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Managing the Public Finances in a Full-Employment Economy

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Abstract

The Government's fiscal response to COVID-19, cost of living pressures and humanitarian support for Ukraine resulted in an increase in government spending of €35 billion between 2020 and 2022. Despite this exceptional rise in expenditure, the headline budget balance returned to surplus in 2022, driven by windfall corporation tax revenue. If this excess corporation tax is excluded, the budget remained in deficit last year. The current macroeconomic environment – characterised by an economy at full employment and with high inflation – presents fresh challenges for fiscal policy. The analysis indicates that discretionary government spending increases or tax cuts above current plans would add to demand and inflation when the economy is already at full capacity. Moreover, the public finances face looming constraints over the medium term due to the need to increase public spending to address the long-term costs of ageing and climate change. Saving windfall taxes today would reduce – albeit not eliminate – the extent of future tax increases needed to fund these new demands on the public finances. Introducing measures to broaden the tax base could help to ease inflationary pressures while public capital spending is being ramped up and at the same time enhance the resilience of the public finances in the face of known future challenges.

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1. Introduction

The scale of fiscal supports introduced by the government since 2019 in response to successive negative events has been enormous. The cost of expenditure measures implemented during the Covid-19 pandemic is estimated at €32.4 billion between 2020 and 2023, or 12 per cent of modified national income (GNI*). Expenditure to help households and businesses address cost of living pressures along with the humanitarian response by the Irish government to the Russian war in Ukraine is expected to amount to a further €8.3 billion (3.1 per cent of GNI*) in 2022 and 2023. In addition to such exceptional outlays that are intended to be one-off in nature, regular, recurring core Exchequer spending has increased at an annual average rate of 6.4 per cent in the five years to 2022 (or by €21.4 billion).[2]

The large counter-cyclical fiscal response to the pandemic was warranted and appropriate. It helped to mitigate the extent of any permanent economic damage from the crisis and laid the foundations for the economy's rapid recovery once the health crisis abated. The temporary measures to address cost of living pressures – in particular those that have been targeted – have reduced the hardship faced by the most vulnerable households and businesses as a result of rising prices. Despite the extensive scale of this additional expenditure since 2020, the overall public finances improved significantly in 2022, driven by the phasing out of the temporary pandemic expenditure along with exceptionally strong growth in tax revenue, in particular corporation tax. These developments saw the headline budget balance improve from a deficit of 2.9 per cent of GNI* in 2021 to a surplus of 3 per cent in 2022, despite the introduction of the new temporary cost of living measures for 2022 and 2023.

With the welcome improvement in the overall budgetary position following the exceptional fiscal interventions of recent years, the public finances and the economy now face new challenges. Evidence across a range of measures – most clearly the unemployment rate which stands at a 20-year low –

[2] The Central Fund, or Exchequer, is the main treasury account held by the Irish Government at the Central Bank of Ireland. All government receipts and expenditures, unless otherwise determined by law, are recorded in the Central Fund on a cash basis. The difference between receipts and expenditures is called the Exchequer balance. The General Government balance (sometimes referred to as the government deficit) is a broader accrual based measure of the fiscal position on an accruals basis, for the whole of government, than the cash based Exchequer balance. It takes account of other agencies and bodies that sit outside the Exchequer giving a more complete picture of a government's fiscal performance. It is the main internationally recognised government accounting aggregate.

signals that the economy is likely to be operating at capacity currently and close to a position where overheating dynamics could emerge. As outlined elsewhere in this *Bulletin*, the inflation rate is high at present with non-energy price pressures expected to remain elevated out to 2025. In response to high inflation in the euro area, the ECB Governing Council has been raising the key policy interest rates to ensure a timely return of inflation back to its 2 per cent medium-term target. As a small open economy in a monetary union, domestic fiscal policy has a key role to play in managing demand and inflation in the Irish economy.[3]

Against this backdrop, our scenario analysis shows that increases in overall public spending and/or discretionary tax reductions beyond existing plans would add to inflationary pressures, risk triggering potentially damaging overheating dynamics and lead to a less favourable budgetary position in the coming years. By increasing demand and inflation in a full-employment economy, additional fiscal expansion would work at cross-purposes to the current stance of monetary policy which is aiming to reduce demand in order to lower inflation. The current fiscal projections in SPU 2023 envisage Exchequer spending growing in line with the Government's 5 per cent net spending rule from 2024 to 2026. The risk of potential overheating in the economy underlines the importance of adhering to these plans. If evidence of more pronounced overheating pressures emerges, the Government should stand ready to adopt a tighter fiscal stance than currently planned, implying that net spending would grow at a rate below the maximum 5 per cent allowed under the rule. This outcome could be achieved by considering measures to increase government revenue as a share of national income by the middle of the decade.

Such an orientation would also begin the process of building resilience into the public finances. This is needed so that the fiscal costs of known future pressures from an ageing population as well as the costs of the green transition can be sustainably met. Saving excess corporation tax into a long-term savings fund over the coming years – as proposed by the Department of Finance – would leave the public finances in a stronger position to meet these fiscal challenges in the future.[4] The resources accumulated by saving windfall tax revenues today would reduce the extent of future increases in

[3] See FitzGerald, J, 2001, "Fiscal Policy in a Monetary Union: the Case of Ireland" special article in Quarterly Economic Commentary. Dublin: The ESRI.
[4] See https://www.gov.ie/en/publication/8a0a8-future-proofing-the-public-finances-the-next-steps/

taxation that will be needed to meet the additional expenditure associated with an ageing population.

Public capital spending has a key role to play in helping to alleviate supply-side pressures in the economy and labour market, as well as enhancing the economy's capacity to adjust to future shocks. While downward revisions to nominal General Government investment along with high inflation will reduce the level of real investment that will be delivered over the coming years compared to projections in 2021, public investment is still forecast to grow strongly over the medium term. Delivering these increases in capital expenditure in the context of an economy at full employment will require careful management. Financing additional spending or tax cuts through extra borrowing or by using excess corporation tax would result in a net injection of funds into the economy, further stimulating demand. Our analysis shows that higher public capital spending financed instead by discretionary increases in tax revenue can deliver similar benefits in terms of long-term growth, while at the same time minimising the impact of the additional spending on demand and inflation. Discretionary increases in tax revenue could be achieved either through changes in existing taxes and/or by broadening the tax base.

The rest of this article is organised as follows. Section 2 provides an overview of the overall cyclical position of the economy drawing on a range of indicators. Section 3 examines key changes in government revenue and expenditure in recent years, focussing on the impact of high inflation and corporation tax on overall revenue growth. Section 4 presents a model-based analysis of the impact of a permanent increase in government expenditure or a reduction in tax above existing plans, taking into account the current full-employment position of the economy. Section 5 discusses some of the structural changes, including population ageing and the climate transition, that will place additional demands on the public finances over the coming years. Lastly, this section assesses options for financing increases in public capital spending that would reduce demand pressures in the economy while at the same time protecting the public finances.

2. Macroeconomic Background

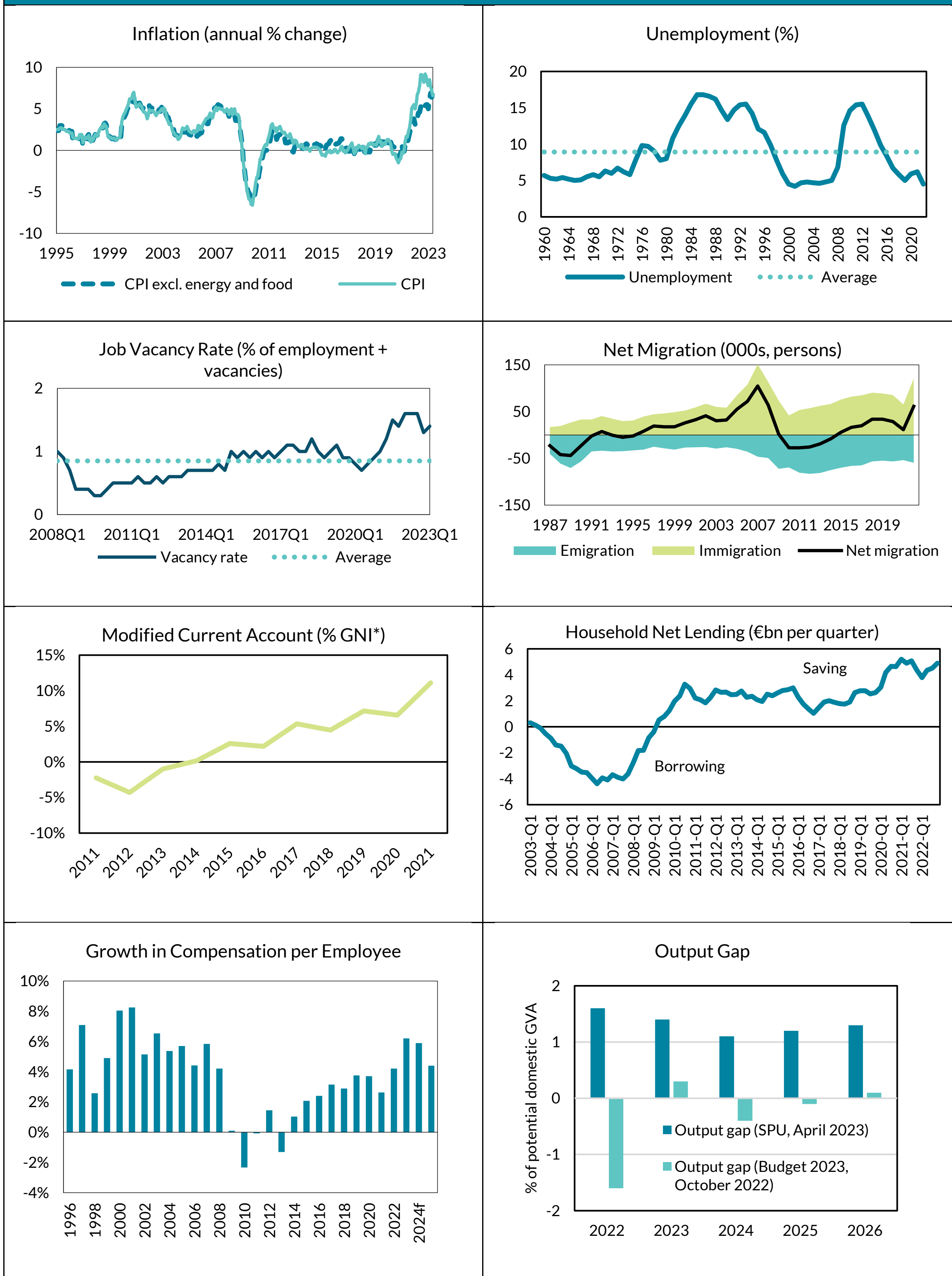
The economy has recovered rapidly from the pandemic, with modified domestic demand (MDD) growing by 8.2 per cent in 2022 and value added in the domestically-oriented sectors of the economy expanding by 7.2 per cent. Although growth is expected to moderate this year, MDD is projected to increase by 2.9 per cent per annum on average between 2023 and 2025,

close to its long-run average rate. These projections imply a continuation of strong demand conditions in the economy out to the middle of the decade.

The implication of the recent observed growth in economic activity – as well as the projected growth envisaged in the central outlook – is that, across a range of measures, there is evidence that the economy is operating at its sustainable capacity in 2023. Figure 1 presents a range of indicators of the cyclical position of the economy based on the latest available data. Given the difficulties in interpreting measures of output produced in the Ireland, the labour market provides the best indication of the degree of spare capacity in the economy. The unemployment rate in May 2023 stood at 3.8 per cent, the lowest rate on record in the period since the early 1960s. At the same time as the unemployment rate has been falling, there has been a pick-up in net inward migration which is estimated to have measured 2.3 per cent of the labour force in 2022. The employment rate – the fraction of the working age population in work – increased to an all-time high of 73.6 per cent in Q1 2023 and the job vacancy rate remains well above its long-term average.

