Irish Fiscal Advisory Council

Fiscal Assessment Report

Rising prices and an uneven recovery

May 2022

Key messages

Key messages

Irish Fiscal Advisory Council

The economy has continued to grow despite the challenges

- The economy has recovered and, despite downward revisions, is expected to grow in the years ahead
- Higher energy and food prices have taken inflation to the highest rates in a generation
- *SPU2022* assumes that energy supply will improve and that inflation will return to normal levels
- But, there are risks of higher inflation and downside risks to activity have increased

SPU 2022 forecasts a sharp improvement in the budget balance

- The deficit is forecast to improve to 0.8% GNI* this year and reach 2.7% of GNI* by 2025
- Measures to address the cost-of-living and support Ukrainian refugees in 2022 are within Covid contingencies
- The debt ratio would fall significantly to just under 80% of GNI* by 2025

This is based on the government meeting its new 5% spending rule in levels

- The 5% Spending Rule is providing a useful signal on policy but should be reinforced

Higher inflation creates significant spending pressures

- Under full indexation to unexpected inflation, there would be no room for additional permanent spending measures under the spending rule relative to current plans in either 2022/23 or the medium term
- The Government will need to make choices between how to address higher inflation and managing other priorities

Key messages

There is delicate balancing act in protecting the economy and poorer households, while avoiding adding to inflation through second-round effects

- A combination of carefully-calibrated and targeted supports and wage and welfare increases could help
- A coordinated approach across policies and with social partners could help

Over-reliance on corporation tax should be gradually unwound

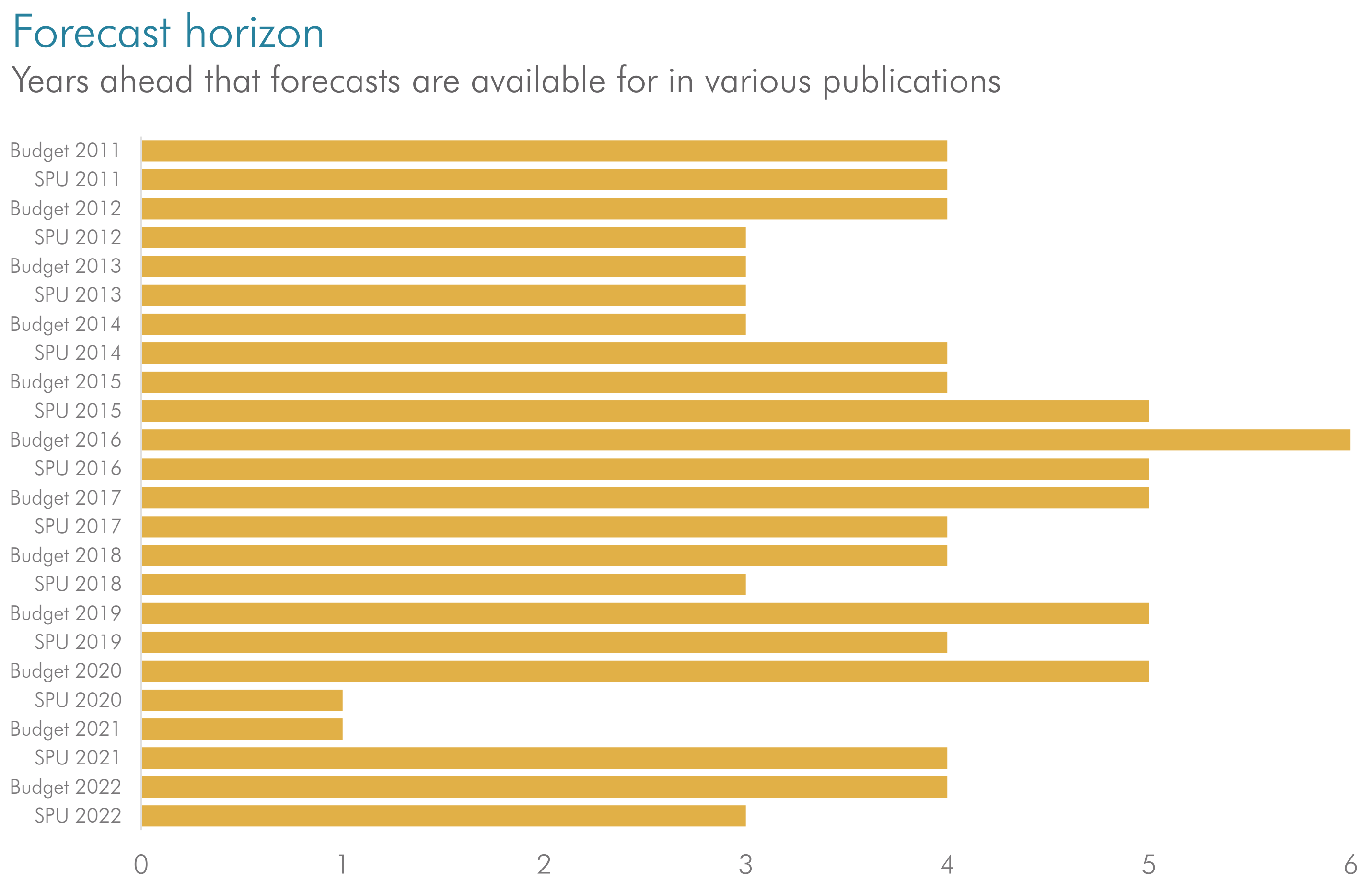
- Corporation tax, much of it paid by a few large multinationals, now accounts for over 20% of Exchequer revenue
- A cap on the amount of corporation tax used to fund spending should be introduced and the overreliance gradually unwound through contributions to the Rainy Day Fund or reducing debt more quickly

Major policy commitments need to be properly costed and factored into the Government’s plans

- There is no estimate of the budgetary cost of implementing the Climate Action Plan
- The costing of *Slaintécare* has not been updated since 2017
- The impact of ageing on the public finances needs to be addressed
- Defence spending in Ireland may rise in the years ahead

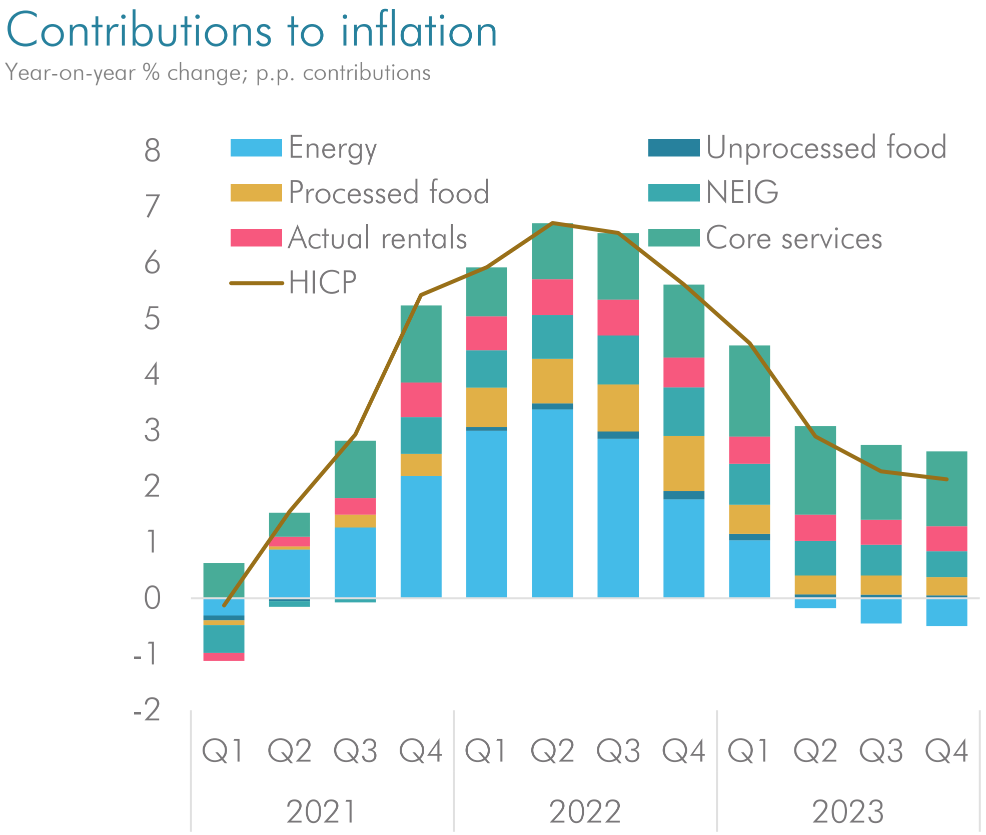
Economic outlook

SPU only forecasts 3-years ahead



- This undermines a medium-term approach to fiscal policy
- Forecasts should always be made to 5 years

Energy and food prices have increased sharply, leading to high inflation

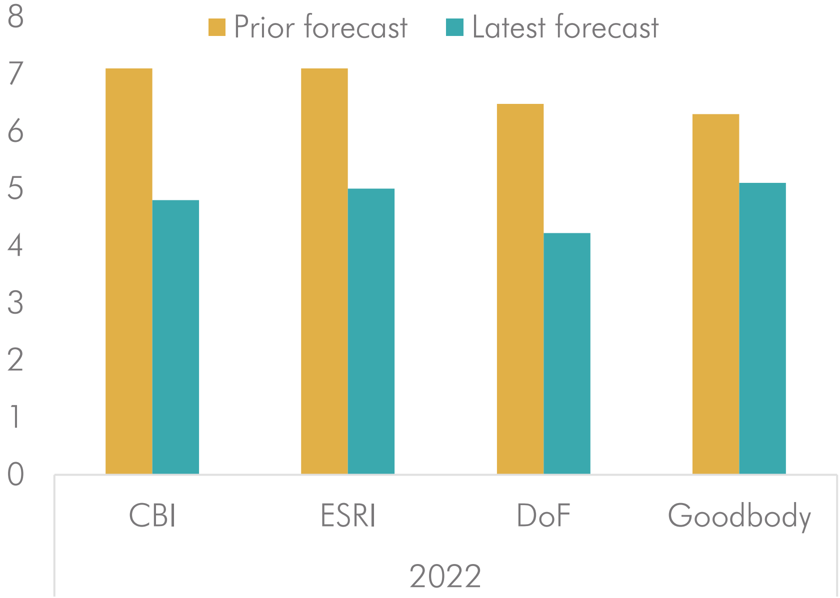


Source: CSO; and Department of Finance.

