Rialtas na hÉireann
Government of Ireland

Summer Economic Statement

July 2021

Prepared by the Departments of Finance and Public Expenditure and Reform

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Foreword

After a very difficult year-and-a-half, there is now growing optimism that we are finally turning the page on the Covid-19 pandemic. Over two-thirds of the population is now partly vaccinated (and over half fully vaccinated), allowing for more-and-more sectors of our economy, and of our society more generally, to re-open and to return to some form of normality.

While a more transmissible variant – the 'delta' strain of the virus – is a concern, it is also fair to say that the success of our vaccination programme means that we are now in a stronger position to address this. That is not to downplay the risks, and we must indeed remain alert and proceed with caution. At the same time, Government is conscious that large parts of the global population will not be immunised for some time, and other countries are pursuing their own preferred national approaches to containing the pandemic. So we in Ireland must be vigilant in order to prevent the emergence of mutant strains which could potentially be vaccine-evading.

Turning to the economic situation, modified domestic demand (MDD) fell by nearly 3 per cent in the first quarter of the year, a much less severe fall than was evident during the first wave of the virus and confirmation that households and firms have become more resilient as the pandemic has progressed. High frequency data point to a strong rebound in the second quarter, in line with the easing of restrictions, and this looks set to gain momentum over the summer.

MDD growth of 2½ and 7½ per cent, respectively, is projected for this year and next, although the exact pace of rebound in the domestic economy will depend on many factors, not least the speed at which households normalise their saving-spending decisions. The magnitude of the savings that have built up is sufficiently large that even minor deviations from the assumed path could move the dial on the overall growth path. Our forecasts are, of course, contingent upon the epidemiological situation.

The MDD projections for this year are unchanged relative to those set out in the *Stability Programme Update* (SPU), published in April. Revised projections will be published, as normal, alongside the budget in October. However, it is clear that exports from a small number of mainly foreign-owned sectors – in pharmaceutical and ICT, as well as in firms who outsource production by way of 'contract manufacturing' – recorded very strong growth in the first half of this year. On this basis, an upward revision to the GDP projection for this year (now projected at 8¾ per cent) has been incorporated, although this has limited downstream effects to the rest of the economy.

Within domestic sectors the recovery is uneven, and Government is acutely aware that, at this point, many contact-intensive sectors, dependent upon face-to-face contact, have been by-passed. These sectors remain the epicentre of the economic fall-out from the pandemic but the risks to the wider society of a full re-opening of these sectors remains high, especially as the delta variant becomes the dominant strain. The central expectation is that, as vaccination coverage widens in the coming weeks, restrictions can be relaxed further.

With the worst of the health pandemic now, hopefully, behind us, we can now start to consider what the post-pandemic world might look like. While the full implications will only become clear with the passage of time, it is fair to say that the pandemic has permanently transformed many facets of our economy. In the space of just over a year, the way in which we work, the way in which we produce goods and services, and the way in which we consume these products have all been transformed. Many of these changes will be positive: more remote working will *inter alia* help to reduce carbon emissions and contribute towards a rebalancing between working and leisure. But there are negative side effects also:

to give just one example, the shift to online purchasing could be at the expense of employment in traditional, 'bricks-and-mortar' retail.

The key point is that there will be both opportunities and challenges in the post-pandemic world. The Government will continue to work to maximise the opportunities and to minimise the challenges. But what we will not do, and cannot do, is to impede change. As supports are withdrawn, the fog will begin to lift on which firms and sectors are viable in the 'new normal'. For workers in firms and sectors that are no longer viable, the policy focus will shift to re-skilling so that these workers can transition to viable sectors.

This *Summer Economic Statement* sets out the Government's medium-term budgetary strategy. This strategy needs to be seen against the background of the extraordinary fiscal, economic and social response since the onset of the pandemic in March last year. Overall, the Government's economic policy response has been geared towards building a bridge through to recovery and, at the same time, minimising the permanent fall-out from the pandemic. A total of €48 billion has been made available to shore-up household incomes and to provide life-lines to firms, while also supporting our social, community and cultural life. Public debt has increased by a broadly similar magnitude; but, the correct approach to a global public health pandemic is to allow indebtedness rise in order to absorb the shock.

In calibrating our budgetary strategy, it is necessary to acknowledge that, while the Government's economic and social policy response has been the correct one, the current pressures on the public finances are not sustainable, and levels of public spending are well in excess of what can be supported by the domestic tax base. We cannot keep financing large deficits. With a public debt-income ratio that is now amongst the highest in the developed world, borrowing beyond the short-term increases our vulnerability and depresses the living standards of future generations.

Against this background, and as the worst of the pandemic fades, it will be necessary to phase out the temporary fiscal supports. To avoid a 'cliff-edge', the Government has extended the *Employee Wage Subsidy Scheme,* the *Covid Restrictions Support Scheme* and the *Pandemic Unemployment Payment.* On this basis, a deficit of €20.3 billion (9.4 per cent of GNI*) is in prospect for this year.

Looking ahead, the Government's budgetary strategy involves setting core (i.e. non-Covid related) public expenditure at €80.1 billion next year, an increase of 5.5 per cent. Additionally, Government will provide for a continuation of some temporary supports amounting to €8 billion (including EU funding). This would be consistent with a deficit of 6.2 per cent of GNI* for next year. This near-term strategy involves an expenditure ceiling of €88.2 billion for next year; if the economic performance is weaker than assumed, Government will allow the deficit to rise without changing the expenditure ceiling and *vice versa*. In relation to the medium-term strategy, annual expenditure growth (net of any discretionary revenue-raising measures), between now and the mid-part of this decade will be 5 per cent, in line with the estimated trend growth rate of the economy.

Our projections now envisage a deficit of €7.4 billion by the mid-part of this decade. This is around €6.5 billion more than envisaged in the SPU and reflects the Government's commitment to resourcing capital investment and to meet the goals of our *National Development Plan* (NDP) review. Indeed, cumulatively the Government will borrow €18.8 billion more than originally set out; of this, nearly €4 billion is due to higher capital spending. This increase is justified given the critical role that capital investment has to play in delivering on our economic, social and climate priorities. From 2023 onwards, the Government will be borrowing only to finance for capital expenditure.

The pandemic clearly had an adverse impact on the delivery of new housing, with most of the construction sector in 'lockdown' for part of last year and this year. With the pandemic now in retreat –

and assuming this is not derailed by the delta or, indeed, other variants – Government is now re-focusing its effects on ramping-up housing supply. In this context, the Government will shortly publish its *Housing for All* strategy, a detailed set of policies designed to boost housing output, including of social housing.

A key element of the medium-term expenditure strategy is to accommodate revised capital expenditure ceilings for the period 2021-2030, which will be published following completion of the review of the NDP. This *SES,* accordingly, sets out the overall capital ceilings for the period 2021-2025, with gross voted capital investment increasing to €13.6 billion, almost 5 per cent of GNI*, by 2025. Given the scale of this investment, it is imperative that we continue to strengthen the assurance arrangements and public sector capability to deliver on our ambitious investment targets.

As we emerge from the pandemic, fiscal trade-offs will once again re-emerge. Resources will be finite and choices will have to be made. We will also need to refocus our attention on the longer-term challenges which face us, including an ageing population, and the need to finance the digital and carbon transitions. These trade-off means that there must be a greater focus on how public expenditure is impacting on people's lives, as well as the effectiveness and efficiency of delivery. Overall, core public spending is projected to be almost €93 billion by 2025. We must ensure that this funding is delivering better outcomes, enhanced well-being and sustainable improvements in public services.

Returning the public finances to a sustainable trajectory puts us in the best position to meet all of the above challenges, as well as the unforeseen challenges which will undoubtedly emerge in the coming years. As evident from recent events, entering the Covid-19 pandemic from a position of balanced budgets provided greater capacity to respond in difficult times.

In conclusion, as the virus retreats – hopefully for good – a very strong economic recovery has taken hold. Budgets must be normalised once again and our public debt-to-income ratio brought back to safer levels. Budgetary policy must 'lean against the wind', during good times as well as bad times. Against this background, and to sustainably build upon recovery, the Government will continue to work towards:

- Firstly, ensuring that those businesses which have borne the brunt of the pandemic continue to be supported as they get back up-and-running or, if this is not possible, assisting them in the transition to newer, more sustainable sectors;

- Secondly, facilitating workers to transition from declining to expanding sectors, by providing them with the necessary skills and education;

- Thirdly, putting the public finances back on a sustainable footing, in order to maintain international confidence in the Irish economy and to ensure that we have the resources we need to deliver public services and invest in infrastructure to meet the challenges we face;

- Fourthly, re-focussing on cost competitiveness and productivity so that Ireland remains an attractive location in a post-Brexit environment, where corporation tax policy may be a less powerful tool in winning new investment; and,

- Finally, ensuring that our substantial investment in public services and infrastructure is being used effectively to have a meaningful impact on social and economic progress and to address the longer-term challenges facing the economy, such as an ageing population, the digital transition, and climate change.

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[1] In line with the Government's *Open Data Initiative* the data underpinning charts in this document are available on the Department of Finance website.
The material set out in this document is based on data available to mid-July. It was compiled by staff in the Departments of Finance and Public Expenditure and Reform, and every effort is made to ensure accuracy and completeness. When errors are discovered, corrections and revisions are incorporated into the digital edition available on the website of the Department of Finance. Any substantive change is detailed in the on-line version.

Executive Summary

The resolution of the public health crisis is now in sight. The roll-out of vaccines, and the associated fall in infection rates, has paved the way for a phased relaxation of public health containment measures. This, in turn, has triggered a rapid economic recovery. Provided that the ‘delta’ variant (and possibly subsequent variants) can be suppressed and further containment measures avoided, the economy is poised for a sharp rebound over the summer and beyond.

Budgetary policy has played a vital role in cushioning private sector incomes during the pandemic. Discretionary measures amounting to nearly 20 per cent of national income have been implemented, with the full fiscal toolbox deployed to limit both the short-term fall in demand and the longer-term damage to the economy’s productive capacity (‘scarring’).

With more-and-more sectors of the economy now able to stand on their own two feet, budgetary policy needs to pivot away from generalised measures towards more targeted supports. This scaling back of emergency supports will be done in a gradual manner, with an eye to ensuring an appropriate balance between supporting recovery and fiscal sustainability.

As the economy emerges from the pandemic, the focus shifts towards correcting the fiscal deficit and to re-building the Government’s balance sheet. With private demand accelerating rapidly, it is necessary to slow the growth rate of public demand in order to avoid overheating the economy; counter-cyclical budgetary policy works in both directions.

The pandemic has wreaked havoc on the economy and on society more generally. While the virus is now in retreat, legacy effects will be evident for years to come. Scars on the public sector’s balance sheet run deep: between this year and the mid-part of the decade, an additional €63.5 billion of public debt will have been accumulated. While managing this additional debt burden is made somewhat easier by the stance of monetary policy over the past eighteen months-or-so, the level of public indebtedness will exceed a quarter of a trillion euros next year. So, as the economy moves up a gear, a key priority is to slow that pace at which debt is accumulated; in other words, allowing economic recovery to gradually close the gap between public revenue and expenditure.

The Government’s medium-term budgetary strategy involves an expenditure ceiling of €88.2 billion for next year, consistent with a budgetary deficit of 6.2 per cent of GNI*. If the actual economic performance deviates from expectations, automatic stabilisers will be allowed to operate in full, while keeping the expenditure ceiling fixed.

Expenditure ceilings are being set for later years also, so that on the basis of the central scenario for the economy, the headline deficit would be c. 2.8 per cent of GNI* (c. 1.5 per cent of GDP) by the mid-part of this decade, although the actual deficit can fluctuate in response to cyclical economic fluctuations over the forecast horizon.

The deficit is significantly in excess of that outlined in the spring and reflects the Government’s commitment to ramp-up the stock of infrastructure and, in particular, to increase the supply of housing. From 2023 onwards, the only borrowing that the Government would undertake would be for capital purposes.

Medium-term budgetary strategy: main components

Expenditure ceilings fixed, incorporating permanent increases of 5 per cent per annum

To ensure that the public finances remain on a sustainable path while, at the same time, addressing critical infrastructural bottlenecks, Government is allowing permanent spending to increase by 5 per cent per annum in the post-pandemic years. This is in line with the economy's estimated trend growth rate (when allowance is made for inflation).

This expenditure rule – with the growth rate of expenditure fixed at trend growth until the mid-part of the decade – will leave Ireland in a strong position for the normalisation of both monetary and fiscal policy over the next year-or-so. In relation to the latter, the European Union's fiscal rules will, once again, formally apply from 2023 onwards.

Consistent with reducing the deficit to low levels by mid-decade

On the basis of the central economic scenario set out in this document (and the associated tax revenue streams that flow from this), these levels of expenditure would be consistent with achieving a deficit of 1.5 per cent of GDP by the mid-part of this decade.

Furthermore, the Government would only be borrowing for capital purposes from 2023 onwards.

Headline deficit can fluctuate in line with the economic cycle

If economic growth deviates from that envisaged in this central scenario, the Government will allow the revenue streams fluctuate also; in this way, budgetary policy will play a counter-cyclical role over the medium term (via the automatic stabilisers).

On the basis of the deficit-GDP projections set out in this document, Ireland should not be a fiscal outlier – in other words, Ireland's deficit trajectory in the coming years should be broadly in line with other European countries.

Debt-income ratio to stabilise, albeit at high levels

The rationale for the Government's approach is to stabilise the debt-income ratio. By next year, public debt will exceed a quarter of a trillion euros and, on a per capita basis, is amongst the highest in the developed world. Lower debt service costs mean that the economy can sustain this but only if the pace of debt accumulation is slowed and eventually halted.

In summary:

- The **objective** is to stabilise, and reduce slightly, the debt-income ratio in the coming years;
- This will be **achieved** by more closely aligning revenue and expenditure (reducing the deficit);
- Fiscal policy in the coming years will **support demand** via the operation of automatic stabilisers;
- Budgetary policy will **support supply** by ramping-up investment spending;
- To **operationalise** this, Government is fixing expenditure ceilings.

Chapter 1
Economic Strategy

1.1 Background

The phased re-opening of many sectors that began in April has, unsurprisingly, triggered a sharp economic rebound, and this looks set to gain momentum over the second half of the year. Consumer spending is leading the recovery, with the release of pent-up demand supporting durable goods consumption. 'Social consumption' – spending on services where product-delivery is based on face-to-face contact – has also benefited, with a stronger rebound in this consumer basket in prospect for the summer months.

Official data confirm that the easing of restrictions has had, at this point, a limited impact on the epidemiological situation. 14-day infection rates stabilised at relatively low levels (around 100 per 100,000) by late-June, before moving up slightly in early-July. Crucially, vaccine-rollout appears to have weakened the link between infection on the one hand and hospitalisation / fatality on the other. On this basis, a further relaxing of public health containment measures is in prospect in the months ahead. This should underpin further recovery in the labour market, as activity in employment-intensive sectors begins to normalise.

The key downside risk to this relatively benign scenario is the possibility of a delta variant-induced fourth wave of the virus. The Government's strategy to minimise this risk is to accelerate vaccine roll-out, including by adjusting the vaccination schedule. As a larger share of the population is immunised, risks to public health, and to the public healthcare system, are reduced.

The Government's economic strategy set out in this document is based on the macro-economic forecasts set out in the *Stability Programme Update* (SPU), published in April. Modified Domestic Demand (MDD) is projected to increase by just over 2½ per cent this year, before accelerating to 7½ per cent next year. While the data published since April point to some upside to this year's numbers, risks around any projection remain elevated, particularly with the unknown health and economic impacts of the delta variant. On this basis the projections are unchanged relative to the SPU, and in line with the usual approach, an updated set of projections will be published alongside *Budget 2022* in the autumn. Over the medium-term, an average growth rate of just over 3¼ per cent per annum is projected.

