DÁIL ÉIREANN

AN COMHCHOISTE UM AIRGEADAS, CAITEACHAS POIBLÍ AND ATHCHÓIRIÚ

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

Déardaoin, 11 Meitheamh 2015

Thursday, 11 June 2015

The Joint Committee met at 2 p.m.

MEMBERS PRESENT:

Deputy Richard Boyd Barrett,	Senator Paul Coghlan,
Deputy Ciarán Cannon,	Senator Jillian van Turnhout.*
Deputy Michael Creed,	
Deputy Stephen S. Donnelly,	
Deputy Alan Farrell,	
Deputy Paul Murphy,	
Deputy Arthur Spring,	
Deputy Peadar Tóibín,	

* In the absence of Senator Sean D. Barrett.

SENATOR AIDEEN HAYDEN IN THE CHAIR.

The joint committee met in private session until 2.25 p.m. Sitting suspended at 2.25 p.m. and resumed in public session at 2.30 p.m.

Business of Joint Committee

Vice Chairman: Before we begin our discussion with the Irish Fiscal Advisory Council, we will note EU scrutiny decisions taken by the Joint Sub-Committee on European Scrutiny - Finance and Expenditure. By way of information for members, the sub-committee at its meetings of 13 May and 10 June decided that the following proposals do not warrant further scrutiny: COM (2015) 129; COM (2015) 135; COM (2015) 150 and 151; COM (2015) 175; COM (2015) 160; COM (2015) 161 and 162; COM (2015) 241; COM (2015) 148; COM (2015) 152 and 153; COM (2015) 203; and COM (2015) 230. Is it agreed to adopt the recommendations of the sub-committee? Agreed.

Fiscal Assessment Report: Irish Fiscal Advisory Council

Vice Chairman: We will now discuss the fiscal assessment report with representatives from the Irish Fiscal Advisory Council. I welcome Professor John McHale, Dr. Róisín O'Sullivan and Dr. Íde Kearney. Dr. Thomas Conefrey, chief economist and head of secretariat, Mr. John Howlin, Mr. Eddie Casey, Mr. Andrew Hannon and Ms Sarah Doyle, all also of the Irish Fiscal Advisory Council, IFAC, are in attendance.

As to the format of the meeting, Professor McHale will make his opening remarks, following which will be a questions and answers session. I remind members, witnesses and those in the public gallery that all mobile telephones must be switched off. I will emphasise this as mobile telephones interfere with the broadcasting equipment.

I advise the witnesses that, by virtue of section 17(2)(*l*) of the Defamation Act 2009, they are protected by absolute privilege in respect of their evidence to this committee. If they are directed by the committee to cease giving evidence on a particular matter and continue to do so, they are entitled thereafter only to a qualified privilege in respect of their evidence. They 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 Houses or an official by name or in such a way as to make him or her identifiable.

I invite Professor McHale to begin.

Professor John McHale: On behalf of the council, I thank the committee for the opportunity to discuss our recent assessment published this day last week. Our engagements with the committee have been valuable in the development of our work and we welcome further feedback from members today. We view the opportunity to explain our assessments publicly as integral to the fulfilment of our mandate and important in fostering greater public awareness of the issues raised in our reports.

With me today are council members Dr. O'Sullivan and Dr. Kearney. This is Dr. Kearney's first appearance before the committee following her appointment to the council in March 2015. Mr. Sebastian Barnes, who is based in Paris, unfortunately cannot attend today. The council secretariat is also present: Ms Doyle, Mr. Casey, Mr. Hannon, Mr. Howlin and Dr. Conefrey, head of the secretariat and chief economist. The secretariat would like to thank the staff of the Oireachtas for their ongoing and useful co-operation.

