Government Finance

The Tax System

- **Functions of Taxation**
  - **Finance Government Activities**
    - To finance all government activities e.g. running of civil service, wages of Public Sector workers.
  - **Economic Objectives**
    - To achieve economic objectives: reducing inflation, favourable balance of payments.
  - **Redistribution of National Wealth**
    - To redistribute the national wealth through transfer payments/social welfare payments.
  - **Automatic Stabiliser**
    - It acts as an automatic stabiliser for the economy. It helps to avoid wide fluctuations in the economic cycle by automatically taking more tax when economy is doing well and taking less when economy is performing poorly.
  - **Social objectives**
    - To achieve social objectives e.g. discourage smoking, drinking / decrease pollution/damage to environment.
  - **Promote enterprise**
    - To help industry through subsidies/grants and other services can be provided to help industry and encourage enterprise e.g. County Enterprise Boards.

- **Canon's of Taxation**
  - **Equity**
    - The tax system must be fair and take into account the ability-to-pay principle; taking a higher proportion of income in tax as income rises. The better able should bear a greater burden of taxation, whether or not they benefit. The idea of this canon is that taxes should be progressive and so income tax in Ireland is equitable as those on higher incomes pay a greater proportion in taxation.
  - **Economy**
    - The costs of collecting taxes should be as low as possible. The income collected should be greater than the cost of collection. The raising of revenue for government is the main aim of taxation. If the taxes imposed are difficult to administer it may result in costs of collection being high relative to the yield from the taxation. The majority of the tax take should be available for the welfare of the economy. The local property tax is economic at it can be collected on-line.
  - **Certainty**
    - The amount paid should be certain and clear. A taxpayer should know when they are paying tax and how much tax they are paying. Similarly the government should know how much they are collecting and when they will receive it. Various taxes such as VAT receipts must be forwarded to the Revenue Commission at certain specified times.
  - **Convenience**

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- The tax should be collected in a way and at a time which is convenient for the taxpayer. It is more convenient to have tax deducted at source e.g. PAYE rather to receive a bill for the total amount due in a single payment after the income has been spent. VAT is collected at the time of purchase and so is convenient for the taxpayer.

- **How the Canons can be used to analyse the Irish Taxation system**
  - **Equity**
    - With PAYE, people on higher incomes pay a greater proportion in tax. One of the accepted functions of taxation is the redistribution of wealth, which is an argument for equity.
    - Highlights that indirect taxes are regressive as a taxpayers' ability to pay is not taken into account.
  - **Economy**
    - If a tax does not collect more than the cost of administering the tax is should not be introduced.
    - One of the arguments against indirect taxation is the complexity of the collection system.
  - **Certainty**
    - The main advantage of direct taxes is that the amount to be collected is clear to the state, thereby helping financial planning.
    - A difficulty of administering indirect taxes is that the amount to be collected is unclear and makes planning by the state difficult.
  - **Convenience**
    - This is one of the justifications for the PAYE system of income tax, where the tax is deducted at source from income. VAT is paid at the time of purchase.
    - If the method of paying and the timing of the tax does not suit the taxpayer is can lead to evasion.

- **Other Principles/Characteristics of a Good Taxation system**
  - **A tax system should have a limited disincentive effect on work / saving**
    - If the rate of personal income tax is considered too high (Ireland's effective highest rate is 51%) and a large proportion of additional income is taxed away this may discourage people from supplying additional effort or labour. Plans for a higher rate of income tax to be charged on people earning over €100,000 may deter foreigners from working in Ireland. The current rate of DIRT of 41% may deter people from saving.
  - **A tax system should have a limited disincentive effect on investing**
    - The current rate of CPT 12.5% is a factor in attracting FDI. If this rate of tax were to increase it may deter MNCs from locating in Ireland and it may mean that some companies re-locate their operations.
  - **Taxes should have a stabilising impact on the economy thus developing into automatic stabilisers**
    - A tax system should prevent the level of economic activity rising too fast as it would otherwise during a period of economic growth. Similarly in a recession, the amount collected in taxes falls, so the decrease in demand is not as great as it would otherwise be.
  - **Tax rates should be consistent with national economic objectives**

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- The taxes levied should help the government achieve other economic/social objectives e.g. raising excise, VAT rates on alcohol may discourage consumption; the introduction of a 'sugar tax' may help reduce Irish obesity levels; the 'carbon taxes' may help reduce our carbon emissions.

