Fiscal Stance

A medium-term strategy is needed

3. FISCAL STANCE

A medium-term strategy is needed

The Government has responded to the Covid crisis by providing substantial support to households and businesses impacted by the pandemic, while also providing funding for health services to respond to the crisis. This support has been funded by a very large deficit and substantial increases in government debt.

This section provides the Council's assessment of the overall prudence of the Government's fiscal stance. First, it assesses the stance in 2020, with immediate fiscal costs associated with Covid-19 high, but necessary to avoid lengthening and deepening the economic crisis (Section 3.1). Second, it looks at the stance in 2021 and the extent to which budgetary supports—that should for the most part be temporary—may be required until 2022 (Section 3.2). Third, it looks at the medium-term fiscal strategy once the economy settles on a new growth path after the recovery and the implications for long-run debt sustainability (Section 3.3).

The Council's assessment of the fiscal stance is informed by (1) a broad economic assessment that considers appropriate management of the cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with domestic and EU fiscal rules.

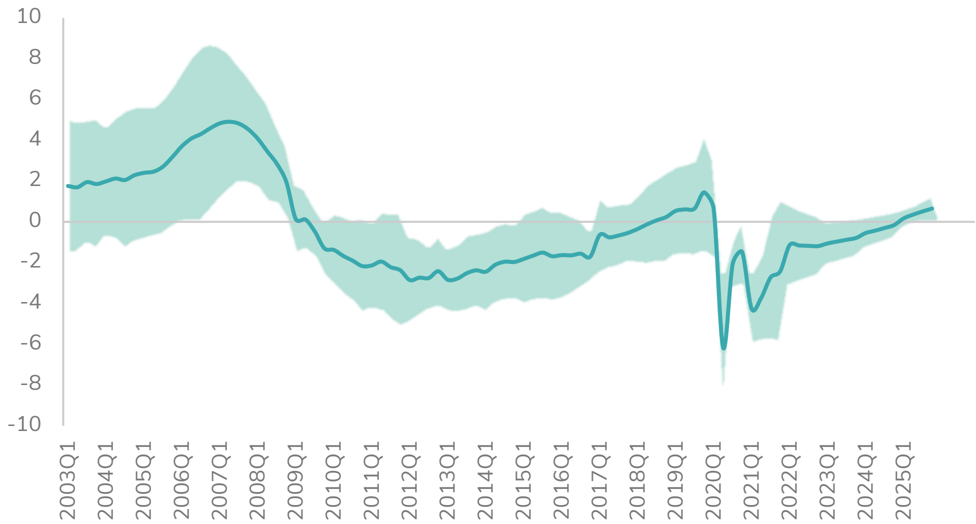
3.1 The fiscal stance in 2020

The pandemic caused the economy to contract substantially in 2020. Estimates of real GNI* suggest that activity fell by 4.2 per cent for the year.

The fall in economic activity contributed to the opening up of a large negative output gap amid the pandemic — that is, the gap between the economy's actual level of output and levels judged to be sustainable over the medium term. This was particularly evident in the spring and winter periods as lockdown measures were enacted by the Government to contain the pandemic (Figure 3.1). While the output gap is anticipated to narrow fairly rapidly during 2021, the economy is not estimated to reach its full potential again until after 2024. However, the output gap is subject to more uncertainty than usual, given the nature of the shock, with restrictions limiting demand in specific areas and its supply-side impacts not yet clear.

Figure 3.1: Ireland's economy fell well below its potential in 2020

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



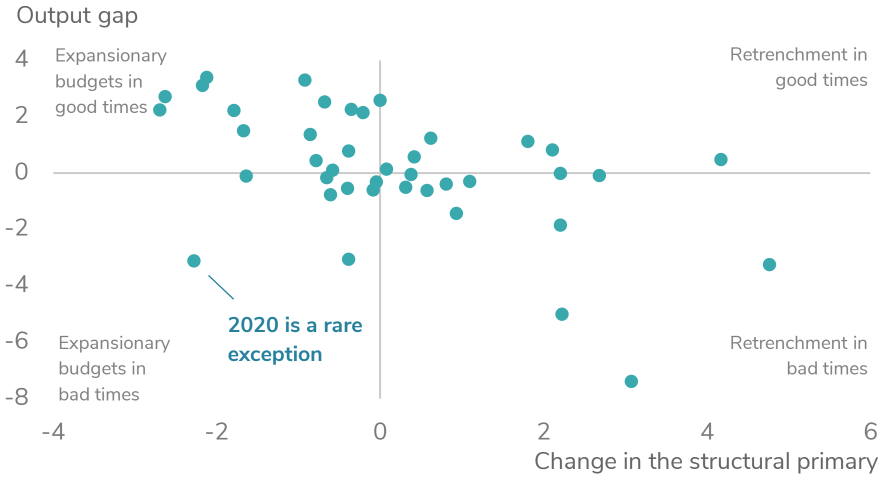
Sources: Fiscal Council workings (based on SPU 2021 forecasts).
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's models and Department forecasts. Given distortions 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). Get the data.

The Government responded to the collapse in activity primarily with new policy measures that were brought about in an active manner (see Section 2). To deal with the challenges posed by Covid-19, the Government introduced a raft of new policy supports. The Pandemic Unemployment Payment and the wage subsidy schemes were the most significant of these. The automatic response, by contrast, was relatively smaller. It entailed allowing taxes to fall as business and household incomes fell and allowing standard unemployment supports to rise.

The scale of the supports is unprecedented in modern times and is helping to bolster the economy at a time when support is needed to limit the damage caused by the pandemic. Unlike the response to the Global Financial Crisis, the Government was able to pursue countercyclical fiscal policy in a way that, historically, the State has largely failed to (Figure 3.2).

Government has been able to support economy in ways it previously failed to

Figure 3.2: Policy in 2020 — a rare example of countercyclical fiscal policy



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. Get the data.

The fiscal supports introduced may have boosted economic activity, in real GNI* terms, by about 5 percentage points. The Council's Maq model incorporates estimates of fiscal multipliers for taxes, current spending and capital spending based on previous work for the Irish economy. If applied to the support measures introduced in 2020, these would suggest that the estimated contraction in real GNI* last year, at -4.2 per cent, was half what it might have been in the absence of these supports. Yet, standard assumptions might be less relevant in this context.[51] For example, the income supports were typically given to people with lower incomes and, hence, a higher likelihood of spending this income. Acting against that, however, was the issue that their ability to spend may have been stifled by Covid restrictions.

[51] In cases where output is falling, unemployment is rising, and the policy rate is at the zero-lower bound, fiscal multipliers may be temporarily higher than usual (see Auerbach and Gorodnichenko, 2012, for example).

The Council is required to assess whether the Government's stance is conducive to prudent economic and budgetary management. For 2020, the Council assesses that the Government's response was prudent and necessary to support the economy. The budgetary costs were high, but it was possible to introduce substantial supports without jeopardising fiscal sustainability. Interest rates were kept at low levels thanks to supportive ECB monetary policy despite the upward pressures on rates from increased borrowing and high debt levels. The supports were also set out as temporary measures in the main. In addition, the measures were relatively well targeted and they should help to limit lasting economic damage.

The Government's response in 2020 was prudent and necessary

3.2 The fiscal stance in 2021

The Government's fiscal stance in 2021 has so far seen it continue its exceptional support in response to the Covid-19 crisis. This is in view of the ongoing Covid-related restrictions in the first half of the year. The Council assesses that this support, which is for the most part expected to be temporary, is appropriate.

The temporary supports set out in *SPU 2021* for this year comprise €12 billion in Covid-related spending and €0.6 billion in tax policy measures. Of the €12 billion, €3.3 billion is due to the expected cost of continuing Pandemic Unemployment Payments and the Employment Wage Subsidy Scheme to end-June. This cost will be exceeded, given the extension of Level 5 restrictions. It is expected that the additional costs will use up most, if not all, of the €5.4 billion set aside in the form of two contingency amounts for 2021 (Section 2).

