2 October 2020

Paul Ng

Clerk to the Committee

Select Committee on Budgetary Oversight

Leinster House

Dublin 2

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Dear Mr Ng

I would like to thank you and the Select Committee for the opportunity to make a written submission to the Committee in relation to Budget 2021.

On account of the limited timeframe we have focused our submission on a select number of the specific issues 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

Nevin Economic Research Institute Submission to the

Select Committee on Budgetary Oversight

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1. Thank you for the opportunity to make a submission to the Committee. Budget 2021 will take place in the midst of an unprecedented economic shock and a deep recession. Economic activity as measured by Modified Domestic Demand fell by almost a fifth in the first half of 2020. The crisis will continue well into 2021 and our expectation is that domestic demand will not return to its end-2019 level until well into 2022.
2. The economic impact is concentrated in a minority of sectors with younger and lower income workers disproportionately impacted. The increase in infections is likely to weaken confidence and slow the modest rebound in activity that we saw in the third quarter. We expect the unemployment rate to remain in double figures until well into 2021. The medium-term labour market scarring will require a robust policy response.
3. The committee posed a number of questions as issues for consideration. I will address some of these now.

What are the key decisions you would like to see included in Budget 2021?

4. The government's multi-billion package of healthcare and economic supports was the correct response to the economic fallout and the largest stimulus in the history of the State. Failure to provide these supports would have transformed a recession into a depression.
5. The wage subsidy scheme and the liquidity supports helped preserve productive capacity. The income supports helped preserve demand and avert poverty while the various supports for business have at least helped delay a potential cascade of business failures.

6. The enormous economic and fiscal costs of the pandemic will likely be added to by a disorderly Brexit at the end of December. It is prudent to assume trade disruption. The fiscal supports and collapse in activity will increase the 2020 deficit to near €30 billion. Even so, these measures are countercyclical, will buttress the economy's medium-term potential output and will pay for themselves in the long-run. Some sectors will continue to need emergency support well into 2021.
7. Our view is that the government will need to continue to show ambition. While there is enormous uncertainty about the post-2020 outlook it seems inevitable that unemployment will remain elevated in the near-term and that this risks embedding higher levels of structural unemployment over the medium-to-long term. In this context there is a strong case for an ambitious multi-year stimulus programme based primarily on investment in green infrastructure, in housing, and in human capital development (education/reskilling/apprenticeships). This is notwithstanding the very significant deficit that will be in the public finances in 2021.
8. The government's stated intent to prioritise investments in health, housing and a green recovery is welcome. Investment in healthcare will be needed to bring the virus under control. In addition, enhanced social protection measures should remain in place in some form in 2021 in order to preserve incomes and demand and to protect vulnerable households. Similarly, the government should retain a short-time work scheme in some form that can be activated quickly to maintain employment relationships in the event of significant shocks, for example through a reformed Employment Wage Subsidy Scheme (EWSS).
9. The Government should remain ready to reintroduce emergency income and business supports if and when incidence of the virus requires further lockdowns on economic activity. The Government should also delay budgetary tightening measures such as increases in taxes on labour and should delay the roll back of income supports and stimulus until at least 2022 and at minimum until a vaccine is widely available and deployed.
10. An important point is that the Covid-19 crisis may compound the medium-term decline in productivity growth that took hold in advanced economies in the 1990s

and that accelerated in the aftermath of the financial crash. Sectors involving social interaction will experience increased costs per unit output in at least the short-term. Prolonged higher levels of unemployment will likely lead to some degree of skills erosion. The higher levels of uncertainty will depress levels of business investment. At the same time, ageing demographics will put increasing downward pressure on hours worked leaving productivity gains as the remaining lever for economic growth.

