Chapter 1

Assessment of Fiscal Stance

1. Assessment of the Fiscal Stance

Key Messages

- The Government based its *Budget 2021* forecasts for 2020 and 2021 on the view that Covid-19 and Brexit would continue to have a major impact. It assumed that a vaccine would not be widely available until at least 2022 and that trade between the UK and the EU would be based on a hard Brexit with WTO terms from January 2021.

- The *Budget 2021* projections imply a 6 per cent decline in real GNI* this year, with a muted 2 per cent recovery in 2021. Sectors like retail, hospitality, transport and the arts, are especially vulnerable to the pandemic. State supports have cushioned the impact of the unprecedented fall in demand for workers. However, there are risks that the economic impacts of the crisis might be felt for a long time.

- Rather than the usual five-year horizon, *Budget 2021* only provides one-year-ahead forecasts. This gives an extremely narrow picture as to how today's policies might affect the economy and public finances. While any medium-term projections are uncertain, such forecasts would help to support a medium-term orientation for fiscal policy and to monitor potential economic imbalances. It is essential that the Stability Programme in April 2021 presents a five-year forecast horizon.

- Given the substantial uncertainties involved and the pressing need for a medium-term orientation to fiscal policy, the Council has developed an extended set of *Budget 2021* projections and two scenarios around this. The extended *Budget 2021* projections suggest that activity is unlikely to return to its pre-crisis (Q4 2019) levels before the final quarter of 2022. A "Milder" scenario could see the economy recover more quickly if effective vaccines/treatments become widely available by mid-2021 and if a free-trade agreement is reached between the EU and UK. This could see real GNI* recover to its pre-crisis levels of activity earlier in 2022. By contrast, if surges in infections lead to heavy restrictions being introduced in both spring and autumn of 2021 and 2022, as happened this year, this could see a

more stunted recovery. In this "Repeat Waves" scenario, real GNI* might not recover its pre-crisis levels until Q3 2023.

- As well as the risks associated with Covid-19, there are major risks associated with Brexit and changes to the international tax system. Although a disorderly Brexit is assumed in *Budget 2021*, Brexit could still prove more damaging than is modelled, particularly given the high labour intensity of sectors most exposed and the considerable uncertainty about how Brexit will interact with the global pandemic. Ireland is also exposed to international tax changes, including those under the OECD's Base Erosion and Profit Shifting initiative (BEPS). Changes could affect foreign investment in Ireland and corporation tax receipts, although the size and direction of these impacts depend on the detail of any changes to the international tax system.

- The Covid-19 pandemic has led to massive government spending on job supports and measures to stimulate demand. Although tax revenues have fallen sharply in some areas, other areas such as corporation tax receipts and income tax receipts have fared better than expected. Nonetheless, a very large budget deficit is projected for this year along with a sharp rise in the debt-to-GNI* ratio to high levels. The projections in Budget 2021 indicate a deficit for 2020 of 10.7 per cent of GNI*. This is better than was expected at the time of April's *SPU 2020* forecasts, when a 13.3 per cent deficit was forecast. However, the recent tightening of measures to contain the spread of the virus in Ireland and elsewhere in Europe is likely to weigh on public finances and may offset some of the improvements projected in *Budget 2021*.

- The Government's decision to continue to borrow to support households and businesses through the Covid-19 crisis and to provide stimulus is appropriate. These measures, though costly, should help to lessen the lasting economic damage of the crisis, and ultimately lead to a more sustainable path for government debt ratios. The Council welcomes the use of contingencies in *Budget 2021* to cope with any additional costs of Covid-19 and Brexit and the use of a Recovery Fund to support a recovery. These

temporary and targeted supports should fall out of spending as the need for emergency measures diminishes and as the economy recovers.

- However, *Budget 2021* also included substantial, permanent increases in spending of €5.4 billion. Rather than being temporary and targeted, these will remain after the pandemic. They are also surprisingly large in the context of past budgets. There is no sense as to how these will be financed sustainably over the medium term. The permanent increases could even be as high as €8.5 billion as it is not possible to ascertain the nature of some of the increases in non-Exchequer areas. This reflects ongoing transparency problems in areas outside of the Exchequer that are traditionally not the focus of the Department.

- The Council assesses that the permanent spending increases without a plan to fund them sustainably included in *Budget 2021* are not conducive to prudent economic and budgetary management. There are considerable uncertainties about how much of the costs of the current crisis might persist and there is no indication as to how these permanent measures will be financed sustainably over the medium term. The Programme for Government rules out tax increases and spending reductions across large parts of the tax base and existing spending. In addition, there is a risk is that some of the estimated temporary spending increases included in 2021 projections end up becoming permanent.

- At the end of last year, Ireland already had one of the highest debt ratios in the OECD, even when liquid and cash assets are accounted for. The <u>net</u> debt burden for end-2019 was equivalent to 86 per cent when set against a more appropriate measure of national income, such as GNI*. This placed Ireland's net debt ratio as the sixth highest in the OECD. *Budget 2021* forecasts are for a rise to 96 per cent of GNI* this year. However, debt levels in almost all countries are likely to rise as result of the Covid-19 crisis.

- The three scenarios considered by the Council in this report would suggest that the government <u>gross</u> debt ratio will climb to between 109 and 127 per cent of GNI* in 2021. The extended *Budget 2021* projections suggest that favourable debt dynamics could help the debt ratio fall towards 100 per

cent of GNI* by 2025. In the Milder scenario, the debt ratio could fall faster. However, in a severe "Repeat Waves" scenario, the debt ratio could stagnate at high levels close to 130 per cent of GNI* without any adjustments such as spending cuts or tax increases.

- The Government faces a number of significant medium-terms challenges once the economy is on a path to recovery. Once a recovery from Covid-19 and Brexit is underway, there may be a need for fiscal adjustment. The Council's simulations suggest that this could be avoidable, with debt ratios likely to fall over the medium term except in a Repeat Waves scenario. However, the unfunded permanent spending increases included in *Budget 2021* make it more difficult to bring the debt ratio back down at a steady pace. In addition, longstanding issues will remain. These include Ireland's rapidly ageing population, climate change, over-reliance on corporation tax and ambitions to embark on large-scale Sláintecare reforms of the health sector. All of these will add to budgetary pressures over the coming years and decades.

- The Council welcomes Government initiatives to help deal with medium-term challenges. These include the establishment of the Pensions Commission, the proposed establishment of a Commission on Welfare and Taxation, and the continued development of the annual spending review process. These initiatives are helpful in terms of setting medium-term fiscal plans on a sustainable footing. However, a decision to not proceed with the planned pension age increase to 67 in 2021 will add to medium-term pressures. The Government should also develop the annual spending reviews into a more comprehensive spending review process with clearer direction on what adjustments could be made to various areas of spending.

- The Government should use its medium-term strategy in April 2021 to set out how these medium-term challenges will be addressed.

- To help deal with the challenges likely to arise over the medium term, the Government should reinforce its budgetary framework with three key reforms. First, it should develop debt targets that are specific to Ireland. These would help guide the government debt ratios to safer levels over the

medium term and allow scope for a countercyclical response to be introduced, as was possible in this latest crisis. Second, the Government should use a Rainy Day Fund and Prudence Account to save temporary receipts, such as corporation tax, rather than use these to fund permanent spending increases. Third, the Government should anchor spending growth to specific limits based on sustainable growth rates.

Table 1.1: Summary table

% GNI* unless otherwise stated, general government basis

	2018	2019	2020	2021
General Government				
Revenue	42.4	41.7	41.5	42.6
Expenditure	42.2	40.8	52.2	52.4
Balance	0.2	0.9	-10.7	-9.8
Balance (€bn)	0.4	1.9	-21.6	-20.5
Interest expenditure	2.7	2.1	1.9	1.7
Primary expenditure	39.5	38.8	50.3	50.7
Primary balance	2.9	3.0	-8.8	-8.1
Revenue growth (%)	7.9	5.9	-5.5	5.3
Primary expenditure growth (%)	7.5	5.6	23.2	3.5
Net policy spending growth [1]	7.2	4.6	1.9	9.9
Real net policy spending growth (%) [1]	6.4	3.7	2.2	9.5
Debt				
Gross debt (€bn)	205.9	204.2	218.6	239.0
Cash & liquid assets (€bn)	28.6	28.4	24.2	22.8
Net debt (€bn)	177.3	175.8	194.5	216.2
Equity and investment fund shares (€bn) [2]	37.1	34.7		
Gross debt ratio (% GNI*)	103.6	95.6	107.8	114.7
Net debt ratio (% GNI*)	89.4	82.2	95.9	103.8
Output				
Real GDP growth (% Change)	8.5	5.6	-2.4	1.7
Potential output (% Change) [3]	5.7	4.3	2.0	1.5
Output gap (%) [3]	0.0	1.3	-3.1	-2.9
Nominal GDP growth (% Change)	8.9	8.9	-1.8	2.6
Nominal GNI* growth (% Change)	6.7	7.6	-5.1	2.7
Nominal GDP level (€bn)	327.0	356.1	349.5	358.7
Nominal GNI* level (€bn)	198.7	213.7	202.8	208.4
One-offs [4]				
Expenditure one-offs (€m)	213	0	16,699	11,887
Revenue one-offs (€m)	300	0	-200	-300
Net one-offs (€m)	87	0	-16,899	-12,187

Sources: CSO; Department of Finance (*Budget 2021*); and Fiscal Council workings.

[1] This measure is outlined in Box A (Fiscal Council, 2018e). It represents total general government expenditure less interest, less cyclical unemployment-related costs, and recognising discretionary revenue-raising or -reducing measures.

[2] This comprises government holdings in equity (shares and other equity) and investment fund shares (F5), including the value of bank shares held by the State.

[3] These estimates are based on the Department of Finance's preferred GDP-based alternative estimates of the output gap.

[4] One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. These comprise all Covid-19 spending, including the Recovery Fund and Covid-19 Contingency Reserve. On the revenue side, €500 million is included for tax warehousing write-offs, €580 million for stamp duty receipts not expected to recur, the costs of the standard VAT rate cut (€280 million in 2020 and €160 million in 2021) and the Stay and Spend scheme costs (€140 million).

1.1 Introduction

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

This chapter draws on analysis from the rest of the report in assessing the fiscal stance in *Budget 2021*. The Council's assessment is informed by: (1) an economic assessment that considers the state of the public finances, the stage of the economic cycle, and growth prospects for the economy; and (2) the extent of compliance with the fiscal rules.

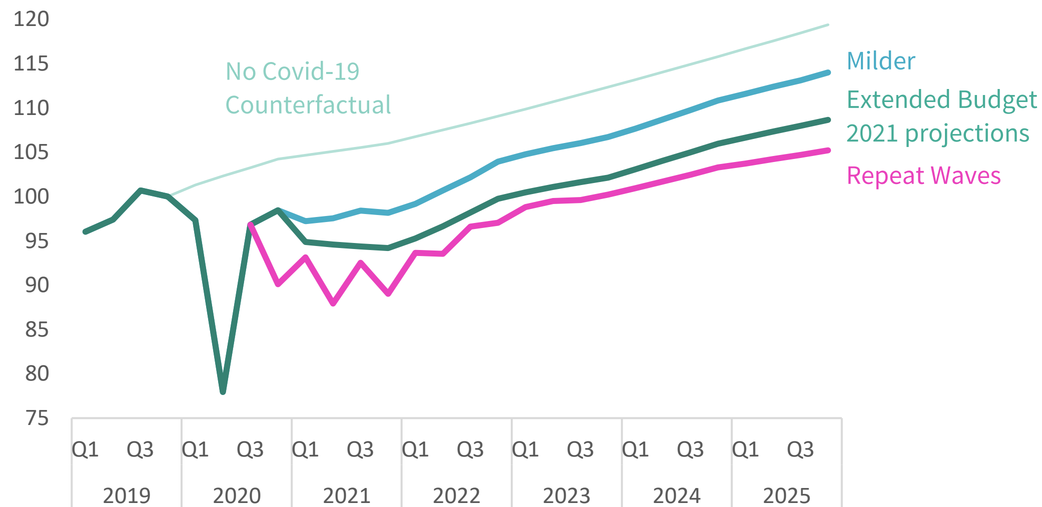
1.2 The Macroeconomic Context

Domestic economic activity

The Covid-19 pandemic and necessary containment measures have had a severe impact on the Irish economy. This is particularly evident in the social economy, including sectors like retail, hospitality, transport and the arts. State supports have cushioned the impact of the unprecedented fall in demand for workers. However, there are risks that the economic impacts of the crisis might be felt for a long time.

Figure 1.1: The outlook is exceptionally uncertain

Real GNI* (Index: Q4 2019 = 100)



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

Note: The scenarios consider different outcomes for the pandemic and Brexit negotiations. On the pandemic, these range from an effective vaccine being widely available in Q3 2021 in the Milder scenario to the Repeat Waves scenarios where twice-yearly waves of the virus and strict confinement measures are required in 2021 and 2022 before a vaccine is available in 2023. In terms of Brexit negotiations, the scenarios range from a free-trade agreement being formed in the Milder scenario to a disorderly shift to harsher WTO tariffs in the *Budget 2021* and Repeat Waves scenarios. The "No Covid-19" counterfactual assumes an EU-UK free-trade agreement.

Figure 1.1 shows "extended *Budget 2021* forecasts" for real GNI*, based on the Department's official projections to 2021 and on Council projections thereafter (Chapter 2).[1] As in the *Budget 2021* forecasts, these assume that a wide-scale rollout of a Covid-19 vaccine is not seen until 2022. They also assume that the EU and UK do not reach a trade agreement and instead revert to harsher World Trade Organisation (WTO) tariffs in a disorderly shift from January 2021. Even if a deal is reached on tariffs and quotas, the exit of the UK from the EU Customs Union could still entail

[1] The Department of Finance does not forecast real GNI*. The Council therefore derives estimates of real GNI* growth that would be consistent with the Department's other forecasts (section 2.3).

non-tariff barriers such as customs declarations, delays at ports, and other supply-chain disruptions that would be damaging for Ireland's exports.

