Irish Fiscal Advisory Council

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

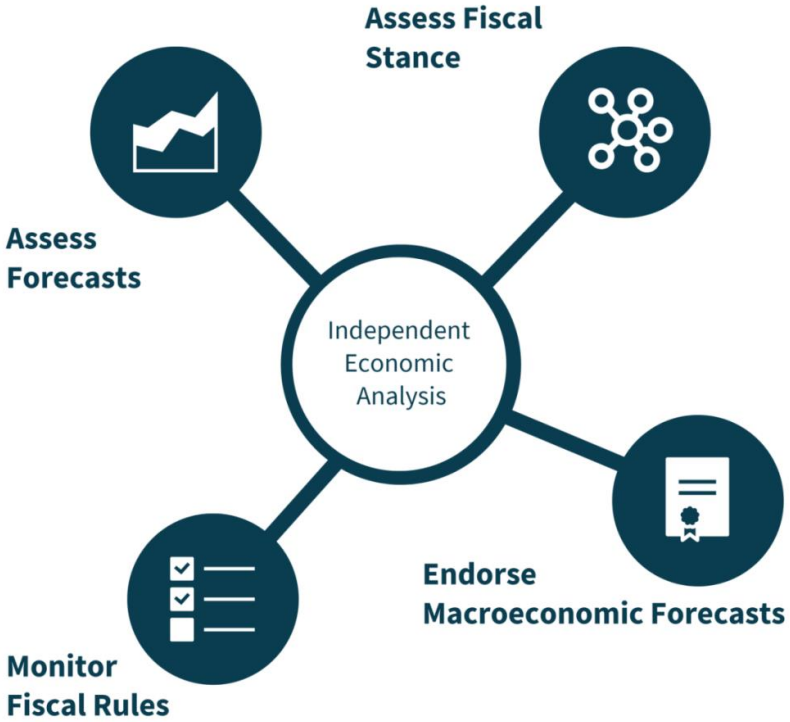
Opening Statement by Mr Seamus Coffey, Chair of the Irish Fiscal Advisory Council (IFAC), Wednesday 5th December 2018

Good afternoon Chair and members of the Committee. On behalf of the Council, I thank you for inviting us to meet with the Committee and to be given the opportunity to publicly discuss our recent *Fiscal Assessment Report*. Joining me today are Mr Sebastian Barnes, Dr Martina Lawless, Mr Michael Tutty (all Council members), and Mr Eddie Casey (Chief Economist and Head of the Secretariat). Members of the Council Secretariat are also present: Mr Niall Conroy, Mr Kevin Timoney, Ms Ainhoa Osés Arranz, Ms Friederike Vogler and Mr Killian Carroll. We continue to value these engagements.

The Council published its 15th Fiscal Assessment Report on the 28th of November. The report covers all aspects of the Council's mandate, as set out in the Fiscal Responsibility Acts 2012 and 2013.

It is important to note that the Council's mandate does not cover commenting on the choice of individual tax measures or spending items/priorities, but rather to comment on the overall fiscal stance.

The Council's Mandate:



There have been significant improvements to macroeconomic conditions in recent years. The Council assesses that the pick-up in growth since about five years ago has been driven by a cyclical recovery in demand. These improvements have been most visible in the labour market with unemployment falling to about 5½ per cent.

Most plausible estimates suggest that the domestic economy has been growing faster than its potential growth rate since 2014 and is now, in 2018, close to its potential. Central forecasts suggest that it will move beyond potential from 2019 onwards, with overheating emerging in later years. While short-term growth prospects look favourable, there are significant risks evident in both directions, and a slowdown in coming years is inevitable.

Significant overheating pressures could build up if a faster-than-expected pick-up in housing construction materialises. On the other hand, Brexit could be more costly than assumed. There are also risks posed by the concentration of Ireland's exporting sector in a handful of specialised areas, the global rise in protectionism, and possible future changes in the international tax environment.

Substantial progress was made from 2008 to 2015 to move the public finances to a safer position. The Government is close to a balanced budget; debt ratios look to be on a downward trajectory; and near-term growth and interest prospects are still relatively favourable.

Though efforts to stabilise the public finances since the crisis have proven successful, improvements on the budgetary front have stalled since 2015. This comes despite a strong recovery in the economic cycle – both domestically and internationally – in addition to a supportive monetary policy environment. Non-interest spending has risen at essentially the same pace as tax revenue since 2015 so that the strong cyclical recovery and favourable external environment have not led to any notable improvement in the underlying budgetary position (excluding interest savings).

It is clear that recent revenue growth has been supported by short-term cyclical developments and a possibly transient surge in corporation tax receipts. Looking through these effects, the

underlying budgetary position would appear to have deteriorated since 2015. *Budget 2019* forecasts indicate that a deficit is to be run again next year, with a surplus now planned for 2020. It is notable that *Budget 2016* had planned a budget surplus for 2018, *Budget 2017* had planned a surplus for 2019, and *Budget 2018* had planned a surplus for 2020.

Against this backdrop of stalling improvements, Ireland's debt burden is still among the highest in the OECD. When set against a more appropriate measure of national income like GNI*, Ireland's net debt burden for 2017 is equivalent to 96.9 per cent, the fifth highest in the OECD behind only Portugal, Italy, Japan and Greece.

Two recent developments on the budgetary front have contributed to a further slowdown in improvements on the budgetary side: (1) a substantial within-year increase in spending in 2018, and (2) a larger-than-planned budget package for 2019.