I will cover our eighth assessment first. The report is written in line with the mandate of the council as set out in the Fiscal Responsibility Act. To begin with some good news, data over recent months have provided further evidence that the recovery in the economy has gathered momentum. A notable aspect of the performance of the economy in 2014 was the expansion in domestic demand, the first such increase since 2007. Crucially, the fruits of the economic recovery are gradually becoming evident in other areas. Unemployment has dipped below 10% for the first time in seven years and Exchequer tax data for the early months of 2015 have been positive.

Assisted by the resumption of strong growth and the impact of the consolidation measures implemented since 2008, the general government deficit, excluding the impact of banking measures, has fallen from a peak of 11.7% in 2009 to 4.1% in 2014. The deficit is expected to fall to well below the 3% excessive deficit procedure, EDP, ceiling in 2015. The main objective of fiscal policy since 2008 has been to reduce the deficit and restore the State's creditworthiness in order to create the conditions for a return to growth in employment, income and living standards. With economic recovery under way, we are entering an important phase in which fiscal policy must be used to ensure that a sustainable pattern of growth is established for the medium term. Ireland's legacy of high debt levels following the crisis calls for continued vigilance to ensure that the debt-to-GDP ratio remains firmly on a downward path in the coming years.

An important accomplishment of recent years has been the institutionalisation of a new budgetary framework comprising EU and domestic components. Consistency between the national and EU frameworks allows the two sets of formal rules and enforcement procedures to reinforce each other. The monitoring, peer pressure and financial sanction procedures of the Stability and Growth Pact helps give credibility to the national rules while the monitoring and enforcement procedures of the national rules, including roles for the Oireachtas and the fiscal council, provide a degree of domestic oversight and ownership of the overall rules framework. If respected, this framework provides an important safeguard against a return to the boom-bust cycle.

In the context of Ireland's new medium-term budgetary framework, MTBF, the spring economic statement, SES, provides a useful innovation in Ireland's medium-term planning by setting out the broad policy stance for 2016 in advance of the budget in October. However, the implementation of the new budgetary framework shows weaknesses that could undermine its effectiveness. As set out in our recent report, the weaknesses are evident in the budgetary plan for 2016 and in the medium-term projections for the public finances, which fall short of meeting what is required under the new budgetary framework in some key respects.

I will discuss the council's assessment of the outlook for 2016 as set out in the stability programme update, SPU. Until Ireland reaches its medium-term objective, MTO, of a balanced budget in structural terms, the Government is required to lower the structural deficit by 0.6% of GDP each year. SPU 2015 sets out a plan that lowers this deficit by just 0.3% of GDP in 2016, thus falling short of the requirement on a forward-looking basis. The rule to lower the structural deficit is supported by the expenditure benchmark, EB, which sets a limit on allowable expenditure growth. As described by the council in April, the original method for calculating the EB contained an anomaly. This has now been corrected. However, the Government has introduced a further adjustment for "tax buoyancy" that goes against the letter and spirit of the EB rule. The council does not include this tax buoyancy effect in its calculation of the EB and, on this basis, there is a considerable risk of non-compliance with the rule in 2016.

The council is strongly of the view that Government plans should be based on expected compliance with the fiscal rules and that the reasons for any deviation should be clearly explained. Rather than a plan that falls short of the requirements, an adjustment in line with the minimum improvement required under the rules would be appropriate in 2016 in light of Ireland's high debt levels and improved cyclical conditions. Full compliance in 2016 would also signal the Government's commitment to the new budgetary framework now that the degree of external surveillance has eased with the ending of the troika programme.

A major theme of last week's report and the council's November 2014 assessment concerned the forecasts for the public finances in the medium term. Proper medium-term fiscal plans are vital for a number of reasons. They provide a comprehensive and realistic framework for the planning and management of public expenditure in the medium term by linking annual budgets to longer term fiscal targets. Well-specified medium-term plans increase the predictability of the budgetary planning process by providing realistic estimates of revenue, expenditure, deficit and debt over a three-year period. Medium-term planning is also important in providing a link between resource allocation and Government policy and priorities and can guard against a return to short-term incremental budgeting.

