Irish Fiscal Advisory Council

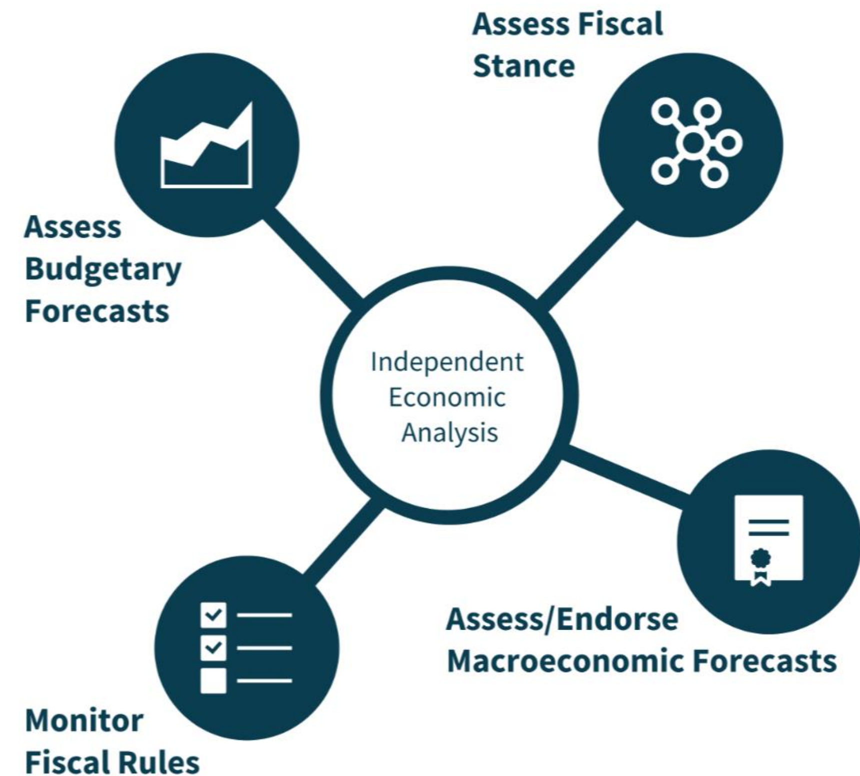
Pre-Budget 2022 Statement

September 2021

Irish Fiscal Advisory Council

Background

- The Fiscal Council is an official independent body with a mandate to assess the public finances
- The September 2022 *Pre-Budget Statement* provides an assessment of the July *Summer Economic Statement* as an input to Budget 2022 in October.



Key messages

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The economy is recovering swiftly

- A “recovery scenario” suggests that growth will be strong in the short run
- Domestic activity could recover to just 1.5 per cent below its pre-pandemic trend by 2025
- The Budget deficit for 2021 is likely to be lower than the Official forecast of 9% of GNI*

The *Summer Economic Statement* sets out a medium-term budgetary plan to 2025

- The Council welcomes the more realistic medium-term budgetary projections based on the “Existing Level of Service”
- However, the macroeconomic projections in the SES were not fully updated or consistent with the fiscal forecasts

The *SES* sets out a new medium-term fiscal framework

- A spending rule sets spending to grow at potential, assumed to be 5%
- The debt target aims to “to stabilise, and reduce slightly, the debt-income ratio in the coming years”
- While the approach is welcome, the rules as set out have a number of problems
- The SES plans do not appear to be consistent with the EU and domestic fiscal rules

This is a major shift in policy: the deficit would be around 1.5% of GNI* in 2025 under the recovery scenario rather than budget balance as in the Programme for Government

- The Government’s own *SES* projections suggest that the deficit would be around 3% of GNI* and that the debt ratio would remain above 105% of GNI* in 2025

Key messages

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Higher investment should help to address climate and housing challenges

- At close to 6% of GNI*, public investment will reach a high level by historical and international comparison
- Capacity constraints and weaknesses in planning could compromise value-for-money
- More detail is needed from the new National Development Plan, Housing for All and the Climate Action Plan

Running significant budget deficits during a period of strong growth and with high public debt carries risks

- The debt ratio will remain high, amplifying risks of higher interest rates or from lower growth
- It is unusual to run such large deficits during a period of strong growth, risking inflation and eventually overheating

For the Budget, existing plans for 2022 are at the limits of what is prudent

- Some temporary and targeted income and job supports may need to continue
- Permanent spending is planned to rise by €4.2 billion (+5.5 %)

For the medium term, a more prudent approach would prioritise between current spending, the increase in investment and adjusting taxes

- The Government plans to increase current spending, ramp up investment spending and introduce tax cuts
- This avoids hard choices between different priorities
- There are significant pressures from ageing, climate change, implementation of Sláintecare and the need to reduce reliance on corporation tax

