Fiscal Stance

Managing the public finances with higher inflation

3. FISCAL STANCE

Managing the public finances with higher inflation

The recovery in the economy from Covid-19 has been rapid, but uneven, and the economy now faces new challenges from the effects of the Russian invasion of Ukraine. Ireland has been helped by the performance of the international sector in terms of activity and taxes, including corporation tax and strong wage gains of higher income workers. Price and wage increases have also boosted tax receipts. As a result, a budget balance looks in prospect much sooner than had been expected, including at Budget time.

The recovery in the economy has been rapid, but even

The Government's SPU projections assume that it plans to stick to its 5% Spending Rule, newly introduced in *Budget 2022*. Core spending levels are consistent with the levels originally set out under this approach.

Maintaining core spending in line with the levels set out under the 5% Spending Rule should help to achieve a balanced budget position on an underlying basis — ignoring temporary, cyclical and one-off factors. This should set the Government's debt ratio on a steady downward path to safer levels. In turn, lowering the debt ratio would provide a buffer so that it is possible to respond to future shocks with sizeable budgetary supports in a similar way to the response during the pandemic.

Sticking to the 5% Spending Rule should set the debt ratio on a steady downward path

The Government's plans to 2025 would allow it to achieve several aims. It would allow it to address investment needs in the areas of housing and climate change by bringing public investment to record levels; largely maintain existing levels of services and the effective tax burden; and do this without providing excessive stimulus to an already fast outlook for growth. In addition, these plans allow for a steady pace of debt reduction averaging close to 4.4 percentage points for the net debt-to-GNI* ratio annually between 2022 and 2025. This would bring the gross debt ratio to 79.4 per cent of GNI* by 2025 and the net debt ratio to 68.5 per cent.

However, there are many important risks and pressures facing the public finances. First, growth is highly uncertain with several downside risks, including those from the war in Ukraine, Brexit, and the impact of price inflation on the domestic and global economy. Second, the sectoral nature of both the pandemic and Russia's war in Ukraine, together with the higher cost of living, means there could be further pressures to provide targeted

However, there are many risks

fiscal supports. Third, an overreliance on corporation tax receipts, which are risky and prone to reversals, to fund government spending has increased. Fourth, the lack of costings on major policy commitments over the medium term poses a major risk to medium-term fiscal sustainability, and there is no space for funding new current spending initiatives on a sustainable basis without tax increases or spending reductions elsewhere.

In this report, the Council makes four key assessments in relation to the fiscal stance. These are in the context of its broader assessment that the *SPU 2022* fiscal stance is conducive to prudent economic and budgetary management. First, the Government faces a delicate balancing act in protecting the economy and poorer households from higher energy and food prices, while avoiding adding to inflation through second-round effects. A combination of carefully calibrated supports and wage increases together with targeted measures could help to achieve this. Second, the 5% Spending Rule should be reinforced so that it captures general government spending, has a link to debt targets, and recognises the impact of tax measures. Third, the over-reliance on corporation tax should be gradually unwound. Fourth, major policy commitments need to be properly costed and factored into the Government's plans.

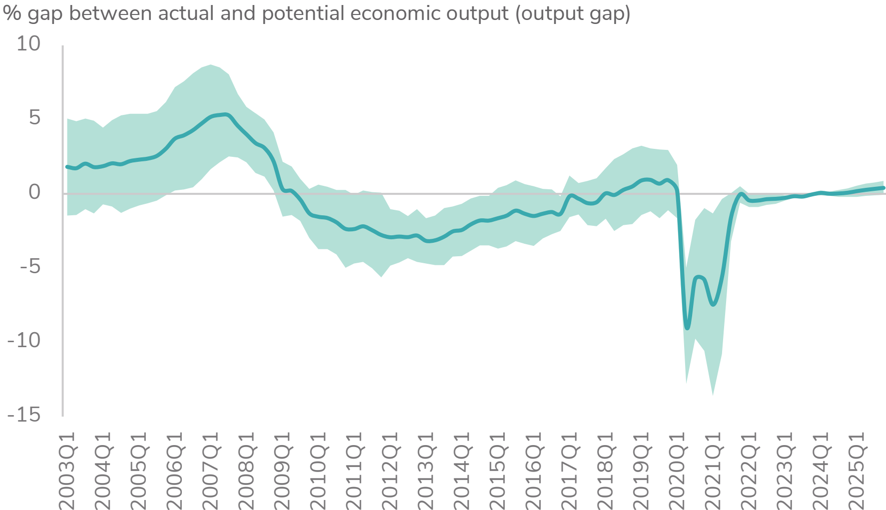
The Government should use targeted measures, reinforce its 5% Spending Rule, reduce its over-reliance on corporation tax, and properly cost its major commitments

The Council's assessment of the fiscal stance is informed by (1) a broad economic assessment that considers appropriate management of the cycle and shocks facing the economy as well as the sustainability of the public finances; and (2) an assessment of compliance with domestic and EU fiscal rules.

3.1 The economy does not require broad stimulus

The pandemic led to a sharp contraction in the domestic economy, followed by a swift, yet uneven, rebound (Figure 3.1).

Figure 3.1: Overall activity has recovered following the pandemic



Source: Fiscal Council workings (based on *Budget* 2022 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.

The Government's official forecasts in *SPU 2022* imply that the economy will operate in line with its overall capacity in the coming years despite some slowing due to higher import prices. This means that neither substantial underuse of workers, nor broader overheating in the economy are anticipated. There also appear to be few risky imbalances in the economy 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, second-round increases in inflation, housing affordability challenges, and the rapid fall in unemployment could spell risks if recent trends continue. Exceptional flows of refugees could add to these pressures, while smaller flows of migrants into Ireland with key skills post-pandemic could add to the pressures.

The path forecast for the economy suggests a relatively neutral stance is needed

This path for the economy, with continued growth, would suggest that fiscal policy should be relatively neutral in terms of its overall stance. That is, it should not provide additional stimulus on a large scale over the years to come beyond growing at a sustainable pace of increase. This would avoid excessively boosting an already fast outlook for growth and it would limit

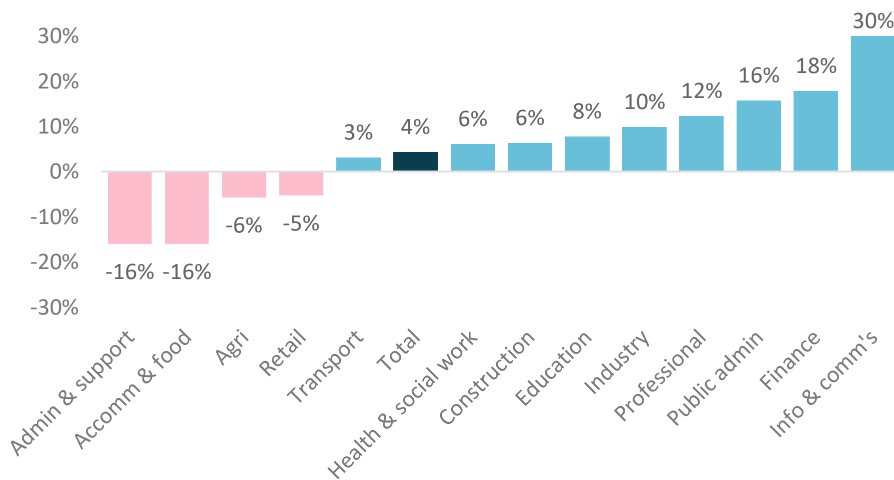
the risks of various pressures potentially leading to overheating in the coming years.

There are clear risks to the path for growth set out in the SPU. There are major downside risks, especially considering the uncertainty surrounding developments related to Russia's war in Ukraine. There are also upside risks, with some sectors facing shortages of workers and ongoing pressures to expand in areas such as housing and public investment that would fuel a further expansion in activity. Policy should stand ready to adapt to these risks.

But there are clear risks to growth

Figure 3.2: The recovery has been uneven

% difference between actual hours worked in Q1 2022 and Q4 2019, seasonally adjusted



Sources: CSO; and Fiscal Council workings.
Notes: In the Labour Force Survey, people can be classified as employed even if they are "away from work" due to temporary layoffs provided they expect to return to work within three months and/or continue to be paid at least half their wage or salary. This complicates assessments of the labour market since the pandemic. The series shown here addresses this issue, with the CSO asking respondents the number of "actual hours" they worked. Get the data.

Complicating the picture is the fact that the recovery has been highly uneven. An illustration of this is provided by hours worked by sector (Figure 3.2). While actual hours worked on aggregate were 4 per cent higher than pre-pandemic levels as of Q1 2022, wide differences remained across sectors. Many sectors have been slower to recover, given the nature of the shock, even as others continued to grow at pace. Some sectors had large reductions in hours worked early this year, such as admin & support services and accommodation & food services, with hours worked down by 16 per in both when compared to Q4 2019. By contrast, hours worked in information & communications and in financial services were 30 per cent and 18 per cent above pre-pandemic levels, respectively.

Some sectors remain relatively depressed, while others continued to grow strongly

The lifting of pandemic-related restrictions this year should see an improvement in sectors worst hit by the pandemic, though the diverging performances means there is wider uncertainty around the long-term supply-side impacts on growth. It is unclear to what extent workers in still-depressed sectors might see demand in those areas recover, or whether they will need to transition to other areas where demand is greater.

In some cases, the same sectors that saw reduced demand owing to confinement measures during the pandemic are also likely to face weaker demand due to price pressures amid the war in Ukraine. For instance, households may reduce expenditure on recreational activities, dining out, and non-essential retail to preserve their expenditure on essential items.

The increase in energy prices will have a significant impact on the economy and public finances, as well as households and firms. The higher prices of imported energy and food imply depressed living standards for the country as a whole by increasing the price of what is consumed relative to what is produced. Fiscal policy cannot permanently shelter the economy from lower real incomes.

In the nearer term, the government faces a delicate balancing act. Certain measures may support households and sectors that are hard hit by higher energy and food prices, which would help avoid an abrupt reduction in domestic spending. But these may also block the necessary adjustment in spending. Large-scale and long-lasting spending would increase the risk of contributing to higher second-round increases in prices and wages, potentially destabilising the economy and the public finances. These policies should aim to moderate the impact of the changes in import prices rather than fully offset them.

Short-term supports can help deal with price pressures

However, some short-term supports, such as those put in place by the Government, can help to avoid an abrupt change in incomes and spending patterns. The supports can help lower-income households that are more vulnerable to higher food and energy prices.

Beyond immediate supports, the Government's choices for economic policy more widely, including on public sector pay and non-pay spending, should avoid adding further to inflationary pressures. Government decisions on pay, together with spending choices, may influence overall economy-wide wage increases and the strength of second-round effects on inflation.

The Government can play a role in encouraging a coordinated response to the higher cost of living. Firms, employees, and the Government could — if they coordinate — achieve an appropriate balance in terms of the supports provided. This could ensure fair outcomes and avoiding sectors competing against each other to raise wages and prices excessively. In the past, “Social Partnership” agreements from 1987 made between governments, employers, trade unions, and other stakeholders sought to ensure a stable pay and industrial relations climate amid changing economic conditions. While the economy has evolved in the intervening years, there is a case to look again at whether a more coordinated approach would help to manage the current situation.

Given the sectoral nature of the shock posed by both the pandemic and the war in Ukraine, targeted and temporary supports will continue to play a key role in supporting the economy. There is a strong argument for temporary and well-targeted supports to be provided to those most deeply impacted by price pressures. These impacts are expected to unwind partially in the coming years, though not necessarily in full.

