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Committee on Budgetary Oversight

Report on Budget 2017

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Contents

Foreword

I welcome the publication of the Committee's Report on Budget 2017.

The Committee on Budgetary Oversight was established on 21st July, 2016 to examine the spending, taxation and charges appropriate to Budget 2017 that will be held on 11th October, 2016.

The Committee has conducted its *ex ante* scrutiny through a range of meetings with expert witnesses which culminated in meetings with both the Minister for Finance and the Minister for Public Expenditure and Reform. It is fair to say however that, as we entered the budget scrutiny cycle as it came to its concluding stages, our examination of Budget 2017 could not go into the level of detail that one would normally associate with the detailed scrutiny of revenue raising and expenditure proposals. As the Report will highlight, the Committee plans to rectify this issue for Budget 2018.

A second key issue that the Committee learned as we got into the process is that there is a need to work with the sectoral committees in the Oireachtas, as it is their work that ultimately feeds into budgetary proposals.

During the course of the Committee's examination of budgetary issues at our public hearings, a number of common themes emerged, and in the case of a number of these there was consensus amongst Members, for example in the need for capital investment. The Report also highlights where other issues, like the future of USC, were examined in detail but where, unsurprisingly, we could not agree a Committee position.

I want to thank all witnesses who gave evidence to the Committee, the Members of the Committee who gave unselfishly of their time especially over the last four weeks and finally to the Committee secretariat for their support to Committee Members.

I commend this Report to the Dáil.

John Paul Phelan

John Paul Phelan TD
Chairman

Introduction

The Committee on Budgetary Oversight (the Committee) was established by order of the Dáil on 21st July, 2016 and held its first meeting on 26th July, when it considered how best to approach examining Budget 2017. The creation of this new Committee is designed to address the weak position traditionally played by the Oireachtas in budget analysis and scrutiny, as outlined in the OECD Review published in November 2015.[1] The establishment of a Budgetary Oversight Committee along with an independent parliamentary budget office subsequently formed a central part of the Report of the sub-Committee on Dáil Reform.[2]

The work of the Committee is part of the change/reform of the way budgets are considered by the Oireachtas, and what has been learned from Budget 2017 confirms the deficiencies that the OECD highlighted, and shows that the Oireachtas has a good deal further to travel before it has the structures and processes that match the benchmarks set by other advanced democratic states.

What also became clear to the Committee as it engaged in the scrutiny and oversight process is that, due to the timing and issues around resources, the work on Budget 2017 could not be extensive in nature, as the Committee entered the process three quarters way through the budgetary cycle. Therefore, the detailed groundwork and analysis that should be part and parcel of the work of an oversight committee was not done. This has significantly limited the impact of the Committee on the budgetary process.

However, while the consideration of Budget 2017 was truncated, the Committee took evidence from a number of expert witnesses so as to capture the fundamental issues that need to be addressed. Both the Minister for Finance and the Minister for Public Expenditure and Reform gave evidence to the Committee, and this report covers a number of common themes that emerged from these discussions, including:

- The need for capital investment in areas such as housing, transport, education
- The volatility of corporation tax receipts
- The proposal to cut and ultimately abolish USC
- The inflexibility of the fiscal rules, especially in the context of public capital formation
- The cost of childcare
- The need for new metrics of underlying economic growth, given that GDP and GNP no longer accurately reflect developments in the Irish economy
- The risks to economic growth, for example from Brexit.

All the above issues require further and far greater levels of analysis by the Committee, and as preparation for Budget 2018 will begin immediately after the presentation of Budget 2017 in October, the Committee plans to commence a process of examination of all these key issues.

The Committee, in considering of Budget 2017, agreed that the following broad principles should underpin all budgets, as they give a better chance that the cyclical nature of budgetary crises are avoided in the future:

[1] Link to OECD report
[2] Link to Dáil Reform Report

1. A broad and stable tax base is necessary for sustainable budgeting and economic growth.
2. Budgetary changes should be progressive and should be proofed for equality, anti-poverty, human rights and regional impact.
3. Budgetary policy should address strategic needs whose impact hinders economic and social development.

The Committee also recognises that the fiscal rules form part of the budgetary framework in the State.

1. Budgetary Context

Ireland's economy has been described as the fastest growing economy in Europe following a significant rebound from the economic crisis experienced in 2008. As outlined by the European Commission in its 2016 Country report, '*the recovery has been accompanied by strong job creation in most sectors*', with unemployment falling to less than 9% in December 2015. Domestic demand is also growing strongly, with private consumption up 3.5% in the first half of the year. Ireland has also exited the Excessive Deficit Procedure, the EU's step-by-step procedure to correct excessive deficit or debt levels.

However, while indicators point to an economy performing well, challenges exist in keeping the Irish economy on track. The unusual uncertainty that exists in advance of Budget 2017 has created challenges and led to most witnesses calling for caution. The CSO's revised National Accounts data showing 26% GDP growth in 2015, uncertainty over the impact of Brexit, and questions over the sustainability of corporation tax receipts, lead the Irish economy into an uncertain period. Ireland also carries a legacy issue of high debt levels along with a housing shortage where output remains well below equilibrium levels.

The Department of Finance has forecast GDP growth of 4.9% in 2016 and a further 3.9% in 2017. Similar growth rates of 4.1% and 3.7% are also predicted for GNP in 2016 and 2017 respectively. The (seasonally adjusted) unemployment rate for August 2016 was 8.3%, unchanged from the July 2016 figure and down from 9.1% 12 months earlier. The Department of Finance forecasts inflation of 0.4% in 2016 and 1.7% in 2017.

However, the Committee is concerned about the reliability of macroeconomic indicators such as GDP, especially in light of the CSO's revision to the National Accounts for 2015. The Committee understands that the revision was caused, in the main, by a few major multinationals on-shoring intellectual property rights.

The Committee believes that the recent dramatic increase in GDP was not a statistical blip and reflects the huge impact of the economy's reliance on foreign direct investment, both real and less tangible. It has had concrete negative impacts such as an increase in the contribution payable by the State to the EU and represents an uncertainty in Irish economic planning that cannot be ignored.

The Committee therefore welcomes the establishment of a consultative group by the CSO to consider the development of alternative indicators in order to strengthen the understanding of the composition of Ireland's economic growth. The Committee notes that these revised indicators are likely to be solely for domestic use. The Committee will seek to have an input into the work of the Group so as to ensure that the values of the metrics and indicators being considered are suitable for public policy analysis.

Strong economic growth in recent years has had a positive effect on the public finances. At end-August, there was an Exchequer deficit of €329 million, ahead of profile by 77.3% (+€1,118 million). The Department of Finance projects a general government deficit of 0.9% of GDP and a structural deficit of 2% in 2016. By 2018, forecasts are for a balanced General Government Balance and structural deficit of 0.5% of GDP. This is in line with Ireland's Medium Term

Objective. The Committee notes that it is the intent of the Government to set up a Rainy Day Fund from 2019, by which €1bn will be set aside for contingency purpose on a yearly basis.

2. Risks & Opportunities

The Committee heard evidence from a number of bodies that highlighted risks to economic growth, including infrastructural deficits, dangers of the economy overheating and the impact of Brexit. Whilst many witnesses focused on risks to the economy and, by extension, budgetary stability, opportunities were also identified. Brexit could benefit certain areas of the economy, a renewed focus on the need for social housing could improve sustainability in the housing market, and the view that the economy is not overheating provides, at the very least, leeway in the short term to deliver critical infrastructure. The Committee recognises these positives and supports initiatives that embrace them.

Bottlenecks

The bottlenecks that are developing in the country's capital infrastructure have the potential to create higher risks to economic growth in the short term. Ireland urgently needs to address the shortage of housing and there is a major need to fast-track transport projects so as to avoid gridlock that has the potential to harm economic output. The issues of connectivity from provincial to major urban centres and the provision of high speed broadband were also raised as key aspects to relieving bottlenecks.

Brexit

The evidence heard by the Committee on the mixed effects of Brexit pointed to weaker foreign demand, unfavourable currency exchange rates for exporters, and diverted foreign direct investment from the UK to Ireland. The SME sector, especially in hospitality, agriculture, and the food and drinks industry, is at particular risk from the potential negative impacts of Brexit.

