Fiscal Stance

From bust to boom

3. FISCAL STANCE
From bust to boom

In this section, the Council assesses the prudence of the Government's overall fiscal stance. Its assessment is informed by (1) a broad economic assessment that considers how to appropriately manage the economic cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with domestic and EU fiscal rules.

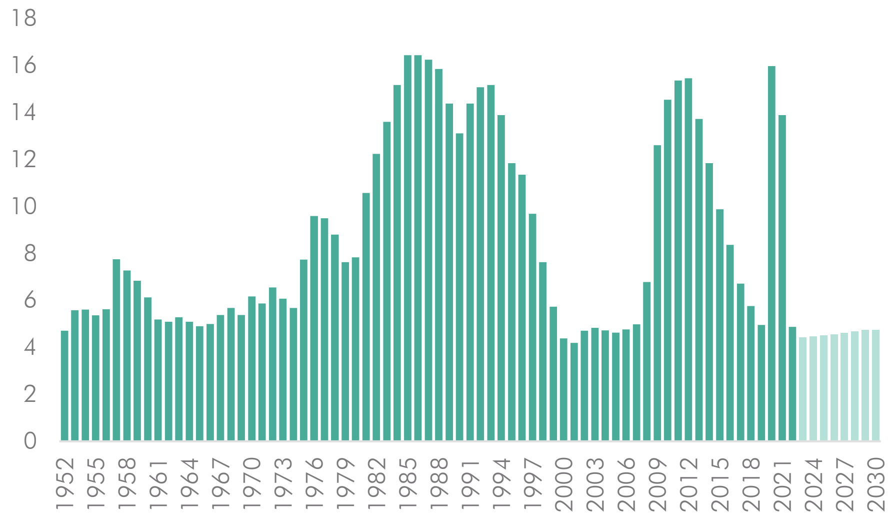
3.1 Assessment of the cyclical position

The Irish economy recovered rapidly from the pandemic. In 2022, it recorded historically low rates of unemployment. This May, the unemployment rate fell to a new record low of just 3.8%. In the past seven decades, only the period October 2000 to April 2001 saw unemployment rates fall near this level when they averaged 3.9%. This signals how tight the labour market is at present.

Unemployment rates have fallen to a record low

Figure 3.1: Unemployment has fallen to record lows

% unemployment rate, ages 15-74



Sources: CSO, AMECO, ESRI, and Fiscal Council workings. Get the data.
Notes: Data are extended back from 1997 using ILO compatible AMECO and ESRI datasets.

Russia's war in Ukraine has contributed to a spike in energy prices. The resulting high inflation and rising interest rates have depressed growth in the domestic economy and internationally, while also prompting some financial instability concerns elsewhere. Downside risks to growth remain, but recent forecasts for the external outlook have been revised up of late and there are signs that price pressures are moderating.

The Irish economy is still likely to be supported by unmet demand in the construction sector and the relative strength of digital and pharmaceutical activities. The Irish labour market has so far withstood risks related to these sectors, with vacancies helping to absorb job layoffs (Box A).

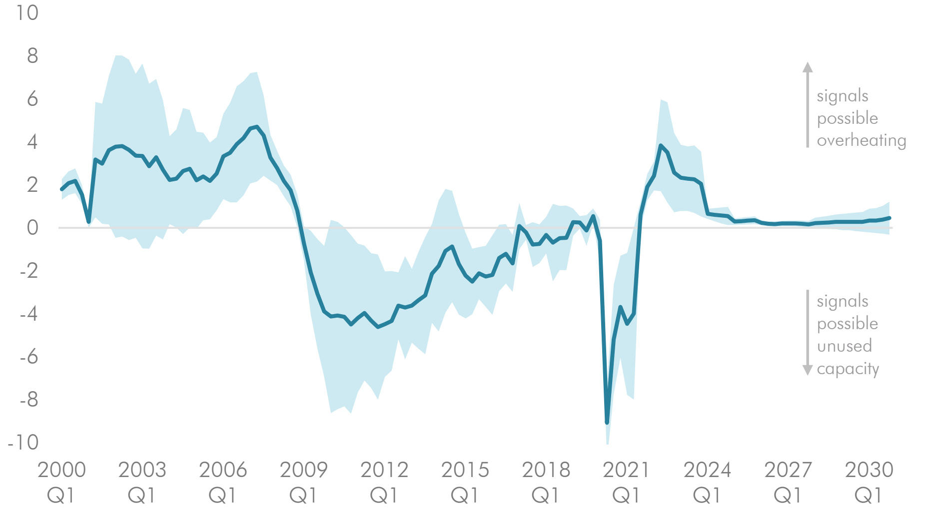
There are key uncertainties related to the risks of the Irish economy overheating (Section 1). Continued growth could see this manifest itself through ongoing labour shortages, strong inward migration flows, and upward pressures on rents and domestic prices, particularly in the services sector. A sluggish response in housing output might mean that further migration inflows, even of construction workers, would add to short-term pressures. The current account balance is an important gauge of economic imbalances but is difficult to interpret at present. Households may have already reduced their rate of saving out of income more than is evident in official estimates (Timoney, 2022). This carries the possibility that their reduced rate of saving is adding to domestic pressures.

The central outlook in the official forecasts is that activity will be slightly above its potential and, despite moderating, capacity constraints are likely to remain. Recent measures of the economy's gap to its normal—or "potential"—level of activity, the "output gap", show it having risen to 3.8% in Q2 2022. It has since moderated slightly to 2.6% in Q4 2022, but it remains relatively high. The projections assume a further easing over the near term.

The outlook suggests economic activity will remain above its potential

Figure 3.2: The economy has hit capacity constraints

% potential output, output gap estimates

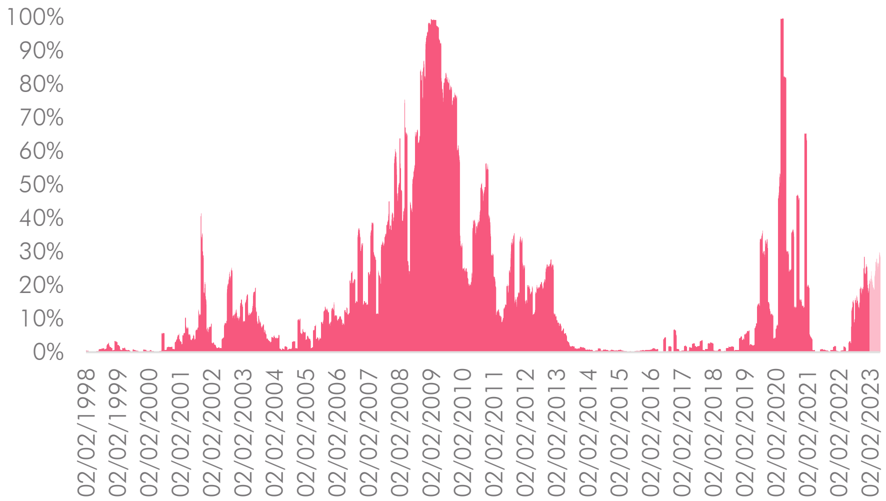


Sources: Fiscal Council workings (based on *Budget 2023* forecasts). Get the data.
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's supply-side models (Casey, 2019) and the Department's forecasts. Given distortions to standard measures like GDP and GNP, and the relative importance of domestic activity to the public finances, the measures focus on modified GNI*. This is a change from the approach in previous publications that used domestic GVA.

