A time for restraint

3 Fiscal Stance

A time for restraint

In this section, the Council assesses how prudent the Government's overall fiscal stance is. 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 Where are we in the cycle?

In general, budgetary policy should seek to support the economy in bad times and provide less support in good times. This approach can help avoid amplifying the economic cycle. It means less risk of adding to price pressures in good times and a greater ability to offset rising unemployment in bad times.

Assessing where the economy is in terms of "good" or "bad" times is obviously difficult. To do this, the Council assesses a broad range of indicators. It uses a range of models of the "output gap" — the difference between actual economic activity and its potential. It pays close attention to measures of domestic economic activity. And it assesses a broad array of macroeconomic imbalances.

This is clearly not a time to amplify the economic cycle

In 2023, the Irish economy appears to have broadly recovered from the pandemic and withstood the effects of the war in Ukraine (see Chapter 1). In fact, the jobs market is tighter than it has ever been — only once in seven decades has unemployment been at this low an annual rate. Price pressures stemming from the domestic economy are high. Inward migration flows have been strong even when Ukrainian refugees are excluded. Historically, these pressures have tended to suggest that the economy is performing above normal levels of activity.

Indeed, every model used by the Council to assess how the economy is performing relative to its potential are signalling some degree of overheating. In some cases, this is estimated to be as high as it was in the mid-2000s prior to the financial crisis.

There are some indicators such as levels of outstanding debt and the current account surplus that allay some of the concerns about overheating. However, the strength of the jobs market, broad economic activity and inflation pressures provide sufficient concern to warrant some restraint in fiscal policy.

While there are clear pressures to improve Ireland's public services and infrastructure, the lessons from the 2000s are clear. Doing everything now will add to price pressures in the economy, will mean worse value for money for public projects than if they were done at another time, and risks exacerbating capacity constraints.

3.2 How sustainable are the public finances?

When assessing the appropriate stance for the Government to take, the Council also assesses how sustainable the public finances are. This is not straightforward.

Typically, best practice involves assessing a broad variety of factors.

1) Most likely path — First, we tend to assess the most likely path for the public finances. This involves assessing current debt levels and the expected path for economic growth, tax revenues, government spending, interest costs and funding requirements.

2) Risks — Second, the Council considers important risk factors, such as how sustainable the tax base is, spending pressures that might not be factored in, and the potential for sudden changes in the economic outlook.

3) Framework — Third, the Council assesses how appropriate the overall budgetary framework is. That is, whether there are reasonable anchors guiding budget decisions, such as a functioning spending rule, or savings funds that might be used to alleviate future pressures.

The path for budgetary measures has drifted up

When assessing the fiscal stance, the Council tries to take a long-run view. One way to do this is to examine the cumulative effects of tax and spending changes over time.

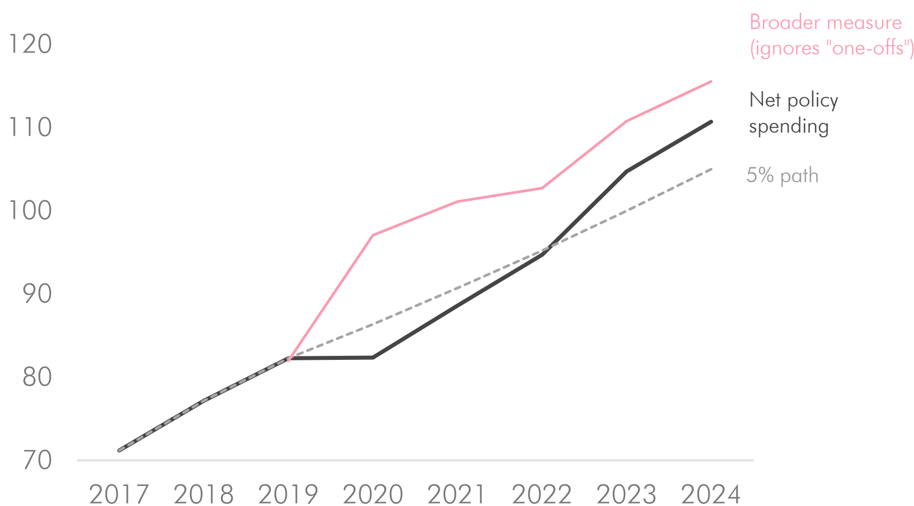
A useful measure in this sense is "net policy spending". This measure bears some similarities to the "core spending" measure underpinning the National Spending Rule, but there are a couple of key differences. First, it is defined on a general government basis and so captures more than the approximately four-fifths of

government spending represented by the Exchequer. Second, it excludes the estimated savings or costs of cyclically high or low unemployment rates. Like the National Spending Rule, it treats tax-raising measures as offsetting net spending increases and tax cuts as adding to net spending increases.

The decisions set out in Budget 2024 see net policy spending drifting above a sustainable path for net policy spending (N°50). The difference between a hypothetical 5% path from 2019, before the pandemic, and the projected outturn for 2024 is €5.7 billion (+5.4%). This equates to 1.9% of GNI*, a little over half the size of one of the typical austerity budgets run between 2009 and 2014 (3.6% of GNI*).

Nº50 **Net policy spending has drifted above a sustainable path**

€ 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.

Net spending may have drifted by more. The Council's assessment of "Net Policy Spending" assumes that most of the cost-of-living measures are truly once off in nature (N°50). This includes the energy credits, reduced student fees, and double welfare payments. The "non-core" spending on health related to Covid (€1.3 billion) and Ukrainian supports (€2.5 billion) is also assumed to be once-off here.

There are reasons to suggest that health "Covid" spending and Ukrainian supports will continue. A likely health overrun in 2023 was left out of Budget 2024 but could raise spending further. The additional health allocation for 2024 was also described as insufficient by the head of the Health Service Executive and the Health Minister.[37] Analysis in Section 2.4 suggests that even with the non-core

[37] Irish Times 17 Oct 2023 "No plans to reopen health service budget allocations, says Donohoe".

Covid allocation included, the health allocation falls marginally short of Stand-Still costs by €0.1 billion.

Taking the Ukrainian supports and Covid spending as essentially permanent would suggest much higher spending. If one were to cut through all the temporary classifications included in Budget 2024, the path for spending would look far different. Ignoring one offs, a broader measure of net policy spending would suggest net spending for 2024 is likely to be €10.5 billion above a hypothetical 5% path since 2019.

The true picture is likely to be somewhere in between. That is, not all of the Ukrainian supports may be needed in future years as more individuals leave emergency accommodation. Many of the cost-of-living supports should be unwound as inflation eases.

Transparency has been exceptionally poor

The transparency around budgetary measures classified as temporary has been exceptionally poor. Many of the measures labelled as "non-core" or one-off look likely to persist beyond 2024. Some of the cost-of-living measures introduced, such as mortgage interest relief, also look unlikely to reverse. This includes the Ukrainian supports and Covid spending in health. Worse still, a new category of capital spending labelled "windfall capital investment" is just additional capital spending and yet was treated as outside of both "core" and "non-core" spending.

These deliberate attempts to game fiscal assessments are deeply concerning. Gimmicks like this tend to crop up when governments want to make budgetary figures look more favourable than they really are (Box D). The National Spending Rule's focus on core spending is also likely to have prompted this. The Council will continue to monitor and highlight these attempts in future.

