FISCAL ASSESSMENT REPORT

Sustaining the Economy through Covid-19

Irish Fiscal Advisory Council

December 2020

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This report can be downloaded at www.FiscalCouncil.ie

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Foreword

The Irish Fiscal Advisory Council was established as part of a wider agenda of reform of Ireland's budgetary architecture. The Council was initially set up on an administrative basis in July 2011 and was formally established as a statutory body in December 2012 under the *Fiscal Responsibility Act*. The Council is a public body funded from the Central Fund. The terms of its funding are set out in the *Fiscal Responsibility Act*.

The mandate of the Irish Fiscal Advisory Council is to:

- endorse, as it considers appropriate, the macroeconomic forecasts prepared by the Department of Finance on which the Budget and Stability Programme Update are based;
- assess the official forecasts produced by the Department of Finance;
- assess government compliance with the Budgetary Rule;
- assess whether the fiscal stance of the Government in each Budget and Stability Programme Update (SPU) is conducive to prudent economic and budgetary management, including with reference to the provisions of the Stability and Growth Pact.

The Council's Chairperson is Mr Sebastian Barnes (Organisation for Economic Co-operation and Development). Other Council members are Dr Martina Lawless (Economic and Social Research Institute), Prof. Michael McMahon (Professor of Macroeconomics at the University of Oxford and Senior Research Fellow of St Hugh's College), and Ms Dawn Holland (Visiting Fellow, National Institute of Economic and Social Research). The Council's Secretariat consists of Dr Eddie Casey, Mr Niall Conroy, Mr Kevin Timoney, Mr Killian Carroll, Ms Karen Bonner, and Dr Elliott Jordan-Doak. The Council would like to acknowledge the kind help from staff at the CSO, Central Bank of Ireland, ESRI, and the NTMA.

The Council submits its Fiscal Assessment Reports to the Minister for Finance and within ten days releases them publicly. This report was finalised on 27 November 2020. More information on the Irish Fiscal Advisory Council can be found at www.FiscalCouncil.ie

Summary Assessment

Summary Assessment

Covid-19 continues to have a major impact on the Irish economy and public finances. The Government based its *Budget 2021* forecasts for 2020 and 2021 on the view that a vaccine would not be widely available until at least 2022. It also assumed that trade between the UK and the EU would be based on a hard Brexit with WTO terms from January 2021. This was prudent, given the uncertainties and risks involved.

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. 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. New analysis in this report highlights some of the regional differences in activity lost due to Covid-19. Western and border regions, areas that are more heavily reliant on sectors like tourism and hospitality, have been worse affected.

The Council has developed three economic and fiscal scenarios to 2025, given the uncertainties and need for medium-term fiscal planning. The extension of forecasts to 2025 is necessary because, 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 impact the economy and public finances. While any medium-term projections are uncertain, such forecasts help support a medium-term orientation for fiscal policy and enable monitoring of potential economic imbalances.

The extended *Budget 2021* projections suggest that activity in the domestic economy is unlikely to return to its pre-crisis levels before the end of 2022. The lasting impacts of the shock to the economy from the pandemic are still unclear, including how resilient firms will be. 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 reintroduced in both 2021 and 2022, this would see a more stunted recovery. In this "Repeat Waves" scenario, real GNI* might not recover its pre-crisis levels until Q3 2023. In addition to risks around the impact of Brexit, there are other risks, including potential changes to the international tax environment.

The Covid-19 pandemic has led to a substantial increase in government spending. The Government expects to run a deficit of just over €20 billion this year. *Budget 2021* projects a deficit of €21.6 billion or 10.7 per cent of GNI* for 2020. This reflects 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. The deficit projections for 2020 are better than was expected at the time of April's *SPU 2020* forecasts, when a 13.3 per cent deficit was forecast. This reflects how a better-than-expected tax performance more than offset the introduction of new policy measures. The recent tightening of measures to contain the spread of the virus is likely to weigh on public finances and may offset some of the improvements projected in *Budget 2021*. This could raise the deficit in 2020 by a further €1.6 billion (0.8 per cent of GNI*).

For 2021, *Budget 2021* sets out a large-scale support and stimulus package, which will result in a substantial deficit being run once again. The budget balance is forecast to improve only slightly next year, with a deficit of €20.5 billion (9.8 per cent of GNI*). This includes contingencies of €2.1 billion for Covid-19-related expenditure and €3.4 billion for unspecified measures to support the economy in response to the pandemic and Brexit.

The three scenarios developed by the Council in this report suggest that the government debt ratio will climb to between 109 and 127 per cent of GNI* in 2021 from 96 per cent in 2019. At the end of last year, Ireland had one of the highest debt ratios in the OECD. The sizeable budgetary response necessitated by Covid-19 will see the debt ratio rise substantially. However, the extended *Budget 2021* projections suggest that the debt ratio would fall towards 100 per cent of GNI* by 2025 due to favourable debt dynamics. In a 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 policy responses such as spending cuts or tax increases.

The Government's decision in *Budget 2021* to continue temporary supports for households and businesses through the Covid-19 crisis, as well as measures to stimulate demand, is appropriate. These measures, though costly, should help to support activity in the economy and lessen the lasting economic damage of the crisis. Despite the fiscal costs, this should ultimately lead to a more sustainable path for government debt ratios. Low interest rates will help to support higher debt. The Council welcomes the allocation of the €2.1 billion for contingencies to cope with any additional costs of Covid-19, and the allocation of a Recovery Fund of €3.4 billion to support recovery. These temporary supports should be targeted and should end as the need for emergency measures diminishes and as the economy recovers.

However, *Budget 2021* also included substantial and permanent increases in spending amounting to €5.4 billion without long-term funding. This includes additional non-Covid-related spending and hiring in health, education and other areas. This spending is likely to remain long after the pandemic. The increases are surprisingly large in the context of uncertain growth prospects and compared to previous Budgets. 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 included in *Budget 2021*—without a sustainable plan to finance them—are not conducive to prudent economic and budgetary management. These permanent measures are substantial. There is no sense as to how this spending will be financed sustainably over the medium term. These unfunded commitments will add to future fiscal pressures. The Programme for Government rules out tax increases and spending reductions in many areas. In addition, there is a risk that some of the estimated temporary spending increases included in the 2021 projections, for example in health, end up becoming permanent.

The Government should use its medium-term strategy in April 2021 to deliver credible plans. It is essential that the Stability Programme in April 2021 presents a five-year forecast horizon and that it sets out detailed and transparent budgetary forecasts. The Government should clarify how large underlying increases in spending introduced for 2021 will be funded sustainably and how other fiscal challenges will be addressed. With a substantial amount of spending going towards permanent increases in health spending—some €1.9 billion— the

Government should clarify how this relates to the Sláintecare reforms and provide a costed plan for how this will be implemented. Furthermore, the Government should set out how medium-term budgetary plans would be modified if government revenues fall short of expectations.

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* will make it more difficult to bring the debt ratio back down at a steady pace. In addition, major longstanding issues 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 Government should introduce three reforms to help reinforce its budgetary framework to better navigate these challenges. 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. Third, the Government should anchor permanent spending growth to specific limits based on sustainable levels and growth rates.

The fiscal rules give leeway for a sizeable budgetary response to the public health emergency and the economic

crisis both this year and next. The relaxation of the fiscal rules in 2020 and 2021 will help to facilitate an adequate response to the public health emergency and economic crisis arising from the Covid-19 pandemic. Based on the Council's Extended *Budget 2021* forecasts, in 2022, the deficit to GDP ratio is forecast to fall below the 3 per cent deficit limit in the SGP. However, for Ireland, GDP is not an appropriate measure to base assessments of the fiscal rules on. It would be more appropriate to specify the domestic fiscal rules, outlined in the *Fiscal Responsibility Act 2012*, in terms of GNI*. However, this would require legislative change.

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.

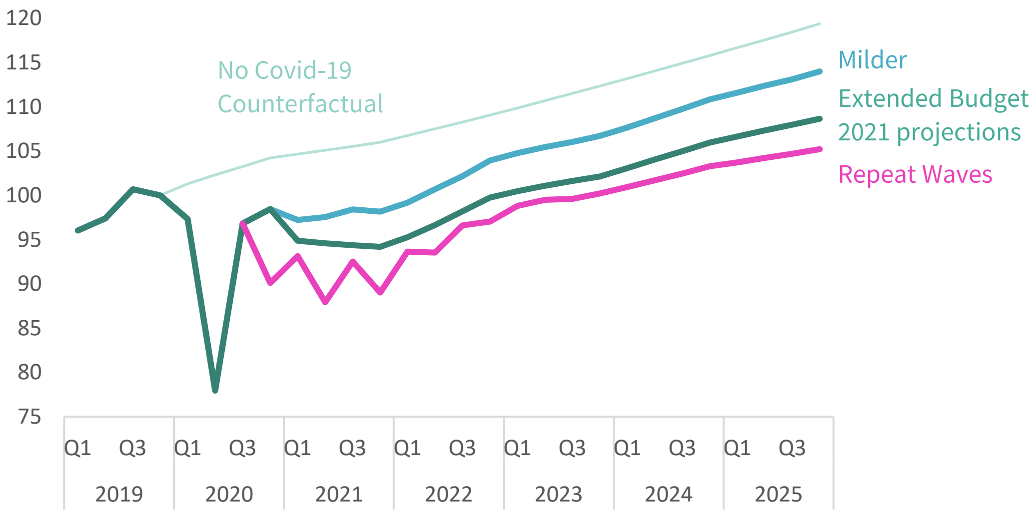
1.2 The Macroeconomic Context

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.

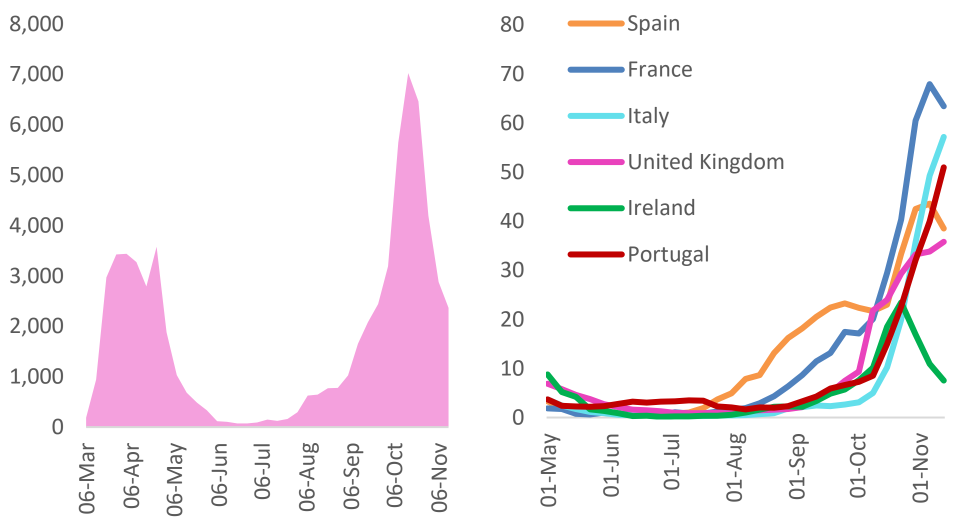
After the financial crisis in 2008, Ireland took a decade to recover its pre-crisis levels of real GNI*, while the recovery in employment took 11 years. By comparison, the Irish economy was in good shape when the Covid-19 shock hit. The shock itself, rather than reflecting domestic imbalances, reflects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

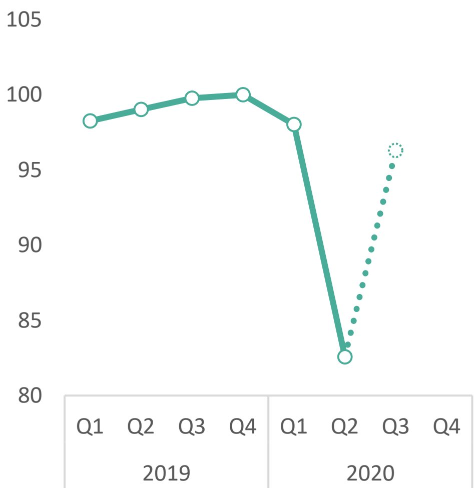
[2] Underlying domestic demand is a useful measure of domestic activity. It looks through most of the distortions arising from the activities of foreign-owned multinational enterprises, although it excludes net exports. It is given as consumer spending plus government consumption plus investment, excluding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

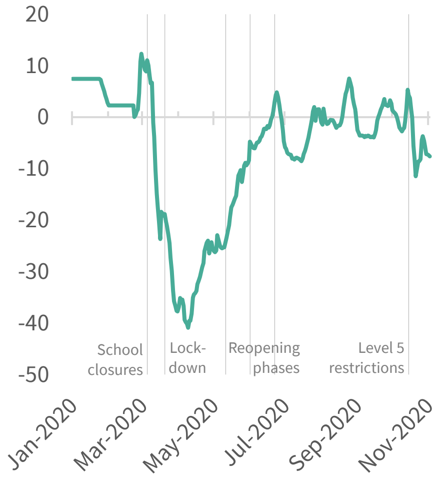
A. Demand rebounded sharply in Q3

Underlying Domestic Demand (Q4'19=100)



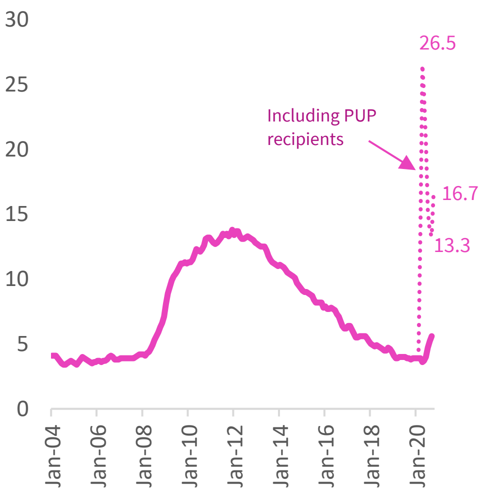
B. Consumer spending recovers but still weak

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



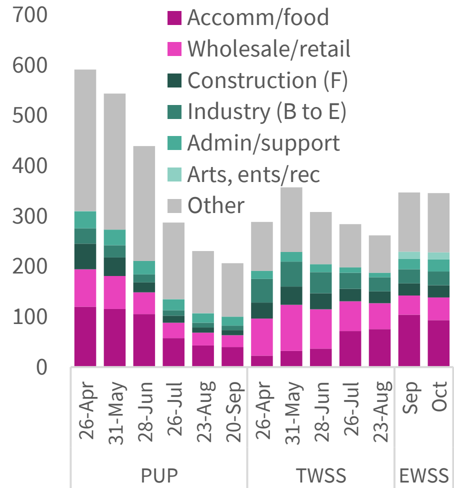
C. Unemployment rates remain high

% 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

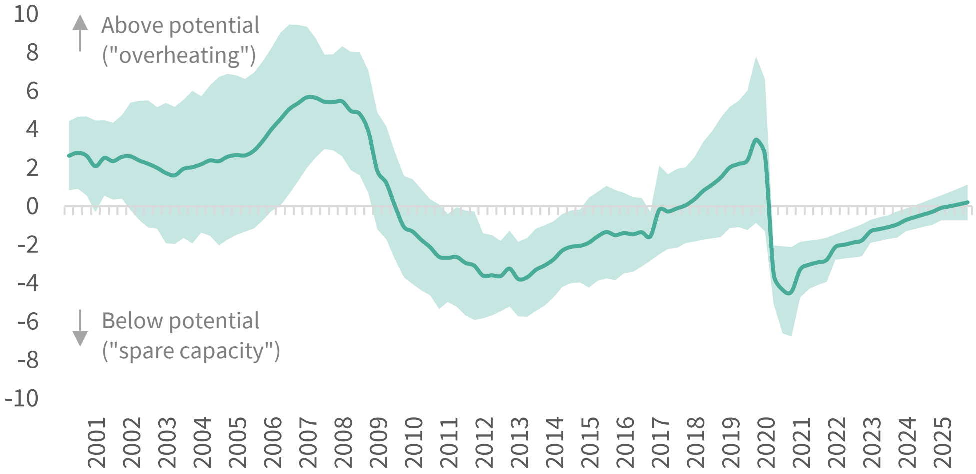
Activity is likely to pick up rapidly as confinement measures ease. But output could remain far below its potential in the near term. This reflects short-term disruptions from a disorderly Brexit with no FTA in place, and continued restrictions at home and abroad on some types of economic activities. 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.

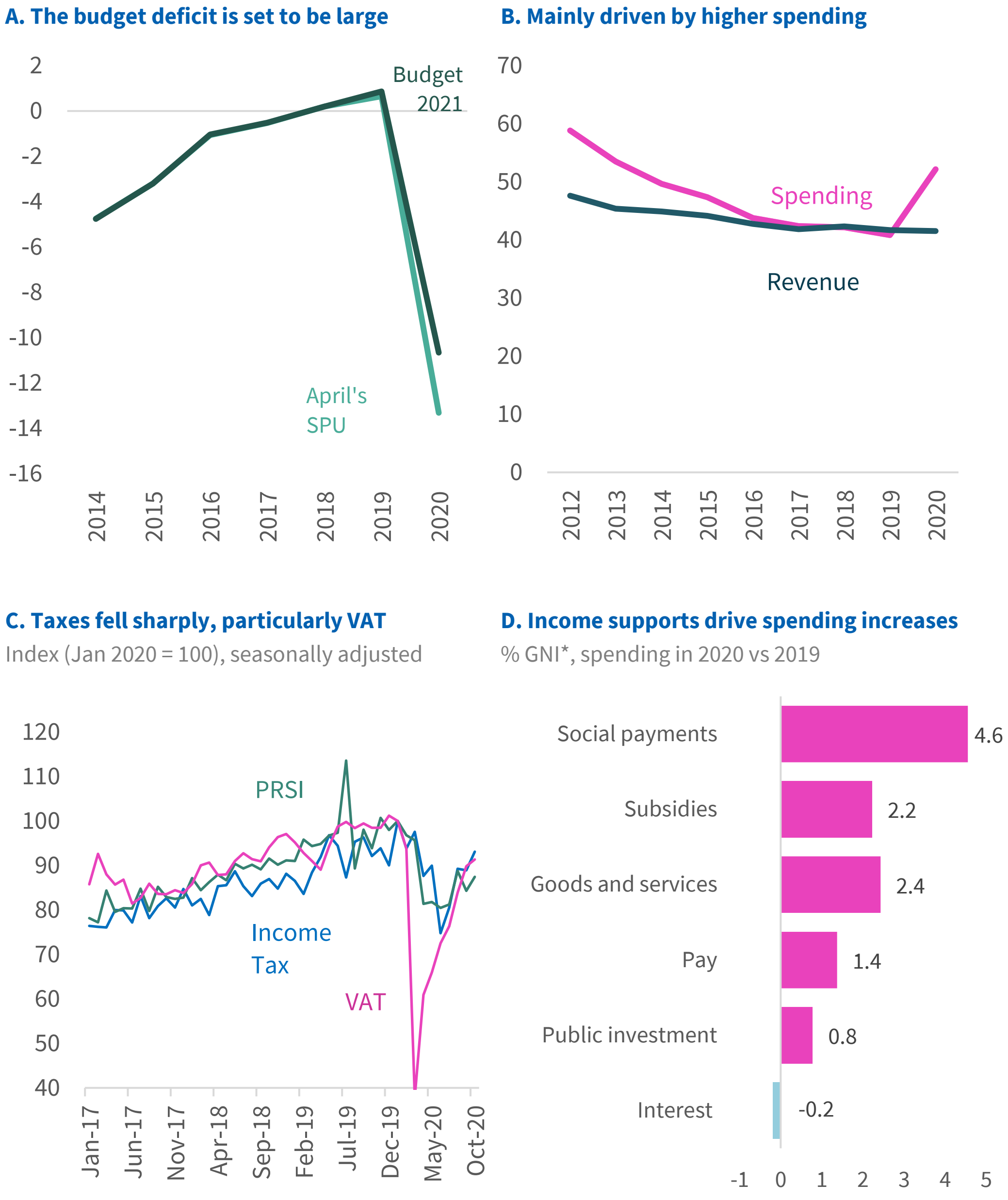
[4] See the Minister of Finance's Budget 2021 speech at: https://www.gov.ie/en/speech/063d4-budget-speech-by-the-minster-of-finance-paschal-donohoe/

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



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

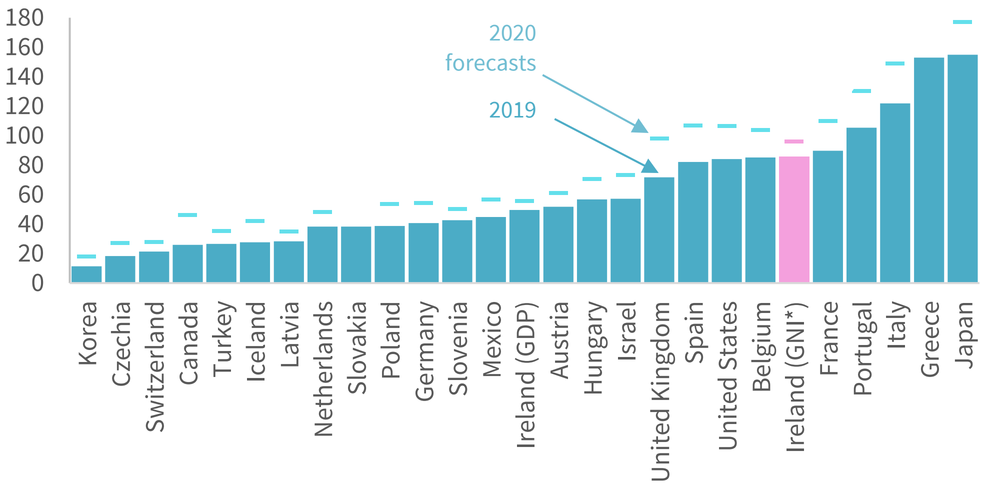
5 Recent outturns in the Department of Finance's Fiscal Monitor have presented monthly outturns of both Income and Corporation Tax as "net" figures, where the costs of the Government's Covid Restrictions Support Scheme have been deducted from these tax heads. Throughout this text, we present the performance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

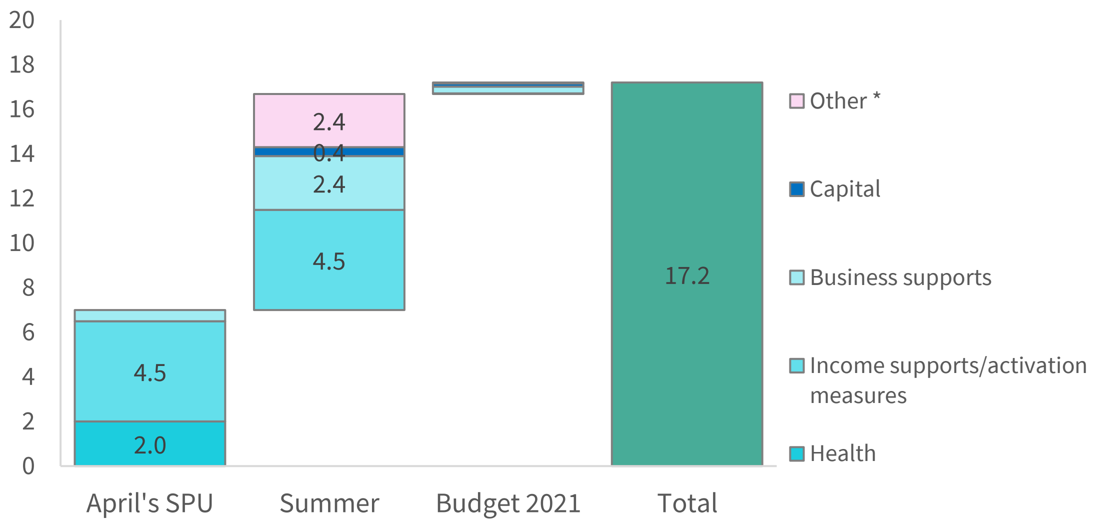
As it stands, Ireland is somewhere between the immediate crisis and the recovery period. Activity in some sectors remains subdued as confinement measures—though less restrictive than in April's lockdown—have had to be reintroduced, hence limiting businesses capacity to operate either entirely or in part. 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

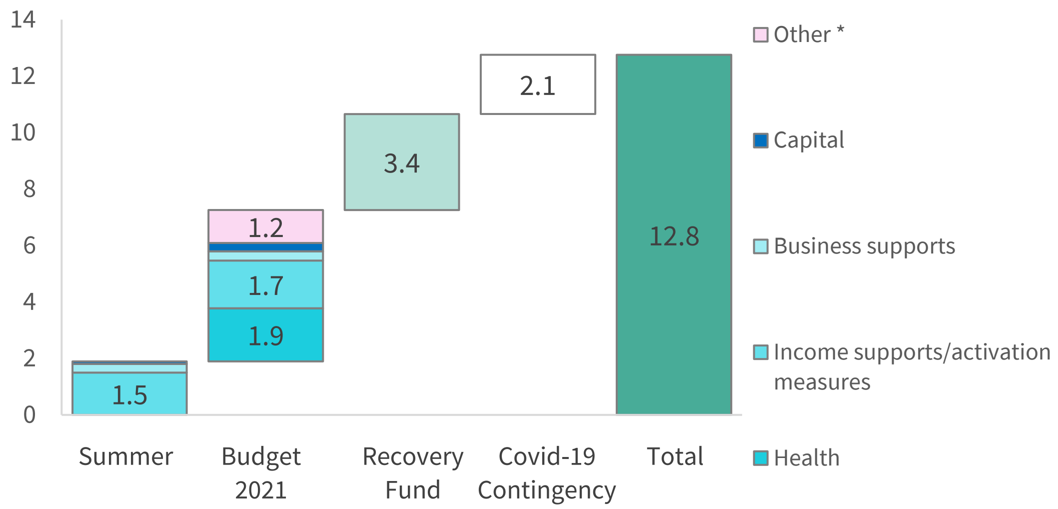
For 2021, the Government has set out plans for permanent increases in spending alongside temporary supports for Covid-19 and Brexit. General government spending for 2021 is set to rise from €105.9 billion to €109.2 billion — a rise of €3.3 billion and some €21.9 billion above the 2019 level. Within this,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

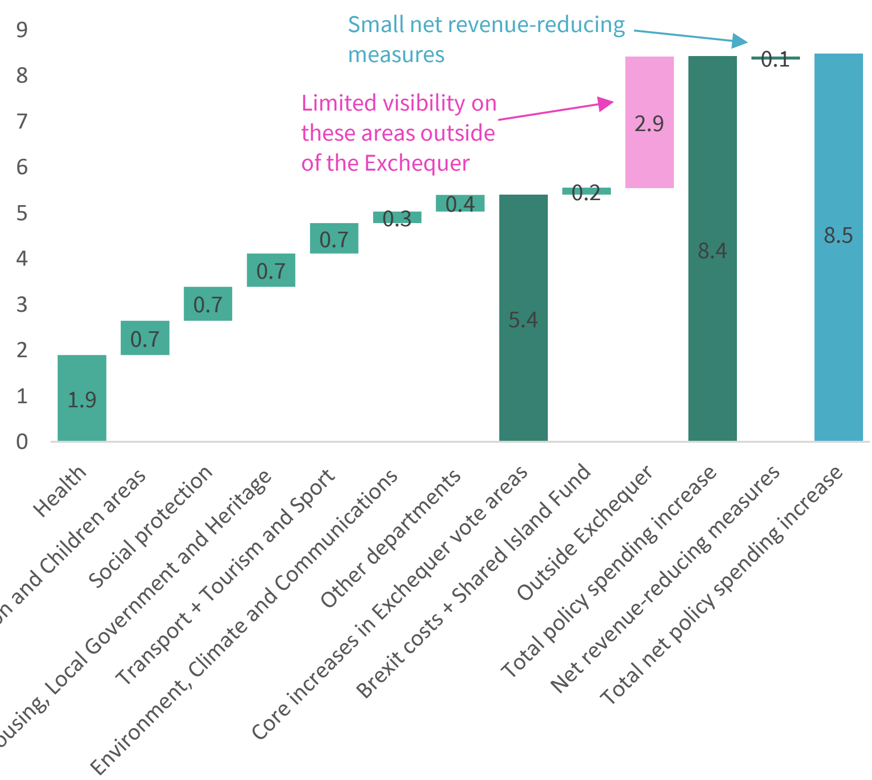
	2020	2021	Change in 2021*
Total Expenditure	105,865	109,180	3,315
- Interest	-3,850	-3,555	295
- One-offs (incl. rise in unemployment benefits)	-16,699	-11,887	4,812
= Policy Spending	85,316	93,738	
- Discretionary Revenue-raising Measures (DRMs)	-960	65	
= Net Policy Spending	84,356	93,803	8,487

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.

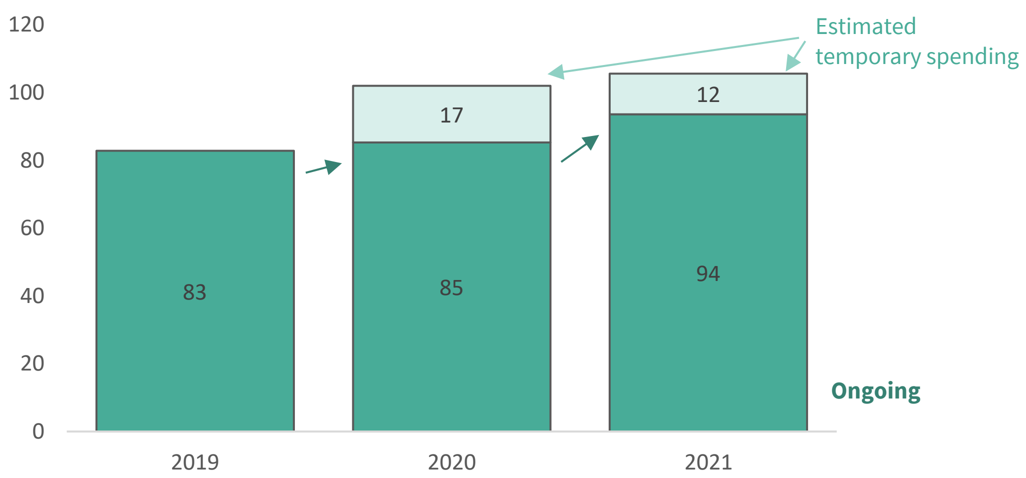
[7] See Box A of the November 2020 Fiscal Assessment Report. The Council has raised these concerns with the Department directly, and it understands that the Department hopes to resolve these issues by publishing more information in future budgetary publications.

[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).

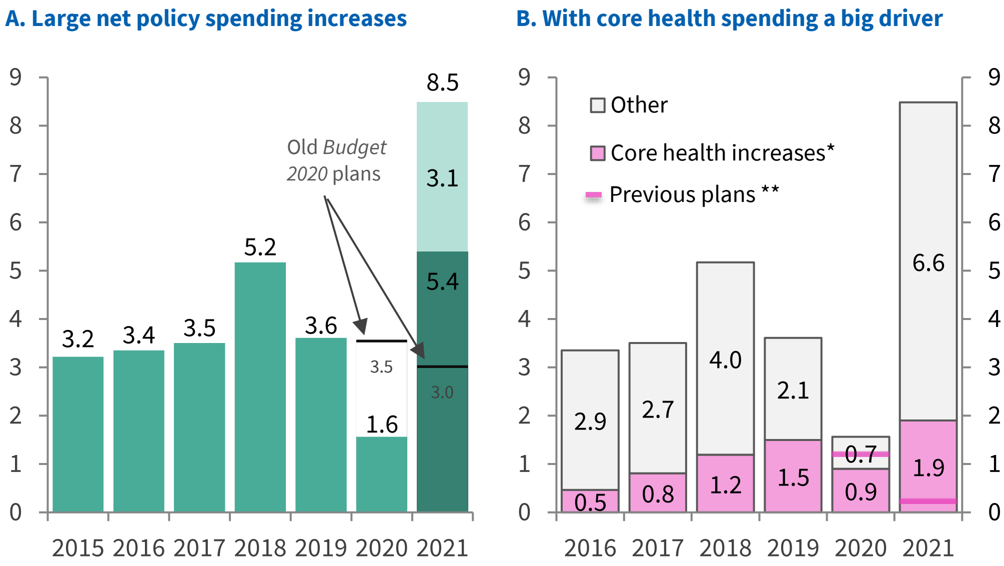
The increase in permanent spending for 2021 continues a pattern of fast government spending growth in recent years, with sharp increases in health spending a key driver. For the years 2015 to 2019, net policy spending has been rising at an annual pace of increase of about €3.8 billion per annum or +5.5 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



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

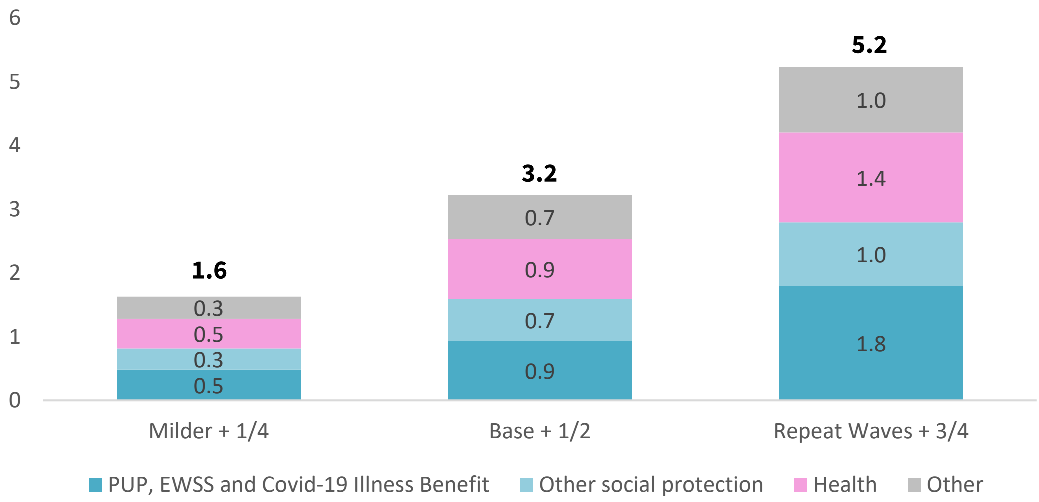
Notes: Net Policy Spending is typically given as total general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment. Given the extensive changes in unemployment benefits associated with the pandemic, the measure is adjusted 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.

