Chapter 1

Assessment of Fiscal Stance

1. Assessment of the Fiscal Stance

Key Messages

- The Government based its *Stability Programme Update (SPU) 2020* on a scenario where the Covid-19 crisis that enveloped global economies in early-2020 would result in a deep economic downturn in the first half of the year. This was appropriate, given the uncertainties and risks involved. The Irish economy was in good shape when the Covid-19 shock hit. The shock itself, rather than reflecting domestic imbalances, resulted from the global health pandemic. Official *SPU 2020* projections envisage a 15 per cent decline in underlying domestic demand in 2020. This reflects a sharp impact from containment measures in Q2 2020 and lasting adverse economic impacts, with unemployment projected to be 9.1 per cent in Q4 2021.

- Given the uncertainties involved, it helps to consider scenarios for different paths of the economy. We develop three alternative scenarios: a "Mild" scenario where conditions improve rapidly and lasting damage is kept to a minimum; a "Central" scenario, building on the official *SPU 2020* forecasts where confinement measures are eased as planned but there are some lasting effects; and a "Severe" scenario where the recovery is protracted and marred by repeat lockdowns and wider financial distress. The scenarios explore paths for recovery that could take between about 2 and 3½ years to return to pre-crisis levels depending on health outcomes. By contrast, the Irish economy took 11 years to recover after the financial crisis.

- Developments since the publication of *SPU 2020* have been broadly consistent with its projections. There are limited data to formally assess the economic impacts associated with the Covid-19 shutdown. Yet, various indicators offer some evidence of a sharp contraction in activity. The unemployment rate rose to 28 per cent in April, when including those on emergency supports, but appears to have stopped rising. Similarly, a steep contraction in consumer spending appears to have lessened.

- The macroeconomic backdrop is exceptionally uncertain. There are also further major risks surrounding the economic outlook, including those associated with Brexit and changes to the international tax system.

- Ireland's government debt burden was high going into the current crisis. The net debt-to-GNI* burden, using the most appropriate measure of national income, was equivalent to 86 per cent at the end of 2019. This placed it as the sixth highest in OECD countries behind France, Portugal, Italy, Greece and Japan. Debt levels in almost all countries are likely to rise as result of the Covid-19 crisis.

- The Government's debt burden (in gross terms) is projected to rise from 99 per cent of GNI* in 2019 to peak at 125 per cent in 2020. By 2022, the debt ratio would likely be below 120 per cent and steadily declining in the Central scenario. However, a more severe outlook would see the debt ratio rise to over 140 per cent and remain stuck at high levels. Additional support measures or costs could shift up the debt ratio substantially more.

- The Government has outlined some €7 billion of additional spending on healthcare, income supports, wage subsidies, and cash supports to business. A further €7 billion of additional supports including guarantees, loans, and investments have also been committed. The Council assesses that the actions taken in 2020 thus far are conducive to prudent economic and budgetary management.

- The appropriate fiscal stance for the coming years will depend on how the crisis evolves. It will need to balance the goals of supporting the economy and avoiding permanent damage to productive capacity with maintaining creditworthiness and sound economic management. A new government will need to finance its policy objectives in a sustainable way.

- The appropriate fiscal stance will likely evolve in three broad phases: (1) the immediate crisis; (2) the recovery period; and (3) the new normal or "steady state" that the economy finds itself in over the medium term. The timing of each phase depends on how the crisis unfolds.

- The first phase is to address the immediate crisis. The Government should seek to limit negative health and income impacts and promote a quick rebound as far as possible through direct spending. This would help to limit lasting economic damage from the outbreak, restore incomes quickly, and

safeguard long-run debt sustainability. The immediate costs will be high, but temporary. Failing to restore incomes quickly could result in lasting damage, endangering growth and the sustainability of the public finances over a prolonged period. Such damage would far outweigh the costs of measures to sustain household incomes and immediate spending needs. The phasing out of supports will primarily depend on how long the health crisis persists. If the health crisis fades quickly, then supports can be withdrawn relatively swiftly. However, if the supports are withdrawn too soon, it could lengthen and deepen the economic crisis.

- The second phase will be a recovery period. The economy will be below its potential, although growth could initially be quite fast as sectors reopen and as high savings rates are run down. Unemployment will be higher than it was pre-crisis, there will be significant unused resources, and productivity will be lower than usual as firms adapt. Some sectors, such as tourism and food services, will fare worse than others. Some job losses will be permanent, and some retraining of workers will be necessary if the economy is to recover its lost potential.

- A large-scale fiscal stimulus would help support activity during the recovery phase and would be an appropriate countercyclical approach for the Government to manage the economy. It should be temporary, targeted and conditioned on the likely state of the economy. It should be phased appropriately over time so that demand can adjust gradually. A stimulus might not be able to support demand in sectors where social distancing is more difficult, but it could boost growth in other parts of the economy.

- The third phase will see the economy settle on a new growth path with government debt at much higher levels. This will leave the economy more vulnerable to further adverse shocks in future. To safeguard the funding of public services and supports, the government should set a credible path for a prudent fiscal policy. One way to achieve this would be to reinforce the budgetary framework. Three reforms would help: (1) meaningful debt ratio targets; (2) saving temporary receipts through a redeveloped Rainy Day Fund; and (3) using sustainable growth rates to guide net policy spending growth along with more realistic medium-term budgetary forecasts.

Table 1.1: Summary table

% GNI* unless otherwise stated, general government basis (based on *SPU 2020* forecasts)

	2018	2019	2020	2021
General government				
Revenue [1]	41.5	42.5	41.6	41.9
Expenditure [1]	41.4	41.9	54.8	49.2
Balance [1]	0.1	0.7	-13.3	-7.3
Interest expenditure	2.7	2.2	2.3	2.0
Primary expenditure [1]	38.7	39.7	52.5	47.2
Primary balance [1]	2.8	2.8	-11.0	-5.3
Revenue growth (%) [1]	7.0	6.6	-17.0	9.5
Primary expenditure growth (%) [1]	6.9	6.9	12.3	-2.4
Net policy spending growth	6.4	6.1	5.4	-0.1
Real net policy spending growth (%) [2]	5.7	5.2	6.0	-0.5
Debt				
Gross debt (€bn)	205.9	204.0	217.5	231.5
Cash & liquid assets (€bn)	28.2	27.6	17.2	20.0
Net debt (€bn)	177.7	176.4	200.3	211.5
Equity and investment fund shares (€bn) [3]	37.0	33.9		
Gross debt ratio (% GNI*)	104.3	99.2	124.6	122.1
Net debt ratio (% GNI*)	90.0	85.8	114.7	111.5
Output				
Real GDP growth (% change)	8.2	5.5	-10.5	5.8
Nominal GDP growth (% change)	9.1	7.2	-9.2	7.1
Nominal GNI* growth (% change)	7.3	4.1	-15.1	8.6
Nominal GDP level (€bn)	324.0	347.2	315.4	337.9
Nominal GNI* level (€bn)	197.5	205.6	174.6	189.6
One-offs				
Expenditure one-offs (€m) [1]	213	0	0	0
Revenue one-offs (€m) [1]	300	0	0	0
Net one-offs (€m) [1]	87	0	0	0

Sources: CSO; Department of Finance; and Fiscal Council workings.
These figures are based on the original Nominal GNI* figures provided by the Department for SPU 2020. The estimates were corrected in a later version of the report, yet the differences are relatively minor.
[1] One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. For 2018, there is €300 million of corporation tax and €213 million for the medical consultants' pay settlement. For 2020, a number of temporary Covid-19 supports were introduced. While these are intended to be temporary, their duration and cost are still unclear at this stage.
[2] This measure is outlined in Box A (Fiscal Council, 2018e). It represents total general government expenditure less interest, cyclical unemployment-related costs, and discretionary revenue measures.
[3] This comprises government holdings in equity (shares and other equity) and investment fund shares (F5), including the value of bank shares held by the State.

1.1 Introduction

The Council has a mandate under the *Fiscal Responsibility Act (FRA) 2012*, and with reference to the requirements of the *Stability and Growth Pact (SGP)*, to assess the Government's fiscal stance.

This chapter draws on analysis from the rest of the report in assessing the fiscal stance in *SPU 2020*. The Council's assessment is informed by: (1) an economic assessment that considers the state of the public finances, the stage of the economic cycle, and growth prospects for the economy; and (2) the extent of compliance with the fiscal rules.

1.2 The Macroeconomic Context

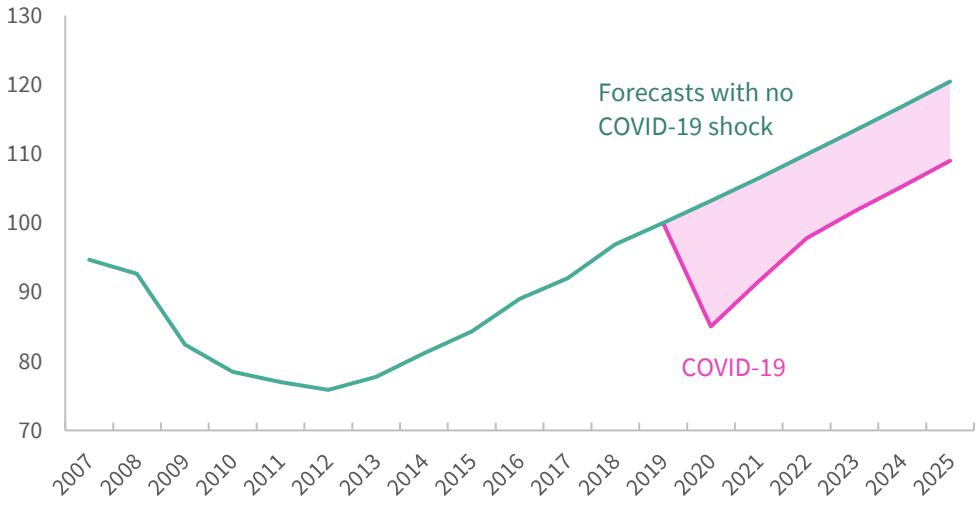
Domestic Economic Activity

The domestic Irish economy came into 2020 with a strong wind at its back — so much so that overheating was in prospect. Growth was rapid. The outlook for major trading partners was reasonably positive. Monetary conditions were favourable, while the budget balance was showing a small surplus, with spending supported in part by corporation tax receipts from multinationals. The risk of an immediate disorderly Brexit had subsided. Persistent shortages of housing meant that an eventual increase in residential construction looked set to further boost activity over the medium term absent an adverse shock. However, by the end of February the situation had taken a dramatic turn.

The Covid-19 pandemic meant that large parts of the economy were locked down as necessary containment measures were enacted to limit the spread of the virus. State supports—both existing and newly introduced—cushioned the impact of the unprecedented fall in demand for workers. In less than three months, the Irish economy went from low unemployment to one-in-every-two people in the labour force relying on social welfare payments or state-backed wage subsidies.

Figure 1.1: The Covid-19 shock is deep and rapid

Underlying domestic demand (Index: 2019 = 100)



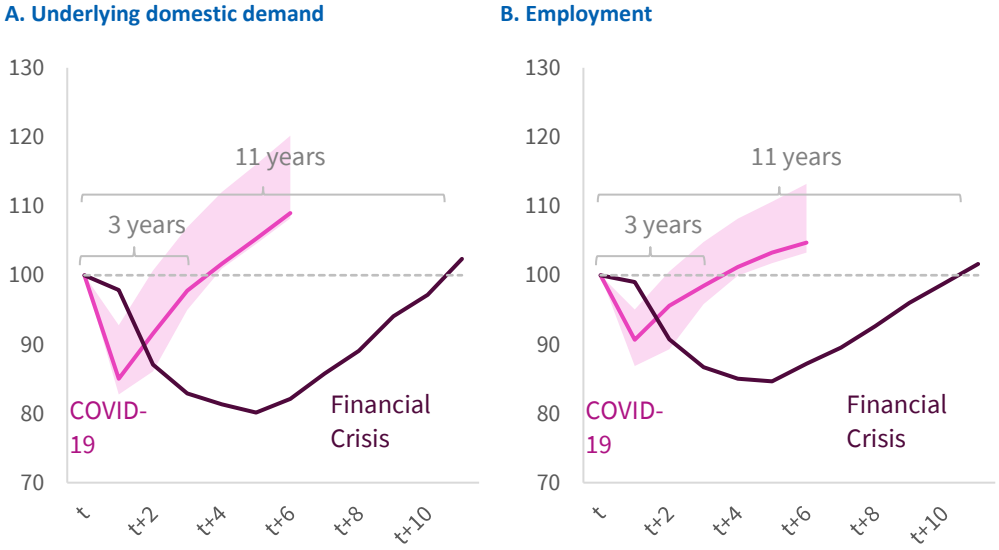
Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Underlying domestic demand comprises consumer spending, government consumption, and investment spending (excluding planes and intangibles). The Covid-19 scenario is the Central scenario outlined in Box D. It is based on an extended version of the official *SPU 2020* forecasts.

Direct confinement measures, negative impacts on work and spending opportunities as people keep their distance, and wider demand shortfalls have

meant a large negative shock to overall economic activity. These will lessen as containment measures ease. But adverse impacts are likely to persist for sectors that are more exposed to travel and social interaction (tourism, food services, retail). Figure 1.1 illustrates the scale and rapidity of the fall in output facing the Irish economy. The outlook depicted in official (*SPU 2020*) forecasts is for a 15 per cent decline in underlying domestic demand in 2020 (Chapter 2). This reflects the assumption of a sharp initial impact from containment measures lasting over Q2 2020 and of lasting adverse impacts on the economy. Damage could persist such that a gap of almost 10 per cent remains by 2025 compared with the pre-Covid-19 path.