Headline inflation in 2022 was the highest recorded since 1984. Although the pace of price increases has begun to moderate, price pressures remain pronounced and increasingly driven by domestic factors, as discussed in the main chapter of this *Bulletin*. Across the range of other indicators in Figure 1, a more mixed picture emerges as to the extent of current overheating pressures. To date, the tightening of the labour market has not been accompanied by significant evidence of strong overall wage pressures. Growth in nominal compensation per employee measured 4.3 per cent in 2022. More detailed quarterly data point to some acceleration remuneration in sectors such as financial services, but overall wage pressures remain broadly contained based on the latest data. The latest Institutional Sector Accounts show that the household sector remained a net lender in 2022. In terms of indicators of external imbalance, the adjusted current account of the balance of payments recorded a surplus of 11.1 per cent of GNI* in 2021 and this is expected to have increased further in 2022.

Figure 1: Indicators of the Position of the Economy in the Economic Cycle



Source: CSO, European Commission, Department of Finance, Central Bank of Ireland

Lastly, the output gap is defined as the difference between an economy's actual level of output in a given year and what it could feasibly produce if all

factors of production (land, labour and capital) were fully utilised. A positive output gap is a signal of potential overheating because excess demand in the economy could result in unsustainable increases in prices and wages. Estimates of the output gap published by the Department of Finance (2023a) suggest that the economy is operating at or slightly above capacity in 2022 and that this position is expected to persist over the forecast horizon.

Taken together, while the evidence from some indicators presents a somewhat mixed picture, conditions in the labour market are consistent with an economy operating at full capacity in 2023. With the unemployment rate below 4 per cent, strong net inward migration and the employment rate at a record high, increases in demand could further add to existing price and wage pressures in the economy and trigger the emergence of potentially damaging imbalances.

3. Developments in General Government Revenue, Expenditure and Overall Budget Balance

3.1 Government Revenue

Irish government revenue has grown at an exceptional pace in recent years, led by developments in taxation receipts. Following the pandemic-led contraction in 2020, Exchequer tax receipts recorded their highest annual growth rates in nearly four decades in 2021 and 2022, at 19.7 and 21.5 per cent respectively. The previous largest increase was 16 per cent in 2006 at the height of the housing boom. The three largest tax heads - income tax, corporation tax (CT) and VAT – all made significant contributions to these growth rates, with the importance of CT strengthening once again last year when it was responsible for half of the total increase in tax revenue (Figure 2). Focusing on the broader measure of General Government (GG) revenue, which also includes social contributions and other non-tax revenues, receipts were almost one-third stronger in 2022 when compared to the pre-pandemic year of 2019. This was more than double the growth rate for the euro area as a whole over the same period (Figure 3). The divergence mainly reflects developments in direct tax receipts – primarily, income and corporation tax – which have increased by 55 per cent in Ireland since 2019, compared to growth of 18 per cent in the euro area.

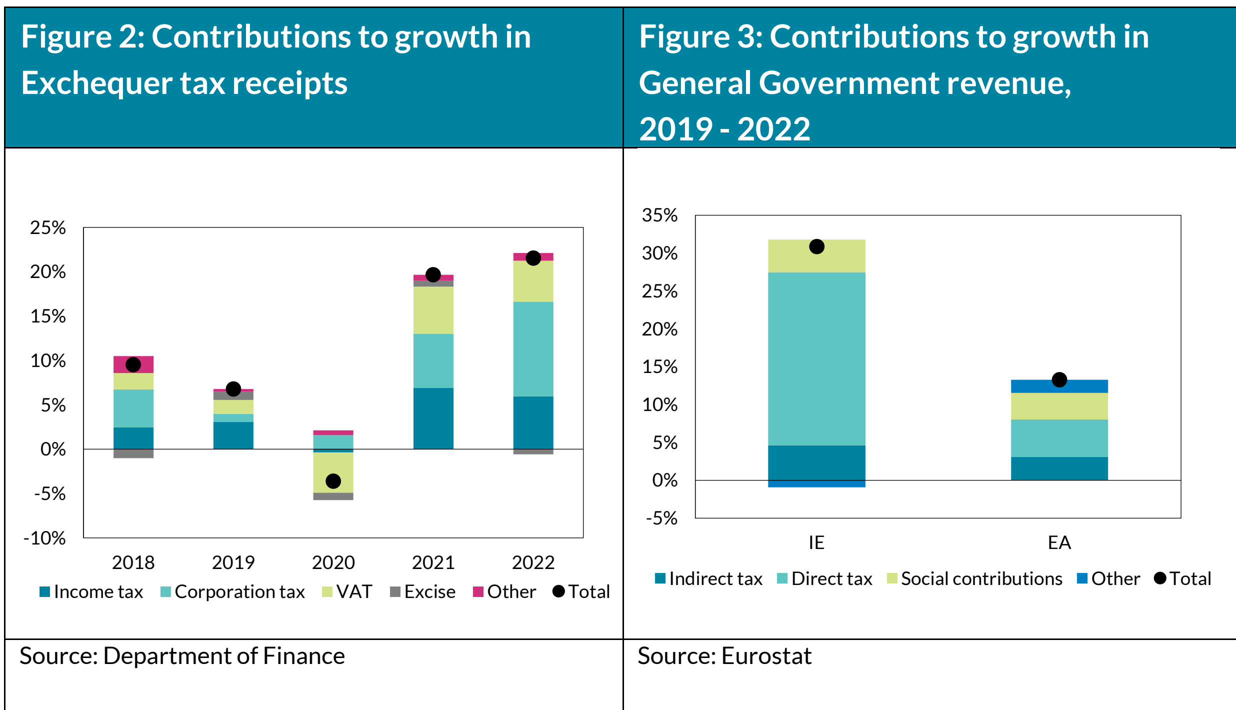


Figure 2: Contributions to growth in Exchequer tax receipts

Source: Department of Finance

Figure 3: Contributions to growth in General Government revenue, 2019 - 2022

Source: Eurostat

3.2 Corporation Tax

CT receipts have continued to grow at a rapid pace, surpassing expectations, over recent years (Figure 4). In 2014 CT was Ireland's fourth largest individual tax revenue source at €4.6bn and accounted for roughly 10 per cent of all tax receipts. Since then it has grown by almost 400 per cent (€18bn in nominal terms – with more than half of this occurring in the last three years), and has surpassed excise and VAT to become the State's second largest tax head. It now accounts for one-quarter of all tax receipts. What's more, one-third of receipts over this period were 'above profile' or higher than had been forecast by the Department of Finance in the previous year. Further strong growth has occurred in the first five months of this year, with CT revenue up by 21 per cent in the year to May 2023 compared to the previous year.

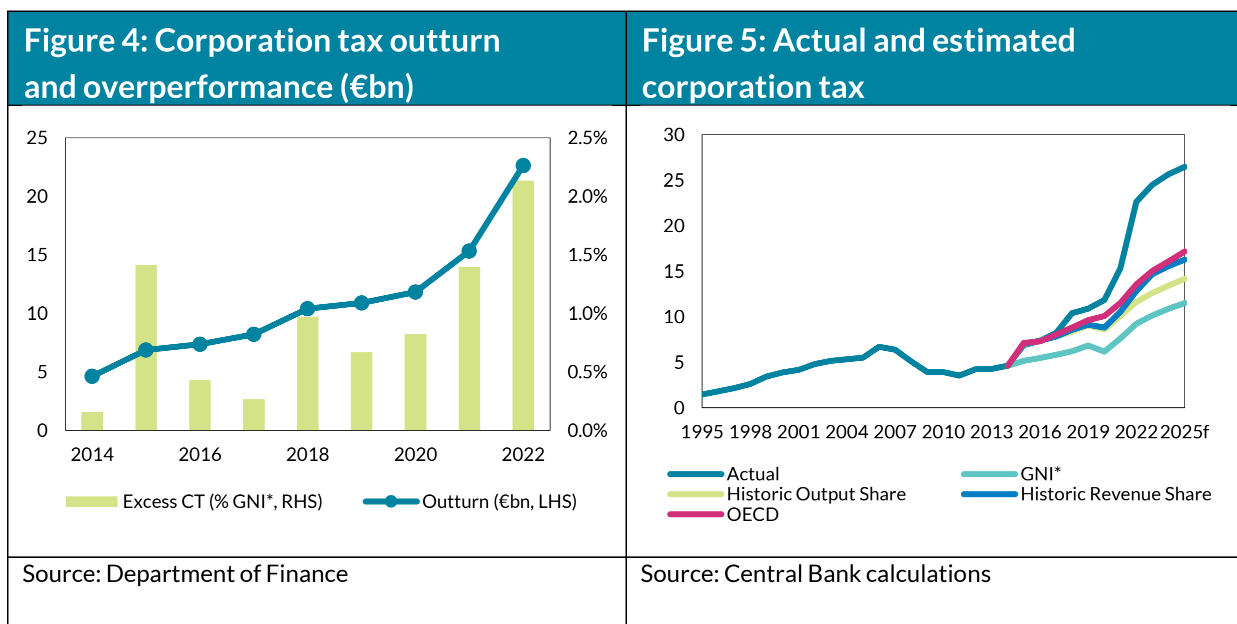
There are two significant concerns over the increasing importance of CT to overall revenue growth in the State. The first of these reflects the narrowness of the tax base. Data from the Revenue Commissioners (2023) show that 57 per cent of net corporation tax receipts – or 16 per cent of all tax receipts - were paid by just 10 large companies last year. [5] Cronin (2023) estimates that three company groups accounted for one-third of corporation tax revenue from 2017 to 2021.[6] This represents a significant concentration risk, leaving Ireland's revenue base – and ability to finance

[5] See https://revenue.ie/en/corporate/documents/research/ct-analysis-2023.pdf
[6] See https://www.fiscalcouncil.ie/understanding-irelands-top-corporation-taxpayers/

public expenditure without borrowing – highly exposed to the decisions and profitability of a very small number of companies.

The second concern is that a very high proportion of CT receipts over the past decade are disconnected from actual economic activity taking place in Ireland. These receipts, which could therefore be vulnerable to reversal, are often referred to as 'windfall' or 'excess' revenues. As outlined by the Department of Finance (2022)[7] and IFAC (2022)[8] estimating the size of excess CT is subject to significant uncertainty and a number of different methodologies can be used. Reflecting this, we use four approaches to estimate a possible range for CT receipts that might be considered unsustainable over the medium to longer term.

Figure 4: Corporation tax outturn and overperformance (€bn) | **Figure 5: Actual and estimated corporation tax**



Source: Department of Finance | Source: Central Bank calculations

The first approach is to examine the increase in CT we would expect to have observed had revenue grown broadly in line with underlying economic activity. We use GNI* as the base to determine the deviation from the expected level as, prior to 2015, GNI* performs reasonably well as a predictor of CT receipts. Furthermore, given GNI* has been specifically designed to exclude globalisation effects unrelated to developments in the Irish economy, it is a suitable indicator for this exercise. This approach

[7] See https://www.gov.ie/en/publication/b838d-de-risking-the-public-finances-assessing-corporation-tax-receipts/
[8] See https://www.fiscalcouncil.ie/fiscal-assessment-report-may-2022/

provides us with an upper-bound estimate of excess CT, with a gap of €15bn between actual and estimated CT emerging by 2025 (Figure 5).[9]

A second approach is to assume that CT should grow in line with its historical share of total tax revenue. In 2022 CT was 27 per cent of total tax receipts, compared to a long run average of 15.4 per cent. Were it to revert to the latter, CT would be €10.2bn lower than the baseline projection by 2025. A third, related, approach is to assume that CT remains consistent with its historical share of economic output. For the reasons outlined above we use GNI* as the most appropriate measure of activity. In 2022, CT receipts were 8.4 per cent of GNI*, close to double the long run average of 4.3 per cent. If CT was to return to this long run average, it would imply a divergence of €12.3bn between actual and estimated receipts by 2025. Finally, we can compare CT growth in Ireland to the experience of other developed economies over the past decade. Corporation tax receipts averaged 2.7 per cent of GDP in the OECD between 2011 and 2020 (the latest data available) compared to 4.5 per cent in Ireland. Returning to this international standard would see CT decline by €9.3bn in 2025 relative to the baseline projection, providing us with a lower bound estimate of excess CT in that year.

