Irish Fiscal Advisory Council

Pre-Budget 2022 Statement

September 2021

This report can be downloaded at **www.FiscalCouncil.ie**

Key messages

The economy is recovering swiftly as vaccinations progress and as individuals adapt to new circumstances. The likely unwinding of the huge savings accumulated by Irish households during the pandemic—a quarter of their disposable income in 2020—would represent a significant boost to economic activity in the coming months. Combined with a larger budgetary expansion now planned, this should mean a faster bounce back that could help to limit the long-term loss of output that will follow the pandemic. However, jobs are likely to recover more slowly than spending in the economy and the ultimate impacts of the pandemic are uncertain. While there are upside risks in the short to medium term, over the longer term it is likely, as was the case prior to the pandemic, that the ageing of the workforce and the convergence of Irish productivity to advanced economy norms would tend to slow growth.

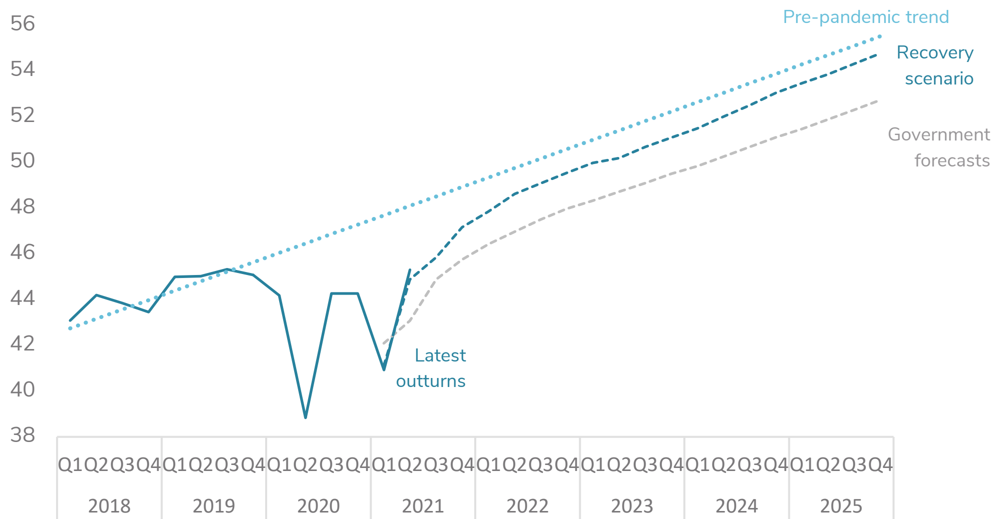
The Government's *Summer Economic Statement* (*SES*) published in July sets out a medium-term budgetary plan to 2025 as promised in the Programme for Government. The plan marks an important shift towards an expansionary fiscal policy. The *SES* includes a more realistic path for spending, but it also foresees higher capital investment and some tax cuts. The Council welcomes the move to more realistic forecasts, though key details of the fiscal plan are still lacking.

However, the *SES*' macroeconomic projections for the Irish economy are not fully updated and are not consistent with the Government's fiscal plans. The Government revised up its projections for GDP but left domestic economic activity unchanged. This partial update did not fully reflect the faster-than-expected recovery in recent months, nor the much larger budgetary expansion now planned for over the coming years. These factors reduce the risk of a more protracted recovery, yet the official projections still assume a high degree of "scarring" (permanent loss of output) compared to international forecasts for other countries. This raises significant issues about the consistency between the macro projections and fiscal plans. All government fiscal plans should be based on coherent projections for both the economy and public finances.

This report develops a "Recovery Scenario" for the economy so that an assessment can be made of the fiscal stance over the medium term. The Recovery Scenario takes on board the better starting point and also reflects a less pessimistic view of longer-term scarring. Overall, the scenario presents a more positive view of the most likely path for the economy in the coming years. The scenario shows domestic activity expected to recover to just 1.5 per cent below its pre-pandemic trend by 2025. By contrast, the latest official Government projections are consistent with scarring of about 5 per cent in 2025. Growth over the medium term in the Recovery Scenario is projected to be around 3½ per cent per annum on average, supported by the fiscal stimulus, but there is a wide range of uncertainty.

The domestic economy could continue to rebound rapidly

€ billions, underlying domestic demand (seasonally adjusted, 2019 prices)



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

Ireland entered the Covid crisis with a government debt ratio that was already high, and the costs of responding to the pandemic have been large. Before the Covid-19 pandemic, Ireland's budget deficit had narrowed over many years, finally reaching a small surplus in 2018 and 2019. This was helped by surges in corporation tax receipts, with overall receipts having risen to 21 per cent of Exchequer taxes in 2020 compared to a long-run average of about 13.5 per cent (1998–2015). In addition, interest costs have been repeatedly revised down as interest rates have fallen. This helped the public finances absorb the impact of the pandemic. However, at the end of 2020, the Government's net debt ratio stood at 90 per cent of GNI*.

This year, the Government expects to run a large deficit again, amounting to about €20.3 billion (9.4 per cent of GNI*). This follows a deficit of €18.8 billion (9 per cent of GNI*) in 2020 — a marked deterioration in the fiscal balance compared to 2019 largely driven by €14 billion of policy measures and mainly for income and health supports. The pandemic's prolonged impacts and the extension of supports introduced to cushion its effects will lead to a second year of an exceptionally large deficit.

With taxes outperforming expectations this year and the recovery gaining momentum, the deficit for 2021 is likely to be smaller than projected by the Government. Income taxes have recovered to above their pre-crisis trend levels, while VAT and corporation tax have also performed well thus far in 2021. The number of claimants of Pandemic Unemployment Payments also appears to be coming in lower than had been assumed. The Recovery Scenario would suggest that a deficit of closer to 7 per cent of GNI* might be possible this year (compared to 9.4 per cent of GNI* in SES).

The Government's response to the crisis, in terms of providing sizeable temporary supports funded by large deficits and substantial increases in government debt, has been appropriate. Indeed, previous analysis by the Council suggests the supports may have halved the contraction in real GNI* in 2020. They also reflect an appropriate decision to support the economy through a downturn — a rare and welcome example of countercyclical fiscal policy that the State has been largely unable to follow in the past. The fiscal costs associated with Covid-19 could remain significant in the months ahead, but they are prudent and necessary to avoid lengthening and deepening the economic crisis.

However, the Government also introduced large unfunded permanent increases in spending in *Budget 2021*—outside of costs associated with the pandemic—that were not prudent. These increases amounted to at least €5.4 billion were reflected in large increases in public sector staff numbers and they were set out without long-term funding to offset them. The increases could be as high as €8 billion once non-Exchequer spending is considered. There continues to be little transparency around non-Exchequer areas of spending, which the SPU and the SES have not addressed. The Government should shift from its traditional focus on Exchequer data to a more harmonised general government presentation in line with Eurostat standards.

For 2022, the Council assesses that some of the temporary and targeted income and job supports may need to continue. These ongoing supports may be necessary for certain sectors to alleviate the impacts of the pandemic. If the economy continues to recover strongly, as the Council anticipates, a large-scale, untargeted stimulus would not be needed and support measures can gradually be withdrawn and made more targeted as conditions allow.

In terms of permanent measures, *Budget 2022* plans look to be at the limit of what is prudent. The Government could better prioritise between all of the expansionary measures planned. In terms of "core" or permanent measures, the Government plans to increase the level of voted permanent spending by €4.2 billion in 2022 (+5.5 per cent), while cutting taxes by €0.5 billion. This is modestly above estimates of the underlying potential growth rate of the economy but would help to support the recovery. The spending increases reflect a €3.1 billion increase in current spending and a relatively-fast €1.1 billion increase in capital spending.

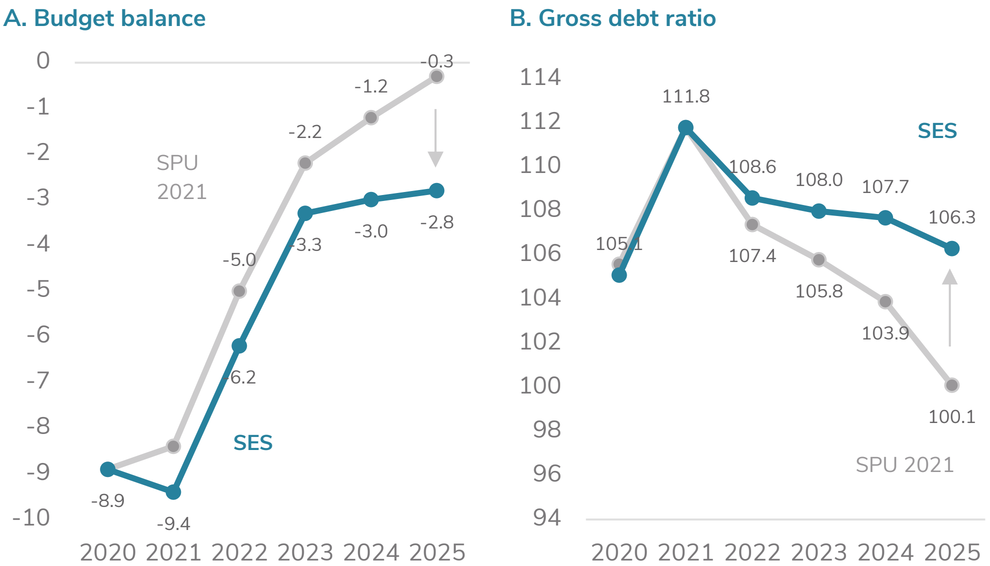
The Council welcomes the more realistic approach to medium-term budgetary projections in the SES. The forecasts allow for the costs of the "Existing Level of Services" — that is, the costs of maintaining existing public services and supports in real terms. While more details on the methodology should be provided, this addresses a long-standing weakness in budgetary forecasts. It provides a more realistic picture of the public finances and should avoid the need for expenditure ceilings to be revised every year. However, the more realistic forecasts crucially highlight how most of the space that a growing economy would sustainably generate is likely to be used up by the cost of standing still.

The SES plans for the medium-term set out a major shift in policy: the new spending rule and the objective to broadly stabilise the debt ratio in the medium-term imply a deficit by 2025 of close to 1½ per cent under the recovery scenario rather than a balanced budget. This would lead to a slower reduction in the debt ratio. The Government's own projections in the SES suggest that the deficit would be around 3 per cent of GNI* and that the debt ratio would barely fall after 2022.

Running significant budget deficits for several years during a period of strong growth and with high public debt carries risks. Many factors would argue for a more cautious approach to budgetary measures in the coming years: the rapid budgetary expansions pursued in recent years; the likelihood of a strong recovery and risks of inflation and eventually overheating from persistent government borrowing; and the need to set high debt ratios on a steady downward path. Given these risks, the Government will need to stick to these plans at a minimum with any additional spending beyond the SES plans met through higher taxation.

The Government now plans for larger deficits and debt ratios

% GNI*, general government basis



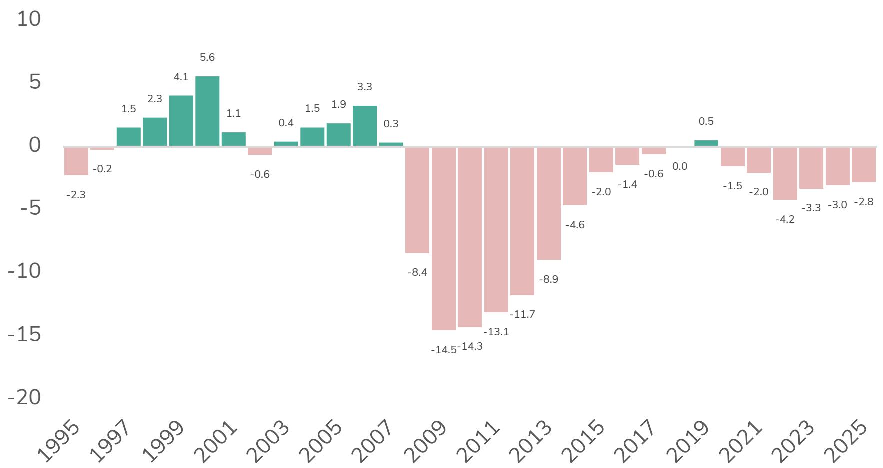
Source: Department of Finance projections (SPU 2021 and SES 2021).

Looking beyond 2022, the Government should prioritise between its plans for significant expansions in public investment, fast increases in current spending and a desire to simultaneously cut taxes. Many factors would argue for a more cautious approach to budgetary measures in the coming years: the rapid expansions pursued in recent years; the likelihood of a strong recovery; and the need to set high debt ratios on a steady downward path. The Council assesses that the Government could prioritise between tax cuts planned, the pace of investment expansion and the speed of increase in current spending. By expanding all areas at once, the Government is effectively evading difficult choices and slowing the return of debt ratios to safer levels. This reduces the scope to ensure that future downturns or crises could be cushioned by strong fiscal support in the same way as during the pandemic. A more prudent approach would be to limit current spending to a slower pace of increase or to avoid plans to reduce the tax base at the same time as a ramp-up in public investment spending is planned.

Even recognising that interest costs are likely to remain low, and that much of the State's debt has been fixed at low rates and long maturities, there are risks to running persistent deficits. The deficits that the Government projects to run out to 2025 would be unprecedented in Irish experience: larger deficits have only previously been run on a sustained basis during the aftermath of the financial crisis. Even allowing for low interest rates into the future, the Council estimates a one-in-four risk that the Government's debt ratio could end up on an unsustainable path. Ireland's deficit and net debt ratio could also still be among the highest in the OECD by 2025, which increases the risks of higher borrowing costs if Ireland is viewed as an "outlier", particularly as a relatively small economy. This leaves the public finances more exposed to shocks, particularly from unexpected shortfalls in growth. It also reduces the likelihood that the Government could respond to future crises by supporting the economy in the same way it did during the pandemic.

Deficits projected would be large

% GNI*, general government balances (excluding one-off items)

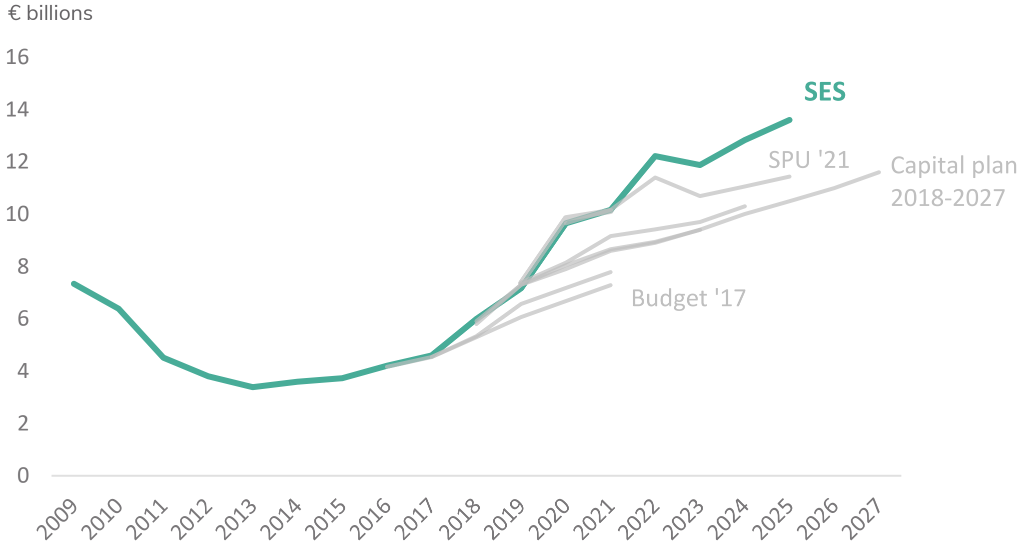


Sources: CSO; Department of Finance (SES 2021 projections); and Fiscal Council workings.

The increase in investment spending should help the Government to address pressures in areas such as housing and climate change.

However, the speed and timing of the ramp-up carries risks and the Government should plan to eventually bring investment down to more normal levels. The Government plans to ramp up public investment spending to exceptionally high levels close to €13½ billion or 6 per cent of GNI*. These plans have been revised up very significantly over the past year from already ambitious levels with a new National Development Plan to be published shortly. The increase will take Ireland's public investment spending to one of the highest rates in its history and to among the highest rates as a share of national income in the OECD. There is a good case for higher spending in areas such as health, climate change, and housing, given that there are clear needs to address various shortfalls. Interest rates are also low, such that a sustained period of exceptionally high investment has merits prior to returning to more normal steady state levels of investment. However, there are risks to this approach. First, the public debt ratio already is high, creating risks regardless of what the additional borrowing is used to finance. Second, with public investment management historically weak in Ireland, there is a need to ensure that future investments generate value for money. Third, many sectors in the economy are expected to recover rapidly in the coming years such that output may rebound to pre-crisis levels quickly and capacity constraints may begin to bite in the construction sector. This could mean higher costs to investment, weakening the Government's ability to achieve value for money. To assess the risks, more information is needed on the Government's investment plans and the underlying economic assumptions.

Investment is rising to high levels; well beyond earlier plans



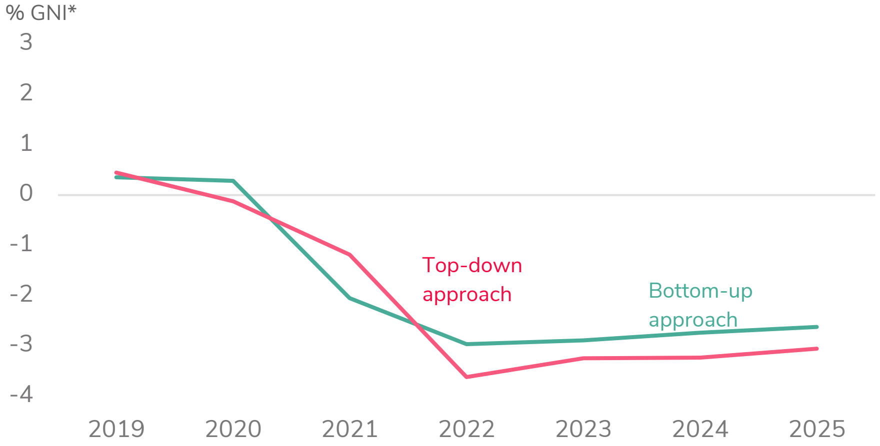
Source: CSO; Department of Finance; and Fiscal Council workings.

The Government has set out in the *SES* a new spending rule and debt objective. The use of these fiscal frameworks is welcome, but they should be better specified. The spending rule is intended to constrain permanent voted spending to grow at the same rate as potential output, assumed by the Government to be around 5 per cent. The Council has recommended a spending rule for several years to help safeguard the sustainability of the public finances by ensuring that spending grows in line with the Government's ability to pay for it. However, applying the rule now at a time when sharp increases in permanent spending have taken place, means that the rule is likely to lock in a higher path for spending than would have been the case if the rule had applied before the pandemic. Aligning spending increases to sustainable revenue increases in this manner will likely maintain a budget deficit, but will not lead to improvements that put the debt ratio on a more prudent downward path. In addition, there are a number of design problems with the rule: (1) there are no legal underpinnings; (2) the assumed trend growth rate is high at 5 per cent and beyond what the Department's own estimates of sustainable growth would suggest; (3) tax cuts are also planned for the coming years, but do not reduce the space allowed for by the rule (in other words, they are in addition to sustainable increases allowed by the rule); and (4) the expenditure rule should be on a whole of government or "general government" basis. As it is, by ignoring tax cuts, the Government has committed more budgetary resources than their own estimates would sustainably allow. The Government should refine the rule if it is to be an appropriate medium-term budgetary anchor that will help to ensure prudent management of the public finances.

The Government's decision to adopt an objective for the debt ratio is also welcome. However, "to stabilise, and reduce slightly, the debt-income ratio in the coming years" is a riskier approach than the assumption previously set out that the budget could be "returned to broad balance by the mid-part of this decade". A budget balance — while not necessarily an optimal goal in itself — would have been consistent with debt ratios falling at a steady pace of more than 3 percentage points per year over the medium term. By contrast, the new objective would see debt ratios remain at high levels well into the medium term. Moreover, the objective is vaguely defined. A better approach would be to develop clear medium-term targets for reducing debt as a share of GNI* and with specified timelines. It is also unclear what the relationship between the spending rule and the debt target is or whether both will apply with the most restrictive being the binding constraint.

The Government's strategy still lacks key details. There are still potentially very large unknowns about expenditure for the coming years, such as whether additional spending might be needed to achieve the Government's climate- and health-related objectives, including for Sláintecare. There is no indication of how taxes would be adjusted if risks arise with the new plans for the medium term. While the Government now plans to run much larger deficits in the coming years, there is no indication as to whether or not this will comply with the EU and domestic fiscal rules.

A structural deficit could remain after this crisis has ended



Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: For details of 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 to the fiscal rules (see Box A of the Assessment of Compliance with the budgetary rule 2018).

Ireland faces a number of major challenges over the coming years.

It is possible that a large structural deficit will remain after the economy recovers from the pandemic. This would reflect the fast pace of permanent spending increases pursued and the pandemic's impact on the economy and sustainable revenues. At the same time, the Government will face mounting pressures related to three key areas: ageing, climate change, and the continued over-reliance on corporation tax receipts. It remains unclear whether existing spending plans will be adequate to meet these challenges: additional information on Housing for All and the new National Development Plan should spell this out. The Government also needs to set out how its Programme for Government commitments, including the implementation of Sláintecare and commitments on other spending items and taxation, are to be funded within the SES package. The risks related to Ireland's over reliance on corporation tax receipts remain high. Corporation tax receipts are typically more volatile than other taxes and are heavily concentrated in a handful of companies. In 2020, 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. The Government should commit to saving future overperformances and to unwinding this over reliance.