Economic and budgetary outlook

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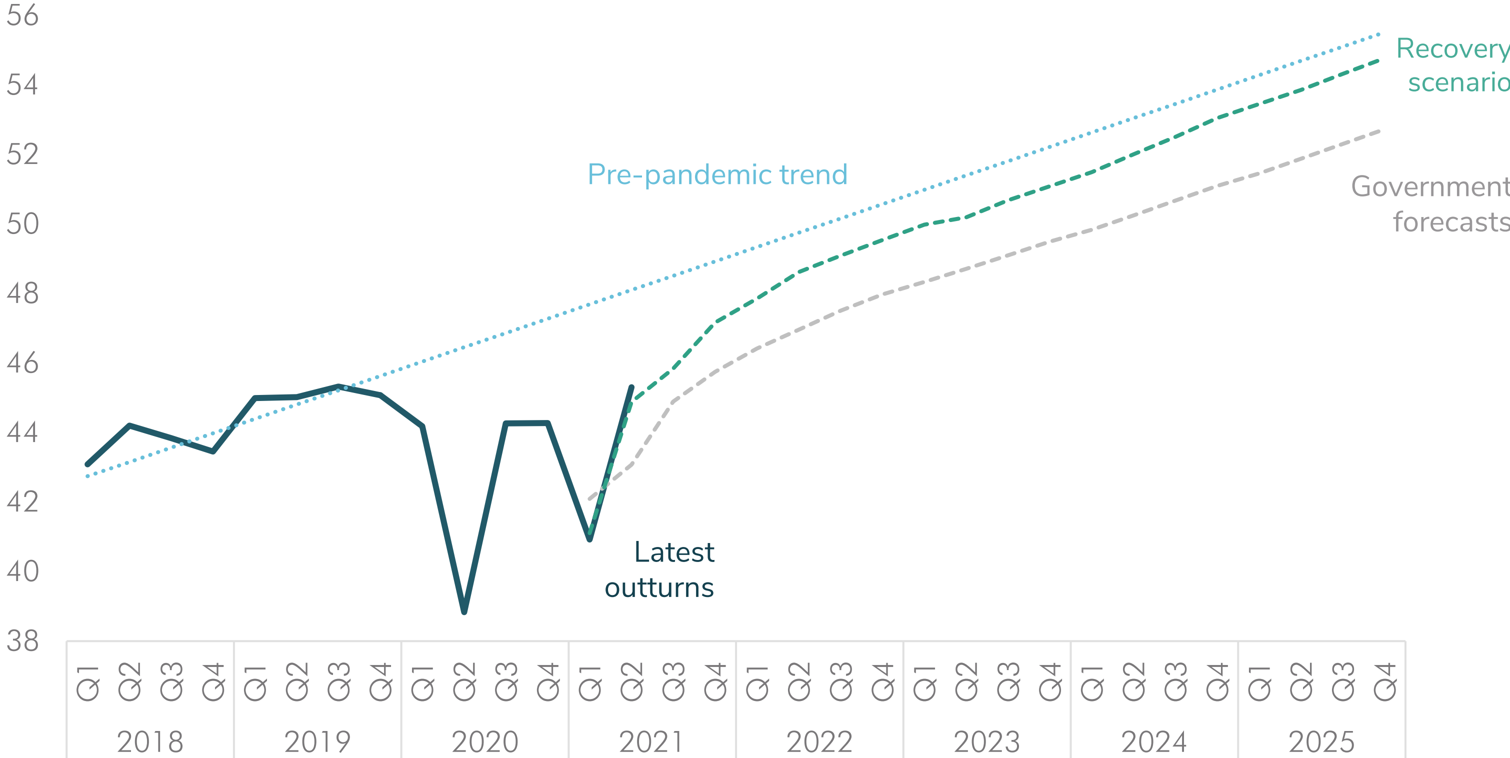
The economy looks set to rebound swiftly



Sources: Central Statistics Office, Department of Finance, and Fiscal Council workings.
Notes: Government forecasts are based on the *SPU 2021* quarterly profiles for personal consumption, government consumption, and modified investment (which excludes aircraft for leasing and R&D intellectual property intangibles). The modified investment profile is used as a basis for an underlying investment projection (i.e., investment excluding all aircraft and all intangibles). The series above reflect downward revisions to historical data in *National Income and Expenditure 2020*. The pre-pandemic trend is based on a quarterly seasonally adjusted data for a sample period of 2014–2019. The Council's latest nowcast for Q3 2021 reflects data available up to 6th September; see Casey (2018) for methodological details.

The Budget deficit for 2021 is likely to be lower than the Official forecast of 9.4% of GNI*

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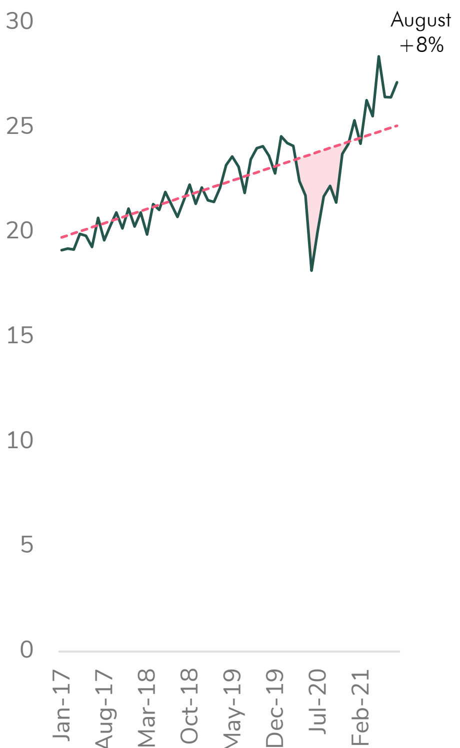
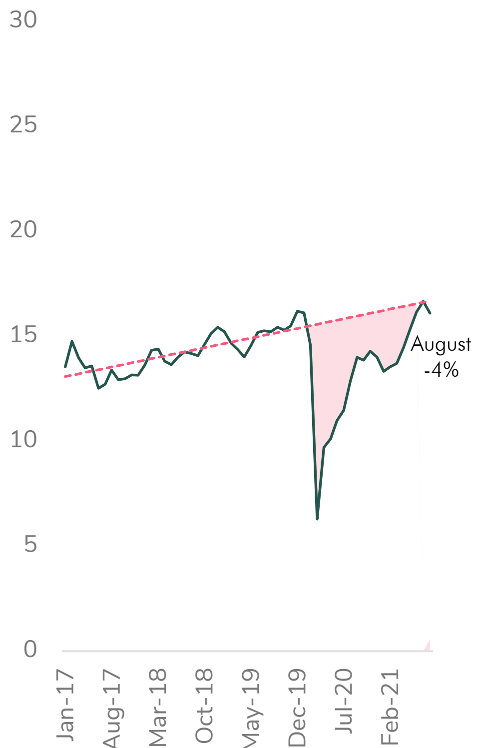
Income tax

