Irish Fiscal Advisory Council

# Fiscal Assessment Report

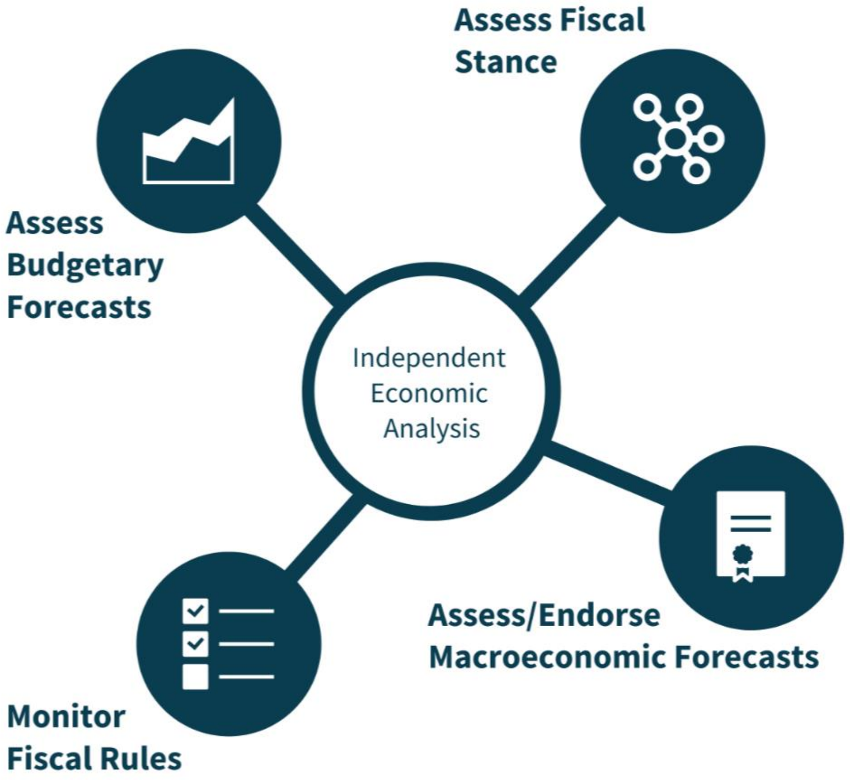
May 2021

Looking beyond Covid-19

# May 2021 Fiscal Assessment Report

## Looking beyond Covid–19

- The Fiscal Council is an official independent body with a mandate to assess the public finances
- The May 2021 *Fiscal Assessment Report* provides an assessment of the projections set out in the April *Stability Programme Update*
- This is the Council's 20th *FAR*. We have redesigned the report.



# Key messages

# Key messages

## The economy is set to bounce-back as Covid restrictions ease

- Uncertainty has fallen, but the extent of "scarring" is a key unknown
- The Council assesses that risks are now to the upside relative to the SPU

## The Government's *SPU 2021* budgetary medium-term projections are poorly founded

- They are not consistent with the Stand-Still cost of maintaining existing services, Programme for Government Commitments, Capital Plan
- SPU income tax projection shows a sharp rise in income tax as share of income (and GNI*)

## An adjusted projection suggests a budget balance of closer to 1.2% of GNI* in 2025 compared to 0.3% in the SPU

- An "upside" scenario would see the budget balance close
- There are significant risks to the public finances, notably changes to the international corporate tax environment

## The debt/GNI* ratio should peak this year, but will remain high at ~100% in 2025

- Low interest rates create favourable debt dynamics, but high debt leaves the public finances vulnerable

# Key messages

## If the economy recovers, future large-scale untargeted stimulus would not be needed

- Supports are likely to be extended from June and more targeted supports may still be needed in 2022
- From 2023, debt should be brought down to more prudent levels
- Achieving a balanced budget by 2025 implies the debt ratio falling by around 3 percentage points per year

## New permanent policy measures need to be funded by tax increases or spending adjustments

- Only modest fiscal adjustment could be needed to balance the budget
- However, large permanent increases in Budget 2021 have already committed gains from future growth

## The Government has failed to deliver a credible medium-term strategy

- There are significant fiscal pressures from ageing, reducing overreliance on corporation tax and climate change
- It is not clear how Programme for Government priorities and commitments will be delivered

## Three initiatives would support good fiscal policy

(1) a firm commitment to national debt targets

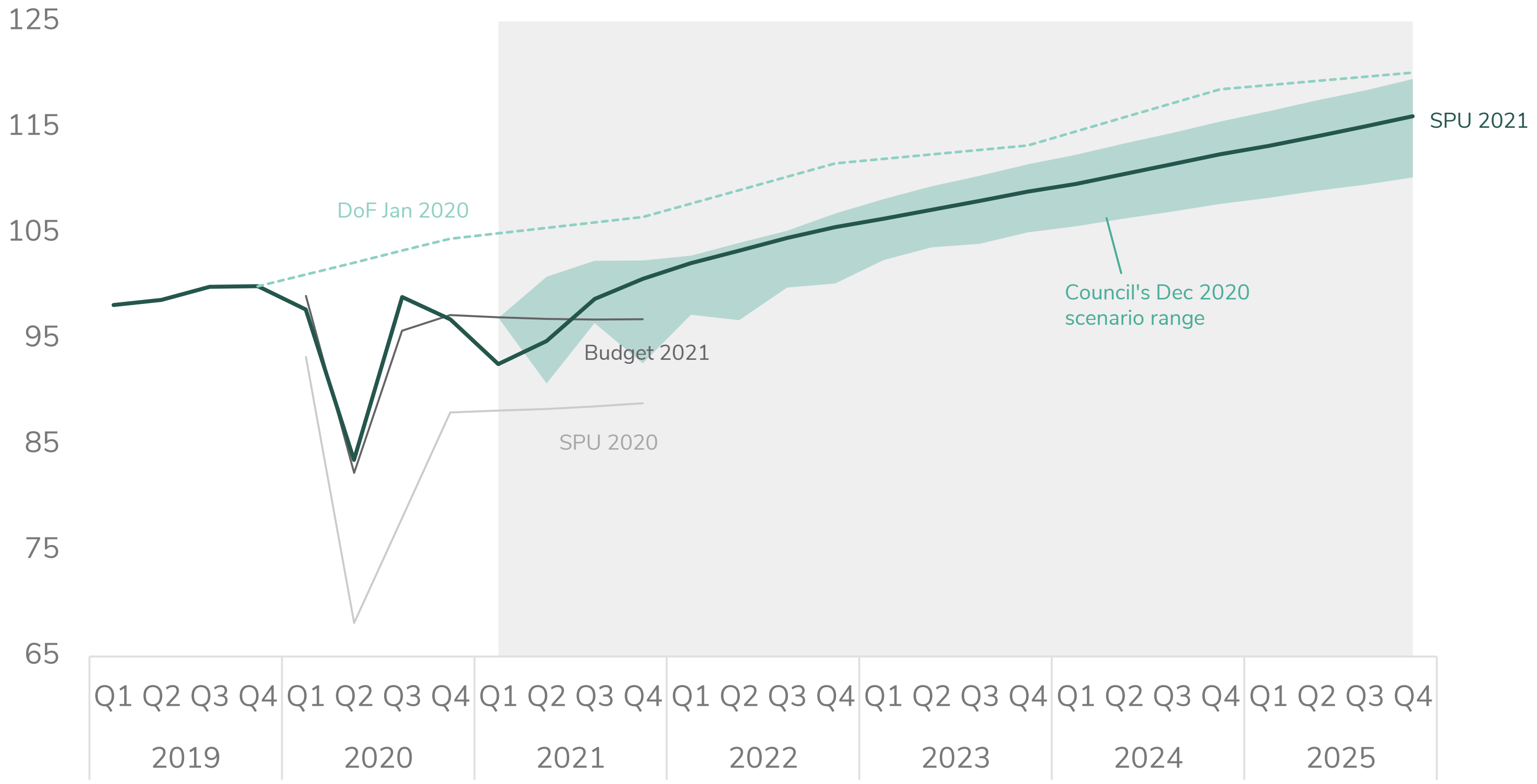
(2) saving corporation tax excess through the Rainy Day Fund

(3) credible expenditure ceilings

# Economic and budgetary outlook

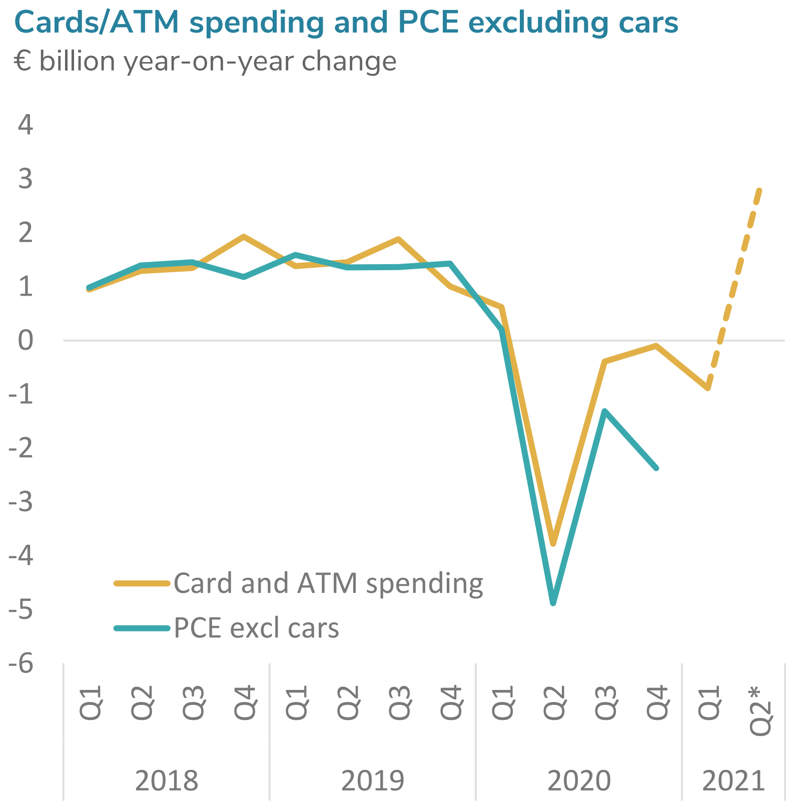
# The economy is set to bounce back as restrictions ease

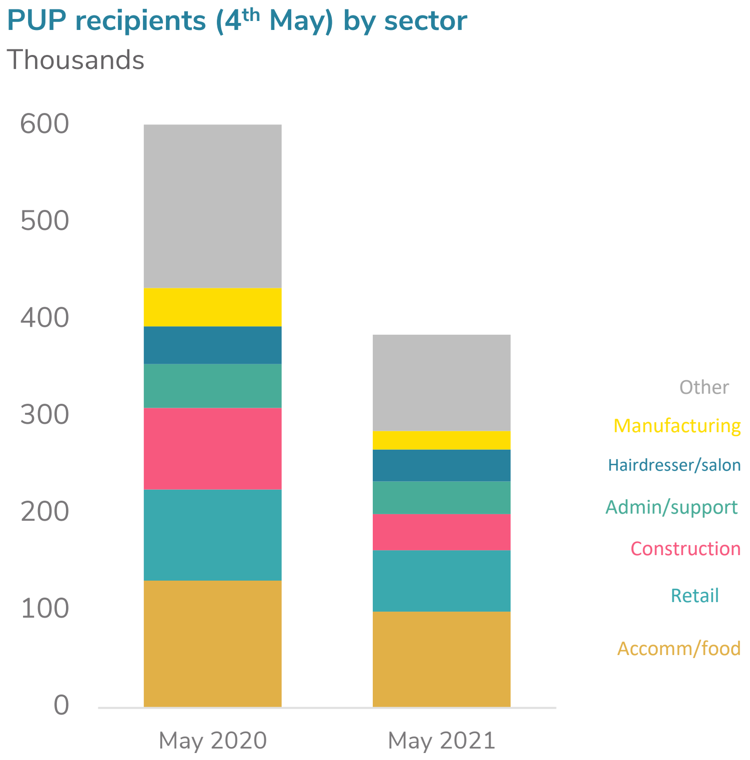
Real underlying domestic demand, Q4 2019 = 100




Sources: CSO; Department of Finance, various forecasts; Fiscal Council, *Fiscal Assessment Report (FAR), December 2020*; and Fiscal Council workings.
Notes: The scenario range is the Council's extension of *Budget 2021* forecasts, with a "Milder" upside scenario and a "Repeat Waves" downside scenario from the December 2020 FAR.