Summary Table of Government SES Projections

% GNI* unless otherwise stated; figures in grey text have been derived by the Council

	2019	2020	2021	2022	2023	2024	2025
Macro forecasts							
Real GNI* growth (%)	2.6	-3.5	2.5	5.5	3.0	2.7	2.7
Nominal GNI* growth (%)	9.0	-3.4	3.6	7.6	4.5	4.5	4.4
Nominal GNI* (€bn)	216	208	216	232	243	253	265
Output gap (% of potential)	0.1	-2.4	-2.1	-0.6	-0.1	0.4	0.5
Potential output growth (%)	5.5	4.8	3.9	3.3	2.8	2.6	2.9
Budgetary forecasts							
Balance	0.5	-9.0	-9.4	-6.2	-3.3	-3.0	-2.8
Balance (€ billion)	1.1	-18.8	-20.3	-14.4	-8.1	-7.6	-7.4
Balance excl. one-offs	0.5	-1.5	-2.0	-4.2	-3.3	-3.0	-2.8
Balance excl. one-offs (€ billion)	1.1	-3.2	-4.4	-9.7	-8.0	-7.7	-7.4
Revenue excl. one-offs	40.9	40.9	42.8	40.5	41.1	40.8	40.6
Expenditure excl. one-offs	40.4	42.4	44.8	44.7	44.4	43.8	43.3
Primary balance excl. one-offs	2.6	0.3	-0.5	-2.6	-1.7	-1.5	-1.4
Revenue growth excl. one-offs (%)	6.5	-3.4	8.4	1.9	5.9	3.8	3.8
Primary expenditure growth excl. one-offs (%)	6.4	2.6	10.4	7.2	3.7	3.3	3.4
Gross debt ratio (% GNI*)	94.7	104.8	111.8	108.6	108.0	107.7	106.3
Net debt ratio (% GNI*)	81.4	90.1	97.9	98.0	97.5	97.0	96.2
Gross debt (€ billion)	204	218	242	252	262	273	282
Cash & liquid assets (€ billion)	29	31	30	25	26	28	27
Net debt (€ billion)	175	188	211	227	237	246	255
Fiscal stance							
Structural primary balance	2.6	1.7	0.4	-2.0	-1.7	-1.7	-1.6
- change (p.p.)	-0.1	-0.9	-1.3	-2.4	0.4	-0.1	0.1
Real net policy spending growth (%)	4.2	1.9	9.6	3.4	3.7	2.4	2.2
Change in net debt ratio (p.p.)	-8.2	8.8	7.8	0.1	-0.5	-0.5	-0.8
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.

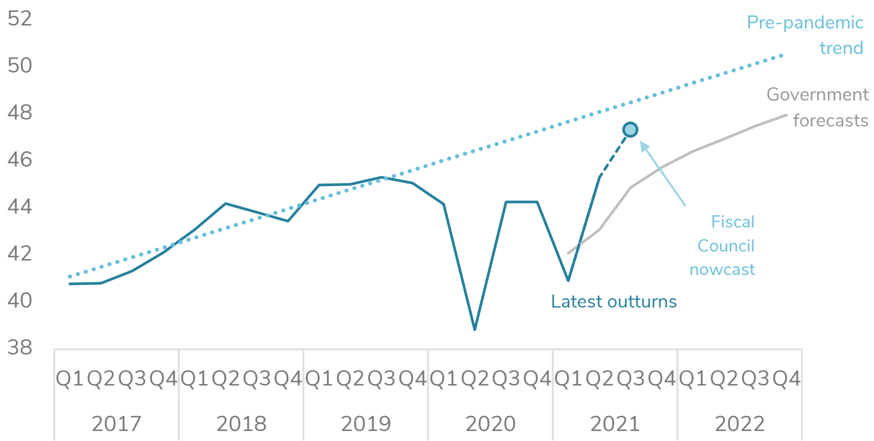
Notes: Output gaps and potential output estimates, including for structural balances, are Department of Finance's preferred GDP-based alternative estimates. xc = Exceptional circumstances apply, meaning temporary deviations from requirements under fiscal rules are allowed. Figures are inferred from SES forecasts by updating SPU projections (e.g., nominal GNI* growth rate forecasts are applied to latest outturns; cash and liquid assets are assumed to be as implied by SPU projections). One-offs that the Council considers relevant are excluded to assess the underlying fiscal position. SES forecasts were only given for the balance in general government terms. For general government revenue, *SPU 2021* forecasts were updated using revisions to tax revenue given in the SES. General government expenditure forecasts were similarly updated, using revisions to voted current and capital expenditure. However, these updates do not fully explain the revision to the general government balance from *SPU 2021*.The residual amounts needed to arrive at the SES general government balance forecast are allocated equally between general government expenditure and revenue. In addition, 2019 and 2020 general government data have been revised since *SPU 2021*. However, SES forecasts did not incorporate these revisions. This table uses the latest data for 2019 and 2020, which is not consistent with numbers used for SES forecasts. As a result, one should caution in comparing 2020 and 2021 figures given above.

1. The Macroeconomic Context for the Budget

The Covid-19 pandemic continues to affect the Irish economy significantly, but there are signs that the economy is rebounding swiftly. Activity has recovered rapidly since restrictions were eased during Spring. The effect of successive lockdowns on the economy has diminished over time as consumers and businesses have adapted. Ongoing large-scale Government supports will continue to help to alleviate the economic consequences of the pandemic. While risks remain, the strong uptake in vaccinations in Ireland contributes to a much-improved outlook for the economy. Figure 1 presents the latest outturns for underlying domestic demand, with the most recent Government forecasts also shown.

Figure 1: The economy looks set to rebound swiftly

€ billions, underlying domestic demand (seasonally adjusted, 2019 prices)



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), with additional calculations from the Council to derive underlying domestic demand. The pre-pandemic trend is based on quarterly seasonally adjusted data for 2014–2019. The Council's latest nowcast for Q3 2021 reflects data available up to 6th September; see Casey (2018) for methodological details.

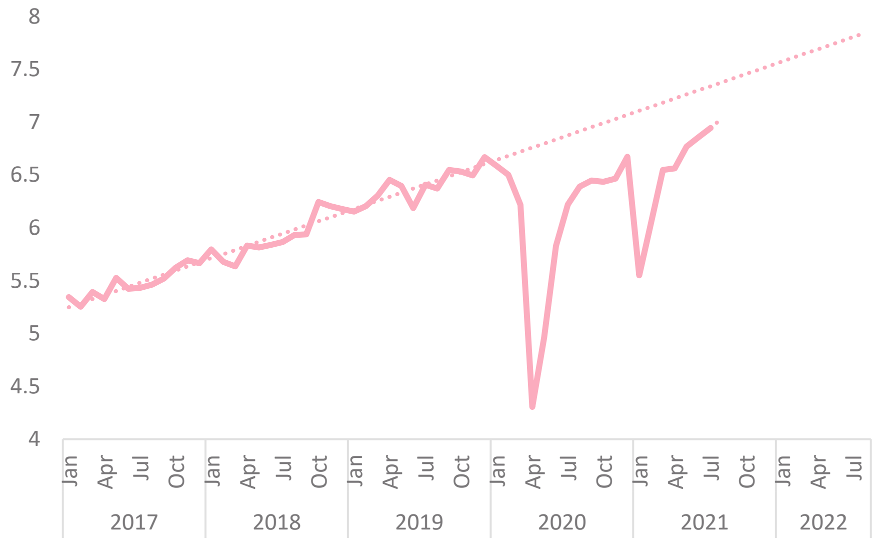
Domestic demand fell in the first quarter of 2021 following the reimposed restrictions on movement and activity in December 2020. However, the economy has rebounded sharply, and a variety of indicators corroborate this view. The Council's latest nowcast for the third quarter implies a continued strengthening of the recovery, and a more benign outcome relative to the latest official forecasts.

Recent data on consumer spending point to rapid growth in Q3 2021. Spending with debit and credit cards and ATM withdrawals show a rapid rebound from the lockdown-driven fall early in 2021. Figure 2 shows that in

July, the total amount of spending was 5.4 per cent below a pre-pandemic trend.

Figure 2: Consumer spending has increased rapidly in 2021

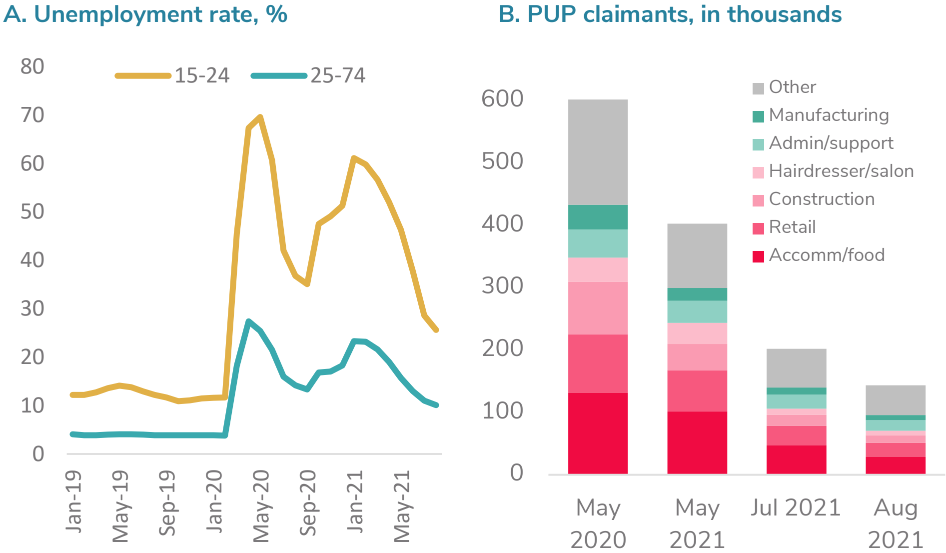
€ billions, card spending and ATM withdrawals (seasonally adjusted)



Sources: Central Bank of Ireland; and Fiscal Council workings.
Note: Monthly data for total card (debit and credit) spending and ATM withdrawals are seasonally adjusted using Tramoseats to obtain the series above. The data point for August 2021 is based on daily card spending and ATM withdrawals. The linear trend is based on data for 2015–2019.

While the recovery in overall activity looks fast, the recovery in the labour market has lagged behind. The unemployment rate including recipients of Covid-related unemployment payments stood at 12.4 per cent in August compared to just 4.8 per cent before the pandemic began (Figure 3A). Data on the number of claimants availing of the Pandemic Unemployment Payment (PUP) highlight how the pandemic has been particularly damaging to certain sectors. More than one third of the outstanding claimants are from the food, accommodation, and retail sectors. Notwithstanding the challenges facing these sectors, the number of claimants has fallen from a peak of about 600,000 in May 2020 to just over 140,000 in August 2021 (Figure 3B).

Figure 3: Unemployment is falling but remains high in places



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

Box A highlights the inconsistency in *SES 2021* between the Government's new fiscal plans and official macroeconomic forecasts for domestic demand over the medium term, which were not updated compared to April's *SPU*. As a result, the Council's Recovery Scenario factors in the Government's announcements regarding fiscal policy as well as recent economic developments. This scenario forms the basis for the Council's updated fiscal projections, and its assessment of the fiscal stance. Similar to the May 2021 *Fiscal Assessment Report* (Fiscal Council, 2021), the Council's view is that medium-term scarring effects of the pandemic, in terms of underlying domestic demand, are likely to be smaller than assumed by the Government in April's *SPU* and July's *SES*.

Box A: Official forecasts of the domestic economy are not consistent with the Government's fiscal plans

The Government's update of its economic projections in the *Summer Economic Statement* (*SES*) published in July was not consistent with its new fiscal plans. Although forecasts of net exports and GDP were updated, the outlook for domestic demand was left unchanged relative to the *Stability Programme Update* forecasts set out in April. This partial update was despite a large budgetary expansion implied by the *SES* plans, and the implications this would have for scarring over the medium term.

Furthermore, a number of available indications of the strength and speed of the recovery in the domestic economy were not factored into the *SES* projections for domestic demand. As noted by the Council in the May 2021 *Fiscal Assessment Report* (Fiscal Council, 2021), upside risks to the domestic economy had already become evident in high-frequency indicators of consumer spending.

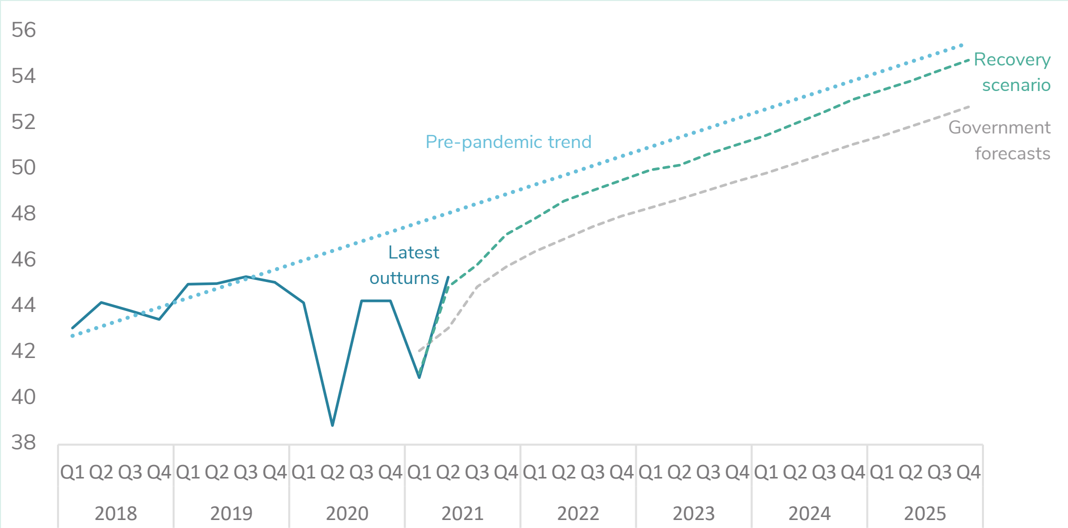
To carry out a meaningful analysis of the fiscal stance over the medium term, this box presents a "Recovery Scenario" for the domestic economy. This forms the basis for a more realistic set of fiscal projections, taking account of the plans for budgetary expansion (see section 3), and a more positive view of most likely path for the economy in the coming years.

Incorporating SES fiscal plans and indications of an ongoing rapid recovery

Figure A1 compares the most recently published official forecasts for the domestic economy with a Recovery Scenario. This scenario takes account of the positive impact on demand of the budgetary expansion set out in the *SES*, and a rapid rebound in activity in Q2 2021.

Figure A1: The domestic economy has rebounded rapidly in 2021

€ billions, underlying domestic demand (seasonally adjusted, 2019 prices)



Sources: CSO, 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*.

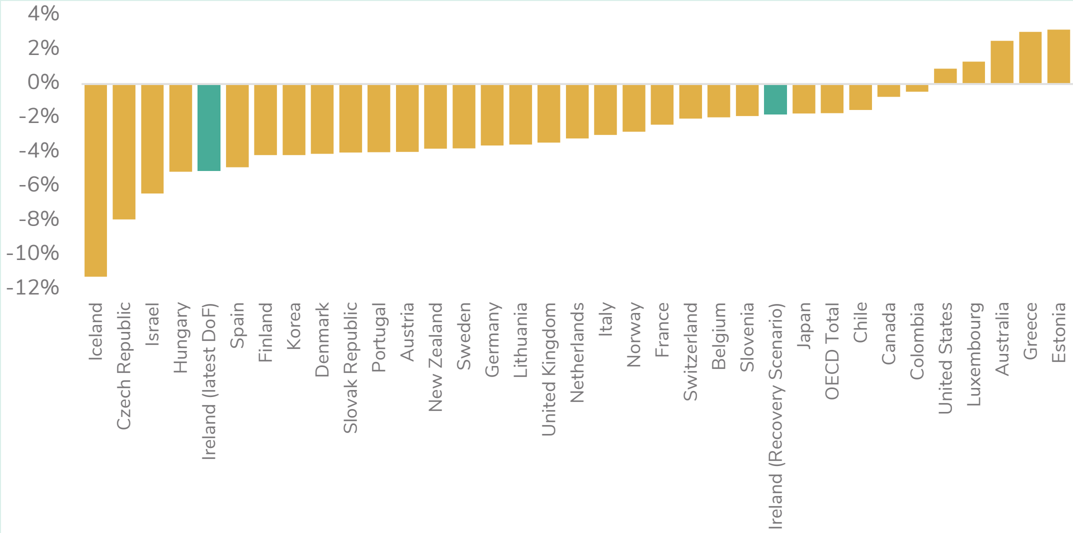
With Covid-related confinement measures easing over the summer period and vaccinations progressing, domestic economic activity has been rebounding quickly. Assuming that 90 per cent of the adult population (16+) are fully vaccinated by end-September, and no reintroduction of confinement measures, it is likely that the economy will continue to recover much of its lost output. Substantial savings have also been accrued by households, which, if spent, could boost the recovery further at least in the short term (as discussed in Box A of the May *2021 Fiscal Assessment Report*). Furthermore, employee compensation has held up well despite repeat lockdowns, as sectors that were not directly affected by the pandemic have continued to grow.

The "Recovery Scenario" implies less scarring than in official forecasts

Figure A2 shows estimated effects of the pandemic on domestic economies across the OECD by Q4 2022, and compares these with the official and Recovery Scenario forecasts for Ireland's underlying domestic demand. The calculations compare OECD forecasts of final domestic expenditure with a pre-pandemic trend, where 2014–2019 is the sample period. The official forecasts include a demand shortfall of 5.1 per cent by end-2022, and as shown in Figure A1, this gap continues until 2025. For the Recovery Scenario, the implied shortfall by end-2022 is 1.8 per cent, and this reduces over time to 1.5 per cent by 2025.

Figure A2: The "Recovery Scenario" is close to the OECD's overall projection

% difference between volumes of forecast domestic demand and pre-pandemic trends in Q4 2022

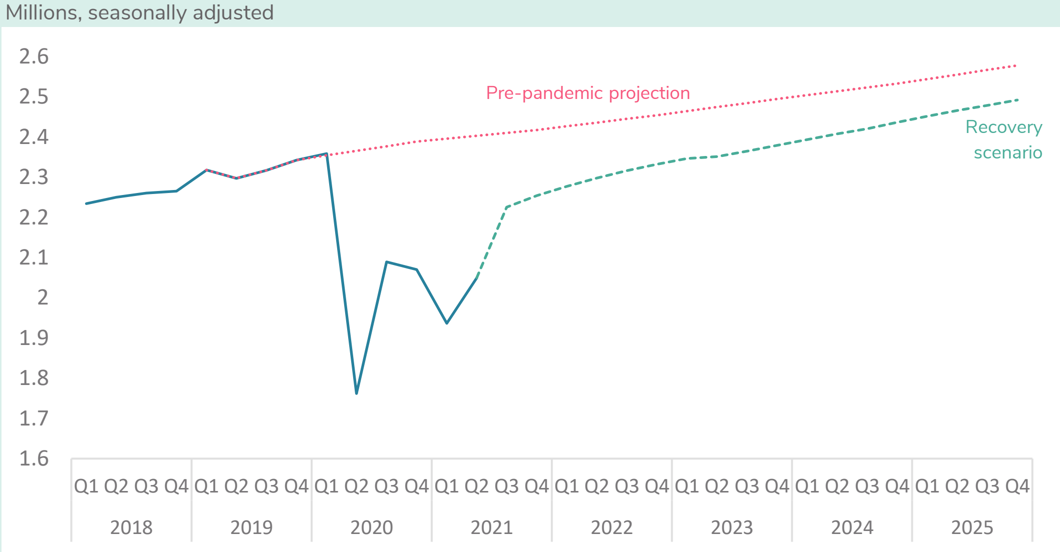


Sources: OECD Economic Outlook (May 2021), Department of Finance, and Fiscal Council workings.
Notes: The OECD forecasts for Q4 2022 are used for all countries except Ireland. The trend is based on a linear trend over Q1 2014 to Q4 2019.

Figure A3 shows seasonally adjusted levels of employment. Official labour market data are adjusted so that those in receipt of the Pandemic Unemployment Payment, but whose labour market status is technically designated as employed, are not included. The Recovery Scenario would point to a significant increase in employment in the second half of this year. Employment would be forecast to exceed its pre-pandemic highs by the middle of 2023, despite some sectors experiencing scarring. By 2025, employment would remain 3.5 per cent lower than a pre-pandemic projection.

Figure A3: Employment could surpass pre-pandemic levels in 2023

Millions, seasonally adjusted

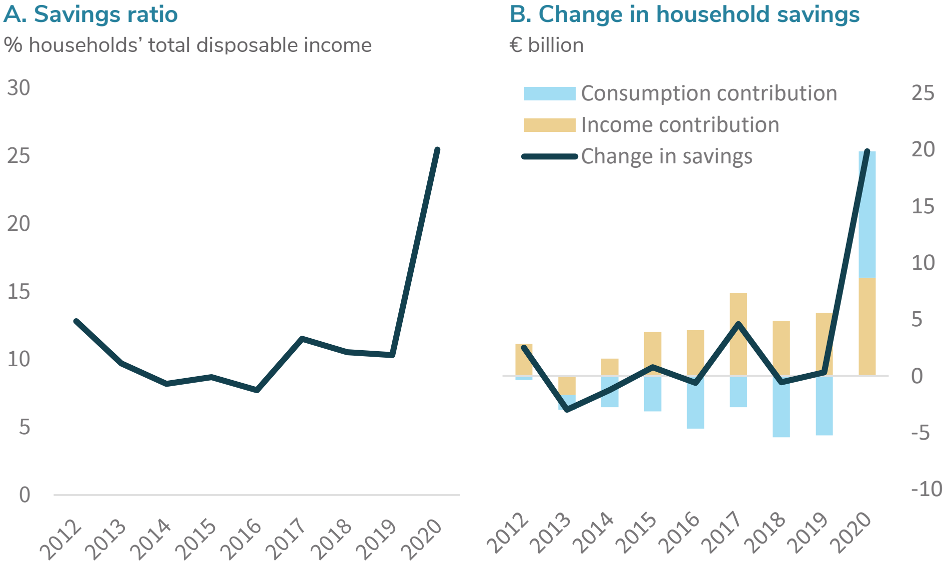


Sources: CSO, and Fiscal Council workings.
Notes: Offical LFS employment figures are adjusted to account for Pandemic Unemployment Payment claimants whose ILO labour market status may be recorded as employed. The pre-pandemic projection is based on the Council's March 2020 "no-pandemic" baseline.

A consequence of the pandemic has been a surge in household savings. Irish households saved over a quarter of their total disposable income in 2020 (Figure 4A). This compares to an average savings rate of 10.5 per cent in the previous decade.

