Comhairle Chomhairleach Bhuiséadach na hÉireann
Irish Fiscal Advisory Council

Meeting between the Oireachtas Committee on Budgetary Oversight

and

The Irish Fiscal Advisory Council

Tuesday 13th December 2016

Opening statement by Professor John McHale, Chair of the Irish Fiscal Advisory Council:

On behalf of the Council, I would like to thank the committee for the opportunity to discuss our recent assessment published on Wednesday, 30th November. We view our appearance before the Committee as integral to the fulfilment of the Council's mandate and important in fostering greater public awareness and debate around macroeconomic and budgetary issues. With me are Council members Mr Sebastian Barnes, Mr Seamus Coffey, Dr. Íde Kearney and Mr Michael Tutty. The Council Secretariat is also present. The Council would like to thank the staff of the Oireachtas for their ongoing very useful cooperation.

On a personal note, as this is my last appearance before the Committee as Chair of the Council, I would like to thank Committee members for their interest in the Council's work over the last 5 and a half years. Our engagements with the Oireachtas in my time as Chair have given me first-hand experience of the commitment, hard work and talent of our parliamentarians – though, needless to say, we have not always agreed.

Today I will cover our eleventh Fiscal Assessment Report. The report is written in line with the mandate of the Council set out in the Fiscal Responsibility Act. The report assesses the macroeconomic and fiscal projections set out by the Government in *Budget 2017*.

Before getting into the detail of our assessment of *Budget 2017,* it is worth reflecting on some of the positive developments in the public finances and in the broader economy over recent years. The public finances have improved considerably with the underlying General Government deficit falling from over 11 per cent of GDP in 2009 to an expected deficit of less than 1 per cent in 2016. Although still at a high level, the debt to GDP ratio has been put on a downward path. The Government's adherence to a credible fiscal adjustment programme, along with initiatives at a European level such as the ECB's bond buying programme, have seen the Government's cost of borrowing fall dramatically from the highs recorded in 2011.

Importantly, the progress in repairing the public finances has been mirrored in other areas. As a result of the strong recovery in the economy since 2012, the number at work has increased by 195,000 and the unemployment rate has halved from its peak of 15 per cent. The available data for 2016 present some mixed signals but the weight of evidence from a range of indicators shows that the economy continues to grow at a solid rate. The Department of Finance's central projection is for further steady real GDP growth of around 3.5 per cent in 2017 and an average of around 3 per cent from 2018-2021.

Notwithstanding the progress that has been made, an important reality behind much of the Council's analysis is that, six years on from Ireland's entry into the EU/IMF programme, the legacy problems from the crisis have not been fully alleviated. Moreover, with a high debt level and tangible risks to growth from external sources such as Brexit as well as domestic risks, the economy and public finances remain susceptible to potential adverse shocks. As an example of this, a GDP growth rate just ½ a percentage point lower than currently forecast each year would mean the public finances would remain in deficit out to 2021.

In this context, an important achievement of recent years has been the putting in place of a new budgetary framework containing both domestic and European elements. The framework consists of sets of rules, processes and institutions, including importantly the role of this committee. The key components of the framework are consistent with principles of sound budgetary management. In an uncertain economic environment, full implementation of the framework can help achieve a phased reduction in the debt to safer levels and ensure that there is sufficient fiscal credibility to avoid forced austerity in bad times. However, as outlined in our recent *Fiscal Assessment Report,* incomplete implementation of the new framework leaves the economy and public finances more exposed to severe shocks such as a "hard Brexit".

Turning to the Council's assessment of the fiscal stance in 2016 and 2017, the projections in *Budget 2017* show that progress in improving the public finances largely stalled in 2016. Despite continued revenue growth and savings from falling unemployment and debt interest costs, the projected improvement in the General Government balance (stripping out financial sector measures) is just 0.1 percentage point of GDP in 2016, while the primary balance (i.e. the balance excluding debt interest spending) is forecast to deteriorate in 2016 , the first worsening since 2009.

The absence of significant improvement in the public finances in 2016 is in part due to within-year increases in expenditure that absorb the majority of the better than expected tax revenue. In June, the Government revised up its forecast of tax revenue for 2016 by €1 billion, with €900 million of this expected to come from corporation tax. With spending revised up by close to the same amount, this additional tax revenue will not contribute to a significant improvement in the deficit in 2016. This repeats what occurred in 2015 when the Government announced a €1.5 billion increase in spending for 2015, in line with an upward revision to corporation tax of close to the same amount.

The Council is concerned at the use of positive revenue surprises to fund permanent spending increases especially when the revenue surprise is largely due to a single, and relatively uncertain, revenue stream – in this case corporation tax. Instead of using the additional corporation tax revenue for permanent expenditure, a more appropriate policy would have been to use this revenue to reduce the deficit. As the sustainability of recent corporation tax increases is not yet assured, this would have left the public finances less exposed in the event of a reversal in corporation tax receipts in the coming years.

The slowdown in the rate of improvement in the public finances in 2016 is reflected in the failure to fully comply with the fiscal rules. The expected improvement in the structural balance in 2016 of 0.3 percentage points of GDP falls short of the 0.6 percentage points of GDP improvement required. The Expenditure Benchmark is complied with in 2016 but only with the inclusion of a technical one-off transaction involving AIB in 2015. Excluding the AIB transaction, the spending limit set by the Expenditure Benchmark would also be exceeded in 2016. As 2016 is the first year the *SGP* Preventive Arm and domestic Budgetary Rules apply following the closing of the Excessive Deficit Procedure, the failure to fully comply with all rules is a source of concern.