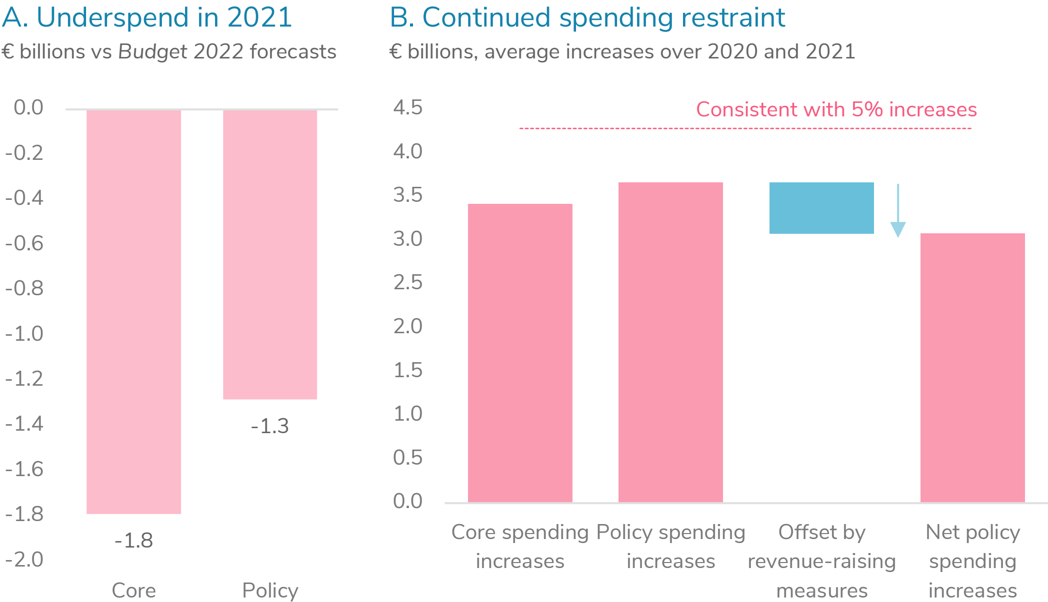
3.2 The Fiscal Stance for 2022

The Council assesses that the Government should stick to its plans for core spending in 2022. This allows for sizeable temporary supports outside of core spending, which are warranted to address cost-of-living impacts and Ukrainian refugees, but these should be well targeted.

The starting position for the public finances in 2022 is now much better than had been projected

The starting position for the public finances in 2022 is now much better than had been projected. Core government spending — outside of Covid-related costs — was revised down in 2020 and 2021. This lessens the risks to the sustainability of the public finances. The underspend in 2021 is visible in two measures of underlying spending. Both core and policy spending point to an underspend of approximately €1½ billion last year (Figure 3.3A).

Figure 3.3: Underspends kept net policy spending growth well below 5%



Sources: CSO; Department of Finance (*SES 2021* and *SPU 2022*); and Fiscal Council workings.
Notes: "Core" spending refers to voted Exchequer spending net of Covid-related expenditure. "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 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. Get the data.

Comparing 2021 levels of spending with 2019, we can see that, on average, permanent spending growth has shown some restraint. Both core spending and policy spending rose, on average by about €3½ billion in 2020 and 2021 (Figure 3.3B). This was offset by the introduction of net revenue-

raising measures of about €½ billion each year.[62] As a result, the net policy spending increases were closer to €3 billion, markedly less than the €4.3 billion that would have been consistent with 5 per cent annual increases like those set out in the new 5% Spending Rule.

It is possible that core spending has settled at a lower level. This could mean that the underspend in previous years might carry through to subsequent years. However, it is also possible that the underspends may unwind, particularly if there is a catch up in health spending or other areas where some parts of core spending were temporarily suppressed due to the impacts of the pandemic or where plans to ramp up recruitment failed to progress as planned.

Recent underspends could yet unwind

Core spending plans for 2022 kept same in levels

The level of core spending set out in the SPU for 2022 is the same as was set in *Budget 2022* last October. Core spending is set at €80.1 billion for this year. However, while the *Budget 2022* projections had assumed core spending would be €75.9 billion for 2021, spending actually came in at €74.1 billion — a sizeable downward revision. In addition, as Section 2 notes, early transfers of money in December 2021 for capital spending due to take place in 2022 mean the actual underspend in 2021 is greater still.

Keeping the core spending plans unchanged in levels for 2022 suggests a sharper year-on-year increase than originally planned.[63] However, when the revisions to past years are considered, the overall trajectory for the public finances is more sustainable.

The Government is implementing the 5% Spending Rule in *level* terms. This means that it is sticking to initially-allocated spending ceilings rather than growing by 5 per cent from the level of spending outturns. As Box I notes, applying the rule in this way certainly helps with medium-term budgeting. But it can be less effective if outturns are substantially higher or lower than expected and if inflation is markedly different to what was expected. The

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[62] These revenue-raising measures include carbon tax increases of about €140 million p.a. in both budgets, tobacco products excise increases of €57 million p.a. and some additional revenue-raising measures, including from partial indexation of the income tax system.

[63] The Budget plans had implied a €4.2 billion (5.5 per cent) increase. This would have been broadly consistent with, although slightly faster than, the Government's 5% Spending Rule. However, the downward revisions to core spending in 2021 mean that the increase in 2022 is now going to be €6 billion (8.1 per cent), albeit that this entails still reaching the same level.

Government should still develop the rule to include the impact of tax changes (currently not considered by the rule).

Temporary spending likely to high in 2022

The Government is likely to spend a substantial amount of resources on temporary supports in 2022. *Budget 2022* had allowed for €7 billion (2.9 per cent of GNI*) in temporary spending measures associated with the Government's response to Covid. This included €3 billion of planned Covid-related spending and €4 billion of contingency reserves.

Substantial temporary supports are likely in 2022

While the €7 billion allocation is unlikely to be needed to respond to the impact of the pandemic, the allocation is likely to be absorbed instead by a raft of budgetary measures introduced since the turn of the year. These measures are to address the unexpected rise in prices in the economy and to support Ukrainian refugees arriving in Ireland.

The additional temporary measures introduced from the turn of the year to the publication of the SPU to address the rise in the cost of living, both in terms of tax and spending measures, have amounted to about €1 billion (0.4 per cent of GNI*). This is on top of general welfare increases introduced in *Budget 2022*. Since the SPU was published, about another €0.2 billion of cost-of-living measures have been introduced. Overall, this is less than the estimated annual boost to receipts from higher nominal growth (about 1 to 1½ per cent of GNI*) that is likely to result in the coming years (Box E).

Table 3.1: Cost-of-living measures not targeted

€ millions

	Cost	Targeted?
Excise duty cuts on petrol, diesel, and marked gas oil until mid-October	417	No
Energy credit of €200 to all households	379	No
Public transport fares reduced by 20%	54	No
VAT cut on electricity and gas	46	No
Tillage incentive scheme	12	Some targeting
Reduced caps on school transport fees	3	Some targeting
Lump sum €125 payment to those on fuel allowance supports	49	Yes, targeted
Lump sum €100 payment to those on fuel allowance supports	37	Yes, targeted
Drug Payment Scheme threshold reduced to €80	17	Yes, targeted
Increase in income threshold for working family payments brought forward to 1 April	4	Yes, targeted
Haulier support scheme of €100 per week	18	Yes, targeted
Total	1,036	

Sources: Department of Finance; and Fiscal Council workings. Figures correct as of SPU publication. However, an additional €0.2 billion of measures have been introduced since then.

The temporary measures introduced to address cost-of-living pressures have mostly relied on measures to cut the final price of energy rather than

targeted interventions. Of the €1.0 billion of measures introduced this year ahead of the SPU, €896 million were not targeted (Table 3.1). Since then, the Government has decided to extent the temporary VAT rate cut for the hospitality sector to 9% for a further six months to March 2023 at an additional cost of €250 million.

Relying on untargeted measures means that substantial public resources are being transferred to individuals who already have high incomes. This means that they are relatively well insulated from the impacts of the recent rise in prices. Higher-income households are also less likely to change their spending patterns as a result of receiving these benefits. It is more likely that such high-income households would simply increase their savings rather than using the additional resources to alter their consumption patterns substantially. In turn, this reduces the likelihood that the Government would see revenues returned to it from any subsequent spending. In addition, the measures, by reducing fuel and energy prices, potentially conflict with the Government's medium-term climate objectives. By contrast, targeting the supports at lower-income households would ensure that those individuals most affected by rising prices would be protected, and it would reduce the deadweight impacts otherwise seen.

Overall assessment for stance in 2022

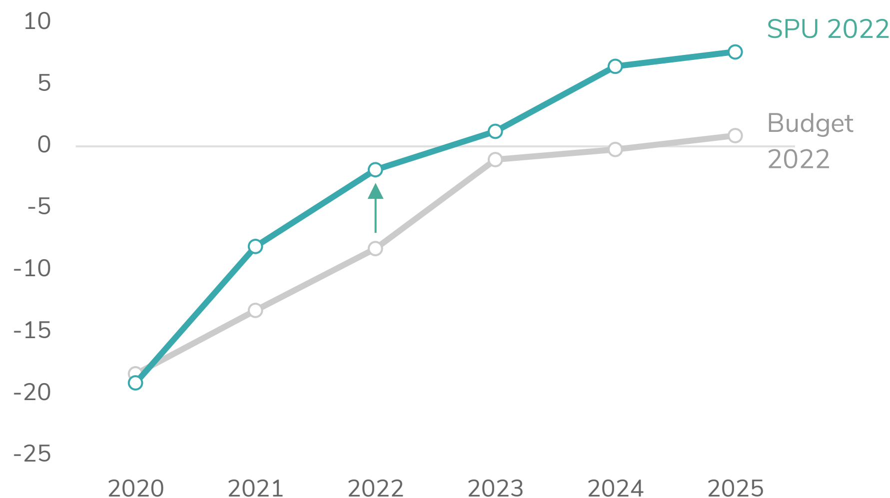
The general government deficit for 2022 is now projected to be just under €2 billion, as compared to €8.3 billion at Budget time in October (Figure 3.4). This improvement is forecast by the Department to be sustained for the most part, with a surplus for 2025 now €6.8 billion larger than was projected at Budget time. This essentially reflects a higher level of tax revenues in 2025 based on the strength of recent outturns, while the expansion in core spending remains closer to what was planned, and in line with the sustainable rate of growth for the economy.

The improvement in revenues can be accounted for in part by the recovery and expected growth. However, it also includes unexpected shifts in receipts that might not be sustained, such as higher corporation tax receipts (Box G), as well as the surprising jump in income tax receipts last year. The latter might well persist. For instance, Box B and Timoney (2022) show that the income tax jump appears to be only partly explained by irregular earnings, such as bonuses, and there is some reason to think that strong

earnings growth in high-income sectors might be sustained, given its performance in recent years

Figure 3.4: Earlier and larger improvement in budget balance projected

€ billions, general government basis



Sources: Department of Finance (SPU 2022 and Budget 2022). Get the data.

The Council's assessment remains that the Government's plans for 2022 strike an appropriate balance between continuing to support the economy, managing the rise in food and energy prices, and keeping the public finances on a sustainable path. While the pace of expansion in overall general government spending for 2022 has risen since budget time, the path for spending in 2022 remains broadly consistent with a sustainable pace of increase over the medium term. That is, a path which is consistent with estimates of the underlying potential growth rate of the economy.

The Government's plans for 2022 strike an appropriate balance between continuing to support the economy and keeping the public finances on a sustainable path

The Council welcomes the use of contingencies to cope with potential additional costs related to the pandemic, supports for refugees, and other temporary measures.

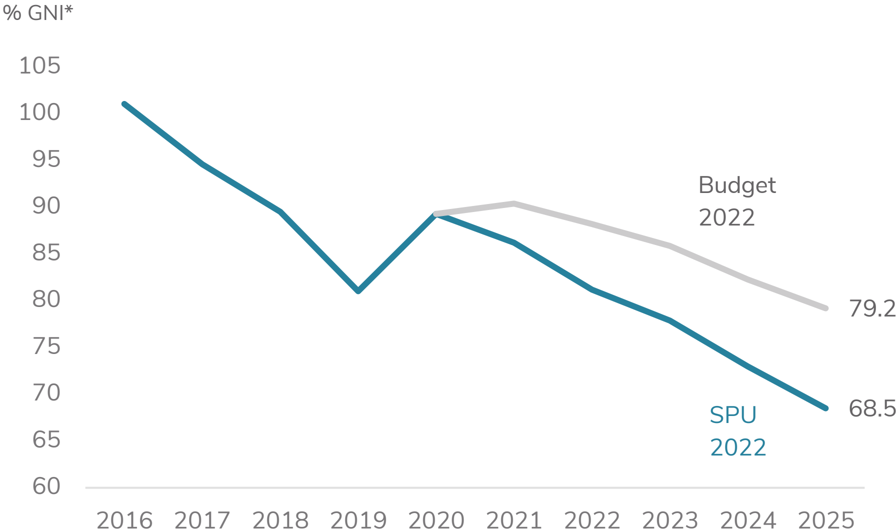
Measures to support the cost of living will help to manage the adjustment to higher energy and food prices. Existing measures may need to be extended or expanded if prices remain high during the year or increase further: these temporary and targeted measures should be carefully designed to minimise the fiscal impact. The Council therefore assesses that the stance for 2022 set out in *SPU 2022* is conducive to prudent economic and budgetary management and should help to support the recovery of the public finances.

