# Fiscal Assessment Report

May 2021

Looking beyond Covid-19

Irish Fiscal Advisory Council

# Foreword

The Irish Fiscal Advisory Council was established as part of wider reforms of Ireland's budgetary architecture. It was 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, with the terms of its funding set out in the Fiscal Responsibility Act.

The Council's mandate 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 Government's fiscal stance set out 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 Prof. Michael McMahon (Professor of Macroeconomics at the University of Oxford and Senior Research Fellow of St Hugh's College), Ms Dawn Holland (Visiting Fellow, National Institute of Economic and Social Research), Dr Adele Bergin (Economic and Social Research Institute), and Mr Alessandro Giustiniani. 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 would also like to thank Máire O' Dwyer for copy editing the report.

The Council submits its Fiscal Assessment Reports to the Minister for Finance and within ten days releases them publicly. This report was finalised on 21 May 2021. More information on the Irish Fiscal Advisory Council can be found at www.FiscalCouncil.ie.


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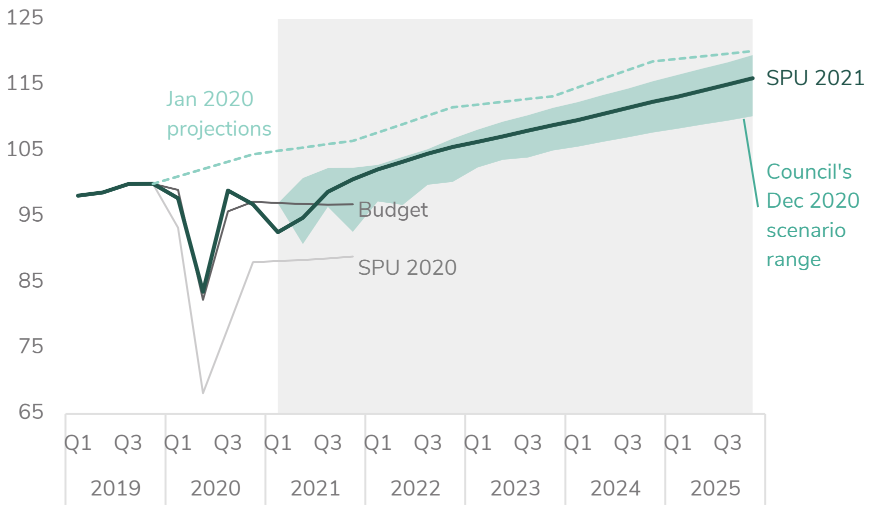
## Summary assessment

### Macroeconomic assessment

- **The economy is set to bounce-back as Covid restrictions ease.** While the pandemic continues to have major impacts, the economy has proven more resilient to repeat waves. Short-term uncertainties have subsided. There is optimism that the rollout of multiple vaccines will lead to a sharp rebound in activity this year.

**Official forecasts imply strong initial recovery but significant scarring**

Real underlying domestic demand, Q4 2019 = 100




Sources: CSO; Department of Finance; and Fiscal Council.
Notes: The scenario range is from the Council's *December 2020 Fiscal Assessment Report* extension of *Budget 2021* forecasts, encompassing "Milder" and "Repeat Waves" scenarios. The "Jan 2020" projections are based on the Department of Finance's modified domestic demand forecasts published in January 2020.

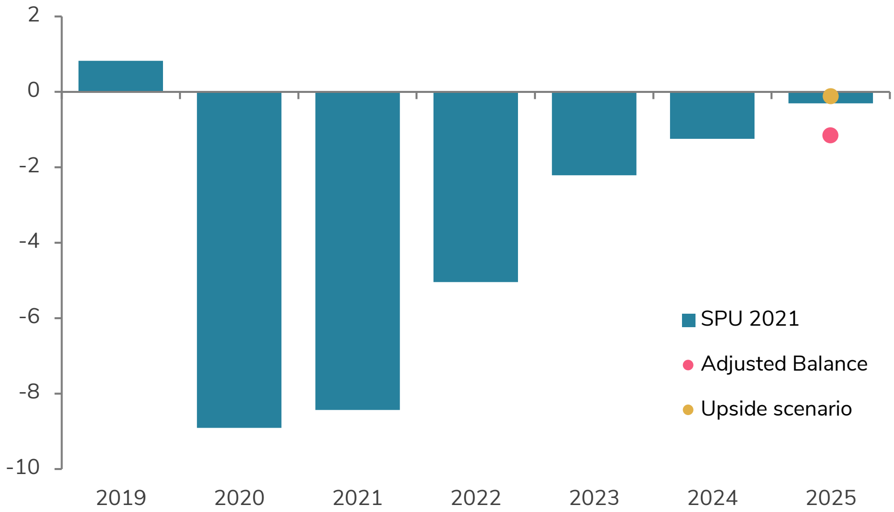
- **The Council assesses that the risks to growth are balanced.** The Government's official Stability Programme Update (SPU) forecasts assume a permanent loss, or "scarring", of around 5 per cent of output due to the pandemic. Yet there is considerable upside potential to the Department's relatively cautious assumptions. Better-performing sectors may be able to pick up the slack more quickly than is projected. In the short term, imports might offset growth less, and the unwinding of savings could significantly boost consumer spending. As a result, long-term scarring could be lower than is assumed. Against that, there are risks that virus mutations could necessitate further lockdowns, that international tax reforms would reduce foreign direct investment, and that Brexit's adverse impacts could be larger than assumed.

## Budgetary assessment

- **The Government forecasts a deficit of 8.4 per cent of modified Gross National Income (GNI*) in 2021, with its contingencies likely to be largely exhausted.** Covid-related spending and sharp increases in core spending will see the Government run a large deficit this year once again. The €5.4 billion of contingency funding set out in *Budget 2021* for this year looks likely to be fully utilised, mainly to cover extensions to income supports, such as the Pandemic Unemployment Payment and the wage subsidy scheme.

**Official forecasts imply deficit shrinking over the forecast horizon**

% 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. and less corporation tax losses (see Section 2.3).

- **The ending of temporary measures and the economic recovery will reduce the deficit in the years ahead.** This reflects the anticipated ending of temporary supports and the positive effect of the economic recovery. The Government expects the deficit ratio to narrow to 5 per cent in 2022 and to 0.3 per cent by 2025.

- **However, the Government's medium-term forecasts are poorly founded.** The *SPU 2021* medium-term spending projections are based on technical assumptions that do not reflect the full cost of providing core spending commitments. They also show income tax receipts growing unrealistically fast relative to incomes. This is not consistent with the *Programme for Government* plans to index the tax system, which would reduce growth in income tax receipts. Furthermore, details about the costs of other policies, such as the implementation of Sláintecare's major healthcare reforms, have not been provided beyond this year.

- **The Council assesses that a more coherent adjusted baseline would be for a deficit of over €3 billion or 1.2 per cent of GNI* in 2025 based on the *SPU*'s growth forecasts.** The *SPU* projects a deficit of €0.8 billion or 0.3 per cent of GNI* for 2025. However, more realistic projections would suggest a larger deficit is probable. Yet an upside scenario would imply that the deficit could still close by 2025 under current policies.

- **There are significant risks to spending forecasts and tax receipts, most notably corporation tax.** The Government's overreliance on corporation tax receipts has grown and receipts have become more concentrated. Just ten corporate groups accounted for 56 per cent of all corporation tax receipts last year. Major changes to the global tax environment could have significant impacts. The *SPU* assumes a gradual €2 billion reduction in corporation tax receipts as a result. However, the impact could be swifter and greater than this. A scenario considered in this report shows how just five firms exiting Ireland could result in €3 billion of lost corporation tax receipts.

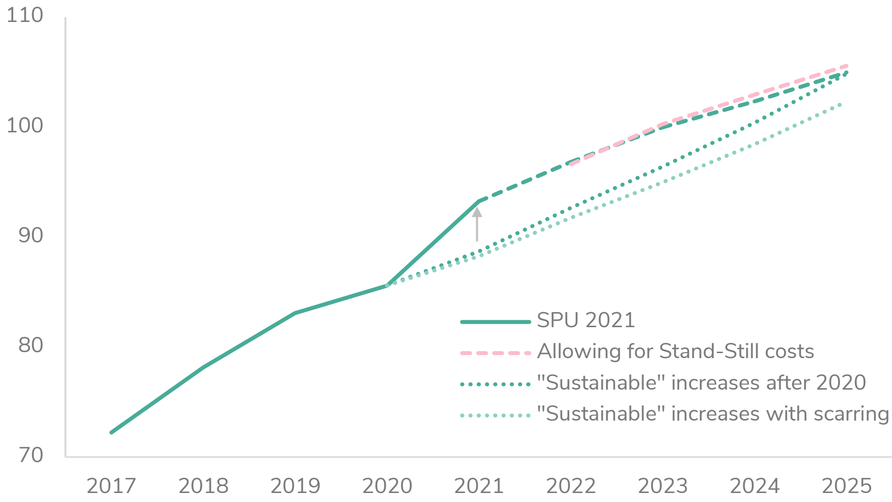
### Fiscal Stance

- **The Government has been able to support the economy unlike in the past: boosting spending and other supports during the downturn.** This approach may have halved the contraction in real GNI* in 2020. The Council assesses that the Government's response in 2020 was prudent and necessary.

- **The Government's decision to continue exceptional temporary supports in 2021 was appropriate, but large permanent increases were not prudent**. *Budget 2021* included substantial and permanent increases in spending amounting to at least €5.4 billion without long-term funding. This could be as high as almost €8 billion once non-Exchequer spending is considered. There continues to be little transparency about non-Exchequer areas of spending.

**The Government is ramping up permanent spending in 2021**

€ billion, 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. The "sustainable" increases assume spending grows in line with potential output and actual price inflation. The projections "allowing for Stand-Still" assume higher price and demographic pressures on spending from 2022 on.

- **Ireland's government debt burden was already 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*. This makes it one of the highest debt ratios in the OECD.

- **However, the State has large resources on hand and interest rates are low.** While Ireland's debt ratio is likely to be high coming out of the crisis, the debt ratio is made more sustainable by lower interest rates. In addition, the State is likely to have close to €20 billion in resources going into next year. This should help to alleviate funding pressures as further deficits are run in the coming years.

- **If the economy recovers strongly as anticipated, a large-scale, untargeted stimulus would not be needed.** Instead, the Government should consider a more targeted approach, reducing supports in a gradual way, supporting those most affected and calibrating this based on how the recovery evolves.

- **In the coming years, current projections suggest that achieving a balanced budget by 2025 would leave no room to implement new policy measures without increasing taxes or reducing spending in other areas**. Achieving a budget balance over the coming years would help to put debt on a downward path to more prudent levels. In the Council's adjusted *SPU 2021* projections, this would require modest fiscal adjustment in the years ahead. In a more optimistic scenario, adjustments would not be needed. But there is no room for additional commitments without offsetting tax or spending changes. The large permanent commitments made in *Budget 2021* have already used up much of the space that a growing economy would generate.

- **Ireland's net debt ratios are projected to fall steadily from high levels but there are risks.** The net debt ratio is projected to be falling at a steady annual pace of close to 3 percentage points of GNI* by 2025. This would slow if spending rises more quickly without additional revenue-raising measures. Higher debt levels magnify the uncertainties for the debt path. New analysis in this report looks at debt sustainability through the lens of stochastic debt sustainability analysis as advocated by Blanchard, Leandro and Zettelmeyer (2021). The Council's estimates suggest that there is a 15 to 20 per cent risk of Ireland's debt ratio being on an unsustainable path by 2025 under the policies set out in the SPU. While this is not alarming, it suggests that the risks are non-negligible and it underlines the importance of reducing debt to more prudent levels.

- **The Government failed to deliver on its commitment to publish a credible medium-term strategy with *SPU 2021*.** As well as being based on poorly founded medium-term spending forecasts, the *SPU* does not incorporate major policy commitments over the medium term. By continuing its current piecemeal approach towards developing real plans, the Government is not providing realistic or useful guidance.

- **The Government needs to set out a credible medium-term strategy; this is both essential and long overdue.** The absence of realistic plans and any fiscal targets leaves the public finances unanchored. A risk is that overspending would lead to larger deficits or the use of corporation tax receipts to mask higher spending. Three initiatives would help to better anchor budget plans: credible debt targets, saving unexpected corporation tax receipts in the Rainy Day Fund, and setting spending limits based on realistic forecasts.

- **Ireland also faces long-term challenges, which will put further pressure on the public finances.** These pressures include a rapidly ageing population and potentially costly adjustments to meet Ireland's climate change targets, as well as policies outlined in the Programme for Government, which are likely to lead to higher spending.

## Fiscal Rules

- **The general escape clause and the exceptional circumstances clause gave leeway within the fiscal rules for a sizeable budgetary response to the public health emergency and the economic crisis both last year and into this year.** While talks are ongoing on reforming the EU fiscal rules, the likely termination of the general escape clause at the European level by the end of 2022 reinforces the need for a clear medium-term strategy.

- **The Medium-term Expenditure Framework is not working.** It has become clear in recent years that departmental expenditure ceilings are set, not with a view to controlling spending with realistic ceilings, but merely to comply with legal requirements. The ceilings do not reflect likely pressures from demographics, prices, and pay increases.

## Summary Table of SPU 2021 Economic and Budgetary Projections

% GNI* unless otherwise stated

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|
| **Macro forecasts** | | | | | | | |
| Real GNI* growth (%) | 1.7 | -4.2 | 2.5 | 5.5 | 3.0 | 2.7 | 2.7 |
| Nominal GNI* growth (%) | 7.6 | -3.3 | 3.6 | 7.6 | 4.5 | 4.5 | 4.4 |
| Nominal GNI* (€bn) | 214 | 207 | 214 | 230 | 241 | 252 | 263 |
| Output gap (% of potential) | 0.1 | -2.4 | -2.1 | -0.6 | -0.1 | 0.4 | 0.5 |
| Potential output growth (%) | 5.8 | 5.1 | 4.1 | 3.4 | 2.9 | 2.7 | 3.0 |
| **Budgetary forecasts** | | | | | | | |
| Balance | 0.8 | -8.9 | -8.4 | -5.0 | -2.2 | -1.2 | -0.3 |
| Balance (€ billion) | 1.8 | -18.4 | -18.1 | -11.6 | -5.3 | -3.1 | -0.8 |
| Balance ex one-offs [1] | 0.8 | -1.4 | -2.7 | -4.0 | -2.2 | -1.2 | -0.3 |
| Balance ex one-offs [1] (€ billion) | 1.8 | -2.9 | -5.9 | -9.1 | -5.3 | -3.1 | -0.8 |
| Revenue ex one-offs [1] | 41.8 | 41.8 | 42.4 | 40.3 | 41.2 | 41.1 | 41.1 |
| Expenditure ex one-offs [1] | 40.9 | 43.2 | 45.1 | 44.3 | 43.4 | 42.4 | 41.4 |
| Primary balance ex one-offs [1] | 2.9 | 0.4 | -1.2 | -2.4 | -0.6 | 0.3 | 1.0 |
| Revenue growth ex one-offs [1] (%) | 6.2 | -3.2 | 5.0 | 2.3 | 6.9 | 4.3 | 4.3 |
| Primary expenditure growth ex one-offs [1] (%) | 5.8 | 3.1 | 9.0 | 5.4 | 2.5 | 2.1 | 2.4 |
| Gross debt ratio (% GNI*) | 95.6 | 105.6 | 111.8 | 107.4 | 105.8 | 103.8 | 100.1 |
| Net debt ratio (% GNI*) | 82.1 | 90.8 | 97.6 | 96.6 | 95.0 | 92.9 | 89.8 |
| Gross debt (€ billion) | 204 | 218 | 239 | 247 | 255 | 261 | 263 |
| Cash & liquid assets (€ billion) | 29 | 31 | 30 | 25 | 26 | 28 | 27 |
| Net debt (€ billion) | 175 | 188 | 209 | 222 | 229 | 234 | 236 |
| **Fiscal stance** | | | | | | | |
| Structural primary balance[2] | 2.9 | -0.6 | -1.5 | -2.1 | -0.6 | 0.0 | 0.7 |
| - change (p.p.) | 0.1 | -3.5 | -0.9 | -0.6 | 1.5 | 0.6 | 0.7 |
| Real net policy spending growth (%) | 5.1 | 2.4 | 7.9 | 1.2 | 1.1 | 0.1 | 0.0 |
| Change in net debt ratio (p.p.) | -7.1 | 8.7 | 6.8 | -1.0 | -1.6 | -2.2 | -3.1 |
| **Fiscal rules** | | | | | | | |
| Spending Rule | ✓ | xc | xc | | | | |
| Structural Balance Rule | ✓ | xc | xc | | | | |
| Overall Assessment | ✓ | xc | xc | | | | |

Sources: CSO; Department of Finance forecasts; and Fiscal Council workings.
Notes: Output gaps and potential output estimates, including those used for the structural balances, are the Department of Finance's preferred GDP-based alternative estimates. xc = Exceptional circumstances apply for these years, meaning that a temporary deviation from the requirements of the fiscal rules is allowed. [1] These figures exclude one-offs. One-offs that the Council considers relevant are excluded to assess the underlying fiscal position (see Table S13.2). Relative to Table S13.2, additional expenditure related to the Pandemic Unemployment Payment of €5 billion and €3.3 billion in 2020 and 2021, respectively, are excluded here, as are expenditure and revenue related to the EU funds for the Brexit Adjustment Reserve and the National Recovery and Resilience Plan). [2]One-offs excluded here are the exact same as in Table S13.2.

# Macro Assessment

## Economy outperforms despite repeat Covid waves

# 1. MACRO ASSESSMENT

## Economy outperforms despite repeat Covid waves

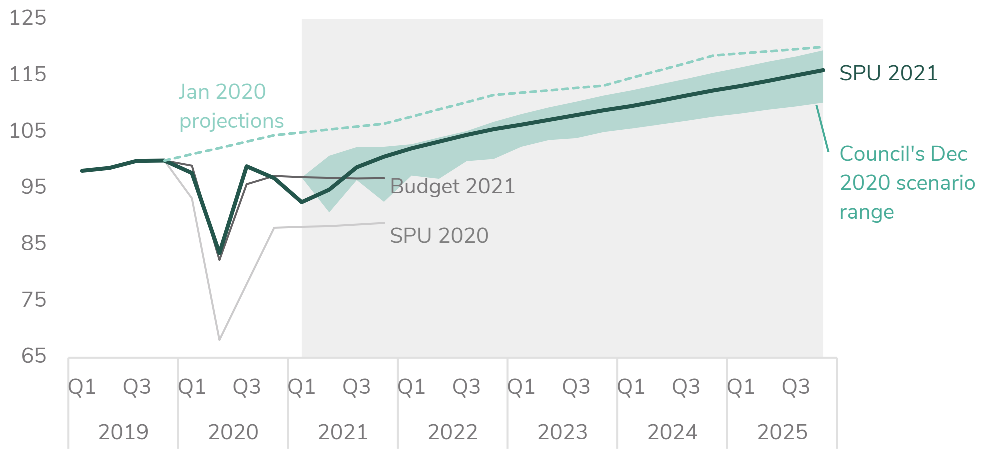
Covid-19 led to an extraordinary shock in 2020 and continues to have major impacts on the Irish economy. The need for additional restrictions to respond to recurring waves of the pandemic has seen stop-start re-openings of a broad range of activities across the economy as well as in Ireland's key trading partners.

**Covid-19 led to an extraordinary shock in 2020 and continues to have major impacts on the Irish economy**

In *Stability Programme Update 2021* (*SPU 2021*), the Department of Finance forecasts a partial recovery in underlying domestic demand (UDD), but with permanently lower output over the medium term compared to previous trends (Figure 1.1).[1] This section discusses the economic outlook and assesses the SPU projections. Section S1 of Supporting Information provides additional information on the Council's endorsement of the *SPU 2021* macroeconomic projections.

**Figure 1.1: Official forecasts imply significant scarring despite strong recovery in near term**

Real underlying domestic demand, Q4 2019 = 100




Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: Scenario range based on the Council's extension of *Budget 2021* forecasts, encompassing "Milder" and "Repeat Waves" scenarios (Box D of December 2020 FAR). The Department's quarterly modified domestic demand profiles are applied to annual UDD forecasts. The "Jan 2020" projections are based on the Department's modified domestic demand forecasts. Get the data.

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[1] Figure 1.1 presents recent forecast vintages of UDD by the Department of Finance, including the Council's scenarios at the time of *Budget 2021*. This illustrates that over the short term, the SPU forecast for the economic recovery is closest to the "Milder" scenario included in the Council's December 2020 Fiscal Assessment Report, which was based on an assumption of very little permanent impacts on the domestic economy due to the pandemic (although Brexit impacts were included which assumed a free-trade agreement would be reached, as transpired). By 2025, the SPU forecast lies 3 per cent below the "Milder" scenario.

The economy has proven more resilient to additional disruptions due to the repeat waves of Covid-19, when compared to the early lockdown months of 2020 (Section 1.1). While employment remains heavily affected for many sectors, especially for consumer-facing services including hospitality, other sectors including technology and the manufacture of pharmaceuticals have grown. High-frequency indicators of consumer spending have all but recovered to pre-pandemic levels despite ongoing restrictions. The rollout of multiple vaccines will likely lead to a sharp rebound in activity from the second half of this year, if not even sooner.

The short-term outlook for 2021 and 2022 reflects an expectation for pandemic-induced restrictions to ease (Section 1.2). The speed and durability of the easing of restrictions remains hard to predict. While the SPU projects a rapid recovery, some short-term indicators and substantial household savings could point to an even stronger outcome this year.

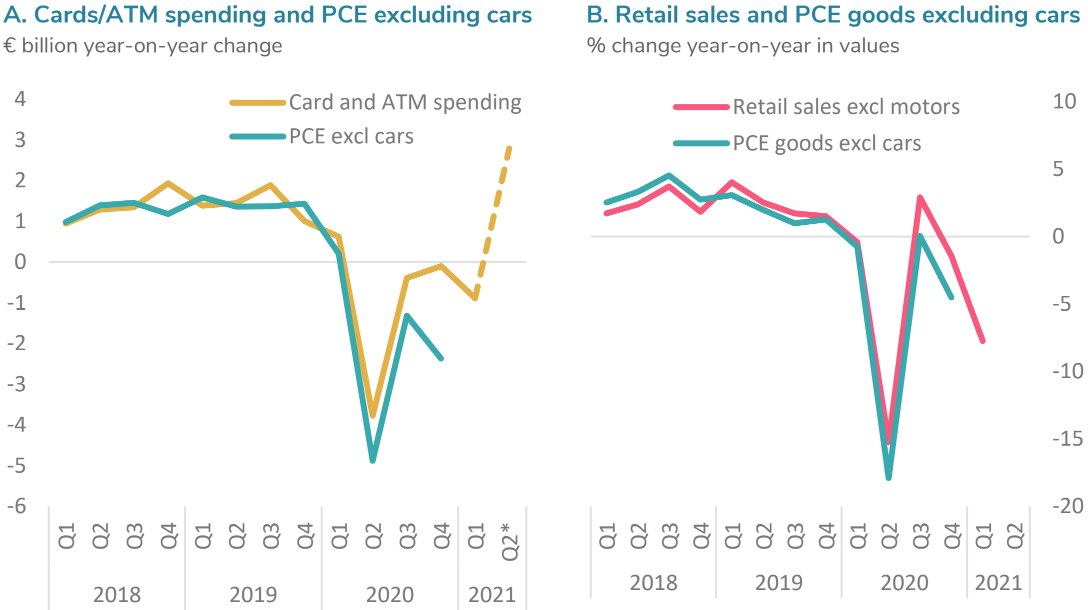
Further ahead, a major source of uncertainty concerns the extent of lasting damage on the economy resulting from the pandemic and Brexit (Section 1.3). The impact on firms and workers of Covid-19 has few precedents. The *SPU* assumes a permanent loss of around 5 per cent of output due to the pandemic, but it may be that the better-performing sectors are able to pick up the slack more quickly than projected.

## 1.1 Recent activity in the Irish economy

Consumers have found ways to adapt their spending habits around the constraints caused by the pandemic. This is encouraging for the economy's short-term prospects. High-frequency indicators such as retail sales and debit/credit card spending/ATM withdrawals are consistent with a less-severe decline in consumer spending in early 2021 relative to the initial fall in Q2 2020 (Figure 1.2). Central Bank of Ireland data show that an increased share of spending has taken place online (Figure 1.3), and that the pandemic has seen an acceleration of this trend.

**Consumers have found ways to adapt their spending habits around the constraints caused by the pandemic**

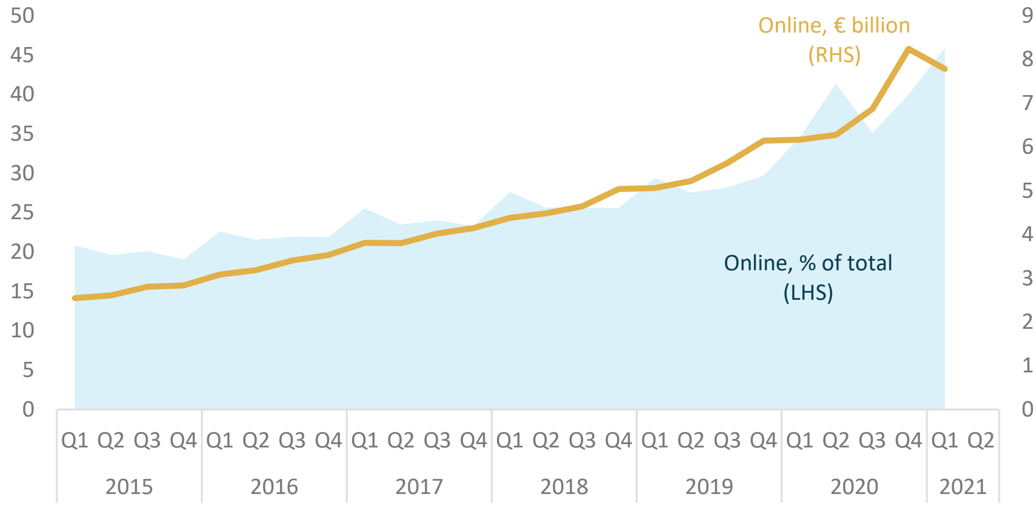
### Figure 1.2: This year's lockdown has had less of an impact on consumer spending




Sources: CSO; Central Bank of Ireland; and Fiscal Council workings.
Note: Q2* 2021 reflects the quarter-to-date increase compared to 2020 to 17th May. The panels portray a generally close link between the high-frequency measures and their corresponding personal consumption measures. However, differences between the measures increased last year, especially in Q4. This relates to weighting issues, although it is also possible that personal consumption will be revised. Get the data.

**Figure 1.3: Lockdowns have accelerated a move towards online spending**

Percentage of total card spending and ATM withdrawals (LHS) and € billion (RHS)



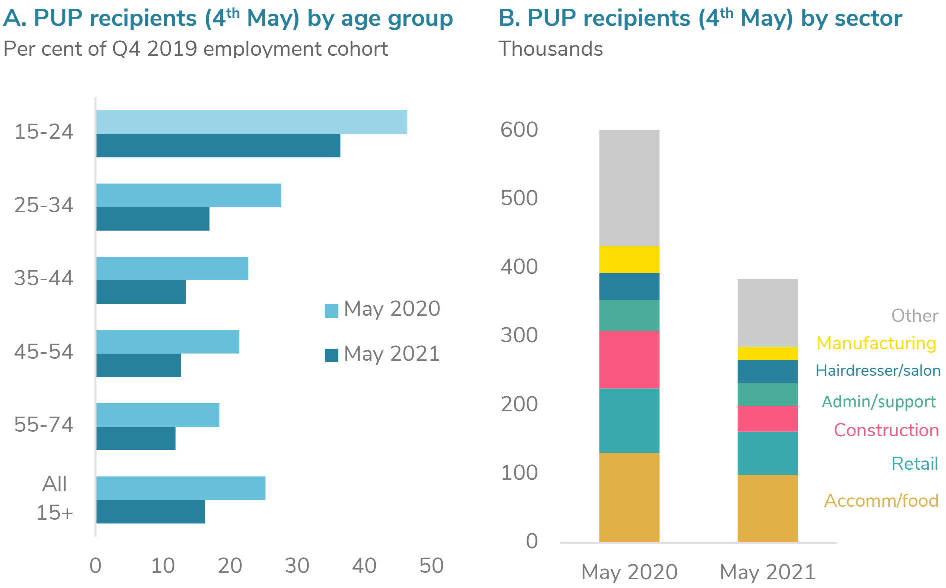

Sources: Central Bank of Ireland; and Fiscal Council workings. Get the data.

The labour market has borne the brunt of the pandemic. The number of workers in receipt of the Pandemic Unemployment Payment (PUP) has risen sharply with each wave of the virus leading to lockdowns. In early May, despite some decline reflecting the gradual easing of restrictions, the number of workers in receipt of the payment remains very high at more than 400,000 (Figure 1.4).[2] This is gradually reducing each week. In terms of PUP recipients, younger workers are the most-affected age group, while accommodation and food services remains the most-impacted sector. More than 100,000 of those aged 15–24 are currently out of work, compared to 264,000 of that age in pre-pandemic employment in Q4 2019.

**The labour market has clearly borne the brunt of the pandemic**

[2] In addition to those being supported by the Pandemic Unemployment Payment, just over 300,000 individuals were being supported by the Employment Wage Subsidy Scheme at the time of writing.

**Figure 1.4: Younger workers and those in hospitality still worst affected**



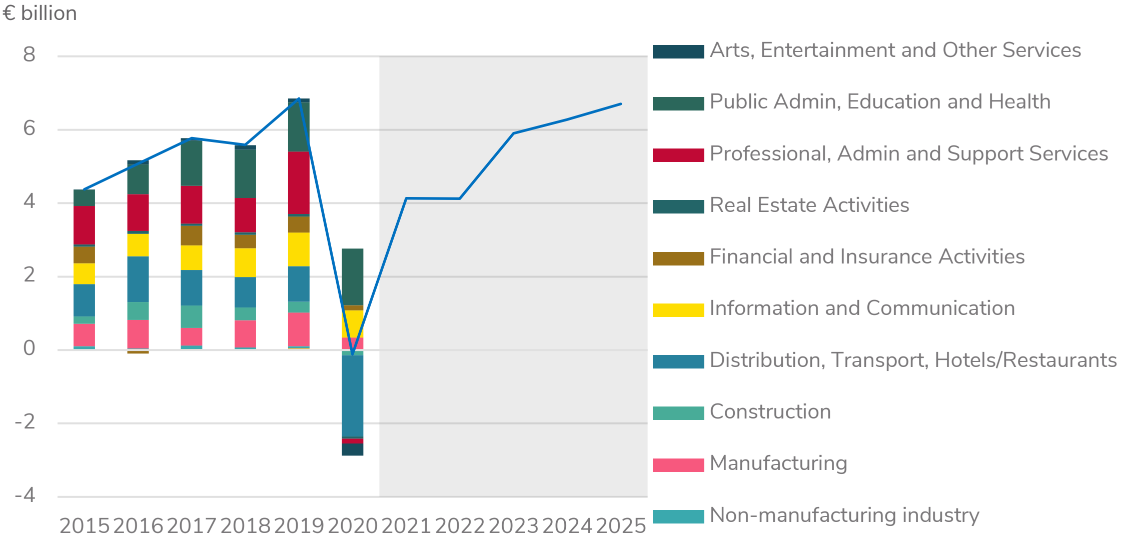

Sources: Department of Employment Affairs and Social Protection; CSO; and Fiscal Council workings. Get the data.

Construction activity fully restarted in April. Despite widespread restrictions for the first quarter of 2021, close to 4,000 new dwellings were completed. While this was 20 per cent fewer than in Q1 2020, it nonetheless compares favourably to the 33 per cent fall in Q2 2020. Furthermore, a rapid rebound in construction last summer resulted in 21,000 completions for the full year — in line with 2019, albeit well below estimates of medium-term demand of 35,000. The ongoing demand for house purchases has been clear from strong mortgage activity, as the volume of drawdowns in Q1 by first-time buyers was the highest in 14 years. This is likely to reflect a combination of pent-up demand, excess savings, and the relatively low incidence of income loss in sectors with higher average earnings (discussed further in Box A).

**The pandemic has caused largely sector-specific shocks to the economy, rather than having a broader-based impact**

The pandemic has caused largely sector-specific shocks to the economy, rather than having a broader-based impact. Figure 1.5 presents the contributions of sectors to the change in total compensation of employees for 2015–2020, with SPU forecasts included for 2021–2025. The sector most affected by the pandemic in terms of wages is distribution/transport/hotels/restaurants, while compensation also contracted in construction, professional/administrative/support services, and arts/entertainment/other services. These sectors typically comprise 38 per cent of national wages and 43 per cent of employment.

**Figure 1.5: The sector-specific nature of the shock to wages in Ireland**




Sources: CSO; Department of Finance, *SPU 2021*; and Fiscal Council workings.
Notes: Although NACE A*10 provides a breakdown to ten industry groupings, the CSO provides a sub-grouping within industry (B-E) for manufacturing (C). The residual non-manufacturing industry is also shown. Compensation of employees in 2020 was €100 billion and includes about €4 billion supported by the Government's wage subsidy schemes. [Get the data](#).

In 2020, declines in the wage bill for certain sectors were offset in full by increases elsewhere. Incomes grew in information and communication, and public administration, education, and health. This was driven by strong increases in earnings in the second half of the year, and it was significantly more favourable than the forecast fall in the wage bill of €10.9 billion in *Budget 2021*. *SPU 2021* forecasts an increase of €4 billion in compensation of employees in 2021 and again in 2022.

There is considerable upside potential to the Department's relatively cautious short-run assumptions. If the higher-paid sectors that grew in 2020 continue to do so at a similar pace, as would seem to be a plausible baseline assumption, then a catch-up increase in sectors that contracted in 2020 would deliver a higher increase in the wage bill for both 2021 and 2022. In light of estimated lost potential earnings in 2020 for recipients of PUP amounting to €7 billion (IBEC, 2021), there is likely to be a faster increase in economy-wide earnings — especially if unemployment falls rapidly over the coming 18 months, as is forecast in *SPU 2021*.

