Fiscal Assessment Report

November 2022

A Budget in the time of inflation

Irish Fiscal Advisory Council

Foreword

The Irish Fiscal Advisory Council was established as part of wider reforms of Ireland's budgetary architecture. It was set up on an administrative basis in July 2011 and was formally established as a statutory body in December 2012 under the Fiscal Responsibility Act. The Council is a public body, with the terms of its funding set out in the Fiscal Responsibility Act.

The Council's mandate is to:

- endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- assess the official forecasts produced by the Department of Finance;
- assess government compliance with the Budgetary Rule;
- assess whether the Government's fiscal stance set out in each Budget and Stability Programme Update (SPU) is conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact.

The Council's Chairperson is Mr Sebastian Barnes. The other Council members are Prof. Michael McMahon, Ms Dawn Holland, Dr Adele Bergin, and Mr Alessandro Giustiniani. The Council's Secretariat consists of Dr Eddie Casey, Mr Niall Conroy, Mr Kevin Timoney, Mr Killian Carroll, Ms Karen Bonner, and Mr Brian Cronin. The Council would like to acknowledge the kind help from staff at the Central Statistics Office (CSO), Central Bank of Ireland, Economic and Social Research Institute (ESRI), and the National Treasury Management Agency (NTMA).

The Council submits its Fiscal Assessment Reports to the Minister for Finance and within ten days releases them publicly. This report was finalised on the 21st November 2022. More information on the Irish Fiscal Advisory Council can be found at www.FiscalCouncil.ie.

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Summary Assessment

Summary assessment

Macroeconomic assessment

- **Ireland's economic growth has slowed considerably during 2022.** The rapid economic recovery from the pandemic has been stunted by a surge in prices. Energy and food pressures have driven inflation, although higher costs have become more widespread. In cash terms, Irish activity continues to expand, but the rising cost of living has weakened real incomes.

- **The near-term outlook for the Irish economy has weakened, and *Budget 2023* forecasts real GNI* growth of 0.4% in 2023.** While the possibility of gas shortages this winter have abated, Ireland's main trading partners could be on the verge of a recession. The labour market is exceptionally tight at present, but some recent high-frequency indicators show signs of softening. As digital sectors have been a key driver of growth in national income, job losses including those recently announced weaken prospects for the Irish economy going forward.

- **The medium-term macroeconomic outlook in *Budget 2023* is difficult to assess, given the forecasts are only to three years ahead.** This is contrary to previous commitments made by the Department of Finance to produce five-year-ahead forecasts. Shortening the forecasting horizon does not allow for a comprehensive analysis of the medium-term trajectory of the economy, economic imbalances, or the Government's medium-term plans. This comes at a time when many medium-term pressures, such as those related to ageing and climate change, are deepening. The Government should return to medium-term forecasting on at least a five-year-ahead basis.

- **Downside risks to the outlook are mainly related to global factors, especially Russia's war in Ukraine and its implications for energy and food prices.** The Department of Finance forecasts real GNI* growth of about 3% in 2024 and 2025. The extent of the pass-through of higher prices to wages will play a key role in determining the persistence of high inflation, and the future path of monetary policy. Pressures around the supply of housing are an important domestic challenge. Nonetheless, imbalances within the economy are relatively minor, and balance sheets are strong overall for households and firms, meaning a less significant effect of higher interest rates on economic activity.

Budgetary assessment

- ***Budget 2023*** **included estimates of excess corporation tax receipts — receipts in excess of what can be explained by the domestic economy — and presented the government balance adjusted for these excess receipts.** The Council welcomes this development, which follows a suggestion made in the Council's *May 2022 Fiscal Assessment Report*.

- **Excluding excess corporation tax receipts, the Government forecasts a deficit of 3.1% of GNI* for this year.** The substantial narrowing of the deficit (from 5.1% in 2021) — even with cost-of-living measures, the defective concrete blocks scheme, and increases in public sector pay — reflects strong revenue growth (even when excluding excess corporation tax) and lower pandemic-related spending. The balance could ultimately be more favourable than forecast in *Budget 2023*, with revenue likely to outperform.

- ***Budget 2023*** **introduced a package of around €11 billion of measures in nominal terms.** This included €6.9 billion in permanent measures (€5.8 billion in spending, €1.1 billion in tax reductions). A further €3.9 billion in temporary measures were introduced aimed at helping households and businesses adjust to the rise in the cost of living.

- **For next year, *Budget 2023* forecasts a corporation tax adjusted deficit of 1.4% of GNI*.** This relies on further falls in temporary spending, as well as growth in revenue which is in part due to the current inflationary environment.

- ***Budget 2023*** **projections show a budget surplus (excluding excess corporation tax) in later years of 1-2% of GNI* in 2025 based on continued compliance with the Government's 5% spending rule.** However, this spending would be insufficient to maintain the real value of existing services and benefits as ageing costs rise. 'Stand-still' estimates from the Council — which assume that spending grows in line with demographic and inflationary pressures — suggest that current spending in 2024 and 2025 would be insufficient to fully accommodate demographic and price pressures, by an average of €0.8 billion per year. This would imply that, to meet the Government's Spending Rule, spending would need to be adjusted in real terms or relative to wages and there would be no space for additional spending measures without finding offsetting resources elsewhere.

- **The net debt ratio is forecast to be 73% of GNI* at the end of this year.** This ratio is expected to fall to 58% of GNI* by 2025, on the back of large primary surpluses, relatively high inflation, and moderate growth. Despite rising interest rates, Ireland's interest expenditure is expected to remain largely flat until at least 2025.

Fiscal Stance

- **Current economic conditions suggest a broadly neutral fiscal stance is appropriate, but this assessment could change and the Government should stand ready to act.** The Irish economy is currently operating at a very high level of activity, but the outlook for growth has weakened. Presently, there is evidence of labour shortages and slight overheating in the Irish economy. However, a contraction in activity this winter seems likely as cost-of-living pressures weigh on the international and domestic outlook.

- **Ireland's debt ratio remains high by international standards.** At the end of 2021, the Government's net debt ratio was 82% of GNI*. This put it as the tenth highest in the OECD. When compared to other small open economies, only three other OECD countries have larger debt burdens: Greece, Portugal and Belgium. A higher starting debt ratio tends to amplify the sustainability risks that can arise from recessions, slower growth or increases in borrowing costs. It can also reduce the scope to respond to future downturns with sizeable budgetary supports.

- ***Budget 2023* struck an appropriate balance between supporting vulnerable households and avoiding adding to inflationary pressures.** The Government has used a mix of permanent budgetary measures and a large package of temporary supports to help address the rise in the cost of living.

- **The Budget package focuses on social welfare and pay together with a large package of temporary supports.** The temporary deviation from the 5% Spending Rule is relatively limited, with core spending rising by 6.8% instead for 2023. The Council assesses that the permanent spending increases in both years are likely to be sustainable. These increases do not compensate for inflation in full, but the gap for lower income households is more than made up for by substantial temporary supports. These measures help limit the impact of the sudden rise in the cost of living on businesses and households. While there is still scope for these measures to be better targeted, the impacts on inflation are

limited by virtue of them being temporary in nature. This approach is welcome. It should also allow the Government to better target supports in subsequent years as the uncertainty around the path for inflation gradually lifts.

- In 2024 and 2025, the Government is planning to return to core spending increases of 5% each year, in line with the Spending Rule. This approach implies a broadly sustainable pace of expenditure growth. It will lead to a structural surplus — even with excess corporation tax receipts adjusted for — and a steady pace of reduction in the debt ratio.

- The Government needs to start planning further ahead. The Government's forecasting horizon continues to be only three-years ahead, despite its commitment to a five-year-ahead horizon. By not lengthening its forecast horizon, sizeable medium-term challenges are not being recognised sufficiently in planning. The expected costs of ageing, climate change and other policy initiatives need to be costed and factored in properly. There is now a good window for Ireland to reduce its debt burden to safer levels, while the exposure to changes in interest rates or growth is relatively manageable. However, this window is likely to be short-lived.

- The climate transition is likely to have a significant budgetary cost, while the Government's decision to maintain the pension age at 66 will lead to materially higher taxes unless spending is cut elsewhere. The public finances are also relying on unpredictable excess corporation tax receipts from the multinational sector estimated at €9 billion this year. Proper medium-term planning is essential if the Government is to address these issues.

- To support medium-term planning, the Government should reinforce its 5% Spending Rule and extend its use of the budget balance adjusted for excess corporation tax. The Government's 5% Spending Rule, first developed in summer 2021, has proven to be a simple and reasonably effective anchor. It has helped to ensure more sustainable fiscal policy, while appropriately reframing fiscal policy in terms of the trade-offs involved. The Department of Finance has also opted to emphasise the budget balance excluding excess corporation tax receipts in *Budget 2023*, in line with the Council's past recommendations. These initiatives help contribute to a more sustainable budgetary

framework for Ireland, yet they still need development. The Spending Rule should be put on a legislative basis, net out tax changes, have a link to debt targets, and be broadened to capture general government spending. The adjusted budget balance should be used more prominently, including in monthly Exchequer releases.

- **The Government should also give more thought to how it plans to use the National Reserve Fund.** The Fund was initially devised as a countercyclical tool — supporting the economy in recessions and taking heat out of booms — and then later as an emergency fund. It is now being used to ensure that permanent spending increases are not unsustainably funded by excess corporation tax receipts. The Government's decision to allocate a cumulative €6 billion to it over 2022 and 2023 means that it could swiftly hit its €8 billion cap. Moreover, the motivation for the Fund is less clear-cut now that the Spending Rule and the excess corporation tax-adjusted budget balance are in place and working reasonably well. The Government should consider increasing the cap and potentially changing the purpose of the Fund, including the option of making it a new National Pension Reserve Fund. This could help to take the pressure off tax increases in future years as a means of bridging the funding shortfall for Ireland's pension system that will develop.

Fiscal Rules

- **The fiscal rules remain effectively suspended.** The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules were activated at the start of the pandemic in 2020 and have remained in place into 2022. This allows countries to temporarily deviate from the requirements under both the domestic and EU fiscal rules in these years.

- **The rules are expected to be reactivated in 2024.** The European Commission has announced that present conditions warrant the extension of the general escape clause through 2023. The Commission cited high uncertainty and downside risks in the context of the war in Ukraine, along with energy price increases and supply-chain disturbances, as contributing to this decision. It expects to deactivate the general escape clause in 2024.

- **Major revisions to how the EU fiscal rules work are being planned.** The European Commission has put forward proposed

changes to the EU fiscal rules. The changes would see the fiscal rules shift to a net spending rule with a debt anchor and away from a reliance on the structural balance. In addition, a more country-specific approach would be adopted. Countries with high debt ratios would have to act sooner to adjust down their debt paths, while countries with lower debt ratios would be granted more time. These changes would likely require Ireland to update domestic legislation governing how the fiscal rules operate at a national level.

- **The Government should publish on time its three-year ceilings for how much each department will spend.** Ireland's Medium-term Expenditure Framework is intended to help Ireland budget over a longer time period than governments have tended to in the past — promoting more forward-looking budgets rather than focusing solely on one year ahead. However, for the third year in a row, the Government has not published these ceilings as part of Budget-Day documentation. Instead, the ceilings have been relegated in terms of their importance and are being published very late in the year (usually late December) — well beyond the October requirement. The Government's failure to publish these ceilings on Budget Day, and their lack of integration into the budgetary framework more generally, represents a backwards step in transparency and a weakness in the overall fiscal framework. The Government should publish realistic spending ceilings on Budget Day from here on out.

Summary Table of *Budget 2023* Economic and Budgetary Projections

% GNI* unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Macro forecasts							
Real GNI* growth (%)	2.8	-4.6	15.4	5.1	0.4	2.7	3.1
Nominal GNI* growth (%)	8.6	-5.1	16.9	11.6	5.3	5.4	5.5
Nominal GNI* (€bn)	211	200	234	261	275	290	306
HICP growth (%)	0.9	-0.5	2.5	8.5	7.1	2.4	1.8
Output gap (% of potential)	3.3	-2.7	-1.6	0.3	-0.4	-0.1	0.1
Potential output growth (%)	3.0	-1.1	4.6	2.9	1.0	2.0	2.2
Budgetary forecasts							
Balance excl. excess corporation tax	-0.7	-11.8	-5.1	-3.1	-1.4	0.6	1.4
Balance	0.8	-9.5	-3.0	0.4	2.2	3.7	4.5
Balance (€ billion)	1.6	-19.0	-7.0	1.0	6.2	10.7	13.7
Balance excl. one-offs [1]	0.8	-1.8	2.4	5.3	4.6	3.9	4.6
Balance excl. one-offs [1] (€ billion)	1.7	-3.5	5.5	13.8	12.5	11.4	14.1
Revenue excl. one-offs [1]	41.9	41.9	42.3	43.5	43.7	42.8	42.9
Expenditure excl. one-offs [1]	41.1	43.6	39.9	38.2	39.1	38.9	38.2
Primary balance excl.one-offs [1]	3.0	0.1	3.8	6.5	5.9	5.2	5.7
Revenue growth excl. one-offs 1 (%)	6.4	-5.1	18.1	14.8	5.8	3.4	5.5
Primary expenditure growth excl. one-offs 1 (%)	6.0	1.9	7.9	7.1	7.6	5.1	4.1
Gross debt ratio (% GNI*)	96.5	108.9	100.9	86.3	81.5	78.3	73.2
Net debt ratio (% GNI*)	82.6	92.8	82.2	72.9	68.9	63.4	57.8
Gross debt (€ billion)	203	218	236	225	224	227	224
Cash & liquid assets (€ billion)	29	32	44	35	35	43	47
Net debt (€ billion)	174	185	192	190	189	184	177
Fiscal stance							
Structural primary balance[2]	1.4	0.8	-0.4	0.5	0.6	1.8	2.5
- change (p.p.)		-0.7	-1.2	0.9	0.1	1.2	0.6
Net policy spending growth (%)	5.3	0.2	7.4	7.1	7.7	4.5	3.7
Real net policy spending growth (%)	4.4	0.7	4.9	-1.3	0.5	2.1	1.9
Change in net debt ratio (p.p.)	-8.7	10.2	-10.5	-9.3	-4.0	-5.5	-5.6
Fiscal rules							
Spending Rule	✓	xc	xc	xc			
Structural Balance Rule	✓	xc	xc	xc			
Overall Assessment	✓	xc	xc	xc			

Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: Output gaps and potential output estimates, including those used for the structural balances, are based on the Department of Finance's preferred alternative estimates. xc = Exceptional circumstances apply for these years, meaning that a temporary deviation from the requirements of the fiscal rules is allowed. [1] These figures exclude one-offs. One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. These include Covid-related expenditure and expenditure and revenue related to the EU funds for the Brexit Adjustment Reserve and the National Recovery and Resilience Plan. [2] This is based on the Council's own "bottom-up" estimates of the structural primary balance.

Macro Assessment

Price pressures stunt the recovery

1. MACRO ASSESSMENT

Price pressures stunt the recovery

1.1 The short-term economic outlook

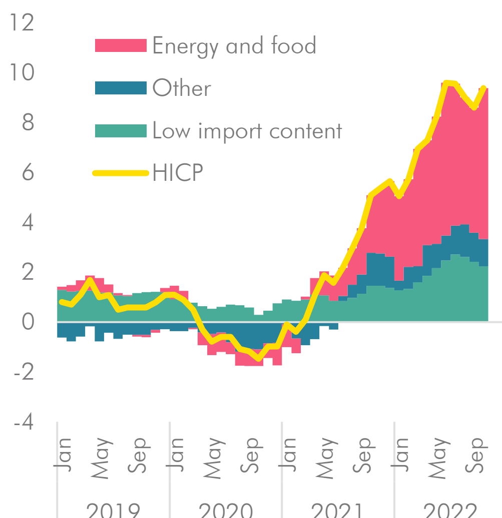
Ireland's economic growth has slowed considerably in 2022, mainly as a result of high inflation. Despite ongoing growth in the value of aggregate demand, the rising cost of living has resulted in a weaker path for the volume of goods and services in the Irish economy this year and reduced real incomes.

Energy and food prices have driven inflation higher, and domestic inflation has also been elevated

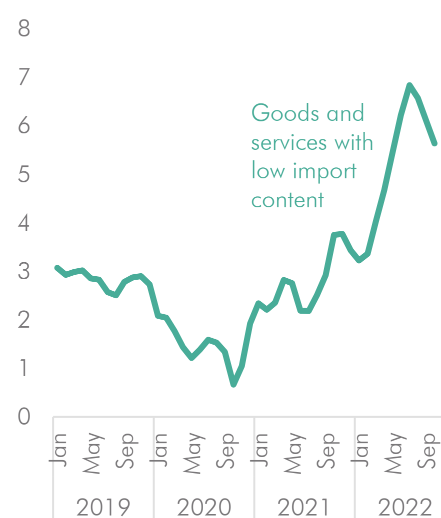
Most of the pick-up in inflation since mid-2021 and in recent months has been driven by energy and food (Figure 1.1a). However, domestically generated inflation is lower and softening. The inflation rate for goods and services with a low import content — of which, more than half of the consumption weights comprise restaurants/cafés and actual rentals for housing — increased by 5.6% in the 12 months to October 2022.[1]

Figure 1.1: Inflation has been mainly driven by energy and food

A. Inflation driven by energy and food
Year-on-year % change and p.p contributions



B. Domestic inflation has picked up
Year-on-year % change



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

Unlike overall HICP, the low-import-content components of Figure 1.1 have had a consistently positive year-on-year inflation rate for the past decade, growing by an average of 2.8% since October 2012. For restaurants/cafés and actual rentals for housing, the last ten years has also seen a consistently positive year-

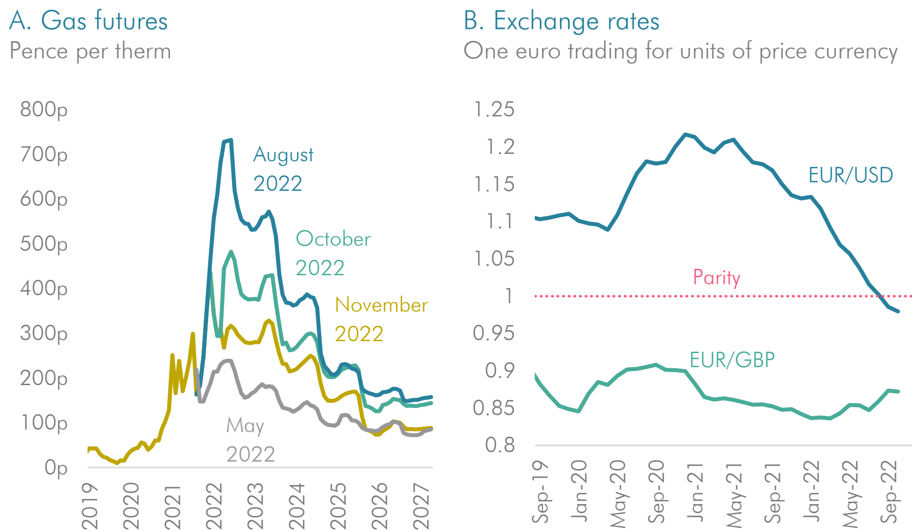
[1] This index of goods and services with low import content is based on work by Fröhling, *et al.* (2022). The authors identify Euro Area goods and services with low import content using input-output tables to account for direct and indirect import content (through intermediate consumption). HICP items with import content of less than 18% are classified as low-import-content items. This list of HICP items identified by Fröhling, *et al.* (2022) with low import content is then applied to Irish HICP data to derive the index shown above.

on-year inflation rate, rising by an average of 3.5%. The sharp pick-up in inflation for goods and services with a low import content seen during 2022 suggests the presence of second-round inflation effects due to the rapid increase in energy prices that has taken place this year.

Despite broad-based and rapid inflation in 2022, which is also expected in the early part of 2023, price momentum slowed considerably between June and September: the month-on-month change in HICP was just 0.2% on average. However, October's reading indicates that energy prices increased sharply again, rising by 13.6% compared to September. The preceding slowdown was largely as a result of lower energy prices, which reflected lower oil prices, and favourable developments for gas storage in Europe. While gas price futures have reduced substantially since *Budget 2023* forecasts were made, they are still expected to remain elevated (Figure 1.2a). Furthermore, the US dollar has appreciated relative to the euro this year (Figure 1.2b); this implies higher euro prices of dollar-denominated goods and services (including oil). Recent depreciation of the British pound is unlikely to significantly reduce inflation in Ireland, though it presents challenges to Ireland's exporters selling to the UK, and year-on-year inflation is expected to remain high in 2023.

Gas futures have fallen back from August peaks, and the euro has weakened against the dollar

Figure 1.2: Gas futures have fallen since the summer, while the US dollar has strengthened to more than parity with the euro



Sources: Refinitiv; Macrobond; and Fiscal Council workings. Get the data.

Box A identifies a risk of higher measured inflation in 2023 by adjusting the weight of the energy component, assuming the projections of energy price changes in the Council's Benchmarks are correct. Nonetheless, it is important to note that there is a considerable degree of uncertainty surrounding the path for market energy prices and those paid by consumers and businesses over the coming years.

Box A: Changing consumer habits pose risks to forecasts of inflation

Both the Covid-19 pandemic and the cost-of-living crisis have dramatically changed the composition of consumer spending in Ireland. This box looks at the impact that the changing composition of the basket of goods and services that consumers buy can have on forecasts of inflation.

The Harmonised Index of Consumer Prices (HICP) is an index of the level of prices in the economy. Price changes are weighted by expenditure. This means that the weight attached to changes in prices of certain goods or services in the index depends on the proportion of expenditure that consumers spend on that good or service. Eurostat updates these expenditure weights annually based on the proportion spent on each consumer product in the previous year. For instance, the expenditure weights used to calculate HICP in 2022 are based on the weights for the consumption basket in 2021.

Despite the constantly changing consumption basket, forecasters of inflation generally assume that the consumption basket is fixed for their entire forecast horizon. This means that the expenditure weights used to calculate HICP do not change in the years being forecast.

In normal times, this is a reasonable assumption: the consumption basket does not change drastically from year to year, so the impact that this assumption has on inflation forecasts is relatively small.

However, both the Covid-19 pandemic and the current cost-of-living crisis have seen large shifts in the composition of consumer spending and large price changes. During the acute phase of the pandemic, consumers switched from spending on services to goods. This reflected the lockdown measures that curtailed access to bars, restaurants and hospitality. This resulted in the weight attached to services in HICP falling from 55% in 2020 to 48% in 2021. During the current cost-of-living crisis, consumers have had to spend much more on electricity, heating and transport, at the expense of other items.

Illustration of impact of increased energy expenditure on inflation forecasts

When prices of certain goods and services increase relative to other goods and services, consumers often reduce their consumption of that item and potentially substitute away from it. This would limit the impact that a price increase would have on the HICP index as it would be offset by a lower expenditure weight. However, as energy is a necessity it is difficult to reduce consumption of energy in the short term, despite the rising prices.

In producing its inflation forecasts for *Budget 2023*, the Department of Finance, like many forecasters (including central banks), has kept the HICP consumption basket weights constant at 2022 levels for each year from 2022 to 2025.

To illustrate the potential impact that the relative increase in the expenditure on energy — both this year and next year — can have on the inflation forecasts, we undertake an exercise using the Council's Benchmark projections of the price changes of the subcomponents of HICP.[2]

We assume that these projections of the price changes of the subcomponents are correct, but when combining these components to arrive at a HICP forecast, we adjust the weights attached to these price changes to account for this relative increase in energy expenditure.

In this scenario, we assume that the weight attached to the energy component is larger next year and the following year — reflecting higher nominal energy consumption this year and even higher nominal energy consumption next year — before reverting back towards 2022 levels.[3] To simplify the illustration, we assume that the higher energy consumption is at the expense of "core services" consumption. That is, the weight attached to "core services" falls as the energy weight increases.[4] Figure A1.B shows the energy weights assumed, with the energy weight peaking in 2024 at 15%.

Figure A1.A shows the impact that the changing consumption basket has on the baseline inflation forecasts. As energy prices are expected to increase relatively more next year than other prices, the higher weight attached to energy prices in 2023 now results in a higher forecast for inflation next year. Under

[2] The Department only forecast the subcomponents of HICP for six quarters, 2022Q3–2023Q4. Thereafter, they forecast on the basis of headline and core HICP. As they do not have individual forecasts of energy and "core services" after 2023Q4, the Council's Benchmark projections of HICP components are used here as an illustration instead. The conclusions for headline HICP remain the same.

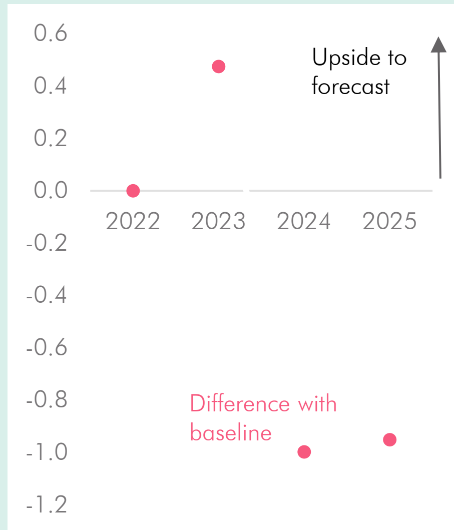
[3] As outlined above, the weights used to calculate HICP for next year would be based on the consumption basket this year, while the weights used to calculate HICP for 2024 would be based on the consumption basket next year. This higher share of energy in the consumption basket can arise from consuming the same volume of energy, but at relatively higher prices.

[4] The "core services" component is services excluding rental prices.

the alternative scenario, the inflation forecast is 0.5 percentage points higher in 2023. As energy prices are expected to fall in 2024, this higher weight on energy leads to a lower inflation rate in 2024, with inflation in the alternative scenario approximately 1 percentage point lower in 2024 than forecast. Similarly in 2025, inflation would be 1 percentage point lower than forecast under the alternative scenario.

Figure A1: The changing consumption basket presents risks to inflation forecasts

A. Risks to baseline HICP forecast
p.p difference with baseline



B. Energy weights assumed
% of consumption basket

Sources: Eurostat; Department of Finance; and Fiscal Council workings. Get the data.

This illustration shows that there are potential upsides to the Department of Finance's HICP inflation forecast for next year, and there are potential downsides to the forecast for inflation in 2024 and 2025 if the changing energy consumption were to be factored into the forecasts. This illustration also shows that, all else equal, as energy prices fall, headline inflation may fall more rapidly than forecast.

As Ireland is a net importer of energy, the rise in energy prices implies lower national income in Ireland and higher national income in energy-exporting countries. As energy is an important input to all parts of the economy, it can have a significant bearing on potential output and higher steady-state prices will put the economy on a permanently lower output path.

As a net importer of energy, Ireland has suffered a terms of trade loss from higher global energy prices

Figure 1.3a, which replicates European Central Bank analysis for the Euro Area by Battistini *et al.* (2022), shows the broadly inverse relationship between the energy weight in the HICP consumption basket and the terms of trade (shown as the ratio between the GNI* deflator and the personal consumption deflator).[5] Figure 1.3b uses real energy prices (scaled with HICP, available up to October 2022) to illustrate that the terms-of-trade index is likely to decline for 2022, meaning a relative weakening of consumers' purchasing power. The period between 2015 and 2021 was broadly characterised by a lower real price of energy and this boosted Ireland's terms of trade and living standards. This

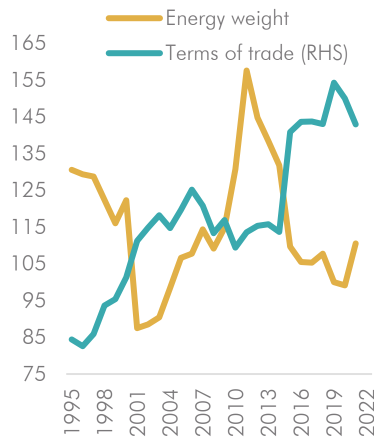
[5] The correlation coefficient for the two series in Figure 1.3a is -0.44.

included a period of strong economic growth in the lead-up to the Covid-19 pandemic in early 2020. If energy prices moved lower, this would limit the damage from energy prices on the Irish economy. Conversely, higher energy prices imply further terms-of-trade losses and weaker consumer prospects.

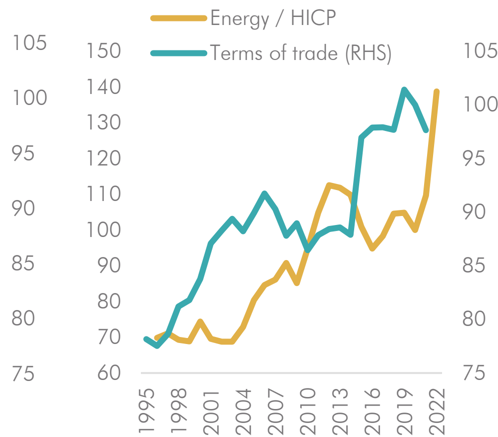
Figure 1.3 Energy shocks weaken Ireland's terms of trade

2020 = 100

A. Energy weight



B. Real energy prices



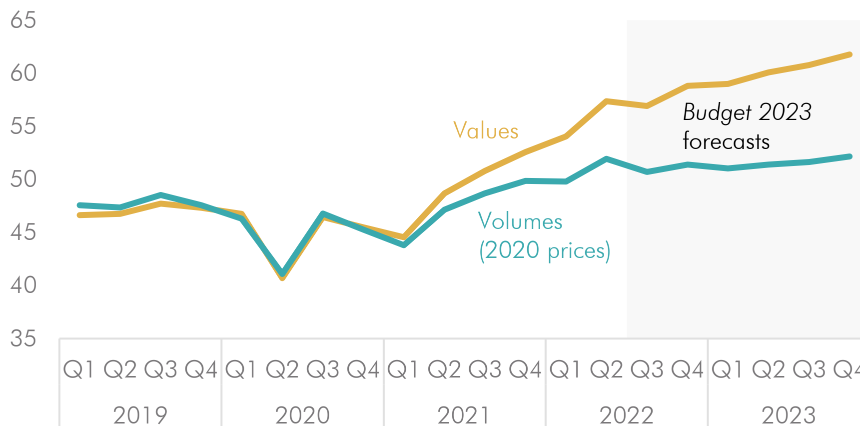
Sources: ECB; CSO; and Fiscal Council workings.
Note: This comparison replicates analysis by Battistini *et al.* (2022) for the Euro Area. For the energy weight in HICP, the 1996 weight refers to 1995 data. The terms of trade is calculated as the GNI* deflator divided by the personal consumption expenditure deflator, to capture instances where energy prices have risen as a share of the consumption basket, and how this implies a higher price level for consumers relative to GNI*, as higher import prices partially offset higher prices in final demand, including for the consumption deflator. Get the data.

Figure 1.4 shows how the terms-of-trade shock are impacting on the value and volume of modified domestic demand. *Budget 2023* short-term projections foresee a broadly flat profile for the volume of demand in the year ahead, while the value is expected to continue to grow albeit at a slower rate.

Modified domestic demand has stagnated due to inflation, which erodes the cash value of spending in the Irish economy

Figure 1.4: Modified domestic demand has stagnated due to inflation

€ billion, seasonally adjusted



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

The main cause of the pick-up in modified domestic demand in Q2 2022 was firm-specific modified investment. The largest component of domestic demand is consumer spending, which is projected in *Budget 2023* to remain subdued until late 2023. The official estimate of the level of personal consumption expenditure from the CSO has not yet recovered to its pre-pandemic level in 2019.

New research shows official estimates of household spending are lower than what alternative indicators suggest

However, as discussed in a new analytical note published by the Council (Timoney, 2022b), the recent historical data for household consumption do not align well with other high-frequency indicators of consumer spending. A stronger performance is evident in value-added tax receipts and in card spending and ATM withdrawals. As well, Central Bank data are consistent with lower levels of household saving compared to the CSO figures. While these sources point to a higher level of consumption than reported, the indicators show a broadly consistent pattern in recent quarters: a slowing upward trajectory for consumer spending.

Overall real consumer spending has continued to grow in 2022, and a number of factors with offsetting effects are contributing to this. The unexpected increase in inflation, which was not factored in by wage agreements, means that many households are experiencing a decline in real disposable income this year and next: *Budget 2023* forecasts a decline in real incomes of 2.8% in 2022 and 2% in 2023. The increase in energy and food prices affects lower-income households more and this could reduce their discretionary spending if savings are not available to bridge the gap. However, within groups there are exceptions, including those with high pay growth and few savings.

Falling real disposable incomes imply slower consumer spending, but savings built up by richer households can mitigate the slowdown

Still, some households have increased their earnings this year, especially employees of high-wage sectors (see Timoney, 2022a). Also, wealthier households in Ireland account for considerably more consumption per household.[6] The savings buffers built up by wealthier households during the pandemic imply a lower marginal propensity to consume (see Byrne *et al.*, 2020), but it is also likely that these households have a lower sensitivity to higher prices. As well, consumption has been boosted by a large flow of net inward migration, which has added to real consumer spending growth in 2022.

