Meeting with Oireachtas Select Committee on Budgetary Oversight

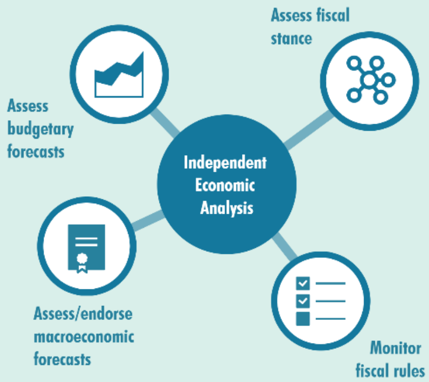
Opening Statement, Irish Fiscal Advisory Council, Wednesday 22 November 2023

The Council is grateful to the Chair and members of the Committee for inviting us to appear before you again. We value these engagements and see them as an integral part of our work.

The Council's Mandate

As an official independent body established under the Fiscal Responsibility Act (2012), the Council's mandate revolves around four elements: endorsing and assessing the official macroeconomic forecasts, assessing official budgetary projections, monitoring compliance with fiscal rules, and assessing the Government's overall fiscal stance.

This means the Council's focus is on the broader fiscal perspective, not individual tax or spending measures.



This meeting in particular is a welcome opportunity to discuss how Existing Levels of Service ("ELS") costs are formed, how they differ from our own "Stand-Still" costs, and why estimating such costs is so important for fiscal budgeting. I know the Committee is interested in how the calculations work and how costs are expected to evolve. We are happy to shed some light on this.

Why estimating such costs is important

First, I want to make a few general points about why this work is important.

Understanding the costs of maintaining existing public supports and services is an essential starting point to the Budget. It tells us the cost of continuing to do what we are already doing. We label this the "Stand-Still" cost — the cost of standing still. In other words, just maintaining what you already do. In health, for instance, this entails maintaining the same number of doctors or nurses per patient, paying them the same relative wages, administering the same drugs, all while reflecting a larger and older population.

For a long time, Irish budgets have focused primarily on the new things we can do with each Budget Day package. This focus made more sense in a time where price inflation was relatively low and demographic pressures were less pronounced. However, Ireland has recently had to grapple with increased price pressures in the wake of the pandemic and the war in Ukraine. As well as that, demographic pressures are coming to bear more and more as Ireland's population ages quickly. These two factors magnify Stand-Still costs.

Understanding Stand-Still costs is essential to good budgeting. The pressures are in some senses unavoidable and so should be planned for. Accounting for them properly can give policymakers a more accurate sense of what space is left over for new measures.

How we estimate Stand-Still costs

The Council has been providing estimates of Stand-Still costs for over five years now. The approach involves a few steps. First, we develop projections of population changes and ageing to assess demographic pressures. These draw on a standard cohort-component method. Second, we use macroeconomic forecasts to assess price and wage pressures as well as other macro changes. Third, we combine these inputs through a cell-based macro simulation to estimate expenditure changes.

A few caveats:

1) The approach does not consider possible efficiency gains or policy changes that could generate savings.
2) The focus is on current spending, though capital spending also faces pressures from prices and population growth.
3) It is purely a planning input. We are not advocating indexation as a policy, merely showing its likely costs.
4) We assume public sector pay rises in line with the general economy unless there is a public sector pay deal in place. This assumption implies the public sector is neither better nor worse off relative to the private sector.
5) We work hard to identify appropriate population cohorts and price drivers to model how spending will evolve. This draws on assessments of historical trends.

How the official ELS costs are calculated

The official ELS estimates are produced in a different way. ELS as a term has been used for years, well before Covid. It's in the Summer Economic Statement from 2018, for example.

Typically, ELS was used to refer to the costs of maintaining services just one year ahead. This would take account of demographics, price pressures, and other macroeconomic factors, like unemployment. While one-year ahead calculations can be quite detailed, ELS calculations for further ahead typically are not. The Summer Economic Statement in 2021 introduced a simple 3% assumption for two years ahead and beyond. That is, the estimated costs of maintaining existing levels of service were estimated as being equivalent to 3% of existing spending. The 3% itself was based on an assessment of typical pressures arising in historical budgets. This remains a rule of thumb for costs facing the Government in the years after the Budget year.

How the Stand-Still and ELS costs look

For 2024, the Department estimated ELS costs to be €1.8 billion, or 2.4% of the core current expenditure base. These costs do not factor in the costs associated with a potential public sector pay deal for 2024, which is typically included in ELS costs, although there remains €0.85 billion unallocated current expenditure for 2024 and this will likely be used to fund any pay deal.

Looking further ahead, the Department assumes ELS costs equivalent to 3% of current core spending meaning €2.4 billion in 2025 and €2.5 billion in 2026.