11. Governments should therefore focus their stimulus packages on reversing the persistently low levels of investment in the productive capital stock and in the economy's innovative capacity. Investments in infrastructure can be targeted to support the necessary transition to a zero carbon economy while increased investments in education, retraining, public R&D, public childcare supports and child poverty reduction would all help improve labour productivity over the long-run.
12. We should invest in people by increasing spending on supports for retraining, upskilling, higher education and apprenticeships. This will assist workers in Covid affected sectors to transition between sectors and between types of work. Such investments will be needed in any event in order to transition to a zero carbon economy. Investments in human capital will also produce long-term benefits in the form of higher productivity growth. This is because human capital is a necessary ingredient of and complement to creativity, innovation and technology diffusion.
13. The Irish government is not yet experiencing budgetary constraints. The average interest rate on Irish debt was just 2.2 per cent in 2019. There is no evidence of the debt burden becoming unsustainable with yields remaining very low in 2020. The Irish economy has the potential to grow by 4 per cent annually in normal times. As such, interest rates of 1 per cent or 2 per cent are very much affordable over the medium-term. The public finances were in surplus prior to the crisis – suggesting the underlying position was sound - and the perception is that Ireland will not be disproportionately affected economically by the Covid-19 crisis relative to other EU countries.

14. As such, the Irish government can and should seek to avail of the low interest environment in order to support the economy through the crisis and in order to fund a multi-billion stimulus programme based on investment in infrastructure and the green transition. The Irish state's revenue base will eventually need to be broadened to ensure fiscal sustainability but this process of reform should be delayed until 2022 so as not to hamper the economic recovery.

Have you costed these policies and if so, how much would they cost?

15. Our emphasis is more in relation to policy direction than to specific micro policies or items of expenditure. In particular, fiscal policy should remain highly accommodative until such time as a vaccine is widely available and household and business confidence is restored.
16. Even so, it is worth considering some examples of specific medium-term reforms and their associated costs. The NERI recently published[1] an analysis of public spending in Ireland. One of our findings (p.14) was that adjusted education spending per pupil was just four fifths of the average for high-income EU countries (peer countries) in 2018. The implied shortfall was in excess of €2.5 billion. Our view is that this spending gap should be closed incrementally over the medium-term. The spending gap is most pronounced at tertiary level (higher education) but there is also a significant gap at primary and lower secondary (levels 1 and 2). Our view is that this underspend represents a false economy that will lead to lower productivity and a weaker economy in the long-run. The government should begin the process of closing these gaps in Budget 2021.
17. The NERI analysis (p.37) also showed that Ireland under-spends on public R&D and had the 2nd lowest spending per capita of 12 high-income Western European countries in 2017 and again in 2018. Only the UK was worse. Ireland's spending was just half of the peer country average implying an under-spend of €900 million per annum. Such an under-spend will have negative consequences for the economy's innovative capacity and growth potential over time. If sustainable economic growth is genuinely a priority, then policymakers should ensure that

[1]NERI (June, 2020) Reforming Tax and Spend in the United Kingdom and in the Republic of Ireland, NERI Working Paper Series, NERI WP 2020 No 67, Dublin: NERI.

the under-spends on education and on R&D are progressively eliminated over the next few years.

18. Finally, Ireland spends significantly less than the peer country average on childcare supports on a per child basis. The cost of childcare is negatively related to participation, with the effect strongest for lower income households. There is a compelling case for heavily subsidised state intervention to directly reduce the cost of childcare. This would increase the effective size and quality of the available workforce.

Can you propose any KPIs that would allow for the impact of the policy to be measured?

19. Cross-country comparisons of classroom sizes can be used as a KPI for per pupil education spending. PISA scores can be used to assess education outcomes. At the higher level, we can use a range of KPIs. These include but are not limited to published journal articles (quality of research), the totality of financial contributions required of students, the average number of students registered for lectures or tutorials, the average hours of contact/access and feedback from lecturers and tutors. For comparisons of cost of childcare we can measure cost of childcare as a percentage of median full-time and part-time net earnings.

