



**Meeting between the Committee on Budgetary Oversight  
and the Irish Fiscal Advisory Council**

**Wednesday 13th June 2018**

**Opening Statement by Mr Seamus Coffey, Chair of the Irish Fiscal  
Advisory Council (IFAC):**

Good afternoon Chair and members of the Committee. On behalf of the Council, I thank you for the opportunity to discuss our recent Fiscal Assessment Report. Joining me today are Dr Martina Lawless, Mr Michael Tutty, and Mr Sebastian Barnes, and Dr Íde Kearney. Members of the Council Secretariat are also present: Mr Eddie Casey (Chief Economist and Head of the Secretariat), Ms Kate Ivory, and Mr Niall Conroy.

The Council's work is enriched by its interactions with the Committee and we continue to value these engagements. We hope we can continue to interact meaningfully with elected representatives and I would also like to acknowledge the ongoing interaction between the Secretariat and the Oireachtas staff to support these meetings.

The Council published its 14th Fiscal Assessment Report on the 5<sup>th</sup> June. The report covers all aspects of the Council's mandate, as set out in the Fiscal Responsibility Acts 2012 and 2013 including:

- Assessing the Government's fiscal stance;

- Assessing the Government's budgetary and macroeconomic forecasts (including the endorsement function); and
- Monitoring compliance with Irish and EU fiscal rules.

The Council notes that the Irish economy has experienced a rapid cyclical recovery since at least 2014 – one that is continuing at a strong pace. Estimates suggest that the economy is producing close to its potential in 2018 and will move beyond it next year and after. In the near term, burgeoning pressures in the housing sector could yield a sharper-than-expected recovery in housing construction.

While the immediate outlook is favourable, negative shocks will inevitably occur in future. There are clear downside risks over the medium term: Brexit, US trade policy and the international tax environment to name but a few. Recognising this, the Council notes that there is currently a window of opportunity that should be used to return debt to safer levels and to make the economy more resilient to shocks. Ireland's debt burden is still among the highest in the OECD and the burden is understated by standard GDP comparisons.

The Council observes that improvements on the budgetary front have stalled since 2015 despite the strong cyclical recovery taking place – one that is reinforced by a number of favourable tailwinds. While the economy has experienced a strong recovery, this has not translated into any notable improvement in the underlying budget balance, taking into account improvements driven by the cycle. Non-interest spending has risen at essentially the same pace as

buoyant cyclical tax revenue since 2015. Allowing for the estimated effects of the cycle, the structural position would appear to have deteriorated since 2015.

It is against this context that the Council welcomes the fiscal stance adopted by the Government in *SPU 2018*, but the Council notes that the Government should at least stick to its existing budgetary plans for 2019. The Council assesses that there is no case for additional fiscal stimulus in 2019 beyond these plans and that anything more expansionary is not likely to be appropriate.

In its assessment, the Council defines an appropriate policy for next year as one in which spending is increased in line with the sustainable long-term growth rate of the economy. This would imply an approximate limit for spending increases or tax cuts of up to €3½ billion (i.e., the “gross fiscal space”) as the starting point for any budgetary plans for 2019.

The calculation is based on (1) potential growth rate estimates for the economy; and (2) forecast price inflation. The Council considers a number of estimates of medium-term potential output growth: the Department’s preferred estimates of real potential output growth, which average close to 3 per cent per annum over the forecast period 2019–2021; the Council’s own estimates of 3¼ per cent; and recent estimates produced by the ESRI of approximately 3.3 per cent. Allowing for inflation, which is forecast to be a little over 1 per cent for 2018, this implies a growth rate of up to 4½ per cent. Applying this to an adjusted measure of expenditure (the

corrected expenditure aggregate in the Expenditure Benchmark) implies a nominal limit of up to €3½ billion.

The cost of previously announced measures – including sharp increases in public investment – means that the Government's scope for new initiatives in Budget 2019 will be limited.