Table 1 – Estimate of ‘excess’ corporation tax receipts

	2021	2022	2023	2024	2025
Central Bank of Ireland	5.8	11.2	11.9	12.2	12.1
Department of Finance	5.0	10.8	11.8	11.8	11.4

Source: Budget 2023, Stability Programme Update 2023, Central Bank calculations.
Note: CBI projection represents midpoint of Figure 5 estimates.

These results highlight the uncertainty in estimating excess CT receipts, but also show that – using a number of different methods - a significant share of CT receipts cannot be explained by developments in the underlying economy or are out of line with historical and international norms. As Table 1 shows, the mid-point of our estimates is broadly in line with the estimates produced by the Department of Finance in Stability Programme Update 2023 (SPU).[10]

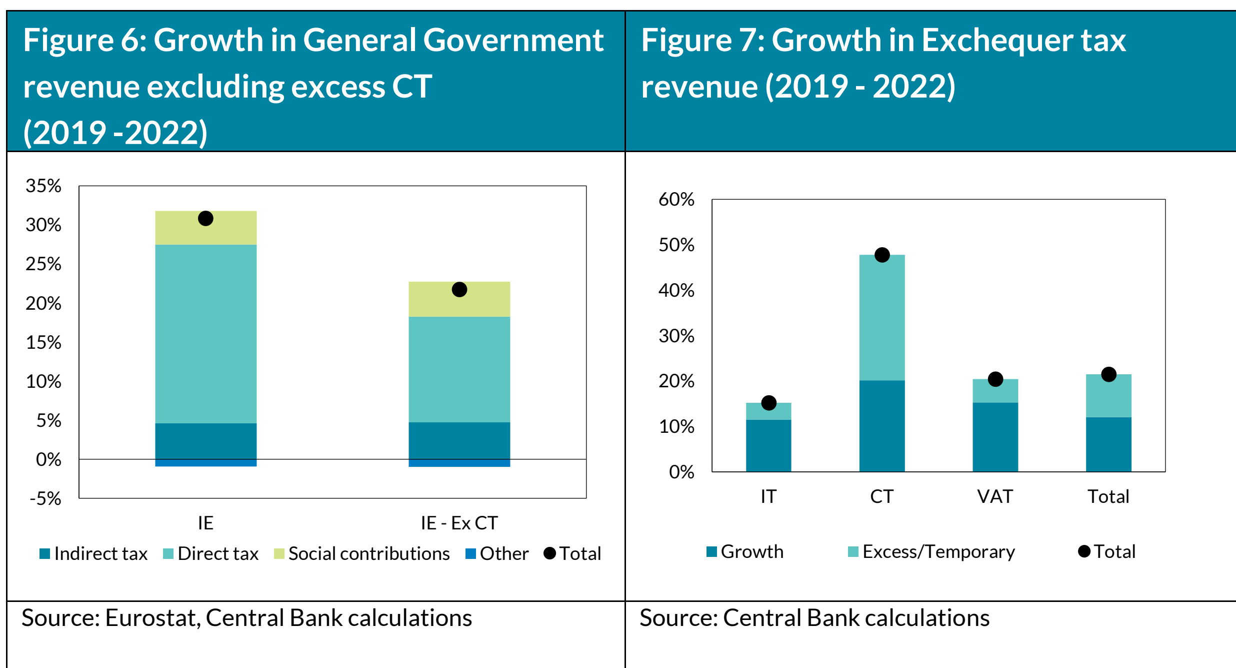
[9] We use a model-based approach to compare actual CT receipts since 2015 to an estimate of CT revenue from a simple equation that relates changes in GNI* to changes in CT revenue The equation we use is: dlog(CT) = c(1) + c(2) * dlog(GNI*). The sample is 1995 to 2014.
[10] See https://www.gov.ie/en/publication/e4f3a-stability-programme-update-2023/

3.3 Inflation and revenue growth

Even excluding excess CT receipts, the growth of government revenue in Ireland has been strong in recent years. As Figure 6 shows, revenue excluding our estimate of excess CT grew by 22 per cent between 2019 and 2022, still well above the increase recorded in the euro area. The ongoing period of high inflation is likely to have boosted tax receipts in recent years. In the short term, high inflation is expected to support VAT and income tax.[11] In the case of VAT, a given level of real expenditure now costs more, and this higher nominal spending directly leads to higher indirect taxation receipts. In progressive income tax systems, meanwhile, increases in income in line with inflation push more workers into higher tax brackets, strengthening direct tax receipts in a process known as 'fiscal drag'. As noted by Bankowski et al. (2023), the persistence of the positive effect of inflation on revenue depends on the nature and length of the inflation shock.[12] An inflationary domestic demand or supply shock can lead to higher output, prices and tax revenues for longer. An external supply side inflationary shock, on the other hand - such as an increase in imported energy prices - can reduce household real income over time, moderating consumer spending and overall activity and eventually reducing tax revenues.

Figure 6: Growth in General Government revenue excluding excess CT (2019 -2022)

Figure 7: Growth in Exchequer tax revenue (2019 - 2022)



Source: Eurostat, Central Bank calculations

Source: Central Bank calculations

[11] Any positive impacts of inflation on excise revenues are very minor, as most components of excise are calculated on a volume basis.
[12] "Fiscal Policy and High Inflation", *ECB Economic Bulletin, Issue 2/2023*

We can estimate the impact that higher-than-expected prices have had on VAT receipts by decomposing the change that occurred in 2022 into real and price effects. We use the Personal Consumption Expenditure (PCE) deflator to deflate nominal VAT and estimate a measure of 'real VAT'. The ECB's target of 'an inflation rate of 2 per cent over the medium term' is then used to determine the expected price increase, implying that 4.6 of the 6.6 per cent change in the PCE deflator was unexpected. Decomposing the VAT change in this way suggests that around €800m of the €3.2bn increase in 2022 or one-quarter of the total change, was due to higher than expected prices (Figure 7).

Similarly we can use changes in the effective income tax rate to estimate the role that inflationary pressures have played in supporting income tax growth through fiscal drag. The effective income tax rate is generated by dividing total income tax receipts by whole economy compensation of employees, with the rate increasing from 24 per cent in 2021 to 24.8 per cent last year. Given actual tax rates did not change, this increase must reflect a greater proportion of compensation being taxed at the higher rate. Were the effective rate to have remained unchanged, the income tax increase would have been approximately €1bn lower. While other factors could be at play, such as compositional changes in employment growth and stronger earnings growth in high wage sectors, this provides an estimate that up to one-quarter of the €4.1bn income tax increase last year was due to fiscal drag.

While these are relatively crude measures, they nevertheless illustrate that a sizeable proportion of last year's Exchequer tax increase was driven by the very high inflation rate in 2022, which has begun to decline in 2023. When our estimate of excess CT is also considered, it suggests that almost half of the increase in total Exchequer tax revenue in 2022 reflected potentially temporary or unsustainable factors (Figure 7).

3.4 Developments in General Government Expenditure

Since the pandemic, developments in Government expenditure are characterised by contrasting trends in core and non-core (or temporary) spending (Figure 8). While total non-core spending (e.g. on Covid and cost of living supports) has fallen each year since 2020, this has been offset by growth in core expenditure. The result is that total government expenditure is now projected to be 30 per cent higher in 2023 than it was in 2019. Given long-run expenditure demands from ageing and climate change, and risks to

key revenue sources, it is important to keep core expenditure growth at a sustainable level over the medium term.

Non-core spending developments

A key driver of the evolution of expenditure growth over recent years has been developments in non-core or temporary spending. Initially this reflected measures introduced in response to the emergence of Covid-19. These measures – which helped to mitigate the negative impact of the pandemic on Irish households, firms and the broader economy - are estimated to have cost €31bn (11.5 per cent of GNI*) in General Government terms between the years 2020 and 2022 (Table 2). Around two-thirds of this reflected the large income support programmes – Pandemic Unemployment Payment (PUP) and Employment Wage Subsidy Scheme (EWSS) – with a further 20 per cent financing additional resources for the health sector.

Table 2 – Non Core Spending (€mn), 2020 – 2025[13]

	2020	2021	2022	2023	2024	2025	Total 2020 - 2025
Covid-19	14700	12500	3700	1500	500	200	**33,000**
Cost of Living			3000	2300			**5,300**
Ukraine			1000	2000			**3,000**
Other			300	700	200	200	**1,400**
Unallocated				700			**700**
TOTAL	**14700**	**12500**	**8000**	**7200**	**700**	**400**	**43,500**

Source: Central Statistics Office, Department of Finance, Central Bank of Ireland calculations. See footnote 13 for details on sources.

[13] The figures in this table are based, where possible, on General Government data and do not include revenue measures. Covid-19 expenditure outturns for the years 2020 to 2022 are sourced from CSO Government Finance Statistics releases, with expenditure projections for subsequent years taken from Table 9 of "Budget 2023 – Economic and Fiscal Outlook". Cost of Living expenditure uses data taken from the Department of Finance's document "The Fiscal Response to the Cost of Living Challenge". Reflecting information from the CSO, however, we assume that €800m of the expenditure on Electricity Credits (paid in January/ February and March / April of this year) occurs in 2023 rather than 2022. Costs of humanitarian support related to the Russian invasion of Ukraine are taken from Table A9 of "Stability Programme Update 2023". Here we assume that the unallocated resources earmarked for humanitarian support are fully utilised. The remaining unallocated expenditure for 2023 is also included in non-core spending as it is noted in the SPU that 'the majority of the remaining unallocated is provision relates to reserve funding for non-core measures, which will be allocated over the course of the year, if required'. Other spending includes expenditure linked to the Resilience and Recovery Fund and is a residual to ensure that total non-core spending for 2022 to 2025 is consistent with the totals presented in Table 11 of the SPU when the above adjustments are accounted for.

As pandemic-related spending has started to dissipate, a range of new non-core spending measures have been introduced to provide cost of living and humanitarian supports. With regard to the former, expenditure measures amounting to €5.3bn have been implemented for 2022 and 2023 in response to heightened inflationary pressures.[14] These have included household energy credits, increased welfare payments and the Temporary Business Energy Support Scheme, and around one-third of the measures appear to be fully targeted to those most affected by the shock. In terms of the latter, expenditure linked to the humanitarian response to the invasion of Ukraine is expected to total €3.0bn by the end of the year - €500m of which is an unallocated contingency. The latest Government expenditure projections include a further €700m of unallocated expenditure and note that 'the majority of which relates to reserve funding for additional non-core measures should they arise'. Assuming this is fully utilised, by end-2025 the accumulated cost of all temporary measures announced since 2020 is projected to be €43.5bn or 16 per cent of GNI*.