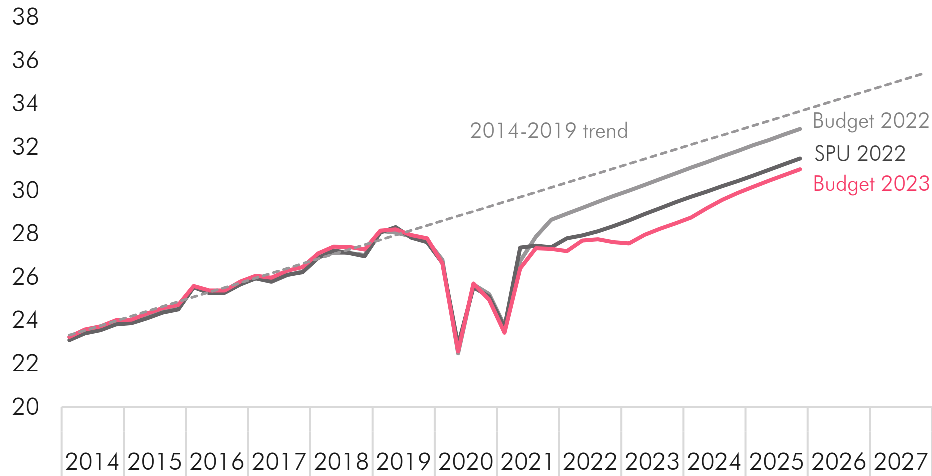
***Budget 2023* forecasts a weaker path for personal consumption**

Figure 1.5 presents the Department's quarterly projections for real personal consumption expenditure until 2025. Forecasts made in October 2021 anticipated further increases in consumption in the latter half of 2021 and into 2022. However, the current estimates of consumption have been considerably weaker than last year's projections. This is largely as a result of rising inflation, but a possible underestimation of the strength of the recovery in personal

[6] Coffey (2022) shows that the upper two-fifths of households (by income) in 2016 accounted for 57% of final national consumption expenditure. This implies an average of 43% more consumption by these households compared to an average household in the lower three-fifths of the distribution.

consumption last year could also be a factor (Timoney, 2022b). Over the forecast horizon, *Budget 2023* projects a gradual recovery starting in 2023.

Figure 1.5: *Budget 2023* projects a weaker path for personal consumption
€ billion, 2020 constant prices, seasonally adjusted



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

As with many advanced economies in 2022, the labour market in Ireland has been exceptionally tight this year. The number of unemployed people per job vacancy fell to a series low of 3.4 in Q2 2022 (Figure 1.6a). Although substantial variation exists in nominal hourly wages across sectors (see Figure 7 in Timoney, 2022a), average real hourly wages were close to pre-pandemic trend in Q2 2022, despite rapid increases in inflation in the first half the year (Figure 1.6b).[7] For the second half of 2022, *Budget 2023* forecasts imply a sharp decline in average real hourly wages, and little or no recovery is expected in 2023. Figure 1.6c shows Indeed job postings data (see Kennedy, 2022) have remained elevated relative to February 2020 levels, although there has been a considerable decline in postings in software development — which is the key series in labour demand for information and communication technology. Furthermore, there have been recent announcements of job cuts by large firms in the technology sector, many of whom with significant employment in Ireland.[8] In Figure 1.6d, administrative data had shown signs of a possible slowdown in employment in Q3 2022, but the latest figures for September 2022 show a more stable level of payrolls since June.

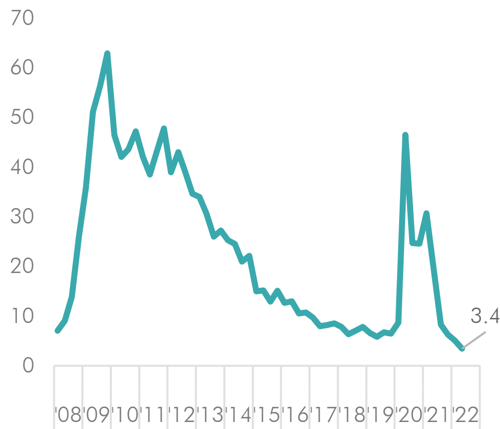
The labour market is exceptionally tight, and despite some signs of softening, payrolls data for recent months have been revised upwards

[7] The spikes seen during the pandemic resulted from an upward shift in average nominal hourly wages, as the falls in hours worked during successive lockdowns were concentrated in low-earning sectors. At the same time, earnings increased in high-wage sectors, providing significant resilience to income taxes (Timoney, 2022a).

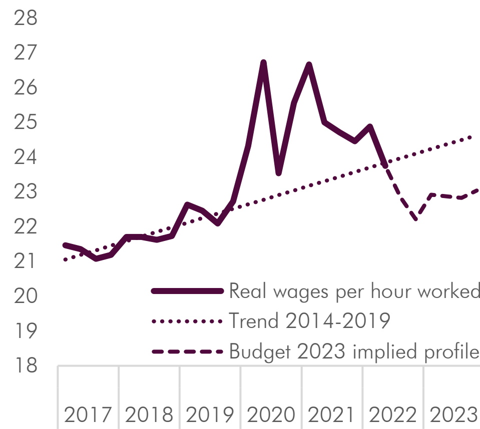
[8] For example, in early November 2022, Stripe, Twitter, and Meta announced intentions to reduce employment levels. Combined, these firms employ a total of about 4,000 staff in Dublin, with a further 6,000 contractors in Meta.

Figure 1.6: The labour market is exceptionally tight, despite some signs of softening

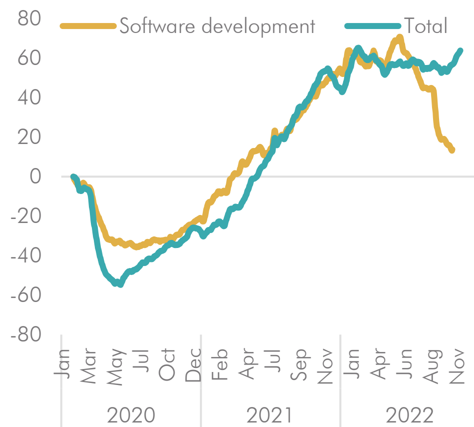
A. Unemployed per job vacancy
Number



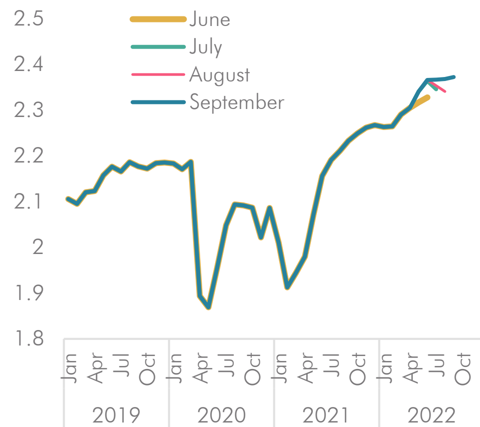
B. Real wages per hour worked
€, 2015 prices (HICP), seasonally adjusted



C. Indeed job vacancy levels
% change since 1 February 2020



D. Employee payroll levels
Millions of employees, unadjusted



Sources: CSO; Department of Finance; Indeed; and Fiscal Council workings.
Notes: For panel B, hours worked are derived using *Budget 2023* forecasts for total employment and average weekly hours worked. The historical data are based on actual hours worked (manually seasonally adjusted for Q1 1998 – Q2 2022). HICP has also been seasonally adjusted (for a sample period of Q1 1990 – Q4 2025), and wages are implied using the CSO's seasonally adjusted wages series in the Institutional Sector Accounts, Non-Financial for Q2 2022. The data for software development in panel C, available up to 14 October 2022, was kindly provided by Indeed. Get the data.

1.2 The medium-term economic outlook

Budget 2023 projects that the Irish economy will slow next year, and then grow close to trend growth rates of 3% per annum in 2024 and 2025 under the assumption that energy prices fall back from their current level as demand and supply adjust and as uncertainty wanes.

***Budget 2023* forecasts a sharp slowdown in economic growth in 2023, but a return to about 3% growth in 2024 and 2025**

Table 1.1 presents key *Budget 2023* macroeconomic forecasts for the Irish economy. Inflation is forecast to remain elevated in 2023, largely as a result of a large carry-over effect from the middle of 2022, when inflation picked up sharply. Employee wages, which did not grow in 2020 as a result of the pandemic, partly caught up in 2021 with close to 10% growth, and a further rapid annual growth of 12% is forecast in 2022. A small and positive output gap is expected to emerge in 2025, signalling strong growth but not significant overheating. Growth in compensation of employees and inflation pressures are expected to ease, with a return towards normal trend rates from 2024.

Table 1.1: *Budget 2023* key macroeconomic forecasts

Year-on-year percentage change in volumes, unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Modified gross national income (GNI*)	2.8	-4.6	15.4	5.1	0.4	2.7	3.1
Modified domestic demand	2.4	-6.1	5.8	7.6	1.2	3.2	3.6
Personal consumption	2.7	-10.9	4.6	5.5	1.8	4.6	4.2
Modified investment	-1.6	-8.6	8.2	17.7	2.2	3.8	4.1
Compensation of employees (nominal)	7.6	0.2	9.8	12.3	7.2	6.6	6.7
Employment[a]	2.9	-16.8	11.0	18.3	1.2	1.6	1.8
Unemployment rate[a] (% labour force)	5.0	19.2	15.9	5.2	5.1	5.0	4.7
Inflation (HICP)	0.9	-0.5	2.5	8.5	7.1	2.4	1.8
Savings ratio (% disposable income)	10.6	25.7	24.3	18.6	16.1	13.2	11.8
Modified current account (% GNI*)	7.1	6.6	11.1	8.4	7.7	7.0	6.3
Output gap (% potential GDP)	3.3	-2.7	-1.6	0.3	-0.4	-0.1	0.1

Sources: Department of Finance, and Fiscal Council workings.
Note: [a] The unemployment rate and employment growth shown for 2020–2022 inclusive are based on the CSO's "upper bound" Covid-19 unemployment data.

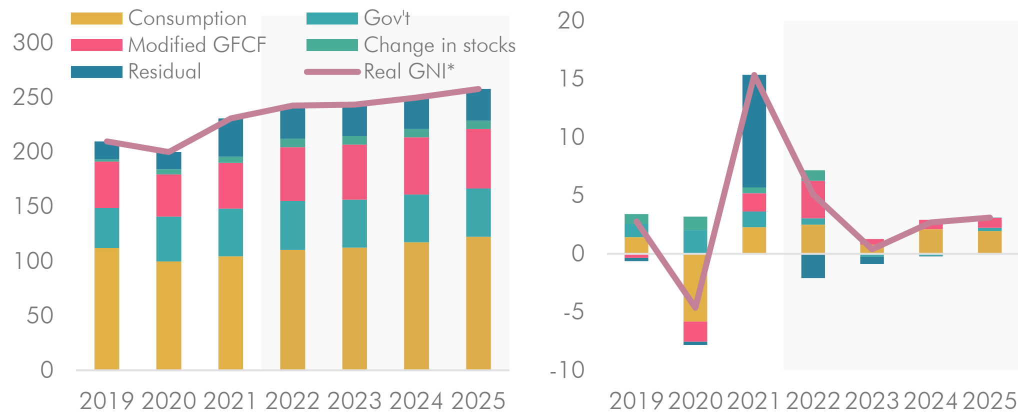
Real GNI* increased sharply in 2021, driven by the residual component (as shown Figure 1.7 and Section 1.4), and it is projected to slow sharply in 2023, before growing close to potential at about 3% a year in 2024 and 2025. Figure 1.7 presents *Budget 2023* forecasts for levels (panel A) and growth rates (panel B) of real GNI*. The slowdown in 2023 is expected to reflect a sharp slowdown in modified domestic demand.

Real GNI* increased sharply in 2021, driven by net external trade (i.e. the modified current account)

Figure 1.7: Real GNI* growth is forecast to slow sharply in 2023, before reverting to the economy's potential growth rate of about 3%

A. Real GNI* levels
€ billion, 2020 prices

B. Real GNI* growth
Year-on-year % change and p.p. contributions

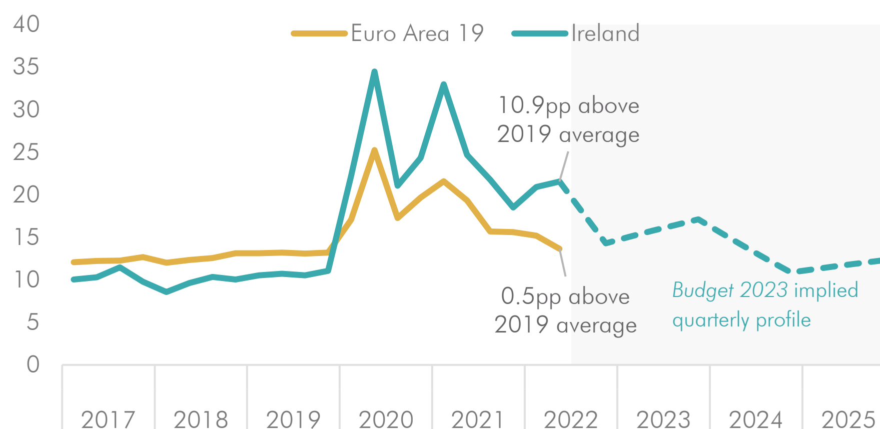


Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.

The household savings ratio has increased in the first half of 2022, as shown in Figure 1.8. However, if the level of household consumption expenditure in 2020 and 2021 were higher, as discussed in Timoney (2022b), this could imply a lower level of household savings, closer to pre-pandemic levels. Eurostat data show that the euro are savings rate has already returned close to its 2019 average, whereas it is almost double the 2019 average in Ireland's official data.

Figure 1.8: The household savings rate in Ireland has increased in 2022 after falling last year, unlike in the Euro Area

Household gross savings as % of total disposable income, seasonally adjusted



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

Budget 2023 forecasts imply that the household savings rate will decline sharply in the second half of 2022, before remaining elevated in 2023 at 16%, and later declining to 11.8% in 2025. For the full period until end-2025, the savings rate is forecast to remain above its 2019 average level of 10.6%. *Budget 2023* projections therefore do not anticipate that household consumption will be funded with savings built up over the pandemic.

Ireland's household savings ratio rose back above 20% this year, but *Budget 2023* forecasts a swift fall to about 12% in 2025

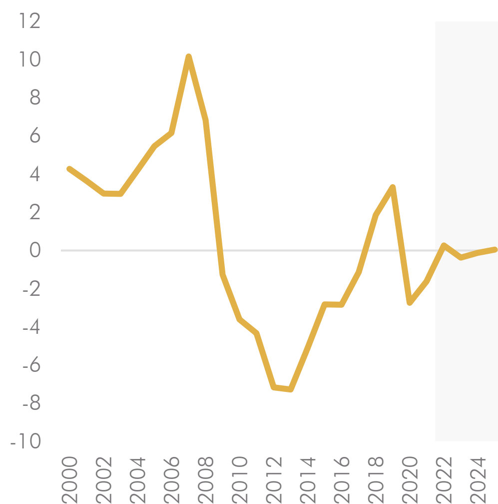
The Department of Finance's preferred methodology now estimates the output gap based on gross value added of sectors whose turnover is not dominated by foreign-owned multinational firms (domestic GVA). This a very small negative output gap opening up in 2023 before reverting to small and positive output gap in 2025 (Figure 1.9a).

***Budget 2023* does not foresee significant overheating in the Irish economy by 2025**

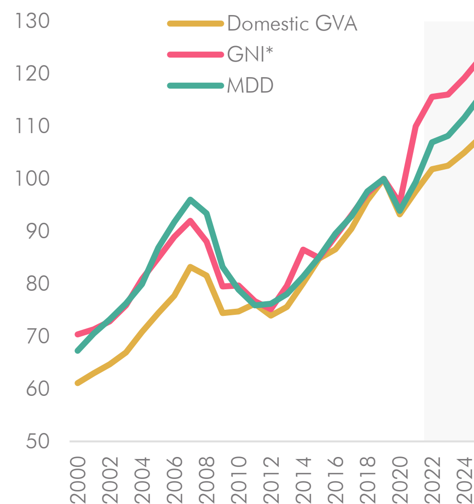
Domestic GVA excludes all activities in the information and communication sector and in some parts of manufacturing, including pharmaceuticals. These are sectors that have been expanding rapidly in recent years, including for compensation of employees, but domestic GVA does not capture this growth. While domestic GVA has historically moved quite closely with modified domestic demand and GNI*, it did not fully recover to 2019 levels by 2021; this gap in its recovery is forecast by the Department to persist over the forecast horizon (Figure 1.9b). A higher trajectory for actual output, such as the path shown for real GNI*, increases the likelihood of a larger positive output gap emerging over the medium term and may provide a more realistic picture of the state of the economy.

Figure 1.9: *Budget 2023* projects a slightly positive output gap by 2025, and domestic GVA is expected to remain on a weaker trajectory compared to MDD and GNI*

A. Output gap estimates
% of potential output



B. Domestic GVA forecasts are weaker
Volumes, 2019 = 100



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

The medium-term path for the Irish economy is likely to be negatively affected by higher interest rates, both globally and domestically. Higher mortgage interest costs will increase mortgage payments and reduce consumption for some households. However, recent analysis by the Central Bank of Ireland (Arrigoni, Boyd and McIndoe-Calder, 2022) shows that owner-occupier households with mortgages are significantly more concentrated in the upper quintiles of the income distribution, suggesting a greater capacity to absorb higher interest costs.

House prices in Ireland have grown continuously on a month-on-month basis for the past two years, reflecting a combination of higher incomes and ongoing shortages of new dwellings relative to various estimates of medium-term requirements. Although higher interest rates could negatively affect house prices, household incomes and supply constraints/pent-up demand are likely to remain positive contributors to the path for Ireland's house prices. Furthermore, the recent decision by the Central Bank of Ireland to amend its macroprudential policies in favour of higher borrowing by households seeking a mortgage is also consistent with higher rather than lower house prices over the medium term.[9]

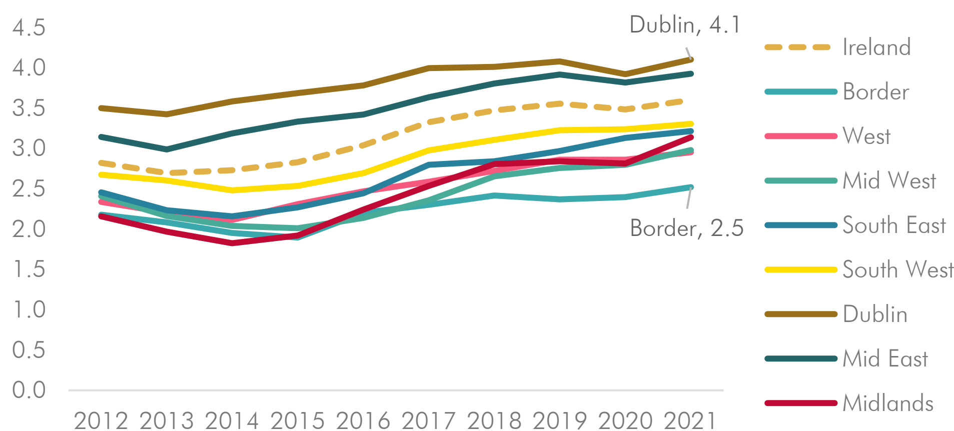
Higher interest rates could reduce house prices, but domestic factors including a higher limit on mortgage borrowing could mitigate the extent of any falls

While residential property prices in Ireland have increased relative to incomes of purchasers over the past decade, recent CSO data reveal that there is a wide regional variation in terms of median prices compared to median incomes. Figure 1.10 shows that for joint applications, which represent the majority of house purchases, the 2021 median house price in Dublin was 4.1 times purchasers' median income, while in the Border region this ratio was 2.5 times. Across all regions of Ireland, it was 3.6 times, broadly unchanged compared to the previous four years.

Relative to median joint-purchasing incomes, median house prices in Ireland have been broadly stable in recent years for most regions

Figure 1.10: House prices have increased relative to joint purchasers' incomes, but the increases have moderated in recent years

House prices relative to incomes for joint purchases



Sources: CSO; and Fiscal Council workings.
Note: The data are for filings and show joint applications' median house prices divided by median incomes. Get the data.

Higher interest rates can affect the medium-term path for the economy through a number of channels. Investment plans could be scaled back as higher interest rates affect net-present-value calculations for project viability, and this could result in fewer new dwelling completions over the coming years. Labour demand is also likely to decline as firms fill vacancies, while others may cut back on activities and reduce their staffing levels at various stages over the coming years.

[9] https://www.centralbank.ie/financial-system/financial-stability/macro-prudential-policy/mortgage-measures/mortgage-measures-framework-review-public-engagement

1.3 Risks to the outlook

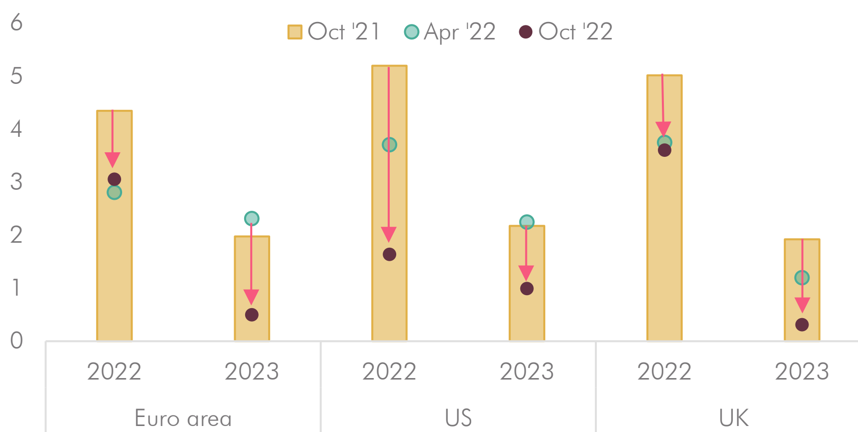
Risks to the outlook in *Budget 2023* are described as being “two-sided but judged to be firmly tilted to the downside”, whereas risks to the inflation projection are “also two-sided and assessed to be skewed to the upside”.

Downside risks have intensified during 2022, including the possibility of prolonged higher inflation, and a global recession

Rather than domestic in nature, global risks, such as war and geopolitical instability, have been the predominant factors affecting Ireland’s economic performance in 2022. Forecast reductions in global growth, particularly in Ireland’s main trading partners, have been a consistent feature of 2022. Figure 1.11 presents IMF forecasts over the past year for the Euro Area, US, and UK, which have seen large downward revisions for 2022 and 2023.

Figure 1.11: Risks to the outlook are highlighted by downward revisions to output growth in Ireland’s main trading partners

Year-on-year % change in real GDP



Source: IMF. Get the data.

The possibility of energy shortages may have declined for the coming winter, but risks remain. Both this winter and next winter could prove very expensive for the Euro Area in terms of securing gas supplies. The risk of a prolonged global slowdown is therefore increasing, or indeed of a more significant global recession. As this would be taking place very soon after the pandemic, there are risks that compounding stress placed on firms could result in a large wave of business failures.

Price inflation has broadened in 2022, as shown in Figure 1.1, with year-on-year price growth in low-import-content items rising to a 20-year high. This suggests that risks of some second-round effects of inflation, noted in the Council’s last *Fiscal Assessment Report* for May 2022, may be materialising. Demands for higher wages may reduce Ireland’s competitiveness and exports depending on relative changes in Ireland’s trading partners. A key risk relates to the potential for inflation expectations to become engrained, resulting in persistently higher inflation over coming years. However, median inflation expectations for the Euro Area remain quite well-anchored, despite the rapid increase in inflation this

year.[10] A more favourable scenario would see inflation receding more rapidly than expected in market-based projections and official forecasts. More rapid increases in renewable energy capacity could mitigate the terms-of-trade loss Ireland and the Euro Area have experienced since mid-2021. However, the near-term likelihood of such a benign scenario remains remote given Russia's ongoing war with Ukraine.

The likelihood of lower foreign direct investment from the multinational sector has risen substantially in recent months, and announcements of job losses in some well-known technology companies has taken place since *Budget 2023* was published. It remains to be seen whether this will affect a significant share of Ireland's employment in the information and communication sector, where jobs and earnings growth rates have been especially rapid over the past decade. Ireland's national income has been boosted considerably by corporation taxes, and the risk of a fall in these receipts would have potentially significant macroeconomic as well as fiscal ramifications.

On the positive side, short- and medium-term growth could still prove higher than assumed. Ireland's relatively resilient performance during the large shock represented by the Covid-19 pandemic suggests it could be relatively well-placed to withstand the predominately global challenges. Furthermore, the extent of scarring from the pandemic appears to have been considerably less than many forecasters feared. The presence of high-skill jobs in many of the sectors most likely to drive economic growth remains a significant benefit to the Irish economy over the medium term.

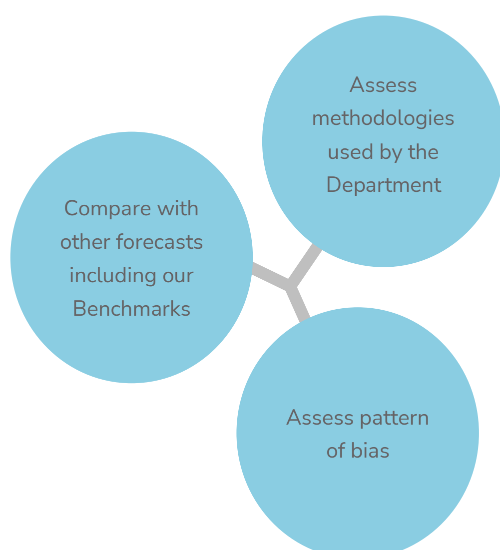
Upside risks to the outlook in *Budget 2023* include if inflation undershoots forecasts, continued high-skill job creation, and the possibility of faster net inward migration

The unexpectedly large rise in net inward migration evident in *Census 2022* suggests that Ireland's population could grow faster than expected over coming years. Notwithstanding numerous domestic challenges, particularly relating to the availability of housing, Ireland continues to attract inward migration well in excess of the number of emigrating Irish nationals, which have been relatively stable in recent years. A rise in housing output would improve Ireland's attractiveness to foreign direct investment. An increased prevalence of remote working could also help to address excess demand for housing in some cases, since the need for living close to city centres where many jobs have been located could be lower as a result. Nonetheless, the expansion of construction activity will require careful monitoring however, as Ireland's construction activity has been especially cyclical.

[10] For example, see: https://www.ecb.europa.eu/stats/ecb_surveys/consumer_exp_survey/results/html/ecb.ces_results_november_2022_inflation.en.html#_Inflation_expectations_three

1.4 Endorsement of the Department of Finance's macroeconomic projections

The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in September 2022.



The Council assessed that the Department's short-term macroeconomic forecasts were within an endorsable range, taking into account the methodology and plausibility of the judgements made. This section explores the key issues that arose in this latest endorsement exercise.

The Council's assessment of the Department's macroeconomic forecasts was broadly favourable regarding the processes and methodologies used. The main queries in the endorsement discussions related to the path for energy prices, the outlook for personal consumption, and projections for the deflator on the net external trade component of GNI*. The issue of only a three-year-ahead forecast horizon used by the Department remains a concern.

Background

The Department's provisional macroeconomic forecasts were completed on 9 September 2022 (for details of the endorsement timeline, see table S1a in the Supporting information section). The Council and Secretariat discussed the forecasts with Department staff on 16 September.

In a welcome development, the Department has expanded its use of underlying economic measures that focus on the domestic economy, including GNI*. This methodology closely follows the Council's approach, as described in Box E of the May 2020 *Fiscal Assessment Report* (Fiscal Council, 2020a). The Council's view remains that a wider move across other forecasting agencies towards underlying measures would provide more meaningful and relevant projections.

Personal consumption

In recent years, the short-term outlook for personal consumption had been greatly affected by developments relating to the pandemic, as lockdowns constrained citizens from engaging in a broad range of activities and spending. Further ahead, medium-term projections had been based on an expectation that the pandemic would result in "scarring", or a permanent loss of activity as a result of behavioural changes or damage to productive capacity. Rather than scarring due to the pandemic, *Budget 2023* projections for personal consumption expenditure have been revised down as a result of the impact of higher prices on purchasing power. However, as discussed in Section 1.2 and in Timoney (2022b), official estimates of household consumption that underpin the Budget projections may be understating the level of spending, and conversely, overstating the level of savings.

Personal consumption has been negatively impacted by higher prices, though it may have recovered more fully from the pandemic than official estimates show

Net external trade in GNI*

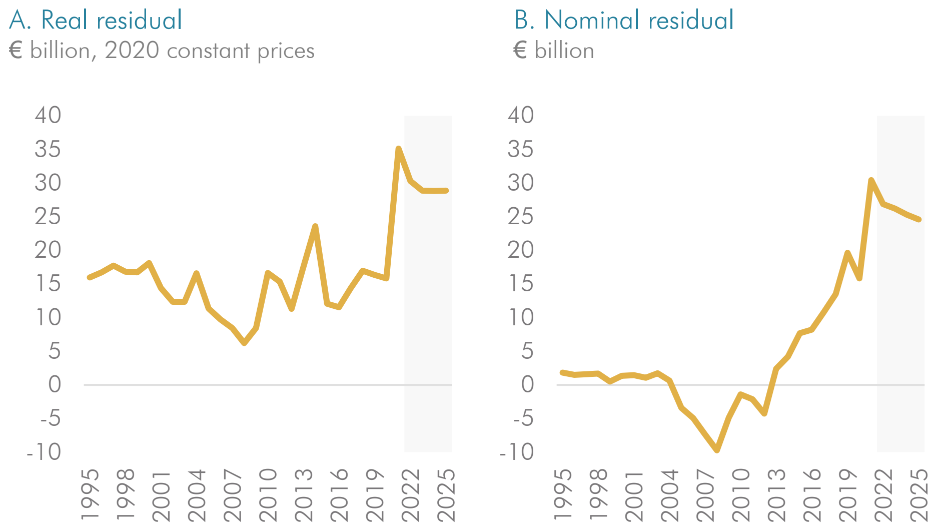
The Department projected GNI* in line with the methodology described in Lennon and Power (2021), which closely follows the Council's approach to forecasting GNI*.[11] The methodology implicitly assumes that the residual component of GNI*, which is not explained by modified total domestic demand, can be projected according to the estimated change in domestic exports less the change in domestic imports. This methodology is applied to projecting both real and nominal GNI*.

However, a weakness of this approach is that a close mechanical following of the methodology can treat an unusually large movement in the real or nominal residual as permanent. Figure 1.12 presents the residual component of GNI* that is not explained by modified domestic demand in both real (panel A) and nominal (panel B) terms. This shows that the sharp rise in the level of the real residual in 2021 is largely retained over the projection horizon, whereas in nominal terms, it declines from a lower spike in 2021.

The Department of Finance forecasts an ongoing high level of net external trade in GNI* over the forecast horizon

[11] Final demand in GNI* comprises modified domestic demand and "domestic exports", which strips out components of exports of goods and services assumed to be dominated by sales of multinational entities, using detailed merchandise trade and balance-of-payments statistics. "Domestic imports" is derived (approximately) as a (negative) residual from GNI* less final demand. Historical data for the import content of final demand in GNI*, along with forecasts of "domestic exports", are used to project the change in the residual component.

Figure 1.12: *Budget 2023* projects a continued high level for the residual component of GNI* that is not explained by modified total domestic demand



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.

The Department's view is that the large increase in the residual component captures an upwards shift in the value-add contribution of multinational entities to the economy in 2021, via corporation and income taxes. However, in nominal terms, the residual increased by €14.6 billion in 2021, whereas Revenue data (McCarthy, 2022) show that corporation taxes paid by foreign-owned multinationals increased by €2.7 billion. Furthermore, while income taxes increased by close to €4 billion in 2021, this increase was quite broad-based, implying a substantial contribution from a recovery in employment in domestic sectors.[12] This suggests the majority of the increase in the residual is not directly explained by corporation and income taxes paid by foreign-owned multinationals.

The Council's view is that the unusually strong growth rate for GNI* in 2021 — driven by the residual component — is not easily explained, and therefore warrants significant caution. Historical volatility in the residual component has been subject to rapid reversals; for example, the sharp reduction in 2015 correcting for the spike in 2014.[13] Furthermore, data revisions could change the interpretation of the drivers of GNI* growth. The size of the residual component in 2020 and 2021would be reduced if household consumption were higher, and savings lower, as indicated by Timoney (2022b).

However, it is possible that official data for 2020 and 2021 understate household consumption, and overstate the level of net external trade in GNI*

[12] Timoney (2022a) showed that PAYE and USC increased by €3.6 billion in 2021, of which €1.6 billion was from the 'High 5' sectors, €1.2 billion was from the 'Middle 6', and €0.9 billion was from the 'Lower 5' sectors (as described in Section 2 of the note).

