Rialtas na hÉireann
Government of Ireland

Summer Economic Statement

JULY 2022

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July 2022

Foreword

The context for this year's *Summer Economic Statement* is one in which a confluence of factors – a shock to energy prices, a land-war in Europe, tensions between the European Union and the United Kingdom over the *Northern Ireland Protocol*, the phasing out of extraordinarily cheap money in the euro area (and other advanced economies) – make for a highly uncertain outlook. These developments coming just as a global pandemic is receding lend support to the view that we are living in a more shock-prone world.

Fortunately, our economy has proven to be very resilient and this should help us to navigate our way through the testing times that appear to be ahead of us. Economic activity has rebounded strongly following the ending of the pandemic and this has paid dividends in the labour market, where the level of employment is now at its highest ever. This confirms that the various fiscal supports, put in place by Government over the two years of the pandemic, were successful in limiting the damage ('scarring') to the economy.

The exit from the pandemic, however, has not been entirely smooth. The rapid rebound in demand – in Ireland and in most advanced economies – has been exceptionally strong, so much so that capacity constraints have emerged. For instance, there is a large body of evidence to suggest that the availability of suitably-skilled workers has become one of the key factors weighing on activity.

In addition, logistical constraints, in part due to the 'zero-Covid' strategy in some of the key manufacturing hubs in China, have limited the availability of key inputs. War in Ukraine, and the effective reduction in the supply of energy products, raw materials and foodstuffs, has magnified this imbalance between demand and supply, and given rise to rates of consumer price inflation not seen since the 1970s. These combined shocks appear to be having 'stagflationary' consequences in Ireland and elsewhere – in other words, slowing the growth rate of the economy while, at the same time, triggering higher inflation.

The Government has responded rapidly and forcefully to mitigate the impact of higher prices on households, especially those at the lower-end of the income spectrum, whose capacity to absorb these price increases is weakest. Around €2.4 billion has been provided by way of tax and spending measures, the equivalent of 1 per cent of national income. This includes, on the spending side, over €½ billion of additional expenditure measures to support households and businesses with increased costs since December of last year. A number of these measures build on supports put in place in *Budget 2022* and are targeted at those most vulnerable. Government has also confirmed that the forthcoming budget will be a 'cost of living' budget; in other words, Government will prioritise measures that help households adjust.

Higher import prices for necessities such as energy means that – by definition – part of Irish national income is being transferred abroad. To put it another way, the nation as a whole is worse-off than it would otherwise have been. No Government anywhere in the world can offset this and, instead, the role of Government is to redistribute the impact in order to ensure that those least able to cope are protected. This targeting of fiscal support has underpinned the Government's approach so far, and will continue to do so in *Budget 2023*.

Turning to the near-term outlook, the Government's spring economic projections – compiled by the Department of Finance – were published in April, and foresaw an expansion in Modified Domestic Demand of 4.2 per cent for this year and 3.9 per cent for next year. At the time, risks to the outlook were judged to be firmly tilted to the downside, and it is becoming increasingly clear that many of these

risks have since materialised. Weaker-than-assumed growth in many of our key export markets will weigh on demand for Irish-produced goods and services, although headline exports will likely continue to benefit from the resilience of pharma, ICT and med-tech exports. Heightened uncertainty associated with war on the European Union's border, as well as unresolved Brexit-related issues, will likely restrain business investment, while higher borrowing costs will be an additional headwind for businesses and consumers alike.

Budget 2023 is, therefore, being framed against an international backdrop that is increasingly difficult and highly uncertain. In terms of the geopolitical situation, risks to European energy supplies (especially natural gas) are real, and any shortfall could trigger a sharp disruption to economic activity across the continent. On the policy front, ensuring that inflation does not become entrenched will be a significant challenge, especially against the backdrop of elevated public debt in some Member States of the euro area.

In summary, this means that the domestic economic outlook for the second half of this year and for next year is less benign than envisaged in the spring, while inflation has proven to be higher, broader and more persistent.

On a more positive note, the public finances have weathered the pandemic relatively well. While substantial amounts of support were made available – around €48 billion in tax, spending and loans (including via guarantees) – the tax revenue performance was much better than could have been anticipated. This, in no small part, reflects the resilience of corporation tax receipts, which amounted to €15.3 billion last year (a decade ago, receipts from this source amounted to just €3.5 billion). That said, these receipts now account for nearly €1 in every €4 collected; moreover, around half of these receipts are sourced from just ten large firms. To put it another way, this means that €1 in every €8 collected by the State comes from an exceptionally small number of firms, a concentration risk which represents a clear vulnerability for the public finances.

In designing the Government's response to the higher cost of living, it is important to recognise that the inflation shock is very different to the pandemic. In relation to the latter, borrowing costs for Governments in almost all advanced economies were brought to exceptionally low levels – in the euro area, most Governments could borrow at interest-free rates. In contrast, the sharp increase in price inflation, and the associated shift in the monetary policy stance, means that sovereign borrowing costs are now on a rising trajectory. If price inflation continues to surprise on the upside borrowing costs could move even higher.

Against this backdrop, a key objective will be to engineer a return to price stability without triggering a decline in economic activity. While monetary policy is the first line of defence against higher inflation, budgetary policy must complement the monetary approach by ensuring that tax and spending policies do not add to inflation.

Budget 2022 provided for up to €87.6 billion in gross voted expenditure this year. A total of €80.1 billion was provided for 'core' expenditure to deliver public services, social supports, and investment in infrastructure. The allocation for this year represents an increase of almost €10 billion (14 per cent) relative to the amount provided for core expenditure in 2020.

In addition, €7½ billion was set aside to fund temporary measures this year, as part of the ongoing response to the pandemic and Brexit. This means that over the period 2020-2022, Government has made available €37 billion of direct expenditure to support households and firms, as well as to ensure the provision of key public services, during the pandemic.

Government continues to prioritise capital investment. The *National Development Plan* (NDP), published in October 2021, provides for total public investment of €165 billion over the period 2021-2030. The NDP is the largest in the history of the State, with Ireland's annual capital investment budget as a share of national income now among the highest in the EU. This year, over €12 billion has been made available for spending on vital infrastructure in areas such as housing, transport, education, enterprise, and climate action.

Looking forward, Government must strike a balance between delivering timely and targeted support while, at the same time, ensuring that the public finances remain on a sustainable trajectory. It is this prudent and responsible management of the public finances that enabled us to respond so pro-actively to the challenges of the pandemic.

The Government's medium-term expenditure strategy, set out in last year's *Summer Economic Statement*, provided for significant additional public spending as well as providing for some tax reductions in 2023 and beyond. Taking into account the more challenging circumstances, Government is revising its fiscal parameters for *Budget 2023.* An overall budgetary package of €6.7 billion is being made available.

On the spending side, the core expenditure ceiling for next year is being increased by €1.65 billion relative to that set out in this year's *Stability Programme Update* (SPU). With €0.4 billion of this uplift phased into 2022, this brings core current expenditure growth for 2023 to 6½ per cent compared with 4.7 per cent in the SPU.

The provision of additional funding of this scale, with overall core spending of €85.8 billion, will support the implementation of measures that can protect the most vulnerable in society, address public service pay in a sustainable manner, support improvements in our public services and infrastructure, while also seeking to not add to inflationary pressures. For spending to be sustainable, it is essential that the overall level of spending is affordable in the long term and that it is delivering improvements in public services and infrastructure. This focus on both sustainability and quality is a key priority for Government.

On the taxation side, a total package of €1.05 billion is being provided for in *Budget 2023*. The priority will be to ensure that workers are not exposed to higher taxation simply because of inflation.

In conclusion, the Government will continue to work to cushion the impact of higher inflation, to deliver high-quality public services, and to ensure that the economy and public finances remain on a sustainable pathway.

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[1] The material set out in this document is based on data available to mid-June. It was compiled by staff in the Departments of Finance and Public Expenditure and Reform, and every effort is made to ensure accuracy and completeness. When errors are discovered, corrections and revisions are incorporated into the digital edition available on the website of the Department of Finance. Any substantive change is detailed in the on-line version.
[2] In line with the Government's *Open Data Initiative,* the data underpinning charts in this document are available on the Department of Finance website.

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SUMMARY AND KEY MESSAGES

While resilient, evidence is mounting that economic momentum is slowing

> Economic recovery from the pandemic has been rapid, with activity now 5.6 per cent above pre-pandemic levels. The evidence points to limited, if any, permanent damage ('scarring') to the economy from the pandemic.

> The strong rebound in activity has paid dividends in the labour market, where the level of employment is now at its highest level ever. By maintaining the employee-employer link during the pandemic, the *Employment Wage Subsidy Scheme* is likely one of the key factors behind the resilience of the labour market.

> Exit from the pandemic, however, has not been entirely smooth. The rapid recovery in demand has run up against supply (capacity) constraints, putting upward pressure on prices. The step-change in energy prices on foot of the Russian invasion of Ukraine has worsened the inflation situation.

> The erosion of real incomes, alongside some precautionary saving, means the recovery in consumer spending is slowing, a situation that is mirrored in other countries.

> Risks to the economic outlook are now firmly tilted to the downside. In particular, a complete withdrawal of Russian natural gas supplies to continental Europe cannot be ruled out, a situation which would cause severe economic disruption in our main export markets.

Government has provided significant support and Budget 2023 will be a cost of living budget

> Government has already provided €2.4 billion (1 per cent of national income) by way of fiscal supports to cushion the impact of higher prices on households.

> *Budget 2023* will provide for an overall package of €6.7 billion; this has been calibrated to balance the need to provide further support with the need to avoid adding to inflationary pressures.

> The overall package will be composed of additional public spending amounting to €5.65 billion and taxation measures amounting to €1.05 billion.

The policy response to the higher cost of living must be different to the pandemic response

> Higher inflation means that the extraordinary monetary support of the last few years is now being withdrawn. Borrowing costs are, accordingly, on a rising trajectory.

> A key question – albeit one that is unanswerable at present – is the speed and scale of monetary tightening needed to ensure that inflation does not become entrenched. This will have a key bearing on economic and fiscal developments in Ireland in the second half of this year and into next.

> Public debt in Ireland is already very high, with significant fiscal challenges now firmly on the horizon. Financing an ageing population, climate change mitigation, the digital transition and improved healthcare via *Sláintecare*, will all put pressure on the public finances in the years to come.

> A higher cost of funding, alongside elevated debt levels, mean that tax and spending policies cannot be used to resolve all problems. Difficult choices will have to be made and Government will not avoid this.

BUDGETARY STRATEGY: AN OVERVIEW

The Government is adapting its budgetary strategy to take account of higher inflation

> Last summer, the Government adopted a medium-term budgetary strategy based on public expenditure growth of 5 per cent per annum over 2023-2025. This was designed to ensure sustainable public expenditure growth, with annual increases in spending anchored to the economy's estimated trend growth, taking into account an assumed inflation rate of around 2 per cent.

> Reflecting the much less benign inflationary environment, and especially the impact of higher energy prices on the most vulnerable groups, the strategy needs to be adapted.

To protect public services, core spending will increase by 6.5 per cent next year

> Government is providing for core spending of €85.8 billion next year. This ceiling will provide for an expenditure budgetary package of €5.65 billion over 2022 and 2023. This is an increase of €1.7 billion relative to what was originally provided for, and will ensure that support is provided to households to help with the higher cost of living.

> This means that core spending will increase by 6.5 per cent next year (compared with the 5 per cent originally foreseen). This additional quantum balances the need to protect core public services while ensuring that budgetary policy does not become part of the inflation problem.

> Government is also providing €4.5 billion in non-core expenditure for temporary measures. This expenditure will provide humanitarian supports for refugees arriving from Ukraine and more limited Covid-19 provision in respect of potential continued requirements.

The overall budgetary package also provides for taxation measures

> Government is also providing for an overall taxation package of €1.05 billion next year. This is double the amount set in the original strategy and, once again, reflects the need to adjust the parameters given the higher-than-assumed inflation.

> A key objective of taxation policy in the forthcoming budget will be to avoid workers paying additional tax simply because they move through higher tax brackets because of inflation.

