# Oireachtas Budgetary Oversight Committee

June 25th 2019

Remarks of Colm McCarthy

## 1. The Framework of Irish Budget Policy.

Government spending can be financed in three ways. These are

(i) Through raising tax revenue

(ii) Through the sale of government debt to the market, or

(iii) Through Central Bank purchases of government securities, or just printing currency for government use.

Governments can also save or realise cash through declining to pay bills, or through selling assets, but these are once-off and unrepeatable expedients.

Ireland does not have a Central Bank which can directly finance the government as in option (iii). In the Eurozone, 'monetary financing' (direct purchases of government bonds) is not permitted – this option was surrendered when the currency was abolished in 1999. Countries with an independent currency which pursue option (iii) may end up with inflation and a weak exchange rate.

So Irish governments must either raise taxes to match government spending, or sell debt instruments in the market, to volunteer purchasers. Budget deficits thus have their counterpart in extra government debt. Extra spending financed by debt expansion can be sustainable provided the economy is growing, but if lenders expect poor economic performance their willingness to lend will weaken. If the government already has a substantial debt burden, lenders are likely to worry more about continuing deficits.

In recent years Ireland's ability to sell debt has recovered remarkably quickly: in 2010 the state was forced, for the first time in its history, into emergency borrowing from the IMF and the European institutions as it lost the capacity to sell debt in the market. Before the crash, debt levels were low, but the deterioration into deficit was so rapid, magnified by bank bail-out costs, that the capacity to borrow at all evaporated inside just three years. Since exit from the troika programme in 2013 the combination of strong economic recovery and support for the Eurozone bond market from the ECB has seen plentiful demand for government debt and interest rates at the lowest levels ever recorded. The budget deficit has fallen and reached close to zero last year. But the circumstances are very different from the pre-crisis period. The inherited debt burden is much higher and the ECB policy of support for Eurozone government bond markets will not last indefinitely.

The avoidance of another resort to the IMF requires that budget policy be sustainable, that is, that the government retain the ability to sell debt in the market in all weathers, even if the economy slows and there is no ECB bond-buying programme.

## 2. Fiscal Advisory Council Report

The recent report from the government's Fiscal Advisory Council should be assessed in this framework, and against the background of the events of 2007 and subsequent years. Each EU member state is nowadays required to maintain an independent body of experts to pronounce on the conduct of budgetary policy. The IFAC report describes the government's budget forecasts bluntly as 'not credible' and lament the failure to keep expenditure within the amounts approved by parliament, as well as over-shoots on capital projects.

