Irish Fiscal Advisory Council

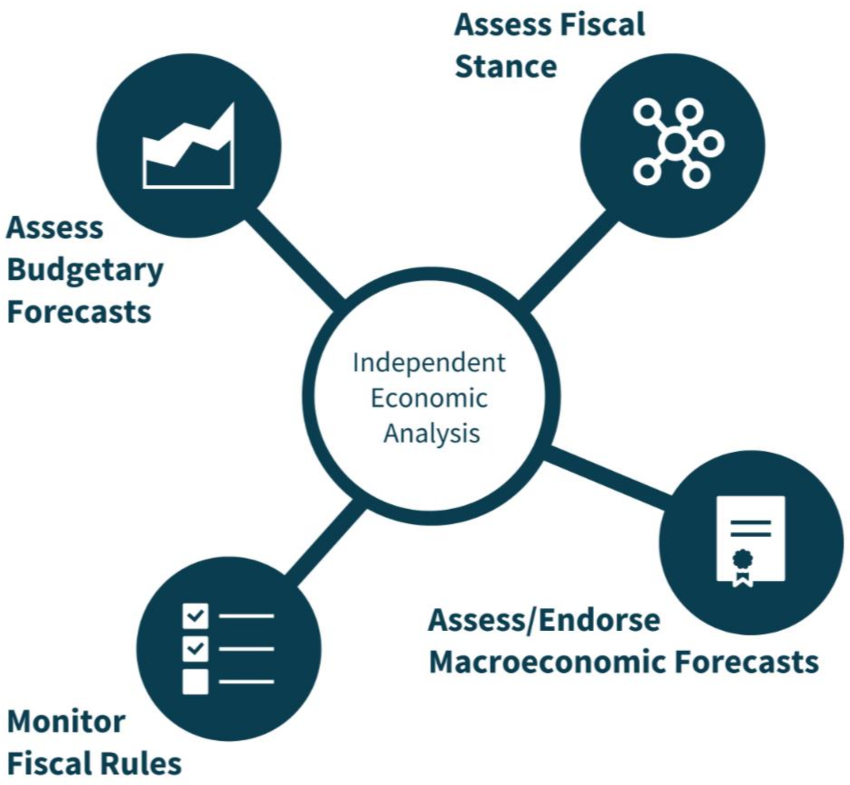
Fiscal Assessment Report

A Budget in the time of inflation

November 2022

Background

- The Fiscal Council is an official independent body with a mandate to assess the public finances
- The November 2022 *Fiscal Assessment Report* provides an assessment of Budget 2023



Key messages

Key messages

Ireland's economic growth has slowed considerably

- Inflation is set to remain high into next year
- Uncertainty is high about the prospects in the global economy and domestic price pressures

The Government forecasts a deficit of 3.1% of GNI* for this year (excl. excess corporation taxes)

- Improvement has been driven by strong tax receipts and ending of pandemic-related spending
- Contingencies have been used to pay for Ukrainian refugees and cost-of-living supports

Budget 2023 introduced a large package of €11 billion of measures for 2023

- €6.9 billion in permanent measures: €5.8 billion on spending, €1.1 billion on tax measures
- €3.9 billion in temporary measures aimed at addressing the rise in the cost of living

This strikes an appropriate balance between protecting vulnerable households and avoiding inflation

- The temporary deviation from the Spending Rule to allow a 6.8% increase in core spending is sensible
- This does not compensate for inflation in full, but the large package of temporary supports helps

Under the 5% spending rule, there would be an underlying budget surplus from 2024

- The debt ratio would be on a downward path
- But, this would be insufficient to "standstill" in terms of current levels of public services and taxes given ageing pressures

Key messages

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The Government needs to improve planning for the long term

- Meeting climate change objectives is likely to have large fiscal costs
- The Government decision not to raise the pension age will add to the future tax burden
- Reliance on unpredictable corporation tax receipts needs to be reduced over time

The fiscal framework should be strengthened

- Forecasts should be made at least to 5 years ahead
- The 5% Spending Rule should be reinforced to recognise the impact of tax measures, capture the full range of general government spending, and link it to debt targets
- Multiyear baseline Departmental expenditure plans should be published with the headline ceilings
- The recommendations of the Tax and Welfare Commission should be quantified

The restoration of the National Reserve Fund is welcome to avoid further increasing reliance on corporation tax receipts

- However, the Fund needs to be better designed and re-focused on saving for future pensions costs

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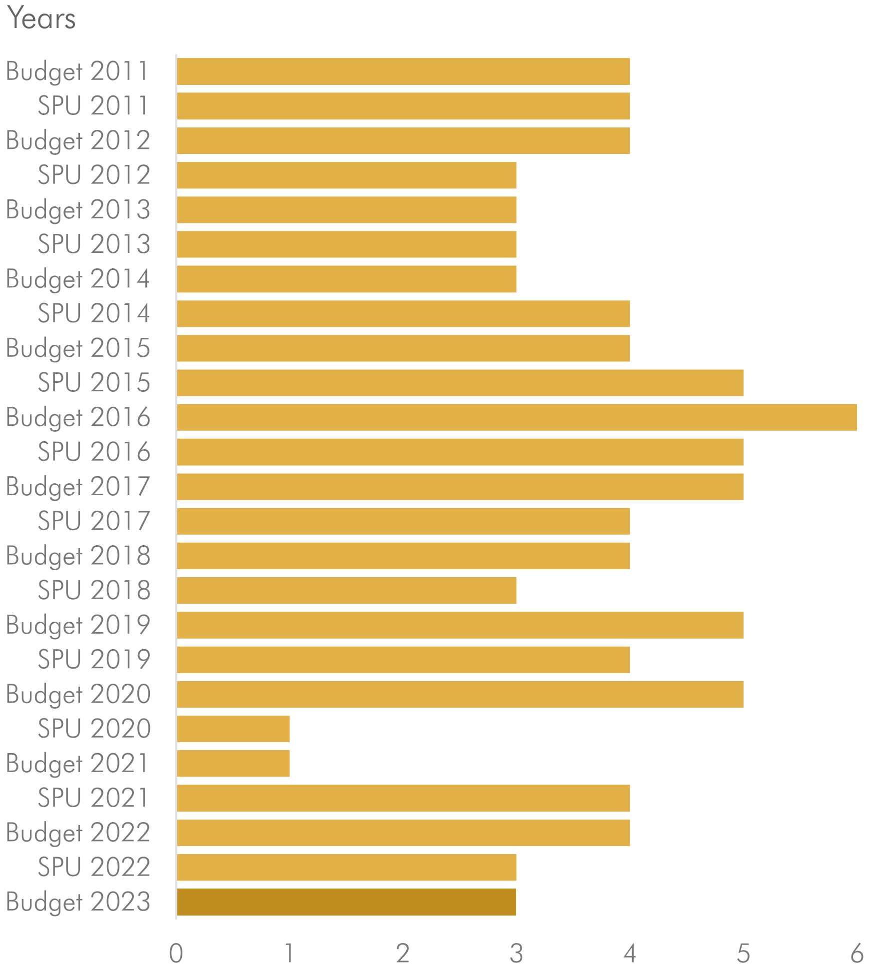
The 3-year forecast horizon is too short, undermining medium-term budgeting

Budget 2023 only forecasts to three years ahead



- This makes it difficult to understand the recovery from the energy shock…
- …and medium-term fiscal pressures like ageing and climate change
- Forecasts should always be made to at least 5-years ahead

Economic outlook

Inflation is running at a high level

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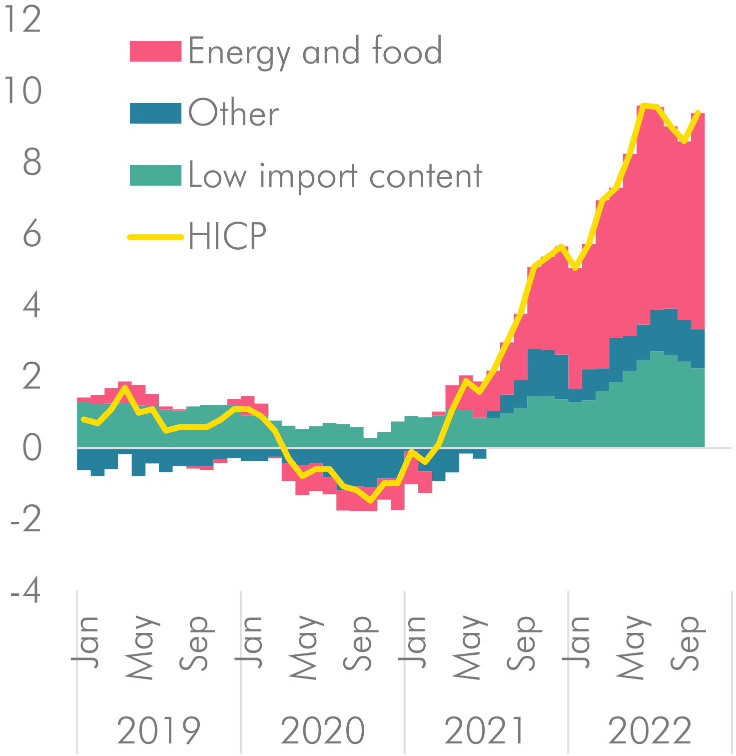
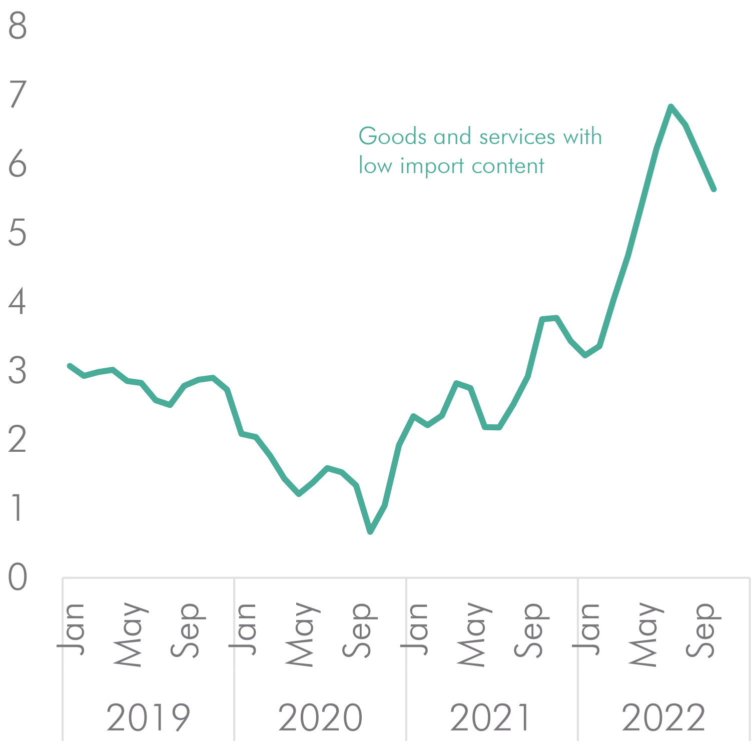
Inflation driven by energy and food