3.3 The Government's fiscal stance for 2023–2025

The Government's overarching budgetary strategy, as stated in *SPU 2022*, is to slow "the pace at which debt is accumulated, so that interest expenditure does not become a burden on economic growth and living standards". The way this strategy is phrased is less ambitious than the commitment, in *Budget 2022*, to ensure that the debt ratio is put on a downward path over the medium term. However, the projections included in the SPU indicate a stronger pace of debt reduction than was planned at the time of *Budget 2022* (Figure 3.5).

The projections indicate a stronger pace of debt reduction than planned at Budget time

Figure 3.5: Debt ratios are projected to be on a more prudent path



Sources: Department of Finance (SPU 2022 and Budget 2022). Get the data.

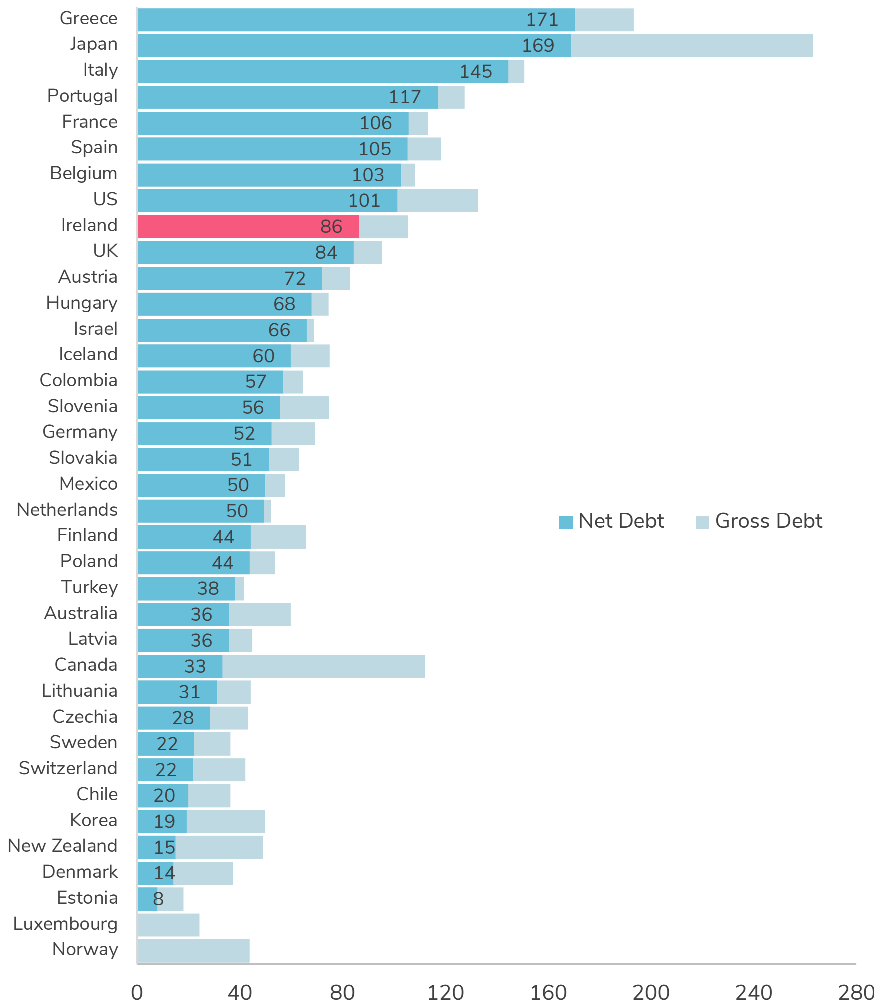
Ireland's level of government debt remains high, as the country entered the pandemic with an already high level. Plans to reduce it are thus welcome. This approach should help to ensure the sustainability of the public finances and maintain Ireland's scope to support the economy in a meaningful way in future downturns. Longer-term challenges remain, including ageing pressures, which will put pressure on deficits and debt ratios in the years ahead. Using good times to build buffers should help to provide scope to deal with unexpected shocks in future.

Ireland's debt ratio entered the pandemic high and remains high

At the end of 2021, Ireland's net debt ratio was 9th highest out of 37 OECD countries for which data are available (Figure 3.6). It is estimated to have been equivalent to 86 per cent of GNI* last year.

Figure 3.6: Ireland has a high debt ratio

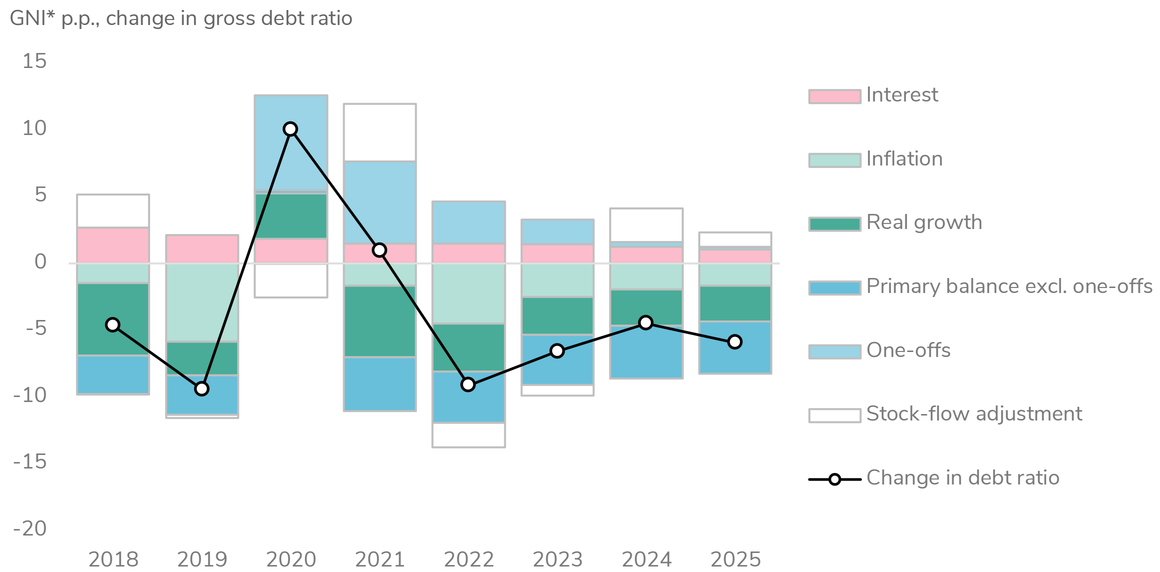
% GDP (% GNI* for Ireland), general government basis, end-2021



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

The net debt ratio should fall steadily in the coming years. This is likely to be helped by strong real growth, inflation, and the positive underlying non-interest or "primary" balance — ignoring one-off spending measures (Figure 3.7).

Figure 3.7: Growth, inflation, and primary surpluses to reduce debt ratios



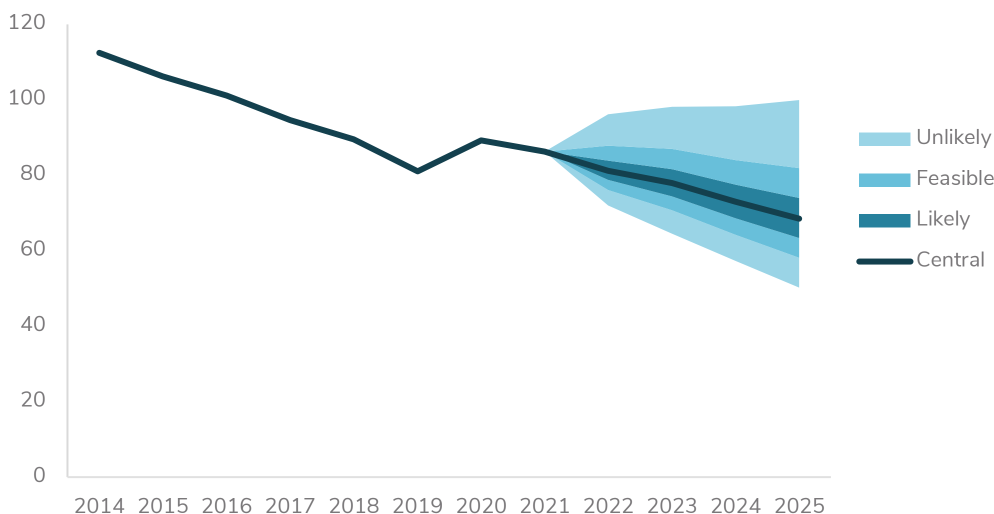
Sources: Department of Finance (SPU 2022); CSO; and Fiscal Council workings. Get the data.

The debt ratio is projected to fall from high levels in the coming years, although a higher starting debt ratio means a greater degree of uncertainty around its path. The SPU projections imply that — if stated policies are followed and macroeconomic conditions remain favourable as indicated — the debt ratio has a high probability of falling steadily in the coming years (Figure 3.8). A modelling exercise suggests that there is a high probability the debt ratio will fall at a steady pace over the next three years. This is based on the current level of debt, interest rates, and growth, together with historical levels of uncertainty. By contrast, the estimated probability of an unsustainable path — defined here as one where debt ratios are above current levels out to 2025 — has fallen to just 15 per cent from the 25 per cent indicated by *Budget 2022* forecasts. This is largely because of the lower debt ratio and smaller deficit in 2022.

A higher starting point means greater uncertainty around the debt ratio's path

Nevertheless, there remain a large number of risks in the current economic and geopolitical environment. Modelling approaches like that shown in Figure 3.8 find it difficult to capture such risks, given their low-probability but high-impact nature. This is particularly true when the historical data used to generate the model do not capture such events (for example, wars or, prior to Covid, pandemics).

Figure 3.8: Probability of unsustainable debt path now smaller



Sources: Department of Finance forecasts; CSO outturns; NTMA data on debt securities; and Fiscal Council workings.
Notes: In the stochastic fan chart projections, the SPU 2022 projections are treated as the central or most likely scenario. "Likely" covers the 30% confidence interval surrounding these projections; "Feasible" the rest of the 60% interval; and "Unlikely" the rest of the 90% interval. The estimates are based on the Council's Maq model (Casey and Purdue, 2021). Get the data.

Measures have been taken to insulate the public finances from interest rises

The cost of Ireland's new issuance of Government debt has risen substantially from low levels in recent months. Ten-year bond yields have risen from a low of about -0.4 per cent in January to about 1.6 per cent (Figure 3.9A).

The cost of Ireland's borrowing has risen, but measures have been taken to insulate the State from interest rate shocks

The sharp rise is in line with wider trends internationally. It also comes amid the European Central Bank's (ECB) decision to phase out exceptional monetary support measures, given that Euro Area Member States have been recovering from the economic impacts of the pandemic. It is also likely to reflect investor expectations that the ECB may tighten policy further to tackle high rates of inflation across the monetary union.