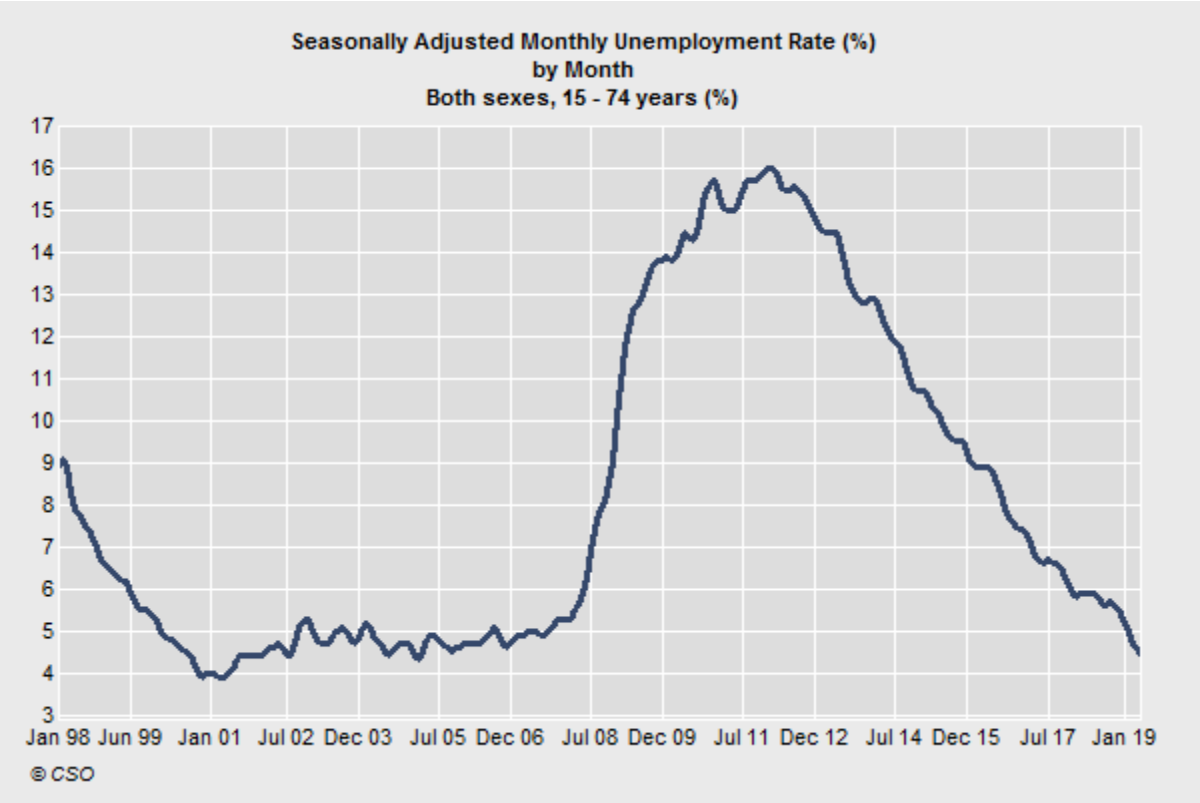
The strictures from the fiscal advisory council follow a series of expansionary budgets back to 2016 as well as the huge cost over-run on the National Children's Hospital and the six-fold increase in the expected cost of the broadband scheme. The council contend that the government should have run small budget surpluses since the economic recovery became established, commencing the reduction of the €205 billion Exchequer debt to safer levels, echoing views expressed repeatedly by the Central Bank, the Economic and Social Research Institute, the OECD, the International Monetary Fund and various other economists and commentators.

The IFAC report documents the recurring pattern of within-the-year over-runs in current spending, most notably in the department of health, for several years past. The amounts spent have exceeded what had been budgeted and approved by Dail Eireann and were covered by supplementary estimates after the event. Since the IFAC report was released, it has been revealed that another health over-run is likely for 2019. Last year the overshoots were offset by an unexpected windfall of extra Corporation Tax receipts, permitting the government to announce that budget balance had finally been achieved. But it was achieved by accident, not by firm policy, and IFAC are nervous that Corporation Tax is a volatile revenue source which cannot be relied upon to finance ongoing expenditure. Ireland's low corporate tax regime is also under threat from international demands for harmonization.

The Irish economy has seen six successive years of economic recovery. Unemployment has fallen from 16% to the most recent May figure of just 4.4%. The fiscal council believes that there is now a prospect of overheating.

*Full Employment is Approaching*

If the economy overheats, any stimulus from budget policy is dissipated in excess demand for productive factors which are simply not available: wages and other business inputs are bid up in a pointless cost inflation, as happened in the bubble years. The competitiveness of the economy is damaged, and the external balance of payments account can head into deficit. Even where government has capacity to borrow and run deficits, there is no useful purpose. Deficits should be confined to periods when the economy is running below capacity, with a bias towards surplus whenever full employment is approaching.




The Irish recovery is now mature – the unemployment rate is back down to the best levels achieved during the bubble and there are widespread reports of labour shortages. Economic recoveries come to a natural end – you can only recover once and the spare capacity in Ireland, especially in the labour force, has been re-employed. Whatever excess supply of housing, especially in the Dublin area, may have emerged during the crash, has also been absorbed.