Potential compliance issues are also signalled in the Government's projections for 2017. The *Budget 2017* forecasts show compliance with the structural balance rule; however, the forecasts indicate a breach of the Expenditure Benchmark. It is important for the credibility of the budgetary process that the Government's fiscal plans show full compliance with the domestic and EU fiscal rules based on the Department of Finance's own estimates of the structural improvement.

Putting these different elements together, the combined €3 billion package (or €3.7 billion in a full year) of tax reductions and expenditure increases announced in 2016 by the Government for 2016 and 2017 goes beyond the limit considered prudent by the Council. Compared to the plan outlined in the July 2016 *SES*, the fiscal stance in *Budget 2017* leaves the public finances more exposed to risks than would have been the case if earlier plans had been adhered to. Viewed in isolation, the deviation from what could be considered a prudent stance in *Budget 2017* is not large but a repeat of the approach to budgetary management evident in 2015 and 2016 over several years would not be conducive to prudent economic and budgetary management.

From 2017 onwards, the Government's projected fiscal stance and intention to comply with the EU fiscal rules is consistent with the deficit and debt remaining on a downward path. Provided the economy is growing at a sustainable rate, the use of the available fiscal space as envisaged in the current forecasts would be consistent with prudent policy.

I would now like to make a number of remarks in relation to the planned fiscal stance in 2017 and over the medium term. Firstly, for 2017, the available fiscal space under the rules has already been allocated in *Budget 2017* for tax cuts and expenditure increases. As a consequence, based on the current projections any new increases in expenditure – such as to fund higher public sector pay – imply lower spending in other areas unless offset by compensatory tax changes. In 2018, €0.7 billion will be required to meet the carry-over cost of tax cuts and expenditure increases introduced in *Budget 2017.* On current estimates, this absorbs over half of the fiscal space for 2018, implying very limited scope for new initiatives in the absence of offsetting savings or new revenue raising measures.

The *Fiscal Assessment Report* also updates the Council's stand-still expenditure analysis contained in previous reports. It is important to reiterate that this exercise is not intended as a forecast or recommendation for automatic indexation, but rather as a means of informing decision makers of the portion of available fiscal space that would be required to maintain the existing provision of public services and preserve the purchasing power of social protection benefits. The results of the analysis in this Report indicate that accommodating estimated demographic pressures and the cost of maintaining real public services and benefits would absorb almost the full amount budgeted for current expenditure increases from 2017-2021.

Lastly, an issue which has raised considerable debate in recent years, not least in view of historically low global interest rates, is the treatment of investment under the fiscal rules and the question of whether the fiscal rules are too constraining on capital investment. It is important to note that a key reason for the relatively constrained budgetary position in the near term is that Ireland still has a budget deficit which needs to be brought down towards a balanced budget position to ensure that the high debt to GDP ratio is reduced. This requires that spending growth, net of discretionary revenue measures, is kept below the potential growth of the economy. Once the medium-term objective is achieved– a structural deficit of less than 0.5 per cent of GDP is reached – spending growth is allowed under the rules to grow at the underlying potential growth rate of the economy. This will allow more resources to be available for both current and capital spending and to meet important societal needs. Moreover, in both the near and longer terms, there is no restriction on faster spending growth provided that the necessary additional revenues are raised.

In the meantime, even if the rules were to make more of a distinction between current and capital spending, it is necessary to ask whether a higher overall deficit path than currently being projected in *Budget 2017* to accommodate higher investment would be appropriate, even taking into account potential long-run benefits for potential output. Ireland already has a very high gross debt which needs to be brought down to safer levels. In the short run, a key step in moving the debt to a safer position is to lower the deficit towards a balanced budget, in line with the current Department of Finance projections.

Therefore, even though there may be concerns that the rules overly constrain capital spending, the current forecasts for the overall budget balance are likely to be close to what should be targeted in the coming years, given the need to bring the debt down and to provision for future demographic pressures. To address the concern that capital spending could be squeezed in the process of achieving the objectives for the overall budget balance, one possible solution is to supplement the main fiscal rule with a separate target for public investment. For example, the Government could aim to achieve an overall level of public investment equal to a certain percentage of economic output. A separate target for public investment could help ensure that viable public investment projects with positive long-term effects are undertaken, while preserving the advantages of the current fiscal rules in helping to avoid deficit bias and procyclicality in setting budgetary policy.

Summing up, the economy has made an impressive recovery from a deep economic and financial crisis, but fragilities remain. Looking to the future, it is important that the hard-won achievements of recent years are protected and built upon to improve the resilience of the public finances in the face of numerous risks and to lay the foundations for sustainable growth in living standards. The risks facing the economy are tangible, with uncertainty around the long-term growth prospects of Ireland's three key trading partners – the UK, US and Euro Area. Avoiding a repeat of past fiscal policy mistakes made in Ireland during relatively good times – such as reliance on transient revenues to fund permanent spending – will be essential to ensure the economy and public finances have the capacity to withstand potential negative shocks in the coming years.