Higher import costs will drag on growth, but the Irish economy has been resilient in recent years

Modified domestic demand

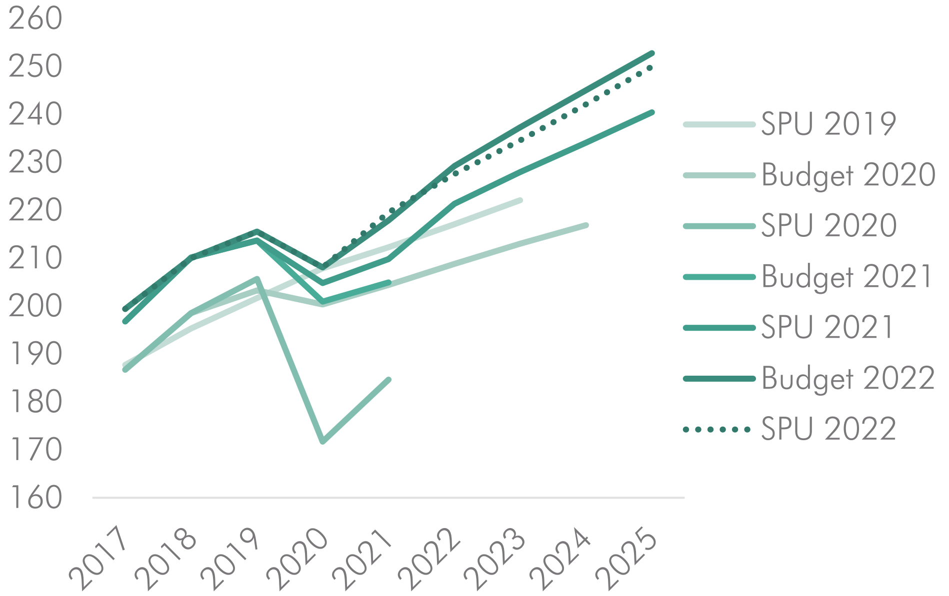
% change in volume



Sources: Central Bank of Ireland; Economic and Social Research Institute; Department of Finance, and Goodbody.

Real GNI*

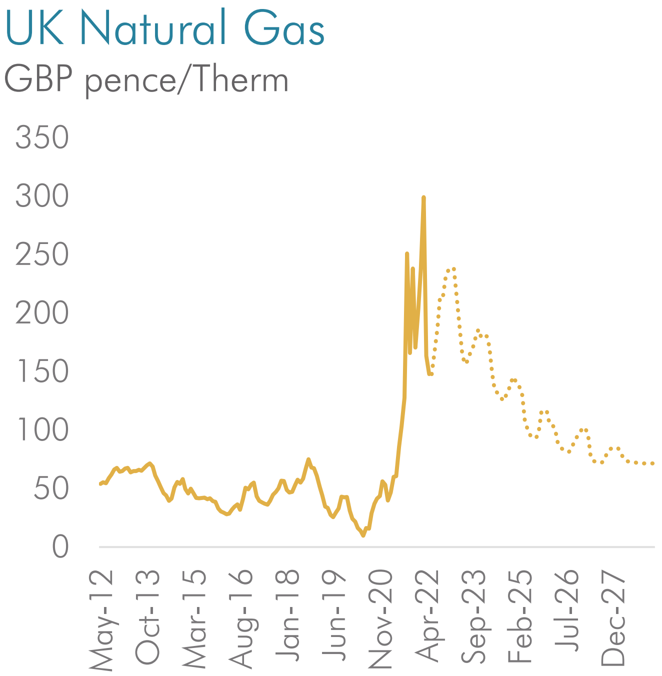
€ billion, 2019 constant prices

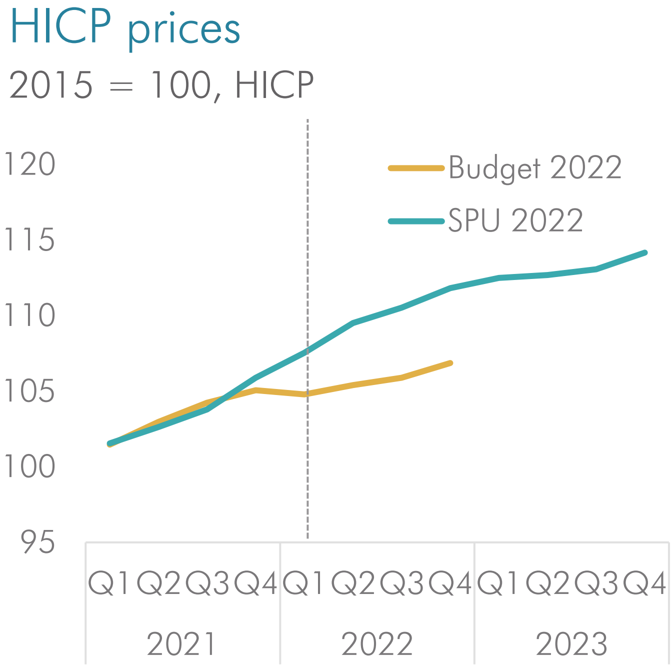


Sources: Department of Finance, Central Statistics Office (CSO), and Fiscal Council workings.

- Ireland has benefitted from favourable trends in the digital, pharma and financial sectors

Uncertainty is high around inflation and there are downside risks to global activity



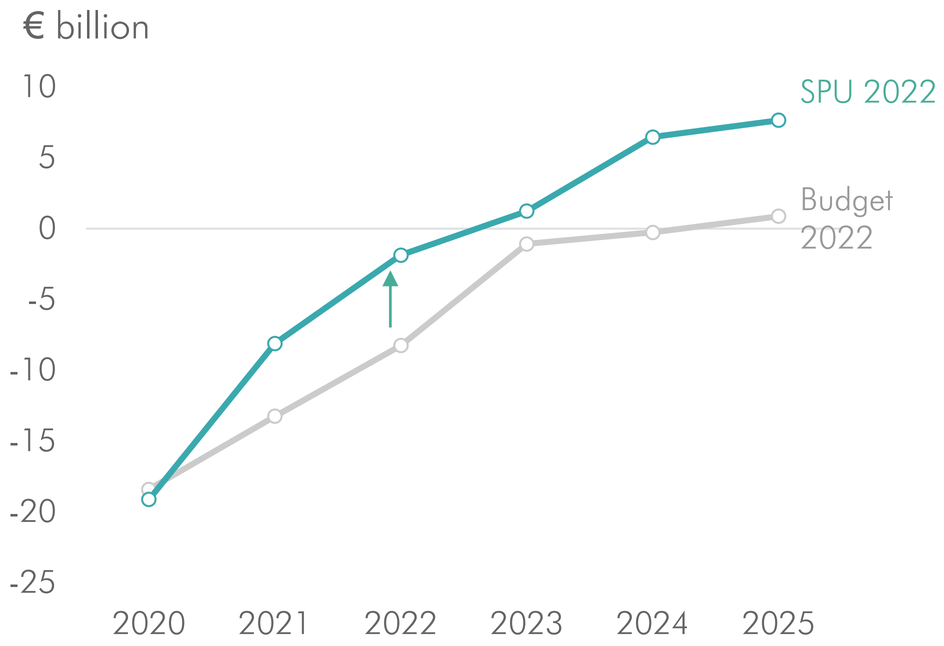


- Energy prices could be higher than anticipated in *SPU2022*
- Pass through to other prices could be higher
- Inflation could be higher due to second-round increase on wages and prices
- Monetary policy is tightening

Budgetary outlook

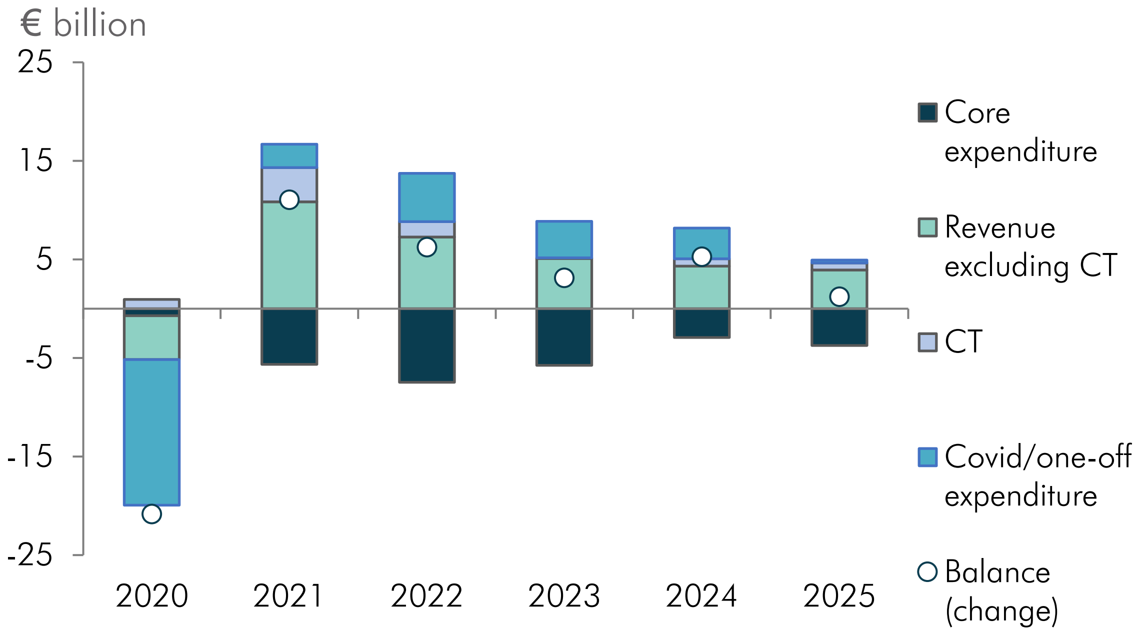
The budget balance is projected to improve