Year-on-year % change and p.p contributions



Domestic inflation has picked up

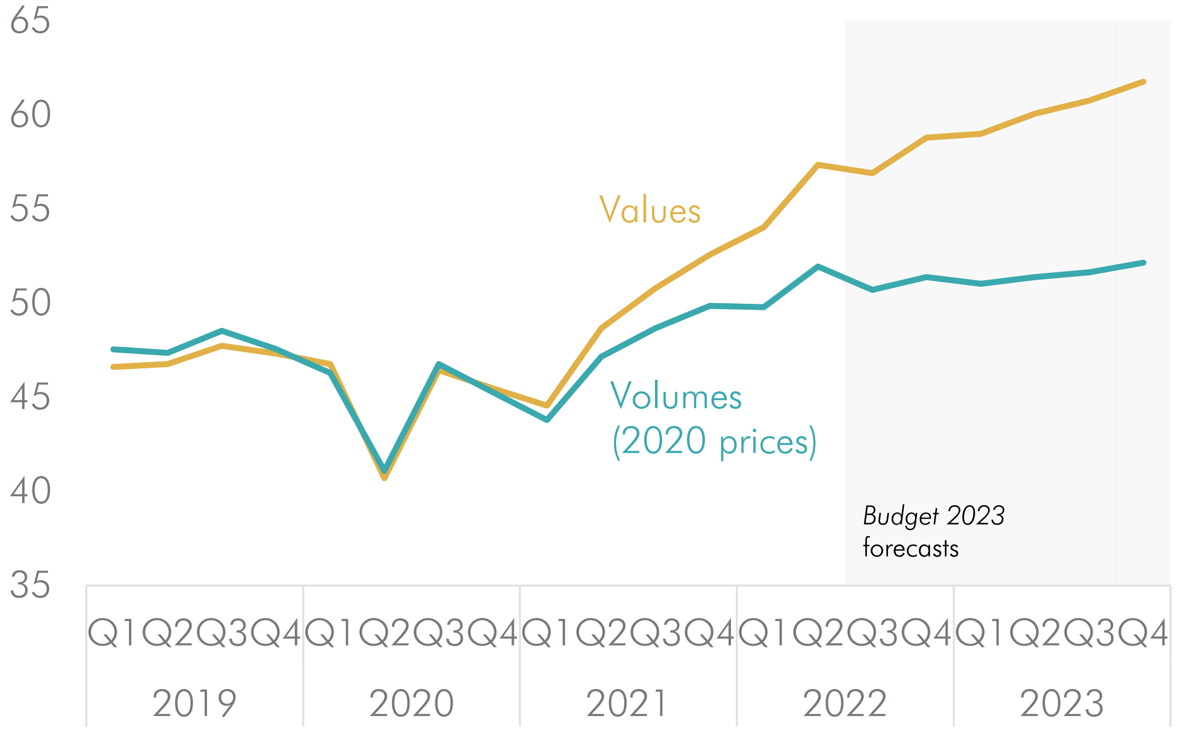
Year-on-year % change



Sources: Eurostat; Fröhling, et al. (2022) and Fiscal Council workings.
Notes: The goods and services with low import are identified by Fröhling, et al. (2022) for the euro area, and replicated here using Ireland's HICP data. "Rest" refers to non-energy and food goods and services with high import content.

High inflation has stunted the recovery

Modified domestic demand has stagnated due to inflation
€ billion, seasonally adjusted



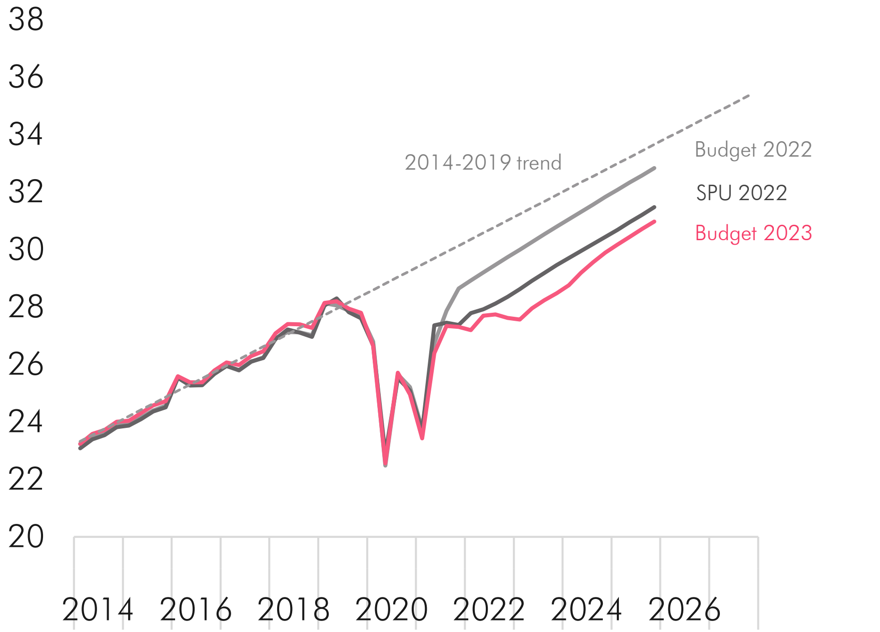
Sources: CSO; Department of Finance; and Fiscal Council workings.

- Higher prices are depressing the volume of spending
- Demand is expected to be flat over the coming quarters
- Internationally, demand is being hit by higher uncertainty and tighter financial conditions

Consumption growth is set to slow, but the starting position is unclear

Budget 2023 projects weaker consumer spending

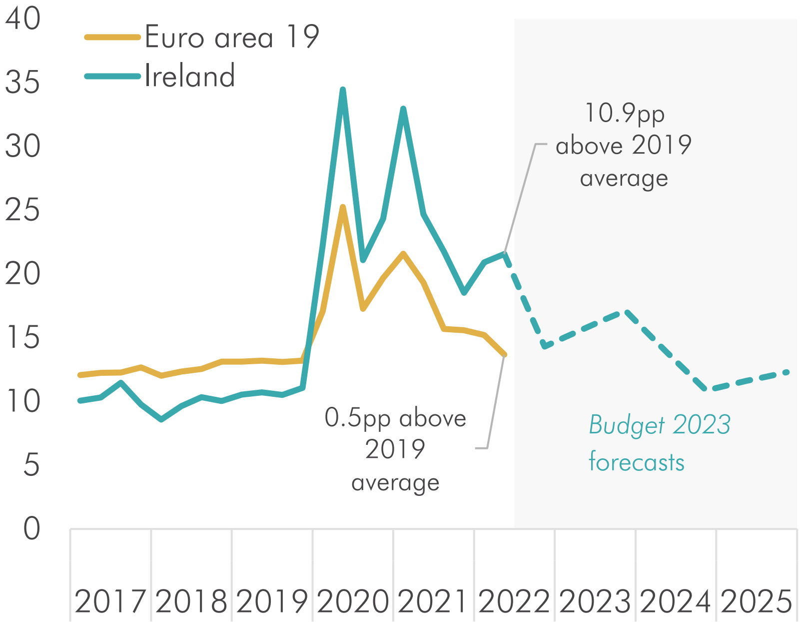
€ billion, 2020 constant prices, seasonally adjusted



Sources: CSO, Department of Finance, and Fiscal Council workings.
Notes: The profiles shown use adjusted historical data to ensure seasonally adjusted levels sum exactly to the non-seasonally adjusted levels. Projections are similarly adjusted with respect to the Department's annual level projections.

Household savings increased in 2022, unlike euro area

Gross savings as % of disposable income, seasonally adjusted



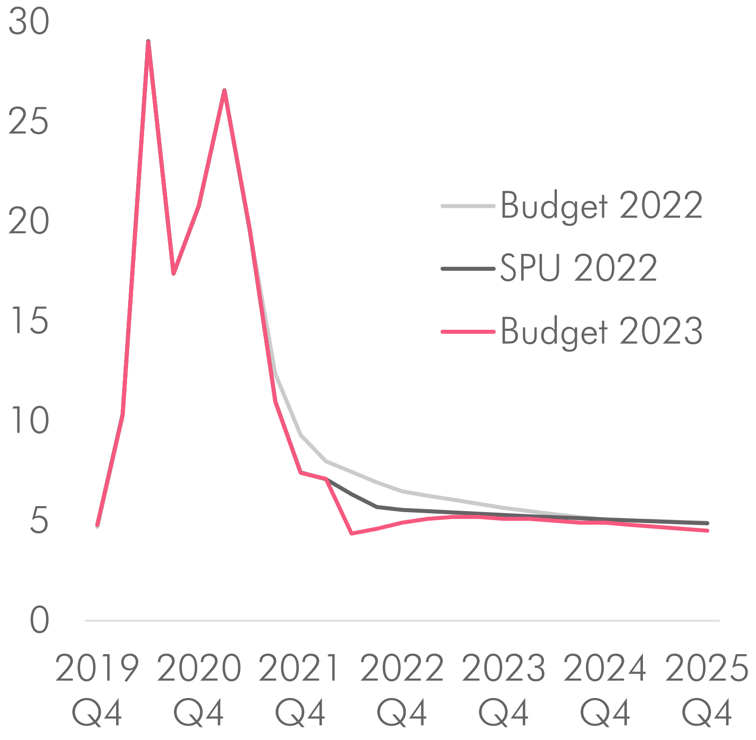
Sources: CSO; Eurostat; Department of Finance; and Fiscal Council workings.

New Analytical Note

The labour market has remained tight, but is projected to weaken

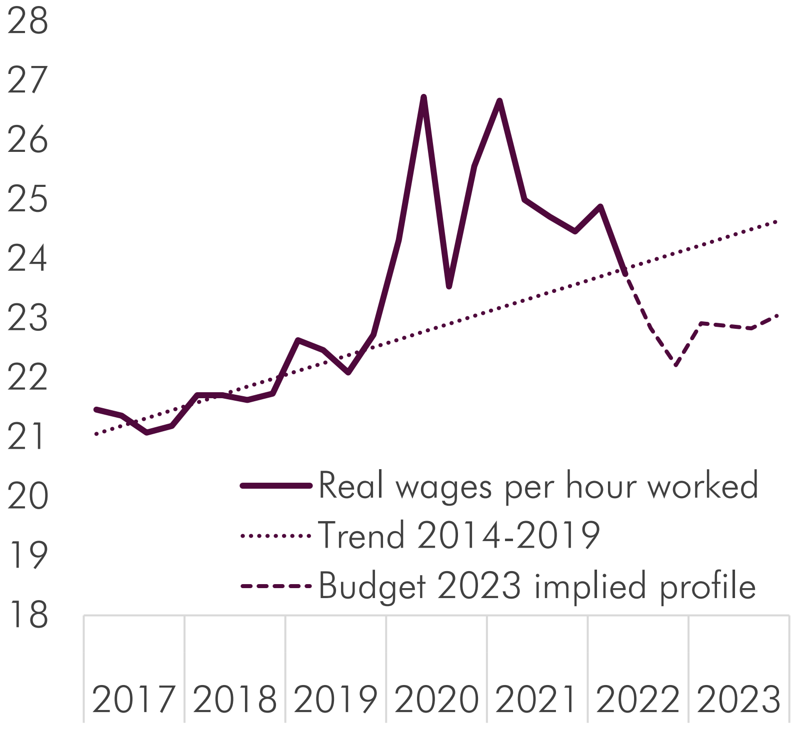
Unemployment to rise slightly from historical lows