The near-term fiscal outlook is highly uncertain

> The uplift in spending will be less than any upward revision to inflation, ensuring that budgetary policy is not an inflationary risk.

> Tax revenue has surprised on the upside in the first half of the year, though most of the overshoot is due to additional corporate tax receipts.

> The economic outlook for the second half of the year has deteriorated relative to earlier expectations, and this could impact on tax revenue over the remainder of the year.

> While highly uncertain, a very modest surplus is possible for this year and next; however, this would only arise because of the strength of corporation tax receipts.

> To put this into perspective, under a hypothetical scenario in which corporation tax receipts had remained unchanged at pre-pandemic levels, deficits would have been in prospect for this year and next (somewhere in the region of -1½ per cent of GDP and -1¼ per cent of GDP, respectively).

Table 1: Budgetary strategy, € billion (unless stated)				
	2022	2023	2024	2025
Expenditure ceiling	88.0	90.3	90.8	95.0
Total budget package^	-	6.7	4.8	5.1
Budgetary decisions^^	-	3.0	3.2	3.4
To be allocated^^^	-	3.7	1.6	1.7
of which: tax measures	-	1.05	0.5	0.5
Voted spending				
Temporary	7.5	4.5	0.7	0.4
Permanent ('core')	80.5	85.8	90.1	94.6
Growth in core spending, per cent^^^^	6.0	6.5	5.0	5.0
Memo^^^^^				
GGB, per cent GDP	0 to ½	¼ to ¾	-	-

Note: Rounding can affect totals
^ €0.4 billion of the *Budget 2023* expenditure package is phased into 2022.
^^ Existing Level of Service in respect of demographics, NDP and public sector pay commitments.
^^^ To be announced on Budget day.
^^^^ This reflects growth in core expenditure compared to 2021 estimate as set out in *Budget 2022*.
^^^^^ very tentative estimates – a full suite of fiscal forecasts will be published alongside *Budget 2023*.
Source: Departments of Finance and Public Expenditure and Reform.

Table 2: Expenditure strategy, € billion (unless stated)				
	2022	2023	2024	2025
Expenditure ceiling	88.0	90.3	90.8	95.0
: core spending	80.5	85.8	90.1	94.6
: non-core spending	7.5	4.5	0.7	0.4
Memo				
Growth in core spending, € bn	4.6	5.3	4.3	4.5
Growth in core spending, per cent	6.0	6.5	5.0	5.0

Note: each year, €0.2 bn of Covid-19 expenditure is funded by the *National Recovery and Resilience Plan*.
Source: Departments of Finance and Public Expenditure and Reform.

Chapter 1
Economic Strategy

1.1 Background

As the direct effects of the pandemic began to subside earlier this year, prospects for Irish economic activity looked reasonably good. Modified Domestic Demand (MDD) had already returned to its pre-pandemic level by the mid-part of last year, and the phasing out of measures designed to limit virus transmission from end-January (with full elimination by end-February) looked set to unleash considerable pent-up demand. The one lingering effect of the pandemic was the disruption to global supply chains which, against a backdrop of a rapid recovery in global demand, had triggered sharp price increases in most economies, including Ireland.

The outbreak of war on the European Union's border has put a major dent in domestic economic prospects. While direct trade and investment links with Russia are relatively minor, spill-overs via higher energy prices, weaker business and consumer sentiment, as well as migrant flows have been substantial. Already on an upward trajectory from the second half of last year, perhaps the most tangible economic impact of war has been to put further upward pressure on energy prices (**box 1**). Because of this, consumer price inflation reached 9.6 per cent in June.

Central banks across almost all advanced economies have responded to the jump in inflation by tightening monetary policy. Borrowing costs – for households, firms and governments – have risen sharply in recent months. A key question – unanswerable at present – is the speed and scale of monetary tightening needed to ensure that inflation does not become entrenched. This will have a key bearing on economic and fiscal developments in Ireland in the second half of this year and into next.

More fundamentally, the Russian invasion of Ukraine has also triggered a geopolitical shift, with the economic fallout likely to reverberate for years to come. After decades of ever-deeper integration, there is now a real risk that the global economy may fragment along emerging geopolitical fault-lines. Coming so soon after the pandemic, which had exposed vulnerabilities in the 'just-in-time' supply chain model, some re-shoring of production in the years ahead is a distinct possibility. This would pose a risk to Ireland's economic model.

War has also brought the issue of energy-security to the fore. In the near-term, any loss of access to Russian natural gas supplies would involve serious disruption to the euro area economy. More broadly, as the European Union decouples from Russian-sourced fossil fuels, this will likely accelerate the transition to renewable energy sources. While the benefits of this are clear, this accelerated transition is likely to involve short-term costs.

Finally, the Government's economic strategy must take into account the possibility of trade frictions with the UK, with the latter's exit from the European Union continuing to cast a shadow.

1.2 Economic Strategy

Budget 2023 is being prepared against this very uncertain macroeconomic backdrop. To address the higher cost of living, Government has already announced, and implemented, fiscal supports amounting to €2.4 billion, the equivalent of around 1 per cent of national income. The overarching objective of the forthcoming budget is to build upon this – to provide further support to households, including through measures targeted towards those who are least able to absorb recent price shifts.

The *National Economic Dialogue* took place in mid-June, with the theme of '*Building Economic Resilience to deal with International Challenges*.' A recurring theme of the Dialogue was the importance of monitoring 'well-being', and this is now being integrated into the budgetary process (**annex 2**).

Government continues to work to enhance Ireland's economic resilience, including by addressing the pre-pandemic challenges, namely boosting housing supply, decarbonising the economy and facilitating the transition to a digitalised economy. None of these key goals can be achieved without sustainable and resilient public finances.

Boosting housing supply

Preliminary results from *Census 2022*[3] show the population reached 5.1 million people in April this year, an increase of almost 12 per cent in just over a decade, a figure that is amongst the highest in the European Union.

While undoubtedly a positive development, the rapid expansion of the population has created challenges, most notably in the provision of housing. Additions to the housing stock have lagged well behind demand, with the pandemic intensifying the demand-supply imbalance – firstly, by temporarily shutting down the construction sector and, secondly, by reducing the availability of key inputs (e.g. concrete, timber) because of supply chain problems.

The Government's policy response – set out in *Housing for All*[4] (**box 4**) – is a suite of measures[5] designed to boost average housing supply to 33,000 units per annum over the remainder of the decade. Leading indicators – new start data for instance – point to a rebound in housing output and Government will continue to work to further enhance supply in the months and years ahead.

Decarbonising the economy

Achieving 'net zero' by 2050 is a key objective for Government and, as an interim target, legislation that requires a halving of carbon dioxide and other greenhouse gas (GHG) emissions by 2030 has been enacted.[6]

Current estimates suggest this will require around a 7 per cent annual reduction in GHG emissions over the remainder of the decade.[7] Latest data from the *Environmental Protection Agency* (EPA), however, show total GHG emissions last year were over 5 per cent higher than pre-pandemic (2019) levels, following the pandemic-induced reduction in 2020.

Highlighting the significant challenges our economy faces in moving towards a lower carbon economy, carbon budgets proposed by the Climate Change Advisory Council have also recently been approved by the *Oireachtas* for the periods 2021-25, 2026-30 and 2031-35.[8] Projections in these carbon budgets show that there is currently a significant gap between the budgets and the projected emission estimates over the budgetary periods.

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[3] Available at: https://www.cso.ie/en/releasesandpublications/ep/p-cpr/censusofpopulation2022-preliminaryresults/
[4] Available at: https://www.gov.ie/en/publication/ef5ec-housing-for-all-a-new-housing-plan-for-ireland/
[5] A summary of the key policy measures is set out in Box 4.
[6] Climate Action and Low Carbon Development Act.
[7] Department of Finance estimates based on Environmental Protection Agency greenhouse gas emissions data published June 2022. Available at: https://www.epa.ie/publications/monitoring--assessment/climate-change/air-emissions/irelands-greenhouse-gas-emissions-projections-2021-2040.php. The EPA is the national body with responsibility to develop, prepare and publish projections of greenhouse gas emissions for Ireland. It produces national GHG projections on an annual basis, in line with EU guidelines, in order to meet EU reporting obligations and to inform national policy development.
[8] Available at: https://www.climatecouncil.ie/carbonbudgets/

Facilitating the transition to a digitalised economy

A key side-effect of the pandemic has been to accelerate the transition towards the digital economy. Out of necessity, and with digitalisation at its core, the pandemic transformed the way people work, the way goods and services are produced and the way that products are purchased.

While the pandemic has receded, it is certain that the level-shift in digitalisation will persist. For a geographically peripheral economy like Ireland, the greater proliferation of e-commerce offers enormous opportunities; for instance, the production of many services (legal, accounting, finance) can be de-coupled from the location in which the services are sold.

While it is ultimately driven by the private sector, there are important public policy dimensions to an increasingly digitised economy. First is the need to facilitate a smooth digital transition, *inter alia* by ensuring the availability of the necessary human (skills) and physical capital. Second is the requirement to help those less-well equipped to transition to e-commerce. Third is the need to harness efficiency gains by digitalising services provided by the public sector, building on the considerable progress made in recent years.

Building more resilient public finances

Recent experience highlights the importance of counter-cyclical budgetary policy – it is only because of the strength of the public finances pre-pandemic that Government could respond as forcefully as it did to support households and firms during the pandemic.

To be sustainable, counter-cyclical polices must apply symmetrically across the cycle; Governments should not run large deficits in 'good' times.

Beyond short-term cyclical developments, structural fiscal challenges are rapidly coming to the fore: pension costs, the green and digital transitions, the exposure to corporation tax receipts (including through international tax policy changes), and a changing interest rate regime.

1.3 Summary

As part of the European Semester, the Department of Finance produces two sets of economic projections each year, a spring forecast (set out in the *Stability Programme Update*) and an autumn forecast (published alongside the Budget, and submitted to the European authorities as part of the *Draft Budgetary Plan*). In keeping with this practice, a full suite of projections will be published in the autumn alongside *Budget 2023*.

In summary, evidence is mounting that higher prices and geopolitical tensions are taking their toll on the domestic economy. While the economy has been fairly resilient so far, downside risks continue to dominate.

Government is doing what it can to cushion the blow of higher inflation. Building on the measures introduced to date, *Budget 2023* will provide for an overall tax and spending package of €6.7 billion.

But Government must work within a changing environment where budget constraints and trade-offs are, once again, a reality.

Box 1: Responding to an inflation shock – some lessons from the 1970s

The very sharp, and rapid, rise in energy prices over the past year or so has parallels in the experience of the 1970s and the policy response at the time provides a useful reference point to guide the response today.

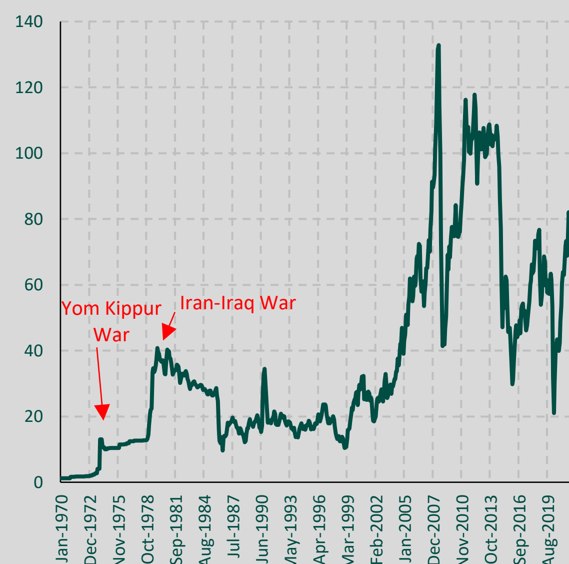
As evident below (**figure 1A**), geopolitical factors triggered a near three-fold increase in oil prices in 1973/74 (Yom Kippur war) followed by a further two-fold increase in 1979/80 (Iran-Iraq war). This supply-side shock (i.e. a shock that increases the price key inputs into the production process) was outside the control of government but, as has been well documented, had a major economic impact in oil-consuming (as distinct from oil-producing) countries.

