Fiscal Assessment Report

June 2023

Managing corporation tax inflows and capacity constraints

Irish Fiscal Advisory Council

Foreword

The Irish Fiscal Advisory Council was established as part of wider reforms of Ireland's budgetary architecture. It was set up on an administrative basis in July 2011 and was formally established as a statutory body in December 2012 under the Fiscal Responsibility Act. The Council is a public body, with the terms of its funding set out in the Fiscal Responsibility Act.

The Council's mandate is to:

- Endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update (SPU) are based.
- Assess the official forecasts produced by the Department of Finance.
- Assess government compliance with the Budgetary Rule.
- Assess whether the Government's fiscal stance set out in each SPU is conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact (SGP).

The Council's Chairperson is Mr Sebastian Barnes. The other Council Members are Professor Michael McMahon, Ms Dawn Holland, Dr Adele Bergin, and Mr Alessandro Giustiniani. The Council's Secretariat consists of Dr Eddie Casey, Mr Niall Conroy, Mr Kevin Timoney, Mr Killian Carroll, Ms Karen Bonner, and Mr Brian Cronin. The Council would like to acknowledge the kind help from staff at the Central Statistics Office (CSO), Central Bank of Ireland, Economic and Social Research Institute (ESRI), and the National Treasury Management Agency (NTMA).

The Council submits its Fiscal Assessment Reports (FARs) to the Minister for Finance and within 10 days releases them publicly. This report was finalised on 2 June 2023. More information on the Irish Fiscal Advisory Council can be found at www.FiscalCouncil.ie.

978-1-8381309-6-1

Contents

Boxes

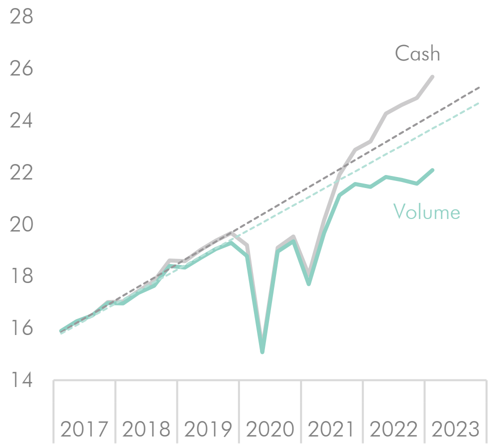
Summary Assessment

Summary assessment

After slowing over winter, Ireland's growth looks set to recover as inflation eases. While high price increases and an uncertain outlook softened the volume of consumer spending in 2022, a rapid recovery following the pandemic has led to once-in-a-generation low unemployment rates. The Government forecasts that real GNI* growth will be just 1.7% in 2023, before recovering to 2.1% in 2024 and 2.5% in 2025.

Capacity constraints have emerged, with the jobs market exceptionally tight. Capacity constraints are now a major challenge. Few construction workers are unemployed, housing output appears to have slowed, and wage and rent pressures could yet prove more persistent.

Consumer spending
€ billion, seasonally adjusted

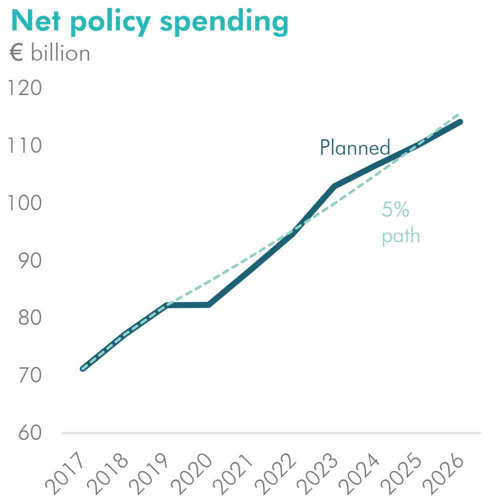


The Government's underlying deficit, excluding excess corporation tax receipts, is projected to narrow to 0.6% of GNI* this year. Some €1.2 billion (0.4 % GNI*) of ad-hoc fiscal supports were introduced in February for businesses and households facing higher prices. However, these are expected to be met within the existing Budget allocations. More transparency is needed around within-year measures like these. Moreover, the justification for such supports is waning as they are poorly targeted and energy prices are falling.

In 2024, the Government expects to run its first underlying surplus in 17 years, when excess corporation tax receipts are excluded. The projections assume the Government sticks to its National Spending Rule. This implies a fall in the net debt-to-GNI* ratio of 23 percentage points between end-2022 and end-2026 (from 69% to 46%). Windfall corporation tax receipts contribute about 16 percentage points of the overall decline, helped by relatively high inflation and robust growth.

Exceptional inflows of corporation tax receipts from foreign multinationals are boosting the public finances. Excess corporation tax receipts, those beyond what can be explained by domestic activity since 2014, now account for €11 billion of annual receipts (4% of GNI*). New research shows that just three corporate groups accounted for one-third of corporation tax receipts over the past five years (Cronin, 2023). This concentration entails a high risk of reversals due to firm-specific risks and changes to the international tax environment. Moreover, the receipts — when spent — represent a net injection of money into the economy as they are based on overseas profits rather than being taken out of domestic activity.

The Government does not appear to have factored in spending pressures fully, and it faces some difficult choices. The measures needed to address climate objectives do not appear to be factored into official plans in full and could be sizeable. In addition, current spending increases in 2024 and 2025 do not appear to fully accommodate demographic and price pressures, falling short by €1.1 billion per year on average. This implies limited scope for additional spending without offsetting tax increases or spending reductions elsewhere.



Against this background, the Council assesses that:

- The Government should stick to its National Spending Rule. This is warranted given the exceptionally tight labour market, high inflation, capacity constraints, and the risks related to tax receipts. The rule limits net spending growth to 5% each year so that permanent policy measures match trend growth rates and are broadly sustainable. Following the rule helps to stabilise activity in the economy and avoid fuelling further price pressures at a time of capacity constraints.

- The Government needs to make choices between new tax and spending measures and how much it maintains existing spending. Under the rule, there is little space once the Stand-Still costs of maintaining existing policies are taken into account. Going beyond this, without offsetting tax increases or spending cuts, risks repeating the mistakes of the 2000s. It would mean using temporary revenues from corporation tax and an economy at full employment to finance permanent expansions. It also risks fuelling further price and wage increases, given how tight the labour market is. With capacity constraints, additional investment may not provide value for money. Instead, the Government should explore ways to alleviate capacity constraints, including through fiscal tightening elsewhere.

- The Government has made important steps towards long-term planning, but further improvements are needed. The Council welcomes the Government extending its macroeconomic forecasts to 2030. However, the budgetary forecasts are only to 2026 — the minimum required. This makes it impossible to fully assess how sustainable the Government's medium-term fiscal plans are. It comes at a time when ageing and climate change pressures are deepening. Lengthening the budgetary forecasts would help improve long-term planning in Ireland.

- The Council welcomes proposals for a new national savings fund. This could represent a landmark reform. It would put excess corporation tax receipts to good use and reduce the need for tax increases or spending cuts to fund pension shortfalls in future years.

- The Government should reinforce its National Spending Rule as a "first line of defence". The Government's National Spending Rule has proven to be a useful anchor. With Ireland likely to face less scrutiny under the new EU fiscal rules, the National Spending Rule takes on more importance as a local safeguard. It should be reinforced in several ways as outlined in a new Analytical Note (Casey and Cronin, 2023), including by putting it on a legislative basis, having a debt anchor, and widening it to capture general government spending.

Summary Table of *SPU 2023* Economic and Budgetary Projections

% GNI* unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025	2026
Macro forecasts								
Real GNI* growth (%)	2.8	-4.6	15.4	9.3	1.6	2.1	2.5	2.3
Nominal GNI* growth (%)	8.6	-5.1	16.9	15.3	5.3	4.9	5.2	5.2
Nominal GNI* (€bn)	211	200	234	270	284	298	313	330
HICP growth (%)	0.9	-0.5	2.5	8.1	4.9	2.5	2.0	2.0
Output gap (% of potential)	3.5	-4.2	-2.5	1.6	1.4	1.1	1.2	1.3
Potential output growth (%)	3.0	-0.9	3.2	3.8	1.8	2.3	2.4	2.3
Budgetary forecasts								
Balance excl. excess corporation tax	-0.6	-11.7	-5.0	-1.0	-0.6	1.5	2.1	2.6
Balance	0.8	-9.3	-2.9	3.0	3.5	5.4	5.8	6.3
Balance (€ billion)	1.7	-18.7	-6.8	8.0	10.0	16.2	18.1	20.8
Balance excl. one-offs [1]	0.8	-1.7	2.5	6.0	5.6	5.6	5.9	6.3
Balance excl. one-offs [1] (€ billion)	1.7	-3.5	6.4	16.3	16.0	16.7	18.4	20.8
Revenue excl. one-offs [1]	41.9	41.9	42.3	43.1	43.8	43.4	43.1	43.2
Expenditure excl. one-offs [1]	41.1	43.6	39.9	37.0	38.2	37.8	37.3	36.9
Primary balance excl.one-offs [1]	3.0	0.2	3.9	7.3	6.8	6.8	6.9	7.4
Revenue growth excl. one-offs [1] (%)	6.4	-5.1	18.2	17.3	6.9	4.0	4.5	5.3
Primary expenditure growth excl. one-offs[1] (%)	6.1	1.8	7.8	7.4	8.5	4.0	3.9	4.1
Gross debt ratio (% GNI*)	96.5	108.9	101.0	83.3	78.8	75.4	70.4	65.4
Net debt ratio (% GNI*)	82.7	93.0	82.4	68.7	64.7	58.4	52.3	46.0
Gross debt (€ billion)	203	218	236	225	223	224	220	215
Cash & liquid assets (€ billion)	29	32	43	39	40	51	57	64
Net debt (€ billion)	174	186	193	185	184	174	164	151
Fiscal stance								
Structural primary balance[2]	1.4	0.8	-0.3	3.0	2.0	2.5	2.6	3.2
- change (p.p.)		-0.6	-1.1	3.3	-0.9	0.5	0.1	0.6
Net policy spending growth (%)	5.4	0.1	7.3	6.9	8.6	3.5	3.2	3.6
Real net policy spending growth (%)	4.5	0.6	4.8	-1.0	3.6	1.0	1.2	1.5
Change in net debt ratio (p.p.)	-8.6	10.3	-10.6	-13.7	-4.0	-6.3	-6.1	-6.3
Fiscal rules								
Spending Rule	✓	xc	xc	xc	xc			
Structural Balance Rule	✓	xc	xc	xc	xc			
Overall Assessment	✓	xc	xc	xc	xc			

Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.

Notes: Output gaps and potential output estimates, including those used for the structural balances, are based on the Department of Finance's preferred alternative estimates. xc = Exceptional circumstances apply for these years, meaning that a temporary deviation from the requirements of the fiscal rules is allowed. [1] These figures exclude one-offs. One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. These include Covid-related expenditure and expenditure and revenue related to the EU funds for the Brexit Adjustment Reserve and the National Recovery and Resilience Plan. [2] This is based on the Council's own "bottom-up" estimates of the structural primary balance.

Macro Assessment

The economy has been resilient but capacity constraints are binding

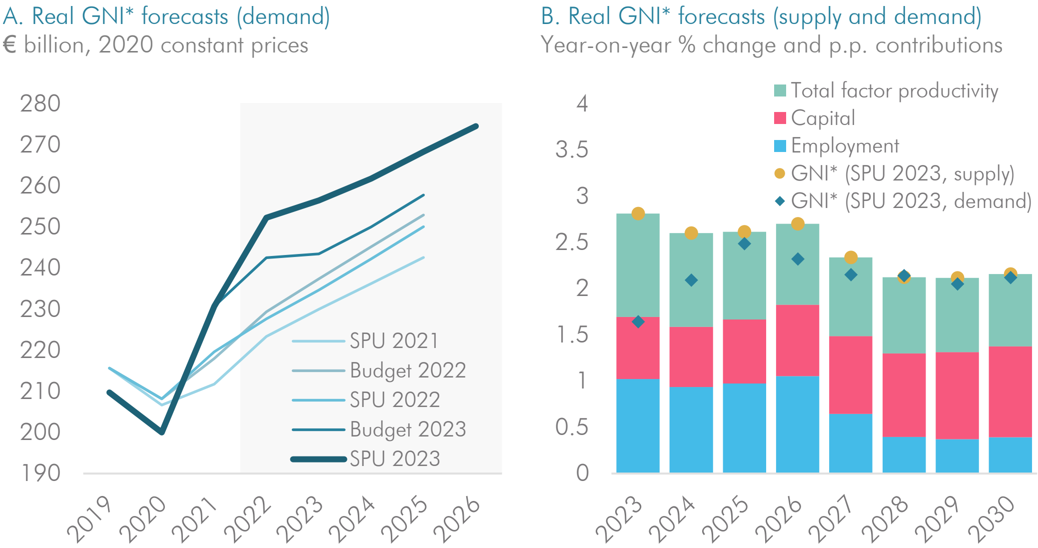
1. MACRO ASSESSMENT

The economy has been resilient but capacity constraints are binding

Growth has been resilient. Despite the impact of much higher inflation in 2022, the Irish economy grew more rapidly than expected. Reflecting stronger momentum, and a lower expected path for inflation in 2023, the Department of Finance increased their forecast for real GNI* growth in the *Stability Programme Update 2023* (*SPU 2023*). As a result, the level of real GNI* is expected to be higher over the next few years than implied by prior forecasts (Figure 1.1A). However, capacity constraints and the likelihood of a global recession are reflected in the Department's expectation that economic growth will slow considerably this year.

Despite higher inflation in 2022, the Irish economy grew more rapidly than expected

Figure 1.1: Ireland's economy is projected to stay resilient



Sources: Department of Finance and CSO. Get the data.

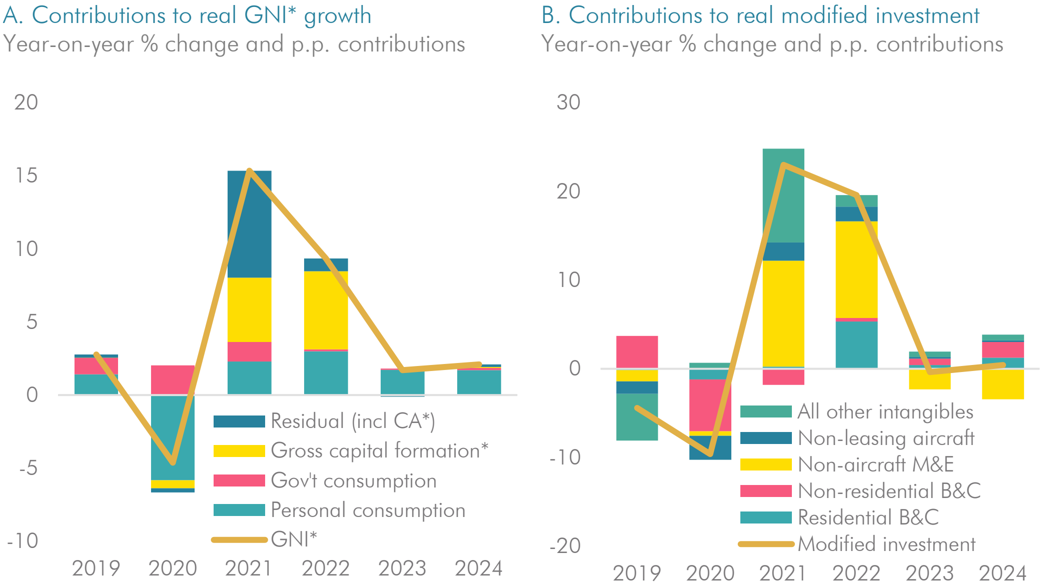
For the first time, the Department has extended its forecasting horizon for its macroeconomic projections to seven years ahead. This is welcome and provides useful insights into how the economy will evolve in the years ahead. In assessing how the economy will evolve out to 2030, it has utilised a growth accounting framework like that used by the Council in its *Long-term Sustainability Report* (Fiscal Council, 2020b). This provides a supply-side complement to the standard demand-side forecasts. The Department projects that real GNI* growth rates will moderate to just over 2% by the end of the decade, reflecting an expected slowdown in the contribution of employment to economic growth (Figure 1.1B).

The Department has extended its forecast horizon

1.1 The short-term economic outlook (2023 to 2024)

The Irish economy grew rapidly in 2022, after a double-digit expansion in 2021, reflecting a strong recovery from the Covid-19 pandemic on economic activity. Figure 1.2A shows that most of the estimated economic growth in 2022 was driven by modified gross capital formation.[1] Within this, modified investment mainly grew as a result of non-aircraft machinery and equipment (M&E). In a recent Analytical Note, Casey (2023) used detailed imports data to show that this can be explained by M&E investment for high-tech computer manufacturing. The Department anticipates a fall in such investment in 2023 and 2024, albeit from an exceptionally high level in 2022.

Figure 1.2: The SPU forecasts a slowdown in real GNI* growth in 2023 and 2024, driven by lower spending on modified investment



Sources: Department of Finance, CSO, and Fiscal Council workings. Get the data.
Notes: Modified gross capital formation is modified gross fixed capital formation (see footnote 1) and the value of physical changes in stocks. M&E stands for machinery and equipment, while B&C stands for building and construction.

While household consumption grew rapidly in 2022 — by 6.6% according to the CSO — there are concerns that the recovery from the pandemic has been underestimated in official statistics (Timoney, 2022), and that CSO estimates of the level of consumption are too low. This would imply that the household savings ratio has not remained considerably higher than its pre-pandemic levels, as CSO data shows. Figure 1.3A shows that real household consumption excluding cars in the official data has been slower to recover compared to inflation-adjusted cards spending and ATM withdrawals. The path for real cards spending and ATM withdrawals weakened in the second half of 2022, before rebounding somewhat in Q1 2023. Similarly in nominal terms, household consumption expenditure has

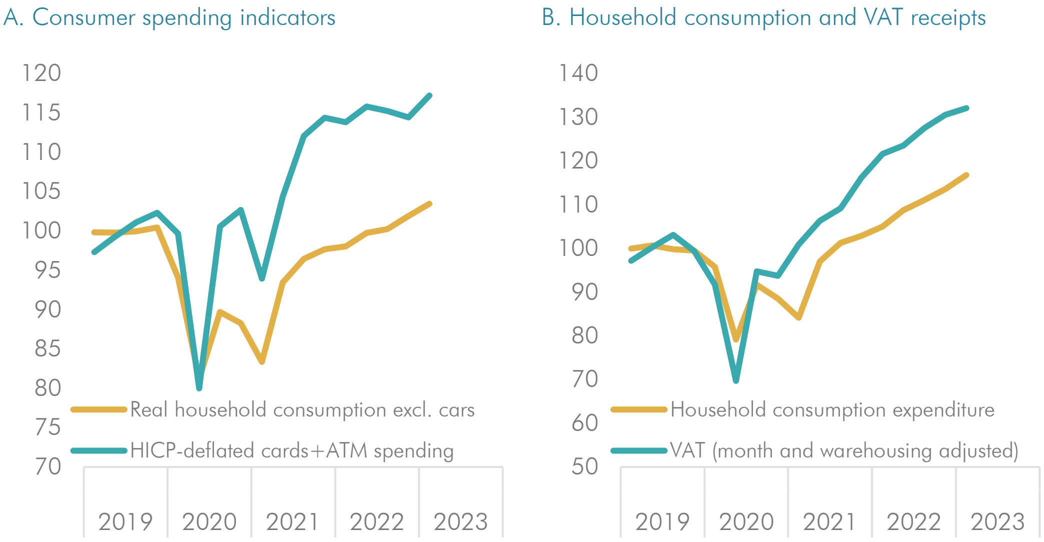
Official data on consumer spending appear low and savings rates too high, implying less scope for "catch-up" growth

[1] These modifications relate to two components of gross fixed capital formation: aircraft for leasing is excluded from machinery and equipment, while expenditure on research and development service imports and trade in intellectual property are excluded from intangibles.

recovered far more slowly in the CSO data compared to VAT receipts (Figure 1.3B).

Figure 1.3: Cards spending and ATM withdrawals grew in Q1 2023, while VAT has recovered more rapidly than household consumption

2019 = 100, seasonally adjusted



Sources: Department of Finance, Eurostat, and Fiscal Council workings. Get the data.

A higher level of consumption and a lower savings ratio could imply less capacity for "catch-up" growth in consumption over the medium term, posing downside risks to the Department's near-term forecasts for consumption growth. Following the approach in Timoney (2022), the faster recovery in cards/ATM spending and stronger VAT receipts imply a nominal level of household consumption about €16 billion higher in 2022 compared to the latest CSO estimates.[2]

Inflation has slowed as energy prices have fallen

Inflation in Ireland has slowed relative to the near-double-digit rates seen in 2022 following Russia's invasion of Ukraine (Figure 1.4A). This price deceleration has been mainly a result of lower energy prices, and despite persistent food price increases. The *SPU 2023* projections assume limited further reductions in consumer energy prices by end-2024. This forecast is based partly on the oil and gas futures, and partly on judgement that these changes will only slowly translate into prices paid by consumers, owing to hedging strategies of energy suppliers and pricing mechanics. Wholesale energy prices have decreased considerably in recent months (Figure 1.4B), towards a mid-2021 level. This could imply that consumer energy prices will fall by more than forecast in *SPU 2023*. However, energy prices are inherently volatile, and uncertainty about their path and other aspects of inflation remains very high.

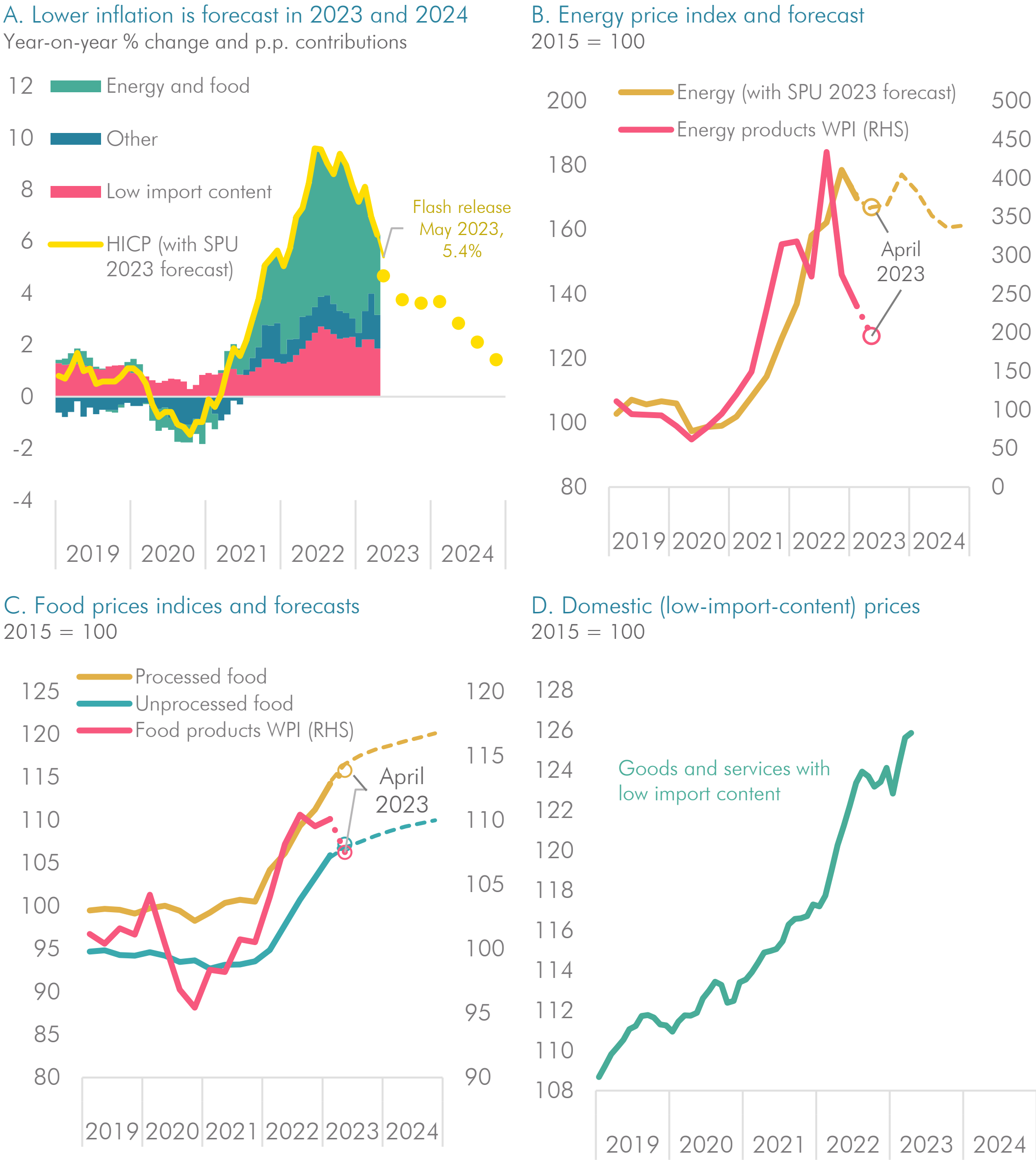
[2] As discussed in a forthcoming paper by Timoney (2023), this need not imply an underestimate of GNI*, since household incomes are not the subject of uncertainty.

SPU 2023 forecasts show a continuous rise in food prices over the near term (Figure 1.4C). However, recent wholesale price signals suggest that prices for food products may have peaked around mid-2022. Lower energy prices could ultimately result in lower food prices.

However, the pass-through of past price increases in inputs and capacity constraints in the domestic economy could lead inflation to remain higher than expected. For low-import-content items that reflect domestic developments more closely (Figure 1.4D), price inflation has been quite fast in recent months. As noted in the November 2022 *FAR*, over half of the low-import-content basket is explained by two components: restaurants, cafés and the like, and actual rentals for housing.

However, past input price increases and capacity constraints could keep inflation higher than expected

Figure 1.4: Headline inflation recedes amid signs of domestic pressures



Sources: Department of Finance, Eurostat, and Fiscal Council workings. Get the data.