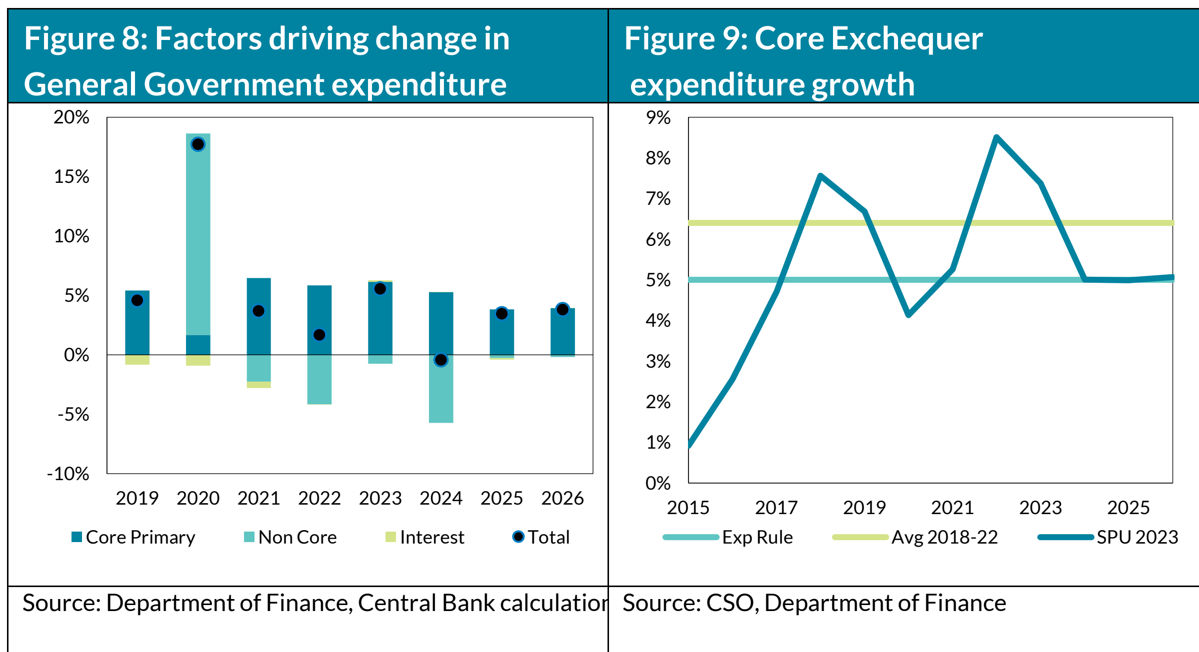


Figure 8: Factors driving change in General Government expenditure

Source: Department of Finance, Central Bank calculation

Figure 9: Core Exchequer expenditure growth

Source: CSO, Department of Finance

The primary risk related to temporary expenditure measures is that they do not unwind as planned. Estimates using the Bank's structural macroeconomic model indicate that the cost-of-living measures in 2022 and 2023 will increase domestic demand by just under 1 per cent in 2023 and add around 0.3 percentage points to inflation. Assuming the measures are temporary as planned, these effects do not persist beyond 2023. The

[14] When revenue measures are also included, it is estimated that cost of living supports will total €7.2bn over the period 2022-23.

Department of Finance's latest projections (SPU 2023) which include no funding for either cost of living measures or humanitarian support in 2024 and 2025.[15] Section 4 considers a scenario to illustrate the impact on growth and inflation where expenditure is increased permanently from 2024. This could arise, among other reasons, from the materialisation of the risk that expenditure currently intended to be temporary does not unwind.

Core expenditure developments

While expenditure on temporary measures has decreased each year since 2020, core expenditure continues to grow strongly (Figure 9). Recent Budgets have introduced significant increases in permanent Exchequer expenditure; between 2021 and 2023 this has amounted to just under €15bn (5 per cent of GNI*), with 30 per cent of this going to the Health vote group.[16] The latest Government forecasts anticipate that core Exchequer spending growth will fall back to 5 per cent from 2024 onwards (Figure 6). While this is in line with the growth rate permitted under the Exchequer net spending rule (discussed in more detail below), it would represent a notable deceleration from the expected growth rate this year (7.4 per cent) and would also fall below the medium term (five year) average growth rate of 6.4 per cent.

Reflecting the change in the global interest rate environment over the past 18-months, sovereign borrowing costs have increased with the Irish 10-year bond yield increasing from 0.3 per cent at the beginning of 2022 to 2.7 per cent at the end of May 2023. Despite this, projections for expenditure on debt interest over the medium term remain relatively contained. This is because there is a modest level of redemptions in the coming years and debt that is debt maturing over the next two years was issued over the period 2009-2014 at rates above the current yield on Irish debt. As a result, the average or effective interest rate on the entire debt stock is expected to remain close to record low levels in the coming years.

Until the general escape clause is deactivated at the end of 2023, and reform of economic governance is completed at EU level, expenditure growth in Ireland is anchored by the Government's domestic expenditure

[15] If not fully spent in 2023, the unallocated resources could be used in 2024. Assuming this expenditure was used to finance temporary measures this would not have a permanent impact on the expenditure base.

[16] Budgets 2021, 2022 and 2023 introduced additional core spending of €5.4bn, €4.2bn and €5.1bn respectively.

rule, set out in the 2021 Summer Economic Statement.[17,18] SPU 2023 clarified that the expenditure rule is set in net terms, i.e. net of discretionary tax changes.

The rule states that annual growth in Exchequer expenditure is fixed at 5 per cent per year in net terms, in line with the estimated sustainable nominal growth rate of the economy. The primary weaknesses in this rule is that it relates only to Exchequer spending, even though about one fifth of Government expenditure takes place outside of the Exchequer.[19] As a result, growth in non-Exchequer spending could push overall government expenditure to excessive levels without breaking the rule.

3.5 Overall General Government Balance

Driven by the rapid growth in revenue outlined above, the General Government balance (GGB) is estimated to have improved from a deficit of 2.9 per cent of GNI* in 2021 to a surplus of 3 per cent last year (Figure 10). In comparison, the Euro area as a whole ran a deficit of 3.6 per cent. There is a broad consensus amongst recent forecast exercises that budget surpluses in Ireland will strengthen further over the medium term as the large temporary spending measures outlined in Section 3.4 unwind (Figure 8).[20]

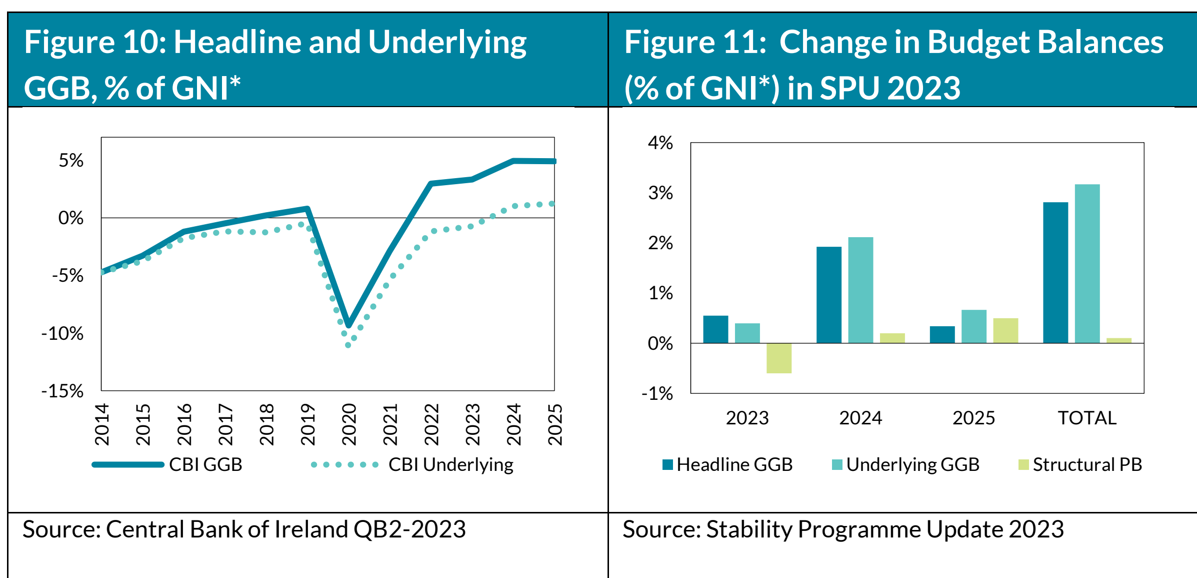


Figure 10: Headline and Underlying GGB, % of GNI*

Source: Central Bank of Ireland QB2-2023

Figure 11: Change in Budget Balances (% of GNI*) in SPU 2023

Source: Stability Programme Update 2023

[17] The general escape clause suspended certain EU fiscal rules in response to the Covid-19 Pandemic. See here for the European Commission's explanation of how fiscal rules will be reintroduced while negotiations on the new framework are ongoing.
[18] Summer Economic Statement, April 2021
[19] See Box A in Managing the Public Finances in Uncertain Times, Central Bank Quarterly Bulletin Article, 2022
[20] See for example Central Bank or Ireland (2023), European Commission (2023) and Department of Finance (2023).

As noted in Section 3.2, however, much of the recent improvement in the budgetary position has been driven by growth in CT, a large part of which cannot be explained by underlying developments in the Irish economy. Given the risk that these excess CT receipts could be subject to sharp reversals, it is prudent to adjust the headline budget balance (GGB) to exclude such inflows. Doing so reveals that the outlook for the 'underlying' fiscal position is not as strong as the 'headline' projections would suggest. As Figure 10 shows, the GGB would remain in deficit this year, and the projected surpluses in 2024 and 2025 would be significantly lower. Accordingly, starting from this less favourable position, fiscal buffers to deal with any future negative economic shocks, or to finance the large known medium to longer term expenditure pressures (discussed in more detail in Section 4), would be substantially smaller.

Strong economic growth is expected to play a key role in driving the improvement in both the headline and underlying GGBs over the coming years. This is evident from the Government's latest fiscal projections. While the Government anticipates large positive changes in the headline and underlying GGB between 2022 and 2025, the structural primary balance is broadly stable over this period (Figure 11). The structural primary balance - which excludes temporary measures (in this case also excess CT receipts), interest spending and adjusts for changes in the economic cycle – is considered a good proxy for the Government's overall fiscal stance as it removes factors not directly under its control. A deterioration in the structural balance indicates fiscal policy is stimulating the economy while an improvement in the balance points to a restrictive stance. While the structural primary balance is forecast to record a surplus of 2.7 per cent in 2025, its relatively stable position for the period 2022 to 2025 as a whole points to a broadly neutral fiscal policy stance in the coming years. Accordingly, any additional government spending or tax cuts – above those that underpin the Government's current fiscal forecasts – could result in an expansionary fiscal stance at a time when the economy is already growing at full capacity.