First quarter data show a very strong GDP growth rate, almost exclusively due to robust exports arising in a small number of mainly foreign-owned sectors. These include pharmaceutical and ICT exports, as well as exports of goods produced abroad but under contract from Irish-resident firms. While there are limited downstream real economy effects associated with these exports – which is the main reason the Department focuses on MDD as an indicator – it is clear that the level of GDP will be higher than anticipated. On this basis, the Department has incorporated an upward revision to its GDP projection for this year, with this variable now projected to grow by 8¾ per cent.[2]

[2] In this document, the focus is on MDD and GNI* which are much more relevant indicators of economic activity in an Irish context (the *Stability Programme Update* is based on GDP as this is required under EU law). Forecasts for MDD set out in the SPU remain consistent with the data that have been published subsequently; however, this is not the case for GDP which has benefited from the strength of exports in a small number of mainly foreign-owned sectors.

1.2 Economic Strategy

Against this economic background, the Government's overarching objective in the years ahead will be the re-absorption of the unemployed and discouraged workers back into the workforce. This may not be straightforward: the transformative nature of the pandemic means there is great uncertainty regarding which firms, which industries and which sectors are economically viable in a post-pandemic world.

The phasing-out of policy support by end-year will provide greater visibility on which sectors remain viable. While market exit of some firms is inevitable, this is not a one-way street. New firms – and possibly new sectors – will emerge, so the post-pandemic world offers opportunities as well as challenges.

Government's role is to facilitate a transition to the post-pandemic economy that is as smooth as possible. From a labour market perspective, this involves policies that equip workers with the human capital to move from declining to expanding firms and sectors. Education, up-skilling, re-skilling and public investment in other activation programmes are all part of the policy toolkit. From a corporate sector perspective, the Government's role is to maintain and enhance the environmental conditions that encourage firm-creation, firm-expansion and market dynamism. In this context, a renewed focus on competitiveness will be needed, especially given potential reforms to global corporation taxation policy which may reduce Ireland's relative advantage in this area.

As set out in the recently published *Economic Recovery Plan* (ERP), the Government will build on the progress made in reopening the economy, providing new supports and investment, and designing policies to promote the next stage of recovery and renewal. Alongside the publication of the ERP, the Government also committed to supporting the recovery by extending the *Pandemic Unemployment Payment* (PUP) and the *Employment Wage Subsidy Scheme* (EWSS), along with enhanced illness benefit and the *Coronavirus Restrictions Support Scheme* (CRSS). As well as protecting jobs and income, the extension of these policy instruments provides greater certainty to the private sector and demonstrates the Government's commitment to bridging through to the recovery phase. Importantly, supports target those sectors and businesses who will continue to be most impacted in the early stages of recovery.

Government is now planning for the post-pandemic economy. The pandemic has been transformative in many respects – transforming the way people work, the way goods and services are produced and the way that products are consumed. Digitalisation has been at the heart of this transformation and this is likely to persist post-pandemic. The pandemic has also showed that goods and services can be produced in a greener way with, for instance, a sharp fall in car-commuting due to home- and remote-working.

As the pandemic retreats, greater opportunities will exist in this greener, more digitised economy. These sectors offer productive (and hence higher wages), innovative, resilient and secure employment into the future. A key goal for Government, therefore, is investing in human capital – that is the knowledge, skills, education, experience of the labour force – so that Ireland can further develop critical mass in these areas. Indeed, the digital economy and ICT services offer enormous benefits to a geographically peripheral economy like Ireland: these services can be exported at the press of a button and, unlike heavy manufactured goods, do not need to be transported at high cost.

A key element in preparing the economy and society for the post-pandemic world will be a proactive approach to technological adoption and diffusion. A key technology will be Artificial Intelligence (AI) and the Government last week published its strategy for AI that set out its agenda for action across the public sector that will help companies, workers and wider society to reap the benefits of this transformative general purpose technology.

The strategic approach outlined in the ERP is operationalised in the Government's new *Pathways to Work 2021-2025* (PtW). PtW focuses on helping people back into employment, training and education and, in doing so, helps to minimise the long-term scarring effects of the pandemic on the labour force for those whose jobs are permanently lost. At their core, the ERP and PtW will help to drive a jobs-rich recovery, with an overall ambition to exceed pre-crisis employment levels by having 2.5 million people in work by 2024.

The Government's economic strategy also recognises that in early July, the *OECD Inclusive Framework* reached agreement, but not consensus, on the key aspects of the two-pillar solution to address tax challenges arising from the digitalisation and globalisation. Work will now continue with a view to finalising a comprehensive agreement in October. Ireland has been clear on the need to achieve a comprehensive, sustainable and equitable agreement on the international tax rules that meets the needs of all countries, large and small, developed and developing. Ireland remains committed to the process and aim to find an outcome that Ireland can yet support. It is important to note that the proposals will have costs to the Exchequer, which are estimated to be between €800 million and €2 billion annually. In addition, as the eventual outcome of reforms become clearer all countries will need to assess the compatibility of their tax systems with new global norms.

To complement the competitive tax rate, it is important to re-focus on traditional strengths, including a flexible business environment and an educated, dynamic workforce.

It is important to note the significant role which the EU has played during the past year and a half. Last summer, EU Heads of State and Government reached agreement on a financial package totalling €1.82 trillion for the 2021-2027 period as part of the *Multiannual Financial Framework* and the *Next Generation EU* (NGEU) recovery fund. Under the NGEU, Ireland's estimated grant allocation amounts to just over a €1 billion.

In summary, the economy is beginning to normalise following a once-in-a-century shock. The new norm will almost certainly be different from the old, however, and this creates opportunities as well as challenges. Government is working to ensure the building blocks are in place so that workers and Irish-resident firms can maximise the opportunities, and to minimise the challenges, in the post-pandemic world. But Government must work within a changing environment where budget constraints and trade-offs are, once again, a reality.

Box 1: Impact of policy measures on household disposable income

A key element of the fiscal policy response to the pandemic, in Ireland and elsewhere, has been to support household income via transfers from the general government sector.

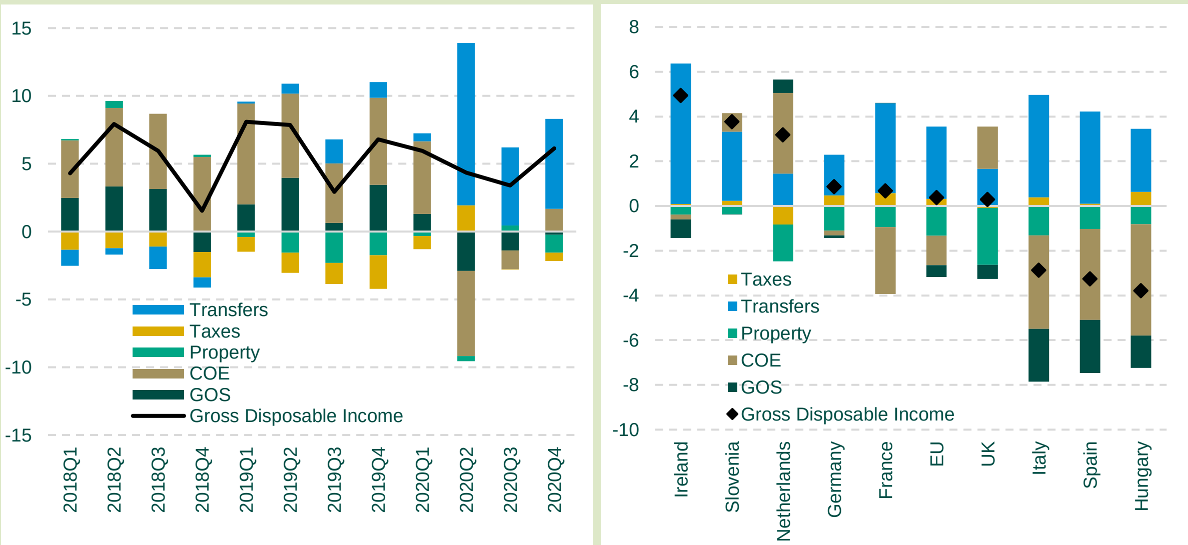
The scale of this support is evident from institutional sector accounts, published quarterly by the Central Statistics Office. This data-rich source shows *inter alia* the evolution of household income during the pandemic and the contributions of the various components of this income. It is worth stressing, however, that the data refers to the aggregate figure and, as is always the case, the aggregate hides a multitude of differences.

Figure 1a shows the annual change in aggregate household gross disposable income (GDI) over the last two years. Households **primary** income arises from the provision of labour services (the wage bill or, in national accounting terminology, 'compensation of employees'); from the ownership of capital (profit income or 'gross operating surplus' in national accounts terms); and from the ownership of assets ('property income' in national accounting terms, which includes, for instance, interest income arising from the ownership of financial assets). In deriving household disposable income, **secondary** income sources such as transfers received as well as taxes and transfers paid by households on their primary income (mainly income and wealth taxes) are taken into account.

Remarkably, household disposable income actually increased last year: nominal disposable income rose by 4.9 per cent (the equivalent of 5½ per cent when account is taken of consumer price inflation). The data confirm annual growth was recorded in each quarter, including in the second quarter during the first wave of the virus.

The contributions data make clear the reasons for this increase: while labour income fell sharply in the second and third quarters, this was more than offset by transfers from the general government sector. This is largely due to the *Pandemic Unemployment Payment* (PUP) which cost c. €5 billion last year. Note that the *Employment Wage Subsidy Scheme* is a transfer to firms, and forms part of the change in the pay bill in these data.

Figure 1: Contribution to annual change in gross disposable income, a) Ireland b) vs EU and UK, pp



Source: a) Department of Finance calculations on the basis of CSO data; b) Eurostat (EU data), ONS (UK data).

How does this compare with other European countries? Gross disposable income data for 2020 are now available for most EU Member States and for the UK. The data (figure 1b) show that among the countries for which these data are available, Ireland saw the largest increase in gross household disposable income in 2020. The 4.9 per cent annual increase compares with growth of 0.4 per cent for the EU as a whole and 0.3 per cent in the UK. The relatively strong growth in disposable income in Ireland is largely explained by the contribution from transfers such as the PUP and also the relatively small decline in wages in 2020, in-part as a result of the wage subsidy schemes. Indeed, the contribution of transfers to household disposable income growth in 2020 was largest in Ireland compared with all other EU Member States for which these data are available.

Chapter 2
Economic Outlook

2.1 Economic Background

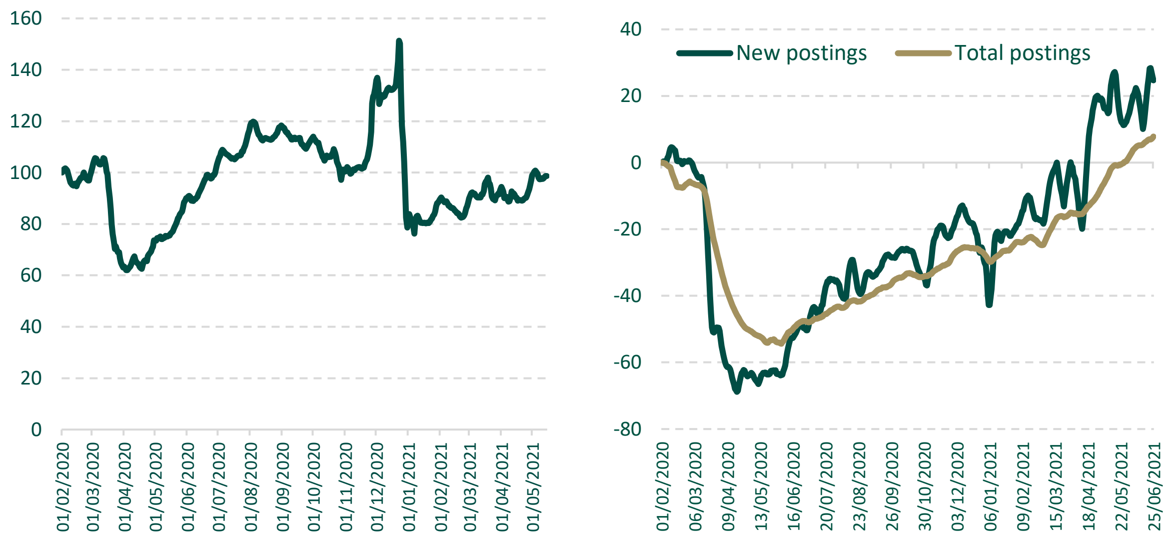
Over the past month-or-so, many sectors of the Irish economy have re-opened following one of the most stringent set of public health measures in the European Union. The public health benefits of restrictions, alongside a successful vaccination programme, are clear: infections and fatalities by end - June were down by close to 95 per cent since their mid-January peaks. The economic costs are, at the same time, also significant, as reflected *inter alia* in lost output, lost employment and higher public debt.

Not surprisingly, official data confirm a fall in modified domestic demand (MDD) in the first quarter. The data also confirm earlier assumptions of a decoupling of economic activity from the severity of restrictions. For instance, the 5 per cent annual fall in MDD in the first quarter compares with a fall of around 15 per cent during the first wave, the result of adaptation on the part of households and firms (box 1). While there are many dimensions to this, perhaps most obvious is the shift to online transactions, which supported consumer spending in the first part of the year (the share of online consumer purchases peaked at just over 50 per cent in late-January). More and more firms have 'gone digital', investing in remote working technologies. This, in turn, has provided support to investment and overall output growth.

Notwithstanding the more limited economic fallout from containment measures, the labour market impact continues to be severe. Almost half a million people were in receipt of the Pandemic Unemployment Payment at its peak in early February (with around 1 million people cumulatively on some form of State income support including wage subsidies); while this has subsequently declined, it remains elevated at close to a quarter of a million (figure 7).

On the external side, exports continued to perform strongly in the early part of the year, driven in the main by foreign sales of pharmaceuticals, 'contract' manufacturing goods and ICT services. This diverging sectoral performance (strong exports, weak domestic demand) is consistent with a 'K-shaped' economic performance during the pandemic (figure 6).

Figure 2: a) *Revolut* spending data; b) *Indeed* job postings



a. Source: *Revolut*; 7-day moving average, spending per user, indexed to February 2020.
b. Source: *Indeed,* 7-day moving average, per cent change relative to 1 February 2020.

Box 2: Improvise, Adapt, Overcome – the relationship between restrictions and output

To assess the economic impact of public health restrictions in real-time, the Department of Finance monitors (and publishes) a range of real-time high frequency indicators, including mobility and payments data. These data point to an evolving relationship between economic activity and mobility, and are suggestive of greater economic resilience during the second and third waves of the pandemic.

Figure 3: a) GDP growth and change in mobility; b) mode of consumer spending

Source: OECD, Google, Revolut, Department of Finance calculations; spending is 7-day average

Figure 3a shows the relationship between changes in output (inc. MDD for Ireland) and mobility levels during 2020. A flattening of this relationship is evident in the fourth quarter of 2020, despite the resurgence of the virus in many countries. This suggests that businesses and consumers were able to maintain relatively high levels of economic activity despite mobility restrictions at this time; this is in contrast to the situation during the first wave last spring in which lower mobility translated into lower economic activity.