However, there are risks in both directions. If the economy does not slow down as projected, overheating risks would increase. This could result in further price and wage pressures, additional flows of migration into Ireland, and rent and housing affordability becoming even more stretched in the near term. Along these lines, the first quarter of 2023 showed a strong expansion in the volume of consumer spending and construction output. On the other hand, while the near-term outlook for Ireland's main trading partners has strengthened, this may call for a tighter-than-expected monetary policy, which would dampen growth. Some of these risks are captured in estimates of Ireland's probability of a recession in the next three months, which remain relatively high at close to 30% (Figure 3.3).

Figure 3.3: Short-term recession risks remain

% likelihood of Irish recession in next 3 months



Sources: Macrobond; and Fiscal Council workings. Get the data.
Notes: The recession probability estimates are based on the preferred model used in Casey and Conroy (2023). The model is based on survey measures of Irish job expectations, and US financial data. The latest estimates (in a lighter shade of red) rely only on US financial data, given the ending of production of the surveyed job expectations data in February.

Circumstances could well change in the coming months and years. If domestic activity were to slow markedly, or if other risks were to materialise, the Government should stand ready to provide additional fiscal support.

3.2 Assessment of sustainability of the public finances

As well as assessing the economic cycle and the possibility of major imbalances, the Council assesses fiscal sustainability as part of its broad economic assessment.

The budget balance excluding excess corporation tax is projected to be in surplus for the first time in 17 years

In 2024, Ireland's budget balance, when excluding excess corporation tax receipts, is projected to head into surplus for the first time in 17 years. The projections assume the Government sticks to its National Spending Rule, which is prudent, and that a package of tax changes amounting to €0.5 billion is pursued. Substantial excess corporation tax receipts are helping to drive the public finances into surplus. In 2022, a headline surplus of €8 billion reflected €10.8 billion of excess corporation tax receipts, and close to another €9 billion of corporation tax flows from foreign multinationals.[41] The excess corporation tax receipts are projected to continue, but there are considerable risks related to them (Box D).

Ireland's debt ratio remains at the upper end for small economies but is falling

Ireland's debt ratio is falling but remains at the upper end of current levels for small economies. At the end of 2022, the Government's net debt ratio was 69% of GNI*. This compares to a median net debt ratio of about 47% for small OECD economies. While Ireland has fallen to the eleventh highest of all OECD economies, it still has the fifth highest net debt ratio for a small economy in the OECD. Only Greece, Portugal, Belgium, and Austria have larger debt burdens (Figure 3.4).

Figure 3.4: Ireland's debt ratio at upper end for small economies but falling

% GDP (% GNI* for Ireland), general government basis, end-2022

Sources: Eurostat, CSO, IMF (April 2023 Fiscal Monitor), and Fiscal Council workings. Get the data.
Notes: As we wish to focus on small OECD countries, we exclude US, UK, Japan, Italy, France, Spain, Germany, Australia, Canada, Mexico, Turkey, and Korea. Net debt is general government gross debt excluding assets held by the State in the form of currency and deposits; debt securities; and loans. The 60% ceiling for government debt set out in the SGP is set in gross rather than net terms. Net debt does not include the State's bank investments.

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[41] Revenue statistics (McCarthy, 2023) indicate that €19.6 billion of net receipts in 2022 were from foreign-owned multinationals, representing 86.5% of all net corporation tax receipts.

Higher starting debt ratios tend to amplify risks and uncertainties. Mechanically, a higher debt ratio magnifies the role played by differences between the effective interest rate on government debt and the rate of economic growth: the so-called the interest–growth differential. Recessions, slowdowns in growth, or sustained increases in borrowing costs can therefore lead to heightened risks of ending up on unsustainable debt paths when debt ratios are already at higher levels (Barnes, Casey, and Jordan-Doak, 2021).

Higher starting debt ratios tend to amplify risks and uncertainties

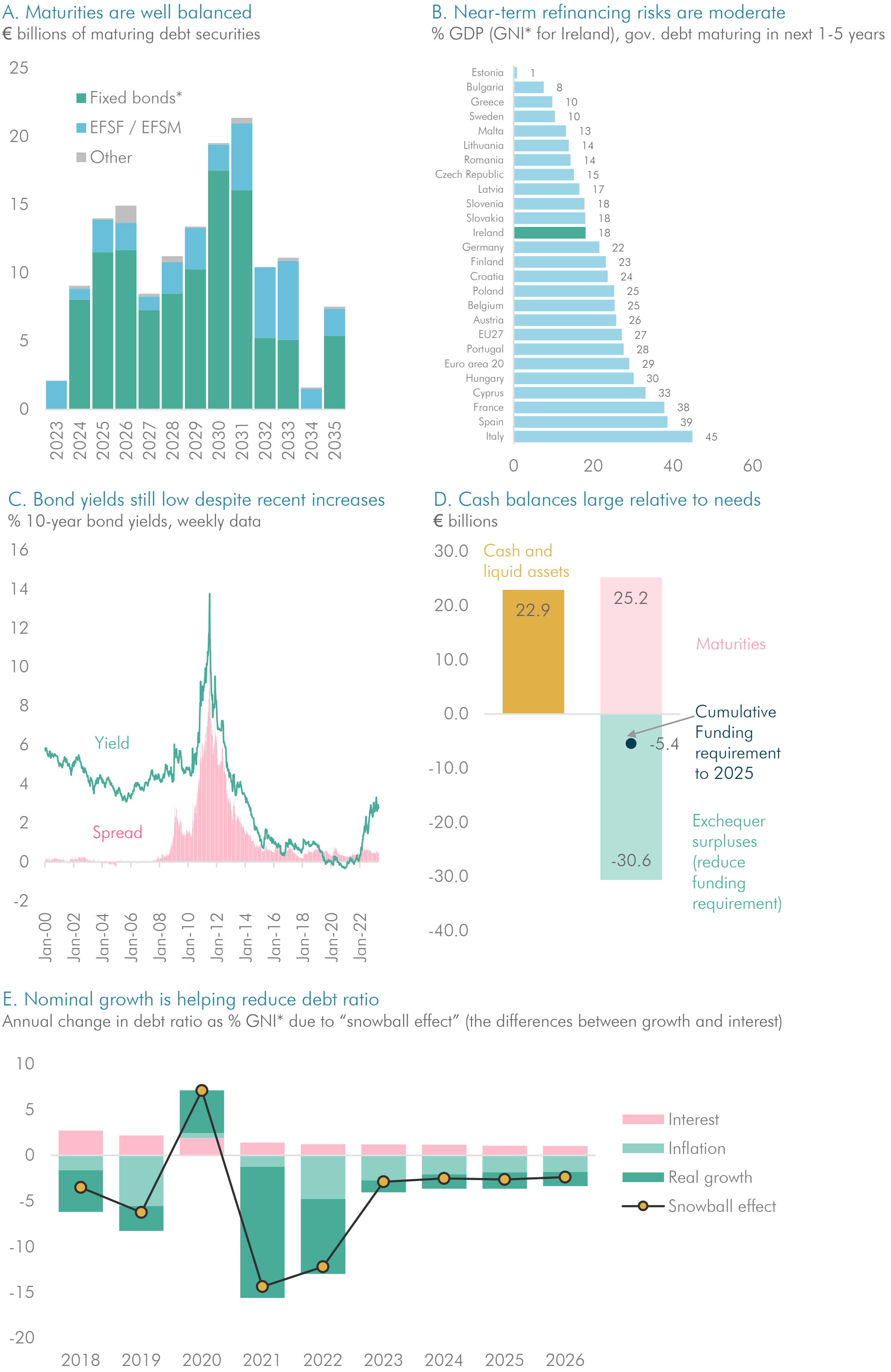
The immediate risks to Ireland's debt sustainability are relatively low. Almost 98% of debt outstanding is at fixed interest rates. The State's debt obligations are also relatively long dated at greater than 10.5 years weighted average maturity. Its maturity profile is relatively smooth in that there is no single year in which a relatively large amount of bonds will have to be redeemed (Figure 3.5A). In terms of the next five years, a moderate amount of debt is maturing compared to elsewhere (Figure 3.5B). In addition, yields on Ireland's 10-year bonds, although having risen to about 2.8%, remain relatively low compared to historical issuances (Figure 3.5C).