High domestic inflation for rents and restaurants reflect an economy that is growing rapidly. Domestic economic activity in Ireland is boosted by foreign-owned multinational firms, paying employee wages and corporation taxes, although their after-tax profits mainly belong to owners abroad.[3] As sectors in which the foreign-owned multinational firms operate have grown, high wages and tax receipts have significantly added to Ireland's national income. These factors also encourage workers abroad to move to Ireland, which further adds to demand, while also increasing the supply of labour.

Domestic price pressures are evident and signal rapid growth and capacity constraints

Domestic inflation pressures can reflect an economy that is running into capacity constraints, as discussed by Conroy, Casey, and Jordan-Doak (2021). As higher wages are spent, and the population rises, it is plausible that domestic price pressures would materialise in a small open economy like Ireland — even if many goods can be sourced internationally. Rent is an important example of this, since dwellings are significantly undersupplied.[4] If domestic inflation for rents remains high as a result of insufficient dwellings construction, Ireland's attractiveness as a location for inward migration by workers abroad is likely to be diminished. At the same time, the shortage of rental accommodation could lead to an increase in emigration.[5] These related challenges are discussed further regarding the medium-term outlook for the Irish economy (Section 1.2).

The labour market is exceptionally tight

The labour market is exceptionally tight at present. At 3.8%, unemployment in May 2023 reached a record low, while wage growth remains relatively contained. The employment-to-population ratio continues to trend upwards, and is now at a record high (Figure 1.5A). Job vacancy levels are high (Figure 1.5B), and firms report difficulty in hiring sufficient labour (S&P Global, 2023). A number of factors could explain the increase in participation since the pandemic. For example, added flexibility due to remote working could be facilitating more people to seek employment. Higher participation has reduced the female unemployment rate to a record low of 3.4%, and net migration has strengthened after a dip during the pandemic. The high cost of living, especially with respect to rents, could also be resulting in more people entering the labour force. Employment growth is forecast to slow to 1.6% this year, and to 1.4% in 2024. However, there are upside risks to this year's forecast, given a strong Q1 2023 implies a growth carry-over of 3% — that is, if employment does not change for the remainder of 2023.

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[3] FitzGerald (2021) estimates that for 2013–2019, 22% of Ireland's net national product (adjusted for re-domiciled PLCs) is attributable to foreign multinationals operating in the Irish economy — whereas the same firms account for over 50% of Ireland's gross value added.

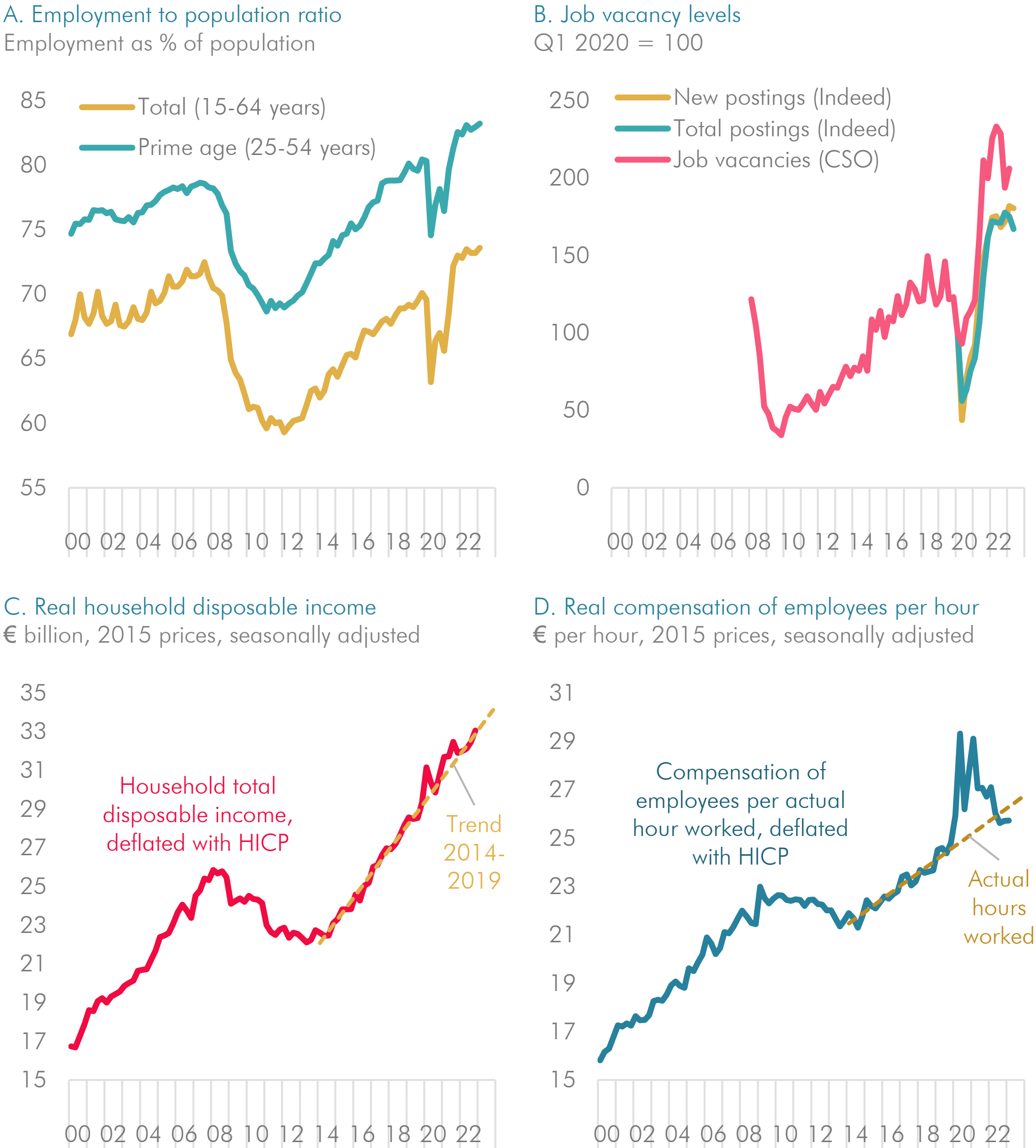
[4] Lyons (2023) recently estimated that Ireland is short as many as 200,000 rental units.

[5] Although there was no indication that a fall in net inward migration had taken place during the year to April 2022, the Covid-19 pandemic continued to have a major impact on international travel during the period.

Despite higher inflation since 2021, aggregate real household disposable income remains close to its pre-pandemic trend (Figure 1.5C). This reflects the fact that real aggregate compensation of employees per hour is close to trend, and well above its end-2019 level (Figure 1.5D), reflecting strong nominal growth in aggregate incomes. These indicators help to assess real income developments in the Irish economy at an aggregate level. However, it is always important to recognise that many households have experienced a decline in real incomes due to higher prices for energy, food, and rents — particularly for workers that have stayed in the same job and experienced only moderate wage growth. As such, contrasting experiences for different cohorts can be masked by aggregates or averages.

On average, incomes, when adjusted for inflation, remain near their pre-pandemic trend

Figure 1.5: The labour market remains very tight, and real household disposable income and hourly wages remain resilient



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

While an expected recession in advanced economies in early 2023 has not yet materialised, recent International Monetary Fund and European Commission forecasts remain largely downbeat about prospects for Ireland's main trading partners. Amid fragilities in the financial sector in particular, the risks of recession in the United States have increased. This increases the risk of a slowdown elsewhere, in the context of the recent tightening in global monetary conditions and sharp increases in interest rates worldwide.

Forecasts remain largely downbeat about prospects for Ireland's main trading partners

External demand is a crucial factor for exporting sectors of the Irish economy — especially for tourism and food in a regional sense. Two sectors that performed particularly well despite weaker overall external demand during the Covid-19 pandemic were information and communication technology (ICT) services and pharmaceuticals manufacturing. Since mid-2022, however, thousands of ICT job losses have been announced. Box A investigates recent developments for these sectors, which broadly appear to be more benign than feared.

Box A: Recent developments in the ICT and pharmaceuticals sectors

This box examines recent developments for two key high-skill sectors in the Irish economy: information and communication technology (ICT) services, and pharmaceuticals manufacturing.

The Irish economy recovered faster and more strongly than expected from the Covid-19 pandemic, and some of this resilience is down to relatively strong performances globally by ICT and pharmaceuticals. Demand for these sectors' products increased during the pandemic, helped by a shift towards remote working and rapid vaccine development. Ireland was well-positioned to benefit from this global demand, and many foreign-owned multinationals continued to invest significantly in Ireland despite the pandemic.[6]

One concern is that a partial reversal of the strong performance in these sectors could occur. This is especially possible for ICT, as tens of thousands of job losses have been announced globally by a broad range of companies, many with a presence in Ireland (Figure A1). For pharmaceuticals, demand for Covid-19 vaccines is much reduced and the World Health Organisation recently declared that Covid-19 no longer constitutes an international public health emergency.

Figure A1: Global ICT layoffs peaked in January

Thousands of layoffs (LHS) and number of companies announcing layoffs (RHS)

Source: LayoffsTracker.com. Get the data.

[6] For example, Pfizer invested €300 million and 300 new jobs in November 2020: https://www.pfizer.ie/media/pfizer-announces-300-million-investment-in-irish-operations

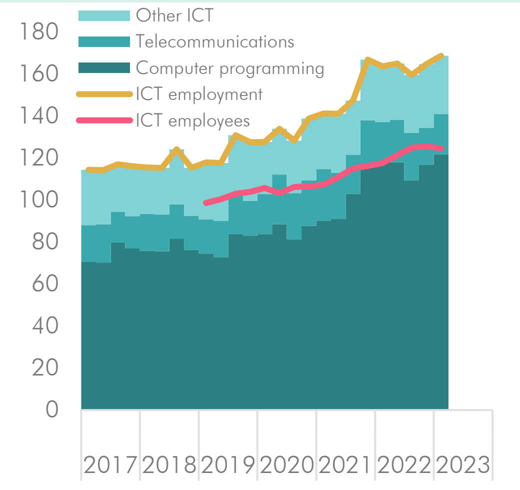
Yet indicators show employment levels in Ireland for ICT and pharmaceuticals achieved during the pandemic have been maintained into early 2023 — for both the *Labour Force Survey*, and employees data (Figure A2). Some workers in Ireland have lost their jobs, but a high level of job vacancies (Figure A3) has provided some opportunities for a return to employment, or perhaps for a substitution of others into these sectors. In net terms, this has so far meant no significant reduction in employment levels.

Conefrey *et al.* (2023) estimated that over 2,300 layoffs had affected Ireland's ICT sector for the year to February 2023. However, CSO data show just over 2,000 job vacancies in ICT on average across Q1–Q4 2022, implying a reasonable capacity for the sector to absorb the announced job losses. Despite this, a less sanguine scenario would depend on the extent to which there is a mismatch between skillsets for job vacancies and those laid off.

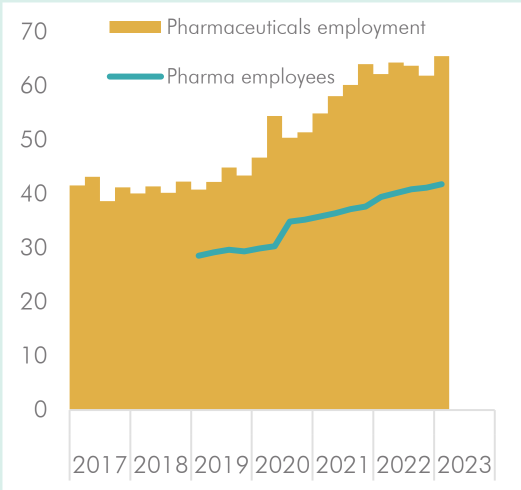
Figure A2: Employment levels in ICT and pharmaceuticals remain high

Thousands, not seasonally adjusted

A. ICT employment



B. Pharmaceuticals employment

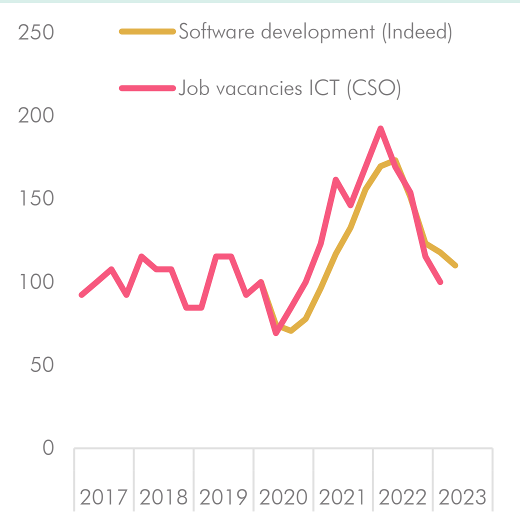


Sources: CSO, and Fiscal Council workings. [Get the data.]
Notes: We thank the CSO for providing the employees in pharmaceuticals series on request.

Figure A3: Elevated job vacancies have helped maintain employment levels

Q1 2020 = 100, not seasonally adjusted (CSO) and seasonally adjusted (Indeed)

A. ICT job vacancies



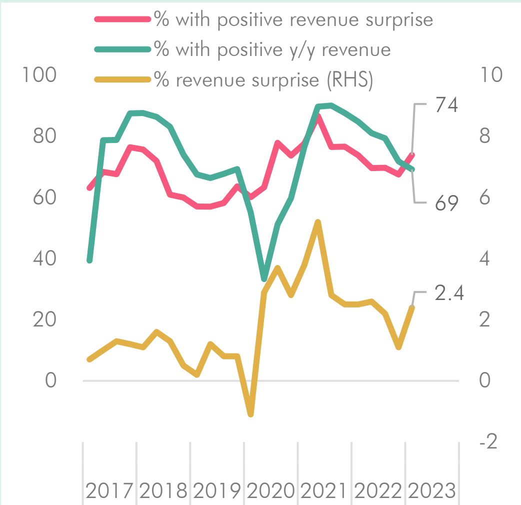
B. Pharmaceuticals job vacancies

Sources: CSO, Indeed, and Fiscal Council workings. [Get the data.]
Notes: We again thank Indeed for providing the job vacancies in ICT and production/manufacturing series on request. The closest available matches for job vacancies data in pharmaceuticals are for production and manufacturing on Indeed, and for Industry (sectors B to E) for the CSO's earnings, hours, and employment costs (EHECS) data. As January 2020 data are not available, February and March 2020 Indeed data are used in place of the full Q1 data.

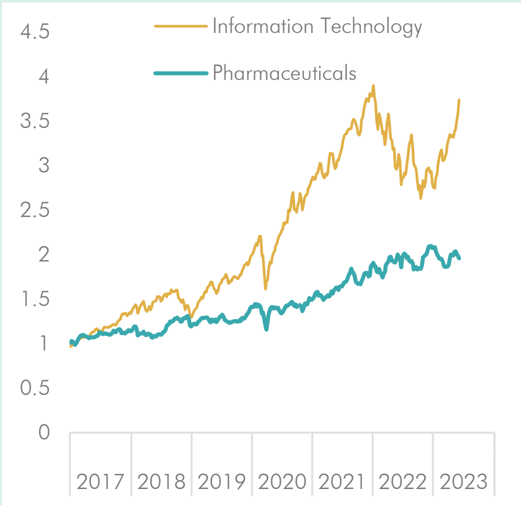
Turning to equity markets, revenue generation for firms in the S&P 500 picked up in Q1 2023 relative to a weaker Q4 2022. This was helped by a strong rebound for ICT, and a continuing upward trend for pharmaceuticals. Figure A4.A shows that revenue was ahead of expectations in nearly three-quarters of firms, whereas 69% of firms saw positive revenue growth in Q1 2023. Relative to expectations, revenues overall were 2.4% higher, up from 1.1% in Q4 2022. The more positive performance by ICT firms is reflected in the total return index for information technology (Figure A4.B), which by mid-2023 had recovered much of the losses seen in 2022. Overall, this suggests a more positive outlook for ICT and pharmaceuticals as key sectors behind Ireland's economic growth.

Figure A4: ICT and pharmaceuticals have helped the S&P 500 to a stronger start to 2023, following a weak end to 2022

A. Revenue performance for the S&P 500
%



B. Industry classifications of the S&P 500
USD thousands, total return index



Sources: Yardeni Research (accessed 9 May 2023), Macrobond, and Fiscal Council workings. Get the data.

1.2 The medium-term economic outlook (2025 to 2030)

Capacity constraints have become a central issue regarding Ireland's medium-term economic prospects. This has broad implications for the economic outlook, especially in terms of the effects on the construction sector, migration, rents, and the sustainability of economic growth.

Capacity constraints are impacting the economic outlook

A fundamental challenge for the economy is the significant shortfall in the stock of residential dwellings. Forecasts for new dwellings construction are only sufficient to keep pace with a rising population, rather than addressing the stock's shortfall. This context is important for understanding the main causes of Ireland's capacity constraints, and their effect on the sustainability of economic growth over the medium term.

Table 1.1 presents key *SPU 2023* macroeconomic forecasts for the Irish economy out to 2030. The Irish economy is expected to grow by around 2–2.5% in the coming years. This reflects an expected slowdown in population growth and productivity. Inflation is forecast to fall this year and next before remaining at 2% from 2025 onwards, while unemployment is projected to remain only slight above the current level. The modified current account is set to narrow as higher consumption and investment leads to an increase in imports, but it is still forecast to remain in surplus. The Department of Finance and the Council both assess that there will be a positive output gap in the years ahead, consistent with demand being above capacity.

Table 1.1: *SPU 2023* key macroeconomic forecasts

Year-on-year percentage change in volumes, unless otherwise stated

	2022	2023	2024	2025	2026	2027	2028	2029	2030
GNI*	9.3	1.6	2.1	2.5	2.3	2.2	2.1	2.1	2.1
Modified domestic demand	7.5	1.8	2.2	3.0	3.2	2.9	2.9	2.6	2.5
Personal consumption	6.6	3.9	3.8	3.4	3.4	3.1	2.9	2.7	2.5
Modified investment	19.8	-0.6	1.2	3.7	4.9	5.0	4.7	4.2	4.2
Compensation of employees (nominal)	11.3	8.3	7.4	6.8	6.3	5.5	4.5	4.0	4.3
Employment[a]	6.6	1.6	1.4	1.5	1.6	1.0	0.6	0.6	0.6
Unemployment rate[a] (% of labour force)	4.5	4.4	4.5	4.5	4.5	4.6	4.7	4.7	4.7
Inflation (HICP)	8.1	4.9	2.5	2.0	2.0	2.0	2.0	2.0	2.0
Savings ratio (% of disposable income)	20.5	18.0	15.8	14.1	13.0	12.7	12.0	11.2	10.9
Modified current account (% of GNI*)	9.7	9.1	8.7	8.0	7.2	6.2	5.4	4.7	4.1
Output gap (% of potential domestic GVA)	1.6	1.4	1.1	1.2	1.3	1.1	0.9	0.6	0.1

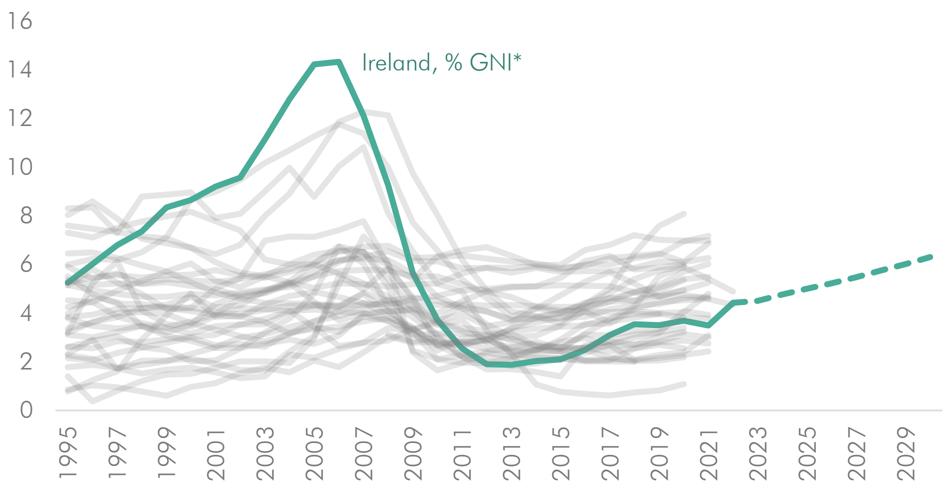
Sources: Department of Finance, and Fiscal Council workings.
Note: [a] The unemployment rate and employment growth shown for 2022 are not adjusted for the effect of Covid-19 pandemic unemployment payments.

Ireland's spending on the capital formation of dwellings has been low relative to other European countries for more than a decade. This has followed a period in which it was relatively high, from 1996–2008. However, the higher investment from 1996 entailed a catch-up period relative to EU15 countries in terms of the stock of dwellings per person. Figure 1.6 shows Ireland's gross fixed capital formation spending on dwellings as a share of GNI*, compared to other European countries as a share of GDP. Figure 1.7 then shows the stock of dwellings per person for the same period, where data are available. Since 2009, Ireland's level of investment in dwellings has been lower than the mid-point of the European range, by 3.2% of GNI* on average. As Ireland's population has increased continuously since 1991, weak investment in dwellings has worsened the trajectory for dwellings per capita, which is likely to remain low by 2030.

Investment in dwellings has been low in Ireland for more than a decade, and the dwellings stock per capita is low relative to the EU15

Figure 1.6: Ireland's investment in dwellings has been low relative to other European countries since 2009

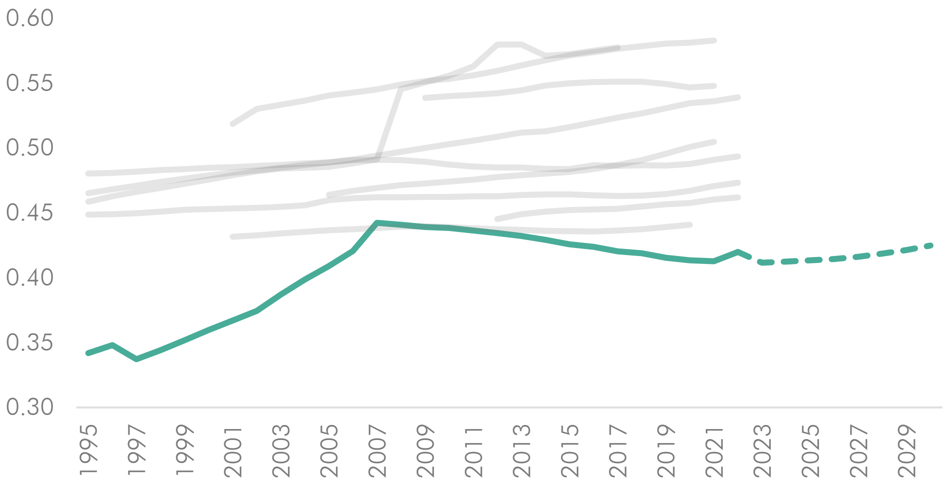
% GDP (GNI* for Ireland)



Sources: Eurostat, CSO, Department of Finance, and Fiscal Council workings. Get the data.

Figure 1.7: Ireland's stock of dwellings per person is forecast to remain well below the recent range for other EU15 countries

Dwellings stock per person



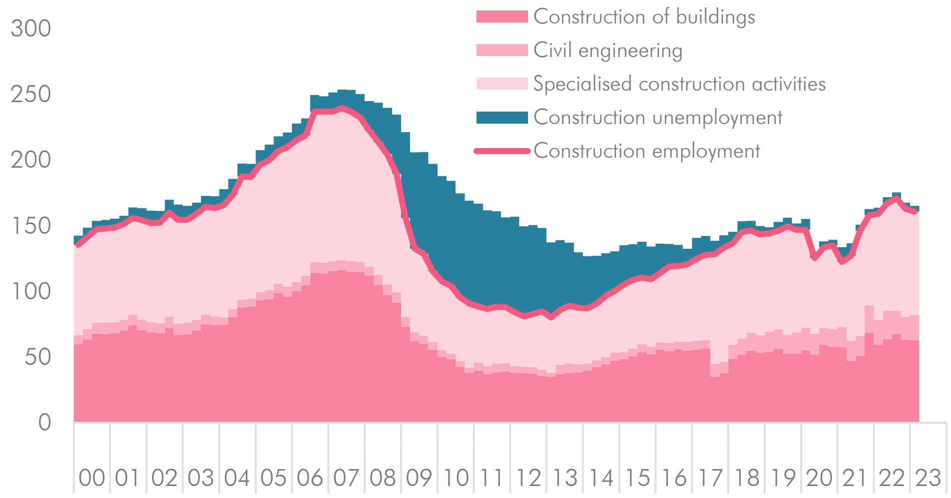
Sources: Eurostat, Statistik Austria, StatBel, Danmarks Statistik, Tilastokeskus Suomi, INSEE, DeStatis, European Central Bank, Centraal Bureau voor de Statistiek, Instituto National de Estatística, Moody's, Statistikmyndigheten, Office for National Statistics, Department of Finance, CSO and Fiscal Council workings. Notes: For Ireland, Census data for 1991, 1996, 2002, 2006, 2011, 2016, and 2022 are used for the dwellings stock. The interim years are approximated using ESB connections (1992–2010) and new dwelling completions (2011–2022) data, and the average annual implied depreciation rate of 0.31% for 1992–2022. The forecast shown is based on *SPU 2023* forecasts for new dwellings completions, population growth, and the same assumed annual depreciation rate of 0.31%. Get the data.

Higher dwellings output would likely require additional construction employment, but the number employed in construction of buildings has been quite flat since 2016 (Figure 1.8). It is possible that construction employment could increase as a result of re-allocation of employment from other sectors, for example manufacturing. However, there could be limited desire for employees to switch into construction work, as part of a multitude of scarring effects from the sector's collapse in the late 2000s. Furthermore, unemployment among previously employed construction workers is at a record low — Conefrey and McIndoe-Calder (2018) find that this is likely due to high emigration from 2008–2012 of this cohort.

More dwellings would likely require more construction workers, but few are unemployed in the sector

Figure 1.8: Construction employment has increased, but unemployment among previously employed construction workers is exceptionally low

Thousands, not seasonally adjusted



Sources: CSO and Fiscal Council workings. [Get the data.]