Budget balance



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

Change in the budget balance



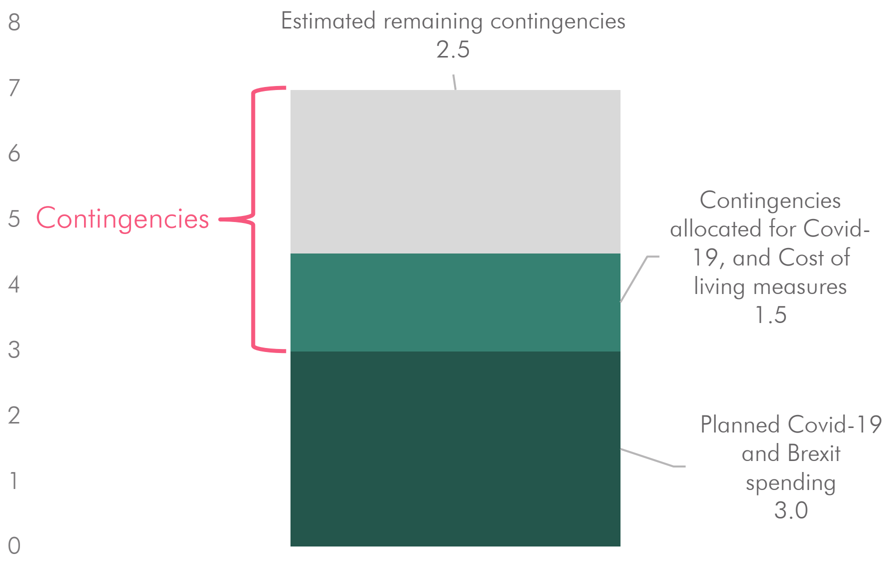
Sources: CSO; Department of Finance; and Fiscal Council workings.

- Recent outturns have been better than expected
- The Government's plans are based on compliance with the 5% spending rule set out in Budget 2022 in terms of the level

Existing temporary measures are within contingencies set out in Budget 2022

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

€ billion

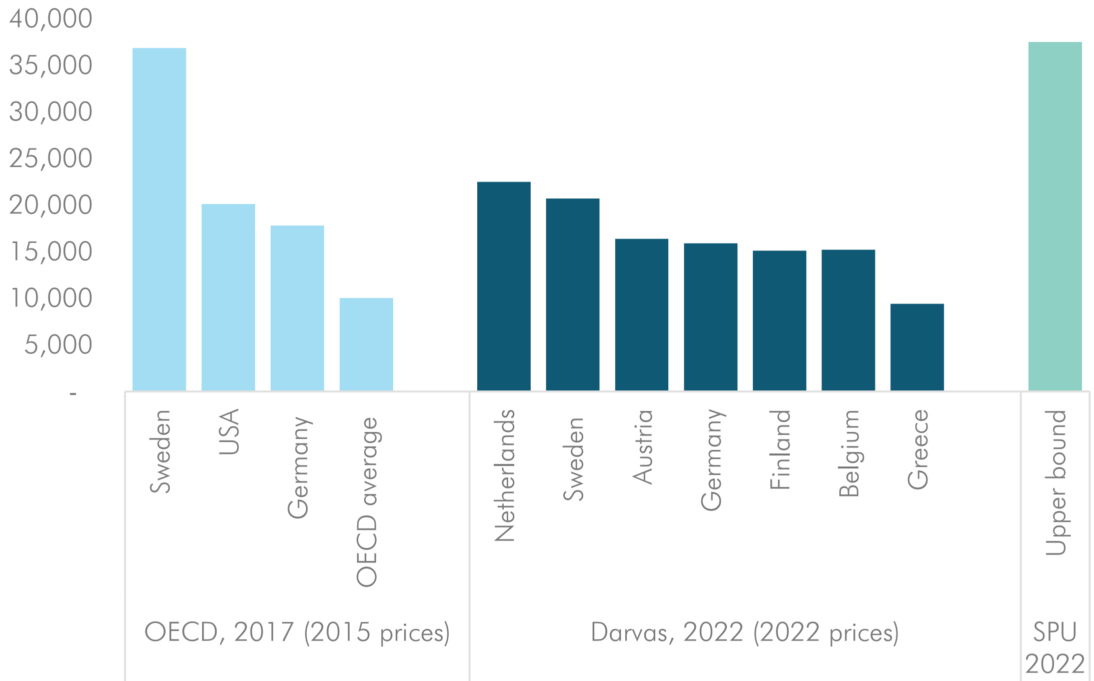


Sources: Budget 2022, SPU 2022 and Fiscal Council workings.

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.

Cost per refugee

€



Sources: Department of Finance; OECD (2017) and Fiscal Council workings.

- Spending to support Ukrainian refugees is highly uncertain

Cost-of-living measures are mostly temporary, but not targetted

	Cost (€ million)	Scheduled Expiry	Targeted?
Measures Since Budget 2022			
Pandemic Special Recognition Payment	100	One-off	
Additional Bank Holiday	50	Permanent	
Excise cuts	417	October 2022	No
Electricity Credit	379	One-off	No
Public Transport Subsidy	54	End 2022	No
Fuel Allowance	86	One-off	Yes, targeted
VAT cut on gas & electricity	46	October 31	No
Haulier Support Scheme	18	One-off	Yes, targeted
Drugs Payment Scheme	17	Permanent	Yes, targeted
Tillage Support Scheme	12	One-off	Some targeting
Working Family Payment	4	Permanent	Yes, targeted
School Transport Subsidy	3	Permanent	Some targeting
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. Figures correct as of SPU publication

Over a longer period, the public finances benefit from several favourable factors

Comparing 2019 and 2025

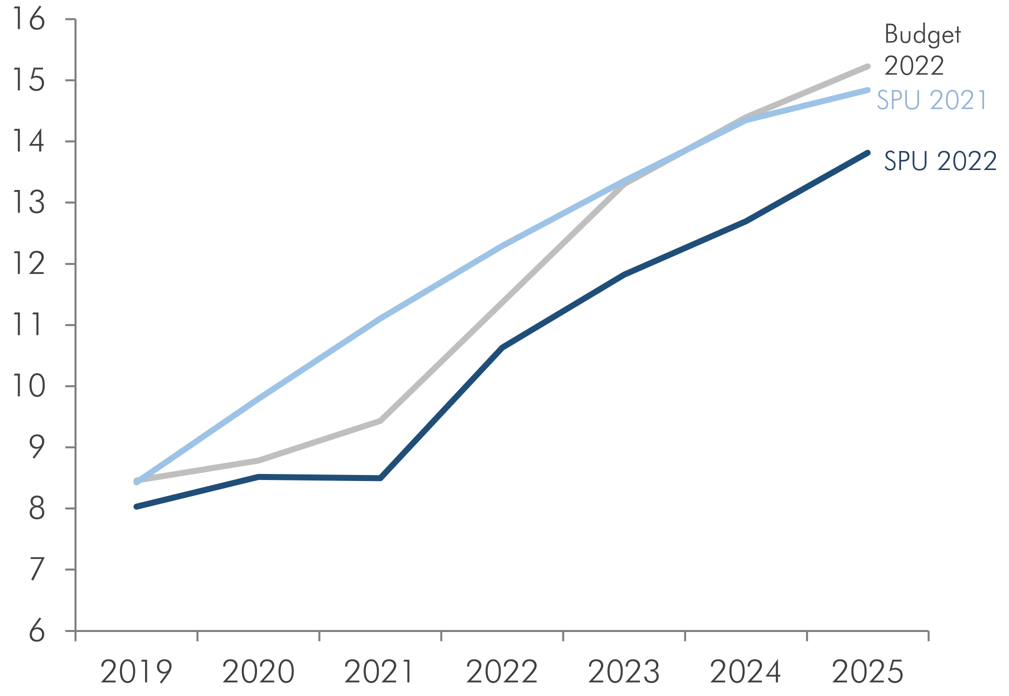
Difference 2025 - 2019

	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; Department of Finance and Fiscal Council workings.

General government capital spending

€ billion



Sources: Department of Finance.

