

# DÁIL ÉIREANN

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AN COMHCHOISTE UM AIRGEADAS, CAITEACHAS POIBLÍ AND ATHCHÓIRIÚ

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

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*Déardaoin, 4 Nollaig 2014*

*Thursday, 4 December 2014*

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The Joint Committee met at 2 p.m.

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## MEMBERS PRESENT:

Deputy Eric Byrne,*	Senator Sean D. Barrett,
Deputy Pearse Doherty,	Senator Thomas Byrne.
Deputy Dominic Hannigan,*	
Deputy Derek Keating,*	
Deputy Michael McCarthy,*	
Deputy Mary Lou McDonald,	
Deputy Michelle Mulherin,*	
Deputy Kieran O'Donnell,	
Deputy John Paul Phelan,*	
Deputy Pat Rabbitte,	
Deputy Peadar Tóibín,*	

\* In the absence of Deputies Ciara Conway, Arthur Spring, Ciarán Cannon, Ciarán Lynch, Tom Barry, Alan Farrell and Brian Stanley, respectively.

In attendance: Deputy Robert Dowds.

DEPUTY LIAM TWOMEY IN THE CHAIR.

**Fiscal Assessment Report - November 2014: Irish Fiscal Advisory Council**

**Chairman:** The purpose of today's meeting is to discuss the Irish Fiscal Advisory Council's fiscal assessment report of November 2014. I welcome the delegates from the council: Professor John McHale, chairman; Dr. Thomas Conefrey, chief economist; and council members, Professor Alan Barrett; Mr. Sebastian Barnes; and Dr. Donal O'Donovan. I understand Dr. Róisín O'Sullivan is unable to attend and sends her apologies. Mr. John Howlin, Mr. Eddie Casey, Mr. Andrew Hannon and Ms Sarah Doyle are also in attendance. We will begin with an opening statement from Professor McHale, followed by a question and answer session.

I remind members, witnesses and persons in the public Gallery that all mobile telephones must be switched off. I advise the witnesses that by virtue of section 17(2)(I) of the Defamation Act 2009, they are protected by absolute privilege in respect of their evidence to this committee. However, if they are directed by the committee to cease giving evidence in regard to a particular matter and they continue to do so, they are entitled thereafter only to a qualified privilege in respect of their evidence. Witnesses are directed that only evidence connected with the subject matter of these proceedings is to be given and are asked to respect the parliamentary practice to the effect that, where possible, they should not criticise or make charges against any person, persons or entity by name or in such a way as to make him, her or it identifiable. Members are reminded of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the House or an official either by name or in such a way as to make him or her identifiable.

I invite Professor McHale to make his opening statement.

**Professor John McHale:** We are delighted to have this opportunity to discuss the Irish Fiscal Advisory Council's latest assessment with the committee. We view our appearances here as being instrumental in ensuring the full delivery of the council's mandate and we look forward to engaging with several new members this afternoon. Other council members in attendance with me today are Mr. Sebastian Barnes, Professor Alan Barrett and Dr. Donal Donovan. Unfortunately, as the Chairman indicated, Dr. Róisín O'Sullivan, who is based in the United States, cannot attend. The council secretariat is represented by Ms Sarah Doyle, Mr. Eddie Casey, Mr. Andrew Hannon, Mr. John Howlin, and Dr. Thomas Conefrey, head of the secretariat and chief economist. The secretariat continues to have very useful interaction with the staff of the Oireachtas, which enhances the engagement we as a council have with this committee. I would like to acknowledge the co-operation of the Oireachtas staff in this ongoing work.

Today I will cover our seventh assessment report, which was published last Tuesday, 25 November. The report is written in line with the mandate of the council set out in the fiscal responsibility Acts of 2012 and 2013 and also with the memorandum of understanding between the council and the Department of Finance. At our last appearance before the committee in June, I began by noting the progress being made in restoring the public finances and the economy to health. In the intervening months, there have been further encouraging signs that the recovery in the Irish economy is solidifying and that the public finances are improving. The general Government deficit is likely to fall below the 3% excessive deficit procedure ceiling in 2015, and the debt-to-GDP ratio is beginning to fall, albeit from a very high level. Market confidence has improved greatly and the State's creditworthiness has been restored. At the same time, economic recovery appears to be taking hold, with employment growing and the unemployment rate falling steadily. Of course the recovery is not yet being felt evenly across the population, and the crisis has left several challenging legacy problems that require ongoing careful policy

attention and action.

It was not always obvious that a recovery pattern of the sort now emerging would materialise. Concerns existed that the implementation of such an enormous programme of fiscal consolidation as that followed since 2008 could trip the economy into a deflationary spiral and even become self-defeating in budgetary terms. These concerns have not come to pass, as the deficit has fallen from a peak of 11.5% of GDP in 2009 and, as noted, signs of a broad-based recovery are evident. While the consolidation measures had a negative impact on domestic demand, they have succeeded in moving the State's finances towards sustainability and in creating the conditions for a return to growth in employment and incomes.

Thanks to the improvements in macro and fiscal aggregates, it was against a comparatively more favourable backdrop that budget 2015 was framed. Despite the announcement of an expansionary package of measures amounting to just over €1 billion, the deficit as a percentage of GDP is expected to fall to 2.7% in 2015, in line with the requirements for exiting the excessive deficit procedure. Achieving this objective has been the key focus of fiscal policy in recent years and is an important milestone on the path towards more sustainable public finances. However, as pointed out in the council's pre-budget 2015 statement, compliance with the official targets does not mean that the overriding task of repairing the public finances has been accomplished.

It is the council's assessment that budget 2015 reflects a missed opportunity to move the public finances more decisively into a zone of safety by following through on previous plans. The State's expenditure is expected to exceed its income by around €7 billion in 2014, a gap which is being closed through additional borrowing. In this context, the decision in budget 2015 to opt for an expansionary package of tax cuts and expenditure increases necessarily results in higher borrowing, larger national debt interest costs and higher debt levels than could have been achieved if previous plans had been adopted. The stance in budget 2015 means that the deficit is projected to be more than one percentage point higher in 2015 than could have been achieved if previous plans had been implemented. An opportunity to create a larger buffer to guard against adverse near- and medium-term growth shocks has thus been missed. All else being equal, the larger deficits will result in the debt level being roughly €10 billion higher in 2018 than if previous plans had been adopted.

The council is keenly aware of the limited tolerance for further tax increases and expenditure cuts following eight consecutive contractionary budgets, compounded by the impact of a deep and prolonged recession. The improved creditworthiness of the State and stabilisation of the debt-to-GDP ratio have reduced the urgency of further adjustment efforts. Nonetheless, it remains the judgment of the council that implementing the plan outlined in the last stability programme update, SPU, and then following the less demanding requirements of the budgetary rule and preventive arm of the stability and growth pact, SGP, would have been, on balance, the most appropriate fiscal stance.

The expansionary measures in budget 2015 are estimated by the Department of Finance to increase GDP growth in 2015 by 0.3 percentage points. The benefits of this limited short-run stimulus, in our view, do not outweigh the longer-term gains and enhanced certainty that would have accrued from implementing one last adjustment effort.

I would like to turn now to a major theme of the fiscal assessment report concerning the importance of Ireland's new budgetary framework and the outlook for the public finances beyond 2015. A positive legacy of the crisis is Ireland's strengthened budgetary framework, incorporating both domestic and European elements. With the State having exited the EU-IMF

programme, a new phase of fiscal policy surveillance guided by the new budgetary framework will begin. Adhering to the new fiscal framework should help to smooth future boom-bust cycles, guide Government debt to safer levels, and underpin borrowing capacity during the period when debt will remain unavoidably high by adding credibility to Government plans. If implemented effectively, the budgetary framework can also act as a bulwark against the types of political pressure that have contributed to inappropriate fiscal policy in the past. At previous appearances before the committee, I described the new framework and elaborated on some of its potential benefits. We are now at the point of implementation and so new challenges have emerged.

A major weakness of Ireland's approach to fiscal policy prior to the crisis was that the annual budgetary process paid insufficient attention to multi-annual fiscal planning. Expenditure plans focused almost exclusively on the following year's spending plans, with medium-term expenditure profiles seen as indicative and subject to change in later years. With spending determined on an *ad hoc* year-to-year basis, this inevitably contributed to pro-cyclicality in fiscal policy.