These projections imply a 6 per cent decline in real GNI* this year, with a muted 2 per cent recovery in 2021. The extended projections suggest that activity would not return to its pre-crisis (Q4 2019) levels before the final quarter of 2022.

Given the uncertainty, this report sets out two alternative scenarios to the extended *Budget 2021* projections (Chapter 2). In the Milder scenario, the economy could recover quickly if effective vaccines/treatments become widely available by mid-2021 and if a free-trade agreement is reached between the EU and UK. If so, real modified GNI* could rebound by 5½ per cent next year as compared to a more muted recovery of 2 per cent, implied by the *Budget 2021* projections. This could see real GNI* recover to its pre-crisis levels of activity by Q2 2022.

By contrast, if surges in infections led to heavy restrictions being introduced in both spring and autumn of 2021 and 2022 as happened this year, this could see a more stunted recovery. In this Repeat Waves scenario, output might not rebound next year from low levels seen in 2020, and real GNI* might not recover its pre-crisis levels until Q3 2023.

Many outcomes within the range of the scenarios presented here are possible. For instance, it is quite possible that a vaccine may be available widely at an earlier stage than assumed in the *Budget 2021* and Repeat Waves scenarios. Yet it is also possible that there may be a hard Brexit unlike in the Milder scenario. The scenarios are intended to present a plausible range rather than a comprehensive set of possible outcomes.

After the financial crisis in 2008, Ireland took a decade to recover its pre-crisis levels of real GNI*, while the recovery in employment took 11 years. By comparison, the Irish economy was in good shape when the Covid-19 shock hit. The shock itself, rather than reflecting domestic imbalances, reflects a global health pandemic.

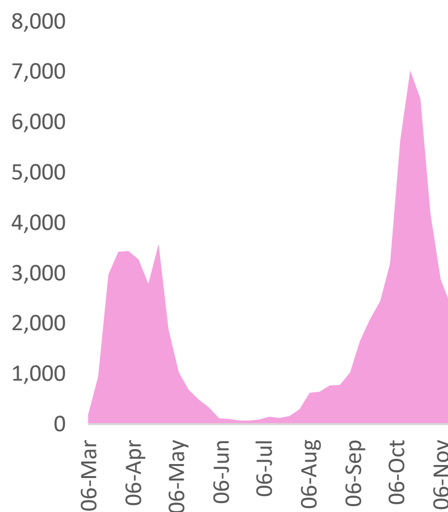
What happens on the health side will be key to the recovery. A lot depends on the success of containment measures — including the introduction of the highest Level 5 restrictions in October — and policies to mitigate economic damage associated

with restrictions. While the number of new cases of Covid-19 moderated over the summer months, cases surged again in September and early October before the introduction of Level 5 restrictions led to a reduction in cases again (Figure 1.2).

Figure 1.2: Number of cases increased sharply from September before Level 5

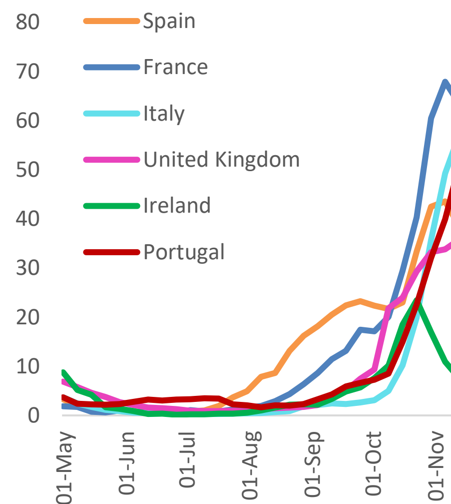
A. Weekly new cases had risen sharply

Weekly cases by epidemiological date



B. Weekly confirmed cases

Weekly cases per 100,000 population



Sources: CSO; European Centre for Disease Control; and Fiscal Council workings. Get the data.
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.

Recent macroeconomic developments

The Government accelerated early phases of its "Roadmap for Reopening Society and Business" as new cases of Covid-19 fell to low levels through the summer. This contributed to a rapid recovery in underlying domestic demand. The Council's latest nowcast suggests that it had returned to just 3.7 per cent below Q4 2019 levels in the third quarter (Figure 1.3A).[2]

However, localised restrictions were introduced in several regions temporarily from August on as health risks re-emerged. These restrictions involved the closure of all but essential shops, and the limiting of bars, restaurants and cafes to take-away/delivery services, although schools and childcare services remained open. High-frequency card and ATM data show relatively minimal disruption from the

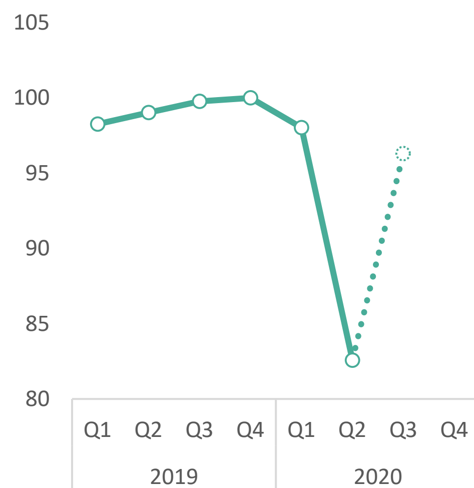
[2] Underlying domestic demand is a useful measure of domestic activity. It looks through most of the distortions arising from the activities of foreign-owned multinational enterprises, although it excludes net exports. It is given as consumer spending plus government consumption plus investment, excluding investment in intangibles and aircraft, both of which have a high import content.

regional restrictions, but nationwide restrictions were reintroduced on 22 October as cases rose to high levels again. It is still very early to assess the impact on economic activity, though recent data suggest that it has been less severe relative to the lockdown in spring. Domestic demand may hold up relatively well compared to the collapse witnessed during the first lockdown: construction sectors remain open; restaurants and pubs are open for takeaway; schools and childcare facilities remain open, and businesses have adapted somewhat to restrictions. However, the restrictions will interrupt the rapid rebound observed in the third quarter.

Figure 1.3: Domestic economy experienced an extraordinary shock but is recovering

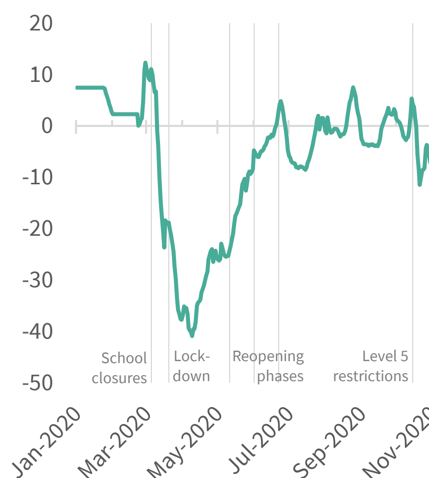
A. Demand rebounded sharply in Q3

Underlying Domestic Demand (Q4’19=100)



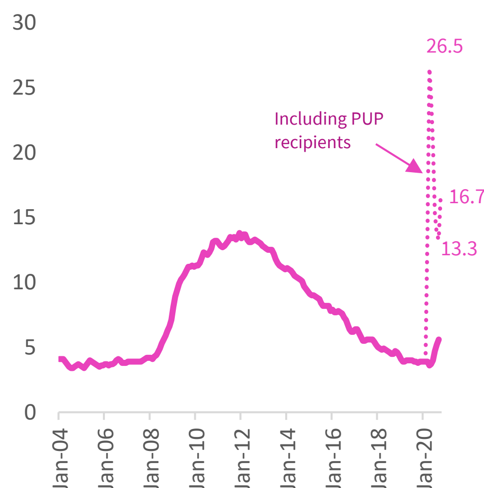
B. Consumer spending recovers but still weak

% change year-on-year, 7-day average



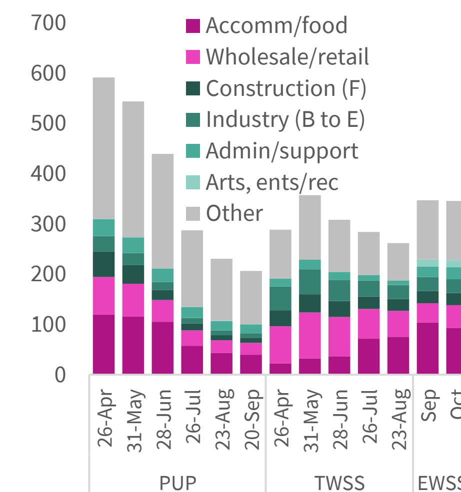
C. Unemployment rates remain high

% labour force (ages 25-74)



D. Some sectors are heavily affected

Thousands of people availing of supports



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

Unemployment rates for those aged 25–74 fell back to 13.3 per cent by September, having peaked at an exceptionally high rate of 26.5 per cent in April (Figure 1.3C). However, in October the rates climbed again to 16.7 per cent as regional restrictions and then national Level 5 restrictions took effect. Workers in tourism, hospitality and retail sectors remain especially affected; — they account for a quarter of those availing of the emergency unemployment supports and almost half of those availing of the wage supports (Figure 1.3D). By comparison, these sectors accounted for approximately one-in-six employed individuals in the fourth quarter of 2019. Numbers on the Pandemic Unemployment Payment are about 43 per cent below their peak, having climbed again after dropping by two thirds prior to recent restrictions. The number of claimants dependent on the wage subsidies has remained relatively steady, with employers using these schemes likely to have been less severely affected than those that let staff go.

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 and chemicals. However, some of the sectors that have sustained economic activity during the pandemic are potentially exposed to disruption related to Brexit in 2021.

The economic recovery

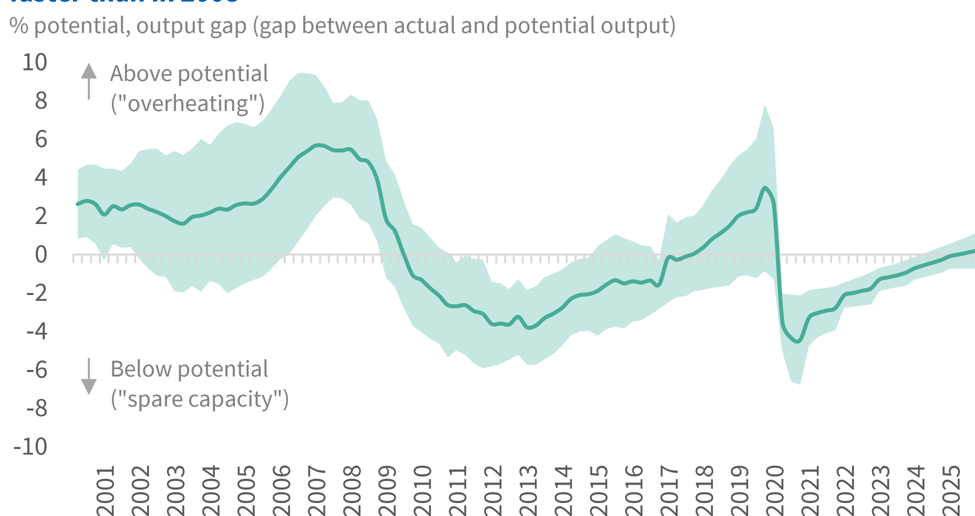
Activity is likely to pick up rapidly as confinement measures ease. But output could remain far below its potential in the near term. This reflects short-term disruptions from a disorderly Brexit with no FTA in place, and continued restrictions at home and abroad on some types of economic activities. It also reflects how concerns around Covid-19 might continue to weigh on confidence and global demand. Activity should gradually recover as these conditions improve.

The Council's suite of output gap models (Casey, 2019) together with the extended *Budget 2021* forecasts suggest that output will fall as low as 4½ per cent below capacity in 2020, from a positive output gap of about 3 per cent in 2019. While uncertainty around these estimates is significant, they reflect a broad pattern of a sharp downturn and then a period of subdued demand to come. The output gap is expected to gradually close over the next four to five years (Figure 1.4).

There are risks that the level of potential output over the long run could be permanently lower due to the lasting impacts of the pandemic and Brexit (see Chapter 2 for a discussion). Behind the current output gap estimates are estimates of potential output growth rates of 1–2½ per cent per annum over the medium term (2022–2025). The latest estimates are weaker than the May 2020 estimates, which ranged from 2–3 per cent. Weaker potential output growth reflects the more pessimistic outlook on Brexit and the *Budget 2021* assumption that a vaccine would not be widely available until 2022. However, estimates of potential growth are subject to considerable uncertainty, as recent revisions show, and may continue to change substantially as the recovery unfolds.

Figure 1.4: Substantial spare capacity in 2020 but likely to return to potential faster than in 2008

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



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

Risks to the outlook

As well as the risks associated with Covid-19, further major risks continue to surround the economic outlook. Two major risks that have faced Ireland for some time are the risks associated with Brexit and changes to the international tax system:

- **Brexit:** There is a risk that Brexit—though a disorderly Brexit is assumed in *Budget 2021*—could be worse than currently projected (see Box D, *November 2019 Fiscal Assessment Report*). This could, for example, reflect

the high labour intensity of sectors most exposed. Even if a free-trade agreement were to be formed between the EU and the UK, this would still be a negative outcome relative to the trading arrangements under the EU's Single Market. There is also considerable uncertainty about how Brexit will interact with the global pandemic. Many of the sectors likely to be worst affected by Brexit, such as agri-food in particular, are different to those worst affected by Covid-19.[3] This suggests that adverse impacts will add to rather than compound adverse developments arising from the pandemic. But there are also risks that planning for any new EU-UK trading arrangements will have been disrupted by immediate challenges associated with the pandemic. Furthermore, any accumulated losses in firms exposed to both shocks will make it more difficult to withstand further losses associated with Brexit.