- Higher corporation tax receipts and strong income taxes are raising revenue
- Lower interest costs and restraint in current spending lower day-to-day expenditure
- This creates space to improve the budget balance and fund public investment

However, inflation complicates the picture

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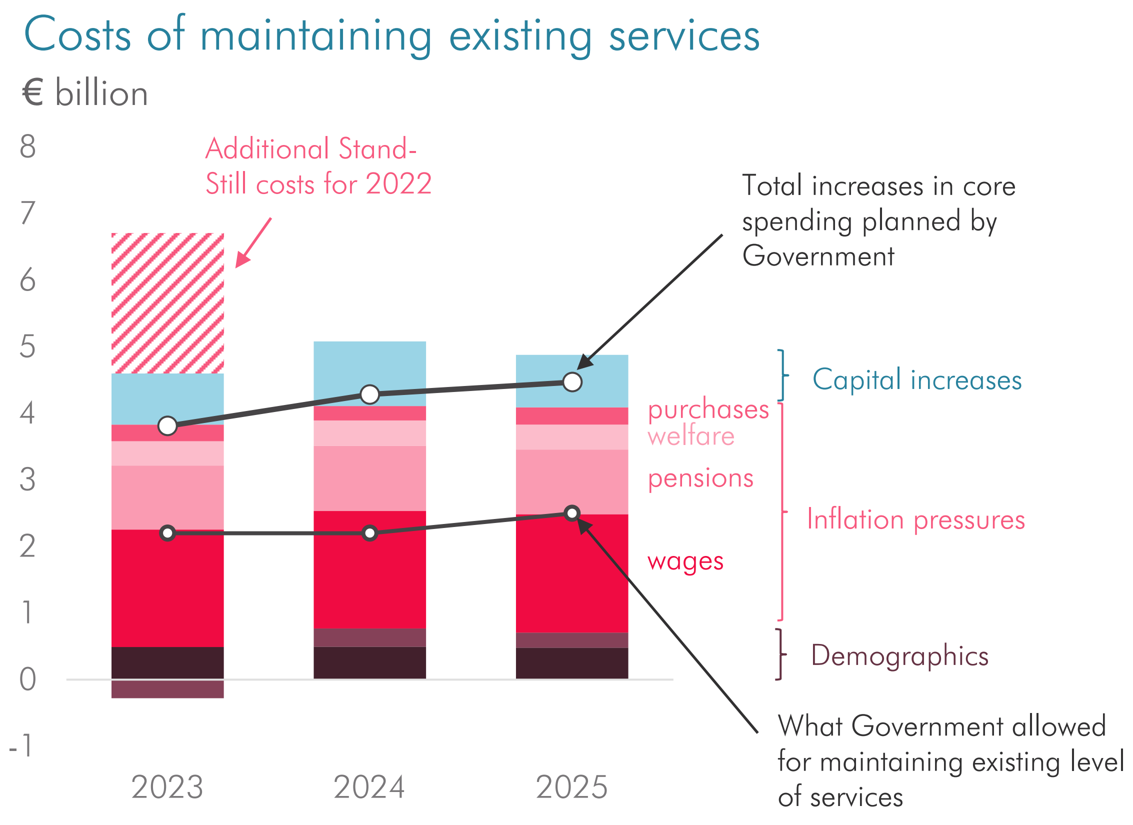
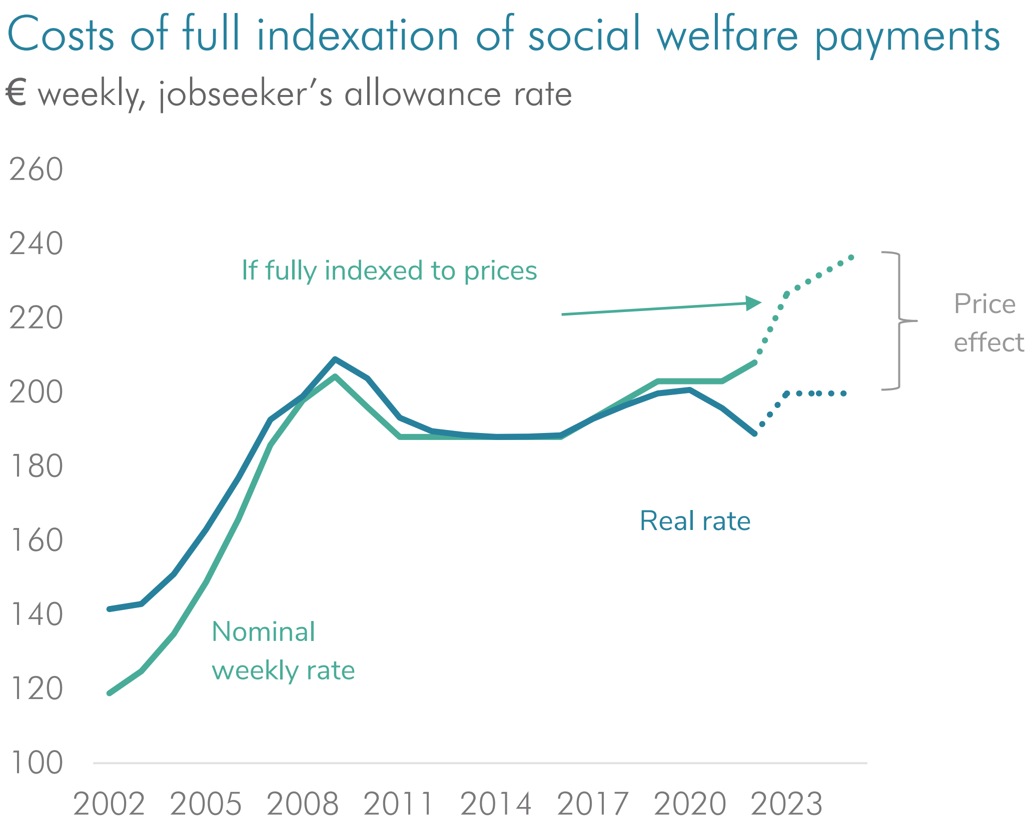
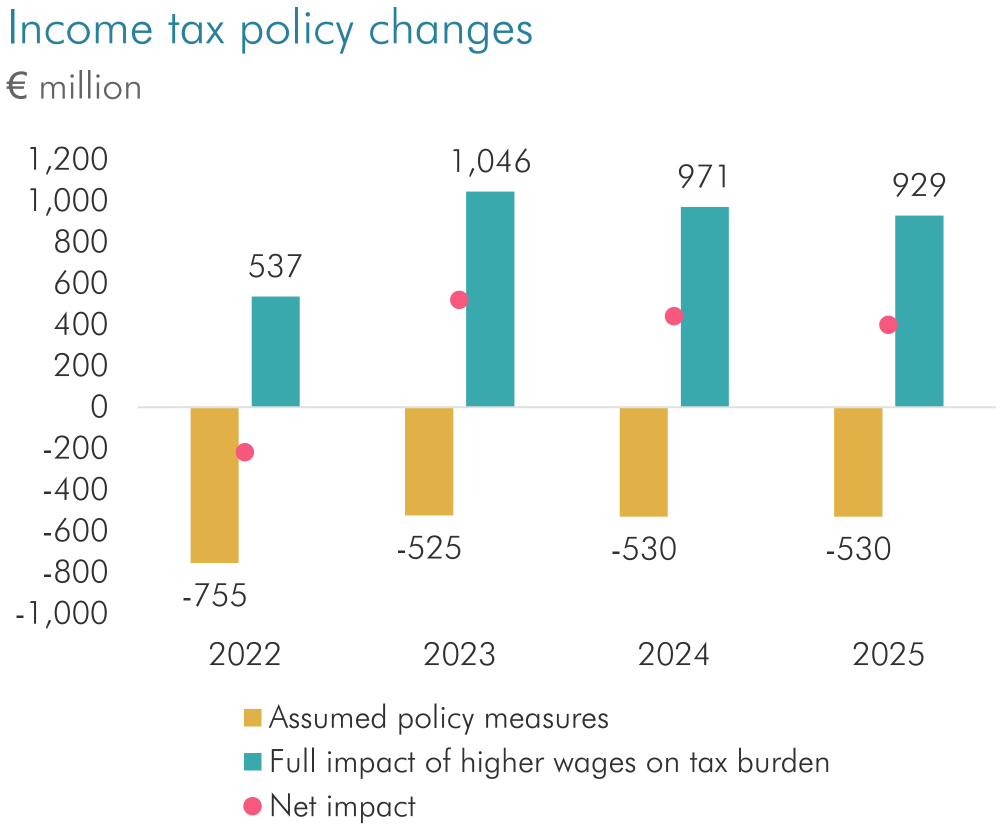


Sources: Fiscal Council workings.



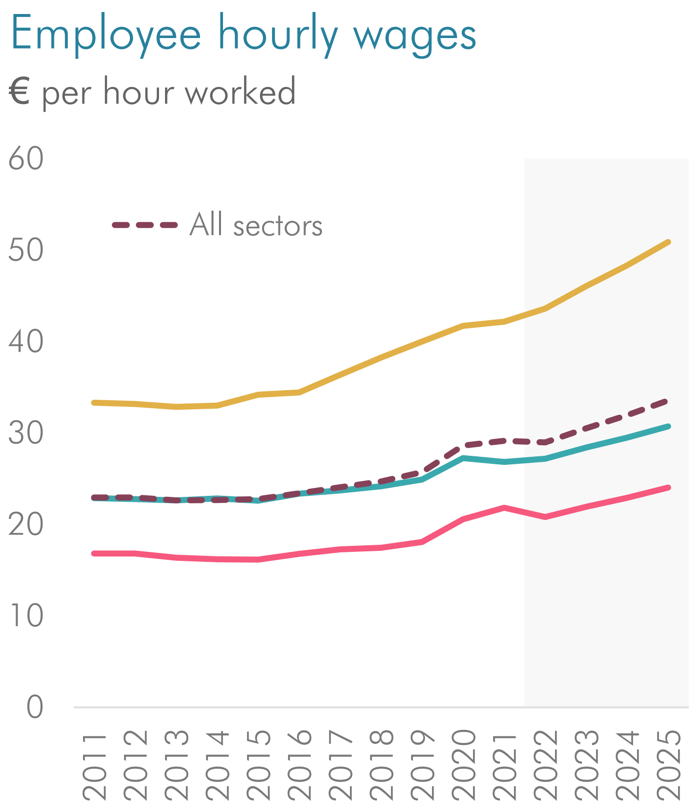
- If wages and benefits were fully indexed, "standing still" in terms of public services and welfare rates would cost more than the total allocated spending increases
- The Government will need to make choices about how far it uprates wages and benefits