Figure 1.2: The Covid-19 shock is not expected to endure like the financial crisis

Index: 2007 =100 for the financial crisis; 2019 = 100 for the Covid-19 shock



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: We set t = 2007 for the financial crisis and t=2019 for the Covid-19 shock. The Covid-19 scenario is the Central scenario outlined in Box D. It is based on an extended version of the official *SPU 2020* forecasts.

Comparing the shock with the financial crisis of 2008/2009 can help us understand the scale and persistence of the downturns (Figure 1.2). It also highlights the differences in the nature of the two contractions. The financial crisis was a deep and prolonged shock. It required a radical correction in the economy from a position of lost competitiveness, large trade deficits, a property bubble, and high levels of debt. The recovery to pre-crisis peak levels of underlying domestic demand and employment took 11 years, even allowing for what were eventually very favourable circumstances. By comparison, the Irish economy was in good shape when the

Covid-19 shock hit and the shock itself, rather than reflecting domestic imbalances, stemmed primarily from a global health pandemic.

Although subject to very high uncertainty, a range of scenarios presented in this Fiscal Assessment Report suggests that the recovery is expected to take between about 2 and 3½ years to return to pre-crisis levels.

There is a high level of uncertainty facing the immediate economic outlook relating to the pandemic. How long the economy will take to emerge from the Covid-19 shock and how deep the economic contraction will be is still unclear at this early stage. What happens on the health side will be key to the recovery. This includes the prospects for safe and effective vaccines or treatments and the effectiveness of containment measures (Box A). In terms of the economic impact, it is uncertain how effective government supports will be and the extent of the global fallout.

Box A: The economic shock depends on how Covid-19 evolves

The Covid-19 shock is unlike typical macroeconomic shocks. It is foremost an epidemiological phenomenon. That is, to understand how it might evolve, we need to understand how the pandemic will evolve. This box considers some aspects of how the pandemic is unfolding in Ireland.

The path out of the crisis depends on transmission risks

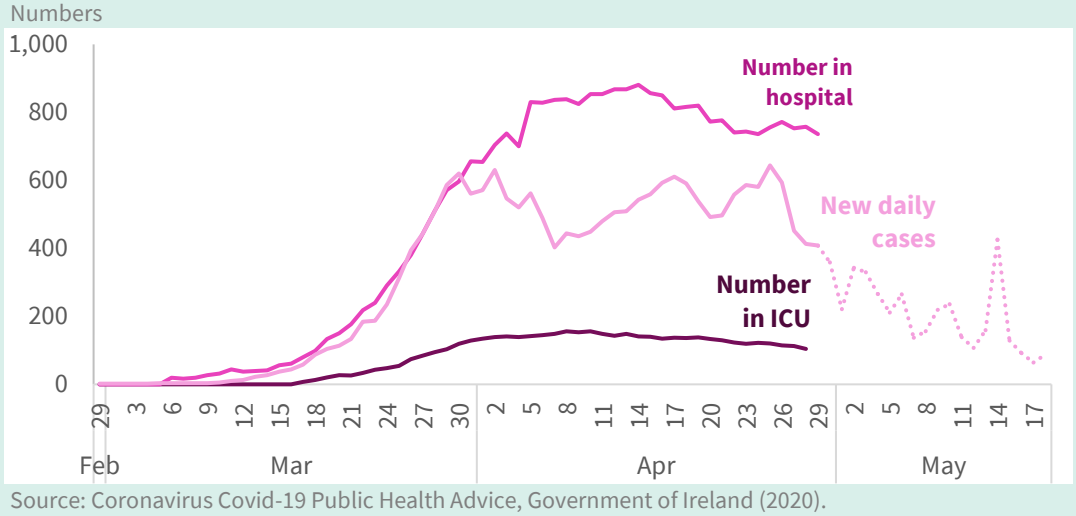
Ultimately, an effective vaccine may be needed to fully interrupt the transmission of Covid-19. As of 15th May 2020, the World Health Organisation (WHO, 2020) had identified eight candidate vaccines that were in clinical evaluation and 110 candidate vaccines in preclinical evaluation. Yet, there are no guarantees that safe and effective vaccines will be successfully identified and timely verification processes could mean that a vaccine might not be available until late next year at the earliest.

If a vaccine is not developed, the development of anti-viral drugs, tests for antibodies, and the gradual build-up of immunity in the population could pave the way for economic activity to further resume. There are of course risks if containment measures are lifted before health risks have dissipated.

Policymakers therefore face a difficult dilemma in balancing health and economic considerations when exiting from the crisis. The WHO has offered advice to countries easing restrictions. There are six criteria:

1) Controlling transmission
2) Ensuring health systems are able to detect, test, isolate and treat cases and trace contacts
3) Minimising outbreak risks in settings like health facilities and nursing homes
4) Putting preventive measures in place in workplaces, schools and other essential locations
5) Managing import risks
6) Ensuring communities are educated, engaged and empowered to adjust to a "new norm"

Figure A.1: Data on Covid-19 in Ireland



Source: Coronavirus Covid-19 Public Health Advice, Government of Ireland (2020).
Note: New daily cases refer to confirmed cases of Covid-19. Numbers in hospital and ICU are cumulative figures. External tests (including those conducted in Germany on behalf of Irish authorities) are backdated to appropriate dates as in the "Covid-19 modelling data published on Thursday 30 April 2020". The dashed line represents the latest unadjusted data on new daily cases.

In Ireland, the transmission of the disease as measured by numbers of new daily cases, numbers in hospital, and numbers in (ICUs) with Covid-19 appears to have peaked for now.

Numbers have either flattened or begun a slow decline from various stages in April (Figure A.1). The peaks in data related to the transmission of the virus are encouraging, and new daily cases have reduced, though there may still be a long way to go before health concerns abate.

The Government's Roadmap

The Government's "Roadmap for Reopening Society and Business" follows similar criteria to that of the WHO. The roadmap sets out five phases for unlocking parts of society and the economy (summarised in Table A.1). Moving through the roadmap phases will depend on the progress of the disease, healthcare capacity, testing and contact tracing, the shielding of at-risk groups, and secondary morbidity and mortality. As part of the roadmap, businesses are expected to develop plans for the safe operation and protection of staff and customers (social distancing, hygiene and cleaning, extended opening hours, shift work, staggered hours).

Table A.1: Summary of the Government's Roadmap

Phase 1 18 May	Outdoor workers (including those in construction) Retailers outdoors or with strong social distancing (garden centres, hardware, farm markets) Outdoor amenities
Phase 2 8 June	20km travel restriction Other solitary workers Small retail outlets (with controls on number of interactions)
Phase 3 29 June	Crèches, childminders and preschools for essential workers Cafes and restaurants, with social distancing/cleaning Organisations with low daily interactions with people All other retail outlets
Phase 4 20 July	Extend travel to outside region Crèches, childminders, and preschools for all other workers (phased, e.g. 1 day/week) Some higher risk services (e.g., hairdressers) Return to work for those who cannot do remote work (shift work, staggered hours) Sports team leagues (with limitations on spectators)
Phase 5 10 August	Large social gatherings (large weddings, festivals) with social distancing/cleaning Higher risk services (bars, nightclubs, cinemas, theatres, etc.) with social distancing/cleaning Primary schools, secondary schools, universities Phased return to onsite working for all others (including those who can do remote work)

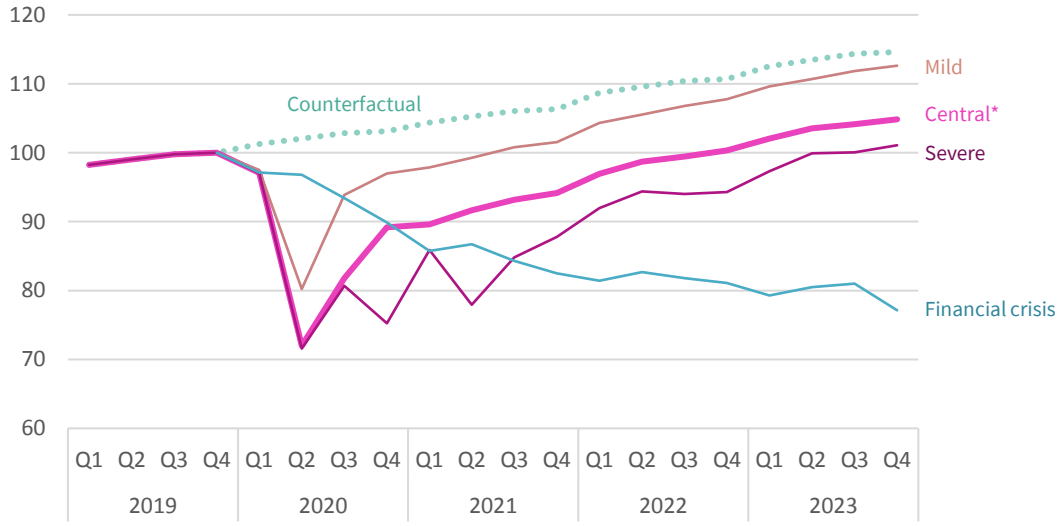
Health guidelines and behavioural norms face more prolonged impacts

The first phase has been passed. Yet, even after all the roadmap phases have been moved through, it is unlikely that the economy and society will return to previous norms. Some level of precaution, both recommended and voluntary, is likely to remain long after the initial containment phase ends.

Given the uncertainties involved, it helps to consider scenarios for different paths of the economy. This Fiscal Assessment Report sets out three scenarios over a five-year horizon to 2025 and shows a range of outcomes: a "Mild" scenario where conditions improve rapidly and lasting damage is kept to a minimum; a "Central" scenario, building on the official SPU 2020 forecasts where confinement measures are eased as planned but there are some lasting effects; and a "Severe" scenario where the recovery is protracted and marred by repeat lockdowns and wider financial distress. Box D, Chapter 2, details the basis for these scenarios.

There is a wide range of potential outcomes in terms of the scale of declines that are possible for 2020 (Figure 1.3). Activity—as measured by underlying domestic demand—could recover quickly if economic and health responses prove successful. If so, the Mild scenario could see underlying domestic demand contract by 7 per cent this year as compared to almost 15 per cent in official projections. By contrast, repeat lockdowns consistent with a second and third wave of infections could see a more stunted recovery where demand contracts by more than 18 per cent this year.

Figure 1.3: Economic scenarios for how Covid-19 plays out vary widely
Underlying domestic demand (Index: Q4 2019 = 100)



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: * The Central forecasts are a replica of the official Department of Finance projections published in *SPU 2020* (see Box D).

The path that the economy recovers to after the end of the containment measures is more important for long-run sustainability than the immediate impact. The scenarios we consider suggest that a return to pre-crisis levels of output might not be possible until anywhere from mid-2021 in the Mild scenario up to mid-2023 in the Severe scenario. A lot depends on the success of containment measures and policies to mitigate economic damage, as well as the extent to which lasting changes in behaviour are observed. The long-term growth rates to which the economy returns will depend on these factors, with more severe outcomes leading to lower rates than previously assumed. The scenarios we consider do not offer a comprehensive range of possible outcomes. The Covid-19 shock could, for instance, give rise to a systematic shift in the global economy that poses far greater downside risks than we consider.

An upside risk is that the official projections do not incorporate any fiscal stimulus after the crisis, although this would likely imply a large budget deficit. *SPU 2020* notes that the "Government will shortly bring forward an economic recovery plan, setting out its approach to repairing the damage caused by the pandemic. The costs of this are not included" (Department of Finance, 2020a, p.10). Downside risks are that the economy takes longer to recover from the health and economic impacts associated with Covid-19. There are also financial risks. Asset prices collapsed and market volatility spiked following the outbreak of the pandemic, with liquidity and financing conditions tightening rapidly (IMF, 2020). While banks have more capital and liquidity than in the past, including at the onset of the financial crisis, ongoing risks from the pandemic could test their resilience, reducing lending and amplifying the slowdown. Brexit and potential changes to the international corporate tax regime present other downside risks outside of Covid-19.

Recent developments

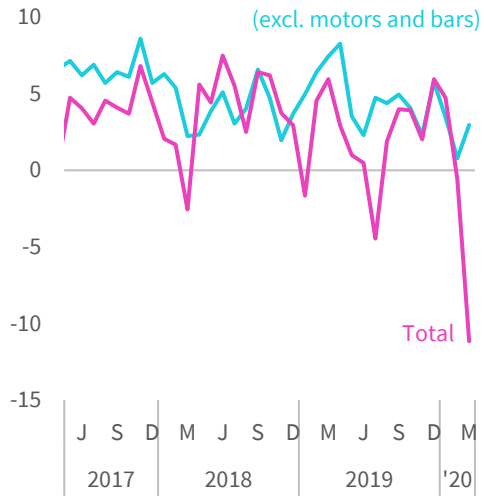
Right now, there is limited hard data available to formally assess the economic impacts associated with the Covid-19 shutdown. Yet high frequency indicators offer some evidence of the sharp contraction in activity (Figure 1.4). The developments so far are broadly in line with the macroeconomic forecasts in *SPU 2020* (Box C).