Professor John McHale of IFAC highlighted the Council's recent research that forecast negative effects on economic growth for a number of years. He pointed out that such a development '*eats into the fiscal space and would have implications for budgetary policy*'. Minister for Finance Michael Noonan informed the Committee that the Department of Finance has built an assessment of Brexit into its figures for the upcoming Budget. He also noted that the timing of the UK Government's triggering of Article 50 will feature strongly in medium-term budgetary planning. Since Minister Noonan's attendance before the Committee, the UK Government has indicated that the process to leave the EU will commence in March 2017.

An issue of concern for the Committee is the cross-border challenges that Brexit will most likely pose. The Committee is therefore supportive of efforts to improve economic planning and co-operation on both sides of the border.

The Committee's ongoing work programme will prioritise issues relating to Brexit. In that regard the Committee also noted the opportunities that could arise from Brexit, for example from enterprise relocation.

Danger of Overheating

A further risk is that the economy might overheat in the coming years. Professor Alan Barrett of the ESRI said that '*the Irish economy is growing at its potential rate and so neither stimulatory nor contractionary fiscal policies are required*'. Professor John McHale of IFAC said that

'*understanding the cyclical position of the economy and avoiding potential overheating will be important considerations in framing fiscal policy post -budget 2017'.* The Committee heard no evidence that indicated the economy is overheating.

Debt Levels

Prior to the recent revision of the National Accounts, the Stability Programme Update (SPU) and the Summer Economic Statement (SES) projected a debt-to-GDP ratio for 2016 of 88% and a fall to 69% of GDP by 2021. Due to the revision to GDP for 2015, the ratio at end-2015 was already 79%. The revisions to GDP have therefore made the SPU projections redundant, as Ireland's debt as a percentage of GDP has already fallen below forecast debt levels for future years.

Under EU debt rules, Ireland must reduce its absolute debt by 5% every year from 2019 onwards until the ratio is 60% of GDP. In his pre-Budget letter to the Minister for Finance, the Governor of the Central Bank suggested that national debt targets, below the 60% of GDP ceiling set out in the Debt Rule, could be considered for domestic policy purposes, once that target is met.

Witnesses held differing views on this measure. Professor John McHale questioned '*whether it is necessary to have a supplementary target for the debt*' below 60%, since Ireland is already on a path *'to a debt-to-GDP ratio that would be in very safe territory*'. Dr Gabriel Fagan of the Central Bank noted '*the 60% is not a target, it is a ceiling. If the country has a lower debt, it is still meeting that ceiling*'.

The question of continuing to go below the ceiling set by the Debt Rule is not a matter for Budget 2017. However, the Committee notes that a key risk arising from high levels of sovereign debt is that it could inhibit the economy from absorbing shocks that could arise in the future, for example if there was a repeat of the economic and financial crisis of 2008.

The Committee further noted that the risk of debt is not limited to sovereign debt. Ireland still remains a highly indebted nation on a private level. Mortgage arrears, SME and personal debt remain elevated and pose a significant risk. The emergence of a "vulture" fund market is regrettable and unacceptable in the context of ways of addressing this risk.

High Marginal Tax Rates

A risk highlighted by some Members of the Committee is that the relatively high marginal tax rate, vis-à-vis competing economies, could disincentivise emigrants from returning to Ireland to take up jobs created as a result of the country's economic growth.

Reliance on Foreign Direct Investment

The concern of the Committee is that economic stability could be put at risk due to circumstances outside Ireland's control, such as if FDI was to be scaled back, which would impact on both tax receipts and employment. While FDI remains key to industrial policy in the State, Committee Members noted that the risks highlighted here provide an opportunity to put a greater focus on the development of indigenous industries.

Housing and Accommodation

This report has a separate section on housing, however an issue raised, especially with the concentration of employment around large urban centres, was that until the shortage in the

supply of housing is addressed, house prices and rental costs will drive up costs for workers, and this could pose a risk to competitiveness and ultimately to economic growth.

Climate Change

The Committee notes that, based on current projections, Ireland is unlikely to reach its carbon emissions targets by 2020, which could result in significant fines from the EU from 2021 onwards. In order to ameliorate the threat of fines, the Committee, aware that there is no major extra funding stream available in this area, recommends that all budgets should provide incentives that encourage a low-carbon economy.

In that regard, it is clear that greater investment in the retrofitting of buildings and in sustainable transport is needed. On the latter issue, the Committee recommends that the Government should examine whether funding can be put in place in Budget 2017 to fast-track projects such as the provision of cycle paths in urban areas.

The long term solution to sustainability in transport is to have high capacity public transport in cities, and in that regard the review of the Capital Plan in 2017 should examine whether the planning, procurement and tendering phase of Metro North (for example) could be brought forward.

The impending review of the National Planning Framework provides the opportunity for every city and region to develop plans for investment in low-carbon infrastructure and to submit such plans to the review of the Capital Plan for consideration. The switch to a low carbon economic model presents an opportunity for Ireland to develop leadership in new clean technology industries. This new move to a sustainable economic model will have implications for our food, transport, waste, energy and industrial systems which need to be facilitated by the whole budgetary process.

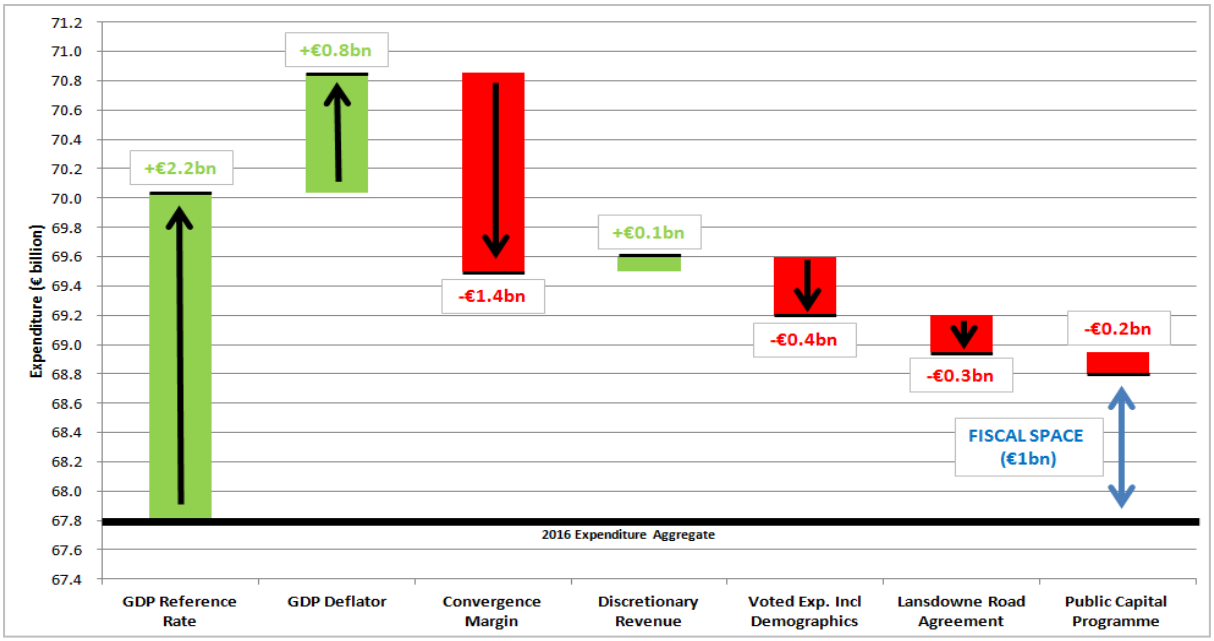
The Committee's Views

- In the context of Brexit, the Committee is aware of difficulties faced by Irish firms exporting to the UK and this is an issue that should be addressed in Budget 2017.
- The Committee encourages the Department of Finance to closely monitor whether the economy is approaching capacity and to adopt policies that mitigate identified risks where necessary.
- As the unemployment rate is at 8.3%, the Committee is of the strongly held view that the Irish economy is not overheating and this should be factored into the calculation of the fiscal space in the next Stability Programme Update.

3. Available Fiscal Space

The question of the quantum of available fiscal space to 2021 formed a core aspect of the Committee's work. The Department of Public Expenditure and Reform and the Department of Finance estimate cumulative fiscal space of €11.3bn between 2017 and 2021. According to June's SES, the government will have net *fiscal space* of €1 billion available for 2017 and, if fully utilised, the split between current and capital expenditure and tax reductions is a choice to be made by government. This fiscal space can be increased through extra discretionary measures.