The State has sizeable cash balances as of end-April 2023 at €23 billion or 8.5% of GNI*. This would cover most of the maturing debt out to end-2025 even if no exchequer surpluses were run (Figure 3.5D). As it stands, the exchequer surpluses projected average about €11½ billion between 2023 and 2026, whereas the expected maturities average just €10 billion. This means that the exchequer surpluses expected should be more than sufficient to cover debt as it matures, without the need to run down the existing level of cash balances. Instead, it would mean that some €1½ billion could be added to the overall level of cash balances each year even before other bond issuances.

The outlook for growth, inflation and Ireland's interest rates on its debt is supportive of debt reduction. Even before the Government's budget balance is considered, the State is likely to benefit, on average, from 2.5 percentage points of a reduction each year between 2023 and 2026, due to the combination of robust growth, inflation reducing the relative value of debt, and reasonably contained average effective interest rates (Figure 3.5E).

Debt sustainability is complex and depends on the interactions between many variables. A useful way to assess debt sustainability is through "stochastic debt sustainability analysis". This is a way of modelling multiple debt paths with different probabilities attached to each path, while recognising the typical relationship between variables (see Blanchard, Leandro and Zettelmeyer, 2021). Using this approach, we can assess the risks of a continuously rising debt ratio — one that could prompt sudden losses in creditworthiness, rising spreads, and a need for a sudden and damaging correction in the public finances.

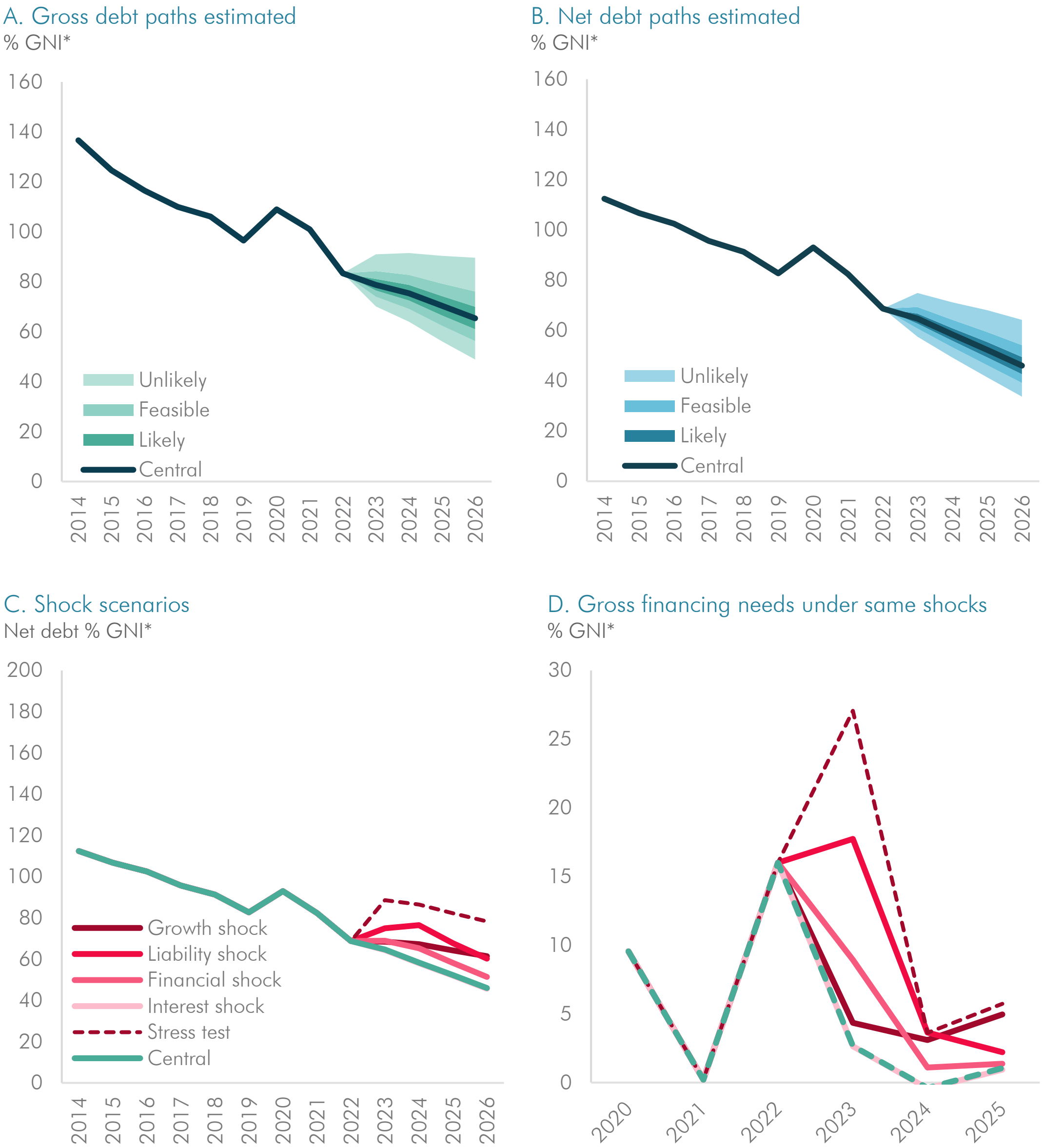
Figure 3.5: Ireland's funding situation is in good shape



Sources: CSO, NTMA, ECB, Department of Finance, and Fiscal Council workings. Get the data.
Notes: Spread in panel C refers to the difference between Irish 10-year yields and German 10-year yields. The snowball effect is the debt ratio change, due to nominal growth less the effective interest rate.