[13] This relates to how real GNI* is calculated subject to the offsetting effects of deflators on large components in GDP, such as total exports, imports, and other large adjustments included in the calculation of GNI* (such as R&D service imports and trade in IP). Small measurement errors on these deflators can result in large divergence between measured real GNI* growth and real modified domestic demand growth, for example, and these differences are captured in an often volatile series for the deflator on the residual.

Forthcoming research by the Council investigates possible solutions to the problem of volatile historical real GNI* growth rates. One alternative would be to estimate real GNI* by a different methodology to the current top-down approach. A bottom-up approach not relying on the large offsetting components of GDP, but instead focusing on sectors with relevance to GNI* in net value-added terms, would be a preferable basis for calculating real GNI*.

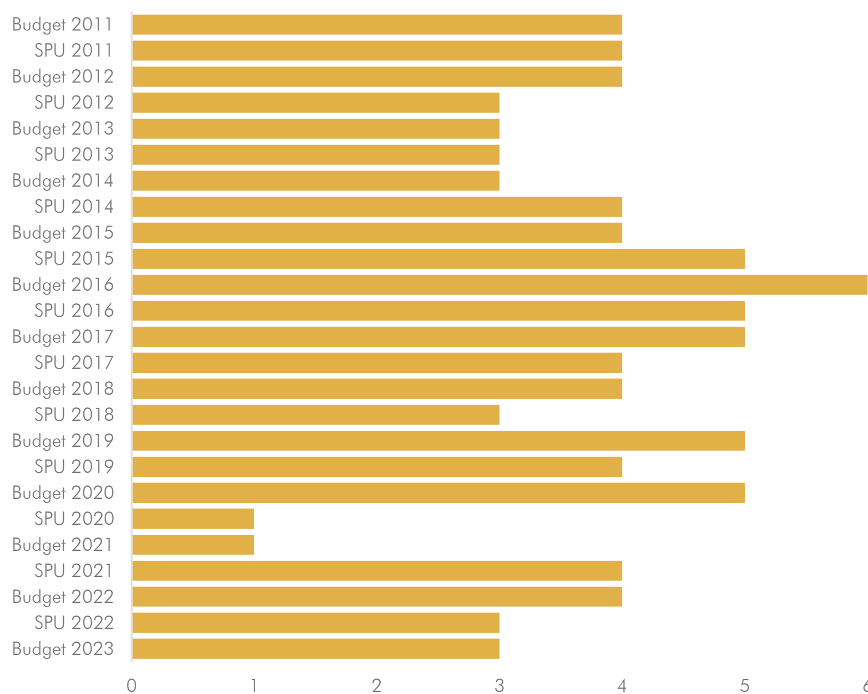
Forecast horizon

Budget 2023 forecast only three years ahead, less than in some previous forecasts and too short a horizon to provide a full picture of medium-term prospects. Figure 1.13 shows that the horizons in official forecasts have rarely stretched to five years or beyond, but the three-year horizon used in *Budget 2023* is nonetheless unusually short. The Department has in the past signalled to the Council its intention to forecast to five years ahead.

***Budget 2023* only forecasts to three years ahead**

Figure 1.13: *Budget 2023* only forecasts to three years ahead

Years



Sources: Department of Finance, and Fiscal Council workings. Get the data.
Note: Budgets are labelled as "Budget t+1", but published in year t; for example, *Budget 2023* will be published in October 2022, meaning its forecast for 2022 is an in-year forecast (for year t).

As well as undermining a medium-term approach to policy, the short forecast horizon limits the Council's ability to assess the consistency of the Department's forecasts between short-and medium-term developments — especially in respect of supply-side variables such as the output gap and potential output growth, and the return of key ratios such as the unemployment rate and savings rate towards medium-term norms. This problem has become increasingly acute given the large and persistent shocks the economy has been facing: a three-year horizon does not allow the forecasts to show how the economy returns to a more normal path

Medium-term forecasting by the Department of Finance should always be undertaken out to at least five years ahead

and this can undermine the realism of the short-term projections. The three-year horizon further obscures the role that ageing, climate change, implementation of international tax reforms and automatic enrolment for pensions could have on the economy.

The Council has previously underlined the importance of always using a five-year horizon at least (Fiscal Council, 2018b), and its concern that the current parliamentary term should not affect the horizon of official macroeconomic and fiscal forecasts. There is also a case for forecasts to stretch well into the next Parliamentary term if needed.[14] Medium-term forecasting should always be undertaken out to at least five years ahead.

[14] See, for example, the November 2018 *Fiscal Assessment Report* (Fiscal Council, 2018b): "The Council assesses that a horizon of at least five years ahead is appropriate to support a medium-term orientation for fiscal policy, and to ensure ongoing emphasis on identifying risks or potential economic imbalances in real time. The Department should not shorten the forecast horizon and should use realistic technical assumptions where needed, for example to forecast the public finances when the forecast horizon exceeds the length of the current parliamentary term."

Budgetary Assessment

Public finances impacted by cost-of-living supports

2. BUDGETARY ASSESSMENT

Public finances impacted by cost-of-living supports

Budget 2023 forecasts an underlying general government deficit of 3% of GNI* in 2022, when windfall corporation tax receipts are excluded.[15] This would represent an improvement of 2 percentage points of GNI* from 2021. The headline general government balance is forecast to return to surplus in 2022, largely as a result of substantial increases in corporation tax receipts. It is likely that the surplus for 2022 will end up even larger than forecast in *Budget 2023*, given the recent buoyancy of tax revenue. Corporation tax, income tax, and VAT are likely to be higher than forecast.[16]

In *Budget 2023*, the Government introduced a large package of €11 billion of temporary and permanent spending and taxation measures, mostly aimed at tackling cost-of-living issues. This large package was facilitated by a temporary deviation from the Government's 5% Spending Rule.

Looking further ahead, core spending — spending excluding one-off and temporary measures — is forecast to grow in line with the Government's 5% Spending Rule from 2024. Excluding excess corporation tax receipts, the government balance is forecast to move from a deficit of €3.8 billion (1.4% of GNI*) in 2023 to a surplus of €4.2 billion (1.4% of GNI*) in 2025. The net debt ratio is now forecast to fall rapidly, from 72.9% of GNI* in 2022 to 57.8% by 2025.

Forecasts contained in the Budget run only to 2025 (see Section 1.4); producing three-years-ahead forecasts runs contrary to prior commitments and does not allow for a comprehensive analysis of the Government's spending and tax plans over the medium term. It also demonstrates a lack of progress on medium-term budgeting more generally and underscores the importance of strengthening the budgetary framework.

Major medium and long-term challenges should be factored into fiscal plans. These include reducing the reliance on windfall corporation tax receipts, spending pressures from an ageing population, Sláintecare, and transitioning to a lower-carbon economy.

[15] As estimated by the Department of Finance.

[16] Revenue has been strong in the two sets of monthly returns since *Budget 2023* forecasts were published. As the Budget took place earlier than normal, *Budget 2023* forecasts were made with eight months of revenue and spending data, rather than the usual nine months.

2.1 Revenue and expenditure forecasts for 2022

2022 sees further improvements to the public finances

Revenue has recovered strongly since the pandemic (Figure 2.1). General government revenue is forecast to rise above €100 billion for the first time in 2022, reaching €112.5 billion or 43.1% of GNI*. All the main areas of general government revenue are expected grow in 2022, but the increase is mainly driven by higher income tax and corporation tax, with taxes on income and wealth increasing by €9.4 billion. PRSI and VAT receipts are also expected to have grown strongly in 2022.

General government expenditure is also forecast to have grown strongly in 2022, increasing by €5.7 billion or 5.4%. Temporary spending measures are expected to have remained high in 2022, at €11.8 billion, falling by only €0.7 billion from 2021. A larger fall in temporary measures for 2022 was expected in April 2022's *Stability Programme Update* as the pandemic receded, but additional measures have since been introduced. These temporary measures include spending on Covid-19 related measures, supports for Ukrainian refugees, cost-of-living measures and approximately €2.7 billion in capital transfers relating to the cost of the defective concrete blocks redress scheme.[17]

Revenue looks set to be higher than forecast in *Budget 2023*

Taken together, *Budget 2023* forecasts a headline budget surplus of €1 billion or 0.4% of GNI* for 2022. However, there are upsides to these forecasts, particularly on the back of recent strong Exchequer revenue data. Income tax, VAT and corporation tax are all likely to overperform budget forecasts.

The 12-month rolling sum of corporation tax was €21.9 billion by the end of October, €0.9 billion more than the forecast total for 2022 in *Budget 2023* (Figure 2.1E). Given trends to date this year, corporation tax receipts in the final two months of this year are likely to be substantially higher than receipts last year, indicating considerable upside.

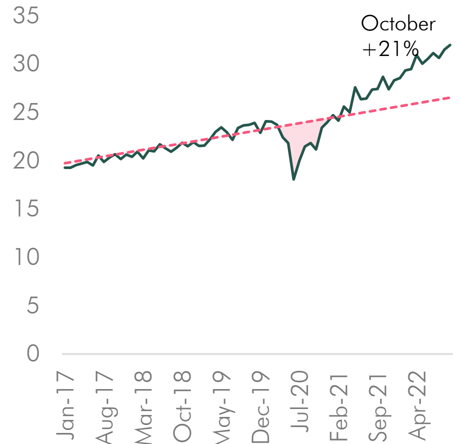
Income tax receipts for 2022 were revised up in the Budget by €765 million relative to SPU forecasts (Figure 2.1F). The cumulative overperformance of income tax, relative to SPU forecasts, by the end of October was €695 million.[18] The budget forecast is likely to be exceeded due to strong income tax receipts expected in the remainder of the year, in part due to payments under the new public sector pay deal.

[17] Section 2.2 shows how one-off spending is forecast to halve in 2023.
[18] Figure 2.1 (panels A, B C and D) show revenue performing strongly relative to pre-pandemic trends. The higher inflation environment has boosted receipts this year (see Box E, Fiscal Council 2022A).

Figure 2.1: Revenue has recovered strongly from the pandemic

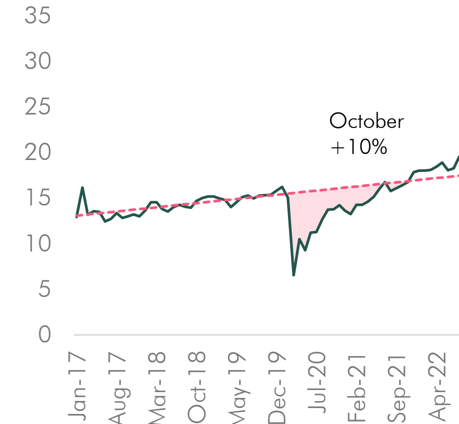
A. Income tax

€ billion, seasonally adjusted and annualised



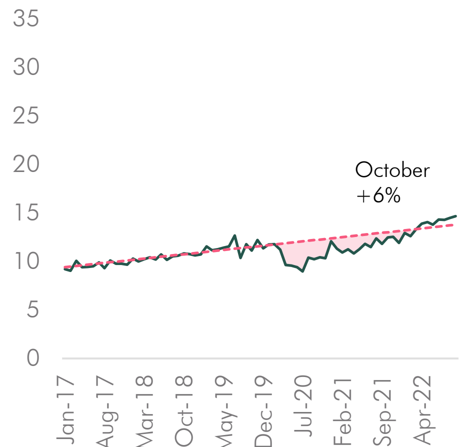
B. VAT

€ billion, seasonally adjusted and annualised



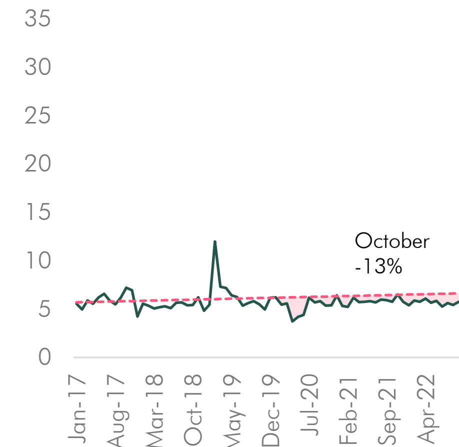
C. PRSI

€ billion, seasonally adjusted and annualised



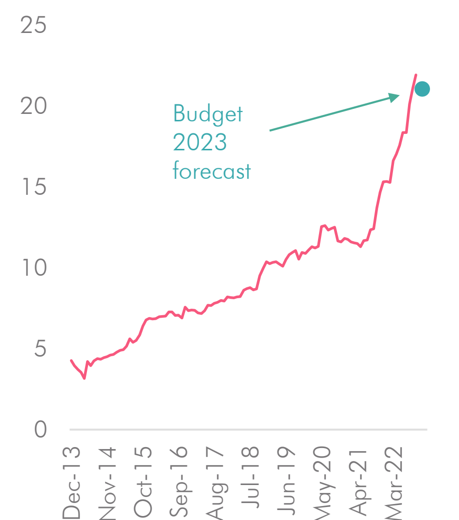
D. Excise

€ billion, seasonally adjusted and annualised



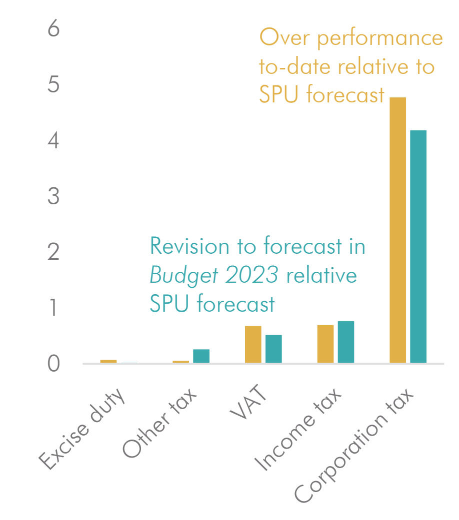
E. Corporation tax

€ billion, 12-month rolling sum



F. Revenue overperforming *Budget* forecast

€ billion, difference relative to SPU 2022



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

Notes: Monthly tax data are seasonally adjusted and annualised (× 12). The pre-pandemic trend is calculated as a linear trend from Jan 2015 to Dec 2019; % differences refer to the gap between the current seasonally adjusted level annualised and its pre-pandemic trend. Corporation tax is shown as a 12-month rolling sum due to difficulties in seasonal adjustment. Get the data.

VAT has also been performing strongly in 2022, with the higher inflationary environment ensuring buoyant receipts. VAT receipts to date are up €677 million relative to SPU forecasts, whereas receipts for all of 2022 in *Budget 2023* were expected to be up by only €520 million relative to SPU forecasts.

Gross voted current expenditure was €61.1 billion at the end of October — €2 billion over the *Budget 2022* profile.[19] However, this spending profile did not include approximately €3.9 billion of contingencies that were factored into *Budget 2022* that are now being used to meet temporary costs, such as cost-of-living measures, Covid-19 related spending and costs associated with accommodating Ukrainian refugees. *Budget 2023* set out further increases in core spending of €0.7 billion related to public sector pay.

Much of the €2 billion overspend to date, relative to the *Budget 2022* profile, on current expenditure is due to new cost-of-living measures introduced. Social protection spending is €0.5 billion over profile; the double social welfare payment in October is estimated to account for €0.3 billion of this. Current expenditure by the Department of Environment, Climate and Communications is €0.8 billion ahead of profile, primarily due to the cost of the electricity credits paid to date.[20, 21]

Current health spending is €0.6 billion over the *Budget 2022* profile. While this is in part due to additional expenditure relating to the Covid-19 pandemic, some relates to overruns on core spending. In June, it was estimated that core current health spending would be €0.35 billion higher than projected for the year.[22] This is despite it being likely that staffing levels in health will be lower than targeted (see Box B).

Gross voted capital spending was €5.5 billion at the end of October, €1.3 billion below profile.[23] Underspends on capital occur across all Departments, with the exception of education, which is currently €0.2 billion ahead of profile. The

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[19] The comparisons made in this section, for gross voted current expenditure vs profile, are relative to the original *Budget 2022* profiles for gross voted current expenditure. These profiles were amended in the October Fiscal Monitor, to account for the reclassification of the electricity credit from capital expenditure to current expenditure. The original gross voted current profile did not include any of the €3.9 billion of contingencies. As a result, comparisons relative to the original profile provide a useful indication of how much of the contingencies have been used to date — including to cover overruns. The updated profile in the October Fiscal Monitor shows gross voted current expenditure €1.3 billion ahead of profile.

[20] As highlighted in the May 2022 *Fiscal Assessment Report*, the electricity credit had previously been classified as capital expenditure (Fiscal Council, 2022a). It has now been reclassified as current expenditure.

[21] Relative to the original current expenditure profile for the Department of Environment, Climate and Communications. The profile has since been updated reflecting the reallocation of the electricity credit to current expenditure.

[22] See letter from Minister Donnelly to Minister McGrath dated 30 June, as reported in the Business Post: https://www.businesspost.ie/news-focus/dear-stephen-mcgrath-told-donnelly-health-overspend-was-of-great-concern/.

[23] Refers to the updated profile in the October Fiscal monitor.

underspends in capital are, once again, likely to lead to a large issuance out of the Exchequer in December, due to a large capital carryover into next year.[24] Section 2.6 discusses the shortfalls in capital spending relative to official plans in recent years.

[24] Departments are allowed to carry over up to 10% of their capital allocation into the following year if it remains unspent in the current year. This amount is issued out of the Exchequer in December of the current year, even though it will not be spent by the Departments until the following year.

Box B: Recent trends in public health sector staffing

Healthcare is very labour-intensive. As a result, a large driver of the increase in health spending annually is staffing costs. The pay bill accounted for, on average, 47% of the health vote costs from 2015 to 2021, but reached 52% in 2021. The number of workers in the health sector is also one of the main drivers of public sector pay more generally, as health workers make up 37% of all public sector workers.[25] For this reason, staffing levels in the health sector are an important indicator for the public finances. This box looks at the recent trends in public health sector staffing.

Health staff levels and demographics

Staffing levels in the health system are likely to reflect demand, including the impact of changing needs over the course of a person's life cycle; for example, in 2018, spending in public hospitals on people aged 65 and over, who account for only 14% of the population, accounted for 43% of the total spending. Therefore, changes in the number of people in these cohorts are a key driver in in explaining the demand for health services.

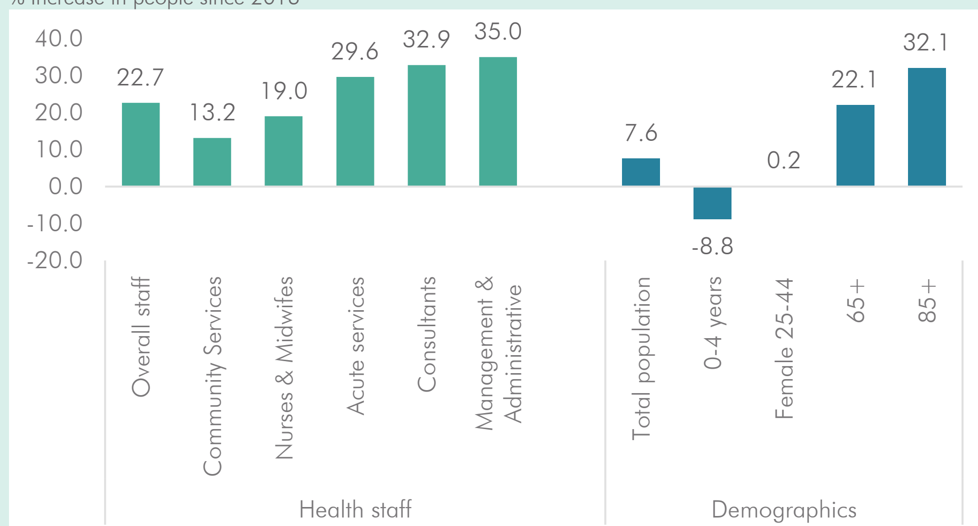
Comparing any increase in staff levels to the increase in these cohorts can be a useful indicator of a real expansion in the level of services in the health sector.

Figure B1 compares the changes in some key areas of staff levels in the health service since 2016 to the changes in some key demographic groups. Overall, the increase in the staffing levels in key health services broadly kept pace with the increasing number of older people. Since December 2016, the number of staff in the public health sector has increased by 25,000, or 22.7%, while the population over the age of 65 has grown by 22.1%.

The changes in the staff levels by area also provide an indication of recent policy priorities. There has been a large increase in the number of staff in Acute Services (29%), and Consultants (32.9%) in recent years. However, front-line services have not seen the largest growth in staff levels. Management and Administration staff have risen to more than 22,600, increasing by 35% since December 2016, more than other areas of the health service.[26]

Figure B1: Increases in key health staff have broadly matched demographic changes, but have been uneven across areas

% Increase in people since 2016



Sources: CSO; Health service personnel censuses; Health service employment reports, and Fiscal Council workings.
Notes: Demographic figures are taken from the Annual Population Estimates and compare April 2022 population to April 2016 population. Health staff figures compare December 2016 Whole Time Equivalents (WTE) figures to September 2022 WTE figures. Get the data.

[25] Data as of Q2 2022, taken from the Department of Public Expenditure and Reform Databank.

[26] This relatively large increase in Management and Administration staff levels is not just due to the Covid-19 pandemic. Staff levels in Management and Administration had grown relatively quickly (by 12.7%) even prior to the pandemic, with only Consultants growing faster (14%) between December 2016 and February 2022.

Recent staffing levels and targets

Figure B2 shows the trend in overall staff levels in the public health sector since December 2016. The HSE National Service Plan for 2022 outlined a minimum target of 137,410, with an upper limit of 141,690 staff by the end of 2022. While the National Service Plan provides a minimum target, funding had been provided and plans developed on the basis of the upper limit: "The NSP works to the maximum target as the HSE is fully committed to deliver to the greatest extent the maximum of the range, acknowledging the significant and unpredictable challenges to workforce supply in 2022" (HSE, 2022).

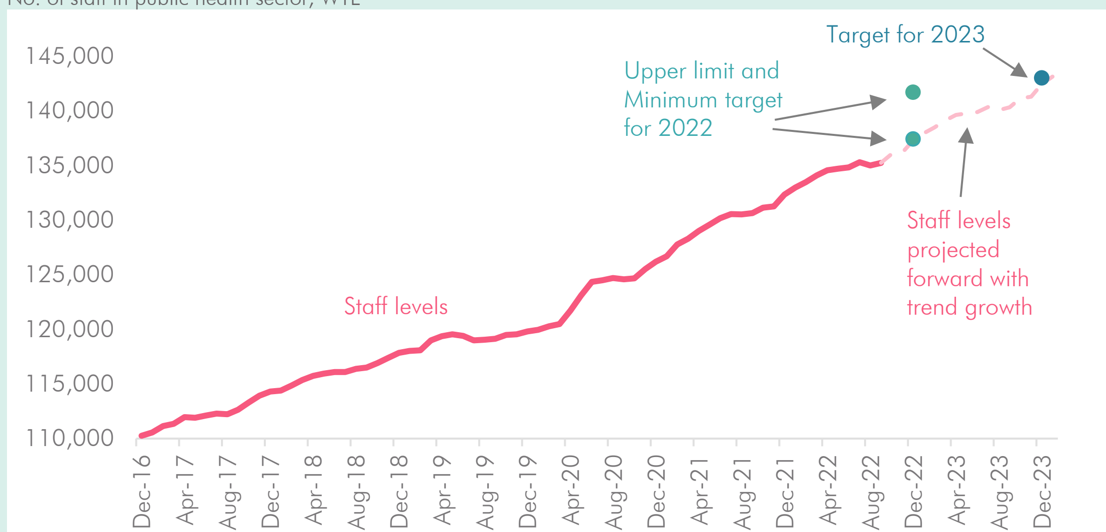
By September 2022 around 135,240 Whole Time Equivalents (WTE) were employed in the public health sector. This implies that the total number of staff in the health sector was 2,170 people shy of the minimum end-2022 target. However, some areas of the health service were already above the minimum target. The number of staff in Acute Services, such as hospitals and ambulances, was above the minimum target for 2022 by 860 people.

Community Services were almost 3,000 below the minimum end-2022 target, and almost 5,900 below the upper limit the National Service Plan worked towards.[27] This shortfall is mainly driven by Primary Care, which is 1,950 staff below the minimum target, but Mental Health (390), Disabilities (590), and Older People (660) were also all below the minimum target by the end of September.[28]

Figure B2 projects forward the level of staff based on recent trend growth in staff. Using this projection, the level of staff numbers by the end of 2022 would fall just shy of the minimum target by 130 staff and more than 4,400 below the upper limit that the HSE's National Service Plan worked towards.[29] Looking further ahead, the *Expenditure Report 2023* sets a target of an increase to 143,000 staff by the end of 2023. Based on the trend growth rate, staffing levels might just meet this target.

Figure B2: Staffing levels likely to just meet minimum target this year

No. of staff in public health sector, WTE



Sources: Health service personnel censuses; Health service Employment Reports; Expenditure Report 2023; HSE National Service Plan 2022 and Fiscal Council workings.

Notes: All figures are on a WTE basis. Upper and minimum target limits for health staff are taken from the HSE National Service Plan 2022. The target for 2023 is taken from the Expenditure Report 2023. Trend year-on-year growth is based on the data from December 2016 to September 2022. The average year-on-year growth in staff levels since December 2016 was 3.75%. Get the data.

[27] There were 56,790 staff in Community Services at the end of September 2022.

[28] For context, at the end of September 2022, Primary Care had 12,150 staff, Mental Health had 10,400 staff, Disabilities had 19,670 staff, Older People had 13,780 staff. At the end of September, Primary Care was 3,130 staff below the upper limit that the National Service Plan worked towards; Mental Health was 670 staff below the upper limit; Disabilities was 1,160 staff below the upper limit; and Older People was 1,550 below the upper limit.

[29] This also follows on from a shortfall of 3,300 staff in 2021 from the end-December target in the HSE National Service Plan 2021.

Implications of a shortfall in staffing

As funding had been made available for the increase in staffing levels, the struggle to meet even *minimum* targets suggests supply constraints in the healthcare labour force. One example of such constraints was highlighted in a recent *Spending Review* paper showing that recruitment in nursing has become heavily reliant on recruiting nurses who have been educated abroad (Caulfield *et al.,* 2022). In 2021, 69% of newly registered nurses had been educated outside Ireland, up from 26% in 2014. The paper also highlighted that domestic supply gaps were likely to persist and that recruitment from abroad would continue to be required. This is despite Ireland committing to the ending of active recruitment of health personnel from developing countries (Caulfield *et al.,* 2022). The paper recommended the expansion of student nursing places.

Given the commitment to end the practice of recruiting from developing countries, the reliance on recruitment from abroad to cover domestic supply gaps and the difficulties in retention of staff in the health sector pose challenges to expanding the number of staff in the health sector.

All else equal, a shortfall in staff would see a lower level of services being provided than originally planned. This is particularly the case in Community Services, which requires an additional 1,000 staff per month for the remainder of the year to meet the minimum target (almost 2,000 per month to meet the upper limit). This target is therefore unlikely to be met. This has implications for the implementation of Sláintecare reforms as many of the reforms centred on shifting towards a community-centred approach and rely on expanding staff levels in Community Services: "The Committee's preferred design is a model where the vast majority of healthcare is provided in the community".[30] As Figure B1 shows, staff in Community Services have grown by only 13.2% since 2016 — a much lower increase than those in other areas. The shortfalls in staffing levels in this area will delay the implementation of the Sláintecare reforms.

In terms of the public finances, a lower level of staffing than planned should see underspends in Health. The savings from the lower level of staff were estimated by the Department of Health to be between €350 and €510 million this year.[31] However, it seems likely that this underspend will be used to cover overspends in other areas, with areas such as Covid-19 measures, waiting lists, the winter flu programme, and pay restoration flagged as areas to which this money might be diverted.[32]

The use of funds to cover spending in areas not originally intended is an indication of poor planning. The inability to expand the supply of the healthcare workforce to meet policy aims also highlights the lack of planning in the healthcare system. Planning could be better facilitated if the HSE finalised its annual *Pay and Numbers Strategy* in a more timely way.[33] A comprehensive, strategic medium-term workforce plan — in line with key policy goals — would better facilitate managing staff levels, particularly if the planned expansion in staff over the medium term is large. This medium-term strategic plan is necessary as there needs to be a corresponding expansion in domestic university places in healthcare ahead of any planned increases in health staffing, as well as policies to ensure the retention of staff.

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[30] See Committee on the Future of Healthcare (2017).

[31] See reporting by the *Business Post*: https://www.businesspost.ie/news-focus/dear-stephen-mcgrath-told-donnelly-health-overspend-was-of-great-concern/.

[32] See reporting by the *Business Post*: https://www.businesspost.ie/news/e350m-hse-surplus-from-under-recruitment-will-fund-covid-costs-and-pay-restoration/.

[33] Connors (2018) outlines how the HSE only submitted the revised 2016 *Pay & Numbers Strategy* to the Department of Public Expenditure and Reform in December 2016, the final month of the year in question. The 2017 *Pay & Numbers Strategy* was only submitted to the Department of Public Expenditure and Reform in November 2017. Connors (2018) argues that "[t]hese timelines result in the Strategy having no impact on the planning and monitoring process".

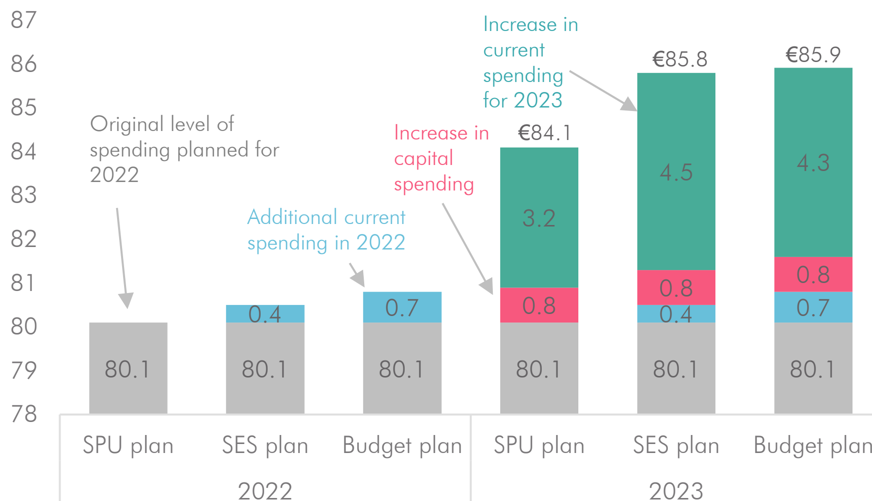
2.2 Budget package

Budget 2023 set out a large package of around €11 billion of permanent and temporary measures.

This included a package of permanent expenditure and tax reducing measures of €6.9 billion, consisting of €5.8 billion in spending measures (Figure 2.2) and €1.1 billion in tax measures (Figure 2.3). This package is €2.6 billion more than was planned in *SPU 2022* for 2023 (€1.8 billion in core spending, €0.6 billion in additional tax-reducing measures).

Figure 2.2: Evolution of the "core" spending plan

€ billion, gross voted "core"



Sources: Department of Finance; and Fiscal Council workings. Get the data.

Both the spending and tax packages announced in *Budget 2023* were larger than previously planned

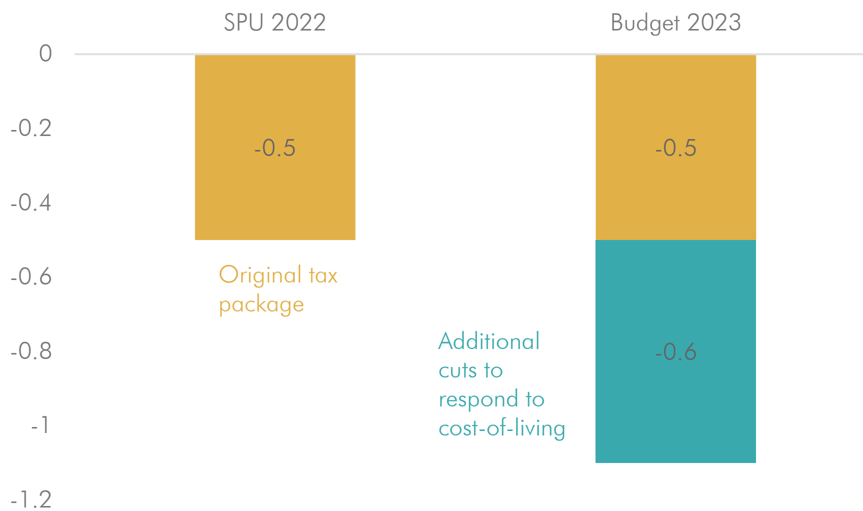
Figure 2.2 shows how core spending plans have been revised up for both 2022 and 2023 with revisions to both years in the July *Summer Economic Statement* and *Budget 2023*. The new public sector pay agreement raises core current spending in 2022 by €0.7 billion and raises the starting level for 2023. In addition, "core" spending is now set to increase by €5.1 billion in 2023 relative to this level, up from €4 billion in the SPU due to the temporary deviation from the Spending Rule, and entirely accounted for by current spending (see Section 3 for a discussion on the appropriateness of this deviation).

