Pre-Budget 2023 Statement

Getting the balance right

September 2022

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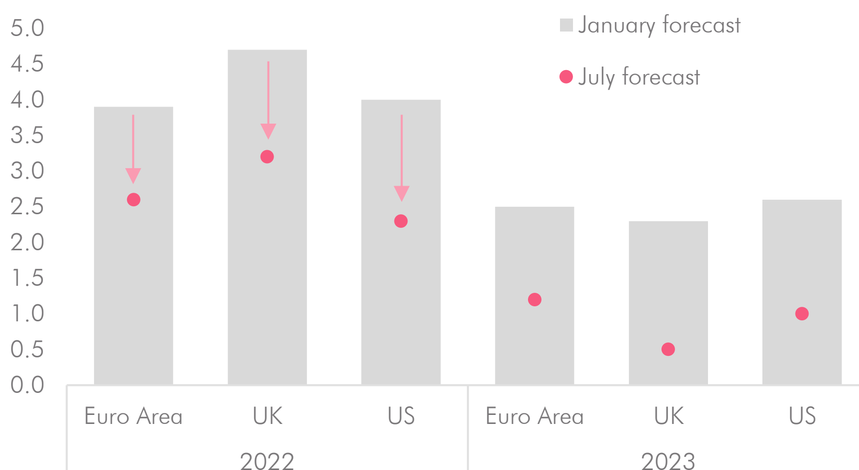
Key messages

The global economic recovery has been hindered by sharp increases in the cost of living amid the war in Ukraine and ongoing impacts of the pandemic. The war in Ukraine has led to sharp increases in global commodity prices, leading to a sharp pick-up in inflation. New outbreaks of the pandemic and subsequent lockdowns in China have exacerbated supply disruptions. These factors have led to a stalling of growth in 2022. At the same time, central banks have responded to rising inflation by tightening policy and raising interest rates, leading to a further downgrading of forecasts for economic growth in Ireland's trading partners.

IMF forecasts for real GDP growth have been sharply reduced

% change in real GDP

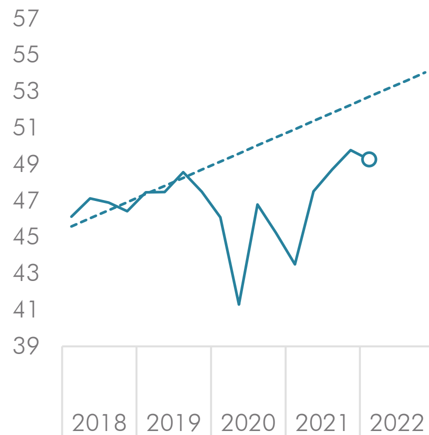


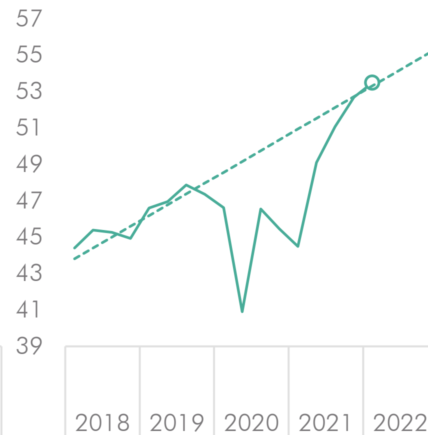
While still strong, Ireland's recovery has lost some momentum in recent months. Ireland's recovery from the pandemic was rapid. Domestic activity bounced back sharply as the pandemic's effects unwound and modified domestic demand closed in on its pre-pandemic trend by the end of 2021. There are mixed signs for Ireland's domestic growth in the first half of this year. Official data for the first quarter suggest consumer spending slowed, pulling down domestic demand over the quarter. This comes as prices have risen, reducing households' spending power. However, other indicators suggest that consumer spending may have been more resilient in cash terms.

Contrary to initial expectations, a lasting upward shift in consumer prices now seems likely. The current outlook for oil and gas suggests that prices, while expected to fall eventually, will stay higher for longer than previously thought. In addition, the pass through to prices elsewhere in the economy could be greater than expected. This raises the risk that Ireland will face higher prices and slower growth over the coming years.

The sharp recovery slowed at the start of 2022 held back by inflation

€ billion, modified domestic demand, seasonally adjusted

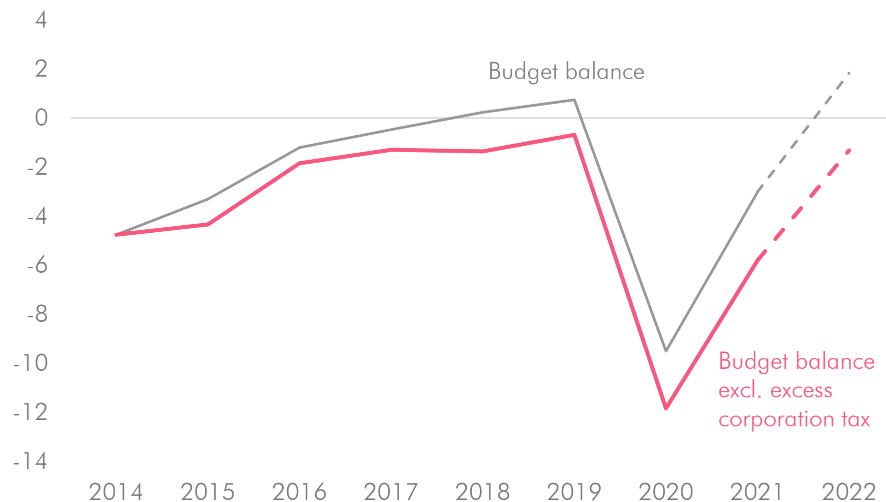




Downside risks have intensified. Long-standing international risks remain, including Covid-19 and Brexit-related uncertainties. Geopolitical tensions also remain, including the risk of a sharp reduction in European gas supplies this winter. Uncertainty around the future path of inflation is high, and financial conditions could tighten significantly. There are also domestic risks that could derail growth, including competitiveness issues and capacity constraints arising from labour shortages, rising wages, and housing costs.

The budget balance is set to return to surplus this year

General government, % of GNI*



Sources: CSO; and Fiscal Council workings.
Notes: Dashed lines indicate the Council's forecasts of the budget balance and the "excess" corporation tax for 2022.

This year, strong tax receipts are likely to push the Government's budget into surplus, supported by high corporation tax receipts. Wage increases and strong cash spending have led to higher tax revenues, notably in the form of income tax and VAT. Corporation tax receipts have continued to surge, with the

portion unexplained by domestic activity having risen to high levels. The Council estimates that the Government's revenue in 2022 could be almost €3.5 billion higher than forecast in July's *Summer Economic Statement*. Corporation tax receipts this year are likely to overtake VAT as the second largest tax heading. Assuming spending is in line with what is projected for the rest of the year, a surplus of about €4½ billion for 2022 is achievable. This compares to the *Summer Economic Statement*'s projection of a surplus of about €1.2 billion.

In the short term, the Government's budgetary stance must strike an appropriate balance between creating space to protect those most vulnerable to the rising cost of living and avoiding stoking inflation further. The Government faces a delicate balancing act in avoiding adding to rising price and wage pressures, while also alleviating their impacts on those most vulnerable. The *Summer Economic Statement* plans entail a 6.5% pace of core spending growth for 2023, with core spending €4.9 billion higher than earlier plans, and a larger-than-planned tax package. This pushes the budgetary expansion beyond the Government's 5% Spending Rule introduced last year — the pace that, in normal circumstances, would be considered sustainable. However, the Government's temporary deviation from the rule is sensible given the exceptional rate of inflation. The pace of expansion is less than what would be implied by tracking both real growth and general price rises in full. The impacts on fiscal sustainability are mitigated by the likelihood that revenues could be higher on a sustained basis, given the higher path for wages. It is now important that the Government sticks to its announced budgetary plans. This would support economic stability and would imply saving any additional excess corporation tax receipts.

To strike the right balance, the Government faces difficult choices and needs to prioritise what it wants to achieve. The Council estimates that to fully track the wage and price increases this year and next and to implement existing plans, including planned capital increases, core spending would have to increase by almost €7½ billion in 2023. However, this would exceed the available space under the Government's spending ceiling for 2023. Choices will need to be made between how far to uprate public sector wages, pensions, and social welfare payments and to what extent existing spending plans and any new permanent spending initiatives are pursued unless taxes are increased.

Improved targeting of supports can help strike the right balance. While policy support so far has largely come through temporary measures, the Budget will need both to address on-going short-term needs and how far to make permanent increases in public sector wages, pensions and welfare payments. The lack of targeting in earlier supports — Council (2022) estimates suggest about 90% were not targeted — leaves fewer resources to address other policy challenges. The Government can strike a better balance by ensuring that supports

are targeted at those most in need. Ireland's welfare and income tax system offer useful avenues through which to better target supports.

The Government needs to set out how it will address major medium-term challenges. First, the Government must halve Ireland's greenhouse-gas emissions by 2030, but it has not factored in the full costs of achieving this. Estimates put the cost at an additional 1.7 to 2.3 per cent of GNI* on average over the years 2026 to 2030 (FitzGerald, 2021). Second, the costing for the Government's "Sláintecare" reforms for healthcare is outdated and no spending plans are available beyond this year. Third, the Government has not responded to the Pensions Commission recommendations on how to address pension funding shortfalls but has indicated that it does not intend to raise the retirement age. Annual spending on pensions is set to rise by about 1½ to 2 per cent of GNI* (about €4 to 5 billion in today's prices) by 2030. The Government needs to make choices about how to address these challenges, including how it intends to reallocate spending from other areas and/or raise taxes.

Against this background, the Government should strengthen its approach to budgeting to improve fiscal sustainability, ensure more effective planning, and achieve better value for money. Three things would help in terms of how Ireland approaches its budgeting. First, the 5% Spending Rule should be reinforced to recognise the impact of tax measures, give it legislative status, capture the full range of general government spending, and link it to debt targets. Multiyear baseline expenditure plans should be published with the headline ceiling. Second, the Rainy Day Fund or a new National Pension Reserve Fund should be used to save excess corporation tax receipts, gradually reducing the State's over-reliance on these risky revenues. Related to this, the Government should routinely identify the level of excess corporation tax receipts and publish the general government balance with and without these receipts. Third, the Government needs to cost its major medium-term commitments properly and identify potential alternative revenue streams should these be needed. This includes the costs of achieving climate objectives, implementing Sláintecare, and addressing rising age-related spending.

Summary Table of latest Government Projections

% GNI* unless otherwise stated; projections are derived from the Government's *Summer Economic Statement* and the *Stability Programme Update (SPU) 2020*

	2021	2022	2023	2024	2025
Macro forecasts (SPU April 2022*)					
Real GNI* growth (%)	14.6	3.7	3.1	3.2	3.3
Nominal GNI* growth (%)	16.9	8.5	6.0	5.6	5.4
Nominal GNI* (€bn)	234	254	269	284	299
HICP	2.5	6.0	3.0	2.2	2.1
Budgetary forecasts (*Summer Economic Statement* July 2022*)					
Balance	-3.0	0.5	0.9	–	–
Balance (€ billion)	-7.0	1.2	2.5	–	–
Balance excl. one-offs	2.3	3.6	2.3	–	–
Balance excl. one-offs (€ billion)	5.4	9.2	6.3	–	–
Revenue excl. one-offs	42.3	43.3	42.4	–	–
Expenditure excl. one-offs	39.9	39.6	40.0	–	–
Primary balance excl. one-offs	3.7	4.9	3.7	–	–
Revenue growth excl. one-offs (%)	17.4	11.0	3.8	–	–
Primary expenditure growth excl. one-offs (%)	7.9	7.9	7.0	–	–
Net debt ratio (% GNI*)	82.2	75.8	71.5	–	–
Net debt (€ billion)	192	191	189	–	–
Fiscal rules					
Spending Rule	xc	xc	–	–	–
Structural Balance Rule	xc	xc	–	–	–
Overall Assessment	xc	xc	–	–	–

Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: *This table uses the latest available data for 2021. Figures are inferred from the Summer Economic Statement forecasts by updating SPU projections (e.g., nominal GNI* growth rate forecasts are applied to latest outturns). One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. Summer Economic Statement forecasts were only given for a range of the general government balance. The midpoint of that range is used here. SPU general government expenditure figures are updated to reflect the latest outturn data and the increases in "core" voted expenditure in the Summer Economic Statement. General government revenue figures are derived using the updated expenditure figures and the general government balance forecast in the Summer Economic Statement. xc = Exceptional circumstances apply, meaning temporary deviations from requirements under fiscal rules are allowed.

