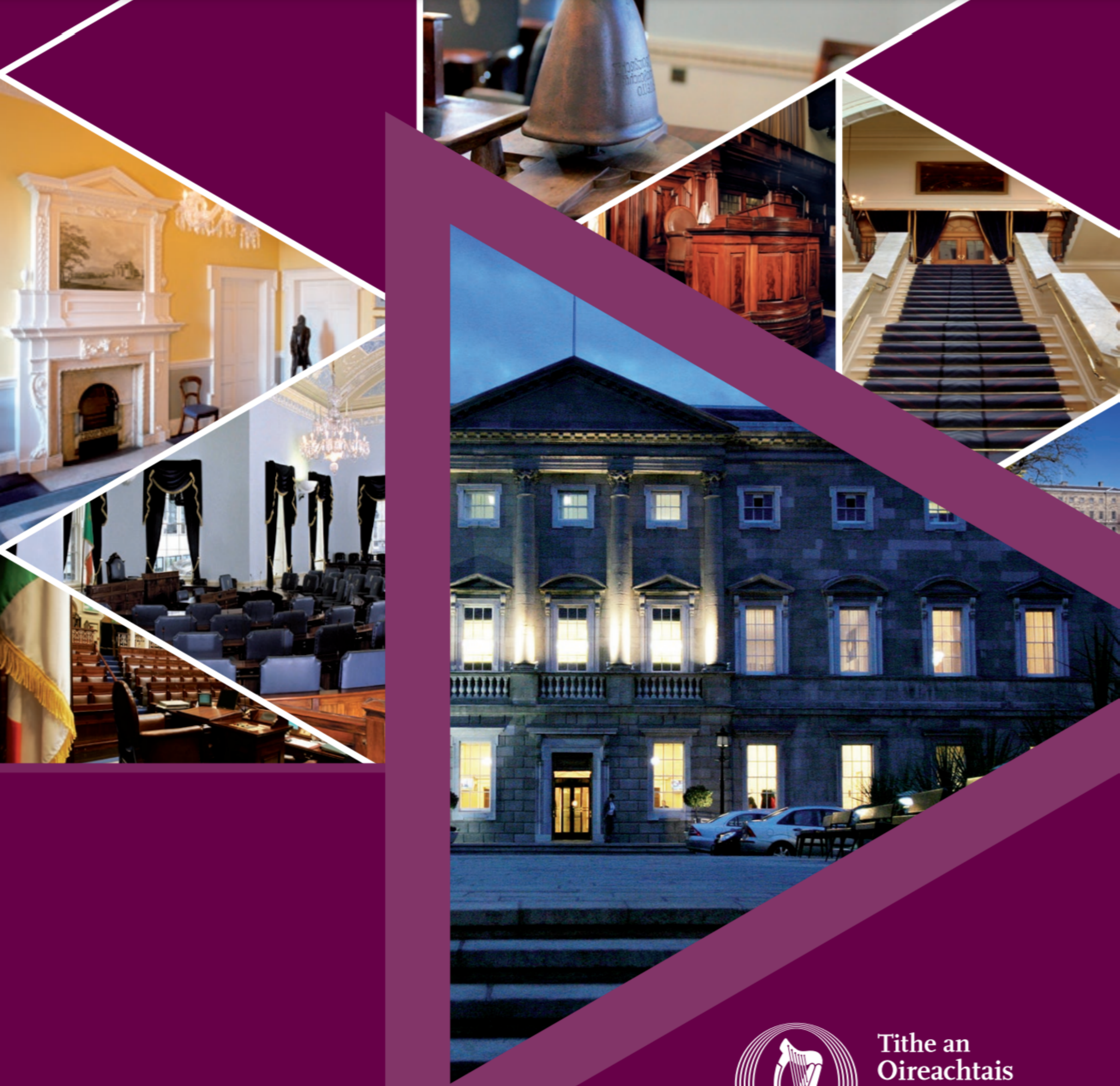

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An Oifig Buiséid Pharlaiminteach
Parliamentary Budget Office

Pre-Budget 2023 PBO Commentary

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This document, and the analysis herein, reflects data and other information available to the Parliamentary Budget Office up to and including **September 14th 2022**.

Séanadh

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Key Messages

Budget 2023 will be a cost-of-living budget. The Government are facing exceptional circumstances – coming out of a pandemic, war in Europe, with consequent energy and supply chain issues, and rates of inflation not seen since the 1980s. Inflation has not just been seen in energy prices and food prices, core inflation (which excludes these items) is also rising. The cost of electricity, home heating and transport fuel is putting more households at risk of fuel poverty this winter. Housing demand still far outstrips supply, with a shortage of properties available to rent and affordability an issue for many. Childcare costs remain high, impacting female labour market participation and acting as an employment barrier for lone parents.

With the unexpected level of inflation in 2022 (forecast by the Central Bank[1] to be 7.8% compared to the Department of Finance's Budget 2022 forecast of 2.2%) and the 2023 forecast for continued inflation, there is considerable pressure on the public finances to maintain the existing level of public services and to insulate welfare recipients and taxpayers from decreases in real income. **Given the limited extra resources available, budget measures should be targeted towards those households most in need, given that rising costs show no signs of easing.**

Despite these challenges, underlying fundamentals of the economy are strong, and the number of people in employment is up 200,000 from pre-pandemic levels with an unemployment rate of 4.2% in July. Tax revenue is up 12.3% (€7.3bn) to end-August compared to last year, driven by strong Corporation Tax, Income Tax and VAT returns (albeit household savings are on the rise again which may indicate that a VAT returns slowdown is on the way).

The Budget is expected to comprise a tax package of €1.05 billion and expenditure developments of €5.65 billion. €400 million of the expenditure developments are expected to take effect in 2022, with a further €800 million relating to increased capital spending in 2023. The balance (approx. €4.5 billion) is split between €2.2 billion to maintain existing levels of service (funding the public sector pay proposal, meeting demographic and inflationary pressures) and €2.3 billion for 'new measures'. These calculations may underestimate the amount required just to standstill and maintain existing levels of service, due to high inflation in 2022. There is a credible risk that the current inflationary pressures will persist into 2023. The PBO estimates that total current expenditure in 2023 may need to be around €74.85bn just to standstill at 2022 levels (accounting for 4.2% inflation in 2023) and would need to be €78.87bn to account for unexpected 2022 inflation combined with forecast 2023 inflation. **The increase required to reach €74.85bn would be €3.02bn and the increase required to reach €78.87bn would be €7.04bn – depending on the definition/timing assumed for a 'standstill' scenario.**

1 *Quarterly Bulletin 2022:3 - Economy forecast to grow in 2022 with higher inflation impacting on households and businesses (centralbank.ie)*

Tax and Welfare

The Government signalled in the *Summer Economic Statement* that, of the total Budget 2023 package of €6.7 billion, tax measures will account for €1.05 billion and that insulating taxpayers from inflation will be the main focus.

A significant widening of the standard rate income tax band is one potential option, which could be combined with targeted increases to tax credits, which will together partially mitigate the impact of inflation on real incomes. Such a broad-based measure will also benefit middle and higher income earners. It will not disproportionately benefit those at or near the minimum wage or those that earn less than the current threshold of €36,800 for a single taxpayer or €45,800 for two-earner couple taxpayers.

Indexation could involve pegging tax band and credit changes to wage growth or price inflation. Combined with welfare indexation, this ensures work incentives are protected while maintaining living standards for welfare recipients.

The Tax Strategy Group paper on social welfare costed a number of potential changes to core welfare rates, as well as subsidiary welfare payment rates. The two options of either a €10 or a €15 increase to core weekly payments, will not be enough to offset current inflation and therefore means a fall in real income for welfare recipients. Yet, the costs involved (e.g. €1.11 billion annual cost for a €15 increase or €740 million for a €10 increase) in the context of the available fiscal space may necessitate a below inflation rate increase. The Government may choose to use subsidiary payment increases as a method of targeted measures aimed at the most vulnerable, e.g. increases to the fuel allowance. It is unclear if any changes to child benefit are on the way – increasing child benefit, a universal payment, is costly and less progressive than potential changes to means-tested payments.

A PBO analysis of targeted compared to universal measures,[2] using SWITCH microsimulations, shows that additional fuel allowance payments are a much more progressive use of public funds than a universal energy credit. Fuel allowance targets those in the lower income deciles that may really struggle with energy bills this winter. Likewise, working family payments and qualified child increase payments are a more progressive use of public funds than the universal child benefit payment. Although the Budget may include a number of universal and targeted measures, the balance should weigh heavily in favour of targeted measures to help alleviate the risk of poverty, and also to curb potential inflationary impacts of universal subsidies.

The PBO welcomes the recent publication of *De-risking the Public Finances – Assessing Corporation Tax Receipts*.[3] The document states that to de-risk the threat to the public finances, some of the receipts from Corporation Tax could be treated as 'windfall' receipts which could be set aside. The PBO welcomes the commitment in this document that the Department of Finance will report, in key publications, its estimates of the budgetary position excluding these windfall receipts. In addition, the recent report from the Commission on Taxation and Welfare provides a medium to long-term focus on sustainability issues.[4] The PBO will discuss this report in future publications.

2 *Progressivity of Targeted v Universal Measures*, PBO September 2022.
3 *gov.ie - De-Risking The Public Finances – Assessing Corporation Tax Receipts (www.gov.ie)*
4 *Government of Ireland: Report of the Commission on Taxation and Welfare.*

Housing

The housing shortage and affordability issue is one of the biggest challenges facing the Government, a problem exacerbated by the current high rate of rent inflation. On the ownership front, the Help to Buy Scheme may continue beyond December 2022 in some form. The PBO has raised concerns about the efficacy of the policy[5] and the further potential cost, circa €190m in 2021. Imminent interest rate hikes will be passed onto homeowners and will put further pressure on mortgage payers and those seeking approval for a first home. Recently introduced policies such as the shared equity scheme will help a proportion of potential purchasers but the underlying issue remains – a drastic increase in the supply of housing is required to meet demand, and have a knock-on effect on high rents. Housing Assistance Payment, which now costs over half a billion a year (€585 million in 2022), is a temporary fix to a long-term structural problem, although in the short-term it is a key component of poverty risk reduction and work incentives for welfare recipients.

Childcare

Increasing subsidies provided under the National Childcare Scheme and the Early Childhood Care and Education Programme, for example via widening means test income thresholds and increasing rates of subsidised childcare, would benefit struggling households,[6] potentially positively impact female labour force participation,[7] at a time when many sectors are having difficulty filling vacancies, and overall would be a progressive use of public funds – targeted to those who need it most. However, in the current inflationary environment, any increases to subsidies will need to exceed inflation to generate any meaningful improvement, rather than simply keeping pace or limiting lost ground. Ireland still lags behind many European Countries in subsidised childcare provision, possibly a consequence of a low rate of social security contributions in Ireland.

Energy

With energy prices currently driving overall high rates of inflation, key decisions at Budget time will include any changes to excise on petrol/diesel and also the rate of carbon tax. One-off measures such as payments to help pay electricity bills or other lump sum subsidies help somewhat in the short term but longer-term energy security and a move to greener forms of energy remain policy priorities. The budget will need to balance the immediate need of households to heat homes and keep cars on the road with longer-term commitments to decarbonisation and emission reductions.

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Possible Spending Measures in Budget 2023

Budget 2023 is expected to provide for a range of non-core spending i.e. non-recurring spending or spending which is expected to be short-term in nature. As of the *Stability Programme Update* there was projected non-core spending of €4.6 billion in 2023, primarily for a Ukrainian Humanitarian Contingency (€3 billion) and Covid-related measures (€1 billion).[8] At present, it is unknown if the amount of non-core spending in 2023 remains the same or if additional funds will be made available. **It is from this non-core spending that one-off or short-term cost-of-living measures can be expected to be resourced.** Due to the lack of certainty around this quantum of spending and how it may be allocated the PBO instead focusses its present analysis on 'core' spending i.e. spending that will generate a recurring liability. **The PBO will address non-core spending increases in its post-budget commentary.**

The *Mid-year Expenditure Report* set out a combined €4.5 billion to fund maintenance of Existing Level of Service (ELS) and to provide for new measures. Table 1 sets out the costs associated with some new measures that could be funded in 2023 and sets out the remaining flexibility should these measures be implemented.

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5 See PBO, *An overview of the Help to Buy Scheme from 2016-2021* (June 2022).
6 *Childcare in Ireland: usage, affordability and incentives to work*, ESRI Working Paper no. 708 (November 2021).
7 *The Impact of Indexation on Jobseeker's Replacement Rates*, PBO (April 2022).
8 Department of Finance, *Stability Programme Update* (April 2022) p.31.

Table 1: Summary of Potential Government Spending Measures in Budget 2023 (€ millions)

2023	New Spending Measures
Funds Available Cost (€ millions)	€2,300
Pay Proposal	€1,130 to €1,400
Social Protection	€741 to €1,112
Further and Higher Education[9]	€0.85 to €85.4
Defence Group	€67
Balance Remaining	-€364.4 to €361.15

As of end-August 2022 gross spending exceeds profiled levels by €198 million, with under profile capital spending largely offsetting significant over profile current spending. It remains to be seen if Supplementary Estimates will be required before year-end. If these emerge, they may indicate a more significant challenge in maintaining existing levels of service (ELS) in 2023. If additional resources are required these may be drawn from unallocated funds provided for in Budget 2022.[10]

Table 1 illustrates that there is very limited scope for new spending measures in 2023 (€2.3 billion). Depending on the measures selected by Government, these extra resources could be substantially eroded by certain 'big-ticket' changes, specifically changes to payment rates of Social Welfare schemes and the implementation of the August pay proposals if ratified by Unions.

Risks in Budget 2023

Overall, the Budget spending metrics outlined in the mid-year expenditure report look, at this point, to be optimistic, as continually increasing inflation may require a larger proportion of available space just to standstill, leaving less space for new measures.

The income tax and social security contribution burden combined in Ireland is relatively low compared to other European Countries and with demographic pressures on the social insurance fund increasing, in the medium term, income tax policy may need to be reconsidered if European style public services are to be provided.

Budget 2023 will be less about stimulating the economy, or even longer-term planning (which should be the norm) and more about dealing with the immediate cost of living pressures faced by many households. Although most recent budgets have been relatively progressive, this budget may need to be even more so to protect the most vulnerable, which includes welfare recipients and lower paid taxpayers. When unexpected 2022 inflation and forecast 2023 inflation are combined, the real impact on household disposable incomes since Budget 2022 paints a worrisome picture. Budget 2023 will only be able to offset part of this decrease in the standard of living and with uncertainty around international events that are currently driving inflation, suitably targeted use of limited public funds is now more important than ever.

9 Department of Further and Higher Education, Research, Innovation and Science, *Funding the Future: An annual options paper on reducing the cost of higher education* (05 September 2022) pp.24-7. This options paper sets out a range of options with associated costs for 2023 and 2024 (to reflect full-year impact). The range selected here reflects the most inexpensive option to the most expensive; however, some combination of the many options presented could also be pursued.

10 *Committee on Budgetary Oversight, 'The updated economic and fiscal position in advance of Budget 2023 and additional one-off measures for 2022' (14 September 2022).*

Structure of paper

The Budget announces proposed changes to taxation and spending for the year ahead, which are subsequently legislated for through the Houses. As such, this report discusses taxes first, which both influence activity for households and businesses, but also provide a source of funding for public services. The report then gives an overview of spending, before providing a discussion of large spending areas and key concerns for this Budget. Finally, a detailed explanation of the economic situation in Ireland is laid out, which provides the context for this Budget and underpins the tax and spending choices made.

Fiscal Position

At Budget time, the Minister for Finance announces changes to taxes, which are subsequently legislated for in the Finance Bill. The Budget documentation also contains updated tax projections. Understanding tax revenue is key as this is one of the key sources to fund public services. Tax changes also directly impact on businesses, workers and households. Changes to taxes can incentivise particular activities, help with the cost of living, or influence someone's labour choices.

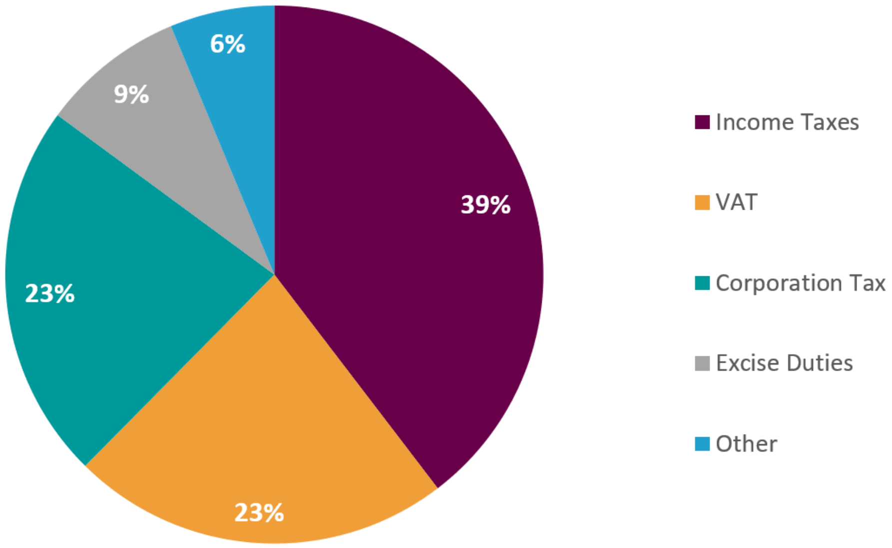
Tax Revenue

The Irish Exchequer is experiencing a substantial increase in revenue compared to previous years, with tax receipts coming in ahead of the profile set out in Budget 2022. Budget 2022 estimated that Exchequer tax revenue for 2022 would be €70.2 billion compared to €67.5 billion in tax revenue in 2021. The *Stability Programme Update* (SPU) 2022 revised estimates for tax revenue in 2022 upwards to €75.8 billion, an increase of €5.6 billion or 8% compared to Budget 2022 forecasts.

On a cumulative basis to end-August 2022, tax revenues stood at €49.8 billion, which was €10.4 billion or 26.3% higher than the same period last year.[11] This has primarily been driven by strong performance in tax receipts raised from Corporation Tax, VAT, and income taxes. It should be noted, however that in the first three months of 2021, Ireland had enforced stringent health measures in response to the public health emergency caused by the COVID-19 global pandemic, which artificially suppressed consumption, although consumers did adapt behaviour over time. This will distort year on year comparisons.
The largest contributors to this tax take were income taxes which raised €26.8 billion, VAT which raised €15.4 billion, and Corporation Tax raised an almost equivalent amount of €15.3 billion. Excise duties contributed €5.8 billion, Capital Gains Tax €1.745 billion, and Stamp Duty contributed €1.5 billion.

[11] Department of Finance, *Fiscal Monitor August 2022*.

Figure 1: Composition of Tax Revenue 2021



Source: PBO Calculations, The Revenue Commissioners.

Income Taxes

Income Tax is the largest revenue source for the Irish Exchequer, and this tax head proved resilient throughout the Covid-19 pandemic. The Irish Exchequer collected €26.8 billion in net receipts from income taxes (including the Universal Social Charge) in 2021. This represents a year-on-year increase of €4.1 billion, or 18.1%, compared to the €22.6 billion collected in 2020. *Budget 2022* forecast tax revenues of €27.5 billion in 2022 however, this was revised upwards in the *Stability Programme Update* 2022 to €29.5 billion, an upwards revision of €2.0 billion or 7.2%.

The Irish Exchequer received €2.4 billion in tax receipts from income taxes in August 2022, approximately €0.2 billion or 9.4% ahead of August 2021.[12] On a cumulative basis for the eight months to end-August 2022, this tax head has raised €19.2 billion, which is over €2.6 billion (or 16%) higher than the same period in 2021.[13] Several factors lead to a higher income tax take in 2022, including increased wages, more people in employment, and some technical issues such as the warehousing of receipts last year artificially reducing the base as noted in the *Fiscal Monitor April 2022*. There were 2,632,500 people in the labour force in Q1 2022, an increase of 231,400 or 9.6% compared to 2,401,100 people in the labour force in Q1 2021.[14]

Parliamentarians will be aware that the introduction of a third rate of income tax is being considered as a possibility in the context of Budget 2023. According to the 2022 Tax Strategy Group Papers, a new 30% rate would cost €525 million in a full-year if a €5,000 band was introduced (€36,800 taxed at 30%) and €945 million in a full-year if introduced with a €10,000 band (€36,800 to €46,800 taxed at 30%).[15] The Tax Strategy Group papers also note that in terms of the distributional impact approximately 1 million (35%) taxpayers would benefit from the introduction of either a €5,000 band or a €10,000 band.[16]

12 Ibid.
13 Ibid.
14 CSO, *Labour Force Survey Quarter 1 2022*.
15 Department of Finance, *Income Tax – Tax Strategy Group July 2022*.
16 Ibid.

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Corporation Tax

As highlighted by the PBO previously, corporation tax receipts now account for approximately one in five euro collected via tax revenue and continue to outperform forecasts.[17] Many bodies have highlighted that this funding is unsustainable and have attempted to estimate "excess" revenues.[18] The Government has previously relied on this excess or windfall revenue to fund public services.