- **Evasion should be impossible**
  - A good tax should be impossible to evade, otherwise the tax is not fair.

Terms

- **Taxation Revenues**: Monies/incomes received by the government in the form of direct & indirect taxes, and used in the running of the country.
- A **regressive tax** is a tax that **does not** take into account the ability to pay of a taxpayer. It takes a higher percentage from a low income earner. Examples of a regressive tax include indirect taxes such as VAT and excise duty.
- A **progressive tax** is a tax that **does** take into account the ability to pay of a tax payer. For example, high earners pay more in PAYE than low earners. When one earns over €32000 they begin to be taxed at the marginal rate.
- **Tax avoidance** (Legal) involves organising your affairs to avoid paying tax or to reduce tax liability. For example, to avoid paying DIRT an individual would not open a savings account.
- **Tax evasion** (illegal) involves organising your affairs to illegally avoid paying tax or to reduce your tax liability. For example, to lower her tax liability, a shopkeeper under-declares her income.
- **The tax wedge** is the difference between the cost to an employer of its employee and the take home wage of the employee as a result of taxation
- **Tax Harmonisation** refers to policy of the EU that aims to make tax regimes similar in all EU member states.
- **The imposition or impact of taxation** refers to the individual, firm or commodity on which a tax is levied.
- **The incidence of taxation** refers to the individual or firm, which actually pays the tax. For example, if the government increased the levy on alcohol, beer companies would simply add the levy to the price of beer in order to collect this tax. Thus the tax is imposed on beer compares but the incidence is been borne by the consumer. The impact/incidence will be the same for goods that have an inelastic supply or demand such as cigarettes.
- **Broaden the tax base:** Increasing the number of people / areas on which tax is levied / in the tax net.
- **Revenue Buoyancy:** refers to a situation where the revenue (income) collected by the government is greater than the amount the government predicted it would collect during the year.

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Types of Taxes

- **Direct taxes** refer to taxes on incomes and wealth. The following are examples of direct taxes.
  - **Income tax/Pay As You Earn (PAYE):**
    - a tax on wages /salaries and income earned. The current rates of income tax are 20% (standard rate) and 41% (marginal rate).
  - **Deposit interest retention (DIRT) tax**
    - is a tax on interest. DIRT currently stands at 41%
  - **Capital Gains Tax**
    - A tax on profits made from the sale of assets (second homes, shares). The current rate is 33%
  - **Capital acquisitions tax**
    - is a tax on gifts and inheritances received. The closer your relationship to the giver the less you pay. The current rate is 33%
  - **Corporation tax**
    - is a tax on company profits. In Ireland, the corporation tax rate is currently 12.5% on trading profits.

- **Indirect taxes** are taxes on goods and services. Indirect taxes are paid indirectly to the government by the final consumer. Examples include:
  - **Value added Tax (VAT)**
    - is a tax on goods and services. Examples include VAT on clothing and on the services of a tradesperson. The current rates of VAT 13.5% and 21%
  - **Excise duty**
    - An excise duty is a tax put on certain products to discourage consumption. Eg excise is placed on alcohol, tobacco and oil-based products
  - **Customs Duty**
    - is a tax on imports from outside the EU. It varies depending on the product being imported
  - **Stamp duty**
    - Duties payable on a wide range of legal and commercial documents, including (but not limited to) conveyances of property, leases of property, share transfer forms and certain agreements. It is currently 1% on residential dwellings.

- **Advantages of Direct Taxes**
  - **Equity:**
    - Direct taxes adhere to the principal of equity. For example, it is only fair that high income earners pay more PAYE than low income earners.
  - **Economy:**
    - The cost of collection for the government is much lower than the amount being collected. For example, PAYE is deducted from the wages of workers by the employers who forward the money to the Revenue Commissioners. The cost of the collection of such taxes is low to the government.
  - **Certainty:**

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        - It is possible for the taxpayer to calculate the liability in advance.
    - **Convenience -**
        - Many direct taxes are collected in a way that's convenient to the taxpayer. For example, banks deduct DIRT from the interest earned on savings and forward this money to the Revenue Commissioners.
    - **Adjustable:**
        - Direct Taxes can be easily adjusted in the budget.