The budgetary frameworks directive requires the Government to provide medium-term projections of each major expenditure and revenue item based on unchanged policies as well as on the basis of envisaged policies. SPU 2015 falls short of these requirements. The post-2016 budgetary projections in the SPU are based on mainly technical assumptions for Government revenue and expenditure. As a result, the forecasts show overcompliance with the fiscal rules even though stated policy in the spring economic statement is to target minimum rule compliance. Tax forecasts assume no change in policy after 2016 while spending profiles do not adequately take account of underlying expenditure pressures. The ratio of non-interest Government spending-to-GDP is projected to fall by more than 5% between 2015 and 2020.

Analysis presented in our recent assessment report demonstrates how such a sustained fall in Government spending would be challenging to achieve while maintaining current services and meeting demands for increases in public services due to demographic and other pressures. A conservative illustrative scenario for Government expenditure that takes account of likely expenditure pressures is set out in the report. The exercise indicates that Government primary expenditure as a ratio of GDP would fall by approximately 2% between 2015 and 2020. As already noted, SPU 2015 in contrast envisages a much steeper 5% fall in expenditure over the same period.

Given these shortcomings, the deficit projections in SPU 2015 do not provide a useful picture of the fiscal position after 2016 and fall short of the requirements envisaged in the budgetary frameworks directive. While it is not expected that specific revenue and expenditure measures would be detailed over the medium term, full acknowledgement of spending pressures, the overall value of intended revenue measures and, consequently, a deficit path should play a central role in medium-term projections.

A major weakness of Ireland's approach to fiscal policy prior to the crisis was that expenditure plans focused almost exclusively on the following year, 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. Multi-annual ceilings were introduced to address serious expenditure management problems and represent a core component of the new domestic budgetary architecture. This system is not working effectively because the Government has consistently made adjustments to the ceilings. This undermines its value as an expenditure planning and control tool. Moreover, the move to annual revisions to the allowable expenditure growth under the expenditure benchmark has removed the multi-year anchor from the domestic medium-term expenditure ceilings. The Government needs to clarify how the system of multi-year ceilings will operate under the revised expenditure benchmark framework. The domestic medium-term expenditure framework should be strengthened to ensure that multi-annual planning is a central element in the budget process.

To conclude, Ireland's post-crisis budget framework should help avoid boom-bust cycles and guide Government debt to safer levels. It is therefore important that the framework is respected in fiscal plans. Rather than being viewed as something externally imposed on Ireland, the new budgetary framework should be seen as something in the national interest to the extent it underpins sound budgetary policy. Adherence to the budgetary framework during good times can help avoid the necessity for the type of painful budgetary adjustments implemented during the recent crisis. In an uncertain growth environment, respect for the framework can improve the resilience of the public finances.

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

Chairman: I thank Professor McHale. We will adhere to our usual ground rules. I propose that the lead speakers for each of the groups present will have ten minutes, followed by other committee members, who will have five minutes. Anyone else who wants to come back in for further questions may then do so. I suggest, as with normal procedures, we start with Deputy Tóibín.

Deputy Peadar Tóibín: Gabhaim mo bhuíochas leis an tOllamh McHale as ucht an cur i láthair. Professor McHale mentioned financial sanctions. What are the financial sanctions within the EU framework?

Professor John McHale: The financial sanctions, as Deputy Tóibín says, are related to the European element of the fiscal rules and not the domestic element. There is a graduated set of sanctions that begin with a remunerated deposit. It then becomes a deposit that does not bear any interest. Finally, if there is continual non-compliance with the rules, there is the possibility of a fine of up to 0.2% of GDP.

Deputy Peadar Tóibín: That is a significant fine.

Professor John McHale: Yes.

Deputy Peadar Tóibín: The last time Professor McHale was here, we discussed the issue of stimulus. The State still has major infrastructural gaps within housing, broadband and a lot of the infrastructure a competitive economy needs. Professor McHale mentioned that there was still space at that moment in time for the Government to be involved in capital investment in these, and for stimulus. In other words, there was capacity within the economy. Is that still the case?