This suggests 'learning effects' at play **on the part of firms**: for instance, firms adapting their business models ('click-and-collect') in order to maintain turnover levels during containment phases. **For governments**, public health restrictions may have become better targeted at reducing transmission, with some industries which had been forced to close during the first wave permitted to operate with adaptations in subsequent virus waves. **For workers**, remote-working arrangements have become widespread during the pandemic: with the infrastructure now in place, the adaptation costs for firms and workers are likely to be lower in later waves of the virus.

Changing behaviour on the part of consumers is evident when looking at spending patterns. Data from *Revolut* (figure 3b) and the *Central Bank of Ireland* show a shift to online consumer spending during containment periods. Evidence from industry shows a growing proportion of Irish businesses carrying out business online. Some of these trends are likely to persist beyond the pandemic: spending online remained higher than pre-pandemic levels despite the widespread re-opening of retail and service industries last summer. Additionally, survey data from Irish firms show that most intend to maintain a hybrid model, involving remote and in-person working beyond the pandemic.[3] Public policy will also contribute to this, in recognition of the environmental, work-life balance, and other positive spill-overs associated with remote working: the *Programme for Government* committed to developing a national strategy on remote working. This was published in January 2021, with a Code of Practice on the Right to Disconnect subsequently signed in April 2021. Work is currently in progress preparing legislation which will provide employees with the right to request remote working.

Looking beyond the pandemic there may even be productivity-enhancing effects due to investment in new technology and other firm organisational changes.[4] That-said, the jury is out on whether productivity growth will be higher or lower in the post-pandemic world.

[3] Anderson, Geraldine, *Returning to the Workplace 2021*, IBEC, May 2021, available at: https://www.ibec.ie/-/media/documents/connect-and-learn/research/return-to-work/returning-to-workplace---final.pdf.

[4] See 'Scarring effects', Economic Insights, Department of Finance, April 2021. Available at: https://www.gov.ie/en/publication/bc298-economic-insights-economic-developments-during-covid-19-and-beyond/

Real-time data are consistent with economic recovery setting in over the course of the second quarter, as restrictions were gradually relaxed (figure 1).[5] The level of consumer spending based on card payments returned to pre-pandemic levels in mid-May and now stands around 10 per cent above pre-pandemic levels.[6] A broadly similar story is evident in the labour market, where total job postings as of end-June were above pre-pandemic levels, with new job postings significantly higher.

Looking to the summer and beyond, the successful vaccination programme (with more than two thirds of the eligible population at least partly vaccinated and around half fully vaccinated) means that a widespread and sustainable re-opening of some of the most affected sectors is now in prospect. The unwinding of household savings from record levels will be an important tailwind.

The Department of Finance spring forecasts – set out in the *Stability Programme Update* – project MDD growth of 2½ per cent this year, followed by a 7½ per cent growth rate next year. A somewhat faster and more widespread than assumed re-opening should mean that there may be some upside to the 2021 projection; however, this is mainly a timing issue as some of the growth would be brought forward from next year (in other words, the level of economic activity at end-2022 would be unchanged relative to the SPU forecasts). The presence of the delta variant represents a downside risk to this outlook, not least because the pathway for the economy is, of course, predicated on the assumption of no re-imposition of containment measures.

2.2 Recent Developments

The epidemiological situation has improved significantly in recent months. Covid-19 case numbers have fallen by almost 95 per cent from the peak in January and the incidence among all age groups has declined. The 14-day incidence rate, which peaked at around 1,500 per 100,000 in January (15 positive cases for every 1,000 persons in the country) has fallen to around 115 at the beginning of July, and is broadly in line with Europe. Meanwhile hospital and ICU admissions have fallen to low levels, with the most vulnerable groups largely vaccinated at this point. Indeed, more than two-thirds of the eligible population has received a first dose of a vaccine, with around half fully vaccinated. This broad epidemiological and immunological situation is mirrored in most advanced economies, although the picture is not as favourable in less developed and emerging market economies.

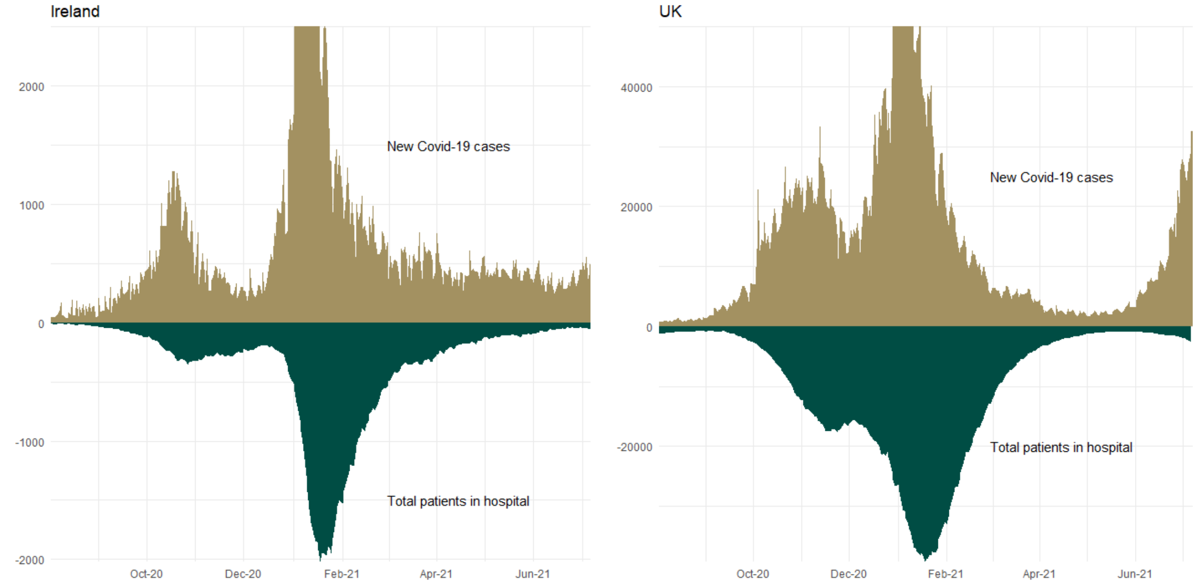
Against this background, the global economic outlook, in particular amongst advanced economies, has improved considerably in recent months. A clear pattern across all economies is the diminishing economic impact of lockdowns, with clear signs of adaptation (box 2). Additional fiscal supports, supported by an accommodative monetary stance, have been implemented in many jurisdictions, and this has helped to mitigate the economic fallout; this may also help to limit any long-term scarring from the pandemic.

First quarter data show GDP growth in the US of around 1½ per cent (q/q, s.a.), with GDP contractions of ⅓ and 1½ per cent in the euro area and UK, respectively. These euro area and UK figures compare with falls of 11 and 19 per cent recorded during the first wave of the virus last year (second quarter, 2020). Global industrial production has continued to strengthen over the first half of the year, and world trade in goods has passed its pre-pandemic level; of note, however, is that the euro area has lagged on both counts. Supply shortages for certain intermediate goods (e.g. semi-conductors, timber, commodities) have led to higher input prices; alongside a number of one-off factors, this has resulted in a pick-up in headline inflation rates (box 3). Service sector output in most advanced economies has

[5] See Department of Finance, *Emerging Economic Developments*, available at:
https://www.gov.ie/en/collection/305e4-emerging-economic-developments/
[6] Part of this could be a structural shift, and not necessarily a like-for-like comparison; nevertheless, these data are very useful in providing real-time information regarding economic developments.

lagged, unsurprisingly given ongoing health-related restrictions. However, continued progress in vaccination programmes should allow for a reopening of contact-intensive activities over the summer months.

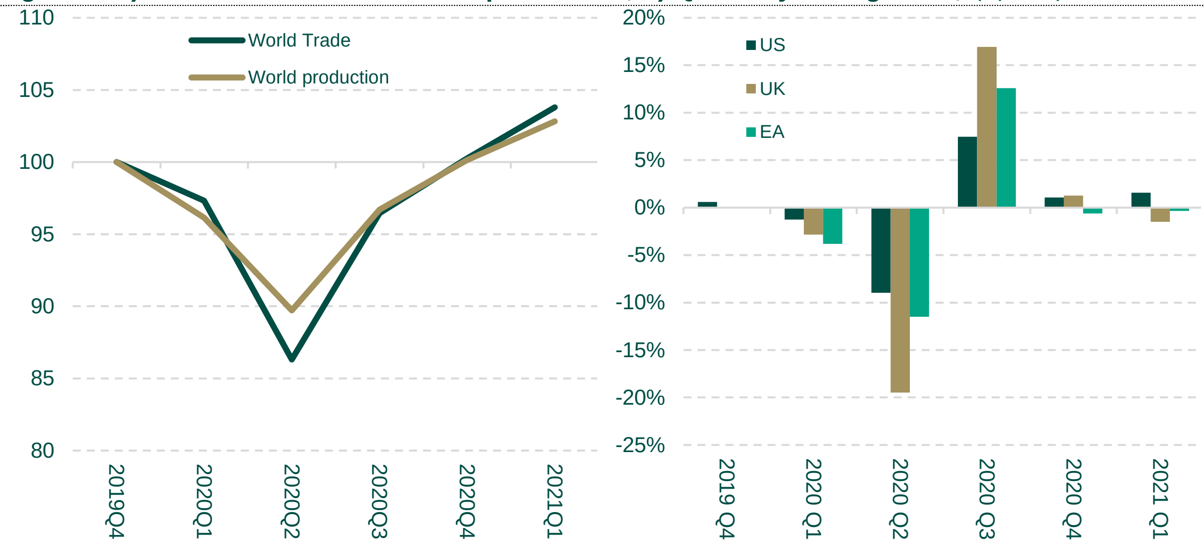
Figure 4: Vaccination – weakening of the relationship between infection and hospitalisation



Source: Department of Health, UK Government. Based on a plot by Colin Angus.
The Y-axis in both plots has been truncated for visualisation purposes.
These plots compare daily new Covid-19 cases reported ('flow') with the total number ('stock') of patients with Covid-19 in hospital.

Against this backdrop, OECD projections suggest world GDP growth of around 5¾ per cent this year. This comes on the back of a 3½ per cent decline in world GDP last year. For 2022, world GDP is projected at almost 4½ per cent, a growth rate which would bring the level of economic activity in most economies back to pre-pandemic levels by next year.

Figure 5: a) World trade and industrial production; b) Quarterly GDP growth, q/q s.a. per cent



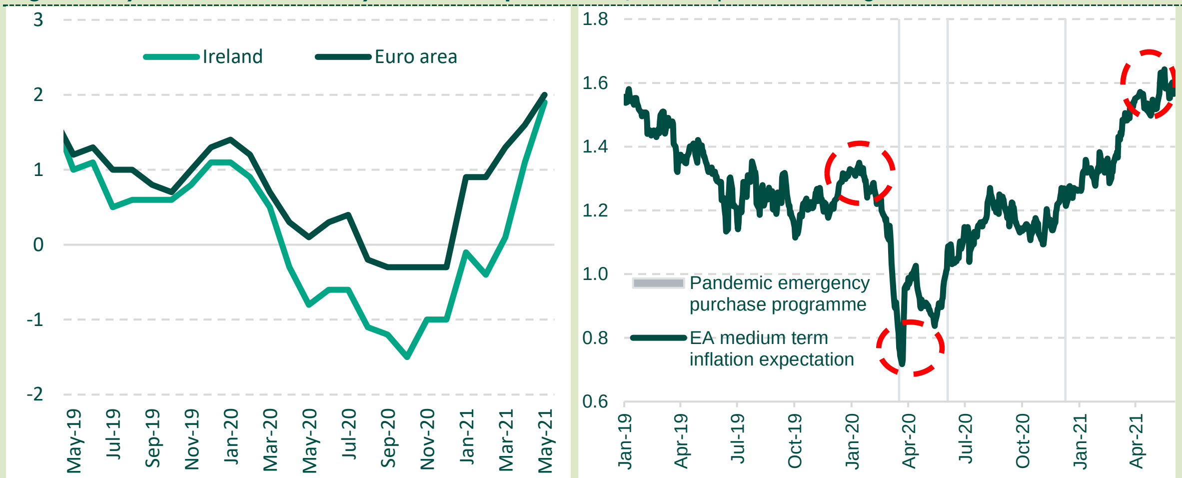
a. Source: CPB Netherlands. World trade and industrial production indexed to 2019 Q4.
b. Source: Macrobond.

Box 3: Inflation developments – temporary spike or persistent?

From an economic perspective, the pandemic can be thought of as both a demand- and a supply-side shock to the global economy. The impact of containment was to significantly lower the **demand** for goods and services while, at the same time, the availability of capital and labour to **supply** goods and services was curtailed.

In the immediate aftermath of the outbreak, the fall in aggregate demand dominated the contraction in aggregate supply, so that the net impact on prices was dis-inflationary in most regions. In order to curtail these dis-inflationary pressures, central banks in many advanced economies deployed 'quantitative easing' measures (using money-creation powers to inject liquidity) in order to lower borrowing costs (to flatten the yield curve).

Figure 6: a) Headline inflation b) Inflation expectations, annual per cent change



Source: Eurostat, Bloomberg

As economies across the world have re-opened, aggregate demand has recovered – rapidly in some cases – raising questions as to whether the pick-up in demand for goods and services has proceeded at a pace that is in excess of the market's capacity to supply these goods and services. That headline inflation has accelerated in many regions since the spring is suggestive of demand-supply imbalances, and this has prompted a lively debate regarding the persistence of these price dynamics. From a fiscal perspective, this is an important question as the stance of monetary policy has a direct read-across to Government financing costs.

There is clearly a time dimension to this debate. In the short-term, a perfect storm of transitory factors is fuelling price inflation in advanced economies. These include base effects associated with the 'normalisation' of oil prices, the reversal of temporary tax cuts in some regions, and a re-weighting of the CPI basket. On the demand side, the release of 'pent-up' demand, financed by the unwinding of high levels of household savings, has also contributed, particularly in capacity-constrained services activities. On the supply side, shipping bottlenecks have increased delivery times, while shortages of inputs (e.g. semi-conductors, timber) and raw materials have raised production costs (with higher costs then passed on to consumers). Disruption to supply-chains is also a factor for some goods prices while, in Ireland, there is the added 'Brexit' dimension, with higher trade costs potentially passing-through to higher consumer prices.

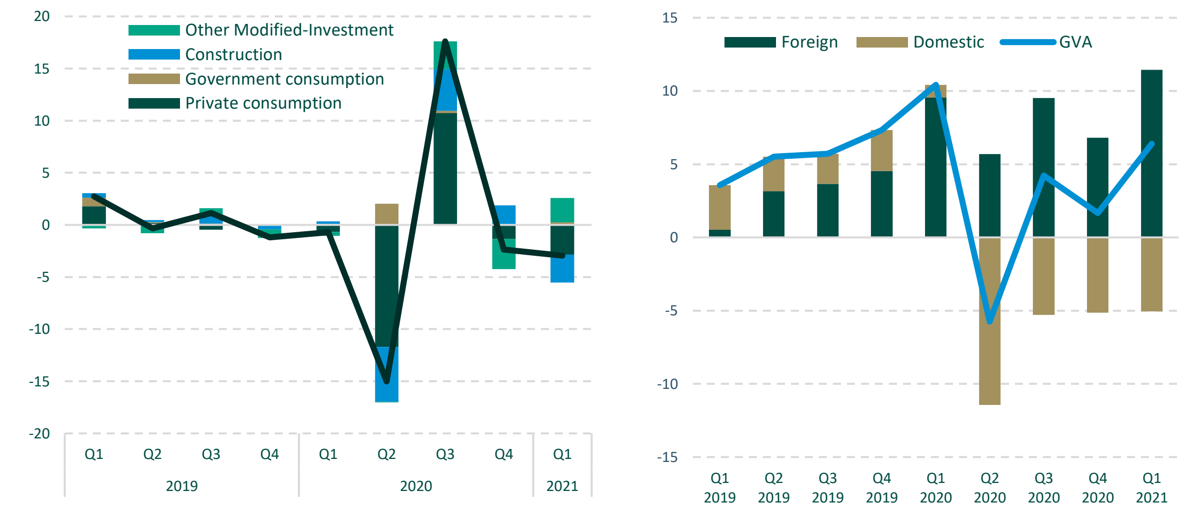
Looking beyond the short-term, one view is that these transitory factors will fade and that price inflation will stabilise at rates broadly consistent with price stability. Indeed, in the case of the euro area, some have suggested that the associated rise in inflation expectations (figure 2b) over the past year may even help to lift the economy out of the low-growth, low-inflation orbit that has dominated since the financial crisis.