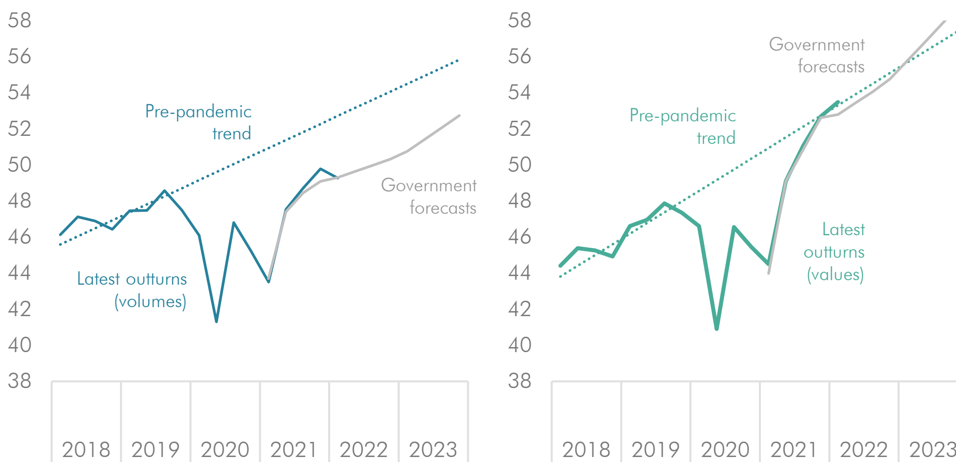
1. The Macroeconomic Context for the Budget

The economy bounced back strongly from the pandemic. The resilience of activity during the pandemic was underpinned by broad support of household incomes by the Government, alongside continued growth in high-skill activities including the digital, pharmaceutical, and medical-technology sectors.

While the nominal value of domestic demand has fully recovered (Figure 1B), real domestic demand has stalled (Figure 1A), owing in part to the highest rates of inflation in a generation.

Figure 1: Sharp recovery slowed in 2022, held back by inflation
€ billions, modified domestic demand (seasonally adjusted)

A. Domestic demand volumes fell in Q1 B. But values continued to increase

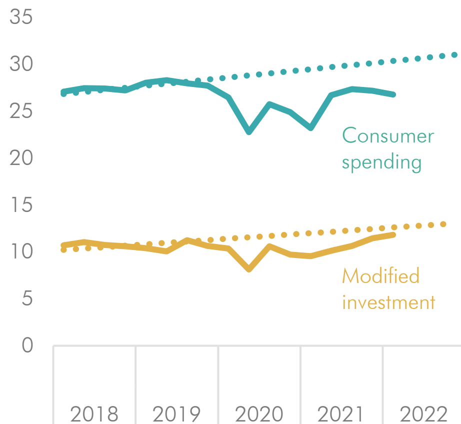


Sources: Central Statistics Office, Department of Finance, and Fiscal Council workings.
Notes: Government forecasts are based on the *SPU 2022* quarterly profiles for personal consumption, government consumption, and modified investment (which excludes aircraft for leasing and R&D intellectual property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

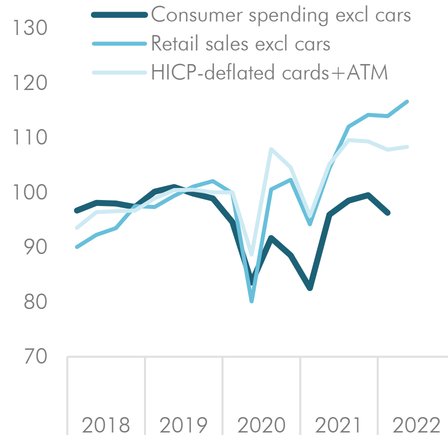
More recent economic data support the idea that activity in Ireland has softened, but there is a mixed picture for consumer spending, which fell in early 2022 (Figure 2A). This reflects a reorientation by households towards higher costs of energy and food. However, survey data on retail sales volumes, and hard data on card-based spending and ATM withdrawals (deflated with HICP) suggest that activity did not soften quite as much as the official measure of consumer spending would indicate (Figure 2B). This stronger picture is also in keeping with the strength of tax receipts this year (as shown in Figure 10).

Figure 2: Latest indicators point to possible softening of activity

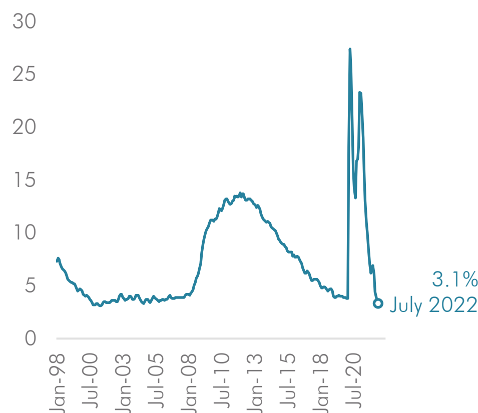
A. Consumer recovery slows
€ billion, 2020 prices, seasonally adjusted



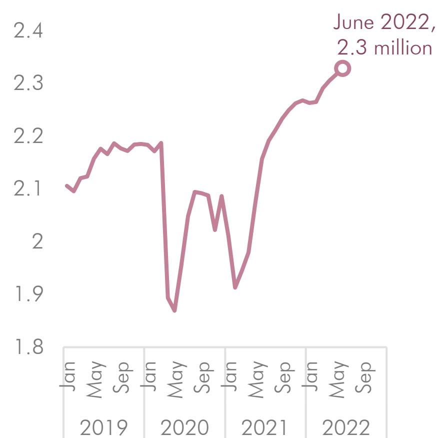
B. But picture depends on measure used
Volumes, 2019 = 100



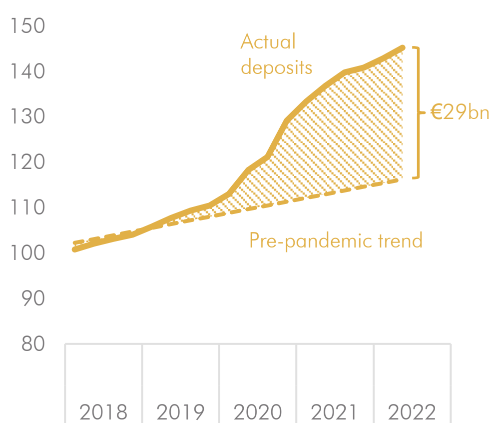
C. Unemployment is at record lows
% of labour force aged 25–74



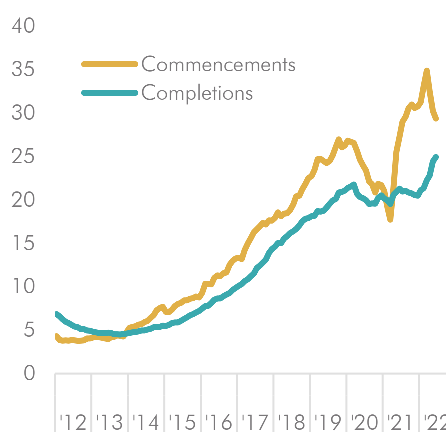
D. Rising number of employees in 2022
Millions, unadjusted (administrative data)



E. Excess deposits held by households
€ billion



F. Housing starts have slowed of late
Thousands, 12-month moving sum



Sources: Central Bank of Ireland; CSO; and Fiscal Council workings.
Note: In panels A and E, the linear trend is based on data for 2014–2019. In panel B, the monthly data for total card (debit and credit) spending and ATM withdrawals are deflated with HICP and seasonally adjusted using Tramoseats to obtain the series above.

Despite a record low for the unemployment rate for those aged 25 and over (Figure 2C), and a record high for the employment-to-population rate for those

aged 15–64 years, the recovery in the labour market remains uneven. For example, two sectors especially affected by the pandemic include hospitality and administration/support services (including aircraft leasing). In Q2 2022, actual hours worked in these two sectors remained 11% below their Q4 2019 (seasonally adjusted) level.

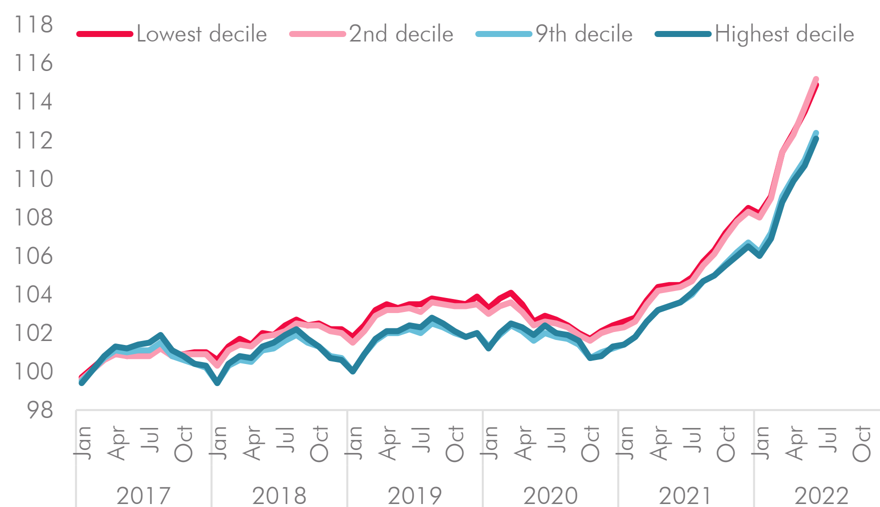
A consequence of the pandemic has been a surge in household savings. This is reflected in the dampening effect of public-health restrictions on consumer spending but also strong wage increases (Figure 4D), particularly in high-earning sectors. Figure 2E shows that household deposits to the end of June 2022 were €29 billion (over 12% of GNI*) above their pre-pandemic (2014–2019) trend. These excess savings could still be deployed to support consumer spending in the face of higher prices.

While housing starts have slowed in recent months (Figure 2F), new dwelling completions have increased, and modified investment had all but fully recovered by the first quarter of 2022.

Inflation could depress growth

The war in Ukraine, supply disruptions, and labour shortages in Ireland have added to price pressures. As such, optimism that price pressures might subside quickly has waned and a lasting upward shift in prices now seems more likely. This shift has had an uneven impact, as consumer prices have risen the most for low-income groups (Figure 3).

Figure 3: Prices have increased most for low-income consumers
Consumer price index, December 2016 = 100



Source: Central Statistics Office.

The current outlook for natural gas suggests that prices will stay higher for longer (Figure 4A and 4B). The euro has also weakened to parity with the US dollar, implying higher prices for goods and services priced in dollars. This raises the risk

that Ireland will face higher inflation and slower growth over the coming years (Figure 4C).

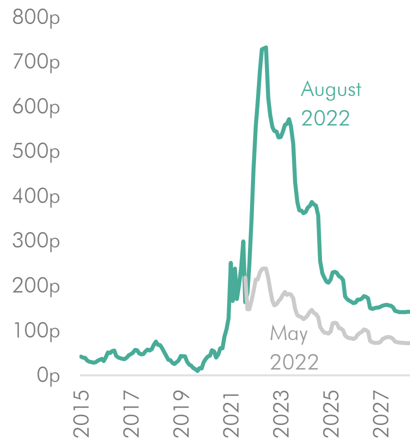
While prices have risen sharply, some households have benefitted from higher employee compensation. Figure 4D shows a substantial increase in wages per actual hour worked across the Irish economy compared to pre-pandemic levels. This is likely to reflect the incomplete recovery in low-earning hours worked in sectors such as hospitality, but also an accelerated shift towards high-earning jobs (Timoney, 2022). Low unemployment has further contributed to hourly wage increases (Figure 4E).