**There is considerable upside potential to the Department's relatively cautious assumptions**

Multinational companies have acted as a shock-absorber during the pandemic. A key foundation of Ireland's economy is the strong demand from abroad for the goods and services produced by multinational entities, especially foreign-owned firms in manufacturing and information and communication technology, and food and beverages in terms of domestic firms. The shock-absorption capacity provided by the presence of these IDA-supported firms in Ireland during the pandemic has been a crucial support to the domestic economy, reflecting both high employee earnings and spillovers to employment in domestic businesses.[3]

Brexit, however, has already resulted in large shifts in Ireland's external trade. The transition period preceding the UK's exit from the European Union ended on 31st December 2020, and this was succeeded by a new free-trade agreement. In the first quarter of 2021, a large fall in Ireland's merchandise trade with Great Britain took place.[4] Exports of chemicals and related products were the main exception with a strong year-on-year increase, mitigating the overall decrease to 3 per cent. However, imports fell by 48 per cent, and the permanent rise in trade barriers will have lasting impacts. Imports of food and live animals were particularly affected, falling by 61 per cent.

**However, Brexit has already resulted in large shifts in Ireland's external trade**

[3] Brady (2019) estimates that three additional jobs are created in a county for each job created in an IDA-supported business in the same county. However, in terms of productivity spillover effects, Di Ubdalo et al. (2018) find limited evidence between the presence of foreign-owned firms and the productivity of domestic firms in the same industry or region.

[4] This fall includes an exaggerated impact in January which reflected largely temporary disruption. A further factor includes a reaction to stockpiling that was seen in latter stages of the transition period.

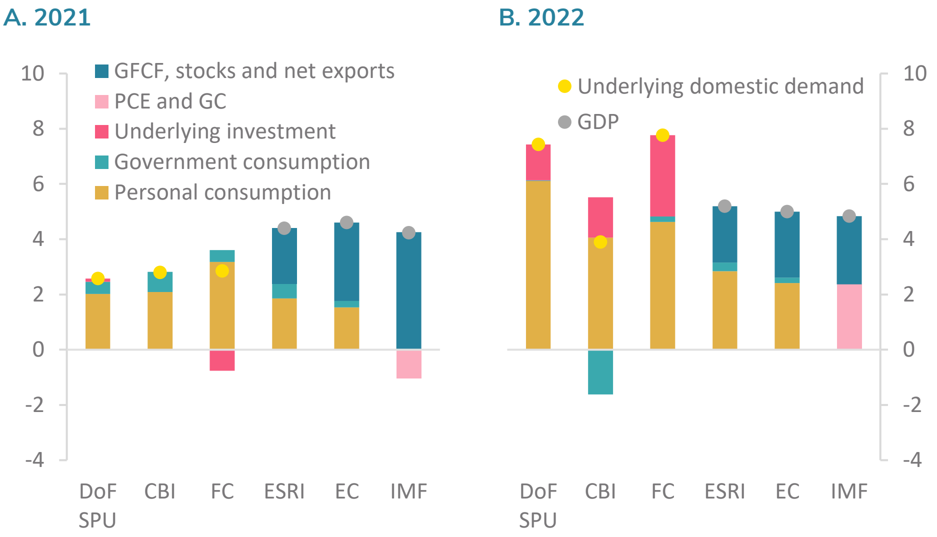
## 1.2 The short-term outlook

The Irish economy is expected to rebound rapidly over 2021 and 2022. This is in line with other recently available forecasts, as shown in Figure 1.6. The Department of Finance expects a relatively stronger recovery in 2022 compared to 2021, mainly driven by consumer spending, while growth in underlying investment is forecast to resume next year.

**The Irish economy is expected to rebound rapidly over 2021 and 2022**

### Figure 1.6: The Irish economy is expected to rebound rapidly over 2021 and 2022

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




Sources: Economic and Social Research Institute (ESRI), *Quarterly Economic Commentary, Spring 2021*; Central Bank of Ireland (CBI), *Quarterly Bulletin No 2 2021*; Department of Finance (DoF SPU), *SPU 2021*; International Monetary Fund (IMF), *World Economic Outlook, April 2021*; European Commission (EC), *European Economic Forecast, Spring 2021*; and Fiscal Council (FC) workings.
Note: For the IMF forecast, contributions from Personal Consumption Expenditure (PCE) and Government Consumption (GC) are residually determined. Get the data.

The economic recovery is likely to be uneven across the economy. Besides the pandemic, this is also due to the negative impact of Brexit on many of Ireland's exporting SMEs. Nonetheless, growth drivers will outweigh such headwinds in the near term. Low interest rates remain beneficial, and the significant support to household incomes and businesses provided by the Government has ensured a far less damaging impact of the pandemic on household consumption, incomes, and savings. Meanwhile, the massive fiscal stimulus in the US and measures in the euro area may at least partly offset the short-term negative impacts of Brexit on the external sector.

**The economic recovery is likely to be uneven across the economy**

Table 1.1 presents *SPU 2021* macroeconomic forecasts for the Irish economy, which imply a gradual, and ultimately incomplete, recovery in the economy from the pandemic. The Council assessed the SPU forecasts as being within an endorsable range, taking account of the assumptions and judgments made (the Supporting Information S1 details the Council's endorsement exercise for *SPU 2021*). The contraction in activity in the first half of 2021 due to Covid-19 restrictions distorts the patterns of year-on-year growth, and this base effect underpins the rapid annual growth forecast for the economy in 2022 — with personal consumption growing by 10 per cent, employment by 11 per cent, and the unemployment rate reducing by half to 8.2 per cent.

**Table 1.1: *SPU 2021* key macroeconomic forecasts**

Year-on-year % change in volumes, unless otherwise stated

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|
| Modified gross national income (GNI*) | 1.7 | -4.2 | 2.5 | 5.5 | 3.0 | 2.7 | 2.7 |
| Underlying domestic demand (UDD) | 4.1 | -4.9 | 2.6 | 7.4 | 3.6 | 3.2 | 3.2 |
| Personal consumption | 3.2 | -9.0 | 3.5 | 10.4 | 3.2 | 2.8 | 2.9 |
| Underlying investment | 4.7 | -6.7 | 0.6 | 6.8 | 7.1 | 5.9 | 5.7 |
| Non-agri wage bill (nominal) | 7.3 | -0.1 | 4.1 | 4.0 | 5.4 | 5.5 | 5.6 |
| Employment[a] | 2.9 | -15.1 | 4.0 | 11.0 | 3.3 | 2.3 | 2.2 |
| Unemployment rate[a] (% labour force) | 5.0 | 18.7 | 16.3 | 8.2 | 6.7 | 6.0 | 5.5 |
| Inflation (HICP) | 0.9 | -0.5 | 1.1 | 1.9 | 1.5 | 1.6 | 1.9 |
| Modified current account (% GNI*) | 7.7 | 7.6 | 8.1 | 6.4 | 5.5 | 4.7 | 3.9 |
| Output gap (% potential GDP) | 0.1 | -2.4 | -2.1 | -0.6 | -0.1 | 0.4 | 0.5 |

Source: CSO; Department of Finance, *SPU 2021*; and Fiscal Council workings.
Notes: [a] The unemployment rate and employment growth shown are based on the CSO's "upper bound" Covid-19 unemployment data.

Ireland's vaccination delivery has been progressing since January, broadly in line with other EU countries for much of the period. However, as shown in Figure 1.7, stated monthly vaccination targets have proven elusive (except for January), and the cumulative shortfall as of early May 2021 is over half a million doses (or about a fortnight of vaccinations at the current pace). This has partly reflected changes in guidance and production delays for some vaccines.

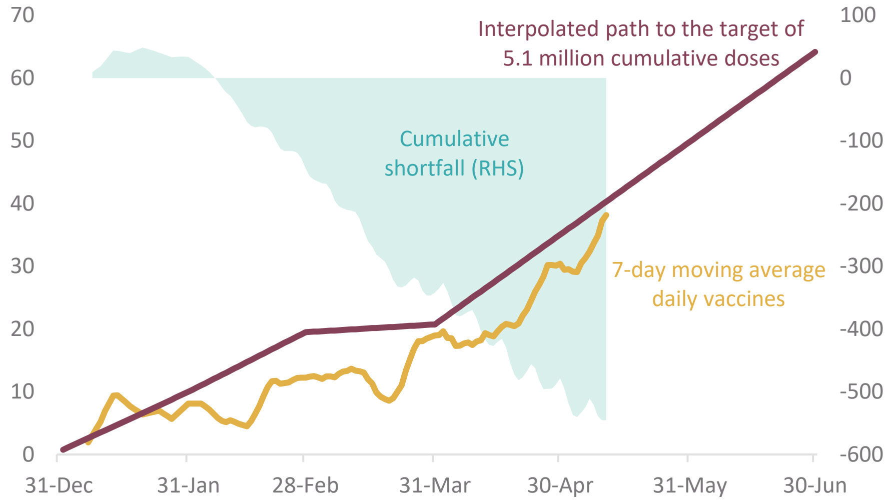
**Uncertainty over the short-term path of the economy has reduced considerably compared to early in the pandemic**

Uncertainty over the short-term path of the economy has reduced considerably compared to early in the pandemic. Brexit has taken place and progress has been made in the management of Covid-19, including the roll-out of effective vaccines. Meanwhile, risks to the outlook have become more balanced. There is upside potential linked to the resilience of spending despite the latest lockdown, a potential acceleration fuelled by excess household savings, and a favourable international context for growth, including the US and EU policy measures that were not factored into the

*SPU 2021* forecasts.[5] Despite these benign factors, a number of adverse developments could also affect the strength of the immediate recovery from Covid-19.

### Figure 1.7: Ireland's vaccine progress

Thousands of vaccines (first and second doses combined) — daily (LHS) and cumulative daily (RHS)




Source: HPSC Ireland; *COVID-19 Resilience and Recovery 2021 - The Path Ahead*; and Fiscal Council workings.
Note: The target shown is a daily interpolated line such that the total number vaccinated is consistent with monthly targets for January–March, and the Q2 total, assuming a rising daily target for vaccine delivery. Get the data.

It is likely that annual inflation in consumer prices will show higher volatility and may strengthen this year as a result of base effects from 2020 and short-run supply pressures. As restrictions are eased, demand for certain goods and services (especially hospitality) may rise rapidly owing to the build-up of savings and a reduction in risk aversion as vaccination rates climb, outpacing the recovery in supply. The higher recent trend for inflation expectations has resulted in modest increases in government bond yields across the Euro Area.

[5] Box I.2.1 in the European Commission's *European Economic Forecast, Spring 2021* estimates spillovers from US fiscal policy on EU27 GDP of 0.3 and 0.2 percentage points for 2021 and 2022, respectively. Ireland is listed as a member states with greatest export sensitivity to higher US demand.

The impact of Brexit on the economy is also difficult to predict with confidence. Although a free-trade agreement was negotiated, meaning a disorderly Brexit did not take place, it remains to be seen how the Irish economy will be affected. For example, the UK's new Border Operating Model will commence in October 2021, resulting in non-tariff barriers to trade and higher costs for Irish exporters selling to Britain. In addition, trade in services is not covered by the free trade agreement. The Council has previously considered the possibility of adverse impacts due to interactions between Brexit and the pandemic, concluding that there was likely to be relatively limited overlap between the shocks across broad sectors.[6] However, it is clear that both Covid-19 and Brexit impart negative impacts of varying magnitudes on a range of activities in the Irish economy.

**Notwithstanding headwinds, increased consumer spending and investment driven by excess household savings and pent-up demand is likely over the coming months**

Notwithstanding a number of possible headwinds to growth, an increase in consumer spending and investment driven by excess household savings and pent-up demand is likely over the coming months. The speed and amount of excess savings that are used up will have an important bearing on how fully Ireland's economy recovers from Covid-19, but could add as much as 2 per cent to the level of household consumption in the short term. As discussed in Box A, the recovery of consumption and investment is likely to have a powerful impact on domestic activity, given the low import content of activities that have been worst affected by Covid-19. Furthermore, the Department's short-term projections for consumption assume that more than 75 per cent of excess savings from 2020 will not be spent, which could mean a considerable degree of upside to the projections. This dynamic also has important implications for medium-term economic growth, as discussed in section 1.3.

Net inward migration has provided the Irish economy with a steady increase in labour supply since 2015. However, preliminary indications from the CSO's analysis of administrative records show a reversal to net emigration took place in Q2 last year, coinciding with the first Covid-19 lockdown.[7] While it is possible that these effects will prove transitory and that a resumption of high net inward migration will be possible as pandemic-

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[6] The Council's analysis in the Pre-Budget 2021 Statement (Box A) noted a relatively limited overlap for broad sectors in terms of their export intensity to the UK compared to their employment exposures to the pandemic (Fiscal Council, 2020d). This finding was in line with a more detailed examination of the issue by Daly and Lawless (2020).

[7] For further details, see: https://www.cso.ie/en/releasesandpublications/fp/fp-miads/migrationestimatesforirelandfromadministrativedatasources2014-2020/

induced travel restrictions ease, the timing of this has important implications for economic growth over the medium-to-long term.

## Box A: Excess household savings could substantially boost economic activity

Irish households saved €29.6 billion in 2020. This was close to a quarter of total disposable income, double the gross savings in 2019, and quadruple the corresponding 2016 amount. Last year included a record-high €11.8 billion (37 per cent) in the second quarter alone, much of this down to restrictions and the sudden changes to everyday life caused by the pandemic.

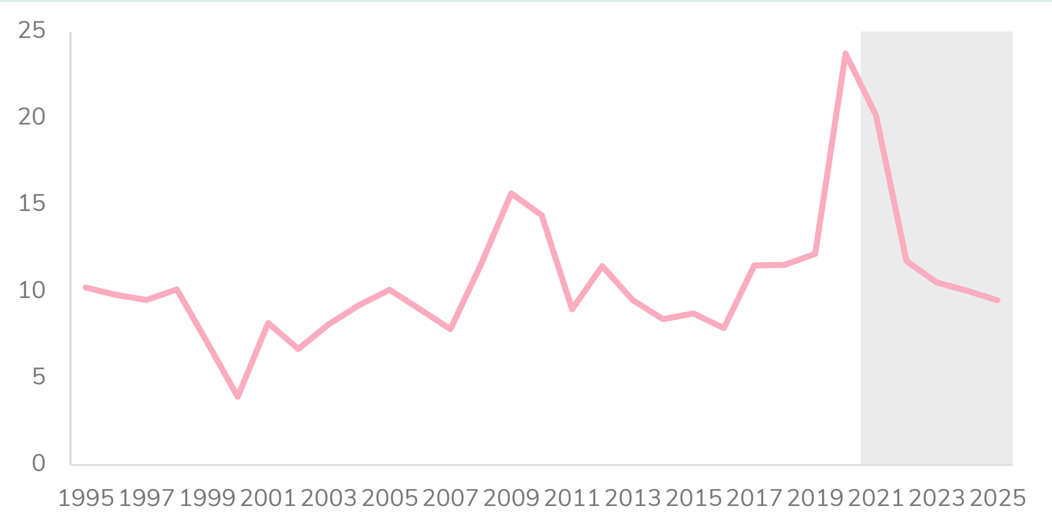
This box first assesses how much of the savings in 2020 were "excess" due to the pandemic, before analysing what an unwinding of these excess savings would imply for consumer spending and imports. If half of the excess savings were spent in the short term, this could add up to 2 per cent to household consumption. Based on the expected usage of excess savings, it is likely that the vast majority of what is consumed will contribute directly to the Irish economy (i.e., to GNI*). This reflects the relatively low import share of the activities most affected by the pandemic.

### Assessing excess savings in 2020

Figure A1 presents Ireland's household savings ratio since 1995, supplemented with *SPU 2021* forecasts. The increase in savings in 2020 far exceeds any previous increase over recent decades. Although large increases in savings were observed in other countries across the developed world in 2020, Ireland's increase stands out as the highest among OECD countries.[8]

**Figure A1: Household savings rose to 24 per cent of disposable income in 2020**

Household savings as a percentage of gross disposable income




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

One challenge for assessing excess savings is that the savings rate rose sharply to a higher level in 2017 before remaining well above its long-term average. The reasons for this shift are unclear. It could be related to some precautionary saving following the Brexit referendum, the impact of higher deposit requirements for mortgages, or the impact of an ageing population. This uncertainty makes it harder to assess what a "normal" post-Brexit savings rate would be.

A benchmark estimate of excess savings in 2020 can be found by applying the same savings ratio in 2019 to 2020 household gross disposable income. In this scenario, households would have

[8] Many factors could contribute to this relatively high saving in an international context including the support by Government to household incomes and the extent of restrictions during lockdowns.

saved €15 billion less in 2020. Lydon and McIndoe-Calder (2021), applying a more sophisticated methodology, recently estimated that €11 billion of excess savings were accumulated by Irish households in 2020 as a result of the pandemic.

Using CSO *Household Budget Survey* data across the distribution of income to identify typical spending in restricted parts of the economy, Lydon and McIndoe-Calder estimate that half of excess pandemic savings could have been accumulated by the top three deciles by household income. Although households with higher income generally have lower marginal propensities to consume, the authors note that this is not necessarily the case for transitory or unexpected income. They also cite evidence from the CSO's *Household Finance and Consumption Survey 2018* and suggest that at least half of excess pandemic savings could be spent on consumption over the coming years. This is based on responses to the survey about expectations for spending versus saving in the event of winning one month of household income in a lottery.

In a typical downturn, savings rise largely due to precautionary motives, and this is undoubtedly a factor for many Irish households over the past year. However, given the concentration of job losses due to the pandemic among younger workers and those employed in sectors with lower earnings, it is likely that the rise in savings has instead been driven by households whose incomes were not directly affected thus far.[9] This is more likely to reflect pent-up demand related to Covid-19 restrictions on activities and mobility.

### What could an unwinding of excess savings imply for consumption?

The pace at which excess savings are unwound in a re-opening is an important factor in the economic recovery from the shock of Covid-19. Much uncertainty remains over the strength and timing of a savings-driven boost to personal consumption expenditure, and indeed the ability of businesses to accommodate higher demand after a long year of disruptions caused by the pandemic.

Nonetheless, assuming that half of €11-15 billion in excess savings will be spent by consumers in 2021 and 2022, this would represent an upside risk to *SPU 2021* forecasts, which only factor in about €2½ billion of consumption out of excess savings.[10] If a higher figure such as €6.5 billion (the mid-point of €5.5–7.5 billion) is assumed to be spent, this could add up to 1.5 per cent to the level of consumption across 2021 and 2022. In terms of the savings ratio, this would imply a temporary reduction of 2 percentage points on average across 2021 and 2022 — albeit this would still mean a high household savings ratio this year.

While some households have paid down debts or replaced durable goods, it is likely that most households will increase their spending on higher-priced services in a re-opening of the economy. These services include restaurant dining, hotel accommodation, and entertainment (such as theatre, music, or sporting events). However, goods consumption could also rise, given non-essential retail has now re-opened. While some forms of missed spending due to the pandemic will not be recovered due to inability to substitute over time, Lydon and McIndoe-Calder note that additional spending by households on a broader basket of goods and services, or more expensive alternatives within an unchanged basket, cannot be ruled out.

### What is the likely import share of higher consumption?

One aspect of the overall gains arising due to any increase in personal consumption in Ireland concerns the import content of the goods and services. For decades, globalisation and technological change have seen an increasing number and volume of imported goods and services available to consumers in Ireland. As a small open economy reliant on trading partners abroad for many everyday products — for example, cars are not manufactured in Ireland and therefore must be imported — it appears reasonable to assume that the import content of households' final

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[9] Lydon and McIndoe-Calder (2021) observe the correlation between tightening and loosening of Covid-19 restrictions with daily cards and ATM spending, concluding that excess savings are more likely to resemble "additional income" rather than precautionary savings.

[10] This lower expected amount by the Department reflects recent KBC survey evidence.

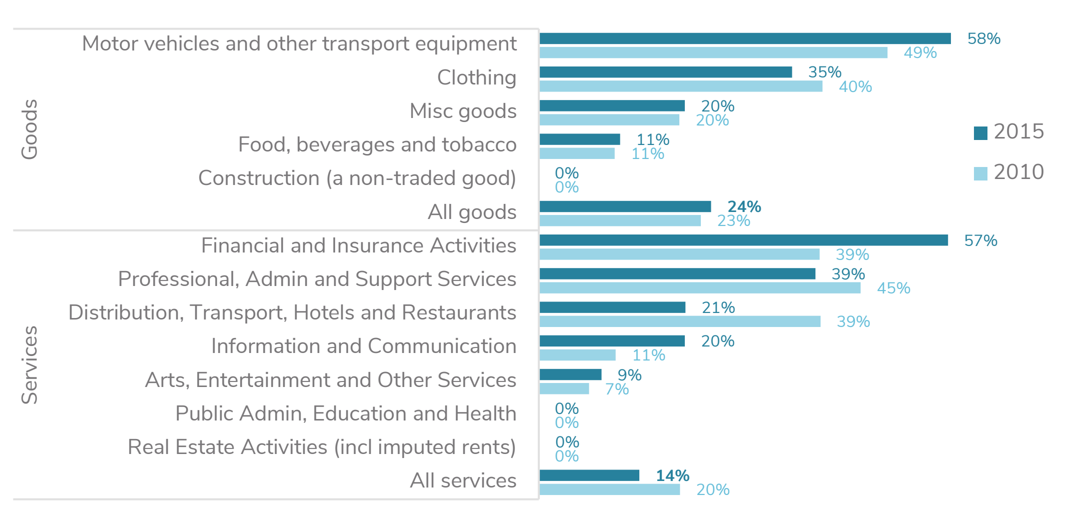
consumption expenditure is high. However, the import content of final consumption expenditure appears to be less than 20 per cent.

Most consumer goods in Ireland are imported. However, only a small share of the value of consumer spending on goods is spent on imports overall. This reflects the inclusion of the cost of government product taxes on consumer goods (such as Value Added Tax) and the costs charged for wholesale and retail services. In 2015, 58 per cent of consumer spending on goods was on imports before product taxes and markups of wholesalers and retailers were taken into account. However, once these were included, only 24 per cent of consumer spending on goods was spent on imports (little changed from 2010), with 34 per cent of consumer spending on goods going to the Exchequer and domestic wholesalers and retailers.

Figure A2 compares the import contents of selected final household consumption categories based on data from the CSO's Input-Output Tables for 2010 and 2015.[11] The chart shows that the highest import content has remained motor vehicles including other transport equipment (58 per cent in 2015, from 49 per cent in 2010), while other largely imported items include financial and insurance services (57 per cent), professional, administrative and support services (39 per cent), and clothing (35 per cent).

## Figure A2: How much final consumption expenditure is imported

% of final household consumption expenditure




Source: CSO, Supply and Use and Input-Output Tables 2010 and 2015; and Fiscal Council workings.

Overall, services consumption is shown to have an average import content of 14 per cent, down from 20 per cent in 2010. (As noted above, goods consumption is somewhat higher at 24 per cent, little changed from 2010). For the sectors within services consumption worst affected by Covid-19 — distribution, transport, hotels, and restaurants; and arts, entertainment, and other services — the combined import content is 18 per cent, meaning most of the increase in consumption on these activities contributes directly to national income.

It is also likely that some households will use savings for investment purposes, such as home renovations, or as a deposit for a house purchase. Although related products for such usage of savings have relatively high import shares — for example, financial and insurance services — the direct import share of a new house purchase as it affects consumption is zero given construction

[11] This uses the imports at basic prices attributed to households by two-digit CPA product code, as a share of final household consumption expenditure at purchasers' prices (reflecting margins earned by wholesalers/retailers, and product taxes such as value-added tax — we thank Eóin Flaherty in the CSO for assistance with interpreting these data).

and real estate services (including imputed rents) are not traded. However, investment spending on such products requires significant imports of indirect inputs such as steel.[12]

If excess savings are instead utilised to go on holidays abroad, this would effectively extinguish the benefit to the Irish economy of these savings. Although holidays overseas count directly towards personal consumption expenditure, the import content of this spending is very high, and the income and activity is gained by the destination abroad.

However, the return of overseas trips to Ireland can partly offset this effect, aided by high-spending visitors (especially those from the US), and visiting emigrants. Virus fears and the current impracticality of international travel due to quarantine and other restrictions mean that pent-up demand for travel to and from Ireland is likely to be significant over coming years. As noted by FitzGerald (2021), a relevant precedent for this dynamic is the exceptional number of visitors to Ireland following World War II.

Investment in building and construction has been significantly disrupted by the pandemic. Lockdowns have prevented the completion of ongoing construction projects, while commencements of new units have slowed significantly. Nonetheless, demand for residential construction in Ireland remains strong, and the sector has been quite agile in responding rapidly once restrictions have eased. The Department forecasts a fall in new dwelling completions to 18,000 units in 2021 and 20,000 in 2022, compared to the 21,000 units completed in 2020. However, as discussed in Section 1.1, completions were reasonably strong in the first quarter despite Level 5 restrictions being in place for the quarter. This could imply a faster delivery of new dwellings than is forecast, especially if excess savings are channelled into housing investment.

**Construction has been disrupted by the pandemic, with the outlook for non-residential construction uncertain**

However, the outlook is far more uncertain for non-residential construction. This is due to its high share in total output (10 per cent of GNI*) prior to the pandemic, and the possibility that construction of office units may scale back considerably as a result of the pandemic and its lasting impact on remote working. In contrast, the Government's fiscal projections indicate a large ramp-up in public investment (see Figure 2.6). Depending on the extent of delivery, this could make up for some of the likely reductions in office building over the coming years.

[12] The expenditure-side components of modified gross national income (GNI*) reflect final goods and services, and the allocation of imports between the components of final demand determines the import content of each of consumption, investment, and exports. However, a higher import content for investment and intermediate consumption is relevant for multiplier effects of increased domestic demand; all else equal, a country with greater domestic industrial capacity will benefit more from higher demand if this results in larger spillover effects for the domestic value chain.

## 1.3 The medium-term outlook

This section assesses the prospects for Ireland's medium-term economic growth, with emphasis on the likelihood and extent of lasting damage due to Covid-19. This is also investigated in terms of modified gross national income (GNI*), and its main components of underlying domestic demand (UDD) and the modified current account (CA*, a relevant measure of net external demand).[13]

A key question for the medium-term is how much permanent loss in output and employment, known as "scarring", will result from changes brought about by the pandemic. Demand may switch between activities; for example, if people permanently switch to remote working tools, this will reduce the need for some travel, office space and city-centre facilities. Cashflow difficulties may also lead some firms to close. As a result, workers may lose their jobs and struggle to find new occupations, while business capital and know-how may be lost.

As discussed in Section 3, there is an important role to be played by the Government in minimising the impact of disruptions due to both Covid-19 and Brexit. The longer that disruptions to the economy last, the more likely it is that scarring effects will become more significant through lost investment and hysteresis. This could be most relevant from a sectoral perspective, as the worst-affected parts of the economy — especially tourism, hospitality, construction, and the arts — could fail to reach their previous share of total activity. Instead, these sectors could recover to much-reduced levels of output only after an extended period of time.

**The negative shock caused by Covid-19 to some sectors could largely be compensated by growth in other sectors**

However, the negative shock caused by Covid-19 to specific sectors will, to some extent, be compensated by growth in other sectors. Growth in sectors not affected by the pandemic could offset, or possibly even exceed, lost output elsewhere. Analysis of the UK economy from the Bank of England (Ramsden, 2020) supports the view that the labour-market recovery following the pandemic could be quite fast, based on the relatively low degree of occupational change required to meet sectoral shifts in

[13] These measures adjust GDP and other traditional economic indicators for distortions arising due to the effects of globalisation and multinational entities in Ireland. See ESRG (2016) for further details.

production.[14] Based on ONS estimates of tasks involved across different jobs, the research finds that even in an extremely negative scenario, the extent of "task re-allocation" required in the recovery from the pandemic is likely to be far lower than the historical average. This suggests a more limited degree of friction for substitution across occupations within labour supply.

By contrast, the Department's SPU projections do not appear to allow for a significant degree of substitution in Ireland over the medium term. Instead, it assumes a less dynamic response of workers to the changes brought about by Covid-19.

In *SPU 2021*, the levels of UDD and employment are projected to remain 4 – 5 per cent lower than in the Department's pre-pandemic forecast update in January 2020.[15] The scar on employment is attributed primarily to a permanent decline in the labour force of roughly 3 per cent. This impact on output is beyond the largest estimates noted in the SPU, and a far higher impact of the pandemic on the Irish economy relative to the IMF's average estimate for advanced economies (1 per cent).[16] It is not clear why a greater degree of "scarring" due to the pandemic should be expected in Ireland compared to other countries for which estimates are available. In light of the relatively resilient performance of the economy as a whole — helped by the presence in Ireland of multinational firms, as argued in Section 1.2 — the Department's relatively adverse medium-term expectations appear rather pessimistic on economic activity.

***The Government's forecasts show domestic demand and employment remaining 4-5 per cent lower than pre-pandemic forecasts***

The Council's Benchmark projection for the level of real GNI* is close to 6 per cent higher than *SPU 2021* has it by 2025. Figure 1.8 presents the SPU medium-term forecasts for real GNI*, with the Council's Benchmark forecasts also shown. The Council's assessment is more optimistic and

[14] The intuition for this is that it is very rare in developed economies for labour-market transitions to occur between fundamentally different occupations — for example, a specialist role such as a coalminer re-training and re-skilling for an office-based services role.

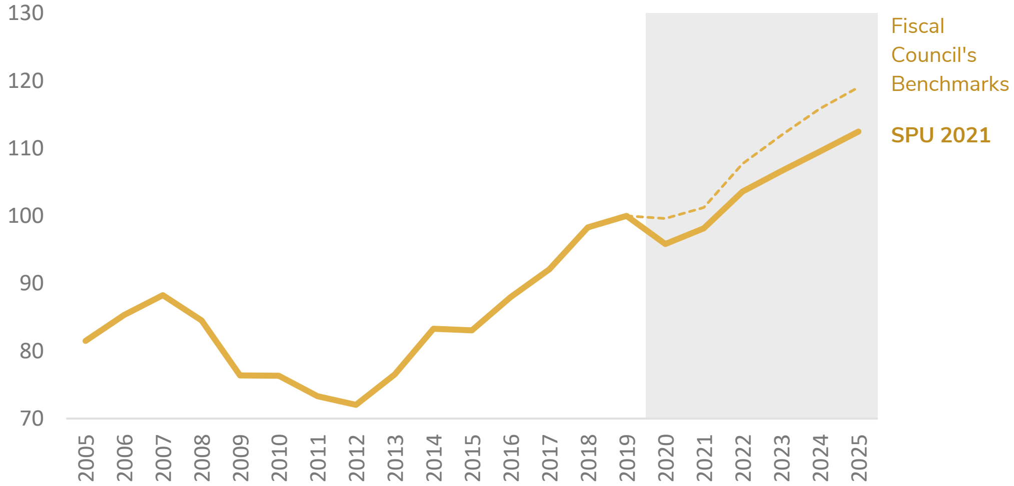
[15] The basis for this assumption is set out in supporting documentation to the SPU by Rehill and Sweeney (2021). The authors consider transmission channels for the pandemic to affect potential output via capital, labour, and productivity, concluding that on balance, the impacts are likely to prove negative overall. The authors also survey international evidence of scarring effects as estimated by various researchers for a selection of economies.

[16] Table 5 includes estimates by the IMF for advanced economies (1 per cent), and the Bank of England, the Office for Budgetary Responsibility, and the National Institute for Economic and Social Research for the UK (1.8, 3, and 4 per cent respectively).

considers there to be upside risks to the official forecasts (discussed further in Section 1.4).

**Figure 1.8: The SPU projects an incomplete economic recovery**

Real GNI*, 2019 = 100

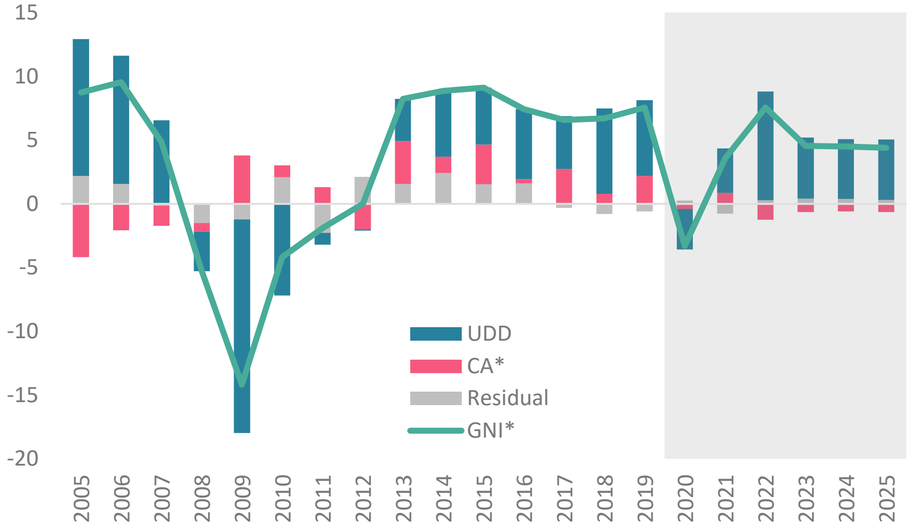



Sources: Department of Finance, SPU 2021; CSO; and Fiscal Council workings. Get the data.

In terms of the composition of demand in the domestic economy, Figure 1.9 shows the growth in nominal GNI* due to UDD, CA*, and a residual category including the change in inventories. This portrays how far the growth of GNI* is driven by domestic components (UDD) and how much by other factors, including the implied relevant measures of exports and imports (CA*). The Department's SPU projections suggest that UDD will increase more rapidly than GNI*. This is at variance with the recent historical experience. Typically, net foreign demand has tended to contribute to the growth of national income, except for in the mid-2000s prior to the global financial crisis. If the contribution of CA* turns out to be more in line with recent historical precedent, this would lead to a higher rate of GNI* growth than allowed for in the Department's forecasts.

