

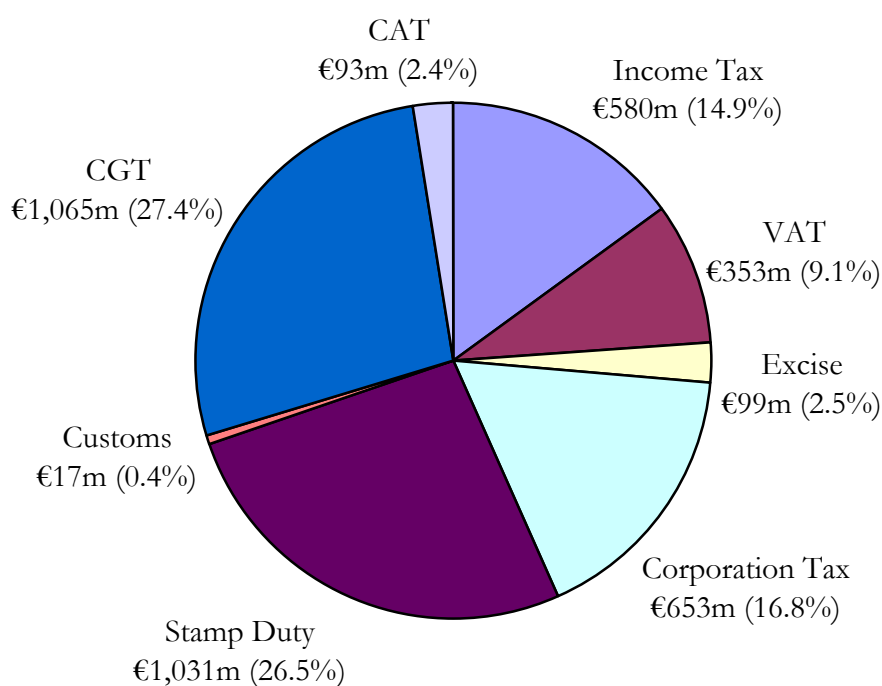
Chapter 2

Tax Forecasting

2.1 Forecasting of Tax Receipts

The Department of Finance prepares estimates of tax receipts each year with the assistance of the Revenue Commissioners. The final estimate, which takes account of changes introduced in the Budget, is presented on Budget day each year and is known as the Post-Budget Estimate. Details of the actual tax collected each year are published in the Revenue Annual Report. The amounts transferred to the Exchequer by Revenue, as opposed to the actual amounts collected, are published in the monthly Exchequer Statement and the annual Finance Accounts. The total Exchequer receipts for 2006 (€45.5 billion) exceeded the forecast (€41.65 billion) by almost €3.9 billion or over 9%.

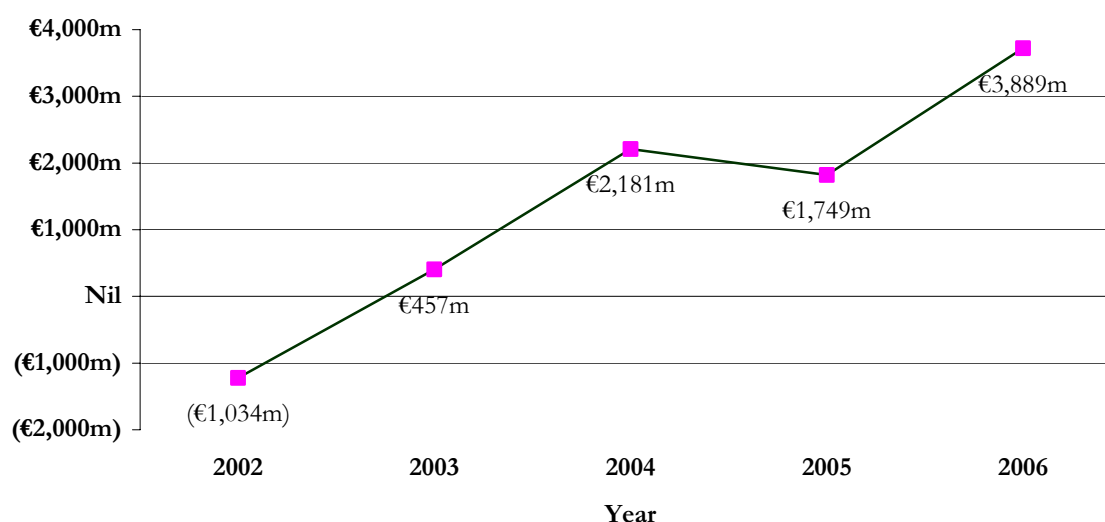
Figure 1 Contribution of each Tax to Total Excess over Forecast 2006⁴



In my 2001 Report, I highlighted the taxation shortfall against forecast of over €2.5 billion that occurred in 2001. While there was also a shortfall in 2002, it was somewhat lower at just over €1 billion. Since 2002, the trend has been for actual tax receipts to exceed forecast as can be seen in Figure 2. While PAYE contributed €763m and €730m to the shortfalls in 2001 and 2002 respectively, actual PAYE receipts in 2006 were within €155m of the forecast.