The temporary Covid supports are costly but a phased removal would help ease the adjustment of the economy. If the Government wishes to continue the supports beyond June, when they are currently budgeted to end, it should consider better targeting supports as conditions improve over the course of this year and into 2022. The Government should also clarify what the estimated cost of further extensions would be.

However, *Budget 2021* also set out substantial increases in permanent core Government spending — measures unrelated to Covid-19. This included clear plans to increase ongoing departmental spending by €5.4 billion, which is surprisingly large in the context of recent budgets. Using a better measure of underlying spending that incorporates non-Exchequer spending too, the increases may be closer to €8 billion.[52] The *SPU 2021* forecasts indicate that this spending increase will indeed be permanent by including them in projections for later years. The increases include permanent increases in staff, most notably in the health and education areas, which together make up close to 15,000 of a 17,700 increase in public sector staff numbers for 2021. It only became apparent very recently that much of the increase in permanent spending set out for 2021 would be related to Sláintecare (see Section 2).

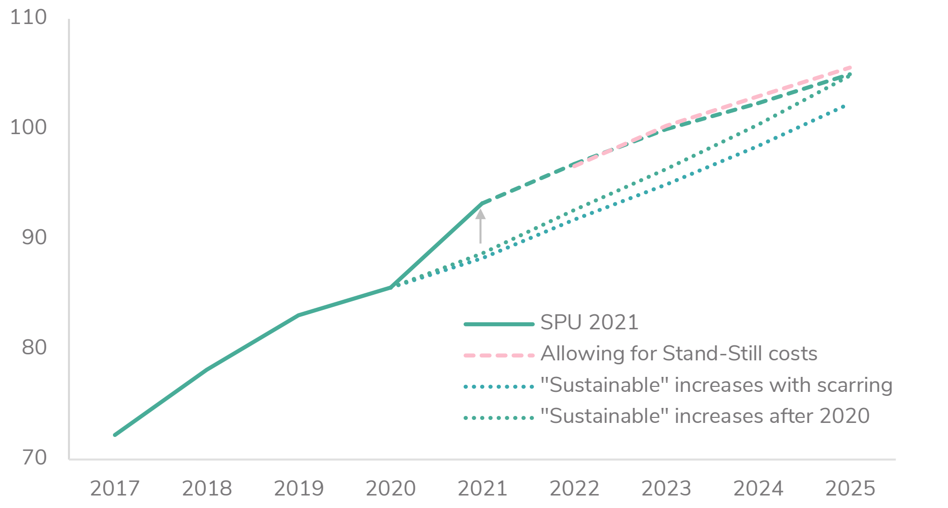
The Government's decision to continue exceptional temporary supports in 2021 was appropriate but large permanent increases were not prudent

[52] See the net policy spending increases for 2021 set out in Supporting Information S9.

The permanent increases in spending for 2021 have put policy spending on a much higher path. As Figure 3.3 shows, if these increases were compared to more sustainable increases in policy spending after 2020, in line with potential output and inflation, the gap in spending in 2021 would be about €4.6 billion; that is, a sustainable annual increase in spending would have been closer to €3 billion rather than the almost €8 billion actually committed.[53]

Figure 3.3: Permanent spending is being ramped up in 2021

€ billions, policy spending



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 path "allowing for Stand-Still costs" includes these estimated costs from 2022 on (see Section 2). Get the data.

The Council assessed that the permanent spending increases in *Budget 2021*—without a credible indication of how they will be financed sustainably—were not conducive to prudent economic and budgetary management.

Based on current projections, and taking into account the cost of providing existing public services, the public finances are on track for a deficit of 0.3 per cent of GNI* in 2025. However, as noted in Section 2, a more coherent adjusted baseline might imply a deficit of over €3 billion or 1.2 per cent of GNI* in 2025 based on the SPU's growth forecasts. An upside scenario to

[53] This assumes real potential output growth of about 2.5 per cent per annum, whereas scarring assumes lower "sustainable" growth of just 2 per cent per annum.

growth and a more benign reduction in corporation tax, in line with the Department's assumptions, would imply that the deficit still broadly closes by 2025 under current policies.

Had the permanent increases introduced in *Budget 2021* not taken place, the Government would be on track to achieve a small surplus by 2025. It means the space available to fund the commitments in the Programme for Government—without raising taxes or cutting other spending—was essentially already used up in *Budget 2021*. To ensure that a balanced budget is achieved by 2025, as *SPU 2021* projects, it is possible that the Government may need to either raise taxes or reduce spending. As noted in the May 2020 *Fiscal Assessment Report*, any required adjustment is likely to be very small compared to the consolidation after the 2008 crisis and could be implemented gradually during a period of strong growth.

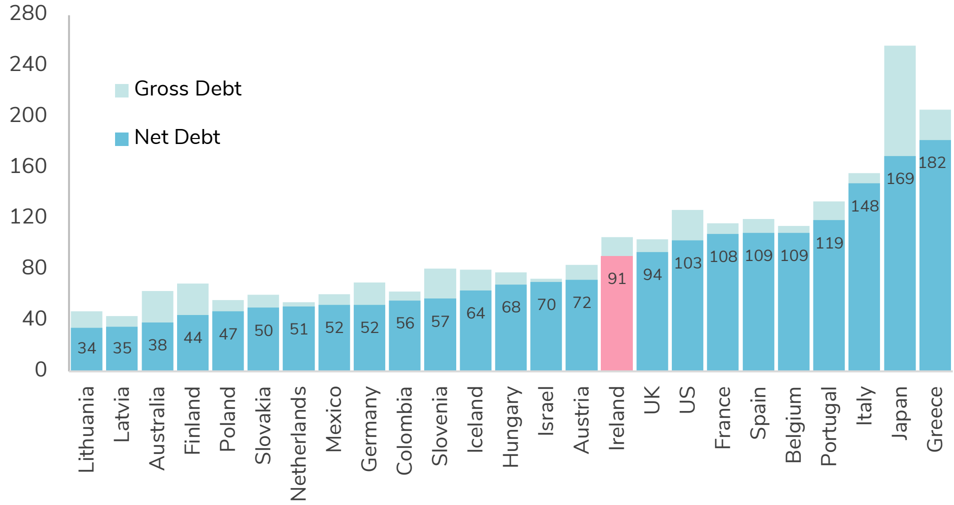
The permanent spending commitments made in 2021 leave debt at a higher level and the public finances more vulnerable than they otherwise would be to future adverse shocks. Sustainable revenue growth is also likely to be on a lower path in the coming years as a result of the Covid-19 crisis, Brexit and the possibly of further reductions in corporation tax receipts beyond what is assumed by the Department of Finance. The ability to use growth to finance higher spending will therefore be very limited and will not be compatible with growing net policy spending at the rates seen in previous years.

Ireland's government debt burden was already high going into the Covid crisis

Ireland's government debt burden was high going into the Covid crisis. At the end of 2020, the net debt burden was equivalent to 91 per cent when set against an appropriate measure of national income like GNI* (Figure 3.4). With other countries experiencing large pressures on their public finances amid the pandemic, however, Ireland's net debt ratio has fallen in relative terms. This places it as the tenth highest in the OECD, having previously been sixth highest at the end of 2019.

Figure 3.4: Ireland's debt ratio remains high, but others have also risen

Debt as % GDP (% GNI* for Ireland) at end-2020



Sources: CSO; Eurostat; IMF (Fiscal Monitor, Apr 2021); and Fiscal Council workings.
Notes: Net debt is gross debt of general government excluding assets held by the State in the form of currency and deposits; debt securities; and loans. The 60 per cent ceiling for government debt set out in the SGP is set in gross terms rather than in net terms. Net debt does not include the State's bank investments. Get the data.