Consumer spending data for the period where containment measures took effect look exceptionally weak. For March, retail sales volumes were down by 11.2 per cent year-on-year. Data on personal debit and credit card activity plus ATM withdrawals show that the combined value of transactions was down 35 per cent year-on-year in April. There was an initial surge in transactions in early- to mid-March as closures of schools, crèches (12th March) and bars (15th March) took effect. Non-essential shops were not closed until 27th March. These data point to some stockpiling by consumers. But this was dwarfed by the precipitous declines in late-March and through April as restrictions on all but essential services were imposed. Activity appears to have bottomed out in mid-April. Card plus ATM transactions were down about 25 per cent year-on-year by the final week of the month and in early May.

Figure 1.4: Early indicators signal a sharp contraction in early 2020

% change year-on-year unless otherwise stated

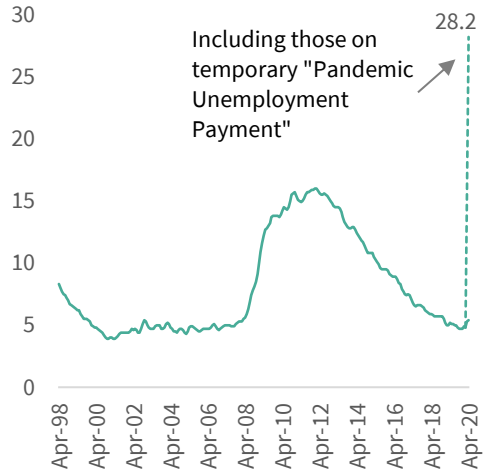
A. Total retail sales fell markedly in March, but some core items held up well



B. Personal Card and ATM transactions plummeted in April

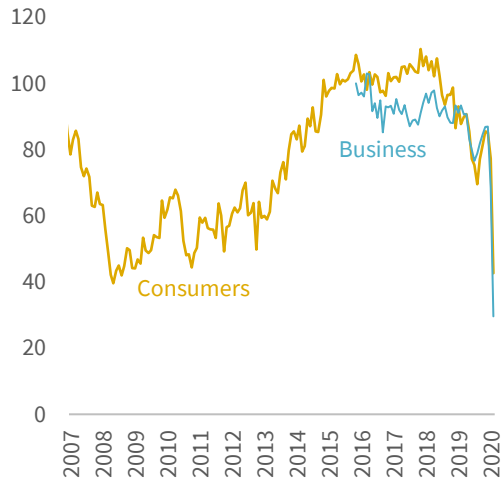
C. Unemployment rates skyrocketed

% labour force



D. Sentiment weakest since financial crisis

Index



Sources: CSO; Central Bank of Ireland Monthly and Daily Card Payments data; KBC; Bank of Ireland; and Fiscal Council workings.

Note: Card data refer to (1) gross new spending on debit cards (Point of Sale Transactions) + (2) ATM withdrawals + (3) gross new spending during the month on all personal credit cards. They are calculated using 7-day moving averages, with the monthly data converted to a daily frequency assuming a constant daily conversion from the monthly series (i.e., each day of the respective month is assumed to have equal levels of spending where daily data are unavailable). This conversion, though imperfect, allows for reasonable year-on-year comparisons. See Hopkins and Sherman (2020) for a detailed exploration of the new daily dataset. Sentiment indicators are the Bank of Ireland "Business Pulse" indicator and the KBC "Consumer Sentiment" index.

The sharp downturn mirrors what is being experienced in other countries affected by the pandemic. French, Spanish and Austrian real GDP contracted by 5.2 per cent, 3.8 per cent, and 2.7 per cent year-on-year respectively in the first quarter of 2020. In the US, consumer spending volumes contracted by 7.3 per cent in March compared to February. Advance estimates suggest that US real GDP contracted at an annual

rate of 4.8 per cent in Q1 2020 and nowcasts suggest a contraction of 31 per cent in Q2 2020. In countries like Sweden where containment measures were relatively limited, economic indicators have held up relatively well (for example, core retail sales continued to grow in annual terms albeit at a slower rate in March).

Soft data also collapsed in recent months. Consumer sentiment dropped to levels not seen since the financial crisis in 2008. Business sentiment experienced a similar fall in recent years (Figure 1.4D). The composite PMI indicator (not shown) suggests real GDP contracting by some 6 per cent in the three months to April based on their historical association.

The economic recovery

Activity is likely to pick up rapidly as confinement measures ease. But output will remain far below its potential level as a result of the current disruptions, remaining restrictions, concerns around Covid-19, weakened confidence, and weak global demand. Demand should gradually recover as these conditions improve.

There are risks that potential output over the long run could be permanently lower and there are risks of a long-run impact on productivity growth following the Covid-19 shock. Key concerns relate to how lasting the impact on investment and unemployment could be. These risks can be thought through in terms of three key factors to production:

Productivity growth could be impacted by the pandemic in a variety of ways. Firms might take pandemic risks into greater account, hence imposing higher costs. There could be less favourable terms of trade, and reduced travel. There could also be a loss of human capital and tacit knowledge if businesses fail. “Reshoring” of global supply chains is a possible response — that is, companies reversing the process of spreading production across the globe to mitigate future risks to production. Yet firms might still find diversification of production across countries more secure than reshoring. Productivity might still improve due to other factors: accelerated moves to automate work; remote working; and through creative destruction. Some of these would allow firms to adjust more flexibly to changing demand and to lessen their reliance on workers subject to infection.

Labour supply could be negatively impacted, with many workers not being able to return to businesses that suffer insurmountable losses. The longer they remain out of work, the higher the probability that they will not return to employment. Conefrey, McCarthy and Sherman (2013) show that the re-employment probabilities for individuals in the post-financial crisis period could be as weak as roughly 10–15 per cent for those with low education, who were out of work for up to five months. The current crisis is obviously unusual in that the expectations of returning to work quickly might reasonably be higher, especially as the shock is largely driven by a temporary set of containment measures, and fundamentals at the onset of the crisis were better than those at the time of the financial crisis. Reduced net migration into Ireland could also reduce labour supply, especially if travel restrictions are in place for an extended period. An accelerated shift to automation could push people out of the workforce.

Investment in capital (infrastructure, machinery and equipment, etc.) will also likely suffer as a result of the shock and the associated uncertainty. Private business investment that might otherwise have occurred is likely to be shelved due to lower revenues, firm bankruptcy, lack of liquidity, and weaker expected demand in future.

The *SPU 2020* projections did not include updated estimates of the economic cycle or potential output.[1] Yet, assessment of cyclical and supply-side conditions is nevertheless a useful input into policy.

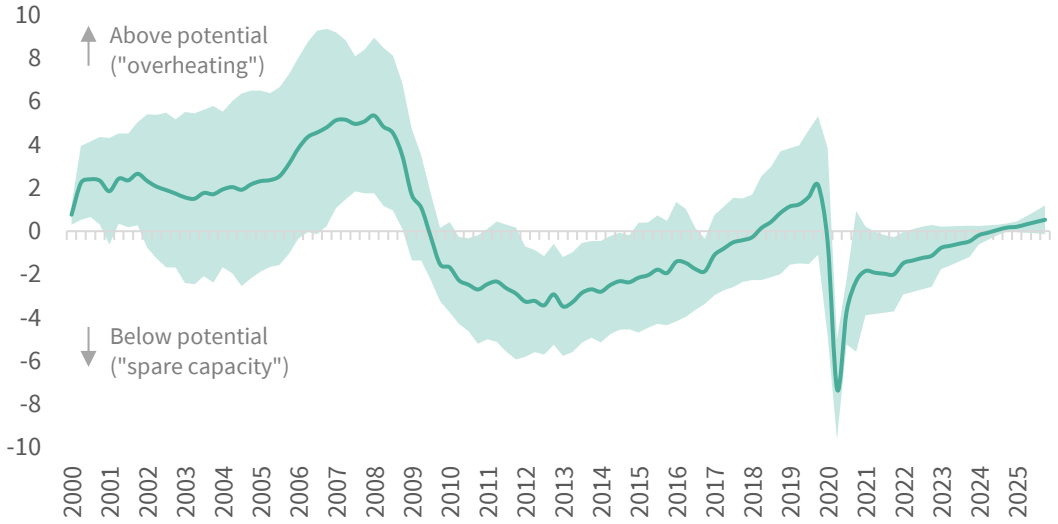
Based on the Council's assessment of potential output, the economy is likely to go from a position where tentative signs of overheating were evident to one where substantial spare capacity opens up (meaning unused labour and other factors of production). Using the Council's suite of output gap models (Casey, 2019) together with the *SPU 2020* forecasts suggests that in the Central scenario the economy would be expected to fall from a slightly positive output gap of 2 per cent to as low as 7½ per cent below its capacity in 2020. It would then gradually close the gap in later years (Figure 1.5). Behind the current output gap estimates are estimates of potential output growth rates of 2–3 per cent over the medium term (2022–2025).

[1] The European Commission issued guidance that supply-side estimates would not be required for the purposes of this stability programme, given the exceptional context.

The latest estimates—though reasonably plausible—are subject to considerable uncertainty and will likely change substantially as new information is incorporated.

Figure 1.5: Substantial spare capacity opens up in 2020 but closes faster than after 2008

% potential, output gap (gap between actual and potential output)



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: The figure shows a range of output gap estimates (the shading) and the mid-range estimates (the line). Estimates are produced using a variety of methods based on the Council's models and Department forecasts (extended to 2025 — see Box D). Given the distortions to standard measures like GDP and GNP and the relative importance of domestic activity to fiscal outcomes, the range focuses on domestic economic activity, including quarterly Domestic GVA (see Casey, 2019).

Risks to the Outlook

As well as the risks associated with Covid-19, further major risks continue to surround the economic outlook. Two key risks are those associated with Brexit and changes to the international tax system:

- **Brexit:** *SPU 2020* assumes that a relatively benign Brexit occurs at the end of this year. There is a risk that a disorderly Brexit could occur and be worse than previously assumed (see Box D, *November 2019 Fiscal Assessment Report*). There is considerable uncertainty about how Brexit will interact with the global pandemic. There is the potential for a global recession and collapse in world trade that could significantly amplify the negative consequences. Yet, with many vulnerable sectors already facing severe demand shortfalls (like accommodation and food services, but not agri-foods sectors), it is possible that the adverse impacts would not necessarily be worse than they otherwise would have been. Brexit could also pose risks to long-run potential output. Productivity growth (the key determinant of long-run growth) has a well-documented association with trade, which is likely to be negatively impacted over a prolonged period. These effects would be limited if Irish exporters overcame challenges to find new markets and if foreign investment and labour supply (through migration) were boosted by Brexit.

- **International tax changes**, including those under the OECD's Base Erosion and Profit Shifting initiative (BEPS), could affect foreign investment in Ireland and corporation tax receipts. Protectionist measures by the US and other nations could escalate further, weakening global trade. And, adverse financial developments could spill over to the Irish economy.

1.3 The Recent Fiscal Context

In the years prior to the Covid-19 crisis, efforts to turn around a large deficit after the financial crisis slowed from 2015 after the 3 per cent of GDP deficit limit was met (Figure 1.6A). Non-interest spending growth quickened from 2015, to largely keep pace with fast revenue growth that was boosted by corporation tax (Figure 1.6B). As a result, the budget balance excluding one-offs and interest costs barely improved after 2015 (Figure 1.6C).

Two features supporting the budget balance in recent years were (1) the cyclical upswing, which boosted revenues and lowered unemployment-related spending; and (2) a number of unexpected surges in corporation tax. Figure 1.6D shows the structural primary balance: the budget balance adjusted for the cycle, one-offs, and interest costs. It deteriorated after 2015. If the "excess" corporation tax receipts—receipts beyond what could be explained by domestic growth— were removed, then the structural primary balance would be seen to have deteriorated even further. Box H shows that some €5.4 billion of corporation tax receipts in 2019 (9 per cent of Exchequer tax revenue) could be considered excess. Excluding these excess receipts would suggest a structural primary balance as low as -0.5 per cent of modified GNI* for 2019 (Figure 1.6D and Box H).[2]

