Non-Technical Summary

Covid-19 continues to have a major impact on the Irish economy and public finances. The Government based its *Budget 2021* forecasts on a vaccine not being widely available until at least 2022. It also assumed that trade between the UK and the EU would be based on a hard Brexit from January 2021. This was prudent, given the uncertainties and risks involved.

State supports have cushioned the impact of the shock. However, the economic impacts of the crisis might be felt for a long time. The *Budget 2021* projections imply a 6 per cent decline in real GNI* this year. A muted 2 per cent recovery is expected in 2021. Sectors like retail, hospitality, transport and the arts are especially vulnerable to the pandemic. New analysis in this report highlights some of the regional differences in activity lost. Western and border regions that heavily rely on tourism and hospitality have been worse affected.

The outlook is exceptionally uncertain, and medium-term planning is essential. Rather than looking five years ahead, as is usual, *Budget 2021* only provides forecasts for one year ahead. This gives a narrow sense of how today's policies might impact the economy and public finances.

The Council has developed three economic and fiscal scenarios to 2025. The projections suggest the domestic economy might not return to pre-crisis activity until late 2022. A "Milder" scenario could see the economy recover more quickly. That assumes an effective vaccine is widely available mid-2021 and the EU and UK reach a free-trade agreement. However, repeat surges in infections could lead to heavy restrictions over the next couple of years. This "Repeat Waves" scenario would see a more stunted recovery. In that case, the economy might not recover its pre-crisis levels until late 2023. There are also other risks, including changes to the global tax environment.

The Covid-19 pandemic has led to a substantial increase in government spending. The Government expects to run a deficit of just over €20 billion this year. *Budget 2021* projects a deficit of €21.6 billion or 10.7 per cent of GNI* for 2020. This reflects massive government spending on job supports and measures to stimulate demand. Tax revenues have fallen sharply in some areas, such as VAT. However, other areas, such as corporation tax receipts and income tax receipts, have fared better than expected. The deficit projections for 2020 are better than was expected in April, when a 13.3 per cent deficit was forecast. This reflects how better revenues coming in have outweighed the cost of new policy measures. The recent measures to contain the virus are likely to weigh on public finances. They could raise the deficit in 2020 by a further €1.6 billion (0.8 per cent of GNI*).

Budget 2021 sets out a large-scale support and stimulus package for next year. This will mean a substantial deficit once again. The budget balance is forecast to improve only slightly next year, with a deficit of €20.5 billion (9.8 per cent of GNI*). This includes contingencies of €2.1 billion for Covid-19. It also includes €3.4 billion for unspecified supports in response to the pandemic and Brexit.

The Council's three scenarios suggest that the government debt ratio will climb to between 109 and 127 per cent of GNI* in 2021. This is up from 96 per cent at the end of 2019. At the end of last year, Ireland had one of the highest debt ratios in the OECD. The sizeable budgetary response needed for Covid-19 will see the debt ratio rise substantially. However, the extended *Budget 2021* projections suggest that the debt ratio would fall towards 100 per cent of GNI* by 2025. This reflects favourable debt dynamics, with low interest rates helping sustainability. In a Milder scenario, the debt ratio could fall faster. However, the Repeat Waves scenario could see debt ratios stagnate at high levels, close to 130 per cent of GNI*.

The Government continued its temporary supports for households and businesses in *Budget 2021*. It also introduced further measures to stimulate demand. While costly, these measures are appropriate. They should help to support economic activity and lessen the economic damage of the crisis. Despite the costs, the measures should ultimately lead to a more sustainable path for government debt ratios. Low interest rates also help to support a higher debt ratio.

The Council welcomes the allocations in *Budget 2021* to deal with further costs of Covid-19 and for a recovery fund. These include the €2.1 billion Covid-19 Contingency Reserve and the €3.4 billion Recovery

Fund. These temporary supports should be targeted and should end as the economy recovers.

However, *Budget 2021* also included substantial and permanent spending increases without long-term funding. These permanent spending increases could amount to €5.4 billion. This includes additional spending unrelated to Covid-19 and hiring in health, education and other areas. This spending is likely to remain long after the pandemic. The increases are surprisingly large in the context of uncertain growth prospects and compared to previous Budgets. The permanent increases could even be as high as €8.5 billion. This reflects the fact that some of the increases are in non-Exchequer areas that lack transparency. The Department of Finance has traditionally put less focus on these areas.

The Council assesses that the permanent spending increases in *Budget 2021*—without a sustainable plan to finance them—are not conducive to prudent economic and budgetary management. These permanent measures are substantial. There is no sense as to how this spending will be financed sustainably over the medium term. These unfunded commitments will add to future fiscal pressures. The Programme for Government rules out tax increases and spending reductions in many areas. There is a risk that some of the temporary spending increases for 2021 end up becoming permanent.

The Government should use its medium-term strategy in April 2021 to deliver credible plans. It is essential that the Stability Programme in April 2021 presents a five-year forecast horizon. It should set out detailed and transparent budgetary forecasts. The Government should clarify how large underlying increases in spending introduced for 2021 will be funded sustainably. A substantial amount of spending—some €1.9 billion—is going towards permanent increases in health spending. The Government should clarify how this relates to the Sláintecare reforms. The Government should also provide a costed plan for how this will be implemented. Furthermore, the Government should set out how its budgetary plans would change if revenues fall short.

The Government faces many challenges once the economy is on a path to recovery. Once a recovery from Covid-19 and Brexit is underway, there may be a need for fiscal adjustment. The Council's simulations suggest that this could be avoidable. Debt ratios are likely to fall over the medium term except in a Repeat Waves scenario. But the unfunded permanent spending increases in Budget make it more difficult to bring debt ratios steadily back down. In addition, major longstanding issues remain. Ireland has a rapidly ageing population. There are costs associated with dealing with climate change. There is an over-reliance on corporation tax. And the Government has ambitions for large-scale reforms of the health sector through Sláintecare. All of these will add to budgetary pressures over the coming years and decades.

The Government should introduce three reforms to help navigate these challenges. First, it should develop debt targets that are specific to Ireland. These would help guide debt ratios to safer levels gradually. Doing so would allow scope for budgetary supports, as was possible in this latest crisis. Second, the Government should save temporary receipts rather than use these to fund permanent spending. It could do so through the Rainy Day Fund and a Prudence Account. Third, the Government should anchor permanent spending growth to sustainable limits.

The fiscal rules were relaxed in 2020 and 2021. This helps to make sure the response to Covid-19 is adequate. The Council's Extended Budget 2021 forecasts suggest the deficit will fall below the 3 per cent limit in 2022. However, GDP is not an appropriate measure for Ireland to base assessments of the fiscal rules on. It would be more appropriate to specify the domestic fiscal rules in terms of GNI*. This would require changes to legislation.