The need to set out credible medium-term plans for the public finances, including multi-annual ceilings for expenditure for each department for the next three years, is a key component of Ireland's budgetary framework. Budget 2015 did not include such a well-specified plan for the public finances. Published tax revenue projections assume no change in policy in the medium term, despite budget commitments to cut taxes in the coming years. Moreover, the budget spending profiles assume that spending will remain unchanged after 2015, despite higher figures for expenditure being set out in the comprehensive review of expenditure for 2015 to 2017. Taken together, the lack of detail underpinning the Government's medium-term projections for both expenditure and revenue means, in turn, that considerable uncertainty surrounds the overall projected path for the general Government deficit.

Spending plans have been revised upwards each year since 2012, with budget 2015 raising the expenditure ceilings for 2015 to 2017. The almost continuous raising of the Government's expenditure ceilings undermines the purpose of multi-annual expenditure planning, which is designed to protect against the type of pro-cyclical trend in Government spending observed in the run up to the crisis. The lack of a well-anchored medium-term plan raises the risk that incoming cyclical revenues will be spent rather than saved, leading to unsustainable spending levels.

The absence of a well-specified medium-term plan for the public finances in budget 2015 indicates that, although public awareness of and political support for the budgetary framework have increased, problems with implementation remain. For the framework to be implemented effectively, domestic ownership is essential. While the new budgetary framework is not without flaws, the complementary national and European elements provide a valuable structure to guide Irish fiscal policy. Rather than being viewed as something imposed on Ireland, it should be seen as a framework that is in the national interest, in that it helps to create the conditions that underpin sustainable growth in Irish incomes and employment and also ensures the future fiscal capacity of the State.

Broad political support and advocacy of Ireland's budgetary framework will be vital if it is to act as an effective guide to sound management of the public finances. This is especially important now that the degree of direct external surveillance has eased with the ending of the programme. The Oireachtas, as well as the council, can play a vital role in ensuring the effective implementation, monitoring and enforcement of the new budgetary framework.

Finally, on several occasions over recent months the question has been raised as to whether the council feels its advice is being ignored. In this context, it is important to note that our reports are not directed solely at the Government. Our analysis is also aimed at raising public awareness and stimulating debate around important public finance issues and fiscal policy options. As representatives of the public, the Oireachtas can play a vital role in helping to promote informed public debate around the various issues raised in the council's analysis.

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

**Chairman:** In the context of the question-and-answer session, I propose that we adhere to the same rules we have used at recent meetings. Those rules assist in terms of ensuring that everyone has an opportunity to ask questions and that proceedings run as smoothly as possible. The lead speakers of each group will have ten minutes and other members will have five. Anyone else who wishes to post questions will also have five minutes. The clerk and I will be monitoring the clock and I will advise members when there is one minute of their time to go in order that they might wrap up their contributions. If members have further questions, I would be happy to allow them to come back in later once others have had a fair opportunity to ask their questions. I ask members to keep their questions short and to the point and to refrain from engaging in side conversations when someone else is speaking because this is distracting for and discourteous to other members and our guests. I ask for members' co-operation in respect of these matters in order that proceedings might run smoothly. Is that agreed? Agreed.

**Deputy Pearse Doherty:** I welcome the members of the Irish Fiscal Advisory Council. I had not intended to ask this particular question but, given that Professor McHale raised the matter to which it refers, I will do so now. He referred to the fact that on several occasions over recent months the question has been raised as to whether the council feels its advice is being ignored. He also referred to the importance of our role as Members of the Oireachtas and the fact that the council's reports are not aimed solely at the Government. Professor McHale asked the question but he failed to answer it. Is he of the view that the Government has ignored the core advice of the fiscal council?

**Professor John McHale:** In terms of the core advice, I would say we do not believe that to be the case. One point that sometimes becomes lost in the debate is the fact that we have supported the broad thrust of the policy that is currently being pursued and also that which was pursued by the previous Government immediately post-crisis. It is important to say that. When we get into matters of detail, it is clear that there have been differences. We are not naive enough to think that everything we recommend will be followed. On the one hand, we look at matters purely from the point of view of economics while, on the other, we realise that there is a need to find a balance in respect of different factors, both political and economic, when decisions are made. In addition, the Government may reach judgments which are different from ours on the economics involved. There have been important cases in which we felt we had influenced the Government's approach. In the Dáil debate following the pre-budget statement - at which the Deputy was in attendance - the Minister explicitly said that the target for the deficit in 2015 was set at 2.7% - partly in response to our report - in order to have some margin of safety around the requirement to get the deficit below 3%. That is a very concrete instance in which our advice was at least partially taken on board. Of course, we recommended that the Government should go further and set a bigger target. However, it does seem that our advice had an impact on the decisions taken by the Government.

The point about our role in advising the Government and providing our analyses to the

Oireachtas and the public is an important one. We are of the view that we are having a significant impact on the public debate. There clearly is interest in our reports from the Oireachtas and there is also a very substantial public and media interest in them. To that extent, we think we are having a very significant impact on the overall discussion in respect of fiscal policy.

**Deputy Pearse Doherty:** I agree with Professor McHale on that matter and I commend the council on the reports and analyses it produces. I do not always agree with the council's recommendations, particularly in light of certain factors relating to the impact that those recommendations could have on people's lives. However, there is no doubt that the council has provided a wealth of information which has informed public debate and opinion.

I stress to our guests that I intend no disrespect with my next question. Is it not the case that the council is hedging its bets? The Wright report refers to warning signals which were ignored by the Government in the past. The fiscal council was established on foot of recommendations relating to the economic collapse. Prior to that collapse, international organisations such as the IMF issued warnings about what might happen in the future but still endorsed the then Government's strategy. Is it not the case that the council is now complaining about what the current Administration is doing and the fact that the latter is not listening to what it is saying about the need to go further with austerity, while - simultaneously - the projections are being endorsed on each occasion? Do the members of the council - as is the tendency for most economists - have two irons in the fire in this regard, and is it not the case that they are going to be winners no matter what happens? Is it a case of the council saying "We told you so"?

**Professor John McHale:** I am not too sure that we will be winners no matter what happens. There are variations in the level of the criticism we are making. There is a requirement in the Fiscal Responsibility Act to the effect that we must assess whether the Government's policy is conducive to economic and budgetary management. We have concluded in each of our reports that this is the case. The Deputy referred to the endorsement function, which only relates to the macroeconomic forecasts which underlie the budget and the stability programme. Recognising the uncertainty that exists around any set of forecasts, we have been in a position to endorse those to which I refer. It is important that we are in a position whereby we can give our best opinion of, for example, what should be the fiscal stance. We should also be in a position to be able to increase the level of criticism if the deviation from what we think should be the appropriate fiscal stance becomes larger. This might be referred to as hedging our bets, but it is important that we do not have just one volume in terms of our criticism. If we feel that deviation is becoming larger, we will increase the volume of our criticism.

**Deputy Pearse Doherty:** That is fine. Sometimes it is unfair to simplify matters when discussing this issue. However, the current opinion is that the council is being critical of or, indeed, whingeing about the fact that the Government is not listening to its recommendations. However, Professor McHale has indicated his opinion to the effect that the Government is not ignoring those recommendations and that the council, in turn, endorses the macroeconomic projections. There is a problem there. I am not necessarily on the same page as Professor McHale in respect of this matter. I am of the view that the information the council provides should inform the debate. Sometimes that debate is too simplistic and that is why there may be a wish to move on. However, Professor McHale can respond to that point.

I wish now to examine a little more the work done by the council which does not attract the type of recognition it deserves. In that context, I will focus on the issue of contract manufacturing. The committee discussed this matter previously with representatives from the Department of Finance and the council drew attention to it in its report in the context of the accuracy

of GDP figures. What is the council's best guess regarding the distortion of the figures as a result of contract manufacturing? The officials from the Department of Finance indicated that the position in this regard is impossible to model at this point. Is there a way to try to strip out contract manufacturing from the relevant figures in order to discover what is the real level of GDP? Those figures have been distorted as a result of the inclusion of contract manufacturing. We might be meeting targets but this could be at a level that does not really exist. I will return later to the question of the revision of GDP, a development that did not really benefit Ireland but that did have a benefit statistically. Is contract manufacturing here to stay and, if so, should we be trying to strip the figures relating to it out of the overall figures for GDP?

**Professor John McHale:** The real issue here relates to the uncertainty that it creates around growth forecasts. The CSO is responsible for measuring GDP, and what happened in the first half of the year was a real phenomenon. Contract manufacturing has been included in the figures in the past but it surged in the first half of this year. Given that it is specific to a handful of firms, nobody really knows how it is going to evolve in the future. However, it had a very big impact in the first six months of the year. That impact was equivalent to approximately 2.5% of annualised GDP or 5% of a half year's GDP. It has almost become a cliché to say that there is uncertainty around Irish macroeconomic forecasts, particularly in light of the volatility in the economy. There is, however, an additional source of uncertainty so that forecasts are unusually uncertain. That is the main point we were making.