The budget package is likely to have fuelled inflation

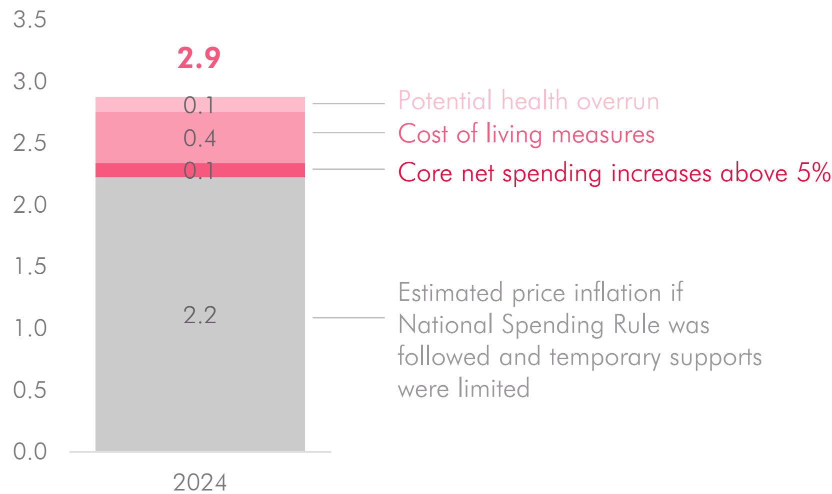
The decision to push net core spending beyond the 5% limit set by the National Spending Rule is likely to have added to price pressures in the economy. Taken together we estimate a boost to the rate of inflation of about 0.7 percentage points in 2024.

The budget package could impact inflation across several channels. Using the Maq model, we estimate that the 5.8% core net spending increase (Chapter 4) is likely to have boosted inflation by 0.1 percentage points in 2024 relative to a situation in which the spending rule was adhered to (N°51). This is likely to persist for inflation rates in the next few years. In addition, the package of cost-of-living measures is estimated to have added a further 0.4 percentage points to inflation in 2024. This could unwind if the supports are removed in 2025. Finally, we

estimate that a potential health overrun of €1 billion could add a further 0.1 percentage points to inflation in the short term.

Nº51 **Fuel to the fire**

% estimated impact on consumer price inflation (HICP) in 2024 due to Budget package



Sources: Fiscal Council workings using the Maq model.
Notes: Estimates are produced by comparing a scenario with a 5% core net spending increase and no cost-of-living package relative to the baseline Budget 2024 forecasts.

There is considerable uncertainty around these estimates. New evidence presented in this report suggests that the tax cuts introduced in Budget 2024 alone could fuel price pressures by more than is estimated here (Box A).

A risk is that these pressures persist into the future. Expectations are vital in terms of how inflationary pressures evolve. By keeping inflation higher, this could lead to a longer-lasting high rate of price increases. By cutting taxes and raising spending at a faster pace, the Government is also acting against efforts by the European Central Bank to dampen price pressures.

Plans are very short

The extent to which the Council can assess how sustainable the Government's plans are on this basis is limited by the short forecast horizon. The Government should extend its fiscal forecasts. This would allow the Council to better assess medium-term sustainability. It would also help deliver more credible plans to tackle medium-term challenges such as climate and ageing.

While the Government previously committed to a five-year-ahead forecast horizon, it has since backslid on this commitment. This is particularly concerning now, given that the pressures associated with the climate transition and ageing-related costs are expected to ramp up significantly towards the end of the decade.

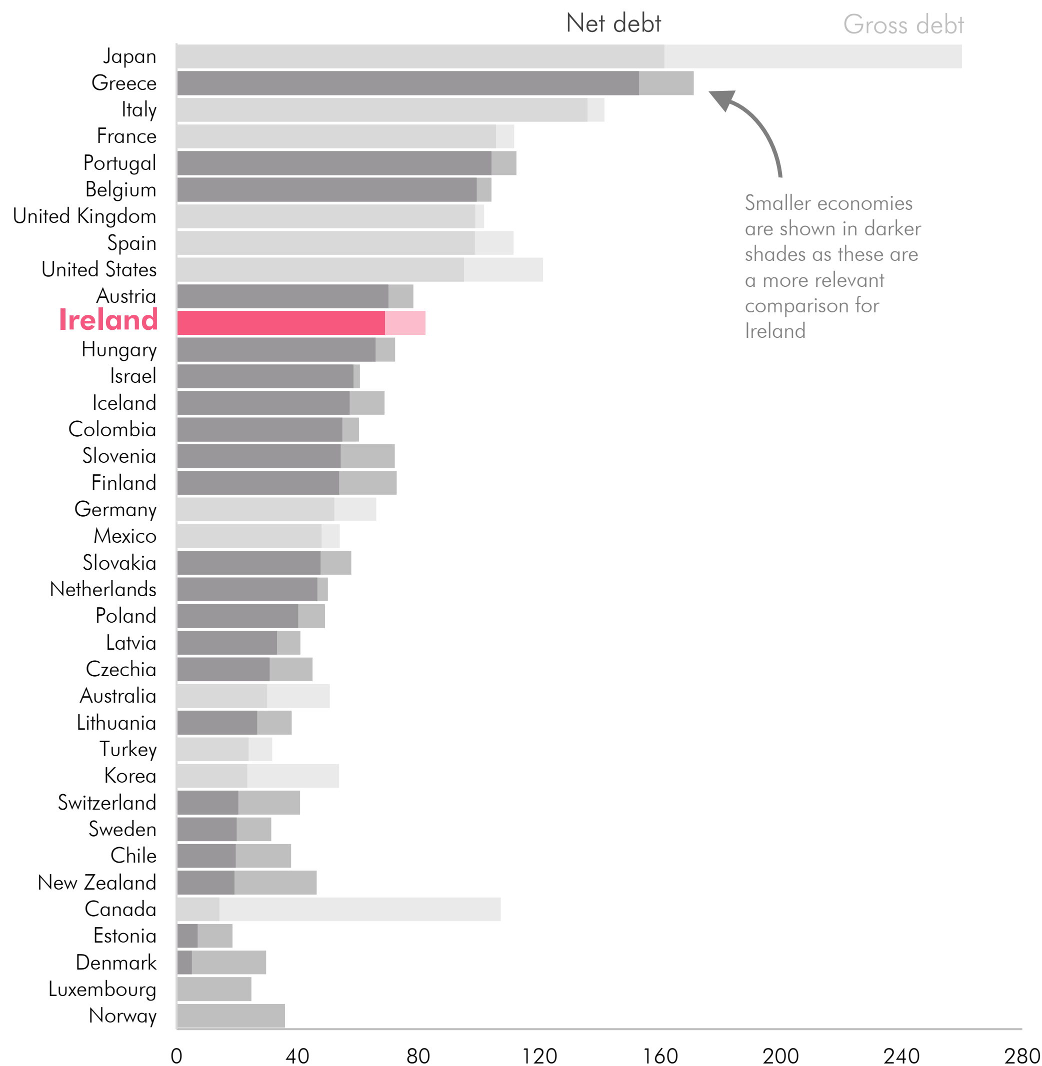
Debt ratio has fallen but remains high for a small economy

Ireland's debt ratio is no longer one of the highest in the OECD. Taking the net debt ratio — which takes account of liquid assets held by the State — Ireland sits as eleventh highest in the OECD at the end of 2022 (N°52).

N°52

High debt for small economy, but no longer among OECD's highest

% GDP (% GNI* for Ireland)



Sources: Eurostat, CSO, IMF, and Fiscal Council workings. Get the data.
Notes: Small OECD countries are a better comparator for Ireland. We define big as above a certain level of nominal GDP in US dollars, which leaves US, UK, Japan, Italy, France, Spain, Germany, Australia, Canada, Mexico, Turkey, and Korea as the "large" economies. Net debt is general government gross debt excluding assets held by the State in the form of currency and deposits, debt securities, plus loan assets. The 60% ceiling for government debt set out in the Stability and Growth Pact is set in gross rather than net terms. Net debt does not include the State's bank investments.