Annualised seasonally adjusted € billion

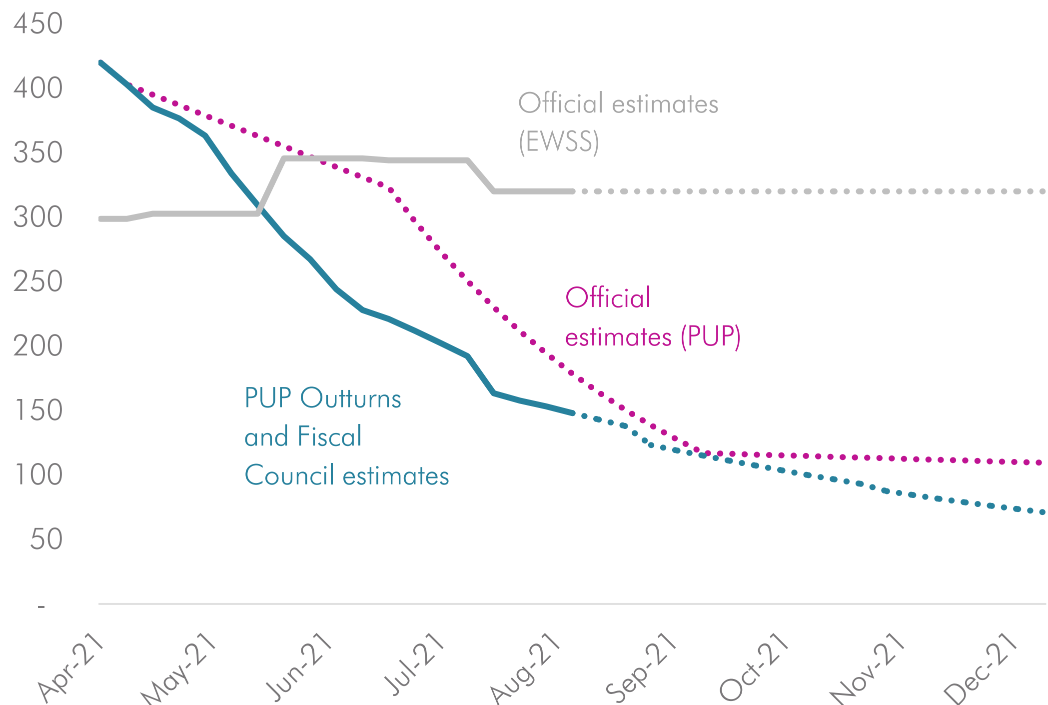


VAT



Fall in PUP claimants is faster than assumed while EWSS claimants forecast to remain elevated

Claimants, thousands



Medium–term budgetary plans to 2025

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The Summer Economic Statement set out a medium-term budgetary plan to 2025

- The Council welcomes the more realistic medium-term budgetary projections based on the "Existing Level of Service"
- However, the macroeconomic projections in the SES were not fully updated or consistent with the fiscal forecasts

The *SES* sets out a new medium fiscal framework

- The spending rule sets permanent voted spending to grow at potential, assumed to be 5%
- The debt targets aims to "to stabilise, and reduce slightly, the debt-income ratio in the coming years"
- The Government also said it would not borrow to fund current expenditure in the medium term
- This compares to the Programme for Government commitment to "return to a broadly balanced budget", which would have led to faster fall in the debt ratio

This is a major shift in policy

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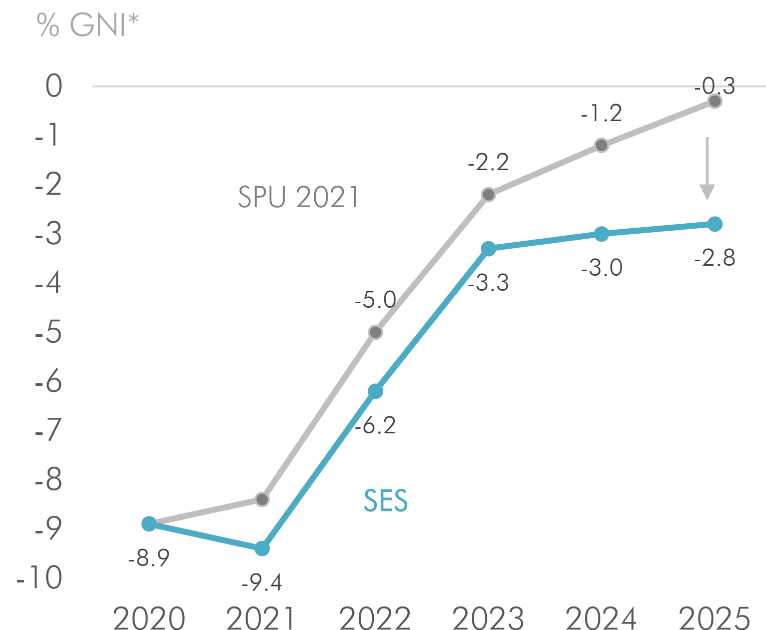
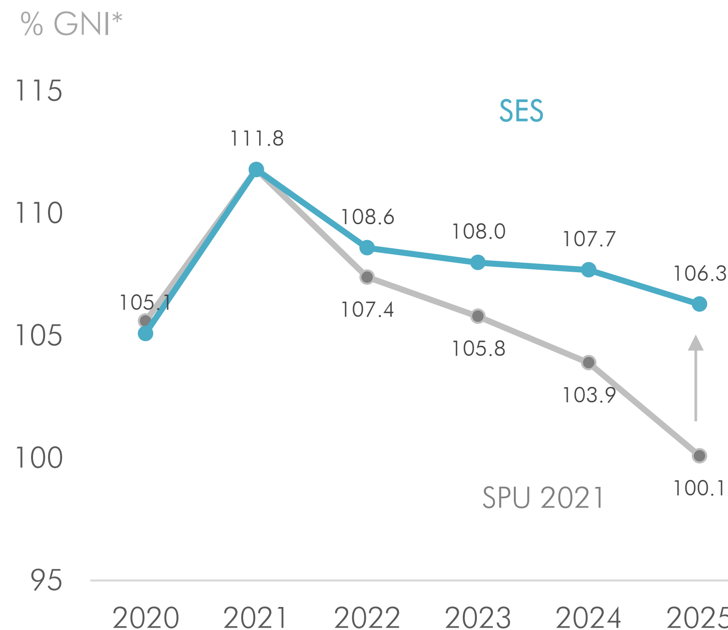
Budget balance