4. Modelling Risks to the Public Finances

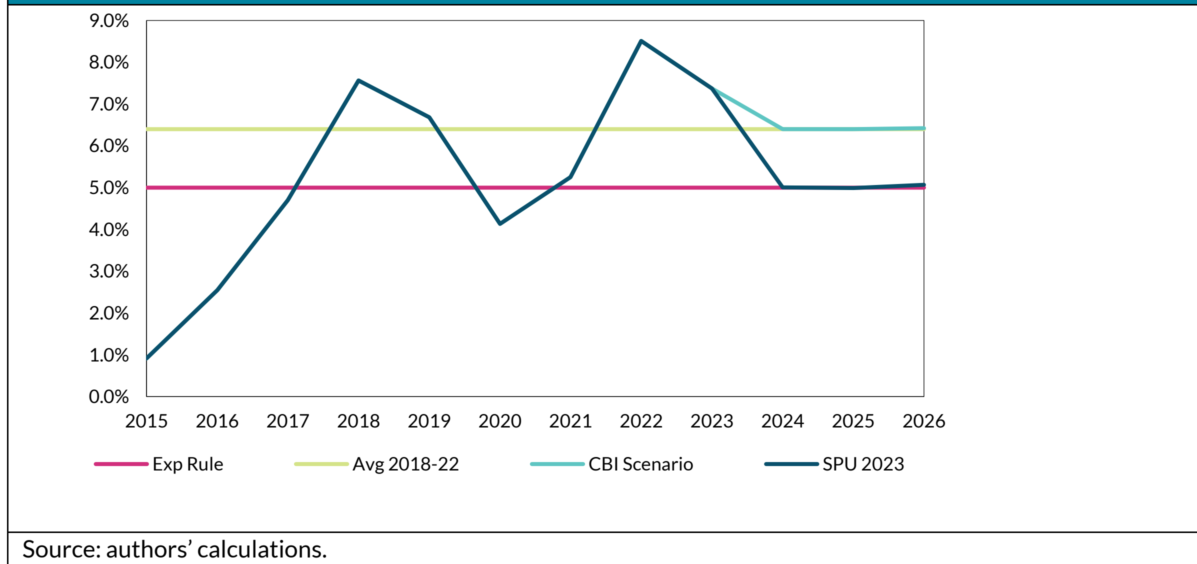
Given the macro-fiscal context outlined above, we use the Central Bank's semi-structural macroeconomic model to illustrate the potential impact of two scenarios on the economy and the public finances: (1) higher than expected core government expenditure and (2) lower government revenue from a reduction in the effective income tax rate. The latter could come

about either as a result of changes in the statutory tax rate or through decisions on indexation.

4.1 A permanent increase in government expenditure

The first scenario illustrates the effect of a permanent increase in core government expenditure. To calibrate the size of the shock, we assume that core expenditure grows in line with recent historical trends in Exchequer spending. Over the period 2018-2022, core Exchequer expenditure grew by 6.4 per cent on an annual average basis, so our scenario assumes that spending continues to grow at this rate over the 2024-2026 period (Figure 12). Under this assumption, public expenditure would exceed the Government's 5 per cent net spending rule. The expenditure path in our scenario is not intended as a forecast but serves to illustrate the implications of higher than budgeted for government expenditure. The spending shock in the scenario amounts to €1.2bn in 2024, €2.5bn in 2025, and €4.0bn in 2026.

Figure 12: Historical and projected (assumed) annual exchequer spending growth, 2015-2026



Source: authors' calculations.

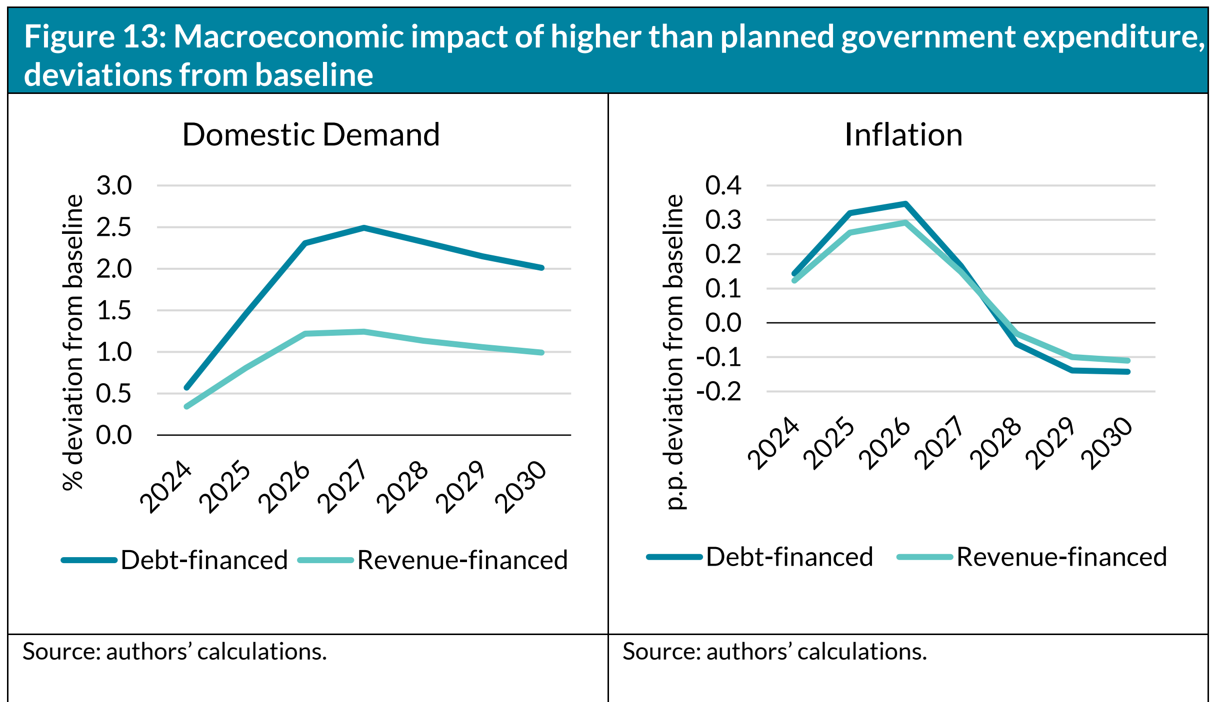
We assume that the additional spending is split equally between government consumption and transfers, and consider what happens when the spending is funded by borrowing and by raising taxes. [21] If instead, the

[21] To capture the current cyclical position in the scenario analysis, we follow Faubert (2021) in allowing for a state dependent effect of the output gap on inflation. The scenario assumes that the additional expenditure is split equally between government consumption and transfers. The macroeconomic impact of a given expenditure increase would differ depending on the precise composition of the spending increase. Model simulations indicate that increases in government consumption typically have a larger macroeconomic impact than higher expenditure on transfers.

additional expenditure was financed using windfall corporation tax, the effect on the economy would be similar to the case where the spending is funded by borrowing. This is because in both instances – funded by borrowing and funded by windfall tax revenue – there is an injection of money into the economy without any offsetting withdrawals elsewhere in the budget.

Figure 13 shows that in the case of a permanent increase in expenditure funded by debt, domestic demand would be over 2.5 per cent higher than the baseline projection by 2026. These macroeconomic effects would be the same if the expenditure was financed by windfall corporation tax. A further output stimulus such as this in an already fast-growing economy would add to capacity constraints and lead to a larger positive output gap than already projected. Moreover, the simulation results point to the emergence of potential imbalances in the economy, including some crowding out of the traded sector over the medium-term as domestic demand accelerates putting upward pressure on prices and wages. With the economy already at full employment, there is some uncertainty over the precise response of wages and prices to an additional demand stimulus and the ultimate effects could be larger than estimated here.

Figure 13: Macroeconomic impact of higher than planned government expenditure, deviations from baseline



Source: authors' calculations.

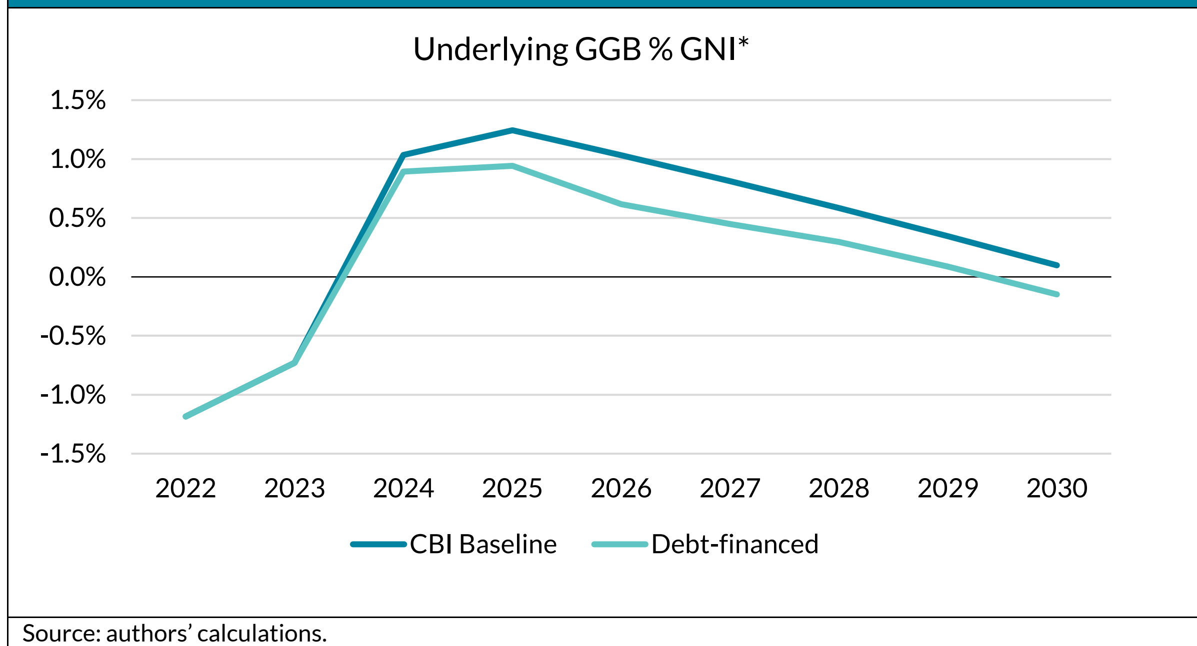
Source: authors' calculations.

The simulation is repeated for the case where the additional spending is financed by raising government revenue rather than by debt. For the purpose of the model analysis, we make a technical assumption that the additional revenue is raised via an increase in the effective income tax rate

but in reality a range of revenue-raising measures could be considered. In this scenario, the increase in both output and inflation would be lower than shown in the debt-funded case (Figure 13). The extent of this offsetting effect on output would be influenced by the revenue-raising measure, or mix of measures, that is used.

In terms of the public finances, the underlying General Government balance would deteriorate by about 0.3 percentage points by 2025. The Central Bank's fiscal forecasts envisage a surplus of 1.2 per cent of GNI* in 2025, so this scenario implies that the surplus would fall to 0.9 per cent (Figure 14). In the revenue-funded case, we assume that there is an increase in the income tax rate to offset the increase in government spending. As a result, the General Government balance in this case is unchanged.

Figure 14: Fiscal impact of higher than planned government expenditure



Source: authors' calculations.