The PBO notes the recent publication by the Department of Finance on *Assessing Corporation Tax Receipts*.[19] This report outlines that Corporation Tax receipts have more than doubled in just five years and estimates that in the region of €4 to €6 billion of last year's receipts are potentially at risk.[20] The document states that to de-risk the threat to the public finances, some of the receipts from Corporation Tax could be treated as 'windfall' receipts. These receipts could be set aside into a 'Rainy Day Fund' or a newly established 'National Pension Reserve Fund'. The PBO welcomes the commitment in this document by the Department of Finance to report, in key publications, its estimates of the budgetary position excluding these windfall receipts (GGB).[21] These receipts have historically, been quite volatile in nature.

In 2021, the Irish Exchequer received €15.3 billion from corporation tax. This exceeded the €13.9 billion forecast for 2021 in *Budget 2022* by €1.4 billion or 10.3%. Budget 2022 did not anticipate the corporate tax take to exceed €15 billion until 2025.

At the end of August 2022, cumulative corporation tax receipts for the first eight months of the year stood at €11.8 billion.[22] This is approximately €4.8 billion (or 68.5%) higher than at end-August 2021.[23]

Budget 2022 forecast corporation tax receipts of €14.1 billion in 2022. The SPU 2022 forecast for the 2022 corporation tax take was revised up from *Budget 2022* to €16.9 billion, an increase of €2.8 billion for a single year. **This represents an upwards revision in corporate tax revenues of 19.8% for 2022 alone.**

Over the period 2022-2025 inclusive, and in respect of corporate tax receipts, the 2022 Budget day forecast of €58.1 billion was revised up in the SPU to €69.9 billion, a significant upwards revision of 20.3%. This means the Irish Exchequer is now forecast to receive an additional €11.8 billion over the four-year period from 2022 to 2025. On average, this corresponds to an extra €2.9 billion per year in extra corporate tax revenue than was forecast in Budget 2022.

Table 2: Changes to Corporate Tax Receipt Forecasts - Budget vs SPU period 2022-2025 inclusive, in millions

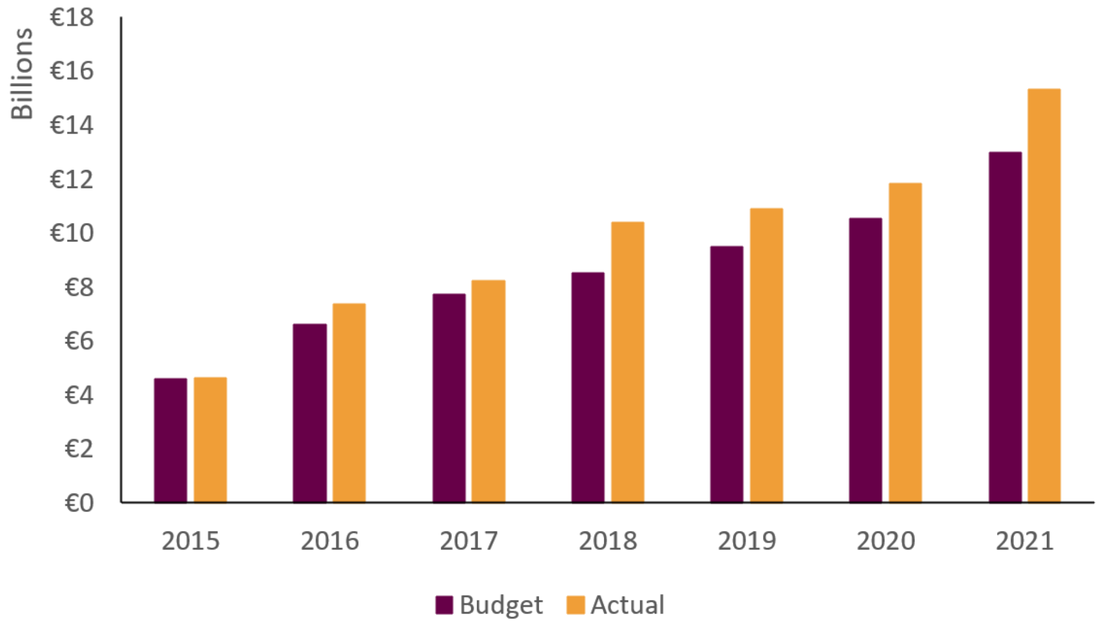
	2022f	2023f	2024f	2025f	Total
Budget 2022	€14,080	€14,170	€14,675	€15,170	€58,095
SPU 2022	€16,865	€16,945	€17,690	€18,410	€69,910
Difference(€)	€2,785	€2,775	€3,015	€3,240	€11,815
Difference(%)	+19.8%	+19.6%	+20.5%	+21.4%	+20.3%

Source: Budget 2022, Stability Programme Update 2022, PBO Calculations.

17 Corporation tax remains extremely difficult to forecast as its growth has decoupled from the underlying economic bases that would normally be used to predict it (CBI, Quarterly Bulletin 03/July 2022).
18 *Fiscal Assessment Report, May 2022 – Irish Fiscal Advisory Council (fiscalcouncil.ie)*.
19 Department of Finance, *De-Risking The Public Finances – Assessing Corporation Tax Receipts*.
20 Ibid.
21 Ibid.
22 Department of Finance, *Fiscal Monitor August 2022*.
23 Ibid.

Historically, tax receipts from corporation tax have exceeded budget day forecasts each year from 2015 to 2021 inclusive. In 2021, receipts from corporation tax of €15.3 billion exceeded the Budget 2021 forecast by over €2.3 billion.

Figure 2: Outperformance in Corporate Tax Revenues Compared to Budget Day Forecasts



Source: PBO based on data from the Department of Finance and the Revenue Commissioners.

Concentration risk

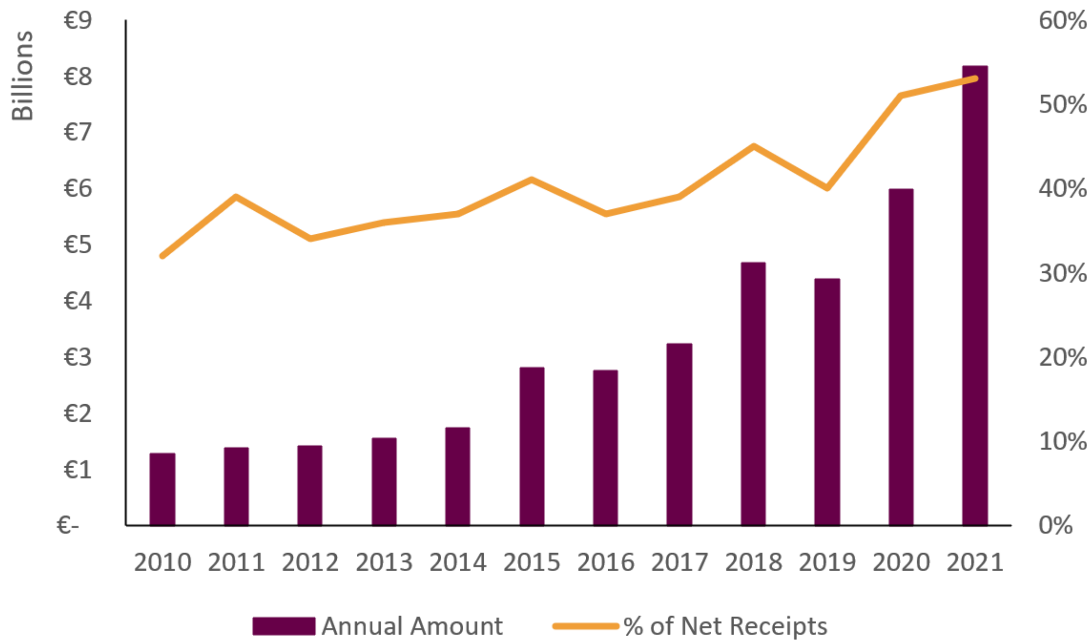
The PBO has previously highlighted the high concentration of corporation tax receipts, the majority of which comes from a small number of multinational firms.

In 2021, just ten companies accounted for €8.2 billion in net corporation tax receipts, accounting for 53% of revenue raised from Corporation Tax that year. **This means that corporate tax receipts from the ten largest companies constituted 12.1% of tax revenue raised in 2021, almost one in every eight euro.**

The top one hundred companies accounted for 79% of tax receipts from corporation tax.[24] Foreign-owned multinationals contributed 80% of corporate tax revenues for that year. Either of these statistics emphasise the concentration risk.

24 The Revenue Commissioners, *Corporation Tax – 2021 Payments and 2020 Returns*.

Figure 3: Corporation Tax Receipts from Top 10 Companies 2010-2021

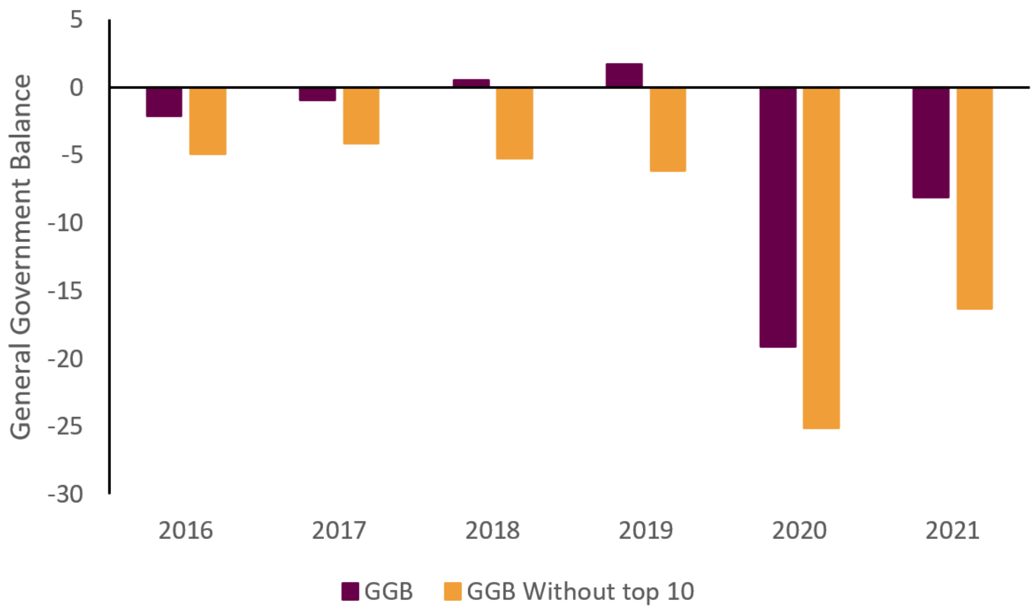


Source: The Revenue Commissioners.

To put the reliance on corporation tax from a small number of companies into perspective, without the receipts from the ten largest contributors, the General Government Balance ('GGB'[25]), which was in deficit to the tune of €8.1 billion in 2021, would have doubled to a deficit of €16.3 billion. There also would have been no surplus in the General Government Balance in either 2018 or 2019. What this means is that, without this revenue, the General Government Balance – which measures the fiscal performance of all arms of Government – would have deteriorated significantly, highlighting the dependence of the Irish Exchequer on these tax receipts. The PBO is not suggesting that this is likely, but such an example helps to illustrate the issue.

[25] GGB stands for 'General Government Balance.' The GGB measures the fiscal performance of all arms of Government. As noted by the Fiscal Advisory Council, it provides a more accurate assessment of the fiscal performance of a more complete Government sector but it does not include commercial state sponsored bodies.

Figure 4: General Government Balance With & Without Top 10 Corporate Taxpayers[26]



Source: PBO calculations.

As noted previously by the PBO, the resilience of a tax system is related to how broad the tax base is.[27] Ireland's increasing reliance on Corporation Tax receipts risks repeating the mistakes of the 'Celtic Tiger' period when the Exchequer became increasingly reliant on Stamp Duty receipts from property transactions. As noted previously by the Irish Central Bank, *'The increasing reliance on property dependent taxes (VAT, stamp duty and capital gains tax) meant that the sensitivity of revenues to cyclical conditions in the economy became unusually high. This left the Irish tax base increasingly vulnerable to both internal and external economic shocks and ensured that the housing market crash, and subsequent movement into recession, had a much bigger impact on the fiscal position than would have otherwise been the case.'*[28]

As previously noted by the PBO,[29] the original OECD Base Erosion and Profit Shifting (BEPS) project resulted in the agreement and publication of the BEPS reports in October 2015.[30] Following on from the G7 meeting of Finance Ministers in June 2021, 131 counties and jurisdictions signed up to a statement (5th July 2021) that committed them to implement the OECD BEPS reforms in profit allocation for digital companies and a global minimum corporation tax rate of 15% by 2023.[31] Ireland announced that it would sign up to the OECD BEPS agreement with cabinet approval to join the international tax agreement announced on 7th October 2021.[32] The Department of Finance has forecast that the proposals (if implemented) could cost the Irish Exchequer €2 billion per year to 2025.[33]

Value Added Tax (VAT)

In 2021, the Irish Exchequer received €15.4 billion in tax revenues from VAT receipts.[34] This yield was up by €2.9 billion or 23.4% compared to 2020, when the receipts from VAT raised €12.5 billion.

26 Source: PBO calculations.
27 PBO, *An Assessment of the Resilience, Sustainability and Vulnerabilities of the Irish Tax Base*.
28 Central Bank of Ireland, *The Financial Crisis in Ireland and Government Revenues*.
29 PBO, *An Assessment of the Resilience, Sustainability and Vulnerabilities of the Irish Tax Base*.
30 Department of Finance, *Corporation Tax – Tax Strategy Group July 2022*.
31 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*.
32 Government of Ireland, *Press Release – Ireland joins OECD International Tax Agreement*.
33 Department of Finance, *Budget 2022: Economic and fiscal outlook*.
34 The Revenue Commissioners, *Annual Report 2021*.

As the Irish economy experienced lockdowns due to public health measures introduced in 2020 and 2021, VAT receipts are forecast to be higher in 2022 due to increases in consumption. Budget 2022 forecast VAT receipts of €16.9 billion for 2022. The *Stability Programme Update 2022* revised the forecast upwards for tax revenues from VAT in 2022 to €17.8 billion.

By end-August 2022, cumulative VAT receipts stood at €12.2 billion, an increase of €2.3 billion or almost 24% on the same period in 2021.[35] Recent price increases, as recorded by the Consumer Price Index (CPI), are associated with increases in VAT receipts. As noted in the *Fiscal Monitor* (June 2022), *'receipts in 2021 were impacted by the temporary reduction in the standard rate of VAT, along with the presence of public health restrictions, flattering the year-on-year comparison. The annual growth in VAT receipts is also boosted by the impact of tax warehousing last year.'*

At present, there is a reduced rate of VAT applying to the hospitality and tourism sector. This is due to expire from 1 March 2023, and estimated to cost €250m over the six months prior to that date.[36]

Excise Duties

Excise Duties were the fourth largest source of tax revenue for the Irish Exchequer in 2021, contributing €5.8 billion in tax receipts. This was up 7.3% compared to 2020. *Budget* 2022 forecast receipts from excise of €6.7 billion; however, this was revised *downwards* by the *Stability Programme Update* to €5.7 billion, a decrease in the forecast profile of €955 million following changes to Excise Duties.

On 8th March 2022, the Irish Government announced a reduction in Excise Duties to assist the public with the increase in the price of fossil fuels such as gas, petrol and diesel following the invasion of Ukraine by the Russian Federation. The Minister for Finance announced a temporary reduction in the Excise Duties charged on petrol, diesel and marked gas oil. Excise Duty was reduced by 20 cent per litre of petrol, 15 cent per litre of diesel and 2 cents for marked gas oil.[37] The Irish Government may announce further measures to try shield households from the rising cost of living in the form of changes to Excise Duties, particularly on fossil fuels, in Budget 2023. Such measures may further reduce revenues collected from Excise Duties.

By end-August 2022, receipts from excise have raised €3.6 billion in the year-to-date, slightly down by €41 million on the same period last year.[38] The Fiscal Monitor July 2022, notes that the *'relative weakness reflects, in part, Government policy introduced to tackle increases in the cost of living as well as the negative impact of rising energy prices on the volume of excise-related consumption.'*

Capital Gains Tax

Capital Gains Tax raised €1.6 billion in 2021, up from €950 million in 2020. *Budget 2022* forecast tax receipts from Capital Gains Tax of approximately €1.3 billion for 2022, this has been revised upwards by the *Stability Programme Update* to circa €1.9 billion. In the year to end-August 2022, Capital Gains Tax receipts stood at €577 million.[39] This has traditionally been a relatively volatile source of revenue compared to other taxes and is sensitive to changes in the economic and fiscal cycle.[40]

35 Department of Finance, *Fiscal Monitor August 2022*.
36 Department of Finance, *Tax Strategy Group – VAT 22/07*.
37 Department of Finance, *Press Release*.
38 Department of Finance, *Fiscal Monitor August 2022*.
39 Ibid.
40 Ibid.

Stamp Duty

Stamp Duty raised €1.5 billion for the Irish Exchequer in 2021, 28.6% from the €2.1 billion raised in 2020. *Budget 2022* forecast tax receipts from Stamp Duty of €1.8 billion in 2022. This was revised upwards in the *Stability Programme Update 2022* to €1.9 billion, an upwards revision of 7.5%. In the year to end-August 2022, tax receipts from Stamp Duty stood at €1.2 billion, which was €0.3 billion higher than the corresponding figure in 2021 *'primarily reflecting a once off payment'* according to the August 2022 Fiscal Monitor.[41]

Capital Acquisitions Tax

Capital Acquisitions Tax ('CAT') raised €582 million in 2021, up 15.3% on the €505 million received by the Exchequer in 2020. The *Stability Programme Update 2022* forecast tax receipts of €615 million from CAT in 2022, an increase of €60 million from the Budget 2022 forecasts. In the year to end-August 2022, receipts from CAT stand at €187 million, down by €6 million compared to the same period last year.[42]

Customs

Net tax receipts from Customs amounted to €520 million in 2021, up from €273 million in 2020. Budget 2022 forecast tax revenues from Customs of €510 million for 2022; however, this was revised upwards by the *Stability Programme Update 2022* to €600 million.

41 Ibid.
42 Ibid.

Fiscal Position

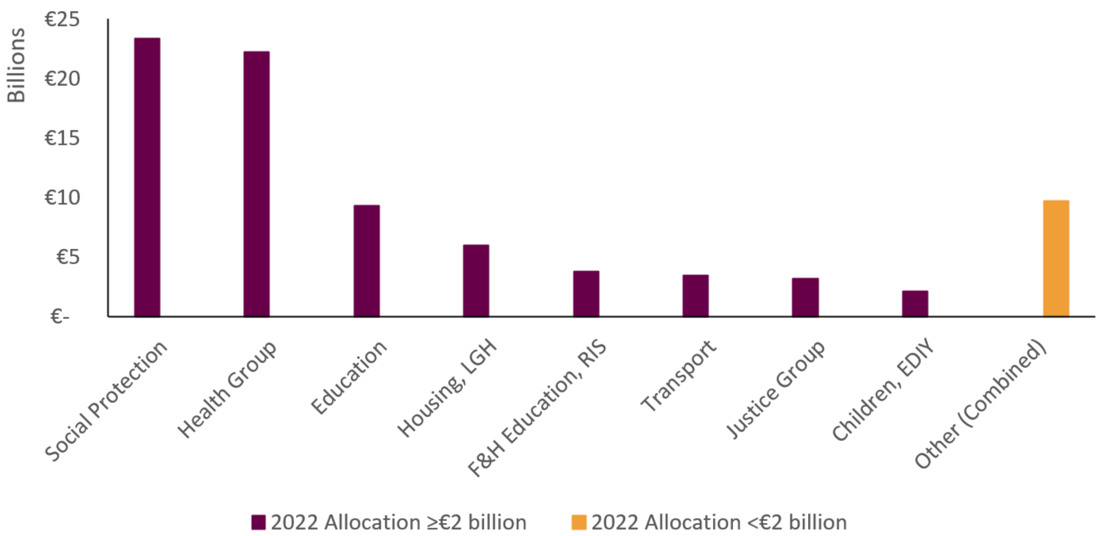
Decisions about changes to the public services provided by the State are announced on Budget day, and subsequently provided for through the Estimates process.[43] At Budget time, Ministers announce spending allocations both for new measures and for the existing services.

Spending

The *Revised Estimates for Public Services 2022* (December 2021) provided for €87.6 billion gross spending in 2022, of which some €4.6 billion was set aside, primarily as part of the COVID-19 Contingency Reserve (€3.9 billion). The balance, almost €83 billion was allocated across 18 Vote groups, which consist of a total of 45 Votes.[44]

Figure 5 illustrates the Vote Groups whose gross allocations were €2 billion or more for 2022. It also shows the combined value of all other Groups whose individual allocations were less than €2 billion as 'Other (Combined)'. Gross spending allocations are highly concentrated in a small number of Vote Groups. The gross allocation to Social Protection, Health, and Education represents 66.1% of the gross allocation for 2022.