Figure 1: Graphical Depiction of the Calculation of Available Fiscal Space for Budget 2017.



Sources: Summer Economic Statement and NERI.
Note: Figures may not sum due to rounding.

Figure 1 is a graphical depiction of the calculation of the available fiscal space for 2017. The black horizontal line represents the 2016 Government Expenditure aggregate of €67.8bn (inclusive of the additional €540m in voted expenditure for the Departments of Health and Justice which was outlined in the 2016 Revised Estimates Volume). Each green bar in Figure 1 represents an expansion in the available fiscal space for the year, while each red bar represents a contraction in the available fiscal space.

For a more detailed explanation of what drives the calculation of the fiscal space for 2017, see Appendix 14.5 (page 35).

2017-2021

Estimates of the total available fiscal space between 2017 and 2021 vary depending on whether demographic pressures and inflation are accounted for. Whilst IFAC accounts for both, Government Departments do not take account of inflation, on the basis that to do so would pre-judge political decisions by Ministers of the day.

The Committee received input from IFAC regarding the divergence between its application of a standstill expenditure scenario and the Department of Finance's "no-policy change" approach.

Between 2017 and 2021, IFAC estimates that €8.5bn would be needed to take account of the Lansdowne Road Agreement, demographics, inflation-linked current expenditure increases, and capital expenditure increases. By contrast, the Department estimates that €4.2bn would be needed to take account of demographics, the Lansdowne Road Agreement, and capital expenditure increases. Hence, applying the IFAC approach would take €4.3bn out of the net fiscal space of €11.3bn over the same period. This would leave €7bn in fiscal space if price and wage inflation effects were to be accounted for. Based on how the €11.3bn has been allocated in the SES, applying IFAC's approach would leave no additional fiscal space for increasing expenditure in the upcoming budget (see IFAC's submission in Appendix 14.6 (page37), with 'stand still' current expenditure requirements, which closely match forecast total current expenditure profile provided in the SES).

An additional issue that arose during the course of the Committee's hearings was the application of the convergence margin in calculating Ireland's fiscal space. As Ireland has not yet reached its MTO of a structural deficit of 0.5% of GDP, which is due to be reached in 2018, the European Commission applies a convergence margin which reduces the fiscal space by €1.4bn for 2017. In calculating the structural balance, the Department and the European Commission examine the extent to which the economy is, or isn't, at its potential output, which is in turn affected by cyclical influences. Amongst the factors considered are wage pressures, the housing stock, and the equilibrium unemployment rate: Dr Tom McDonnell of NERI noted that '*the Commission had an equilibrium unemployment rate of over 10% quite recently*'. Given that Ireland's current unemployment rate is around 8%, this could imply that the Irish economy is close to overheating. Dr McDonnell argued that, given that Ireland had a very low unemployment rate less than a decade ago, NERI '*disagree that the economy is overheating and, therefore, the fiscal space figure for 2018 is overly conservative*'.

A further point is that the revision to the National Accounts for 2015 might reduce the structural deficit as a percentage of GDP. As Ireland's structural deficit for 2017 is forecast to be 1% of GDP, all of these factors, taken together, might result in Ireland reaching its MTO in 2017. If that was to be the case, the convergence margin would not be applied in that year and the fiscal space would increase. The Committee is concerned about the methodology used to estimate whether the Irish economy is at its potential or not, and the extent to which this impacts on Ireland's fiscal space. As part of its ongoing work schedule, the Committee will seek to examine this issue further.

Demographic Pressures

Over the coming years demographic pressures will grow which will increase the costs on the Exchequer of providing the same level of services. These pressures will impact upon education, housing, and pensions, amongst other areas. In the short term, our young population necessitates additional resources in education. Meanwhile, as the population ages, more resources will need to be allocated to provide for healthcare and pensions.

The Committee heard evidence that differences exist between IFAC and the Department of Finance in relation to estimating the impact of demographics. Mr Michael Tutty of IFAC told the Committee that the Council is '*trying to narrow the differences between us and the Department so that we can get a fix on what the real demographic pressures are, but our estimates are still somewhat ahead of the Department's*'. The Department's Mid-Year Expenditure Report also

notes (p15) that '*work is currently underway to develop a common framework for modelling government spending that extends beyond an analysis of demographic drivers*'.

The Committee's Views

- The Committee is cognisant of future demographic pressures and recognises the need to account for these in medium-term budgetary planning.
- The Committee will, over the course of 2017, work closely with relevant stakeholders to better understand the drivers of the costs associated with demographic pressures.
- The Committee encourages the Government to ensure that, at a minimum, demographic changes do not impact on the standards of public services.

Indexation and Inflation

The question of whether to index welfare payments and tax bands and allowances during the formation of budgets forms an important debate. For income tax payers, non-indexation could potentially result in a tax increase when wages increase. For welfare recipients, non-indexation results in the value of the payment decreasing as inflation lowers the buying power of pensions and payments. By contrast, indexation of tax bands, allowances, and welfare payments ensures taxpayers and welfare recipients are not made worse off due to inflation.

The Committee heard differing views on whether to include indexation for inflation when calculating the fiscal space. Mr Michael Tutty of IFAC said that '*one must take account of the fact that there are inevitable pressures from inflation that will add to the costs of social welfare and other things over the medium term*.' Professor Alan Barrett explained the ESRI position as follows: '*our view is that budgetary figures and analysis should be presented with a baseline of indexation applied*'.

By contrast, the Minister for Finance, Michael Noonan, informed the Committee that '*the movement towards automatic indexation, as happens in other countries, has not happened in Ireland and I have no proposal to introduce it at this stage*'. The Minister for Public Expenditure an Reform, Paschal Donoghue, expressed a similar view when he told the Committee: '*I believe that making expenditure increases automatic in terms of income payments or other payments that we make available to people will take us down a path which leads to the kind of difficulties that we are trying to get out of at present*'.

The Committee's Views

- The Committee recognises the debate surrounding indexation as part of the budgetary process and acknowledges both sides of that discussion.
- The Committee broadly accepts that the indexation of taxation and expenditure is a matter for Government.
- While acknowledging the Departments' perspective on this issue, the Committee encourages the Departments to present a set of numbers with indexation as an auxiliary to their main set of budgetary expenditure numbers, so that the effect of indexation, if implemented, can be seen.

4. Capital Expenditure

A key concern of the Committee is the need to improve the country's infrastructure and services. As a result of low capital expenditure during the recession, bottlenecks have emerged in the areas of education, social housing, childcare and broadband, amongst others. The Mid-Year Expenditure Report sets out the pre-Budget baseline position, which shows an Exchequer capital budget of €4.13bn for 2017 and €4.38bn for 2018.

The evidence heard by the Committee strongly indicated that capital investment should be a priority over the coming years. Professor Alan Barrett of the ESRI commented that '*we certainly see a need for infrastructural investment, given that it has been cut back for many years and still stands at a low proportion of GDP*'. He explained the ESRI position as follows: '*we believe capital investment that increases the productive capacity of the economy to be desirable, including spending on housing*'.

Dr Tom McDonnell of NERI said that '*we have a major problem in terms of public capital investment, which is at extremely low levels. It is barely more than depreciation*'. Minister Michael Noonan explained that '*investing in infrastructure and addressing expenditure priorities while encouraging labour market participation and reforming the income tax system will serve to facilitate continued economic growth*'.

As there was consensus on the need for increased capital investment in all aspects of productive infrastructure, the focus of the Committee was on the scope available to the State to commence a large scale programme. The Committee is of the view that the fiscal rules inhibit the ability to address the bottlenecks that are posing a risk to the continued development of our economy and society. This is an issue that needs to be addressed by the Government at EU level and it is a matter that will be raised by the Committee in its future interactions with the EU Commission. This issue is dealt with in more detail in Section 5 of this Report.

As outlined above, within the fiscal space, public capital investment is factored or 'smoothed' in but Member States may average it out over a four year period. . The Committee encourages the Government to explore all elements of Gross Fixed Capital Formation which could be 'smoothed', with a view to maximising the available fiscal space from 2017.