# Consumer spending resilient, but some sectors have been negatively affected

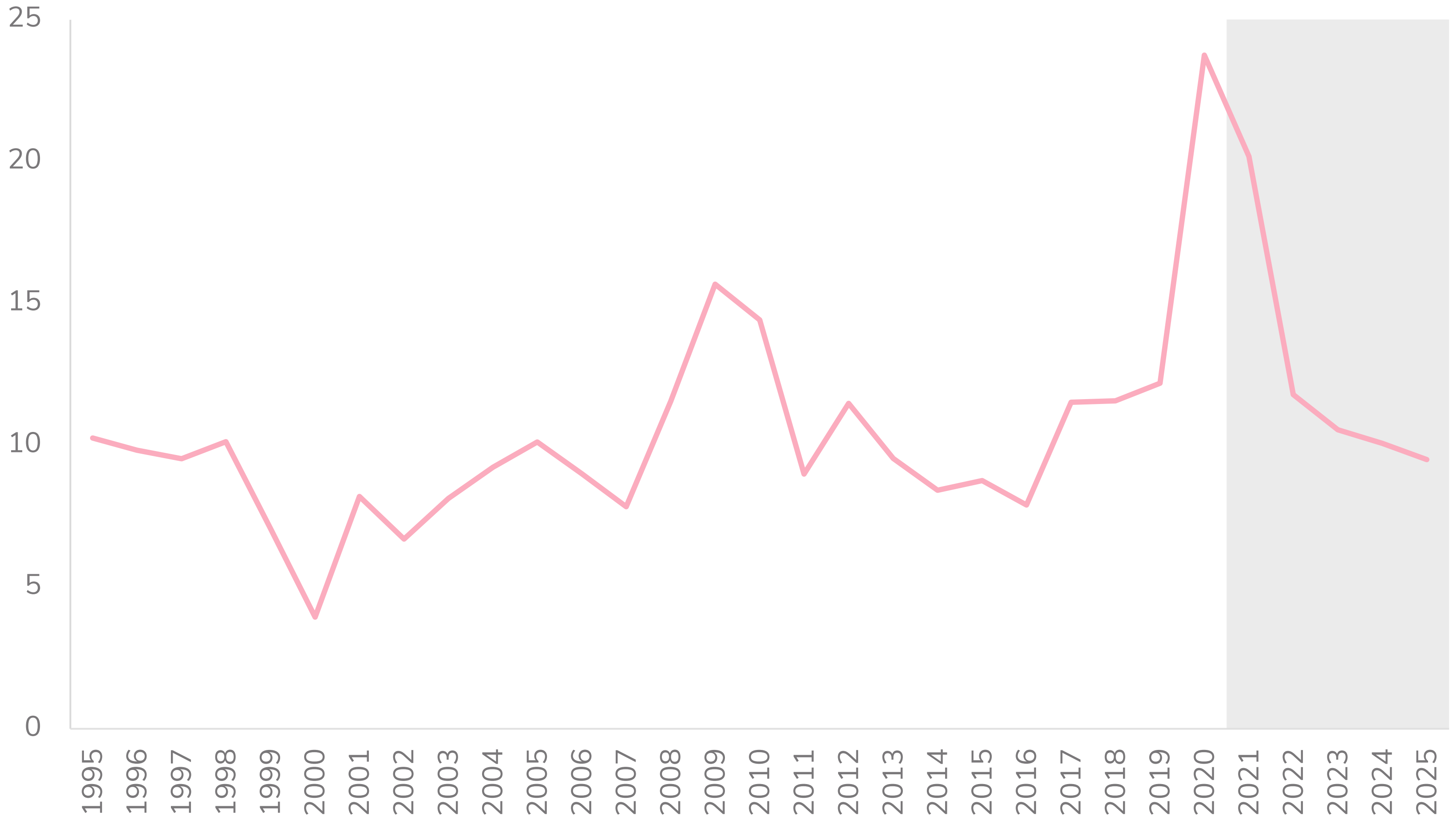



Sources: CSO; Central Bank of Ireland; Department of Employment Affairs and Social Protection; CSO; and Fiscal Council workings.
Note: Q2* 2021 reflects the quarter-to-date increase compared to 2020 to 17th May.

# Consumption will be boosted by pent up savings, but long-term trends less clear

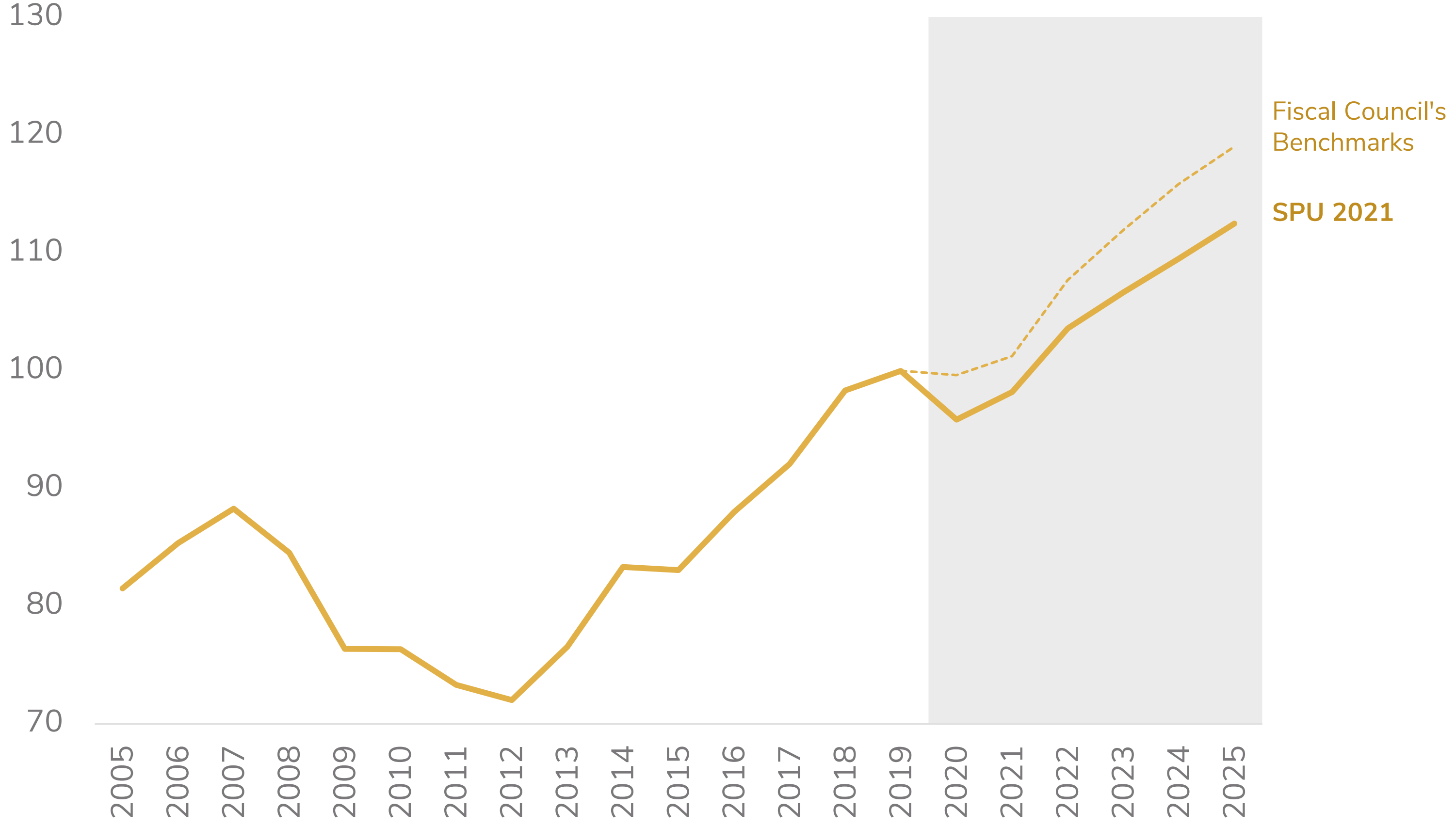
Household savings as % of disposable income




Source: CSO; and Department of Finance, SPU 2021.

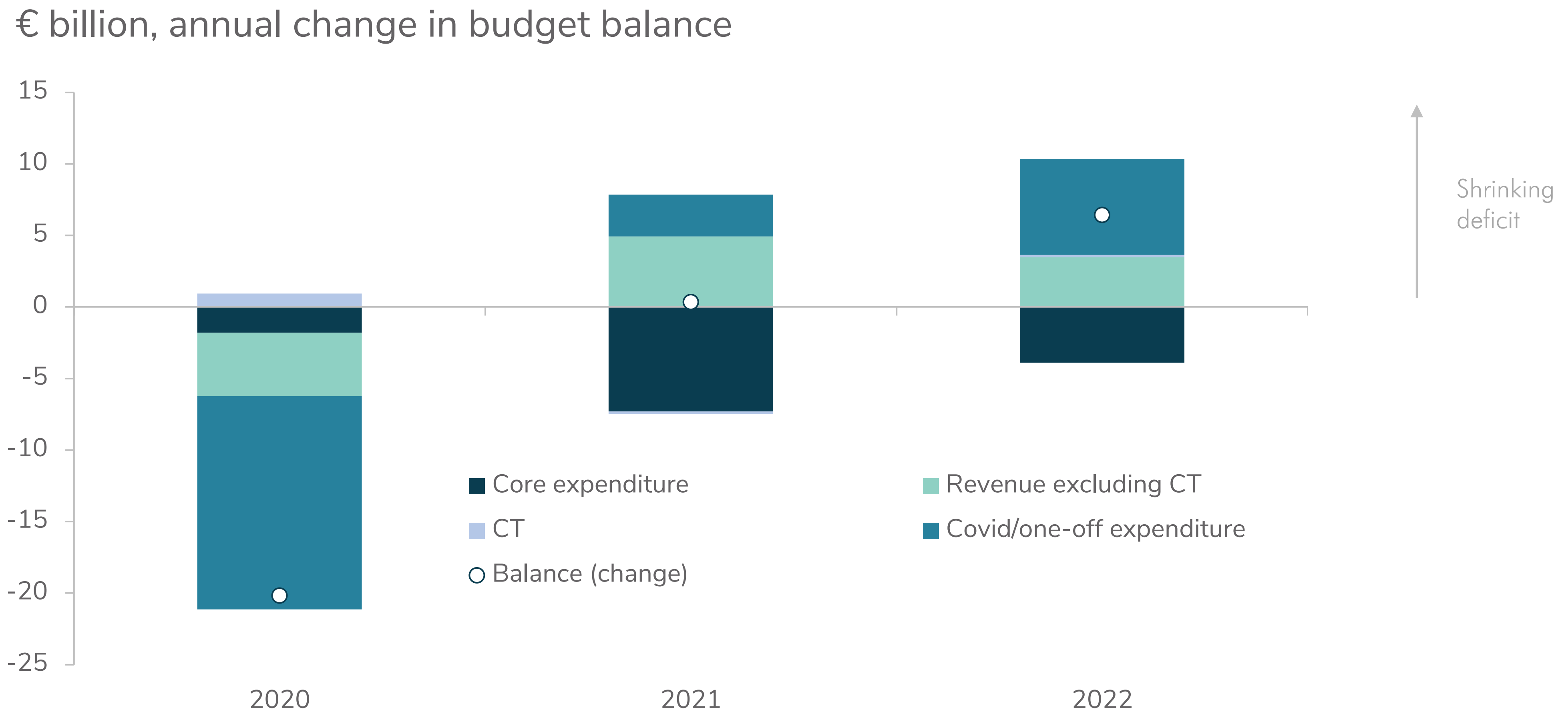
# Long-term impact of pandemic: the extent of "scarring" is a key unknown, but risks to the upside

Real GNI*, 2019 = 100




Sources: Department of Finance, *SPU 2021*; CSO; and Fiscal Council workings.