Notwithstanding a variety of sources putting upward pressure on prices over the past year, some global factors could become disinflationary over coming months such as a further reduction in commodity prices or supply-chain pressures (Figure 4F).

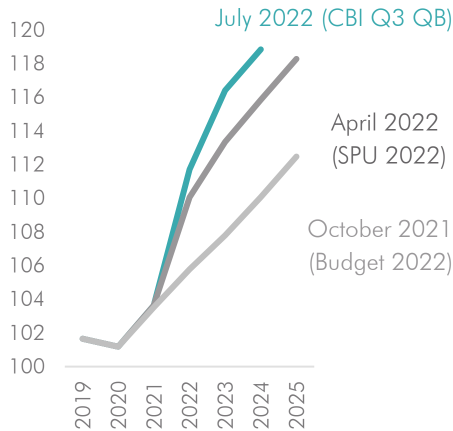
Figure 4: Price pressures continue

A. Oil prices expected to fall less than thought
EUR/Barrel, Brent Crude oil

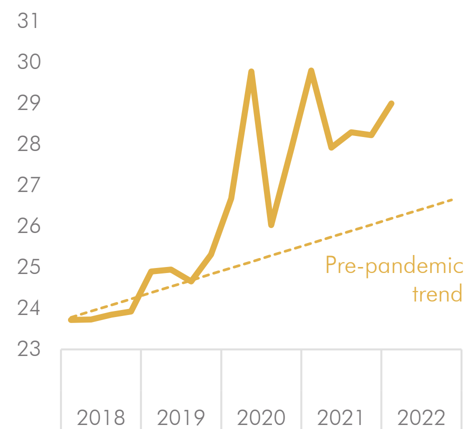
B. Gas prices likely to stay high for some time
GB Pence/Therm, natural gas



C. HICP forecasts revised up
Index (2015 = 100)



D. Average hourly wages rise sharply
€ per hour, seasonally adjusted



E. Low unemployment linked to wage rises
Hourly nominal pay growth

F. But supply pressures are moderating
GSCI index (standardised)

Sources: Eikon, Central Bank of Ireland, Department of Finance, Federal Reserve Bank of New York and Fiscal Council workings.

Notes: In panel A, brent crude futures prices have been converted from USD to EUR using trailing 10-day averages of the EUR/USD spot exchange rate. Panel C outlines forecasts for HICP produced at end-September for *Budget 2022*, at end-April 2022 as part of *SPU 2022*, and in July 2022 as part of the Central Bank of Ireland's Q3 Quarterly Bulletin. For Panel E, the sample is 2000-2019.

Rising interest rates will dampen demand

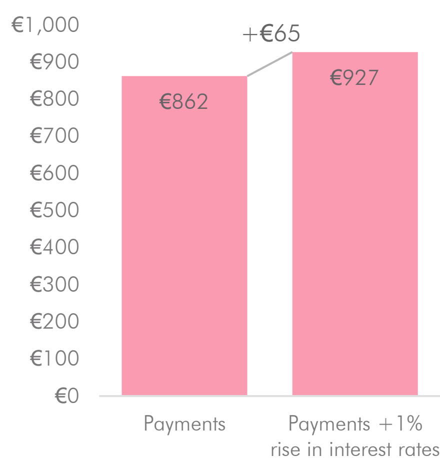
Central banks internationally are responding to heightened inflationary pressures by raising interest rates and tightening monetary policy to quell rising prices. This presents challenges for borrowers who already face rising inflation.

For households, the rise in interest rates will raise loan repayment costs. The Central Bank of Ireland (2022b) estimates that the median borrower on a standard variable rate could see a €65 increase in their monthly mortgage payment for a 1% increase in mortgage rates. Mortgages taken out more recently and those taken out between 2005 and 2009 face relatively larger repayment burdens. However, Central Bank simulations of a 2 percentage point rise in mortgage interest rates suggest that most borrowers, including median borrowers in the lower 25% of incomes, would remain below the 30% of gross income threshold in terms of debt servicing costs that usually indicates higher risks to household spending.[1]

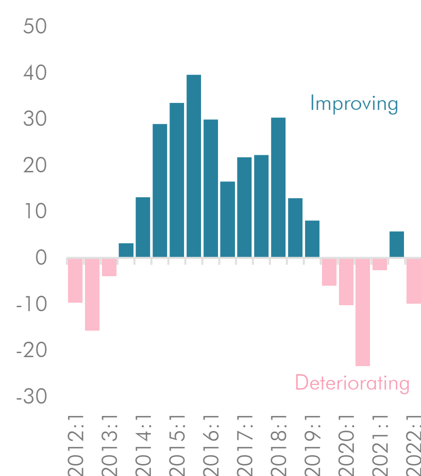
Businesses are also facing tighter financing conditions. Irish SMEs surveyed over the course of March and April of this year reported that they expect a deterioration in their access to most forms of external financing in the near future (Figure 5).

Figure 5: Households and businesses face tighter financing conditions

A. Monthly mortgage repayments
€, median borrower



B. SME expectations of bank lending conditions
Net improvement/deterioration



Sources: Central Bank of Ireland (2022b); ECB SAFE survey; and Fiscal Council workings.
Notes: Panel A shows the estimated immediate monthly impact of a 1% increase in mortgage rates for standard variable rate borrowers based on Central Bank (2022b) analysis. Panel B shows the net responses (expected bank loan increases less expected decreases) for SME respondents in the ECB's Survey on Access to Finance of Enterprises (SAFE).

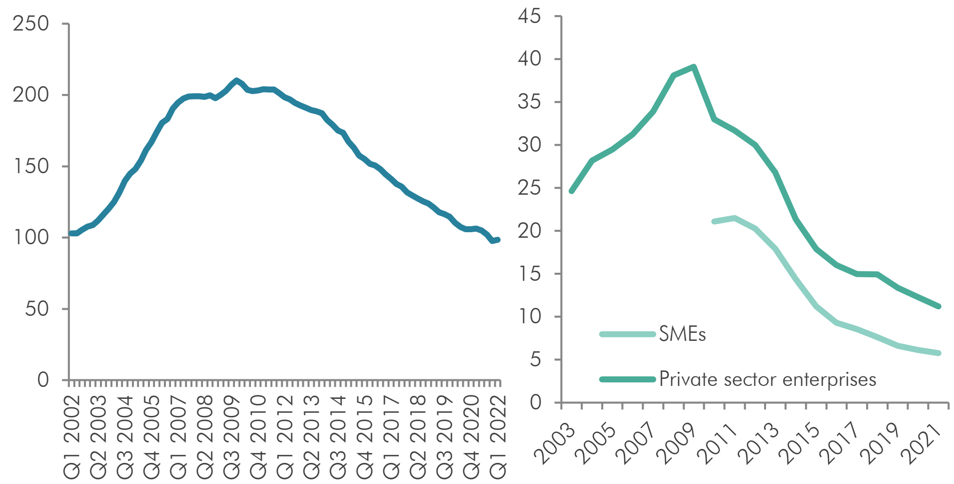
[1] This allows for a 5% random unemployment shock on individuals in employment, with incomes then falling to the max Jobseekers' benefit. However, it does not allow for higher inflation in addition to the interest + unemployment shock. Central Bank data for Q2 2021 suggest that 54% of outstanding mortgage balances in the main 5 Irish retail banks were tracker mortgages and standard variable rate mortgages, while 32% had a 1–2 year fix. This suggests a high share are exposed to rate changes over a relatively short period of time.

However, household and business debt has fallen to less vulnerable levels in recent years. The debt-to-income ratio for households has halved from a peak of just over 200% in the late 2000s to 98% as of Q1 2022 (Figure 6A). This moderates the risks around increased repayment costs. Similarly, SME debt has fallen from a peak of over 21% of GNI* to stand at less than 6% (Figure 6B).

Figure 6: Household and business debt is much lower than it was

A. Household debt burden half its peak
% disposable income

B. Corporate debt burden also far lower
% GNI*



Sources: Central Bank of Ireland; CSO; and Fiscal Council workings. SMEs = Small and Medium Enterprises.

Risks to the outlook

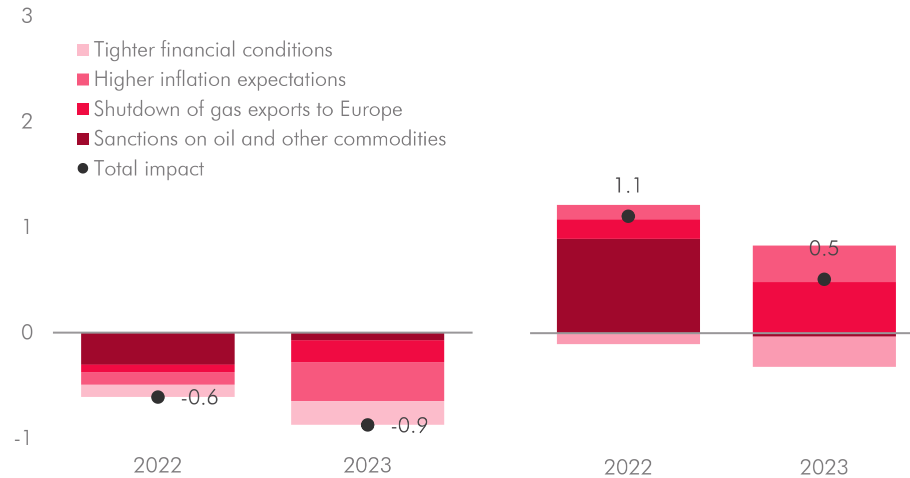
There are substantial risks to the outlook. Long-standing international risk factors remain, including Covid-19, risks around Brexit, and persistently weak economic performance within the Eurozone.

An acute risk is that supplies of natural gas to Europe from Russia are shut off. The IMF estimates that this could weaken annual GDP growth globally and raise consumer prices (Figure 7). It estimates that the EU would be particularly affected, with growth 1.3 percentage points lower than in the baseline, implying near zero growth for 2023, and a drag on Ireland's growth prospects as a small open economy.

Figure 7: IMF downside scenarios for the euro area

A. A shutoff would weaken growth
% deviation from baseline global GDP forecasts

B. And lead to higher inflation
% deviation from baseline global CPI inflation forecasts



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

While Ireland's economy has proven resilient in recent years, there are also domestic risk factors that could derail growth. These include competitiveness issues (especially relating to high house prices and rents), and capacity constraints, especially for the delivery of dwellings and other infrastructure. Furthermore, a slowdown in job creation by foreign-owned multinational enterprises would weaken the trajectory of economic growth and tax revenues.

Looking further ahead, a slowdown in Ireland's economic growth rates should be expected in the latter half of the current decade, as discussed in the Council's *Long-Term Sustainability Report* (Fiscal Council, 2020). This is due to a combination of an ageing population and an expected convergence in productivity with the ratios of output per worker seen in other developed economies.

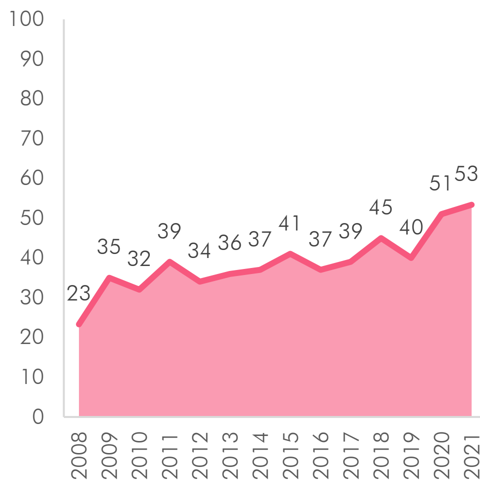
2. The Public Finances ahead of the Budget

The public finances have benefited from higher-than-expected revenues and lower-than-projected spending on Government supports related to the pandemic and Ukrainian refugees. The *Summer Economic Statement* (Department of Finance, 2022b) forecasts a surplus of 0.5% of GNI* for 2022 and 0.9% for 2023.

