Irish Fiscal Advisory Council

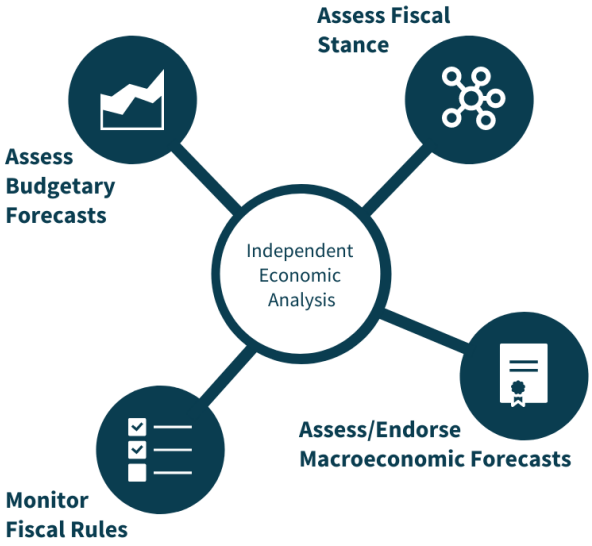
Meeting between Oireachtas Select Committee on Budgetary Oversight

Opening Statement by Mr Sebastian Barnes, Chairperson of the Irish Fiscal Advisory Council, Tuesday 8th December 2020

The Council would like to thank the Chair and members of the Committee for inviting us today. Joining me remotely today are Council Members Dr Martina Lawless, Prof Michael McMahon, and Ms Dawn Holland and our Chief Economist and Head of Secretariat, Dr Eddie Casey. We value our engagements with the Oireachtas and we see these opportunities as an important part of our work.

The Council is an independent body established under the Fiscal Responsibility Act (2012). Its mandate is to endorse and assess the official macroeconomic forecasts, assess the budgetary projections, assess compliance with the fiscal rules and assess the fiscal stance. This focusses on the overall fiscal stance, rather than on individual tax measures or spending items/priorities.

The Council's Mandate:



Sustaining the Economy through Covid-19

The Council's Fiscal Assessment Report published last week assesses *Budget 2021*. Covid-19 continues to have a major impact on the Irish economy and public finances. During October, the Government escalated the level of nationwide restrictions in response to a second wave of Covid-19 infections. This resulted in the closure of restaurants and non-essential retail. Nonetheless, the outlook for the economy in 2021 has improved following positive announcements on the vaccine front.

Economic outlook

The economic impact of the pandemic has been severe. The Budget projections imply a 6 per cent decline in real modified gross national income—or GNI*—this year, followed by a muted 2 per cent recovery in 2021. While the recovery in the domestic economy in the third quarter was strong, and multinational enterprises have boosted wider activity, November's Covid-adjusted unemployment rate remains high at 17.4 per cent for those aged 25–74.

For *Budget 2021*, the Government assumed that a vaccine would not be widely available until at least 2022, and that trade between the UK and the EU would be based on a hard Brexit. This was prudent, given the uncertainties and risks involved.

The Budget forecasts cover just one year ahead, unlike the normal five-year horizon. This gives an extremely narrow picture as to how today's policies might impact the economy and public finances. While medium-term projections are uncertain, they help to promote good fiscal policy and to identify economic imbalances. A return to five-year forecasting is essential for next April's Stability Programme.

The Council developed three scenarios to 2025 in its report to help frame the medium-term challenges Ireland faces. The Extended *Budget 2021* projections would see the economy recover pre-crisis levels of activity by end-2022. A "Milder" scenario, with an effective vaccine by summer and an EU-UK free-trade agreement, could see the economy recover pre-crisis levels of activity earlier in 2022. By contrast, a "Repeat Waves" scenario, with further level 5 restrictions in 2021 and 2022, could see the recovery delayed until Q3 2023.

The outlook remains highly uncertain and the impacts of the crisis might be felt for a long time. Sectors like retail, hospitality, transport and the arts are especially vulnerable to the pandemic. Counties more reliant on tourism and hospitality have been worse affected, especially western and border regions. The impact of Brexit, though assumed disorderly for the budget, is still unclear and could be much different than assumed. Ireland is also exposed to international tax changes. Changes could reduce future corporation tax receipts and foreign direct investment.

Fiscal impacts

Covid-19 has led to massive government spending on job supports, health responses and measures to stimulate demand. Tax revenues have fallen sharply in some areas, notably VAT. Yet corporation tax and income tax have fared better than expected. A very large deficit close to €20 billion (or 10 per cent of GNI*) is likely this year and this will lead to a sharp rise in the debt-to-GNI* ratio, which was already at high levels pre-crisis — the sixth highest in the OECD.

Temporary versus permanent expenditure increases

The Government's decision to continue to borrow to support households and businesses through the Covid-19 crisis and to provide stimulus is appropriate. These measures, though costly, should help to lessen the

lasting economic damage of the crisis, and ultimately lead to a more sustainable path for government debt ratios. The Council welcomes the use of contingencies in *Budget 2021* to cope with any additional costs of Covid-19 and Brexit and the use of a Recovery Fund. These temporary and targeted supports should fall out of spending as the need for emergency measures diminishes and as the economy recovers.

However, *Budget 2021* also included substantial, permanent increases in spending of at least €5.4 billion. Rather than being temporary and targeted, these will remain after the pandemic. They are also surprisingly large in the context of past budgets — budgets since 2015 have had packages closer to €3½ billion on average. The permanent increases could even be as high as €8.5 billion as it is not possible to ascertain the nature of some of the increases in non-Exchequer areas. This reflects ongoing transparency problems in areas outside of the Exchequer that are traditionally not the focus of the Department.

The Council is not opposed to a permanent rise in spending in and of itself. The issue is that there is no sense of how the lasting increases will be financed sustainably over the medium term. The Programme for Government rules out tax increases and spending reductions across large parts of the tax base and existing spending. The risk is that, instead, these will lead to larger deficits, which will put upward pressure on debt ratios. In addition, there is a risk is that some of the estimated temporary spending increases included in 2021 projections end up becoming permanent.

Looking ahead

The Council's simulations suggest that Ireland's debt ratios will climb to between 109 and 127 per cent of modified gross national income by end-2021. Assuming interest rates remain reasonably favourable, debt ratios should fall over the medium term except in a Repeat Waves scenario.

The €5.4 billion of core spending increases planned for 2021 will slow the pace of debt reduction. These could add about €5 billion to the deficit even by 2025. This builds up so that debt could be over €20 billion (7 per cent of GNI*) higher.

The Government faces a number of significant challenges once the economy is on a path to recovery. In addition to possible scarring effects of Covid-19 and Brexit on future growth, longstanding issues remain. These include Ireland's rapidly ageing population, climate change, the over-reliance on corporation tax and the ambitions to embark on large-scale Sláintecare reforms of the health sector. All of these will add to budgetary pressures over the coming years and decades.

The Government should use its medium-term strategy in April 2021 to deliver credible plans. That would include five-year forecasts; detail on non-Exchequer areas; plans for sustainably financing the large increases in recurrent spending; proper costings; and how its budgetary plans would change if revenues fall short. Three reforms would help: debt targets set in GNI* terms; tools to save temporary receipts such as unexpected corporation tax; and sustainable growth limits for spending.