Figure 5: Vote Group Allocations in 2022

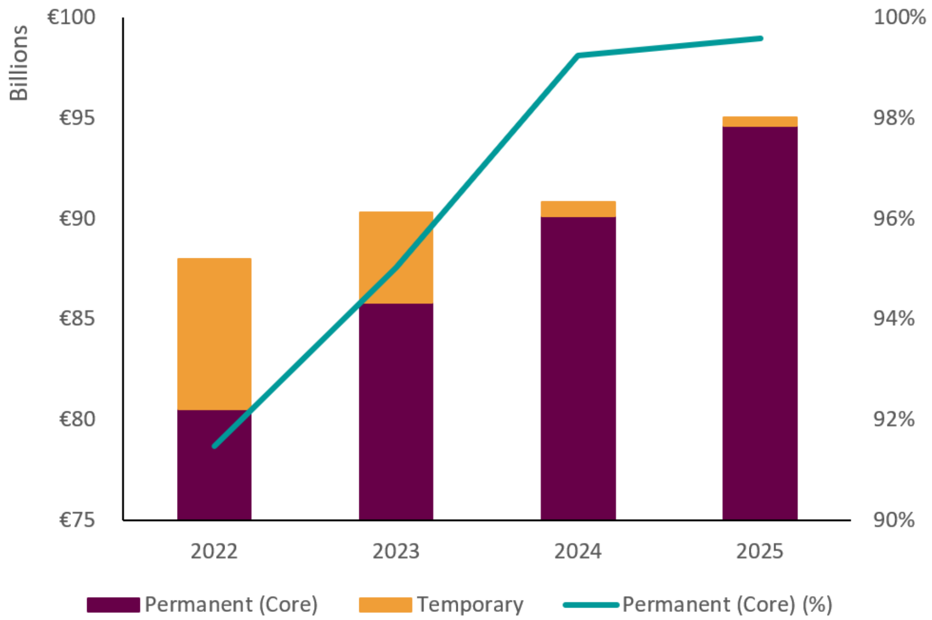


Source: PBO based on Revised Estimates for Public Services 2022 (December 2021).

43 PBO, *The Role of the Oireachtas in the Provision of Public Services* (2020).
44 This spending also includes spending of two funds, the Social Insurance Fund (SIF) and the National Training Fund (NTF).

Figure 6 illustrates the Expenditure Ceiling for the period 2022 to 2025. Most significantly, spending is anticipated to grow within this timeframe from €88 billion to €95 billion (an increase of 8%); however, this growth is concentrated within core (permanent or recurring) spending (+€14.1 billion / 17.5%), with temporary (non-core) spending declining significantly (-€7.1 billion or 94.7%). Non-core spending has, in recent years, been primarily associated with Brexit and Covid. However, as Covid supports have been wound down, "the full contingency amount is not expected to be required for Covid supports", allowing for flexible use of these funds for cost-of-living supports and to "provide funding for the provision of humanitarian supports for refugees arriving in Ireland from Ukraine."[45]

Figure 6: Composition of Expenditure Ceiling 2022 to 2025



Source: PBO based on Department of Public Expenditure and Reform, Summer Economic Statement (July 2022) p.xiii.

The *Summer Economic Statement* described €2.4 billion of cost-of-living measures including the Budget 2022 package of social welfare measures and those addressing the cost of living and affordability such as health affordability supports, housing, education, and childcare related cost supports.[46] In addition to this, a February package valued at €505 million was also introduced.[47] A further additional €100 payment was made to households receiving the fuel allowance at a total cost of €37.1 million.[48]

45 Department of Public Expenditure and Reform, *Mid-Year Expenditure Report* (July 2022) p.12.

46 Department of Finance and Department of Public Expenditure and Reform, *Summer Economic Statement* (July 2022) pp.24-5; and Department of Children, Equality, Disability, Integration and Youth, '*Minister O'Gorman announces "transformative" €183 million budget package*' (October 2021).

47 Department of Finance and Department of Public Expenditure and Reform, '*Ministers McGrath and Donohoe announce €505 million package in measures to mitigate the cost of living*' (February 2022).

48 Department of Social Protection, '*Extra Fuel Allowance payment of €100 will be made this week - Minister Humphreys*' (May 2022).

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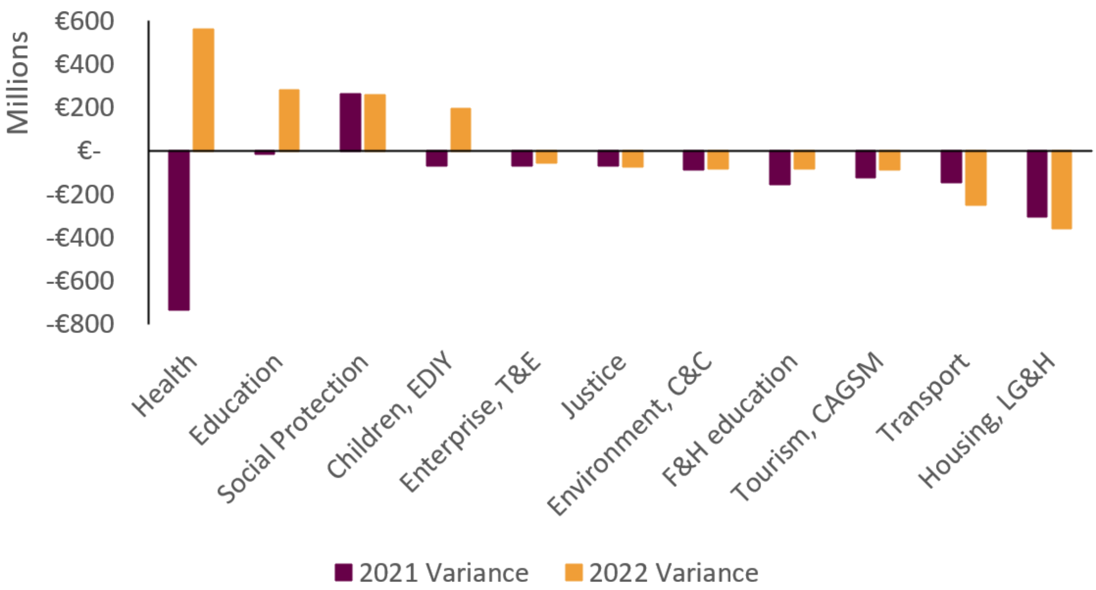
Variance in Gross Spending (end-August 2022)

Variance is the difference between projected spending at a point in time and the actual spend at that time. **Monitoring variance is important as it can help identify Vote Groups in which Supplementary Estimates may arise, either to reallocate available monies (savings) or to seek additional funding where it has insufficient resources for the current year.** Due to this year's budget taking place earlier than usual, it is less certain which Votes may require additional funding before year end, or where savings may occur (where spending is lower than profile).[49] This section focusses on Vote Groups with the most significant variance in € millions; however, it is also important to consider variance as a proportion of the specific Vote Group's profile (e.g. at end-August 2022 the Rural and Community Development Vote Group's spending was €36 million lower than profiled, about 18% less than profile).

As of end-August, total gross cumulative spending reached €51,192 million, €197 million (0.4%) more than profiled. A small number of Vote Groups have, as of end August, spent more than had been profiled (€1,308 million); however, this 'overspend' was almost entirely offset by below profile spending in other Vote Groups (-€1,111 million). Overall (total) capital variance at end-August 2022 was -€803 million (see Figure 9, p.18). Capital variance tends to decline at year-end, meaning the off-setting effect of 'underspends' in capital are generally exaggerated at earlier stages of the year.

Figure 7 illustrates total variance of gross spending at end-August 2022 compared to end-August 2021 for all Vote groups where variance was greater than €50 million at end-August 2022. All Vote groups, in which gross variance was less than €50 million, are illustrated separately in Figure 8.

Figure 7: Variance (in Gross spending) at end-August 2022 compared to end-August 2021



Source: PBO based on Department of Finance, Fiscal Monitor (August 2021 and August 2022).

Variance as set out in Figure 7 continues some trends identified and explained in the Mid-Year Expenditure Report 2022, with higher levels of spending "due to provision of additional supports to respond to Omicron wave of Covid-19 measures, the implementation of cost of living measures and the provision of humanitarian supports required for arrivals to Ireland from Ukraine".[50]

Figure 8 illustrates that Vote Groups with variance less than €50 million as of August 2022. These Vote Groups tended to spend below profiled levels. Only two groups (Foreign Affairs and Public Expenditure and Reform) spent more than profiled (by €11, and €7 million respectively). The other Vote Groups illustrated spent a combined €123 million less than profiled. Together, these 'Other' Vote Groups spent €105 million less than profiled.

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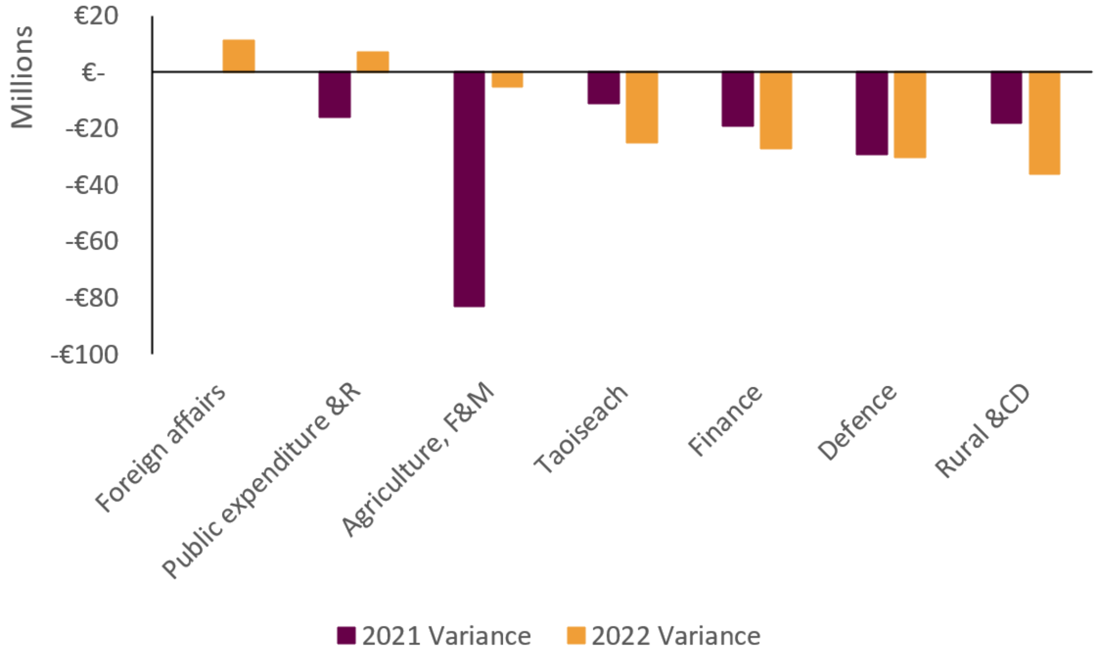
49 Over or under profile spending must be treated with caution. Spending over profile can reflect that additional public services were delivered or that the cost of services was higher than anticipated. Likewise, under-profile spending is not necessarily a saving (public services costing less than forecast) but could also reflect under-delivery.

50 Department of Public Expenditure and Reform, *Mid-Year Expenditure Report* (July 2022) p.7.

Figure 8: Variance at end-July 2022 compared to end-August 2021 (in Vote Groups where variance was <€50 million)



Source: PBO based on Department of Finance, Fiscal Monitor (August 2021 and August 2022).

Variance is important to analyse under two primary measures.

I. **Total variance** looks at how accurate forecast levels of spending are. It measures the degree of variance by Vote Group and totals these measures – it does not set savings against overspending. This measure reflects how accurately levels of spending have been forecast and can indicate the general quality of profiling. At end-August 2022 this figure was €2,419 million. This measure can indicate that Supplementary Estimates will be required to redistribute resources or to allocate additional resources.

II. **Cumulative variance** measures the variance by Vote Groups and offsets overspending against under profile spending. This results in a netting-off effect which shows, on aggregate, how close projected levels of spending are to profile. This obscures the individual performance of Vote Groups but provides a general sense of whether resources allocated for 2022 are sufficient. Low cumulative variance suggests that the overall level of resourcing is adequate – but cannot indicate if those resources have been allocated appropriately across Vote Groups. At end August 2022, cumulative variance was €197 million.

Capital Variance

Figure 9 illustrates within-year variance in capital spending (the difference between projected spending at a point in time and the actual spend at that time). Consistently capital spending tends to display negative variance (actual spending being lower than profiled). Figure 9 illustrates that variance in capital spending has been significant in recent years, this is at least partly attributable to the impact of crises on capital spending in-year and the knock-on effect of this into subsequent years arising from capital carryover (the application of deferred surrender). The distortive effect of capital carryover has been explained by the PBO previously.[51] As already discussed, understanding variance is important as it can be a useful predictor of (i) whether sufficient cumulative resources have been allocated; and (ii) whether those resources are allocated appropriately across Vote Groups. The distortive effect of capital carryover on profiled spending (and therefore on measured variance) is therefore problematic.

[51] PBO, *Capital Carryover (Deferred Surrender) 2022* (March 2022).

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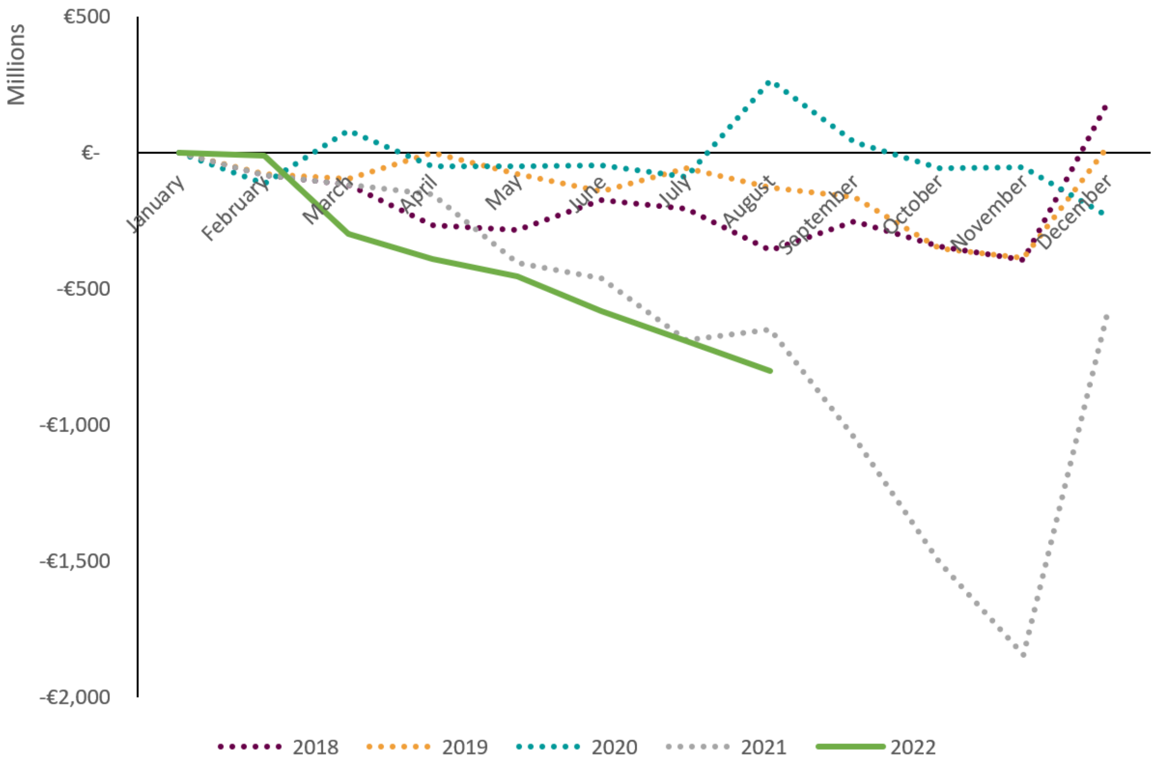
Figure 9: Gross Capital Variance (2018 to 2022)



Source: PBO based on Fiscal Monitors (2022 series and older editions).

The PBO has previously commented on capital spending outlining how capital carryover distorts profiles. A portion of the capital allocation in a year ('X') is spent in the subsequent year ('X+1') but is accounted for as having been spent in the December of year 'X'. This means that capital profiles do not accurately reflect the in-year capital spending (in year 'X+1') as monies carried forward are not reflected in either the profiles or outturn for that year.[52] Significant capital spending occurs in December most years and is likely (at least partially) attributable to this technical accounting practice.

Looking at 2021 specifically, capital variance was -€580 million at end-2021. However, €748.5 million had been carried into 2021 (but was accounted for as 2020 spending). Likewise, some €820.1 million was carried forward from 2021 to 2022 (but accounted for as spent in 2021). This potentially contributes to seemingly low levels of capital spending early in each year – as capital carryover is not incorporated within profiled spending. Capital carryover's direct impact on profiled spending, and indirect effect on variance make rigorous analysis of capital spending challenging. **Ideally additional data could be incorporated within the monthly Fiscal Monitor publications to illustrate profiles and spending inclusive of capital carryover.**

52 For more detailed discussion of capital carryover please see PBO, *Capital Carryover (Deferred Surrender) 2022* (March 2022).

Welfare Rate Changes, Potential Tax & Welfare Indexation and Work Incentives

The Tax Strategy Group paper on Social Protection outlined potential options for welfare rate changes in Budget 2023.[53] A €15 increase in all weekly welfare payments would cost approximately €1.11bn in a full year.[54] A €15 increase in core social welfare payments (e.g. Jobseeker's Allowance/Benefit, One Parent Family Payment, Illness Benefit) that are currently set at €208 equates to a 7.2% increase. Based on the ESRI's inflation forecast for 2022 in their Summer Quarterly Economic Commentary of 7.1%, the €15 increase would cover 2022 inflation.[55] However, given actual inflation rates since then, the forecast in their upcoming Autumn publication is likely to exceed 7.1%, meaning that the €15 increase would not cover 2022 inflation, resulting in a fall in the real value of core social welfare rates. A €15 increase in the Contributory State Pension (currently €253.50) equates to a 5.9% increase – falling considerably short of the likely overall 2022 inflation rate and resulting in a fall in a real value. It should be noted that covering 2022 inflation would only maintain core social welfare rates if there were no inflation in 2023 – which seems unlikely.

A €10 increase in core weekly welfare payments from €208 to €218 is a 4.8% increase, and a 3.9% to the Contributory State Pension, both substantially below 2022 inflation. A €10 increase in all weekly welfare payments would cost approximately €740m in a full year. An increase of €14.77 in the core weekly welfare payments covers inflation in 2022 at 7.1%, although an increase of almost €18 would be required to cover 2022 inflation in the case of the Contributory State Pension.

A 7.1% increase in all weekly welfare payments (the ESRI's latest inflation forecast) would cost approximately €1.21bn and an 8.3% increase in all weekly welfare payments (included as an option in the Tax Strategy Group options) would cost approximately €1.42bn in a full year. Full indexation becomes much more expensive if Child Benefit and other subsidiary payments in addition to the core weekly payments are included. For instance, full welfare indexation at 7.1% would cost approximately €1.49bn, in comparison to the €1.21bn cost for 7.1% indexation of core weekly payments only.

Increases to weekly core social welfare payments may raise work disincentive concerns, as welfare net income may increase relative to potential in-work net income. However, similar changes to tax bands, credits and changes to Housing Assistance Payment and subsidised childcare parameters would largely offset the increases in welfare payments for those who move from welfare to work. A PBO analysis of replacement rates shows the impact on work disincentives is minimal at an example indexation rate of 5%.[56] Key to this is the indexation of HAP and childcare rates/income thresholds for lower income groups and one parent families – without this indexation, they would face an increase in poverty.

Expenditure Increases and Existing Level of Service Provision (ELS) in the Context of High Inflation

Department of Public Expenditure and Reform Databank data show that 2022 current expenditure is scheduled to be circa €71.83bn.[57] Based on the Central Bank's inflation forecast (Harmonised Index of Consumer Prices - HICP), inflation in 2022 will be around 7.8%, with the 2023 rate forecast to be around 4.2%.[58]

53 *Tax Strategy Group Papers, Budget 2023*.
54 The costs outlined here exclude Child Benefit – a €15 increase in Child Benefit would cost approximately €220m for a full year. Subsidiary payments, such as fuel allowance and the living alone allowance, are also not included in these core costs analyses but are included in the PBO's fully interactive Tax and Welfare Exchequer Budget Tool, available *here*.
55 *ESRI Quarterly Economic Commentary Summer 2022*.
56 *PBO Replacement Rates Analysis, 2022*. Replacement rates are a measure of net income on welfare as a proportion of net income in employment. Therefore, a higher rate indicates a potential disincentive to move from welfare to work.
57 *DPER Databank gross expenditure data*.
58 *Central Bank Quarterly Bulletin 3 of 2022*.

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Therefore, the PBO estimates that total current expenditure in 2023 may need to be around €74.85bn just to standstill at 2022 levels (accounting for 4.2% inflation in 2023) and would need to be €78.87bn to account for unexpected 2022 inflation combined with forecast 2023 inflation. **The increase required to reach €74.85bn would be €3.02bn and the increase required to reach €78.87bn would be €7.04bn – depending on the definition/timing assumed for a 'standstill' scenario.**

Conservatively assuming the required increase of €3.02bn, this is still considerably above the €2.2bn estimate to maintain existing level of services (ELS) in 2023 outlined in the Government's 2022 *Mid-Year Expenditure Report*.[59] **If a larger increase is required to maintain ELS, then the amount budgeted for new measures (€2.3bn in 2023) may need to be reduced accordingly.** The 'new measures' may include increases in social welfare rates, likely below inflation, which will consume a large proportion (potentially half) of the €2.3bn.

Income Tax in Ireland Compared to Other European Countries

A recent publication by the PBO comparing income tax rates, bands and burden across Europe shows that Ireland is a relatively low income tax country compared to our European neighbours, when the income tax and social security contributions burden is combined.[60] This low rate of social security contributions in Ireland and the overall relatively low income tax burden on low and average earners has obvious consequences for public expenditure decisions. In order to have the level of public services available in some European countries, the approach to income tax and social security contributions may need to be reconsidered, particularly given the precarious nature of corporation tax receipts and likely future pressure to deal with the growing and ageing population.