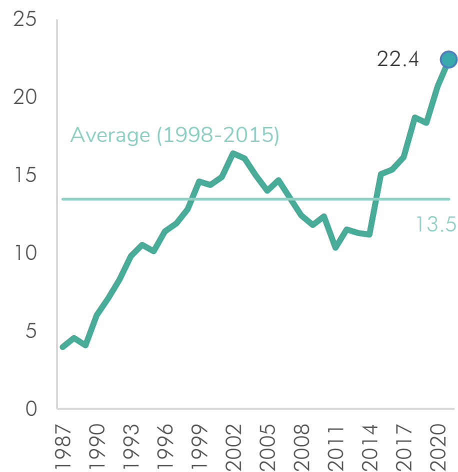
Exceptional levels of corporation tax receipts have helped to support the turnaround in the budget balance. In 2021, corporation tax receipts were €4.4 billion higher than in 2019. Corporation tax has been rising rapidly as a share of total taxes in recent years (Figure 8B). It is likely that, this year, corporation tax receipts will overtake VAT as the second largest source of tax revenue. Corporation tax receipts are highly concentrated as well as being the most volatile and least predictable of the main taxes collected by the Government. Some 53% of net receipts in 2021 came from ten companies (Figure 8A).

Figure 8: Corporation tax are more concentrated and make up a larger share of revenue

A. % net corporation tax from top ten companies



B. Corporation tax as a percentage of total Exchequer taxes



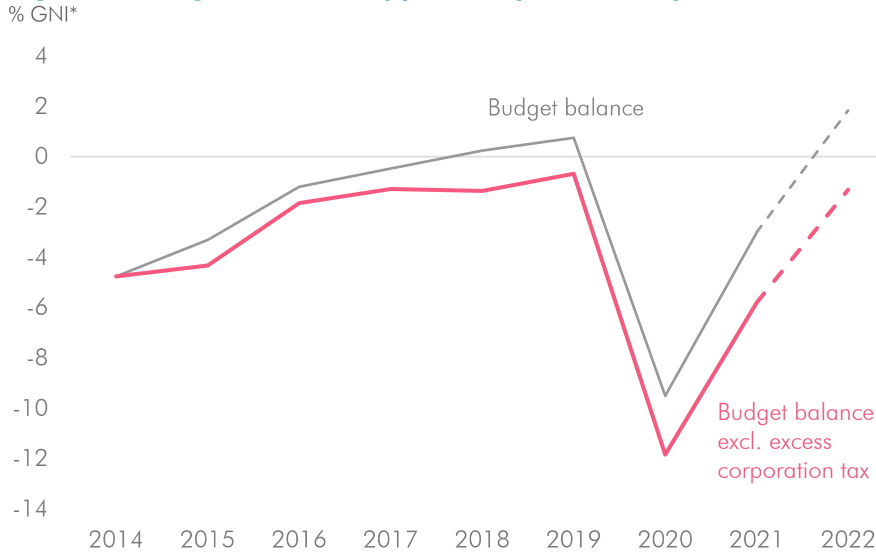
Sources: Department of Finance and Revenue data.

When the excess corporation tax receipts collected in recent years are excluded, the budget balance would show a sizeable deficit in 2022 with a shallower recovery from the pandemic (Figure 9).[2]

[2] See Box G in Fiscal Council (2022) for an explanation of how excess corporation tax receipts are calculated.

Figure 9: Budget balance supported by excess corporation tax

% GNI*

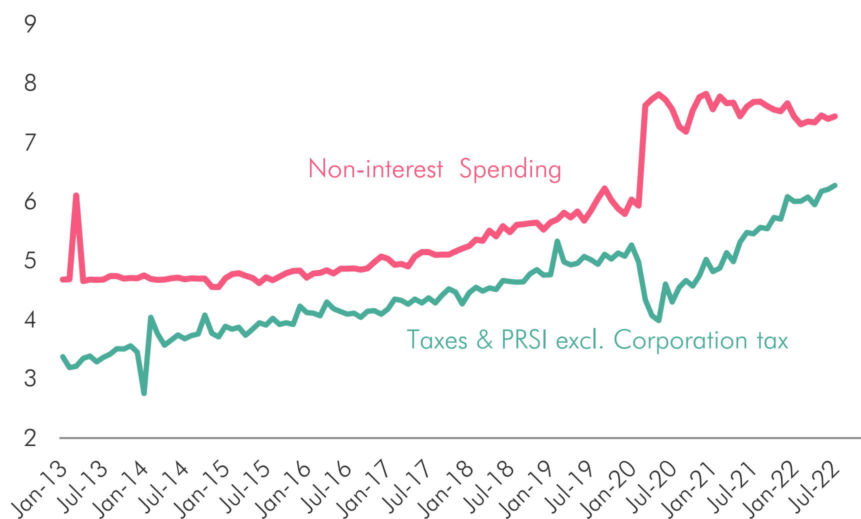


Source: Department of Finance; CSO; and Fiscal Council workings.
Notes: Dashed lines indicate the Council's forecasts of the balance and the "excess" corporation tax for 2022. See Box G in Fiscal Council (2022) for an explanation of how excess corporation tax receipts are calculated.

Developments in recent months show that taxes have continued to outperform, while spending is below expectations (Figure 10). At the end of July, tax revenue was €1.9 billion ahead of the April SPU forecasts. This has been largely driven by strong corporation tax receipts, which are currently €1.0 billion ahead of forecasts. VAT and income tax revenue have also been strong, with both €0.3 billion ahead of forecast.

Figure 10: Revenue and expenditure trends

€ billion, seasonally adjusted monthly data (Exchequer cash basis)



Source: Department of Finance and Fiscal Council workings. Source: Department of Finance and Fiscal Council workings.
Notes: The data are seasonally adjusted using the Tramoseats method over monthly observations for the duration of the sample period 2013-2022. Non-interest spending excludes transactions with no general government impact, while the revenue series shown includes taxes, PRSI and NTF receipts, and excludes corporation tax.

The *Summer Economic Statement* revised up the forecast for the budget balance for 2022, relative to SPU forecasts, but there are further upsides for the budget balance this year. The *Summer Economic Statement* forecasts imply an upward revision to general government revenue of approximately €3.4 billion for 2022 compared to the SPU.[3] However, tax and PRSI receipts at the end of July were already €2.6 billion ahead of SPU forecasts and it seems likely that revenues will continue to outperform for the rest of this year.

Further to this, temporary spending in 2022 has remained unchanged relative to SPU projections. This means that, as estimated by the Fiscal Council in its *May 2022 Fiscal Assessment Report*, around €2.5 billion of unallocated contingencies remains available for spending this year if needed (Table 1). The Christmas Bonus has not been budgeted for yet again despite some form of payment being made in every year since 2014. It is possible that the Government will cover it using the unallocated contingencies for 2022 at a cost of around €0.3 billion

Table 1: Some €2.5 billion of contingencies for 2022 remain if needed
€ billions, 2022

	2022 € billion
Total non-core expenditure	7.5
Brexit Adjustment Reserve	0.5
- Initially allocated to departments for Covid & Brexit spending	3.0
- Since committed to Covid-19 + cost of living measures	1.5
- National Recovery and Resilience Plan	0.2
- Unallocated	2.5

Sources: *Summer Economic Statement* 2022; and Fiscal Council workings.

The Council estimates that revenue in 2022 could be almost €3.5 billion higher than forecast in the *Summer Economic Statement*.[4] Assuming that spending is in line with what is projected in the *Summer Economic Statement* for the rest of this year, this would imply a general government budget surplus somewhere in the region of €4½ billion for 2022. This compares to the *Summer Economic Statement* projection of a surplus of about €1.2 billion, or 0.5% of GNI*. Uncertainty remains both about the path of revenue and spending in the months ahead.

[3] This is based on the mid-point of the budget balance range in the *Summer Economic Statement*. The top of the range for the budget balance would imply an upward revision to revenue of approximately €4.6 billion.

[4] Revenue estimates are based on projections of individual tax heads, taking into account recent trends and adjusting for seasonal and temporary factors and the historic relationship between monthly receipts.

With the *Summer Economic Statement*, the Government set a larger budgetary package. The package differs from previous plans set out in the April SPU 2022 projections in that:

1) The core spending budget for 2022 is to be increased by €0.4 billion. The *Summer Economic Statement* notes that this for "the provision of new current expenditure measures…to be allocated in 2022 for the early implementation of new measures".

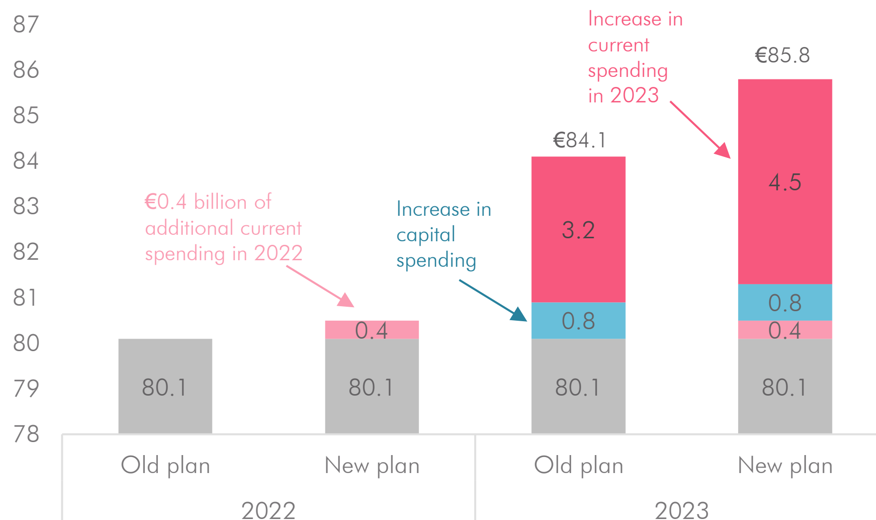
2) The core spending budget for 2023 is set to increase by 6.5% rather than the 5% previously planned. This means core current spending increases of €4.5 billion in 2023 as compared to €3.2 billion. The capital increase is unchanged at €0.8 billion.

3) A larger tax package of €1.1 billion is now planned for 2023, up from €0.5 billion.

Taken together, the new plans for the Budget represent a package of €6.7 billion. This consists of a tax package of €1.1 billion, an increase in core capital spending of €0.8 billion, and a total increase in the level of core current spending in 2023 of €4.9 billion. This €4.9 billion comprises a €0.4 billion increase in the level of core current spending this year and a further €4.5 billion increase in 2023 (Figure 11). Altogether, the combined upward revisions to core current spending of €1.7 billion, plus the additional €0.5 billion of tax measures mean a total revision to the budgetary package, since April's SPU, of €2.3 billion.

Figure 11: 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.

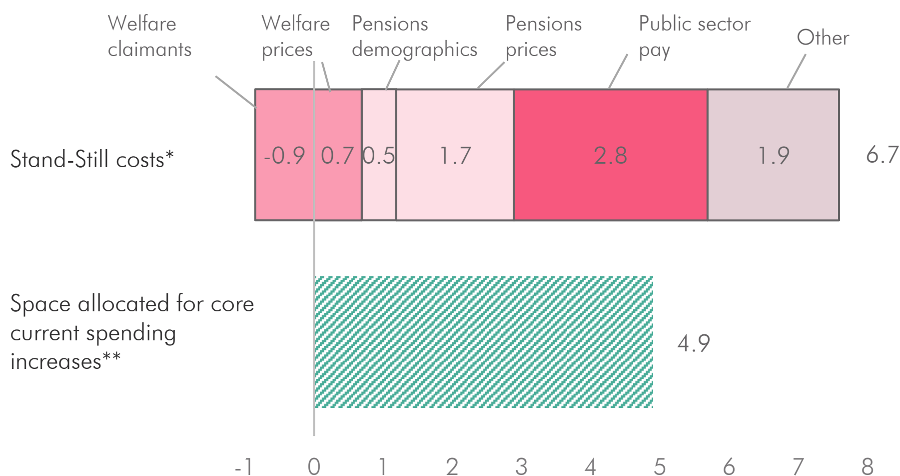
The public finances face substantial pressures from high inflation

The continued rise in prices and wages will exert considerable pressure on government spending. This will be particularly important for the cost of maintaining the "existing levels of service" and for capital spending.