Two factors have contributed to this unprecedented level of savings (Figure 4B). First, the imposition of public-health restrictions has resulted in a significant reduction in consumer spending from March 2020 onwards (as shown in Figure 2). Second, despite the economic downturn and the increase in unemployment, households' total disposable income increased.[1] This reflects rapid wage increases in sectors that were less affected by the pandemic, and Government income supports.[2]

Figure 4: Households have amassed large savings



Sources: CSO and Fiscal Council workings.
Notes: In panel B, the consumption contribution is the change in household final consumption expenditure (P.3), and the income contribution is the change in household total disposable income — which is equal to gross disposable income (B.6g) plus the adjustment for the change in pension entitlements (D.8).

Excess savings by households in 2020 and early 2021 could be deployed as the economic recovery progresses, acting as a boost to consumption and investment. As discussed in Box A of the May 2021 *Fiscal Assessment Report* (Fiscal Council, 2021), the relatively low import content for many

[1] The 2020 increase in household total disposable income of €8.7 billion is mainly as a result of €8.2 billion in higher net transfers. Compensation of employees increased by €0.5 billion, while a small reduction in taxes paid was offset by a fall in other income.

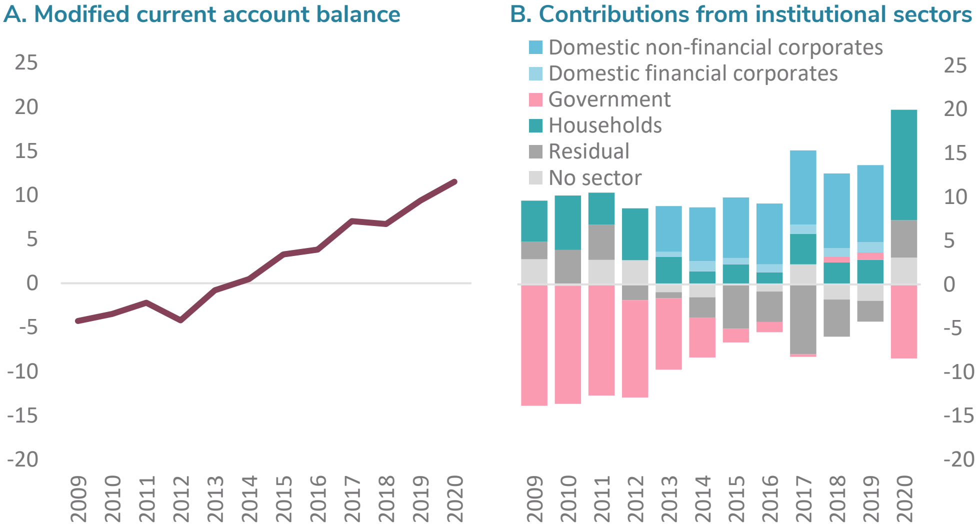
[2] PUP constituted the main direct household income support, although other supports such as the wage subsidy schemes provided an indirect increase in household income.

activities that were most impacted by the pandemic implies a large potential benefit to the economy from these excess household savings.

The increase in household savings contributed to the rise in the modified current account last year, as shown in Figure 5, and more than offset the negative contribution by government. The large surplus for the modified current account of 11.5 per cent of GNI* is in contrast to the current account deficit around the global financial crisis.

Figure 5: Ireland has a substantial current account surplus

% GNI*



Sources: CSO and Fiscal Council workings.

Notes: In panel B, contributions are shown as gross savings less gross capital formation by institutional sector. 'No Sector' is included in to report taxes and subsidies on products in cases where it is not possible to allocate these amounts to sectors. The residual reflects the difference between the other components and the modified current account shown in panel A, and for 2009–2012 and 2020 this includes the savings less capital formation of domestic financial and non-financial corporations, due to data unavailability for these years.

Significant deleveraging has taken place in the Irish economy alongside a period of rapid real economic growth, exceeding 4 per cent per annum. This balance-sheet repair placed the Irish economy in a strong position to recover from the shock of the pandemic, since households, government, and domestic firms were net lenders rather than net borrowers in the years prior to 2020. Furthermore, the presence of many multinational enterprises in Ireland — in particular, those operating in pharmaceuticals and information/communication technology sectors — has provided a significant advantage to the domestic economy, given the large spillover benefits of these firms' high-skilled employment in Ireland.

While new variants of Covid-19 have the potential to again disrupt the path for domestic demand, the periods during which public-health restrictions have been eased have seen strong recoveries in the direction of pre-pandemic trend levels of activity. Furthermore, the speed with which effective vaccines have been developed and distributed since the pandemic began is a mitigating factor against further widespread disruption to the economy due to Covid-19. Nonetheless, it remains possible that trade disruptions with the UK could re-emerge, and that the limited impact of Brexit on Irish exports to date could become more adverse.[3] New import controls will be introduced in the UK starting in October, with possible negative implications for Irish agricultural exports.[4] In aggregate however, it can prove difficult to predict the impact of Brexit on the Irish economy, given the possibility for both challenges in some sectors occurring alongside opportunities for expansion in others.[5]

Further ahead, challenges remain for the economy over the longer term due to a number of factors. A slowdown in Ireland's economic growth rates should be expected in the latter half of the current decade, as discussed in the Council's *Long-Term Sustainability Report* (Fiscal Council, 2020). This is due to a combination of demographic factors and an expected convergence in productivity with the ratios of output per worker seen in other developed economies. Another key long-term risk concerns the landscape for international corporation taxation, which could have a considerable impact on Ireland's capacity to attract multinational entities to create high-skill employment in Ireland over coming decades.

[3] The first half of 2021 has seen a year-on-year increase in Ireland's exports to the UK across each of agricultural, forestry and fishing, and industrial products: see table 6 in https://www.cso.ie/en/releasesandpublications/er/gei/goodsexportsandimportsjune2021/

[4] For details, see: https://www.gov.ie/en/publication/cd195-preparing-for-new-uk-import-controls-1-april-1-july/

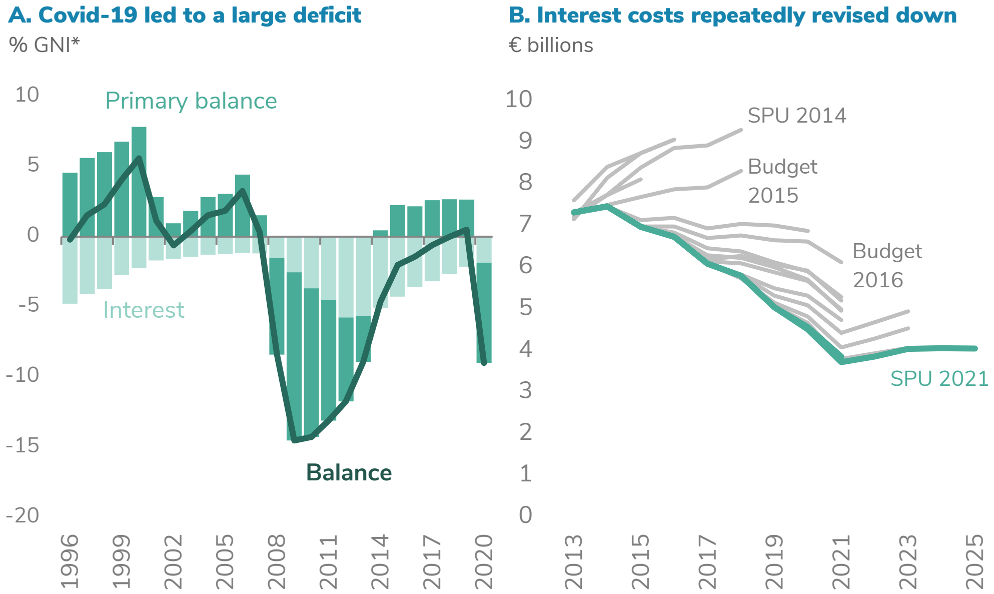
[5] For example, exports of financial and insurance services have grown very rapidly in the first half of 2021, rising by 22 per cent compared to the first half of 2019 and by 15 per cent compared to the first half of 2020.

2. The Fiscal Context for the Budget

The pandemic led to substantially higher government spending on health, as well as job and income supports, while some tax revenues fell sharply. This led to a large budget deficit in 2020. While taxes have recovered as economic activity rebounded, the ongoing large spending supports will lead to another large deficit this year. As a result, the debt-to-GNI* ratio will have risen to well over 100 per cent.

Before the Covid-19 pandemic, Ireland's budget deficit had narrowed over many years, finally reaching a small surplus in 2018 and 2019 (Figure 6). In addition, forecasts of interest costs have repeatedly been revised down as interest rates have fallen. As a result, the public finances were able to absorb the impact of the pandemic without having to reduce non-Covid spending.

Figure 6: The Recent Fiscal Context



Source: Department of Finance and Fiscal Council workings.
Notes: One-offs including bank recapitalisations are removed from the years prior to 2020 in panel A to show the comparable underlying budgetary balances being run.

In 2020, the government ran a substantial deficit of €18.8 billion (9 per cent of GNI*). The sizeable deficit predominantly reflected new spending measures to support incomes and jobs along with additional health spending. The deficit marked a €19.9 billion deterioration compared to the small €1.1 billion surplus of 2019. The deterioration was driven by a €16.2 billion rise in spending. About €14 billion of the spending increase can be attributed to policy measures — mainly related to supports for incomes and the health response (Table 1). Overall revenues were more resilient, falling by €3.6 billion, of which about €1 billion reflects tax supports adopted. While receipts from many tax heads fell, others were remarkably buoyant. The overall package of budgetary supports introduced in 2020 was about €15 billion. Automatic stabilisers—supports that occur automatically such as reduced taxes and higher unemployment benefits—played a smaller role than the new policy supports introduced.

For 2021, the Government forecast a deficit of €20.5 billion as part of *Budget 2021*, released in October 2020. The composition of this deficit reflected a mix of support measures and contingency allocations in response to Covid-19 worth over €12 billion. There were also permanent increases in spending of between €5.5 billion and €8 billion. The deficit was revised down to €18.1 billion with April's *SPU 2021* forecast update as tax revenues held up well despite the reintroduction of confinement measures and as spending plans appeared to contain sufficient buffers to weather the impact on health and income supports.

Table 1: Covid-related supports

€ billions

	2020	2021 forecasts
Total change in spending	16.7	4.4
Spending policy measures	13.9*	15.2
Pandemic Unemployment Payment	5.0	3.8
Wage subsidy schemes	4.1	4.8
Health spending on Covid-19	2.0	1.9
ICT spending	0.8	
Restart Grants and Covid Restrictions Support Scheme	0.6	0.8
Other enterprise supports	0.1	
Other	1.3	3.2
Contingency allocation		0.7
Total change in revenue	-3.5	4.8
Tax policy measures	-1.0*	-1.4
Tax warehousing write-off	-0.5	-0.5
Loss relief	-0.2	
VAT cuts	-0.3	-0.5
"Stay and spend" and other schemes	-0.0	-0.4
Total change in deficit	20.2	-0.4
Total policy measures	14.9*	16.6

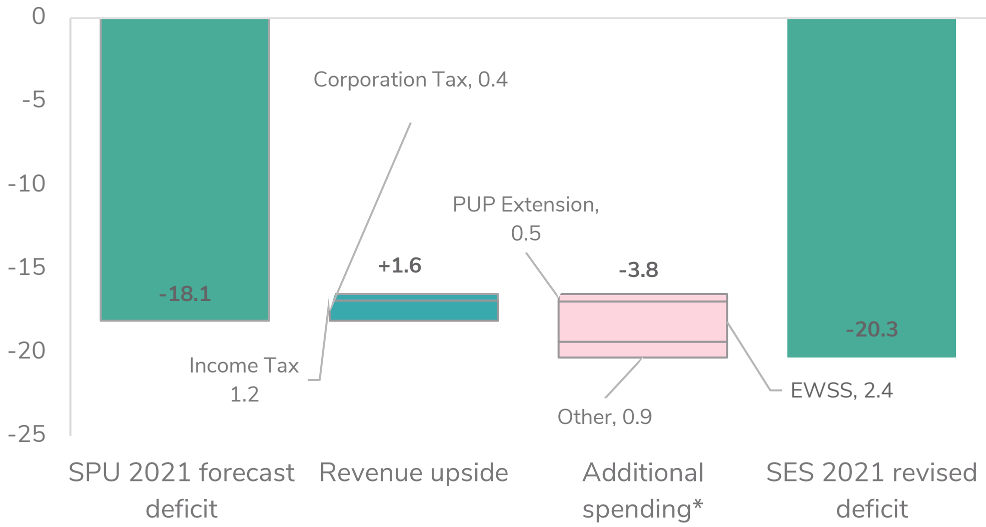
Sources: CSO; Department of Finance; and Fiscal Council workings.
Notes: The Covid Restrictions Support Scheme is included here as an expenditure item in line with the CSO's classification (the Department classified it initially as a tax measure). Tax warehousing amounts refer to amounts of receipts warehoused and not expected to be repaid (25 per cent). Single asterisked (*) amounts in 2020 differ from SES 2021 estimates but are in line with CSO estimates of Covid-specific spending. This, however, may be revised up in future vintages.

However, in July, the *Summer Economic Statement 2021* (*SES 2021*) contained revised projections, with a deficit of €20.3 billion (close to what had been originally projected in *Budget 2021*). This reflected the Government's decision to extend a range of existing supports at a cost of €3.8 billion (Figure 7).[6] The Government assumes these costs will exceed the €5.4 billion set aside in contingency funding as part of *Budget 2021*. Around €4 billion of this total had already been allocated to the Department of Employment Affairs and Social Protection for additional costs that arose between January and June of this year. Approximately €1 billion had been allocated to other government departments.

Offsetting these increases in spending was a further upward revision to the forecast tax take for 2021 of €1.6 billion. The revision was solely due to income tax and corporation taxes, although other taxes had been performing well too.[7]

Figure 7: Evolution of this year's deficit forecast since *SPU 2021*

€ billion, budget balance in general government terms



Source: Department of Finance and Fiscal Council workings.
Notes: The NERP is the Government's *National Economic Recovery Plan*, which was published in June. *Other additional spending is calculated as a residual between the revised SES deficit for 2021 and the estimated deficit impact of the extended PUP and EWSS supports.

[6] With the National Economic Recovery Plan (NERP), the Pandemic Unemployment Payment (PUP) was extended beyond 30 June 2021 for existing claimants but closed to new claimants. After 7 September, the scheme is to be reduced by €50 per week from its current maximum of €350 per week and claims for students are to end. A further €50 per week reduction is planned for 16 November and 8 February 2022 bringing payments in line with the primary rate of Jobseeker's Benefit at €203 per week. The total cost of the extension is expected to be €0.45 billion. The NERP also saw the Employment Wage Subsidy Scheme (EWSS) extended beyond 30 June 2021 to 31 December 2021 at an estimated cost of €2.42 billion.

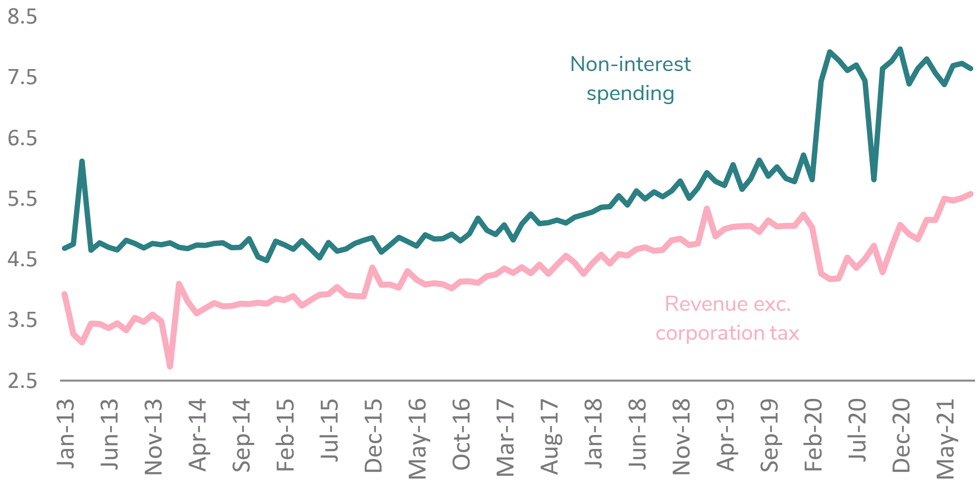
[7] This figure is net of extensions to supports as part of the NERP, of which around €85 million of Corporation Tax (CT) receipts are expected to be redirected towards the Covid Restrictions Support Scheme (CRSS), leaving the gross revision to CT at around €0.5 billion.

The updated SES forecasts for the 2021 deficit look pessimistic as they do not reflect the strength in the underlying recovery in activity and employment. On one side, government revenue projections do not appear to take full account of the strength of taxes thus far in 2021. On the other side, expenditure projections assume higher numbers of claimants for Covid supports than recent data would suggest. Overestimating the number of claimants would then lead to an overestimation of the likely cost of extensions to the supports for jobs and incomes.

The total additional cost assumed from the decision to extend these income and wage support schemes was €2.9 billion, with €2.4 billion of this estimated as the cost of the Employment Wage Subsidy Scheme.[8] However, the number of PUP claimants began to fall relatively quickly as far back as April, with this performance continuing as lockdown measures were eased over summer (Figure 11). This is likely to leave social protection spending lower than forecast by the end of the year relative to *SES 2021* projections if claimants continue to fall at a fast pace. Additional, unplanned costs such as a Christmas Bonus for PUP claimants or other social protection supports could offset any savings from lower numbers of claimants.

Figure 8: Revenue and Expenditure Trends

€ billion, seasonally adjusted monthly data (Exchequer cash basis)



Source: Department of Finance and Fiscal Council workings.
Notes: The data are seasonally adjusted using the Tramoseats method over monthly observations for the duration of the sample period 2013-2021. Non-interest spending excludes transactions with no general government impact, while the revenue series shown includes taxes, PRSI receipts, and excludes corporation tax.

[8] This costing was based on the number of EWSS claimants remaining elevated.

Figure 8 shows the seasonally adjusted trends for non-interest spending and revenues excluding corporation tax have evolved over recent months. While non-interest spending remained elevated in August as the economy continued to reopen, health expenditures have gradually dropped below profile and social protection spending fell as unemployed cohorts returned to work.

Revenue developments this year

Government revenues have exceeded expectations so far this year. Taxes are recovering as public health restrictions continue to ease and economic activity resumes. Certain revenue sources, such as income tax, are maintaining the strong performance seen last year (Table 2). This reflects the uneven impact of Covid-19 on different sectors of the economy.

Table 2: Revenue Developments 2021

Cumulative difference to August, % change

	Relative to 2020	Relative to SES 2021
Exchequer Tax	15.2	5.4
Exchequer Tax excl. Corporation tax	16.8	3.7
Income Tax	18.9	1.3
VAT	25.9	6.2
Corporation Tax	8.1	14.0
Excise Duty	8.3	-0.1
Other Taxes	-9.4	18.3
PRSI Receipts	10.6	7.9
Other Revenue	7.0	21.2
Total	13.9	6.7
Total excl. Corporation tax	14.9	5.6

Sources: Department of Finance and Fiscal Council workings.

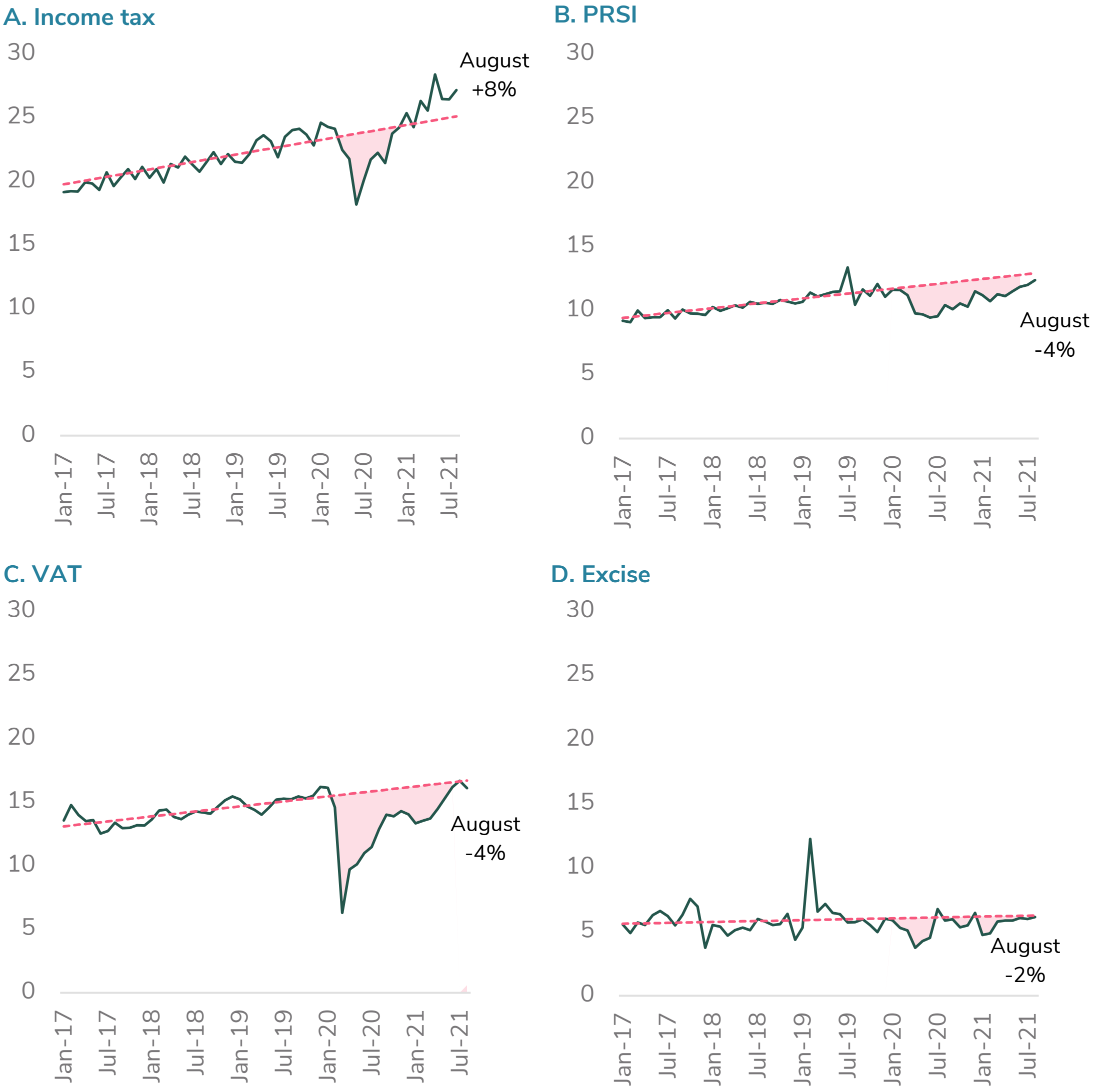
Notes: Data are cumulative monthly outturns from January to August of each year. Other taxes include stamps, capital taxes, motor tax, customs, and other unallocated tax receipts. Other revenue includes the National Training Fund, other A-in-As, non-tax revenue, and capital resources. PRSI and National Training Funds include their corresponding excess as indicated in the memo items.