The continued fiscal costs of Covid-19 are projected by the Department of Finance to lead Ireland's net debt ratio to a peak of 97.7 per cent of GNI* in 2021 before declining steadily.

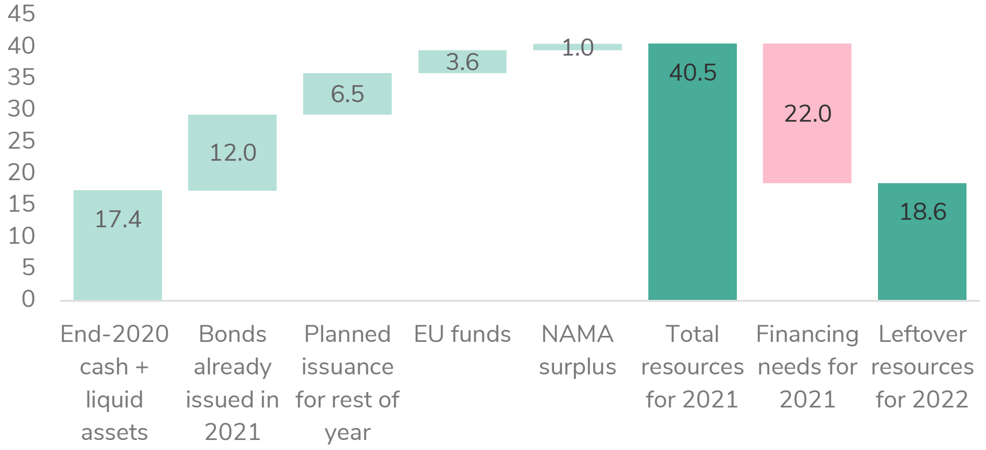
But the State has large resources on hand and interest rates are low

While the debt ratio is high and the deficit is large in 2021, the Government will have substantial resources of close to €40 billion to weather these pressures. Its funding requirements in 2021 are expected to amount to about €22 billion, mainly due to the large deficit. Repayments are otherwise small, including a €0.5 billion repayment in March for an outstanding UK loan dating back to the financial crisis. In terms of resources, the State had €17.4 billion of cash and liquid assets at the end of 2020 — more than had been planned at budget time. The Government has been able to borrow €12 billion so far this year by issuing benchmark bonds at very low rates and for relatively long durations. The issuance to date has attracted a weighted average yield of 0.14 per cent on average, with an average maturity of 14.6 years. The target bond funding range for the year is €16 to €20 billion. In addition, the State expects to receive €3.6 billion in EU funding (Box G) and €1 billion from a surplus generated by the National Asset Management Agency (NAMA).[54]

[54] The EU funding referred to for 2021 relates to an assumed €2.5 billion from the temporary "Support to mitigate Unemployment Risks in an Emergency" (SURE) funds; €0.9 billion from the Brexit Adjustment Reserve; and €0.2 billion from the Recovery and Resilience Fund.

Figure 3.5: The State will have large resources on hand

€ billions

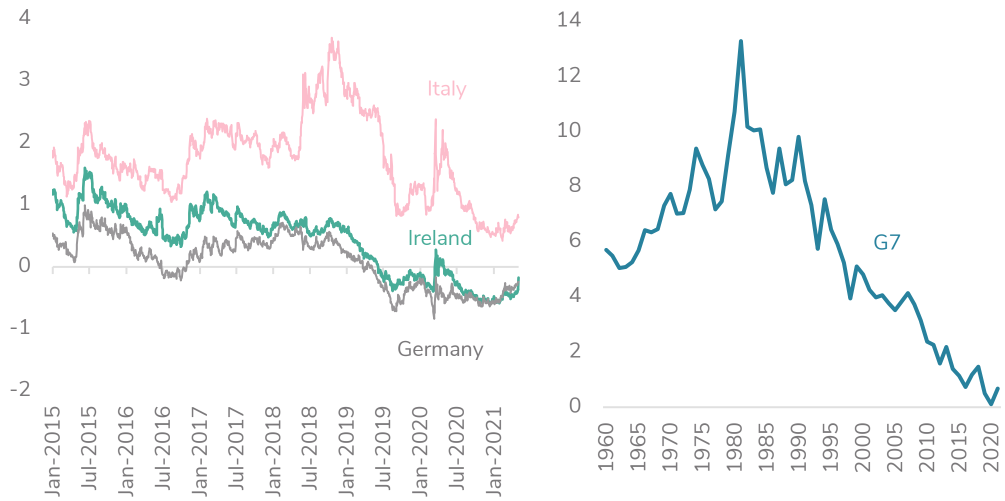


Sources: NTMA; Department of Finance; and Fiscal Council workings.
Notes: Financing needs are made up of the Exchequer balance, rollovers of existing medium- and long-term debt securities, and the cancellation of floating rate notes. Get the data.

Interest rates have remained low throughout the crisis, which has helped to reduce potential sustainability challenges (Figure 3.6). Two external factors are relevant here. First, interest rates have been kept low by accommodative monetary policy, including the ECB's interventions. Second, interest rates have been on a downward path for the past three decades. Ten-year bond yields for the G7 countries excluding Italy have fallen from approximately 13 per cent in the early 1980s to almost zero per cent in 2020. While interest rates picked up slightly of late, risks are mitigated by the large degree of fixed rate debt and long maturities (see Section 2 and S12).

Figure 3.6 Borrowing costs have fallen to historical lows

% yields (ten-year sovereign bonds)



Sources: Refinitiv Datastream; and Fiscal Council workings.
Notes: 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 meaning that data for all G7 countries are not available for all of the earlier years in the sample. Get the data.

Box G: EU Funds will add to the State's resources

Ireland is likely to avail of three key EU supports entailing a total impact of €4.4 billion. These supports were designed to assist Member States responses to the Covid crisis and Brexit. This box looks at how the funds are expected to impact Ireland's public finances. For a more general discussion of the supports, see Box C of the Council's *Pre-Budget 2021 Statement*.

Most of the receipts are expected to help funding in 2021, with spending spread over several years (see Table G1). Over time, it is expected that the EU programmes will likely lead to increased budget contributions that will offset the short-term benefits associated with the funding.

Table G1: 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.

The SURE programme provided €2.5 billion in lending

The largest single source of funds is the Support to mitigate Unemployment Risks in an Emergency (SURE) Instrument. Ireland drew down €2.5 billion under the SURE instrument in the first quarter of 2021. This amount was based on costs associated with the Temporary Wage Subsidy Scheme, which cost over €2.7 billion in 2020 before the scheme was replaced by the Employment Wage Subsidy Scheme.[55]

The general government accounting of SURE loans is relatively clear. Any expenditure associated with the SURE loans—subsidies in Ireland's case—would be treated as general government expenditure, while interest on the loans would be accounted as such. There is no general government revenue impact on receipt of funds. In other words, the spending increases the deficit without any revenue offset in the normal way.[56] This programme supports the financing of these amounts, substituting for market-issued debt.

[55] The SURE loans are raised on markets by the European Commission and allow Member States benefit from the EU's strong credit rating, low borrowing costs, and long-term financing (repaid no later than 2053). Member States back the loans with guarantees covering 25 per cent of total lending. Ireland's guarantee is €483 million (1.9% of EU-27 GNI). If a Member State did not meet its loan obligations, say a missed loan repayment, the Commission could call on guarantees pro-rata. Before doing so, however, the Commission is expected to draw on its own resources to some extent. For more detail, see Eurostat's note: https://ec.europa.eu/eurostat/documents/10186/10693286/Treatment_guarantees_MS_SURE_methodological_note.pdf

[56] The guarantees are treated as contingent liabilities. If called, they would be treated as general government expenditure (capital transfers), disimproving the deficit. Similarly, repayments would be treated as revenue (capital transfers), improving the deficit.

The Brexit Adjustment Reserve grants are expected to represent €1.1 billion in funding

The *SPU 2021* projections assume that the Brexit Adjustment Reserve will provide €1.1 billion in grant funding, mostly coming in 2021, then being spent entirely on capital spending in 2022. The amounts were not specified for any particular department.

