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Fiscal Policy in a High Inflation Environment

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Inflation in Ireland is currently well above its pre-pandemic level. High inflation has implications for the public finances by affecting government revenue, spending decisions and debt. This Box discusses how the rise in inflation can affect the public finances, outlines the government measures to mitigate the effect of higher inflation announced to date, and looks at considerations for possible future policy actions.

Transmission channels of high inflation to the public finances

The most immediate effect of the rise in inflation is on Government revenue, as higher prices translate into higher income from indirect taxes like VAT and excise duty. Together, these two tax headings accounted for around one quarter of Exchequer revenue last year. It is likely that the Exchequer has already benefited from the rise in prices, but any secondary effects of higher inflation such as potential reductions in household consumption could eventually reduce indirect tax receipts. Moreover, the Government recently announced a temporary cut to excise on fuels that will directly reduce revenue from this source by €320 million. Direct taxes and social contributions, by comparison, are not automatically affected by higher inflation. If wage growth accelerates, PAYE and USC may also come in ahead of expectations. This is due to the increase in total wages, as well as the fact that unless the tax bands are adjusted, a greater share of income will be taxed at the higher income tax rate (this is known as fiscal drag). Against this, it is possible that lower non-energy consumption could lead to weaker employment growth, placing downward pressure on the base for income taxes.

On the expenditure side, the direct effects are limited. Unlike many other euro area countries, Ireland's pension and social welfare system does not use automatic indexation.[1] This means that any increases to the state pension and unemployment benefits will be at policymakers' discretion.

[1] Chcherita-Westphal, Public Wage and Pension Indexation in the Euro Area, 2022.

However, higher prices may still lead to spending pressures. Government could choose to compensate certain groups for higher prices by increasing social benefits, and long-term capital projects will be more vulnerable to cost overruns. More generally, a given level of real expenditure could now cost more in nominal terms. Since headline inflation is an average figure, it does not capture the varying impact that price increases can have on different household types. Low-income households, for example, spend a greater share of their income on energy goods.[2] This makes these households more exposed to the recent rise in prices and various measures have been put in place by Government to help alleviate the higher cost of living, some of which are targeted towards lower income groups (discussed below). Any extension or expansion of these programmes could increase expenditure above what was included in Budget 2022. More persistent inflationary pressures could over time also lead to higher debt interest payments as interest rates would generally rise. In the Irish case, however, there are limited bonds maturing (€12bn between now and end-2023) over the coming 18 months and the National Treasury Management Agency (NTMA) has significant cash reserves on hand (€34.4bn at end-February 2022), providing it with funding flexibility. The NTMA currently plans to issue €10 - €14bn of bonds this year, €4.5bn of which has already been raised in the first quarter.

Higher inflation can impact the ratio of debt-to-national income through both the numerator and denominator channels. In the case of the former, this can occur through changes in the interest-growth differential (either through higher nominal growth rates, higher effective interest rates, or a combination of the two) or changes in the primary balance. The overall direction of the impact will depend on which of these factors dominates. In the case of the denominator, one would expect nominal GNI* to be higher for a given real level of output, putting downward pressure on the debt ratio.

Irish Government response to date

The Irish government has announced a number of measures in recent months to mitigate the impact of higher energy costs on households and businesses. These include a temporary reduction in excise duty on fuels, an energy credit of €200 per household, an exceptional payment of €125 to households in receipt of the fuel allowance and subsidies for hauliers. As Table 1 outlines, it is estimated that these measures will cost €855m or 0.3 per cent of GNI* in 2022. These measures are in addition to an increase in the weekly rate of the fuel allowance announced in Budget 2022. The better than expected performance of the public finances last year, coupled with the large COVID-19 contingency reserve, has provided the Government with some additional space to fund this expenditure.[3] Nevertheless,

[2] Lydon, Household characteristics, Irish inflation and the cost of living, 2022.
[3] As recently as Budget 2022 a General Government deficit of €13.3bn (-5.9 per cent of GNI*) was expected for 2021, but this is now estimated to have been closer to €9bn (-3.8 per cent of GNI*) reflecting higher than expected tax receipts and lower than projected spending. The Government's projected €8.3bn deficit for this year includes a €2.8bn (1.1 per cent of GNI*) unallocated COVID-19 contingency.

with the public finances in a deficit position following COVID-19, this expenditure will be funded by borrowing.