% labour force, ages 15–74



Real wages per hour worked

€, 2015 prices (HICP), seasonally adjusted



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

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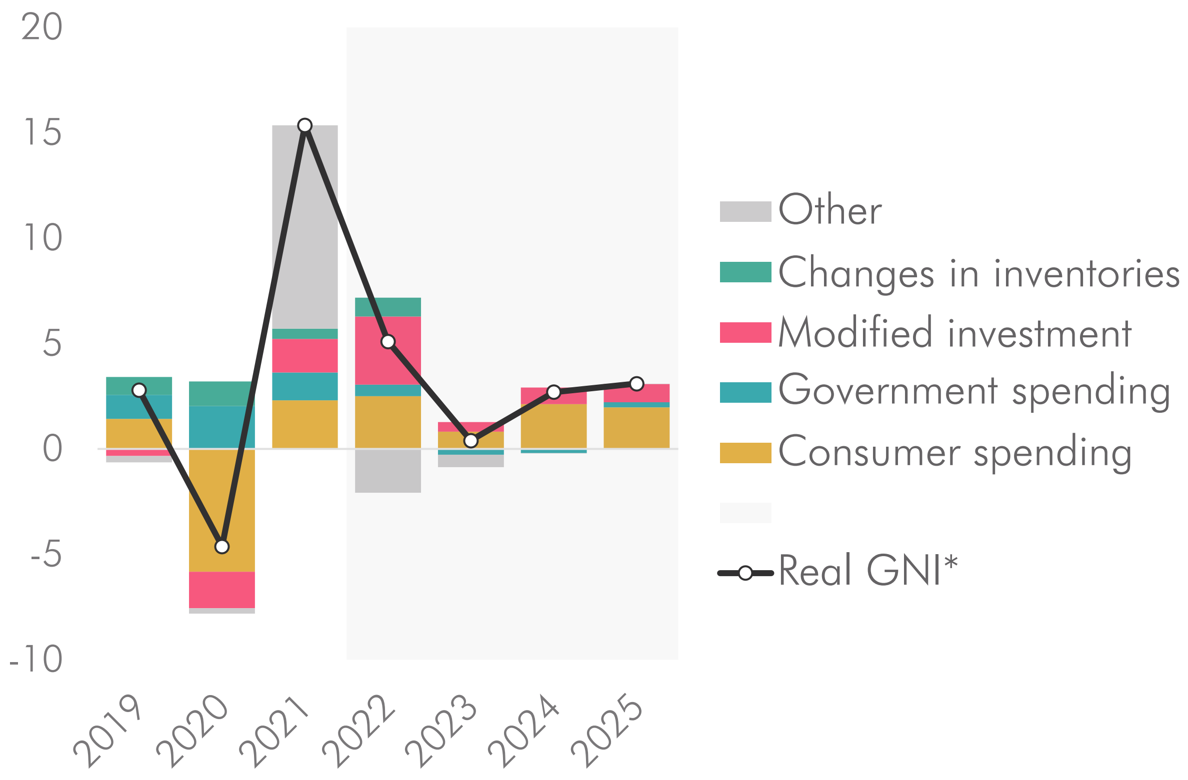
Over the medium term, growth is forecast to recover

Real GNI* growth

% change year-on-year and p.p. contributions



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

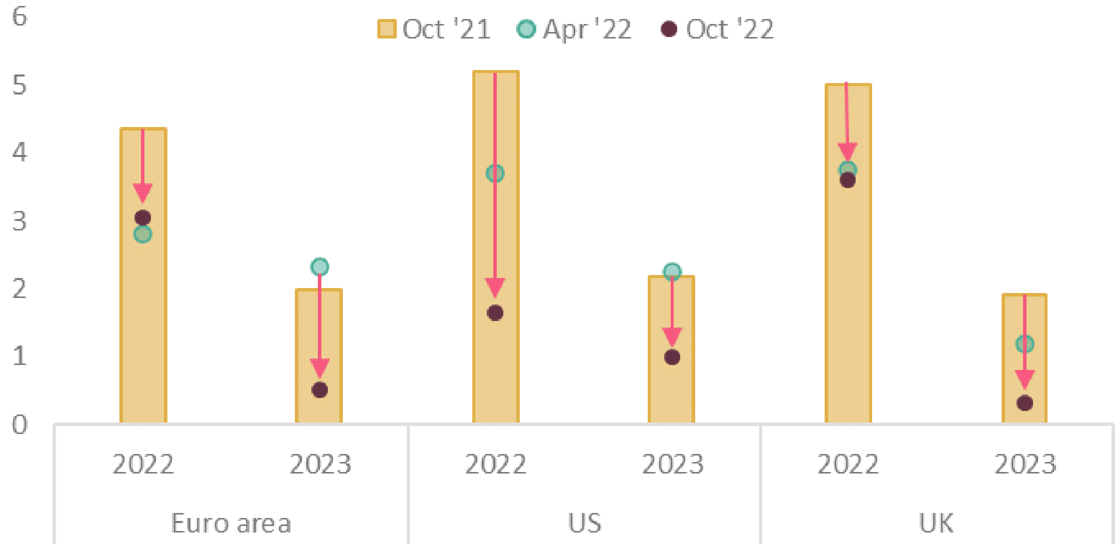
- But, output is expected to be permanently lower due to higher energy costs
- Household disposable income could fall by close to 5% in 2022/23

Risks to activity are mainly to the downside

- Risks around energy supply in Europe remain
- An intensification of the war in Ukraine or adverse market developments could hit prices and activity
- Domestic price pressures could be stronger than anticipated
- There is uncertainty about the housing market and the digital sector

Risks to the outlook are highlighted by downward revisions to forecasts of output growth in Ireland's main trading partners

Year-on-year % change in real GDP



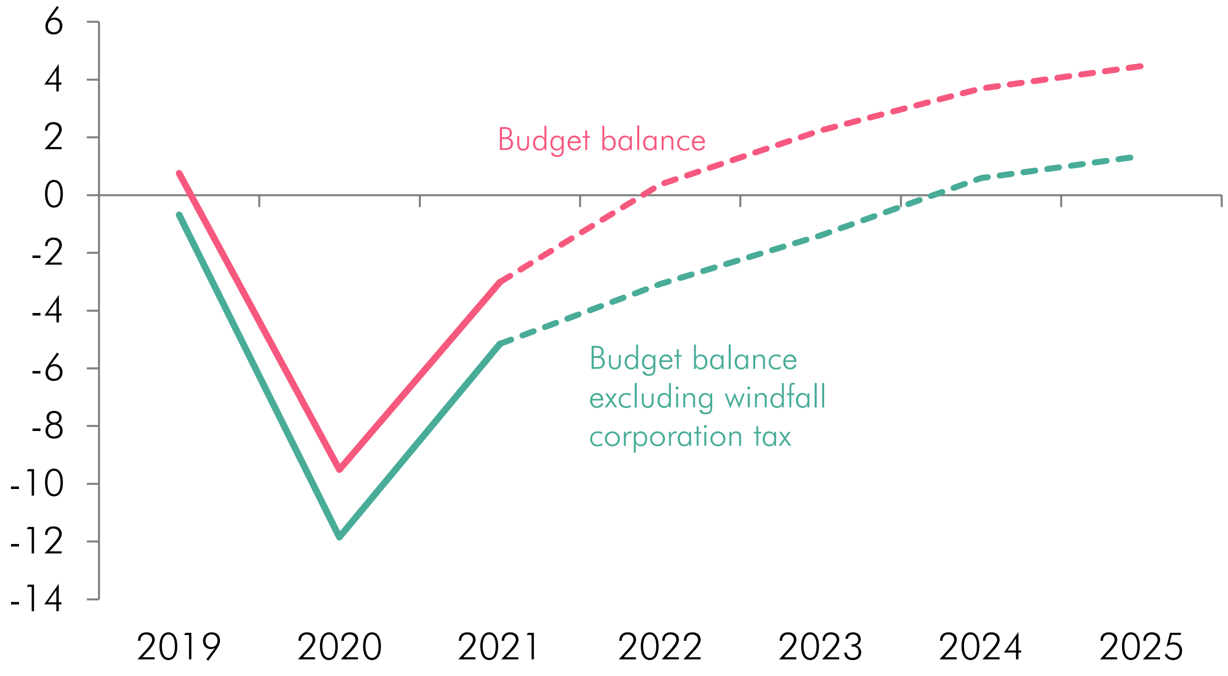
Source: IMF.

Budget outlook

A new measure — the budget balance *excluding excess corporation tax receipts*

Balance excluding windfall corporation tax

% of GNI*, general government



- It removes the part of corporation tax that cannot be explained by growth of the domestic economy since 2014
- This is welcome and should be more widely applied
- This measure is more robust and will not vary with movements in corporation tax paid by multinationals

Sources: CSO; *Budget 2023* projections; and Fiscal Council workings.
Note: Dashed line indicates *Budget 2023* forecasts. Fiscal Council estimates of excess corporation tax receipts are used for 2015 – 2020. Estimates of excess corporation tax for 2021 – 2025 are taken from *Budget 2023*. Revenue and expenditure one-offs are as assessed by the Council.

The Government forecasts a deficit of 3.1% of GNI* for this year (exc. excess corporation tax receipts)

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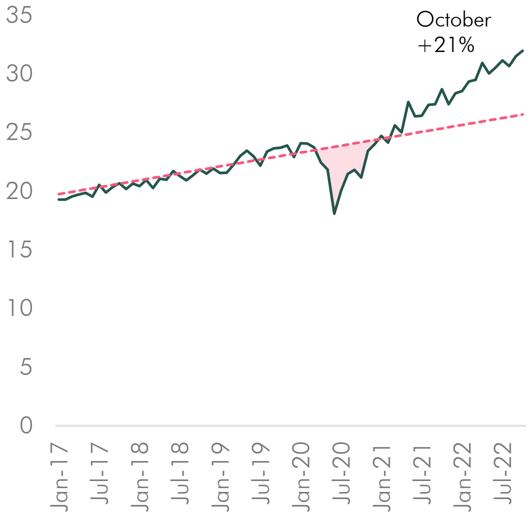
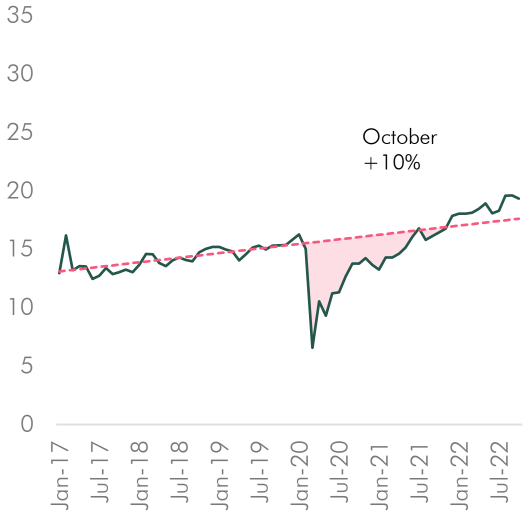
Income tax
€ billion, seasonally adjusted and annualised



VAT
€ billion, seasonally adjusted and annualised



Sources: CSO; Department of Finance, and Fiscal Council workings.
Notes: Monthly tax data are seasonally adjusted and annualised (× 12). The pre-pandemic trend is calculated as a linear trend from Jan 2015 to Dec 2019; % differences refer to the gap between the current seasonally adjusted level annualised and its pre-pandemic trend.

- Income tax and VAT revenues have grown strongly
- Pandemic supports have been scaled down
- €12 bn of temporary spending measures were used for Covid, refugees and cost-of-living measures and concrete blocks redress scheme
- In the final months, public sector pay and welfare have increased

Budget 2023 set out an unusually large package of measures

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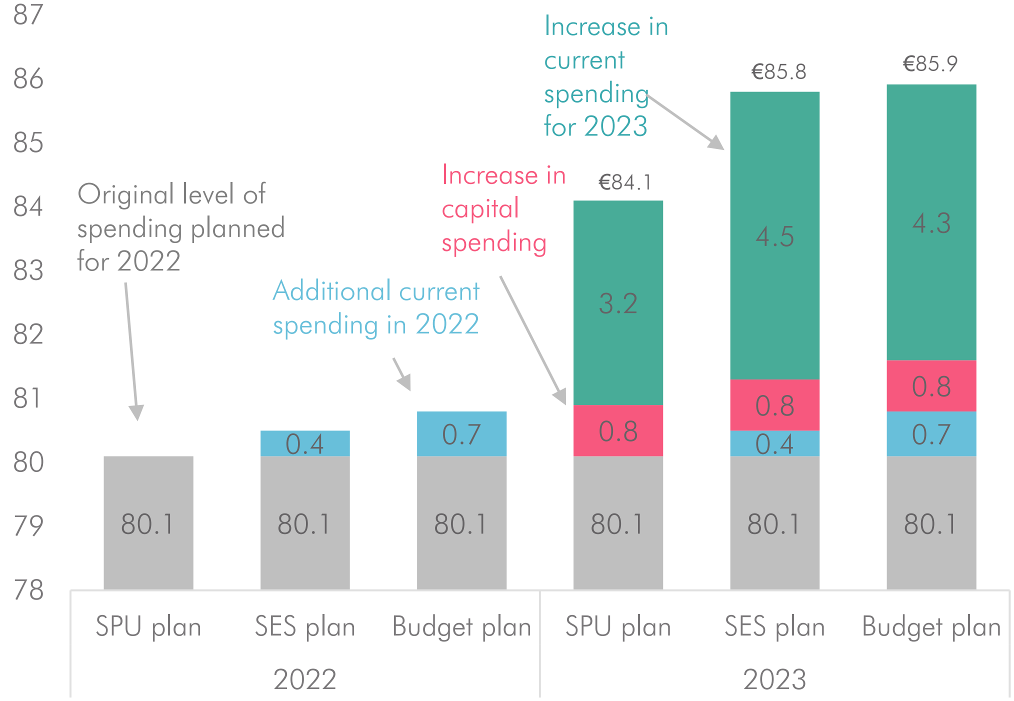
Evolution of the "core" spending plan