59 *2022 Mid-Year Expenditure Report*.
60 *A Comparison of Income Tax Rates, Bands and Burden Across Europe, PBO 2022*.

Spending Issues and Priorities

Overview

Public sector pay, maintenance of existing levels of service delivery (and quality) and additional costs driven by higher levels of service use (for example arising from demographic change) have the effect that "the year-on-year decisions that are made in the annual budgetary process to change spending priorities are limited in scope".[61] The scrutiny of budgets largely focusses on new spending at the margins. While this is understandable, it is insufficient from a scrutiny perspective. The Spending Review papers are a means to address this issue as they provide detailed analysis of spending on schemes, services, or programmes which may indicate where reforms may be merited (either saving money or increasing the efficacy of the policy/scheme etc.).[62] The PBO has previously noted the value of the Spending Review process and suggested means to enhance its utility.[63]

Budget 2023 is expected to provide a total package of changes valued at €6.7 billion, with €1.05 billion in taxation measures and the balance, €5.65 billion, being used for "expenditure developments".[64] Spending is divided between €4.9 billion in core current spending (€400 million of which is to be spent in 2022) and €800 million of core capital spending. Excluding €400 million for early implementation of budget measures (spending in 2022 rather than 2023) and €2.2 billion provided to maintain existing levels of services (ELS) into 2023, only €2.3 billion is available as core current spending for new measures in 2023.[65]

The Fiscal Council has estimated that:

- If the Government were to fully protect the real value of services and supports against inflation, this would cost almost €7 billion […]. This exceeds the total core current spending increases of €4.9 billion set out in the Summer Economic Statement for 2022 and 2023 combined.[66]

Budget 2023 will therefore involve challenging decisions regarding spending priorities, with some doubt as to whether the budget package (as currently outlined) can fully support ELS. In effect, the introduction of new measures may be to the detriment of underlying ELS. Potential new measures in 2023 could include some combination of the following:

61 PBO, *General Government Expenditure: How its composition constrains decisions about government spending* (2019) p.13.
62 Department of Public Expenditure and Reform, *'Spending Review 2022'* (Accessed 07 September 2022).
63 PBO, *The future of the Government's Spending Review: A parliamentary scrutiny perspective* (2019).
64 Department of Public Expenditure and Reform, *Mid-Year Expenditure Report* (July 2022) p.25.
65 Ibid.
66 Irish Fiscal Advisory Council, *Pre-Budget 2023 Statement: Getting the balance right* (September 2022) p.21.

- A recent Department of Social Protection paper projected a cost of €741 million for a €10 increase to "all weekly social welfare payments with proportionate increases for qualified adults and those on reduced rates of payment".[67] This cost rose to €1,112 million with additional adjustments.
- Assuming a linear increase in spending towards its 2028 target, approximately €67 million will be required by way of an increase to the Defence Vote Group (Defence Vote and Army Pension Vote).
- A recent paper on reducing the cost of higher education set out various policy options that could be adopted, with associated costs for 2023 and 2024 (to reflect the full-year costs of implementation).[68] These options range from €0.85 to €85.4 million for 2023; however, various combinations of measures could be adopted as a package.

Public sector pay and pensions are expected to cost approximately €25.6 billion in 2022 and reflected pay developments as outlined in *Building Momentum*.[69] A new proposed public sector agreement on August 30th 2022 includes a retrospective element as well as phased increases during 2023.[70] If agreed, the pay deal "will have to come out of the overall package of around €2.7 billion".[71] The PBO has attempted to cost the proposed increases, detailed in Box 1: Developments in Public Sector Pay 2022 and 2023 (page 24) of this paper, totaling at approximately €603 million for 2022.

Significantly, **the PBO's costing of the pay proposal for 2022** (603 million excluding any associated pension costs) **exceeds the portion of the Budget 2023 package set aside for early implementation of new measures** (400 million). The PBO's costing tends towards a conservative estimation of costs, thus, **the cost of early implementation of Budget 2023 measures (specifically addressing the public sector pay proposal) may exceed the funding allocation described in the Budget package by a significant margin. It is not clear how this shortfall may be addressed.**

67 Department of Social Protection, *Social Protection Budget Package – Budget 2023 Issues Tax Strategy Group -22/05* (July 2022) p.15.
68 Department of Further and Higher Education, Research, Innovation and Science, *Funding the Future: An annual options paper on reducing the cost of higher education* (05 September 2022) pp.24-7.
69 PBO based on DPER Databank. This reflects only Voted spending on public sector pay (excluding Local Authorities) and pensions (the state pension contributory may be claimed by some pension recipients – this is funded by the Social Insurance Fund (Non-Voted)).
70 Cormac McQuinn, '*Public sector pay talks conclude with unions offered 6.5% increase*' (The Irish Times, 30 August 2022).
71 Committee on Budgetary Oversight, '*Summer Economic Statement 2022: Discussion*' (14 July 2022).

Public Sector Pay

Public sector pay is fundamental to the delivery of public services.[72] The composition of the public sector and the number of persons it employs is set out in Table 3.

Table 3: Public Sector Composition & Employment (Q2 2022)

2022Q2	Sub-sector	Employment
Central Government	Civil Service	44,500
	Defence	9,000
	Garda Síochána	14,400
	Education	113,400
	Health	155,500
	Non-commercial semi-state companies	16,700
Local Government	Regional Bodies	35,400
Public Corporations	Commercial semi-state companies	41,500
Total (Including semi-state bodies)		430,500
Total (Excluding semi-state bodies)		372,200

Source: PBO based on CSO, 'EHQ10' (Accessed 05 September 2022).

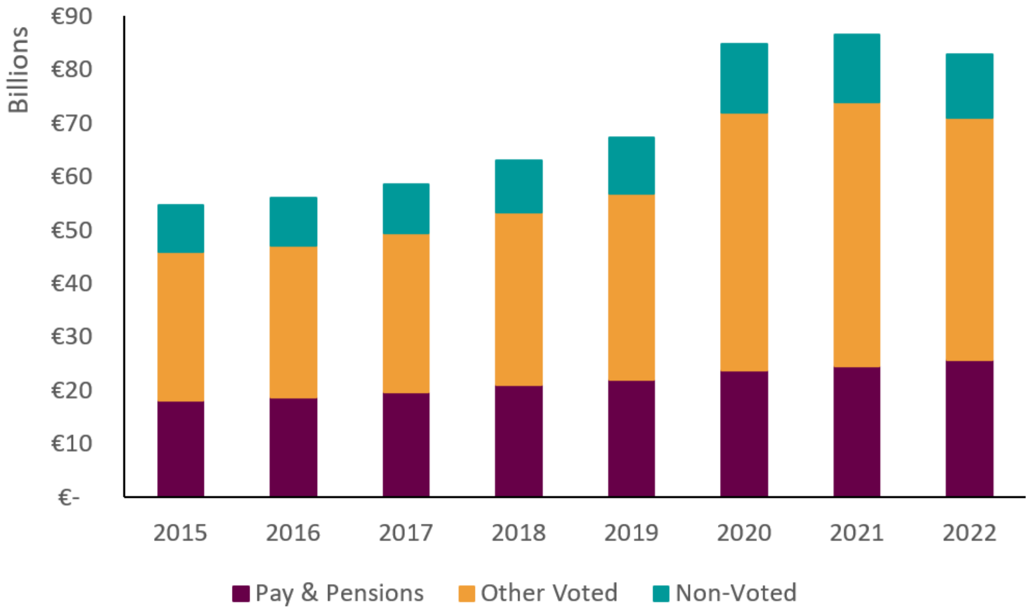
Public sector pay is a substantial component of Voted Expenditure and Government Expenditure. Voted expenditure is the spending which requires Dáil approval and is given legal effect in the annual Appropriation Act. Government expenditure as defined in the *Ministers and Secretaries (Amendment) Act 2013* is the sum of Voted expenditure and the spending of both the Social Insurance Fund (SIF) and the National Training Fund (NTF) (which are not Voted).

The *Revised Estimates for Public Services* presents Government Expenditure projected for the coming year – thereby including spending from the SIF and NTF. Pay and pensions costs set out in the Revised Estimates for Public Services are the most up-to-date source of data available on pay and pension spending in the public sector but importantly do not reflect the entire pay and pension costs of the public sector. In particular, the pay Voted upon annually does not reflect the pay of Local Authority workers. The most recent data available shows local authorities had payroll costs of almost €1.93 billion in 2020.[73] Figure 10 illustrates Government Expenditure for the period 2015 to 2022 broken down between Voted components (pay and non-pay) and non-Voted items (SIF and the NTF).

[72] PBO, *The Irish Public Sector: An Overview of the Composition of the Public Sector, and of the Development of Exchequer Funded Public Sector Pay* (2021).

[73] Department of Housing, Local Government and Heritage, *Amalgamation: Audited Annual Financial Statements 31 Local Authorities For The Year Ended 31 December 2020* (August 2022) p.32.

Figure 10: Public Sector Pay in Context of Government Expenditure (2015 to 2022)



Source: PBO based on DPER, 'Databank' (Accessed 16 August 2022).

Public sector pay averaged 32% of Voted spending in the period illustrated. Non-core spending in recent years has impacted on the relative significance of pay within Voted spending, with the pandemic and Brexit driving increases in 'Other Voted' spending. For the period 2015 to 2019 public sector pay made up 33% of Voted spending annually. When pension costs are also included, almost 40% of Voted spending was comprised of pay and pensions prior to the pandemic.

The impact of the approval of the *Report of the Independent Hours Body* (January 2022) on the public sector pay bill for 2023 is unclear but may be significant. Based on 2022 costings it is highly likely that this cost will be concentrated in the Health Vote, with €102 million (57%) of the €179 million cost for 2022 associated with the Health Sector.

Box 1: Developments in Public Sector Pay 2022 and 2023

This box discusses the PBO's calculations of the gross pay cost of public sector pay proposal (August 2022). Details of the PBO costing are available on request. The PBO has not costed additional pension costs arising from the proposal.

In the context of public sector pay, it is essential to note that the gross pay bill should not be considered entirely in isolation from the associated revenue impacts. **Additional public sector pay also generates additional revenue for the Exchequer (primarily through Income tax) therefore, the net cost of public sector pay increases (when their impact on tax revenues are factored in) is likely to be considerably lower than the gross headline figure.** The PBO's estimate of gross pay costs involves the following assumptions and caveats necessitated by the limits of the data available to the PBO:

I. Public sector pay figures are calculated by reference to the Voted allocation for 2022 as set out in the *Revised Estimates for Public Services 2022* (December 2021) of €21.92 billion.

II. It is assumed that pay spending changes month-to-month only in line with agreed or proposed % increases, i.e. the costing does not account for changing staffing levels or fluctuations in hours worked, overtime etc. during the period.

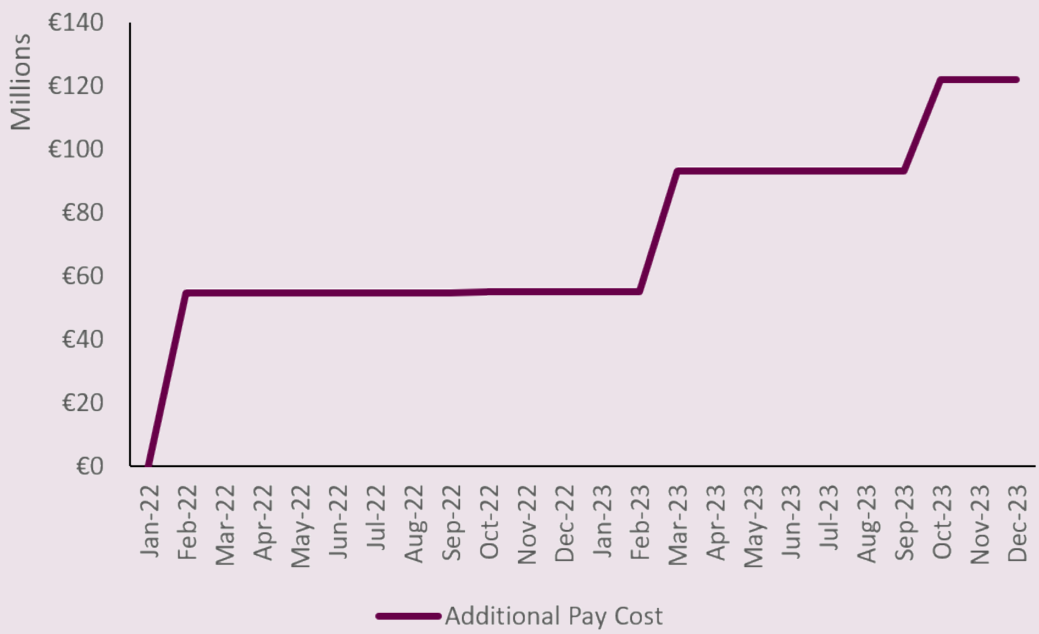
III. Changes to pay are applied to the entire month in which they occurred, will occur, or are proposed to occur.

IV. Local authority pay is not reflected in the *Revised Estimates for Public Services* and therefore is not incorporated within this costing.

V. Pay costs are calculated on the assumption all staff receive the % increases outlined in *Building Momentum* and the proposal of August 30th 2022. The PBO does not have access to data to reflect that a large number of public sector workers will receive fixed increases to pay in October 2022 under Building Momentum (the greater of a 1% increase or €500) in October 2022 and under the August 2022 proposal (the greater of 1.5% or €750 in October 2023).

Subject to the caveats above the PBO has estimated the gross additional pay costs of the August proposal in 2022 and 2023 (noting that net costs will be lower as these pay increases will also generate additional revenue to the Exchequer). **The PBO's costing methodology tends to be conservative** (see points II, IV and V above), **with actual gross pay costs likely to rise above the levels estimated herein**.

Figure 11: In-month Additional Cost



Source: PBO costing, with reference to Building Momentum (December 2020), Revised Estimates for Public Services 2022 (December 2021), and Review of Building Momentum (August 2022, currently unpublished).

Figure 11 illustrates the additional monthly costs of the pay proposal compared to the baseline (no further pay adjustments other than provided for in *Building Momentum*). The impact of backdating of a 3% increase being almost €55 million per month from February 2022 to September 2022 and rising to just over €55 million from October 2022 until February 2023. The monthly pay cost rises to over €93 million as of March 2023 before rising to over €122 million per month from October 2023.

Figure 12 illustrates the total additional cost of the current pay proposals in 2022 and 2023. The additional cost in 2022 is approximately €603 million, rising to €1,130 million in 2023, with full year costs emerging in 2024 of €1,467 million.

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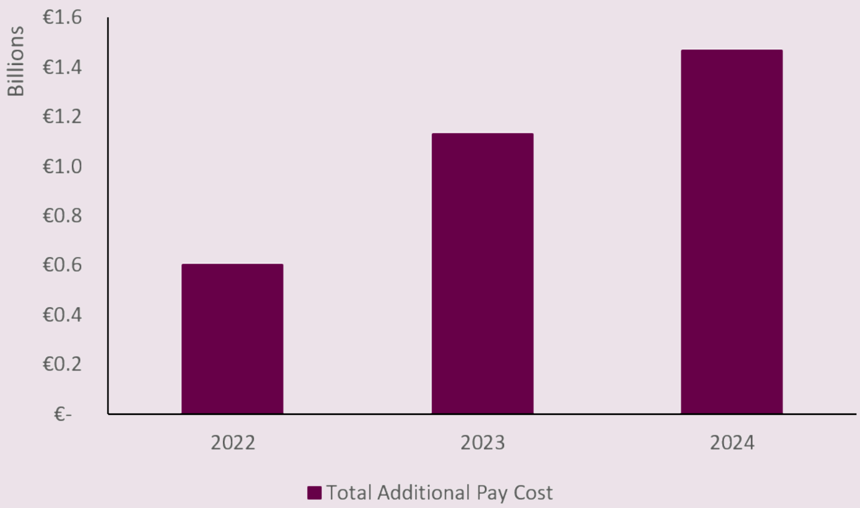
Figure 12: Additional Annual Costs of Pay Proposal



Source: PBO costing, with reference to Building Momentum (December 2020), Revised Estimates for Public Services 2022 (December 2021), and Review of Building Momentum (August 2022, currently unpublished).

To date there is limited information available from Government as to the cost of the pay proposal; however, the Minister for Public Expenditure and Reform has previously stated that the approximate cost per % point pay increase is €250 million, with the cost for each % change to pensions being in the region of €20 to €30 million.[74] More recently Minister McGrath has stated that: [75]

- *"The additional cost of the pay adjustments that we agreed last night [...] come in at approximately €1.6 billion. That is spread across a 3-calendar year period, 22, 23 and 24, but there will be significant provision required in the context of Budget 2023 which will be of the order of €1.4 billion."*

The 'additional cost' referred to by the Minister is likely to refer to the increased in-year cost of the pay proposal, i.e. the additional in-year cost compared to the status quo. The PBO's pay costing for 2023 is considerably lower than that of the Fiscal Council (€2.8 billion),[76] whose costing appears to account for full indexation, and is also lower than the cost set out by the Minister (above). The PBO's costing being lower due to the caveats outlined above (in particular, the absence of data on Local Authority pay is likely to be significant). However, **the PBO's costing should be reasonably consistent with pay increases for 2023 to be outlined in Budget 2023 (which will also not reflect Local Authority pay).**

Social Protection

Payment Rates

Social Protection is the single largest area of spending described in the budget. It combines the Vote (social assistance) and Social Insurance Fund (SIF) (social insurance) payments. Vote 37 Social Protection is subject to annual approval by Dáil Éireann, while SIF spending is presented as part of the budget (under legislation it is defined as part of Government Expenditure), it is not subject to approval by Dáil Éireann, i.e. it is non-Voted.[77]

74 Committee on Budgetary Oversight, '*Summer Economic Statement 2022: Discussion*' (14 July 2022).
75 RTÉ, '*News at One*' (30 August 2022).
76 Irish Fiscal Advisory Council, *Pre-Budget 2023 Statement: Getting the balance right* (September 2022) p.21.
77 SIF spending is non-Voted spending as it has a legislative basis and does not require annual approval by Dáil Éireann.

As discussed in the Economy section, while Ireland has rebounded strongly from the pandemic, insofar as levels of employment are concerned, considerable inflationary pressures are being experienced. Social protection spending has two primary drivers, the number of persons in receipt of payment, and the rates of payment. In the current environment, with low levels of unemployment, inflationary pressures are driving demand for increases to social protection payment rates. **Social welfare payments are subject to a fine balance, in particular, where too high a rate of payment acts as a disincentive to labour force participation and where too low a payment rate may indicate the payment is insufficient to maintain a decent standard of living.**[78] PBO analysis has shown that:[79]

- "flat increases in social welfare payments, such as the €5 increase to be applied to core benefits in 2022, result in disproportionate percentage changes and do not systematically account for price (or wage) inflation in a consistent manner."

The Select Committee for Budgetary Oversight was broadly supportive of indexation of social welfare and taxation and has recommended, *inter alia*, "that the establishment of such an indexation system is examined by relevant Departments."[80] Increases to payment rates which may be implemented, either as *ad-hoc* increases, or as part of a formal process of indexation of payment rates, will result in increased spending from both the Vote and the Social Insurance Fund (SIF).

Indexation could drive large increases in the short-term which could significantly increase the levels of spending associated with social protection. A more incremental approach, with core payment rates increasing at a level below inflation, would provide greater flexibility for other spending measures, including targeted measures responding to inflation. It should be noted that recipients of social welfare payments are generally a vulnerable group,[81] and increased payment rates for various schemes could be deemed a reasonably targeted approach in alleviating inflationary pressures on less well-off members of society.

If once-off or bonus (additional) payments are proposed in response to cost-of-living pressures, they will pose a challenge in terms of profiling future social protection spending. The discretionary nature of 'bonus' type payments is problematic where these payments become a regular feature of the budget, with the Fiscal Council noting that the Social Protection Christmas Bonus, as of Budget 2022, "has been paid every year in some form since 2014".[82] The fact the Christmas Bonus was not budgeted for reflects "a long-standing weakness in budgeting".[83]

Pensions & the Social Insurance Fund (SIF)

The Social Insurance Fund (SIF) is a fund from which payments for Social Protection benefits are drawn. The SIF's primary source of funding is PRSI contributions (about 99.7% of the SIF's estimated income in 2022 is from PRSI contributions). When the SIF's income exceeds its liabilities, the surplus is added to the SIF's reserves. These reserves are drawn upon when SIF liabilities exceed its income; however, if SIF liabilities exceed its income and its reserves, the balance must be made up by a subvention (effectively a top-up payment) from the Exchequer via the Voted allocation to Vote 37 Social Protection. Figure 13 illustrates in a simplified form how the SIF operates.

78 PBO, *The Impact of Indexation on Jobseeker's Replacement Rates: A 2022 Case Study Approach* (April 2022) p.1.
79 PBO, *Social Welfare Rate Changes 2011 – 2022* (December 2021) p.1.
80 Select Committee for Budgetary Oversight, *Report on Indexation of the Taxation and Social Protection System* (July 2022) p.8.
81 Some payments (for example Child Benefit) are not means tested and therefore may be paid to persons or families, for whom the impact of inflation is comparatively less significant.
82 Fiscal Council, *Fiscal Assessment Report* (December 2021) p.50.
83 Ibid.