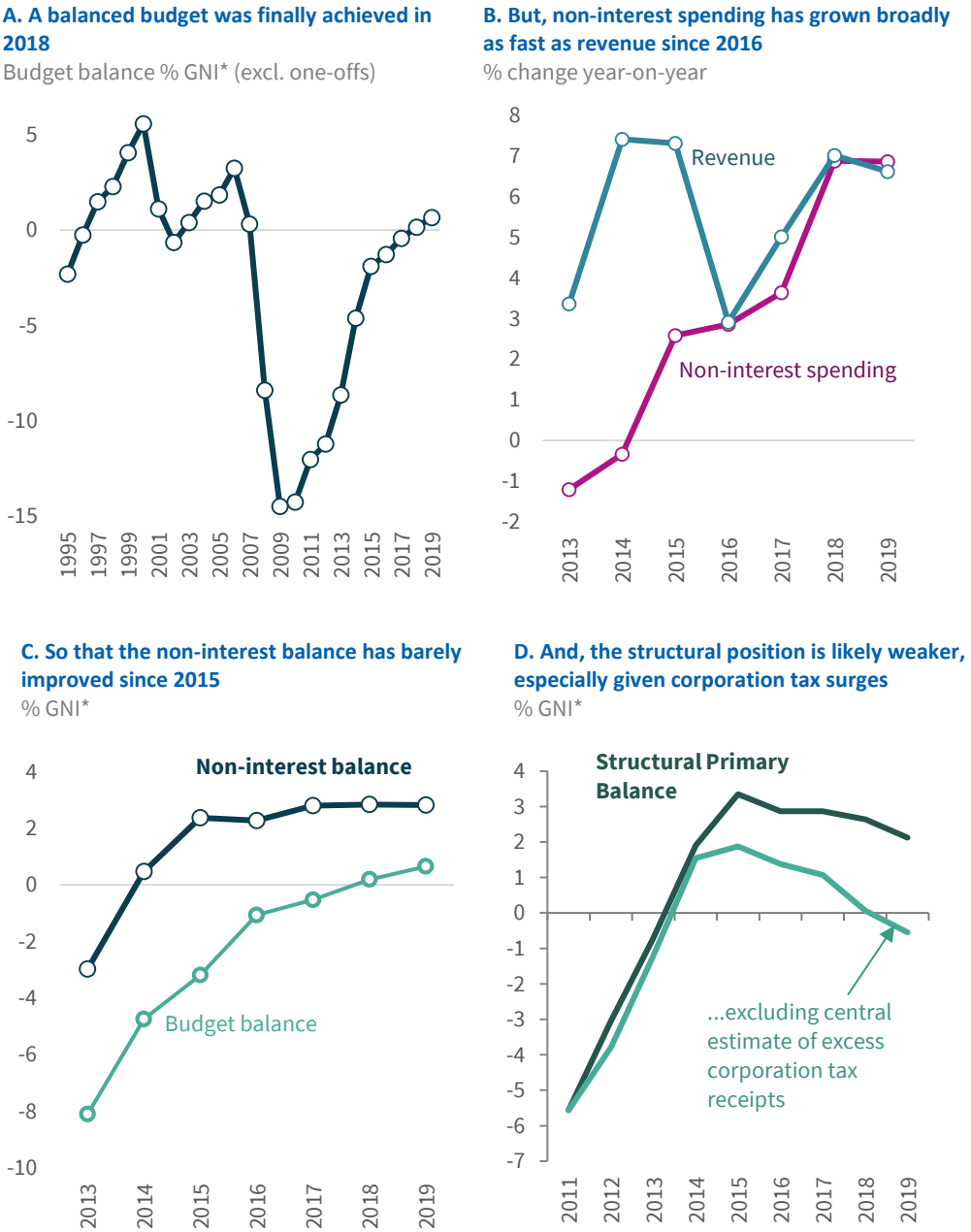
The surges in corporation tax receipts boost government revenues, but they also boost the economy. Four-fifths of receipts are due to foreign-owned multinational enterprises. This means that—unlike conventional tax receipts that are paid out of domestic activity—they represent a net injection to the Irish economy. The associated higher profits and net exports contribute to the higher growth in headline GDP seen in recent years and they inflate Ireland's strong current account surplus, though they are largely disconnected from underlying economic activity.

A repeated pattern of unplanned spending increases, particularly in health, used up much of the recent surges in corporation tax, plus much of the cyclical revenues built up in recent years. These "within-year" spending increases were outside the normal budgetary process. That is, rather than being planned for in budget documents, they arose during the year as overspends or unplanned increases in

[2] See Box B of the *June 2019 Fiscal Assessment Report* for an assessment of excess corporation tax receipts.

total government spending. Most of the increases in health spending since 2013 were unplanned (see Box I, *November 2019 Fiscal Assessment Report*).

Figure 1.6: Underlying budgetary improvements stalled after 2015



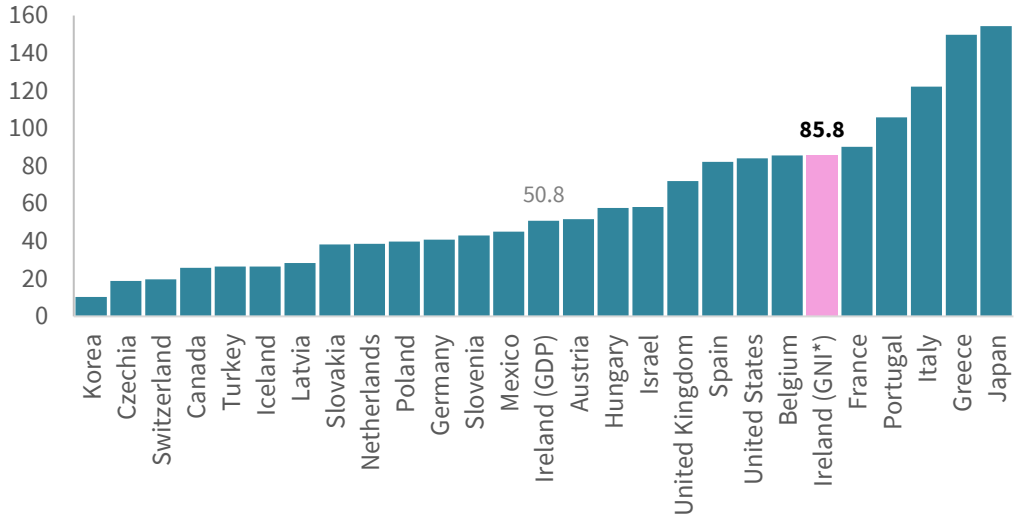
Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Revenue and non-interest spending growth and the budget balance in panel C as well as its improvement noted in panel D exclude one-offs. See Box H for how the excess corporation tax receipts are calculated.

Ireland's government debt burden was high going into the current crisis. Even if various assets held by the State were removed, the net debt burden for end-2019 was equivalent to 86 per cent when set against a more appropriate measure of national income like GNI* (Figure 1.7). This placed it as the sixth highest in OECD

countries behind France, Portugal, Italy, Greece, and Japan, although debt levels in almost all countries are likely to rise as result of the Covid-19 crisis.

Figure 1.7: Ireland had one of the OECD's largest debt burdens last year

% GDP (and % GNI* for Ireland), end-2019, net debt on a general government basis



Sources: CSO; Eurostat; IMF; and Fiscal Council workings.
Notes: Net debt is gross debt excluding assets held by the State in the form of currency and deposits; debt securities; and loans. The SGP criterion of a 60 per cent ceiling for government debt is set in gross terms rather than in net terms. Net debt does not include the State's bank investments.

1.4 Assessment of the Fiscal Stance

This section assesses the appropriate fiscal stance in the context of the severe shock posed by Covid-19. Given the uncertainties involved, the Council draws on the macroeconomic and fiscal scenarios outlined in this report to form its assessment.

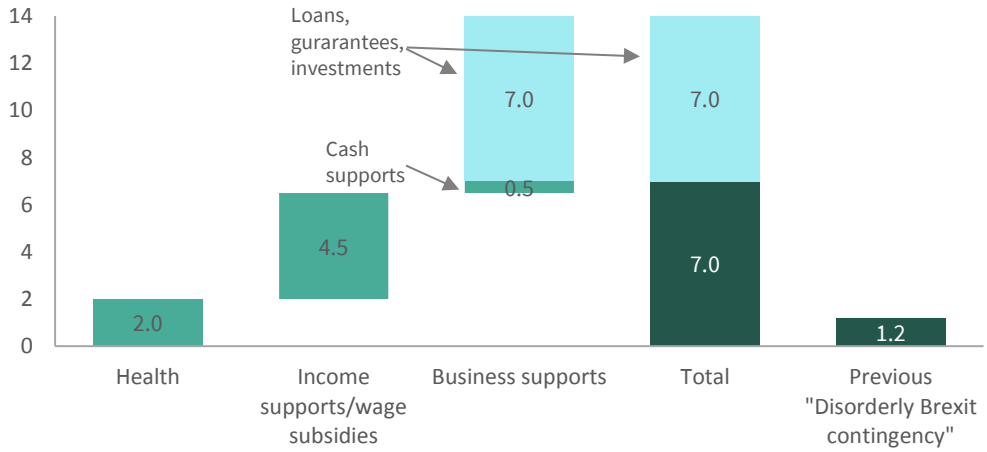
The appropriate fiscal stance will depend on how the crisis evolves. With this in mind, the Council's assessment of the fiscal stance refers to three broad phases: (1) the immediate crisis; (2) the recovery period; and (3) the new normal or "steady state" that the economy finds itself in over the medium term. The timing of each of these phases will depend on how the state of the economy evolves, illustrated by the range of scenarios in this report.

Phase 1: The fiscal stance for the immediate crisis

In early 2020, the Government acted quickly to unleash large-scale and supports to individuals and businesses, as well as expanding resources available to the health sector, in response to the pandemic.

Figure 1.8: The supports for Covid-19 dwarf previously planned Brexit supports

€ billions, impact on 2020 government expenditure



Sources: Department of Finance; and Fiscal Council workings.
Note: The previously planned "Disorderly Brexit Contingency" for 2020 was set out in *Budget 2020*, when the official forecasts assumed a disorderly Brexit for this year. It comprised about €650 million for the worst-hit sectors; about €450 million for employment supports; and the remainder for compliance checks and infrastructure costs (Box H, *November 2019 Fiscal Assessment Report*). Note that €0.75 billion of the €14 billion shown is repurposed expenditure previously outlined for 2020 so that the total new supports equate to €13.3 billion.

The fiscal supports introduced to support the health system and the economy are very large. For comparison, the Government's anticipated disorderly Brexit supports were to amount to €1.2 billion in 2020 — a small fraction of the €7 billion of spending

and €7 billion of additional supports (guarantees, loans and investments) currently envisaged for addressing the Covid-19 impacts in 2020 (Figure 1.8).

Half the supports (€7 billion) are in the form of loans, guarantees or investments. These forms of support are very different from cash supports. Initially, they may have limited impacts on the Government's debt and deficit. However, if loan losses or failures of firms materialise over time, it could add to the fiscal impacts (Box J).[3]

Initially, the temporary fiscal supports introduced by the Government were primarily aimed at supporting the incomes of those at risk of becoming unemployed and at boosting the capacity of the health system, while business supports were ramped up later. Box F provides further detail on the temporary supports.

The support measures currently outlined can be broken down as follows:

- **Income supports** include expanded illness benefits, unemployment payments, and wage subsidy supports for businesses to retain employees. When combined, these amount to an estimated €4½ billion assuming they last for a twelve-week period (though these are likely to be extended, particularly for sectors remaining closed further into the future).

- **Business supports** are predominantly made up of a mix of loans, guarantees, and investment supports that together amount to an estimated €7 billion. A much smaller amount of cash support (€0.5 billion) has been provided. Amounts are tied to firms' previous tax returns for 2019 and capped at €10,000 per firm.

- **Health supports** amounting to €2 billion include increased staffing (mainly through early recruitment of nursing students and medical interns on temporary contracts), securing private hospitals, providing supports for nursing homes, and the costs associated with procuring additional equipment.

[3] While loans and equity injections add to gross government debt, guarantees do not. Guarantees would add to government debt if called on, and where they do not have an economic rate of return. In terms of the budget balance, all three (loans, guarantees and equity injections) worsen the budget balance if the firm fails, defaults, or calls on the guarantee.

The supports are obviously very large and raise the question: would a Severe scenario imply austerity being needed? Not necessarily. Rather than outright austerity—where involuntary unemployment or a negative output gap results from cuts to existing public spending or tax increases—a Severe scenario might simply mean less ambitious budgetary plans being possible in future, without revenue-raising measures or savings being sought elsewhere.[4] It would perhaps mean a slower pace of increase in net government spending and it would be against a backdrop of a recovering economy. This would be very different to the financial crisis where sharp cuts to spending and tax increases needed to be made when the economy was in the midst of a severe downturn.

The Government's balance sheet and creditworthiness

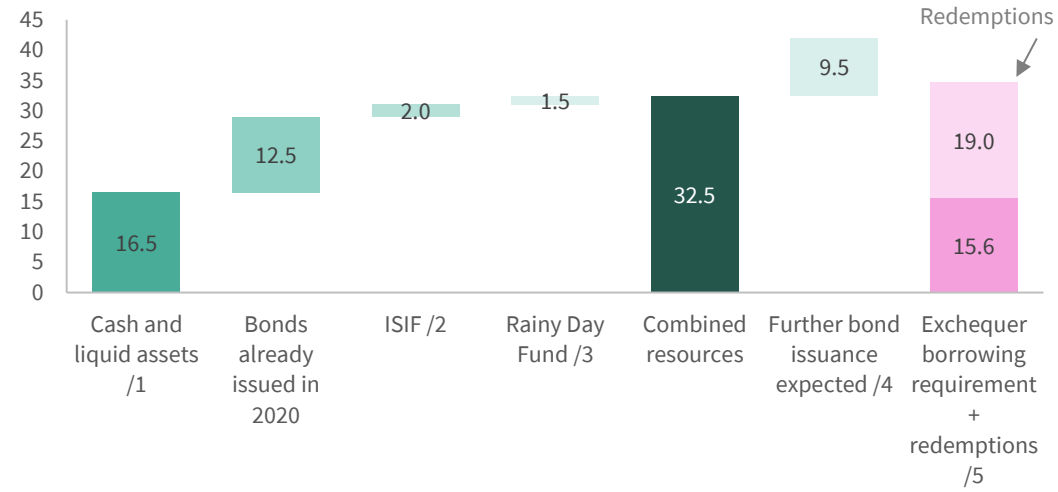
The Government's balance sheet should be able to play a central role in supporting the economy in the short term and avoiding long-term damage to the economy.

