Tax surge sees budget deficit shrink

Budget 2022 was framed against a backdrop of a strongly recovering economy and rapidly improving public finances as Ireland emerges from the grips of the Covid-19 pandemic, though the virus is still very much with us. The strength of the recoveries in both the labour market and public finances is particularly striking.

Employment has rebounded strongly during 2021. This is reflected in the sharp decline in the jobless rate (including those on the Pandemic Unemployment Payment) from 27% earlier in the year to 10% by September, with the number continuing to fall in early October. Ireland is not unique in this regard, with the unemployment rates in both the UK and US now back below 5%. However, Ireland is enjoying a much quicker recovery in its public finances than elsewhere.

The Irish economy entered last year’s severe global recession in good shape, with surpluses in both the Government finances and balance of payments, full employment, low private sector debt levels and no sign of imbalances within the economy. The large multinational sector performed very strongly through the pandemic, registering rapid export growth.

Meanwhile, the domestic economy has benefited from enormous fiscal supports, which have totaled almost 20% of national income during 2020-21. Thus, the decline in the domestic economy at 5% last year, was considerably less than in most other European countries. Meanwhile, the latest forecasts from the Dept. of Finance and Central Bank are that the domestic economy will grow by 5.25-5.5% this year, recovering all the ground lost in 2020.

The most striking thing about the public finances this year has been the strength of tax receipts. Total tax revenues fell from €59.3bn in 2019 to €57.2bn in 2020, a decline of 3.5%. Tax receipts, though, have surged across the board this year, with the Dept. of Finance now forecasting that they will increase by 15.5%, or circa €9bn, to over €66bn.

With Covid-19 related spending also declining at a quicker than expected pace following a highly successful vaccination campaign, the outlook for the public finances has been transformed. The budget deficit is now anticipated to come in at €13.25bn in 2021, far below the target of €20bn. With the strong economic recovery expected to be sustained in the next couple of years, the budget deficit is projected to fall to €8.25bn in 2022 and just over €1bn in 2023.

Thus, in the space of a couple of years, it is expected that a very large budget deficit, equating to almost 9% of national income, will be eliminated, without the need for any fiscal tightening. This is crucially dependent, though, on a continuation of the strong economic recovery.

Perhaps the biggest risk to the favourable outlook for the economy and public finances is that the current upsurge in inflation proves sustained. This would almost certainly trigger a marked tightening of monetary policy by central banks, with an end to QE as well as significant rate hikes.

It is doubtful in this situation, whether fiscal policy could provide the type of support to the economy seen over the past two years. Governments could no longer rely on the benefits of substantial bond purchases by central banks and exceptionally low funding costs. Thus, it is important that inflation falls back over the course of next year to allow macroeconomic policy to remain supportive of the recovery.

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