**Deputy Pearse Doherty:** Do I only have one minute left?

**Chairman:** Yes.

**Deputy Pearse Doherty:** Time flies when one is having fun.

The council plays a key role in the context of public information and education.

Will Professor McHale explain whether the growth of 2.5% in GDP in contract manufacturing is real growth? When we talk about figures, in terms of the economy having grown by 4%, and say we must all be doing well, we must realise some of it may not be real growth. There has been no real growth; what we have is statistical growth. The key issue on which I want to focus is the expenditure benchmark. This is a huge issue which the council has outlined in its report and on which I tabled a parliamentary question to the Minister for Finance. The public is not aware of the restraints in increasing expenditure in the State. In that parliamentary question I asked what were the limits to which we could increase expenditure as a result of the six pack rule and the Department advised that between 2015 and 2016 we could increase expenditure by €400 million. Given the fact that public sector increments will be due to be paid in that period and taking account of other factors such as inflation, how will the State be able to remain within that benchmark in 2016? It seems it will be next to impossible without a range of cuts in other areas.

**Professor John McHale:** The expenditure benchmark is potentially a constraining aspect of the fiscal rules. For the period to 2016, it is required that expenditure fall by 0.7% of GDP. When we look towards 2016, the Government is very close to that benchmark and its expenditure estimate is slightly above what would be allowed. This shows that there is very little additional room for additional expenditure increases or tax cuts because when we have discretionary changes in taxes, that is counted also. The way it works is that we can increase expenditure beyond the benchmark if we have discretionary revenue raising measures, but when we have discretionary measures that reduce revenue, that is also factored into the calculation of the

expenditure benchmark. The situation in respect of the figures for 2016 is very tight and there is no room either for additional expenditure increases beyond those already projected for that year or revenue reducing measures.

**Deputy Kieran O'Donnell:** I thank Professor McHale and his colleagues for their presentation. I want to take up a few points.

I understood that last year the way in which GDP was calculated changed and contract manufacturing which represents the work Irish companies do abroad was factored in in GDP. The previous year we had the patent cliff, which understated Ireland's growth rate. While I cannot prove it, that is my gut feeling. Will Professor McHale indicate if he considers the feature of contract manufacturing is here to stay? It obviously involves repatriation of profits back to Ireland; therefore, there is a logic to it. There is a degree of ambiguity as distinct from uncertainty. Professor McHale might give me his take on it.

**Professor John McHale:** Dr. Donovan has been looking closely at that issue.

**Dr. Donal Donovan:** This area is, as we all recognise, very unclear, but I will give the Deputy my understanding of it. For some years the general methodology - it is a worldwide methodology and the IMF is more or less the guardian of how these things are calculated - has been to include contract manufacturing, in principle, in the way in the way the figure is represented in the national accounts in Ireland. What has changed, however, is the size of the activity which has, as our chairman said, suddenly exploded in the first six months of the year. There is a table in the report which shows that up to now on a net basis contract manufacturing more or less represented a small plus or minus, but suddenly it went up dramatically and accounted for growth of about 2.5%.

**Deputy Kieran O'Donnell:** I thought there was a change in the way it was incorporated into GDP.

**Dr. Donal Donovan:** My understanding is that the change has been made for some years, but that it did not matter because on a net basis-----

**Deputy Kieran O'Donnell:** That would not have been the general impression. People believed there was a change.

**Dr. Donal Donovan:** This is my understanding. Nobody took much notice of contract manufacturing because on a net basis it represented a figure of approximately zero. Nobody focused on it, but for reasons to which I will come, it jumped dramatically and suddenly people were asking what was the reason for this huge additional activity. It is not a methodological change, it is the reality that the level of contract manufacturing, for reasons we do not know, has increased. I think it is fair to say that not too many people know why there has been a sudden explosion in the level of this activity. We understand it may include a very small number of firms and could have something to do with taxation arrangements - a very complex issue - which are changing all the time and people move operations in different ways. That is certainly one hypothesis, but we do not have a sense that the Department of Finance has a very clear handle on it. The problem then is that if we not know what caused this to happen, we do not have a basis for knowing whether it will continue, whether it is a one-off or whether there may be offsetting expenditures in royalties. It is hard to say.

**Deputy Kieran O'Donnell:** Has the council been able to quantify it?

**Dr. Donal Donovan:** I do not have the table included in our report to hand, but perhaps Mr. Conefrey might refer to it. In one of the tables we show exports and imports balancing out and there is then this huge increase which works out at about €5 billion on a net basis.

**Deputy Kieran O'Donnell:** I am open to correction, but I understand there was a change in the way it was incorporated into GDP, but Dr. Donovan is saying that is not the case.

**Dr. Donal Donovan:** Yes, there was change, but it was not made at the beginning of 2014.

**Deputy Kieran O'Donnell:** Was it made from 1 May?

**Dr. Donal Donovan:** The change has been made for some years, following a revision of methodology worldwide, but as it did not really matter, people did not take any notice. I think I am correct in saying the same methodology has been used in the CSO's figures.

**Dr. Thomas Conefrey:** It is not the change in methodology that is picking up this effect that has not been counted previously; the phenomenon was being counted, but, as Dr. Donovan pointed out, the scale increased. It is important to explain that this activity is carried out in Ireland. Plenty of multinational companies send raw materials to Ireland where minimal processing is carried out and they are then exported. These are Irish resident firms carrying out this activity abroad. It is as if the opposite is happening; for a long time the effects cancelled out the adjustment in the national accounts in taking account of contract manufacturing, but the extent of Irish resident companies contracting out manufacturing abroad is now outweighing the other and we have this large positive adjustment to our export figures which can be seen clearly if one looks at the national accounts. Exports of goods were up by about 14% in the first half of the year, but there is not the same adjustment on the imports side.

**Deputy Kieran O'Donnell:** Moving on, the delegates are making a case for tighter arrangements with regard to the budget. All of the indicators in the council's table - GDP, consumption, investment, exports and imports - are showing an upward curve. Employment is going up, while unemployment is coming down. The main indicators are good, but there is another factor in the council's modelling, namely, the social dimension. People are under enormous pressure and will get to a point, financially, where they will not be able to take that extra notch in the belt. If it is tightened too much, they will not be able to function. There is growth in the economy; jobs are being created on a daily basis and unemployment is going down, but people are still under enormous pressure. There has to be some easing of the burden on ordinary people. I would like Professor McHale to comment on the social dimension. Ireland Inc. is not like a normal company. We have a social dimension to our remit. What are considered to be the risks to the Irish economy in the next 12 months in terms of meeting the 3% target? We have a margin of 0.3%. Could Professor McHale outline where he sees the possible challenges and headwinds that could prevent us meeting targets? Could we put policies in place to deal with such possibilities? Could Professor McHale frame his reply in the context of Ireland Inc. being made up of individual families that are under enormous pressure?

**Professor John McHale:** That is an excellent question. Part of our role, which is not an easy message to get across, is to take account of the budget constraint the State faces over time. To put that in the simplest possible terms, if one borrows more today, one will have to pay it back in the future with interest. Irish people will pay the money back. That is the first effect. Part of our role is, essentially, to be that voice for people in the future. It is not that we just care about-----

**Deputy Kieran O'Donnell:** I do not in any way question the remit of the Irish Fiscal Advisory Council, IFAC.

**Professor John McHale:** In one sense, that partly explains the way we come at the issue. It is a difficult balancing act to determine what the appropriate budgetary policy is at a particular point in time. There certainly can be good reasons for running deficits. There can be good counter-cyclical reasons if the economy is in recession. One may want to run a deficit now and pay it back later with interest. If one has extraordinary costs, as we have had during the crisis, again, there is a good reason to run a deficit, but then there are reasons to run smaller deficits as well. For instance, we face major demographic pressures from an ageing population and good fiscal policy would indicate that if one did not have other constraints, one should probably be running surpluses to prepare for that. We also still have very large debts and in a very fragile global economy, that leaves us vulnerable. Putting everything else aside, the appropriate policy would be to try to get the debt down to get us into a safer position. When we try to identify the appropriate fiscal stance, recognising the budget constraint the Government faces over time, we are trying to balance those factors.