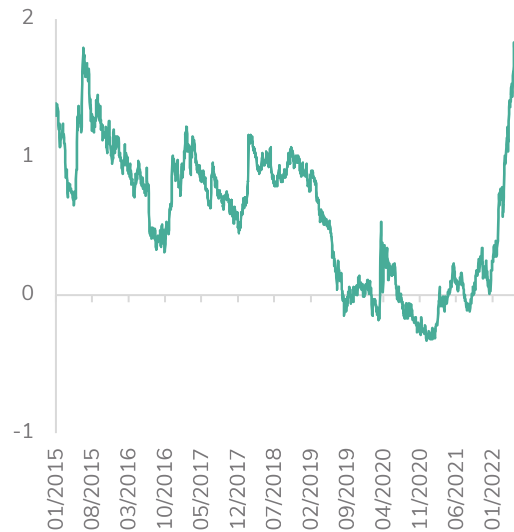
The difference, or "spread", between Ireland and German 10-year yields by comparison has remained reasonably stable (Figure 3.9B). The spread has traded at a narrower range of typically 0.3 to 0.4 percentage points over the past two years. Recently, this has risen to about 0.6 percentage points above German yields, which is close to where spreads were around the start of the ECB's Pandemic Emergency Purchase Programme (PEPP) and in line with the pre-pandemic average over 2015–2019 (at 0.5 percentage points). This suggests that Irish creditworthiness, compared to assessments in

recent years, is currently not regarded by markets as especially risky relative to German creditworthiness.

Figure 3.9: Bond yields have risen, but broadly in line with wider trends

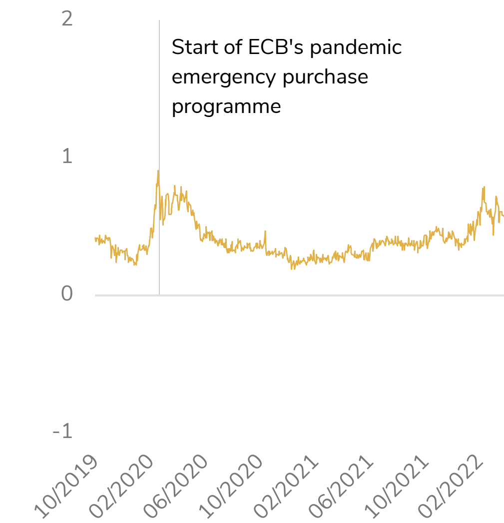
A. Spike in yields

Percentage points, 10-year bond yields



B. Broadly consistent with international trends

Percentage points, spread of Irish vs German 10-year yields



Source: Macrobond; and Fiscal Council workings.

Initial Government borrowing costs this year have remained reasonably favourable. The NTMA has issued €5.75 billion thus far in 2022. The average term of this debt has been 13 years at an average rate of 0.76 per cent.

While the recent rise in interest rates has been sharp, some context is needed:

First, interest rates still remain low from a historical perspective. For example, the average rate for G7 countries, aside from Italy, has risen to 1.7 per cent of late, but this is still remarkably low compared to interest rates in recent decades. Indeed, rates only fell below 2 per cent persistently after 2012, having spent the previous three decades at higher levels (Figure 3.10).

Figure 3.10: Interest rates still remain low in an historical context

% ten-year bond yields, G7 countries excluding Italy

Sources: Macrobond; and Fiscal Council workings.
Notes: As in Rachel and Summers (2019), yields for the G7 are the average of securities across the G7 excluding Italy. Data form an unbalanced panel meaning that data for all G7 countries are not available for all of the earlier years in the sample. Get the data.

Second, Ireland's public finances have built up some resilience to interest rate shocks in the coming years due to the structure of existing debt. The Council's debt sustainability modelling using the Maq model suggests that each additional 1 percentage point increase in typical borrowing costs, if sustained out to 2025, would translate to a deficit impact of 0.2 per cent of GNI* and 0.3 percentage points by 2032. This suggests the rise seen so far of about around 1.5 percentage points would mean a deficit impact of around 0.3 per cent of GNI* by 2025 and 0.45 per cent by 2032.[64] This recognises the expected refinancing of existing debt, given their maturity profile, and the composition of debt (for example, bonds with fixed or variable interest costs associated with them).

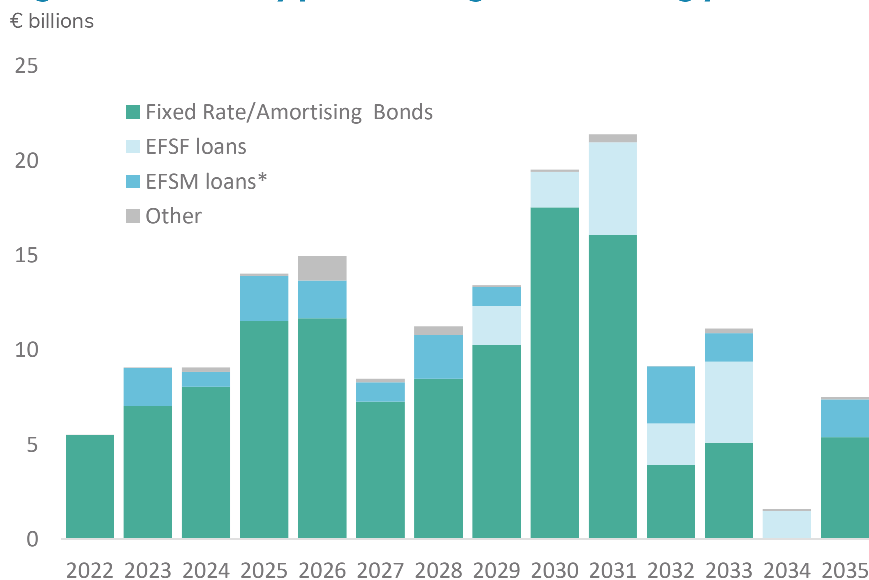
Third, Ireland has very large cash balances outstanding. As of end-March, cash and liquid assets held by the State amounted to €29 billion, equivalent to 13 per cent of GNI* (see also Box F). This would be almost sufficient to cover the entirety of Ireland's medium- and long-term debt of €32 billion maturing between end-March 2022 and end-2025, assuming EFSM loans

[64] The impact is roughly linear: a 2-percentage point impact would translate to 0.4 per cent of GNI* additional interest expenditure, and 3 percentage points to 0.6 per cent of GNI*. Extended to 2032, the impacts would rise to 0.3 percentage points, 0.6 percentage points, and 0.9 percentage points for sustained interest rate rises of 1, 2, and 3 percentage points, respectively. By weakening the annual budget balances being run, the eventual effect of the rise in interest rates would be estimated to accumulate to impacts on the 2032 debt ratio of +11, +12, and +16 percentage points, respectively.

are extended (Figure 3.11). The Exchequer borrowing requirement is also expected to be negative over this period. That is, Ireland is expected to run budget surpluses from next year. This would further slow the likely rundown of cash balances so that the State will probably hold large cash balances for some time to come, assuming the NTMA continues to issue debt in line with the policy of recent years. For example, a policy of targeting bond issuance of even about €6 billion per annum — less than half the average €13.7 billion of annual issuance over the past ten years — could see cash balances remain at or above current levels assuming the current Exchequer borrowing requirements projected are correct. These cash balances may amount to pre-funding in an environment of high uncertainty and rising interest rates and should help to mitigate against more extreme "tail" risks.

Figure 3.11: Maturity profile manageable in coming years

€ billions



Sources: NTMA; and Fiscal Council workings. Get the data.
Notes: The EFSM loans are subject to being extended, such that their weighted average maturity will be a maximum of 19.5 years — about seven years more than the initial average maturity. The Figure assumes no extension, though these loans could individually be extended.

While the measures taken by the State to insulate itself from interest shocks will help, there are other risks tied to interest rate rises that are more difficult to contain. The impact of higher interest rates on households and businesses with outstanding debts could dampen activity, while international demand could face similar impacts if interest rates rise globally. To the extent that this dampens activity, this could depress Government revenues in future and raise spending on unemployment-related supports.

The Government has developed more credible plans, but gaps remain

The Government has made significant steps towards developing a credible fiscal plan, as first committed to in the 2020 *Programme for Government*. It has established an approach to allow for the costs of maintaining public supports and services in real terms; and it has committed to a new 5% Spending Rule.

The Government still needs to substantially improve its medium-term budget planning

Table 3.2: Some backward steps in terms of developing credible fiscal plans

Objective	SPU 2022	Council calling for this since	Progress	
Present five-year-ahead forecasts	Despite a commitment to five-year-ahead forecasts, the Department has now reverted to three-year-ahead forecasts	Nov-17		Limited (downgraded)
Base projections on realistic spending plans	More realistic than previous rounds; but slightly short of Stand-Still costs	Jun-16		Mostly there
Commit to medium-term fiscal objectives	The 5% Spending Rule provides more formal numerical targets, but these need development	Nov-17		Mostly there
Consider measures to strengthen fiscal framework	Spending Rule and Existing Level of Services are excellent initiatives but can be improved further	Nov-17		Some
Provide transparent costings of major policy changes	Still not clear if major Programme for Government (2020) policies including Sláintecare are factored in	Dec-20		Some
Show how rules will be complied with	Document sets out structural balances that appear compliant, but some areas are overlooked	Dec-20		Some
Indicate how taxes would be adjusted if needed	No information on this, but Tax and Welfare Commission established	Dec-20		Limited
Make non-Exchequer forecasts more transparent	Marginal improvement in transparency shown	Nov-19		Marginal/none
Clarify how the Rainy Day Fund will be used in future	No mention of it	Jun-16		Marginal/none
Overall progress				**Some**

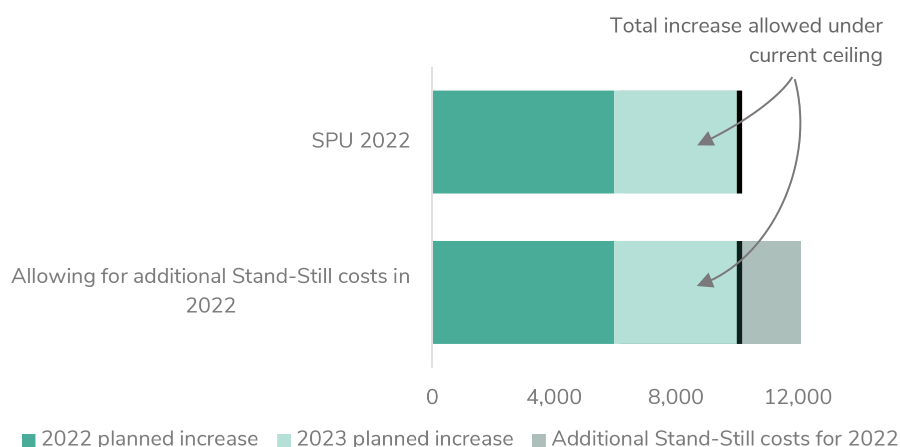
Note: Compared to the Council's past December 2021 assessment, the only revision was to downgrade the assessment of progress on the Government's forecast horizon (revised down from "Mostly there").

However, the Government still needs to substantially improve its medium-term budget planning (Table 3.2). Furthermore, the Government has backslid on its five-year forecast horizon; costings of major policy commitments such as Sláintecare and climate-transition measures are still not available; the transparency of fiscal projections has not improved; there remains a lack of planning for potential tax-raising measures; and there are no plans for the Rainy Day Fund. While the Existing Level of Service approach (Box D) helps, it only applies to one-year-ahead forecasts.

For 2023, the Government has space within the spending rule to introduce spending increases and adjustments to wages and welfare rates to reflect unexpected inflation, but it will have to make some choices. The unexpected inflation in 2022 will mean real cuts to various public services and supports. This is due to the fact that the actual rate of increase was slower than wage and price inflation in the economy (Box I). Allowing for full indexation could require another €2 billion in core spending increases (Figure 3.12). This would push spending increases beyond both *SPU* 2022 plans and the total increase allowed under the Government's current ceiling.

Figure 3.12: Full indexation would push spending above the 2023 ceiling

€ million increases in core spending



Source: Department of Finance (SPU 2022) forecasts; and Fiscal Council workings. Get the data.