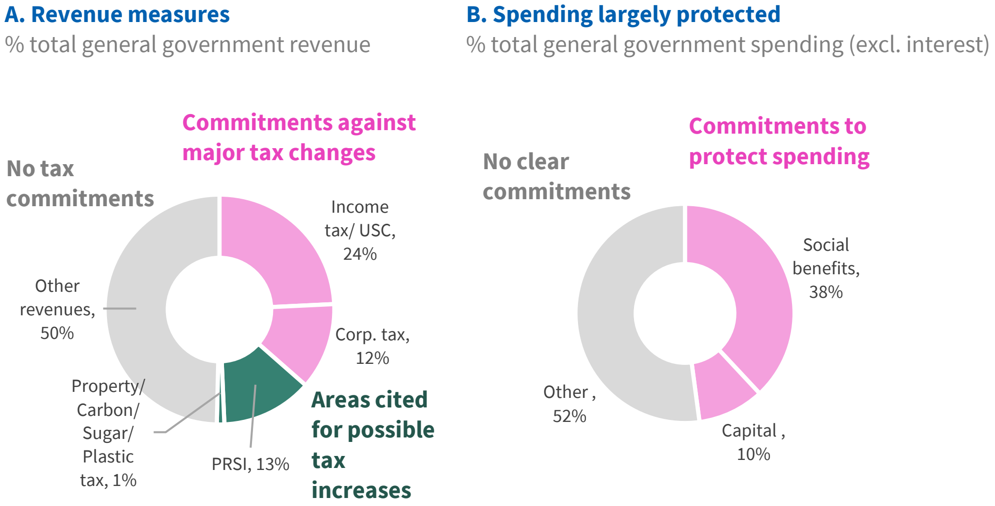
In addition, there is a risk that some of the estimated temporary Covid-19 or Brexit spending increases included in 2021 projections end up becoming permanent. For example, it may be difficult to withdraw some support measures once the crisis lessens or there may be higher than expected costs, such as 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



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).

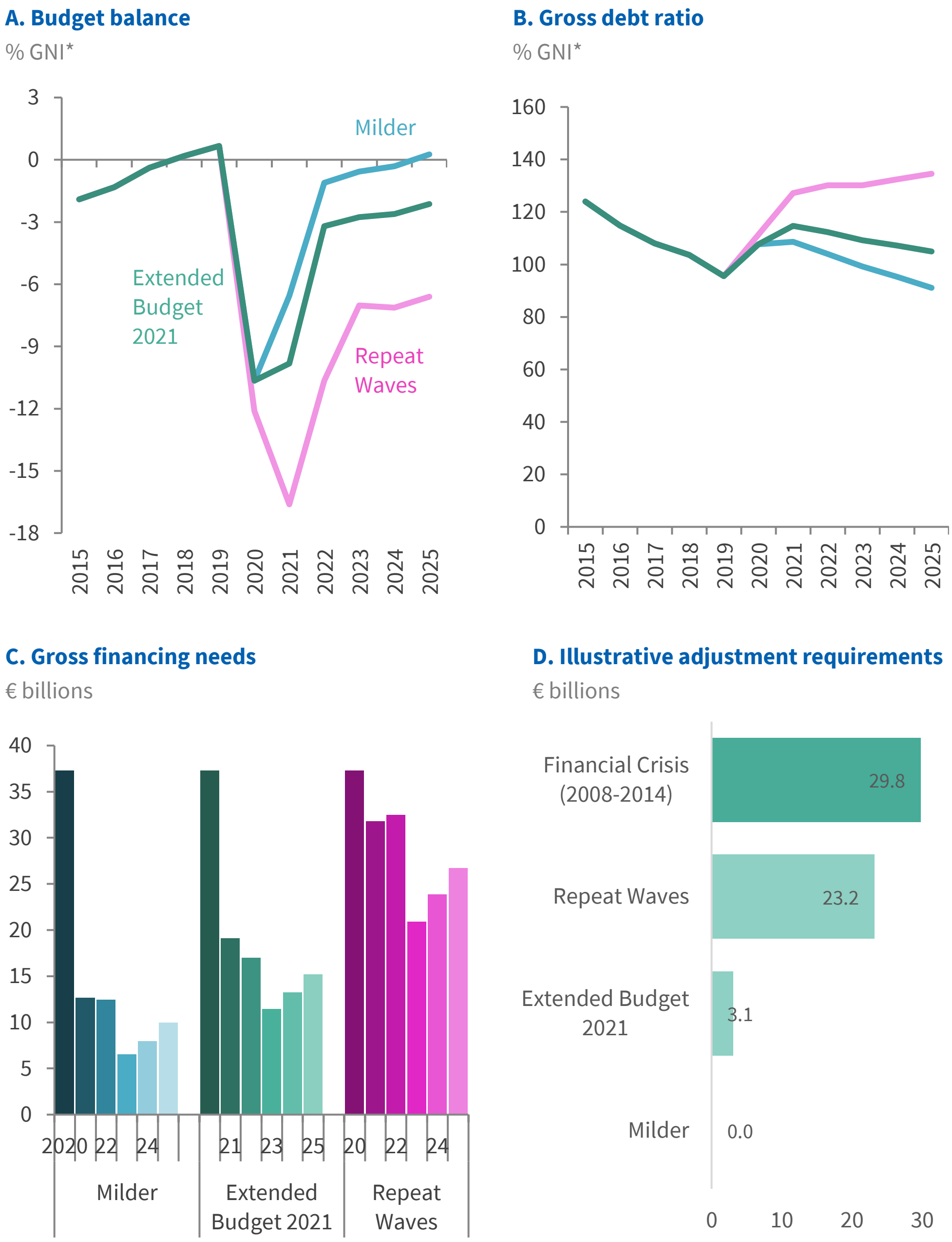
The budget balance is set to remain in deficit in all of the scenarios considered for some time. A deficit of €21.6 billion (10.7 per cent of GNI*) is projected for 2020. A severe Repeat Waves scenario might see it end up closer to €24 billion (12.1 per cent) should the costs of Level 5 restrictions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



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.

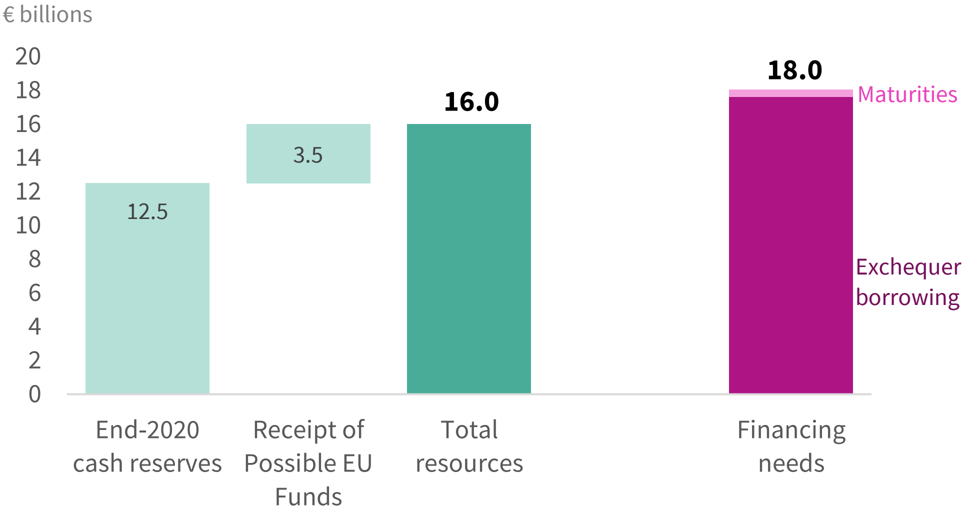
after the 2008 financial crisis at an estimated €23 billion as compared to the €29.8 billion undertaken over the period 2008–2014.

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

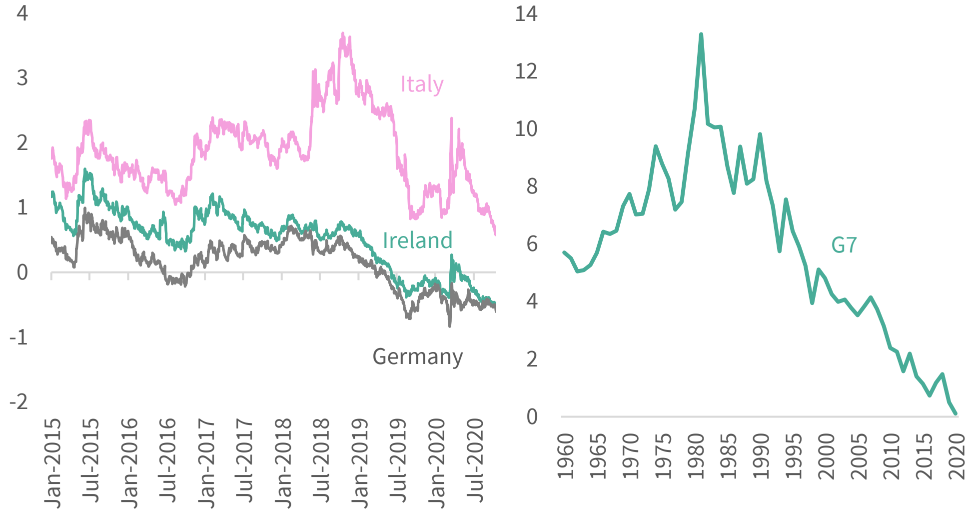
Date	Amount €m	Maturity (year)	Rate (%)
08-Jan	4,000	2035	0.45
12-Mar	1,000	2029	-0.16
07-Apr	6,000	2027	0.24
14-May	650	2050	0.79
	850	2029	0.04
09-Jun	6,000	2030	0.29
09-Jul	300	2050	0.60
	700	2030	-0.03
	500	2027	-0.26
10-Sep	250	2050	0.52
	1,000	2031	-0.10
08-Oct	525	2035	0.06
	325	2030	-0.19
	650	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.

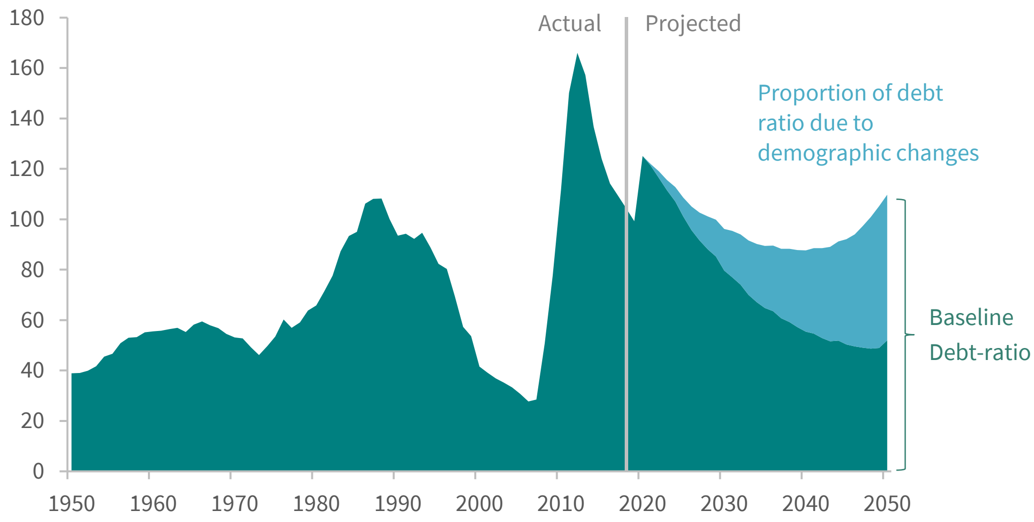
This rapid ageing of the population has major implications for the public finances. Government spending on state pensions, public service pensions, health, and long-term care will increase in real terms as the population ages. The growing number of recipients is estimated to add some €370 million annually 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.

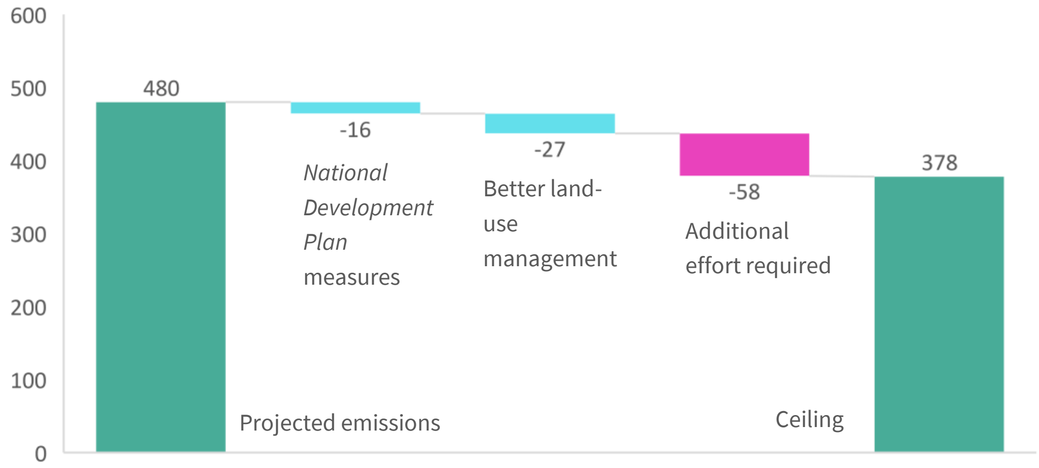
Transitioning to a low-carbon economy will have costs

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)



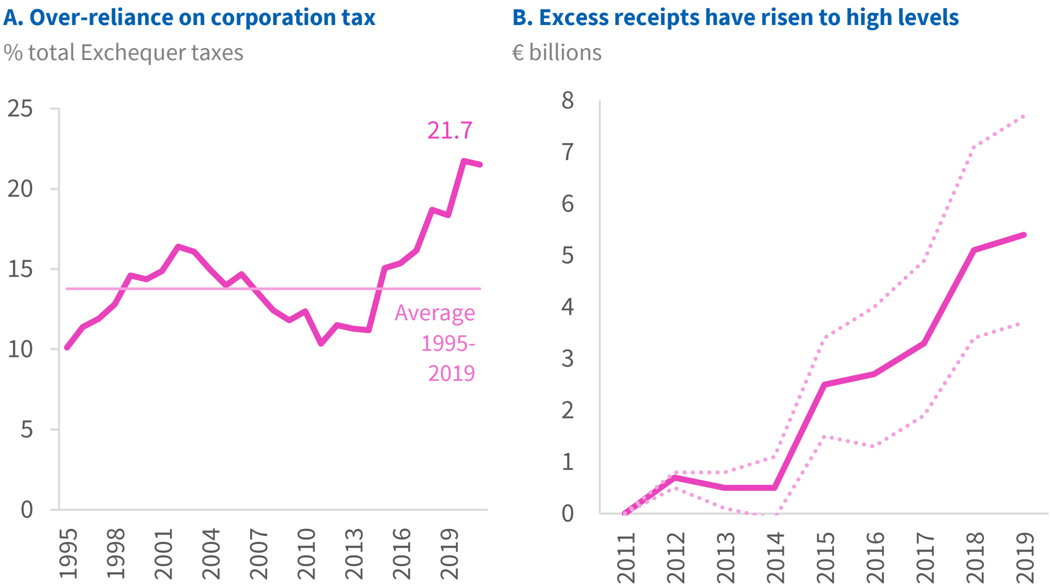
Source: Climate Action Plan 2019. Get the data.
Note: NDP = National Development Plan.

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



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:

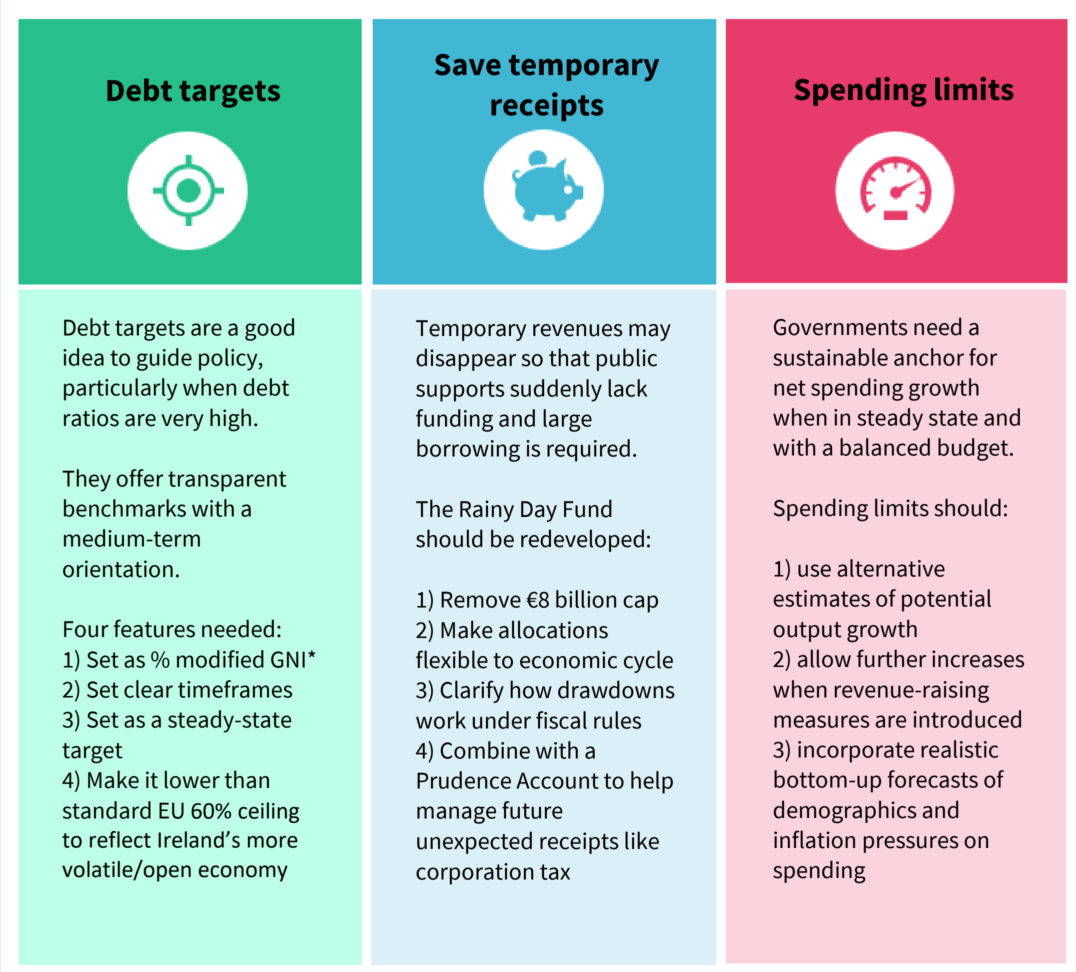
1) *Detailed, five-year-ahead, medium-term expenditure projections*. These should take into account the cost of providing existing public services in terms of wages, social welfare rates and pensions, together with any planned policy measures. The Government should also take more strides forward in terms 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.

Chapter 2

Endorsement and Assessment of the Macroeconomic Forecasts

2. Endorsement and Assessment of the Macroeconomic Forecasts

Key messages

- The Irish economy has endured a major Covid-19 shock, and the onset of further nationwide restrictions since October has left 350,000 people in receipt of the Pandemic Unemployment Payment. Nevertheless, the impact of Covid-19 on the domestic economy has been less severe than forecast, helped by multinational entities with substantial employment in Ireland.

- Underlying domestic demand fell by 16 per cent in the second quarter of 2020 in year-on-year terms, yet this outperformed the Council's most optimistic "mild" scenario published in the May 2020 *Fiscal Assessment Report*, along with the Government's *Stability Programme Update (SPU) 2020* forecast. Encouragingly, the pace of economic recovery remained strong through the summer while virus transmission slowed, albeit some sectors and regions have been particularly badly affected by the pandemic. New analysis in this chapter finds that activity has been worst affected in western and border counties as a result of their greater reliance on consumer-facing industries, including tourism and hospitality.

- The Council endorsed the Government's *Budget 2021* macroeconomic forecasts as being within an endorsable range. The forecasts again cover just one year ahead, to 2021, unlike the normal five-year horizon. Medium-term forecasts are important for sound budgetary planning and assessing the consistency of the short-term forecasts. The Council therefore assesses that a return to five-year-ahead forecasting is essential from *SPU 2021*.

- In this *Fiscal Assessment Report*, the Council provides an update to its macroeconomic scenarios out to 2025, now with a focus on estimated quarterly GNI*. As before, one scenario extends the *Budget 2021* forecasts; a "Milder" scenario considers a faster recovery in the event of a vaccine becoming available during 2021, and a disorderly Brexit being avoided; and a "Repeat Waves" scenario is based on recurring periods of Level 5-type restrictions and weaker external demand. The scenarios imply a wide range of possible outcomes for medium- and long-run economic performance.

2.1 Introduction

The Covid-19 pandemic and required policy measures resulted in a sharp economic downturn and major shock to many sectors of the economy. Although the situation continues to evolve rapidly, in the months since the May 2020 *Fiscal Assessment Report* it has become apparent that the impact of Covid-19 on the overall economy has been less severe than expected.

Reflecting the high degree of uncertainty, this chapter updates previous scenario analysis covering 2020–2025, now focusing on estimated quarterly real GNI*. Our Extended *Budget 2021* scenario uses the same assumptions as the Budget macroeconomic forecasts of no vaccine availability before 2022 and a disorderly Brexit. A "Milder" scenario illustrates possible outcomes of a swifter improvement in health and economic conditions if a vaccine becomes available sooner, alongside a free-trade agreement between the UK and EU for 2021 onwards. Lastly, a "Repeat Waves" scenario traces out the impact of worse public health outcomes that would require further restrictions over coming years. The medium- and long-term implications of these scenarios are also considered.

At present, the Repeat Waves scenario appears less likely to transpire given recent announcements by pharmaceutical manufacturers Pfizer/BioNTech, Moderna and AstraZeneca. These developments suggest that an effective vaccine could be widely available sooner than assumed in *Budget 2021*.

We are unable to compare these forecasts with those of Government except in the very near term. This because the Government's *Budget 2021* forecasts, endorsed by the Council in September, cover just one year ahead. This is despite the Council noting in May the importance of a return to the normal practice of forecasting five years ahead. For sound budgetary planning, and to ensure consistency of the short-term forecasts, the Council assesses that a return to five-year-ahead forecasting is essential from next year's *Stability Programme Update*.

2.2 Endorsement of *Budget 2021* Forecasts

The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in September 2020 (see Appendix A for the endorsement timeline details).[14]

The Department's provisional macroeconomic forecasts were completed on 21st September 2020. The Council and Secretariat discussed the forecasts with Department staff on 25th September 2020. On 13th October 2020, following the publication of *Budget 2021*, the Department provided a final update of forecasts reflecting the estimated impact of policy changes introduced in the Budget.

The Department's short-term macroeconomic forecasts for 2020 and 2021 in *Budget 2021* were judged as being within an endorsable range, taking into account the methodology and plausibility of the judgments made. The Council again noted the very high degree of uncertainty around the economic forecasts due to the on-going challenges of Covid-19, and the potential adverse impacts of a hard Brexit.

The endorsement process focuses on three main aspects: the appropriateness of the methodology used; the pattern of recent forecast errors; and comparisons with the Council's benchmark projections and other forecasts. A further consideration of these three aspects is the horizon for the forecasts, as discussed below.

Forecast Horizon

As for the *Stability Programme Update 2020* (*SPU 2020*) in April, the Government's forecasts only cover a one-year-ahead forecast horizon. This is shorter than the five-year-ahead forecast horizon adopted by the Department in recent years, and the Council assesses this to be a significant shortcoming of *Budget 2021*.

For April's SPU, the pandemic and associated containment measures led to an unprecedented and fast-moving situation. Limiting the horizon for macroeconomic forecasts was therefore understandable from an operational perspective, if still undesirable for sound planning and crisis management. However, as the situation

[14] The statutory function is detailed in Fiscal Council (2013) and Fiscal Council (2014a). Benchmark projections prepared by the Secretariat form a key part of the endorsement process.

has stabilised in the intervening months, the same rationale for a shortened forecast horizon was less applicable for *Budget 2021*.

The need for medium-term forecasts is now greater given the scale of the shock already suffered due to Covid-19, the threat to the economy posed by a possible disorderly Brexit, and the magnitude of measures that the Government has introduced to support households and businesses during 2020. At the same time, developing five-year forecasts helps to ensure the quality of shorter-term projections from a technical perspective and in terms of their coherence, with a view to where the economy is heading once short-term factors play out. The Council therefore assesses that a return to five-year-ahead forecasting is essential from *SPU 2021*. The Department has committed to delivering medium-term forecasts.[15]

Methodology

The Council is satisfied that the Department's forecasting broadly conforms to that of other forecasting agencies, including in the way the unprecedented Covid-19 shock has been addressed.

For *Budget 2021*, the approach to forecasting the economy was somewhat different to *SPU 2020*. The April forecast began with a model-based counterfactual scenario in which no pandemic or Brexit would occur, and subtracted impacts consistent with the Government's assumptions for each of the two shocks.

For September, the Department calibrated an initial forecast according to the assumption that there would be no Covid-19 vaccine available in 2021, and where a limited free-trade agreement (FTA) would be reached between the UK and EU. Additional shocks were then layered in to take account of a disorderly no-deal Brexit. As noted in *Budget 2021* and based on recent research by Daly and Lawless (2020), the overlap between sectors weakened by Covid-19 and those that are most vulnerable to Brexit is limited, implying an additive impact of Brexit shocks; this is also in line with the Council's findings (see Box A in Fiscal Council, 2020c).

[15] Slide 16 in the Department's presentation to Irish Fiscal Advisory Council entitled 'Budget 2021: Macroeconomic outlook', available at: https://www.gov.ie/en/press-release/4b5e5-minister-donohoe-publishes-economic-forecasts-that-will-underpin-budget-2021/

Seasonally-adjusted quarterly profiles for the key variables can be useful in building up estimated impacts of a shock through various interlinkages in an economy, such as those described by Conroy and Casey (2017). Quarterly profiles also help to validate that the shocks have been applied in a consistent manner, such that the forecasts represent a plausible short-term path for the economy given assumptions about the path of the virus. At a time when output has shifted significantly between quarters, this also helps to ensure that annual forecasts are consistent with the underlying pattern of activity.

Further scope exists for development of these quarterly profiles, which could strengthen the quality and internal consistency of the Department's forecasts. Profiles for one year ahead (a six-quarter-ahead forecast at Budget time) could be updated following the Budget for the impact of policy changes, which may not necessarily be evenly distributed across quarters. Improvements could also be made to the quarterly profiling itself; for the *Budget 2021* profiles, some of the expenditure components of GDP are forecast with constant quarter-on-quarter growth rates over the forecast horizon. This seems unrealistic and unlikely to be consistent with the medium-term recovery of the economy, although overall the annual figure is within a realistic range.[16, 17] A richer framework would instead prioritise the coherence of quarterly developments for the level of activity in each subcomponent, and their rates of change.

Pattern of Recent Forecast Errors

When analysing patterns of forecast errors, the main objective is to assess whether there is a systematic tendency or bias in forecasts to contextualise current forecasts and possibly highlight areas of risk. Since 2013, year-ahead forecasts by the Department for underlying domestic demand have often been less positive than

[16] For example, the quarterly growth in modified investment in the Department's profiles accelerates from 1.8 per cent in Q4 2020 to 4.9 per cent in Q1 2021, despite the assumption that a disorderly Brexit has taken place. While this reflects a mechanical derivation of the quarterly profiles, a more coherent and nuanced profile would provide an additional sense check on whether further judgement is appropriate for the annual growth forecast. Furthermore, the Department's forecast for business investment (machinery and equipment excluding other transport equipment) appears to be entirely judgement-based. Monthly data sources relevant to machinery and equipment investment, such as merchandise trade data and new goods vehicle licensing, suggest a stronger performance is likely in 2020 than the Budget forecast of -20 per cent.

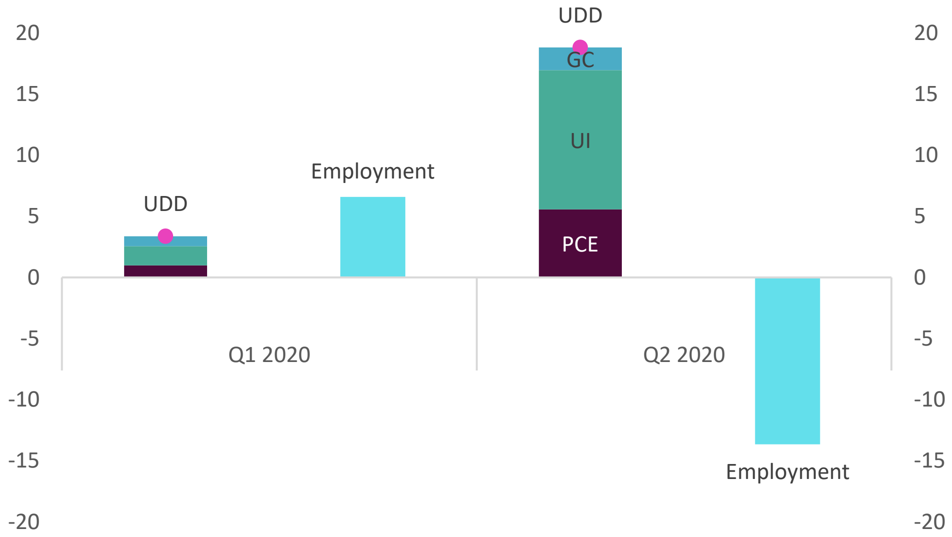
[17] The Department's deflator forecast for government consumption in 2020 is also high. The Department forecasts annual deflator growth of 4.5 per cent, which would require 6.3 per cent of year-on-year deflator growth for the second half of 2020, which seems unlikely.

outturns. This has been down to consistently outperforming personal consumption and government consumption, whereas underlying investment has more often underperformed.

As the sharp and sudden impact of the pandemic has increased emphasis on quarterly forecasts this year, it is worthwhile to compare forecasts with outturns at a higher frequency. Although exceptional uncertainty surrounded any forecast produced in April 2020, it is valuable to compare assumed economic impacts with those that actually occurred as the exercise may help to improve understanding of how the economy functions. This is particularly the case when *SPU 2020* forecasts necessarily relied on a high degree of judgement. Figure 2.1 shows underlying domestic demand (UDD) and employment forecast errors for Q1 and Q2 2020 based on *SPU 2020* forecasts.

Figure 2.1: Underlying domestic demand outperformed *SPU 2020* forecasts despite weak employment

Percentage difference in levels, and percentage-point contributions for UDD components



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Note: Employment is measured by the Department of Finance in *SPU 2020* and *Budget 2021* as the ILO definition adjusted for Pandemic Unemployment Payment recipients.

Real UDD for 2019 is now 0.8 per cent higher than assumed at the time of *SPU 2020* due to data revisions, and the short-term impact of Covid-19 was more benign than forecast for UDD in both Q1 and Q2 2020. This performance was largely due to a less severe fall in investment, owing to a shorter initial period of restrictions affecting the construction sector in Q2 2020.[18]

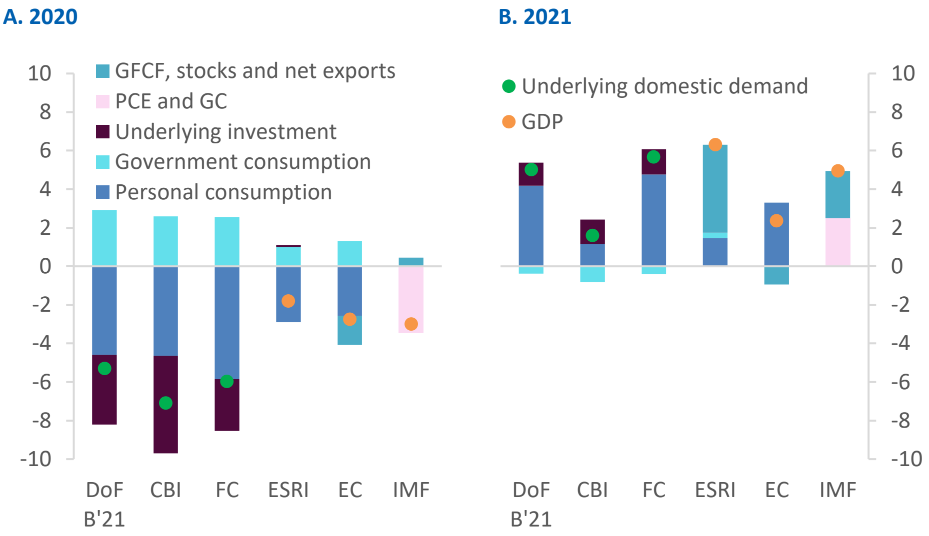
However, the impact of Covid-19 on employment has been more severe than forecast. A factor in this relates to take-up levels for the Pandemic Unemployment Payment as opposed to the Temporary Wage Subsidy Scheme, given that recipients of the latter are still classified as employed. However, the main explanation is that the pandemic had a more severe impact on employment than initially expected.

Comparison with Other Projections

Comparison across forecasts can be a useful way of assessing their robustness. The most recent forecasts of economic growth for Ireland from a selection of forecasters are shown in Figure 2.2.

Figure 2.2: Recent forecasts of economic growth

Percentage-point contributions and year-on-year percentage change in volumes



Sources: Economic and Social Research Institute (ESRI), *Quarterly Economic Commentary, Autumn 2020*; Central Bank of Ireland (CBI), *Quarterly Bulletin No 4 2020*; Department of Finance (DoF B'21), *Budget 2021*; International Monetary Fund (IMF), *World Economic Outlook, October 2020*; European Commission (EC), *European Economic Forecast, Autumn 2020*; and Fiscal Council (FC) workings. Get the data.
Note: For the IMF forecast, contributions from personal consumption expenditure and government consumption are residually determined.

The forecasts for 2020 in Figure 2.2A reveal greater weakness for UDD compared to GDP, owing to the strength of net exports to date in 2020. This export strength has been driven by rising sales by foreign-owned multinationals in pharmaceuticals and

[18] The construction sector began to return to work in May, around six weeks ahead of *SPU 2020* assumptions, which included three months of containment measures followed by a gradual recovery including ongoing social distancing.

computer services. For 2021, the UDD growth forecasts shown in Figure 2.2B have been prepared on the basis of a disorderly Brexit and no widespread availability of a Covid-19 vaccine.[19]

The Council's benchmark projections are a key input to the endorsement process and allow the Council to work through the issues in each forecast round. The numbers are presented in Appendix B. These were completed in September and the forecasts were made using real GNI* as the preferred measure of aggregate demand. Overall, the benchmark projections are similar to the *Budget 2021* forecasts.

[19] Recent developments from pharmaceutical manufacturers Pfizer/BioNTech, Moderna and AstraZeneca suggest an effective vaccine could be available sooner than assumed in *Budget 2021*.

2.3 Assessment of the *Budget 2021* Macroeconomic Forecasts and Scenarios to 2025

The economic outlook remains highly uncertain, mainly as a result of Covid-19 and Brexit. A wide range of paths could plausibly occur next year and further ahead.

Although all sectors have been adversely affected by the pandemic, some parts of the Irish economy have been less exposed than others. The presence of large foreign-owned multinationals in pharmaceuticals, medical devices, information and communication technology, and computer hardware has supported activity and earnings, as has the high capacity for working from home.[20] Household incomes overall have also been partly insulated from the worst effects of the pandemic through substantial government supports for employment and firms.

