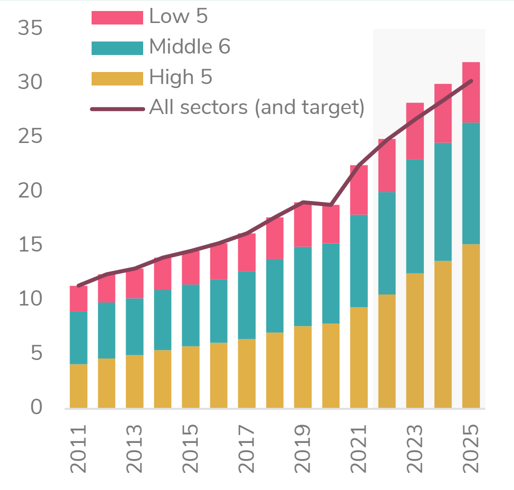
$$Income\ tax_t = Wages_t * ETR_{t-1} * (1 + \beta * \%\Delta hourly\ pay_t)$$

Figure B4.A presents these bottom-up projections compared to the *SPU 2022* forecasts for employee taxes, building on the calibrated wages by sector from the previous section (Figure B3.A). In Figure B4.B, the derived ETRs are shown, including the implied *SPU 2022* projection.

Figure B4: Bottom-up projections of employee taxes

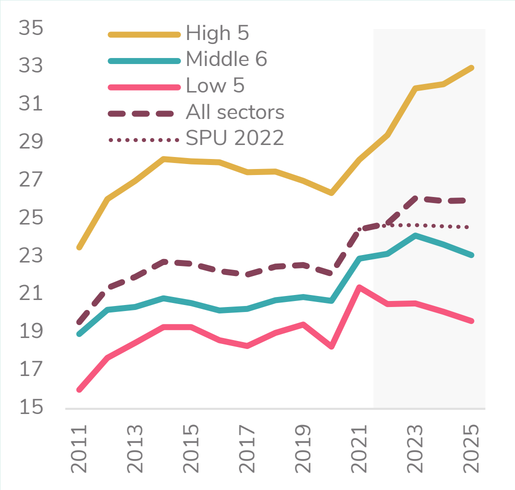
A. Levels (and *SPU 2022* forecast)

€ billion



B. Estimated effective tax rates across sectors

Employee taxes / wages and salaries



Sources: Revenue Commissioners; Eurostat; Department of Finance; and Fiscal Council workings. Get the data.
Notes: In panel A, the bottom-up projections come from multiplying calibrated wages and salaries (see Figure 9A in Timoney, 2022) by the elasticity-based extensions of ETRs shown in panel B.

Over the forecast horizon, the bottom-up approach implies a higher level of income taxes than the official projections shown in *SPU 2022* for the same aggregate pay increase. This suggests that the increase in the aggregate ETR can more than be explained by aggregate pay growth from a bottom-up perspective, and by 2025, the bottom-up sum of projected tax receipts is €1.7 billion (5.8 per cent) above *SPU 2022* forecasts, implying a larger rise in the aggregate effective tax rate. This could partly reflect negative judgements applied by the Department of Finance to their PAYE and USC projections — see section S5 for further details on these judgements.

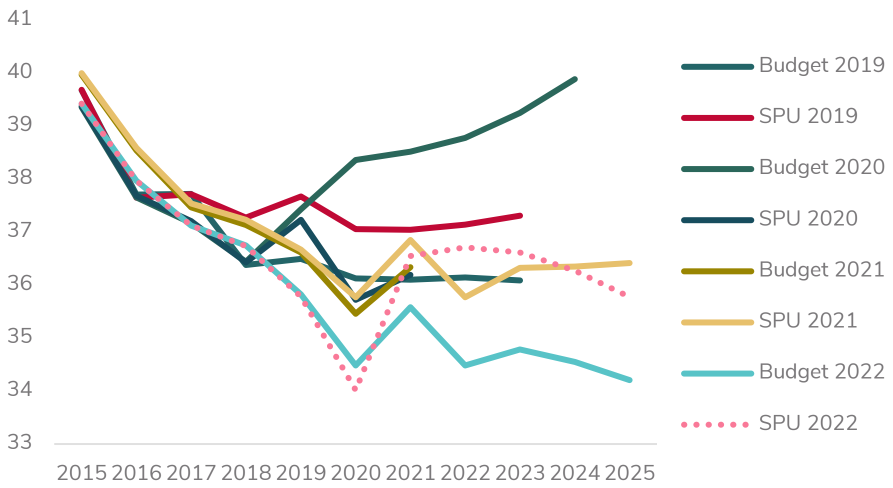
While this would appear encouraging in terms of supporting the idea that the upward shift in the average effective tax rate can be explained by sectoral factors, this conclusion should be treated with caution given the many assumptions required and the recent nature of this shift, at a time when the economy was subject to a number of sectoral shocks.

[21] See Table 5 in Conroy (2020) for a summary of estimated income tax elasticities in Ireland. Conroy's estimated elasticity using policy-adjusted income tax is 1.4, considerably higher than 0.8 when using income tax not adjusted for policy changes.

Notwithstanding the conclusion in Box B — that a higher average effective tax rate on employee income is a plausible baseline forecast — it is important to note that there has been an apparent lack of consistency across recent official projections of macroeconomic and fiscal outcomes. Figure 1.11 shows recent ratios based on official forecasts of government revenues (excluding corporation tax) as a share of GNI*. The wide range of outcomes for this ratio over the forecast horizon across official forecast vintages suggests considerable uncertainty for the tax richness of the economy.

Figure 1.11: Recent projections suggest a wide range of uncertainty around relative macro-fiscal outcomes

General government revenues excluding corporation tax, as a percentage of GNI*

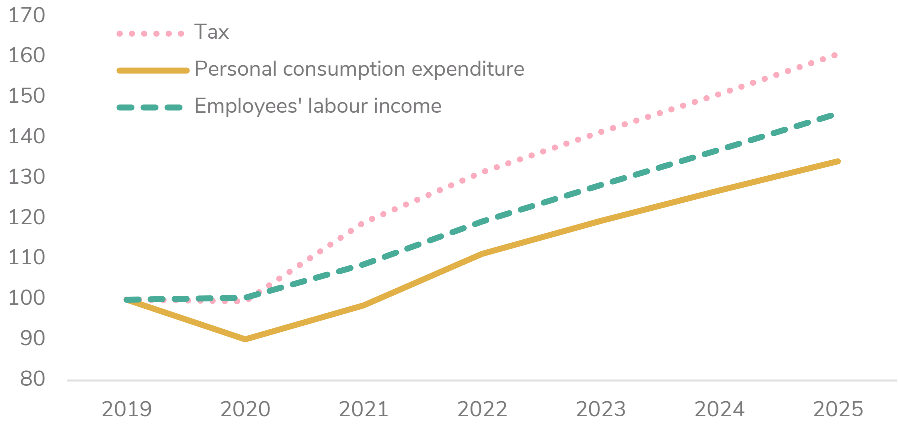


Sources: Central Bank of Ireland, and Fiscal Council workings. [Get the data.]

Furthermore, the projected strength of tax receipts and employees' labour income in *SPU 2022* — which have been revised up considerably since last October's *Budget 2022* — is in contrast to the unchanged and relatively weak recovery for nominal personal consumption (Figure 1.12).

Figure 1.12: *SPU 2022* forecasts weaker personal consumption relative to taxes and labour income

2019 = 100, annual values

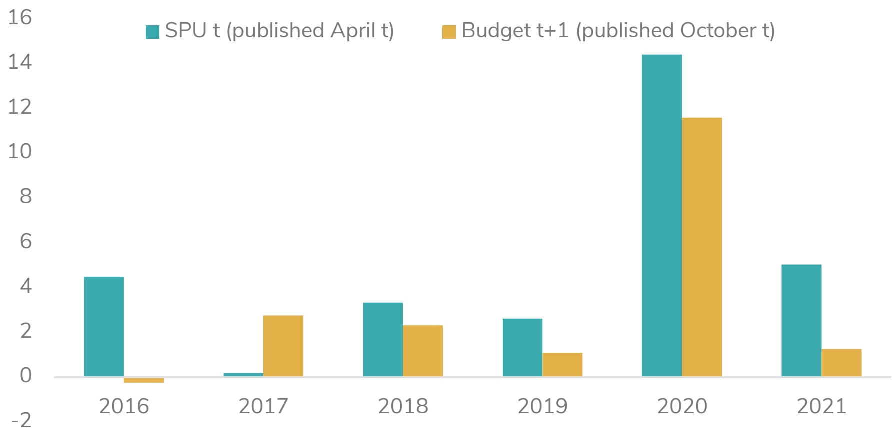


Sources: CSO, Department of Finance, and Fiscal Council workings. [Get the data.]

As shown in Figure 1.13, the Department's projections for labour income have often been significantly lower than outturns in the years prior to the pandemic. This indicates a systematic pattern of downwards bias in the gross income projections.

Figure 1.13: Official forecasts have tended to underestimate in-year labour income

€ billion (positive figure = income greater than forecast)



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

Notes: The chart shows the latest outturns for labour income of employees less the Department's in-year forecast. This does not correct for revisions to historical data that may have influenced the magnitude of forecast errors in some cases. [Get the data.]

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*

2021 turned out better than expected

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.

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

€ millions unless otherwise stated

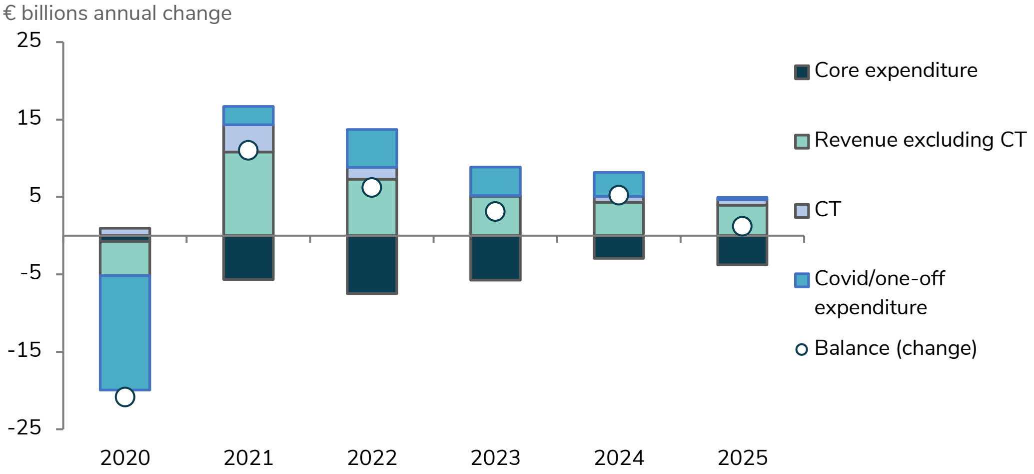
	November Budget	2021 Outturn	Forecast error
General Government Revenue	**93,110**	**96,961**	**3,851**
Corporation Tax	13,890	15,325	1,435
Income Tax	26,015	26,665	650
Capital Gains Tax	1,100	1,640	540
General Government Expenditure	**106,360**	**105,072**	**-1,288**
Of which: Capital Spending	9,430	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.

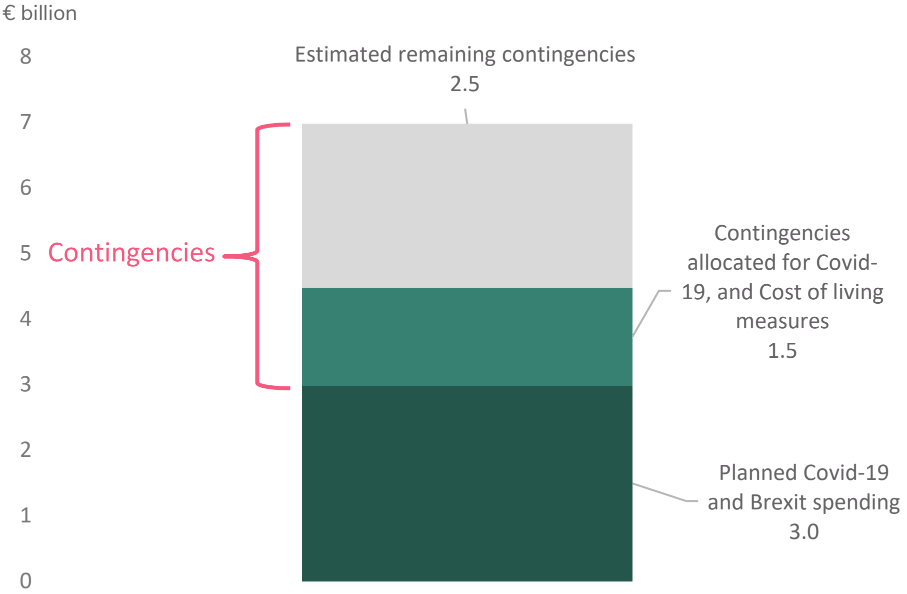
SPU forecasts for revenue and spending in 2022 incorporate new measures introduced since *Budget 2022*. Many of these measures were intended to alleviate pressure on households and businesses facing higher energy prices. The main measures are listed in Table 2.2. Of the €7 billion in contingency spending 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.

Sizeable contingencies remain to respond to various crises

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.

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*.

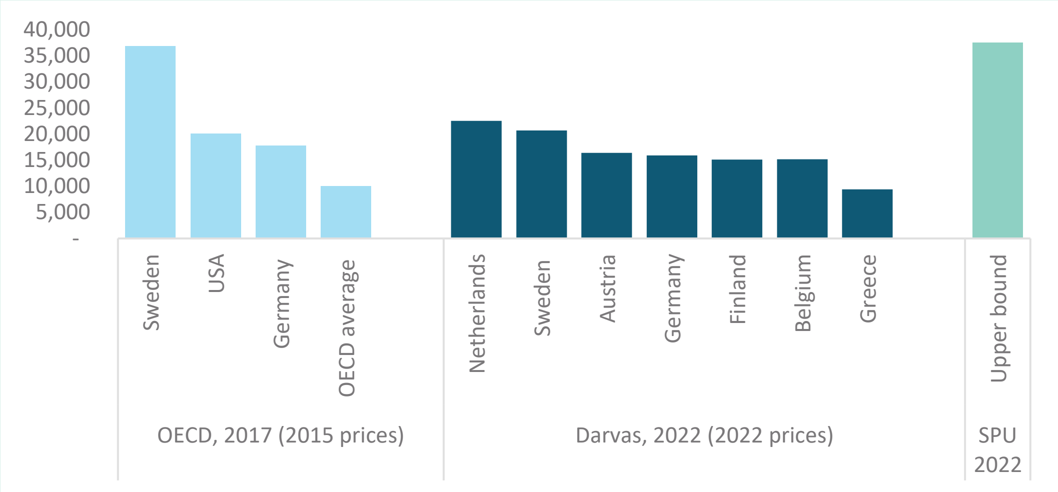
Some €3 billion has been set aside for Ukrainian humanitarian spending in 2023. With 100,000 refugees assumed to arrive in Ireland, the level of spending in 2023 per refugee would be approximately €30,000.[25] Historical estimates of the cost per refugee vary across countries. Recent estimates of the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

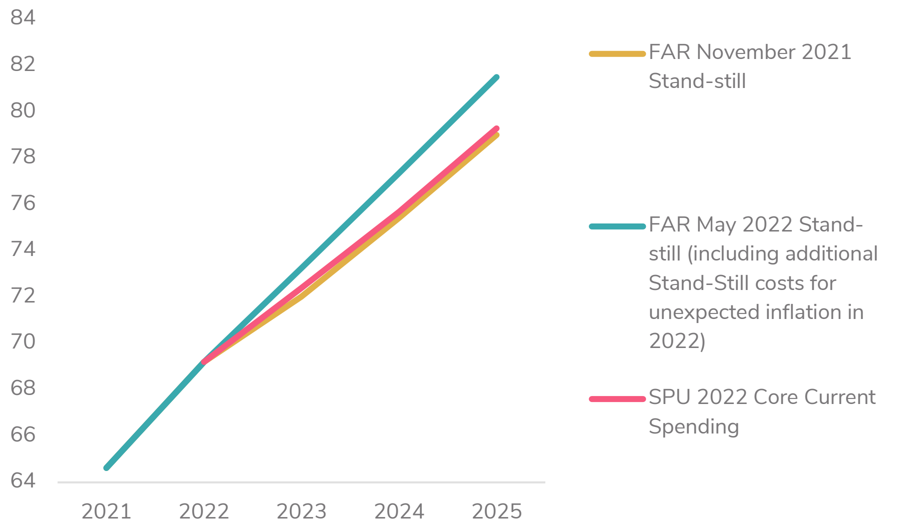
[44] Lydon (2022) calculates that inflation for the lowest 20 per cent of earners in December 2021 was 6.1% as opposed to 5.3% for the top 20 per cent

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

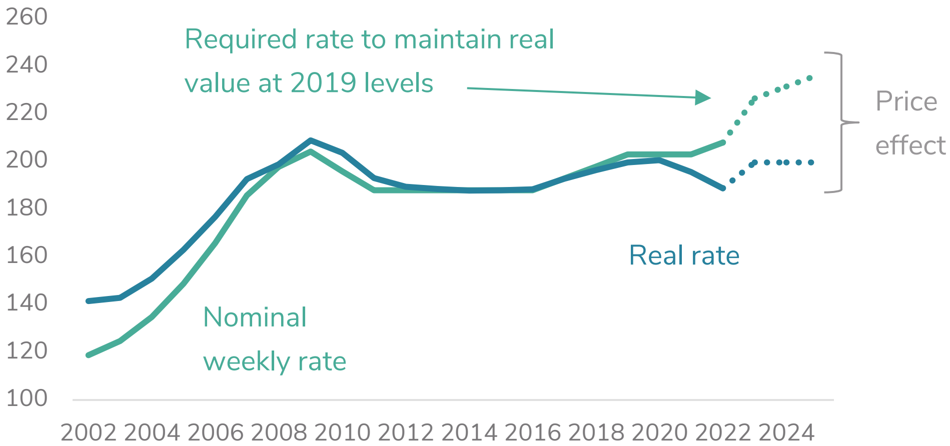
[45] This assumes that core spending in 2022 is as forecast in *SPU 2022*. As Section 2.2 highlights, there may be underspends.

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.

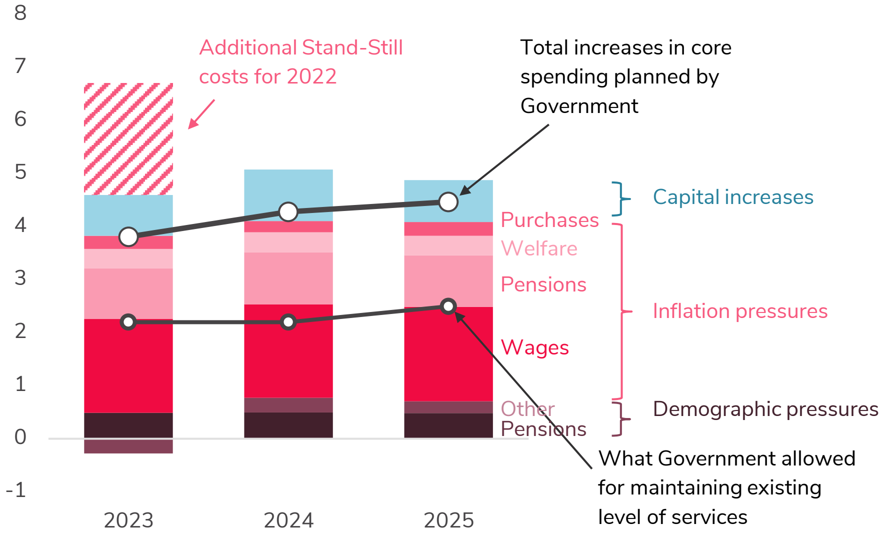
Notes: Nominal weekly rates are deflated using the HICP index.

