Pre-Budget 2021 Statement

September 2020

Irish Fiscal Advisory Council

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Key Messages

Covid-19 has had a very severe impact on the Irish economy, but activity has picked up since May. Recent developments have been broadly consistent with the Mild to Central scenarios set out by the Council in May. While the number of new cases of Covid-19 moderated over summer months, an increase in cases has been evident of late, as has happened elsewhere, and risks of a more pronounced resurgence remain high. Unemployment rates for those aged 25–74 peaked at 26.5 per cent in April but they remain high at 12.6 per cent as of August. Underlying domestic demand looks to have been lower by over 18 per cent in the second quarter of 2020 compared to the fourth quarter of 2019. Yet early estimates suggest a strong pick-up in activity in the third quarter and the impact thus far has been somewhat less damaging than assumed in April's *Stability Programme Update* (*SPU) 2020*.

The macroeconomic outlook remains exceptionally uncertain. Risks of further waves of the virus, lasting economic damage on some sectors of the economy and a no-deal Brexit remain. While short-run developments in the economy have been less adverse than considered in the Council's Severe scenario, risks of severe outcomes remain in the coming months. There is substantial uncertainty surrounding the path for the economy and health risks. There could be a further upsurge in transmission of the virus. If this occurs, regional lockdowns and perhaps even further nationwide lockdowns could be introduced to manage health risks. In addition, UK trade deal negotiations with the EU could fail to be completed by the end of this year. That raises the prospect of a "no-deal Brexit", which would see substantial tariffs and other trade barriers introduced between the UK and EU Member States such as Ireland in 2021. This would dampen demand in sectors that have helped to sustain the economy during the Covid-19 crisis, including in agri-foods and pharma-chem.

The Covid-19 crisis has led to a sharp rise in government spending and a falloff in certain taxes. There are considerable uncertainties about the impact of the Covid-19 crisis on the public finances for this year. A substantial deficit of €24–€30 billion (13–17.4 per cent of GNI*) is likely for 2020. This is more than the projected €23 billion set out in April's *SPU 2020*. The upward revision mainly reflects how the original forecast did not include provisions for an intended stimulus launched in July as well as other policy measures. However, revenues have thus far performed better than projected in the SPU thanks to continued outperformance in corporation tax and the progressive nature of the income tax system. Ireland's debt ratio is likely to be around 120 per cent of GNI* this year, well above the pre-Covid-19 crisis level.

While the path for the economy is highly uncertain, the Covid-19 crisis can be thought of in terms of three broad phases. (1) The first phase is the "immediate crisis" when health risks are high and economic activity is suppressed on a significant scale. (2) The second "recovery phase" is when health risks have diminished but unemployment remains high and the economy has yet to recover its pre-crisis levels of activity. (3) The new normal or "steady state" that the economy finds itself in over the medium-term phase will see the economy eventually settle on a new growth path. This phase is likely to see government debt-to-GNI* ratios near post-financial crisis historic highs, given the extraordinary but warranted budgetary supports introduced in earlier phases. Low interest rates will help to make higher debt ratios manageable. Each phase requires a different policy response.

At present, the economy remains somewhere between the first immediate crisis phase and the second recovery phase. While some sectors have survived through the crisis thus far relatively well, others face ongoing challenges. Many businesses, including those in the tourism, hospitality and retail sectors, face ongoing restrictions due to health risks. It is still unclear at this stage how much lasting damage will result from the crisis.

The Government should continue to support business and household incomes through the Covid-19 crisis. The government has to date provided sizeable fiscal supports to households and businesses to cope with Covid-19's impacts on the economy and society. Temporary and targeted budgetary supports should remain broadly in place to support vulnerable workers and businesses for as long as is needed, even if there may be scope to adapt them as circumstances evolve. If such measures were removed too early, it would lead to a strong contractionary force on the economy and risks lasting damage to businesses, employment prospects and regions.

The July stimulus introduced by the government is welcome to support disrupted sectors and demand. The second recovery phase of the Covid-19 crisis will see unemployment remaining very high. Measures such as the Employment Wage Subsidy Scheme, the Pandemic Unemployment Payment, along with any investment stimulus will be helpful to support incomes and employment.

***Budget 2021* should ensure that there is a substantial multi-year stimulus in place for 2021 and beyond to continue targeted support measures and to support demand. Given the high uncertainty around Covid-19 and Brexit, putting in place an appropriately-sized contingency would help manage risks.** Even though government debt ratios will be high, a stimulus is warranted to support the economy's return to a strong growth path. The Council considered an illustrative €10 billion stimulus phased over several years in its *May 2020 Fiscal Assessment Report*. Since *SPU 2020,* tax cuts and additional spending of approximately €9½ billion have been announced for 2020, with some €2 billion announced in the July Stimulus for 2021. While the required size of stimulus should depend on more up-to-date information, the Government should be prepared to provide further targeted stimulus to address the demand shortfall and support supply. Efforts to restore employment including activation measures and a focus on investment, which has higher impacts on activity, should be prioritised. As in *Budget 2020*, an appropriately-sized contingency should be put in place to cover the costs of a failure to reach a trade agreement between the EU and UK. This should also cover Covid-19-related contingencies including support schemes beyond next March and additional stimulus measures should economic damages associated with Covid-19 prove more severe.

While fiscal adjustment is likely to be needed after the Covid-19 shock, this should not happen before a recovery is well-entrenched. The supports to the economy being provided by the Government are sizeable but they should be temporary and targeted so as to lessen the lasting economic damages of the crisis. The debt ratio is likely to peak and remain at high levels, but debt servicing costs can remain relatively low given low interest rates. Once the economy and employment recovers, fiscal adjustment should be feasible without a return to severe austerity.

In the medium term, the Government will need to balance competing pressures. These include a weaker underlying budget position, the need to reduce public debt, rising ageing costs, reducing the overreliance on corporation tax, addressing climate change and meeting social objectives as set out in the Programme for Government, particularly around health and housing. In part, any further stimulus could be used to alleviate some of these future challenges, such as on climate and housing. However, addressing these challenges is complicated by commitments not to increase a substantial part of the tax burden and to maintain large spending items. Strengthening Ireland’s approach to medium-term budgeting would help to manage these competing pressures.

Pre-Budget 2021 Statement

1. Introduction

The Council's mandate includes assessing the prudence of the Government's fiscal stance. The basis for the Council's assessment is twofold: first, the Council conducts an economic analysis, which assesses the appropriateness of the fiscal stance in terms of the principles of sound economic and budgetary management; second, the Council assesses whether the Government's fiscal plans are in line with the requirements of the budgetary framework.

This *Pre-Budget 2021 Statement* reviews the fiscal stance in advance of *Budget 2021* in line with these aspects of the Council's assessment. Since the Council's Fiscal Assessment Report May 2020, the Government has published its *July Stimulus*. The Government did not opt to publish a Summer Economic Statement in 2020 as it had in previous years to provide an update on budgetary plans ahead of the budget or to update its May analysis for policy changes and other developments.

2. The Macroeconomic Context for the Budget

The economy has undergone an extraordinary shock in 2020. The unemployment rate for those aged 25–74 surged to a record 26.5 per cent in April and economic activity crashed in the second quarter of the year as a result of lockdown measures required to manage the Covid-19 pandemic.

While activity has partly recovered since then and the scale of the contraction was less than had been feared, unemployment remains high and the path for the economy is highly uncertain.

In May, the Council assessed that the Irish economy was in good shape when the Covid-19 shock hit. Growth in underlying domestic demand had averaged over 4 per cent year-on-year for the previous year and a half and was relatively consistent. But the global health pandemic and necessary policy measures would have a major impact (*Fiscal Assessment Report May 2020*).

Given the uncertain outlook about the pandemic and its economic implications, the Council developed three scenarios for how the pandemic might impact the economy. A "Mild" scenario where conditions would improve rapidly, with lasting damage minimised. A "Central" scenario, building on official forecasts, where confinement measures would ease as planned but with lasting impacts. And a "Severe" scenario with repeat lockdowns and wider financial distress. The scenarios implied that it would take up to 2 to 3½ years to return to pre-crisis levels of activity depending on health outcomes. By contrast, the Irish economy took 11 years to recover after the financial crisis.

Recent Domestic Economic Activity

Short-run developments in the economy appear to have been somewhere between the Mild and Central scenarios envisaged by the Council in its *May 2020 Fiscal Assessment Report*. Compared to the *SPU 2020* assumptions, early phases of the Government's "Roadmap for

Reopening Society and Business" were accelerated as new cases of Covid-19 fell to low levels through the summer. However, localised restrictions were introduced in several regions temporarily and the opening up of bars and nightclubs was delayed as new cases rose again. While some opening up of bars is now planned for 21st September, there are continued risks that a full reopening of the economy may be subject to further delays or that regional and even nationwide restrictions may have to be reintroduced.

Underlying domestic demand is a useful measure of domestic activity. It looks through most of the distortions arising from the activities of foreign-owned multinational enterprises, although it excludes net exports (Figure 1A).[1] The first quarter of 2020, which in late-February and March started to see the impacts of Covid-19, saw activity shrink by 0.2 per cent year-on-year (1.8 per cent quarter-on-quarter) with early impacts of the pandemic lowering consumer spending primarily. Activity then collapsed by 16.6 per cent year-on-year in the second quarter (16.9 per cent quarter-on-quarter) leaving it 18.5 per cent below the level of the pre-pandemic final quarter of 2019. Most of the fall was driven by consumer spending as opportunities to consume were restricted, although a decline in construction activity and investment in machinery and equipment more closely linked to restrictions on going to work added to the decline.

High frequency card and ATM data suggest that consumer spending bottomed out at almost 41 per cent below last year's levels around mid-April. Since then, as restrictions have been eased, spending has returned to, or slightly above, the levels a year ago (Figure 1B). A similar pattern can be seen in monthly retail sales data.

However, retail sales data to July also reveal that spending in certain areas remains weak. The retail categories bars; department stores; and books, newspapers and stationery remain sharply down in terms of

[1] Underlying domestic demand is consumer spending plus government consumption plus investment excluding investment in intangibles and aircraft, both of which have a high import content.

volumes from the same period of 2019 even though sales recovered somewhat in June.

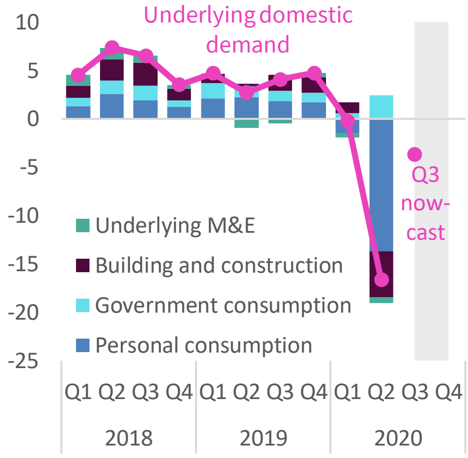
Some sectors have performed well despite Covid-19. Industrial production and merchandise exports were resilient as were exports of computer services. The modern manufacturing sector performed well, driven by pharmaceuticals, chemicals, and medical devices (Figure 1C).

However, many domestic activities were significantly weaker. The traditional sector saw volumes of production decline by 21 per cent year-on-year in the second quarter of 2020. Goods exports outside of the multinational-dominated sectors also fared poorly, with a 20 per cent year-on-year decline in the value of merchandise exports excluding organic chemicals and medicinal/pharmaceutical products (Figure 1D). Many services sectors were also weaker, as shown by a year-on-year decrease of 16.4 per cent in the value of non-computer services. Aircraft leasing has been impacted by Covid-19, with sales falling by 8.5 per cent between April and June.

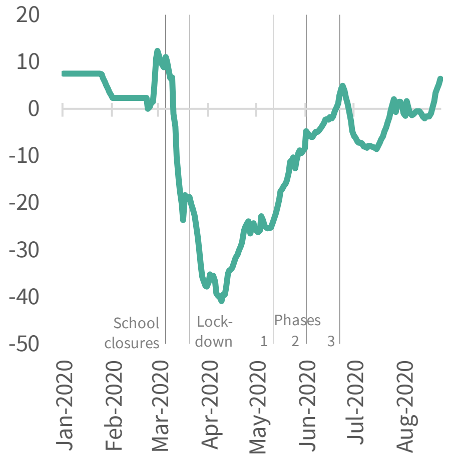
The sectoral impact of the pandemic is also clear from unemployment data. The headline rate (including the Pandemic Unemployment Payments) fell back to 12.6 per cent in August for those aged 25–74 having peaked at 26.5 per cent in April (Figure 1E). Workers from the tourism, hospitality, and retail sectors remain especially impacted — they account for a quarter of those availing of the emergency unemployment supports and almost half of those availing of the wage supports (Figure 1F). By comparison, these sectors accounted for approximately one-in-six employed individuals in the fourth quarter of 2019. While numbers on the Pandemic Unemployment Payment have fallen by almost two thirds from their peak, those dependent on the wage subsidy scheme have remained relatively steady.