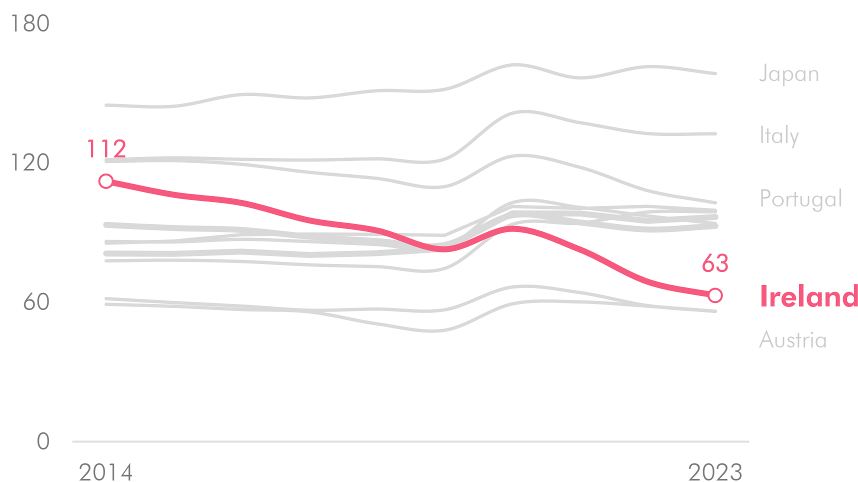
Ireland's net debt ratio is high for a small open economy. It is the fifth highest in the OECD when focusing solely on smaller economies. Smaller economies tend to have more volatile growth and a greater exposure to economic shocks (Furceri and Karras, 2007 and 2008). In particular, they cannot rely on a large domestic market to help offset economic turbulence coming from elsewhere. The

implication is that they carry a greater vulnerability to downturns and to sudden changes in debt sustainability.

Ireland has been able to reduce its net debt ratio relatively quickly. This is despite numerous challenges, including the pandemic and the war in Ukraine. Indeed, since 2014, the reduction in the net debt ratio has been almost 50 percentage points (N°53). This steady reduction is unlike experiences in any of the other high debt countries in the OECD. With the exception of Portugal, others have seen their debt ratios remain broadly at the same rate and in some cases increase.

Nº53 **Ireland has been able to reduce its high debt quickly**

% GDP (% GNI* for Ireland), net debt



Sources: Eurostat, CSO, IMF, and Fiscal Council workings. Get the data.

Financing conditions are relatively favourable

While interest rates have risen substantially, Ireland's funding outlook remains favourable.

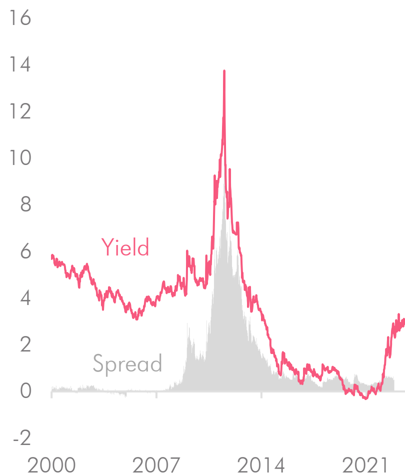
Interest costs are manageable. Yields on Ireland's 10-year bonds have risen to about 3.4%, which is high but still below the pre-financial crisis rates that prevailed during the 2000s (N°54). Almost 98% of debt outstanding is at fixed interest rates meaning that changes in interest rates have little bearing on the existing stock of debt and interest costs attached to it. The effective interest rate is projected to remain around 1.6% out to 2026. Of course, if interest rates remained high much further out, this would gradually add to annual interest costs.

There are also large buffers available to the State. Cash and liquid assets remain high at €28 billion as of end-October 2023. These are sufficient to cover

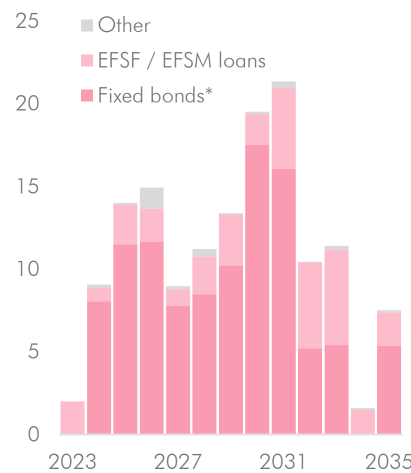
maturing debt out to the end of 2025 even if no Exchequer surpluses were run.[38] As it stands, the Department projects annual average Exchequer surpluses of about €2.7 billion between 2024 and 2026. This reduces the need to draw on existing cash buffers.

Nº54 **Funding is broadly favourable despite higher interest rates**

A. % 10-year bond yields, weekly data



B. € billions of maturing debt



Sources: Macrobond; NTMA; and Fiscal Council workings.

The debt path is sustainable in the near term

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.[39] Using this approach, we can assess the risks of a continuously rising debt ratio — one that could prompt sudden losses in creditworthiness, rising borrowing costs, and a need for sudden and painful tax increases and spending cuts.

Over the near term, the debt ratio appears set to continue falling. Using official forecasts, the probability of the net debt ratio remaining at or climbing above its current level by the end of the forecast horizon is estimated to be less than 5%.[40]

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[38] The cash balance includes the National Reserve Fund. As its funds are transferred over to the Future Ireland Fund and the Infrastructure, Climate and Nature Fund, the cash balances will reduce correspondingly.

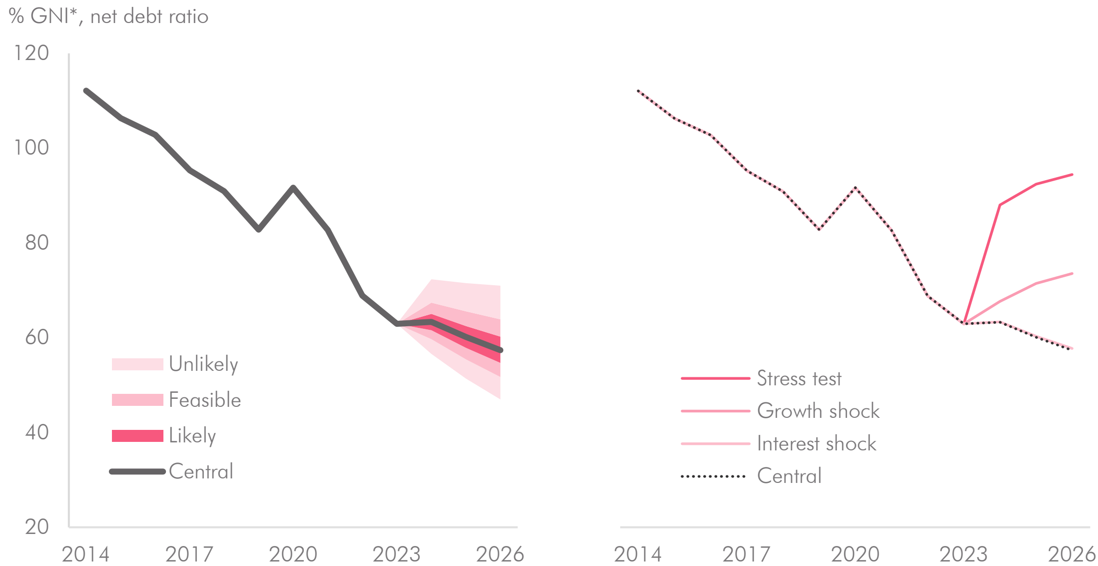
[39] See Blanchard, Leandro and Zettelmeyer (2021) for a clear discussion and Casey and Purdue (2021) for an application to Ireland.

[40] The work by Blanchard, Leandro and Zettelmeyer (2021) proposes a 5% threshold as a useful fiscal standard for gauging debt sustainability. Of course, maintaining a probability less than 5% 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.

The Government’s fiscal plans also appear reasonably robust to a series of conservative “stress tests” (N°55).

Nº55 **Debt sustainability looks reasonably assured in the near term**

% GNI*, net debt ratio



Sources: Department of Finance, CSO, NTMA data on debt securities, and Fiscal Council workings. Notes: The fan chart on the left shows the probability of different paths for the net debt ratio. The “Likely” range covers the 30% confidence interval, “Feasible” the rest of the 60% interval, and “Unlikely” the rest of the 90% interval. The chart on the right shows risk scenarios. The “Growth shock” assumes real GNI* growth rates 3.6 percentage points weaker than the central scenario in each of two years (equivalent to one standard deviation on growth rates over 1996 to 2019 excluding the financial crisis and leaving output about 7% below the central scenario). The “Interest shock” assumes marginal interest rates are 2 percentage points higher for the full period. The “Stress test” combines the growth and interest shocks with an assumed realisation of 25% contingent liabilities suddenly in one year. Get the data.