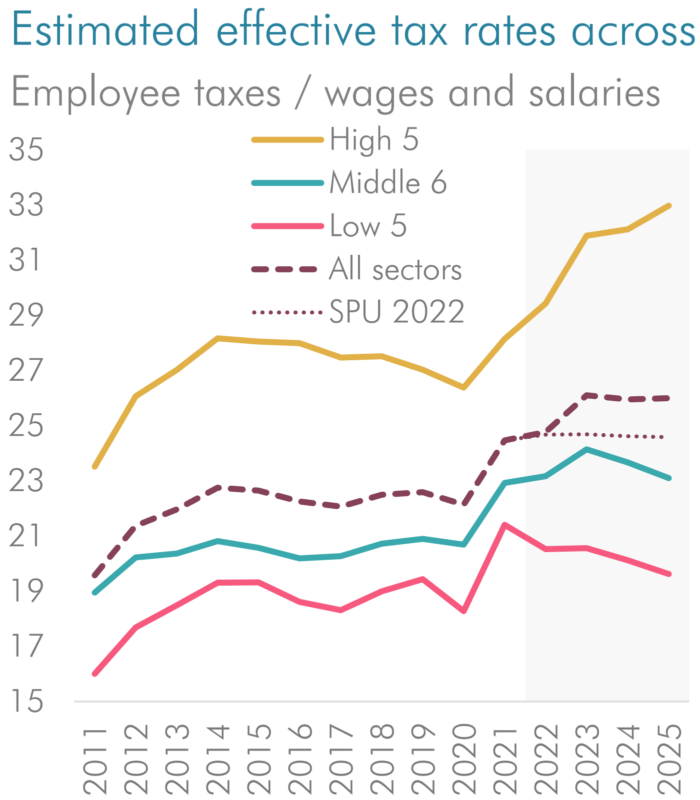
Higher wages and prices could also boost revenues



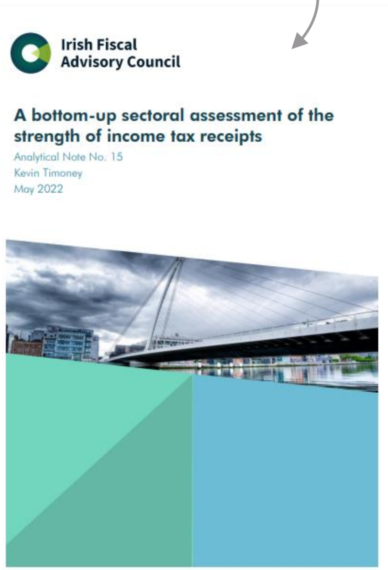
- Forecast revisions suggest a gain of 0.8 to 1.9 percentage points of GNI* due to the higher inflation without any change in policy settings
- The assumed partial indexation of tax bands and credits increases revenue more at higher inflation rates

Income tax receipts have been boosted by growth in high pay, high tax work





Read more



- Income tax receipts grew by 17% in 2021, more than double labour income
- This partly reflects higher wages and more jobs in high-pay sectors
- This could boost income tax receipts permanently, although caution is required

The debt ratio is now on a steeper downward path

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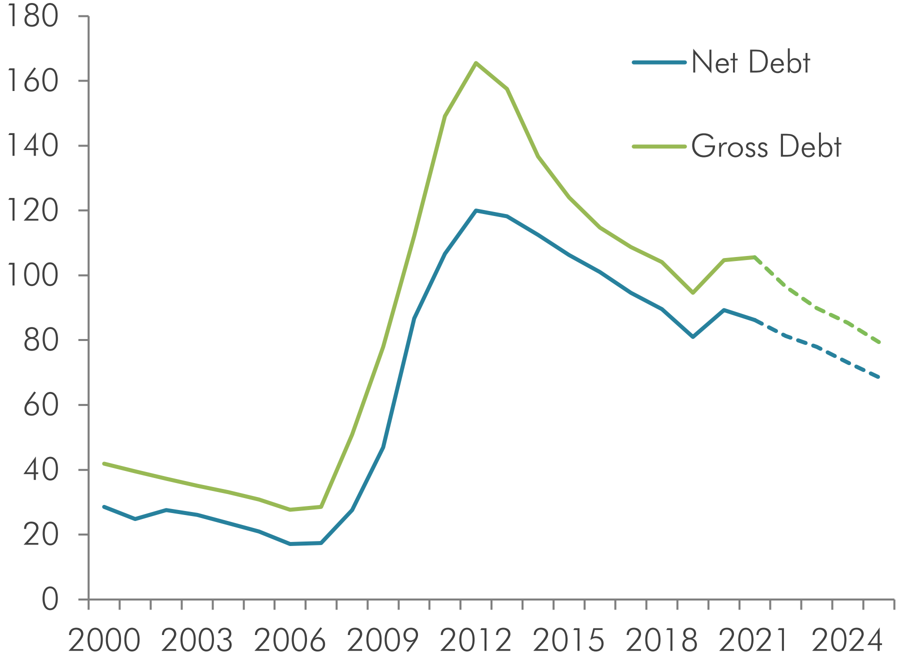
Debt ratios

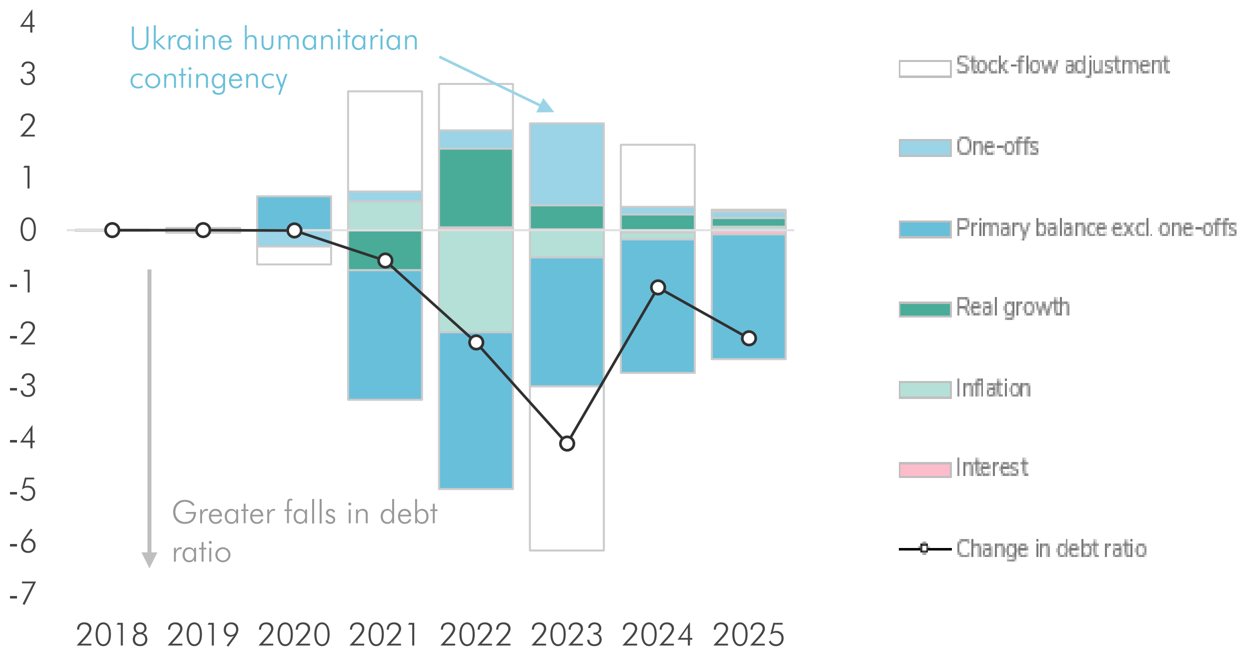
% of GNI*



Sources: Department of Finance.

Revisions to the gross debt ratio since budget 2022

p.p. GNI* (revisions to changes in gross debt ratio since Budget 2022)



Sources: Department of Finance and Fiscal Council workings.

- Although interest rates on government debt have increased, interest costs are projected to continue to fall in the coming years

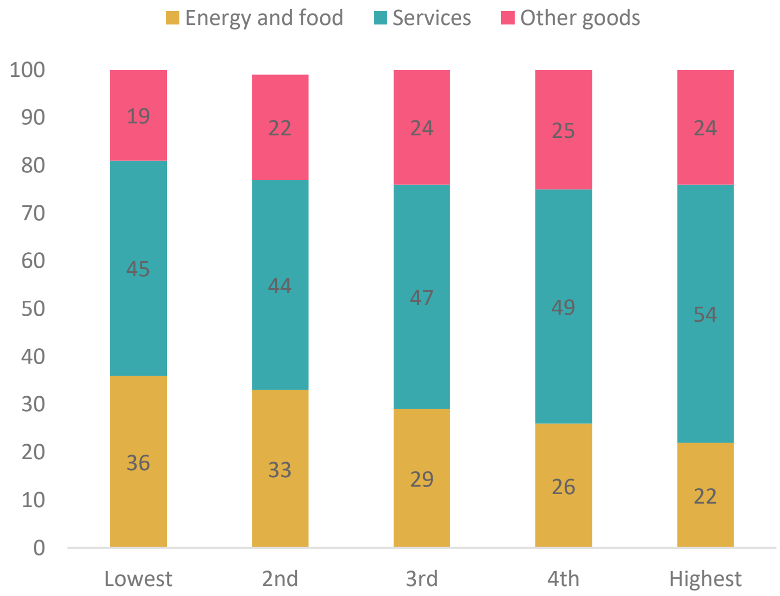
Fiscal stance

The Government faces a delicate balancing act

A balance is needed between protecting the economy and poorer households from higher energy and food prices, while not adding to inflation through second-round effects

Lower income households spend more than a third of disposable income on energy and food

Expenditure weights by quintile of net disposable household income



- The negative impact of higher imports prices cannot be fully offset for everyone
- Carefully-calibrated supports, wage increases and targeted measures could help to achieve this
- Co-ordination between public and private sector wages, welfare changes and other policies, as undertaken in the past with Social Partnership, could help

The fiscal rules support this process

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- “Exceptional circumstances” continue to apply at the EU level, but from 2022 Ireland would fully compliant in any case
- The 5% Spending rule is providing useful signals that choices need to be made between different spending and tax alternatives