Overall tax revenues have risen by over 15 per cent (€5.2 billion) for the year to August 2021 compared to the same period of last year. They are also ahead of *SES 2021* forecasts by 5.4 per cent (€2 billion). The *SES* forecasts that tax revenues for the full year in 2021 will be 8.4 per cent higher than last year.

Income taxes have built upon their robust performance in 2020 and are almost 19 per cent (€2.6 billion) above 2020 levels. This reflects strong wage growth in sectors not affected by the pandemic and the progressive nature of the income tax system. As Figure 9 illustrates, income taxes recovered quickly from the impact of the first round of Covid-19 restrictions.[9] Further lockdowns did not have a material impact on income taxes, which have expanded further to exceed the level indicated by a pre-pandemic trend (overperforming trend by 8 per cent as of August 2021). Receipts are also 1.3 per cent above the most recent *SES 2021* projections.

Figure 9: Income tax expands strongly, while others have broadly recovered

Annualised seasonally adjusted € billion



Source: Department of Finance and Fiscal Council workings.
Notes: Red dashed lines indicate pre-pandemic trend. Pre-pandemic trends are estimated as a linear trend of monthly tax data from Jan 2015 to Dec 2019. The data are seasonally adjusted using the Tramoseats method over monthly observations for the duration of the sample period 2013-2021.

PRSI receipts have had a more gradual recovery relative to income taxes but are above 2020 levels. For the year to end-August, PRSI receipts are

[9] The impact on income tax was largely a product of government supports for the warehousing of income taxes.

10.6 per cent (€0.7 billion) ahead of last year's levels. However, PRSI receipts remain around 4 per cent below their pre-pandemic trend. Part of the lower PRSI intake reflects provisions made as part of the income support schemes (the EWSS and the previous Temporary Wage Subsidy Scheme), which allowed for some degree of PRSI forbearance. A total of over €0.2 billion worth of PRSI was foregone under the schemes in 2020. This year, €0.5 billion has been foregone so far. PRSI is a less progressive tax than income tax. However, receipts are likely to rise as the economy reopens and unemployment falls.[10]

VAT experienced the largest fall of the major taxes during periods of the highest public health restrictions in 2020 and 2021 as consumption contracted, and some forbearance on VAT was allowed. VAT has recovered strongly as the economy reopened in 2021 and normal consumption patterns began to resume. The performance this year has greatly exceeded the 2020 level so far, standing 25.9 per cent higher (€2 billion) and has largely recovered to its pre-pandemic trend.

The Government has extended provisions for the 'warehousing' of VAT- and income tax-related receipts from firms negatively impacted by public health restrictions. To date, around €2.4 billion of these taxes have been warehoused with Revenue subject to gradual repayment. The Department has assumed a substantial proportion of these debts are never repaid (between 25 and 50 per cent), which may result in revenue forecasts being too conservative. Although the overall impact on revenues from this would be relatively small.

Firm failures as supports are unwound or a faster than expected return to pre-Covid-19 trading for these businesses represent revenue risks in both directions. Furthermore, the extension of the VAT cut for the hospitality sector to end-2022, estimated to cost around €0.35 billion, will hold back receipts.

Excise duties have remained volatile throughout the Covid-19 period, demonstrating a sensitivity to public health restrictions. Intake for 2021 remains up on 2020 levels despite the longer shutdown of the economy this year, with year-to-date receipts 8.3 per cent above last year's level to end-August. This is 2 per cent above estimated pre-Covid-19 trend levels, but

[10] Particularly among lower earners, who may have previously paid little income tax, but were liable for PRSI. Increased numbers of workers supported by the EWSS would moderate the increase in PRSI receipts as forbearance of contributions continues under the scheme.

flat against *SES 2021* profiles. International travel resuming and other areas of the domestic economy reopening may pull in different directions for excise intake this year.

Corporation tax receipts remain robust this year, with the gains to key tax-paying sectors offsetting the pressures on the profitability of sectors that are less central to CT receipts. For the year to date, receipts are 8.1 per cent (€0.5 billion) higher than the 2020 outturn for the same period. Corporation tax receipts are also over the *SES* forecasts by 14 per cent (€0.9 billion). Headline receipts presented in the exchequer returns are lowered by the impact of government supports for businesses impact by Covid-19, with a total of €0.5 billion in corporation tax being recycled back into the CRSS. If this amount had not been used to fund this scheme, underlying receipts would be over 15 per cent higher than in 2020. While the CRSS has been extended until the end of the year, further easing of restrictions should see fewer firms claiming supports under this scheme, reducing the likelihood of a material impact on net corporation tax receipts.

Corporation tax receipts have continued to surprise on the upside again this year, as highlighted by the revised profiles produced as part of the *SES*. However, these revisions may be still underestimate corporation tax receipts, as they incorporate only the overperformance relative to *SPU 2021* profiles by end-June, with no further upside estimated beyond then. This is at odds with research produced by the Department of Finance which shows that the performance of June receipts is positively correlated with November's outturn, suggesting further upside potential for receipts for the rest of the year. Using an estimation method produced by the Department shows that November receipts alone could reach between €3.7 billion and €4.3 billion, any figure between this range would represent the highest ever outturn, with the Department's profile for November receipts currently at €3.2 billion.

Expenditure developments this year

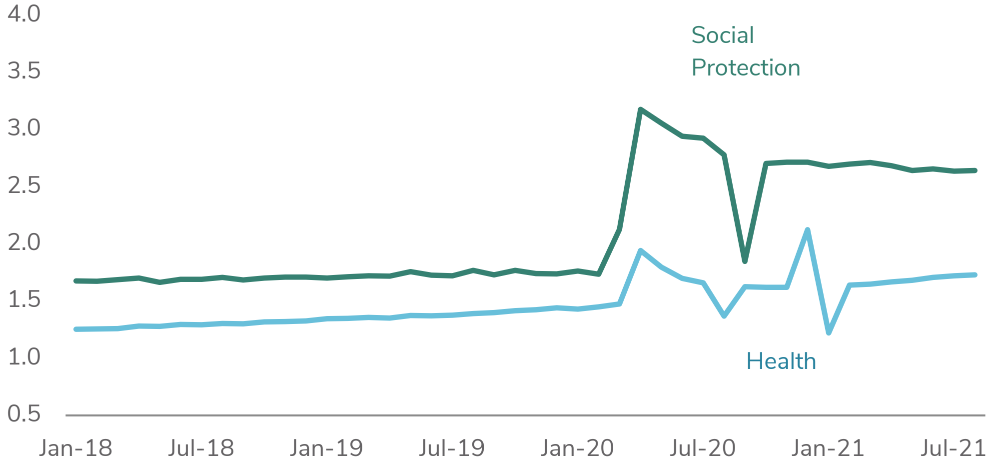
Government spending has remained high owing to the ongoing income and employment supports used to mitigate the impact of Covid-19. Spending for the year to date is higher than was the case to end-August 2020, with total expenditure up around 2.3 per cent (€1.3 billion). However, this outturn is actually below expectations at the time of the *SES* by 3 per cent (€1.8 billion), partially reflecting the large size of the contingency funds allowed for in *Budget 2021*. This outturn is partly the result of a faster than forecast reduction in pandemic-related spending, but also that other government departments have spent less than would be expected of their *Budget 2021* allocations.[11]

Capital spending is considerably below *SES 2021* forecasts. The capital underspend for the year to date is almost 15 per cent (€0.65 billion). This is not unusual at this time of year, however, and it is possible that these underspends would be made up towards the end of the year.

Social Protection spending remains high (Figure 10), driven by income and employment supports through the EWSS and PUP schemes, although it has fallen considerably since the peak of the crisis this year. Total outlays on social protection this year have reached almost €21 billion, around 3.3 per cent higher than the same time in 2020, reflecting the longer lockdown experienced this year. Total spending on social protection is 1.3 per cent above profile.

Figure 10: Health and Social Protection spending

€ million, Seasonally Adjusted Monthly



Source: Department of Finance and Fiscal Council workings.
Notes: The data are seasonally adjusted using the Tramoseats method over monthly observations for the duration of the sample period 2013-2021.

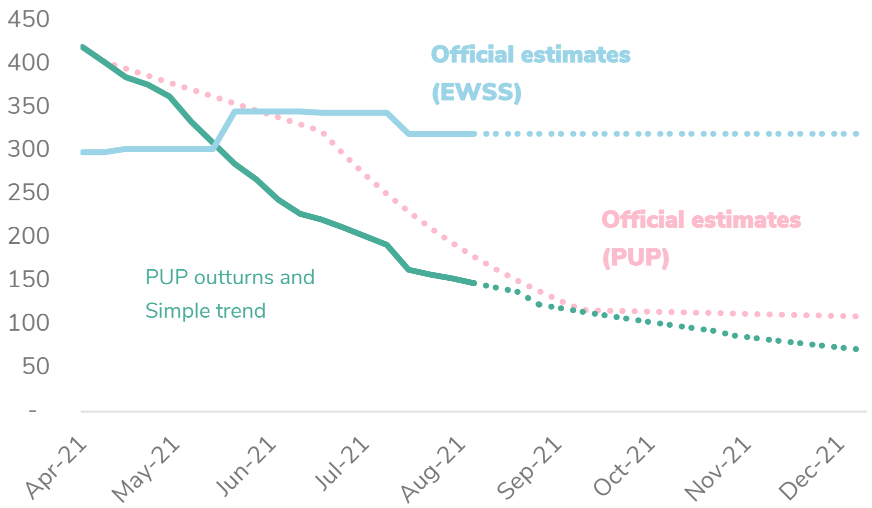
Both the EWSS and PUP have been extended to the end of the year, meaning spending will remain elevated. While PUP numbers have fallen quickly, EWSS claimants remain high and have been relatively stable throughout the pandemic. Currently around 341,500 jobs are being

[11] Around €4 billion of the contingency allocations made as part of *Budget 2021* have been allocated for social protection spending as part of the SES 2021 spending forecasts.

supported, with official forecasts indicating that this number will remain static for the rest of the year (Figure 11). This would mean social protection spending is likely to remain relatively elevated until the end of the year at least.

Figure 11: Fall in PUP claimants is faster than assumed while EWSS claimants forecast to remain elevated

Claimants, thousands



Source: DEASP, Department of Finance, Revenue, and Fiscal Council workings.
Notes: Official estimates are based on estimates received from the Department of Finance (the weekly PUP forecasts are interpolated from end-quarter forecasts provided by the Department). The simple trend forecast assume that claimants return to work at the same pace from August, and further claimants exit the scheme as it is tapered.

Relative to projections made by the Department of Finance for the path of PUP claimants (Figure 11), the number of workers exiting the scheme has been faster than anticipated, primarily reflecting the economy reopening more quickly than expected in *SPU 2021*. The Department estimates that most of the falls in those claiming the PUP will occur before by the end of the third quarter of this year.

Health spending in 2021 is now above levels seen to the same period in 2020, but remains below profile. It would appear that the permanent increases of around €2 billion coupled with a Covid-19 allocation of €1.8 billion set out in *Budget 2021* have been more than sufficient to absorb the additional costs of higher infection rates in the early part of this year, with the year-to-date underspend now at 4.8 per cent (€0.7 billion) for current spending. On an annual basis, current spending in the Department of Health to date this year now stands 1.9 per cent above levels to end August 2020. Pent-up demand for health services delayed because of the pandemic, coupled with ongoing Covid-19 admissions could see the health underspend reversed as more regular hospital treatments resume.[12] Further waves of Covid-19 infections from new variants also serves as an ongoing upside risk to spending.

Risks to the deficit for 2021

The development and deployment of effective vaccines against the dominant strains of Covid-19, and progress in treatment of those with the disease have allowed for significant progress in reopening the economy. Further waves of the virus and the emergence of new variants of concern could hinder the recovery and hence result in lower tax revenues and increased spending on income supports.

Similarly, continued underspending in some Government departments represents an upside risk to the Exchequer in 2021. It is possible that underspends on capital and across various departments related to restrictions in place early in 2021 could not be made up by the end of 2021. This would mean a smaller deficit, all else equal.

Employment gains that are faster than expected represent an upside risk to revenues. How much this increased employment might contribute to income tax depends on the composition of employment gains. A recovery in lower paying sectors would yield a limited increase in income tax. However, strong performances in the sectors least exposed to Covid-19 would represent a key upside risk. With robust wage growth seen throughout 2020 and 2021, continued expansion of these sectors would likely see income taxes rise ahead of profile to a greater extent.

The Council's recovery scenario (see Box A) would suggest a much smaller deficit than that projected in the SES could materialise. Under this scenario, government revenue (particularly income tax and corporation tax) could exceed forecasts in *SES 2021*. Spending on income supports (such as the PUP) could be much lower than assumed in *SES 2021*. Combining these two impacts, a deficit of 7 per cent of GNI* could materialise under the recovery scenario (Table A2).

[12] Resuming normal services while patients are being admitted for Covid-19 on an ongoing basis may increase the overall cost of providing services to patients.

Additional short-term risks related to Covid-19 and government supports

Other risks over the short term relate to Covid-19 related uncertainties. Further increases in infection rates or the emergence of new, immunity-escaping variants represent obvious risks to the economy.

Further to this, there is uncertainty around the continuation of Governmental business supports, both in terms of duration and coverage. For example, the extent to which support schemes, particularly those that are more costly on a weekly basis such as the EWSS, are benefiting unviable firms is difficult to estimate but represents a risk as supports are tapered off over the coming months. Similarly, firms that could ultimately demonstrate viability, for example those in the tourism sector or areas that may take longer to return to their pre-Covid-19 levels, may fail if supports are unwound too quickly.

Lastly, there remains a risk that supports initially designed to be temporary in nature become permanent. One example of such a policy in the past has been the decision to implement 'temporary' VAT cuts that ultimately may take many years to reverse.[13]On the other hand, a premature withdrawal of government supports for businesses in 2022 could result in viable firms failing.

[13] The VAT cut for the hospitality sector legislated in response to Covid-19 has already been extended to the end of 2022, at an estimated cost of €350m, while the cut to the higher rate, initiated in 2020 has been discontinued. A VAT cut for the hospitality sector enacted in 2011 ran to 2019, well beyond its scheduled initial expiration date of 2013.

3. The Fiscal Stance for Budget 2022

In this section, the Council assesses the prudence of the Government's overall fiscal stance ahead of *Budget 2022*. It is informed by (1) a broad economic assessment that considers how to appropriately manage the economic cycle as well as the sustainability of the public finances; and (2) an assessment of compliance with the legislated domestic and EU fiscal rules.

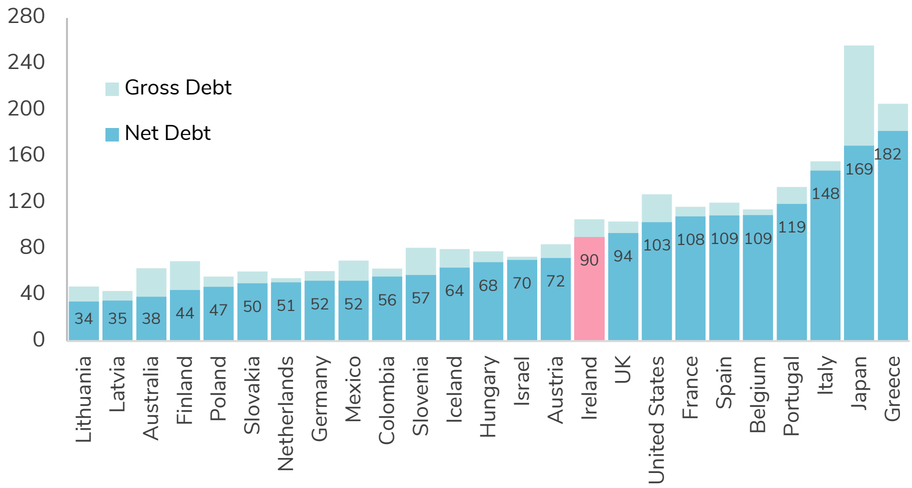
Budgetary supports for Covid have been broadly appropriate

To date, the Government's response to the crisis has been appropriate in terms of providing sizeable temporary supports funded by large deficits and substantial increases in government debt. Indeed, the supports may have halved the contraction in real GNI* in 2020 (Fiscal Council, 2021). They also reflect an appropriate decision to support the economy through a downturn — a rare and welcome example of countercyclical fiscal policy that the State has been largely unable to follow in the past.

The Council assesses that the immediate fiscal costs associated with Covid-19 could remain significant in the months ahead, but that they are prudent and necessary to avoid lengthening and deepening the economic crisis.

Figure 12: Ireland has one of the highest net debt ratios in the OECD

% GDP (% GNI* for Ireland), general government basis, end-2020



Sources: Eurostat; CSO; IMF (April WEO); 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.

The Government's net debt ratio going into the crisis was already high. At the end of 2020, the Government's net debt ratio was 90 per cent of GNI*.

This put it as the tenth highest in the OECD (Figure 12). When compared against other high debt countries, Ireland is now slightly lower than it would have been prior to the pandemic. This reflects the fact that other countries saw a sharp rise in their debt ratios following Covid-19 and that the income shock impacted the denominator (GDP or GNI*) differently across countries. It remains to be seen what impact the pandemic will have on relative debt ratios.

Large permanent spending increases outside of Covid measures were not appropriate

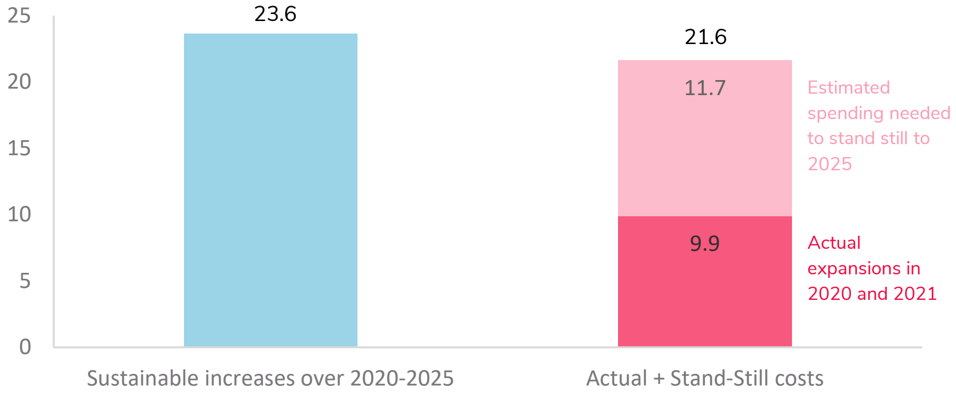
The Government introduced large permanent increases in spending in *Budget 2021*—outside of costs associated with the pandemic—that were not prudent. In 2021, these increases amounted to at least €5.4 billion and they were set out without long-term funding to offset them. The increases could be as high as €8 billion once non-Exchequer spending is considered. There continues to be little transparency around non-Exchequer areas of spending, which the SPU and the SES have not addressed.

The Government has effectively committed much of the benefits to the public finances from growth, in terms of sustainable revenue increases, for many years to come. The permanent budgetary expansions in both 2020 and 2021 combined amount to almost €10 billion. The Council estimates that some €11.7 billion will be needed over 2022 to 2025 just to maintain existing public services and supports. Taken together, this suggests some €21.6 billion is required just to absorb the permanent spending introduced in 2020 and 2021 and to accommodate pressures on existing levels of services out to 2025 (Figure 13).

Ignoring the cost of temporary supports, the pace of expansion in permanent budgetary measures has been rapid. If a policy of increasing policy spending in line with sustainable growth rates had been followed from 2019 to 2025, this would be estimated to have entailed some €23.6 billion of resources being available as the proceeds from sustainable growth in the economy and revenues. This suggests that there is almost no scope left for budgetary expansions over the next three years without imparting a larger structural deficit than was run in 2019.[14]

Figure 13: Large permanent spending increase in 2021 commits sustainable growth benefits for years to come

€ billions, policy spending (net of new tax measures from 2020)



Sources: Department of Finance (*SPU 2021* and SES 2021 projections); and Fiscal Council workings.
Notes: Starting with the level of policy spending in 2019, the figure first shows what sustainable increases would amount to if expanded in line with estimated potential growth rates of 3 per cent plus projected HICP inflation (1.7 per cent p.a.). Second, the figure shows actual policy spending increases in 2020 and 2021 net of tax measures, as well as the estimated Stand-Still costs for 2022 to 2025 — the cost of maintaining existing levels of services while allowing for price and demographic pressures.

The Council assessed that the permanent spending increases in 2021 outside of Covid-related supports were not appropriate, given the scale of the expansion and the fact that permanent funding sources were not identified.

Summer Economic Statement set out large deficits for years to come

The Government plans to run large deficits over the coming years, meaning a slower pace of debt reduction from current high levels.

The increased medium-term spending reflects three factors:

1) a strategy of factoring in the full cost of maintaining existing commitments. This is referred to as the "Existing Level of Services" and is broadly akin to the Council's "Stand-Still" costs.