In many (net) oil-consuming countries, governments tried to shield consumers from these price increases *inter alia* via wage increases, tax changes and subsidies. This policy response resulted in a sharp increase in public debt and, equally importantly, triggered second- and third-round inflationary effects (e.g. wage-price spiral). In other words, rather than a once-off price level shift, inflationary expectations became de-anchored and morphed into a multi-annual problem across many OECD countries, with persistent double-digits price increases.

To address this, a deflationary policy response was required. The case of the US is, perhaps, most insightful where inflation had peaked at around 15 per cent in early 1980. In order to restore price stability at the time, the country's central bank increased its policy interest rate significantly (the 'Volker disinflation'), reaching a peak of 20 per cent in June 1981. This meant the US had to 'sacrifice' GDP and employment losses^ in order to bring inflation to more tolerable rates (the inflation rate fell below 3 per cent by 1983).

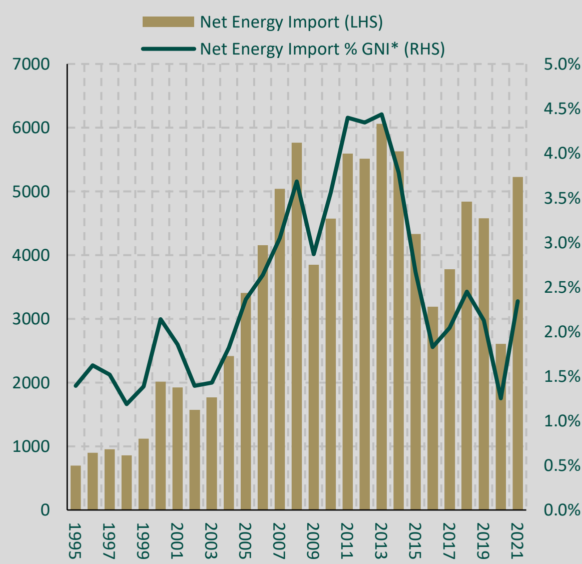
Figure 1: Oil price shocks – then and now

A: Oil prices 1970-present, $ per barrel



Source: macrobond.

B: Net energy imports, € mn



Source: CSO

As well as the parallels, it is also insightful to consider the difference between now and then. Perhaps most important is the institutional framework, which is much different now. For instance, central banks in most advanced economies are fully independent and have greater credibility in achieving price stability. The economic data also points to lower levels of unionisation in advanced economies, weakening the link between inflation and wages, as does the lower prevalence of automatic wage indexation.

Other factors, unrelated to the institutional frameworks, are also notable. For example, advanced economies are more efficient in their oil consumption: the oil intensity of production has fallen in recent decades (although part of this reflects a shift from oil to other energy sources). In addition, the world economy is now more integrated, and global competition will help limit price pressures.

Ireland is (and was) a net energy importer (**figure 1B**) and the increase in energy prices means that part of domestic incomes are, by definition, transferred abroad. That said, in designing the fiscal policy response to higher prices, Government is conscious that it cannot fully absorb the shock. Households, corporates and the exchequer (i.e. future taxpayers) must share the burden while recognising that higher inflation imposes significant hardship on those least able to meet the higher costs of essentials.

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^ the phrase 'sacrifice ratio' was coined at the time to describe the loss of output and employment needed to bring inflation down by 1 pp.

Chapter 2
Economic Outlook

2.1 Economic background

The Irish economy is being buffeted by the fall-out from Russia's invasion of Ukraine. This has triggered a sharp increase in energy and non-fuel (agricultural, metals) commodity prices,[9] worsened supply chain disruptions and dented both household and business confidence. Central banks around the world, including in the euro area, have responded to exceptionally high rates of inflation, with higher borrowing costs an additional headwind for the economy.

Coming just as the pandemic was receding, the war in Ukraine is the latest in a series of external shocks to hit the Irish economy in recent years. While the pandemic and war are 'fast-moving', they are playing out against the backdrop of heightened frictions between the EU and the UK arising from the dispute over the *Northern Ireland Protocol.*[10]

Beyond the short-term, this series of public health and geopolitical shocks has fundamentally altered the economic landscape, with far-reaching consequences that will likely persist for years to come. The 'new normal' is likely to involve *inter alia* a slower pace (or even a reversal) of global integration and higher global borrowing costs.[11]

While the humanitarian fall-out from war is, of course, of primary importance,[12] the focus of this document is the economic consequences. Given limited trade and investment links with Russia, higher energy prices is the dominant channel through which the war is affecting domestic living standards. While the pick-up in consumer price inflation had preceded the invasion, the imposition of sanctions and further curtailing of supply has exacerbated price pressures, and put paid to previous suggestions that inflation was transitory. Moreover, evidence is mounting that price increases are becoming increasingly broad-based. Elevated inflation is eroding real incomes and this is weighing on economic activity.

2.2 Recent Developments

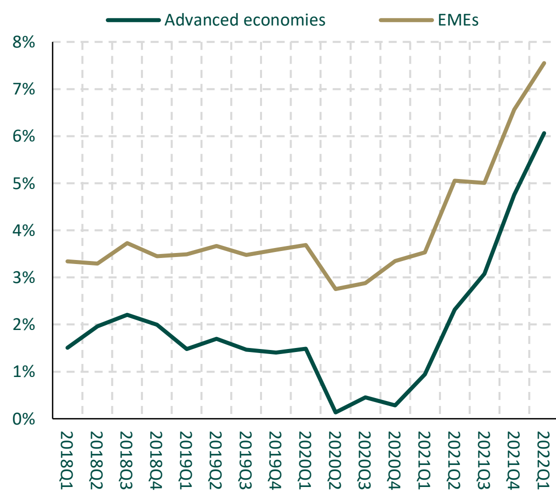
International economic developments

The global outlook has been turned on its head following Russia's invasion of Ukraine, which, from an economic perspective, has triggered a large supply-side shock to the global economy. The main economic transmission channel is via energy prices and some other commodity prices, which has resulted in higher inflation (**figure 2A**). Some of Ireland's key trading partners are highly reliant on Russia and Ukraine for various raw materials and inputs into the production process. The jump in commodity prices, and the possible disruptions to production, are weighing on demand in these markets, with economic projections in most advanced countries being downgraded in recent months (**figure 2B**).[13]

[9] Prices for many non-energy commodities surged in the immediate aftermath of the invasion but have subsequently retreated somewhat.
[10] The NIP is part of the *Withdrawal Agreement* and was put in place to ensure no 'hard' border on the island.
[11] For a further elaboration on some of these issues, see "*Budgetary policy in an uncertain world*", speech by Minister for Finance at *ESRI Budget Perspective Conference* (June 2022) available at:
https://www.gov.ie/en/speech/32226-budgetary-policy-in-an-uncertain-world-opening-remarks-by-minister-for-finance-paschal-donohoe/
[12] At end-June, over 7 million Ukrainians have been displaced within Ukraine, with a further 8 million fleeing their home country. The Irish government has played its part in providing refuge: around 39,000 Ukrainian refugees have arrived in Ireland.
[13] See, for instance, IMF World Economic Outlook (May 2022) and OECD Economic Outlook (June 2022).

Figure 2: Inflation dynamics and slowing global economy

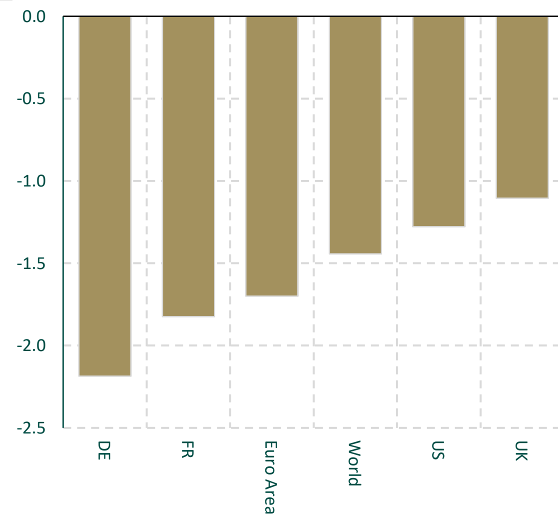
A: Median inflation rate, annual growth



Note: EMEs = emerging market economies.

Source: OECD

B: Revision to OECD GDP projections for 2022



Note: Revisions relate to the OECD June 2022 *Economic Outlook* vs. December 2021 *Economic Outlook.*
Source: OECD

The disruption to global supply chains, which was expected to ease this year as demand and supply began to 'normalise', has been more persistent, with the war prolonging this disruption. Additionally, the ongoing 'zero-Covid' strategy in China has compounded the problem.

Taken together, these factors are all adding to global inflationary pressure. The euro area (8.1 per cent), the US (8.6 per cent) and the UK (7.9 per cent) all recorded multi-decade high rates of inflation in May.[14] Equally worrying is the fact that price pressures increasingly show signs of broadening, suggesting that inflation could remain elevated for longer than previously anticipated.

Alongside the enormous fiscal effort by Governments across the world, central banks were at the forefront in responding to the pandemic, reducing interest rates, rapidly escalating and expanding asset purchases and injecting additional liquidity into markets. However, monetary policy in now, out of necessity, becoming less accommodative. Central banks in almost all advanced economies have now ceased asset purchases and have implemented, or signalled, a number of interest rate rises over the coming months. The aim is to slow demand and, in doing so, to bring it more in line with supply so that price stability is restored. The key question is how far, and how fast, this tightening of monetary policy takes place; this will be a key determinant of economic conditions in advanced economies over the next year or so.

In summary, therefore, the positive momentum in many of Ireland's main export markets from the ending of the pandemic is now being offset by the inter-related headwinds from the war, supply chain disruptions and the elevated level of inflation. These headwinds are strongest in continental Europe, which is most exposed to Russian fossil-fuel inputs. This is confirmed by high frequency data, which show that after only modest expansion in the first quarter, a further weakening occurred in the second quarter.

[14] While all regions have seen an increase in prices, the root-cause is somewhat different (more demand-driven price inflation in the US, more of a supply-side (energy price) shock in the euro area.

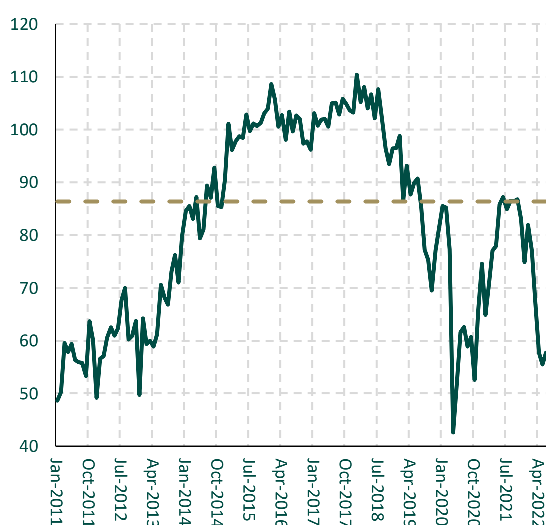
Domestic economic developments

Official data confirm a decline in the domestic economy at the start of the year, with Modified Domestic Demand (MDD) declining by 1 per cent in the first quarter. Part of this was due to the restrictions associated with the *Omicron* wave in January, though by the end of the quarter, the surge in commodity prices on foot of war in Ukraine was an additional factor weighing on demand.

Faced with the dual headwinds from *Omicron* and the Russian invasion, consumer spending fell by 0.7 per cent in the first quarter. While some households reduced the volume of spending in the face of higher prices, others ramped up savings, partly in a 'forced' sense (restrictions on contact-intensive activity) but also for precautionary reasons. Indeed, having been on a downward trajectory in previous quarters, the household savings rate picked up noticeably at the start of the year, increasing to 19 per cent in the first quarter. As a result, consumer spending in the first quarter remained 1.7 per cent below pre-pandemic levels.