- **Disadvantages of Direct Taxes**
    - **Work may be discouraged:**
        - For example, the more you earn, the more you pay in direct tax. As a result, a worker may not wish to work overtime as he will have to pay more tax.
    - **Investment is discouraged:**
        - For example, high corporation taxes discourage industrial development and enterprise.
    - **When direct taxes rise, there may be an increase in the size of the black economy.**
        - The black economy refers to unrecorded economic activity. When direct taxes rise people then seek ways to avoid paying them. For example, a worker who receives payment in cash from his employer to avoid paying tax.
    - **Savings are discouraged**
        - if DIRT is increased, then the return (earnings) from savings falls and the incentive to save is reduced.

- **Advantages Of Indirect Taxes**
    - **Economy**
        - They cost the government very little to collect. The collection of such taxes is carried out by the sellers/service providers and the costs are borne by them.
    - **Convenience**
        - It is collected in a manner convenient to the taxpayer. The price the consumer pays includes the tax.
    - **Work/investments are not discouraged by indirect taxes.**
        - When indirect taxes are increased workers do not feel like money is being taken directly from their wages. Even though the cost of living is increasing, psychologically one is not discouraged from working because the tax is not directly on wages.
    - **Environmental/Social Benefits**
        - Excise duties levied on fuel can discourage its consumption and thereby help the environment. Indirect taxes can be used by the government to achieve other aims: For example, excise duties on alcohol and cigarettes discourage their consumption and thereby improve health.

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- **Disadvantages of Indirect Taxes**
  - **Inequitable**
    - They can be seen as unfair, e.g. a high income earner who buys a new TV pays the same amount of VAT as a low income earner.
  - **Inflationary**
    - They increase the price of goods and services and so contribute to inflation.

- **Consequences of moving from Direct Taxation to Indirect Taxation**
  - **Lower rates of direct tax may incentivise workers and companies as direct taxes tend to be progressive.**
    - More take-home pay will increase the incentive to work. Rewards for risk taking encourages effort.
  - **Lower rates of direct taxes may lead to increased FDI.**
    - Moving from direct to indirect can make the tax system more regressive
  - **Indirect taxes tend to be regressive.**
    - Lower income groupings may end up paying a greater proportion of their income in this form of tax because they spend a greater portion of their income. In 2010 a carbon tax was introduced in Ireland resulting in higher costs of purchase. Indirect taxes do not take account of ability to pay.
  - **Evasion is more difficult with indirect tax**
    - Since the indirect tax e.g. VAT is included in the selling price of the good or service, it is impossible to evade. If you buy a good, then you must pay the tax on that good.
  - **Revenue collected is not as certain with indirect tax**
    - The revenue collected is not as predictable as that from direct taxation. This may hinder the government's financial planning. Indirect taxes can distort demand patterns thus making it more difficult to predict the amount of revenue that will be collected.
  - **Indirect taxes can be inflationary**
    - A rise in VAT / Excise duties will increase the CPI in the short term. This may cause consumers to possibly decrease their spending and /or defer their spending.
  - **May lead to a growth in the 'shadow economy'**
    - An increase in the rates of indirect taxation may cause some consumers to switch to the shadow economy as they seek lower prices for some goods and services.

- **Positive Consequences of Increasing VAT**
  - **Economic**
    - The costs of collection are borne by traders / retailers and not by the state. The revenue collected is much greater than the costs of collection.
  - **Impossible to evade**
    - As the tax is built into the selling price they are impossible to evade.
  - **Convenient**

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        - As they are included in the selling price they are convenient for the taxpayer.
    - **No disincentive to work**
        - With an increase in direct taxes taxpayers may feel a disincentive to work. This does not occur with an increase in VAT.
    - **Used by government to change consumption patterns.**
        - The government could increase VAT on those commodities which it deems harmful to the public i.e. cigarettes, alcohol
    - **Acts as a built in stabiliser.**
        - As the economy expands spending rises and so too will the revenue collected from taxation.