# The budget deficit in 2021 will remain around 8% of GNI* as gains are offset by €5.4bn of permanent *Budget 2021* measures



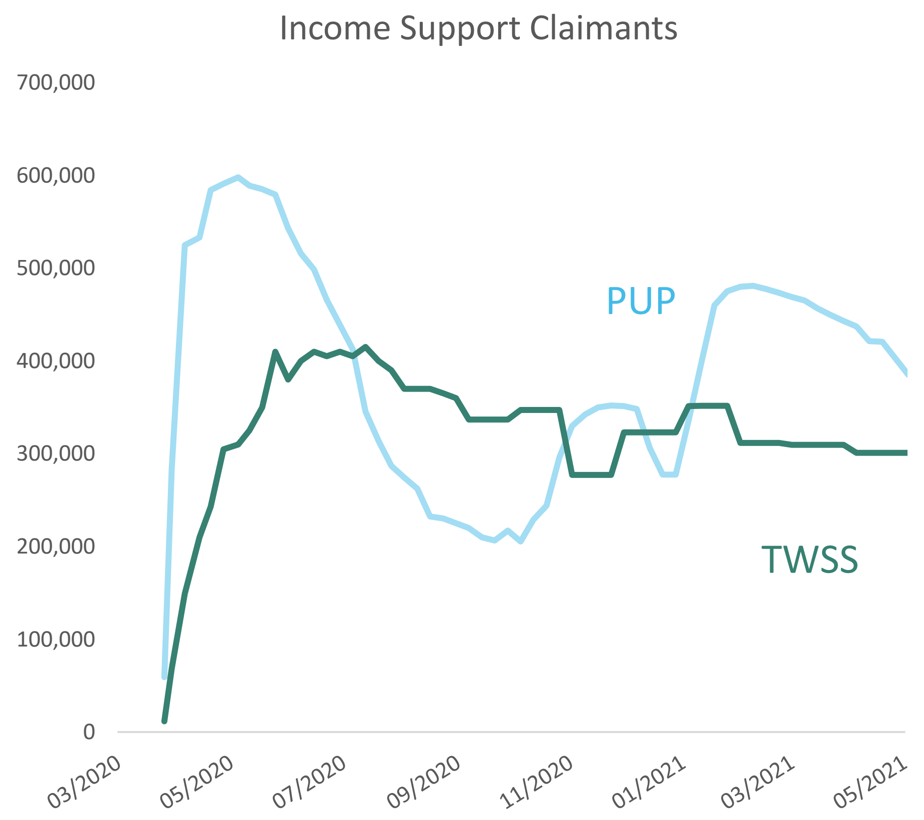

Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Changes in expenditure are recorded as their impact on the balance (i.e. expenditure increases are recorded as negative, as they worsen the balance). Covid/one-off expenditure as outlined in Table 2.2. CT = Corporation Tax.

# Support schemes should be extended if needed, but will largely exhaust contingencies

**Policy supports in response to Covid-19 are very large**
**€ billions, reductions in revenue indicated by negative numbers**

| | 2020 | 2021* |
|---|---|---|
| Total change in spending | 16.7 | 4.4 |
| Spending policy measures** | 13.1** | 12.0 |
| Pandemic Unemployment Payment | 5.0 | 0.6* |
| Wage subsidy schemes | 3.8 | 1.2* |
| Health spending on Covid-19 | 2.0 | 1.9 |
| ICT spending | 0.8 | |
| Restart Grants and Covid Restrictions Support Scheme | 0.6 | |
| Other enterprise supports | 0.1 | |
| Other | 0.8 | 2.9 |
| Contingency allocation | | 2.0 |
| Recovery Fund | | 3.4 |
| Total change in revenue | -3.5 | 4.8 |
| Tax policy measures | -1.4 | -0.7 |
| Tax warehousing write-off | -0.5 | -0.1 |
| Loss relief | -0.6 | |
| VAT cuts | -0.3 | -0.5 |
| "Stay and spend" and other schemes | -0.0 | -0.1 |
| Total change in deficit | 20.2 | -0.4 |
| Total policy measures | 14.5 | 12.7 |

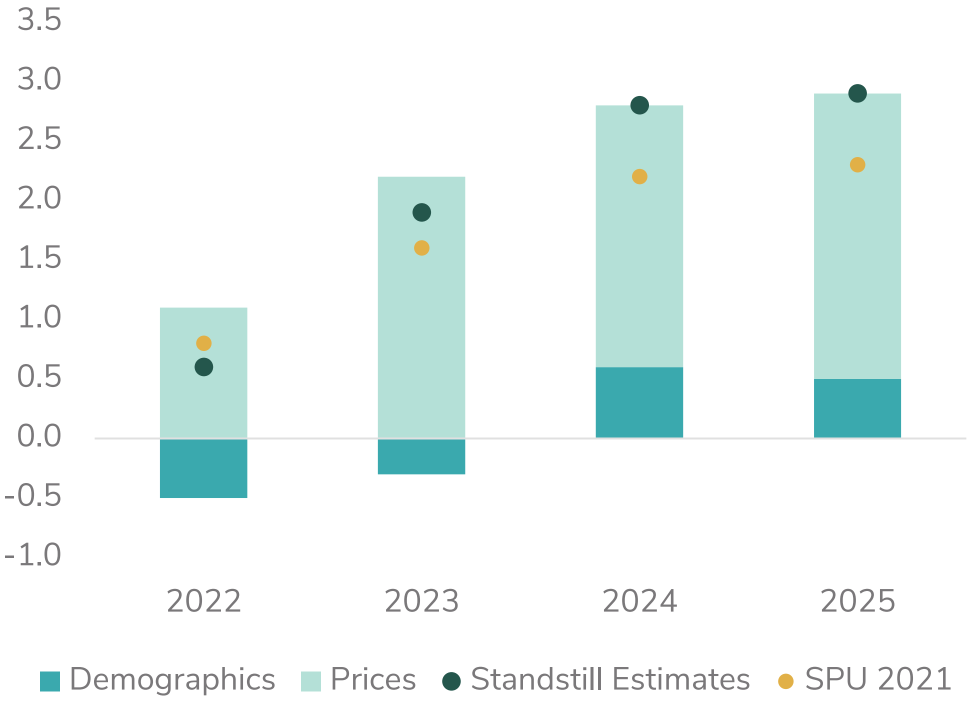
**A significant portion of the labour force remains on income support schemes**
**Weekly claimants**



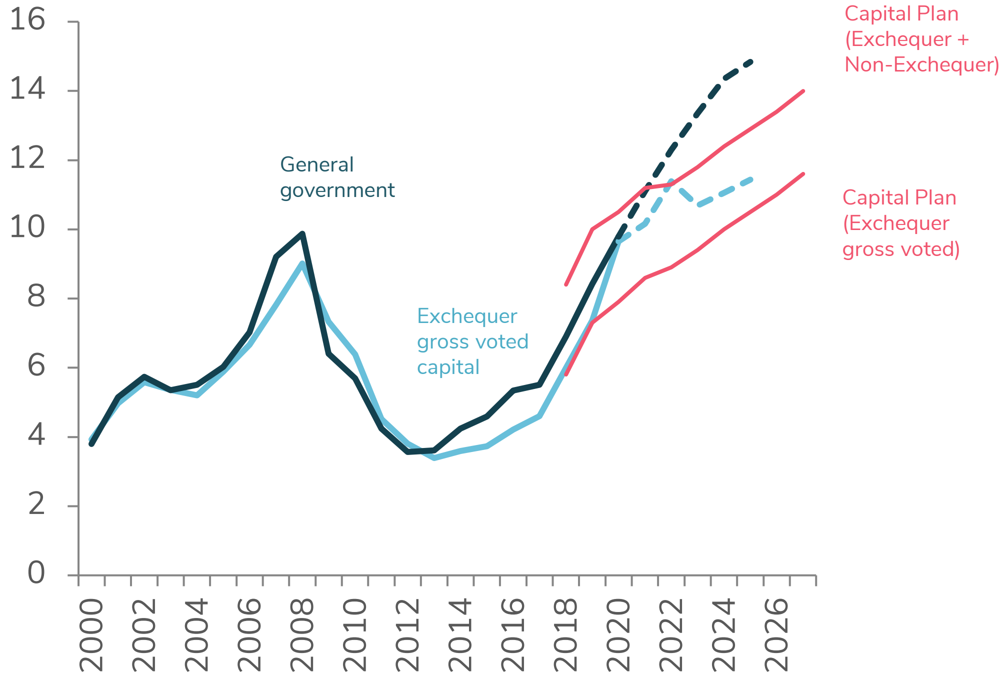
# SPU 2021 medium-term current and capital projections are poorly founded

Irish Fiscal Advisory Council

Gross voted current spending
Annual change in € billion




Public Investment
€ billion



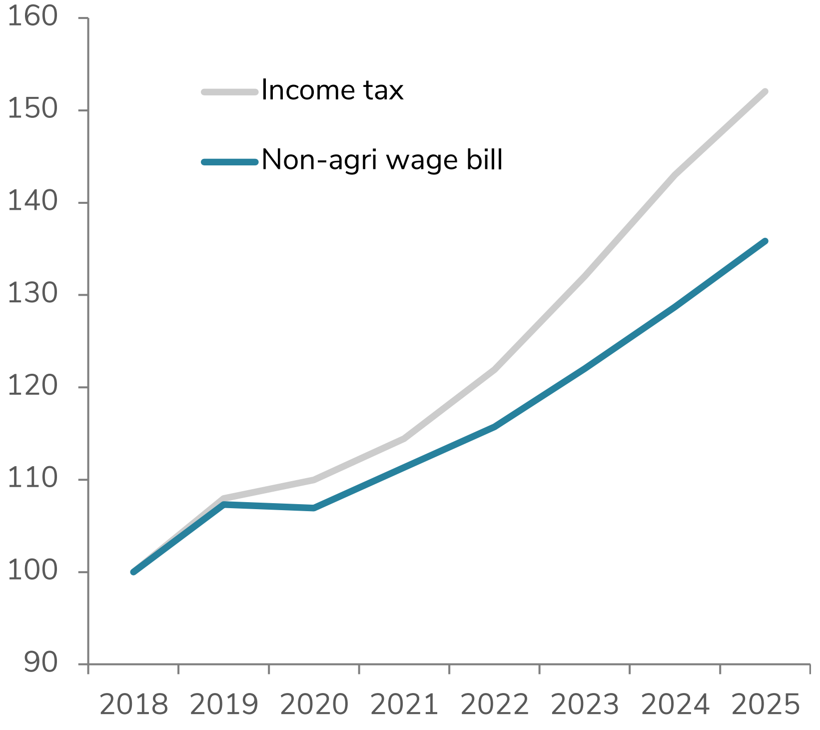

Sources: SPU 2021, Revised Estimates 2020, CSO, Department of Expenditure and Reform, HIPE, HSE; National Development Plan; CSO; and Department of Finance forecasts.
Note: While the gross voted measures shown are comparable, the capital plan (National Development Plan) did not present public investment plans on a general government basis, which makes things difficult to compare in this respect. The Exchequer + Non-Exchequer amounts set out in the plan would include routine maintenance and repairs, for example, but this would be excluded from the general government measure, which only counts major investments.