On the other side of the debate is the view that the exceptionally strong recovery underway in many regions, alongside unprecedented monetary and fiscal support, will lead to persistent demand-supply imbalances, especially if diminished supply capacity is a factor. In relation to the latter, one key risk is that the forces which have kept inflation in check in recent decades begin to unwind. For instance, the wave of globalisation – the expansion of global value chains, the integration of China into the global economy – in the decades that preceded the pandemic was associated with muted price inflation. If the pandemic was to trigger a wave of de-globalisation (a re-shoring of activity, for instance), the dis-inflationary pressures of recent decades could be reversed.

Focussing on Ireland's main trading partners, very strong growth is projected in the US which, in no small part, reflects a combined $2¾ trillion dollars in stimulus packages since December (namely the *Consolidated Appropriations Act of 2021* and the *American Rescue Plan*). Closer to home, growth in the euro area is projected at over 4 per cent both this year and next; for the UK, where the pace of vaccination was more akin to that in the US, a very sharp rebound is projected for this year, moderating slightly next year (GDP growth rates of 7¼ and 5½ per cent this year and next, respectively). Importantly, recent estimates of permanent scarring in major economies are lower than initial estimates, although, clearly, it will be some time before more definitive assessments can be provided.

On the domestic front, official data for the first quarter paint a mixed picture, as has been the case throughout the pandemic. Unsurprisingly, the domestic economy contracted in the face of a comparatively stringent set of public health restrictions, with MDD down by nearly 3 per cent quarter-on-quarter. On the other hand, exports increased by 18 per cent, driven once again by the high-tech sectors, as well as a pick-up in contract manufacturing (essentially the manufacture of goods abroad, under contract, for Irish-resident MNCs) contributing positively to annual GDP growth of just under 12 per cent. However, parts of the indigenous exporting base have had a challenging year-to-date, in no small part due to the UK's exit from the *Single European Market* at the beginning of this year (box 4).

Figure 7: a) Contributions to changes in MDD; b) Gross value-added

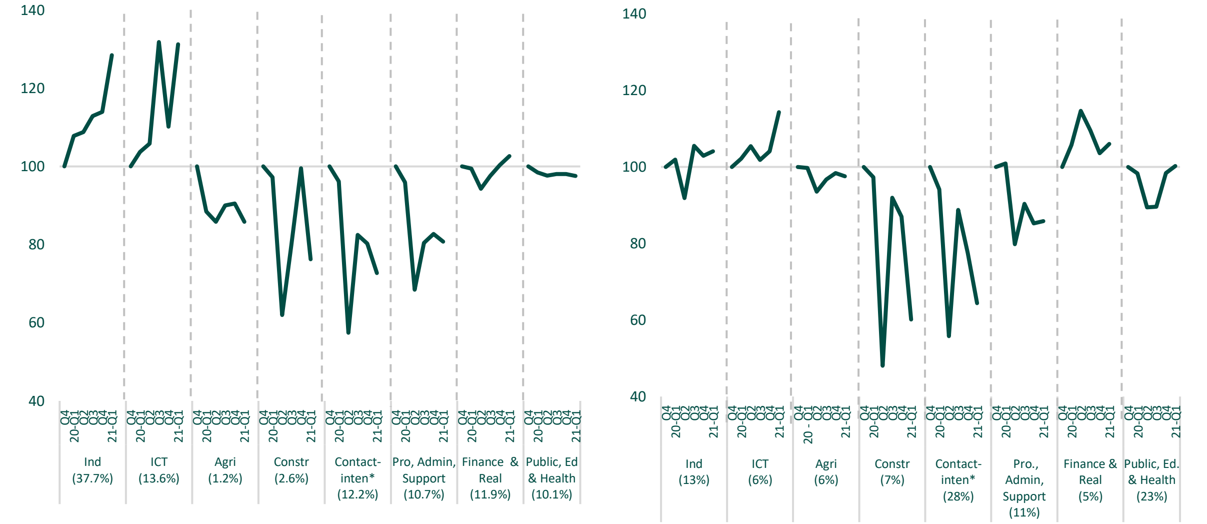


Modified domestic demand (MDD) represents the sum of private consumption, government consumption and investment excluding stocks, investments in aircraft by the leasing sector and net R&D imports. Other modified investment is machinery and equipment excluding investments in aircraft by the leasing sector, plus domestic R&D.
Source: CSO, Department of Finance.

At a sectoral level, official data confirm a heterogeneous economic impact of the pandemic. This "K-shaped" economic impact is evident in figure 6, which shows gains in gross value added (GVA) in the multinational exporting sectors with, at the same time, losses in GVA in domestic-facing sectors. Within the multinational sector, output in the ICT and manufacturing sectors grew by 19 and 13 per cent, respectively, in the first quarter, while output in contact-intensive service sectors fell by 9 per cent.

In line with the re-opening of construction, retail and parts of hospitality, incoming data point towards a relatively robust recovery in the second quarter. 'Core' retail sales data for May increased by 9 per cent while payments data from the Central Bank and *Revolut* are now around 10 per cent above pre-pandemic levels. PMI surveys for May indicated the highest reading for manufacturing on record while services exceeded the pre-pandemic level; consumer sentiment is now at a two-year high. Record housing starts in April indicate a recovery in the construction sector.

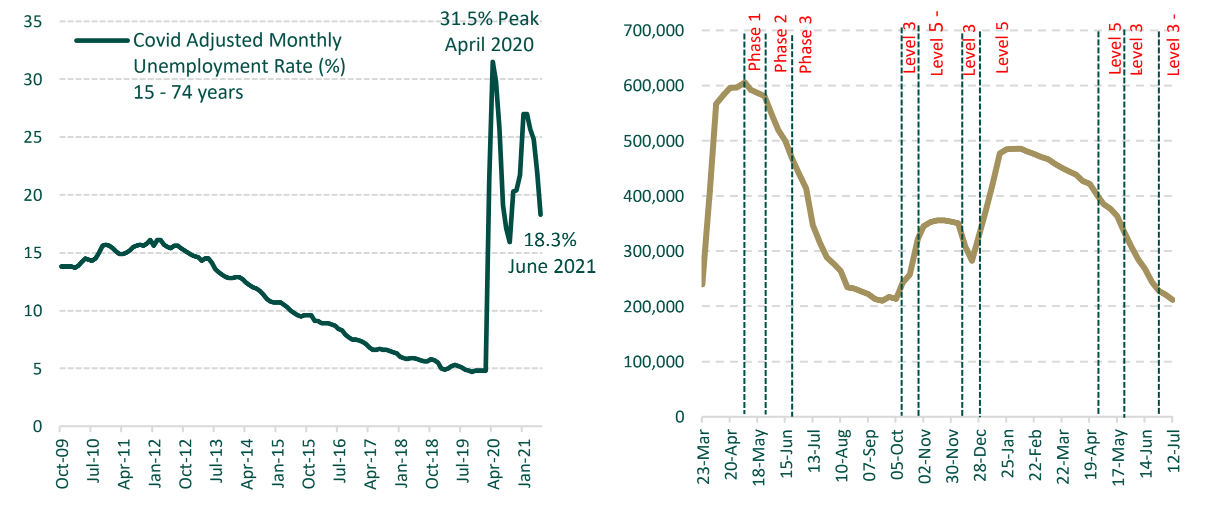
Figure 8: K-shaped recovery in a) output and b) hours worked, Q4 2019 = 100



Notes. Gross-value added at constant prices. Hours worked based on total actual hours worked.
Contact-intensive sectors grouping covers Distribution, Transport Restaurants and Hotels and Arts, Entertainment and Other Services.
Figures in brackets are sector weights in 2019 Q4.
Source: CSO, Department of Finance.

These developments are paying dividends in the labour market, where the numbers of persons on the PUP has fallen by more than half to around 212,000 in early July from a third-wave peak of around 485,000 in February this year. The decline averaged around 16,000 per week in June. Further reductions are in prospect when more labour-intensive activity, such as indoor dining, resumes. According to employment website *Indeed,* as of 26th June, total job postings are nearly 8 per cent above the pre-pandemic baseline with new postings 25 per cent above.

Figure 9: a) Covid-adjusted unemployment rate; b) weekly number in receipt of PUP



Source: CSO, Department of Finance.

2.3 Economic Outlook: 2021[7]

On the assumption of continued vaccine roll-out, and in the absence of any vaccine resistant variants, economic recovery should continue over the second half of this year. Personal consumer spending will

[7] More detailed analysis is set out in the *Stability Programme, April 2021 Update*.

be supported by the release of pent-up demand, financed, in part, by an unwinding of some of the estimated €12 billion in 'excess' savings accumulated during lockdown.[8] Amid a favourable global economic backdrop and improving sentiment indicators, firms should begin rebuilding their productive capacity, which will support a gradual improvement in core machinery and equipment investment (i.e. excluding investment in aircraft) in the second half of this year.

On the external front, improving demand in key export markets should support a recovery in some of the more indigenous exports. Tourism exports are expected to grow modestly (albeit off a low level) in the latter half of this year with the introduction of the European *Digital Covid Certificate*. Healthy growth in pharma and ICT exports should continue this year.

Overall, MDD is expected to expand by 2½ per cent this year, with the level of MDD expected to pass its pre-pandemic level in the fourth quarter this year. A somewhat faster and more widespread than assumed re-opening in the second quarter should mean that there may be some upside to the 2021 MDD projections, provided there is no re-imposition of containment measures in the face of the delta and other variants. The re-opening of labour-intensive sectors should support a strong recovery in employment, with the unemployment rate expected to fall to 11 per cent by the fourth quarter of the year. Price pressures could emerge, particularly in domestic services where supply is expected to be constrained somewhat, with external supply factors and one-off factors also contributing to inflation. As a result of much stronger than expected exports from highly globalised MNCs in the first quarter, GDP is now expected be 8¾ per cent this year, an upward revision from the SPU. However, there is limited domestic economic implications from these activities.

2.4 Economic Outlook: 2022 and the medium-term

The expected momentum over the second half of this year is expected to continue into and throughout next year. It is also assumed that lingering social distancing restrictions that limit supply, particularly in contact-intensive sectors, will be eased completely next year. While some constraints may exist in respect of foreign travel to certain parts of the world, travel within most of Ireland's major tourism markets should be less restrictive (again, assuming vaccine rollout and the absence of any vaccine-resistant strain of the virus).

Table 1: Macroeconomic growth and labour market forecasts 2020-2025

	2020	2021	2022	2023	2024	2025
Economic Activity						
Real MDD	-5.5	2.6	7.4	3.8	3.4	3.4
Real GDP	3.4	8.8	5.1	3.7	3.3	3.2
Labour Market						
Total Employment ('000)^	1,972	2,051	2,276	2,351	2,405	2,457
Employment	-15.1	4.0	11.0	3.3	2.3	2.2
Unemployment (per cent)	18.7	16.3	8.2	6.7	6.0	5.5

^ Nearest 1,000.
Source: 2020: CSO (outturn). 2021-2025: Department of Finance, *Stability Programme Update* 2021 (forecasts).

[8] The methodology for this estimate is described in box 3, *Stability Programme Update*, April 2021

Box 4: Assessing the immediate impact of Brexit on Irish-UK bilateral trade[9]

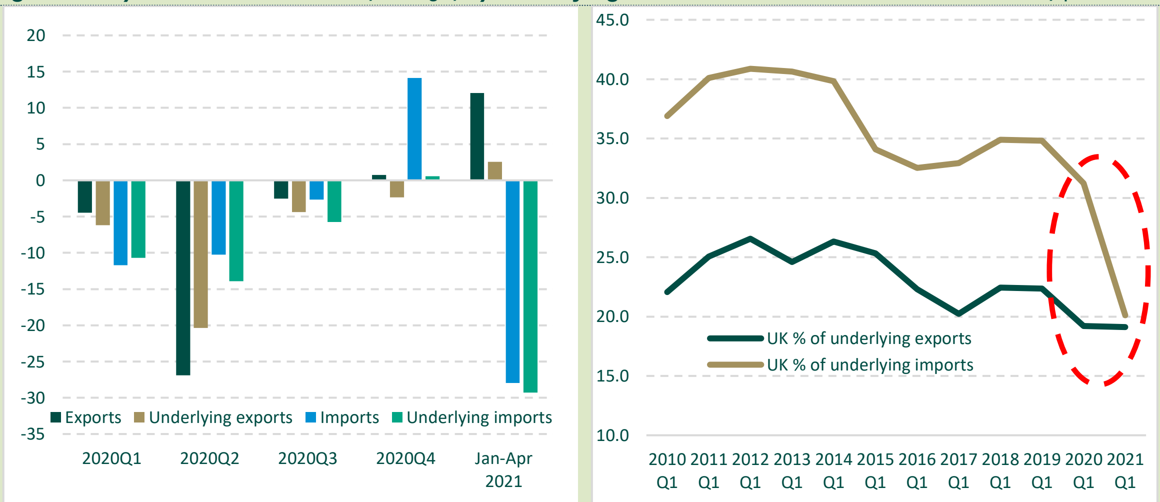
The UK's exit from the *Single European Market* (SEM) concluded at the end of last year and the *Trade and Co-Operation Agreement* (TCA) now governs trade between the two jurisdictions. From an Irish perspective, this ensures a continuation of tariff-free, quota-free trade in goods for Irish firms exporting to, and importing from, the UK.

However, bilateral trade under this new regime will be affected by a variety of non-tariff barriers, including rules-of-origin checks, customs procedures and additional Sanitary and Phytosanitary (so-called SPS) checks on agri-food products. These requirements have been implemented from 1 January 2021 by the EU (for imports to the SEM from the UK).[10] In contrast, the UK has chosen to implement the new procedures (to its imports from the EU) on a phased basis, with full customs checks only applying from the first quarter of 2022. Given the phased introduction of the new procedures, the full economic impact of Brexit will not be evident for some time.

Having said that, the early data provide evidence that the UK's exit from the SEM has had a clear and immediate impact on bilateral trade in goods between Ireland and the UK.[11] On the imports side of the equation, Irish purchases of goods from the UK declined by almost 30 per cent over the January-April period (i.e. relative to the same period of 2020); a broadly similar figure is apparent even if pharma and aircraft products are excluded (figure 10a). At a sectoral level, the decline was fairly broad-based, with significant falls recorded in most sectors.

A corollary of this is an acceleration in the long-term trend decline in the share of Irish imports sourced from the UK (figure 10b). In the first quarter of 2021, just one-fifth of (underlying) Irish merchandise imports were sourced from the UK; a decade earlier, the equivalent figure was two-fifths.