Focussing more on medium-term forecasts of potential output

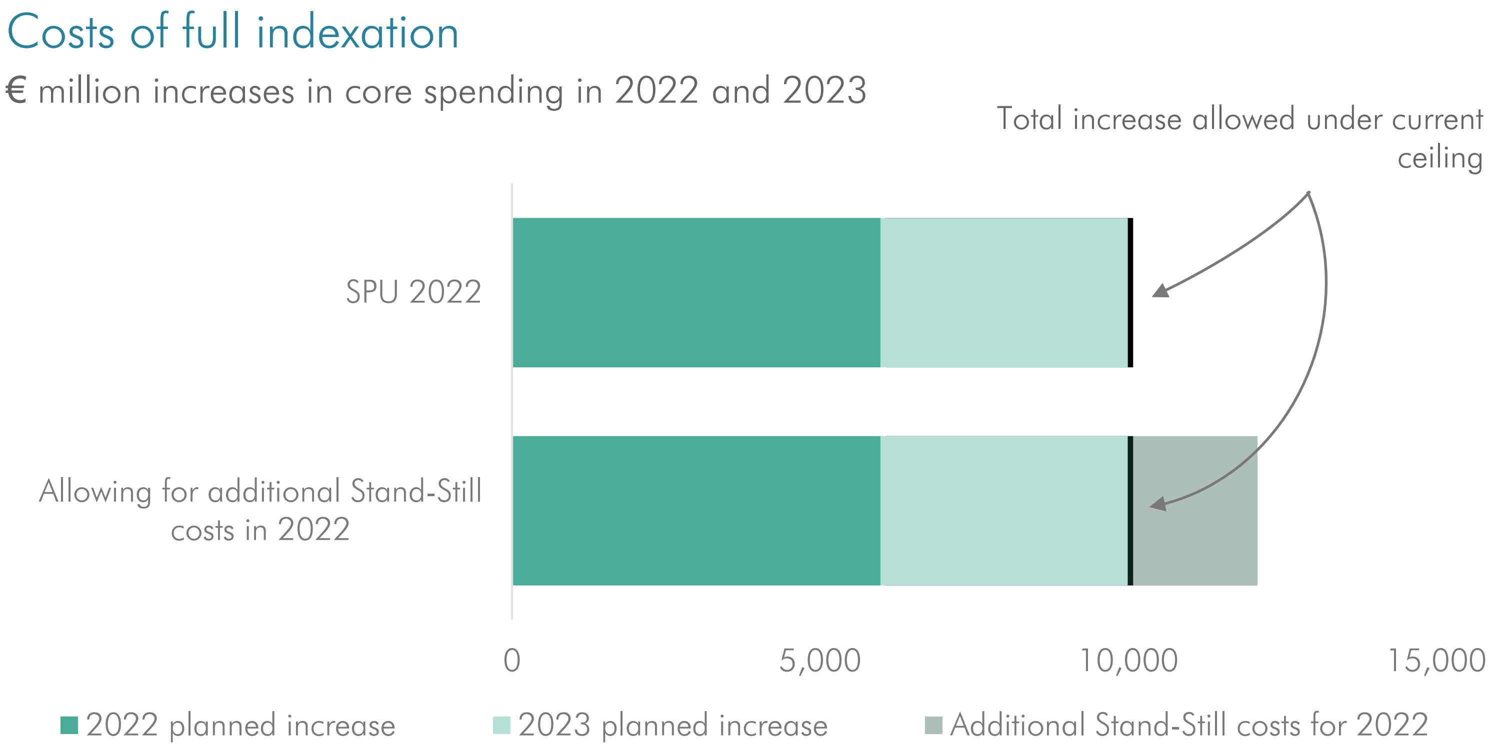
Broadening the focus to general government and including revenue

Linking to a debt target

Placing the rule on a statutory basis and specifying key design features

- Failure to publish Departmental Expenditure Ceilings in a timely way or to produce credible numbers is a missing opportunity

For 2022/23, full indexation of wages and benefits to higher inflation would break the 5% rule



- The Government faces a choice about how far to adjust wages/welfare rates compared to scaling back existing plans in other areas
- Underspends in 2021 could create space if these continue

Further ahead, the Government needs to make choices

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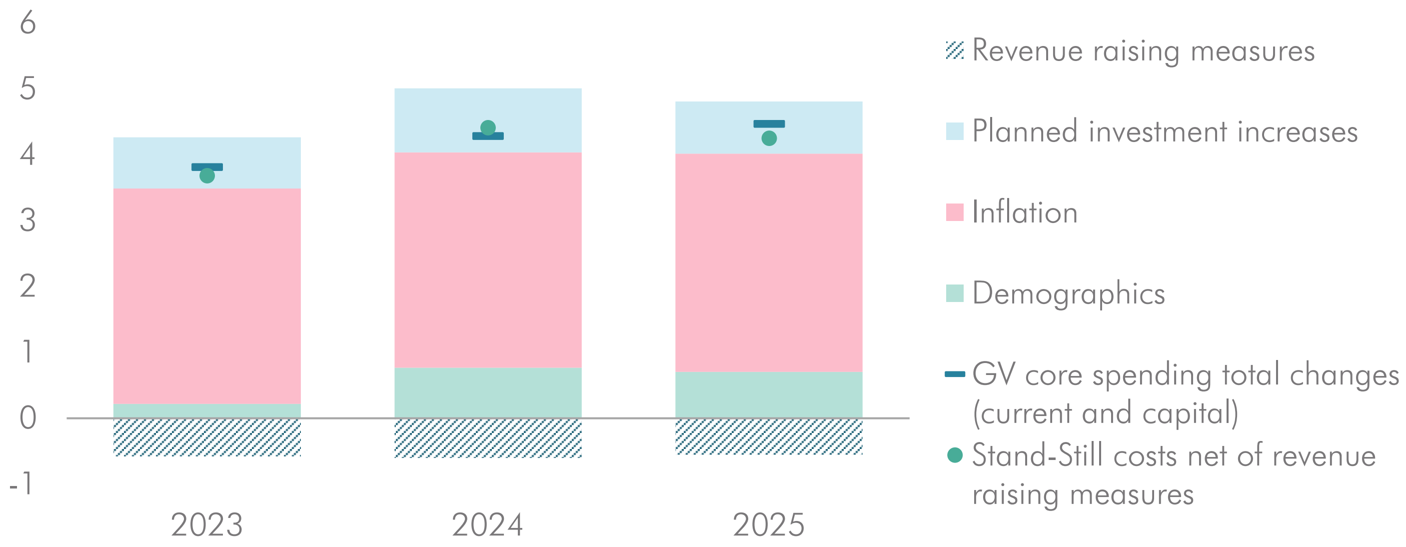
Stand-still costs

€ billion, year-on-year changes



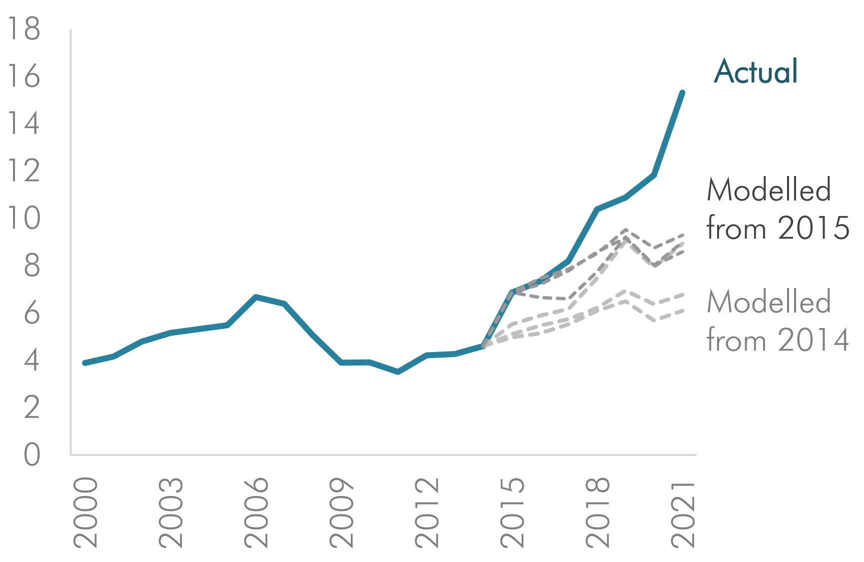
Sources: Fiscal Council workings.

- Maintaining existing services and current plans would barely fit within the 5%
- The Government may need to prioritise or raise taxes, particularly given major commitments that are not budgeted

Corporation tax is expected to remain above 20% of Exchequer revenues

Actual vs Modelled Corporation tax receipts

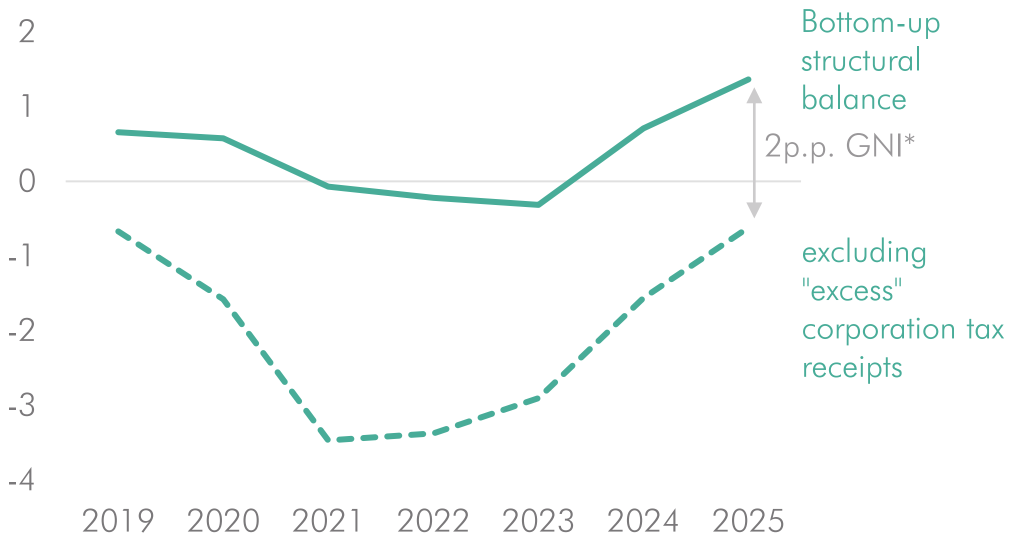
€ billion



Sources: Revenue data; and Fiscal Council workings.