Figure 1: The domestic economy has experienced an extraordinary shock but is recovering

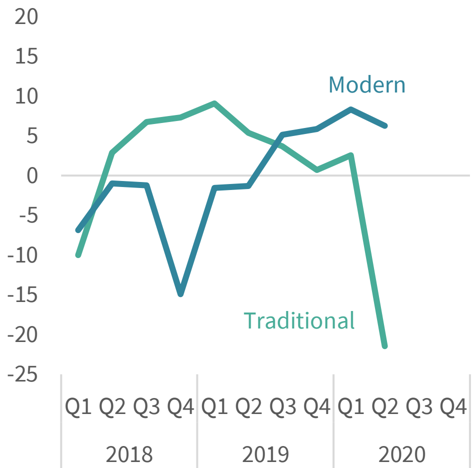
A. A sharp fall in activity took place in Q2
% change year-on-year in volume



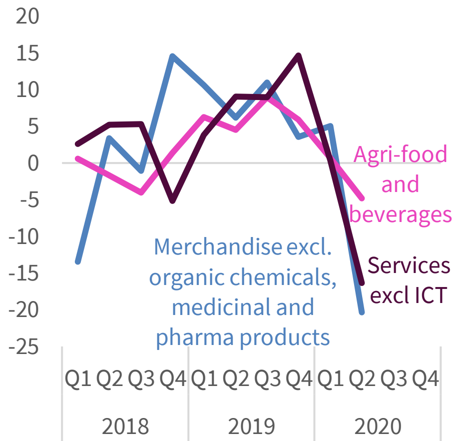
B. Consumer card spending has picked up
% change year-on-year, 7-day average



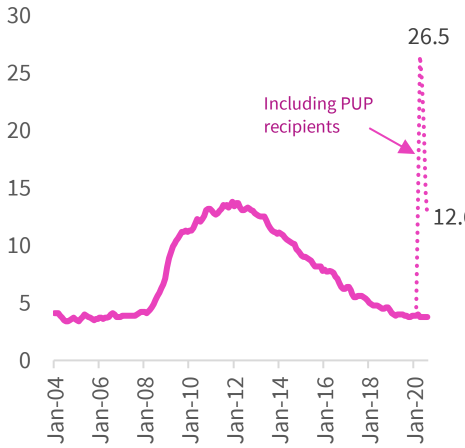
C. Industrial production shows divergences
% change year-on-year in volume



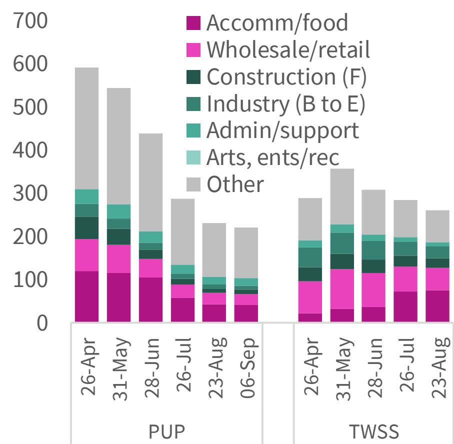
D. Exports by domestic sectors weaker
% change year-on-year in value



E. Unemployment rates remain high
% labour force (ages 25-74)



F. Some sectors rely heavily on supports
Thousands of people availing of supports

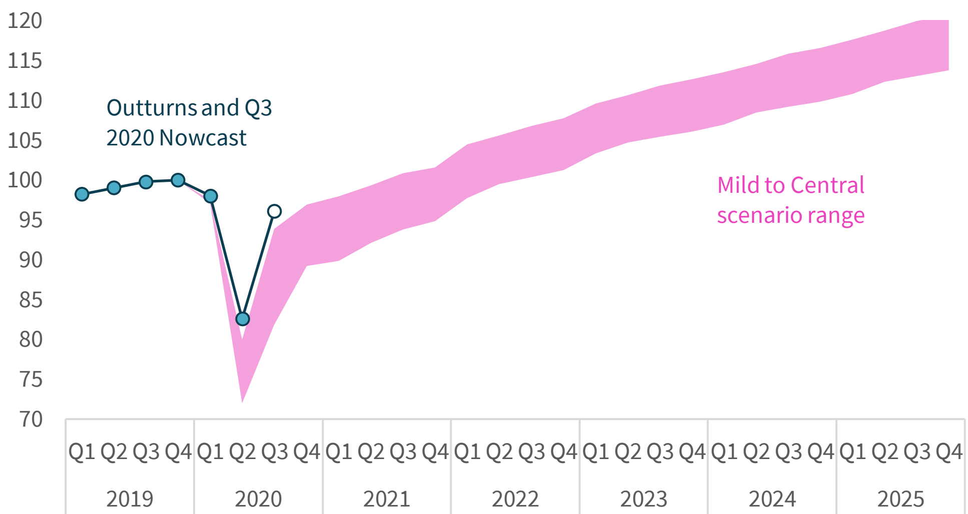


Sources: CSO; Central Bank of Ireland credit card + ATM data; and Fiscal Council workings.
Note: PUP = Pandemic Unemployment Payment; TWSS = Temporary Wage Subsidy Scheme.

The contraction in economic activity in the first half of 2020 was steep, but the initial evidence that it has been somewhat less severe than was anticipated in the April *SPU 2020* and the *May 2020 Fiscal Assessment Report*. The contraction in domestic demand in the second quarter was less than the Council had projected in its best-case "Mild" scenario (Figure 2). In the third quarter, the Council's latest nowcast of economic activity would suggest that underlying domestic demand recovered somewhat, with the year-on-year contraction narrowing to around 3½ per cent. Again, this suggests that outcomes have been somewhere between the Central and Mild scenarios—which were not revised since the Council's May 2020 Fiscal Assessment Report—if not even slightly better than the Mild scenario. The earlier-than-anticipated easing of some restrictions and the July stimulus may have contributed in part to this outcome.

Figure 2: The collapse in domestic demand is—so far—less than feared

Q4 2019 = 100



Sources: CSO; and Fiscal Council workings.
Notes: Underlying domestic demand for Q1 2020 is estimated using the year-on-year growth rate for modified machinery and equipment. This is due to suppression of data for investment in machinery and equipment and intangibles, arising due to confidentiality issues related to the onshoring of intellectual property.

Risks to the Outlook

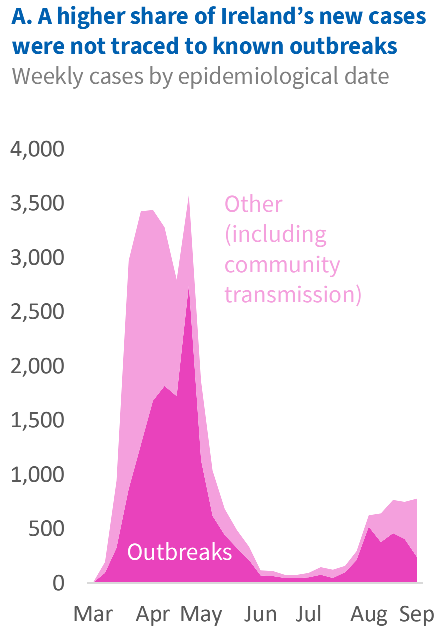
The economic outlook remains exceptionally uncertain because of risks around Covid-19 health outcomes, and its economic impact, together with risks from the EU-UK trade negotiations and the changing global tax environment. While more is now known about the Covid-19 virus and the dynamics of the crisis, much remains uncertain.

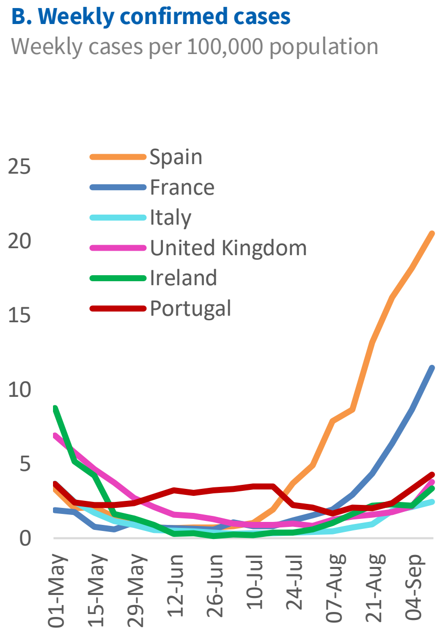
Covid-19 risks

Covid-19 cases are rising in Ireland and the risk of a second wave of Covid-19 in Ireland leading to a further set of restrictions on activity remains. For certain regions in August, the Government temporarily re-introduced some of the restrictions on activity that previously applied during the first wave of the virus in March. These included restrictions on movements outside of the region and closures of restaurants, pubs and various recreational services. A higher share of Ireland’s new cases has not been traced to known outbreaks (Figure 3A), meaning the incidence of other causes including community transmission has risen.

While some western European countries have been more successful than others in flattening the curve following the first wave, subsequent accelerations in infections have occurred. Figure 3B charts weekly reported cases for a selection of nearby countries. Ireland’s weekly new cases have increased to 3.4 per 100,000 for the week leading up to 11th September. This greater than Italy, but slightly below the United Kingdom, Portugal, and well below recent infection rates in France and Spain which have risen sharply since mid-July.

Figure 3: Number of cases is increasing





Source: CSO; European Centre for Disease Control; and Fiscal Council workings.
Notes: In Panel A, cases by epidemiological date refer to the earliest of either onset date, date of diagnosis, laboratory specimen collection date, laboratory received date, laboratory reported date or event creation/notification date.

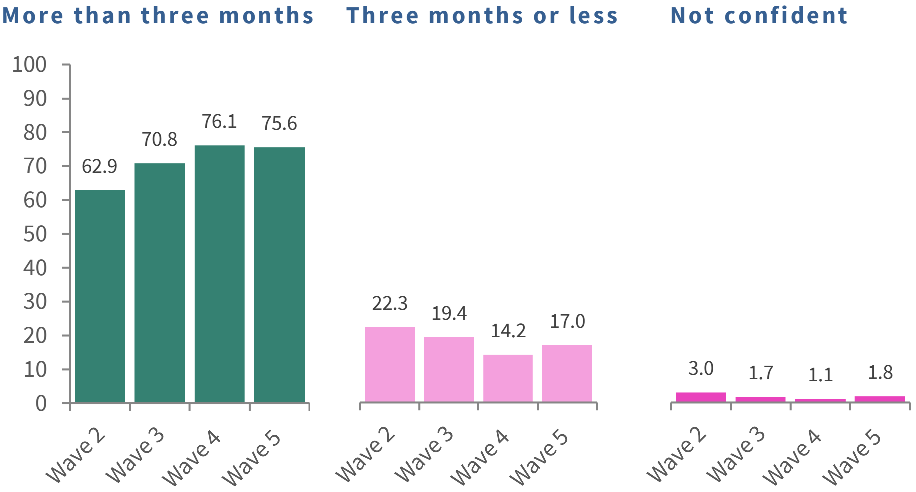
Health outcomes are highly uncertain and could lead to some sectors remaining disrupted for a significant period of time, particularly if a resurgence of the virus triggers more restrictive policies. While the risks of a full nationwide lockdown recurring may be more remote, with regional restrictions and more tailored responses possible, ongoing restrictions appear likely for some time in many areas. This could further increase stress on businesses and trigger higher unemployment in vulnerable sectors, potentially with negative knock-on impacts for long-run growth.

The Council's scenarios assume that there will be an effective treatment or vaccine for the virus by mid-2021. But there is a possibility that health risks do not diminish by then and that effective vaccines and treatments arrive later than is hoped.

A key question is the resilience of businesses and whether they will be able to weather further disruptions to activity arising from the pandemic. Figure 4 shows that an increasing share of enterprises appear to have become confident in having the financial resources to continue operating through the Covid-19 crisis. However, the trend reversed slightly in the latest survey. It is also not clear to what extent the increased confidence as surveyed might reflect "survivorship bias". That is, one possibility is that companies that have permanently stopped operating may have fallen out of the survey, hence biasing the results to be more positive. Renewed balance sheet risks could arise if there are further waves of the pandemic or due to failure to reach a new EU-UK trade agreement.

Figure 4: Businesses slightly more confident of operating through crisis

% enterprises indicating confidence in financial resources to operate throughout Covid-19 crisis



Sources: CSO (Business Impact of Covid-19 Surveys).
Notes: Different response periods covered by each survey wave: Wave 2 (20 April - 3 May); Wave 3 (4 May - 31 May); Wave 4 (1 June - 28 June); and Wave 5 (29 June – 26 July).

A further risk is that the types of consumer expenditure that have rebounded quickly over summer months are concentrated in areas where purchases might not be sustained in future. This could mean that consumer spending could dip again in coming months, despite a temporary reprieve. For instance, retail sectors such as furnishings, hardware, and electricals were between 19 and 27 per cent up on last year's levels in July retail sales data. But this form of expenditure may simply reflect one-offs either due to delays in purchases, temporary increases in durables purchases as households adjusted to remote working, or purchases brought forward from future months.

Brexit

The official forecasts for the economy contained in *SPU 2020* assumed a soft Brexit — one where a free-trade agreement is concluded at the end of the current transition period on 31st December 2020. That relatively benign scenario would allow for continued tariff- and quota-free trade in goods to flow between the EU and the UK.

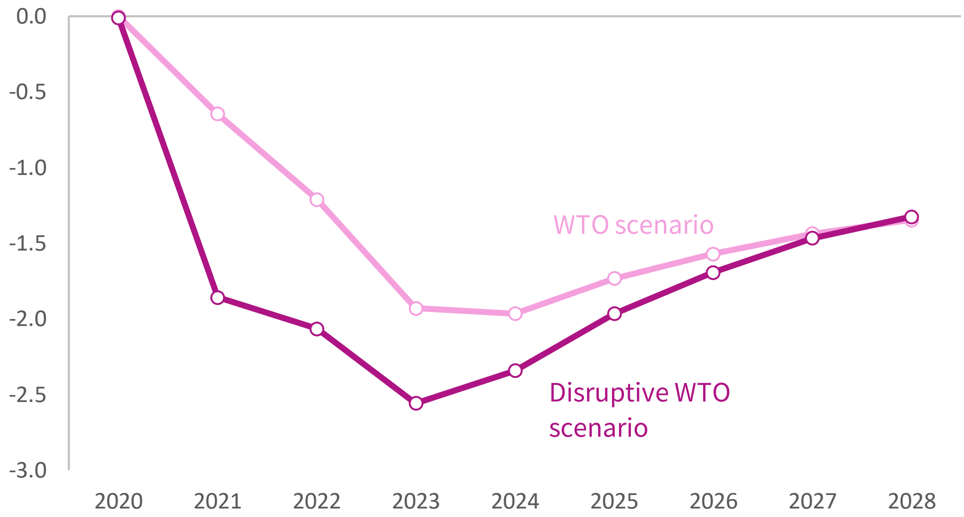
However, progress on EU-UK trade negotiations has been challenging. There is a risk that an agreement is not reached, and that the EU and the UK will end up trading on the basic and harsher World Trade Organisation terms from January 2021. This would mean tariffs on goods and other non-tariff barriers such as border checks.

Previous modelling of the impacts of a hard Brexit suggested that the Irish economy could be expected to shrink by a further 0.6 to 2 percentage points in 2021 relative to a scenario where a relatively benign Brexit occurs (Central Bank, 2020). The long-run impact on Irish output is projected to be of the order of 1.3 percentage points (Figure 5).

There is considerable uncertainty about how Brexit will interact with the global pandemic (Box A). There is the potential that the global recession and collapse in world trade driven by the Covid-19 crisis could significantly amplify the negative consequences of Brexit. Yet, with many vulnerable sectors already facing severe demand shortfalls (such as tourism and hospitality), one possibility is that the adverse impacts would not necessarily be much worse than they already were. However, there is some evidence that sectors vulnerable to Brexit have been relatively more insulated from Covid-19's effects. For example, agri-foods and financial, insurance and real estate services have not been severely impacted. Nevertheless, planning for any new EU-UK trading arrangements will have been disrupted by immediate challenges associated with the pandemic and accumulated losses—where these exist—will make it more difficult to withstand further losses associated with Brexit.

Figure 5: Impact on economic output of a WTO Brexit scenario (relative to FTA)

Percentage point impact on level of output



Sources: Central Bank of Ireland (2020); and Fiscal Council workings.
Notes: Impacts shown are calculated as World Trade Agreement (WTO) impacts minus the Free Trade Agreement (FTA) impact, when compared to a no Brexit counterfactual.

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 (via migration) were boosted by Brexit.

Box A: A hard Brexit would compound the negative impact of Covid-19 on Ireland's domestic economy

The Covid-19 pandemic has caused an extraordinary shock to the Irish economy in 2020, and the impact has varied across sectors of the economy. On top of this challenging backdrop, a hard Brexit remains at risk at the end of 2020.