# SPU forecasts for income tax imply an implausible sharp rise relative to wages

Irish Fiscal Advisory Council

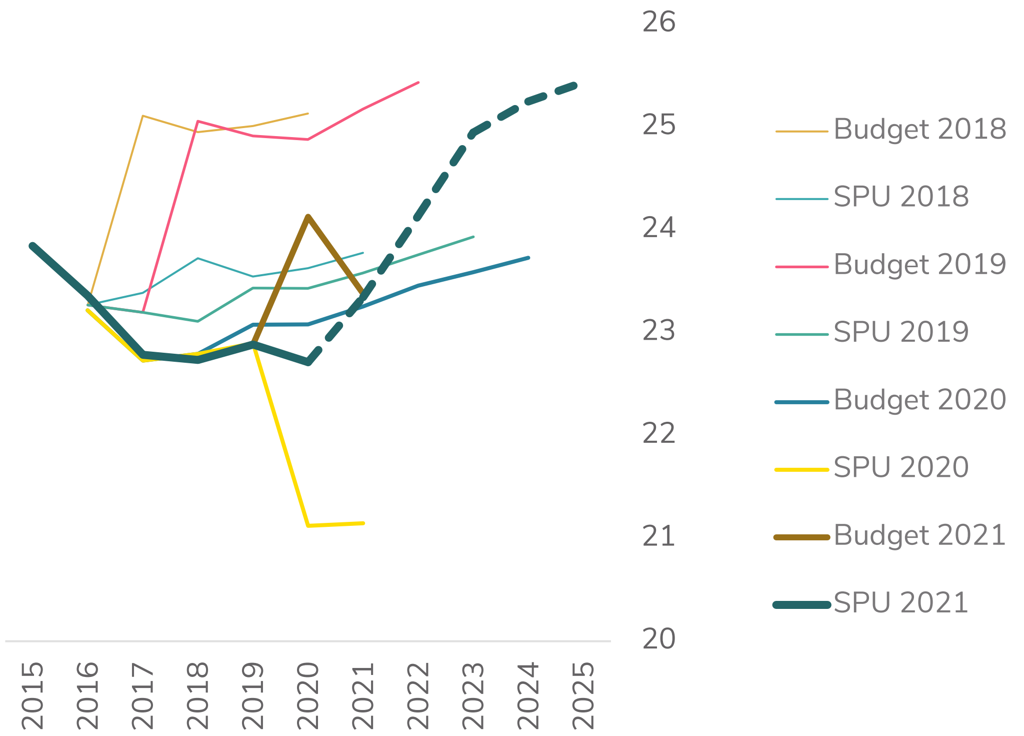
### Income tax forecast to grow rapidly

Index 2018 = 100




### Average income tax rate vintages

Percentage of compensation of employees




Sources: Department of Finance (various forecasts); and Fiscal Council workings.

Irish Fiscal Advisory Council

# Adjusted projection suggests a budget balance closer to 1.2% of GNI* in 2025 compared to 0.3% in the SPU

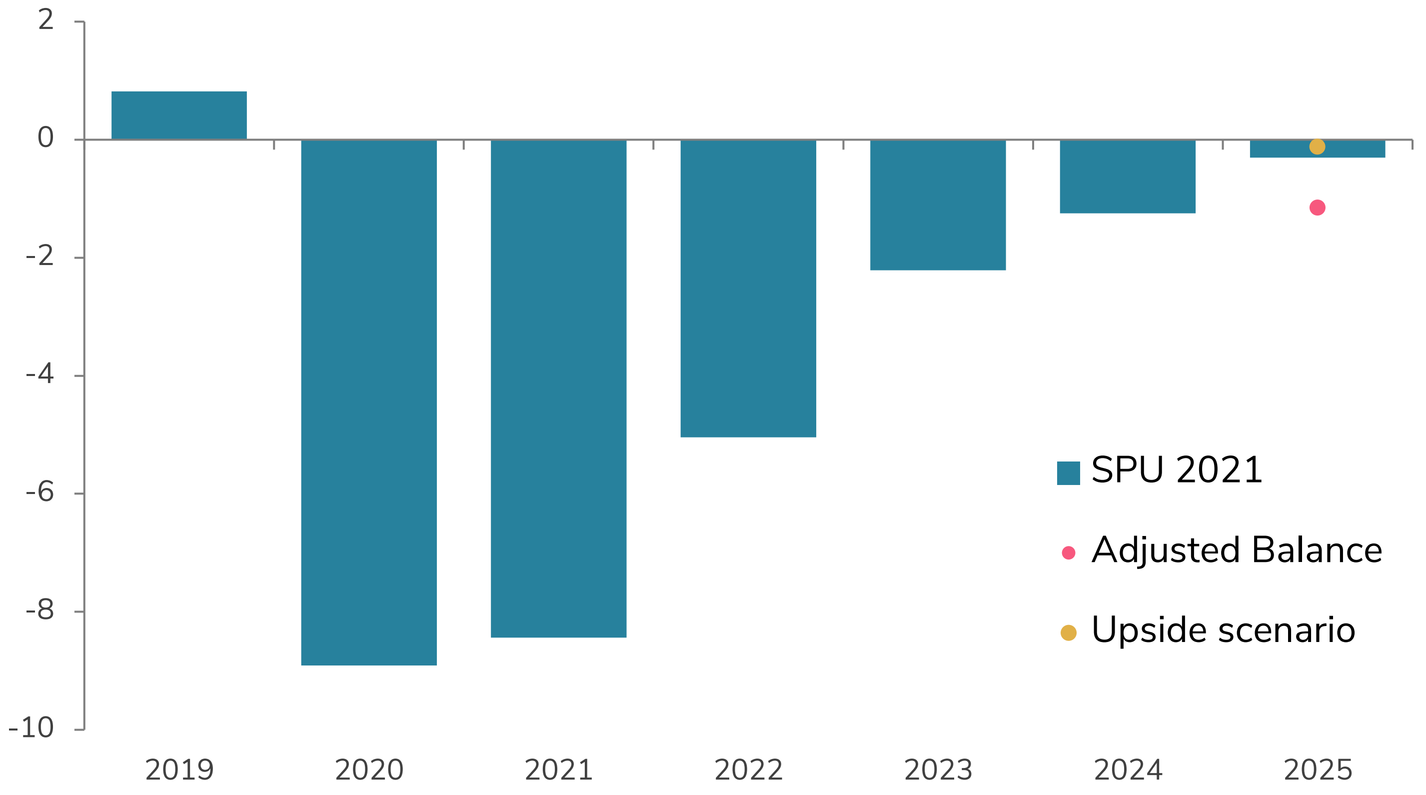
## Alternative general government spending, revenue, and balances for 2025

€ billions

| | *SPU 2021* | Adjusted SPU |
|---|---|---|
| Current Primary Spending | 90.6 | 91.8 |
| Interest Spending | 3.4 | 3.4 |
| Capital Spending | 14.8 | 12.9 |
| General Government Expenditure | 108.9 | 108.1 |
| Income tax | 32.3 | 30.8 |
| Corporation tax | 12.5 | 11.0 |
| Other General Government Revenue | 63.3 | 63.3 |
| General Government Revenue | 108.1 | 105.1 |
| General Government Balance | -0.8 | -3.0 |

# However, an upside scenario would close the deficit by 2025

% GNI*, general government balance

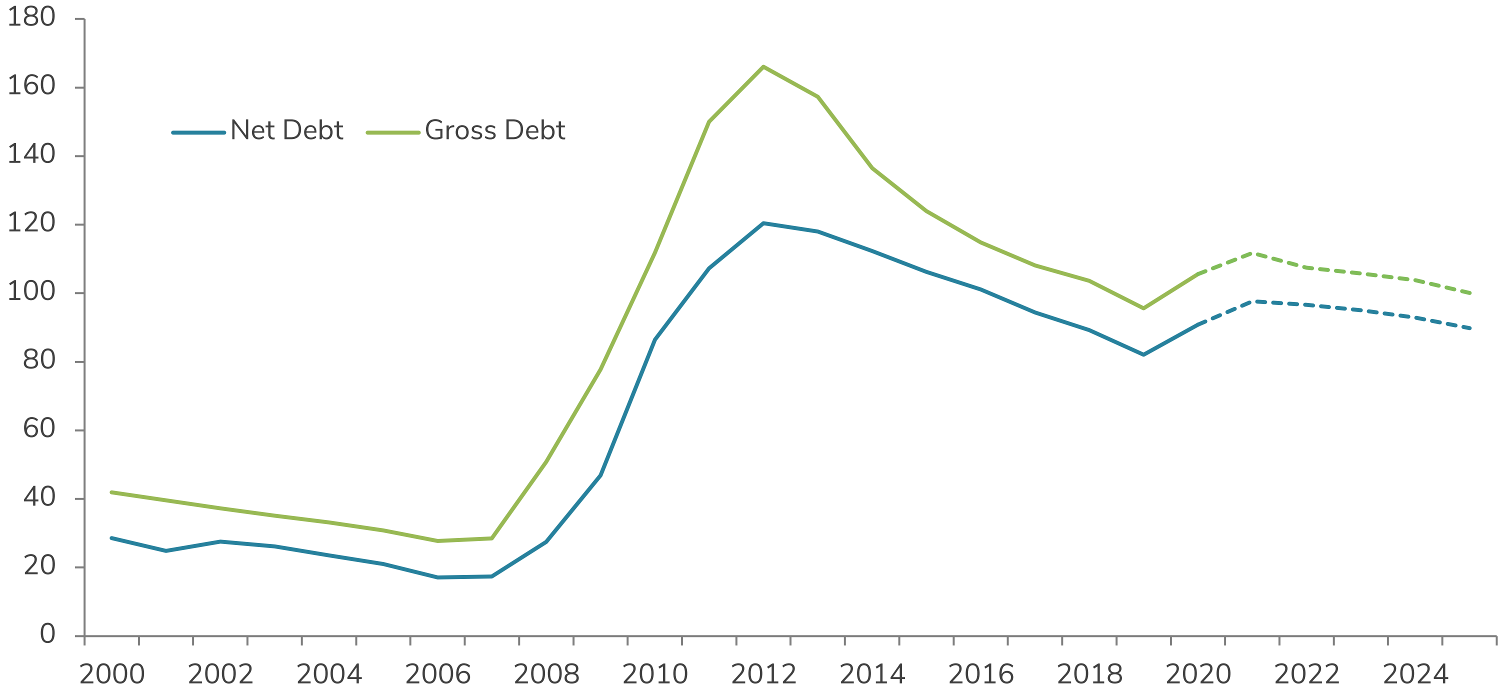



Sources: CSO; SPU 2021, and Fiscal Council workings.
Notes: Two alternative scenarios for the general government balance are shown for 2025: an "Adjusted Balance", with more realistic assumptions for the deficit and an "Upside" scenario that assumes less scarring from the pandemic.