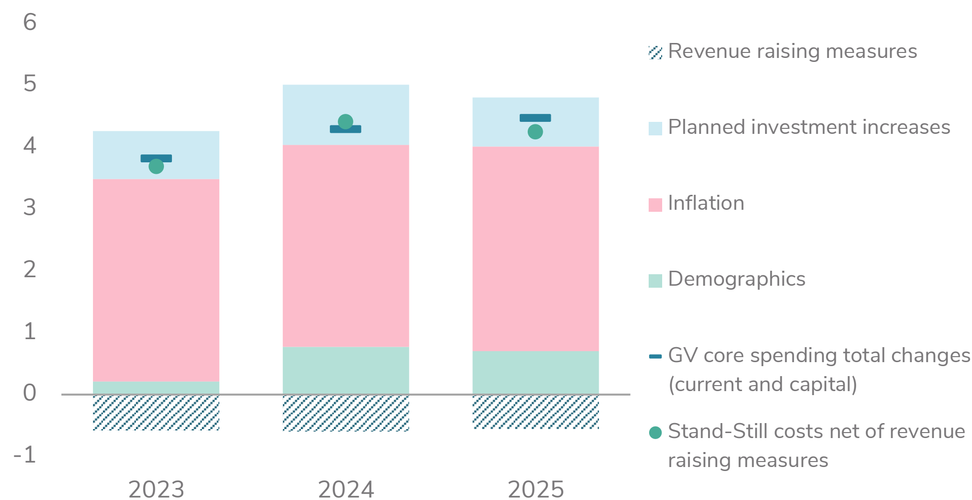
Looking further ahead, allowing for full indexation of spending in a Stand-Still-type approach would also likely see the Government exceed its spending ceilings over the entire forecast horizon. This approach would entail tracking economy-wide wages and price rises for public sector wages and welfare rates, while also sticking to capital plans. As Figure 3.13 shows, the increases for core current and capital spending implied by the 5% Spending Rule are slightly below what a full provision for Stand-Still pressures plus capital plans would suggest is required for full indexation.

It is possible that the underspends in 2021 could alleviate these pressures. The SPU does not currently assume underspends in 2021 will carry through to 2022 and subsequent years. However, the additional fiscal space afforded by a lower underlying starting level of core spending, given planned ceilings, could yield sufficient scope to address some of the Stand-Still costs arising from unexpected inflation.

The Government needs to spell out what choices it will make, given various spending pressures arising. If it is to stick to its ceilings, the there are some difficult trade-offs. To stay within the ceilings, it may need to *only partially* index some parts of current spending, introduce additional revenue-raising measures, or reduce/delay its capital plans. Alternatively, partial indexation of the tax system — as is assumed here and in the SPU figures — would bring policy changes in line with 5 per cent net increases.

Figure 3.13: Inflation and pensions costs will raise spending pressures

€ billion, year-on-year changes



Source: *SPU 2022* and Fiscal Council workings. Get the data.
Notes: Planned investment increases refer to gross voted core capital spending changes set out in the SPU. "GV core spending total changes" refers to the planned increases in both gross voted current and capital spending as set out in the SPU projections.

Implications of the medium-term fiscal stance

For 2023 to 2025, the *SPU 2022* sets out Government plans for net policy spending increases that are broadly consistent with sustainable growth rates in the economy and revenues.

The Government's plans for 2023 to 2025 are broadly aligned with sustainable growth rates in the economy and revenues

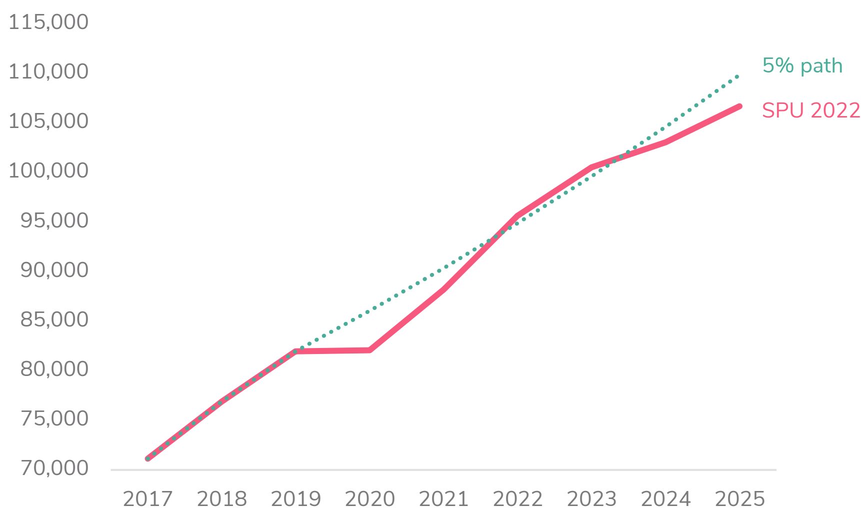
One way to illustrate the sustainability of the Government's plans is to examine the path for policy spending less revenue-raising measures. This differs from the Government's 5% Spending Rule in that it recognises the impact of tax measures as well as spending measures. A "sustainable" path could be considered where net policy spending grows in line with potential output growth rates of about 3 per cent per annum plus some measure of inflation. There are different approaches to taking inflation into account: this is sometimes based on actual or near-term forecasts of inflation or can also be set based on a long-term view of price stability (Box I). Taking into account inflation could lead to procyclical increases in spending if this

inflation is due to overheating or negative supply shocks. However, it may be difficult to use a steady-state inflation assumption at a time of large deviations of inflation from the medium-term rate.

One way to assess the *SPU 2022* projections and the path they imply for the public finances is to assess them against a 5 per cent path, similar to the Government's spending rule. A caveat is that the Government's 5% Spending Rule does not apply to general government spending, and it does not account for the impact of tax measures. However, if applied to this benchmark, the projections suggest that net policy spending would remain within this out to 2025 (Figure 3.14).

Figure 3.14: Net spending path broadly aligned with 5% path

€ million, policy spending adjusted for cumulative net revenue-raising measures from 2019 on



Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: Policy spending is general government expenditure less interest costs, one-offs, and the estimated costs associated with cyclical unemployment. The "5% path" assumes that policy spending grows in line with potential output of 3 per cent and steady-state price inflation of 2 per cent. Get the data.

The Council estimates that the structural budget balance — the underlying budget balance when corrected for temporary factors — is broadly close to a balanced position. Having broadly closed the structural balance after the financial crisis, Ireland entered the pandemic with a neutral balance.

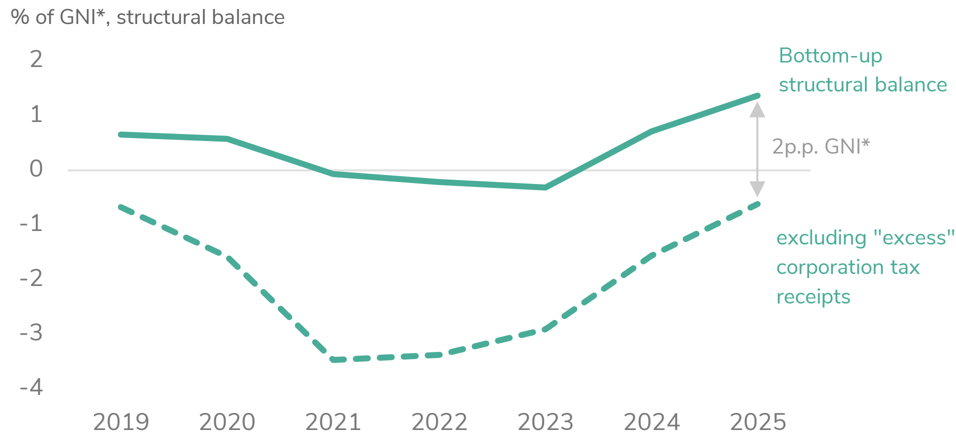
However, the underlying budget balance is supported by exceptional levels of corporation tax

However, the structural budget balance is supported by exceptionally high levels of corporation tax receipts (Figure 3.15). This impact has grown over time and means that the underlying fiscal position is potentially much less benign than it otherwise would be. Leaving out estimated "excess" corporation tax receipts would leave a structural deficit of 0.6 per cent in 2025 — some two percentage points lower. This provides an indication of

the “gap” in the public finances that could appear if these excess receipts were to stop. It also provides a measure of how much Ireland is currently benefitting from inflows of revenue derived from foreign-owned multinational enterprises.

Figure 3.15: The underlying budgetary position is close to balance but supported by exceptional corporation tax receipts

% of GNI*, structural balance



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Note: This figure shows the Council’s bottom-up estimate of the structural balance where potential output is assumed to grow at 3 per cent over 2021 to 2025. Inflation forecasts are based on the Department of Finance’s *SPU 2022* forecasts. See Box I of the May 2021 *Fiscal Assessment Report* for further details. The “excess” corporation tax receipts for forecast years are the same in nominal terms as those estimated for 2021, €7.6 billion, but adjusted down for the Department’s €2 billion allowance for a downward correction to corporation tax receipts so that it is €5.6 billion by 2025.

Given the projections for growth and the budget balance, the net debt ratio should stabilise this year and start to fall steadily after 2022. However, because debt ratios are already high, this amplifies some of the existing uncertainties, given the magnifying impact that are mechanically borne out due to changes in growth, inflation, and interest rates (Barnes, Casey, and Jordan-Doak, 2021).

3.4 Medium-term challenges

There are multiple challenges facing the Government's fiscal plans, which it needs to address urgently. This section explores these in more detail.

There are multiple major challenges facing the Government's fiscal plans

Over-reliance on corporation tax receipts

The Government continues to see its reliance on corporation tax to fund public services rise over time. In 2014/2015, about one-in-ten euros of core spending was covered by corporation tax receipts. In 2021, it was more than one-in-five euros.

There are other tax risks related to the concentration of activities beyond corporation tax. Revenue (2021) data show that almost 5 per cent of all income tax, USC, employers' PRSI and VAT paid by companies came from the top 10 corporate groups. On average, each of these paid about €144 million in those taxes for 2021, as compared to about €165,000 for all other companies.

It is now urgent that the Government set out clear plans to reduce its dependency on corporation tax receipts. As Box G shows, at least €6 billion of corporation tax receipts collected last year were not explained by the domestic economy according to the Council's estimates. And, while corporation tax receipts have risen sharply since the Government first estimated potential losses owing to international tax changes, these have not been updated since that time.

The Government has collected some €22 billion of excess corporation tax receipts

The Council estimates that, since 2014, the Government has collected some €22 billion of corporation taxes beyond what can be explained by the domestic economy. A substantial portion of this figure has been absorbed into permanent spending, including on health. This raises the risk that potential reversals of these receipts in future could lead to sharp increases in borrowing requirements to fund recurrent commitments.

Recognising and unwinding the reliance on corporation tax could be helped with two actions. First, the Government should present the budget balance excluding its estimate of excess corporation tax receipts — similar to what is shown in Figure 3.15. Second, it should implement a strategy to unwind this excess gradually over time, potentially through the Rainy Day Fund or by a rapid reduction in debt. Box G provides more detail on how these actions could be implemented.

Box G: Exchequer has benefited from some €22 billion "excess" corporation tax

This box presents new analysis showing how the Exchequer has benefited from some €22 billion in corporation tax receipts in recent years, which could be considered "excess". That is, beyond what is explained by the performance of the domestic economy.

Over the past seven years, corporation tax receipts have continued to surge and become even more concentrated among a handful of firms. Receipts represent nearly one-in-every four euro raised by the Exchequer, and the top-ten paying companies account for more than half of those receipts: up from a quarter in 2008.

Corporation tax receipts could still be subject to sharp reversals. They are more volatile than other major taxes; prone to larger forecast errors; concentrated in a handful of companies; and they are exposed to changes in the global tax environment.

At the same time, the Government has increased its reliance on these receipts to fund day-to-day public services and supports. By funding current spending with corporation tax receipts, the Government risks having to adjust current spending down to set the public finances on a sound footing should receipts fall.

Unfortunately, the Government has no explicit strategy to reduce this over-reliance. This box sets out the Council's assessment that (1) the Government should clearly show the impact of excess corporation tax receipts on the budget balance and (2) the Government should take measures, including potential use of the Rainy Day Fund or faster reductions in debt, to save rather than spend these excess receipts.