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

[3] See Daly and Lawless (2020) and Box A of the Council's *Pre-Budget 2021 Statement*.

Box A: BEPS Reforms of International Tax Rules

Some 137 international tax jurisdictions are discussing proposals for major reforms of international tax rules under the aegis of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting project. The reforms come as challenges posed by an increasingly digital economy have become more prominent, with existing taxing rights relying heavily on physical presence. This box discusses some of the latest work published on these reforms and assesses the potential implications for Ireland.

Two pillars

The BEPS initiatives are split into two pillars. Two reports, published in October 2020, set out blueprints for how each of the pillars would work (OECD, 2020a and 2020b).

1. "Pillar One" involves a change to the way rights to tax digitally-intensive/consumer-facing MNEs are allocated. In particular, it would allocate a portion of profits for taxing rights to the jurisdiction where the market or user is located. This would be a significant change from the existing approach, which principally allocates taxing rights on the basis of physical presence. The aim is to ensure that MNEs pay taxes where they have significant business, even without a physical presence.
2. "Pillar Two" involves a global minimum corporate tax rate. This would reduce incentives for firms to shift profits to low-tax jurisdictions. It would only apply to businesses that meet or exceed a threshold for annual gross revenue of €750 million.

The impact of reforms

As part of the BEPS workplan, the OECD carried out an economic analysis and impact assessment of the proposals (OECD, 2020c). Without giving country-specific estimates, the OECD report covers so-called "investment hubs" — jurisdictions with a total inward FDI position above 150 per cent of GDP. This category includes Ireland and the OECD notes that these hubs would tend to lose out on tax revenues. The Minister for Finance noted in his budget speech that reforms would reduce taxable profits in Ireland.[4] The negative assessment contrasts with the assessments for other jurisdictions, which shows that both BEPS pillars would be expected to boost tax revenues.

Country-specific estimates of the revenue impacts of Pillar One and Pillar Two were shared with jurisdictions by the OECD on a confidential and bilateral basis. The impact on Ireland has not been made public and the Department of Finance did not share the estimates produced under the new analysis. However, it noted that it did not feel that there were enough grounds to change its previous estimated revenue impact range of €0.8 to €2 billion, which were incorporated in previously published medium-term forecasts. The Department cited the unreliable and partial nature of the OECD estimates and highlighted several reasons for sticking with its own original estimates. These included that (1) the newer estimates predate recent developments, including various aspects of the BEPS Action Plan and key tax reforms in the US (the Tax Cuts and Jobs Act); (2) the tool captures profit-making sub-groups rather than net overall profits from all MNE entities, which underestimates tax impacts for Ireland; and (3) important behavioural responses like investment decisions are not incorporated in the tool.

The path ahead

Finance ministers of the G20 (2020) committed to address remaining issues and reach a global solution by mid-2021. It is also possible that tax reforms at EU level could happen if these are not otherwise agreed at the OECD level, while any future tax policy changes in the United States could also affect developments in Ireland.

[4] See the Minister of Finance's Budget 2021 speech at: https://www.gov.ie/en/speech/063d4-budget-speech-by-the-minster-of-finance-paschal-donohoe/

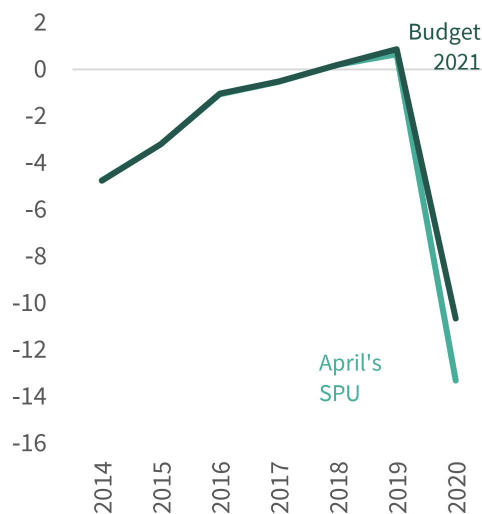
1.3 The Recent Fiscal Context

The Covid-19 pandemic has led to substantially higher government spending through job supports and measures to stimulate demand. Although tax revenues have fallen sharply in some areas, corporation tax receipts and income tax receipts have fared better than expected. Nonetheless, a very large budget deficit is expected this year, along with a sharp rise in the debt-to-GNI* ratio to high levels.

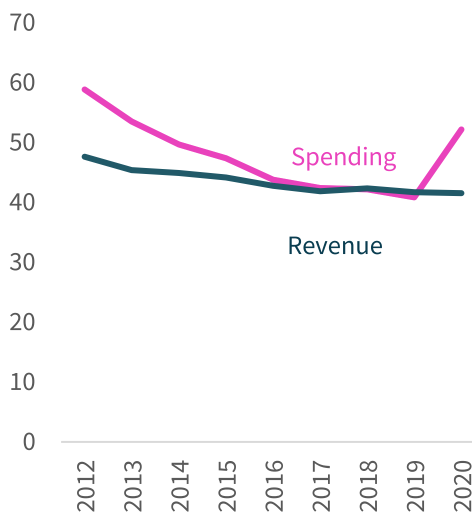
Figure 1.5: A large deficit opened up as spending supports rose sharply

% GNI*, general government basis unless otherwise stated

A. The budget deficit is set to be large

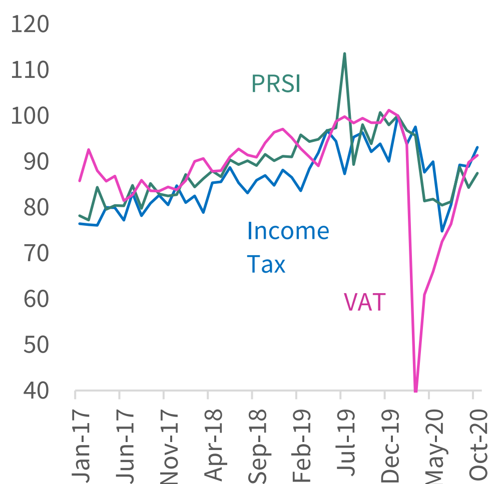


B. Mainly driven by higher spending



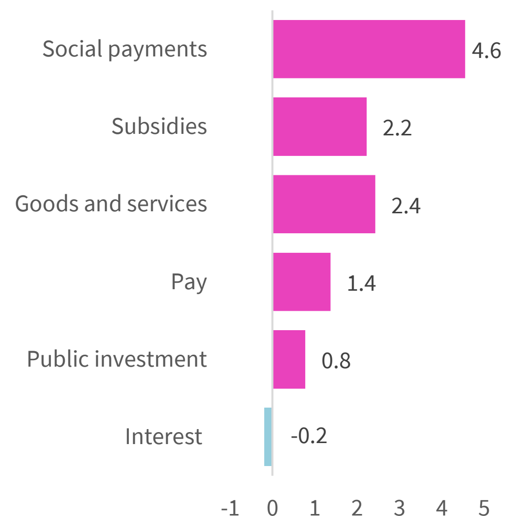
C. Taxes fell sharply, particularly VAT

Index (Jan 2020 = 100), seasonally adjusted



D. Income supports drive spending increases

% GNI*, spending in 2020 vs 2019



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

Notes: "Goods and services" refers to intermediate consumption and includes spending on personal protective equipment, for example. "Public investment" refers to Gross Fixed Capital Formation.

In *Budget 2021*, the deficit for 2020 is projected to be 10.7 per cent of GNI*. As Figure 1.5A shows, this is better than was expected at the time of April's *SPU 2020* forecasts, when a 13.3 per cent deficit was forecast. While government spending rose sharply, revenues have notably been relatively resilient (Figure 1.5B). At Budget time, revenues were projected to fall by just 5.5 per cent in 2020. The deficit is likely to be adversely affected by Level 5 restrictions introduced nationwide in late October. These will add to spending on income supports and subsidies while the restrictions are likely to dampen wider economic activity and tax revenues, potentially widening the deficit by €1.6 billion relative to budget day forecasts (Chapter 3). But budget prospects remain highly uncertain, and this could be offset by further potential upsides to corporation tax receipts this year.

The strength of revenues to date has surprised many. Corporation tax receipts, which are heavily dependent on foreign-owned multinationals, have outperformed expectations. These are projected to be €2.1 billion or 1 per cent of GNI* better than was expected in April's forecasts.[5] In addition, income tax receipts have proven resilient for a couple of reasons. First, in early 2020 and before the pandemic struck, income tax receipts performed strongly (in seasonally adjusted terms, they rose by more than 11 per cent in January relative to December). The strength of the early performance has flattered annual comparisons for the year to date. Second, the pandemic has had a disproportionate impact on lower-income workers, who account for a small share of income tax. This, combined with the progressivity of the Irish income tax system, has meant that income tax receipts have held up relatively well considering the extent of job losses (Chapter 3).

By contrast, other tax receipts, most notably VAT, have fared much more poorly. VAT receipts bottomed out at 60 per cent below January's level of seasonally adjusted receipts in March amid the initial lockdown response to Covid-19. Monthly VAT receipts recovered sharply in subsequent months as the economy reopened. They were just 8.6 per cent below January's seasonally adjusted levels by end-October. Given the impact that the confinement measures had on VAT receipts during the

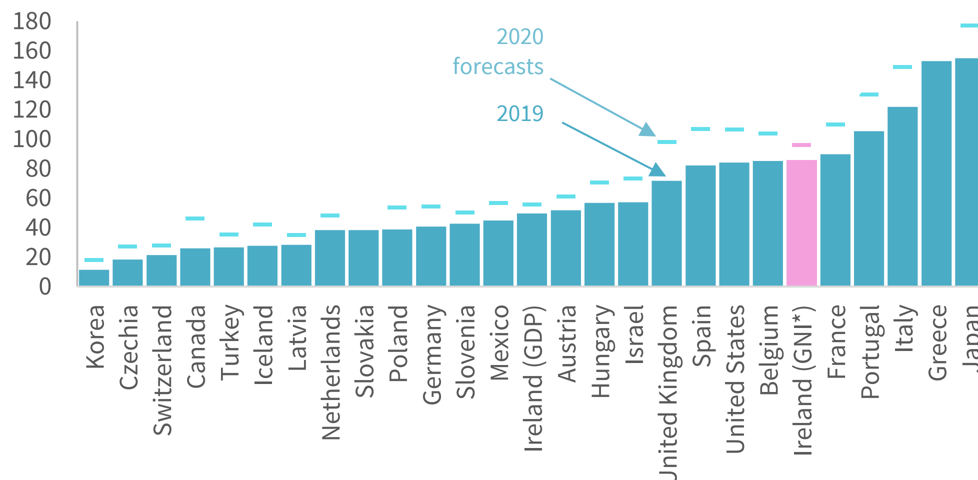
5 Recent outturns in the Department of Finance's Fiscal Monitor have presented monthly outturns of both Income and Corporation Tax as "net" figures, where the costs of the Government's Covid Restrictions Support Scheme have been deducted from these tax heads. Throughout this text, we present the performance and forecasts of these revenue sources in gross terms.

original lockdown this year, it is reasonable to expect that the introduction of Level 5 restrictions will also reduce VAT receipts relating to October and November.

The sharp rise in the deficit this year is driven primarily by a rise in government spending. Figure 1.5D shows spending areas where key changes were projected in *Budget 2021*. Of the 11.4 percentage points of GNI* increase projected, some 6.8 percentage points are due to an increase in social payments and subsidies. This is primarily the result of increased income supports associated with the pandemic. Another 2.4 percentage points relate to goods and services (including medical equipment), while a rise in the pay bill in 2020 makes up a further 1.4 percentage points of the overall rise.

Figure 1.6: Ireland already has one of the highest net debt ratios in the OECD

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



Sources: Eurostat; CSO; IMF Fiscal Monitor (October 2020); and Fiscal Council workings. Get the data.
Notes: Net debt is gross debt excluding assets held by the state in the form of currency and deposits; debt securities, and loans. The SGP criterion of a 60 per cent ceiling for government debt is set in gross rather than net terms. Net debt does not include the state's bank investments. Forecasts for 2020 net debt for Slovakia and Greece were not available.

At the end of last year, Ireland already had one of the highest debt ratios in the OECD. The end-2019 net debt burden, which accounts for liquid and cash assets, was equivalent to 86 per cent when set against a more appropriate measure of national income like GNI* (Figure 1.6). This placed Ireland's net debt ratio as the sixth highest in the OECD. The widening of the deficit this year will add to government net debt sharply. *Budget 2021* forecasts are for a rise to 96 per cent of GNI*. However, net debt levels in almost all countries are likely to rise as result of the Covid-19 crisis. Forecasts from the IMF would suggest that debt ratios in the UK, Spain, US and Belgium may surpass Ireland's by the end of the year.

1.4 Assessment of the Fiscal Stance

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

Rather than the usual five-year horizon, *Budget 2021* only provides one-year ahead forecasts. This gives an extremely narrow insight as to how today's policies might affect the economy and public finances. With the Government having introduced sizeable new policy measures—many of which will last beyond the immediate crisis—there is a need for robust planning. While the heightened uncertainty makes producing medium-term projections difficult, such projections would help support a medium-term orientation for fiscal policy and would help to enable monitoring of potential economic imbalances. It is essential that the Stability Programme in April 2021 presents a five-year forecast horizon.