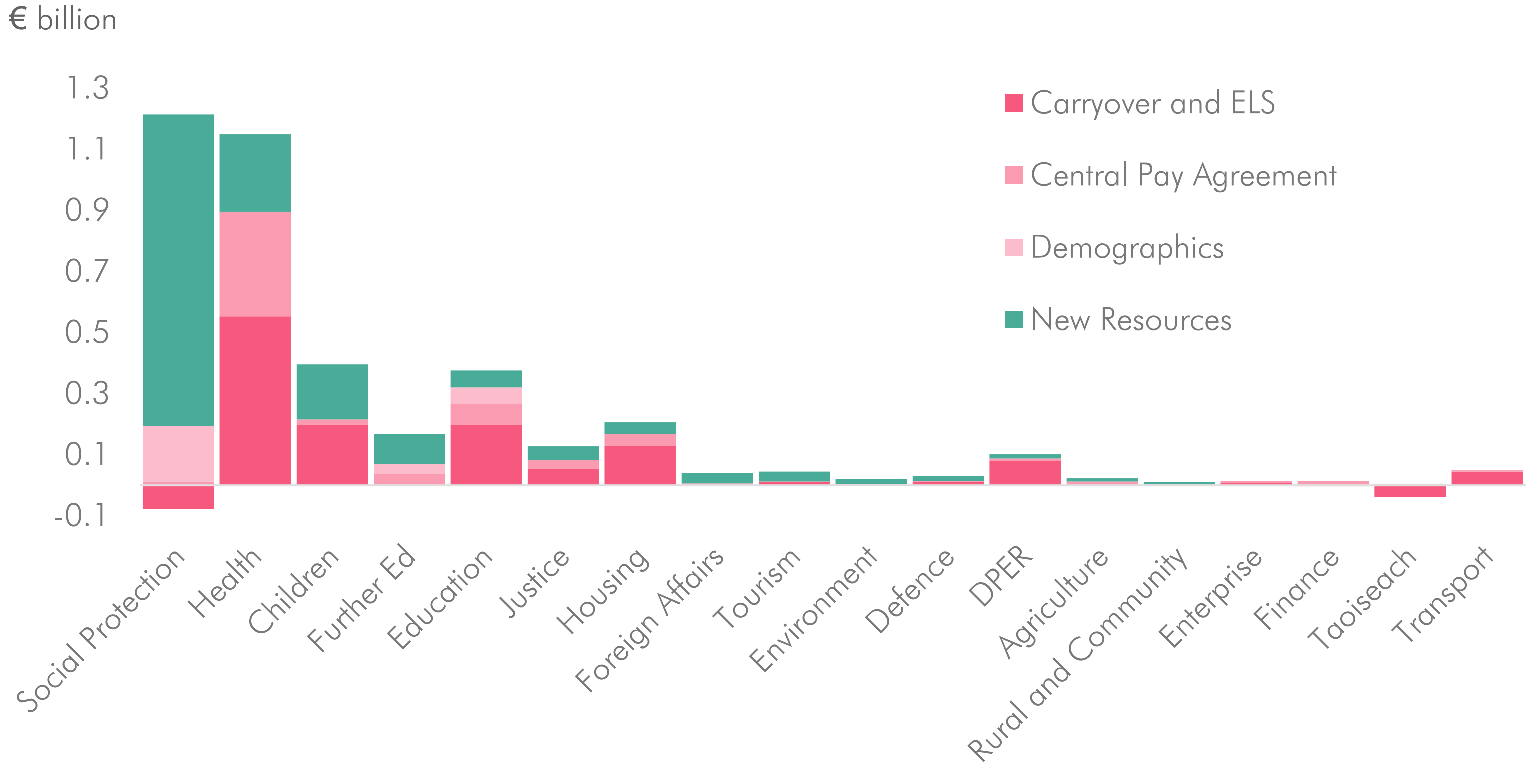
€ billion, gross voted "core"



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

- €11 billion of measures for 2023
- €6.9 billion in permanent measures:
  - €5.8 billion on spending
  - €1.1 billion on tax measures
- €3.9 billion in temporary measures

Permanent measures were mostly aimed at the cost-of-living and public sector pay



Source: Department of Finance.
Notes: This table outlines the allocations included in the Expenditure Report 2023. It excludes the unallocated amounts of €1.4bn contained in the overall budgetary package for 2023 to cover costs arising from the potential approval and implementation the extension of the Building Momentum pay agreement. The figure for Health "carryover and ELS" also includes demographics as the *Expenditure Report 2023* did not provide these figures separately.

These measures are large in cash terms, but do not fully compensate for high inflation

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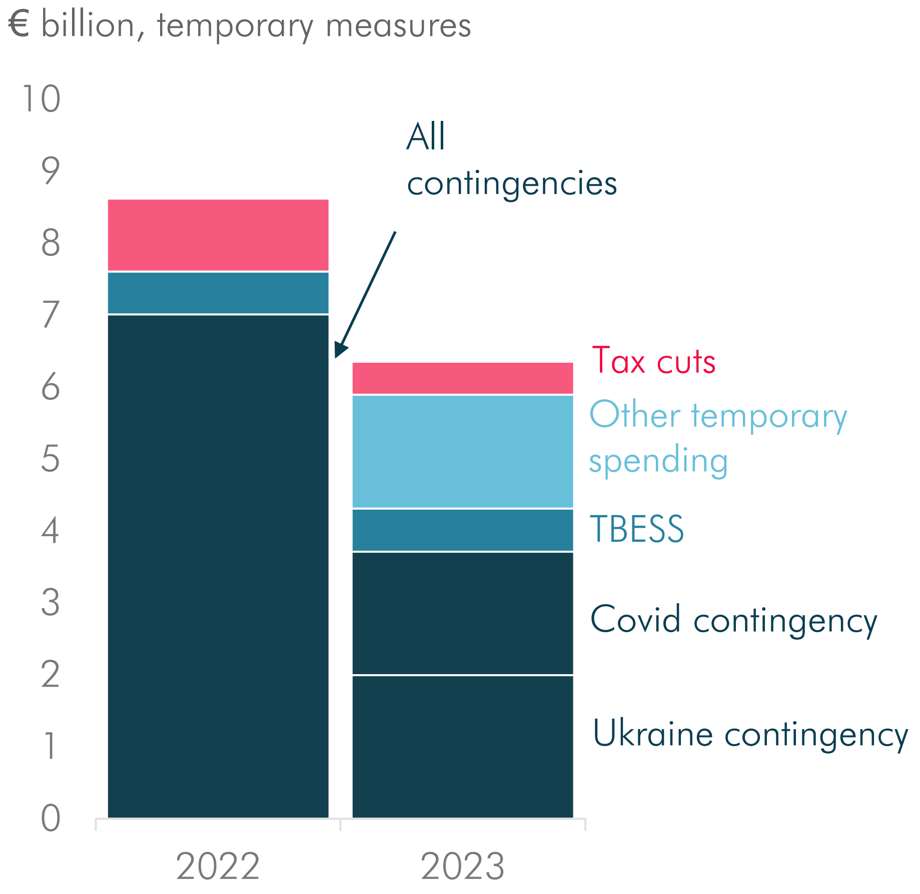
Temporary measures play an important role



- Sensible to use temporary measures to smooth adjustment and given uncertainty
- Around 1/3 of measures targeted

Main temporary support measures

Budget 2023 temporary measures

€ million

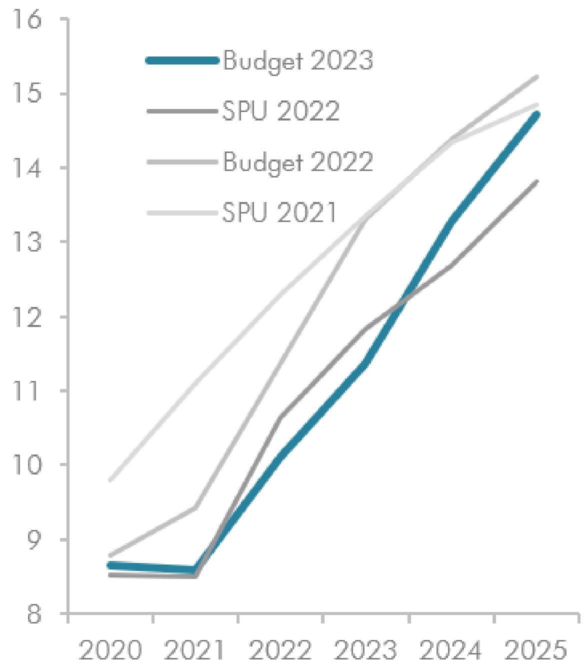
Total temporary measures	3,938	Targeted?
Spending measures	3,612	
For Households	2,212	
Electricity credit	1,200	No
Double welfare payment	316	Yes
Fuel allowance	149	Yes
Carers, disability allowance, blind allowance etc.	175	Yes
Living alone allowance	46	Yes
Working family payment	23	Yes
Child benefit	170	No
Student fees reduction	106	No
Student (SUSI) maintenance and PhD payment	19	Yes
Student assistance fund	8	Yes
For Businesses	1,400	
Ukraine emergency response scheme	200	No
Business energy support scheme	1,200	No
Tax measures	326	
Excise cut on petrol, diesel, market gas oil	281	No
VAT cut on gas and electricity	45	No

Sources: Department of Finance; and Fiscal Council workings.
Notes: As outlined above, the rent tax credit is not included as a one-off measure as it is intended to be permanent. The Council treat the rent tax credit as applying on a permanent basis from 2022, as it is accrued on rent paid in 2022. Both of the business supports listed above are classified as untargeted. This is because both schemes appear to be applicable to almost all firms.

Public investment has been revised down

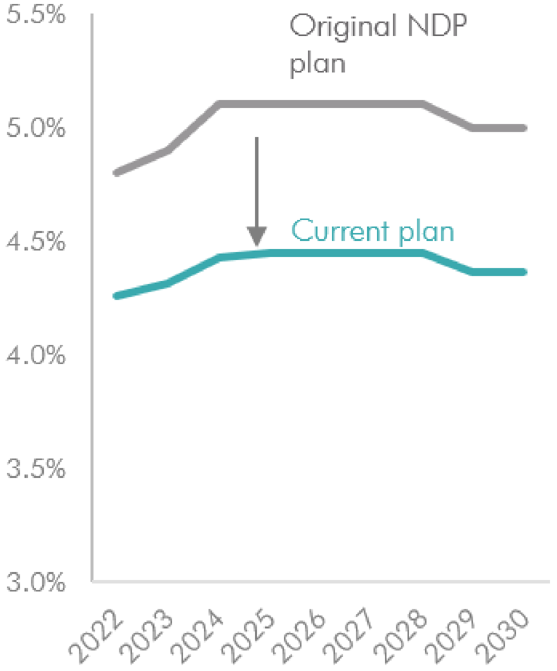
Capital spending revised down

€ billion, general government investment



NDP plans would now represent a lower share of national income

% GNI*, Exchequer capital

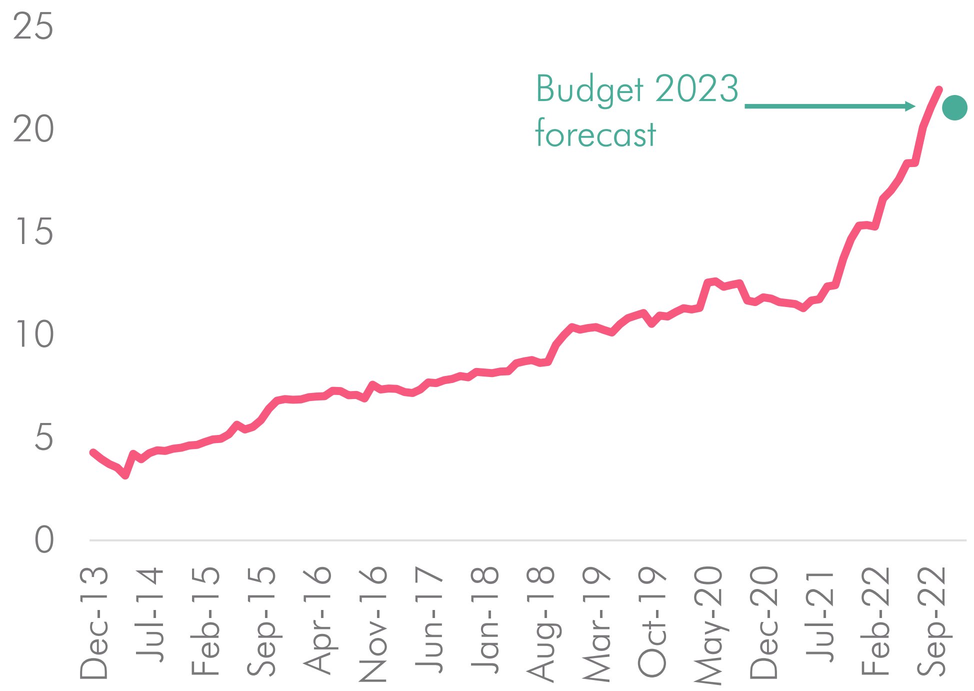


- Higher prices imply pressures on spending or that less will be delivered
- Investment will remain high by historical standards
- Planning should be improved, particularly outside the Exchequer