The State has financial resources available to weather the large need for fiscal supports in the short-term (Figure 1.9). Existing cash balances (€19.3 billion at end-April) can be run down to partially fund the 2020 financing needs. There is one remaining bond redemption this year (€6.5 billion in October) and there are no bond redemptions or repayments in 2021 aside from the ending of the UK bilateral loans (€0.5 billion). That will mean that most of the funding requirement in 2021 will be made up of the Exchequer Borrowing Requirement, which the *SPU 2020* central projection puts at €11.1 billion for 2021. Moreover, redemptions for 2021–2024 (€26.5 billion) are much lower than in previous years (€70 billion for 2017–2020). Bond issuance of €20–24 billion is now planned for 2020, with €12.5 billion of this already complete. In addition, the Government plans to draw on other financial resources on its balance sheet, including some of the assets in the Irish Strategic Investment Fund (ISIF) (€2 billion), which is earmarked for a recovery fund, and all of the Rainy Day Fund (€1.5 billion).

[4] A helpful definition of "austerity" is given by Wren-Lewis (2017). Austerity can be taken to mean fiscal consolidation that leads to significant increases in involuntary unemployment. A more technical definition would be that austerity is fiscal consolidation that leads to a noticeably larger negative output gap. This definition implies that while austerity will always involve fiscal consolidation, fiscal consolidation could occur without austerity.

Figure 1.9: The State has large resources on hand

€ billions



Sources: NTMA; Department of Finance; and Fiscal Council workings.
Notes:
/1 Cash and liquid assets are as at end-2019 (at end-April there were €19.3 billion in assets available after the April bond redemption).
/2 Irish Strategic Investment Fund assets are being used to fund part of the guarantees being issued, though these are not expected to impact the Exchequer Borrowing Requirement in 2020.
/3 The Rainy Day Fund has €1.5 billion, which is expected to be drawn down.
/4 Total bond issuance for 2020 is guided at €20–24 billion by the NTMA, with €12.5 billion issued.
/5 Following the 18th April redemption, the remaining redemptions for 2020 were €6.5 billion (due in October 2020).

The low cost of borrowing is a positive for Ireland's crisis-resolution efforts. Borrowing requirements are likely to be far larger in the coming years than previously anticipated.

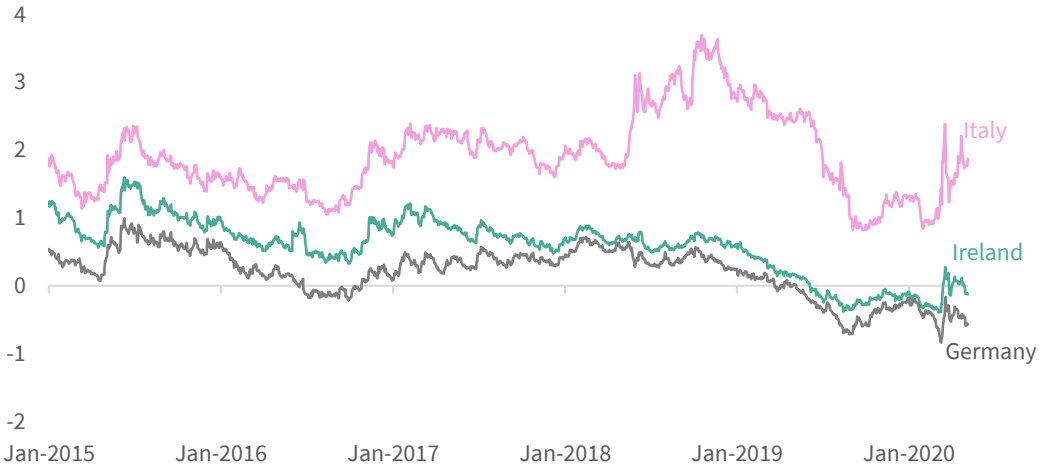
Fortunately, borrowing costs are low and have fallen since the Covid-19 crisis began. Yields on Irish ten-year sovereign bonds had sunk to lows of between -0.1 and -0.4 per cent in the early part of the year, before Covid-19 enveloped markets. Rates began to climb in the second week of March. But the rise was stemmed by substantial European Central Bank (ECB) commitments. The ECB decided to make €1 trillion of additional asset purchases (7.3 per cent of Euro Area GDP) between now and end 2020 and to lift a cap on purchasing more than a third of a country's outstanding sovereign debt under the Pandemic Emergency Purchase Programme (PEPP). Since then, Irish yields have fallen back to -0.1 per cent.

Yet creditworthiness is not guaranteed, and risks of rising borrowing costs remain important for a small, open economy in a monetary union like Ireland. The gap between Irish and German yields widened following the outbreak of the pandemic (Figure 1.10). This spread indicates the relative riskiness (in terms of default)

attached to Irish government bonds by lenders. Ireland's yields remain highly favourable—and the risks should not be overstated—but the widening of the spread is a reminder of how risk reassessments are made frequently and rapidly. Market-implied assessments of default risks are also currently low. Using data on bond yields, Figure 1.11 maps the evolution of implied default risk for Government borrowing. Again, this highlights that the risks associated with Irish borrowing are low at present. Yet, we know from previous experience that market assessments of creditworthiness can change suddenly.

Figure 1.10: The State's borrowing costs remain at historical lows

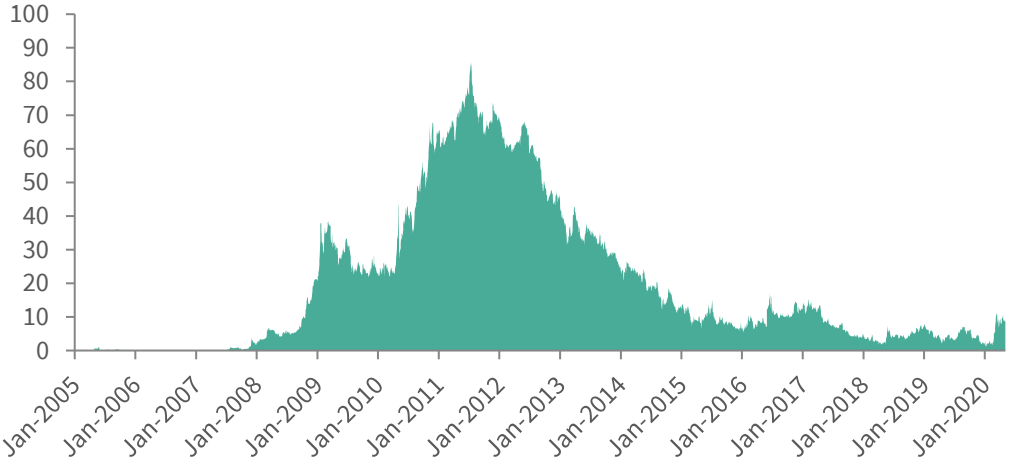
% yields (ten-year sovereign bonds)



Sources: Thomson Reuters Datastream; and Fiscal Council workings.

Figure 1.11: Implied probability of default has risen, but is far lower than before

% probability of default



Sources: Thomson Reuters Datastream; and Fiscal Council workings.
Note: The annual implied probability of default under these assumptions is $p = (r - r_f)/(1 + r - c)$, where r is yield on the bond, r_f is the yield on the German bond, and c is the recovery rate in the event of default. For an n-year bond, the total probability that this bond will never default is $(1 - p)^n$. For an n-year bond, the total probability that that bond will never default is $(1 - p)^n$. The probability of default before maturity (over a 10-year period) is then $1 - (1 - p)^n$. It assumes risk-neutral investors, no liquidity premium, a 50 per cent recovery rate in the event of a default and treats German bonds as risk free.

The budgetary supports will help both to alleviate the short-run impacts on the economy and to limit lasting damage. The analysis in Box B suggests that the €6½ billion of supports for healthcare and household incomes will offset some 2.3 percentage points of the decline in underlying domestic demand this year, for example. Yet, they will add some 2.2 percentage points to the deficit as a share of modified GNI*.

These supports should be largely temporary in nature. The need for enhanced income supports, business supports, and expanded healthcare resources are expected to unwind. This should happen as the health crisis fades and as the subsequent economic impacts subside. If this proves to be the case, then the impact on the deficit in 2020 will be large, but it could reverse quickly. This would leave less of a lasting adverse impact on the government debt trajectory.

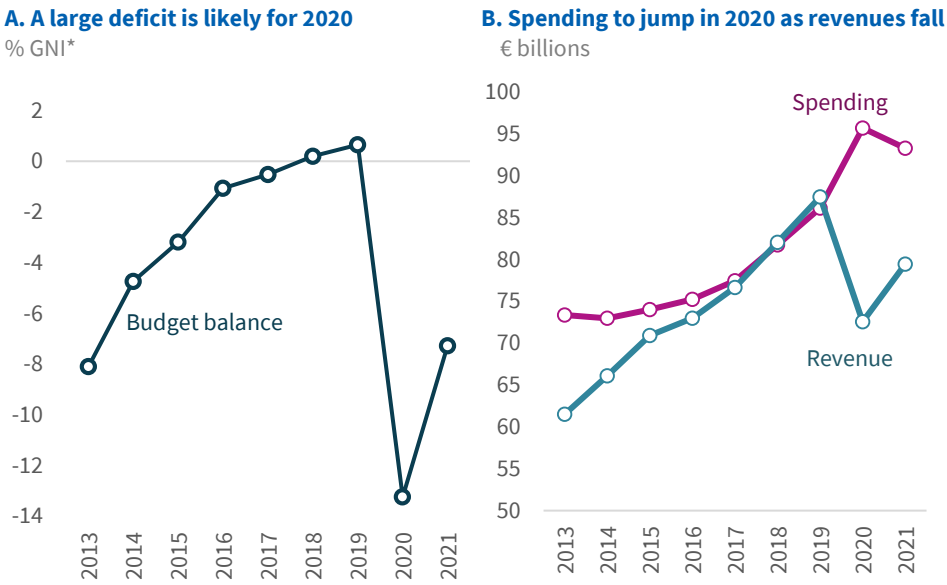
The Council assesses that the current fiscal policy is within the range of policies to support conducive to prudent economic and budgetary management. First, a large-scale response is needed to support demand and reduce the chance of permanent damage to individual and firm balance sheets and to preserve employment relationships, as well as to avoid social hardship. Second, the responses are expected to be largely temporary. Third, the Government's cost of borrowing is essentially zero. Fourth, strong cash resources are available, thanks to an effective debt management strategy in recent years. Fifth, the fiscal rules have built-in flexibility for exactly these types of situations (see Chapter 4).

Phasing out the economic supports will primarily depend on how long the health crisis persists. If the health crisis fades quickly, then supports can be withdrawn relatively swiftly. However, if the supports are withdrawn too soon, it could mean that the related economic crisis worsens and persists over a longer time, with greater risks of lasting damage. There is of course a risk that many of the supports will become more costly or more long-lasting than is assumed. Health workers employed on temporary contracts could be retained for longer; further or more costly procurement of essential medical equipment might be required; enhanced unemployment supports could—and are expected to—extend beyond 12 weeks; more job losses might occur; and business supports might bear larger losses than assumed.

If the fiscal supports associated with Covid-19 prove temporary—as is intended by the Government—then the deficit is forecast to reach 13.3 per cent of modified GNI* in 2020 before falling back to 7.3 per cent in 2021 (Figure 1.12). The *SPU 2020* forecasts show that the additional expenditure will cause non-interest spending to rise by 12 per cent in 2020 and revenue to fall by 17 per cent. However, the temporary nature of the crisis means that revenues are expected to bounce back by 9.5 per cent in 2021, while expenditure is expected to fall slightly by 2.5 per cent.

There are clear risks to these forecasts. As Chapter 3 notes, the official forecasts do not incorporate costs arising from the economic recovery plan or any extensions to supports or new policy measures, while revenues might also be worse than forecast.

Figure 1.12: Covid-19 will result in a sharp deficit in 2020



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Figures exclude one-offs and are on a general government basis.

Ultimately, the Government will need to be cognisant of the budget constraints that will eventually bind it. The supports being provided in 2020, if required for further subsequent waves of the pandemic, coupled with further lockdowns and more lasting economic impacts, would be immensely costly. This would likely reduce the space for other budgetary objectives being met in future without additional revenue-raising measures or savings elsewhere. The scenarios we consider in this report suggest that a Severe scenario—with two further waves of the virus and two further lockdowns—could lead to debt ratios ending up stuck at higher levels unless taxes were raised or expenditure savings were made elsewhere.

Box B: Fiscal supports cushion the economic impact of Covid-19

Since the outbreak of Covid-19 in Ireland, the Government has introduced substantial budgetary supports. These are not a conventional fiscal stimulus; rather, they are primarily intended to sustain companies and workers while containment measures slow the transmission of the virus. The supports should help to ensure that businesses have resources to weather the containment period and to retain staff. This box looks at some of the key supports introduced and tries to model their impact on economic growth.

A large number of fiscal measures have been introduced

The two key measures that the Government introduced to respond to the Covid-19 shock are (1) an enhanced unemployment payment; and (2) a temporary wage subsidy for companies whose revenues are hit, but which opt to retain employees. Together they have an estimated fiscal cost of €4.5 billion. Importantly, this cost estimate may overstate the true policy cost, as standard unemployment benefits would likely have been paid to many recipients anyway as a result of the downturn. These income supports are particularly important to low-income and vulnerable households, with Beirne *et al.* (2020) noting that about one-third fewer families would have income losses beyond 20 per cent due to the supports.