However, younger workers and those lower in the income distribution have been hardest hit, as have firms in the tourism, hospitality, and retail sectors (Byrne *et al.*, 2020). As discussed in Box C, western and border counties have been worst affected by the pandemic as a result of their greater reliance on such consumer-facing activities. Furthermore, any form of Brexit will compound the challenges faced by the economy in recovering from the pandemic.

This section first assesses the Budget's short-term forecasts, before setting out three scenarios for the economy to 2025.

Budget 2021 Short-term Forecasts

The Department's forecast for UDD in 2020 has been revised significantly higher to -5.3 per cent, from -15.1 per cent in *SPU 2020*. For UDD this year, *Budget 2021* forecasts show smaller reductions in underlying investment and personal consumption expenditure, and higher government consumption expenditure.[21]

Table 2.1 sets out forecasts of key macroeconomic indicators contained in *Budget 2021*. Real GNI*, based on nominal GNI* deflated with the GNP deflator, implies a fall

[20] EU survey data suggests that Ireland has the second-highest share of hours worked from home during Covid-19: see https://www.eurofound.europa.eu/data/covid-19

[21] Underlying investment: year-on-year fall of -17 per cent, 24 percentage points higher than forecast in *SPU 2020*. Personal consumption expenditure: -7.5 per cent, +6.7 percentage points. Government consumption: +15.2 per cent, +6.1 percentage points.

of 6 per cent in 2020. This represents a considerable upward revision compared to the fall of 16 per cent implied by *SPU 2020* forecasts, mirroring the change for UDD.

Table 2.1: *Budget 2021* macroeconomic forecasts

Percentage change in volume, unless stated

	2019[a]	*2020*	*2021*
Demand			
GNI* (implied)[b]	1.7	-6.0	2.0
...of which (contributions)			
Underlying domestic demand[c] (p.p.)	*3.5*	*-4.4*	*4.8*
Change in stocks, subsidies less taxes[c] (p.p.)	*0.3*	*0.0*	*0.0*
Adjusted net exports[c] (p.p.)	*-2.1*	*-1.6*	*-2.8*
Underlying domestic demand	4.1	-5.3	5.0
GDP	5.6	-2.4	1.7
Personal consumption	3.2	-7.5	7.0
Government consumption	6.3	15.2	-1.6
Underlying investment[b]	4.7	-16.9	9.2
Exports	10.5	1.9	1.0
Underlying imports[b]	12.8	2.8	2.7
Labour market			
Population	1.3	1.1	0.7
Labour force	2.0	-2.6	0.9
Employment[d]	2.9	-13.7	7.6
Unemployment rate (% labour force)[d]	5.0	15.9	10.3
Prices (year-on-year percentage change)			
Harmonised index of consumer prices	0.9	-0.3	0.4
Personal consumption deflator	2.4	1.5	1.6
GDP deflator	3.1	0.6	0.9
Gross national product (GNP) deflator	3.5	0.9	0.7
Nominal value			
Nominal GNI*	7.6	-5.1	2.7
Nominal GNI* (€ billion)	213.7	202.8	208.3
Nominal GDP	8.9	-1.8	2.6
Nominal GDP (€ billion)	356.1	349.5	358.7
Modified current account (% of GNI*)	7.7	6.5	2.6

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

Notes: [a] Denotes latest outturns from the CSO.

[b] Derived from nominal GNI* in *Budget 2021* deflated with the GNP deflator.

[c] Contributions to real GNI* growth rates in percentage points. Adjusted net exports are residually determined from the implied real GNI* forecast less real UDD, stocks, and subsidies less taxes (which are assumed unchanged from 2019 onwards).

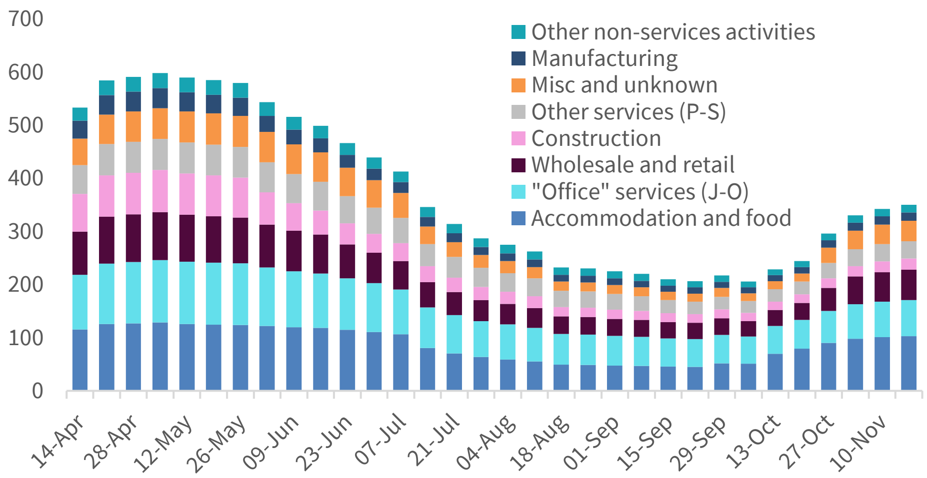
[d] Employment and unemployment in 2020 and 2021 are measured by the Department as the ILO definition, but adjusted to consider PUP recipients as a reduction in employment and increase in unemployment. In line with the ILO definition, workers whose jobs are supported by the Government's wage subsidy schemes are included as employed.

Although level forecasts for 2021 have also been revised up, the quarter-on-quarter path for UDD is now flat, and the quarterly levels of activity forecast in *Budget 2021* and *SPU 2020* almost converges by early 2022 (see Box D, Figure D.1B). This is due to a faster-than-forecast rebound from the initial Covid-19 shock — which was less severe for UDD than assumed, as shown in Figure 2.1 — and the change in assumption that there will be a disorderly Brexit at the beginning of 2021.

However, the restrictions to activity due to Covid-19 caused a large fall in employment of close to 600,000 people in Q2 2020. The impact of Covid-19 on the **labour market** was more severe in April and May (the initial restrictions) than in October and November (when restrictions on activity were increased to the top of the five-level *National Framework for Living with Covid-19,* in response to a rise in infection levels). This is reflected in Figure 2.3, which shows a relatively high current level of enforced inactivity for accommodation and food services workers in receipt of the Pandemic Unemployment Payment (PUP), but lower levels for other sectors.

Figure 2.3: Pandemic Unemployment Payments up 145,000 since October

Thousands



Sources: Department of Employment Affairs and Social Protection; and Fiscal Council workings. Get the data.

Note: "Office" services sectors J-O comprise the following industries: information and communication; financial and insurance; real estate; professional, scientific, and technical; and public administration and defence. Other services P-S includes: education; human health and social work; and arts, entertainment, recreation, and other services.

As restrictions were initially eased in May and into June, and several sectors were able to return to work, a transition took place for many workers out of PUP and into the Temporary Wage Subsidy Scheme — which was replaced in September by the Employment Wage Subsidy Scheme. The easing of restrictions encouraged a rapid recovery in hours worked in the third quarter of the year, which rebounded to 5 per cent lower than for the same period in 2019 — up from 22 per cent lower in Q2 2020. Although a gradual reduction in the number of subsidised workers took place over the summer months, the Employment Wage Subsidy Scheme has returned to similar levels seen in its temporary predecessor at the end of May (see Figure 1.3D).

The impact of Covid-19 disruptions to **output and value added** in the domestic Irish economy at a sectoral and regional level is considered in Box C. The analysis combines PUP data by sector and region (kindly supplied by the Department of Employment Affairs and Social Protection) with CSO data for regional gross value-added excluding foreign-owned multinational firms, which is imputed from sector-level aggregates. The findings suggest substantial falls in output for all regions in Q2 2020, but that Dublin's activity was relatively less affected than elsewhere in Ireland. This is due to a higher share of employment and activity in Dublin in sectors that have been less exposed to lost value-added as a result of the pandemic.

Box C: The regional impact of Covid-19 on Ireland's domestic economy

This Box highlights some of the regional differences in terms of activity lost due to Covid-19. For the analysis we estimate lost gross value added (GVA) excluding foreign-owned multinational firms across sectors and regions of Irish economy in Q2 2020.

The estimates are based primarily on the impact of the pandemic on regional employment, and also with reference to value-added outturns from the CSO's latest *Quarterly National Accounts*. This approach effectively assumes that employment and activity impacts have been concentrated in Irish-owned entities. The advantage of excluding foreign-owned multinational firms is that it allows for a more realistic analysis of the likely losses in Irish incomes in the form of domestic profits and labour earnings (see FitzGerald, 2020).[22]

Initial estimates for losses of GVA excluding foreign-owned multinational firms (GVAX) for a sector (j) and region (k) of the economy are imputed as:

$$\frac{GVAX_{j,k,2017}}{Employment_{j,k,2017}} * PUP_{j,k,Q2\ 2020}$$

That is, we calculate economic activity by worker in each sector for each region in 2017, and estimate the loss by each sector and region by seeing how many workers were displaced by the Covid-19 disruption using the region-sector PUP numbers. This estimate assumes a uniform output of any lost worker within a regional sector, and also that this productivity has remained unchanged since 2017. While basic, it provides a preliminary comparison of the sectoral impact of the pandemic across regions in Ireland.

[22] 2017 output data is used as this is the latest available breakdown of GVA by sector and region published by the CSO, along with GVA excluding foreign-owned multinational firms (S.11a, S.11c, and S.12a) by industrial sector group in the *Institutional Sector Accounts*. Imputation is then used to derive a more detailed breakdown of gross value added excluding foreign-owned multinational firms by sector and region. The results are therefore approximations. The South-West and Mid-West regions have been combined due to confidentiality suppression.

Next, as a check on the preliminary estimates above, we compare the aggregate estimated losses in GVAX to the actual annualised sectoral losses in total GVA in Q2 2020, as shown in Table C.1. This shows that in certain sectors such as agriculture, hospitality, professional admin/support, and arts/entertainment, imputed GVAX losses based on lost employment are likely to be underestimated. As a result, we allocate additional lost GVAX for each sector to regions in proportion to the 2017 regional GVA breakdown. Figure C.1 presents results.

Table C.1: Lost activity in many sectors is underestimated by lost employment

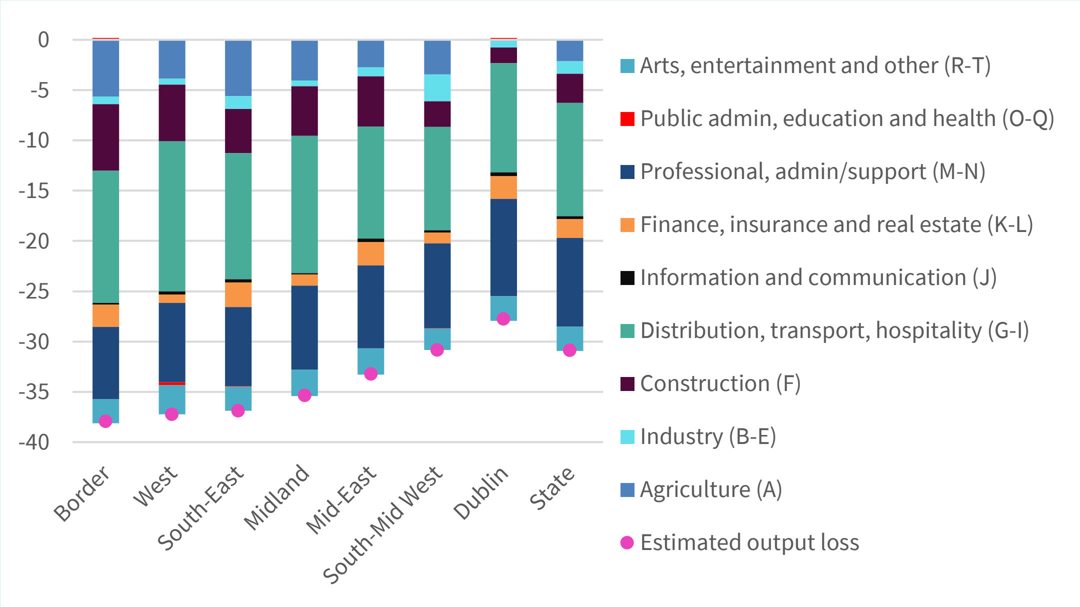
€ billion, annualised

Sector group	Estimated loss in GVAX	Actual loss in total GVA	Additional loss in GVAX
Agriculture (A)	0.2	2.6	2.4
Industry (B-E) [a]	1.5	1.5	N/A
Construction (F)	3.5	3.6	0.1
Distribution, transport, hospitality (G-I)	8.9	13.9	5.0
Information and communication (J) [a]	0.4	0.4	N/A
Finance, insurance, real estate (K-L)	2.1	2.3	0.2
Professional, admin/support (M-N)	2.0	10.8	8.8
Public admin, education, health (O-Q)	2.7	-0.1	-2.8
Arts, entertainment, other (R-T)	0.4	3.0	2.6
Total estimated output loss	21.8	38.1	16.3

Sources: CSO; Department of Employment Affairs and Social Protection; and Fiscal Council workings.
Notes: The table compares employment-based losses in estimated GVAX with actual losses in total GVA (annualised for seasonally adjusted outturns in Q2 2020 compared to Q4 2019). [a] Employment-based estimates for lost domestic activity in Industry (B-E) and Information and communication (J) are preferred to actual GVA losses, given total GVA in these sectors is dominated by foreign-owned multinational firms.

Figure C.1: Q2 2020 activity in Dublin was likely less affected than elsewhere

% change (based on 2017 gross value added data by sector and region)



Sources: CSO; Department of Employment Affairs and Social Protection; and Fiscal Council workings.
Note: South-West and Mid-West have been combined because of repressed data due to confidentiality.

While all regions suffered severe declines in domestic value added in the second quarter, the fall was least acute in Dublin. This reflects a lower negative contribution from agriculture and construction than in other regions, given the higher share of employment and activity in Dublin in sectors that have been less reliant on PUP support.

In regions that are particularly reliant on the tourism and hospitality sectors, such as in the West (counties Galway, Mayo, and Roscommon), the estimated fall in activity is the second-largest. The largest contribution to the decline is in the sector group including hospitality (G-I).

Further analysis of the impact of Covid-19 on the Western Region and Atlantic Economic Corridor is available in Lydon and McGrath (2020) — see also Lydon (2020) for a regional labour market analysis of the impact of Covid-19.

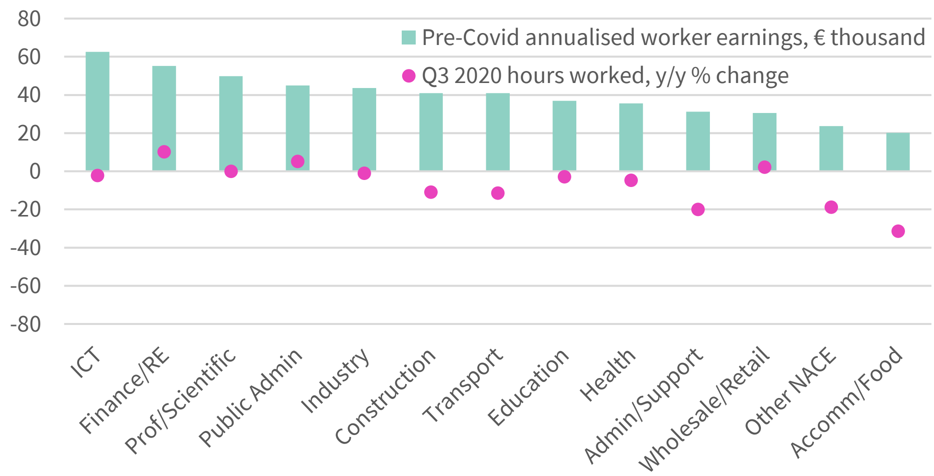
For the State as a whole, the estimates in Figure C.1 show domestic activity losses due to the pandemic in Q2 2020 of about 30 per cent. This is a sharper decline compared to domestic demand in the second quarter, which was close to 20 per cent below its pre-pandemic (Q4 2019) level. Although some of this difference in performance is likely to reflect a weakened net exports position for the domestic economy, it also highlights the importance of foreign-owned multinational firms in Ireland. The difference implies that the Irish economy would be worse off in a downturn if foreign-owned firms were not supporting domestic activity and employment. This emphasises that the risks to the economy of a fall in future foreign direct investment would exceed the related losses in corporation tax.

Personal consumption expenditure fell sharply in Q2 2020 by 22 per cent in volume terms, with similar declines across goods and services. Compared to high-frequency indicators such as credit/debit card and ATM statistics, which fell €3.8 billion in the quarter, the year-on-year decline in the value of consumption excluding cars was more severe at €5 billion. Similarly, retail sales values excluding motor trades declined by 15 per cent whereas the value of goods consumption, excluding cars, fell by 18 per cent. These differences suggest some upward revisions to personal consumption are possible. Nonetheless, while the indicators all confirm that a large decline in consumption took place as a result of Covid-19, the fall was less severe than forecast by the Department in *SPU 2020*, and marginally less severe than in the Council's Mild scenario in the May 2020 *Fiscal Assessment Report*.

Budget 2021 forecasts for consumption in Q3 2020 reflect the stronger recovery indicated by a number of high-frequency data sources. Retail sales have been exceptionally strong since June, which likely reflects pent-up demand from the initial Covid-19 restrictions. While *Budget 2021* forecasts were finalised prior to the escalation of nationwide restrictions in early October, current indications from daily card and ATM spending data suggested a more limited impact on consumption in Q4 2020. Spending for the first six weeks of the quarter was 5 per cent below the same period in 2019, whereas the corresponding decline for the first six weeks of Q2 2020 was 34 per cent. This may indicate that consumers are adapting their spending habits around the Covid-19 constraints; online shopping and substitution towards goods and services that are available to purchase could explain some of the higher spending in October and November compared to April and May.

A further possible explanation for the resilience of consumption in the third quarter can be found in the sectoral composition of earnings and hours worked. Figure 2.4 (updating Chart D in Hickey *et al.*, 2020) ranks sectors by pre-Covid annualised average earnings and considers the year-on-year change in hours worked for each sector. The top five sectors for annualised gross earnings experienced limited declines (or increases in some cases) in hours worked in Q3 2020, unlike for lower-earning sectors such as administration and support and accommodation and food, where hours worked fell 20-30 per cent.

Figure 2.4: Workers in low-earning sectors are worst affected by Covid-19



Sources: CSO, Labour Force Survey and Earnings and Labour Costs; and Fiscal Council workings. Get the data.
Note: Annualised worker earnings are shown for Q3 2019. These are millions of hours worked per week, times (365/7), times average hourly earnings, divided by total employment in a quarter.

In *Budget 2021*, income tax forecasts have been prepared on the basis that much of the gain in employment in 2021 will be down to returning workers, mainly from lower-income sectors. As discussed in Chapter 3, this assumption forms the basis for the negative judgement applied to forecasts for PAYE and USC revenues next year. However, the Department's macroeconomic forecast for labour income does not align well with this assumption; labour income is forecast to grow by 9 per cent in 2021 despite the impact of Covid-19 and an assumed disorderly Brexit.[23]

A further potential source of upside risk to the forecasts is the *Budget 2021* quarterly profile for personal consumption expenditure, which is assumed to remain essentially unchanged for six quarters after rebounding strongly in Q3 2020. This is despite an ongoing forecast gain in employment and concurrent fall in the unemployment rate. The high marginal propensity to consume by those with lower earnings that are expected to return to employment in 2021 suggests an increasing consumption profile may be more likely. The Department's forecast assumes that the savings ratio remains very high in 2021. While this is possible due to precautionary savings in the event of a hard Brexit, Irish households already amassed €11 billion of savings (34 per cent of gross disposable income) in Q2 2020, following over a decade of deleveraging and balance-sheet repair. The possibility that consumption could grow more rapidly than profiled for 2021 therefore represents an upside risk. Finally, the strong possibility that a Covid-19 vaccine will become available sooner than expected in *Budget 2021* represents an additional upside risk.

Government consumption in *Budget 2021* is set to grow by 15 per cent in volume terms in 2020 as a result of higher health spending and other government activity to manage the impact of Covid-19 (see Chapters 1 and 3 for detailed analysis of these policy measures). In 2021, government consumption is forecast to fall 1.6 per cent as temporary supports are scaled back.

By contrast, **underlying investment** is projected in *Budget 2021* to fall by close to 20 per cent in 2020 — a substantial upward revision from the 42 per cent fall forecast in *SPU 2020*. The Department forecast growth of 3.5 per cent for residential construction in 2021, with annual completions expected to reach 20,000 units, up from 18,000 this year. However, data released since the Budget suggest a stronger

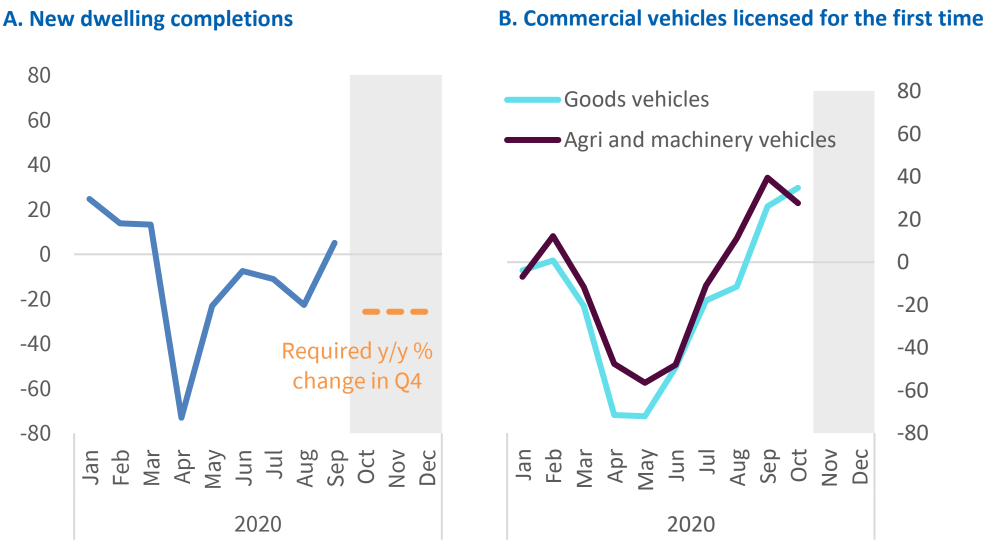
[23] According to the Budget's forecast, the fall in average labour income per lost worker in 2020 is close to €35,000 (-€11 billion in labour income and -320,000 for employment), whereas 2021 forecasts for employment (+150,000) and labour income (+€8 billion) suggest a higher average increase in labour income per worker of over €50,000.

performance in 2020. Monthly completions data provided with the most recent release indicate a return to year-on-year growth in September 2020 (Figure 2.5A), and significant pent-up demand is evident in mortgage approvals for the same month (up 21 per cent year-on-year). Conversely, the Department forecasts non-residential construction to grow more rapidly than residential construction in 2021 at 7.5 per cent. This is despite possibly weakened prospects for commercial property, given the prevalence of working from home during Covid-19 could lead to a permanently reduced demand for office construction, and the elevated prior level (9.7 per cent of GNI* in 2019) of investment in non-residential construction.

Underlying machinery and equipment investment is forecast by the Department to grow by 6 per cent in 2021, following a sharp decline of 20 per cent this year. As discussed in relation to the forecast methodology, this forecast appears to be heavily reliant on judgement. Monthly merchandise trade imports of machinery and equipment, along with commercial vehicles licensed for the first time (Figure 2.5B), and outturn data for Q2 2020, suggest business investment may outperform the Budget forecast in 2020.

Figure 2.5: Recovery in new-dwelling completions and commercial vehicles

Year-on-year percentage change



Source: CSO; and Fiscal Council workings. [Get the data](#).
Note: Panel B shows growth in new and second-hand imported vehicles licensed for the first time. Agri and other machinery is tractors, new public services vehicles, and vehicles NEC.

External demand was very weak in Q2 2020 given that most of Ireland's main trading partners were simultaneously in lockdowns during April and May.[24] Despite this, Ireland's measured exports performed strongly due to chemicals/pharmaceuticals and computer services, which respectively grew 11 and 4 per cent in year-on-year terms for the three months to end-June. Furthermore, monthly merchandise trade data indicate that growth in organic chemicals and medicinal/pharmaceutical products increased to 23 per cent in Q3 2020. This performance has driven total exports value into growth in 2020, whereas *SPU 2020* had forecast a contraction in the value of exports of 6.5 per cent. Although some outperformance was expected for pharmaceuticals and computer services, the strength of outperformance was not anticipated, while other components of exports (more relevant to employment) performed more in line with expectations. Non-computer services fell 16 per cent in the second quarter, including a 90 per cent fall in tourism exports. Merchandise exports excluding organic chemicals and medicinal/pharmaceutical products fell by 20 per cent in the second quarter, and continued to decline by 12 per cent in Q3 2020.

For underlying imports, some outperformance relative to recent forecasts has occurred, in line with the outperformance in final demand.[25] *SPU 2020* (page 18) noted that imports were not expected to fall as much as final demand, reflected in an underlying import share of 47 per cent for the first half of 2020. This is higher than the recent ten-year average of 43 per cent, although outturns show an underlying import content in final demand of about 45 per cent.

The Council has previously noted that Ireland's external trade variables have been difficult to forecast accurately, given the distortions caused by multinational firms. The composition of GDP and GNP result in headline economic growth rates that are often overstated relative to a more relevant measure of aggregate demand, such as modified gross national income (GNI*). The issue arises due to the overweighting of net exports. An 18 per cent outperformance for the level of underlying net exports in Q2 2020 provided a strong boost to the GDP outturn. However, GNI* is unlikely to

[24] See https://covidtracker.bsg.ox.ac.uk/ for cross-country comparisons of government responses to Covid-19 over time.

[25] Underlying imports exclude investments in aircraft and intangibles, which are heavily imported and distort investment and import trends due to their large size and irregular timing.

have performed as well, as the offset due to lower imports in 2020 is likely to be far less relevant for the level of GNI* than for GDP.

Macroeconomic Scenarios to 2025

A high degree of uncertainty applies to any short-term economic forecast at present. While the *Budget 2021* forecasts include a brief discussion of more adverse scenarios for GDP and their implications for the general government balance, this *Fiscal Assessment Report* provides further context for the range of risks to the forecast by developing three scenarios to 2025: “Milder”, “Extended *Budget 2021*”, and “Repeat Waves”. These scenarios cover a wide range of health, policy and economic outcomes. Given high uncertainty, the likelihood of the scenarios is impossible to assess in a meaningful way.

The Government’s quarterly profiles are used for the Extended *Budget 2021* projections, matching the Department of Finance’s annual forecasts for GNI* in 2020 and 2021. The Department’s preferred GDP-based estimates of the output gap and potential output are then used to assess the implied path for actual output, which is calibrated to UDD until end-2025, with an assumption that personal consumption and underlying investment drive most of the required growth. By 2025, the level of UDD is projected to be 5 per cent below its estimated medium-term path if no pandemic had occurred, whereas real GNI* and employment would remain off by 7–8 per cent. With the output gap already closed by then, this would represent a permanent economic loss in the extended *Budget 2021* projections due to the effects of Covid-19 and a disorderly Brexit.

The scenarios are presented in Box D.

Box D: Updated Macroeconomic Scenarios to 2025

This box describes three scenarios for the Irish economy, in an update to those explored in the Council's May 2020 *Fiscal Assessment Report* (Fiscal Council, 2020c). As before, the scenarios include an extension of the official forecasts to 2025 at quarterly frequency, with scenarios for a benign "Milder" projection and an adverse "Repeat Waves" outcome also developed.

Further granular detail of the projections is also presented, and the main outcome variable presented is now real GNI* — based on the Council's latest GNI* forecasting approach (see Box E in Fiscal Council, 2020c).

Comparing the latest macroeconomic scenarios with those published in May

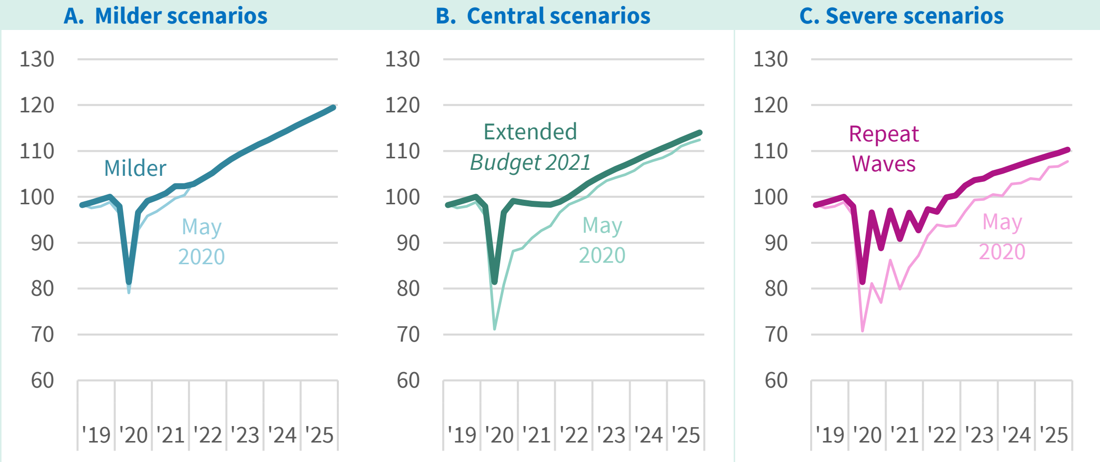
The short-term macroeconomic forecasts in *SPU 2020* were subject to huge uncertainty. To date, the domestic economy as a whole has performed stronger than forecast. Underlying domestic demand (UDD) in Q2 2020 was even stronger than projected in the Council's "Mild" scenario in May 2020 — although this is despite an even more adverse immediate impact on employment than projected in the Council's severe scenario.

While not exhaustive, the scenarios aim to capture the most likely trajectories for the economy subject to the outcome for several key assumptions, in particular those relating to Covid-19 and Brexit.

Figure D.1 compares the latest scenarios for UDD with those published by the Council in May 2020, showing an improved short-term projection in each case.

Figure D.1: Underlying domestic demand has outperformed in the short term

100 = Q4 2019 for the latest scenario



Sources: CSO; Department of Finance, *Budget 2021*; and Fiscal Council workings. Get the data.
Notes: The volume of underlying domestic demand in 2019 was revised up by 0.8 per cent in *National Income and Expenditure 2019*, compared to the initial estimate re-based to 2018 prices. This revision is reflected in the May 2020 data shown above.

Assumptions behind the macroeconomic scenarios

The Milder scenario is now based on two upside risks compared to the central scenario. First, it assumes that a free-trade agreement (FTA) is reached between the UK and EU in advance of 2021. Second, a vaccine for Covid-19 becomes widely available by Q3 2021, sooner than is assumed in *Budget 2021*. Nonetheless, trading is expected to remain challenging for several sectors until next summer at least and employment does not recover as rapidly as previously expected, only reaching its pre-pandemic level by early 2023 (Figure D.1A).

The Extended *Budget 2021* scenario sees a rapid initial recovery in the second half of 2020 stagnate in 2021 on account of a disorderly Brexit and the absence of a widely available vaccine until 2022 at the earliest.

Compared to the Department of Finance's *SPU 2020* forecast in April and the Council's central scenario in May, a key difference for this scenario is that a relatively benign FTA outcome for Brexit is no longer assumed. This is expected to constrain activity next year and beyond. Nonetheless, the path for UDD remains higher, with the two paths converging by early 2022 (Figure D.1B).

The Repeat Waves scenario assumes no effective mass vaccination until 2023, and that fluctuations in virus transmission levels result in further periods of Level 5-type restrictions. The intermittent eight-week restrictions and gradual reopenings are assumed to occur in alternating cycles throughout 2021 and 2022, although with dissipating initial impacts for subsequent periods of restrictions over time. However, the economy remains on a shallower trajectory over the medium term, reflecting more lasting damage to growth prospects as a result of the protracted disruption (Figure D.1C). Table D.1 sets out the key assumptions for each scenario.

Table D.1: Key assumptions for the scenarios

	Milder	**Extended *Budget 2021***	**Repeat Waves**
Broad description	A vaccine by mid-2021 and a free-trade agreement between the UK and EU ensures a more rapid recovery can take hold.	The Government's *Budget 2021* forecasts assume a disorderly Brexit and no vaccine available by end-2021, delaying a full recovery until mid-2022.	With effectively no vaccine before 2023, repeated restrictions in response to cycles of higher infection are compounded by a disorderly Brexit.
Covid-19 containment measures	Social distancing and disruptions to certain sectors remain in place until summer 2021.	Social distancing and disruptions to certain sectors remain in place until end-2021.	Eight-week restrictions and gradual reopenings run on half-year cycles in 2021 and 2022, but with diminishing impacts.
Employment prospects	A gradual recovery in jobs takes three full years to reach pre-pandemic levels, and remaining 5 per cent below trend by 2025.	By end-2021, a quarter of overall jobs lost in Q2 2020 have not yet been recovered, and a complete recovery does not take place until late-2023.	Each eight-week disruption causes vast job losses concentrated in hospitality sectors; employment remains 17 per cent below trend by 2025.
Recovery	GNI* recovers to pre-crisis (Q4 2019) levels by Q2 2022, with UDD recovering by Q2 2021.	About a year beyond the Milder scenario: Q1 2023 for GNI*, Q2 2022 for UDD.	Economy does not recover to pre-pandemic (Q4 2019) GNI* levels until Q4 2023.
Potential output	Growth returns to previous projections of about 3 per cent per annum over the medium term.	Growth reverts to previous projections of about 3 per cent per annum over the medium term.	Permanent scarring on growth; remains closer to 2 per cent per annum over the medium term.