The Committee's Views

- The Committee encourages the Government to invest in infrastructure as a means of reducing structural deficits and supporting economic growth.
- There is a need to change the fiscal rules on Expenditure so as to allow flexibility for capital investment that would boost the productive capacity of economies that are recovering from a recession, or as in Ireland's case, an economic and financial collapse.
- The Committee notes that the Capital Plan will be reviewed in mid-2017, and plans to conduct a number of hearings in 2017 examining capital expenditure levels and needs. In particular it will seek to explore how projects scheduled for later periods can be brought forward, and where the preparatory work of planning and procurement can begin early on major capital projects.

5. Flexibility to Invest

The Committee sought input from witnesses regarding the constraints of the fiscal rules, in particular in the context of the low level of capital expenditure detailed in the previous chapter. There was broad agreement that the EU's fiscal rules restrict public investment and should be reviewed.

Professor Alan Barrett of the ESRI questioned '*the notion of treating the productive impact, for example, of a road or houses in the same way as a reduction in the universal social charge, USC strikes me as kind of crazy'*. Professor John McHale of IFAC said that '*it would be a positive development to develop the rules to make more of a distinction between current and capital so one does not face these types of constraints*'.

In contrast to this, Mr Michael Tutty of IFAC noted that '*even if one looks for some flexibility, one would still have to look at the overall deficit in the country and determine whether that level of deficit was appropriate*'. Mr John Flynn of the Central Bank told the Committee that '*the Stability and Growth Pact rules are there and do not specifically make any exemptions for public investment*'.

Mr Tutty put forward a view when he told the Committee that '*there is some flexibility there in the fiscal rules on investment. It is very limited and it applies only where one is making a major investment that is equivalent to a structural reform, namely, reforming an area through capital investment and it will bring returns to the Government over the future years. It is very limited; it only applies to 0.5% of GDP on a once-off basis so it is not really relevant'*. The Committee is aware that this refers to the Structural Reform Clause.

The Committee was advised that avenues for off-balance sheet funding are currently under investigation, including via ISIF, NAMA and PPPs. Off-balance sheet funding could facilitate increased investment in infrastructure in a manner which would not adversely affect either the Government's debt burden or its adherence to the fiscal rules. On this point, Minister Paschal Donohoe said that the Government is '*trying to obtain full, absolute and ongoing clarity on what investment is treated as off balance sheet and what investment is treated as on balance sheet*' in order to inform future decisions.

The Committee heard evidence that, in the context of historically low interest rates on bonds, borrowing for productive purposes can lead to strong returns. The Committee also heard evidence that the re-profiling of debt can reduce interest costs and can facilitate an increase in capital expenditure, provided fiscal policy remains within the EU's fiscal rules framework.

The Committee's Views

- The Committee encourages the Government to advance the case for greater flexibility in the treatment of capital expenditure within the EU's fiscal rules, particularly in light of infrastructure issues apparent in the Irish context.

- The Committee is of the view that all options for borrowing for productive purposes should be explored at both the domestic and European levels with the specific aim of increasing capital expenditure.
- The Committee recognises the need for caution when examining funding options that are potentially off the Government's balance sheet, but encourages the Government to explore all available options in conjunction with relevant bodies so as to deliver increased public investment in infrastructure.
- The Committee will examine the scope available to invoke the Structural Reform Clause as a way of increasing fiscal space, at future meetings.

6. Housing

The budgetary process can help in alleviating the shortages in housing supply and the demand for social housing. In that regard the Committee held a wide ranging discussion with witnesses on the social and economic impacts of the housing and accommodation shortages which, as highlighted earlier in this Report, pose a risk to economic growth and recovery.

Views around issues such as the ownership and hoarding of development land and the need to maintain an adequate stock of local authority housing, while outside the direct scope of Budget 2017, were flagged by Members as needing to be addressed in an overall budget context. The Committee will work with the Joint Committee on Housing Planning and Local Government to address these issues.

With regard to the need to address housing supply issues the Committee heard from Dr Tom McDonnell who noted that '*there is a market failure in the private sector for various reasons and there is, therefore, a role for the Government to use its own capacities in a fiscal context to intervene directly and to start building houses*'. Professor Kieran McQuinn of the ESRI advised the Committee that '*one must accept that it is both a private and a public issue. The public sector cannot provide all of that housing, but there must be a strong Government involvement in providing social housing*'. Professor McQuinn estimated an annual cost of €1.5bn to the State to build social housing, based on the fact the Government was '*building approximately 3,500 to 4,000 social housing or public authority housing units*' in 2007 and 2008 and was '*spending approximately €1.5 billion on it*'. He advised the Committee that this must be borne in mind when considering the €5.5bn package outlined in the Governments plan on housing.

Some witnesses commented on developments in the rental market. Dr McDonnell noted that '*there might not be a productivity-enhancing aspect to social housing but there is a competitiveness aspect because more housing means lower rental costs, which improves competitiveness in wage demands vis-à-vis other economies*'. Professor McQuinn identified the fact that rental levels are '*surging to the extent to which they can only put upward pressure on and cause potential deterioration in our competitiveness, particularly when we are trying to attract people to come and work in our major cities especially and in Dublin in particular*'.

In examining ways to address the shortage of housing, Dr Gabriel Fagan outlined the Central Bank's view that '*any measures taken by the Government to address housing problems should try to avoid exacerbating the distortions that are seen in the market*'. Professor Alan Barrett of the ESRI noted that '*tax incentive measures have very little effect on supply and, very often, their effect is to transfer money not to the people we are trying to help but to the people at the end of the line*'. Whilst the specific measures proposed in Budget 2017 were not made available to the Committee, the Minister for Finance indicated that he was planning to introduce a 'help to buy' scheme for first time buyers. Minister Noonan noted that his Department is planning this '*with the full knowledge of the Central Bank. It knows exactly what I have in mind and it approves of it*'. Some Members called for such a measure and also called for supports to increase the supply of rental properties.

The Committee discussed a range of issues that it will consider with the appropriate sectoral committee, including:

- The future sale of local authority houses and whether sales agreements could be structured so that the local authority retains a right to bring the house back into public ownership when it comes to resales, thus ensuring that the public housing stock is not depleted.
- The need for better connectivity between major urban centres and satellite towns to address some affordability issues. This issue is critical in the case of Dublin.
- The ongoing need to address the ownership of development land and the need to introduce measures to disincentivise speculation, which is leading to hoarding of development land.

The Committee's Views

- The Committee strongly encourage the Government to do all in its power to address the difficulties in the housing market, focussing on measures to increase supply.
- Local authorities need to recommence supplying social housing.
- The vacant land levy (*site tax*), due to be introduced in 2019, could be introduced sooner so as to encourage supply of development land for housing.
- The Committee will work with the Joint Committee on Housing, Planning and Local Government to address issues around protecting the State's housing stock, so as to mitigate against cyclical shortages and also on the use of budgetary measures to address issues around tackling speculation in and hoarding of development land.

7. Childcare

The Committee notes that childcare costs in Ireland are the second highest and highest in the OECD for couples and lone parents respectively.[3]

Whilst giving evidence before the Committee, Dr Tom McDonnell of NERI noted that this *'is a massive barrier to labour force participation by second earners and by lone parents'.* Professor Alan Barrett of the ESRI stated that *'there is evidence to suggest that the cost of child care is genuinely an obstacle to people's participation in the labour force'.* He noted that '*doing something really substantial on child care will have an impact on labour supply*'.

The Committee heard evidence from both Minister Noonan and Minister Donoghue as to the high cost of childcare in Ireland and proposals regarding how those costs can be reduced. Two options emerged from the discussions:

1. The provision of a tax break **or**
2. The provision of subsidies.

Minister Noonan noted that *'parents on very low incomes who pay no tax would not benefit from a tax break on child care payments. Couples or mothers paying tax at the standard rate would benefit at the standard rate only. Better-off individuals on higher incomes who pay tax at the higher marginal rate would benefit at the higher marginal rate'.* Minister Noonan also advised the Committee that *'in the world in which we live it [tax credits] might also result simply in increases in child care charges*'.

Minister Noonan informed the Committee that the proposals being considered by the Government for Budget 2017 '*are not tax-based*'. He did not indicate that the proposals would be subsidy-based.