# Gross debt ratio set to peak in 2022, remaining in 2025 above 100% GNI*

## Debt ratios to remain at high levels

Gross and Net General Government Debt to GNI*

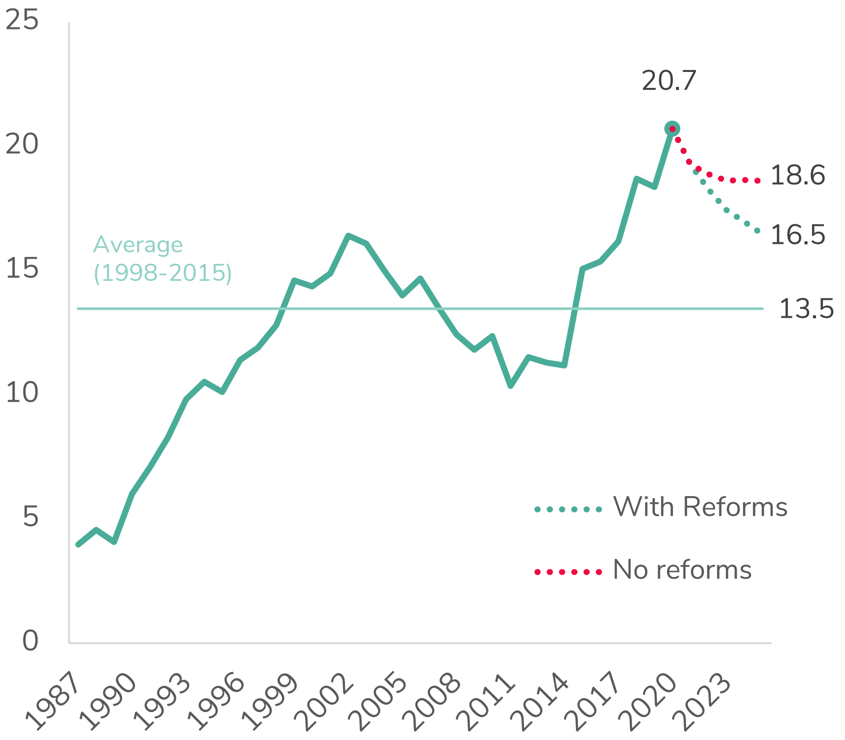



Sources: CSO and SPU 2021.
Note: Dashed lines indicate forecasts from SPU 2021.

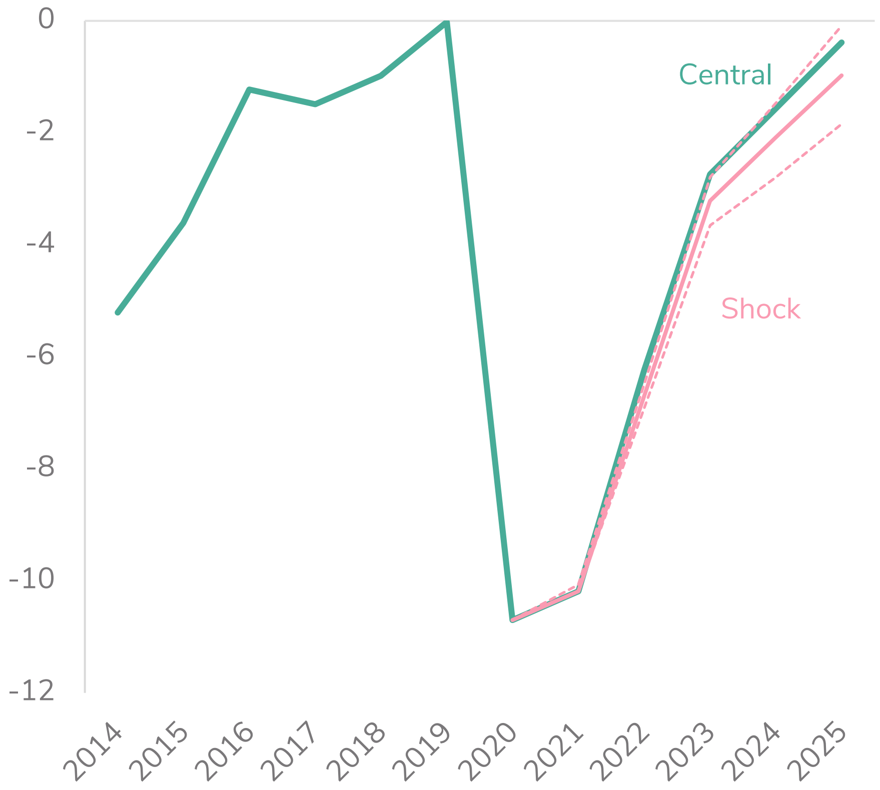
Irish Fiscal Advisory Council

# Risks from overreliance on corporation tax have intensified as the global tax debate evolves

## Corporation tax
% Exchequer tax revenue

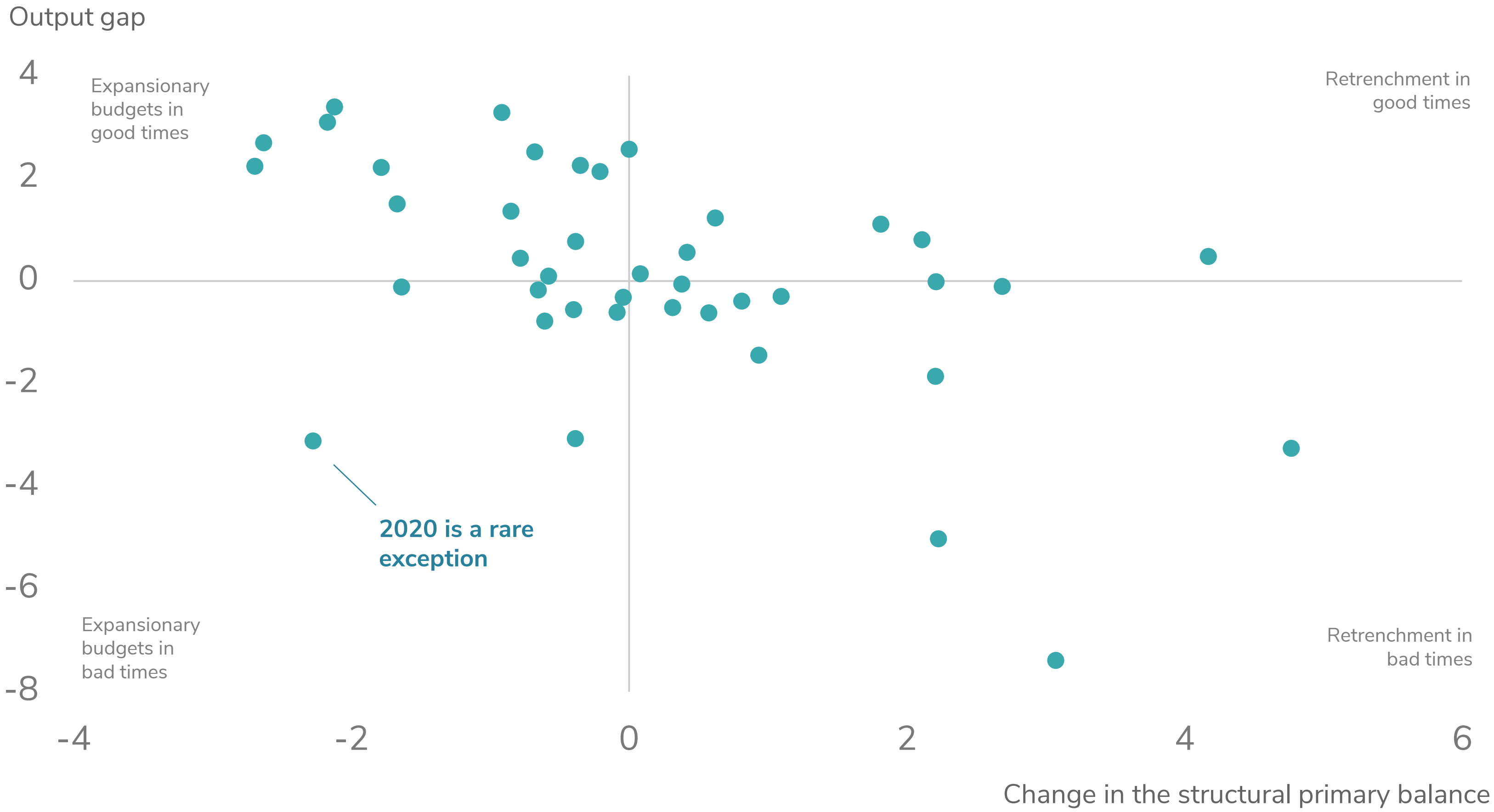



## Budget balance
% GNI*



# Fiscal stance, planning and framework

# The Government has been able to support the economy unlike in the past

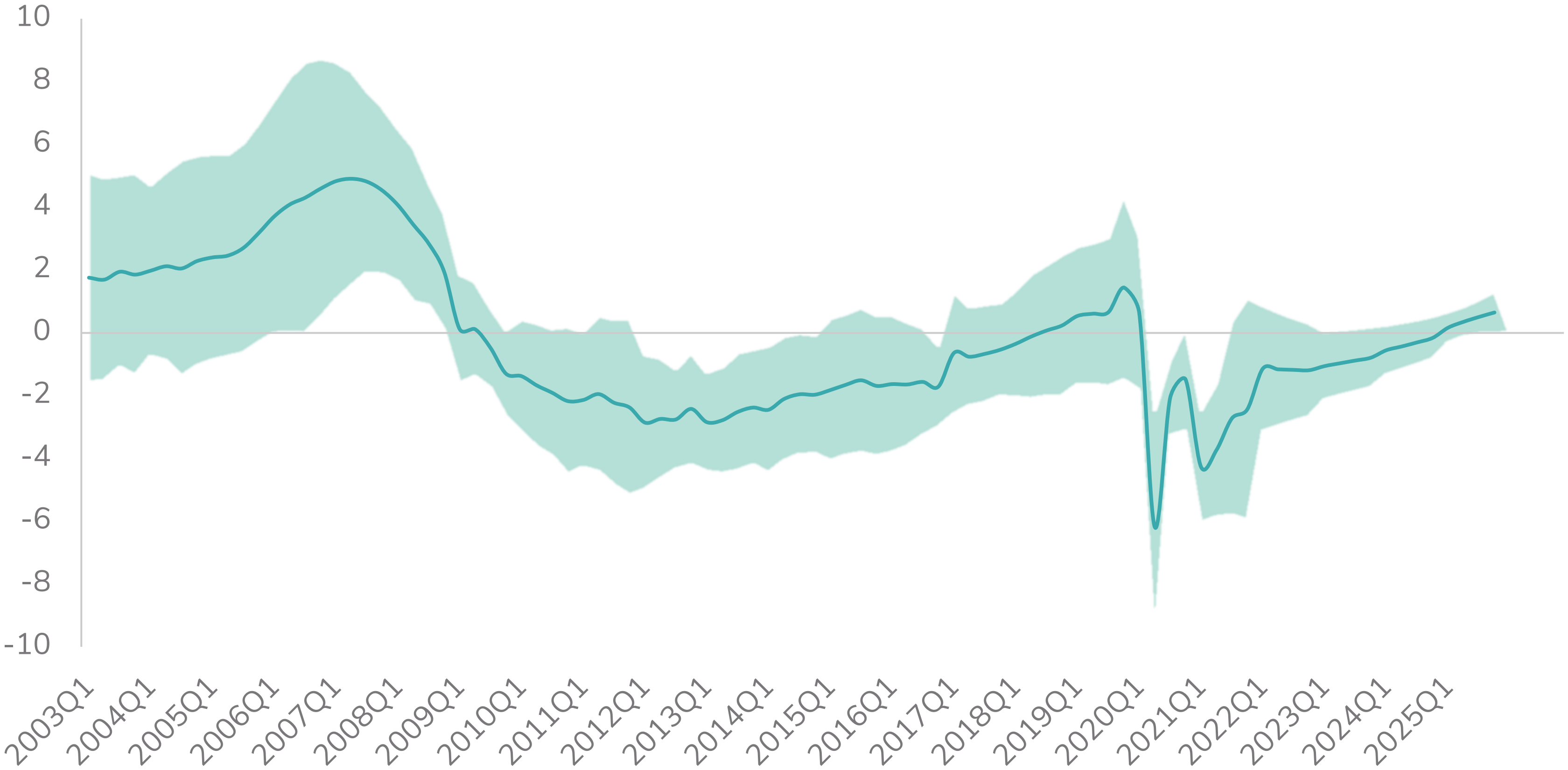



This approach may have halved the contraction in real GNI* in 2020

Sources: Fiscal Council workings.
Notes: Estimates of the output gap and of the structural primary balance cover the period 1980–2020 and are based on the Council's own estimates of the cycle using its suite of models that focus on the domestic economy. "Retrenchment" means fiscal contractions