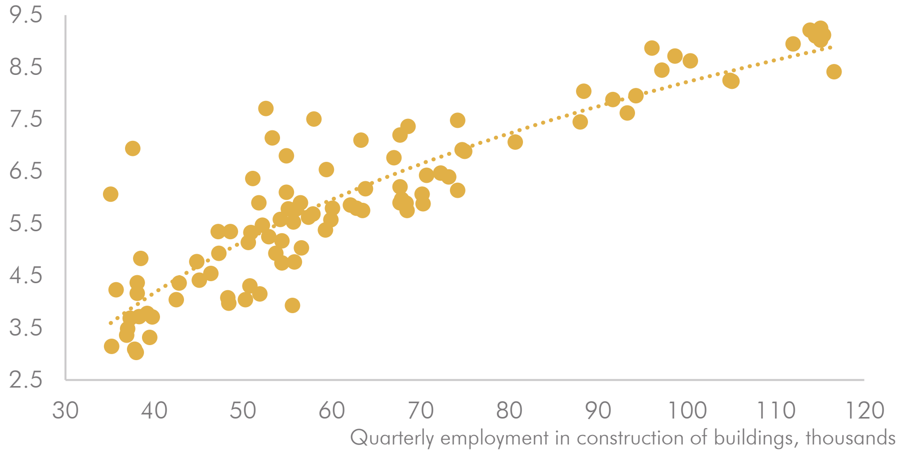
Figure 1.9 provides an update to analysis by Conroy, Casey, and Jordan-Doak (2021), who noted that Ireland's productivity in the construction sector in 2019 was 44% below the average of the top five European countries. Similarly, their analysis showed that research and development spending in construction was the second-lowest for Ireland, ahead of Greece. While more workers in construction of buildings imply higher output levels, the data may imply diminishing marginal increases for additional workers.

But there is evidence that the gains from having additional workers diminishes

In 2022, there were just over 63,500 workers engaged in the construction of buildings, compared to a peak of 115,550 for 2007 — which also coincided with peak inward migration of 151,100. This suggests that without significant immigration of building workers over coming years, or a switching of workers into construction from other sectors, it is unlikely that the shortage of dwellings in Ireland will be meaningfully addressed. However, it is important to note that some of the observed shortfall in new dwelling completions could reflect a "crowding out" effect by investment activities elsewhere in the economy — for example, construction of offices, hotels, factories, data centres, schools, hospitals, and other non-residential building projects.

Figure 1.9: More work in construction of buildings allows for higher investment, but historically with a diminishing marginal impact

Quarterly investment in building and construction, € billion, 2020 constant prices



Sources: CSO and Fiscal Council workings. Get the data.

Note: The sample period is Q1 1998 – Q1 2023.

The current account is also an important indicator for understanding the sustainability of economic growth. While CA* is a more appropriate measure for Ireland, CA* analysis can be further refined by examining the contributions of households, general government, and corporate institutional sectors. Dwellings capital formation, dwellings stock per person, and capacity constraints in the economy also provide important context for understanding Ireland's CA* position.

Timoney (2023, forthcoming) shows that CA* reflects an excess of modified gross savings over modified gross capital formation. Figure 1.10A shows this breakdown of the modified current account (CA*) as a share of GNI*, and Figure 1.10B shows the changing composition of modified gross capital formation in terms of investment spending by institutional sectors of the economy.

The modified current account surplus reflects high modified savings and low modified gross capital formation, especially by households

The share of modified gross capital formation by domestic sectors is only about three-fifths for 2013–2021, with foreign-owned multinational firms explaining 42% of this amount. The muted flows of investment spending on dwellings as shown in Figure 1.7 are evident in the weak level of gross capital formation by households (and non-profit institutions serving households).[7] By 2026, *SPU 2023* forecasts that household gross capital formation will reach just 4.3% of GNI*, less than half of its share from the earlier Celtic Tiger period of 1995–2000.

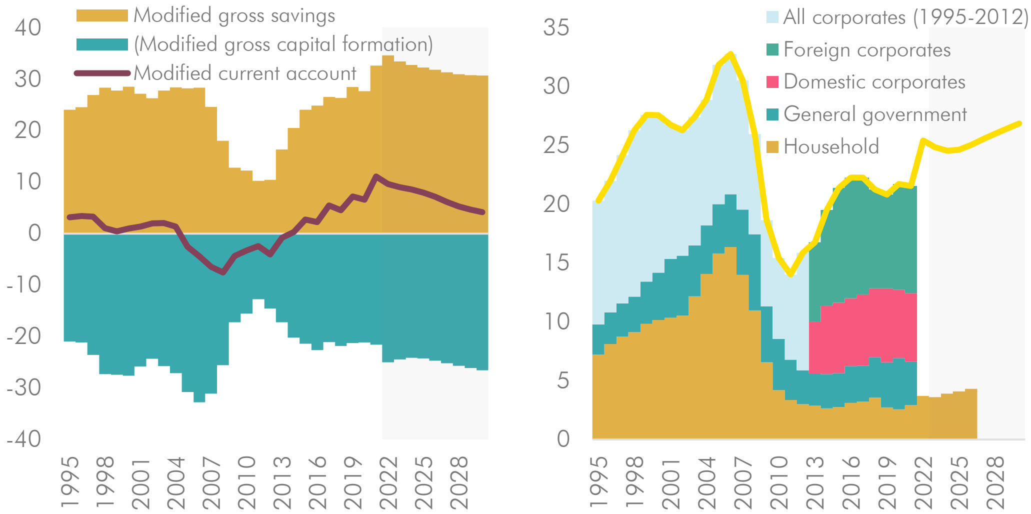
[7] See Coffey (2022) for further exploration. While the private (construction) sector typically builds new dwellings in Ireland, which represents gross capital formation spending by this sector, the investment is later attributable to households or general government when the dwelling is purchased by these sectors.

Figure 1.10: Ireland's modified current account reflects weak level of investment by domestic institutional sectors, especially households

% GNI*

A. Modified gross savings, gross capital formation, and current account

B. Modified gross capital formation by institutional sector



Sources: Timoney (2023, forthcoming), CSO, Department of Finance, and Fiscal Council workings.
Notes: See Box in Timoney (forthcoming). Modified gross savings equal modified gross disposable income (that is, GNI* before net current transfers), less consumption. Modified gross capital formation adds up gross capital formation for all domestic sectors, but removes aircraft for leasing, and research and development service imports and trade in intellectual property, from gross capital formation by the foreign sectors (foreign non-financial corporates, foreign financial corporates, and re-domiciled PLCs). Get the data.

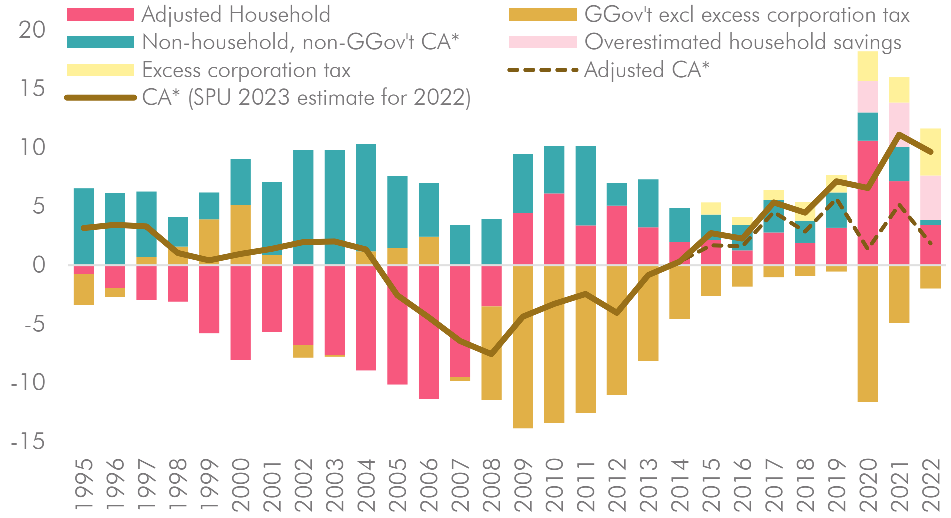
As for modified gross savings, Timoney (2022) found that household consumption since the Covid-19 pandemic could be underestimated, and that savings could be overestimated. Furthermore, gross savings of the general government sector are boosted by excess corporation tax receipts. Without these amounts as in Figure 1.11, an "adjusted CA*" measure remains in surplus, albeit considerably lower for 2022 at 1.9% of GNI* (or 2% of GNI* adjusted for excess corporation tax), compared to 9.7% of GNI* as estimated in *SPU 2023*.

An adjusted current account balance would appear to be in surplus in 2022, excluding excess corporation tax and possibly overestimated household savings

A significant increase in residential construction activity is required to address the shortage in Ireland's stock of dwellings. In the absence of rebalancing between non-residential and residential construction, this would require an increase in modified gross capital formation, which could result in a deficit for the adjusted CA* measure shown above.

Figure 1.11: Ireland's modified current account remains in surplus without excess corporation tax and overestimated household savings

% GNI*



Sources: Timoney (2022), CSO, Department of Finance, and Fiscal Council workings.

1.3 Risks to the outlook

Risks to the outlook now appear more balanced

Macroeconomic risks in April's *SPU 2023* are described as being "two-sided though tilted to the downside", while for inflation, "upside risks dominate". The Council's view was broadly similar in March when finalising the Benchmark projections, but given strong labour market signals since, and a slowdown in domestic inflation, risks to the outlook now appear more balanced.[8]

Global risks remain

Global risks remain central to the challenges that could cause a sudden reversal of fortunes in the Irish economy. Russia's invasion of Ukraine continues, and the potential for new energy price shocks remains as a result. Energy shortages were an acute concern for last winter, and while outages did not come to pass, risks remain that a reliance on gas will again prove expensive for Europe towards the end of 2023. Bank failures in the US economy have been increasingly frequent as a result of the sudden rise in interest rates in recent years. Some fear that this could be a sign of the start of a more widespread financial crisis, although the likelihood of this taking place remains contained for now. Risks of a global recession have increased as indicated by the significantly inverted US yield curve — which is also an important signal in estimating the probability of a recession in Ireland, as shown by Casey and Conroy (2023).

Domestic capacity constraints are increasingly important

Domestic capacity constraints have become increasingly challenging for the Irish economy. An expansion in construction activity is necessary to address a long-running shortage of housing, but it will require careful monitoring as Ireland's construction activity is especially cyclical and prone to booms and busts. However, notwithstanding numerous domestic challenges, Ireland continues to attract strong levels of inward migration. Remote working could partly reduce excess demand for housing in urban areas, although it is important to note that housing shortages affect rural as well as urban parts of the country.

Food and energy prices could fall faster than forecast, and the labour market remains strong

Following a sustained period of rising price pressures, a tentative slowdown in inflation has been evident to date in 2023. In particular, food and energy prices could fall faster than forecast in *SPU 2023*, and given the strength of the labour market alluded to above, this would likely translate into stronger real economic growth. The strong labour market — along with the Government's income supports — have combined such that by end-2022, aggregate real household disposable income had not fallen below its pre-pandemic trend, although many households have experienced a fall in living standard. Fears of a slowdown in key growth sectors, such as ICT and pharmaceuticals, have not yet translated into a net reduction in employment for these activities, as shown in Box A. The presence of high-skill jobs in many of the sectors most likely to drive economic growth would provide significant benefits to the Irish economy over the medium term.

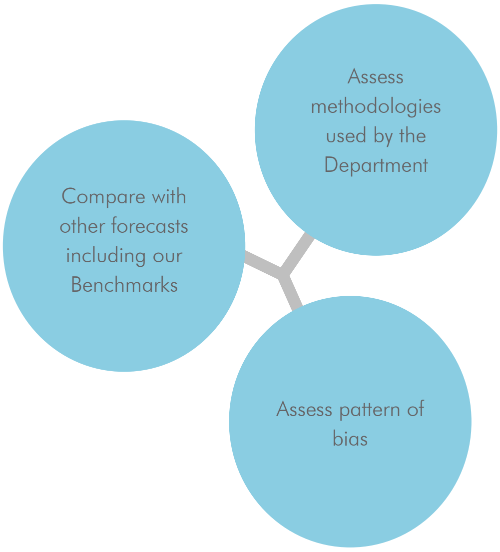
[8] Employment was 1.8% stronger than *SPU 2023* forecast for Q1 2023, and the Department's forecast for full-year employment growth of 1.6% looks likely to be exceeded with a carry-over of 3%.

1.4 Endorsement of the Department of Finance's macroeconomic projections

The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in March 2023.

Background

The Department's provisional macroeconomic forecasts were completed on 23 March 2023 (for details of the endorsement timeline, see table S1a in the Supporting Information section). The Council and Secretariat discussed the forecasts with Department staff on 27 March.



The Council assessed that the Department's macroeconomic forecasts were within an endorsable range, taking into account the methodology and plausibility of the judgements made. The Council's assessment of the Department's macroeconomic forecasts was favourable regarding the processes and methodologies used.

In a welcome development, the Department has expanded its macroeconomic forecast horizon to seven years ahead, addressing the Council's concern that macroeconomic forecasts should always be made to at least five years ahead. This section describes the key issues that arose in the endorsement discussions. The main queries related to modified domestic demand (MDD), the savings ratio, and how capacity constraints were addressed in the forecasts.

Modified domestic demand in 2023 and 2024

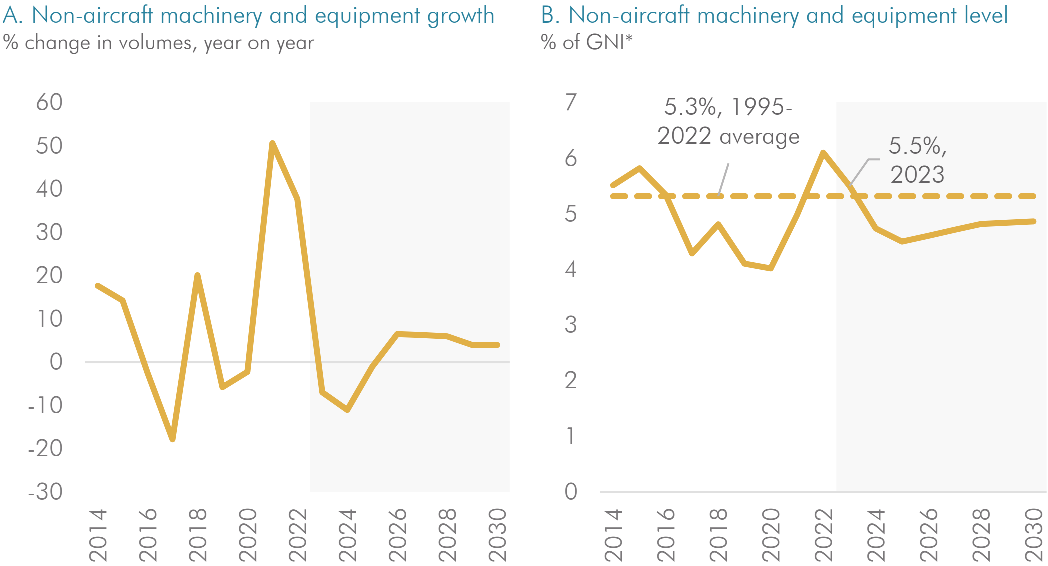
In *SPU 2023*, the Department of Finance projects continued growth in MDD. In this round, the composition of MDD growth required scrutiny as a result of unusual base effects. MDD grew by 8.2% in 2022, and this was driven mainly by a rapid 38% increase in non-aircraft machinery and equipment, following an even faster rise of 51% in 2021.

Large investments in machinery and equipment often relate to the activities of foreign-owned multinational firms. Examples include equipment for manufacturing of specialised pharmaceuticals, computer parts, and data centres. In 2022, there was a large increase in imports of machinery and equipment used to develop semiconductors (Casey, 2023). This investment drove MDD up in the first half of 2022, but it then declined in the second half of the year. It is expected to be a short-lived investment, lasting into 2023 but ending thereafter.

The Council's endorsement focused on the importance of interpreting these developments carefully. The link to imports was crucial from a forecasting perspective and the Council assessed that modified investment could remain at exceptionally high levels in 2023 but would likely fall back to more normal amounts from 2024 onwards.

In *SPU 2023*, the Department projects a decline in non-aircraft machinery and equipment of –7% in 2023 and –11% in 2024 (Figure 1.12A). Despite a year-on-year decline, the Department expects that this investment will continue at an elevated level in 2023 (5.5%, as shown in Figure 1.12B), before reverting below its long-run 5.3% share of GNI*.

Figure 1.12: Investment in non-aircraft machinery and equipment was exceptionally high in 2022



Sources: Department of Finance, CSO and Fiscal Council workings. Get the data.

Given such a rapid increase in 2021 and 2022, if a faster decline takes place in 2023 or 2024 than assumed by the Department, MDD growth could potentially turn negative. However, as discussed by Casey (2023), negative MDD growth in this scenario is mechanical in nature, and would be offset if using measures such as GNI* which capture the offsetting role of imports. That is, lower imports would likely negate the impact of the fall in investment. As such, the data for 2022 highlight the need to interpret MDD carefully as an indicator of the Irish economy when used in isolation.

Savings ratio

According to official CSO estimates, Ireland's household savings ratio remained very high in 2022 at 21% of total disposable income. As noted above, this likely to be overestimated, as official statistics appear to under-report household consumption (Timoney, 2022). The Department of Finance recognises this issue, but beginning from the official data in 2022 makes it challenging to interpret how the economy is forecast to evolve over coming years. Lower household savings reduces Ireland's CA* surplus, and the scope for catch-up consumption growth.

SPU 2023 forecasts incorporate the planned introduction of an auto-enrolment pension scheme. As shown in Box B, assuming the introduction of such a scheme would increase the savings ratio relative to a no-policy-change counterfactual. The introduction of the scheme increases measured household income, due to contributions made by employers and the Government.[9] By contrast, consumption may fall as employees have lower take-home pay and if households increase their saving rather than switching between different savings vehicles. Both factors lead to a higher measured savings rate. Box B estimates that by 2030 this impact could be around 1.2 percentage points.

Box B: Auto-enrolment and the savings ratio

The Government plans to introduce an auto-enrolment pension scheme in 2024. A box in a previous *FAR* outlined many of the proposed details of the scheme.[10] This box outlines how consumption and the savings rate could be impacted by the introduction of this scheme.

For illustrative purposes, it is assumed that there are 750,000 eligible employees and that 95% remain opted in (in line with international evidence). It is assumed that these employees have an average salary of €35,000 and that they grow at around 2% per year. From these assumptions, the following contributions to the pension scheme are implied. The rates of contribution increase in 2027 and 2030.[11]

From a national accounting perspective, household income would increase due to the scheme. This is because the employer's contributions (likely to be classified as compensation of employees) and the state contributions (likely to be classified as social transfers) are both adding to income.[12,13]

Those who remain in the scheme will see a reduction in take-home pay as they make contributions to their pension. As a result, consumption may decline relative to a counterfactual where the scheme is not introduced.[14] By 2030, consumption could be €1.1 billion lower.[15]

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[9] The increase in income due to employer contributions could be offset by employers reducing wages and salaries paid to employees.
[10] See Box H, May 2022 *FAR*.
[11] A final increase in the rates of contribution is planned for year 10 of the scheme (2033)
[12] The employer's contributions to the scheme would likely be treated like employer's PRSI, which is classified as compensation of employees.
[13] A final decision on the statistical classification of the state contribution would not be made until the scheme is finalised and operational.
[14] This relies on the assumption that employee contributions to this pension scheme are not just displacing other forms of saving. While some saving may be redirected to the pension scheme, it is safe to assume that total saving increases as a result of the scheme.
[15] The €1.3 billion reduction in take-home pay results in a €1.1 billion reduction in consumption, implying a marginal propensity to consume of 0.85.

Table B1: Assumed contributions to auto-enrolment pension scheme

€ million

	Employee contributions	Employer contributions	Government contributions
2024	374	374	125
2025	382	382	127
2026	389	389	130
2027	794	794	265
2028	810	810	270
2029	826	826	275
2030	1,264	1,264	421

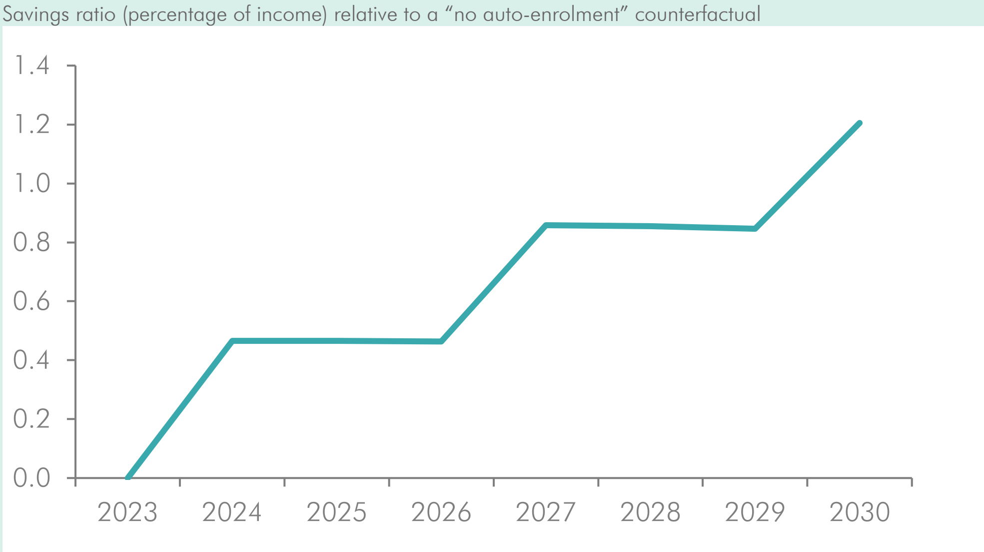
Sources: Fiscal Council calculations.
Notes: Rates of contribution assumed are 1.5% for employers and employees for 2024–2026, rising to 3% for 2027–2029 and then 4.5% in 2030. Government contributions are assumed to be 0.5% (2024–2026), 1% (2027–2029) and 1.5% (2030).

As shown in Table B1, contributions in the first three years of the scheme (2024, 2025, and 2026) are relatively modest from a macroeconomic perspective. However, as the rate of contributions increases in 2027 and again in 2030, the impacts could be much larger.

For this illustrative exercise on the savings rate, we assume that household income rises by the quantity of contributions by employers and the State. From Table B1, we can see an estimate of €1.7 billion in 2030 (contributions from employers and from the State).[16] At the same time, consumption is falling. Both higher income and lower consumption are contributing to a higher savings rate.

Figure B1: Savings ratio is increased by the introduction of the auto-enrolment pension scheme

Savings ratio (percentage of income) relative to a "no auto-enrolment" counterfactual



Sources: Fiscal Council calculations.
Notes: The difference between the savings rate with auto-enrolment and without auto-enrolment is what is shown.

Figure B1 shows an illustrative example of the impact of the scheme on the savings rate. By 2030, the savings rate is more than one percentage point higher than would have been the case without the scheme. The impact on the savings rate increases each time the rate of contributions increases (2024, 2027, and 2030). This estimate of the impact may be an upper bound. This is because it assumes that household contributions to the scheme are increasing household savings, rather than just displacing other forms of saving that households made before the scheme was introduced.

[16] This estimate of the impact on income can be considered as an upper bound. It is likely that employers may moderate pay growth to offset the cost of the scheme (relative to a counterfactual where the scheme is not introduced).

New dwelling completions, rents, and migration

Housing and construction labour shortages are acute, rent inflation remains elevated, and net inward migration has been rapid. The Council and the Department covered housing, rents, and migration in detail in the endorsement discussions, as they are crucial to understanding the medium-term path for the economy.

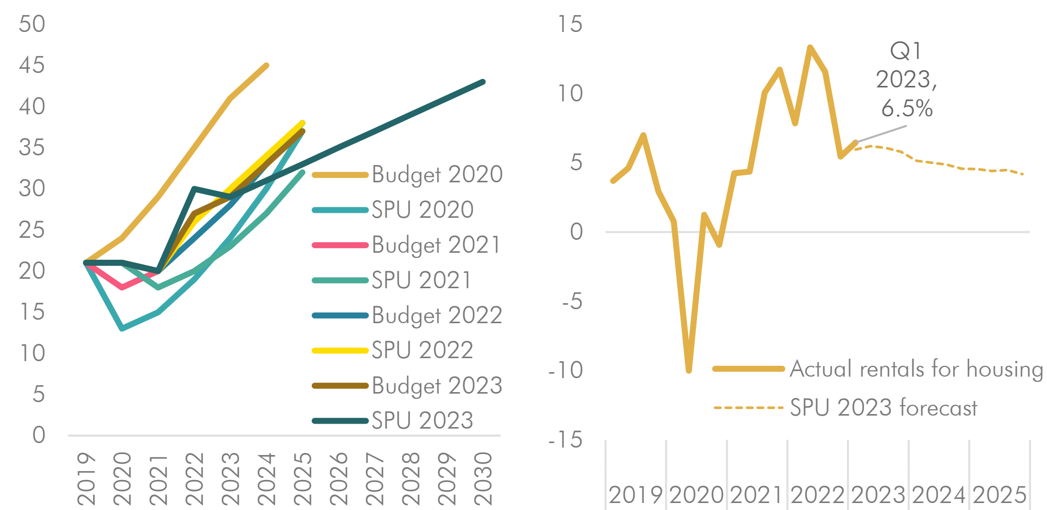
Figure 1.13A shows that new dwelling completions have been subdued compared to the pre-pandemic forecast in *Budget 2020*. While the 2022 outturn was above what had been expected in forecasts since the start of the pandemic, this is likely to reflect a backlog of construction projects that would have been completed sooner had it not been for the pandemic. *SPU 2023* forecasts show that an increase to 43,000 completions is now expected by 2030, although prior to the pandemic, *Budget 2020* had forecast 45,000 completions would be achieved six years sooner (by 2024).

This weakness for dwelling completions has coincided with rapid growth in rents since Q4 2020, and rent inflation is projected to remain similarly fast compared to its current annualised rate of 6.5% (Figure 1.13B). High rents negatively affect the ability to attract inward migration, on which the construction sector heavily relied in order to meet the demand for labour during the 2000s.

