3.4 Medium-term Fiscal Scenarios and Risk Analysis

Five-year-ahead fiscal projections, as usually provided in the Budget and SPU, are key to informing budgetary choices. With uncertainty exceptionally high, this section develops three fiscal scenarios out to 2025 that are consistent with the three scenarios set out in Chapter 2. The Extended *Budget 2021* scenario is designed so that it matches general government expenditure and revenue forecasts (for 2020 and 2021) published in *Budget 2021*. These scenarios reflect both different economic outcomes and the different policy measures required in each scenario, assuming that policy reactions are broadly in line with those to date.

The Extended *Budget 2021* and Milder scenarios do not take into account the six-week Level 5 restrictions which were announced after *Budget 2021* projections were made. As a result, projections for these two scenarios for 2020 may overstate revenue (unless tax receipts outperform) and understate expenditure. The Repeated Waves scenario does incorporate an assumed increase in restrictions in Q4 2020.

Box G: Policy Measures and Fiscal Scenarios

This box sets out three fiscal scenarios based on the macroeconomic scenarios set out in Chapter 2. These scenarios are based on the implementation of announced and existing policy measures. For periods of heightened confinement measures, it is assumed that the Government mobilises the same supports as have been used to date. For the Repeat Waves scenario, there are additional 8 week-long periods of heavy restrictions assumed for Q4 2020, Q2 2021, Q4 2021, Q2 2022 and Q4 2022. No vaccine is assumed to be widely available until Q1 2023. In the Milder scenario, a vaccine is assumed to be widely available and distributed by the middle of 2021.

We identify the Covid-19 related-expenditure budgeted for 2021 using data from the Expenditure report. For the Extended *Budget 2021* scenario, we assume that this expenditure is not carried forward into 2022 or beyond (when a vaccine is assumed to be widely available). As outlined earlier, this still implies a significant increase in permanent expenditure in 2021, which carries into 2022. In all three scenarios, this permanent increase in expenditure is reflected in forecasts of spending. However, in the short run, the amount of temporary Covid-19 spending varies between the three scenarios. For the Milder scenario, not all of the budgeted Covid-19-related expenditure is needed in 2021, as Covid-19 is controlled mid-way through the year. Conversely, in the Repeat Waves scenario, much of the Covid-19 spending continues into 2022, as described below.

Income supports/Unemployment payments.

In periods of heavy restrictions, we assume that the enhanced PUP and the EWSS are available. We base the costs of the EWSS on the published estimates of how much it is expected to cost for the recently announced 6-week period of heavy restrictions. This implied a cost of €340 million per month.

Four of the additional periods of heavy restrictions occur after Q1 2021, when the EWSS is assumed to have ended, hence the full cost is in addition to what is included in the Extended

Budget 2021 and Milder scenarios. In all other periods, those who are unemployed are assumed to receive the standard Jobseeker's Benefit/Jobseeker's Allowance payments. This is different from the policy employed since the beginning of the pandemic, but it is the basis on which *Budget 2021* forecasts were made. An obvious risk to spending levels is that these enhanced unemployment payment rates are extended beyond Q1 2021.

We assume that social welfare payments are indexed in line with private-sector wages after 2021. Pension expenditure (state pensions and public-sector pensions) is projected to increase by approximately €1 billion per year on average over 2022–2025. This is driven by both demographic change and increases in line with private sector wages. It is assumed that the statutory retirement age remains at 66 during the forecast horizon.

Health expenditure

We assume that the additional funding planned for health spending is sufficient in the Extended *Budget 2021* scenario. For the Milder scenario, we assume the same level of health expenditure in 2020 compared to the Extended *Budget 2021* scenario. For 2021, as a vaccine is assumed to be available in the middle of the year, we assume that Covid-19-related healthcare expenditure in 2021 is half of that in the Extended *Budget 2021* projections. This results in a saving of €1 billion, mainly assumed to be in intermediate consumption.