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 dashed red 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

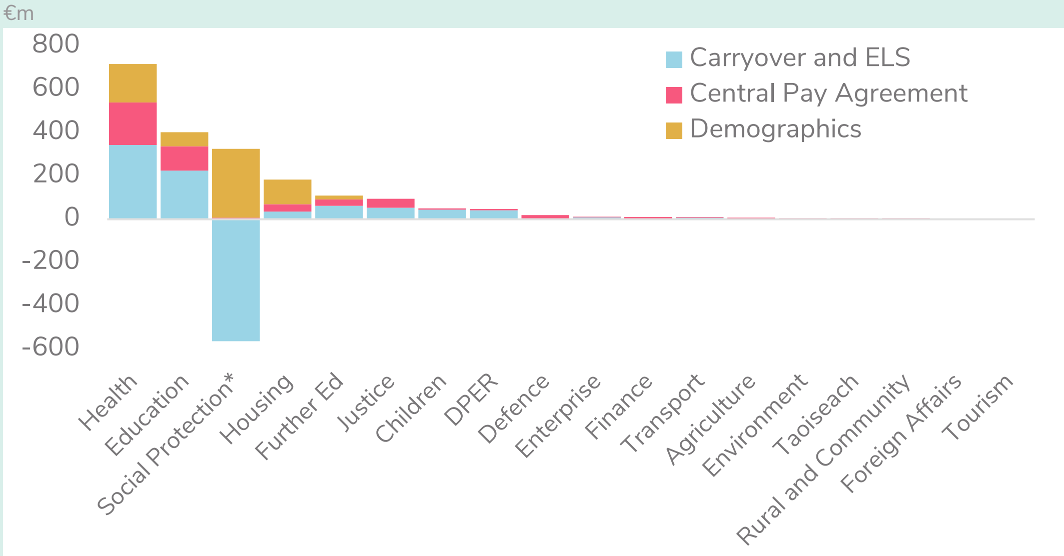
After years in which medium-term forecasts for government spending were based on arbitrary growth rate assumptions, following repeated calls from the Council to move towards a Stand-Still methodology, the Government has recently adopted a new approach, which it refers to as the "ELS". This approach, 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.

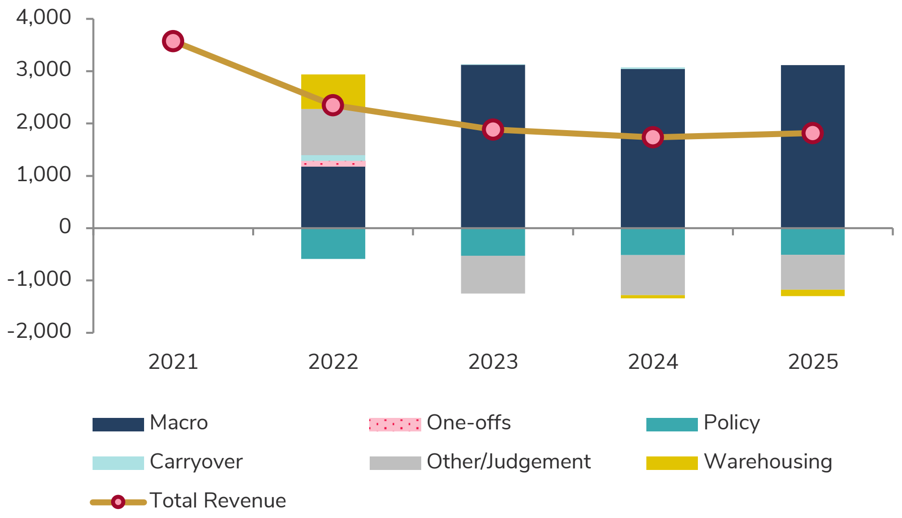
2.4 Tax forecasts

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



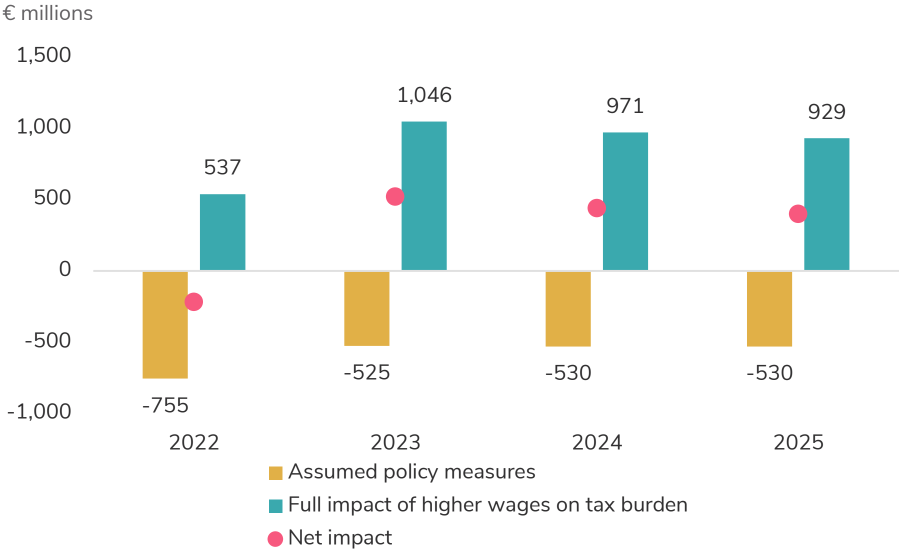
Sources: Department of Finance; and Fiscal Council workings. Get the data.
Notes: This chart shows the decomposition of combined USC and PAYE receipts, which makes up more than 84 per cent of income tax receipts

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.

[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

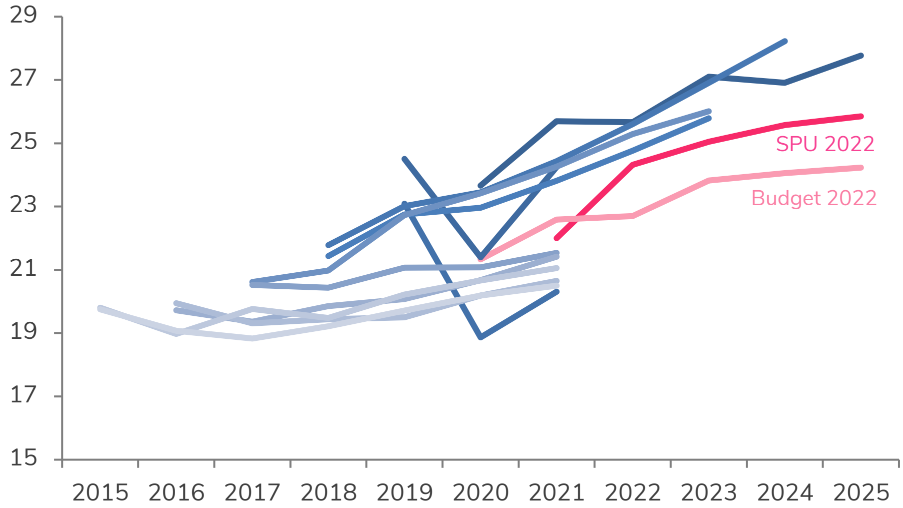
	2022	2023	2024	2025
Income Tax	1,325	1,790	1,935	2,205
Social contributions	509	769	1,379	1,639
VAT	835	910	750	685
GG Revenue (excluding CT)	3,859	3,649	3,994	4,099
GG Revenue (excluding CT) (% GNI*)	1.6	1.4	1.5	1.4

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

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.

Capital spending has been revised down

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.

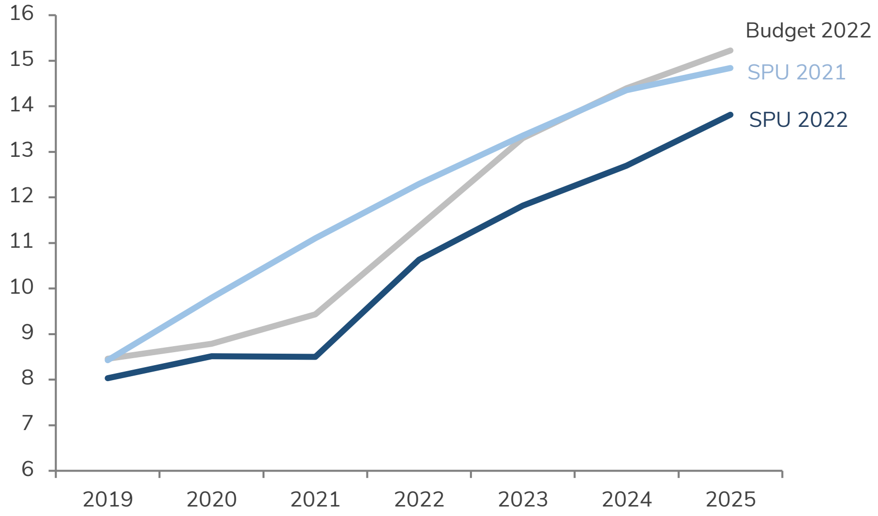
The shortfall in capital spending recorded in 2021 is projected to widen over the medium term (Table 2.4). However, these downward revisions are not mirrored in the projections of gross voted capital spending for 2023-2025, which are unchanged from *Budget 2022* forecasts. This suggests that non-exchequer 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

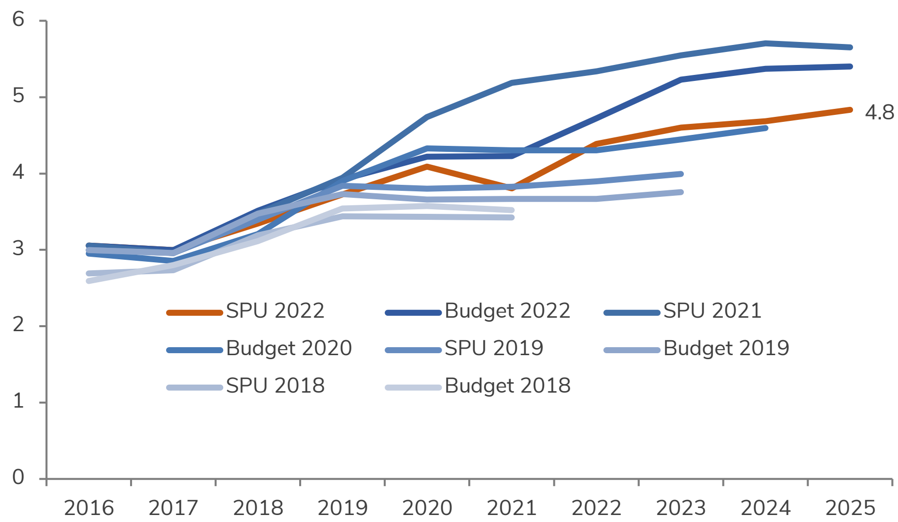


Source: Department of Finance. Get the data.

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.

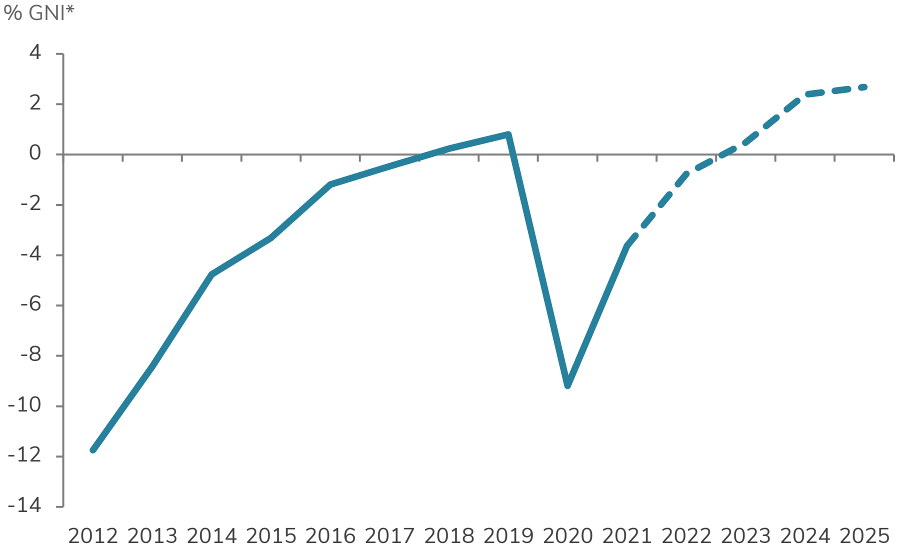
2.6 How the public finances are forecast to evolve

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.

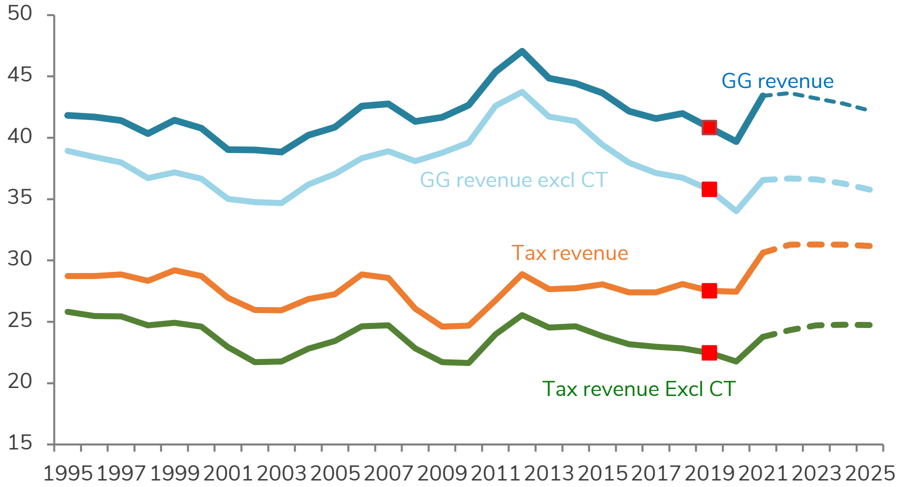
Notes: Changes are in the format 2025 level minus 2019 level. As a result, positive values indicate a variable increasing over the period or taking up a larger share of GNI* than was the case in 2019. The annualised growth rate shows what rate of growth applied for every year from 2019 would yield the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

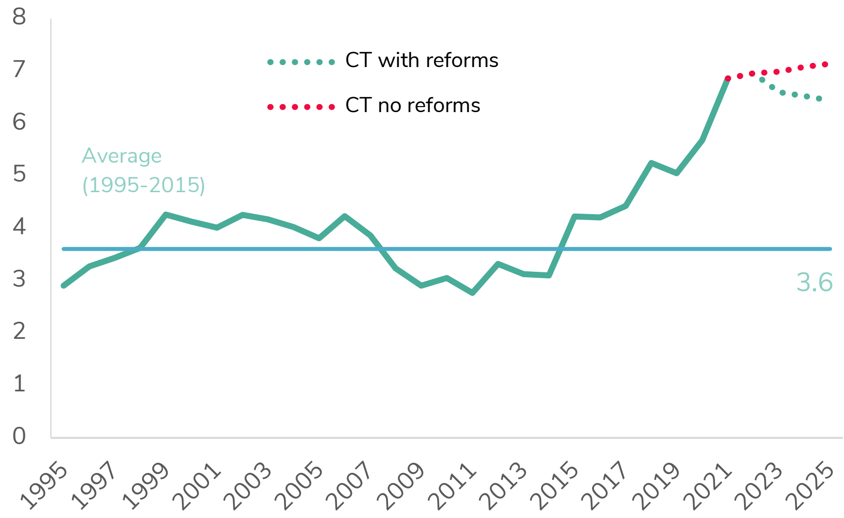
2.7 Increasing reliance on Corporation Tax

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).

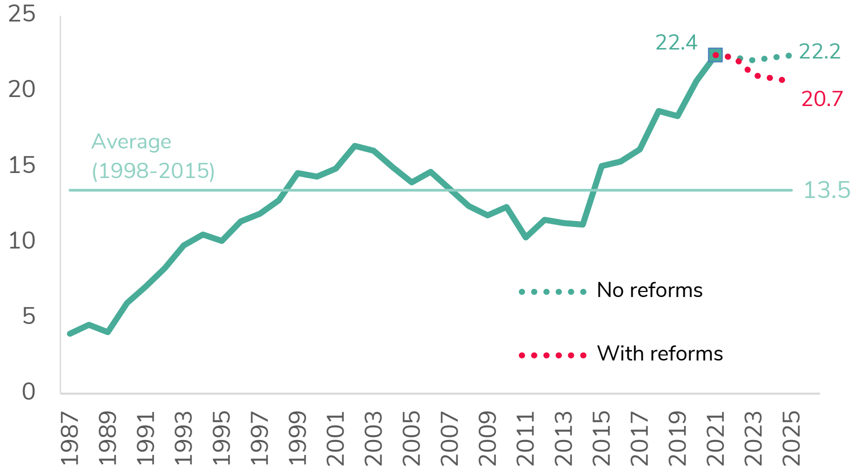
As a result, the reliance on corporation tax receipts used to fund recurring spending has also grown. In 2011, corporation tax accounted for 10.3 per cent of exchequer tax revenue, but this has risen to 22.4 per cent by 2021 (Figure 2.14).

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).

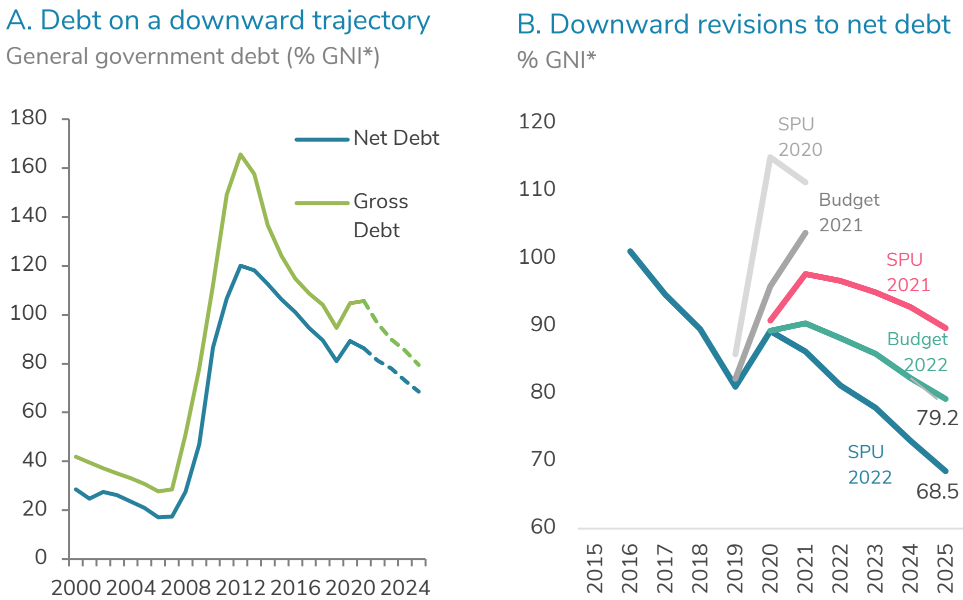
[58] As a recent Fiscal Council analytical note points out, these large increases in corporation tax receipts have been used to fund overruns in health spending (see Casey and Carroll, 2021)

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



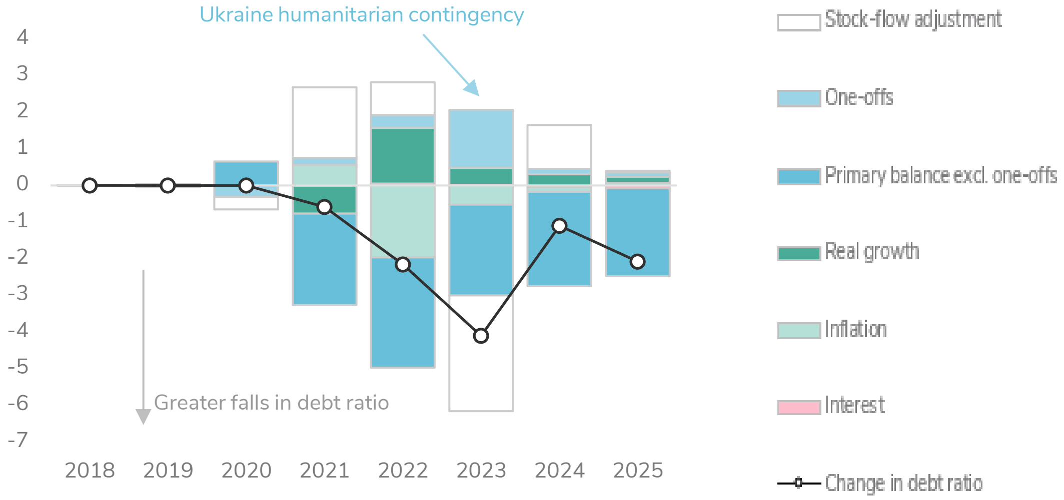
Sources: CSO; Department of Finance; and Fiscal Council workings. [Get the data.]