Figure 1.13: Housing completions have been subdued, and rents have grown rapidly since end-2020

A. New dwelling completions
Thousands

B. Rent inflation
% change in quarterly rents, annualised



Sources: Department of Finance, CSO and Fiscal Council workings. Get the data.

Budgetary Assessment

Turnaround in the public finances helped by exceptional corporation tax receipts

2. BUDGETARY ASSESSMENT

Turnaround in the public finances helped by exceptional corporation tax receipts

The Government forecasts an underlying general government deficit of 0.6% of GNI* in 2023, when windfall corporation tax receipts are excluded.[17] This would represent a modest improvement of 0.4 percentage points relative to 2022. The headline general government balance is forecast to be a €10 billion surplus (3.5% of GNI*) in 2023, due largely to windfall corporation tax receipts.

In *SPU 2023*, the Government forecasts that the gross debt-to-GNI* ratio will fall to 65.4% by 2026. However, these debt forecasts are contingent on the Government sticking to the National Spending Rule, on continuing windfall corporation tax receipts, and on any potential transfers to the National Contingency Reserve Fund or to an alternative fund.

While the macroeconomic projections go out as far as 2030, the budgetary projections only go as far as 2026—the minimum required for an SPU. The failure to lengthen its forecast horizon for budgetary forecasts leads to sizeable medium-term challenges not being sufficiently recognised in planning. The expected costs of ageing, climate change, and other policy initiatives need to be costed and factored in properly.

There are several shortcomings to the methodology used for fiscal forecasts in *SPU 2023*. First, spending projections do not include the costs associated with Ukrainian refugees beyond this year. Second, costs associated with the auto-enrolment pension scheme have not been included, despite being incorporated into macroeconomic projections. Third, no provision has been made for payment of the Christmas bonus, which has been paid in every year since 2014. Fourth, no provision has been made for costs associated with the Defective Concrete Blocks Redress scheme beyond this year. Fifth, on the revenue side, PRSI forecasts for 2023 are unchanged relative to *Budget 2023* forecasts, despite strong evidence from data so far this year that they should have been revised upwards. Sixth, the methodology for forecasting general government components should be improved, as aspects of the current approach creates inconsistencies (see Box C).

[17] Windfall corporation tax receipts are estimated by the Department of Finance.

2.1 Outturns for 2022 and revisions

Excluding excess corporation tax, the general government deficit was €2.8 billion in 2022, €5.3 billion better than forecast in *Budget 2023*. This was largely driven by a change in the timing of costs related to the Defective Concrete Blocks Redress scheme (€2.7 billion), larger social contributions by government employee and imputed government employer contributions (€1.5 billion), and lower-than-anticipated social protection expenditure (€1.4 billion).[18]

Windfall corporation tax receipts were also larger than forecasts at Budget time (€1.8 billion). As a result, the headline General Government Budget recorded a surplus of €8 billion in 2022, more than €7 billion higher than forecast in *Budget 2023*.

The budget balance was better than forecast in *Budget 2023*

Table 2.1: 2022 Fiscal outturns and *Budget 2023* forecasts

2022, € million

	Budget 2023 Forecast	Outturn	Forecast error
Revenue	112,475	115,506	3,031
Corporation tax	21,050	22,645	1,595
of which: excess corporation tax	9,000	10,800	1,800
Social contributions	18,365	19,836	1,471
Expenditure	111,510	107,473	-4,037
Social payments	38,575	37,133	-1,442
Capital transfers	4,530	1,855	-2,675
Budget Balance	965	8,033	7,068
Budget Balance excl. excess corporation tax	-8,035	-2,767	5,268

Sources: Budget 2023, CSO and Fiscal Council workings.
Notes: At the time *Budget 2023* was prepared only one quarter of General Government data was published by the CSO, instead of the usual two quarters. However, eight months of exchequer data were available. The forecast error of €2.7 billion for capital transfers is due to a technical reclassification of the concrete blocks redress scheme. The lower than forecast social payments (€1,442 million) was partially due to the reclassification of the electricity credits (€800 million).

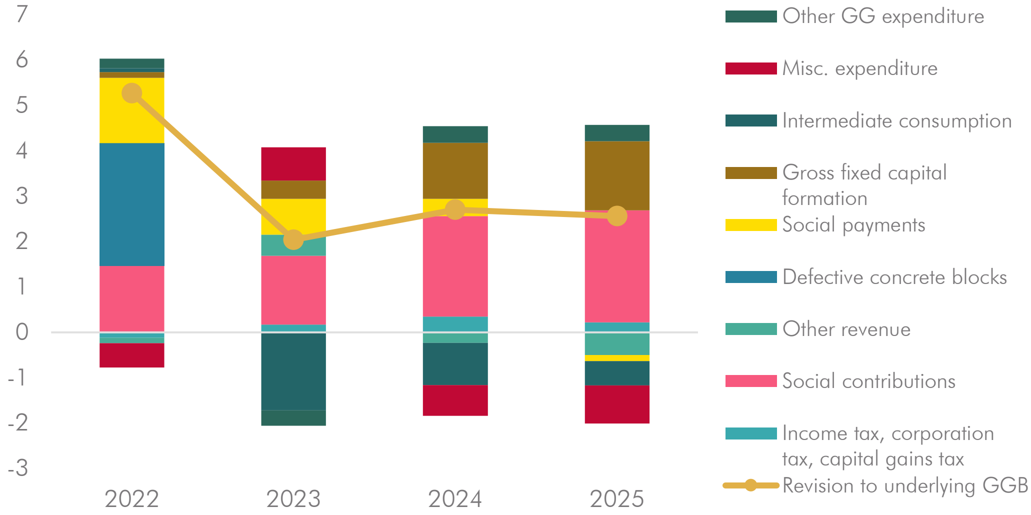
Lower social payments make a significant contribution to the forecast error for the underlying balance in 2022 and have a knock-on impact for the rest of the forecast horizon (Figure 2.1). The outturn for social payments in 2022 was €1.4 billion lower than forecast in *Budget 2023*. This was due, in part, to a reclassification of the electricity credits of €0.8 billion from social payments to current transfers.

[18] Capital transfers in 2022 were €2.7 billion lower than forecast in *Budget 2023*. This is due to a reclassification of spending on the Defective Concrete Blocks Grant Scheme, following Eurostat guidance. Previously it had been assumed that all the costs would be accrued in 2022. Now, the costs are expected to be spread over several years, with limited amounts accrued in 2022 and 2023.

Other general government expenditure, which includes current transfers, was €0.2 billion lower than forecast in *Budget 2023*. Adjusting for the reclassification, this expenditure was €1.0 billion lower than forecast, equivalent to a forecast error of 23% of the outturn.

Figure 2.1: Revisions to underlying balance driven by social contributions

€ billion, SPU 2023 forecasts vs Budget 2023 forecasts



Sources: SPU 2023, CSO, and Fiscal Council workings. Get the data.

Notes: A positive (negative) value for an expenditure item means expenditure has been revised down (up). Underlying balance refers to the general government balance excluding windfall corporation tax receipts. Income tax, Corporation Tax (CT), Capital Gains Tax (CGT) category refers to taxes on income and wealth, excluding windfall corporation tax receipts. Misc. expenditure includes compensation of employees, interest, subsidies (and TBESS), capital transfers (excluding the defective concrete blocks scheme) and resources non allocated.

General government forecasts methods need improvement

There are clear shortcomings in the forecast methodology for both general government revenue and expenditure that should be addressed. The methods for forecasting social contributions revenue is flawed, as discussed in more detail in Box C. Another approach that could potentially help improve the forecasts would be to more clearly map gross voted expenditure into the appropriate areas of general government expenditure by function (COFOG) and use this as a basis to aid the forecasting of general government expenditure.[19]

[19] Publishing data on expenditure by function (COFOG) is optional in the Stability Programme Update, but is deemed as "highly desirable" by the European Commission. Of the 27 Member States, 18 publish at least some data on a COFOG basis in their Stability Programmes. Ireland is one of nine that do not publish any data on a COFOG basis.

Box C: Forecast errors point to inconsistencies in the fiscal forecasts

This box explores the 2022 forecast error for social contributions revenue and how this relates to the forecasts of government expenditure.[20]

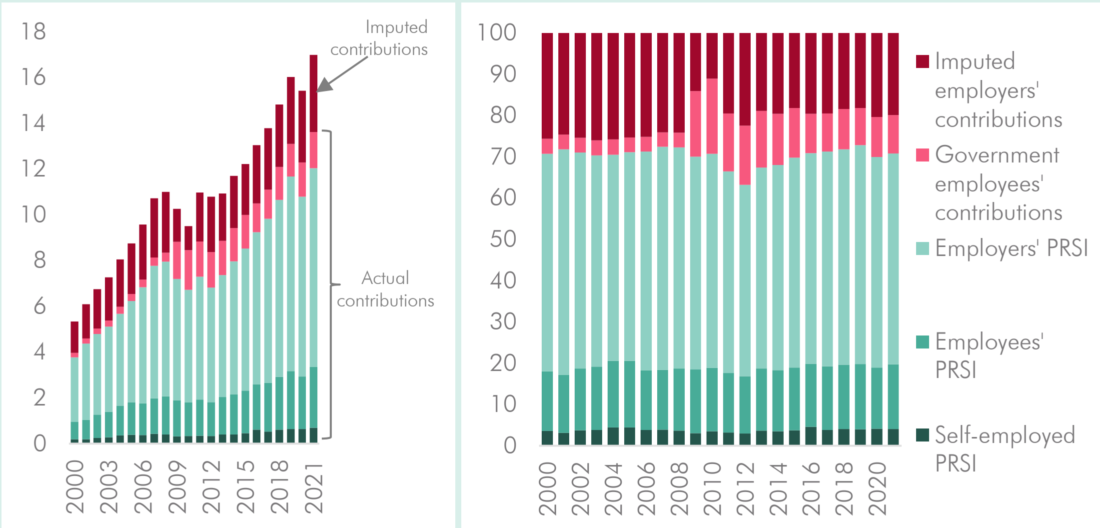
Government total social contribution revenue is made up primarily of PRSI receipts—of employees, employers and the self-employed—which amounted to just over €12 billion in 2021, and non-PRSI receipts (Figure C1.A). The non-PRSI element of social contributions includes government employees' contributions, making up 9.3% (or €1.6 billion), and imputed employers' contributions making up 19.9% (or €3.4 billion) in 2021 (Figure C1.B).[21]

While the forecast of PRSI revenue for 2022 at Budget time was relatively accurate (with a forecast error of just -€0.05 billion for PRSI), the non-PRSI revenue—the government employee contributions and imputed employer contributions—had a large forecast error of €1.5 billion (Figure C2.B). This error was equivalent to 26% of the non-PRSI social contribution outturn (or 7.7% of the total social contributions outturn).[22]

Figure C1: Revisions point to inconsistencies in fiscal forecasts

A. Social contributions continue to rise
€ billion, general government basis

B. Composition of social contributions
% of total social contributions



Sources: Eurostat, CSO, and Fiscal Council workings. Get the data.
Notes: Data in panels A and B are from the National Tax lists published by Eurostat. Panel C shows data for government compensation of employees.

[20] Previous work conducted by the Council has explored how the macroeconomic and fiscal forecasts of Government have been inconsistent with each other (see Box A of the May 2022 FAR). This box explores how the revenue and expenditure forecasts of Government are inconsistent with each other.

[21] Imputed employers' contributions arise when the benefit that an employee receives (or is expected to receive) is larger than the actual contributions made by the employee and the employer. The imputed contributions are the estimated gap between the employee's estimated benefit and the actual contributions made. The cost of this imputed benefit is attributed to the employer, as it is the employer that bears the risk in providing this additional benefit, over and above the actual contributions made. In the government accounts, the imputed employers' contributions should "net out" with an equal amount included on both the revenue and expenditure side. The cost of the imputed contribution is treated as government expenditure on compensation of employees. This expenditure is matched by an equal value of social contributions from households, which the Government receives on the revenue side.

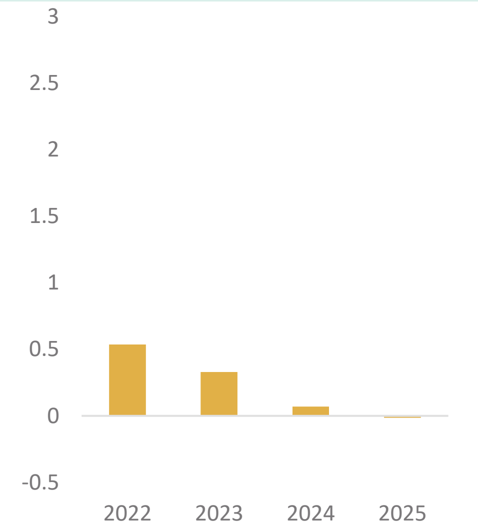
[22] The scale of this forecast error cannot realistically be attributed to base effects. At the time *Budget 2023* forecasts were compiled the *Government Finance Statistics* (*GFS*) Q1 2022 release was available. The figures contained in that release for social contributions for 2021 broadly match those in the most recent *GFS* release for 2021 (revision of less than €0.1 billion). Typically, there would be two quarters of in-year *GFS* data available at Budget time. However, as *Budget 2023* was brought forward by two weeks, figures were only available for the first quarter of 2022. The figures for Q1 2022 have been revised up by only €0.15 billion in the most recent *GFS* release, relative to those available at budget time. This revision is not of a scale to explain the €1.5 billion forecast error for social contributions for the full year.

Both the government employee contributions and the imputed employer contributions make up a part of government expenditure on compensation of employees. As a result, any forecast error in government employee contributions and imputed employer contributions should also lead to a forecast error in government compensation of employee expenditure.

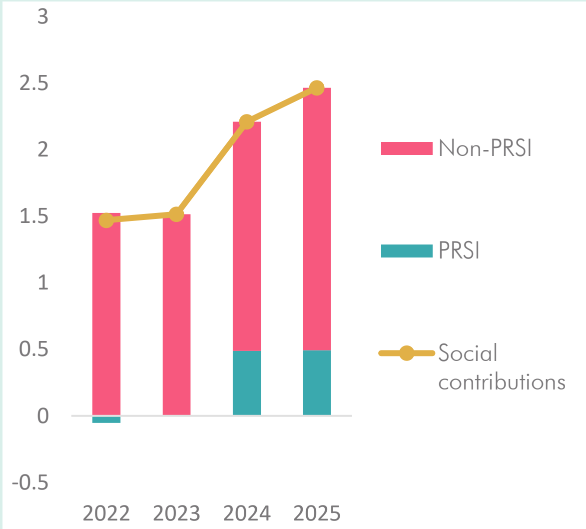
However, the forecast error for government compensation of employees was €0.5 billion, a third of the forecast error of non-PRSI social contributions (Figure C2.A). These forecast errors point to inconsistencies in the Government's fiscal forecasts.

Figure C2: Revisions point to inconsistencies in fiscal forecasts

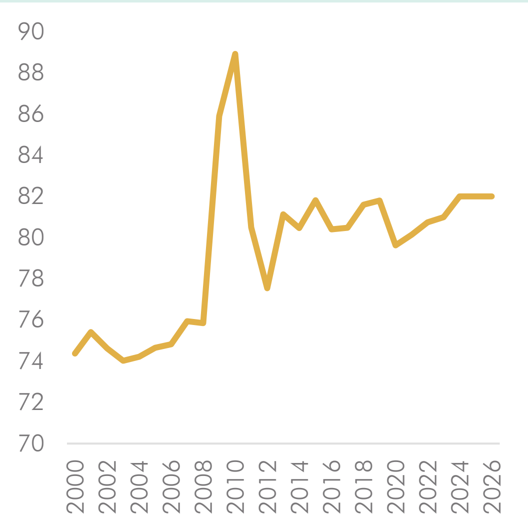
A. Revision to public sector pay
€ billion, *SPU 2023 vs Budget 2023*



B. Revision to social contributions
€ billion, *SPU 2023 vs Budget 2023*



C. Ratio of actual contributions to total contributions
Ratio of (D611 + D613) to D61, *SPU 2023*



D. Government employee pension contributions
€ billion, *SPU 2023*

Sources: CSO, Department of Finance and Fiscal Council workings. Get the data.
Notes: In panel B, estimates of PRSI receipts are based on cash receipts. Non-PRSI receipts cover accruals, imputed employer contributions, and government employee contributions. Panel D shows the implied forecast of government employees' pension contributions. This is arrived at by assuming that general government PRSI receipts grow in line with cash PRSI receipts over the forecast horizon.

The Department's current methodological approach to forecasting social contributions assumes that over the forecasting horizon, the ratio of actual social contributions (PRSI and Government employee pension contributions) to total social contributions (actual contributions plus imputed employer contributions) remains broadly consistent with the recent historical data. Figure C2.C shows the ratio of actual social contributions to total social contributions since 2000.

Using this methodological approach can lead to implausible forecasts. Figure C2.D shows the implied forecasts for government employee's pension contributions based on this approach. The value of government employee's pension contributions is forecast to be lower in 2026 than it was in 2021. This is implausible given public sector pay growth and an increase in the numbers working in the public sector expected over this period.

From a methodological perspective, there is limited justification to assume that the ratio of actual social contributions to total social contributions would remain relatively constant. PRSI received by Government (which makes up most of actual social contributions) is based on economy-wide wages and salaries, whereas the non-PRSI component relates solely to government decisions on public sector pay, pensions and pension contributions. In addition, PRSI receipts are highly cyclical in contrast to public sector pay which would tend to fluctuate less. Any policy changes to PRSI rates would also alter this relationship. A more appropriate methodology would relate the non-PRSI social contributions forecasts to the government expenditure forecasts of compensation of employees, to ensure that these are fully consistent.[23]

[23] There should be an equal amount of imputed employer contributions included on the expenditure side of the government accounts as there is on the revenue side of the accounts. This would not be the case under the Department's current forecasting approach—with separate forecasting approaches used on the revenue and expenditure side for this component—implying a violation of national accounting identities in the Department's forecasts. This is evident in the revisions to the forecasts in Figures C2.A and C2.B.

2.2 Expenditure and revenue forecasts for 2023

The budget balance, excluding windfall corporation tax, for 2023 has been revised up since *Budget 2023*.[24] This is driven mainly by higher social contributions combined with lower spending on social payments and capital expenditure. Somewhat offsetting these forces is higher forecast spending on intermediate consumption.[25]

Revenue could overperform forecasts for 2023

Tax revenue has continued its strong momentum into 2023 and the Department now expects growth of 7% year on year (Table 2.2). At the end of May, income tax was up 9.4% relative to 2022 and is now 21% above its pre-pandemic trend (Figure 2.2A). On an underlying basis, VAT revenue has also been performing strongly and is up by 9% year to date.[26]

While the forecasts for PRSI and tax revenue for 2023 have been revised up by €1.9 billion to €104 billion since *Budget 2023* (Table 2.2), there is reason to believe that these forecasts are still too low, notably for PRSI and corporation tax receipts.

The SPU forecast of PRSI receipts for 2023 is unchanged relative to *Budget 2023* forecasts. For the full year, PRSI receipts are forecast to be 16.5% higher than 2022. However, PRSI receipts have been growing strongly with end-May receipts up 18.2% year-on-year. On average, monthly PRSI receipts have been 8% ahead of forecast so far this year (Figure 2.2C). Were PRSI receipts to be just 5% ahead of forecast for the remaining months of the year, PRSI revenue could be almost €1 billion higher than currently forecast. The PRSI forecasts for 2023 should have been revised upwards considering the strong performance to date that was evident by the time the SPU forecasts were compiled.

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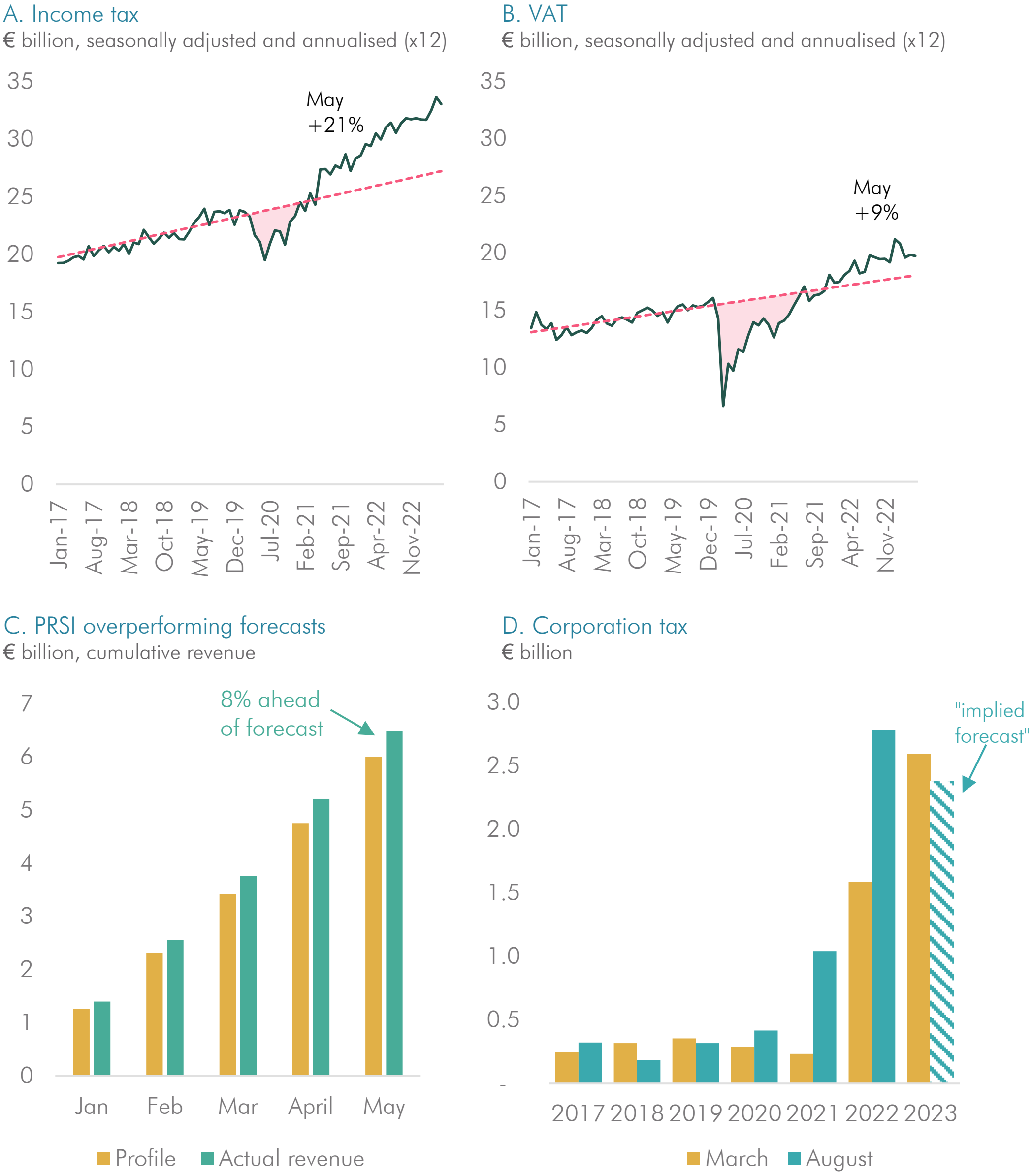
[24] The underlying budget balance excludes excess corporation tax receipts.

[25] Intermediate consumption is the consumption of goods and services that are used up in the production of other final goods or services. For instance, electricity may be used up to heat or light classrooms in the provision of education services in schools. In this instance, electricity is the intermediate good, while education is the final service provided.

[26] In headline terms, VAT revenue is up 11.7% year on year. The figure above is adjusted for a technical issue that inflated January receipts by €0.2 billion.

Figure 2.2: Tax revenue has been growing strongly



Sources: Department of Finance and Fiscal Council workings. [Get the data.]
Notes: The pre-pandemic trend is calculated as a linear trend from January 2015 to December 2019. % difference refers to the gap between the current annualised seasonally adjusted level and its pre-pandemic trend. The implied forecast of August 2023 corporation tax receipts in panel D is arrived at by applying the Q3 year-on-year growth rate to the August 2022 corporation tax receipts.

Large companies pay preliminary corporation tax in month 6 of their financial year and in month 11 of their financial year, with the final corporation tax payment paid 9 months after their financial year-end. As a result, there is a link between corporation tax receipts received in certain months. Figure 2.2D shows the corporation tax receipts in March and August (months 6 and months 11 for companies with September year-end). Despite corporation tax receipts in March

2023 being up by 63% year on year, the implied forecast for August receipts—which should be linked—shows a year-on-year fall of 8.2%.[27]

The Department has stated that it believes much of the March over-performance relative to last year relates to an earlier than expected payment of receipts. However, the Department indicated the same last year, when March 2022 receipts had grown substantially on the previous year. Subsequently, the August 2022 receipts substantially overperformed forecasts.

In addition, publicly available information on the exhaustion of capital allowances available to certain companies with September year-end, taken together with the substantial increase in March receipts would suggest a large increase could be in store for receipts due to be paid in August.

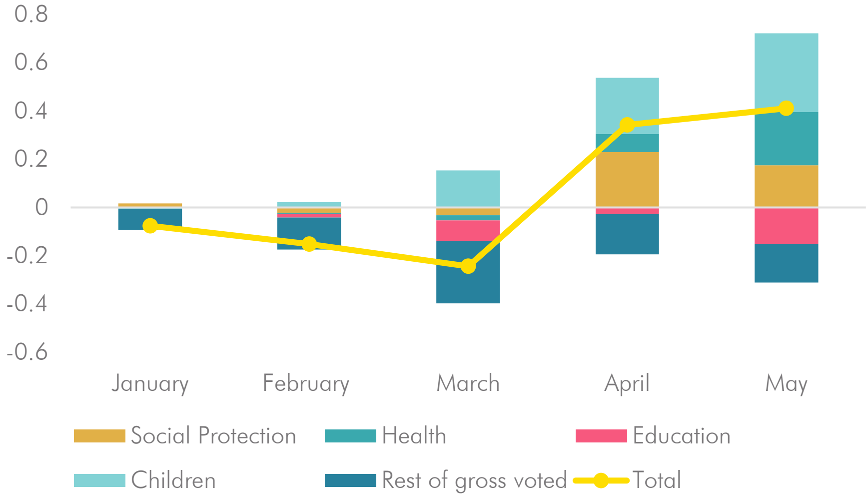
While an overperformance of corporation tax receipts for Q3 appears likely, this could be partially offset by lower than forecasts receipts for other quarters, with receipts in May down year on year.