Figure 13: SIF decision tree

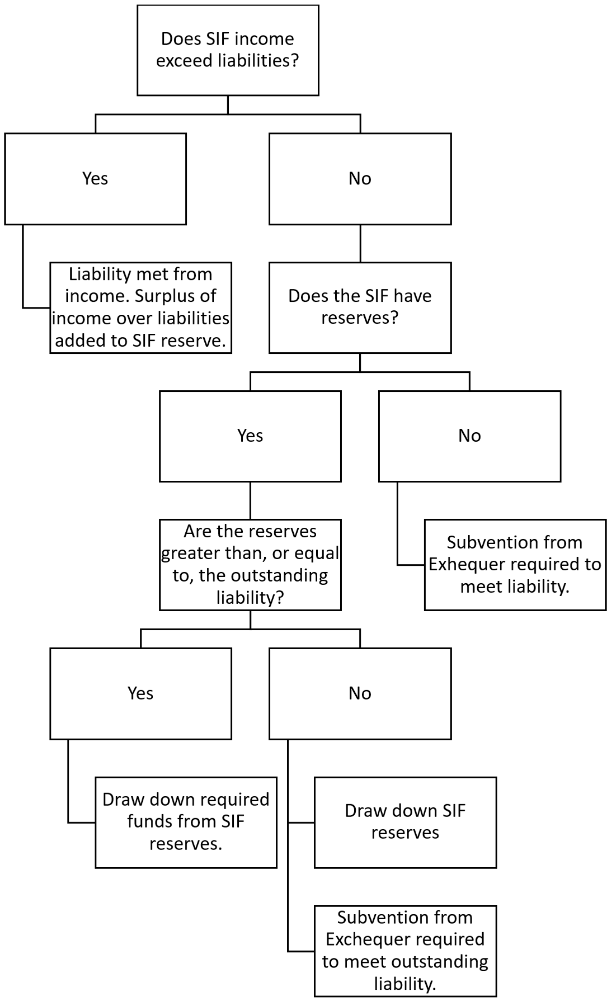
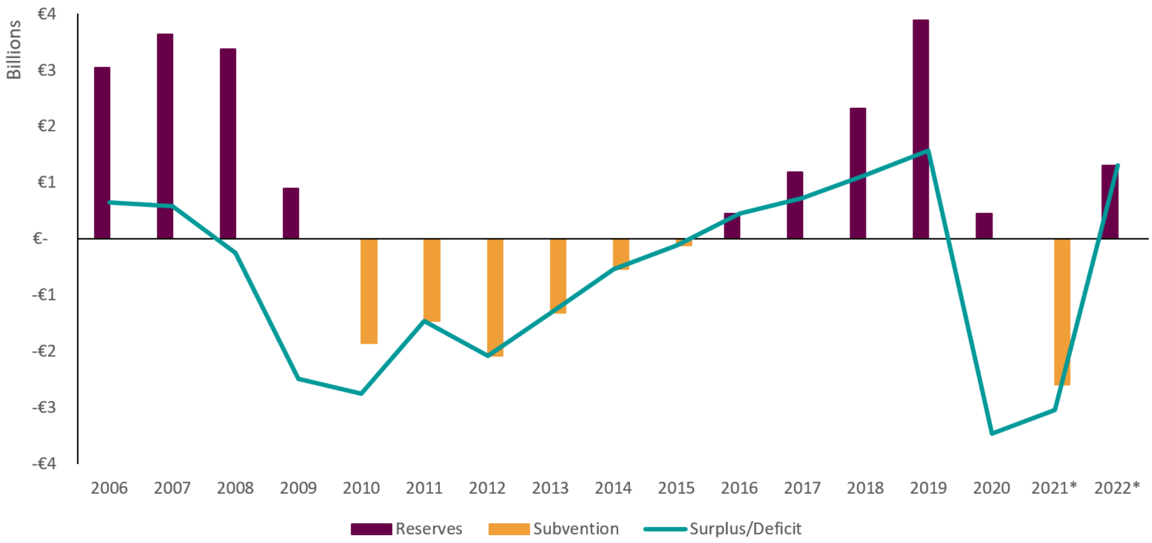


Figure 14 illustrates the main measures of the SIF's financial performance for the period 2006 to 2022. It highlights how quickly accrued reserves of the SIF are reduced or entirely depleted during a crisis.

Prior to the pandemic, it had been projected that the SIF's income in 2020 would exceed its liabilities by almost €1.86 billion, this would have left the SIF with end-2020 reserves of over €5.7 billion. In response to the pandemic, the SIF instead was forced to draw down a considerable amount of its accrued reserves (over €3.4 billion). In 2021 the SIF's reserves were entirely depleted and the Exchequer was required to provide a subvention of almost €2.6 billion to the SIF.

Figure 14: SIF Developments 2006-2022



Source: PBO based on Department of Social Protection, Accounts of the Social Insurance Fund (2007, 2008, 2010, 2012, 2014, 2016, 2018, and 2020), and the Revised Estimates for Public Services 2022 (December 2021).
Note: 2021 and 2022 figures are drawn from the Revised Estimates for Public Services 2022 and are subject to change.

As illustrated above, the SIF's reserves are volatile, and can be severely impacted by shocks which affect levels of employment. However, the majority of SIF expenditure is ordinarily associated with pension payments. The viability of the SIF (or at least its ability to run surpluses) will be impacted by:

I. levels of employment,

II. rates of payment of schemes it funds, and

III. the number of persons availing of these schemes.

Not implementing stricter eligibility criteria, such as increasing pension age, will result in a greater draw upon SIF resources. In addition, **if payment rates for social insurance schemes are increased, the ability of the SIF to achieve surpluses (and the scale of those surpluses) would be negatively impacted** even in a high-employment scenario.

During the Select Committee for Budgetary Oversight's engagement on the indexation of the Taxation and Social Protection System, it was informed that:[84]

- *Future pressures on the public finances due to an ageing population are well documented. […] Department of Finance calculations included in the pensions commission's report estimate that expenditure on social welfare pensions will increase from around 3.8% of modified GNI in 2019 to 5% by 2030, assuming that the pension age is retained at 66. By 2050, this estimate increases to 7.9%.*

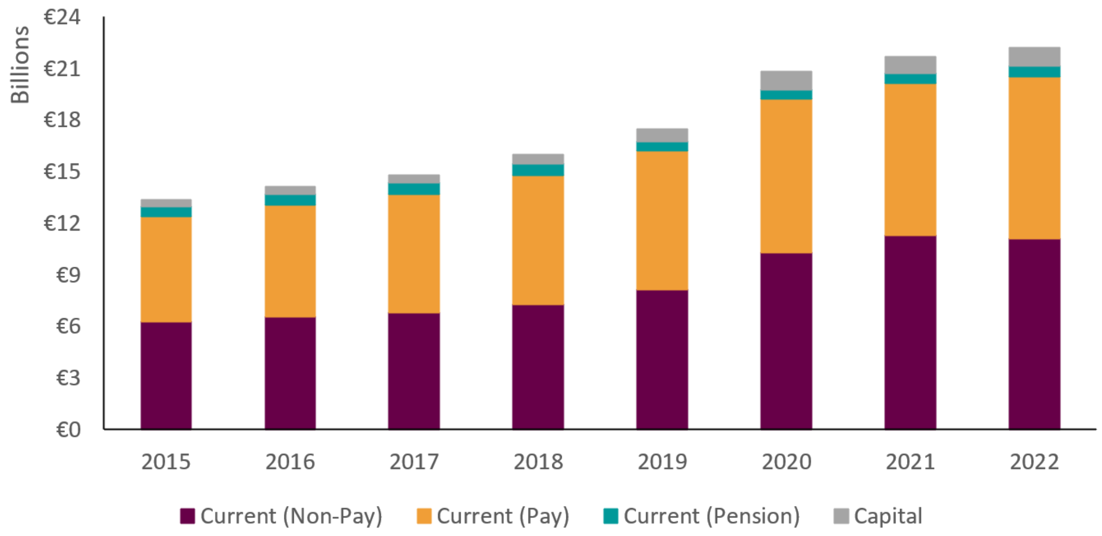
In 2022, pension payments funded by the SIF were projected to exceed €8 billion (71%) of SIF total expenditure. This means that changes to payment rates of pensions in particular will impact on the SIF's ability to run in-year surpluses. As the population ages and the ratio of workers to pensioners grows less favourable, the SIF's income relative to its expenditure will decline. This process will be accelerated by increasing payment rates without increasing the age of pension eligibility and/or the SIF's income is increased (the primary means of doing so would be to increase PRSI rates).

84 Jasmina Behan (Department of Public Expenditure and Reform), '*Committee on Budgetary Oversight debate*' (16 February 2022).

Health

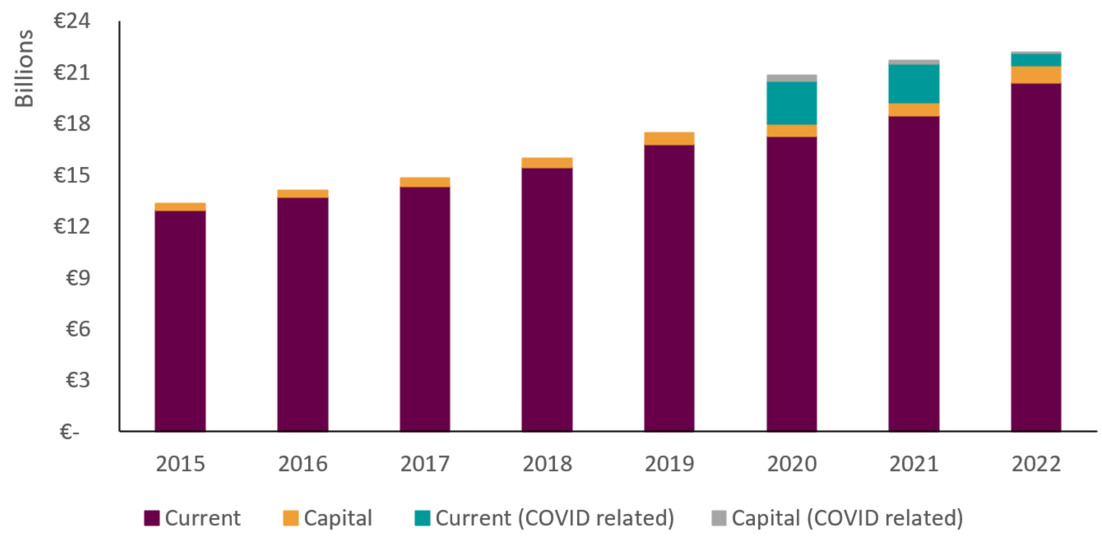
Figure 15 and Figure 16 illustrate developments in Health (Vote 38) spending since 2015. The impact of the pandemic is visible in both figures, with Figure 15 highlighting that current (non-pay) and current (pay) spending in particular grew in 2020. Figure 16 controls for the impact of the pandemic by isolating pandemic related spending (as identified through COVID specific subheads introduced in 2020). This illustrates that Health spending has increased annually notwithstanding the pandemic.

Figure 15: Health Spending 2015-2022



Source: PBO based on DPER, 'Databank' (Accessed 18 July 2022).

Figure 16: Health Spending 2015-2022 and Pandemic Related Spending



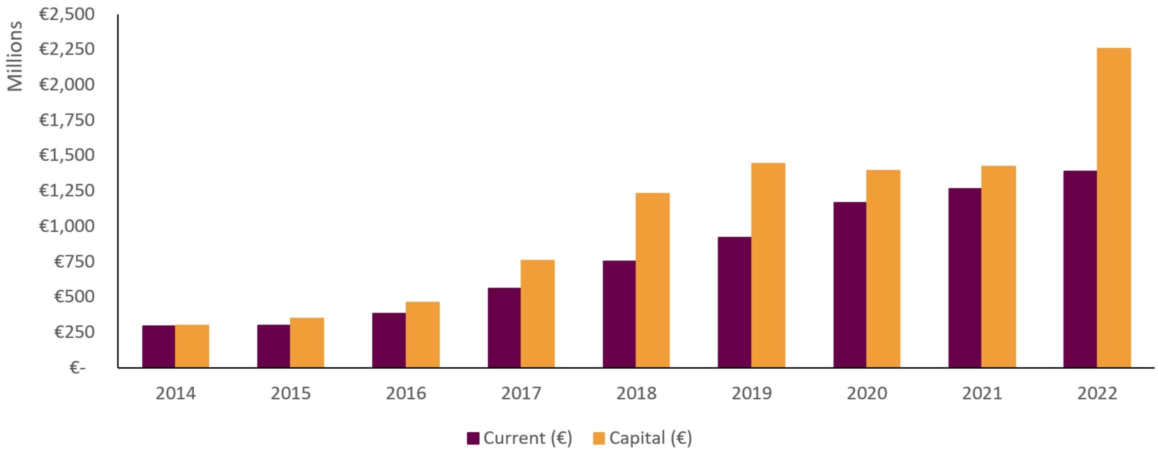
Source: PBO based on DPER, 'Databank' (Accessed 18 July 2022).

It seems likely that health spending could become a significant pressure in 2023, in particular if the €2.2 billion allocation to maintain existing level of service (ELS) described in the Mid-Year Expenditure Report proves to be insufficient (see also Expenditure Increases and Existing Level of Service Provision (ELS) in the Context of High Inflation, p.19). That increase (€2.2 billion) reflects a 3% year-on-year increase in core current spending, well below levels of inflation experienced in 2022 (albeit inflation as measured in the CPI may be a poor measure of inflation experienced by Government). This issue is exacerbated by the fact that the August pay proposal, if agreed, will also be drawn from funds allocated to maintain ELS.

Housing

Spending on Housing (Programme A of Vote 34 Housing, Local Government and Heritage) has grown considerably in recent years. Figure 17 illustrates recent trends in housing spending, with current spending being about 4.7 times 2014 levels, and with capital spending being over 7.5 times greater than in 2014. Over the period illustrated, capital spending has generally been growing as a % of total housing spending; however, the impact of the pandemic on capital delivery reversed this trend in 2020 and 2021. **As of 2022 capital spending on housing was 61.9% of housing spending, up from 50.4% in 2014.**

Figure 17: Housing Spending 2014-2022



Source: PBO based on DPER, 'Databank' (Accessed 18 July 2022).

There are multiple spending pressures in relation to housing which are unlikely to alleviate in the short-term. First and foremost, both current and capital spending are likely to remain high for the foreseeable future as the Government continues to support persons in accommodation (such as with the Housing Assistance Payment (HAP)) and through construction of new units. However, shortages of skilled labour, rising costs of materials, addressing defective properties and retrofitting pressures will serve to constrain supply.[85] An industry survey found a recurring theme that construction costs were rising faster than the value of projects, posing a potential risk to viability.[86] Constraints to supply will have negative impacts in the property market – driving higher accommodation prices and rents.[87]

A measure of Construction Activity in July is concerning. BNP Paribas' seasonally adjusted Real Estate Ireland Construction Total Activity Index recorded a decline form 46.4 in June to 41.8 in July.[88] This signals "a sharp and accelerated decline in Irish construction activity. The fall was the fastest since March 2021 when pandemic restrictions impacted the sector. In fact, excluding periods of COVID-19 disruption, the contraction was the most marked for a decade."[89]

Addressing Housing Defects

Notwithstanding the challenges of delivering new 'additional' units of housing, there is a significant difficulty in addressing defects in units that have already been built (and which may currently be occupied). This will include a significant cost in addressing defects in apartments of between €1.56 and €2.5 billion.[90] In addition to defects in apartments there are substantial financial pressures associated with MICA, with the redress scheme estimated to cost €2.7 billion as of June 2022.[91]

85 Central Bank of Ireland, *Quarterly Bulletin: QB 3 – July 2022* (July 2022) p.53.
86 Joe Brennan, '*Soaring costs and construction skills shortages threaten housing targets*' (The Irish Times, 20 July 2022).
87 See PBO, *Housing Ireland: Trends in Spending and Outputs of Social and State Supported Housing 2001-2020* (March 2022) p.14.
88 A measure above 50 represents growth compared to the preceding month, figures less than 50 indicate contracting activity relative to the preceding month.
89 BNP Paribas, *BNP Paribas Real Estate Ireland Construction PMI* (August 2022) p.1.
90 *Defects in Apartments: Report of the Working Group to Examine Defects in Housing* (July 2022).
91 Sandra Hurley, '*€2.7bn defective block scheme extended to Clare, Limerick*' (RTÉ, 14 June 2022).

Remedial work on existing units will strain scarce labour supplies for the construction sector and will not contribute additional units to the market but may render units habitable where they have been vacated due to defects. However, remedial works are essential, particularly where defects pose a risk to the health and/or safety of the occupants.

The quality of existing housing stock also requires investment, in order to bring existing stock up to higher standards of energy efficiency and improve thermal comfort. The *Climate Action Plan 2021* sets out a commitment to retrofit 500,000 homes by 2030 (including increased funding through the National Development Plan specifically for free upgrades for low-income households) and to install 680,000 renewable energy heat sources in both new and existing residential buildings.[92] The ESRI have highlighted the significant capital cost of retrofitting existing housing stock,[93] and suggested that policy makers should bear this in mind when considering decarbonisation plans.

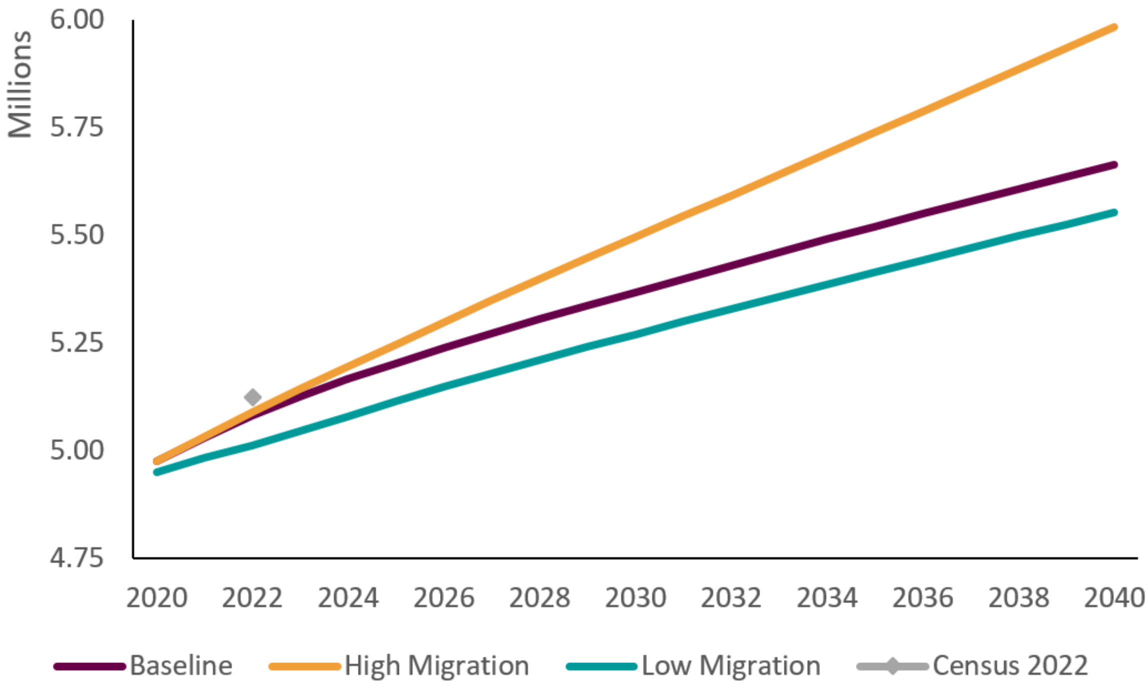
Housing Demand

The *National Planning Framework (NPF)* stated that an average output of at least 25,000 homes was required for the period 2018 to 2040.[94] Alternative projections suggest potential demand of 33,000 units per year for the period 2020-2039.[95] Shortfalls in output delivered over the last few years mean that delivery must exceed these levels consistently in order to meet demand – i.e. housing pressures will continue for some time unless construction activity increases rapidly.

Figure 18 illustrates projected population growth based on 2016 census data and population as recorded in Census 2022. It shows that the actual population recorded in Census 2022 was higher than any of the ESRI's projections for 2022. It should be noted that projecting demographic change is highly complex and relies on assumptions made at a point in time.[96] The population recorded at Census 2022 was 34,382 greater than the 'high migration' projection and 42,013 greater than the 'baseline' projection. These figures highlight the risk that the NPF's projections may be overly conservative should population growth continue to exceed the high migration projection to 2040 – with a risk for greater divergence over time.

92 Department of the Environment, Climate and Communications, *Climate Action Plan 2021* (2021).
93 *DECARBONISING HEAT THROUGH ELECTRICITY: COSTS, BENEFITS AND TRADE-OFFS FOR THE IRISH POWER SYSTEM (esri.ie)*
94 Government of Ireland, *Project Ireland 2040: National Planning Framework (2018* (2018) p.94.
95 Thomas Conefrey and David Staunton, '*Population Change and Housing Demand in Ireland*' [2019] 2019/14 Central Bank of Ireland Economic Letter | 20/07/2022 p.11.
96 "Demographic projections have underlying assumptions generally informed by the context of the point in time in which the projection is made. [...] It is therefore important to note the limitations of projections. Reasonable and prudent assumptions may not be borne out in reality." See PBO, *Demographics and Voted Expenditure* (2019) p.11.