Corporation tax is now the 2nd largest tax head, overtaking VAT

Corporation tax

€ billion, 12-month rolling sum



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

- These receipts are unpredictable
- A large share is accounted for by 4-5 multinational firms
- Firm-specific factors are hard to predict
- These receipts rely heavily on the digital sector
- International tax policy changes could have a large but uncertain impact

Under the 5% Spending Rule, there would be an underlying surplus of 1-2% GNI* in the coming years

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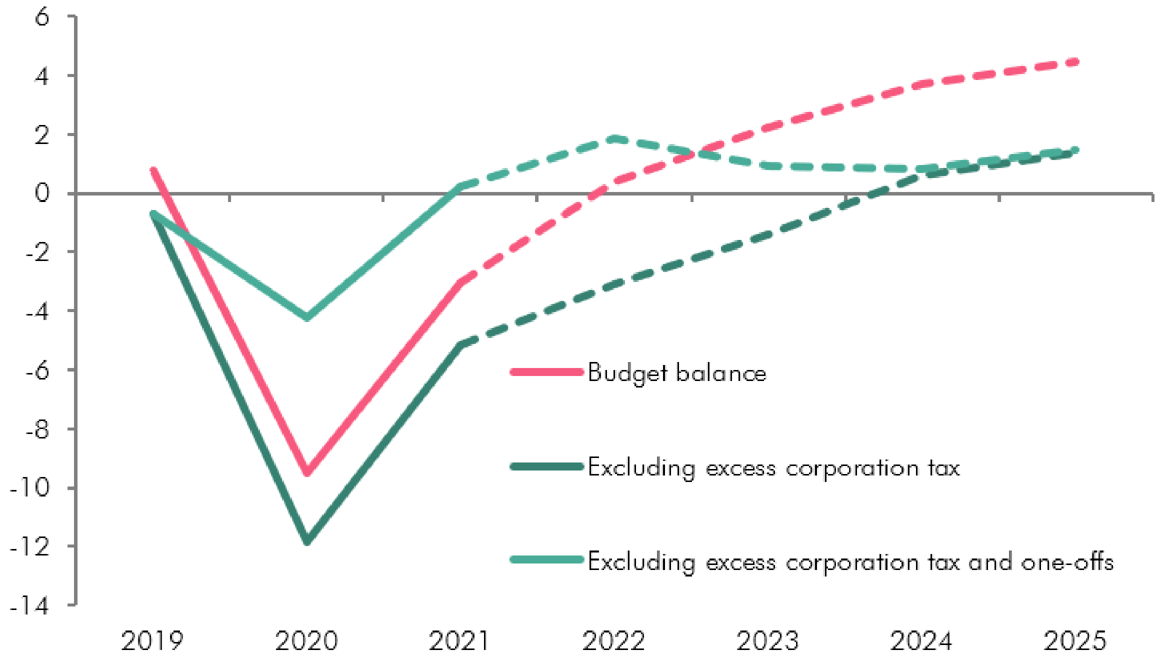
General Government Balance

% GNI*

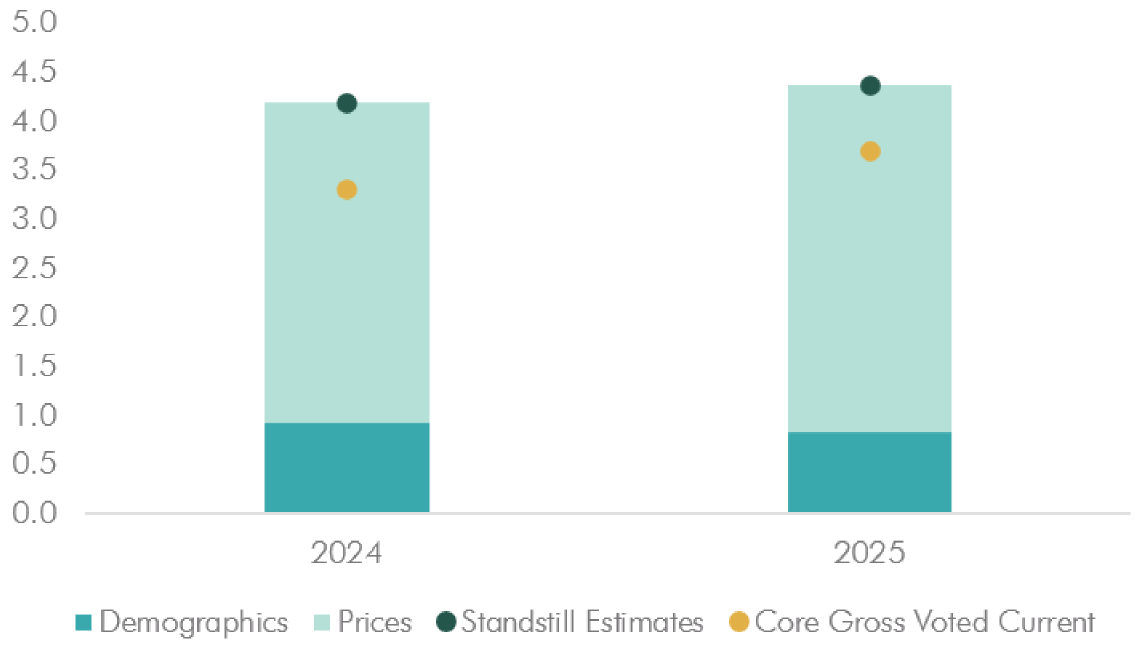


Sources: CSO; Budget 2023 projections; and Fiscal Council workings.
Note: Dashed line indicates Budget 2023 forecasts. Fiscal Council estimates of excess corporation tax receipts are used for 2015 – 2020. Estimates of excess corporation tax for 2021 – 2025 are taken from Budget 2023. Revenue and expenditure one-offs are as assessed by the Council.

But, meeting the 5% Spending Rule will require choices

Stand-still costs diverge from *Budget 2023* projections in 2024 and 2025

€ billion, annual change



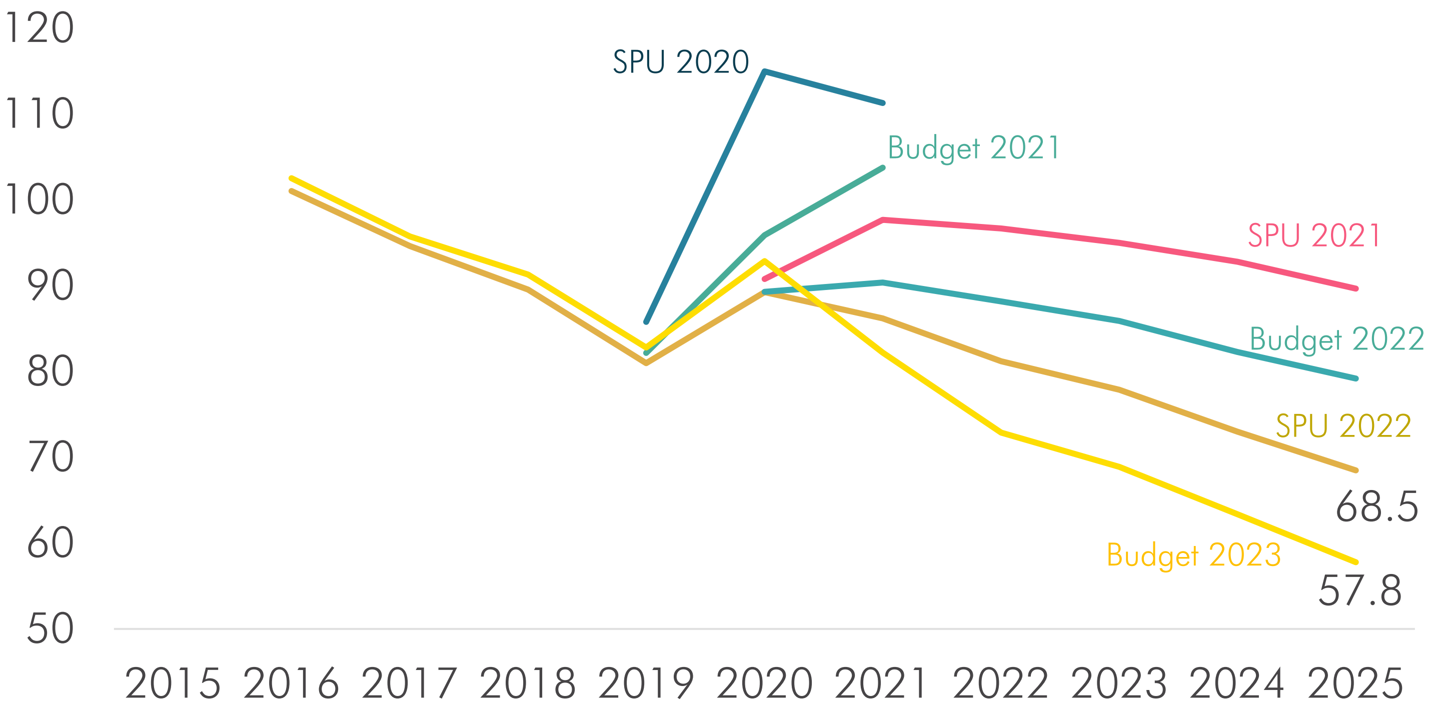
Source: Department of Finance; and Fiscal Council workings.
Notes: Stand-still estimates assumes spending on social welfare, health and education will grow in line with key demographic growth and that key welfare rates and public sector pay rates will grow in line with forecasts of private sector wage rates in 2024 and 2025, while other spending increase in line with inflation.