For the Repeat Waves scenario, we assume that each additional period of heavy restrictions implies additional healthcare costs of €0.5 billion per 8-week period in 2020 and 2021. We assume that in 2022 this cost halves, as some capacity and equipment has already been built up. As a result, for the Repeat Waves scenario, there is an additional €0.5 billion of health spending in Q4 2020, Q2 2021 and Q4 2021. For Q2 2022 and Q4 2022, there is additional health spending of €0.25 billion.

Beyond 2021, for all three scenarios, health spending is projected forward using Fiscal Council Stand-Still (Fiscal Council, 2019b) estimates (with the exception of the periods of heavy restrictions for the Repeated Waves scenario). These are estimates of the cost of maintaining 2021 service levels, after taking account of service demand (driven by demographics) and price pressures. In all scenarios, Covid-19 specific health spending is excluded from the base when projecting into the later years.

Business supports

For the Extended *Budget 2021* and Milder scenarios, it is assumed that loan guarantees do not lead to fiscal costs. As a result, the only costs incurred are the additional €0.13 billion in business supports which are included in *Budget 2021* projections.

The maximum amount of exposure to the State under the credit guarantee scheme is currently €2 billion. Under the Repeat waves scenario, we assume that business support schemes are expanded. Under these more adverse economic conditions, borrowers have a higher credit risk and subsequently large amounts of nonrepayment and default. As a result, €500 million of losses arise in 2023 and a further €1 billion in 2024.[56] There is risk outside the scenario that the State would have to intervene in other cases, potentially leading to higher costs.

Public pay bill

For the Extended *Budget 2021* scenario, *Budget 2021* forecasts of compensation of employees are used for 2020 and 2021. Thereafter, Fiscal Council Stand-Still Scenario estimates are used (Fiscal Council, 2019b). These take account of increases in public sector employment required to hold service levels constant in light of increasing demand due to demographic change.

[56] This does not include the non-repayment of warehoused tax liabilities. This is addressed below in the revenue section.

We account for some health staffing being considered temporary in 2021. This is quite small however, as most of the Covid-19-related health spending is understood to be on equipment (intermediate consumption in general government terms).

Pay rates are assumed to increase in line with private sector wages. There are slight differences between the three scenarios for the public sector pay bill, as inflation and private sector wage pressures differs in each of the three scenarios.

Capital spending

For the Extended *Budget 2021* and Repeat Waves scenarios, capital spending takes the values forecast in *Budget 2021* for 2020 and 2021. For the Milder scenario, capital spending is slightly lower in 2021 as some capital expenditure for 2021 is Covid-19 related.

After 2021, general government capital spending is assumed to be 4.4 per cent of GNI*. This reflects previous government plans to have Exchequer capital spending amounting to 4 per cent of GNI*. A further 0.4 percentage points of non-exchequer spending is assumed, with general government public investment assumed at 4.4 per cent.

As GNI* is different in each of three scenarios, this mechanically leads to different levels of capital expenditure in each of the three scenarios. In 2025, capital spending in the Milder scenario is projected to be €0.8 billion higher than in the Repeat Waves scenario.

Unallocated resources

Budget 2021 outlines that there are €5.5 billion of expenditure which is yet to be allocated to specific areas for 2021. This is in addition to the areas covered above. Specifically, €3.4 billion relates to the *Recovery Fund,* with the remaining €2.1 billion for other expenditure which may arise (Covid-19 Contingency Reserve). In the Extended *Budget 2021* and Repeat Waves scenario, it assumed that these resources are spent in full. For the Milder scenario, it is assumed that the Recovery fund is spent in full, with half of the Covid-19 contingency fund spent in 2021 (€1.05 billion). In the Repeat Waves scenario, it is assumed that the €2.1 billion of spending under the Covid-19 contingency fund is required in 2022 also.

Revenue

In terms of government revenue, we assume that there is no difference in policy between the three scenarios. In effect, this assumes that there are no major policy changes that yield or cost significant revenue, apart from those already announced in *Budget 2021*.[57]

We assume that the carbon tax is increased by €7.50 per tonne/CO2 every year out to 2025. We also assume this does not trigger major behavioural responses, hence the yield from each increase is the same as that given in *Budget 2021* documentation (€108 million in the initial year, €147 million in a full year).