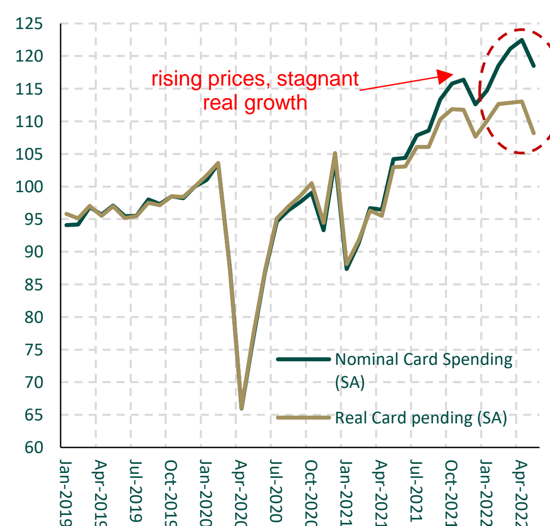
Figure 3: Consumer sentiment and spending

A: KBC Consumer Sentiment Index



Source: Macrobond.

B: Central Bank card data, Dec 2019 = 100



Note: Nominal debit and credit card data from Central Bank, deflated, seasonally adjusted using TRAMOSEATS.
Source: Central Bank of Ireland, DoF calculations.

Higher frequency data point to a modest recovery in the second quarter: the positive impetus from the full relaxation of containment measures was partly offset by higher inflation and the dent to confidence associated with war in Europe (**figure 3A**). Retail sales data for the second quarter of the year, for instance, show only modest growth notwithstanding the large amount of 'excess savings' accumulated by households. This is confirmed by real-time data, such as spending-based card-payments which shows sluggish consumer spending for May (**figure 3B**).[15]

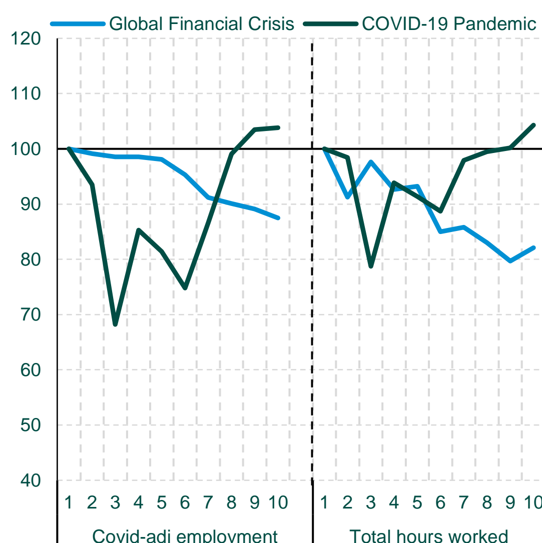
The weakness in consumer spending has been somewhat at odds with labour market developments over recent quarters. The rebound in aggregate employment has been remarkably swift and this continued in the first quarter, helped, in no small part, by the various measures the Government put in place to support workers during the pandemic. With more than 2½ million people at work, there are now more people working than ever before. New administrative data (**box 2**) confirm that employment growth continued during the second quarter.

[15] See Department of Finance, *Emerging Economic Developments*, available at: https://www.gov.ie/en/collection/305e4-emerging-economic-developments/

Increased participation amongst females and younger workers has underpinned employment growth, with an additional 100,000 women, and 50,000 young people, now part of the labour force compared with the pre-pandemic level. Strong employment growth has also been the catalyst for a rapid decline in the unemployment rate, which fell to 4.7 per cent in May, the lowest level, on a quarterly basis, since 2006. To put this into perspective, it has taken just two years for employment to recover to the pre-crisis peak; it took more than ten years for the same to occur following the Global Financial Crisis (**figure 4A**). That said, the recovery is – as of yet – incomplete, with contact intensive services sectors lagging the rebound in aggregate employment, and in services generally (**figure 4B**).

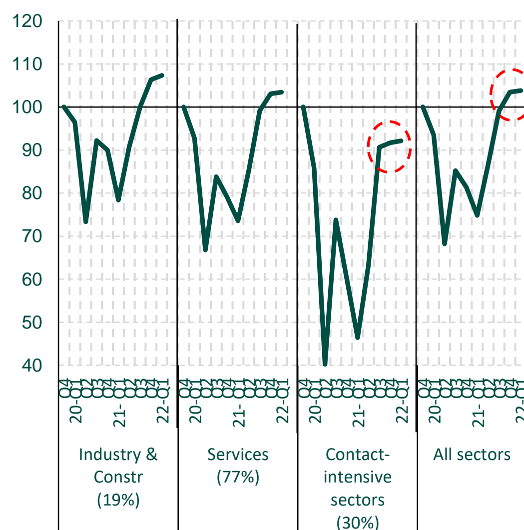
Figure 4: Labour market developments

A: Employment and hours worked, qtrs. post peak index



Source: CSO, Dept. of Finance.

B: Employment index, q419 = 100



Note: COVID-adjusted is employment less PUP recipients
Source: CSO, Dept. of Finance.

Despite the deterioration in the international environment, exports from Ireland have performed strongly so far this year. On an annual basis, underlying exports (excluding globalisation-related distortions) rose by 26 per cent in the first quarter. This strong expansion was driven by sector-specific dynamics, with particularly strong growth in pharmaceutical and computer services exports. These exports, as well as a number of 'once-off' factors such as the timing of royalty payments, resulted in GDP growth of 11 per cent in the first quarter.

2.3 Economic Outlook: 2022

The Department of Finance spring forecasts– set out in the *Stability Programme Update* (SPU) – were conditional on a series of assumptions related to the duration of the war, the scope of sanctions against Russia and the scale of spill-over effects. The margin of error around these projections was exceptionally wide, as reflected in the downside scenario published alongside the central forecasts. A number of the key risks outlined in the SPU have now come-to-pass: inflation is running higher than expected, supply chain disruption is more protracted, and growth prospects in Ireland's main trading partners have weakened.

In the short-term, price dynamics will continue to play a key role in shaping the domestic economic outlook. Sustained volatility in the wholesale oil and gas markets are expected to feed into higher energy prices, eroding real incomes. The pass-through of higher energy prices, alongside tighter labour

market conditions and supply chain disruptions, is expected to keep core inflation at an elevated level this year.

Despite the positive tailwinds from the reopening of the economy, the headwinds households face continue to mount. With a sharp fall in consumer sentiment and a decline in real incomes, consumers will likely continue to adopt a precautionary approach until these headwinds subside. With lower levels of consumer spending, falling external demand as well as higher input costs (including labour costs) businesses are likely to adopt a 'wait and see' approach, holding back on investment in the process. .

As usual, a full suite of updated macro-economic projections will be published alongside *Budget 2023* in the autumn. At this point, it is clear that downside risks to the growth projections this year and next have undoubtedly increased; upside risks to inflation projections have also increased. Much will, of course, depend on how the war in Ukraine evolves as well as what, if any, arrangements are put in place around the *Northern Ireland Protocol.*

The robust growth in the multinational sector, particularly in the pharma and ICT sub-sectors, is likely to be sustained over the rest of this year. Indeed, these multinational dominated sectors proved highly resilient throughout the pandemic, supporting the Irish economy via employment, wages and tax revenue, and look set to cushion the impact of the global supply shock on the Irish economy. As a result, the GDP forecast of 6½ per cent will likely be bettered.

Box 2: Frontier indicator – monthly estimates of employment

The Central Statistics Office published for the first time monthly estimates of employment in mid-June. These estimates are calibrated using administrative data and refer to payroll employees.

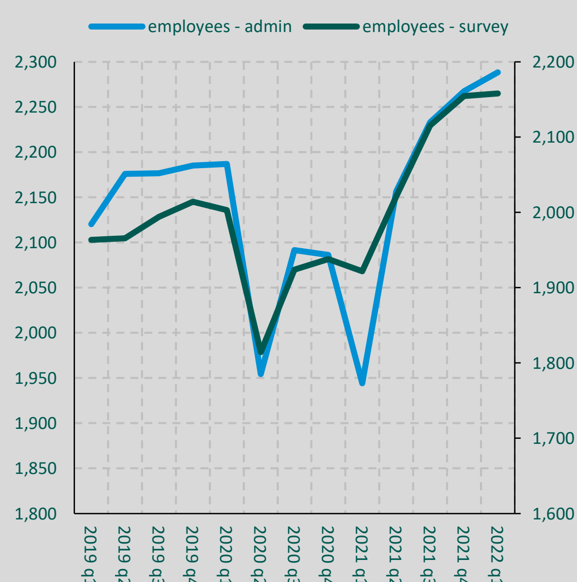
These monthly data are published with a two-month lag, and provide a more timely indicator of labour market conditions than the quarterly Labour Force Survey.

Over time, these data have the potential to become one of the main sources of real-time information on Irish economic developments. In the US, for instance, the monthly US non-farm payroll report is a key barometer and signal of US economic conditions, and is compiled in a similar manner to the new Irish data.

The indicator excludes PRSI classes M (primarily pensioners), S (self-employed), and as a result is mostly aligned with series employed for estimating non-agricultural wages in the economy. Importantly, the administrative data and survey data are highly correlated (**figure 5A**).

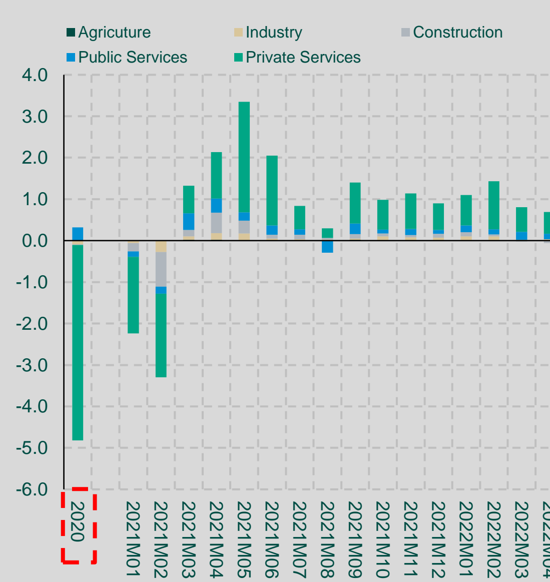
Figure 5: Administrative employment data

A: employment – survey vs administrative data



Source: CSO

B: Contributions to m/m per cent change employment



Source: CSO

The data confirm the sharp fall in employment in the first wave of the pandemic, with the level of employment bottoming out at 1.8 million in the second quarter of 2020.

Employment subsequently recovered but fell once again during the *Delta* wave in the first quarter of 2021. Despite the stringent lockdown at the time, the decline in employment was much less severe than during the first wave.

From the second quarter of last year, employment recovered very strongly, reaching just under 2.2 million at the end of last year (recalling that the self-employed are excluded from this index).

The main driver was private services employment gains (**figure 5B**), and this has continued over the first four months of this year. Within this, strongest growth has been in sectors most impacted by the pandemic that are continuing to recover: Accommodation and food, Arts, entertainment and other. Of the sectors that were less exposed to the pandemic, ICT continues to record strong monthly gains.

The latest monthly data show some moderation in employment growth in March and April; this is probably more of a reflection of labour supply and labour demand.

In April, the (seasonally adjusted) level of employment was 2.344 million, 135,000 (6.1 per cent) higher than its level immediately pre-pandemic (i.e. February 2020).

2.4 Economic Outlook: 2023 and the medium-term

The positive tailwinds from the reopening of the economy this year are expected to wane next year, with contact-intensive sectors beginning to approach a steady state pace of growth. With indications that inflationary pressures are broadening, and energy prices at a more elevated level, the pace at which annual inflation tails-off next year is likely to be slower and later than previously assumed. Taken together, these factors will weigh on domestic economic activity next year and could lead to a further moderation in the pace of growth.

The outlook for the economy over the medium-term will depend on the availability of capital and labour and the efficiency with which these are combined to produce output. In this context, a more sustained increase in whole economy input costs could do lasting damage to potential output.

The UK's exit from the European Union is also expected to impact on the supply potential of the economy, with higher non-tariff (i.e. regulatory) barriers limiting trade and in turn productivity. Pre-existing labour shortages in certain sectors represent a particular risk for increasing wage pressures. Against this backdrop, there is a real risk that a wage-price spiral emerges as the economy approaches full employment and prices remain elevated. This would damage Ireland's cost competitiveness and hamper the economy's ability to compete in the global market place.

Box 3: Irish labour market recovery – strong but uneven

The recovery in the labour market has been, perhaps, the single most remarkable aspect of the economic rebound following the ending of the pandemic.