Another key measure we consider is the increase in health spending, which will boost government consumption. This is primarily intended to improve the capacity of the health system, including by increasing staffing and paying for overtime costs. The estimated cost of these health measures is a further €2 billion.

There are a large number of additional government supports that we do not consider here (see Box F). These include a mix of loans, tax deferrals (for VAT and business rates), transfers, grants, and other government spending increases that have also been introduced but are relatively smaller in scale.

Table B.1 shows the main measures that we have modelled in our simulation.

Table B.1: Fiscal supports introduced

	Estimated cost €m
Pandemic Unemployment Payment + Temporary Wage Subsidy	4,500
Health spending	2,000
Extension to Fuel Allowance & Working Family Payment	75

Sources: Department of Finance; and Fiscal Council workings.
Note: We assume the payments are only made for twelve weeks in Q2 of 2020. The four-week extension to the Fuel Allowance and to the Working Family Payment eligibility is estimated to cost €70–80 million (Beirne *et al.*, 2020).

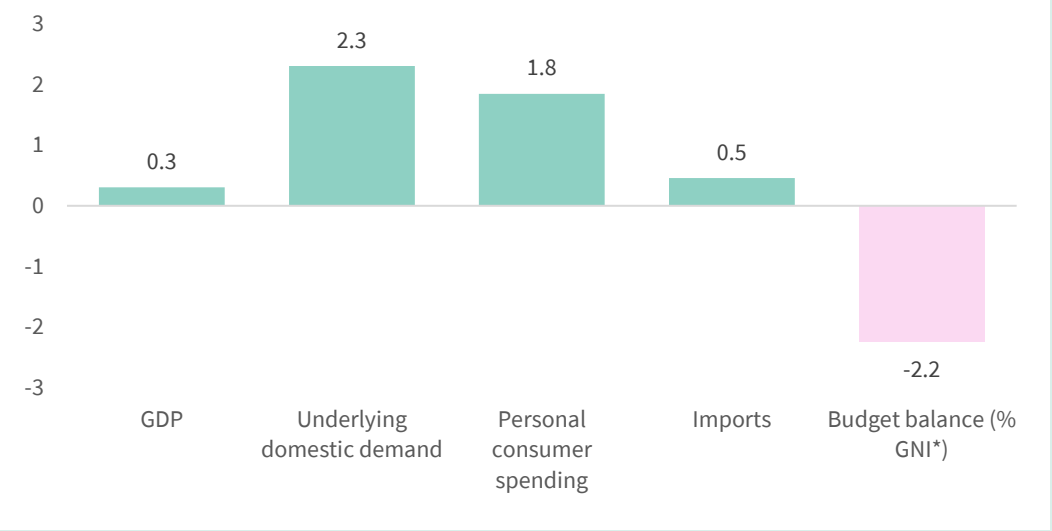
We use the Council's suite of forecasting models (Conroy and Casey, 2017) to estimate the gross impacts of the policy measures and to also allow for import leakages. Using these, we develop a counterfactual forecast where the income supports had not been provided. Comparing this counterfactual forecast with the baseline allows us to make an estimate of the impact that the supports are likely to have. Specifically, we use model estimates based on the historical relationship between consumer spending and incomes and based on the relationship between final demand and imports.

The comparison with a counterfactual scenario suggests that the measures introduced may have offset 2.3 percentage points of the decline in underlying domestic demand in 2020. This is primarily achieved by sustaining consumer spending through income supports and by raising government spending (Figure B.1). The impact on GDP is smaller, especially given the artificially high level of GDP due to distortions from multinational enterprises, but also given

the offset from higher imports. In terms of the fiscal impacts, we estimate that the general government balance will weaken by 2.2 percentage points of GNI* due to these supports.

Figure B.1: Fiscal supports boost underlying domestic demand but widen the deficit

% impact in volumes, unless otherwise stated



Sources: Fiscal Council workings.
Notes: Estimates of the impact of fiscal supports are calculated using the Council's suite of forecasting models (Conroy and Casey, 2017).

Given the exceptional nature of the downturn, these estimates are highly uncertain. Avoiding widespread collapse of firms in the business sector or the impact on vulnerable families is hard to assess. There are three further caveats worth noting:

First, the ultimate cost of the Pandemic Unemployment Payments and Temporary Wage Subsidy Scheme could be very different from the assumptions made here. The schemes could be availed of by more people or extended beyond twelve weeks. This would further boost underlying domestic demand, while worsening the government budget balance. Yet, this scenario would likely only occur in a situation where transmission of the virus and economic impacts were also more adverse. By contrast, the schemes might also end up costing less if the initial cost estimates prove to be too conservative.

Second, liquidity constraints will likely be significantly higher among the recipients of social transfers than those on average incomes. As a result, the elasticity of consumption to income may be higher than suggested by the historical relationship based on nationwide incomes. This would boost the impact on personal consumption spending relative to the estimate in Figure B.1.

Third, in cases where output is falling, unemployment is rising, and the policy rate is at the zero-lower bound, fiscal multipliers may be temporarily higher than usual. For example, Auerbach and Gorodnichenko (2012) estimate spending multipliers to be close to zero in US expansions and as high as 2 or 3 in recessions. This suggests that the fiscal supports might boost economic activity more than our estimates suggest, posing upside risks to the outlook. However, fiscal policy will not fully shield the dramatic shock posed by the crisis.

Phase 2: The fiscal stance for the recovery period

The second phase for the fiscal stance is the recovery period. This is the period over which the economy will eventually begin to recover from the immediate adverse impacts of the pandemic and necessary containment measures.

This second phase will see output well below its potential though growth could initially be quite fast as sectors reopen. That is, unemployment will still be higher than it was pre-crisis (the Central scenario projects an unemployment rate of 9.1 per cent in Q4 2021), there will be lots of unused resources for production and productivity will be lower than usual as firms adapt. Some sectors, such as tourism and food services, will fare worse than others in terms of the pace of their recovery. Some job losses will be permanent, and some retraining of workers will be necessary if the economy is to recover much of its lost potential.

On the fiscal side, the Government is forecasting that emergency supports introduced for 2020 will have fully unwound by 2021. The *SPU 2020* forecasts imply that the 2021 deficit will be half what it was in 2020 (falling to €13.8 billion or 7.3 per cent of GNI*). The main fiscal overhang from the pandemic would therefore be higher unemployment supports and significantly weaker revenues. The debt burden would be much higher. If fiscal stimulus were put in place, growth would be stronger but the deficit larger.

A fiscal stimulus would be appropriate and should be carefully designed

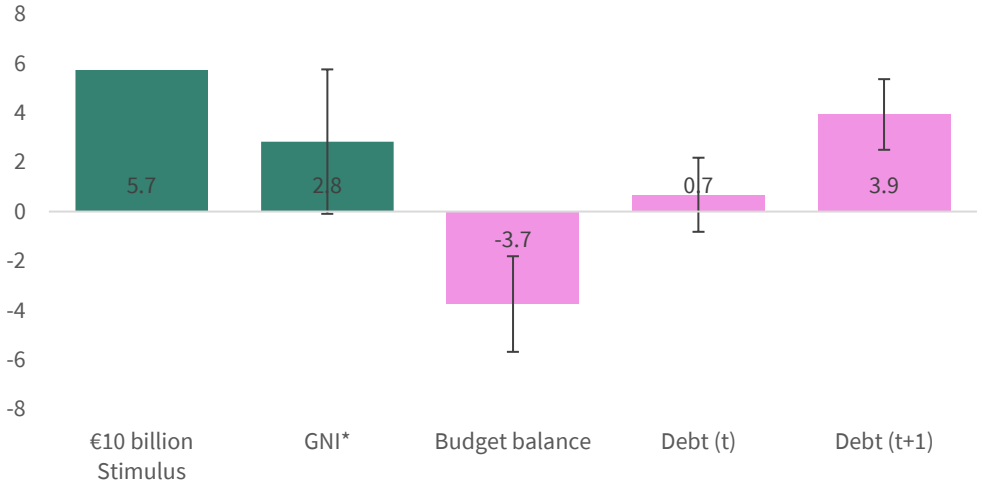
Given the large shortfall in demand that will remain and high cyclical unemployment, it would be appropriate to undertake fiscal stimulus during Phase 2 of the recovery. A stimulus would represent the appropriate countercyclical response provided that creditworthiness is maintained. It should be temporary, targeted and conditioned on the likely state of the economy. Stimulus will be most effective if guided by the best available knowledge of fiscal multipliers. It should be phased appropriately over time so that demand can adjust gradually. The Government is currently considering a stimulus or "economic recovery plan" to counteract the economic fallout from Covid-19.

To give a sense of the impacts of a fiscal stimulus, Figure 1.13 shows the typical impact of an illustrative fiscal stimulus worth €10 billion or 5.7 per cent of modified

GNI* for 2020. This indicative amount is not a recommendation from the Council and any package will need to be designed in light of the prevailing circumstances. Assuming the stimulus is temporary, it would be estimated to boost nominal modified GNI* by 2.8 percentage points. The deficit and debt ratio would be expected to rise by 3.7 percentage points and 3.9 percentage points, respectively.[5]

Figure 1.13: A fiscal stimulus could boost growth in the short term

% GNI*, 2020 impact



Sources: Fiscal Council workings.
Notes: The stimulus of €10 billion is assumed to unwind in one year. The ratios are based on nominal GNI* for 2020. An overall deficit multiplier of 0.5 is the central estimate, while error bars examine multipliers ranging from zero to one.

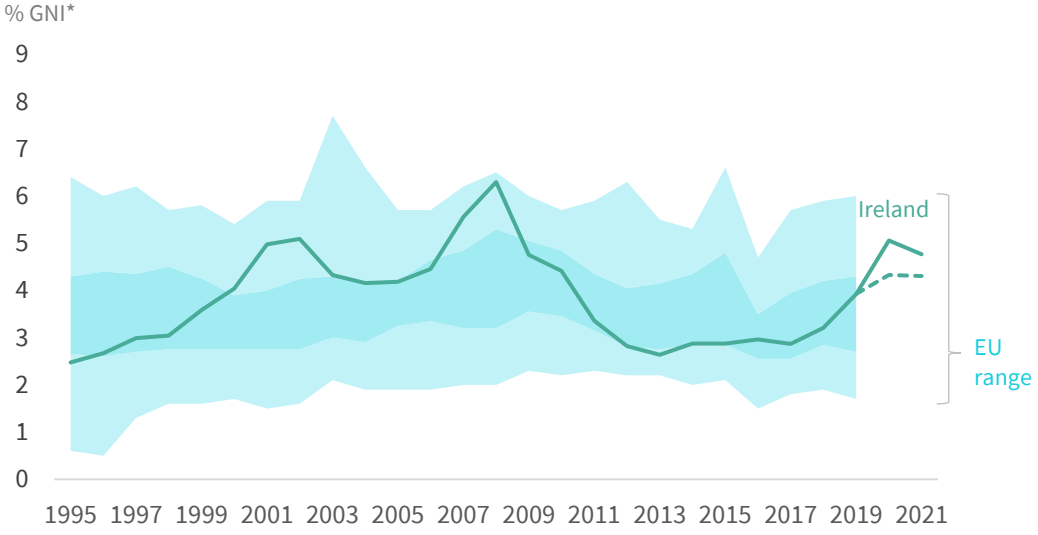
Withdrawing the stimulus gradually would also allow demand to adjust in a gradual way. One example would be where the stimulus was phased over the period 2020–2022 (with €5 billion in 2020, €3 billion in 2021, and €2 billion in 2022). That would be estimated to leave the debt ratio about 3.5 percentage points higher over the medium term.

A key question is the nature of the stimulus and the wider economic circumstances. Recent work for Ireland (Ivory, Casey and Conroy, 2020) using a variety of approaches suggests that fiscal policy impacts depend on the type of fiscal

[5] This estimated impact assumes a standard relationship between growth and budgetary measures (the "fiscal multiplier") whereby every euro of tax cuts or spending increases results in a 50 cent boost to total economic activity, given leakage to imports and behavioural responses. This relatively small impact is common for smaller, more open economies like Ireland's. While there must be significant error bands around the 0.5 estimate, the Council is reasonably confident that the overall deficit multiplier for Ireland is positive though small. From its experience with budgetary projections, the Department of Finance has also found it useful to assume an overall deficit multiplier in the region of 0.5. For a useful exploration of the multipliers literature in an Irish context, see Box 4.1, *Fiscal Assessment Report, October 2011* and Box G of the *Fiscal Assessment Report, April 2013*.

intervention. Public investment measures are seen to have a greater impact on activity than other types of government spending. Yet the impacts are wide-ranging and are not found to be significantly different from zero over the long run. This supports previous findings for Ireland and other countries (Varthalitis, 2019; Hall, 2010; Bénétrix and Lane, 2009; Giordano *et al.*, 2007). In terms of the wider economic circumstances, the literature tends to suggest that fiscal multipliers (as in, the impacts of a stimulus) are stronger in downturns, in currency unions, and when debt is low (Ilzetzki, Mendoza and Vegh, 2012; Corsetti *et al.*, 2012; Auerbach and Gorodnichenko, 2012). A question for the current situation is how effective fiscal stimulus can be for sectors where demand is constrained by social distancing measures. Rather than stimulating demand, the best that stimulus can hope to yield is stronger demand in other parts of the economy, while fiscal policy partly sustains incomes in those sectors worst affected.