The appropriate fiscal stance will depend on how the crisis evolves. With this in mind, the Council's assessment of the fiscal stance refers to three broad phases:

1) the immediate crisis;
2) the recovery period; and
3) the new normal or "steady state" that the economy finds itself in over the medium term.

The timing of each of these phases will depend on how the state of the economy evolves, illustrated by the range of scenarios in this report.

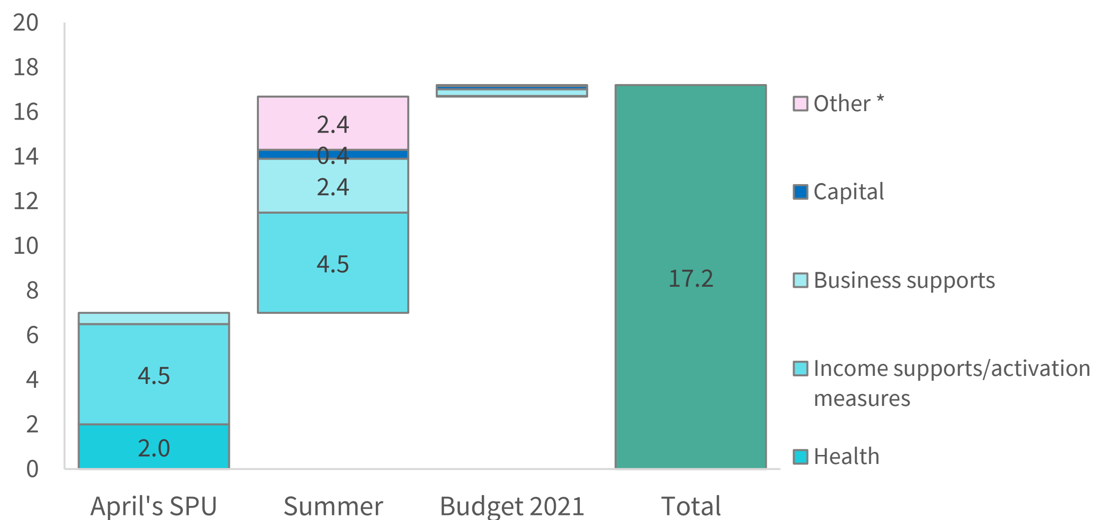
As it stands, Ireland is somewhere between the immediate crisis and the recovery period. Activity in some sectors remains subdued as confinement measures—though less restrictive than in April's lockdown—have had to be reintroduced, hence limiting businesses capacity to operate either entirely or in part. The fiscal stance for 2020 and 2021 therefore straddles both Phase 1 and Phase 2 of the crisis. That is, some costs are still being incurred for the immediate crisis, with confinement measures reducing revenues and raising spending on income supports and healthcare. In addition, some measures have been introduced to help the recovery Phase 2. These include stimulus measures like VAT rate reductions, schemes to

support spending on hospitality, increased public investment spending and other increases in current spending.

The fiscal stance for 2020

The fiscal stance for 2020 has been dominated by efforts to contain the pandemic and its impact on businesses and households. Since the start of the year, some €17.2 billion of new supports have been set out for the Covid-19 crisis in various budgetary documents, up to and including *Budget 2021*. More than half of this (€9 billion) has been for income supports, such as the Pandemic Unemployment Payment and the Temporary/Employment Wage Subsidy Scheme (Figure 1.7). A small fraction is for job activation measures. A further €2 billion has been allocated to health spending this year, given the costs of dealing with the pandemic. Another €2.4 billion of net spending on business supports has been introduced. Just €0.5 billion has been allocated to accelerating public investment spending in 2020. Additional spending on various departments of €2.4 billion has also arisen due to the impacts of the pandemic.

Figure 1.7: Net spending related to Covid-19 in 2020 has grown substantially
€ billions, net spending in 2020



Sources: Department of Finance; and Fiscal Council workings. Get the data.
Notes: Net spending is shown in gross voted terms. Tax measures, such as the reduction in the VAT rate from 23 to 21 per cent, are included as net spending on business supports. “Other” measures include additional spending spread across various departments.

The supports introduced for dealing with the immediate crisis, though large, are warranted in order to limit adverse impacts on people’s health and incomes. The measures should also help to promote a subsequent recovery by continuing to maintain links between employers and employees. The budgetary costs of crisis

measures will be high. But the direct costs will be temporary and will help to limit lasting economic damage.

Post-Budget measures arising as a result of the move to Level 5 restrictions in response to the rise in Covid-19 cases will also have an impact in 2020. These include the costs of additional recipients on the Pandemic Unemployment Payment and businesses that avail of the Covid Restrictions Support Scheme (CRSS) (Chapter 3). The restrictions are likely to have an additional budgetary impact—mainly on spending—of around €1.6 billion over and above the estimated deficit set out in *Budget 2021* for 2020.

The fiscal stance for 2021

For 2021, the Government has set out plans for permanent increases in spending alongside temporary supports for Covid-19 and Brexit. General government spending for 2021 is set to rise from €105.9 billion to €109.2 billion — a rise of €3.3 billion and some €21.9 billion above the 2019 level. Within this, temporary Covid-19 and Brexit spending amounts account for €12 billion — a fall of €4.6 billion from temporary spending on Covid-19 for 2020.

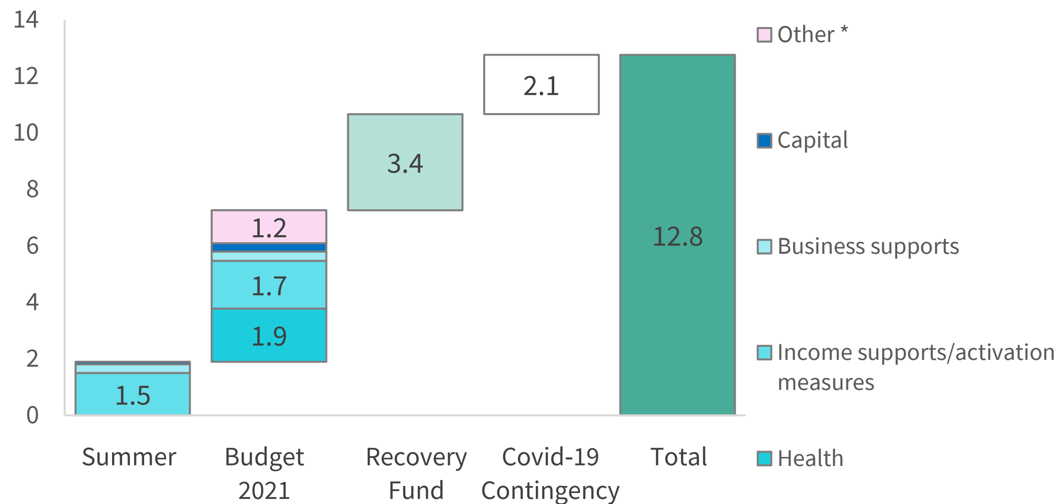
In addition to these temporary spending measures, the level of underlying general government spending is projected to be up to €8.5 billion higher than it was in 2020. Some €5.4 billion of this is clearly core spending increases that are permanent in nature. The increase in permanent spending is surprisingly large, there is limited transparency on a large portion of it, and there is little indication as to how new measures will be financed sustainably over the medium term.

The Government's decision to continue to borrow to support households and businesses through the Covid-19 crisis is appropriate and should help to lessen the lasting economic damage of the crisis. However, these temporary and targeted supports are distinct from the underlying increases in spending that formed a substantial part of *Budget 2021*. The Government should use its medium-term strategy in April 2021 as an opportunity to clarify how these underlying increases in spending, which are likely to be long-lasting, will be funded sustainably.

The spending supports for Covid-19 for 2021 are also considerable. Initially, *SPU 2020* set out some €1.9 billion in supports, mainly in the form of the income support

schemes (Figure 1.8). *Budget 2021* added to this with €5.4 billion of supports spread across health, income support and other departmental areas. In addition to that, *Budget 2021* set out two contingencies: the €3.4 billion Recovery Fund and the €2.1 billion Covid-19 contingency reserve that could be drawn on depending on outcomes (the former could also be drawn on for Brexit-related costs).

Figure 1.8: Net spending related to Covid-19 for 2021 is also considerable
€ billions, net spending in 2020



Sources: Department of Finance; and Fiscal Council workings. Get the data.
Notes: Net spending is shown in gross voted terms. Tax measures are included as net spending on business supports. "Other" measures include additional spending spread across various departments.

The temporary measures for 2021

Budget 2021 includes about €12 billion of temporary measures to respond to both Covid-19 and Brexit. The bulk of this relates to the labour-market impacts of Covid-19, with €3.2 billion of social protection spending projected to be needed for the steep rise in unemployment and the extension of the Pandemic Unemployment Payment and the wage subsidy scheme. A €2.1 billion "Covid-19 Contingency Reserve" is also outlined in *Budget 2021* to meet any further costs arising due to the impact of the pandemic over the course of 2021. In addition, a €3.4 billion "Recovery Fund" is included in the spending measures for 2021. This has not been allocated to any specific Department, with the intention being to retain flexibility so that it can be used for tailored policy measures to support the economy in 2021 amid both Covid-19 and Brexit. Details about the functioning of the Fund remain very limited. Temporary health spending of €1.9 billion is included for the supply of protective

equipment, testing capacity and other measures. A further €1.4 billion is spread across other Departments for costs arising from Covid-19.

The Covid-19 Contingency Reserve and Recovery Fund are welcome features of the Budget plans for 2021. They are in line with the Council's prior advice to set aside some contingencies to help manage risks arising from uncertainties relating to the pandemic and the possibility of a disorderly Brexit. While the amounts set aside may not be used in full, meaning some upside risk to the deficit forecast for 2021, they are useful for planning purposes.

The permanent measures for 2021

However, *Budget 2021* also includes substantial permanent increases in spending. There are clear plans to increase gross voted spending across departments by €5.4 billion, which is surprisingly large in the context of recent budgets. These are substantial increases and there is no indication as to how these permanent measures will be financed sustainably over the medium term. The wider general government spending increase suggests that the expansion in spending could be even higher at up to €8.5 billion. The increases include permanent increases in staffing including in health and education areas.

Table 1.2: Net policy spending increases substantially in 2021
€ million, general government basis

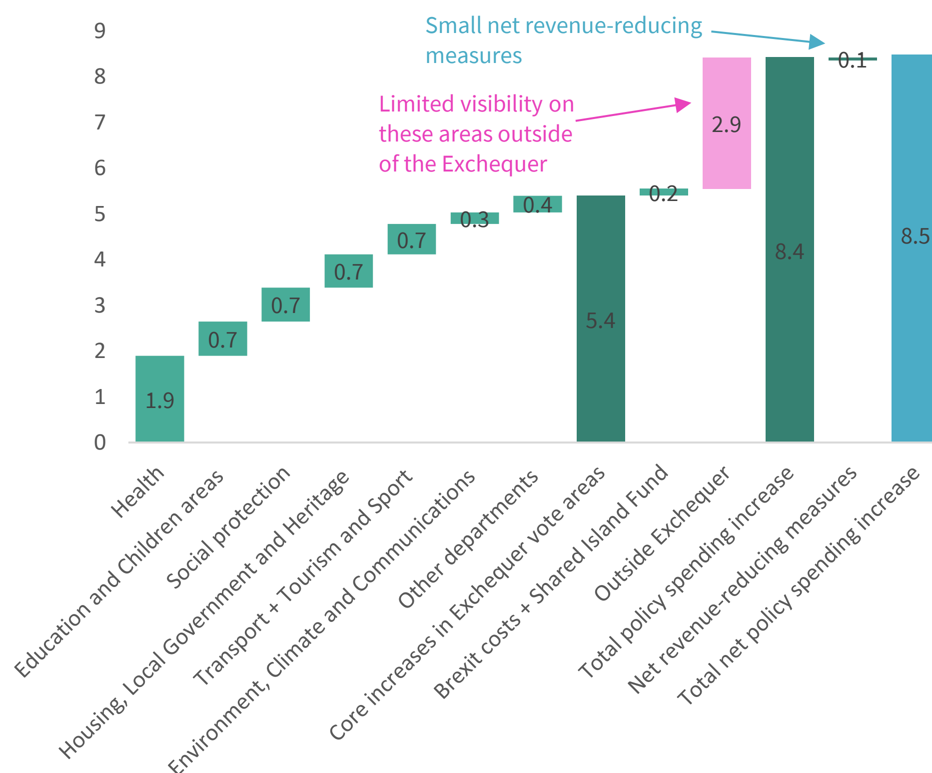
	2020	2021	Change in 2021*
Total Expenditure	105,865	109,180	3,315
- Interest	-3,850	-3,555	295
- One-offs (incl. rise in unemployment benefits)	-16,699	-11,887	4,812
= Policy Spending	85,316	93,738	
- Discretionary Revenue-raising Measures (DRMs)	-960	65	
= Net Policy Spending	84,356	93,803	8,487

Sources: Department of Finance, and Fiscal Council workings.
Notes: Net Policy Spending is typically given as total general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment. Given the extensive changes in unemployment benefits associated with the pandemic, the measure is adjusted on this occasion so that it takes the "non-core" increase in social protection spending in 2021 as the basis for the temporary/cyclical increase in unemployment benefits (this is included in "one-offs" along with other Covid-19 supports and Brexit supports). As usual, the measure also takes account of the impact of discretionary revenue measures (for example, net revenue-raising measures reduce the measured growth rate). *The change in net policy spending for 2021 assesses the difference between *net* policy spending in 2021 as compared to policy spending in 2020.