This box estimates the sectoral impacts of Covid-19 on the domestic economy and assesses the potential exposures to exports as a result of a hard Brexit. The findings show that the two shocks are unlikely to be positively correlated across sectors — that is, the impact of a hard Brexit would add to the negative effects of the pandemic, but not primarily add to the existing pressures faced by sectors. This conclusion aligns with a more detailed exploration of the subject by Daly and Lawless (forthcoming).

Measuring exposure to a hard Brexit and Covid-19

To illustrate the exposure to a hard Brexit that various sectors have, the share of Ireland's exports going to the UK in sector *j* can be used:

$$Hard\ Brexit\ exports\ exposure_j = \frac{Exports\ to\ the\ UK_j}{Total\ exports_j}$$

This is similar to the "proportional" exposure measure described in Smith *et al.* (2017).[2] This approach shows that the sectors with the highest reliance on exports to the UK include other services (73 per cent), agriculture and mining (43 per cent), and financial, insurance and real estate services (32 per cent).[3]

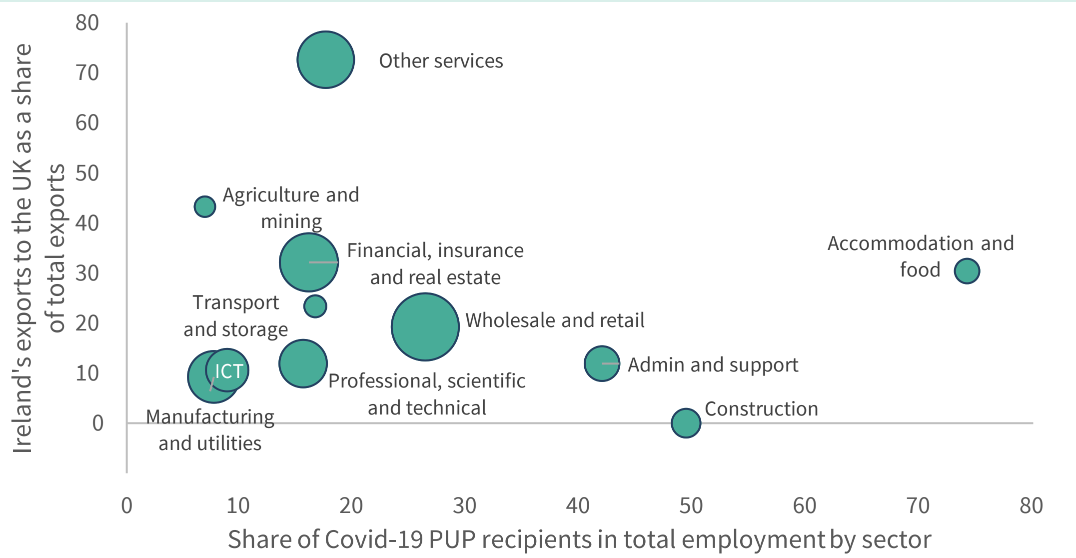
The sectoral impact of Covid-19 on Ireland's domestic economy can be assessed by examining the share of Pandemic Unemployment Payment recipients in a sector as a share of seasonally adjusted Q4 2019 employment levels.[4] The worst-hit sector in Q2 2020 was accommodation and food (74 per cent), followed by construction (49 per cent) and administration and support services (42 per cent).

Comparing the impact of Covid-19 with a possible hard Brexit

Figure A1 compares sectoral exposures due to a hard Brexit and Covid-19 on the basis of the measures described above. Sector (bubble) sizes are represented by their contribution to tax revenues. This means the largest sector shown — wholesale and retail — is the largest aggregate contributor to the public finances across VAT, income tax, corporation tax, and capital-gains tax.

Figure A1: Exposures for Ireland's exports due to a hard Brexit are not positively correlated with exposures to Ireland's domestic economy due to Covid-19

Measure of exposure to respective shocks (larger numbers indicate more vulnerability)



Sources: Department of Employment Affairs and Social Protection; Revenue; and Fiscal Council workings.
Note: Weights shown correspond to the sector's share in taxes (VAT, income tax, corporation tax, and capital gains tax), based on data from the Revenue.

[2] Total exports equals all merchandise and services (contract manufacturing is excluded). Exports are aligned to employment sectors using the breakdown of 2016 (latest available) exports by two-digit NACE code in the CSO supply and use tables. UK equivalents are imputed using related sectors of merchandise and services exports in detailed 2016 data for trade and the balance of payments.

[3] Other services are NACE O–U: public administration and defence; education; human health and social work; arts, entertainment, and other NACE activities.

[4] The estimated impact on the domestic economy does not account for the temporary wage subsidy scheme, given jobs supported by the scheme can still be carried out without a direct loss of economic activity. While some activity has recovered, a large number of such jobs could become outright job losses in future, representing scarring effects of the pandemic over the medium term.

The absence of a positive correlation (a coefficient of -0.16, albeit not strongly negative) suggests that the impact of a hard Brexit could be more adverse for exports in sectors that have performed relatively well throughout the Covid-19 shock, such as agriculture and mining, and services such as financial, insurance and real estate. Conversely, some of the worst-hit sectors in Covid-19, such as construction and administration and support, would be relatively less exposed to a hard Brexit.

It is also possible that substitution in favour of firms located in Ireland could occur, a result of Brexit-related tariffs and other trade barriers affecting UK exporting entities. This could offset some of the losses across sectors from sales to the UK, and would imply a lower risk to total exports than represented by the shares presented in Figure A1. For example, some re-location of banks and other financial services firms has occurred in recent years since the Brexit vote.

For other sectors, including manufacturing and utilities, information and communication technology, and professional, scientific and technical services, the impact of Covid-19 has been relatively benign, and a large share of sales would not be directly at risk due to a hard Brexit. However, it is likely that domestic manufacturing firms have been worse affected than foreign-owned multinationals, whose firms are typically much larger in terms of persons engaged and average labour costs.[5]

[5] The 2017 Census of Industrial Production shows that an average domestic manufacturing firm has less than ten persons engaged, each costing €42,500 per year, whereas foreign-owned manufacturing entities have more than 200 persons engaged, each costing €64,300 per year.

3. The Fiscal Context for the Budget

Covid-19 has led to substantially higher government spending on job supports and measures to stimulate demand, while tax revenues have fallen sharply in some areas. This will lead to a very large budget deficit this year and a rise in the debt-GNI* ratio to high levels.

The lead up to the Covid-19 crisis

Prior to the Covid-19 crisis, efforts to turn around a large deficit slowed from 2015 after the 3 per cent of GDP deficit limit was met. Relatively small surpluses of 0.2 per cent and 0.7 per cent of GNI* were run in 2018 and 2019, respectively (Figure 6A).

However, “excess” corporation tax receipts—unexplained by the performance of the domestic economy—boosted the budgetary position since 2012. Last year, corporation tax receipts were €10.9 billion — €5.4 billion more than the level estimated based on growth in the domestic economy (Figure 6B). The presence of companies in Ireland could change as the result of company-specific decisions or changes in global circumstances and policy regimes.

Low interest rates also helped the public finances in recent years. This partly reflects wider trends of falling interest rates over the past three decades (Rachel and Summers, 2019), but also falling risk premiums paid on Irish issuances and the gradual replacement of outstanding debt that carried higher interest rates. This has helped reduce the expect cost of interest payments on Irish debt across successive projections (Figure 6C).

Frequent overspending in health areas was a recurring challenge in recent years and this was masked by corporation tax and interest tailwinds. Health overruns have averaged €500 million annually since 2015 (Figure 6D). These overruns are long-lasting and are not matched by savings or revenues raised elsewhere.

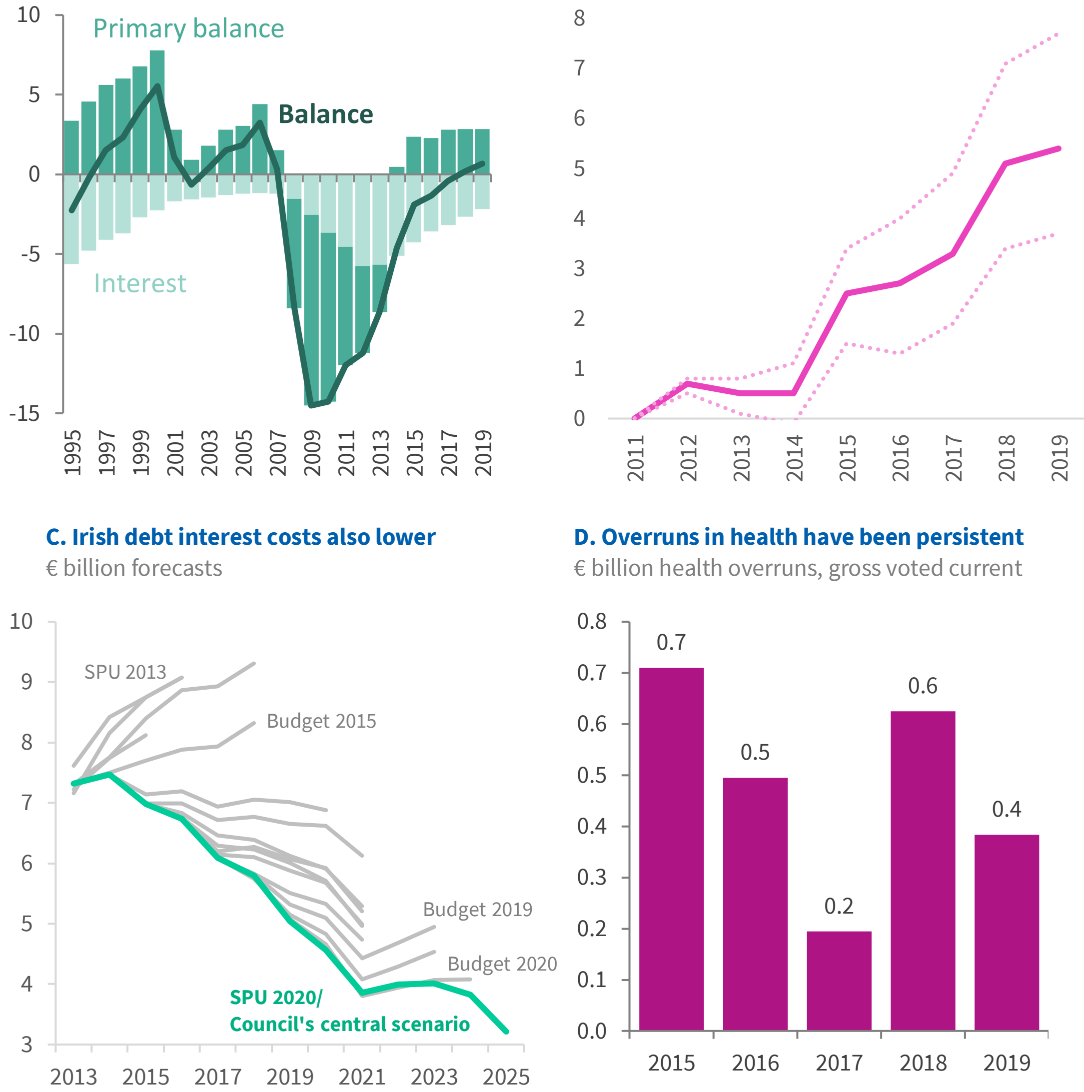
Figure 6: Recent fiscal context

A. Small surpluses in 2018 and 2019
% GNI*

B. Helped by excess corporation tax
€ billions

C. Irish debt interest costs also lower
€ billion forecasts

D. Overruns in health have been persistent
€ billion health overruns, gross voted current

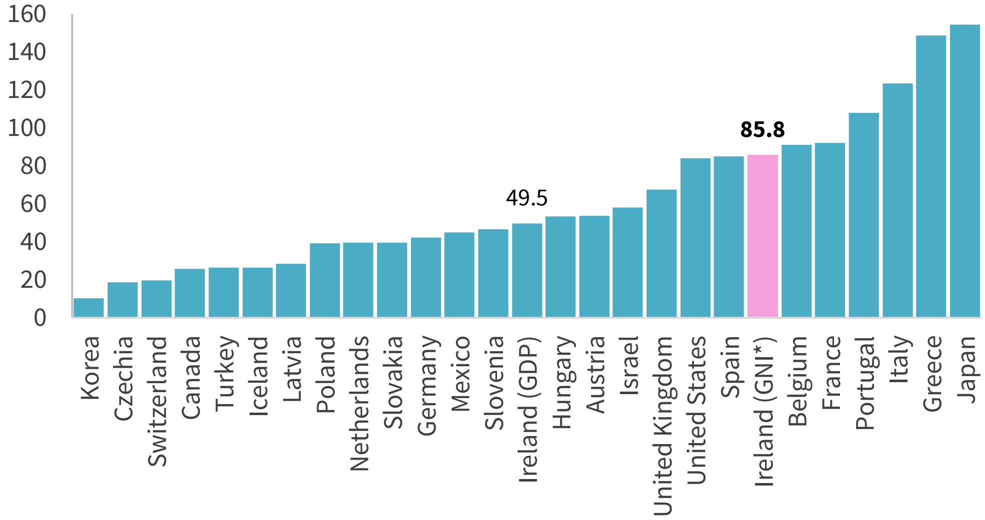


Sources: Department of Finance; and Fiscal Council workings.
Note: For panel A, one-offs are also excluded from the balance shown. For panel B, the "excess" is estimated as the € billion difference between actual annual corporation tax receipts and model projections. Model projections use a suite of models together with actual nominal GNI* and domestic GVA outturns to project forward expected corporation tax receipts from 2012. Central estimates in solid line are surrounded by the upper and lower estimates from a suite of models (see Box H of the *May 2020 Fiscal Assessment Report*). In panel C, successive vintages of projected interest payments are shown since *SPU 2013*. In panel D, Overruns here are defined as the outturn of gross voted health expenditure for the year minus forecast gross voted health spending.

Ireland's government debt burden was high going into the current crisis. Taking into account various assets held by the State, 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 7). This placed Ireland's net government debt burden as the seventh highest in the OECD, although debt levels in almost all countries are likely to rise as result of the Covid-19 crisis.

Figure 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: IMF (April 2019 WEO); CSO; Eurostat; and Fiscal Council workings.
Notes: The Stability and Growth Pact criterion of a 60 per cent ceiling for government debt is set in gross terms rather than in net terms. Also, the net debt measure does not include the State's bank investments.