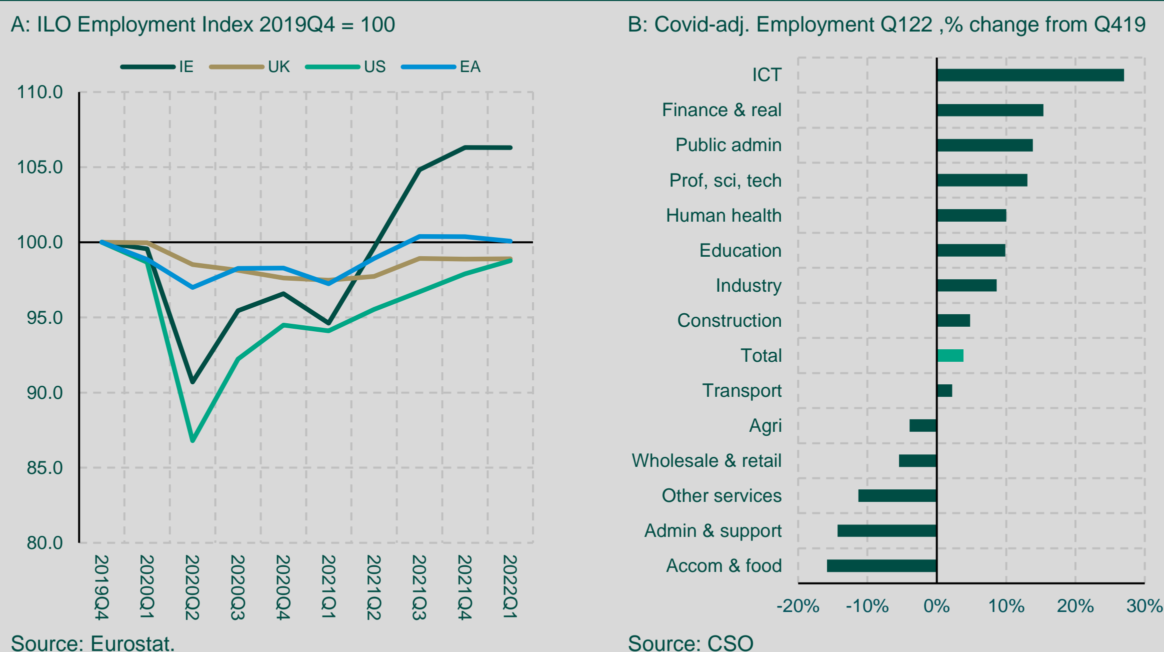
Data from the Labour Force Survey show that, in the first quarter of this year, more than 2½ million people were in employment, the highest level on record. To put this into perspective, it is worth noting that, at the height of the pandemic, the number of people at work fell to just over 1½ million (Covid-adjusted basis), with around 1¼ million in receipt of some form of income support at the time.

How does this compare with elsewhere?

Quarterly employment data relating to Ireland's main trading partners are set out below (**figure 6A**), with the quarter immediately before the pandemic set equal to 100. In both the US and UK, the level of employment remains around 1 per cent below its pre-pandemic peak. On the other hand, employment in the euro area is now back at pre-pandemic levels.

These cross-country data also confirm that the fall in employment in the US was much more severe than in the euro area. This would suggest that different institutional features of the respective labour markets were at work: in particular, many countries in the euro area relied on short-term working schemes as a key policy response to the pandemic. On the other hand, the US relied more on direct income supports.

Figure 6: Employment in international and sectoral perspective



Source: Eurostat.

Source: CSO

Labour supply also appears to be part of the reason for the differential employment performance across countries. For instance, in the UK both the working age population and participation rates have fallen (sometimes called 'the big quit'), depressing labour supply. In contrast, labour supply continues to increase in Ireland, with both increases in the working age population and participation. Indeed, Ireland's employment recovery has been driven by increased participation, principally in the female and youth cohorts. More than 100,000 additional women, and 45,000 additional youths are now a part of the labour force compared with the level pre-pandemic.

Greater participation is reflective of both cyclical, and structural factors – such as greater flexibility offered by remote working and education. The pace of recovery also reflects the strong policy response to the pandemic, which helped to maintain the employer-employee link through successive waves of containment measures.

On a sectoral basis, data also show that the post-pandemic employment recovery has not been homogenous, with the level of employment yet to recover to pre-pandemic levels by the first quarter (**figure 6B**). With record vacancy rates in some of these sectors, this suggests 'mismatches' between supply and demand for labour in some sectors.

Chapter 3
Budgetary Strategy

3.1 Summary

The forthcoming budget is being framed against a backdrop of exceptionally high inflation, heightened uncertainty and rising borrowing costs. In this regard, the Government has introduced a suite of measures amounting to €2.4 billion (around 1 per cent of national income) to help address increases in the cost of living (**figure 9A**).

The Government's key objective in framing its policy response is to balance the need to mitigate the impact of higher inflation on households while, at the same time, avoiding fanning the inflation flames. To minimise this trade-off, Government policy will focus on targeted measures, aimed at those most in need. In designing its overall response, Government must also be conscious of the growing dependence of the public finances on revenue streams linked to the corporate sector (corporate taxes but also a significant part of income tax). In addition, sovereign borrowing costs are now on a rising trajectory.

The Government's medium-term fiscal framework, set out in last year's *Summer Economic Statement,* was calibrated in a much more benign inflationary environment. Given the energy price shock, the framework needs to be adapted somewhat, with the parameters adjusted to take account of the higher inflationary environment.

For next year, an overall budgetary package of €6.7 billion is being made available, with the main focus of *Budget 2023* being on addressing the higher cost of living. This overall budget package will be composed of a spending allocation amounting to €5.65 billion over 2022 and 2023. 'Core' expenditure will grow by 6 and 6.5 per cent in 2022 and 2023 respectively. This would be consistent with a modest fiscal surplus next year; however, this would only be due to exceptionally high levels of corporation tax receipts. An overall taxation package amounting to €1.05 billion will be provided, focusing on the need to adjust income tax bands and credits so that workers are not 'dragged' into higher levels of taxation by virtue of wage inflation ('fiscal drag').

Reflecting the expected moderation in inflation, core public expenditure will be allowed to grow at a rate of 5 per cent per annum over the years 2024-2025; this growth rate is broadly consistent with the estimated trend growth rate of the economy.

3.2 Fiscal Developments in 2022: an update

At end-June, taxation receipts were up almost €7½ billion (25 per cent) on an annual basis, driven by strong growth in income tax, corporate tax and VAT receipts. The strong annual growth reflects the ongoing recovery in the Irish economy, as well as a number of positive 'base effects' (the introduction of stringent public health restrictions in the opening months of last year weighed on economic activity – and hence tax revenue – at the time). However, tax revenue growth is expected to decelerate in the second half of this year as these 'base effects' fade and economic growth slows.

In the spring, tax revenue was projected at €75.8 billion this year, up almost 11 per cent on an annual basis; while there is some upside potential to this, it is important to recognise that a large part of any overshooting will be due to corporation tax receipts, whose continued flow cannot be guaranteed over the medium-term.

Total gross voted expenditure in the first half of this year amounted to €38.5 billion, a decrease of €1.4 billion (3.5 per cent) in year-on-year terms. The trend was driven by significant declines in Covid-related expenditure, in particular, in relation to the *Employment Wage Subsidy Scheme* and *Pandemic Unemployment Payment*, both of which have now been fully unwound.

3.3 Budgetary Strategy: key factors

The need for a credible fiscal strategy for rebuilding fiscal buffers takes on an increased urgency in the context of multiple challenges facing the public finances.

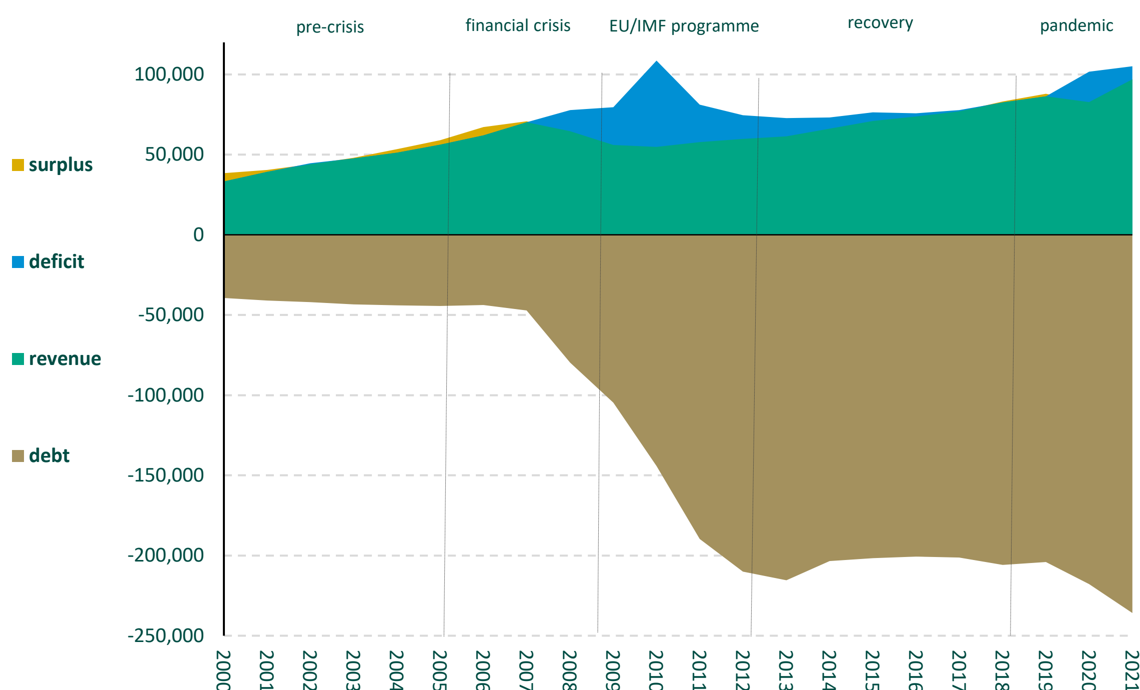
Challenge 1: High debt

Acting to protect households from the most severe impacts of the pandemic and from rising inflation, has been both necessary and appropriate, but these interventions have come at a significant cost. In particular, public debt is expected to amount to over €230 billion by the end of this year.

This has meant a further increase on the elevated stocks of public debt built up during the financial crisis period (**figure 7**). On a per capita basis, the projected level of public debt this year now amounts to around €47,000, a figure which is amongst the highest debt burdens in the world.

Figure 7: Public finances

A: **Evolution of the public finances since 2000, €mn**



Note: all figures on a general government basis.
Source: CSO, Dept. of Finance.

The optimal strategy for absorbing this level of debt is to ensure that net additions to the stock of debt are minimised and that, simultaneously, the economy continues to expand so that the debt-income ratio remains on a downward trajectory.

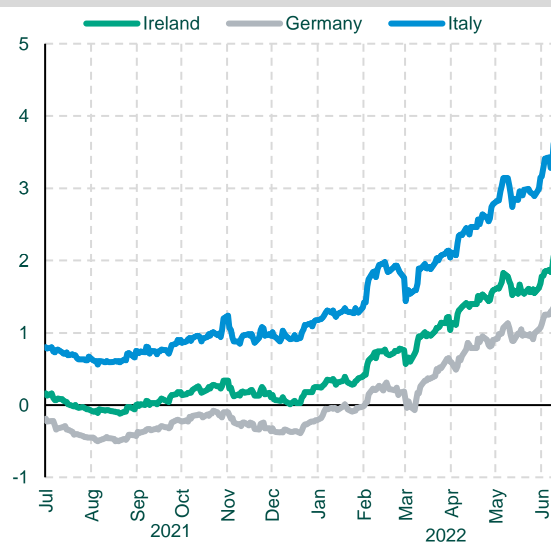
Challenge 2: Rising borrowing costs

The monetary policy landscape has also changed significantly since the beginning of the year. Multi-decade highs in inflation in virtually all advanced economies mean that monetary policy is becoming less accommodative, with the majority of central banks (including in the euro area) already beginning to tighten policy.