Using the Council's macro-fiscal model, the Maq, we can assess the probability of the Government's net debt ratio rising over the forecast period (Figures 3.6A and 3.6B). This analysis is constrained by the Government's failure to provide proper medium-term fiscal forecasts. The Government should extend its fiscal forecasts in line with its macroeconomic projections. This would enable the Council to better assess medium-term debt sustainability and it would help to deliver credible plans for how to tackle medium-term challenges such as climate and ageing.

Figure 3.6: Debt sustainability analysis



Sources: Department of Finance, CSO, NTMA data on debt securities, and Fiscal Council workings.
Notes: The fan chart projections show the probability of different debt paths. The "likely" range covers the 30% confidence interval, "Feasible" covers the rest of the 60% interval, and "Unlikely" covers the rest of the 90% interval. The "Growth shock" assumes real GNI* growth rates 3.6 percentage points (one standard deviation, 1996-2019 excl. financial crisis) weaker than the Central scenario for two years (leaving output about 7% below the central scenario). The "Liability" and "Financial" shocks, respectively, assume that 15% and 10% GNI* contingent liabilities materialise, based on an historical assessment of fiscal risks internationally. The "interest shock" assumes that marginal interest rates rise by 2 percentage points for the full period. The "Stress test" combines all previous shocks. Get the data.

The State looks set to be on a sustainable debt trajectory. This is thanks to the Government broadly sticking to its 5% Spending Rule, the stronger-than-expected economic recovery from the pandemic, the surge in corporation tax receipts, and a less-than-expected need for fiscal contingencies during the pandemic.

The probability of the net debt ratio remaining at or climbing above its current level by the end of the forecast horizon is now estimated to be less than 5% (Figure 3.6B). This would pass the indicative fiscal standards set out by Blanchard, Leandro and Zettelmeyer (2021), which proposed a 5% threshold as a useful fiscal standard.[42] The Government's fiscal plans also appear reasonably robust to a series of conservative "stress tests" (Figures 3.6C and 3.6D).

The results highlight the window of opportunity that Ireland now has for reducing its debt ratio to much safer levels. Doing so would help on two fronts. First, it would limit the exposure Ireland has to changes in interest rates or growth rates in future. Second, it would allow greater scope for fiscal support to be provided in future downturns, in a similar way to how the Government responded during the pandemic. It also comes ahead of a time at which Ireland will see a gradual build-up of pressures arising from an ageing population. However, it means that policy would have to stay on its current track.

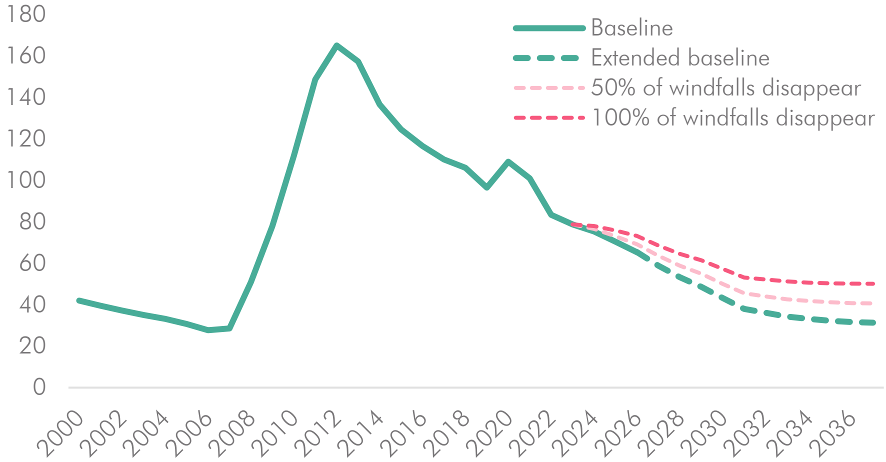
An appropriate fiscal stance should also consider the wider context. This includes whether there is a need to return the economy to full employment, whether the tax forecasts are sound, or whether spending pressures are adequately factored into current plans. The projection period is shorter than would be desirable for an appropriate assessment of medium-term fiscal sustainability. More generally, these types of analysis may not deal well with low-probability but high-impact risks, such as the pandemic.

There is a window now to get debt down in advance of future pressures

[42] However, such a standard does not necessarily imply that debt is "sustainable" in practice. What it implies is that some form of adjustment to the Government's fiscal plans is unlikely to be needed to achieve a high probability of debt sustainability.

Figure 3.7: Losing corporation tax windfalls would slow debt reduction

% GNI*, gross general government debt



Source: CSO; Department of Finance projections (SPU 2026); and Fiscal Council workings. Get the data.
Notes: Baseline assumptions extended in line with Casey and Cronin (2023). Scenarios assume 50% or 100% immediate reversals of the €11.8 billion windfall corporation tax receipts projected for 2024.

A concern is that the official budgetary forecasts may ignore several important factors. Accommodating Ukrainians, Stand-Still pressures, and the Christmas Bonus are near-term costs absent from official forecasts (Section 2). But there are also medium-term costs not factored in, such as climate-related investment and revenue losses (Section 3.3). One risk is that excess corporation tax receipts could reverse in a way that alters the debt path, slowing its decline (Figure 3.7).

Several important costs are missing from the official forecasts

3.3 Assessment of the Government's fiscal stance

Drawing on its broad assessment of the economy and the sustainability of the public finances, this section sets out the Council's assessment of the Government's fiscal stance.

Broad fiscal stance assessment

The Council assesses that the fiscal stance for 2023 is conducive to prudent economic and budgetary management.

The Government's plans for core spending are broadly in line with its National Spending Rule and the Government has thus far struck an appropriate balance between supporting households and businesses without adding unduly to inflation.

The Government has so far struck an appropriate balance between providing support and not adding too much to inflation

The Government had revised up its core spending ceilings compared to the original levels set out in *Budget 2022* plans. However, to date, the actual outturns for core spending are closer to the original plans and to a hypothetical 5% path (€100 million below the original ceiling for 2022 and €300 million above a 5% path). By contrast, it is well below what would be implied by fully accommodating inflationary pressures. In other words, it is less than if spending was increasing in line with a 3% growth rate plus rates of inflation.

The Government's approach to keeping spending increases in line with more sustainable pace of increases in the economy and revenues has several advantages. It means that the State does not build up further over-reliance on potentially reversible surges in corporation tax receipts, when funding ongoing spending. It also means that revenues generated by the cyclical rebound in the economy are not being treated as permanent. The approach therefore helps to smooth through potentially short-lived changes in economic conditions by anchoring spending in a more sustainable way. Moreover, by not chasing inflation in full with permanent increases, the Government strategy of managing the energy shock is limiting the risk of adding to inflationary pressures.