# If the economy recovers, future large-scale untargeted stimulus would not be needed

Output gap (% gap between actual and potential economic output)

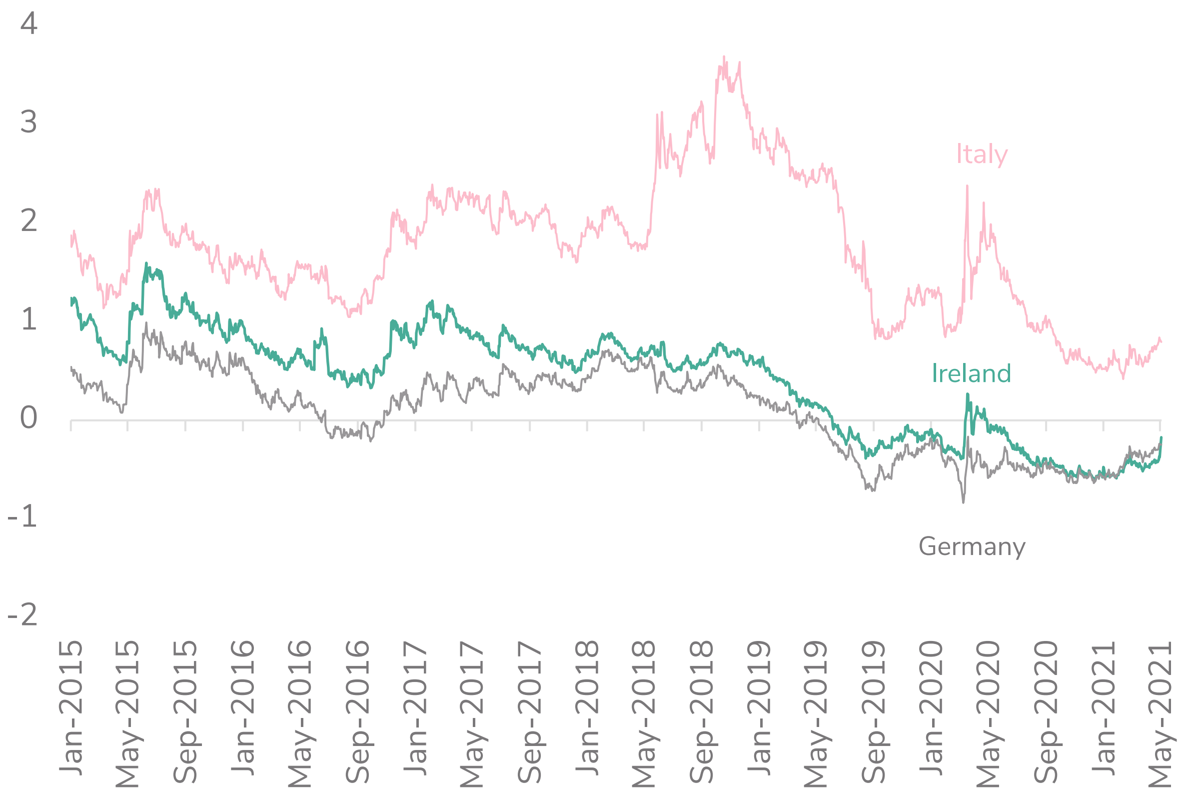



Targeted supports may be needed until 2022

Sources: Fiscal Council workings (based on SPU 2021 forecasts).
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's models and Department forecasts. Given distortions to standard measures like GDP and GNP and the relative importance of domestic activity to the public finances, the measures focus on domestic economic activity, including quarterly Domestic GVA (see Casey, 2019 for more detail).

# Debt dynamics will be favourable in the years ahead due to low interest rates

% yields (ten-year sovereign bonds)

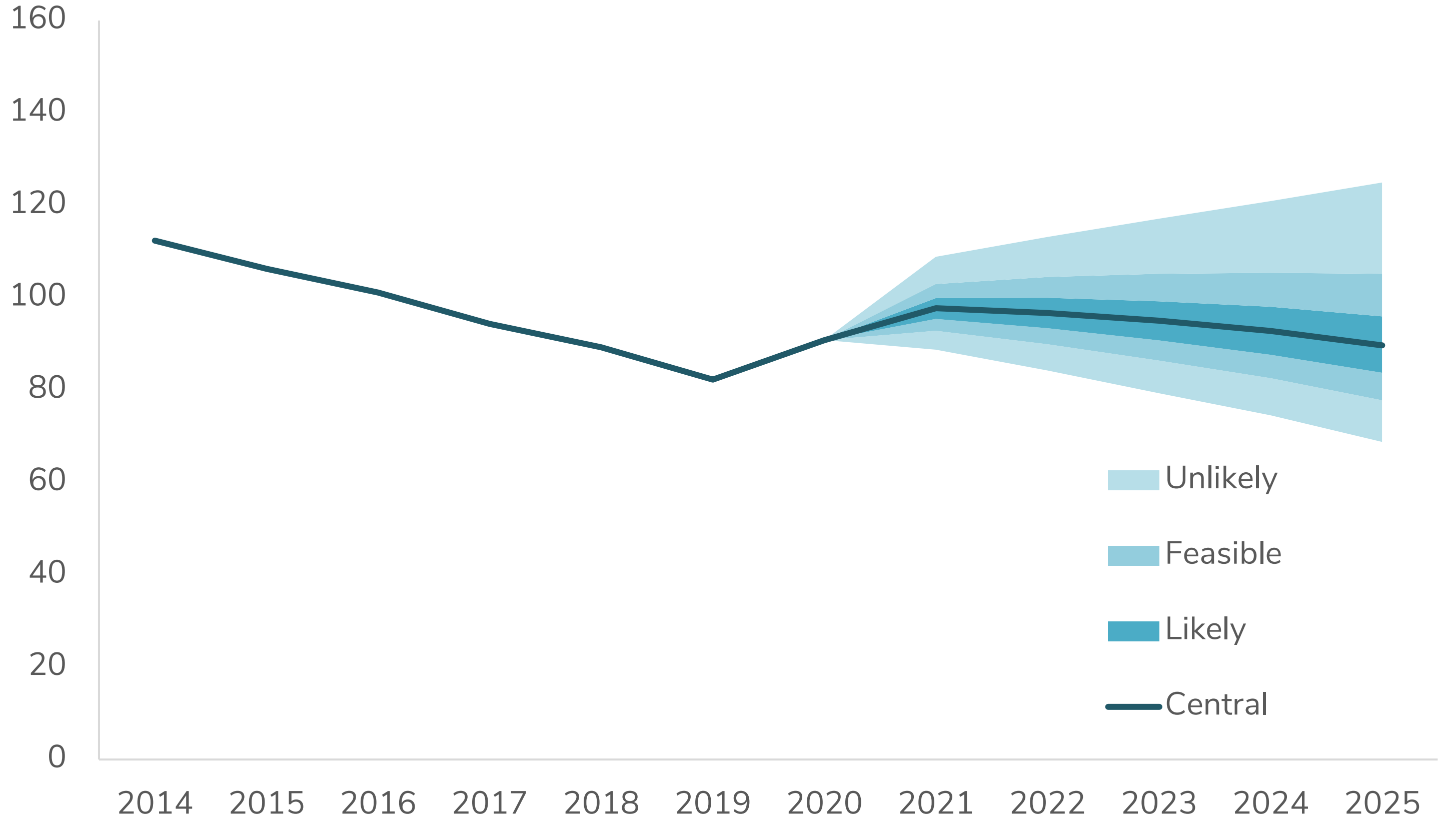



Sources: Refinitiv Datastream; CSO; Department of Finance forecasts (SPU 2021); and Fiscal Council workings.

# But, a higher level of debt increases vulnerability to changes in conditions

## There is wide uncertainty around the path for public debt

% GNI*, net general government debt

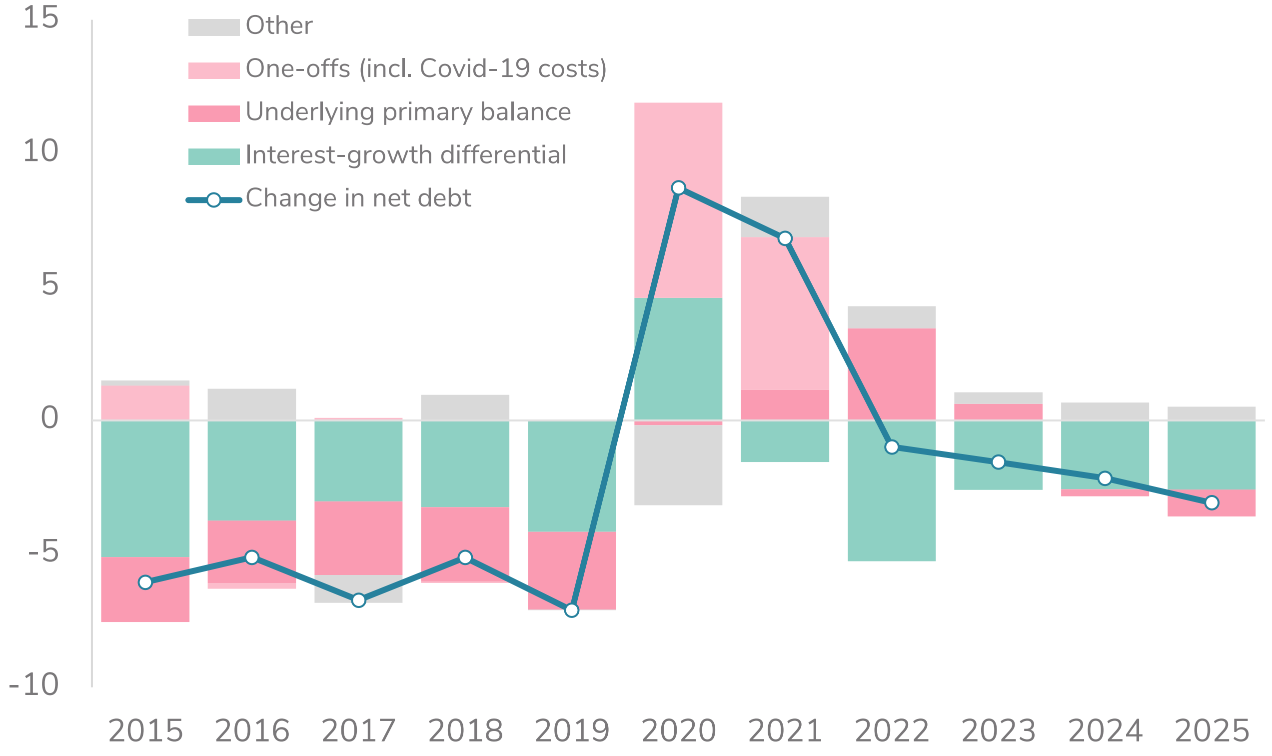



There is a 15–20% probability on the current path that the primary balance would be insufficient to stabilise the debt ratio

Sources: Fiscal Council workings using Department of Finance SPU 2021 forecasts.
Notes: In the stochastic fan chart projections, "Likely" covers the 30% confidence interval, "Feasible" the rest of the 60% interval; and "Unlikely" the rest of the 90% interval.