From a fiscal perspective, this changing monetary policy landscape means that borrowing costs for Government are now rising (**figure 8A**). The best way to insulate the public finances from the higher cost of borrowing is to ensure that Ireland's debt ratio is not out-of-sync with other small open economies (**figure 8B**). This will require a consistent reduction in the debt-income ratio over the medium-term.

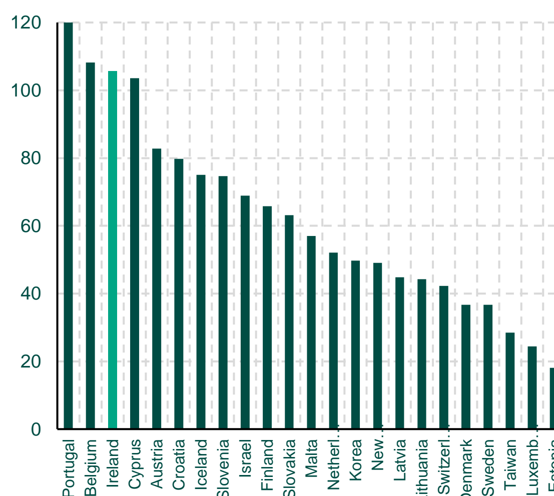
Figure 8: Public debt developments

A: Interest cost on 10-year Government bond, per cent



Note: as per-end June.
Source: Macrobond.

B: Debt-to-GDP ratio in small open economies, 2021



Note: IE debt ratio as a share of GNI*
Source: European Commission, IMF, CSO.

Challenge 3: Medium-term fiscal challenges

In designing an appropriate budgetary strategy, the Government must take into account the fiscal challenges that Ireland is facing over the medium-term. Government will have to meet the fiscal costs associated with an ageing population and those costs necessary to finance the 'net zero' transition. On both of these issues, the scientific evidence is clear and unambiguous: the Irish population is ageing and the world is warming.

There is also a pressing need to finance the digital transition and the provision of better healthcare, including via *Sláintecare*. The fiscal costs associated with these developments, as well as the medium-term costs arising from Government decisions taken in recent months, are very substantial and will require spending restraint elsewhere to accommodate these pressures.

Challenge 4: Exposure to corporation tax

On the revenue side, Government must also be conscious of the very real possibility of a decline in corporation tax receipts. There are two distinct issues.

The first, and perhaps most immediate risk, relates to the impact of international corporate tax reforms. The *Department of Finance's* central estimate is that the OECD's Base Erosion and Profit Shifting (BEPS) process will lead to a loss in revenue of around €2 billion over the medium-term.

The second issue is the concentration risk. This arises from the fact that corporation tax receipts have more than tripled since 2014, but these revenues are subject to significant volatility. As the corporation tax yield has increased, the tax base has narrowed: last year, just ten firms accounted for over half of all corporate tax receipts (**figure 9b**). This means that receipts have become increasingly reliant on the business decisions of a small number of large firms, and a shock which impacted on the multinational sector would have severe implications for the fiscal position.

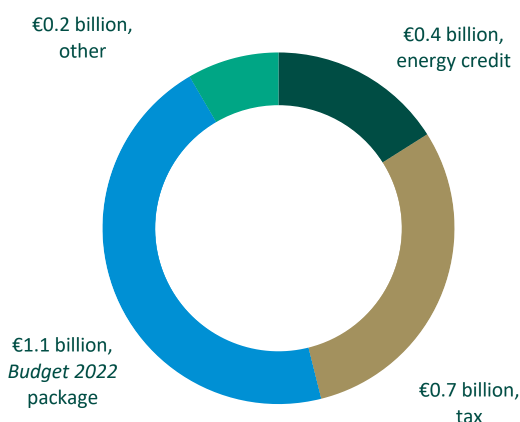
For these reasons, Government sees it as crucial to use the current elevated level of corporation tax receipts to rebuild fiscal buffers over the coming years.

Challenge 5: Need to avoid adding to inflation

The Government faces a difficult balancing act between supporting those least able to absorb recent price shifts while avoiding adding to inflationary pressures and overheating the economy. Therefore, Government policy will continue to focus on targeted fiscal measures. This is the appropriate response to a 'terms-of-trade' shock – whereby a country's import bill rises because of higher prices – as the Government cannot fully absorb the costs of this shock.

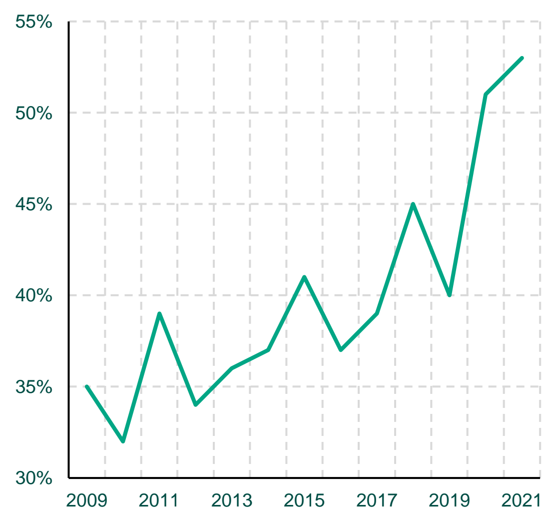
Figure 9: Cost of living support and exposure to corporation tax

A: Cost of living package



Source: Department of Finance.

B: Corporation tax paid by top ten payers, share of total



Note: data on a net receipts basis.
Source: Revenue Commissioners.

3.4 Budgetary Strategy

In order to take into account both the elevated inflationary environment and challenges facing the public finances, *Budget 2023* will be based on a total package of €6.7 billon. This is composed of a core expenditure package of €5.65 billion, and a net tax package of €1.05 billion.

Taking into account the end-June exchequer returns, this would be consistent with a modest surplus next year; however, if this were to arise, it would only be because of exceptionally high corporate tax receipts, whose sustainability cannot be guaranteed.

Given significant capacity constraints in an increasing number of sectors, any spending beyond this would risk increasing inflationary pressures and overheating the economy.

Beyond next year, inflation is projected to moderate over the medium-term and trend back towards 2 per cent per annum, broadly in line with the ECB target for price stability in the euro area. On that basis, Government will revert to the original strategy set out last year. Specifically, core public expenditure will be allowed to grow at a rate of 5 per cent per annum over the years 2024-2025; broadly in line with the estimated trend growth rate of the economy. As the economy and tax revenue fluctuate around its trend growth, the fiscal accounts will be also be allowed to fluctuate, while keeping the spending ceiling fixed, i.e. even if tax revenue exceeds expectations expenditure ceilings will be maintained at a sustainable level.

Box 4: Fiscal response to the housing shortage

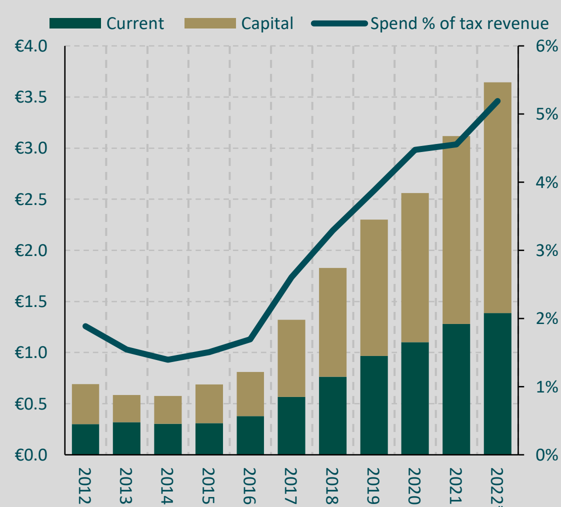
Published in September 2021, *Housing for All* is the whole-of-Government strategy to address the demand-supply imbalance that has characterised the Irish housing market since the recovery of the economy from the sovereign debt crisis nearly a decade ago. The strategy covers the period 2021-2030 and encompasses four key pathways — supporting home ownership, increasing social housing delivery, increasing new housing supply and addressing vacancy.

The overall objective is to construct an additional 300,000 new homes by 2030 and, to support this, the Government has introduced a large number of policy tools, including a ramping-up of public expenditure on housing. In *Budget 2022,* a record level of funding was allocated to housing: this year the total amount allocated amounts to €4 billion (**figure 10A**), a trebling since 2017.

Under the strategy, average Exchequer funding of over €4 billion per annum is being provided. To put this into perspective, Exchequer spending on housing now accounts for around 1½ per cent of GNI*, an exceptionally high level. In addition to direct public expenditure, substantial levels of public funding is also available through other State agencies (*Housing Finance Agency, Home Building Finance Ireland, the Land Development Agency, the National Asset Management Agency* and the *Irish Strategic Investment Fund*).

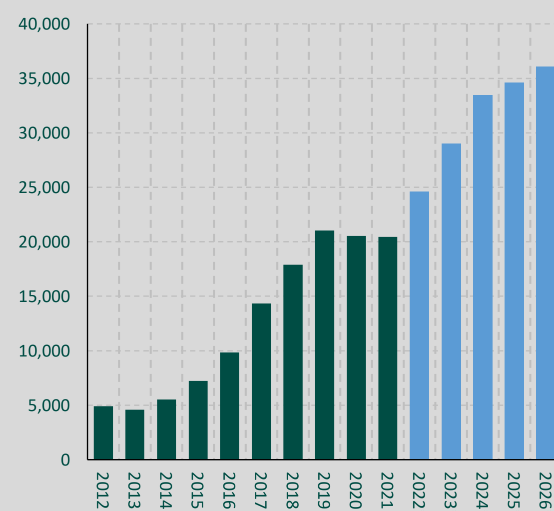
Figure 10: Boosting housing supply – the role of public expenditure

A: Exchequer expenditure in housing, 2012-2022



Note: 2022 is a forecast.
Estimate for tax receipts for 2022 are sourced from *Budget 2022 Economic and Fiscal Outlook*
Source: Budget.gov.ie & Finance Accounts.

B: Housing completions and *Housing for All* targets



Note: 2022-2026* are represent HFA targets

Source: CSO and *Housing for All*

Exchequer spending on housing can be decomposed into current and capital outlays. Current expenditure items include rental supports such as the Housing Assistance Payment (HAP) and the Rental Accommodation Scheme (RAS). It also includes the social housing programme which provides support to local authorities and Approved Housing Bodies (AHBs) for the leasing of residential units. Capital expenditure items include the delivery of new social homes by local authorities through direct build and acquisition, as well as the funding of public infrastructure projects via the Local Infrastructure Housing Activation Fund.

Significant capital investment in housing will be required to keep pace with demographic, economic and societal changes in the coming years. In recognition of this fact, the share of capital as a proportion of overall housing expenditure has increased, rising from 57 per cent in 2017 to 62 per cent in 2022. In nominal terms, capital spending has increased from €0.7 billion in 2017 to €2.3 billion in 2022.

Since 2018, total capital investment in housing has been more than €8.6 billion. It is noteworthy that the increase in capital spending has occurred despite the existence of large fiscal deficits. This is in sharp contrast to the reduction in capital spending in the aftermath of the sovereign debt crisis in 2008.

Finance Accounts (containing annual tax receipts), available at:
https://www.gov.ie/en/collection/1f1c3a-finance-accounts/
Annual expenditure allocations are taken from the housing programme from the *Revised Estimates Volumes for Public Services*, available at:
https://www.gov.ie/en/collection/e20037-revised-estimates

Chapter 4
Public Expenditure Strategy

4.1 Overview

The events of the past few years posed considerable challenges for the economy and society. This required a timely policy response through the provision of additional direct public expenditure resources. During 2020 and 2021, Government provided over €30 billion to support households, businesses and public services in responding to the challenges posed by the pandemic.

During this time, Government also continued to invest substantial resources in core expenditure measures, with some €80 billion provided in 2022 to support public service delivery. This allocation reflects the continued prioritisation of capital investment and the incremental development in public services, including health, education and social welfare.

A new set of challenges has now emerged. A mismatch between demand and supply has triggered a sharp rise in inflation, which has been compounded by the conflict in Ukraine. This has put pressure on households, particularly in relation to energy prices and especially for those on lower incomes.