*Weak External Outlook*

The international outlook is clouded. There is continued sluggish performance in Europe and President Trump has embarked on a trade war with China. He has also initiated trade conflicts with Mexico and Canada and has threatened a trade dispute with the European Union. Should there be trade disruption between the USA and the EU, Ireland is exposed more than any other EU member, both directly through export dependence and indirectly through the dominance of US firms in inward investment.

The leading candidates for the leadership of the UK's Conservative party have been expressing fearlessness in the face of a no-deal Brexit crash-out. Aside from the UK itself, the downside from Brexit for Ireland is greater than for any other EU member, whatever form Brexit takes. The risk of no-deal, the most damaging outcome for Ireland, has risen sharply these last few weeks.

Economists have been urging caution in budgetary policy for a reason. In Ireland's circumstances, with no currency of its own and a heavy sovereign debt overhang, there is limited capacity to stabilize the economy in the next downturn, whatever its source. The Central Bank of Ireland cannot create liquidity for the government and there is no exchange rate to be adjusted downwards. The only source of leeway

is the ability to borrow in the markets, freely available recently but not guaranteed when things get difficult. The markets can turn against indebted countries very quickly and the opportunity to bolster state solvency and improve the credit rating has been spurned. The cost is the increased risk of an enforced return of austerity if the Eurozone bond markets begin to fragment again.

*Eurozone Problems*

The Eurozone reforms implemented since the crisis are incomplete and the mechanisms for dealing with another crisis in the common currency area are likely to prove inadequate. In Ireland the risk of another banking bust, with bail-out costs for the Exchequer, are much reduced, since the banks are fewer, better capitalised and better supervised, with Frankfurt more directly involved in bank supervision. But another sovereign debt crisis would find some states unable to borrow and there has been resistance to any formal centralisation of support for countries facing bond market difficulties. The ad hoc troika arrangement will not be repeated as the IMF became unhappy with its role on the last occasion.

The country most likely to trigger another sovereign debt crisis is Italy, whose bond market is the biggest in the Eurozone. Whenever the next crisis comes, Ireland will be starting with a very high initial debt burden and risks re-classification, in a nervous debt market, with the 'peripheral' group to which it was assigned by the markets from 2010 onwards.

The European Central Bank has, through rapid expansion of its balance sheet via the purchase of government bonds, enabled low borrowing costs for countries, including Ireland, which would face much higher annual debt service costs in normal circumstances. Unless the ECB can continue this policy in the face of a repeat crisis, there will be a re-pricing of sovereign risk in Europe to Ireland's disadvantage. Longer-term the ECB will need to re-normalise and cannot purchase the debt of troubled sovereigns indefinitely.