One way to assess the change in underlying spending for 2021 is to consider the Council's "Net Policy Spending" measure. Net Policy Spending examines spending growth excluding temporary factors while also allowing for the offsetting impacts of tax-raising measures. It represents a good measure of the fiscal policy stance.[6] Table 1.2 shows that, on the basis of net policy spending, expenditure is estimated to have risen by €8.5 billion in 2021, largely driven by spending including €5.4 of Exchequer voted spending. On the tax policy side, revenue-raising measures such as the carbon tax increase—which are ringfenced for additional spending—largely net off against tax cuts introduced like the reduction in the lower rate of VAT.

Figure 1.9: Permanent spending increases are spread across many areas

€ billions, core spending increases in 2021



Sources: Department of Finance; Department of Public Expenditure and Reform; and Fiscal Council workings. Get the data.

Note: "Core" increases refer to those classified by the Department of Public Expenditure and Reform as being unrelated to temporary costs associated with Covid-19, temporary increases in unemployment supports and any one-off costs associated with Brexit. *Non-voted current spending here only includes amounts that have an impact on general government spending and are, in the main, made up of increases in Ireland's EU budget contribution.

The permanent increases in spending included in *Budget 2021* for next year are spread across a range of areas. Figure 1.9 shows that some €5.4 billion can be

[6] The measure is outlined in Box A of the *November 2018 Fiscal Assessment Report*.

accounted for by so-called "core" spending increases in Exchequer vote areas, with another €0.2 billion of expenditure for Brexit and the Shared Island Fund that is expected to be repeated in subsequent years. These core Exchequer spending increases for 2021 include €1.9 billion in health, €0.7 billion in education and children areas, €0.7 billion in social protection, €0.7 billion in housing and €0.7 billion in transport. The amounts cover substantial increases in staffing, particularly in health (see Chapter 3).

The €1.9 billion rise in ongoing health spending appears to go well beyond a response to the pandemic. It is unclear how much of the increase is related to the Sláintecare reforms — a large programme of reforms to how health care is provided in Ireland that involves reducing private payments in favour of more universal care. The Department of Expenditure and Reform notes that the additional allocation of core funding "has a focus on Sláintecare priorities such as greater access to primary care and medicines but also on increasing capacity in key areas such as acutes". However, it is not clear how much of this is devoted to the wider Sláintecare reforms. No up-to-date costing of the implementation of Sláintecare has been published.

A further €2.9 billion in spending increases for 2021 comes from non-voted and non-Exchequer areas. There is little transparency on what is driving this increase in terms of Budget Day documentation. Part of it is the non-voted current spending increase attributable to Ireland having a larger EU budget contribution. The White Paper published prior to the Budget (Department of Finance, 2020b) shows a €1 billion increase in Ireland's EU budget contribution for 2021. This is likely to be a persistent increase. However, about half of this would appear to be driven by estimated increases in customs revenue under the disorderly Brexit scenario. Most of these receipts (about three quarters) are transferred to the EU budget and hence the additional expenditure is offset. The other half appears to be driven by an increase in the non-customs element of the EU budget contribution, which is not offset. It is unclear from budget documentation what the remainder of the €2.9 billion relates to.

Despite the volume of information provided with the Budget day documentation, it is not possible to ascertain where a substantial portion of increases in non-Exchequer spending comes from. Little information is provided in budgetary

documents for areas outside of the Exchequer. These areas typically account for about one-fifth of government spending as discussed in Box A of the *November 2019 Fiscal Assessment Report*. It is possible that the increases in spending outside of the Exchequer are temporary also, but it is not possible to be definitive on this without more information and with such a short forecast horizon being adopted in *Budget 2021*. The Council understands that the increases appear to reflect capital spending increases to a greater extent than current spending, though capital spending increases could also attract permanent increases in current spending over time too (for example, as workers are employed to operate new public infrastructure).

An ongoing problem is that the Department does not provide estimates of how it moves from the Exchequer figures—that it traditionally places more emphasis on—to the wider general government figures.[7] The only exposition of this is the so-called "walk", which is only provided in net terms and gives little clarity on what is happening outside of the Exchequer.

The Government should routinely provide more detail on general government forecasts in its budgetary publications than it currently does. To improve transparency on how budgetary information is presented, budgetary documents should show gross spending and gross revenues attributed to (1) local government (including approved housing bodies), (2) non-commercial semi-state bodies (like Irish Rail, Irish Water, RTÉ, Solas, Tusla, the aggregate institutes of technology, etc), and (3) Extra Budgetary Funds (such as the Irish Strategic Investment Fund) for all years considered in budgetary documentation.[8] Ideally, these would be broken down more so that the reasons for year-to-year changes could be identified. For example, it should be possible to identify what the nature of spending changes is, including whether it is likely to be a long-lasting or temporary change. Reforms to how forecasts and policies are presented would also help to improve wider transparency for the public finances.

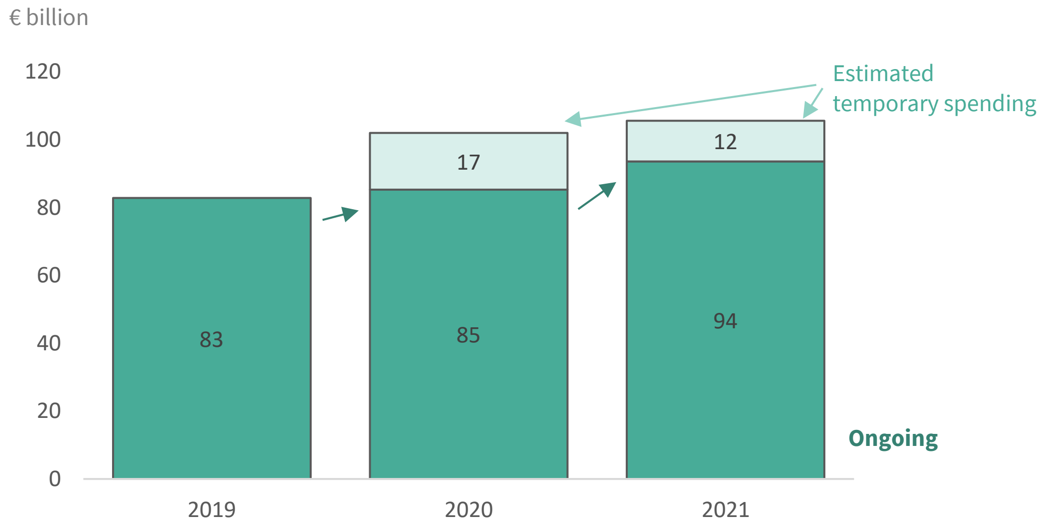
[7] See Box A of the November 2020 Fiscal Assessment Report. The Council has raised these concerns with the Department directly, and it understands that the Department hopes to resolve these issues by publishing more information in future budgetary publications.

[8] *Budget 2021* includes some information on local government spending and revenue in the Economic and Fiscal Outlook, albeit this is only included for one year (2021) so that annual comparisons cannot be made.

As a result of the sharp increases in core spending, policy spending is set to rise markedly in 2021. The level of policy spending is set to rise by €8.4 billion from €85 billion to €94 billion (+9.7 per cent) next year when temporary spending amounts are removed. Figure 1.10 highlights the extent of this and how the reduction in one-off measures masks the extent of the increase in total policy spending (excluding interest and one-offs).

Figure 1.10: Fall in temporary spending masks sharp rise in policy spending in 2021

€ billion



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

Notes: Net Policy Spending is typically given as total general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment. Given the extensive changes in unemployment benefits associated with the pandemic, the measure is adjusted on this occasion so that it takes the "non-core" increase in social protection spending in 2021 as the basis for the temporary/cyclical increase in unemployment benefits (this is included in "one-offs" along with other Covid-19 supports and Brexit supports. As usual, the measure also takes account of the impact of discretionary revenue measures (for example, net revenue-raising measures reduce the measured growth rate).

The increase in permanent spending for 2021 continues a pattern of fast government spending growth in recent years, with sharp increases in health spending a key driver. For the years 2015 to 2019, net policy spending has been rising at an annual pace of increase of about €3.8 billion per annum or +5.5 per cent per annum (Figure 1.11A). Two-fifths of the increases in recent years have been attributable to increases in recurrent health spending (Figure 1.10B). Over these years, net policy spending with strong economic growth through Budget decisions and health overruns.

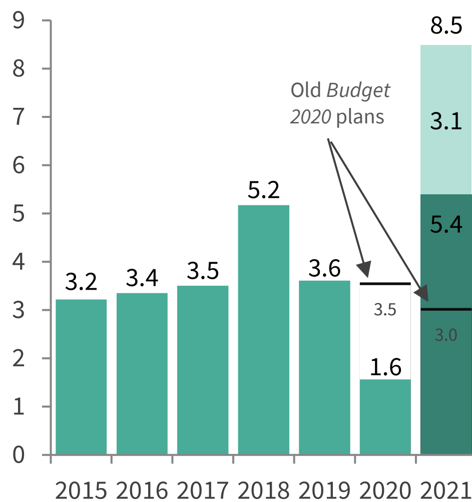
The permanent spending increase in 2021 looks large by the standards of recent budgets. On the face of it, it is larger than the increase in spending in 2018 (Figure

1.11A). This may partly reflect weaker core spending in 2020, but the increase over the two years would nevertheless remain sizeable.

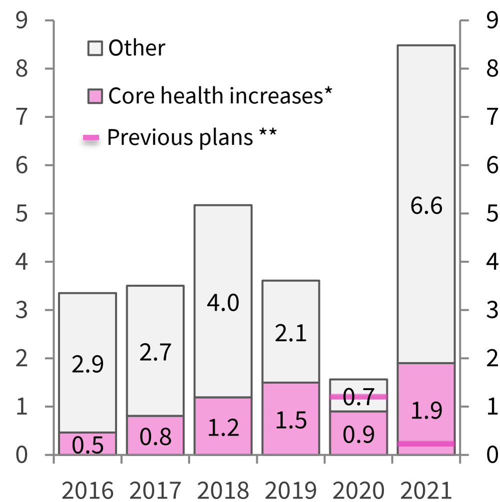
Figure 1.11: Pattern of fast spending continues in 2021, with health spending a key driver in recent years

€ billion increases

A. Large net policy spending increases



B. With core health spending a big driver



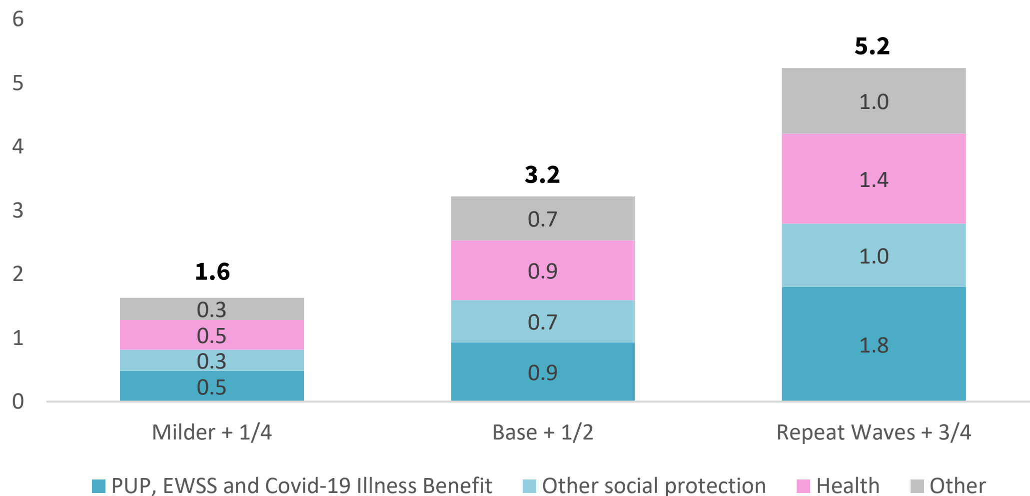
Sources: CSO; Department of Finance; Eurostat; and Fiscal Council workings. Get the data.
Notes: Net Policy Spending is typically given as total general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment. Given the extensive changes in unemployment benefits associated with the pandemic, the measure is adjusted on this occasion so that it takes the "non-core" increase in social protection spending in 2021 as the basis for the temporary/cyclical increase in unemployment benefits (this is included in "one-offs" along with other Covid-19 supports and Brexit supports. As usual, the measure also takes account of the impact of discretionary revenue measures (for example, net revenue-raising measures reduce the measured growth rate). * The core health spending increases exclude Covid-19 related costs and are taken from Eurostat COFOG data up to 2018. For 2019 to 2021, the health spending increases are estimated based on the increase in gross voted spending in health areas excluding non-core increases due to Covid-19. ** Previous plans cover the *Budget 2020* planned increases in core gross voted health spending for 2020 and 2021.

The *Budget 2020* plans indicated an increase in net policy spending of about €3.5 billion for 2020, while current projections indicate an increase closer to half that at €1.6 billion. This could reflect certain areas of expenditure in 2020 being lower than expected due to disruptions caused by the pandemic such as deferred spending or reduced costs. However, much of this appears to be related to health spending and so may reflect a temporary shifting of existing resources and costs associated with Covid-19. This would unwind as the pandemic recedes. In addition, given that much of public spending is accounted for by recurrent items such as wages and welfare payments, the scope of temporary spending reductions seems modest. The implied

€1.9 billion of savings in 2020 are in any case dwarfed by the €5.5 billion upward revision to net policy spending in 2021.

Figure 1.12: Continuing Covid supports after 2021 would add to costs

€ billions, annual estimates of extending 2021 Covid supports under different scenarios



Sources: Department of Expenditure and Reform; and Fiscal Council workings. Get the data.
Notes: The scenarios assume that Pandemic Unemployment Payments continue for those unemployed and not on standard unemployment benefits. The numbers of claimants rise across each successive scenario (fewer in the Milder scenario and most in the Repeat Waves scenario). All other temporary Covid supports are assumed to persist at one-quarter, one half, or three-quarters of their 2021 levels.