On the spending side, at the end of May, current spending is €0.4 billion (1.3%) ahead of profile (Figure 2.3). The Department of Social protection is ahead of profile by €0.2 billion, while the Department of Children, Equality, Disability, Integration and Youth is ahead of profile by €0.3 billion. Relative to the Department of Children's expected expenditure, this is the equivalent of 24% over profile. This is related to additional costs associated with Ukrainian refugees, and this overspend relative to profile may yet be covered by the €0.4 billion of unallocated spending for Ukrainian refugees (see below).

[27] The Department of Finance is no longer publishing monthly profiles for tax receipts. It is instead publishing quarterly profiles. The figure for August 2023 is implied from the year-on-year growth rate of the Q3 2023 profile for corporation tax.

Figure 2.3: Current spending this year ahead of forecasts

€ billion, cumulative gross voted current expenditure relative to profile



Sources: Department of Finance and Fiscal Council workings. [Get the data.]
Note: Education includes both the education vote and the higher education vote.

There could be an overspend in the health area this year. Current health spending is €0.2 billion ahead of profile and certain budgetary allocations appear too low and the. For instance, the health vote has a 6% reduction in pension-related expenditure despite a 2% expected increase in pensioners.

Furthermore, if there were to be any new public sector pay deal affecting 2023, this would likely see overspends in several departments. The current public sector pay deal is due to run until the end of 2023, with an increase in public sector pay rates of 1.5% on 1 October.

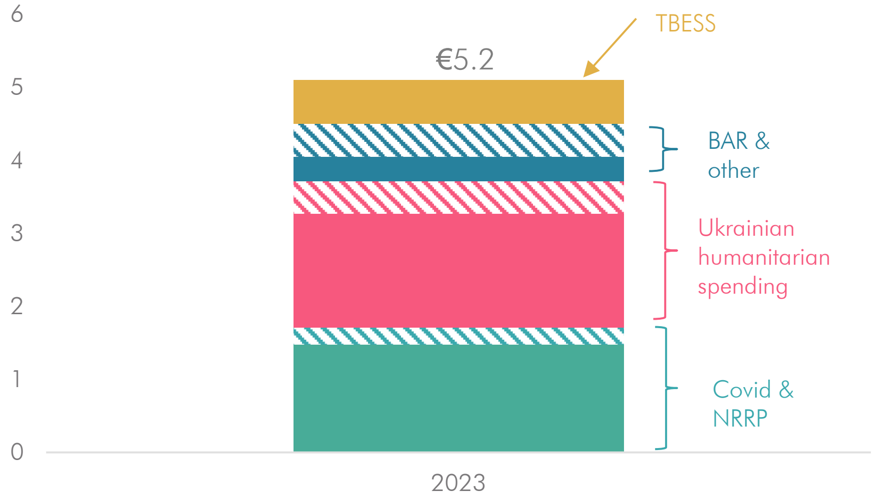
SPU 2023 included one-offs/temporary measures amounting to €5.2 billion for 2023 (Figure 2.4). Of this, €1.1 billion has not yet been allocated, but has been earmarked for Covid (€0.2 billion), Ukrainian refugees (€0.4 billion), and the Brexit adjustment fund (€0.4 billion). The only cost-of-living measure included in the one-offs/temporary measures for 2023 is the temporary business energy support scheme (TBESS), costing €650 million. It seems unlikely that all €650 million will be spent on the TBESS, as only €81 million of claims had been approved by 27 April.

In February 2023, a further cost-of-living package was introduced, with €0.8 billion in tax cuts and €0.4 billion in expenditure measures announced. At the time of introduction of the spring measures, it was unclear what the exact cost of individual supports might be. It was also unclear how they would be funded: whether these supports would be met by existing contingencies or require new funding. As a matter of principle, the Government should provide more detail on measures introduced outside the usual budget process.

Since then, the Government has indicated that these temporary expenditure measures are expected to be covered under the Government Expenditure Ceiling and will not lead to additional expenditure over and above what was already laid out in *Budget 2023*. The Department also expected that revenue buoyancy will somewhat offset the cost of the tax cuts.

Figure 2.4: Approximately €1.1 billion of non-core spending remains unallocated

€ billion, shaded regions refer to unallocated amounts



Sources: SPU 2023, CSO and Fiscal Council workings. Get the data.
Notes: Shaded regions refer to €1.1 billion of non-core spending which has been earmarked for certain areas but remains unallocated within those areas. TBESS refers to the temporary business energy support scheme. BAR is the Brexit adjustment reserve and NRRP is the EU's Recovery and Resilience Fund.

Table 2.2: *SPU 2023* summary fiscal forecasts

€ billions

	2022	2023	2024	2025	2026
General government					
Revenue	115.5	123.4	129.2	135.0	142.1
Expenditure	107.5	113.4	113.0	116.8	121.3
Balance	8.0	10.0	16.2	18.1	20.8
Revenue one-offs	-0.7	-0.8	0.0	0.0	0.0
Expenditure one-offs	7.6	5.2	0.5	0.3	0.0
Windfall corporation tax	10.8	11.8	11.8	11.4	12.4
Expenditure excl. one-offs	99.9	108.3	112.5	116.6	121.3
Revenue excl. one-offs and windfall corporation tax	105.4	111.6	117.4	123.6	129.7
Balance excl. one-offs and windfall corporation tax	5.5	3.4	4.9	7.0	8.4
Exchequer and social Insurance Fund					
Gross voted "core" expenditure	80.0	85.9	90.2	94.7	99.5
Gross voted "core" current expenditure	69.6	74.3	77.6	81.3	85.3
Gross voted "core" capital expenditure	10.5	11.7	12.6	13.4	14.2
Tax and PRSI revenue	97.2	104.0	111.0	116.6	123.7
Tax revenue	83.1	88.9	94.4	99.0	105.0
PRSI	14.0	15.1	16.6	17.6	18.7

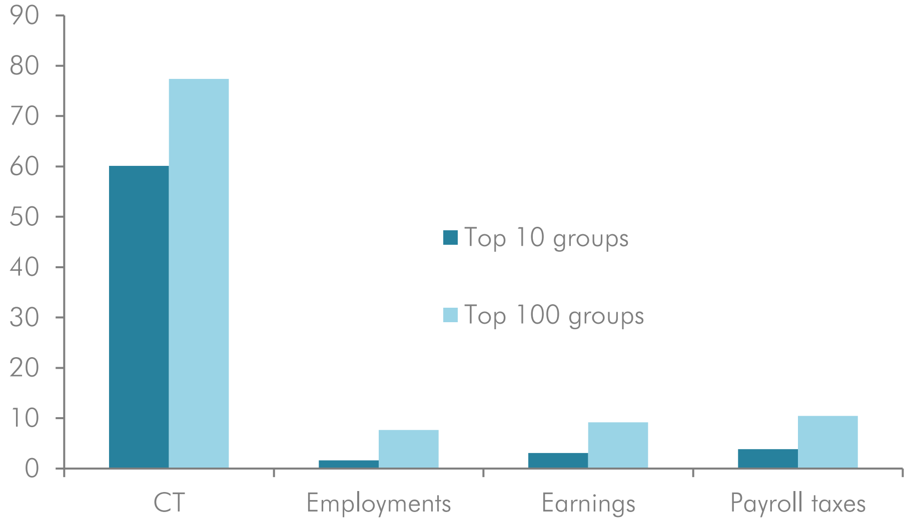
Sources: CSO; *SPU 2023*, and Fiscal Council workings.
Notes: Estimates of windfall corporation tax receipts are the Department of Finance's estimates published in *SPU 2023*. Estimates of revenue and expenditure one-offs are those judged by the Council.

2.3 Corporation tax

Corporation tax is concentrated among a small number of corporate groups, which are also significant contributors to other revenues. Figure 2.5 shows the contribution made by these groups to other aspects of the Irish economy outside corporation tax alone. In 2022, the top 100 groups account for almost 80% of corporation tax paid, but also account for around 10% of employment, earnings and payroll taxes. Recently published work (Cronin, 2023) estimates that just three corporate groups accounted for around a third of all corporation tax revenues from 2017 to 2021, with ICT and pharma-chem being the top sectors.

Figure 2.5: Top payers of corporation tax have proportionally smaller real economy impacts

% of total for the largest payers of corporation tax in 2022



Sources: Revenue Commissioners, CSO, and Fiscal Council workings. [Get the data.](#)
Notes: CT = corporation tax. Figures refer to the percentage of each of the categories accounted for by the top 10 or top 100 payers of corporation tax in Ireland (corporate groups). The share of employments shown here is a slight overestimate. The numerator is the number of employments accounted for by the top 10 or 100 groups. The denominator is the number of people employed (from the CSO Labour Force Survey). Employments will exceed the total numbers employed, due to people working in multiple jobs or changing jobs within a year. Payroll taxes refers to income tax, USC, and PRSI combined.

Corporation tax receipts are forecast to remain roughly unchanged as a share of national income in the coming years. As a result, excess corporation tax receipts are forecast to remain elevated out to 2026. Figure 2.6 shows that excess receipts are forecast to be between 3.5% and 4.2% of national income. The Department assumes that the negative impact of the OECD's Base Erosion and Profit Shifting (BEPS) pillar I and pillar II reforms do not take effect until 2025. SPU forecasts incorporate a €2 billion negative impact from 2025 onwards.

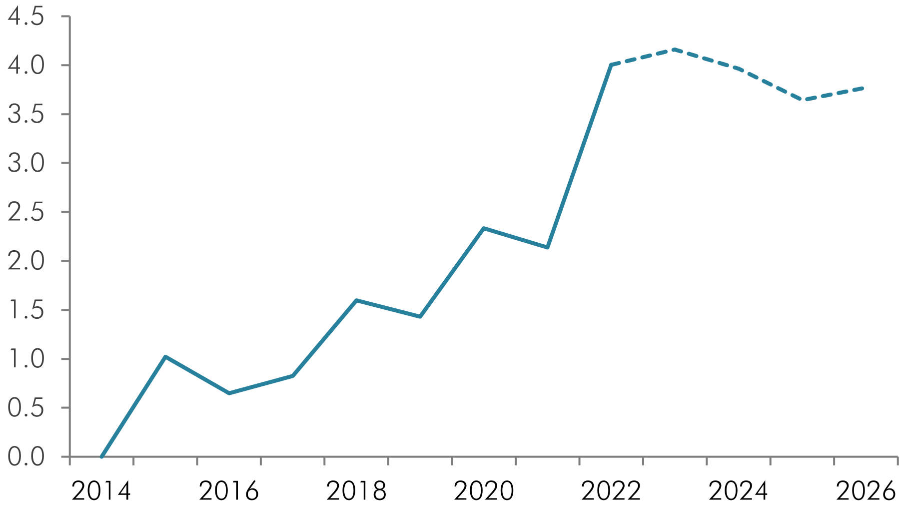
This estimate of the impact of the BEPS reforms has remained unchanged since January 2020. In the meantime, corporation tax receipts have grown substantially. As a result, the €2 billion impact is a much smaller share of corporation tax receipts than was the case when it was originally estimated. €2 billion was 18.4% of 2019 receipts but is 8.8% of 2022 receipts.

The Department has assumed that €1.2 billion of 2022 receipts are one-off. As a result, these receipts are not assumed to recur in 2023. This reduces *SPU 2023* forecasts of corporation tax in 2023 and beyond. However, given the strength of receipts so far this year, it seems likely that receipts in 2023 could surpass *SPU 2023* projections. Supplementary information section S5 shows a decomposition of these forecasts.

Section 3.3 discusses the importance of these receipts when considering an appropriate fiscal stance for Ireland. The medium-term outlook for these risks is highly uncertain. Box D explains how the public finances have benefitted from excess corporation tax receipts.

Figure 2.6: Excess corporation tax is forecast to remain high

% GNI*



Sources: *SPU 2023*, CSO, and Fiscal Council workings. *SPU 2023* figures are used for 2021-2026.
Notes: For 2014-2020, Fiscal Council estimates are used (see Box D). Get the data.

Box D: Windfall corporation tax receipts flattering the public finances

The public finances are benefiting significantly from windfall corporation tax receipts, receipts in excess of what can be explained by domestic economic activity.

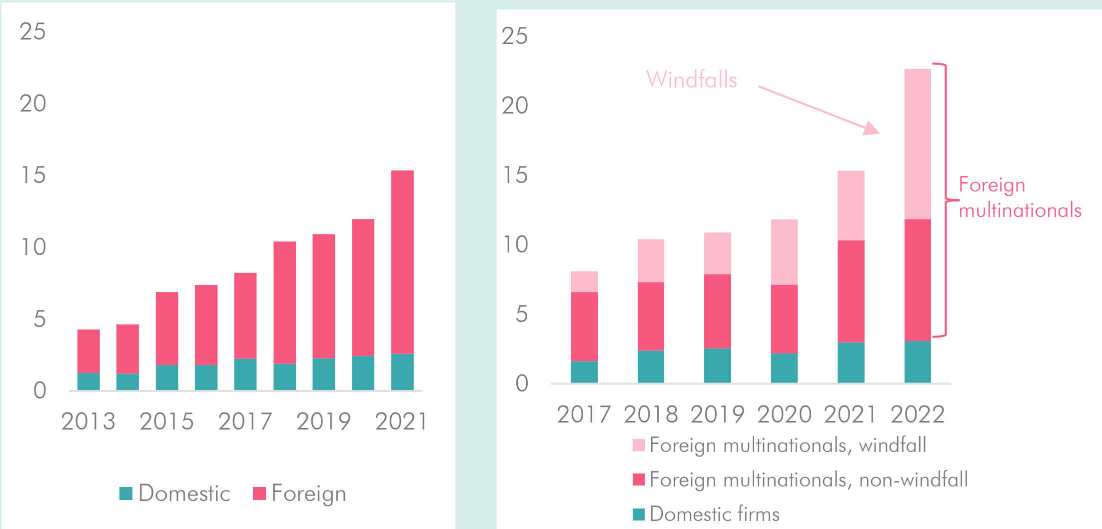
Much of Ireland's corporation tax receipts come from foreign-owned multinationals. Figure D1 shows data from two different sources on the proportion of corporation taxes paid by foreign-owned multinationals. Panel A shows data from the CSO's Institutional Sector Accounts, while panel B shows the data from the Revenue Commissioners.[28] Both data sources show a substantial rise in corporation tax payments in recent years, much of this being driven by foreign-owned multinationals.

Much of the growth in receipts of these foreign-owned multinationals is in excess of what can be explained by growth in the domestic economic activity (Figure D1.B). While these windfall receipts are substantial, the economy and the public finances has benefited greatly from non-windfall receipts from foreign multinationals. The non-windfall receipts from foreign multinationals amounted to €8.8 billion in 2022. This is more than double the total corporation tax take in 2013.

Figure D1: Foreign multinationals pay a disproportionate share of corporation tax

A. Corporation tax, CSO
€ billion, taxes on income and wealth

B. Corporation tax, Revenue Commissioners
€ billion, net payments



Sources: CSO; Revenue Commissioners and Fiscal Council workings. Get the data.
Notes: Panel A shows taxes on Income and wealth of foreign and domestic firms taken from the institutional sectoral accounts. Taxes on income and wealth includes capital gains taxes and corporation taxes paid by firms. However, most of taxes on income and wealth paid by firms is corporation tax. Panel B shows the share of net corporation taxes paid by foreign owned multinationals, taken from the Revenue Commissioners' data. Windfall corporation tax receipts are estimated by the Department of Finance for 2021 and 2022. For 2017-2020 the Council's estimates are used.

The growth in the windfall receipts has flattered the headline indicators of the public finances. These receipts are highly concentrated coming from just a handful of firms (Figure 2.5). As a result, these receipts could be subject to sharp reversals, which could occur from changes to the international tax environment.

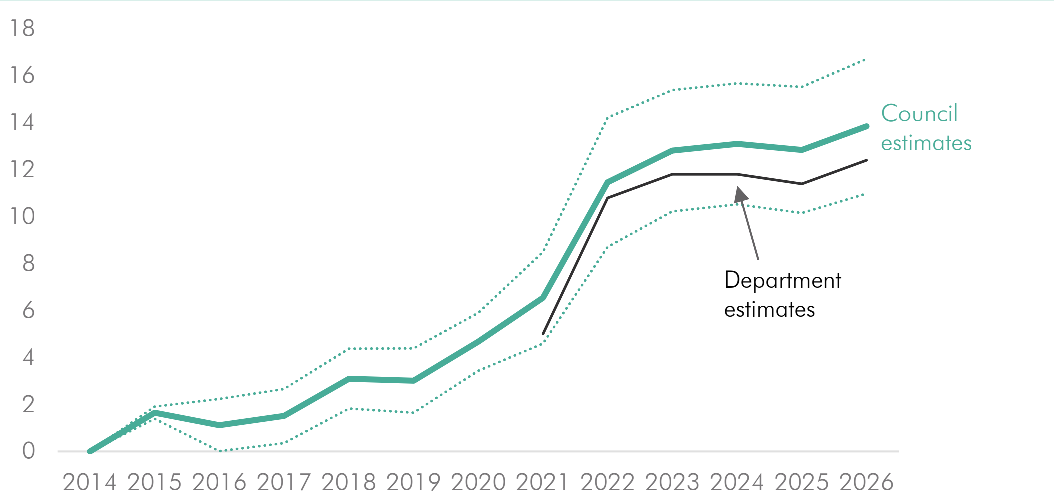
As a result, the Department has estimated the proportion of these receipts that may be deemed windfalls—those in excess of what can be explained by domestic economic activity. The Department uses a range of approaches to estimate these windfalls, as does the Council. The Council's models suggest that the windfalls could be potentially larger than the Department's estimates (Figure D2) and there are

[28] The CSO's institutional sectoral accounts data are derived using data from the Revenue Commissioners. However, the CSO's data is based on accrual accounting methods whereas the Revenue Commissioners' data are based on cash payments. There are also differences in the definitions for foreign and domestic owned firms. In addition, the CSO's data on taxes on income and wealth includes capital gains taxes and corporation taxes paid by firms. However, most of taxes on income and wealth paid by firms is corporation tax.

risks around these windfall estimates with the upper bound on windfall receipts substantially above the Department's estimate.[29]

Figure D.2: Windfall receipts could potentially be higher than the Department is estimating

€ billion



Sources: Department of Finance and Fiscal Council workings. [Get the data.]

Notes: See Fiscal Council (2020) for an overview of the models used to estimate windfall corporation tax receipts.

[29] Some of the approaches used by the Department to estimate the windfall receipts would tend to bias downwards the estimated windfall receipts. For instance, one approach the Department uses to estimate the windfall amount is to see how much higher the share of corporation tax revenue in total tax revenue is from its long-run average share, or "norm". However, the Department estimates this long-run share over a period in which we have been receiving these windfall receipts. It is widely accepted that these windfall receipts began around 2015. By including a post-2015 period in its estimation of the long-run share, the Department is including windfall receipts in its long-run "norm". This therefore biases up the long-run share and biases down the amount that could be considered windfall under this approach.

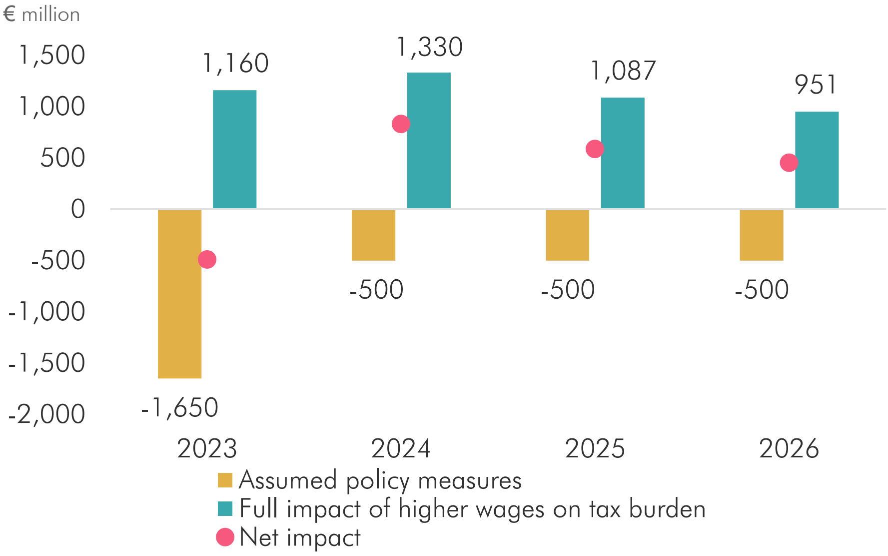
2.4 Tax revenue forecasts

To assess revenue projections and understand the underlying dynamics, tax forecasts can be decomposed into several factors. Supporting information Section S5 shows a breakdown of the various factors contributing to *SPU 2023* forecasts of tax receipts. These factors include growth in macroeconomic drivers, policy changes, one-off effects, and judgement applied to the forecasts.

By looking at this breakdown, one can better assess if revenue projections are reasonable. For example, if strong revenue increases were based on judgement rather than policy changes or growth in the macroeconomic drivers, that might be a cause to question such a forecast. As has been documented previously, forecasting government revenue in Ireland is difficult, with large absolute errors relative to other countries (Hannon et al, 2015; Tax Forecasting Methodology Review Group, 2019).

Figure 2.7 shows that income tax changes assumed as part of *SPU 2023* are consistent with partial indexation of the tax system from 2024. Tax reductions of €500 million per year are assumed. However, this is lower than what would be required to index tax bands and credits to wage growth and, all else equal, this would lead to an increase in the effective tax rate and higher tax revenue.

Figure 2.7: Assumed tax cuts are consistent with partial indexation



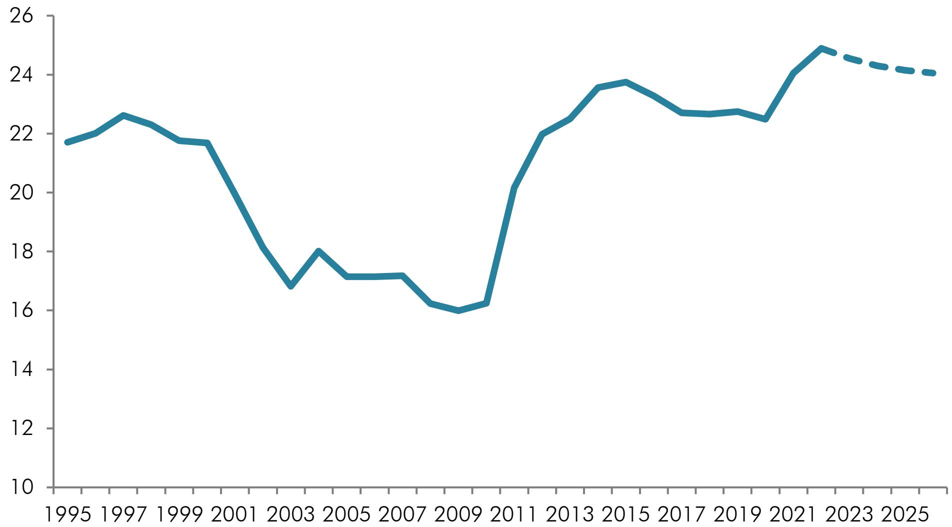
Sources: *SPU 2023*, CSO, and Fiscal Council workings. Get the data.
Notes: A net impact less than zero indicates that assumed policy changes are greater than the assumed yield from not indexing income tax bands and credits. As a result, income tax revenue would be lower than if full indexation of the income tax system were assumed. The cost of indexation for 2023–2024 is given by Department of Finance estimates. The 2025 and 2026 estimates are derived by combining the Revenue Commissioners' post-*Budget 2023* "ready reckoner" with the Department of Finance's forecasts of hourly earnings growth.

Assumed tax cuts are consistent with partial indexation

However, the Department has also applied negative judgement to its forecasts of income tax of approximately €1 billion per year over 2024-2026 (see supplementary information section S5). This implies the income tax share of the wage bill relatively flat, rather than rising as it would be without applying this judgement (Figure 2.8). This negative judgement exceeds the additional tax changes over what has been assumed for *SPU 2023* which would be required to fully index the income tax system.

Figure 2.8: Income tax to fall slightly from a historically high share

Exchequer income tax as a percentage of compensation of employees



Sources: *SPU 2023*, CSO, and Fiscal Council workings. Get the data.

Excise is another revenue source that is impacted by assumed policy changes. Excise receipts are boosted by the planned increases in the carbon tax over the forecast horizon (averaging €140 million over 2024-2026).

As noted in Section 2.2, PRSI receipts could be stronger than SPU forecasts for 2023. A higher base for 2023 would also lead to higher receipts in the following years.

The Council requested information on the methodology used to forecast PRSI receipts.[30] No further information was provided, so it is impossible to assess how *SPU 2023* projections for PRSI were arrived at. Given PRSI makes up 12% of general government revenue, this makes it difficult for the Council to fulfil its mandate to assess the fiscal forecasts in *SPU 2023*.

[30] The Department of Social Protection forecast PRSI receipts, not the Department of Finance.

2.5 Government spending and Stand-Still costs

As outlined earlier, *SPU 2023* budgetary projections only go as far as 2026—the minimum required for an SPU. Due to this short forecast horizon, sizeable medium-term challenges are not being sufficiently recognised in planning. The expected costs of ageing, climate change, and other policy initiatives need to be costed and factored in properly.

Three likely costs have not been included in *SPU 2023* spending forecasts:

Three likely costs have not been included in *SPU 2023* expenditure forecasts

First, spending related to Ukrainian refugees has not been provided for after 2023 in SPU projections. The Department outlined that this is because *SPU 2023* is compiled on a no-policy-change basis. This seems implausible. It implies that current government policy is that there will be no government spending on supporting Ukrainian refugees in 2024. This is despite the Government's macroeconomic forecasts assuming that there will continue to be more Ukrainian refugees arriving in 2024, and no major outflows of people thereafter.