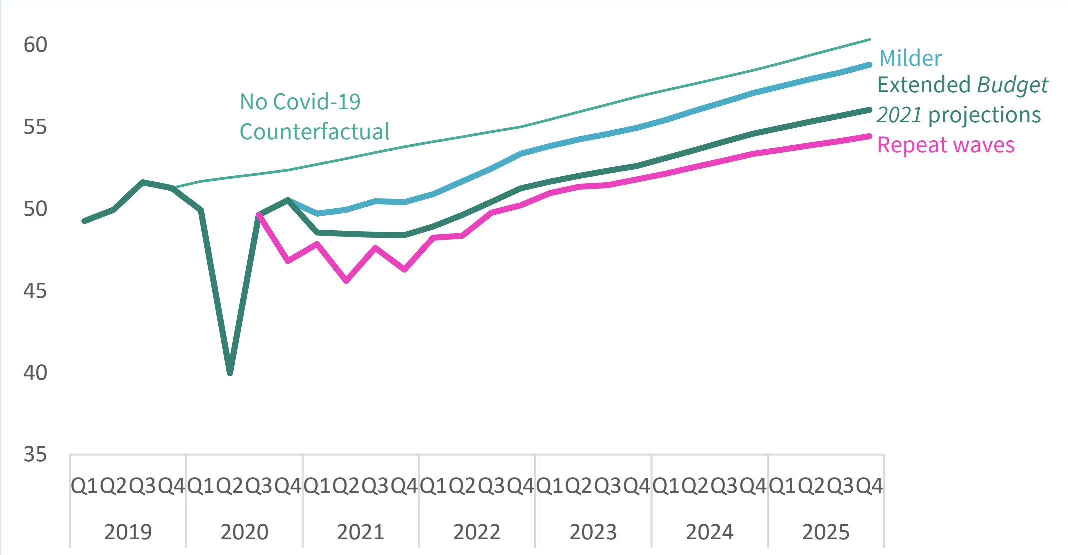
An approximation of seasonally adjusted quarterly real GNI*

The Council's approach to forecasting real GNI* using adjusted exports and adjusted imports can also be used to approximate seasonally adjusted quarterly real GNI*. This is constructed as the sum of UDD, the change in inventories, estimated quarterly subsidies less taxes, and estimated adjusted exports less adjusted imports. The latter items are broadly based on traded sectors with the most relevance to domestic-owned firms, since foreign-owned multinationals' profits included in measured net exports are largely excluded from GNI*.[26]

Figure D.2 presents the projections for each of the scenarios and a counterfactual, where Covid-19 did not occur and where an EU-UK FTA is agreed in advance of 2021.[27]

Figure D.2: Scenarios for real quarterly GNI*

€ billion, 2018 constant prices



Sources: CSO; Department of Finance, *Budget 2021*; and Fiscal Council workings. Get the data.
Notes: Quarterly real GNI* is estimated as the sum of UDD, the change in inventories, subsidies less taxes, and adjusted exports less adjusted imports, where the latter items are constructed according to the method described in Box E of the May 2020 *Fiscal Assessment Report*.

The Milder and Extended *Budget 2021* projections diverge initially in Q1 2021 due to the more benign assumption in the Milder scenario regarding Brexit. Although the move to an EU-UK FTA still results in a modest initial fall in GNI*, this is followed by a pickup in activity in response to the widespread availability of a Covid-19 vaccine in Q3 2021. For the Extended *Budget 2021* and Repeat Waves projections, there is assumed to be no such vaccine available, and an assumed disorderly Brexit further compounds the challenges posed by Covid-19 for the economy.

For the Milder scenario, the Extended *Budget 2021* projections are first adjusted to exclude the estimated additional impact of a disorderly Brexit relative to an EU-

[26] Although a higher level of adjusted exports can be assumed based on which sectors of merchandise or services trade are excluded, the higher the level of adjusted exports, the higher the estimate of adjusted imports content of final demand. Ultimately, the implications of adjusted net exports for annual real GNI* growth remain limited given that UDD comprises the vast majority of GNI* — although it can contribute more prominently to quarter-on-quarter GNI* growth rates.

[27] The counterfactual in Figure D.2 is projected by first building a no-Covid and no-Brexit counterfactual for quarterly real GNI*, which is informed by the Government's expectations for UDD pre-*SPU 2020*, alongside IMF pre-Covid world demand growth rates. Shocks are then applied to each component of final demand in line with prior ESRI/Department of Finance analysis of the impact of an EU-UK FTA, using the Cosmo model (Bergin *et al.*, 2019). Employment forecasts are then generated as a function of the quarterly change in UDD.

UK FTA, based on the findings of Conefrey and Walsh (2020). Furthermore, the components of UDD are income- and behaviour-adjusted according to the Keogh-Brown *et al.* (2009) framework, as previously described in relation to the May 2020 scenarios.

The estimated impacts of Covid-19 on categories of personal consumption in Q2 2020 have been updated to reflect impacts on comparable categories of retail sales and credit/debit card spending. The strong V-shaped consumption rebound in Q3 2020, as projected in *Budget 2021*, requires little additional gain for a full recovery to its Q4 2019 level, and the Milder scenario assumes that any ongoing effects from the shock dissipate entirely by Q2 2023. Underlying machinery and equipment and adjusted exports also gain on account of a more benign assumed path for external demand compared to the Extended *Budget 2021* scenario.

UDD is projected to settle marginally (0.6 per cent) below its estimated level in 2025 if no pandemic had occurred, with real GNI* and employment remaining 2½–5 per cent lower respectively. While this implies a structurally reduced level of potential output and employment below trend, which is not expected to be regained in the absence of a cyclical upswing, it is consistent with a far lower degree of lasting economic damage than under the Extended *Budget 2021* projections.

For the Repeat Waves scenario, alternating eight-week periods of Level 5-type restrictions and gradual reopenings continue until end-2022, and a disorderly Brexit compounds the situation for a strained domestic economy. Each eight-week disruption causes significant job losses, which are assumed to be concentrated in hospitality sectors, although many retail jobs are also lost; by 2025, the resulting scarring effects cause a 17 per cent permanent loss.

The most adverse outcome considered for external demand is the OECD's September 2020 "downside" scenario, which applies to the Repeat Waves scenario from Q4 2020 onwards, and a shallower medium-term path follows relative to the Extended *Budget 2021* projections. This results in a larger fall in adjusted exports and underlying machinery and equipment in 2021, and permanent impacts leave UDD and GNI* 8-9 per cent below trend by 2025.

2.4 Medium- and Long-term Growth Implications and Risks

Medium- and Long-run Growth Implications

In each scenario in Box D, it is likely that permanent losses in activity and employment will result from the Covid-19 and Brexit shocks. Besides causing a shock to demand, the economy's long-run potential level and growth rate could also be negatively affected. Although this is difficult to estimate, three key factors of production could be affected: productivity, labour supply, and investment in capital. The Council assesses that long-run growth is likely to be lower than in the absence of Covid-19 and Brexit. Impacts could include a loss of capital in businesses and firm destruction, missed investment, and lower inward migration.

The scenarios cover a plausible range of potential outcomes. However, there is continuing uncertainty surrounding the future path of Covid-19 and Brexit. Furthermore, the scenarios do not allow for possible spillover effects, such as a banking or financial crisis arising due to increases in non-performing loans, and the more adverse implications this would entail. Table 2.2 summarises annual volumes for GNI*, UDD, and employment for each scenario, along with the permanent percentage loss versus trend in 2025.

Table 2.2: Lasting losses to employment could range between 5 and 17 per cent

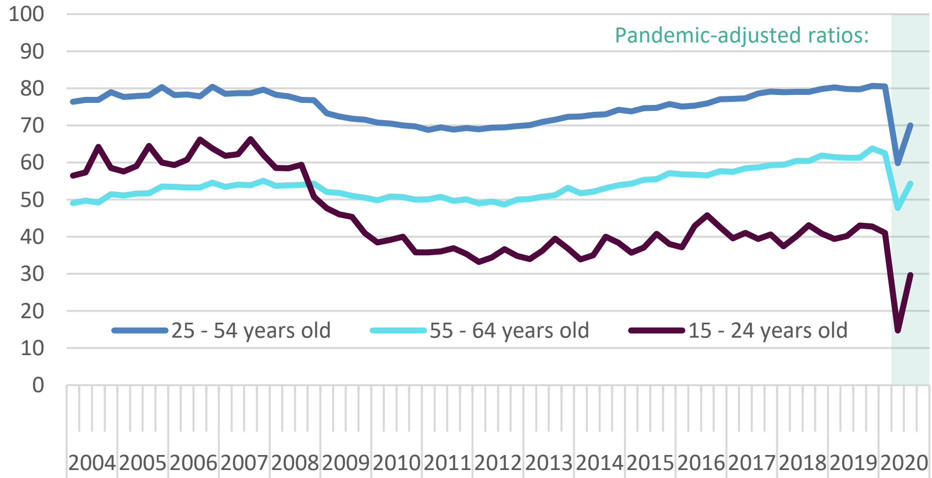
	2020	2021	2022	2023	2024	2025	Permanent loss, %
Milder							
GNI* *(% change)*	-6.0	5.5	3.9	4.4	3.4	3.3	N/A
GNI* *(2018 € billion)*	190.0	200.5	208.4	217.6	225.0	232.5	2.5
UDD *(2018 € billion)*	168.9	182.5	188.6	197.9	205.2	212.4	0.6
Employment *(000s)*	2,004	2,185	2,291	2,390	2,460	2,527	4.8
Extended *Budget 2021*							
GNI* *(% change)*	-6.0	2.0	3.3	4.2	3.2	3.1	N/A
GNI* *(2018 € billion)*	190.0	193.8	200.2	208.6	215.4	222.0	6.9
UDD *(2018 € billion)*	168.9	177.4	181.6	190.1	196.7	203.1	4.9
Employment *(000s)*	2,004	2,157	2,239	2,330	2,392	2,449	7.8
Repeat Waves							
GNI* *(% change)*	-7.8	0.6	4.9	4.6	2.7	2.4	N/A
GNI* *(2018 € billion)*	186.3	187.3	196.6	205.5	211.0	216.1	9.4
UDD *(2018 € billion)*	164.3	169.8	177.5	187.0	192.2	196.9	7.8
Employment *(000s)*	1,964	1,971	2,039	2,136	2,176	2,207	16.9

Sources: Department of Finance, SPU 2020; and Fiscal Council workings.
Notes: Permanent losses are calculated as the percentage difference to counterfactual in 2025. Employment and unemployment are measured as the ILO definition, but adjusted to consider PUP recipients as a reduction in employment and increase in unemployment.

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

Labour supply could be negatively affected, with many workers unable to return to businesses that suffer insurmountable losses. The longer they remain out of work, the higher the probability that they will not return to employment. The current crisis is unusual in that the expectations of returning to work quickly might reasonably be higher, as supported by the recovery in hours worked in Q3 2020. Policy supports have also helped firms and employers to maintain a relationship. Furthermore, fundamentals at the onset of the crisis were better than those at the time of the financial crisis, following which there was a full recovery in employment/population ratios for those aged 25-64 to pre-financial crisis levels, as shown in Figure 2.6.

Figure 2.6: Employment-population ratios fully recovered following the Great Recession for those aged 25-64

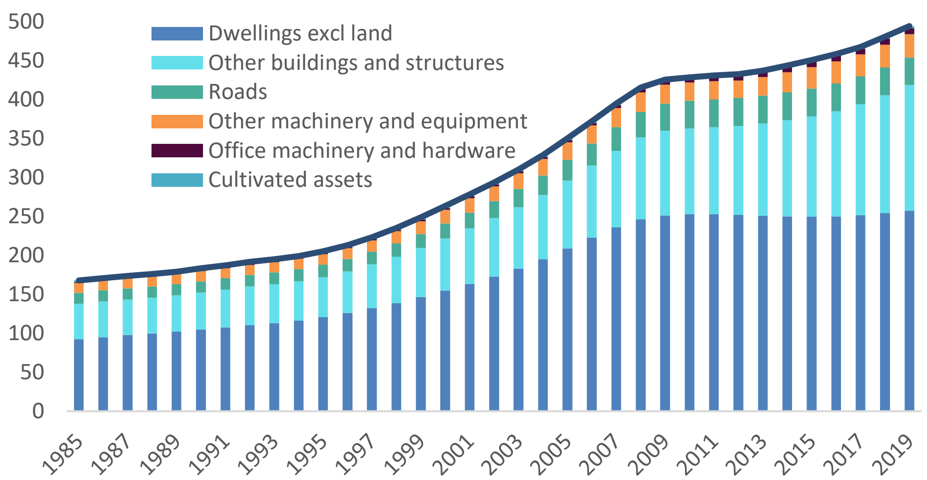


Sources: CSO; Department of Employment Affairs and Social Protection; and Fiscal Council workings. Get the data.
Note: Employment data for Q2 and Q3 2020 have been adjusted for average PUP claims by age.

However, a significant challenge could be workers with low level of skills in sectors that don't fully recover. Reduced net migration into Ireland could also reduce labour supply, especially if travel restrictions are in place for an extended period. An accelerated shift to automation could push people out of the workforce.

Investment in capital (e.g. infrastructure and machinery and equipment, etc) may also suffer as a result of the Covid-19 and Brexit shocks reflecting the dampening role played by elevated uncertainty. Private business investment in certain sectors that might otherwise have occurred might be shelved due to lower revenues, firm bankruptcy, lack of liquidity, and weaker expected demand in future. The recent example of the Great Recession revealed the consequences of large-scale firm failure concentrated in a particular sector. As shown in Figure 2.7, Ireland's net capital stock of dwellings excluding land has not increased for the past decade, reflecting overheating and subsequent collapse in the construction sector that took place in the mid-2000s.

Figure 2.7: Ireland's net capital stock of dwellings has remained flat for the past decade
€ billion, 2018 constant prices



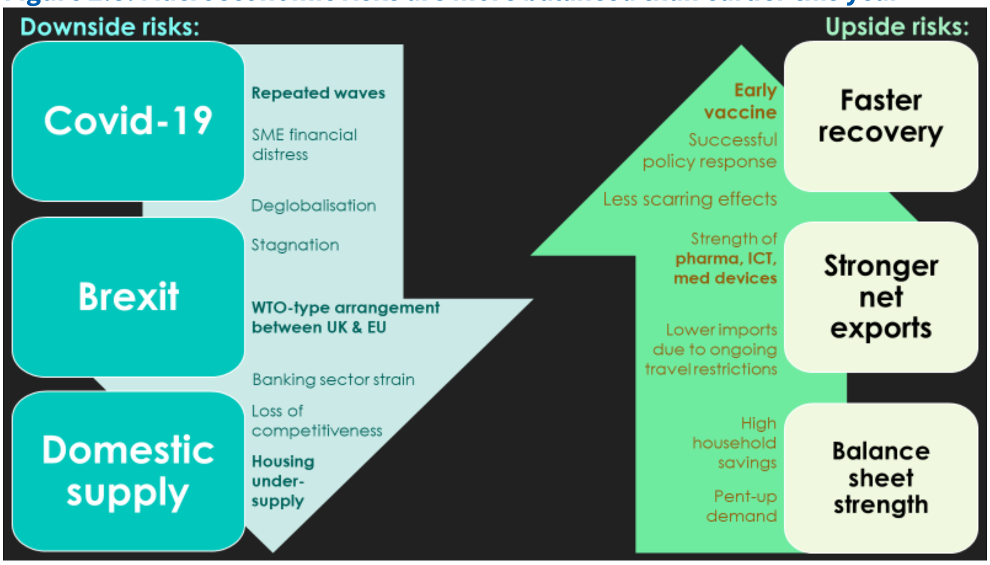
Sources: CSO; and Fiscal Council workings. Get the data.
Notes: Domestic net capital stock excludes transport equipment and intangible assets.

Macroeconomic Risks

Uncertainty around the macroeconomic outlook remains high, albeit lower than at the beginning of the Covid-19 emergency given the resilience shown by the economy in the period since. Relative to the *Budget 2021* forecast and the Extended *Budget 2021* projections described in Box D, risks are now more balanced than was the case earlier this year. As a small open economy, Ireland is particularly exposed to global economic conditions, which have been severely disrupted by Covid-19. Besides a more adverse impact than forecast of a disorderly Brexit in 2020 and 2021, other risks include the possible relocation of multinational firms' activities out of Ireland, global trade tensions, and deglobalisation resulting in lower external demand. The realisation of such external downside risks could result in a slower economic recovery over the medium term.

However, *Budget 2021* notes that there are also upside risks to the forecasts. These include a vaccine becoming available earlier than anticipated in *Budget 2021* (as appears likely given recent announcements by Pfizer/BioNTech, Moderna, and AstraZeneca), the possibility of positive forecast revisions to personal consumption expenditure and underlying investment, less scarring of employment and firms in the Irish economy, and continued outperformance of net exports. Irish households have accumulated significant net savings in 2020, and these could be deployed more rapidly than anticipated in *Budget 2021* over coming years. Figure 2.8 summarises the downside and upside risks facing the Irish economy.

Figure 2.8: Macroeconomic risks are more balanced than earlier this year



Sources: Department of Finance, SPU 2020; and Fiscal Council workings.
Note: Size of arrows indicates subjectively assessed combined impacts and likelihoods.

Chapter 3

Assessment of Budgetary Forecasts

3. Assessment of Budgetary Forecasts

Key messages

- *Budget 2021* shows a sharp deterioration in the general government balance in 2020 due to the impact of Covid-19. A deficit of €21.6 billion is forecast (10.7 per cent of GNI*) for 2020. This reflects an increase of €18.6 billion in spending and a €4.9 billion fall in general government revenue.

- The 2020 deficit compares to a surplus of €1.9 billion (0.9 per cent of GNI*) in 2019. The deficit projection for 2020 has been revised down since *SPU 2020* (€23.1 billion). Stronger revenue (mainly corporation tax and income tax) more than offset upward revisions to spending for 2020.

- For 2021, the Government set out a large-scale support and stimulus package. The budget balance is forecast to improve only slightly, with a deficit of €20.5 billion (9.8 per cent of GNI*). This includes contingencies of €2.1 billion for Covid-19-related expenditure and €3.4 billion for unspecified measures to support the economy in response to the pandemic and Brexit.

- There is a very high level of uncertainty surrounding economic and fiscal forecasts in *Budget 2021*. The fiscal outlook will largely be determined by how quickly or slowly the economy bounces back. If restrictions on economic activity are tighter and/or last longer than assumed, then the deficit may be larger than forecast. In addition, new policy measures or extension of current schemes would contribute to a larger deficit in 2021.

- A significant amount (over €5.4 billion) of spending increases in 2021 is permanent in nature. As a result, significant deficits may be expected beyond 2021.

- The *Budget 2021* and accompanying documentation lacks clarity, making spending plans difficult to assess. Information on the costing of Covid-19 supports is limited. As the forecast horizon only extends to 2021, it is hard to assess how much of the spending increases in 2020 and 2021 are likely to persist beyond this horizon.

- With no projections beyond 2021 in *Budget 2021*, three scenarios are presented for paths for the public finances to 2025. Assuming no policy changes and taking into account demographic and price pressures, the general government balance is projected to improve. By 2025 the balance ranges from a small surplus to a deficit of over 6 per cent of GNI*.

- General government debt will rise significantly. Debt as a share of GNI* is projected to peak in 2021 (114.7 per cent of GNI*) and fall gradually without policy action from 2022. However, debt would remain above 100 per cent of GNI* out to 2025. There are risks around this forecast. In a milder scenario, the debt ratio could fall more quickly. However, a scenario in which there are repeated waves of economic restrictions throughout 2021 and 2022 would leave debt levels elevated and stagnant at around 135 per cent of GNI*.

3.1 Introduction

The fiscal forecasts for *Budget 2021* were made amidst the extreme shock due to Covid-19. Along with the economic outlook, the fiscal outlook is exceptionally uncertain. The economic downturn, combined with new policy measures such as income supports, means that *Budget 2021* projects a substantial deficit for this year and next. In line with the macroeconomic forecasts, *Budget 2021* only forecasts fiscal variables for 2020 and 2021.

This chapter assesses a wide range of recent data and focusses on official fiscal outturns from the Central Statistics Office (CSO), Department of Finance and the Revenue Commissioner, along with official Government forecasts consistent with *Budget 2021,* and other materials.

In 2019, the general government balance (excluding one-off items) reached a surplus of €1.9 billion, an improvement of €1.6 billion relative to 2018 (Table 3.1). For 2020, a large deficit has emerged due to the impact of Covid-19 and policy response.

Economic conditions are forecast to improve in 2021 supporting higher revenues. However, new/extended policy measures are deficit-increasing and hence the budget balance is forecast to only marginally improve in 2021. If heavier-than-assumed restrictions on economic activity were to be in place for 2021, that would lead to a larger deficit.

The large increase in spending in 2020 is mostly temporary and related to Covid-19. For 2021, it appears that temporary spending related to Covid-19 will be lower. Despite this, general government spending is increasing. This reflects an increase in general government spending of up to €8.4 billion in 2021 not related to Covid-19 or Brexit, of which €5.4 billion is a large permanent increase in Exchequer spending not matched by an increase in sustainable funding.

There is exceptional uncertainty surrounding the current macroeconomic and fiscal projections. Given the uncertainty, three scenarios for the public finances out to 2025 are presented (Box D and Box G).

Table 3.1: Summary of fiscal outturns (2019) and *Budget 2021* forecasts (2020–2021)

€ billion

	2019	2020	2021
General government balance	1.9	-21.6	-20.5
Total revenue	89.1	84.2	88.7
… % change	5.9	-5.5	5.3
Total expenditure	87.3	105.9	109.2
… % change	4.2	21.3	3.1
Interest expenditure	4.5	3.9	3.6
Primary expenditure	82.8	102.0	105.6
… % change	5.6	23.2	3.5
Primary balance	6.3	-17.8	-16.9
Nominal GNI* growth (% change)	7.6	-5.1	2.7

Sources: CSO; Department of Finance, and Fiscal Council workings.
Note: Rounding can affect totals.

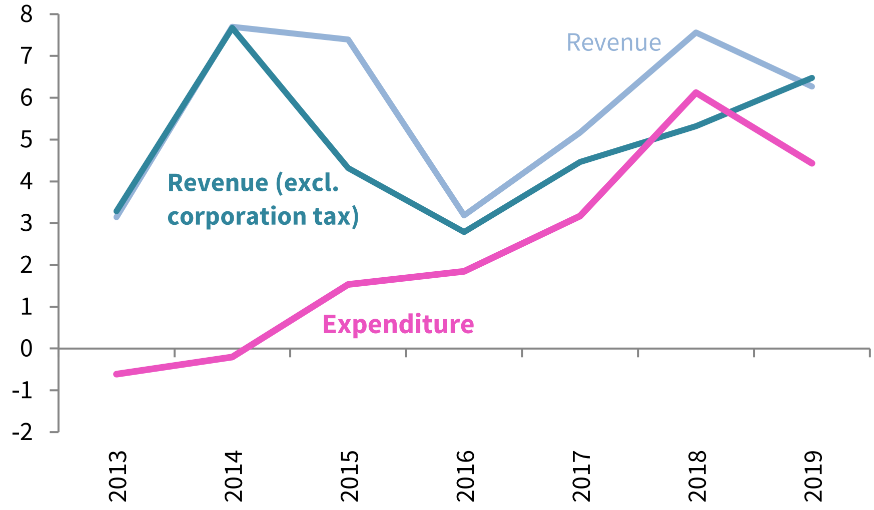
3.2 Assessment of 2019 Outturns

Balance, 2019

The **general government surplus** for 2019 was €1.9 billion, an improvement on 2018 (when a surplus of €0.4 billion was recorded). This improvement was aided by strong cyclical revenue growth, declining unemployment and falling interest payments (€0.9 billion lower than in 2018). Figure 3.1 shows underlying revenue and expenditure trends. General government expenditure growth accelerated over the past five years, with growth above 4 per cent in both 2018 and 2019. Despite this accelerating trend, spending growth has been generally surpassed by revenue growth, although by a smaller margin if corporation tax revenue is excluded.

Figure 3.1: Expenditure growth has accelerated since 2013

% growth, year on year



Sources: CSO; Department of Finance, and Fiscal Council workings. Get the data.
Note: Revenue and expenditure are in general government terms. They exclude one-offs as assessed by the Council, as per Table 1.1, Chapter 1.

The **primary surplus** (excluding one-off items) was €6.3 billion in 2019, €0.7 billion higher than 2018.[28] Given that interest payment fell, non-interest spending grew by more than 5.5 per cent in 2019 (excluding one-off items), slightly slower than revenue.

Expenditure, 2019

General government **primary expenditure** (excluding one-off items) grew by €4.6 billion in 2019. The largest increases for the year came from gross fixed capital formation (GFCF, €1.7 billion), intermediate consumption (€1.2 billion) and compensation of employees (€1.1 billion).[29] Spending in the Department of Health was €0.4 billion higher than planned. This is consistent with outturns in recent years, with the average annual overrun since 2015 being €0.5 billion.

Revenue, 2019

The outturn for **general government revenue** in 2019 was €89.1 billion, €2.8 billion higher than anticipated in *Budget 2020*. This overperformance relative to *Budget 2020* forecasts was mostly driven by corporation tax, PRSI and non-Exchequer

[28] One-offs are as assessed by the Council, given in Table 1.1, Chapter 1.
[29] Much of the increase in compensation of employees and intermediate consumption is related to increased health expenditure.

revenue (this includes revenue collected by non-market public corporations, the HSE and institutes of technology).

3.3 Forecasts for 2020 and 2021 in *Budget 2021*

Budget 2021 shows large deficits for both 2020 and 2021. This is due to the Covid-19 crisis, the impact of temporary policy measures introduced to mitigate the economic downturn, the large fall in tax revenues, and discretionary permanent increases in health, education and other spending. Exceptionally high uncertainty surrounds economic and fiscal forecasts at present.

Medium-term economic and fiscal projections should have been published in *Budget 2021*. In line with the macroeconomic forecasts, fiscal projections in *Budget 2021* were published for this year and next year, rather than the usual five-year horizon. While the heightened uncertainty makes producing medium-term projections difficult, such projections would help support a medium-term orientation for fiscal policy and enable monitoring of potential economic imbalances. It is essential that the Stability Programme in April 2021 presents a five-year forecast horizon.

More generally, the documentation accompanying *Budget 2021* lacks clarity, particularly on the expenditure forecasts. The main detail on expenditure is contained in the Expenditure report. While this report is detailed, it only covers voted Exchequer spending. As a result, there is limited publicly available information on non-voted expenditure or non-Exchequer general government expenditure. These two items combined account for a fifth of spending. This lack of clarity, combined with the short forecast horizon, makes it difficult to assess how much of the spending increases in 2020 and 2021 would be expected to be maintained into 2022 and how much is temporary.

Both macroeconomic and fiscal projections are largely dependent on the progression of Covid-19, both in Ireland and abroad. *Budget 2021* forecasts are formed on the assumption that there is no widely distributed vaccine in 2021. Since the publication of *Budget 2021*, a six-week period of nationwide Level 5 restrictions was announced.

Expenditure

For 2020, the *Budget 2021* anticipates an increase in general government expenditure of €18.6 billion (21.3 per cent). With interest costs set to fall by €0.6 billion, general government primary spending is projected to have increased by

€19.2 billion in 2020 (23.2 per cent). Approximately €16.7 billion of this has come from Covid-19 measures, with the remaining general government spending increases (€2.5 billion) likely to be permanent (Table 3.2).

Table 3.2: General government expenditure
€ million

	2019	2020	2021
Primary general government spending	82,828	102,015	105,625
Change in primary general government spending		19,187	3,610
Temporary spending		16,699	11,887
Permanent primary general government spending	82,828	85,316	93,738
Change in permanent primary general government spending		2,488	8,422

Sources: *Budget 2021*. Get the data.
Note: For 2020, temporary spending is made up of Covid-19 spending. For 2021, temporary spending incorporates Covid-19 spending, the Covid-19 Contingency Reserve and the Recovery Fund. Funding for preparing for Brexit and the Shared Island Fund are considered permanent. See Table 3.3 for a breakdown of amounts.

The *Budget 2021* projections imply that around 55 per cent of Covid-19 spending in 2020 will have been on income and wage subsidies. Both the Temporary Wage Subsidy Scheme (TWSS) and Pandemic Unemployment Payment (PUP) schemes having already been extended twice to officially run until 31st March 2021, with the TWSS now replaced with the Employment Wage Subsidy Scheme (EWSS). The remaining amount is split between a combination of measures. Increased health capacity was budgeted as costing over €2 billion, with other departments receiving additional funding of €4.7 billion (Table 3.3). Lastly, business supports in the form of direct transfers through the Restart Grant and others have been budgeted at around €0.9 billion for 2020.

Table 3.3: Covid-19 direct spending and tax measures

€ billion

	2020	2021
Tax Measures	1.8	0.75
Spending measures:	16.7	11.9
of which:		
PUP / TWSS / LR (March to September)	7.8	
PUP / EWSS (September to March 2021)	1.3	3.2
Additional Departmental Funding	4.7	1.4
Business supports	0.9	
Health (in addition to *Budget 2020*)	2.0	1.9
Recovery Fund		3.4
Covid-19 Contingency Reserve		2.1
Total	18.5	12.65

Sources: *Budget 2021*.
Notes: PUP stands for Pandemic Unemployment Payment, TWSS stands for Temporary Wage Subsidy Scheme, EWSS stands for Employment Wage Subsidy Scheme. Tax measures include rates waivers, VAT cuts, homebuying schemes, loss relief schemes. Departmental funding includes labour activation measures. Rounding can affect totals.

Budget 2021 added to spending in 2020, including the Christmas bonus, which again had not been included in budgetary planning. For 2021, this payment has again not been budgeted for, despite previous experience indicating it is highly likely to be paid.

After *Budget 2021*, Level 5 restrictions were effective as of 22nd October for a period of six weeks. This is expected to increase the 2020 general government deficit. Recently released revised estimates suggest that spending in 2020 is likely to be €1.6 billion higher than was forecast in *Budget 2021*, primarily due to additional welfare costs associated with the increased restrictions.[30] Some €1.3 billion of this additional spending is in the Department of Employment Affairs and Social Protection and the Social Insurance Fund.

For 2021, spending in gross voted terms is forecast to increase somewhat from the already high 2020 base (Table 3.4). Temporary spending related to Covid-19 is forecast to fall in 2021.[31] As a result, core gross voted spending (that which is likely

[30] https://ptfs-oireachtas.s3.amazonaws.com/DriveH/AWData/Library3/Documents%20Laid/pdf/PERdoclaid040320_041120_195458.pdf

[31] Even when including the Recovery Fund (€3.4 billion) and Covid-19 Contingency Reserve (€2.1 billion).

to be permanent) is forecast to increase by €5.4 billion (7.7 per cent). This is an acceleration compared to 2020 (€3.2 billion or 4.7 per cent).

Table 3.4: Gross voted expenditure

€ million

	2019	2020	2021
Core Gross Voted Spending	67,221	70,377	75,777
Covid-19 Spending	0	16,669	6,387
Brexit + Shared Island Fund	0	0	150
Covid-19 Contingency Reserve	0	0	2,100
Recovery Fund	0	0	3,400
Total Gross Voted Spending	67,221	87,076	87,814
Change in core Gross Voted Spending		3,155	5,400
Change in total Gross Voted Spending		19,855	738

Sources: *Budget 2021*.

Note: While not classified as "core" spending in the expenditure report, spending on Brexit and the Shared Island Fund are likely to be permanent. Funding for the Shared Island initiative is estimated to be €500 million over five years.

Looking at general government primary spending, the increase in spending is bigger for 2021 than in the previous year (€3.6 billion, Table 3.2). Temporary Covid-19-related spending is set to remain high, but is projected to be €4.8 billion lower than in 2020 (if one includes the Covid-19 Contingency Reserve and Recovery Fund as part of temporary spending in 2021). This implies there is an increase in permanent spending, not related to Covid-19 of up to €8.4 billion in 2021. This is consistent with the "Dual Strategy" set out in the Expenditure Report regarding Covid-19-related spending but also to increase spending on public services.

Temporary Expenditure

The bulk of the temporary Covid-19 spending in 2021 relates to the labour market impacts of Covid-19, with €3.2 billion of social protection spending projected to be needed for elevated levels of unemployment and the extension of the Pandemic Unemployment Payment and the wage subsidy scheme. In addition, 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.

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. Given the likelihood of some upside expenditure risks materialising, specifically those related to the income support schemes, it is possible that the unallocated contingency funding would be used even in a relatively benign environment. Allocating funding for adverse scenarios is prudent, but there is limited information on the likely uses of these contingencies. It is important to note the distinction between “rainy day” funding and money that has yet to be allocated to a specific area, but will likely be spent. At €2.1 billion, the contingency allocation for Covid-19 is substantial and warranted but should still be accompanied with clear costings as to which scenarios would likely see the amount used, and why.

The €3.4 billion “Recovery Fund” is to be disbursed in 2021, with no scheduled rollover beyond the end of the year. 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. Few details have been provided on this allocation. The budget documentation notes that it is intended to be used to support the economy and will be allocated to “specific revenue or expenditure measures that can be most effective at that particular time”. *Budget 2021* notes that the Recovery Fund will distribute reimbursements as part of the Covid Restrictions Support Scheme (CRSS) and can be used for other spending or revenue-reducing measures.[32]

In addition to planned increases in spending, a contingency allocation of €2.1 billion has been reserved for additional costs that arise as a result of health cost pressures or greater levels of unemployment. Given the likelihood of some upside expenditure risks materialising, specifically those related to the income support schemes, it is possible that the unallocated contingency funding would be used even in a relatively benign environment.

The macroeconomic forecasts underlying *Budget 2021* assumed that no vaccine would be widely available until 2022 at the earliest. As a result, no procurement costs of a vaccine were factored into fiscal projections.[33]

In addition to the increase in core spending, a further €1.9 billion is allocated to health in *Budget 2021* for Covid-19-related spending (€1.8 billion current, €0.1 billion

[32] Further indications are that it will focus on funding infrastructure development, labour market activation and other measures to support investment and jobs.
[33] As a rough calculation, applying a costing of €30 per person to a population of five million would imply a costing of €150 million. Additional costs (administration, distribution etc) may be substantial (relative to the cost of acquiring doses).

capital). Health expenditure may pose a risk to fiscal forecasts in *Budget 2021*. Expenditure in this area has proven difficult to manage in recent years.[34] A failure to contain Covid-19 effectively would lead to additional expenditure. However, in this event, it would seem likely that some of the unallocated resources for 2021 could be diverted toward health expenditure.

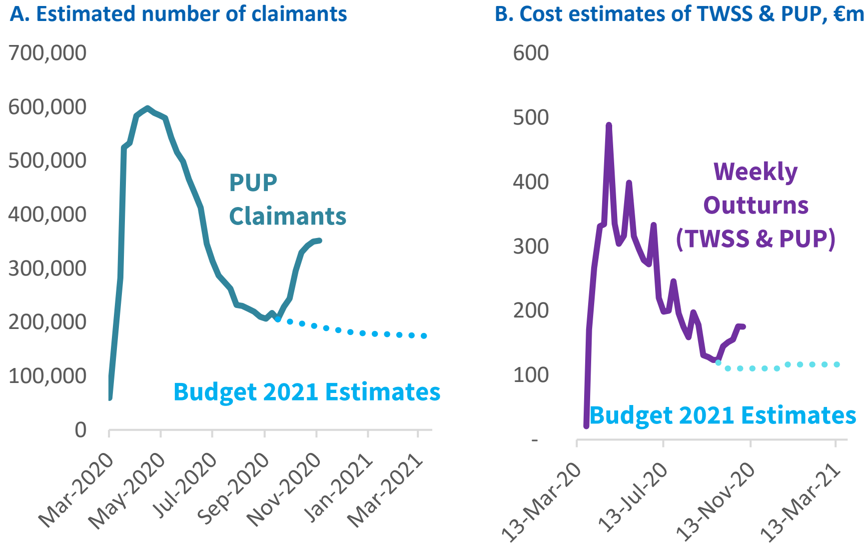
Covid-19 wage and income supports set up in 2020 will continue into 2021. The total allocation for Covid-19-related expenditure by the Department of Employment Affairs and Social Protection (DEASP) in *Budget 2021* is €3.2 billion.[35] This will cover payments for the PUP and EWSS, which have been costed at €1.4 billion for the first quarter of 2021, along with additional Covid-19-related Live Register costs.