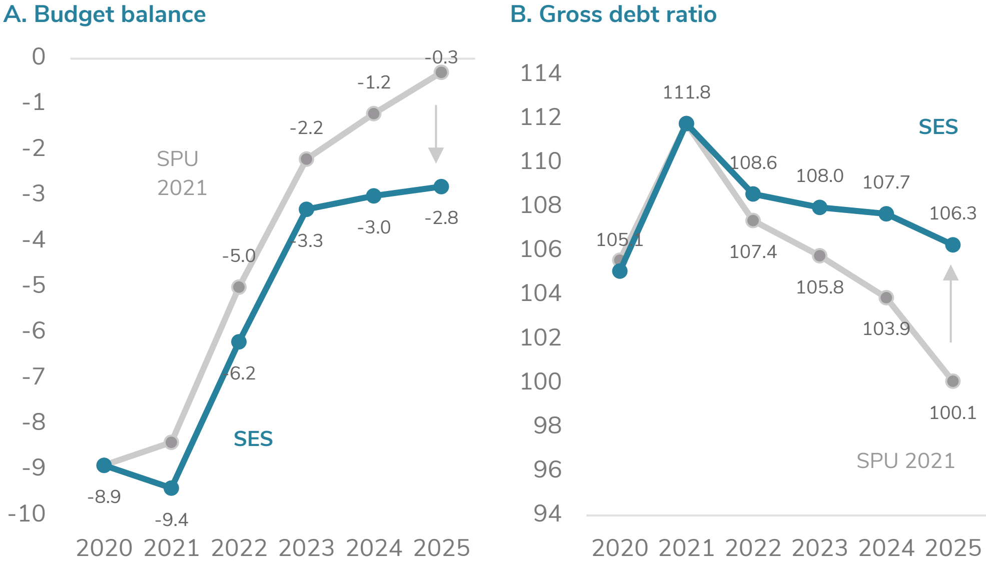
[14] Box I of the May 2021 *Fiscal Assessment Report* noted that there was likely to have been a small structural surplus of about 0.7 per cent of GNI* in 2019 prior to the crisis. This was expected to deteriorate in subsequent years, regardless of the pandemic's effects, in a scenario where excess corporation tax receipts unwound.

2) a decision to grow "core" current spending—that is, excluding Covid-related spending—in line with the economy's estimated "trend growth rate" from the current base.

3) a decision to revise up capital spending.

Figure 14: The Government now plans for larger deficits and debt ratios

% GNI*, general government basis



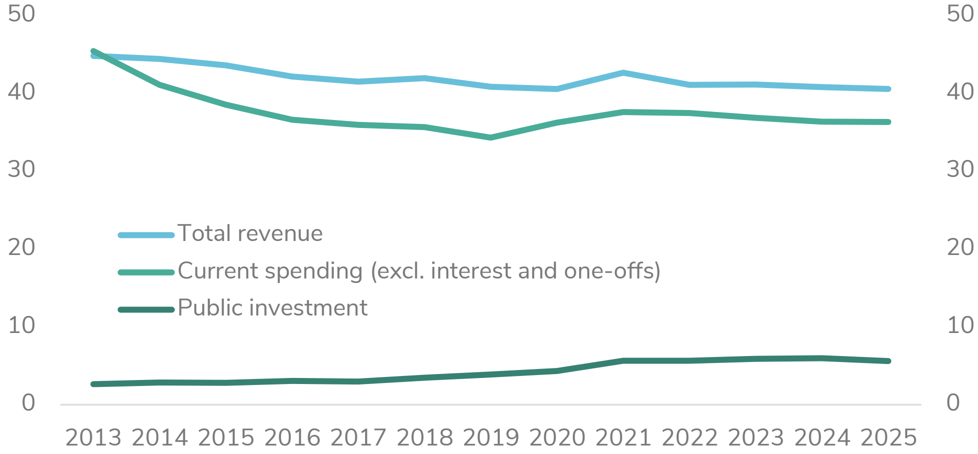
Source: Department of Finance projections (*SPU 2021* and *SES 2021*).

Official forecasts suggest that the debt ratio will remain high at 106.3 per cent of GNI* by 2025 (Figure 14). Furthermore, this implies that the debt ratio would barely fall and would remain on a broadly unchanged trajectory, declining in 2025 by just 1.4 percentage points compared with declining by 3.8 percentage points in 2025 in the SPU projections.

The additional spending reflects the Government's stated desire to increase spending in areas such as climate, housing and health, while maintaining existing levels of services and supports. The SES plans would be consistent with revenues remaining around 40.6 per cent of GNI* by 2025, close to their 2019 level of 40.9 per cent. Yet current spending would rise to about 36.3 per cent from 34.3 per cent in 2019. Capital spending would rise from 3.9 to 5.6 per cent (Figure 15). As the SES gives no detail on specific spending areas nor on specific tax measures planned, it is difficult to assess the impact on the economy and public finances. In addition, the Housing for All Plan gives limited detail on the timing and nature of additional expenditure planned. More information is needed from the forthcoming updated National Development Plan, and the Climate Action Plan to assess the impact of the Governments plans on the economy and public finances, as well as how they reach the Government's objectives.

Figure 15: Revenues to fall as spending rises

% GNI*, general government basis

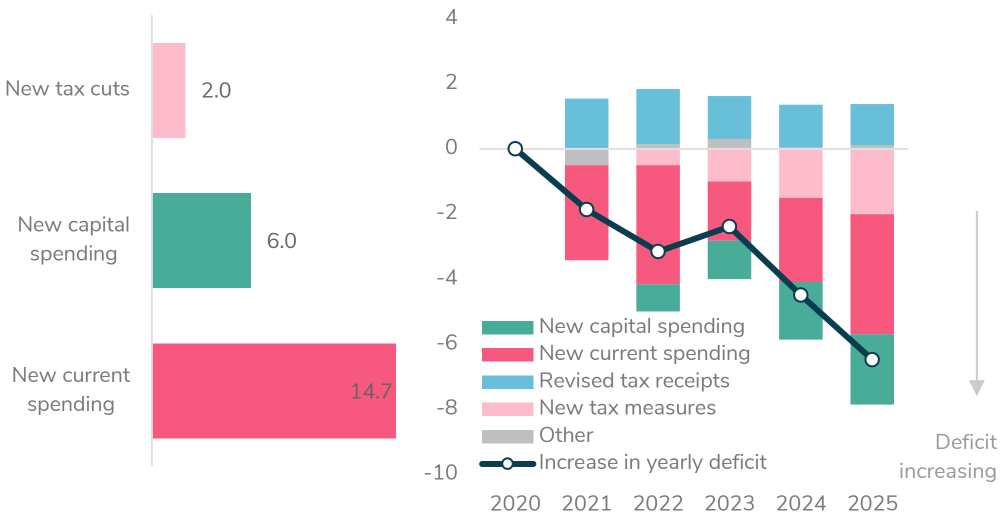


Source: Department of Finance projections (SES 2021); CSO; and Fiscal Council workings.

Based on the limited information provided in the SES, the upward revision to the deficit is predominantly driven by higher current spending. Current spending over the period 2021 to 2025 is now planned to be €14.7 billion higher than was suggested by April's SPU; capital spending is to be €6 billion higher; and there is to be €2 billion of new tax-reducing measures. As such the larger deficits can be said to be driven by upward revisions to current spending, a lot of which reflects more realistic forecasting of pressures to maintain existing levels of services (Figure 16).

Figure 16: Larger deficit mainly due upward revisions to current spending

€ billions, difference between SES and SPU

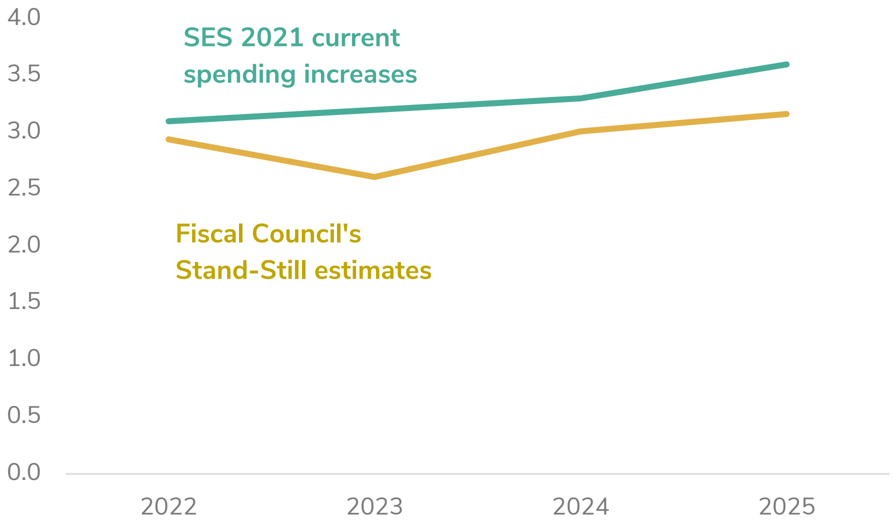


Source: Department of Finance projections (SPU 2021 and SES 2021).

The practice of taking into account the costs of maintaining existing service levels, absent explicit policy decisions to cut services, provides a more realistic basis for fiscal projections and should be continued in the future. Taking these costs into account and having clear spending targets could help in making expenditure ceilings credible, avoiding the necessity for upward revisions to simply maintain existing spending levels or implement government policies.

Figure 17: Current spending will increase above "Stand-Still" costs

€ billions, annual changes



Source: Department of Finance and Fiscal Council workings.
Notes: The Stand-Still estimates exclude temporary costs associated with Covid-19 in both unemployment, health and other areas. The estimates project the costs associated with holding existing levels of service constant in real terms while adjusting for price and demographic pressures.

The SES included greater detail than previous forecasts on the assumed costs of demographic changes and the provision of "Existing Levels of Services (ELS)". There are indications that around €2.1 billion has been set aside for these purposes in 2022. This is greater than the €1.1 billion previously allocated for these costs as part of *Budget 2021*. The amount is based on an estimate by the Department that 3 per cent growth of core current expenditure is typically required to cater for demographic and price pressures.

However, there is little detail on how this figure was derived, especially with respect to the assumed cost breakdown of prices and demographics, or how it is assumed to evolve, particularly as additional policy measures are introduced into the spending base over the coming years. The Department of Finance has indicated that should eventual ELS costs fall short of this pre-committed amount, the residual will increase the resources available to fund new measures. In addition, the SES provides explicitly for budgetary measures over and above these increases to fund ELS, worth €1 billion per year.

The expansion in capital spending is large. The level of capital spending now planned for, at €13.6 billion in 2025, is large and exceeds the €7.4 billion deficit planned for in 2025. As such, the Government strategy could be assessed to be to fund its capital spending through borrowing. Gradually reducing general government public investment to the Government's previously targeted rates of about 4 per cent of GNI* over the medium term would imply an improvement in the deficit of up to 2½ percentage points.

The Fiscal Stance for Budget 2022

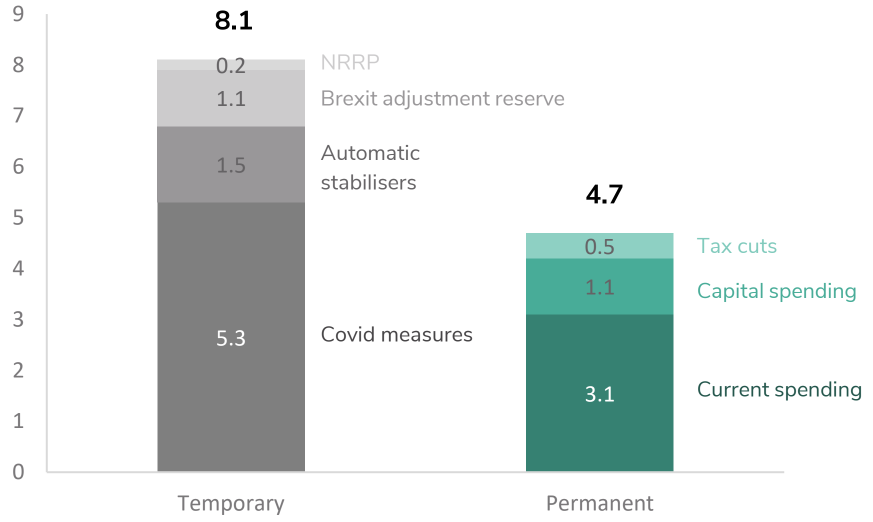
Looking ahead to *Budget* 2022, the SES set out €12.8 billion of budgetary measures for 2022. This mainly comprised €8.1 billion of temporary measures, though there are also €4.7 billion of permanent measures planned (Figure 18).

For 2022, the temporary measures primarily relate to €6.8 billion of additional measures related to Covid-19.[15] Most of this may not ultimately be required, but it is prudent to incorporate a contingency. The Covid-related buffers comprise €2.8 billion in a "reserve fund" to meet any further challenges emerging from Covid-19; €1.5 billion for "automatic stabilisers", costs associated with unemployment being above pre-pandemic levels; and €2.5 billion to help deliver public services should other costs arise related to public health recommendations. In addition to that, there is additional temporary spending related to funding received through the EU under the Brexit Adjustment Reserve (€1.1 billion) and the National Recovery and Resilience Plan (€0.2 billion).

[15] This includes the automatic stabilisers as a cost associated with Covid-19.

Figure 18: Large temporary and permanent supports planned for 2022

€ billions



Sources: Department of Finance (SES 2021); and Fiscal Council workings.
Notes: NRRP refers to the National Recovery and Resilience Plan.

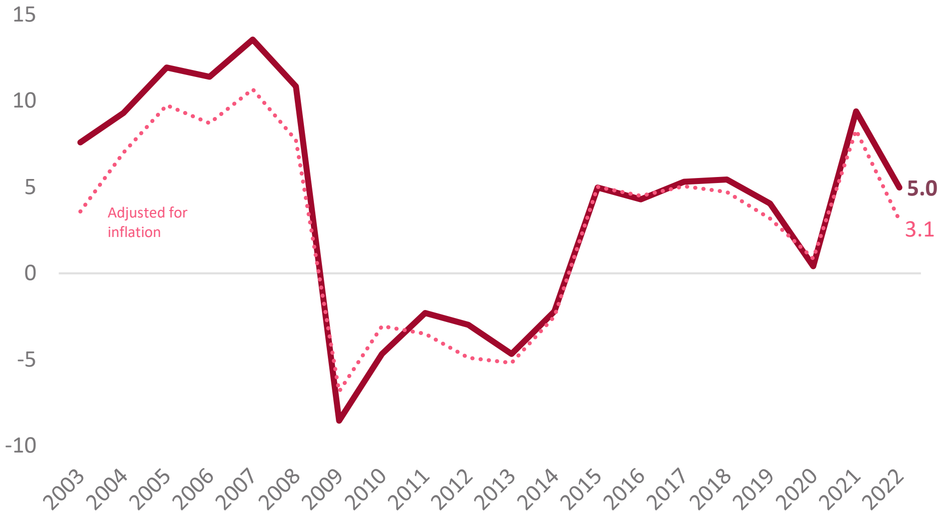
In terms of "core" or permanent measures, the Government plans to increase its level of voted permanent spending by €4.2 billion in 2022 from €75.9 billion to €80.1 billion (+5.5 per cent), while also cutting taxes by €0.5 billion. The spending increases reflect a €3.1 billion (+4.7 per cent) increase in current spending and a relatively fast €1.1 billion (+11.2 per cent) increase in capital spending. It is unclear what specific tax areas will be cut. The €500 million of tax cuts now planned contrast with previous projections, including the SPU's, which suggested net increases in tax of €650 million for 2022. The Programme for Government noted that "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 would limit the degree revenues increase with earnings by a similar amount, but it is not clear whether these are linked.

The larger-than-planned increase in current spending next year mainly reflects the Department introducing more realistic assumptions about the cost of maintaining existing supports and services. This more realistic approach is welcome and should be continued into the future. The Council has been recommending that more realistic assumptions such as these be implemented for a long period of time to allow for better budgeting of what will ultimately be required to maintain existing services.

The increase in capital spending for 2022 is broadly consistent with previous plans, including the level of capital spending earmarked in the *National Development Plan 2018–2027*.

Figure 19: Net policy spending excluding investment rising quickly

% change year-on-year



Sources: Department of Finance projections (SES 2021); CSO; and Fiscal Council workings.
Notes: Net policy spending is a measure of spending that attempts to assess the Government's overall fiscal policy stance. It represents overall general government spending excluding temporary factors like one-offs and spending on unemployment benefits that are not likely to be long-lasting. It also recognises the role of tax changes: a rise in net policy spending is offset by tax-raising measures but is added to by tax cuts. The measure "adjusted for inflation" uses HICP inflation to derive a real series.

The pace of permanent budgetary expansion set out in the SES is fast by historical standards. If assessed on a net policy spending basis, and stripping out public investment spending, the pace of expansion is 5 per cent. This is equivalent to the fast increases seen over 2015–2019, which averaged 4.8 per cent per annum (Figure 19). It also means that, for the three post-pandemic years, growth in underlying net policy spending will have averaged 4.9 per cent — effectively unchanged from the speed of growth preceding the crisis. However, this partly reflects higher price inflation. When adjusting for inflation, the growth rate for 2022 at 3.1 per cent would be below the 4.5 per cent average seen over 2015–2019.

In terms of the appropriate stance for 2022, the Council assesses that some of the temporary income and job supports will necessarily continue as certain sectors require ongoing support to alleviate the impacts of the pandemic. There are declining numbers of claimants on PUP, while the scheme is planned to end along with the EWSS scheme in 2022. It is also likely that health-related costs will normalise somewhat next year. Revenue difficulties in transport and educations sectors should also ease. As such, the €6.8 billion of expenditure set aside for Covid-related supports would appear more than sufficient to cater for the costs likely to be incurred next year and is a welcome contingency measure to include.

If the economy recovers strongly, as the Council anticipates, a large-scale, untargeted stimulus would not be needed. Instead, the Council assesses that 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.

Beyond the supports to sectors most vulnerable to the pandemic, the Council previously assessed that there would be no room for additional budgetary commitments without offsetting tax or spending changes beyond existing commitments and Stand-Still costs. This reflected the fact that large permanent spending commitments made in *Budget 2021* had already used up much of the space that a growing economy would sustainably generate, while still bringing the budget deficit down and reducing debt at a steady pace.

The pace of expansion in permanent budgetary measures for 2022 looks to be at the limit of what might be considered prudent. Several factors are relevant here: the rapid expansions already pursued in recent years, the likelihood of a strong recovery, and the need to set high debt ratios on a steady downward path. These factors would suggest that the expansion planned for 2022, a permanent expansion modestly above estimates of the underlying potential growth rate of the economy, would be appropriate and would help to support the recovery.

The Government's medium-term fiscal stance

The Government has set out several new commitments for how it will manage the public finances over the medium term. First, it commits to stabilise, and reduce slightly, the debt-income ratio in the coming years. Second, it sets up a new spending rule for permanent voted spending. Third, it has committed to only borrowing for capital investment from 2023.

The new commitments are welcome in principle and the Council has sought commitments to this effect in the past. In particular, the Council assesses that spending ceilings could help to anchor budgetary expansions to a more sustainable path, especially when coupled with more realistic forecasts of pressures on spending as set out in the SES.

However, the Government's commitments remain somewhat vague and need further development if they are to lend a credible framework for ensuring sound management of the public finances and the economy. As currently implemented, the spending ceilings risk locking in large structural deficits into the medium term. This is due to the fact that the ceilings focus solely on aligning current voted spending—about 70 per cent of general government outlays—with the economy's "trend" growth rates. The approach ignores the role of tax cuts and increases in other spending areas. Such an approach would not ensure that debt ratios fall to safer levels at a steady pace. Moreover, by not recognising the risks around debt sustainability and by focusing solely on a relatively narrow measure of the public finances, the spending ceilings cannot serve as a useful anchor in and of themselves. In this respect, the debt commitments are vaguely defined. They only refer to an objective of stabilising and slightly reducing debt, with no specific targets or timeframes.

Box B explores the Government's new commitments. It sets out the weaknesses with Ireland's budgetary framework in the past and areas where further development is needed in relation to the newly proposed spending rule.

Box B: The Government's new spending rule is welcome but needs work

With the Summer Economic Statement, the Government committed to a new expenditure rule. This is something the Council had been recommending for several years.[16] This box examines the recent experience with Ireland's medium-term expenditure framework as well as international experience of expenditure frameworks, in light of the new expenditure rule and highlights some shortcomings with the new rule.

A credible medium-term expenditure framework, together with realistic costing helps to make explicit the cost of current budgetary decisions into the future. Anchoring medium-term spending (net of new tax measures) to a sustainable growth rate of the economy can help to ensure prudent fiscal policies and to prevent expenditure drift, provided that changes in spending and sustainable revenues are well aligned and there is not a large structural deficit or debt sustainability problem to begin with.

Ireland has had a statutory medium-term budgetary framework since the Ministries and Secretaries (Amendment) Act 2013. This was a reform instituted after the crisis years to correct a major shortcoming in policy formulation prior to the financial crisis. A discussion document on reforming Ireland's budgetary Framework post financial crisis noted that, in the years leading up to the financial crisis, there was not enough control of medium-term spending:

> *"The challenges in restraining expenditure growth were rooted not in any deficiency in the annual expenditure management processes – in fact the annual Estimates of Expenditure, as voted by the Dáil, were adhered to quite closely each year. Instead,* ***the shortcomings lay in the almost complete focus being placed on the first year's spending plans, with the multi-annual dimension of expenditure planning often seen as indicative, non-binding and subject to future budgetary processes****",*
>
> (Department of Finance, 2011).

Figure B1A shows the Government's repeated pattern of large spending overruns in the run up to the financial crisis. A similar pattern has been evident since the medium-term expenditure framework was introduced in 2013 (Figure B1B). Spending has exceeded initial ceilings by on average 7.3 per cent since 2015. It is clear that there continues to be an almost complete focus on one-year-ahead spending plans, while the medium-term ceilings continue to be "seen as indicative, non-binding and subject to future budgetary process". [17]

Despite the introduction of the medium-term expenditure framework, increases since 2015 have been of a similar magnitude to those prior to the financial crisis.[18] This has also been coupled with deficiencies in controls on spending levels within the year. Large within-year overspends have been evident in recent years —something which was not persistently the case prior to the financial crisis.