Shortly before the budget, the Government decided to increase spending in 2018 by a further €1.1 billion beyond what was originally envisaged just four months earlier. The increases were largely due to health overruns. While some variation relative to initial plans is inevitable, these expenditure increases are likely to be long-lasting. Within-year increases in expenditure of this nature should be funded through sustainable increases in taxation, reallocation of existing spending or by reduced

spending increases in later years. The Council assesses that the within-year spending increases this year are not consistent with prudent budgetary management.

For 2019, the Council set out in its *Pre-Budget 2019 Statement* how an appropriate fiscal policy could be arrived at. The Council noted that the economy was close to its potential, the budget deficit almost closed, and that the structural budgetary position would appear to be near balance. It noted that little further adjustment would be required to close an underlying deficit or to enable a steady pace of reduction in the government debt ratio. To maintain this position, net policy spending could rise at or below the pace of sustainable revenues. Various estimates would put this at approximately 3¼ per cent per annum. When combined with inflation, this would imply a limit of up to €3½ billion for spending increases or tax cuts for 2019 or a 4½ per cent increase. By not indexing the tax system, revenue would be raised, thus enabling a further €0.6 billion spending increase over and above that limit. This is far from what might be considered a tight budgetary constraint.

The actual budget day package for 2019 amounted to €1.1 billion. This was higher than the €0.8 billion package that was planned prior to the budget.

Taken together, the within-year increases introduced in 2018 and the larger than assumed budget package in *Budget 2019* exceed

the limit that the Council had assessed as appropriate. Government spending is now planned to increase (net of tax measures) by €4.5 billion in 2019 compared to what was originally planned for 2018. This compares to the €3½ billion that the Council had assessed as an appropriate limit. If additional spending measures beyond the quantity in the *Summer Economic Statement 2018* were to be addressed, the Council assessed that these should have been funded by additional tax increases or through re-allocations of existing spending.

The Department of Finance's own *Budget 2019* estimates also indicated that Government plans were not consistent with complying with the fiscal rules for 2018 and 2019. The Government should aim to comply with the fiscal rules as a minimum standard when setting out its budgetary plans. A separate assessment by the European Commission has since assessed that 2017 outturns and 2018 plans showed a number of possible breaches of the fiscal rules, but that the 2019 plans were compliant. The European Commission also expressed concern about the over-spending within the health sector, noting that "much of the better-than-expected revenue for 2018 is being used to fund within-year current expenditure increases in healthcare, which raises concerns both about the long-term fiscal sustainability and the pace of adoption of the Strategy."[1]

[1] Page 13, European Commission Staff Working Document SWD(2018) 519 final https://ec.europa.eu/info/sites/info/files/economy-finance/swd_2018-ie_en.pdf

The Council's assessment of the fiscal stance is based on a broader economic assessment than just a mechanical application of the fiscal rules. The Council has highlighted on a number of occasions that the fiscal rules at this stage in the cycle are becoming less helpful for the overall sustainability of the public finances. 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 over the medium term. This is particularly true, given that the strict legal application of the current fiscal rules using the EU's Commonly Agreed Methodology for potential output estimation will not necessarily prevent a repeat of procyclical fiscal policy mistakes made in the past.

The Minister echoed these concerns in his Foreword to the *Summer Economic Statement 2018* (p.ii) noting that:

> *"we must continue to be prudent in relation to management of the public finances. The fiscal rules are currently unhelpful in this regard. A full and literal application of the fiscal rules would involve the adoption of pro-cyclical policies not remotely appropriate to our position in the economic cycle."*

The repeated failures to prevent unplanned spending increases have resulted in long-lasting increases in spending which are difficult to reverse. These failures represent a repeat of the policy mistakes of the past. Pressures in the health sector and elsewhere

should be funded through sustainable tax revenues or decreases in spending categories elsewhere. These unfunded spending increases have left the public finances more exposed to adverse shocks, with the budget balance in deficit rather than in surplus.

Health spending for 2018 is set to exceed the level of spending budgeted for yet again. The Department of Health has experienced numerous overruns historically and the problem of unrealistic forecasts coupled with a “soft budget constraint” has undermined the credibility of expenditure ceilings.

Given previous experience, there is a strong possibility that health spending will exceed budget forecasts in 2019. In addition, the Christmas bonus, which was paid in full this year, has not been budgeted for in 2019. These two items alone pose significant upward risks to expenditure forecasts for 2019.

The Council welcomes the return in *Budget 2019* to forecasting five years ahead. The Council also wishes to acknowledge the substantial progress that the Department of Finance has made in terms of macroeconomic forecasting. The Department has developed and published its own estimates of the supply side of the economy. This means that better measures of medium term economic growth and of the underlying state of the economy can be used to inform policy.

However, the Government’s budgetary plans for later years lack credibility. Specifically, the medium-term spending forecasts are

based on technical assumptions that look unrealistic. Expenditure is assumed to grow at a modest pace, resulting in increasing surpluses in later years. The expenditure growth forecasts for the later years would only barely cover the IFAC "stand-still" estimates of the costs of maintaining current service levels, given demographic and price pressures. The current intention to run budget surpluses for the foreseeable future if conditions allow is vague. Previous commitments to outperform the requirements of the EU fiscal rules and to reduce debt to 55 per cent of GDP over the medium term are no longer referenced.

In addition, the Government's system of three-year budget ceilings is not working, with repeated, procyclical, upward revisions to ceilings. The Council welcomes the introduction of the rainy day fund (the "National Surplus (Exceptional Contingencies) Reserve Fund"). Though it is potentially useful, the current design is insufficient to offset faster-than-prudent growth rates allowed under the spending rule as it is currently applied. Annual allocations to the Fund have been lowered from previously planned amounts, despite a surge in corporation tax receipts.

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.