For additional context, the *Stability Programme Update* published in April 2022, which was also compiled on a no-policy-change basis, incorporated a contingency for spending on Ukrainian refugees for the following year, 2023. *Budget 2023* then allocated €2 billion of spending for 2023. While the exact quantity of spending in this area for 2024 is uncertain, it is likely to be significant again. Despite this, *SPU 2023* expenditure forecasts include no explicit provision for it.

Second, government contributions to the planned auto-enrolment pension scheme have not been incorporated into spending forecasts. This is despite the scheme having been incorporated into the macroeconomic projections underpinning *SPU 2023*. As outlined in Box B, this is likely to imply costs of over €125 million per year in the years 2024-2026. This reflects the estimated cost of government contributions to the scheme, which are set at one-third of employee contributions.

Third, payment of the Christmas bonus has not been budgeted for in any part of the forecast horizon. This is despite its payment to some extent, in every year since 2014. There has been repeated failure to budget for this in advance of the Budget Day announcements, after which the Government then systematically provides these payments for the approaching Christmas period.

Given these issues, the methodology employed to forecast government expenditure in *SPU 2023* is substandard. Taking the three items listed above, these could imply additional expenditure of approximately €2.6 billion in 2024 (€2.1 billion for Ukrainian refugees, €125m for state contributions to the auto enrolment pension scheme, and €350 million for the Christmas bonus).

The *Stability Programme Update 2021* introduced the concept of "core" and "non-core" government spending. Non-core spending, initially related to the Covid-19 pandemic, was assumed to be temporary. Amounts for the Brexit adjustment reserve, and the National Recovery and Resilience Plan were also counted as non-core spending as these were funded by the EU and were temporary.

After the onset of the Russian war on Ukraine, the definition of non-core spending expanded to incorporate spending related to supporting Ukrainian refugees and temporary cost of living measures.

The distinction between core and non-core expenditure is becoming somewhat blurred

Some amount of Covid-19 related expenditure is likely to be necessary indefinitely. In addition, the war in Ukraine could continue for a protracted period and some refugees may settle in Ireland. As a result, the distinction between non-core and core spending is becoming somewhat blurred. Given that a substantial proportion of non-core expenditure is likely to continue indefinitely, this should be factored into the core expenditure base over time as it becomes more certain and to avoid unduly distorting core spending that is used for the National Spending Rule.

Core government spending is expected to grow in line with the National Spending Rule, currently set at 5% over 2024-2026. In addition, non-core expenditure growth is forecast to average €0.4 billion annually over this period.

To evaluate the disparity between realistic spending plans and current plans, Figure 2.9 shows "Stand-Still" estimates, which incorporate the cost of maintaining existing services, including support for Ukrainian refugees, state contributions to the auto-enrolment pension scheme and payment of the Christmas bonus.[31] The "Stand-Still" assumes that demographic changes are accounted for, welfare rates and public sector pay grow in line with the Department's forecasts for wage growth, while other costs grow in line with inflation forecasts.[32]

Expenditure forecasts in *SPU 2023* are below levels required to Stand Still

The estimated "Stand-Still" costs in 2024 are €5.6 billion (including €0.9 billion in capital spending). This is €1.3 billion more than the increase in core expenditure expected in *SPU 2023* and that is available under the National

[31] This assumes that all Ukrainian humanitarian spending becomes "core" spending. For the "Stand-Still" analysis, costs related to Ukrainian humanitarian spending are assumed to increase in line with inflation.

[32] Whether welfare rates and public sector pay grow in line with wage increases is ultimately a policy decision. This also assumes no efficiency gains in government current expenditure.

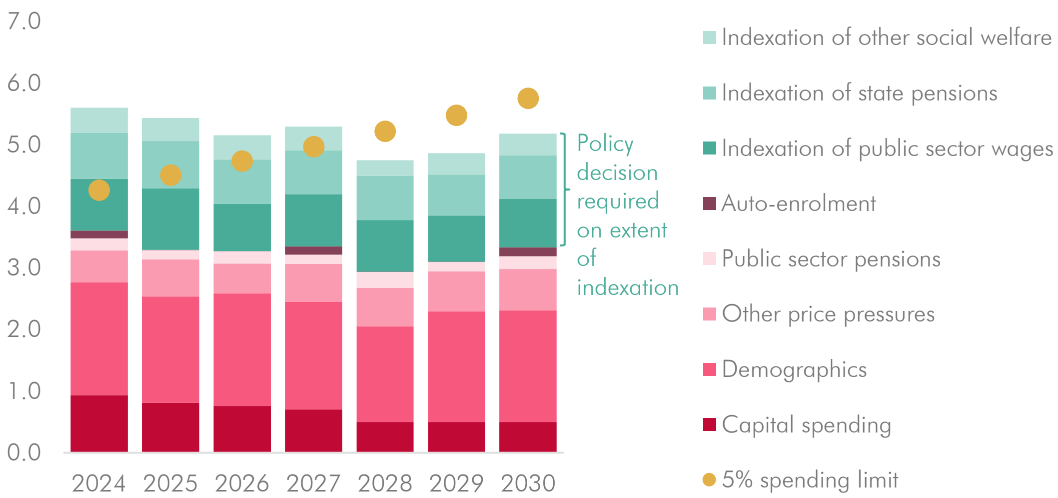
Spending rule.[33] Of the €5.6 billion, €2.5 billion relates to the indexation of public sector pay and welfare rates to forecast wage growth. Were public sector pay and welfare rates to grow at a slower rate than economy-wide wage growth as has been the case in a number of years, Stand-Still costs would be lower.

Over 2025-2026, the cost of standing still is approximately €0.6 billion per annum more than the increase of core expenditure allowed at present under the Government's National Spending Rule (Figure 2.9).

As the Government's National Spending Rule is set in net terms (net of tax changes), tax increases could provide room for further spending increases beyond those outlined in *SPU 2023*.[34] In addition, the Government could decide to grow public sector wages or social welfare payments at a slower rate than economy-wide wage growth or slow spending growth in other areas.[35]

Figure 2.9: Spending plans may not be enough to cover Stand-Still costs

Annual change in € billion (gross voted spending)



Source: Fiscal Council workings. Get the data.

Notes: The stand-still assumes that public sector pay rates and social welfare rates grow in line with forecasts of economy-wide wage growth, while other prices grow in line with inflation forecasts. Capital spending is as outlined in the NDP for 2027-2030. Figures for the 5% spending limit show the existing ceilings. Including Ukrainian humanitarian aid in the base for core spending would increase the existing ceilings by circa €0.1 billion for each year.

[33] The inclusion of Ukrainian humanitarian aid in the base for core spending adds approximately €0.1 billion to standstill costs in 2024. Including this in the base for core spending would also change the ceilings for core spending going forward. Excluding Ukrainian humanitarian costs, stands-still costs would be €1.2 billion more than the increase in core current expenditure expected in *SPU 2023*.

[34] Conversely, further tax cuts would reduce the amount of space available for spending increases under the National Spending Rule.

[35] There is no rule of indexing public sector wages or social benefits to inflation or wages. Decisions on such changes are made year-to-year and can exceed or fall short of inflation or private sector wage changes.

2.6 Capital spending plans

Capital spending (gross fixed capital formation, or GFCF) forecasts were revised down in *SPU 2023* relative to *Budget 2023* (Figure 2.10A). The downward revision in general government terms contrasts with forecasts of gross voted capital spending, which remains unchanged from budget day. This suggests that it is non-voted capital expenditure that has been revised down, particularly around local government or Approved Housing Authorities.

The Department has indicated that this downward revision is in part due to a reclassification of government spending from capital spending into intermediate consumption and capital transfers.[36] In addition, there been a downward revision of general government bodies (which sit outside the Exchequer) forecasts for capital expenditure.[37] For 2024, gross fixed capital formation was revised down by €1.2 billion.

Capital spending has been revised downwards

More generally, in recent years, capital expenditure has fallen short of forecast levels (particularly in housing). Figure 2.10A below shows capital spending plans as a share of national income. Nominal national income has been revised up due mainly to higher inflation. *Budget 2022* forecast capital spending to reach almost 5.5% of national income by 2025. *SPU 2023* forecasts capital spending to be 4.2% of national income in 2025.

Since *Budget 2022*, nominal government capital spending has been revised down, while inflation has increased. Both factors mean that a lower level of real output is now expected. By 2025, the gap between the real level of investment foreseen in *SPU 2023* and *Budget 2022* is almost 24%.

Capital spending now makes up a lower share of total spending than originally planned, as gross voted (core) current spending has been increased in response to higher inflation, and little to no upward response of capital spending to inflation (Figure 2.10C).

As a result, the *National Development Plan* (NDP) will now account for a lower share of national income than originally planned (Figure 2.10D).

It could be the case that capital spending is revised down in the short term, with higher levels of investment coming later. However, with the short forecast horizon (three years ahead) in *SPU 2023*, this is unclear. To return to the same share of national income as originally planned, exchequer capital spending would have to be on average €2.7 billion higher per year over 2024 to 2030.

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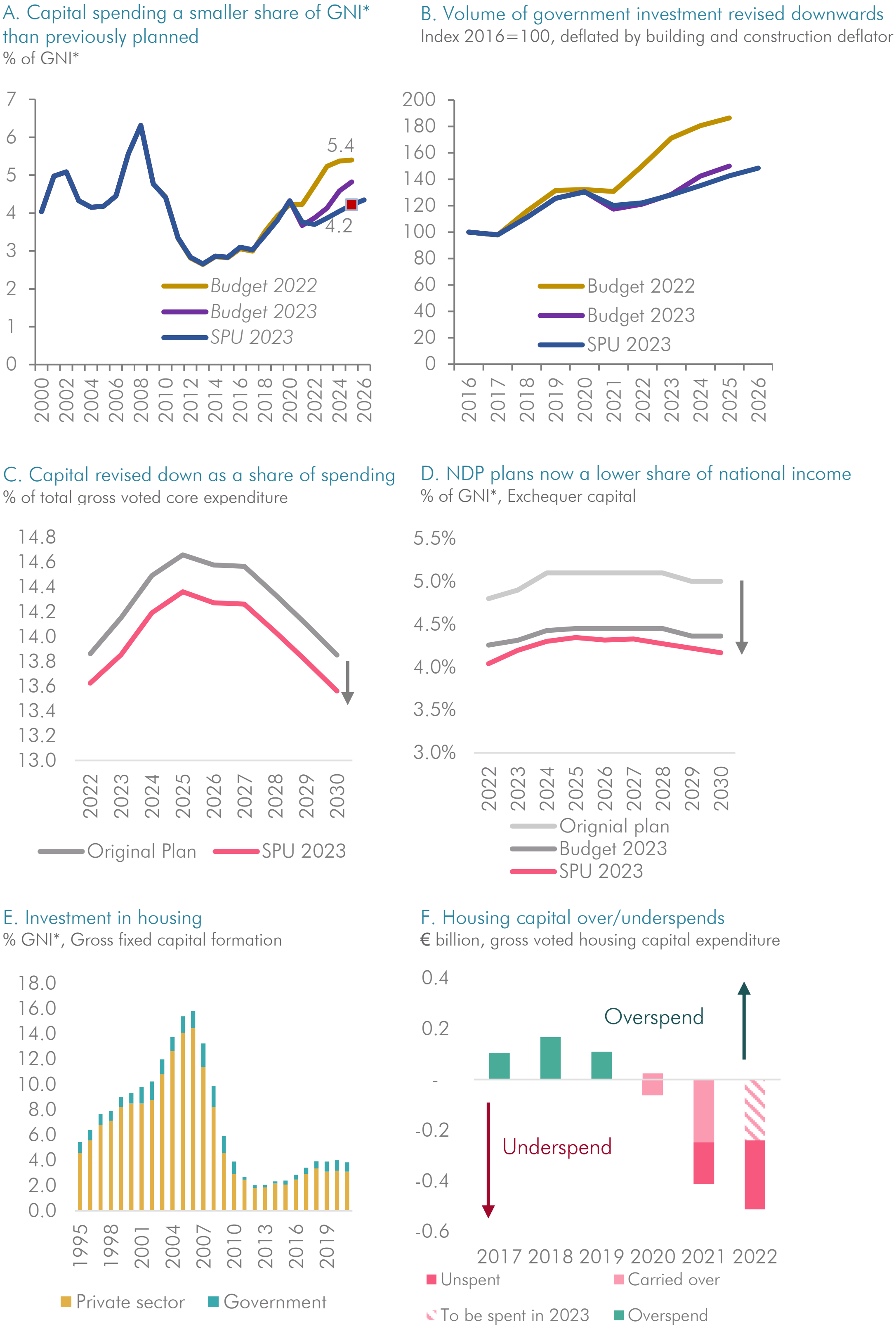
[36] The Department was unable to provide estimates of how large these revisions were.
[37] Intermediate consumption refers to goods and services consumed by general government units in their productive activities.

Figure 2.10: Capital spending revisions and underspends



Sources: Department of Public Expenditure and Reform; Eurostat; CSO; and Fiscal Council workings.
Notes: Panel B shows the government gross fixed capital formation spending deflated by the building and construction deflator from the national accounts. Government investment in panel E refers to government gross fixed capital formation (P51G) and Investment grants (D92) for housing (COFOG codes GF0601 & GF1006). Panel F shows data relative to original allocation. Get the data.

This sort of smoothing (even if not entirely planned) could prove beneficial, as the economy does not require further stimulus at present and capacity constraints do appear to be binding in certain areas. However, some forms of capital spending could help alleviate some capacity constraints currently being experienced by the Irish economy.

Housing has been a key part of capital underspends in recent years. Relative to the original allocation in the Revisited Estimates, there has been a cumulative within year underspend of €1 billion in housing capital expenditure over the last three years (2.11F). However, of the underspend in 2020, €0.1 billion was carried over into 2021 and subsequently spent.[38] Similarly, a further €0.25 billion of the underspend in 2021 has been carried over into 2022 and spent. A further €0.25 billion of the underspend in 2022 has been carried over into 2023 and will likely be spent this year. This means that the true unspent amounts in the housing capital programme in the last three years is in the region of €0.4 billion.

As discussed in Section 2.1, a large capital transfer related to the Defective Concrete Blocks Redress scheme (€2.7 billion) is now to be accounted for over several years. Previously all of this expenditure was expected to be accounted for in 2022.

Beyond this year (where €40 million of expenditure is expected), expenditure on the Defective Concrete Blocks Grant Scheme has not been incorporated into SPU forecasts. While the timing of payments may be uncertain (and may extend beyond the fiscal forecast horizon of *SPU 2023*), the total cost of this scheme across multiple years is expected to be around €2.7 billion.

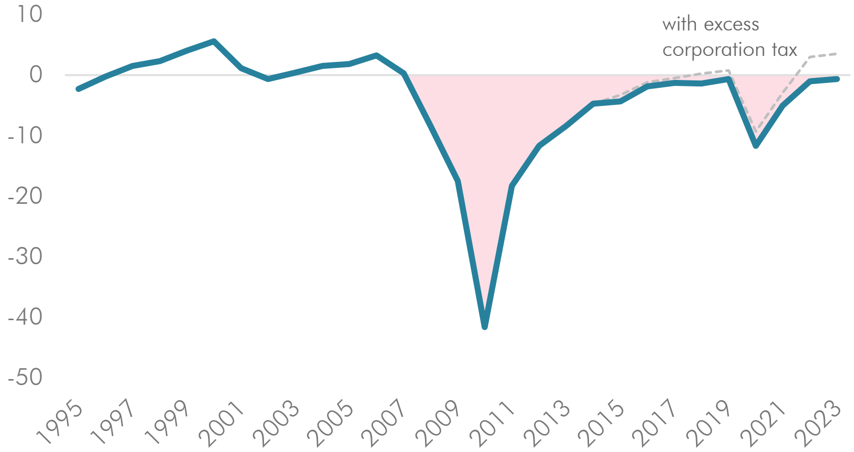
[38] Given the way this spending is accounted for in the exchequer accounts, it does not show up in the following year's capital expenditure. Instead, it comes out of the exchequer in the year in which the underspend occurs.

2.7 How the public finances are forecast to evolve

When excluding excess corporation tax, the general government balance is forecast to remain in deficit in 2023. This would be the sixteenth consecutive year in which this has occurred (Figure 2.11).

Figure 2.11: Government balance excluding excess corporation tax forecast to remain in deficit this year

General government balance excluding excess CT receipts, % GNI*

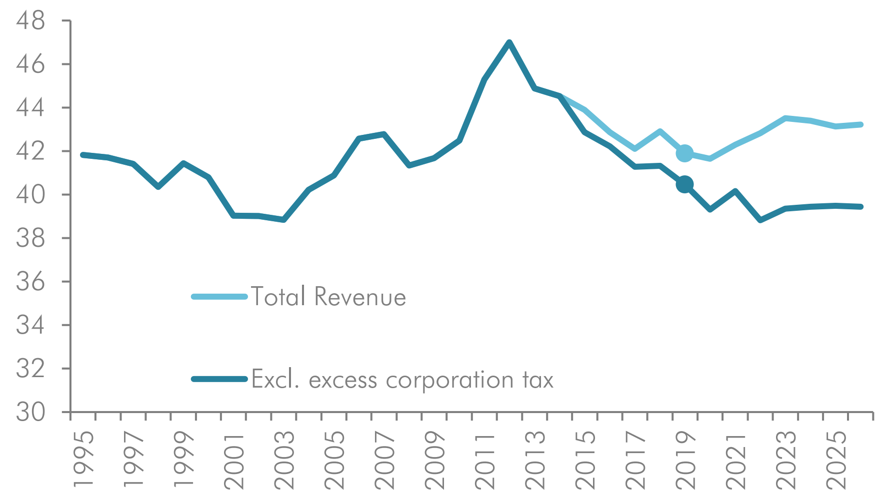


Sources: SPU 2023, CSO, and Fiscal Council workings. Get the data.
Notes: For excess corporation tax, SPU 2023 figures are used for 2021-2026. For 2014-2020, Fiscal Council estimates are used (see Box D).

To give a perspective on the underlying dynamics of the public finances over the coming years, Table 2.3 compares the *SPU 2023* forecast of the level of several fiscal variables in 2026 to the last outturns before the pandemic (2019) as a way aof "looking through" the impact of the pandemic.

Figure 2.12: Headline revenue diverges from underlying revenue as a share of national income

% GNI*, general government revenue



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Notes: Dots show 2019 levels. For excess corporation tax, *SPU 2023* figures are used for 2021-2026. For 2014-2020, Fiscal Council estimates are used (see Box D).

Underlying general government revenue is forecast to remain broadly flat as a share of national income. Figure 2.12 illustrates the role of excess corporation tax receipts. Headline general government revenue increases as a share of national income, while there is a slight fall in the underlying measure (relative to 2019).

On the spending side, current primary spending is forecast to fall as a share of national income. While current primary spending is forecast to grow by almost 5% on average over the period, nominal GNI* growth averages 6.6%. Capital spending is forecast to grow as share of national income relative to 2019. However, this increase is more modest than previous plans would have implied (Section 2.6). Interest spending is forecast to fall in nominal terms (and hence even more as a share of national income). This is due to the average interest rate on outstanding government debt falling over the period. A substantial fall occurred between 2019 and 2021.[39]

Table 2.3: Comparing 2019 and 2026

Difference 2026 – 2019

	p.p change in GNI*	€ billion change	% Change	Annualised growth rate
GG revenue	1.3	53.8	61.0	7.0
GG revenue (excl. excess corporation tax)	-1.0	44.5	52.2	6.2
Tax revenue	3.8	45.7	77.1	8.5
PRSI	0.3	7.3	63.4	7.3
Non-tax, non-PRSI revenue	-2.7	0.9	5.1	0.7
Income tax	1.0	16.3	71.0	8.0
Corporation tax	3.1	16.3	149.7	14.0
:of which "excess"	0.5	9.4	310.8	22.4
VAT	-0.9	10.2	67.7	7.7
Other tax revenue	-0.9	2.9	27.8	3.6
GG spending	-4.2	34.7	40.2	4.9
Gross fixed capital formation	0.5	6.3	78.1	8.6
Interest	-1.2	-1.2	-26.9	-4.4
Current primary spending	-3.6	29.7	40.2	4.9
GG balance	5.5	19.1		
GG balance (excl. excess corporation tax)	3.2	9.7		
Level of GNI*		118.2	56.1	6.6

Sources: CSO and *SPU 2023*.
Notes: Changes are in the format 2026 level minus 2019 level. As a result, positive values indicate a variable increasing over the period or taking up a larger share of GNI* than was the case in 2019. The annualised growth rate shows the rate of growth for every year from 2019 that would yield the 2026 level forecast in *SPU 2023*. GG = general government. For excess corporation tax *SPU 2023* figures are used for 2021-2026. For 2014-2020, Fiscal Council estimates are used (see Box D).

Even after adjusting for excess corporation tax receipts, the government balance is forecast to improve from 2019 to 2026. A €9.7 billion improvement is forecast (3.2% of GNI*).

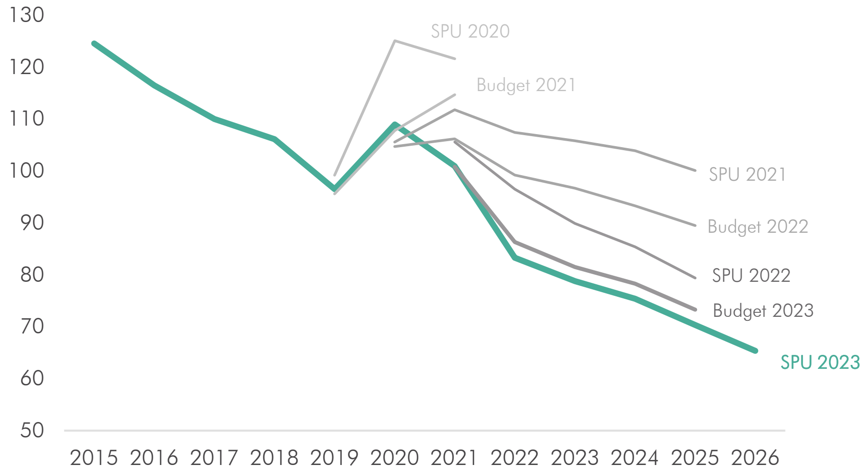
[39] Using general government interest expenditure divided by gross general government debt, the average interest rate fell from 2.3% in 2019 to 1.4% in 2021. It is projected to rise to 1.6% in 2026.

2.8 Debt trajectory

The gross debt to GNI* ratio is forecast to fall by 18 percentage points from end-2022 to end-2026. This is a further downward revision in the gross debt ratio forecasts previously made by the Department (Figure 2.13).

Figure 2.13: Debt forecasts repeatedly revised down

Gross debt, % of GNI*



Sources: CSO, Department of Finance, and Fiscal Council workings. [Get the data.]

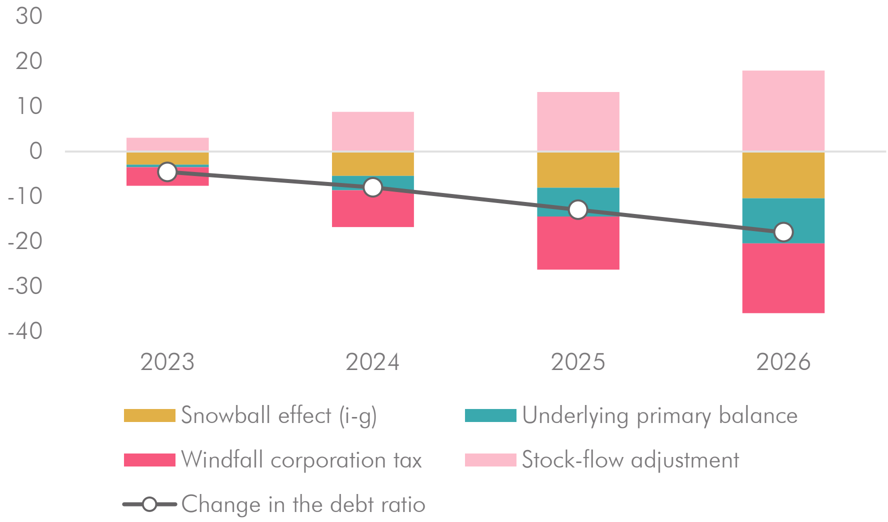
Debt forecasts have been repeatedly revised down

Windfall Corporation tax receipts have played a substantial role in recent declines in the debt ratio and are expected to continue to do so. Having contributed just over 6 percentage points of the cumulative decline in the debt ratio between end-2020 and end-2022, windfall receipts are expected to contribute another 16 percentage points by 2026 (Figure 2.14).

However, the "stock-flow adjustment" — changes in debt not captured by interest, growth or the budget balance — is forecast to act in the opposite direction. On average, it is projected to increase the debt ratio by 4.5 percentage points of GNI* each year over 2023 to 2026. These large contributions mainly reflect two things: first, the expectation that the Exchequer will increase the size of the cash balances it holds; and second, that the Social Insurance Fund will accrue larger surpluses and thus hold larger reserves. This is based on the forecasts showing large budget surpluses and low unemployment rates — hence implying high PRSI receipts into the Social Insurance Fund but low benefit payments out of it. Other government bodies, outside of the Exchequer, accruing more liquid assets is also playing a role.

Figure 2.14: Windfall corporation tax is a significant component of the forecast reduction in debt ratio

% of GNI*, cumulative change



Sources: CSO, Department of Finance, and Fiscal Council workings. Get the data.
Notes: The snowball effect refers to the impact of the interest rate versus economic growth (i-g) differential.