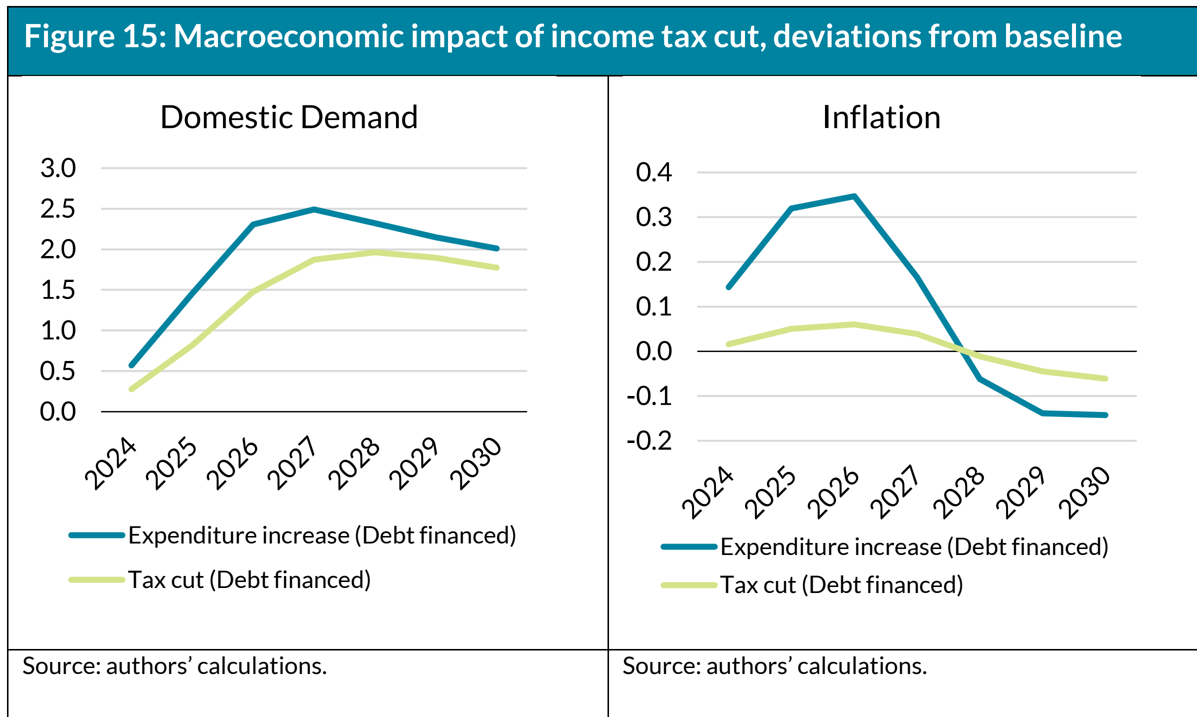
4.2 A permanent reduction in the effective income tax rate

The second scenario illustrates the effect of a permanent reduction to the effective income tax rate. As noted, a lower effective rate could arise as a result of a cut in the statutory tax rate or through changes in indexation. The shock is calibrated such that the reduction in tax revenue from income taxes matches the size of the government expenditure shock from the previous section, i.e. the effective income tax rate declines such that income tax revenues fall by €1.2bn in 2024, €2.5bn in 2025, and €4.0bn in 2026.

The macroeconomic impact of the debt-financed tax cut is shown in Figure 15 along with the results from the debt-financed spending increase in the

previous section. In the debt-financed tax cut scenario, the model results suggest that domestic demand would increase by over 1.5 per cent by 2026 which could add to capacity constraints given the current cyclical position of the economy as outlined in Section 2. The stimulus provided by the tax cut would increase inflation, albeit by a smaller amount when compared to the debt-financed expenditure shock. There is some uncertainty around the precise scale of inflationary impact of the tax cut as it would be influenced by the response of the overall wage bargaining process.[22]

Figure 15: Macroeconomic impact of income tax cut, deviations from baseline



Source: authors' calculations.

Source: authors' calculations.

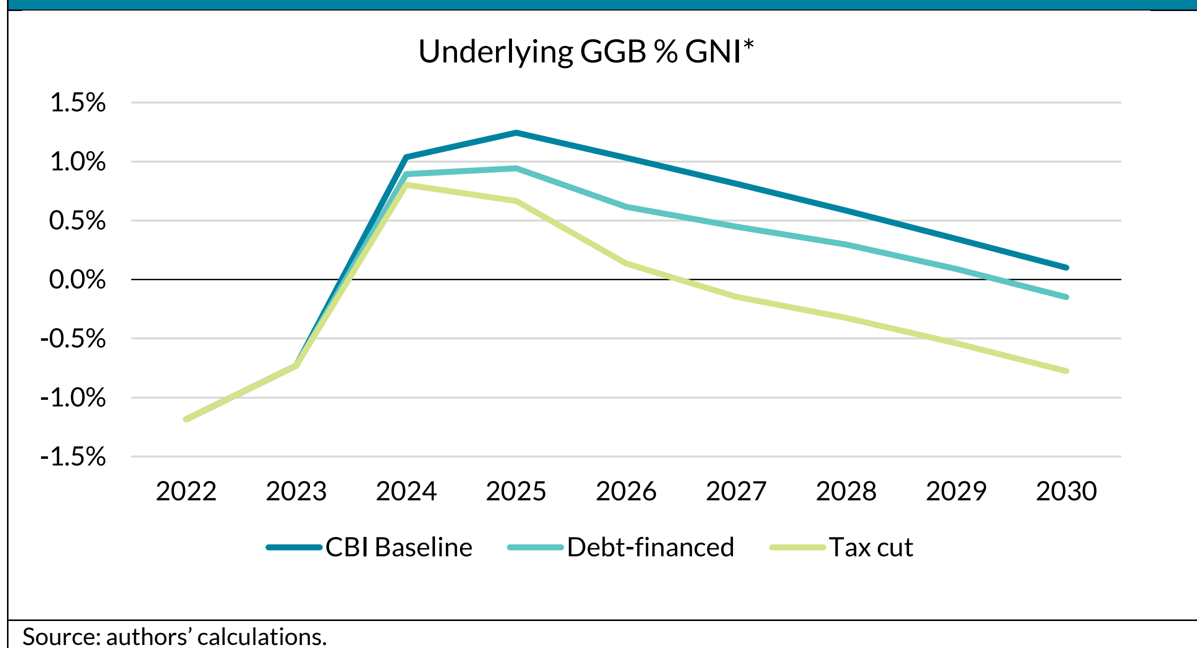
In the scenario with a reduction in income tax, the underlying General Government balance would deteriorate by about 0.6 percentage points by 2025, which compares to 0.3 percentage points in the debt-financed expenditure increase scenario. Applying these results to the Central Bank's fiscal forecasts would imply an underlying surplus of 0.7 per cent in 2025 with a deficit emerging further out the horizon in 2027 (Figure 16). The model simulation shows that the General Government debt-to-output ratio would increase by over 1 percentage point by 2026 with a growing fiscal cost further out the horizon. The income tax cut bears a higher fiscal cost

[22] In the model, workers are assumed to bargain in terms of real after-tax wages. Under this assumption, the introduction of tax changes could affect workers' wage bargaining as they trade off the income gain (loss) from lower (higher) tax against demands for wage increases. This in turn would affect the response of inflation to the tax change. The extent to which this mechanism is present in reality would depend on a range of factors including the prevailing conditions in the labour market and the institutional wage setting arrangements in place at the time.

compared to the expenditure shock due to the relatively weaker macroeconomic stimulus provided by the tax cut.

Current government fiscal projections show expenditure growing in line with the Government's 5 per cent net spending rule from 2024 to 2026. Overall, the scenarios in this section illustrate that additional expenditure or tax reductions above existing plans would aggravate overheating pressures and result in a less favourable budgetary position than currently projected by the middle of the decade. Indeed, even under current plans where (net) spending is forecast to grow at 5 per cent, there is a risk of overheating pressures emerging given, in particular, the conditions in the labour market. If evidence of more pronounced inflationary pressures were to emerge than are envisaged in current central forecasts, then a tighter fiscal stance than currently planned could be required. This would involve reducing the growth in net spending to below the maximum 5 per cent allowed under the Government's rule. This outcome could be achieved by considering measures to increase government revenue as a share of national income by the middle of the decade.

Figure 16: Fiscal impact of income tax cut



Source: authors' calculations.

5. Longer-Term Constraints on the Public Finances

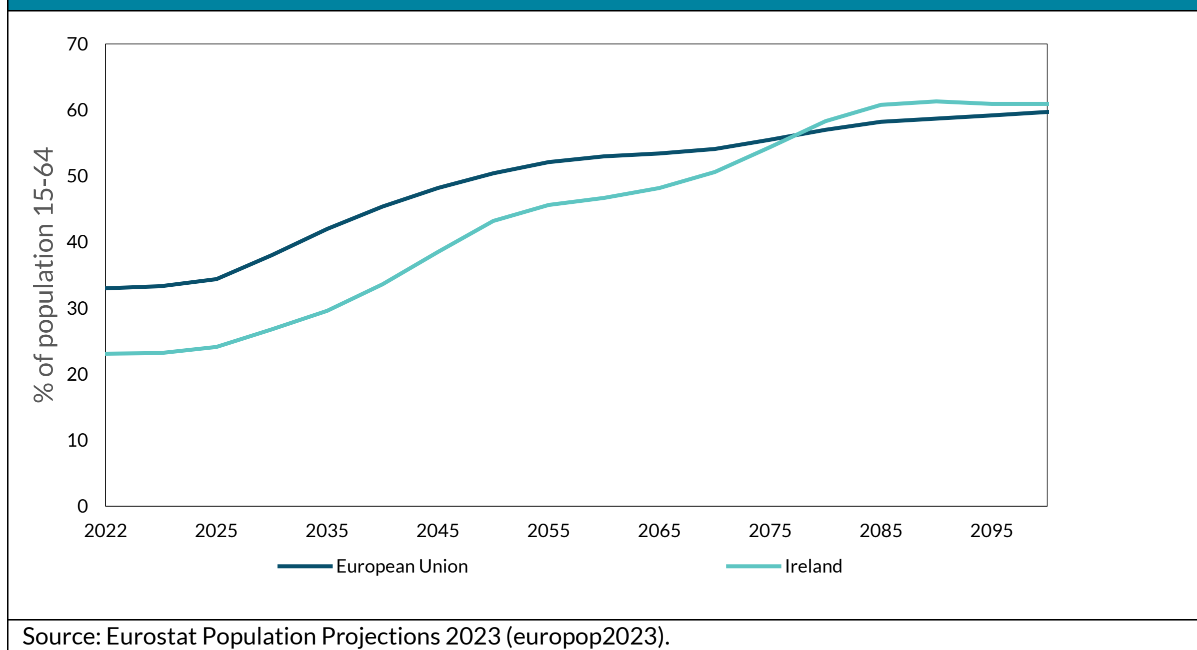
Beyond the immediate near-term challenge of managing the public finances sustainably in an economy at full-employment, other pressures will increasingly impinge on the State's budgetary position out to the end of this decade and beyond. This section discusses some of the underlying structural

changes that will constrain the public finances in the coming years. In some cases, the likely fiscal costs of these structural changes are well understood and quantified (for example, ageing) while for others such as the fiscal impact of the green transition or digitalisation, the precise fiscal impact is more uncertain.

5.1 Age-related costs

While Ireland's demographic profile is currently favourable in a European context, the position will change rapidly in the coming years with a large increase in the old age dependency ratio – i.e. the population aged 65 and over as a proportion of the working-age population. Projections from Eurostat estimate that the old age dependency ratio is expected to increase from around 23 per cent in 2022 to 27 per cent in 2030 and to 47 per cent by 2060 (Figure 17). The old age dependency ratio in Ireland is projected to exceed the EU average in the mid-2070s. This implies that the number of persons of working age for each person aged 65 and over in Ireland will drop from around four currently to just over two by 2060.

Figure 17: Projected Old Age Dependency Ratio, EU and Ireland



Source: Eurostat Population Projections 2023 (europop2023).

This transition to an older population structure will have significant fiscal implications for both tax revenue and government expenditure. On the taxation side, an ageing population will reduce the growth in labour supply, limiting the pace of economic growth and hence government revenue. At the same time, an older population will require increases in public expenditure to meet higher costs in the areas of healthcare, long-term care and pensions.

To deliver existing levels of public services to an older population, the Department of Finance estimates that by 2030 additional expenditure of €7 billion to €8 billion will be required relative to the outlay in 2019. The fiscal costs of ageing will continue to increase thereafter with overall age-related government spending expected to rise to just under 30 per cent of GNI* in 2050, up from 21.4 per cent in 2019.[23] As a result of the Government's decision not to increase the State pension age in line with the recommendations of the Pension Commission, the Department of Social Protection has indicated that future pension costs will instead be met by increasing PRSI.[24] The increase in taxation is likely to have a negative impact on the labour market and economic activity relative to a scenario where the rise in taxes was minimised. The higher tax burden would present an additional drag on economic growth which will already be slowing as a consequence of population ageing.