Unexpected corporation tax receipts have helped

The net debt ratio has been brought down with the help of stronger-than-expected nominal growth and exceptional corporation tax receipts. Of the 30-percentage point greater-than-expected reduction in the net debt ratio between 2021 and 2025, 14 percentage points were due to outperforming corporation tax receipts (N°48 and Section 2.9).

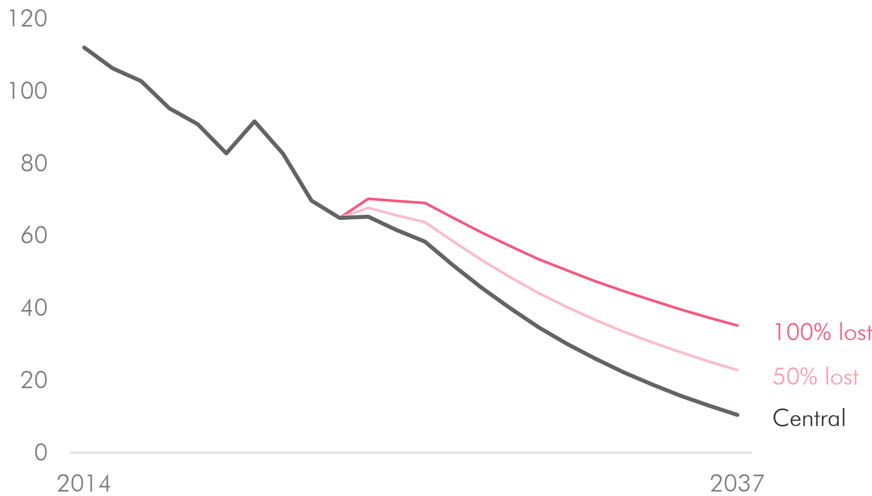
Whether or not these factors will continue to drive down the debt ratio quite so fast is hard to say. It depends on growth remaining robust and the excess corporation tax receipts remaining high. A loss of corporation tax windfalls alone would probably slow debt reduction. However, if governments stuck broadly to the National Spending Rule in future years, it would not necessarily put debt on an unsustainable path (N°56).

This highlights how the corporation tax windfalls are not essential to ensuring a steady downward path for the debt ratio. What matters is that growth continues relatively undisturbed and that Government decisions around spending increases and tax cuts remain broadly in line with the National Spending Rule. In this

context, the decision to reduce the reliance on windfalls by allocating some of these to the two new savings funds is welcome.

Nº56 **Losing corporation tax windfalls would slow debt reduction**

% GNI*, net debt ratio



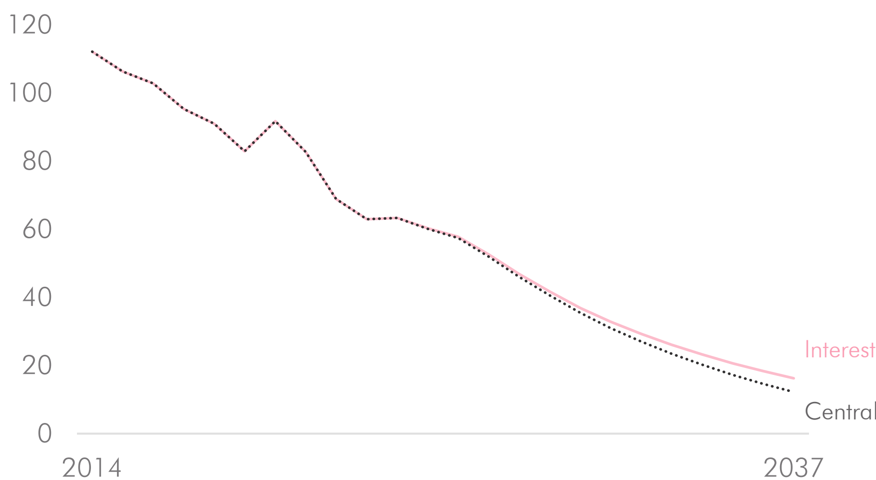
Sources: Department of Finance, CSO, NTMA data on debt securities, and Fiscal Council workings.
Notes: The central scenario is extended in line with Casey and Cronin (2023) except for windfall corporation tax receipts being assumed to remain in place for the extended central scenario. The scenarios assume that either 50% or 100% of the average €11.2 billion of windfall corporation tax receipts projected for 2024 to 2026 are permanently lost.

A rise in interest rates would take a long time to impact

One risk worth considering is a sustained increase in interest rates. If the State were to face higher borrowing costs over a sustained period, this could raise the debt path, but not substantially (N°57).

Nº57 **Higher interest rates would feed in slowly**

% GNI*, net debt ratio



Sources: Department of Finance, CSO, NTMA data on debt securities, and Fiscal Council workings.
Notes: The central scenario is extended in line with Casey and Cronin (2023). The Interest shock scenario assumes marginal interest rates are 2 percentage points higher for the full period.

There are major costs ahead not factored into plans

The official forecasts paint an encouraging picture for the public finances. However, there are several important factors not included in these projections. As well as the short-term spending pressures such as health overruns and the likelihood of ongoing supports for Ukrainian refugees being needed, Ireland faces two major challenges in the coming years and decades.

Ireland needs to face up to the budgetary impacts of the climate transition and its rapidly ageing population.

The rapidly ageing population

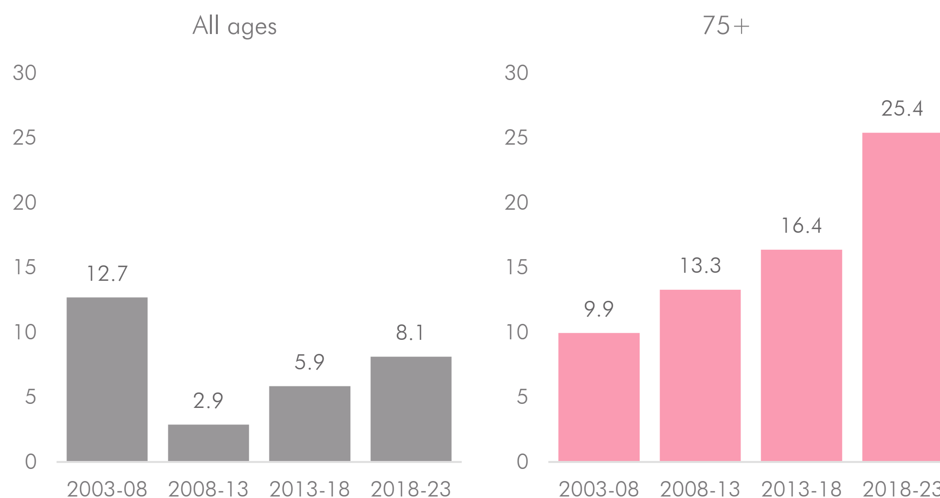
The most substantial challenge facing the Government over the medium term is Ireland's rapidly ageing population.

Ireland faces a sharp increase in pensioners relative to workers in the coming years. Those in retirement are also expected to have a longer life expectancy. These two factors will put substantial pressure on the public finances. It will mean higher expenditure, including for pensions and healthcare spending. It will also contribute to a slowdown in economic growth and tax revenues.

Some of this rapid ageing has already been evident. While the total population grew by 8.1% between 2018 and 2023, the over 75 age cohort grew by 25.4% — more than three times faster. This pattern of faster growth in the older age cohorts that typically put more pressure on health and long-term care services, for example, has been evident for some time (N°58).