The size of the tax package also increased in *Budget 2023*. The total package of tax-reducing measures announced was €1.1 billion, €0.6 billion more than originally planned (Figure 2.3). These measures would more than offset the increase in the tax revenue that would have occurred in 2023 with no adjustment of income tax thresholds.[34]

[34] See Section 2.5 and Figure 2.8 for details on income tax.

Figure 2.3: The size of permanent tax-reducing measures has increased

€ billion, net tax measures



Sources: CSO; Department of Finance and Fiscal Council workings.
Notes: Figures have been updated to incorporate the reduced yield from the concrete blocks levy, which is now expected to yield €32 million in a full year. On a full-year basis, the tax cuts announced cost €1.4 billion. Get the data.

The Budget also introduced a large package of temporary supports to help households and businesses to cope with higher prices. This package amounts to €3.9 billion, of which €3.6 billion is for additional spending measures and €0.3 billion is for extending temporary tax cuts into next year (Table 2.1).[35]

The temporary spending measures for households, announced in *Budget 2023,* were largely untargeted

A total of €2.2 billion of the temporary spending measures is directed at households, while €1.4 billion is for supports for businesses. The Council estimates that approximately 33% of the temporary spending for households announced in *Budget 2023* is targeted.[36] However, the degree of targeting of temporary measures needs to be viewed alongside the permanent spending measures introduced. Increases in core social welfare rates are more heavily targeted at those most in need.

[35] The rent tax credit is treated as a permanent measure accruing in 2022, as it applies to rent paid in 2022.

[36] In its "flash release" immediately after the Budget, the Council assessed that approximately half of the temporary measures were targeted. This was based on the Business Energy Support Scheme being considered as targeted. As more information has become available about this scheme, the Council now assesses this scheme to be an untargeted measure.

Table 2.1: *Budget 2023* temporary measures

€ million

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

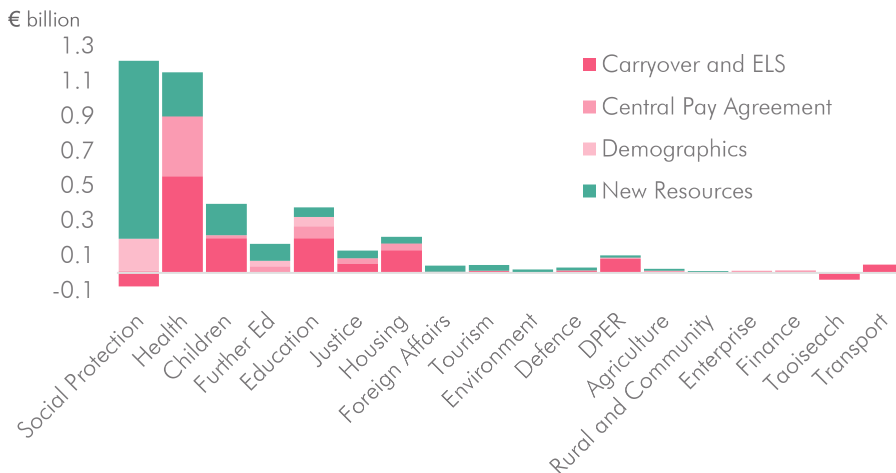
Sources: Department of Finance; and Fiscal Council workings.
Notes: As outlined above, the rent tax credit is not included as a one-off measure as it is intended to be permanent. The Council treat the rent tax credit as applying on a permanent basis from 2022, as it is accrued on rent paid in 2022. Both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

Figure 2.4 outlines the permanent core current spending allocations by Department in *Budget 2023*. The total size of this package, which excludes non-core amounts for Covid-19 related spending, is around €5.8 billion and has largely been focussed on addressing cost-of-living pressures, particularly for social welfare recipients. The additional spending is largely focussed on social welfare and on health, where higher pay will raise costs. The overall package of €5.8 billion is nevertheless approximately €0.9 billion below the Council's estimate of stand-still costs of wage and price inflation for 2023 and catch-up costs for unexpected inflation in 2022.[37] However, once combined with the temporary measures, the *Budget 2023* package insulates all income deciles from forecast inflation in 2023 (see Figure 3.11 and Doolan *et al.,* 2022).

This breakdown also helps illustrate the exceptionally large pressures from higher inflation in the current period; new cash resources that might usually contribute to real increases in services have instead been required to offset inflation in 2023. Discretionary policy has followed a path that has attempted to increase spending to protect the level of services and supports while not fully following inflation, which is significantly above trend.

[37] In the Council's most recent stand-still update prior to the release of the Budget, the estimated cost of fully indexing current spending in 2023 to account for the "catch-up" from unexpectedly high inflation in 2022, and forecast inflation in 2023, was around €6.7 billion (Fiscal Council, 2022b).

Figure 2.4: The majority of *Budget 2023* "new resources" are used to maintain the real value of services and benefits



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

Taken together, general government expenditure is set to rise by just €1.8 billion in 2023, despite the large permanent increases (€7.7 billion). This is because temporary measures are set to fall by €5.9 billion in 2023 as Covid-19-related spending falls and other one-off factors, like the defective concrete blocks redress scheme, are not repeated.

Looking at expenditure excluding one-offs, compensation of employees is forecast to grow by 4.1% in 2023, reflecting the recently agreed public sector pay deal. This entails a 2% increase in March 2023 and a further 1.5% increase in October 2023. Similarly, social payments are forecast to grow by 2.2% in 2023, less than the pace of increase in core benefits because of the winding-down of temporary measures introduced for 2022. The percentage increase in welfare rates varies by scheme, but most of the largest schemes are increasing by around 5%.

This increase in underlying general government expenditure is larger than the core spending increases discussed in Section 3. General government expenditure is a broader measure, whereas core spending is on an Exchequer basis. Several expenditure items which are outside the Exchequer but are inside general government are forecast to grow in 2023, including mostly likely spending on housing outside the central government. There is limited available information on spending in these non-Exchequer areas. [38]

[38] Non-Exchequer capital spending is forecast to grow by €0.4 billion. Spending by local authorities and non-commercial semi state bodies is also likely to increase substantially in 2023.

General government revenue (excluding one-offs and excess corporation tax) is forecast to rise by €5.4 billion in 2023, reflecting moderate growth and relatively high inflation (Table 2.2).

Corporation tax is forecast to grow by €1.7 billion in 2023. Most of this increase (€1 billion) is deemed to be "excess" by the Department. Section 2.5 details some of the key judgements and assumptions underlying *Budget 2023* forecasts of corporation tax. Most notably, €850 million of negative judgement is applied in 2023, with a further €2 billion of negative judgement in 2024. Income tax and PRSI are also forecast to increase strongly (€2.8 billion), reflecting strong nominal wage growth. A range of other headings contribute to revenue growth in 2023.

Table 2.2: *Budget 2023* summary fiscal forecasts

€ billions

	2021	2022	2023	2024	2025
General government					
Revenue	98.7	112.5	119.5	124.0	130.9
Expenditure	105.8	111.5	113.3	113.3	117.2
Balance	**-7.1**	**1.0**	**6.2**	**10.7**	**13.7**
Revenue one-offs	-0.1	-1.0	-0.5	0.0	0.0
Expenditure one-offs	12.5	11.8	5.9	0.7	0.4
Windfall corporation tax	5.0	9.0	10.0	9.0	9.5
Expenditure excl. one-offs	93.3	99.7	107.4	112.6	116.8
Revenue excl. one-offs and windfall corporation tax	93.8	104.5	109.9	115.0	121.4
Balance excl. one-offs and windfall corporation tax	0.5	4.8	2.5	2.4	4.6
Exchequer and Social insurance fund					
Gross voted "core" expenditure	74.1	80.8	85.9	90.2	94.7
Gross voted "core" current expenditure	74.1	69.9	74.3	77.6	81.3
Gross voted "core" capital expenditure	9.4	10.9	11.7	12.6	13.4
Tax and PRSI revenue	80.2	95.6	102.1	107.3	114.1
Tax revenue	68.4	81.6	87.0	91.2	97.0
PRSI	11.8	14.1	15.1	16.1	17.1

Sources: CSO; *Budget 2023* and Fiscal Council workings. Get the data.
Notes: General Government Expenditure shown above for 2023 includes the cost of the Temporary Business Energy Support Scheme (TBESS). While *Budget 2023* does incorporate the expected negative impact this scheme will have on the general government balance, it does not list this as part of its general government revenue or expenditure forecasts. This is because there is uncertainty over how this scheme will be classified. Estimates of windfall corporation tax receipts are the Department of Finance's estimates published in *Budget 2023*.

On a headline basis, revenues would rise faster than spending so the headline surplus would improve by €5.2 billion in 2023. However, after excluding one-offs and windfall corporation tax, the underlying balance is expected to deteriorate by €2.5 billion. Box C looks at adjusting the government balance for windfall corporation tax receipts.

However, timing effects may be playing a role in the public finances in 2022 and 2023. A significant improvement in the underlying balance is forecast for 2022 (€4.3 billion). Underlying revenue is forecast to benefit from the higher inflation

environment in 2022. The full effects of a higher price level on expenditure may not have been fully reflected in 2022, resulting in faster growth in 2023. As a result, both the improvement in the underlying balance in 2022 and the deterioration in 2023 may be overstated. In attempting to look through these potential timing effects, the underlying surplus in 2023 is €2 billion larger than in 2021.

Box C: Adjusting the general government balance for excess corporation tax receipts

In recent years corporation tax receipts have grown substantially. This year, corporation tax will become the second largest source of government revenue, surpassing VAT.

The Council has repeatedly pointed out that the recent growth in corporation tax has been well in excess of what might be explained by the performance of the domestic economy. Furthermore, these tax receipts have become even more concentrated among a handful of firms. Hence, corporation tax receipts could be subject to sharp reversals, due to company-specific factors, sectoral shocks or changes in the international tax environment.

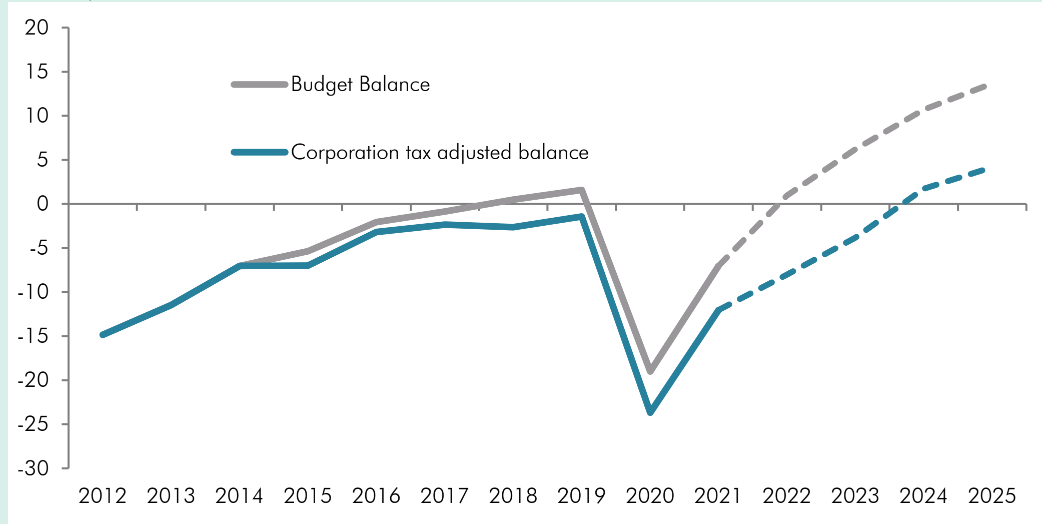
The Council has therefore advised that the Government reduce its reliance on corporation tax receipts for day-to-day expenditure.

One of the measures suggested by the Council (2022a) was for the Government to "clearly show the impact of excess corporation tax receipts on the budget balance".

In *Budget 2023* documentation, a general government balance excluding excess corporation tax receipts was shown. The Council welcomes this development, which is similar to an exercise in the *May 2022 Fiscal Assessment Report* (Fiscal Council, 2022a). This measure gives a better picture of how the public finances would look if the excess corporation tax were to significantly fall or disappear altogether.

Figure C1: Corporation tax-adjusted government balance is projected to remain in deficit until 2024

€ billions, General Government Balance



Sources: Department of Finance, and Fiscal Council calculations. Get the data.
Notes: Estimates of excess corporation tax for 2015–2020 are those calculated by the Council. Estimates of excess corporation tax for 2021–2025 are taken from *Budget 2023*.

The corporation tax-adjusted balance is calculated as the headline general government balance minus the amount of corporation tax receipts that are estimated as excess. This excess is based on the difference

in the growth of corporation tax receipts compared to domestic activity since 2014.[39] *Budget 2023* estimates "excess" corporation tax at around €9 billion and €10 billion over 2022 to 2025.

Were corporation tax receipts to increase substantially (without a corresponding increase in domestic activity), this measure of excess receipts would automatically increase, leaving the corporation tax adjusted balance unchanged. This measure therefore provides a more robust and stable measure of the underlying position of the public finances.

Figure C1 shows the headline general government balance and the corporation tax adjusted general government balance. The gap between these two measures has been widening significantly in recent years. When looking at the underlying balance, this is forecast to remain in deficit until 2024.

2.3 Government spending plans and stand-still costs

As *Budget 2023* forecasts run only to 2025, uncertainty continues around the medium-term orientation of government expenditure and policy priorities. The forecast costs of maintaining the existing level of service are outlined only for 2023 and are based on technical assumptions for 2024 and 2025.

***Budget 2023* only forecasts to three years ahead**

Large policy commitments continue to be unrecognised in projections for government expenditure, and departmental expenditure ceilings for the medium-term were once again not published as part of the budgetary documentation (see Section 4 for further discussion on expenditure ceilings).

Despite this, the expenditure amounts implied by the Government's Spending Rule continue to provide some signal for the trajectory of policy.[40] The deviation from the Spending Rule in 2023 is expected to be temporary and not repeated in 2024 and 2025. Growth rates in core current spending will moderate from over 6% in 2023 to an average of 4.6% in 2024 and 2025, broadly in line with the Government's estimates of sustainable growth. This contributes to the forecast surpluses shown in Table 2.2.

These growth rates are in line with what was outlined originally when the Spending Rule was announced as part of *Summer Economic Statement 2021*. Nevertheless, this means that expenditure will be higher in cash terms in 2025 than originally planned, by around €2 billion, due to the larger increases in 2022 and 2023.

In evaluating the credibility of these projections, the Council's stand-still exercise takes the most up-to-date departmental allocations for spending and forecasts how these will evolve based on expectations for price and demographic pressures. These stand-still estimates assume that spending on social welfare, health and education will grow in line with demographic growth and that key

[39] The Fiscal Council "suite of models" approach uses both domestic GVA and GNI* as measures of domestic activity.
[40] Supporting Information Section S4 shows *Budget 2023* fiscal projections in more detail.

welfare rates and public sector pay rates will grow in line with forecasts of private sector wage rates in 2024 and 2025, while other spending increases in line with inflation.

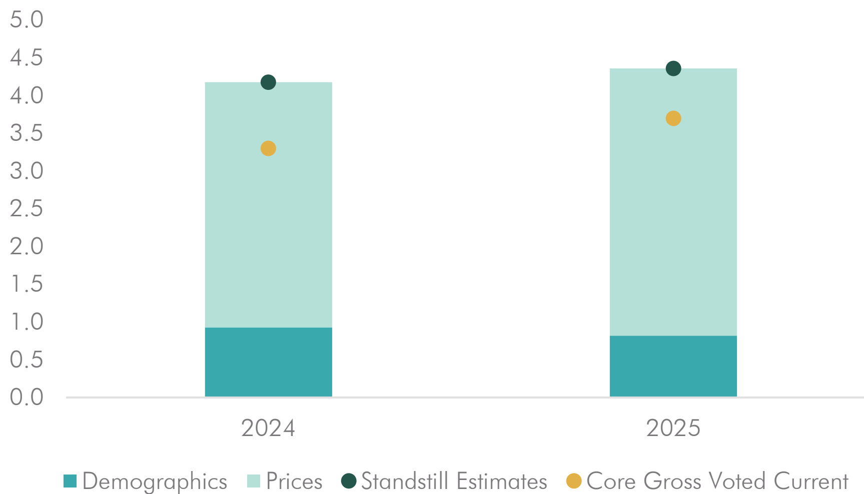
In the years 2024 and 2025, the estimated cost of "standing still' exceeds *Budget 2023* forecasts of spending by around €0.8 billion on average (Figure 2.5). This would imply that spending would need to be adjusted in real terms or relative to wages to meet the Government's Spending Rule and there would be no space for additional spending measures without finding offsetting resources elsewhere. This reflects, in part, the growing impact of ageing costs.

Spending pressures ahead, as costs of standing still leave little room for new measures

At the same time, there are major spending pressures that are not factored in these plans but that will need to be addressed. The Government will have to address climate change and implement Sláintecare reforms; it is also unclear how recent reforms to the pension system, including auto-enrolment and the changes to the retirement age, are factored in.

Figure 2.5: Stand-still costs diverge from *Budget 2023* projections in 2024 and 2025

€ billion, annual change



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

The Government's spending projections outline a detailed costs of maintaining the "existing levels of services" for only the Budget year (2023). They use technical assumptions for the "existing levels of services" in 2024 and 2025, with an estimate of 3% of core gross voted current spending required to maintain service levels. Details are not given on the expected costs of demographics and price increases (including pay).

This approach continues to reflect a short-term attitude to budgeting, particularly in the areas of uprating welfare payments and public sector pay. The amount of

spending required to stand-still is consistently higher than the allocations ostensibly made for this purpose. The Council's stand-still estimates are higher than the amounts derived from the technical assumption of 3% of core current spending being required to maintain service levels.

The amount of discretionary spending is large each year, but, as shown by the stand-still, a full indexation of pay, pensions and other supports to 2025 would allow for little to no real improvement in these areas. Given the recent decision on not increasing the pension age and the increasing numbers of claimants in the coming years, greater transparency in this regard could contribute to more accurate medium-term budgeting. More accurate projections of the costs of standing-still that incorporate Government priorities would allow for greater clarity on progress towards major policy reforms.

2.4 How the public finances are forecast to evolve

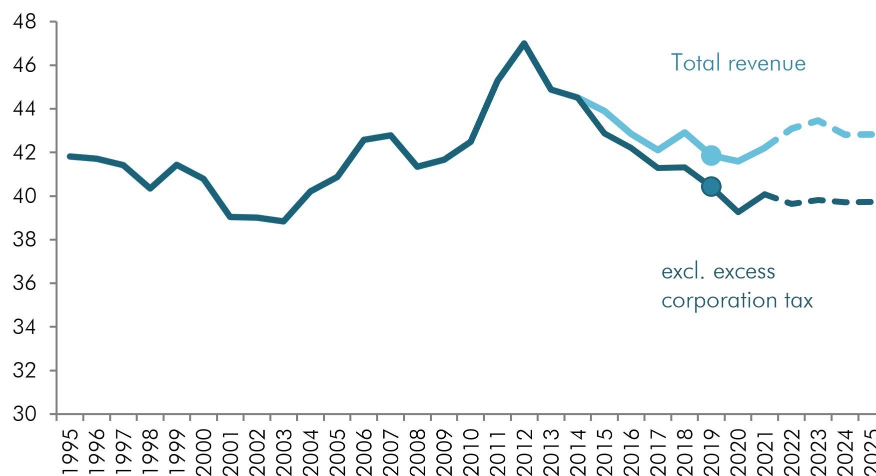
To give a perspective on the underlying dynamics of the public finances over the coming years, Table 2.3 compares the *Budget 2023* forecast of the level of several fiscal variables in 2025 to the last outturns before the pandemic (2019) as a way of "looking through" the impact of the pandemic.

The public finances (excluding excess corporation tax) are forecast to improve out to 2025

One of the main features over this period is the growth of corporation tax. In headline terms, corporation tax receipts are forecast to more than double from 2019 to 2025 (a €12.8 billion increase). More than half of this increase could be deemed to be in "excess" of what is generated by domestic activity.[41]

Figure 2.6: Revenue excluding excess corporation tax to remain around its 2019 share of GNI*

% GNI*, general government revenue



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Dots show the 2019 levels. For 2015 – 2020, Fiscal Council estimates of excess corporation tax are used. For 2021 – 2025, estimates published in *Budget 2023* are used.

[41] Section 2.5 details some of key judgements and assumptions made by the Department for *Budget 2023* forecasts.

On the revenue side, when excess corporation tax receipts are excluded, general government revenue is forecast to grow broadly in line with national income, with the ratio remaining roughly flat (Figure 2.6). Income tax sees the biggest increase in nominal terms (€13.3 billion). As explained in Section 2.5, the effective income tax rate rose in 2021, and is expected to remain elevated for the forecast horizon. Non-tax, non-PRSI revenue is forecast to fall slightly over the period, and hence is falling as a share of national income.

On the spending side, the main feature over this period (2019 to 2025) is the 72% growth in public investment spending (rising 9.5% annually, on average). The nominal increase in public investment, €5.8 billion, takes the share of public investment in national income to almost 5%.[42] Despite this increase in public investment, overall general government spending falls as a share of national income. Interest spending is forecast to fall in nominal terms (and hence even more so as a share of national income).[43] Current primary spending is forecast to grow at an average annual rate of 5.0% over the period, which leads to a fall as a percentage of national income. This comes despite the spending pressures which are likely to arise due to an ageing population (Fiscal Council, 2020b).

Table 2.3: Comparing 2019 and 2025

Difference 2025 – 2019

	p.p change in GNI*	€ billion change	% Change	Annualised growth rate
GG revenue	1.0	42.8	48.6	6.8
GG revenue (excluding excess corporation tax)	-0.6	36.3	42.7	6.1
Tax revenue	3.6	37.7	63.6	8.5
PRSI	0.2	5.7	49.7	7.0
Non tax, non-PRSI revenue	-2.7	-0.6	-3.3	-0.6
Income tax	1.0	13.3	58.0	7.9
Corporation tax	2.6	12.8	117.8	13.9
:of which "excess"	1.7	6.5	214.8	21.1
VAT	0.2	7.4	48.7	6.8
Other tax revenue	-0.2	4.2	40.4	5.8
GG spending	-2.7	30.7	35.5	5.2
Gross Fixed Capital Formation	1.0	5.8	72.0	9.5
Interest	-1.1	-1.3	-28.6	-5.5
Current primary spending	-2.6	25.4	34.3	5.0
GG balance	3.7	12.1		
GG balance (excluding excess corporation tax)	2.0	5.6		
Level of GNI*		94.8	45.0	6.4

Sources: CSO, and *Budget 2023*. Get the data.

Notes: Changes are in the format 2025 level minus 2019 level. As a result, positive values indicate a variable increasing over the period or taking up a larger share of GNI* than was the case in 2019. The annualised growth rate shows the rate of growth for every year from 2019 that would yield the 2025 level forecast in *Budget 2023*. GG = general government.

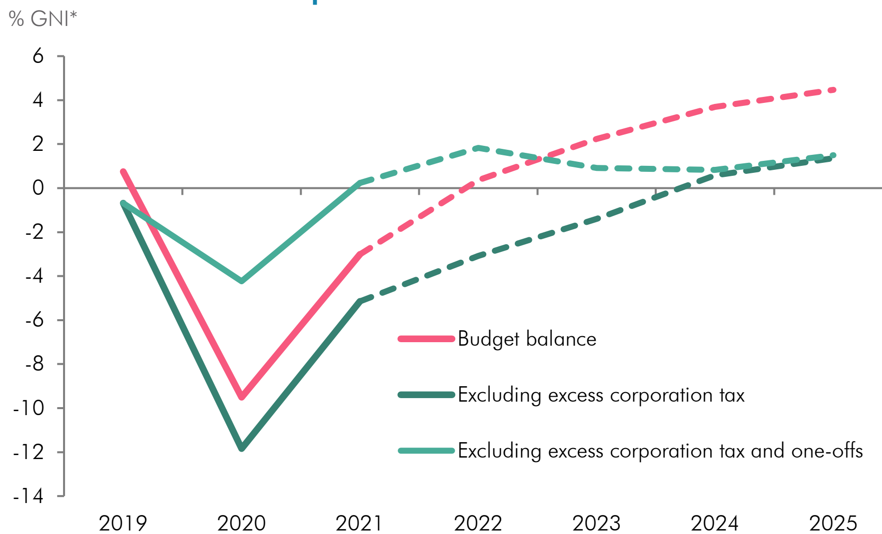
[42] While this increase is large, as noted earlier in the section it is a more modest increase than was forecast in *Budget 2022*.

[43] While the interest environment has become less favourable, Ireland has relatively low financing needs, and the gross debt level is forecast to be a much lower share of national income in 2025 (73.2% of GNI*) compared to 2019 (96.5% of GNI*).

As noted earlier, excess corporation tax receipts play a significant role in how the public finances are forecast to evolve from 2019 to 2025. Over half of the improvement in the headline general government balance (€12.1 billion) is driven by increases in excess corporation tax (€6.5 billion).

However, even the corporation tax-adjusted general government balance is projected to improve from 2019 to 2025 (Figure 2.7). A €5.6 billion improvement is forecast (2.0% of GNI*). Strong tax growth and falling interest payments more than offset increases in public investment and current spending. On this basis, there is a modest decline in 2023, due to the large package of measures introduced. Thereafter, the position is largely flat, with a surplus of 1-2% of GNI*.

Figure 2.7: The Government's corporation tax-adjusted budget balance is forecast to reach surplus in 2024



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

2.5 Tax forecasts and the effective tax rate

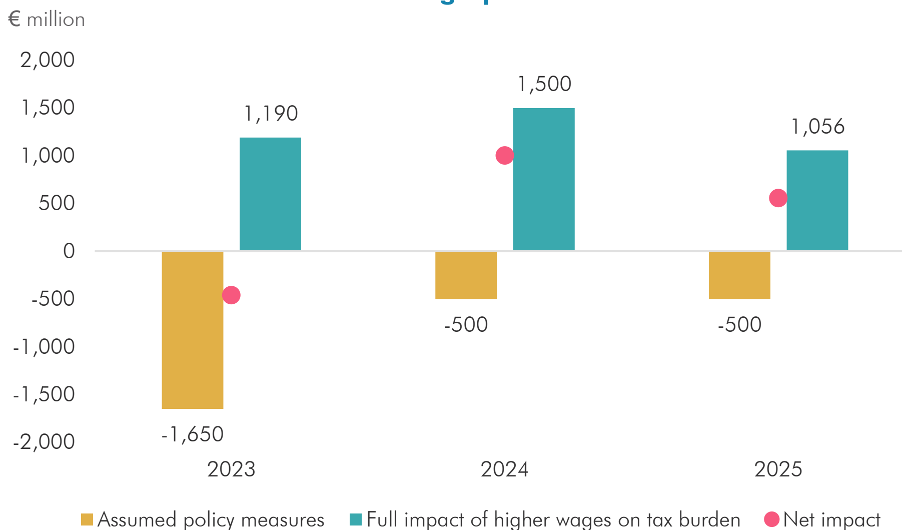
To assess revenue projections and understand the underlying dynamics, tax forecasts can be decomposed into several factors. Supporting information Section S5 shows a breakdown of the various factors contributing to *Budget 2023* forecasts of tax receipts. These factors include growth in macroeconomic drivers, policy changes, one-off effects, and judgement applied to the forecasts.

By looking at this breakdown, one can better assess if revenue projections are reasonable. For example, if strong revenue increases were based on judgement rather than policy changes or growth in the macroeconomic drivers, that might be a cause to question such a forecast. As has been documented previously,

forecasting government revenue in Ireland is difficult, with large absolute errors relative to other countries (Hannon et al, 2015; Tax Forecasting Methodology Review Group, 2019).

Substantial income tax policy measures for 2023 were announced as part of *Budget 2023*. These policy measures are around €500 million more than the assumed cost to fully index income tax bands and credits to wage growth (Figure 2.8), meaning that the effective aggregate tax burden is expected to decline relative to 2022. For 2024 and 2025, €500 million of income tax policy measures are assumed for each year. Given expected wage growth in these years, these policy measures are less than the amount needed to fully index income tax bands and credits.

Figure 2.8: Assumed income tax policy changes would mitigate the increase in the tax burden through partial indexation



Sources: *Budget 2023* projections, and Fiscal Council workings. Get the data.
Note: A net impact greater than zero indicates that assumed policy changes are less than the assumed yield from not indexing income tax bands and credits. As a result, income tax revenue would be higher than if full indexation of the income tax system were assumed. The cost of indexation for 2023–2024 is given by Department of Finance estimates. The 2025 estimate is derived by combining Revenue's post-*Budget 2023* "ready reckoner" with Department of Finance forecasts of hourly earnings growth.

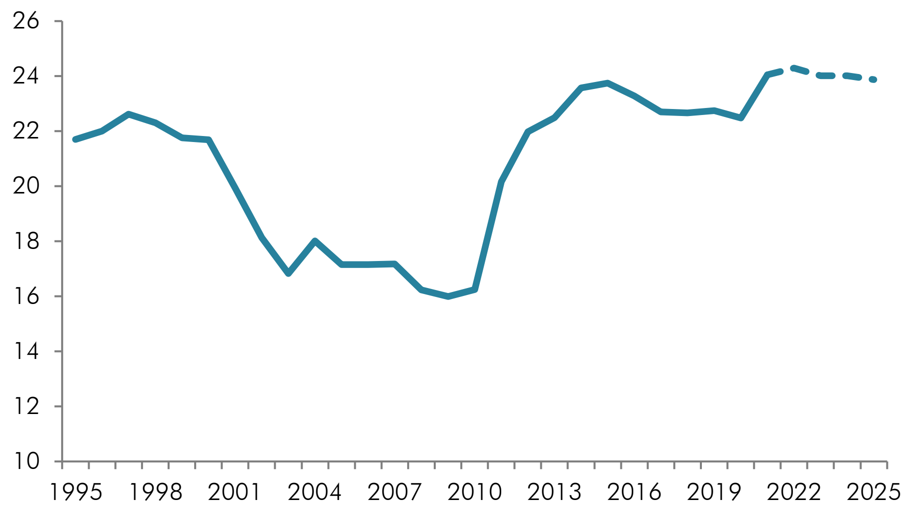
Ratio of income tax to the wage bill to remain elevated

Income tax receipts rose significantly in 2021 as a share of compensation of employees. This increase in the effective tax rate on income was largely driven by the strong performance of higher-wage sectors (Timoney, 2022a). Provided the high-wage sectors continue to perform well, this upward shift in the effective tax rate could be permanent (Figure 2.9).

High inflation may also result in the effective tax rate rising, as assumed policy measures are less than what would be required to fully index income tax bands and credits in 2024 and 2025. Offsetting this, some negative judgement is applied by the Department for *Budget 2023* forecasts of income tax. This is done to keep the effective tax rate relatively flat over the forecast horizon.

Figure 2.9: Ratio of income tax to wage bill to remain elevated

Exchequer income tax as a percentage of compensation of employees



Sources: CSO, and *Budget 2023* projections. Get the data.
Note: Dashed line indicates *Budget 2023* forecasts.

Excise receipts are forecast to grow strongly. This is aided by increases in the rate of carbon tax assumed throughout the forecast horizon. This contributes an additional €155 million in revenue each year on average over 2023–2025, amounting to close to €500 million in total.

For corporation tax, negative judgement of €850 million is applied in 2023, as some of the 2022 receipts are not expected to carry into the base for 2023. In addition, a further €2 billion of negative judgement is applied to corporation tax forecasts for 2024 reflecting the Department's assumed impact of the OECD's base erosion and profit shifting (BEPS) reforms.

This estimate of the impact of the BEPS reforms has remained unchanged since January 2020. In the meantime, corporation tax receipts have grown substantially. As a result, the €2 billion impact is a much smaller share of corporation tax receipts than was the case when it was originally estimated. €2 billion was 18.4% of 2019 receipts, but is 9.5% of the *Budget 2023* forecast of 2022 receipts.