Treatment of these amounts in general government terms is unclear at this stage. However, it seems likely that the expenditure associated with the funds would be treated as general government spending, with this being fully offset by general government revenue in the form of a capital transfer. This would therefore not impact the general government deficit or debt.

The Recovery and Resilience Facility (RRF) grants are assumed to provide €0.9 billion

The RRF is provided to mobilise investment and frontload financial support in the first years of the recovery from Covid-19. The *SPU 2021* projections assume that €0.9 billion of grant funding will be received and spent over the four years 2022–2025. Although there is an option to avail of loans under the facility as well, it is possible that Ireland will not do so. Eurostat has given preliminary guidance that the RRF grants will be deficit neutral. That is, they will not disimprove the deficit. This suggests that if there is any general government impact, such as an increase in public investment, this would be offset by a corresponding increase in revenue (capital transfer).[57]

[57] Eurostat's guidance: https://ec.europa.eu/eurostat/documents/10186/10693286/GFS-Draft-guidance-note-statistical-recording-recovery-resilience-facility.pdf

3.3 The Government's medium-term fiscal plans

Despite commitments to do so in the Programme for Government and in *Budget 2021*, the Government did not publish a credible medium-term budget strategy this spring. As well as being based on poorly founded medium-term spending forecasts, the *SPU* does not incorporate major policy commitments over the medium term.

The Government failed to meet its commitment to publish a credible medium-term strategy

The Programme for Government, first published in June 2020, stated "At *Budget 2021*, as we have greater clarity on the likely economic impact of the COVID-19 Emergency domestically and internationally, we will set out a medium-term roadmap detailing how Ireland will reduce the deficit and return to a broadly balanced budget." There was no such medium-term roadmap at budget time. The Minister's *Budget 2021* speech noted "My department will, therefore, publish an updated Medium-term Budgetary Strategy as part of the Stability Programme Update next year."

The SPU makes no mention of when a medium-term strategy will be published. However, the Minister noted in a subsequent Oireachtas appearance that "it is my aim to do a summer economic statement but if the SPU has taught me anything, it is how difficult it is to do that with all the uncertainty we are confronting at the moment". While uncertainties have been exceptionally high over the past year, the availability of multiple effective vaccines and the progress in rolling these out suggests that uncertainties have drastically reduced in recent months. It is essential that a credible strategy be set out in the coming months.

The Government fell short of achieving all the objectives the Council identified as pre-requisites to a credible medium-term plan. In addition to earlier recommendations, the Fiscal Council set out in its *December 2020 Fiscal Assessment Report* specific objectives that the forthcoming SPU should seek to achieve. Table 3.1 fleshes out these objectives and assesses the progress made.

While the SPU has introduced medium-term forecasts for the first time in over a year, the budgetary forecasts lack credibility. The spending forecasts are not realistic (see Chapter 2). They simply assume that current spending will rise by 3.5 per cent on average after 2021. The forecasts do not fully incorporate demographic pressures or the expected increases in prices of providing public services. Moreover, the Minister for Finance has admitted that actual spending is unlikely to be as slow as set out in the SPU.[58]

Table 3.1: The SPU makes limited progress towards a credible fiscal plan

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**

The unrealistically low current spending forecasts give no scope for new priorities to be met, while also maintaining core public spending. The forecast increase in annual spending set out in the SPU is broadly in line with the Council's estimated Stand-Still costs for 2022 and 2023. However, in 2024 and 2025, it falls short of these costs by about €600 million each year. This suggests real cuts to welfare, public sector pay or other core

The Government's medium-term spending forecasts are unrealistic and give no scope for new priorities

[58] Responding to questions on the pace of core spending growth—which is technically assumed at 3.5 per cent on average over the medium-term—in a meeting of the Committee on Budgetary Oversight, and in the context of future policy decisions, the Minister noted: "I expect it will be higher than 3.5% but how much higher it will be depends on two factors, the first of which is the decisions the Government makes over time in the management of the Covid levels of expenditure we have. Second, it depends on the Estimates process and the work the Minister for Finance, Public Expenditure and Reform does. That work is yet to be done but I expect it will be higher than 3.5%".

spending as the pace of spending increase is likely to fall short of what is required by rising prices and demographic pressures.

The Government has not set out how major policy plans, such as the Sláintecare reforms and other policies set out in the Programme for Government, are expected to be implemented and funded in the future. The Sláintecare reforms represent a large programme of reforms to how health care is provided in Ireland. This will involve reducing private payments in favour of more universal, taxpayer-funded care. Up until the publication of the *Sláintecare Implementation Strategy & Action Plan 2021–2023* earlier this month, it was not clear how much of the increase in health spending set out for 2021 would go towards Sláintecare reform. The Review notes that €1.2 billion of the health allocation set out in *Budget 2021* for this year will now go some way to "advance the implementation of Sláintecare". This was not clear from the Expenditure Report that accompanied *Budget 2021*. Furthermore, the Government has not provided any updated estimates of the overall costs of implementing Sláintecare with the plans published. As such, there are no clear, updated estimates of how much funding would be needed for Sláintecare beyond this year. The most recent public estimates date from an Oireachtas report published in 2017. This is a serious information gap in terms of how spending is likely to evolve in the coming years and in terms of major policy commitments.

There is limited detail on new revenue-raising measures and other policies in the SPU. Major decisions on tax, welfare and pensions have been effectively postponed. The Government is unlikely to make decisions until such time as the Commission on Pensions reports by June 2021, while the newly established Commission on Taxation and Welfare reports by July 2022 and so will shape decisions only from 2023 onwards. The work of both commissions is welcome and could contribute to long-term reforms that underpin fiscal sustainability. However, it will be necessary for measures to be implemented once the Commissions have reported.

The Commission on Taxation and Welfare is tasked with considering how Ireland's tax and welfare systems can best support the economy while ensuring there are sufficient resources to fund public services. The Commission's terms of reference are expansive. They include examining how the tax system can be modernised, how it can help decarbonisation, and how well public health is promoted, as well as considering NESC's

(2020) detailed assessment of Ireland's social welfare system. The NESC Report sets out numerous proposals for enhancing social spending (establishing a group to advise on indexing payments, expanding activation supports), alongside funding proposals that include increasing PRSI contributions, digital, capital and property taxes; limiting tax exemptions; imposing caps on tax expenditures; and introducing more income tax rates.

The Government has ruled out tax increases and spending reductions across large parts of its tax base and existing spending areas. The Programme for Government committed to no changes for a third of overall taxation. 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. PRSI rates have not been increased in several decades. On spending, the Government commits to protecting welfare and capital spending — close to half of all general government spending. There are no clear commitments to reduce other areas of existing spending, including by efficiency measures.

More generally, questions about how Ireland's budgets will be framed in future have not been addressed in the SPU. This includes questions about how the rules would be complied with once the pandemic risks diminish and the normal application of the rules resumes. As Section 4 notes, the preventive-arm rules are likely to apply in 2023. This could entail required improvements in Ireland's structural deficit by 0.5 per cent of GDP each year (approximately €2 billion) until any underlying deficit is effectively closed.

The Government has failed to set out any medium-term targets or anchors for its budget policy. The SPU projections do not include any commitment by the Government to achieve the pace of spending growth, the deficits or the debt ratios set out in the document. The domestic spending ceilings also continue to be weakly applied (see Section 4).

The absence of any fiscal targets leaves the public finances unanchored

The absence of fiscal targets leaves the public finances unanchored. Without knowing what the Government's actual targets are for key measures such as the pace of spending growth net of new tax-raising measures, the public finances are at risk of very different outcomes compared to what is projected. It is possible that, as in recent years, additional permanent spending increases will be funded by further borrowing or by fragile revenue sources such as corporation tax receipts.