Figure 18: Projections of Population (2018 to 2040) and Population Recorded in Census 2022



*Source: PBO based on Department of Housing, Local Government and Heritage, '*ESRI Population Projections by Local Authority*' (2021); and CSO, '*Census of Population 2022 - Preliminary Results*' (June 2022).*

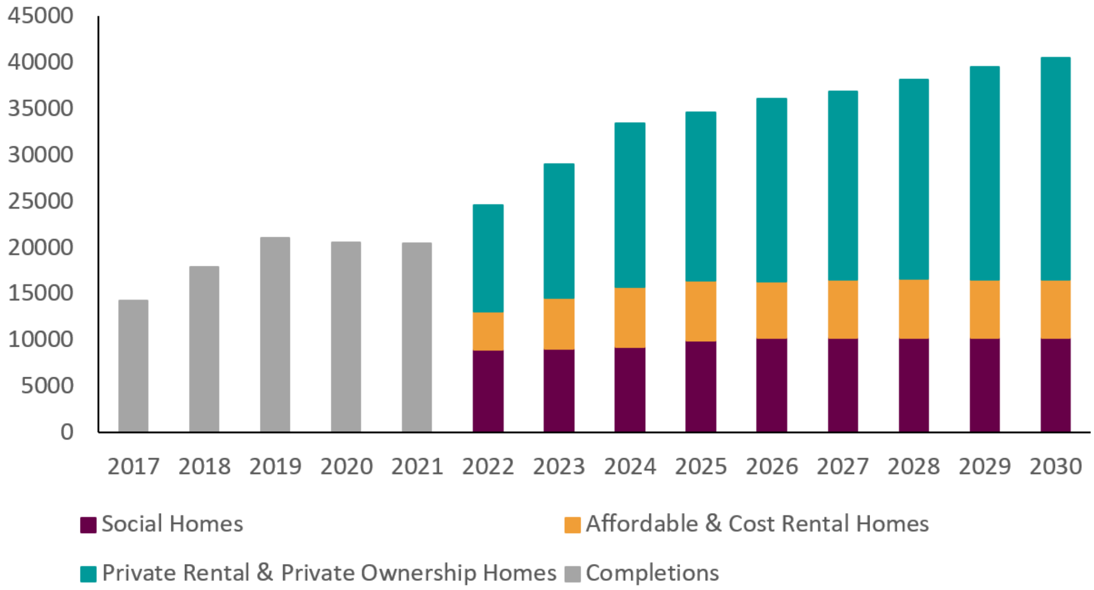
It is necessary to reconsider the projections of housing demand given the preliminary results of Census 2022. Population projections will, invariably, include uncertainty and thus must be reflected upon when new Census data is available; in particular, when Census data differs significantly from the projections previously produced. Additional factors need to be considered within these projections, including that Ireland's population may grow further as Ukrainian refugees arrive in Ireland, who may potentially stay long-term.

Social & Affordable Housing

Years of pent-up housing demand, interrupted delivery due to the pandemic, rising material costs, and shortages of skilled labour combine to create significant difficulties in the Irish housing market. These challenges necessitate a dual approach to address housing demands through meeting immediate needs by current funded programmes while providing for long-term needs by building or procuring units through capital programmes.[97]

97 For a detailed analysis of social housing in Ireland please see PBO, *Housing Ireland: Trends in Spending and Outputs of Social and State Supported Housing 2001-2020* (March 2022).

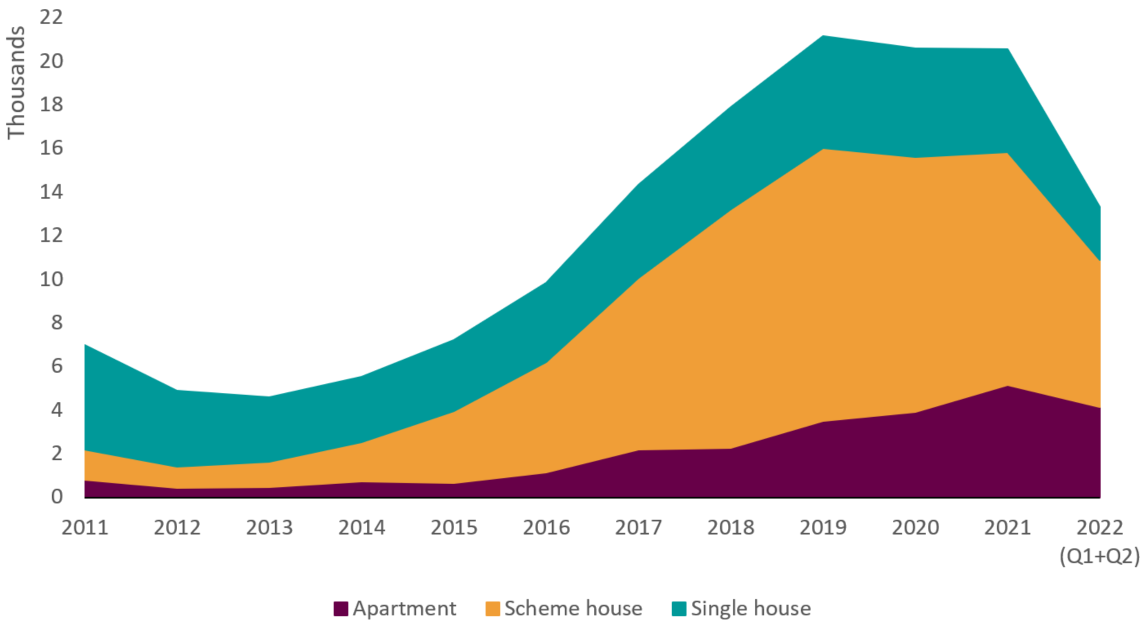
Figure 19: Housing Completions (to end 2021) and Projected Housing Output (2022 to 2030)



Source: PBO based on Department of the Taoiseach and Department of Housing, Local Government and Heritage, Housing for All: A New Housing Plan for Ireland (September 2021) p.32; and Department of Housing, Local Government and Heritage, 'Housing for all' (accessed 27 July 2022).

Figure 19 illustrates the level of housing completions prior to and during the worst of the COVID-19 pandemic. Housing completions declined relative to 2019 levels – likely primarily as a result of public health measures, with estimates of between 6,500 and 16,000 additional homes not being built as a consequence of the pandemic.[98]

Figure 20: New Dwelling Completions by Unit Type



Source: CSO, 'NDA02: New Dwelling Completions' (Accessed 26 August 2022); and CSO, 'NDQ01: New Dwelling Completions' (Accessed 26 August 2022).

98 Department of the Taoiseach and Department of Housing, Local Government and Heritage, *Housing for All: Q2 2022 Progress Report* (July 2022) p.8.

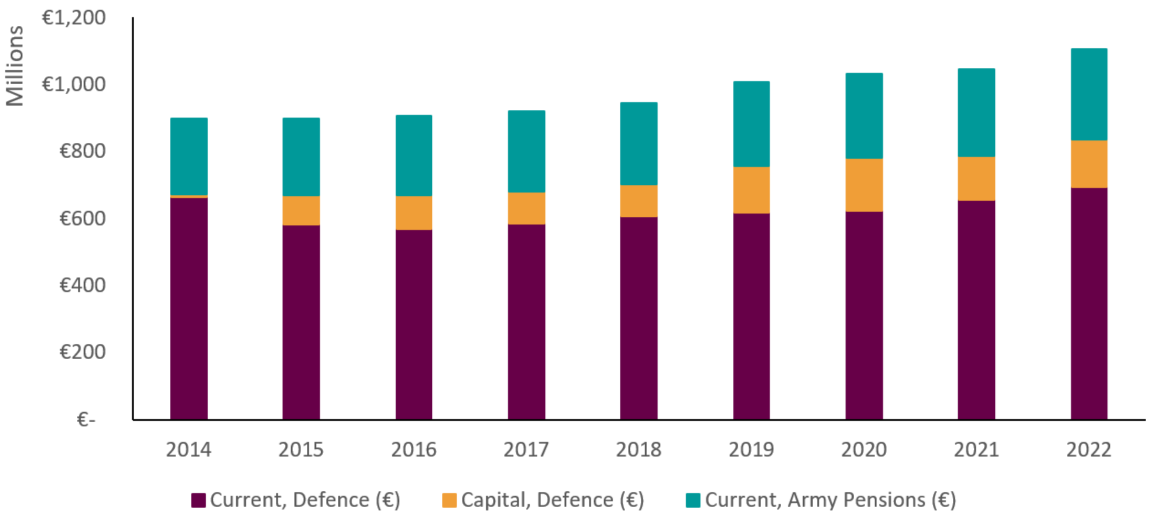
Figure 20 illustrates the impact of the pandemic on housing delivery, with delivery in 2020 and 2021 remaining at levels similar to 2019, ending a period of annual growth from 2014 to 2019. It also illustrates the changing composition of dwelling completions, from 2011 to the first half of 2022:

- Single houses have consistently declined as a % of dwelling completions, from 69% of all units just 18% of units;
- Apartments have risen from 12% of total units delivered to 31% of dwelling completions; and
- Scheme houses have risen from 19% to 51% of dwelling completions.

Defence

Defence spending, as illustrated in Figure 21, is primarily associated with Vote 36 Defence; however, Defence spending can also include Vote 35 Army Pensions. Recently, increases to defence spending were announced, to bring Defence spending from €1.1 billion in 2022 to €1.5 billion by 2028 (in 2022 prices). This projection provides for an additional 2,000 personnel (civil and military).[99] This estimated cost in 2028 does not take into account increases necessitated to maintain existing levels of service, and thus achieving the intended changes may require more funding.

Figure 21: Defence Spending (2014-2022)



Source: PBO based on DPER, 'Databank' (Accessed 18 July 2022).

As of 2022 current spending was €966 million (87.3%) of just over €1,107 million of total defence spending.

The *High Level Action Plan* sets out the Government's position in relation to the *Report of the Commission on the Defence Forces*.[100] The Report of the Commission set out actions under 3 levels of ambition (LOAs), with LOA 1 being the least substantial in terms of ambition (cost and reform), and LOA 3 being the most ambitious. Government has adopted LOA 2, which includes measures which would involve significant capital spending, including:

- Replacement of current fleet of armoured personnel carriers (accepted in principle);
- Addition of fixed wing aircraft with strategic reach capability and two additional medium lift rotary wing aircraft (accepted in principle);
- The replacement of the existing medium lift helicopter fleet with a fleet of eight super-medium helicopters (accepted in principle); and

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99 Department of the Taoiseach, '*Government announces move to transform the Defence Forces and the largest increase in the Defence budget in the history of the State*' (18 July 2022).

100 Department of Defence & Óglaigh na hÉireann, *"Building for the Future – Change from Within" High Level Action Plan for the Report of the Commission on the Defence Forces* (2022) pp.19-32.

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- An accelerated programme of Naval vessel replacement to ensure a balanced fleet of nine modern ships by early in the next decade (accepted in principle).

Other measures which would involve considerable levels of additional capital spending are outlined under level of ambition 3 (LOA 3). These measures will revert to Government at a later date and are not being progressed at this time. These include:

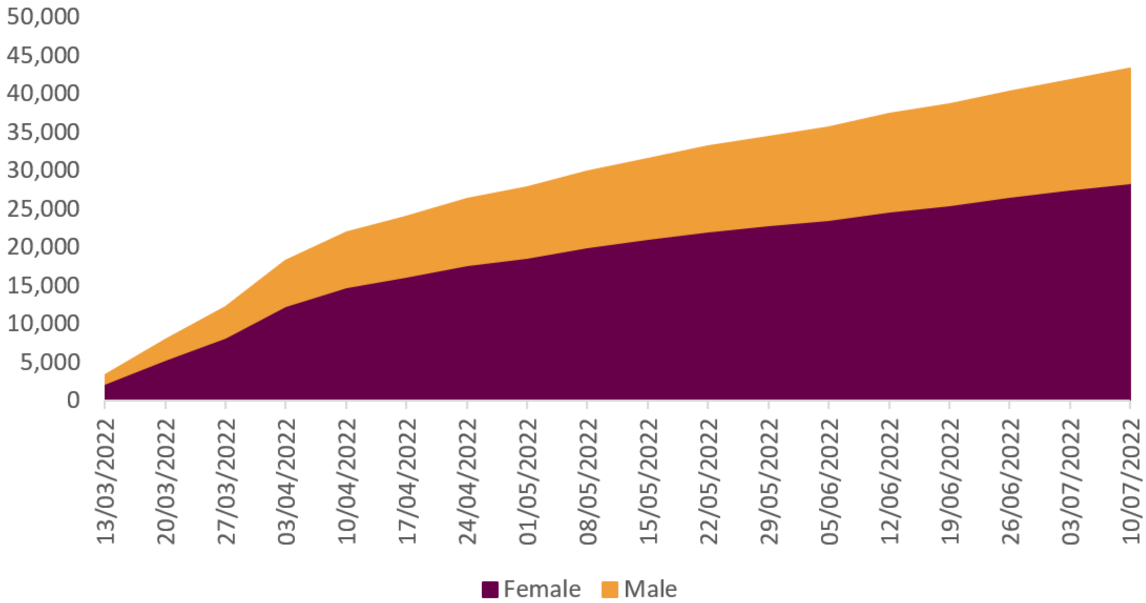
- By 2040 the Naval Service would comprise a balanced fleet of at least 12 ships, supported by appropriate technology, as part of a joint Defence Forces structure; and
- As part of a national Air Defence Plan, the Air Corps would develop an air combat and intercept capability through the acquisition of a squadron of jet combat aircraft, allied to the development of associated operational, infrastructure and support arrangements.

Based on the actions set out as part of LOA 2, we can expect growth in capital spending on defence as new equipment is purchased alongside growth in current spending (particularly on pay) as we progress towards 2028 levels of spending. **It should be noted that inflationary pressures will erode some of the value of additional defence funding.**

Ukraine Crisis

In the *Stability Programme Update 2022* (SPU 2022) an indicative allocation of €3 billion was set out for 2023[101] in order to provide for the "necessary accommodation, health, education and welfare supports for refugees arriving in Ireland."[102] At the time of the SPU 2022, it was assumed that some 80,000 – 100,000 Ukrainian citizens would come to Ireland under the central scenario.[103]

Figure 22: PPSN Allocations of Arrivals from Ukraine (by Gender)

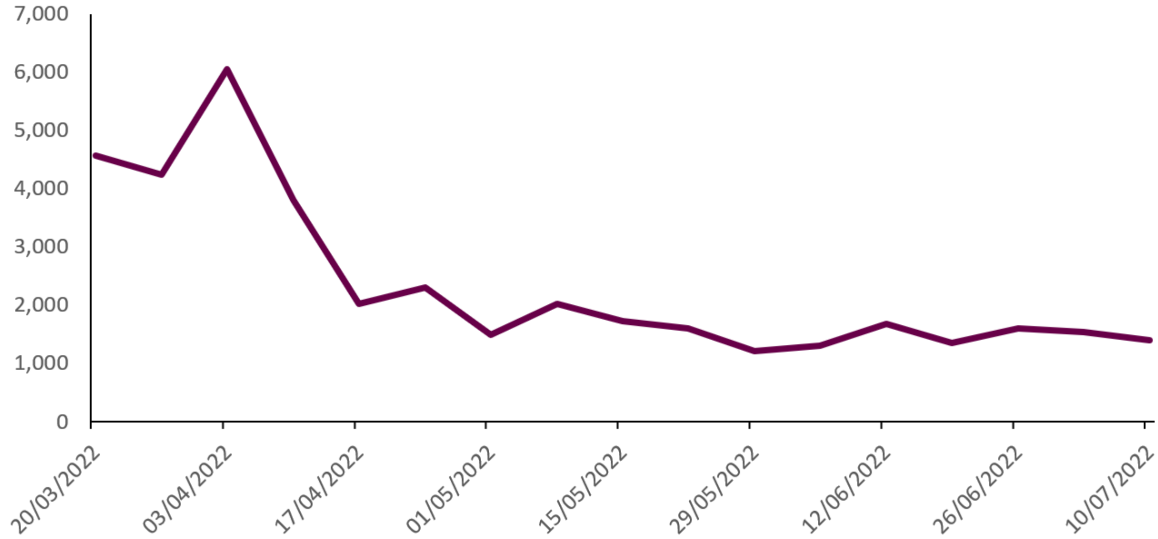


Source: PBO based on CSO, 'UA06 PPSN Allocations of Arrivals from Ukraine' (Accessed 19 July 2022).

Figure 22 illustrates the volume of Ukrainian refugees from early March to early July. As of 10 July Ireland, was hosting 43,256 refugees from Ukraine. Given the prolonged nature of the conflict in Ukraine it seems likely that this number could continue to grow.

101 Department of Finance, *Stability Programme Update* (April 2022) p.6.
102 Department of Public Expenditure and Reform, *Summer Economic Statement* (July 2022) p.25.
103 Department of Finance, *Stability Programme Update* (April 2022) p.11.

Figure 23: PPSN Allocations (Weekly)



Source: PBO based on CSO, 'UA06 PPSN Allocations of Arrivals from Ukraine' (Accessed 19 July 2022).

Figure 23 illustrates that the weekly allocation of PPSNs peaked in early April and has been relatively stable since mid-April. If the conflict continues in its current form (no major losses or gains on either side) then it may be assumed that the inflow of refugees may remain relatively stable.

If the inflow of refugees (as reflected by PPSN allocations) remains at the average level of the period 17 April to 10 July 2022 (c.1,635 weekly), the SPU's lower-bound projection of 80,000 Ukrainian refugees would be met in mid-December and the higher-bound estimate of 100,000 would be met in early March 2023.

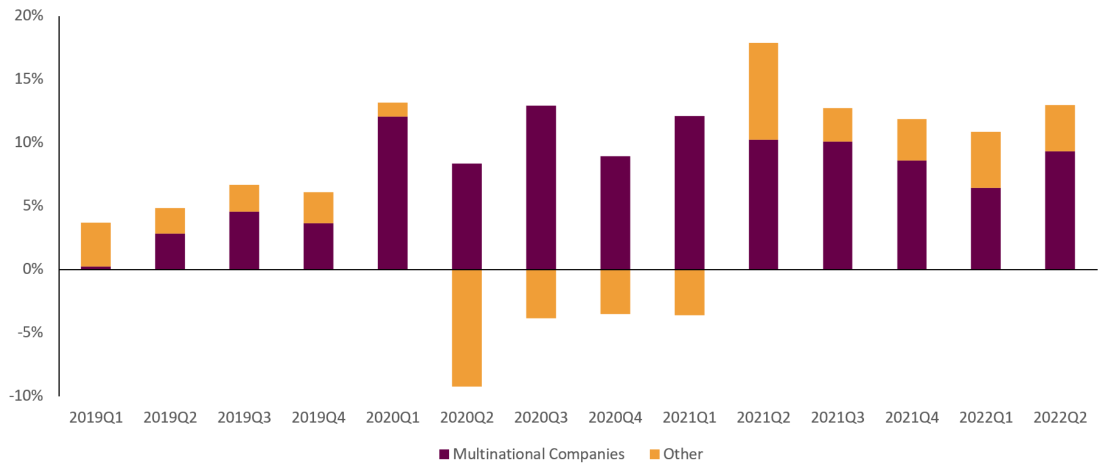
Economic and Fiscal Outlook

At Budget time, detailed economic and fiscal material is published. This includes details of the performance of the economy, and official forecasts about expected future economic activity in Ireland. This economic and fiscal material underpins the spending and tax decisions made in the Budget.

Economy

In the second quarter of 2022, GDP was 28% higher than pre-pandemic levels.[104] There are two trends underlying this growth. Multinational companies in Ireland grew significantly during the pandemic, with output from these sectors now 70% higher than the same period 2019.[105] As a result of this growth, these companies now account for 54% of overall production in the economy.[106]

Figure 24: Contributions to GVA

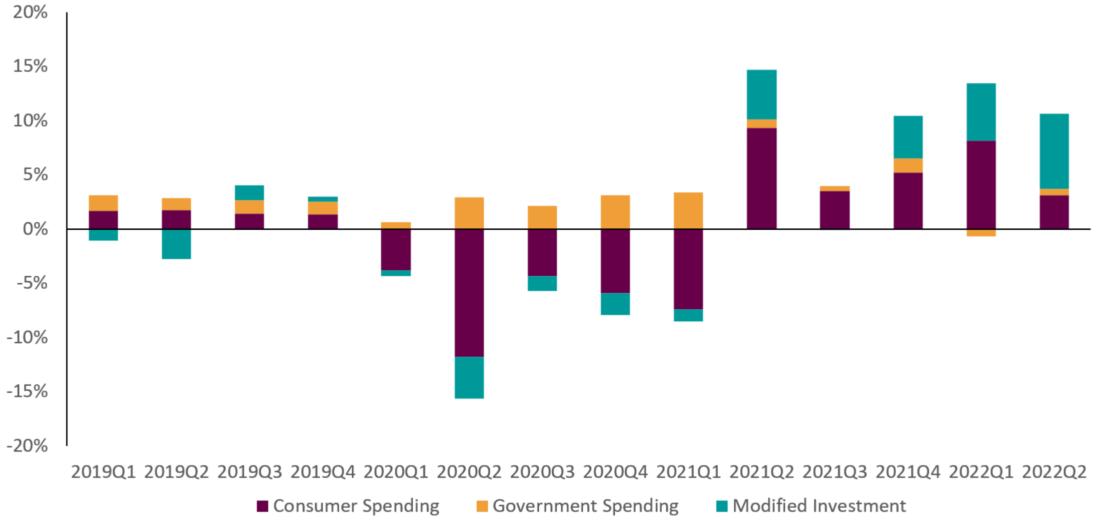


Source: CSO.