While the Council does not recommend full indexation of spending, it is useful to consider what across-the-board indexation would entail were it to take place. Here, we assess what it would cost, first for core current spending, and second, what the implications of higher inflation are for capital spending. These exercises underline the spending pressures due to higher inflation.

The amount set aside in the *Summer Economic Statement* to cater for rising prices and wages and their impact on the provision of recurrent public services and supports in 2023 has not changed since April's SPU. The *Summer Economic Statement* sets aside €2.2 billion for what the Department refers to as "existing levels of service" costs. These costs include funding for public sector pay increases, the impact of demographic changes on government spending, and carryover costs from last year's budget. However, the €2.2 billion figure is the exact same as was set out in April's SPU. Despite higher inflation pressures arising in the meantime: HICP inflation was projected in April's SPU to be 6.2% in 2022 and 3% in 2023; whereas the Central Bank forecast 7.8% and 4.2%, respectively, in its July projections.

Figure 12: Space for core spending is less than Stand-Still costs
€ billion changes



Sources: Department of Finance; and Fiscal Council workings.
Notes: *The Stand-Still costs are based on Council estimates of the cost of covering demographics and price/wage pressures for inflation in 2023 along with the unexpected inflation in 2022 (difference between Budget 2022 forecast and latest estimates). **Core current spending increases here are the €4.5 billion of combined new spending measures + existing level of service costs for 2023 plus the additional €400 million core current spending allocated to 2022 as part of the Budget 2023 package.

Looking first at just current spending, tracking price pressures in 2023 fully and compensating for the unexpected inflation in 2022 would entail costs far in excess of what the Government has set aside. The Council estimates that if the

Government were to fully protect the real value of services and supports against inflation, this would cost almost €7 billion (Figure 12).[5] This exceeds the total core current spending increases of €4.9 billion set out in the *Summer Economic Statement* for 2022 and 2023 combined.

Taking the total core current spending increases of €4.9 billion set out in the *Summer Economic Statement* for 2022 and 2023 combined, we can consider what various degrees of indexation would imply for accommodating price increases within the overall budget package. As a way to consider how the €4.9 billion allocation can get absorbed, Table 2 draws on a number of illustrative welfare packages, including some of what has been considered as part of the Tax Strategy Group papers (Department of Finance, 2022c). This shows that fully uprating welfare payments and pensions to the average rate of inflation would cost around €1.7 billion, around one-third of the available budgetary package for core spending.

Table 2: Welfare increases and associated costs

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, approximately offsetting unexpected inflation for 2022. 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. Pension rates are estimated costs and refer to the State pension only.

Table 3 shows how other parts of existing levels of service might have to adjust for each percentage point increase in a relevant driver, such as general economy wage growth. As an example, if public sector wages were to be indexed to general economy wages at a rate of 6.6% — the latest Central Bank (2022a) forecast for 2023 — this would mean that the remaining space for spending would be used up by a further €1.5 billion.

If wage growth increases, this would increase the need to adjust tax bands to maintain the tax burden at its existing level. €1.1 billion of tax measures is currently planned. Every 1 percentage point increase in wages would entail a cost of €0.2 billion to index the tax system. Scope for any additional unfunded

[5] This is produced on the basis of more recent inflation forecasts from the Central Bank (2022a), which assume HICP inflation of 7.8% for 2022 and 4.2% for 2023 as compared to rates of 2.2% and 1.9%, respectively in the *Budget 2022* forecasts.

measures to reduce taxes is limited in order to avoid overheating the economy and to ensure fiscal sustainability.

Table 3: Potential pressures on spending and indexing taxes

Cost of 1pp increase in relevant price driver

Item	Driver assumed	€m
Government purchases	Average costs of purchases	346
Public sector wages	Wage growth	227
Pensions	Wage growth	243
Other welfare	Wage growth	43
Tax indexation	Wage growth	205
Total		1,064

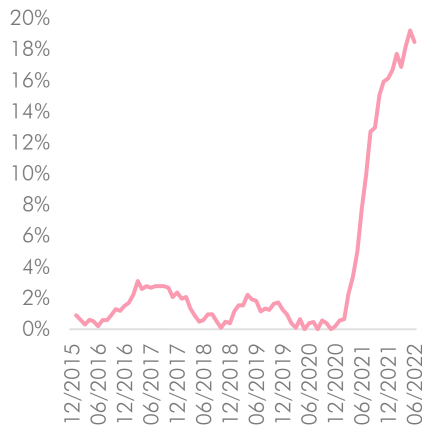
Sources: Department of Finance; Revenue; and Fiscal Council workings.
Notes: Government purchases refers to all government spending outside of health, social protection, pensions and education. Public sector wages = the public sector wage bill excl. pensions. Pensions include state, public sector, and other pension spending. Other welfare includes payments on supports such as the fuel allowance and other Government transfers. Tax indexation includes the costs associated with indexation for 1% wage growth and covers changes to the PAYE credit and exemption limits, personal tax credits and rate bands, the earned income credit, and USC rate bands and exemption limits.

There are also pressures on capital spending from rising prices. Cost increases in construction raise questions about how the Government's capital plan will be delivered. The capital allocations under the National Development Plan (NDP) were set at a time when building and construction prices were forecast to be much lower. Tender prices for building projects have risen by 24% when comparing the first half of 2020 with the same period of 2022 (Figure 13B). The most recent forecasts suggest that building and construction prices will be 20% higher by 2025 than was forecast at the time of the NDP's publication (Figure 13C).

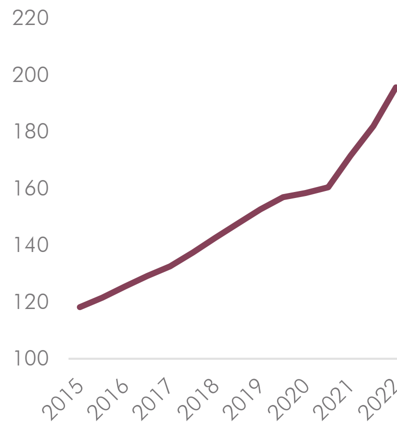
While prices have increased, the allocations under the NDP have remained unchanged. This raises questions about whether the volume of output delivered under the current NDP will be a lot less than originally envisaged, with the same being spent in cash terms, or whether spending on delivering NDP projects will ultimately be revised up to accommodate higher costs. Projects could also be deferred. To return to the same level of capital spending in the economy as a share of GNI* as originally planned would require an average of €1.7 billion per year over the period 2022 – 2030 (Figure 13F).

Figure 13: Materials costs rose sharply, feeding into rising tender prices

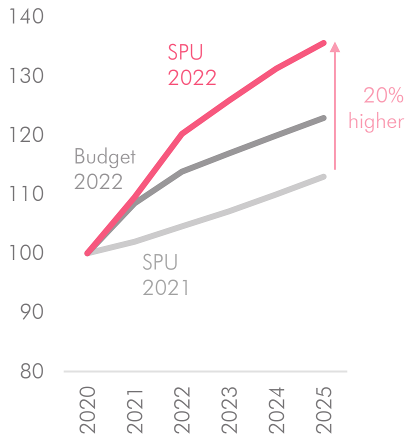
A. Wholesale prices
y/y % change



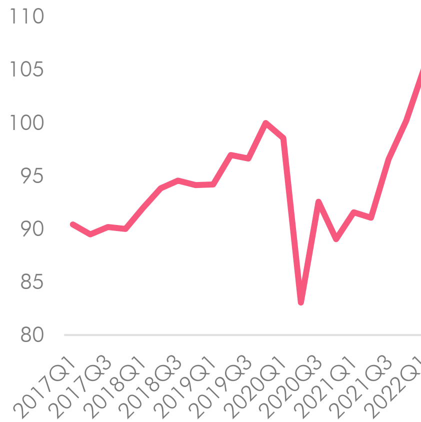
B. Tender price index
Index: 1998 = 100



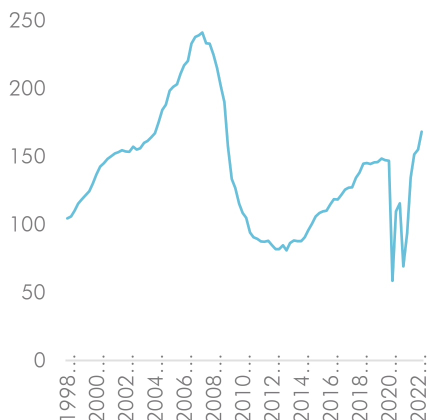
C. Construction prices much higher
Index 2020=100



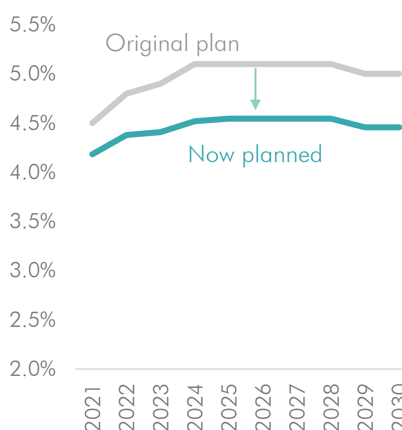
D. Construction labour costs increased
Average hourly total labour costs, 2019 Q4 =100



E. Construction employment rising
000's



F. Capital plans shrink relative to income
% GNI*, Exchequer capital spending



Source: CSO, Department of Finance, and SCSI.
Notes: Wholesale Price Index is a composite price index for all construction materials ex VAT. The SCSI tender price index is a sentiment-based indicator of median tender prices for commercial, new-build projects > €0.5m in Ireland (H1 2022 data shown for 2022). Construction prices are SPU 2022 forecasts for the Building and construction deflator. Construction labour costs = average hourly total labour costs from the CSO's EHECS. Panel E shows CSO labour force survey data, where construction employment is adjusted for PUP recipients (2020Q1 to 2022Q1). GNI* figures used in the green line of panel F are as in the Summary Table. Growth rates assumed for 2026-2030 are the same as those assumed in the NDP.

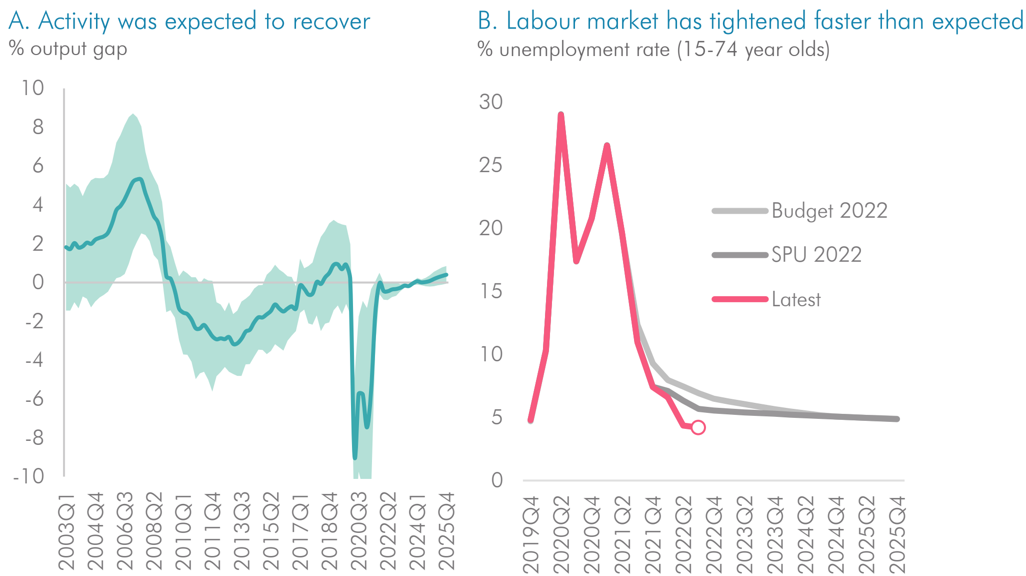
3. The Fiscal Stance for Budget 2023

In this section, the Council assesses the prudence of the Government's overall fiscal stance ahead of *Budget 2023*. It is informed by (1) a broad economic assessment that considers how to appropriately manage the economic cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with the legislated domestic and EU fiscal rules.

