Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Box D: QB 1 – February 2020

This Box content is extracted from the Quarterly Bulletin – Q1 2020

Developments in Corporation Tax – An Update

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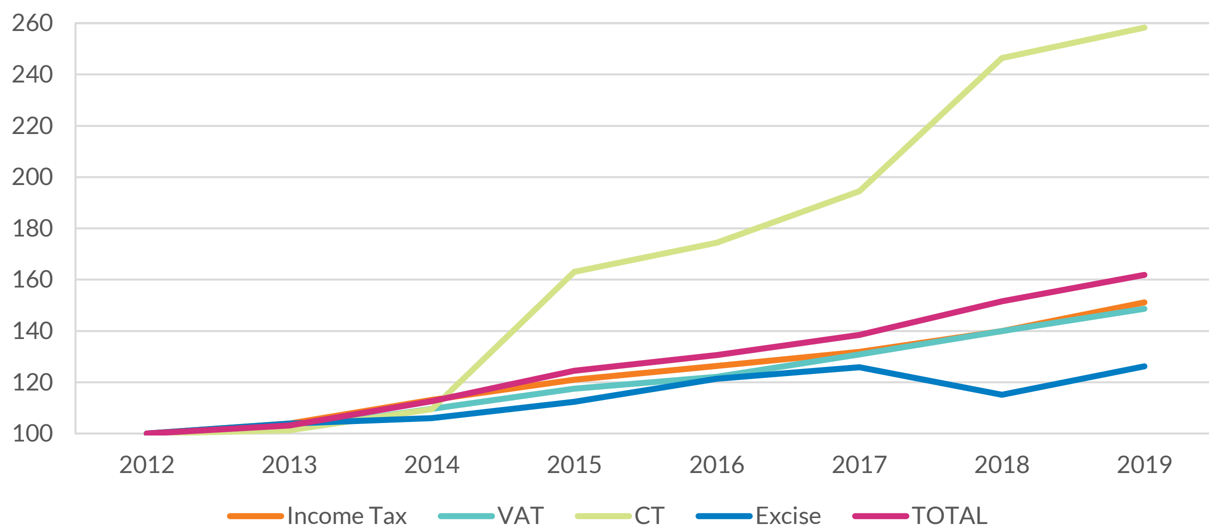
Corporation tax (CT) receipts reached a record high of €10.9 billion in 2019, once again significantly surpassing budgetary expectations. Against this backdrop this Box provides an update on the latest developments in CT, building on other recent analysis by the Central Bank.[1] It highlights the substantial growth that has occurred in CT receipts since end-2014 and the difficulty in forecasting these developments given the high proportion of tax payments that occur in the final two months of the year. It also finds that, had CT moved in line with nominal GNI* growth from 2015 onwards, it would have been around €4¼ billion - or close to 40 per cent – lower than its actual outturn at the end of last year.

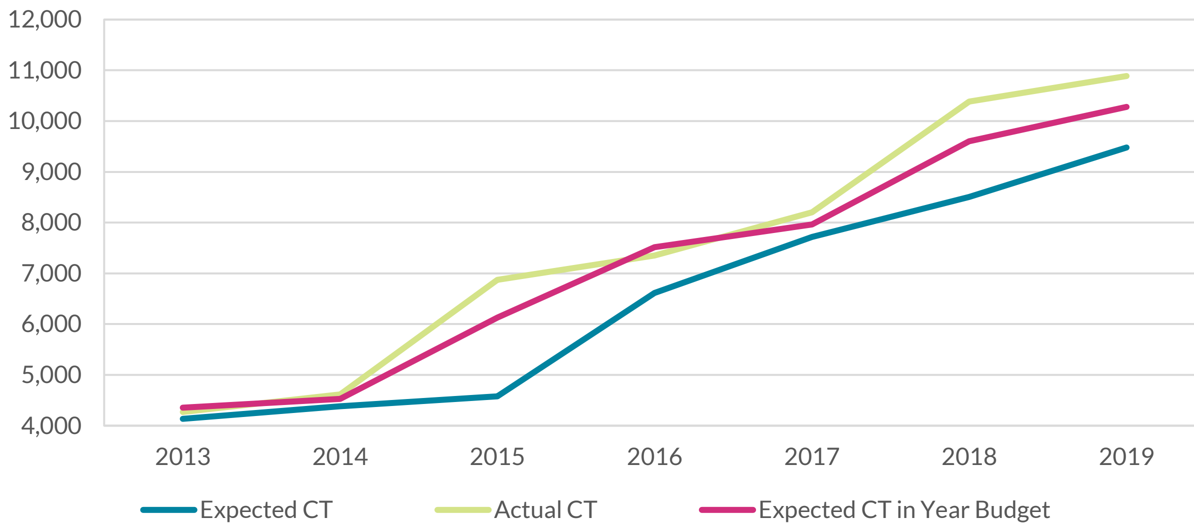
Chart A: Growth in Major Tax Heads (2012=100)