The budgetary impact of Covid-19

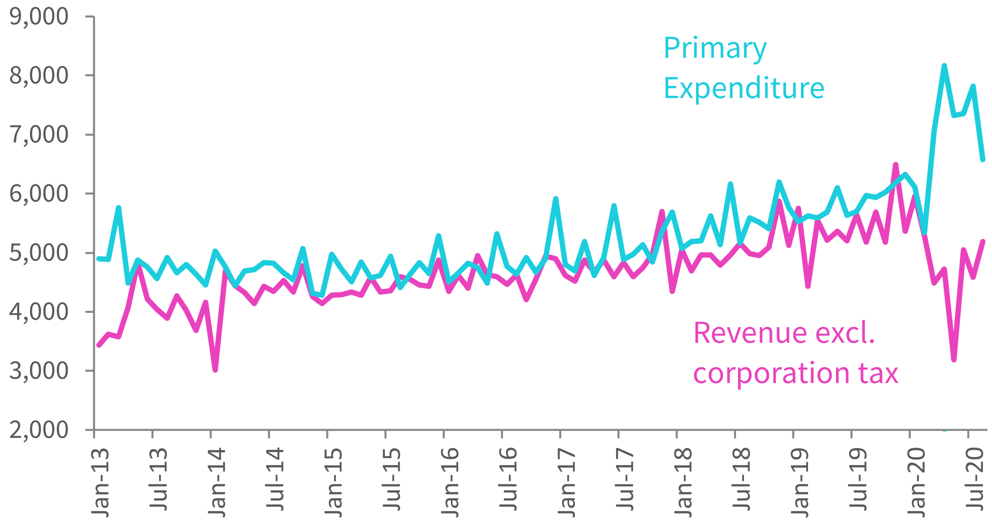
The Covid-19 crisis has led to a sharp rise in government spending and a fall in tax revenues (Figure 8).

There are considerable uncertainties about the impact on the public finances for this year and beyond. For 2020, and taking into account information for the year to end-August, a substantial deficit of €24–€30 billion (13–17.4 per cent of GNI*) is likely.

While the April *SPU 2020* and the Council's Central scenario projected a deficit of €23 billion for 2020, those projections did not include various spending increases and policy measures announced since April, including the Government's "July Stimulus". In part these deficit-increasing factors were offset by a stronger performance of the domestic economy than was expected and stronger revenues.

Figure 8: Central Government Revenue & Primary Expenditure

€ million (seasonally adjusted)



Sources: Department of Finance and Fiscal Council workings.
Note: Transactions without general government impacts are excluded. Total Revenue is Exchequer tax and non-tax revenue plus appropriations in aid and excess capital resources. Primary Expenditure is Gross Exchequer Expenditure minus national debt interest. Data are adjusted using the STL decomposition method over monthly observations for the duration of the sample period 2013-2020.

Three scenarios for the budget balance were outlined in the *May 2020 Fiscal Assessment Report*. The "Mild" scenario had a mild initial contraction, a faster recovery and more successful containment measures, economic supports, and progress on treatments. The "Central" scenario assumed a sharp contraction in Q2 2020, followed by a very protracted recovery. Whereas the "Severe" scenario assumed a sharp initial contraction and a protracted recovery marred by repeat lockdowns and wider financial distress. Short-run developments suggest that the economy is in the range of the Mild to Central scenarios and possibly closer to the Mild scenario. However, there are risks of further lockdowns, both regional and nationwide, which would bring things closer to a severe scenario.

The Government's July Stimulus documentation outlines how outturns to date and policy measures introduced have led to the Department of Finance increasing its deficit forecast in 2020 to €30.1 billion. Table 1 updates the three scenarios outlined in the *May 2020 Fiscal Assessment*

Report by adjusting them by €7 billion to match that outlined in the July Stimulus.[6]

Table 1: Updated estimates of the impacts of Covid-19 on the budget balance

% GNI* and € billions, 2020

Scenario	Budget Balance (€ billions)	Budget Balance (% GNI*)
SPU 2019 forecasts (April 2019)	1.2	0.6
Mild Scenario	-23.7	-13.0
Central Scenario	-30.1	-17.4
Severe Scenario	-40.2	-23.8

Sources: *SPU 2020*, Department of Finance, and Fiscal Council workings.
Notes: Calculations include the effects of government supports outlined in both May and July. Note that the *SPU 2019* forecasts are used for comparison as, unlike the *Budget 2020* forecasts, these exclude the projected impact of a disorderly Brexit in 2020. The scenarios are based on the Council's *May 2020 Fiscal Assessment Report*.

As discussed below, revenue outturns for the year to date since *SPU 2020* have been stronger than expected. In the July Stimulus documentation, it is assumed that tax revenue this year is €3.7 billion higher than was anticipated in *SPU 2020*. This reflects the stronger than anticipated revenue from income tax and Corporation tax in the year to date.[7] This is offset by weaker than expected PRSI receipts (-€1.0 billion) and by public bodies receiving less income for services, including in transport and education (-€0.5 billion). As such, general government revenue has been revised up across the scenarios by €2.2 billion.

Increases in departmental spending since *SPU 2020* have added some €3 billion to planned Government spending for 2020. This reflects a further €1.25 billion allocated to contingencies for the Department of Education for reopening schools, the Justice Department, and the Department of Health for any possible further costs incurred beyond the €2 billion additional funding already budgeted for Health in the *SPU 2020*. There is a separate increased allocation for social protection spending of €1.1 billion. There is also an additional €0.7 billion of

[6] This also incorporates forecasts of tax revenues being increased by €3.7 billion in the July Stimulus compared to *SPU 2020*.

[7] These two tax headings alone are almost €4 billion above profile as of end-August

increased allocations to other Departments where funding requirements have risen, mainly for public transport. As of early September, Google Mobility data showed that public transport use remained down approximately 30 per cent relative to median daily levels over the period 3rd January – 6th February 2020.[8]

Policy measures are also expected to widen the deficit. A further €6.2 billion has been added to expected spending in 2020 due to expanded policy supports. This comprises extensions to the income supports schemes (the PUP and TWSS) at a cumulative cost of €3.2 billion, along with a range of tax relief and rates measures (€1.5 billion), sectoral packages and business grants (€0.7 billion), and other spending including capital investment and labour market activation (€0.8 billion).

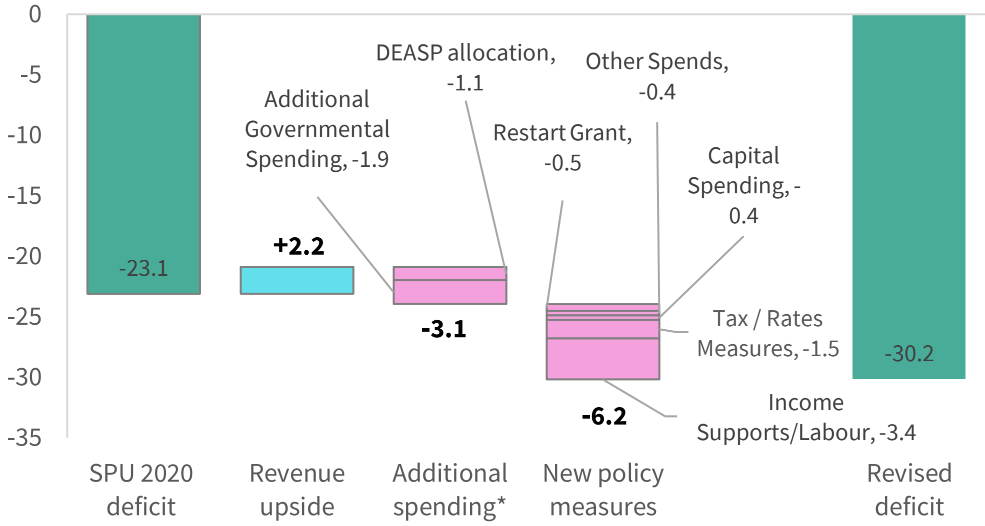
The costs of measures introduced since *SPU 2020* are difficult to interpret due to limited information being published by the Government. Many of the policy measures introduced in the past six months lack detail on what specific spending areas are impacted or how their costs were estimated. Key assumptions, such as the number of individuals assumed to claim income support schemes were not published with estimates. It was also unclear whether costs were on a gross basis or if savings elsewhere were netted off against the estimated costs published. This makes it difficult to estimate the likely cost implications should these schemes be extended further again. Additionally, large allocations of contingency funding provided to various government departments were detailed only in aggregate terms, making any overlapping spending unclear. The Government should provide more detail and information on the cost estimates provided for large policy measures, including the underlying assumptions used to generate such estimates.

[8] These included packages for sectors such as culture and sport, and Departments of an Taoiseach, Agriculture and Transport Tourism and Sport (€460 million).

Figure 9 shows how these changes impact on the Department of Finances' forecast of the general government balance for this year has evolved since *SPU 2020*. *SPU 2020* projected a deficit of €23.1 billion for 2020. While revenues have proven more resilient than expected, at about €6.4 billion ahead of the projections made in *SPU 2020,* additional spending and new policy measures have led to the Departments central projection of the deficit for 2020 increasing to €30.1 billion (published in documentation accompanying the July Stimulus).

Figure 9: Evolution of deficit forecast since *SPU 2020*

€ billion, budget balance in general government terms



Sources: Department of Finance.

Notes: Blue bars show items which reduce the projected deficit. Pink bars show items which contribute to a widening of the projected deficit. * Additional spending outside of new policy measures relates to certain general government adjustments. The "DEASP allocation" refers to the budget allocated to the Department of Employment Affairs and Social Protection. See Box B for further details on the full range of supports launched since the onset of the crisis.

For 2020, the July Stimulus measures are projected by the Department of Finance to increase the deficit by €3.7 billion.[9,10] The stimulus made temporary tax cuts amounting to a revenue cost of €0.9 billion in 2020. These included €0.6 billion of temporary corporate tax loss relief to provide additional liquidity supports for businesses and income tax

[9] This figure relates strictly to the exchequer cost of the measures introduced and is exclusive of any potential impact on growth.

[10] Some measures announced have an impact on the exchequer balance for 2020 and 2021 but are neutral in General government terms. For example, the warehousing of tax payments is exchequer deficit increasing in 2020 (decreasing in 2021). In general government terms however, this action makes no difference to either year.

relief for the self-employed, and €0.3 billion for a six-month decrease in the standard VAT rate from 23 per cent to 21 per cent until end February 2021. Several new spending measures were also introduced amounting to €2.8 billion for 2020. These include the new Employment Wage Subsidy Scheme (EWSS)—a replacement for the TWSS that will last until 31 March 2021—and an extension of the Pandemic Unemployment Payment until 1 April 2021.[11] The combined cost of the extension of the PUP and the new EWSS was estimated to be €1.3 billion for 2020.[12] Additional business supports, capital spending and labour activation measures were also announced for delivery in 2020 at a cost of €1.5 billion.

Some measures announced as part of the July 2020 stimulus continue in 2021, increasing the deficit by €1.8 billion. Tax measures expected to cost a further €0.3 billion as the VAT measure and “Stay-and-Spend” initiative carry on until end-February and end-April respectively. Spending measures, mainly the EWSS (€0.9 billion) and extension to the PUP (€0.4 billion) plus expanded job activation measures (€0.1 billion), are projected to add another €1.5 billion to spending for 2021 under the assumption that these measures end and are not extended next March.

[11] The EWSS differs from the TWSS in that the maximum subsidy payable is €203 (compared to €410) per week. New employees and seasonal workers are eligible (which was not the case under the TWSS). Those earning less than €151.50 per week are not eligible for the EWSS.

[12] Unlike previous costings, the €0.3 billion cost of extending the PUP refers only to the additional cost of this scheme, relative to a scenario where claimants would receive standard social welfare payments.

Revenue developments

Government revenues have fallen in 2020 as a result of the pandemic with very large falls for some taxes, though the overall impact has thus far been less than feared thanks to a continued outperformance in corporation tax and the progressive nature of the income tax system. Overall, total Exchequer tax and PRSI revenues to July 2020 were down just 3.4 per cent (€1.5 billion) compared to the same period of 2019 (Table 2). The expectation in the *SPU 2020* and the Council's Central scenario was that it would be down by 11.5 per cent for the year as a whole.

Table 2: Central Government Revenue to end-August 2020
€ million cumulative, unless stated

	2020	2019	Difference	Difference (%)
Exchequer Tax	34,248	35,050	-802	-2.3
Income Tax	13,886	14,080	-194	-1.4
VAT	7,794	9,901	-2,108	-21.3
Corporation Tax	6,478	4,928	1,550	31.4
Excise Duty	3,337	3,916	-579	-14.8
Other Taxes	2,754	2,224	529	23.8
PRSI Receipts	6,773	7,459	-686	-9.2
Other Revenue	3,206	3,251	-45	-1.4
Total	44,227	45,760	-1,533	-3.4

Sources: Department of Finance and Fiscal Council workings.
Note: Note: Other taxes include stamps, capital taxes, motor tax, customs and other unallocated tax receipts. Other revenue includes the National Training Fund, other A-in-As, non-tax revenue, and capital resources. PRSI and National Training Funds include their corresponding excess as indicated in the memo items.

Income taxes have remained relatively robust in 2020, ending the year to August only 1.4 per cent down on performance in 2019. This partly reflects (1) strong revenue growth during 2019 and in the first quarter of 2020 and (2) the relatively progressive nature of the tax system. Incomes taxes in the first quarter were up 13 per cent year-on-year, prior to the full effect of the lockdown.[13] The second quarter outturns were more than 10 per cent lower year-on-year, demonstrating that the

[13] 241,700 people filed for the PUP payment over a one-week period between the last week in March and the first in April.

first quarter outturns significantly offset the declines seen in the second (Figure 10A).[14] Given that sectors with the largest employment losses and income support claimants are those that tend to have lower average incomes, the progressivity of the tax system has helped to maintain income tax receipts and should do so further ahead also. While TWSS/EWSS and PUP payments are subject to income tax, TWSS liabilities fall due at the end of the year but, given their level of earnings, this implies only limited upside to receipts from those drawing on these schemes.[15]

PRSI's performance contrasts strikingly with the performance of income tax. PRSI receipts to end August were over 9 per cent lower than in 2019. The discrepancy between income tax and PRSI intake is partly due to employer's PRSI being liable on all levels of income and less progressive. As a result, employment and earnings losses at the bottom of the income distribution would impact on PRSI more than income tax. In addition, PRSI contributions from both employees and employers did not apply to TWSS payments, and salary top ups by employers were subjected to a reduced PRSI rate of 0.5 per cent rather than the standard 11.5 per cent. Employee PRSI contributions will be deducted as normal through the EWSS scheme, while employer PRSI will be subject to the reduced rate of 0.5 per cent. Similarly, as part of the warehousing of debts for firms impacted by Covid-19, employer PAYE payments were also eligible for deferment by businesses in the months until June.

VAT receipts have fallen sharply, with outturns €2.1 billion lower (21.3 per cent) by end August compared to the same period last year. The announcement of a rate cut to VAT in July from 23 per cent to 21 per

[14] This is consistent with the large numbers of claimants on income support schemes from March onwards and the deferment of income tax payments. Latest data from Revenue (2020a) notes that over the course of the TWSS scheme, just €151 million has been paid in related income tax.

