9 June 2020

Aileen Fallon

Clerk to the Committee

Special Committee on Covid-19 Response

House of the Oireachtas

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Dear Ms Fallon

I would like to thank you and the Special Committee on Covid-19 Response for the opportunity to make a written submission to the Committee on the topic of the state's budgetary position.

The Nevin Economic Research Institute (NERI) welcomes the establishment of the Special Committee.

On account of the limited timeframe we have focused our response on the five issues for consideration specifically identified by the Committee.

We are happy to assist the Committee in the future and to offer clarification in relation to any aspect of our submission or to answer any additional questions.

Yours sincerely

Dr Thomas A McDonnell

Co-director

Nevin Economic Research Institute Submission to the Special Committee on Covid-19 Response

Fiscal Developments – Expenditure and Budgetary Position

1. Thank you for the opportunity to make a submission to the committee. The committee posed a number of questions as issues for consideration. I will address each of these in turn.

What is the likelihood that the General Government Deficit will go beyond €30 billion this year?

2. There is an extremely high level of uncertainty surrounding the fiscal projections for 2020. Most notably, a second wave of infections or additional period of economic shut-down would place further stress on the public finances. In addition, there is a high probability that rates of business failure will be elevated for the remainder of the year. Yet estimating the scale of these failures is extremely difficult given the lack of historical precedent for an economic crisis of this nature.
3. Crucially, the scale of business failure and job loss is endogenous to current and future policy decisions. A new government will inevitably wish to introduce further measures to support the economy including further revisions to the phased unlocking of the economy, additional sectoral supports and bailouts, and further changes to employment and social protection supports.
4. Further supports will increase the scale of the deficit in 2020. However, if properly targeted and designed they will also buttress the economy's potential output and pay for themselves in the long-run.
5. The NERI's baseline assumption is for a 2020 general government deficit of close to but below €30 billion, that is about 9% of GDP or 16% of GNI*. The deficit would likely exceed €30 billion in the event of a second shut-down. Additional corporation tax receipts represent an upside risk to the forecast.

What would be the fiscal implications of any additional periods of economic shut-down?

6. A second shut-down would do significant damage to the public finances. The Temporary Wage Subsidy Scheme (TWSS) and Pandemic Unemployment Payment (PUP) would either have to be extended in duration or restored. Reduced incomes and aggregate demand would place downward pressure on tax receipts, while additional supports for business would become necessary to maintain business viability.
7. The economic and social costs of Ireland's relatively cautious approach to easing its lockdown have understandably been widely discussed in recent weeks. However, the economic costs arising from a few additional weeks of lockdown must be weighed against the severe macroeconomic and fiscal costs associated with a potential second wave of infections and associated shut-down.
8. We do not know the probability of further waves of infection. Nor do not have a working model of the potential diffusion paths of the infection through the population. As such, it is impossible for us to undertake cost benefit analyses of the different strategies available to government.
9. A second shutdown would likely lead to a loss of confidence in the government's ability to control the virus and would cause a further increase in precautionary saving and postponed investment decisions. This would exacerbate the fall in aggregate demand and deepen and prolong the recession.
10. The NERI's view is that the current approach and timescale re unlocking the economy is broadly appropriate, given the trend in identified cases and the virus's estimated reproduction number. However, we do not believe the timescale should be further accelerated at this stage.

What is the likelihood that bond market conditions may become less favourable to Ireland?

11. The average interest rate on Irish debt was just 2.2% in 2019, and recent debt issuances have been attracting even lower interest rates. Interest expenditure will be close to €4 billion in 2020 and down from over €6 billion in 2016. A cumulative increase in the debt of €40 billion to €45 billion over the 2020-2021 period will add around half

a billion to annual interest expenditure. There is as yet no evidence of the debt burden becoming unsustainable.

12. Our analysis is that there is little chance that bond market conditions will evolve in such a way that Ireland's market access will become impaired. The scale of the ECB's bond buying programme (PEPP) and expressed willingness to 'do whatever it takes' has de facto (if not de jure) converted the ECB into a lender of last resort. At the same time, the EU Commission's proposals around a new €750 billion recovery instrument and reinforced long-term budget will protect weaker member states from experiencing high borrowing costs and prevent sovereign bond market contagion of the type seen during the great financial crisis of 2008-2012.
13. Ireland's very high deficits of 2020 and 2021 will be replicated in almost all other advanced economies and unlike the 2008-2012 crisis are understood as the appropriate Keynesian response to a severe exogenous shock. In this context, there is no reason to suppose that Ireland would be singled out by bond markets. All three major credit rating agencies assess Ireland to have some form of A rating for the purpose of establishing Ireland's creditworthiness.

What is the impact for Ireland of the ECB's current asset purchasing levels?

14. The ECB's asset purchasing is anchoring Eurozone member states borrowing costs at very low interest rates. Equally important is the expressed willingness to do whatever it takes to keep interest rates at sustainable levels. An essential component of the euro crisis that evolved in the wake of the great financial crisis was that Eurozone member states could run out of money because they did not have a guaranteed lender of last resort and were therefore exposed to insolvency risks.
15. There was no institutional mechanism for breaking the 'doom loop' of negative feedback loops of increasing sovereign bond yields and deteriorating debt sustainability. This forced vulnerable countries to embrace austerity policies, which in turn prolonged the duration of recession and stagnation. A number of countries completely lost access to bond market financing.
16. The Eurozone still lacks a de jure lender of last resort. However, the ECB has become a de facto lender of last resort exemplified by its willingness to purchase up to €1.35

trillion of government debt on the secondary market. This additional demand pushes up the price of sovereign debt and therefore pushes down the interest rate. In addition, the EU Commission's new recovery instrument will further ease sovereign debt sustainability concerns.