⁴ Excludes levies.

Figure 2 Variation against Forecast 2002 to 2006



I asked the Accounting Officer of the Department of Finance what were the reasons and underlying factors for the large surplus in each of the years 2004, 2005 and 2006. In reply he confirmed that Exchequer tax revenues in each of the last three years had significantly outperformed their Budget day targets. In 2004, tax revenues were 6.5% ahead of target. In 2005, receipts were 4.7% ahead of target and, in 2006, tax revenues were 9.3% ahead of target.

However, he pointed out that focusing on the major tax-heads – VAT, income tax, corporation tax and excise duty – which, in the years 2004, 2005 and 2006 have accounted for around 85-90 % of total taxes and excluding the impact of receipts from Revenue’s special investigations, tax revenues had been close to target, particularly in 2004 and 2005.

He provided me with the following analyses of the surpluses for 2004, 2005 and 2006.

2004

The 2004 Budget day target for tax revenues was €33,400m. The actual outturn was €35,581m giving an overall tax revenue surplus of €2,181m. The individual tax-head breakdown is in Table 5.

Over half of the excess in 2004 came from stamp duties and capital gains tax, a reflection of the continued strength of the asset market, particularly the property market that was not foreseen by any commentators at the time of the 2004 Budget. The prudent nature of the tax forecasts for these particular tax-heads in 2004 reflected that view.

Included under the income tax heading were receipts of €673m in respect of the main Revenue special investigations in 2004, the Offshore Assets Group and Bogus Non-Resident Account investigations. Receipts from these sources were forecast at €150m, giving an excess over target of €523m. This represented almost one quarter of the total excess. By their nature, receipts from this source could not be forecast with any degree of accuracy.

Excluding these special investigations moneys, receipts from the major tax-heads, VAT, income tax, corporation tax and excise duty, that accounted for almost 90% of total taxes in 2004 were just 1.4% ahead of target.

Tax Forecasting

Table 5 2004 Exchequer Tax Revenue – Outturn v Forecast

	2004 Forecast €m	2004 Outturn €m	+/- €m	+/- %
Customs Duty	137	173	+36	+26.3
Excise Duty	4,864	4,928	+64	+1.3
Capital Gains Tax	851	1,516	+665	+78.1
Capital Acquisitions Tax	150	190 ⁵	+40	+26.7
Stamp Duty	1,600	2,088	+488	+30.5
Income Tax	10,077	10,651	+574	+5.7
Corporation Tax	5,348	5,332	-16	-0.3
VAT	10,368	10,693	+325	+3.1
Levies	5	10	+5	–
Total	€33,400m	€35,581m	+€2,181m	+6.5%

2005

The 2005 Budget day target for tax revenues was €37,505m. The actual outturn was €39,254m, giving an overall tax revenue surplus of €1,749m. The individual tax-head breakdown is provided in Table 6 below.

Table 6 2005 Exchequer Tax Revenue – Outturn v Forecast

	2005 Forecast €m	2005 Outturn €m	+/- €m	+/- %
Customs Duty	170	226	+56	+32.9
Excise Duty	5,075	5,233	+158	+3.1
Capital Gains Tax	1,500	1,960	+460	+30.7
Capital Acquisitions Tax	180	249 ⁶	+69	+38.3
Stamp Duty	2,085	2,725	+640	+30.7
Income Tax	11,105	11,266	+161	+1.4
Corporation Tax	5,760	5,492	-268	-4.7
VAT	11,625	12,089	+464	+4.0
Levies	5	14	+9	–
Total	€37,505m	€39,254m	+€1,749m	+4.7%

As in 2004, a large proportion of the excess in tax revenues in 2005, almost 63%, came from stamp duties and capital gains tax. Once again this was due to the continued strength of the asset market, particularly the property market in the latter half of the year.

18% or €313m of the total excess was due to a greater than expected yield from Revenue's main special investigations. The main tax yielding investigation in 2005 was the Single Premium Insurance

⁵ Includes a minor amount in respect of Residential Property Tax.

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Investigation. Receipts from the main investigations in 2005 were forecast at €200m. The actual yield was €513m.

Excluding these moneys, receipts from the major tax-heads, which accounted for 87% of total taxes in 2005, came in just 0.6% above target.

2006

The 2006 Budget day target for tax revenues was €41,650m. The actual outturn was €45,539m, giving an overall tax revenue surplus of €3,889m. An individual tax-head breakdown is provided in Table 7.