Department estimates provided to this committee note that spending pre-commitments of €2.6 billion have already been made for 2019. This isn't necessarily the correct estimate to compare against the approximate limit of up to €3½ billion but it does highlight that there is limited scope in the next budget.

A point that is often missed is that the objective of the rules is to ensure overall sustainability – not to prevent government spending. Tax policies that increase revenue in a sustainable manner (i.e., in a way that can be expected to last over the long run) allow a government to grow spending at a faster pace than the initial limits set by the rules. Similarly, real efficiency gains in public spending that can be sustained allow a government to provide more services.

It would be desirable for the Government to improve the budget balance by more than planned, especially given the risks of overheating and the opportunity provided by favourable times. Unexpected increases in tax revenues or lower interest costs should not be used to fund further budgetary measures as happened in recent years. The window of opportunity should be used to return debt to safer levels and to make the economy and

public finances more resilient to shocks. Revenues arising from a faster-than-expected recovery in housing construction should be used to build buffers either through additional contributions to the Rainy Day Fund or through faster debt reduction. Moreover, spending should not be allowed to continue to drift up as unexpected – and likely cyclical or transitory – revenues arise.

Looking forward, the Council assesses that the Government needs a credible plan for the medium term. As we show in our report, relying solely on the fiscal rules would not have guaranteed sustainability in the public finances during the 2000s and is not likely to fully mitigate future crises. Focusing on the right budgetary stance and being prepared to be more cautious than the fiscal rules allow is the correct approach for the Government to follow. Yet there are a number of challenges and no scope for complacency.

There is a danger that the current policy framework is insufficiently equipped to prevent a return to procyclical fiscal policy. Sensible policy tools such as the Rainy Day Fund and a medium-term debt target, which were set up to help with medium-term budgeting, are only half-formed and need more development if they are to be effective.

There are a number of solutions that should be pursued:

- (1) The Government should make an explicit commitment to adhere to what it sees as a sensible medium-term path for spending growth (net of tax measures). This could be operationalised on the basis of – at a minimum – following

the spending rule (the Expenditure Benchmark) even when not formally required to. This should be informed by the Department's own medium-term estimates of potential output growth and of the natural rate of unemployment.

- (2) The proposed design of the Rainy Day Fund should be strengthened. The Rainy Day Fund should be foremost a truly countercyclical fund – one that dampens swings in the cycle and alleviates procyclicality in the rules rather than just allocating fixed contributions regardless of this. A recent IFAC working paper outlines how relatively modest changes in the fiscal rules would help to achieve this.
- (3) The Government's forecast horizon should return to five years ahead. The shortening of the horizon in the most recent projections from five to three years ahead is not compatible with the aim of achieving medium-term fiscal stability. For context, Budget 2016, which was released in October 2015, was forecasting as far ahead as 2021: the same endpoint as for current plans. This risks complacency seeping into medium-term planning and future publications should extend the horizon back to a five-year-ahead basis.
- (4) The Government's medium-term debt target, which aims for a debt level of 55 per cent of GDP over an unspecified timeframe, would be better specified if it were: (1) clearly time-bound; (2) set against a more appropriate denominator than GDP; (3) set as a ceiling rather than as a target; (4)

committed to in a credible manner; and (5) actually set at a low or prudent level.

An important area that the Department has made progress on, which the Council welcomes, is its publication of alternative estimates of the output gap. Understanding the economic cycle is an essential part of assessing the appropriate fiscal stance. It can help us to understand whether current levels of tax receipts or unemployment benefits are temporarily high or low compared to when the economy is in a steady state. A failure to do so can mean that deteriorations in the underlying budgetary position are not adequately recognised and another painful correction of the public finances might ultimately be required. The economy's potential growth rate is also a critical determinant of how fast taxes will sustainably grow at and how sustainable levels of spending and the public debt burden will prove to be. The Council believes that these alternative measures should feature more prominently in future Department publications and future endorsements.

To conclude, I thank the Committee for again providing us with the opportunity to attend today and we look forward to taking questions and hearing the views of members.