Ireland's Current and Future Fiscal Model

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1. Current Fiscal Context

Headline fiscal position ostensibly positive

- GGB of €7.8 billion in 2023 (circa 2.6% of GNI*) notwithstanding once-off cost of living measures
  - Surpluses projected out to 2026 and beyond
- Net debt ratio is falling (63% of GNI*) but is above the OECD average (11th)
  - EU fiscal rules will not be binding in practical terms
- Effective interest rate of close to 1.6% out to 2025. This will gradually creep higher if 10-year bonds remain elevated (currently 2.5%) but higher interest rates are unlikely to meaningfully raise the debt path over the medium-term
- Caveats
  - High concentration (volatile and potentially windfall nature) of corporation tax receipts
  - Context of very strong labour market and high employment rate is helping the public finances (sustainable?) - ongoing capacity constraints and housing/infrastructure needs
  - Short-term focus ignores looming megatrends – ageing demographics and slower growth, green and digital transitions, de-globalisation etc (large fiscal costs)

Skewed tax composition – overreliance on corporation tax windfalls?

- Corporation tax receipts of €23.8 billion (larger than total health spending at €21.2 billion and close to double capital spending at €12.5 billion)
  - Close to 8% of GNI* - well above EU norms (2.5% to 3%)
  - Department of Finance estimates that circa €11 billion of CT receipts is windfall
    - Doesn't <u>necessarily</u> imply it wont be recurring
    - Excluding the 'windfall' generates an underlying deficit of €3.2 billion (circa 1.1% of GNI*)
    - How should we treat a potentially non recurring source of revenue?

International comparisons (% GDP or % GNI* for Ireland)

	2019		2021	
	EU	Ireland	EU	Ireland
Indirect taxes	13.7	13.3	13.8	12.9
of which 'other taxes on production'	*2.5*	*1.8*	2.5	1.6
Direct taxes	13.2	17.6	13.6	19.8
*of which '**corporate income taxes**'*	*2.7*	*5.2*	**2.9**	**6.6^**
Social contributions	13.1	6.2	13.2	5.8
of which 'employer'	*7.2*	*4.1*	7.3	3.5
Total	39.9	37.1	40.7	38.5

Irish taxes are concentrated centrally
Local and state taxes made up 18.1% of EU27 taxes in 2021 (17.7% in 2019) but just 1.3% of taxes in Ireland (2% in 2019)

^CIT projects at 8% GNI* in 2023

International comparisons (% GDP or % GNI* for Ireland)

	2019		2021	
	EU	Ireland	EU	Ireland
Consumption	11.1	11.5	11.2	11.0
Labour	20.7	16.0	20.9	16.2
Employer	*8.2*	*4.4*	*8.2*	*4.1*
Capital	8.1	9.6	8.5	11.2
Corporate income	*2.8*	*5.2*	*3.0*	*6.6*
Capital Stocks	*2.4*	*2.2*	*2.4*	*2.2*
Total	39.9	37.1	40.7	38.5

Implicit Tax Rates, % (Labour)
EU27 2019 = 37.9; EU27 2021 = 37.8
Ireland 2019 = 32.5; Ireland 2021 = 33.1

Implicit Tax Rates, % (Consumption)
EU27 2019 = 17.3; EU27 2021 = 17.9
Ireland 2019 = 19.7; Ireland 2021 = 20.7

Recent policy lessons - A tale of two crises

- Response to the pandemic lockdown
    - Necessary and proportionate response to a temporary exogenous shock (income and business supports, wage subsidies)
    - Preserved the productive capacity of the economy enabling it to bounce-back
- Response to the ‘cost of living’ crisis
    - Untargeted income supports and tax cuts (tax cuts disproportionately benefited those least impacted by cost of living pressures)
        - Significant deadweight as anti-poverty measures, counterproductively added to inflation, pro cyclical
        - ‘Once-off’ supports will eventually be rolled back but higher prices will persist – so ineffective at preventing poverty/deprivation over the medium-term
        - Unwise introduction of new tax breaks (mortgage interest relief)
        - Breaching of spending rule during a period of overheating
- Lessons from both
    - Need for a countercyclical fund
    - Different shocks require different responses
        - Pandemic lockdown was a temporary shock whereas the cost of living crisis was a structural uplift in prices suggesting the use of untargeted temporary supports was the wrong approach

Longer-term planning?