Figure 1.14: Public investment has risen since being cut in the financial crisis



Sources: Fiscal Council workings.
Notes: The range is for all EU countries. Inner band is the middle 50 per cent of countries. Outer band is the full (max to min) range. The dashed green line for Ireland represents the ratio of public investment to modified GNI* based on the Budget 2020 forecasts for nominal GNI* (nominal investment amounts are unchanged).

Public investment can be a key tool in fiscal stimulus given the often high multiplier and the fact that it can contribute to productivity in the future. It can be particularly useful to make up for shortfalls in construction demand and jobs. Ireland's rate of public investment has risen to more normal levels by international and historical standards in recent years and was equivalent to 3.9 per cent of modified GNI* in 2019 (Figure 1.14). It is projected to rise further in line with the National Development Plan such that Ireland would soon have one of the largest public

investment rates among EU countries. Past Irish experience has shown public investment to be particularly procyclical — rising in good times and falling in downturns when government intervention is most needed. Public investment spending fell by 61 per cent between 2007 and 2012, whereas other government spending was broadly unchanged over the same period.[6] Given the relatively stronger fiscal multipliers attached to public investment, a repeat of this pattern would be expected to worsen the lasting damages of the current crisis.

Phase 3: Fiscal stance for the new normal and the longer term

Once the recovery has progressed and a new normal path has been reached, the fiscal stance will need to move from supporting the economy to ensuring medium-term sustainability and rebuilding the public finances. The requirements will depend on the impact of lower revenues on the budget balance, the level of the debt to GNI* ratio, growth and interest rates. These are very uncertain and depend on the path the economy takes in the coming years, including the use of stimulus measures.

Figure 1.15 considers debt scenarios based on the three macroeconomic and fiscal scenarios developed in this report (Figure 1.3 and Boxes D and I). It highlights the relative vulnerability of the debt ratio to health and growth outcomes.

- A **Mild scenario** could see debt ratios fall steadily in later years to levels nearer to 90 per cent of modified GNI* from a peak of around 119 per cent. The deficit would fall close to 3½ per cent next year and gradually close in subsequent years. The cost of servicing debt (interest burden as a percentage of GNI*) would be relatively low at about 1½ per cent. Annual average funding requirements would be very manageable at roughly €16 billion per annum for 2022–2025.

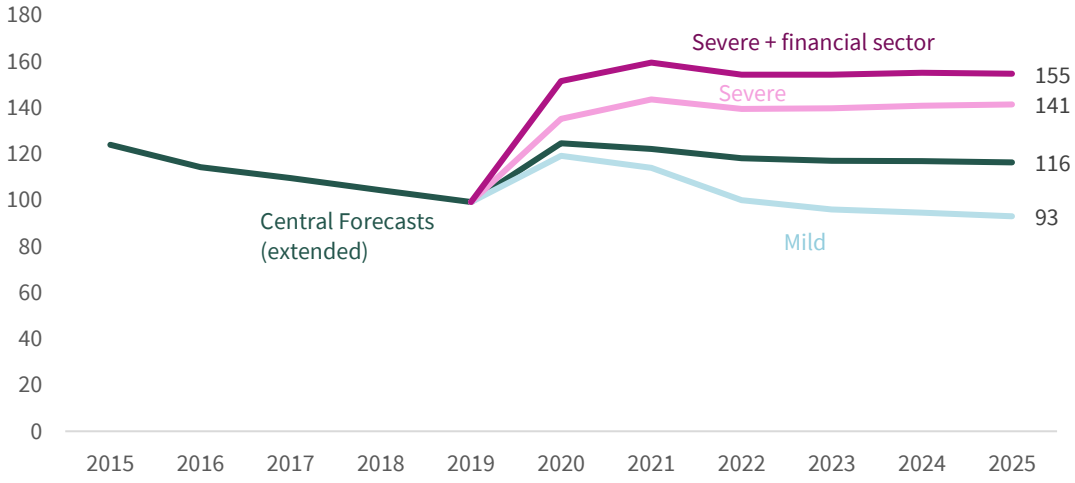
- A **Central scenario**, with a steep initial downturn and limited recovery would see the debt-to-GNI* ratio peak at 125 per cent in 2020. By 2022, the debt ratio would likely be below 120 per cent and steadily declining.

[6] Other spending here refers to total general government expenditure less interest, unemployment-related spending (COFOG: GF1005); and public investment (gross fixed capital formation). This measure rose by 1.8 per cent between 2007 and 2012.

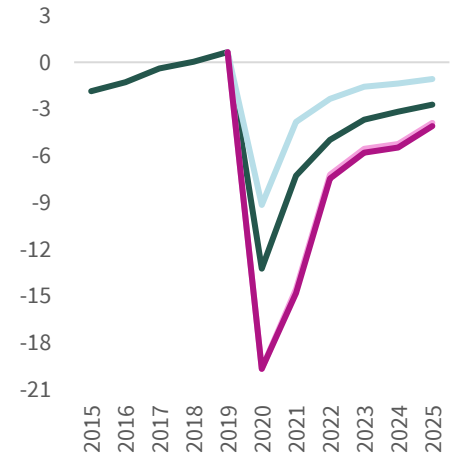
- A **Severe scenario**, with further waves of the pandemic leading to further lockdowns in Q4 2020 and Q2 2021, could see debt ratios climb to over 140 per cent in 2021 and flattening at that level. If a financial sector recapitalisation were required—for illustrative reasons set at an arbitrary 10 per cent of the value of assets of domestic banks (the Irish headquartered group)—the debt ratio could rise to almost 160 per cent. Such an outcome could be triggered by loan losses resulting from business failures, for example, and if the government were to intervene. It is possible that other sectors could also seek supports, rather than just the banking sector. Fiscal stimulus would also further add to government debt.

Figure 1.15: Debt sustainability depends on recovery scenarios

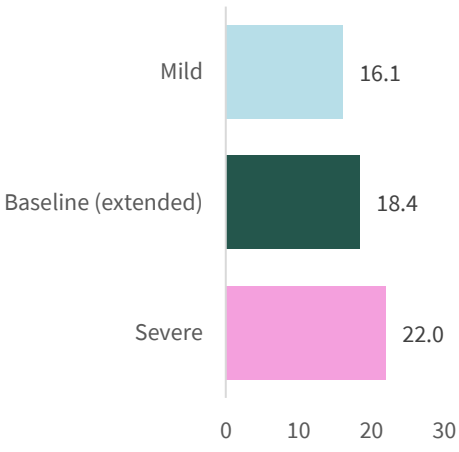
A. Debt ratios % GNI*



B. Budget balance % GNI* (excl. one-offs)



C. Average annual funding requirements (€bn, 2022–2025)



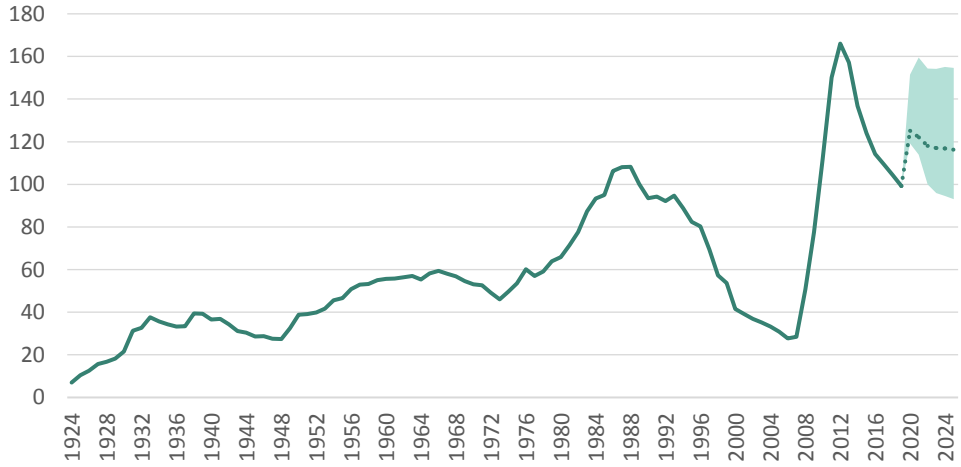
Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Scenarios are consistent with the macroeconomic and fiscal assumptions set out in Boxes D and I. The Severe + scenario includes a financial sector shock that assumes a recapitalisation of domestic banks equivalent to 10 per cent of the value of their assets (€27.8 billion) in 2021.

The Severe scenarios would see Ireland's government debt burden stuck at very high levels in the absence of any fiscal adjustment. The deficit could remain as large as 4 per cent by 2025. While debt servicing costs might still be lower than at the time of the financial crisis, annual funding requirements could be somewhat large at €20–25 billion on average.[7]

If the debt ratio climbs to very high levels and stabilises, this would be sustainable in a narrow sense (it would not lead to ever-rising debt ratios). These levels would also be consistent with the record debt ratios that Ireland experienced after the financial crisis (Figure 1.16).

Figure 1.16: Government debt could return to near historic highs

% GNI*, general government gross debt



Sources: CSO; FitzGerald and Kenny (2018); Department of Finance; and Fiscal Council workings.
Note: Modified GNI* is linked to GNI for the historical period. The range depicts the debt ratios consistent with the Council's Mild and Severe scenarios (including potential costs of recapitalising the banking system).

However, a higher debt position leaves Ireland more vulnerable to further adverse risks in future. In particular, the path of the debt-to-GNI* ratio would be far more sensitive than in the recent past to developments in interest rates and growth. With interest rates expected to be well below the Irish rate of growth, this creates a strong downward force on the debt burden. However, if this were to reverse through low growth and higher interests, the debt burden could be on a very sharp upward trend that would require a very large primary balance to stabilise.

[7] Note, we assume marginal ten-year borrowing costs of close to 1 per cent in all scenarios. While there are upside risks to this assumption for more severe scenarios, more accommodative monetary policy would also be possible in those scenarios, which would be expected to drive down interest rates.

There are several risks surrounding the economic outlook already known, including a harder-than-assumed Brexit or larger-than-expected reductions in annual corporation tax receipts. Higher levels of debt increase the likelihood that debt can rise inexorably without much harsher measures being required to reign it in. This includes debt defaults and sudden loss of funding, with deficits then having to be closed rapidly to sustain the funding of public services and supports.

Future fiscal adjustment

Given the very high level of debt and lower revenues, some fiscal adjustment is likely to be required in Phase 3 so that the debt-to-GNI* ratio is put on a downward path towards safer levels. While the scale of the adjustment required is uncertain, it should be possible to avoid a return to severe austerity, while at the same time bringing debt ratios to levels below 100 per cent in the coming decade. An increase in interest rates or a poor growth outcome would make this more challenging.

The need to undertake some fiscal adjustment implies that any expansion of public services or cut in taxes would need to be financed by savings elsewhere, by higher public sector efficiency or by tax increases.

One way to assess the scale of the challenges ahead is to consider what fiscal adjustment would be needed to get debt on a steady downward path again. *SPU 2019* planned for a primary surplus of 2.6 per cent in 2020 and for an annual pace of debt ratio reduction of almost 3 percentage points of GNI* per annum over the period 2020–2023. Table 1.2 explores what would happen if adjustments were made to gradually return to that pace of reduction in debt ratios by 2025. It shows three strategies: (1) the Government does nothing — that is, it maintains taxes and spending in real terms; (2) it adjusts spending or taxes to achieve a pace of debt ratio reduction of 3 percentage points by 2025; and (3) it introduces a €10 billion stimulus package over 2020 to 2022 before adjusting spending and taxes to achieve reductions in the debt ratio of 3 percentage points by 2025. These illustrative adjustments are phased in over three years (2023–2025). Both the scale of the adjustment and the paths to achieve this are uncertain.

- In a "**policy as usual**" strategy, the pace of debt reduction would be slow in the baseline scenario, averaging 0.6 percentage points per annum. A Mild scenario would put it at 2.3 percentage points, but a Severe scenario would see the debt ratio rising slightly at an average pace of about 0.6 percentage points per annum.

- In an "**accelerate debt reduction**" strategy, adjustments to future tax and spending plans of between €2 billion to €4.7 billion would have to be made in the years 2023–2025 to get debt ratios falling at a pace of 3 percentage points of GNI* by 2025.

- In a "**stimulus + accelerate debt reduction**" strategy, the Government first introduces a three-year stimulus of €10 billion (€3.5 billion in 2020; €5 billion in 2021; and €1.5 billion in 2022). This is used to reduce spare capacity in the economy and would return real GNI* to its 2019 level by 2022 in a baseline scenario. After the stimulus ends in 2022, the Government accelerates debt reduction. This would require adjustments of between €2 billion and €4.7 billion to tax and spending plans per annum in the later period (2023–2025). These adjustments are similar to those in the "accelerate debt reduction" strategy as they assume the stimulus would have been phased out by 2023 and so the fiscal balance is in a similar position.[8] EU supports like those proposed by France and Germany may allow for a stimulus that is funded with jointly issued debt, such that the stimulus might carry less cost to the Irish government.

[8] Given the €1 billion of stimulus in 2022, this implies a slightly greater tightening of the fiscal stance in 2023 compared with the no stimulus case.