**Figure 1.9: The SPU projects medium-term GNI* growth dominated by domestic demand, with a drag from net foreign demand**

Year-on-year percentage change in values and percentage-point contributions




Source: CSO; Department of Finance, *SPU 2021*; and Fiscal Council workings.
Notes: This chart presents CSO outturns up to 2019 for the change in nominal GNI*, as explained by the contributions of nominal UDD, CA*, and a residual (which includes stocks, EU subsidies less taxes, statistical discrepancy, secondary income balance, and two components of modified investment that are excluded from underlying investment (namely non-R&D-IP intangibles and non-leasing aircraft)). Shaded years reflect *SPU 2021* forecasts, except for the change in UDD for 2020 (which is a preliminary CSO outturn). Get the data.

With net foreign demand acting as a drag on growth, the Department projects a decline in Ireland's large CA* surplus. Figure 1.10 presents a decomposition of Ireland's CA* balance as represented by savings less investment of institutional sectors.[17] This shows that CA* has increased significantly since 2013, at a time when UDD was also growing rapidly. As such, the positive contributions shown for Irish households and domestic firms are indicative of the rapid underlying growth rate of the Irish economy in recent years.

**The underlying current account balance has tended to perform better than expected**

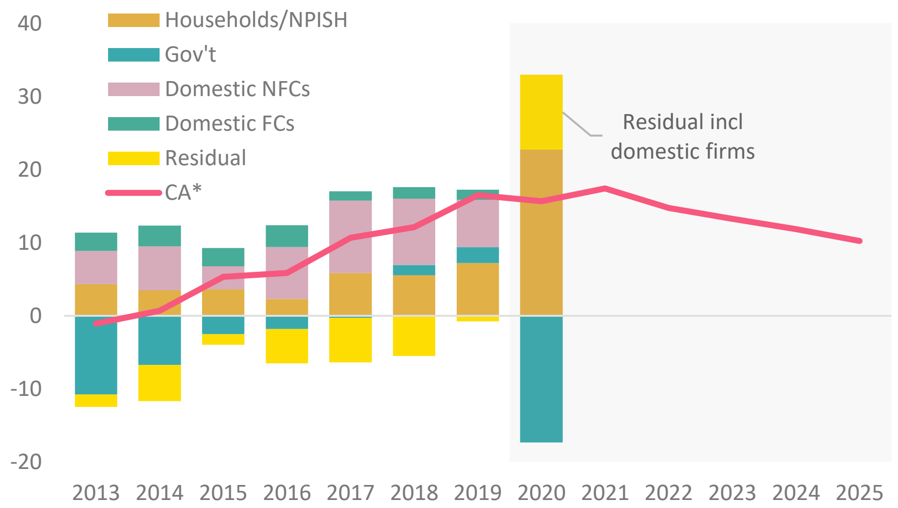
In recent years, CA* has provided largely unanticipated support to GNI*. A downward bias to the Department's CA* forecasts has been evident in recent years. This is shown in Supporting Information S5. Underestimating the increase in CA* has accounted for most of the underprediction of GNI*, and by very significant amounts in 2019 and 2020 (this assumes the Department's SPU estimate for 2020 matches the outturn, which has yet to

[17] From an income perspective, the CA* surplus represents national income that has not been spent on consumption or investment — instead, it has been accumulated as savings.

be published).[18] The unexpected extent of the surplus has corresponded to faster growth in "adjusted" exports over time compared to corresponding "adjusted" imports (with net relevance to GNI* — described in Box E of Fiscal Council, 2020a).

**Figure 1.10: A current account surplus is forecast to remain by 2025**

€ billion




Source: CSO; Department of Finance, SPU 2021; and Fiscal Council workings.
Notes: CSO data are shown for 2013–2019 and 2020 sectoral balances for household/NPISH, general government, and not sectorised. Get the data.

Over the medium term, it is possible that international trade could slow down, leading to a reduction in adjusted exports and a fall in Ireland's large CA* surplus, as projected in *SPU 2021*. Alternatively, if recent patterns of adjusted trade prove more persistent than allowed for by the Department, there is space for upside risk to the outlook for GNI*. This interpretation is supported by the findings of Box A regarding the relatively low import content of household final consumption expenditure. An acceleration in UDD would not necessarily be reflected in faster growth for adjusted imports. Depending on the composition of higher UDD and the associated multiplier effects, this could also imply faster medium-term GNI* growth rates than forecast in the SPU — for example, closer to pre-pandemic real GNI* growth rates of about 4 – 4½ per cent a year, rather than the 2¾ – 3 per cent growth rates forecast by the Department.

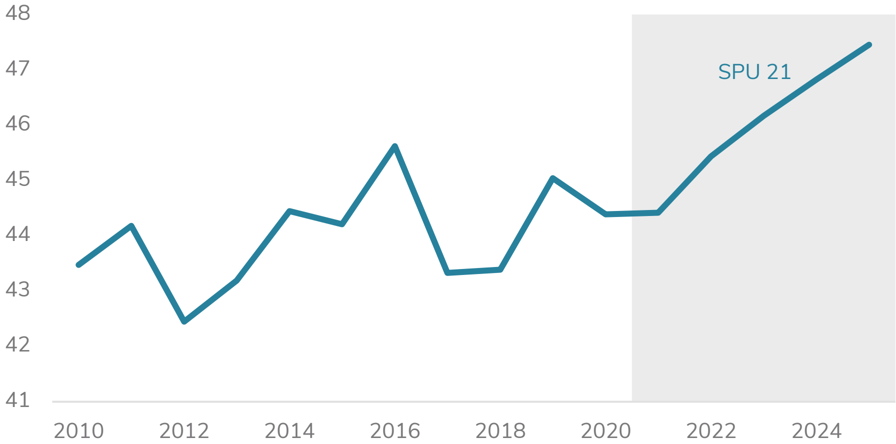
**The Department's forecasts of imports are likely to be overestimated**

[18] Although GNI* and CA* have only been published by the CSO since summer 2017, the Department has been including GNI* projections since *Budget 2018* — albeit initially included on a purely technical basis, grown in line with GNI — and CA* projections have been included since *Budget 2019*.

The Department's forecasts of imports, included in GDP, are likely to be overestimated. Underlying domestic demand has a relatively low import content. The Department forecasts modified imports based on their estimated relationship with final modified demand (that is, modified domestic demand and total exports).[19] However, this approach implicitly assumes an equivalence between the import content of modified domestic demand and that of total exports, despite the heavy distortions of high-import-content export sales activities of foreign-owned multinationals.[20] As a result, for a given rise in modified domestic demand, the projected rise in imports is likely to be overestimated. This is illustrated in the projected underlying imports content of final underlying demand shown in Figure 1.11. By 2025, this ratio is significantly higher than suggested by historical norms. The SPU forecast for real GDP would be over 6 per cent higher by 2025 if the underlying import content of final underlying demand were to remain stable, rather than rising to the historically high share shown in Figure 1.9.

**Figure 1.11: *SPU 2021 forecasts for imports are likely to be too high***

% of final underlying demand (underlying domestic demand plus exports)




Sources: Department of Finance forecasts in SPU 2021; and Fiscal Council workings.
Notes: Underlying imports is total imports excluding investment on other transport equipment (mainly planes) and intangibles. Get the data.

A decomposition of the real GNI* growth is shown in Figure 1.12, with contributions from labour productivity and hours worked shown. This

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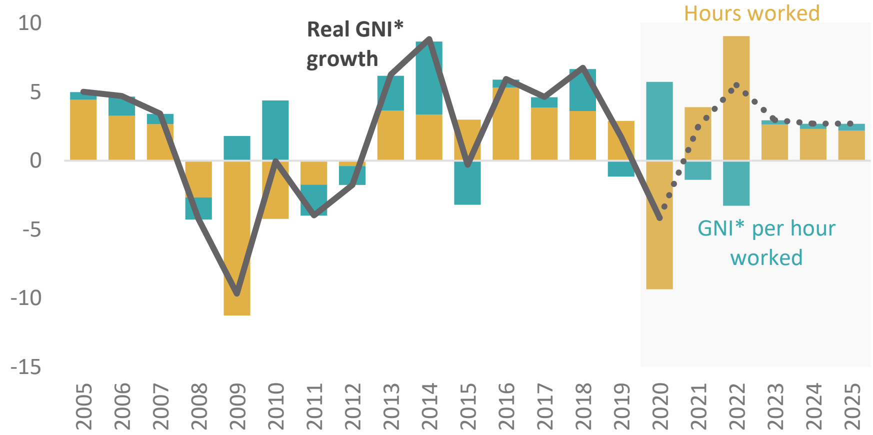
[19] See Supporting Information S1. Although the Department uses modified measures — which exclude more specific subcategories of intangibles and aircraft — the Council prefers to assess on the basis of underlying measures which exclude all intangibles and aircraft, as sub-categories within the CSO's modified series are frequently unavailable as a result of confidentiality issues.

[20] The effective import content of total exports is higher considering net factor income from abroad is equivalent in character to imports of royalties, when viewed from the perspective of the import content of final underlying demand in GNP rather than in GDP — see Figure E.1 in Fiscal Council (2020a).

highlights that, since 2005, labour productivity growth in the Irish economy has typically been positive, in particular during the recovery period following the global financial crisis.[21] Hours worked have also generally grown strongly, with the exception of 2008–2012.

**Figure 1.12: *SPU 2021* projects slower growth in hours worked and productivity after 2022**

% of final underlying demand (underlying domestic demand plus exports)




Sources: Department of Finance forecasts in *SPU 2021*; and Fiscal Council workings.
Notes: Underlying imports is total imports excluding investment on other transport equipment (mainly planes) and intangibles. Get the data.

As discussed further in Box B, the path for Ireland's medium-term productivity has moved considerably higher as a result of the pandemic. Over the medium term, the Department's forecast for growth in hours worked falls towards 2 per cent, down from a pre-pandemic rate of over 3.5 per cent per annum.

[21] Two exceptions are 2015 and 2019, when large distortions to Ireland's national accounts were caused by activities of foreign-owned multinational firms. However, the economy's underlying growth rate in these years was strong, as discussed by FitzGerald (2021). Therefore, it is more likely that both productivity and hours worked grew in these years.

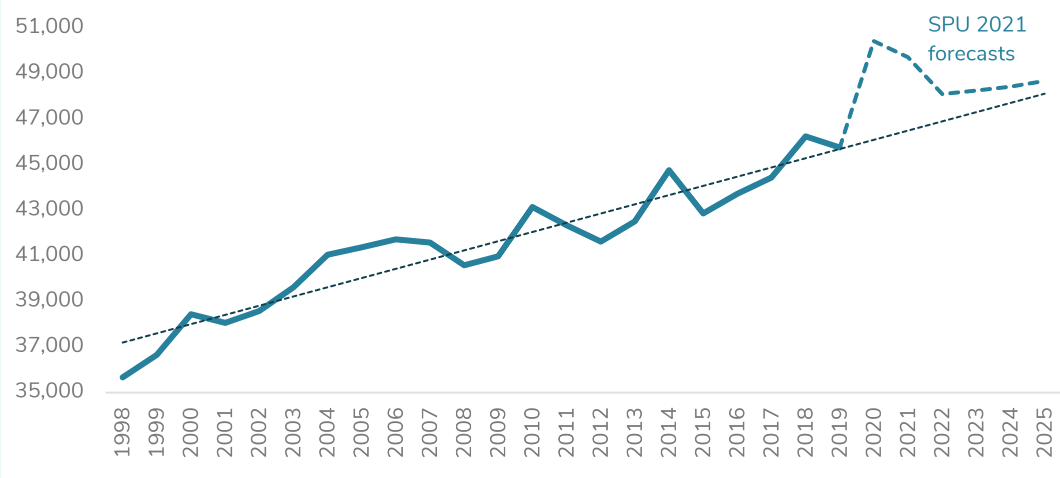
## Box B: Higher productivity is an artefact of the pandemic

One of the interesting aspects of the pandemic and its effects on the economy is that overall productivity has risen; something that is expected to persist. This box explores some of the reasons for this and the outlook for productivity in Ireland.

A standard measure of productivity is output per hour worked. Figure B1 shows the recent performance for the Irish economy and the official *SPU 2021* forecasts on this basis. It shows that productivity levels are expected to be significantly higher for a time following the pandemic.

**Figure B1: Productivity is expected to be on a higher path post-Covid**

Real GNI* per hour worked




Sources: CSO; Department of Finance (SPU 2021) forecasts; and Fiscal Council workings.
Notes: The linear trend shown is for the period 1998–2019. Get the data.

The overall effects of Covid-19 on productivity mask some large and offsetting forces. There are two key reasons why productivity levels have increased.

First, the compositional nature of the shock has played a major role. Relatively low productivity sectors, such as construction, have seen employment plummet, whereas higher productivity sectors, such as the manufacturing of pharmaceuticals, have been less effected. This phenomenon could be temporary: as lower productivity sectors recover, this should reduce overall productivity levels. Yet with more severe scarring forecast for lower productivity sectors, it is possible that the economy will end up on a somewhat higher path with overall productivity higher than pre-crisis trends would have suggested. Exploring evidence for UK firms, Bloom et al. (2021) find similar effects using survey data for a large panel of UK firms. In this case, they find the increased share of work being done in higher productivity sectors partly offsets productivity losses elsewhere caused by higher costs associated with Covid containment measures.

Second, sectors that have been able to continue work throughout the pandemic relatively unperturbed have seen a rise in output per worker. This could be due to the positive aspects of work-from-home practises. For instance, Barrero et al. (2020) expect a 1 per cent productivity boost in conventional productivity measures post-pandemic for individuals engaged in work-from-home practises. The authors use a large survey of 30,000 US individuals over multiple waves and find most respondents adopting work-from-home practices report higher productivity than pre-pandemic expectations.

There are risks to this outlook. If firms reduce research and development or investment spending to cover costs associated with containment measures or losses made during the pandemic, this could hamper medium-term growth. There is also a risk that the natural destruction of inefficient firms—so-called "zombies"—is halted due to emergency supports introduced during the pandemic, which could arrest productivity growth.

## 1.4 Risks to the outlook

The Council assesses that risks to the economy over the medium term are broadly balanced.[22] While the Department notes that risks are "tilted to the downside", there are a number of reasons why both short- and medium-term growth may be higher than assumed. For instance, growth could be higher due to less scarring or lower-than-assumed levels of imports. Compared to the situation over the past year, uncertainty is now lower as Brexit has taken place and progress has been made in the management of Covid-19, including the roll-out of effective vaccines.

**The Council assesses that risks to the economy over the medium term are broadly balanced rather than "tilted to the downside" as the SPU suggests**

A faster and larger unwinding of savings owing to pent-up demand could provide a significant boost to consumption in 2021 and in 2022. The relatively low import content of higher consumption, especially for restricted services such as hospitality, imply a greater domestic content, and higher domestic multiplier effects, of an increase in domestic consumption.

Spillover effects from expansionary fiscal policy in the US could also provide a substantial boost to the Irish economy. The National Institute for Economic and Social Research estimates that the US stimulus will raise growth outside the US by about ½ of a percentage point in 2021. Given Ireland's openness and links to the US through exports and multinational firms, the spillovers to Ireland may be even bigger.

A key downside risk is the potential for virus mutations, which could require new vaccine development, and necessitate further lockdowns.

The risk that global and international tax reforms will reduce foreign direct investment and reduce government tax revenues has increased. This could slow down or reverse growth in earnings for high-pay sectors of the economy, with considerable negative risks for local enterprises, as discussed further in Box F.

Risks remain around Brexit that existing arrangements could unwind, and it is also possible that negative impacts on the Irish economy of the new free-trade agreement with the EU will be larger than projected.

[22] See Supplementary Information S4 for the Council's assessment of macroeconomic risks.

# Budgetary Assessment

## Deficit to improve as economy recovers

# 2. BUDGETARY ASSESSMENT
## Deficit to improve as economy recovers

After a gradual narrowing of the deficit in the years up to 2019 (Section 2.1), budgetary developments remain dominated by the impact of the pandemic on government spending and revenue during 2021 (Section 2.2).

The medium-term budgetary outlook will be shaped by the recovery and policy decisions, as well as various spending and revenue pressures (Section 2.3). *SPU 2021* forecasts a deficit of 8.4 per cent of GNI* in 2021, narrowing to 5.0 per cent in 2022 and then 0.3 per cent by 2025, but this does not fully take into account the cost of maintaining existing policies.

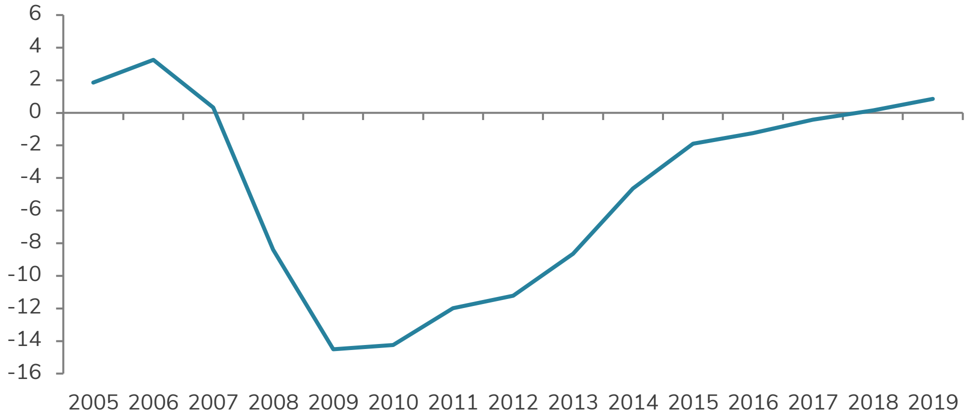
This section develops an adjusted *SPU 2021* budget balance, taking into the cost of on-going spending and correcting for apparent overestimation of capital spending and income receipts, which leaves the 2025 deficit at 1.2 per cent of GNI*. In both the short and medium term, there are substantial risks to the budgetary outlook (Section 2.4).

## 2.1 The recent budgetary context

Prior to the Covid-19 pandemic, the budget deficit had narrowed over many years, finally reaching a small surplus in 2018 and 2019 (Figure 2.1). As a result, the public finances were somewhat better placed to absorb the pandemic's impacts in 2020 and beyond. However, "excess" corporation tax receipts—unexplained by the performance of the domestic economy—have boosted the budgetary position since 2012. Last year, corporation tax receipts were €11.8 billion — up to €6.3 billion more than the level estimated by the Council to be in line with growth in the domestic economy (see section S9).

**Figure 2.1: The Government's budget balance reached a surplus in 2018**

% GNI*, excludes one-off items




Sources: CSO; and Fiscal Council workings.
Note: Data are adjusted to exclude one-offs as assessed by the Council. Get the data.

Current estimates suggest that a general government deficit of €18.4 billion (8.9 per cent of GNI*) was recorded in 2020. This marked a deterioration of €20.2 billion compared to 2019. This was driven by increased spending of €16.7 billion. About €13 billion of the spending increase can be attributed to policy measures — mainly related to supports for incomes and the health response (Table 2.1). Overall revenues were more stable, falling by €3.5 billion, of which about €1.4 billion reflects tax supports adopted. While receipts from many tax heads fell, others were remarkably resilient. The overall package of budgetary supports introduced in 2020 was about €14.5 billion, with automatic stabilisers playing a much smaller role by comparison.

**Both revenue and expenditure outturns were more favourable than expected for 2020**

Overall, tax revenue in 2020 was much more resilient than expected. Income and employment losses were sector specific and concentrated in the lower half of the income distribution, while pay increases agreed before the pandemic raised earnings for many. As a result, income tax receipts (when adjusted for warehousing as explained in the next section) grew in 2020 (see Box D). This outcome was far better than initially projected, largely because wages have been more resilient than expected.

Outcomes for 2020 were also better than expected even in *Budget 2021* in mid-October, despite the additional lockdown measures that were not factored in. General government revenue was €1.5 billion higher than in *Budget 2021*. Income tax was stronger than forecast in *Budget 2021* (€1.2 billion), while corporation tax was lower (€0.5 billion).

On the spending side, general government spending was €1.7 billion lower than forecast in *Budget 2021*. This was despite the unanticipated imposition of Covid restrictions in mid-October. *Budget 2021* forecasts assumed €16.7 billion of Covid-19 related spending in 2020. It appears that Covid-19-related spending was €14.9 billion (€1.8 billion lower).[23] This suggests that non-Covid-19-related spending was in line with *Budget 2021* forecasts.

**Table 2.1: 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 |

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

Notes: The Covid Restrictions Support Scheme is included here as an expenditure item in line with the CSO's classification (the Department classified it initially as a tax measure). Tax warehousing amounts refer to amounts of receipts warehoused and not expected to be repaid (25 per cent). Single asterisked (*) amounts refer to budgeted allocations as part of *Budget 2021/Revised Estimates 2021*; excesses over these amounts will be funded through Contingency allocations and the Recovery Fund. Double asterisked (**) amounts in 2020 differ from *SPU 2021* estimates of €14.9 billion but are in line with CSO estimates of Covid-specific spending. This, however, may be revised up in future vintages.

[23] *SPU 2021* lists Covid-19 related spending for 2020 of €14.9 billion. However, the CSO classified €13.1 billion of 2020 spending as Covid-19 related. This figure is subject to revision in future vintages. For now, the *SPU 2021* figure is used.

## 2.2 The short-term outlook

*SPU 2021* forecasts the general government deficit to be almost unchanged in 2021 relative to 2020 (€18.1 billion or 8.4 per cent of GNI*). Both revenue and expenditure are forecast to grow by over €4 billion in 2021 as the economy recovers.

Spending is forecast to rise in 2021 despite Covid-19/one-off spending being forecast to fall by almost €3 billion. Permanent spending is forecast to rise by over €7.3 billion in general government terms following decisions in *Budget 2021*. This is an unusually large year-to-year change in core government spending, unrelated to the pandemic.

Spending forecasts in *SPU 2021* are made on the basis of temporary supports like the PUP and Employment Wage Subsidy Scheme (EWSS) ending as of end-June 2021, but contingencies were built into the overall Budget. These contingencies have broadly protected overall spending projections in *Budget 2021* from the impact of the unanticipated health-related restrictions in the first half of 2021. *SPU 2021* indicates that almost €12 billion of spending in 2021 is related to Covid support schemes, additional health spending, and additional unemployment payments.[24]

Forecasts of total general government expenditure in 2021 were revised down in *SPU 2021* by €0.6 billion relative to *Budget 2021*. This suggests that effectively all €5.4 billion of contingency spending, which was left unallocated in *Budget 2021* (made up of a Recovery Fund of €3.4 billion and a Covid-19 Contingency reserve of €2 billion) is now expected to be used. In other words, there is no unallocated spending in the *SPU 2021* fiscal projections.[25]

[24] Income support schemes and social protection payments of €3.3 billion, a Recovery Fund of €3.4 billion, a Contingency allocation of €2 billion, and the remainder in departmental Covid-19 contingencies.

[25] Section S7 provides some insights into where much of the previously unallocated funding (€5.5 billion) appears to now be allocated.

**Table 2.2: Fiscal forecasts from *SPU 2021***

€ millions unless otherwise stated

| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|
| **General Government Revenue** | **85,780** | **90,515** | **94,150** | **99,470** | **103,700** | **108,120** |
| Change in General Government Revenue | -3,488 | 4,735 | 3,635 | 5,320 | 4,230 | 4,420 |
| **General Government Expenditure** | **104,200** | **108,575** | **105,765** | **104,790** | **106,835** | **108,920** |
| Covid/One-off Expenditure | 14,916 | 11,960 | 5,275 | 975 | 700 | 500 |
| Change in Covid/One-off Expenditure | 14,916 | -2,956 | -6,685 | -4,300 | -275 | -200 |
| "Core" General Government Expenditure | 89,284 | 96,615 | 100,490 | 103,815 | 106,135 | 108,420 |
| Change in "Core" General Government Expenditure | 1,794 | 7,331 | 3,875 | 3,325 | 2,320 | 2,285 |
| **General Government Balance** | **-18,415** | **-18,060** | **-11,615** | **-5,320** | **-3,130** | **-805** |

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

Notes: Covid/one-off spending in 2022 is made up of €2.5 billion in Covid-19 supports, €1.5 billion in "Covid automatic stabilisers", €1.1 billion for the Brexit Adjustment Reserve Fund, and €0.2 billion for the National Recovery and Resilience Plan. One-off amounts for 2023 to 2025 are made up of Covid automatic stabilisers and the National Recovery and Resilience Plan. CSO estimates suggest Covid specific spending in 2020 was €13.1 billion. This estimate is subject to further revision, however, so the *SPU 2021* estimate of €14.9 billion is used.

*SPU 2021* forecasts are compiled on the basis that supports schemes such as the PUP and EWSS finish at the end of June 2021. The original allocations for these income support schemes were €0.6 billion and €1.2 billion respectively, with a further €1.4 billion made available for unemployment spending following the proposed closure of the PUP and EWSS in March 2021. Spending above these levels was to be supported through the Contingency and Recovery funds.[26]

The unexpected deterioration in the public health situation from last autumn has resulted in tighter restrictions and a significantly larger number of workers claiming the PUP than was expected in *Budget 2021*, and at higher rates of pay. Costs associated with the PUP and EWSS are now likely to be around €5.7 billion in total between January and June 2021.[27]

**The costs of unexpected lockdowns have used up most contingencies, leaving little room for stimulus measures without additional funding**

This will require fully drawing down the Covid-19 allocation for the Department of Social Protection, along with the entire Contingency Fund and some of the Recovery Fund. Further income supports provided for the rest of the year through extensions of these schemes or standard jobseeker's payments has been signalled by the Government and would require further drawdowns from the Recovery Fund, leaving little to no

[26] These figures are the higher, Revised Estimates released after the initial *Budget 2021* figures of €0.4 billion for the PUP and €0.9 billion for the EWSS.

[27] Based on details provided by the Department of Finance, excluding foregone PRSI through the EWSS.

funding for further stimulus efforts within the Government's €12 billion allocation for Covid-19-related expenditure in 2021.[28]

*Budget 2021* planned for large permanent increases in spending, not related to Covid-19. In gross voted terms, permanent increases in spending of €5.4 billion are forecast. In general government terms, this increase is even larger. These remain part of the spending increases in *SPU 2021*.

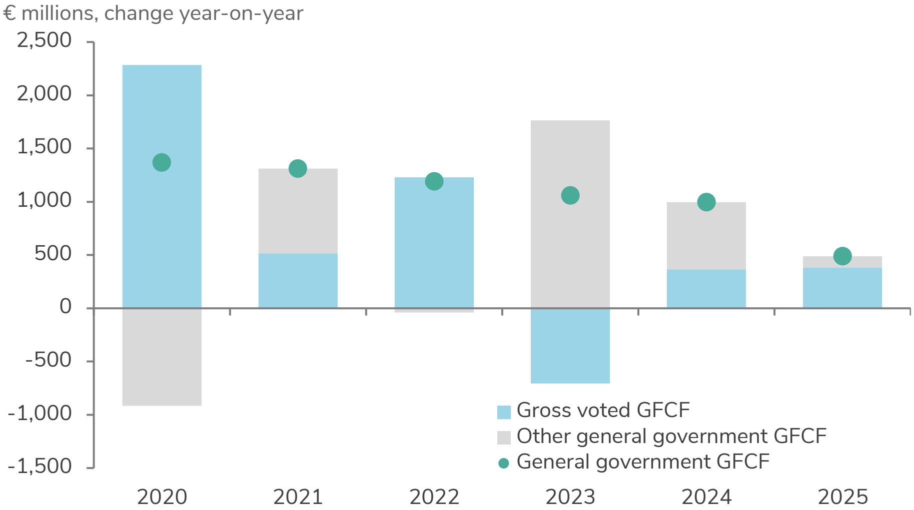
Spending projections in *SPU 2021* do not take account of payment of the Christmas bonus in 2021 or beyond. Given the recent history that it has been paid in each of the past seven years, it should have been budgeted for by default (see Box B, Fiscal Council 2020d). In 2020, full payment of the Christmas bonus cost €0.3 billion.

This is one part of the wider transparency issues around budgetary projections. For example, the only mention of Sláintecare in the Revised Estimates for 2021 came under the heading of "health care reform" and showed an associated amount of just €45 million for 2021. It was not until the publication of the *Sláintecare Implementation Strategy & Action Plan 2021–2023* in May that the actual costs associated with the reforms in 2021 were clarified as being some €1.2 billion of 2021 health spending allocation.

General government capital spending is forecast to grow by €1.3 billion in 2021 (13.4 per cent). This is driven by both exchequer and non-exchequer bodies (Figure 2.2). Much of the forecast increase in capital spending after 2022 comes from non-Exchequer areas. Yet there is limited available information on spending in non-Exchequer areas. The Council had called in its previous Fiscal Assessment Report for more transparency to be provided on these areas. *SPU 2021* shows no major improvements from *Budget 2021* in this regard.

[28] While the government has indicated that these schemes are likely to continue beyond June, there are no official details on the form that they will take.

**Figure 2.2: Capital spending increases driven by exchequer and non-exchequer bodies**




Sources: CSO; *SPU 2021*. Get the data.

On the revenue side, *SPU 2021* forecasts general government revenue to increase by €4.7 billion in 2021. The level for 2021 has been revised up by €1.8 billion relative to *Budget 2021* forecasts. This is mainly driven by general government revenue being €1.5 billion higher in 2020 than forecast in *Budget 2021* (mainly due to income tax; see Figure S.8a). Box C outlines the impact of warehousing on Exchequer tax receipts.

## Box C: The impact of warehousing on tax receipts

One of the measures introduced in response to the pandemic was the warehousing of some tax due in 2020 and 2021. Some income tax and VAT which were due to be paid in 2020 and 2021 were deferred, to be repaid over the period 2021–2023.

Overall, €2,253 million of receipts were warehoused (€1,900 million in 2020, €353 million in 2021). On an Exchequer basis, these receipts will not be included in the year they were originally due, but rather in the year they are eventually collected (cash basis). However, on a general government basis, these warehoused tax receipts are included in 2020 and 2021 (accrual basis) figures rather than over the period received (2021–2023).

Forecasts of income tax in *SPU 2021* are compiled on an Exchequer basis. These then are used as an input into forecasts of general government revenue (which are on an accruals basis). In 2020 and 2021, €1,026 million of income tax receipts were warehoused.[29] *SPU 2021* assumes a default rate of 25 per cent. This means that €770 million of income tax is expected to be recovered (over the period 2021-2023).

This default rate was arrived at by the Department after consultations with Revenue. Given the unusual nature of the scheme, there is significant uncertainty over the appropriate default rate to be assumed. Given this uncertainty, the Department used what it believed to be a relatively high default rate as a prudent assumption.[30]

### Table C1: Income tax forecasts from SPU 2021

€ millions unless otherwise stated

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|
| Exchequer income tax (cash basis) | 22,934 | 22,711 | 24,305 | 26,130 | 28,470 | 30,385 | 32,305 |
| Warehousing | 0 | 649 | 121 | 0 | 0 | 0 | 0 |
| Repayments | 0 | 0 | 115 | 231 | 423 | 0 | 0 |
| Net Warehousing impact | 0 | 649 | 5 | -231 | -423 | 0 | 0 |
| “Underlying” income tax (accruals basis) | 22,934 | 23,360 | 24,310 | 25,899 | 28,047 | 30,385 | 32,305 |
| Exchequer income tax growth (%) | 8.0 | -1.0 | 7.0 | 7.5 | 9.0 | 6.7 | 6.3 |
| “Underlying” income tax growth (%) | 8.0 | 1.9 | 4.1 | 6.5 | 8.3 | 8.3 | 6.3 |

Sources: *SPU 2021*.

Note: Of the €1,026 million of income tax receipts that were warehoused in 2020 (€865 million) and 2021(€161 million), *SPU 2021* forecasts assume that 75 per cent are repaid (€770 million). €649 million of this relates to income tax warehoused in 2020, with €121 million related to income tax warehoused in 2021. As a result, “underlying” income tax receipts for 2020 are €649 million higher than given by the Exchequer presentation. 2021 sees a mixture of some warehousing of receipts and some repayments of income tax warehoused in 2020. Conversely, “underlying” income tax receipts for 2022 and 2023 are lower than the Exchequer presentation.

The income tax forecasts in *SPU 2021* reflect this assumed impact of warehousing and subsequent repayment. Table C1 shows what “underlying” income tax receipts would look like under the *SPU 2021* forecasts. This adjustment attributes the recovered amounts of income tax to 2020 and 2021, rather than 2021-2023. After making this adjustment, “underlying” income tax receipts are forecast to grow by 4.1 per cent in 2021. This is much more modest that the headline 7 per cent growth rate, and closer to the growth of the non-agricultural pay bill.

As with income tax receipts, VAT receipts are also impacted by warehousing in 2020 and 2021, with payments due in subsequent years (Table C2). VAT receipts of €1,227 million were

[29] Almost all the warehoused income tax is PAYE, with self-employed income tax accounting for less than 5 per cent of warehoused income tax.

[30] In reporting the Government Finance Statistics, the CSO has accrued €874 million of income tax/VAT receipts into 2020. This implies a default rate of 54 per cent. This will be further reviewed as more data becomes available. See background notes, transactions of note 2020: https://www.cso.ie/en/releasesandpublications/er/gfsa/governmentfinancestatisticsapril2021/

warehoused over 2020-2021 and, as is the case with income tax, 75 per cent of the warehoused VAT is expected to be repaid over the period 2021–2023 (€920 million). On an underlying basis, VAT fell less severely in 2020 and is forecast to grow more modestly in 2021 (8.9 per cent).

### Table C2: VAT forecasts from *SPU 2021*

€ millions unless otherwise stated

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|
| Exchequer VAT (cash basis) | 15,118 | 12,425 | 14,370 | 15,885 | 17,280 | 18,105 | 19,015 |
| Warehousing | 0 | 776 | 144 | 0 | 0 | 0 | 0 |
| Repayments | 0 | 0 | 138 | 276 | 506 | 0 | 0 |
| Net warehousing impact | 0 | 776 | 6 | -276 | -506 | 0 | 0 |
| "Underlying" VAT (accruals basis) | 15,118 | 13,201 | 14,376 | 15,609 | 16,774 | 18,105 | 19,015 |
| Exchequer VAT growth (%) | 6.2 | -17.8 | 15.7 | 10.5 | 8.8 | 4.8 | 5.0 |
| "Underlying" VAT growth (%) | 6.2 | -12.7 | 8.9 | 8.6 | 7.5 | 7.9 | 5.0 |

Sources: *SPU 2021*.
Note: Of the €1,227 million of VAT receipts that were warehoused in 2020 and 2021, *SPU 2021* forecasts assume that 75 per cent are repaid (€920 million, €776 million relating to 2020 warehousing, €144 million relating to 2021 warehousing). As a result, "underlying" VAT receipts for 2020 are €776 million higher than given by the Exchequer presentation. Conversely, "underlying" VAT receipts for 2022 and 2023 here are lower than the Exchequer presentation.