[15] Both the TWSS/EWSS and PUP payments are subject to income tax, with the TWSS liabilities falling due at the end of the year, and the EWSS' being deducted per pay period. Recent comments from the Minister for Finance have suggested that the government will facilitate these payments to be made by claimants over the course of several years (RTÉ, 2020).

cent, beginning September, will weigh on VAT returns. The government has costed this policy at €440 million for a 6-month period beginning in September.

Excise duties are down by 14.8 per cent, but have fallen less than might be expected, with the Department of Finance noting the boost in domestic purchases of tobacco due to lower levels of foreign travel, along with increased consumption of alcohol helping to lift receipts.

Corporation tax receipts for 2020 are 31.4 per cent higher than in 2019, offsetting falls in other areas (Figure 10B). Several factors explain this. Foreign-owned multinationals account for 77 per cent of net corporation tax receipts (Revenue, 2020) and sectors such as pharmachem, medical devices and ICT, which tend to be dominated by foreign-owned multinationals and have weathered the crisis relatively well. A significant portion of receipts is also determined by economic activity in the previous year.[16] This means that these outturns are vulnerable to downside risks in 2021. Additionally, the Government has outlined plans as part of its July stimulus to allow for corporation tax loss relief to the value of €450 million (equivalent to 4 per cent of 2019 corporation tax receipts).[17]

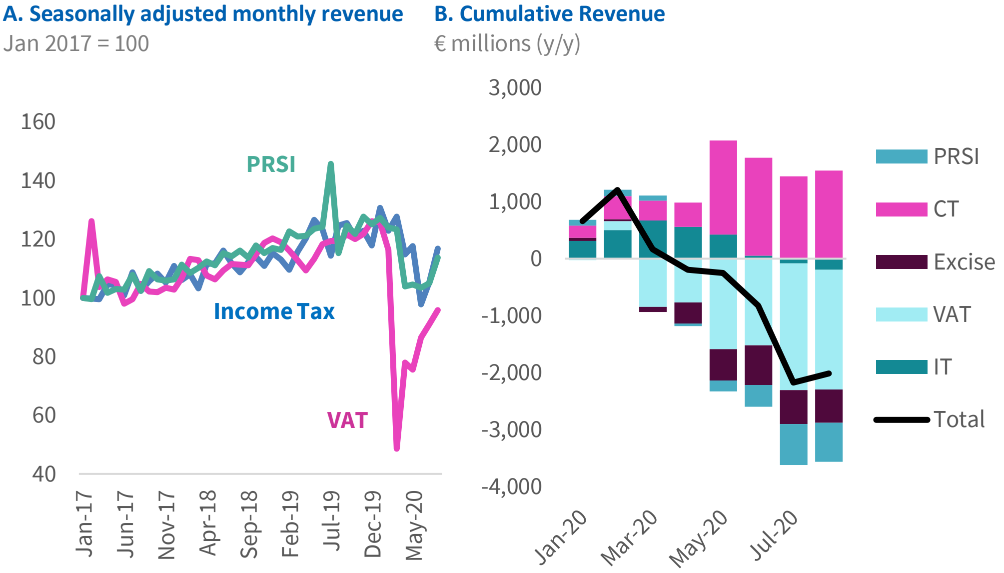
Overall, tax revenues are ahead of expectations issued in April's *SPU 2020* projections by around 21 per cent (€6.0 billion), which already took into account the effects of Covid-19, but still down by 2.3 per cent on the same period last year and around 9 per cent (€3.5 billion) below the Government's projections in January. Of the €44 billion taken in Exchequer and PRSI revenues in 2020, over 46 per cent can be attributed to Income and Corporation Tax receipts, compared with 41 per cent in 2019. If those revenue sources that have fallen least

[16] For instance, Revenue (2020b) note that corporation tax returns for 2019 (the "CT1" return) are not due until nine months after the end of the accounting period, which is in the latter half of 2020 in most cases. However, analysis of receipts liable in 2017 and 2018 suggests that the liabilities correspond closely with net receipts received in the calendar year (differing by less than €200 million in both cases).

[17] Under this scheme, firms negatively impacted by Covid-19 can submit accelerated tax relief claims of 50 per cent of their trading losses against the preceding accounting period.

continue to remain relatively robust, and assuming that broader conditions remain in line with the Council's scenarios, revenue outturns to date suggest that the eventual government revenue figure will fall closer to the Mild scenario of €76 billion, compared with €74 billion in 2019.

Figure 10: Strong revenue outturns in early 2020 have helped offset falls



Sources: Department of Finance and Fiscal Council Workings
Notes: Data in Panel A are seasonally adjusted monthly outturns using the Tramoseats method. Panel B uses unadjusted monthly outturns. IT = Income Tax; CT = Corporation Tax; and PRSI = Pay-Related Social Insurance.

Expenditure developments

Spending has increased very quickly in 2020. Total expenditure to end August stands at just under €58 billion, around 20 per cent (€9.7 billion) higher than at the same time in 2019, and owing to the extension of income support schemes and the introduction of new policy measures, over 15 per cent (€7.7 billion) above the projections made in *SPU 2020* to end August.

The spending increases in 2020 have been primarily driven by Covid-19 related wage and income supports, social payments and healthcare responses, together with the other items increasing broadly as planned in *Budget 2020*. Other items have evolved broadly as planned. The largest outlays are for Social Protection and Health, reflecting the need to support businesses and households through the pandemic and to expand the capacity of the health system to respond to it.

Social protection spending increased in line with unemployment numbers and those on wage support schemes from March onwards. Spending in total reached €20.3 billion by August — 48 per cent higher than the cumulative figure to August 2019 (€13.7 billion).

Table 3: Income Support Schemes cumulative cost estimates and outturns
€ billion

Scheme	Official cumulative cost estimate	Cumulative cost outturn	Difference
March: PUP, TWSS and illness benefit (initial 12 weeks)	4.5	3.8	-0.7
June: PUP/TWSS extension to Aug	6.3	6.2	-0.1
July: PUP extension to Dec	8.0		
July: EWSS introduction (Aug to Dec)	8.9		

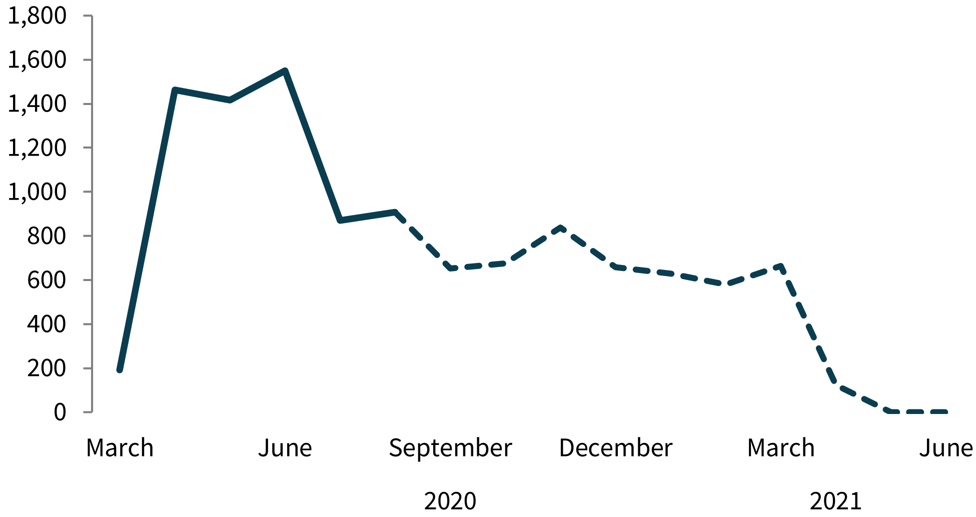
Sources: Department of Finance, Revenue Commissioners and Fiscal Council workings.

The TWSS and PUP are the two key measures driving higher social protection spending in 2020. Initially, the PUP, TWSS, along with the smaller Covid-19 Illness Benefit, were costed for a 12-week period from March to early June at €4.5 billion. Take up of these schemes was lower than anticipated with the cost for the first 12 weeks approximately €3.8 billion. In June, all three measures were extended over June to September 2020. The costs associated with these extensions was expected to be €1.8 billion. Recent outturns suggest that the cost was higher at €2.4 billion. From September, the TWSS is being replaced by the EWSS. Combining the various costings provided, the official estimates would suggest a cumulative cost for the PUP/TWSS/EWSS schemes of €8.9 billion for 2020 (Table 3).[18,19]

For the official costings of these schemes to prove accurate, a modest fall in monthly costs would be needed (Figure 11). This is contingent on the economy continuing to recover and fewer people availing of these schemes.[20] If the weekly costs of these schemes to remain at the last outturn level, then total costs for the year would be approximately €9.4 billion.[21]

Figure 11: Monthly costs of Covid-19 income support schemes

€ million



Sources: Government of Ireland, Revenue, and Fiscal Council workings.
Notes: Dashed line indicates a path of future weekly costs for both the PUP and TWSS which would result in an annual costing of €8.9 billion. Some months have 5 payment dates rather than 4 hence may appear more costly than surrounding months (June 2020, August 2020 November 2020 and March 2021).

The EWSS and PUP are set to remain in place in 2021 until 1st April. The July Stimulus suggests that the cost for the first three months of next

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[18] The Covid-19 Enhanced Illness Benefit has also been extended, but no costing has been provided by the Department of Finance as costs are expected to be low.

[19] A costing of €300 million for extending the PUP until the end of 2020 refers only to the net cost of this extension, i.e. the cost above funds already allocated to the Department of Employment Affairs and Social Protection. The gross cost is approximately €1.7 billion. This gross cost is used for Table 3 and Figure 11.

[20] In addition, some seasonal workers who were availing of Covid-19-related schemes during earlier months may not be claiming during the winter (third-level students for example).

[21] A costing of €8.9 billion for the year is consistent with an average weekly cost of €166 million per week in the last 17 weeks of the year. If the weekly cost were 50 per cent higher (€250 million), this would imply an additional €1.4 billion in payments in 2020.

year is likely to be €1.3 billion (€0.9 billion for the EWSS and €0.4 billion for the PUP).[22] A risk to spending projections is that the supports are extended beyond their current timelines, or are replaced by new schemes if health risks remain and do not allow for a loosening of restrictions on certain sectors. Recent outturns suggest that the gross weekly cost per claimant per week is around €300. This gives some sense of the likely costs if further regional lockdowns were to occur, leading to an increase in claimants. Furthermore, if the additional income support schemes were to end or restrictive changes were made to eligibility criteria, claimants may transfer to standard social welfare and unemployment payments.

Health spending also increased by a large margin in 2020. At €12.7 billion, the current spend so far this year is 15.6 per cent greater than in the same period of 2019. The SPU in April had allocated €2 billion to increased capacity for dealing with and supressing the spread of Covid-19 in Ireland, but it provided no clear timeline as to the deployment of these resources. Over the summer, the numbers of new cases and patients with Covid-19 in hospital had fallen to their lowest levels since the peak in April. This entailed less of a burden on the health system. To end-August, health spending is €1.2 billion higher than *Budget 2020* forecasts, meaning much of the additional funding has already been spent.

Other policy supports have been introduced in addition to the measures outlined above. These include measures with an immediate impact, such as the expansion of the restart grant to €550 million, a continued commercial rates waiver costing €600 million, a 'staycation' tax credit of €140 million, self-employed tax relief of €150 million, and an enhanced 'Help to buy' scheme of €18 million. These plans have been complemented with development policies such as accelerated

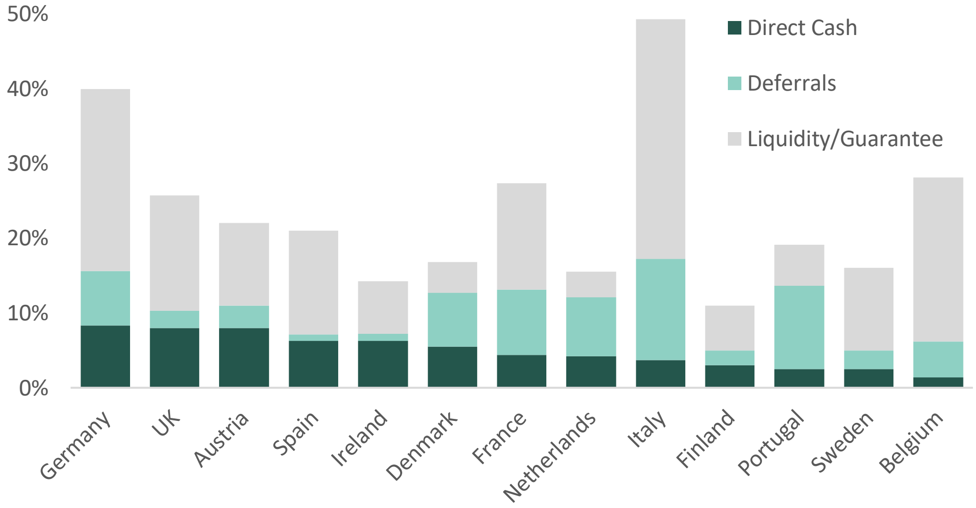
[22] These costings are based on the number of weekly PUP claimants falling from 173,000 in December 2020 to 123,000 by April 2021. The EWSS costing is based on 350,000 weekly recipients in early 2021, falling gradually thereafter. Claimants on the PUP currently stand at 209,941, with around 360,000 being supported on the TWSS, totalling around 24 per cent of the labour force.

capital works and labour market activation policies. The €2 billion credit guarantee scheme that was announced earlier in the year has also been signed into legislation.

In total, the Government has allocated over €25 billion (14 per cent of GNI*) to various policy supports, of which around €18 billion is through direct spending. Box B provides a summary of the policy measures introduced thus far in response to Covid-19.

Figure 12: Government fiscal responses to Covid-19 internationally

% GDP (% GNI* for Ireland)



Sources: IMF, OECD, Bruegel, and Fiscal Council Workings.
Notes: Credit guarantees are reported as the estimated coverage of private sector activity as a proportion of GDP, GNI* for Ireland.

It is difficult to compare the policy supports introduced by Ireland on a like-for-like basis with other countries, given differences in specific programmes, in the role played by automatic stabilisers, and the variation in the economic shock experienced by each country.[23] However, as shown in Figure 12, the economic response by authorities across Europe has varied in size. The total amount of economic assistance per country has ranged from around 11 per cent of GDP to almost 50 per cent, including further differences in the composition of these supports. Much of this variation can be explained by some states

[23] In particular, some countries that have strong social security systems may appear to have enacted smaller stimulus. This can be due to the fact that much of their additional expenditure due to Covid-19 occurs automatically and hence is not at the government's discretion.

deploying sizeable credit guarantee schemes, which when leveraged can cover a significant percentage of economic activity without incurring direct costs to the exchequer. Credit guarantees removed, the economic response in Ireland has been broadly in line with other comparable European economies to date, with a mix of income assistance, health service expenditure, and deployment of business supports representing the bulk of spending.