[104] PBO calculation based on CSO data. *Quarterly National Accounts Quarter 2 2022*. Table NQQ48
[105] PBO calculation based on CSO data. *Gross Value Added for Foreign-owned Multinational Enterprises*. Table NAQ06.
[106] CSO National Accounts. Table *NAQ06*.

Modified domestic demand (which can be considered a proxy for the domestic economy), was 9% higher in Q2 2022 compared to pre-pandemic levels.[107] This is due to higher government spending and modified investment which were 20% and 25% higher in Q2 2022 compared to Q4 2019 (on a seasonally adjusted basis).[108] The increase in investment was due to more activity in the residential construction sector compared to pre-pandemic levels. Consumer spending (in real terms) was roughly the same as pre-pandemic levels.[109] This may fall over the coming months as high inflation will mean consumer incomes will not stretch as far as they did before.

Figure 25: Modified Domestic Demand



Source: CSO.

Labour Market

The Irish labour market is in a very strong position. In August, the unemployment rate was 4.3%.[110] There are now 200,000 more people at work compared to pre-pandemic levels. All sectors have returned to pre-covid levels apart from hospitality and administrative activities. However, there may be little capacity in the economy for employment to grow further, and it has been reported that firms are finding it harder to find workers. There are now twice as many job vacancies as there were compared to pre-pandemic levels,[111] which is the largest increase in the EU.[112] The job vacancy rate[113] is highest in finance, professional activities, and ICT. At the same time, the job vacancy rate in construction has had the largest increase compared to pre-pandemic levels, rising from a low base of 0.4 to 1.6 in Q1 2022. This means the number of job vacancies has quadrupled.

107 PBO calculation based on CSO data. *Modified Total Domestic Demand and Components of Modified Gross Domestic Fixed Capital Formation*. Table NAQ05.
108 PBO calculation based on CSO data. *Quarterly National Accounts Quarter 2 2022*
109 CSO National Accounts. Table *NAQ05*.
110 CSO (2022) *Monthly Unemployment August 2022*.
111 Eurostat (2022) *Job vacancy statistics*.
112 Job vacancy statistics.
113 The job vacancy rate is the percentage of unfilled positions compared to the total number of positions in the labour market.

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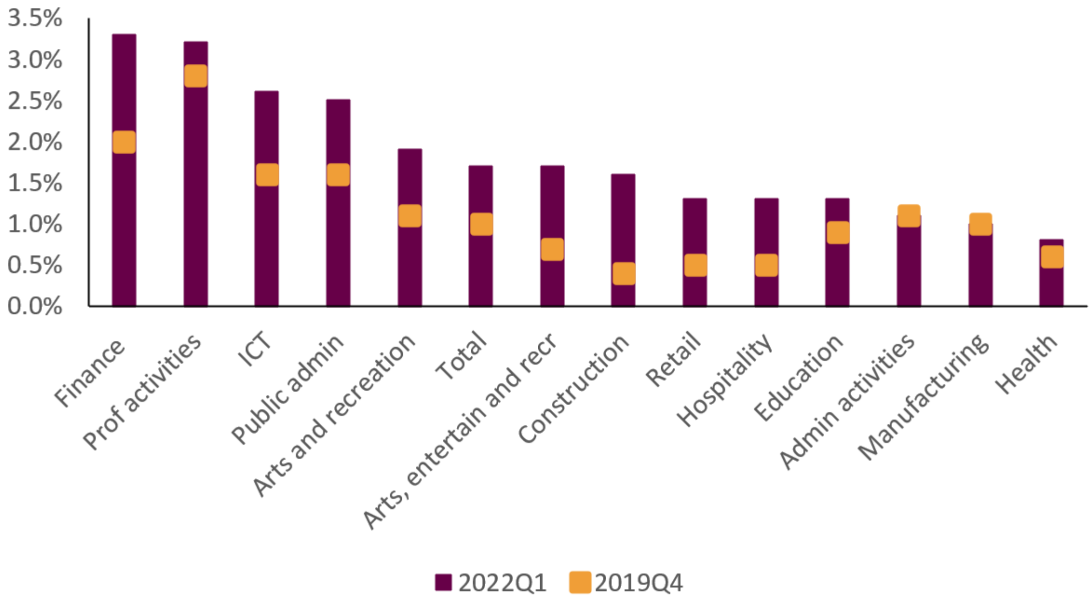
Figure 26: Job Vacancy Rate by Sector



Source: Eurostat.

The tight labour market will benefit workers, making it easier to find or switch jobs while leading to higher wage growth. However, higher wage growth can exacerbate inflation. It can also hinder economic growth if firms cannot find workers and deliver the same level of output. Labour market slack is currently 10.4% - roughly the same as the EU average. Labour market slack is a broader measure of unemployment and takes into account those who are:

- Unemployed
- Part-time but want to work more hours
- Available for work but not looking
- Looking for work but not immediately available.

Reducing levels of labour market slack could help solve some of the challenges in the labour market. Inward migration may also contribute to the labour force.

Wages and Inflation

The interpretation of wage statistics has become more complicated since the onset of the pandemic and the introduction of COVID-19 income supports. In particular, changes in employment composition in certain sectors have impacted the estimated wage trends over 2020/2021. For example, in Q4 2020, average weekly earnings increased by 7.8% compared to Q4 2019.[114] An exit of low-wage workers due to COVID-19 can partly explain this.

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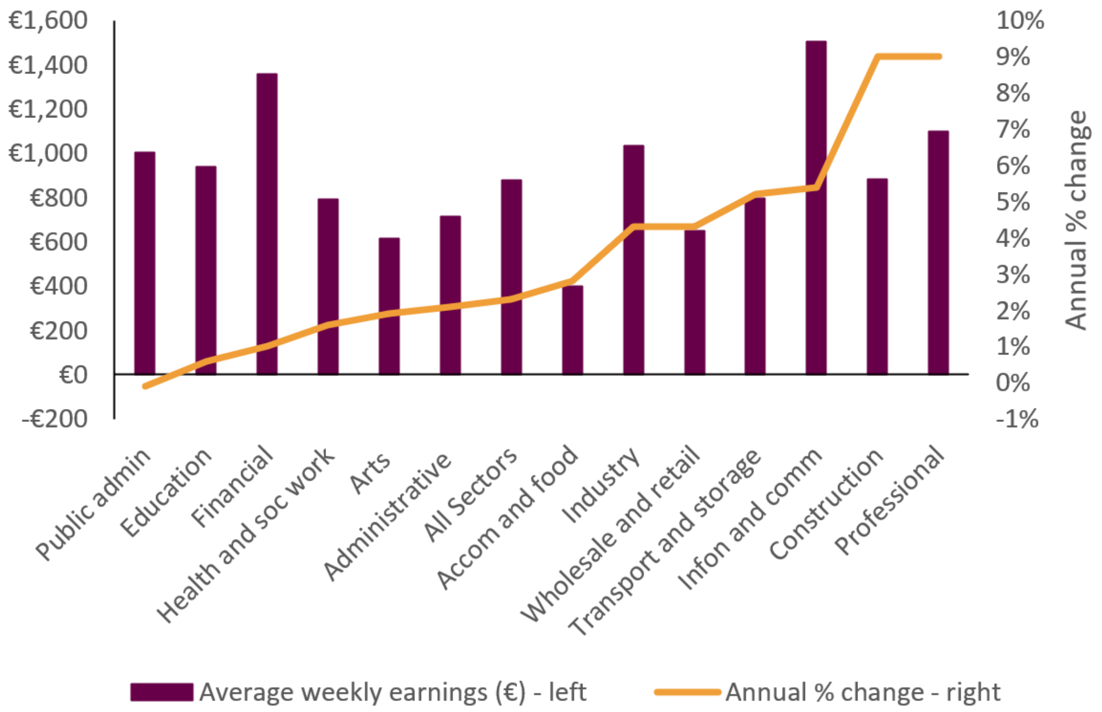
[114] CSO (2022) *Earnings and Labour Costs Quarterly*.

Figure 27: Average Weekly Earnings by Economic Sector (Q1 2022)

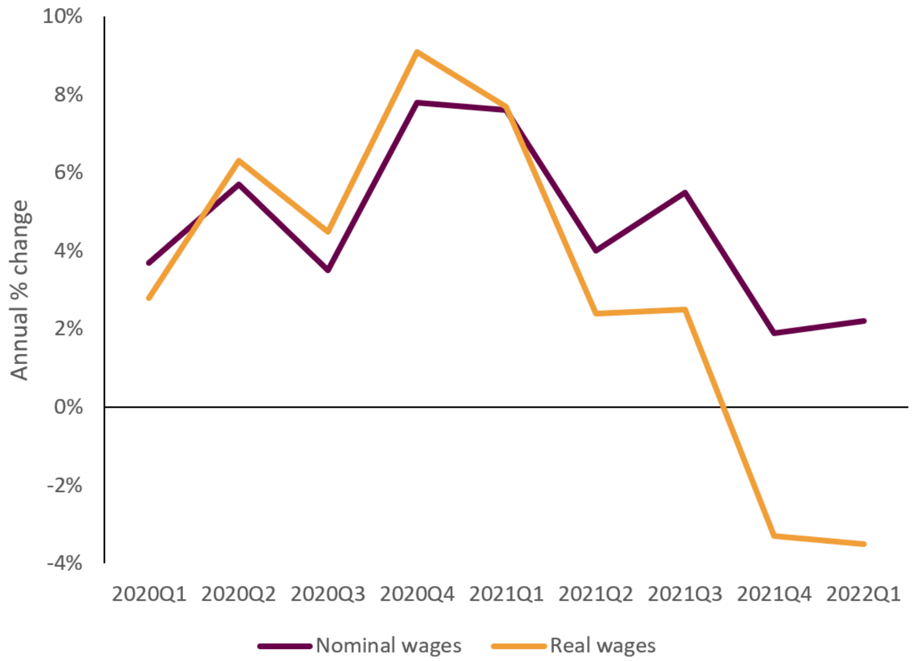


Source: CSO.

The most recent Q1 2022 statistics show that average weekly earnings across all sectors have increased by 2.3% year on year.[115] Wage growth has been more robust in industries such as Construction and Professional Activities sectors (both increasing by 9%), while Public Administration experienced slightly negative wage growth (-0.1%). When looking at the 3-year change over Q1 2019 / Q1 2022 to control the pandemic's effects on earnings statistics, average weekly earnings have increased by 14%. This highlights a broad-based increase in wages over this period.[116]

115 Ibid.
116 Ibid.

Figure 28: Average Weekly Earnings Adjusted for Inflation



Source: PBO based on CSO data.

However, since the second quarter of 2021, wage growth has been eroded by increased general prices in the economy (Figure 28). Wages in real terms (after adjusting for inflation) have experienced negative growth, with average weekly earnings 3.5% lower in Q1/2022,[117] compared to the same period last year (Figure 28). As measured by the Harmonised Index of Consumer Prices (HICP), inflation was estimated at 9.6% in June,[118] the highest value recorded since 1996. Energy products account for about half of the prices increase (Figure 29). However, the overall HICP index that excludes energy has been trending upwards, suggesting a broad-based prices increase.

Figure 29: Inflation (Annual % Change)

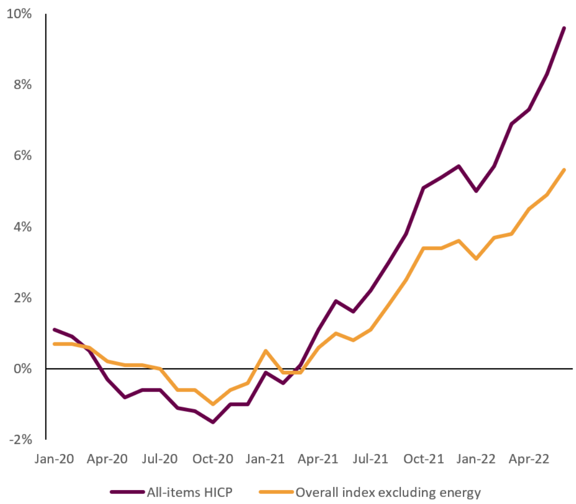
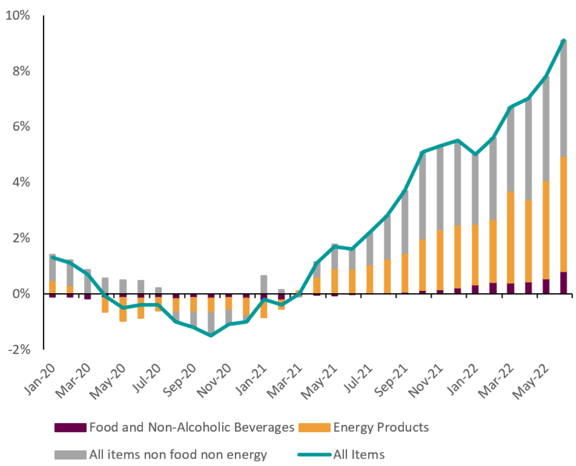


Figure 30: Contributions to changes in the Consumer Price Index



Source: Eurostat, and PBO based on CSO data.

It's challenging to forecast future inflation developments, given how much these depend on the currently significantly uncertain external environment. The main factors which are expected to have an impact on inflation are:

117 CSO (2022) *Earnings and Labour Costs Q1 2022 (Final) Q2 2022 (Preliminary Estimates).*
118 CSO (2022) *Consumer Price Index.*

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- the unfolding geo-political tensions (primarily the war in Ukraine);
- further potential disruptions to global growth and supply chains; and
- the increase in interest rates by the monetary authorities.

The main forecasting bodies expect inflation to moderate over time and converge to the 2% inflation rate. It is reasonable to expect that base effects will play a role in reducing the observed year-on-year changes. However, further adverse shocks to global supply chains and policy-driven stimuli could contribute to price increases.

Figure 31: Inflation rate by Income Decile, June 2022

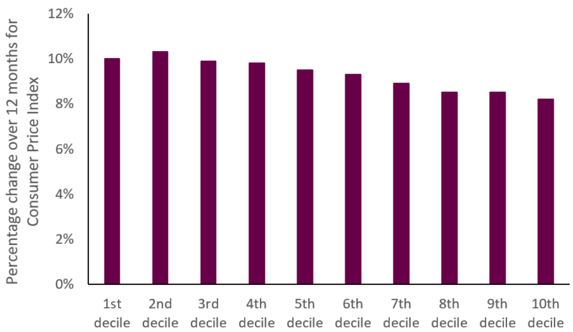
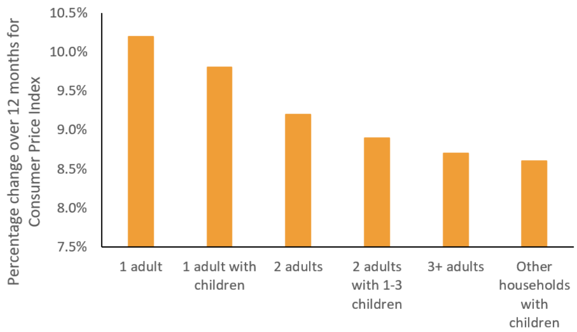


Figure 32: Inflation rate by Household Composition, June 2022



Source: CSO.

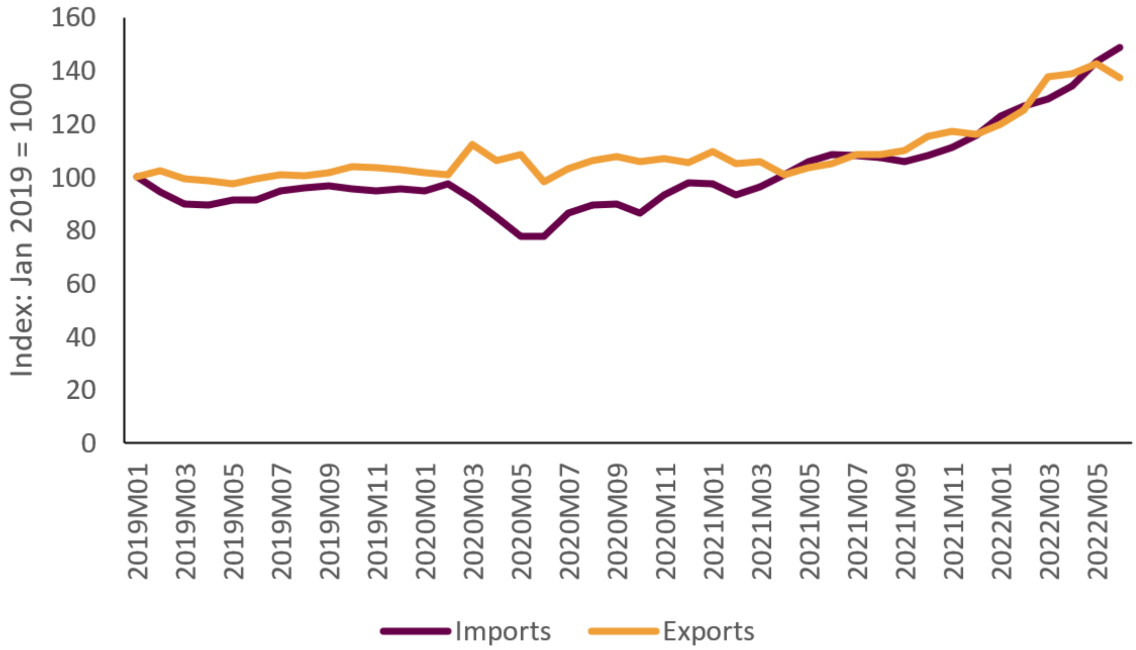
The CSO publishes statistics on the estimated impact of inflation on different income levels and household compositions (Figure 31). With energy and food price inflation, lower income deciles experience a higher impact rate than households with higher incomes. For example, inflation for the second lowest income decile was 10.3% in June vs. 8.2% for people in the highest income decile. This is likely explained by the fact that lower-income households are more exposed to energy price increases. In terms of household composition, one adult household experienced a relatively higher inflation rate (10.5%) than other household compositions. This is also the case for families living in rural areas vs. urban areas (9.7% vs. 8.8%) and for households where the age of the household reference person is above 65 (9.8%).[119] The Central Bank has warned that a decline in real wages will have implications for consumer spending decisions in the near future as they anticipate a decrease in their purchasing power and respond to higher interest rates.[120]

Trade and External Risks

In the first six months of 2022, the euro depreciated significantly against the dollar, sterling, and other currencies.[121] When this happens, Irish exports to non-eurozone countries become cheaper while imports become more expensive, and this also contributes to inflation in Ireland. This partly explains the exceptional performance of Irish exports in the first six months of this year. Total goods exports increased by 31%. Chemical and pharmaceutical products, which account for more than 60% of total goods exports, increased by 33%, while the remainder of products increased by 25%.[122] Exports were up across all major markets, with 27% growth in the EU, 35% in the UK and 32% in the US.[123] Exports to all other countries increased by 35%.

[119] CSO, *Estimated Inflation by Household Characteristics June 2022*.
[120] CBI (2022) *A snapshot into inflation and earnings expectations by Irish residents*.
[121] ECB (2022) *Euro foreign exchange reference rates*.
[122] CSO (2022) *Goods Exports and Imports June 2022*.
[123] Ibid.

Figure 33: Index Imports and Exports



Source: CSO.

The value of imports also increased 36% in the first six months of 2022. This could be partly explained by the weak euro which has made imports more expensive. Rising energy prices also contributed to this increase. The value of oil imports in the first six months of 2022 was twice what it was during the same period last year, while gas imports were four times higher. Together gas and oil imports accounted for 19% of the overall increase in imports this year.

Energy Prices

Rising energy prices have been a key driver of inflation this year. In July, gas prices (measured by the CPI) were 56.6% higher than the same period last year, while diesel and petrol prices were 44.8% and 35.4% higher.[124] Futures contracts for gas have surged in both the UK and the EU suggesting that gas prices will rise further over the coming months. This increase will hurt the economy as consumers will have less money to spend on other items and businesses will face higher costs. The price effect alone will have a significant impact on the economy. If there are shortages and restrictions on energy use, this will hurt the economy further. On the back of this, consumer and business sentiment (which can be considered a leading indicator for the economy) has dropped in recent months reflecting the pessimistic outlook for the economy.

Geopolitical risks

There remain geopolitical risks that could affect Ireland's fiscal position. The war in Ukraine has reminded us that major geopolitical incidents, though relatively rare, can significantly affect macroeconomic conditions across countries beyond their immediate neighbourhood. The war's trajectory remains uncertain and, therefore, so does the longevity and ultimate scale of its effect on the global and Irish economies.

124 CSO (2022) *Consumer Price Index*.

In addition, it has been reported that both policy and business circles are expressing a concern on another geopolitical risk – the Taiwan Strait.[125] While it is hard to predict what will happen, the escalation of the geopolitical tension in the region, even short of war, could hinder smooth international economic operations and, thereby, a highly globalised Irish economy. The IMF has also noted, *"As concerns over food and energy supplies increase, risks of social instability are rising."*[126] In other words, there could be a perfect storm of geopolitical incidents and economic challenges on the global stage. As the Irish economy is relatively more dependent on global economic conditions, geopolitical risks should be closely monitored.