The Government needs to set out a credible medium-term strategy; this is both essential and long overdue. The Government's strategy should meet the basic objectives set out by the Council. It should provide a clear plan for how competing pressures can be achieved. These include higher pension spending, measures to address climate change, a reduced reliance on corporation tax reliance and other ambitions in the Programme for Government.

The Government needs to set out a credible medium-term strategy; this is both essential and long overdue

The Government can introduce three initiatives to reinforce its budgeting in the coming years: debt targets, a reformed Rainy Day Fund and spending limits (Figure 3.7). These would help to put the public finances on a sound footing.

Debt targets would be a helpful approach given the high level of debt. A clear and achievable target for the end of the current parliament would be helpful, together with a clear plan of how to achieve it. This should be set in net terms and set relative to GNI*. Debt targets have been introduced twice in the past decade, but these lacked a legislative basis and political commitment. This led to them being quickly abandoned or forgotten.

Recommencing the use of the Rainy Day Fund from 2023 on should be considered so as to set aside positive surprises in corporation tax receipts relative to the current profile assumed by the Department. The Department assumes a loss of receipts as the result of international tax developments. Using the Rainy Day Fund in this manner would help to ensure that the overreliance on fragile corporation tax receipts to fund ongoing spending is not allowed to continue. Given that the timing is uncertain, gradually withdrawing this revenue from supporting spending would ease the transition. Better-than-expected outturns in the early years may signal that the adjustment will come later rather than that it will not happen. The Rainy Day Fund was first proposed in 2016. It was intended that €1 billion would be set aside every year starting in 2019 to build up a safety buffer. However, the planned allocations were first scaled back and then abandoned as a disorderly Brexit formed the backdrop to *Budget 2020*.[59]

[59] A transfer of €1.5 billion of cash assets from one arm of the State (the Irish Strategic Investment Fund) to another (the Rainy Day Fund) did take place. However, annual savings as originally intended did not take place (see Box B of the November 2019 Fiscal Assessment Report for more detail).

Figure 3.7: Three initiatives could improve Ireland's budgeting

Debt Targets

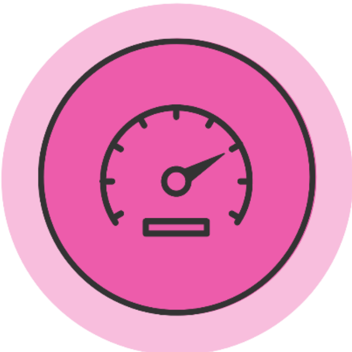
Debt targets can act as transparent medium-term benchmarks to help guide policy when debt ratios are very high. They should:

(1) be set as % modified GNI*,
(2) have clear timeframes, such as annual targets,
(3) be set as a steady-state target, and
(4) be less than EU 60% limits, given Ireland's volatility.

Rainy Day Fund reforms

The Government should adjust the Rainy Day Fund in four ways to help prevent any disappearance of temporary revenues from leading to a sudden lack of funding for public supports that requires large borrowing.

1) Remove €8 billion cap
2) Make allocations flexible to economic cycle
3) Clarify how drawdowns would work under fiscal rules
4) Use Prudence Account to save unexpected corporation tax



Spending Limits

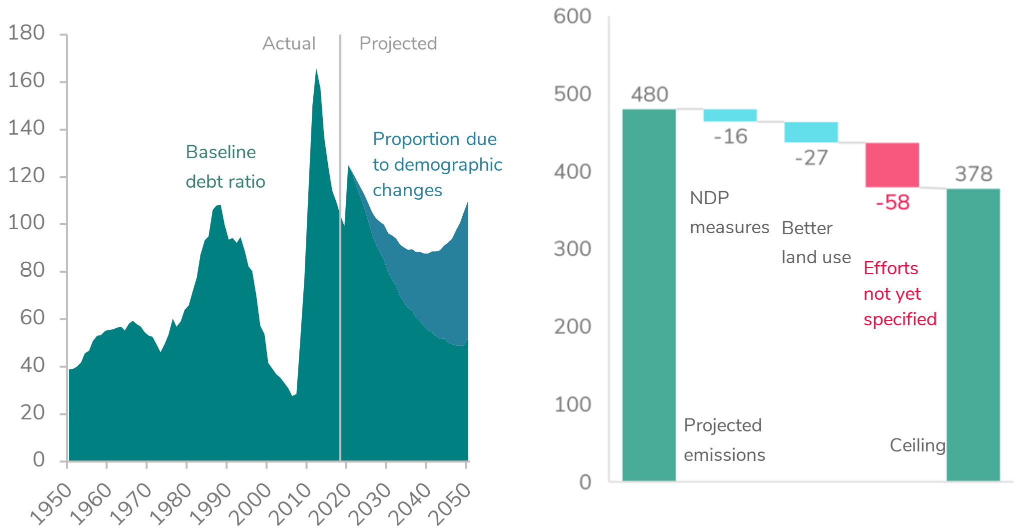
Governments need a sustainable anchor for net spending growth when in steady state and when there is a balanced budget in structural terms. The limits should:

1) use alternative estimates of potential output growth
2) allow further increases with revenue-raising measures
3) incorporate realistic bottom-up forecasts of price and demographic pressures on spending

Ireland's population is rapidly ageing

Ireland's population is rapidly ageing putting pressure on pensions and health spending. The growing number of pension recipients was estimated to add some €370 million annually to pension costs on average over 2021 to 2025. This was before a legislated-for increase in Ireland's pension age to 67 this January was deferred pending the review by the Pensions Commission. The deferral is estimated to raise annual expenditure by some €575 million in 2021, with costs rising over time. Increases in average payments to allow for price increases in the economy would push this upwards. Under current policies, combined spending on pensions and healthcare is projected to increase from 13.3 per cent of GNI* in 2019 to almost 25 per cent in 2050, with costs rising more rapidly after 2030.[60] Ageing will also lead to a shrinking labour force, while productivity growth rates are likely to moderate further in future as labour productivity converges on international regions with already high levels of productivity.

Figure 3.8: Demographics and climate change pressures will add to deficits



Sources: Fiscal Council (2020b); Climate Action Plan 2019.
Note: The first panel shows gross debt, with the blue shaded region indicating the estimated proportion of the baseline debt ratio that can be attributed to an ageing population relative to 2020 demographics. The second panel is from the Climate Action Plan 2019. 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. Get the data.

Transitioning to a low-carbon economy will also have substantial costs. 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. However, it may also carry costs for both growth and the public finances as firms transition to new technologies. Additional efforts will be required to achieve the 2030 ceiling for levels of greenhouse gas emissions (Figure 3.8 and Box E). As with other long-term fiscal challenges, delaying adjustment would ultimately prove more costly.

Transitioning to a low-carbon economy will also have costs

By continuing its current piecemeal approach towards developing credible plans, the Government is not providing realistic guidance to the public and is

By continuing its current piecemeal approach towards developing real plans, the Government is not providing realistic guidance

[60] The projections assume that service levels remain constant and that social payments (such as pensions) rise in line with wages. See the Fiscal Council's (2020) Long-term Sustainability Report for more detail.

increasing the risks that things could go wrong. There are clear risks to the forecasts: spending is very likely to grow at a faster pace than is shown, and the overreliance on corporation tax to fund ongoing spending looks set to continue. Setting clear objectives and reinforcing the domestic fiscal framework would mitigate these risks.