Are there potential "low hanging fruit" policy options that could increase revenue without negating economic growth in the short term?

17. To adequately answer this question we must first briefly assess whether Ireland already has high or low levels of taxation relative to other EU countries. GDP based comparisons are unhelpful. Table 1 shows that cumulative taxes and social security contributions (SSCs) in Ireland (% of GNI* basis) are below that of the EU average (% of GDP basis). In 2018 the gap was equivalent to €4.15 billion on an annual basis. This suggests there is scope to increase revenue over the medium-term.[1]
18. Table 1 and Table 2 show that taxes on consumption are already relatively high in Ireland, whether assessed on an output basis (Table 1) or on an implicit basis (Table 2).[2] The academic literature shows that consumption taxes on necessities are generally regressive. The implication is that there may be limited scope to introduce net increases on consumption taxes in a manner consistent with progressivity unless the increases are restricted to luxury goods. The necessary reforms to increase consumption taxes on environmentally damaging activities could be combined by equivalent reductions in other taxes in consumption. On the other hand, increasing taxes on consumption in order to expand universal basic services could, if properly designed, generate progressive and growth enhancing outcomes.
19. Table 1 and Table 2 offer a more nuanced picture for taxes on capital. Table 1 suggests that receipts from taxes on capital are high – this is on account of elevated receipts

[1] Another way to assess tax/SSC levels is to compare per capita revenue in Ireland with population weighted revenues in the other high-income EU countries. Forthcoming NERI analysis shows that per capita 'under-taxation' in Ireland in 2018 was over €2,200, or €11 billion when scaled to the Irish population (see NERI, June 2020).

[2] The implicit tax rate is calculated as the tax yield divided by the tax base. We can think of it as an economy-wide average effective tax rate on a particular type of economic activity (consumption, labour income or capital income).

from corporation tax – but that taxes on property (and capital stocks) are relatively low. Table 2 suggests that effective (implicit) taxes on capital are relatively low. Research from the OECD shows that taxes on capital stocks (wealth) and property are the least damaging taxes vis-à-vis economic growth. In addition, these taxes are generally progressive. Thus, our view is that these forms of taxation (Local Property Tax, Capital Acquisitions Tax, Net Wealth Tax) offer the most promising 'low hanging fruit' for increasing revenue without negating economic growth in the short term. However, the short term scope for increasing revenue from these areas is in the order of 1% of GNI*. Thus, while eminently justified from an economic perspective such reforms would only form a modest component of restoring the public finances to a sustainable path.

20. Table 1 and Table 2 both show that combined taxes and social security contributions (SSCs) from labour income are relatively low by EU standards. Specifically, Table 1 shows that SSCs from employers account for the entirety of the nominal gap between Ireland and the EU average. Table 2 illustrates that while implicit taxes on labour income are low, combined taxes/SSCs paid by employees are not low when considered in aggregate across the economy. The 'hole' in labour taxes is the relative absence of employer payments. Income from self-employment is another area that is taxed relatively lightly in Ireland.

21. Thus, by far the greatest scope to increase government revenue (in the sense of exploiting areas of relative under taxation) is via increases in employer PRSI. However, taxes/SSCs on labour income should not be increased during a recession as this will exacerbate the severity and duration of the downturn. Reforms in this area are better timed for after the early stimulus phase i.e. post 2022.

22. A final point to note in relation to medium-term fiscal policy is that Ireland had low levels of public spending compared to Western European norms in 2018. Per capita public spending in Ireland was just under €16,900, €2,000 less than the comparator average[3] of almost €18,900. The large gap suggests that public spending increases should be prioritised over tax cuts during the 2021-22 stimulus phase and that any

[3] The comparator group is the set of 12 high-income European countries with GDP per capita of at least €30,000 and population of at least 1 million.

post-2022 budgetary tightening should focus on increasing revenue instead of lowering public spending increases.

Table 1: Aggregate Taxes and Social Contributions as a percentage of national output (GDP)

	2008	2013	2018
All			
EU-28	37.8	38.7	39.2
Ireland	29.0	28.8	22.6
Ireland (GNI*)	34.7	37.8	37.1
Consumption			
EU-28	10.5	11.1	11.2
Ireland	10.5	9.8	7.0
Ireland (GNI*)	12.6	12.9	11.5
Capital			
EU-28	8.5	8.1	8.5
Ireland	7.2	6.1	6.0
Ireland (GNI*)	8.6	8.0	9.8
Property			
EU-28	2.3	2.5	2.6
Ireland	1.8	1.8	1.2
Ireland (GNI*)	2.2	2.4	2.0
Labour			
EU-28	18.8	19.5	19.6
Ireland	11.3	12.9	9.7
Ireland (GNI*)	13.5	16.9	15.9
Labour (paid by employer)			
EU-28	7.5	7.7	7.6
Ireland	3.4	3.1	2.6
Ireland (GNI*)	4.1	4.1	4.3

Source: European Commission Data on Taxation; **Note**: 2018 aggregate gap between Ireland (GNI*) and EU28 is €4.15 billion

Table 2: Implicit Tax Rates (aggregate effective tax rates by type of activity)

	2008	2013	2018	2018
Consumption				
EU-28	15.8	16.3	16.9	
Ireland	19.2	19.3	19.6	
Capital				
EU-28 (median)	22.3	22.6	23.1	
Ireland	21.7	14.8	14.7	
Labour				
EU-28	35.6	36.0	36.3	
Employee				20.6
Employer				15.7
Ireland	25.6	32.1	32.9	
Employee				24.1
Employer				8.8

Source: European Commission Data on Taxation; **Note**: 2018 I