Keeping spending increases sustainable has several advantages

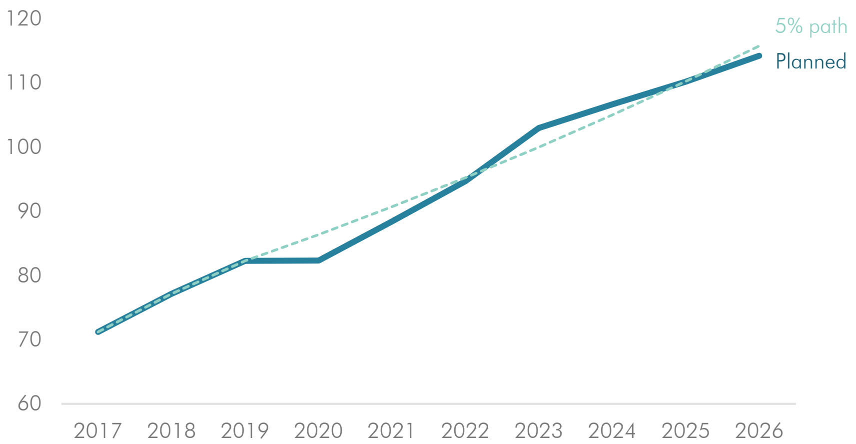
While a spending rule is a useful approach, it should be assessed in tandem with changes made to the tax system and on a general government basis. For instance, a permanent tax cut would weaken the budget balance in a broadly similar way to permanent increases in spending.

With *SPU 2023*, the Government has clarified for the first time that it conceives of the National Spending Rule as a <u>*net*</u> Spending Rule (Section 4). This means that new tax measures are treated as permanent measures that either offset spending increases, in the case of tax increases, or that add to them, in the case of tax cuts. However, the SPU itself only shows forecasts of core spending without netting off tax measures. As the rule only applies to exchequer spending, large areas of government outlays such as by Approved Housing Bodies (AHBs) in local government are excluded from the rule at present.

To account for the impact of tax changes, and to capture the broader general government sector, we assess the fiscal stance using “net policy spending”. This measure is defined on a general government basis, and it recognises the role of tax changes. Specifically, it treats tax-raising measures as offsetting net spending increases and tax cuts as adding to net spending increases.

Figure 3.8: When tax measures included, path is broadly sustainable

€ billion, net policy spending



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Net policy spending is overall general government spending, excluding temporary factors like one-offs, and cyclical spending on unemployment benefits. As a net measure, it recognises the role of tax changes; that is, a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts. Estimated proceeds from not indexing the tax system are also included.

The path for net policy spending set out in *SPU 2023* is broadly in line with potential growth and is broadly sustainable (Figure 3.8). It makes some allowance for high inflation recently experienced. This is evident from the rise in the path in 2023, reflecting, for example, permanent increases in core welfare rates and public sector pay. This is warranted given the exceptional and supply-side nature of the shock to the economy arising from the war in Ukraine. The decision to pause the National Spending Rule in 2023 takes spending to a higher level than would be implied by a 5% path.

The path for net policy spending set out in official forecasts is broadly sustainable

In 2022 and early 2023, the Government responded to the impact of higher inflation with temporary measures. The approach is broadly welcome and appropriate. These measures helped to alleviate the impact of higher prices on business and households. However, as the Council has shown in previous reports, the measures could have been better targeted with as little as one quarter of measures directed towards households being clearly targeted. As noted in Section 2, the new measures set out in February should have clearly been stated as drawing on remaining spending contingencies, rather than relying on tax buoyancy.

Looking ahead, the *SPU 2023* projections imply net policy spending increases of 3½ % on average over 2024 to 2026. This reflects the 5% core spending increases, net revenue-raising measures that reduce the growth rate by about 0.7 percentage points on average (when the impact of non-indexation is accounted for), and slower spending increases outside of the Exchequer that are not part of core spending.

The result of the overall fiscal stance being projected, together with buoyant revenue forecasts, is that the Government is likely to see a steady fall in its net debt ratio over the coming years. This averages almost 6 percentage points of GNI* for each of the years 2023 to 2026 (Figure 3.9A).

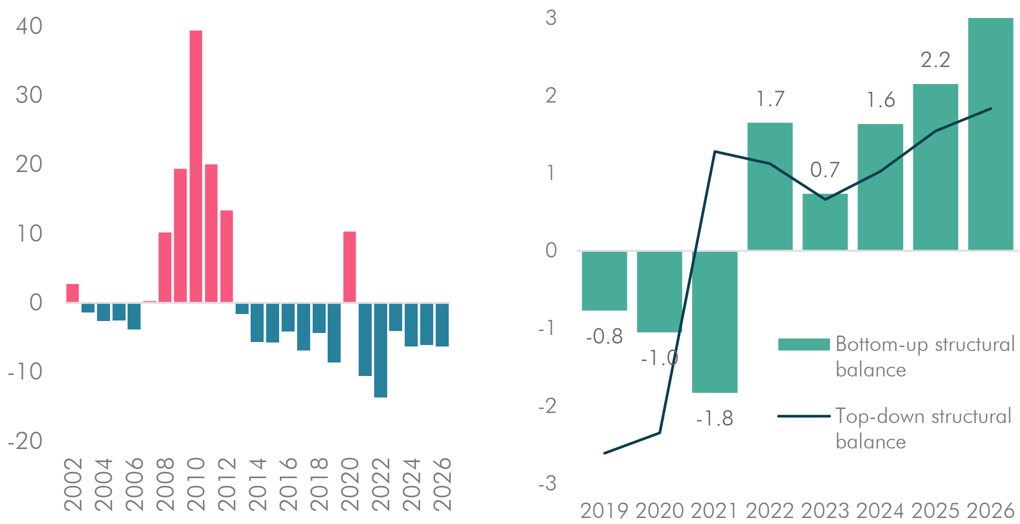
The projections suggest the Government would see a steady fall in its net debt ratio

Furthermore, the Council estimates that the Government's structural balance on a GGB* basis, which excludes excess corporation tax receipts, is likely to be slightly positive this year at 0.7% of potential output (Figure 3.9B). This estimate is based on approaches that exclude excess corporation tax receipts.[43] Part of the improvement reflects the less-than-full allowance for inflation in various spending areas, including in core welfare rates and in public sector pay.

Figure 3.9: Steady pace of debt reduction and structural surplus

A. Steady pace of debt reduction projected
Percentage points of GNI*, net debt ratio changes

B. A structural surplus is implied by projections
% potential GNI*, structural balance



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Notes: The structural balance measured on a bottom-up basis is based on Box I, May 2021 *FAR*.

Funding is no longer a major near-term constraint for the Government. More important constraints for the public finances right now are the extent to which any further measures would add to inflation, and how much value for money can be

The risk of adding to inflation is more of a constraint now than funding

[43] The bottom-up approach assumes that structural revenue grows in line with potential output growth. It adjusts for any new discretionary revenue measures plus the assumed impact on corporation tax receipts from the OECD's BEPS initiatives (this reduces corporation tax by €2 billion from 2025 onwards). Structural spending removes all one-offs and the estimated cyclical savings or costs associated with current unemployment levels.

achieved considering evidence of capacity constraints, particularly in the labour market and construction.

