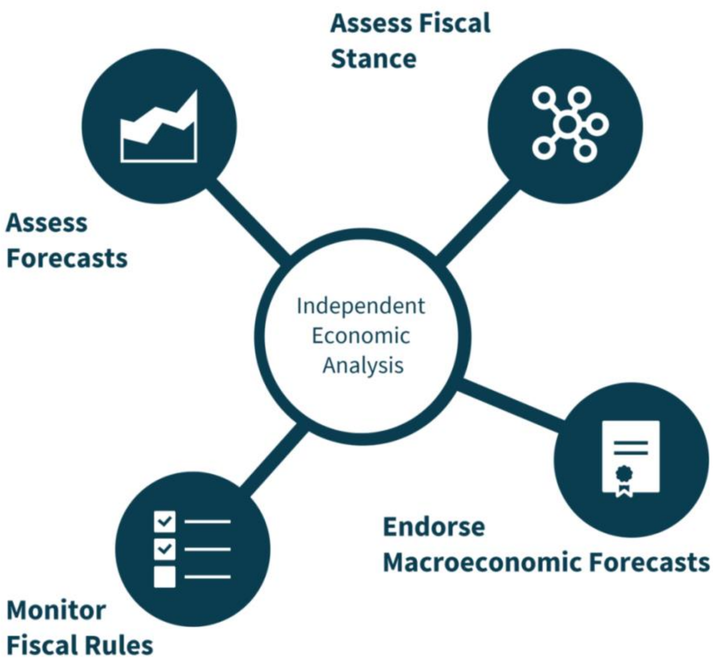
Meeting between the Committee on Budgetary Oversight and the Irish Fiscal Advisory Council

Opening Statement by Mr Seamus Coffey, Chair of the Irish Fiscal Advisory Council, Wednesday 4th December 2019

The Council would like to thank the Chair and members of the Committee for inviting us to meet with them to publicly discuss our latest Fiscal Assessment Report. Joining me are Mr Michael Tutty, Dr Martina Lawless, and Mr Sebastian Barnes (all Council members), and Dr Eddie Casey (Chief Economist and Head of the Secretariat). Members of the Council's Secretariat are also present: Mr Kevin Timoney, Ms Ainhoa Osés Arranz, Mr Killian Carroll, and Mr Niall Conroy. We continue to value these engagements.

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:



The domestic Irish economy has shown continuing strong growth since about 2013. It has recovered from a deep crisis and is now operating near capacity. This is most visible in the labour market with the unemployment rate falling to about 4.8 per cent. The rate of people working is high as well. If we take the key working age groups (ages 25–54), we can see that 79.7 per cent of these individuals were employed in the four quarters to Q2 2019 — above the pre-crisis peak of 78.6 per cent.

Efforts up until 2015 to turn around a large budget deficit were successful. Creditworthiness improved and the budget balance appears to be close to a balanced position.

However, even with large tailwinds in recent years, it is telling that improvements in the budget balance excluding interest costs have stopped since 2015. Furthermore, if one were to account for excess corporation tax collected in recent years and for the recovery in the economy due to the upswing in the cycle, then the underlying structural budget balance (excluding interest costs) is likely to have deteriorated over this time.

This underlying deterioration reflects fast spending growth — beyond what would be expected for revenues if these were to have grown at a sustainable pace. Between 2015 and 2018, net policy spending growth rose at a nominal pace of 5.4 per cent per annum on average (it accelerated to 6.9 per cent in 2018). Sustainable growth rates would have been closer to a range of 2½–4 per cent over this period. While spending growth looks set to decelerate in 2019, it is still fast relative to the economy's potential growth and what might be expected for sustainable growth in revenues.

This fast pace of spending growth is, to a large extent, unplanned. One reason for upward revisions to spending plans is that each budget introduces additional spending measures than had been planned in earlier years. Another reason is that within-year spending increases emerge over the course of the year. These within-year increases are outside of the normal budgetary process. They are, for the most part, not funded by offsetting measures or decisions to increase revenue elsewhere. They have averaged €0.9 billion per annum since 2015. Absent these, we estimate that the primary surplus (that is the budget balance excluding interest) would have been 1.6 percentage points of GNI* higher by 2019.

Health spending overruns have been a common feature in recent years (averaging €0.5 billion since 2014). Our report highlights how much of this is accounted for by hospitals spending more than is budgeted for in recent years. Looking into this in more detail, we can see that the hospitals have not had substantial budget increases planned since 2013. On average, annual decreases between 2013 and 2018 of €80 million per annum were planned. By contrast, unplanned annual increases of €280 million occurred over the same period.