The Committee did not reach a conclusion on the optimal approach to childcare given the absence of a policy outline on the likely budgetary measures referred to by the Minister. However, the Committee was clear that any direct support should lead to quality assured care and broader income support measures should be proofed for equality and anti-discrimination. In that regard concerns were raised from within the Committee that any support measures introduced in the budget should not be discriminatory between parents who choose different models of childcare. There is a concern that exclusive provision of financial support for full time childcare facilities would leave parents who care for children themselves or who use family members or individual childminders to care for their children at a disadvantage. The existence of such discriminatory measures combined with existing tax individualisation measures could make it increasingly difficult for parents to choose their preferred childcare option.

[3] OECD, *Economic Surveys: Ireland* (2015), data from 2012

The Committee's Views

- The Committee notes that Budget 2017 will address issues around the cost of childcare where the costs in Ireland are extremely high, especially for those who are in the labour force and who have to purchase childcare.
- The Committee encourages the Government to take a multi-faceted and long-term approach to reforming childcare, including via the budgetary process. In that regard, the different models of childcare should be reviewed with a view to the provision of supports.
- The Committee will work with the Joint Committee on Children and Youth Affairs to establish the optimum way in which budgetary measures can assist in the development of childcare policy in Ireland.

8. Corporation Tax

At end-August 2016, corporation tax receipts were ahead of profile by 17%/€508m. This reflects a continuation of the strong performance of this tax head, which increased from €4.6bn to €6.9bn between 2014 and 2015, a rise of 49%.

Professor Kieran McQuinn of the ESRI noted that corporation tax receipts come '*with quite an amount of uncertainty in that we do not really have a good understanding of how stable those tax receipts [are]*'. Mr Seamus Coffey of IFAC said that corporation tax *'is highly volatile and the sustainability issue is because this year we are seeing it rise, yet next year it could fall. Should we be basing spending, as one would expect to do on a weekly, monthly, and annual basis, on something that is as volatile as that?"*

On the question of the concentration of this revenue stream, Mr Gerry Howard of the Revenue Commissioners informed the Committee that '*approximately half of the increased corporation tax receipts came from a small number of companies*'.

Minister Michael Noonan advised the Committee that Budget 2016 was based on a projection for corporation tax receipts of €6.6bn, lower than the actual outturn of €6.9bn. He said that the Department was '*allowing for the fact that there might be some fall off*' last year.

The broad input received by the Committee indicates that corporation tax is a concentrated source of revenue that fluctuates frequently. A number of witnesses expressed a desire for more speedy access to corporation tax returns for analytical purposes.

The Committee also learned that because final corporation tax returns for 2015 will not be submitted until end-September 2016, the Revenue Commission is not in a position to fully explain fully the reasons for the uplift in 2015. Hence, whilst there appears to be a relationship between increased corporation tax receipts and the revision to GDP figures by the CSO, the question of causality cannot yet be answered.

Some Members raised concerns about the impact of tax expenditures and other aspects such as the "double Irish" in reducing the Corporation tax take. Witnesses outlined that many of these were capital allowances and trade charges that are a standard feature of all tax laws. However the scale of the allowances and deductions are vast relative to the size of the economy, primarily as the major source of Corporation tax in Ireland is from the multi-national sector.

The Committee's Views

- The Committee will conduct a review of corporation tax when the Revenue Commission have assessed the 2015 tax returns, which are due at end-September. This review is likely to take place in early 2017.
- Given that corporation tax is approximately 15% of the tax take in the State, it is important from a budgetary context to establish whether it has now reached a new sustainable higher base. To that end, and as part of its preparation for Budget 2018, the Committee intends to conduct an extensive review of corporation tax including the

relationship, if any, between the 2015 surge in receipts and the spike in GDP. The Committee will also examine tax expenditures as they apply to the corporate sector.

9. Income Taxes

The forecast for 2016 is for income tax revenue – income tax, PRSI and the USC – to reach €19bn, or 40% of total tax revenue. At end-August, income tax receipts were 0.8%/€99m behind profile. The Committee heard evidence relating to the stability and progressivity of the income tax system, as well as regarding the entry point for the higher rate.

Professor Alan Barrett of the ESRI said that '*one of the themes that has emerged [from an ESRI study] is the relative stability of income taxes and hence the desirability of maintaining such taxes as a sizeable share of total revenues*'. Witnesses broadly agreed that the Irish income tax system is progressive. In examining the drivers of this, Dr Tom McDonnell of NERI explained that '*the pre-tax distribution of income in Ireland is very inequitable relative to many of our western European peers*'.

The Committee engaged with witnesses on the impact of the entry-point to the marginal tax rate. Professor Barrett noted that a feature of the Irish income tax system is '*the extent to which people start paying the higher marginal tax rate at relatively low levels of income*'. Likewise, Dr McDonnell said that the '*marginal tax rates kick in at a high rate, which is a little above the average industrial wage'*. Minister Michael Noonan explained that '*the literature would say that once there are high marginal rates of tax, it begins to affect the economy in an adverse way*'. However, Professor Barrett was of the view that '*at some point this is probably true but we can ask if is there evidence to suggest that the current tax rates are leading to widespread withdrawals from the labour market'*. The Committee was encouraged to support research that would investigate the effect of marginal tax rates on the incentive or disincentive to work.

On the issue of income tax receipts being behind profile, Mr Seamus Coffey of IFAC noted that '*it does not seem to be reflective of an underlying weakness in the economy. We still have employment and expenditure growth. It is something on which we will keep an eye, but at this stage we would not say that there is weakness there*'.

The Committee's Views

- The Committee is aware that income tax revenue was behind profile at end-August. The Committee recognises that this may be a timing issue but encourages the Department of Finance to monitor this development, especially in light of increasing employment numbers.
- The Committee recognises that Ireland has a progressive income tax system and encourages the Government to ensure that this remains the case.
- The Committee recognises that, relative to other countries, workers in Ireland enter the higher tax band at close to average wage levels.

10. Universal Social Charge

Revenue from the Universal Social Charge (USC) is expected to amount to approximately €4bn in 2016 and the current estimate of the Department of Finance is that, on a no policy change basis, that figure would reach €5.6bn by 2021. The Programme for a Partnership Government has a provision to phase out the USC.

The Committee heard from a broad range of witnesses supportive of the retention of the USC. Professor Alan Barrett of the ESRI told the Committee that '*the USC has many desirable features as a source of revenue: progressivity, transparency and stability, to mention three. For this reason we are unconvinced that moves to abolish the USC are wise*'. Dr Tom McDonnell said that '*the USC has a simple and highly progressive structure'* and cautioned against its removal.

Minister Michael Noonan explained his rationale for reducing the USC over the coming years as follows: '*The reason I am reducing USC rather than income tax is before one starts looking at the income tax code, one should take out the emergency taxes first*'. The Minister explained that in doing this, his plan will be '*directed towards reducing the impact on low and middle income earners*'. In addition to this, the Minister clarified his policy when he stated *that 'one will note it was never the intention to abolish the USC for those on high incomes. There was a proposal to reduce it but it was to be replaced by another tax. It might not be called the USC but would have the same effect on income, and there would be the same flow'.*

The Committee's Views

USC has proved a divisive issue for the Committee with Members taking very differing positions. The spectrum of views include those who argue for:

1. its abolition as it is deemed an emergency tax
2. its retention as it's a valuable source of revenue that is needed for public services and its abolition would erode the tax base
3. a restructuring of USC by linking it with PRSI so as to make future provision for pensions
4. the phasing out of USC to focus initially on reducing the tax burden on low and middle income earners.

In light of the Minister's contribution about replacing the USC with a tax on high income earners and while noting that the abolition will be over a number of budgets, the Committee will ask that the way in which the fiscal shortfall created by the abolition of the USC will be met should be clearly articulated by the Minister.

11. Tax avoidance Structures (including the use of Section 110)

Members of the Committee raised concerns with both the Minister and the Revenue Commissioners about the activities of investment vehicles (generally referred to as vulture funds) that are using tax avoidance measures such as the provisions of Section 110 to effectively evade tax on profits and capital gains made from their activities in Ireland.

