Irish Fiscal Advisory Council

Pre-Budget Statement

Getting the balance right

September 2022

Key messages

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While it has been strong, Ireland’s recovery has lost some momentum in recent months

- Higher energy and food prices have taken inflation to the highest rates in a generation
- Risks have intensified, including around a cut-off in Russian gas supply to Europe this winter

The budget balance is set to move into surplus this year

- The surge in corporation tax receipts accounts for a large share of the improvement
- There would be a deficit of 2% of GNI* excluding “excess” corporation tax receipts

Budget 2023 plans strike an appropriate balance between creating space to protect vulnerable households and avoiding stoking inflation

- Some temporary deviation from the 5% Spending Rule is sensible
- There is scope for additional temporary measures
- The Government should stand ready in case additional support measures are needed during the winter

Choices need to be made between protecting people from inflation and other priorities

- The close to €7 billion cost of full indexation of public sector pay, pensions and welfare payments and existing plans exceeds the €4.9 billion available for core spending increases
- Better targeting of support measures would help

Key messages

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Major medium-term challenges need to be addressed

- The Government has yet to respond to the Pensions Commission report and has signaled a costly decision to keep the pension age at 66
- Meeting climate change objectives has not been costed or fully built into budgetary plans
- An updated estimate of the cost of implementing *Sláintecare* health reform is needed

The 5% spending rule should be strengthened

- It should be given legislative status, recognise the impact of tax measures, capture the full range of general government spending, and link it to debt targets

The Rainy Day Fund or a new National Pension Reserve Fund should be used to save excess corporation tax receipts

- Reliance on unpredictable corporation tax receipts from multinationals to fund day-to-day spending should be capped and gradually reduced over time

Energy and food prices and inflation are likely to remain higher than expected

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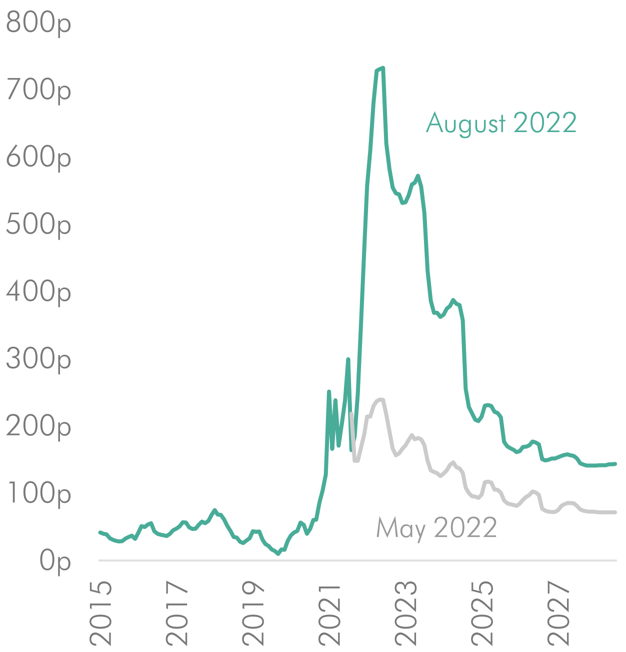
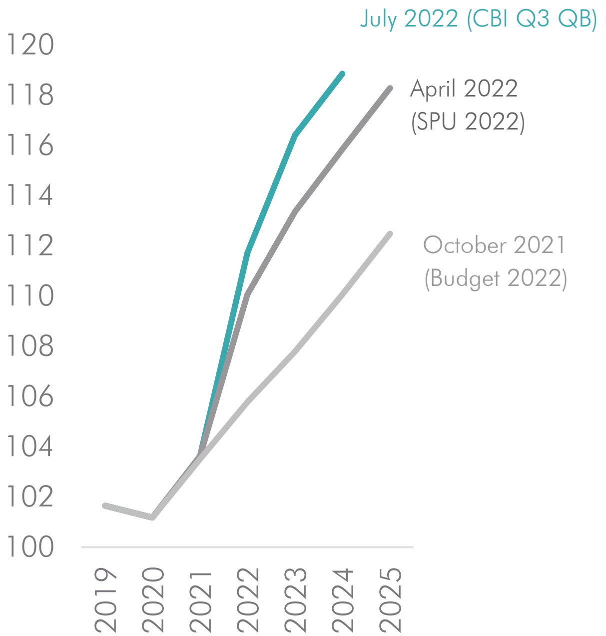
Gas prices likely to stay high for some time

GB Pence/Therm, natural gas



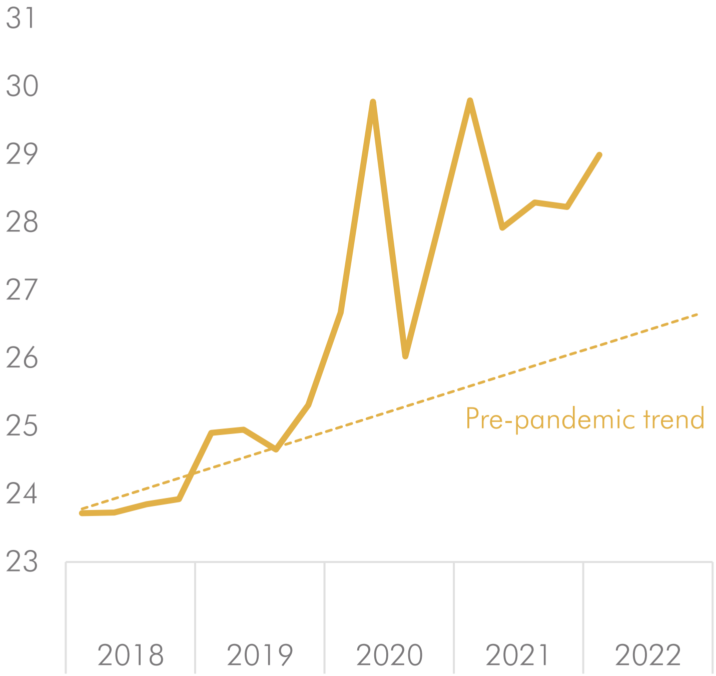
HICP forecasts revised up

Index (2015 = 100)