Table 7 2006 Exchequer Tax Revenue – Outturn v Forecast

	2006 Forecast €m	2006 Outturn €m ⁷	+/- €m	+/- %
Customs Duty	240	257	+17	+7.1
Excise Duty	5,490	5,589	+99	+1.8
Capital Gains Tax	2,035	3,100	+1,065	+52.3
Capital Acquisitions Tax	260	353 ⁸	+93	+35.8
Stamp Duty	2,685	3,716	+1,031	+38.4
Income Tax	11,810	12,390	+580	+4.9
Corporation Tax	6,030	6,683	+653	+10.8
VAT	13,095	13,448	+353	+2.7
Levies	5	3	-2	-
Total	€41,650m	€45,539m	+€3,889m	+9.3%

As in the previous two years, a significant proportion, €2.1 billion or 54%, of the overall excess came from stamp duties and capital gains tax that continued to benefit from buoyancy in the asset market and, in particular, the property market. Again, this level of activity was not anticipated by forecasters generally.

The corporation tax surplus of €653m was partially due to some unexpectedly high payments from a small number of large companies and partially due to some new companies paying significant amounts of tax for the first time.

Income Tax also performed above expectations, coming in €580m or 4.9% ahead of target. The bulk of this excess arose on the non-PAYE side.

Excluding the impact of special investigations receipts which were not as significant in 2006 as they were in 2004 and 2005 and which actually came in below target in 2006, the major taxes which together accounted for 84% of actual tax revenues in 2006, were 4.8% ahead of target.

⁷ The 2006 tax revenue outturn is taken from the end-December Exchequer Returns and may be subject to change in the 2006 Finance accounts, to be published later in 2007.

⁸ Includes a minor amount in respect of Residential Property Tax.

Review of Forecasting Performance

In October 2005, the International Monetary Fund (IMF) published an analysis of Ireland's track record on forecasting the fiscal balance.⁹ On the revenue side the analysis found that stronger-than-expected economic growth and buoyant asset price developments were the main reasons for the overshooting of tax revenue. In terms of economic growth forecasts, upon which the tax forecasts are based, it was outlined that Department of Finance forecasts were not dissimilar to those of other institutions, and the difficulty in forecasting economic growth in a period of strong economic growth was highlighted. The IMF recommended the continuation of what it called the "prudent approach" to budget forecasts given the risks that asset developments may not continue to contribute significantly to large upside surprises. It also stated that the institutional framework for fiscal policy and budget forecasting practices in Ireland are relatively strong compared with other countries.

The Accounting Officer informed me that many factors can affect the outcome of a tax revenue forecast that is subject to an appreciable degree of uncertainty. He stated

- Tax revenue is a product of the level of economic activity, and forecasting economic activity is not an exact science. Budget tax forecasts are made at a time when reliable economic data on the current or forecast year is not available. Economic data for previous years published by the Central Statistics Office (and similar statistical bodies elsewhere in the world) is subject to regular revision for a number of years after the end of the year in question.
- The actual composition of economic activity is also a key factor and this, likewise, is difficult to predict in advance.
- The actual outturn for current year tax receipts is not known at the time that Budget tax forecasts have to be made and also has to be estimated.
- The impact of once-off or extraneous factors e.g. special investigations receipts, from year to year can be significant.
- The effect of structural changes in the tax system that can sometimes impact on taxpayer behaviour with unforeseeable results on tax revenues in the short term.

Improving Forecasting

In response to my enquiry as to what action has been taken or is planned to improve the accuracy of budget forecasting, the Accounting Officer informed me that a Direct Tax Base Working Group, an informal group made up of officials of the Department of Finance and the Revenue Commissioners, was set up with the approval of the Minister for Finance in mid-2002. The original purpose of the group was to build on the earlier analyses of shortfalls in direct tax revenue in 2001 and 2002 and to examine issues that may have an impact on the tax yield from direct taxes, including income tax, for the purpose of improving the tax forecasting methodology. The work of the group is ongoing.

The Tax Forecasting Methodology Review Group, chaired by a senior economist on secondment to the Department of Finance from the Central Bank and comprising representatives from the Department of Finance, the Revenue Commissioners, the Central Bank, the Economic and Social Research Institute and the European Commission, was set up in December 2006. The terms of the reference for the group are

- To review the existing tax forecasting methodology
- To examine the reason for the tax forecast divergences

⁹ IMF Selected Issues paper, July 2005 *Favourable Fiscal Outturns: Is It Just the Luck of the Irish?*

- To analyse the information bases on which forecasts are made
- To review the structural parameters of tax elasticities
- To look at the experience in other relevant jurisdictions and
- To make recommendations for changes to the methodology, where appropriate.

The group first met in January 2007 and has met five times so far. The group has examined a range of issues. These include

- The existing approach to tax forecasting
- The performance of the tax forecasts produced by the Department since 1998
- Revising the forecasts based on the most-up-to date economic data available
- Accounting for one-off receipts and recent property market performance
- Examining the long-run aggregate tax elasticity and
- Examining the tax forecasting methodology of other institutions.

He also informed me that, in order to concentrate resources on the work of this group, it had been agreed that the Direct Tax Base Working Group would postpone its work until after the Review Group had reported. This is expected some time during Summer 2007 and it is expected that its report will be published in due course.