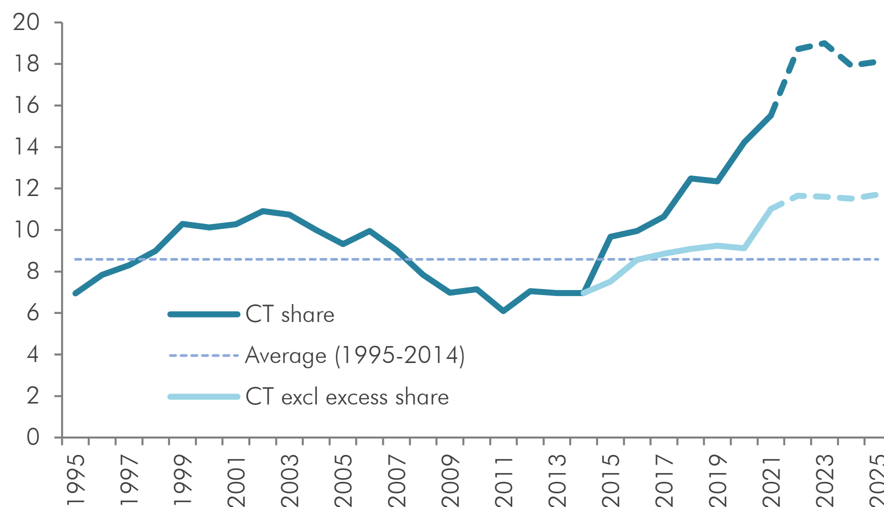
A potential upside to the current corporation tax forecasts is the increase in the corporation tax rate from 12.5% to 15% under the BEPS Pillar Two reforms.[44] The Department has not yet factored in any impact of this reform into its forecasts for corporation tax revenue. Overall, there is uncertainty about the impact of BEPS reforms on Irish tax revenues, depending in part on how firms choose to adapt their behaviour, and also on the exact path the reforms take.

[44] Based on figures from the Revenue Commissioners, 61 corporate groups in Ireland in 2018 had worldwide revenue greater than €750 million, which is the qualifying threshold to be liable for this 15% rate (Revenue, 2022).

Another potentially large upside to short-term corporation tax receipts arises from the exhaustion of large capital allowances by key multinational corporations. Some large multinationals are expected to exhaust their currently available capital allowances in the coming years, and, provided that their company structures and profits do not change significantly when the allowances are exhausted, this could lead to large corporation tax increases as early as next year. However, were corporate structures to change substantially and intellectual property relocated elsewhere, the risks could be in the opposite direction.[45] In addition, any reduced profitability of multinational corporations, particularly in the tech and pharmaceutical sectors, poses downside risks to corporation tax receipts.

Figure 2.10: Corporation tax to reach a record high share of revenue

Exchequer corporation tax as % of general government revenue



Sources: CSO; *Budget 2023* projections, and Fiscal Council workings. Get the data.
Note: Light blue line denotes the share of corporation tax excluding excess receipts in general government revenue (also excluding excess corporation tax receipts). Dashed line indicates *Budget 2023* forecasts. Fiscal Council calculations for estimates of excess corporation tax for 2015–2020. Department of Finance estimates published in *Budget 2023* are used for 2021–2025. CT = corporation tax.

Figure 2.10 shows that the State is forecast to remain heavily reliant on corporation tax receipts, which are forecast to peak as a share of general government revenue in 2023, before falling slightly thereafter. If excess corporation tax receipts are excluded, the share is modestly above its long-term average.

2.6 Capital spending has fallen short of plans in recent years

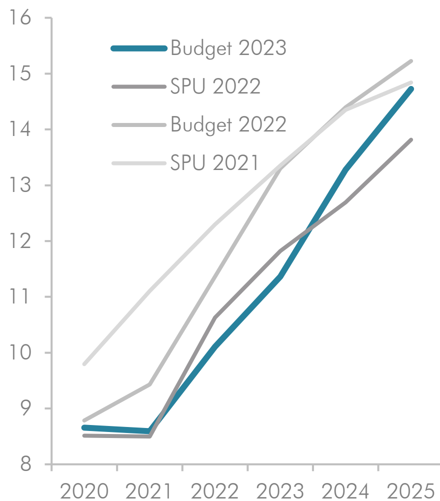
Conroy *et al.* (2021) highlighted that there may be challenges in ramping up public capital spending as quickly as is projected in the current National Development Plan (NDP), published in October 2021. While some pandemic restrictions may be responsible for spending shortfalls since 2020, more general

[45] While capital allowances are used to offset a firm's tax liability, the amount that can be claimed in each year is limited, meaning there may be a residual tax liability associated with the asset. It is this residual tax liability that could be at risk.

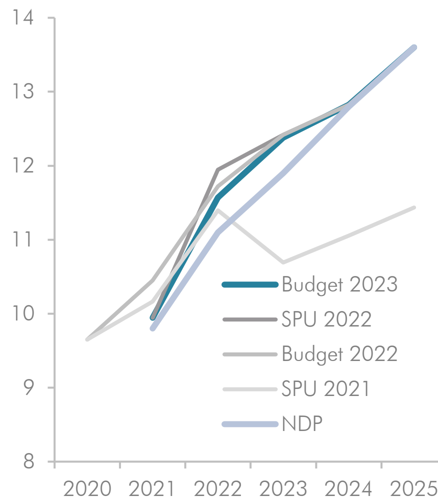
issues around capacity constraints, particularly in the construction sector, may be playing a key role.[46]

Figure 2.11: Capital spending to make up a smaller share of national income

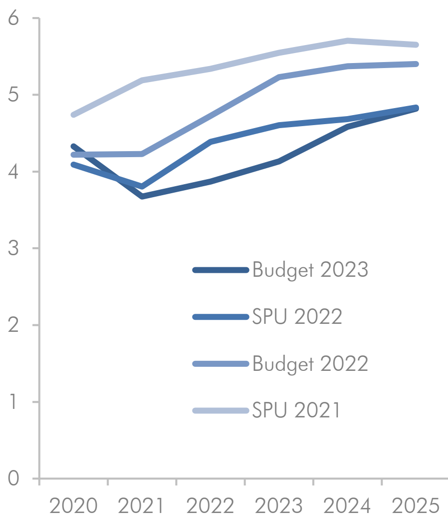
A. Capital spending revised down
€ billion, general government investment



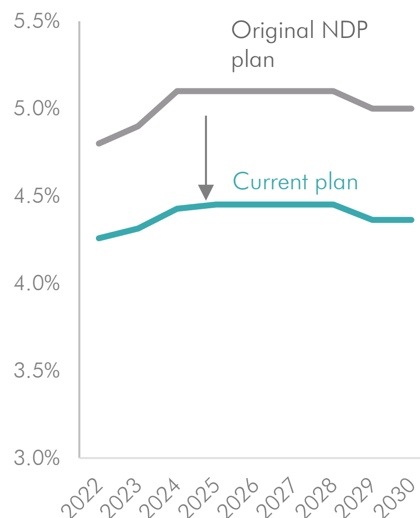
B. Gross voted capital
€ billion



C. Also revised down as share of economy
% GNI*, general government GFCF



D. NDP plans would now represent a lower share of national income
% GNI*, Exchequer capital



Sources: CSO; Department of Finance, and Fiscal Council workings.
Notes: GFCF is gross fixed capital formation. Growth rates assumed for GNI* over 2026–2030 in panel D are the same as those assumed in the NDP. Get the data.

In nominal terms, *Budget 2022* set out the largest capital spending plans in the history of the State. *Budget 2023* sees a similar level of investment in gross voted

[46] However, Section 1.3 notes that recent estimates of inward migration are likely to be revised up when *Census 2022* is fully incorporated.

terms but is lower in general government terms (Figure 2.11).[47] Given that the price level is now expected to be much higher than was the case in previous plans, *Budget 2023* forecasts imply a lower level of real output.

This scaling-back of real capital spending can be seen when examining spending as a share of nominal income. *Budget 2023* forecasts imply a lower share of national income than was the case in previous forecast rounds (Figure 2.11C). In terms of Exchequer spending, an average of €2.1 billion extra capital spending per year would be required to return to the original share of capital spending in the economy consistent with what was outlined in the National Development Plan (NDP) (Figure 2.11D).[48]

While these downward revisions as a share of national income are significant, the plans still represent an ambitious level of capital spending. With capital spending projected to reach almost 5% of GNI* in 2025, this would put Ireland well above EU norms. As outlined in Conroy et al. (2021), in OECD countries, public investment has tended to range between 3% and 4% of national income.

More generally, we can see that, with various plans being published, there has been significant volatility in forecasts of capital spending. From Figure 2.11A, revisions have been focused in non-Exchequer areas that are included in general government.

2.7 Debt burden projected to fall significantly

The gross debt-to-GNI* ratio peaked at 108.9% of GNI* at the end of 2020 (Figure 2.12); for 2022, it is expected to fall by 14.5 percentage points due to high nominal growth, and a small headline general government surplus. By 2025, the gross debt ratio is expected to be below 75% of GNI*.

The net debt ratio has also been revised down over the course of recent forecasts (Figure 2.13). A year ago, *Budget 2022* forecast a net debt ratio of 79.2% by 2025. This was revised down to 68.5% in the *SPU 2022* forecast. This has now been further revised down to 57.8% in *Budget 2023*. As discussed in Section 3, much of this downward revision is due to strong real GNI* growth in 2021 and 2022 as well as higher inflation, but an improvement in the general government balance has also contributed (see Figure 3.4E).

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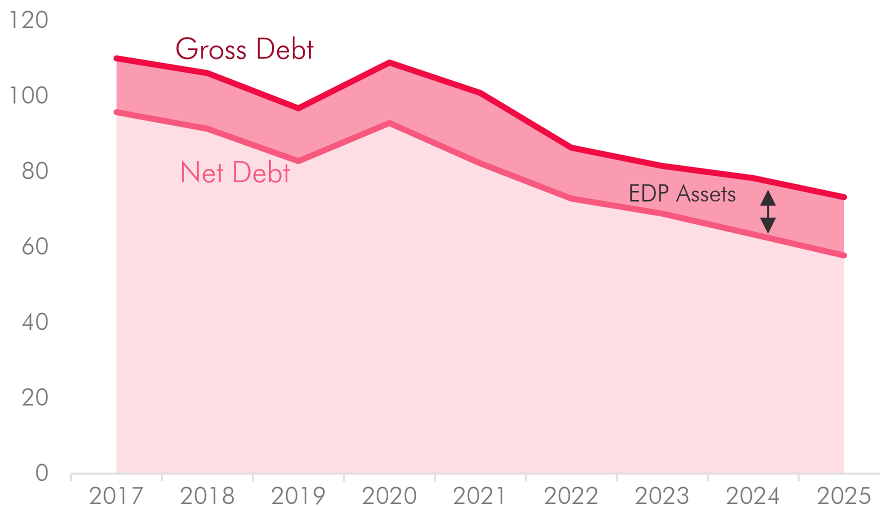
[47] Given the downward revisions in general government terms (Figure 2.11A) are not apparent in gross voted terms (Figure 2.11B), this suggests that investment in non-Exchequer areas has been revised down.
[48] The same level of output could be delivered as was outlined in the NDP, but that would require plans being extended beyond the timeframe of the NDP.

Figure 2.12: Plans imply a steady downward trajectory for the debt ratio

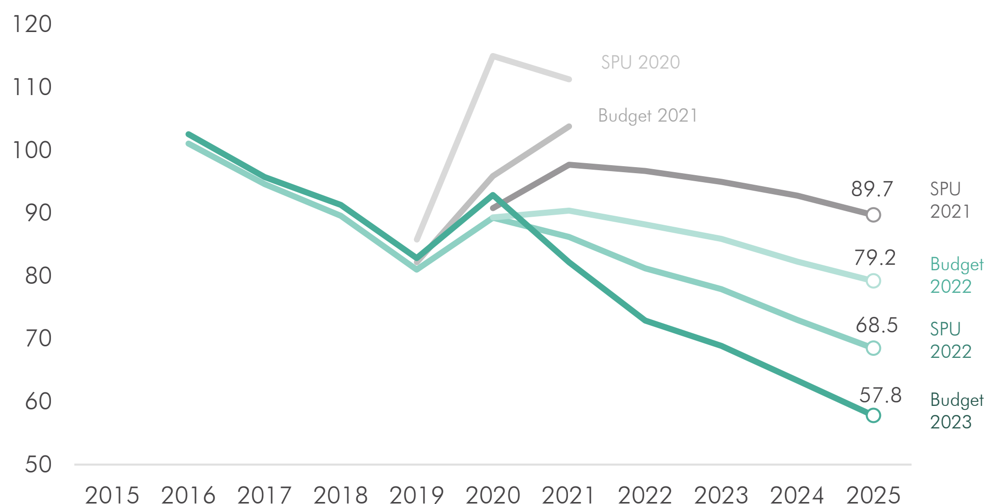
% GNI*, general government



Sources: CSO; Department of Finance, and Fiscal Council workings.
Notes: EDP (excessive deficit procedure) assets refers to EDP debt instrument assets, held in Currency and Deposits (F2), Debt securities (F3) and Loans (F4). Get the data.

Figure 2.13: Net debt has been revised down

% GNI*, general government



Sources: CSO; Department of Finance. Get the data.

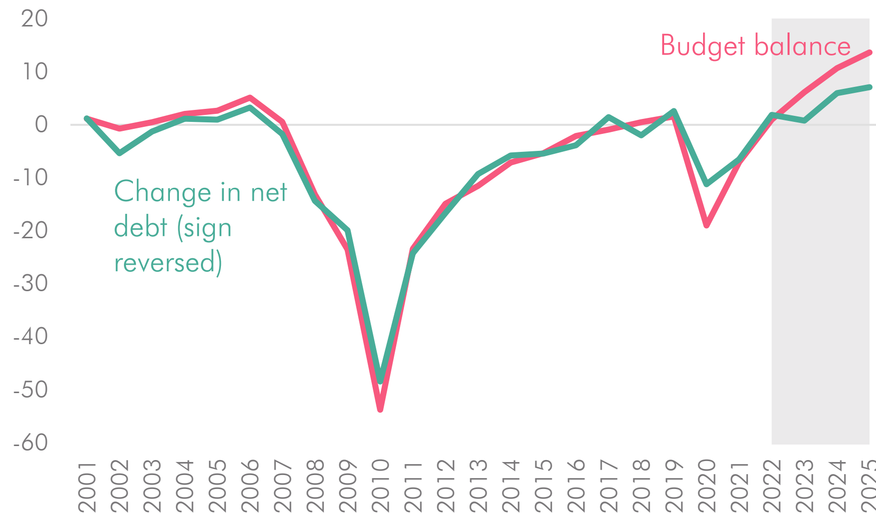
A good approximation for the change in net debt is the size of the government surplus/deficit (Figure 2.14). In the past, the change in net debt tracked the budget balance closely with the difference made up of equity and other investments, statistical discrepancies, and adjustments and revaluations. The net debt forecasts produced by the Department are based on a "mechanical extrapolation of financial assets".

However, the *Budget 2023* forecast for the net debt would suggest a sustained divergence between the budget balance and the change in net debt (Figure 2.14). While this is possible due to changes in the other components mentioned above, it is likely that the change in the net debt will track closer to the budget balance. Were the change in the net debt equal to the budget surplus out to

2025, the net debt ratio could be 52.6% in 2025, 5.2 percentage points lower than currently forecast by the Department.

Figure 2.14: Larger surplus suggests net debt may fall more rapidly

€ billions, general government



Sources: CSO; Department of Finance, and Fiscal Council workings.
Notes: Forecasts shown in the grey shaded region. Get the data.

Ireland's interest costs have been falling for years (Figure 2.15). In 2014, cash payments for interest were €7.5 billion. By 2021, interest payments were almost €4 billion lower at €3.6 billion. Over 2015–2021 the cumulative saving in interest payments, relative to an annual payment of €7.5 billion, is €13.5 billion.

The forecasts for interest payments for 2023–2025 have been revised up slightly since *SPU 2022*, but are expected to remain largely flat after 2022, despite rising interest rates (Figure 2.15). This is due to a combination of:

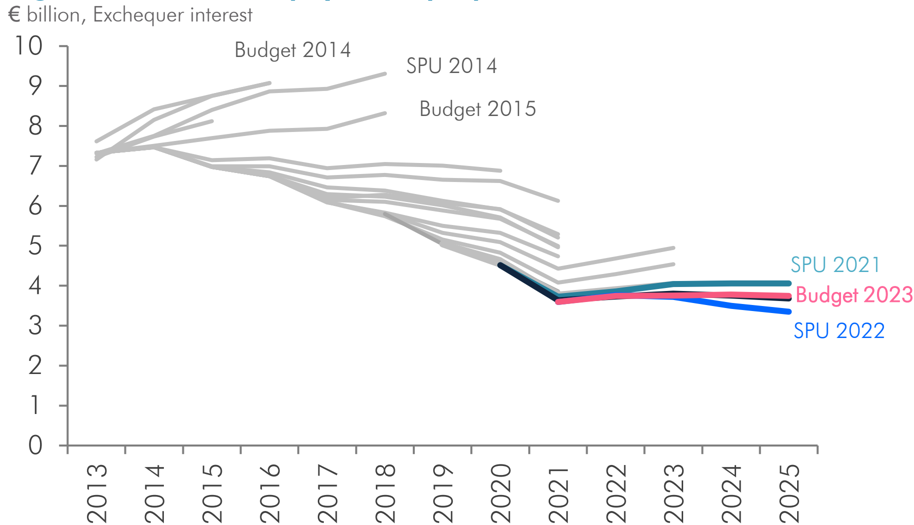
1) government surpluses and large cash balances (€26.7 billion at end of October) being used to pay for part of the maturing debt; and

2) the maturing debt having high coupon rates which can be replaced by debt with lower yields.

For instance, €26.5 billion of fixed-rate bonds are due to mature between 2023 and 2025. The lowest coupon rate on these bonds is 3.4%. Despite the rising interest rates, these bonds could still be replaced with debt yielding lower interest rates, if the benchmark 10-year yield on Irish government bonds is still below 3.4% (current bond yield at time of writing is 2.5%). This can result in lower interest costs despite the rising interest rates.

Figure 2.15: Interest payments projected flat after 2022

€ billion, Exchequer interest



Sources: Department of Finance. Get the data.

2.8 Fiscal risks

As outlined in Section 1, both a Covid-19 resurgence and the ongoing fallout from the war in Ukraine pose immediate risks to the macroeconomy and to the public finances. The potential for lower growth and higher prices could put significant pressure on the public finances. While higher prices may lead to more tax revenue, particularly VAT, higher prices could also put upward pressure on spending. A slowing of the economy could weaken revenues, particularly if associated with revenue-rich activities. A further large inflow of Ukrainian refugees this winter and constraints in the capacity to accommodate them could add to spending pressures.

There are obvious upside risks to the revenue forecasts. These include one-off revenue windfalls; for instance, from fines issued by the Data Protection Commission, or, less predictably, from the Apple tax case.[49]

As noted in Section 2.5, several factors could influence corporation tax receipts in the coming years. These include the implementation of the OECD BEPS initiatives, the exhaustion of large capital allowances by key multinational corporations and the level of profitability in a small number of firms.

On the expenditure side, 2022 saw one-off expenditure incurred in relation to a redress scheme for defective concrete blocks. Similar once-off expenditure may arise in the coming years; for instance, from the remedial costs of fixing defects in

[49] In 2016, the European Commission ruled that Ireland had illegally provided state aid of up to €13 billion plus interest to Apple. Its ruling was annulled by the General Court in July 2020. The European Commission has since appealed to the European Court of Justice. This process could be lengthy. In the meantime, the €13 billion plus interest will remain in an escrow fund. More recently the data Protection Commission issued a €405 million fine against Meta, which is subject to ongoing appeal.

apartments and duplexes built between 1991 and 2013, or from other redress schemes.

There are several medium-term risks to the public finances. The general price level is expected to remain permanently higher which may result in temporary cost-of-living measures, such as tax cuts on energy products or other expenditure supports becoming permanent.

Temporary spending on Covid-19 could become permanent, particularly in the area of health spending. Already, temporary Covid-19 spending in health has been used to tackle longer-term issues like waiting lists.[50] Several guarantee schemes and measures introduced during the pandemic could yet put pressure on the public finances. For example, write-offs for the tax warehousing scheme could be higher than assumed.

The cost of government contributions to the new auto-enrolment pension scheme has yet to be factored into fiscal forecasts, despite the scheme being due to come into operation in 2024. Although it has been paid to some extent in every year since 2014, payment of the Christmas bonus has not been budgeted for in 2023 and beyond.

Long-term risks to the public finances remain unaddressed. The population is ageing, which will result in increased spending pressures on health and pensions. The Government has signalled that the state pension age will remain at 66, but has not yet set out a clear plan on how higher public spending on pensions will be funded. This higher spending will have to be met by increased tax revenue or lower spending elsewhere.[51]

On climate spending, detail on the economic and budgetary impact remains lacking. Several of the recently introduced temporary measures could conflict with medium-term goals in transitioning from fossil fuels. These temporary measures could increase the long-term costs of transitioning to a lower-carbon economy.

While the infrastructure investments necessary to mitigate climate change appear to have been included in the NDP (particularly energy investments), other spending needs have not been addressed. These include current spending for incentives that encourage changes in consumer behaviour and home energy efficiency. There is also little detail on the extent to which behavioural changes from the public are required to meet emissions targets. Should this fall short of government expectations, further costs may be incurred. In addition,

[50] The *Expenditure Report 2023* indicates that some €225 million of Covid-19 spending in 2023 will be used to tackle waiting lists.

[51] See Casey (2022) for the potential revenue raising effect of measures proposed by the Commission on Tax and Welfare.

compensation may be needed for people and activities that are hit by the climate transition.

Regarding healthcare, the fiscal implications of Sláintecare remain unclear. Casey and Carroll (2021) outline several areas where information on health spending and planning is lacking. There is no more additional information on the remaining costs of implementing this reform.

Fiscal Stance

Managing the energy crisis and preparing for the future

3. FISCAL STANCE

Managing the energy crisis and preparing for the future

Growth in the Irish economy and in its major trading partners is being undermined by sharp increases in the cost of living amid the war in Ukraine and ongoing impacts of the pandemic. However, Ireland is expected to continue to benefit over time from its exposure to sectors that have fared better than others during downturns, including the digital and pharmaceutical sectors. Unemployment, though expected to rise slightly in the coming months, is projected to remain low by historical standards.

Growth is being undermined by the cost of living, the war, and the ongoing impacts of the pandemic

The Government struck a balance with *Budget 2023*, supporting those impacted by rising prices while avoiding boosting price pressures excessively. It sensibly allowed for a slightly faster-than-planned increase in permanent spending for 2023, given the substantial pressures from rising prices. The temporary deviation from the 5% Spending Rule is limited, especially relative to the increase in inflationary pressures, with core spending rising by 6.8% instead for 2023. The Government plans imply core spending increases reverting to 5% in later years in line with the rule.

The Government struck a balance with *Budget 2023*

Budget 2023 was supplemented with a large package of temporary support measures. These measures help limit the impact of the sudden rise in the cost of living on businesses and households. While there is still scope for these measures to be better targeted, the impacts on inflation are limited by virtue of their being temporary in nature. This approach is welcome.

The 5% Spending Rule, introduced last year, appears to be guiding policy in an effective way. The rule's anchoring effect will be essential for the years to come. It ensures a more sustainable path for core spending, sets the debt ratio on a steady downward path from current high levels, and provides some certainty to various arms of government about future overall budgetary resources. This should help with planning, which is vital when major, interconnected challenges are looming.

While there are many positives to take from *Budget 2023*, the Government now needs to start planning further ahead. It should extend its forecast horizon and lean more heavily on the national Spending Rule as a means to develop realistic and fully-costed plans further into the future. These plans should reflect the full costs associated with an ageing population, achieving the State's climate targets, other major policy objectives, and the risk of excess corporation tax receipts unwinding.

However, the Government now needs to start planning further ahead

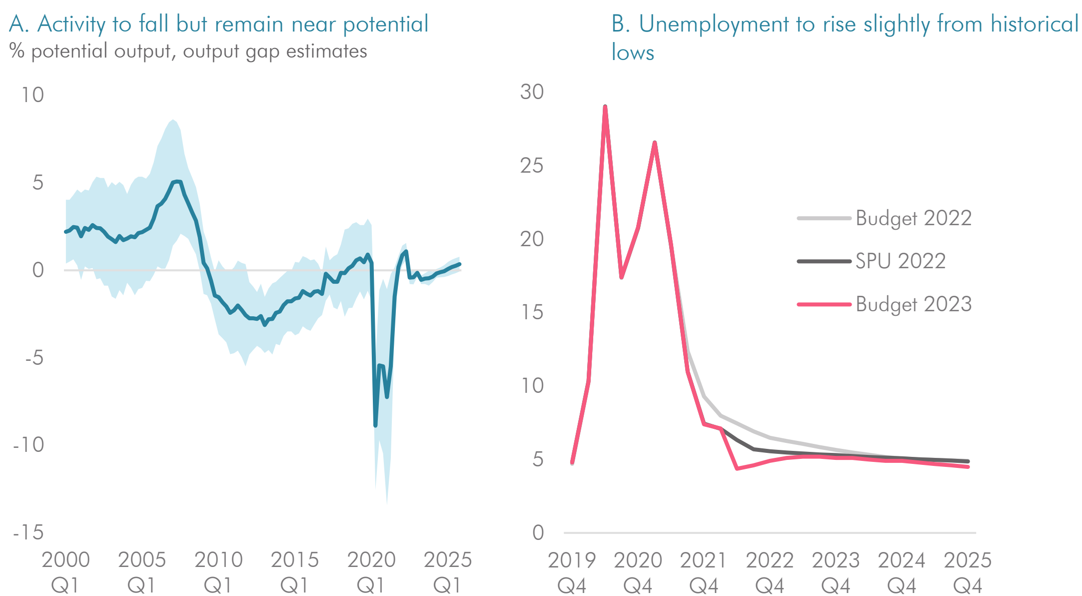
In this section, the Council assesses the prudence of the Government's overall fiscal stance. Its assessment is informed by (1) a broad economic assessment that

considers how to appropriately manage the economic cycle as well as the sustainability of the public finances, and (2) an assessment of compliance with the legislated domestic and EU fiscal rules.

3.1 Assessment of the cyclical position

High inflation and rising interest rates are expected to depress growth in the domestic economy and internationally. However, the Irish economy is still likely to be supported by the relative strength of digital and pharmaceutical activities. Domestic spending could also be supported by exceptional levels of savings built up during the pandemic and by increases in wages.

Figure 3.1: The economy is slowing but from a position of strength



Sources: Fiscal Council workings (based on *Budget 2023* forecasts). Get the data.
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's supply-side models (Casey, 2019) and the Department's forecasts. Given distortions to standard measures like GDP and GNP and the relative importance of domestic activity to the public finances, the measures focus on domestic economic activity, including quarterly Domestic GVA.

A contraction in activity is projected for this winter

The Government's official projections in *Budget 2023* imply a contraction in activity towards the end of this year. Overall activity in the economy is set to weaken briefly relative to its potential, before recovering over the course of 2023 (Figure 3.1A). Unemployment rates are projected to rise by about one percentage point before recovering from next summer onwards (Figure 3.1B).

This comes at a time when Ireland's economy has been performing relatively strongly up to now

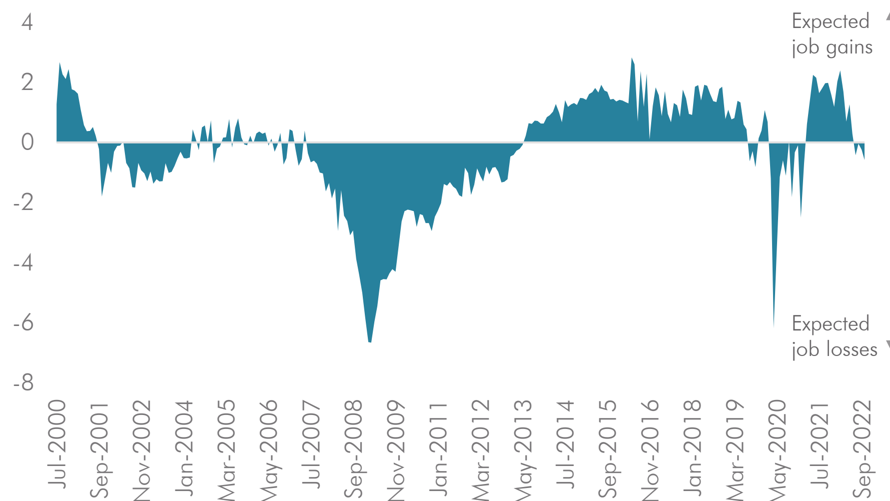
The projected contraction in activity arrives at a time when Ireland's economy has been performing very strongly. Overall activity is estimated to have been operating slightly above its potential in Q2 2022. This implies labour shortages or slight overheating in the economy. Similarly, unemployment rates fell to record lows, with readings averaging just 4.2% over the summer — their lowest in over two decades.

Risky imbalances in the economy also appear to be offsetting at present. Moderate lending, lower levels of indebtedness, high savings, and the large current account surplus point to fewer pressures on the domestic economy and resources. However, high energy costs and labour shortages could yet feed into other price pressures, spelling risks to growth. The exceptional flows of refugees could add to these pressures.

As a small open economy, Ireland is unlikely to withstand international pressures for long. Downgrades to forecasts among Ireland's trading partners will weaken export demand, while the same pressures, in terms of rising prices, are moderating demand at home as well. Job hiring expectations and individuals' expectations about their own employment prospects have proven to be a useful bellwether for recessions in the past. These expectations have softened materially from late summer into autumn (Figure 3.2).

Figure 3.2: Irish job expectations have softened

Composite survey-based jobs indicator, + balance suggests job gains, – suggests job losses



Sources: DG ECFIN; Eurostat; and Fiscal Council workings. Get the data.
Notes: The jobs indicator is a composite measure of surveyed expectations for employment in Ireland in the coming months across various sectors, including consumers expectations related to their own employment. A positive value suggests that, on balance, an increase in employment is expected as compared to a decrease in employment when negative.

A broadly neutral fiscal stance is appropriate for now

Current economic conditions therefore suggest that a broadly neutral fiscal stance was appropriate for *Budget 2023*. That is, the Council assessed that a large-scale stimulus over the years to come would not be appropriate.

But things could change, and the Government should stand ready to act

This assessment could change, and the Government should stand ready to act. While there is a tight labour market at present and a reasonably positive growth outlook, there are clearly large risks looming. The risks around the path for the economy are unusually wide and the prospects for growth are highly uncertain. Further impacts from Russia's war in Ukraine, Covid-19 and international price pressures pose major risks. Yet it is also possible that shortages of workers and ongoing pressures to expand in areas such as housing and public investment

could add fuel to pressures in the economy if growth continues. The Government should stand ready to act if domestic economic activity slows markedly or if other risks materialise.

3.2 Assessment of sustainability of the public finances

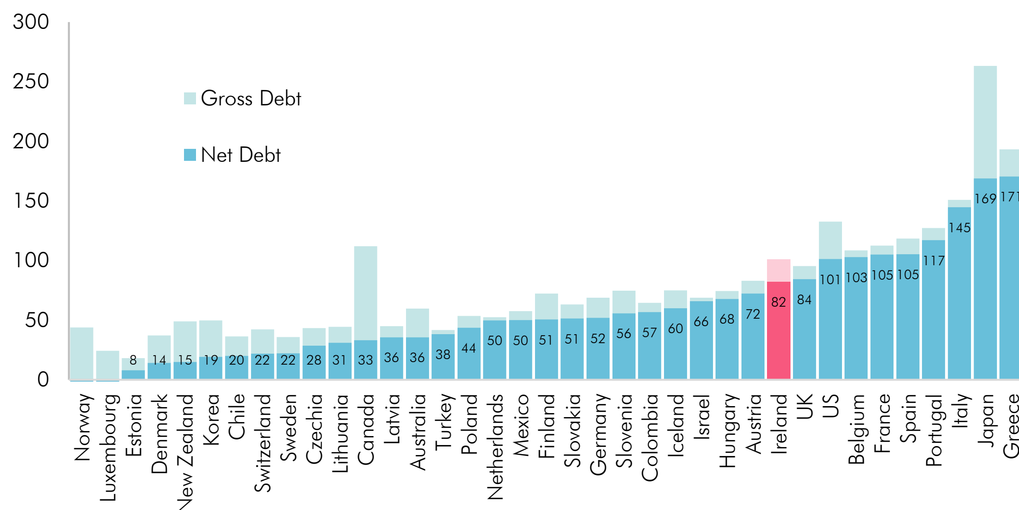
As well as assessing the economic cycle and the possibility of major imbalances, the Council assesses fiscal sustainability as part of its broad economic assessment.

Ireland's debt ratio remains high, especially compared to other small open economies

Ireland's debt ratio remains high by international standards. At the end of 2021, the Government's net debt ratio was 82% of GNI*. This put it as the tenth highest in the OECD (Figure 3.3). Only three other small open economies in the OECD have larger debt burdens: Greece, Portugal and Belgium. A higher starting debt ratio tends to amplify the sustainability risks that can arise from recessions, slower growth or increases in borrowing costs (Barnes, Casey, and Jordan-Doak, 2021).