The rates at which the PUP is paid are scheduled to reduce as employment recovers, with the scheme scheduled to end on 31st March 2021. Recent indications suggest however that both the PUP and EWSS will be extended in some format beyond the official end Q1 2021 deadline should demand remain high. A continuation of the schemes, for example on a stand-still basis for a further six months could cost approximately €2.8 billion in spending. While higher-than-expected numbers transitioning to the Live Register from the PUP and EWSS could also increase costs beyond the budgeted €3.2 billion.

It is unclear whether the Recovery Fund would contribute to these schemes, or whether any expenditure overrun would have to be funded by the Covid-19 Contingency Reserve and/or increased total expenditure.

[34] Recent years have seen overruns averaging of €0.5 billion per year.
[35] See Department of Finance (2020c).

Figure 3.2: Claimants of PUP to date and illustrative scenarios



Sources: *Budget 2021*, DEASP, Revenue Commission. Get the data.

The number of PUP claimants assumed under *Budget 2021* projections was forecast at 199,000 by the end of 2020, and to be at 174,000 when the scheme is due to end in March 2021 (Figure 3.2).[36] Monthly profiles have not been provided by the Department of Public Expenditure and Reform or DEASP, but the estimated number of claimants on the Live Register (drawing standard unemployment benefits rather than those introduced for Covid-19) by end 2021 in *Budget 2021* is around 380,000. To put this estimate in context, the most recent outturn for Live Register claimants was 203,172. Despite the large numbers on the EWSS, this suggests that the level of unemployment will remain high well into 2021, with modest levels of job recovery for those claiming the PUP.

It is important to note that fiscal forecasts in *Budget 2021* were based on the policy measures known or announced at that time. Some changes to income and employment supports have been announced since *Budget 2021*, as these forecasts did not anticipate the additional nationwide restrictions applied for six weeks effective from 22nd October. Repeat lockdowns or additional restrictions in 2021 could similarly result in both more claimants and a higher rate of payment under the PUP and EWSS. As for the CRSS, it is likely that payments will continue even under less strict restrictions. For example, the CRSS is expected to pay out an

[36] The remaining claimants are assumed to transition to regular jobseekers once the scheme expires in April 2020.

estimated €0.16 billion per month to businesses affected even under Level 3 restrictions.

In addition, the Pandemic Unemployment Payment has been restored to its higher level of €350 per week for those were earning more than €400 per week before the pandemic. These higher levels of payments are to continue until end-January 2021.[37] Given that the additional restrictions will result in increased numbers of those in the reinstated higher-income bracket of the PUP structure, the average cost per claimant would rise to around €337 for the period of increased payments from around €307. This would result in an estimated additional cost of around €10.6 million per week over previous rates.[38]

Table 3.5: Employment Wage Subsidy Scheme payment levels
€ per week

Weekly Wage	*Budget 2021* assumed payment	New payment (until 31st January 2021
€151 - 203	151.5	203
€203 - 300	203	250
€300 - 400	203	300
€400 - 1,462	203	350

Sources: Department of Finance. Get the data.
Note: Weekly wage refers to gross pay. Employees earning less than €151 or more than €1,462 per week are deemed ineligible for this scheme.

The forced closure of many firms will further result in more claimants. The October/November lockdown may have a slightly lower impact on employment as more sectors are deemed "essential" than was the case in April.[39] In addition, firms may be better placed to deal with severe health restrictions than was the case earlier in the year. Despite this, DEASP estimates put the potential employment losses of a Level 5 lockdown at around 167,000 extra claimants. This would put the total claiming at approximately 367,000 for the period of the restrictions (around 16 per cent of the workforce) and would likely lead to further permanent job losses as businesses become insolvent.

Changes have also been announced to the Employment Wage Subsidy Scheme since *Budget 2021*. These changes, due to be in place until the end of January 2021

[37] The other three rates of payment (€203, €250 and €300 per week) remain unchanged.
[38] This estimate assumes an average cost of around €120 million per week with an average of 356,000 claimants.
[39] For example, construction and some manufacturing activities are permitted to continue.

are shown in Table 3.5. As well as the payment levels increasing, the number of claimants is expected to increase over the six-week lockdown period. These additional costs will add to those budgeted as part of the extension to the EWSS scheme until April 2021. This assumes 350,000 workers, representing approximately 15 per cent of the total labour force, would be supported under the EWSS. The expected cost of this is €0.9 billion, or €0.3 billion per month. Taking these costings, the average spend for a worker being supported under the scheme is €214 per week over the first quarter of 2021. A full breakdown of these costs can be seen in Table 3.6.

Overall, 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. As mentioned earlier, spending is likely to be €1.6 billion higher relative to Budget Day forecasts.[40]

Table 3.6: Income support schemes

	Peak Claimants 2020	Peak Claimants (Month)	Latest Claimants	Est Avg Claimants Q1 2021	Est Avg Cost PP (Week €)	Est Avg Cost PP (Month €)
PUP	598,000	May	352,000	186,000	224	896
TWSS	415,000	July	-	-	-	-
EWSS	347,400	-	347,200	350,000	214	857
C-19 Illness Benefit	-	-	2,296	-	350	1,400
Live Register	244,562	July	203,172	227,000	168	672

Sources: Department of Finance, Revenue Commission, DEASP.
Note: Data accurate as of 26/11/2020. Cost estimates do not account for higher rates paid under the most recent Level 5 restrictions. Estimated costs of the EWSS do not include foregone PRSI.

Adding to this, further business supports may be required. For example, extending commercial rates waivers would come at a cost of around €0.1 billion per month. As contained in *Budget 2021*, €0.05 billion, around 1 per cent of total funding, has been made available for Covid-19-related costs in 2021 for the Department of Housing, Local Government, and Heritage. *Budget 2021* forecasts of €1.6 billion of local government revenue from rates, in line with normal revenue assumptions and

[40] Revised estimates show a €1.6 billion increase in expenditure relative to *Budget 2021*. €1.3 billion of this arises from the Department of Employment Affairs and Social Protection and SIF expenditure.

implying no further waivers. There is a risk that rate revenue may fall short, or further waivers would be granted, which would require greater spending.

Budget 2021 details that business supports with a direct fiscal impulse of €0.9 billion, liquidity supports worth €2 billion each in guarantees, tax warehousing, Irish Strategic Investment Fund (ISIF) investments, and €1.3 billion in loans were provided in 2020. Of these liquidity supports, no direct costs are assumed but will rather add to the Government's liabilities and not to annual spending unless losses materialise. While business supports have a set cost, potential costs from liquidity supports or loan guarantees are more uncertain.

Box E: Covid-19 Support Measures

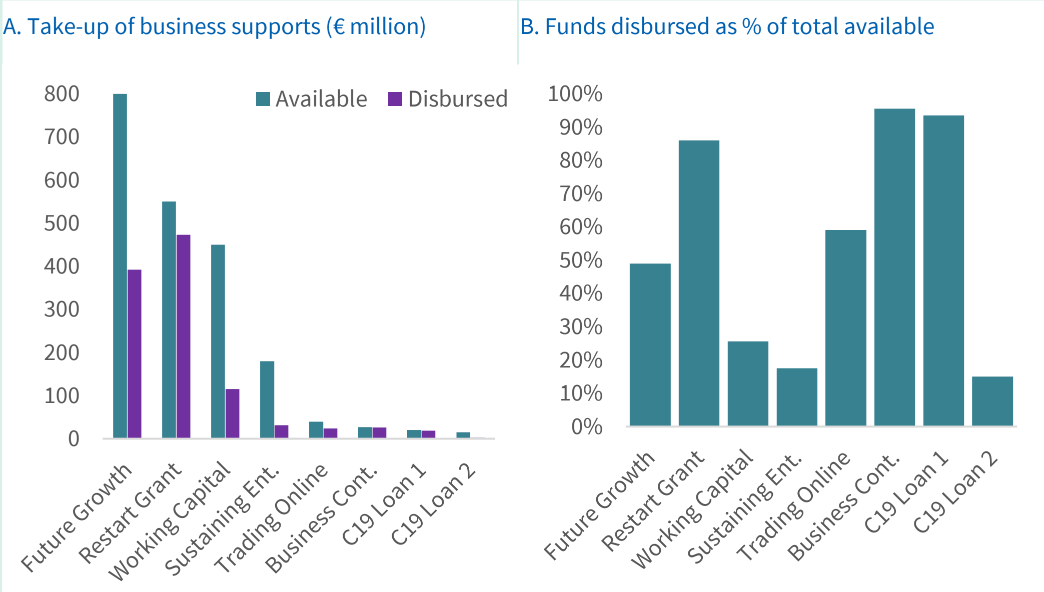
The level of governmental support for businesses, households, and the wider economy has reached around €26 billion in 2020. As part of the Government's effort to provide stimulus and support, a range of measures have been used, including tax cuts, employment subsidies, capital investment, loans, grants, guarantees and cash transfers.

This box provides an overview of some of the supports and policies introduced since March. We note three main findings. First, that the amount of overall support has been large and warranted. Second, more specific targeting and appropriate timing could boost take-up of certain measures. Third, areas such as capital investment and labour market activation remain open for further use.

Business support measures

Excluding tax cuts, rates waivers, and job retention schemes and other similar measures, the Government has allocated around €1.5 billion in liquidity loan supports to businesses affected by the crisis, with a further €0.6 billion in direct cash grants. Figure E.1 shows available data on the take-up of the most substantive of these schemes to date. Many of the business support measures have had lower-than-budgeted drawdowns. In general, measures such as direct cash grants and the smaller schemes have disbursed funds into the economy more quickly than the larger allocations of loans, guarantees and investments. Various factors may help to explain this: a reluctance to increase leverage, conditionality arrangements which are restrictive or insufficiently targeted to firms that have suffered the greatest falls in turnover, or a preference from firms for other supports may all play a role in determining demand.

Figure E.1: Take-up of Covid-19 business support measures



Source: Department of Enterprise, Trade and Employment, and Fiscal Council Workings.
Notes: Latest data accurate as of 28/10/2020

Tax measures

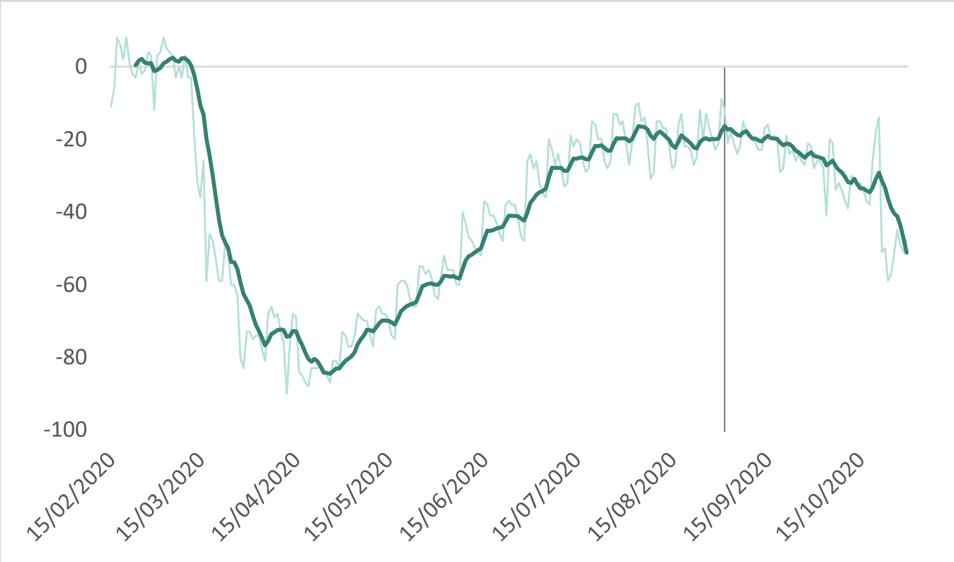
Tax cuts, rebates and waivers with a direct budgetary impact have been outlined to the value of around €1.8 billion in 2020, with measures in 2021 estimated at €0.7 billion. Over a third of this total relates to commercial rates waivers for businesses, allowing for immediate liquidity to flow to firms. The drawdown of most of the residual amount budgeted as part of the tax measures depends heavily on how consumer demand, particularly in key sectors like tourism and hospitality, progresses over the coming months.

As Figure E.2 shows, activity in retail and recreational sectors was faring relatively well in August and September, after recovering strongly from its April low. At such levels, well targeted tax measures could be expected to stimulate demand. The VAT cuts enacted by the Government could allow for consumers to save on purchases, or for struggling businesses to receive a direct liquidity boost by restricting the passthrough of the rate reduction. Such a policy might also be expected to normalise pre-Covid-19 consumer habits in an uncertain health environment.

The introduction of Level 5 restrictions in October however, as the tax measures were enacted, has meant that consumers have had little opportunity to avail of the schemes, assuming their expiration dates remain unchanged. Activity is now weaker again relative to pre-Covid-19 periods and is likely to remain so for the duration of the Level 5 restrictions

Figure E.2: Mobility data for retail and recreation

Deviation from Baseline



Source: Google; and Fiscal Council workings.
Note: The marker line denotes the introduction of the VAT rate cut from 23% to 21% on September 1. The bolder line represents the 7-day moving average of the underlying data series.

In addition to these restrictions on spending, other factors which might limit the effectiveness of the measures are that the VAT cuts merely subsidise purchases which would have taken place anyway, particularly with respect to consumer durables. Limited passthrough of the rate cut, as businesses increasing need liquidity, and ongoing consumer uncertainty could also dampen its effect.

Labour-market activation

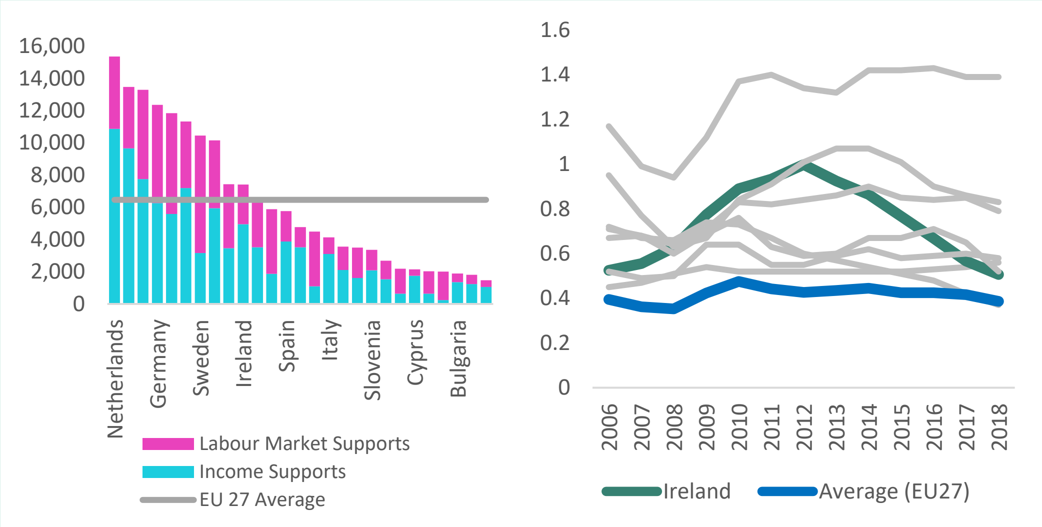
As part of the July stimulus measures, the Government allocated additional funding for labour market activation of around €200 million, with €130 million to be used in 2020 and the remainder in 2021. This was supplemented by an allocation of €10 million in *Budget 2021.* As a percentage of *Budget 2020* figures, this total is around a 20 per cent increase.

Figure E.3 shows that by various measures, Ireland spends around the EU average on such policies in normal times, but is far below the highest spenders.

In 2021, the employment outlook implies that significant spending increases would be needed to close the gap between current funding (including the recent additional allocations) and demand for social welfare services in the form of labour market activation schemes. This stretch on services can manifest in areas such as the caseworker-client ratio in social welfare centres. With Ireland's ratio already considerably above the best-practice figure of around 150:1, the greatly increased caseload as a result of the pandemic will see this ratio deteriorate further.[41]

Figure E.3: Expenditure on Income and Labour Market Activation Supports

PPS per person wanting to work (2018) GNI* (% GDP for other countries)



Source: Eurostat, and Fiscal Council workings.

With health restrictions likely to continue, many of those in unemployment will likely become long-term unemployed, defined as a period of six months or over. Among other benefits, labour-market activation policies are one of the ways in which the Government can both reduce unemployment in the short run, and increase human capital in the long run.

Investment measures

Public investment tends to have a larger impact on economic activity compared to other forms of public spending (Ivory, Casey and Conroy, 2020; Varthalitis, 2019; Hall, 2010; Bénétrix and Lane, 2009; Giordano et al., 2007). As well as having higher multipliers, public investment can also contribute to productivity in the future. With social distancing limiting the effectiveness of demand stimulus in sectors where demand is low due to health risks, public investment can also be a key tool to divert resources and stimulate demand to areas that are less constrained. In particular, it can be useful to make up for shortfalls in construction demand and jobs that might not return quickly.

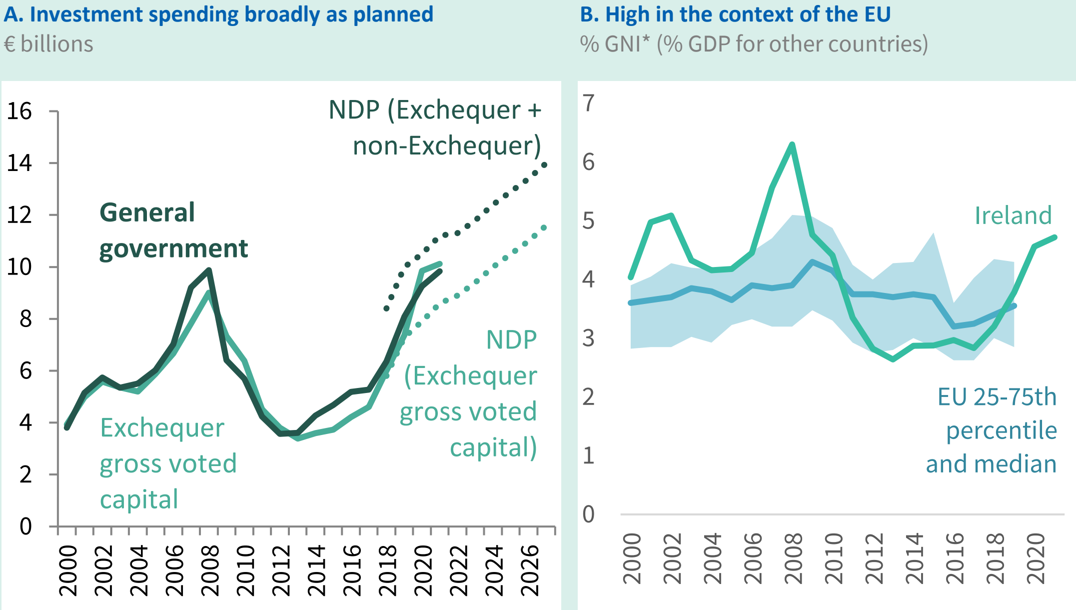
In terms of responding to the current crisis and providing stimulus for the recovery, public investment has not been expanded much, relative to pre-existing plans. General government gross fixed capital formation—a broad measure of how much the Government spends on capital projects in a given year—was set to rise from €8.8 billion to €9.1 billion between 2020 and 2021 according to *Budget 2020* plans. The *Budget 2021* projections put the respective levels of investment at €9.3 billion and €9.8 billion for the same years — a combined increase of €1.2 billion. For context, this amounts to about 3.8 per cent of the increase in total general government spending over the two years relative to the *Budget 2020* plans.

However, public investment is set to rise to high levels. Ireland's level of public investment as a share of GNI* is set to rise to 4.7 per cent in 2021. This would be the highest level since 2009, just prior to the sharp cuts to investment introduced after the financial crisis. This would also

[41] IMF (2017a) noted that this figure had declined from 800:1 in 2013 but remained high at 500:1 in 2015.

see Ireland having relatively high levels of investment in the context of the EU where normal ranges over the past two decades were between 3 and 4.5 per cent of GDP.

Figure E.4: Public investment is set to rise to high levels



Sources: National Development Plan (NDP), 2018–2027; CSO; Department of Public Expenditure and Reform; Eurostat; and Fiscal Council workings.
Notes: The NDP notes that commercial semi-state bodies, state-owned enterprises and other non-Exchequer bodies make their investment decisions in line with business plans that, for the vast majority, did not extend past 2021 at the time of the publication of the NDP.

Permanent Expenditure

Alongside Covid-19 related temporary measures, *Budget 2021* included €5.4 billion of permanent increases to core gross voted spending, with up to €8.4 billion in terms of general government spending (as shown in Table 3.2 and Table 3.4). These increases are unrelated to Covid-19 under the Government's "Dual Strategy" to continue to increase spending in core areas. These increases in spending are likely to be permanent. These 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.

A further €1 billion increase is evident in non-voted current spending areas (not including cash interest payments on national debt). There is little transparency on what is driving this increase in terms of budget documentation.[42] However, from the White Paper that is published prior to the Budget (Department of Finance, 2020b), the Council understands that it predominantly relates to an increase in Ireland's EU budget contribution for 2021, which is likely to be a persistent increase. About half of this would appear to be driven by estimated increases in customs revenue under the disorderly Brexit scenario, which are transferred to the EU budget. The other half appears to be driven by an increase in the non-customs element of the EU budget contribution.

Despite the volume of information provided with Budget Day documentation, it is not possible to ascertain where a substantial portion of increases in non-Exchequer spending comes from. There is very little information provided in budgetary documents for areas outside of the Exchequer — these areas typically account for about one-fifth of government spending. 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 increases appear to reflect capital spending more than current spending, though capital spending increases would also attract long-lasting increases in current spending too.

[42] While the white paper gives information on non-voted spending, this is done on a pre-budget basis.

Budget 2021 also included significant permanent increases in core (non-Covid-19-related) spending. Core current health spending is set to increase by €1.9 billion in 2021. No estimates were made available as to how much of this increase is split between pay and non-pay items.

Table 3.7: General government expenditure forecasts in *Budget 2021*
€ billion

	2019	2020	2021
General gov. expenditure	87.3	105.9	109.2
Compensation of employees	23.0	24.6	25.8
Intermediate consumption	12.5	16.8	14.8
Social payments	31.7	39.3	38.4
Interest	4.5	3.9	3.6
Subsidies	1.7	6.1	4.8
Gross fixed capital formation	8.1	9.3	9.8
Capital transfers	1.9	1.9	2.2
Other	3.9	4.0	4.4
Unallocated resources	0.0	0.0	5.5
Primary expenditure	82.8	102.0	105.6
Primary expenditure (% GNI*)	38.8	50.3	50.7

Sources: *Budget 2021*.
Note: Primary expenditure is calculated as total expenditure minus interest payments.

Core social protection spending is to increase by €741 million in 2021. This reflects the assumption that the state pension age will remain at 66 in 2021. Increasing the state pension age—as had been legislated for but was subsequently deferred by Government pending a review—would have led to expenditure being reduced by up to €0.6 billion (Fiscal Council, 2020b).

Welfare payments, other than those related to Covid-19, were held fixed in nominal terms. The full-year cost of the October 2020 increase in public pay will add €0.3 billion to public spending in 2021 compared with 2020, reflecting the cost of increments and the full-year effect of the final pay increase paid in autumn under the current pay deal. No further pay deal is currently in place.

Risks for transport revenues remain in 2021. An allocation was made to the value of €0.45 billion this year to fund shortfalls from March, representing around 45 per cent of total 2018 revenues for CIÉ.[43] Given that levels of activity are forecast to remain

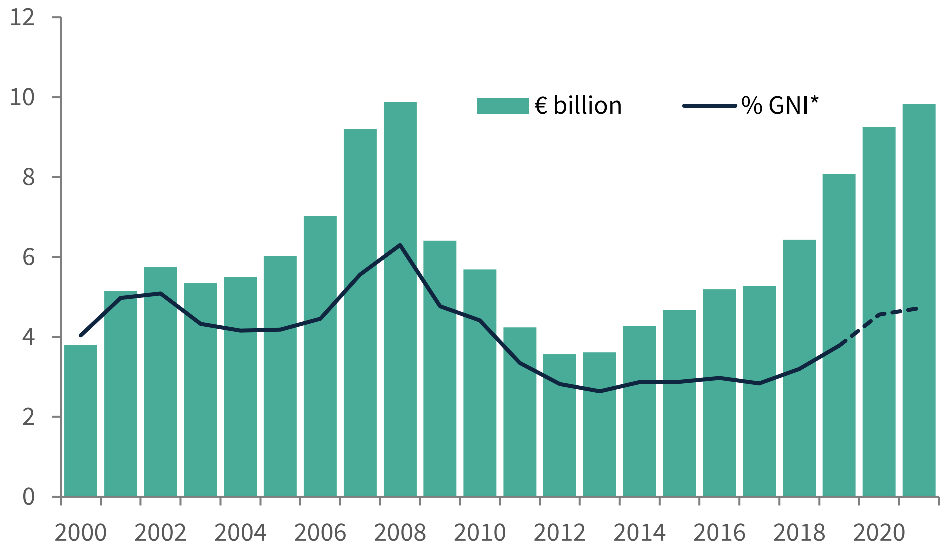
[43] See CIÉ (2019).

low throughout all of 2021, the allocation of €0.395 billion for the year in *Budget 2021* may prove insufficient. Further risks remain from structural changes in the commuting and travel habits of both domestic and international travellers.

Public investment is set to rise to high levels. Gross fixed capital formation is forecast in *Budget 2021* to grow by €1.2 billion in 2020 (Figure 3.3).[44] Central and local government are both expected to contribute approximately €0.6 billion each.[45] This is an upward revision of €0.3 billion since *Budget 2020*. Forecasts suggest that government investment as a share of GNI* will increase in both 2020 and 2021, which will take it to high levels in an historical and international context (Box E). Gross voted capital expenditure is forecast to grow more strongly in 2020 (€2.5 billion). This increase is larger than the General Government increase as some of the gross voted capital expenditure is classified as intermediate consumption.

Figure 3.3: Government investment is set to increase to high levels

General government gross fixed capital formation



Sources: CSO and *Budget 2021*. Get the data.
Note: Dashed line indicates forecast values.

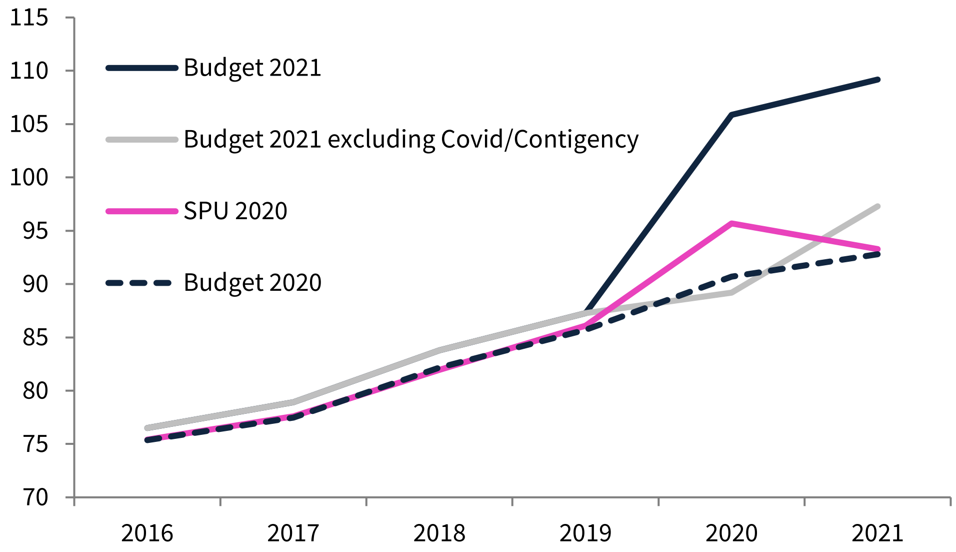
Overall general government expenditure is forecast to increase further in 2021 (€3.3 billion or 3.1 per cent), leaving it €21.9 billion above its 2019 level. Overall, there have been large revisions to forecasts of general government expenditure over recent forecast rounds (Figure 3.4). Fiscal forecasts in *SPU 2020* incorporated some temporary additional spending measures introduced for 2020. Since then, various

44 An increase of €0.9 billion was projected in *Budget 2020*.
45 Spending by Approved Housing Bodies (AHBs) is expected to increase by €0.4 billion.

policy announcements have been made that affect expenditure in 2020 and 2021. *Budget 2021* incorporates a broader range of measures affecting spending in 2020 and 2021. Figure 3.4 shows that the large revisions seen in *Budget 2021* largely reflect temporary Covid-19 spending and contingencies.

Figure 3.4: General government expenditure has seen large revisions in recent rounds

€ billion

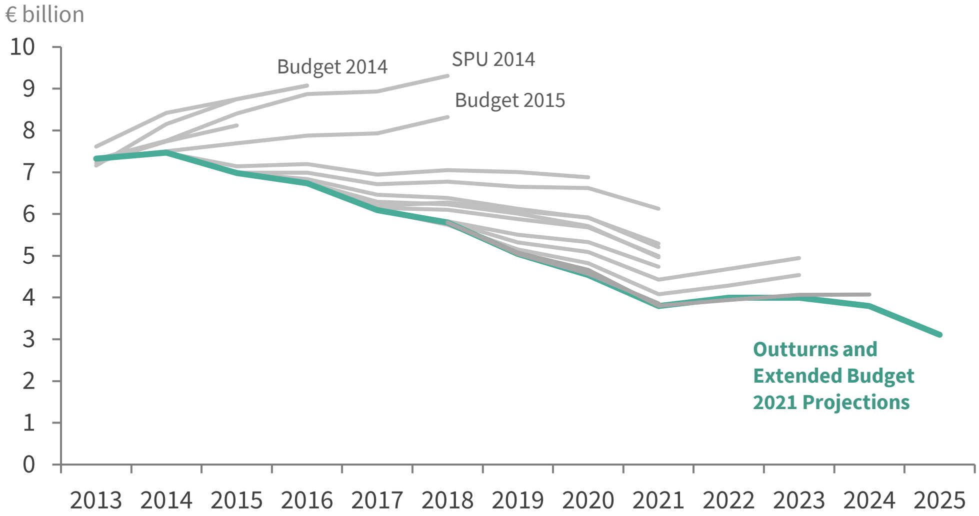


Sources: *Budget 2020*, *SPU 2020* and *Budget 2021*. Get the data.
Note: Covid-19 spending here also includes the Covid-19 contingency reserve and the Recovery Fund.

Interest expenditure

Figure 3.5 shows the reduction in forecast and actual interest costs. It also shows that interest costs have been consistently lower than forecast for a number of years. Given the short forecast horizon in *Budget 2021*, the impact of large deficits and increasing funding requirements is not evident in the forecasts.

Figure 3.5: National debt cash interest payments have been less than expected



Sources: Department of Finance. [Get the data](#).

Despite the absolute amount of Irish government debt increasing in 2020 and 2021, the cost of servicing this debt is forecast (in *Budget 2021*) to fall in 2021. Improvements in government creditworthiness, policy actions by the ECB and other central banks, and the secular decline in interest rates have contributed to the reduction of the interest rate at which the government can borrow. Retiring higher coupon bonds and refinancing at lower rates has in turn brought down the effective interest rate on Irish government debt. The falls in interest rates more than outweigh the increase in the stock of debt, hence debt service costs fall. In the coming years, the marginal rate will be important due to high funding requirements both for new borrowing and rolling over existing liabilities.

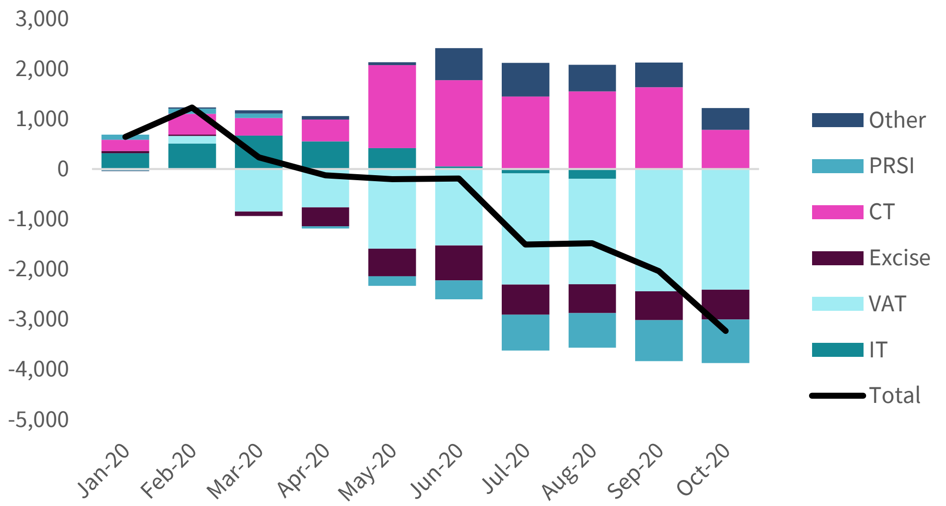
Revenue

The sharp fall in economic activity in 2020 has lowered government revenue substantially. A reduction in income and employment has meant lower direct taxes and social contributions. Income tax and PRSI combined are anticipated to have fallen by €3.3 billion. Falling consumption and VAT policy changes have meant lower indirect tax receipts (*Budget 2021* forecasts a fall of €2.7 billion in VAT and excise receipts). At the same time, corporation tax receipts are expected to grow by €1.4 billion.

Policy measures to support the economy have also contributed to the reductions in revenue. Measures such as VAT reductions, rates waivers, loss relief, and others such as the Help-to-Buy scheme have been costed at around €1.8 billion for 2020.

Figure 3.6: Cumulative revenue change

€ million (y/y)



Source: Department of Finance. Get the data.

A key development has been the robustness of some tax revenues compared with the fall in activity: while up to 40 per cent of the workforce was unemployed or on support schemes at the peak of the crisis, income tax revenue for 2020 is anticipated to be only marginally below its 2019 level. Part of this can be explained by the strong performance of income tax receipts in early 2020, before the pandemic struck (Figure 3.6). In seasonally adjusted terms, income tax receipts rose by more than 9 per cent in January relative to December.

Table 3.8: *Budget 2021 Revenue Measures*

€ million

Measure	2021 Impact	2022 Impact
VAT reduction for Tourism / Hospitality	-336	-
Non-Indexation of Tax Bands/Credits	192	-
Carbon Tax Rate Increase of €7.50	108	147
Excise Increases on Tobacco	57	57
Help to Buy Scheme Extension	-43	-43
Income Tax Credit Increases	-29.7	-30.4
Farmers Flat Rate Increase of 0.8%	-10	-12
USC Qualifying Threshold Increase	-6	-7
Other Measures	-6.1	-6.8
Total	-73.8	104.9

Source: Department of Finance.
Note: Reduced VAT rate for hospitality sector has a 2020 impact of €65 million, while changes to income tax credits have a cost of €13 million in 2020.