Average hourly wages rise sharply

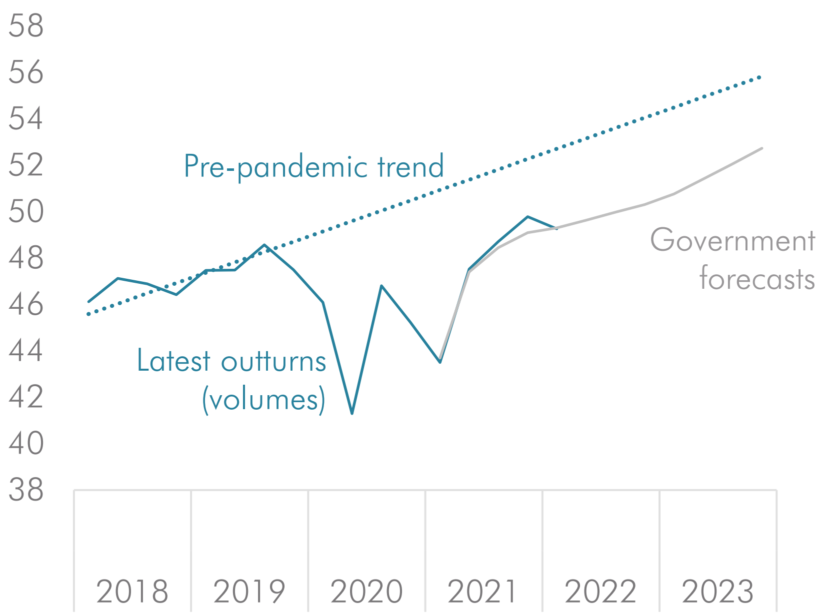
€ per hour, seasonally adjusted



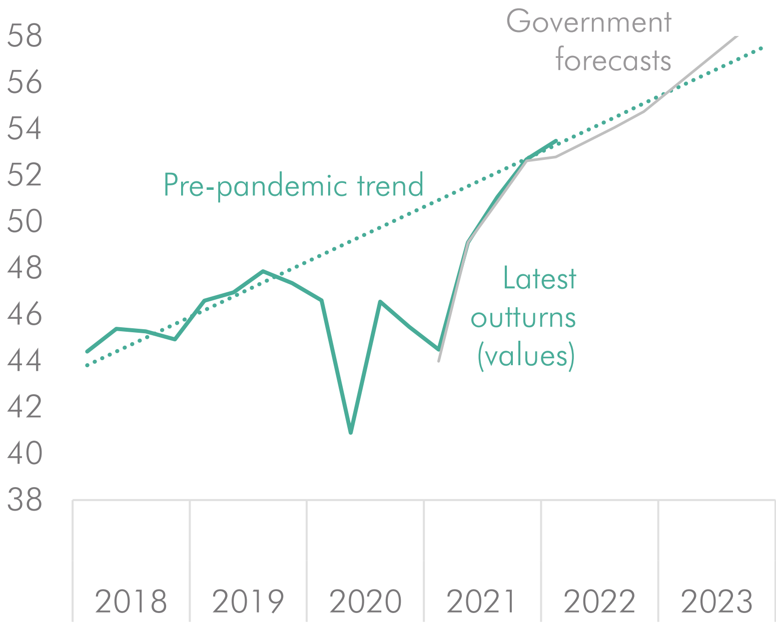
Inflation is slowing growth in demand

Domestic demand volumes fell in Q1

€ billions, modified domestic demand (seasonally adjusted)



But values continued to increase

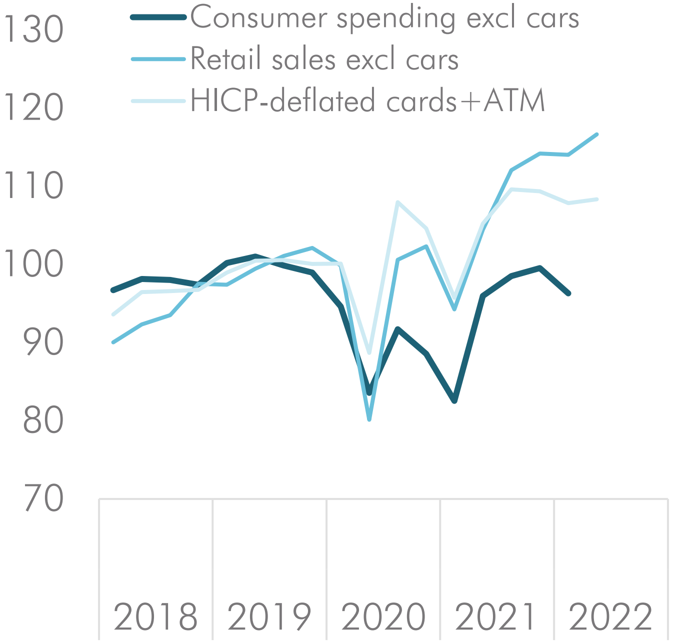


Sources: Central Statistics Office, Department of Finance, and Fiscal Council workings.
Notes: Government forecasts are based on the *SPU 2022* quarterly profiles for personal consumption, government consumption, and modified investment (which excludes aircraft for leasing and R&D intellectual property intangibles). These are shown re-based to 2020 prices. The pre-pandemic trends are based on quarterly seasonally adjusted data for 2014–2019.

While global growth has slowed, the picture for Ireland is mixed

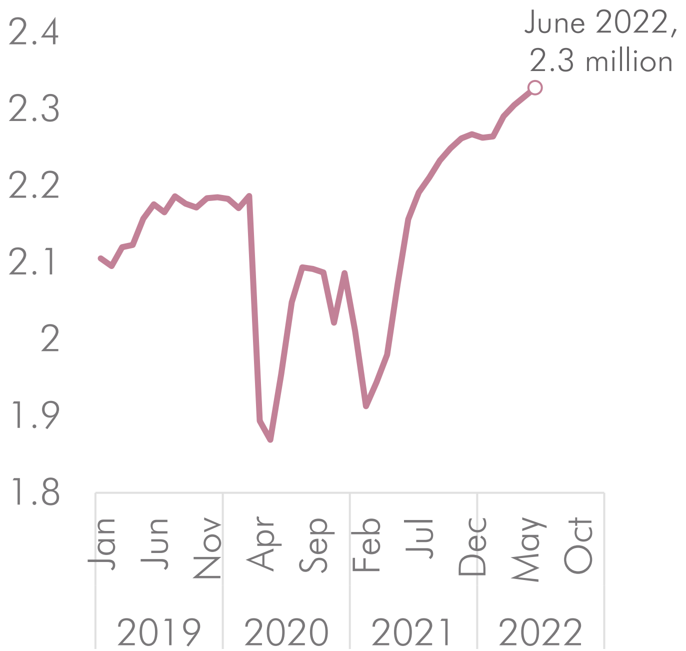
Spending levels vary across measures

Volumes, 2019 = 100



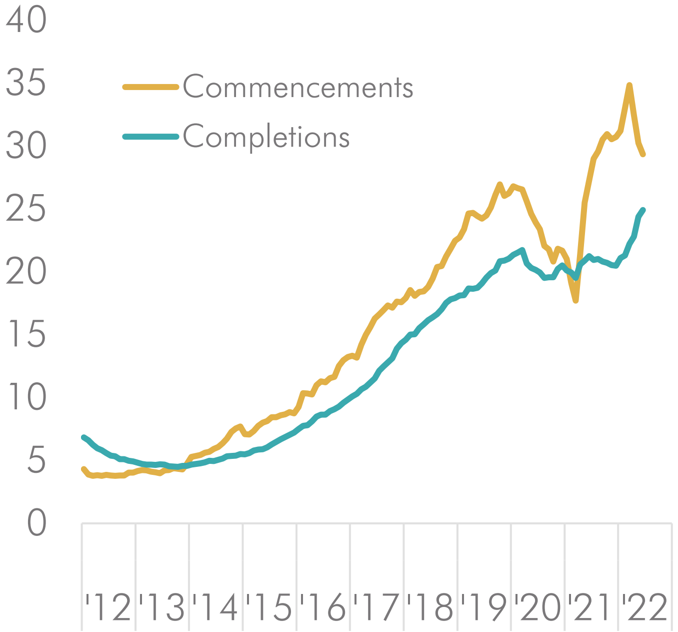
Rising number of employees in 2022

Millions, unadjusted (administrative data)



Housing starts have also slowed of late

Thousands, 12-month moving sum

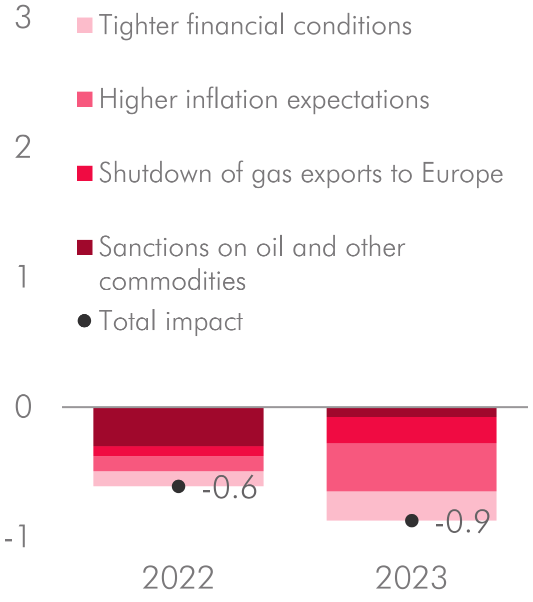


Downside risks have intensified

IMF downside scenarios for the euro area

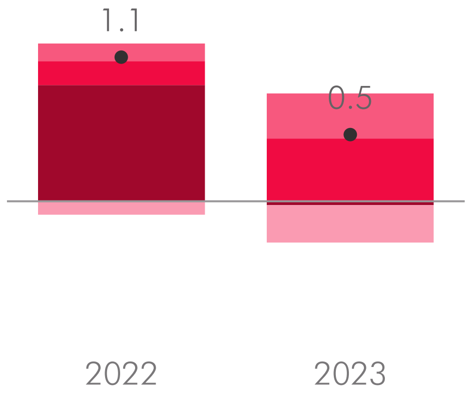
A shutoff would weaken growth

% deviation from baseline global GDP forecasts



And lead to higher inflation

% deviation from baseline inflation forecasts



Source: IMF (2022).
Notes: The impacts are shown in terms of percentage point differences with baseline forecasts for annual growth rates.