However, there are longer-term challenges facing the public finances and these are not adequately incorporated into plans. Ageing, climate-related costs, and other spending pressures are likely to lead to weakening budget balances in the absence of policy action.

Specific issues relating to stance in 2023

A serious issue that arose in 2023 was the ad-hoc way in which additional budgetary supports were introduced post-*Budget 2023*. The Government introduced a further set of temporary cost-of-living supports in February equivalent to about €1.2 billion.

As a matter of principle, the Government should provide more detail on measures introduced outside the usual budget process. At the time of introduction of the spring measures, it was unclear what the exact cost of individual supports might be. It was also unclear how they would be funded: whether these supports would be met by existing contingencies or require new funding. The measures also prolonged temporary measures that the Government had committed to unwinding. This included the unplanned extension of the VAT rate cut for hospitality (€300 million). It will be important for the credibility of budget plans to withdraw this as currently planned. Using revenue buoyancy to reduce taxes is the textbook definition of procyclical fiscal policies.

Other pressures in spending could emerge this year but should be avoided or offset as appropriate. There is a strong case to help vulnerable households and businesses in the context of recent price rises. The Government used an appropriate mix of temporary supports, welfare payments, and pay increases in *Budget 2023* to address higher prices. The temporary measures assisted households and businesses. They helped to protect against real income losses across the income distribution. Moreover, temporary measures have less long-term impact on the public finances and add less fuel to inflationary pressures when compared to permanent measures.

As energy prices decline, the justification for ad-hoc temporary supports is waning

As energy prices decline, the justification for these types of support is waning. More importantly, the supports to households continue to be poorly targeted. About one quarter of the new measures since Budget Day have been targeted.

There is a broader risk that Ireland's main trading partners might experience a slowdown in growth or outright recession. If this were to take hold, the Government should stand ready to act. If a severe downturn were to take hold, additional budgetary supports might be warranted.

In the meantime, a tight labour market and steady growth look likely. In these circumstances, the Government should explore ways to alleviate capacity constraints, including through fiscal tightening elsewhere.

Specific issues relating to fiscal stance for 2024

As the Government looks to Budget 2024, it should stick to its National Spending Rule. This would enhance the credibility of its plans. It would reduce the risk of putting further strains on capacity constraints and adding to inflationary pressures, while steering the debt ratio in an appropriately downward trajectory. This approach would help to build room for manoeuvre in future in case the Government should need to run deficits again in another downturn. This would imply no additional increase in reliance on corporation tax receipts from the multinational sector, which would be saved for future use.

The Government should stick to its National Spending Rule in Budget 2024

The *SPU 2023* plans imply a core spending increase of 5% next year and tax-reducing measures of about €0.5 billion.

There is strong evidence of overheating risks in the economy, which could argue for a tighter pace of expansion than allowed under the National Spending Rule (Section 3.1). With capacity constraints apparent, notably in construction, there is a real risk that pumping more money into the economy would simply fuel further inflation and lead to poor value for money if directed to public investment projects. These factors would tend to argue for doing less than the 5% allowed under the National Spending Rule.

The Government faces choices with *Budget 2024* and in the years ahead. For 2024, the Council estimates that Stand-Still costs for next year will be about €1.3 billion more than is currently provided for by the planned increase in core gross voted current expenditure, given investment and other commitments (Section 2.5). To comply with the spending rule, the Government will need to make a choice between additional tax measures, the level of increase of public sector pay, and welfare rates and other spending increases.

The Government faces choices between existing programmes, new spending and tax measures

The pressure to deliver on public investment projects is high, with shortfalls on capital outlays evident in recent years. This partly reflects pandemic disruptions and capacity constraints. A risk is that more money will be required to deliver the same projects, given cost pressures. In this context, it would be wise to re-assess the timelines and priorities for the delivery of various National Development Plan projects, potentially prioritising projects that would alleviate, or at least not exacerbate, capacity constraints.

There are also several areas where the Government has not budgeted for likely costs. This includes the absence of budgeting for costs associated with Ukrainian refugees beyond this year; costs associated with the planned rollout of the auto-enrolment pension scheme next year; and the likely payment of the Christmas bonus. Section 2 notes that these costs could amount to as much as €2½ billion.

Medium- and long-term budgetary challenges

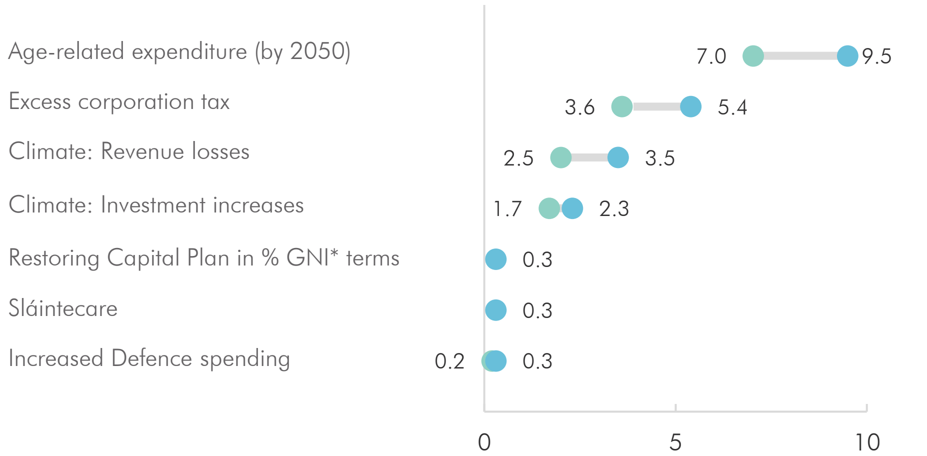
While Ireland's fiscal sustainability has improved, there are major challenges that could change the outlook. This is particularly true given that many of these challenges have not been fully costed and factored into the Government's budgetary plans.

Ireland's ageing population is a substantial challenge to the Government

The most substantial challenge facing the Government over the medium term is that of Ireland's ageing population. Next to that is the risks around excess corporation tax receipts and the costs associated with the climate transition (Figure 3.10). Together, the potential revenue losses and additional investment requirements related to the climate transition outweigh the substantial excess corporation tax being collected by the Government.

Figure 3.10: Ageing pressures are at the forefront of fiscal challenges

% GNI* estimated ranges of annual impacts on government's budget balance



Sources: FitzGerald (2021); Commission on the Defence Forces (2022); and Council estimates.
Notes: Age-related expenditure estimates are the Fiscal Council's (2020b) pessimistic to optimistic range. Excess corporation tax receipts, potential climate-related revenue losses, capital plan restoration, and Sláintecare costs are all Council estimates. The climate-related investment increases are from FitzGerald (2021). Get the data.