Figure 10: a) IE-UK bilateral trade, change**; b) Underlying IE-UK bilateral trade as share of total,** per cent



Source: CSO. 'Underlying' excludes exports/imports of pharma and aircraft.

The annual decline in imports was particularly sharp following the immediate introduction of the new arrangements in January and February, but has eased significantly in recent months. While this may suggest that firms are beginning to adjust to the new arrangements, it also possibly reflects the unwinding of pre-Brexit stockpiling as well as the weakness of imports in April 2020, the first full month of public health restrictions.

Turning to exports, Irish sales to the UK increased by 12 per cent in the January-April period. This was driven by very strong growth in pharma exports, with more modest 'underlying' export growth of just 2½ per cent. Exports to the UK were initially impacted by temporary disruptions in January, but have since recovered (although they remain below 2019 levels). On a sectoral basis, food and live animal exports remain in negative territory so far this year, albeit with evidence of some recovery in recent months.

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[9] More detailed analysis will be set out in *Economic Insights*, Department of Finance, July 2021 (forthcoming).
[10] Further requirements were applied by the EU, in respect of composite produces, from April 2021.
[11] Balance of payments data from the first quarter indicate little to no immediate impact on services trade with the UK, with both service exports and imports increasing by almost 8 per cent despite a dramatic decline in tourism and travel trade due to Covid-19.

The divergent outcome for exports and imports in the first quarter led to Ireland recording its first merchandise trade surplus with the UK since 2012 and largest since 2002.

Assessing the immediate impact of Brexit on bilateral trade is complicated by the fact that there are a number of other factors which are also likely to have affected trade flows in the early months of 2021. Specifically, there was a large increase in 'underlying' imports from the UK in the months leading up to Brexit, up 8 per cent in late-2020, consistent with pre-Brexit stockpiling. The re-imposition of stringent public health restrictions in both jurisdictions is likely to have affected goods trade although the fall in imports in the first quarter dwarfs the decline evident during the first lockdown when a broadly similar level of restrictions was in place.

While these factors may also be at work, the stark divergence between exports to, and imports from, the UK means that it is difficult to avoid the conclusion that diverging non-tariff barriers are impacting upon bilateral trade between Ireland and the UK. The impact of Brexit can also be seen by comparing the change in Irish (underlying) imports from the UK and EU (graph 11b). Notably, all other EU countries also recorded a decline in imports from the UK in the first quarter.

Figure 11: a) Irish imports from the UK, yoy change**; b) IE bilateral trade Jan-Apr 2021,** yoy change

Source: CSO

The early data also suggest that the new arrangements have led to substantial growth in merchandise trade with Northern Ireland, albeit from a low base.[12][13] This helped somewhat offset the significant decline in imports from Great Britain, and possibly indicates an initial substitution of goods trade and associated change in UK supply chains following the UK's exit from the SEM.

The Department will monitor, and report on, additional data over the course of this year and, more importantly, next year once UK customs checks are fully applied by the UK authorities.

Growth is expected to be consumer-driven with the consumption basket expected to shift towards big-ticket, durable goods, as well as certain services that were 'foregone' during the pandemic. A recovery in building and construction activity is expected. Investment in core machinery and equipment is projected to accelerate next year, on foot of improving business sentiment following the completion of the vaccine rollout programmes both domestically and in key trading partners. On the external side, exports are expected to grow broadly in line with external demand. Tourism exports could make a strong contribution, albeit from an exceptionally low base.

[12] However, the CSO has reported that historical data with Northern Ireland is subject to ongoing revisions, which may affect the scale of the increase.
[13] Ireland-Northern Ireland trade is not subject to the new customs and regulatory checks due to the provisions in the Northern Ireland Protocol.

Overall, MDD growth of just under 7½ per cent is expected with GDP growth of just over 5 per cent. A much stronger recovery is projected in the labour market next year bringing the unemployment rate to around 7¼ per cent by the end of the year.

While the eventual removal of restrictions will mean that most of this supply will come back on stream, over the medium term there is a real possibility that some workers or firms will permanently exit the market, dampening the economy's productive capacity. The UK's exit from the European Union will also impact on the supply potential of the economy, with higher non-tariff (i.e. regulatory) barriers limiting trade and in turn productivity. Taking these supply-side issues into account, GDP growth over the medium-term is tentatively projected at 3¼ per cent per annum. It is assumed some mismatches will exist in the labour market: the skills needed by firms in expanding sectors of the economy being different to the skills of those in firms in declining sectors.

Chapter 3
Fiscal Response to the Pandemic

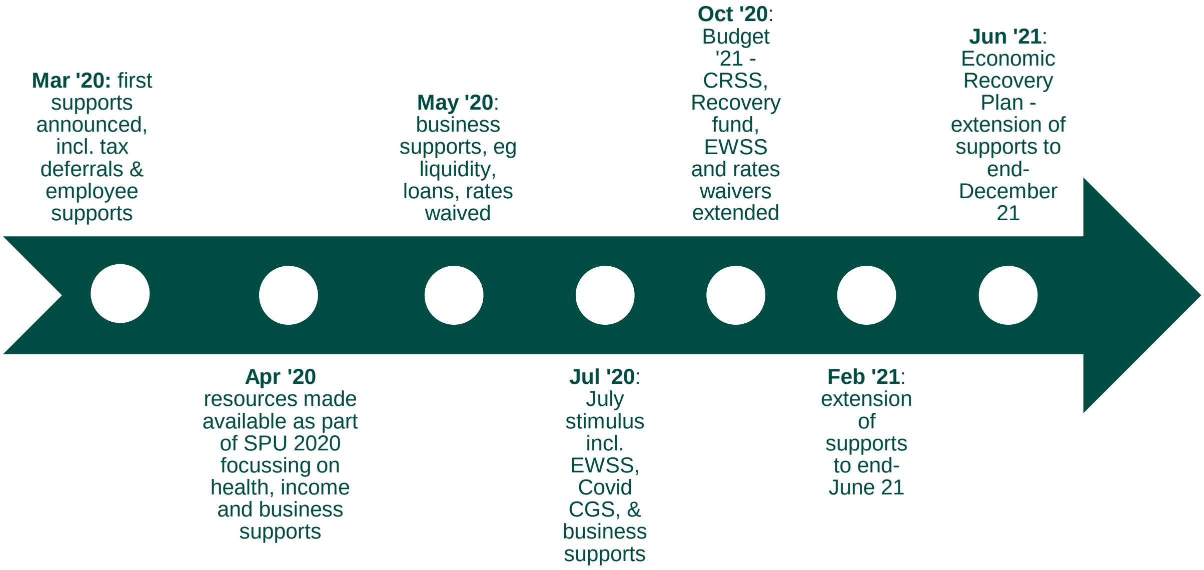
3.1 Introduction

The Government has responded forcefully to counteract the worst effects of the pandemic, deploying its balance sheet to replace lost income in the private sector and to minimise the long-term damage ('scarring') caused by the pandemic. Taking into account the measures announced alongside the *Economic Recovery Plan*, approximately €41 billion (or nearly one-fifth of national income as measured by GNI*) has been made available over 2020 and 2021, involving the full suite of policy tools, namely direct public expenditure, tax expenditures and 'below the line' supports such as loans and guarantees. When allowance is made for the cost of extending measures into 2022 (as provided for in the ERP), the total amount provided for rises to around €48 billion.

3.2 Timeline of interventions

As the first wave of the virus took hold last spring, the Government reacted swiftly to cushion the impact of necessary restrictions on households, employees and firms. The first fiscal supports were introduced in March 2020 and, since then, the Government has adopted a pro-active, flexible approach, tailoring support to the evolving economic and epidemiological situation.

Figure 12: Timeline of Covid-19 government support measures



Source: Department of Finance.

Broadly speaking, a set of seven interventions has taken place (figure 12). In aggregate terms, Government has provided around €38 billion by way of direct expenditure measures (table 2). Transfers to households (mainly the PUP) and firms (mainly the EWSS) account for the bulk of the expenditure measures. On the revenue side of the equation, tax deferral measures have provided important liquidity support to firms. In common with other jurisdictions, the Government has also provided guarantees; while this does not directly impact on the headline deficit, this policy instrument does raise contingent liabilities.

Table 2: Total fiscal support, € billions (unless stated)

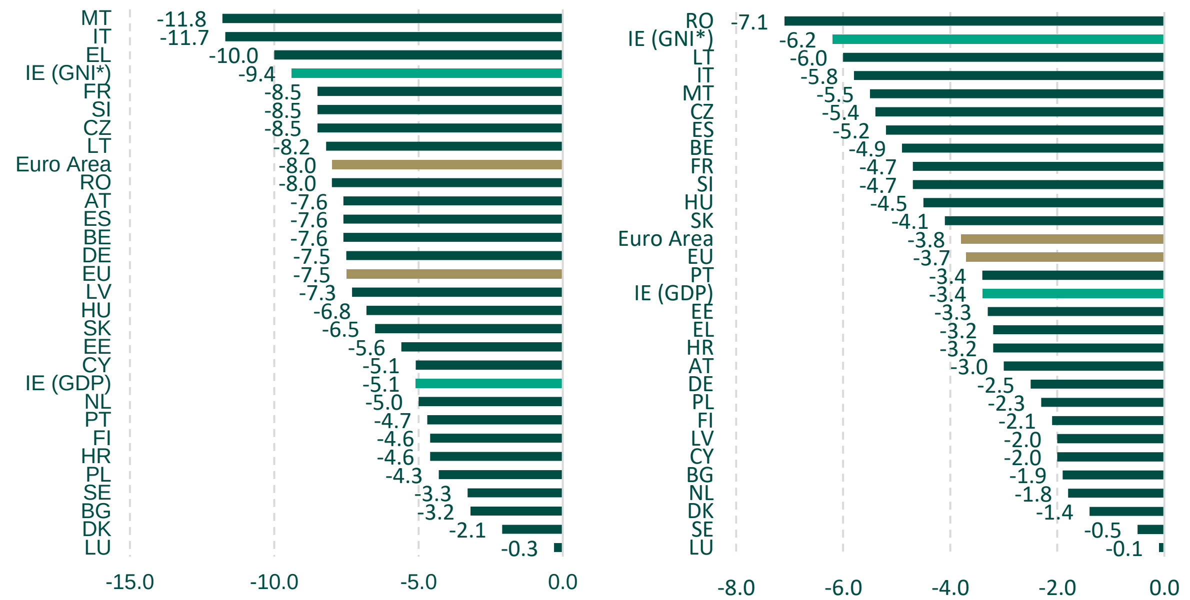
	2020	2021	2022	Total	% GNI*
Taxation measures	3.4	1.5	0.35	5.25	2.5
Expenditure measures	16.6	14.8	6.8	38.2	17.8
'Below the line' measures	5.0	0	0	5.0	2.4
TOTAL FISCAL SUPPORT	**25.0**	**16.3**	**7.15**	**48.4**	**22.7**

Source: Departments of Finance and of Public Expenditure and Reform;
Rounding may affect totals.
GNI* relates to modified Gross National Income and is estimated at c. €208bn for 2020, €216bn for 2021 and €232bn for 2022

3.3 Fiscal support: comparison with European norms

The unprecedented level of fiscal support provided by Government has given rise to substantial multi-year deficits. Figure 13 below puts Ireland's projected deficit in a European context, for this year and for next. In both years, the deficit projection compares favourably to other European countries when measured in GDP terms – towards the lower end of the distribution – but is at the upper end of the distribution in GNI* terms, the latter begin generally regarded as a more appropriate barometer of Irish living standards.

Figure 13: EU Member State deficits a) 2021; b) 2022, per cent of GDP (unless stated)



Source: European Commission Spring Forecasts, Department of Finance.

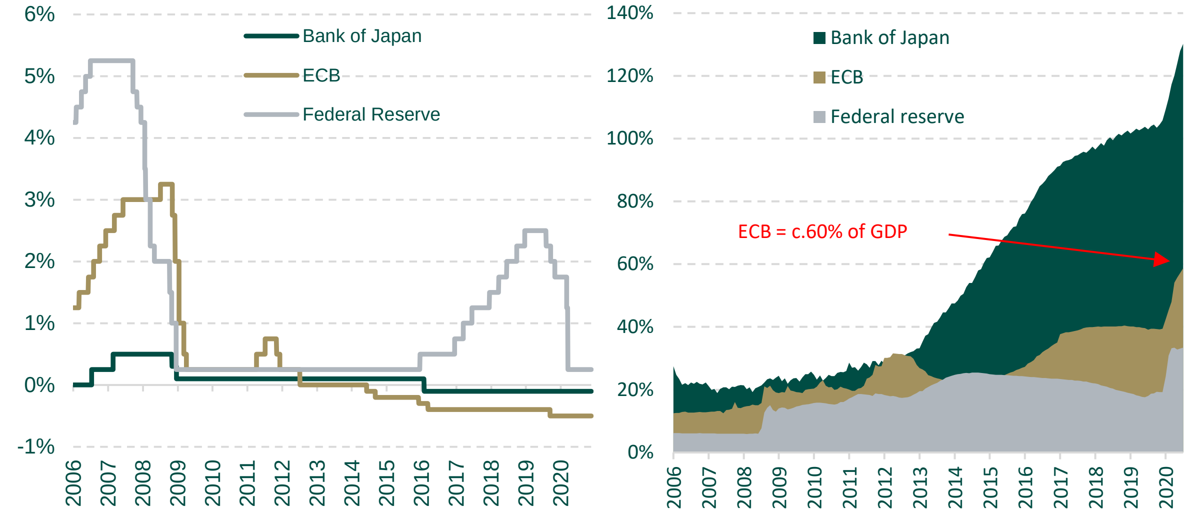
3.4 Fiscal and monetary policy support working *in tandem*

The Government – as in other advanced economies – has been supported in pursuing an aggressive fiscal response to the pandemic by the accommodative monetary policy stance of central banks. In terms of the macroeconomic toolbox, unlike fiscal policy, monetary policy cannot, at least in general terms, target specific sectors of the economy. Therefore, the approach adopted over the past year and a half in most advanced economies has involved proactive, counter-cyclical budgetary policy financed by issuing debt instruments at low cost, the latter facilitated by the stance of monetary policy.

In the case of the euro area, the *Pandemic Emergency Purchase Programme* (PEPP) is a key vehicle through which central banks purchase sovereign debt instruments. From an Irish perspective, some €16.8 billion in Irish sovereign debt instruments have been purchased to end-May 2021 under the

PEPP. Including bond purchases under other non-standard policies, the *eurosystem* has purchased almost €56 billion of Irish debt to date; this means that the *Central Bank of Ireland* is the single largest holder of the Irish Government bonds. A similar situation applies in some other euro area Member States.

Figure 14: Key central banks a) policy rates, per cent**; b) balance sheets,** per cent of GDP



Source: macrobond.

The PEPP is set to continue until March next year. The *Asset Purchase Programme* – a form of quantitative easing in the euro area that pre-dated the PEPP – continues, while the *eurosystem* continues to provide long-term funding to the banking system until the end of this year as part of the *Targeted Longer-Term Refinancing Operations* (TLTRO III).

In summary, monetary and fiscal policy in the euro area have been mutually reinforcing during the pandemic. This has helped to limit the fall in demand and to preserve, in so far as possible, the productive capacity of economies in the euro area, including Ireland.