- Uncertainties around Covid and Brexit remain
- The risk of a shortage of gas this winter hangs over Europe
- In Ireland, labour shortages, rising wages and high housing costs could complicate the outlook

The budget balance is set to move into surplus this year, supported by corporation tax revenues

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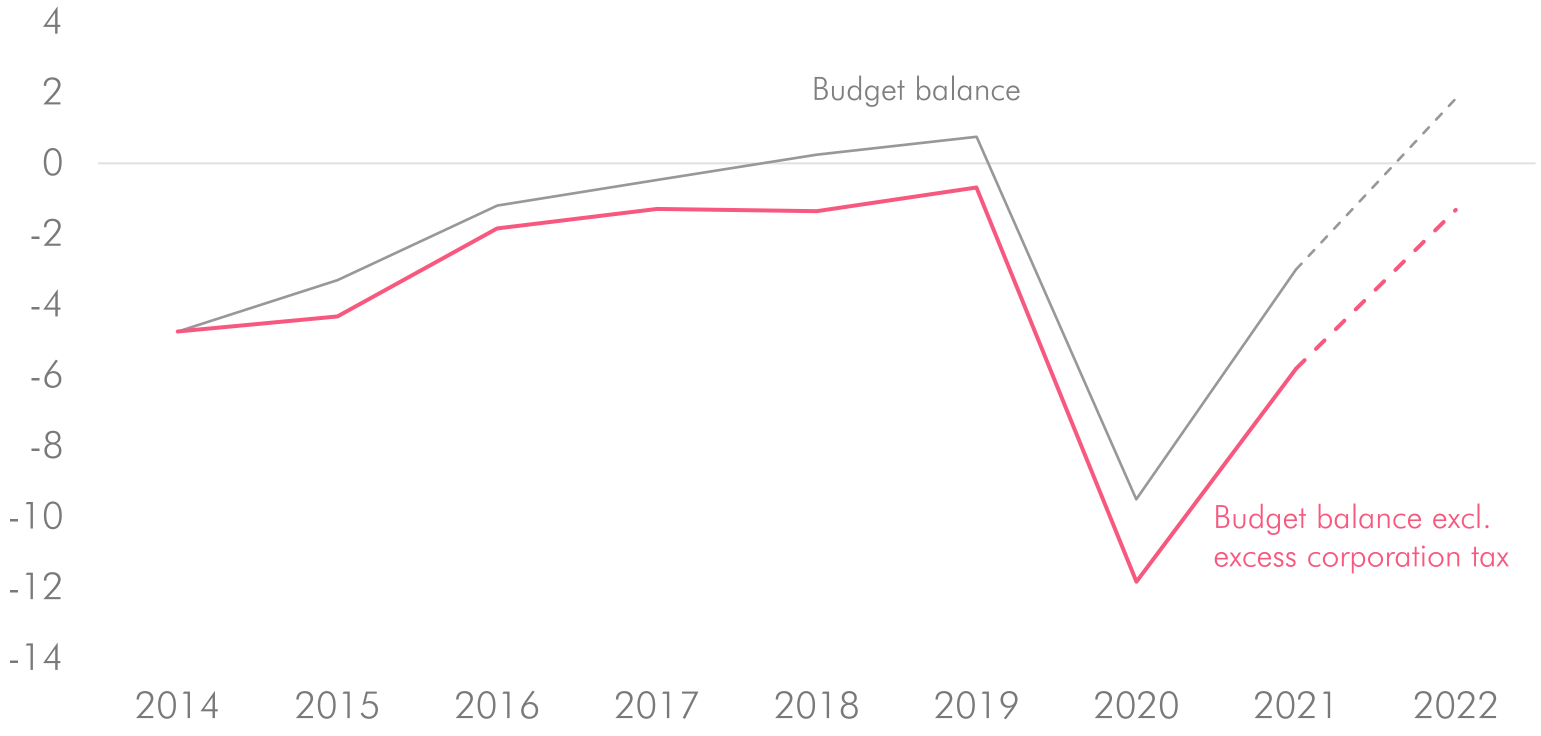
Budget balance supported by excess corporation tax

% GNI*



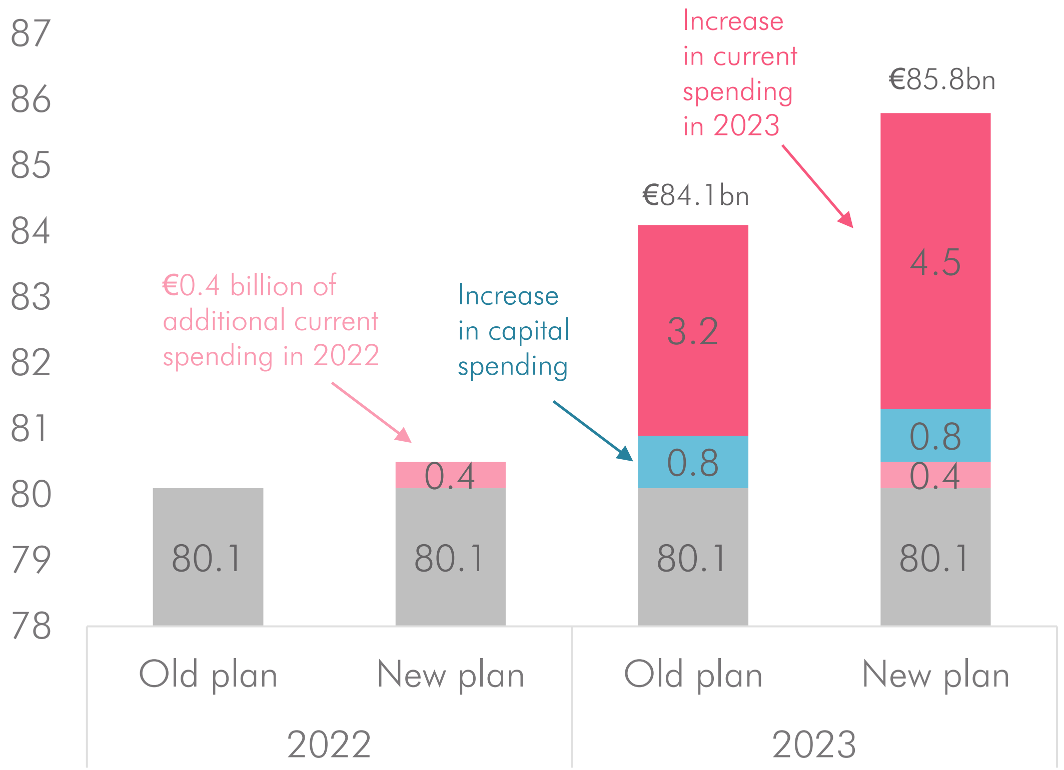
- Excluding "excess" corporation tax receipts, there would be a deficit around 2% of GNI*

Source: Department of Finance; CSO; and Fiscal Council workings.
Notes: Dashed lines indicate the Council's forecasts of the balance and the "excess" corporation tax for 2022. See Box G in Fiscal Council (2022) for an explanation of how excess corporation tax receipts are calculated.

The July *Summer Economic Statement* outlined an enlarged budgetary package

The *Summer Economic Statement* outlines an increase in core spending of €1.7 billion in 2023 relative to old plans

€ billion, core spending



Source: Department of Finance and Fiscal Council workings.