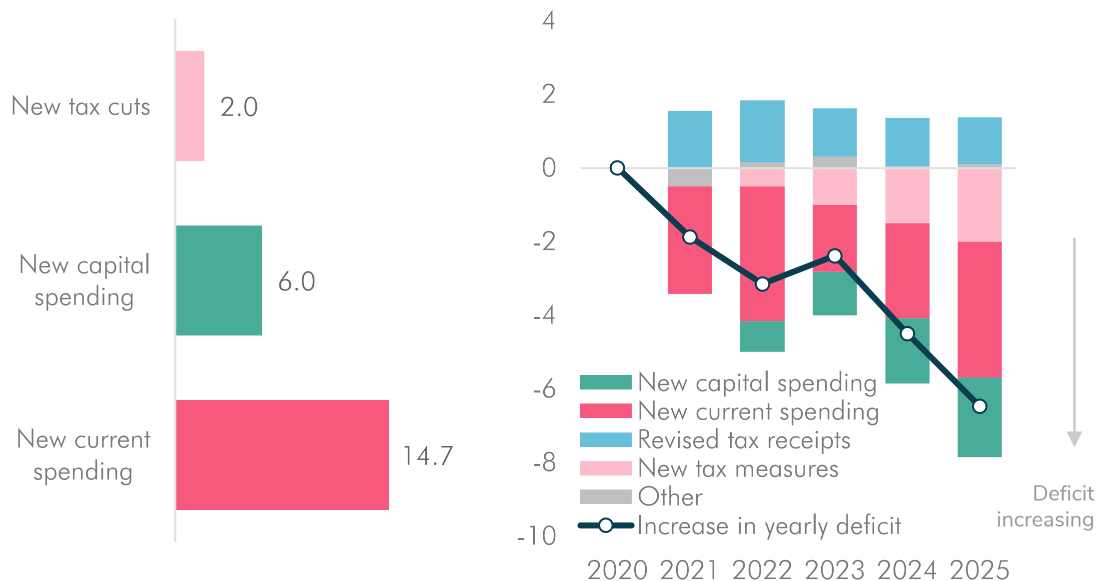
Gross debt ratio

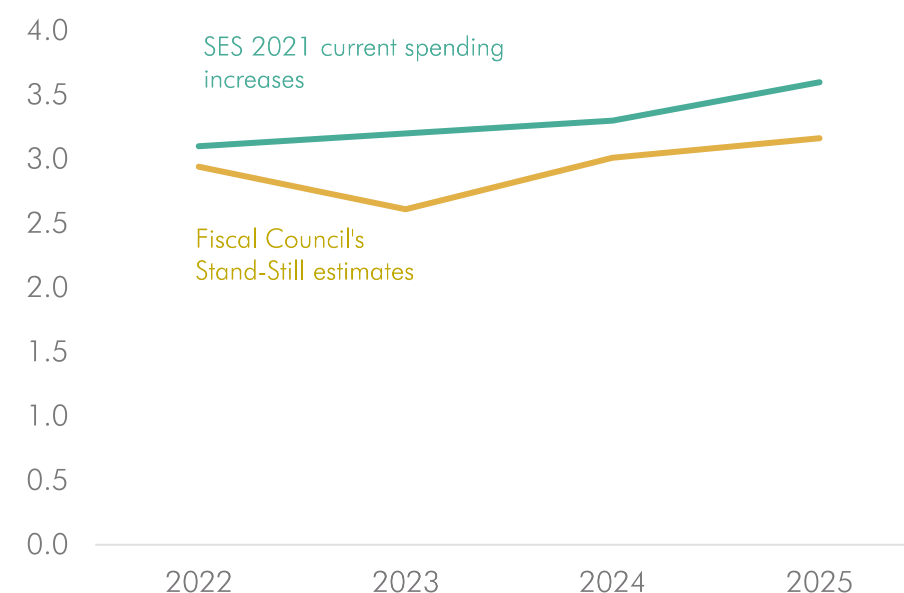


Source: Department of Finance projections (*SPU 2021* and *SES 2021*).

- The Government's SES projections suggest that the deficit would be around 3% of GNI*
- The deficit would be around 1.5% of GNI* in 2025 under the recovery scenario
- The debt ratio would fall slower and remain higher

The larger deficit is due both to higher current and capital spending

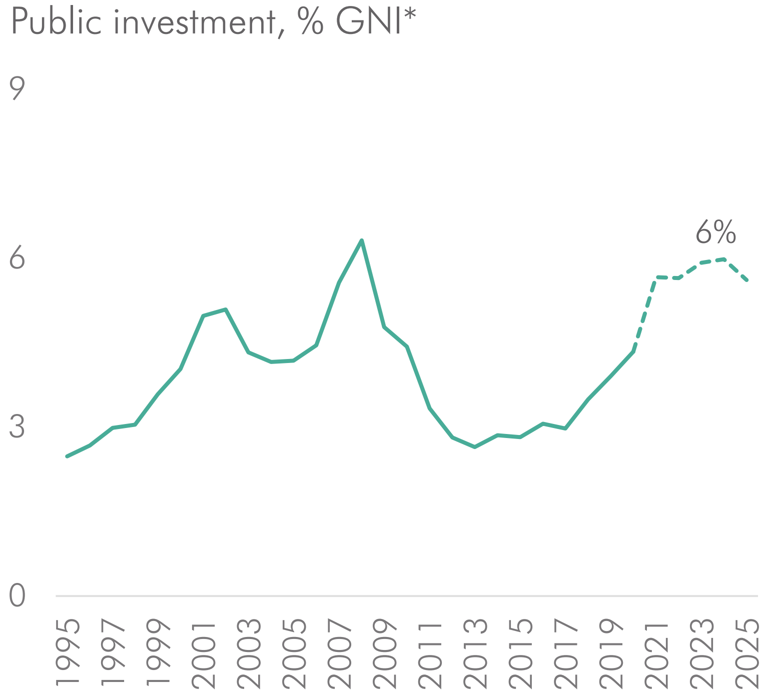


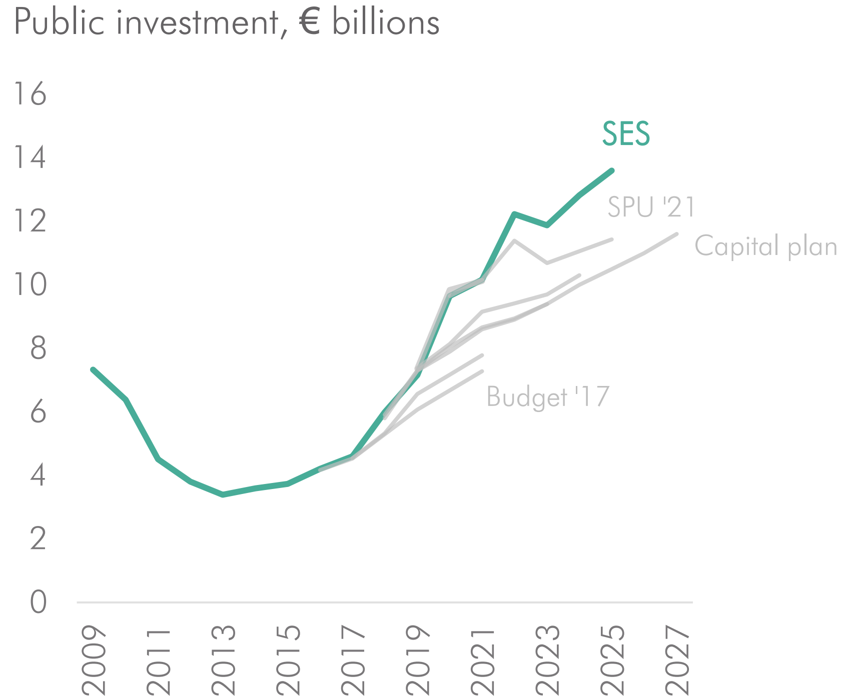


Sources: Department of Finance and Fiscal Council workings.