Debt is likely to fall but at a slower pace than before the crisis

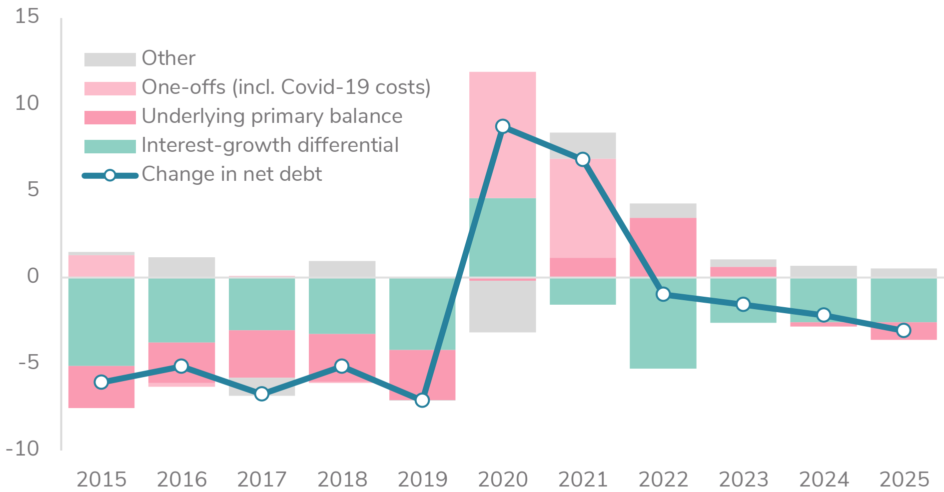
The SPU projections show a pace of net spending growth that is sufficient to close the deficit and have the net debt ratio falling at an annual pace of 3 percentage points of GNI* by 2025. This is similar to the path set out in pre-Covid forecasts, but slower than seen in the years before the crisis.

As Figure 3.9 shows, this debt reduction would rely more heavily on a favourable interest-growth differential than on the primary surplus. If current spending increases were in line with the Council's estimated stand-still costs, the pace of net debt reduction would slow by 0.3 percentage points in 2024 and 2025. It is also likely that growth will slow in the coming years as the population ages and as the economy converges on productivity growth rates consistent with economies that already have high productivity levels. This would tend to slow debt reduction.

Ireland's net debt ratios are projected to fall at a steady pace, but this would slow if spending rises more quickly

Figure 3.9: Net debt ratios expected to fall as Covid spending unwinds

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



Sources: CSO; Department of Finance forecasts (SPU 2021); and Fiscal Council workings. Get the data.

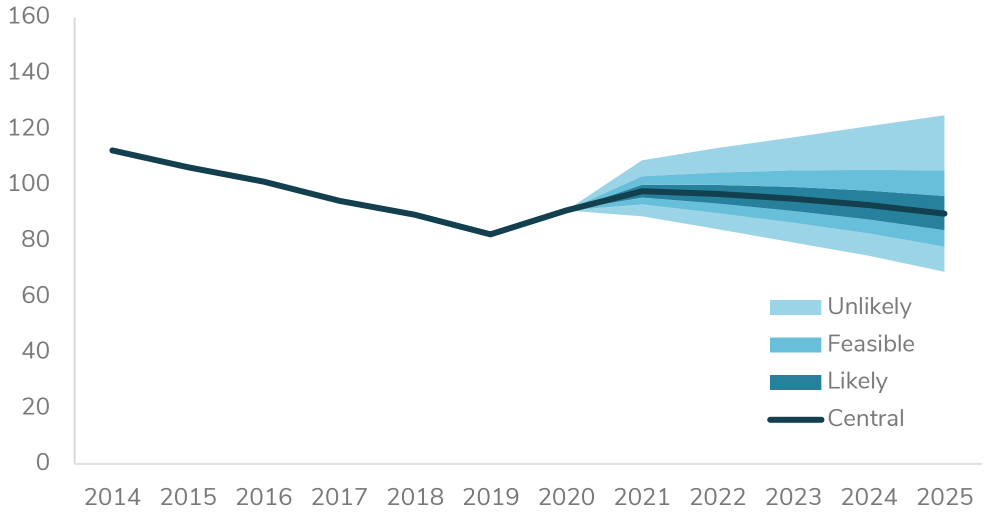
As it stands, the technical projections set out in the SPU indicate that the net debt ratio would fall with a significantly high probability. Estimates from the Council's Maq model suggest it is unlikely that net debt ratios will rise again over the next four years, though there are wide uncertainties around the path for the debt ratio (Figure 3.8).

Higher debt levels magnify the uncertainties for the debt path

Higher debt levels magnify the uncertainties for the debt path, which is a key reason to bring the debt ratio to a safer level. The sensitivity to swings in growth and interest rates increases when debt ratios are at higher levels. As Barnes, Casey and Jordan-Doak (2021) show, this increases the overall risk of instability. Mitigating this risk is the fact that the bulk of Ireland's government debt attracts fixed interest rates at long maturities. However, creditworthiness is not guaranteed. There are risks that borrowing costs could rise in future. Past experience, including in the aftermath of the 2008 financial crisis, highlights how market assessments of creditworthiness can change suddenly. This risk could be more acute in cases of shocks that are unique to Ireland in terms of their impact. Such shocks might not see increased ECB support to the same extent that Covid-19 has.

Figure 3.10: There is wide uncertainty around the path for public debt

% GNI*, net general government debt



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. Get the data.

One challenge is knowing what level of debt is safe or sustainable, taking into account risks and also long-term fiscal pressures. On the debt side, research by Blanchard, Leandro and Zettelmeyer (2021) suggests looking at the probability of the primary balance being insufficient to stabilise the debt ratio. As the analysis in Box H suggests, there is a 15–20 per cent probability, on the current path, that this instability would occur. While this is not alarming, it suggests that the risks are non-negligible and that it is important to reduce these vulnerabilities.

Box H: Irish debt fares reasonably well on a "fiscal standards" assessment

This Box explores recent proposals by Blanchard, Leandro and Zettelmeyer (2021) to redesign the EU fiscal rules. Their proposal has generated significant debate and attention in the context of discussions as to how the rules might be reformed. Their proposal entails abandoning fiscal rules in favour of fiscal standards. The fiscal standards they envisage would see the rules replaced with qualitative prescriptions, more room left for judgement, and a process to decide whether the standards are met or not. Using the Fiscal Council's macro-fiscal model, the Maq (Casey and Purdue, 2021), this box explores how these standards might be applied to the official forecasts for Ireland.

How to apply fiscal standards

The primary tool proposed to assess fiscal standards is "stochastic debt sustainability analysis" – a way to model multiple debt paths with different probabilities attached to each path. The basic idea is to:

1. Generate a distribution of paths for debt. This distribution takes into account a government's policy plans and the interactions between growth and fiscal policies. The main focus is on the paths for the primary balance and the debt-stabilising primary balance.

2. Use the paths generated to assess the probability that the debt-stabilising primary balance exceeds the actual primary balance. The debt-stabilising primary balance is the budget balance excluding interest costs that is sufficient to prevent the debt ratio from rising from existing levels.[61] If the actual primary balance is above this debt-stabilising level, this would indicate risks to debt sustainability. If the probability were low (with the example given of less than 5 per cent), then the fiscal standard is satisfied. If higher, the country would need to adjust its policies to achieve debt sustainability.[62]

Applying the standards and stochastic debt sustainability analysis to Ireland

We can use the Maq model to estimate debt paths with various probabilities. These estimates are based on the official *SPU 2021* forecasts and allow for the complex interactions between macro-fiscal variables as well as using detailed information on individual debt securities issued by the State. As with any analysis of this sort, it relies on the central forecasts being reasonably unbiased and realistic. The probabilistic debt paths are generated within the model.

The results suggest that there is a 15 to 20 per cent risk of being on an unsustainable debt path by 2025 under the policies set out in *SPU 2021* (Figure H1).

This probability would fail the indicative fiscal standards set out by Blanchard, Leandro and Zettelmeyer (2021). Their standards consider keeping the probability of being on an unsustainable debt path to below 5 per cent. In this context, and with the policy stance set out in SPU 2021, this would be consistent with gross debt ratios at least as high as 120 per cent of GNI*. The standards would therefore suggest that Ireland would need to adjust its budgetary policies, with the speed of adjustment depending on the risks to sustainability, the state of the economic cycle, and the capacity of monetary policy to offset the contractionary impact of adjustment on the EU as a whole.