Figure 3.3: Ireland has a high debt ratio

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



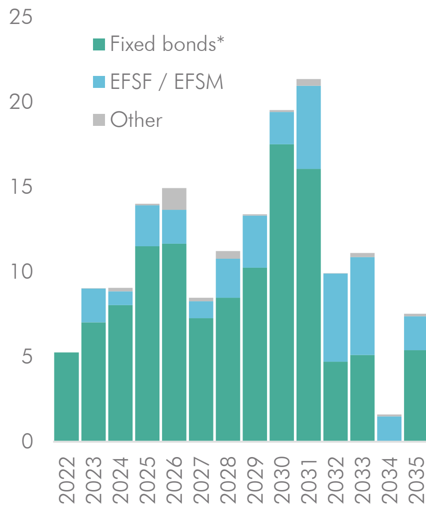
Sources: Eurostat; CSO; IMF (April 2022 Fiscal Monitor); and Fiscal Council workings. Get the data.
Notes: All OECD countries are shown aside from Costa Rica. Net debt is general government gross debt excluding assets held by the state in the form of currency and deposits; debt securities; and loans. The 60% ceiling for government debt set out in the Stability and Growth Pact is set in gross rather than net terms. Net debt does not include the State's bank investments.

But the immediate risks to debt sustainability are relatively low

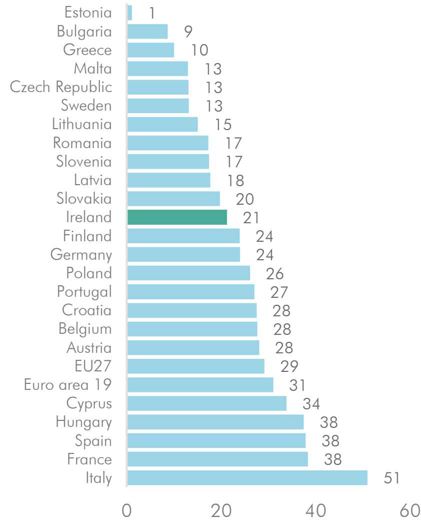
The immediate risks to Ireland's debt sustainability are relatively low. Almost 98% of debt outstanding is at fixed interest rates. The State's debt obligations are also relatively long-dated at 10.5 years weighted average maturity (by ECB calculations), with a smooth maturity profile (Figure 3.4A) and a relatively small amount of debt maturing over the next five years (Figure 3.4B).

Figure 3.4: Ireland's funding situation is in good shape

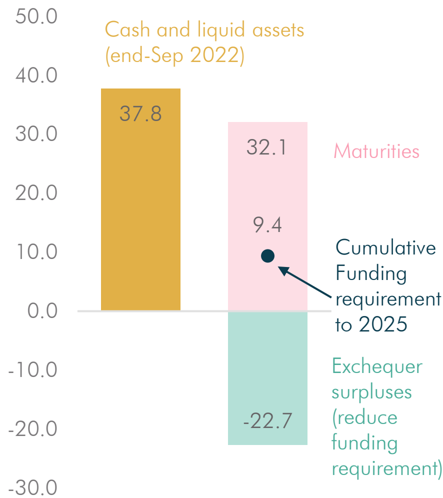
A. Maturities are well balanced
€ billions of maturing debt securities



B. Near-term refinancing risks low compared to others
% GDP (GNI* for Ireland), gov. debt maturing in next 1-5 years

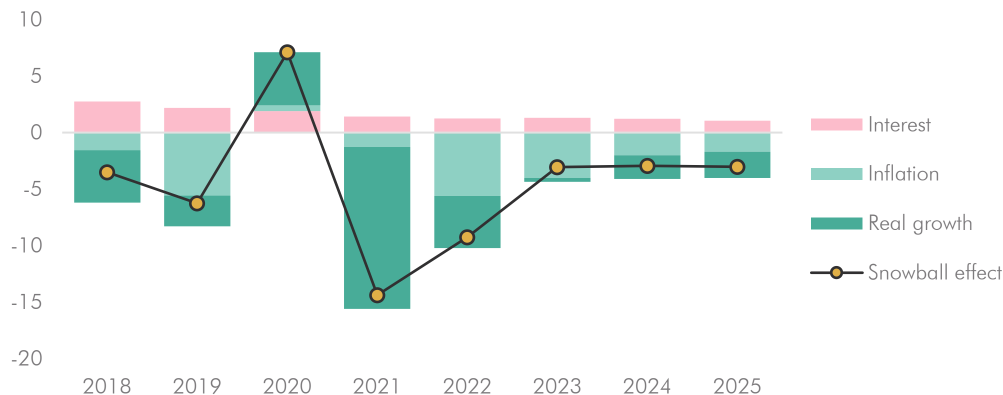


C. Cash balances large relative to needs
€ billions



D. Bond yields still low despite recent increases
% 10-year bond yields, weekly data

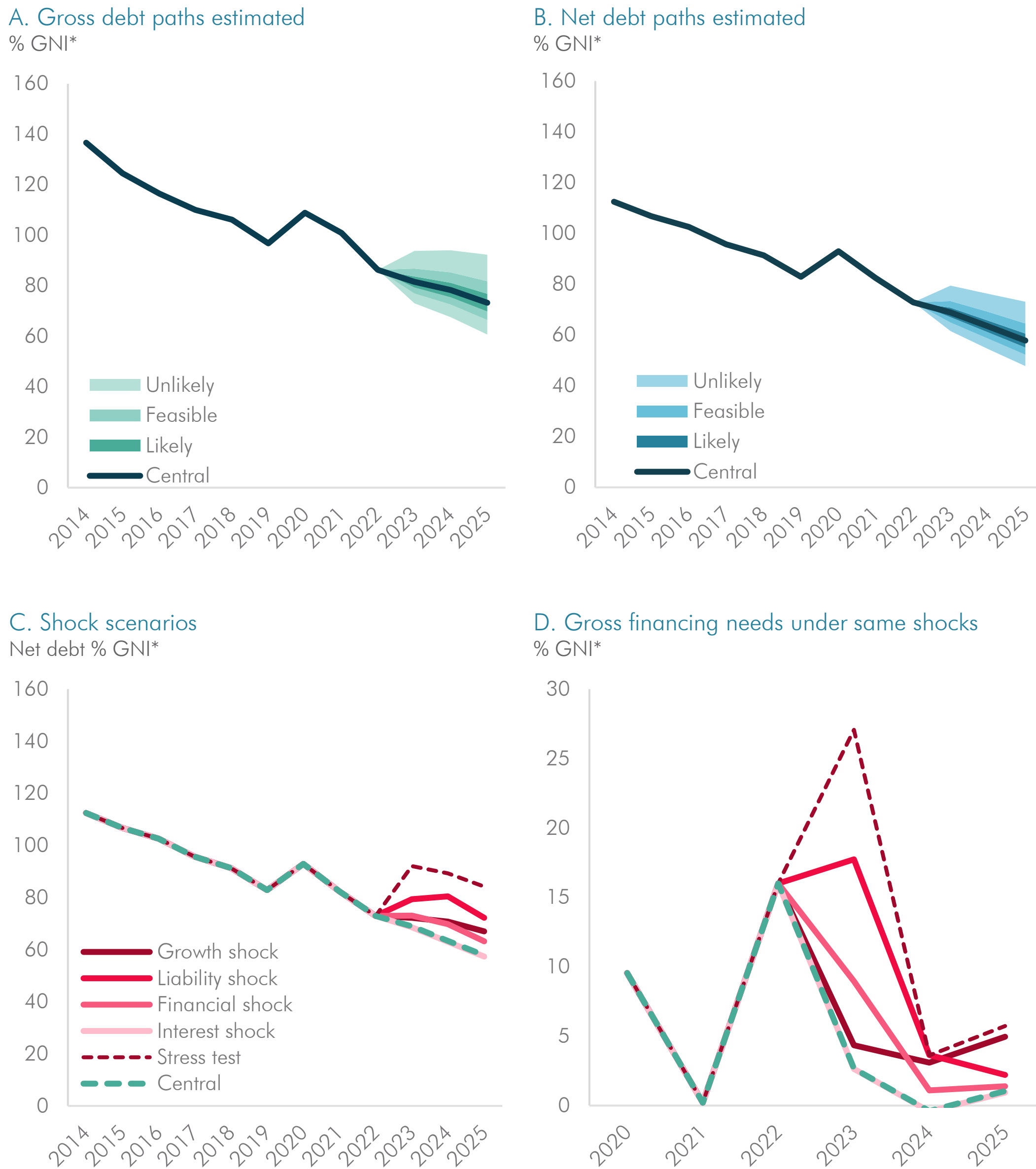
E. Nominal growth is helping reduce debt ratio
Annual change in debt ratio as % GNI* due to "snowball effect" (the differences between growth and interest)



Sources: CSO; NTMA; ECB; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Spread in panel D refers to the difference between Irish 10-year yields and German 10-year yields.
The snowball effect is the debt ratio change due to nominal growth less the effective interest rate.

The State had accumulated sizeable cash balances (€26.7 billion or 10% GNI*) by end-October. This would cover more than four-fifths of the maturing debt out to end-2025 even if no Exchequer surpluses were run (Figure 3.4C). As it stands, the Exchequer surpluses projected average about €7½ billion between 2023 and 2025. This means that the total cumulative funding requirement to cover both debt maturities and the Exchequer's borrowing requirements over these years is €9.4 billion — just a third of the cash and liquid assets currently held.

Figure 3.5: Debt sustainability analysis



Sources: Department of Finance; CSO; NTMA data on debt securities; and Fiscal Council workings.
Notes: The fan chart projections show the probability of different debt paths. The "likely" range covers the 30% confidence interval, "Feasible" covers the rest of the 60% interval, and "Unlikely" the rest of the 90% interval. The "Growth shock" assumes real GNI* growth rates 3.6pp (one standard deviation, 1996-2019 excl. financial crisis) weaker than the Central scenario for 2 years (leaving output about 7% below the central scenario). The "Liability" and "Financial" shocks, respectively, assume that 15% and 10% GNI* contingent liabilities materialise, based on an historical assessment of fiscal risks internationally. The "Interest shock" assumes that marginal interest rates rise by 2pp for the full period. The "Stress test" combines all previous shocks. Get the data.

One way to assess debt sustainability is through "stochastic debt sustainability analysis". This is a way of modelling multiple debt paths with different probabilities attached to each path. This approach is proposed in Blanchard, Leandro and Zettelmeyer (2021) as an alternative to conventional fiscal rules that assume specific debt limits are sustainable.

Using the Council's macro-fiscal model (the Maq), we can assess the probability of the Government's net debt ratio rising over the forecast period (Figure 3.5A and 3.5B). It is important to note that this analysis, as with other such work, is severely constrained by the Government not having proper medium-term forecasts beyond the current three-year window to 2025. A return to five-year-ahead forecasting, as previously committed to by the Government, would allow the Council to give a proper assessment of medium-term debt sustainability.

The State looks set to be on a much more sustainable debt trajectory than previously estimated. This is thanks to the Government broadly sticking to its 5% Spending Rule, while the stronger economic recovery, higher corporation tax receipts, and a less-than-expected need for fiscal contingencies have materialised through the pandemic. The probability of an "unsustainable" debt path — defined here as a net debt ratio remaining at or climbing above its current level by the end of the forecast horizon — is estimated to be between 5% and 10%. This would almost pass the indicative fiscal standards set out by Blanchard, Leandro and Zettelmeyer (2021), which proposed a 5% threshold as a useful fiscal standard. However, such a standard does not necessarily imply that debt is "sustainable" in practice. What it implies is that some form of adjustment to the Government's fiscal plans is unlikely to be needed to achieve a high probability of debt sustainability.

The results are nonetheless encouraging. They suggest that a tighter-than-planned fiscal policy would not be needed in the near future to ensure a prudent path for the debt ratio.

Fiscal policy would not have to tighten in the near future to ensure a prudent debt path

The Government's fiscal plans would also appear to be relatively robust to a conservative "stress test". The stress test assesses how the public finances would respond to a large shock occurring across several dimensions simultaneously. This includes weaker growth, higher interest rates, and the realisation of other large fiscal risks such as state-supported bailouts of the corporate sector.[52] As Figure 3.5C shows, a stress test could cause the net debt ratio to rise to about 92% of GNI* before returning to a steady downward path. Gross financing needs

[52] The stress test is described in Casey and Purdue (2021). To inform its design, it draws on a comprehensive IMF survey of fiscal risks covering 80 countries over a period of two and a half decades as well as Irish-specific information on past recessions.

would temporarily skyrocket under a stress scenario, but this could be mitigated by use of the State's cash balances.

This analysis, though useful, covers only part of what the Council assesses. An appropriate fiscal stance should take into account the wider context. This includes whether there is a need to return the economy to full employment, whether the tax forecasts on which the forecasts are based are sound, or whether spending pressures are adequately factored into current plans. The projection period is also shorter than would be desirable for an appropriate assessment of medium-term fiscal sustainability. More generally, these types of analyses may not deal well with low-probability but high-impact risks, such as the pandemic.

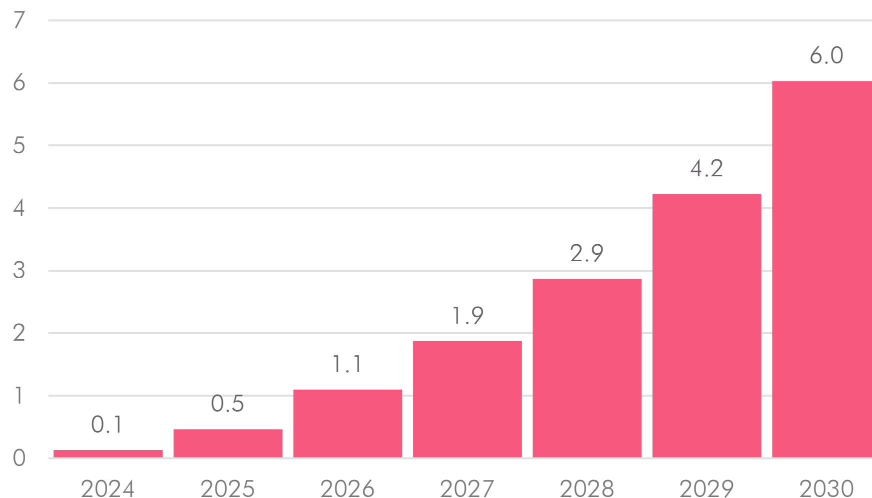
One area that the analysis would tend to suggest is of less concern is higher marginal interest rates on government debt. This can be seen from Figure 3.4C where the impact on the debt ratio is negligible in the short term.

Ireland is insulated from rising interest rates in the short term. However, if we extend the *Budget 2023* forecast horizon to 2030 mechanically, we can examine the risks from rising interest rates over a longer time horizon. If interest rates were to be permanently higher by two percentage points, this would serve to push up the gross debt ratio in 2030 by approximately six percentage points of GNI* compared to the baseline (Figure 3.6).

Ireland is insulated from rising interest rates in the near term

Figure 3.6: Higher interest rates would gradually raise debt ratios

% GNI*, Gross General Government debt (impact of 2p.p. shock on marginal interest rate)



Source: Department of Finance; and Fiscal Council workings. Get the data.
Note: The extended baseline assumes that real growth reverts to 3%, with a deflator of 1.5% beyond 2026. The marginal interest rate is solved endogenously for the baseline, with the shock scenario assuming a permanent 2 percentage-point increase in the implied rate for 2023 onwards.

There is a window for Ireland to get debt down to a level where the exposure to changes in interest rates or growth is relatively manageable. This comes ahead of the likely pressures arising from an ageing population. However, it would mean that policy would have to stay on its current track.

There is a window now to get debt down in advance of future pressures

3.3 Assessment of the Government's Fiscal Stance

Drawing on its broad assessment of the economy and the sustainability of the public finances, this section sets out the Council's assessment of the Government's fiscal stance.

Fiscal stance for 2022

The Council assesses that fiscal stance was broadly appropriate in 2022. The Government's initial plan in *Budget 2022* for core spending was broadly in line with its 5% spending rule. It responded to the impact of higher inflation with temporary spending measures, although these could have been better targeted.

The fiscal stance was broadly appropriate in 2022

The Government now expects to increase core spending — excluding temporary measures — by €6.8 billion (9.1%) in 2022 (Figure 3.7A). This fast pace of increase partly reflects a catch-up on underspends in 2021 related to confinement measures that were in place at the time (Fiscal Council, 2022). It also reflects increases in social spending and public pay implemented in the final months of the year to address higher price and wage pressures. While faster than what would be implied by sticking to the 5% Spending Rule, the pace of increase is still less than would be implied if growing in line with inflation and real growth. The Government is right to avoid adding further to inflationary pressures by compensating for price increases in full. Contingency measures were used in line with original plans, albeit directed to other one-off measures rather than Covid.

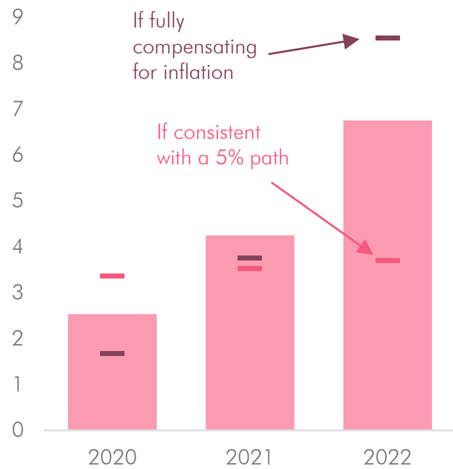
On the tax side, the Government's stance for 2022 is broadly neutral (Figure 3.7B). That is, the impact of all tax measures, not just on the income tax side, is likely to just offset what would be raised by not indexing the income tax system — as in, not raising tax credits and bands to prevent people drifting into higher effective tax rates as wages rise.

The Government used substantial contingencies and temporary measures in 2022. These helped to accommodate Ukrainian refugees, to temporarily alleviate energy and commodity price pressures facing households and businesses, and to provide for further pandemic-related supports.

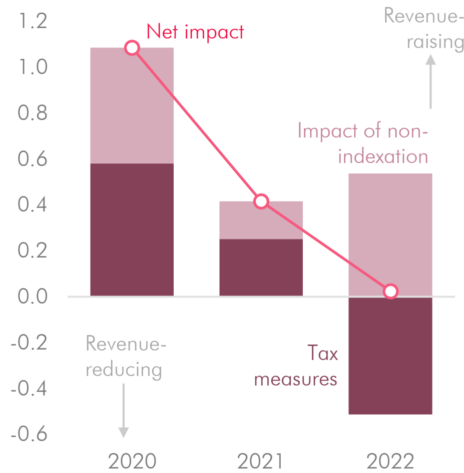
The Government's use of contingencies as a means of responding to uncertain costs has worked broadly well in recent years. However, the Department should be more transparent in terms of how these contingencies are baked into monthly spending profiles set out for the year, separating these contingencies from other spending within departments. This would allow better scrutiny of how spending is evolving month to month. The use of contingencies has partly led to overly high funding requirements being targeted by the National Treasury Management Agency (NTMA). In recent years, this additional borrowing has not been needed as these contingencies have proved unnecessary. This has contributed to a large build-up of cash balances.

Figure 3.7: A large budgetary package in 2022 but still sustainable

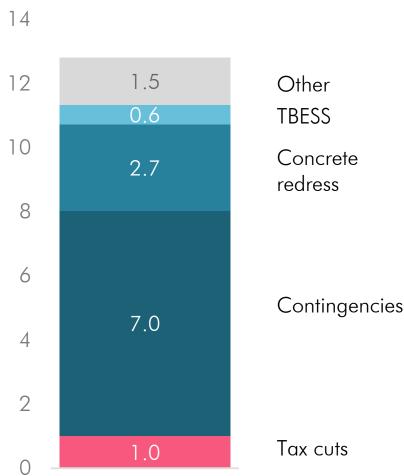
A. Core increases large but below inflation
€ billion, core spending



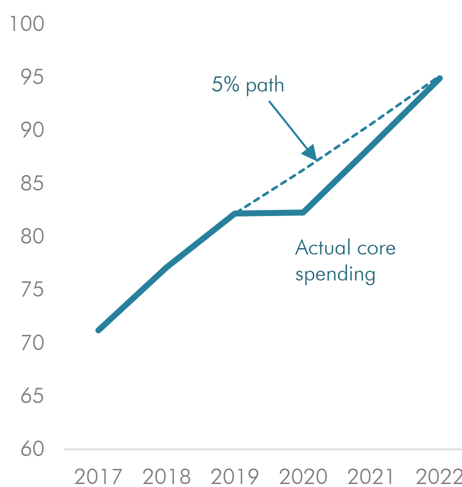
B. Tax decisions were neutral in 2022
€ billion



C. Sizeable temporary measures used
€ billion, temporary measures



D. Net policy spending path still sustainable
€ billion, net policy spending



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Core spending refers to Exchequer spending in cash terms excluding temporary measures such as those related to Covid-19, and supports for Ukrainian refugees. The impact of non-indexation is the estimated additional revenue that would be raised if the income tax system did not adjust for higher wages in the economy. "TBESS" is the Temporary Business Energy Support Scheme. Net policy spending is overall general government spending, excluding temporary factors like one-offs, and cyclical spending on unemployment benefits. As a net measure, it recognises the role of tax changes; that is, a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts.

While the pace of spending was fast, the Council assesses that the fiscal stance for 2022 was conducive to prudent economic and budgetary management. The path for net policy spending — a broad measure of the Government's spending path that also adjusts for the impact of tax measures over time — would suggest that the level of spending remained in line with what a hypothetical 5% spending path would have implied from 2019 on, even if there was some catching up to this path in 2022. The 5% spending path is significant as it aligns with the Government's own Spending Rule, but also with what more typical rates of inflation plus the economy's trend growth rate would imply. If such a path is broadly sustained over the medium term, this would tend to limit the risk that net

spending deviates substantially from the pace of increase in both the domestic economy and sustainable revenues.

Fiscal stance for 2023

The Government went into *Budget 2023* with an improved fiscal outlook, but with substantial pressures to provide further fiscal supports amid rising energy and commodity pressures. Higher tax receipts helped the budgetary outlook: notably higher corporation tax receipts, but also higher income tax and VAT receipts.

Budget 2023 entails a very big package by historical terms, although it reflects a relatively large temporary package and a more moderate permanent package.

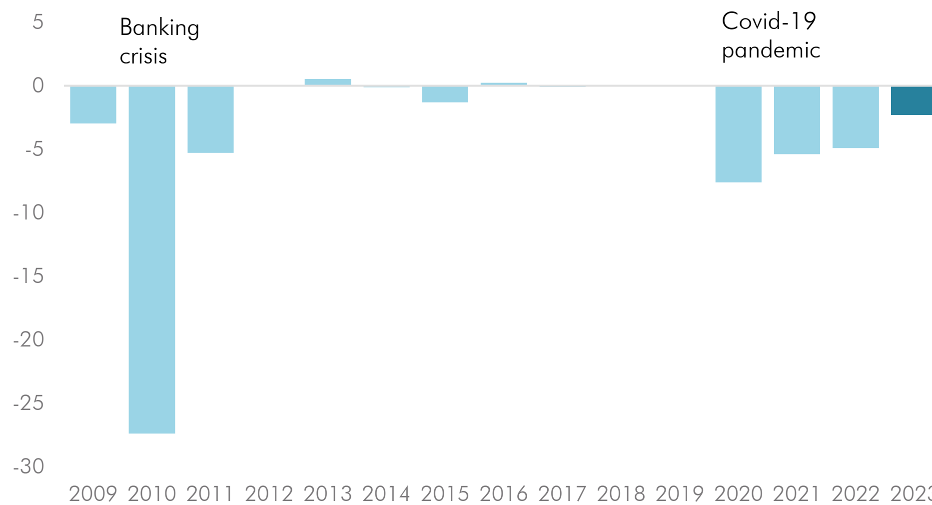
***Budget 2023* is big, but reflects large temporary measures and a more moderate permanent package**

At close to €11 billion, the budget package is exceptionally large outside of Covid times. It comprises a core package of €6.9 billion: core current spending increases of €0.7 billion in 2022, €4.3 billion in 2023, core capital increases of €0.8 billion in 2023, and €1.1 billion of permanent tax measures, primarily to update tax bands. There are also temporary measures equivalent to €3.9 billion for cost-of-living supports and supports to businesses, primarily during the winter months. Separately, there are unallocated contingencies of €2 billion for humanitarian assistance for refugees from Ukraine and €0.5 billion for Covid-related costs in 2023.

If we look at the history of temporary measures, we can see that the *Budget 2023* package entails a relatively large outlay. For 2023, this equates to 2.3% of GNI*. This is larger than temporary measures would normally be, leaving aside the banking crisis between 2009 and 2011 and the worst of the pandemic in 2020 and 2021 (Figure 3.8).

Figure 3.8: *Budget 2023* applies sizeable temporary measures

% GNI*, one-off measures



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: One-off measures refers to Council estimates of the various temporary / one-off items that impacted on the general government balance over this period.

The temporary measures are warranted

While large, the temporary measures for 2023 are warranted. First, about half of the temporary measures in 2023 are for contingencies related to Covid-19 and Ukrainian refugees. These outlays may ultimately not be needed but it is wise to prepare for them, given the uncertainties involved. Second, the cost-of-living measures will help to protect people from higher energy prices and wider inflation without substantially weakening the Government's overall fiscal sustainability, or adding unduly to inflationary pressures.

The Government still needs to substantially improve its targeting of temporary supports

The Government could still substantially improve its targeting of supports. Section 2 notes that only about one-third of the temporary cost-of-living spending supports directed at households were targeted. Large measures such as the electricity credit are still weakly targeted as are the extensions of the VAT and excise reductions on fuels, gas, and electricity. However, the degree of targeting has improved relative to measures introduced previously in 2022. The degree of targeting of temporary measures also needs to be viewed alongside permanent spending measures introduced. Increases in core social welfare rates are more heavily targeted at those most in need.

Permanent increases appear large, but are modest in the context of high inflation

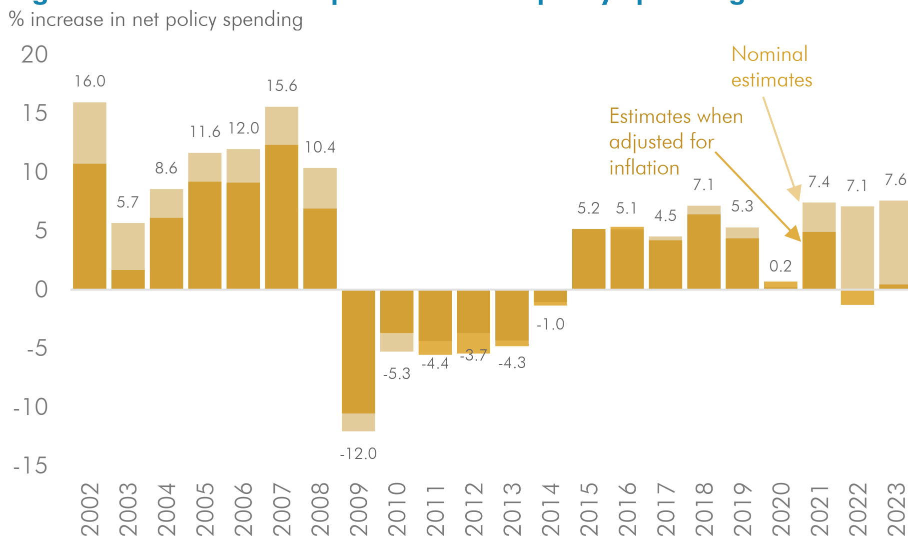
Looking at the permanent increases *Budget 2023* implies, these appear large, but are more modest when taking account of the high inflation environment.

Core spending is set to rise faster than the Government's 5% Spending Rule would imply, but much less than inflation plus the real trend growth rate of the domestic economy. Core spending is to rise from an originally planned level of spending of €80.5 billion in 2022 to €85.9 billion in 2023 as a result of *Budget*

2023.[53] This equates to a 6.8% increase, and compares to a 6.5% increase set out in the *Summer Economic Statement*: a difference of just €0.2 billion. Actual inflation plus real growth of 3% — close to the trend growth rate estimated for the domestic economy in recent years — would imply a growth rate of 10.3%.

Another way to assess the pace of increase in fiscal measures, is to take on board broader measures of government spending and the impact of tax changes. In terms of the increase in "net policy spending" — basically, general government expenditure less temporary items, interest, cyclical spending on unemployment and less net tax-raising measures — the change planned for 2023 is the largest since 2008 in nominal terms (Figure 3.9). But when adjusted for inflation the increase is far smaller. The Government is right to avoid fully tracking real growth plus inflation as this would add to inflationary pressures, and it remains uncertain how much of the recent increase in price levels will be sustained.

Figure 3.9: Increases in permanent net policy spending are more modest



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

[53] Note that this 6.8% growth rate compares the updated *Summer Economic Statement* base level for 2021 (€80.5 billion) with the *Budget 2023* ceiling for 2023 (€85.9 billion), whereas the 6.5% growth rate is based on the *Summer Economic Statement* ceilings alone. This approach allows us to control for the additional spending announced in *Budget 2023* but frontloaded to 2022.

The Council assesses that the trajectory for the public finances implied by *Budget 2023* is conducive to prudent economic and budgetary management. Core spending increases are above what a hypothetical 5% path would give — in line with the Government's Spending Rule — but well below a path implied by real growth and actual inflation. By not fully indexing the tax system, tax decisions are likely to be slightly revenue-raising. Temporary measures are large but much reduced relative to last year and made up of substantial contingences, which are prudent.

The Council assesses that the trajectory for the public finances implied by *Budget 2023* is conducive to prudent economic and budgetary management

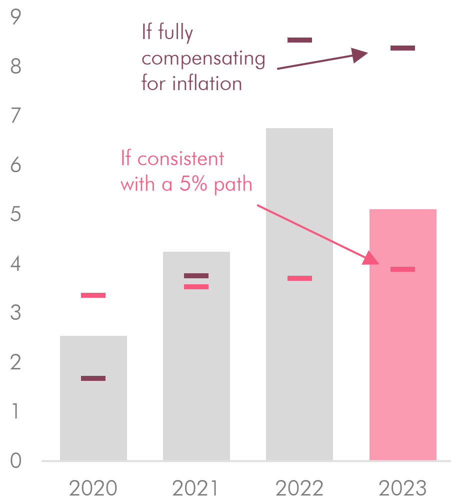
The overall path for net policy spending makes some allowance for unexpectedly high inflation, which is warranted given the exceptional and supply-side nature of the shock. The decision to pause the 5% Spending Rule in 2023 will take spending to a higher level than would be implied by a 5% path. When compared to what a hypothetical 5% path would imply, net policy spending in 2023 is €2.3 billion higher. However, this level of spending planned would still be substantially lower than if the exceptional inflation levels were allowed for in full, which is the appropriate response to a supply-side shock of this nature

With revenues faring well, a more important constraint for the public finances right now is the extent to which any further measures would add to inflation. The Government's decision to implement a larger budgetary package with *Budget 2023*, compared to the Summer Economic Statement plans, will add to existing price pressures in the economy slightly more than it otherwise would have. It will also reduce the size of the budget surplus the Government was going to run.