N°58 **Older age cohorts have been growing quickly**

% growth rates between periods shown (example: from 2003 to 2008)



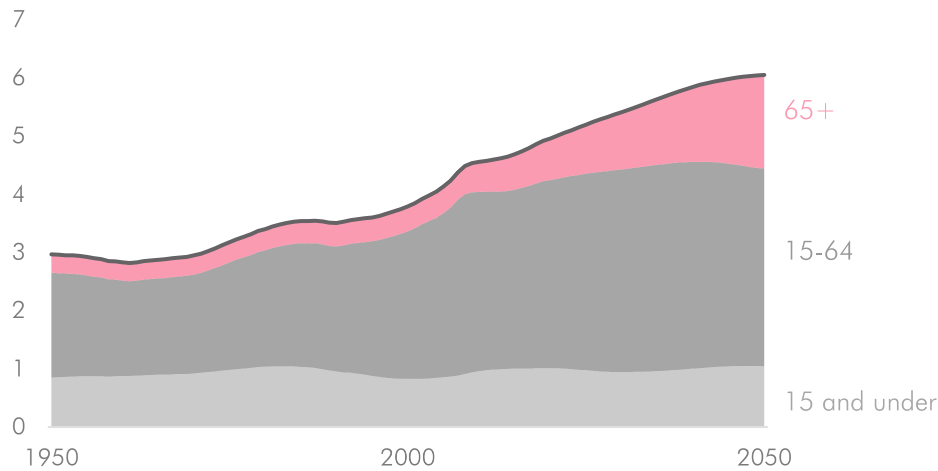
Source: CSO population estimates.

This pattern is expected to continue. As a result, older age cohorts will expand sharply in the coming years and decades to make up a greater share of the overall population (N°59).

Nº59

Older age cohorts will continue to expand sharply

Population in millions



Source: Fiscal Council (2020), Long-term Sustainability Report.

The ageing of Ireland's population is expected to add as much as 7 to 9.5% of GNI* to Ireland's expenditure by 2050 relative to 2019 (Fiscal Council, 2020). In today's terms, this equates to an additional annual outlay of about €20 to 28 billion.

This has big implications for planning around the State's pensions, healthcare and long-term care commitments. Both the Pensions Commission and the Tax and Welfare Commission were clear that the funding requirements were substantial and that revenue-raising measures would likely be needed.

In this respect, the Government's recent decision to approve a series of small multi-year increases in social contributions (PRSI) rates are welcome. They should go some way towards addressing the funding gap related to pensions expenditure. However, the increases are smaller than was envisaged in the Pension Commission's proposals. They imply a 1.4 percentage point increase in employee and employer's rates between 2023 and 2030. This is broadly in line with the Commission's proposals for a 1.2 percentage point increase assuming no increase in the pension age. Yet the envisaged increase in the employers' PRSI rate of just 0.7 percentage points over this period is substantially less than the 6 percentage point increase proposed by the Commission.

The climate transition

There are three key avenues through which the public finances will be affected by the climate transition.

First, there will be direct impacts related to the green transition. Tax revenues will reduce as people shift away from fossil fuels and spending on supports to encourage the transition will most likely be needed. Recent work by the Council (Casey and Carroll, 2023) estimates that as much as 0.9% of GNI* (€2.5 billion in today's terms) of annual revenues could need replacing by the end of the decade, rising to 1.6% of GNI* (€4.4 billion) by the 2040s. On the spending side, costs of between 0.6 and 1.1% of GNI* (€1.6 to 3.0 billion in today's terms) per annum over the years 2026 to 2030 may be required to encourage the adjustments needed. These could then average between 0.4 and 0.7% of GNI* (€1.1 to 1.9 billion) from 2031 to 2050.

Second, there will be costs if Ireland misses its targets. Ireland is legally bound to achieve carbon neutrality by 2050 and to stay within three sequential carbon budgets between 2021 and 2035. Estimates by Walker *et al.* (2023) put the potential costs of non-compliance at about €0.35 billion annually up to 2030, when costs rise to €0.7 billion (0.2% of GNI*).

Third, there are likely to be costs associated with damage caused by extreme weather events and improving defences. Ireland has seen an increase in major weather events over time. Increased rainfall and rising temperatures carry risks of more regular flooding and wildfires. When these events occur, the costs associated with them could be in the region of 0.2% of GNI* (about €0.5 billion in today's money). Limiting these risks could require further adaptation costs beyond the €0.1 billion per annum allocated for flood defences in the National Development Plan.

While the costs involved in the climate transition are substantial, they can be managed and planned for. Box G takes a look at what the expenditure supports might mean for public debt assuming that revenues are replaced.

Box G: Ireland's green transition can be managed

Climate change will have large impacts on the public finances, but these costs can be managed.

The costs of the green transition appear high

In a new report, published in October, staff at the Fiscal Council considered the potential fiscal costs related to climate change (Casey and Carroll, 2023). The area with the largest impact relates to the green transition.

If Ireland meets its targets, lower fossil fuel use would reduce tax revenues from petrol, diesel, and natural gas. Vehicle taxes tied to emissions would also reduce. The reductions in revenue could rise to 1.1% of GNI* by the end of the decade and to 1.6% of GNI* over the long run. Spending supports would also be required to encourage the transition. These could require annual outlays of about 1.1% of GNI* towards the end of the decade, eventually settling at closer to 0.7% of GNI* over the long run.

But taxes could be replaced and spending may be manageable

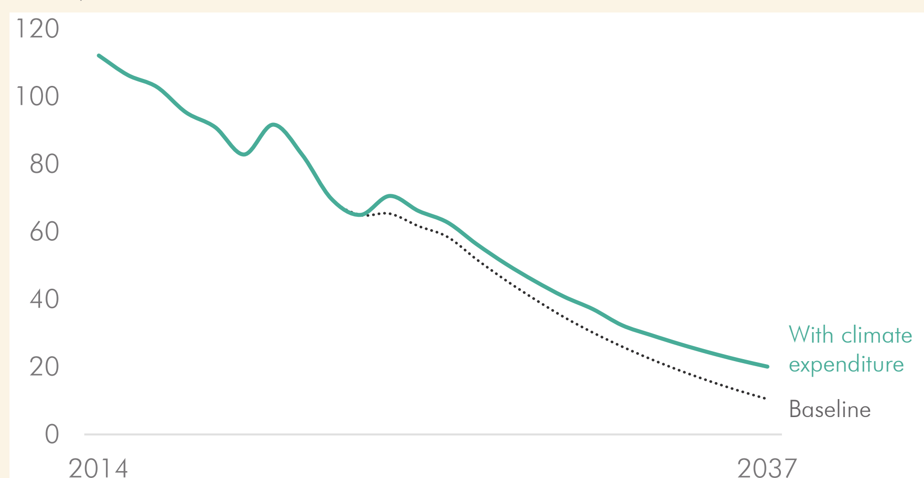
A point worth stressing is that the reductions in revenues related to the climate transition could be replaced without changing the average effective tax burden. As in, these are revenues that are already being collected today. In a sense, these could simply be replaced without adding to tax rates on average.

The expenditure impacts could also prove quite manageable. While the outlays are large initially, they are less than half the scale of the revenue losses expected over the long term. Moreover, they are not that large when compared against other long-term challenges. For instance, they are estimated to be at most one-tenth the estimated impact ageing will have on long-run spending. And, assuming that revenues are replaced and the economy avoids more severe shocks, the costs could be managed while still ensuring a steady pace of debt reduction.

We consider the impact the government's net debt ratio using the Council's Maq model. We assume that revenues are replaced in full such that there is no change in the effective tax burden related to the climate transition. As in, taxes on fossil fuels are replaced by other taxes of some form. Drawing on the expenditure costs estimated in the "high cost" scenario in Casey and Carroll (2023), we model the impact on the net debt ratio. For simplicity, we assume all expenditure is additional, financed by smaller surpluses, in the form of public investment, and that it therefore has a macroeconomic impact ordinarily associated with public investment.

Nº60 **Climate-related spending supports could be managed**

% GNI*, net debt ratio



Source: Fiscal Council workings drawing on Casey and Carroll (2023).
Notes: The baseline scenario is extended in line with the central scenario in Casey and Cronin (2023).