- Amount of spending would be insufficient to meet stand-still costs
- Higher ageing costs are putting pressure on the public finances
- Choices will need to be made between spending priorities (and taxes)
- Budget projections should set out how this will be done

Debt is expected to fall and short-term financing needs are modest

Net debt has been revised down

% GNI*, general government



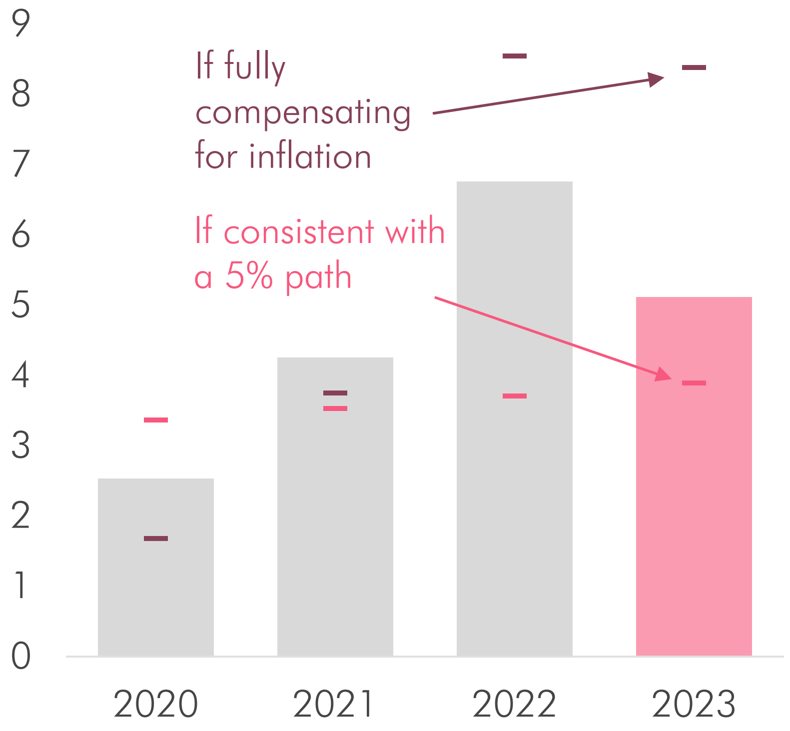
Sources: CSO; Department of Finance.

Budget 2023

Budget 2023 struck an appropriate balance between supporting households and avoiding adding to inflation

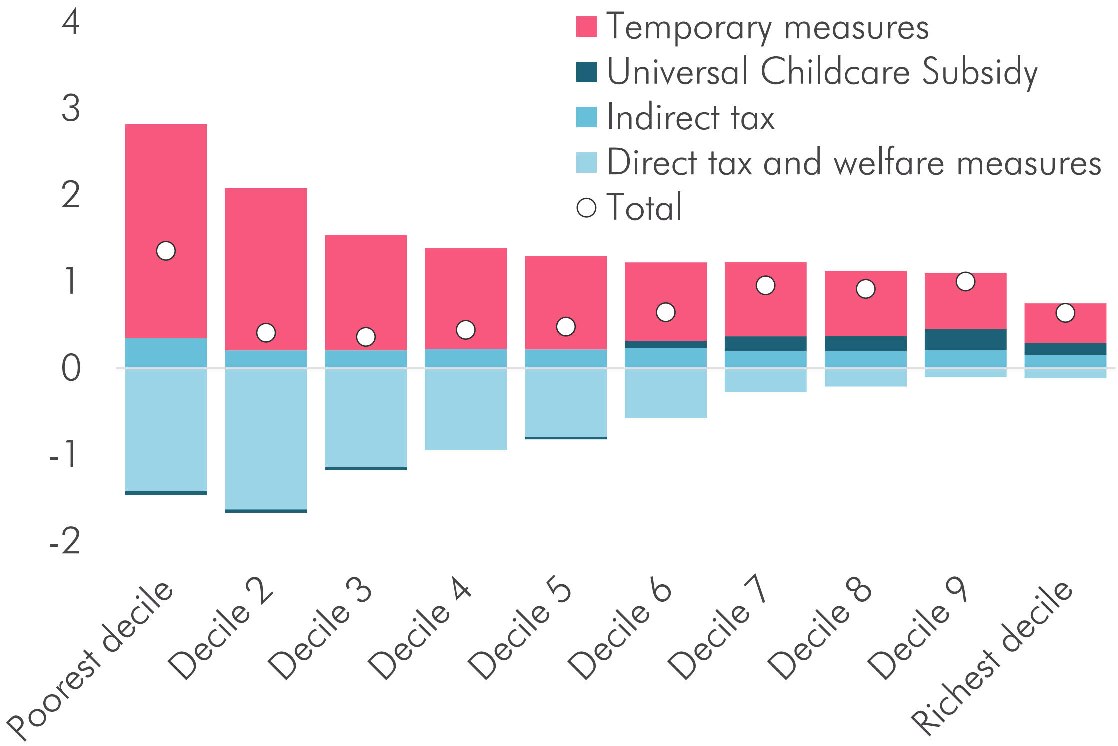
Core increases well below inflation for 2023

€ billion, core spending



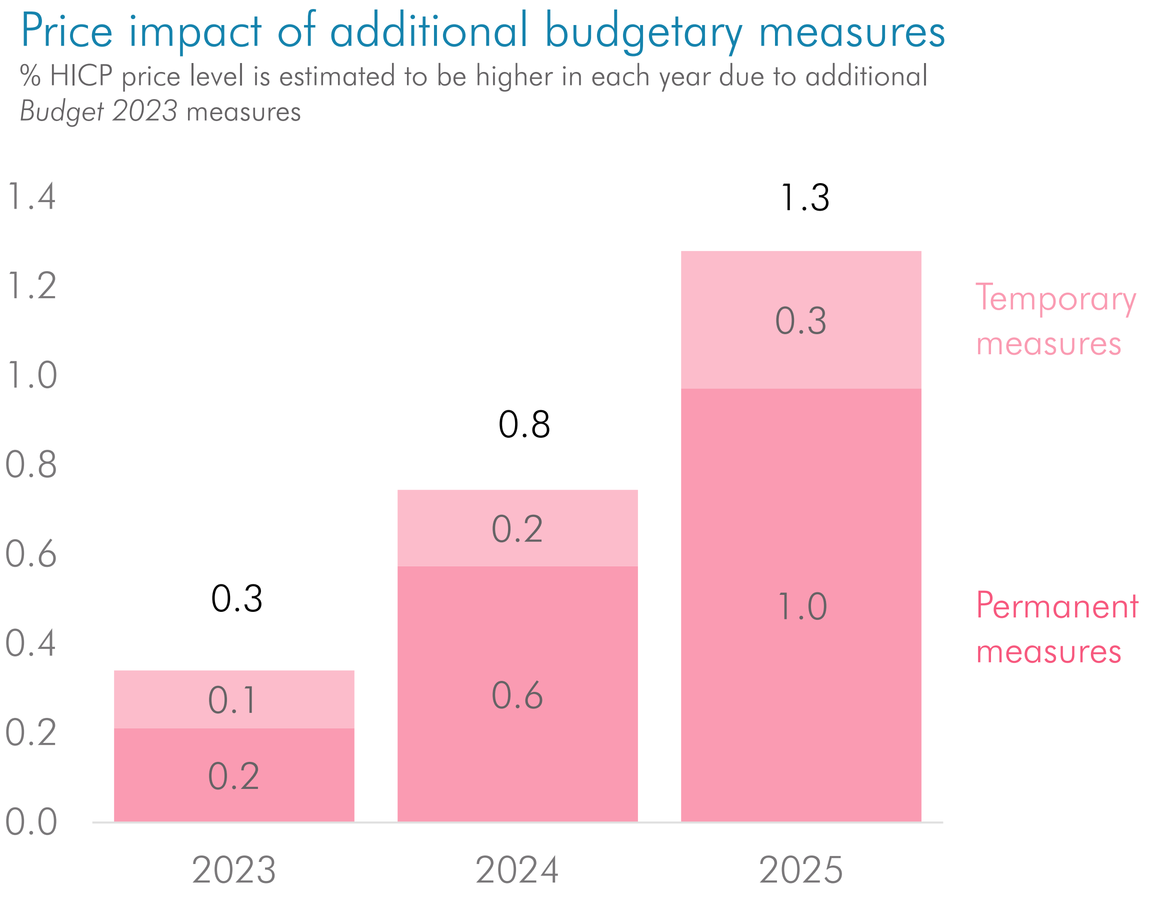
Permanent and temporary measures helped to protect households

% change in disposable income, 2023 vs 2022



Sources: Doolan, Doorley, Regan and Roantree (2022).
Notes: The analysis shows the distributional effect of *Budget 2023* compared to a hypothetical Budget that is fully indexed for inflation at an assumed rate of 7.1% in 2023 (in line with *Budget 2023* projections). The direct and indirect tax measures plus the universal childcare subsidy are compared to the hypothetical indexed budget, with the impact of temporary measures then added to the analysis.

Inflation pressures nevertheless remain



Sources: Fiscal Council workings (based on *Budget 2023* forecasts).
Notes: The first figure shows a simulation of the HICP price level impact arising from the additional measures outlined in Budget 2023 in terms of a) the difference between core spending in the Budget vs a hypothetical 5% spending path (€2.2 billion) plus the additional €0.55 billion of tax cuts introduced; and b) the difference in "non-core" or temporary spending (€4.8 billion) between Budget 2022 and Budget 2023 plus the additional temporary tax measures (€1.7 billion) for 2022 and 2023. It uses the Council's Maq model (Casey and Purdue, 2021) to estimate the impact on the economy of additional spending and tax-reducing measures.The second figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's supply-side models (Casey, 2019) and the Department's forecasts.

In terms of the path of core spending, the deviation is relatively small

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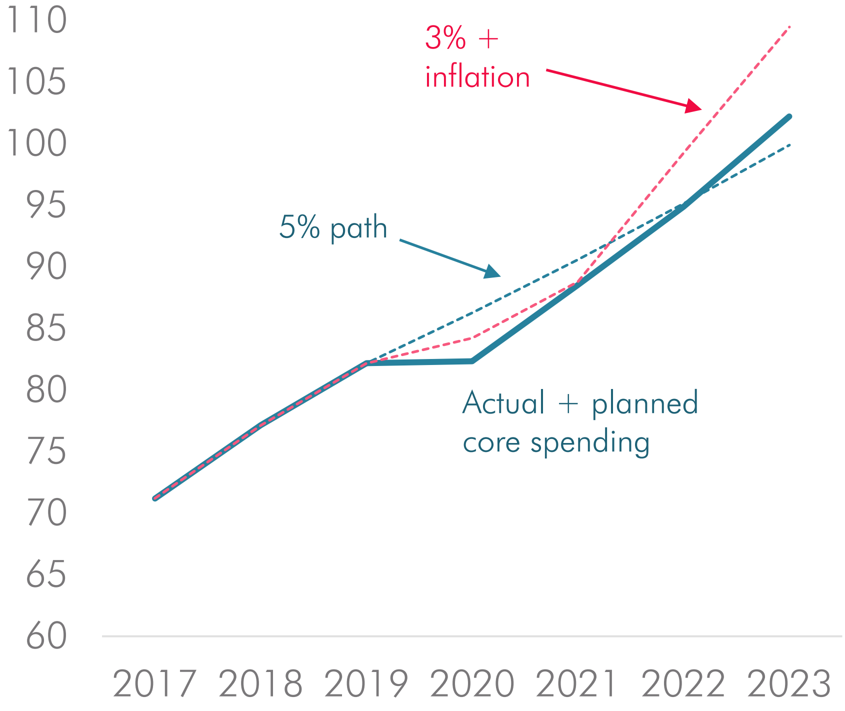
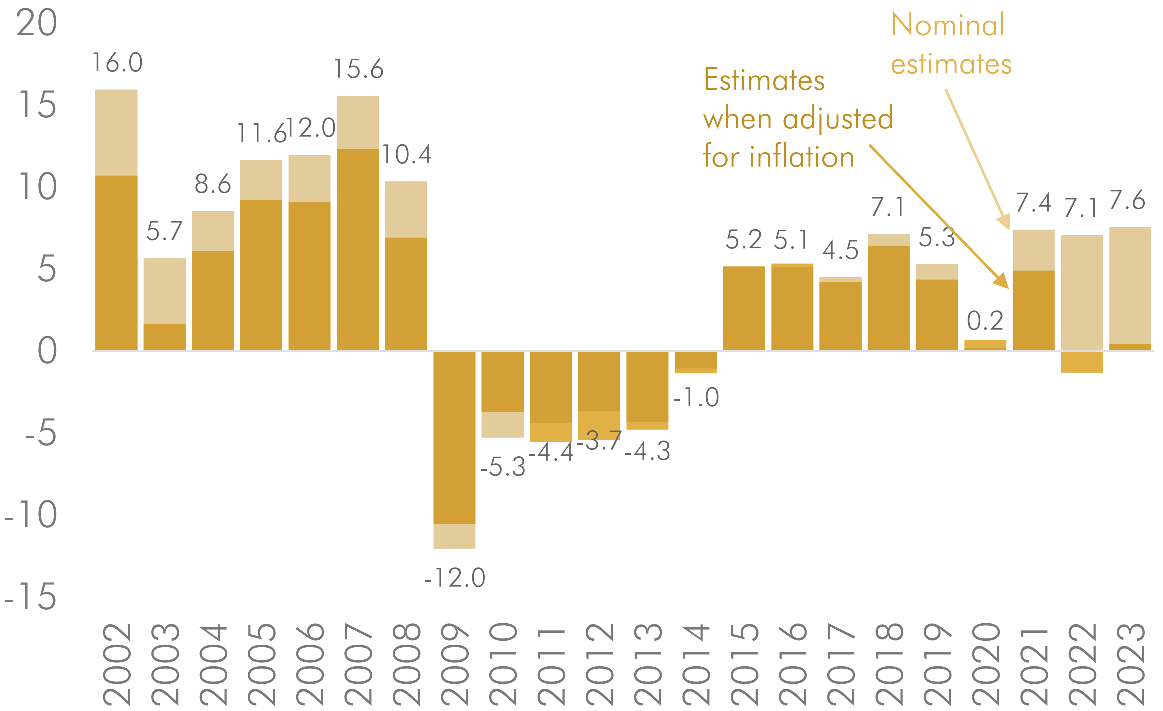
Net policy spending path still sustainable