- Core spending growth at 6.5%, a temporary deviation from the 5% spending rule
- This allows for a total increase of €4.9bn in core spending in 2023
- The tax package was revised up to €1.1bn

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Inflation is creating significant pressures on public spending

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	Social welfare		State pension		TOTAL
Scenario	Weekly increase for welfare	In % terms for welfare	Weekly increase for pensions	In % terms for pensions	Cost
Offsetting 2023 inflation only	€8.74	+4.2%	€10.64	+4.2%	€0.7bn
Offsetting unexpected inflation for 2022	€15.00	+7.2%	€15.00	+5.9%	€1.1bn
Full offset for 2022 and 2023	€20.38	+9.8%	€24.82	+9.8%	€1.7bn

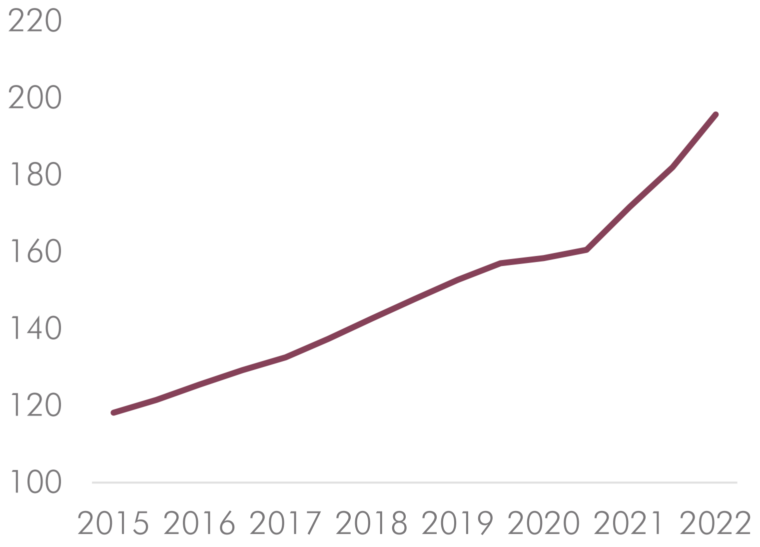
Sources: Department of Finance; Central Bank of Ireland, Department of Social Protection and Fiscal Council workings.
Notes: In the first scenario, weekly welfare increases track expected HICP inflation in 2023 alone. In the second scenario, welfare payments increase by a flat €15 per week. This represents an increase of 5.9% for those in receipt of the contributory state pension and around 7.2% for those on an average welfare rate of €208 per week in 2022. In the final scenario, rates increase by 9.8%: this allows for full protection against inflation in 2023 and the erosion in the real rate of payment from unexpectedly high inflation in 2022. In all three scenarios, estimates are drawn from the overall increases as part of the Tax Strategy Group papers where all welfare scheme payments are subject to proportionate increases, including increases for qualified adults. Pension rates are estimated costs and refer to the State pension only.

- Increases in cash spending would be needed if Government were to maintain the real value of public sector wages, pensions and welfare payments
- The public sector pay bill increases by around €200m for each 1 percent increase in pay rates

Higher construction prices raise questions about the capital plan

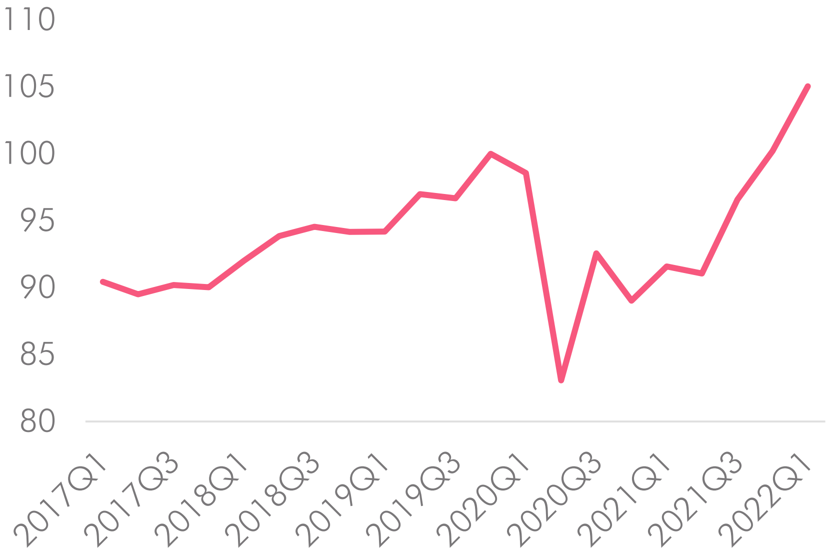
Tender price index

Index: 1998 = 100



Construction labour costs increased

Average hourly total labour costs, 2019 Q4 =100



- Higher costs could be addressed by increasing spending, deferring investment or lowering planned outputs

Budget 2023

The Government faces a delicate balancing act

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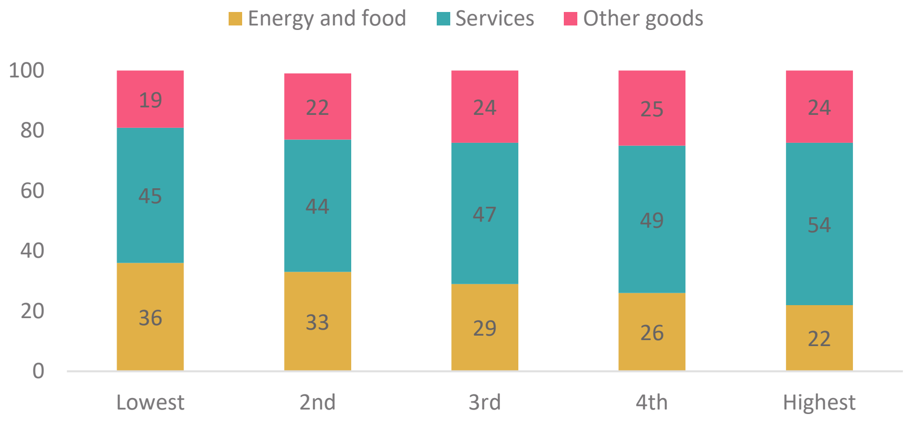
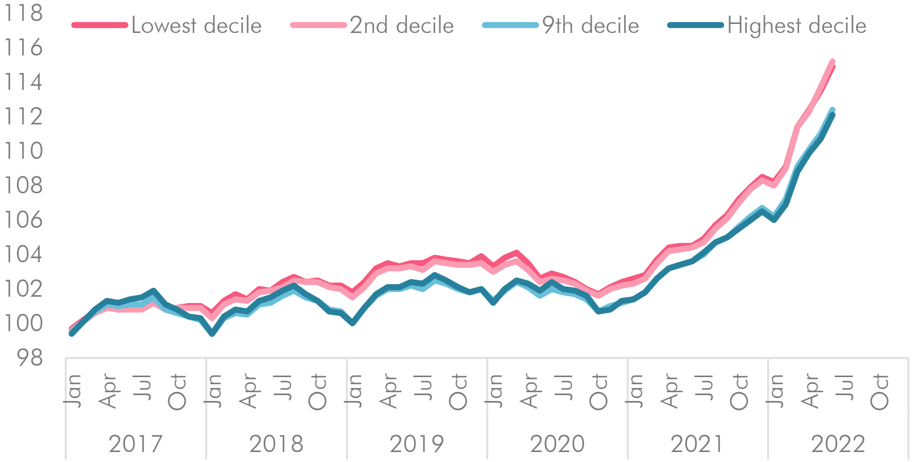
Lower income households spend more on energy and food