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

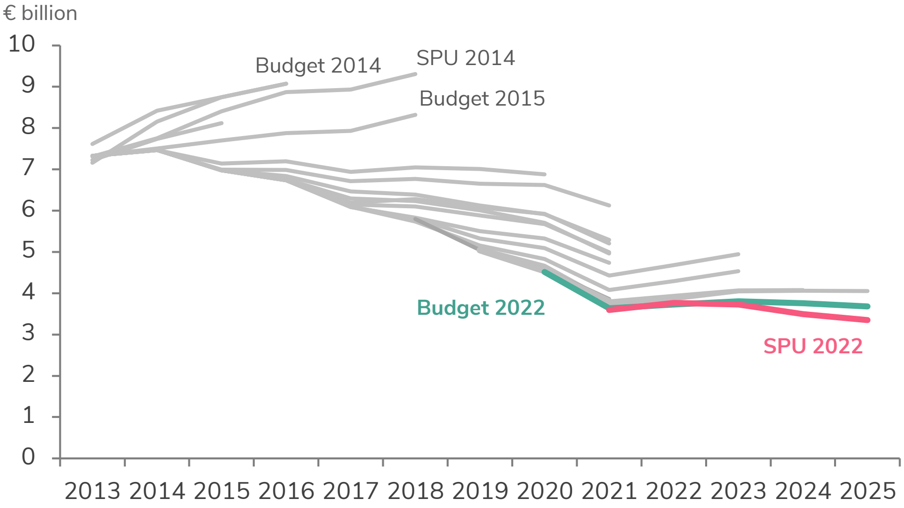
[59] While not due to mature in this timeframe, Ireland also has €1.1 billion in inflation linked bonds, and €4.5 billion in floating rate bonds outstanding. The interest payments associated with these outstanding bonds will rise the higher inflation or interest rates go, respectively. The interest rate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

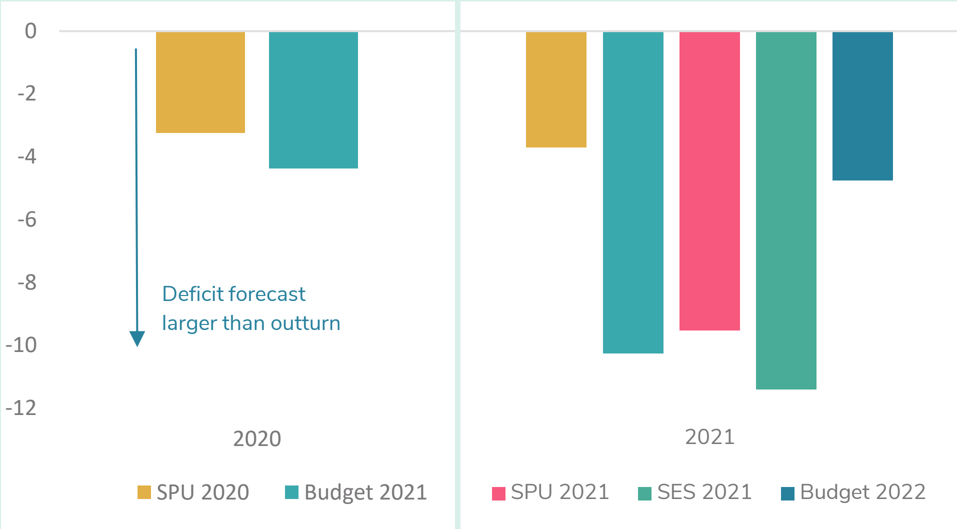
At end-March 2022, the exchequer had €29 billion cash on-hand, equivalent to 13 per cent of 2021 GNI*. This is partly due to the NTMA's strategy of prefunding future bond redemptions but also due to the Department overestimating past borrowing requirements. The larger-than-expected cash balances can 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.

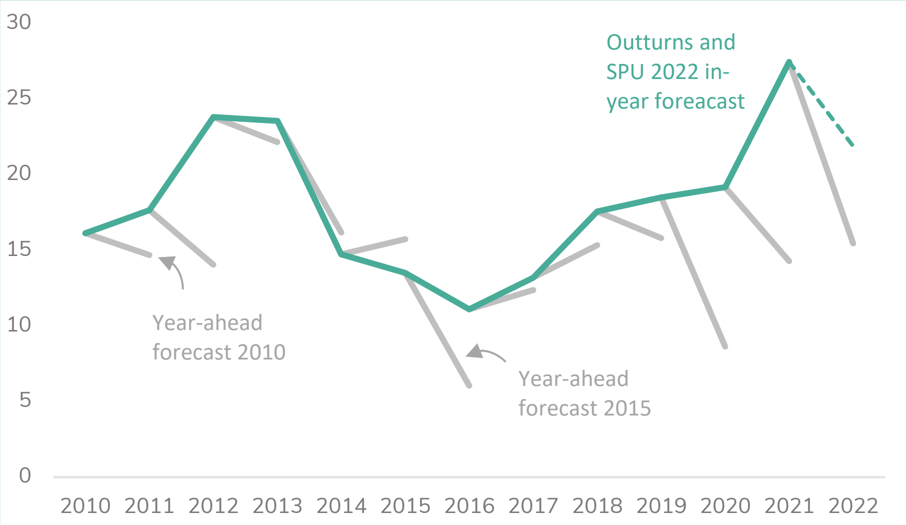
As shown in Figure F2, this additional borrowing has contributed to a run up in cash assets. The result of which is there is an almost 20 percentage point difference in the gross debt-to-GNI* ratio, which was 105.6 per cent, and the net debt ratio, which was 86.2 per cent.

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.

Fiscal Stance

Managing the public finances with higher inflation

3. FISCAL STANCE

Managing the public finances with higher inflation

The recovery in the economy from Covid-19 has been rapid, but uneven, and the economy now faces new challenges from the effects of the Russian invasion of Ukraine. Ireland has been helped by the performance of the international sector in terms of activity and taxes, including corporation tax and strong wage gains of higher income workers. Price and wage increases have also boosted tax receipts. As a result, a budget balance looks in prospect much sooner than had been expected, including at Budget time.

The recovery in the economy has been rapid, but even

The Government's SPU projections assume that it plans to stick to its 5% Spending Rule, newly introduced in *Budget 2022*. Core spending levels are consistent with the levels originally set out under this approach.

Maintaining core spending in line with the levels set out under the 5% Spending Rule should help to achieve a balanced budget position on an underlying basis — ignoring temporary, cyclical and one-off factors. This should set the Government's debt ratio on a steady downward path to safer levels. In turn, lowering the debt ratio would provide a buffer so that it is possible to respond to future shocks with sizeable budgetary supports in a similar way to the response during the pandemic.

Sticking to the 5% Spending Rule should set the debt ratio on a steady downward path

The Government's plans to 2025 would allow it to achieve several aims. It would allow it to address investment needs in the areas of housing and climate change by bringing public investment to record levels; largely maintain existing levels of services and the effective tax burden; and do this without providing excessive stimulus to an already fast outlook for growth. In addition, these plans allow for a steady pace of debt reduction averaging close to 4.4 percentage points for the net debt-to-GNI* ratio annually between 2022 and 2025. This would bring the gross debt ratio to 79.4 per cent of GNI* by 2025 and the net debt ratio to 68.5 per cent.

However, there are many important risks and pressures facing the public finances. First, growth is highly uncertain with several downside risks, including those from the war in Ukraine, Brexit, and the impact of price inflation on the domestic and global economy. Second, the sectoral nature of both the pandemic and Russia's war in Ukraine, together with the higher cost of living, means there could be further pressures to provide targeted

However, there are many risks

fiscal supports. Third, an overreliance on corporation tax receipts, which are risky and prone to reversals, to fund government spending has increased. Fourth, the lack of costings on major policy commitments over the medium term poses a major risk to medium-term fiscal sustainability, and there is no space for funding new current spending initiatives on a sustainable basis without tax increases or spending reductions elsewhere.

The Government should use targeted measures, reinforce its 5% Spending Rule, reduce its over-reliance on corporation tax, and properly cost its major commitments

In this report, the Council makes four key assessments in relation to the fiscal stance. These are in the context of its broader assessment that the *SPU 2022* fiscal stance is conducive to prudent economic and budgetary management. First, the Government faces a delicate balancing act in protecting the economy and poorer households from higher energy and food prices, while avoiding adding to inflation through second-round effects. A combination of carefully calibrated supports and wage increases together with targeted measures could help to achieve this. Second, the 5% Spending Rule should be reinforced so that it captures general government spending, has a link to debt targets, and recognises the impact of tax measures. Third, the over-reliance on corporation tax should be gradually unwound. Fourth, major policy commitments need to be properly costed and factored into the Government's plans.

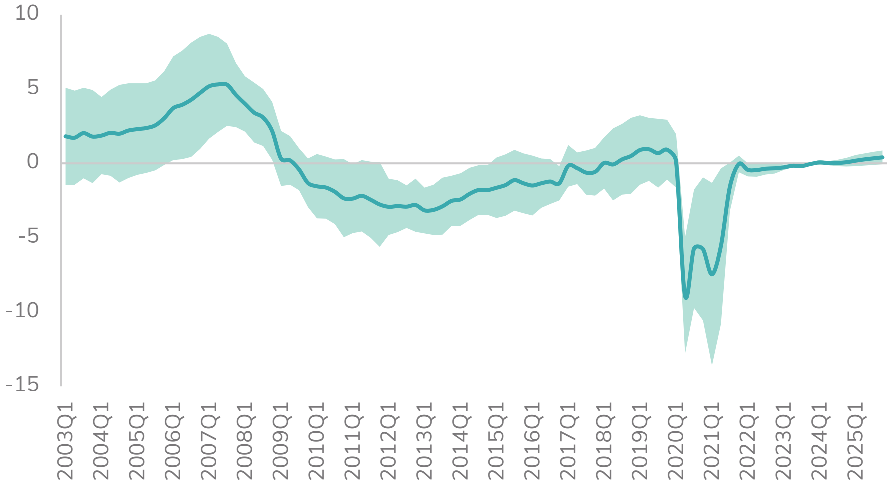
The Council's assessment of the fiscal stance is informed by (1) a broad economic assessment that considers appropriate management of the cycle and shocks facing the economy as well as the sustainability of the public finances; and (2) an assessment of compliance with domestic and EU fiscal rules.

3.1 The economy does not require broad stimulus

The pandemic led to a sharp contraction in the domestic economy, followed by a swift, yet uneven, rebound (Figure 3.1).

Figure 3.1: Overall activity has recovered following the pandemic

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



Source: 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.

The Government's official forecasts in *SPU 2022* imply that the economy will operate in line with its overall capacity in the coming years despite some slowing due to higher import prices. This means that neither substantial underuse of workers, nor broader overheating in the economy are anticipated. There also appear to be few risky imbalances in the economy at present. Moderate lending, lower levels of indebtedness, high savings, and the large current account surplus point to fewer pressures on the domestic economy and resources. However, second-round increases in inflation, housing affordability challenges, and the rapid fall in unemployment could spell risks if recent trends continue. Exceptional flows of refugees could add to these pressures, while smaller flows of migrants into Ireland with key skills post-pandemic could add to the pressures.

The path forecast for the economy suggests a relatively neutral stance is needed

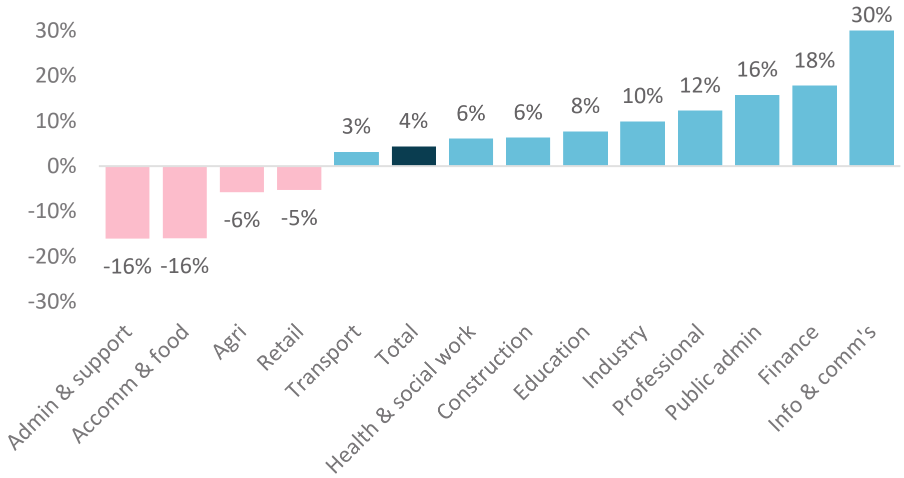
This path for the economy, with continued growth, would suggest that fiscal policy should be relatively neutral in terms of its overall stance. That is, it should not provide additional stimulus on a large scale over the years to come beyond growing at a sustainable pace of increase. This would avoid excessively boosting an already fast outlook for growth and it would limit the risks of various pressures potentially leading to overheating in the coming years.

There are clear risks to the path for growth set out in the SPU. There are major downside risks, especially considering the uncertainty surrounding developments related to Russia's war in Ukraine. There are also upside risks, with some sectors facing shortages of workers and ongoing pressures to expand in areas such as housing and public investment that would fuel a further expansion in activity. Policy should stand ready to adapt to these risks.

But there are clear risks to growth

Figure 3.2: The recovery has been uneven

% difference between actual hours worked in Q1 2022 and Q4 2019, seasonally adjusted



Sources: CSO; and Fiscal Council workings.
Notes: In the Labour Force Survey, people can be classified as employed even if they are "away from work" due to temporary layoffs provided they expect to return to work within three months and/or continue to be paid at least half their wage or salary. This complicates assessments of the labour market since the pandemic. The series shown here addresses this issue, with the CSO asking respondents the number of "actual hours" they worked. Get the data.

Complicating the picture is the fact that the recovery has been highly uneven. An illustration of this is provided by hours worked by sector (Figure 3.2). While actual hours worked on aggregate were 4 per cent higher than pre-pandemic levels as of Q1 2022, wide differences remained across sectors. Many sectors have been slower to recover, given the nature of the shock, even as others continued to grow at pace. Some sectors had large reductions in hours worked early this year, such as admin & support services and accommodation & food services, with hours worked down by 16 per in both when compared to Q4 2019. By contrast, hours worked in information & communications and in financial services were 30 per cent and 18 per cent above pre-pandemic levels, respectively.

Some sectors remain relatively depressed, while others continued to grow strongly

The lifting of pandemic-related restrictions this year should see an improvement in sectors worst hit by the pandemic, though the diverging performances means there is wider uncertainty around the long-term supply-side impacts on growth. It is unclear to what extent workers in still-depressed sectors might see demand in those areas recover, or whether they will need to transition to other areas where demand is greater.

In some cases, the same sectors that saw reduced demand owing to confinement measures during the pandemic are also likely to face weaker demand due to price pressures amid the war in Ukraine. For instance, households may reduce expenditure on recreational activities, dining out, and non-essential retail to preserve their expenditure on essential items.

The increase in energy prices will have a significant impact on the economy and public finances, as well as households and firms. The higher prices of imported energy and food imply depressed living standards for the country as a whole by increasing the price of what is consumed relative to what is produced. Fiscal policy cannot permanently shelter the economy from lower real incomes.

In the nearer term, the government faces a delicate balancing act. Certain measures may support households and sectors that are hard hit by higher energy and food prices, which would help avoid an abrupt reduction in domestic spending. But these may also block the necessary adjustment in spending. Large-scale and long-lasting spending would increase the risk of contributing to higher second-round increases in prices and wages, potentially destabilising the economy and the public finances. These policies should aim to moderate the impact of the changes in import prices rather than fully offset them.

Short-term supports can help deal with price pressures

However, some short-term supports, such as those put in place by the Government, can help to avoid an abrupt change in incomes and spending patterns. The supports can help lower-income households that are more vulnerable to higher food and energy prices.

Beyond immediate supports, the Government's choices for economic policy more widely, including on public sector pay and non-pay spending, should avoid adding further to inflationary pressures. Government decisions on pay, together with spending choices, may influence overall economy-wide wage increases and the strength of second-round effects on inflation.

The Government can play a role in encouraging a coordinated response to the higher cost of living. Firms, employees, and the Government could — if they coordinate — achieve an appropriate balance in terms of the supports provided. This could ensure fair outcomes and avoiding sectors competing against each other to raise wages and prices excessively. In the past, “Social Partnership” agreements from 1987 made between governments, employers, trade unions, and other stakeholders sought to ensure a stable pay and industrial relations climate amid changing economic conditions. While the economy has evolved in the intervening years, there is a case to look again at whether a more coordinated approach would help to manage the current situation.

Given the sectoral nature of the shock posed by both the pandemic and the war in Ukraine, targeted and temporary supports will continue to play a key role in supporting the economy. There is a strong argument for temporary and well-targeted supports to be provided to those most deeply impacted by price pressures. These impacts are expected to unwind partially in the coming years, though not necessarily in full.

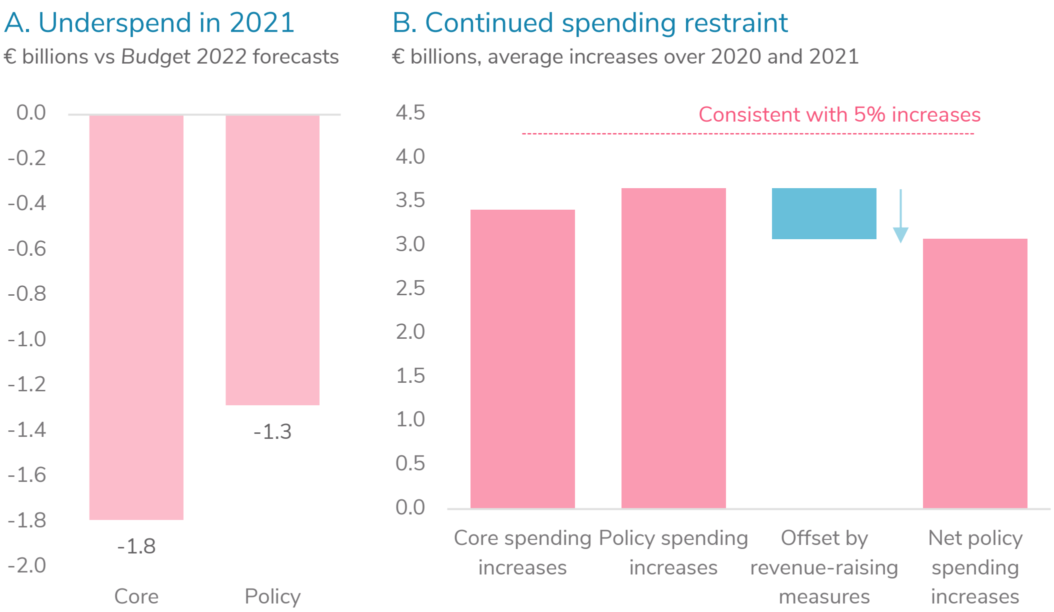
3.2 The Fiscal Stance for 2022

The Council assesses that the Government should stick to its plans for core spending in 2022. This allows for sizeable temporary supports outside of core spending, which are warranted to address cost-of-living impacts and Ukrainian refugees, but these should be well targeted.

The starting position for the public finances in 2022 is now much better than had been projected. Core government spending — outside of Covid-related costs — was revised down in 2020 and 2021. This lessens the risks to the sustainability of the public finances. The underspend in 2021 is visible in two measures of underlying spending. Both core and policy spending point to an underspend of approximately €1½ billion last year (Figure 3.3A).

The starting position for the public finances in 2022 is now much better than had been projected

Figure 3.3: Underspends kept net policy spending growth well below 5%



Sources: CSO; Department of Finance (SES 2021 and SPU 2022); and Fiscal Council workings.
Notes: “Core” spending refers to voted Exchequer spending net of Covid-related expenditure. “Policy” spending is overall general government spending, excluding temporary factors like one-offs, and spending on unemployment benefits that are not likely to be long-lasting. The net policy spending measure 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.