€ billion, net policy spending



Increases in permanent real net policy spending are modest

% increase in net policy spending

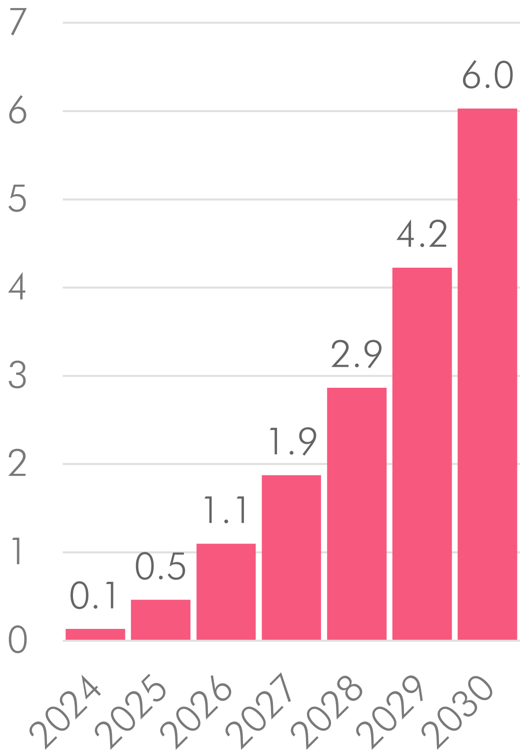


Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: "Policy" spending is overall general government spending, excluding temporary factors like one-offs, and spending on unemployment benefits that are not likely to be long-lasting. The net policy spending measure used above recognises the role of tax changes; that is, a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts. The inflation-adjusted measure is HICP-adjusted.

There is a window for Ireland to get debt down to a safer level

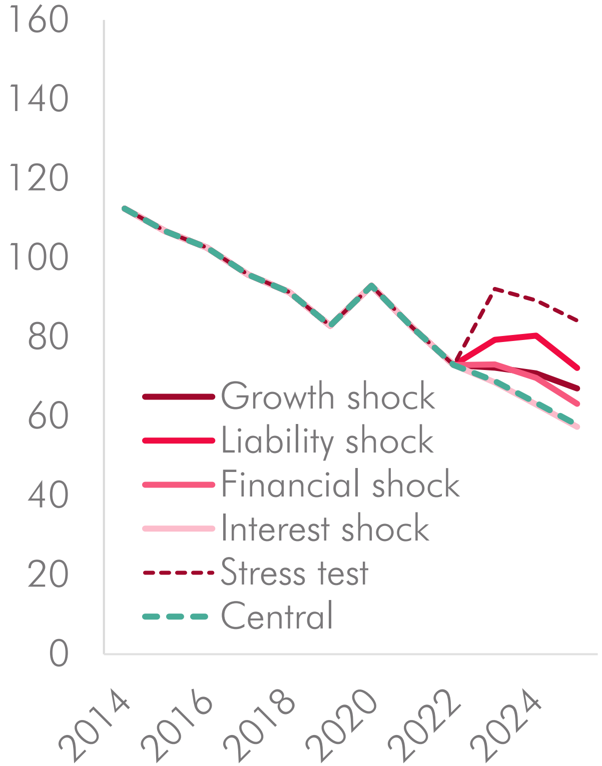
Higher rates would raise debt

% GNI*, gross debt ratio



Shock scenarios

Net debt % GNI*



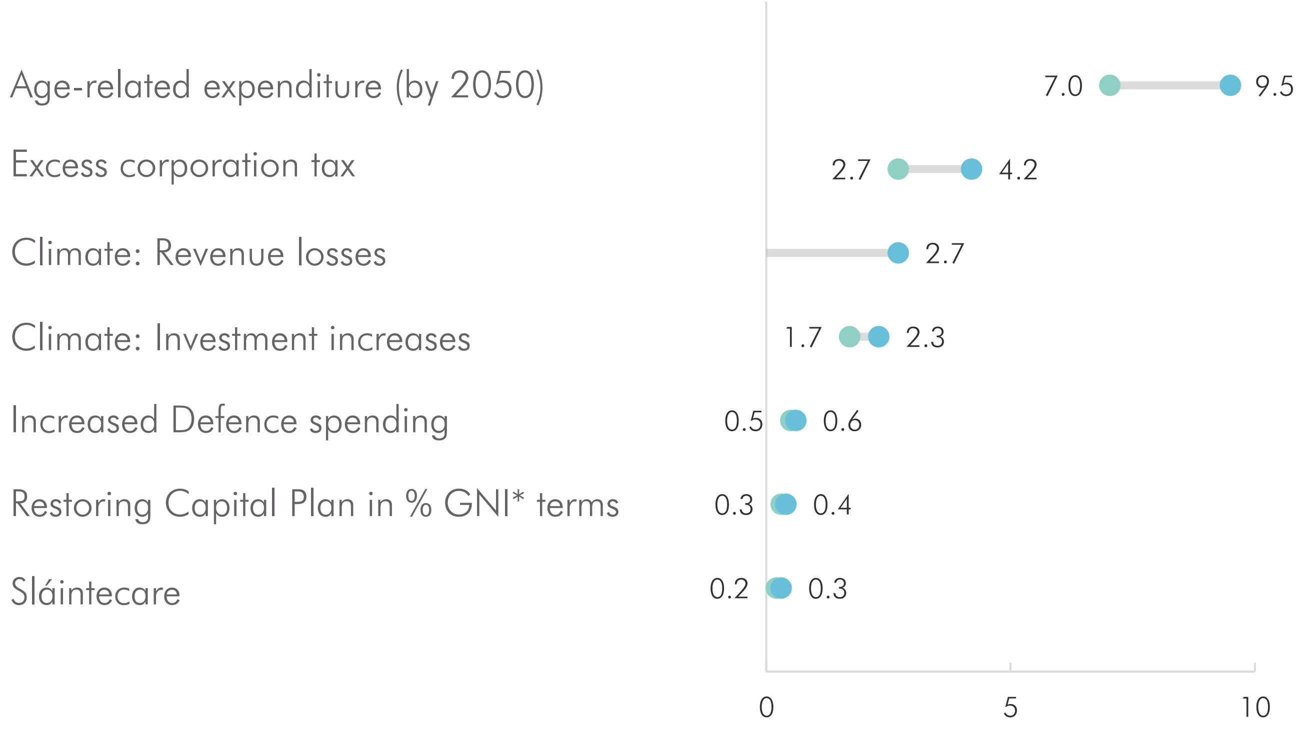
- Reducing the debt ratio over the coming years, while interest rates are low, will leave the public finances in a safer position
- Higher interest rates will kick-in for the medium term
- Growth and financial shocks can be larger

Sources: Department of Finance; CSO; NTMA data on debt securities; and Fiscal Council workings.
Notes: The first Figure assumes that real growth reverts to 3%, with a deflator of 1.5% beyond 2026. The marginal interest rate is solved endogenously for the baseline, with the shock scenario assuming a permanent 2 percentage-point increase in the implied rate for 2023 onwards. For the second Figure, the "Growth shock" assumes real GNI* growth rates 3.6pp (one standard deviation, 1996-2019 excl. financial crisis) weaker than the Central scenario for 2 years (leaving output about 7% below the central scenario). The "Liability" and "Financial" shocks, respectively, assume that 15% and 10% GNI* contingent liabilities materialise, based on an historical assessment of fiscal risks internationally. The "Interest shock" assumes that marginal interest rates rise by 2pp for the full period. The "Stress test" combines all previous shocks.

Medium–term challenges

Government needs to improve planning for the long term

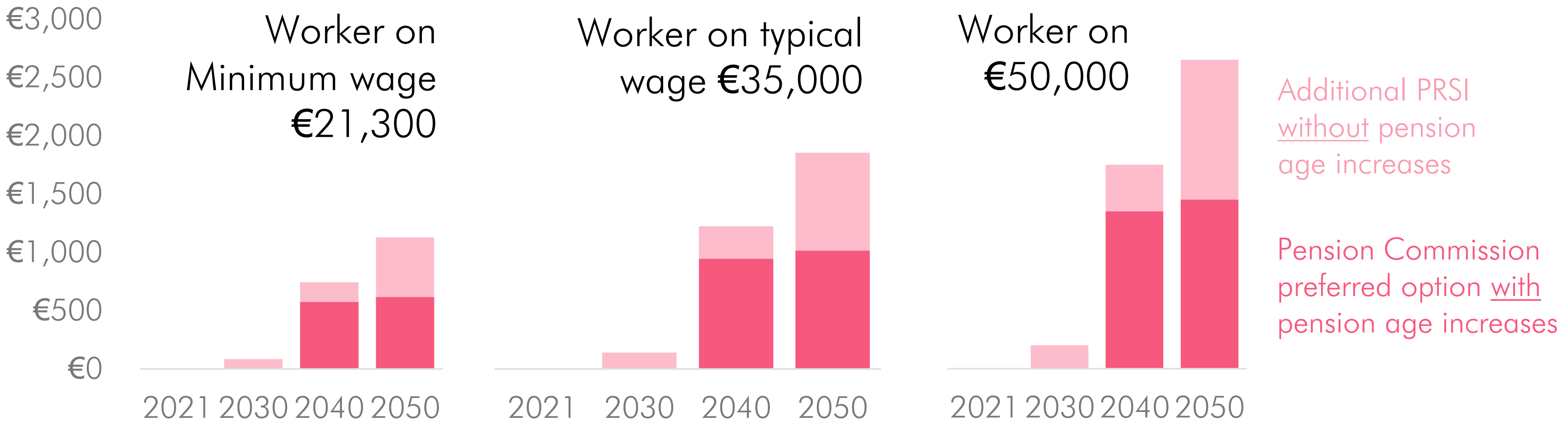
- Ageing and pension costs
- Climate Change
- Overreliance on corporation tax