Reference was made to the strong, recent economic performance, but that cuts both ways. On the one hand, it makes it easier to hit the fiscal targets. On the other hand, the actual case for a counter-cyclical stimulus is lessened somewhat. At the moment, even though there are questions about the recent growth figures in terms of what they really indicate about the strength of the economy, taken at face value, we are growing beyond the underlying potential growth rate of the economy so that, from a counter-cyclical perspective, lessens the argument for more stimulus. It is a balancing act. Putting politics aside, but recognising that ultimately what matters is the interests of the Irish people – not just now, but in the future – one has to balance those factors. Recognising the risks that result-----

**Deputy Kieran O'Donnell:** What does Professor McHale see as the risks in the next 12 months? I am aware of the time constraints.

**Chairman:** I will have to postpone a response to the question.

**Deputy Kieran O'Donnell:** I had asked previously about the risks.

**Professor John McHale:** The major risks are around economic growth. One of the things we do in this report is to show the sensitivity of the budgetary numbers to even small changes in growth. For instance, if growth were even to be half a percentage point less in 2015 than currently projected, without off-setting some policy measures we would be in danger of missing the 3% target. There are many uncertainties around growth, partly relating to the uncertainties that exist at a global level and also in particular at eurozone level. Growth risks are still the major source of uncertainty that we would highlight.

**Deputy Kieran O'Donnell:** I thank the council members.

**Senator Thomas Byrne:** I apologise for being late for the presentations but I was voting against the Finance Bill, partially on the recommendation of the Fiscal Advisory Council. It was not the recommendation of the Fiscal Advisory Council to vote against any measure but my decision was based on some of the reasons outlined by the council.

I would like to follow up on some of the points raised by Deputy Pearse Doherty. It seems to me that the IFAC is becoming a bit like Cassandra, who was given the power of prophecy by Apollo and then when she did not play ball, she was cursed with not ever being believed. There

are similarities. It was said in response to Deputy Pearse Doherty that the Government might not listen to the case made by members of IFAC but it is important that they play their part in the media and engage in public debate. I put it to the members that under the legislation setting up IFAC, its primary function is to give the assessment to the Minister. Unlike a body such as the Ombudsman for Children, who has wide-ranging functions in legislation to contribute to the public debate or comment on various issues that affect children, IFAC does not have a similar range of functions. The legislation is very short and the primary function of IFAC is to the Minister. The debate that happens in the public domain is natural but the Government seems to dismiss the views of IFAC every year, which is dangerous as the council was set up for a very good reason. We did not listen to the few prophets who spoke out during the boom and that caused us problems. I do not accept what the members of the council have said and that it is okay if the Government does not listen because the media or the public will listen, as the primary function of IFAC is to advise the Government. Perhaps someone will comment in that regard.

There has been much discussion on contract manufacturing but illicit activities were also added to the national accounts this year. Have prostitution, drugs and smuggling made much of an impact on the Central Statistics Office, CSO, figures?

**Professor John McHale:** I will ask my colleague, Professor Alan Barrett, to answer the first part of the question.

**Professor Alan Barrett:** On the issue raised, that in some sense our focus and remit should be talking directly to the Minister, and that some of the other stuff-----

**Senator Thomas Byrne:** I suggest that is the statutory function of IFAC.

**Professor Alan Barrett:** Possibly, but going back to when we were established, I remember we all read extensively at the time about the design of fiscal councils. Essentially, there were two models. One is where one has a body which makes decisions. It is a bit like a monetary authority for the banks when the Government lets an agency decide. Some fiscal councils have very strong powers. We were set up on the basis that we did not actually have any powers and that our purpose was more to influence the debate, exactly the sort of things Professor McHale has talked about. The phrase that was used in some of the literature was “raising the political cost of inappropriate fiscal policy”. It is not the case that we talk directly to the Minister and nobody else. It was always intended, on the basis of the model under which we were set up, that the channels of influence had to be in part through the media, through public debate and public representatives and that the very issues we were talking about would be highlighted more and more so that when the Minister decided to do X, Y or Z, there was a much broader and more robust context in which he was doing it. There is truth on both sides, but I wish to re-emphasise what Professor McHale said-----

**Senator Thomas Byrne:** I am not criticising the members of the council.

**Professor Alan Barrett:** I am sure that is not the case, but it is important to make the case that the council was designed on the basis of a model where the sort of thing Professor McHale talked about was viewed as absolutely critical and was part of the route through which a fiscal council of our type achieves its ultimate objective.

**Dr. Thomas Conefrey:** On illegal activities, the CSO adopted international standards, as of its 2013 national accounts, and they now incorporate estimates of illegal activities but also

research and development. While the illegal activities have got a lot of media attention, they are by far the smallest component of the upward revision to GDP. It has increased the level of GDP. The CSO has revised it back but it does not affect annual growth rates, it just lifts the level again. By far the largest component of the change is due to the inclusion of research and development expenditures in GDP rather than illegal activities.

**Senator Thomas Byrne:** Although most of us here know the answer, I still see the letter of endorsement as being misused. On some websites I have seen reference to “the attached letter of endorsement” as if the letter of endorsement relates to the budget itself. Could that be explained briefly?

**Mr. Sebastian Barnes:** That confusion is unhelpful. To be clear, our job is to endorse the micro-economic forecasts and in the budget it is just for the year ahead. It is not for outer years, although it goes out the full length of the stability programme update, SPU. We assess whether those forecasts are an appropriate set of forecasts, and that is purely a judgment on the technical side of the projections.

In the full fiscal assessment report we have to assess the fiscal stance, which is a more normative judgment. That is a very different exercise, and we never use the word “endorsement” in that context because it is a very different process.

**Senator Thomas Byrne:** It is an old chestnut that is still hanging around, unfortunately.

**Deputy Pat Rabbitte:** I thank the members of the Fiscal Advisory Council for attending. I have a single question. It would be a shame for the witnesses to visit a political establishment and not be asked a political question. We all understand, I hope, the thrust of what they have been saying in the advice they have been giving. I did not understand until now that Fianna Fáil would take €2 billion out of the budget as recommended but I did understand the rest. The witnesses can give me the answer that it is none of my business, that they have a particular remit and engaging with the politics is not part of it but in the circumstances in which we find ourselves, if the Government had proceeded to implement the advice to the letter of the law and against the fact that the indicators, especially with regard to the deficit, are ahead of target, and in the current febrile mood where there is such a cranky environment after eight contractionary budgets, as they say in their statement, and six long years of recession and so on and people feeling they cannot take any more, does the Government not have to make decisions or are we in a circumstance where, notwithstanding the Government’s huge majority, it goes out of business, the Fiscal Advisory Council is still in business counselling prudence and so on but there is chaos politically? We could easily find ourselves in that circumstance if the Minister for Finance had proceeded to implement the letter of the witnesses’ advice. I understand the reason that advice is proffered but no Government could take the recommendations and say even though the skies fall we will implement them. We really have tested people’s forbearance as far as it can be done, especially when the backdrop is the economic indicators being largely positive. There is a huge conflict for the average citizen when they hear Ministers and financial and economic commentators saying that all the macro-indicators are generally positive when the combination of wages decline and tax increases means that they have taken a severe hit over six years. It is not the witnesses’ business but what is their view?

**Professor John McHale:** As the Deputy said, the political implications are not our business. Our job is to identify what we think is the most appropriate fiscal policy from a macro-economic perspective. Our remit does not get into the details of tax and expenditure policy but to look at it at the level of deficits and debt and identify the most appropriate policy. We are

non-partisan. We are driven by our view of the appropriate policy but as Professor Barrett said, even though we are non-partisan, part of the job of independent fiscal institutions is to raise certain political or reputational costs of inappropriate policies. That becomes even more important when all the political pressures are pushing in a particular direction. Those political pressures, not just in Ireland but in other countries as well, can lead to mistakes in fiscal policy. There is a large amount of literature on deficit bias and pro-cyclicality where those pressures probably becomes strongest in good times. That can lead to pro-cyclical policies that are followed later by being forced into extreme contractions so they are over-expansionary in the good times and forcibly overly contractionary in the bad times. Ultimately, to go back to Deputy O'Donnell's question, it is people who suffer from those policies.

Part of our role is to be that advocate not just for the present where the political pressures are strongest, but also for the future. However, it is also about people. It is not something that is just about the economy and not about people. Giving that voice to the future, and people's interest in the future, is part of our role. It is when those political pressures are strongest, recognising that not everything we say will be done. We are not at all surprised and we understand the very difficult pressures that not just Government politicians, but all politicians, are under, which are very much in the present, but our role is to be that voice for the future.