Two temporary policy changes have been made to VAT. The temporary reduction to the higher rate of VAT (from 23 per cent to 21 per cent) is due to expire on 28th February 2021. For the three scenarios it is assumed that thereafter the rate reverts to its previous higher level. This leads to €160 million of extra receipts in 2023 and thereafter. The VAT rate applicable to tourism and hospitality sectors has been reduced from 13.5 per cent to 9 per cent. This is scheduled to revert at the end of 2021. For the three scenarios we assume that the lower rate is maintained out to 2025. Previous experience suggests that a temporary cut to this VAT rate can remain for much longer than anticipated. Were this VAT rate to revert to 13.5 per cent, it would yield approximately an additional €335 million of receipts annually from 2022 onwards.

Budget 2021 forecasts were made based on around €2 billion of warehousing of income tax and VAT in 2020. It is expected that about €1.5 billion of this will be recouped in 2021 and 2022,

[57] For income tax, beyond 2022, it is assumed that tax bands widened in line with wage rates. As a result, there is no yield from non-indexation beyond 2022.

with €0.5 billion proving to be non- recoverable. In the Repeat Waves scenario, we assume that an additional €0.5 billion is not recovered in 2021/2.

Changes in the macroeconomic driver multiplied by the elasticity are used for projections of revenue. Judgement applied to forecasts in 2020 and 2021 is assumed to unwind over the following two years. As a result, there is no judgement applied for 2024 or 2025 (apart from corporation tax).

For income tax, receipts in 2020 fell much less sharply than developments in income combined with a standard elasticity would have suggested. This reflects the distributional pattern of job losses to date which have been focused in lower paid sectors. In effect, this means the actual elasticity which is applying to income tax receipts is much lower than would typically be the case. When employment and income recovers, one might expect a similarly low elasticity to apply.

To incorporate this formally, we use three different elasticities to project income tax. We use a low elasticity (60 per cent lower than standard) when unemployment is high. We use a slightly higher elasticity when unemployment recovers somewhat. Finally, when unemployment gets close to pre pandemic levels, the standard elasticity applies.[58]

Corporation Tax

Judgement is applied to corporation tax receipts after 2021. This is to take account of the possible impact of the OECD's BEPS initiative. The amount of judgement applied is based on the estimates given in the *January 2020 Fiscal Strategy* published by the Department of Finance (2020b). Corporation tax receipts are reduced relative to the baseline level by €0.5 billion in 2022, €1 billion in 2023, €1.5 billion in 2024, and €2 billion in 2025.

In addition to the BEPS based judgement, further negative judgement of a similar quantity is also applied to corporation tax receipts. This is a prudent approach that aims to reflect the risk of a gradual loss of some of the corporation tax receipts that might be considered "excess" relative to domestic economic growth. Fiscal Council (2020a) showed that up to €5.4 billion of 2019 corporation tax receipts could be considered excess. Despite this negative judgement, corporation tax receipts are projected to stay relatively flat (from 2020) in the extended *Budget 2021* scenario.[59]

Budget dynamics and interest costs

An interest model nested in the Council's Fiscal Feedbacks Model was used to generate interest projections, with the assumption that marginal interest costs were about 1 per cent in each scenario. This is an increase relative to current levels (with Irish ten-year bond yields averaging -0.5 per cent over the past three months) and, hence, is a somewhat prudent assumption.

While there are upside risks to this assumption for more severe scenarios, more accommodative monetary policy would also be possible in those scenarios, which would be expected to drive down interest rates. The Extended *Budget 2021* and Repeat Waves scenarios mirror projected interest costs for 2020 and 2021, while the Milder scenario has lower costs for 2021.

[58] Income tax receipts in 2022 are forecast to surpass 2019 levels in the Extended *Budget 2021* scenario. This is consistent with the projection that nominal non-agricultural income will exceed its 2019 level in 2022.

[59] Despite the negative judgement applied, 2025 levels of corporation tax in the Extended *Budget 2021* scenario are €0.7 billion higher than was the case in the central scenario in the May 2020 Fiscal Assessment Report.