Box B: Policy measures introduced since the Covid-19 outbreak

Government support has continued to be provided to the economy on an ongoing basis through the Covid-19 crisis. These supports have comprised of a combination of income supports for those made unemployed or medically affected by the virus, business supports for concessional access to credit, the subsidising of firm's employees, direct cash grants for businesses, credit guarantees, tax waivers and warehousing, along with other labour market activation measures and capacity expansion for the health service.

Collectively, the Government has allocated over €25 billion (14 per cent of estimated GNI* for 2020) of funding for the provision of these programs (of which around €16 billion is through direct spending). This box provides a brief overview of the Government's fiscal measures.

Table B.1: Overview of fiscal measures introduced amid Covid-19

	Est. cost € millions
Income Supports	**11,317**
Pandemic Unemployment Payment: Emergency unemployment payment to those who have lost their jobs on or before 13th March due to Covid-19.	
Temporary Wage Subsidy Scheme: A tiered payments system that subsidises part of an eligible employee's salary. Has been extended as part of July's stimulus and was replaced by the Employment Wage Subsidy Scheme (EWSS) on 1 September 2020.	
Enhanced Illness Benefit Scheme: Illness payments for those who have been diagnosed with Covid-19 or advised to self-isolate.	
Business and Sectoral Supports	**11,885**
Covid-19 Loan Schemes: Designed to facilitate access to short-term liquidity for businesses impacted by the virus. Terms contain concessionary elements.	1,300
Credit Guarantee Scheme: Designed to reduce the onset of liquidity and credit constraints for smaller borrowers. Offers banks an 80 per cent government guarantee against losses incurred by lending to firms affected by Covid-19.	2,150
Pandemic Stabilisation and Recovery Fund: Replaces the ISIF global portfolio as an investment fund focusing on near-term stimulus and stabilisation of the Irish economy.	2,000
Sectoral Grants Packages: Includes funding for various sectors such as an Gaeltacht, Arts, Beef, Sports, Ferries. Also includes online voucher schemes and others.	345
Contingency Allocations and Government Spending: Includes aggregate allocations for multiple government departments, including for Transport shortfalls and Health excesses.	1,720
Commercial Rates Break / Tax Forbearance & Warehousing: VAT, commercial rates, and other taxes to be either deferred until 2021 or waived entirely for a period of time. Includes tax credits for 'staycation', other similar measures, and loss relief.	3,820
Restart Grant Plus: Cash transfer fund for SMEs affected by Covid-19. Extended and enhanced in July's stimulus package.	550
Labour Market & Investment	**700**
Various: Labour market activation schemes including training funding and employment, investment in education, accelerated capital Works.	700
Health Sector Supports	**2,000**
Increasing capacity, staffing and overtime; securing the use of private healthcare facilities; additional funding in support of the Covid-19 Action Plan; and supports for nursing homes.	
Total:	**25,902**
-- of which direct spending*	18,452
-- of which guarantees / loans / investments	7,450
-- of which contingency allocations to government departments	1,260
Less funds previously allocated for other purposes	–750
Total (less funds previously allocated)	**25,152**

Sources: Department of Finance; DBEI; and Fiscal Council workings.
*The government has also allocated spending for smaller measures related to the Covid-19 crisis, including repatriation of Irish citizens abroad and other measures.

Risks to the deficit for 2020

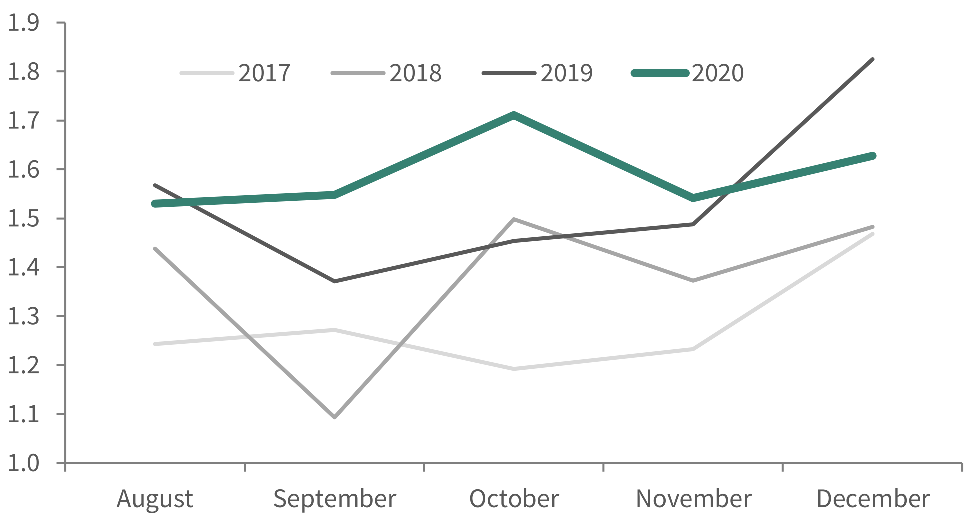
The main risks to the deficit for 2020 relate to developments with Covid-19 and the economy, particularly through tax revenues, the numbers of claimants on existing income support measures and Health spending.

Health spending planned for 2020 could rise due to (1) typical overruns observed late in the year and (2) additional outbreaks or case surges that put pressure on resources to cope with Covid-19 responses, which could compound seasonal flu outbreaks.

Even before Covid-19-related spending measures, the forecast for health spending in late-2020 was likely to have been unrealistic (Figure 13). The official forecasts, estimated pre-Covid-19 and so not including the €2 billion of additional funding for health spending in 2020, show two aspects to projected spending in December: (1) the projection for December does not show the usual seasonal increase in spending compared to preceding months; and (2) spending projected for December is lower than the outturn in 2019. This seems unrealistic even if one were to exclude the Covid-19-related increases in spending.

Figure 13: Initial Health spending forecasts for 2020 suggested a lower level of spending in December compared to last year

€ billion, total gross voted health expenditure by month



Sources: Department of Finance; and Fiscal Council workings.
Note: 2020 refers to the monthly profile as per the *Budget 2020* forecasts. Figures for earlier years are outturns.

4. The Fiscal Stance for *Budget 2021*

In this section, the Council assesses the prudence of the overall fiscal stance for *Budget 2021*. It is informed by (1) a broad economic assessment that considers appropriate management of the cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with the legislated domestic and EU fiscal rules.

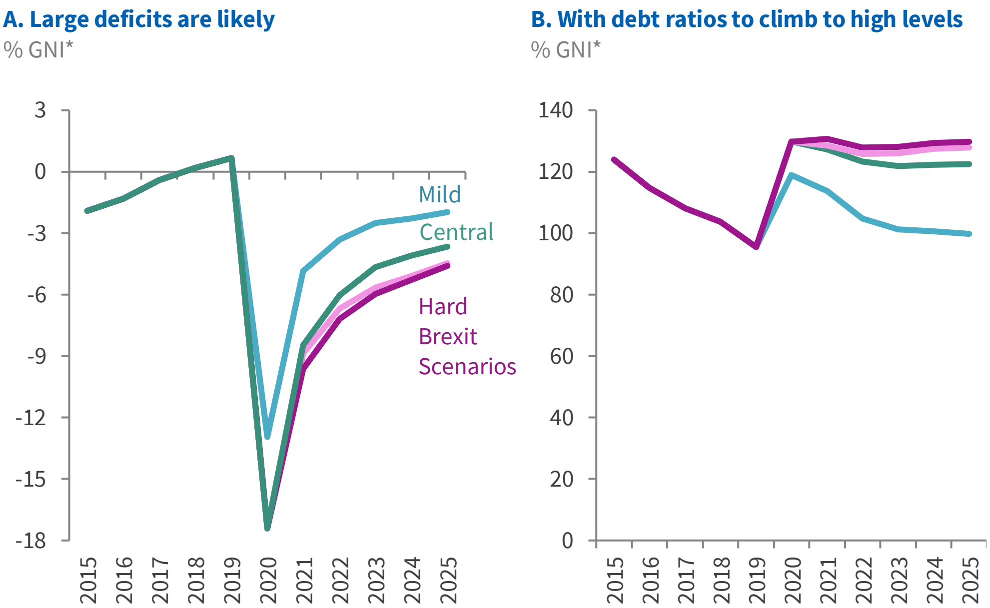
While the immediate fiscal costs associated with Covid-19 will be high, they should for the most part be temporary. Budgetary supports to limit the lasting impacts of the shock should be provided on a large-scale for as long as is needed. This will avoid lengthening and deepening the economic crisis. It will also support a more favourable growth path after the second recovery phase has ended. The growth path that the economy settles on after the recovery from the crisis will be pivotal for determining long-run debt sustainability. Policy needs will change over time, and supportive measures should be adjusted as appropriate to fit these needs.

Given the high uncertainty, Figure 14 considers future fiscal outturns in the context of the Council's macroeconomic scenarios. The scenarios are updated based on new policy measures and tax revenues as discussed in the previous section. It focusses on the Mild and Central scenarios. Also considered are two harder-than-assumed scenarios for the UK-EU trade agreement: a WTO scenario and a disorderly WTO scenario (both are assessed relative to the Central scenario).

While the deficit is projected to be large for 2020 at between 13 per cent and 17½ per cent of GNI* (€23.7 and €30.1 billion), across all scenarios considered, the deficit closes rapidly in 2021 to between about 5 per cent and 9½ per cent in 2021. By 2025, the deficit would be projected to fall to between 2 per cent and 4½ per cent of GNI*. However, these projections do not include the fiscal impact of additional support measures that may be put in place, taking into account their direct costs and their impact on growth. These would tend to lead to a higher deficit for the period they are in place. Since the publication of *SPU 2020*, the Government outlined that the previously planned increase in the state pension age in 2021 is to be deferred pending a review. It is estimated that deferring the pension age increase would cost €575 million in 2021 (Fiscal Council, 2020b).

Running large deficits for an extended period of time will to lead to a higher debt ratio. The revised Mild fiscal scenario would see the debt ratio falling quickly initially, with slower declines in later years and a ratio of close to 100 per cent would still be expected by 2025. However, the Central scenario would see it stabilise at just over 120 per cent of GNI*. With the harder-than-assumed Brexit scenarios, it could be as high as 130 per cent.

Figure 14. Deficits and debt ratios would potentially be very large



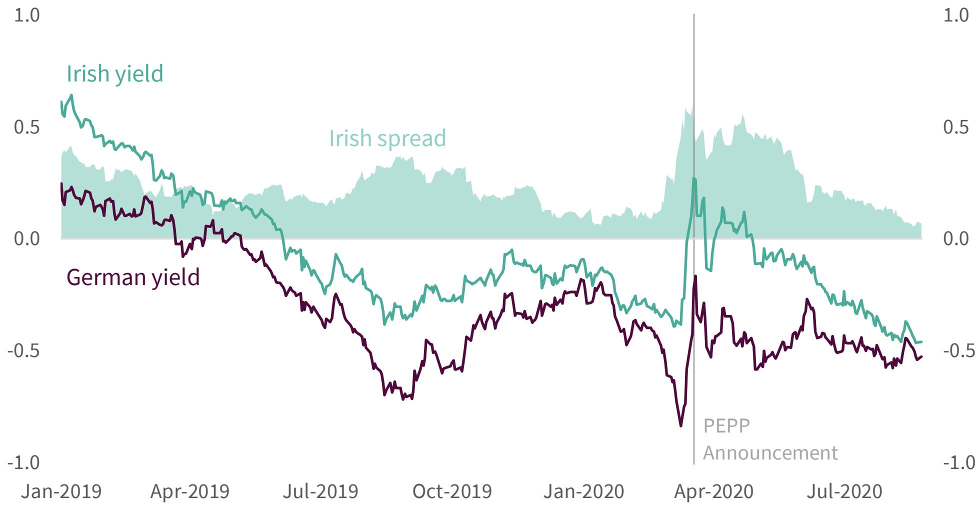
Sources: CSO; Department of Finance; Central Bank of Ireland; Fiscal Assessment Report, May 2020: "The Fiscal Impact of Covid-19".
Notes: The "Hard Brexit scenarios" are based on the macroeconomic impacts associated with the WTO and disorderly WTO scenarios in Central Bank (2020), with these impacts applied to the Central scenario.

The projections assume that interest rates will remain low, converging to roughly 1 per cent for new 10-year borrowings. This is a key assumption. As Figure 15 shows, ten-year bond yields have fallen as a result of the ECB's support measures.

The interest rate reductions are likely to facilitate more favourable debt ratio reductions. While debt ratios are set to rise to higher levels, the path for the future debt ratio will benefit from low interest rates. Where interest costs are less than growth rates, higher debt paradoxically increases the rate at which the debt ratio falls. That is, for the same primary balance, better interest-growth differentials produce larger debt reductions (Barnes and Casey, 2020). This is contingent on interest rates remaining low, though risks to rates rising are mitigated by the fact that the majority of Ireland's outstanding debt is at fixed interest rates.

Figure 15: Bond yield and spread increases contained following ECB programme

% ten-year bond yields and Irish spreads



Source: Datastream; and Fiscal Council workings.
Note: Spreads are the difference between Irish and German ten-year yields. "PEPP" is the European Central Bank's pandemic emergency purchase programme (PEPP) — a non-standard monetary policy measure initiated in March 2020.

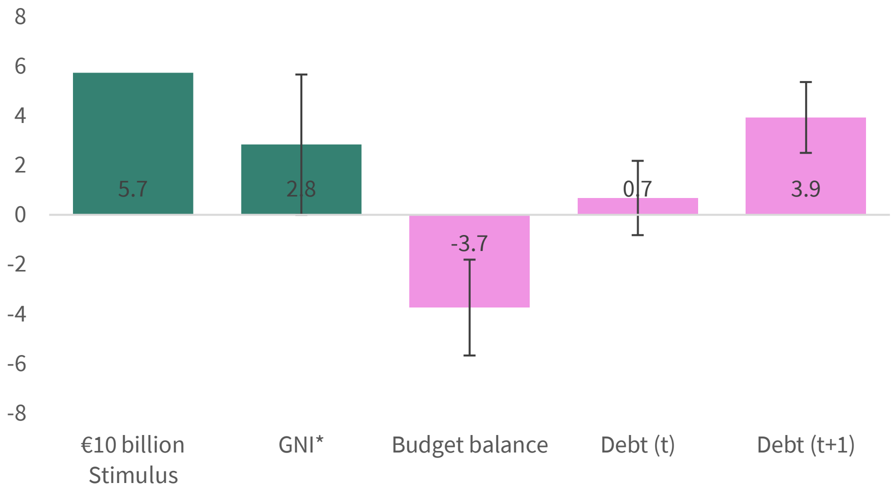
A stimulus is warranted to support the recovery

There is likely to be a large number of individuals unemployed after the immediate crisis has ended. To ensure that individuals unemployed return to work and to put the economy and public finances on a more sustainable path, a sizeable stimulus would be warranted, in addition to on-going support measures where needed. This would help to offset demand shortages in sectors that are worst impacted as well as potentially boosting the supply side and creating incentives to invest. Any stimulus measures should be timely, temporary and targeted.