It is clear that Ireland's medium-term spending framework has not been working. It was envisaged at the time of its introduction, that the 2013 expenditure framework would be based on

[16] See, for example, Fiscal Council (2018a, p,29).

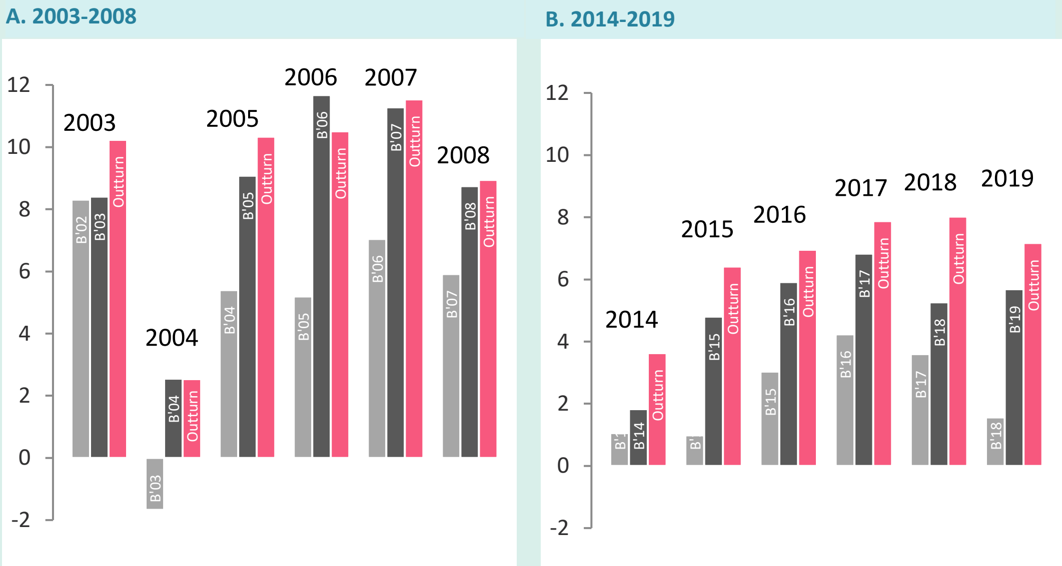
[17] Indeed, the current Minister for Finance (and former Minister for Public Expenditure and Reform) said as much, when speaking to the Oireachtas Committee on Budgetary Oversight on the matter: "I take a different view. If that is the path we go down, we will get to a point where a Minister for Finance in the future will be making decisions on tiny parts of his or her budget. It is the preserve of Ministers.... to be able to decide how they allocate a degree of funding at budget time. Expenditure growth in the future will be higher than the figures to which the Deputy is referring but that will be the result of budget day decisions" (Committee on Budgetary Oversight debate -Thursday, 18 Apr 2019).

[18] For context, inflation forecasts surprised on the upside in 2005-2008, and inflation surprised on the downside in 2014-2019. Had inflation been as forecast, the deviations over the period 2005-2008, would have been relatively lower, while the deviations from 2014-2019 would have been relatively higher.

international best practice. The document itself noted that "the expenditure aspects of budgetary planning would be strengthened through the introduction of a Medium-term Expenditure Framework, based on international best practice", (Department of Finance, 2011). However, the Medium-term Expenditure Framework that resulted from the 2013 reforms is not considered in line with international best practice.[19]

Figure B1: Revisions to expenditure ceilings have been of a similar magnitude to those prior to the Great Recession

% deviation from original ceiling



Sources: Department of Finance; Department of Public Expenditure and reform; 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.

Case study – The Medium-term Expenditure framework of the Netherlands[20]

The Dutch Budgetary framework has long served as a standout example of good medium-term budgeting. The framework is primarily built around medium-term spending ceilings (Vierke & Masselink, 2017).[21]

The Dutch framework works on the basis of what is considered a trend-based mechanism — that is, revenues are allowed to fluctuate over the cycle, without prompting a need to adjust the public finances, but expenditure ceilings must be respected regardless of cyclical developments. This

[19] For instance, Ireland's framework is assessed across five dimensions in a European Commission assessment of the quality of medium-term expenditure frameworks. The quality of Ireland's Medium-term Framework is towards the bottom half of the EU countries, with a score of 0.67. The quality of the medium-term Framework is assessed across five dimensions: 1) the coverage of the spending included under the ceilings; 2) how the medium-term plans relate to the annual budgetary process; 3) involvement of the national parliament in setting the medium-term plans; 4) involvement of independent fiscal institutes in setting the medium-term plans; and 5) the level of detail included in the medium-term plans. See here for further details: https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/medium-term-budgetary-framework_en

[20] See Vierke & Masslink (2017) for a detailed description of the Dutch medium-term expenditure framework and how it relates to the EU fiscal rules: https://ec.europa.eu/info/sites/default/files/economy-finance/eb027_en.pdf

[21] Ireland's framework is built around the annual budgetary process.

trend-based framework is similar to the principle behind the Expenditure Benchmark in the EU fiscal rules. However, under the Dutch Framework the focus is on the *level* of spending rather than on annual growth rates in spending. Spending ceilings are fixed at the start of a government term, and these remain in place for the entirety of the four-year term. This prevents "spending drift" from occurring whereby an overspend in one year can then get carried forward to other years, while still ostensibly complying with individual yearly limits on the pace spending can grow at. Ireland's framework has historically been weak in this respect. Ceilings, both departmental and overall, are revised every year based on outturn data. This means that overspends in previous years typically get baked in for subsequent years and there is no mechanism to re-align spending levels with sustainable increases in revenue.

Figure B2 gives an overview of the Dutch Framework. Prior to elections, medium-term projections set the background for which political parties base their election policies on. These policies are independently costed prior to the election. Once a government is formed, a fully costed programme for government based on the medium-term projections is agreed. This is the basis for the expenditure ceilings that are then in place for the entirety of the government term. Execution of the expenditure ceilings are monitored annually, with corrections on the expenditure side if overruns occur.

Figure B2: The Dutch Framework

Sources: Vierke & Masselink (2017).
Notes: The CPB is an independent fiscal institute similar to the Fiscal Council. The SBR is a non-partisan national advisory group on budgetary policy. The DNB is the Dutch Central Bank. The MLT is the medium-term projection.

Ireland's newly proposed expenditure rule

The introduction of the new spending rule is an opportunity to strengthen Ireland's medium-term budgetary framework. The new spending rule was set out in the *Summer Economic Statement*:

> *"Over the medium term out to 2025, anchoring core expenditure growth to an appropriate trend growth rate for the economy of c. 5 per cent can provide a pathway back to a more sustainable budgetary position, while also providing the necessary resources to enhance our public services, social supports and infrastructure."*
>
> (*Summer Economic Statement*, 2021).

The Council welcomes the adoption of an explicit spending rule for the medium term based on sustainable growth in the economy and revenues. This should help to ensure a better medium-term budgetary anchor is in place to help with prudent management of the public finances. Combined with more realistic fiscal projections that properly reflect the future cost of providing existing levels of public services and welfare rates (including pensions as the population ages) should help to avoid the need to revise the spending ceiling systematically.

However, there are still some aspects of the proposed rule that should be clarified and developed. The expenditure rule should seek to have the following features:

1) Under the assumption that a trend growth rate of the economy is about 5 per cent, growing expenditure by 5 per cent would only be sustainable provided that there were no additional

tax cuts.[22,] However, on top of the 5 per cent growth in core expenditure, the Department have also incorporated tax cuts of €0.5 billion per year in their budgetary package. This does not leave the public finances on a sustainable footing, given the Department's own assumption of the trend growth rate of the economy.

2) The new expenditure rule should be put on a statutory footing. Without primary legislation, the rule may be seen as indicative and non-binding and this would increase the likelihood that ceilings repeatedly get revised, repeating the mistakes of the past.
3) The trend growth rate should be better informed by the expected potential growth rate of the economy, together with projections of inflation. The Mid-year Expenditure Review (MYER) outlines how the trend growth rate was set, by looking at historical GNI*, PRSI and tax revenue growth rates.[23] However, past growth rates are no indication of future growth rates, and as such should not be used to inform future spending limits.[24]
4) Due to recent imprudent increases in permanent spending included as part of *Budget 2021*, sticking to the current spending rule is likely to lock in a higher path for spending than would have been the case if the rule had applied before the pandemic. This risks the Government also locking in a structural deficit over the medium term. However, the rule should also ensure a steady medium-term pace of debt reduction is achieved, which would be consistent with a smaller structural deficit. This link to debt sustainability is something that is missing from the rule as it is operationalised.
5) The expenditure rule appears to only cover "core" Exchequer spending. The expenditure rule should be on a whole of government basis or "general government" basis. This would ensure that close to one fifth of government spending does not get excluded from the rule. The spending currently left out includes local government spending and spending by public sector bodies such as approved housing bodies.[25] If expenditure in areas outside of the Exchequer grows by more than the 5 per cent limit, this could lead to imprudent increases in general government expenditure.
6) At the moment, it is not clear how spending overruns are to be dealt with. Past precedent has been to simply revise up ceilings when overruns occur. There should be an explicit statement in *Budget 2022* outlining how overruns are to be dealt with. Overruns in one year should be either offset by offsetting new revenue-raising measures or by a corresponding lower growth rate in the following year so that the level of spending (adjusted for revenue raising measures) remains on a sustainable path.[26] This could be better formalised by setting the expenditure rule in levels of expenditure (adjusted for revenue raising measures), instead of growth rates.

---

[22] Growing expenditure in line with the economy's trend growth rate can help ensure that the public finances are on a sustainable footing, provided that sustainable revenues grow in line with the trend growth rate of the economy. This is often a reasonable assumption provided that policy does not change. However, introducing tax cuts would mean that revenues grow below the trend growth rate of the economy, which creates a divergence between changes in spending and sustainable revenues. To ensure that the public finances are on a sustainable footing, if tax cuts are implemented, expenditure should grow by a correspondingly lower growth rate than the trend growth rate. On the other hand, tax-raising measures should allow expenditure to grow by a corresponding higher growth rate.

[23] See here for details: https://www.gov.ie/en/collection/d2e199-mid-year-expenditure-reports-myer/

[24] This is particularly the case when the past growth rates used incorporate a period in which corporation tax performed above what can reliability be explained by the underlying domestic economy. As such, using such growth rates is not a reliable indicate of the future sustainable growth rate of the economy.

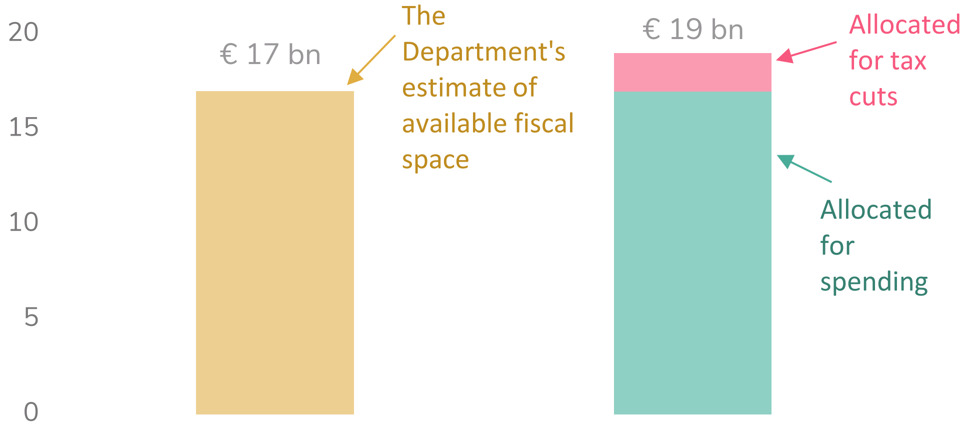
[25] In addition, the debt, deficit, expenditure, and revenue figures for the fiscal rules are all assessed on a general government basis.

[26] In recent years, spending overruns have been masked by unexpected corporation tax receipts, meaning that these overruns were not reflected in worsening deficit figures (See Box D of the *November 2018 Fiscal Assessment Report*; Fiscal Council, 2018b).

The Government has committed to using more fiscal space than its spending rule would suggest is available.[27] The Government's assumption underpinning the new spending rule is that the trend growth rate of the economy is close to 5 per cent (see below for why this is not necessarily a prudent assumption). This would create fiscal space of €17 billion over the period 2022 to 2025 (Figure 20). However, the Government appears to have allocated €19 billion for budgetary measures over this period, with €17 allocated for spending increases and €2 billion allocated for tax cuts.

Figure 20: The Government has committed to using more than the available fiscal space for 2022-2025

€ billion



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.

As Figure 21 shows, the path for policy spending net of new tax measures set out in the SES looks to be high. This reflects the increases in permanent spending introduced in 2021 and the plan to now grow this higher spending base at a rate of approximately 5 per cent annually. Ultimately, it suggests that net policy spending levels will end up slightly above a hypothetical path where policy spending in 2019 had been increased consistently by 5 per cent annually (ending up about €1 billion or 0.9 per cent above this path by 2025).

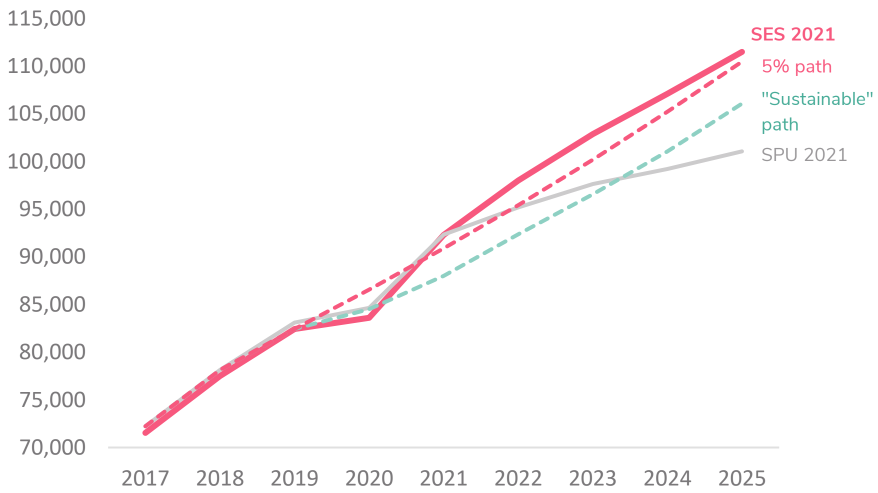
However, the 5 per cent path is questionable as a measure of the sustainable growth rate for the Irish economy. There is no clear justification provided for this pace of growth other than to say that the economy grew at

[27] See the Council's Fiscal Space Calculator for a useful exploration of budgetary resources available and their potential use over the medium term.

this pace in the past (Department of Expenditure and Reform, 2021).[28] The Department of Finance's preferred estimates of potential output growth for the economy average about 3 per cent over the medium term. This would suggest that price inflation across the economy would have to average 2 per cent annually for the 5 per cent path to be sustainable. This looks optimistic. In the five years preceding 2020, core HICP inflation averaged just 0.7 per cent in terms of year-on-year changes. The ECB's target is now a "symmetric" 2 per cent. Inflation has been picking up in Ireland and elsewhere amid the recovery, yet it is unclear to what extent this may be a temporary or more persistent phenomenon. The Department's own projections suggest that inflation will average 1.7 per cent over 2022–2025.

Figure 21: The SES path is more realistic but goes beyond what a sustainable path would suggest

€ billions, policy spending (net of new tax measures after 2019)



Sources: Department of Finance (*SPU 2021* and *SES 2021* projections).
Notes: The chart starts with policy spending in 2019. That is total general government expenditure in 2019 less interest, one-off spending and the estimated savings from unemployment benefits being lower than in an assumed steady state unemployment rate of 5.5 per cent. The paths for policy spending thereafter are produced on a net basis. That is, they take account of changes in policy spending adjusted for discretionary tax measures: reducing the estimated expenditure increase by any offsetting tax-raising measures and increasing it by any tax cuts. The 5% path assumes increases from 2019 for policy spending rose at 5 per cent annually, whereas the "sustainable" increases after 2019 assume that policy spending were to have risen at 3 per cent (consistent with central estimates of real potential output growth) plus the annual rate of HICP inflation using Department forecasts after 2020.

A more prudent assumption for the spending rule would be to base it on actual projections of inflation and the economy's estimated potential growth rate. There are risks to the 5 per cent assumption for trend growth. Future growth is highly uncertain but is likely to moderate as the economy matures

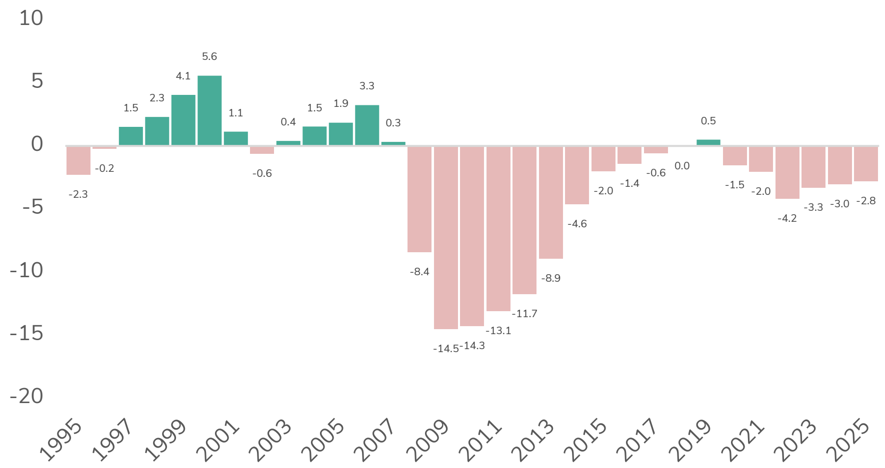
[28] The Mid-Year Expenditure Report (p.12) notes that over 2009–2019, "GNI* showed a compound annual growth rate of 5%, in line with the growth in Exchequer tax revenue and PRSI, with higher growth of 7% for GDP."

and workforce ages (Fiscal Council, 2020), and inflation has tended to fall short of target. Downward nominal adjustments have also proven more difficult to achieve politically than slower spending growth.

The Government's new commitments imply large increases in both current and capital spending as well as a series of new tax cuts over the medium term. These measures are projected to be funded by running larger deficits, as no new tax-raising measures have been identified. The implication is that large deficits will be run for a sustained period of time. As Figure 22 shows, sustained deficits on this scale are unprecedented in the past three decades outside of the financial crisis period when Ireland needed emergency borrowing from the IMF and other official lenders to sustain itself. This will also lead to debt ratios remaining at high levels.

Figure 22: Deficits projected would be large

% GNI*, general government balances (excluding one-off items)



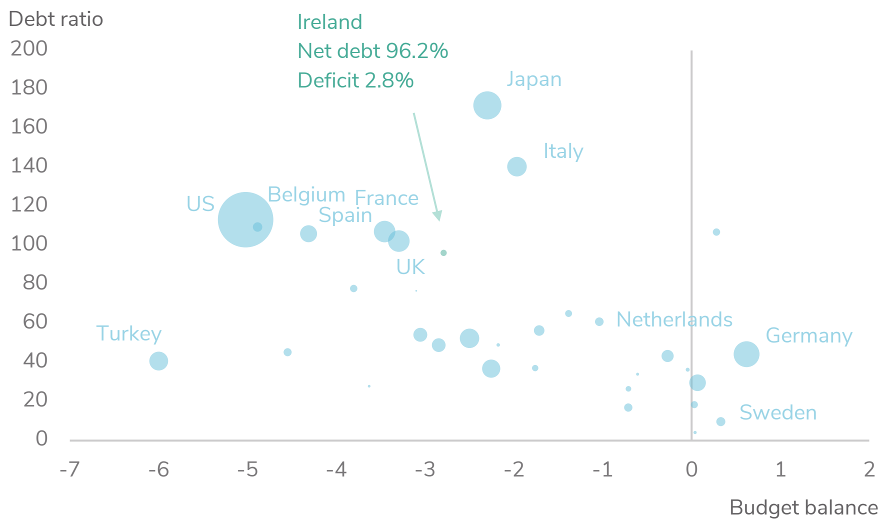
Sources: CSO; Department of Finance (*SES 2021* projections); and Fiscal Council workings.

With the Government now planning on having spending much higher over the medium term, Ireland will have a higher debt ratio in the coming years than previously planned. The SES notes that the Government's new objective is "to stabilise, and reduce slightly, the debt-income ratio in the coming years". This is a riskier approach than the assumption previously set out that the budget could be "returned to broad balance by the mid-part of this decade" (*SPU 2021*, p.3). Balancing the budget in this way, while not an optimal policy in and of itself, would have put the debt ratio on a steady downward path, falling at a rate of around 3 percentage points a year by 2025. The Government's projections suggest that the debt ratio will remain high at 106.3 per cent of GNI* by 2025, compared to SPU projections of a 100.1 per cent of GNI* debt ratio. The deficit would be 2.8 per cent of GNI* as compared to 0.3 per cent in the SPU, hence meaning that the trajectory beyond 2025 would be for a higher debt path also.

Taken at face value, the SES projections would suggest that Ireland's deficit and net debt ratio would be among the highest in the OECD by 2025. This puts Ireland closer to an "outlier" status, particularly as a relatively small economy (Figure 23).