The results suggest that the path for Ireland's debt ratio would remain on slower but still steadily downward path. It is estimated to be about 10 percentage points higher by 2037, but still low at close to 20% of GNI*.

How exactly this will be managed needs to be thought through carefully

There are risks. The climate-related spending could push up price inflation by as much as one percentage point on average out to the end of the decade if it is in addition to what is allowed by the National Spending Rule. This risk would be more pronounced if unemployment remains low and if capacity constraints continue to bind.

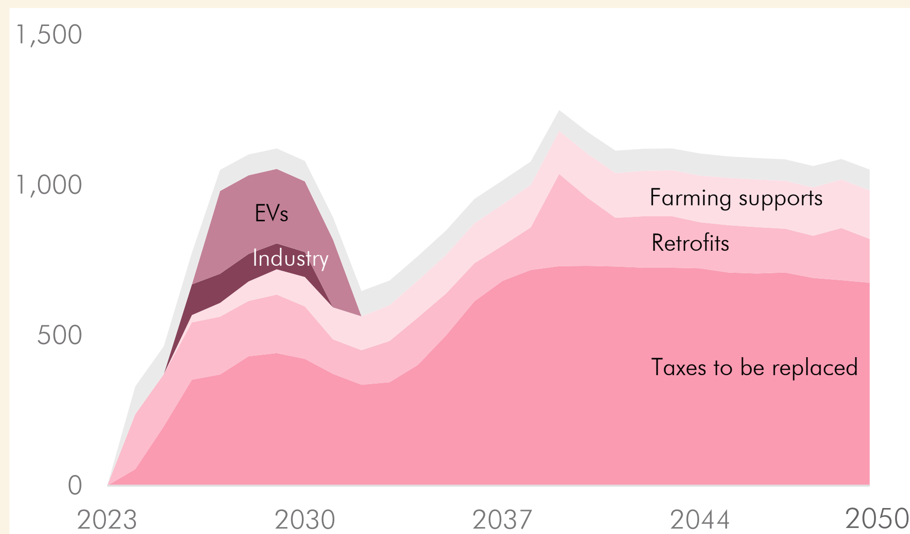
One useful way to think of climate challenges is through the lens of its potential impacts on individuals.

The largest single area of impact will be the taxes that dry up related to reduced fossil fuel use (N°61). This equates to about €700 of taxes per person needing replacement in some form. This could be achieved through spending cuts, by increasing existing taxes or by creating alternative tax sources.

Decisions on what spending supports might look like are also needed. Temporary costs will likely be needed to encourage the uptake of electric vehicles and to help facilitate carbon capture systems being introduced in industry. But ongoing costly supports are also likely to be needed to retrofit the housing stock. In addition, there may be a need for income supports for farmers most impacted. However, there are questions around whether these income supports will be necessary. Both impacts in these areas are of the order of €150 to €160 per person annually.[41]

N°61 **Big decisions are needed on Ireland's climate transition**

€ per person estimated impact of climate-related supports and revenue reductions, 2023 prices



Source: Fiscal Council workings; Casey and Carroll (2023).

Addressing these costs will require a lot of big decisions. Planning for the transition carefully will be essential to ensure a smooth transition and to guide behaviour effectively. Introducing supports incrementally or in an ad-hoc way could undermine efforts if individuals choose to delay actions, for example on retrofits or on personal transport, in the hope that more financial supports will be introduced at a later stage.

There are also large costs to inaction. Purchasing credits and transfers could prove difficult as well as costly.

[41] These costs are on a per capita basis. If set on a per worker basis, they would be larger and potentially rising more as the workforce shrinks with an ageing population.

Ireland needs a serious fiscal framework

If Ireland is to face up to the costs not yet factored into official plans and other risks, it needs a serious fiscal framework. While the Council has been calling for improvements that would help for a considerable time now, progress remains modest (N°62).

Several key aspects of Ireland's budgetary framework are weaker than they should be.

The recent undermining of the National Spending Rule is a notable weak point. This has manifested itself in terms of plans to repeatedly breach the rule, while using fiscal gimmickry and unrealistic spending forecasts to mask these breaches. This, coupled with the lack of any alternative rules that will credibly guide fiscal policy (the EU fiscal rules are unlikely to act as a constraint), means that Ireland's fiscal policy lacks strong direction. Without this, it is at the discretion of the government of the day. This leaves the public finances at risk of giving way to unsustainable decisions from budget to budget.

N°62

Funds are a big step, but much more progress is needed

Recommended action	Budget 2024 assessment	Council calling for action since	Progress
Forecast five years ahead	Fiscal forecast horizon continues to shrink	Nov-17	-1
Strengthen fiscal framework	National Spending Rule severely undermined, but savings funds introduced	Nov-17	-2
Make spending plans realistic	Spending projections less realistic again	Jun-16	-1
Provide transparent costings of major policies	Climate action costs still not factored in	Dec-20	
Clarify how Reserve Funds will work	Comprehensively addressed	Jun-16	+1
Show how rules will be complied with	Limited information and gimmickry used	Dec-20	-1
Show how taxes will be adjusted if needed	No information on this. Tax and Welfare Commission recommendations dismissed	Dec-20	
Make non-Exchequer forecasts more transparent	No improvement in transparency	Nov-19	

Overall assessment: Some progress

Ireland's budgetary planning should also be substantially improved. The forecast horizon for budgetary projections remains short at just three years ahead. The end point, 2026, comes at a crucial time. Many of the large-scale challenges facing Ireland in terms of climate transition and ageing pressures will begin to ramp up towards the end of the 2020s. It is a missed opportunity to plan for these challenges. The Department of Finance has developed macroeconomic forecasts with a longer horizon. These could easily be adapted to facilitate longer-term revenue projections. However, the sticking point is expenditure. The

latest spending forecasts are not realistic for 2023, let alone for future years. They are far from what is needed to adequately plan for the future.

Finally, transparency is weak. This is relevant in terms of the lack of information on how the National Spending Rule is being adhered to. It is also important in terms of the lack of information on non-Exchequer areas of spending. This includes, for example, spending on housing by approved housing bodies. The Government should also be more upfront about how it would increase taxes if needs be, particularly given the heightened expenditure pressures that lie ahead. In this respect, the Government's apparent dismissal of recommendations by the Tax and Welfare Commission is unhelpful.

The National Spending Rule is key

Reinforcing the National Spending Rule would be a major step to ensure the public finances are managed sustainably. It could form a central part of Ireland's fiscal framework, bringing it in line with international best practice (Casey and Cronin, 2023).

Ireland's public finances are unlikely to be guided by EU fiscal rules in future. The Government is also clearly less committed to the spirit of the National Spending Rule. Official plans show repeated breaches, and gimmicks are being used to hide the extent of these. The rule can help guide the public finances through challenges such as the climate transition and the rapid ageing of Ireland's population. It can also help ensure that the Government is able to support the economy through future downturns rather than raising taxes and cutting spending, as it did during the austerity period. To ensure this, the rule needs to be reinforced and adhered to.

One of the reasons the Government cites for breaching the rule is that inflation is high. Yet this is how the rule should work. The idea is to avoid procyclicality — doing too much in an already tight economy, hence adding to price pressures. By contrast, the rule is more generous in times when price pressures are low. That is, it still allows growth consistent with an implicit 2% inflation assumption when price pressures are lower than that.

The National Spending Rule could be reinforced along several dimensions. As explored in Casey and Cronin (2023), the Government could:

- Review the 5% assumption for steady state nominal growth figure every five years. At present, the rule sets a 5% limit that implicitly reflects real trend growth of 3% and a medium-term inflation rate of about 2%. While inflation is higher at present, trend growth rates are projected to moderate. Projections for real GNI* converge closer to 2% over the medium term.