Two key considerations for any stimulus are the nature of the stimulus and how effective fiscal stimulus can be for sectors where demand is constrained by social distancing measures. First, stimulus should be well-targeted: recent work for Ireland on the economic impacts of fiscal measures (Ivory, Casey and Conroy, 2020) suggests that public investment measures have a greater impact on activity than other types of government spending in the short run. Second, while social distancing is still prominent in some sectors, it may be difficult to increase demand in those activities directly. A stimulus may help to achieve stronger demand in other parts of the economy, while sustaining incomes in those sectors worst affected.

Figure 16: A fiscal stimulus could boost growth in the short-term

% GNI*, 2020 impact



Source: 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.

The appropriate use of a stimulus and the nature of the fiscal stance adopted 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. However, the timing of each phase depends on how the crisis unfolds and, at present, the economy remains somewhere between the first immediate crisis phase and the second recovery phase. While some sectors have survived through the crisis thus far relatively well, others face ongoing challenges. A stimulus should support the recovery phase to help restore employment.

Since the *SPU 2020* was published, a number of additional budgetary supports have been introduced. Some €9½ billion of additional spending and tax cuts have been announced since *SPU 2020*.[24] These tax cuts and additional spending support incomes and boost demand.

The Council previously considered what the impact of an illustrative €10 billion stimulus phased over several years would be when compared to the central scenario set out in the SPU (Fiscal Council, 2020a). The exact amount was not a recommendation and any package should be designed in light of the prevailing circumstances. However, assuming the stimulus is temporary, it could boost nominal modified GNI* by 2.8 percentage points, with the deficit and debt ratio expected to rise by 3.7 and 3.9 percentage points, respectively (Figure 16). Withdrawing the stimulus gradually would also allow demand to adjust in a gradual way. Such a package could be implemented in a staggered way over a number of years to reflect the shape of the recovery and avoid sharp changes in demand. Some stimulus, of course, has already been implemented.

While the size of the stimulus for 2021 should be based on updated forecasts for the Budget, an appropriately-sized contingency should be put in place to cover the costs of a failure to reach a trade agreement between the EU and UK. This should also cover Covid-19-related contingencies including potential extensions to income support schemes beyond next March and for additional stimulus measures should economic damages associated with Covid-19 prove more

[24] This estimate includes all of the additional spending and tax cuts announced. This may somewhat overstate the size of the “stimulus”. Many of the individuals availing of the newly introduced income support schemes (such as the TWSS and PUP) would likely have availed of standard Jobseeker’s Allowance or Jobseeker’s Benefit in the absence of the new schemes. Another way to calculate the actual cost of the new income support schemes would therefore be to exclude the automatic increases in spending in areas such as social protection that would have resulted absent those schemes. This would lower the estimated discretionary stimulus provided by the new schemes.

severe. Such contingencies help to support budgetary planning in the face of known risks of uncertain size, making a useful distinction between fiscal measures that will implemented in any event and other areas where policies will depend on the course of future events. This can improve planning and transparency. As it stands some measures have already been adopted by the Government and some might be included in any contingency for 2021 and later years.

The July stimulus included €0.5 billion to accelerate “capital works” that were already planned for in coming years.[25] This equates to just over 2 per cent of total direct supports provided thus far in terms of the cumulative amount of policy support implemented by the Government and about 6 per cent of planned capital spending for 2020. There is scope for future measures to be more focused on investment areas that would be more likely to provide stronger support to economic activity.

Measures that focus on job activation and re-training also form a relatively small part of the supports provided to date. Activation measures were included in the July Stimulus but amounted to just €0.2 billion. This would be particularly true if vulnerable sectors were to remain constrained by necessary health and social distancing measures for a long time.

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[25] Mainly comprised of €113 million for active travel, public transport and renewal of transport infrastructure; €100 million for the Energy Efficiency National Retrofit Programme; €75 million for minor works on primary and secondary schools; and €60 million for returning vacant local authority housing to use and investment in water infrastructure (Department of the Taoiseach, 2020).

Dealing with a harder-than-expected Brexit

UK exit from the EU Single Market could add further stresses to the Irish economy starting at the end of 2020, beyond those caused by Covid-19.

The assumption in April's *SPU 2020* official projections and Council projections is that a Free Trade Agreement is formed and that the impacts on the economy are relatively modest. However, negotiations could fail such that the UK reverts to a more restrictive WTO trading arrangement with the EU.

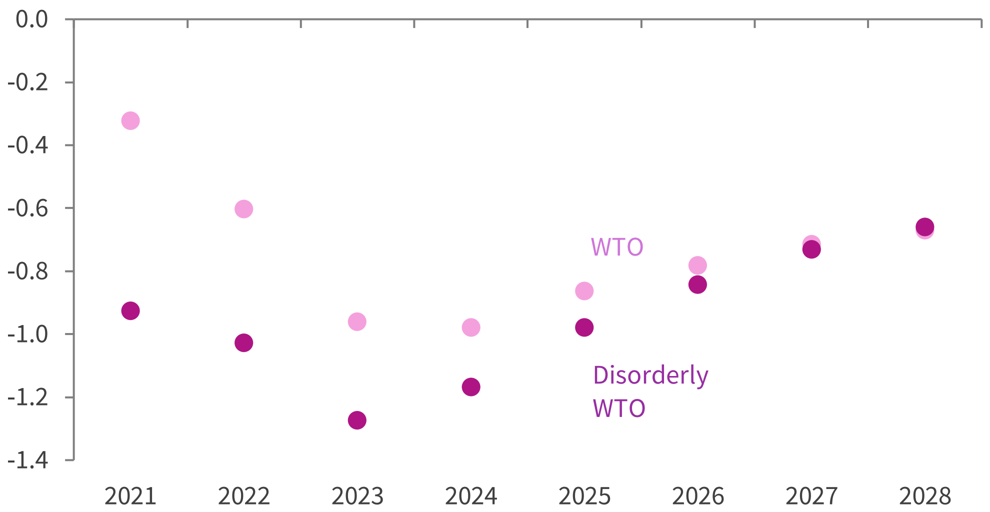
As Box A shows, sectors with the greatest exposure to Brexit are somewhat negatively correlated with those most exposed to the pandemic. This has advantages in the sense that firms vulnerable to Brexit may have had less of their cash reserves depleted as a result of the pandemic and may have had more scope to prepare for the transition. However, it also means that the shock is likely to widen the number of firms that are exposed to weaker demand for their goods and services, assuming that the pandemic continues to hamper demand elsewhere.

A Brexit on WTO terms (rather than a free trade agreement) would have a significant adverse impact on the public finances. If a disorderly WTO scenario were to arise, these impacts would be more severe initially. For 2021, a WTO scenario would be estimated to increase the deficit by 0.3 percentage points of GNI* compared to an FTA scenario (Figure 17). A disorderly WTO scenario could increase the deficit by as much as 0.9 percentage points. The impact on the deficit would be expected to peak in 2023 at between 1 and 1.3 percentage points of GNI* before diminishing to about 0.7 percentage points in 2028 under both scenarios.

The fiscal stance will have to be adjusted to allow for the impact of Brexit over and above the impact of the pandemic. Letting the automatic stabilisers operate—letting unemployment-related spending rise and taxes fall—would be appropriate. However, if Brexit turns out to be more severe, the situation would be more challenging. A stimulus would be desirable and an appropriate response to support the economy in a time of unusually weak demand. Long-term levels of output would be worse in any such scenario rather than simply being an issue of temporary disorder in the economy. Should a more adverse shock materialise, the policy response would need to be carefully assessed.

Figure 17: Impact on the GGB of an orderly/disorderly WTO Brexit scenario (relative to FTA)

Percentage points, GNI*



Sources: Conefrey and Walsh (2020); and Fiscal Council workings.
Notes: Impact shown is calculated as WTO impact minus FTA impact.

Flexibility in the fiscal rules and European financing

While Ireland entered the current crisis in a reasonable fiscal position, had spending limits been adhered to, Ireland's fiscal position could have been better.

In 2019, under the Council's Principles Based Approach to the Domestic Budgetary Rule, the structural balance of -0.2 per cent of GDP was better than the Medium-term Budgetary Objective of a structural balance of no lower than -0.5 per cent of GDP. [26] Net expenditure in 2019 also grew at a pace below the limit set under the Expenditure Benchmark. However, Ireland's compliance with the fiscal rules in recent years has been flattered by Corporation tax receipts that are in excess of what can be explained by underlying economic activity (see Figure 6.B).

On 13th March, the European Commission activated the general escape clause in the *Stability and Growth Pact*.[27] This clause allows for a temporary deviation from the budgetary requirements under the fiscal rules for all Member States in 2020.

Given that the pandemic will persist into next year, it is likely that the general escape clause will remain in place, at least into 2021. The Country Specific Recommendations for Ireland did not include any quantitative fiscal requirements for 2021.[28]

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[26] The structural balance gives a measure of the underlying trend in the budget balance. The structural balance is the actual general government budget balance net of a cyclical component and one-off and other temporary measures.

[27] See the Communication from the Commission to the Council on the activation of the General Escape Clause of the Stability and Growth Pact (March, 2020): https://ec.europa.eu/info/sites/info/files/economy-finance/2_en_act_part1_v3-adopted_text.pdf.

[28] The Country Specific Recommendations for Ireland recommend that in 2020 and 2021 Ireland should, "In line with the general escape clause, take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment". See https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1591720698631&uri=CELEX%3A52020DC0507.

However, the application of the general escape clause does not suspend the procedures of the *Stability and Growth Pact.* Instead, it allows for a temporary deviation from its requirements for as long as the general escape clause is active. This means that, as Ireland has been found non-compliant with the deficit criterion for 2020 (a deficit greater than 3 per cent of GDP), an "Excessive Deficit Procedure" will be opened.[29, 30] It is likely that, once the general escape clause ceases to be active, any budgetary requirements will be set under the Excessive Deficit Procedure (EDP). Under normal circumstances the minimum annual requirement under the EDP is an adjustment in the structural balance of 0.5 per cent of GDP.

Box C outlines the funds available from the EU's recovery package.

Box C: The EU's recovery package

On the 21st July 2020, European Council agreed to €750 billion recovery fund named "Next Generation EU".[31] As part of the package, the EU will borrow the €750 billion from capital markets to finance expenditures throughout the Union, with €360 billion comprising of loans to Member States, while €5.6 billion is for guarantees, and €384.4 billion for grants to Member States.[32]

Of the grants, the Recovery and Resilience fund accounts for the majority of funds (€312.5 billion). Of the €312.5 billion, 70 per cent of the fund will be distributed in 2021 and 2022 and will be allocated on the basis of a predefined allocation key.[33] The remaining 30 per cent will be distributed in 2023 on the basis of an updated allocation key which takes into account economic outcomes in 2020 and 2021.[34]

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[29] For Article 126(3) report on the existence of the excessive deficit in Ireland for 2020 see: https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-541-ie_en.pdf.

[30] In May 2020, the Commission opted to delay launching the Excessive Deficit Procedure. See Box 1 of the 2020 European Semester: Commission Communication on Country Specific Recommendations for an outline of the rationale behind not launching an EDP for Member States at that juncture: https://ec.europa.eu/info/publications/2020-european-semester-commission-communication-country-specific-recommendations_en.

[31] The €750 billion is based on 2018 prices.

[32] Loans for a Member state cannot exceed 6.8 per cent of the member states GNI.

[33] The allocation is determined based on criteria relative to the EU 27 average. The allocation depends on 1) the 2019 population, 2) the inverse of the 2019 GDP per capita, and 3) the 2015-2019 average unemployment rate (Darvas, 2020).

[34] The updated allocation key replaces the unemployment criterion with an equal proportional weight of 1) the loss in real GDP in 2020, and 2) the cumulative loss in real GDP over the period 2020-2021.

As the final allocation of grants is based on future GDP outcomes for both Ireland and the rest of the EU, it is uncertain how much Ireland will ultimately benefit from the recovery fund. However, on the basis of European Commission forecasts, it is estimated that Ireland will receive €1.53 billion in grants over 2021-2023 from the Next Generation EU fund (Darvas, 2020).

Net borrowing activity of the Fund will stop by the end of 2026, with the final repayment scheduled to take place before the end of 2058 (European Council, 2020). This means that repayment of the fund will be spread out over 30 years. The fund will be repaid in part by contributions from "new own resources" and from contributions from Member States.[35] Member States contributions in a given year are linked to GNI. This means that there is uncertainty around how much Ireland will contribution to the fund as it depends on future Irish GNI and on the future GNI of other member states. It has been suggested that Ireland will contribute in the region of €18.7 billion to the Next Generation EU fund over the next 30 years.[36] However, this is likely an overstatement of Irelands potential contributions, as it is based on Ireland's share (2.5 per cent) of the total €750 billion.[37] Of which, €360 billion is for loans to Member State. The individual Member States that receive these loans are the ones responsible for repaying the corresponding amount they receive. So, Ireland's actual contribution will be based on the remaining €390 billion (the equivalent 2.5 per cent share for Ireland is €9.7 billion) in addition to the repayment of loans Ireland might receive from the fund, should Ireland choose to access these loans.[38]

In addition to the Next Generation EU fund, an additional €5 billion from a Brexit Adjustment Reserve has been agreed to help Member States affected by Brexit. The mechanism for allocation of these funds across Member States has yet to be worked out.

[35] New own resources include a new carbon border adjustment mechanism, a digital levy, a national contribution based on the weight of non-recycled plastic packaging waste, amongst others (European Council, 2020).

[36] See *EU Budget Contribution Dáil Éireann Debate*, Tuesday - 28 July 2020: https://www.oireachtas.ie/en/debates/question/2020-07-28/219/.

[37] The €18.7 billion figure is based on Ireland's share of 2019 EU GDP and comes from Table A.1 of the European Commission Staff Working Document *Identifying Europe's recovery needs:* https://ec.europa.eu/info/sites/info/files/economy-finance/assessment_of_economic_and_investment_needs.pdf. This document was prepared prior to the final details of the Next Generation EU fund being agreed.

[38] Loans to each Member State cannot exceed 6.5 per cent of its GNI.

Developing a credible budgetary framework amid medium-run challenges

The impact of Covid-19 will be evident on the public finances long after the economy recovers. Higher debt ratios, higher annual funding requirements and higher debt servicing payments will result. This will limit the scope for deficit-financing of public services and supports.

There is a strong possibility that a large structural deficit may have to be closed once the crisis has ended and the economy and employment has recovered. The *May 2020 Fiscal Assessment Report* considered several scenarios for the economy, policy approaches (including a stimulus) and the adjustments that might be required for spending and revenue from 2023 onwards. In all scenarios, the adjustments required were estimated to be substantially less than was required after the 2008 financial crisis. For instance, the Mild and Central scenarios were estimated to involve adjustments between a fifth and a third the size of the overall adjustment required after the financial crisis.