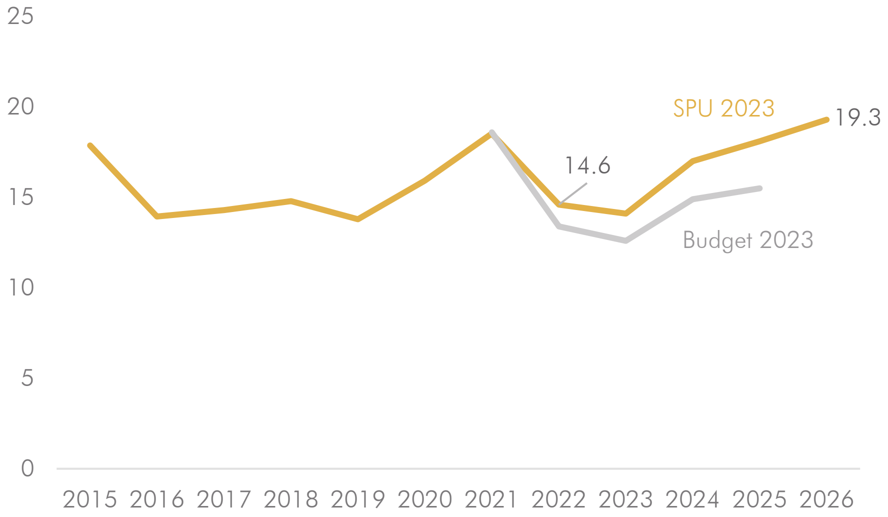
Given this rise in cash balances, the net debt ratio is expected to fall by 22.7 percentage points between 2022 and 2026, more than gross debt, which is expected to fall by 18 percentage points. However, the potential introduction of a national savings fund will impact on the forecasts for net debt (defined as gross debt net of liquid assets) as the government would potentially invest in longer term assets rather than paying down debt or building up cash reserves. For the time being, much of the surplus the Government expects to run is being forecast as an increase in cash balances. However, if funds were to be transferred to a new national savings fund, and these funds invested, they may no longer be counted as liquid assets, and as a result the net debt ratio would be higher.

Figure 2.15 below shows the forecast rise in liquid assets, excessive deficit procedure (EDP) debt instrument assets, from 14.6% of GNI* at the end of 2022, to 19.3% of GNI* by the end of 2026. Exchequer deposits in SPU 2023 are now expected to be €10.8 billion higher by the end of 2025, relative to what *Budget 2023* had forecast.

The forecast for cash interest payments is broadly the same over the medium term, with the rise in interest rates being offset by a downward revision to the debt ratio and the debt level since *Budget 2023* forecasts (Figure 2.16). This marks a significant change from recent years where falling rates led to consistent downward revision in expected interest costs.

Figure 2.15: Liquid assets forecast to rise but may be impacted by introduction of a new savings fund

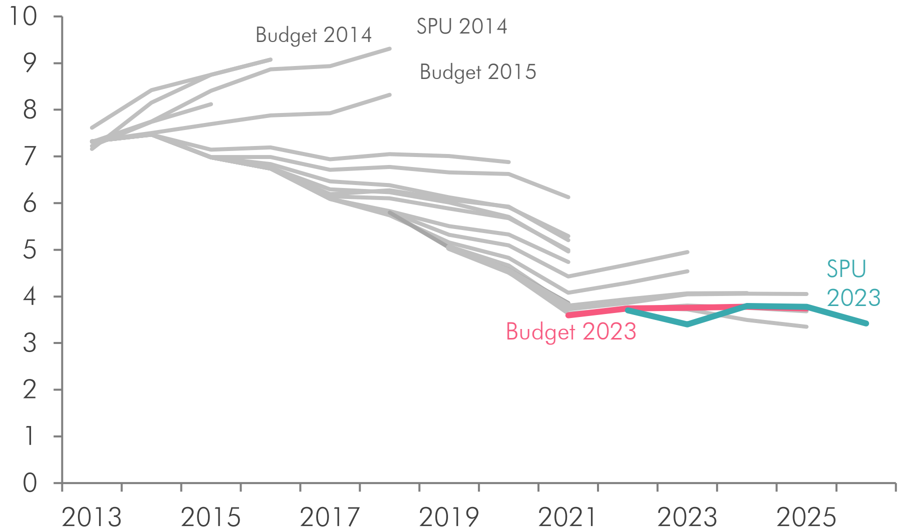
% of GNI*



Sources: CSO, Department of Finance and Fiscal Council workings. [Get the data.]
Notes: Figure shows EDP debt instrument assets, which includes cash assets and other highly liquid assets.

Figure 2.16: Cash interest payments revised downwards for 2023

€ billion, Exchequer cash interest



Sources: Department of Finance, and Fiscal Council workings. [Get the data.]

2.9 Fiscal risks

Several factors could influence corporation tax receipts in the coming years. These include the implementation of the OECD BEPS initiatives and the exhaustion of large capital allowances by key multinational corporations. Given that 10 corporate groups account for more than half of corporation tax receipts, the level of profitability in these firms is a key factor in Irish corporation tax receipts. The introduction of the 15% rate could potentially increase revenue significantly.

There are upside risks to the revenue forecasts. These include one-off revenue windfalls; for instance, from fines issued by the Data Protection Commission, or, less likely, from the Apple tax case.[40] After publication of the *SPU 2023*, Data Protection Commission issued a fine of €1.2 billion to a social media company for violating privacy rules. However, this fine is likely to be appealed.

Several likely areas of expenditure have not been included in *SPU 2023* projections. First, the costs associated with government contributions to the auto-enrolment pension scheme have not been included for 2024-2026. Second, payment of the Christmas bonus has not been budget for. Third, there is no provision for spending on supporting Ukrainian refugees after 2023. Fourth, significant expenditure in relation to a redress scheme for defective concrete blocks has not been budgeted for beyond 2023.

More generally, similar once-off expenditure may arise in the coming years; for instance, from the remedial costs of fixing defects in apartments and duplexes built between 1991 and 2013, or from other redress schemes.

Another key risk to the public finances is political pressure to increase spending or cut taxes in response to forecast headline surpluses. Large headline surpluses may be required given (1) the continued impact of large windfall corporation tax receipts; (2) the longer-term fiscal challenges from ageing and climate change; and (3) the current cyclical position of the Irish economy.

The Council's Stand-Still scenario outlines the significant cost of demographics and price pressures in the years ahead. If the Government chooses to fully index public sector wages and social welfare payments, this will imply significant expenditure growth, more than forecast in *SPU 2023*. If the Government wishes to fully accommodate these spending pressures while adhering to the National Spending Rule, revenue-raising measures would be required.

[40] In 2016, the European Commission ruled that Ireland had illegally provided state aid of up to €13 billion plus interest to Apple. Its ruling was annulled by the General Court in July 2020. The European Commission has since appealed to the European Court of Justice. This process is likely to be concluded in 2023. In the meantime, the €13 billion plus interest will remain in an escrow fund.

Long-term risks to the public finances remain unaddressed in the projections for the public finances. The population is ageing, which will result in increased spending pressures on health and pensions.

On climate spending, detail on the economic and budgetary impact remains lacking. While the infrastructure investments necessary to mitigate climate change appear to have been included in the NDP (particularly energy investments), other spending needs have not been addressed. These include current spending for incentives that encourage changes in consumer and business behaviour and home energy efficiency. In addition to direct fiscal costs, compensation may be needed for people and activities that are more immediately affected by the climate transition.

Large capital projects could see cost overruns. Even in normal times, overruns on large projects are not uncommon. Given the capacity constraints in the Irish economy (particularly construction), these could lead to costs of capital projects exceeding initial estimates.

Regarding healthcare, the fiscal implications of Sláintecare remain unclear. Casey and Carroll (2021) outline several areas in which information on health spending and planning is lacking. There is no more additional information on the remaining costs of implementing this reform. However, it remains unclear how much (if any) of the increased spending on health in recent years has been used to address these reforms.

Fiscal Stance

From bust to boom

3. FISCAL STANCE
From bust to boom

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

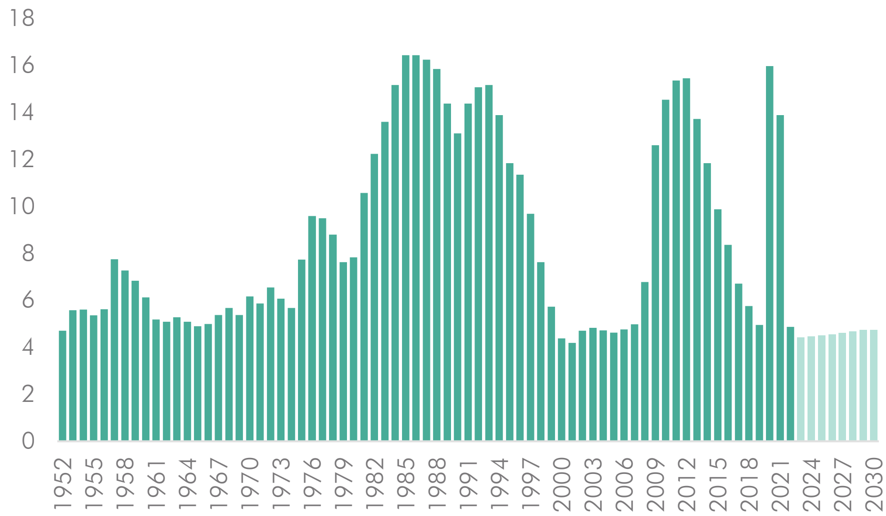
3.1 Assessment of the cyclical position

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

Unemployment rates have fallen to a record low

Figure 3.1: Unemployment has fallen to record lows

% unemployment rate, ages 15-74



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

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

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

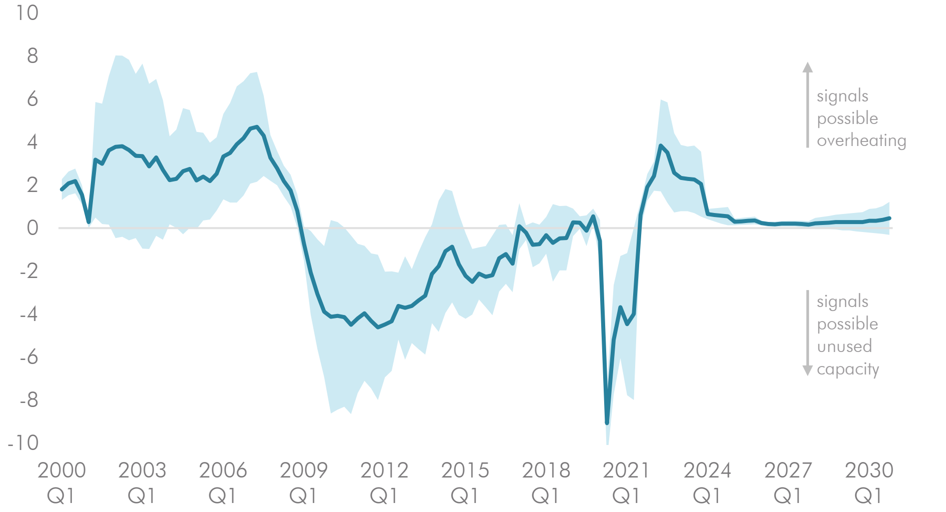
There are key uncertainties related to the risks of the Irish economy overheating (Section 1). Continued growth could see this manifest itself through ongoing labour shortages, strong inward migration flows, and upward pressures on rents and domestic prices, particularly in the services sector. A sluggish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

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

The outlook suggests economic activity will remain above its potential

Figure 3.2: The economy has hit capacity constraints

% potential output, output gap estimates

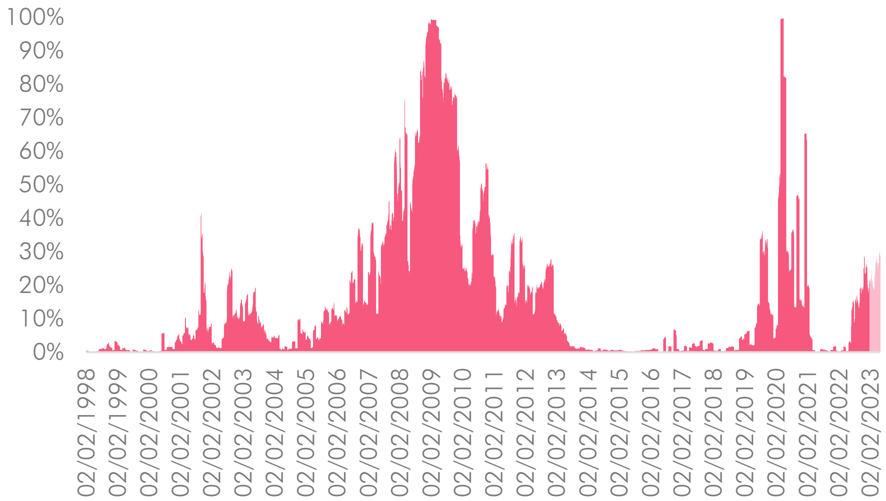


Sources: Fiscal Council workings (based on *Budget 2023* forecasts). Get the data.
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's supply-side models (Casey,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

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

Figure 3.3: Short-term recession risks remain

% likelihood of Irish recession in next 3 months



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

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

3.2 Assessment of sustainability of the public finances

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

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

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

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

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

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

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

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

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

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

Higher starting debt ratios tend to amplify risks and uncertainties

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

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

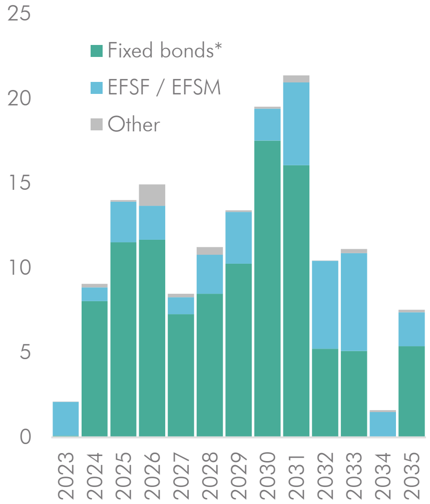
The outlook for growth, inflation and Ireland's interest rates on its debt is supportive of debt reduction. Even before the Government's budget balance is considered, the State is likely to benefit, on average, from 2.5 percentage points of a reduction each year between 2023 and 2026, due to the combination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

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

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

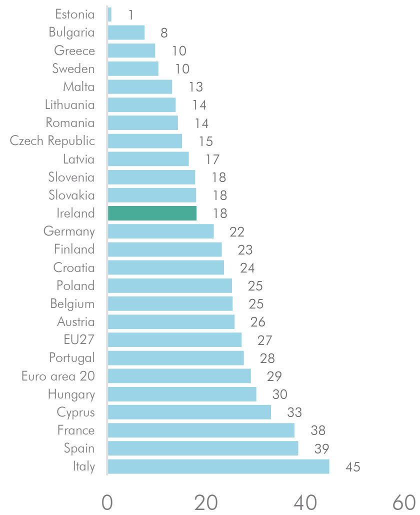
A. Maturities are well balanced

€ billions of maturing debt securities



B. Near-term refinancing risks are moderate

% GDP (GNI* for Ireland), gov. debt maturing in next 1-5 years

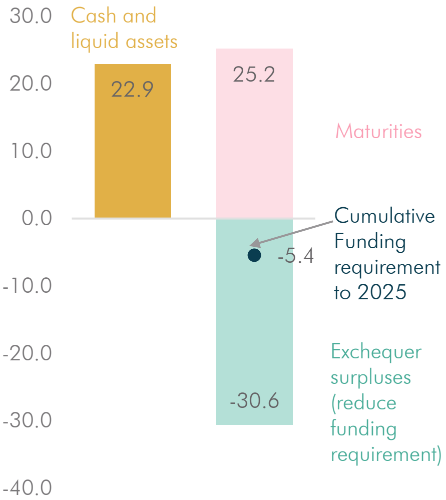


C. Bond yields still low despite recent increases

% 10-year bond yields, weekly data

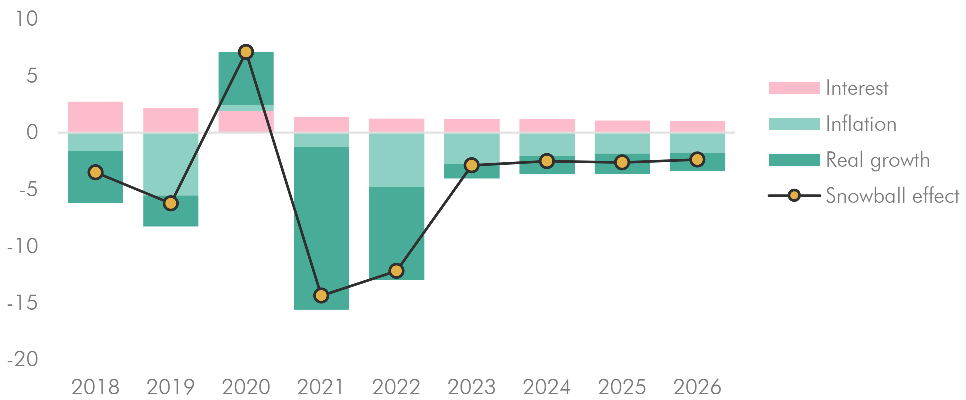
D. Cash balances large relative to needs

€ billions



E. Nominal growth is helping reduce debt ratio

Annual change in debt ratio as % GNI* due to "snowball effect" (the differences between growth and interest)

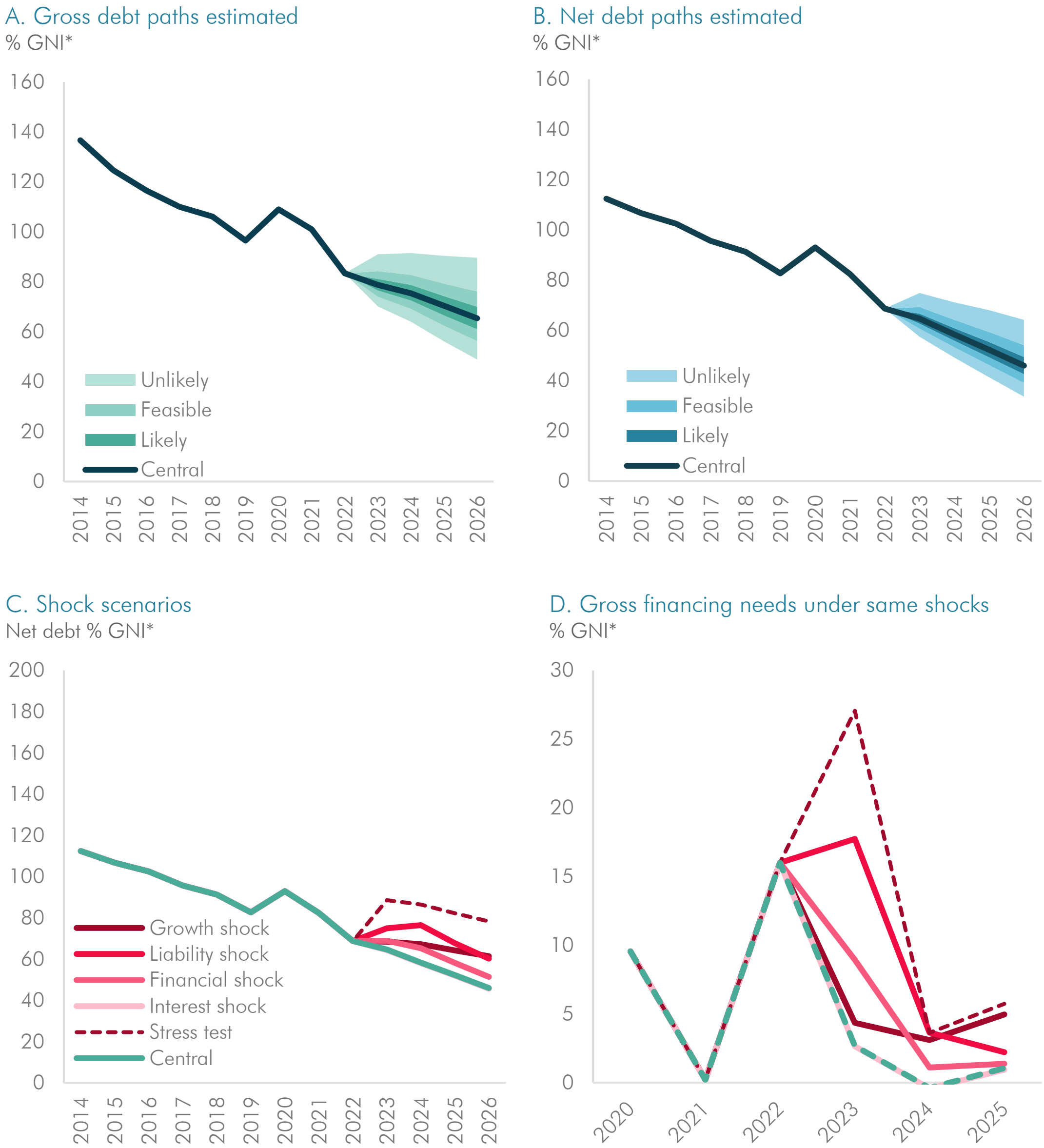


Sources: CSO, NTMA, ECB, Department of Finance, and Fiscal Council workings. Get the data.

Notes: Spread in panel C refers to the difference between Irish 10-year yields and German 10-year yields. The snowball effect is the debt ratio change, due to nominal growth less the effective interest rate.

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

Figure 3.6: Debt sustainability analysis



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

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

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

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

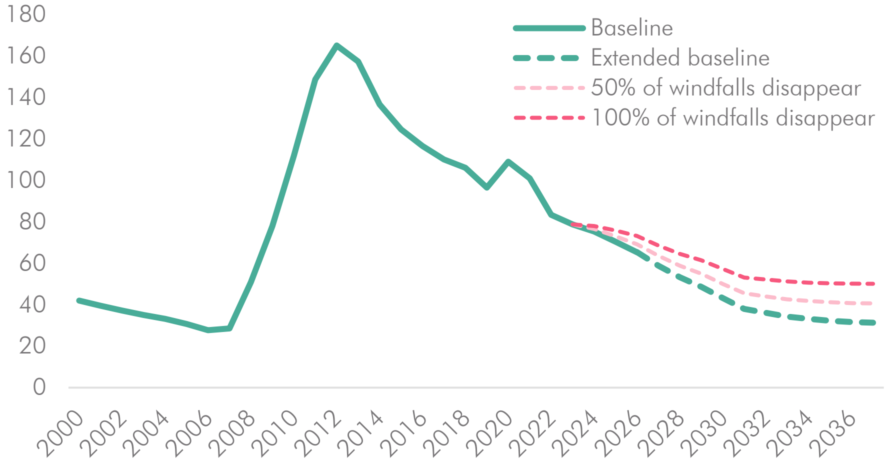
An appropriate fiscal stance should also consider the wider context. This includes whether there is a need to return the economy to full employment, whether the tax forecasts are sound, or whether spending pressures are adequately factored into current plans. The projection period is shorter than would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

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

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

Figure 3.7: Losing corporation tax windfalls would slow debt reduction

% GNI*, gross general government debt



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

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

Several important costs are missing from the official forecasts

3.3 Assessment of the Government's fiscal stance

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

Broad fiscal stance assessment

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

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

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

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

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

Keeping spending increases sustainable has several advantages

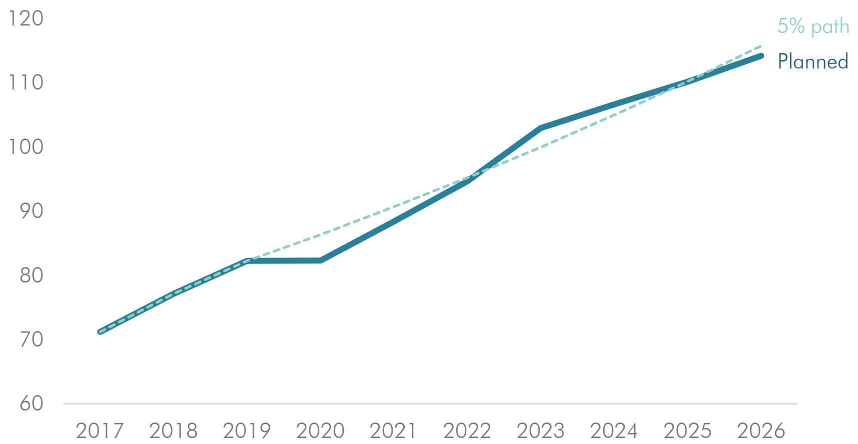
While a spending rule is a useful approach, it should be assessed in tandem with changes made to the tax system and on a general government basis. For instance, a permanent tax cut would weaken the budget balance in a broadly similar way to permanent increases in spending.