Importantly, however, as Blanchard, Leandro and Zettelmeyer (2021) note, a violation of the fiscal standard would generally not imply that debt is unsustainable, only that fiscal adjustment is required to achieve a high probability of debt sustainability. This is a crucial point. While there is a

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[61] The debt-stabilising primary balance is given as: $PB_t = D_{t-1}(\frac{i_t - g_t}{1+g_t})$ where PB is the primary balance, D the debt ratio, i the effective interest rate on debt, and g the nominal growth rate.

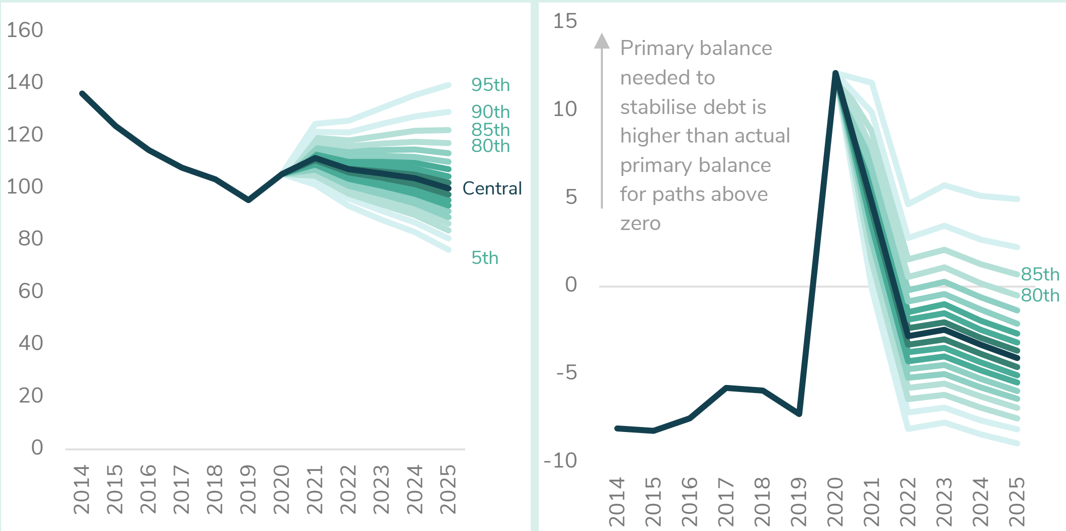
[62] The speed of adjustment would depend on the risks to sustainability, the state of the economic cycle, and the capacity of monetary policy to offset the contractionary impact of adjustment on the European Union as a whole.

higher probability estimated for Ireland ending up on an unsustainable path than is required by the fiscal standards, it may not necessarily be high enough to warrant a much tighter fiscal policy in the immediate period after the Covid crisis. An appropriate fiscal stance would take into account the wider context, including the need to return the economy to near full employment, which would also reinforce debt sustainability.

Figure H1: Reasonably low risk of debt being unsustainable

Gross debt as % of GNI*

Gap between debt-stabilising primary balance and actual primary balance (p.p. of GNI*)



Sources: Fiscal Council workings based on Department of Finance (*SPU 2021*) forecasts.
Notes: Each line shows a path for debt dynamics at various percentiles. The "Central" line represents the official *SPU 2021* forecasts.

The fiscal stance in the coming years

The deficit is most likely going to close to a large extent in the coming years. This would be likely to happen with no need for large-scale fiscal adjustment or for much wider stimulus measures beyond those already set out. If Covid-19 disruptions are largely addressed by the vaccine and other measures, the economy should recover swiftly in 2021, and the economy should resume growth at a healthy pace. This would tend to close much of the deficit. However, some permanent structural deficit could remain as indicated by the Council's "adjusted" SPU projections (Section 2).

If the SPU proves accurate, the economy should recover, the deficit should close and the need for a large-scale, untargeted stimulus would be weaker

Most of the gap between the economy's actual level of activity and its potential is expected to be closed by next year. That is, overall activity in terms of output and spending in the economy would be expected to return to levels in line with medium-term potential. However, unemployment would be slower to recover, with the Department forecasting it at about 7 per cent by end-2022 and only recovering to low levels of about 5½ per cent by mid-2025. In fiscal terms, this means that taxes would likely recover more quickly as sectors with higher incomes rebound and as consumer spending picks up. As Box I shows the structural deficit—looking through temporary costs associated with the crisis—is likely to remain small in the coming years.

What does this mean in terms of the need for additional stimulus? If the path for the economy set out in the SPU turns out to be accurate, this suggests that the need for additional, large-scale, untargeted stimulus beyond 2021 would be weaker during the recovery phase. Indeed, public investment rates in Ireland are already set to climb to very high levels by international and historical standards. This ramp-up in capital spending might be difficult to achieve, as noted in Section 2, but it would be expected to help the recovery and potentially raise the medium-term growth rate of the economy.

Instead, the Government should consider a more targeted approach in 2022, when the pandemic's impacts wane. This approach would be careful to provide support where it remains needed, either for firms experiencing longer lasting effects of the crisis or requiring support to shift to new activities. It might also see the Government ensuring that the return to work for the unemployed is eased as much as possible through provision for activation measures and retraining supports. This would see overall public spending to support the economy reduce significantly in 2022.

The Government should consider a more targeted approach, calibrating this based on how the recovery evolves

The priority for now should be to support the recovery. In later years, it is not likely that further stimulus would be required. Once the economy has recovered and is growing at a good pace, close to its potential of 2.5 to 3.5 per cent per annum, modest or no fiscal adjustments are likely to be needed. Any adjustments that might be required would help to ensure that debt ratios return to safer levels at a steady pace, close to the 3 percentage points of GNI* annually that is set out in the *SPU* for 2025.

Adjustments to close a structural deficit could be avoided but this depends on policies for 2022 onwards and the economy's medium-term growth path. If the Government revises up the pace of spending planned over the medium term or if the economy finds itself on a slower growth path in future, debt levels could remain stagnant at high levels. Some fiscal adjustment may therefore be warranted to return debt to safer levels. This would ensure that the Government could respond to future crises in the way that it has been able to respond to Covid: by supporting the economy when it is weak.

The Government's response should be calibrated based on how the recovery evolves. Further stimulus might be warranted should the recovery falter or should other risks emerge, such as if vaccines were to prove ineffective over time. However, the extent and nature of any fiscal adjustment—upon the economy having recovered to a steady state—should be guided by credible medium-term fiscal plans.

Box I: A bottom-up assessment of Ireland's structural primary balance

This box outlines an alternative, bottom-up approach to estimating Ireland's structural balance. The standard approach used by the Department of Finance and others, including the European Commission, relies heavily on the accuracy of two things: the output gap and a "top down" estimate of the relationship between the deficit and the output gap.

While the Council has undertaken considerable work in recent years to better assess Ireland's cycle (Casey, 2019) and its relationship with spending and revenue (Carroll, 2019), there is more scope to better understand how the structural balance is performing.

An alternative bottom-up approach can prove useful. This can be especially true when output gap estimates are prone to more error than usual, such as in times of significant economic change or when the public finances have been temporarily affected in ways that might not be captured by the usually assumed relationship. While the "top down" method leaves residual errors in the structural balance, it is less clear that this will be the case in the "bottom up" method.

Structural revenue

To start with a bottom-up assessment, we consider what level of revenue would have been expected if the economy remained at its potential. To estimate structural revenue, revenue in 2019 is taken as a starting point. For 2019, the Department of Finance estimate that the output gap was approximately zero. As a result, a reasonable assumption is that in 2019, structural revenue equals actual revenue. At this point, general government revenue was approximately 41.7 per cent of GNI*.

Using an assumption that structural revenue grows in line with potential output growth, we can project forward sustainable revenue.[63] This sustainable revenue figure is then adjusted up or down based on new discretionary revenue measures introduced by the Department.[64] For instance, if the Government implements a tax cut, this revenue share of potential GNI* is adjusted down by the corresponding fiscal cost of the tax cut.