However, three key long-run challenges will also become more prominent at the same time as policymakers finally get to grips with the costs of the Covid-19 crisis and the new trading relationship between the UK and the EU: ageing, climate change and the over-reliance on corporation tax receipts.

Ageing pressures

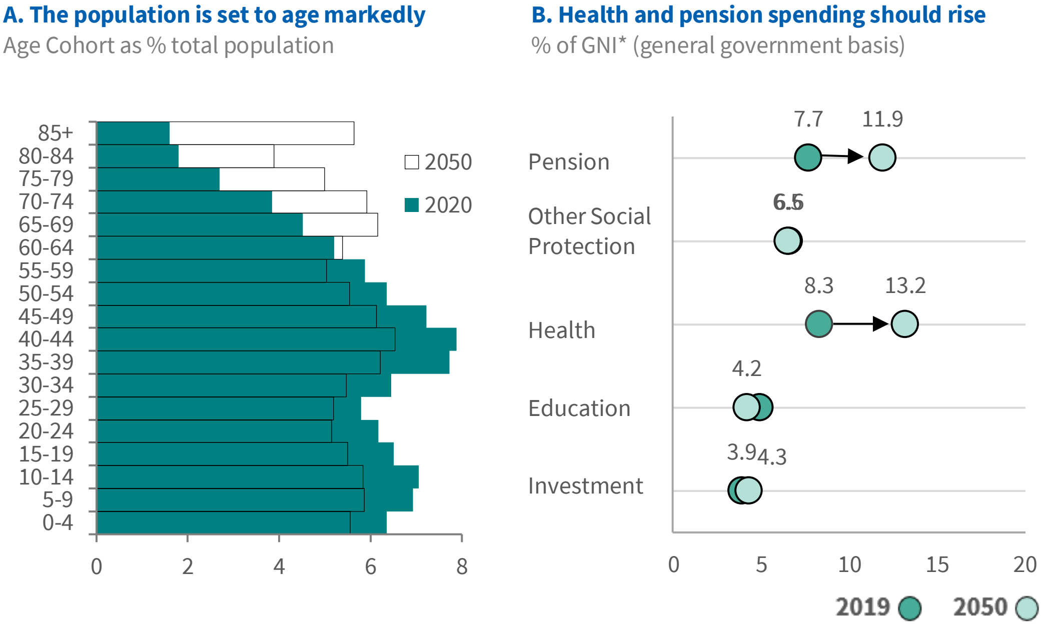
The Council's first Long-term Sustainability Report (Fiscal Council, 2020b) highlighted how the Irish population is likely to age rapidly in coming decades (Figure 18A). This will put pressure on spending that is sensitive to ageing, most notably health and pension spending.

By 2030, health spending is projected to add 2.5 percentage points of GNI* to deficits when compared to 2019, assuming policies are unchanged, and a further 2.3 percentage points by 2050. Pension spending would add some 1.4 percentage points to the deficit by 2030, and a further 2.7 percentage points by 2050 (Figure 18).

However, these figures are on the basis of current legislation. The Programme for Government has committed to the establishment of a Commission on Pensions to outline options for addressing issues relating to the sustainability and the eligibility of state pensions (Fine Gael, Fianna Fáil and Green Party, 2020). The Commission is to report by June 2021. In the meantime, the Government has committed to deferring the legislated increase in the state pension age from 66 to 67 that is due to take place next year. It is estimated that deferring the pension age increase would cost €575 million in 2021 (Fiscal Council, 2020b). In addition, keeping the pension age at 66 instead of the legislated increase to 68 in 2028, would cost €1.5 billion.

Some reforms will inevitably be required to ensure that these spending pressures do not lead to unsustainable increases in government debt. Taking action earlier to strengthen the budget balance through increases in revenues or decreases in spending would ultimately require less fiscal adjustment overall. For instance, if these adjustments took place from 2026–2035, they would be less than half the scale of required adjustments if delayed until 2036– 2050. Timely action to reform the pension system, including pension age increases and other reforms to the pension system, would reduce the impact of ageing costs.

Figure 18: An ageing population is projected to increase health and pension spending



Sources: Eurostat; CSO; Department of Public Expenditure and Reform; Department of Finance; and Fiscal Council projections.
Note: The bars in Panel A are in terms of shares of 5-year age cohorts, except for the 85+ age category. The underlying total population is 4.9 million in 2020 and 6.0 million in 2050. For Panel B, Pension includes public sector pensions; Health includes long-term care, and is based on the assumption that the pension age increases to 67 in 2021 and to 68 in 2028 as is currently legislated.

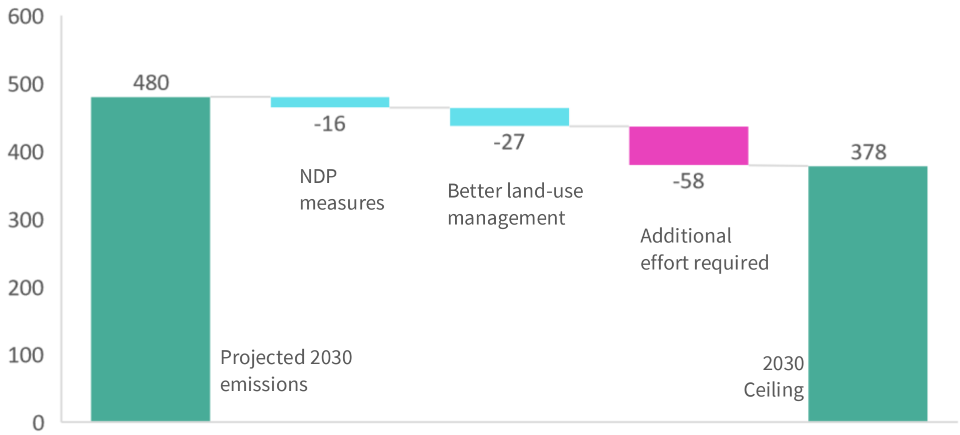
Climate change

Another long-run challenge is climate change. Excessive dry weather, rainfall or rising sea levels will potentially have widespread impacts on the economy and public finances, while measures to reduce emissions or mitigate climate change are likely to lead to fiscal costs.

Already, expenditure of roughly 1.5 per cent of GNI* per annum is allocated to address climate change under the National Development Plan 2018–2027 (Department of Public Expenditure and Reform, 2018). However, both the level and share of expenditure on climate-related activities is likely to rise over the long term, given physical and transitional risks. Figure 19 shows the projected emissions for 2030, alongside the impact of current plans on these projects. Further government initiatives and spending will be required if Ireland is to meet its 2030 targets.[39] In addition, revenues with strong links to carbon emissions (such as vehicle registration tax and motor tax) contribute more than 2 per cent of GNI* to annual revenues and are likely to eventually decline as behaviour changes even if carbon tax rates rise in the interim.

Figure 19: Additional measures are needed to meet the 2030 ceiling

Levels of greenhouse gas emissions (Mt CO_2eq)



Sources: Source: Climate Action Plan 2019.
Note: NDP = National Development Plan.

It is important that policymakers set out credible plans for addressing challenges associated with climate change. A smoother transition towards meeting Ireland's commitments for a low-carbon economy would help to reduce the adverse impact that mitigation policies may have on the economy. It is also likely that delayed mitigation action may result in more drastic and costly action having to be taken in later years, at the same time as ageing pressures are rapidly increasing.

The reliance on corporation tax receipts

Recent years have seen a strong reliance on corporation tax receipts develop. Over 18 per cent of Exchequer tax receipts were accounted for by corporation tax in 2018 and 2019 — up from a low of 10.3 per cent in 2011. While the strong performance of corporation tax has been helpful

[39] See Box E of the Long-term Sustainability Report (Fiscal Council 2020b) for a more detailed discussion of these issues.

in sustaining the government's revenues in 2020 as other taxes fell, it is also likely to result in a higher dependency on these receipts.

The standard risks associated with corporation tax receipts relate to its volatility, the difficulties in forecasting it accurately, the high concentration in relatively few companies, and the vulnerability to reversals. Reversals could happen as a result of company-specific decisions or changes in global circumstances and policy regimes (for example, including the OECD BEPS initiatives). If this were to happen, the Government could be faced with the possibility of a sharp drop in revenues and a related deterioration in the budget deficit. Covid-19 could potentially lead to new risks associated with corporation tax receipts. It could lead to a shift in decisions in terms of where companies choose to locate.

A fall in corporation tax receipts could compound debt increases in future years. A scenario considered in the Council's Long-term Sustainability Report (Fiscal Council, 2020) is one where corporation tax receipts were to fall by a further €3.5 billion beyond the €2 billion assumed by the Department of Finance in coming years. The result—even with no real economy impact assumed—would be for the debt ratio to end up about 26 percentage points higher by 2050, unless policy were to respond by introducing additional revenue-raising measures or savings elsewhere.

The importance of keeping options on the table

With big challenges ahead, high uncertainty and the Government's stated ambitions to proceed with large reforms such as Sláintecare, the Government should keep all options on the table. This would recognise the reality that difficult economic and political choices are likely to be needed to close any remaining structural deficit after the economy recovers from the pandemic and Brexit.

However, as Box D shows, the Programme for Government (Fine Gael, Fianna Fáil and Green Party, 2020) lacks clear commitments to finance new spending in the coming years with sustainable sources. There are limited references to specific plans to reduce existing spending programmes or to raise revenues. This calls into question the credibility of the new Government in terms of its willingness to maintain a prudent budgetary stance. There is also no explicit commitment to the EU and domestic fiscal rules, any reference to the Rainy Day Fund, nor are there any plans to improve medium-term budgeting and to reduce the Government's reliance on corporation tax.

The Programme for Government commits to setting out a medium-term roadmap detailing how Ireland will reduce the deficit and return to a broadly balanced budget as part of *Budget 2021*. This will partly be facilitated by the commitment to establish a new independent Commission on Welfare and Taxation to consider how the tax system can support economic activity, while ensuring that there are sufficient resources available to meet the costs of the public spending.

While there will still be considerable uncertainty about the impact of the pandemic and Brexit, it will be helpful to have a clearer roadmap for how competing pressures will be managed and what the Government would do in its main scenario for the next five years. It is important to avoid ruling out scope for the public finances to adjust to changing circumstances.

Box D: Options for funding the Programme for Government

On the 15th June 2020, Fianna Fáil, Fine Gael and the Green Party published an extensive Programme for Government. Among other things, the Programme focused on increased public spending on housing and healthcare and ambitious policies to reduce carbon emissions. However, there were relatively few areas identified for financing these ambitions, either through tax-raising measures or reduced spending elsewhere. This box takes a look at some of the margins for adjustment that were effectively ruled out.

Major areas for spending and tax adjustments ruled out

The Programme for Government rules out changes to a number of key areas that could sustainably finance future spending plans.

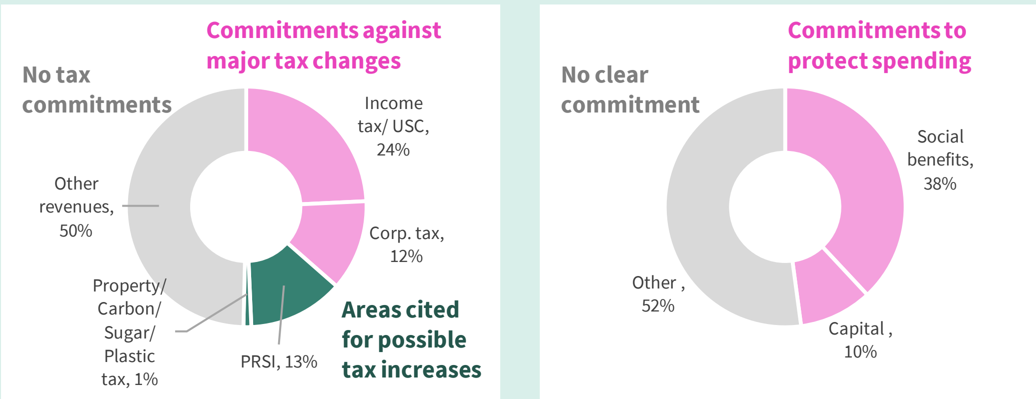
On the revenue side, the Programme makes commitments not to increase taxes that cover a third of overall taxation. This includes income tax and the universal social charge — effectively a quarter of all revenues (Figure D1A). It also notes that from Budget 2022 onwards, credits and bands will be indexed to earnings that would prevent an increase in the real burden of income tax provided that incomes are rising again. This would further limit the scope to use increasing incomes to finance increases in public spending. The Programme also notes that the Government is committed to the 12.5 per cent corporation tax rate.

Instead, it commits to focus any changes in tax on either PRSI or a number of areas that represent a relatively small share of overall revenue, specifying an intention to tax "behaviours with negative externalities, such as carbon tax, sugar tax, and plastics" (p.23). Together, these represent about 14 per cent of all existing tax revenues. The Programme does commit to increase the carbon tax to €100 per tonne from €26 by 2030 though this revenue source would be expected to dwindle over time as behaviours change and individuals move away from carbon-intensive activities. Revenues raised from the new taxes would be relatively small compared to the other tax heads. Overall, half of revenues, including VAT, do not have any clear commitment.

Figure D1: Limited financing commitments in Programme for Government

A. Revenue measures
% total general government revenue

B. Health and pension spending should rise
% total general government spending (excl. interest)



On the spending side, the Programme commits to "protect" core weekly social welfare rates. Social benefits represent about 38 per cent of total non-interest spending by the general government (Figure D1B). Similarly, there is a commitment to not frustrate or delay existing projects in relation to the National Development Plan, which sets out public capital initiatives for the coming years. Public capital spending represents 10 per cent of non-interest spending.

A credible medium-term budgetary framework

Dealing with the challenges posed by Covid-19, an ageing population and climate change will require careful planning and monitoring. 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 Government should reinforce Ireland's fiscal framework to ensure that the public finances are managed prudently so that public services and supports can be funded sustainably. This would help to avoid the mistakes of the past when Ireland had to cut spending and raise taxes as conditions deteriorated.

The Council assesses that three key 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 (Fiscal Council 2020a; 2019; Barnes and Casey, 2019; and Casey *et al.*, 2018).

Reform 1: Meaningful debt ratio targets

Debt targets 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. To address these risks, the Rainy Day Fund can be redesigned to operate in a countercyclical manner. It should not be capped at a set amount and annual allocations should not be pre-determined as this undermines countercyclical objectives. Moreover, its scope to be used in a downturn should be clarified in the context of the EU fiscal rules. While such a fund may not be needed for a while following the Covid-19 crisis, it is more likely that payments will be made in a future upswing in a timely way if an appropriate instrument is in place. It may also be used, including with a Prudent Account, to help manage future increases in Corporation tax beyond those that can be considered sustainable.

Reform 3: Sustainable spending limits

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. 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 overall spending 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 the long-run sustainability of Irish budgetary policy.

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