Comparing 2021 levels of spending with 2019, we can see that, on average, permanent spending growth has shown some restraint. Both core spending and policy spending rose, on average by about €3½ billion in 2020 and 2021 (Figure 3.3B). This was offset by the introduction of net revenue-raising measures of about €½ billion each year.[62] As a result, the net policy spending increases were closer to €3 billion, markedly less than the €4.3 billion that would have been consistent with 5 per cent annual increases like those set out in the new 5% Spending Rule.

It is possible that core spending has settled at a lower level. This could mean that the underspend in previous years might carry through to subsequent years. However, it is also possible that the underspends may unwind, particularly if there is a catch up in health spending or other areas where some parts of core spending were temporarily suppressed due to the impacts of the pandemic or where plans to ramp up recruitment failed to progress as planned.

Recent underspends could yet unwind

Core spending plans for 2022 kept same in levels

The level of core spending set out in the SPU for 2022 is the same as was set in *Budget 2022* last October. Core spending is set at €80.1 billion for this year. However, while the *Budget 2022* projections had assumed core spending would be €75.9 billion for 2021, spending actually came in at €74.1 billion — a sizeable downward revision. In addition, as Section 2 notes, early transfers of money in December 2021 for capital spending due to take place in 2022 mean the actual underspend in 2021 is greater still.

Keeping the core spending plans unchanged in levels for 2022 suggests a sharper year-on-year increase than originally planned.[63] However, when the revisions to past years are considered, the overall trajectory for the public finances is more sustainable.

The Government is implementing the 5% Spending Rule in *level* terms. This means that it is sticking to initially-allocated spending ceilings rather than growing by 5 per cent from the level of spending outturns. As Box I notes, applying the rule in this way certainly helps with medium-term budgeting. But it can be less effective if outturns are substantially higher or lower than expected and if inflation is markedly different to what was expected. The

[62] These revenue-raising measures include carbon tax increases of about €140 million p.a. in both budgets, tobacco products excise increases of €57 million p.a. and some additional revenue-raising measures, including from partial indexation of the income tax system.

[63] The Budget plans had implied a €4.2 billion (5.5 per cent) increase. This would have been broadly consistent with, although slightly faster than, the Government's 5% Spending Rule. However, the downward revisions to core spending in 2021 mean that the increase in 2022 is now going to be €6 billion (8.1 per cent), albeit that this entails still reaching the same level.

Government should still develop the rule to include the impact of tax changes (currently not considered by the rule).

Temporary spending likely to high in 2022

The Government is likely to spend a substantial amount of resources on temporary supports in 2022. *Budget 2022* had allowed for €7 billion (2.9 per cent of GNI*) in temporary spending measures associated with the Government's response to Covid. This included €3 billion of planned Covid-related spending and €4 billion of contingency reserves.

Substantial temporary supports are likely in 2022

While the €7 billion allocation is unlikely to be needed to respond to the impact of the pandemic, the allocation is likely to be absorbed instead by a raft of budgetary measures introduced since the turn of the year. These measures are to address the unexpected rise in prices in the economy and to support Ukrainian refugees arriving in Ireland.

The additional temporary measures introduced from the turn of the year to the publication of the SPU to address the rise in the cost of living, both in terms of tax and spending measures, have amounted to about €1 billion (0.4 per cent of GNI*). This is on top of general welfare increases introduced in *Budget 2022*. Since the SPU was published, about another €0.2 billion of cost-of-living measures have been introduced. Overall, this is less than the estimated annual boost to receipts from higher nominal growth (about 1 to 1½ per cent of GNI*) that is likely to result in the coming years (Box E).

Table 3.1: Cost-of-living measures not targeted

€ millions

	Cost	Targeted?
Excise duty cuts on petrol, diesel, and marked gas oil until mid-October	417	No
Energy credit of €200 to all households	379	No
Public transport fares reduced by 20%	54	No
VAT cut on electricity and gas	46	No
Tillage incentive scheme	12	Some targeting
Reduced caps on school transport fees	3	Some targeting
Lump sum €125 payment to those on fuel allowance supports	49	Yes, targeted
Lump sum €100 payment to those on fuel allowance supports	37	Yes, targeted
Drug Payment Scheme threshold reduced to €80	17	Yes, targeted
Increase in income threshold for working family payments brought forward to 1 April	4	Yes, targeted
Haulier support scheme of €100 per week	18	Yes, targeted
Total	1,036	

Sources: Department of Finance; and Fiscal Council workings. Figures correct as of SPU publication. However, an additional €0.2 billion of measures have been introduced since then.

The temporary measures introduced to address cost-of-living pressures have mostly relied on measures to cut the final price of energy rather than targeted interventions. Of the €1.0 billion of measures introduced this year ahead of the SPU, €896 million were not targeted (Table 3.1). Since then, the Government has decided to extent the temporary VAT rate cut for the hospitality sector to 9% for a further six months to March 2023 at an additional cost of €250 million.

Relying on untargeted measures means that substantial public resources are being transferred to individuals who already have high incomes. This means that they are relatively well insulated from the impacts of the recent rise in prices. Higher-income households are also less likely to change their spending patterns as a result of receiving these benefits. It is more likely that such high-income households would simply increase their savings rather than using the additional resources to alter their consumption patterns substantially. In turn, this reduces the likelihood that the Government would see revenues returned to it from any subsequent spending. In addition, the measures, by reducing fuel and energy prices, potentially conflict with the Government's medium-term climate objectives. By contrast, targeting the supports at lower-income households would ensure that those individuals most affected by rising prices would be protected, and it would reduce the deadweight impacts otherwise seen.

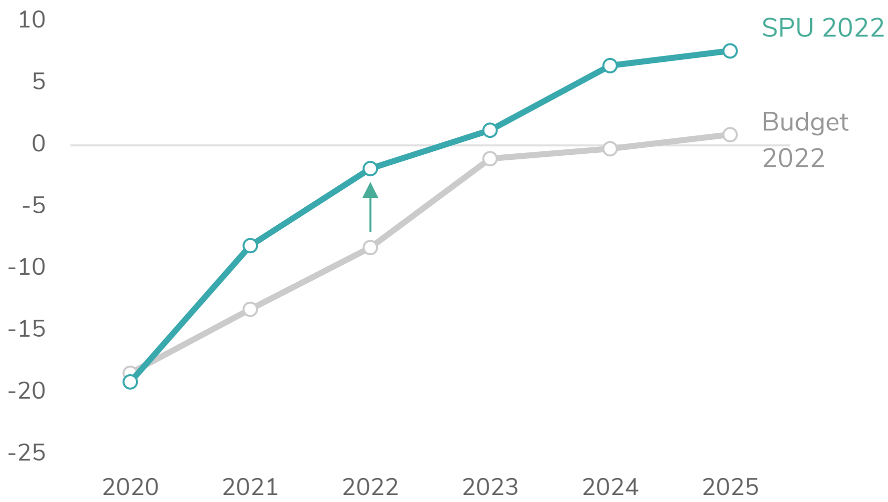
Overall assessment for stance in 2022

The general government deficit for 2022 is now projected to be just under €2 billion, as compared to €8.3 billion at Budget time in October (Figure 3.4). This improvement is forecast by the Department to be sustained for the most part, with a surplus for 2025 now €6.8 billion larger than was projected at Budget time. This essentially reflects a higher level of tax revenues in 2025 based on the strength of recent outturns, while the expansion in core spending remains closer to what was planned, and in line with the sustainable rate of growth for the economy.

The improvement in revenues can be accounted for in part by the recovery and expected growth. However, it also includes unexpected shifts in receipts that might not be sustained, such as higher corporation tax receipts (Box G), as well as the surprising jump in income tax receipts last year. The latter might well persist. For instance, Box B and Timoney (2022) show that the income tax jump appears to be only partly explained by irregular earnings, such as bonuses, and there is some reason to think that strong earnings growth in high-income sectors might be sustained, given its performance in recent years

Figure 3.4: Earlier and larger improvement in budget balance projected

€ billions, general government basis



Sources: Department of Finance (SPU 2022 and Budget 2022). Get the data.

The Council's assessment remains that the Government's plans for 2022 strike an appropriate balance between continuing to support the economy, managing the rise in food and energy prices, and keeping the public finances on a sustainable path. While the pace of expansion in overall general government spending for 2022 has risen since budget time, the path for spending in 2022 remains broadly consistent with a sustainable pace of increase over the medium term. That is, a path which is consistent with estimates of the underlying potential growth rate of the economy.

The Government's plans for 2022 strike an appropriate balance between continuing to support the economy and keeping the public finances on a sustainable path

The Council welcomes the use of contingencies to cope with potential additional costs related to the pandemic, supports for refugees, and other temporary measures.

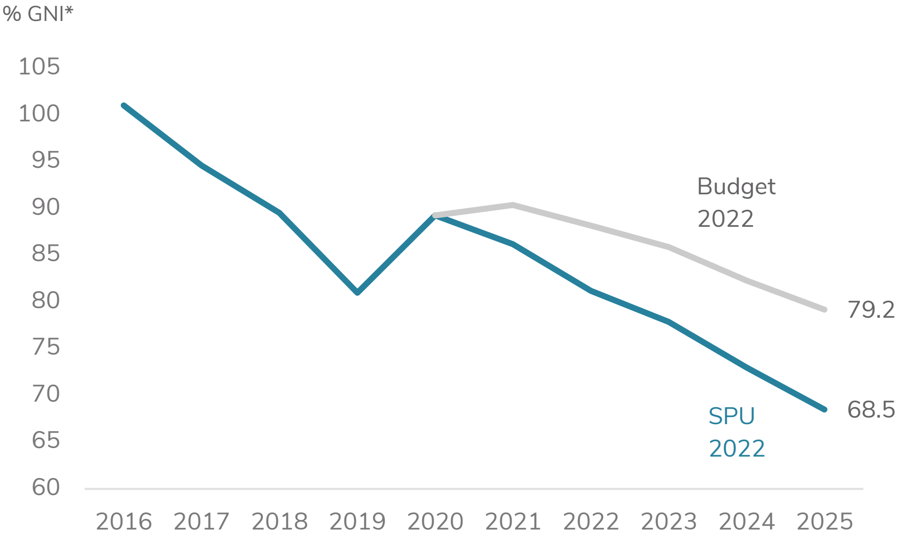
Measures to support the cost of living will help to manage the adjustment to higher energy and food prices. Existing measures may need to be extended or expanded if prices remain high during the year or increase further: these temporary and targeted measures should be carefully designed to minimise the fiscal impact. The Council therefore assesses that the stance for 2022 set out in *SPU 2022* is conducive to prudent economic and budgetary management and should help to support the recovery of the public finances.

3.3 The Government's fiscal stance for 2023–2025

The Government's overarching budgetary strategy, as stated in *SPU 2022*, is to slow "the pace at which debt is accumulated, so that interest expenditure does not become a burden on economic growth and living standards". The way this strategy is phrased is less ambitious than the commitment, in *Budget 2022*, to ensure that the debt ratio is put on a downward path over the medium term. However, the projections included in the SPU indicate a stronger pace of debt reduction than was planned at the time of *Budget 2022* (Figure 3.5).

The projections indicate a stronger pace of debt reduction than planned at Budget time

Figure 3.5: Debt ratios are projected to be on a more prudent path



Sources: Department of Finance (SPU 2022 and Budget 2022). Get the data.

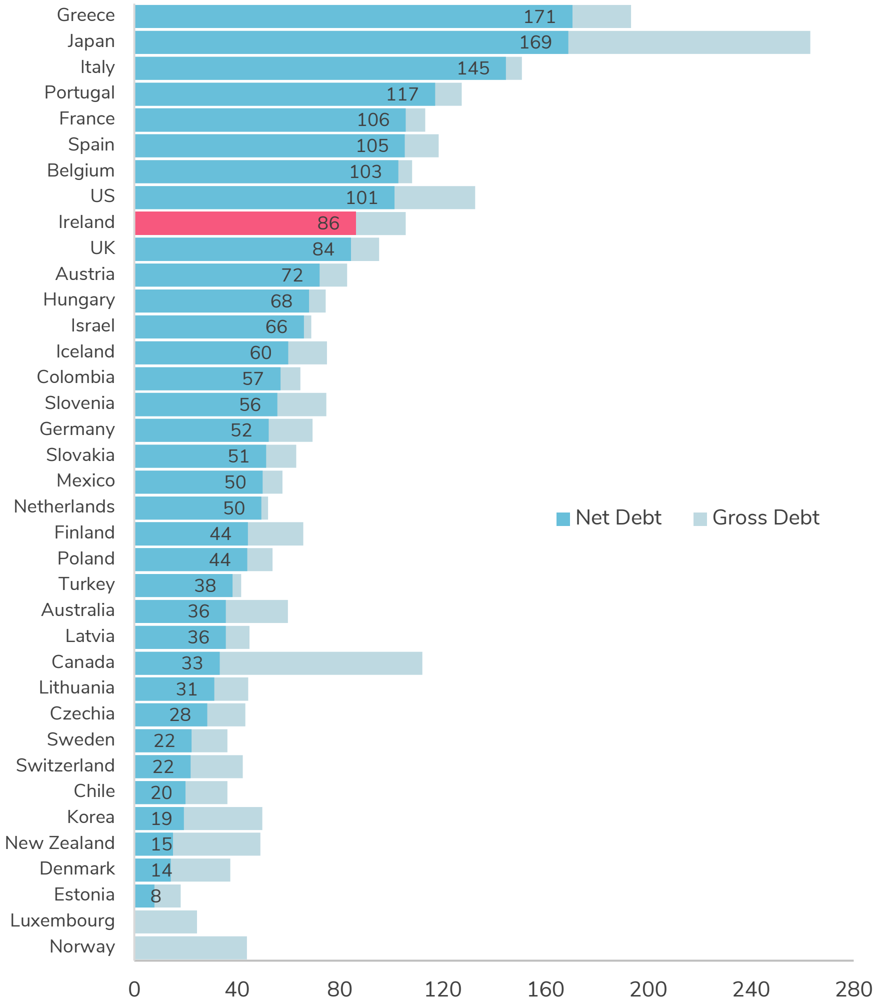
Ireland's level of government debt remains high, as the country entered the pandemic with an already high level. Plans to reduce it are thus welcome. This approach should help to ensure the sustainability of the public finances and maintain Ireland's scope to support the economy in a meaningful way in future downturns. Longer-term challenges remain, including ageing pressures, which will put pressure on deficits and debt ratios in the years ahead. Using good times to build buffers should help to provide scope to deal with unexpected shocks in future.

Ireland's debt ratio entered the pandemic high and remains high

At the end of 2021, Ireland's net debt ratio was 9th highest out of 37 OECD countries for which data are available (Figure 3.6). It is estimated to have been equivalent to 86 per cent of GNI* last year.

Figure 3.6: Ireland has a high debt ratio

% GDP (% GNI* for Ireland), general government basis, end-2021

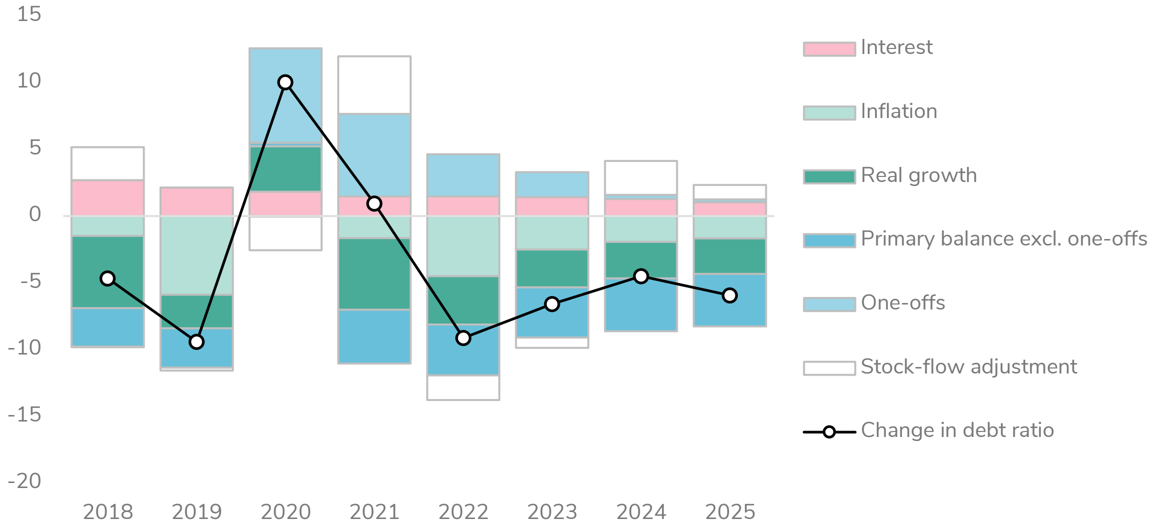


Sources: Eurostat; CSO; IMF (April 2022 Fiscal Monitor); and Fiscal Council workings. Get the data.
Notes: All OECD countries are shown aside from Costa Rica. Net debt is gross debt of general government excluding assets held by the state in the form of currency and deposits; debt securities; and loans. 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.

The net debt ratio should fall steadily in the coming years. This is likely to be helped by strong real growth, inflation, and the positive underlying non-interest or "primary" balance — ignoring one-off spending measures (Figure 3.7).

Figure 3.7: Growth, inflation, and primary surpluses to reduce debt ratios

GNI* p.p., change in gross debt ratio



Sources: Department of Finance (SPU 2022); CSO; and Fiscal Council workings. Get the data.

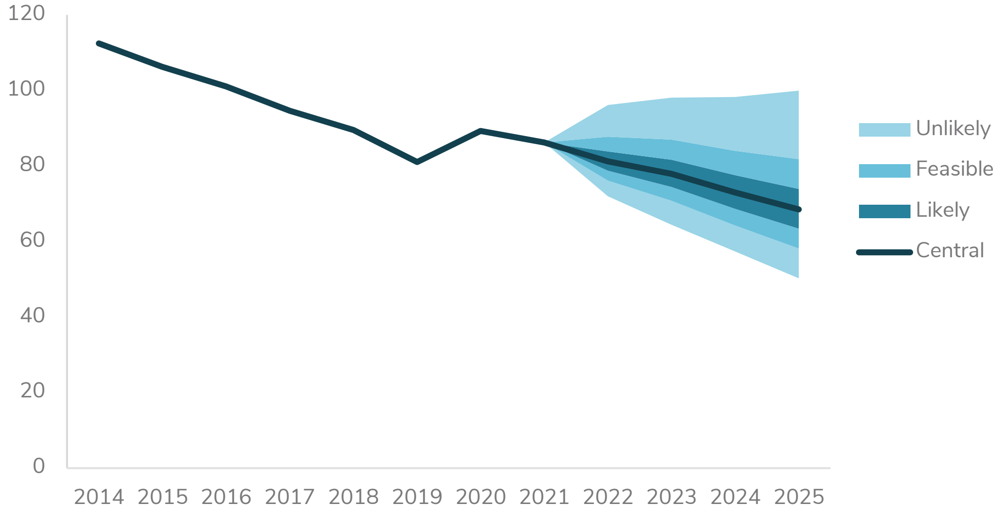
The debt ratio is projected to fall from high levels in the coming years, although a higher starting debt ratio means a greater degree of uncertainty around its path. The SPU projections imply that — if stated policies are followed and macroeconomic conditions remain favourable as indicated — the debt ratio has a high probability of falling steadily in the coming years (Figure 3.8). A modelling exercise suggests that there is a high probability the debt ratio will fall at a steady pace over the next three years. This is based on the current level of debt, interest rates, and growth, together with historical levels of uncertainty. By contrast, the estimated probability of an unsustainable path — defined here as one where debt ratios are above current levels out to 2025 — has fallen to just 15 per cent from the 25 per cent indicated by *Budget 2022* forecasts. This is largely because of the lower debt ratio and smaller deficit in 2022.

A higher starting point means greater uncertainty around the debt ratio's path

Nevertheless, there remain a large number of risks in the current economic and geopolitical environment. Modelling approaches like that shown in Figure 3.8 find it difficult to capture such risks, given their low-probability but high-impact nature. This is particularly true when the historical data used to generate the model do not capture such events (for example, wars or, prior to Covid, pandemics).

Figure 3.8: Probability of unsustainable debt path now smaller

% GNI*, net general government debt



Sources: Department of Finance forecasts; CSO outturns; NTMA data on debt securities; and Fiscal Council workings.
Notes: In the stochastic fan chart projections, the *SPU* 2022 projections are treated as the central or most likely scenario. "Likely" covers the 30% confidence interval surrounding these projections; "Feasible" the rest of the 60% interval; and "Unlikely" the rest of the 90% interval. The estimates are based on the Council's Maq model (Casey and Purdue, 2021). Get the data.