Brexit

Recent budgets have sought to respond to the shock of Brexit. The UK's longstanding mutual benefit in the EU single market has been replaced by increased regulation and shipping delays, with knock-on effects for Ireland. Increased regulations have resulted in British imports being spread across more containers, making trade less efficient and more expensive. While the value of Irish exports increased by €2.2 billion from 2019 to 2022, the value of imports fell by €1.1 billion. In 2019, 10%[127] of all goods exported went to the UK, and 22% of goods imported came from the UK. In 2021, Britain accounted for 9% of goods exports and 18.8% of goods Imported.[128] Exports to the UK have remained relatively stable due largely to the surge in trade between Ireland and Northern Ireland (NI). Imports from NI to Ireland increased 23% between January and May 2022 compared with the same period in 2021.[129] Irish exports to Northern Ireland jumped by 42% in the same comparative periods.[130]

Ireland is uniquely exposed to Brexit due to its close economic, cultural, and geographical ties with the UK as well as the free travel area implying a joint labour market. Ireland was allocated €1.1 billion[131] under the *Brexit Adjustment Reserve* (BAR) to respond to the challenges posed by the UK's departure from the EU which has not all been disbursed yet.[132] The EU-UK *Trade and Cooperation Agreement* (TCA) outlines the framework for Ireland's new trading relationship with the UK. Under the Northern Ireland protocol, there are no checks on goods crossing the border between NI and the Republic of Ireland. While the NI protocol is in place, there is a growing sense of instability around it. Under the NI protocol, inspections and document checks are conducted between NI and Great Britain. The UK government has proposed changes to the protocol, which have not been agreed, and there are concerns that "Article 16"could be triggered.[133]

[125] E.g., Demetri Sevastopulo and Andrew Edgecliffe-Johnson, "*Executives Seek Briefings on Taiwan War Risk*" (Financial Times, 12 July 2022); Kathrin Hille and Demetri Sevastopulo, "*Taiwan: preparing for a potential Chinese invasion*" (Financial Times, 7 June 2022).

[126] Kristalina Georgieva, "*Facing a Darkening Economic Outlook: How the G20 Can Respond*" IMF Blog, 13 July 2022.

[127] CSO (2020) *Ireland's Trade in Goods 2019*.

[128] Department of Enterprise, Trade and Employment (2022) *Tánaiste welcomes record goods exports of €165.2bn for 2021*.

[129] CSO (2022) *Goods Exports and Imports May 2022*.

[130] Ibid.

[131] €500 million of the overall BAR allocation was made available in 2022 as a first tranche of funding for Brexit measures, with the remainder available in 2023.

[132] Department of Finance (2022) *Stability Programme Update 2022*.

[133] Reuters (2022) *'No time to waste on Brexit': EU uneasy about Truss as UK leader*.

Monetary Policy

After over a decade of accommodative monetary policies, Central Banks around the world are tightening monetary conditions. On 21st July 2022, the Governing Council of the European Central Bank ('ECB') increased its three key interest rates by 0.50% or 50 basis points. Accordingly, the interest rate on the main refinancing operation will increase to 0.50%, the marginal lending facility to 0.75%, and the deposit facility will increase to 0%, from 27th July 2022.[134] On the 8th September 2022, the Governing Council of the ECB announced a further increase in its three main interest rates by 75 basis points (0.75%). The interest rate on the main refinancing operations will be increased to 1.25%, the marginal lending facility to 1.5%, and the deposit facility will be increased to 0.75%, all with effect from 14th September 2022.[135] Further rate hikes have been signalled.

Other central banks have also increased interest rates several times in recent months, including the Federal Reserve (which sets monetary policy for the United States of America), the Bank of Canada, the Bank of England, and the Reserve Bank of Australia. One noticeable exception is the Bank of Japan.

Monetary policy is about keeping the prices of the goods and services we buy stable. In a stable economic environment, householders can feel secure in their consumption and saving decisions, while corporates can concentrate on their investment decisions and making profits for their shareholders. Governments can decide to spend money to provide public services, support the economy and reduce inequalities. Monetary policy is not easy as the ECB runs a single monetary policy to keep prices stable for the entire euro area, while the 19 national governments run their own fiscal budgets (although they are also subject to common rules to keep their spending in check).[136]

All governments had become reliant on exceptionally low interest rates for raising sovereign debt.[137] During the pandemic, additional asset purchases (mostly sovereign bonds) and longer-term refinancing by the ECB was necessary to ensure that financing conditions would not collapse by reinforcing the incentive for banks to lend to firms and households. The net effect is that the ECB now holds a significant proportion of the sovereign debt of the euro area Member States including Ireland, which is subject to rising interest rates.

[134] European Central Bank (ECB), *Monetary Policy Decisions Press Release* 21 July 2022.
[135] European Central Bank (ECB), *Monetary Policy Decisions Press Release* 8 September 2022.
[136] European Central Bank (2021), "Monetary-fiscal policy interactions in the euro area", ECB Occasional Paper Series No 273, September 2021. Available *online*.
[137] Constâncio, V. (2016), "The challenge of low real interest rates for monetary policy", Lecture by Vítor Constâncio, Vice-President of the ECB, Macroeconomics Symposium at Utrecht School of Economics, 15 June 2016. Available *online*.

An analysis of the Fiscal Stance – Pre Budget 2023

The Government published its *Summer Economic Statement* (SES) on July 4, setting out its strategy for Budget 2023 and updating the overall amounts for government spending. Strong tax revenues particularly from corporation tax has led to a new official projection for a budget surplus in 2022. It primarily reflects stronger-than-expected tax receipts.[138][139]

As such, the fiscal stance,[140] which indicates the short-term impact of fiscal policy on the economy, is set to remain supportive. Due to the fiscal impulse[141] from the COVID-19 temporary emergency measures, which already prevented a fall in aggregate demand, net primary current expenditure[142] is set to exceed the medium-term potential growth rate.

At the current juncture, it is appropriate to ensure a smooth transition from broad-based support to the economy during the pandemic towards an increasing focus on temporary and targeted measures to deal with the effects of the higher cost of living. As noted in previous sections, the main indicators of economic activity have surpassed pre-pandemic levels. Better targeting of policy supports would mitigate the trade-off effect between giving supports for cost-of-living increases and the risks of second-round inflation.

A long-standing negative output gap[143] has been closing fast. While the latest Department of Finance economic forecasts (SPU April 2022) estimate that it will remain mildly negative for 2022, some commentators have estimated that it is already positive.[144] These forecasts imply that the real output in the economy could soon reach its long-run sustainable level without the need for further fiscal stimulus. A policy-driven increase in real demand would add further price pressures and push the positive output gap larger relative to the current baseline forecasts. This could risk amplifying another set of economic imbalances, namely supply-side constraints and labour market tightness.

138 The overall parameters for Budget 2023 provide for a total package of €6.7 billion, with just over €1 billion for tax measures and almost €5.7 billion for expenditure measures over 2022 and 2023. This deviates from the previous Medium-Term Expenditure Strategy to grow core spending in line with an underlying sustainable growth rate of the economy, estimated at 5 per cent.

139 Inflation tends to raise the tax burden as it draws more income into the higher tax bands.

140 The fiscal stance refers to how the level of government spending and taxation impact on aggregate demand and economic growth or more precisely the tendency of the tax and spending policies embodied in a government's budget to expand or contract the economy. Technically it is measured as the structural primary budget balance in per cent of (potential) output i.e. it is the level of fiscal support.

141 The fiscal impulse is the change in the structural primary budget balance in per cent of (potential) output i.e. it is the change in fiscal support.

142 Net primary current expenditure includes recovery support measures as well as new measures to help households and firms cope with the surge in in energy prices.

143 The output gap is defined as the deviation of actual growth from potential growth (usually GDP) measured as a percent of potential GDP.

144 In July 2022, the *IMF* have determined that the output gap for Ireland will be positive at 0.5 per cent for this year dropping back to 0.0 per cent for 2023 and 2024. The *OECD* maintain a negative output gap for Ireland out past 2023.

The process of withdrawing the pandemic supports started last year. However, total General Government spending is expected to continue increasing, reflecting steady growth in 'core' or permanent expenditure.[145] The Department of Finance anticipates that a decline in temporary spending,[146] outweighed by increased permanent spending, will continue to drive the evolution of government spending over the medium term. The projections for expenditure on a General Government basis are underpinned by close to 5% growth in core voted Exchequer spending in 2023, 2024, and 2025, consistent with the Department's Medium-Term Expenditure Framework. Such growth would be lower than that experienced by the Exchequer in recent years, with average growth of 6.4% over the past five years. On this basis, the general government balance could continue to improve. On the other hand, there is a risk that spending will be higher than anticipated in the coming years.

The spending projections also anticipate significant increases in capital spending over the medium term. Gross fixed capital formation is forecast to grow by an average of 13% per annum in the four years to 2025. In part due to an infrastructural gap that developed due to Ireland's very low public investment in the period following the global financial crisis, recent and planned increases in capital investment are now considered high by international standards.[147] The National Development Plan (NDP) sets out total public spending of up to €165bn between 2021 and 2030. Abstracting from the difficulty of achieving this due to high inflationary pressures and labour shortages, fiscal decisions on balancing current and capital expenditure and taxation need to be carefully calibrated.

The specific nature of the macroeconomic inflation shock, largely due to the war in Ukraine as well as its long-term implications for the EU's energy security, call for a careful design of fiscal policy for this coming Budget. Fiscal policy will continue to finance the National Development Plan (NDP) but needs to be cognisant of not overly inflating primary current expenditure, while allowing automatic stabilisers to operate and providing temporary and targeted measures to mitigate the impact of the energy crisis, the need to speed up the green transition and to provide for Ukrainian immigrants here. At the same time, fiscal policy needs to remain agile given global uncertainty, while reflecting the need to avoid amplifying the inflationary effects of ongoing supply and demand shocks. Beyond this coming budget, fiscal policy should revert to a multiannual framework aimed at achieving a prudent medium-term fiscal position with credible and gradual debt reduction to ensure fiscal sustainability through consolidation, investment and reforms.

The SES suggests this Budget will add a significant fiscal impulse in 2023 compared to previous years. In defining a sustainable fiscal position, it must be noted that volatile corporation tax receipts drove the improvements in the general government balance. Spending should therefore be aligned with the associated risks. A prudent fiscal position should aim to build up reserves and reduce the national debt. The EU Commission will make use of the 'severe economic downturn clause' also in 2023,[148] although no severe economic downturn is projected (yet) for the near future. In the short term, some fiscal flexibility is needed to strike a balance between supporting the economy in case of a large external shock linked to the exceptional level of global uncertainty and containing (but also not contributing to) inflation in the domestic economy.

In the medium term, more evidence-based spending is warranted to facilitate the transformation of the economy while safeguarding fiscal sustainability. Key infrastructural gaps and structural bottlenecks should be addressed (e.g., housing and climate). Large areas of government spending should be regularly reviewed and potentially subjected to reform to ensure efficient use of resources. The long-term fiscal policy mix should secure stable resources to finance the public investment and address sustainability, social and aging-related expenditure needs. Multi-annual policies must be supported by a clear prioritisation of expenditures to support investment based on a prudent medium-term fiscal framework to progress the composition and quality of the public finances.

145 Core spending is defined as total General Government expenditure minus interest payments minus temporary measures.

146 Covid-19 measures are deemed to be temporary as well as spending to mitigate the impact of high energy prices on households and firms and to provide humanitarian support for Ukrainian refugees. There are also temporary spending increases linked to the Next Generation EU receipts, although given that these are fully financed by EU grants they should have a neutral impact on the government balance. There is a lack of information on the planning and timing of future temporary spending but such measures could amount to €7.5bn in 2022 falling to €4.6bn in 2023 before falling further to less than €1 billion for 2024 and 2025 (CBI, 2022).

147 See IFAC (2022): *PowerPoint Presentation (fiscalcouncil.ie)*.

148 *EU fiscal rules to be suspended for another year – EURACTIV.com*.

On a technical note, high inflation is likely to affect the measurement of the fiscal stance as it implies a higher cost of goods and services purchased by the government. The increase in spending on pensions, social welfare, public wages and new investment projects will be pushed up by higher inflation, likely with some delay. The overall impact of inflation on the measured fiscal stance will depend on the interaction between HICP and the GDP deflator. The growth in government expenditure will be more closely related to HICP inflation rather than the GDP deflator inflation used in potential growth measurement. Further these will likely be quite different in the near term. The 'potential growth effect' will appear to be lower than the 'spending effect', and the calculated fiscal stance will suggest an overall 'expansionary' impact of higher inflation on the fiscal stance this year and 2023 (larger next year).[149]

[149] EU Commission (2022), "The 2022 Stability and Convergence Programmes: An Overview with an Assessment of the Euro Area Fiscal Stance", European Economy Institutional Paper 182, July 2022.

Debt Sustainability

The Summer Economic Statement (SES) did not contain any revised macroeconomic projections, and instead, laid out the likely size of the tax and spending package to be included in Budget 2023.[150] Tentative estimates of the General Government balance were provided for 2022 and 2023, ranging from 0% to 0.5% of GDP, and from 0.25% to 0.75% of GDP, respectively.

A budgetary package of €6.7 billion is expected to be made available across tax and spending measures. Relative to SPU forecasts, this represents an increase in core spending of €0.4 billion for 2022 and €1.7 billion for 2023. In addition, core spending for 2024 and 2025 has been revised up by €1.8 billion in each year.

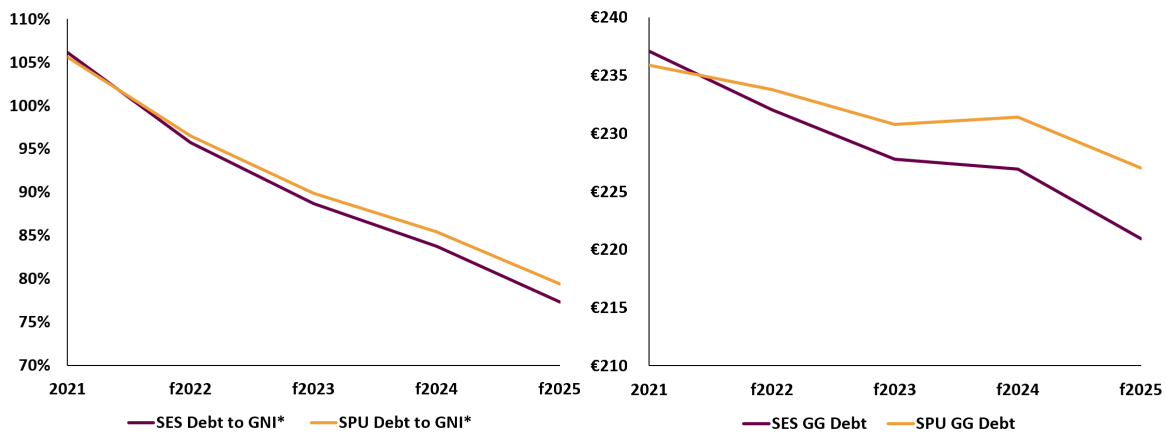
Using the macroeconomic forecasts set out in the SPU, Figure 34a models the impact of these revisions on the debt-to-GNI* ratio over 2022 to 2025. The mid-point of the General Government balance estimates for 2022 and 2023 is used, while estimates for 2024 and 2025 are based on the revisions to core spending for those years, with a technical assumption that revenue grows in line with SPU forecasts (albeit from a higher base of receipts in 2023). Other factors, like the stock flow adjustment, are unchanged from the SPU.

It is worth noting that in terms of GDP, although currently suspended, the core EU fiscal rules (a debt-to-GDP ratio below 60%, and a deficit-to-GDP ratio below 3%) would not be breached under either the SPU or revised SES scenarios. This is due to Ireland's high nominal GDP.

[150] Department of Finance, *Summer Economic Statement 2022* (July 2022).

Figure 34: Debt Projections SES Versus SPU

(a) Projected Debt-to-GNI∗ Ratio **(b) Projected National Debt (Billions)**



Source: SPU, SES and PBO Debt Sustainability Analysis Calculator SPU 2022
Notes: The SPU scenario is based on macroeconomic and fiscal forecasts included in the SPU. The SES scenario is based on macroeconomic forecasts included in the SPU, with changes to the forecast of the General Government balance, as outlined in the SES, for 2022 and 2023. For 2024 and 2025, core spending increases outlined in the SES have been included, while for revenue, we apply a technical assumption that growth will be in line with the SPU forecast of revenue growth in those years (albeit from the higher base of receipts in 2023).

While a modest surplus is anticipated for 2022 and 2023, despite the upward revision to core spending for those years, much of this is being driven by the out-performance of Corporation Tax versus forecasts. As of end-August, tax revenue is 8.2% above profile. Excluding Corporation Tax, this is just 3.2%. The PBO has cautioned previously that revenue surprises (particularly windfall Corporation Tax receipts) should not be used to fund core or permanent spending.

Box 2 below presents a hypothetical scenario analysis, examining the implications for Ireland's debt sustainability of a significant loss in Corporation Tax revenue in the medium-term, against a backdrop of a tightening of monetary policy. As illustrated below, while Ireland is largely insulated from interest rate shocks in the short-term due to the debt maturity profile, prolonged interest rate hikes do pose a sustainability risk, particularly when coupled with a deterioration in the General Government balance.

Box 2: Ireland's Debt Sustainability in a Combined Revenue and Interest Rate Shock Scenario

This box examines the implications for public debt sustainability (in terms of GNI∗) if Corporation Tax (CT) receipts approximately halved, relative to their current level, between 2026 and 2030.[151] This shock is further examined against a backdrop of increased interest rates. The baseline for this analysis is the SES scenario presented above.

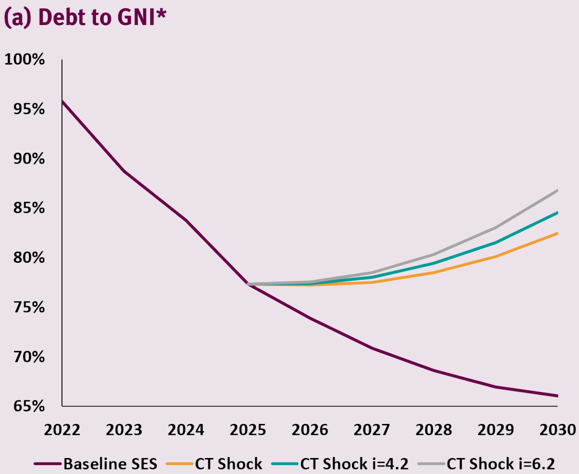
To model this scenario, the *PBO Debt Sustainability Analysis Calculator* is used, the assumptions of which are laid out in the associated user guide. The reduction in Corporation Tax is captured by a reduction in the forecast of General Government revenue of approximately €9 billion relative to baseline, for the years 2026 to 2030. In the chart below, we can observe the impact of this shock on the debt-to-GNI∗ ratio.

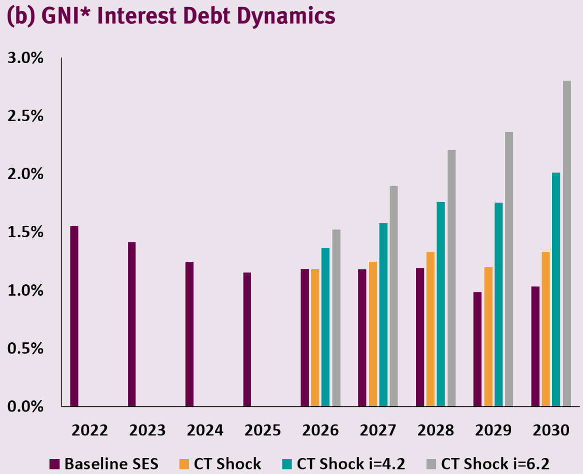
Building on this shock, we examine the case where market interest rates increase over the same period, to 4.2% and 6.2% respectively. This approximates the average and highest effective rates observed since the mid-1990s.

The results of these scenarios are shown in Figure 35a and Figure 35b. Figure 35a shows the projected trajectory of the debt-to-GNI* ratio, while Figure 35b shows the impact of the interest rate on the dynamics of the debt ratio. As shown, the loss in revenue would pose challenges for debt sustainability, setting the debt ratio on an upward trajectory, with the ratio increasing year-on-year out to 2030. This would be exacerbated in a high interest rate environment, with the increased rates adding significantly to the debt ratio each year.

This hypothetical scenario is not intended to establish a forecast, but rather, to highlight the exposure of the debt position to adverse fiscal and monetary policy developments.

Figure 35: Projections of the Debt-to-GNI Ratio and the Estimated Impact of Interest Rates





Source: Analysis using PBO Debt Sustainability Analysis Calculator SPU 2022, based on the baseline SES scenario outlined above, and technical assumptions regarding long-term revenue and spending growth (more information on these assumptions is available in the PBO Debt Sustainability Analysis Calculator Explainer).
Notes: "CT shock" refers to a loss in General Government revenue of approximately €9 billion each year from 2026-2030. "CT shock i=4.2" and "CT shock i=6.2" replicate this revenue shock in the event that interest rates have reached 4.2% and 6.2% respectively.

151 Estimates by the Fiscal Council suggest that approximately half of Corporation Tax receipts are not explained by the performance of the domestic economy and are in "excess" of what might be expected (see Fiscal Assessment Report, May 2022). A more recent analysis by the Department of Finance suggests that approximately €4 billion to €6 billion of 2021 receipts are potentially at risk, while acknowledging that the figure could be in excess of this amount (see De-risking the public finances – Assessing Corporation Tax receipts, Department of Finance, September 2022).

Contact: *pbo@oireachtas.ie*
Go to our webpage: *www.Oireachtas.ie/PBO*
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Houses of the Oireachtas
Leinster House
Kildare Street
Dublin 2
D02 XR20

www.oireachtas.ie
Tel: +353 (0)1 6183000 or 076 1001700
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