**Chairman:** I thank Professor McHale. Is Deputy Tóibín a member of the committee?

**Deputy Peadar Tóibín:** I do not think I am officially a member of the committee as of yet.

**Chairman:** Okay. I call Senator Barrett.

**Senator Sean D. Barrett:** I welcome the visitors. Their role is valuable because we have a clientelist political system and massive rent seeking up and down the Exchequer - the Niskanen bureaucracy. Some voice telling us that we have to balance the books on the odd occasion is valuable because the forces that led us over a cliff in 2008 have not gone away. As a Member of the Parliament in the three years since 2011, I believe we have not reformed enough of the machinery.

There are 100 sections in the Finance Bill but there is not an ounce of economic analysis in terms of who benefits, the effect it will have, the income distribution consequences and so on. As I understand the term fiscal, it should refer to both the way we implement the tax system in this document rather than just the macro aggregates with which the witnesses deal. There are 100 measures, some of which seem strange. One of them proposes to abolish a €0.5 million income limit. Another is that capital allowances previously disallowed can now be used and so on. In economic terms there is an immense amount of analysed activity taking place and I am sure much of it is counter-productive. There is a ceiling of €0.5 million in the special assignee relief programme. I do not know whether any cost-benefit analysis was done of that, who lobbied hardest and so on.

The Wright report shows the Department of Finance to be seriously deficient in economic expertise, with 93% of staff not qualified in economics at master's level. In Ottawa, from where Mr. Wright came, 60% of similar staff were qualified. The economic analysis Professor McHale and his colleagues bring is very important. However, I do not know whether those deficiencies in the Department of Finance have been rectified yet.

People have referred to the macro-economic aggregates but a deeper analysis needs to be done. The more macro-economic good news that is published, the more people will be march-

ing outside these Houses because they have not seen the effects of that. What instruments would realise the kind of growth that would percolate down? The employment numbers are good but there is not a feel-good factor in the country. For example, perhaps the structure of the universal social charge, USC, is a possibility. I have never heard of a tax that gives one an exemption of €12,000 and change but then, when one goes over €12,000, the entire income below €12,000 is brought into the tax base. A tax-free allowance used to mean just that, a tax-free allowance and it is a strange kind of tax. I acknowledge we needed the money at the time we did it. I hope the Irish Fiscal Advisory Council will extend its role to consider all the State's economic policies because its input is badly needed. I made the point in the Seanad today that the debate on the Finance Bill was like one from 40 years ago, in that none of the developments in economics since then appear to have influenced the budgetary process at all. This is an important subject and we lost out seriously between 2008 and 2011 by not having the expertise at this committee which today's witnesses possess. More interventions and statements made by them will only improve the quality of decision-making, which I would welcome.

**Professor John McHale:** I thank Senator Barrett for his remarks and for his encouragement, which has been greatly valued by us since our establishment. Basically, we must deal with the mandate we have been given, which has four well-defined elements to it, namely, the endorsement function, assessing budgetary forecasts, assessing compliance with fiscal rules and assessing the fiscal stance. The type of elements about which the Senator is talking often are referred to as focusing more on costings and broader micro-policy evaluation. There are independent fiscal institutions that do that kind of work and if one looks across fiscal institutions across the world, in the Netherlands, for instance, the Central Planning Bureau has a long tradition of doing such costing work. The Office for Budget Responsibility in the United Kingdom also conducts costing work of that type and one sees huge variations in this regard. One point I would make however is that independent institutions that have such a mandate tend to be a lot bigger than we are. As the Senator is aware, that type of cost-benefit analysis and costing work is a highly resource-intensive activity. As for comparing us with fiscal institutions in other countries, I have actually just returned from a conference in Spain, which has set up a new council. It currently has 45 staff members and the people there were complaining about the size because they want to get to a staff complement of 70. When I told them the size of our organisation, they really could not believe it. While part of the reason for that is they have a mandate that requires them to do things our mandate does not require us to do, I agree with the Senator that this type of work needs to be done. At the executive level, the new Irish Government Economic and Evaluation Service is doing more of that sort of cost-benefit analysis. However, I will repeat something I have stated in public previously, which is that an Oireachtas budget office that would do this type of work would be a valuable addition to the overall institutional framework in Ireland. While this could be done by a much-expanded fiscal council, I believe we are working well with the mandate we have at present in our current size. I believe we do it very efficiently, in part because we have such excellent people working for us. I will take this opportunity to thank the secretariat, who do the heavy lifting. The reason we can do this with such a small staff is because of the quality of the people we have. However, the Senator's broader points that there must be much greater input into the policy process at that micro-economic level, as well as the potential of an Oireachtas budget office to do that, certainly are worth considering.

**Deputy Peadar Tóibín:** Gabhaim buíochas leis na finnétithe as an cur i láthair sin. While I support fiscal responsibility wholeheartedly, the key question concerns the manner in how it is achieved. Social justice and fiscal responsibility are not mutually exclusive in any way and at a time when people are dying on the streets, it is important that those elements are focused upon.

One key point on which Deputy Pearse Doherty has spoken is the issue of the expenditure benchmark. It appears to me that, in reality, it is an expenditure cap or an expenditure break. Given the pressures on public services and public sector pay in the next year and given that the Taoiseach already has indicated policywise that the top rate of tax will be brought down by one percentage point, from what I can discern this potentially would wipe out the 0.6% increase. It is likely that the aforementioned promise by the Taoiseach is not actually achievable within that expenditure break as it is currently, unless there is further reduction in other parts of the expenditure sheet. My first question is to confirm whether that is the case. Second, is this a real European rule or is it one of those European rules that countries regularly break and get away with? If it is a real European rule, what are the outcomes or ramifications for this country if it is breached?

**Dr. Donal Donovan:** I will respond to the first part of Deputy Tóibín's remarks. Yes, there is an important issue here that we highlighted in the June fiscal assessment report and we came back again and highlighted it in our recent report. It is not for us to say what may have to give on either expenditure or revenue specifically. Those are political and social decisions the Legislature and the Government must decide. However, what we did stress both times and which we continue to stress is that it is important that the Government initiates a debate on some of these difficult choices by being more explicit about the fact that, as the Deputy correctly stated, one cannot have everything. There are pay pressures, ageing pressures and potential taxation reduction pressures and one cannot have all of these.

Within the context of a credible medium-term budgetary framework, it is appropriate for a government to set out some broad options, not necessarily decisions, that indicate trade-offs on these different aspects. This is why we were somewhat disappointed that the recent budget essentially just contained a set of technical numbers, chosen perhaps somewhat arbitrarily, and did not address the meat of the issue, which are these policy choices. We would not expect any government to provide extreme detail about its precise policy plans for the year or two ahead; that is not common. However, I refer to the broad thrust of policies such as, for example, whether the wage bill is likely to go up or down as a percentage of GDP, whether benefits are likely to rise or fall and similarly with tax rates, direct taxation and other arrangements. In other words, what is the thrust of the envisaged policy directions of the Government? We urge strongly that this be present.

**Deputy Peadar Tóibín:** I have a specific question. On its own, a 1% reduction in the top rate of tax would breach the expenditure benchmark. Is this correct?

**Dr. Donal Donovan:** I believe that is the case but I will let my colleagues reply to that.

**Dr. Thomas Conefrey:** I believe the cost in this regard would be approximately €150 million.

**Deputy Peadar Tóibín:** Would it not be more? Would it not be approximately €400 million?

**Dr. Thomas Conefrey:** I believe the cost of a 1% reduction in the top rate would be in the order of €100 million to €150 million.

**Professor John McHale:** In a full year, I have to hand the Department of Finance-----

**Deputy Peadar Tóibín:** I seek the precise figure because if it does expend the full expenditure, it is an important policy decision for the Oireachtas.

**Professor John McHale:** Based on the numbers from the Revenue Commissioners, were one to do it for 2015, it would be €164 million. However, for a full year it would be €234 million.

**Deputy Peadar Tóibín:** Very well. The other part of the question pertains to the ramifications for the State if that benchmark is breached.

**Mr. Sebastian Barnes:** As questions about the European Union's fiscal rules are very complex, I feel as though I have been preparing for an exam here in terms of the answers. However, let me try to give the Deputy an answer that is as helpful as possible. I believe the point about the expenditure benchmarks and ceilings is that, fundamentally, they ought to be a good idea or there is a strong case for them. In a way, they are an implication of what one needs to get to one's targets for the budget balance. In a sense, they are not adding anything to the other rules that are supposed to support getting to them. However, because one pre-commits to it, there is a case that it avoids the risk that as extra tax revenue comes in, one simply spends it without thinking about whether it is structural or cyclical. Obviously, we are painfully aware of how that can go wrong. It is important in terms of public sector efficiency. If there is a three-year plan, one really just thinks about what one is doing for the next three years and tries to deliver it. If every year one is basically focusing on having a fight in the budgetary process to get a bit more cash, one may not think about long-term planning in the same way. Basically, that is the reason for having these kinds of rules. There is an EU dimension, because of the EU expenditure benchmark, and also domestic expenditure ceilings, which happen to coincide. We should not forget the domestic element and it would be helpful if the Government put more emphasis on the domestic part in addition to the EU part.