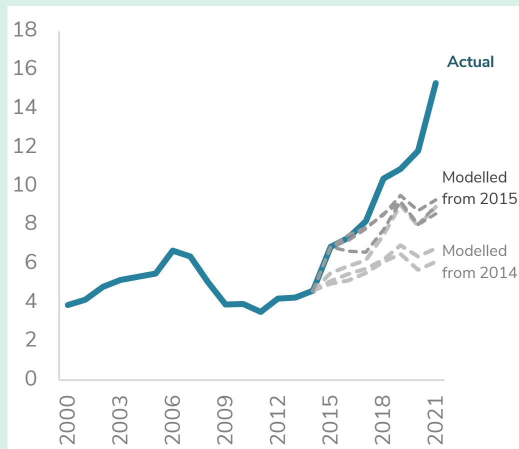
How much corporation tax receipts are potentially at risk?

The Council's analysis suggests that some €6 to 9 billion (40–60 per cent) of the total €15.3 billion of annual corporation taxes collected in 2021 are not explained by the performance of the domestic economy (Figure G1A).[65] In other words, these appear to be "excess" to what might be driven by the expansion in domestic economic activity.

Figure G1: A substantial amount of corporation tax can be considered "excess"

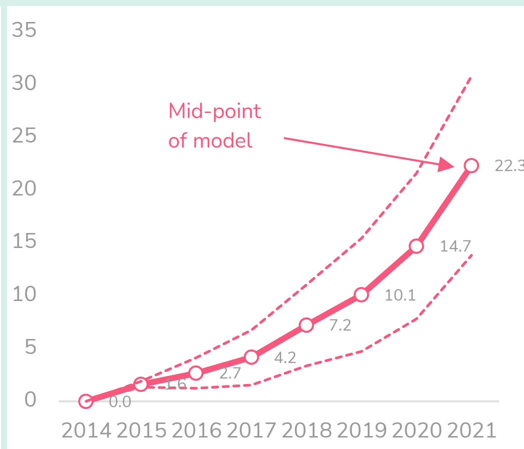
A. Modelled vs actual receipts

€ billions



B. Cumulative "excess" receipts collected

€ billions, cumulative gap for model vs actual



Sources: Revenue data; and Fiscal Council workings. Get the data.
Notes: The suite of models estimates use Domestic GVA and GNI* to predict receipts from 2014 and 2015.

[65] Estimating receipts potentially at risk of sudden reversals is complicated. One way to get at this applied by the Council is to adapt similar modelling approaches to the Department's for forecasting. However, instead of applying these approaches to the overall economy, we apply it to CSO measures of the domestic economy. This helps ascertain the exceptional performance in corporation tax receipts driven by foreign-owned multinationals.

Looking at the cumulative excess of receipts received since 2015, the analysis suggests that some €22 billion of corporation taxes have been collected over and above what can be explained by the performance of the domestic economy (Figure G1B). The uncertainty range around this is very large, with estimates ranging from €14 to 31 billion depending on the modelling approach used.

In line with this approach, two years ago, the Department of Finance (2020) recommended assessing the potential "froth" in corporation tax receipts. Its approach was intended to identify what was "potentially 'windfall' in nature". The approach involved comparing corporation tax's share of total taxes to its historical average of 14 per cent. Anything above 14 per cent could, in the Department's approach, then be considered froth.

If the Department's approach was applied to the same period as the analysis above, it would suggest that a cumulative €15 billion of froth in corporation tax has been collected in recent years.

The analysis above suggests that (1) there is a large exposure to annual corporation tax receipts that is *not* explained by the performance of the domestic economy; and (2) this has resulted in a substantial gain to the Exchequer in recent years.

As shown in the Council's recent report on the health budget (Casey and Carroll, 2021), a substantial portion of the excess receipts has been absorbed into ongoing spending. For instance, corporation taxes have come in on average €1.2 billion higher than forecast at the start of the year each year since 2014. Over the same period, health spending has averaged overruns of €0.8 billion each year, with most of this permanent in nature, including for permanent staff increases or current spending increases elsewhere.

Ireland's own form of oil wealth

A useful analogy for these exceptional levels of receipts is the oil wealth from which countries such as Norway have benefited. In much the same way, Ireland's remarkable levels of corporation tax receipts are volatile, difficult to forecast, somewhat removed from other activities, and subject to potential reversals in future.

In 1990, Norway decided to start sending its oil and gas revenues to a special oil fund. Various goals included saving wealth for future generations; cushioning fiscal sustainability in case commodity prices reversed; and avoiding the temptation to spend revenues in full. A concern was that spending receipts as they came in would have had procyclical consequences: domestic inflation, appreciation of the domestic currency, and lost competitiveness. Instead, the Norwegian Government opted to use only the returns generated by the oil fund to serve current generations, while preserving its overall value for future generations (Yukhov, 2021; Bhopal, 2021).

What can be done to reduce the risks?

Ireland's dependency on exceptional corporation tax receipts is now regularly baked into the annual budgetary arithmetic. That is, the Government does not currently have a plan to reduce its dependency on corporation tax receipts. Instead, the tax base is for the most part assumed to grow broadly in line with wider economic activity and there are no plans to actively manage down the associated risks.

Forecasting slightly lower corporation tax receipts and planning for reducing the Government's reliance on these receipts are two different things. Reducing the risks should entail a clear strategy being set. This should include ways to reduce the dependency already built up and plans for how these receipts might be replaced in future, should they reverse.

The Commission on Taxation and Welfare is likely to focus on potential areas for replacing any lost corporation tax receipts when it submits its report to the Minister for Finance (by 1 July 2022). But, as it stands, the Government does not have a credible strategy to address the over-reliance on corporation tax receipts built up in recent years.

The Council's assessment is that risks could be mitigated with two actions.

First, the Government could report on its budget balance, excluding a measure of "excess" receipts in order to better communicate what the underlying fiscal position is likely to be. Figure 3.15

shows what this would look like when applied to the structural budget balance. The Department of Finance (2019) proposed defining a budget balance figure excluding some element of the corporation tax "froth" three years ago, given its view that the headline balance was "being flattered by very strong [Corporate Tax] receipts".

Second, the Government should establish a mechanism to reduce its reliance on excess corporation tax receipts. This would involve two steps:

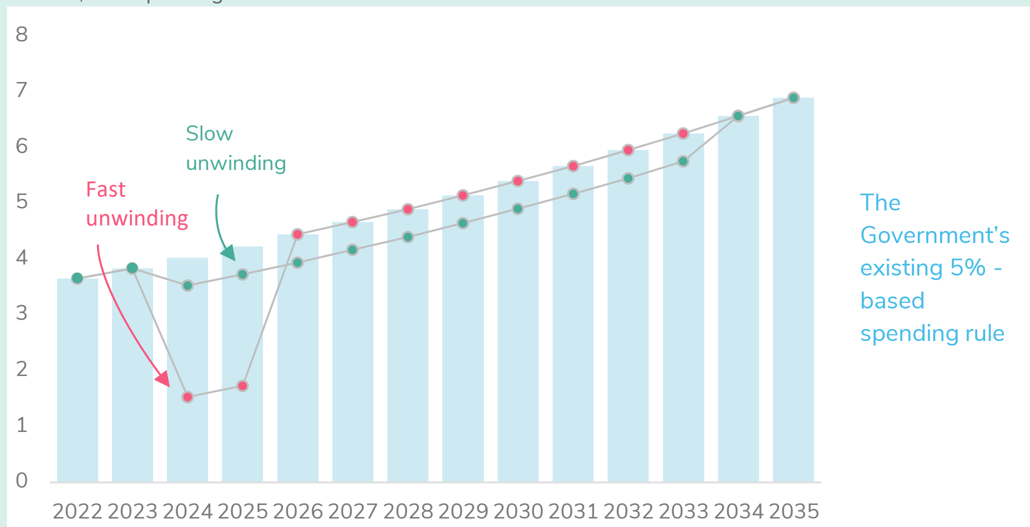
a) the Government should identify the amount of corporation tax currently raised annually that it considers to be excess.

b) the Government should develop a plan to gradually reduce the reliance on this excess over a defined period of time.

As an example of how the dependence could be reduced, consider an illustrative scenario in which the excess corporation tax receipts were identified as being €5 billion with a plan set to reduce the reliance on this either urgently (say, over two years) as might happen if these receipts were to disappear rapidly, or gradually (say, over ten years) which could happen if the Government took pre-emptive action to reduce dependence on excess corporation tax revenues. This could entail reducing planned core spending increases by €2.5 billion in both 2023 and 2024 or by €0.5 billion annually over the next ten years (Figure G2). Alternatively, revenue-raising measures equivalent to the same amounts could be introduced to offset the overreliance on corporation tax and return spending to the higher level consistent with the 5% Spending Rule.

Figure G2: Excess can be unwound with slower spending rises or new revenues

€ billions, core spending increases



Source: Fiscal Council workings.

These approaches give an illustration of how excess corporation tax receipts built up to date could be unwound. If followed, along with the 5% Spending Rule, the Government would also ensure that potential future overperformances unexplained by domestic economic activity could be saved rather than spent. At a minimum, the Government should cap its exposure to the surge in corporation tax receipts. This would entail ensuring that further outperformances in corporation tax — beyond reasonable projections for growth in the domestic economy — be set aside.

By using excess receipts to fund ongoing expenditure, the Government has potentially opted not to set aside some €22 billion in a Rainy Day Fund or to reduce net debt by a substantial amount. Using these resources, which could be considered an injection of funds from overseas, will have boosted economic activity and tax receipts to some extent in the meantime, meaning that the full €22 billion is not the ultimate opportunity cost to reducing net debt. though the risks to fiscal sustainability from these decisions remain sizeable.

Uncosted policy commitments

A challenge that has persisted for several years now is that two major policy commitments have not been properly costed and factored into budget plans. These include the costs of transitioning to a low carbon economy and the cost of the Government's commitment to major healthcare reforms.

Transitioning to a low carbon economy: The Government has provided little clarity on the fiscal costs of achieving its required 51 per cent reduction in overall greenhouse-gas emissions by 2030.[66]

While the Government did produce an estimate of the overall cost of meeting the new objectives, at some €125 billion to 2030, it did not outline how much of this would specifically be borne by the Government in its *Climate Action Plan 2021*.

The Government has not properly costed and factored in its climate objectives

However, the Climate Action Plan 2021 does note that, for about 40 per cent (about €5½ billion annually or 2 per cent of GNI*) of total investment costs, it is unlikely that the returns to the investment will be positive. This means that the State would probably have to make some intervention, perhaps up to the full amount, 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.

The potential costs to the State are better articulated in FitzGerald (2021). Additional annual investment costs to meet the 2030 targets are estimated at 1.7 to 2.3 per cent of GNI* (Figure 3.16).[67] Two scenarios are considered: one where both agricultural and energy emissions are cut by 51 per cent and a more costly scenario where agricultural emissions are cut less (by 33 per cent) so that energy emissions must be cut more (by 61 per cent). The paper estimates the additional annual government expenditure between 2026 and 2030 required to meet the 2030 target while fairly distributing

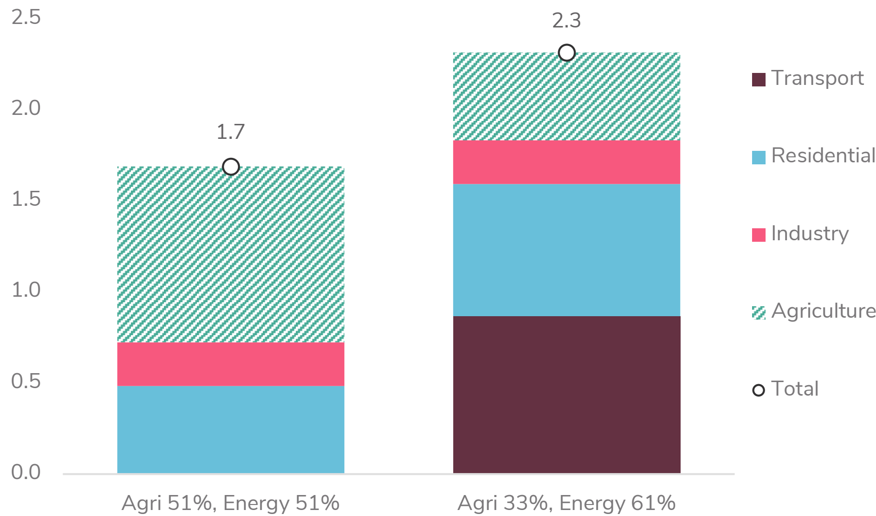
[66] These legally binding objectives are set out in the Climate Action and Low Carbon Development (Amendment) Act 2021.