Could be better

- Spending Rules (domestic and EU)
  - Domestic rules need to be refined and based on rolling multi-annual averages (countercyclical)
  - EU fiscal rules will not impact Ireland (but could impede the green transition in other countries)
- Lack of adequate multi-annual budgeting or medium-term forecasts (either not being done or lack of transparency)
  - Fiscal Council concerned at budget ‘gimmickry’ and use of ‘non-core’ concept to present spending as lower than it is
- Lack of engagement with Commission on Taxation and Welfare findings (message not politically convenient)
- Lack of benchmarking (adequacy and sustainability)

Some long-term planning (quibble over details)

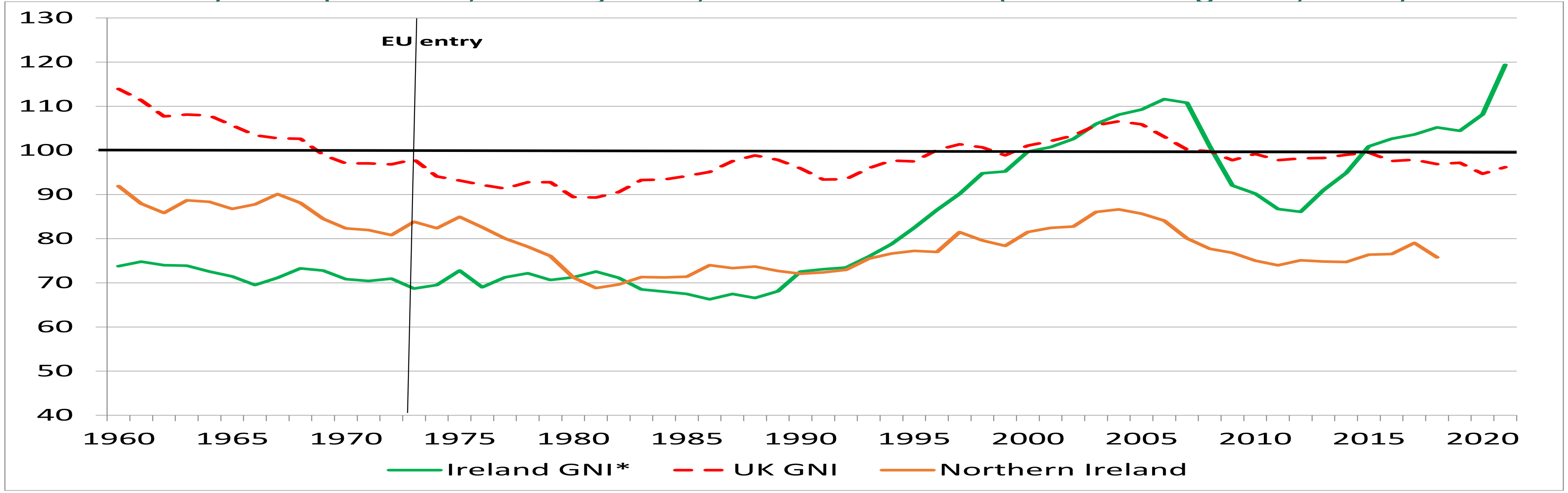
- €70 billion Future Ireland Fund (sovereign wealth fund - €6 billion per year from 2024 to 2035) and the €14 billion Infrastructure, Climate and Nature Fund (countercyclical infrastructure fund – €2 billion per for 7 years))
- PRSI increases to support an expanded social wage and

2. Fiscal Impacts of Megatrends

Looking back and looking ahead

- The economy is constantly in a state of transition
  - Compare today to 1990, 1960, 1930 etc
  - We can be sure that the economy of 2050 will be very different from today

GDP/GNI* per head, PPS adjusted, relative to EU 15 (Source: Fitzgerald, 2023)



Looking a generation ahead

- Ongoing megatrends for the next 30 years?
  - Demographic shifts (ageing, weaker growth, better leverage for workers)
  - Climate change and climate action (global warming, biodiversity loss, extreme events)
  - Technological disruption (4th industrial revolution, AI, robotics)
  - De-globalisation (subsidy based industrial policy, implications for FDI)

- All have fiscal implications

Demographic change

Rapid ageing

- Slowing economic growth (working age ratio will decline, labour supply constraints)
  - Capacity issues? Migration policy?
- Changing labour demand – caring and healthcare will grow as shares of employment
  - Implications for education policy
- Shift in consumption patterns
- **Fiscal implications are profound – greater need for spending on pensions and healthcare (rising old-age dependency ratio) combined with less tax receipts from employment**
  - Rapid growth in over 75s puts particular pressure on long-term care and on health
  - Lower working age ratio reduces income from taxes on labour
- Funding requirements are enormous – The ageing population could increase expenditure by 7% to 9% of GNI* by 2050 according to the Fiscal Council – even if this is an overestimate there will be difficult tax and spending decisions ahead

Climate transition costs

- Green transition costs include:
    - Green infrastructure and upgrades, cost of extreme weather events (land, infrastructure, flood defences), threats to food security, climate migration, changing demand for commodities, changing supply chains
- Political economy – change will be resisted – a 'just transition' – income supports/re-skilling
    - Implications for agriculture and for land use - new financial model is needed for rural communities (the state paying for eco system services)
- Spending side transition costs are likely to approach 1% of GNI* by 2030

- **Transition to net zero has implications for green taxes**
    - A successful transition away from fossil fuels (petrol, diesel, gas) implies revenue falling to zero (Casey and Carroll estimate loss of 0.9% of GNI* in revenues by 2030 and 1.6% of GNI* by the 2040s).
    - Ought we treat as interim windfall receipts and hypothecate to green transition funding?
    - Green taxes will eventually need to be replaced with new taxes or with increases in other taxes
- EU fines for failing to meet targets