With regard to the EU part itself, members will be aware that the EU rules are very complex. Many of the details still have to be fully clarified as the new EU regime comes in. The EU expenditure benchmark definitely is a real one and countries are expected to meet it. In certain circumstances, one could eventually be sanctioned in some ways. The sanctions are not the same as those under the excessive deficit procedure, which is part of what is called the corrective arm. However, even the preventive arm implies some sanctions. Under this regime - I believe I am right - no country has yet been sanctioned under the preventive arm. Enforcement before the post-crisis reforms never really occurred under the preventive arm so we are in somewhat unknown territory. However, there is provision for that ultimately. However, the real point is that there should be a strong interest in managing expenditure on a multi-year basis, which the rules are supposed to underpin this.

**Deputy Peadar Tóibín:** The witnesses mentioned that because of growth, stimulus would be less useful. However, the economy is obviously not at capacity as we still have such a high level of unemployment, at over 10%. Stimulus, therefore, would still have a part to play in the reduction of the unemployment level.

Debt-to-GDP ratios are obviously very important in all the delegation's work. A key element concerns bank debt and recapitalisation. It is not on the horizon and it is not in this document. Is it on the delegation's horizon with regard to understanding these things?

**Professor John McHale:** The Deputy makes a very good point on stimulus. On the economy growing above a sustainable rate, the Deputy makes a very important point that one should not just consider growth rates, but also levels and whether the economy is still operating below capacity. To the extent that it is, that is an argument for a less-contractionary or more expansionary policy, depending on how one looks at it.

Based on official measures of what is called the output gap, or the gap between the current output of the economy and the estimate of its potential, there is currently no negative output gap. It is not considered to be below potential based on the official measures, which largely come from a methodology that has been agreed by the EU member states and the European Commission. We have big doubts about that methodology. We tend to agree with the Deputy that there is still slack in the economy. If we were not constrained by other factors, we would be supporting a more expansionary policy. The problem is that this is just one factor feeding into the analysis of what is the appropriate policy. One of the factors is underlying spending pressures, which need to be prepared for with the ageing population. There is a very high level of debt, which leaves us in a vulnerable position. However, we take the Deputy's point. That, in itself, is an argument for not pursuing a more contractionary policy, but we have to weigh it against these other factors.

We need better measures of the true amount of slack in the economy. The official agreed methodology has some serious flaws. Addressing that is actually part of our work project for next year. We have been urging the Department of Finance to come up with better measures of the output gap.

The Deputy mentioned the bank issue.

**Deputy Peadar Tóibín:** Recapitalisation.

**Professor John McHale:** Is he referring to the possibility of selling the current Government stakes in the banks and to the implications of this for the debt-to-GDP ratio?

**Deputy Peadar Tóibín:** I am mostly referring to potential bank recapitalisation, maybe in that form. I am also referring to the treasury bonds, promissory note and other arrangements that are obviously part of our debt profile also.

**Professor John McHale:** Dr. Donovan wants to contribute. First, I would like to add that we have been analysing the impact of selling the current Government stakes in the banks. A conservative estimate is that they are worth approximately €13.4 billion. A more optimistic estimate puts the figure above €20 billion. A very interesting calculation the secretariat produced was on the impact of selling the stakes over a period of three to four years on the debt-to-GDP ratio. The calculation estimated the size of the gross shock that would occur next year that would leave one in the same place in 2018 as one would be left according to the current projection. In other words, I refer to a combination of selling the stakes to pay down the debt and having a gross shock next year. It is striking that, with the more conservative estimate of €13.4 billion, a gross shock next year of just 1.2 percentage points, followed by a return to the growth that is currently projected, would result in the same debt-to-GDP ratio in 2018, which is 95% of GDP. The point of that sort of calculation is that it does not make a huge difference to the time path of the debt-to-GDP ratio and could be offset by a relatively small shock. Even if one used a more optimistic estimate of the value of the bank stakes, which is approximately €21 billion, one would conclude that a gross shock of 1.9 percentage points would leave one with the same debt-to-GDP ratio in 2018 as the one currently projected. In other words, it would fully offset the advantage of selling the stakes. Selling the stakes to pay down debt does help the debt-to-GDP ratio but, at the same time, the effect is somewhat limited.

**Chairman:** Do the witnesses mind if I proceed to Deputy Mulherin? I will return to Dr. Donovan. I want to keep to the schedule.

**Deputy Michelle Mulherin:** My question is on energy prices and the cost of fuel. We know the cost of a barrel of oil has come down significantly, by up to 40%. Unfortunately, we do not see this reflected in any way at the forecourts of the filling stations. Why is this the case? Is there not a compelling reason to try to push down the cost of fuel for both heating and transport? This would tackle a lot of problems, including fuel laundering and petrol stretching, which are related to the cost of fuel in the first instance. Other issues are fuel poverty and the cost of doing business. Is there a cartel in operation, meaning that the reduction is not being reflected in people's fuel bills?

**Professor John McHale:** It is a specific question and is a little outside our mandate. One matter that is relevant is the fraction of the price of fuel products that is accounted for by taxation. It is very high in the Irish context. I do not know if we have the percentage to hand. When one has a reduction in the price of crude oil, it only affects a relatively small fraction of what determines the price of, for instance, a litre of petrol or diesel. That is why in Ireland one sees falling crude prices having smaller effects on prices at the petrol pumps than in other countries where taxation does not make up such a large share of the price. Senator Sean D. Barrett probably knows more about the structure of the market in this case than we do, but it seems to be reasonably competitive. I am not an expert in this area, but I would not think anti-competitive practice offer the main explanation for the relatively small movement in price. It comes down mainly to the high share of taxation.

**Deputy Michelle Mulherin:** Does Professor McHale believe, therefore, that the few cent by which it has come down reflects a 40% reduction in the price of a barrel of crude oil? It sounds extraordinary.

**Professor John McHale:** The fuel sale price reduction seems very small and it may be something that will take some time to take full effect. Because of the high taxation component of the price, however, one will see nothing close to a 40% reduction. If that is the expectation, it is just not going to happen because it will be affected by the relatively small share the cost of the raw material has in the price. I would certainly have thought one would have seen a reduction of more than a couple of cent, but it may take time to see the full effect. My colleagues may have more insight into the workings of this market than I do.

**Deputy Pearse Doherty:** I revert to some of the questions I asked earlier. To return to the issue of contract manufacturing, there is annualised growth of 2.5%, but this is based on six month figures. Has the council projected to where it will be at the end of the year? What component will contract manufacturing make up in the 4.7% growth rate anticipated this year? That is the way we calculate growth rates, but from a simplistic viewpoint, if we look at the rules under which the council is asked to advise the State, they concern the capacity to manage debt or deficits. When growth is generated in this way, which is not real, the impression is given that the country is booming because we have a 4.7% growth rate; therefore, people think there must be a lot of activity and work being done. However, the majority of it is not genuine activity. I am open to correction if I am wrong.

**Professor John McHale:** Dr. Conefrey has been following the issue of contract manufacturing most closely.

**Dr. Thomas Conefrey:** On the Deputy's first question concerning the projections for the rest of the year, it is something we have not done. It is company specific information and really difficult to project whether this will happen in Q3 and Q4. We will have the Q3 data next week and be watching closely to see if this activity is still evident. Given that there were buoyant ex-

port numbers in the first half of the year, we would have expected to see higher import royalties associated with them. Royalties were up a little but not to the extent we would have expected, given the sharp jump in export figures. It is possible, therefore, that before the end of the year, either in Q3 or Q4, we will see a big increase in import royalties which would unwind the big increase in GDP. It is possible that we will see this activity continuing. We could have even higher growth figures than in the first two quarters of the year. The Deputy's point, however, and the one we make in the publication is that it is true that this activity is likely to have a small domestic impact. If the activity is carried out abroad, there is little or no impact on employment here. We are trying to get the message across that clearly there is underlying momentum in the economy and growth across a number of sources which is becoming more broad-based but not to the extent the headline numbers suggest.

**Professor John McHale:** It is worth underlining the point that we believe there is strong growth momentum in the economy.