These investment vehicles [reference was made in the Committee debates to qualifying investor, alternative investment funds (QIAIF's) and Section 110s; however the Committee noted that two other investment vehicles are also involved, namely Irish Collective Asset Management Vehicles (ICAVs) and Real Estate Investments Trusts (REITs)] are acquiring either the underlying property associated with distressed loans or are taking over the loans from financial institutions. Some of these funds have registered as Section 110 companies or as one of the other investment vehicles. The underlying position is that the investment vehicles are avoiding paying tax on the profits that are being generated in the State.Minister Michael Noonan informed the Committee that Section 110 has been applied in cases in which it had not intended to be applied. He explained that '*after consultation with Revenue it was decided to close what was regarded as a loophole or an unintended application of the Section*'. The Committee is aware that an amendment to Section 110 which will be effective from early September 2016 will be introduced in the Finance Bill 2016 and that further changes will also be incorporated in this measure. The Committee remains concerned that the amendment will not have an impact as:

1. It allows the assets to be marked to current market value;
2. Vulture funds will continue to use arm's length loan notes which can be set against profits made; and
3. The amendment only applies to property.

The Committee was informed by Revenue that the amendment, which will restrict the use of Section 110, is still a work in progress. The Committee will work with the Revenue Commissioners and the Minister to introduce an amendment that will ensure that the appropriate tax is levied on any gains accruing to these investment vehicles.

While the Committee understands that Section 110 was originally designed to facilitate finance entities located in the IFSC but whose financial assets were located internationally, the funds that acquired the underlying loans are dealing with financial assets located in the State and therefore profits on those assets should be taxable in the State. For that reason, the Committee recommends that the amendments proposed to Section 110 deal with that distinction.

In addition, the Committee recommends that the current review of the operation of Section 110 examines whether a form of withholding tax can be introduced so that taxes are not artificially eroded through loan notes. The Committee understands that this is a feature of other tax jurisdictions in their treatment of such investment vehicles.

12. Miscellaneous Taxation Issues

The Committee considered a number of tax changes that feature in the Tax Strategy Group Papers and the views of Committee Members are outlined hereunder.

Sugar-Sweetened Beverage Tax

The Department of Health recommends that a sugar tax should be applied to water-based and juice-based drinks which have an added sugar content of 5grams/100ml and above. Forecasts are that a 1c levy on a 330ml can would raise €10.1m, a 5c levy would raise €50.7m, and a 20c levy would raise €202.6m.

The Committee is aware of Revenue concerns in terms of designing a new tax system and to that end Revenue suggested that 2018 may be a preferable date. In addition the imposition of a tax has the potential to create a grey market in cross-border trading of soft drinks and therefore it would be preferable to have a sugar tax introduced simultaneously in both jurisdictions.

The Committee agrees that 2018 is a more appropriate time to introduce a sugar tax and is also of the view that the introduction of a sugar tax can form only a small part of a wider health programme that is designed to improve health and tackle obesity.

Equalisation of Petrol and Diesel Excise Duty

At present there are excise rate incentives that encourage the sale of diesel vehicles. As diesel emissions are more damaging to the environment, the suggestion that there should be an equalisation on excise between petrol and diesel was suggested as one way of encouraging consumers back towards petrol vehicles.

The Committee notes that any move to equalise petrol and diesel costs in the short term would unfairly penalise those who have already invested in diesel vehicles. The Committee notes that the introduction of equalisation can only be done over a series of budgets and is of the view that the Minister should give an indication in Budget 2017 that he is going to begin a process of equalisation from 2018 onwards.

Inheritance Tax

The Committee raised with the Minister the proposal to increase the inheritance thresholds in respect of family homes. The Tax Strategy Group Papers outlined that the cost of increasing the threshold to €500,000 for a parent to child inheritance would amount to €75 million per annum. The Minister indicated that he proposed to increase the thresholds over a number of budgets, due to the cost thereof. Some members of the Committee support the proposal in respect of the inheritance of the family home by children of deceased parents.

13. Regional Development

The Committee raised with a number of expert witnesses the extent to which Budget 2017 could boost economic development in the regions. It is clear that large scale economic development is gravitating towards large centres of population like Dublin, Cork, Limerick and Galway, and that some areas, in particular the North West and the South East, are falling further behind.

The Committee notes that central to the balanced development of the State is the roll-out of high speed broadband to every part of the county. That will boost employment, especially in the IT sector, and it will enable the SME sector to take advantage of the global market by selling goods and services online. Budget 2017 should be proofed to assess its impact on the regions and the Committee will review this issue in the coming months.

A second area of policy that will encourage balanced regional development will be the creation of regional hubs to act as powerhouses for the development of enterprise. The Committee welcomes the current work on a revised spatial strategy, the *National Planning Framework*. The Committee recommends that the *Framework* addresses issues such as third level education so as to improve levels of educational attainment in the regions.

14. Appendix

14.1 Terms of Reference

"That, until 31 December 2016 or until the Dáil shall otherwise order-

(1) A Select Committee, which shall be called the Committee on Budgetary Oversight, is hereby established to consider -

(a) public expenditure policy;

(b) policy affecting Exchequer revenue receipts; and

(c) the overall fiscal position, including the aggregated position on revenue and expenditure and the General Government Balance (including on a structural basis) and medium-term projections for the public finances.

(2) Notwithstanding the generality of the foregoing, for the purposes of considering Budget 2017, the Committee shall consider –

(a) the expenditure position having regard to

(i) the Government Expenditure Ceiling and,

(ii) where significant variation from the expenditure profile could potentially impact on the overall fiscal position, Ministerial Expenditure Ceilings applying to individual estimates or groups of Estimates for public services;

(b) the position regarding Exchequer revenue receipts;

(c) the fiscal position, including the question of whether or not fiscal rules are being complied with; and

(d) recommendations made by any other Committee pursuant to paragraph (7).

(3) The Committee on Budgetary Oversight shall have the following powers:

(a) power to send for persons, papers and records as defined in Standing Order 85(2A) and 88;

(b) power to take oral and written evidence and submissions as defined in Standing Order 85(1) and (2);

(c) power to appoint sub-Committees as defined in Standing Order 85(3);

(d) power to engage consultants as defined in Standing Order 85(8);

(e) power to travel as defined in Standing Order 85(9).

(4) Every report which the Committee on Budgetary Oversight proposes to make shall on adoption by the Committee, be laid before the Dáil forthwith, whereupon the Committee shall be empowered to print and publish such report, together with such related documents it thinks fit.

(5) The Committee on Budgetary Oversight shall consist of 15 Members, none of whom shall be a member of the Government or a Minister of State, and 6 of whom shall constitute a quorum, nominated as follows:

(a) four members by the Government,

(b) four members by Fianna Fáil,

(c) two members by Sinn Féin, and

(d) one member each by the Labour Party, AAA-PBP, Independents 4 Change, the Rural Independent Group and Social Democrats-Green Party Group.

(6) For the purposes of considering Budget 2017, but with due regard however to the limited opportunity available, each Sectoral Committee may consider, in relation to Departments and bodies accountable to it -

(a) actual performance and associated expenditure and the adequacy of performance targets, including the improvements and that may be necessary or appropriate; and

(b) changes contemplated to outputs and service delivery, in respect of which Government or Ministerial approval would or might be required, and in the associated funding as a result.

(7) Each Sectoral Committee may report its opinions and recommendations and the basis of its assessment as the Committee considers appropriate: Provided that where a Sectoral Committee proposes to make recommendations that cannot be accommodated within the three year expenditure ceilings for the relevant Estimates or group of Estimates for public services, the recommendations shall be contained in a report to be made to the Committee on Budgetary Oversight."