Assessment of cyclical position

While the economy recovered strongly from the pandemic, higher inflation will tend to depress growth in the domestic economy and globally. The Irish economy is likely to continue to be supported by the strength of digital and pharmaceutical activities. Much will depend on how much domestic spending is supported by savings built up during the pandemic and increases in wages. There are risks that second-round inflation pressures could materialise at the same time that real demand slows.

Figure 14: The economy has recovered and tightened sharply



Sources: Fiscal Council workings based on SPU 2022 forecasts; and CSO.
Notes: Panel A shows a range of output gap estimates (shading) and the mid-range of these estimates (line). The estimates are derived using the Council's supply-side models (Casey, 2019) on the Department's forecasts and focus on domestic economic activity, including quarterly Domestic GVA. Panel B uses the CSO's Covid-adjusted unemployment rate where available and the latest Q3 estimate is based on the monthly outturn for July 2022.

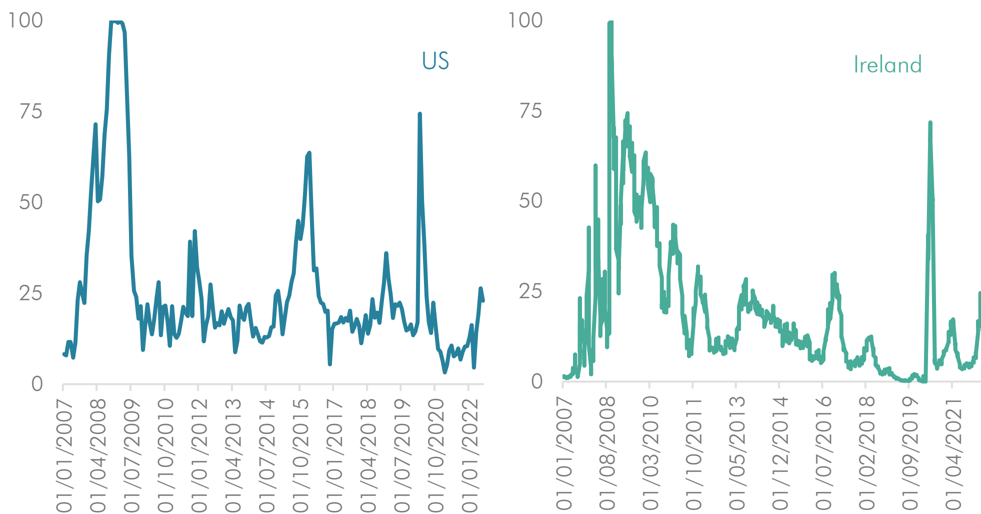
Coming into the budget, the economy appears to be close to operating at its overall capacity (Figure 14A). This means neither substantial underuse of workers, nor broader overheating in the economy. Imbalances are visible but appear to be offsetting. Moderate lending, lower indebtedness, high savings, and the large current account surplus suggest limited pressures on domestic resources. Yet there are signs of the economy tightening, especially the labour market. Unemployment rates have fallen faster than envisaged, with July 2022 estimates

just 4.2% — their lowest in over two decades (Figure 14B). Second-round increases in inflation, housing affordability challenges, and labour shortages could spell overheating risks if trends continue.

However, since April, the outlook for the global economy has deteriorated, while the domestic recovery lost some of its momentum early this year. The probability of an imminent recession in the US is estimated to have risen to almost a one-in-four chance. This risk does not appear to have translated to similar probabilities of a recession for Ireland as yet (Figure 15). Ireland's underlying growth rate is higher and so a similar slowdown in growth might not trigger a contraction in output. However, there are other risks facing Ireland in terms of prospects for its largest trading partners. The Bank of England (2022) expects the UK to enter a recession from the fourth quarter of this year. The latest ECB (2022) projections imply the Euro Area will no longer recover to pre-pandemic forecasted levels of activity until after 2024, more than a year later than earlier estimates.

Figure 15: Probability of recession in US rises, but appears low for Ireland

% probability of recession four quarters ahead



Sources: US Federal Reserve; and Fiscal Council workings.
Notes: The Recession risk indicator for the US is derived based on a logit model of the probability that the change in the unemployment rate four-quarters-ahead will be above its 80th percentile. It uses the credit and term spreads as well as the change in the OECD's composite leading indicator as predictors. For Ireland, we use the same approach on Ireland's unemployment rate. We retain the US predictors, assuming that Ireland as a small open economy is exposed to fluctuations in the US economy, but we use the OECD's composite leading indicator for Ireland as the third predictor.

While large risks clearly loom on the horizon, tight labour market conditions and the still-positive immediate outlook for growth would suggest that the Government should aim to pursue a relatively neutral fiscal stance in Budget 2023. 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. A sustainable pace is what is embodied in the Government's 5% Spending Rule based on the economy's estimated medium-term real potential growth rate of about 3% per annum and more normal rates of inflation closer to 2%. Given the current

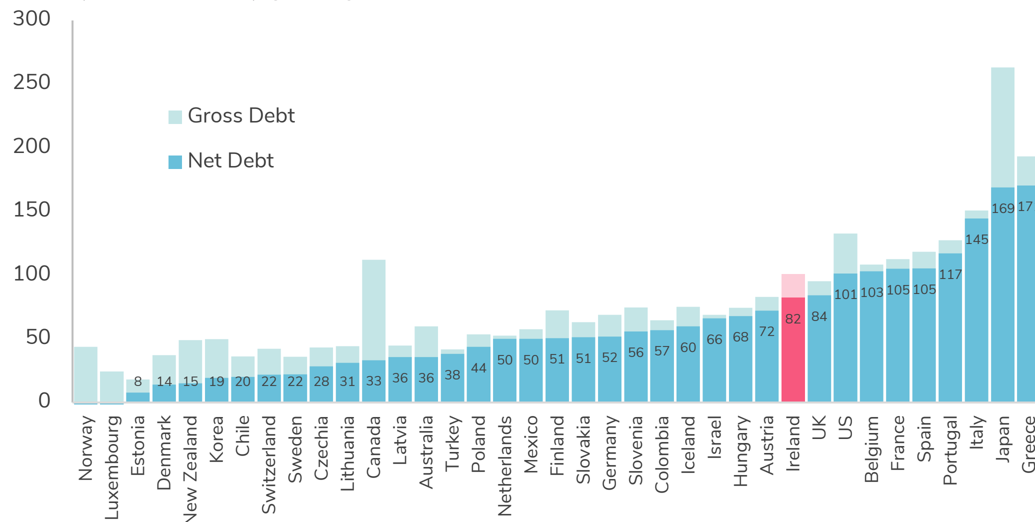
exceptionally high rate of inflation, the proposed deviation from the rule to 6.5% is sensible and should not unduly add to inflationary pressures.

The Government's debt ratio remains high and vulnerable to shocks

The Government entered the Covid crisis with one of the highest debt ratios in the OECD and borrowed significantly during the pandemic. At the end of 2021, the Government's net debt ratio was 82% of GNI*. This put it as the tenth highest in the OECD (Figure 16). Only three other small open economies in the OECD have larger debt burdens (Greece, Portugal, and Belgium).

Figure 16: Ireland has a high debt ratio

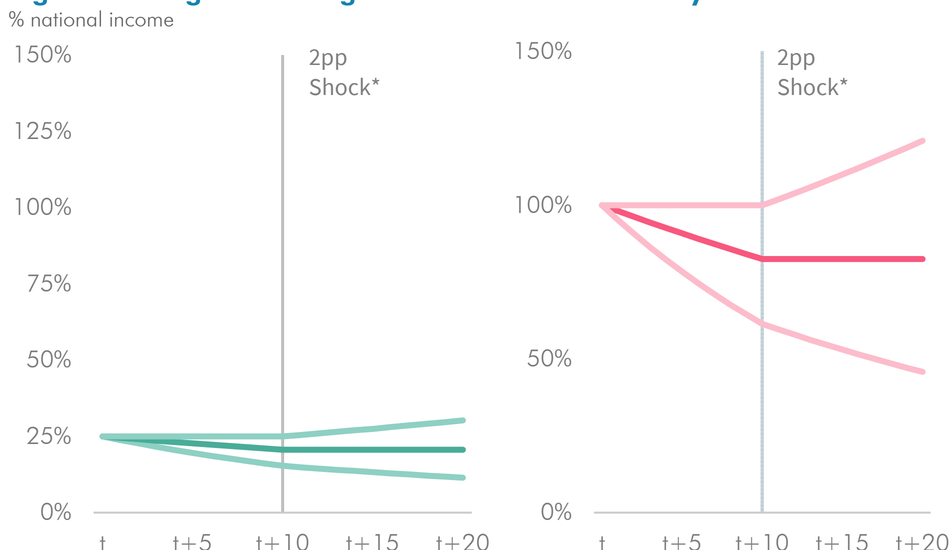
% GDP (% GNI* for Ireland), general government basis, end-2021



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.

A higher starting debt ratio tends to amplify the sustainability risks that can arise from recessions, slower growth or increases in borrowing costs. We can see this by examining an illustrative shock to a critical variable for how debt ratios evolve: that is, the difference between the interest rate on government debt and the economy's nominal growth rate (Figure 17). For a smaller debt ratio, such as 25% of national income — about the rate Ireland entered the financial crisis with — a 2 percentage point shock to the interest-growth differential could yield an impact of +/- 9 percentage points on the debt ratio ten years after the shock hits. However, for a higher starting debt ratio, one closer to 100%, the range of potential impacts from the same shock is four times wider at +/- 38 percentage points after ten years.

Figure 17: Higher starting debt ratios are inherently more vulnerable



Source: Barnes, Casey and Jordan-Doak (2021).
Notes: For different starting debt ratios, the figure shows how debt ratios evolve for an illustrative interest-growth differential of -5% (bottom lines), -2% (middle lines), and 0% (top lines) and a primary balance = 0. * The shock shows what happens if the interest-growth differential worsens by 2 percentage points.

The risks posed by rising interest rates are mitigated by actions taken in recent years. More than 90% of Ireland's existing government debt is issued at fixed interest rates. More than four-fifths of the fixed rate bonds maturing before end-2025 have a coupon payment of 3.4% or more. This means that the State could roll over its debt by issuing new bonds with marginally lower coupon payments, and interest costs would still fall. In addition, the State has built up considerable cash balances, equivalent to €35 billion or nearly 14% of GNI* at end-July, and the maturity of outstanding debt is relatively long at over 10 years.[6] Simulations using the Maq model (Casey and Purdue, 2021) suggest that a persistent increase in interest rates of 1, 2, and 3 percentage points would lead to the debt ratio being higher in 2032 by 11, 12, and 16 percentage points, respectively.

Government bond yields have risen since the end of last year. After peaking in June at 2.4%, Ireland's ten-year government bond yield fell back to about 1.5% but has since risen again to around 2% (Figure 18). The introduction of the Transmission Protection Instrument (TPI) by the European Central Bank appears to have mitigated some of the pressure on yields.[7]

[6] For a more detailed discussion, see Box F, Fiscal Council (2022).

[7] The European Central Bank's Governing Council approved the TPI on 21st July 2022. The TPI can be activated to counter what are considered to be "unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area". It will mean that the Eurosystem can intervene to purchase government debt securities on the secondary market if financing conditions deteriorate, provided that certain criteria are being met (such as if the jurisdiction is pursuing "sound and sustainable fiscal and macroeconomic policies" including complying with EU fiscal rules and their recovery and resilience plans).