**Deputy Pearse Doherty:** But at about 2.2%.

**Professor John McHale:** In the Department of Finance's forecast, if one looks beyond this year, it is conservative in what it assumes what the level of contract manufacturing will be next year. The 3.9% growth number is uncontaminated by the contract manufacturing issue. We see a broadening of growth to include domestic demand, but one needs to be cautious of the tearaway growth that might be suggested by the figure of 4.7%. However, that is not to take away the message that there is momentum because there is real momentum in the economy.

**Deputy Pearse Doherty:** I have another question. Professor McHale will be aware that the CSO refused or clamped down on the Government's attempt to take the €250 million equity investment in Irish Water off the Government's balance sheet. It is back on the Government's balance sheet because it claimed Irish Water had been established on 1 October 2014. The council did not raise any concern about this. It was announced in the budget last year and I was concerned about it and teased it out with the Government. Is it something about which the council had concerns or did it go unnoticed?

The second point is that the issue of Irish Water is subject to EUROSTAT approval in March 2015. If it comes back in the negative, all rules will have been breached at that stage. Is the council concerned about this, given that the CSO has not come back in one case already?

**Professor John McHale:** I will let Dr. Conefrey answer the point about the CSO. We certainly do talk about Irish Water as one of the fiscal risks we face. The Deputy has mentioned that EUROSTAT's design essentially must stay on the general Government accounts, but the Government seems to have concluded that EUROSTAT will allow Irish Water to be off the general Government accounts, but there is a real risk in that regard. As the Deputy knows, there were two tests that needed to be passed. The share of revenue coming from non-Government sources as a fraction of the total output of Irish Water must be greater than 50%. We have been examining how that output will be measured. The Government is using a Revenue measure of output.

Another possibility is that the denominator in the calculation will be operating costs. It then becomes much closer whether the 50% test will be passed. There is uncertainty about how EUROSTAT will rule on this issue, but we will not know until next April or perhaps even for a number of years. It may take it a number of years to see, for instance, how the revenues being billed actually match the revenues coming in. In its calculations it is billed revenue that is

being used; therefore, the assumption is that the revenue will be raised. Initially, EUROSTAT may accept this, but it may then look at the pattern in terms of the discrepancy between billed revenues and actual revenues. There is uncertainty that is a source of risk and could potentially have a big impact.

**Deputy Pearse Doherty:** None of us will know probably until March next year. When the Minister toyed with the idea of tax relief, when questioned in the Dáil he mentioned that if the tax relief was to be given at source, it would fail. That is because it would be seen as a Government subsidy to Irish Water, but if it were to be clawed back, it is likely it would not be seen by EUROSTAT as a Government subsidy. That is the type of fine detail we are considering. Is Professor McHale concerned that the conservation grant which has nothing to do with conservation and is conditional on registering with Irish Water could be seen in the same light? If so, that is the one - pardon the pun - that will put the whole thing under water.

**Professor John McHale:** All we can say is that we do not know how EUROSTAT will rule on this issue. We have been examining how it has ruled on similar issues in the past and the process it goes through. It could be that it sees the conservation grant essentially as being a way to increase public transfers to Irish Water. It is yet another source of uncertainty in terms of how it will rule on this issue. It keeps its cards close to its chest and has not really indicated anything as of yet. From our point of view, it is a source of risk. If EUROSTAT was to decide Irish Water had to stay in the general Government accounts, we would be very much at risk of missing the 3% target. It is something at which we are looking and watching very carefully.

Mr. Conefrey can give an answer to the first part of the question about the CSO.

**Dr. Thomas Conefrey:** I do not really have much to add to what Professor McHale has said. As they are negotiating as we speak, we have as much information as is in the public domain.

**Deputy Pearse Doherty:** I am supposed to be in the Dáil speaking about the Water Services Bill and had better go. The expenditure stuff must be teased out a great deal more. The delegates have flagged this issue on two occasions.

The last point I want to make is that in its next report I encourage the council to go further on the expenditure ceiling. The report looks at how we have broken it this year, even though it does not apply this year, and will be close to edge in 2016. Combined, we are very close in terms of the two year rule. The demographic pressure on expenditure which the council has highlighted in previous reports is not being factored in. The former Minister, Deputy Pat Rabbitte, talked about chaos. If we factor in the demographic pressure, the already announced budgetary cuts in higher income tax rates and the ceiling, we will be in a serious position in budget 2016 unless something moves. In its next report I would like the council to expand on the work it has done to draw the public's attention to this issue.

At what other areas will the council look? It always looks at certain areas in its report, but has it identified the areas at which it will look now? The banks were mentioned, as well as possible share sell-offs, but are there other areas?

**Professor John McHale:** We are having an all-day fiscal council meeting tomorrow to discuss exactly that issue and set out our plan which I do not want to pre-empt. Certainly, the issue of expenditure ceilings and, more broadly, medium-term planning, particularly as it relates to expenditure, are the subject of ongoing work and will be a key part of the next report. We will take on board the Deputy's underlining of the issue and give it additional attention. We very

much welcome the joint committee's suggestions and when we receive them, we try to follow through to provide members with the information they need.

**Mr. Sebastian Barnes:** When we appeared before the joint committee six months ago, one of things we said was that these pressures were already being felt and that we had drawn attention to them. We also said it was very important that the comprehensive expenditure review addressed these issues and exactly how all of this was going to add up. We have seen two things since. First, the medium-term forecasts in the budget were just technical assumptions. They do not really line up with various statements. Also, the comprehensive expenditure review has not really delivered in giving us the detail of how all of this is going to fit together. There are important choices to be made, but it is not clear they have been made, both on the tax and revenue and expenditure sides and how they all fit together. That is a very serious concern.

**Deputy Pearse Doherty:** I am sorry, but I have to leave at this stage.

**Deputy Peadar Tóibín:** I had a question which Dr. O'Donovan was going to answer.

**Dr. Donal Donovan:** The Deputy had two questions. The first was on bank recapitalisation and the possibility that had surfaced at the EU summit attended by the Taoiseach two years ago. The idea could have been that the ESM would take over part of the capital the Government had put into the Irish banks and would do so without requiring a Government guarantee, which, other things being equal, would have meant a reduction in the Government's debt by the same amount. That proposal has not gained much political traction in European circles since the summit. To our knowledge, there has not been any public intimation at political level in Europe of progress since our last report. That is why we did not mention it, as there was nothing to mention. It remains a political decision for which there does not appear to be a great deal of support.

The Deputy's second question was on the status of the Anglo promissory note. In early 2013 it was replaced by long-term Government bonds. There are two aspects to this. First, the bonds were of a considerably longer duration than the original promissory note. While this did not affect the total size of the debt, it improved its profile considerably - at least for this portion of the debt - as the repayment and liquidation period of the bonds was much longer. The second aspect was they had a shorter-term financial nature because under the agreement with the ECB, they had to be repaid according to a minimum schedule starting next year. Without getting into too technical a level of detail, there are two effects as this happens. One is that there is some interest cost to the Government because as it sells these bonds on the open market, the interest will no longer come back to be included in the budget. On the other hand, as it sells the bonds, it may well be and probably is the case that there will be capital gains, given that interest rates are very low. Both of these things could offset each other and there might be a gain in the budget as these transactions take place. Their timing is a matter for the Central Bank, of course, and it may well pursue a timing plan which has significant effects on the budget.

I should note in respect of the beneficial effects of these operations, that while they are good for the budget, they do not count, by and large, in the measurement of the budget deficit for the purposes of compliance with the excessive deficit procedure. Members may recall in the debate on the fiscal council's views the Minister for Finance, Deputy Michael Noonan, made the point that actually the deficit for next year was really 2.5%, not 2.7%. The 0.2% difference relates to the net beneficial effect of the Central Bank's operations which cannot formally, according to EUROSTAT rules, be counted. Of course, economically it can be counted, but from the point of view of measurement, it is not.

**Chairman:** Has the council done much work on the comprehensive review of expenditure?

**Professor John McHale:** We have certainly looked very carefully at all of the documents produced. We believed it fell somewhat short in terms of good bottom-up expenditure planning. One of the things about which we talk in the report is that expenditure planning tends to be done more on a top-down basis as determined by the fiscal rules and then ceilings are given to particular Departments without fully taking into account the pressures on them. One then sees a pattern of ceilings being raised year after year as the pressures become apparent. Ideally, one should have more bottom-up expenditure planning underpinned by a comprehensive review of expenditure to identify pressures, where efficiencies can be made, with the best prioritisation of expenditure. Following this process, one would then set realistic expenditure ceilings taking into account these pressures and opportunities to achieve efficiencies. Ideally, Departments would then be held to these ceilings. More use could be made of the comprehensive review of expenditure procedure to engage in bottom-up planning. One would then move from a system of what are sometimes termed “soft budget constraints” where one tells Departments, “This is your budget and you had better stick to it,” but then changes the ceiling when pressures emerge. We have seen this particularly in the Department of Health. What one wants to move to is a hard budget constraints system under which the initial ceilings reflect the realities and the pressures on a Department. When one has hard budget constraints, it is better from the point of view of planning at the Department’s level because it will have a good idea of its budget. It also provides better incentives to seek out efficiencies and the better prioritisation of spending. We believe there is substantial room for improvement as part of an overall medium-term planning framework.