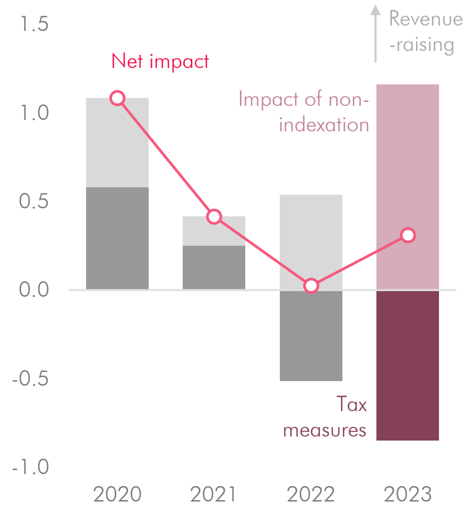
An important constraint for the public finances right now is the extent to which any further measures would add to inflation

Figure 3.10: Stance for 2023 is sensible

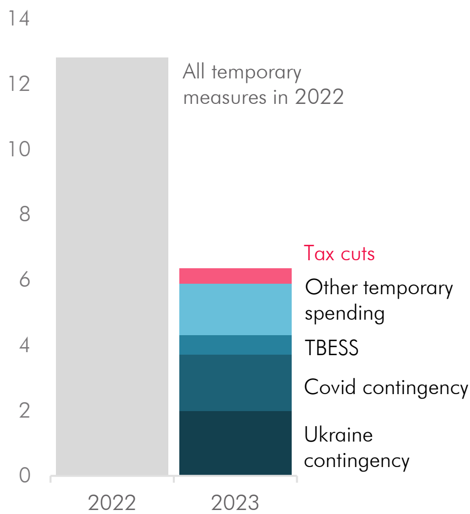
A. Core increases well below inflation for 2023
€ billion, core spending



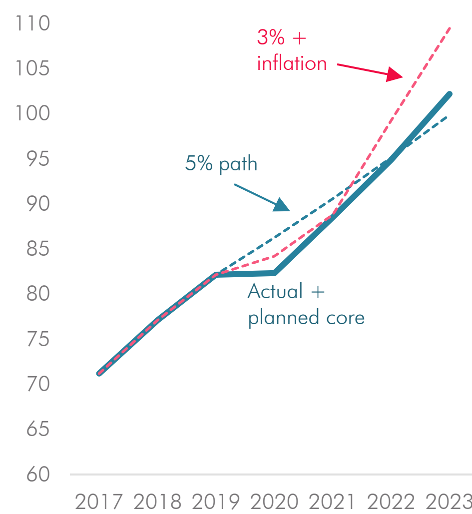
B. Tax decisions slightly raise revenues in 2023
€ billion



C. More temporary measures used
€ billion, temporary measures



D. Net policy spending path still sustainable
€ billion, net policy spending

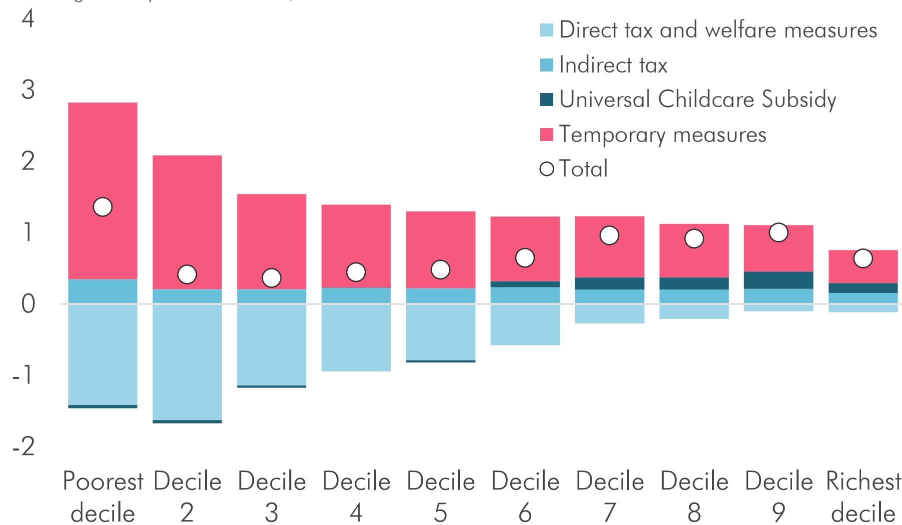


Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Core spending refers to Exchequer spending in cash terms excluding temporary measures such as those related to Covid-19, and supports for Ukrainian refugees. The impact of non-indexation is the estimated additional revenue that would be raised if the income tax system did not adjust for higher wages in the economy. "TBESS" is the Temporary Business Energy Support Scheme. Net policy spending is overall general government spending, excluding temporary factors like one-offs, and cyclical spending on unemployment benefits. As a net measure, it recognises the role of tax changes; that is, a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts.

The permanent measures included in *Budget 2023* mostly increase core welfare rates, pensions and public sector pay. The permanent increases across these areas do not compensate for price rises in full. Instead, temporary measures play a big role. Looking at the impact of permanent welfare and tax changes, together with the temporary supports, these more than compensate for price rises, particularly for the poorest-income households (Figure 3.11). The temporary measures should add to inflationary pressures relatively less than the permanent measures. However, there is still substantial scope for temporary measures to be better targeted (Section 2).

Figure 3.11: Temporary measures protect against real income losses

% change in disposable income, 2023 vs 2022



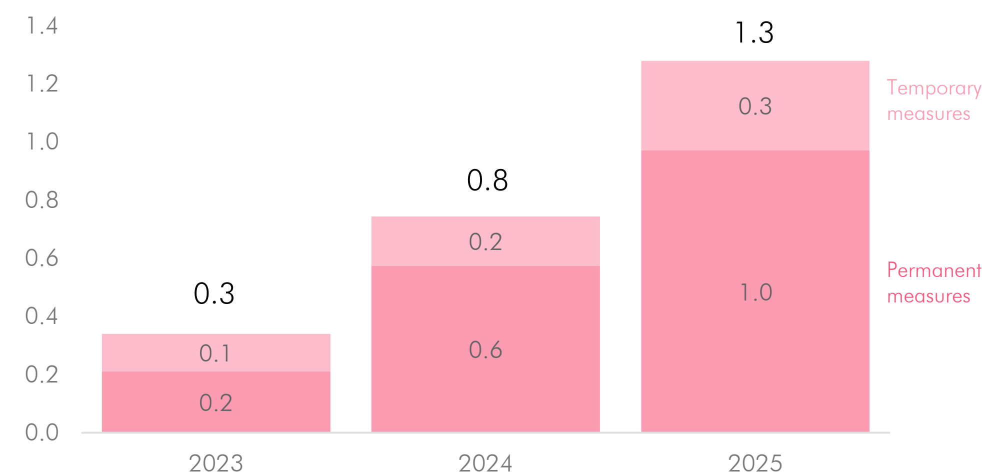
Sources: Doolan, Doorley, Regan and Roantree (2022).
Note: The analysis shows the distributional effect of *Budget 2023* compared to a hypothetical Budget that is fully indexed for inflation at an assumed rate of 7.1% in 2023 (in line with *Budget 2023* projections). The direct and indirect tax measures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

The Council estimates that — compared to a situation in which the 5% Spending Rule was followed and temporary spending was unchanged from previous plans — prices in the economy will be 1.3% higher by 2025 as a result of the larger budgetary package (Figure 3.12).

The additional budget measures are estimated to raise prices by 1.3%

Figure 3.12: Price impact of additional budgetary measures

% HICP price level is estimated to be higher in each year due to additional *Budget 2023* measures



Sources: *Budget 2023*; and Fiscal Council workings. Get the data.
Notes: The figure shows a simulation of the HICP price level impact arising from the additional measures outlined in *Budget 2023* in terms of a) the difference between core spending in the Budget vs a hypothetical 5% spending path (€2.2 billion) plus the additional €0.55 billion of tax cuts introduced; and b) the difference in "non-core" or temporary spending (€4.8 billion) between *Budget 2022* and *Budget 2023* plus the additional temporary tax measures (€1.7 billion) for 2022 and 2023. It uses the Council's Maq model (Casey and Purdue, 2021) to estimate the impact on the economy of additional spending and tax-reducing measures.

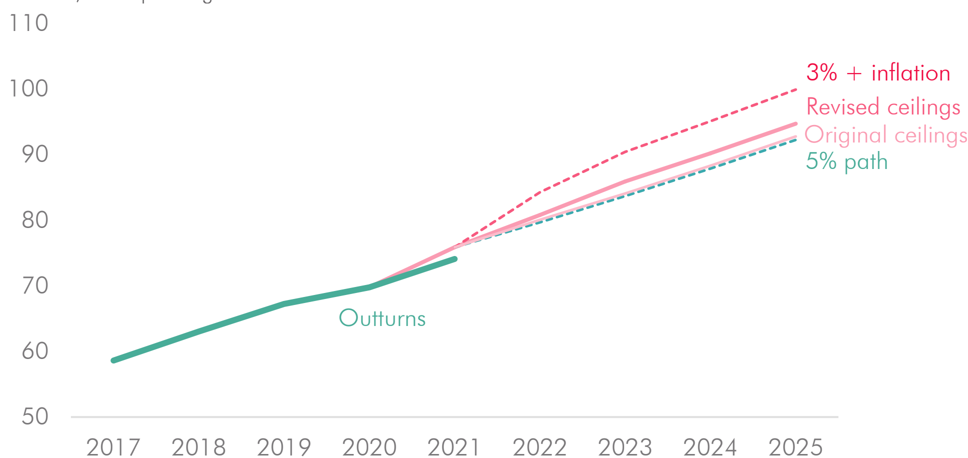
Fiscal Stance for 2024–2025

In keeping with the 5% Spending Rule, *Budget 2023* sets out 5% core spending increases for 2024 and 2025. However, given the higher starting point in 2023, the level of spending for 2025 is €2 billion above the original *Budget 2022* ceilings and €2.5 billion above the level implied by a hypothetical 5% path.

While the Government has revised up its core spending ceilings compared to *Budget 2022* plans, the trajectory for core spending remains closer to the original plans and a hypothetical 5% path than what would be implied by increasing spending in line with a 3% growth rate plus actual inflation projected over the forecast horizon (Figure 3.13).

Figure 3.13: Core spending path revised up, but less than full inflation

€ billion, core spending



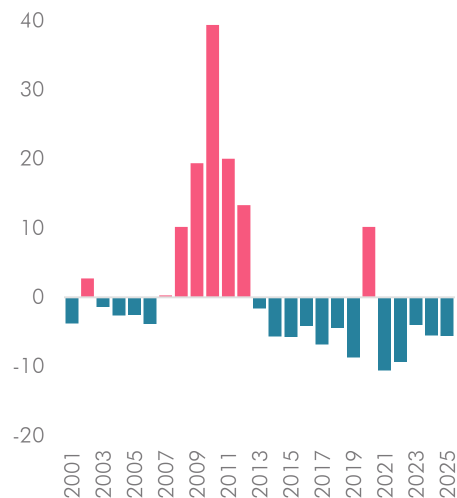
Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Core spending is Exchequer spending excluding temporary measures. The original ceilings refer to *Budget 2022* ceilings.

The projected path for spending, if followed, will lead to a steady pace of debt reduction in 2024 and 2025 and a structural surplus. Both years would see the net debt ratio fall by about 5½ percentage points of GNI* (Figure 3.14A). This steady reduction in the net debt ratio would bring it to 58% of GNI* — its lowest level since 2009 when it was 47%. The structural balance would rise to 1.4% of GNI* when adjusting for windfall corporation tax receipts as well as other one-offs (Figure 3.14B).

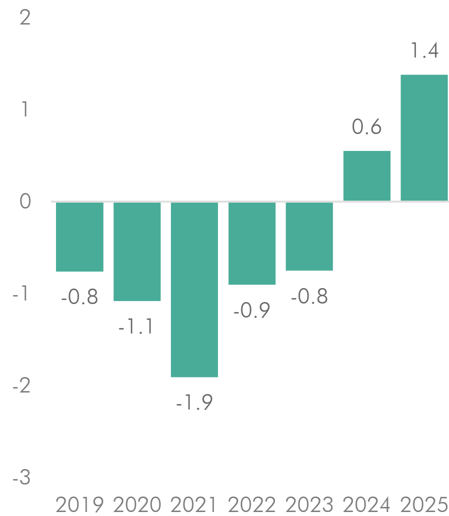
The path for spending should lead to a steady pace of debt reduction in 2024 and 2025 as well as a structural surplus

Figure 3.14: Steady pace of debt reduction and structural surplus

A. Steady pace of debt reduction projected
Percentage points of GNI*, net debt ratio changes



B. A structural surplus is implied by projections
% potential GNI*, bottom-up structural balance



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: The structural balance is measured on a bottom-up basis (Box I, May 2021 Fiscal Assessment Report).

The planned reduction in the Government's net debt ratio is prudent. It would bring debt ratios to safer levels, which would help to make the economy more resilient to shocks — allowing it more scope to respond to future recessions with strong budgetary support, similar to during the pandemic. Building these buffers while the window is there to do so will also help the State navigate numerous fiscal challenges that are likely to materialise in the coming years and decades.

Building these buffers will help the State navigate numerous fiscal challenges

Medium- and long-term budgetary challenges

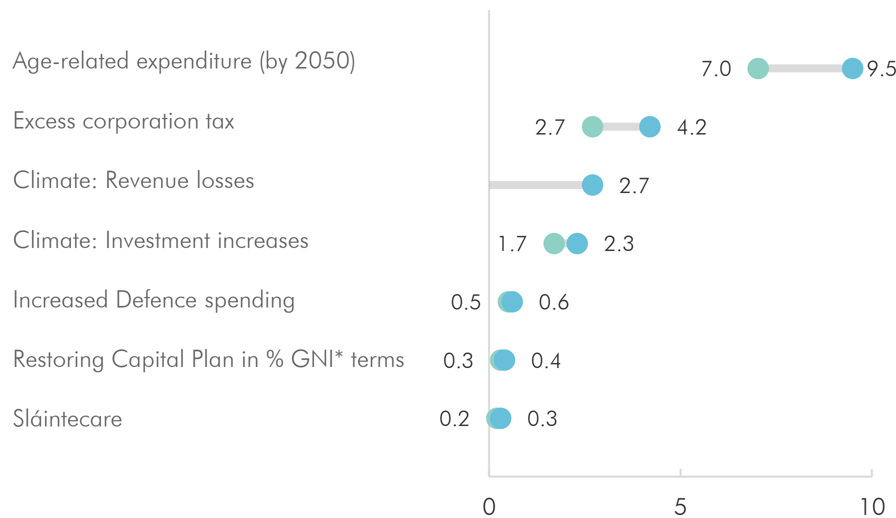
While Ireland's fiscal sustainability has improved, a number of major challenges remain that could change the outlook. This is particularly true given that many of these challenges have not been fully costed and factored into the Government's budgetary plans.

The largest single source of risk to Ireland's fiscal sustainability is the pressures arising from an ageing population (Figure 3.15). These pressures will build gradually over the coming decades. As they do, the Government will also have to address its over-reliance on corporation tax receipts, meeting Ireland's climate objectives, and implementing other Government ambitions in relation to health reforms (Sláintecare), defence spending, and housing.

A number of challenges remain, many of which are not yet fully costed

Figure 3.15: Ageing pressures are at the forefront of fiscal challenges

% GNI* estimated range of annual impacts on government's budget balance



Sources: FitzGerald (2021); Commission on the Defence Forces (2022); and Council estimates.
Notes: Age-related expenditure estimates are the Fiscal Council's (2020b) pessimistic to optimistic range. Excess corporation tax receipts, potential climate-related revenue losses, capital plan restoration, and Sláintecare costs are all Council estimates. The climate-related investment increases are from FitzGerald (2021). Get the data.

Ageing pressures: The Irish population is rapidly ageing. This will put pressure on pension and healthcare spending at the same time that growth is likely to slow.[54] The annual pressures associated with a projected rise in spending on pensions and healthcare will be substantial at some 7 to 9.5% of GNI* per annum by 2050. These pressures will mount as the number of individuals reaching age 65 increases from about 50,000 each year this decade to just over 75,000 per annum by the 2040s. Over the same period, life expectancy at age 65 is set to increase from 85 to 89 by 2050 — thus lengthening the time over which pension payments are made.

The population is ageing rapidly, putting pressure on pension and healthcare spending at the same time growth is likely to slow

The Government has cancelled plans to raise the pension age from 66 to 67 — a decision originally due to take place in 2021. This is a costly decision. Keeping the pension age at 66 would add 2% of national income per year to expenditure by 2050 (Fiscal Council, 2020b), equivalent to around €5 billion today. Funding this will add significantly to future tax rises. Over the coming years, higher pension costs from ageing alone — not counting higher prices — will add around €500 million each year to public spending.

Very large increases in taxation or cuts in spending will be required to meet these challenges. By 2050, for a worker on a typical wage of €35,000 per annum in today's money, the costs associated with addressing pensions shortfalls would amount to €1,900 per annum in today's money in additional PRSI payments (Figure 3.16). About €800 of this would be due to the decision to not increase

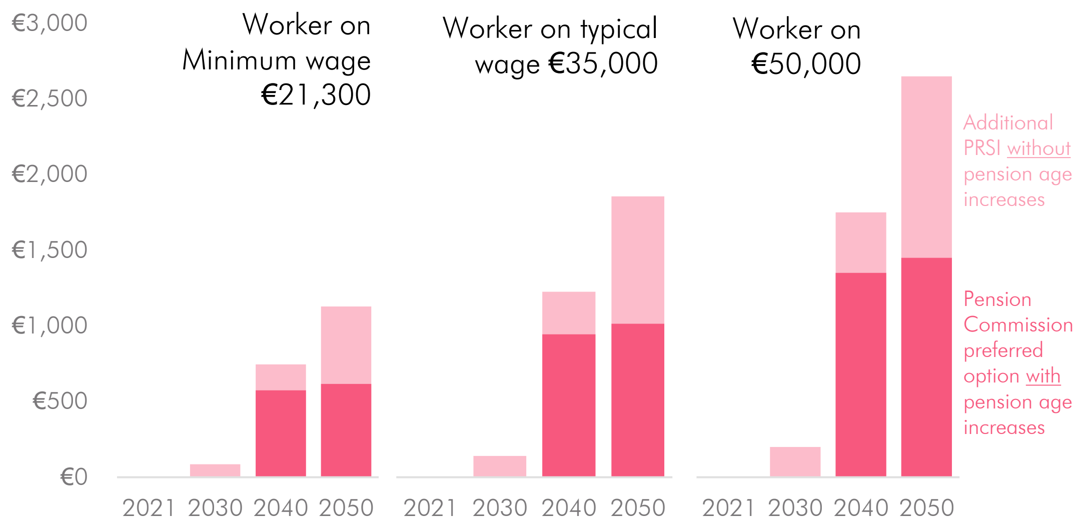
[54] Growth is likely to moderate due to both a shrinking labour force and maturing level of productivity, which implies moderating growth rates in future (see Box A in Fiscal Council, 2020b).

the pension age gradually, as recommended by the Pensions Commission. Around €1,000 would be required just to finance the larger number of people reaching retirement age and longer life expectancy.

A variety of reforms could limit the costs associated with ageing, but speed is of the essence. The Council's (2020b) analysis suggests that acting sooner would reduce costs substantially. In a scenario where policy aims to prevent debt ratios from rising above 90% of GNI* amid ageing pressures, acting earlier would entail reducing spending or raising taxes by a cumulative 0.8% of GNI*. However, delayed action would cost almost three times that, at 2.1% of GNI*. Earlier increases in taxes would help to raise revenues while a large share of the population is in work. This, in turn, would reduce the burden on future generations.

Figure 3.16: PRSI increases for workers based on proposed pension reforms

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



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

The Government in recent months has taken a number of steps towards reforming the pensions system. However, it has opted not to raise the pension age — something which would have had a much greater impact on the overall sustainability of the pensions system. The measures that it is likely to enact are unlikely to have a major impact on overall sustainability, with many of these netting off against each other (Table 3.1).

The Government has opted not to raise the pension age

Table 3.1: The Government has made numerous pension reforms

Reform	Detail	Budgetary impact
State pension age to remain at 66	The Government agreed to maintain the State Pension age at 66	Negative (likely to raise costs by 0.4% of GNI* p.a.)
Flexible pension age (to age 70)	The Government agreed to introduce a new flexible pension age model from January 2024 allowing workers to continue working up to age 70 in return for higher pensions	Neutral
Auto-enrolment	The Government has approved a draft Bill to introduce mandatory workplace pensions from 2024.	Official cost to State estimated at 0.1% GNI* p.a. over first ten years but could alleviate some of the pressure on the public pensions system to provide for individuals with low cover.
Total Contributions Approach	The Government agreed to shift from allowing people availing of the state pension to choose between the most favourable option of either the "Yearly Average Approach" or a "Total Contributions" approach to only having the option of the latter. The shift would be a phased move over 10 years, starting in January 2024.	Positive (estimated savings of nearly 0.1% GNI* p.a.)
Level of PRSI rate increases to be assessed every 5 years	The Government agreed to have a statutory actuarial review assess the level and rate of increase in social insurance rates required every 5 years.	Positive (but actual impact depends on whether rate increases are implemented and extent of increase)
Long-term carers coverage	The Government agreed to introduce Enhanced State Pension provision for long-term carers from January 2024.	Negative (likely to raise costs but no official estimates of this)
Modified Benefit Payment	The Government committed to explore the design of a scheme that would modify the current Benefit Payment for 65-year-olds to provide a benefit payment for people who, following a long working life (40 years or more) are not in a position to remain working in their early 60s.	Negative (likely to raise costs but no official estimates of this)

Two of the main pensions reforms of late are the auto-enrolment scheme and the decision to introduce a flexible retirement age.

First, the Government has approved the draft heads of a Bill to introduce mandatory workplace pensions from 2024 in a so-called "auto enrolment" scheme.[55] The scheme will result in contributions being paid by the State to top up employer and employee contributions. Official estimates put the cost of the scheme to the State at €3 billion in total over the first ten years (equating to €300 million per annum or about 0.1% of GNI*). The scheme should increase pension coverage in the private sector, potentially alleviating some pressure on the public pensions system. However, it could also dampen people's disposable income during their working lives. This would, in turn, be expected to reduce consumer spending, although, in the very long term, consumption is likely to be boosted by pensioners having higher income than would otherwise have been the case.

[55] Box H of the May Fiscal Assessment Report (Fiscal Council, 2022) explores the key design aspects. Many of these are unchanged as of the latest announcement: https://www.gov.ie/en/press-release/b9de4-historic-progress-on-automatic-enrolment-minister-humphreys/

Second, the Government has opted to introduce a new flexible pension age model from January 2024 that would see people being given the option to continue working beyond the pension age of 66 up to age 70 in return for a higher pension.[56] This measure is unlikely to generate substantial savings. Indeed, the Pensions Commission (2021) notes that 1) take-up in such schemes tends to be very small — as low as 2% of eligible individuals; and 2) numbers of dependents or "qualified adults" that increase pension payments are declining as higher female employment rates mean more women are entitled to the State Pension Contributory.

Excess corporation tax receipts: Excess corporation tax receipts have grown to around €10 billion, representing about one-quarter of tax receipts. They continue to be unpredictable, with receipts highly concentrated among a handful of foreign-owned multinational enterprises. Some 56% is accounted for by 10 corporate groups.

Excess corporation tax receipts have grown to about €10 billion, one-quarter of tax receipts

In a welcome development in *Budget 2023*, the Department has shifted to presenting estimates of the budget balance excluding excess corporation tax receipts as well as in headline terms. This uses the Department's estimates of how much of annual corporation tax receipts it considers to be potentially windfall in nature. The stated purpose is to ensure that such receipts are "not used to finance permanent increases in public expenditure". This is something the Department itself noted should have been introduced as early as 2019 (Department of Finance, 2019) and follows recommendations made by the Council.

To reinforce the approach that excludes excess corporation tax receipts from measures of the budget balance, the Department should also apply this approach to its monthly Exchequer balance estimates. Within year, this could be done simply by including the above-profile amounts of corporation tax as part of the excess receipts that are calculated on an annual basis, updating these estimates once outturn data for the year are available.

The Spending Rule and the adjusted budget balance help address the over-reliance on excess corporation tax receipts, but they do not unwind this over-reliance

The introduction of the 5% Spending Rule and the Department's approach to adjusting the budget balance for excess corporation tax receipts have implications for the Reserve Fund. The Government used the Reserve Fund in *Budget 2023* as a means of preventing permanent spending increases from being based on potentially transitory revenues. This is in line with the Council's recommendations in the past. However, the role of the Reserve Fund could usefully be re-examined in light of the recent changes to the budgetary framework. Box D looks at these implications.

[56] See the official announcement here: https://www.gov.ie/en/press-release/6b939-minister-humphreys-announces-landmark-reform-of-state-pension-system-in-ireland/

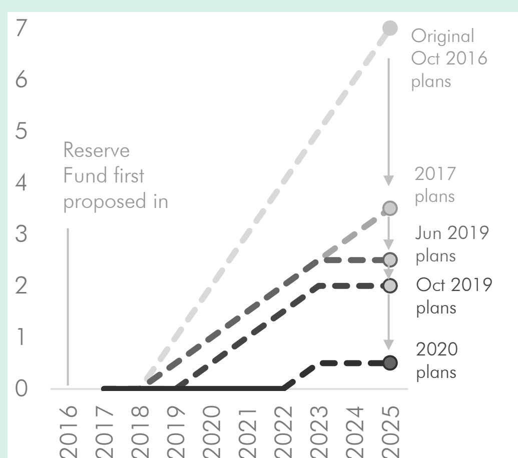
Box D: Ireland's Reserve Fund is restored but needs some rethinking

In *Budget 2023*, the Government set out plans to restore Ireland's "National Reserve Fund". The Reserve Fund was first proposed as part of the May 2016 Government programme as a way of securing "sound public finances and a stable and broad tax base".[57] But a series of policy announcements saw government ambitions for the Fund repeatedly scaled back. Until now, the State did not make any actual annual contributions to the Fund (Figure D1).[58]

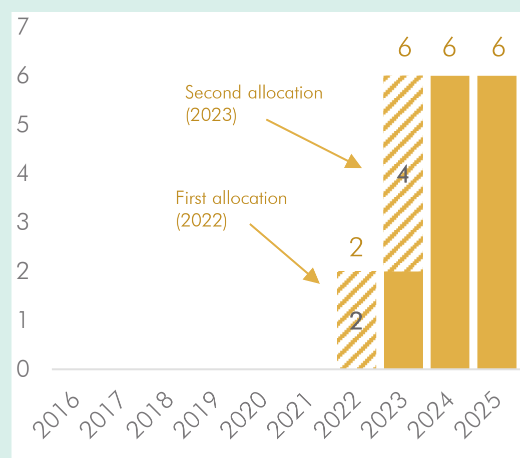
Plans for the Reserve Fund have now been scaled up significantly. The Fund is to be used to ensure that "windfall corporate tax receipts are not used to finance permanent increases in public expenditure". On Budget Day, the Government carried a motion to make a €2 billion allocation in 2022 and a €4 billion allocation in 2023. This entails €6 billion of cumulative allocations to the Reserve Fund by end-2023. It also represents a rapid catching-up on the original plans set out in October 2016, when annual allocations of €1 billion per annum were proposed from 2019 on (Figure D1).

Figure D1: Plans for the Reserve Fund were scaled back but now return

A. Old plans had been scaled back
€ billions, reserves accumulated in the fund



B. But new plans mean significant allocations
€ billions, reserves accumulated in the fund



Sources: Fiscal Council workings. Get the data.

The Council has long considered the Reserve Fund a potentially useful tool.[59] It offers a way to 1) sustain budget surpluses in good times, withstanding pressures to loosen policy as revenues grow strongly; 2) help governments avoid forced austerity in the event of losing the ability to borrow at low interest rates; and 3) access useful financial assets in the event of a crisis.

However, the Reserve Fund has several design problems:

1) Operating with discretion rather than countercyclically — the Reserve Fund is designed in a way whereby it does not function as a countercyclical tool. That is, it does not act in a manner that would lessen Ireland's tendency in the past to ramp up spending and cut taxes during a boom. Instead, the design assumes pre-determined allocations of €0.5 billion each year. These allocations have to be passed by Dáil Éireann. The allocations therefore depend on political discretion and do not necessarily evolve with the cycle. For example, this approach does not automatically entail larger contributions if there is a drastic upswing in the economy or if large tax windfalls suddenly arise. Similarly, withdrawals from the Fund are not linked to the cycle. These are instead intended to address only specific events or shocks — such as those arising due to very "exceptional circumstances" — rather than to smooth the impact of the cycle.

2) Capped arbitrarily at €8 billion — the Reserve Fund is limited to a maximum size of €8 billion. The reason for this is unclear. Simulations in Casey *et al.* (2018) and Fiscal Council (2018) suggested that, at the time, this level would be reasonable to smooth a typical cyclical downturn. However, it would not necessarily cover large downturns. Its size, which is set in nominal terms, is also shrinking

[57] At the time, the Fund was referred to as the "Rainy Day Fund".

[58] A transfer of €1.5 billion of cash assets from one arm of the State to another did benefit the Fund in 2019. This involved the State moving assets from the Irish Strategic Investment Fund to the Reserve Fund. Yet this was far different in effect to the planned savings or contributions intended for the Fund as it had no impact on the State's net asset position.

[59] See Box B, *June 2016 Fiscal Assessment Report*.

relative to the size of the economy as prices rise. When established in 2019, €8 billion was equivalent to about 4% GNI*. By 2030, assuming trend growth of 3% and economy-wide inflation of between 1½ and 2%, the Fund's maximum value relative to the size of the economy could fall to almost half that. This will gradually weaken the tool's effectiveness as a way to counteract downturns in the economy. In addition, the fact that a cumulative €6 billion is planned to be allocated by next year could see the Fund rapidly hit this cap.

3) Potential conflicts with the fiscal rules — withdrawals from the Fund could breach EU fiscal rules if they entail higher-than-allowed spending. For example, the spending rule, referred to as the "Expenditure Benchmark", sets an annual limit on how much real spending can increase by after excluding interest and temporary costs. If the Government were to comply with the fiscal rule by a small margin, any additional spending funded by withdrawals from the Reserve Fund would most likely lead to a breach of the rule. This represents a major shortcoming of the fiscal rules. Policymakers using such funds could be unfairly punished for setting aside savings in good times when these funds are eventually used. To resolve this problem, Casey *et al.* (2018) suggest treating allocations as discretionary revenue-raising measures. This would mean the allocations using up fiscal space afforded by the rule. Withdrawals could then be treated as an offset to spending increases measured under the rule. However, this would require changes at EU level and it is not clear that such changes are likely to take place.

How the allocations to the Fund are treated in an accounting sense?

The allocations to the Reserve Fund are treated as increasing the Exchequer deficit (or reducing an Exchequer surplus). However, in terms of the broader general government definition, they do not have any impact on the budget balance. Allocations to the Reserve Fund represent a transfer within Government, and hence represent neither an increase in spending nor a reduction in revenue. The allocation therefore has no impact on the budget balance.

However, the focus on the budget balance measure adjusted for estimated corporation tax windfalls means that the excess corporation tax receipts do not impact on that measure. In effect, the Fund is providing a vehicle for saving part of the difference between the headline and the underlying measure, reinforcing the overall fiscal framework in this regard.

Will the new allocations limit the risks surrounding corporation tax receipts?

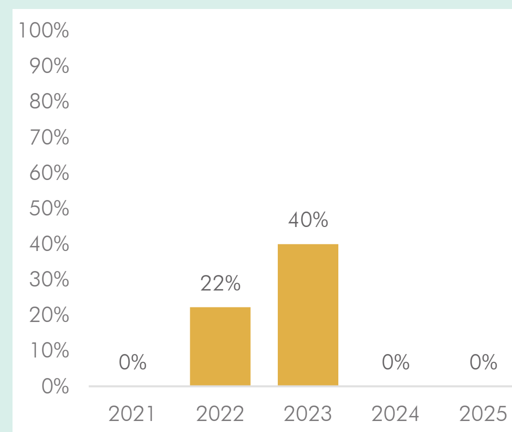
The objective of the new Reserve Fund allocations is to limit the risk that permanent increases in public expenditure are being funded by corporation tax receipts that could potentially prove to be windfall in nature. This approach is in line with recommendations made by the Council since 2017 (Fiscal Council, 2017). The Council's recommendations have been 1) to avoid using concentrated and unpredictable increases in corporation tax receipts as a basis for increasing permanent spending and 2) to redirect these to the Reserve Fund or towards debt reduction.

The allocations to the Reserve Fund, while welcome, on their own will not be sufficient to limit the risks surrounding corporation tax receipts.

Figure D2: Reserve Fund captures some but not all corporation tax windfalls

A. Windfalls estimated to be large
€ billions

B. Reserve fund allocations capture only a portion
Reserve Fund allocations as % of annual windfalls



Sources: Department of Finance; and Fiscal Council workings. Get the data.

First, the allocations are small relative to the size of windfall corporation tax receipts. The Department estimates that windfalls were of the order of €5 billion in 2021, rising to €9 billion in 2022. Further windfalls are projected for 2023, 2024 and 2025, at around €9 to 10 billion each year. However, compared to these substantial figures, the allocations to the Reserve Fund are relatively small at €2 billion in 2022 and €4 billion in 2023 (Figure D2A). For these two years, the allocations are just 22% and 40% of the estimated windfalls, respectively (Figure D2B). Beyond 2023, it is unclear whether any further allocations are planned. It is clear that the windfalls are not being fully captured by the Reserve Fund. Moreover, these excess corporation tax receipts have been building up since about 2015. The Council's own estimates of excess corporation tax receipts would suggest that excess corporation tax receipts taken in since 2015 could have amounted to a cumulative €32 billion by 2022. This is in effect the size of a Fund that might have resulted had these excess receipts been allocated in full to the Reserve Fund. Note that the uncertainty range around estimates of the cumulative excess receipts is very wide at €21 to 43 billion.

Second, the 5% Spending Rule and planned surpluses are doing more to limit risks, with the Reserve Fund playing a relatively passive role. The key change in policy in recent years helping to generate budget surpluses and to contain risks associated with corporation tax receipts is the 5% Spending Rule. By broadly following this, the Government is helping to ensure permanent spending growth is tied to more sustainable growth in revenues. In particular, by applying this in 2022 and 2023, the Government helped to limit its exposure to excess corporation tax receipts closer to 2021 levels of around €5 billion. The additional annual windfalls over-and-above this level are ending up in larger surpluses, with a portion of these, in turn, being allocated to the Reserve Fund. However, the Reserve Fund itself is not directly contributing to the additional saving, although it may play a supportive role.