Ageing

Ireland's ageing population is a substantial challenge to the Government

Ireland faces the challenges of a rapidly ageing population and slowing economic growth. As the number of individuals reaching retirement age rises, pressures on pension and healthcare spending will mount. The decision to keep the pension age at 66 instead of raising it to 67 will add significant costs, equivalent to €5 billion in today's money by 2050. The increase in numbers retired and longer life expectancy will add around €500 million each year to public spending between now and 2030. Addressing the shortfalls in pension funding will require substantial tax increases or spending cuts in the absence of other reforms.

Acting sooner rather than later is crucial to limit the costs associated with ageing. The estimated combination of spending cuts and tax hikes required to keep debt steady would fall from 2.1% of GNI* in a "delayed action" scenario to just 0.8% of GNI* in an "act sooner" scenario. Implementing reforms promptly, such as raising taxes while a large portion of the population is employed, would relieve the burden placed on future generations.

In what could prove to be a landmark reform, the Government has set out ambitious plans to save windfall corporation tax receipts in a fund. These savings would go towards addressing ageing costs. The Council welcomes these plans. The Government should look to save these windfalls in full and avoid injecting them into the economy (Box E). It should also consider transferring some of the large cash balances it has amassed in recent years to the fund. This would a) help the NTMA with ongoing liquidity management, b) offer a way to develop greater returns on liquid assets currently held, and c) put these resources to good use in terms of addressing future challenges.

Ambitious plans to save windfall corporation tax receipts in a fund could prove a landmark reform

The Government has outlined some additional pension reforms recently, albeit with modest impacts. These include an auto-enrolment scheme and a flexible retirement age.

The auto-enrolment scheme is expected to require mandatory workplace pensions from 2024, with state contributions to supplement employer and employee payments. Official estimates put the cost of the scheme to the State at €3 billion in total over the first ten years (equating to €300 million per annum or about 0.1% of GNI*). The timeline is ambitious and may be missed.

The auto-enrolment scheme could increase private sector pension coverage. This should lessen pressure on the state to provide transfers for old age cohorts in future. However, it could also reduce disposable income during working years and hence indirect taxes (Box B). The decision to offer a flexible pension age, allowing people to work beyond 66 for a higher pension, is not expected to generate significant savings due to low uptake.[44] However, the presence of more working pensioners may boost long-term consumption.

[44] The Pensions Commission (2021) notes that 1) take-up in such schemes tends to be very small — as low as 2% of eligible individuals; and 2) numbers of dependents or "qualified adults" that increase pension payments are declining as higher female employment rates mean more women are entitled to the State Pension Contributory.

Box E: New fund could be a landmark reform

In May 2023, the Government set out an ambitious vision for how to address tomorrow's spending pressures, including from ageing, while saving today's windfall corporation tax receipts. While the proposals have yet to be enacted and details will be key, the Council welcomes the broad approach.

The official paper (Department of Finance, 2023) looks at how unreliable excess corporation tax receipts could be saved to part-fund substantial future costs as Ireland's population ages. It is described as a scoping paper and sets out various options: namely, how much of the windfall corporation tax would be saved, and how withdrawals would work.

Why windfall corporation tax receipts should be saved rather than spent

The rationale for saving windfall corporation tax receipts is clearcut.

First, these receipts are exceptionally unreliable and have a high risk of suddenly reversing (Box D). The increase is linked to the stellar performance of a handful of foreign-owned multinationals generating profits overseas but paying tax in Ireland. Making permanent budget commitments on the basis of potentially temporary revenues would create risks.

Second, using these receipts now would be particularly destabilising for the economy. The receipts represent a net injection into the Irish economy as compared to conventional receipts that take from domestic resources. The labour market is exceptionally tight, notably in construction, and appears unable to respond to additional demand without fuelling further price and wage pressures.

Figure E1: Windfalls then and now

% total Exchequer taxes

Source: Addison-Smyth and McQuinn (2010); Department of Finance; and Fiscal Council workings.

Ireland has had painful recent experiences in using windfall receipts to fund permanent spending increases. Repeating these past mistakes should be avoided. Over the period 2004 to 2008, the public finances benefited from about €7.5 billion in windfall stamp duty and VAT receipts linked to the property bubble (Addison-Smyth and McQuinn, 2010). These receipts were used to fund tax cuts and permanent spending increases. Fiscal policy was not the main cause of the boom-to-bust experience Ireland had in the 2000s though it contributed to the need for austerity measures precisely when the economy most needed support. The exceptional levels of corporation tax being collected by the Government has some parallels with the experience of the 2000s. The receipts are substantial in size and disconnected from economic fundamentals, and there is considerable uncertainty about how long they will last.

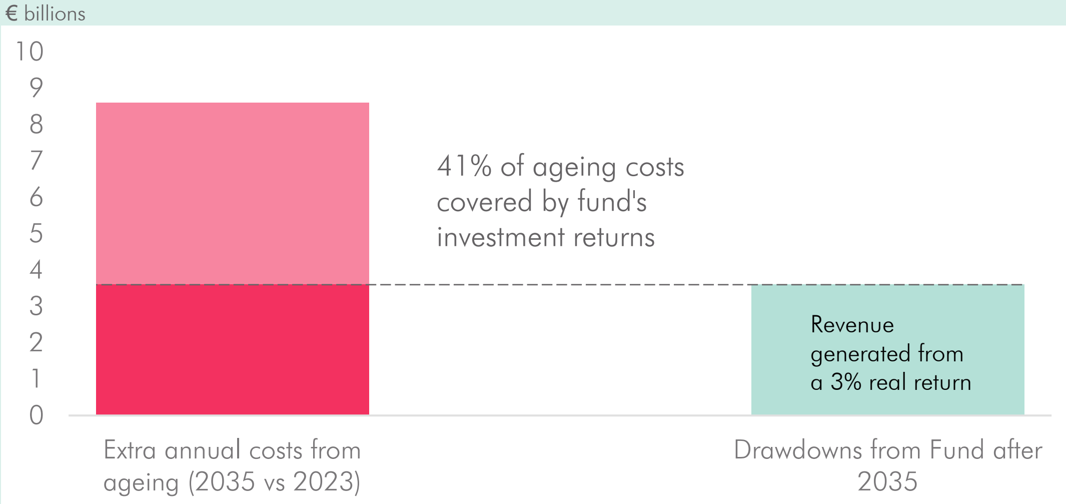
Ageing costs will be substantial

By contrast, Ireland faces predictable increases in public spending in the coming decades due to the rapid ageing of its population. The decision to abandon planned increases in the pension age adds to projected costs. The Department estimates that, in today's terms, the increase in annual spending related to ageing will be about €8½ billion by 2035, when compared to 2023 levels. Presently, there is no credible plan to address the likely shortfalls in funding. However, the new fund could go some way towards addressing these shortfalls, even if additional measures are still likely to be required.

The fund could generate returns to cover a large portion of ageing costs

The Department's scoping paper explores a range of options for how much of the windfall corporation tax receipts to save and the potential returns generated. A 3% real — or inflation adjusted — return would be reasonably plausible. It is in line with what is used by Norway, Canada, and, more generally, in OECD (2021) modelling. If the windfall receipts were fully saved from 2024 to 2030, the Department estimates that returns along these lines would be sufficient to cover 56% of new annual ageing costs in 2030 and 41% in 2035 (Figure E2).