**Chairman:** Has the council done work on this? We hear much lip-service being paid to the comprehensive expenditure but is it relatively new?

**Professor John McHale:** This is the second round. Our feeling is that full use was not made of the process in terms of best practice and expenditure management. The Chairman is correct that this is at an early stage but, hopefully, it will improve over time. In this round, our conclusion is that it fell short of best practice in this area.

**Chairman:** Moneys can be allocated in the budget for a certain area but may never be spent on it and go somewhere else. When this is raised, the response is usually a shrug of the shoulders. Is there a concern that the administrative capacity is not in place to carry out these types of reviews? When one goes to certain conferences and meets top-level administrators, they often talk about the deficit and gathering information on it. Is there a lack of political will with regard to it?

**Professor John McHale:** The political will is important in recognising that this is a core component of a modern public finance system. Other countries have developed good medium-term expenditure control frameworks. On paper, we have what looks like a strong framework in place. There has been a deficiency in its implementation, however. The resources are there but the political will needs to be there too.

**Chairman:** Does our system have the capacity? I presume the council has made a comparison with the UK system.

**Professor John McHale:** One area we have looked at is the Swedish system which is a very well-developed expenditure control framework. There is best practice out there that one can examine. I see no reason our system does not have the capacity. It is about overall system

design and implementation of a framework.

**Professor Alan Barrett:** One could argue that doing a budget on an annual basis with aggressive lobbying in its negotiation consumes a significant amount of resources both for the political and senior Civil Service class. One can make the argument that by doing it on a multi-annual basis and sticking to it, one economises on resources which one can then deploy in doing the sort of evaluation to which Senator Barrett often refers.

**Chairman:** Is Sweden the best comparison?

**Professor John McHale:** Sweden would be considered a leader in this area. It went through its own fiscal crisis in the 1990s and, accordingly, put in place a strong fiscal framework. As a result of that, it survived the crisis very well. The question is whether we will follow through on the fiscal framework, which is strong, that we have put in place. If we do, we can avoid doing to ourselves again what we have done on more than one occasion in the past. This will be examined carefully in coming reports with the design and implementation of the framework.

**Mr. Sebastian Barnes:** I agree with my colleagues. We have not done a detailed comparative study of Ireland's administrative capacity compared to other countries. Part of this is the political commitment. A concern I had about the budget was that expenditure seems to have been pushed up again. That is not about administrative capacity. Someone has taken a decision somewhere and it is an important one.

Reading through the budget, I got a feeling of a lack of ownership about some of the fiscal rules. There was much discussion about the EU fiscal rules which come from Brussels. There was little discussion about the domestic budgetary rule or the domestic expenditure ceiling framework. If people are serious about the framework, there needs to be that buy-in and a willingness to reference to domestic rules. It is also important to state these are good rules which will be taken seriously. Instead, they were really downplayed in the budget documentation. That raises a question about the will to implement it and not about the capacity of civil servants to make a particular system work.

**Chairman:** If the council has any material on this, will it send it on to the committee for its consideration?

Some members tried to give the impression that the Irish Fiscal Advisory Council is unloved by the Government. I can assure the council that if some of the Opposition parties were in government, then it would be even more unloved. If there is a change in Europe and a move towards a stimulus policy which led to significant growth, could we be more positive about where we are going?

**Professor John McHale:** On the point about being unloved and Deputy Pearse Doherty's observation that we have been whingeing a lot about being ignored, it is actually the opposite. We do not feel we are being ignored but feel we are having a significant impact on this debate, partly through the committee too.

There is certainly an argument for more of a stimulus policy at European level, particularly for the countries that have fiscal space. This would be very beneficial to Ireland. The European Central Bank, ECB, is slowly moving in the right direction. Whether it will do more with quantitative easing is still up in the air. We would welcome more stimulus at European level.

One point we emphasise in the report is that there is good news for the economy. The

growth momentum is real. There have been dramatic improvements in Irish credit worthiness with bond yields at historic lows, along with strong improvements in the public finances. Naturally, the focus of the report tends to be on the risks which we point out are real. I hope the impression is not created that the council is not aware of the positive trends and progress Ireland has made.

**Chairman:** Does the council believe the Strategic Banking Corporation of Ireland could help improve the economy?

**Professor John McHale:** That really is getting away from our mandate and is more into policy issues. It is not helpful for the council to weigh in on issues such as that.

**Chairman:** I believe the council's work is good. It speaks about fiscal stability but we have to keep an eye on the political aspects of it. We find it terrible to think we might lose the general election in 2016 and the council was wrong because the economy was better than it said.

**Professor John McHale:** We certainly appreciate the political pressures. We also have a particular role to play which I said in one interview is to be a counterweight and, to some extent, a voice for future voters and participants in the economy, as well as being an advocate for their living standards. I am talking about the future and people who are around today who will also be there and trying to make a living in the economy. We have different roles to play and it is important that we play our role without fear or favour in terms of what the response to that will be.

**Chairman:** When we look at this comprehensive review of expenditure, this will obviously be seen as a very political issue and no doubt, the Irish Fiscal Advisory Council will be referenced in respect of it. If the council has any background work, we would really appreciate it and it would really help make it a very good debate because we will also be requesting the same background work from the Minister for Public Expenditure and Reform.

**Professor John McHale:** Yes.

**Chairman:** That is everybody's role here. When these meetings started a few years ago, it used to be impossible to get out of here. Things have improved slightly from that point of view. Does Senator Barrett wish to make another comment?

**Senator Sean D. Barrett:** In respect of the strategic banking corporation, the Minister took an amendment to the articles of association that its activity should operate in a counter-cyclical way. Our amendment ruled out the building industry because we have done that before. Some of it is incorporated in the articles of association. I think the Minister for Finance took it to some meeting of finance Ministers in Spain. The Irish Fiscal Advisory Council should keep an eye on them and make sure they operate as it would like them to operate because it is in the articles of association in any case.

I would like the comprehensive public expenditure reviews to be from the bottom upwards. If we look at Professor McHale's own area of interest, which is the health service, that is the target so what are the instruments? There are some studies showing that we keep people in hospital for far too long and it is extremely expensive. Other studies examine the balance between outpatients, GP services and hospitalisation, whether hospitalisation is extremely expensive, and the average length of stay is long. Top-level budgets for the health service just did not work. They just ignored them because the alternative was to throw patients out. If we are carrying out analysis, one might say that we can keep the healthiness but reduce the budget by not keeping people in. Certain treatments here take 11.6 days when they would take 3.7 days inter-

nationally. It is down to the way VHI pays hospitals. Of course, they will keep one in because one is a little goldmine when one is there. I would like to see a lot of this analysis rather than the kind of top-level stuff to which Professor McHale referred.

**Chairman:** That is outside Professor McHale's remit.

**Professor John McHale:** That is sectoral. Part of what Senator Barrett has been talking about is what is referred to as the soft budget constraint phenomenon. This is where one threatens to impose a budget constraint but when it becomes apparent what the consequences of imposing it will be, particularly late in the year, namely, throwing patients out or people dying, it is not credible to impose it. This then has important incentives because people do not take the constraint seriously to begin with. One can design systems of accountability so that if one does need to increase the budget to prevent those terrible outcomes, they may be the personal responsibility of the people who did not control the budget in the first place. These are issues of system design that we do see as part of our remit in terms of good expenditure planning and indeed forecasting, which is very much part of our mandate.

**Chairman:** The Senator mentioned my own interest as I am a GP. Primary care gives a massive return for every €1 invested in it and yet year after year, it has remained the Cinderella of the service. It is almost impossible to get the HSE or the Department of Health to make significant transfers of funds to primary care. That is not something the Irish Fiscal Advisory Council really does.

**Professor John McHale:** That probably gets too specific given our mandate.

**Chairman:** Professor McHale has enough on his plate. We will have to give him another 30 people. I thank Professor McHale and all of the members of the Irish Fiscal Advisory Council and its secretariat who have come here today. It has been very informative, as usual.

The joint committee adjourned at 3.54 p.m. until 2 p.m. on Wednesday, 10 December 2014.