Figure 18: Government bond yields have risen

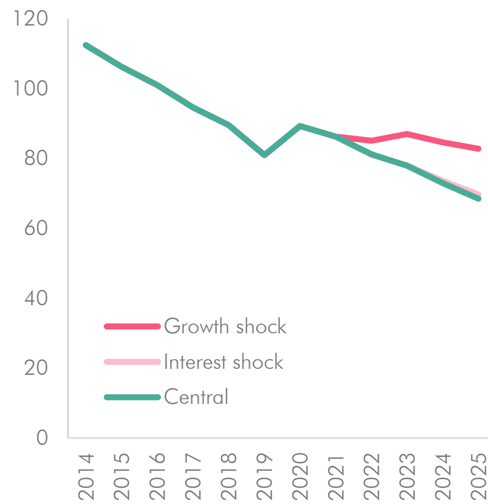
% yield on ten-year Irish Government bonds

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

A greater risk to the path for Ireland's debt ratio is from growth shocks (Figure 19). The Council's debt sustainability modelling suggests that if growth was weaker than forecast by 3.6 percentage points for two years (accumulating to a 7% shock), then the debt ratio would be estimated to be just over 14 percentage points higher by 2025.[8]

Figure 19: Growth poses greater immediate risks to debt path

A. Debt ratio is more sensitive to growth
% GNI* net government debt ratio



B. Financing needs also more sensitive to growth
% GNI* gross annual financing requirement

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.

[8] This is based on one standard deviation of annual real GNI* growth rates between 1996 and 2019 excluding the financial crisis period.

In the absence of a major shock to growth, the net debt ratio should fall steadily in the coming years, helped by strong real growth, inflation, and budget surpluses. The *Summer Economic Statement* projections imply a reduction in the net debt ratio of 6.4 percentage points in 2022. Assuming real GNI* growth remains steady at about 3%, economy-wide inflation of 2 to 3% from 2023 on, and the primary balance stays unchanged at 2.3%, the decline in the net debt ratio could be more than 5 percentage points per annum. This would hold even if even if the Government's marginal borrowing costs rose by 2 percentage points over the forecast period.

The Fiscal Stance for Budget 2023

Looking ahead to *Budget 2023*, the Government faces a delicate balancing act between supporting those most vulnerable to rising costs and not adding to inflation. This includes households as well as businesses, which face higher energy costs in addition to other rising prices and labour costs.

Striking the right balance will mean the Government has to make difficult choices. It will have to prioritise between maintaining the real value of public services and supports, sticking to its capital plans, increasing spending elsewhere, or raising additional revenues.

The Council assesses that the Government's plans, as set out in the *Summer Economic Statement* strike an appropriate balance. The larger budget package set out in the *Summer Economic Statement* is consistent with a 6.5% increase in core spending rather than the 5% originally planned in April. The impact of the larger package on fiscal sustainability is mitigated by the likelihood that revenues will be higher on a sustained basis owing to the higher path for wages and prices.

The faster rate of expansion should allow the Government to accommodate some of the unexpected price and wage pressures that have arisen. However, as Section 2 notes, it will likely fall short of the costs implied by fully tracking these pressures. This implies that the Government will need to make choices between how far it accommodates inflation pressures on welfare rates, pensions, public sector pay and other spending priorities.

The Council assesses that the Government's planned budgetary package sticks relatively close to a neutral fiscal stance, while going some way towards accommodating the exceptional inflationary pressures that have arisen. The Government cannot fully compensate all households for the impact of higher imported energy and food prices.

There could be a strong surplus next year, but, as in 2022, this is likely to be largely explained by excess corporation tax receipts. The excess corporation tax receipts are pushing the public finances into surplus territory, with excess receipts

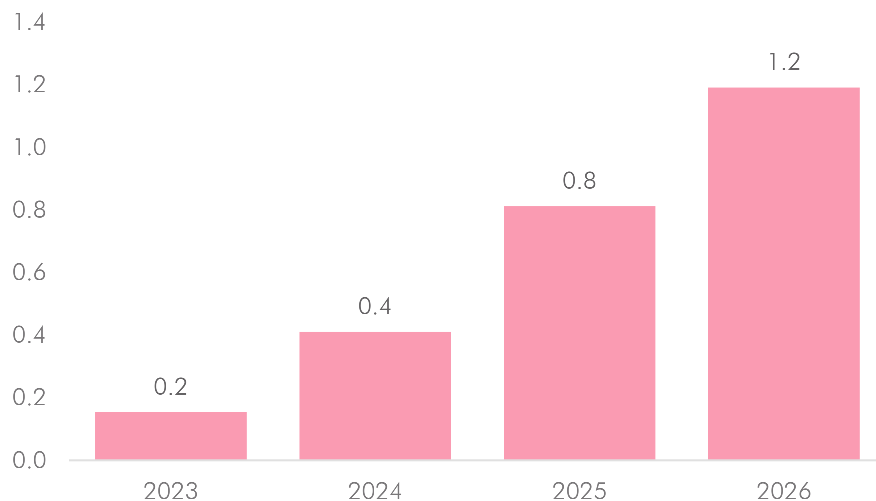
estimated to be close to 3% of GNI* this year (Figure 9). Four-fifths of corporation tax receipts are due to foreign-owned multinational enterprises. Unlike conventional tax receipts paid out of domestic activity, these receipts represent a net injection into the Irish economy — one which, in a tight labour market, can serve to add further upward pressure to house prices, wages and other prices.

A relatively neutral stance achieves three things. First, it avoids excessively boosting the economy when it is already close to full employment, hence limiting the risks of further price increases and domestic overheating. Second, it helps achieve a steady pace of debt reduction, thus banking the gains of the upswing in the economy, and building buffers to support the economy through future downturns. Third, it helps to anchor expectations for how budgets will be managed in the coming years. This provides a better platform for decision making across the public sector — one guided by more predictable availability of resources (IMF, 2013; Ayuso i Casals, 2012; and European Commission, 2007).

By contrast, a decision by the Government to fully track price and wage rises with welfare, pension and public sector pay increases would have important implications. First, it would push spending increases beyond both the *SPU 2022* and *Summer Economic Statement* plans and further beyond the Government's ceiling implied by its 5% Spending Rule. Second, it would risk adding further upward pressure to already rising prices and wages.

Figure 20: The larger fiscal package is likely to add to price pressures

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



Sources: Fiscal Council workings.
Notes: The figure shows a simulation of the HICP inflation impact arising from the additional measures outlined in the *Summer Economic Statement* relative to the package set out in April's SPU. It uses the Council's Maq model (Casey and Purdue, 2021) to estimate the impact of additional spending and tax-reducing measures on the economy.

The more expansionary fiscal stance set out in the *Summer Economic Statement* would add to inflation and borrowing relative to full compliance with the 5%

Spending Rule. Estimates from the Council's Maq model (Casey and Purdue, 2021) would suggest that the additional €2.1 billion of budgetary measures set out in the *Summer Economic Statement* could increase prices in the coming years by around 1.2% (Figure 20). In addition, given that they are permanent measures, they would add some 3.6 percentage points of GNI* to the Government's net debt ratio by 2026. Inflation could be a lot higher in the coming months and years, either due to a surge in energy prices or if wages rise rapidly in response to inflationary pressures.

A useful way to strike a better balance between avoiding further price pressures, while addressing spending pressures would be to target supports carefully. A combination of carefully calibrated temporary and targeted supports and permanent social welfare, wage and spending increases could help to achieve this. The lack of targeting in earlier supports — Council (2022) estimates suggest about 90% were not targeted — means that fewer resources are available than otherwise would be when it comes to supporting those most affected by cost-of-living increases. Ireland's welfare and income tax system offer useful avenues through which to better target supports.

The Government should stand ready to act if domestic economic activity slows markedly or if other risks materialise. The risks around the path for the economy are unusually wide and the prospects for growth are highly uncertain. Further impacts from Russia's war in Ukraine, Covid-19, and international price pressures could derail the economic recovery. Yet it is also possible that shortages of workers and ongoing pressures to expand in areas such as housing and public investment could add fuel to activity if growth continues. Policy should stand ready to adapt to these risks.

The Government's medium- and long-term fiscal stance

The Government has set out several new commitments for how it will manage the public finances over the medium term. First, it commits to stabilise, and reduce slightly, the debt ratio in the coming years. Second, it has committed to a new 5% Spending Rule for core spending. Third, it has committed to only borrowing for capital investment from 2023.

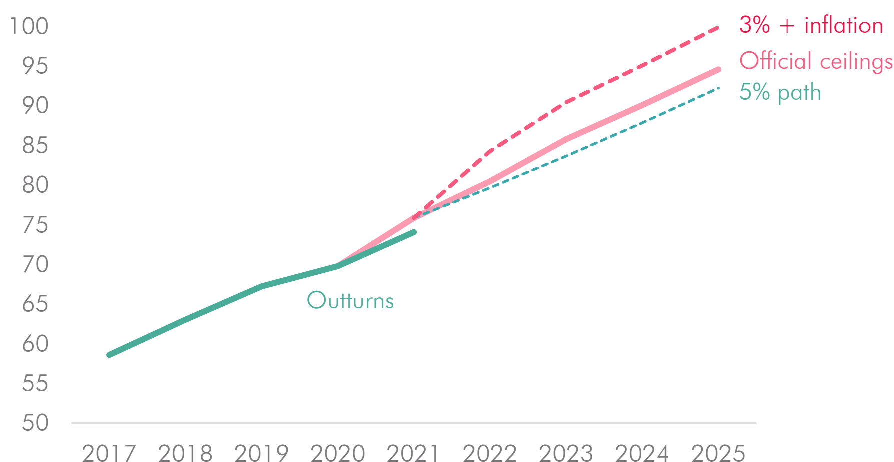
While the Government has opted to "pause" the 5% Spending Rule in 2022, allowing a 6.5% increase instead to respond to exceptional inflation pressures, the rule is due to be restored from 2024. This means that the Government plans to revert the path for spending to 5% increases for 2024 and subsequent years.

The decision to pause the 5% Spending Rule in 2023 will take spending to a higher level than would be implied by a 5% path (Figure 21). The €400 million increase in core spending for 2022 raises the base level of spending this year and the faster 6.5% growth rate for 2023 leads to core expenditure of €85.8

billion as compared to the original ceiling of €84.1 billion. This means a base level of core spending €1.7 billion larger than originally planned in 2023. When compared to what a hypothetical 5% path would imply, by 2025, the spending ceiling would be €2.4 billion higher.[9] However, the level of spending planned would still be lower than if the exceptional inflation levels were allowed for in full (as shown by the "3% + inflation scenario" in Figure 21).

Figure 21: 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 5% 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).

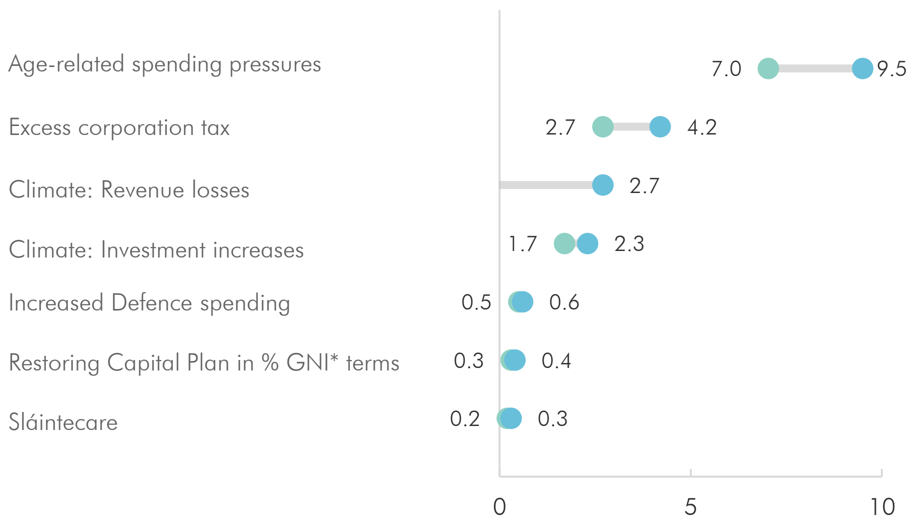
Some allowance for unexpectedly high inflation is warranted given the exceptional nature of the shock. Growth in high-earning sectors is still likely to contribute to a higher tax take (Timoney, 2022), although the sustainability of this remains to be established. The Government's tax plans also imply that income tax measures taken in budgets for 2024 and 2025 will be less than full indexation so that tax revenues would be expected to rise. The net effect would be to partly offset the impact of the higher path for spending on the deficit.