- **Negative Consequences of Increasing VAT**
    - **Revenue uncertain**
        - The revenue collected by the state is not as certain as that collected under direct taxes.
    - **Inflation**
        - Increased VAT rates will lead to higher prices causing cost- push inflation.
    - **Inequitable / Regressive**
        - Indirect taxes do not take a person's ability to pay into account and so the burden falls more heavily on lower income groups.
    - **Disincentive to spend**
        - With rising prices in the current recession it may cause people to defer spending.
    - **May lead to black economy activities**
        - Some consumers may switch to the black economy leading to a loss of revenue for the state.
    - **Burden of collection passed to retailers/traders.**
        - They act as revenue collectors and procedures must be put in place to collect, record and remit the revenue, increasing the costs for the firms. Welfare benefits could be increased / maintained

- **Ways to eliminate income inequalities**
    - **Welfare benefits could be increased / maintained**
        - This means that those on lowest incomes would receive additional income.
    - **Tax changes**
        - The government could make taxes like income tax, CGT and CAT more progressive. Abolish tax reliefs and shelters that are used by very high income earners to avoid paying taxes. Widen the lower income tax band so as to increase the real income of low income earners.
    - **Wealth tax**
        - The government could introduce a wealth tax in its budget similar to that introduced in economies like France where incomes over €1m are taxed at 75%.
    - **Target universal entitlements**
        - Instead of giving child benefit to every household with children it could be means tested or targeted at parents in receipt of welfare payments and working parents earning low wages.

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- **Increase the minimum wage rate**
  - In doing so workers on lower incomes would have a higher disposable income.

- **Impact of Increasing Public Sector Charges as opposed to Taxes Positive consequences:**
  - **Less pressure to ↑ taxes/ borrowing**
    - By raising public charges there will be less pressure on the government to raise additional revenue by increasing taxation.
  - **More efficient use of services**
    - Where people pay for services it may encourage a greater efficiency in their use e.g. encourage people to re-cycle / use public transport etc.
  - **Saving scarce resources**
    - Those people who can afford to pay for these services now do so. Hence the resources which were being used to finance these services would no longer be necessary – saving scarce resources.
  - **Targeting use of resources economically**
    - By charging those who can afford to pay the government can provide direct payments to help those who cannot – thereby targeting the use of our resources more economically.
  - **Pressure to improve quality of service**
    - Agencies may be forced to improve the quality of service provided as people now pay e.g.
      - – Better frequency of service
      - – More re-cycling centres
      - – Pay-per-weight for refuse
      - – cause people to dump their rubbish
      - – avoid toll roads & disrupt local communities
  - **Lower Tax base**
    - Ireland can maintain a low tax base and hence encourage continue investment into the economy
  - **Uses of revenue collected.**
    - Revenue is collected. This can be targeted for best use, to help achieve further aims e.g. the plastic bag tax.

- **Impact of Increasing Public Sector Charges as opposed to introducing new Taxes: Negative consequences**
  - **Increased cost of living**
    - The prices of those services for which charges are being imposed will increase thereby increasing the cost of living.
  - **Increased inflation**
    - Inflation will rise. This will affect the economy negatively: reduced competitiveness; demand for compensatory wage increases etc
  - **Affects lower income groups most**
    - The increased charges will have the greatest impact on lower income groups – those with the least ability to cope with the higher prices. Their standard of living will deteriorate.
  - **Viability of Partnership Agreements**

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        - Trade unions may consider that the increase in these charges are 'stealth taxes' and this may affect their decision to enter into future agreements / seek higher wage increases.
    - **Inequity / fairness**
        - The disparity in charges or in the quality of service / the introduction of charges – may cause disquiet in citizens
    - **Higher costs for business**
        - They must now pay higher toll charges; refuse charges; water charges –increasing costs which may require higher prices or reduction in jobs.

Government Budgets

- **Government Current Budget:**
    - Outlines the government's planned revenues and expenditures for the forthcoming year for day to day purposes Current revenue is money collected in taxes (direct / indirect; and other income during the year. Eg VAT; Income Tax revenues; Stamp Duties. Example of Current expenditure include Teachers Salaries; Social Welfare Payments.
- **Current Budget Deficit**
    - Current government expenditure exceeds current government revenue (Day-to-day revenue and expenditure).