Structural balance excluding "excess corporation tax"

% GNI*



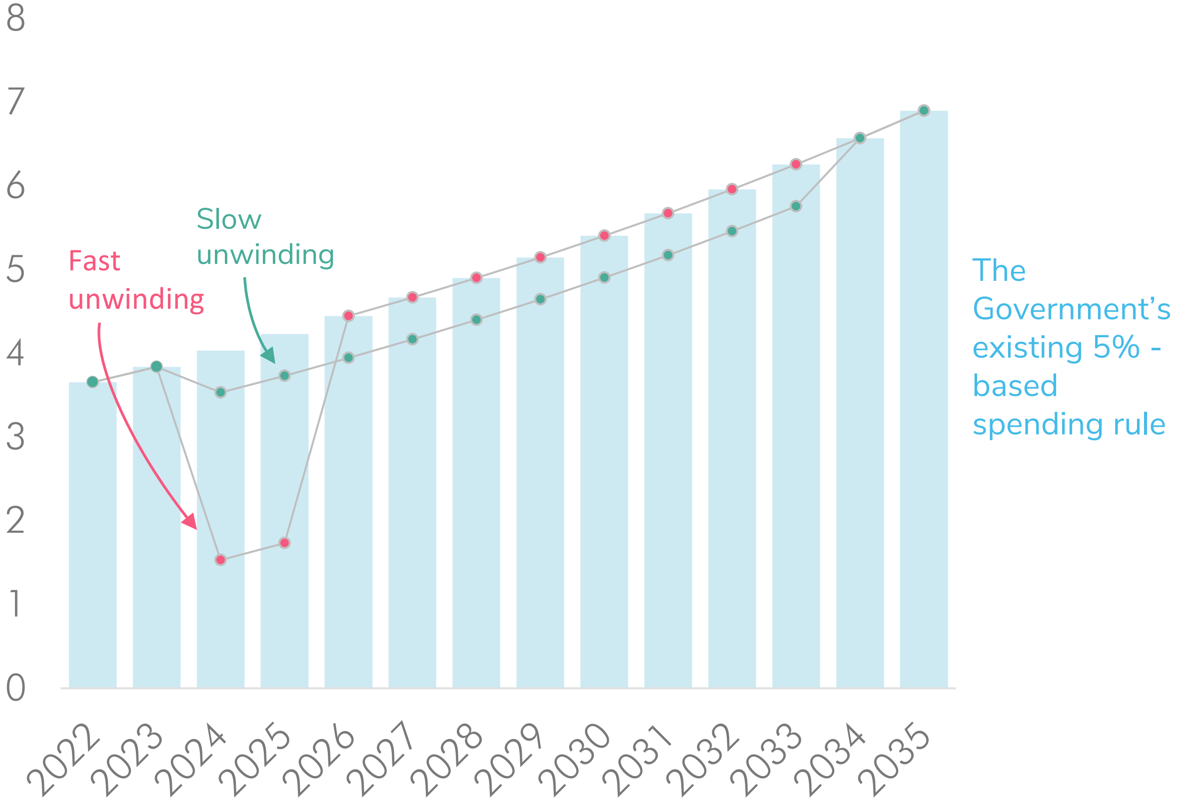
Sources: Fiscal Council workings.

- The Council estimates that €6 to 9bn of corporation tax receipts could be deemed as "excess", beyond what can be explained by historical and international experience
- DOF has not updated its €2bn estimate for the impact of BEPS since January 2020
- The Budget balance excluding "excess" corporation tax will remain in deficit

Reliance on corporation tax to fund spending should be reduced

Excess can be unwound with slower spending rises or new revenues

€ billions, core spending increases



- At a minimum, reliance on corporation tax should be capped at the current level
- Reliance should gradually be reduced
- The excess can be used to re-build the Rainy Day Fund or reduce debt

Sources: Fiscal Council workings.

Notes: This figure takes 2021 as a base year for core spending and grows it by 5% annually in line with the Government's 5% Spending Rule. As an illustrative scenario, this figure shows an example where excess corporation tax receipts are identified as €5 billion. A plan to reduce the reliance on this either urgently (over 2 years) or gradually (over 10 years) reduced. This entails planned core spending increases being reduced by €2.5 billion in both 2023 and 2024 or by €0.5 billion annually over the next ten years. Alternatively, revenue-raising measures of the same amounts could be introduced to return spending to the higher level consistent with the 5% Spending Rule.

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Major policy commitments need to be costed and factored into the Government's plans

Climate Change

Sláintecare

Ageing costs

Defence spending

Climate change costs may significantly impact the public finances

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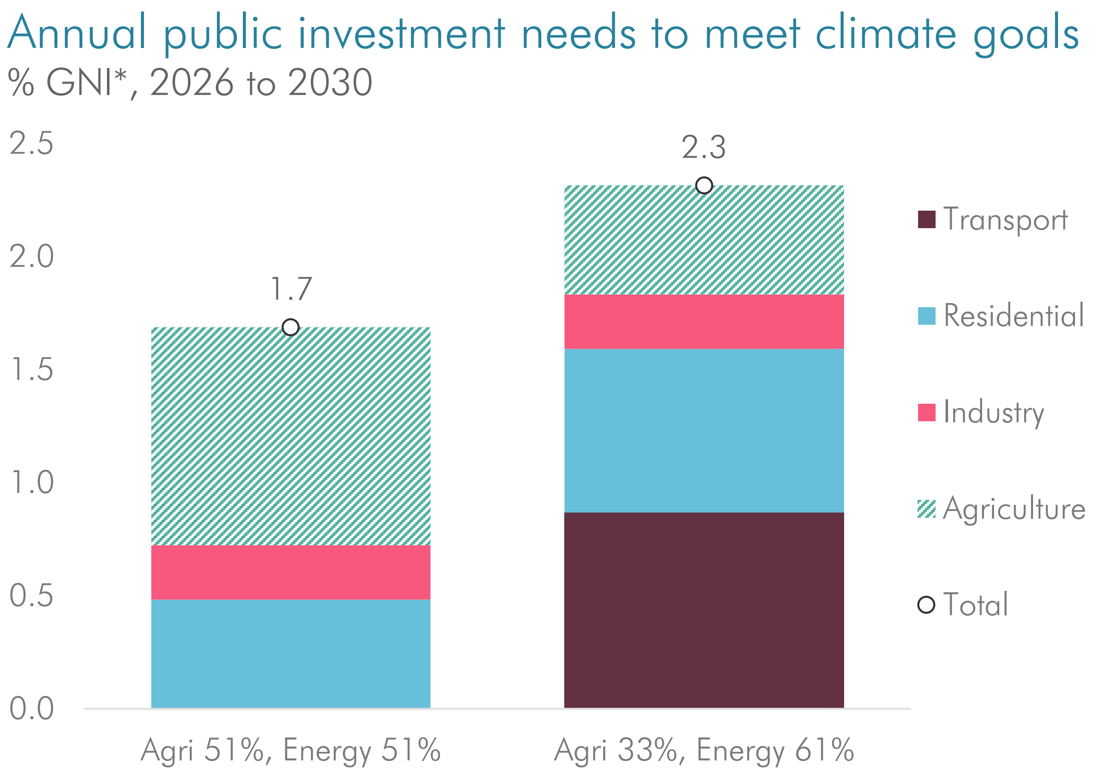

Source: FitzGerald (2021).

- Investments appear to be largely covered by the NDP
- But, not higher current spending
- Loss of tax revenue, e.g., on motor fuels, could be very large (relevant revenues were €6 billion or 2.8% GNI* in 2019)

- There is no estimate of the budgetary cost of implementing the Climate Action Plan

More clarity is urgently needed on health costs

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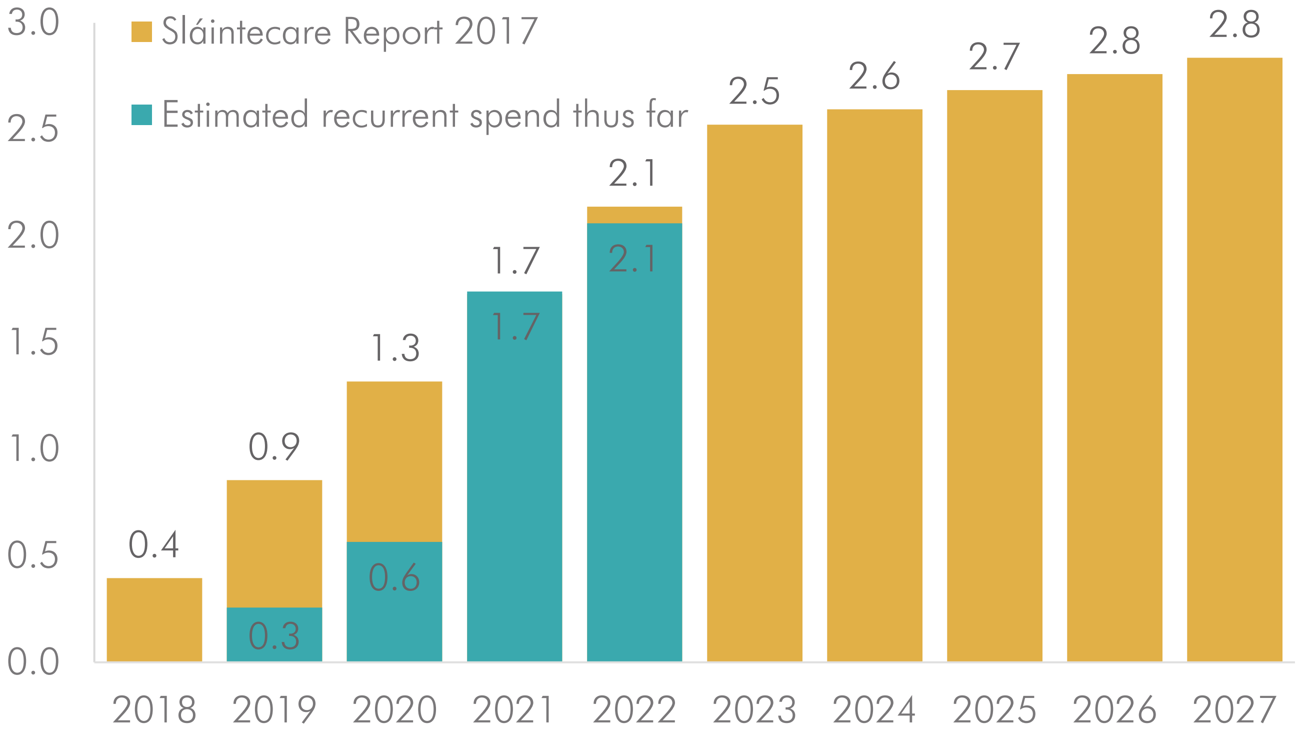
Estimated expenditure on Sláintecare
€ billion