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

PRSI increases for workers based on proposed pension reforms

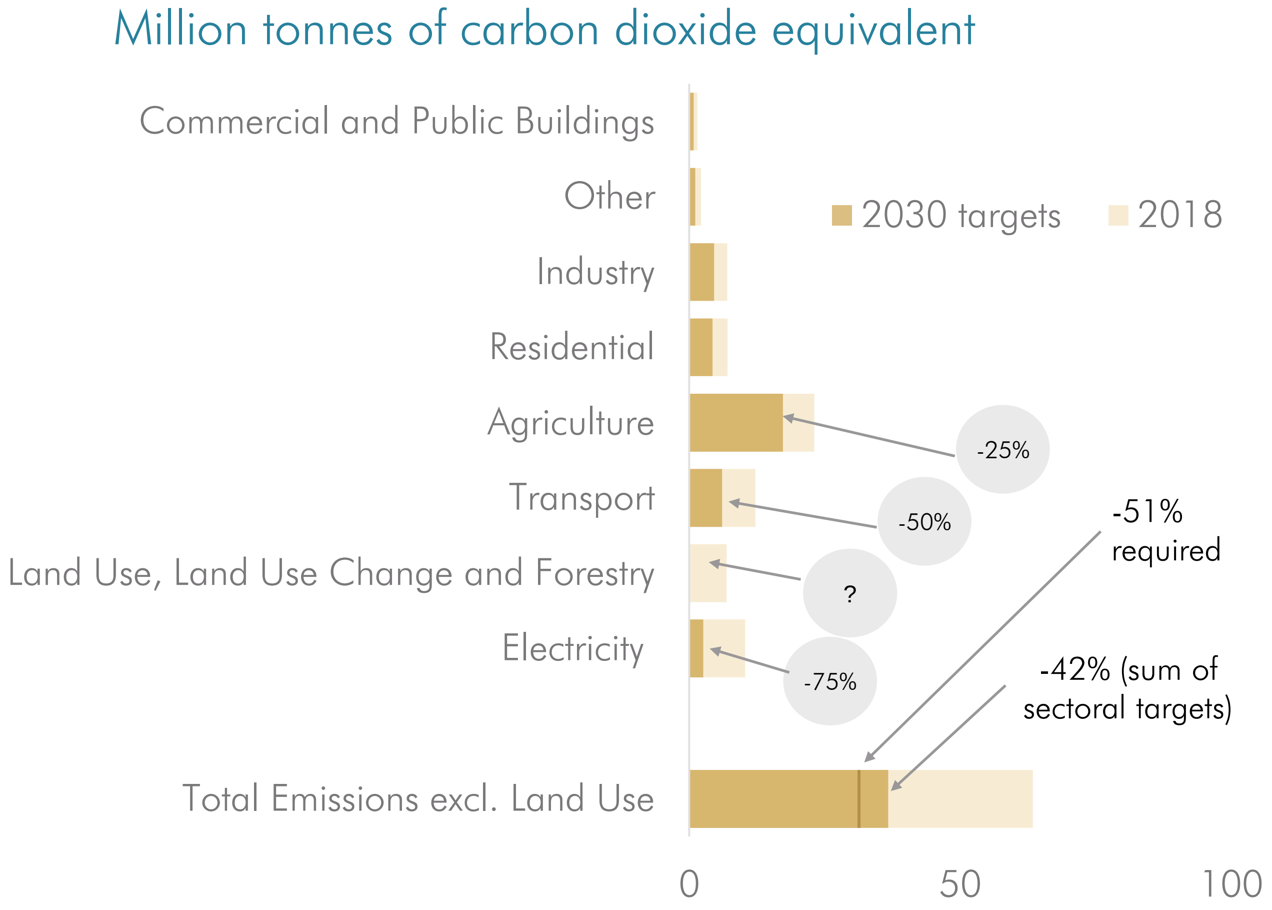
€ change implied for PRSI for workers in today's terms based on policy options



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.

- The Government should be transparent about these costs
- Short-term fluctuations in the Social Insurance Fund do not justify inaction

Climate targets are short of ambition and lack clarity



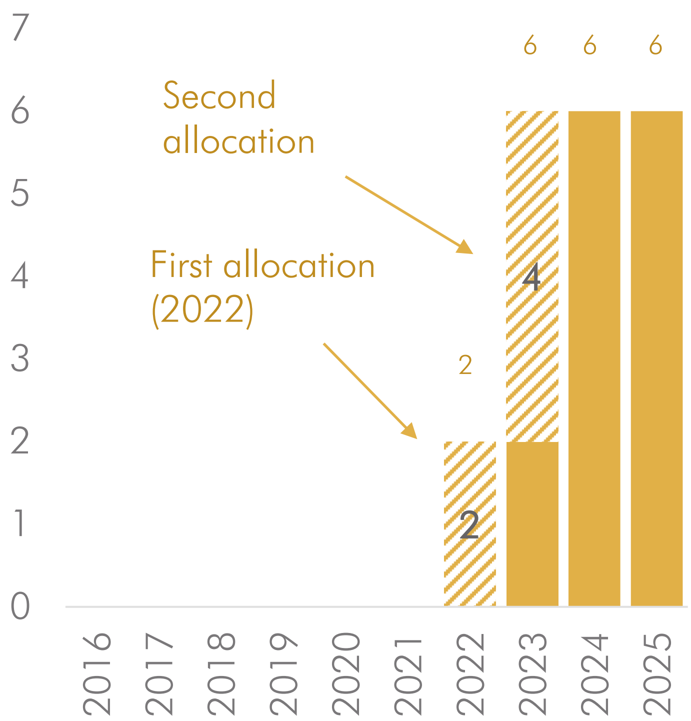
Sources: Climate Change Advisory Council (2022).
Notes: The Figure compares the Government's Sectoral Emissions Reduction Targets announced on 27 July 2022 with 2018 levels of emissions in terms of million tonnes of carbon dioxide equivalent.

- Sectoral climate targets are a step forward
- But, fall short of overall goal
- Detail is lacking on how these targets will be achieved
- The fiscal implications could be very large, but have not been spelt out
  - Investment needs 2-3% GNI*
  - Loss of fuel taxes up to 3% GNI*

Use of National Reserve Fund for CT receipts is welcome, but role needs to be developed

New plans mean significant allocations

€ billions, reserves accumulated in the fund



Sources: Fiscal Council workings.

- Allocating large amounts to NRF contributes to *not increasing* exposure to excess corporation tax receipts
- But, the workings of the Fund could be improved
- *Reducing* exposure to corporation tax receipts by allocating spending to building up reserves to pay for future pensions should be explored

Options to raise taxes over time should be explored

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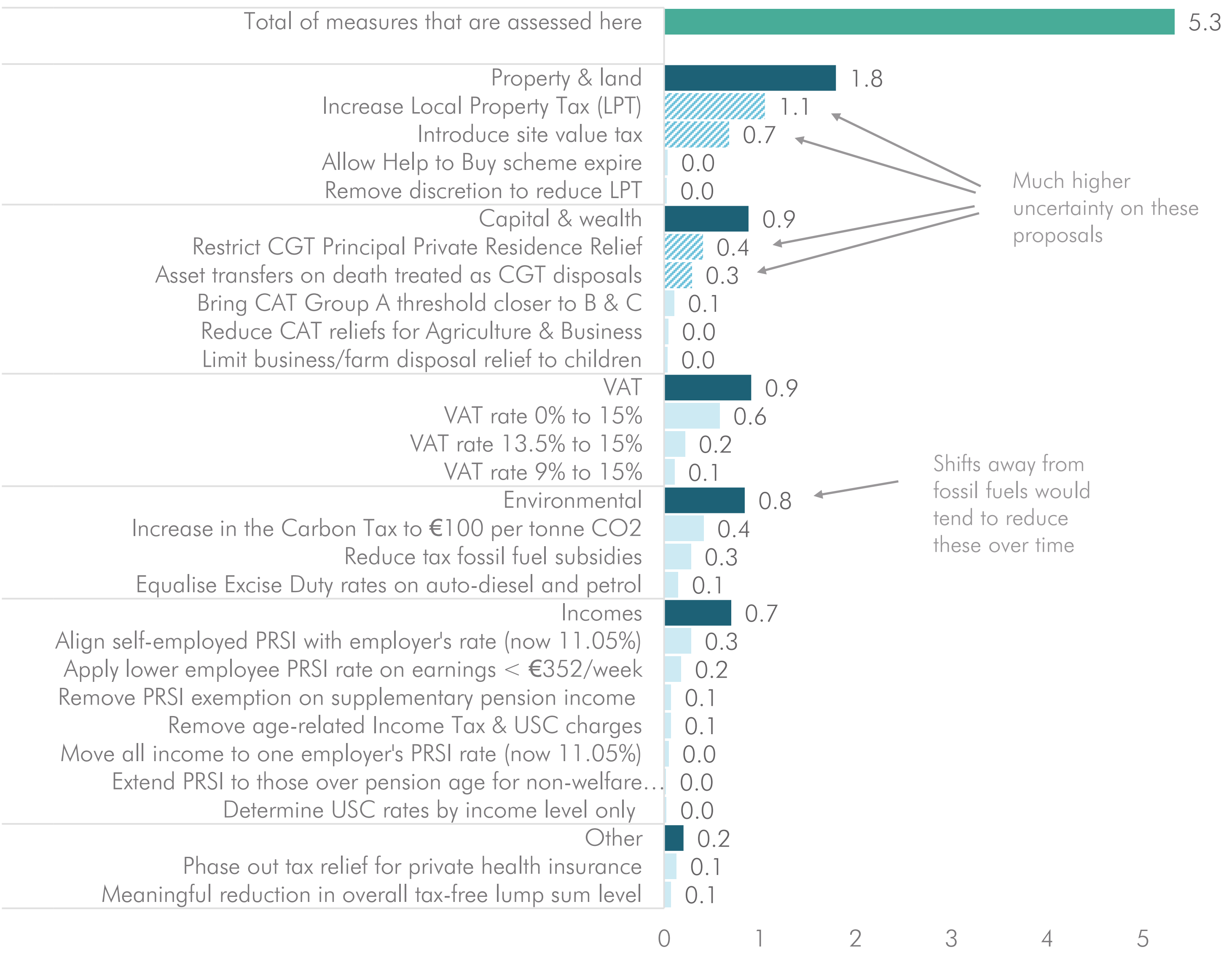
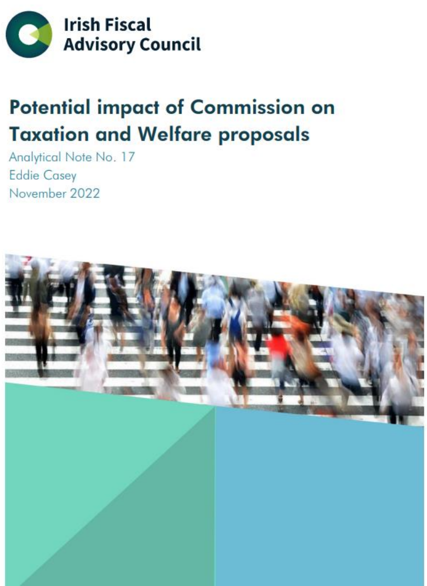


Potential impact of tax measures proposed by the Commission on Taxation and Welfare

% GNI* estimated full-year yield

- The Commission on Taxation and Welfare's independent assessment of revenue-raising options is welcome
- The Government should quantify the impacts
- A more effective spending review process would also help

New Analytical Note



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Strengthening budgeting would help to improve sustainability

Forecast 5+ years ahead

The 5% Spending Rule should be reinforced

- recognise the impact of tax measures
- underpin in legislation
- widen to whole of General Government sector
- link it to debt targets

Publish medium-term Departmental spending ceilings

This medium-term focussed approach would be consistent with the proposed revisions to EU economic governance

Key messages

- Ireland’s economic growth has slowed considerably and risks are high
- The Government forecasts a deficit of 3.1% of GNI* for this year (excl. excess corporation taxes)
- *Budget 2023* introduced a large package of €11 billion of measures
- This strikes an appropriate balance between protecting vulnerable households and avoiding inflation
- Over the medium term, the budget would be in surplus and the debt ratio fall under the 5% spending rule
- But, this will require choices, particularly given ageing and climate changes costs, together with the need to reduce reliance on corporation tax
- The Government needs to improve planning for the long term
- The fiscal framework should be strengthened (including 5yr forecasts; reinforced spending rule)
- The restoration of the National Reserve Fund is welcome to avoid further increasing reliance on corporation tax receipts, but needs to developed further