Forecasting income tax presents a number of challenges given the sharp changes in the composition of the forecast, which have changed the standard relationship between income and income tax receipts.

In addition to the complexities of warehousing, Section S.8 outlines some of the difficulties in forecasting income tax at a time of high volatility and with large differences in the situation of different taxpayers using the Department's methodology in this round. This has led to large amounts of judgement being applied to income tax forecasts in 2022 (see Figure S.8b). Box D outlines some of the challenges in forecasting income tax receipts.

### Box D: The resilience of income tax in 2020

Income tax was surprisingly resilient in 2020, falling by just 1 per cent. It would have grown by 1.9 per cent if deferred, or "warehoused", tax receipts were included. This reflects how the total wage bill in Ireland was effectively flat in 2020, despite substantial lost earnings for some sectors. In each case, the performance in 2020 was far more benign than the Department of Finance projected in *SPU 2020* and in *Budget 2021*. This Box analyses the compositional issues affecting income tax as observed in 2020 due to the Covid-19 pandemic.

Figure D1 presents detailed data from recent Revenue analysis of PAYE receipts in 2020 (Collins and O'Rourke, 2021). This demonstrates that the sectors with the largest annual falls in income taxes paid in percentage terms tended to be those sectors that pay a small share of total PAYE receipts. In contrast, the top seven sectors — each with shares of at least 10 per cent of PAYE receipts — saw tax payments increase by 2.3 per cent (in weighted average terms) in 2020.

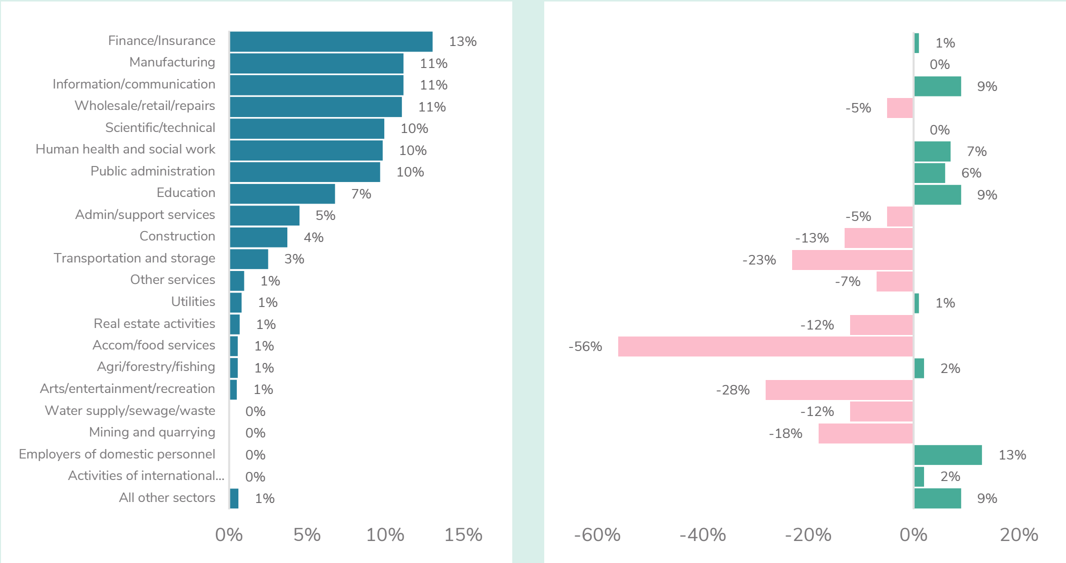
Overall decreases in PAYE receipts for sectors that declined amounted to approximately €650 million, whereas the increases for sectors that grew totalled €450 million. By far the largest decrease was in accommodation and food services (about €220 million), followed by other services (close to €120 million). The largest increase was for information and communication (about €130 million), followed by human health and social work (€100 million).

Figure D2 presents recent forecast vintages of income tax (panel A) and the average income tax rate (panel B). As discussed in Section 2.3, income tax (excluding the adjustment for warehousing) is forecast to recover gradually from a modest fall in 2020, with the level of receipts by 2023 back in line with pre-pandemic projections. The eventual reduction in 2020 receipts was far more benign than expected in *SPU 2020* or *Budget 2021*, reflecting the extreme uncertainty brought on by the pandemic.

### Figure D1: Incomes held up in sectors paying the most income tax

A. PAYE receipts by sector
% total

B. PAYE growth rate by sector
% change year-on-year




Source: Collins and O'Rourke (2021).

### Figure D2: Forecasts of sharp changes in effective income tax rates have proven inaccurate

A. Income tax vintages
€ billion

B. Average income tax rate vintages
Percentage of compensation of employees


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

PAYE makes up the majority of income tax (70 per cent in 2020). Department of Finance forecasts of PAYE are made using two macroeconomic drivers: non-agricultural earnings per person and the numbers employed. An elasticity of 2.1 is applied to non-agricultural earnings per person, while an elasticity of 1 is applied to employment.[31] Due to the sector-specific nature of the pandemic, employment and average earnings per person employed diverged strongly. In 2020, employment fell, while average earnings per person still employed rose sharply due to the compositional changes.

Using the two elements of the wage bill (pay per person and employment) may be problematic in this case and this is best illustrated by examining the impact of macroeconomic drivers on 2022 forecasts. *SPU 2021* forecasts that in 2022, employment and labour market conditions will improve. The return of many lower paid employees means average pay per employee is forecast to fall in 2022. This is offset somewhat by employment rising. However, as a much higher elasticity (2.1 as opposed to 1) is applied to pay per employee, the overall "macro" effect on PAYE receipts is negative. This runs counter to the idea that a recovering labour market should boost income tax receipts.

Given the problems with the methodology, significant judgement is applied by the Department of Finance to arrive at the forecasts in *SPU 2021* (Section S.8). A simpler and possibly more robust alternative in this case would have been to use an alternative method, such as the elasticity of PAYE receipts to compensation of employees.

Corporation tax receipts are forecast to fall in 2021, due to payments under the Covid Restrictions Support Scheme (CRSS).[32] While recent outturns suggest that the cost of this scheme has been lower than anticipated, around €0.3 billion of corporation tax receipts this year have been redirected to impacted businesses through the CRSS.[33] The scheme is scheduled to

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[31] The same two macroeconomic drivers are used to forecast Universal Social Charge receipts. However, the elasticity used for earnings per person (1.2) is much closer to that applied to employment growth (1.0). As a result, the differing growth rates of these two variables is less problematic.

32 The CRSS is a direct cash payment scheme for firms forced to close as a result of public health restrictions, and was originally to be funded through the €3.4 billion Recovery Fund.

[33] Previous estimates were for CRSS payments to total around €0.16 billion per month under Level 3 restrictions. The introduction of the Covid-19 Business Aid Scheme worth €60 million has likely supported businesses that would have required some of the €0.16 billion monthly estimate.

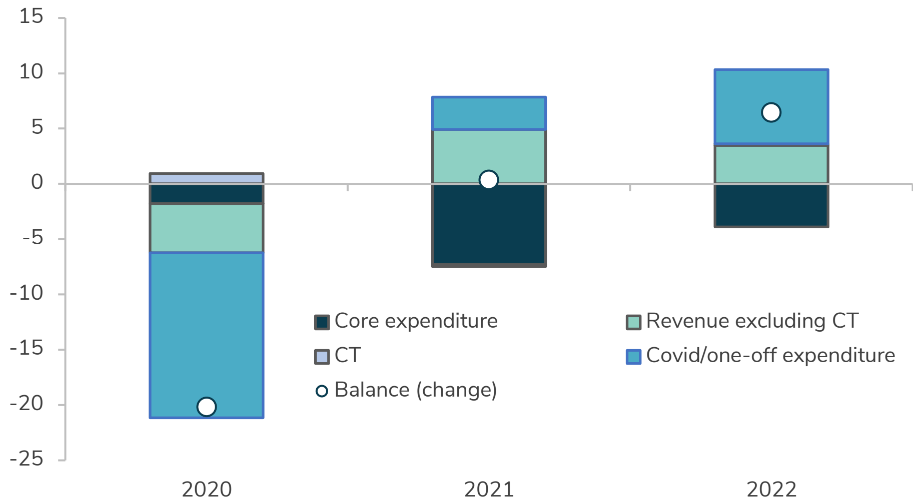
remain in place until the end of June, with indications it will be extended in some form.

Figure 2.3 shows the elements contributing to changes in the general government balance in 2021. Revenue growth in 2021 contributes to improvement in the general government balance, together with lower Covid/one-off spending. However, increases in core expenditure almost entirely offset these improvements. As a result, the balance is forecast to only marginally improve in 2021.

**Falls in Covid-19-related spending and revenue increases in 2021 are offset by rising core spending**

### Figure 2.3: Improvements in the budget balance from revenue increases and falls in temporary spending are largely offset by increases in core spending

€ billion, annual change




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. Get the data.

## 2.3 The medium-term outlook

Fiscal projections in *SPU 2021* go out to 2025. The Council welcomes this longer forecast horizon relative to *SPU 2020* and *Budget 2021* and would welcome a return to full 5-year ahead forecasts in the autumn.

However, *SPU 2021* spending projections over the period 2022-2025 are "technical" in nature in that they are not intended to reflect Government policy decisions.

This means that the *SPU 2021* forecasts do not aim to fully reflect the cost of continuing existing policies and do not take into account the commitments in the 2020 *Programme for Government*.

Current spending projections for core voted spending from 2022 are based on the *ad hoc* assumption of 3.5 per cent growth per year, following a forecast increase of non-Covid related spending of 7.7 per cent in 2021.[34] As noted below, this level of spending growth would be insufficient to hold current service levels constant and index social payments. The assumed capital spending profile does not match the Capital Plan.

**Temporary spending on Covid-19 remains in 2022, with technical assumptions of 3.5% spending growth relied upon thereafter in SPU 2021**

For 2022, there is €2.5 billion of spending set aside for Covid-19 spending/sectoral supports. This is presented as indicative of spending that may be required in certain sectors.[35] A further €1.5 billion in spending is related to automatic stabilisers (mainly jobseeker's payments). €1.1 billion of capital spending in 2022 is to be funded by the Brexit Adjustment Reserve Fund. These assumptions mean that Covid-19/one-off expenditure is forecast in *SPU 2021* to fall by €6.7 billion in 2022. This outweighs core spending growth of €3.9 billion, meaning general government expenditure is forecast to fall by €2.8 billion.

[34] *SPU 2021* forecasts nominal GNI* growth of 7.6 per cent in 2022.

[35] The Minister for Finance suggested that these funds may be required "to support semi-state companies, the continuation of social distancing within public transport and some of the measures that are in place in our schools". See https://www.oireachtas.ie/en/debates/debate/committee_on_budgetary_oversight/2021-04-27/2/

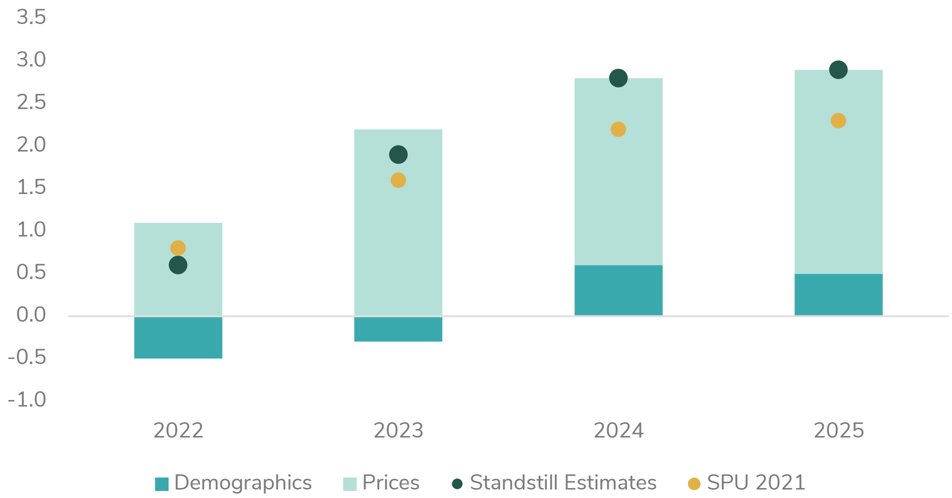
For the medium term, a better methodology to forecast spending is based on the "Stand-Still costs" of maintaining existing public services and value of welfare payments, taking into account inflation, wages increases and the costs of ageing, and any envisaged policy changes which have implications for spending. In assessing this, the Council is not recommending indexation. These increases would be realistic to expect as (1) they would be in line with past patterns and (2) they would be required to maintain their relative real value (such that that public sector wages and welfare payments would increase in line with economy-wide wages). This approach provides the best anchor for understanding the consequences of policy changes relative to existing commitments.

**Estimating Stand-Still costs associated with price and demographic pressures allows for a more realistic projection of future spending**

Section S11 outlines the Council's Stand-Still cost estimates. These indicate the costs of maintaining current government service levels and indexing social welfare payments to account for demographic and price pressures. This includes adjusting for the estimates of Covid and unemployment-related supports, which are expected to fall as the economy recovers.

### Figure 2.4: Stand-still costs exceed medium-term gross voted spending allocations

Annual change in € billion (gross voted current spending)




Source: SPU 2021, Revised Estimates 2020, CSO, Department of Expenditure and Reform, HIPE, HSE, and Fiscal Council workings. Get the data.

The Stand-Still estimates imply that spending would need to increase by approximately €2.1 billion each year on average (for 2022-2025) to maintain existing commitments (see section S11). These pressures are largely driven by price effects but with some impact from ageing in the later years (Figure 2.4).

Stand-Still costs of €2.1 billion per year are higher than the €1.7 billion annual average increase in gross voted current spending from 2022-2025 in *SPU 2021*. This cumulates to €1.2 billion over the period. This implies that core spending increases projected in *SPU 2021* would be insufficient to maintain current service levels and index social payments. The gap between the Department's current spending forecasts and the Stand-Still estimates remains the same, even if changes in social benefits owing to lower numbers unemployed are removed from the analysis. This is before any new policy priorities are considered or any upside risks to spending in areas such as health are realised.[36]

**Expenditure levels in *SPU 2021* are not credible when compared with Stand-Still costs**

This suggests that the medium-term spending plans are not credible as they do not appear consistent with on-going spending plans yet alone additional policy priorities set out in the Programme for Government. At the same time, the lack of detailed foundations to these SPU projections makes it difficult to understand what is driving the projections. While the assumption of 3.5 per cent growth in spending is likely to be more realistic than some projections in some past years, which assumed flat spending in nominal terms. It appears both unfounded and unrealistic.

This highlights the limitations of using unrealistic technical assumptions to forecast medium-term spending. A better methodology would be to forecast spending based on a bottom-up assessment of demographic and price pressures, as with the Stand-Still estimates, and any envisaged policy changes which have implications for spending. This would provide a more realistic projection and provide a better way of articulating the factors impacting the public finances.

Interest costs are projected to stay relatively stable over the medium term. Gross financing needs are projected to be below 10 per cent of GNI*, which would limit the immediate impact of an increase in the marginal interest rate. *SPU 2021* forecasts of interest costs in 2021 are lower than those in *Budget 2021*, repeating a recent pattern of downward revisions.

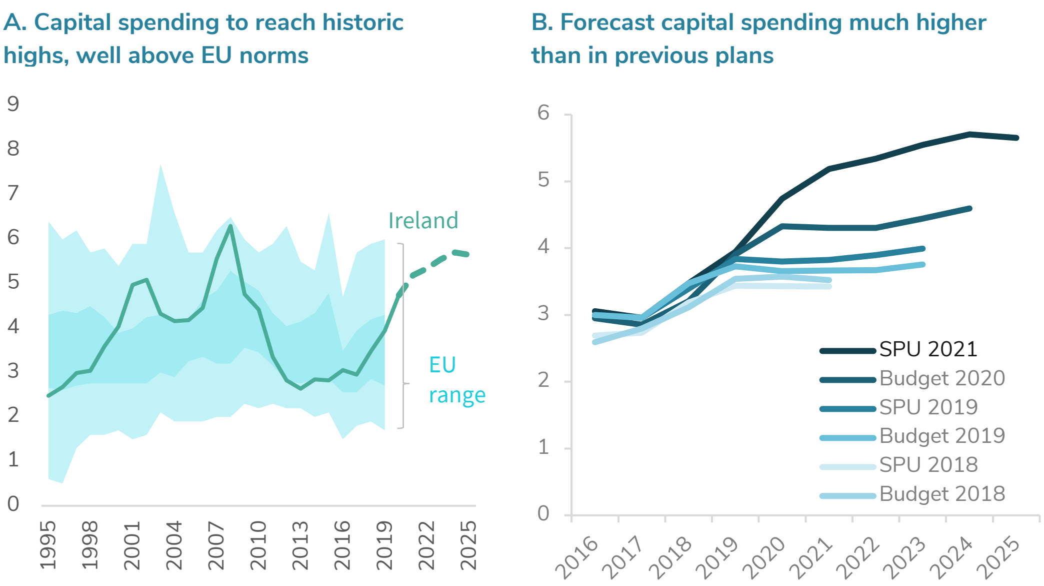
[36] See Box E for an overview of how costs associated with the government's climate change policies are likely to add to spending pressures over the coming years.

One area of spending that *SPU 2021* forecasts to grow rapidly over the forecast horizon is capital spending.[37] General government capital expenditure is forecast to exceed 5.5 per cent of GNI* from 2023 onwards. This would put Ireland well above current EU averages for public investment as a share of national income (Figure 2.5, Panel A). Previous forecasts of public investment in Ireland showed much lower levels of investment planned for the later years of the forecast horizon (Figure 2.5, Panel B). Much of the increase in general government capital spending in the later years is focused in non-exchequer areas (Figure 2.2).

**Ireland's capital spending as a share of national income is forecast to become one of the highest in Europe**

### Figure 2.5: Capital spending to increase as a share of national income.

% GNI*




Sources: CSO and Department of Finance.
Note: Dashed line in Panel A indicates forecasts from *SPU 2021*. The EU range shows the minimum and maximum levels of public investment as a share of national income in EU countries (GDP for all countries apart from Ireland). The darker shaded area shows the inter quartile range of EU levels of investment. Darker lines in Panel B represent more recent forecasts. *SPU 2020* and *Budget 2021* are excluded due to their short forecast horizons. Get the data.

The upward revision to planned increases in investment is substantial and might be difficult to achieve. It is possible that the Government might not have the capacity to ramp up public investment to the extent that is now planned meaning that the public investment forecasts set out in the *SPU 2021* could be too optimistic.

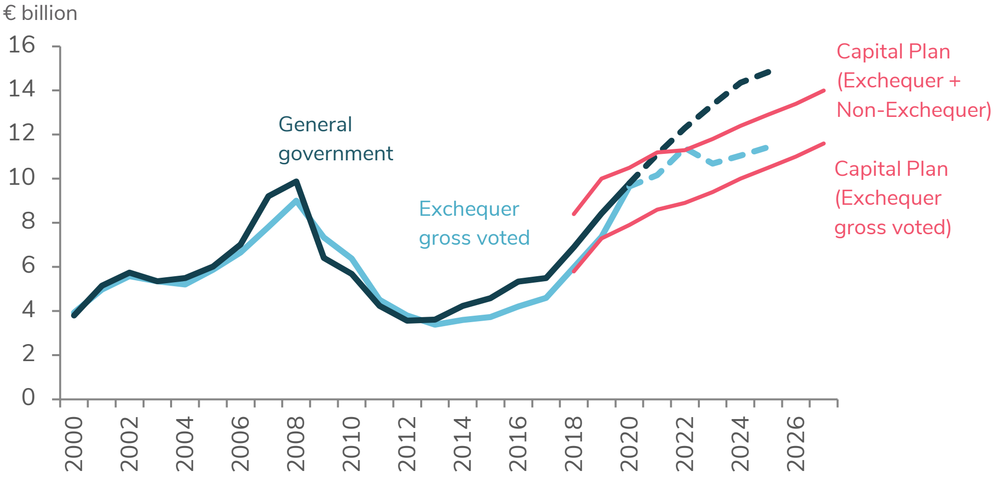
**Ambitious capital spending plans will require careful planning to achieve targets**

Furthermore, the planned increase in investment is higher in than in the Government's capital plan: the "National Development Plan". Figure 2.6 shows that the ramp up would see general government investment

[37] *SPU 2021* indicates that €1.1 billion of capital spending in 2022 is to be funded by the Brexit adjustment reserve fund.

spending exceed the capital plan's allocation for both Exchequer and non-Exchequer areas by almost €2 billion. It is also notable that there is a lack of detail in *SPU 2021* in terms of what areas this investment is targeted at. While the Revised National Development Plan is to be released in the coming months, it is impossible to determine if the allocations made in *SPU 2021* are consistent with this upcoming publication and whether they capture costs of major policies envisaged such as meeting climate change targets, housing priorities or Sláintecare reforms.

**Figure 2.6: Public investment is forecast to exceed the Capital Plan**




Sources: 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. Get the data.

The implementation of policy priorities from the 2020 Programme for Government such as emissions reductions, the provision of housing, and Sláintecare, in particular, appear to present upside risks to spending over the medium term as they are not explicitly factored into *SPU 2021* and the amounts projected for current spending are insufficient to maintain existing activities in real terms.

At the same time, it remains unclear how the large permanent increase in spending from *Budget 2021* is being allocated relative to the Government priorities. While we now know that some €1.2 billion of the €1.9 billion of permanent increases in health spending for 2021 are actually allocated to the implementation of Sláintecare, there remains no clear guidance as to how far these costs go towards implementing the Sláintecare reforms in full. This was estimated in May 2017 at €3 billion. In other areas of current spending, it is unclear how Government objectives will be funded.

**Sláintecare represents a significant spending risk, given the scale of its ambition and the lack of detail on costings**

More generally, there is a lack of detail and transparency in recent budgetary documentation. For example, the expenditure report released as part of *Budget 2021* detailed large and permanent increases to health spending, but with no clear information provided on how these costs related to plans of delivering Sláintecare.[38]

On the revenue side, "Underlying" income tax is forecast to grow strongly over 2022-2025 (7.4 per cent on average). This is faster growth than growth for the non-agricultural wage bill (5.1 per cent on average over 2022-2025).[39] This suggests that the average effective tax rate is increasing (Figure 2.7b).

**Income tax forecasts in SPU 2021 imply growth rates that are stronger than expected for wages**

While not explicitly stated in the documentation, *SPU 2021* projections appear to have been based on income tax bands and credits not being indexed after 2021. This means that the average effective tax rate increases due to inflation and higher wages as more taxpayers move into the higher tax bands and as the real value of thresholds fall. The Programme for Government committed to income tax bands and credits being indexed from *Budget 2022* onwards.[40] As a result, *SPU 2021* projections do not incorporate a significant government policy commitment that would substantially reduce revenue is later years.

If a policy of indexing income tax bands and credits were to be pursued over the period 2022-2025, that would result in 2025 receipts being between €1 and €2 billion lower. As a result, approximately half of the increase in the income tax to compensation of employee's ratio can be attributed to the yields from non-indexation.[41]

[38] The only mention of Sláintecare in the Revised Estimates for 2021 came under the heading of "health care reform" and showed an associated amount of just €45 million for this year. It was not until the publication of the *Sláintecare Implementation Strategy & Action Plan 2021–2023* in May that the actual costs associated with the reforms in 2021 were clarified as being some €1.2 billion of 2021 health spending allocation.

[39] This would imply an elasticity of 1.5. This is larger than the range of policy-adjusted estimates (1.3 to 1.4) found in Conroy (2020). These policy-adjusted elasticities did not account for the yield from non-indexation, so can be considered an upper bound.

[40] "From Budget 2022 onwards, in the event that incomes are again rising as the economy recovers, credits and bands will be index linked to earnings. This will be done to prevent an increase in the real burden of income tax". See https://www.gov.ie/en/publication/7e05d-programme-for-government-our-shared-future/

[41] Were income tax to remain at its 2019 share of non-agricultural wages, then that would imply income tax being €3.2 billion lower than the level forecast in *SPU 2021*.

The remaining increase in the income tax to compensation of employee's ratio implies an elasticity of income tax (with respect to compensation of employees) above one. This could occur if jobs and incomes are moving towards higher income categories, which are more heavily taxed under the progressive income tax system. Were indexation assumed after 2020 and a lower elasticity was applied, receipts in 2025 could be up to €2 billion lower than projected in *SPU 2021*.

**Income tax indexation does not appear to have been clearly factored into *SPU 2021* forecasts, leading to difficulties in assessment and inconsistencies with the Programme for Government**

While *SPU 2021* income tax projections appear to be too strong given the assumptions used, income tax receipts could indeed be as high as projected in *SPU 2021*. This could arise if wages and incomes are stronger than forecast in *SPU 2021* (Section 1). In other words, a macroeconomic forecast error could offset a fiscal forecasting error.

**Figure 2.7: Income tax forecast to grow much more rapidly than the non-agricultural wage bill**

**A. Income tax forecast to grow rapidly**
Index 2018 = 100

**B. Income tax share of wage bill**
Income tax as a percentage of the non-agri wage bill


Sources: CSO and *SPU 2021*.
Note: Both panels use "underlying" income tax receipts, which adjusts for the impact of warehousing over the years 2020-2023 (see Box C). Dashed line in Panel B shows the ratio implied by *SPU 2021* forecasts of income tax and the non-agricultural wage bill. The sharp increase in 2011 is due to the introduction of the universal social charge. Get the data.

While the forecast of income tax receipts might be an overestimate, the projection of PRSI revenue might be underestimated in *SPU 2021*. Given the sector specific nature of changes in the labour market, changes in PRSI may not mirror changes in aggregate income. PRSI receipts fell significantly in 2020 (8.3 per cent), despite aggregate income being broadly flat. This may be because employment losses in 2020 were focused in low paying sectors, who were previously paying PRSI contributions. By contrast, many

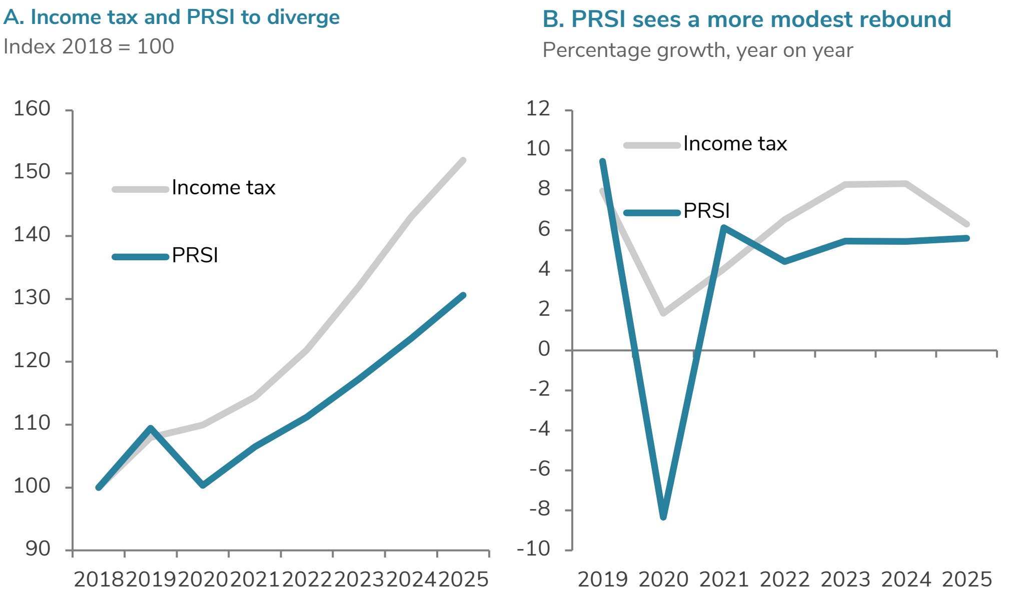
**PRSI is forecast to grow at a modest pace relative to income tax**

of these lower paid employees may not have been paying any income tax, which grew on an underlying basis in 2020.

As a result of this compositional factors, when employment in these lower paying sectors returns, one would expect PRSI receipts to grow faster than aggregate income. *SPU 2021* forecasts PRSI to grow slightly faster than income in 2021, and broadly in line with income thereafter. It would appear more likely that PRSI receipts would grow faster than aggregate income when employment is growing in 2022 and 2023, before reverting to mirroring aggregate income growth. Hence there could be an upside risk to PRSI forecasts in *SPU 2021*.

Figure 2.8 shows how forecasts of PRSI and underlying income tax differ greatly. Having fallen more severely in 2020, PRSI sees more moderate growth than income tax (apart from 2021).

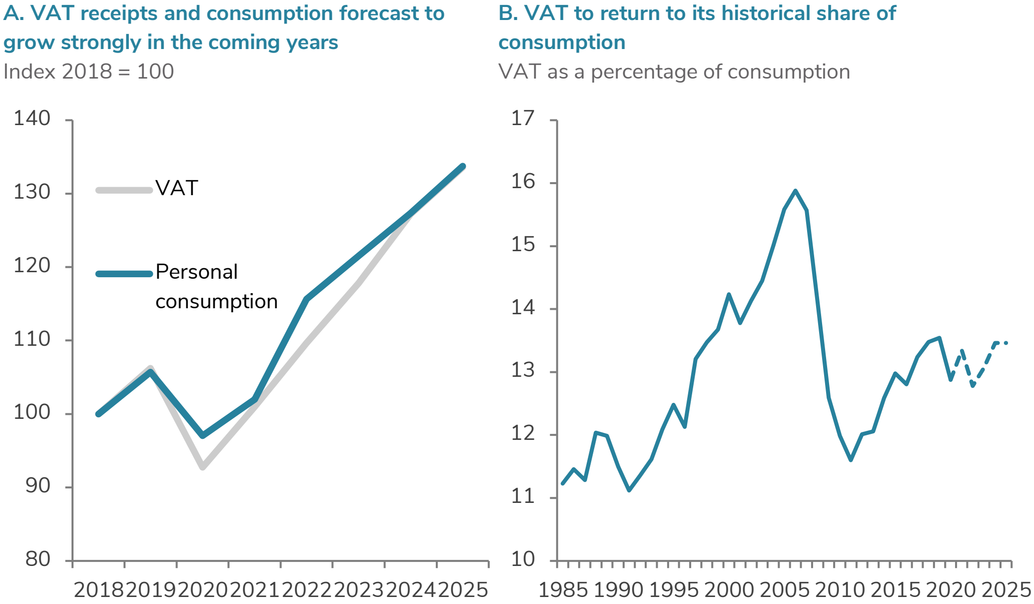
**Figure 2.8: PRSI forecast to grow much more slowly than the income tax**




Sources: CSO and SPU 2021.
Note: Both panels use "underlying" income tax receipts, which adjusts for the impact of warehousing over the years 2020-2023 (see Box C). Get the data.

Underlying VAT is projected to grow strongly over the medium term (7.3 per cent on average over 2022-2025). This mirrors nominal consumption growth and would keep the VAT to consumption ratio broadly constant (Figure 2.9). Were some upside risks to consumption realised, VAT receipts could be stronger than *SPU 2021* projections (see Box A).

## Figure 2.9: VAT and personal consumption forecast to grow at similar rates after 2021




Sources: CSO and SPU 2021.
Note: In both panels VAT receipts are adjusted for the impact of warehousing over the period 2020-2023 (Box C). Dashed line in Panel B shows the ratio implied by SPU 2021 forecasts of VAT and nominal personal consumption. Get the data.

**Reforms to the global tax environment are expected to reduce corporation tax receipts over the coming years**

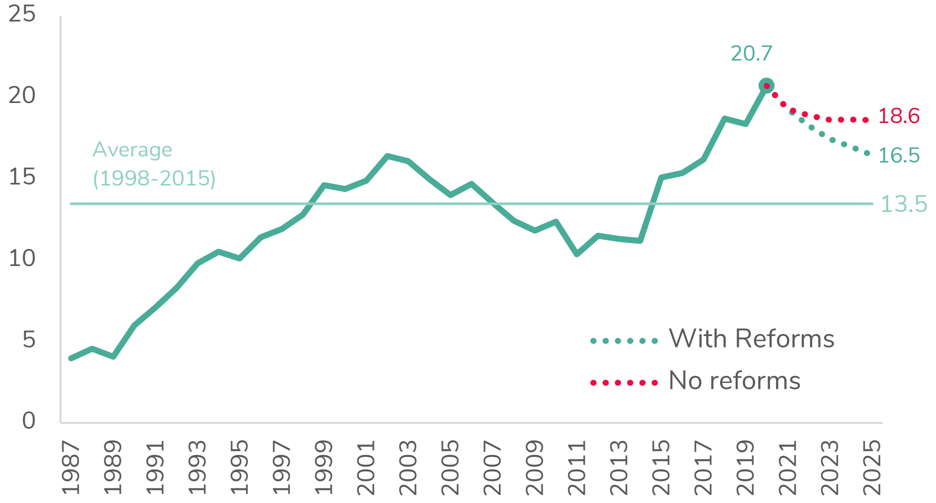
SPU 2021 forecasts suggest modest growth in corporation tax beyond 2021 as growth in the economy is offset by the assumed negative impact of a changing international tax environment. This mainly reflects the OECD's Base Erosion and Profit Shifting (BEPS) process. Payments by domestic firms may be reduced in the years ahead due to the carry-forward of losses during the pandemic or due to Brexit.

From 2022 to 2025, the assumed impact of a changing international environment is €500 million per year (see judgement in Section S.8). As a result, corporation tax receipts in 2025 are forecast to be €2 billion lower than would be the case in an unchanged international environment.[42] Box F further explores the several risks to Irelands corporation tax receipts, including a changing international tax environment. As a result of more modest growth, corporation tax as a share of Exchequer tax revenue is forecast to fall over the forecast horizon. Were these impacts not assumed, then the corporation tax share of Exchequer tax revenue would fall somewhat in 2021 and stay relatively stable thereafter (Figure 2.10).