- The move to projecting current spending taking into account the “Existing Level of Service” has led to higher current spending
- But, the government is also planning to increase current spending in volume terms

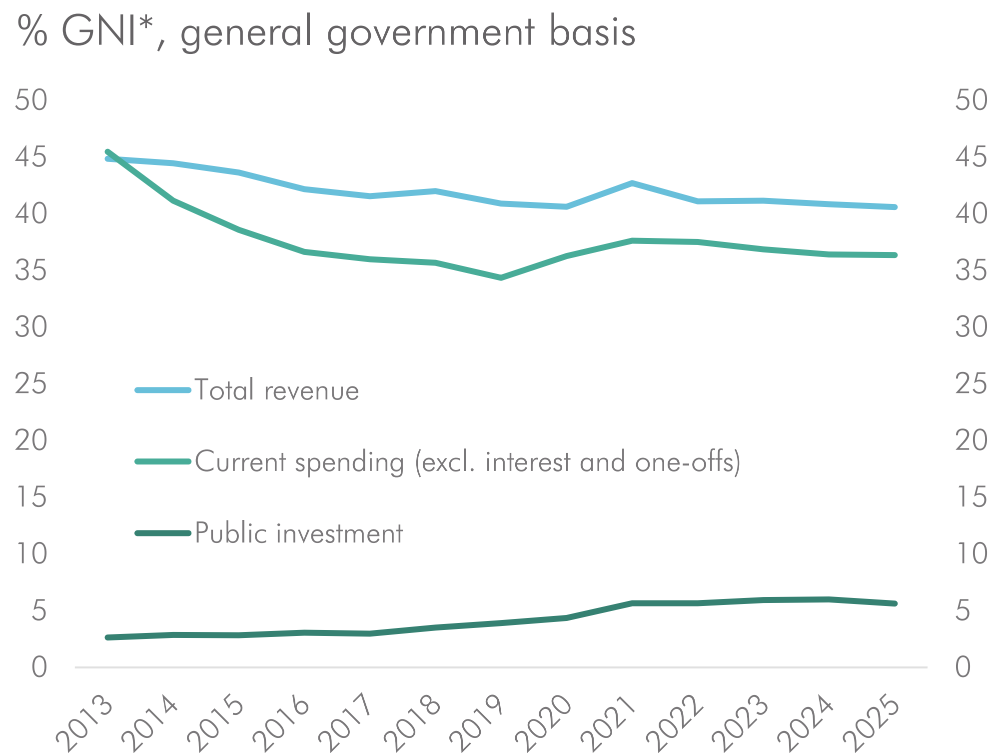
Higher investment should help to address climate and housing challenges



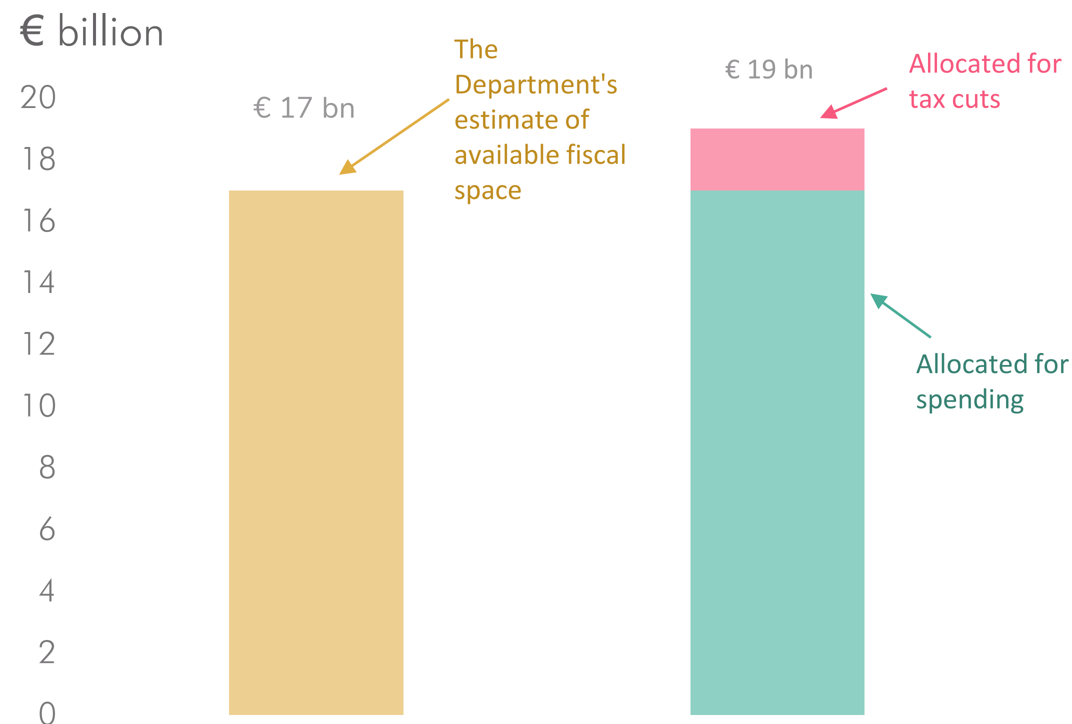


- Investment will be high by historical and international standards

The SES plans to simultaneously increase current spending, raise investment and cut taxes



Source: Department of Finance projections (SES 2021); CSO; and Fiscal Council workings.



Sources: Department of Finance; and Fiscal Council workings.
Note: Available fiscal space is based on the Department's own assumption of a trend growth rate of the economy of 5 per cent, as outlined in the SES.