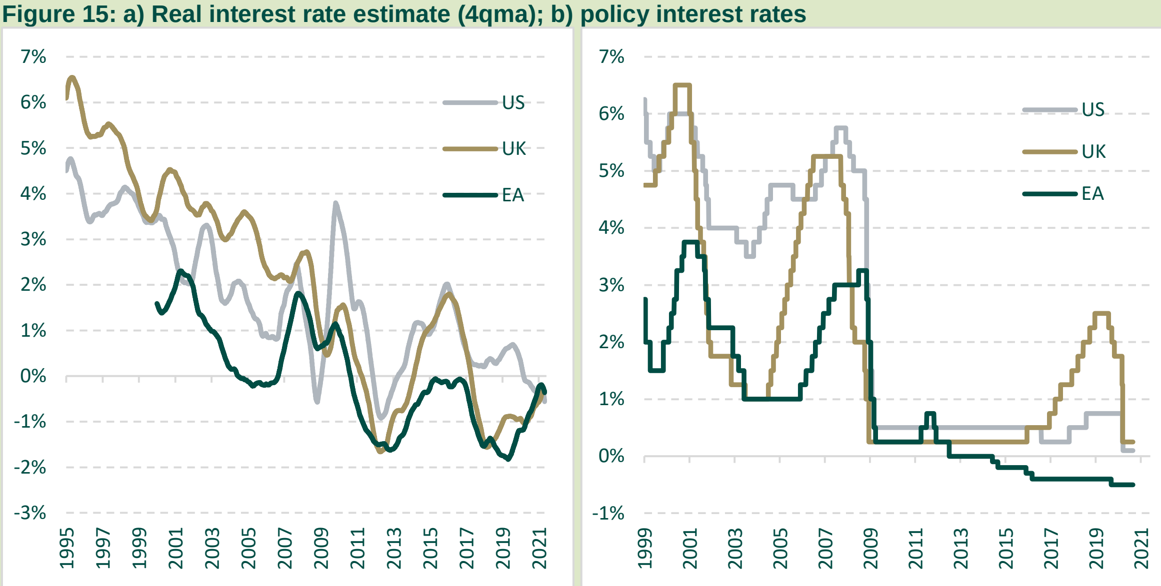
Box 5: The concept of 'secular stagnation' – a primer

Borrowing costs for advanced economy governments have been on a downward trajectory for decades (figure 15a). This trend has triggered an important debate within the economic profession regarding its drivers and, relatedly, whether these drivers represent a permanent shift. This, of course, is not just an academic issue; it has important policy implications *inter alia* with respect to financial stability and external sustainability. From a fiscal perspective, the decline in sovereign borrowing costs has a clear read-across to public debt sustainability.

Several factors have been advanced to explain the trend fall in long-term interest rates. These have largely (though not exclusively) centred on a global savings-investment nexus in which the interest rate adjusts in order to equilibrate the flow of savings (the supply of loanable funds) and the flow of investment (the demand for loanable funds).

Within this framework, the decline in interest rates reflects a combination of an outward shift in the supply of savings and an inward shift in desired investment. The (increasingly vast) literature advances several candidates to explain these shifts. In relation to increased savings, the most important relate to a 'glut' of savings in emerging market economies (most notably China), an ageing population in many advanced economies, and rising inequality in some regions. While all of these developments raise the propensity to save from current income, technological advances have reduced the relative prices of capital goods, in turn lowering the level of investment spending needed to achieve the optimal capital stock. Additionally, by reducing the rate of return, sluggish productivity growth may be contributing to lower levels of investment.

Figure 15: a) Real interest rate estimate (4qma); b) policy interest rates



Source: Macrobond, real interest rate estimate = nominal 10yr yield less CPI; Department of Finance

These developments have led some to conclude that the equilibrium (real) interest rate – sometimes referred to as the 'neutral interest rate', in other words the rate at which aggregate demand and supply are on an even keel and consistent with price stability – may have shifted downwards. This is related to the concept of 'secular stagnation', the idea that many advanced economies are moving in a low-growth orbit *inter alia* due to higher levels of savings and lower levels of investment. While the jury is still out on this concept, one important implication of such a lower neutral interest rate environment is that there is less scope for monetary policy to stabilise demand around its trend growth rate. An importantly corollary of this is that fiscal policy has a potentially larger role in stabilising demand (in both good and bad times).

Importantly, however, the direction of travel for some of the factors that may have shifted the supply of savings in recent years could potentially reverse. For instance, a reversal of the fall in the equilibrium rate could be triggered by a deepening of financial markets in emerging economies, which would reduce the demand for 'safe assets' of advanced economies. Alternatively, a shift in the Chinese growth strategy – from an exporting model to one driven by consumption – would also reduce the flow of world savings (supply of loanable funds). On the investment side, a post-pandemic recovery in productivity could potentially trigger sustained higher levels of world demand for loanable funds (investment).

Chapter 4
Budgetary Strategy

4.1 Background

The macroeconomic context against which the forthcoming budget will be framed is one in which economic recovery is gaining significant momentum. While some sectors have been bypassed, it is also clear that supply-side bottlenecks are becoming apparent in others, and this is impacting on price developments.

Against this backdrop, it is important that budgetary policy does not add fuel to the flames. To put it simply, budgetary policy should lean 'against the wind'. Government has pursued a counter-cyclical approach during the pandemic; to be effective, budgetary policy must be counter-cyclical during the recovery phase also. In other words, with the private sector recovery gaining momentum, it is necessary for public supports to be rolled back so as not to overheat the economy.

With the end of the pandemic now (possibly) in sight, it is also important to provide certainty regarding the medium-term orientation of budgetary policy. Government will target a deficit of 3.4 per cent of GDP for next year, the equivalent of €14.4 billion. To achieve this, the expenditure ceiling will be set at €88.2 billion for next year; Government will allow tax revenue to fluctuate in accordance with the economic cycle without amending the ceiling. This means that if the economic performance is worse than assumed, Government will allow for a larger deficit and *vice versa.* Expenditure ceilings are fixed – growing at an average rate of just above 5 per cent per annum at for the years 2022-2025; this growth rate is broadly consistent with the estimated trend growth rate of the economy (allowing for inflation).

4.2 Fiscal developments in 2021: an update

A deficit target of 4.7 per cent of GDP (8.4 per cent of GNI*) was set out in the *Stability Programme Update*. This was based on policies prevailing at the time and did not provide for additional fiscal interventions. It assumed that the two budgetary contingency funds – the *Covid Contingency Fund* and the *Recovery Fund* – were fully utilised (the equivalent of €5.4 billion), which has proved to be the case.

The Government published the *Economic Recovery Plan* (ERP) on 1st June. This contained up to €5 billion worth of fiscal measures *inter alia* in order to support sustainable economic growth post-pandemic.

Table 3: Budgetary projections 2020-2025, € millions (unless stated)

	2020	2021	2022	2023	2024	2025
Voted spending ceiling	85,285	90,720	88,200	85,100	89,040	93,230
Exchequer Balance	-12,310	-18,775	-13,010	-6,005	-6,915	-8,035
General Government Balance	-18,410	-20,285	-14,370	-8,050	-7,630	-7,355
GGB, per cent of GDP	-5.0	-5.1	-3.4	-1.8	-1.6	-1.5
GGB, per cent of GNI*	-8.9	-9.4	-6.2	-3.3	-3.0	-2.8
GG debt, € billions	218.2	241.5	252.3	262.3	273.4	281.7
GG debt, per cent of GDP	59.5	60.3	58.9	58.1	57.7	56.7
GG debt, per cent of GNI*	105.1	111.8	108.6	108.0	107.7	106.3

Source: Department of Finance
Note: Figures are rounded to the nearest €5 million and may affect totals

Total gross voted expenditure to end-June 2021 was €39.9 billion, an increase of €1.5 billion (4.0 per cent) in year-on-year terms. Total voted expenditure is now projected at €90.7 billion for this year. On the revenue side, taxation receipts have held up, with robust income tax and corporation tax receipts. Consequently, the Department has revised up its tax forecast in 2021 by €1.6 billion.[14] Tax revenue is projected at €61.9 billion for this year, an increase of 8.4 per cent relative to last year.

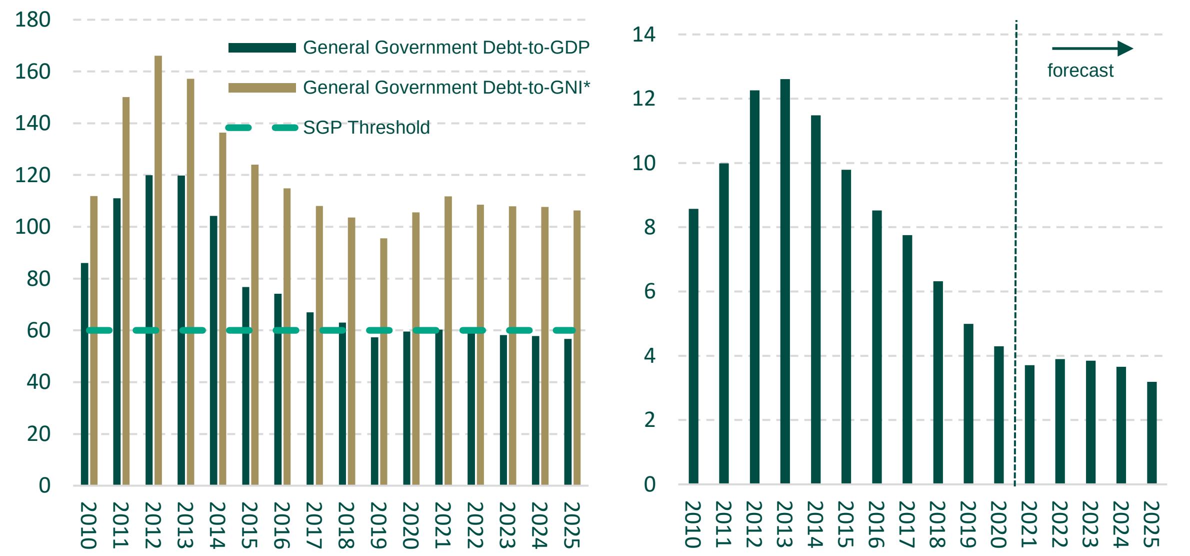
Table 3 sets out the key fiscal metrics consistent with the additional expenditures contained in the ERP as well as provision for further covid-related expenditure in 2022. Overall, a budgetary deficit of 5.1 per cent of GDP (9.4 per cent of GNI*) is now projected for this year. It should be noted that these are high level 'top-down' estimates. As is the norm, a fully-fledged macro-fiscal forecast will be published alongside *Budget 2022* in October.

4.3 Budgetary Strategy: key factors

Since the onset of the pandemic, the Government has leveraged its balance sheet in order to compensate for the huge reduction in private sector demand (both personal and corporate). As the pandemic begins to fade, budget constraints will once again become a fact of life. Extraordinary monetary support will be withdrawn, presumably in a gradual manner, from next year. The corollary of this is that borrowing costs will, almost certainly, begin to rise.

The medium-term budgetary strategy is determined by the need to ensure that the public finances remain on a sustainable path while continuing to support economic activity. In relation to sustainability, it is worth stressing that, by the end of this year, Irish public sector debt will stand at close to a quarter of a trillion euros, or 112 per cent of GNI*. On a per capita basis, in 2020, public debt stands at just under €44,000 per person, one of the highest levels in the world.[15] As outlined in this document, Government will continue to borrow over the medium-term, so that the level of debt will rise further.

Figure 16: a) General government debt-to-income; b) Interest-to-revenue ratio



Source: CSO and Department of Finance.

Legal obligations are also relevant in defining medium-term parameters that guide budgetary policy. The General Escape Clause of the *Stability and Growth Pact*[16] will be de-activated at some stage –

[14] This figure is net of further changes made in respect of measures announced with the ERP.
[15] See *Annual Debt Report 2020*, Department of Finance, available at: https://www.gov.ie/en/publication/291b8-annual-report-on-public-debt-in-ireland-2020/
[16] Formally, the fiscal rules set out in the SGP remain in place; however, the escape clause has been activated which means that the requirement to meet various numerical targets have been suspended.

presumably next year – so that Member States are legally required to meet various deficit and debt metrics. Domestically, the *Fiscal Responsibility Act* was enshrined in law following the constitutional referendum on the *Fiscal Stability Treaty* in 2012; this requires a balanced budget (or progression towards a balanced budget) in normal times.

Against this background, the Government is committed to exiting the temporary fiscal supports. Unwinding non-core expenditure allows Government to concentrate on the core elements of spending: the delivery of day-to-day public services and capital investment that, in most circumstances, is repeated year-after-year.

In designing an appropriate budgetary strategy, the Government is also taking into account the significant expenditure pressures mounting over the medium and long-term, most notably from:

- an ageing population;
- the digital and carbon transitions;
- the need to finance the provision of better healthcare, including via *Sláintecare*.

Additionally, the Government must take into account adverse revenue developments, most notably the very real possibility of lower corporation tax receipts. Recent agreement at the G7 brings international corporate tax reform a step closer; while further agreement is needed within the OECD framework, there is no doubt that this poses a serious risk to Irish corporation tax revenues. The Department of Finance's central estimate is that revenues from this source could be around €2 billion lower over the short to medium-term; however, there remains considerable uncertainty with the possibility that the overall impact could be even larger.[17]

4.4 Budgetary Strategy

Government's budgetary policy response to the pandemic has helped to limit damage to the economy. As the pandemic begins to pass, budgetary policy must also begin to normalise. For this year, a deficit of 5.1 per cent of GDP (c. 9.4 per cent of modified gross national income) is in prospect; while this can be absorbed as a temporary response to the pandemic, running a deficit of this magnitude beyond the very short-term is simply not sustainable. Pivoting away from generalised supports to more targeted measures is the most appropriate way of balancing support for the economy while, at the same time, putting the public finances back on to a sustainable path.

A medium-term budgetary anchor is a key part of a budgetary framework, in that it provides guidance to households and firms regarding the stance of Government policy. To this end, *Budget 2022* will be consistent with an expenditure ceiling of €88.2 billion. This would be consistent with bringing the deficit to 3.4 per cent of GDP next year; in the event that the economy evolves in a different manner to that projected, the automatic stabilisers will be allowed to operate fully and symmetrically. The levels of the expenditure ceilings are also fixed for 2023-2025, at growth rates consistent with estimates of the trend growth rate of the economy.

This approach to calibrating the medium-term budgetary strategy is consistent with short-term cyclical stabilisation (by fixing expenditure ceilings and allowing automatic stabilisers operate in response to

[17] Whilst the fiscal projections continue to assume an eventual €2 billion loss in corporation tax receipts, the political statement following the 1 July *Inclusive Framework* indicates that a revenue impact in 2022 is now unlikely, with the statement signalling the intention that implementation become effective from 2023. These developments represent a downside risk to the revenue projections and, as technical and operational elements of these proposals are further discussed and as more information becomes available, it will be necessary to adjust the corporation tax revenue assumptions.

cyclical economic swings) and medium-term fiscal sustainability (by setting out a pathway towards broad balance). In addition, this approach ensures that Ireland's borrowing requirement is not out-of-sync with other euro area Member States. The need to avoid outlier status is reinforced by the monetary policy stance – existing policy involves central banks in the euro area tapering their purchases of sovereign debt early next year; in a nutshell, this means growing reliance on private capital markets to fund debt issuance with, in all likelihood, a higher cost of borrowing.

Adverse demographic trends underlie the need to restore broad balance to the fiscal accounts over the medium-term. On this, the scientific evidence is clear: the Irish population is ageing and the fiscal costs associated with this are very large. Ignoring the facts is not an option and Government will not bury its head in the sand.