5.2 Other structural transitions – climate and digitalisation

There are other structural changes currently underway that are likely to result in additional fiscal outlays but whose precise costs are less well understood and quantified relative to the costs of ageing or a loss of corporation tax. Under its legally binding Climate Action and Low Carbon Development (Amendment) Act 2021, the government committed to achieving a 51 per cent reduction in emissions by 2030 (relative to 2018 levels) and net-zero emissions no later than 2050.[25]

The overall fiscal costs of the transition to a low carbon economy are uncertain and not fully quantified. The Climate Action Plan 2021 estimates that additional investment of €125 billion could be required between 2021 and 2030 to achieve the 2030 climate targets.[26] However, this figure refers to total investment – the estimated additional Exchequer capital contribution that will be required is not specified. The 2021 Plan states that around 40 per cent of the €125 billion in additional expenditure may not generate a positive investment return. IFAC has estimated that if the Exchequer was required to make up the full amount of this 40 per cent of investment whose return is uncertain, this would average about €5½ billion

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[23] See: https://www.gov.ie/en/publication/6ba73-population-ageing-and-the-public-finances-in-ireland/
[24] See : https://www.gov.ie/en/press-release/6b939-minister-humphreys-announces-landmark-reform-of-state-pension-system-in-ireland/
[25] See https://www.irishstatutebook.ie/eli/2021/act/32/enacted/en/print
[26] See https://assets.gov.ie/203558/f06a924b-4773-4829-ba59-b0feec978e40.pdf

annually or 2% of GNI* at the time of the plan.[27] Based on a different methodology which calculates investment needs at a sectoral level, FitzGerald (2021) estimates that additional annual government expenditure of 1.7-2.3 per cent of GNI* would be required per annum to meet 2030 targets.[28]

The digital transition could also place additional demands on the public finances over the next decade. These costs would arise if additional government expenditure is needed to fund the adaptation by workers and firms to new digital technologies. To date, the potential fiscal costs of this have not been quantified but it represents another possible demand on public resources in future, as recognised by the Department of Finance.[29]

5.3 Possible Reduction in Corporation Tax

These known future expenditure pressures are emerging in a context where there is a material risk to the State's second largest revenue source. The nature of the rapid increase in corporation tax revenue in Ireland since 2015 as well as the underlying characteristics of the corporation tax base mean that there are risks that revenue from this source could decline in future. A number of developments could trigger this risk. Changes in international tax arrangements could prompt firms to re-evaluate the amount of their global profits currently booked in Ireland, leading to a reversal of the enormous inward profit flows which have been behind the surge in corporation tax revenue since 2015. Corporation tax revenues are highly concentrated in a small number of sectors (manufacturing, financial services, ICT). A sector-specific negative shock which reduced the profitability of one sector – for instance, a more severe and prolonged downturn in the ICT sector – would reduce corporation tax revenue by a material amount. In the case of this latter shock, there would also be reductions in revenue from other tax headings such as income tax and VAT, given the high proportion of these taxes accounted for by MNEs and their employees.

The scale and timing of a possible loss of corporation tax is uncertain. For illustrative purposes, if half of the current CT receipts that are deemed windfall or excess were to be lost gradually between 2024 and 2026, the

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[27] See (page 80) https://www.fiscalcouncil.ie/wp-content/uploads/2023/06/Fiscal-Assessment-Report-June-2023.pdf

[28] See https://www.climatecouncil.ie/media/climatechangeadvisorycouncil/contentassets/documents/cbcbackgroundpapers/MacroEconomicImplications_JF_210914.pdf

[29] See https://www.gov.ie/en/press-release/6406e-minister-for-finance-publishes-department-paper-entitled-future-proofing-the-public-finances-the-next-steps/

current headline GG surplus projected for 2026 would decline from €15.6 billion to €9.7 billion (4.6 per cent of GNI* to 2.8 per cent). This would leave the public finances in a significantly less favourable position at a time when fiscal pressures related to ageing and climate change will be increasing. The uncertainty over the sustainability of CT receipts means that they cannot be used to fund permanent spending. Any windfall receipts collected in the coming years should be saved, given the possibility that the exceptional increases in recent years are unlikely to continue indefinitely.

5.4 Implications for the public finances

The existence of the known future fiscal costs such as from ageing as well as the material risk of a loss of corporation tax has implications for fiscal policy decisions taken today. To ensure the public finances remain sustainable in future in the face of these additional new pressures, fiscal buffers should be increased when economic growth is strong and tax revenue is being boosted by corporation tax windfalls. This can be achieved by running budgetary surpluses or by saving a portion of government revenue into a savings fund. In this context, the Department of Finance's proposal to establish a new longer-term savings fund is welcome. This is a model which has been used successfully in other countries whose public finances have benefitted from revenue windfalls, for example Norway.

Providing the instalments to the fund would take place as planned and it is appropriately managed, saving excess corporation tax revenues would create resources that could be used to help offset some of the additional fiscal costs that will arise over the coming years, and especially from 2030 when ageing costs will increase substantially. This would reduce the extent of the tax increases or reductions in expenditure that would otherwise be required to meet these costs in the absence of the fund, but additional revenue raising measures are still likely to be needed.

Focussing only on ageing costs, the Department of Finance has produced a number of stylised scenarios to illustrate the extent to which the resources accumulated in a national savings fund could be used to fund additional age-related expenditure after 2030. The analysis shows that in a scenario where €70 billion of tax revenue is transferred to the fund between 2024 and 2030 and the fund earns an annual rate of return of 5 per cent, drawdown from the fund after 2030 would be sufficient to meet around 78 per cent of the increase in age-related expenditure from that date. If a lower 3 per cent rate of return is assumed, drawdowns would cover 43 per cent of the estimated increase in spending. Similarly, IFAC (2023) considers a scenario whereby

€30.5 of windfall corporation tax receipts are transferred to a savings fund between 2023 and 2025 and assess the implications for required changes in employer and employee PRSI. In this case, the analysis indicates that the combined employee and employer (higher) rate of PRSI would need to be raised by over 2 percentage points from the end of this decade, compared to an estimated increase of just under 3.5 percentage points in the baseline in the absence of any accumulated CT windfall savings.

Taken together, this work indicates that even in a favourable scenario where substantial amounts of windfall corporation tax is saved over the coming years, this would not be sufficient to cover the full estimated cost of additional age-related expenditure after 2030. Since age-related spending represents only one of a number of additional demands that will be placed on the public finances in the coming years, this points to the importance of ensuring at a minimum that windfall corporation tax receipts are saved over the coming years. At the same time, it would be prudent to consider options for broadening the tax base that would result in an increase in government revenue as a share of national income, in line with the recommendations of the Commission on Taxation.[30] This is because additional tax revenue, along with resources from the reserve fund, are likely to be required to meet the full fiscal costs of ageing, climate change and digitalisation.

5.5 The role of public capital investment

Public capital investment has an important role to play in helping to alleviate current supply-side bottlenecks in the economy, in particular in housing and other infrastructure. As noted above, increases in public (and private) investment will also be needed to ensure Ireland meets its climate change targets and to assist firms and households with the transition to a low-carbon economy. Targeted and productive government investment differs from government consumption as it contributes to the stock of public capital, which can have a longer lasting impact on the economy. While estimates of the effect of public capital on growth vary – and depend on

[30] See https://www.gov.ie/en/publication/7fbeb-report-of-the-commission/#:~:text=agus%20Liosta%20Molta%C3%AD-,Foundations%20for%20the%20Future%3A%20Report%20of%20the%20Commission%20on%20Taxation,in%20the%20Programme%20for%20Government.

factors such as the composition and efficiency of spending – the literature typically finds a positive relationship between the two.[31]

The National Development Plan (NDP) published in October 2021 set out total nominal capital expenditure of €165bn from 2021 to 2030. Since the publication of this plan, real capital spending forecasts have changed considerably.[32] In addition to the impact of inflation (Figure 18), revisions to nominal General Government investment spending have affected the level of real government investment projected to be undertaken over the coming years. This effect primarily stems from developments in 2021 (Table 3) when pandemic-related issues contributed to much weaker actual investment growth (0.8 per cent) than had been anticipated in the SPU that year (forecast of 13.4 per cent growth). This lower than expected investment level has carried through the rest of the forecast years, despite the growth rates in later years actually being revised up since 2021.

Table 3: General Government investment spending projections (nominal), 2021 - 2023

		2020	2021	2022	2023	2024	2025
Levels	SPU 2021	9,795	11,105	12,295	13,355	14,350	14,840
	SPU 2023	8,638	8,709	9,980	10,965	12,050	13,200
Growth Rates	SPU 2021		13.4%	10.7%	8.6%	7.5%	3.4%
	SPU 2023		0.8%	14.6%	9.9%	9.9%	9.5%

Source: Stability Programme Updates

Combining the effect of the downward revisions to nominal General Government capital expenditure along with the impact of higher than expected inflation, the level of real public investment from 2022-2025 is now projected to be €3 billion lower per annum on average than had been expected in 2021 (Figure 19). Nominal public capital spending is also projected to be smaller as a share of national income out to 2025. Under the original NDP, published in 2018, public capital spending was expected to increase to just above 5 per cent of GNI* by 2025 but this has been revised down to 4.2 per cent in the most recent SPU 2023 forecasts. With a reduced level of real expenditure now expected out to 2025, the actual delivery of specific projects will be lower than originally planned under the NDP. This

[31] Ivory et al. (2019) surveys the literature on estimating the impact of different forms of public spending and provides estimates for Ireland. See also Broner et al. (2019) and Hickey et al. (2018).
[32] National Development Plan, 2021 – 2030, Table 4.1

points to the need for careful planning and management of capital spending over the coming years to identify priority projects.

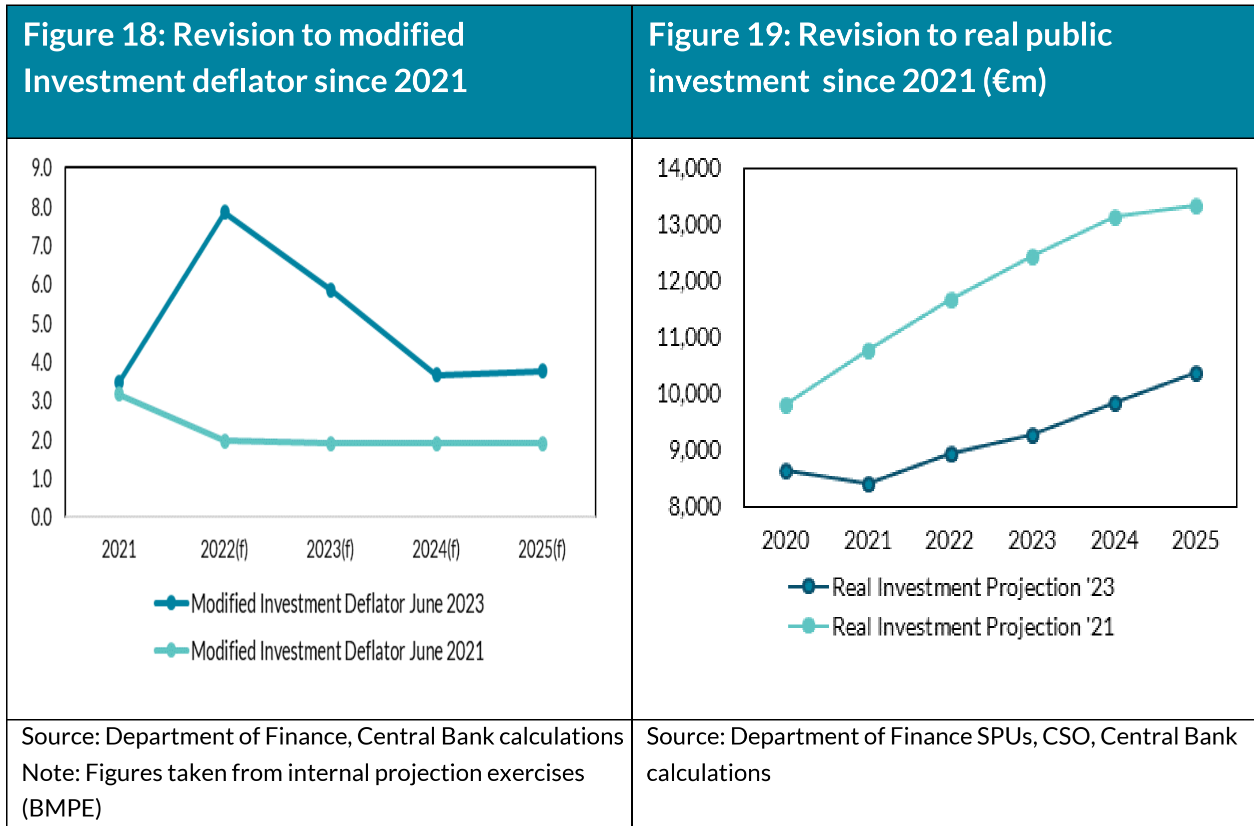


Figure 18: Revision to modified Investment deflator since 2021

Source: Department of Finance, Central Bank calculations
Note: Figures taken from internal projection exercises (BMPE)