- The Government has allocated more than its own estimate of fiscal space to 2025

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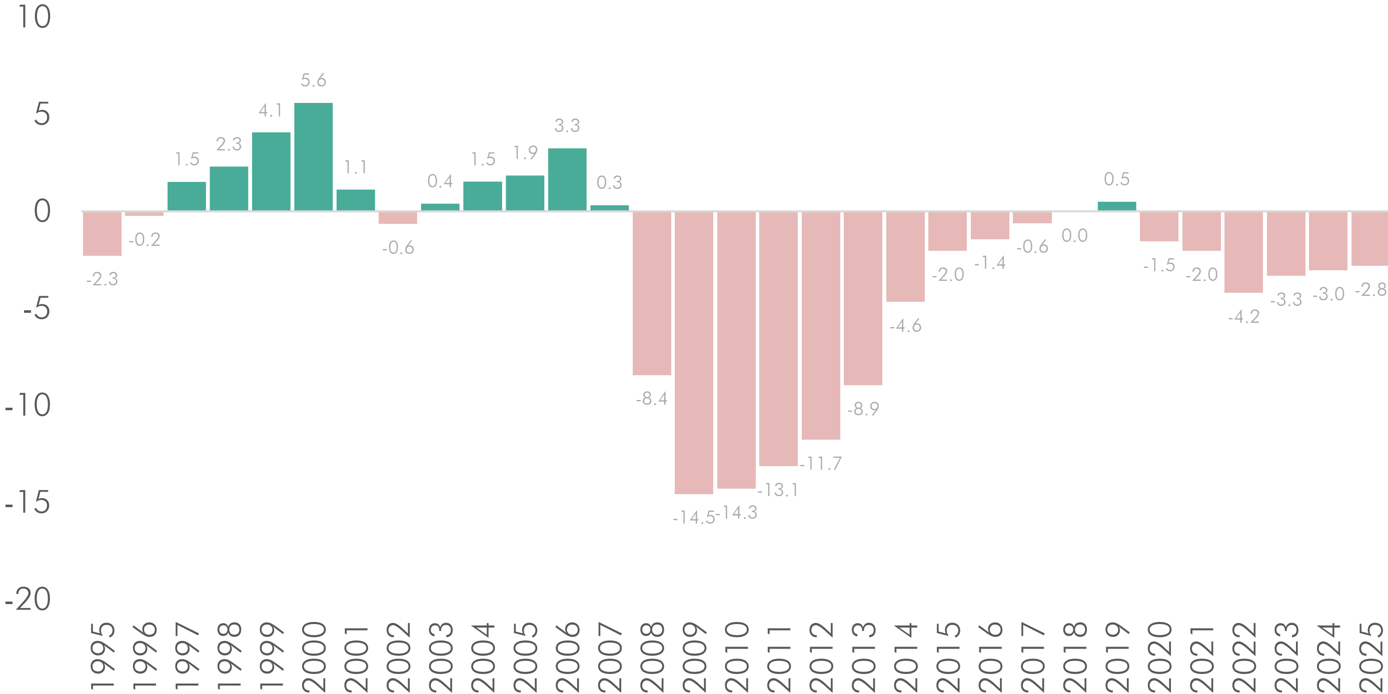
Running significant budget deficits for several years carries risks



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

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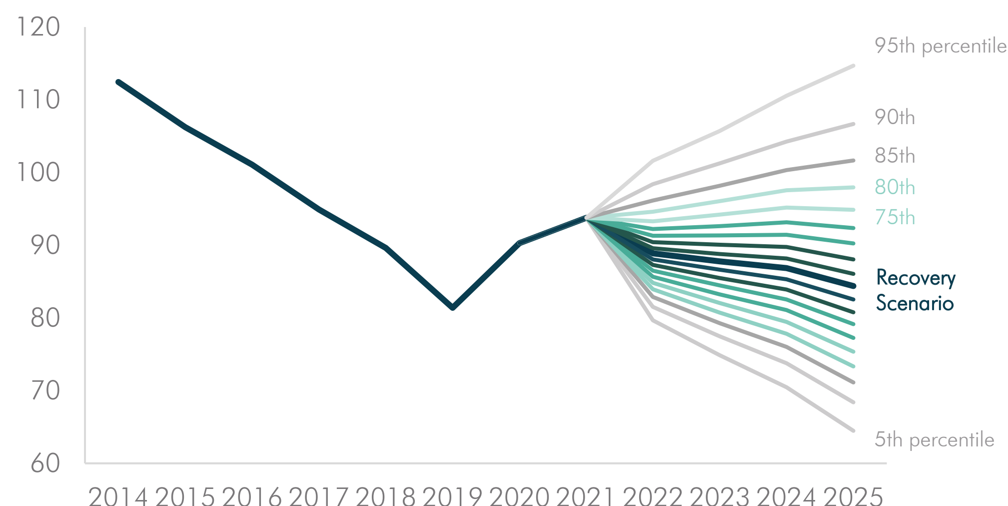
The government debt ratio is high and set to fall only slowly

One-in-four risk of unsustainable debt path

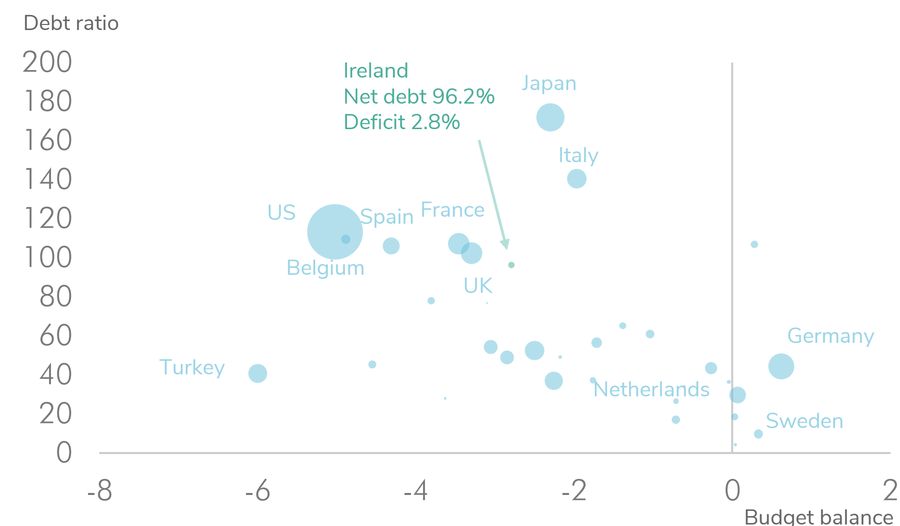
Gross debt ratio, % GNI*



Sources: Fiscal Council workings.
Notes: Each line shows a path for debt dynamics at various percentiles. The "Central" line represents the official *SES 2021* forecasts. The estimates are based on the Council's Maq model (Casey, 2021).