Expenditure weights by quintile of net disposable household income



As a result, prices have increased most for low-income consumers

Consumer price index, December 2016 = 100



- 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

- There is scope for some continued targeted and temporary measures

The Government should stick to its plans

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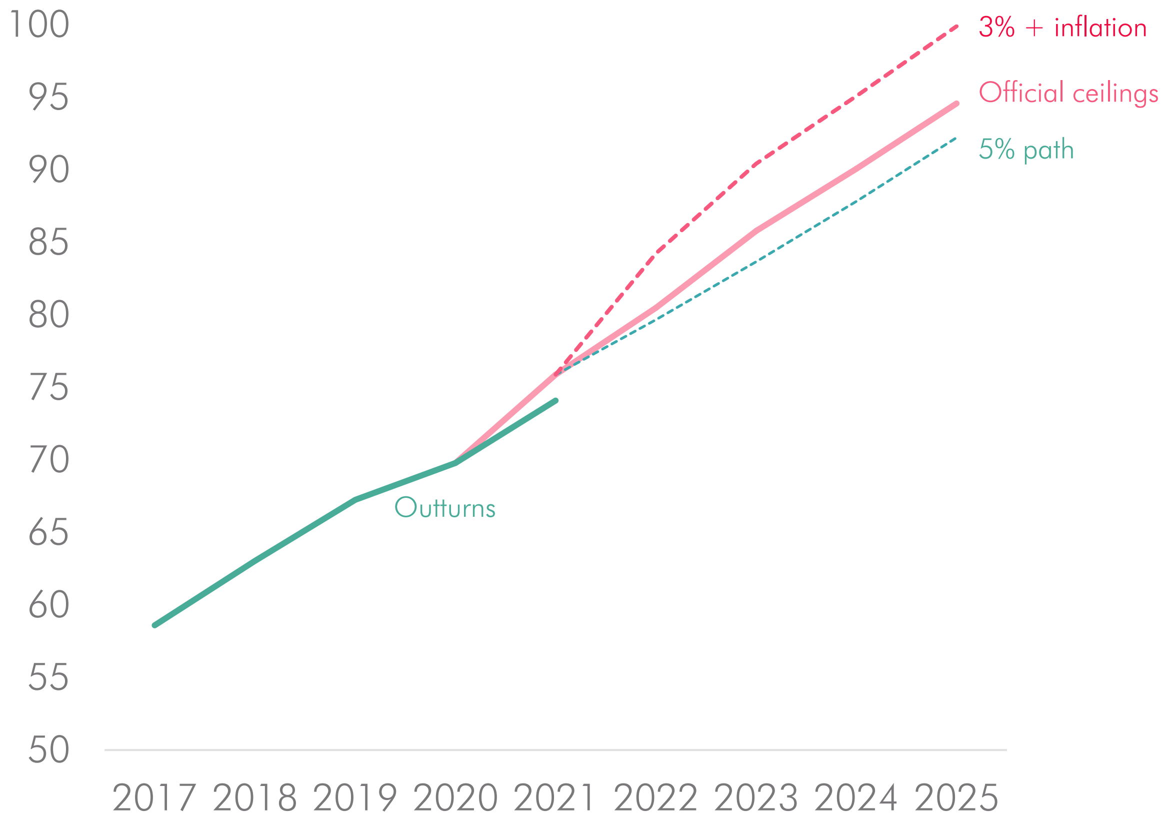
The path for "core spending"

€ billions, core spending



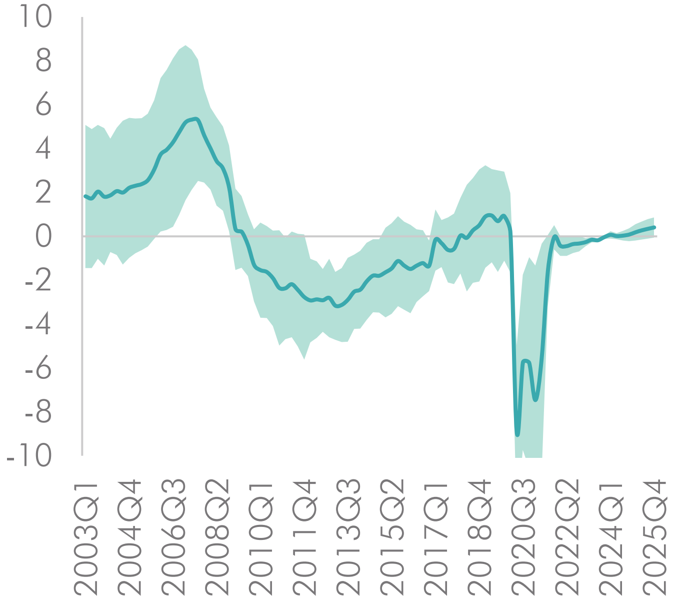
Sources: Department of Finance (*SPU 2022* and *Summer Economic Statement 2022* projections).
Notes: The figure shows "core" spending: Exchequer current + capital spending less the cost of temporary measures associated with Covid and supports for Ukrainian refugees. For 2021 onwards, three paths are shown. The official plans are those in the *Summer Economic Statement*. The 5% path is what would result if spending grew exactly in line with the 5% Spending Rule. The "3% + inflation" path is what would result if spending grew with assumed real growth of 3% per annum + latest projections of HICP inflation from the Central Bank of Ireland (2022a).

- The 5% Spending Rule provides a useful anchor
- But, it is sensible to allow a temporary deviation as the Government plans
- The Government should stand ready to act if the outlook deteriorates

A neutral budget is appropriate

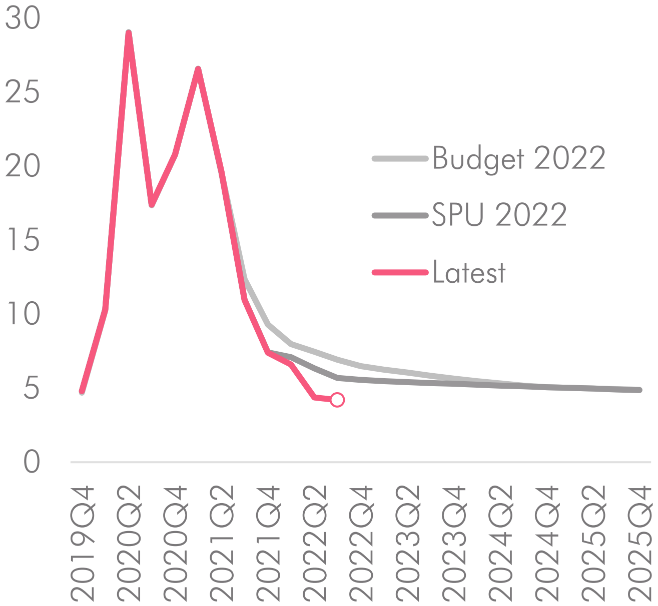
Activity was expected to recover

% output gap



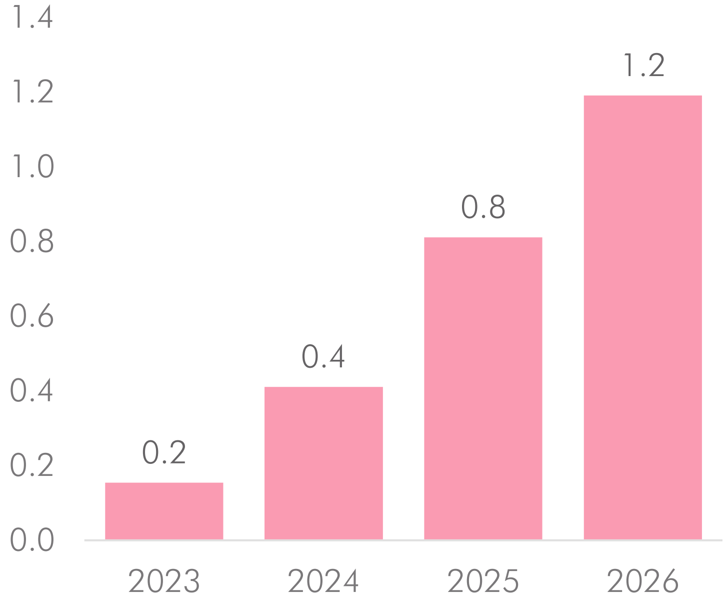
Labour market has tightened faster than expected

% unemployment rate (15-74 year olds)