How sustainable do you think the present expenditure levels are into the medium-term?

20. 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, or about five sixths of the comparator average. The sustainability of public spending depends on the revenue capacity of the state. While the fiscal cost of the crisis could be in excess of €50 billion by the end of 2022 we will be able to afford this given the very low cost of government borrowing. The state was running a modest structural surplus on the eve of the crisis and the public finances were fundamentally sound, albeit with a high per capita debt ratio.
21. The deficit will fall dramatically over the next five years without the need for any austerity measures provided we are able to restore growth and increase employment year-on-year. In this scenario, the annual deficit in GDP terms would

fall below the real GDP growth by 2023 as tax revenues increase and emergency and countercyclical spending fall.

22. Our view is that the best way to ensure growth returns to the economy is through a maintenance of economic supports as needed, combined with a temporary investment stimulus, and additional supports for labour activation and education/reskilling. This strategy will best preserve and expand the economy's productive capacity

23. Even so, it is clear that the revenue base of the State needs to be expanded. Our analysis is that taxes and social insurance contributions will need to significantly increase over the medium-term.

Are there any revenue raising measures that you would recommend and if so, how much do you think they could generate?

24. Ireland's low level of public spending prior to the crisis was matched by its low level of per capita revenue generation relative to other high-income EU countries. In particular, NERI analysis (July, 2020) shows that Ireland is a low revenue country in terms of social contributions levied on employers and in terms of taxes on capital stocks. This suggests there is scope to increase revenue over the medium-term. On a GNI* basis Ireland's revenue shortfall relative to the EU in 2018 was €6 billion.

25. Taxes on consumption are already relatively high in Ireland, whether assessed on an output basis or on an implicit basis.[2] 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 the taxation of environmentally damaging activities could be combined with equivalent reductions in other taxes on consumption. Alternatively, increasing taxes on consumption in order to expand universal basic

[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).

services could, if properly designed, generate progressive and growth enhancing outcomes.

26. Ireland's receipts from taxes on capital are high – this is on account of elevated receipts from corporation tax – but taxes on property and capital stocks 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.
27. Combined taxes and social security contributions (SSCs) from labour income are relatively low by EU standards. Specifically, SSCs from employers account for the entirety of the nominal gap between Ireland and the EU average. 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.
28. 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 2022 and beyond.

How much do you think the government should borrow to fund expenditure in 2021?

29. It is difficult to be definitive as uncertainty is still exceptionally high concerning both Covid-19 and Brexit. A deficit in excess of €15 billion is plausible. Our view is that existing supports should be maintained and that net discretionary measures to close the deficit should be delayed until 2022 at the earliest. Indeed, our

analysis is that the capital budget should be increased in 2021 in order to fund an enhanced programme of public investment.

Would it be prudent to borrow in excess of what is required in order to avail of the historically low interest rates? Rather than run the risk of borrowing at higher interest rates in the medium term should interest rates rise.

30. With interest rates as low as they are it makes sense to use the opportunity to build cash reserves with a view to funding a multi-annual investment stimulus. There is only so much that governments can pump into the economy each year in the form of public investments. Our view is that the Government should borrow in excess of what it needs in 2021 and warehouse funds while interest rates remain on the floor.

What are your opinions on the introduction of a digital sales tax as a revenue raising measure?

31. The US decision to suspend talk with EU countries on a new global tax framework may lead to European countries retaliating with the introduction of digital sales taxes (DSTs). DSTs will generate some modest revenue from multinationals. However, they are not the solution to profit shifting, unearned rents, global tax avoidance or global inequalities in taxing rights between countries. At best, DSTs are a stop-gap measure and will not solve the problem of global tax avoidance. Meaningful reform in this area from a tax justice perspective would involve steps such as the introduction of minimum tax rates and/or moves towards using the common consolidated corporate tax base rule set for the taxation of multinationals and the use of a unitary taxation system whereby multinationals are treated as a single entity.