- **Government Capital Budget:**
    - Outlines the government's planned expenditure on items not used up during the year but which increase the productive capacity of the country.
    - The money to pay for capital expenditure is usually through borrowing by the government. Examples of capital expenditure include building roads, building hospitals. Examples of capital income includes sale of semi state company or sale of state land.

- **Exchequer Borrowing Requirement (Exchequer Balance)**
    - The amount borrowed by central government to fund a current budget deficit and any borrowing for capital purposes/current budget deficit plus borrowing for capital purposes.

- **Public Sector Borrowing Requirement (General Government Balance)**
    - The exchequer borrowing requirement plus borrowing for semi-state/state sponsored bodies and local authorities.

- **Positive consequences of a Current Budget Surplus**
    - **Reduced inflationary pressures.**
        - The government is withdrawing more money from the economy than it is putting in. This tends to have a deflationary effect in the economy.
    - **Managing our finances.**
        - The existence of a budget surplus means that government does not have difficulty in controlling its finances. This can lead to confidence in the economy and attract investment.
    - **Adhering to EU guidelines.**
        - The fact that a budget surplus exists indicates that the country is meeting the EU agreed guidelines without any difficulty. This

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alleviates the need for the EU to comment adversely on government economic policy.

- **Scope for taxation reforms.**
  - The fact that a surplus exists indicates that scope exists for reform in the taxation system in the country. This should allow for improvements in the tax system allowing people to retain more of their income e.g. widened tax bands etc.
- **Uses of this increased govt. revenue.**
  - With increased revenue flowing into the government, they now have the ability to make use of this additional revenue. They may use for current projects e.g. services or on long term projects e.g. infrastructure.

- **Negative consequences of a Current Budget Surplus**
  - **Rise in conflicting expectations.**
    - When citizens observe the budget surplus they may demand improvements in state services e.g. health services; education provision etc. However, the demands/expectations made on the government may conflict.
  - **Public Sector Workers.**
    - When public sector workers see this budget surplus they may see it as an opportunity for wage negotiations. Workers may thus demand pay increases and /or an increase in the level of the workforce.
  - **Tax reductions.**
    - Taxpayers who feel that they are paying too much tax may feel aggrieved. They may demand reductions in their tax / improved equity in the tax system.
  - **Discontinuity in Social Partnership.**
    - The existence of the budget surplus may cause discontent within society. Citizens may feel that certain sectors are benefiting more from government policies. May prove difficult in approving national agreements.
  - **Government financial planning.**
    - The surplus may indicate that the planning by the government was not sufficiently accurate at budget preparation time.
  - **Opportunity costs of a surplus.**
    - The budget surplus may have been achieved by the reduction of expenditure on services within the country. Thus essential services such as health, education etc may deteriorate

- **Consequences of a Current Budget Deficit**
  - **Additional taxation**
    - The government needs to increase revenue to finance its activities and so has increased the rate of VAT; introduced the Property Tax and Septic tank tax. It also plans to introduce water charges.
  - **Cuts in public expenditure**
    - In the recent budget the rate of child benefit was cut and this affects all families in the state resulting in a reduction in their standard of living etc...
  - **Reduction in the provision of state services**

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        - The provision of services such as SNAs; home help for care assistants is causing difficulties for sectors of the population.
    - **Troika intervention**
        - The requirement to reduce the current budget deficit by the Troika means that the Troika can intervene and advise the Irish government on policy measures within the economy.
    - **Public sector pay**
        - The government is insisting that the public sector pay bill is reduced and that measures to increase efficiencies in public services must be introduced.
    - **Reduction in aggregate demand / job losses**
        - With the additional taxation consumer spending has fallen. This has resulted in job losses particularly in the retail sector.
    - **Loss of confidence / emigration**
        - The impact of extra taxation; reduced consumer spending; job losses etc. means that people are fearful about the future which affects business confidence. People, who are mobile, are emigrating.
    - **Moderation in citizens expectations**
        - Citizens are aware of the current financial position. They may accept more readily charges for state / local services; increased taxes and a reduction in state services for some individuals e.g. fewer hours for care assistants etc.

- **Relationship between a budget deficit and national debt**
    - A government budget deficit exists when total government expenditure exceeds total government revenue. A budget deficit is financed by increased government borrowing.
    - National debt is the total amount (cumulative) of government borrowing which is outstanding (due / owed). A budget deficit will result in an increased national debt in absolute terms and a higher cost of servicing the national debt.