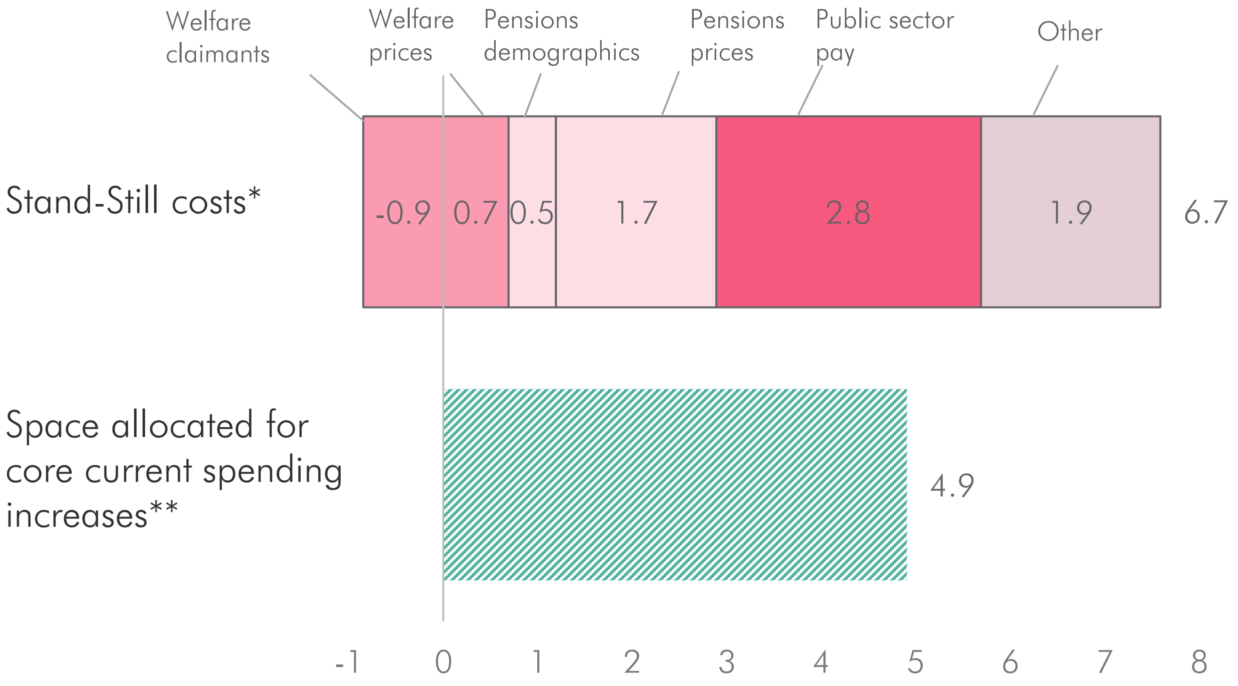
Larger fiscal package likely to add to price pressures

Cumulative percentage point increase in HICP level due to additional *Summer Economic Statement* measures



- Growing spending close to the underlying growth of the economy provides stability and avoids adding too much to inflationary pressures

2023 Budget will require difficult choices



- Choices will need to be made between protecting people from inflation and other priorities
- More targeted policies would help

The interest rate cycle has turned

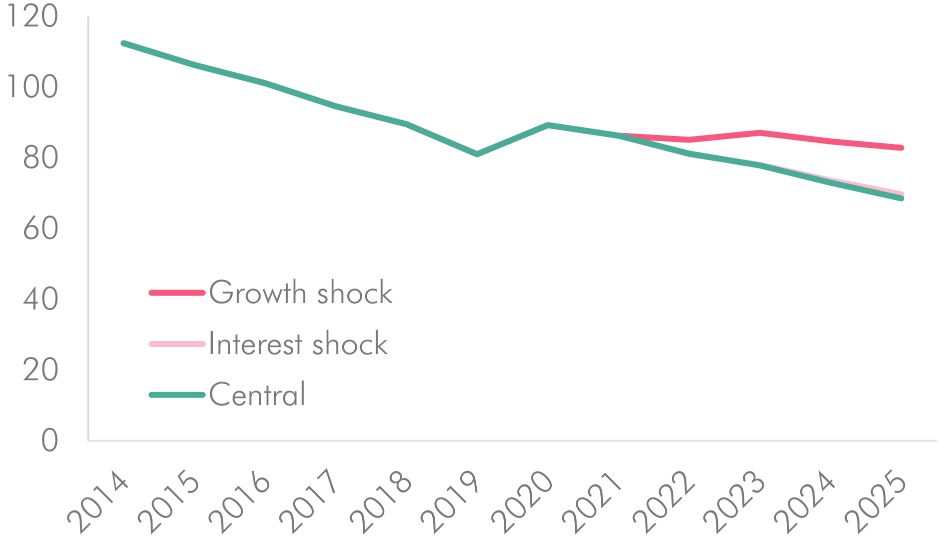
Bond yields down from spike, but still higher

% yield on ten-year Irish Government bonds

Sources: Macrobond.
Notes: The TPI is the European Central Bank's Transmission Protection Instrument introduced on 21st July 2022.

Debt ratio is more sensitive to growth

% GNI* net government debt ratio



Sources: Fiscal Council workings.
Notes: The Figures show the simulated paths for the debt ratio and financing needs as % GNI* with the central scenario depicting the SPU 2022 projections. The simulations are produced using the Council's Maq model (Casey and Purdue, 2021). The growth shock is a cumulative 7%, while the interest shock is a persistent 2pp rise in marginal interest rates.

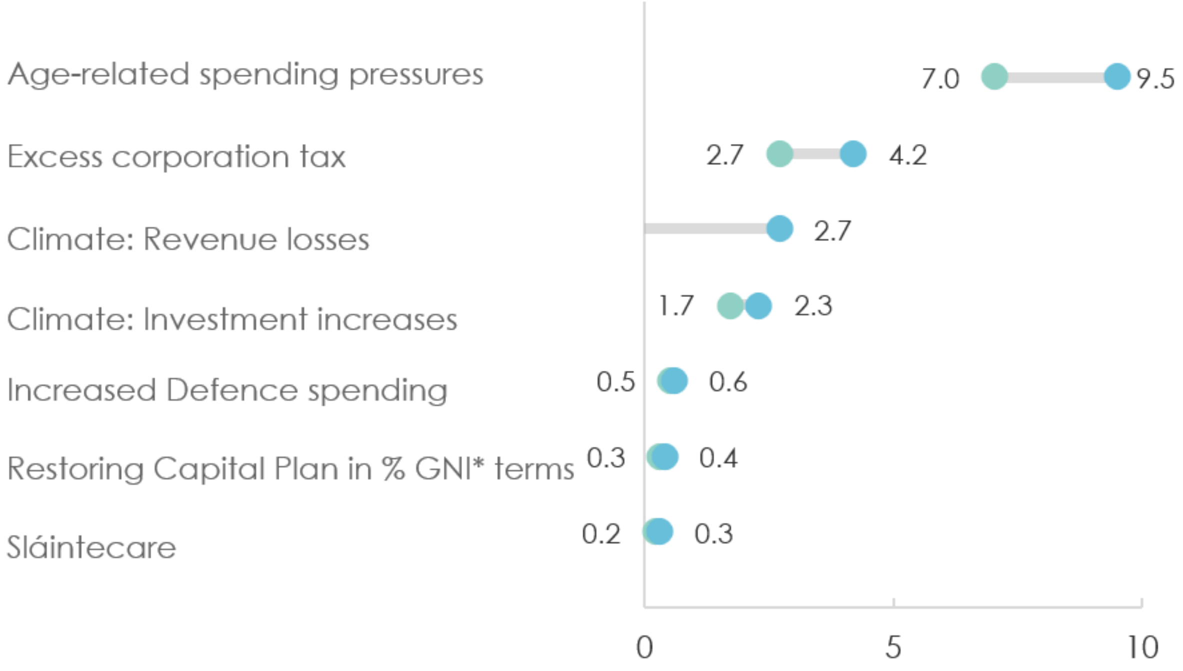
- However, Ireland is well-positioned in the short run
- Weaker growth or a fall in corporation tax inflows are larger risks to the public finances

Medium-term challenges need to be addressed in today’s Budget plans

- Ageing costs
- Overreliance on corporation tax
- Climate Change
- Sláintecare

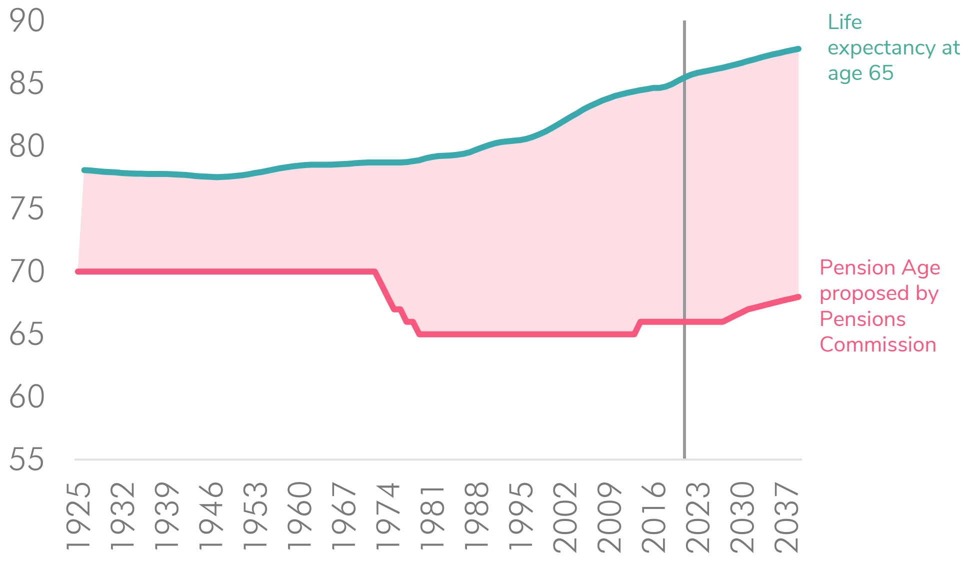
Medium and long-term challenges need to be addressed