[42] While an impact of €2 billion is significant, Fiscal Council estimates of "excess" corporation tax receipts are up to €6 billion.

**Figure 2.10: Corporation tax to fall as a share of Exchequer tax revenue**

Corporation tax (per cent share of Exchequer tax revenue)




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

Note: The "with reforms" series shows how the corporation tax share is forecast to evolve in *SPU 2021* (which incorporates impacts from Base Erosion and Profit Shifting (BEPS) reforms). The "no reforms" series shows how the forecast would differ were these impacts not assumed and the forecasts were otherwise as in *SPU 2021* (hence increasing CT and total tax receipts relative to *SPU 2021* forecasts). Get the data.

**The impact of increased carbon taxes has not been included in *SPU 2021*, but is likely to be deficit neutral**

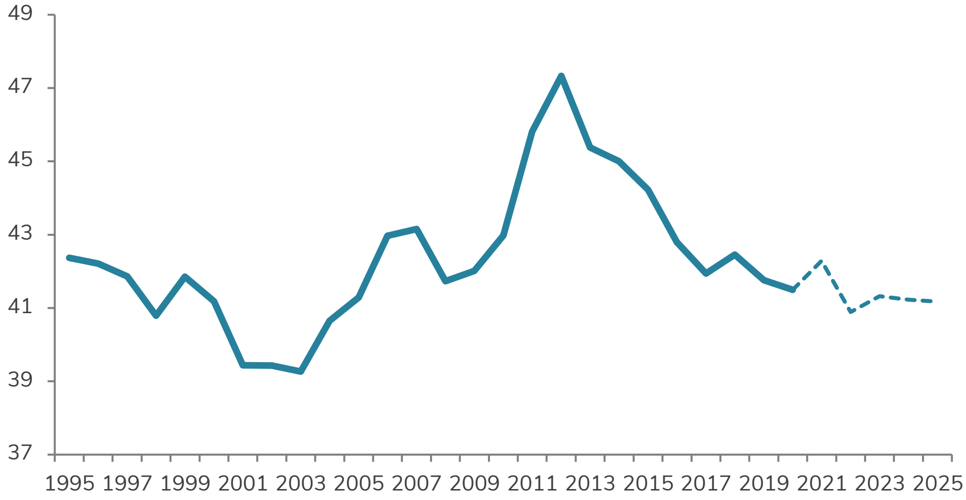
While increases in the rate of carbon tax out to 2030 were legislated for in *Budget 2021*, the additional yield (approximately €147 million per annum) from increases beyond 2021 has not been incorporated into *SPU 2021* projections of excise receipts. However, as the increased revenue from the tax has been hypothecated for new climate-related expenditure, this is likely to be neutral to the balance. Were the increases in the carbon tax included (along with assumed expenditure), this would lead to higher levels of revenue and expenditure.[43]

Overall, *SPU 2021* forecasts suggest general government revenue will grow at a slower pace (4.5 per cent) than GNI* (5.3 per cent) over 2022-2025. The rapid growth of income tax assumed almost entirely offsets the negative judgement applied to corporation tax. As a result, the general government revenue-to-GNI* ratio is broadly flat over this period and is slightly below its 2019 levels (Figure 2.11).

[43] If one assumed no major behavioral changes in response to the tax increases, revenue and hence expenditure would rise by approximately €147 million per annum out to 2030.

**Figure 2.11: Overall revenue grows in line with GNI* in later years**

General government revenue (per cent share of GNI*)




Sources: CSO and SPU 2021.

Note: Dashed line indicates SPU 2021 forecasts. Get the data.

*SPU 2021* projections of revenue and expenditure result in an improving balance over 2022-2025 to reach a deficit of €0.8 billion or 0.3 per cent of GNI* by 2025. While this outcome is possible, some of the technical assumptions underlying *SPU 2021* fiscal projections may be unrealistic. For example, the rapid growth in both income tax and investment spending.

The Council assesses that a better-founded and more useful projection for the budget balance can be made using an adjusted projection of the budget balance. Table 2.3 presents the adjusted projection together with an alternative "upside scenario" for the general government balance for 2025.

**Revising current spending upwards, relative to SPU 2021 provides a more realistic view of the public finances**

The "adjusted SPU" projection aims to show the budget balance that would arise based on current government policies and spending commitments based on the SPU's macroeconomic projects. On the spending side, this assumes the current primary spending is €1.2 billion higher in 2025 than *SPU 2021* projections to cover Stand-Still costs. Capital spending is assumed to reach 4.9 per cent of GNI*, which is consistent with Exchequer and non-Exchequer spending outlined in the National Development plan. This is lower than the level of investment projected in *SPU 2021*.

On the revenue side, two adjustments are made to *SPU 2021* forecasts. First, income tax is reduced by €1.5 billion, largely reflecting the costs of indexing income tax bands and credits. Second, corporation tax receipts are assumed to be lower by €1.5 billion bringing the impact on receipts assumed by the Department more in line with the lower end of the Council's estimates of excess corporation tax receipts.[44] This entails an impact on corporation tax receipts equivalent to about 30 per cent of its 2020 level.

Overall, the changes to the revenue and spending projections result in a larger deficit — €2.2 billion wider than projected in *SPU 2021*.

**Table 2.3: Alternative general government spending, revenue, and balances for 2025**

€ billions

| | *SPU 2021* | Adjusted SPU | Upside scenario |
|---|---|---|---|
| Current Primary Spending | 90.6 | 91.8 | 93.4 |
| Interest Spending | 3.4 | 3.4 | 3.4 |
| Capital Spending | 14.8 | 12.9 | 13.2 |
| General Government Expenditure | 108.9 | 108.1 | 110.0 |
| Income tax | 32.3 | 30.8 | 32.3 |
| Corporation tax | 12.5 | 11.0 | 12.5 |
| Other General Government Revenue | 63.3 | 63.3 | 64.9 |
| General Government Revenue | 108.1 | 105.1 | 109.7 |
| General Government Balance | -0.8 | -3.0 | -0.3 |

Sources: *SPU 2021* and Fiscal Council workings.

Second, an "Upside scenario" is also presented, reflecting upside risks to growth set out in Section 1. This scenario assumes that the long run loss in output from the pandemic (or "scarring") is half of that incorporated in *SPU 2021* projections (take to imply 2.5 per cent scarring on GNI* rather than 5 per cent). As a result of the stronger economy, income tax in 2025 reaches the levels projected in *SPU 2021* (i.e. the positive macroeconomic error offsets a negative fiscal error). Corporation tax is assumed to be unaffected by further losses than those assumed in the *SPU* and to be unaffected by the reduced scarring, as receipts are largely detached from the performance of the domestic economy. Other general government revenue is assumed to be 2.5 per cent higher than projected in *SPU 2021* (implying an elasticity of one). Overall, this leads to general government revenue being €4.6 billion higher than on the "adjusted SPU" measure, (or €1.6 billion higher than *SPU 2021* projections).

In the "upside scenario", current primary spending is increased by €1.2 billion (relative to *SPU 2021*) to cover higher Stand-Still costs. In addition, the positive macroeconomic shock (relative to *SPU 2021*) would be expected to lead to additional Stand-Still costs reflecting the impact of higher growth and wages. It is assumed that half of the revenue gains

[44] This is in addition to the €2 billion of negative judgement applied in *SPU 2021* forecasts.

(€1.54 billion out of €3.08 billion) are offset by further increases in Stand-Still costs due to stronger growth.[45]

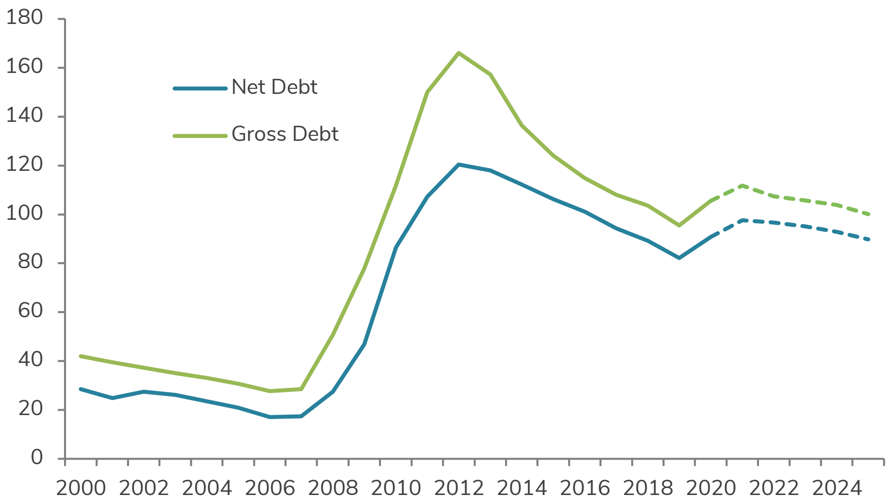
Capital spending in the "upside scenario" is again assumed to be 4.9 per cent of GNI*. However, as GNI* is larger than in the "adjusted SPU" scenario, this implies additional spending relative to that scenario. Overall, the "upside scenario" sees a slightly smaller general government deficit for 2025 compared to *SPU 2021*.

The scenarios are illuminating. They suggest that the deficit could be wider than is depicted in the SPU, given how alternative assumptions for key areas of uncertainty and more realistic spending profiles might impact the public finances. However, the scope for a wider deficit could be offset if the scarring on the economy caused by the economy is less than presumed and if outcomes on corporation tax receipts are more benign.

Gross and net debt-to-GNI* ratios are expected to remain at very high levels over the forecast horizon, even based on the *SPU 2021* budgetary projections (Figure 2.12). Section S12 illustrates how different adverse scenarios could lead to much higher debt ratios.

**Figure 2.12: 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. Get the data.

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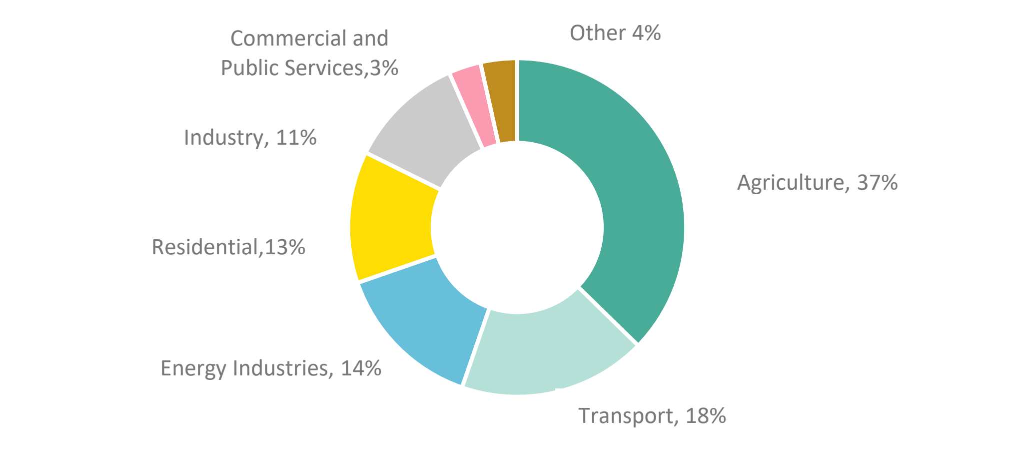
[45] Increased corporation tax receipts are assumed to have no impact on Stand-Still costs, hence only the increase in income tax and other general government revenue are considered here. Overall, primary spending is €2.74 billion higher than in *SPU 2021*. €1.2 billion of this is due to Stand-Still costs using SPU 2021 macroeconomic projections. The further €1.54 billion is due to assuming stronger growth in the upside scenario relative to *SPU 2021*.

## Box E: The Government's new climate change targets need clear costings

Changing political dynamics and the Covid-19 crisis has brought the impact of climate change under increased focus both in Ireland and internationally. As part of the Government's efforts to reduce carbon emissions, it introduced the *Climate Action Plan* in 2019. This plan detailed Ireland's efforts towards supporting the broader EU goal of net-zero emissions by 2050. In March, the Government moved toward giving the targets legislative underpinnings through the *Climate Action Bill* 2021. This in line with the *Programme for Government*, which effectively aims to legally enshrine the target of carbon neutrality in Ireland by 2050.

### Figure E1: Reducing emissions will require strong collective action

% of Total Emissions in Ireland in 2020




Source: Environmental Protection Agency

As part of this goal, ambitious targets have been set for annual reductions in carbon emissions over the next three decades in the country. While the costs of inaction on this front are high, the adjustment process will require a fundamental reorientation of how the economy operates, incurring heavy claims on the governments resources and requiring careful planning. This box explores some of the potential fiscal implications of achieving these targets and in the context of medium-term planning, discusses where greater budgetary clarity is required to estimate the overall impact on the public finances.

### Meeting reduction targets requires immediate and substantial adjustments

The costs associated with meeting reduction targets could be substantial. The Climate Action Plan (2019) set out how emissions could be cut by a fifth to meet 2030 targets. It showed National Development Plan measures contributing to a reduction in emissions of 16.4 of the total 102 $MtCO_2eq$ reduction planned. But more than half (58 $MtCO_2eq$) of the overall reduction was unspecified. That is more than 3½ times the reduction achieved by the National Development Plan measures, which cost just over €20 billion over ten years (€2 billion per annum and about 1 per cent of GNI*).[46]

Another striking feature of the overall emissions reduction targets is how much the adjustments required to achieve the 2030 targets are now likely to be frontloaded, with a 51 per cent emissions reduction to be achieved by this time.[47] This frontloading means the government will target a 7 per cent annual reduction in emissions over the full period to 2030, up from the 3.5 per cent average in the Climate Action Plan (2019).[48]

[46] These cost estimates are set out in the National Development Plan (p.22), while the Climate Action Plan 2019 (p.26) sets out the policy assumptions on the NDP's contribution to overall emissions reductions.

[47] Relative to a 2018 emissions benchmark.

[48] The 2019 plan had targeted a 7 per cent annual reduction after 2030.

To date, the government has provided little detail on either the costs of reaching these revised targets or the ways in which it will do so, although a new *National Development Plan* scheduled to be released this year should provide greater detail. As can be seen in Figure E1, overall reductions in emissions will require collective action across a broad range of stakeholders, and with the Government committed to a "Just Transition", this is likely to incur significant costs.

**Competing priorities are exerting pressures on the public finances**

While the ambitious targets are necessary to mitigate climate change, it comes at a time when there are several substantial demands on the public finances. In the short term, the implementation of Sláintecare and resources required to ensure the post-Covid-19 economic recovery will command high costs, while population ageing will reduce long term growth and increase healthcare and pension costs substantially in the coming decades. Furthermore, the *Programme for Government* rules out increases to large sources of the Exchequer tax take, increasing pressures on the revenue side.

**More transparency is required to understand the path to implementation**

These pressures, along with generalised risks to the outlook, and the potential for bottlenecks under the already increased 'core' capital expenditures, underscore the importance of careful budgetary planning to meet these competing demands. With the forecasts in *SPU 2021* containing only technical assumptions, and little indication of the full set of costs associated with the implementation of the *Climate Action Bill*, the implications of the new targets for fiscal policy are unclear.

While carbon tax increases will generate revenues in the short run, at least 20 per cent of these intakes will likely be redistributed in targeted social protection, while the overall tax take will likely diminish as households and businesses adapt, moving their behaviour away from using carbon intensive activity in the first place. Furthermore, with the *Programme for Government* ruling out increases to major tax sources, and estimates of Stand-Still costs running over current allocations, it is difficult to see how these ambitious targets will be achieved under current spending assumptions set out in *SPU 2021*. One possibility is that any spending impacts may come through on the capital side, which would help to explain the upward revisions in spending relative to the capital plan.

While climate change mitigation is of paramount concern, the government must outline not only the costs associated with its revised emissions targets, but also both the ways in which funding will be generated to meet these demands and also the implementation strategy over the medium term.

## 2.4 Risks to the outlook

In the short term, the macroeconomic and public health environments pose major risks to fiscal projections in *SPU 2021*. Were public health restrictions required again, that would imply higher levels of spending for longer, as well as depressing revenue. The main fiscal risks are listed in Section S4, which contains a fiscal risk matrix outlining potential likelihoods and impacts.

**Short term risks to spending and revenues stem from Covid-19-related uncertainty**

Further out in the forecast horizon, significant risks to the fiscal forecasts in *SPU 2021* arise both on the revenue and spending sides. On the revenue side, growth outturns and how they translate into revenues are important uncertainties. On the spending side, there is a risk that some of the recent spending increases which are assumed to be non-recurring turn out to be more long lasting. This could be the case in the health area, for example, which showed a rapid increase in spending and persistent overruns in the years prior to the pandemic.

As outlined earlier, expenditure increases allocated in *SPU 2021* fall short of what would be required to maintain current service levels and to index social payments. As a result, simply holding present service levels and indexing social payments would imply higher expenditure than forecast in *SPU 2021*.

**Spending pressures from ambitious policy priorities represent medium term risks.**

Any new policy measures or service improvements including those set out in the Programme for Government, such as Sláintecare, could imply significantly higher levels of expenditure. If these were funded by tax increases or spending restraint elsewhere, this would not impact the overall public finances. However, it remains unclear how such measures will be implemented and funded.

The fiscal response from the government has included significant outlays on loan schemes, credit guarantees, and tax deferrals, resulting in the accumulation of contingent liabilities. Losses from these schemes could arise if firms become insolvent and fail to repay. Similarly, if firms default at a higher-than-assumed rate on warehoused tax liabilities, then that would adversely impact fiscal forecasts in *SPU 2021*. Conversely, the Department's assumptions regarding losses arising from warehoused VAT and income tax liabilities could fail to materialise, presenting an upside risk to revenues. In addition, were some of the upside macroeconomic risks highlighted in Section 1 to materialise, this would provide an upside risk to *SPU 2021* fiscal projections.

Reforms to the global corporation tax environment also represent a further potential risk to tax revenues in the coming years. Efforts by various international organisations and stakeholders to facilitate both a global minimum corporation tax rate, along with plans to address the digitalisation of profits could see Ireland collect lower levels of corporation tax in the coming years if introduced. Against this uncertain backdrop, *SPU 2021* fiscal projections are based on the assumption that these factors will reduce corporation tax receipts by €500 million per year from 2022. It has been indicated that these losses may be higher. One risk is that a downward adjustment takes place suddenly, rather than gradually as assumed, complicating the budgetary position in specific years more severely.

**Reforms to the global tax environment represent a risk to corporation tax intake**

### Box F: Corporate tax reforms could reduce revenues

Ireland has benefited enormously from attracting large foreign-owned multinationals to set up operations on its shores. As well as generating substantial corporation tax receipts for the Government, this policy has attracted significant employment. In turn, this contributes to higher tax receipts being received from employee earnings and from wider economic activity more generally.

However, it has been recognised for some time that the reliance on tax receipts associated with these large multinationals poses risks. Recent efforts to reform the international corporation tax landscape have now gained impetus with the Biden administration's tax proposals. This adds to the concerns around the sustainability of Irish corporation tax receipts.

This box looks at the risks around corporation tax, new reform proposals, and it explores a stylised scenario of what could happen should a number of large multinationals exit Ireland.

#### Over-relying on corporation tax is a risk to funding spending

The Government's reliance on corporation tax has risen in recent years such that almost 21 per cent of Exchequer taxes come from corporation tax as compared to a long-run average of about 13.5 per cent. There are three risks in particular:

1) **Volatility** — corporation tax receipts are more volatile than other taxes. This also means that forecasts for corporation tax are prone to much larger errors than other taxes. Funding permanent spending on the back of volatile receipts is especially risky. It could entail a widening of deficits or a need to adjust spending downwards at a later stage should receipts fall rather than rise to ensure the public finances are on a sound footing.

2) **Concentration** — corporation tax receipts are heavily concentrated in a handful of companies. In 2019, ten corporate groups accounted for 56 per cent of net receipts. This concentration exposes the Government to risks around firm-specific profitability and various other idiosyncratic risks.

3) **Sudden reversals** — there is a risk that changes in policy regimes and circumstances globally lead to decisions for some firms to relocate. in some cases, companies may be relatively footloose meaning that they have relatively limited physical presence (workers or factories)

and can easily shift activities from one location to another. This could expose the government of the day to a large reversal of corporation tax receipts.

Assessing the risks involved with corporation tax receipts needs to reflect the full range of negative impacts that could occur, including the macroeconomic and labour-market impacts as well as the budgetary effects.

### Even just five large multinationals leaving could have big impacts

Building on previous work (Box C of the *June 2018 Fiscal Assessment Report*), this box considers a scenario whereby five stylised large, foreign-owned multinational enterprises exit Ireland.

Revenue produces detailed information on large corporation taxpayers in Ireland by different groupings. Using this information, we can estimate how much tax is paid by a typical large foreign-owned multinational: about €99 million in 2019 for the top 99, rising to €456 million for the top 10 payers. Table F1 estimates a stylised large foreign-owned multinational firm based on the available Revenue data.

For the purposes of illustrating a potential shock associated with five major foreign firms exiting Ireland, we build on the stylised firm in Table F1 and assume:

- direct corporation tax losses of €3 billion (about a quarter of all corporation tax and 3.5 per cent of total government revenue);
- a shock to real GNI* of 1 per cent. As noted in FitzGerald (2015), in terms of their impact on the real economy, most of the output of foreign firms in Ireland is confined to the wage bill and the corporation tax paid on the profits; the rest of the profits are repatriated. We therefore calibrate the shock based on estimates of (1) the direct wage bill losses arising from the firm exits and (2) the indirect wage bill losses from local jobs supported. This analysis would suggest that the real economy effects would be relatively small even though the impact on tax receipts would be substantial.[49]

### Table F1: Large multinationals account for significant jobs and taxes

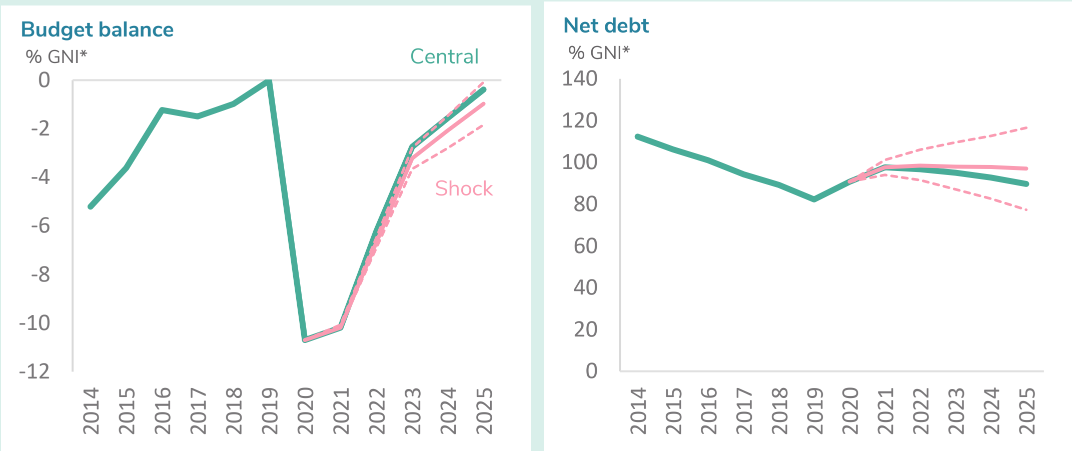
| | All | Top 10 | A stylised firm (estimated) |
|---|---|---|---|
| No. of Companies | 99 | 10 | 1 |
| Employments | 103,822 | | 1,049 |
| Total staff earnings | €4,203,000,000 | | €42,454,545 |
| Average wage | €40,483 | | €40,483 |
| Corporation tax liability | €6,813,000,000 | €6,072,000,000 | €607,200,000 |

Source: Revenue (2021); and Fiscal Council workings.
Notes: This table looks at the larger foreign-owned multinational enterprises contained in Revenue data.

The results (Figure F1) suggest that the deficit could be wider by 0.6 to 1.4 per cent of GNI* by 2025, with the result that the net debt ratio would be on a flatter path in later years (2023–2025), falling by just 0.5 percentage points per annum as compared to 2.3 percentage points in the central scenario.

[49] Specifically, we assume 5,000 direct job losses and 15,000 indirect job losses based on Brady (2019) multiplier estimates for local jobs created. Of the direct job losses, we considered between 10–25 per cent translate to higher unemployment, 20–50 per cent to higher emigration, and the remainder re-employed at the median wage. This would suggest that a 1 per cent shock to domestic income is a reasonably conservative estimate.

**Figure F1: Exits of foreign firms would widen deficits and slow debt reduction**




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

### Biden and BEPS proposals are expected to reduce future FDI and taxes

Discussions on reforms of international tax rules have been ongoing under the OECD/G20 Inclusive framework on Base Erosion and Profit shifting (BEPS). As part of the BEPS 2.0 proposals, there are two 'pillar' reforms that change the global corporation tax environment. Pillar one relates to changing a share of tax collection from where firms have physical presence to where the firm's market or user is located. Pillar two relates to the establishment and enforcement of a global minimum corporation tax rate.

The Biden administration has given renewed impetus to the implementation of these reforms through recent corporate tax proposals of its own.[50] Aligning most closely with Pillar two, the Biden proposals include raising the current US Global Intangible Low-Taxed Income (GILTI) tax to a minimum of 21 per cent on profits of US corporations on a country-by-country basis and removing certain key exemptions, namely the exemption for Qualified Business Asset Investment (QBAI). The current GILTI system includes a global minimum corporate tax rate of 10.5 per cent and also allows for the higher profits paid in one jurisdiction to offset the lower profits paid in another jurisdiction, so that globally the 10.5 per cent rate is met. In addition, the proposals signal a shift from digitally-targeted tax reforms to ones that focus primarily on the largest companies.

However, the proposals will ultimately have to be passed by US congress, so their final form is uncertain. Similarly, the final form of the OECD BEPS reforms are also uncertain. As a result, it is difficult to gauge their impacts on both the macroeconomy and the public finances.

There are a number of channels through which revenues may be reduced. The location of profit booking is an important consideration for Ireland, with the shifting of profits from Irish domiciled firms naturally reducing corporation tax primarily. If firms have incentives to relocate these profits elsewhere, corporation taxes may be lower going forward.

There are also risks around the location of 'real' multinational activity in the event of changes to the global corporation tax environment. Reduced inflows of such activity in Ireland would have clear spillovers into other sectors of the economy and would impact Exchequer revenues more broadly and to a more significant extent. However, it may not have a significant impact on the current level of investment by multinational firms who already have a presence here.

The Department has estimated that some €2 billion in revenue will be lost over 2022-2025 as a result of the BEPS reforms. While tax rates are one of a number of factors multinational firms would consider when deciding where to invest, any reduction still has important implications for

[50] See the White House fact sheet on the American Jobs Plan for further details of the Biden administration's proposals: https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/.

the provision of public services and the implementation of policy priorities in the coming years. Ultimately, both pillars of the OECD's framework would reduce the relative attractiveness of Ireland as a place for new US FDI, and potentially reduce direct profitability. With corporation taxes largely representing an exogenous inflow into the Irish economy, their use to fund current spending in recent years requires careful consideration in the context of a changing global taxation environment.

In addition to risks posed by the OECD and US proposals, the EU is also exploring other avenues for corporate taxation reforms. These are contained in its May 2021 communication on "Business Taxation for the 21st century" (European Commission, 2021). The proposals include new approaches to allocating taxable profits between Member States. The European Commission is also expected to set out proposals for a digital levy this summer.

# 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.

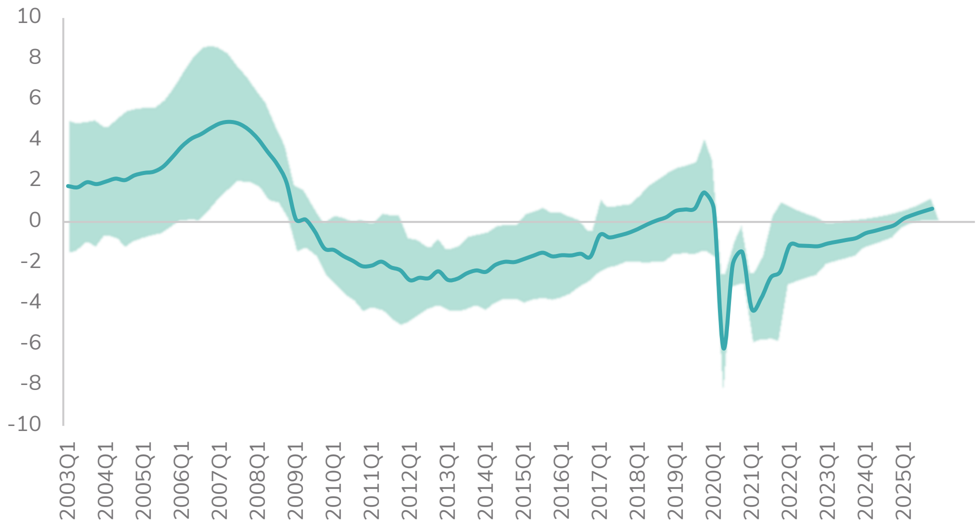
## 3.1 The fiscal stance in 2020

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)



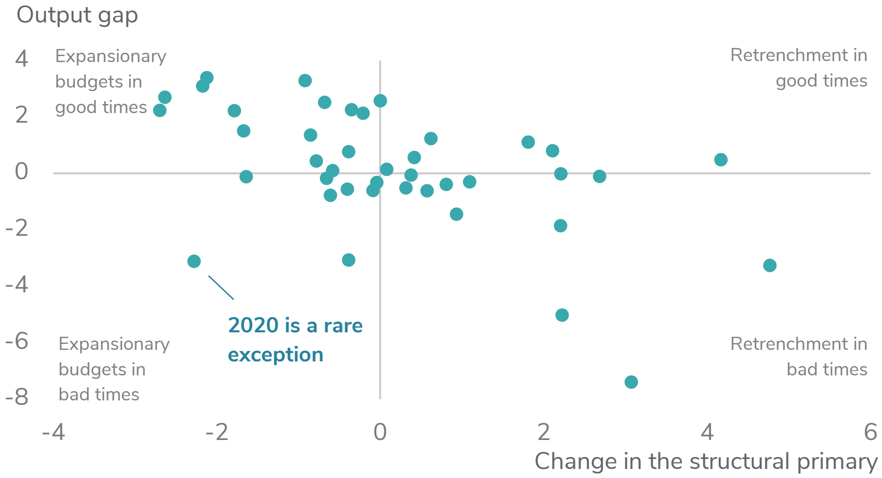

Sources: Fiscal Council workings (based on SPU 2021 forecasts).
Notes: The figure shows a range of output gap estimates (the shading) and the mid-range of these estimates (the line). The estimates are produced using a variety of methods based on the Council's models and Department forecasts. Given distortions 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 Government's response in 2020 was prudent and necessary**

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.

## 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.

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

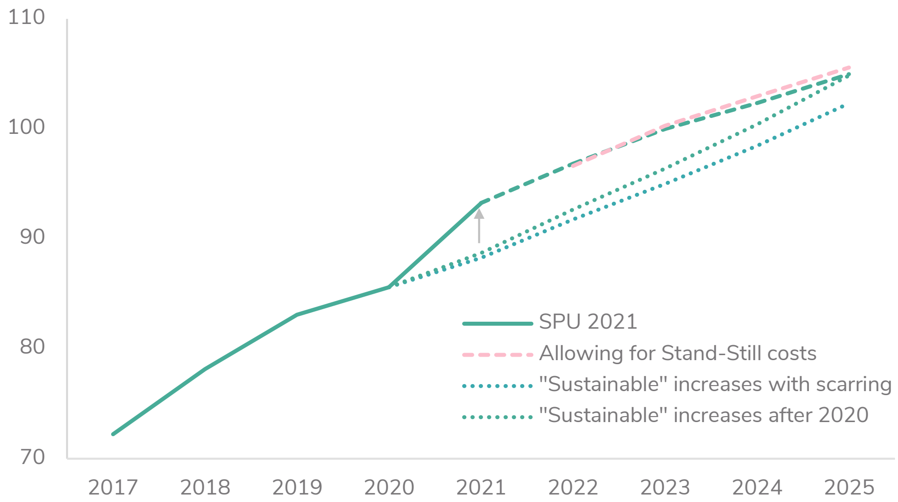
However, *Budget 2021* also set out substantial increases in permanent core Government spending — measures unrelated to Covid-19. This included clear plans to increase ongoing departmental spending by €5.4 billion, which is surprisingly large in the context of recent budgets. Using a better measure of 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).

[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.

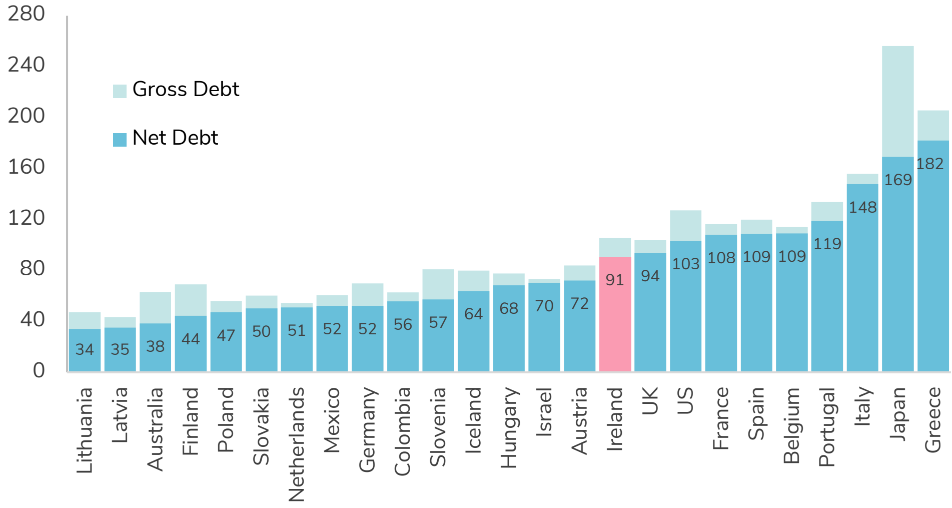
The permanent spending commitments made in 2021 leave debt at a higher level and the public finances more vulnerable than they otherwise would be to future adverse shocks. Sustainable revenue growth is also likely to be on a lower path in the coming years as a result of the Covid-19 crisis, Brexit and 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.