Measures have been taken to insulate the public finances from interest rises

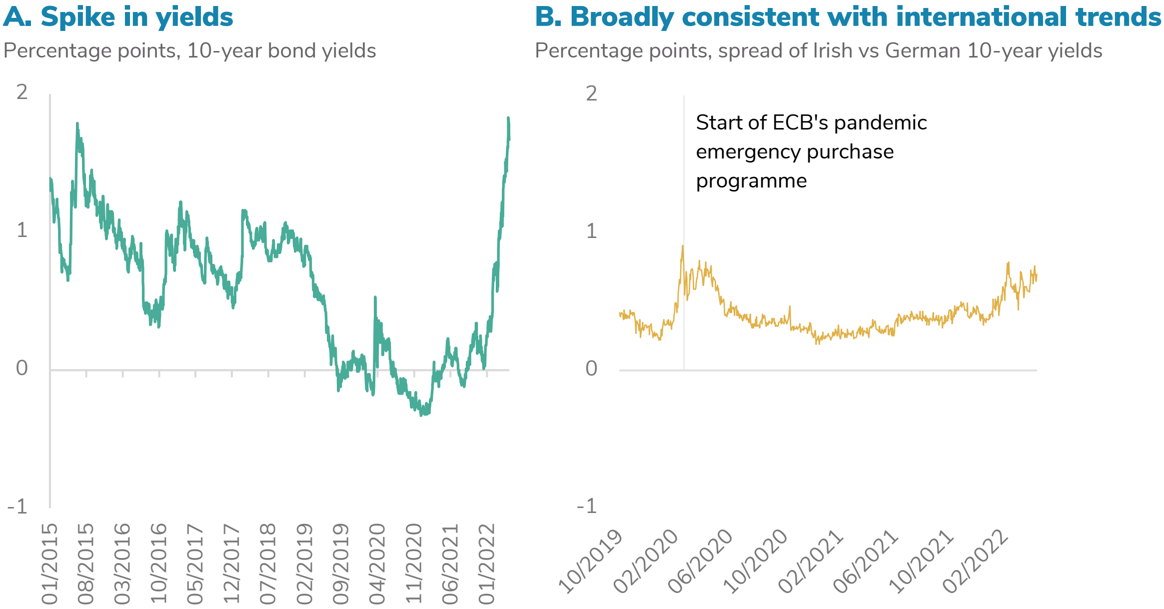
The cost of Ireland's new issuance of Government debt has risen substantially from low levels in recent months. Ten-year bond yields have risen from a low of about -0.4 per cent in January to about 1.6 per cent (Figure 3.9A).

The cost of Ireland's borrowing has risen, but measures have been taken to insulate the State from interest rate shocks

The sharp rise is in line with wider trends internationally. It also comes amid the European Central Bank's (ECB) decision to phase out exceptional monetary support measures, given that Euro Area Member States have been recovering from the economic impacts of the pandemic. It is also likely to reflect investor expectations that the ECB may tighten policy further to tackle high rates of inflation across the monetary union.

The difference, or "spread", between Ireland and German 10-year yields by comparison has remained reasonably stable (Figure 3.9B). The spread has traded at a narrower range of typically 0.3 to 0.4 percentage points over the past two years. Recently, this has risen to about 0.6 percentage points above German yields, which is close to where spreads were around the start of the ECB's Pandemic Emergency Purchase Programme (PEPP) and in line with the pre-pandemic average over 2015–2019 (at 0.5 percentage points). This suggests that Irish creditworthiness, compared to assessments in recent years, is currently not regarded by markets as especially risky relative to German creditworthiness.

Figure 3.9: Bond yields have risen, but broadly in line with wider trends



Source: Macrobond; and Fiscal Council workings.

Initial Government borrowing costs this year have remained reasonably favourable. The NTMA has issued €5.75 billion thus far in 2022. The average term of this debt has been 13 years at an average rate of 0.76 per cent.

While the recent rise in interest rates has been sharp, some context is needed:

First, interest rates still remain low from a historical perspective. For example, the average rate for G7 countries, aside from Italy, has risen to 1.7 per cent of late, but this is still remarkably low compared to interest rates in recent decades. Indeed, rates only fell below 2 per cent persistently after 2012, having spent the previous three decades at higher levels (Figure 3.10).

Figure 3.10: Interest rates still remain low in an historical context

% ten-year bond yields, G7 countries excluding Italy

Sources: Macrobond; and Fiscal Council workings.
Notes: As in Rachel and Summers (2019), yields for the G7 are the average of securities across the G7 excluding Italy. Data form an unbalanced panel meaning that data for all G7 countries are not available for all of the earlier years in the sample. Get the data.

Second, Ireland's public finances have built up some resilience to interest rate shocks in the coming years due to the structure of existing debt. The Council's debt sustainability modelling using the Maq model suggests that each additional 1 percentage point increase in typical borrowing costs, if sustained out to 2025, would translate to a deficit impact of 0.2 per cent of GNI* and 0.3 percentage points by 2032. This suggests the rise seen so far of about around 1.5 percentage points would mean a deficit impact of around 0.3 per cent of GNI* by 2025 and 0.45 per cent by 2032.[64] This recognises the expected refinancing of existing debt, given their maturity profile, and the composition of debt (for example, bonds with fixed or variable interest costs associated with them).

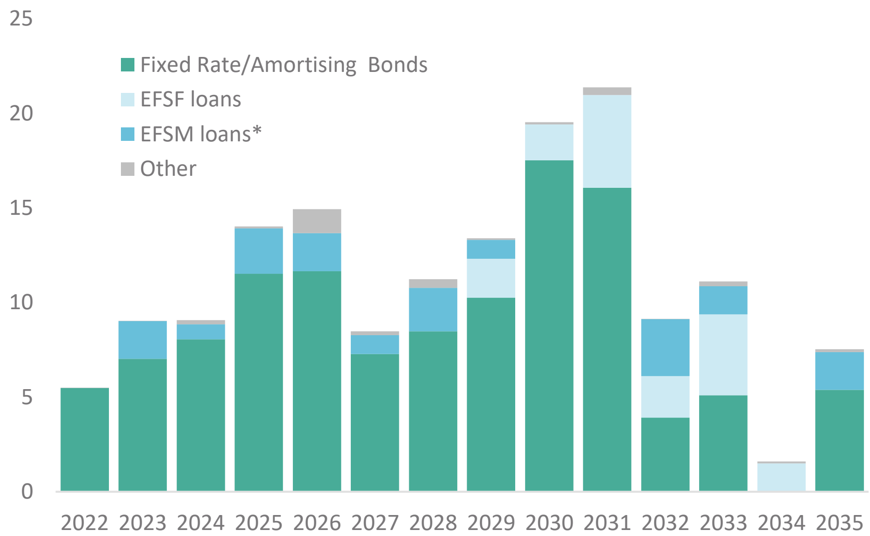
Third, Ireland has very large cash balances outstanding. As of end-March, cash and liquid assets held by the State amounted to €29 billion, equivalent to 13 per cent of GNI* (see also Box F). This would be almost sufficient to cover the entirety of Ireland's medium- and long-term debt of €32 billion maturing between end-March 2022 and end-2025, assuming EFSM loans are extended (Figure 3.11). The Exchequer borrowing requirement is also

[64] The impact is roughly linear: a 2-percentage point impact would translate to 0.4 per cent of GNI* additional interest expenditure, and 3 percentage points to 0.6 per cent of GNI*. Extended to 2032, the impacts would rise to 0.3 percentage points, 0.6 percentage points, and 0.9 percentage points for sustained interest rate rises of 1, 2, and 3 percentage points, respectively. By weakening the annual budget balances being run, the eventual effect of the rise in interest rates would be estimated to accumulate to impacts on the 2032 debt ratio of +11, +12, and +16 percentage points, respectively.

expected to be negative over this period. That is, Ireland is expected to run budget surpluses from next year. This would further slow the likely rundown of cash balances so that the State will probably hold large cash balances for some time to come, assuming the NTMA continues to issue debt in line with the policy of recent years. For example, a policy of targeting bond issuance of even about €6 billion per annum — less than half the average €13.7 billion of annual issuance over the past ten years — could see cash balances remain at or above current levels assuming the current Exchequer borrowing requirements projected are correct. These cash balances may amount to pre-funding in an environment of high uncertainty and rising interest rates and should help to mitigate against more extreme "tail" risks.

Figure 3.11: Maturity profile manageable in coming years

€ billions



Sources: NTMA; and Fiscal Council workings. Get the data.
Notes: The EFSM loans are subject to being extended, such that their weighted average maturity will be a maximum of 19.5 years — about seven years more than the initial average maturity. The Figure assumes no extension, though these loans could individually be extended.

While the measures taken by the State to insulate itself from interest shocks will help, there are other risks tied to interest rate rises that are more difficult to contain. The impact of higher interest rates on households and businesses with outstanding debts could dampen activity, while international demand could face similar impacts if interest rates rise globally. To the extent that this dampens activity, this could depress Government revenues in future and raise spending on unemployment-related supports.

The Government has developed more credible plans, but gaps remain

The Government has made significant steps towards developing a credible fiscal plan, as first committed to in the 2020 *Programme for Government*. It has established an approach to allow for the costs of maintaining public supports and services in real terms; and it has committed to a new 5% Spending Rule.

The Government still needs to substantially improve its medium-term budget planning

Table 3.2: Some backward steps in terms of developing credible fiscal plans

Objective	SPU 2022	Council calling for this since	Progress
Present five-year-ahead forecasts	Despite a commitment to five-year-ahead forecasts, the Department has now reverted to three-year-ahead forecasts	Nov-17	Limited (downgraded)
Base projections on realistic spending plans	More realistic than previous rounds; but slightly short of Stand-Still costs	Jun-16	Mostly there
Commit to medium-term fiscal objectives	The 5% Spending Rule provides more formal numerical targets, but these 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 (2020) 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**

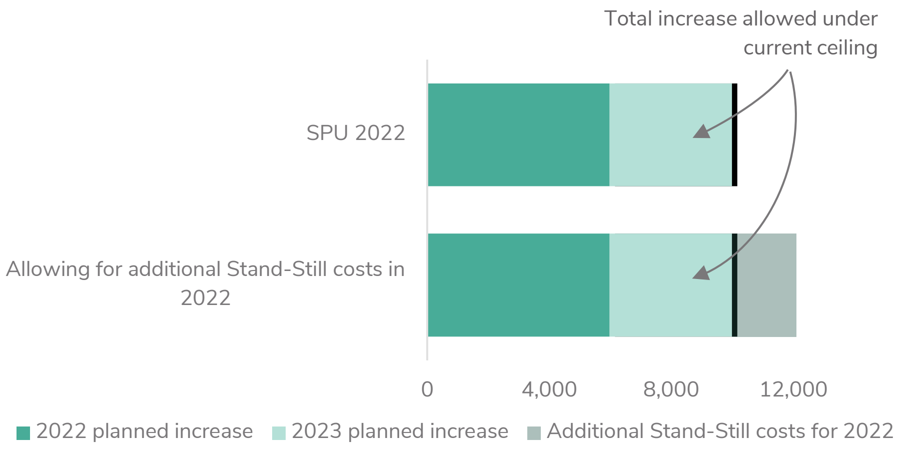
Note: Compared to the Council's past December 2021 assessment, the only revision was to downgrade the assessment of progress on the Government's forecast horizon (revised down from "Mostly there").

However, the Government still needs to substantially improve its medium-term budget planning (Table 3.2). Furthermore, the Government has backslid on its five-year forecast horizon; costings of major policy commitments such as Sláintecare and climate-transition measures are still not available; the transparency of fiscal projections has not improved; there remains a lack of planning for potential tax-raising measures; and there are no plans for the Rainy Day Fund. While the Existing Level of Service approach (Box D) helps, it only applies to one-year-ahead forecasts.

For 2023, the Government has space within the spending rule to introduce spending increases and adjustments to wages and welfare rates to reflect unexpected inflation, but it will have to make some choices. The unexpected inflation in 2022 will mean real cuts to various public services and supports. This is due to the fact that the actual rate of increase was slower than wage and price inflation in the economy (Box I). Allowing for full indexation could require another €2 billion in core spending increases (Figure 3.12). This would push spending increases beyond both *SPU 2022* plans and the total increase allowed under the Government's current ceiling.

Figure 3.12: Full indexation would push spending above the 2023 ceiling

€ million increases in core spending



Source: Department of Finance (SPU 2022) forecasts; and Fiscal Council workings. Get the data.

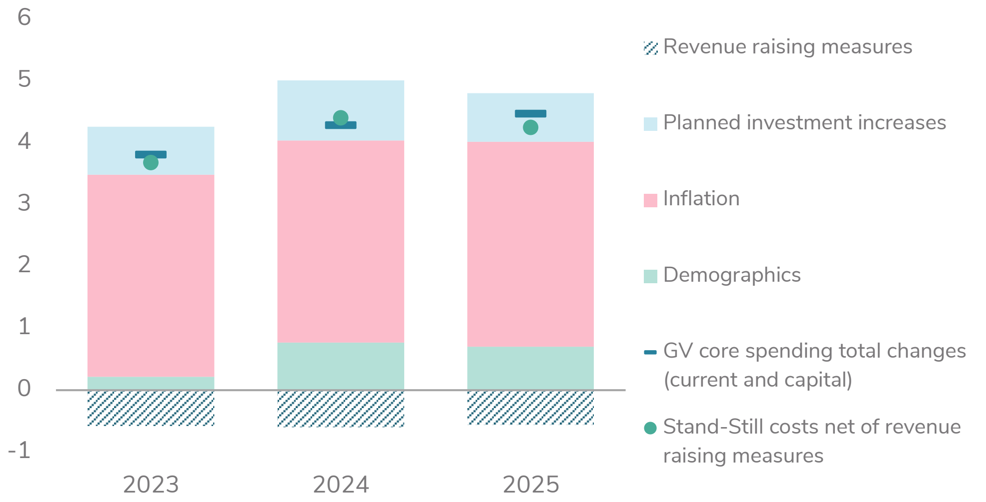
Looking further ahead, allowing for full indexation of spending in a Stand-Still-type approach would also likely see the Government exceed its spending ceilings over the entire forecast horizon. This approach would entail tracking economy-wide wages and price rises for public sector wages and welfare rates, while also sticking to capital plans. As Figure 3.13 shows, the increases for core current and capital spending implied by the 5% Spending Rule are slightly below what a full provision for Stand-Still pressures plus capital plans would suggest is required for full indexation.

It is possible that the underspends in 2021 could alleviate these pressures. The SPU does not currently assume underspends in 2021 will carry through to 2022 and subsequent years. However, the additional fiscal space afforded by a lower underlying starting level of core spending, given planned ceilings, could yield sufficient scope to address some of the Stand-Still costs arising from unexpected inflation.

The Government needs to spell out what choices it will make, given various spending pressures arising. If it is to stick to its ceilings, the there are some difficult trade-offs. To stay within the ceilings, it may need to *only partially* index some parts of current spending, introduce additional revenue-raising measures, or reduce/delay its capital plans. Alternatively, partial indexation of the tax system — as is assumed here and in the SPU figures — would bring policy changes in line with 5 per cent net increases.

Figure 3.13: Inflation and pensions costs will raise spending pressures

€ billion, year-on-year changes



Source: *SPU 2022* and Fiscal Council workings. [Get the data.](#)
Notes: Planned investment increases refer to gross voted core capital spending changes set out in the SPU. "GV core spending total changes" refers to the planned increases in both gross voted current and capital spending as set out in the SPU projections.

Implications of the medium-term fiscal stance

For 2023 to 2025, the *SPU 2022* sets out Government plans for net policy spending increases that are broadly consistent with sustainable growth rates in the economy and revenues.

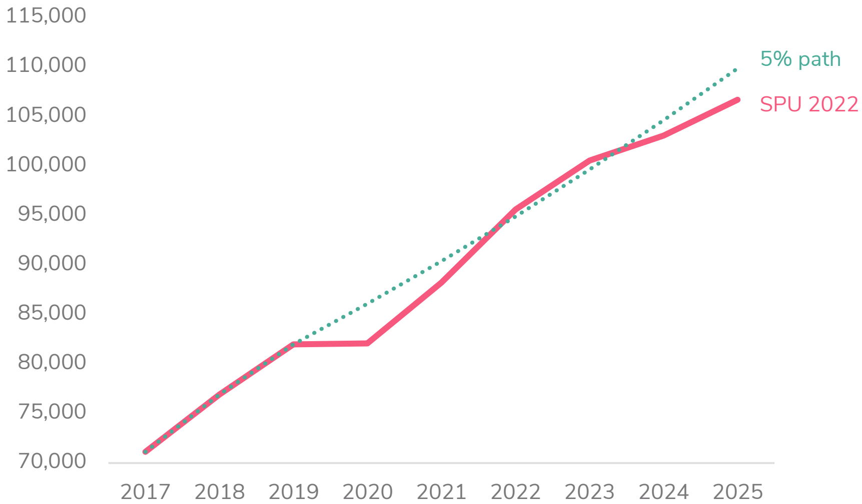
The Government's plans for 2023 to 2025 are broadly aligned with sustainable growth rates in the economy and revenues

One way to illustrate the sustainability of the Government's plans is to examine the path for policy spending less revenue-raising measures. This differs from the Government's 5% Spending Rule in that it recognises the impact of tax measures as well as spending measures. A "sustainable" path could be considered where net policy spending grows in line with potential output growth rates of about 3 per cent per annum plus some measure of inflation. There are different approaches to taking inflation into account: this is sometimes based on actual or near-term forecasts of inflation or can also be set based on a long-term view of price stability (Box I). Taking into account inflation could lead to procyclical increases in spending if this inflation is due to overheating or negative supply shocks. However, it may be difficult to use a steady-state inflation assumption at a time of large deviations of inflation from the medium-term rate.

One way to assess the *SPU 2022* projections and the path they imply for the public finances is to assess them against a 5 per cent path, similar to the Government's spending rule. A caveat is that the Government's 5% Spending Rule does not apply to general government spending, and it does not account for the impact of tax measures. However, if applied to this benchmark, the projections suggest that net policy spending would remain within this out to 2025 (Figure 3.14).

Figure 3.14: Net spending path broadly aligned with 5% path

€ million, policy spending adjusted for cumulative net revenue-raising measures from 2019 on



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 "5% path" assumes that policy spending grows in line with potential output of 3 per cent and steady-state price inflation of 2 per cent. Get the data.

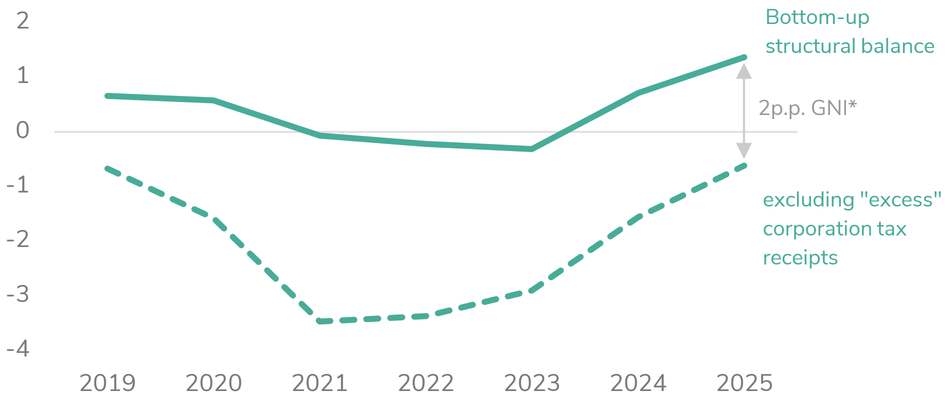
The Council estimates that the structural budget balance — the underlying budget balance when corrected for temporary factors — is broadly close to a balanced position. Having broadly closed the structural balance after the financial crisis, Ireland entered the pandemic with a neutral balance.

However, the underlying budget balance is supported by exceptional levels of corporation tax

However, the structural budget balance is supported by exceptionally high levels of corporation tax receipts (Figure 3.15). This impact has grown over time and means that the underlying fiscal position is potentially much less benign than it otherwise would be. Leaving out estimated "excess" corporation tax receipts would leave a structural deficit of 0.6 per cent in 2025 — some two percentage points lower. This provides an indication of the “gap” in the public finances that could appear if these excess receipts were to stop. It also provides a measure of how much Ireland is currently benefitting from inflows of revenue derived from foreign-owned multinational enterprises.