The Council's Stand-Still estimate for 2024 was €4.5 billion and averages close to €5 billion annually for 2025 and 2026. Of this, demographics are €1.7 billion; price and wage pressures are €3.4 billion. As inflation recedes, Stand-Still costs average €4.6 billion from 2027 to 2030. Unlike the ELS calculations, these specifically look at demographics, the costs of maintaining welfare rates and public sector pay in line with general wage growth, and the cost of other inflationary pressures. They also maintain Ukrainian supports and Covid spending.

Specific issues in Health

In the lead up to Budget 2024, there was widespread coverage on potential health overruns. Despite this, the Budget 2024 allocation for health was less than the expected 2023 overrun plus the estimated Stand-Still costs for 2024.

Budget 2024 provided an increase of €0.8 billion for core current health spending in 2024. Of this, €0.7 billion was to maintain the existing level of service. This is less than the Council's Stand-Still estimates for 2024 of €1.1 billion (€0.8 billion for demographics and €0.3 billion for higher prices). A potential public sector pay deal would add to this, but there are some unallocated funds to cover it.

It is possible that non-core spending related to Covid-19 within the health vote could be used to cover ELS costs. If so, this would bring the health allocations to just €0.1 billion shy of the Council's Stand-Still estimates as the Covid amounts for health are set to increase by €0.3 billion in 2024.

As well as the gap to Stand-Still costs, there is a possible overrun in 2023 that will raise the overall level of health spending. Health spending was running €0.6 billion ahead of forecasts going into the budget.

Once overruns occur, it is important that a detailed assessment be carried out. This should involve assessing the factors driving recent overruns to highlight where ELS costs have been under-estimated. Failing this risks repeating the overruns.

It is also important that budgets take a forward-looking approach. The ELS's 3% assumption is based on Ireland's historical experience. However, this is not necessarily a good guide to what we can expect in future. The population is ageing rapidly and price pressures may continue to remain higher than historical levels over the next few years. As such, these pressures may well be larger than we experienced in the past.

A case of history repeating

Part of the problems facing healthcare spending are not new. In 2021, the Council published research showing that health overruns had been a feature of Ireland's experience for a considerable number of years, making up more than half of total annual spending overruns.[1] Health overruns averaged €590 million annually from 2015 to 2019, with €260 million due to hospitals and €148 million due to community primary care services. About two-thirds was pay or staffing related.

The overruns won't be surprising. What might surprise you is that our 2021 analysis suggested they are fairly predictable. That is, the

[1] See the Council's Analytical Note, "The Path for Ireland's Health Budget".

size of the overruns corresponded closely to the additional amounts that would have been needed to stand still. Simply allowing for Stand-Still costs in full would have been broadly sufficient to cover both the planned allocations and the overruns eventually seen.

Part of the problem seems to be that hospital and primary care budgets are often set very tight, maybe with the hope that efficiencies will be generated. This might have had more merit if it had a record of producing savings or preventing overruns. Instead, providing limited budget increases in big spending areas appears to have set the scene for spending overruns. This looks like a failure of planning, coupled with wishful thinking.

What economists call a “soft budget constraint” seems to have taken hold. Managers know that overruns will be financed and so there is little incentive to stick to ceilings and create efficiencies.

That is not to say that healthcare spending cannot be made more efficient. Ireland ranks as a high spender on health internationally even with a relatively young population today. This is particularly evident for outpatient services — daily hospital services excluding overnight or longer-term hospitalisations. But Ireland has had more average spending on capital areas and it still has a middling rank when it comes to its health infrastructure.

Staff planning could be far better. The HSE’s “Pay and Numbers Strategy” is meant to give detailed information on the number of staff to be hired. Yet this is often submitted at the end of the year in question, or at the earliest in February of the same year.

Big challenges ahead

Spending on an older population is likely to continue to grow. The number of people aged over 65 will more than double by 2050. Over 65s are also expected to live 3 years longer on average by then. This means more pressures in terms of annual increases for healthcare and pensions just to stand still. The Council’s long-term projections suggest annual public spending related to ageing will rise by 4.8 percentage points of GNI* between 2023 and 2050 — about €14 billion in today’s money.[2]

To address these challenges, healthcare spending forecasts need to be more realistic and developed earlier. That means taking account

[2] See the Council’s “Long-term Sustainability Report”.

of long-term demographics, price pressures and increased demands as people's incomes rise.

More generally, if we realistically wish to generate savings in health, a more strategic approach is needed. This might involve a larger-scale review of health spending independently led and supported by IGEES economists. It would not need to be driven by an over-arching objective to cut pay or staff numbers, but to find savings and to develop more effective ways of using the same staff and resources, hence making for a better work environment.

Closing

Good fiscal decision making requires good budgeting, which, crucially, involves understanding the costs of maintaining existing public supports and services as an essential starting point. We thank the Committee for the opportunity to discuss this aspect of Irish fiscal policy, and we look forward to answering your questions.