The Government should continue to stick to its 5% Spending Rule

The key way to mitigate risks around how much of the excess corporation tax receipts are used for permanent spending is through the Government's 5% Spending Rule rather than through the Reserve Fund. Sticking to the 5% Spending Rule would ensure that the Government increases spending at a pace that is broadly sustainable. It would entail "looking through" the additional excess corporation tax receipts collected in a given year and limit the increase in public spending to a rate more consistent with trend growth in the economy and in government revenues.

While the 5% Spending Rule is an effective way of limiting risks associated with further increases in excess corporation tax receipts, it does not help to reduce the existing level of risk. It basically caps the Government's exposure to excess corporation tax receipts at recent levels It does not address the past build-up of excess receipts. For instance, the Government looks set to broadly stick to the spending rule in 2022 and 2023. However, doing so would only limit the exposure to 2021 levels of excess corporation tax receipts. These are estimated by the Government to be of the order of €5 billion. If the Government were to unwind its exposure, this would require it to grow core spending by less than the 5% set out in the Spending Rule or to introduce net revenue-raising measures elsewhere.

Conclusions

Using the Reserve Fund is a welcome development. It helps set aside any additional excess receipts, but it does not cover the full extent of their impact. In any case, the Government, by broadly sticking to its 5% Spending Rule, will most likely generate relatively larger surpluses. These savings would far exceed the expected Reserve Fund allocations.

The Government needs to develop its thinking on the goals and design of the Reserve Fund. The purpose of the Fund has evolved over time from a countercyclical tool in the Programme for Government to a Fund that only helps in exceptional circumstances, and now to a Fund that is limiting the risk of permanent increases in public spending being funded by excess corporation tax receipts. However, its importance as a tool is diminished by the more important roles being played by the 5% Spending Rule and the adjusted general government balance. A fund with liquid assets could prove helpful in future downturns, but the State has already amassed large cash buffers elsewhere, with further surpluses adding to these. In addition, the current design shortcomings of the Fund will limit its effectiveness.

One option for the Reserve Fund might be to redefine it as a new Pension Reserve Fund. This would set a new goal for the large assets that are being accrued; it would give it a mandate to invest in assets with potentially greater returns, and help deal with a longstanding problem — the expected shortfall in pension funding over the coming decades. In particular, it could take some of the pressure off the tax system having to raise additional revenues to meet these shortfalls.

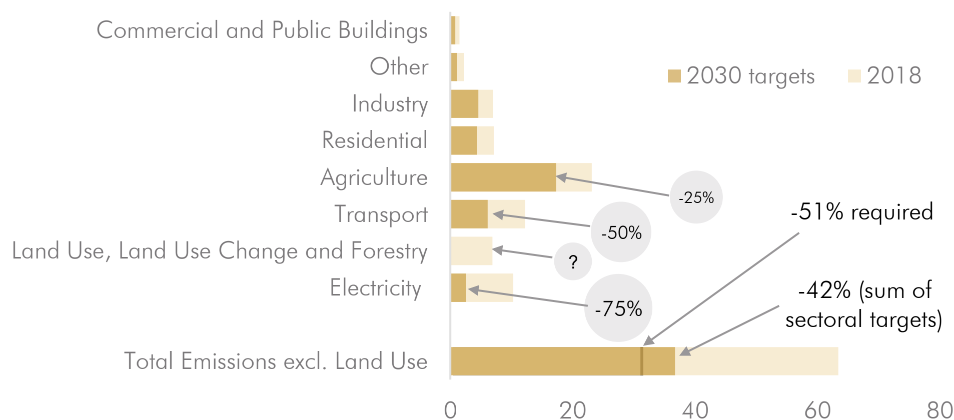
Climate-related pressures: The Government's climate targets are lacking in basic detail and are potentially short of the required ambition. The Government has yet to clarify the estimated fiscal costs of achieving its required 51% reduction in overall greenhouse-gas emissions by 2030.[60] It has also not clarified how this reduction will actually be met despite announcing "Sectoral Emissions Reduction Targets" in July.

The Government's climate targets are lacking in basic detail and are potentially short of the required ambition

The Climate Change Advisory Council (2022) welcomes the Government's new Sectoral Emissions Reduction Targets as an important milestone but points to several major shortcomings. First, the overall emissions reductions amount to only a 42% reduction — short of the 51% reduction legally required (Figure 3.17). Second, the targets do not show how the land-use sector will be included in meeting the targets. Third, the targets do not clarify how carbon budgets are to be allocated within sectors. The Climate Change Advisory Council assesses that, while the targets are a useful starting point, they will need to be revised upwards to be consistent with a 51% reduction and monitored closely.

Figure 3.17: Climate targets are short of ambition and lack clarity

Million tonnes of carbon dioxide equivalent



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

Achieving the overall 51% reduction in emissions would require the Government to direct investment spending of about 2% of GNI* per annum towards climate areas between now and 2030. This rough estimate assumes that the Government makes some intervention to facilitate climate investments without positive financial returns.[61] FitzGerald (2021) provides a better articulated assessment of the additional annual investment costs to meet the 2030 targets and lands on similar

[60] These legally binding objectives are set out in the Climate Action and Low Carbon Development (Amendment) Act 2021.

[61] The Climate Action Plan 2021 notes that about 40% (about €5½ billion annually or 2% of GNI*) of the total estimated €125 billion investment costs of achieving these targets — both public and private —would be unlikely to have positive investment returns. This means that the State would probably have to make some intervention, perhaps up to the full amount, over 2021–2030 to encourage these investments. It's likely that the costs would now be higher, given that they were produced at a time when inflation was lower and projected to remain so.

estimates at between 1.7 and 2.3% of GNI*. These estimates assume that the agriculture sector would cut its emissions by either 51% or, in the more costly scenario, by 33%. However, since then, the Government has announced official Sectoral Emissions Reduction Targets that involve a smaller (–25%) reduction by the agricultural sector than modelled in the more costly scenario assessed by FitzGerald (2021). This suggests that the ultimate cost could be greater than assumed in the FitzGerald (2021) analysis.

As well as involving additional state spending, Ireland's transition to a low-carbon economy will have wider budgetary impacts. It will mean lower revenues being raised on fossil fuels as people adapt their behaviour to use less of these. Revenue such as motor tax, vehicle registration tax, carbon tax, excise and VAT on fuels are all likely to be directly affected. In 2019, before the pandemic, the Government raised almost €6 billion (2.8% of GNI*) from associated taxes.

The Government's temporary cost-of-living measures more than offset the impact of the carbon tax increases introduced in 2022 and 2023. However, carbon taxes are legislated to rise further in the coming years. Current high energy and fuel prices could therefore be seen as a foretaste of some of the changes that will come in future.

Other pressures: As well as the above challenges, the Government has yet to spell out the costs of other major policy initiatives.

Other pressures include the cost of Sláintecare reforms, increases in defence spending, and rising costs for capital spending

The Government has not clarified the progress to date and ultimate cost of implementing in full its **Sláintecare** healthcare reforms. This is both in terms of how much the overall reforms have been implemented relative to initial plans and the expected increase in recurrent costs in future years that are now likely (Box B).

Updating the original Sláintecare costings would suggest that recurrent costs could ultimately be higher. A mechanical estimate, updated for wage and price pressures that have arisen in the interim, would suggest that these recurrent pressures could be close to €1 billion higher than originally envisaged in the 2017 Sláintecare Report (or between 0.2 and 0.3 percentage points of GNI*). To better inform policy and planning, the Government should produce updated costings that factor in these pay and price pressures.

Following the invasion of Ukraine by Russia, there is strong pressure across EU countries to ramp up **Defence** spending. Ireland's defence expenditure has historically been very low, in part reflecting its neutrality. However, the Minister for Defence has indicated that Ireland is likely to increase annual defence spending by at least €500 million in the coming years.[62] This broadly aligns with the

[62] https://www.irishtimes.com/news/ireland/irish-news/ireland-s-defence-spending-set-to-rise-by-at-least-50-says-coveney-1.4864427

"middle" estimate of the Report of the Commission on the Defence Forces (2022), whereby spending would rise by 0.2 to 0.3% of GNI* annually over an unspecified timeframe.

Capital spending is another area that is likely to see pressures for additional spending in the coming years. The Government's capital plans are very ambitious: capital spending is projected to reach almost 5% of GNI* in 2025, well above OECD norms of about 3 to 4%. However, capacity constraints and rising costs could undermine these plans. As Section 2 notes, the Government's capital plans are set in cash terms, but are falling in real terms as price and wage pressures rise. To restore capital spending to the same share of GNI* consistent with the original National Development Plan for 2021–2030 would require an average of €2.1 billion extra capital spending per year.

The Government needs to start planning for how it might address these pressures

Recognising the scale of the fiscal challenges it faces, the Government needs to start planning for how it might address these pressures. The report of the Commission on Taxation and Welfare (2022) makes an important contribution in this respect. It sets out a number of potential reforms with a view to sustaining the public finances over the medium and longer term. The independent assessment of options to raise revenue is welcome and it shares as a starting point the Council's assessment of the existence of medium-term fiscal pressures. A more effective spending review process would further support the sustainability of the public finances.[63]

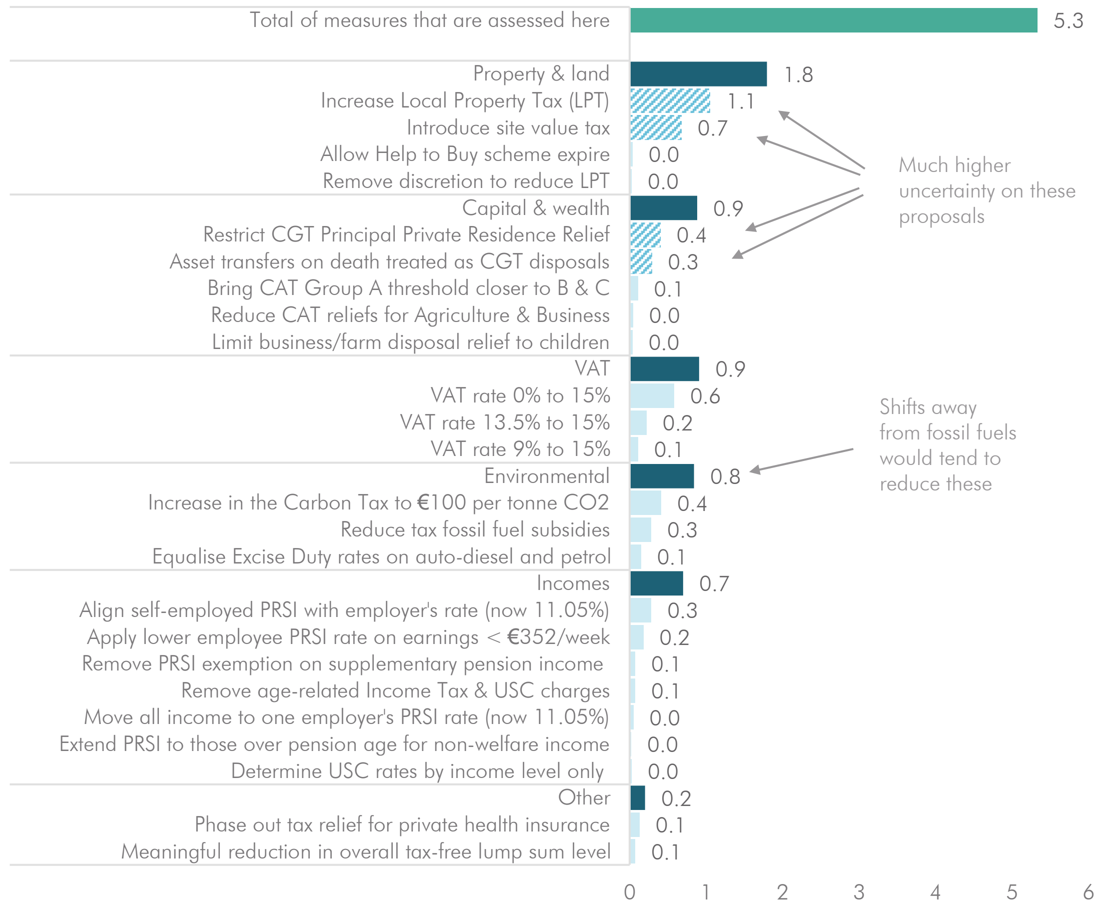
The report of the Commission on Taxation and Welfare makes an important contribution in this respect

Casey (2022) explores the Commission's recommendations, particularly on the tax side. It is difficult to assess the Commission's proposals in full — most changes are not specified in terms of precise changes. Instead, the proposals set out a broad way to guide a net revenue-raising policy that might begin to deal with challenges such as those identified above. However, assessing the measures that can be quantified in some way, Casey (2022) notes that there is upwards of 5% of GNI* worth of revenue-raising measures implied by the proposals (Figure 3.18). While property and land taxes would appear to make up the largest individual revenue-raising area, other reforms are broad-based, with capital taxes, environmental taxes, VAT, and taxes on incomes contributing.

[63] See Box E of the June 2017 Fiscal Assessment Report on spending reviews.

Figure 3.18: Potential impact of tax measures proposed by the Commission on Taxation and Welfare where estimates are available

% GNI* estimated full-year yield



Source: Casey (2022). Get the data.

Notes: The Figure is based on the author's interpretation of proposals contained in the Commission on Taxation and Welfare's (2022) recommendations. Costings are taken from a variety of sources and estimated where needed.

Fiscal Rules

Exceptional circumstances continue

4. FISCAL RULES

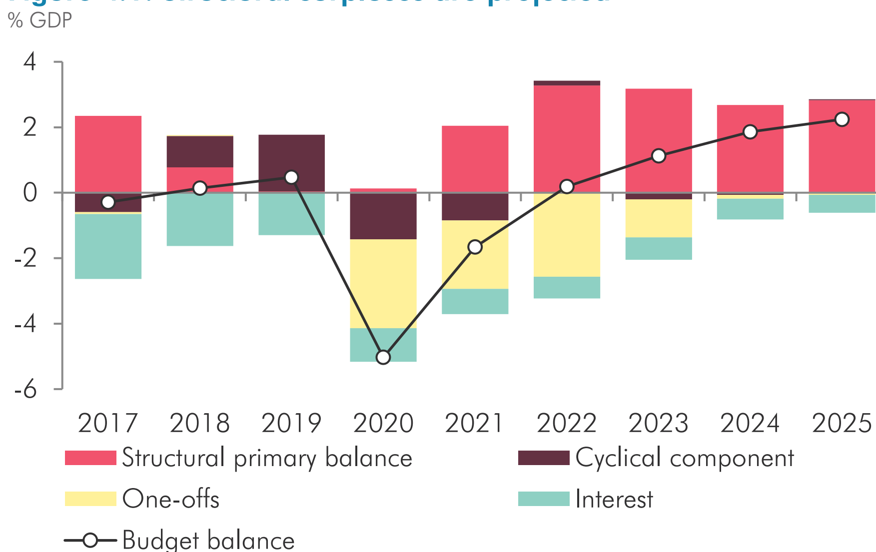
Exceptional circumstances continue

The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules were activated at the start of the Covid-19 pandemic in 2020 and have remained in place into 2022.[64] This allows Ireland to temporarily deviate from the requirements under both the domestic and EU fiscal rules in these years.

The rules remain effectively suspended

The European Commission has also announced that present conditions warrant the extension of the general escape clause through 2023.[65] The Commission cited high uncertainty and downside risks in the context of the war in Ukraine, along with energy price increases and supply-chain disturbances as contributing to this decision. It expects to deactivate the general escape clause in 2024.

Figure 4.1: Structural surpluses are projected



Source: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Note: The structural element of the budget balance is estimated using the top-down approach. This is the approach used in assessing legal compliance with the fiscal rules. The cyclical budgetary component is calculated as 0.52 times the Department's GVA-based output gap measure.

Although the escape clause offers some fiscal leeway, the structural balance is projected to be in surplus in 2022 and in subsequent years. Therefore, Ireland is on track to comply with domestic and EU fiscal rules, should they be reinstated in their current form in 2024 (Figure 4.1). The windfall corporation tax receipts flatter the fiscal balance. But, even in the absence of these excess revenues, the structural balance is expected to be in surplus from 2022— well within the formal requirements of the rules (Figure 4.2).

Even in the absence of excess corporation tax receipts, the structural balance is expected to be in surplus from 2022.

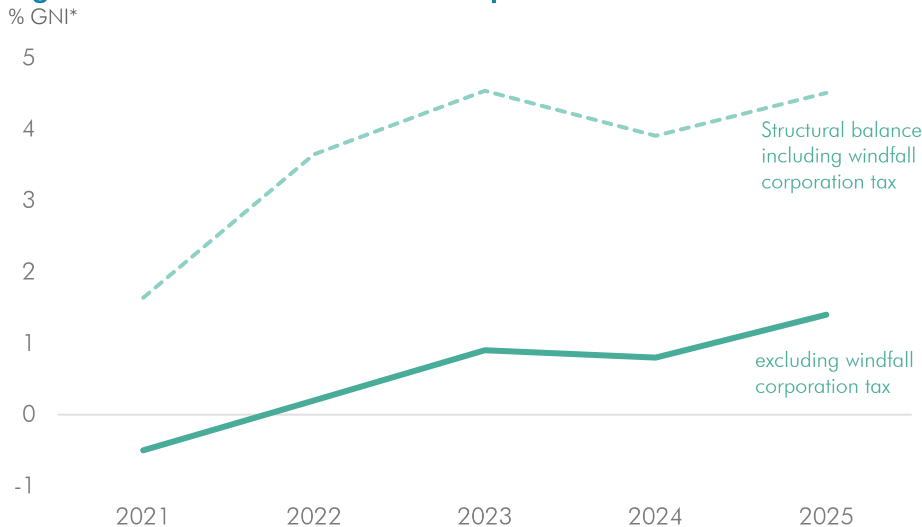
Despite the rapid increase in spending, both this year and next, net expenditure growth is forecast to be below the Expenditure Benchmark limit — under the

[64] See Box K from the May 2020 FAR for an overview of these dispensations.

[65] The press release from the Commission can be viewed here: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3182

Council's principles-based approach to the fiscal rules.[66] Based on current projections, net expenditure is set to be below the Expenditure Benchmark limit over the forecast horizon. The debt-to-GDP ratio is estimated to be below 60% of GDP this year and is likely to remain below this level over the forecast horizon.[67]

Figure 4.2: Structural balance in surplus without windfalls



Source: Department of Finance and Fiscal Council workings. Get the data.
Note: Figure shows the Council's bottom-up approach to estimating the structural balance. The "windfall" corporation tax receipts rely on the Department of Finance estimates of these for the period shown.

Supporting Information section S7 provides a full overview of compliance with the fiscal rules based on the Council's principles-based approach.

Medium-term Expenditure Framework

Ireland's Medium-term Expenditure Framework is intended to help it budget over a longer time period than governments have tended to in the past. In other words, the idea is to help set out conditions that would ensure budgets are more forward-looking, with a greater emphasis on medium-term planning, rather than focusing on just the Budget for the next year.

Under its Medium-term Expenditure Framework, the Government is legally required to set ceilings for how much each department will spend for the following three years. However, for the third year in a row, these ceilings have not been published as part of Budget-day documentation. Instead, the ceilings have been relegated in terms of their importance and are only being published in December as of recent years.

[66] See Table S7.2 for a summary of the Council's principles-based approach to the domestic budgetary rule.

[67] The legal requirement is to assess the debt ratio relative to Ireland's GDP. However, due to well-known distortions in Ireland's GDP due to the globalisation activities of a few large multinationals, this is not an appropriate benchmark for Ireland. A more appropriate metric for Ireland is the debt-to-GNI* ratio. This is forecast to be 86% at the end of 2022 and fall to 73% by the end of 2025.

As noted in the guidelines around Ireland's Medium-term Expenditure Framework (MTEF) (Department of Public Expenditure and Reform, 2013, p.42), the principle is one of transparency:

> *"The MTEF model is centred upon the principles of transparency and openness in regard to the setting and review of Departmental spending priorities, and upon the necessity for clear medium-term planning so that available resources are deployed, managed, and re-allocated (as appropriate) to best effect. A major feature of the MTEF is the move from the previous system of annual budgeting to a system of preparing three year parameters for current expenditure for Government Departments and Offices."*

The Government's failure to publish these ceilings on Budget Day, and their lack of integration into the budgetary framework more generally, represents a backwards step in transparency and a weakness in the overall fiscal framework.

The Government's failure to publish ceilings on Budget Day is a backwards step

Moreover, in delaying the publication of ceilings, the Government is not abiding by its own guidelines to publish these in October of each year. This is stated in the requirements around the framework (Department of Public Expenditure and Reform, 2013, p.43)

> *"Following Government Decision, these ceilings will be published in the Expenditure Report issued by the Department of Public Expenditure & Reform in October of each year and will be reported upon in the Stability Programme Update published by the Department of Finance in April of each year. Any changes to existing ceilings will be reconciled fully."*

The Government's 5% Spending Rule has become a useful guide for medium-term spending. It should help to give certainty around the availability of fiscal resources in future and provide a platform from which to produce realistic medium-term spending ceilings. The Government should avail of this and publish realistic spending ceilings on Budget Day from here on out.

The Government should use its Spending Rule as a platform to publish ceilings on Budget Day

Revisions to the fiscal rules

In November, the European Commission issued a communication containing proposals for how the revised EU fiscal rules could look (Box E). A multiyear net spending rule would form the operational part of the rules. Countries would propose a fiscal path that would put the debt ratio on a downward path, which would be subject to approval by the EU Council and where structural reforms and investment could allow a less ambitious path. The proposals envisage a larger role for national independent fiscal institutions (IFIs) like the Council.

A net spending rule would be at the heart of the potential revised rules

The Commission's proposals represent some shift away from a rules-based framework and could represent a relaxation of the existing fiscal rules depending on what fiscal paths are agreed. They may grant some countries more time to achieve reductions in their debt ratios. A key question is whether they will improve national ownership and compliance with the framework as intended.

The proposals would likely require legislative reforms to the Fiscal Responsibility Act (2012), which transcribes the fiscal rules for Ireland. The Act has an emphasis on structural balance targets and the debt rule, which could be all but abandoned in the new framework. It has no explicit mention of a spending rule. The proposed risk-based surveillance approach may have an impact on EU level scrutiny of the Irish public finances if it is GDP based or if the GNI*-based debt ratio declines as anticipated.

However, these reforms would likely have important implications for Ireland's legislation

Box E: Potential reforms to the EU fiscal rules

The European Commission (2022) recently published potential reforms to the EU fiscal rules. The reforms, if implemented, would see a shift towards a focus on a fiscal trajectory proposed by each Member State to put the debt ratio on a downward path or keep it at low levels. A net spending rule would be used to achieve this. The 3% of GDP budget deficit limit would be kept, but other parts of the fiscal rules would be eliminated. Among other elements, a large role is foreseen for national independent fiscal institutions.

The Commission's proposals seek to address concerns surrounding the current fiscal rules. They respond to criticisms that the rules have become overly complex, weakly enforced, and too reliant on unobservable indicators, such as the output gap, that are difficult to measure and subject to frequent revisions (EU IFI Network, 2021; Martin, Pisani-Ferry and Ragot, 2021; European Fiscal Board, 2019).

The Commission's proposals aim to simplify the framework, boost transparency, and encourage greater national ownership and compliance.

This box takes an initial look at the proposals.

Overview of the reforms

The Commission's main proposal involves moving from multiple rules currently in force to a simpler set of rules. The main focus would be on a fiscal trajectory proposed by each Member State for the debt ratio and approved by the ECOFIN — the part of the Council of the EU comprising Member States' economics and finance ministers. This would be guided by a reference adjustment path set out by the Commission (see below) and could take into account analysis from independent fiscal institutions (IFIs), such as the Fiscal Council.

This would be operationalised using a spending rule that would be set to achieve the fiscal trajectory proposed by each Member State. This should ensure that the debt ratio is on a downward path at the relevant horizon in cases where debt ratios are judged to be relatively high.

The net primary spending measure excludes interest, temporary spending on unemployment related to the cycle, and adjusts for the impact of tax measures. It is essentially the same measure that is used for the current "Expenditure Benchmark". Tax-raising measures would allow for larger spending increases, whereas tax cuts would reduce the scope for spending increases (although the rule is set differently).

It is proposed to eliminate most other rules. This includes the Medium-Term Objective (MTO) — a minimum requirement for the budget balance adjusted for the cycle and one-offs — and the Expenditure Benchmark, a spending rule designed to achieve the MTO. The Commission also plans to dispense with the existing "1/20th" Debt Rule — a rule that broadly reduces the gap between a Member State's debt ratio and 60% of GDP by 1/20th every year. However, it proposes keeping the 3% of GDP deficit limit.

A risk-based approach to surveillance would be introduced based on debt ratios and a broader range of sanctions would be available.

Many key details remain unclear or are yet to be determined. For example, it is not clear whether one-off measures will be excluded from the net spending rule, given that they are, by definition, non-recurring and largely considered outside of a government's control.

Requirements under the reference adjustment paths

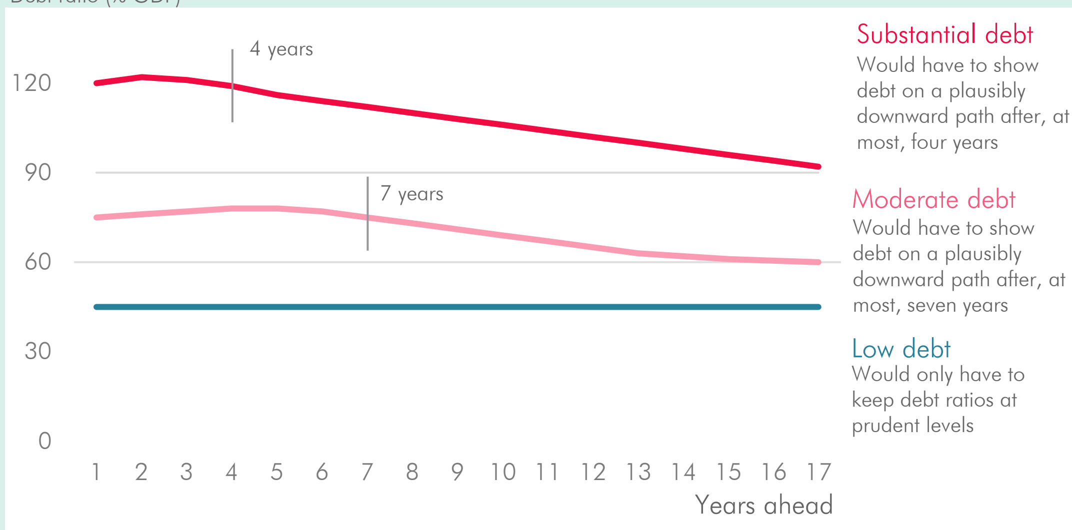
Under the proposals, the Commission would set out reference adjustment paths based on a country's debt ratio. Some Member States would be defined by the Commission as having "substantial" debt ratios — those exceeding 90% of GDP. Member States with "moderate" debt ratios would have ratios of between 60 and 90% of GDP. Lastly, those with "low" debt ratios would have ratios below 60% of GDP.

For countries with substantial debt challenges, the trajectory would be based on a four-year net primary spending path that — if maintained — would put the debt ratio on a plausible downward course over a ten-year horizon. Those with a moderate debt challenge would have more time — at most, seven years — to ensure that their debt ratios are on a downward path.[68] Those with low debt ratios would essentially need to keep the debt ratio stable and below 60% at the ten-year horizon. In addition, all countries would need to stay within the 3% of GDP budget deficit limit over the medium term.

Figure E1 uses indicative debt ratio estimates to map out how this downward path might look in practice.

Figure E1: Paths would depend on how high debt ratios are initially

Debt ratio (% GDP)



Source: Fiscal Council workings.
Notes: Substantial debt ratios are defined as more than 90% of GDP, intermediate as 60 to 90% of GDP, and low as below 60% of GDP.

Each Member State would come up with their own four-year net spending plan, taking account of the Commission's recommendations. The plan would cap net spending at a certain level each year. It would also contain country-specific reform and investment commitments. The ECOFIN would endorse the plan upon a positive assessment by the Commission. In addition, a Member State could extend its four-year plan by up to three years, provided the extra time facilitated investment and structural reforms which supported debt sustainability and matched common EU priorities, such as achieving a fair green and digital transition.

Enforcement

The revised fiscal rules would be underpinned by new enforcement mechanisms at the EU level. A Member State could be non-compliant with the revised fiscal rules in three ways.

[68] The communication notes for high debt, "the reference net expenditure path should ensure that by the horizon of the plan (4 years)[…]the 10-year debt trajectory at unchanged policies is on a plausibly and continuously declining path," and for moderate debt, "…the reference net expenditure path should ensure that[…]at most 3 years after the horizon of the plan, the 10-year debt trajectory is on a plausibly and continuously declining path at unchanged policies".

First, it could breach the 3% of GDP budget deficit limit. As is the case currently, a deficit-based Excessive Deficit Procedure (EDP)[69] would be opened in this instance.

Second, a Member State could deviate from the path set out in its agreed net spending plan. Should this occur, the severity of the sanction would depend on whether the Commission has assessed the Member State as having a substantial, moderate, or low debt ratio. For those with a substantial debt ratio, a debt-based EDP would be opened, by default. For those rated as moderate, a debt-based EDP could potentially be opened.

Third, a Member State could fail to implement its structural reform and investment commitments.

Moreover, the Commission would look to use a wider range of potential penalties, including financial sanctions, reputational sanctions, and a suspension of EU funding.[70]

When might the reforms to the rules be implemented?

The Commission intends to swiftly agree upon the revised rules with the Member States, with a view to activating them from 2024. However, it is unclear whether the changes will involve legislative change and how and in what form Members States and the European Parliament will agree to the proposals.

The Commission plans to provide guidance to Member States for fiscal policy in Q1 2023. It then proposes that each Member State would submit their four-year net spending plan for assessment by the Commission in April 2023. The ECOFIN would aim to endorse the plan by June 2023, subject to a positive assessment by the Commission.

The Commission would also monitor compliance by each Member State on an ongoing basis. For example, starting in autumn 2023, it would assess the extent to which a Member State's draft budgetary plan for 2024 complies with its endorsed net spending plan. In Spring 2025, the Commission would then assess whether a Member State complied with the targets set out in its net spending plan in 2024.

The Commission envisages that IFIs, such as the Irish Fiscal Advisory Council, could have a role to play in informing the design of the adjustment path and in monitoring compliance. However, it notes that such a role would require improving the set-up of these IFIs. The Commission and the ECOFIN would continue to make the final decisions when assessing and endorsing net spending plans and evaluating compliance.

Implications for Ireland

The rules, if implemented, will have several implications for Ireland:

1. Although unlikely to be binding, the revised fiscal rules would require the Department of Finance to produce macroeconomic forecasts with a more long-term focus. For example, in *Budget 2023*, the forecasts only covered three years ahead — shorter than the five-year-ahead forecast horizon adopted by the Department in previous years. However, the Commission proposes that net spending plans would map out estimates of relevant macro-fiscal variables at least 14 years into the future.

2. Given a Member State's debt burden will continue to be expressed in terms of GDP, the new rules are unlikely to give useful guidance for Ireland. This is because Ireland's GDP levels are artificially high due to distortions caused by the globalisation activities of a few foreign-owned multinational enterprises. The debt-to-GNI* ratio is a more appropriate measure of Ireland's debt sustainability.

3. The proposed rule changes would likely require an updating of Ireland's Fiscal Responsibility Act (2012). This would include moving from a structural balance target to a target for net primary spending (not currently included in the Act), and the removal of the "1/20th" Debt Rule. This would present an opportunity for the Government to put its own national Spending Rule on a statutory footing. In addition, the Spending Rule could be amended such that it captures general government spending, is linked to debt targets, and recognises the impact of tax measures. These changes could ensure that the Government's Spending Rule becomes a cornerstone of fiscal policy — one better tailored to Ireland's domestic conditions and not subject to the distortions that come from more one-size-fits-all approaches that depend on GDP and harmonised estimates of potential output.

[69] An Excessive Deficit Procedure (EDP) refers to a procedure according to which the Commission and the Council of the EU monitor national budget balances and public debt to assess and/or correct the risk of excessive deficit. A breach of the 3% of GDP deficit limit will result in the opening of a 'deficit-based' EDP, as could a deviation from the agreed net spending path, depending on the debt ratio.
[70] The Commission suggests lowering the amounts of existing financial sanctions to make them more effective. In addition, reputational sanctions would be enhanced. For example, the Commission suggests that Ministers from those Member States assigned an EDP could be required to present their proposed corrective measures in the European Parliament.

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