- Protect public investment with a minimum steady state target set as a % GNI*. This could help avoid sudden cuts, while improving long-term planning.
- Introduce an appropriate escape clause. Not every situation will be anticipated by the design of the National Spending Rule. Escape clauses, if appropriately designed, can be a helpful way of dealing with exceptional circumstances.
- Link the spending rule to the debt ratio. Maintaining spending in line with trend growth in the economy and revenues should help avoid unsustainable deficits building and steadily reduce Ireland's debt ratio. However, a smarter design would allow more scope for expansion in circumstances where debt ratios are favourable, or less scope when the debt path is unsustainable.
- Expand the Rule's coverage to general government. This wider measure of government activity is a more relevant basis for assessing fiscal policy. The current focus on the Exchequer ignores about one-fifth of spending.
- Allow for cyclical savings and costs related to unemployment. Unemployment costs are a key area of expenditure that varies with the cycle. In good times, they can make the public finances look stronger than they would otherwise be, while in bad times they can make the public finances look weaker. This can be adjusted for by considering the welfare expenditure that would be associated with more normal rates of unemployment of, say, 5% for example.

The Future Ireland Fund strengthens Ireland's framework

As part of Budget 2024, Ireland announced the details of two new savings funds. The funds are designed to set aside some of the windfall corporation tax receipts Ireland expects to collect in the coming years.

Both funds will help to ringfence the excess corporation tax receipts Ireland expects to collect. This is an appropriate use of tax receipts that are exceptionally concentrated and subject to risks of sudden reversals.

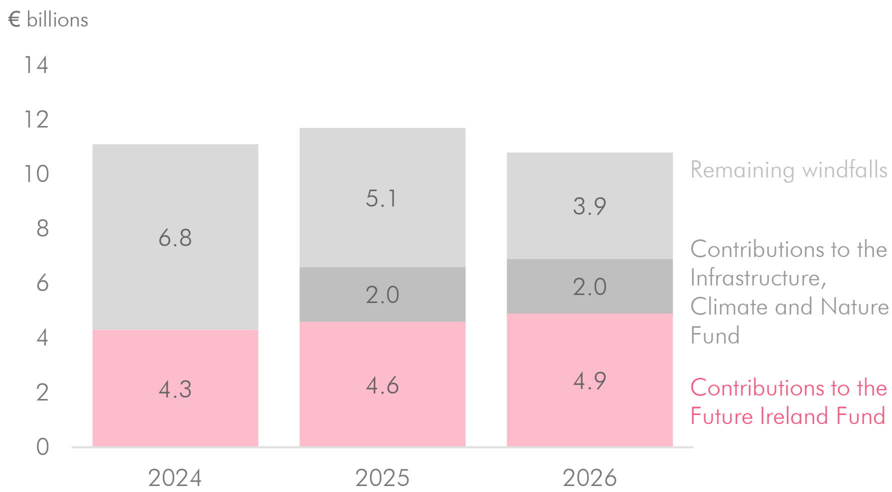
The Council welcomes the development of the Future Ireland Fund in particular. This puts the excess receipts to good use. The Fund will invest them and generate returns that can be used to offset future costs such as ageing. As Box H shows, the Fund could build to a substantial size. Assuming the Fund continued contributions beyond 2035, it could cover more than half of the increase in ageing costs vs 2023 in 2041 and a quarter by 2050. The range is again large, with a 90% probability that roughly 10% to 50% of additional costs could be covered by 2050.

The second fund, the Infrastructure, Climate and Nature Fund will also help ringfence corporation tax receipts (Box I). However, this could have been achieved with the Future Ireland Fund and the need for a countercyclical tool is less clearcut provided Ireland sticks to the National Spending Rule and debt remains on a broadly sustainable path.[42]

The Government already has two necessary tools to plan for sustainable increases in capital spending. First, the National Development Plan provides a means of planning capital projects over a ten-year horizon. Second, the National Spending Rule helps ensure government spending does not exceed typical growth rates for the economy and government revenues. Sticking to the rule helps limit excessive spending increases or tax cuts that might warrant undesirable cuts to capital spending in future if the public finances suddenly needed to adjust course. A better approach would be to build on these existing tools.

Nº63 **Some windfalls are left outside the new savings funds**

€ billions



While the savings funds set aside some corporation tax windfalls, the Council had hoped that more of these would have been saved. As it stands, some 40% of the windfalls are left unsaved — €5 billion in 2025 and almost €4 billion in 2026 (N°63). These may ultimately be used for debt reduction or for building cash buffers elsewhere. However, by leaving them outside of the Fund, there is a risk that the remaining windfalls are used for larger-than-planned budget packages that push budgetary measures further beyond what is deemed sustainable.

[42] See Box A of Fiscal Council (2023b).

Box H: The Future Ireland Fund

This box looks at the larger of the two new funds announced as part of Budget 2024, the "Future Ireland Fund". The Fund is intended to generate a savings pot with annual investment returns used to offset future costs such as ageing. The Council welcomes this initiative having called for such a vehicle in the past.

Ireland's new savings vehicle, the Future Ireland Fund

The Future Ireland Fund's aim is broadly stated as helping to "defray costs incurred by the State". The general scheme mentions several areas that could be addressed: ageing, climate, digitalisation and other fiscal and economic challenges. While its purpose is vague, it nonetheless achieves two key aims.

First, it will help to alleviate the burden on future generations from a predictable rise in ageing-related costs, such as for healthcare and pensions.

Second, it saves some of the windfall corporation tax receipts rather than using these to fund permanent budgetary outlays such as increases in recurrent spending or tax cuts. These receipts are exceptionally unreliable and have a high risk of suddenly reversing. The recent increase in receipts is linked to the 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 be risky. Furthermore, using these receipts at a time of very low unemployment would likely fuel further price and wage pressures.

For these reasons, the development of the fund is something to be welcomed.

Key features of the Future Ireland Fund [43]

Initial transfer and annual contributions

- Some €4.1 billion is being transferred to the Fund from the dissolved Reserve Fund
- Yearly contributions equivalent to 0.8% of GDP will be made to the Fund until 2035
- At that point, a decision will be made about future contributions
- A "significant deterioration" in the public finances could warrant varying contributions

Drawdowns

- Drawdowns will not be permitted until 2041
- Drawdowns cannot reduce the overall value of the Fund to below its capital
- Drawdown amounts would be advised on by the NTMA
- Drawdowns would require a Dáil resolution and government approval
- If the NTMA advises that the Fund's average returns over ten years would be less than borrowing costs, the Minister could propose to reduce the Fund's capital

Investment strategy

- The NTMA will determine the investment strategy
- Investments will be on a commercial basis in or outside the State
- The focus of investments is to be global, but since Irish assets are a feature of global indices, there is provision to allow for Irish exposures to be managed
- Investments are to be "responsible" in line with Environmental, Social and Governance (ESG) considerations
- All income, capital and benefits received from holdings and investments will be paid into the Fund and invested to its benefit to allow the Fund's value increase faster

Linking the contributions to GDP is a little surprising. Ireland's GDP has been historically volatile and unpredictable given that it is heavily distorted by the activities of foreign-owned multinationals. The rationale for using GDP is that this is a close equivalent of the tax base itself for corporation tax receipts.[44] Another option would have been to link contributions to

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[43] Note that these key features are based on the General Scheme of the Bill that was published on 12 October 2023. These are subject to ongoing development in the drafting of the Bill.

[44] A closer equivalent to the tax base would be net operating surplus, yet econometric modelling of corporation tax receipts has tended to favour using GDP (Casey and Hannon, 2016; Purdue, 2016).

more appropriate measures of the economy, such as GNI*. This measure is more predictable and less volatile, but there is a weaker link to how corporation tax receipts evolve than with GDP. Another option would have been to tie the contributions more clearly to the estimated level of corporation tax windfalls actually collected. This would have meant a clearer link to windfalls. However, there would still be challenges involved in terms of defining the exact level of windfalls.

There are other implications of linking contributions to GDP. If windfalls rose more than the rise in GDP, these would not automatically be saved. This could happen if, for instance, capital assets used to offset tax payments were fully depreciated resulting in higher windfalls but lower GDP. The GDP link also means that contributions are likely to be made even in cases where corporation tax windfalls reduced.