% GNI*, estimated cost range

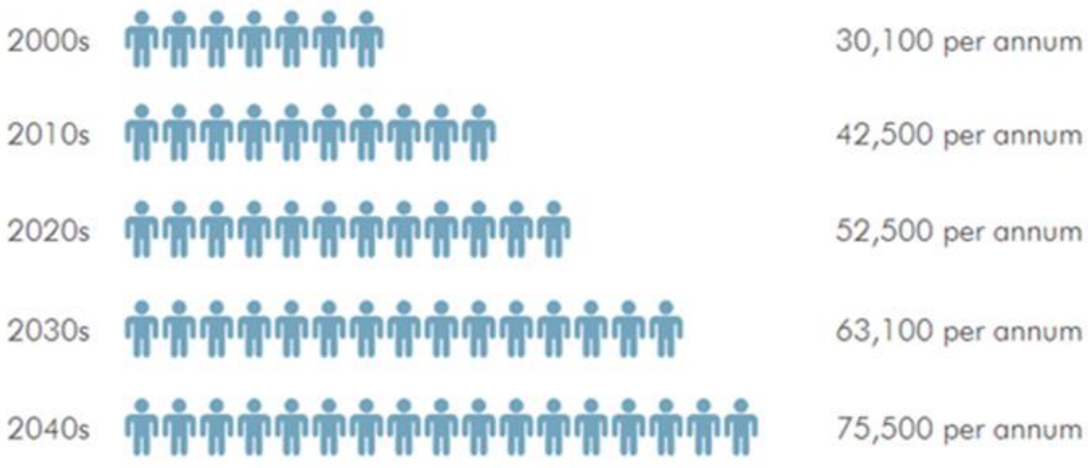


Ageing population

Life expectancy at age 65 is rising

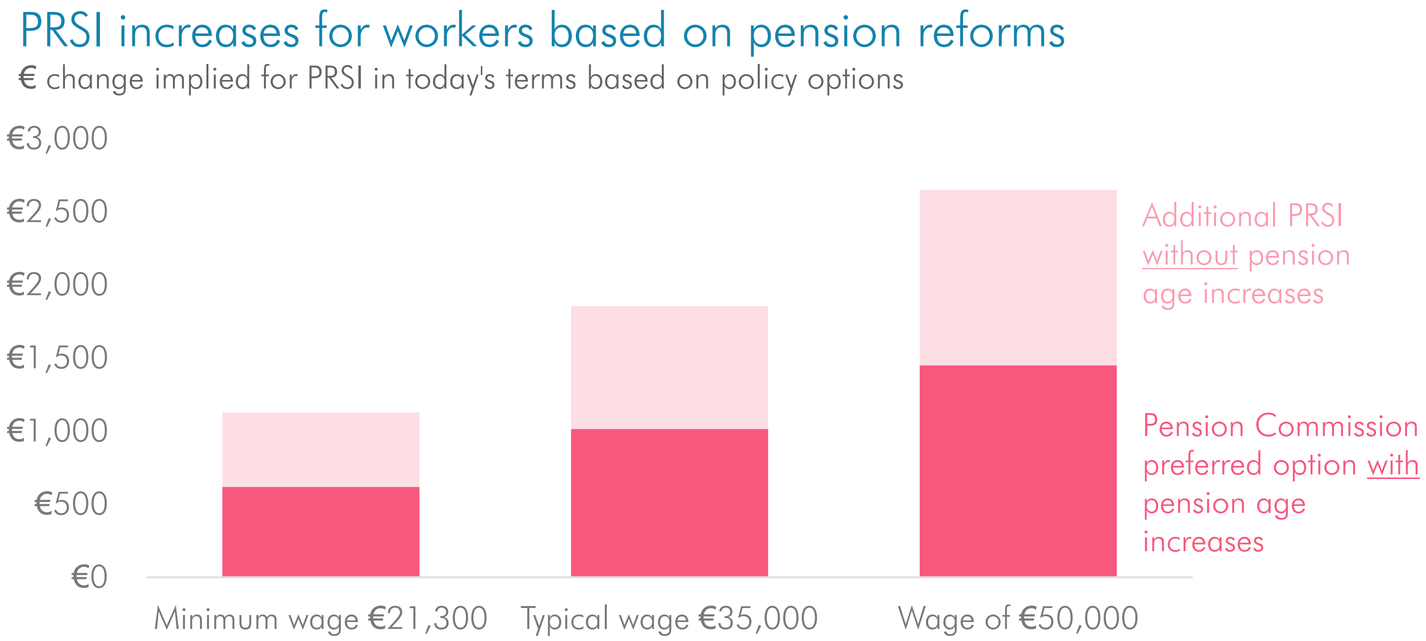


The number of people reaching age 65 is increasing rapidly



Sources: Fiscal Council workings (Long-term Sustainability Report).

Maintaining the retirement age at 66 adds to future costs and taxes

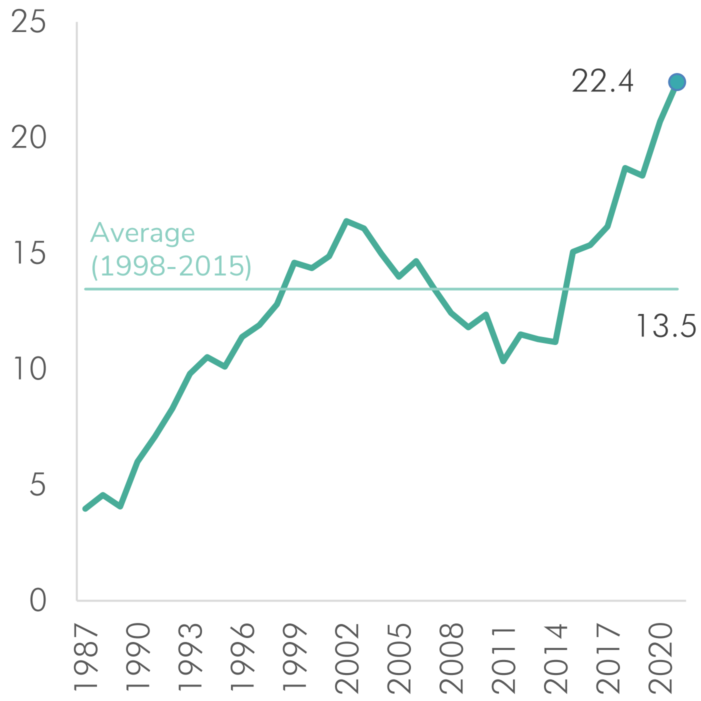


Sources: Pensions Commission (2020); and Fiscal Council workings.
Notes: Figures are based on Package 4 and Package 3 of the Pension Commission's (2021) options and the rate changes due by 2050. There is still an additional "Exchequer Contribution" in both packages, which may have to be made up with further tax increases.