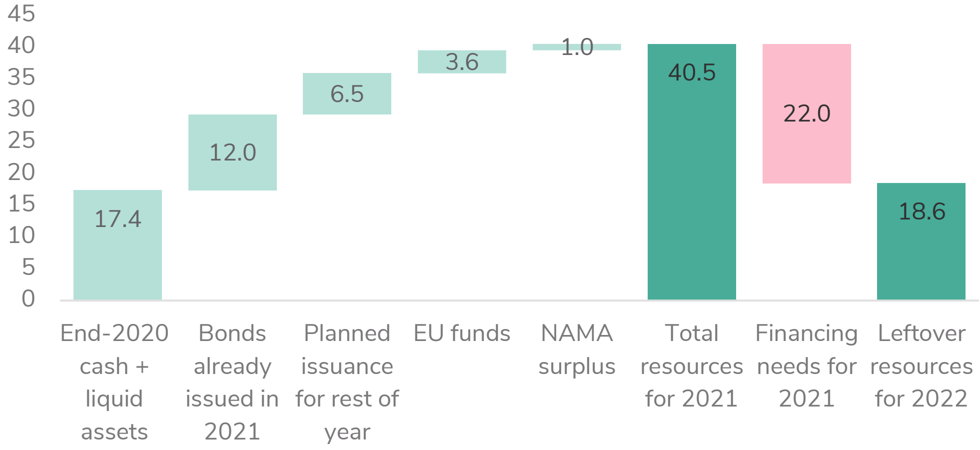
**But the State has large resources on hand and interest rates are low**

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

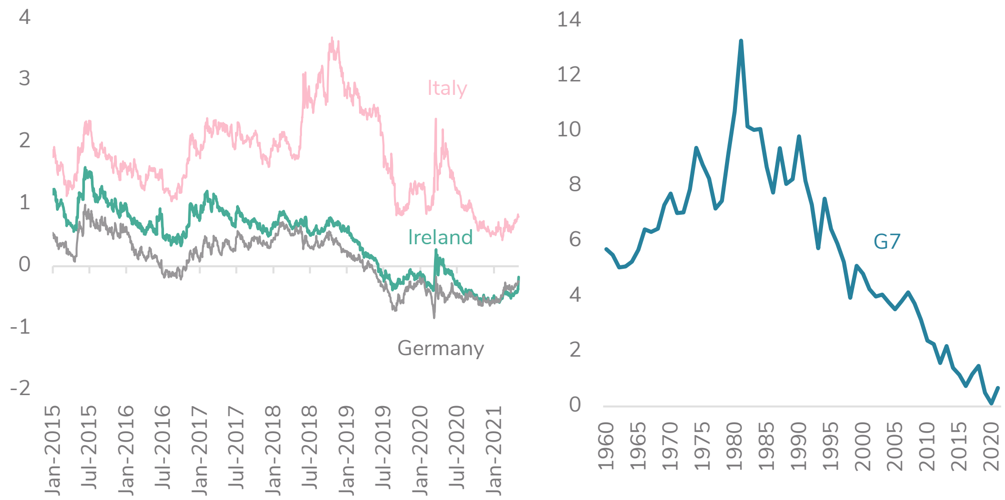



Sources: NTMA; Department of Finance; and Fiscal Council workings.
Notes: Financing needs are made up of the Exchequer balance, rollovers of existing medium- and long-term debt securities, and the cancellation of floating rate notes. Get the data.

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 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 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

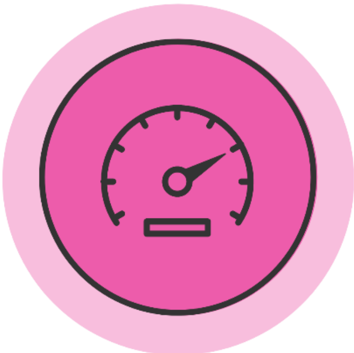
Debt targets can act as transparent medium-term benchmarks to help guide policy when debt ratios are very high. They should:

(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

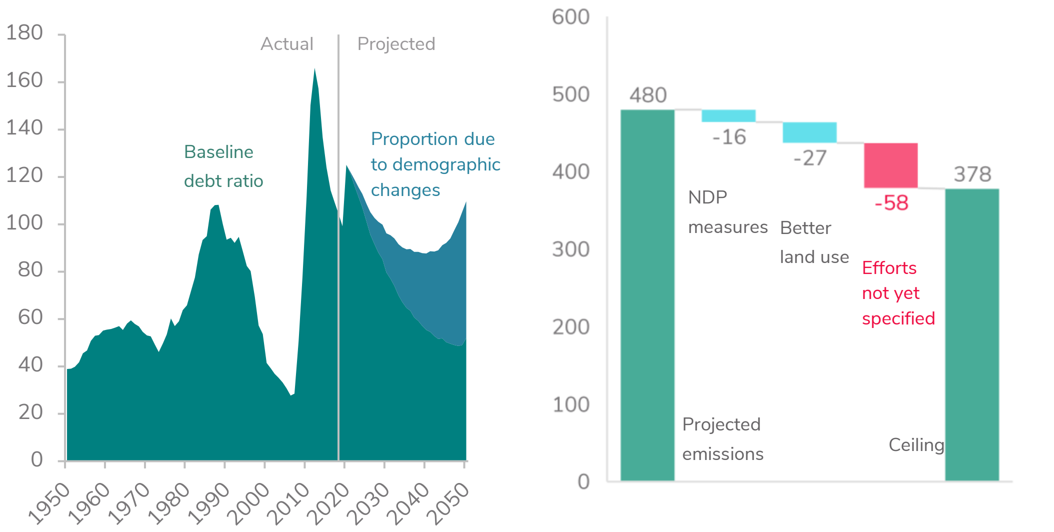
Governments need a sustainable anchor for net spending growth when in steady state and when there is a balanced budget in structural terms. The limits should:

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

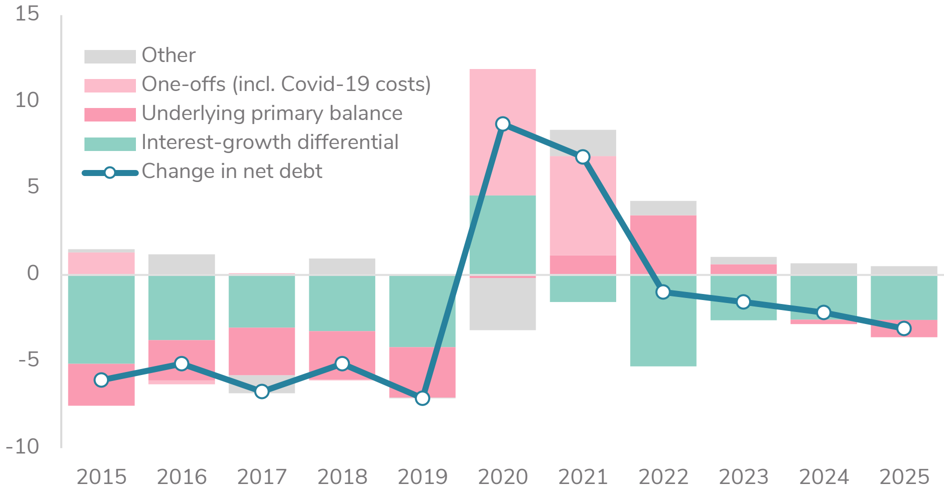
The SPU projections show a pace of net spending growth that is sufficient to close the deficit and have the net debt ratio falling at an annual pace of 3 percentage points of GNI* by 2025. This is similar to the path set out in pre-Covid forecasts, but slower than seen in the years before the crisis.

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](#).

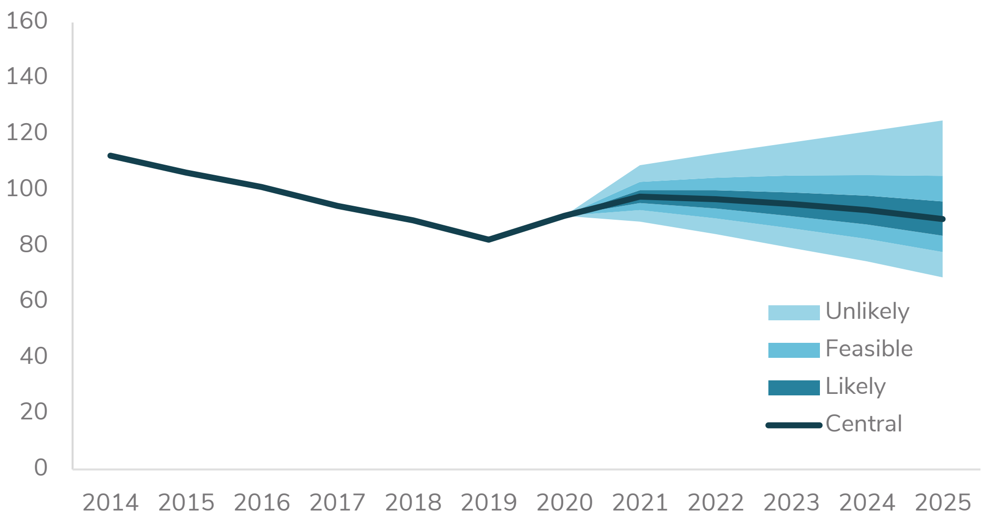
As it stands, the technical projections set out in the SPU indicate that the net debt ratio would fall with a significantly high probability. Estimates from the Council's Maq model suggest it is unlikely that net debt ratios will rise again over the next four years, though there are wide uncertainties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

[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.

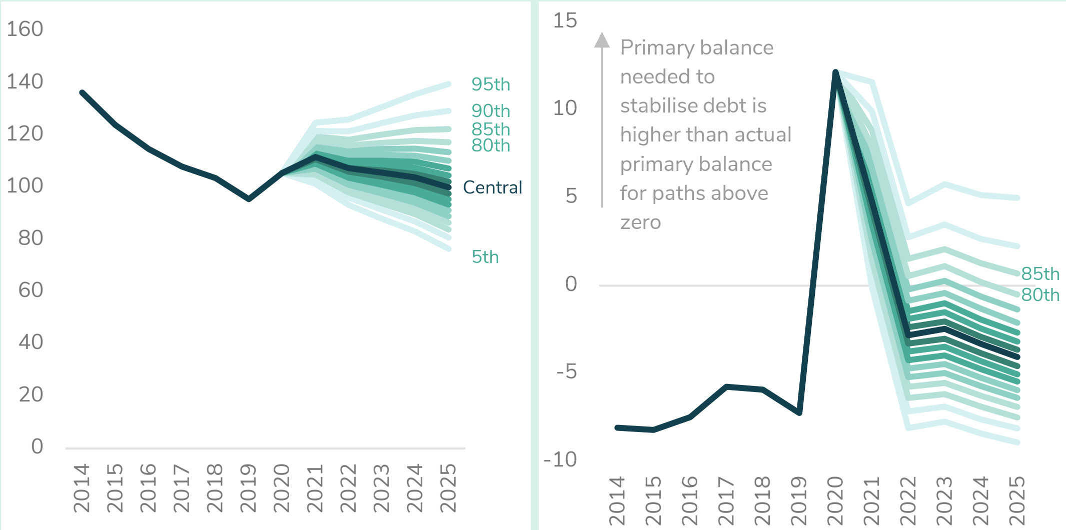
[62] The speed of adjustment would depend on the risks to sustainability, the state of the economic cycle, and the capacity of monetary policy to offset the contractionary impact of adjustment on the European Union as a whole.

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.

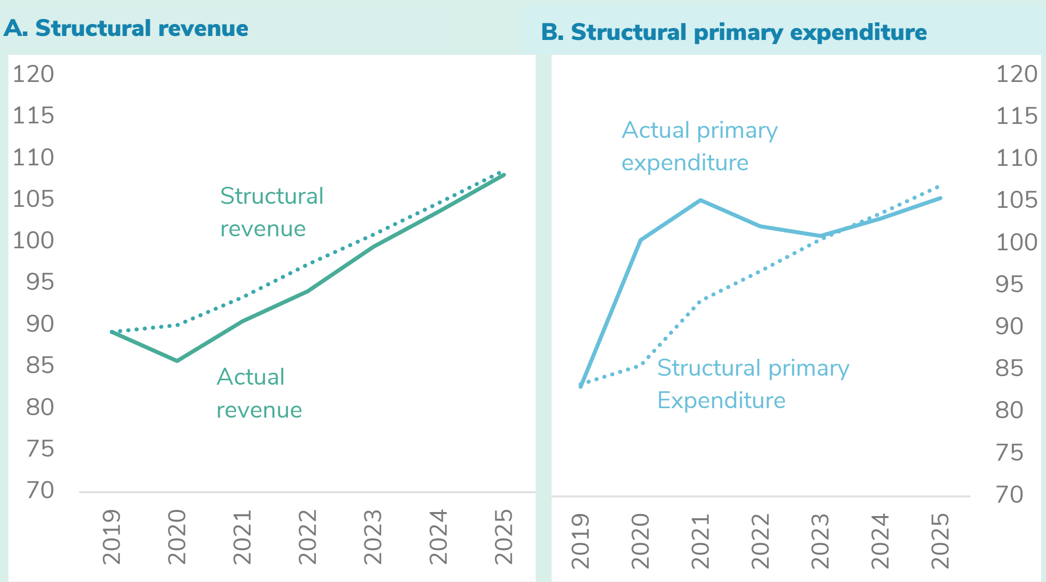
### Structural expenditure

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

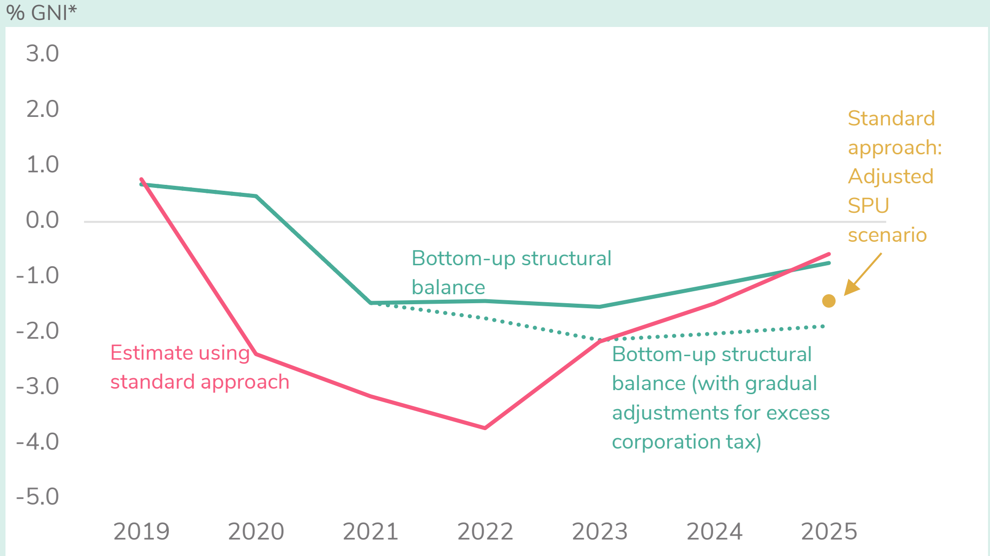
[65] More specifically, where the Department's forecasts of spending do not cover Stand-Still costs fully, these additional costs are added on to the forecast expenditure figures.

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.

# Fiscal Rules

## Exceptional circumstances continue

# 4. FISCAL RULES

## Exceptional circumstances continue

Due to the ongoing public health and economic crisis, the "exceptional circumstances" clause continues to apply in the domestic fiscal and EU rules. This allows for deviation from the requirements under both the domestic and EU fiscal rules for the years 2020-2021. Table 4.1 shows a summary of the Council's recent assessments, based on the Council's principles-based approach to the fiscal rules.[67]

**Table 4.1: The Council's assessment of compliance with the Domestic Budgetary Rule**

| | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|
| Spending Rule | Breach | Significant Deviation | Compliant | Exceptional Circumstances |
| Structural Balance Rule | Compliant | Compliant | Compliant | |
| Overall Assessment | 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 minus 0.5 per cent of GDP for 2016-2019) or moving towards the MTO at an adequate pace. The spending rule requires that 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*.

The Council assessed in its May 2020 *Fiscal Assessment Report* that "exceptional circumstances" existed for 2020. "Exceptional circumstances" is a provision included in the Fiscal Responsibility Act, 2012, that allows for a temporary deviation from the requirements set out under Ireland's Domestic Budgetary Rule. The Council's assessment was made in light of the ongoing Covid-19 pandemic, and the effect it has had on the economy and the public finances. Subsequently, the Council assesses that exceptional circumstances continue to exist in 2021.[68] This will allow the government to provide the appropriate fiscal response to the continuing Covid-19 crisis.

Separately, in March 2020 the European Commission activated the general escape clause in the *Stability and Growth Pact* (SGP), which allows for temporary deviation from the EU fiscal rules. The European Commission has

[67] See supporting information section S13 for further details on the Council's principles-based approach.

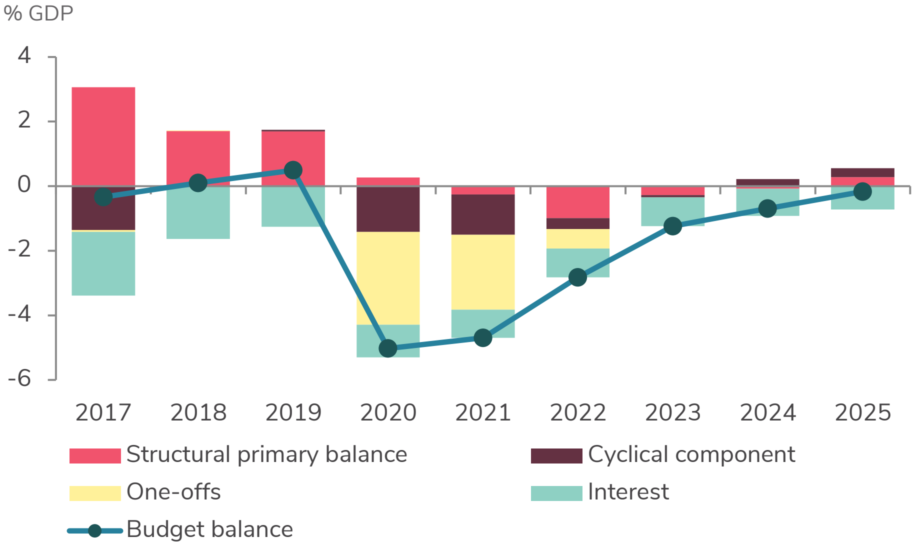
[68] The Council has not yet made a determination as to whether exceptional circumstances will continue to exist in 2022.

indicated that the general escape clause is likely to be in place until the end of 2022.[69]

For 2020, the Council assesses that, due to exceptional circumstances, the budgetary rule was not complied with. Ireland's deficit-to-GDP ratio, of 5 per cent, was above the 3 per cent reference value in the *Stability and Growth Pact*. The medium-term budgetary objective (MTO) of a structural deficit no greater than 0.5 per cent of GDP was not met. Ireland's structural deficit was 0.7 per cent of GDP in 2020. However, the Council assesses that the failure to comply with the budgetary rule in 2020 was only due to exceptional circumstances and that the failure to comply with the budgetary rule in 2020 does not endanger medium-term fiscal sustainability.[70] The debt-to-GDP ratio increased by 2.2 percentage points, to 59.5 per cent, but remained below the 60 per cent of GDP reference value in the SGP.

**The domestic Budgetary Rule was not met in 2020, due to exceptional circumstances.**

### Figure 4.1: The Department forecasts a small underlying deficit




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

[69] However, a final determination by the European Commission, as to whether the general escape clause will be in place in 2022 has not yet been made. The Commission has outlined that the key criteria for deciding whether the general escape clause will no longer be in place is whether EU-wide GDP is above end-2019 levels. Based on the Commission Winter 2021 forecasts GDP is expected to be above end-2019 levels by the middle of 2022. As such, the Commission has indicated that the general escape clause will likely be in place into 2022, but a final decision will be made after the Commission's spring forecasts. See *Communication from the Commission to the Council: One year since the outbreak of Covid-19*, 3 March, 2021: https://ec.europa.eu/info/sites/info/files/economy-finance/1_en_act_part1_v9.pdf.

[70] This assessment is contingent on the Covid-19 related expenditure proving to be temporary and on the forecast recovery for the economy.

Over the medium-term Ireland's deficit will close, with the deficit-to-GDP ratio forecast to fall below 3 per cent by 2022 (Figure 4.1). With Ireland's deficit-to-GDP ratio forecast to be below 3 per cent by 2022, it is likely that Ireland will be subject to the preventive arm of the *SGP* in 2023. While there is ongoing discussion around the future of the EU fiscal rules, the current requirement for 2023 under the preventive-arm of the *SGP* would be an improvement in the structural balance of 0.5 per cent of GDP based on the *SPU* forecasts. While estimates of the structural balance are subject to considerable uncertainty at this time (see Box I), based on *SPU* forecasts the structural balance is set to improve by 0.7 per cent of GDP in 2023, exceeding what would be required (Table S13.1). However, this is based on expenditure figures that may not fully incorporate Stand-Still costs (see Section 2).

For further information on the Council's assessment of the fiscal rules see Supporting Information S13.

## 4.1 Medium-term Expenditure Framework

Every year, under the medium-term expenditure framework, the Government is required by law to set expenditure ceilings for the following three financial years.[71] Ceilings are required to be set for overall expenditure and for each department. This framework was introduced in 2013 in order to provide a better mechanism for controlling spending over the medium-term and to ensure the Expenditure Benchmark is complied with.

**Expenditure ceilings are not working. They are not set to control spending and ignore demographics, price, and pay increases.**

However, while the Government has, in the past, complied with the letter of the law, it has not complied with the spirit of the law. It has become clear in recent years that these ceilings are set, not with a view to controlling spending by putting in place realistic ceilings, but instead merely to comply with legal requirements. That is, departmental ceilings are often set so as to be constant in nominal terms over the subsequent three years. This provides no realistic control of spending as these do not even factor in price increases or increases in public sector pay.

The Council has also asked the Department, on several occasions, for the current and capital expenditure ceilings for each department, for 2022-2023, that were set in 2020. However, at the time of writing, the Department has not provided these.

For further information on the government expenditure ceilings see Supporting Information S14.

[71] This reform was introduced in the Minsters and Secretaries (Amendment) Act 2013. Once set, the Minister is required to present the ceilings to Dáil Éireann.

# Supporting Information

# Supporting information

The following sections provide supporting information and analysis related to various parts of the Council's mandate and its assessments.

This section includes a review of the Council's recent endorsement exercise, whereby the Council endorses the Department of Finance's macroeconomic forecasts. It also explores key analytical areas that the Council routinely assesses. The insights provided by these sections are an essential part of how the Council thinks through how the economy and public finances are evolving.

# S1. Endorsement

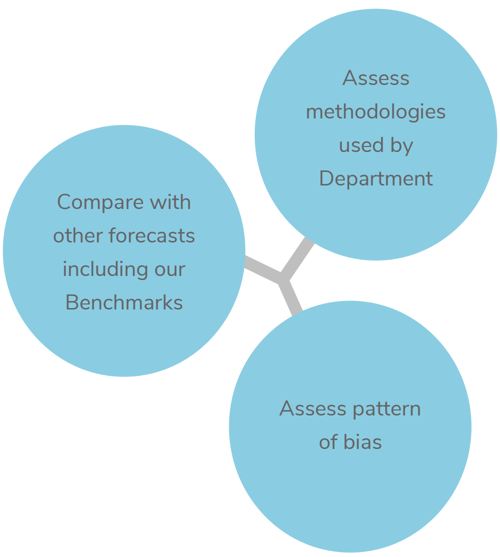
The Council's most recent endorsement exercise of the Department of Finance's macroeconomic forecasts was undertaken in March and April 2021. This section explores the key issues that arose in this latest endorsement exercise.

## Background

The Department's provisional macroeconomic forecasts were completed on 26th March 2021 (see table S1a for details of the endorsement timeline). The Council and Secretariat discussed the forecasts with Department staff on 1st April 2021. On 13th April, following the publication of *SPU 2021*, the Department provided a final update of forecasts reflecting the estimated impact of policy changes envisaged.

The Department's medium-term macroeconomic forecasts for 2021 to 2025 were judged as being within an endorsable range, taking into account the methodology and plausibility of the judgments made. The Council noted that the endorsement of the Department's economic forecasts was conditioned on the Government's assumptions about vaccination progress and the easing of restrictions.

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.



## Real GNI*

The Council welcomed new work by the Department to develop real GNI* forecasts for the first time with *SPU 2021*. This followed the Department's introduction of nominal GNI* forecasts in 2019 (for *Budget* 2020).

The move to presenting real GNI* forecasts represents a key shift in focus for the Department. Irish economic data has long been bedevilled by the globalisation effects, with activities by foreign companies leading to large net factor income flows to the rest of the world. The inclusion of enormous amounts of depreciation on intellectual property assets led to both GNP and GDP ballooning in recent years. As a result, neither GNP nor GDP are considered reliable proxies for the Irish tax base as is the case in other countries (see Box C, Fiscal Council 2018 for a discussion).

## Labour market and incomes

The Department projects a modest year-on-year improvement in labour market conditions in 2021. Despite employment increasing in 2021, the Department is forecasting a fall in personal disposable income (net of consumption of fixed capital), due to a subdued forecast recovery in compensation of employees and a fall in transfer payments. Employment is forecast to grow more strongly in 2022, almost reaching 2019 levels. At 4 per cent (unchanged from 2021), the Department's forecast for labour income growth in 2022 is considerably weaker than employment growth of 11 per cent. This could reflect that the jobs lost during and regained after the pandemic are predominantly in lower paying sectors. However, continued earnings growth for other sectors that were less affected by the pandemic would suggest that an acceleration in earnings growth in 2022 is more likely. The resilience of these less-affected sectors in 2020 was a key source of upside surprise to the Department's labour income forecasts.

Taxes and government transfers play an important role in forecasting household income. Forecasts of taxes and net social transfers are often compiled in a separate process to the macroeconomic forecasts. As a result, these forecasts can potentially be inconsistent with the broader macroeconomic forecasts. In the later years of the Department's projections, taxes paid by households are forecast to grow faster than compensation of employees or nominal GNI*. Were taxes projected to grow at a more moderate pace, household disposable income would be higher. From 2022 to 2025, personal disposable income (net of consumption of fixed capital) is forecast to grow at an average rate of 3.7 per cent. This is well below GNI* growth on average over the period (5.3 per cent).

### Personal consumer spending

On balance, the Council assessed that the Department's forecasts for consumer spending were initially softer than might be justified by recent data, whereas its forecasts for the medium term seemed to be driven by falls in the savings ratio to levels lower than had been seen in the years preceding the crisis.

The Department forecast a sharp fall in personal consumer spending in Q1 2021 (-10.2 per cent year-on-year), followed by a rebound in Q2. While the levels of consumer spending ended up at a similar place to other forecasts, including the Council's Benchmark projections, the contraction in Q1 seemed large. Indeed, retail sales data available at the time for January-February 2021 suggested an annual fall of -4.8 per cent assuming sales volumes were no worse in March than they were in February. This chimed with Central Bank card data that suggested a contraction in annual (value) terms of -5.1 per cent.[72]

The Department's expectation of a weaker outturn for Q1 than high-frequency indicators like the cards and retail sales data indicated appeared to be driven by use of new data sources. The Department's use of Revolut data on spending, which indicated a weaker Q1, was one factor. The Council noted that there were both advantages and potential risks to relying on this data, notably that it appeared to be dominated by younger cohorts, which would have made for a less representative picture than other sources.

Supporting the consumer spending picture was the Department's view that savings would remain elevated initially but fall over the forecast years. High savings rates partly reflected Covid-19 restrictions, which limited people's spending behaviour. Precautionary motives also likely played a role — consumers saving due to fears about future income prospects. The Department argued that Brexit and the macroprudential regulations had led to higher savings rates since 2015, but that Brexit fears would become less of an issue for the forecast horizon. The Department's projections implied

[72] This is based on Central bank card data up to March 22nd 2021. The average daily card spending from March 1st-22nd was used to extrapolate for the remaining days in March. This figure is adjusted for the additional day in Q1 2020 due to 2020 being a leap year.

that, as Covid-19 restrictions and associated health risks eased, savings rates would fall to levels lower than in the pre-Covid years.

A possible alternative to this scenario could see faster growth in real incomes as the driver of consumption growth over the medium term. Continued elevation for the savings ratio could be expected if macroprudential regulations retain influence over the flows of savings and consumption. While the stock of savings built up during the pandemic could partly be used to fund consumption in the nearer term, it seems less likely that it will still be relevant to consumption by 2025. To the extent that it is also used for non-consumption purposes, such as investment in property or deleveraging, this would also mitigate against a lasting fall in the savings ratio over the medium term.

### Investment

The Department's view underpinning its medium-term forecasts was that underlying machinery and equipment would recover strongly from low levels over the forecast horizon. This reflected its assessment that underinvestment was a factor in the years following the financial crisis and that there was evidence of a strong pipeline of investments planned by multinational enterprises based on discussions with IDA and IBEC. This led to their forecasts showing a substantial uptick in machinery and equipment investment spending as a share of GNI* (Figure S1a).

**Figure S1a: Underlying machinery and equipment investment**


Sources: Department of Finance forecasts in *SPU 2021*; and Fiscal Council workings.
Notes: Underlying machinery and equipment is total machinery and equipment investment spending excluding that on other transport equipment (mainly planes).

## Trade

The Department projected continued strong growth in total exports over the forecast horizon, especially due to services exports. However underlying imports — excluding aircraft and intangibles — were projected to grow more rapidly than underlying final demand over the forecast horizon, resulting in a rising share of imports in underlying final demand (Section 1).

If this import content were instead to be held constant at the historical ten-year average (44 per cent), it would have resulted in a faster rate of GDP growth of 1.3 percentage points on average for 2021–2025, or a level of real GDP 6.4 per cent higher than in the Department's forecasts.

The Department forecasts a decline in the modified current account (CA*) balance over the medium term, which is a familiar projection since its published forecasts of CA* began, in *Budget 2019*. However, since then, CA* has consistently increased rather than declined as expected (see S5). For 2020, the Department's forecast shows a small decrease of €0.8 billion, whereas in-year forecasts contained in *SPU 2020* and *Budget 2021* showed larger declines of €4.7 billion and €3.3 billion, respectively. These large forecast revisions have important implications for the sustainability of economic growth over the medium term.

It is likely that a top-down forecasting approach for GNI*, which estimates CA* in a consistent manner, contributes to some of these large revisions. This relates to the magnitude of the distortions to the economy as measured by GDP, since the modified current account combines several large components of GDP that are subject to considerable forecast and estimation error. Instead, a bottom-up forecast of GNI* would have the advantage of arriving at a CA* balance that is consistent with undistorted components of GNI*, whose forecasts do not rely on adjustments to net factor income from abroad, gross imports, or gross exports — the latter of which is projected to reach 242 per cent of GNI* by 2025. The Council welcomed the Department's efforts to develop bottom-up forecasts for GNI* in *SPU 2021*, similar to the Council's approach (see Box E in Fiscal Council, 2020a).

### Table S1a: Timeline for Endorsement of SPU 2021 Projections

| | |
|---|---|
| 5 March | The CSO released its Quarterly National Accounts estimates for Q4 2020. |
| 9 March | The Council's Secretariat and Department staff met with the CSO to clarify technical details of latest Quarterly National Accounts estimates. |
| 19 March | The Department sent its technical assumptions underpinning its forthcoming forecasts. |
| 26 March | The Department sent the Council preliminary forecasts in line with Memorandum of Understanding requirements. |
| 1 April | The Department of Finance presented its latest forecasts to the Council and Secretariat and answered questions. It agreed to follow up on some queries from the Council. After the meeting the Council had a preliminary discussion on its endorsement decision. |
| 6 April | The Council received updated and final forecasts from the Department of Finance. After reviewing these, the Council finalised a decision on the endorsement. The Chairperson of the Council wrote a letter to the Secretary General of the Department of Finance endorsing the set of macroeconomic forecasts underlying *SPU 2021*. |
| 13 April | The Department's forecasts were published in *SPU 2021*, updated for the impact of policy changes, and the Council received final forecasts from the Department in line with Memorandum of Understanding requirements. |

# S2. Council's Benchmark projections

Below is a summary of the Council's Benchmark projections, which were an input to its endorsement exercise. The Council finalised these projections on Friday 26th March before receiving the Department of Finance's preliminary forecasts.