Figure 23: Ireland to be among high deficit, high debt pack in 2025

% GDP (% GNI* for Ireland)

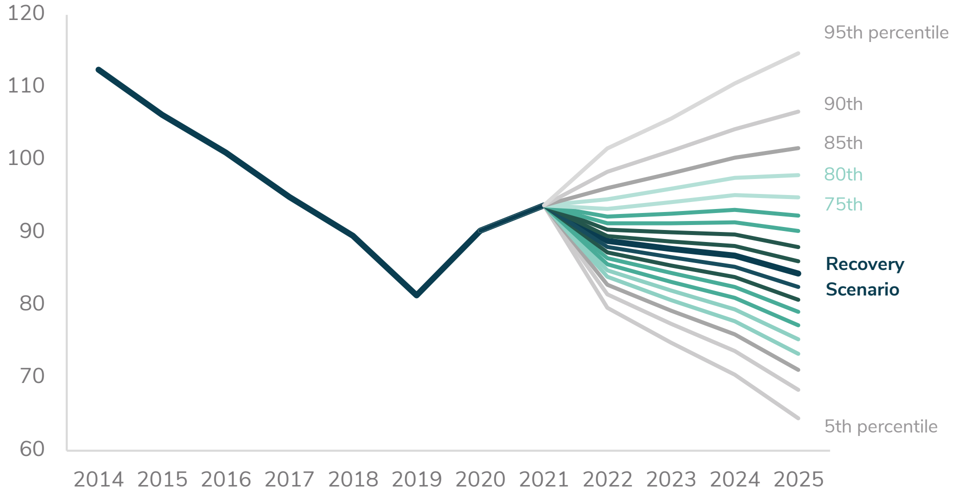


Sources: Department of Finance (SES) projections for Ireland; IMF April WEO forecasts for other OECD countries; and Fiscal Council workings.
Notes: The size of the bubbles represents the level of nominal GDP in purchasing power parity terms, international dollars, with Ireland shown in terms of nominal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

With debt already at high levels, the additional spending planned increases the risks of an unsustainable debt path arising in future — one where debt ratios rise indefinitely from existing levels. Even recognising that growth will likely be stronger than official projections portray and that interest costs have fallen to low levels and are likely to remain low, the risks of debt rising unsustainably increase with higher levels of borrowing. Using the Council's Maq model (Casey and Purdue, 2021), it is possible to assess the probability of various paths for the debt ratio (see Box H of the *May 2021 Fiscal Assessment Report*). Even with the assumptions of a Recovery Scenario, the upward revisions to spending over the medium term increase the probability of the Government finding itself on an unsustainable debt path to about 25 to 30 per cent — a more than one-in-four risk (Figure 24).

Figure 24: One-in-four risk of unsustainable debt path

Gross debt ratio, % GNI*



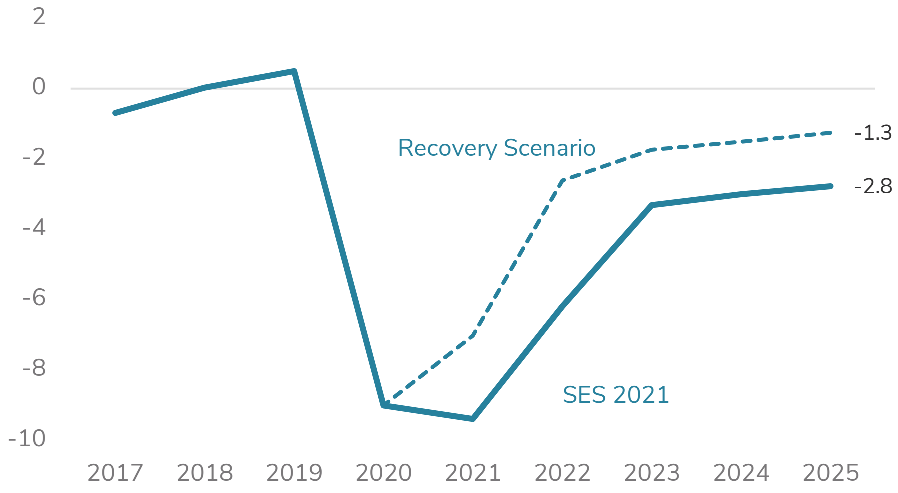
Sources: Fiscal Council workings.
Notes: Each line shows a path for debt dynamics at various percentiles. The "Central" line represents the Recovery Scenario projections. The estimates are based on the Council's Maq model (Casey, 2021).

Using the "Recovery Scenario" set out in Box A, and assuming that the Government sticks to the spending path set out in the SES, it is possible that the deficit could narrow more than is shown in official projections by 2025. Figure 25 shows the SES projection alongside projections based on the "Recovery Scenario". The SES assumes that the deficit will be 2.8 per cent of GNI* by 2025. However, the Recovery Scenario suggests that the deficit could be lower at 1.3 per cent of GNI*.[29] This scenario assumes that corporation tax losses associated with international tax reforms gradually amount to receipts that are lower by €3.5 billion annually — in line with the lower end of the Council's estimates of excess corporation tax receipts (Fiscal Council, 2021).

[29] See Appendix A for detailed figures on the SES and Recovery Scenario fiscal projections.

Figure 25: Smaller deficits could arise in a Recovery Scenario

General government balance, per cent of GNI*



Source: Department of Finance and Fiscal Council workings.
Notes: The Council's "Recovery Scenario" is based on the macroeconomic assumptions set out in Box A, their estimated impacts on revenues and expenditure, and an assumption of higher negative impacts on corporation tax receipts from global tax reforms. The estimated impact is €1.5 billion more than the Department of Finance assumes by 2025 — the Department assumed a €2 billion cumulative impact for its forecasts. This brings the cumulative impact on receipts in line with the lower end of the Council's estimates of "excess" corporation tax receipts at €3.5 billion.

Public investment is set to ramp up quickly

The Government is planning on raising public investment to rates that have little precedent in Ireland's recent history. The rise in investment spending should help the Government to directly address pressures in areas such as health, climate change, and housing.

A sustained period of exceptionally high investment has merits prior to returning to more normal steady state levels of investment. As Box C notes, the case for higher spending in these areas is reasonably strong and interest rates are also low.

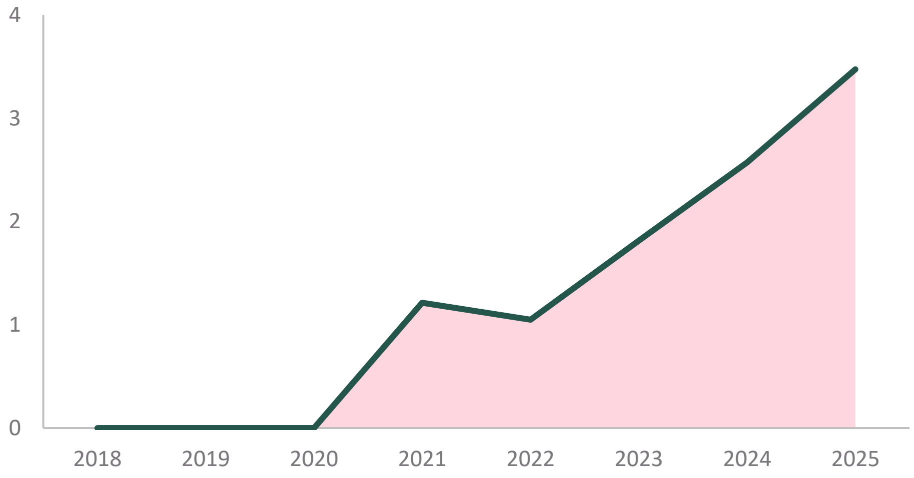
However, the case needs to be made for such a high level of public investment and it should be clear how long this is planned to persist for.

The timing and pace of the Government's planned ramp-up in spending may result in higher costs, poorer outcomes in terms of value for money, and greater capacity constraints without some plan to offset risks elsewhere. There is a risk that the speed of the build-up in Government spending could backfire leading to higher costs for the same level of output should capacity constraints bind. The increased budget deficit should stimulate output but could also mean higher price pressures in later years. This reflects the fact that the stimulus will come as the economy is already recovering. Current spending typically has weaker positive impacts on the economy compared to public investment spending, for example.

Using the Council's Maq model, the Government's plans to run more expansionary budgetary policy over the medium term can be shown to boost economic activity over the coming years (Figure 26). Initially, this would be quite strong, with the level of activity higher by almost 1½ percentage points in 2021. Most of this boost would be in real terms. However, the cumulative 3.5 percentage point impact estimated by 2025, is estimated to instead add predominantly to price pressures in the economy.[30] That is, the additional stimulus is estimated to boost nominal GNI* primarily, only boosting real GNI* to a modest extent as the economy recovers its lost capacity and as unemployment falls.

Figure 26: Higher spending should boost the economy, but could also mean higher price pressures in later years

% deviation from baseline, nominal GNI*



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.

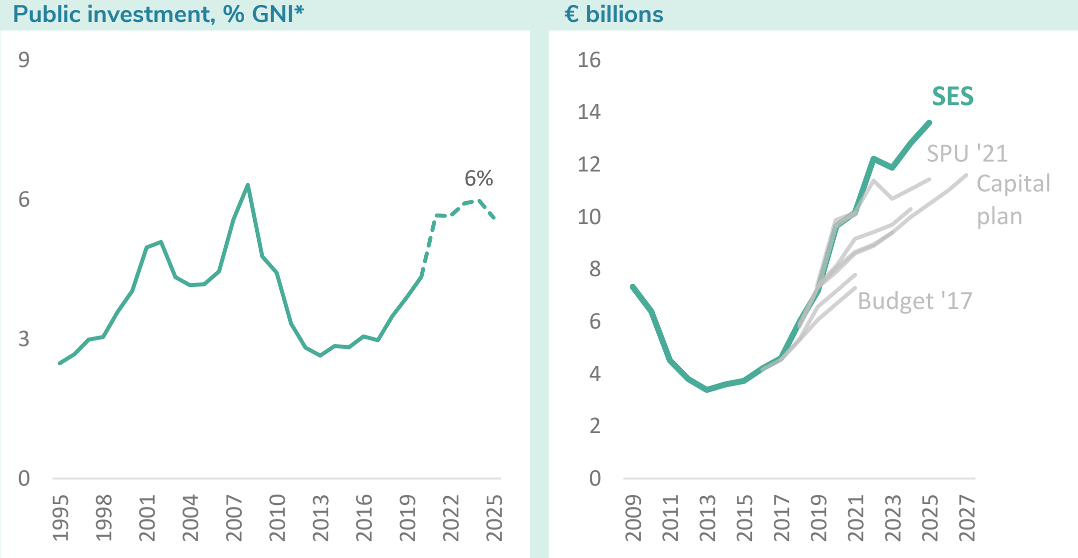
While the expansionary fiscal policy should boost economic activity, most of the short-term gains from the more expansionary budgetary policy are likely to be cyclical. Borrowing to finance investment after the recovery could also lead to inflation and, eventually, overheating. Most notably, supply-constraints in construction may lead to rising prices.

[30] These estimates are similar to those set out in Conefrey, Hickey and Walsh (2021).

Box C: Higher investment helps address priorities but could be costly

The Irish Government plans to ramp public investment spending up to levels not seen in any other period outside of 2007–2008 in the past three decades (Figure C1). The increase will not only take Ireland's public investment spend to one of the highest rates in its history, but also to the fourth highest in the OECD by 2022 and above the median observed across OECD countries during the past decade (Figure C2). Successive Budgets and policy statements have rapidly ramped up planned investment spending; SES plans for spending this year are 40 per cent higher than was set out in *Budget 2017*.

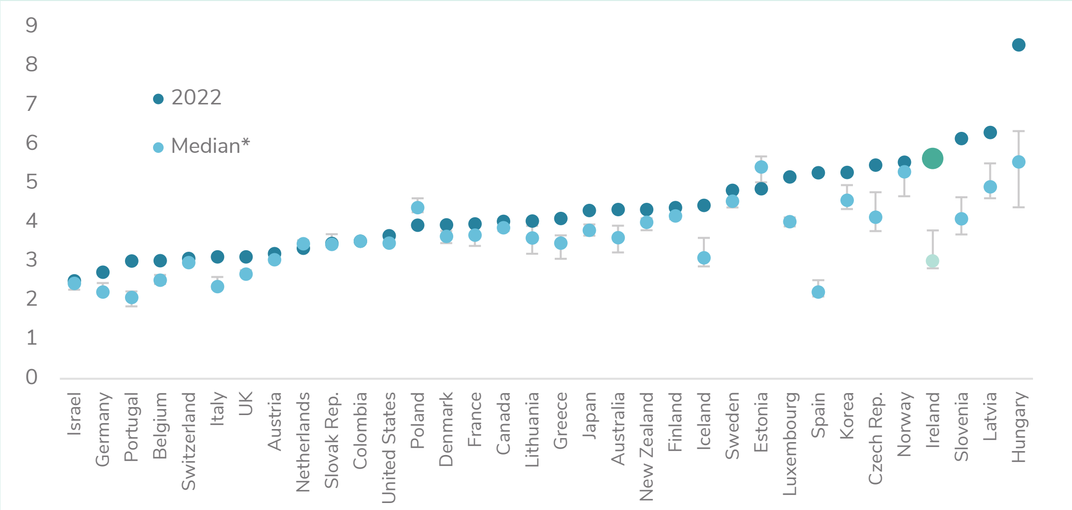
Figure C1: Investment is rising to high levels; well beyond earlier plans



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

Figure C2: Investment will be high by international and historical standards

Public investment as % GDP (GNI* for Ireland), general government basis



Source: OECD; and Fiscal Council workings.
Notes: The median shows the median public investment ratio for the past ten years (2012–2021) and lines the middle 50% (interquartile) range observed over the same period.

The rise in investment spending should help the Government to directly address pressures in areas such as health, climate change, and housing. The case for higher spending in these areas is reasonably strong, given that there are clear needs to address various shortfalls. Interest rates are also low, such that a sustained period of exceptionally high investment has merits prior to returning to more normal steady state levels of investment.

Efficient capital spending should provide benefits to the State in future years, either in the form of a flow of public services or through benefits to the private economy that may flow back to the government in the future through higher revenues. Conceptually, there is therefore an important difference between spending on current services and payments and capital spending in the timing of spending: current services are paid for when they are used, while capital investment requires a payment that is made up front and may require on-going payments to service the interest on the debt accumulated as a result. In a low interest rate environment, it is more attractive to borrow as these interest costs are lower and the marginal return required for investment projects is lower.

However, the speed of the ramp up in investment and the fact that it is planned to be financed by running larger deficits implies risks. One question is whether the planned increase in capital spending is realistic and can be delivered. In the past, investment spending has not always been fully delivered.

More importantly, capacity constraints in construction could see the costs of delivering investments rise. This would threaten the value-for-money assessments of investment projects. There are also wider sustainability risks, given that Ireland's government debt ratio will remain at more vulnerable levels as a result of the higher borrowings.

Two important considerations will be (1) the costs and benefits of the investments and (2) how sustained of an impact they will have on the public finances and the economy.

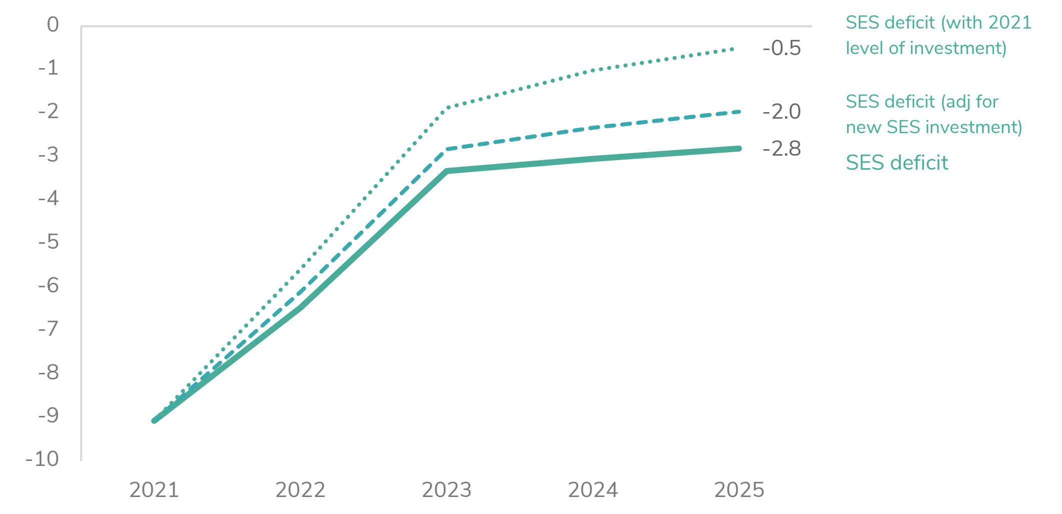
The impact of budgetary supports on growth is one of the most contentious questions in macroeconomics. Returns are notoriously difficult to estimate for various forms of public spending let alone specific investment programmes. Estimates of the fiscal multiplier—the economic impact of public spending—tend to be higher for public investment than other forms of budgetary stimulus. Previous work by the Fiscal Council (Ivory, Casey and Conroy, 2019) using a range of approaches suggests that short-term benefits to growth are indeed higher from investment spending. However, their effects become statistically insignificant after a few years. This chimes with findings elsewhere for Ireland and other countries (Bénétrix and Lane, 2009; Hall, 2010; Giordano et *al*., 2007). As such, it is hard to say with confidence that public investment spending will result in higher growth beyond the short term. Timing also matters. Fiscal multipliers tend to be higher in recessions. For example, Auerbach and Gorodnichenko (2012) estimate spending multipliers to be close to zero in US expansions and as high as 2 or 3 in recessions. This suggests that the benefits to investment may be higher in the early recovery phase but substantially smaller once the economy has recovered. In addition, the nature of the investment is important. More labour-intensive investment, such as in housing, would be expected to be more domestically oriented, with stronger positive growth impacts. However, it could also mean that capacity constraints may be greater. By contrast, more capital-intensive investment, such as infrastructure and equipment, would be less likely to hit these constraints, though many countries are likely to increase investment in these areas at the same time and domestic growth benefits would be less.

Value for money is an important consideration. In its 2017 technical assistance report on public investment, the IMF (2017) assessed that Ireland had shortcomings in the effectiveness of past investment spending. Comparing the quality and quantity of infrastructure to the size of past investment spending (the size of the capital stock per capita), it estimated an efficiency gap of 58 percent compared to the best performing advanced countries. The relatively poor "bang for buck" from public investment in Ireland was assessed to be due to a variety of factors. A proliferation of sector strategies, weak results frameworks, limited information on cost estimates, inadequate links between plans and funding decisions, and a need to prioritise maintenance spending contributed to the assessment. It noted substantial scope for the Irish authorities to adopt policies that will help improve the efficiency of public investment management.

As well as the costs and benefits of individual investments, one should also consider the sustainability of the public finances and the economy. Taking the other SES budgetary plans as given, the rise in investment spending after 2021 originally planned for in the SPU would have implied a deficit of roughly 2 per cent of GNI* as compared to a broadly balance position of about 0.5 per cent if investment had remained at 2021 levels. However, the additional investment set out in the SES means that the deficit is now projected to be about 2.8 per cent of GNI* (Figure C3). The larger deficit also reflects the fact that the SES projections for current spending rise at a more realistic pace sufficient to cover the cost of maintaining Existing Levels of Services, recognising demographic and price pressures. As a result of the additional borrowing, official projections would suggest that the net debt ratio will remain at high levels close to 100 per cent of GNI* out to 2025 and falling at a slow pace.

Figure C3: Planned deficits are accounted for heavily by investment increases

% GNI*, general government balance



Sources: Department of Finance; and Fiscal Council workings.
Notes: The SES deficit path is first adjusted for the newly announced public investment relative to SPU 2021 (dashed line), then for all of the increases in investment relative to 2021 currently planned in the SES, plus the estimated interest costs associated with the additional spending. Note that the 2021 level of public investment at €11.1 billion in general government terms would be broadly consistent with a public investment ratio of just over 4 per cent of GNI* by 2025.

One strategy for the coming years might be to frontload the build-up of the capital stock with a temporary period of unusually high public investment spending. Investment rates could then be returned to more normal historical levels and in line with norms for advanced economies after a period of time, closer to 4 per cent of GNI*, for example, then the deficit would unwind over time.[31] Gross investment would nevertheless need to remain higher than in the past to maintain the new higher level of the capital stock.

This strategy has some merit, especially when interest rates are currently low and the pressures to address longstanding priorities like housing and climate change targets exist. Frontloading some of the spending could also entail efficiency gains if it means less spending being required over the long run, particularly if interest rates are at temporarily low levels. An example of this is in housing where the costs of current spending supports might outweigh the costs of frontloaded capital outlays.

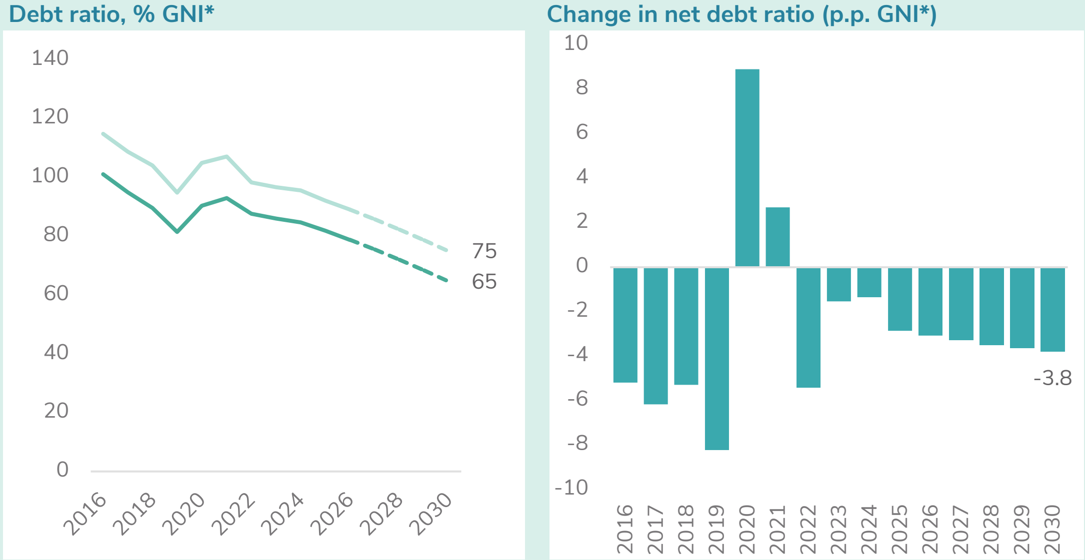
Figure C4 considers an illustrative extension of the Recovery Scenario where public investment rates are gradually returned to a 4 per cent of GNI* rate after 2025. This would be in line with previous targets, including those set out in the National Development Plan, and close to the OECD median. Provided that the Recovery Scenario broadly pans out, with no shocks in the interim, and

[31] A 4 per cent of GNI* investment rate would also be consistent with the original National Development Plan. The Plan projected that public capital investment would reach 4 per cent of GNI* by 2024, with “sustained investment” averaging 4 per cent on an annual basis over the period 2022 to 2027 (Department of Public Expenditure and Reform, 2018).

that other parts of the budget are maintained, the deficit could gradually be closed by the end of the decade. This would mean that the Government's net debt ratio would fall towards 65 per cent of GNI* by 2030, with a steady pace of debt reduction of over 3½ percentage points per annum reached by then.