14.2 Membership of the Committee

Seán Barrett TD

Fine Gael

Richard Boyd-Barrett TD

Anti-Austerity Alliance – People Before Profit

Colm Brophy TD

Fine Gael

Thomas P. Broughan TD

Independents 4 Change

Joan Burton TD

Labour

Dara Calleary TD

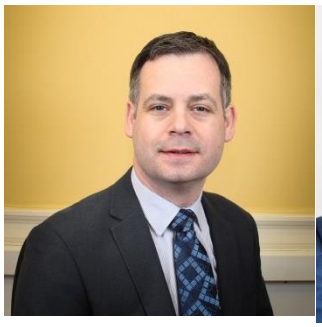
Fianna Fáil

Lisa Chambers TD

Fianna Fáil

David Cullinane TD

Sinn Féin



Pearse Doherty TD

Sinn Féin

Stephen Donnelly TD

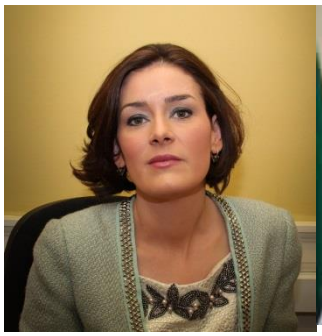
Independent

Marc Mac Sharry TD

Fianna Fáil

Michael McGrath TD

Fianna Fáil



Kate O'Connell TD

Fine Gael

John Paul Phelan TD

Fine Gael

(Chairman)

Eamon Ryan TD

Green Party

14.3 Links to Transcripts

6th September 2016 - Central Bank of Ireland - Analysis of Economic Forecasts and Nevin Economic Research Institute (NERI) - Economic and Fiscal Position

Transcript

7th September 2016 - The ESRI - Economic and Fiscal Position:

Transcript

13th September – The Irish Fiscal Council – Pre-Budget Statement

Transcript

20th September – Minister for Finance and Revenue Commissioners – Revenue Raising Proposals

Transcript

21st September – Minister for Public Expenditure and Reform – Current & Capital Expenditure

Transcript

14.4 Glossary

Appropriations-in-Aid are receipts which may be retained by a Government Department or Office to offset expenditure in a given period, to the extent authorised by the annual Appropriation Act. Receipts are retained instead of being paid into the Exchequer Account of the State's Central Fund.

The Budgetary Rule falls under the preventive arm of the Stability and Growth Pact (SGP) and limits government annual budget deficits to 3% of GDP. Failure to comply with this Rule results in Member States transferring to the corrective arm of the SGP, also known as the Excessive Deficit Procedure (EDP).

Convergence Margin is applied to the Reference Rate for Member States that have not reached their Medium-Term Budgetary Objective (MTO), and reduces the amount of resources available for additional Government expenditure and/or tax reductions by that Member State.

The Debt Rule falls under the preventive arm of the SGP and limits public debt levels to 60% of GDP. If in excess of 60%, public debt must reduce by 1/20th annually (on average over three years). Failure to comply with this Rule results in Member States transferring to the corrective arm of the SGP, also known as the Excessive Deficit Procedure (EDP).

EDP: Excessive Deficit Procedure is the corrective arm of the SGP. Member States in the EDP are subject to more stringent fiscal rules to move towards a 3% deficit to GDP and/or a 60% public debt to GDP ratio.

Expenditure Benchmark limits government budgetary expansions to the medium term potential rate of GDP growth (Reference Rate). This can only be exceeded if the excess is matched by discretionary revenue measures.

Fiscal Space refers to the projected amount of resources available for additional Government expenditure and/or tax reductions (after having taken account of discretionary revenue measures), while ensuring compliance with the Expenditure Benchmark.

GGB: General Government Balance is the overall difference between Government revenues and expenditure for a given period.

GNI: Gross National Income is GNP plus net receipts from abroad of wages and salaries and of property income, plus net taxes and subsidies receivable from abroad (i.e. EU contributions and receipts).

Government Expenditure Ceiling translates the EU's Expenditure Benchmark into the Irish budgetary system, but is narrower in definition in only including Central Government expenditure (as opposed to expenditure by all bodies that constitute the government sector). It is then broken down into individual Ministerial Expenditure Ceilings, which cannot be exceeded.

Gross Fixed Capital Formation consists of public and private investment, deducting disposals, in fixed assets retained for own use.

MTO: Medium-Term Budgetary Objective is a budgetary target for Member States to reduce structural deficits at a rate of 0.5% of GDP per annum. MTOs are updated every three years. Annual targets on the way towards the MTO are set, and the expected path of debt to GDP ratios is forecasted.

Rainy Day Fund is a contingency reserve designed to support activity and employment should the economic situation deteriorate, and is planned commence with projected contributions of €1 billion per annum once the State's MTO is reached. It was committed to unilaterally by the Irish government in 2016 in accordance with the Programme for a Partnership Government (PfPG).

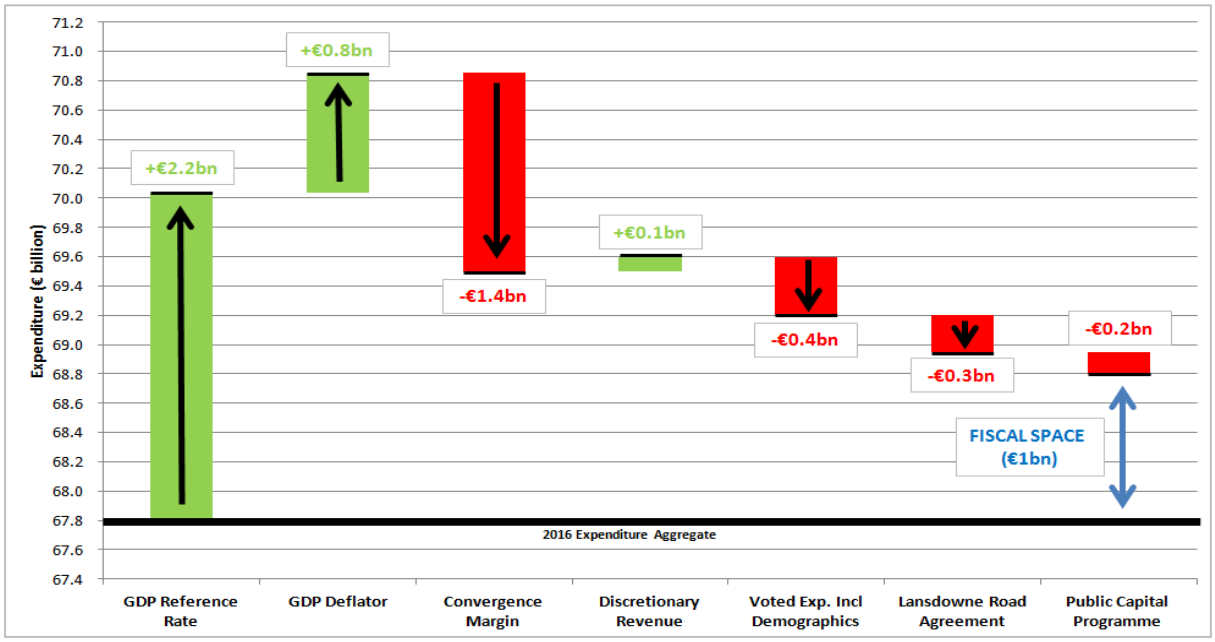
Reference Rate is the maximum allowable rate of budget expansion for a given year under the Expenditure Benchmark. It excludes interest expenditure, EU funding and cyclical unemployment expenditure, but includes gross fixed capital formation by the public sector (averaged over a four year period).

SPU: Stability Programme Updates lay out each EU Member State's fiscal plans for the next three years, and are produced every April.

Structural Budget Balance is, in simplified terms, the cyclically adjusted budget balance less one-offs and temporary budgetary measures. It arises from an underlying imbalance in government revenues and expenditures.

14.5 2017 Fiscal Space Explained

Figure 1: Graphical Depiction of the Calculation of Available Fiscal Space for Budget 2017.



Sources: Summer Economic Statement and NERI.
Note: Figures may not sum due to rounding.

The fiscal space for 2017 is influenced by the following:

- Ireland's potential GDP growth rate, or Reference Rate, for 2017 is 3.3%. This is the upper limit on allowable expenditure growth as set out under the EU's Expenditure Benchmark, and equates to a €2.2bn expansion in fiscal space. This is represented by the first green bar on the chart.

- A GDP Price Deflator is also applied to represent inflation in the Irish economy. This further increases the available fiscal space. The GDP Price Deflator for 2017 is 1.2% of the 2016 Expenditure Aggregate. This equates to €800m as represented by the second green bar in Figure 1. The sum of the first two green bars amounts to an allowable expansion in expenditure of 4.5% or approx. €3bn in 2017.

- However, as Ireland has not yet reached its Medium Term Objective (MTO) of a structural deficit of 0.5% of GDP, its fiscal space for 2017 is reduced. A Convergence Margin of 2 percentage points is taken off the cumulative 4.5% allowable expansion outlined above. This 2 percentage point decrease represents a €1.4bn reduction in the available Fiscal Space for the year.