Table 1: Fiscal measures announced since Budget 2022 in response to increase in Inflation

Date of Announcement	Measure	Estimated Cost in 2022
Feb-22	Fuel allowance lump sum payment	€49m
February	Energy credit payment of €200	€378m
February	Reduction in public transport fares	€54m
February	Reduction in Drug Payment Scheme threshold	€17m
February	Increased income threshold for Working Family Payment	€4m
February	Reduced cost of school transport fees	€3m
Mar-22	Temporary reduction in excise duty on fuels	€320m
March	Subsidy for hauliers	€18m
March	Targeted intervention for tillage sector	€12m
	Total	**€855m**

Source: Department of Finance, Department of Transport

In terms of the overall impact of higher energy prices on the fiscal position, our latest estimates show that the negative impact on real activity more than offsets the positive impact of higher prices this year. Accordingly, when coupled with the direct costs of the measures outlined above, it appears that higher energy prices will have a negative effect on the public finances in 2022.

As set out in the scenario analysis in *Box A* of this *Bulletin*, further increases in energy prices could lead to higher inflation and lower than expected growth than in the central forecast. The scenario results indicate that, while higher inflation would directly increase government revenue from some tax headings, this would be offset by the impact of slower overall economic activity. The net impact on the public finances would be negative. In scenario 1 (oil prices +15 per cent, gas +50 per cent), the General Government deficit would be higher by 0.2 percentage points in 2023 while in scenario 2 (oil +35 per cent, gas +120 per cent), the deficit would be 0.5 percentage points larger than in the central forecast. The scenarios assume that no additional government support measures are introduced.

Options for the future

In the event that further government supports are deemed necessary to help offset higher inflation, it is important that any such measures are temporary in nature and targeted to those most affected by the price increases. Were the need to arise for the measures already introduced to remain in place for

an extended period beyond 2022, options for the sustainable funding of these supports would need to be considered.

Measures also need to limit the risks of second round effects emerging, generating the need for additional supports. The European Commission published a toolbox of short and medium-term measures last October that could be taken to support consumers and industry in response to a spike in inflation.[4] These include targeted social payments to those most at risk, deferrals of bill payments, reduced tax rates for vulnerable households and aid to companies in line with EU state aid rules.

Permanent and across the board spending increases - which are not offset by additional revenue raising measures - would weaken the structural budgetary position, at a time when the government debt ratio remains at an elevated level and spending pressures over the medium to longer term are set to increase due to factors such as demographics and climate change. The full year cost of the measures already announced is estimated to be around 0.5 per cent of GNI*. Were these measures not to be rolled back in due course they would therefore lead to a permanent increase in spending of this magnitude that would need to be financed. It is notable that the projected improvement in the budget balance in the coming years is expected to be driven by a strengthening of the cyclical position and an unwinding of temporary measures rather than structural developments.[5]

Subject to protecting those households with greater difficulty in absorbing the higher commodity-based inflation, it is also important that additional support measures introduced do not unnecessarily add further stimulus to the economy. While there has been a sharp increase in the level of uncertainty surrounding the economic outlook since the last Quarterly Bulletin, the economy and labour market are still expected to be running at close to its potential level before the end of the projection horizon. While the expectation is for somewhat lower real growth as a result of the Russian invasion of Ukraine, the geopolitical situation poses a more fundamental supply-side shock to the economy. Against this backdrop, and with inflationary pressures already high, the fiscal stance should not add further demand in the economy over and above existing plans. Expenditure which supports supply-side conditions, builds resilience to future shocks and over the longer-term enhances the structural budgetary position becomes a more immediate priority the longer energy and other commodity prices are expected to remain high.

Summary

Overall, there is a strong rationale for using fiscal policy to compensate those most affected by the recent increase in energy prices. As the pandemic response has shown, a temporary and targeted fiscal response can mitigate the negative impact of an exogenous shock on households and firms, while at

[4] European Commission, Tackling rising energy prices: a toolbox for action and support, October 2021.
[5] See Government of Ireland, 'Budget 2022 Economic and Fiscal Outlook', Table 11 Page 32.

the same time limiting the exposure of the broader economy and the public finances.[6] Any additional measures introduced should limit the potential for second round effects, while the overall fiscal stance should remain unchanged from the plans in Budget 2022 to ensure fiscal policy does not add further to demand in the economy given existing supply constraints.

[6] For example see Conefrey et al, 'COVID-19 and the public finances in Ireland', Central Bank of Ireland Economic Letter 2021-3.