[67] FitzGerald (2021) notes that the costs for agriculture are an underestimate, as no allowance is made for the costs of supporting workers losing their jobs in food processing to transition to other sectors. Nor is any allowance made for any additional costs arising from the need to ramp up investment in the power and services sectors. Depending on the scenario, he notes that compensating for this could add between just under 0.5 per cent and 1 per cent of GNI* to government expenditure over 2026 to 2030.

costs. It draws on detailed analysis by the UCC MAREI Institute and Teagasc of costs associated with paths towards Ireland decarbonising.

Figure 3.16: Large additional annual investment to meet climate goals

% GNI*, estimated additional average annual public investment to meet 2030 targets (2026 to 2030)



Source: FitzGerald (2021). Get the data.

As it stands, the only clear information on amounts committed towards meeting the additional climate objectives in the Climate Action Plan 2021 is that about €8.5 billion of the estimated €125 billion will be public spending. This comprises at least €8 billion of public spending on residential retrofit to 2030, by the Government, partly funded by €5 billion of the €9.5 billion in carbon tax receipts planned to be raised by 2030. In addition, €0.5 billion of the *National Recovery and Resilience Plan 2021* amounts are to be allocated towards decarbonising measures such as retrofitting, ecosystem resilience and regeneration, climate mitigation and adaptation, and green data systems.

The transition to a low-carbon economy will have wider fiscal impacts. It will mean lower revenues being raised on fossil fuels as people adapt their behaviours, using less of these. Various sources of revenue are likely to be directly affected: motor tax, vehicle registration tax, carbon tax, excise on mineral oils, VAT on fuels. In 2019, before the pandemic, the Government raised almost €6 billion (2.8 per cent of GNI*) from taxes on climate-relevant activities, such as the use of fossil fuels.

For the UK, the OBR (2022) estimates the potential losses on motoring taxes at about 1.6 per cent of GDP by 2027 as the vehicle stock moves from petrol/diesel to electric vehicles, which pay no fuel duty or vehicle excise

duty.[68] They also note how the transition to electric vehicles has been faster than expected. Take-up appears to have followed the pattern of other new technologies: slow initial take-up when the technology is novel, followed by a more rapid spread as it proves itself. The process of adapting the economy to lower carbon emissions may have positive effects on employment and investment. However, it may also carry costs for both growth and the public finances as firms transition to new technologies.

Ireland's legislated carbon tax increase for 2022 went through in difficult circumstances, given the cost-of-living pressures observed. Carbon taxes are set to rise further in the coming years, and so the current high prices now are perhaps a foretaste of some of the changes that will come in future. The temporary measures introduced elsewhere to counteract the cost of living increases more than offset the impact of the carbon tax increase at present.

Uncosted Sláintecare reforms: The Government has failed to outline basic detail on major reforms to public healthcare spending. The costs of these reforms, which will see greater public funding of universal healthcare access, are not budgeted for beyond this year. Moreover, essential information on costs and progress to date is severely lacking (Casey and Carroll, 2021). It appears that some €2.1 billion of recurrent spending has been allocated to the reforms to end-2022. While total costs were estimated at €2.8 billion per annum in 2017, these are highly outdated and do not include subsequent price and wage pressures. A mechanical estimate, using wage and price pressures in the interim, would suggest that costs could prove to be upwards of €3½ billion by 2027 to implement the reforms, with recent price pressures and capacity constraints in the economy likely to raise such estimates. The Government should update its costings and provide more transparency on progress to date to better inform policy and planning.

Sláintecare reforms are not costed properly, nor are they budgeted for beyond this year

Ageing costs: The Irish population is rapidly ageing. This will put pressure on spending for healthcare and pensions. It will also lead to a shrinking labour force at the same time as Ireland's productivity growth rates are likely

[68] This estimate is based on the original OBR (2021) analysis adjusted for the OBR's (2022) subsequent update.

to moderate (regions tend to exhibit slower rates of productivity growth as they rise to higher productivity levels).

Under current policies, combined spending on pensions and healthcare is projected to increase from 16 per cent of GNI* in 2019 to almost 25 per cent in 2050, with costs rising more rapidly after 2030.

Pensions will be a significant driver of ageing pressures and Ireland faces twin challenges

Pensions will be significant driver of the spending pressures linked to ageing. Revised estimates from the Fiscal Council and estimates from the Department of Finance (2022) suggest that annual spending on pensions is set to rise by about 1½ to 2 per cent of GNI* by 2030.[69] In this respect, Ireland's pension system faces twin challenges (Figure 3.17):

- First, there is the looming retirement of a bulge in the population from the Irish "baby boom" in the 1970s/80s. In the 2000s about 30,000 individuals reached age 65 each year. By the 2040s, the Council estimates that this will rise to about 75,500.

- Second, people are living longer. The Council estimates that, by 2050, the average Irish person could, at age 65, expect to live ten years longer than an average 65-year-old would have in 1980 (from 79 years in 1980 to 89 in 2050). By contrast, the pension age has only risen by one year over the same period (from 65 to 66).

The Pensions Commission report last September projected a €13 billion shortfall in funding for pensions by 2050. To deal with the sustainability challenge, the Commission set out a preferred option with a mix of responses: gradual increases in the pension age from 2028; increased PRSI for employees, employers and the self-employed; and other unspecified funding sources (mostly likely further tax increases or spending reductions elsewhere).

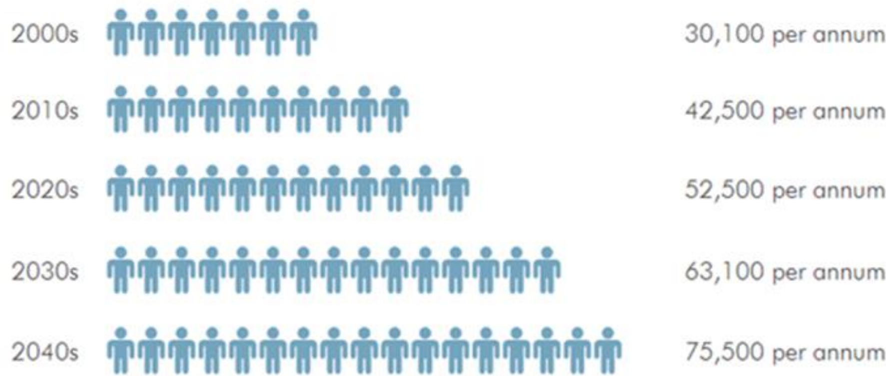
Spreading the costs makes sense, given the scale of the challenge. However, recent developments suggest that more of the burden will be put

[69] The Department of Finance estimates are contained in Table 21 of SPU 2022, while the Council's estimates are based on an updated assessment of the analysis contained in the Long-term Sustainability Report (Fiscal Council, 2020).

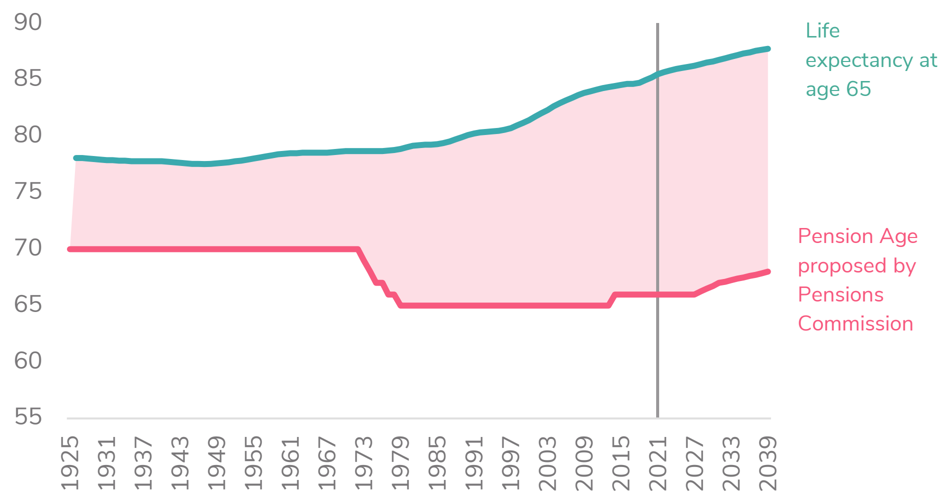
on raising taxes rather than adjusting the pension age.[70] This raises questions about the credibility of the response, when it involves potentially much greater tax increases that are yet to be acted on.

Figure 3.17: Twin challenges associated with pension spending

Number of people reaching age 65



Expected years of retirement: the pension age and life expectancy at age 65



Source: Fiscal Council Long-term Sustainability Report, 2020.

Not increasing the pension age will lock in a longer, and growing, average retirement period. The Fiscal Council (2020) estimated that the growing number of pension recipients would add some €370 million annually to pension costs on average over 2021 to 2025. That was before the Government deferred the planned pension age increase from 66 to 67 in 2021. The Council estimates that the decision to defer the pension age increase raises annual expenditure by €575 million from 2021, with these

Not increasing the pension age will lock in a longer, and growing, average retirement period

[70] See, for example, the Joint Committee on Social Protection, Community and Rural Development and the Islands' (2022) report on pensions. The report set out a political response to the Pension Commission's recommendations. The response basically stated that (1) the pension age should remain at 66, and (2) the costs of pensions should be funded by higher taxes and social contributions.

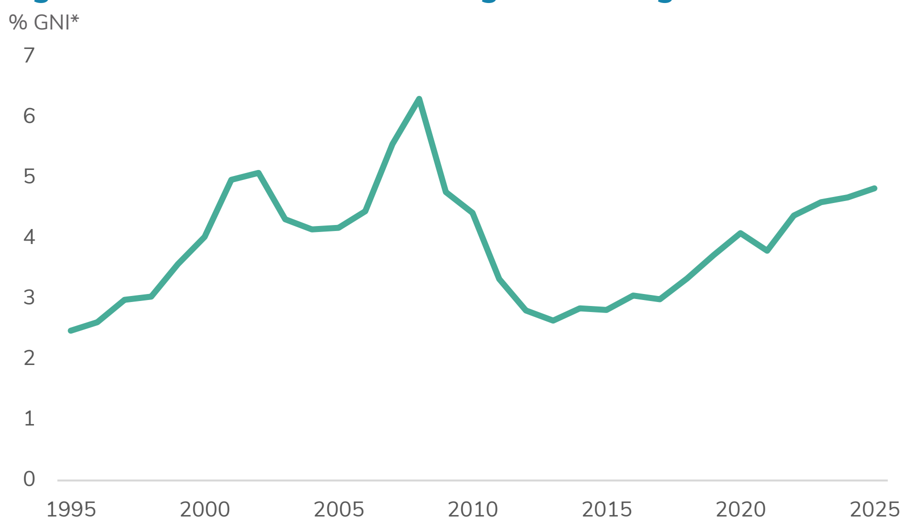
costs rising incrementally over time. Increases in average payments to allow for price increases in the economy further push this cost upwards.

While nothing has been decided in relation to tackling the pensions challenges, the Government has set out proposals to introduce an auto-enrolment scheme for a large number of employees without pension cover (Box H). The fiscal costs of this scheme could amount to €300 million per annum or about 0.1 per cent of GNI*. The costs are not built into *SPU* 2022 projections.