Source: Department of Finance, Central Bank calculations

[1] See, for example, Conefrey, Hickey and Walsh, 'Debt and uncertainty: Managing risks to the public finances', CBI Economic Letter, No 11, 2019. Also 'Box E: The role of Corporation Tax in driving Irish tax growth, 2015 to 2018', CBI Quarterly Bulletin 2 2019.

Chart B: Expected v Actual CT (€m)



Source: Department of Finance
Note: Expected CT refers to CT which was projected at the time of the corresponding year's budget.

Chart A illustrates growth in the 'big four' tax heads, along with total taxes, since 2012. Total taxes have increased by 62 per cent over this period, which compares very favourably with the broader euro area (22 per cent growth over the period 2012 to 2018) and individual countries in the region (the only countries with higher growth over the period 2012 to 2018 are Malta and Estonia).[2] Income tax and VAT, the two largest taxes in nominal terms have both increased by around 50 per cent as employment, earnings and consumer spending have recovered. What is striking from Chart A, however, is the very significant growth in CT that has occurred, with a particularly sharp acceleration from 2015 onwards. While the 4.8 per cent increase in 2019 was lower than in previous years – due to some early payments made in 2018 – it was 15 per cent or €1.4 billion above what had been expected at the time of Budget 2019 (October 2018). CT receipts have more than doubled since end-2014 and this single tax head has been responsible for 35 per cent of total tax revenue growth over this period, a higher contribution than income tax despite the latter's much larger nominal tax base.[3] It should be noted that excluding CT, taxes have grown by around 50 per cent since end-2012, still well above the euro area average, highlighting the strong performance of the economy over this period.

Chart B, meanwhile, shows that a higher than expected CT outturn - as seen last year - has been a general trend since the end of 2014, with an average CT 'windfall' (difference between what the government has projected for the year in the previous October's Budget and the actual outturn) of

[2] The comparable figure for Ireland over the period 2012 to 2018 is 52 per cent.
[3] Corporation tax has been responsible for 35 per cent of total tax growth since end-2014, compared to 32 per cent for income tax, 22 per cent for VAT and 5 per cent for excise.

€1.4bn per annum over this period. The total amount of additional CT revenue collected by the government over this period – in excess of their budgetary projections - has been €6.8bn (or 3.4 per cent of 2018 GNI*). To further highlight the unpredictable nature of CT in recent years, Chart B also shows the expected CT outturn at Budget time (October) in the particular year in question, i.e. just ten weeks prior to the end of the year.[4] Even though nine months of Exchequer data have been available at this time, the average 'windfall' has still been around €450m. This reflects the very high proportion of CT receipts that are paid in the final two months of the year – 35 per cent of total receipts were expected to be paid in November and December of this year. Prior to 2013 the Budget was published in December, reducing the potential for these intra-year errors.

The exceptional growth in CT revenue since 2015 has been well in excess of the rate of growth in underlying economic activity in Ireland as measured by various indicators. For example, modified Gross National Income (GNI*) is an adjusted measure of national income that strips out the effects of certain multinational activity that does not impact the incomes or employment of Irish residents. From 2015-2019, this is estimated to have grown at an average annual rate of 6½ per cent. In contrast corporation tax revenue increased by an average of around 20 per cent per year over the same period.

Accordingly it is worth examining what increase in CT we would expect to have seen had revenue grown broadly in line with underlying economic activity.[5] The difference between this and the actual corporation tax outturn can be considered a measure of windfall revenues. It may also be instructive in providing an estimate of how much of the recent inflow could be considered as potentially unsustainable – as it is unrelated to developments in the Irish economy. This is, of course, only one way of trying to identify the potentially unsustainable element of CT, with other methodologies having been employed recently by the IMF, IFAC and the Department of Finance, amongst others.[6]

Having looked at a range of variables, we use modified Gross National Income (GNI*) as the base to determine how far CT receipts have deviated from the level that would be expected based on underlying developments in the economy. Prior to 2015, GNI* performs reasonably well as a predictor of CT receipts. Furthermore, as GNI* has been specifically designed to exclude globalisation effects unrelated to developments in the Irish economy or labour market, it is a more suitable indicator for this exercise than GDP or gross operating surplus. Although gross operating surplus may appear to be a more appropriate macro base given it is a measure of profits in the economy, the 55 per cent annual