In addition, there is a risk that some of the estimated temporary Covid-19 or Brexit spending increases included in 2021 projections end up becoming permanent. For example, it may be difficult to withdraw some support measures once the crisis lessens or there may be higher than expected costs, such as maintaining testing infrastructure. This could widen the deficit over the medium term unless offsetting measures are adopted elsewhere. For example, Figure 1.12 considers what would happen in the Council's macroeconomic scenarios if one quarter (Milder scenario), a half (extended Budget 2021) or three quarters (Repeat Waves scenario) of the Covid-spending was to remain in place for 2022. The Pandemic Unemployment Payment supports are adjusted in line with the unemployment projections for each scenario. This analysis suggests that some €1.6 billion to €5.2 billion could be added to the deficit projected for 2022 depending on the extent to which supports are left in place.

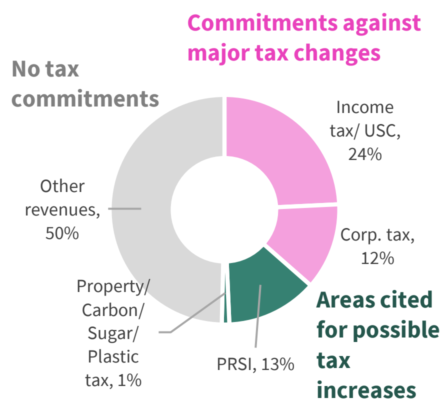
The substantial increases in policy spending have been committed with no indication of how they will be financed sustainably over the medium term. Revenue-raising measures introduced for 2021 were offset in full by tax cuts (see Chapter 3).

There were no projections for beyond 2021 and it is not clear that tax cuts will be reversed in later years or that other revenue-raising measures will be introduced. One commitment the Government has indicated in terms of sustainably raising revenue is a commitment to gradual increases in carbon tax. The plan is to gradually raise it to €100 euro per tonne by 2030 from its 2021 level of €33.50 per tonne. This would be estimated to raise €1 —€1½ billion in the absence of changes in behaviour that reduce the tax take. Yet the Programme for Government notes that *all* additional carbon tax revenue raised will be used for additional spending, including on targeted social welfare to prevent fuel poverty, on a national retrofitting programme and on schemes to encourage sustainable farming.

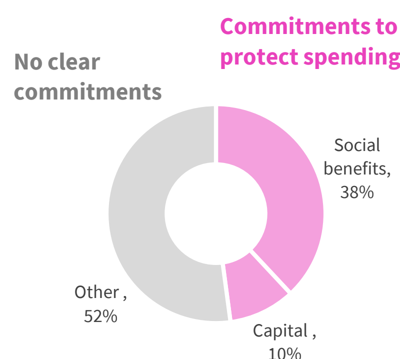
The Government has also ruled out tax increases and spending reductions across large parts of its tax base and existing spending areas. As part of its Programme for Government, the Government has made commitments that it will not change a third of overall taxation (Figure 1.13A). This includes income tax, the Universal Social Charge and corporation tax. Only PRSI and smaller taxes, which together account for 14 per cent of the tax base, are cited as areas where new revenue might be raised sustainably. On the spending side, the Government commits to protecting welfare and capital spending — close to half of all general government spending (Figure 1.13B). There are no clear commitments to reduce/reprioritise other areas of existing spending.

Figure 1.13: Limited financing commitments in Programme for Government

A. Revenue measures
% total general government revenue



B. Spending largely protected
% total general government spending (excl. interest)



Source: Programme for Government (2020); and Fiscal Council workings based on 2019 outturns (see Box D of the *Pre-Budget 2021 Statement*). Get the data.

The Council assesses that the permanent spending increases included in *Budget 2021*, without an indication of how they will be financed sustainably, were not conducive to prudent economic and budgetary management. Unless sustainable revenue streams are identified in future, this will leave debt at a higher level and the public finances more vulnerable than they otherwise would be to future adverse shocks. In addition, sustainable revenue growth is likely to be a on lower path in the coming years as a result of the Covid-19 crisis and Brexit, so the ability to use growth to finance higher spending will be very limited and not compatible with net policy spending growth at the rates seen in previous years. While deficit-funded financing of government spending can contribute to temporary fiscal stimulus, this cannot be sustained over the medium term. The €5.4 billion of core spending increases planned for 2021 will likely leave the deficit €5 billion (2 per cent of GNI*) higher than it otherwise would be in 2025 at 2.5 per cent as compared to 0.5 per cent. Over time, this would build up so that debt would be estimated to be €21.5 billion (7.4 per cent of GNI*) higher.[9]

Debt sustainability

With a sharp rise in the debt ratio likely as a result of Covid-19 and Brexit, in any shape or form, the risks around future debt sustainability are key to assessments of the current fiscal stance. The Council's three scenarios help to assess debt sustainability (Figure 1.14A).

The budget balance is set to remain in deficit in all of the scenarios considered for some time. A deficit of €21.6 billion (10.7 per cent of GNI*) is projected for 2020. A severe Repeat Waves scenario might see it end up closer to €24 billion (12.1 per cent) should the costs of Level 5 restrictions prove high and should corporation tax receipts fall short of expectations in the key month of November.

The *Budget 2021* projections envisage the deficit falling only marginally to 9.8 per cent of GNI* in 2021. A Milder scenario could see better revenues next year; limited, if any, use of the Recovery Fund and Covid-19 Contingency Reserve, and lower costs associated with the pandemic and Brexit more generally. This could see the deficit fall more sharply to 6.6 per cent. It could then recover to a surplus of 0.3 per cent by

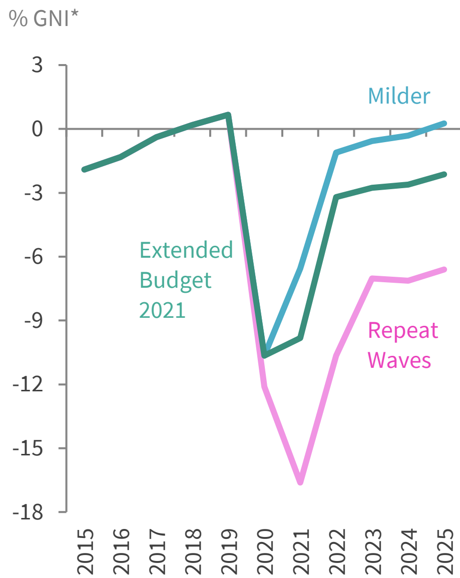
[9] These estimates are based on the Council's Fiscal Feedbacks Model and the extended Budget 2021 scenario. They assume no other change in policy other than the reduction in spending by €5.4 billion in the counterfactual.

2025. By contrast, a “Repeat Waves” scenario could see repeated confinement measures together with a disorderly Brexit result in substantial income supports, increased health expenditure and far weaker revenues. In this scenario, the deficit could widen to 16.6 per cent of GNI* in 2021 and remain wide at just over 6½ per cent by 2025.

Figure 1.14A: High debt ratios appear manageable

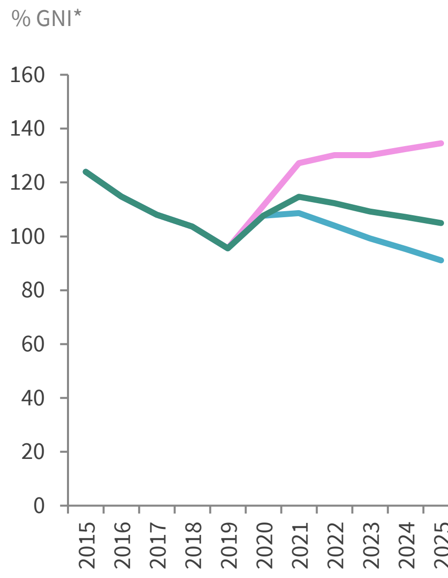
A. Budget balance

% GNI*



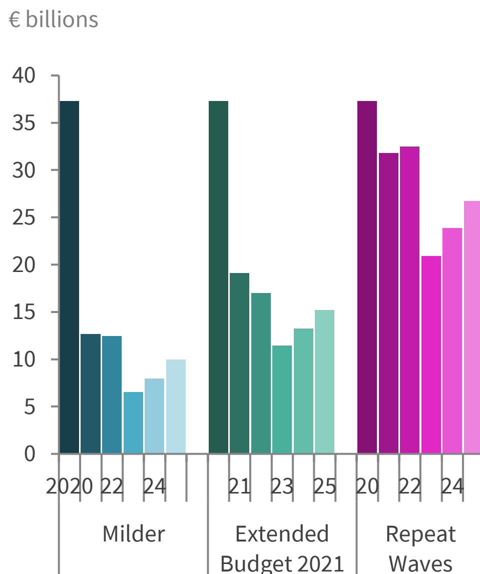
B. Gross debt ratio

% GNI*



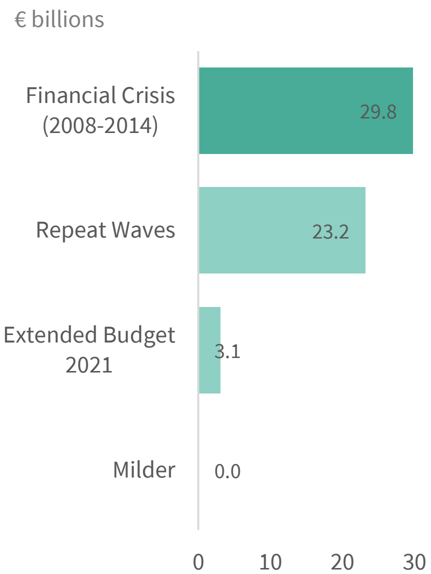
C. Gross financing needs

€ billions



D. Illustrative adjustment requirements

€ billions



Sources: Department of Finance; NTMA; CSO; and Fiscal Council workings. Get the data.
Notes: Scenarios are consistent with the macroeconomic and fiscal assumptions set out in Boxes D and G.

The scenarios considered by the Council would suggest a debt ratio that climbs to between 109 and 127 per cent of GNI* by end-2021. The extended *Budget 2021*

projections suggest that favourable debt dynamics could help the debt ratio fall towards 100 per cent of GNI* by 2025, with average annual reductions of about 2½ percentage points from 2023 — similar to the pace of reduction pre-crisis. In a Milder scenario, the debt ratio could fall faster in the absence of any correction: averaging annual reductions of over 4 percentage points per annum from 2023 onwards. However, in a severe "Repeat Waves" scenario, the debt ratio could stagnate at high levels, close to 130 per cent of GNI*, without any policy responses such as spending cuts or tax increases.

In terms of financing needs, Ireland could expect to have to raise about €13 billion per annum on average over the period 2023–2025. This could be much lower in a Milder scenario at about €8 billion on average but could rise to as much as €24 billion in a Repeat Waves scenario. It would equate to between 3½ per cent to 10½ per cent of GNI* across the three scenarios in terms of annual average gross financing needs for 2023–2025 (5.8 per cent for the extended *Budget 2021* forecasts). For context, the IMF considers thresholds for gross financing needs of 20 per cent of GDP as a concern for advanced economies. In 2019, pre-crisis, the IMF estimated gross financing needs across advanced economies ranging from 3.7 per cent to 11.6 per cent of GDP.[10]

Based on the Council's analysis across the three scenarios considered, fiscal adjustment could be avoided or manageable. Both the Milder and Extended *Budget 2021* projections suggest that large adjustments to the public finances will not be required when the economy has recovered. However, the fiscal situation would still remain challenging, given the medium-term challenges set out below. Debt ratios in those scenarios would be expected to adjust to a steady downward path much like that observed pre-crisis. This is encouraging, and it reflects the combination of a lower-than-expected starting debt ratio for 2019, persistently low interest rates, and a milder-than-expected—though still severe—shock to the economy and the public finances in 2020. Only in a severe Repeat Waves scenario does it seem likely that fiscal adjustments might be required. Even in that extreme case, which now seems a relatively remote possibility, the adjustments would be far less than that observed

[10] This is based on the 25th to 75th percentile of country financing needs for 27 advanced economies. Smaller economies tend to have lower gross financing needs than larger economies. Restricting the sample to these, the gross financing needs for 2019 were estimated to average closer to 5½ per cent of GDP.

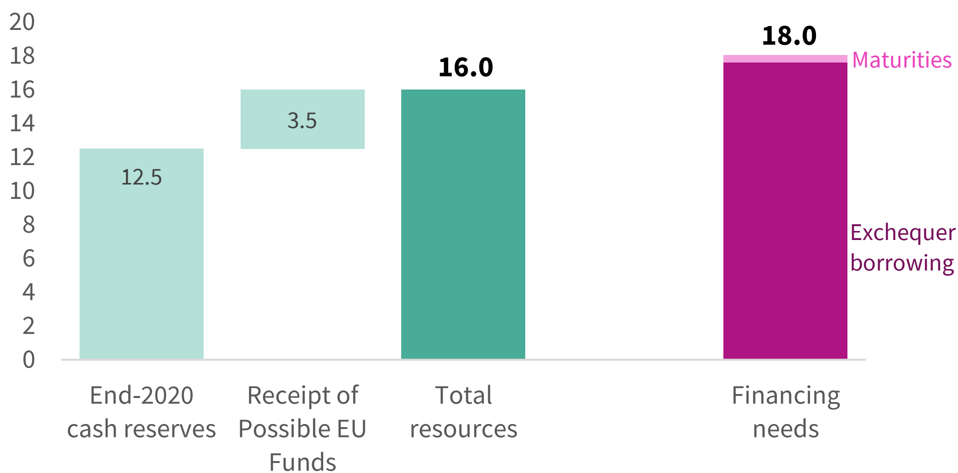
after the 2008 financial crisis at an estimated €23 billion as compared to the €29.8 billion undertaken over the period 2008–2014.