### The Council's Benchmark projections

% change in volumes unless otherwise stated

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|---|---|---|
| Demand | | | | | | | | |
| GNI* | 1.7 | -0.4 | 1.6 | 6.4 | 3.9 | 3.5 | 2.7 | 2.8 |
| *...of which (p.p. contributions)* | | | | | | | | |
| *Underlying domestic demand[b] (p.p.)* | 3.5 | -2.9 | 2.4 | 6.7 | 2.7 | 2.6 | 2.7 | 2.8 |
| *Adjusted net exports[b] (p.p.)* | -2.1 | 3.5 | -1.3 | -0.3 | 1.2 | 0.9 | 0.1 | 0.0 |
| *Other, incl. stocks (p.p.)* | 0.3 | -0.9 | 0.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Underlying domestic demand[a] | 4.1 | -3.3 | 2.8 | 7.8 | 3.1 | 3.0 | 3.1 | 3.2 |
| Consumption | 3.2 | -6.2 | 5.4 | 7.6 | 2.9 | 2.6 | 2.3 | 2.3 |
| Government | 6.3 | 9.9 | 2.0 | 0.9 | 1.1 | 2.4 | 2.8 | 2.8 |
| Underlying investment[a] | 4.7 | -7.2 | -4.1 | 16.7 | 5.7 | 5.0 | 5.8 | 6.2 |
| Adjusted net exports | -18.7 | 38.6 | -10.3 | -3.0 | 11.9 | 8.0 | 0.7 | 0.1 |
| *...of which (p.p. contributions)* | | | | | | | | |
| *Adjusted exports* | *17.7* | *-40.0* | *30.0* | *22.2* | *18.2* | *12.6* | *11.2* | *12.1* |
| *Adjusted imports* | *-36.4* | *78.6* | *-40.3* | *-25.2* | *-6.3* | *-4.6* | *-10.4* | *-12.0* |
| Supply | | | | | | | | |
| Potential output | 3.5 | -6.6 | 2.9 | 5.8 | 2.9 | 2.7 | 2.6 | 2.7 |
| Output gap (% potential output) | 0.7 | -1.7 | -3.4 | -1.5 | -1.2 | -0.9 | -0.3 | 0.4 |
| Labour Market | | | | | | | | |
| Labour force | 2.0 | 0.7 | -0.6 | 2.0 | 1.1 | 1.4 | 1.4 | 1.4 |
| Employment | 2.9 | -13.3 | 2.3 | 10.1 | 3.0 | 2.2 | 2.3 | 2.2 |
| Unemployment rate (% labour force) | 4.9 | 18.2 | 15.8 | 9.1 | 7.4 | 6.7 | 5.9 | 5.2 |
| Prices | | | | | | | | |
| HICP | 0.9 | -0.5 | 1.7 | 1.8 | 1.4 | 1.6 | 2.1 | 2.3 |
| Personal consumption deflator | 2.4 | 1.0 | 2.1 | 2.1 | 1.8 | 1.9 | 2.4 | 2.6 |
| GNI* deflator | 5.7 | 1.5 | 1.0 | 1.3 | 0.8 | 1.1 | 2.1 | 2.3 |
| Other | | | | | | | | |
| Nominal GNI* | 7.6 | 1.1 | 2.6 | 7.8 | 4.7 | 4.7 | 4.9 | 5.2 |
| Nominal GNI* (€ billion) | 213.7 | 216.1 | 221.7 | 239.0 | 250.3 | 262.1 | 274.8 | 289.1 |
| Modified current account (% GNI*) | 7.7 | 10.2 | 8.7 | 7.7 | 7.9 | 7.9 | 7.6 | 7.3 |
| Savings ratio | 12.2 | 20.2 | 16.4 | 13.7 | 12.9 | 12.9 | 13.0 | 13.0 |

a Underlying (final) domestic demand, underlying investment, and underlying imports exclude "other transport equipment" (mainly aircraft) and intangibles.

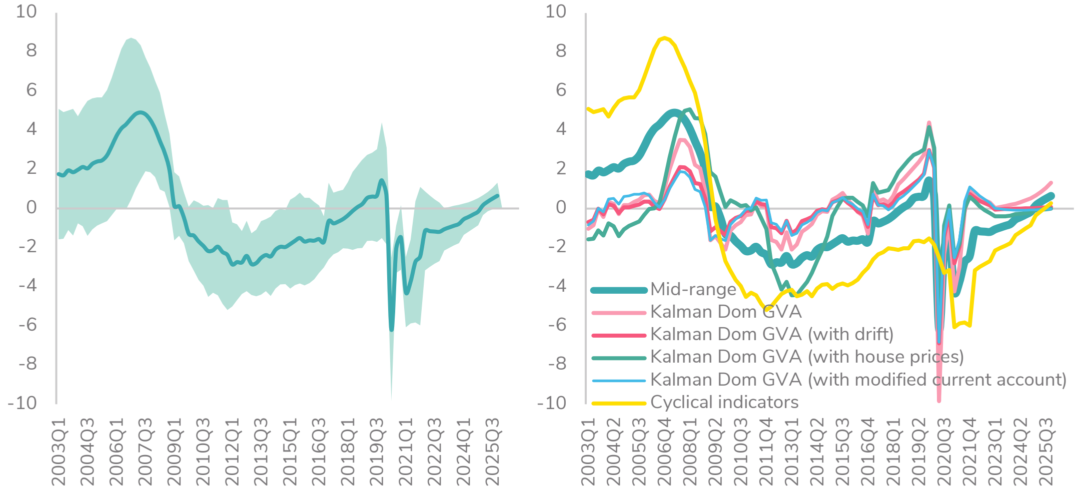
b Underlying contributions to real GNI* growth rates in percentage points — here adjusted net exports is forecast based on adjusted exports and adjusted imports, whose levels in 2019 (in 2018 constant prices) are estimated as €93.2 billion and €74.8 billion, respectively.

# S3. The cycle and imbalances

This section looks at estimates of the Irish cycle and potential imbalances in the Irish economy. Estimates of the cycle are based on the Council's models, which primarily focus on Domestic Gross Value Added — a measure of domestic economic activity that strips out sectors dominated by foreign-owned multinationals (see Casey, 2019). Potential output is the maximum level of economic output sustainable where output is not unduly influenced by external, domestic or financial economic imbalances. The output gap is the gap between actual output and its potential.

### Council's output gap models

Output gap (actual output as % of potential output)

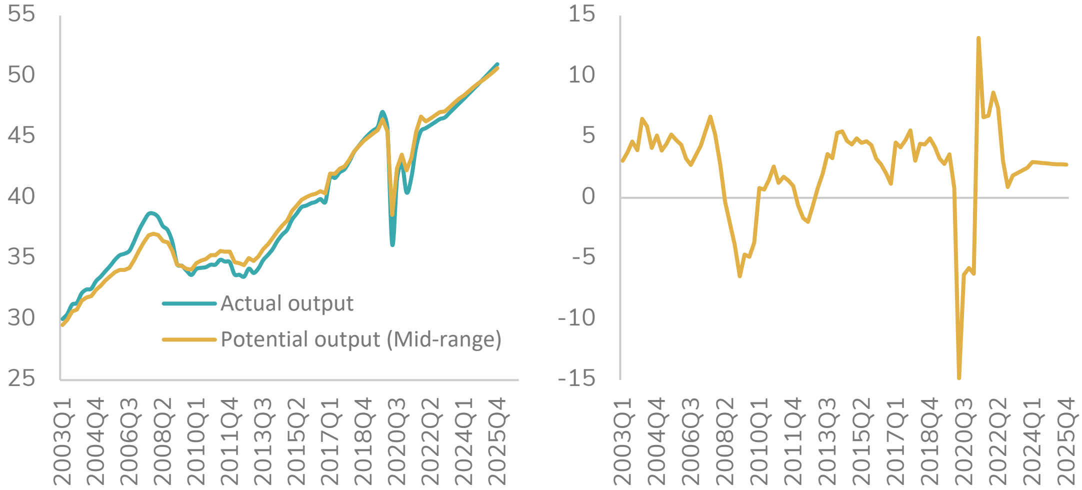



Sources: Fiscal Council workings.

Notes: Fiscal Council models of the output gap are applied to the Department's SPU 2021 forecasts.

### Council's estimates of potential output

Levels (€ billion) in left panel and potential output growth rates in right panel




Sources: Fiscal Council workings.

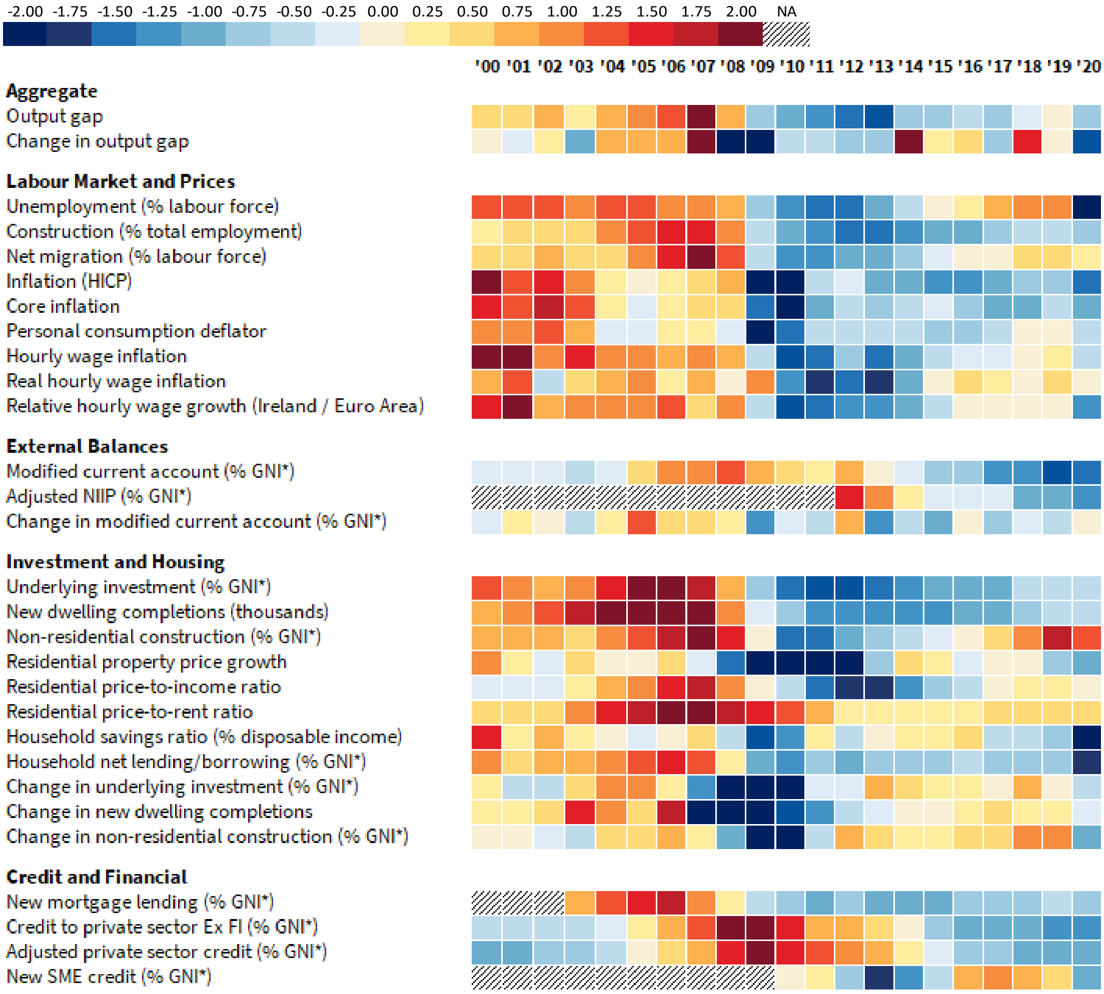
Notes: Fiscal Council models of the output gap are applied to the Department's SPU 2021 forecasts.

As well as producing estimates of the cycle, the Council monitors potential economic imbalances that might be overlooked by single indicators like output gaps. It focuses on four areas in particular: (1) the labour market and prices; (2) Ireland's external balances with the rest of the world; (3) investment and housing; and (4) financial conditions.

The following heat map assesses potential imbalances across four areas based on their departure from historical norms. Colder (bluer) indicators suggest spare capacity, while hotter (redder) suggest potential overheating or other imbalances.

### Heat map of economic imbalances

Tiles show the extent of departure from historical norms (in standard deviations)




Sources: The main sources for the data underpinning the table are the CSO; Central Bank of Ireland; Department of Finance; and Fiscal Council workings. For more information on the data used and basis for deriving the heat map, see Timoney and Casey (2018).

# S4. Macro-fiscal risks

This section outlines the major risks envisaged for the Government's official economic and budgetary forecasts. The risks shown are primarily those noted in *SPU 2021*, but with additional risks identified by the Council.

### Macro Risks Matrix

Likelihoods and impacts are as assessed by the Council

| Likelihood | Impact | |
|---|---|---|
| High | High | **Less scarring effects**: there is a high likelihood of less scarring than the SPU assumption of 5 per cent over the medium term, as discussed in Section 1.3. |
| Medium | High | Larger spending rebound: as discussed in Box A, the likelihood of a high-impact spending rebound over the short-term is significant. |
| Medium | High | **Lower FDI** due to international tax reform: a slowdown or partial reversal of foreign direct investment in Ireland over the medium term could occur due to international corporation tax reform; given the importance of FDI for the Irish economy, this could have significantly negative implications for high-skill job creation in Ireland. |
| Medium | High | **Brexit** 'after-effects': although a free-trade agreement has been reached rather than a disorderly Brexit as feared in recent years, it is possible that the assumed impact of Brexit on the Irish economy will prove more severe than assumed. |
| Medium | Medium | **Stronger output from MNCs**: the main benefits to the Irish economy of MNCs include wages paid to employees, corporation taxes paid to the Exchequer, and spillover employment to domestic firms; however, the relevance of stronger output from MNCs to the Irish economy — which resulted in GDP growth in 2020 alongside a contraction in underlying domestic demand — should not be overstated. |
| Medium | Low | **Inflation** shock: higher inflation could slow the recovery somewhat, although it is also possible that higher inflation would prove temporary; furthermore, the substantial savings of Irish households accumulated over the past year (as discussed in Box A) could mean a limited impact of higher inflation on consumer spending, given many consumers are likely to be willing to pay higher prices for goods and services that have been unavailable for extended periods of time. |
| Low | High | **Financial sector** amplification: spillovers to the financial sector due to an increase in non-performing business loans could cause a negative feedback loop between the financial sector and the real economy; however, the likelihood of this could be remote given Ireland's very high modified current account surplus going into (and seemingly maintained despite) the pandemic. |
| Low | High | **De-globalisation**: the pandemic could result in more permanent shifts away from trade and globalisation, exacerbating previous trade tensions and trends, with adverse implications for a small, open economy such as Ireland. |
| Low | High | **Premature policy withdrawal**: it appears to be a low likelihood that policy supports will be withdrawn prematurely, however if this were to occur, the impact on households and firms would be very significant. |
| Low | High | **Larger-than-expected scarring**: as discussed in Section 1, there are a number of reasons to expect that scarring will be lower than assumed in *SPU 2021*, nonetheless in the event of greater scarring than expected for the Irish economy, this would be a high impact given the permanently lower path for output it would imply. |
| Not quantified | High | **Vaccine-resistant variants**: the impact of further restrictions due to the pandemic would be very high, although it is significant that the economy has performed relatively well in Q1 2021 compared to Q2 2020 when the worst effects of the first lockdown were in place — helped of course by the pandemic policy supports put in place by the Government. |
| Not quantified | Medium | **Delayed vaccine rollout**: despite some delay in vaccine rollouts as noted in Section 1.2, the economy has nonetheless commenced re-opening in May 2021, sooner than expected in *SPU 2021*; as above, the capacity of the economy to navigate the latest lockdown suggests the impact of a delayed vaccine rollout would not necessarily be high at a macroeconomic level. |

Sources: Department of Finance (*SPU 2021*); and Fiscal Council assessments.

## Fiscal Risks Matrix

Likelihoods and impacts are as assessed by the Council

| Likelihood | Impact | |
|---|---|---|
| High | High | **Pandemic related costs**. The extension of support programmes this year and into next is highly likely. The costs to spending and revenue of possible further waves would be large but likelihood is not assessed. |
| High | High | **Health overruns**. Beyond the immediate pressures of the pandemic, spending pressures in the health area remain a significant risk. Sláintecare reforms could also add significant costs. This risk is added by the Council. |
| High | Medium | **Corporation tax**. Adverse impacts of a changing international environment could be substantial (Box E). However, *SPU 2021* forecasts already incorporate a significant impact. As a result, a medium impact may be more appropriate over the forecast horizon considered. There is high uncertainty about the outcomes in this area. |
| High | Medium | **Other spending pressures/overruns**. Some obvious spending pressures have not been budgeted for 2021 and beyond such as the Christmas bonus and the full Stand-Still costs of maintaining core public supports. This risk is added by the Council. |
| High | Medium | **Climate change and renewable energy targets**. *SPU 2021* says "While Ireland's 2030 climate change and renewable energy targets are to be determined, they are likely to be ambitious and failure to comply would have financial costs". The Council assesses this risk to be medium impact. |
| Medium | Medium | **Population ageing**. There is a risk that the costs of ageing could be larger than allowed for under *SPU 2021* forecasts. Stand-Still costs in the coming years are significant, partially due to population ageing. |
| Medium | Medium | **Contingent liabilities**. Significant loans and guarantees to support sectors during the pandemic. Losses could arise if firms are unable to repay. The Council assesses this risk to be medium likelihood. |
| Medium | Low | **EU Budget contributions**. Stronger than assumed national income growth (relative to other EU countries) could lead to larger EU budget contributions. The Council assesses this risk to be low impact. |
| Low | Medium | **Litigation risk**. Any unexpected litigation against the state could lead to additional expenditure. The Council assesses this risk to be low likelihood? |
| Low | Low | **Borrowing costs**. Borrowing conditions have been favourable in recent times. Were conditions to reverse, that would have implications for Irish borrowing costs, particularly given the high debt levels. However, given the low gross financing needs in the coming years, the Council assesses this risk to be low impact. |
| Low | Low | **Dividend payments**. Lower-than-expected dividend returns from the States shareholdings in financial institutions and semi state bodies. The Council assesses this to be low impact. |

Sources: Department of Finance (*SPU 2021*); and Fiscal Council assessments.

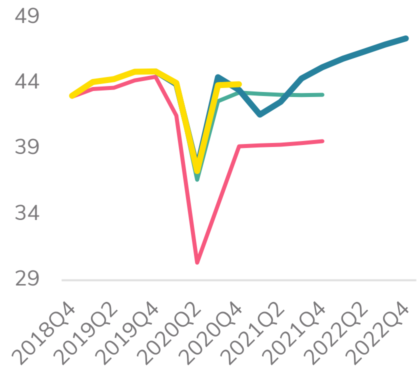
# S5. Macroeconomic forecast errors

This section shows how the Department's macroeconomic forecasts have evolved over recent forecast rounds.

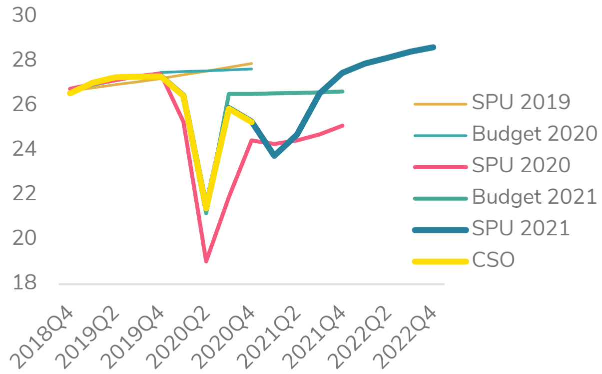
### The economy recovered more rapidly than forecast during the pandemic

€ million, 2018 constant prices

**Underlying domestic demand**



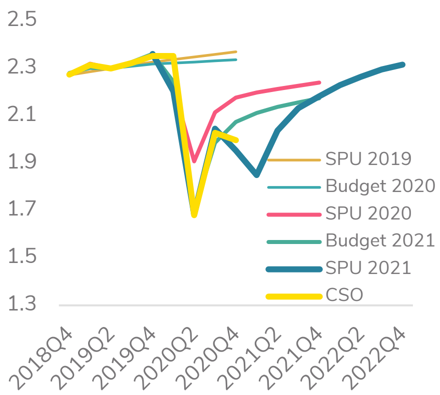

**Personal consumption expenditure**



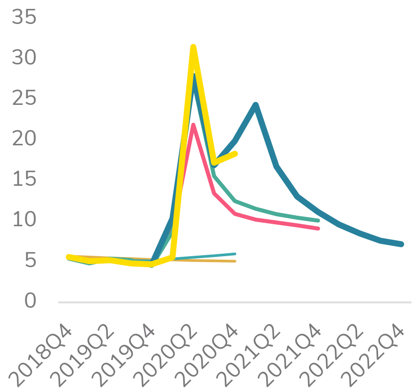

Sources: Department of Finance; Central Statistics Office; and internal Fiscal Council workings.
Note: The Department of Finance's quarterly profiles have been indexed to constant 2018 prices (beginning with the Q4 2017 CSO outturn) and adjusted for precise consistency with the endorsed annual forecasts; the profile provided for modified investment has been evenly adjusted to match forecasts for underlying investment.

### Whereas the labour market fared worse than forecast

**Employment** (millions)

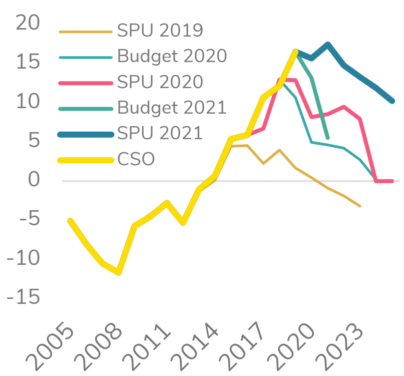



**Unemployment rate** (% labour force)

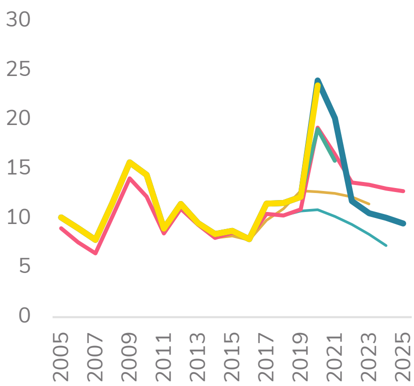



### For several years, the current account has been higher than expected

**Modified current account** (€ billion)




**Savings ratio** (% of household disposable income)



# S6. Detail on fiscal outturns and forecasts

This section sets out key budget figures on spending, taxes and the budget balance based on recent outturns and latest forecasts.

### Fiscal forecasts from SPU 2021.

€ millions unless stated

| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|
| **General Government Revenue** | **85,780** | **90,515** | **94,150** | **99,470** | **103,700** | **108,120** |
| Income Tax | 22,710 | 24,305 | 26,130 | 28,470 | 30,385 | 32,305 |
| VAT | 12,425 | 14,370 | 15,885 | 17,280 | 18,105 | 19,015 |
| Corporation Tax | 11,835 | 11,640 | 11,795 | 12,035 | 12,275 | 12,490 |
| PRSI | 10,491 | 11,133 | 11,627 | 12,264 | 12,932 | 13,656 |
| Excise | 5,450 | 5,840 | 6,410 | 6,630 | 6,825 | 7,040 |
| Stamp Duties | 2,090 | 1,525 | 1,470 | 1,570 | 1,690 | 1,820 |
| Other GG Revenue | 20,779 | 21,702 | 20,833 | 21,221 | 21,488 | 21,794 |
| **General Government Expenditure** | **104,200** | **108,575** | **105,765** | **104,790** | **106,835** | **108,920** |
| Social payments | 39,035 | 39,985 | 36,190 | 33,210 | 33,265 | 33,255 |
| Compensation of employees | 24,850 | 25,680 | 26,600 | 27,040 | 27,985 | 28,865 |
| Intermediate consumption | 14,660 | 15,775 | 16,165 | 16,580 | 16,835 | 17,315 |
| Capital expenditure | 9,795 | 11,105 | 12,295 | 13,355 | 14,350 | 14,840 |
| Interest expenditure | 3,685 | 3,360 | 3,665 | 3,830 | 3,795 | 3,445 |
| Subsidies | 5,655 | 6,115 | 3,375 | 3,145 | 2,265 | 2,310 |
| Other | 6,520 | 6,555 | 7,475 | 7,630 | 8,340 | 8,890 |
| **Primary expenditure** | **100,515** | **105,215** | **102,100** | **100,960** | **103,040** | **105,475** |
| **Current Primary expenditure** | **90,720** | **94,110** | **89,805** | **87,605** | **88,690** | **90,635** |
| **General Government Balance** | **-18,415** | **-18,060** | **-11,615** | **-5,320** | **-3,130** | **-805** |

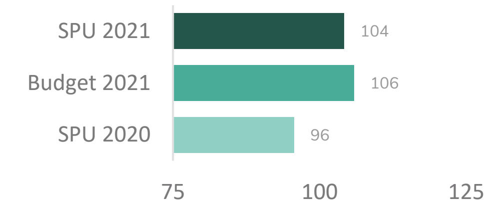
Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Other GG revenue is calculated as a residual. It comprises some of the smaller Exchequer tax headings (motor tax, customs and capital taxes) as well as non-Exchequer GG revenue.

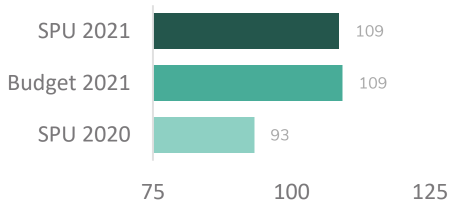
# S7. Analysis of budget forecast revisions

This section shows how forecasts of the public finances have evolved over recent forecast rounds.

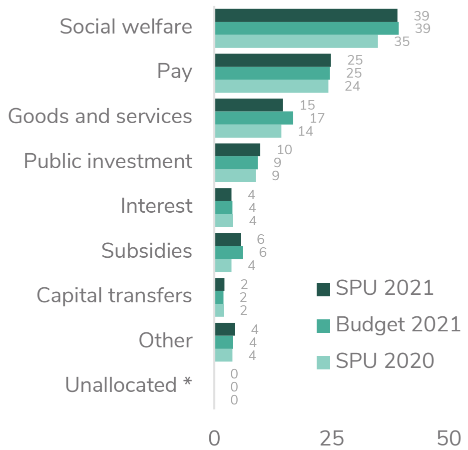
**2020** **2021**

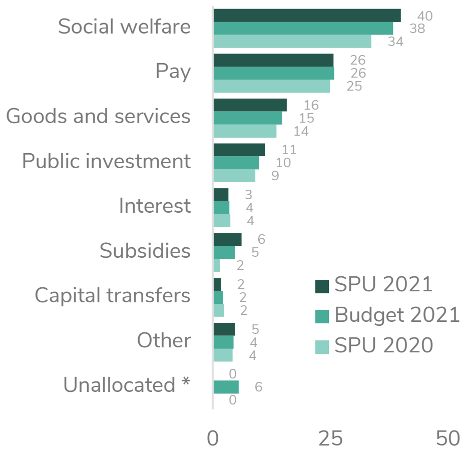
## Total general government spending forecasts



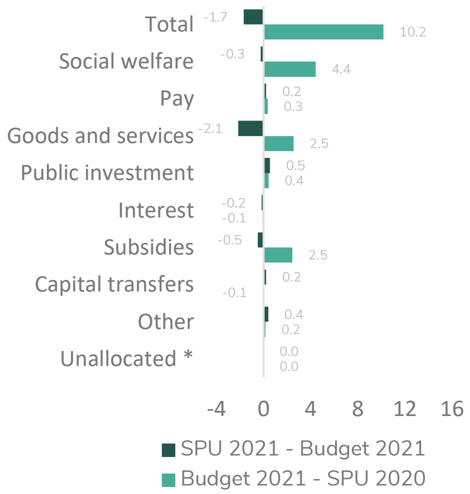

## Breakdown of general government spending

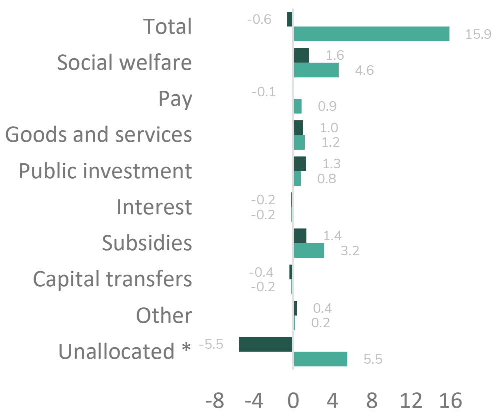



* "Unallocated" spending includes amounts set aside for the Covid-Contingency (€2 billion) and the Recovery Fund (€3.4 billion).

## Revisions to general government spending



### Revisions to expenditure forecasts for 2021 – Unallocated spending is now largely going towards intermediate consumption

€ millions unless stated

| | Budget 2021 | SPU 2021 | Difference between SPU 2021 and Budget 2021 | Revision due to Budget 2021 forecast error | Revisions not due to change in 2020 starting point |
|---|---|---|---|---|---|
| | A | B | C = B-A | D | E = C-D |
| Total expenditure | 109,180 | 108,575 | -605 | -1,665 | 1,060 |
| Compensation of employees | 25,805 | 25,680 | -125 | 225 | -350 |
| Intermediate consumption | 14,765 | 15,775 | 1,010 | -2,145 | 3,155 |
| Social payments | 38,380 | 39,985 | 1,605 | -245 | 1,850 |
| Interest expenditure | 3,555 | 3,360 | -195 | -165 | -30 |
| Subsidies | 4,765 | 6,115 | 1,350 | -480 | 1,830 |
| Gross fixed capital formation | 9,830 | 11,105 | 1,275 | 545 | 730 |
| Capital transfers | 2,155 | 1,760 | -395 | 205 | -600 |
| Other | 4,425 | 4,795 | 370 | 400 | -30 |
| Unallocated expenditure | 5,500 | 0 | -5,500 | | |

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

Note: Column C is the difference between column B and column A. Column D shows the difference between the outturn data for 2020 from the CSO and the forecast for 2020 included in *Budget 2021*. This can be considered as the change in the starting point for forecasts for 2021. Column E is the difference between column C and column D. Column E is therefore largely a reflection of the areas where the €5.5 billion, of previously unallocated spending, has now been allocated to.

# S8. Tax forecasts decomposed

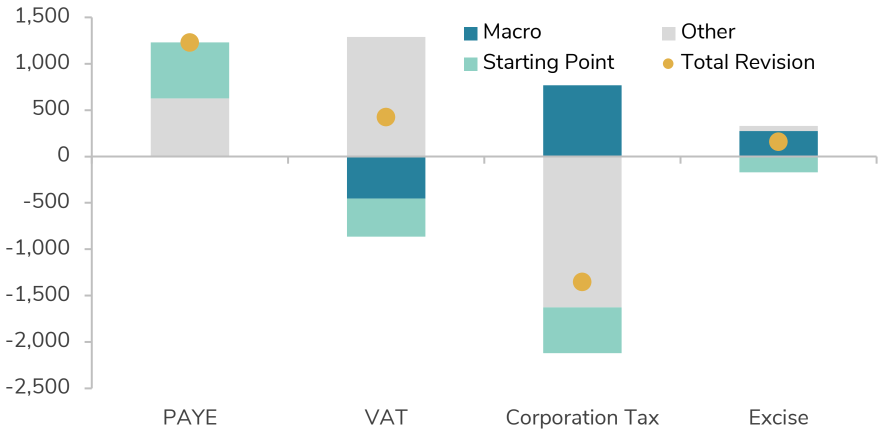
This section examines the official Department of Finance forecasts of the main tax heads. It compares the latest set of forecasts with previous forecasts. This section also decomposes the projected changes in tax receipts to better understand how the forecasts are arrived at.

### Changes to forecasts since Budget 2021

This section first looks at the revisions to the Department's tax forecasts for 2021 compared to *Budget 2021* forecasts. The revisions are assessed in terms of: (1) the change in the "**macro**" economic outlook relevant for each tax head; (2) the error arising from an incorrect "**starting point**" estimate of 2020, which biases the 2021 forecast (a positive starting point means that the 2020 outturn was actually higher than expected at budget time); and (3) an "**other**" source of revision, caused by use of incorrect estimates of any other component of the forecast.

**Tax forecast revisions in 2021.**

€ million, SPU 2021 - *Budget 2021*




Sources: Department of Finance; and internal Fiscal Council workings.
Note: The chart breaks down the total revision to the Department's official tax forecasts into the "macro" component—the part driven by changes to economic growth—, the starting point, component, and the "other" component. As described in the text, there are issues with how the macroeconomic environment is reflected in in PAYE forecasts. As a result, revisions to PAYE are broken into just two categories here, starting point and other.

As an example of how to interpret this, the upward revision to VAT is entirely driven by factors (including judgement) that are unrelated to macro drivers or the revised starting point: the 2020 outturn was lower than forecast in *Budget 2021*. Judgment pushing up the forecasts may be explained by the impact of a policy measure of tax warehousing depressing the base (2020) level, as well as incorporating strong receipts in 2021Q1.

## Analysing tax forecasts

The second part of this section looks at the latest official tax forecasts. It shows the yearly changes expected for receipts from VAT, corporation tax, excise duties, and the PAYE and USC components of income tax.[73] The annual changes are attributed to a number of components:

1) "**macro**" is the part of the forecast driven by growth in the relevant macro driver (such as wage growth, recognising the sensitivity of income tax growth to this driver)
2) "**one-offs**" — non-recurring items that effect expected receipts
3) "**policy**" changes, such as tax cuts or tax increases
4) "**warehousing**" the impact of lower taxes in (e.g. in 2020 and 2021) due to warehousing with higher receipts in later years.
5) "**carryover**" effects — policy impacts carried over from previous years
6) "**other**" — other potential elements affecting the forecasts, including judgment applied by the Department of Finance. It is calculated as the difference between the Fiscal Council's internal forecasting exercise and the Department of Finance's own forecasts.

Warehousing of PAYE receipts has boosted receipts in 2021 for two reasons. First, 2020 receipts are understated, due to the warehousing of €865 million of income tax. Second, 15 per cent of the liabilities are assumed to be paid in 2021, then increasing in 2022 and 2023, before falling to zero. VAT forecasts are similarly influenced by warehousing.