Ireland among high deficit, high debt pack by 2025

% GDP (% GNI* for Ireland)



Sources: Department of Finance (SES) projections for Ireland; IMF April WEO forecasts for other OECD countries; and Fiscal Council workings.
Notes: The size of the bubbles represents the level of nominal GDP in purchasing power parity terms, international dollars, with Ireland shown in terms of nominal GNI*.

- High debt increases the vulnerability to interest rate increases or growth shortfalls
- Ireland's relatively high deficit and debt increases risks of negative market reactions

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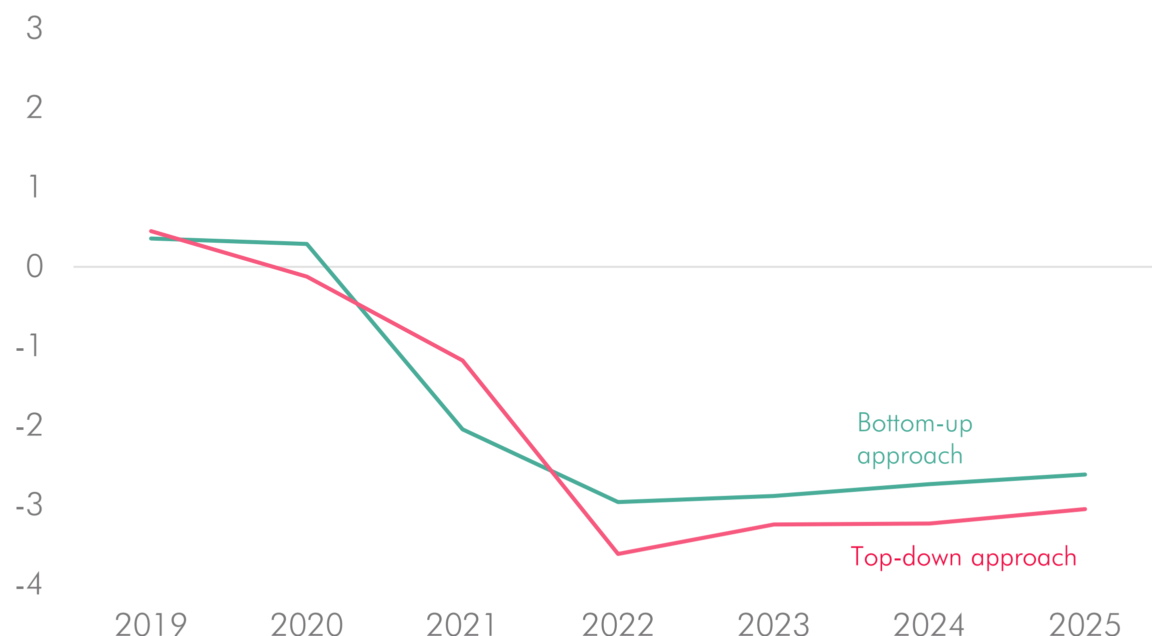
The budget deficit will remain large, including in structural terms



The *SES* fails to explain how these plans are consistent with the EU and domestic fiscal rules, notably the medium-term objective

Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: The "Bottom-up approach" refers to the Council's bottom-up approach to estimating the structural balance (see Box I of the May 2021 FAR). The "top-down approach" is based on the Council's principles based approach (see Box A of the Assessment of Compliance with the budgetary rule 2018). The output gap used is from the Department of Finance's *SPU 2021* forecasts. The general government balance forecasts are taken from the SES. The budgetary semi-elasticity used is 0.588.

There is a case for borrowing to fund public investment projects

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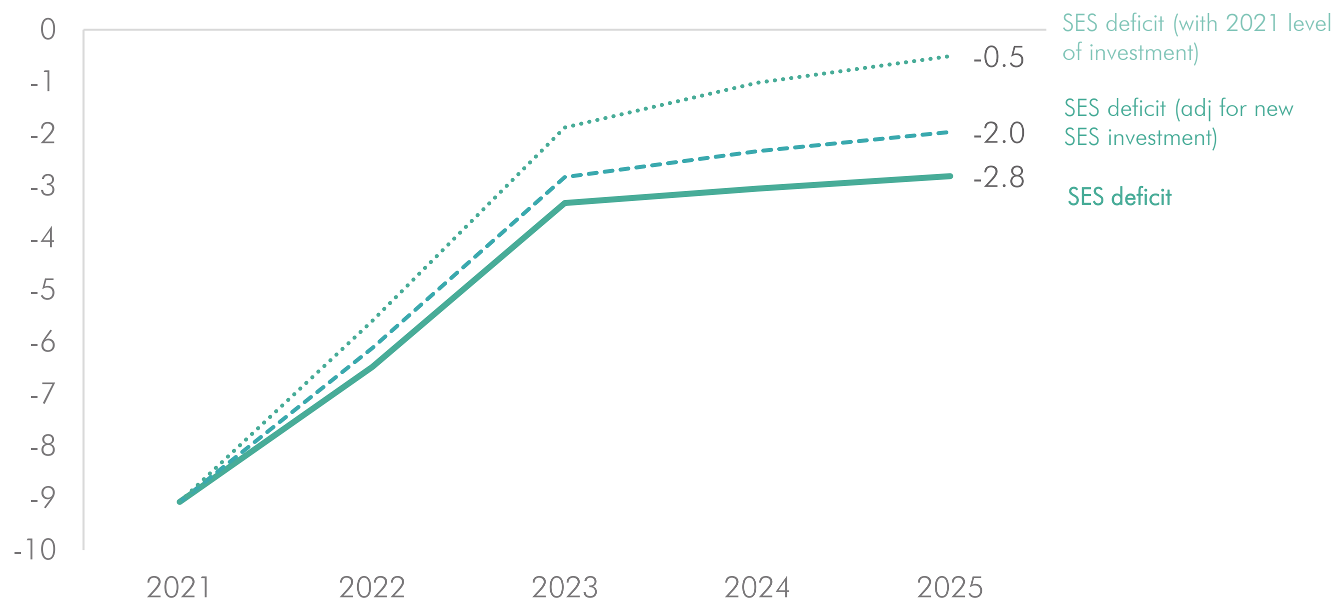