Table 4: Budgetary strategy, € billions (unless stated)

	2021	2022	2023	2024	2025
Expenditure ceiling	90.7	88.2	85.1	89.0	93.2
Total budget package	5.5	4.7	4.5	4.8	5.0
Budgetary decisions*		3.2	3.0	3.2	3.4
Yet to be allocated**		1.5	1.5	1.6	1.6
of which: tax measures		0.5	0.5	0.5	0.5
Voted spending					
Temporary	14.8	8.1	1.0	0.7	0.5
Permanent	75.9	80.1	84.1	88.3	92.8
Growth in permanent spending, per cent	7.8	5.5	5.0	5.0	5.0
Core current	66.1	69.2	72.4	75.7	79.3
Core capital	9.8	10.9	11.7	12.7	13.4
Change in core capital	0.0	1.1	0.8	1.0	0.8
GGB, per cent GDP	-5.1	-3.4	-1.8	-1.6	-1.5
GGB, per cent of GNI*	-9.4	-6.2	-3.3	-3.0	-2.8

Source: Department of Finance
*ELS, demographics, NDP and public pay
**to fund enhanced public services and social welfare package
Note: Rounding may affect totals.

Taking all of the above into account **three strands** of budgetary strategy emerge. Firstly, as outlined in the *Economic Recovery Plan*, **pandemic-related supports must be unwound as appropriate over the course of this year and next**. Progress on returning the public finances to a sustainable path depends on a significant reduction in Covid-related spending in 2022. Any spending that is not unwound, i.e. that becomes structural, will need to be financed through additional revenues.

Secondly, fiscal policy over the coming years will have to recognise the **deepening challenges that Ireland faces over the medium-term.** Government will have to prioritise expenditure *inter alia* to meet the fiscal costs of an ageing population and to limit climate change. Across the board, generalised increases in public expenditure limit the ability of Government to meet these challenges and, in practice, impede their attainment.

Thirdly, it is necessary to **anchor budgetary policy within a medium-term framework** in order to provide certainty. This involves fixing the overall amounts of public expenditure (at levels set out in table 4); as the economy fluctuates around its trend growth, the headline deficit will be allowed to fluctuate also, while keeping the spending ceiling fixed. This expenditure rule – where increases in spending are fixed at the economy's estimated trend growth rate – is consistent with stabilisation of the debt ratio at just over 106 per cent of GNI* by mid-decade.

Taking these factors into account, *Budget 2022* will be delivered within the context of a (gross) spending allocation amounting to €88.2 billion. On the basis of current expectations, this would be consistent with a general government deficit in 2022 of 3.4 per cent of GDP (6.2 per cent of GNI*).

Government will allow automatic stabilisers operate so that weaker economic growth will result in a larger deficit, while keeping the expenditure allocation fixed. A symmetric application of this rule will be applied in the event of stronger-than-expected economic growth.

Table 5: key fiscal aggregates, € millions unless stated

	2020	2021	2022	2023	2024	2025
Total voted spending	85,285	90,720	88,200	85,100	89,040	93,230
: current	75,635	80,555	75,975	73,225	76,215	79,630
: capital	9,650	10,165	11,145	11,875	12,825	13,600
plus: Brexit Adjustment Reserve			1,080			
Tax revenue	57,165	61,945	65,815	69,330	72,225	75,185
GGB	-18,410	-20,285	-14,370	-8,050	-7,630	-7,355
Current budget balance	-4,000	-9,015	-1,380	5,200	5,365	5,085
GG interest expenditure (SPU)	3,685	3,360	3,665	3,830	3,795	3,445
Primary (non-interest) balance	-14,725	-16,925	-10,705	-4,220	-3,835	-3,910
Debt, € billions	218.2	241.5	252.3	262.3	273.4	281.7
Debt-to-GNI*	105.1	111.8	108.6	108.0	107.7	106.3

Source: Department of Finance.
Rounding may affect totals

Beyond next year, Government will aim to bring the deficit to 2.8 per cent of GNI* (1.5 per cent of GDP) by the mid-part of this decade. This will involve allowing core spending growth of 5 per cent per annum and, again, allowing for the full and symmetric operation of automatic stabilisers. Table 5 above sets out various fiscal metrics associated with this budgetary strategy.

The deficit resulting from this overall strategy is significantly in excess of that envisaged at the time of the *Stability Programme Update* (table 6). This reflects *inter alia* the Government's commitment to increase the supply of housing and other critical infrastructure.

Table 6: Budgetary projections 2020-2025, € millions

	2020	2021	2022	2023	2024	2025
Deficit per SPU	-18,410	-18,060	-11,615	-5,320	-3,130	-805
Deficit per SES	-18,410	-20,285	-14,370	-8,050	-7,630	-7,355
Difference	-	-2,225	-2,755	-2,730	-4,500	-6,550
Capital spending per SPU (ex-BAR)		10,165	10,345	10,690	11,055	11,435
Capital spending per SES (ex-BAR)		10,165	11,145	11,875	12,825	13,600
Difference		-	800	1,185	1,770	2,165

Source: Department of Finance.
Rounding may affect totals.

Chapter 5
Public Expenditure Strategy

5.1 Overview

Direct public expenditure measures have formed a critical part of the Government's response to Covid-19. Over the course of this year and last, over €31 billion has been made available by Government to fund expenditure measures to support and protect households and enterprises, as well as to fund additional public services during the pandemic. Taking into account the further supports set out in the *Economic Recovery Plan*, the gross expenditure provision for the year will be almost €91 billion. This compares with just over €70 billion in planned expenditure for 2020 pre-Covid and reflects almost €15 billion in expenditure either allocated or earmarked for Covid-related spending measures.

While we are facing uncertainty with the delta variant, the vaccine rollout is continuing at pace, and more and more of our people are benefitting from the protections. As the economy starts to recover, the priority will be to support our people in getting back to work and using the available public resources to stimulate economic activity while ensuring the public finances are in a position to address key priorities for our people in housing, health, education and climate action.

To deliver on this priority will require that there is an appropriate phased removal of temporary pandemic-related supports alongside increases in core expenditure that are sustainable both today and in the future. This approach is reflected in the expenditure projections set out in this document, with for 2022 almost €7 billion set aside for Covid-related expenditure next year while core expenditure grows by an annual average of just over 5 per cent over the forecast horizon.

This would see core spending growing from €76 billion in 2021 to almost €93 billion in 2025. This significant level of expenditure on services and investment in infrastructure requires that there is a continued focus on ensuring that this expenditure delivers value for money and improved outcomes.

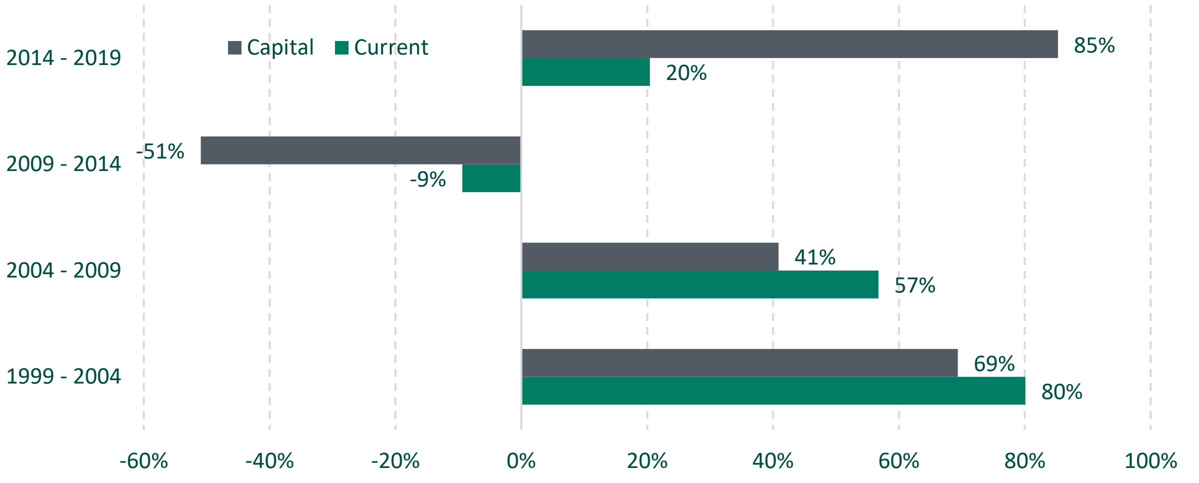
5.2 Sustainable Growth in Expenditure

In relation to core areas of expenditure, the challenge is to deliver on the key policy priorities, as set out in the *Programme for Government,* in an overall fiscal envelope that is sustainable over the medium-term. A pattern of unsustainable increases followed by significant expenditure consolidation puts economic and social well-being at risk.

The period prior to the recent public health crisis saw annual average increases in expenditure of c. 5 per cent to support incremental improvements in the provision of day-to-day services and social supports and significant uplifts in public investment. This strategy left the public finances in a position to support the significant fiscal response to Covid-19.

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.

Figure 17: Growth in current and capital gross voted expenditure, five-year intervals



Source: DPER databank; figures are expressed in nominal terms.

5.3 Covid-19 Response

Across 2020 and 2021, significant fiscal supports have been put in place by Government to respond to the impacts of Covid-19 on people, businesses and on key public services. Taking into account measures announced in the *Economic Recovery Plan,* around €31 billion in direct expenditure supports have been provided over the course of 2020 and 2021.

Provision for almost €12 billion in supports was made as part of *Budget 2021*, separate to core Departmental allocations, with €6½ billion of this allocated at Departmental level and €5.4 billion held in reserve (the *Contingency Reserve* and the *Recovery Fund*). The additional funding provided to Departments allowed for the continuation of income and employment support schemes; ongoing supports for businesses; funding for the transport sector; additional training and education places, and safe school operation.

The public health restrictions resulting from the resurgence of the virus in late 2020 resulted in higher demand for the main income and employment support schemes than had been envisaged at the time of *Budget 2021*. The Further Revised Estimates voted by *Dáil Éireann* in June reflected additional funding for Covid-19 related supports of over €4¼ billion, with just over €4 billion in additional funding for the Department of Social Protection. Taking into account funding earmarked for sectors including Health, Education and Further and Higher Education, and the funding required for commercial rates waivers for businesses impacted by public health restrictions, the €5.4 billion in funding held in reserve is, at this stage, either accounted for or allocated.

Further measures were announced by Government on June 1st as part a comprehensive package of supports under the *Economic Recovery Plan* including the further extension of enterprise and labour market supports, complemented by targeted supports for the most impacted sectors. These measures will bring Covid-19 expenditure for this year to €15 billion, leaving overall gross voted expenditure at €90.7 billion, before taking account of any offsetting underspends that may arise over the year.

Within the overall estimated amount of €15 billion, it is estimated that by the end of the year €10 billion will have been provided in income and employment supports on Covid schemes by the Department of Social Protection this year. As outlined in *Box 1*, the *Pandemic Unemployment Payment* and the *Employment Wage Subsidy Scheme* have been critical to cushioning the impact on people's incomes.

5.4 *Budget 2022* and Medium-Term Expenditure Strategy

The approach adopted in relation to core expenditure, which underpins the fiscal forecasts set out in this document, is based on an annual average growth rate of expenditure of just over 5 per cent, broadly in line with the trend growth rate of the economy. This approach sees spending fixed, while allowing the deficit to fluctuate with the automatic stabilisers operating as the economy fluctuates around its trend growth rate. This approach along with the unwinding of the temporary Covid supports sees the public finances move to a more sustainable position by the mid-part of the decade.

Addressing key infrastructure requirements in housing and to meet the challenges of climate change are key priorities of Government. Consequently, over the period 2022-2025, while core current expenditure grows by on average just under 4.7 per cent, the annual growth rate in core capital expenditure is over 8 per cent on average over this period, with total capital investment, including measures funded by the NRRP growing by an average of just over 8½ per cent.

In relation to *Budget 2022*, the overall increase in core expenditure is 5.5 per cent reflecting a significant uplift in capital investment. This would allow for an increase of €4.2 billion in overall core expenditure with current expenditure increasing by €3.1 billion and capital investment by €1.1 billion. This level of additional funding would be to meet existing level of service (ELS) costs, allow for the implementation of policy measures to enhance public services and social supports, and provide a further significant uplift in capital investment.

Based on budgets in recent years pre-Covid, and an assessment of the position in advance of *Budget 2022*, the ELS costs, arising from pay agreements, demographics, carryover of prior year measures, and pressures on certain demand led schemes can amount to c. 3 per cent of the current expenditure base. This would leave c. 1½ per cent of this base available for new measures. This illustrates that expenditure sustainability requires that measures be prioritised to meet our key challenges and that there is an ongoing focus on delivering public services effectively and efficiently.

Table 7: medium term core expenditure trajectory, € billions

	2021	2022	2023	2024	2025
Total core expenditure	75.9	80.1	84.1	88.3	92.8
of which: core current expenditure	*66.1*	*69.2*	*72.4*	*75.7*	*79.3*
year-on-year increase, per cent	*6.3%*	*4.6%*	*4.7%*	*4.5%*	*4.8%*
of which: core capital expenditure	*9.8*	*10.9*	*11.7*	*12.7*	*13.4*
year-on-year increase, per cent	*19.8%*	*11.7%*	*7.0%*	*8.4%*	*6.2%*
total year-on-year increase	5.5	4.2	4.0	4.2	4.4
total year-on-year increase, per cent	7.8	5.5	5.0	5.0	5.0
Memo item: gross capital investment including NRRP	9.8	11.1	11.9	12.8	13.6

Source: DPER calculations (2021 is versus REV2020 pre-Covid).

Consistent with the position set out in the *Stability Programme Update*, additional supports in respect of Covid-19 are assumed to be fully unwound by 2023. The exceptions to this are automatic stabiliser costs associated with returning to pre-Covid levels of employment and investments under the *National Recovery and Resilience Plan*.

For 2022, the SPU included an amount of €2½ billion for Covid-19 related costs. This primarily relates to funding requirements that would arise in delivering public services next year in areas such as Health, Education and public transport due to the likely need to continue to implement public health measures in 2022. In addition, €1½ billion was included in the SPU for expenditure on automatic stabilisers based on the unemployment projections for next year. A further amount of €2.8 billion is now reflected in the expenditure projections as a contingency reserve. This is a prudent approach given the uncertainty that still exists in relation to Covid-19 and the requirement to ensure that supports are carefully withdrawn in a manner that supports recovery in the economy.

Costs related to measures funded by the *Brexit Adjustment Reserve* (BAR) are assumed to be spent entirely in 2022. Funding under the BAR will be used to support employment, businesses and local communities negatively affected by Brexit, including those in the fishing industry and will be allocated across *Budget 2022* and *Budget 2023*.

Table 8: non-core expenditure trajectory, € billions

	2022	2023	2024	2025
Covid-19 measures and contingency	5.3			
Automatic stabilisers	1.5	0.8	0.5	0.3
Brexit Adjustment Fund	1.1			
National Recovery and Resilience Plan	0.2	0.2	0.2	0.1

Source: DPER calculations.

5.5 National Development Plan

A key element of the medium term expenditure strategy will be setting out revised capital expenditure ceilings for the period to 2030 following completion of the review of the *National Development Plan* (NDP). In line with the *Programme for Government*, the review has been brought forward to 2021 in order to assess the capital investment requirements to meet the challenges facing us as a nation including in the areas of climate action, housing, balanced regional development, health, transport, and education.