Elevated inflation adds complexity to the formulation of the Government's fiscal strategy in the short-term. Government cannot absorb the full impact of an inflationary shock. Instead, fiscal policy will seek to strike a balance between delivering targeted supports, capable of timely implementation, protecting public services and maintaining expenditure on a sustainable path.

The Medium-Term Expenditure Strategy sets out the dual objective of delivering sustainable expenditure over the medium term through:

- setting the core expenditure growth rate at a sustainable level; and,
- providing ongoing improvements in public services.

In order to protect the real value of public services, a short-term adjustment to the Strategy is required (**section 4.3**). Recognising the core inflationary environment, the core expenditure growth rate will increase above the long run average of 5 per cent in 2023. This change will seek to balance the need to protect the real value of public services without feeding into further inflationary pressures.

This development would see core spending growing from some €80 billion in 2022 to €94½ billion in 2025. This significant level of expenditure on services and investment in infrastructure, coupled with the challenges posed by rising prices, underlines the importance of ensuring that this expenditure delivers value for money and improved outcomes.

4.2 Sustainable Public Expenditure

One of the aims of the overall fiscal strategy is to deliver sustainable public expenditure. This requires the management of two criteria:

- the level of core expenditure growth must be sustainable over the long-term; and,
- the investment in expenditure must protect and deliver improvements in public services.

These criteria informed the development of the Medium Term Expenditure Strategy and will also feed into its ongoing implementation.

Medium Term Expenditure Strategy

The *2021 Summer Economic Statement* (SES) and *Mid-Year Expenditure Report* (MYER) set out a strategy to anchor core expenditure growth to the trend growth rate of the economy, estimated at about 5 per cent. By anchoring the expenditure growth rate to an appropriate trend growth rate for the economy, the Medium Term Expenditure Framework sought to ensure a sustainable path for expenditure while also providing the necessary resources to enhance our public services, social supports and infrastructure.

Impact of inflation

Inflationary pressures are generally dealt with on a year-by-year basis as part of the normal budgetary process. There is an expectation and a responsibility across all Departments and agencies to generate efficiency dividends and promote productivity with the resources that are provided. This is vital to ensure that value for money is delivered across Government projects and programmes. However, there is a limit to this approach in an environment with above average inflation levels.

Elevated levels of inflation mean there is a risk of a real decline in investment in public services. This would serve to undermine the second criteria of our overall fiscal strategy, eroding the ability to deliver in real terms on the key priorities of enhancing public services and social supports during 2023. As outlined earlier in this document, the inflation forecasts for 2022 and 2023 mean a significant deviation from the assumed average of 2 per cent.

As noted earlier, the drivers of inflation are external and beyond the control of the Government. These drivers largely relate to external developments including supply chain issues, the global energy market—the impact of the war in Ukraine has exacerbated these pressures—and the global level of savings. The difference between the headline and core inflation rate is largely due to energy price increases. Given the differing drivers of inflation and the external nature of these economic shocks, a two-pronged policy response is being adopted combining elements of core and non-core expenditure.

Overall, the strategy must be responsive to the emerging economic landscape and take account of the exceptional and external driven nature of these economic shocks.

Core versus Non-Core Response

The scale of the external economic shocks has necessitated a dual approach to expenditure provision; core and non-core expenditure. Core expenditure relates to the ongoing permanent expenditure pressures to support public services and capital expenditure including core health services, social protection, education and housing supports. This permanent core expenditure was anchored to the trend growth rate of the economy.

In contrast, non-core expenditure relates to transitory pressures requiring temporary public expenditure measures. These expenditure measures are not included in the base going forward and the level of support fluctuates depending on the severity of the shock and response required. This flexibility has been an important lever in allowing Government to respond to external shocks whilst also protecting the continued investment in day-to-day public services. Non-core expenditure has been put in place to help citizens and businesses cope with challenges posed by the pandemic. Similarly, the *Brexit Adjustment Reserve* (BAR) provides temporary support, over the period 2020-2023, to counter the

adverse economic, social, territorial and, where appropriate, environmental consequences of the withdrawal of the UK from the European Union.

In designing the response to the impact of inflation on the economy and society, a similar approach is considered appropriate. Non-core inflationary pressures, most notably energy price increases, are expected to be transitory. Energy prices are subject to considerable volatility. Supply and demand impacts are expected to moderate considerably over the medium term. Therefore, additional supports related to these cost-of-living pressures are provided through non-core expenditure. A package of measures, including the electricity credit and fuel allowance payments, was introduced in early 2022. Further details are set out below (**section 4.4**).

4.3 *Budget 2023* and Medium-Term Expenditure Strategy

The *2021 Summer Economic Statement* set out a fiscal framework for the period to 2025, including planned annual expenditure ceilings based on the medium term expenditure strategy's 5 per cent anchor. Given the elevated levels of inflation, it is appropriate, that Government has provided additional support this year in targeted tax and expenditure measures, and that there be an adjustment to the medium term expenditure strategy (**box 5**). This adjusted approach provides for the revised expenditure ceilings (**table 3**).

Table 3: medium-term core expenditure trajectory, € billions

	2022	2023	2024	2025
Total core expenditure	80.5	85.8	90.1	94.6
year-on-year increase	4.6	5.3	4.3	4.5
year-on-year increase, per cent	6.0	6.5	5.0	5.0

Source: Department of Public Expenditure and Reform.

Budget 2023

The total core expenditure ceiling for 2023 of €85.8 billion will provide for both ongoing costs of current service provision and an additional level of investment.

Approximately 3 per cent of the core current expenditure base, as indicated in the 2021 SES and MYER, will be available to meet existing levels of service (ELS) costs. This includes:

> Continued investment in the public sector workforce, as set out in Building Momentum, as the delivery mechanism for a wide range of critical services;
> Funding for demographic developments including supporting a growing population and the changing profile of our citizens;
> The full year impact of measures from *Budget 2022*, which are being implemented on a phased basis.

This ceiling will also provide a package of €2.7 billion for the provision of new current expenditure measures with €0.4bn to be allocated in 2022 for the early implementation of new measures. This allocation must accommodate priorities across a wide range of policy areas. The public service pay bill is a significant driver of current expenditure, amounting to close to a third of core current spending each year. Spending on Social Protection accounts for around another third. Further to this Government commitments in relation to housing, climate change and health must also be accommodated. Effective prioritisation will be required taking account of the trade-offs inherent in all public policy decisions.

Box 5: Adjusted medium-term expenditure strategy

In order to ensure sustainable fiscal policy over the medium term coupled with responding to the inflationary environment, the growth rate of expenditure for 2022 and 2023 is being increased.

This adjustment will result in increase in the core expenditure growth rate to 6.0 per cent in 2022 and 6.5 per cent in 2023 (**table 4**). This will facilitate an additional €1.7 billion of core expenditure over the two-year period compared to the ceiling set out in the *Stability Programme Update* (SPU).

Table 4: SPU vs SES core expenditure ceilings

	2022	2023
SPU		
Total core expenditure	80.1	84.1
year-on-year increase	4.2	4.0
year-on-year increase, per cent	5.5	5.0
SES		
Total core expenditure	80.5	85.8
year-on-year increase	4.6	5.3
*year-on-year increase, per cent^*	6.0	6.5

Source: Department of Public Expenditure and Reform
Notes: This reflects growth in core expenditure compared to 2021 estimate as set out in *Budget 2022*.

This short-term adjustment balances the two criteria underpinning the overall fiscal strategy. On the one hand, it provides additional resources to continue a steady upward trajectory of investment to support citizens through income supports, access to services and building infrastructure capacity. On the other hand, the upward adjustment is below the headline inflation rate to limit the risk of expenditure policy feeding into an inflationary spiral.

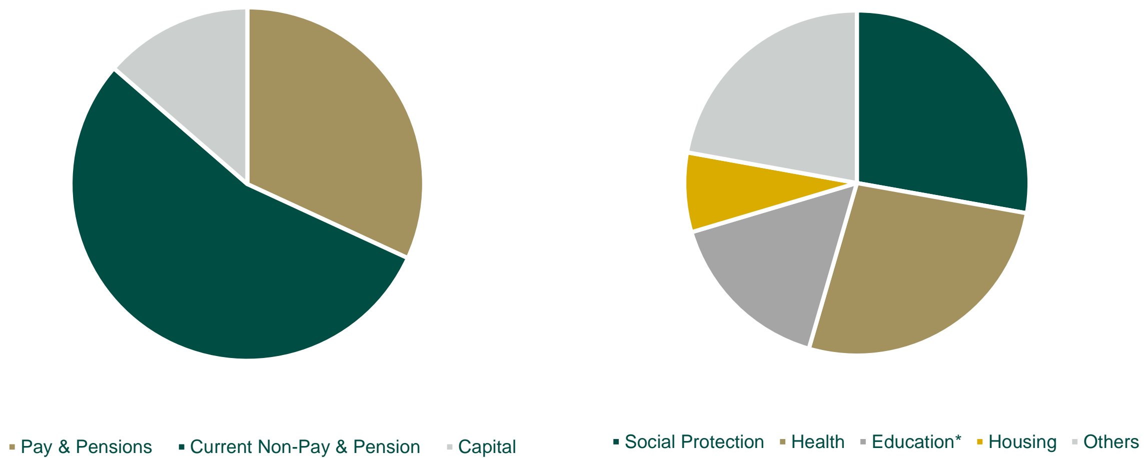
In tandem with non-core expenditure response, this adjustment provides a balanced response to the challenging economic environment for 2023. Over into the medium-term, inflation is expected to revert to around 2 per cent in 2024 and 2025. This will facilitate the 5 per cent anchor in expenditure growth being restored and core expenditure will reach €94.6 billion by 2025.

Core capital expenditure will reach some €11.7 billion in 2023, an increase of 7 per cent, in line with the *National Development Plan 2021-2030*. This funding will provide for key investment across sectors including health, education and transport while also investing in Ireland's climate goals.

Figure 11: Core expenditure in 2022

A: 2022 core expenditure breakdown

B: Departmental breakdown of overall core funding 2022



Source: Department of Public Expenditure and Reform

Note: *Education includes both the Department of Education & the Department of Further and Higher Education. Others includes remaining unallocated funding.
Source: Department of Public Expenditure and Reform

4.4 Non–Core Expenditure Response

Ireland has faced increased uncertainty over the past three years with three severe economic shocks. Since 2020 Ireland has seen the impact of global pandemic and the challenges which that has placed on our society and economy. The UK left the European Union two years ago disrupting the Irish Economy and supply chains. With recent events in Ukraine and the geopolitical fallout of the war there has been wide ranging impacts on both our economy and society as Government provide humanitarian supports for refugees arriving in Ireland. Fiscal policy has needed to remain responsive and flexible to address these challenges.

Additional resources, outside day-to-day core expenditure, have provided Government with this flexibility (**table 5**). This non-core expenditure has provided temporary supports which can be unwound when they are no longer required whilst also insulating core expenditure levels and maintaining them at sustainable levels.

Table 5: Non-core expenditure trajectory, € billions

	2022	2023	2024	2025
Total non-core expenditure	7.5	4.5	0.7	0.4
Covid-19 expenditure	7.0	1.0	0.7	0.4
of which: National Recovery and Resilience Plan	*0.2*	*0.2*	*0.2*	*0.2*
Brexit Adjustment Reserve	0.5	0.6		
Ukraine Humanitarian Contingency		3.0		

Source: Department of Public Expenditure and Reform.

Non-core expenditure of €7.5 billion has been made available in 2022, including €0.5 billion under the BAR, to Departments to respond to pressures arising from these external developments. As outlined in the *Stability Programme Update* (SPU), non-core expenditure provision of €4.5 billion will be put in

place for 2023. This includes some €3 billion of expenditure on humanitarian supports for refugees arriving from Ukraine.

Looking beyond 2023, Covid supports will be unwound over the period to 2025, with provision for automatic stabilisers into the medium term. National Recovery and Resilience Plan (NRRP) funding over the period will contribute to a sustainable equitable, green and digital recovery from the pandemic impacts, in a manner that complements and supports the Government's broader recovery efforts.