Focusing on **Exchequer tax revenue**, *Budget 2021* forecasts a fall of €2.6 billion (4.4 per cent) in 2020. A much sharper fall was forecast in *SPU 2020* (a fall of €9.7 billion or 16.4 per cent). The upward revision to tax revenue is mainly driven by income tax (€3.3 billion) and corporation tax (€2.1 billion). These upward revisions are due to stronger-than-anticipated outturns for the year to date.

The usual methodology to compile official forecasts would project the change of revenue using the change in the associated macroeconomic driver, multiplied by an elasticity.[46] The elasticity reflects how closely receipts move with its macroeconomic driver. Where applicable, any assumed impacts of policy changes are also included. In addition to these factors, judgement is often applied. This can be helpful to take account of specific factors such as changes in behaviour or where the elasticities may be misleading.

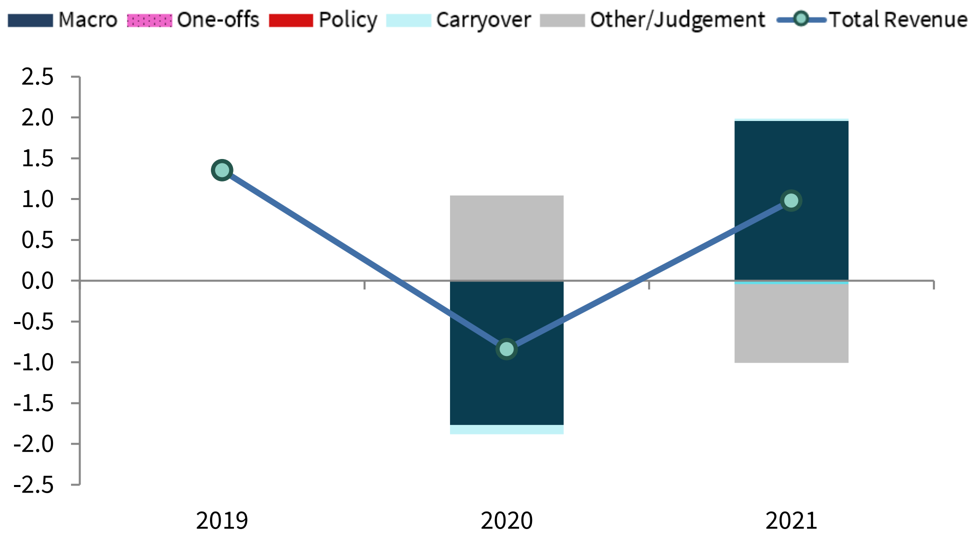
As nine of the 12 months of returns were available, *Budget 2021* forecasts for this year involves forecasting three months of receipts. These forecasts were arrived at in consultation with the Revenue Commissioners and account for any Budget Day tax policy changes that affect receipts for the remainder of 2020. For 2021, a typical forecasting approach was applied, using macroeconomic drivers and elasticities.

[46] When forecasting at budget time, in-year forecasts typically do not follow this methodology. Forecasts from the SPU are updated manually to account for recent outturns and any policy changes in the budget. Forecasts beyond the current year typically use an elasticity combined with a macroeconomic driver.

There may be reasons to anticipate factors other than those typically considered as affecting on receipts. For example, income tax receipts in 2020 have not fallen as severely as simply applying an elasticity and macroeconomic driver would imply. This appears to be due to employment and income losses being concentrated at the lower end of the income distribution. Due to the highly progressive income tax schedule, these employment and income losses result in smaller income tax losses, as those on lower incomes are subject to a lower-than-average tax rate. Conversely, when this employment returns, one should not anticipate as big an increase in income tax receipts as a standard approach would imply. Year-on-year comparisons of income tax receipts in 2020 also benefit from a strong performance in the first quarter of the year.

Figure 3.7: Judgement has been used to smooth changes implied by macro drivers for income tax (PAYE and USC)

€ billion change year-on-year



Sources: Department of Finance, and Fiscal Council workings. Get the data.
Note: "Other" reflects other factors/judgement applied by the Department of Finance and carryover impacts from previous policy measures. The elasticities used by the Department of Finance are used for this exercise (2.1 for PAYE income tax, 1.2 for USC). See Appendix C for more details.

While tax forecasts for 2020 in *Budget 2021* were not compiled by applying a macroeconomic driver with an elasticity, correcting for policy changes/one-offs and applying judgement, we can simulate what such a forecasting methodology would have implied for 2020. As a result, we can infer what level of judgement is implied from the forecasts for 2020 given in *Budget 2021*.

For income tax, the usual tax elasticity would imply a much larger fall in income tax in 2020 than is likely to have occurred. Positive judgement in the forecast for 2020 reflects the stronger than predicted return for the year to date (Figure 3.8).[47] As a result, in 2021, there is an offsetting negative judgement to unwind these effects. This means that the recovery in employment and income is assumed to be less tax-rich than would be typically the case. Other factors play relatively minor roles in both 2020 and 2021.

Looking specifically at PAYE, 2020 receipts are forecast to be higher than would be implied by simply applying a standard elasticity and macroeconomic driver.[48] This is equivalent to applying a much lower elasticity (60 per cent lower) and not applying judgement. If this same low elasticity were applied in 2021 (without applying judgement), this would also yield forecast receipts close to that in *Budget 2021*.

While unwinding the 2020 judgement in 2021 income tax forecasts may be reasonable, there is a risk to income tax forecasts from the macroeconomic drivers. As described in chapter 2, substantial income growth is forecast for 2021. This would imply either that the employment recovered in 2021 is not exclusively focused in low paying sectors, or that wage growth in high-earning sectors for existing workers will be substantial. Either case would pose an upside risk to income tax forecasts in 2021.

PRSI receipts are anticipated to fall in 2020 by 16.6 per cent. For the first three quarters of 2020, the fall has been 9.8 per cent. This fall is more severe than is the case for income tax and reflects the fact that income tax is more progressive and has a broader base.[49] As a result, the distributional nature of the job losses has not insulated PRSI receipts to the same extent. For 2021, PRSI is forecast to grow by 17.8 per cent, almost recovering to its 2019 level.

[47] As mentioned earlier, income and employment losses in 2020 have been focused on the bottom of the income distribution. As the Irish income tax system is highly progressive, this fall in income and employment has less of an impact on income tax receipts than would otherwise be the case.

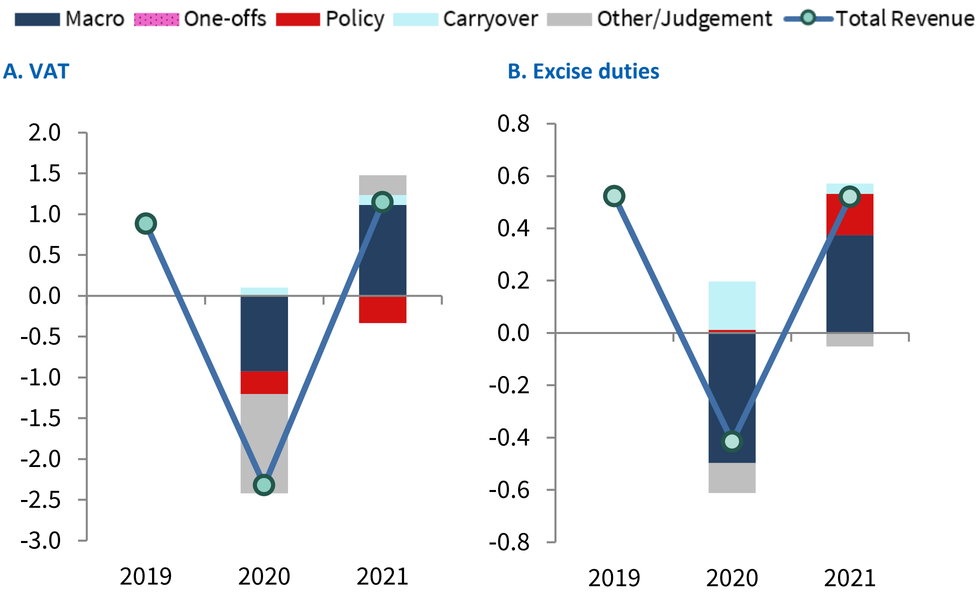
[48] PAYE makes up about 70 per cent of total income tax receipts. USC makes up approximately 14 per cent.

[49] In addition, full PRSI was not charged to employers or employees in instances where the TWSS or EWSS were in operation, unlike income tax.

VAT receipts are anticipated to decline in 2020 by €2.3 billion (15.3 per cent). This reflects the projected fall in consumption. Policy also plays a role (the reduction in the higher rate of VAT). In addition, there is some negative judgement implied (€1.2 billion or 9.5 per cent of receipts). This reflects forbearance measures in place from the Revenue Commissioners in 2020 (approximately €1 billion).

Figure 3.8: VAT and excise see substantial falls in 2020, rebounding in 2021

€ billion change year-on-year



Sources: Department of Finance, and Fiscal Council workings.
Note: "Other" reflects other factors/judgement applied by the Department of Finance and carryover impacts from previous policy measures. See Appendix E for more detail.

For 2021, VAT receipts are forecast to recover somewhat, reflecting the recovery in personal consumption (Figure 3.8). Positive judgement is applied in 2021 (€0.2 billion) overall, driven by two contrasting factors. Firstly, it is assumed that forbearance measures from the Revenue Commissioners will not continue into 2021, leading to positive judgement.[50] Secondly, *Budget 2021* forecasts take account of a change in the accounting of VAT paid on imports. This is expected to delay some receipts in the later part of the year until 2022 (this is expected to have an impact of around €160 million and is expected to be a permanent change). *Budget 2021* forecasts an increase in receipts of €1.1 billion (8.9 per cent) in 2021. This reflects policy measures that will reduce revenues being offset by assumed repayments of

[50] This is applied as positive judgement, as the negative judgement in 2020 leads to a lower base for 2021 forecasts. As a result, model forecasts for 2021 are affected by the judgement applied in 2020.

warehoused taxes in 2020 to the value of €0.375 billion.[51] Repayment failures or extending VAT reductions beyond their legislated expiration dates risks adding to the €0.8 billion in estimated foregone revenues for 2020 and 2021 and would weigh heavily on intake for the year.[52]

Excise duties are forecast to fall in 2020 (€0.4 billion or 7.0 per cent). This decrease is driven mainly by reduced personal consumption.[53] Downward judgement of €0.1 billion is implied for 2020. Excise receipts are forecast to grow in 2021 (€0.5 billion or 9.6 per cent). This is driven by both improved macroeconomic conditions and also policy changes (increase in the carbon tax and tobacco tax).

Customs receipts are expected to increase in 2021 due to Brexit (€0.7 billion). However, only €0.2 billion of this increase will be retained by the Exchequer, with a €0.5 billion increase in EU contributions. Were a trade deal to be successfully negotiated, then these impacts could be expected to be much lower.

Receipts from the local property tax (LPT, €0.5 billion) are assumed in *Budget 2021* to be unchanged in 2020 and 2021. Originally, valuations were to be updated on 1st November 2019. This was subsequently deferred by a year to November 2020. The Minister has announced a further deferral of the LPT valuation date from 1st November 2020 to 1st November 2021. If a revaluation had gone ahead on 1st November 2019 with no change in the rate of the tax, 2020 receipts would be approximately €729 million. This suggests that the revenue lost because of not proceeding with revaluations on 1st November 2019 on a no-policy-change basis was in the region of €247 million annually.

Corporation tax (CT) receipts have grown for the first three quarters of this year (up €1.6 billion or 27.9 per cent). Again, this illustrates how this revenue source can contrast with the performance of the domestic economy. When *Budget 2021* forecasts were compiled, returns for nine of the 12 months were available. Previously it has been shown that November corporation tax receipts are well

[51] In general government terms, these receipts would still be accrued to 2020. A further €0.375 billion is expected to be collected in 2022. As a result, €0.75 billion out of the €1 billion of 2020 warehoused liabilities is expected to be collected.

[52] A VAT cut for the hospitality sector enacted in 2011 ran to 2019, well beyond its scheduled initial expiration date of 2013.

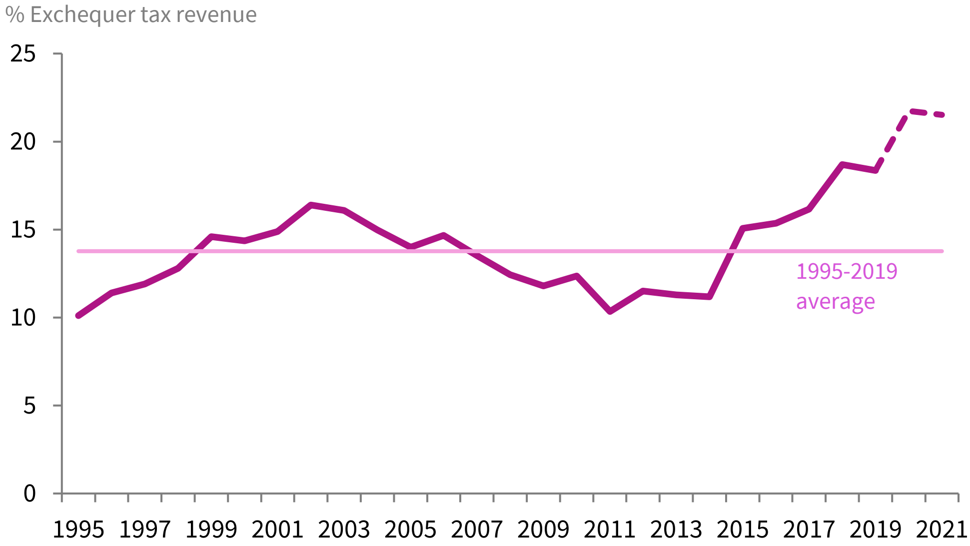
[53] Revenue (2018a) report that 43 per cent of 2017 excise duties were derived from alcohol and tobacco. A further 34 per cent of excise duties came from petrol and diesel.

correlated with June receipts (Department of Finance, 2017e). If one assumes that this relationship holds, then corporation tax receipts in 2020 would likely be €12.6 billion (€0.3 billion higher than *Budget 2021* forecasts).

Economic shocks such as Covid-19 and Brexit are likely to strongly affect many domestic firms. These firms could suffer substantial losses, which could then be used to offset CT liabilities in future years. By contrast, sectors that are dominated by foreign-owned multinationals (particularly pharmaceuticals and the digital sector) could perform quite well in this environment.

While the Department assesses that the OECD's Base Erosion and Profit Shifting (BEPS) process may reduce CT receipts in the future, this impact is expected to arise from 2022 and is therefore beyond the forecast horizon in *Budget 2021* (see Box A). These impacts are reflected in the scenario analysis (Section 3.4). *Budget 2021* forecasts a moderation in growth of CT receipts in 2021. The strength of CT receipts relative to other tax headings means that the CT share of tax revenue is forecast to increase to its highest ever levels (Figure 3.9). Policy measures are not set to play a role in determining the outturns for either 2020 or 2021, as the €0.45 billion in accelerated loss relief introduced in the July stimulus should be neutral in general government terms. It is subject to the risk, however, that affected firms do not recover significantly to see net CT revenue balance next year.

Figure 3.9: Corporation tax is forecast to reach a record high share of tax revenue



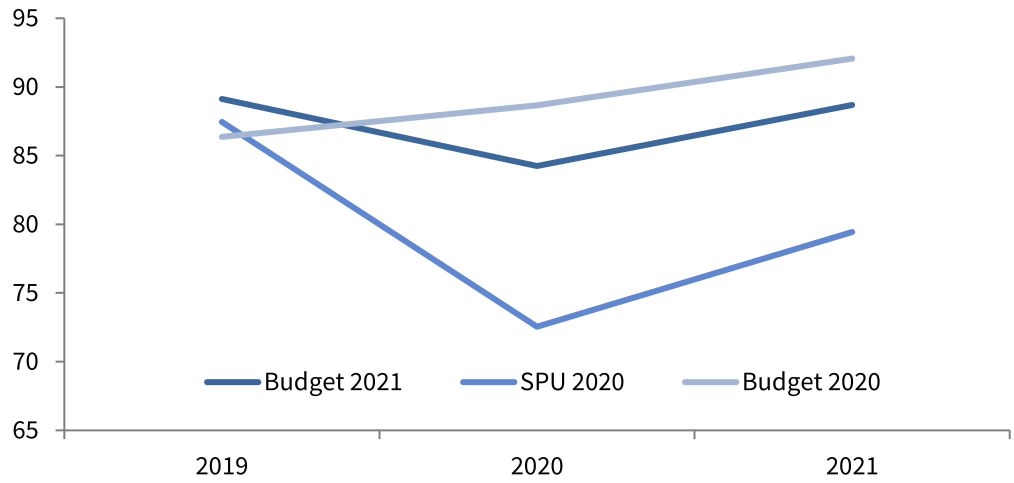
Sources: Department of Finance, and Fiscal Council workings. Get the data.
Note: Dashed line indicates *Budget 2021* forecasts.

Budget 2021 forecasts of non-tax revenue for 2020 are €0.3 billion higher than forecast in *Budget 2020*. The upward revision mainly reflects higher-than-projected payments to the Exchequer from the Central Bank, arising from its disposals of Floating Rate Notes. However, most of this income does not affect general government revenue. Payments from the Central Bank are expected to continue into 2021, albeit at a much lower level (down from €2 billion to €0.4 billion).

The large impact of Covid-19 on Exchequer revenue in 2020 is reflected in general government revenue. It is forecast to decline by €4.9 billion (5.5 per cent) in 2020 to €84.2 billion (Table 3.9). This is a €11.7 billion upward revision compared to *SPU 2020*. This upward revision also affects 2021 receipts, which have also been revised up significantly (€9.3 billion).

Figure 3.10: Forecasts of general government revenue have seen large revisions in recent rounds

€ billion



Sources: *Budget 2021, SPU 2020, and Budget 2020*. Get the data.

Budget 2021 projects that general government revenue will recover somewhat in 2021, in line with the economy (Figure 3.10). Growth of €4.4 billion (5.3 per cent) is forecast. With this growth, revenue almost returns to 2019 levels. However, excluding corporation tax receipts this leaves general government revenue 6.7 per cent lower than what was forecast a year ago in *Budget 2020* (3.7 per cent lower if corporation tax receipts are included). Revisions imply a shallower fall in revenue in 2020, but also a more gradual recovery in revenues in 2021.

Table 3.9: *Budget 2021* general government revenue forecasts

€ billion

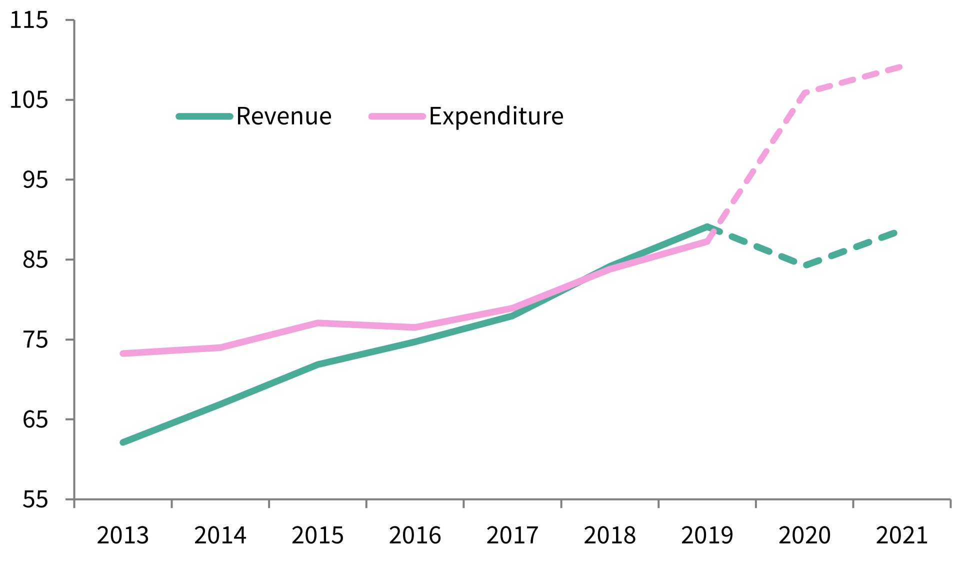
	2019	2020	2021
General gov. revenue	89.1	84.2	88.7
Taxes on production and imports	27.5	24.9	25.7
Current taxes on income, wealth	36.6	37.5	38.3
Capital taxes	0.5	0.5	0.4
Social contributions	15.8	14.0	15.4
Property income	1.6	1.1	0.4
Other	7.1	6.3	8.5

Source: Department of Finance.

Taxes on production and imports are forecast to fall most rapidly, by €2.5 billion (9.2 per cent). This mirrors the fall forecast for VAT and excise receipts in Exchequer terms. Taxes on income and wealth (mainly income and corporation tax) are forecast to increase by €0.8 billion (2.3 per cent). Social contributions (mainly made up of PRSI) are forecast to fall by €1.8 billion (11.4 per cent) in 2020.

Figure 3.11: General government revenue and expenditure

€ billion



Sources: Department of Finance, and CSO. Get the data.

As with the expenditure forecasts, revenue forecasts in *Budget 2021* were made on the assumption of higher levels of confinement measures not being introduced in 2020. The introduction of six-week nationwide Level 5 restrictions in late October after the budget will result in lower employment, hence weaker income tax and

PRSI. Given that employment losses are likely to be concentrated in low-paying sectors, the impacts may be somewhat lower than would be the case if employment losses were spread evenly across the income distribution. Consumption is also likely to be affected, lower VAT and excise receipts are likely.

Box F: Seasonal Adjustment of Exchequer Tax Revenues

Monthly cash tax and spending data published each month in the Exchequer Returns display cyclical, seasonal, and trend patterns that make direct comparisons between time periods challenging.

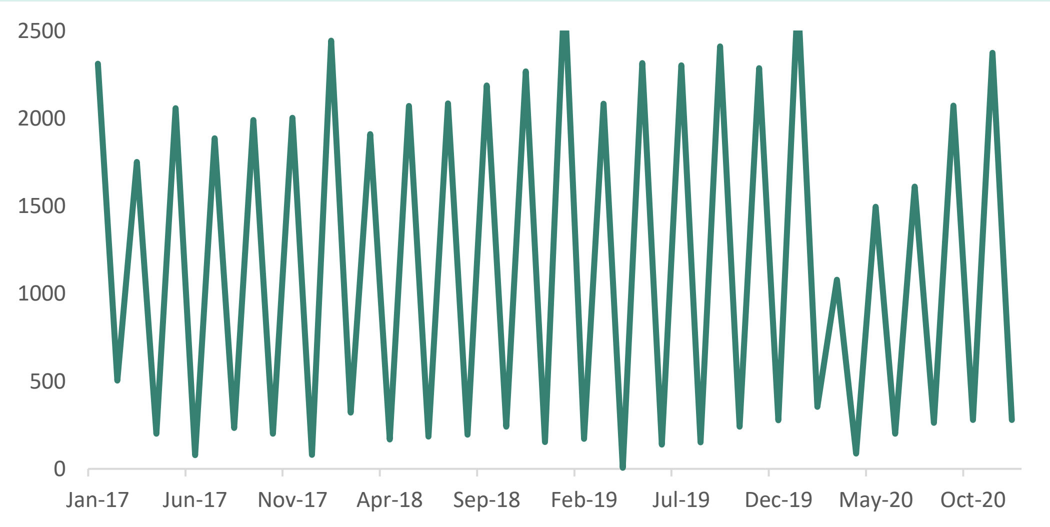
Revenue streams can vary significantly from month to month depending on the time of the year – and/or on expected variations in the timing of the year for economic transactions or tax payment dates. For example, high spending around Christmas boosts VAT receipts, as can be seen in Figure F.1 below, while November is the key month for Corporation tax receipts.

This can make it difficult to analyse underlying developments over time. The process of seasonal adjustment can be used to estimate and remove these various components of a time series dataset that often dominate the period-to-period changes, allowing for more reliable comparison of high-frequency datapoints. This has become critical during the Covid-19 crisis as the economic situation and policies have shifted rapidly.

The standard approach to assess these data has been to compare year-to-date figures between years to control for seasonal factors. Due to the sharp movements in activity this year, and multiple policy interventions, this approach is less reliable currently. This box sets out a method used by the Council in recent months to assist in analysing tax and spending by the Government when conditions have evolved quickly and when a clear interpretation of economic developments is vital.

Figure F.1: VAT outturns in Ireland

€ million



Source: Department of Finance.

Methodology

Two conditions should be met to consider seasonal adjustment. First, the time series dataset should ideally be at least five years long (Cholette, 1979), and, second, clear evidence of seasonality should be present.[54]

First, the data is preadjusted for missing observations, calendar effects, and other issues, before being disaggregated into estimated random and predictable components, such as seasonality, trend, and shocks. The relationship can be described as:

$$X_t = T_t + S_t + C_t + U_t$$

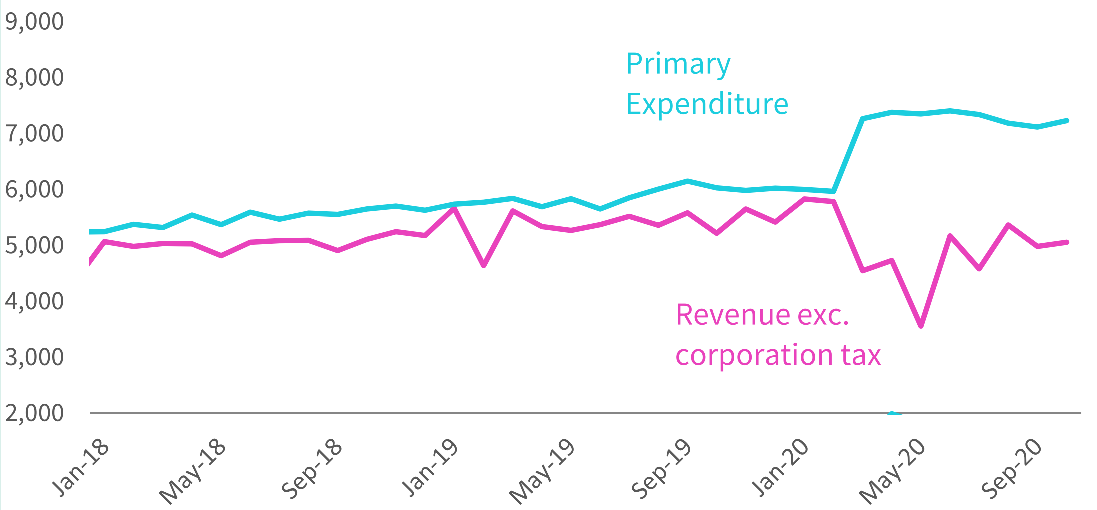
Where the original series is the sum of the trend (T), seasonal (S), calendar (C), and irregular components (U) respectively. The final seasonally adjusted series therefore is equal to the original series adjusted for both seasonal and calendar effects.

An Example: VAT returns in Ireland

Figure F.2 contains an illustrative example of isolating the components identified above, where Exchequer VAT returns from 2004 to the present day are decomposed using the TRAMO-SEATS method.[55] As can be seen above, the presence of trend, seasonal and irregular effects is clear. Much of the variation in this series can be attributed to the fact that VAT returns are due on a bi-monthly basis, leading to significant movements in the figures from month to month. However, consistently strong trend growth is observable alongside unexpected shocks.

Figure F.2: Seasonally adjusted revenue and primary expenditure

€ million



Source: Department of Finance and Fiscal Council workings.

Looking at 2020, the stop-start nature of economic activity since March, along with policy changes such as VAT forbearance and rate cuts has made standard comparisons such as between month-on-month or year-on-year outturns more difficult to interpret. For example, both Figures F.1 and F.3 show clearly the impact of the health restrictions on VAT intake, but with some significant differences. In the unadjusted case, VAT demonstrates predictable fluctuations as economic transactions become due. In normal times this would be less of an issue for interpreting the level of VAT returns but, with the economic policies taken in response to Covid-19, the usual correlations between months have broken down. Seasonally adjusted

[54] The IMF (2017b) recommends this for quarterly datasets, specifically Quarterly National Accounts.

[55] More information on this technique is available in Gómez and Maravall (1996).

returns, as seen below, allow us to have a more intuitive understanding of where the current level stands relative to previous outturns.

Insights for fiscal policy

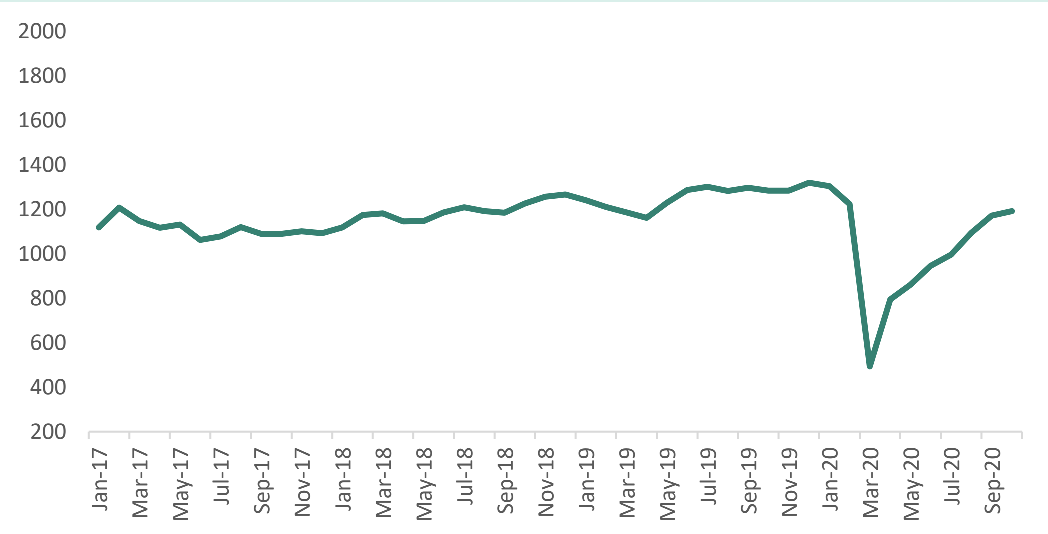
By providing a more appropriate assessment of the underlying starting point, using seasonally adjusted data can help inform the path of future outturns.

For example, on this basis, VAT in recent months is around 8.6% below the level in January. This provides a good starting point for making projections going forward. By contrast, the cumulative figure of 2020 is over 19% lower than the year before, but that does not provide a helpful guide to projecting forward as it is consistent with a wide range of levels.

For longer-term projections - even monthly profiles over a period of one year ahead for example - cumulative receipts and expenditures for a certain part of the year are often used to forecast. Clearly, such estimations can be contaminated by one off shocks, periods of above or-below trend growth, policy changes, or other factors. Applying the same process to both revenues and expenditures, as displayed in Figure F.2, can help inform an understanding of where the government's budget balance may settle in a given year.

Despite this, using seasonally adjusted data is not a panacea to understanding the underlying dynamics of the Government's finances. The process operates with a margin of error that can make precise estimations difficult. That said, it remains a valuable tool for analysts interested in evaluating rapidly changing economic situations.

Figure F.3: VAT outturns seasonally adjusted
€ million

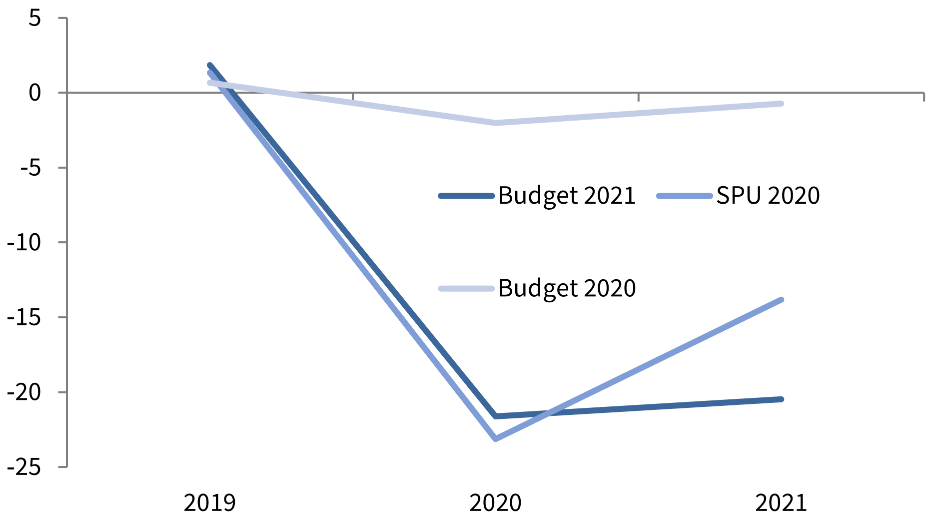


Sources: Department of Finance and Fiscal Council workings.

Budget balance, 2020 and 2021

Budget 2021 anticipates a **general government deficit** of €21.6 billion (10.7 per cent of GNI*) in 2020. To give a sense of the scale and speed of revisions, Figure 3.12 shows the last three forecasts of the general government balance.

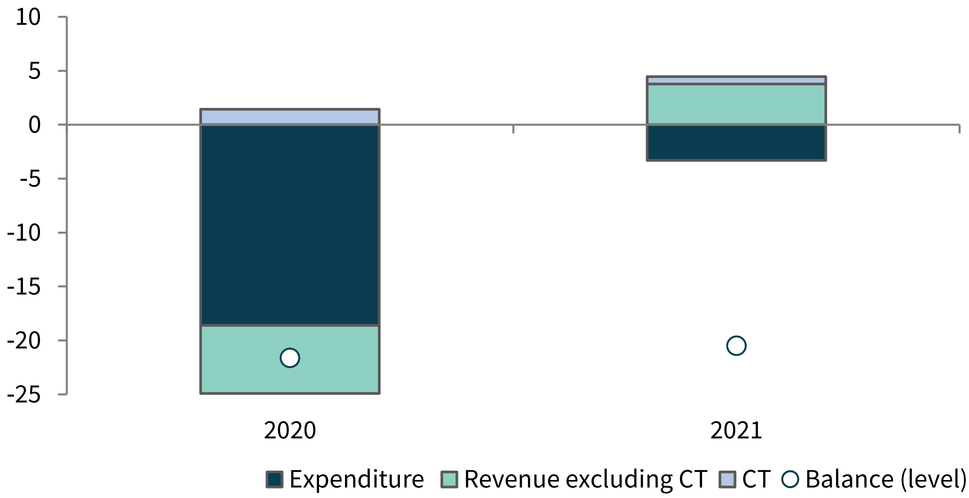
Figure 3.12: Recent vintages of the general government balance
€ billion



Sources: Department of Finance, and CSO. Get the data.
Note: One-offs are those assessed by the Council as applicable.

For 2021, a deficit of €20.5 billion (9.8 per cent of GNI*) is forecast in *Budget 2021*. This is only slightly lower than the 2020 forecast level. While spending is anticipated to increase further in 2021, Figure 3.13 shows that this will be largely offset by higher revenue. Whether the deficit does improve depends on many factors, including whether the outturn in 2020 is higher or lower than expected.