- Better governance around public investment could help improve returns
- The Government needs to make the economic case for investment in the *Housing for All* plan, the new *National Development Plan* and the Climate Action Plan

Borrowing to ramp up investment could put pressure on supply-constraints

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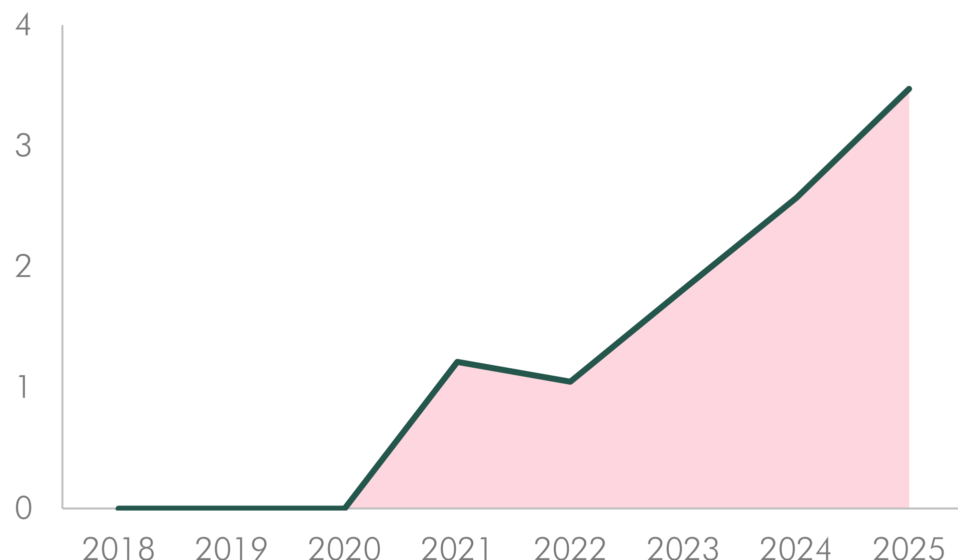

By 2025, it is estimated that about 90% of the impact would be on nominal output would be reflected in terms of ***higher prices*** rather than real activity

Sources: Fiscal Council workings based on *SES 2021* and *SPU 2021* forecasts.
Notes: The figure shows the difference in the level of nominal GNI* between a scenario that includes the higher levels of spending set out in the Summer Economic Statement and one that does not. The estimates are produced using the Council's Maq model by adjusting SPU forecasts for the higher tax cuts, current and capital spending set out in the SES, recognising the different fiscal multipliers associated with each category.

- Supply-constraints in construction may lead to rising prices
- Borrowing to finance investment after the recovery could lead to inflation and, eventually, overheating

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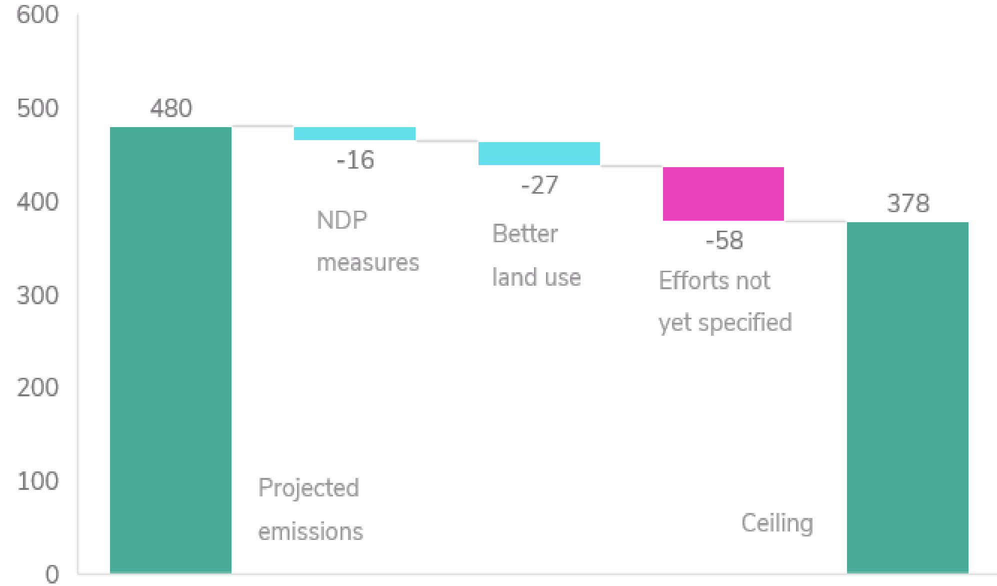
The Government needs to spell out how priorities and challenges will be met

- Overreliance on corporation tax
- Population ageing
- Climate change
- Sláintecare

The Government needs to set out how its climate objectives will be reached

Levels of greenhouse gas emissions

$MtCO_2eq$



The new Climate Action Plan should spell out how the emissions reductions targets will be met

Source: Climate Action Plan (2019).

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The proposed spending rule and the debt rule should be strengthened

Design of spending rule

Too narrow	Calibration may not be appropriate	Institutional underpinning
• Only covers voted spending • Tax changes not covered	• Designed to maintain the budget balance, not improve it • Locks in high 5% growth rate	• No statutory footing • Relationship to debt rule unclear

- The approach of having a spending rule and a target are welcome
- But, the design of both could be improved to make them more credible and effective
- Key features should be clarified

Budget 2022

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For the Budget, existing plans for 2022 are at the limits of what is prudent

- Temporary Covid-19 measures may still be needed
- Plan would raise permanent spending by €4.2 billion in 2022 (+5.5 %), while cutting taxes by €0.5 billion

The approach to the medium term is risky

A more prudent approach would prioritise between current spending, investment and taxation

- The Government could moderate the planned increases in current spending, the rise in investment or raise taxes to fund these measures

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Key messages

- The economy is recovering swiftly
- The Summer Economic Statement sets out a medium-term budgetary plan to 2025 and a new medium fiscal framework
- Major shift in policy: deficit around 1.5% of GNI* in 2025 in the recovery scenario rather than budget balance in the Programme for Government
- Higher investment should help to address climate and housing challenges
- Running significant budget deficits for several years during a period of strong growth and with high public debt carries risks
- For the Budget, existing plans for 2022 are at the limits of what is prudent
- For the medium term, a more prudent approach would prioritise between current spending, the increase in investment and adjusting taxes