The Government's balance sheet and creditworthiness

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

The State has substantial financial resources available to weather the large need for fiscal supports in the short term (Figure 1.15). Cash balances are projected to be close to €12–13 billion for end-2020. The Government will also have access to other financial resources, including a possible €3.5 billion from EU funds, such as SURE and the Brexit Adjustment Reserve. For 2021, there is an expected Exchequer Borrowing Requirement of €17.6 billion and only one major repayment consisting of a €0.45 billion UK bilateral loan. That suggests that funding requirements for 2021 will be relatively limited.

Figure 1.15: The State will have large resources on hand for 2021



Sources: NTMA; Department of Finance; and Fiscal Council workings. Get the data.
Notes: Projected end-2020 cash reserves are based on forecasts set out in *Budget 2021*, with a range of €12–13 billion projected in the Economic and Fiscal Outlook. EU funds amounts assume that €2.5 billion in funding is made available under the EU Fund known as "SURE" (or the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency) and that at least a further €1 billion is made available under the Brexit Adjustment Reserve — a €5 billion EU fund that will counter unforeseen and adverse consequences in Member States and sectors that are worst affected by Brexit.

The low cost of borrowing is a positive for Ireland's crisis-resolution efforts. To date in 2020, Ireland has raised €24 billion of medium- to long-term borrowings from the market at a weighted average maturity of approximately 11 years and at an average

rate of just 0.21 per cent (Table 1.3). As an example of the reduction in costs, two large bonds worth approximately €17 billion matured this year. These two bonds alone added some €800 million to Ireland's annual interest bill. If assumed to be replaced at the weighted average rate of 0.21 per cent observed so far this year, the equivalent cost of debt each year is just €36 million.

Table 1.3: Bond issuance this year at long maturities and low rates

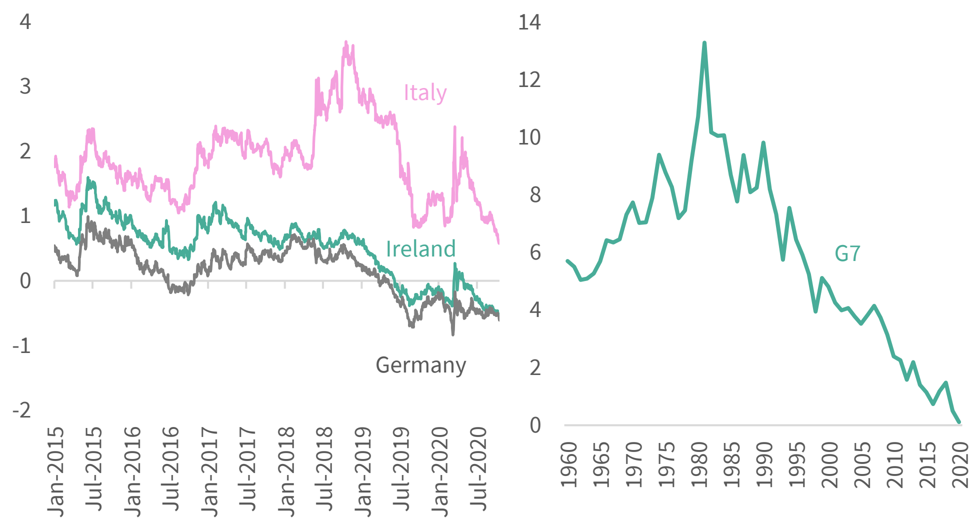
Date	Amount €m	Maturity (year)	Rate (%)
08-Jan	4,000	2035	0.45
12-Mar	1,000	2029	-0.16
07-Apr	6,000	2027	0.24
14-May	650	2050	0.79
	850	2029	0.04
09-Jun	6,000	2030	0.29
09-Jul	300	2050	0.60
	700	2030	-0.03
	500	2027	-0.26
10-Sep	250	2050	0.52
	1,000	2031	-0.10
08-Oct	525	2035	0.06
	325	2030	-0.19
	650	2027	-0.42
12-Nov	850	2030	-0.20
	400	2050	0.42
Total	24,000		
Weighted average of issuance in 2020		2031 (11 years)	0.21

Source: NTMA; and Fiscal Council workings. Get the data.

Yields on Irish ten-year sovereign bonds have sunk to lows of about -0.25 per cent. Rates began to climb in the second week of March. However, this was reversed by substantial European Central Bank (ECB) commitments to expand purchases of Euro Area Member States' outstanding sovereign debt under the Pandemic Emergency Purchase Programme (PEPP). Recent falls in interest rates have been accentuated by the ECB's interventions, yet interest rates have already been on a downward path for the past three decades. Indeed, ten-year bond yields for the G7 countries have fallen from approximately 13 per cent in the early 1980s to essentially zero per cent in 2020 (Figure 1.16).

Figure 1.16: Borrowing costs have fallen to historical lows

% yields (ten-year sovereign bonds)



Sources: Thomson Reuters Datastream; and Fiscal Council workings. Get the data.
Note: As in Rachel and Summers (2019), yields for the G7 are the average of securities across the G7 excluding Italy. Data form an unbalanced panel.

Yet creditworthiness is not guaranteed, and risks of rising borrowing costs remain important for a small, open economy like Ireland that is operating in a monetary union. We know from previous experience, including in the aftermath of the 2008 financial crisis, that market assessments of creditworthiness can change suddenly. This risk could be more acute in cases of "asymmetric shocks" — shocks that are unique to Ireland in terms of their impact. Such shocks might not see increased ECB support to the same extent that a relatively common shock like Covid-19 has thus far.

The use of the Rainy Day Fund to finance the deficit is sensible, though it highlights how insufficient the fund was coming into this crisis. At €1.5 billion, the size of the fund was just 3½ per cent the cumulative deficits expected to be run for 2020 and 2021. Furthermore, annual allocations were never actually made to the Rainy Day Fund, as had been planned. Instead, existing cash resources of €1.5 billion were transferred to it from the Ireland Strategic Investment Fund, another state fund that operates on a commercial basis to support economic activity and employment in Ireland. The first allocation was to be made in 2019 but was abandoned, given that a disorderly Brexit formed the backdrop to *Budget 2020*.

There are significant weaknesses in how the Rainy Day Fund operates that should be addressed for the future (Casey *et al.*, 2018). The €8 billion cap on how large the Rainy Day Fund can become is clearly small and arbitrary. The fact that allocations

to the fund are pre-determined as fixed amounts undermines its capacity to respond to changing economic circumstances. Finally, its scope to be used in a downturn remains unclear: this is due to lingering questions over its interaction with the EU fiscal rules, which have not been adequately resolved and have only been avoided due to the application of the General Escape Clause (Chapter 4). The fund has the potential to be an effective tool for improving budgetary outcomes in Ireland, but these weaknesses need to be overcome.

1.5 Medium- and Long-Term Challenges

Covid-19, Brexit and possible changes to the global tax environment form a difficult backdrop to Ireland's outlook for the coming years. While these present more immediate challenges, longstanding issues remain that will need to be addressed in the medium-term as the economy recovers. These include an ageing population, climate change, over-reliance on corporation tax and ambitions to embark on large-scale Sláintecare reforms of the health sector, alongside any required fiscal adjustment. All of these will add to budgetary pressures over the coming years and decades. Managing the economy and public finances prudently as Ireland seeks to recover from immediate shocks while also adapting to changing circumstances will require a careful approach.

Ireland is ageing rapidly

Ireland is soon likely to have one of the fastest ageing populations in Europe (Fiscal Council, 2020b). This reflects the rapid ageing of a bulge in Ireland's population distribution—itself reflecting a baby boom in the 1970s/80s—and these individuals are set to approach retirement within the next three decades. The Fiscal Council's projections suggest that Ireland's population aged 65 and over as a share of those aged 15–64 will more than double, from 22 per cent in 2020 to 47 per cent in 2050.

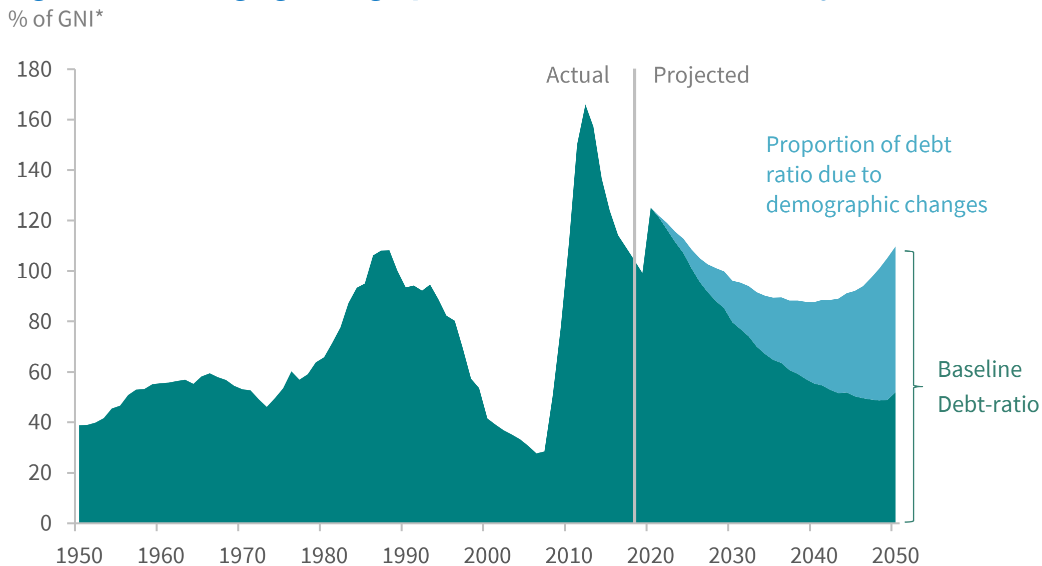
This rapid ageing of the population has major implications for the public finances. Government spending on state pensions, public service pensions, health, and long-term care will increase in real terms as the population ages. The growing number of recipients is estimated to add some €370 million annually to pension costs on average over the years 2021–2025. Increases in the average payments to allow for price increases in the economy would push this upwards. Under current policies, combined spending on pensions and healthcare would be projected to increase from 13.3 per cent of GNI* in 2019 to almost 25 per cent in 2050, particularly after 2030.[11] Ageing will also lead to a diminishing labour force, while productivity growth rates are also likely to moderate further in the future, as labour productivity converges on regions with already high levels of productivity.

[11] The projections assume that service levels remain constant and that social payments (such as pensions) rise in line with wages.

The combination of an ageing population and moderating economic growth rates will exert upward pressure on deficits and, hence, on Ireland's government debt ratios. The Council estimates that, under current policies, around half the debt burden in 2050 would reflect unfunded ageing costs (Figure 1.17).

Figure 1.17: Changing demographics are set to add considerably to the debt burden

% of GNI*



Sources: Fiscal Council (2020b). Get the data.

Note: Graph shows gross debt. Modified GNI* is linked to GNI for 1970–1995 and to GNP for 1950–1969. The blue shaded region shows the proportion of the baseline debt ratio that can be attributed to an ageing population relative to 2020 demographics.

The Government's decision to defer the pension age increase to 67 next January raises the costs associated with ageing. The Programme for Government committed to deferring the planned increase of the pension age to 67. This was due to occur on January 2021. Instead, a Commission on Pensions has been established and tasked with examining sustainability and eligibility issues within the current pensions system. It is to outline options for the government to address issues including qualifying age, contribution rates, total contributions and eligibility requirements. The deadline for delivery of this report is June 2021, with the Government pledging to take action on the recommendations within six months. The Council estimates that the additional cost of leaving the pension age constant at 66 is close to €575 million in 2021, about 0.3 per cent of GNI*, with these costs rising over subsequent years.

Transitioning to a low-carbon economy will have costs

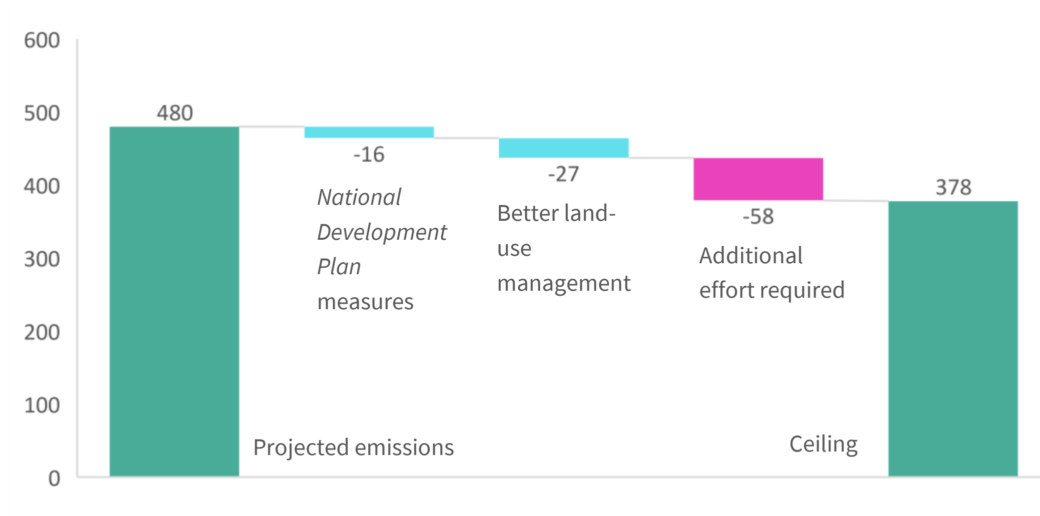
Climate change will also pose risks to fiscal sustainability. Climate change could significantly affect economic activity and long-run growth prospects. Traditional

sources of revenue (including excise, vehicle registration tax, motor tax and carbon tax) are likely to be affected as behaviour changes in response to climate-change mitigation policies. The process of adapting the economy to lower carbon emissions may have positive effects on employment and investment, though it may also carry costs for both growth and the public finances as firms transition to new technologies.