- The cost of *Sláintecare* reforms has not been updated since 2017 and no estimates are available after 2022
- Mechanical estimates suggest spending might need to rise by €1½ billion by 2027, given recent price pressures and capacity constraints (with recruitment challenges a reflection of this)

Source: Sláintecare Report 2017; Department of Health; and own workings.

Notes: The "estimated spend thus far" represents the increase in recurrent annual health spending that is associated with Sláintecare as derived from budget day plans. The actual increases may vary, however, as these are plans rather than outturns, and the figures are not precise, in that costs tend to be mixed in with the costs of other more general expansions in publicly provided health services.

Ageing population

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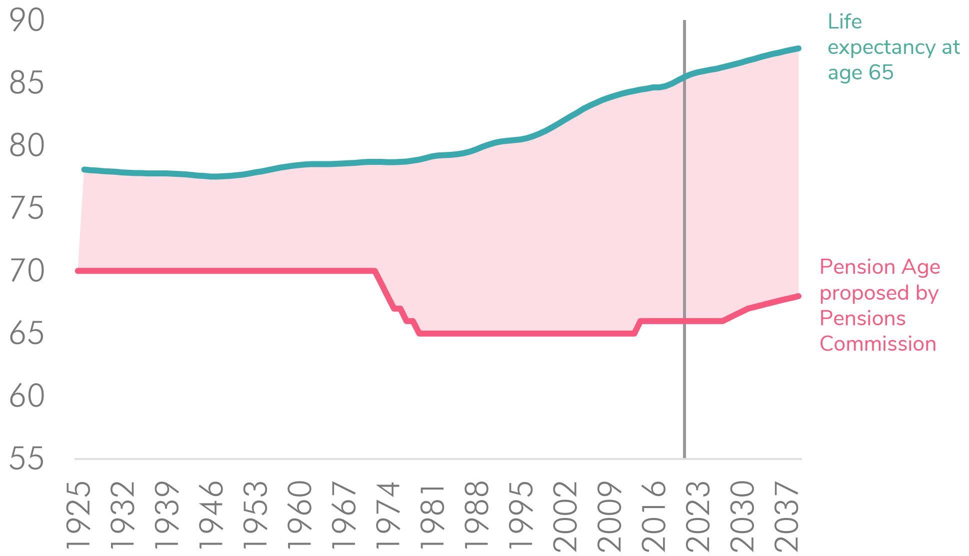
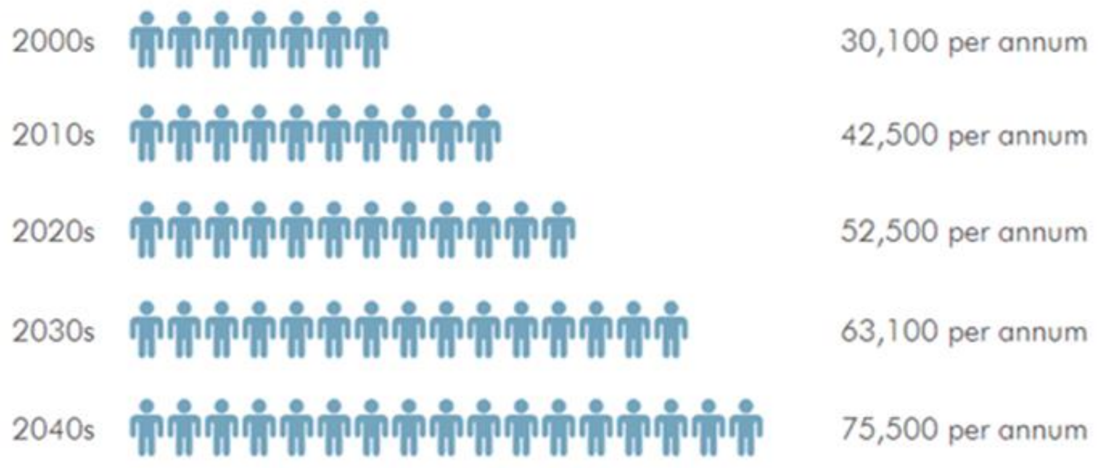
Expected years of retirement: the pension age and life expectancy at age 65



Number of people reaching age 65



- The Government has yet to respond to the Pensions Commission proposal
- Auto enrolment should help people to save more for retirement, but the fiscal costs are not reflected in existing spending plans

Defence spending

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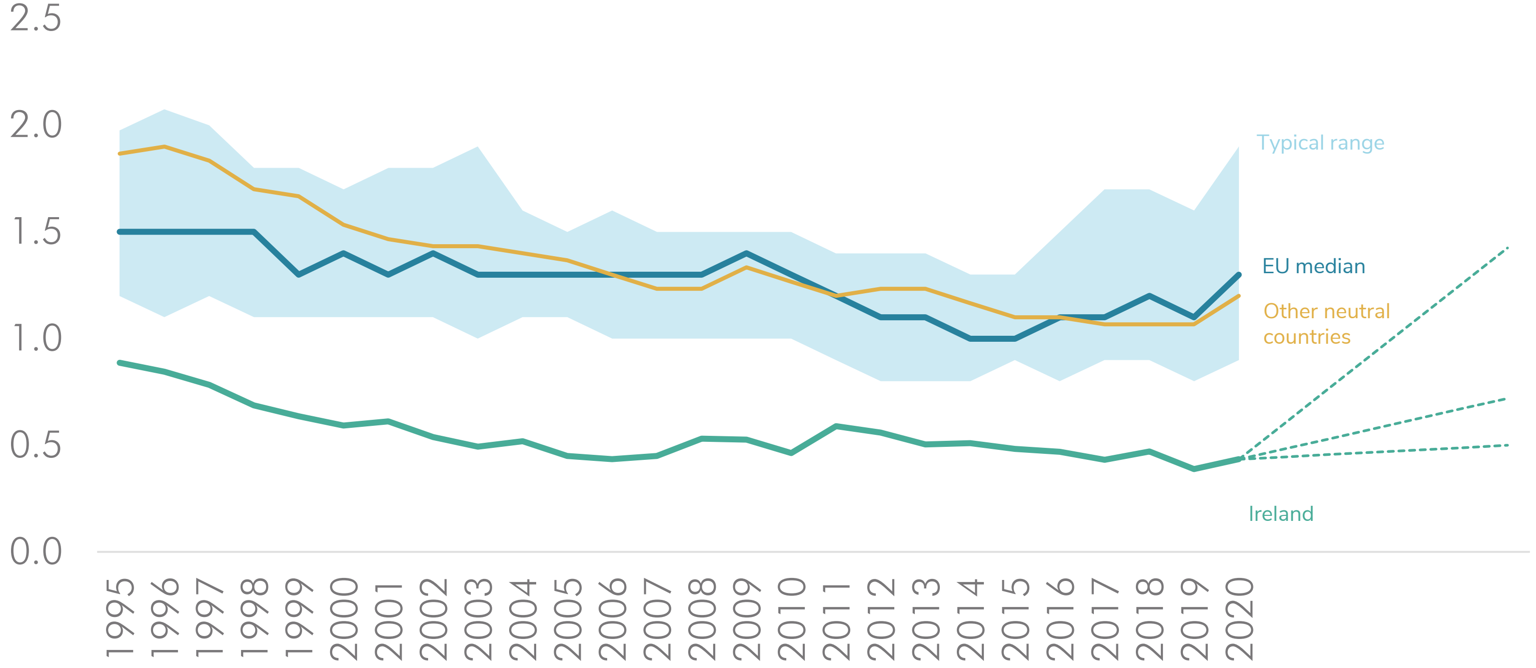
Ireland's defence spending low compared to others

% GNI* for Ireland (% GDP otherwise)



- The *Report of the Commission on the Defence Forces* (2022) establishes a range of scenarios of strengthening defence capability

Key messages

- The economy has continued to grow despite the challenges, but risks are high
- SPU 2022 forecasts a sharp improvement in the budget balance
- Higher inflation creates significant spending pressures
- There is delicate balancing act in protecting the economy and poorer households, while avoiding adding to inflation through second-round effects
- A combination of carefully-calibrated supports and wage increases together with targeted measures could help
- Choices will need to be made about how to address the cost-of-living and other policies
- Over-reliance on corporation tax should be gradually unwound
- Major policy commitments need to be properly costed and factored into the Government's plans