Covid Expenditure

Since the onset of the Covid-19 pandemic in 2020, substantial direct expenditure measures have been introduced by Government for supports to mitigate the impacts on citizens, businesses and key public services. Some €30 billion was made available across 2020 and 2021 while up to €7 billion, inclusive of funding under the NRRP, is available in 2022.

This funding has been critical to allowing the health sector deliver essential care and to rollout one of the largest vaccination programmes in the state's history. It has supported businesses and workers by protecting incomes during closures and supporting the reopening of the economy. It has also ensured that 1 million learners have returned to school.

These were exceptional temporary supports, introduced in the face of the extraordinary challenge posed by the Covid-19 pandemic. This financial provision was the appropriate response to the impacts of the pandemic, where public health restrictions required curtailment of many types of activity. This support has protected lives and livelihoods but has resulted in increased public debt, with an increase of €32 billion since end 2019.

In order to return the public finances to a sustainable position, it is necessary that these exceptional supports, as they are no longer required, are unwound on a careful, phased basis. As part of this phased unwinding, separate Covid-related and core expenditure allocations were set out in Budgets 2021 and 2022.

Looking beyond 2023, Covid supports will be unwound over the period to 2025, with provision for automatic stabilisers into the medium term.

The NRRP funding will continue to support projects as part of the *NextGenerationEU*, a shared response to the public health, economic and social crisis caused by Covid-19. The overall objective of Ireland's Plan is to contribute to a sustainable, equitable, green and digital recovery and is based on sixteen investment projects and nine reform measures covering the following priorities: Advancing the Green Transition; Accelerating and Expanding Digital Reforms and Transformation; and Social and Economic Recovery and Job Creation.

Other Non-Core Expenditure

Cost of Living – Targeted energy response

Global supply chain pressures and increasing prices, particularly for energy, have meant increased inflation since the second half of 2021. The war in Ukraine has exacerbated these supply chain and energy price issues. The increased consumer prices mean many households, particularly those on lower incomes, are experiencing difficulties with the rising cost of living. A range of expenditure measures, totalling some €1.2 billion, were included in *Budget 2022* and assist with the impact of

increased prices[16]. In addition to supports provided through *Budget 2022*, a further €½ billion in expenditure measures have been introduced during 2022.

Ukraine Humanitarian Provision

Responding to the humanitarian crisis as a result of the war in Ukraine is a challenge being addressed through the provision of the necessary accommodation, health, education and welfare supports for refugees arriving in Ireland. The provision of these vital humanitarian supports will require substantial resources. The exact level of costs will depend on a number of factors, including the total number of arrivals, the length of stay and the accommodation solution provided. Uncertainty remains in relation to many of these factors. In the SPU, contingency funding of €3 billion was set out as an indicative figure for 2023. The latest available information will be reviewed in the context of *Budget 2023* preparations and inform funding allocations.

Brexit

Since Budget 2017, Government has committed significant supports to ensuring Ireland is as prepared as possible for the impacts of Brexit. This financial support includes funding from the EU through the BAR, which provides a €1.1 billion allocation to Ireland to deal with the adverse consequences of Brexit. The eligibility period for expenditure runs from 1 January 2020 to 31 December 2023. It has been assumed that €500 million of the overall BAR allocation will be made available in 2022 with the remainder available in 2023. To allow Departments to proceed with programmes to be funded under the BAR, initial allocations were made to a number of Departments in *Budget 2022*, with the remainder to be considered as part of the upcoming budgetary process. Funding under the BAR will be used to support enterprise supports; measures to support fisheries and coastal communities; targeted supports for the agri-food sector; reskilling and retraining; and checks and controls at ports and airports.

[16] This includes a broader range of measures than included in figure 9 under the budget package, which only includes the social welfare package. *Budget 2022* introduced a range of measures which will impact on affordability and the cost of living, these measures include income supports, health affordability supports, housing and education supports.

Annexes

Annex 1
Monitoring imbalances in the Irish economy

An important lesson from the last crisis is that macroeconomic imbalances within the single currency area can trigger contagion effects and, hence, pose a threat to overall economic and financial stability of the euro area as a whole. In Ireland, serious economic and financial imbalances were allowed to accumulate in the early- to mid-2000s, with serious consequences for the domestic and wider euro area economies.

This historical experience illustrates the importance of monitoring, identifying and addressing potential emerging imbalances in the economy before these become problematic.

As part of the revised economic architecture put in place after the Global Financial Crisis, *the European Commission* (the 'Commission') monitors key macroeconomic developments in all Member States, with a view to identifying emerging imbalances. An annual assessment for each Member State is published each spring, alongside policy-relevant recommendations.

For Ireland, the assessment this year found no macroeconomic imbalances, the first time this has been the case since the new framework was put in place a decade or so ago.

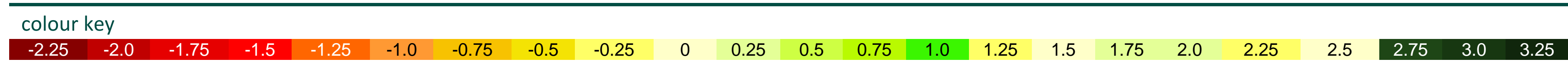
The Commission's assessment highlighted significant progress made in reducing government and private indebtedness, as well as net external liabilities. The assessment pointed to the decline in Government debt ratios in recent years which, notwithstanding the temporary interruption of this trajectory during the pandemic, are expected to continue declining. In addition, the assessment showed that Corporate debt has decreased, although the full impact of the withdrawal of pandemic-related Government supports for businesses remains to be seen. The household sector was seen as being on a much more robust footing than just a few years ago, with household sector debt continuing to fall and household net worth rising to a record high in the final quarter of last year. Finally, Ireland's external position has also been improving in recent years on foot of strong surpluses in the modified current account.

Each year, the Department complements the Commission's annual assessment with a 'heat map' analysis (**table A1**). This type of analysis is part of the overall macroeconomic assessment toolkit and is not, and should not, be applied in a mechanistic manner: deviations from a threshold are not always a negative development while, symmetrically, a reading within the threshold is not necessarily always a benign development.

Looking ahead, decades-high inflation alongside an extremely uncertain geopolitical environment could trigger the build-up of new macro-imbalances. In this context, resilience and adaptability will be key, and it will be important to closely monitor the evolving situation.

Table A1: Heat-map of macroeconomic indicators, 2005-2021

Indicator	LR avg	Threshold*	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21
Current account balance, % GDP	-1.3%	-4/6%																	
Alternative: CA % GNI**	1.5%	-4/6%																	
NIIP, % GDP	-115%	-35%																	
*Alternative: Underlying NIIP, % GNI**	-69%	-35%																	
REER, 1-year % change	0.0%	±5% (EA)																	
Export market share - % of world exports	1.1%	-6%																	
ULC, nominal 1-year % change	0.1%	9% (EA)																	
House price index, 1-year % change	2.0%	6%																	
Private sector credit flow, % GDP	7.7%	14%																	
Private sector debt, % GDP	222%	133%																	
Alternative: Household debt (% GNI)*	98%																		
Government debt, % GDP	61%	60%																	
*Alternative: Government debt, % GNI**	82%	60%																	
Unemployment rate, %	9.1%	10%																	
Financial sector liabilities, 1-year % change	11%	16.5%																	



Source: Department of Finance calculations based on Eurostat, CSO, Central Bank data.
How to read: Darker colours suggest imbalances (whether dark red or dark green, with green imbalances generally less harmful), while light yellow shading represents values broadly in line with the long-run average for each indicator. Grey areas indicate data gaps.
Note: the indicators for unit labour costs, private sector credit and debt, household debt, government debt, unemployment and financial sector liabilities have been inverted such that red represents a value above the long-run average, and *vice versa*. The three additional employment indicators in the MIP scoreboard are not shown here. GNI* and CA* values in 2021 are DoF estimates and subject to revision with the official release of the 2021 NIE results by the CSO. NIIP = net international investment position; REER = real effective exchange rate; ULC = unit labour cost
*Threshold refers to the MIP threshold set out in the European Commission's procedure

Annex 2
Ireland's well-being framework

It is well established that macroeconomic data, such as GDP, employment, etc., do not fully capture the quality of life in a country. Reflecting this, the literature around 'well-being' has expanded significantly in recent years – in a nutshell, the objective is to provide a more comprehensive measure of quality of life rather than focussing solely on the narrower, purely economic indicators.

The *Programme for Government*[17] recognised this, and committed to the development of "a set of wellbeing indices to create a well-rounded, holistic view of how our society is faring." Ireland's 'Well-being Framework' (**table A2**) has been developed by the Department of the Taoiseach, in partnership with the Departments of Finance and Public Expenditure and Reform, and in consultation with the Interdepartmental Working Group on Well-being.

It is an attempt to systematically consider progress in Ireland across economic, environmental and social issues, including as part of the Budget Process. The National Economic Dialogue this year included a specific breakout session, chaired by the Minister for Public Expenditure and Reform, which discussed 'Sustainable Spending through a Multi-dimensional Well-being Framework'.

The Framework includes 11 overall dimensions, from which the 35 indicators in the Well-being Dashboard[18] (hosted by the CSO) flow. Analysis of the Dashboard published in June 2022 provides an overall picture of the country's progress, using data that facilitates a longer-term view of quality of life. The analysis reviews trends over 5-year periods and makes international comparisons.

Overall, the dashboard paints a generally positive picture of quality of life in Ireland. Across the 35 indicators, Ireland performs well in 20 indicators; 6 indicators show negative performance, including net Government wealth, greenhouse gas emissions and experience of discrimination; while the performance of the other 9 indicators are more nuanced.

The CSO Hub also breaks down each indicator by specific cohorts, chosen on the basis of relevance, research and data availability. This allows an examination of equality across dimensions. Several cohorts were identified that experience inequality across a high proportion of indicators. These are women, single-parent households, households with lower incomes, people with permanent sickness or disability, immigrants/non-Irish, and households in rented accommodation.

Certain indicators are 'tagged' to highlight their importance for sustainable well-being (economic, environmental, social & democratic). The performance of these indicators provides insight into whether progress is broadly sustainable (supports maintenance of well-being at least at current levels into the future). Of the 14 'sustainable' indicators, three show an overall negative performance. These are net Government wealth, greenhouse gas emissions and water quality, and are therefore concentrated in environmental sustainability. A further three show a neutral performance.

While the dashboard provides an overall positive picture, it points towards specific areas that suggest sustained issues over the longer-term across quality of life, sustainability and equality. More detail on the analysis and the Framework, including the full report, is available on the Well-being Portal.[19]

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[17] Available at: https://www.gov.ie/en/publication/7e05d-programme-for-government-our-shared-future/
[18] Available at: https://www.cso.ie/en/releasesandpublications/ep/p-wbhub/well-beinginformationhub/
[19] Available at: https://www.gov.ie/en/campaigns/1fb9b-a-well-being-framework-for-ireland-join-the-conversation/?referrer=http://www.gov.ie/wellbeing-framework/

Figure A1: Understanding life in Ireland – a 'well-being' framework

Rialtas na hÉireann
Government of Ireland

Understanding life in Ireland
A Well-being Framework

Sustainability and Equality

Environment, Climate & Biodiversity
Environmental quality | Human impact | Experienced environment

Safety and Security
Incidents of crime | Threats to safety | Perception of safety

Housing and Built Environment
Access to housing | Quality of housing | **Built environment**

Subjective Well-being
Life satisfaction | Emotional state | Meaning/purpose

Knowledge, Skills and Innovation
Skills for life | Innovation and creativity | Formal education

Mental and Physical Health
Physical health | Mental wellness | Access to health services

Understanding life in Ireland
A Well-being Framework

Connections, Community and Participation
Community and cultural participation | Social quantity | Social quality

Work and Job Quality
Work quantity | Work quality | Work satisfaction

Civic Engagement, Trust and Cultural Expression
Opportunity and Impact | Institutional trust | Cultural expression, Identity and Non Discrimination

Time Use
Demands on time | Personal time | Satisfaction with time use

Income and Wealth
Disposable income **| Wealth | Economic security**

Measures – Trends, International Comparison and Inequalities

= supports economic, environmental or social sustainability

Source: Department of Finance.

Rialtas na hÉireann
Government of Ireland

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