In the coming years, the Climate Action Plan (2019) indicates that additional efforts—larger than what has already been set out—are still required to achieve the 2030 ceiling for levels of greenhouse-gas emissions (Figure 1.18). As with other long-term fiscal challenges, delaying adjustment may ultimately prove more costly. Taking appropriate action may create additional fiscal costs in the coming years.

Figure 1.18: Additional measures are needed to meet the 2030 ceiling

Levels of greenhouse-gas emissions (Mt CO2eq)



Source: Climate Action Plan 2019. Get the data.
Note: NDP = National Development Plan.

Ireland should reduce its over-reliance on corporation tax receipts

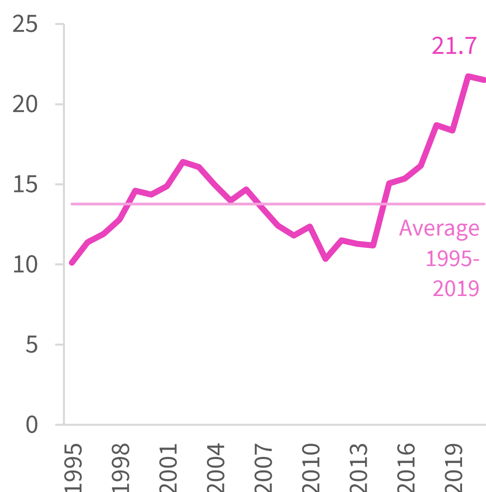
The funding of Ireland's public services and supports has become increasingly dependent on corporation tax receipts. Receipts are expected to rise to a record share of total Exchequer tax receipts at 21.7 per cent in 2020, remaining high at a projected 21.5 per cent in 2021 (Figure 1.19A). Excess receipts—receipts that are not explained by the performance of the domestic economy—are estimated to have risen to 5½ billion in 2019 (Figure 1.19B). That is equivalent to half of the total €10.9 billion of corporation tax receipts collected in 2019.

Corporation tax receipts have been relied on to help fund recurrent spending in recent years and—reflecting their concentration in multinational sectors—helped sustain revenues during the current crisis. Unexpected corporation tax receipts helped to mask repeated and long-lasting upward revisions to spending in the years prior to the crisis. This was most notable in health, where overruns from 2015–2019 averaged €500 million per annum.

Figure 1.19: Corporation tax poses risks for sustainable funding of public services

A. Over-reliance on corporation tax

% total Exchequer taxes



B. Excess receipts have risen to high levels

€ billions

Sources: Department of Finance; and Fiscal Council workings. Get the data.
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 based on the performance of the domestic economy (as in, looking past distortions caused by foreign-owned multinationals, which would be reflected in the use of GDP). Central estimates in the 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*).

Box A cites Base Erosion and Profit Shifting (BEPS) initiatives as one source of risks to the sustainability of corporation tax receipts, but there are other sources of risk beyond potential changes to the international tax environment. Corporation tax receipts are highly concentrated: 43 per cent of receipts were from ten corporate groups in 2019 and 77 per cent of total receipts were from foreign-owned multinationals. This leaves corporation tax receipts exposed to idiosyncratic firm-specific developments and to potential reversals should a large corporate group shift its operations. More generally, corporation tax receipts are the most volatile of the main tax heads and they have historically had the largest forecast errors (Casey and Hannon, 2016).

Sláintecare reforms are ambitious but lack detail and need updating

The implementation of Sláintecare—a 10-year programme to transform Ireland's health and social care services—has been discussed for a number of years and the 2020 Programme for Government commits to its implementation. Estimates of the cost of implementation of the Sláintecare programme suggest an additional rise in annual public spending on health for the first 10 years that will accumulate to €2.8 billion per annum. These estimates are outlined in the Sláintecare Report (Committee on the Future of Healthcare, 2017). However, three and a half years on from the Sláintecare report and with large increases in ongoing health spending contained in *Budget 2021*, the Government needs to publish a clear plan and cost plan for the implementation of the reforms.

How to navigate these challenges

The challenges facing the Government are sizeable but—with good planning—should be possible to manage prudently. To help navigate these challenges it is critical that the Government sets out a clear fiscal strategy.

The Council welcomes the Government's commitment to publish a medium-term strategy next spring that will give an indication of its plans to finance its objectives amid these challenges. The Council also welcomes the establishment of the Pensions Commission, which will examine the legislated pension age increase that was deferred, as well as other aspects of Ireland's pension system, and the proposed establishment of a Commission on Welfare and Taxation.[12]

The Government should produce a more comprehensive spending review. The annual spending reviews produced by the Department of Public Expenditure and Reform are not consistent in providing clear conclusions. Instead, they frequently focus on recent trends in spending areas, with no clear direction as to what adjustments might be made or if these are necessary at all. Examining trends is useful in the sense that it can shine a light on spending areas where data and

[12] The Government notes that the Commission will independently consider how best the tax system can support economic activity and promote increased employment and prosperity, while ensuring that sufficient resources are available to meet the costs of the public services and supports in the medium and longer term. It notes that this will be essential for putting the public finances on a sustainable basis over the coming years. It also indicates that the Commission will have particular regard to the impact of the Covid-19 pandemic, as well as long-term developments such as ageing demographics, the move to a low-carbon economy, and the rise of digital disruption and automation.

analysis was previously quite limited. But it falls short of what spending reviews would normally aim to achieve. Typically, spending reviews would seek to (a) examine how savings might be made by altering how certain public services can continue to be delivered, or (b) assess whether or not certain public services are still relevant, with a view to generating savings. Box E of the *June 2017 Fiscal Assessment Report* discusses this and gives the examples of the UK 2010 Comprehensive Spending Review and the Netherlands Comprehensive Expenditure Review. Both sought to achieve savings or reductions in spending by carefully examining spending areas and providing conclusions about what adjustments should be made.

For a credible medium-term strategy, the Government should set out a number of key elements in its medium-term plan next spring. Box B sets out what these elements should be, including providing detailed projections of medium-term spending and revenue; transparent costings of major policy changes like Sláintecare; compliance with fiscal rules; how plans will change if revenue falls short; and how the Rainy Day Fund and other measures to improve the fiscal framework will operate.

To help deal with the challenges likely to arise over the medium term, the Government should reinforce its budgetary framework along three key channels. First, it should develop debt targets specific to Ireland. These would help guide the government debt ratios to safer levels over the medium term and allow scope for a countercyclical response to be introduced, as was possible in this latest crisis. Second, the Government should use a Rainy Day Fund and Prudence Account to save temporary receipts like corporation tax rather than use these to fund permanent spending increases. Third, the Government should anchor spending growth to specific limits based on sustainable growth rates.

Box B: What the Government's medium-term strategy should do

In spring 2021, the Government will publish an updated Medium-term Budgetary Strategy as part of its Stability Programme Update. The Department of Finance notes in *Budget 2021* that this will set out a medium-term trajectory showing how the deficit will be eliminated. It also notes its anticipation that "economic recovery will likely do most of the heavy lifting" (Department of Finance, 2020c; p.2).

With debt set to reach high levels and substantial medium-term pressures, there is a critical need for careful planning for the medium-term. It will be important to set out how competing fiscal pressures from any adjustment needs, ageing, climate change and plans to upgrade public services will be managed.

Key features of a credible medium-term plan

The Government's medium-term plan should seek to cover the following six objectives:

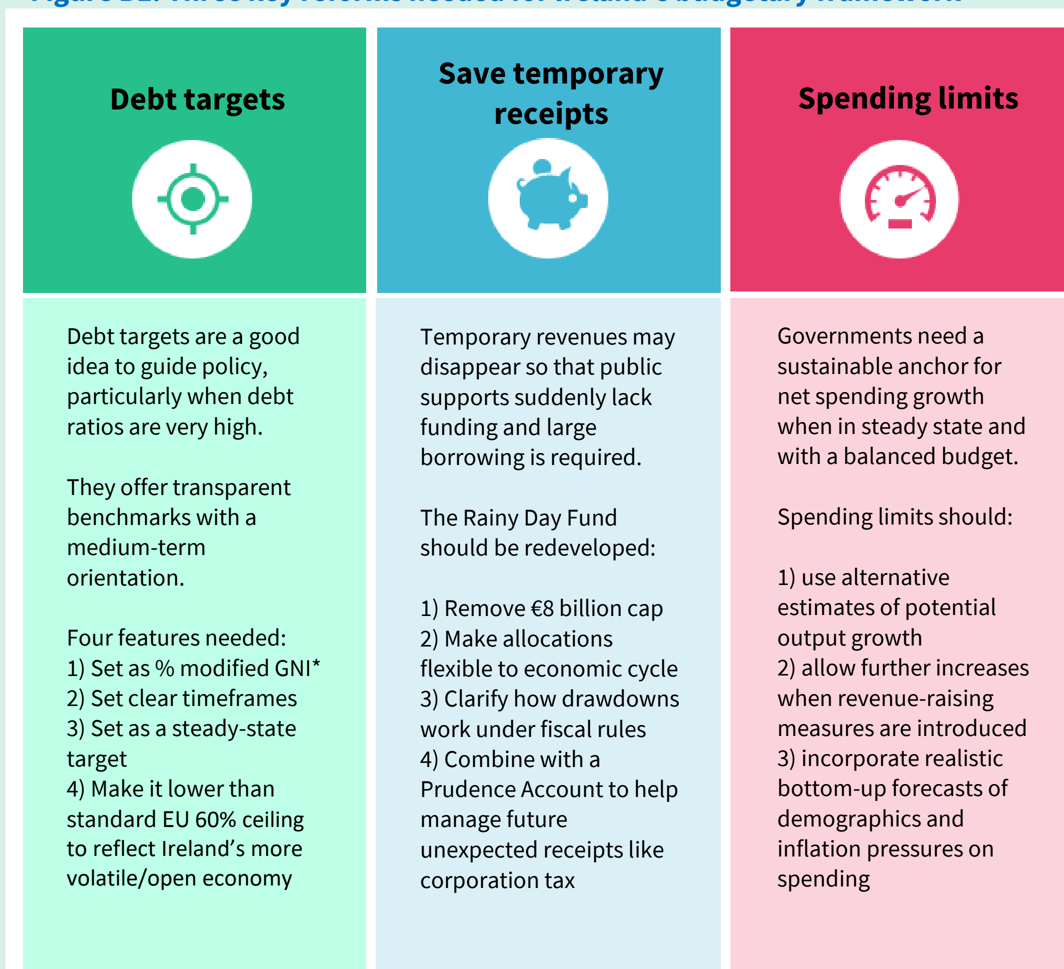
1) *Detailed, five-year-ahead, medium-term expenditure projections*. These should take into account the cost of providing existing public services in terms of wages, social welfare rates and pensions, together with any planned policy measures. The Government should also take more strides forward in terms of transparency on how non-Exchequer spending is presented. This should include detail on spending in non-commercial semi-state bodies, extra budgetary funds, and local government. The payment of the Christmas Bonus—paid to welfare recipients in each of the past seven years—should be budgeted for by default, given the high likelihood that it will be paid.
2) *Medium-term, five-year-ahead revenue projections*. These should also outline how major tax heads would be adjusted to meet government plans.
3) *Transparent costings of major changes in policy*. These costings should account for major policy changes that are expected to have ongoing impacts, such as the implementation of the programme of Sláintecare reforms in health and social care spending.
4) *Medium-term fiscal objectives and compliance with domestic and EU fiscal rules*. Budgetary documents published in 2020 provide little information on compliance with fiscal rules, given that the General Escape Clause applied (Chapter 4). Despite this, ongoing monitoring of key metrics relevant for the fiscal rules is a good practice that should be incorporated into budgetary forecasts.
5) *An indication of how plans would be modified if revenue falls short of expectations*. The outlook for the economy is exceptionally uncertain. If the recovery is weaker than expected, revenues may fail to recover as expected and expenditure on unemployment benefits may be larger. The Government should have a clear plan as to how to sustainably reduce any persistent increase in borrowing that arises in the coming years.
6) *An indication of how the Rainy Day Fund and other measures to strengthen the fiscal framework are to be used*. The Fiscal Council assesses that several key reforms to how the budgetary framework operates in Ireland are warranted so as to help ensure prudent management of the economy and public finances. These are set out in the next subsection of this box. It would help if the Government uses its medium-term strategy to develop these further.

Whether or not these six objectives are met will form a key part of the Fiscal Council's assessment of the medium-term plan that the Government sets out in spring.

Three key reforms would help to anchor Irish budgetary policy

The Fiscal Council assesses that three key reforms would help current and future governments to navigate through all the challenges that lie ahead. These reforms have been developed over several publications by the Fiscal Council, but also by the Department of Finance.[13] The reforms are set out in Figure B1. They involve (1) the establishment of clearer debt targets (introduced by the previous government, but subsequently ignored for the most part); (2) mechanisms to ensure that temporary receipts like corporation tax are saved rather than used to fund permanent spending increases; and (3) a better system of ensuring that spending growth rates are anchored effectively — one that is tailored to Ireland's highly open and volatile economy.

Figure B1: Three key reforms needed for Ireland's budgetary framework



[13] The reforms were outlined in previous work by the Council, including in Box N of the *November 2019 Fiscal Assessment Report*; Barnes and Casey, 2019; and Casey *et al*., 2018. The Department of Finance (2019) has partly considered some proposals to reinforce the budgetary framework in a "Fiscal Vulnerabilities Scoping Paper", though these should be developed further along the lines of what is suggested here.