Figure E2: A substantial share of ageing costs could be covered



Source: Department of Finance.
Note: This assumes that €18 billion is transferred to the fund in 2024 (€6 billion from the existing National Reserve Fund and €12 billion from windfall corporation tax), with €12 billion windfalls transferred annually until 2030.

The Council sees the fund as a major tool for addressing ageing challenges

The Council welcomes the fund proposals and the scoping paper set out by the Department. It presents a clear vision for how to tackle some of the major challenges facing the public finances both today and over the coming decades.

There are several ways in which the Council assesses that the proposals should be reinforced:

1) The fund should seek to use all the windfall corporation tax receipts. The justification for using any of these receipts for other purposes is weak and poses substantial risks to the economy and public finances.

2) The fund should invest in international assets, outside of Ireland, and aim to limit exposure to areas that Ireland is already vulnerable to, including through corporation tax receipts—namely the tech and pharma sectors with operations in Ireland.

3) The Government should specify what areas are to be covered by the fund. It would make sense to focus on cost areas clearly related to ageing, such as pensions, which have a high likelihood of materialising and around which the costs are relatively more certain.

4) The fund should not be seen as an end in and of itself. The challenges faced by Ireland related to ageing costs are substantial. Broader reforms and a longer-term horizon will be needed. As shown by Carroll and Barnes (2023), adjustments to the tax system could be reduced substantially if reforms were introduced sooner rather than later. This could potentially take the form of PRSI adjustments, which would appear to be in line both with Government proposals and the Pensions Commission options that omit changes to the pension age, though it could also take the form of spending cuts elsewhere.

Climate

Ireland has not set out the amount of public expenditure that will be required to meet its climate objectives for a 51% reduction in overall greenhouse-gas emissions by 2030. Furthermore, its sectoral targets amount only to a 42% reduction and lack sufficient detail (Climate Change Advisory Council, 2022).

On the revenue side, Ireland stands to lose a substantial amount of tax related especially to motor vehicles. Lower revenues will be raised on fossil fuels as people adapt their behaviour to reduce their use of these. Revenues such as motor tax, vehicle registration tax, carbon tax, excise, and VAT on fuels are all likely to be directly affected. The Council estimates that losses on annual revenues in these areas could amount to between 2.5 and 3.5% of GNI*.

The climate transition will also have substantial budgetary impacts

On the expenditure side, estimates suggest that additional public investment of the order of 2% of GNI* will be required every year out to 2030 to meet Ireland's climate objectives.[45] The decision to lower the agricultural sector's required reduction in emissions, and the recent rise in cost inflation, will likely increase the overall necessary outlays.[46]

Capital spending

There is also a risk that capital outlays will rise, due to rising cost pressures in terms of labour and materials, given the strains on resources being experienced.

In May 2022, the Government introduced measures to address the rise in energy and materials costs impacting public investment projects. The "Inflation Co-operation Framework" provides Government support for up to a maximum of 70% of the additional inflationary related costs faced by firms involved, subject to budgetary constraints and applying from 1 January 2022. Any additional costs arising under the Framework are to be met from within existing capital allocations.

With amounts set out for the National Development Plan fixed in nominal terms and cost pressures having risen substantially, it is unclear what will happen. There may be overruns, projects might be deferred, or the volume of output could be lowered. One way to estimate the potential costs associated with maintaining the

[45] How much of this might be met from existing National Development Plan allocations is unclear.

[46] These estimates assume the Government makes some intervention to facilitate climate investments without positive financial returns. The Climate Action Plan 2021 notes 40% of the total estimated €125 billion investment costs of achieving these targets — both public and private —would be unlikely to have positive investment returns. This means that the State would probably have to make some intervention, perhaps up to the full amount, over 2021–2030 to encourage these investments. This averages about €5½ billion annually or 2% of GNI* at the time of the plan. FitzGerald (2021) provides a better articulated assessment of the additional annual investment costs to meet the 2030 targets and lands on similar estimates at between 1.7 and 2.3% of GNI*. However, these estimates assume the agriculture sector cuts its emissions by either 51% or, in the more costly scenario, by 33%. Since then, the Government announced official sectoral targets involving a smaller (–25%) reduction by the sector, which suggests overall costs will be higher.

overall level of capital spending in real terms is to assess what would be required to restore the level of outlays associated with the National Development Plan in % of GNI* terms. On this basis, it would cost approximately €2.7 billion per year over 2024 to 2030 to return to the same share of National income originally planned (Section 2.6).

The credibility of medium-term plans

The Government has made substantial steps forwards in terms of developing a credible fiscal plan as first committed to in the Programme for Government in 2020. In particular, the National Spending Rule and the proposed Savings Fund have the potential to set the public finances on a more sustainable path, while addressing medium-term challenges in a more credible way. However, these tools need to be developed.

The Government has made substantial steps forwards in terms of developing a credible fiscal plan

While the horizon of macroeconomic projections has increased, fiscal projections remains at a three-year horizon and there are a number of issues with the credibility of spending projections developed by the Department of Public Expenditure, NDP Delivery and Reform (Section 2). There are significant gaps in planning and in terms of costing medium-term pressures, with no detailed strategy about how spending and revenues might adjust to accommodate various pressures. The recommendations of the Tax and Welfare Commission have not led to new revenue-raising plans, while the spending review process remains weak. Altogether, the Council has a slightly more favourable assessment as regards the quality of the Government's medium-term plans (Table 3.1). Previously, its plans were assessed as having made marginal or no progress overall.

But there are gaps in planning and costing of medium-term pressures

Table 3.1: Some steps forwards, but some steps backwards in terms of planning

Objective	SPU 2023	Council calling for this since	Progress					
Present five-year-ahead forecasts	Macroeconomic forecasts to 2030 but budgetary forecasts still only to 2026.	Nov-17						Mostly there
Commit to medium-term fiscal objectives	The National Spending Rule has helped guide policy, but it needs development. Savings Fund is welcome.	Nov-17				+2		Mostly there
Clarify how the Reserve Fund will be used	Scoping paper sets out options, though key decisions are yet to be made.	Jun-16				+3		Mostly there
Consider measures to strengthen fiscal framework	The National Spending Rule should be strengthened. Plans for a Savings Fund are welcome.	Nov-17				+3		Mostly there
Base projections on realistic spending plans	Less realistic than previously. Absence of predictable expenditures.	Jun-16				-1		Some
Provide transparent costings of major policy changes	Major policies including climate action and Sláintecare not factored in.	Dec-20						Some
Show how rules will be complied with	Limited reference to EU rules, and National Spending Rule is difficult to assess on net basis as intended.	Dec-20						Some
Indicate how taxes would be adjusted if needed	No information on this. Tax and Welfare Commission recommendations dismissed.	Dec-20		-1				Marginal/none
Make non-Exchequer forecasts more transparent	No improvement in transparency shown, despite commitments being made by Department.	Nov-19						Marginal/none
Overall progress					+1			**Some**