Figure 3.13: Expenditure and revenue contributing to changes in the general government balance
€ billion, annual change



Sources: Department of Finance, and CSO. Get the data.
Note: Changes in expenditure are recorded as their impact on the balance (i.e. expenditure increases are recorded as negative, as they worsen the balance). The level of the general government balance is also shown. CT refers to Corporation Tax.

3.4 Medium-term Fiscal Scenarios and Risk Analysis

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

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

Box G: Policy Measures and Fiscal Scenarios

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

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

Income supports/Unemployment payments.

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

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

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

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

Health expenditure

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

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

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

Business supports

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

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

Public pay bill

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

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

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

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

Capital spending

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

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

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

Unallocated resources

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

Revenue

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

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

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

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

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

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

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

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

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

Corporation Tax

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

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

Budget dynamics and interest costs

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

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

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

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

Expenditure

The three scenarios show that there is still some uncertainty surrounding the level of expenditure for 2020. For 2021, there is much greater uncertainty around expenditure, with projections from the three scenarios ranging from €105.0 billion to €114.8 billion.

In the Milder case, the economy recovers quite rapidly after Q2 2021. As a result, reduced unemployment results in falling social payments in 2021, and enhanced income supports such as the PUP and EWSS end as scheduled in Q1 2021. Only €4.5 billion of the €5.5 billion of unallocated resources (in *Budget 2021*) for 2021 is spent (in addition to all of other schemes mentioned). In addition, half of the 2021 Covid-19-specific health spending budgeted for in *Budget 2021* is assumed not to occur in the Milder scenario (resulting in spending being €1 billion lower). While the Milder scenario assumes a less severe Brexit, there is no assumed reduction in spending to prepare for Brexit. This is because such spending is assumed to be planned and committed to before the final outcome of negotiations is known.

From 2022 onward, spending in the Milder scenario is driven mainly by demographics and price pressures, given by the Fiscal Council's "Stand-Still" estimates (Fiscal Council, 2019b). An ageing population results in higher spending, particularly in areas such as pensions and health (increasing by almost €2.5 billion per annum over 2022–2025). Some savings on social payments are made as unemployment continues to gradually fall, from 6.3 per cent in 2022 to just under 5 per cent in 2025. Primary spending growth averages 4.3 per cent over 2023–2025.

In the Repeat Waves scenario, the unemployment rate averages almost 16 per cent in 2021. This leads to significantly higher spending on social payments and subsidies (€14.4 billion higher than 2019). There is also additional health spending of €500 million relative to the Extended *Budget 2021* scenario.

Expenditure in the Repeat Waves scenario falls in 2022, as the unemployment rate falls below 13 per cent. As unemployment continues to fall over 2023–2025, this partially offsets spending increases in other areas in line with demographics and price pressures. Due to the rising level of debt, interest costs rise in 2022 and 2023, before falling thereafter.

Expenditure in all three scenarios converges to a similar level by the end of the forecast horizon (Table 3.10). This reflects the assumption that additional spending is largely mobilised in the short term to tackle direct Covid-19 effects. The differing expenditure profiles incorporates differences in terms of Covid-19- related expenditure unwinding at different stages depending on the scenario. The Milder scenario gives a faster fall in expenditure in 2021 and 2022 as a result. Unemployment stays higher for longer in the Repeat Waves scenario. Savings from unemployment falling in the later years leads to more modest spending growth in 2023–2025 than is the case in the other scenarios.

Table 3.10: Expenditure, Revenue and Balance under the three Scenarios

€ billion

	2019	2020	2021	2022	2023	2024	2025
Expenditure							
Milder	87.3	105.9	105.0	98.9	102.6	106.5	109.8
Extended *Budget 2021*	87.3	105.9	109.2	99.4	102.6	106.3	109.6
Repeat Waves	87.3	107.1	114.8	107.7	104.4	108.0	110.2
Revenue							
Milder	89.1	84.2	91.0	96.4	101.3	105.7	110.5
Extended *Budget 2021*	89.1	84.2	88.7	92.4	96.2	100.0	104.2
Repeat Waves	89.1	83.1	81.6	85.1	88.6	91.3	94.1
Balance							
Milder	1.9	-21.6	-14.0	-2.5	-1.4	-0.8	0.7
Extended *Budget 2021*	1.9	-21.6	-20.5	-7.0	-6.4	-6.3	-5.4
Repeat Waves	1.9	-24.0	-33.2	-22.5	-15.8	-16.7	-16.1

Sources: CSO; *Budget 2021*, and Fiscal Council workings.
Notes: The three scenarios are as outlined in Box D in Ch2.

Revenue

General government revenue falls in all scenarios but recovers at different speeds. For 2020 and 2021, the *Budget 2021* forecasts of Exchequer tax and general government revenue are used for the Extended *Budget 2021* scenario.

In the Milder scenario, the recovery assumed in 2021 yields an increase in receipts of €6.7 billion, meaning revenue exceeds its 2019 level (Table 3.10). Increases in employment and wage rates yield increased income tax receipts. Revenue growth moderates thereafter, averaging 4.7 per cent over 2023–2025.

Table 3.11: Revenue by heading and scenario

€ billion

	2019	2020	2021
Income tax			
Milder	22.9	21.5	23.1
Extended *Budget 2021*	22.9	21.5	22.7
Repeat Waves	22.9	21.5	20.5
VAT			
Milder	15.1	12.8	14.3
Extended *Budget 2021*	15.1	12.8	13.9
Repeat Waves	15.1	12.3	12.5
Corporation tax			
Milder	10.9	12.3	13.5
Extended *Budget 2021*	10.9	12.3	13.0
Repeat Waves	10.9	12.2	12.4
All other gen govt. revenue			
Milder	40.2	37.6	40.1
Extended *Budget 2021*	40.2	37.6	39.0
Repeat Waves	40.2	37.1	36.2

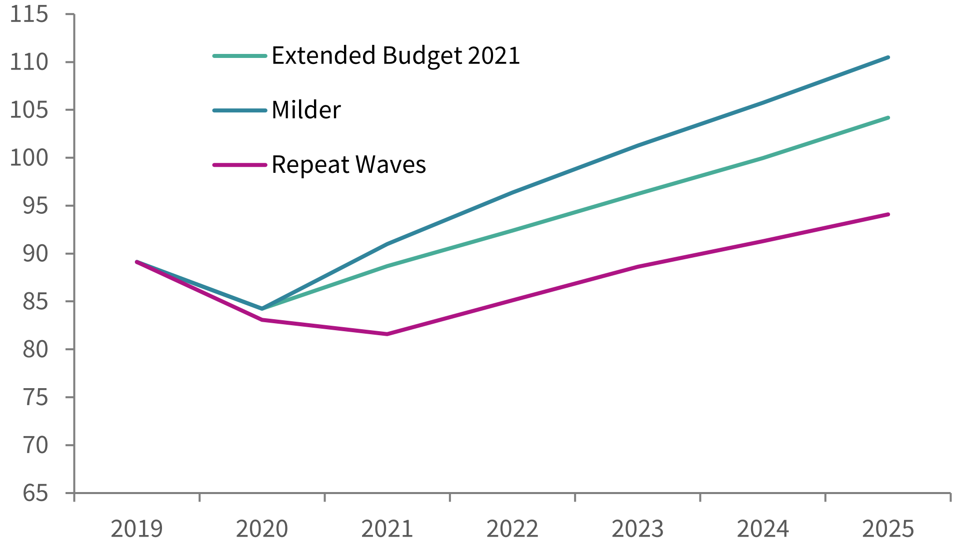
Sources: CSO; *Budget 2021,* and Fiscal Council workings.
Notes: Three scenarios are considered in this exercise. They are as outlined in Box D in Ch2.

In the Extended *Budget 2021* scenario, the gradual recovery of employment income and consumption leads to strong revenue growth (averaging 4.7 per cent over 2021 and 2022). Despite this, general government revenue does not exceed 2019 levels until 2022. Thereafter, revenue growth slows to an average of 4.1 per cent (2023 to 2025).

Under the Repeat Waves scenario, general government revenue recovers far more slowly, not exceeding 2019 levels until 2024 (Figure 3.14). The lower potential growth rate in the Repeat Waves scenario (0.5 percentage points lower relative to the Extended *Budget 2021* or Milder cases) is reflected in slower revenue growth in 2024 and 2025 (3.0 per cent on average as opposed to 4.1 per cent in the Extended *Budget 2021* scenario).

Figure 3.14: General government revenue under three scenarios

€ billion



Sources: *Budget 2021*, and Fiscal Council workings. Get the data.

Budget Balance

Figure 3.15 shows the general government balance under the three scenarios. As outlined earlier, these scenarios assume no major tax policy changes (except for VAT and the carbon tax as detailed in Box G). Spending over the medium term reflects Covid-19-related expenditures along with the estimated costs of holding service levels constant, while accommodating price pressures. Were a further/increased fiscal stimulus package introduced in the coming years, this would likely result in higher spending and a deterioration of the balance, while fiscal adjustment in later years could improve the balance.[60]

All three scenarios are more favourable than those presented in the May Fiscal Assessment Report (Fiscal Council, 2020a). While there are a number of differences in the assumptions, the main difference is that the starting point for revenue in 2020 is likely to be significantly better than originally assumed. This largely reflects unexpected improvements in corporation tax receipts and the better than expected performance of the economy.[61]

[60] Increases in spending above those needed to maintain current service levels would also have negative implications for the general government balance (relative to those shown here).

[61] Other tax heads, notably income tax, have been more robust than expected but this will likely lead to a shallower recovery so there is less of an impact in the later years of the projections.

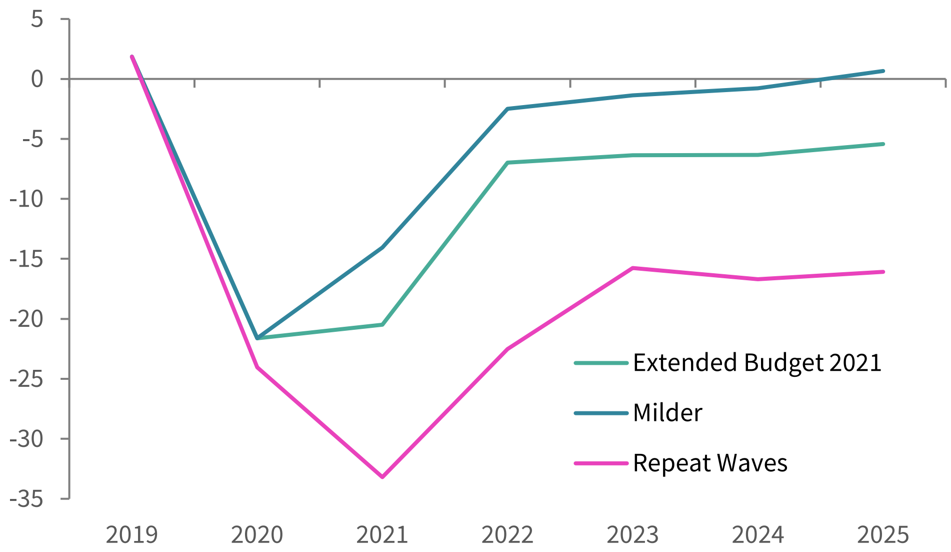
The Milder scenario shows a rapid improvement in the general government balance in 2021 and 2022. This leaves a small deficit in 2022 of 1.1 per cent, which improves to a position of surplus in 2025 (0.3 per cent of GNI*).

The Extended *Budget 2021* scenario shows a modest improvement in the budget balance in 2021. In 2022, there is a more significant fiscal improvement as unemployment and Covid-19-related expenditure falls. The balance improves at a more modest rate thereafter, with the deficit at 2.1 per cent of GNI* by 2025.

The Repeat Waves scenario shows a further deterioration of the general government balance in 2021, mainly driven by increased spending. A slow recovery thereafter leads to substantial deficits being run out to 2025 (where a deficit of more than 6.5 per cent of GNI* is projected).

Figure 3.15: General government balance under three scenarios

€ billion

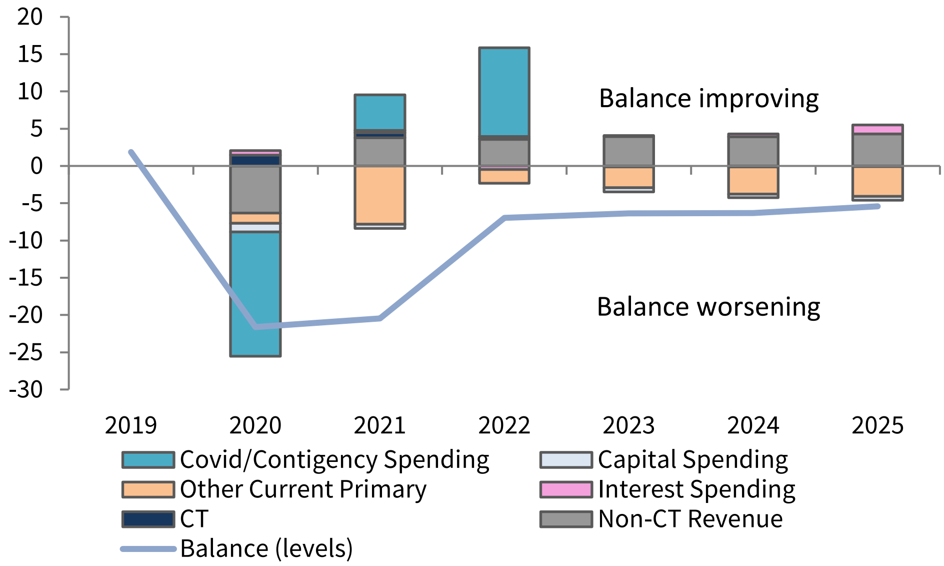


Sources: *Budget 2021,* and Fiscal Council workings. Get the data.

Figure 3.16 shows the contributions to the change in the general government balance in the Extended *Budget 2021* scenario. The deterioration in the balance in 2020 is caused by both Covid-19-related expenditure and falling revenue (excluding corporation tax). While Covid-19 spending falls and revenue increases in 2021, this is offset by increases in other current spending. 2022 sees a large improvement in the balance. This is driven by Covid-19-related expenditure falling along with increases in revenue. Changes in the balance thereafter are modest, with increases in revenue largely being offset by increases in current primary spending. This reflects the substantial costs in maintaining public service levels due to demographics and price pressures.

Figure 3.16: Contributions to the change in the General government balance

€ billion, Extended *Budget 2021* scenario, year-on-year change



Sources: *Budget 2021*; and Fiscal Council workings. Get the data.

Notes: Covid/Contingency Spending includes the Covid-19 Contingency Reserve (€2.1 billion) and the Recovery Fund (€3.4 billion) in 2021. Positive values correspond to balance improving items (increasing revenue or falling expenditure). Negative values represent balance worsening items (falling revenue or increasing expenditure).

General government debt

While the *Stability and Growth Pact* reference value of 60 per cent is set in terms of debt-to-GDP, it is worth remembering that for Ireland this 60 per cent of GDP reference value would be equivalent to 100 per cent of GNI* (using 2019 nominal outturns for both variables).[62]

Budget 2021 anticipates the debt ratio will rise to 107.8 percent of GNI* in 2020 due to the large deficit. In addition to the absolute level of debt increasing, national income is forecast to fall in 2020. Both numerator and denominator effects contribute to the debt to GNI* ratio increasing sharply.

The debt to GNI* ratio is forecast to increase further in 2021 to 114.7 per cent. While a recovery in GNI* tends to lower the ratio, the increase in the absolute level of debt in 2021 dominates.

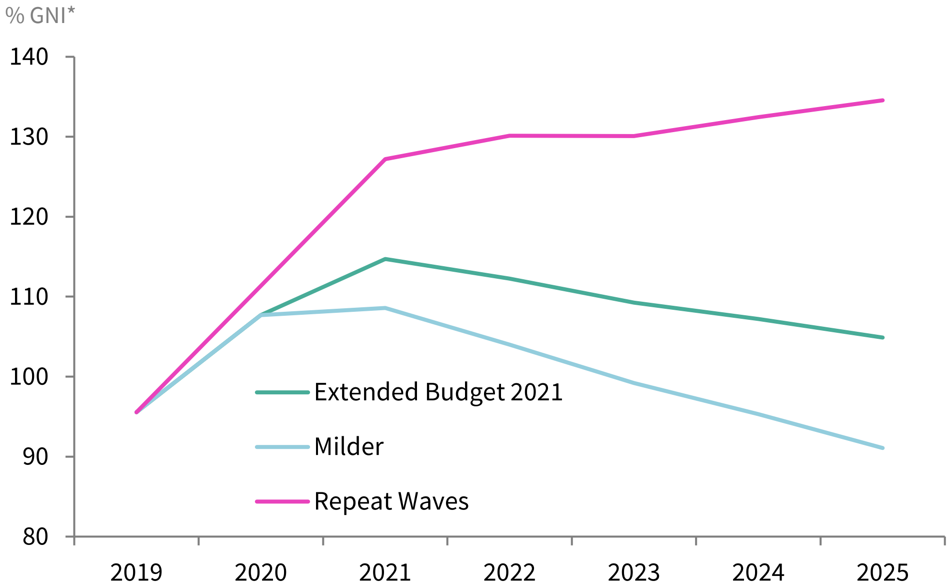
[62] Gross general government debt fell below 60 per cent of GDP in 2019.

Figure 3.17 shows general government debt to GNI* for the Milder, Extended *Budget 2021* and Repeat Waves Scenarios out to 2025. These are consistent with the different scenarios for the general government balance shown in Figure 3.15.

In the Milder scenario, after an initial increase in 2020, the ratio stabilises and then declines. As a result, the debt to GNI* ratio reaches a lower level in 2025 (91.1 per cent) than in 2019 (95.6 per cent). The Extended *Budget 2021* scenario mirrors *Budget 2021* forecasts for 2020 and 2021. Thereafter, the ratio is projected to fall gradually to about 105 per cent by 2025.[63]

In the Repeat Waves scenario, the debt to GNI* ratio increases sharply in 2020 and 2021. Thereafter, the ratio increases more gradually, almost reaching 135 per cent of GNI* by 2025. Without policy action, the debt ratio increases throughout the forecast period and is at a high level.

Figure 3.17: General government debt



Sources: *Budget 2021* and Fiscal Council workings. Get the data.
Notes: Scenarios are outlined in Boxes D and G.

[63] Unlike in the May Fiscal Assessment Report, the improvement in growth is sufficient to put the debt GNI* ratio on a downwards trajectory.

Chapter 4

Assessment of Compliance with the Fiscal Rules

4. Assessment of Compliance with the Fiscal Rules

Key Messages

- As a result of the Covid-19 pandemic, the Council, in May, assessed that "exceptional circumstances" exist for 2020. This allows for deviations from the requirements set under Ireland's Domestic Budgetary Rule. The European Commission has also activated the general escape clause under the Stability and Growth Pact (SGP), which allows for deviations from the requirements set under the EU fiscal rules.

- The general government deficit for 2020 is forecast to be 6.2 per cent of GDP, exceeding the 3 per cent deficit limit in the SGP. While the activation of the general escape clause means deviation from the requirements under the rules is allowed, it does not suspend the procedures of the SGP. Therefore, in May, the European Commission found Ireland non-compliant with the deficit criterion of the SGP for 2020, meaning Ireland will likely enter an Excessive Deficit Procedure (EDP).

- Exceptional circumstances will continue to exist into 2021 and the general escape clause will remain in place. The Council assesses that this is appropriate given the on-going Covid-19 pressures.

- The general government deficit is forecast to improve by 0.5 percentage points, to 5.7 per cent of GDP in 2021. However, the structural deficit is forecast to be relatively unchanged in 2021, at 0.8 per cent of GDP.

- Over the medium term, based on the Council's Extended Budget forecasts, the deficit to GDP ratio should fall below the 3 per cent deficit limit in the SGP, in 2022. Ireland will then be under the preventive arm of the SGP.

- At the time of writing, the Government has not produced a full set of expenditure ceilings this year, as required by law. Every year, the Government is required by law to produce a set of expenditure ceilings for the following three years. Typically, these expenditure ceilings are set on budget day. However, it appears that expenditure ceilings were set for only 2021, instead of the required ceilings for 2021-2023. The Department have indicated that these ceilings will now be published in the Revised Estimates in December.

- The Council assesses that GDP is not an appropriate metric against which to assess compliance with the fiscal rules. It would be more appropriate if the domestic fiscal rules, outlined in the *Fiscal Responsibility Act, 2012*, were assessed based on a more relevant measure of the domestic economy like Modified Gross National Income (GNI*). However, this would require legislative change.

4.1 Introduction

The Council's mandate includes assessing compliance with Ireland's Domestic Budgetary Rule, as set out in the Fiscal Responsibility Act 2012 (FRA), and the EU fiscal rules, as set out in the Stability and Growth Pact (SGP).

This chapter assesses consistency of the projections laid out in *Budget 2021* with Ireland's Domestic Budgetary Rule and with both the preventive arm and the corrective arm of the SGP. In particular, it examines compliance with the Medium-term Budgetary Objective (MTO), the Expenditure Benchmark, the Deficit Rule, and the Debt Rule.

In the Council's May 2020 Fiscal Assessment Report (FAR), the Council assessed that "exceptional circumstances" exist for 2020, in light of the Covid-19 pandemic.[64] "Exceptional circumstances" is a provision included in the Fiscal Responsibility Act, 2012 that allows for temporary deviation from the requirements under Ireland's Domestic Budgetary Rule. In March 2020, the European Commission activated the "general escape clause" in the SGP to allow Member States to depart from their budgetary requirements under the EU fiscal rules for 2020. [65] The European Commission has not set any quantitative fiscal adjustment requirements for 2021.

The assessment in this chapter examines compliance with Ireland's Domestic Budgetary Rule, based on the Council's "principles-based approach" to the budgetary rule, using the Department of Finance's GDP-based estimates of potential output in *Budget 2021* and considering the Council's own assessment of one-off/temporary measures. While legal compliance with the EU fiscal rules is assessed based on the *Vade Mecum on the Stability & Growth Pact (2019)*—using the EU's Commonly Agreed Methodology (CAM) for estimating the output gap — the Council and the Department have identified a number of shortcomings with this methodology.[66] Therefore, since 2018, the Council has opted to base its assessment

[64] See Box K of the May 2020 FAR (Fiscal Council, 2020c).

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

[66] The Department of Finance did not estimate any CAM-based estimates of potential output and the output gap for *Budget 2021.*

of the Domestic Budgetary Rule on a framework that is more appropriate for Ireland.[67] Table 4.1 provides a summary assessment.

[67] For more information on the Council's principles-based approach, see Appendix D of this report and Box A of the Fiscal Council's *Ex-post Assessment of Compliance with the Domestic Budgetary Rule 2018* (Fiscal Council, 2019a).

Table 4.1: Assessment of compliance with the fiscal rules[1, 2, 3,4]

% of GDP unless otherwise stated. For deviations, negative values = non-compliance

	2019	2020	2021
Corrective Arm			
General government balance (% GNI*)[4]	0.9	-10.7	-9.8
General government balance	0.5	-6.2	-5.7
General government balance Limit	**-3.0**	**-3.0**	**-3.0**
General government debt (% GNI*)[4]	95.6	107.8	114.7
General government debt	57.4	62.6	66.6
1/20th Debt Rule Limit	**67.1**	**60.0**	**61.7**
Debt Rule met?	Y	Y	Y
Preventive Arm & Domestic Budgetary Rule			
Structural balance adjustment requirement			
MTO for the structural balance	**-0.5**	**-0.5**	**-0.5**
Structural balance	-0.3	-0.9	-0.8
MTO met?	Y	N	N
Minimum change in structural balance required	**–**	**0.0**	**–**
Change in structural balance	-0.4	-0.6	0.1
1yr deviation (€ bn)	–	-2.2	0.2
1yr deviation (p.p.)	–	-0.6	0.1
2yr deviation (€ bn)	–	-1.7	-1.0
2yr deviation (p.p.)	–	-0.5	-0.3
Expenditure Benchmark			
(a) Reference rate of potential growth (% y/y)	3.5	3.6	3.4
(b) Convergence margin	0.0	0.0	0.0
(a-b) Limit for real net expenditure growth (% y/y)	3.5	3.6	3.4
GDP deflator used	3.1	0.6	0.9
Limit for nominal net expenditure growth (% y/y)	**6.7**	**4.1**	**4.4**
Net expenditure growth (% y/y)	3.6	15.9	7.4
Net expenditure growth (corrected for one-offs) (% y/y)	3.9	0.8	9.6
1yr deviation (corrected for one-offs) (€ bn)	2.1	2.7	-4.3
1yr deviation (corrected for one-offs) (% GNI*)	1.0	1.3	-2.0
2yr deviation (corrected for one-offs) (€ bn)	0.2	2.4	-0.8
2yr deviation (corrected for one-offs) (% GNI*)	0.1	1.2	-0.4
Limit for nominal net expenditure growth (€bn)	**5.1**	**3.3**	**3.6**
Net expenditure increase (€bn)	2.8	12.8	6.9
Net expenditure increase (corrected for one-offs) (€bn)	3.0	0.6	7.8
Current Macroeconomic Aggregates			
Real GDP growth (% y/y)	5.6	-2.4	1.7
Potential GDP growth (% y/y)	4.3	2.0	1.5
GDP output gap	1.3	-3.1	-2.9
GDP deflator used (% y/y)	3.1	0.6	0.9

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

Notes: [1]All figures are presented on a general government basis. Assessments examine the *Budget 2021* revenue and expenditure plans, using the Council's principles-based approach to the Domestic Budgetary Rule and considering the Council's views on one-off/temporary measures (see Box H for an outline of one-off/temporary measures). Potential output and output gap estimates are taken from *Budget 2021*. For more information on the Council's principles-based approach see Appendix D of this report and Box A of the Fiscal Council's *Ex-post Assessment of Compliance with the Domestic Budgetary Rule 2018* (Fiscal Council, 2019a).[2] The 1/20th Debt Rule requires that the debt-to-GDP ratio should make annual progress toward the reference value of 60 per cent of GDP. Once the debt-to-GDP ratio falls below 60 per cent, the requirement is to maintain a ratio below 60 per cent.[3] Figures in red indicate a significant deviation from the limit. Figures in amber indicate some deviation from the limit.[4] Exceptional circumstances exist for 2020, and 2021. Therefore, deviations from the requirements for these years are allowed. [5] The general government balance and general government debt are shown here as a per cent of GNI* for reference purposes only. Legal compliance with the corrective arm of the SGP is assessed based on GDP ratios.

4.2 Summary of past compliance with the Domestic Budgetary Rule

Ireland entered the current crisis in reasonable fiscal position. However, if it adhered to spending limits, Ireland would have been in a better position to deal with the current crisis. Table 4.2 provides a summary of the Council's past assessments of the Domestic Budgetary Rule.

Table 4.2: The Council's assessment of compliance with the Domestic Budgetary Rule

	2016	2017	2018	2019
Spending Rule	Compliant	Breach	Significant Deviation	Compliant
Structural Balance Rule	Compliant	Compliant	Compliant	Compliant
Overall Assessment	Compliant	Compliant	Compliant	Compliant

Sources: Fiscal Council workings.
Note: The structural balance rule requires that the structural balance be above the medium-term budgetary objective (MTO) (set at -0.5 per cent of GDP for 2016-2019) or moving towards the MTO at an adequate pace. The spending rule requires that the net government expenditure be below the average medium-term potential growth rate of the economy (the Expenditure Benchmark). Significant Deviation means that the limit for the corresponding rule was exceed by more than 0.5 per cent of GNI* for the spending rule, or 0.5 per cent of GDP for the structural balance rule. Breach means the limit for the corresponding rule was exceeded by less than 0.5 per cent of GDP or 0.5 per cent of GNI*.

A tendency to formulate plans that are at the limit of what is allowed under the rules, coupled with repeated Health overruns and providing the Christmas bonus without budgeting for it in advance, has led to the Expenditure Benchmark being breached in recent years.

While the structural balance was compliant with the rules in all years, this was flattered by corporation tax receipts that are in excess of what can be explained by underlying economic activity.

4.3 In-year assessment for 2020

Due to the unprecedented Covid-19 pandemic and its effect on the economy and on the public finances, the Council assessed that "exceptional circumstances" exist for 2020 (see Box K, May 2020 FAR). The existence of exceptional circumstances allows for a deviation from the requirements under Ireland's Domestic Budgetary Rule. In addition, the European Commission has activated the "general escape clause", which allows for a deviation from the requirements under the SGP for 2020.

Ireland's general government deficit is forecast to be 6.2 per cent of GDP (Figure 4.1). This is above the deficit limit of 3 per cent of GDP. The activation of the general escape clause does allow for the deviation from the normal budgetary requirements under the SGP, but it does not suspend the procedures of the Pact. The European Commission has therefore issued an Article 126(3) as a result of the general government deficit breaching the 3 per cent SGP limit in 2020.[68] However, despite finding that Ireland is non-compliant with the deficit criterion for 2020, the European Commission has not yet launched an *Excessive Deficit Procedure* (EDP).[69]

The estimated structural balance is set to deteriorate from a position of close to balance in 2019, to a deficit of 0.9 per cent of GDP in 2020 (Table 4.1).[70] While there is particularly high uncertainty around the measurement of the output gap and the structural balance in the context of the Covid-19 pandemic, it is clear that many of the spending measures taken have been temporary in nature and that the economy will recover over time (see Box H for a discussion of these issues). This should ensure

[68] Under the SGP, the European Commission is required to prepare an Article 126(3) report if the 3 per cent deficit limit is breached, or is forecast to be breached (the forecast can be from the Member State or the European Commission forecasts). This report considers a series of factors and assesses whether an EDP should be launched. An Article 126(3) report was issued for all Member States (except for Romania, which was already in an EDP) as all Member States are forecast to breach the 3 per cent deficit limit in 2020.

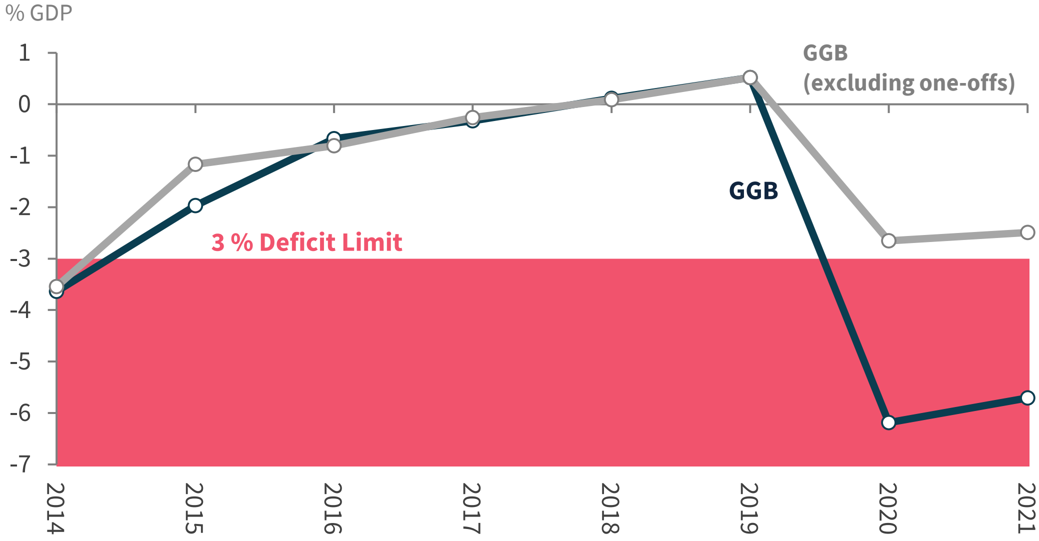
[69] For the Article 126(3) report for Ireland see: https://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/com-2020-541-ie_en.pdf. See Box 1 of the *2020 European Semester: Commission Communication on Country Specific Recommendations* for an outline of the rationale behind not launching an EDP in May of 2020:https://ec.europa.eu/info/publications/2020-european-semester-commission-communication-country-specific-recommendations_en. In their opinion on the draft budgetary plan, the European Commission has again opted to defer opening the EDP (European Commission, 2020).

[70] Estimates of the structural balance at this time are exceptionally uncertain. Box H outlines some of the issues in relation to estimating the structural balance during the current crisis. In addition, the continued strong performance of corporation tax, over and above what can be explained by the underlying economy, masks some of the deterioration in the structural balance. See Box H of the May 2020 FAR for further details on this overperformance of corporation tax (Fiscal Council, 2020a)

that the deterioration in the structural balance will be much less than the change in the headline position.

In 2019, the debt ratio fell below the 60 per cent of GDP limit under the SGP for the first time since 2008. However, the debt ratio is now forecast to breach the limit again, with a ratio of 63 per cent of GDP expected in 2020.

Figure 4.1: The general government balance is forecast to exceed the 3 per cent deficit limit for the first time since 2014



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Note: GGB stands for general government balance. See Box H and Table H.1 for one-offs.

Box H: Covid-19, the structural balance, and one-off/temporary measures

This box outlines the challenges in estimating the structural balance in light of the Covid-19 pandemic. It also provides a preliminary examination of the extent of one-off and temporary measures introduced in response to the Covid-19 pandemic on the basis of the standard approaches adopted in the fiscal rules.[71]

In its Draft Budgetary plan submitted to the European Commission, the Department of Finance included estimates of the structural balance.[72] However, following guidance from the European Commission, these estimates of the structural balance did not incorporate any one-off/temporary measures related to Covid-19. While at present it may be difficult to determine what measures are truly one-offs, to get a true sense of the structural balance, the impact of one-off/temporary measures needs to be factored in.[73]

Uncertainty, measurement issues and the structural balance

In normal times, the in-year and year-ahead estimates of structural balance are surrounded by some degree of uncertainty. Often, this is due to issues relating to measuring the current point the economy is at in the economic cycle (the output gap), and also due to the uncertainty in estimating the effect that changes in the cyclical position of the economy have on government revenue and expenditure.[74] The effect that the Covid-19 pandemic has had on the economy has exacerbated these issues.

The lasting effect of the Covid-19 crisis on the economy is not yet known. As a result, estimating the potential or sustainable level the economy can currently operate at is challenging. For instance, it is not yet known how many businesses will no longer be viable and how many job losses will become permanent.[75] The more viable businesses that fail, the lower the potential productive capacity of the economy. This creates substantial uncertainty about the current level of potential output and how far away from that level the economy is currently operating at.

Furthermore, the Covid-19 crisis is not a typical economic downturn. The structural balance adjusts the headline government balance for revenues and expenditures which typically fluctuate in line with the economic cycle. When an economy is booming, revenues are higher and expenditures are lower, than they would be if the economy were operating at a sustainable level. Similarly, in a downturn, revenues are lower, and expenditures are higher than they might otherwise be. However, the magnitude of this typical relationship between the budget balance and the economic cyclical may not hold for this unique downturn.