Ramp-up in public investment: The Government plans to increase public investment spending to almost 5 per cent of national income by 2025 (Figure 3.18). The National Development Plan suggests it will stay at these high levels out to the end of the decade. There are only a few examples when Ireland's public investment rates were higher in the past two-and-a-half decades. It represents a rapid pick up compared to the low levels of public investment in the aftermath of the financial crisis when rates fell to about 3 per cent of national income. By comparison, other OECD countries tend to see rates of about 3 to 4 per cent. The increase in public investment should help to meet climate change and housing objectives. Indeed, 30 per cent of the National Development Plan allocation for 2021–2025 is for housing, 22 per cent is for transport, and 7 per cent is for environment and climate areas. The exact allocation for measures consistent with achieving climate objectives is not clear (Conroy, Casey and Jordan-Doak, 2021).

Public investment is set to pick up rapidly, but is likely to encounter capacity constraints

Figure 3.18: Public investment being raised to high levels



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

However, achieving these ambitions may be difficult. Ireland's public investment spending had been experiencing some minor, but growing shortfalls before the pandemic (Section 2.5). This may have reflected rising capacity constraints in the sector. For instance, Conroy, Casey and Jordan-Doak (2021) estimate a construction sector unemployment rate and find that this could have been as low as 2 to 3 per cent at the end of 2019 — well below historical rates. Inward migration flows could boost labour supply in the sector as in the past. However, other countries have narrowed the wage gap with Ireland, and costs remain high such that Ireland's relative attractiveness has fallen by more than one-third relative to the mid-2000s. The ramp-up in public investment will also come at a time when many other countries are making similar efforts to increase public investment in the same areas.

A risk to the Government's public investment plans is that these could see higher costs or lower output for a given price. Poorer value for money and possible spending overruns could therefore be the result.

If Ireland is to avoid further overruns and poor value-for-money outcomes in future, it will need to improve how public investment spending is governed. A key recommendation in the past was for the Department of Public Expenditure and Reform to take on more responsibility in ensuring value for money is achieved in capital projects. A high degree of diligence will ultimately be required, given capacity constraints, the high scale of investment, and the greater need to ensure value for money when government debt levels are already high.

Defence spending: Following the invasion of Ukraine by Russia, there is significant 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.[71] This sort of increase would broadly fall in line with the middle estimate of the *Report of the Commission on the Defence Forces* (2022), with spending rising by 0.2 to 0.3 per cent of GNI* annually over an unspecified timeframe (Figure 3.19).

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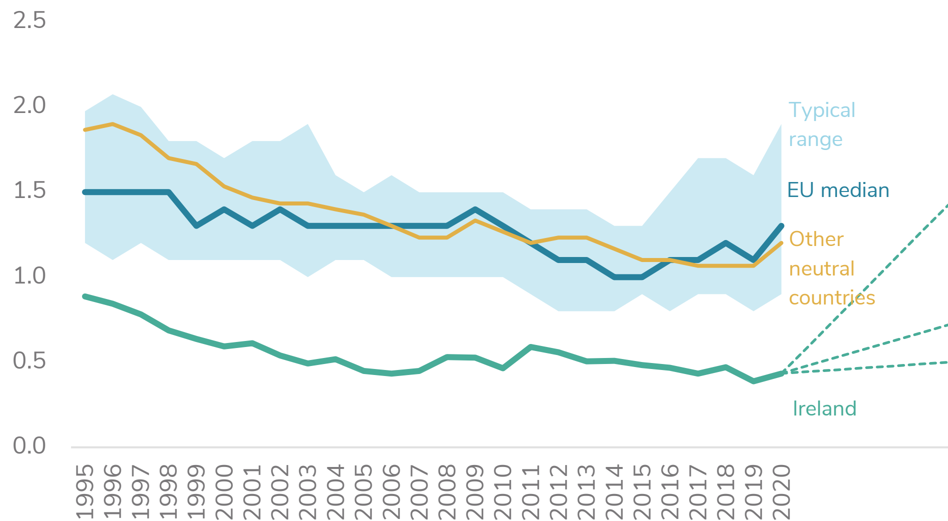
[71] https://www.irishtimes.com/news/ireland/irish-news/ireland-s-defence-spending-set-to-rise-by-at-least-50-says-coveney-1.4864427

Figure 3.19: Ireland's defence spending has been exceptionally low

% GNI* for Ireland (% GDP otherwise)



Sources: Eurostat; CSO; Report of the Commission on the Defence Forces (2022); and Fiscal Council workings. Get the data.

Notes: The Commission on the Defence Forces focused its work around three possible tiers of levels of ambition for the scale of funding of Ireland's Defence Forces. These were set at 0.5% (current capabilities); 0.7% (in line with the medium-term costs assessed as required to address specific gaps in Ireland's ability to deal with an assault on Irish sovereignty and to serve in higher intensity peace support, crisis management and humanitarian relief operations overseas); and 1.4% of GNI* (based on an analysis of international comparators), respectively. Illustrative paths to these levels of expenditure are shown as dashed lines for Ireland.

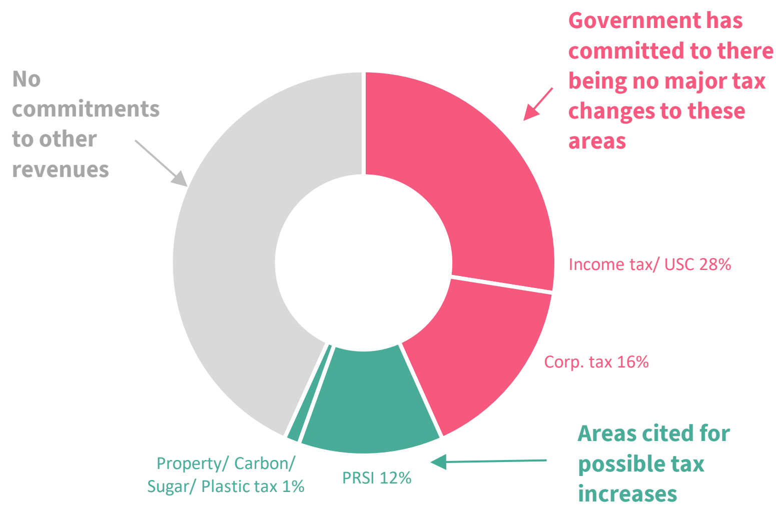
Further spending pressures and limited plans for raising new revenues: The Government faces many other pressures to increase spending. One example of this is the additional €307 million of funding for higher education, which may not be explicitly factored into SPU plans, though could yet come from the existing allocation for voted spending in this area.[72] Others include the public sector pay talks and the possible expansion of the mica redress scheme.

The Government has limited plans for areas where new tax revenues could be raised

[72] The Department of Further and Higher Education, Research, Innovation and Science (2022) notes that the 'Funding the Future' policy, which was approved for publication by Government, addresses funding issues by setting out plans to commit additional Exchequer investment and employer contributions through the National Training Fund, instead of opting to use student loans as part of its response, to gradually reduce student contributions.

Figure 3.20: Only small areas where taxes might be raised

% total general government revenue in 2021



Source: CSO; Revenue; Programme for Government; and Fiscal Council workings. Get the data.

However, the Government has limited plans for areas where new tax revenues could be raised to fund additional commitments. It has ruled out major changes to areas that accounted for about 43 per cent of receipts in 2021. There is no explicit commitment to any changes to another 43 per cent. Only 13 per cent of existing revenues are cited as areas where the Government might raise revenues: PRSI, which accounted for 12 per cent of receipts in 2021, and a mix of smaller taxes that make up the remaining 1 per cent: carbon, sugar, plastic and property tax (Figure 3.20). One area where there are currently plans to introduce revenue-raising measures is in the area of unused land and properties. The Government's *Housing for All* plan in 2021 set out plans to collect data on vacancy with a view to introducing a new Vacant Property Tax. The Government has also committed to a new zoned land tax to replace the existing vacant site levy.

Box H: Auto enrolment could have significant macro and fiscal implications

In March, the Government announced plans to implement a new scheme. Some 750,000 workers — one third of all people employed in Ireland — would be automatically enrolled in a retirement savings system. It is proposed that the scheme would commence in 2024 (Department of Social Protection, 2022). The scheme would involve employees, employers and the State all making contributions to worker pensions.

This proposal could represent a major change to how Irish people are likely to save for retirement. Foster, Wijeratne, and Mulligan (2020) note that from its introduction in the UK in 2012 to 2016, auto-enrolment saw pension participation among eligible employees rise by over 31 percentage points to 73 per cent. They note the largest increases in contributors to pensions were the youngest age cohorts, and the average opt-out rate was low at around 9 per cent.

As the Government notes, Ireland is the only OECD country not yet operating some form of auto enrolment system to promote savings for retirement (OECD, 2014).[73] This box looks at some of the potential implications for the economy and public finances.

Key details

The proposed scheme is intended to encourage workers to save earlier with an opt-out rather than opt-in approach and by providing for significant employer and state contributions as well.

Table H1: Pension contributions are proposed to increase over time

Pension contributions as a percentage of salary under auto-enrolment plans

	Employee	Employer	State	Total
2024-2026	1.5	1.5	0.5	3.5
2027-2029	3.0	3.0	1.0	7.0
2030-2032	4.5	4.5	1.5	10.5
2033 onwards	6.0	6.0	2.0	14.0

Source: Department of Social Protection, 2022.

The scheme would work as follows:

1) From 2024, all employees aged 23 to 60 earning over €20,000 and not already in a work pension scheme will be automatically enrolled in one. Employees will have the option of opting out after participating in the scheme for six months.
2) Employees, employers and the state would all make contributions. Employers would match employees' contributions, while the state would top them up by €1 for every €3 saved by the participant. In other words, every €3 employee contribution would automatically grow to €7 before it is invested.
3) Both employer and employee contributions are to start at 1.5 per cent and increasing every three years by 1.5 per cent of qualifying earnings, reaching 6 per cent by year 10 (2033, see Table H1).
4) The drafting of legislation is set to commence this year.

Economic and fiscal impacts

The establishment of an auto enrollment scheme could have several effects. First, it will increase the level of pension coverage in the private sector.[74] This should see individuals with a financial situation that is better prepared for retirement and less likely to see significant falls in their income upon retirement. An increased level of private sector pensions coverage should also alleviate some of the pressure on the public pensions system. This is key, as demographic changes are expected to lead to significant additional fiscal costs (Fiscal Council, 2020).

Data from the Revenue Commissioners suggest that there would be approximately 750,000 employees enrolled in the initial phase. With an assumed 95 per cent retention rate and an

[73] At the time of the report, Ireland and New Zealand were the only countries without a mandatory earnings-related pillar for retirement savings. Since then, New Zealand has introduced a system whereby all employees are automatically enrolled in a pension scheme.
[74] International experience would suggest that auto enrolment could increase pension coverage substantially (Bourquin et al, 2020; Chalmers et al., 2021; and Beshears et al. 2009). Of those not currently enrolled in a pension in Ireland, 45 per cent said they had not yet done so because they "never got around to organizing it" (CSO, 2021). This accounts for a larger share than those who said they could not afford to contribute (40 per cent).

average wage level of €35,000 per annum amongst participants, the fund would potentially accumulate €21 billion in contributions by year 10.[75,76]

Using this scenario, we can attempt to estimate the potential impacts of the auto-enrolment scheme on personal disposable income and hence consumption. When contributions are set at 1.5 per cent of annual salary (2024-2026 under current proposals), employee contributions would equate to approximately 0.25 per cent of economy-wide personal disposable income. By 2033, the rate of contributions is proposed to have increased fourfold. As a result, this would equate to approximately 1 per cent of aggregate personal disposable income. However, the international experience suggests that those auto enrolled would tend to be at the lower end of the income distribution. One might therefore expect that those affected could have an above-average marginal propensity to consume out of their incomes. With that in mind, the impact on consumption could be larger than the impacts on disposable income described above. In the very long term, consumption is likely to be boosted by pensioners having higher income than would otherwise have been the case.

The scheme will result in contributions being paid by the State. 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 per cent of GNI*).

[75] €9.0 billion from employers, €9.0 billion from employees, and €3.0 billion from the State.

[76] Bercholz et. al (2019) found that pension non-coverage was more pronounced among younger workers and those on lower incomes.