National Debt

- **National Debt**
    - This is the total amount /accumulated total of outstanding borrowing by the government.

- **Reasons for the National Debt**
    - **Improved Public services:**
        - If the increased debt is caused by an increase in current borrowing, the government may continue to spend on public services resulting in a continuation of these services.
    - **Increased spending on infrastructure:**
        - If the increased debt is caused by an increase in capital borrowing then there may be greater spending on the state's infrastructure, which may assist the future growth of the economy.
    - **Future Economic Growth:**
        - Increased National Debt may boost aggregate demand and may provide opportunities for further economic growth.
    - **Self-Liquidating debt:**

        - If the return on the borrowings is able to meet the cost of repayments then the borrowing has been self-liquidating.

- **Negative Consequences of a National Debt**
    - **Opportunity costs involved / loss of public services**
        - With more funds being used to meet our annual interest repayments the government has less funds available for other purposes. The government has cut spending on public services, resulting in deterioration in provision of some services e.g. the health service; education service
    - **Increased burden on current and future taxpayers**
        - The increase will mean that the government will have to consider increasing future taxes on future taxpayers.
    - **Annual interest repayments**
        - The increasing national debt means that the annual cost of repaying our national debt is rising. Interest payments are payments for past consumption and they are made at the expense of current consumption.
    - **Loss of economic sovereignty / intervention of Troika**
        - When a country cannot fund itself it can apply to external bodies, such as the IMF, for funding. However to get the funding a country has to accept conditions as specified by the external bodies.
    - **Reduction in our international credit rating**
        - High debt means that credit ratings will be affected. This will have an impact on the ability of the Irish Government to get private external funding in the bond market.
    - **Sale of semi-state bodies**
        - The current government is committed to the privatisation of some state companies and to use the revenue to reduce our debt. This is in line with Troika requirements.
    - **Poor management of economy**
        - Some citizens may become aware of the government's poor management of the economy and this may diminish their confidence in the economy.
    - **Risk in Provision of Public Services / pressure on government to cut spending**
        - Due to an increase in the national debt the government has cut back spending on certain public services, thereby affecting the provision of some services e.g. the health service; education service.
    - **Servicing the external portion of the National Debt**
        - The external portion of the national debt is subject to exchange rate movements, if borrowed from outside the eurozone. The Irish Government doesn't earn tax revenue on the repayment of external sources, unlike on the repayment of internal sources.

- **Ways to make the National Debt more sustainable**
    - **Debt write off**
        - Many commentators agree that Irish Debt levels are unsustainable and some of it must be written off in order for the economy to grow into the future.
    - **Negotiate Lower interest rates**

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        - NTMA should try to ensure that the annual interest repayments are less costly for the country.
    - **Negotiate a longer time repayment period**
        - This would reduce the annual interest repayments and may make the National Debt more sustainable.
    - **Ensure debt is 'self-liquidating'**
        - The government must ensure the funds are used to generate revenue that helps to repay the debt rather than the debt being 'deadweight'.
    - **Encourage Economic growth**
        - The government could encourage aggregate demand which would be a source of additional income for people and subsequent additional tax/income for the government. With the increase in the government's current income the national debt would be easier to repay/could be repaid in increased instalments, which would leave the debt more sustainable.

- **Role of the National Treasury Management Agency**
    - Borrowing on behalf of the Irish Government / sale of government bonds.
    - Managing the Irish National Debt on behalf of the government.
    - Managing of the National Pension Reserve Fund.
    - Managing of other government funds such as the Social Insurance Fund and Dormant Account Fund.
    - Borrows on behalf of the Housing Finance Agency.
    - Provision of financial advice, possibly funding, and providing guarantees for all major public investment projects carried out by the National Development Finance Agency operating through the NTMA.
    - Provides a Central Treasury Service for the taking of deposits and lending to local government bodies and liquidity management for the Central Bank and Financial Services Authority of Ireland.
    - Personal injuries claims brought against Government departments and other State Authorities/ the State's Clinical Indemnity Scheme managed by the NTMA as the State Claims Agency.
    - NAMA Operates under the aegis of the NTMA

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