The design of the Fund is relatively airtight in terms of ensuring contributions and limiting withdrawals before 2041. A government would likely have to change legislation for withdrawals before 2041 to occur. This is possible of course, but the logic of saving for future needs and reducing the burden on the next generation may deter future governments from abolishing the Fund or reducing its value.

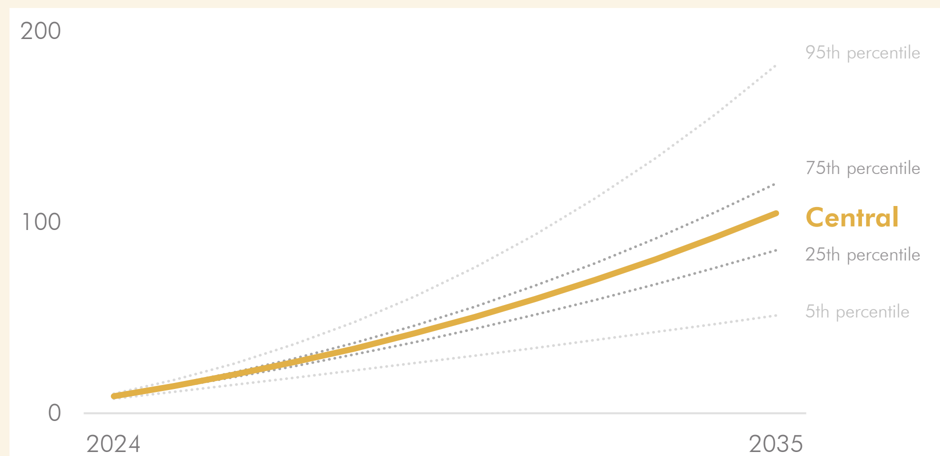
How might the Fund evolve?

The Government has suggested that the annual contributions and re-invested returns could see the Fund grow to €100 billion by 2035. This would be in line with annual returns of roughly 5% each year and nominal GDP growth averaging just over 4% annually.

There are obviously wide uncertainties. Linking contributions to GDP growth adds to the uncertainties around what returns might be achieved on investments. Using historical data on international investment returns from similar national pension funds and historical GDP growth rates, we simulate the Fund's potential returns and contributions (N°64).[45] On this basis, we estimate a 50% probability of the Fund ranging from €85 to €120 billion in size by 2035. There are strong upsides to the potential size of the Fund. Historical returns in equivalent funds have averaged higher than 5% annually and closer to 6%.

N°64 **The Fund could grow substantially over the next decade**

€ billions, potential fund reserves



Sources: Department of Finance projections and Fiscal Council workings.
Notes: The central projections assume nominal GDP growth in line with official assumptions in *Budget 2024* up to 2026, *SPU 2023* for 2027 to 2030, and Department of Finance (2023c) for 2031 to 2050. The assumed return is close to 5%.

A fund that grows to a size in this range would make a substantial dent in ageing costs in the coming decades. Extending the above simulations and assuming contributions continue after 2035, the Fund could cover more than half of the increase in ageing costs vs 2023 in 2041 and a quarter by 2050 (N°65). The range is again large, with a 90% probability that roughly 10% to 50% of additional costs could be covered by 2050. While not covering all of the

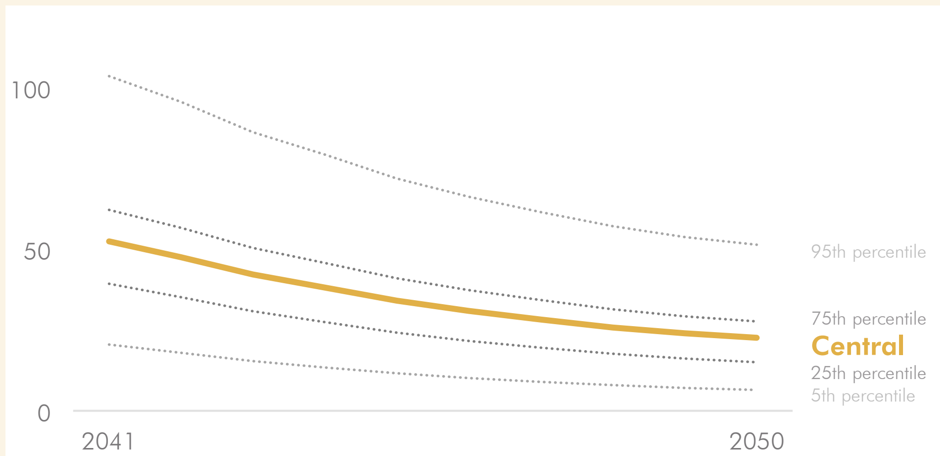
[45] Specifically, we treat nominal GDP growth as a random walk and develop 10 million simulations of the Fund's reserves drawing randomly from a distribution of the historical returns of similar pension funds (Norway, Japan, Australia). The sample used for GDP growth rates is 1990 to 2023.

additional costs associated with an ageing population, this would nonetheless reduce the need for tax increases and spending cuts for future generations.

Nº65

The Fund could cover a substantial portion of ageing costs

% of estimated additional ageing costs relative to 2023



Source: Fiscal Council workings.
Notes: The chart draws on estimates from the Council's (2020) Long-term Sustainability Report, comparing the increase in costs related to ageing for each of the years shown versus 2023.

Box I: The Infrastructure, Climate and Nature Fund

Ireland's second new fund is the Infrastructure, Climate and Nature Fund. This Fund is the smaller of the two new funds outlined at the time of the Budget. It is intended to help avoid the need to cut capital spending in future downturns. More generally, its dual purpose is stated as to provide for countercyclical investment in the economy and to help achieve climate and nature goals.

The Fund is intended to provide support when

1) there is a significant deterioration in the public finances; and

2) there are projects that can help achieve Ireland's climate and nature goals.

Key features of the Infrastructure, Climate and Nature Fund[46]

Initial transfer and annual contributions

- An initial €2 billion will be transferred to the Fund from the dissolved Reserve Fund
- Yearly contributions of €2 billion will be made to the Fund from 2025 to 2030
- A €14 billion cap will apply in terms of contributions by 2030
- This cap equates to 5% of GNI*, the current annual target for capital expenditure
- Additional contributions can be made on Dáil resolution once the cap is not exceeded
- Contributions have to be made unless there is a specific Dáil resolution to halt or amend these or if a significant deterioration in the public finances is judged to exist
- In 2030, a decision will be made about future contributions

Drawdowns

- The Minister will evaluate whether a significant deterioration in the public finances has occurred such that resources will be drawn down in the following year
- Drawdowns to the Exchequer can occur in 2026 to 2030 following government approval and a Dáil resolution
- No more than one-quarter of the Fund's value can be paid out in a given year
- There are two criteria for drawdowns
- In a situation where the economic criteria are used to draw down amounts, all new climate and nature projects will be suspended and no further payments can be made except for those already underway
- For the climate criteria, drawdowns would only be allowed for projects reducing greenhouse gas emissions, improving water quality or meeting wildlife targets
- For climate criteria, no more than 22.5% of the Fund's value can be paid out and no more than €3.15 billion by 2030
- No commitments can be entered into which will provide for expenditure on the Fund post 2030

Investment strategy

- The NTMA will determine the investment strategy
- Investments will be on a commercial basis in or outside the State
- Investments should allow a timely drawdown
- The focus of investments is to be global, but since Irish assets are a feature of global indices, there is provision to allow for Irish exposures to be managed
- Investment are to be "responsible" in line with Environmental, Social and Governance (ESG) considerations

The Fund will help ringfence risky corporation tax receipts

In advance of the Fund being created, the Council assessed that it would be useful to ringfence excess corporation tax receipts, though its broader merits were less clearcut.[47] This is still the Council's broad assessment. A countercyclical fiscal policy is of course desirable, but it is not clear that the Fund is necessary to achieve this, with the National Spending Rule being a more critical tool in this regard.

[46] Based on the General Scheme of the Bill, which is subject to ongoing development.

[47] See Box A of Fiscal Council (2023b).