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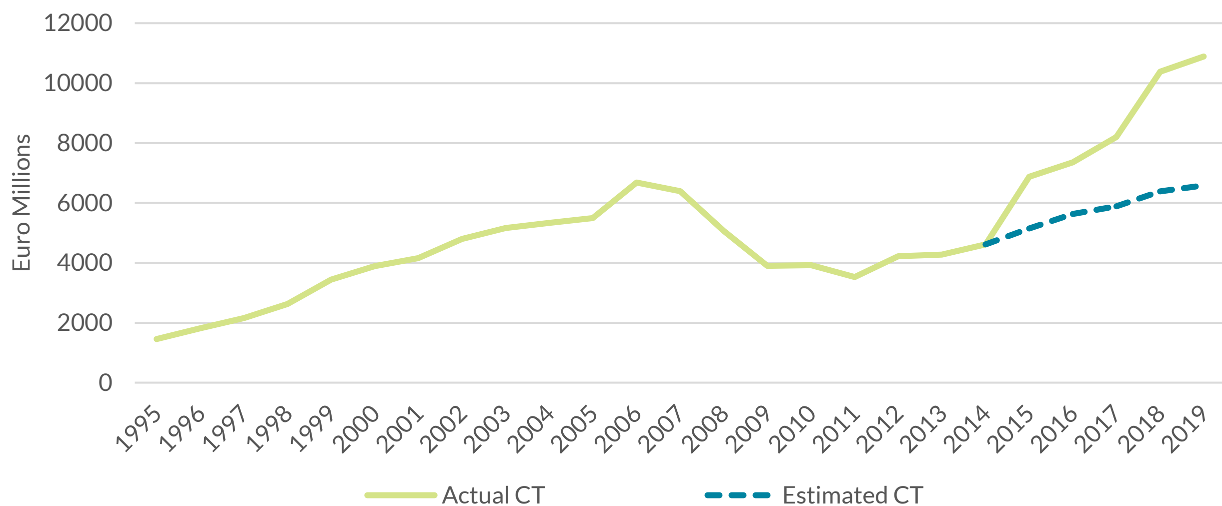
[4] Prior to Budget 2014 the Budget, and corresponding fiscal projections, was published in December.
[5] This differs from a forecasting exercise where the objective is to estimate a model which can predict as closely as possible the actual level of corporation tax.
[6] See IMF 'Ireland 2019 Article IV Consultation', June 2019; IFAC 'Fiscal Assessment Report', June 2019; Department of Finance 'Budget 2020 – Addressing Fiscal Vulnerabilities', October 2019

increase it experienced in 2015 appears disconnected from actual underlying activity that year.[7] We produce a model based estimate using the equation:

$$\Delta CT_t = \alpha + \beta \Delta GNI*_t + \varepsilon_t$$

The equation results suggest that, given the historical relationship between CT and GNI*, overall CT revenue was €4¼ billion higher at the end of 2019 than we would have expected given GNI* growth. This figure is broadly in the middle of the recent estimates of the potentially unsustainable part of CT produced by the Department of Finance and IFAC. As Chart C shows, the increase in GNI* in recent years projects strong growth in CT, averaging around 7½ per cent per annum. The actual increase in CT revenue, however, has been considerably stronger, with an annual average increase of almost 20 per cent since the end of 2014.

Chart C: Observed increase in CT since 2015 has been larger than an estimate based on the growth in national income



Source: Central Bank of Ireland calculations
Note: Model based estimate uses GNI* as the base measure

It is important that any 'windfall' or unexpected revenue is saved rather than used to fund long lasting spending commitments. The pattern observed in recent years has been for such spending to occur, with voted primary current expenditure overshooting its budget profile by an average of €870m per annum since end-2014. Given current economic conditions, saving windfalls would help to alleviate overheating pressures while also building up buffers to limit the cost of any future downturns. Fiscal buffers accumulated during times of buoyant tax revenue growth could be used to avoid the need for damaging fiscal tightening in a recession.[8]

[7] Prior to 2015 - and this rapid growth in gross operating surplus (GOS) noted - GNI* has a strong correlation with GOS (0.78).
[8] See Conefrey, O'Reilly and Walsh, 'Fiscal windfalls: A model based analysis', CBI Economic Letter, No 3, 2019.