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

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

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

€ billion, net policy spending



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

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

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

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

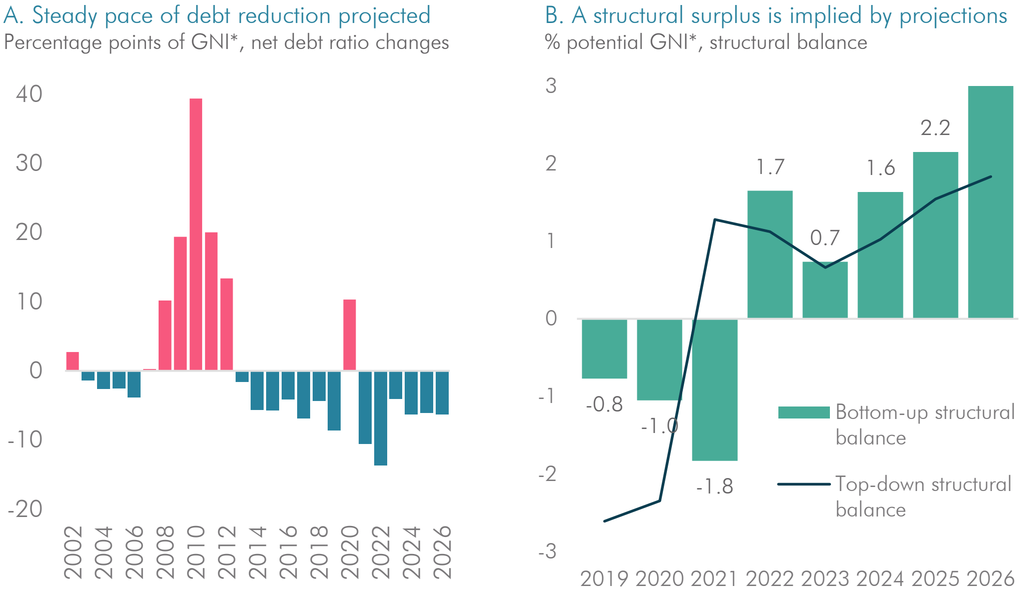
Looking ahead, the *SPU 2023* projections imply net policy spending increases of 3½ % on average over 2024 to 2026. This reflects the 5% core spending increases, net revenue-raising measures that reduce the growth rate by about 0.7 percentage points on average (when the impact of non-indexation is accounted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

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

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

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

Figure 3.9: Steady pace of debt reduction and structural surplus



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

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

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

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

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

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

Specific issues relating to stance in 2023

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

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

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

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

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

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

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

Specific issues relating to fiscal stance for 2024

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

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

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

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

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

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

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

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

Medium- and long-term budgetary challenges

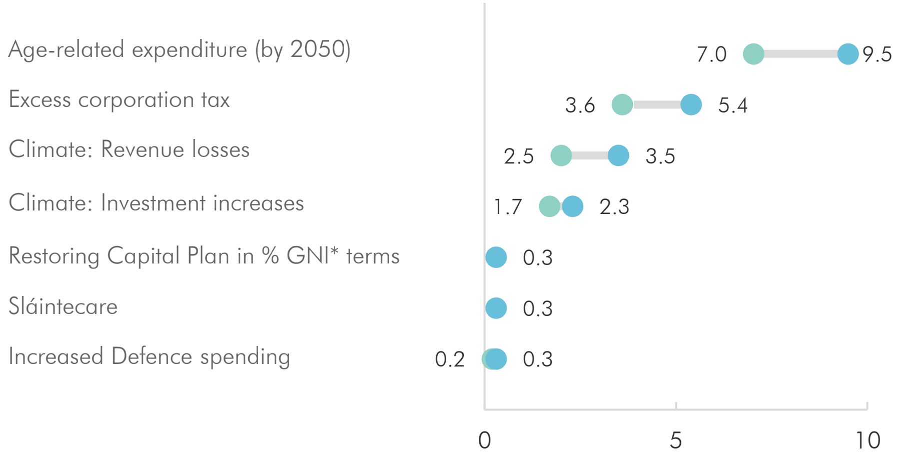
While Ireland's fiscal sustainability has improved, there are major challenges that could change the outlook. This is particularly true given that many of these challenges have not been fully costed and factored into the Government's budgetary plans.

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

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

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

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



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

Ageing

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

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

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

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

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

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

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

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

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

Box E: New fund could be a landmark reform

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

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

Why windfall corporation tax receipts should be saved rather than spent

The rationale for saving windfall corporation tax receipts is clearcut.

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

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

Figure E1: Windfalls then and now

% total Exchequer taxes

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

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

Ageing costs will be substantial

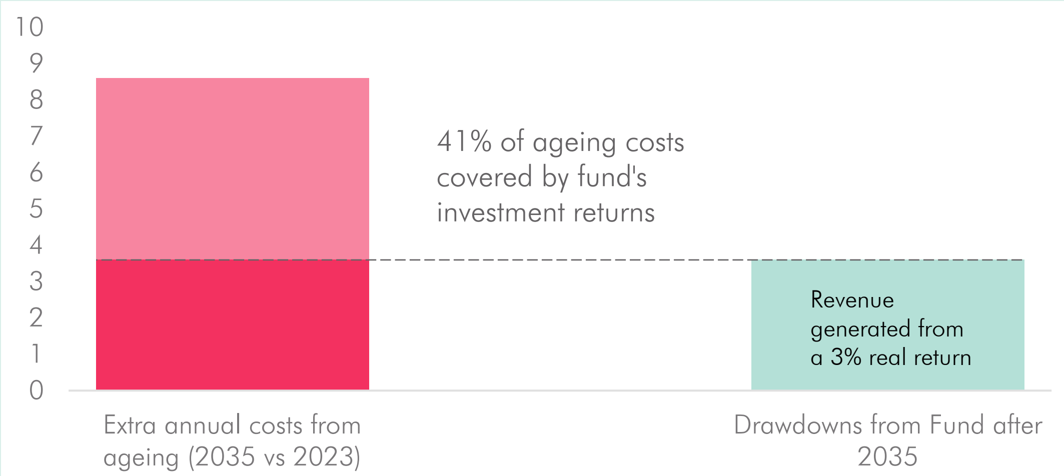
By contrast, Ireland faces predictable increases in public spending in the coming decades due to the rapid ageing of its population. The decision to abandon planned increases in the pension age adds to projected costs. The Department estimates that, in today's terms, the increase in annual spending related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

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

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

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

€ billions



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

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

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

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

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

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

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

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

Climate

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

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

The climate transition will also have substantial budgetary impacts

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

Capital spending

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

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

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

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

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

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

The credibility of medium-term plans

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

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

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

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

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

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

Fiscal Rules

Exceptional circumstances coming to an end

4. FISCAL RULES

Exceptional circumstances coming to an end

The "exceptional circumstances" and general escape clauses of the domestic and EU fiscal rules were activated at the start of the Covid-19 pandemic in 2020 and will remain in place throughout 2023.[47] This allows Ireland to temporarily deviate from the requirements under both the domestic and EU fiscal rules in these years.

The rules remain effectively suspended.

In March, the European Commission (2023a) confirmed that the general escape clause will be deactivated at the end of 2023.[48] In addition, the Council assesses that "exceptional circumstances" will also cease to exist at year-end. The European economy has rebounded, such that it has surpassed its pre-Covid levels and overcome the acute phase of the energy price shock caused by Russia's invasion of Ukraine. However, uncertainty remains high.

Table 4.1 presents a summary of the Council's previous assessments of compliance with the Domestic Budgetary Rule, as well as the Council's assessment for 2023.[49]

Table 4.1: The Council's assessment of compliance with the Domestic Budgetary Rule

	2017	2018	2019	2020-2023
Spending Rule	Breach	Significant Deviation	Compliant	Exceptional Circumstances
Structural Balance Rule	Compliant	Compliant	Compliant	
Overall Assessment	Compliant	Compliant	Compliant	

Source: Fiscal Council workings.
Notes: The structural balance rule requires that the structural balance be above the medium-term budgetary objective (MTO) (set at minus 0.5% of GDP for 2016–2019) or moving towards the MTO at an adequate pace. The Spending Rule requires that the net government expenditure be below the average medium-term potential growth rate of the economy (the Expenditure Benchmark). Significant deviation means that the limit for the corresponding rule was exceeded by more than 0.5% of GNI* for the Spending Rule, or 0.5% of GDP for the structural balance rule. A "breach" means that the limit for the corresponding rule was exceeded by less than 0.5% of GDP or 0.5% of GNI*.

Under the Fiscal Responsibility Act 2012, the Council has a mandate to monitor and assess compliance with the Domestic Budgetary Rule on at least an annual basis. While the Council deemed that exceptional circumstances existed in 2022, it has assessed that the Government would have complied with the Domestic Budgetary Rule and the corresponding 3% of GDP deficit limit imposed by the Stability and Growth Pact (SGP) in any event.

[47] For an overview of these dispensations see Box K from the *May 2020 FAR*.

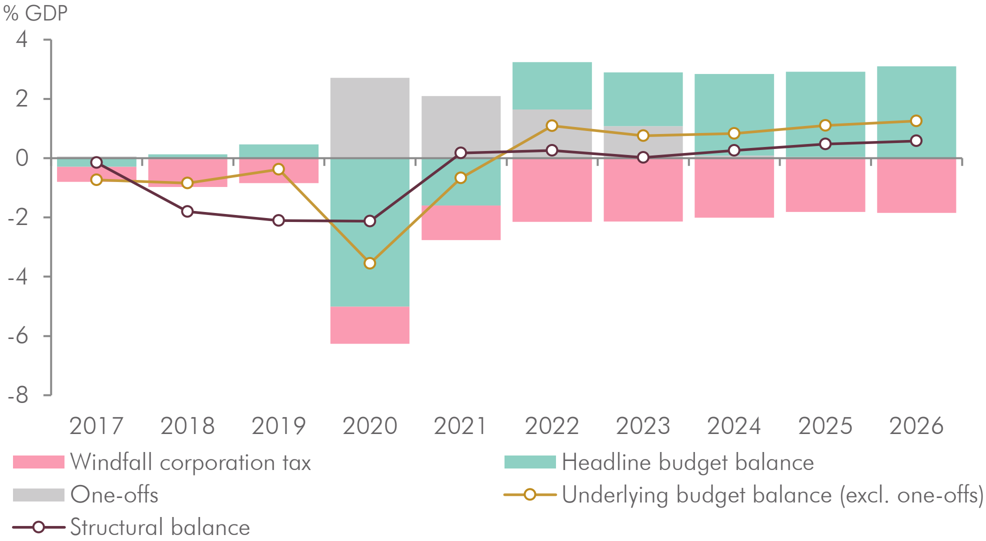
[48] The press release from the Commission can be viewed here: https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1410

[49] This is based on the Council's principles-based approach to the Domestic Budgetary Rule. For further information see Table S6.2 in the supporting information section.

Legal compliance with the fiscal rules continues to be assessed against GDP. A general government surplus of 1.6% of GDP was run in 2022 (Figure 4.1). In addition, Ireland's debt-to-GDP ratio stood at 45% at the end of 2022, and is projected to fall further to 32% by end-2026. These outturns are well within the 60% limit of the SGP. However, this assessment relies on a GDP-based measure, which does not paint an accurate picture of the Irish economy.[50]

Although the escape clause continues until year-end, the structural balance is projected to remain marginally in surplus in 2023 and to improve in subsequent years. Therefore, Ireland would be on track to comply with domestic and EU fiscal rules, assuming these rules are reinstated in their current form in 2024 (Figure 4.1). However, the Commission has recently tabled legislative proposals to reform the EU's fiscal framework from 2024.

Figure 4.1: Structural surpluses are projected on a GDP basis



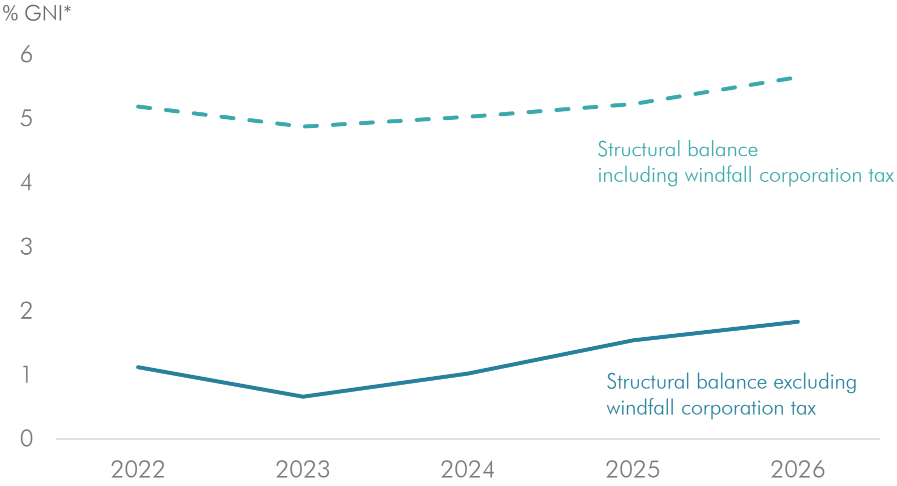
Sources: CSO, Department of Finance, and Fiscal Council workings. [Get the data.]
Notes: The structural element of the budget balance is estimated using the top-down approach. This is the approach used in assessing legal compliance with the fiscal rules. The cyclical budgetary component is calculated as 0.52 times the Department's GVA-based output gap measure. The underlying budget balance (excl. one-offs) refers to the headline budget balance adjusted for one-offs and windfall corporation tax. Windfall corporation tax receipts are estimated by the Department of Finance from 2021 onwards. For 2017-2020 the Council's estimates are used. Estimates of revenue and expenditure one-offs are those judged by the Council.

Even in the absence of excess corporation tax receipts, the structural balance is expected to remain in surplus.

The windfall corporation tax receipts flatter the fiscal balance. But, even when these excess revenues are removed, the structural balance is expected to be in surplus over the coming years. Figure 4.2 shows this surplus as a share of GNI*, a more appropriate measure for the Irish economy.

[50] The Council advocates using GNI* as a more appropriate benchmark for assessing Ireland's fiscal position. Ireland's debt-to-GNI* ratio is forecast to be 79% at the end of 2023 and fall to 65% by the end of 2026.

Figure 4.2: Structural balance in surplus without windfalls



Sources: Department of Finance and Fiscal Council workings. Get the data.
Note: The structural balance is measured on a top-down basis using the Council's estimates of one-off items together with the Department of Finance's alternative estimates for the output gap, its GNI* forecasts, and its estimates of windfall corporation tax receipts.

Supporting Information section S6 provides a full overview of compliance with the fiscal rules based on the Council's principles-based approach.

Medium-term Expenditure Framework

Ireland's Medium-term Expenditure Framework was established in 2013 as part of a broader package of budgetary reform in Ireland. It is designed to help Governments to plan further ahead than they have previously tended to do. Rather than focus solely on the following year, the framework aims to ensure budgets become more focused on the future, with a clear emphasis on realistic medium-term planning.

The framework legally compels the Government to set ceilings for how much each department will spend over the next three years. However, for the third year in a row, the Government failed to publish these spending ceilings on Budget Day, last September. Instead, they were again published in December. The persistent exclusion of these expenditure ceilings from the budgetary process implies that they are set, not with a view to imposing realistic spending controls, but as a tick-the-box exercise to comply with legal requirements.

Furthermore, the medium-term estimates produced by the Department of Public Expenditure and Reform for individual department ceilings are highly unrealistic. In many areas, including health, they ignore demographic, price, and wage pressures and assume essentially constant levels of current spending in nominal terms. The Department leave large unallocated amounts that are then allocated where needed at a later stage. This approach to applying the ceilings undermines their credibility and is a backwards step in terms of transparency and the overall functioning of the fiscal framework.

Assessing compliance with the National Spending Rule

The National Spending Rule seeks to anchor "core expenditure" growth over the medium term.[51] Although the rule lacks a statutory footing and the Council is not legally mandated to assess compliance with it, an assessment is useful in determining the effectiveness of the rule as an anchor. This represents the first such assessment, given the rule guided spending for the first time in 2022.

The rule itself aims to limit core spending growth to 5% each year, in line with the estimated trend growth rate of the Irish economy. This approach implies a broadly sustainable pace of expenditure growth, given revenues also tend to grow at this rate. Until now, it was unclear whether the rule was a net spending measure. However, *SPU 2023* (Department of Finance, 2023, p. 30) notes that:

> *"The Government's spending rule is calibrated on the basis of net spending, i.e., spending net of discretionary taxation measures. Accordingly, the expenditure ceiling figure would be different – higher or lower – if the Government introduced discretionary tax changes"*.

This implies that the National Spending Rule focuses on <u>*net*</u> core spending. In other words, it treats new revenue-raising measures (such as tax increases) as permanent measures that offset spending increases.[52] By contrast, it regards new revenue-reducing measures (such as tax cuts) as permanent measures that lower the scope for spending increases. However, *SPU 2023* only shows forecasts of core spending without adjusting for tax measures. In addition, the Department makes no reference to the original ceilings first set out in *Budget 2022*.

In 2022, the Government complied with its National Spending Rule.

In 2022, the Government complied with its National Spending Rule. The Council assesses compliance with the rule on a net basis, in line with the Government's description of the rule. Table 4.2 shows how the original ceiling for core spending, set in *Budget 2022*, was €80.1 billion. This was then revised up to €80.8 billion in November 2022 in *Budget 2023*. Actual core spending amounted to €80.0 billion at year-end 2022 and the net impact of new tax measures was negligible when the impact of non-indexation was accounted for.

Therefore, net core spending amounted to €80.0 billion in 2022, €0.8 billion below the latest ceiling, set in *Budget 2023*. Current spending accounted for €0.34 billion of the underspend, with the capital underspend amounting to €0.44 billion.

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[51] Core expenditure is exchequer spending excluding one-off and temporary measures, primarily those related to the cost of supporting Ukrainian refugees, Covid-related expenditures, and once-off cost-of-living measures. Given the National Spending Rule only applies to exchequer spending, it ignores significant public outlays, such as those made by Approved Housing Bodies in local government.

[52] These tax measures include the expected yields arising from the non-indexation of the income tax system.

Table 4.2: The Government complied with its spending rule in 2022

€ billions

	2021	2022	2023	2024	2025	2026
Core spending						
Budget 2022 ceilings	75.9	80.1	84.1	88.3	92.8	
Latest ceilings	75.9	80.8	85.9	90.2	94.7	99.5
Outturns	74.1	80.0				
Projections			85.9	90.2	94.7	99.5
Assessed on basis of spending alone						
Vs original ceiling		-0.1	1.8	1.9	1.9	
Vs latest ceiling		-0.8	0.0	0.0	0.0	0.0
Assessed net of tax measures						
Revenue-raising measures	0.6	1.1	1.8	1.6	1.3	1.1
Revenue-reducing measures	0.1	1.1	1.5	0.6	0.5	0.5
Net measures	0.4	0.0	0.3	1.0	0.8	0.6
Net core spending outturn	73.6	80.0				
Net core spending projections			85.6	88.9	92.6	96.8
Vs original ceiling		-0.1	1.5	0.6	-0.2	
Vs latest ceiling		-0.8	-0.3	-1.3	-2.1	-2.7

Sources: Department of Finance and Fiscal Council workings. Get the data.
Notes: Net core spending refers to core spending, adjusted for the impact of tax measures, and includes the expected yields arising from the non-indexation of the income tax system. Revenue-raising measures (such as tax increases) can be used to offset bigger spending increases, whereas revenue-reducing measures (such as tax cuts) would lower the scope for spending increases. Estimates of revenue-reducing and revenue-raising measures are those judged by the Council.

The Government has revised up its ceiling for 2023, taking spending to a level above what would be implied by a 5% growth path. This decision was made to allow spending to adapt to the elevated levels of inflation at present.[53] In its latest projections, core spending is expected to grow by €5.9 billion in 2023. From 2024, core spending is forecast to grow in line with the National Spending Rule once again. On a net basis, the projections imply that the Government will continue to comply with the rule, with additional space available due to the yields arising from the non-indexation of the income tax system.

Revisions to the fiscal rules

In April, the European Commission (2023b) provided more detail on how the EU fiscal rules might be reformed. This builds on the initial proposals set out last November and follows extensive discussions among EU Member States. Box F discusses the changes relative to the November proposals.

There are several key aspects to the latest proposals. First, there are stricter requirements for debt reduction in high-debt countries and for deficit reductions when above 3% of GDP. Second, the reforms may require changes to domestic

[53] For a discussion on the appropriateness of this decision, see Chapter 3.

legislation enshrining the fiscal rules in Irish law. Third, they entail an expanded role for national independent fiscal institutions, such as the Fiscal Council.

Crucially, Ireland is likely to face less scrutiny under the new EU fiscal rules. This reflects their focus on GDP-based measures (Casey and Cronin, 2023). However, a more appropriate assessment on a GNI* basis and reflecting excess corporation tax would signal greater risks. The Council assesses that the National Spending Rule should be further developed as a "first line of defence" to ensure sound management of the economy and public finances at home.

Box F: Updated reform proposals to the EU fiscal rules

In April, the European Commission (2023b) published its latest reform proposals for the EU fiscal rules. These proposals build on the Commission's initial set of ideas from November last year (European Commission, 2022), and follow on from discussions among EU Member States. Box E of the *November 2022 Fiscal Assessment Report* discussed the original proposals in greater detail. Here, we take a look at the key elements of the updated proposals.

The November communication introduced the concept of a risk-based economic governance framework based on a country's debt ratio. Under the proposals, the scale and speed of the required fiscal adjustment depended on whether a Member State had a substantial, moderate, or low debt challenge.[54] However, these categories no longer exist. Instead, there are only two categories:

1) Member States with a deficit above 3% of GDP or a debt ratio above 60% of GDP.
2) Member States with a deficit below 3% of GDP and a debt ratio below 60% of GDP.

At the outset, all Member States would be expected to prepare "medium-term fiscal-structural plans". These medium-term plans will map out a Member State's net spending path, as well as its reform and investment commitments. Low debt countries would face little scrutiny. The Commission would only provide them with guidance on the structural primary balance necessary to comply with the 3% deficit limit. This would assume no additional policy measures in the 10 years following the period covered by the four-year plan.

However, high debt countries or those with deficits greater than 3% would come under a much sharper focus. First, the Commission would put forward a reference adjustment path for net spending that would ensure debt is put on a plausibly downward course, and the deficit is brought or kept below 3% of GDP over the medium term. These countries would then consider this reference path when designing their own medium-term plans, which would cap net spending increases at a slower rate than might otherwise be considered sustainable.[55] The plan would cover a minimum adjustment period of four years, which could be extended by up to three years if the Member State commits to certain reforms and investments.[56] The plan will be binding once approved by the ECOFIN.[57]

In addition, the latest proposals also involve an assessment by the Commission as to whether:

- The debt ratio at the end of the path (between 4 and 7 years out) is below its level in the year before the path begins;
- In cases where Member States run deficits greater than 3% of GDP, that this is reduced by 0.5% of GDP each year. The proposals are ambiguous in terms of what this 0.5% refers to;

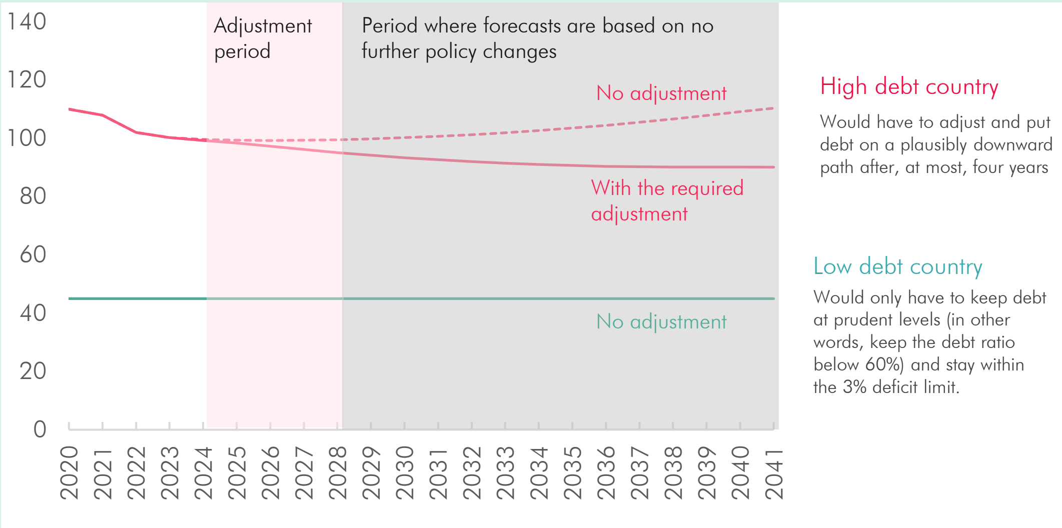
[54] A substantial debt challenge was defined as a debt ratio above 90% of GDP. A moderate debt challenge was defined as a debt ratio between 60% and 90% of GDP. Lastly, a low debt challenge was defined as a debt ratio below 60% of GDP (European Commission, 2022).
[55] In this instance, sustainable means in line with usual — or "potential" — economic growth, and, by extension, revenue growth. This is one area where an unobservable measure (potential growth) remains in place in the new framework.
[56]The criteria include whether the reform and investment commitments are: 1) growth-enhancing; 2) support fiscal sustainability; and 3) in line with common EU priorities, such as the European Green Deal (European Commission, 2023).
[57] The ECOFIN is the part of the Council of the EU comprising Member States' economics and finance ministers.

- In cases where Member States benefit from an extended fiscal adjustment period, that they deliver most of the adjustment during the first four years covered by the plan;

To illustrate how the new proposals might work, Figure F1 provides an illustrative example. We take two countries, one with a starting debt ratio of around 100% and the other with a starting debt ratio of 45%. For simplicity, we assume neither country is expected to breach the 3% deficit limit such that all that matters is the expected debt path. The low debt country would not come under much scrutiny, provided it complies with the 3% deficit limit. By contrast, the high debt country would have to grow net spending at a slower rate than otherwise planned, thereby ensuring its debt ratio is on a plausibly downward trajectory by the end of the adjustment period (assumed to be four years here).

Figure F1: The path for debt plays a key role in how the rules work

Debt ratio (% GDP)



Source: Casey and Cronin (2023)

Looking ahead, the Commission intends to swiftly agree upon the revised rules with the Member States, with a view to activating them from 2024. However, the proposed legislative changes will need to be agreed by both the European Parliament and the ECOFIN.

What do the latest proposals mean for Ireland?

Ireland is unlikely to come under much scrutiny under the proposed reforms to the EU fiscal rules (Casey and Cronin, 2023). GDP will continue to underpin the Commission's debt ratio assessments despite it being an inappropriate measure of the Irish economy. Ireland's debt ratio is currently below 60% of GDP and is projected to stay below this level. In addition, substantial injections of corporation tax receipts continue to flatter Ireland's budget balance and, as a result, its debt path.

Casey and Cronin (2023) explore how the proposed new framework might look were it better tailored to Ireland. They substitute GNI* for GDP and adjust for excess corporation tax receipts when determining the stress tests. They find a very different, albeit still encouraging, picture for how public debt is likely to evolve. The Commission's approach, if applied on this basis, might involve closer monitoring under the new EU fiscal rules if these aspects were allowed for.

Independent fiscal institutions could take on wider responsibilities

The proposals envisage a stronger role for independent fiscal institutions (IFIs), such as the Irish Fiscal Advisory Council. While traditionally mandated to assess compliance with *national* budgetary rules, the reforms propose IFIs assess compliance with the *EU rules* as well. That is, they would assess whether the budgetary outturns reported in the Government's annual progress reports comply with the agreed net spending path. However, to deliver upon this expanded role, the Commission notes that IFIs would require greater levels of resources and improved access to data.

Moreover, IFIs would be expected to carry out a number of additional tasks. These include:

- producing or endorsing budgetary forecasts underpinning the Government's medium-term plans;
- assessing the Government's debt sustainability analyses;
- assessing the impacts of policies with fiscal sustainability and growth-enhancing implications.

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