[71] The structural balance is estimated as: $SB_t = GGB_t - Oneoffs_t - 0.588 \times OG_t$, where GGB, the general government balance, and one-offs are expressed as a per cent of GDP, and OG is the output gap expressed as a percentage of potential GDP. Alternatively, Modified Gross National Income (GNI*) can be used instead of GDP as a denominator.

[72] These estimates were not included in the documentation published on Budget Day (13th October 2020), but were submitted to the European Commission on 15th October 2020.

[73] Without factoring in one-off/temporary measures, the estimate is not a true structural balance, but simply a cyclically adjusted balance.

[74] A separate issue in estimating the structural balance, but unrelated to Covid-19, is the continued overperformance of corporation tax receipts that cannot be explained by the underlying performance of the domestic economy (for further information, see Box H of the May 2020 FAR (Fiscal Council, 2020a)). The structural balance estimates do not reflect the degree to which these receipts may prove transient.

[75] To date, there has been limited impact of the crisis on firm insolvencies, likely due to government business supports, loan payment breaks and other support measures introduced since the onset of the Covid-19 pandemic (see McGeever, Sarchi and Woods, 2020). However, these supports will not continue indefinitely, and a prolonged crisis will increase the likelihood of more business closures.

For instance, the typical elasticities between economic activity and income tax have performed poorly at estimating the fall in tax revenue (they predicted a much larger fall in tax revenue than was the case). This is partly due to the composition of the employment losses (mainly at the lower end of the income distribution) and the progressive tax system (those at the lower end of the distribution pay less taxes). Similarly, the typical elasticities used to estimate the response of the Government's budget to the economic cycle will not accurately capture the dynamics of this crisis. This will lead to measurement error in the structural balance.

In addition to those measurement issues, there is also some uncertainty around the degree to which measures introduced in response to this crisis are temporary or permanent measures. While temporary measures affect the headline budget balance, they do not affect the underlying budgetary position and so do not affect the structural balance. This box uses the best available information to determine what can currently be considered one-off/temporary measures to get a preliminary estimate of the structural balance.

Expenditure one-offs

As a starting point, all Covid-19 related expenditures are considered temporary measures. This amounts to some €16.7 billion in 2020 and €11.9 billion in 2021 on a general government basis. However, as outlined above, the structural balance also adjusts the headline government balance for expenditure that is cyclical in nature. Typically, this accounts for unemployment-related expenditure, which rises in downturns and falls in upturns in the economy. As a result, some of the Pandemic Unemployment Payment (PUP) expenditure can be considered cyclical. Were the PUP not in place, many of the recipients would likely have received standard unemployment benefits. To avoid double-counting these expenditures, the amounts for the PUP are subtracted from the Covid-19 related expenditure above.[76]

Revenue one-offs

Revenue one-offs for 2020 include: (1) an assumed (by the Department of Finance) unrecovered tax warehousing costing €500 million; (2) a temporary cut in the standard rate of VAT costing €280 million in 2020; and (3) €580 million relating to one-off stamp duty receipts.[77] For 2020, these net to a one-off reduction in revenue of €200 million (Table H.1). The one-offs assumed for 2021 are €140 million for the stay-and-spend initiative and €160 million from the reduction of the standard rate of VAT. These measures net to a one-off reduction in tax revenue of €300 million in 2020.

Table H.1 outlines the amounts the Council deems as one-offs at this time. In the future, some of these measures currently considered temporary, may be considered permanent.

With the above caveats in mind, Figure H.1 decomposes the headline general government balance into one-offs, interest payments, a cyclical component, and the structural primary balance. While most of the deterioration in the general government balance in 2020 can be attributed to one-off/temporary measures introduced in response to Covid-19, there was also a structural deterioration (Figure H.1). The headline general government balance is forecast to improve marginally in 2021. This is mainly due to a fall in one-off/temporary measures in 2021. This leaves an estimated structural primary balance of -0.9 per cent of GNI* largely unchanged from 2020.

[76] Note, this adjustment only applies to the one-offs included in this chapter, to avoid double counting of unemployment-related expenditure in the assessment of the Expenditure Benchmark and the structural balance.

[77] This receipt relates to a single, large transaction that incurred a tax liability. While tax receipts are not usually considered for one-offs, on this occasion the amount was considered worthwhile as it was (a) inherently once off in nature, (b) large (greater than 0.1 per cent of GNI*), and (c) outside of the usual volatility associated with this tax head.

Table H.1: One-off and temporary measures

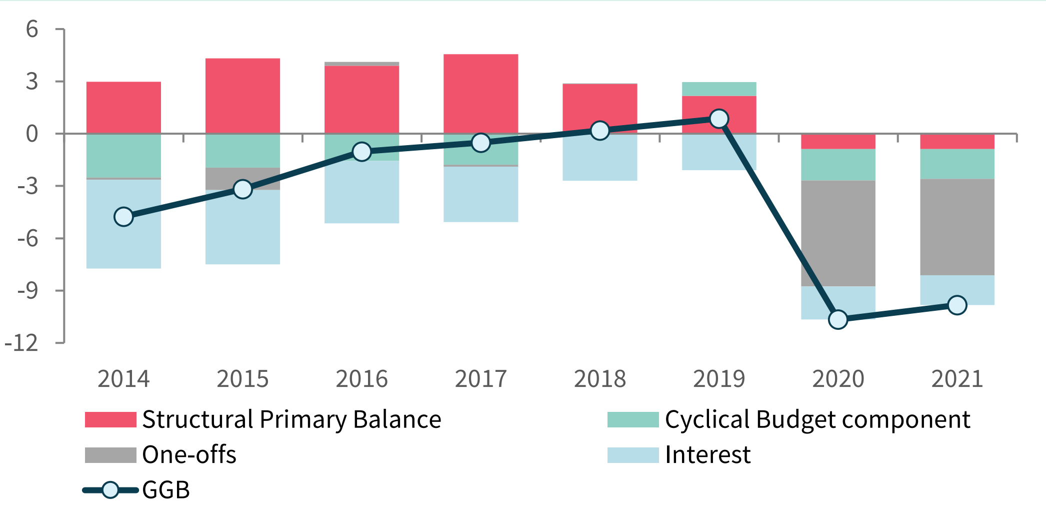
€ millions unless stated

	2020	2021
Expenditure		
Covid-19	16,699	11,887
less PUP	-4,550	-644
Expenditure one-offs	12,149	11,243
Revenue		
Tax warehousing write-off	-500	
VAT standard rate cut	-280	-160
Stay and Spend		-140
Stamp Duty	580	
Revenue one-offs	-200	-300
Total one-offs	**-12,349**	**-11,543**

Sources: Department of Finance; and Fiscal Council workings.
Note: The PUP expenditure is excluded from one-offs to avoid double counting of this expenditure in the adjustments for the Expenditure Benchmark and the structural balance. The cut in the rate of VAT for the tourism sector is not considered a one-off at this time. The previous time this measure was introduced it remained in place for several years. Instead, it is classified as a discretionary revenue-reducing measure. The figure for stamp duty relates to revenue from one extremely large transaction that incurred a tax liability.

Figure H.1: Decomposition of the general government balance

% of GNI*



Sources: CSO; Department of Finance; and Fiscal Council workings. Get the data.
Note: The cyclical budget component is calculated as 0.588 times the Department's GDP output gap estimates.

4.4 *Ex-ante* assessment of 2021

The Council assesses that exceptional circumstances will continue to exist for 2021. In addition, the European Commission has not set any quantitative fiscal requirements for 2021. This means that the appropriate leeway within the rules has been granted to allow an adequate fiscal response to the Covid-19 pandemic to continue into 2021.

In 2021, the general government deficit is forecast to remain above the 3 per cent deficit limit in the SGP. It is forecast to be 5.7 per cent of GDP in 2021, an improvement of 0.5 per cent of GDP relative to 2020. Were measures deemed to be one-offs excluded, the deficit would be 3.4 per cent of GDP.

The structural deficit is forecast to be 0.8 per cent of GDP, a 0.1 percentage point improvement over 2020. Despite exceptional circumstances applying, the rules may continue to provide useful guidance. Net expenditure (corrected for one-offs) is forecast to grow by 9.6 per cent in 2021. While the normal requirements to adhere to limits under the Expenditure Benchmark do not apply for 2021, this expenditure is above the 4.4 per cent growth limit that would have applied, indicating that there was a significant unfunded expansion in 2021.

The debt ratio is forecast to rise to 66.6 per cent of GDP in 2021 (114.7 per cent of GNI*).

4.5 Medium-term compliance with the fiscal rules

As Ireland has been found non-compliant with the deficit criterion of the SGP in 2020, Ireland will likely be placed in an excessive deficit procedure and subject to the corrective arm of the SGP once the general escape clause ceases to be in place. While it is currently uncertain what fiscal requirements will be in place after the general escape clause is no longer active, the current minimum fiscal requirement under an EDP is a fiscal adjustment of 0.5 per cent of GDP in structural terms.[78]

However, based on the Extended Budget 2021 forecasts (Box D and Box G), the deficit is forecast to fall below the 3 per cent deficit limit in the SGP in 2022.[79] Should this transpire, Ireland would be under the Preventive rm of the SGP in 2023.

Box I: Making the domestic fiscal rules more relevant

Ireland's Domestic Budgetary Rule and the Debt Rule are outlined in the *Fiscal Responsibility Act, 2012* (FRA). These largely mirror EU requirements. However, the domestic rules could be made more relevant to Ireland's circumstances and better aligned to the original intentions of the framework.

Under the FRA, the following definition is given for the structural balance:

> "'annual structural balance of the general government', in relation to a year, means the general government deficit or general government surplus for the year, cyclically adjusted and net of one-off and temporary measures, expressed as a percentage of gross domestic product at market prices"

Similarly, the definitions for (1) the debt ratio under the Debt Rule, and (2) the lower limit of the Medium-term budgetary objective are also expressed as a percentage of GDP.

As a measure, GDP is an appropriate estimate of the size of the domestic economy in most EU countries. However, due to well-documented issues relating to the globalisation activities of the multinational sector, GDP is not an appropriate measure of the size of Ireland's domestic economy (see, amongst others, Fiscal Council (2016b; 2016c; 2017b)).[80]

This was exacerbated in 2015, when real GDP grew by approximately 25 per cent, largely due to the globalisation activities of a few large multinationals. As a result, the CSO developed a new measure of domestic economic activity, modified Gross National Income (GNI*), that strips out many of the components that distort the GDP figures.[81]

This implies that GDP-based rules do not align well to Ireland's situation. By overstating national income, the measure overstates the size of the tax base. Dividing deficits and debt by GDP means that these ratios are lower than for other countries relative to the true level of

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[78]For further details, see Article 3(4) of Regulation (EC) 1467/97: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01997R1467-20111213&from=EN.

[79] Indeed, the European Commission's Autumn 2020 forecasts show the same.

[80] See, for instance, Box D of the June 2017 Fiscal Assessment Report (Fiscal Council, 2017c).

[81] GNI* is constructed by taking gross national income (GNI) and adjusting for the factor income of redomiciled companies, the depreciation of R&D service imports and Intellectual Property trade, and the depreciation on aircraft leasing.

national income. For instance, a deficit of 3 per cent of GDP in 2019 would equate to €10.7 billion, or 5 per cent of GNI*. Similarly, a debt ratio of 60 per cent of GDP in 2019 would equal a debt ratio of 100 per cent of GNI*. This implies that the rules are significantly laxer than intended.

The Council assesses that a more appropriate basis for defining the variables in the FRA would be to define them in terms of GNI* rather than GDP GNI* is now well-accepted and widely used in Ireland. However, putting the FRA on a sounder economic footing, by using GNI* instead of GDP, will require legislative changes to the FRA. Making this change would ensure that the rules are fully relevant for Ireland and based on the most relevant economic measures.

4.6 Medium-term Expenditure Framework

The Medium-term Expenditure Framework (MTEF) was a reform introduced in the Ministers and Secretaries (Amendment) Act 2013 to provide a better mechanism to control spending over the medium term and to ensure the Expenditure Benchmark is complied with. The framework requires that, at least once every financial year, the government sets expenditure ceilings for the following three years. The framework requires that ceilings be set for overall expenditure and for ministerial departments.

Typically, these expenditure ceilings are set on Budget Day. However, only expenditure ceilings for 2021 were set out in the Expenditure Report in *Budget 2021*, instead of the required ceilings for 2021–2023. The Department initially cited the uncertainty surrounding the Covid-19 pandemic and Brexit as a reason for not providing expenditure ceilings for 2022–2023. After the Council highlighted the legal requirement for these ceilings, the Department then indicated that these would be provide in the Revised Estimates for 2021, published in December.[82]

[82] The overall medium-term expenditure ceilings and total ministerial expenditure ceilings for years *t+2* and *t+3* have never before been included in the Revised Estimates.

Appendices

Appendix A: Timeline for Endorsement of *Budget 2021* Projections

Date	
7 September	CSO releases *Quarterly National Accounts* estimates for Q2 2020.
9 September	The Secretariat and Department of Finance met the CSO to clarify technical details of latest *Quarterly National Accounts* estimates.
16 September	The Secretariat received Department of Finance technical assumptions underpinning *Budget 2021* forecasts.[83]
21 September (PM)	The Council received preliminary forecasts from the Department in line with *Memorandum of Understanding* requirements.
22 September (AM)	After consideration by the Council, Benchmark projections were finalised by the Secretariat prior to viewing the preliminary forecasts received from the Department of Finance the prior evening.
22 September (PM)	The Secretariat met remotely with the Department and requested clarifications of a factual nature.
23 September	The Council received quarterly profiles and supply-side estimates from the Department.
24 September	The Council received input data for the Department's supply-side models.
24 September	The Council met remotely to discuss the Department of Finance forecasts.
25 September	A remote meeting took place between the Department of Finance staff and the full Council and Secretariat. The Department presented their latest forecasts and answered questions. The Council then finalised a decision on the endorsement.
28 September	The Chair of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *SPU 2020*.
13 October	The Department's forecasts were published in *Budget 2021*, updated for the impact of policy changes, and the Council received final forecasts from the Department in line with *Memorandum of Understanding* requirements.

[83] These included assumptions related to oil prices, exchange rates, and sources of forecasts for the growth of major trading partners. They did not include assumed real and nominal growth rates for net expenditure by central and local government on current goods and services, but these followed on 18 September.

Appendix B: The Council's Benchmark Projections

Benchmark projections for 2019–2025

% change in volumes unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Demand							
GNI*	1.7	-6.6	2.9	3.5	3.1	2.7	2.9
...of which (p.p. contributions)							
Underlying domestic demand[b] (p.p.)	3.5	-5.3	5.0	3.3	2.4	2.4	2.5
Stocks and subsidies less taxes (p.p.)	0.3	1.2	0.0	0.0	0.0	0.0	0.0
Adjusted net exports[b] (p.p.)	-2.1	-2.5	-2.1	0.2	0.7	0.3	0.4
Underlying domestic demand[a]	4.1	-6.0	5.7	3.6	2.6	2.6	2.8
Gross domestic product	5.6	-2.5	5.0	4.1	4.8	4.7	5.0
Personal consumption expenditure	3.2	-9.6	8.1	4.6	3.0	3.0	2.9
Government consumption	6.3	13.3	-1.8	2.8	2.8	3.2	3.5
Underlying investment[a]	4.7	-13.6	7.3	1.4	1.3	0.9	1.3
Exports	10.5	0.4	1.5	6.5	6.4	5.8	5.7
Underlying imports[a]	12.8	0.7	-0.3	7.5	5.9	5.1	4.7
Supply							
Potential output							
Output gap (% potential output)							
Labour Market							
Labour force	2.0	0.5	1.9	1.5	1.4	1.5	1.5
Employment	2.9	-11.1	11.1	3.6	2.3	1.5	1.5
Unemployment rate (% labour force)	4.9	15.9	8.5	6.7	5.8	5.6	5.5
Prices							
HICP	0.9	-0.5	0.2	1.2	1.3	2.7	2.9
Personal consumption deflator	2.4	0.3	0.5	1.6	1.7	1.7	1.6
GDP deflator	3.1	0.4	-0.8	0.5	0.5	0.6	0.7
GNP deflator	3.5	0.1	1.1	1.6	1.7	1.7	1.7
Other							
Nominal GNI*	7.6	-6.5	4.0	5.2	4.8	4.5	4.7
Nominal GNI* (€ billion)	213.7	199.8	207.8	218.6	229.1	239.4	250.6
Nominal GDP	8.9	-2.1	4.2	4.6	5.4	5.4	5.7
Nominal GDP (€ billion)	356.0	348.7	363.2	380.0	400.4	421.8	446.0
Modified current account (% GNI*)	7.7	5.3	2.9	3.0	3.5	3.7	4.0

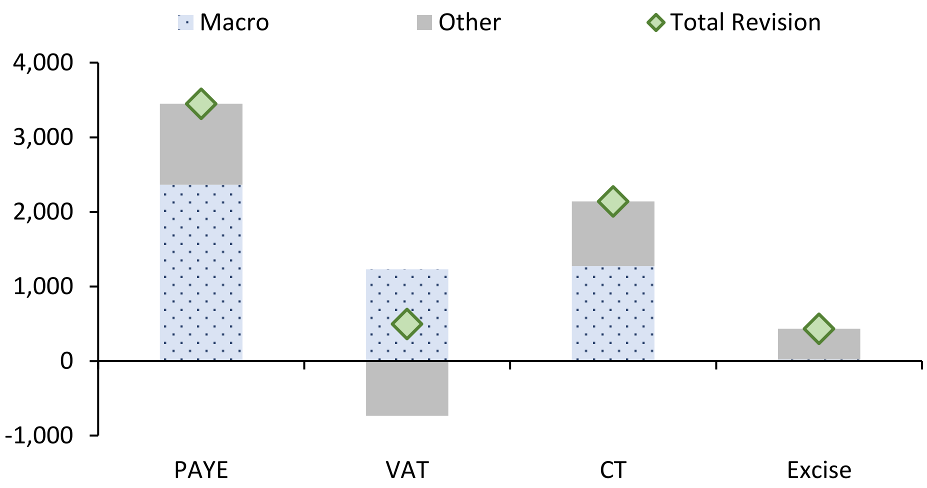
Sources: CSO; and internal Fiscal Council workings.
Notes: [a]Underlying (final) domestic demand, underlying investment, and underlying imports exclude "other transport equipment" (mainly aircraft) and intangibles. [b]Underlying contributions to real GNI* growth rates in percentage points—here adjusted net exports is forecast based on adjusted exports and adjusted imports, as described in Chapter 2.

Appendix C: Tax Forecasts Decomposed

The first part of this Appendix explores the revisions to forecasts of the main tax heads for 2020. It shows how the 2020 forecasts in *Budget 2021* have changed relative to *SPU 2020.* Two categories are identified in this analysis as drivers of these revisions: (i) an update to the 2020 "**macro**" economic outlook relevant for each tax head; and (ii) an "**other**" source of revision, caused by use of incorrect estimates of any other component of the forecast. It is the residual of the "macro" after accounting for revisions to the macroeconomic outlook.[84]

Appendix Figure C.1: Tax Forecast Revisions in 2020: Budget 2021 versus *SPU 2020*

€ million, *Budget 2021 – SPU 2020*



Sources: Department of Finance; and internal Fiscal Council workings.
Note: The chart breaks down the total revision into the macro component and an "other" component.

[84] A "starting point" error is not relevant in this case, as tax revenues for 2019 were not revised between April 2020 and October 2020

The second part of this Appendix examines the latest tax revenue forecasts produced by the Department of Finance in *Budget 2021* for the projection horizon 2020–2021. In particular, it shows the yearly changes in the forecasts of VAT, corporation tax, excise duties, and the PAYE and USC components of income tax (see Appendix Figure C.1).[85] For a detailed description of the Fiscal Council's forecast replication model, see Hannon (2014).

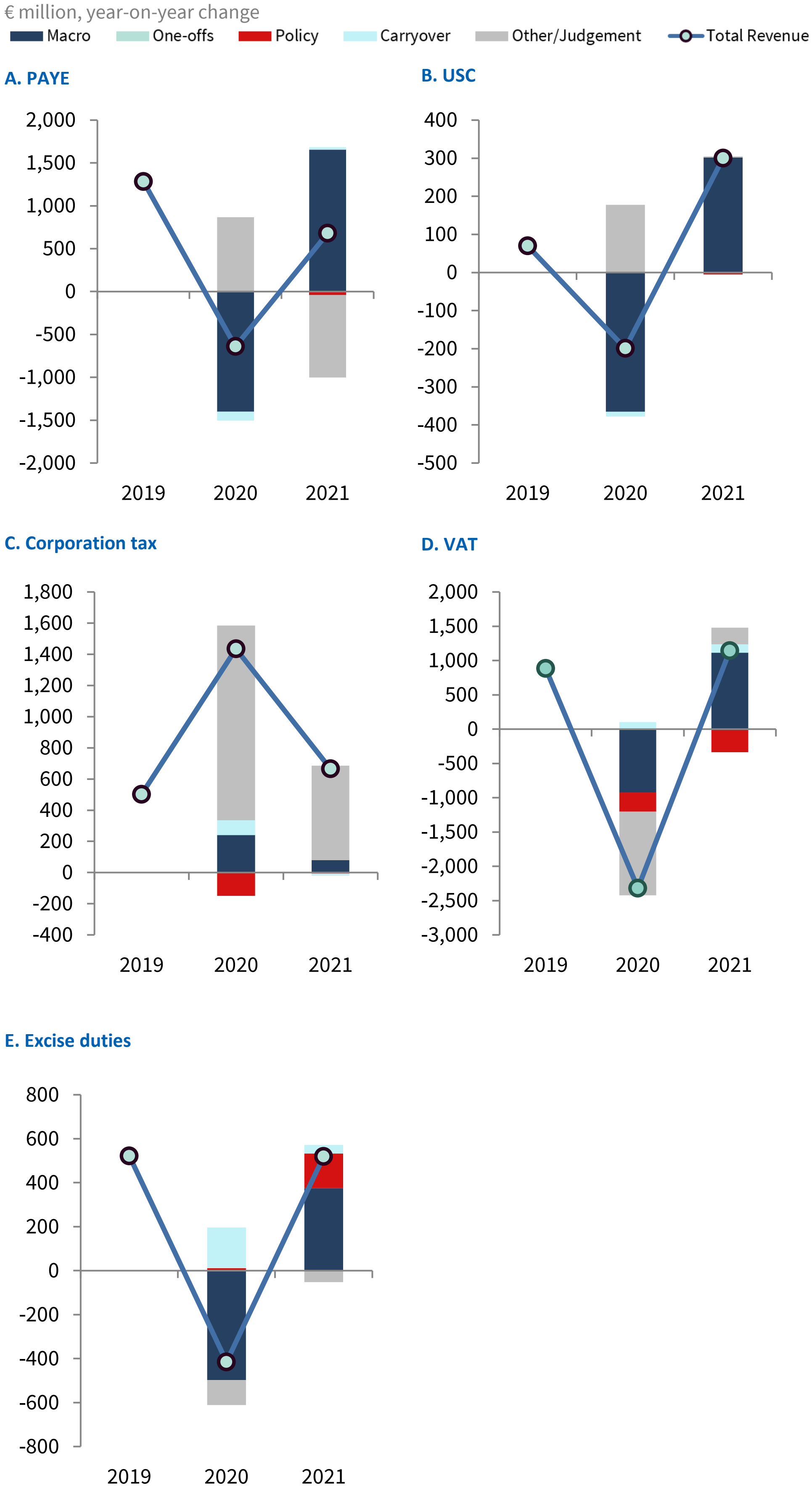
The changes on the tax forecasts (year-on-year) are attributed to a number of components: (i) "**macro**" is the part of the forecast driven by the growth in the relevant macro driver (e.g. wage growth and its corresponding elasticity when analysing income tax); (ii) "**one-offs**" refer to non-recurring items that impact on expected tax receipts; (iii) "**policy**" impacts account for the estimated impacts from policy changes in a given year (e.g., discretionary tax cuts); (iv) "**carryover**" effects account for policy impacts carried over from previous years; (v)"**other**" represents potential elements affecting the forecasts (calculated as the difference between the Fiscal Council's internal forecasting exercise and that carried out by the Department of Finance), including judgement applied by the Department of Finance.

For 2020, *Budget 2021* forecasts of tax revenue were based on the first nine months of data for the year. Forecasts for the remaining quarter were compiled in consultation with the Revenue Commissioners. For illustrative purposes, Figure C.1 shows how one could arrive at the *Budget 2021* forecasts for 2020. By identifying the other factors (the impact of the macroeconomic driver, one-offs, policy changes and carryover effects) that impact on tax receipts, we can arrive at an estimate of what judgement is implied by the forecasts in 2020. For 2021, this exercise is more precise, as the *Budget 2021* forecasts were compiled using the standard methodology.

[85] The generic formula applied by the Department of Finance to forecast revenue in 2021 is given by:
$\mathrm{Rev}_{t+1} = (\mathrm{Rev}_t - \mathrm{T}_t) * (1 + \mathrm{B}_{t+1} * \mathrm{E}) + \mathrm{T}_{t+1} + \mathrm{M}_{t+1} + \mathrm{M}_t + \mathrm{J}_{t+1}$,
where revenue forecasts (Rev_{t+1}) depend on their lag stripped of one-off items (T_t), one-off items in the current period (T_{t+1}), the macro drivers (B_{t+1}) and their associated elasticity (E), current policy (M_{t+1}) and carryover policy impacts (M_t), and judgement (J_{t+1}). See Hannon (2014) for a discussion of this approach. Rewriting the formula in terms of annual changes yields: $\Delta\mathrm{Rev}_{t+1} = \mathrm{Rev}_t * \mathrm{B}_{t+1} * \mathrm{E} - \mathrm{T}_t * \mathrm{B}_{t+1} * \mathrm{E} + \Delta\mathrm{T}_{t+1} + \mathrm{M}_{t+1} + \mathrm{M}_t + \mathrm{J}_{t+1}$. In this way, yearly revenue changes for each tax head are attributed to the addition of: (i) the macro driver, which covers the parts of the formula affected by B_{t+1}; (ii) changes in one-off items, as shown in ΔT_{t+1}; (iii) current and previous policy changes ($M_{t+1}$and M_t, respectively); and other adjustments, mainly judgement, as covered in the component J_{t+1}.

Appendix Figure C.2: Tax forecasts decomposed

€ million, year-on-year change



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

Appendix D: The Council's Principles-Based Approach to the Budgetary Rule

Table D.1: Outline of the Council's principles-based approach to the Budgetary Rule

Criteria	Fiscal Council Approach	European Commission Approach
Potential Output and the Output Gap	The Department's GDP-based estimates of potential output and the output gap.	The European Commission's own CAM-based estimates of potential output and the output gap.
Reference Rate for Expenditure Benchmark	Based on the Department's latest estimates of GDP-based potential output growth (i.e. not frozen).	Based on the European Commission's CAM-based estimates of potential output, frozen in spring of year *t-1.* No reference rate is set for *t+2* or later years.
Deflator for Expenditure Benchmark	Based on the Department's latest estimates of the demand-side GDP deflator (i.e. not frozen).	Based on the European Commission's estimates of the GDP deflator, frozen in spring of year *t-1.*
Adjustment Requirement and Convergence Margin	Based on the latest estimates of distance from the MTO in year *t-1* (i.e. not frozen). No negative convergence margin applied.	Based on the European Commission's estimates of distance from the MTO that are frozen in either spring or autumn of year *t-1* (whichever is more favourable). For ex-post assessment, requirements can be unfrozen in spring of year *t+1* if these are more favourable in terms of compliance. Negative convergence margin allowed.
NAWRU	Assumed constant at 5.5%.	The Commission's latest CAM-based estimates of the NAWRU.
Margin of Tolerance	No margin of tolerance.	0.25% of GDP from the MTO.
Significant Deviation from the Expenditure Benchmark	0.5% and 0.25% of GNI* for 1-year and 2-year assessment respectively.	0.5% and 0.25% of GDP for 1-year and 2-year assessment respectively.
Budgetary Semi-Elasticity	0.588	0.522

Note: For a full explanation of the Council's Principles-based Approach (PBA) to the Domestic Budgetary Rule see Box A of Ex-post assessment of compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a) and Box M of the November 2019 Fiscal Assessment Report.

Glossary

Automatic stabilisers: Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

Budget balance: The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses General Government aggregates.

Cyclical component of budget balance: That part of the change in the budget balance that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the output gap.

Discretionary fiscal policy: Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of automatic stabilisers.

Discretionary Revenue Measures (DRMs): The estimated current year impact of any discretionary revenue raising/decreasing measures (e.g., tax increases/cuts).

Excessive Deficit Procedure (EDP): A procedure according to which the Commission and the Council monitor the development of national budget balances and public debt in order to assess and/or correct the risk of an excessive deficit in each Member State.

Exchequer: The Central Fund of Ireland. It is the Irish central government's main treasury account and it is recorded on a cash basis. The Exchequer represents only a portion of the total government financial position. Receipts into the Central Fund consist of Exchequer tax and non-tax revenues, EU receipts and other capital receipts. Central Fund expenditure includes Departmental spending, wages and pensions of the President, the C&AG, and the judiciary, running costs of the Oireachtas, debt servicing costs, and EU Budget payments.

Expenditure rules: A subset of fiscal rules that target (a subset of) public expenditure.

Fiscal consolidation: An improvement in the budget balance through measures of discretionary fiscal policy, either specified by the amount of the improvement or the period over which the improvement continues.

General government: As used by the EU in its process of budgetary surveillance under the Stability and Growth Pact and the excessive deficit procedure, the General Government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Maastricht reference values for public debt and deficits: Respectively, a 60 per cent General Government debt-to-GDP ratio and a 3 per cent General Government deficit-to-GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union.

Medium-Term Budgetary Framework: An institutional fiscal device that lets policymakers extend the horizon for fiscal policymaking beyond the annual budgetary calendar (typically 3-5 years). Targets can be adjusted under Medium-Term Budgetary Frameworks (MTBF) either on an annual basis (flexible frameworks) or only at the end of the MTBF horizon (fixed frameworks).

Medium-Term Budgetary Objective (MTO): According to the reformed Stability and Growth Pact, stability programmes and convergence programmes present a Medium-Term Objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms.

Modified current account balance (CA*): The current account balance adjusted to subtract (1) net factor income of re-domiciled PLCs, as well as depreciation of R&D imports, traded intellectual property, and leased aircraft; and (2) to add back the cost of imported investment in net aircraft related to leasing, R&D-related intellectual property, and the imports of R&D services. The adjustments in (1) apply to net primary income, whereas those in (2) affect net exports of merchandise and services. The idea is to better reflect domestic activities/resources rather than those related to foreign-equity owners. Depreciation of foreign-owned domestic capital is an operating cost of foreign-owned firms, and therefore does not affect the resources generated by domestic residents.

Modified gross national income (GNI*): Gross national income (gross domestic product less net factor income from the rest of the world, and taxes net of subsidies) adjusted for foreign-owned primary income in the balance of payments, which affects net factor income from the rest of the world. The adjustments to primary income subtract the impact of net factor income of re-domiciled PLCs (as this income reflects future dividend payments to foreign-equity owners that will not accrue to Irish residents); depreciation of R&D-related service imports and trade in intellectual property; and depreciation of aircraft for leasing (depreciation of foreign-owned domestic capital is an operating cost of foreign-owned firms, and therefore does not affect the resources generated by domestic residents).

Minimum benchmarks: The lowest value of the structural budget balance that provides a safety margin against the risk of breaching the Maastricht reference value for the deficit during normal cyclical fluctuations. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks. They are a lower bound for the Medium-Term Budgetary Objectives (MTO).

Net Policy Spending: A measure of government expenditure which reflects the level of spending that is under the control of government, and which takes into account any offsetting tax changes (be they discretionary revenue-raising or revenue-decreasing measures). Interest spending, cyclical unemployment spending, and one-off and temporary measures (as assessed by the Council), are all largely considered to be beyond the control of government.

Net Expenditure: A measure of government expenditure used to assess compliance with the Expenditure Benchmark. Net Expenditure takes into account any offsetting tax changes (be they discretionary revenue-raising or revenue-decreasing measures), interest spending, cyclical unemployment spending, and one-off and temporary measures (as assessed by the Council), are all largely considered to be beyond the control of government. In addition, net expenditure smooths the impact of government investment in large scale projects by using a four year average of government investment instead of the one-year impact of government investment.

One-off and temporary measures: Government transactions having a transitory budgetary effect that does not lead to a sustained change in the budgetary position.

Output gap: The difference between actual output and estimated potential output.

Potential output: The maximum level of economic output that is sustainable in the medium to long run, where "sustainable" implies that output, when at its potential, is not unduly influenced in any particular direction by imbalances in the economy, be they external, internal or financial. An alternative definition, often used by Central Banks, is that potential output is the level of economic output that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate.

Primary budget balance: The budget balance net of interest payments on General Government debt.

Primary structural budget balance: The structural budget balance net of interest payments.

Principles-based approach: The approach that the Council takes when assessing compliance with Ireland's domestic Budgetary Rule. The principles-based approach differs to the European Commission's approach to assessing compliance with the EU fiscal rules across a number of strands (removing some layers of complexity; availing of the Department of Finance's alternative method for estimating potential output and the output gap; and drawing on the latest available information to a greater extent).

Pro-cyclical fiscal policy: A fiscal stance which amplifies the economic cycle by increasing the structural primary deficit during an economic upturn, or by decreasing it in a downturn. A neutral fiscal policy keeps the cyclically-adjusted budget balance unchanged over the economic cycle but lets the automatic stabilisers work.

Public debt: Consolidated gross debt for the General Government. It includes the total nominal value of all debt owed by public institutions in Member States, except that part of debt owed to other public institutions in the same Member State.

Significant deviations: "Significant deviations" are defined in the EU framework as referring to any deviation in structural balance adjustments toward MTO where the deviation is equivalent to at least 0.5 percentage points of GDP in a single year or at least 0.25 percentage points on average per year in two consecutive years. The same thresholds apply for the Expenditure Benchmark (i.e., for deviations in expenditure developments net of discretionary revenue measures impacting on the government balance). When assessed, significant deviations can lead to a Significant Deviation Procedure, which itself can result in sanctions. Under the Council's principles-based approach to the Domestic Budgetary Rule, the thresholds of at least 0.5 percentage points of GNI* in a single year or at least 0.25 percentage points on average per year in two consecutive years apply.

Sovereign bond spread: The difference between risk premiums imposed by financial markets on sovereign bonds for different states. Higher risk premiums can largely stem from (i) the debt -service ratio, also reflecting the countries' ability to raise their taxes for a given level of GDP, (ii) the fiscal track record, (iii) expected future deficits, and (iv) the degree of risk aversion.

Stability and Growth Pact (SGP): Approved in 1997 and reformed in 2005 and 2011, the SGP clarifies provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997).

Stability programmes: Medium-term budgetary strategies presented by those Member States that have already adopted the Euro. They are updated annually, according to the provisions of the Stability and Growth Pact.

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