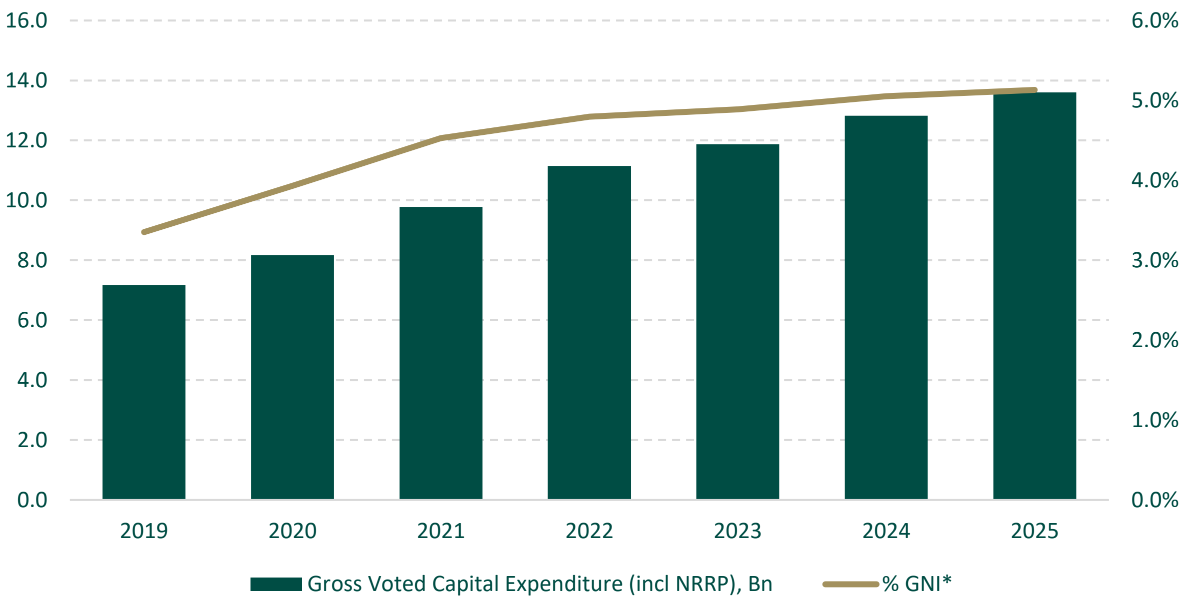
The first phase commenced in October 2020, which included the public consultation, *Review to Renew*, as well as further evidence-gathering by way of sectoral submissions from Departments and a series of technical papers. The results of Phase 1 were published by the Department of Public Expenditure and Reform in April this year.

The technical and consultative work carried out as part of Phase 1 forms the evidence base to underpin the decisions to be taken in Phase 2 of the NDP. The objective of Phase 2 of the NDP is to set out revised sectoral capital allocations for the upcoming 10-year period, including non-Exchequer investment, as well as providing a renewed focus on delivery of efficient and cost-effective public infrastructure. The range of indicated sectoral priorities will be identified as part of the final revised NDP.

Engagement is ongoing with Departments in this regard with a view to finalising this work over the coming period with the allocations set within the overall expenditure parameters set out in this document.

Project Ireland 2040 set out the 10-year capital envelope for the period 2018-2027, starting from a baseline of €4.6 billion in Exchequer funded capital investment in 2017. This represented 2½ per cent of national income as measured by GNI*. The starting point for the capital envelope for the 10-year period 2021-2030 is significantly different, with planned core capital investment of €9.8 billion for 2021. Taking into account the additional capital investment provided in respect of Brexit and Covid, and the capital carryover of €0.7 billion from last year, there is an amount of €10.8 billion in Exchequer funded resources available for capital investment this year. As outlined in Figure 18 below, core capital investment and expenditure funded under the NRRP is now forecast to reach €13.6 billion in 2025. This represents c. 5 per cent of GNI*, double the level in 2017 before *Project Ireland 2040.* This significant level of investment reflects the key role of this investment in supporting economic recovery and delivery of Government's key priorities including Housing and Climate Action.

Figure 18: Capital expenditure 2019-2025



Source: DPER

This level of investment requires a continued and increased focus on achieving value for money. The current review of the NDP provides an opportunity to reflect on and incorporate the lessons learned so far into the ongoing roll out of *Project Ireland 2040*. A key focus of the review of the NDP is on the capability and capacity of the public service to deliver the ambitious targets for investment that are set out in the plan. Building on recent reforms such as the update of the Public Spending Code, the NDP Review will set out a suite of reforms to strengthen the assurance arrangements and public sector capability to deliver *Project Ireland 2040*. These will include a new External Assurance Process for projects in excess of €100 million in Exchequer funding, strengthening of the *Project Ireland 2040* Delivery Board to include more external membership and setting out a 'backbone' of future reforms to improve public sector delivery capacity and capability through the Supporting Excellence Action Team.

5.6 Expenditure Reforms

The implementation of a sustainable expenditure policy needs to meet certain key requirements including:

- Ensuring that the overall level of expenditure remains affordable over the longer term; and,
- Delivering sustainable improvements in public services and infrastructure.

Consequently, this not only requires that expenditure growth is set at a level that is consistent with the longer-term growth potential of the economy, but also that there is an ongoing focus on the quality of expenditure. To ensure sustainability these two elements of the expenditure framework are necessarily interlinked.

The reforms to the expenditure framework implemented in recent years seek to embed sound expenditure management practices that maintain a focus on the totality of spend rather than the incremental amount added each year. Key elements within this suite of expenditure reform measures include Performance and Equality Budgeting, the Irish Government Economic and Evaluation Service (IGEES) and the Spending Review process.

As we look to ensure that the recovery from Covid-19 is fair and balanced it will be important to utilise these reforms to provide the evidence to inform decision making. The development of the Wellbeing framework for Ireland can support this approach, in terms of developing a shared understanding of what makes for better lives and influencing public debate on strategic priorities. The development of a knowledge base around well-being as a policy objective and integrating well-being metrics into the various stages of the policy making cycle can inform efforts to improve the impact of public policy on people's lives.

As outlined above, it will be necessary to prioritise and to ensure that the overall amount of public expenditure is being used effectively. The budgetary reforms implemented in recent years, including the spending review process, are tools to facilitate effective budgetary management through the consistent evaluation of existing expenditure commitments. Over the coming years, it is important that these reforms are not only maintained but enhanced to ensure the delivery of improvements in public services within a sustainable level of public resources.

Annex 1
Assessing imbalances in the Irish economy

An important lesson from the last crisis is that macroeconomic imbalances – as opposed to fiscal imbalances – pose a threat to overall economic stability (real and financial) and, accordingly to living standards. Nowhere is this more relevant than in Ireland, where serious imbalances were allowed to accumulate in the early- to mid-2000s. It is important, therefore, to monitor, identify and address potential emerging imbalances in the economy before these become problematic.

The European Commission – as part of the *Macroeconomic Imbalance Procedure* (MIP, part of the suite of reforms implemented following the euro area crisis) – monitors developments in all Member States and publishes its assessment each spring. The Department complements this annual assessment under the MIP with the use of 'heat map' analysis published each year (table A1). This part of the macroeconomic assessment toolkit is not, and should not, be applied in a mechanistic manner: deviations from a threshold are not always a negative development while, symmetrically, a reading within the threshold is not necessarily always a benign development.

The most serious imbalances relate to the labour market. When those in receipt of the Pandemic Unemployment Payment (PUP) are included, the Covid-adjusted unemployment rate was estimated to average 18¾ per cent last year,[18] well above the threshold of 10 per cent. With recovery gaining pace and as the PUP is phased out, labour demand and supply should move closer together.

The impact of the pandemic on corporate debt is another key concern for the European economy. However, high frequency credit and lending data suggest that the immediate macroeconomic impact of the pandemic on corporate debt in Ireland has been limited, with total outstanding NFC and SME credit actually declining last year likely due to a combination of policy support and a lack of appetite among firms for new lending. As such, corporate debt will need to be monitored closely for signs of deterioration in the wake of the withdrawal of policy supports.

On a positive note, the external sustainability of the Irish economy as measured by the modified current account balance appears to have been relatively unaffected by the pandemic with a surplus of 7½ per cent of modified GNI estimated by the Department of Finance for last year. In other words, domestic residents are saving more than investing and, as a result, Ireland's net external liabilities are continuing to fall (the overall external situation is complicated by the multinational sector, where corporate savings as a share of income are exceptionally large).

[18] The Department of Finance's projections (and 2020 outturn) included in the heat map are on the basis of the CSO's Covid-adjusted series which treats all recipients of the PUP as unemployed, rather than the standard ILO measures, used by *Eurostat*, which classifies only around 12 per cent of PUP recipients as unemployed. On the basis of the ILO measure, Ireland recorded a much lower unemployment rate of 5¾ per cent last year.

Table A1: Heat-map of Macroeconomic Indicators, 2005-2025

Indicator	LR avg	Threshold*	05	06	07	08	09	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
Current account balance, % GDP	-1.2%	-4/6%																					
Alternative: CA % GNI**	0.4%	-4/6%																					
NIIP, % GDP	-112%	-35%																					
*Alternative: Underlying NIIP, % GNI**	-70%	-35%																					
REER, 1-year % change	0.0%	±5% (EA)																					
Export market share - % of world exports	1.1%	-6%																					
ULC, nominal 1-year % change	0.3%	9% (EA)																					
House price index, 1-year % change	1.9%	6%																					
Private sector credit flow, % GDP	8.3%	14%																					
Private sector debt, % GDP	224%	133%																					
Alternative: Household debt (% GNI)*	100%																						
Government debt, % GDP	61%	60%																					
*Alternative: Government debt, % GNI**	80%	60%																					
Unemployment rate, %	8.8%	10%																					
Financial sector liabilities, 1-year % change	11%	16.5%																					

colour key

-2.25	-2.00	-1.75	-1.50	-1.25	-1.00	-0.75	-0.50	-0.25	0	0.25	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25

Source: Department of Finance calculations based on Eurostat, CSO, Central Bank data.
How to read: Darker colours suggest imbalances (whether dark red or dark green, with green imbalances generally less harmful), while light yellow shading represents values broadly in line with the long-run average for each indicator.
Note: the indicators for unit labour costs, private sector credit and debt, household debt, government debt, unemployment and financial sector liabilities have been inverted such that red represents a value above the long-run average, and *vice versa*. The three additional employment indicators in the MIP scoreboard are not shown here.
Grey areas are those variables for which the Department does not produce a forecast or for which there are data gaps.
NIIP = net international investment position; REER = real effective exchange rate; ULC = unit labour cost
* Threshold refers to the MIP threshold set out in the European Commission’s procedure.

Annex 2
Main budgetary supports

Table A2: Covid-19 taxation measures, € billions

	2020	2021	2022	% GNI*
Phase 1: April / May	**2.00**	**-**		**1.0**
Tax warehousing	2.00	-		1.0
Phase 2: July stimulus	**0.90**	**0.32**		**0.6**
Loss relief				
: for self-employed	*0.15*	-		*0.1*
*: for corporations **	*0.45*	-		*0.2*
Stay and Spend initiative	-	0.14		0.1
VAT	0.28	0.16		0.2
Cycle-to-work	0.00	0.00		0.0
Interest reduction on tax liabilities	-	0.02		0.0
Help-to-Buy	0.02	-		0.0
Phase 3: *Budget 2021*	**0.50**	**0.40**		**0.4**
Reduced VAT rate for hospitality sector	0.00	0.34		0.2
Covid Restrictions Support Scheme **	0.50	0.50		0.5
Extension of stimulus Help To Buy enhancements	-	0.04		0.0
Economic Recovery Plan		**0.78**	**0.35**	**0.5**
Tax warehousing		0.50		0.2
EWSS PRSI foregone (Q3 only)		0.18		0.1
Extension of 9% VAT rate to Sept 2022			0.35	0.2
CRSS		0.10		0.0
TOTAL TAX	**3.40**	**1.50**	**0.35**	**2.5**

Source: Department of Finance; rounding may affect totals
The figures above relate to the estimated cost at the time the measure was announced. Outturn costs will differ.
GNI* relates to modified Gross National Income and is estimated at c. €208bn for 2020, €216bn for 2021 and €232bn for 2022.
* CT loss relief acceleration is cost neutral over two years.

Table A3: Covid-19 direct expenditure measures, € billions

	2020	2021	Total	% GNI*
Social Protection	**10.07**	**10.06**	**20.13**	**9.5**
of which:				
Pandemic Unemployment Payment	5.09	3.32	8.41	4.0
EWSS/TWSS	4.53	2.37	6.90	3.3
Other (illness benefit, activation measures, etc.)	0.45	1.50	1.95	0.9
ERP extension of the EWSS (Q3 2021)		1.22	1.22	0.6
ERP extension PUP		0.45	0.45	0.2
ERP provision for EWSS extension (Q4 2021)		1.20	1.20	0.6
Health	**2.60**	**1.86**	**4.46**	**2.1**
of which: capacity, equipment, PPE, testing	2.60	1.86		2.1
Education	**0.33**	**0.31**	**0.64**	**0.3**
of which: Roadmap for Reopening Schools	0.14			0.1
Further and Higher Education	**0.32**	**0.15**	**0.47**	**0.2**
Business, Enterprise & Innovation	**0.93**	**0.34**	**1.26**	**0.6**
of which:				
Liquidity supports and Business Restart Grants	0.49			0.2
July Stimulus including additional funds for Restart Grants	0.45			0.2
Business Support Schemes		0.34		0.2
Housing, Local Government and Heritage	**1.11**	**0.50**	**1.61**	**0.8**
of which:				
Commercial Rates Waiver	0.90	0.29		0.6
ERP extension to the Commercial Rates Waiver		0.16		0.1
Transport	**0.61**	**0.44**	**1.05**	**0.5**
of which: Public Service Obligation	0.46	0.37		0.4
Other	**0.64**	**0.41**	**1.05**	**0.5**
Total allocated	**16.60**	**14.07**	**30.66**	**14.5**
Covid Contingency Fund - earmarked expenditure		**0.70**		**0.3**
Provision for 2022 Covid expenditure			**6.80**	**2.9**
TOTAL DIRECT EXPENDITURE	**16.60**	**14.77**	**38.16**	**17.8**

Source: Department of Finance, Department of Public Expenditure and Reform
The figures above relate to resources made available. Outturn costs will differ.
Rounding may affect totals
GNI* relates to modified Gross National Income and is projected at c. €208bn for 2020, €216bn for 2021 and €232bn for 2022.

Table A4: 'Below the line' supports, € billions (unless stated)

	2020	2021	Total	% GNI
Credit Guarantee Scheme	2.00	0.00	2.00	1.0
Pandemic Stabilisation Fund (ISIF)	2.00	0.00	2.00	1.0
Future Growth Loan Scheme (longer-term loans)*	0.50	0.00	0.50	0.2
Liquidity support through SBCI - Working Capital Loan Scheme**	0.29	0.00	0.29	0.1
Sustaining Enterprise Fund	0.18	0.00	0.18	0.1
MicroFinance Ireland (loans)	0.04	0.00	0.04	0.0
Seed and Venture Capital Scheme (in relation to Covid-19)	0.01	0.00	0.01	0.0
TOTAL	**5.02**	**0**	**5.02**	**2.4**

Source: Departments of Finance and of Public Expenditure and Reform.
Rounding may affect totals
For simplicity all supports are presented as accruing in 2020
The figures above relate to resources made available. Actual drawdown and outturn costs will differ.
GNI* relates to modified Gross National Income and is projected at c. €208 billion for 2020.
*€500m expansion in addition to original €300m giving the total scheme value of €800m
**€250m of the existing €300m Brexit Loan Scheme repurposed into WCLS for businesses impacted by Covid. The overall scheme is also being expanded by €37.5m to bring the total amount to €337.5m.

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