Table 1.2: A stimulus is warranted but some fiscal adjustments would be needed in Phase 3 to put government debt on a steady downward path

% GNI* unless stated

		Policy as usual			Accelerate debt reduction			Stimulus + accelerate debt reduction		
		2023	2024	2025	2023	2024	2025	2023*	2024	2025
Mild	Debt ratio	95.9	94.6	93.0	95.7	93.5	90.5	98.8	96.6	93.6
	change (pp)	-4.1	-1.3	-1.6	-4.3	-2.2	-3.0	-4.2	-2.2	-3.0
	Primary balance	0.0	0.1	0.1	0.7	1.3	1.9	0.6	1.3	1.8
	Adjustment €bn	0.0	0.0	0.0	2.0	2.0	2.0	2.0	2.0	2.0
Central	Debt ratio	117.0	116.8	116.3	116.8	115.2	112.2	120.3	118.7	115.7
	change (pp)	-1.0	-0.2	-0.6	-1.3	-1.5	-3.0	-0.9	-1.6	-3.0
	Primary balance	-1.8	-1.5	-1.3	-0.7	0.8	1.9	-0.7	0.7	1.8
	Adjustment €bn	0.0	0.0	0.0	3.2	3.2	3.2	3.2	3.2	3.2
Severe	Debt ratio	139.7	140.9	141.3	139.6	139.0	136.0	143.4	142.7	139.7
	change (pp)	0.3	1.2	0.4	0.2	-0.6	-3.0	0.6	-0.7	-3.0
	Primary balance	-3.4	-3.3	-2.2	-1.7	0.1	2.7	-1.7	0.0	2.7
	Adjustment €bn	0.0	0.0	0.0	4.7	4.7	4.7	4.7	4.7	4.7

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

Notes: Estimates are derived within the Council's Fiscal Feedback's Model. "Change" refers to the annual change in gross debt-to-GNI* ratios in percentage points. The primary balance is the budget balance as a percentage of modified GNI* excluding interest costs. The "adjustments" are changes to planned spending increases. The planned spending increases are assumed to be of the order of €2.5 billion per annum in line with a "Stand-Still" basis — in other words, where today's level of public services and benefits are maintained in real terms over the medium term (allowing for price and wage increases and demographic pressures). * In 2023, the adjustment for the "stimulus + accelerate debt reduction" strategy would be €1.5 billion higher than shown here if the adjustment were taken to include the unwinding of the stimulus in 2022.

The scenarios are illustrative, but they point to the types of challenges that could be faced in later years.

A need for severe austerity is unlikely in these scenarios. The scenarios suggest tax and spending plans might have to be adjusted by some €6 billion to €14 billion to put debt on a steady downward path in later years (2023–2025).[9] Even in a Severe scenario, this is less than half the €30 billion of consolidation measures introduced after the financial crisis and should be easier to achieve (Figure 1.17). It would be

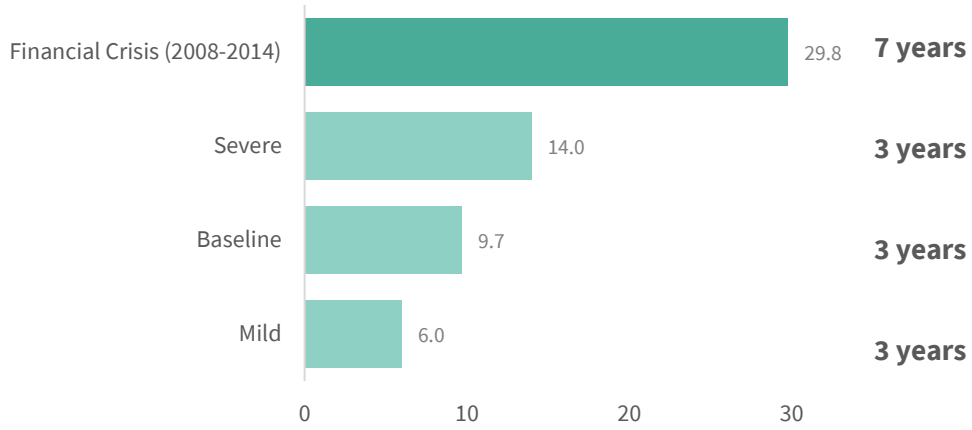
[9] There are a number of factors that could influence the scale of consolidation needs, including economic and fiscal outturns. The illustrative example assume that public sector wages and welfare changes rise in line with general wages during Phases 1 and 2. Earlier measures to control on-going spending or to raise revenues could reduce future adjustment needs somewhat.

conducted at a time when the economy is growing and is close to pre-crisis levels of activity, unlike the adjustments that took place after the financial crisis.

These illustrative adjustments are typically larger than the minimum that could be required under the fiscal rules. The rules would typically require adjustments of about 0.5 percentage points of GDP per annum. That would equate to about €2 billion in GDP terms or about €1 billion if expressed relative to GNI* in line with the Principles-Based Approach advocated by the Council (Chapter 4). However, these smaller adjustments would delay the return of debt to safer levels and prolong the fiscal adjustment period.[10]

Figure 1.17: Consolidation measures after the financial crisis were far worse than might be required down the line

€ billions



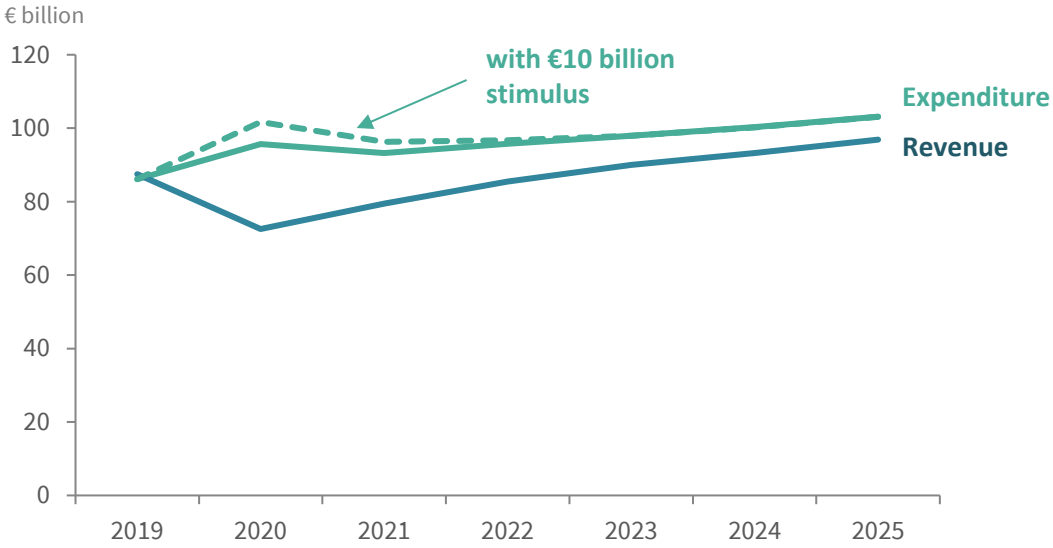
Sources: NTMA; Department of Finance; and Fiscal Council workings.
Note: Unlike the consolidation amounts during the financial crisis, the amounts set out for scenarios are relative to a situation where public sector wages and welfare payments are assumed to rise in line with general wages. The adjustments also take place over a shorter time period (three years as compared to seven years). And they take place at a stage when the economy is assumed to be growing relatively fast again.

The origins of the need for adjustment can be illustrated by looking at the gap between spending and revenue that is likely to persist with or without a stimulus package. Figure 1.18 shows how a large persistent gap is projected to open up in 2020 in the absence of policy action with revenue falling by €15 billion and spending rising by €10 billion. This narrows only gradually in a "policy as usual" scenario, such that the gap between spending and revenue, the deficit, is still over €6 billion by

[10] The EU could also require greater progress to be made than this minimum standard.

2025 in the central case. To close this gap, spending would need to adjust downwards, or taxes would need to increase.

Figure 1.18: The gap between ongoing spending and revenue is likely to be wide with or without a stimulus



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: The figure shows general government spending and revenue under the Central scenario, and an illustrative stimulus assumed at €10 billion and phased over three years (as in Table 1.2).

Another way to understand the intuition behind the debt dynamics is to look at the budget balance (excluding interest) that would be required just to stabilise debt ratios. For the same nominal growth rate, the higher levels of debt expected for 2024 and 2025 would imply a need for a primary balance 0.5 percentage points higher than pre-Covid-19 just to stabilise debt ratios. If marginal interest rates were to rise by 1 percentage point relative to our assumptions, this would require the primary balance to be a further 0.5 percentage points higher over the medium term.

Achieving the fiscal adjustment that might be required

The need to undertake fiscal adjustment should inform the choices of an incoming government. While temporary stimulus would be justified in Phase 2 of the recovery, permanent increases in spending or cuts in taxation require durable financing. On-going adjustment will require resources to be found each year during this period, so choices will need to be made about how to achieve this. In addition, lower medium-term growth and population ageing will mean that there is less fiscal space created as the economy grows than in recent years. A downward adjustment in corporation tax receipts could add to these additional pressures.

The draft document between Fianna Fáil and Fine Gael to facilitate negotiations with other parties for forming a new government includes important social objectives such as in the areas of health, housing and climate change. Implementing these policies remains feasible, but would require additional reductions in other spending areas or tax increases.

The adjustments that might be required could be achieved through different combinations of spending reductions and tax increases. To give a sense of what an annual adjustment of €2 billion could mean, freezing public sector pay would generate about €0.5 billion each year.[11] A 1 per cent reduction in non-welfare spending would equate to about €0.5 billion. Maintaining public investment at 2019 levels rather than increasing it as planned would lower spending by €2 billion relative to current plans. Not indexing income tax bands would raise about €0.5 billion each year. An increase in both the 20 per cent and 40 per cent income tax rates of 1 percentage point would raise around €1 billion euros. Doubling the Carbon Tax from €26 per tonne would raise about €0.5 billion in a full year.[12] This list is not exhaustive and is intended only to give a sense of the scale of changes in policy that would be required during the illustrative fiscal adjustment. The Council takes no view on the merits of specific tax and spending measures.

While uncertainty is high, it will be helpful to keep all options on the table, given the difficult economic and political choices that will be needed.

[11] Note that a different figure for the public sector wage freeze was provided in an earlier version of this report.

[12] Various estimates of potential revenue policy change impacts are outlined in the "Ready Reckoner" produced by Revenue. It is available at: https://www.revenue.ie/en/corporate/documents/statistics/ready-reckoner.pdf

1.5 The value of a robust fiscal framework

Navigating through the three phases identified by the Council will require careful monitoring and prudent management of the public finances. The correct fiscal stance will depend on how the recovery ultimately evolves. Both the EU fiscal rules and the Council's "Principles-Based Approach" can serve as a helpful guide for budgetary policy in future years.

The next Government should reinforce Ireland's fiscal framework. A robust framework of rules and procedures based on a principles-based approach to managing the public finances prudently would ensure that public services and supports are funded sustainably. This would help to avoid the mistakes of the past when Ireland had to cut spending and raise taxes as conditions deteriorated. Indeed, one of the few bright spots in the current crisis is that the budget balance was in a reasonable shape to begin with so that pursuing a supportive fiscal policy early on and having the possibility of a stimulus later is now more possible than it was after the financial crisis. In addition, sound fiscal frameworks can contribute to maintaining creditworthiness and credibility with markets, reducing the risks associated with high debt.

Three reforms to the fiscal framework would help to chart a prudent path for managing the public finances in coming years (these are outlined in previous work by the Council, including the *November 2019 Fiscal Assessment Report*; Barnes and Casey, 2019; and Casey *et al.*, 2018).

Reform 1: Meaningful debt ratio targets

Debt targets, in principle, are a good idea to guide policy, particularly when the debt ratio is very high. They offer transparent benchmarks for assessing sound budgetary policy over the medium term. A good debt target would have four features. It should (1) be stated as a percentage of modified GNI*; (2) have clear timeframes so that performance can be assessed; (3) be set as a steady-state target; and (4) be lower than the conventional 60 per cent ceiling that is set for EU Member States to reflect Ireland's more volatile and open economy.

Reform 2: Save temporary receipts

Using temporary revenues such as corporation tax or an economic upswing to fund long-lasting spending increases carries risks. Temporary revenues may disappear so

that government services and supports suddenly lack funding and large borrowing is required. Potentially, this can happen very suddenly.

The Council has argued for use of two tools to mitigate these risks. The Rainy Day Fund can be redesigned to operate in a countercyclical manner. It should not be capped nor should amounts allocated be pre-determined as this undermines countercyclical objectives. And its scope to be used in a downturn should be clarified in the context of the EU fiscal rules through greater engagement with the European Commission.

Reform 3: Guide policy with sustainable growth rates

A sound way to guide budgetary policy over the medium term, when the budget is in balance and the economy is in its steady state, is to anchor net policy spending growth to a sustainable growth rate.[13] This can be achieved by using alternative estimates of potential output growth like those developed by the Department of Finance and the Fiscal Council as an anchor for setting spending limits. Spending ceilings can be framed within these upper limits. If additional spending is desirable beyond such limits, then this can be funded sustainably with additional revenue-raising measures. If coupled with realistic forecasts for spending (taking account of bottom-up spending pressures from demographics and inflation), this approach would substantially reinforce Irish budgetary policy.

[13] Net policy spending examines spending growth net of tax measures and represents a good measure against which to assess the sustainability of fiscal policy. The measure is outlined in Box A, November 2018 Fiscal Assessment Report. It is total general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment. It also takes account of the impact of discretionary revenue measures (for example, net revenue-raising measures reduce the measured growth rate).