Figure 3.15: The underlying budgetary position is close to balance but supported by exceptional corporation tax receipts

% of GNI*, structural balance



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Note: This figure shows the Council’s bottom-up estimate of the structural balance where potential output is assumed to grow at 3 per cent over 2021 to 2025. Inflation forecasts are based on the Department of Finance’s *SPU 2022* forecasts. See Box I of the May 2021 *Fiscal Assessment Report* for further details. The “excess” corporation tax receipts for forecast years are the same in nominal terms as those estimated for 2021, €7.6 billion, but adjusted down for the Department’s €2 billion allowance for a downward correction to corporation tax receipts so that it is €5.6 billion by 2025.

Given the projections for growth and the budget balance, the net debt ratio should stabilise this year and start to fall steadily after 2022. However, because debt ratios are already high, this amplifies some of the existing uncertainties, given the magnifying impact that are mechanically borne out due to changes in growth, inflation, and interest rates (Barnes, Casey, and Jordan-Doak, 2021).

3.4 Medium-term challenges

There are multiple challenges facing the Government's fiscal plans, which it needs to address urgently. This section explores these in more detail.

There are multiple major challenges facing the Government's fiscal plans

Over-reliance on corporation tax receipts

The Government continues to see its reliance on corporation tax to fund public services rise over time. In 2014/2015, about one-in-ten euros of core spending was covered by corporation tax receipts. In 2021, it was more than one-in-five euros.

There are other tax risks related to the concentration of activities beyond corporation tax. Revenue (2021) data show that almost 5 per cent of all income tax, USC, employers' PRSI and VAT paid by companies came from the top 10 corporate groups. On average, each of these paid about €144 million in those taxes for 2021, as compared to about €165,000 for all other companies.

It is now urgent that the Government set out clear plans to reduce its dependency on corporation tax receipts. As Box G shows, at least €6 billion of corporation tax receipts collected last year were not explained by the domestic economy according to the Council's estimates. And, while corporation tax receipts have risen sharply since the Government first estimated potential losses owing to international tax changes, these have not been updated since that time.

The Government has collected some €22 billion of excess corporation tax receipts

The Council estimates that, since 2014, the Government has collected some €22 billion of corporation taxes beyond what can be explained by the domestic economy. A substantial portion of this figure has been absorbed into permanent spending, including on health. This raises the risk that potential reversals of these receipts in future could lead to sharp increases in borrowing requirements to fund recurrent commitments.

Recognising and unwinding the reliance on corporation tax could be helped with two actions. First, the Government should present the budget balance excluding its estimate of excess corporation tax receipts — similar to what is shown in Figure 3.15. Second, it should implement a strategy to unwind this excess gradually over time, potentially through the Rainy Day Fund or by a rapid reduction in debt. Box G provides more detail on how these actions could be implemented.

Box G: Exchequer has benefited from some €22 billion "excess" corporation tax

This box presents new analysis showing how the Exchequer has benefited from some €22 billion in corporation tax receipts in recent years, which could be considered "excess". That is, beyond what is explained by the performance of the domestic economy.

Over the past seven years, corporation tax receipts have continued to surge and become even more concentrated among a handful of firms. Receipts represent nearly one-in-every four euro raised by the Exchequer, and the top-ten paying companies account for more than half of those receipts: up from a quarter in 2008.

Corporation tax receipts could still be subject to sharp reversals. They are more volatile than other major taxes; prone to larger forecast errors; concentrated in a handful of companies; and they are exposed to changes in the global tax environment.

At the same time, the Government has increased its reliance on these receipts to fund day-to-day public services and supports. By funding current spending with corporation tax receipts, the Government risks having to adjust current spending down to set the public finances on a sound footing should receipts fall.

Unfortunately, the Government has no explicit strategy to reduce this over-reliance. This box sets out the Council's assessment that (1) the Government should clearly show the impact of excess corporation tax receipts on the budget balance and (2) the Government should take measures, including potential use of the Rainy Day Fund or faster reductions in debt, to save rather than spend these excess receipts.

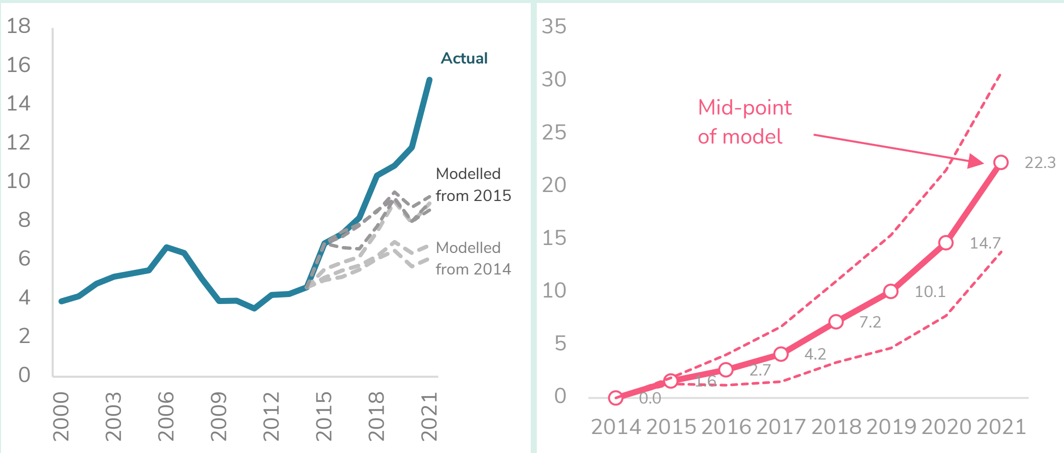
How much corporation tax receipts are potentially at risk?

The Council's analysis suggests that some €6 to 9 billion (40–60 per cent) of the total €15.3 billion of annual corporation taxes collected in 2021 are not explained by the performance of the domestic economy (Figure G1A).[65] In other words, these appear to be "excess" to what might be driven by the expansion in domestic economic activity.

Figure G1: A substantial amount of corporation tax can be considered "excess"

A. Modelled vs actual receipts
€ billions

B. Cumulative "excess" receipts collected
€ billions, cumulative gap for model vs actual



Sources: Revenue data; and Fiscal Council workings. Get the data.
Notes: The suite of models estimates use Domestic GVA and GNI* to predict receipts from 2014 and 2015.

[65] Estimating receipts potentially at risk of sudden reversals is complicated. One way to get at this applied by the Council is to adapt similar modelling approaches to the Department's for forecasting. However, instead of applying these approaches to the overall economy, we apply it to CSO measures of the domestic economy. This helps ascertain the exceptional performance in corporation tax receipts driven by foreign-owned multinationals.

Looking at the cumulative excess of receipts received since 2015, the analysis suggests that some €22 billion of corporation taxes have been collected over and above what can be explained by the performance of the domestic economy (Figure G1B). The uncertainty range around this is very large, with estimates ranging from €14 to 31 billion depending on the modelling approach used.

In line with this approach, two years ago, the Department of Finance (2020) recommended assessing the potential "froth" in corporation tax receipts. Its approach was intended to identify what was "potentially 'windfall' in nature". The approach involved comparing corporation tax's share of total taxes to its historical average of 14 per cent. Anything above 14 per cent could, in the Department's approach, then be considered froth.

If the Department's approach was applied to the same period as the analysis above, it would suggest that a cumulative €15 billion of froth in corporation tax has been collected in recent years.

The analysis above suggests that (1) there is a large exposure to annual corporation tax receipts that is not explained by the performance of the domestic economy; and (2) this has resulted in a substantial gain to the Exchequer in recent years.

As shown in the Council's recent report on the health budget (Casey and Carroll, 2021), a substantial portion of the excess receipts has been absorbed into ongoing spending. For instance, corporation taxes have come in on average €1.2 billion higher than forecast at the start of the year each year since 2014. Over the same period, health spending has averaged overruns of €0.8 billion each year, with most of this permanent in nature, including for permanent staff increases or current spending increases elsewhere.

Ireland's own form of oil wealth

A useful analogy for these exceptional levels of receipts is the oil wealth from which countries such as Norway have benefited. In much the same way, Ireland's remarkable levels of corporation tax receipts are volatile, difficult to forecast, somewhat removed from other activities, and subject to potential reversals in future.

In 1990, Norway decided to start sending its oil and gas revenues to a special oil fund. Various goals included saving wealth for future generations; cushioning fiscal sustainability in case commodity prices reversed; and avoiding the temptation to spend revenues in full. A concern was that spending receipts as they came in would have had procyclical consequences: domestic inflation, appreciation of the domestic currency, and lost competitiveness. Instead, the Norwegian Government opted to use only the returns generated by the oil fund to serve current generations, while preserving its overall value for future generations (Yukhov, 2021; Bhopal, 2021).

What can be done to reduce the risks?

Ireland's dependency on exceptional corporation tax receipts is now regularly baked into the annual budgetary arithmetic. That is, the Government does not currently have a plan to reduce its dependency on corporation tax receipts. Instead, the tax base is for the most part assumed to grow broadly in line with wider economic activity and there are no plans to actively manage down the associated risks.

Forecasting slightly lower corporation tax receipts and planning for reducing the Government's reliance on these receipts are two different things. Reducing the risks should entail a clear strategy being set. This should include ways to reduce the dependency already built up and plans for how these receipts might be replaced in future, should they reverse.

The Commission on Taxation and Welfare is likely to focus on potential areas for replacing any lost corporation tax receipts when it submits its report to the Minister for Finance (by 1 July 2022). But, as it stands, the Government does not have a credible strategy to address the over-reliance on corporation tax receipts built up in recent years.

The Council's assessment is that risks could be mitigated with two actions.

First, the Government could report on its budget balance, excluding a measure of "excess" receipts in order to better communicate what the underlying fiscal position is likely to be. Figure 3.15

shows what this would look like when applied to the structural budget balance. The Department of Finance (2019) proposed defining a budget balance figure excluding some element of the corporation tax "froth" three years ago, given its view that the headline balance was "being flattered by very strong [Corporate Tax] receipts".

Second, the Government should establish a mechanism to reduce its reliance on excess corporation tax receipts. This would involve two steps:

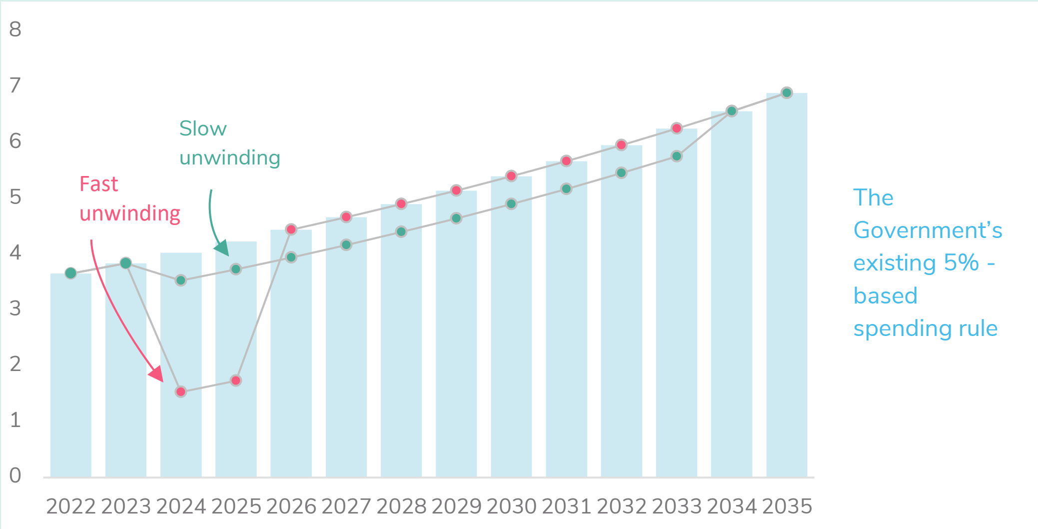
a) the Government should identify the amount of corporation tax currently raised annually that it considers to be excess.

b) the Government should develop a plan to gradually reduce the reliance on this excess over a defined period of time.

As an example of how the dependence could be reduced, consider an illustrative scenario in which the excess corporation tax receipts were identified as being €5 billion with a plan set to reduce the reliance on this either urgently (say, over two years) as might happen if these receipts were to disappear rapidly, or gradually (say, over ten years) which could happen if the Government took pre-emptive action to reduce dependence on excess corporation tax revenues. This could entail reducing planned core spending increases by €2.5 billion in both 2023 and 2024 or by €0.5 billion annually over the next ten years (Figure G2). Alternatively, revenue-raising measures equivalent to the same amounts could be introduced to offset the overreliance on corporation tax and return spending to the higher level consistent with the 5% Spending Rule.

Figure G2: Excess can be unwound with slower spending rises or new revenues

€ billions, core spending increases



Source: Fiscal Council workings.

These approaches give an illustration of how excess corporation tax receipts built up to date could be unwound. If followed, along with the 5% Spending Rule, the Government would also ensure that potential future overperformances unexplained by domestic economic activity could be saved rather than spent. At a minimum, the Government should cap its exposure to the surge in corporation tax receipts. This would entail ensuring that further outperformances in corporation tax — beyond reasonable projections for growth in the domestic economy — be set aside.

By using excess receipts to fund ongoing expenditure, the Government has potentially opted not to set aside some €22 billion in a Rainy Day Fund or to reduce net debt by a substantial amount. Using these resources, which could be considered an injection of funds from overseas, will have boosted economic activity and tax receipts to some extent in the meantime, meaning that the full €22 billion is not the ultimate opportunity cost to reducing net debt. though the risks to fiscal sustainability from these decisions remain sizeable.

Uncosted policy commitments

A challenge that has persisted for several years now is that two major policy commitments have not been properly costed and factored into budget plans. These include the costs of transitioning to a low carbon economy and the cost of the Government's commitment to major healthcare reforms.

Transitioning to a low carbon economy: The Government has provided little clarity on the fiscal costs of achieving its required 51 per cent reduction in overall greenhouse-gas emissions by 2030.[66]

While the Government did produce an estimate of the overall cost of meeting the new objectives, at some €125 billion to 2030, it did not outline how much of this would specifically be borne by the Government in its *Climate Action Plan 2021*.

The Government has not properly costed and factored in its climate objectives

However, the Climate Action Plan 2021 does note that, for about 40 per cent (about €5½ billion annually or 2 per cent of GNI*) of total investment costs, it is unlikely that the returns to the investment will be positive. This means that the State would probably have to make some intervention, perhaps up to the full amount, to encourage these investments. It's likely that the costs would now be higher, given that they were produced at a time when inflation was lower and projected to remain so.

The potential costs to the State are better articulated in FitzGerald (2021). Additional annual investment costs to meet the 2030 targets are estimated at 1.7 to 2.3 per cent of GNI* (Figure 3.16).[67] Two scenarios are considered: one where both agricultural and energy emissions are cut by 51 per cent and a more costly scenario where agricultural emissions are cut less (by 33 per cent) so that energy emissions must be cut more (by 61 per cent). The paper estimates the additional annual government expenditure between 2026 and 2030 required to meet the 2030 target while fairly distributing

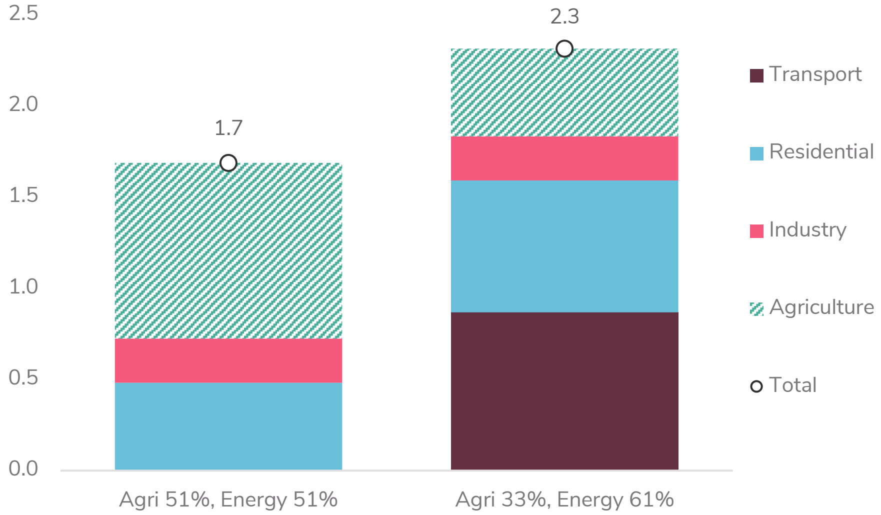
[66] These legally binding objectives are set out in the Climate Action and Low Carbon Development (Amendment) Act 2021.

[67] FitzGerald (2021) notes that the costs for agriculture are an underestimate, as no allowance is made for the costs of supporting workers losing their jobs in food processing to transition to other sectors. Nor is any allowance made for any additional costs arising from the need to ramp up investment in the power and services sectors. Depending on the scenario, he notes that compensating for this could add between just under 0.5 per cent and 1 per cent of GNI* to government expenditure over 2026 to 2030.

costs. It draws on detailed analysis by the UCC MAREI Institute and Teagasc of costs associated with paths towards Ireland decarbonising.

Figure 3.16: Large additional annual investment to meet climate goals

% GNI*, estimated additional average annual public investment to meet 2030 targets (2026 to 2030)



Source: FitzGerald (2021). Get the data.

As it stands, the only clear information on amounts committed towards meeting the additional climate objectives in the Climate Action Plan 2021 is that about €8.5 billion of the estimated €125 billion will be public spending. This comprises at least €8 billion of public spending on residential retrofit to 2030, by the Government, partly funded by €5 billion of the €9.5 billion in carbon tax receipts planned to be raised by 2030. In addition, €0.5 billion of the *National Recovery and Resilience Plan 2021* amounts are to be allocated towards decarbonising measures such as retrofitting, ecosystem resilience and regeneration, climate mitigation and adaptation, and green data systems.

The transition to a low-carbon economy will have wider fiscal impacts. It will mean lower revenues being raised on fossil fuels as people adapt their behaviours, using less of these. Various sources of revenue are likely to be directly affected: motor tax, vehicle registration tax, carbon tax, excise on mineral oils, VAT on fuels. In 2019, before the pandemic, the Government raised almost €6 billion (2.8 per cent of GNI*) from taxes on climate-relevant activities, such as the use of fossil fuels.

For the UK, the OBR (2022) estimates the potential losses on motoring taxes at about 1.6 per cent of GDP by 2027 as the vehicle stock moves from petrol/diesel to electric vehicles, which pay no fuel duty or vehicle excise duty.[68] They also note how the transition to electric vehicles has been faster than expected. Take-up appears to have followed the pattern of other new technologies: slow initial take-up when the technology is novel, followed by a more rapid spread as it proves itself. 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.

Ireland's legislated carbon tax increase for 2022 went through in difficult circumstances, given the cost-of-living pressures observed. Carbon taxes are set to rise further in the coming years, and so the current high prices now are perhaps a foretaste of some of the changes that will come in future. The temporary measures introduced elsewhere to counteract the cost of living increases more than offset the impact of the carbon tax increase at present.

Uncosted Sláintecare reforms: The Government has failed to outline basic detail on major reforms to public healthcare spending. The costs of these reforms, which will see greater public funding of universal healthcare access, are not budgeted for beyond this year. Moreover, essential information on costs and progress to date is severely lacking (Casey and Carroll, 2021). It appears that some €2.1 billion of recurrent spending has been allocated to the reforms to end-2022. While total costs were estimated at €2.8 billion per annum in 2017, these are highly outdated and do not 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, with recent price pressures and capacity constraints in the economy likely to raise such estimates. The Government should update its costings and provide more transparency on progress to date to better inform policy and planning.

Sláintecare reforms are not costed properly, nor are they budgeted for beyond this year

Ageing costs: The Irish population is rapidly ageing. This will put pressure on spending for healthcare and pensions. It will also lead to a shrinking labour force at the same time as Ireland's productivity growth rates are likely

[68] This estimate is based on the original OBR (2021) analysis adjusted for the OBR's (2022) subsequent update.

to moderate (regions tend to exhibit slower rates of productivity growth as they rise to higher productivity levels).