Large positive judgement is applied in 2022, as the impacts of an improving economy and labour market are not captured by the methodology employed. Negative judgement is applied in 2025 as tax growth is believed

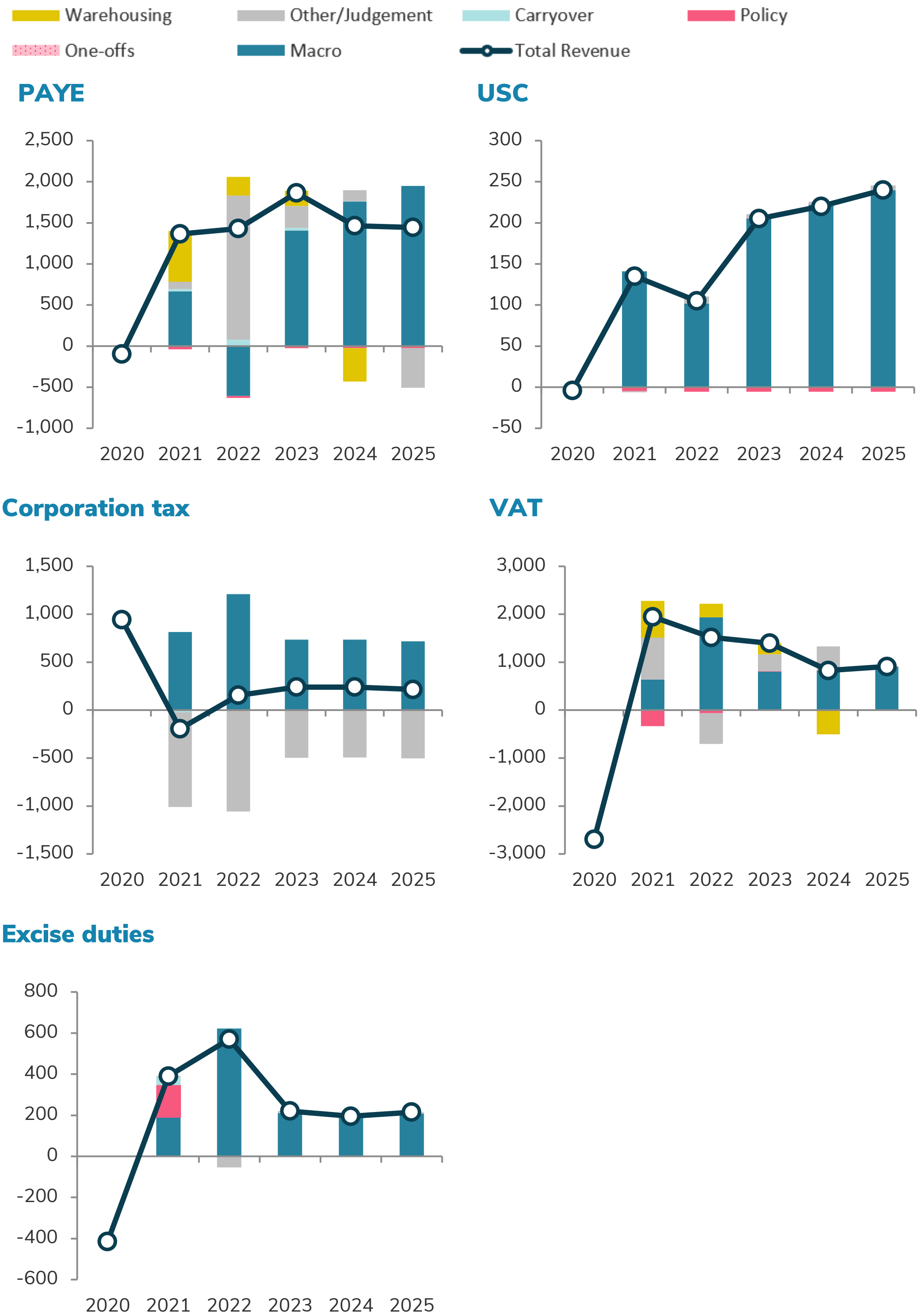
[73] The generic formula applied by the Department of Finance to forecast revenue is given by: $\mathrm{Rev}_{t+1} = (\mathrm{Rev}_t - \mathrm{T}_t) * (1 + \mathrm{B}_{t+1} * \mathrm{E}) + \mathrm{T}_{t+1} + \mathrm{M}_{t+1} + \mathrm{M}_t + \mathrm{J}_{t+1}$,

where revenue forecasts ($\mathrm{Rev}_{t+1}$) depend on their lag stripped of one-off items ($\mathrm{T}_t$); one-off items in the current period ($\mathrm{T}_{t+1}$); the macro drivers ($\mathrm{B}_{t+1}$) and their associated elasticity ($\mathrm{E}$), current policy ($\mathrm{M}_{t+1}$) and carryover policy impacts ($\mathrm{M}_t$), and judgement ($\mathrm{J}_{t+1}$). 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 $\Delta T_{t+1}$; (iii) current and previous policy changes ($M_{t+1}$and $M_t$, respectively); and other adjustments, mainly judgement, as covered in the component $J_{t+1}$. For a detailed description of the Fiscal Council's forecast replication model, see Hannon (2014).

to be too high in these years, due to the elasticity being too high (elasticity of 2.1 applied to pay per employee growth).

**Tax forecasts decomposed**

€ million, year-on-year change




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

# S9. Net policy spending

This section looks at government spending in terms of "net policy spending" — a measure of spending that attempts to assess the Government's overall fiscal policy stance.

Policy spending shows the level of overall general government spending excluding temporary factors like one-offs and spending on unemployment benefits that are not likely to be long-lasting. "Net" policy spending recognises the role of tax changes. For instance, new tax-raising measures can be used to fund spending increases. A rise in net policy spending is offset by tax-raising measures but is added to by tax cuts.

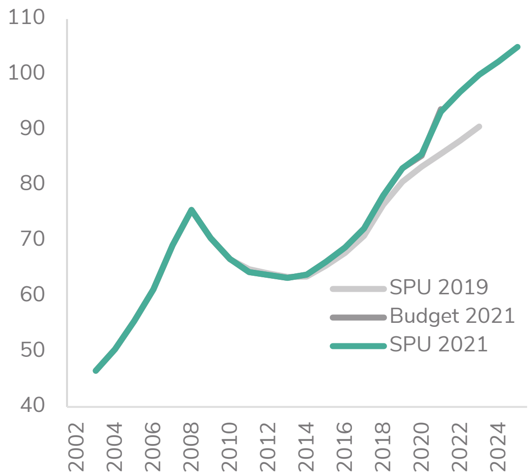
## Recent net policy spending

€ millions

| | Levels | | | | Changes | | |
|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | 2022 | 2020 | 2021 | 2022 |
| Total Expenditure | 87,285 | 104,200 | 108,575 | 105,765 | 16,915 | 4,375 | -2,810 |
| - Interest | -4,457 | -3,685 | -3,360 | -3,665 | 772 | 325 | -305 |
| - One-offs (incl. temporary unemployment costs) | 263 | -14,916 | -11,960 | -5,275 | -15,179 | 2,956 | 6,685 |
| = Policy Spending | 83,091 | 85,599 | 93,255 | 96,825 | 2,508 | 7,656 | 3,570 |
| - Discretionary revenue-raising measures | -958 | -960 | 65 | -650 | -3 | 1,025 | -715 |
| = Net Policy Spending * | 82,134 | 84,639 | 93,320 | 96,175 | 1,548 | 7,721 | 2,920 |

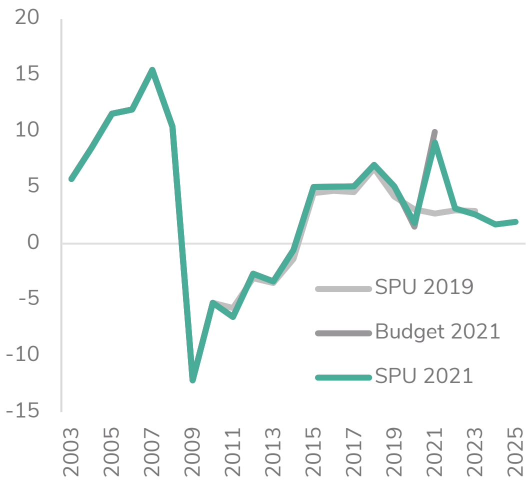
## Policy spending levels

€ billions




## Net policy spending growth

% change year-on-year



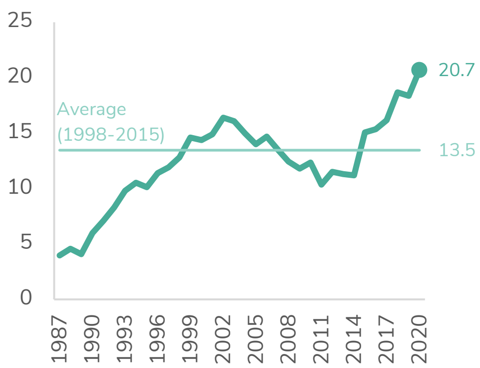

Sources: Department of Finance (SPU 2021 forecasts); and Fiscal Council workings.
Notes: Net Policy Spending is general government expenditure less interest costs, one-off expenditure items, and the estimated costs associated with cyclical unemployment. Given the extensive changes in unemployment benefits associated with the pandemic, recent calculations include "non-core" social protection spending increases as the basis for the temporary/cyclical increase in unemployment benefits. This is included in "one-offs" along with other Covid-19 and Brexit supports. * Changes in net policy spending are the difference between net policy spending in 2021 as compared to policy spending in 2020.

# S10. Corporation tax analysis

This section looks at Ireland's corporation taxes and how these have grown in importance to overall tax receipts in recent years.

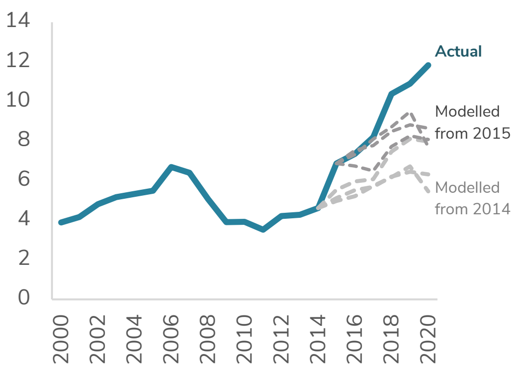
### Corporation tax at record shares

% total Exchequer taxes




### Receipts exceed model estimates

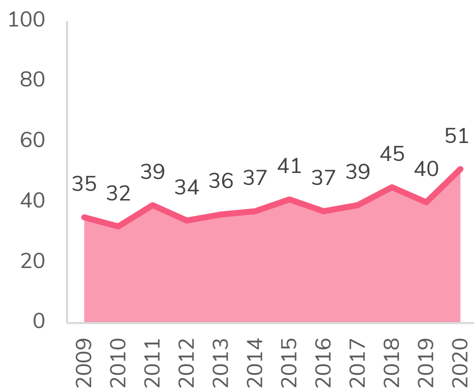
€ billions




Source: Revenue data; and Fiscal Council workings.
Notes: Model estimates based on ordinary least squares and error correction models of corporation tax receipts using Domestic GVA and Modified Gross National Income to predict receipts from 2014 and 2015.

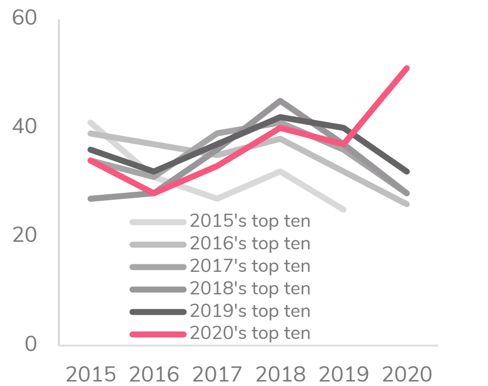
### Receipts are concentrated

% net receipts accounted for by top ten companies




### Though top ten changes over time

% net receipts accounted for by top ten companies




Source: Revenue data; and Fiscal Council workings.

### Corporation tax receipts

€ billions unless otherwise stated

| | |
|---|---|
| Total corporation tax in 2020 | 11.8 |
| % of Exchequer taxes | 20.7 |
| Estimates of excess: lowest estimate | 3.2 |
| central estimate | 4.8 |
| highest estimate | 6.4 |
| % net receipts from Top 10 companies | 51 |
| % net receipts from Top 100 companies | 79 |
| % net receipts from Foreign-owned MNEs | 82 |

Source: Fiscal Council workings.
Notes: "Excess" is the difference between actual and modelled corporation tax receipts.

# S11. Stand-still scenario for spending

This section provides an update of the Council's "Stand-Still" scenario for government spending. The Stand-Still analysis estimates the cost of maintaining today's level of public services and benefits in real terms over the medium term based on anticipated demographic and price pressures.

### Stand-still costs slightly higher than forecast increases

Annual change in € billion (gross voted current spending)

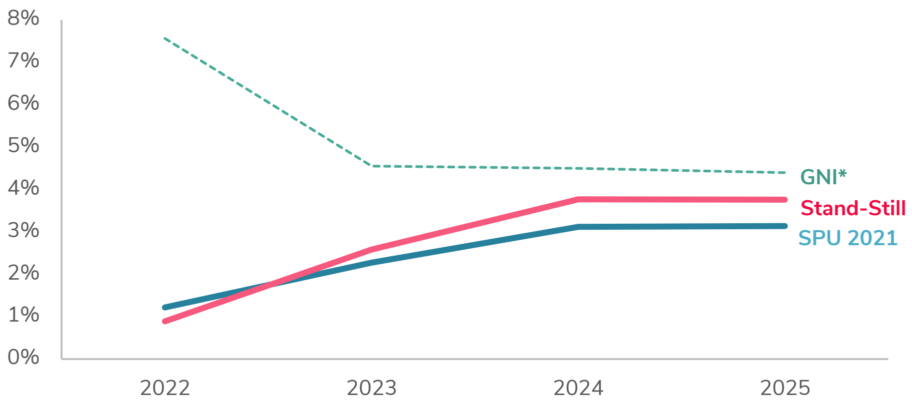
| | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|
| Stand-Still scenario | 0.6 | 1.9 | 2.8 | 2.9 |
| - demographic pressures | -0.5 | -0.3 | 0.6 | 0.5 |
| *of which unemployment costs* | -2.0 | -1.1 | -0.3 | -0.3 |
| *of which other age related* | 1.5 | 0.9 | 0.9 | 0.9 |
| - price pressures | 1.1 | 2.2 | 2.2 | 2.4 |
| Total Increases in *SPU 2021* | 0.8 | 1.6 | 2.2 | 2.3 |
| Gap to Stand-Still | -0.2 | 0.3 | 0.6 | 0.6 |

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

To stand still, the Council estimates that increases of the order of €2.5 billion per year would be required over the medium term (2023–2025). By comparison, *SPU 2021* spending forecasts show spending increasing by around €2 billion per year over the same period, when Covid-19 related costs are omitted. The average shortfall of €0.5 billion per year is driven primarily by price pressures, with expected rises in prices of goods and services and in wages likely to add to costs over the medium term.

### Stand-Still estimates of spending increases are closer to output growth

% change year-on-year



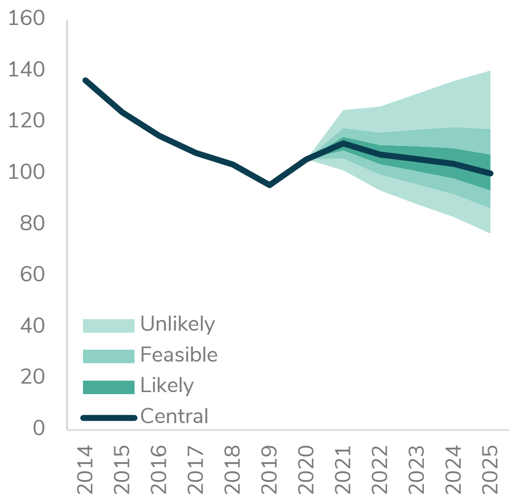

Source: Department of Finance; and Fiscal Council workings.

# S12. Debt sustainability assessment

This section uses the Maq (Casey and Purdue, 2021), a macro-fiscal model, to assess paths for the government debt ratio. It draws on past relationships between variables and detailed debt security data to gauge probabilities associated with different outcomes, while also exploring potential shocks around the Department of Finance's "central" forecasts.

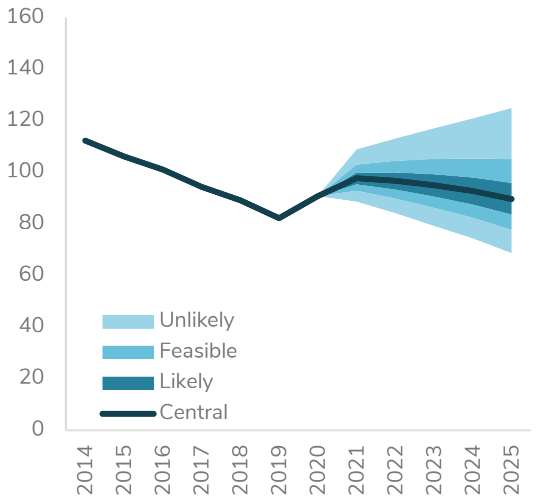
### Gross debt fan chart

% GNI*



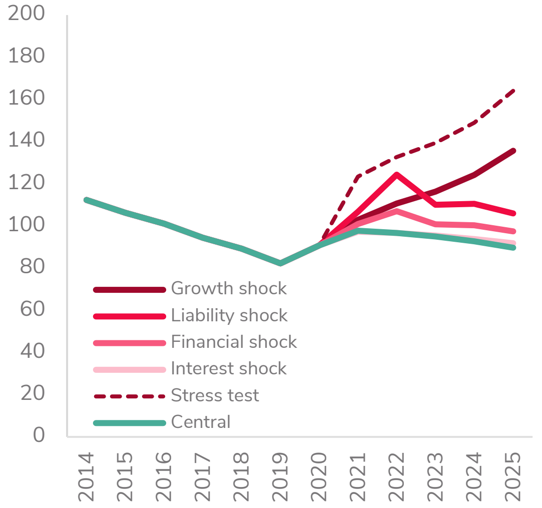

### Net debt fan chart

% GNI*



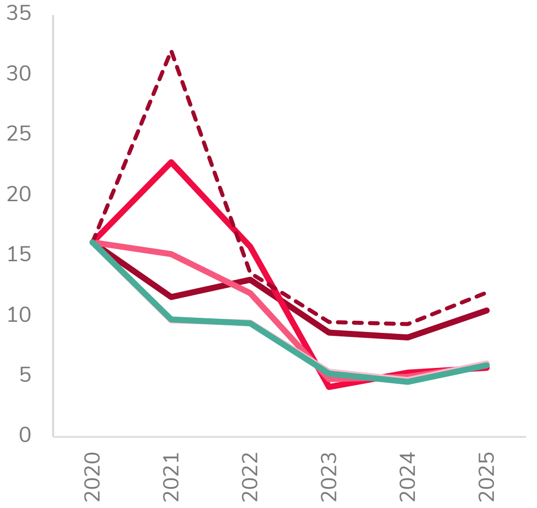

### Shock scenarios

Net debt % GNI*




### Gross financing needs

% GNI*




Sources: Department of Finance forecasts; CSO outturns; NTMA data on debt securities and Fiscal Council workings.
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. The "Growth shock" assumes real GNI* growth rates 3.6pp (one standard deviation, 1996-2019 excl. financial crisis) weaker than the Central scenario for 2 years (leaving output about 7% below the central scenario). The "Liability" and "Financial" shocks, respectively, assume 15% and 10% GNI* contingent liabilities materialise, based on an historical assessment of fiscal risks internationally. The "Interest shock" assumes marginal interest rates rise by 2pp for the full period. The "Stress test" combines all previous shocks.

# S13. Detailed fiscal rules assessment

This section provides a more detailed assessment of the Fiscal rules. Table S13.1 shows a summary assessment of compliance with the fiscal rules, using forecasts included in *SPU 2021*, along with the Council's assessment of one-off and discretionary revenue measures (see Table S13.2 for the Council's estimates of one-offs).

This assessment is based on the Council's principles-based approach to assessing the domestic Budgetary rule (see Table S13.3 for a summary of this approach).

For 2020 and 2021, due to the ongoing Covid-19 pandemic, the Council assesses that exceptional circumstances exist.[74] "Exceptional circumstances" is a provision included in the *Fiscal Responsibility Act*, 2012, that allows for a temporary deviation from the requirements set out under Ireland's Domestic Budgetary Rule.

Separately, the European Commission have activated the general escape clause which allows for deviations from the requirements under the EU fiscal rules. The general escape clause will likely remain in place into 2022.[75]

[74] The Council has not yet made a determination as to whether exceptional circumstances will continue to exist into 2022.

[75] The European Commission has outlined that the key criteria for deciding whether the general escape clause will no longer be in place is whether EU wide GDP is above end 2019 levels. Based on the latest Commission forecasts GDP is expected to be above end 2019 levels by the middle of 2022. As such, the Commission has indicated that the general escape clause will likely be in place into 2022. See here for further details: https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_885.

## Table S13.1 Summary Fiscal rules assessment[1, 2, 3, 5]

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

| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|
| **Corrective Arm** | | | | | | |
| General government balance (% GNI*)[5] | -8.9 | -8.7 | -5.2 | -2.2 | -1.3 | -0.3 |
| General government balance | -5.0 | -4.7 | -2.8 | -1.2 | -0.7 | -0.2 |
| General government balance Limit | -3.0 | -3.0 | -3.0 | -3.0 | -3.0 | -3.0 |
| General government debt (% GNI*)[5] | 105.6 | 114.9 | 110.2 | 106.9 | 104.4 | 100.1 |
| General government debt | 59.5 | 62.2 | 60.2 | 59.0 | 57.7 | 55.4 |
| 1/20th Debt Rule Limit | 60 | 60 | 60.7 | 60.7 | 60.0 | 60.0 |
| Debt Rule met? | Y | not met | Y | Y | Y | Y |
| **Preventive Arm & Domestic Budgetary Rule** | | | | | | |
| **Structural balance adjustment requirement** | | | | | | |
| **MTO for the structural balance** | **-0.5** | **-0.5** | **-0.5** | **-0.5** | **-0.5** | **-0.5** |
| Structural balance | -0.7 | -1.1 | -1.9 | -1.2 | -0.9 | -0.4 |
| MTO met? | N | N | N | N | N | Y |
| **Minimum change in structural balance required** | **0.0** | **0.0** | **0.6** | **0.5** | **0.5** | **0.4** |
| Change in structural balance | -1.2 | -0.4 | -0.7 | 0.7 | 0.2 | 0.5 |
| 1yr deviation (€ bn) | -0.9 | -2.5 | -5.6 | 1.0 | -1.2 | 0.3 |
| 1yr deviation (p.p.) | -0.2 | -0.6 | -1.3 | 0.2 | -0.3 | 0.1 |
| 2yr deviation (€ bn) | 0.2 | -1.7 | -4.0 | -2.3 | -0.1 | -0.4 |
| 2yr deviation (p.p.) | 0.1 | -0.4 | -1.0 | -0.6 | 0.0 | -0.1 |
| **Expenditure Benchmark** | | | | | | |
| (a) Reference rate of potential growth (% y/y) | 4.7 | 4.5 | 4.5 | 4.6 | 3.8 | 3.5 |
| (b) Convergence margin | 0.0 | 0.0 | 2.4 | 2.1 | 2.2 | 1.9 |
| (a-b) Limit for real net expenditure growth (% y/y) | 4.7 | 4.5 | 2.0 | 2.5 | 1.6 | 1.6 |
| GDP deflator used | -0.5 | 0.4 | 1.8 | 1.5 | 1.6 | 1.6 |
| **Limit for nominal net expenditure growth (% y/y)** | **4.2** | **4.9** | **3.8** | **4.0** | **3.3** | **3.2** |
| Net expenditure growth (% y/y) | 10.1 | 6.7 | 1.9 | 0.0 | 2.7 | 3.2 |
| Net expenditure growth (corrected for one-offs) (% y/y) | -2.2 | 9.1 | 9.1 | 2.6 | 2.7 | 3.2 |
| 1yr deviation (corrected for one-offs) (€ bn) | - | -3.3 | -4.6 | 1.3 | 0.6 | 0.1 |
| 1yr deviation (corrected for one-offs) (% GNI*) | - | -1.6 | -2.1 | 0.6 | 0.2 | 0.0 |
| 2yr deviation (corrected for one-offs) (€ bn) | - | - | -4.0 | -1.7 | 1.0 | 0.3 |
| 2yr deviation (corrected for one-offs) (% GNI*) | - | - | -1.8 | -0.8 | 0.4 | 0.1 |
| **Limit for nominal net expenditure growth (€bn)** | **3.4** | **4.0** | **3.3** | **3.8** | **3.2** | **3.2** |
| Net expenditure increase (€bn) | 8.1 | 6.0 | 1.8 | 0.0 | 2.6 | 3.2 |
| Net expenditure increase (corrected for one-offs) (€bn) | -1.8 | 7.3 | 8.0 | 2.5 | 2.6 | 3.2 |
| **Current Macroeconomic Aggregates** | | | | | | |
| Real GDP growth (% y/y) | 3.4 | 4.5 | 5.0 | 3.5 | 3.2 | 3.1 |
| Potential GDP growth (% y/y) | 5.1 | 4.1 | 3.4 | 2.9 | 2.7 | 3.0 |
| GDP output gap | -2.4 | -2.1 | -0.6 | -0.1 | 0.4 | 0.5 |
| GDP deflator used (% y/y) | -0.5 | 0.4 | 1.8 | 1.5 | 1.6 | 1.6 |

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

Notes: [1] All figures are presented on a general government basis. Assessments examine the *SPU 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 Table S13.2 for these). Potential output and output gap estimates are taken from SPU 2021. For more information on the Council's principles-based approach see Table S13.3 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). The MTO is not currently set for 2023-2025, but is assumed constant at -0.5 per cent of GDP.

[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 2020–2021. 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.

### Table S13.2: One-offs

€ millions

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|---|---|
| Revenue | 0 | -650 | -250 | 0 | 0 | 0 | 0 |
| Expenditure | 0 | 9,916 | 8,660 | 2,500 | 0 | 0 | 0 |
| Net one-offs | 0 | 10,566 | 8,910 | 2,500 | 0 | 0 | 0 |

Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: The revenue one-off figure for 2021 differs to the Department's figures shown in Table 11 of SPU 2021. The Council do not consider the reduction in the rate of VAT for the hospitality sector a one-off, but instead treat it as a discretionary revenue raising measure.

For 2020, Ireland's deficit-to-GDP ratio was 5 per cent, above the 3 per cent reference value in the *Stability and Growth Pact*.[76] The medium-term budgetary objective (MTO) of a structural balance of no less than -0.5 per cent of GDP was not met. Ireland's structural balance was -0.7 per cent of GDP in 2020, which represents a deterioration by 1.2 percentage points since 2019. As a result, the Council assessed that the domestic budgetary rule was not complied with for 2020. However, the Council has assessed that the non-compliance with the budgetary rule was only due to exceptional circumstances caused by the Covid-19 pandemic. The Council assesses that the failure to comply with the budgetary rule in 2020, does not endanger medium-term fiscal sustainability.

In 2020, the debt-to-GDP ratio was 59.5 per cent, an increase of 2.2 percentage points since 2019. However, this is still below the 60 per cent of GDP reference value in the SGP.

For 2021, it is expected that the budgetary rule will not be complied with. However, this is as a result of the Covid-19 pandemic and as such, the Council assesses that this non-compliance is due to exceptional circumstances. The deficit-to-GDP ratio is forecast to be 4.7 per cent of GDP in 2021, above the 3 per cent reference value in the SGP. Were one-offs excluded, Ireland's deficit-to-GDP ratio would be 2.4 per cent. The structural balance is forecast to be 1.1 per cent of GDP in 2021, a deterioration of 0.4 percentage points.

Net expenditure (corrected for one-offs) is forecast to grow by 9.1 per cent in 2021, above the Expenditure Benchmark limit of 4.9 per cent. This

[76] As the deficit-to-GDP ratio was forecast to exceed the 3 per cent reference value in the SGP, last may the European Commission prepared an Article 126(3) report. The report found Ireland to be non-compliant with the deficit criterion of the SGP. This would typically result in an *Excessive Deficit procedure (EDP)* being opened for Ireland. However, as yet the European Commission have not opened an EDP. 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.

represents a significant deviation from what is allowed under the Expenditure Benchmark, with net expenditure growing by €3.3 billion more than the limit.

In 2021, the debt-to-GDP ratio is forecast to breach the 60 per cent reference value in the SGP. The debt ratio is forecast to be 62.2 per cent of GDP.

In 2022, net expenditure (corrected for one-offs) is forecast to grow by 8.8 per cent, above the Expenditure Benchmark limit of 3.8 per cent. This is some €4.6 billion above the limit. As a result, the structural deficit is set to deteriorate by 0.7 percentage points, to 1.9 per cent of GDP. This is above the Medium-term Budgetary Objective (MTO) of a structural deficit of no greater than 0.5 per cent of GDP.

The structural deficit is forecast to improve in 2023, reaching to 1.2 per cent of GDP. This improvement of 0.7 percentage points would be a larger improvement than would be required under the rules (an improvement of 0.5 percentage points). Net expenditure is forecast to grow by 2.5 per cent in 2023, below the Expenditure Benchmark limit of 4.0 per cent. In 2023, the debt-ratio is forecast to be 59 per cent of GDP, below the 60 per cent reference value in the SGP.

In 2024, the structural deficit is forecast to improve by 0.2 percentage points, below what would be required under the rules (0.5 percentage points). However, the structural deficit is forecast to be 0.4 per cent of GDP in 2025, above the (current) MTO.[77] Net expenditure is forecast to grow by 2.7 per cent in 2024, below the Expenditure Benchmark limit. In 2025, net expenditure is forecast to grow by 3.2 per cent, at the Expenditure Benchmark limit.

[77] The MTO has not yet been set for 2023-2025. As a result, it is assumed constant at a structural deficit of no greater than 0.5 per cent of GDP.

## Table S13.3: 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).<br>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 |

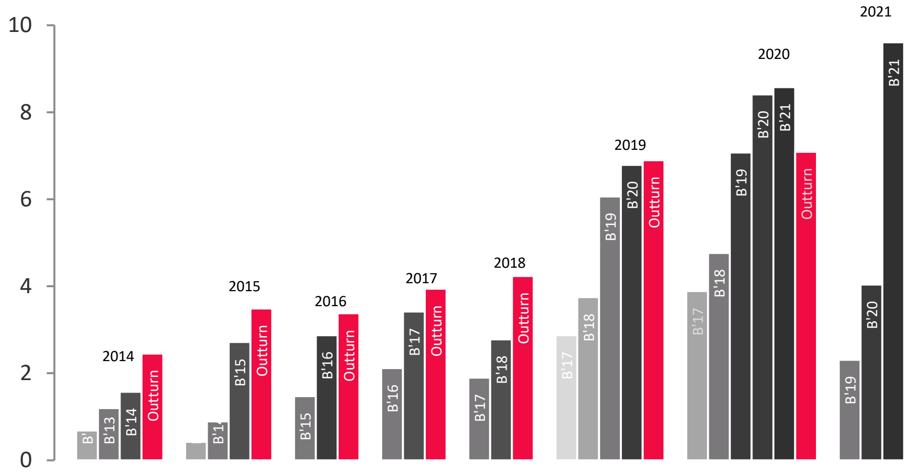
Note: For a full explanation of the Council’s Principles-based Approach (PBA) to the Domestic Budgetary Rule see Box A of Ex-post assessment of compliance with the Domestic Budgetary Rule 2018 (Fiscal Council, 2019a) and Box M of the November 2019 Fiscal Assessment Report (Fiscal Council, 2019e).

# S14. Medium-term spending ceilings

This section analyses the governments medium-term expenditure ceilings. Every year, the Government is required by law to set expenditure ceilings for the following three financial years for overall expenditure and for each Department.[78] These ceilings are set in order to provide a better mechanism for controlling spending over the medium-term and to ensure the Expenditure Benchmark is complied with.

Figure S14.1 shows the change in total gross voted expenditure ceiling relative to the initial ceiling. Prior to the pandemic, there had been a period of procyclical increases in the ceilings, with the outturn in 2019 €6.9 billion higher than originally planned.

**Figure S14.1: Change in gross expenditure ceiling relative to initial ceiling**
€ billion




Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Bars show the change in forecasts from various budgets followed by outturns, versus the earliest budget forecast for that year (e.g., B'15 = expenditure forecasts in Budget 2015 minus the earliest forecast for the specified year). Red bars relate to the change in outturn expenditure versus the earliest forecast for expenditure for the year specified above. Note figures for Budget 2021, and the outturn for 2020 are Covid-19 adjusted.

The Council has asked the Department, on three sperate occasions, for the three-year current expenditure ceilings for each government department that were set in 2020. At the time of writing, these were still not provided to the Council.

[78] These Expenditure ceilings are set under the Medium-term Expenditure Framework (MTEF), which was introduced in the Ministers and Secretaries (Amendment) Act 2013.

# S15. Policy costings (based on official sources)

This section gives an illustration of the expected impacts that typical tax and spending adjustments are estimated to have on the public finances.

### Examples of tax & spending changes

€ million, estimated full year impact

| | |
|---|---|
| Income tax | |
| Yield from 1 percentage point (pp) rise in 20% income tax rate | 664 |
| Yield from 1 pp rise in 40% income tax rate | 319 |
| PRSI | |
| Increase in 4% employee PRSI rate to 4.5% | 377 |
| Increase in 10.05% employer PRSI rate to 10.55% | 374 |
| VAT | |
| One pp change on 9% rate | 10 |
| One pp change on 13.5% rate | 243 |
| One pp change on 23% rate | 442 |
| Carbon tax | |
| Increase by €15 a tonne | 316 |
| Local property tax | |
| Additional charge of €100 on every property | 183 |
| Capital acquisitions tax | |
| Increase from 33% to 43% | 132 |
| Capital gains tax | |
| Increase in 33% rate by 1pp | 33 |
| Social insurance spending | |
| €1 increase in jobseekers allowance (for max rate) | 14 |
| €1 increase in jobseekers allowance (for ages 18-24) | 1 |
| €1 increase in jobseekers benefit | 3 |
| €1 increase in carer's allowance (under 66) | 3 |
| €1 increase in carer's allowance (66+) | 0.5 |
| €1 increase in disability allowance | 8 |
| €1 increase in maternity and adoptive benefit | 1 |
| €1 increase in state pension (contributory) | 24 |
| €1 increase in state pension (non-contributory) | 5 |
| €1 increase in illness benefit | 3 |
| Public investment spending | |
| Keeping at 2020 levels in € (avg annual savings over 2022-25) | 3,915 |
| Indexing the tax system | |
| A 1% wage increase is assumed to raise €161 million from not indexing income tax | 160 |
| A 1% wage increase is assumed to raise €21 million from not indexing USC | 21 |

Sources: Most estimates are from Revenue's "Post-Budget 2021 Revenue Ready Reckoner, Nov 2020". PRSI rate changes are from the Tax Strategy Group report in July 2019. Social insurance increases are from the PBO's Pre-Budget 2021 Ready Reckoner.
Note: Estimates seldom include behavioural impacts.

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