However, there are risks to this approach. First, with the public debt ratio already high and public investment management historically weak in Ireland, there is a greater need to ensure that future investments generate value for money. Second, many sectors in the economy are expected to recover rapidly in the coming years such that output may rebound to pre-crisis levels quickly and capacity constraints may begin to bite in the construction sector. This could mean higher costs to investment. Third, there are of course risks that shocks to growth in the coming years could arrest the improvement in the deficit, and potentially lead to debt rising again.

Figure C4: A path to gradually reduce exceptional rates of public investment



Sources: Fiscal Council workings.
Notes: The scenario shown is an illustrative extension of the Recovery Scenario wherein public investment rates return to 4 per cent of GNI* by 2030 linearly after 2025. It is assumed that both taxes and current spending are kept constant as a share of GNI* (except for interest costs, which are projected by assuming the average effective interest rate remains constant).

The Government's strategy still lacks key details

The SES made welcome progress in terms of setting out (1) more realistic spending forecasts and (2) a new spending rule to steer policy. These steps come amid longstanding recommendations from the Council to strengthen the fiscal framework. More realistic forecasts provide a better guide to future budgetary policy and the choices that the government faces.

However, there remains a lack of detail around key elements of the Government's plan for the coming years. There are still potentially very large unknowns about expenditure for the coming years.

First, as noted in Section 2, it is unclear how much additional spending might be needed to achieve the Government's climate- and health-related objectives and whether or not the new spending projections set out in the SES allow sufficient scope for these priorities to be addressed. Similarly, while the Housing for All plan sets out a vision for how much funding will be required for housing-related spending out to 2030, it is unclear what impact this will have on wider capital spending. The update of the National Development Plan should provide key information needed to assess the impact of the Government's planned policies and risks, particularly if they are feasible and will be sufficient to meet policy commitments.

Second, there is no indication of how taxes would be adjusted if risks arise with the new plans for the medium term. In this respect, the Council welcomes the Commission on Taxation and Welfare. As the Commission is not due to issue recommendations until July 2022, it is only likely to shape decisions from 2023 onwards and its recommendations would need to be followed through on.

Third, while the Government now plans to run much larger deficits in the coming years, there is no indication as to whether or not this will comply with the fiscal rules. Box D discusses how the application of the "Exceptional Circumstances" clause in the fiscal rules has helped to allow a large fiscal response to the pandemic and examines what issues might arise for compliance with the fiscal rules should they apply formally once again in the near future.

Box D: The SES makes no reference to compliance with the fiscal rules

The public finances are forecast to improve over the medium term as activity resumes, Government revenues pick up and income supports unwind. Yet there is a substantial risk that fiscal rules will not be met due to the recent policy decision to increase permanent spending levels over the medium term, while also introducing new tax cuts.[32] Indeed, the SES makes no reference as to how the Government's new budgetary strategy will be compliant with the fiscal rules.

In light of the Covid-19 pandemic, the Council deemed that "Exceptional Circumstances" existed in 2020 and will continue throughout 2021. The Exceptional Circumstances clause allows for a deviation from the requirements under the Domestic Budgetary Rule. Activation of the clause was

32 While the government has committed to increasing capital spending in its new budgetary package, by and large, the fiscal rules make no distinction between capital and current spending. As such, under the current EU fiscal rules, no allowance will be made for increases in spending that relate to capital spending. It is also unlikely that any increases in capital spending will be treated as part of the structural reform clause in the EU fiscal rules.

appropriate and necessary to ensure that the Government could provide the necessary support to the economy throughout the pandemic.

Similarly, the European Commission activated the general escape clause in 2020, which allows for deviation from the requirements under the EU fiscal rules. The Commission have indicated that this will remain in place until 2022, and then be deactivated in 2023.[33]

Due to the continued exceptional circumstances, the Domestic Budgetary rule will not be met in 2021, with the SES forecasting a deficit of 5.1 per cent of GDP. Based on SES forecasts, it is likely that the debt rule will also not be met in 2021, with a debt-to-GDP ratio of 60.3 per cent, above the 60 per cent of GDP reference value in the SGP.

In 2022, the debt ratio is forecast to fall to 58.9 per cent of GDP, below the 60 per cent limit. The deficit is forecast to fall to 3.4 per cent of GDP, however this is still greater than the 3 per cent reference value in the SGP.

The structural balance will not be at the Medium-term Budgetary Objective (MTO) in 2023, and as such, there will be a requirement to improve the structural balance in 2024 and 2025. Based on current forecasts, there will be no improvement in the structural balance over 2024-2025.

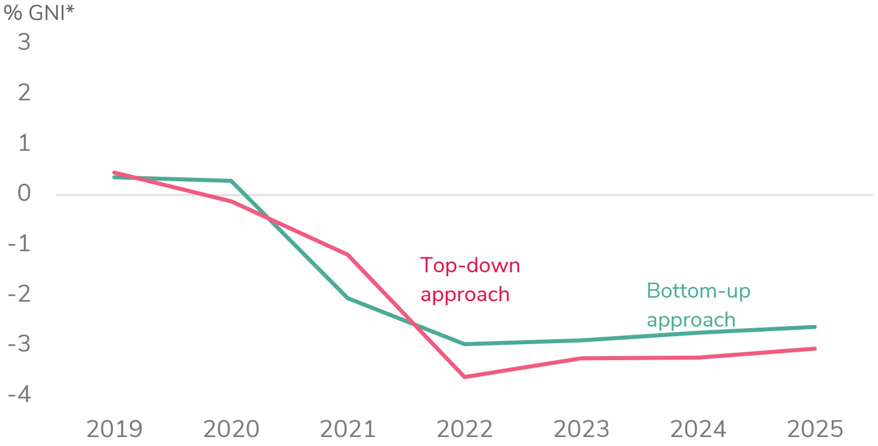
Long-term fiscal stance

The impact of Covid-19 in terms of higher debt ratios and higher annual funding requirements is likely to remain long after the economy recovers. This will limit the scope for funding public services and supports through sustained deficits.

There is a strong possibility that a large structural deficit may have to be closed once the crisis has ended and the economy and employment has recovered. Figure 27 shows the structural deficit based on the Council's bottom-up approach to estimating the structural deficit, as well as the conventional approach (labelled top-down approach). A large persistent structural deficit would be projected to remain over 2022-2025. This is partly contributed to by a ramp up in public investment and future tax cuts. No reference was made to the structural deficit in the SES nor whether the spending plans and structural deficits planned would be compliant with the fiscal rules.

[33] Based on the Commission's spring 2021 forecasts, the Commission judged that the conditions to continue to apply the general escape clause were met in 2022. See here for further details: https://ec.europa.eu/info/sites/default/files/economy-finance/com-2021-507_1_en_act_part1_v3.pdf

Figure 27: A structural deficit could remain after this crisis has ended



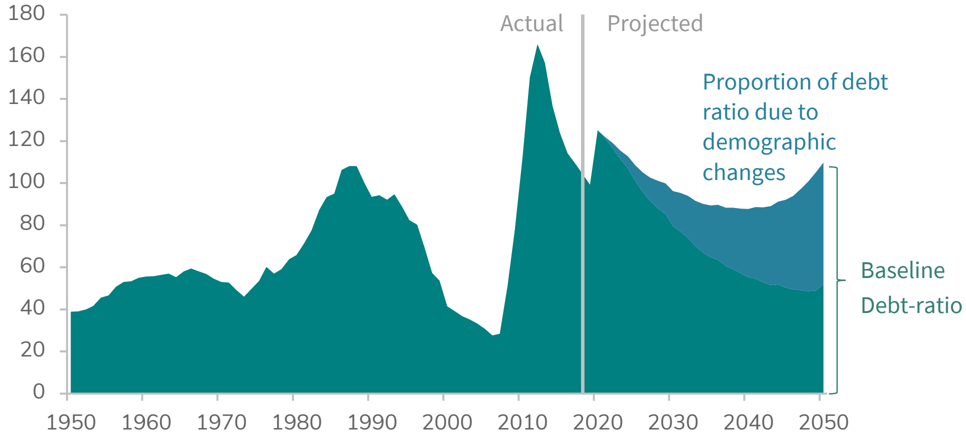
Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: For details of the Council's "bottom-up" approach to estimating the structural balance, see Box I of the May 2021 FAR. The top-down approach is based on the Council's principles based approach to the fiscal rules (see Box A of the Assessment of Compliance with the budgetary rule 2018).

Three longstanding challenges will become more prominent at the same time as Ireland emerges from the Covid-19 crisis: ageing, climate change and the overreliance on corporation tax receipts.

Ageing presents a major challenge to the long-run sustainability of Ireland's public finances (Fiscal Council, 2020). While the share of older people in Ireland is relatively low today by European standards, the population will age relatively quickly so that the dependency ratio will reach the current EU average by the mid-2030s. The ageing process is set to accelerate in the 2030s and 2040s. This has major implications for public spending. Under current policies, the Council projects that combined spending on pensions and health care would increase from 13.3 per cent of GNI* in 2019 to almost 25 per cent in 2050, particularly rising after 2030. This would add substantially to the debt ratio over the coming decades under unchanged policies (Figure 28).

Figure 28: Ageing costs set to add considerably to the debt burden

Gross debt ratio, % GNI* general government basis



Source: Fiscal Council workings (Long-term Sustainability Report 2020).
Notes: The blue shaded region shows the proportion of the baseline gross general government debt ratio that can be attributed to an ageing population relative to 2020 demographics.

At the same time as ageing costs are likely to rise, the Government also plans to introduce major reforms to how healthcare is provided in Ireland. The costs of these reforms were estimated in May 2017 to add €3 billion to annual spending by completion. To date, it is unclear how much has been spent on the reforms cumulatively and how much is likely to be spent in future. The recent Sláintecare action plan also fails to set out any indication of planned expenditure beyond this year.[34] In fact, it was not until the publication was released in May of this year that the actual costs associated with the reforms in 2021 were clarified as being some €1.2 billion of the 2021 allocation to health spending set out on Budget day the previous October. Prior to the pandemic, difficulties in budgeting expenditure in health had been highlighted (Fiscal Council, 2019). Substantial overruns had been common in recent years (averaging €500 million per annum over 2015-2018).

Pensions costs are also expected to rise with ageing. The Government decided to not proceed with a planned pension age increase from 66 to 67 in 2021 as well as a further increase to 68 in 2028, which adds to these pressures. A Commission on Pensions was established and tasked with examining sustainability and eligibility issues within the current pensions system. It was due to outline options for the government to address issues including qualifying age, contribution rates, total contributions and eligibility requirements by June 2021, with the Government pledging to take action on

[34] Sláintecare Implementation Strategy and Action Plan 2021-2023. Available at: https://www.gov.ie/en/publication/6996b-slaintecare-implementation-strategy-and-action-plan-2021-2023/

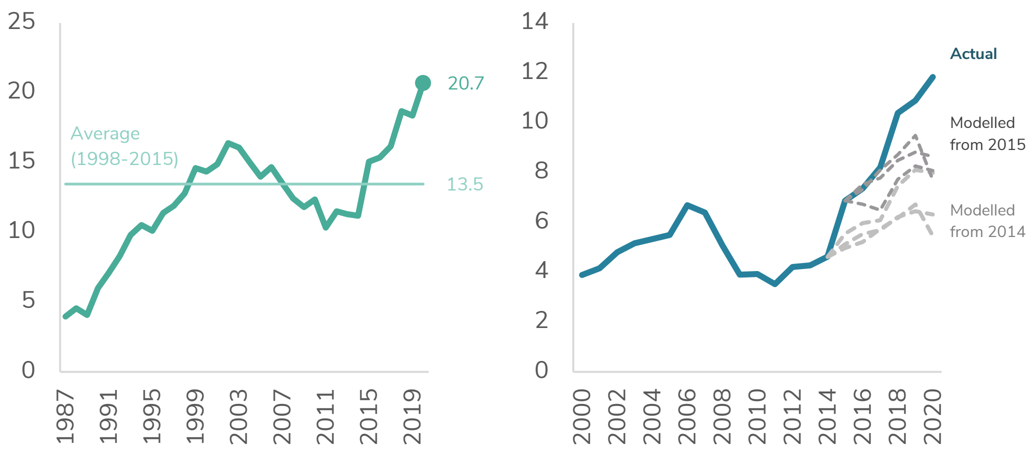
the recommendations within six months. As yet, the Commission's report has not been published.

Corporation tax: The Government has become increasingly over reliant on corporation tax receipts to fund ongoing spending. Corporation tax receipts represented one in every five euro of Exchequer taxes collected in 2020 (Figure 29A). The outperformances in corporation tax receipts helped to mask repeated health spending overruns that averaged €500 million per annum during the years 2015–2019. Modelled estimates suggest that, had corporation tax receipts grown in line with domestic activity from 2014 or 2015, the annual level of corporation tax receipts would have been substantially lower in 2020 (Figure 29B).

Figure 29: Corporation tax overreliance has grown in recent years

A. Corporation tax at record shares — % total Exchequer taxes

B. Receipts exceed model estimates — € billions



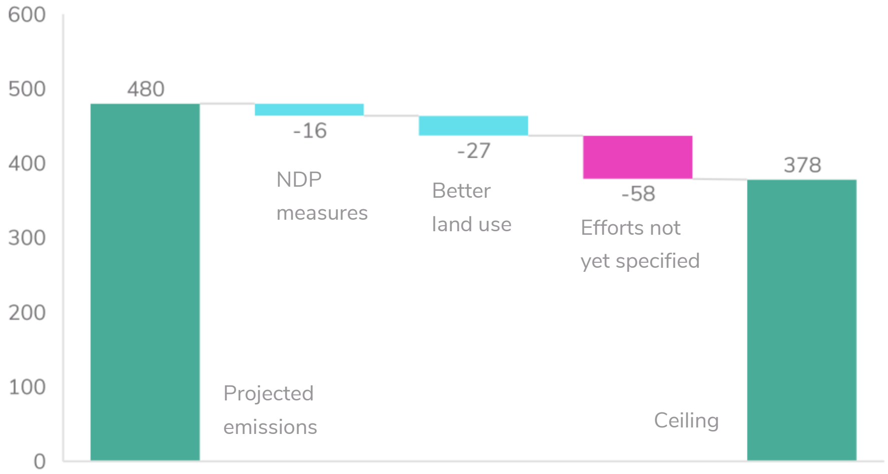
Source: Revenue data; and Fiscal Council workings.
Notes: Model estimates based on ordinary least squares and error correction models of corporation tax receipts using Domestic GVA and Modified Gross National Income to predict receipts from 2014 and 2015.

There are risks related to the over reliance on corporation tax receipts. Corporation tax receipts, much of which is paid by foreign owned multinationals, are more volatile than other taxes and have become more concentrated over time. Just ten corporate groups accounted for 56 per cent of all corporation tax receipts last year. For these reasons, corporation taxes are not a reliable revenue base for recurrent spending. Furthermore, major changes to the global tax environment through the OECD's BEPS initiative and changes to the US corporate tax system could also have significant impacts. The Department of Finance assumes a gradual €2 billion reduction in corporation tax receipts will result from international tax changes. Yet the impact could be swifter and greater than this. A scenario considered in the

Council's May 2021 *Fiscal Assessment Report* showed that if just five major firms were to no longer pay corporation tax in Ireland, this could result in €3 billion of lost corporation tax receipts.

Figure 30: Meeting carbon targets is likely to incur significant costs

Levels of greenhouse-gas emissions (Mt CO2eq)



Source: Fiscal Council (2020), Climate Action Plan (2019)
Notes: 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.

Climate-related spending: the Government has set out ambitious targets for annual reductions in carbon emissions over the next three decades. To date, however, the Government has given little detail on how it intends to achieve these targets or the associated costs. A detailed plan is expected to be published in the autumn. This plan could entail much higher spending over the medium term, possibly beyond the upward revisions already set out in the Summer Economic Statement. For context, the National Development Plan (NDP) 2018–2027 set out €20 billion in funding to help achieve a reduction in emissions of 16.4 of the total 102 MtCO2eq reduction planned. But more than half (58 MtCO2eq) of the overall reduction was unspecified (Figure 30). That is more than 3½ times the reduction achieved by the NDP measures implying a potentially very large extra cost of €7 billion per annum if the NDP measures were scaled up. This is similar to IMF (2021) estimates for the annual costs estimated to be required over the next 10 years to achieve additional targets set out in the 2021 Climate Action Bill.

Bibliography

Auerbach, A., Gorodnichenko, Y., (2012). Measuring the Output Responses to Fiscal Policy. American Economic Journal: Economic Policy, 4(2), pp. 1-27. May 2012. Available at: https://www.aeaweb.org/articles?id=10.1257/pol.4.2.1

Casey, E. (2018). Nowcasting to Predict Data Revisions. Irish Fiscal Advisory Council Working Paper Series No. 7. Dublin. Available at: https://www.fiscalcouncil.ie/wp-content/uploads/2018/10/Nowcasting-to-Predict-Data-Revisions-E.-Casey-October-2018.pdf

Casey, E. and D. Purdue, (2021). Maq: A Fiscal Stress Testing Model for Ireland. Irish Fiscal Advisory Council Working Paper Series No. 13. Dublin. Available at: https://www.fiscalcouncil.ie/wp-content/uploads/2021/02/Maq-A-Macro-Fiscal-Model-for-Ireland.pdf

Conefrey, T., R. Hickey and G. Walsh (2021). An Analysis of Medium-Term Risks to the Public Finances. Central Bank of Ireland Economic Letter Vol 2021 No 6. Dublin. Available at: https://www.centralbank.ie/docs/default-source/publications/economic-letters/vol-2021-no-6-analysis-of-medium-term-risks-to-the-public-finances.pdf?sfvrsn=5

Department of Finance (2021a). Stability Programme Update 2021. Dublin: Department of Finance Available at: https://www.gov.ie/en/press-release/07c73-minister-donohoe-publishes-stability-programme-update-2021/

Department of Finance (2021b). Summer Economic Statement 2021. Dublin: Department of Finance Available at: https://www.gov.ie/en/publication/4d84e-summer-economic-statement-2021/

Department of Finance (2017). Budget 2018: Economic and Fiscal Outlook, October 2017. Dublin: Department of Finance. Available at: http://www.budget.gov.ie/Budgets/2018/Documents/Budget_2018_Economic_and_Fiscal_Outlook.pdf

Department of Finance (2011). Reforming Ireland's Budgetary Framework: A Discussion Document. Available at: https://www.fiscalcouncil.ie/wp-content/uploads/2014/06/RIBF_March11.pdf

Fiscal Council, (2018a). Fiscal Assessment Report, June 2018. Dublin: Irish Fiscal Advisory Council. Available at: https://www.fiscalcouncil.ie/wp-content/uploads/2018/06/IFAC-Fiscal-Assessment-Report-June-2018.pdf

Fiscal Council, (2018b). Fiscal Assessment Report, November 2018. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

Fiscal Council, (2019). Fiscal Assessment Report, November 2019. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

Fiscal Council, (2020). Long-term Sustainability Report, July 2020. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

Fiscal Council, (2021). Fiscal Assessment Report, May 2021. Dublin: Irish Fiscal Advisory Council. Available at: http://www.fiscalcouncil.ie/publications/

IMF (2021). Ireland: Selected Issues. Country Report No. 2021/124. International Monetary Fund: Washington. Available at: https://www.imf.org/en/Publications/CR/Issues/2021/06/15/Ireland-Selected-Issues-460785

OECD Economic Outlook (2021). No Ordinary Recovery. May 2021. Paris. Available at: https://www.oecd.org/newsroom/oecd-sees-brighter-economic-prospects-but-an-uneven-recovery.htm

Revenue, (2021). Corporation Tax – 2020 Payments and 2019 Returns. Revenue Commissioners. Available at: https://www.revenue.ie/en/corporate/documents/research/ct-analysis-2021.pdf

Varthalitis, P. (2019). FIR-GEM: A SOE-DSGE Model for Fiscal Policy Analysis in Ireland. ESRI Working Paper 620. Dublin. Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3363741

Vierke, H., and Masselink, M., (2017). The Dutch Budgetary Framework and the European Fiscal Rules. European Economy Economic Brief 027, May 2017. European Commission. Available at: https://ec.europa.eu/info/sites/default/files/economy-finance/eb027_en.pdf

Appendix A: Detailed fiscal projections

Table A1: SES Fiscal projections

€ millions unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Revenue	88,132	84,527	91,638	95,613	99,763	103,538	107,405
Spending	87,060	103,287	111,923	109,983	107,813	111,168	114,760
Balance	1,072	-18,760	-20,285	-14,370	-8,050	-7,630	-7,355
Balance (% GNI*)	0.5	-9.0	-9.4	-6.2	-3.3	-3.0	-2.8
Gross debt ratio (% GNI*)	94.7	104.8	112.0	108.8	108.2	107.9	106.5

Sources: SES 2021 and CSO.
Notes: 2019 and 2020 data are updated Government Finance Statistics and National Accounts data, which were not used for SES projections. GNI* data is also updated for 2019 and 2020. Values from 2021 onward are obtained by applying SPU growth rates to the new 2020 base

Table A2: Recovery Scenario Fiscal projections

€ millions unless otherwise stated

	2019	2020	2021	2022	2023	2024	2025
Revenue	88,132	84,527	95,429	99,769	103,351	107,132	111,498
Spending	87,060	103,287	111,024	106,183	107,813	111,168	115,040
Balance	1,072	-18,760	-15,595	-6,414	-4,461	-4,035	-3,542
Balance (% GNI*)	0.5	-9.0	-7.0	-2.6	-1.7	-1.5	-1.3
Gross debt ratio (% GNI*)	94.7	104.8	107.1	98.3	96.7	95.6	92.1

Sources: CSO; and Fiscal Council workings.
Notes: See Box A for assumptions underpinning the Recovery Scenario.