The Council therefore assesses that the Government's medium-term plans under the 5% Spending Rule are conducive to prudent economic and budgetary management.

However, the Government faces major challenges in the coming years and decades that have not been fully costed or built into its budgetary planning (Figure 22).

[9] The original ceilings set out in *Budget 2022* provided for an increase of 5.5% in 2022 and a 5% increase in 2023. The revised ceilings imply increases of 6% and 6.5%, respectively.

Figure 22: Medium and long-term challenges need to be addressed
% GNI*, estimated cost range



Sources: FitzGerald (2021); Commission on the Defence Forces (2022); and Council estimates.
Notes: Age-related spending pressures from Council's Long-term Sustainability Report (2020) are the pessimistic to optimistic range of outcomes for total age-related expenditure. Excess corporation tax estimates are from the May Fiscal Assessment Report (Fiscal Council, 2022). Climate-related revenue losses are shown as a range up to 2.7% of GNI* — the Council's estimate of total general government revenues sensitive to changes in climate policy. Climate-related investment increases draw on scenarios in FitzGerald (2021). Actual costs are likely to be higher as agricultural emissions are planned to be reduced by less than in the higher cost scenario. Defence spending increases are estimated based on Government statements suggesting increases of at least €500 million per annum that broadly align with middle estimates in the Report of the Commission on the Defence Forces (2022), where spending rises by 0.2 to 0.3 per cent of GNI* annually. Cost estimates for restoring the capital plan to its original path are consistent with the originally implied % GNI* level. Actual costs could be greater as construction costs have risen at a faster rate than economy-wide inflation. Sláintecare estimates are based on the Council's mechanical update of the original 2017 cost estimates using wage and price pressures that have arisen since 2017 less the estimated amount of recurrent spending allocated to date.

Ageing pressures: The Irish population is rapidly ageing. This will put pressure on pension and healthcare spending at the same time that growth is likely to slow.[10] The Council's (2020) estimates suggest that total age-related spending pressures could mount to a level that is between 7 and 9.5 percentage points of GNI* higher by 2050 compared to 2019. This is a substantial increase and represents by far the largest challenge to the public finances in the coming years and decades (Figure 22).

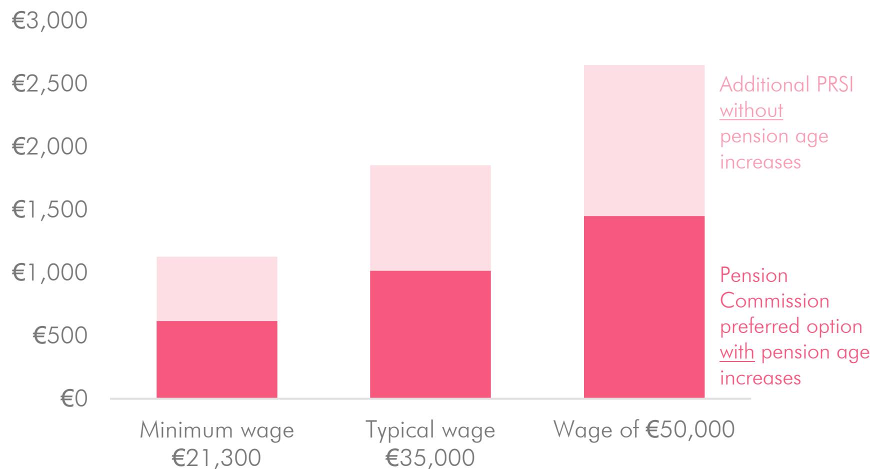
The Government has yet to announce its formal response to the report from the Pensions Commission published last October. However, it has indicated that this is forthcoming. It has further signalled that it will not raise the pension age, compared to earlier plans to raise the pension age to 67 in 2021. Maintaining the pension age while life expectancy at 65 continues to rise will mean a longer expected retirement period and adds to the cost of pensions. This comes at the same time that the number of people reaching age 65 rises rapidly as Ireland's baby-boomers begin to retire.

[10] Growth is likely to moderate due to both a shrinking labour force and maturing level of productivity, which implies moderating growth rates in future (see Box A Council, 2020).

Over the coming years, higher pension costs from ageing alone — not counting higher prices — will add around €500 million each year to public spending. Very large increases in taxation will be required to meet these challenges: for a worker on a typical annual wage of about €35,000, around €1,000 additional taxes per year would be needed in the coming decades just to finance the larger number of people reaching retirement age (Figure 23). An additional €800 increase in taxes would be required to keep the pension age at its current level. Earlier increases in taxes would help to raise revenues while a large share of the population is in work and reduce the burden on future generations.

Figure 23: PRSI increases for workers based on pension reforms

€ change implied for PRSI in today's terms based on policy options



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 using PRSI rate increases assumed out to 2050. There is still an additional "Exchequer Contribution" in both packages, which may have to be made up with further tax increases.

Overreliance on excess corporation tax receipts: Corporation tax receipts look set to overtake VAT as Ireland's second largest source of tax revenues this year. Up until 2015, it was the fourth largest tax source. However, the State's reliance on this tax source to fund recurring spending is risky. Corporation tax receipts are the most volatile and least predictable of the main taxes Ireland collects.[11] They are also extremely concentrated — ten corporate groups account for 56% of receipts. Moreover, a large proportion of receipts cannot be explained by underlying economic activity in Ireland. The Council's estimates suggest that some €6 to 9 billion (40–60%) of the total €15.3 billion of annual corporation taxes collected in 2021 are not explained by the performance of the domestic economy. These receipts could be subject to sudden reversals, given their concentrated and unpredictable nature, as well as their exposure to changes in the global tax environment.

Climate-related impacts: The Government has not spelled out the fiscal costs of achieving its required 51% reduction in greenhouse-gas emissions by 2030. Yet

[11] See Box G in the May 2022 Fiscal Assessment Report.

the potential costs to the State could be sizeable. This is reflected in terms of the annual revenues at risk, which could amount to as much as 2.7% of GNI*. It is also reflected in terms of substantial additional public investment required. FitzGerald (2021) puts the additional investment costs at between 1.7 and 2.3% of GNI*. The former estimates assumed an even set of reductions across agriculture and other energy emissions of 51% each. But the latter represent a more costly scenario where agricultural emissions are cut by less (–33%) so that energy emissions take on a greater burden (–61%). In late-July, the Government agreed to reducing agricultural emissions by even less (–25%) than what was assumed in the costlier scenario.[12] This would suggest that the investment increases required could be higher than the upper estimates in FitzGerald (2021).

As well as that, the Government will also have to assess the potential costs of raising defence spending, achieving its capital plans, and implementing Sláintecare reforms. These commitments will potentially be more costly when implemented at a time of labour shortages and capacity constraints, most notably in the construction sector (Conroy, Casey, and Jordan-Doak, 2021).

Reinforcing how Ireland approaches budgeting would help

The Government should carefully develop its budgeting framework to help tackle these medium- and long-term challenges effectively, while ensuring it achieves value for money. A shift to more robust multi-year budgeting would support these objectives. It would also give stakeholders greater certainty over what can be expected in the coming years.

Three things would help in terms of how Ireland approaches its budgeting.

1) The 5% Spending Rule should be reinforced to give it legislative status, to capture general government spending, link it to debt targets, and recognise the impact of tax measures. The legally required 3-year Departmental ceilings should be set as part of the Budget — as was done in the past — and these should be realistic and fully consistent with the 5% Spending Rule.

2) The Rainy Day Fund or a new Pension Reserve Fund should be used at a minimum to cap and preferably to reduce excess reliance on corporation

[12] See the Government's Press Release on the pathway to a 51% reduction in overall emissions at: https://www.gov.ie/en/press-release/40b39-pathway-to-51-reduction-in-economy-wide-emissions-agreed-mcconalogue-confirms-25-reduction-in-agricultural-emissions/#:~:text=%E2%80%9CToday%20the%20government%20has%20agreed,the%20Climate%20Action%20Plan%202021.

tax receipts.[13] Related to this, the Government should routinely identify the level of excess corporation tax receipts it estimates to exist and show the general government balance with and without these receipts as recommended by the Council and implemented in July's *Summer Economic Statement* for the first time.

3) The Government needs to cost its major commitments properly and identify potential alternative revenue streams should these be needed. This includes the costs of achieving climate objectives, implementing Sláintecare, and addressing rising age-related spending.

The Government now has an opportunity to bring debt to lower levels in the coming years, while also protecting supports and services for those most vulnerable to rising prices. Establishing a stronger framework for budgeting in the coming years would help to anchor future decisions. It would help to build buffers so that future crises could be alleviated through sizeable Government supports in a similar way to the pandemic. A greater medium- and long-term focus would also ensure that the public finances remain sustainable, while significant policy challenges are met.

How the Budget itself is set out, including the accompanying documentation, should also be improved. Macroeconomic and fiscal forecasts included in the Budget should cover at least the next 5 years. This means that Budget 2023 should include forecasts out to at least 2027. The Department have committed to forecasting on a five-year horizon in the past. This would help to ensure sound medium-term planning, would help make clear the future costs of current policies, and allows for an appropriate assessment of the medium-term risks. The parliamentary term should not affect the horizon of official macroeconomic and fiscal forecasts.

The White Paper, an important pre-Budget document covering a no-policy change scenario, should be modernised.[14] A full breakdown of the expected no-policy change expenditure and revenue on a general government basis should be provided. Figures in the White Paper should also be presented on a "Gross" Exchequer basis rather than on a net basis, which tends to mask underlying developments when there are offsetting transactions. Figures for expected spending by Department should be included. The White Paper should also cover

[13] See the recent opinion piece from the Council on saving excess corporation tax revenues to limit future tax rises needed to pay for pensions. The Rainy Day Fund as currently designed suffers from several shortcomings. The Council has noted in the past that it should be developed further to 1) remove the arbitrary €8 billion cap, 2) make allocations flexible to economic cycle 3) clarify how drawdowns work under the fiscal rules; and 4) use it to help manage future unexpected receipts, including from corporation tax.

[14] The White Paper, also known as the "Estimates of Receipts and Expenditure for the year ending 31 December XXXX", is a technical document published prior to the Budget outlining the expected revenue and the costs of maintaining existing policies.

a five-year forecast horizon. Pre-budget analysis would be helped by also including this information in the *Summer Economic Statement*.

The Fiscal Rules

While the *Summer Economic Statement* only provides a partial update of official forecasts, the rules look set to be complied with in the coming years. The General Escape Clause has been extended to 2023 by the European Commission, and the Council assesses that exceptional circumstances exist in 2022. This means that the EU rules, in effect, do not apply for this year and next, while the domestic rules do not apply for this year.

The structural balance as typically estimated looks set to be in excess of what is required, while the debt-to-GDP ratio was projected to remain below the 60% threshold. Faster than expected growth and larger surpluses could allow for a faster pace of debt reduction, while a closed or negative output gap would indicate that the structural balance will remain in compliance with the MTO.

Corporation tax and the use of GDP in assessing compliance with the EU fiscal rules and domestic Budgetary Rule both continue to flatter the assessments. While the Government is likely to run a surplus this year above what was projected at the time of the SPU, this is largely explained by excess corporation tax receipts (Figure 9).

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