# A balanced budget in 2025 implies the debt ratio falling by around 3 percentage points per year

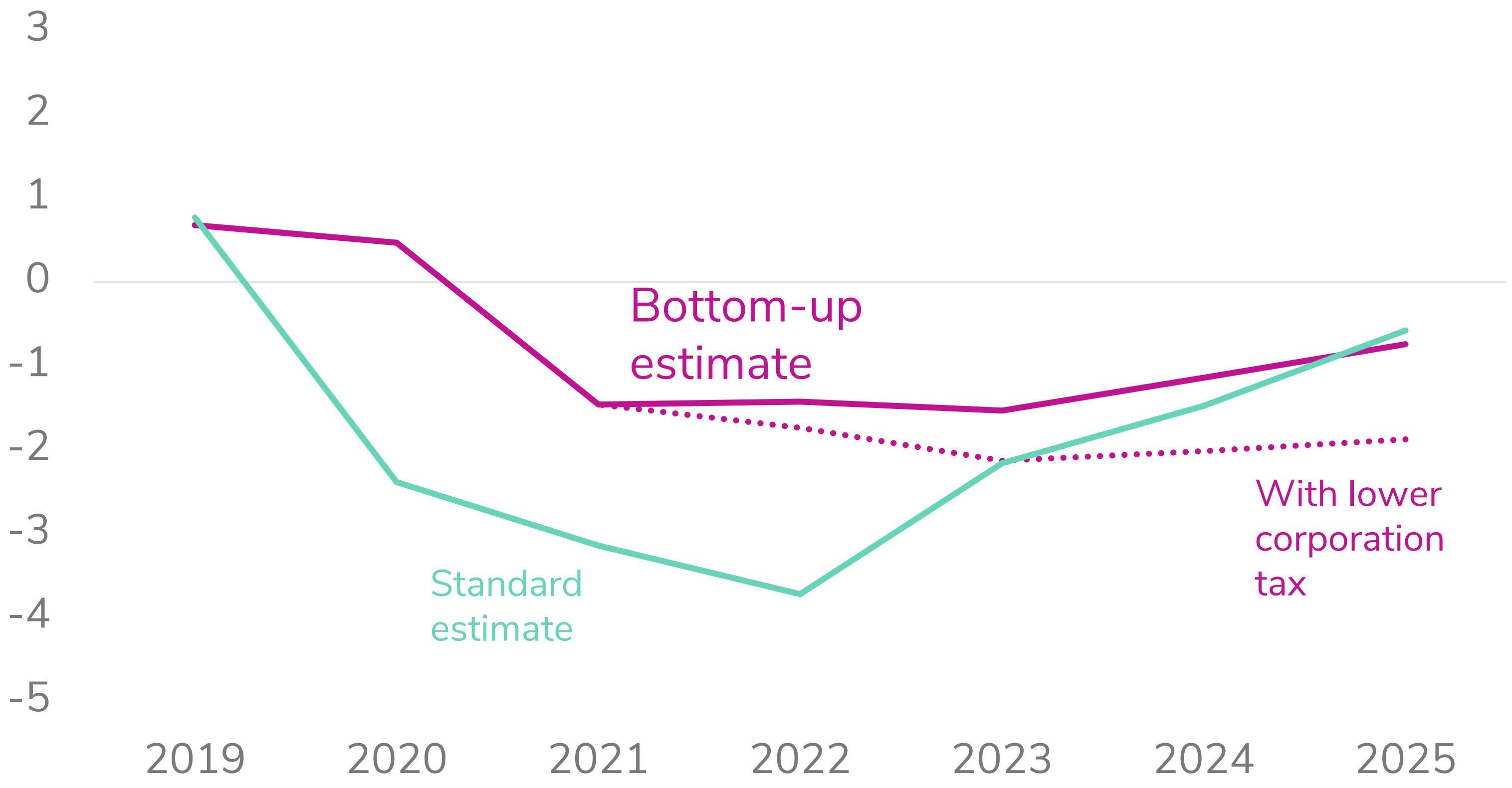
% GNI*, changes in net debt ratio and contributions in p.p. of GNI*



# Modest or no fiscal adjustment may be needed from 2023

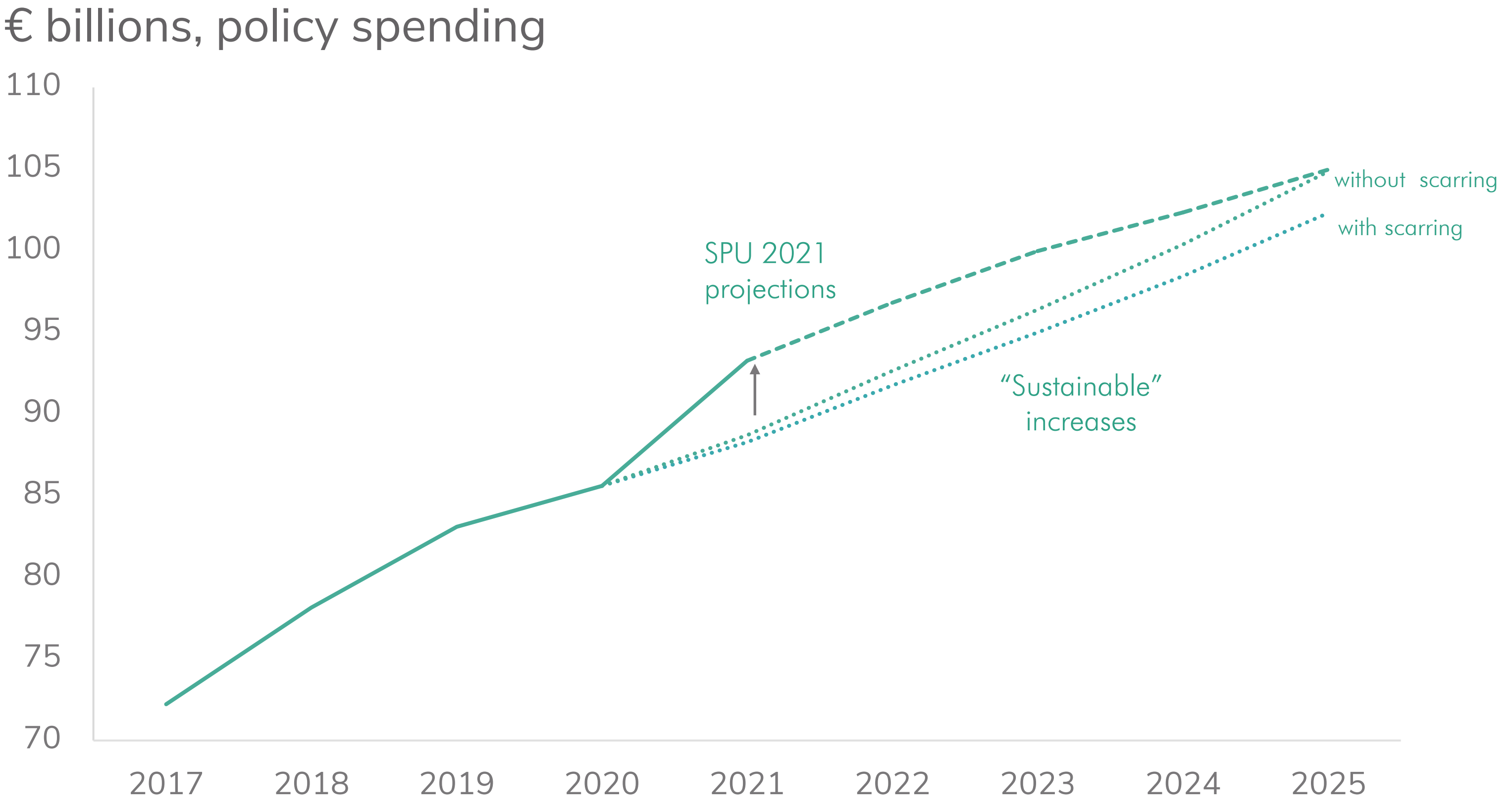
## Structural balance

% GNI*




Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Corporation tax is adjusted in the second set of estimates of the bottom-up structural balance (depicted by the dashed line). The adjustments phase in the gap between the Council's central estimate of excess corporation tax of €4.8 billion and the Department's assumed reductions of €2 billion over the period 2022–2025 as downward adjustments of €0.7 billion per annum. The "adjusted SPU scenario" is set out in Section 2.

# New permanent policy measures need to be funded by tax increases or adjustments to spending




Budget 2021 included €5.4 to €8.8bn of permanent spending measures.

There is now no space to fund additional policy measures

Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: Policy spending is general government expenditure less interest costs, one-offs, and the estimated costs associated with cyclical unemployment. Given the extensive changes in unemployment benefits associated with the pandemic, recent calculations include "non-core" social protection spending increases as the basis for the temporary/cyclical increase in unemployment benefits (see Supporting Information S9 for more detail on this measure). The sustainable increases assume that spending grows in line with potential output and actual price inflation.