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.

Pensions will be a significant driver of ageing pressures and Ireland faces twin challenges

Pensions will be significant driver of the spending pressures linked to ageing. Revised estimates from the Fiscal Council and estimates from the Department of Finance (2022) suggest that annual spending on pensions is set to rise by about 1½ to 2 per cent of GNI* by 2030.[69] In this respect, Ireland's pension system faces twin challenges (Figure 3.17):

- First, there is the looming retirement of a bulge in the population from the Irish "baby boom" in the 1970s/80s. In the 2000s about 30,000 individuals reached age 65 each year. By the 2040s, the Council estimates that this will rise to about 75,500.

- Second, people are living longer. The Council estimates that, by 2050, the average Irish person could, at age 65, expect to live ten years longer than an average 65-year-old would have in 1980 (from 79 years in 1980 to 89 in 2050). By contrast, the pension age has only risen by one year over the same period (from 65 to 66).

The Pensions Commission report last September projected a €13 billion shortfall in funding for pensions by 2050. To deal with the sustainability challenge, the Commission set out a preferred option with a mix of responses: gradual increases in the pension age from 2028; increased PRSI for employees, employers and the self-employed; and other unspecified funding sources (mostly likely further tax increases or spending reductions elsewhere).

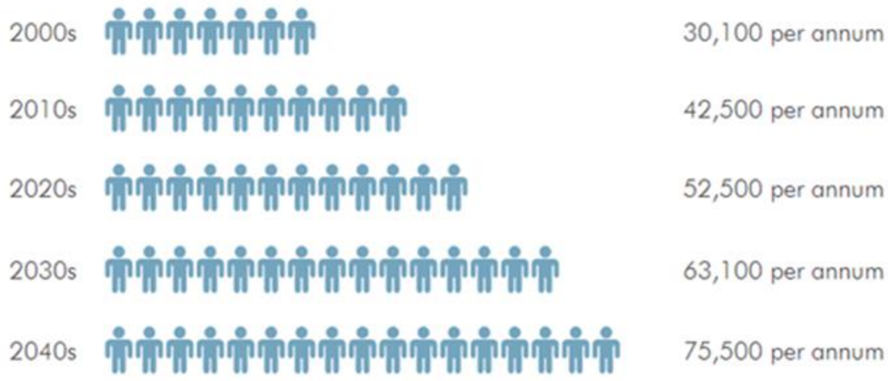
Spreading the costs makes sense, given the scale of the challenge. However, recent developments suggest that more of the burden will be put

[69] The Department of Finance estimates are contained in Table 21 of SPU 2022, while the Council's estimates are based on an updated assessment of the analysis contained in the Long-term Sustainability Report (Fiscal Council, 2020).

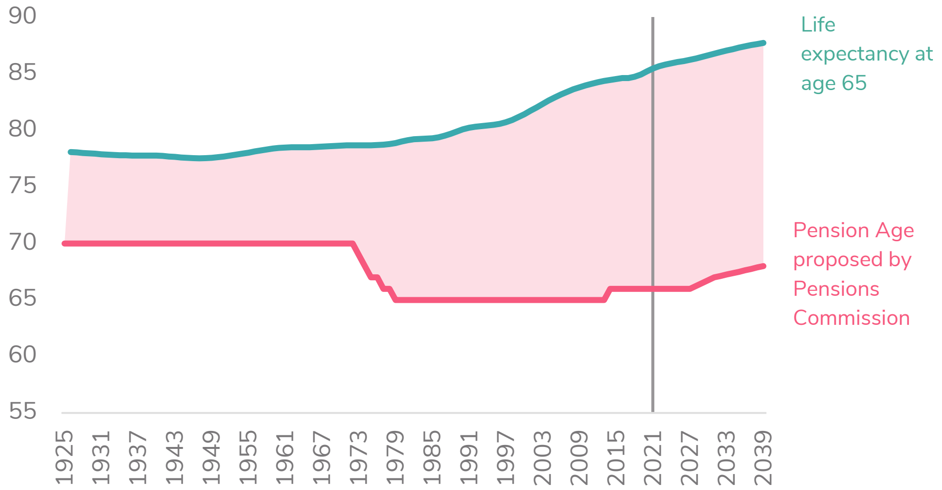
on raising taxes rather than adjusting the pension age.[70] This raises questions about the credibility of the response, when it involves potentially much greater tax increases that are yet to be acted on.

Figure 3.17: Twin challenges associated with pension spending

Number of people reaching age 65



Expected years of retirement: the pension age and life expectancy at age 65



Source: Fiscal Council Long-term Sustainability Report, 2020.

Not increasing the pension age will lock in a longer, and growing, average retirement period. The Fiscal Council (2020) estimated that the growing number of pension recipients would add some €370 million annually to pension costs on average over 2021 to 2025. That was before the Government deferred the planned pension age increase from 66 to 67 in 2021. The Council estimates that the decision to defer the pension age increase raises annual expenditure by €575 million from 2021, with these

Not increasing the pension age will lock in a longer, and growing, average retirement period

[70] See, for example, the Joint Committee on Social Protection, Community and Rural Development and the Islands' (2022) report on pensions. The report set out a political response to the Pension Commission's recommendations. The response basically stated that (1) the pension age should remain at 66, and (2) the costs of pensions should be funded by higher taxes and social contributions.

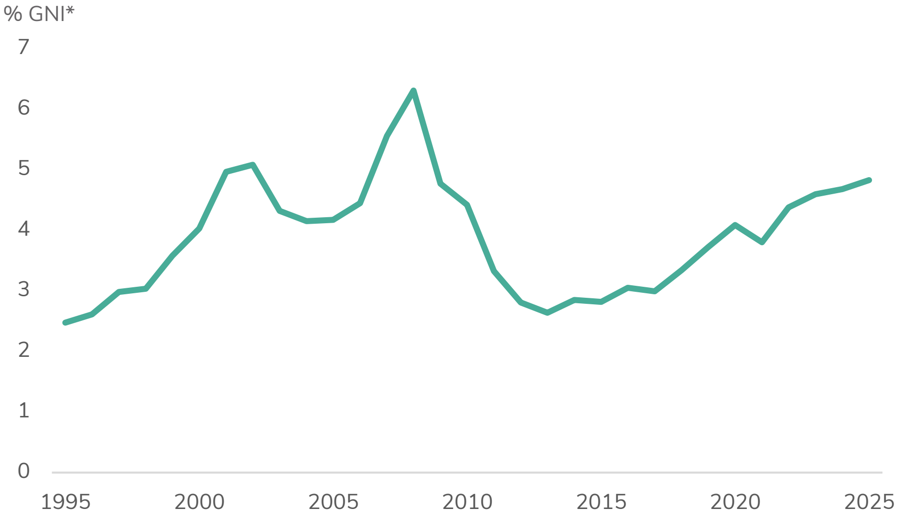
costs rising incrementally over time. Increases in average payments to allow for price increases in the economy further push this cost upwards.

While nothing has been decided in relation to tackling the pensions challenges, the Government has set out proposals to introduce an auto-enrolment scheme for a large number of employees without pension cover (Box H). The fiscal costs of this scheme could amount to €300 million per annum or about 0.1 per cent of GNI*. The costs are not built into *SPU 2022* projections.

Ramp-up in public investment: The Government plans to increase public investment spending to almost 5 per cent of national income by 2025 (Figure 3.18). The National Development Plan suggests it will stay at these high levels out to the end of the decade. There are only a few examples when Ireland's public investment rates were higher in the past two-and-a-half decades. It represents a rapid pick up compared to the low levels of public investment in the aftermath of the financial crisis when rates fell to about 3 per cent of national income. By comparison, other OECD countries tend to see rates of about 3 to 4 per cent. The increase in public investment should help to meet climate change and housing objectives. Indeed, 30 per cent of the National Development Plan allocation for 2021–2025 is for housing, 22 per cent is for transport, and 7 per cent is for environment and climate areas. The exact allocation for measures consistent with achieving climate objectives is not clear (Conroy, Casey and Jordan-Doak, 2021).

Public investment is set to pick up rapidly, but is likely to encounter capacity constraints

Figure 3.18: Public investment being raised to high levels



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

However, achieving these ambitions may be difficult. Ireland's public investment spending had been experiencing some minor, but growing shortfalls before the pandemic (Section 2.5). This may have reflected rising capacity constraints in the sector. For instance, Conroy, Casey and Jordan-Doak (2021) estimate a construction sector unemployment rate and find that this could have been as low as 2 to 3 per cent at the end of 2019 — well below historical rates. Inward migration flows could boost labour supply in the sector as in the past. However, other countries have narrowed the wage gap with Ireland, and costs remain high such that Ireland's relative attractiveness has fallen by more than one-third relative to the mid-2000s. The ramp-up in public investment will also come at a time when many other countries are making similar efforts to increase public investment in the same areas.

A risk to the Government's public investment plans is that these could see higher costs or lower output for a given price. Poorer value for money and possible spending overruns could therefore be the result.

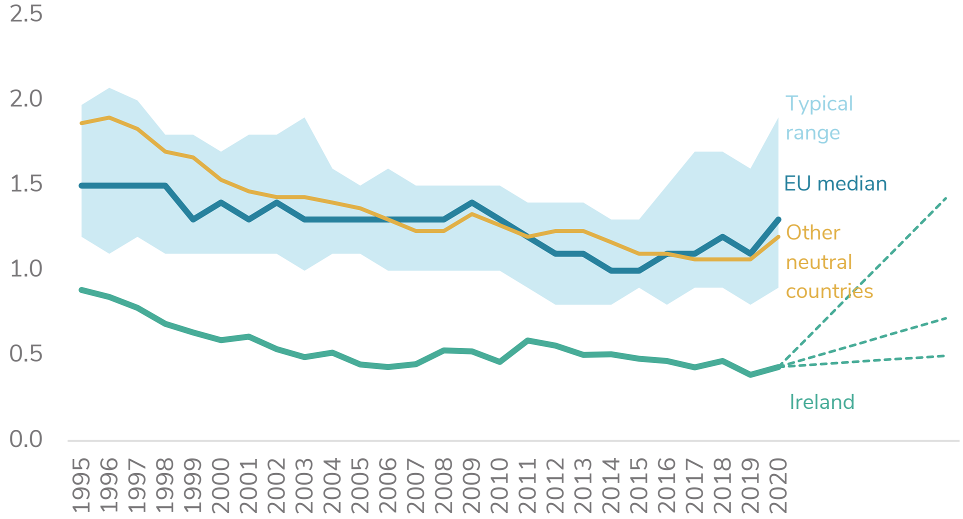
If Ireland is to avoid further overruns and poor value-for-money outcomes in future, it will need to improve how public investment spending is governed. A key recommendation in the past was for the Department of Public Expenditure and Reform to take on more responsibility in ensuring value for money is achieved in capital projects. A high degree of diligence will ultimately be required, given capacity constraints, the high scale of investment, and the greater need to ensure value for money when government debt levels are already high.

Defence spending: Following the invasion of Ukraine by Russia, there is significant pressure across EU countries to ramp up defence spending. Ireland's defence expenditure has historically been very low, in part reflecting its neutrality. However, the Minister for Defence has indicated that Ireland is likely to increase annual defence spending by at least €500 million in the coming years.[71] This sort of increase would broadly fall in line with the middle estimate of the *Report of the Commission on the Defence Forces* (2022), with spending rising by 0.2 to 0.3 per cent of GNI* annually over an unspecified timeframe (Figure 3.19).

[71] https://www.irishtimes.com/news/ireland/irish-news/ireland-s-defence-spending-set-to-rise-by-at-least-50-says-coveney-1.4864427

Figure 3.19: Ireland's defence spending has been exceptionally low

% GNI* for Ireland (% GDP otherwise)



Sources: Eurostat; CSO; Report of the Commission on the Defence Forces (2022); and Fiscal Council workings. Get the data.

Notes: The Commission on the Defence Forces focused its work around three possible tiers of levels of ambition for the scale of funding of Ireland's Defence Forces. These were set at 0.5% (current capabilities); 0.7% (in line with the medium-term costs assessed as required to address specific gaps in Ireland's ability to deal with an assault on Irish sovereignty and to serve in higher intensity peace support, crisis management and humanitarian relief operations overseas); and 1.4% of GNI* (based on an analysis of international comparators), respectively. Illustrative paths to these levels of expenditure are shown as dashed lines for Ireland.

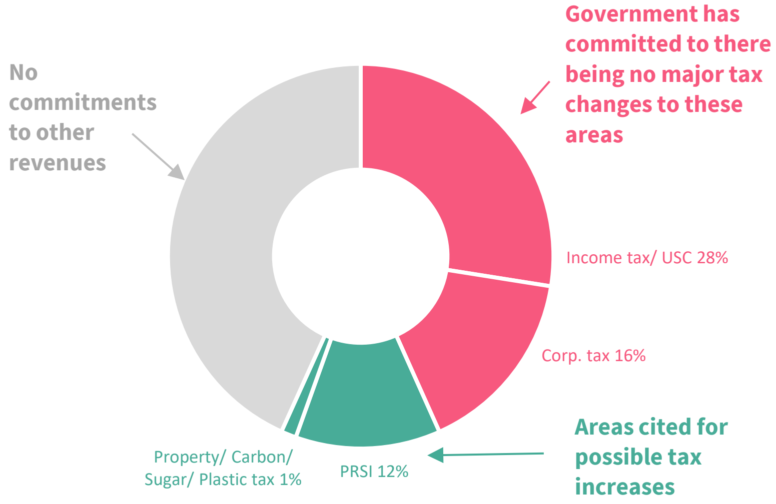
Further spending pressures and limited plans for raising new revenues: The Government faces many other pressures to increase spending. One example of this is the additional €307 million of funding for higher education, which may not be explicitly factored into SPU plans, though could yet come from the existing allocation for voted spending in this area.[72] Others include the public sector pay talks and the possible expansion of the mica redress scheme.

The Government has limited plans for areas where new tax revenues could be raised

[72] The Department of Further and Higher Education, Research, Innovation and Science (2022) notes that the 'Funding the Future' policy, which was approved for publication by Government, addresses funding issues by setting out plans to commit additional Exchequer investment and employer contributions through the National Training Fund, instead of opting to use student loans as part of its response, to gradually reduce student contributions.

Figure 3.20: Only small areas where taxes might be raised

% total general government revenue in 2021



Source: CSO; Revenue; Programme for Government; and Fiscal Council workings. Get the data.

However, the Government has limited plans for areas where new tax revenues could be raised to fund additional commitments. It has ruled out major changes to areas that accounted for about 43 per cent of receipts in 2021. There is no explicit commitment to any changes to another 43 per cent. Only 13 per cent of existing revenues are cited as areas where the Government might raise revenues: PRSI, which accounted for 12 per cent of receipts in 2021, and a mix of smaller taxes that make up the remaining 1 per cent: carbon, sugar, plastic and property tax (Figure 3.20). One area where there are currently plans to introduce revenue-raising measures is in the area of unused land and properties. The Government's *Housing for All* plan in 2021 set out plans to collect data on vacancy with a view to introducing a new Vacant Property Tax. The Government has also committed to a new zoned land tax to replace the existing vacant site levy.

Box H: Auto enrolment could have significant macro and fiscal implications

In March, the Government announced plans to implement a new scheme. Some 750,000 workers — one third of all people employed in Ireland — would be automatically enrolled in a retirement savings system. It is proposed that the scheme would commence in 2024 (Department of Social Protection, 2022). The scheme would involve employees, employers and the State all making contributions to worker pensions.

This proposal could represent a major change to how Irish people are likely to save for retirement. Foster, Wijeratne, and Mulligan (2020) note that from its introduction in the UK in 2012 to 2016, auto-enrolment saw pension participation among eligible employees rise by over 31 percentage points to 73 per cent. They note the largest increases in contributors to pensions were the youngest age cohorts, and the average opt-out rate was low at around 9 per cent.

As the Government notes, Ireland is the only OECD country not yet operating some form of auto enrolment system to promote savings for retirement (OECD, 2014).[73] This box looks at some of the potential implications for the economy and public finances.

Key details

The proposed scheme is intended to encourage workers to save earlier with an opt-out rather than opt-in approach and by providing for significant employer and state contributions as well.

Table H1: Pension contributions are proposed to increase over time

Pension contributions as a percentage of salary under auto-enrolment plans

	Employee	Employer	State	Total
2024-2026	1.5	1.5	0.5	3.5
2027-2029	3.0	3.0	1.0	7.0
2030-2032	4.5	4.5	1.5	10.5
2033 onwards	6.0	6.0	2.0	14.0

Source: Department of Social Protection, 2022.

The scheme would work as follows:

1) From 2024, all employees aged 23 to 60 earning over €20,000 and not already in a work pension scheme will be automatically enrolled in one. Employees will have the option of opting out after participating in the scheme for six months.
2) Employees, employers and the state would all make contributions. Employers would match employees' contributions, while the state would top them up by €1 for every €3 saved by the participant. In other words, every €3 employee contribution would automatically grow to €7 before it is invested.
3) Both employer and employee contributions are to start at 1.5 per cent and increasing every three years by 1.5 per cent of qualifying earnings, reaching 6 per cent by year 10 (2033, see Table H1).
4) The drafting of legislation is set to commence this year.

Economic and fiscal impacts

The establishment of an auto enrollment scheme could have several effects. First, it will increase the level of pension coverage in the private sector.[74] This should see individuals with a financial situation that is better prepared for retirement and less likely to see significant falls in their income upon retirement. An increased level of private sector pensions coverage should also alleviate some of the pressure on the public pensions system. This is key, as demographic changes are expected to lead to significant additional fiscal costs (Fiscal Council, 2020).

Data from the Revenue Commissioners suggest that there would be approximately 750,000 employees enrolled in the initial phase. With an assumed 95 per cent retention rate and an

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[73] At the time of the report, Ireland and New Zealand were the only countries without a mandatory earnings-related pillar for retirement savings. Since then, New Zealand has introduced a system whereby all employees are automatically enrolled in a pension scheme.

[74] International experience would suggest that auto enrolment could increase pension coverage substantially (Bourquin et al, 2020; Chalmers et al., 2021; and Beshears et al. 2009). Of those not currently enrolled in a pension in Ireland, 45 per cent said they had not yet done so because they "never got around to organizing it" (CSO, 2021). This accounts for a larger share than those who said they could not afford to contribute (40 per cent).

average wage level of €35,000 per annum amongst participants, the fund would potentially accumulate €21 billion in contributions by year 10.[75,76]

Using this scenario, we can attempt to estimate the potential impacts of the auto-enrolment scheme on personal disposable income and hence consumption. When contributions are set at 1.5 per cent of annual salary (2024-2026 under current proposals), employee contributions would equate to approximately 0.25 per cent of economy-wide personal disposable income. By 2033, the rate of contributions is proposed to have increased fourfold. As a result, this would equate to approximately 1 per cent of aggregate personal disposable income. However, the international experience suggests that those auto enrolled would tend to be at the lower end of the income distribution. One might therefore expect that those affected could have an above-average marginal propensity to consume out of their incomes. With that in mind, the impact on consumption could be larger than the impacts on disposable income described above. In the very long term, consumption is likely to be boosted by pensioners having higher income than would otherwise have been the case.

The scheme will result in contributions being paid by the State. Official estimates put the cost of the scheme to the State at €3 billion in total over the first ten years (equating to €300 million per annum or about 0.1 per cent of GNI*).

[75] €9.0 billion from employers, €9.0 billion from employees, and €3.0 billion from the State.

[76] Bercholz et. al (2019) found that pension non-coverage was more pronounced among younger workers and those on lower incomes.

Fiscal Rules

Exceptional circumstances continue

4. FISCAL RULES

Exceptional circumstances continue

The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules have been activated since the start of the Covid-19 pandemic in 2020 and have continued into 2022.[77] In the case of the general escape clause, the European Commission recently announced that it considers the conditions required to maintain the activation of the clause as met for 2023, with its deactivation to occur in 2024.[78] The Commission cited high uncertainty and downside risks in the context of the war in Ukraine, along with energy price increases and supply chain disturbances as contributing to this decision.

These flexibilities in both the domestic and EU fiscal rules allow for deviations from the normal requirements. The activation of these clauses has allowed for an appropriate fiscal response to the pandemic in 2020 and 2021, along with provisions to address the humanitarian implications of the war in Ukraine in 2022.