[63] Here we assume a constant medium-term growth rate of real potential output of 2.5 per cent over the medium-term, 2021-2025. This assumption is based on a combination of mechanical estimates and judgement. It is also assumed that prices grow in line with the Department's GNI* deflator for 2021-2025.

[64] This figure is also adjusted down based on the Department's assumptions around corporation tax receipts. The Department assume a loss in corporation tax receipts of €500 million each year from 2022-2025 as a result of the BEPS reforms (See Box F for details).

This bottom-up estimate of structural revenue is shown in Figure I.1A. In 2020, actual revenue fell below structural revenue by €4.3 billion. However, as the economy recovers over the medium-term, actual revenue converges towards the structural revenue estimate.

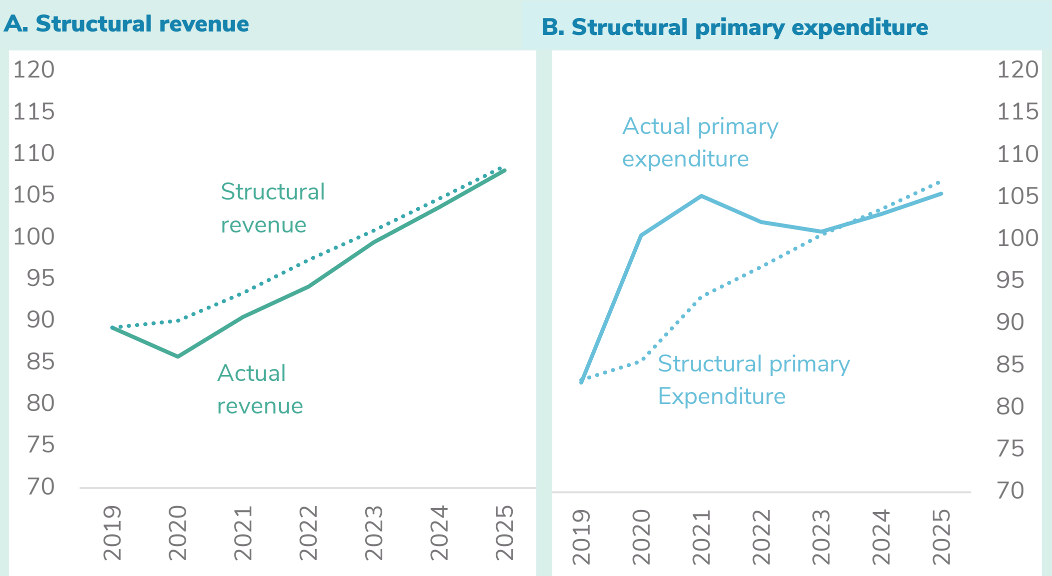
Structural expenditure

To arrive at a structural primary expenditure figure, all one-offs and temporary measures, and interest expenditure are excluded. The Council's estimates of Stand-Still costs —the cost of maintaining current policies into the future—are then incorporated into the expenditure figures (see supporting information section S11).[65] It is then assumed that unemployment-related expenditure is the only cyclical element of government spending. The estimate for cyclical unemployment expenditure used here is the same as the estimate used in constructing the measure "net policy spending" (see Supporting Information Section S9).

As shown in Figure I.1B, in 2019, there was only a minimal gap between structural primary expenditure and actual primary expenditure. As a result of the pandemic, a large gap opened up between structural primary expenditure and actual primary expenditure, with a €14.9 billion difference in 2020. This gap is forecast to fall slightly to €12 billion in 2021, and with the unemployment rate forecast to be 6.7 per cent by 2023, this gap is largely closed. Structural primary expenditure rises above actual primary expenditure in 2024 and 2025 as the Government's forecasts for actual expenditure do not fully incorporate the costs of current policies.

Figure I.1: Bottom-up structural revenue and expenditure

€ billion



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Structural primary expenditure = Actual expenditure – One-offs – Cyclical unemployment expenditure – intere costs + additional Stand-Still costs. Get the data.

The bottom-up structural balance

Figure I.2 shows the budget balance that arises from combining the bottom-up approaches for structural revenue and structural primary expenditure after forecast interest costs are added back in. The structural balance was 0.5 per cent of GNI* in 2020. A large deterioration occurred in 2021, with the structural balance falling to -1.5 per cent of GNI*, largely as a result of a €7.7 billion increase in permanent expenditure, included in *Budget 2021*. For comparison, the standard, top-down approach to estimating the structural balance is shown in pink. This estimate shows an implausibly large deterioration in the structural balance of 3.2 percentage points in 2020. Taking

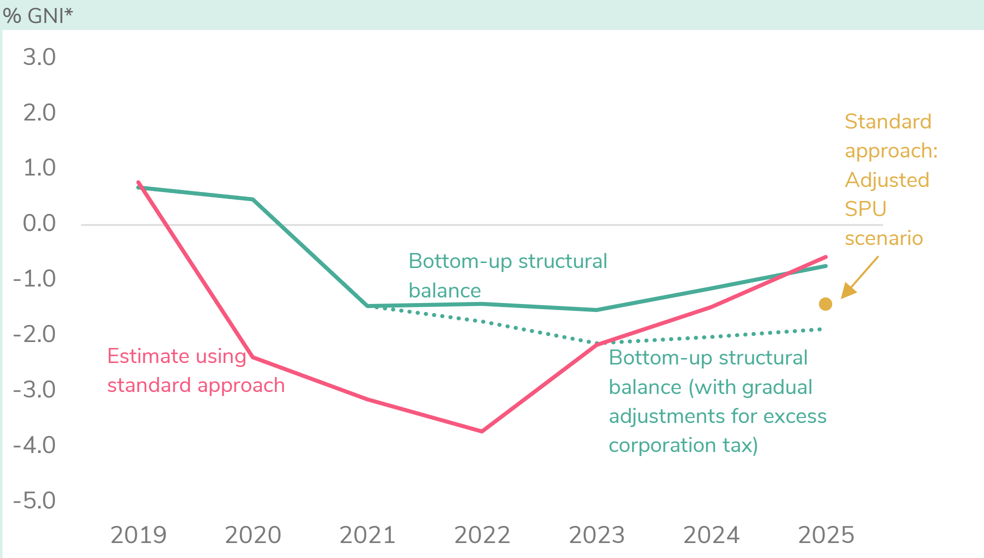
[65] More specifically, where the Department's forecasts of spending do not cover Stand-Still costs fully, these additional costs are added on to the forecast expenditure figures.

the Council's adjusted SPU scenario (See Table 2.3), and applying the top-down approach, the structural deficit in 2025 is 1.4 per cent of GNI*, 0.8 percentage points worse than the SPU forecasts suggest.

However, one factor that has recently flattered the picture for the structural balance is the corporation tax receipts that are largely unexplained by domestic economic activity, and as a result, may ultimately prove transitory (see Section S10). To account for this, we phase in downward adjustments to the structural balance in line with the Council's central estimate of excess corporation tax of €4.8 billion.[66] The dashed line in Figure I.2 shows the structural balance that incorporates the reduction of this excess corporation tax. In this case the structural balance is largely unchanged from 2023-2025 at around -1.9 per cent of GNI*.

The Council believes this bottom-up approach to the structural primary balance is a more accurate reflection of the structural position of the State's finances and can provide a better steer on the fiscal stance. Going forward, the Council will continue to develop and refine this approach.

Figure I.2: Bottom-up structural balance



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. Get the data.

[66] The phasing in of this adjustment is assumed to take place gradually and equally over the period 2022–2025. That is the same time period over which the Department assumes that corporation tax receipts fall by €2 billion due to changes in the international tax environment. As the bottom-up structural balance already incorporates a €2 billion adjustment, the additional adjustment applied here is €2.8 billion.