- Discretionary revenue measures provide for an increase in available fiscal space of approximately €100m in 2017. These measures are subject to Government policy decisions, mainly the non-indexation of tax bands, less the impact of certain carry-over measures from Budget 2016.[4]

[4] http://www.finance.gov.ie/sites/default/files/Information%20Note%20on%20Fiscal%20Space%202017%20fin.pdf

- The available fiscal space for 2017 would be €1.8bn but for pre-committed measures which reduce the Fiscal Space to further. These measures include expenditure increases which capture demographic changes and reduce the fiscal space by approximately €400m in the year. The Lansdowne Road Agreement and pre-commitments to the Public Capital Programme account for reductions in the fiscal space of approximately €300m and €200m respectively.

- Once all of these factors have been accounted for, the net fiscal space available for increased Government Expenditure in 2017 is €1bn.

14.6 IFAC Stand Still Expenditure Estimate

IFAC Stand-Still Expenditure Estimate

Note Provided to Oireachtas Select Committee on Budgetary Oversight, Irish Fiscal Advisory Council, 30 September 2016.

This Note provides details on IFAC's Stand-Still expenditure estimate. It is important to note that this estimate is not intended as a forecast of future government expenditure but is instead designed to provide an estimate of the future path of spending allowing for demographic pressures and the cost of maintaining the real value of public services and benefits over the medium term. There is no suggestion from the Council that automatic indexation of future expenditure should be followed. The purpose of the Stand-Still expenditure estimate is not to recommend automatic indexation but rather to provide an illustrative estimate of the cost of maintaining the real value of public services and benefits in an environment where prices are forecast to rise. Starting from an estimate of the cost of standing still is an important input into good expenditure planning and would help inform policy makers of the scope for new spending or tax initiatives, absent efficiency gains or cuts to real benefits.

It should also be noted that the Council continues to develop the methodology underpinning the stand-still projections and the estimates presented here are likely to change in future as aspects of the current approach are improved and refined. The scenario will be updated following the publication of new fiscal and macroeconomic forecasts in *Budget 2017*.

Table 1 below sets out the projections for voted expenditure (current and capital) in the *Summer Economic Statement* (panel A) and the IFAC Standstill scenario (panel B). The difference between the IFAC scenario and the forecasts in the *SES* is shown in panel C. To summarise:

- The total increase in voted current and capital spending between 2017 and 2021 in the IFAC Standstill scenario is €8.5 billion. This is IFAC's estimate of the increase in spending consistent with meeting demographic pressures and growing expenditure in line with inflation.
- The Government's net fiscal space would not be reduced by €8.5 billion if spending was to rise in line with the IFAC scenario. This is because the Department of Finance's baseline expenditure forecasts already make allowance for some increase in spending for commitments under the Lansdowne Road Agreement (in 2017 and 2018) and demographics (2017-2021). In total, the Department's baseline forecasts show an increase in spending of €4.2 billion between 2017 and 2021.
- The difference between the IFAC Standstill estimate and the increase in spending already allowed for is €4.3 billion (€8.5 minus €4.2). €4.3 billion is an estimate of the net fiscal space that would be used up to meet the expenditure increase we project in the Standstill scenario.

The projections for expenditure in panel A of the Table below come from Table A1 of the *SES*. These projections are on a "no-policy change basis" as described by the Department of Finance. The projections allow for an overall increase in total voted expenditure of €4.2 billion between 2017 and 2021. This is accounted for mainly by a €2 billion provision for demographics, a total of €600 million

for Lansdowne Road commitments in 2017 and 2018 and a €1.6 billion increase in capital spending between 2017 and 2021. The capital spending forecasts are in line with those published in *SPU 2016* and exclude the increases in capital expenditure subsequently announced in the *SES*.

Panel B of the Table shows the IFAC Standstill scenario estimates. In this scenario, total voted spending is projected to rise by €8.5 billion by 2021. This is made up of a €2.7 billion increase for demographics (similar to the €2 billion allowed for the in the *SES*). The IFAC scenario allows for increases in social protection benefits and other spending in line with inflation. This gives rise to a cumulative additional €4.2 billion in expenditure by 2021. The *SES* spending forecasts make no allowance for wage/price inflation apart from the €600 million for Lansdowne Road in 2017 and 2018. As stated above, in carrying out this exercise there is no suggestion that automatic indexation should be followed; however, an expenditure projection that estimates the cost of maintaining the current level of public services and benefits in real terms should be an important input into expenditure planning. For capital spending, the IFAC scenario uses the Department of Finance projections from Table A1 of the *SES* (the "revised Baseline forecasts"). These forecasts for capital expenditure exclude the additional net fiscal space allocated to capital spending in the *SES*.

The Committee asked in particular that the Council provide a breakdown of its estimate of the cost of price/wage inflation as this is the main source of the difference between the Council's expenditure estimate and the Department of Finance forecasts. Table 2 below decomposes the growth in expenditure from wage/price effects into pay, non pay and social protection areas. Of the estimated overall €4.2 billion increase in spending from price/wage effects by 2021, under half (€2 billion) arises in the public sector pay area. In the stand-still scenario, public sector pay in 2017 and 2018 increases in line with the Lansdowne Road Agreement. From 2019-2021, public sector pay is assumed to grow in line with economy-wide non-agricultural wages as forecast by the Department of Finance in *SPU 2016*. As shown in Table 2, Health and Education account for the bulk of the increase in the overall pay bill.

Assuming social protection benefits and pensions increase in line with Department of Finance forecasts for HICP inflation would result in a rise in spending of around €1.3 billion by 2021. Finally, assuming non-pay current spending grows in line with the projected growth in the GDP deflator would lead to an increase in expenditure of just under €1 billion by 2021.

Table 1: IFAC Standstill Scenario and *SES* Baseline Forecasts, € million

A. SES	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	
Current voted	51,870	52,575	53,195	53,600	54,030	54,490	
Capital voted	3,965	4,130	4,390	4,735	5,140	5,540	
Total Voted Expenditure	55,835	56,705	57,585	58,335	59,170	60,030	
Annual Change (€ millions)							Total (2017-2021)
Current voted		705	620	405	430	460	2,620
Of which: Demographics		400	300	400	400	500	2,000
Remainder of current voted		305	320	5	30	-40	620
Capital voted		165	260	345	405	400	1,575
Total voted current and capital		870	880	750	835	860	4,195
B. IFAC standstill	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	
Current voted	51,872	53,112	54,255	55,705	57,236	58,805	
Capital voted	3,965	4,130	4,390	4,735	5,140	5,540	
Total Voted Expenditure	55,837	57,242	58,645	60,440	62,376	64,345	
Annual Change (€ millions)							Total (2017-2021)
Current voted		1240	1142	1450	1532	1569	6,933
Of which: Demographics		576	420	549	575	573	2,692
Price/wage effects		664	723	901	957	996	4,241
Capital voted		165	260	345	405	400	1,575
Total voted current and capital		1,405	1,402	1,795	1,937	1,969	8,508
C. Comparison (IFAC - SES)	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	
Current voted		537	1,060	2,105	3,206	4,315	
Capital voted		0	0	0	0	0	
Total Voted Expenditure		537	1,060	2,105	3,206	4,315	
Annual Change (€ millions)							Total (2017-2021)
Current voted		535	522	1,045	1,102	1,109	4,313
Of which: Demographics		176	120	149	175	73	692
Remainder of current voted		359	403	896	927	1,036	3,621
Capital voted		0	0	0	0	0	-
Total voted current and capital (IFAC-SES)		535	522	1,045	1,102	1,109	4,313

Note: The SES forecasts correspond to the revised baseline forecast 2016-2021 taking account of 2016 revenue & expenditure updates provided in Table A1, Annex 1 of the Statement.

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Table 2: Breakdown of Change in Expenditure by Driver, € million

	2017	2018	2019	2020	2021	Total (2017-2021)
Total Pay	282	280	444	479	517	2,002
of which Health	96	102	187	202	218	805
Education	132	121	164	178	194	789
Other	54	58	92	98	105	408
Social Protection	210	243	256	268	282	1,258
Total Non-Pay (excluding Social Protection)	173	199	202	210	197	981
of which Health	62	68	70	71	72	343
Education	20	23	25	25	26	119
Other	91	108	108	114	99	519
					Total Price/Wage effects	4,241

Notes: Social protection is predominantly non-pay.