The persistent health overruns that have taken place over the last few years have been the result of weak planning and weak spending controls. This has led to a “soft budget constraint” problem. That is, the budget allocations are not seen as credible by health managers, and subsequent overruns are largely tolerated. This can perpetuate unplanned increases in spending and weaker controls on spending. If overruns are longlasting (which they have been, for example, often relating to unexpected recruitment of permanent staff), but are funded with potentially temporary revenues (for example, corporation tax), then the sustainability of the public finances can be put at risk. The concerns that the Council has are therefore not with spending itself, but the fact that it is not being planned and budgeted for adequately and that it is not necessarily being funded by sustainable revenue sources.

The Council is concerned about the extent to which potentially temporary revenue sources are being used to fund longlasting spending increases. It is our assessment that large tailwinds worth €10–14 billion annually have not been used to improve the budget balance, with the deficit instead only improving by €3 billion over the period 2015 to 2018. These tailwinds include the lower-than-expected interest bill and higher tax and lower unemployment benefits due to the recovery in the economy. Most importantly, there is the largely unaccounted for surge in corporation tax.

The Government has become increasingly reliant on corporation tax to fund spending. Almost one-in-every-five euro of tax collected by the Exchequer is from corporation tax. And some €2–6 billion of the €10 billion forecast for this year is estimated to be "excess". By excess we mean beyond what would be expected based on the economy's underlying performance and historical or international norms. This range of estimates is something that the Department of Finance also finds in its "Fiscal Vulnerabilities Scoping Paper" released with the budget. It notes that "scenario analysis based on extreme, though far from implausible, assumptions suggests that, in the absence of corrective measures, a permanent budgetary gap of the order of €2 – €6 billion could potentially open up".

The increased reliance on corporation tax for funding public services and supports leaves these exposed to potential reversals. While corporation tax doubled from 2014 to 2018, the domestic economy grew by just over 20 per cent. This highlights the extent to which non-domestic sources of income are driving the surges we have seen. Concentration is another key problem, with half of revenues accounted for by just ten corporate groups. This concentration, coupled with the fact that 80 per cent of receipts are understood to be accounted for by foreign-owned multinationals, means that the underlying tax base is more prone to idiosyncratic shocks and that the tax base is likely to be more mobile in nature. Corporation tax is also vulnerable to global tax changes, including the OECD's Base Erosion and Profit Shifting (BEPS) proposals, which would include firms paying taxes wherever they have significant consumer-facing activities and potential minimum effective tax rates. Yesterday's tax data suggests that corporation tax will overperform again in 2019, despite forecasts having already been revised up in the budget.

An aspect of *Budget 2020* that we welcomed in this report—and something that the Council has been advocating for a long time—was that it incorporated overruns in 2019 into the budget for next year. This meant that overruns expected for 2019 of some €0.7 billion were to be offset by measures elsewhere on the Exchequer side.

The 2019 overruns include the expected €0.3 billion overrun in health spending and the payment of the Christmas Bonus, which was again not budgeted for, despite being paid out to varying degrees in each of the past six years. The health overrun comes despite an extra €1.1 billion being allocated by the Government in last year's budget (an increase of 6.6 per cent). With the overrun, the health spending increase is likely to be more than 9 per cent. If health spending goes beyond its forecast €0.3 billion overrun or if social welfare spending is revised upwards to reflect higher-than-expected payments in 2018, this could worsen the upward revisions to spending for the year.

For 2020, the Government offset overruns on the Exchequer side, but upward revisions to spending outside of the Exchequer mean general government spending is forecast to expand more rapidly than previously planned. This includes spending by local government and by housing bodies. While housing increases are to be welcomed, given the lack of supply in recent years, such increases should be fully incorporated into budgetary plans. They also add stimulus to the economy just as much as central government spending, but there is little transparency about these areas of expenditure in budgetary documents.

The increase in net spending planned for 2020 is now 4.4 per cent, putting it right at the limit of what would be considered sustainable for next year. This compares to 3.1 per cent growth set out in April. The Brexit contingency included in Budget 2020, if spent, would raise this further. As regards the Rainy Day Fund, the first annual payments to be made to the fund in 2019 and 2020 were postponed.

The Government can ensure a prudent fiscal policy where net policy spending growth does not exceed sustainable growth in revenues. Three reforms would help to achieve this: (1) using the rainy day fund and a prudence account to save temporary receipts, including corporation tax; (2) guiding net spending with sustainable growth rates informed by alternative estimates of potential output; and (3) establishing meaningful debt ratio targets. These are the types of reforms that are needed to help Irish fiscal policy avoid its next crisis.