Table 4.1 shows a summary of the Council's previous assessments of compliance with the Domestic Budgetary Rule, as well as the Council's assessment for 2022.[79]

Table 4.1: The Council's assessment of compliance with the Domestic Budgetary Rule

	2017	2018	2019	2020	2021	2022
Spending Rule	Breach	Significant Deviation	Compliant	Exceptional Circumstances	Exceptional Circumstances	Exceptional Circumstances
Structural Balance Rule	Compliant	Compliant	Compliant			
Overall Assessment	Compliant	Compliant	Compliant			

Sources: Fiscal Council workings.
Note: The structural balance rule requires that the structural balance be above the medium-term budgetary objective (MTO) (set at minus 0.5% of GDP for 2016–2019) or moving towards the MTO at an adequate pace. The spending rule requires that net government expenditure be below the average medium-term potential growth rate of the economy (the Expenditure Benchmark). Significant deviation means that the limit for the corresponding rule was exceeded by more than 0.5% of GNI* for the spending rule, or 0.5% of GDP for the structural balance rule. A "breach"

[77] See Box K from the May 2020 FAR for an overview of these dispensations.

[78] The press release from the Commission can be viewed here: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3182

[79] This is based on the Council's Principles-based approach to the Domestic Budgetary Rule. For further information see Table S9.3 in the supporting information section.

means that the limit for the corresponding rule was exceeded by less than 0.5 per cent of GDP or 0.5% of GNI*.

To assess Ireland's fiscal position, the Council advocates using GNI* as an appropriate measure of the size of the domestic economy. However, legal compliance with the fiscal rules is assessed against GDP, which exaggerates the capacity of the domestic economy and is somewhat disconnected from its underlying performance. This can flatter Ireland's compliance with the rules on an underlying basis and would obscure the degree of adjustment required in the event of a downturn.

As part of the Fiscal Responsibility Act 2012, the Council has a mandate to monitor and assess compliance with the domestic budgetary rule on at least an annual basis. While the Council deemed that exceptional circumstances related to the pandemic prevailed in 2021, the Council has assessed that the Government would have been compliant with the domestic budgetary rule and the corresponding 3 per cent of GDP deficit threshold stipulated in the SGP in any case.

The fiscal rules have been met in the short term, and are forecast to be complied with in the medium-term

A general government deficit of 1.9 per cent of GDP was run in 2021 (Figure 4.1).[80]. Similarly, while the onset of Covid-19 led to a sharp increase in borrowing to fund the fiscal response to the crisis, the debt-to-GDP ratio stood at 56 per cent in 2021, below the 60 per cent limit of the SGP, although this relies on a GDP-based measure which presents a misleading picture for Ireland.

Much of the contingent funding set aside for Covid-19 related spending in 2022 will be used to support the humanitarian response to the war in Ukraine and cushion the impact of rising energy prices for households and firms. However, in 2023, significant costs associated with the settlement of refugees from the conflict are also expected.

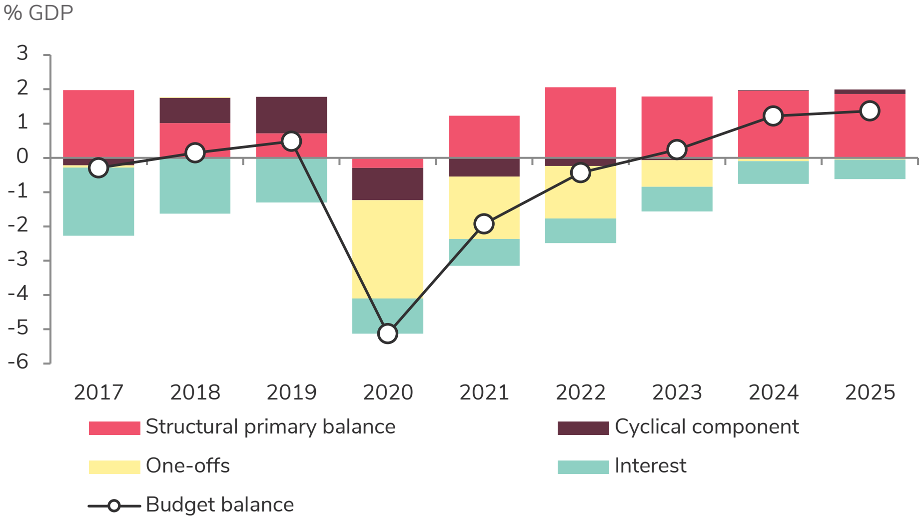
Despite this, based on *SPU 2022* forecasts, both the headline and structural balance are forecast to improve both this year and next to levels that would yield compliance with the fiscal rules. The headline general government deficit is forecast to fall to 0.4 per cent of GDP in 2022, below the 3 per cent limit in the SGP.

[80] While the Council recommends using GNI* as a more appropriate benchmark for assessing Ireland's fiscal position, legal compliance with the fiscal rules continues to be assessed against GDP.

The structural balance is projected to be positive in 2022 and throughout the forecast period. In 2022, it is forecast to be 1.4 per cent of GDP, therefore complying with the Medium-term Budgetary Objective (MTO) of a structural deficit of no more than 0.5 per cent of GDP. Should these forecasts transpire, the fiscal rules would be complied with in 2022 and up to 2025 and would not see the Adjustment Path Condition applied.

Such a performance would highlight the fact that a continuation of the exceptional circumstances clause within the rules would be inconsequential for Ireland, as it is set to comply regardless. It also demonstrates that while any extension of the clause may be justified on the grounds of the war in Ukraine and the fallout from this, Ireland remains relatively less economically exposed to the conflict than other EU members. However, a broader slowdown in the Eurozone would of course have negative implications for the Irish economy.

Figure 4.1: Both headline and structural balances are forecast to improve



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Note: The structural element of the budget balance is estimated using the top-down approach. This is the approach used in assessing legal compliance with the fiscal rules. The cyclical budgetary component is calculated as 0.52 times the Department's GVA-based output gap measure.

The future of the fiscal rules in the Eurozone remains unclear in the medium term. The European Commission's review of the EU's economic governance and fiscal rules is ongoing, and it is still intended that guidance will be provided to Member States regarding any broad reforms to the rules well in advance of 2023.

Last September, the Network of EU Independent Fiscal Institutions (IFIs), of which the Fiscal Council is a member, released a publication as part of its submission to the governance review by the European Commission regarding the rules. It highlighted areas where the expertise of IFIs could be more efficiently deployed to enhance the fiscal governance framework of the EU. These included producing assessments of measurement issues, budgetary forecasting, compliance with fiscal rules, and in generating overall assessments of the fiscal position of the member in question (EUIFI, 2021).

The Network recently released two further papers as part of this topic, including on the possible future role of IFIs in the EU semester and outlining its views in more detail on the need for an expanded role for IFIs in many countries and ways in which this might be achieved, including the introduction of legislative backing for a set of “minimum standards” to help support a wider role for national IFIs in fiscal governance at the EU level (EUIFI, 2022a; EUIFI, 2022b).

The Government’s introduction of a new spending rule helps to achieve the compliance with the rules over the medium-term, but will still be subject to upward pressure as inflation overshoots in 2022 and 2023 may be built into the base of spending to some degree (see Box I below for a more comprehensive overview of this topic).

For further details on the Council’s assessment of compliance with the fiscal rules see section S9: Supporting information.

Box I: Inflation and the Government's 5% Spending Rule

This box reviews the Government's 5% Spending Rule and its design, particularly considering the recent high-inflation environment.

The Government's spending rule in principle

As part of the *Summer Economic Statement* in 2021, the Government outlined a new expenditure rule that would seek to anchor 'core' expenditure growth — Exchequer spending less Covid-related expenditure — over the medium term. The rule would effectively seek to tie expenditure growth to the estimated sustainable nominal growth rate of the economy, at 5 per cent per year. The Council had for many years argued in favour of implementing credible spending rules, with this latest development broadly welcomed.

At the time of the rule being proposed, the Council also outlined that a range of issues relating its design required further attention. These included:

1) the backward-looking nature of estimating the economy's sustainable growth rate, rather than focussing on medium-term forecasts of potential output;
2) the narrow focus on *Exchequer* spending rather than on a general government basis;
3) the lack of a statutory footing for the rule;
4) the lack of a link to departmental ceilings set for each year;
5) the potential disconnect with other domestic fiscal rules;
6) the absence of a role for factoring in a meaningful debt target;
7) the omission of the impact of tax policy changes (in other words, tax cuts are ignored in the rule as it is designed, which is a clear flaw); and
8) the absence of a clear procedure for how the rule would operate in the case of under- or over-spends.

Without these facets, the stated benefits by Government of minimising revenue windfalls being spent on permanent increases and maintaining high levels of capital spending are being undermined. Also, without an anchor to a debt target or structural balance, the rule is in danger of locking in large deficits or high debt ratios (see Box E, Fiscal Council 2021b).

The Government's spending rule in practice

The Government appears to have stuck to the 5% Spending Rule since it was initiated. The rule is operationalised as a growth rate of spending applied to a nominal allocation in levels, rather than growth rates on outturns over the medium-term. This means that while the growth rates fluctuate around the anchor of 5 per cent, the medium-term levels remain broadly unchanged.

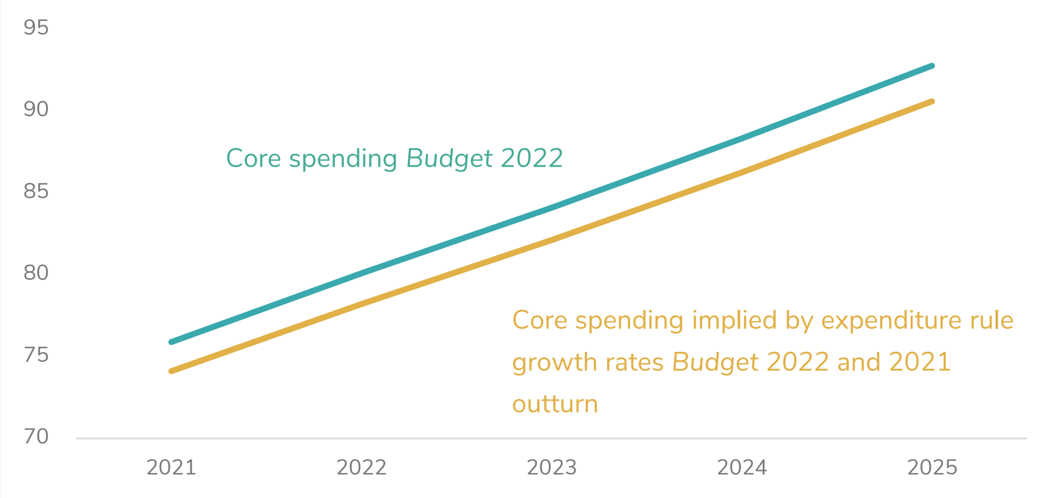
For example, the level of core spending in 2021 anticipated in *Budget 2022* has since been revised down by around €1.8bn, however the level of core spending in 2022 has remained unchanged in *SPU* 2022 from what was forecast in *Budget* 2022.

This leads to an expected growth rate in core spending of 8.1 per cent in 2022, rather than the 5.5 per cent growth rate for 2022 anticipated in *Budget* 2022, which was more aligned with the 5% Spending Rule.

Applying the originally anticipated growth rates to the actual core spending outturn in 2021 shows that spending levels will only be temporarily higher in 2022 relative to this counterfactual as a result of the higher growth rate of spending being projected, medium-term spending levels are essentially unchanged from *Budget* 2022 expectations (Figure I1).

Figure I1: Core spending is projected to be higher in 2022 only than had the Government grown spending by its originally forecast growth rates

€ billion



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

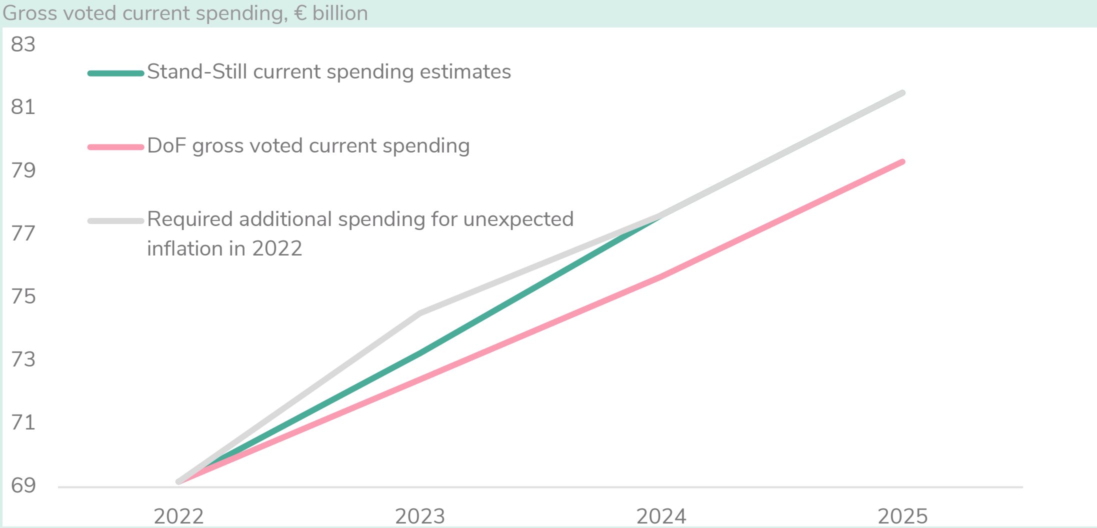
Notes: The green line shows *Budget 2022* core expenditure forecasts, yellow line outlines the levels of spending that would have been implied by the 2021 outturn and core spending growth rates from Budget 2022.

The spending rule and inflation

As part of *Budget* 2022, annual HICP inflation was forecast to be, on average, 2.5 percentage points lower in 2022 and 2023 than the latest SPU projections. Given that the spending rule appears to be applied in nominal level terms, the unexpected inflation would typically reduce the amount of real spending that could occur relative to earlier plans, although at present the 2021 underspends create some leeway. To illustrate the tensions that can arise with a rule specified in nominal terms when inflation is higher than expected, Figure H2 shows how unexpected inflation has pushed Stand-Still costs above spending levels anticipated in SPU 2022 over the medium term under the rule (Figure I2).

Figure I2: Inflation 'catch-up' costs in 2023 would drive spending higher than Current Stand-Still estimates

Gross voted current spending, € billion



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

Notes: The grey line above represents the additional cost of recovering the real level of service provision in 2023, following the higher than expected inflation seen in 2022. This is calculated as the difference in HICP, wages and GNP deflator between Budget 2022 and SPU 2022.

This further complicates the budgetary arithmetic and creates challenges for policymakers. This would require policymakers to make a clear choice about whether or not to fully adjust spending to higher inflation, to make cuts in some areas or to raise taxes. With higher-than-expected inflation, it becomes more difficult to keep to the spending plans specified in nominal terms without real falls in the levels of services provided. For example, the unexpectedly high price increases seen in 2022 would permanently reduce the real value of services in the absence of a 'catch-up' in spending. Figure I2 shows how such a catch-up effect would translate into higher spending in 2023 if policy intended to fully compensate for the excess of unexpected inflation in 2022.

At the same time however, inflation is in net terms likely to boost revenues all other things equal. As noted earlier (Box E), higher inflation may generate higher revenues, assuming that consumers and businesses do not scale back on purchases and that wages increase. All equal, this would help the budget balance and – if the spending rule is followed – lead policy to tighten.

Incorporating inflation into the spending rule

Taken together, these factors illustrate the complexity surrounding both the impact of inflation on the public finances and the pressures that will be exerted on the spending rule when specified in nominal terms.

Adjusting the rule to accommodate inflation could be done by specifying the rule in real terms (for example, as a 3 per cent real spending rule) with inflation allowed to vary in line with actual forecast rates. This approach is used in a number of countries including the Netherlands. However, revisions to forecasts, temporary supply shocks and the varying incidence of pressures complicate the picture.

Alternatively, the spending rule may continue to be specified in nominal terms as is currently the case. As Lane (2021) points out, a spending rule that takes account of the ECB's 2 per cent inflation target on a symmetric basis would actually improve the utility of the rule as a counter-cyclical tool by increasing the fiscal space available during periods of below-target inflation and vice versa.

From an economic perspective, it makes little sense to increase the overall expenditure ceiling on the back of unexpectedly high inflation, particularly in the case of a negative supply shock such as the global economy is experiencing now. The same argument would apply, for example, to a deflationary period.

One option would be to retain the nominal targets but with an allowance for an inflation adjustment where forecasts deviate too far from trend. This could necessitate specifying the required deviation in levels, growth rates, and the nature of the driver, or this could be addressed on an ad-hoc basis.

4.1 Medium-term Expenditure Framework

The medium-term expenditure framework, established in 2013 as part of a wider package of budgetary reform in Ireland, requires the Government to set and publish departmental expenditure ceilings for the upcoming three years. This change was part of an intention to provide both an anchor for spending over the medium-term and to ensure that the Expenditure Benchmark is complied with.

Recent experience has demonstrated that this framework is not working as intended. There have been consistent overruns in spending relative to the levels specified as part of these expenditure ceilings. Furthermore, these deviations have been on a similar scale to that which took place prior to the financial crisis.

Medium-term departmental ceilings are based on unrealistic technical assumptions

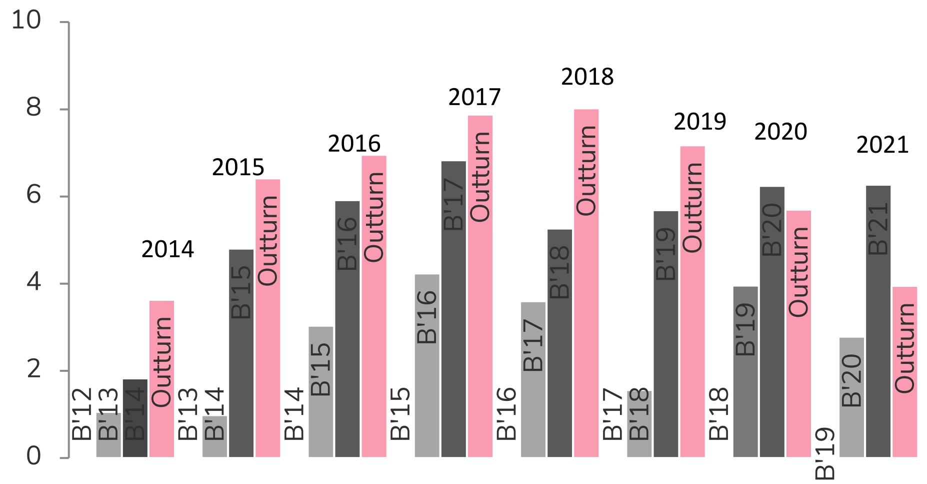
As part of *Budget 2022*, the Government failed to publish the required ceilings, despite this taking place each year between 2014 and 2020.[81] This suggests that the production of the expenditure ceilings was not part of the core budgetary process but rather a technical exercise, with the eventual ceilings being agreed by Government only in December 2021 as part of the Revised Estimates process. The failure to publish these ceilings at the time of the budget and their lack of integration into the budgetary framework more generally represents a backwards step in transparency and a weakness in the overall fiscal framework.

Furthermore, the current baseline core current departmental ceilings, contained in the December 2021 Revised Estimates, have been held constant for both 2023 and 2024. This contributes further to the indication that the ceilings are non-binding, unlikely to act as a constraint on procyclical spending, and have little relevance or connection with the Government's new 5% Spending Rule.

[81] Expenditure Report 2021 did not include three-year-ahead expenditure ceilings. The Department originally cited uncertainty around Covid-19 and Brexit as the reason for not providing these. After the Council highlighted the legal requirement to publish these and lay them before the Dáil, the Department indicated that these ceilings would be fixed as part of the Revised Estimates process in December 2021 and were published then.

Figure 4.2: Change in gross voted current expenditure ceiling relative to initial ceiling

% deviation from original ceiling



Sources: CSO; Department of Finance; and Fiscal Council workings. [Get the data.](#)

Note: Bars show the change in forecasts from various budgets followed by outturns, versus the earliest budget forecast for that year (e.g., B'15 = expenditure forecasts in Budget 2015 minus the earliest forecast for the specified year). Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above. Note that figures for Budget 2021, and the outturns for 2020 and 2021 are Covid-19-adjusted (they incorporate only "core" expenditure).

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