Figure 19: Revision to real public investment since 2021 (€m)

Source: Department of Finance SPUs, CSO, Central Bank calculations

Despite the recent downward revisions, public capital spending is still projected to grow strongly in the coming years with nominal spending forecast to increase by just under 10 per cent on average between 2023 and 2025 (Table 3). These planned increases in public capital spending need to be considered in the wider context of conditions in the economy. In particular, with inflation still high and the labour market at full employment, how public investment is financed takes on added significance.

To illustrate the importance of financing decisions we use the Central Bank's Dynamic General Equilibrium model to analyse the effects of an increase in government investment on economic output, inflation and the public finances in Ireland. This exercise draws on previous analysis by Hickey et al. (2018).[33] The central scenario in the model assumes that government investment spending increases in line with the SPU 2023 projections out to 2026, after which the growth in public investment returns to close to its long-run average rate. Whilst the model necessarily simplifies some real

[33] See https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/quarterly-bulletin-signed-articles/irish-government-investment-financing-and-the-public-capital-stock-(hickey-lozej-and-smyth).pdf?sfvrsn=2

world behaviour, it provides useful insights into the channels through which public investment spending affects the wider economy.

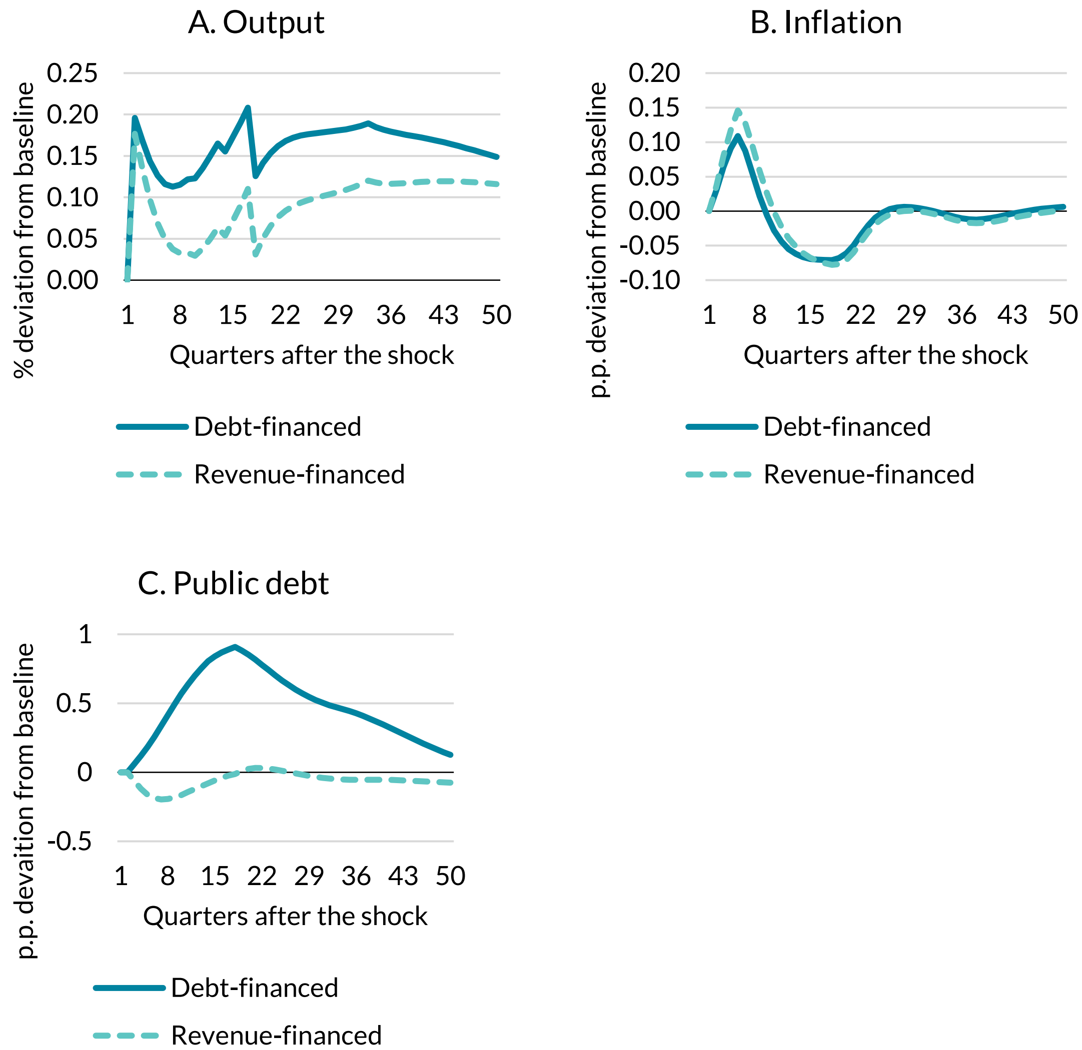
Two scenarios are considered for the increase in public investment: (i) where expenditure is financed fully by issuing debt and (ii) where the increase in government spending is offset by a discretionary increase in tax revenue, so that the spending is ex-ante budget neutral (dashed line).[34] As noted in Section 4, if the additional capital spending was funded by windfall corporation tax, the effect on the economy would be the same as in the case where the spending is debt financed.

The impact of the increase in increase in public investment is shown in Figure 20. The rise in public investment boosts the stock of public capital which increases by around 5 per cent at peak. This investment leads to higher levels of output in the medium and long-term in both scenarios (panel (A)), consistent with the positive relationship between public capital and growth discussed above. Finally, in the case of debt-financed investment, the level of public debt increases before gradually returning to its long-run level (panel (C)).

Crucially however, the magnitude of output increases in the near term in the debt-financed case are significantly larger than in the case of a budget-neutral approach. In the medium run, this causes higher inflation, and for a longer period of time, than in the tax-financed case. If windfall corporation tax was used to fund the additional spending rather than borrowing, the same macroeconomic effects would hold relative to the budget-neutral case. This is because in the budget-neutral scenario higher taxes restrain the growth in domestic demand (consumption and (private) investment) thereby partly offsetting higher government expenditure. In both scenarios the increase in public investment leads to higher employment in the short run. The strong increase in employment with debt financing would contribute to wage and price pressure in the economy and potentially erode its competitiveness. While these are stylised examples, they are important in that they highlight potential risks of overheating dynamics emerging, particularly for an economy already at full employment.

[34] As for the analysis in Section 4, the choice of income tax is a purely technical assumption and in reality, a range of revenue-raising measures could be considered including changes to broaden the tax base.

Figure 20: Effect of an increase in public investment financed by debt and budget-neutral (revenue) financing



Source: authors' calculations.

6. Conclusions

The headline budget balance moved into surplus last year, despite the introduction of new temporary expenditure measures to address cost of living pressures. The latter occurred just as previous pandemic-related spending was being reduced. The improvement in the headline budget balance – making Ireland one of only five euro area countries to record a surplus last year – was driven by a number of temporary exceptional factors, in particular further growth in windfall corporation tax. Stripping this out, the budget remained in deficit last year. While the headline budget balance is expected to move further into surplus over the coming years, much of the improvement is expected to be driven by economic activity. The underlying structural balance – a measure of the budgetary position excluding the

effect of the economic cycle and windfall CT – is projected by the Department of Finance to remain broadly unchanged between 2023 and 2025, consistent with a neutral fiscal stance over this period.

Accordingly, any additional government spending or tax cuts – above those that underpin the Government's current fiscal forecasts – could result in a stimulatory fiscal stance at a time when the economy is already growing at or above full capacity. Model-based analysis presented in this *Article* shows that permanent increases in current spending or tax cuts over and above existing plans would slow down the improvement in the public finances. Moreover, the analysis indicates that the additional demand stimulated by this higher spending or tax reductions would add to inflationary pressures in an economy already at full employment. These risks would be heightened if expenditure was increased in the absence of offsetting revenue-raising measures. This points to the need to ensure that any additional current expenditure above existing plans, such as to address ongoing cost of living pressures, do not result in a more accommodative fiscal stance overall. Indeed, even under existing plans there is a risk of overheating pressures emerging given, in particular, conditions in the labour market. If evidence of more pronounced overheating pressures emerges, it may be necessary to consider reducing net spending growth to below the 5 per cent currently planned from 2024 to 2026. This could be achieved by introducing measures to raise government revenue as a share of national income.

In the coming years, a number of underlying structural changes will place increasing demands on the public finances. The most readily quantifiable of these is the fiscal impact of ageing which is projected to result in an increase in public spending of almost 10 per cent of national income by 2030 compared to 2019. Other changes include the fiscal impact of the transition to a low carbon economy and digitalisation, both of which are likely to require increases in public expenditure in the coming years. Meanwhile, there is a significant structural risk to government revenue arising from the uncertainty over the sustainability of current windfall corporation tax. If half of the estimated windfall CT receipts over the period 2023-25 were to be lost, the headline budget surplus projected for 2025 would drop from over €16 billion to below €10 billion.

These known future fiscal demands mean that there is a necessity to save any unexpected revenue windfalls over the coming years. By saving rather than spending unexpected revenues, this reduces the risk of fiscal policy adding to overheating pressures given the current macroeconomic environment. Such an outcome would ensure that the stance of both

monetary and fiscal policy work in tandem to reduce inflationary pressures. Moreover, it ensures that resources are accumulated in the coming years when revenue growth is expected to be strong that can then be used to part finance the additional government spending on ageing and climate that will be required in the coming years. In this context, the Department of Finance's proposals for the establishment of a long-term savings fund are welcome. Provided the instalments to the fund would take place as planned and it is appropriately managed, the resources available would reduce the extent of future tax increases needed to address the structural challenges ahead.

Even under the assumption that significant amounts of excess corporation tax are saved in a long-term fund in the coming years, the fund is unlikely on its own to be sufficient to meet the full extent of the new fiscal demands that will emerge after 2030, particularly from ageing. In this context, it may be prudent to consider introducing measures that would contribute to increasing government revenue as a share of national income and broadening the tax base, in line with the recommendations of the Commission on Taxation. In the short run, this could help to ease inflationary pressures while public capital spending is being ramped up while at the same time helping to create a more sustainable tax revenue base and more resilient public finances with which future fiscal challenges can be addressed.

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