## 3. Avoiding Unplanned Austerity

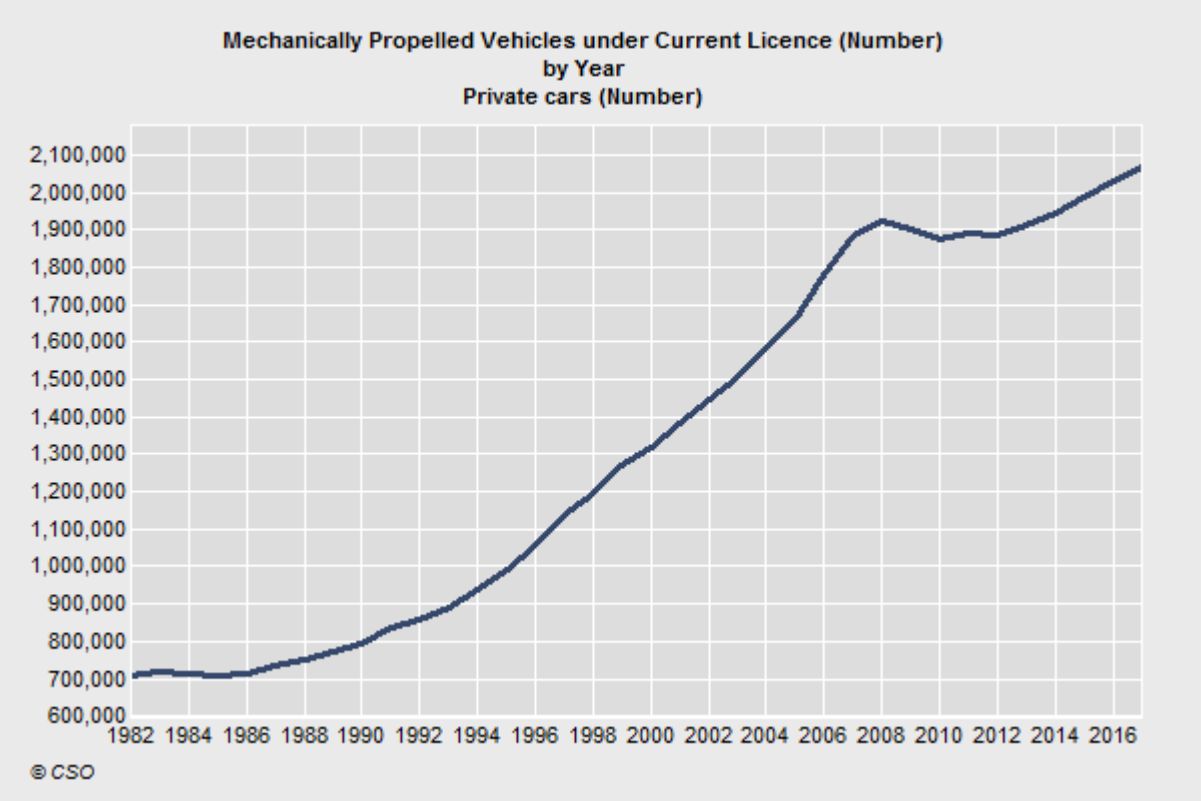
The response to the crash in government revenue, followed by the banking collapse, from 2007 onwards was an effort to retain national solvency (the capacity to borrow in the markets) through cutting expenditure and raising taxes. It failed and bail-out followed, but much of the necessary adjustment had already been made and the Irish troika programme was largely written in Merrion Street, in contrast to the debacle in Greece. Minimising exposure to a repeat requires that the sovereign debt overhang be reduced. As the NTMA has elaborated, Ireland's ratio of outstanding debt to government revenue is one of the highest in the Eurozone. The economy is still expanding on all the available evidence and it is unfortunate that the opportunity was lost to get the budget firmly into surplus over the last several years. The cost will come if a tighter budget stance is enforced by the markets when the economy weakens. The pay-off for a prudent budget policy over the cycle is the avoidance of untimely bouts of unplanned austerity.

Annex – Volatile Tax Revenue

The Parliamentary Budget Office has prepared some valuable reports on tax revenue volatility, for example one by Keith Fitzgerald and Jacopo Bedogni in February 2019. The excess reliance on stamp

duties from property transactions has been reduced but not eliminated, given the partial restoration of the rate on commercial real estate. The main political parties have also chosen to oppose the introduction of water charges in urban areas, another stable revenue source, and have resisted increases in residential property taxes, which are low in Ireland.

The PBO analysis breaks down tax revenue into seven broad categories, such as VAT, excise and income tax. A finer breakdown would be worthwhile. For example, Ireland taxes road users in three ways, annual license fees and fuel taxes, which are stable, and extra purchase taxes, on top of VAT, on new car sales (or used imports). This is called VRT and is highly unstable. New car sales collapsed as the bubble burst. But the stock of cars did not.




The overall tax base would be more stable if VRT was scrapped and the revenue loss made up with higher fuel taxes and/or higher annual car tax. Explicit tolls and congestion charges are another possibility and may be needed anyway if electric cars become popular. The PBO should consider if there are other opportunities to make the tax base more resilient by looking at a finer breakdown of government revenue.