# The Government has failed to deliver a credible medium-term strategy

| Objective | SPU 2021 | Council calling for this since | Progress |
|---|---|---|---|
| Present five-year-ahead forecasts | Four-years-ahead | Nov-17 | Mostly there |
| Base projections on realistic spending plans | More realistic than previous rounds, but rely on simple assumptions and are below Stand-Still costs | Jun-16 | Some |
| Provide transparent costings of major policy changes | Major Programme for Government policies including Sláintecare not factored in | Dec-20 | Some |
| Indicate how taxes would be adjusted if needed | No information on this, but Tax and Welfare Commission established | Dec-20 | Limited |
| Commit to medium-term fiscal objectives | No formal numerical targets, but general commitment to return to budget balance | Nov-17 | Limited |
| Show how rules will be complied with | Document does not set out how it will be achieved but forecasts appear compliant | Dec-20 | Limited |
| Clarify how the Rainy Day Fund will be used | No mention of it | Jun-16 | Marginal/none |
| Consider measures to strengthen fiscal framework | No measures considered | Nov-17 | Marginal/none |
| Make non-Exchequer forecasts more transparent | No improvement in transparency shown | Nov-19 | Marginal/none |
| **Overall progress** | | | **Limited** |

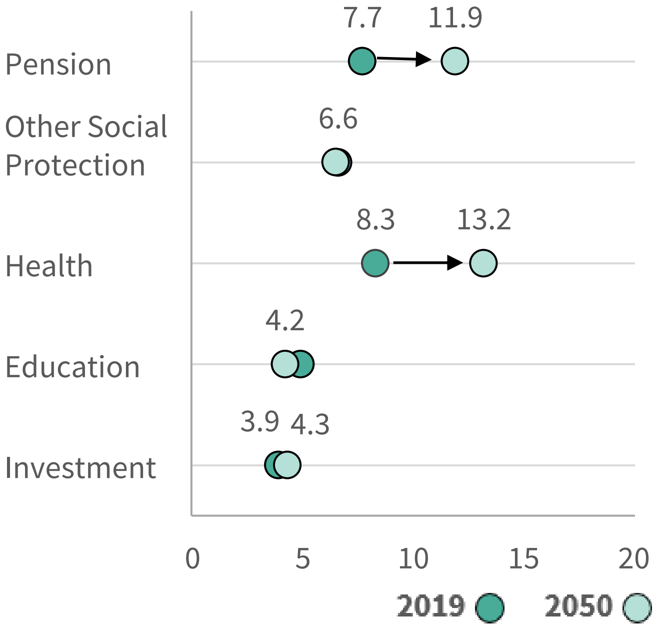
# Once the recovery is underway, 5 major challenges

- Ensuring debt is on a downward path
- Overreliance on corporation tax
- Population ageing
- Climate change
- Delivering PfG commitments

# Ageing will add around €850m to public spending each year until 2025

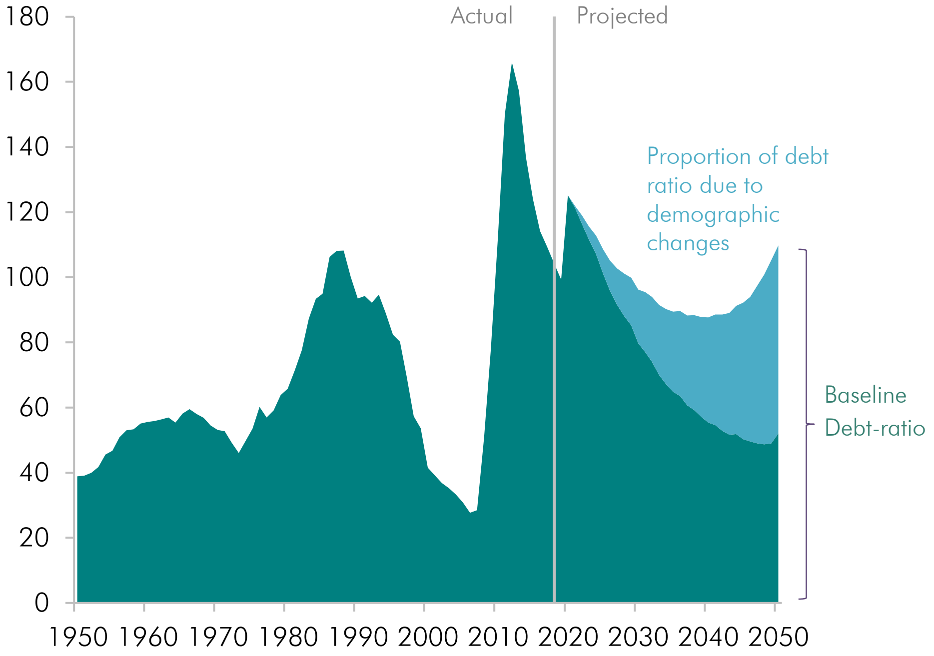
## Health & pension spending to rise

% of GNI* (general government basis)




## Ageing costs are considerable

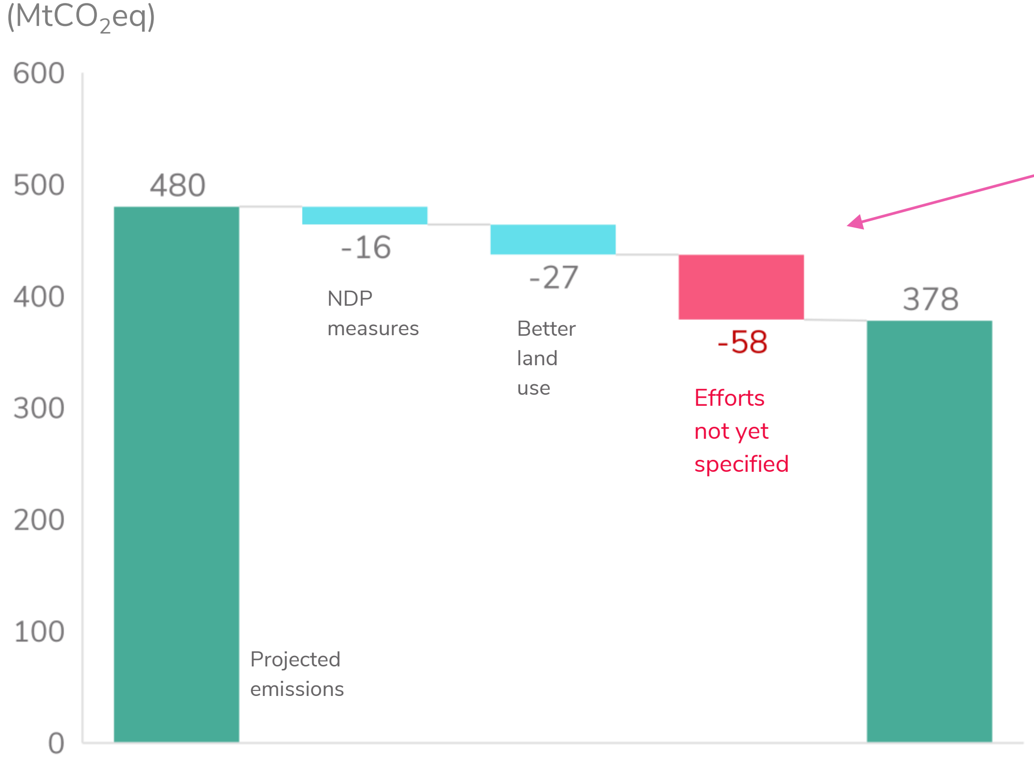
% of GNI*




Source: Fiscal Council projections (Long-term Sustainability Report, 2020).

# Climate change measures required could be substantial

## Levels of greenhouse-gas emissions



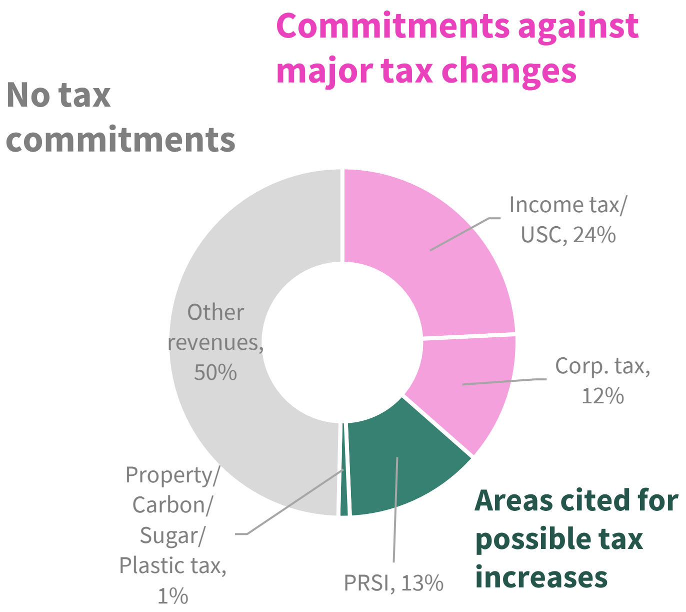

More than half of overall reduction unspecified

Equivalent to more than 3½ times the reduction achieved by the National Development Plan measures, which are projected to cost just over €20 billion over ten years (€2bn per annum, ~1 per cent of GNI*)

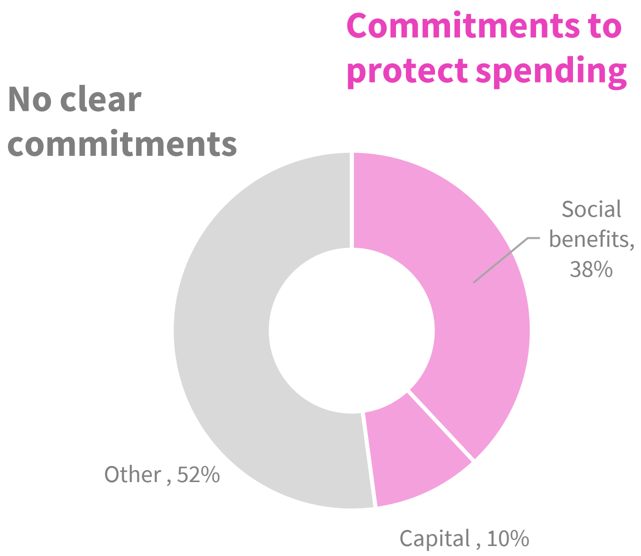
Sources: Fiscal Council (2020b); Climate Action Plan 2019.
Notes: NDP refers to the measures set out in the National Development Plan. Better land use refers to the additional carbon absorption expected from forestry over a period of years.

# Programme for Government ruled out many revenue or spending adjustments

Revenue measures
% total general government revenue




Expenditure measures
% total general government spending (excl. interest)




Commission on Tax and Welfare is welcome, but measures will need to be implemented

# Three initiatives would support good fiscal policy

Irish Fiscal Advisory Council

## Commit to national Debt Targets

(1) set as % modified GNI*
(2) clear timeframes and staging posts

## Use Rainy Day Fund to reduce CT reliance

1) Use to save CT receipts above current profile
2) Clarify how drawdowns would work under fiscal rules

## Set credible Departmental spending limits

Base on realistic bottom-up forecasts of price and demographic pressures on spending

# Key messages - Summary

- The economy is set to bounce-back as Covid restrictions ease
- The Government's *SPU 2021* budgetary medium-term projections are poorly founded
- An adjusted projection suggests a budget balance closer to 1.2% of GNI* in 2025 compared to 0.3% in the SPU
- The debt/GNI* ratio should peak this year, but will remain high at ~100% in 2025
- If the economy recovers, future large-scale untargeted stimulus would not be needed
- New permanent policy measures need to be funded by tax increases or adjustments to spending
- The Government has failed to deliver a credible medium-term strategy
- Three initiatives would support good fiscal policy: debt targets, using the Rainy Day Fund to save excess CT and credible expenditure ceilings

# Annex slides

# EU support plays a modest role for Ireland, but a wider impact

## Cash impact of EU Funding

€ billion

| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2020-25 |
|---|---|---|---|---|---|---|---|
| SURE loans | | | | | | | |
| impact on cash spending | 2.5 | | | | | | 2.5 |
| impact on cash receipts | | 2.5 | | | | | 2.5 |
| Brexit Adjustment Reserve grants | | | | | | | |
| impact on cash spending | | | 1.1 | | | | 1.1 |
| impact on cash receipts | | 0.9 | 0.2 | | | | 1.1 |
| Recovery and Resilience Facility grants | | | | | | | |
| impact on cash spending | | | 0.2 | 0.2 | 0.2 | 0.2 | 0.9 |
| impact on cash receipts | | | 0.2 | 0.2 | 0.2 | 0.2 | 0.9 |
| Total impact | | | | | | | |
| impact on cash spending | 2.5 | 0.0 | 1.3 | 0.2 | 0.2 | 0.2 | 4.4 |
| impact on cash receipts | 0.0 | 3.4 | 0.4 | 0.2 | 0.2 | 0.2 | 4.4 |

Sources: Department of Finance; and Fiscal Council workings.