De-globalisation, Technological disruption and FDI

Technological disruption (e.g. AI) raises concerns around job loss/insecurity, job quality, inequality – but could also lead to faster growth

- Fast rates of change could increase labour market mismatch and/or structural unemployment (implications for social insurance model and for retraining – use for National Training Fund)
- Countries may increasingly need to focus education policy on digital skills and STEM (and on sectors benefiting from other shifts such as ageing and net zero)

De-globalisation and a shift in industrial policy towards subsidies and on-shoring may have implications for future FDI streams to Ireland

- May be more difficult to 'sell' Ireland on purely tax grounds
- Difficult to be definitive – a lot of uncertainty

What about the corporation tax windfall?

- Will IP move offshore once capital allowances run out?
- Will carve-outs etc undermine the intent of the global reforms?
- Unlikely that the US will enact Pillar 1 – could lead to re-emergence of CCCTB by a subgroup of EU states

Other ‘future proofing’ issues

- Reconciling the public capital stock to future needs
  - Set as % of GNI*? (catch-up needed? – capacity constraints)
- Declining working age ratio means we will need to increasingly rely on productivity gains for growth
  - So higher spending on public R&D, on lifelong human capital development and on business support for tech diffusion and start-up costs
- Future well-being and benchmarking welfare payments
  - To a % of wages or to MESL? – reconciling adequacy with sustainability
- Serious discussion needed on revenue sufficiency and revenue raising choices (COTW)
  - How best to identify and treat windfalls
- Are new fiscal rules or frameworks needed?
  - What goals should they seek to achieve?
  - How should fiscal rules interact with major economic transition costs?
  - Protocols around the use of ‘once-off’ supports

3. COTW Recommendations

Main recommendations (Overall strategy and welfare)

- Overall approach
  - 5 design principles (sustainability, reciprocity, adequacy, equity, efficiency)
- Key message
  - **Ireland faces major fiscal sustainability challenges. Over time, the overall level of taxation as a share of national income will have to increase**
- Significant recommendations on the revenue side and on the welfare side
  - Main recommendations on the welfare side focused on adequacy (central to poverty reduction), simplicity and coherence
    - Emphasis on adopting a benchmarking strategy and on using coordinated income tapered supports (conscious of METRs)
    - Approach applies equally to child, working age and old age supports

Main recommendations (Tax ratio)

- 116 Recommendations – most were on the tax side
- Meaningful increase in revenue to GNI* ratio needed – this was the main finding
  - Appears to have been dismissed by government – seen as ‘left wing’ – e.g. see response to recommendations re inheritance tax
    - No mature willingness to engage with the issue of fiscal sustainability or intergenerational equity
    - Will the media resurrect the debate when it comes to the General Election?
- Existing and new taxes were viewed through lens of the five design principles
- Key finding that tax expenditures should only be used in extremis
  - Seen as distortive, regressive, high levels of deadweight, non-transparent
  - Needs to be a clear market failure, full ex ante economic and social evaluation of likely impact, automatic sunset clauses
  - Eliminating tax expenditures has scope to generate additional billions per annum
  - But note deviation from 5 principles in Chapter 9 (business supports)

Main recommendations (Tax changes)

- Assessment was that the greatest scope for increasing taxes was in relation to the taxation of capital and wealth
  - Concerns re potential employment/growth impact of labour taxes and the potentially regressive impact of most consumption taxes
    - Main proposed increases in consumption taxes relate to elimination of fossil fuel subsidies and additional yield from ‘green’ taxes e.g. carbon and congestion
    - Main proposed increases in relation to labour taxes were on self-employed PRSI and on the widening of the tax and PRSI base via elimination of certain tax expenditures
- Recommendations to increase yield from CAT, CGT, LPT, and to introduce a site value tax i.e. to tax land, property and wealth more generally
    - Net wealth tax conditional on failure to increase yield from other sources of wealth
- But no recommendation to meaningfully reform CIT

4. Conclusion

Conclusion

- Fiscal policy is worryingly reliant on the yield from corporation tax
  - Yield is inherently volatile and risky particularly given its concentrated and cyclical nature
  - Corporation tax battles will continue (resurrection of CCCTB if BEPS reform stalls?) and the future location of IP assets is uncertain
  - Treating the yield as partially windfall in nature makes sense (2 new funds)
- Current fiscal model is not sustainable into the 2030s and beyond
  - Mature debate needed about expenditure needs and revenue sufficiency
  - If COTW recommendations are not acceptable then what is the alternative?
  - Multi-annual and transparent fiscal planning needs to be a priority
- What is our future economic growth strategy?
  - Can we develop a viable growth strategy consistent with adequacy, equality and green goals?
- How does corporation tax fit into this debate?
  - Unfortunately the misalignment of and tension between Irish development goals and international tax justice goals will persist