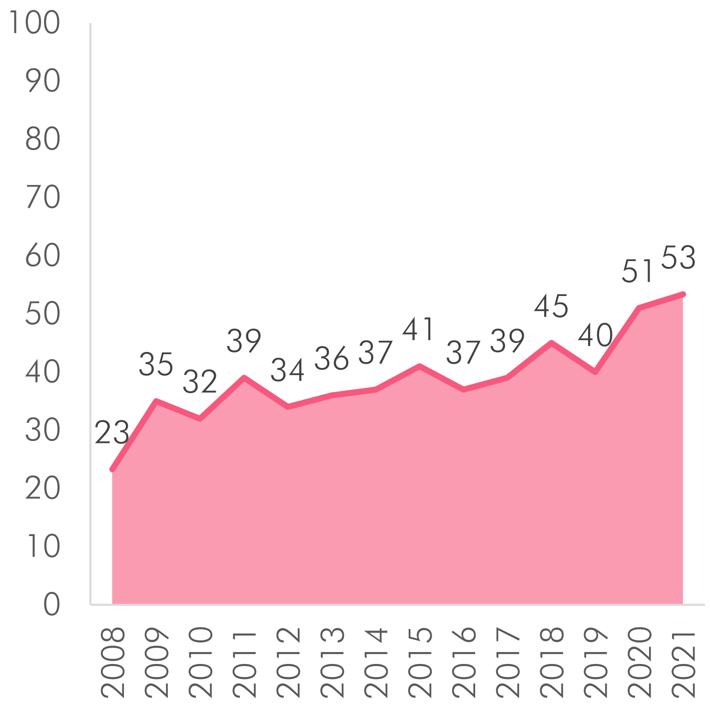
- The Government has yet to respond to the Pensions Commission recommendations, but has indicated that the retirement age will not rise
- Maintaining the retirement age at 66 is a costly decision

Overreliance on corporation is risky and needs to be reduced

Corporation tax
% of total Exchequer taxes



Share of net corporation tax from top 10 companies

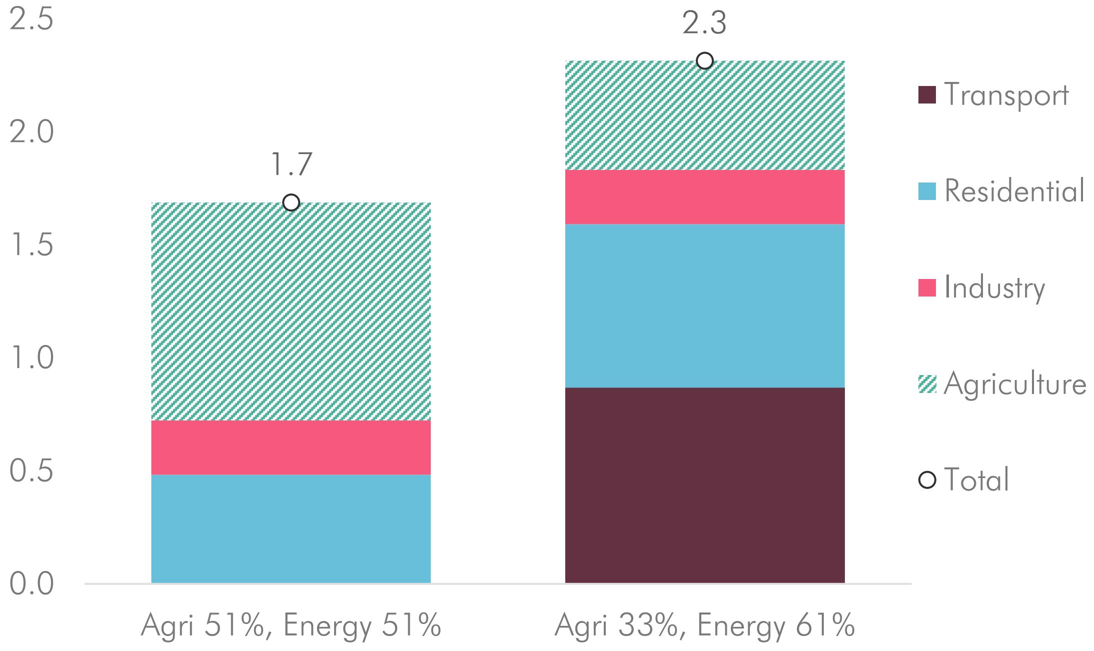


- Corporation tax receipts are unpredictable
- Overreliance should be reduced by saving in the Rainy Day Fund or a new National Pension Reserve Fund

Climate change costs may significantly impact the public finances

Annual public investment needs to meet climate goals

% GNI*, 2026 to 2030



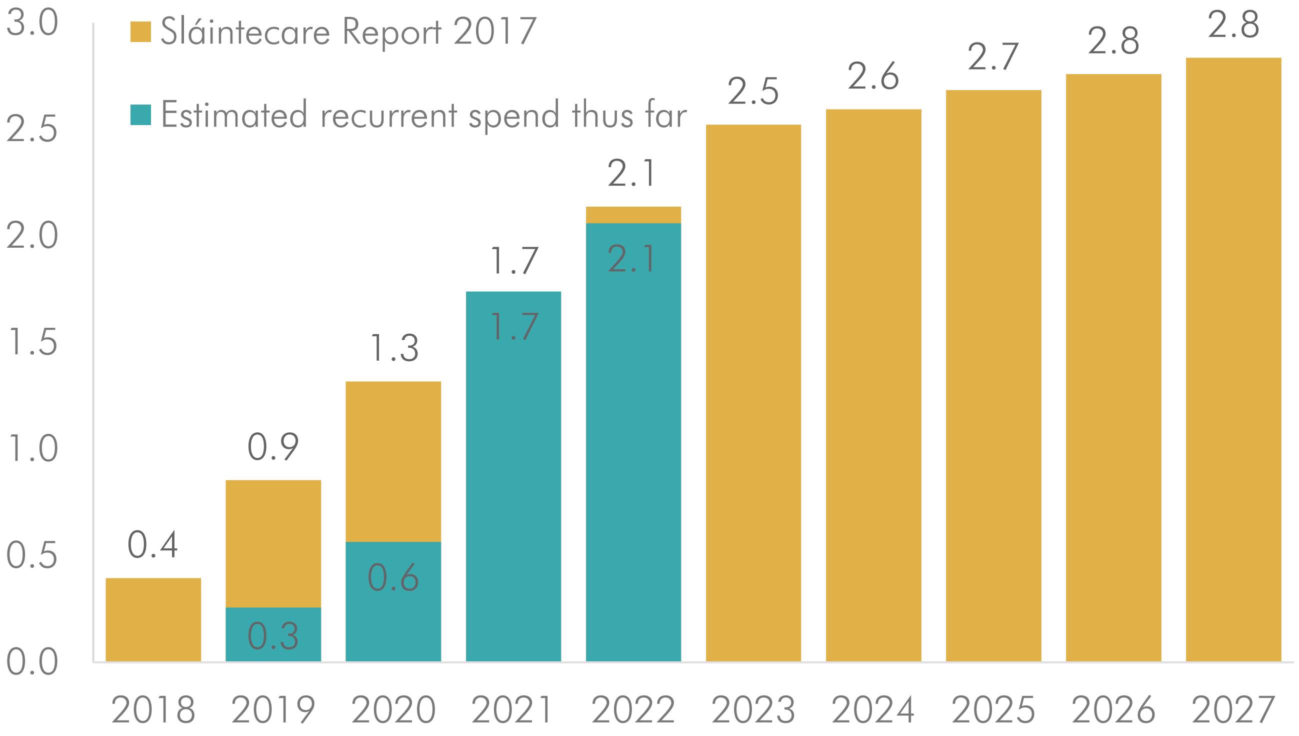
Source: FitzGerald (2021).

- There is no estimate of the budgetary cost of implementing the Climate Action Plan
- Loss of tax revenue, e.g., on motor fuels, could be very large (relevant revenues were €6 billion or 2.8% GNI* in 2019)

More clarity is urgently needed on health costs

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

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.

Strengthening the 5% Spending Rule

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- Recognise the impact of tax measures
- Underpin legislation
- Widen to whole of General Government sector
- Link it to debt targets

Key messages

- While remaining strong, Ireland’s recovery has lost some momentum in recent months
- The budget balance is set to move into surplus this year, but is in deficit allowing for excess CT
- Budget 2023 plans strike an appropriate balance between creating space to protect vulnerable households and avoiding stoking inflation
- Choices will need to be made between protecting people from inflation and other priorities
- Major medium-term challenges need to be addressed
- The fiscal framework should be strengthened
- Rainy Day Fund or a new National Pension Reserve Fund should be used to save excess corporation tax receipts