Professor John McHale: The official measure of the state of the economy, which is referred to as the outward gap, is now slightly positive. The official measure would have the economy operating slightly above its potential. Our assessment is that there is probably still some excess capacity in the economy and there is a small but narrowing outward gap, in the sense that there is room for the economy to expand without unsustainable pressures building up.

Deputy Peadar Tóibín: It is a week since this report was published. Has the council had any deep conversations with the Government? What has been its engagement with the Government so far on the report?

Professor John McHale: We do not really engage at a non-public level with the Government. We very much report publicly, including appearing before this committee. Our discussions with the Department of Finance would be on a technical level. There have not been discussions about the report at a political level.

Deputy Peadar Tóibín: With regards the criticisms the council has made, what would be required to satisfy it? What would the Government need to do to satisfy the council?

Professor John McHale: We would like to see the Government implement the budgetary framework that has been put in place. As we note in the report, this framework should provide important protections so that we do not repeat the kind of mistakes that have been made before, in particular, mistakes that tended to get made in good times. The budgetary framework is a combination of the European rules, mainly the Stability and Growth Pact. There is also a domestic component to that framework. We have our own Fiscal Responsibility Act. In addition to that, we have a system of medium-term expenditure ceilings, more broadly, the medium-term expenditure framework. The budgetary framework that I am referring to is a combination of European and domestic elements. It has been very nicely brought together in a document called the Medium Term Budgetary Framework, which lays out all the different elements and how they interact. We would like to see the basic framework being respected and the plans that the Government lays out being consistent with the requirements of that framework. The plans that were laid out in the stability programme and spring economic statement were not consistent with the requirements of the framework for 2016 and, even more seriously, a full and proper plan that was consistent with the requirements of the framework was not laid out for the period post-2016 .

Deputy Peadar Tóibín: If the Government were to reduce its plans to give tax back in the next budget, would that bring it within the framework?

Professor John McHale: It would depend on the amounts. The plans laid out in the spring economic statement involved an expansionary package of €1.2 billion. It said that the package could be between €1.2 billion and €1.5 billion, but the plans themselves were based on a budgetary package of €1.2 billion. Our calculations suggest that to be fully in compliance with the various rules, the package would be somewhere in the region of €700 million. The precise figure may well change by budget time. There are many moving parts to this. Our concern is that, based on the Government's own best projections, it set out a plan that was not fully consistent with the requirements of the framework.

Deputy Peadar Tóibín: Given the Government's expansion is approximately twice what Professor McHale thinks it should be, does he think the Government is anti-cyclical or procyclical?

Professor John McHale: That is a very good and difficult question. At the moment, as I said earlier on, we think there is a probably relatively small but shrinking shortfall relative to the potential of the economy. If we did not have any other constraints, it would be appropriate to have a more expansionary policy. Unfortunately, we do have additional constraints, including the very high debt level and the fact that we still have a deficit and are continuing to borrow. We need to get that debt onto a downward path. Balancing the different factors together - the need for cyclical stimulus is now reducing but we still have these issues with the high debt level - we think that a policy that is broadly in compliance with the fiscal framework would be appropriate. I would not exaggerate the effect of the somewhat larger expansionary package the Government is planning from a purely substantive economics point of view. However, one concern is that if one begins to disregard the framework at this very early stage, and we are not that long out of the crisis, there is a question of whether the institutional framework really will be strong enough to prevent us from making the kind of mistakes we have seen before. We would, therefore, like to see the framework being respected.

Deputy Peadar Tóibín: It seemed to me that if one took out the tax breaks to those on upper incomes, what was left in the spring economic statement with regard spending and public expenditure was really only going to take account of the growth in demographics. The *per capita* spend on that side would actually be static or slightly falling. Is that Professor McHale's assessment?

Professor John McHale: From our understanding, the breakdown of the €1.2 billion is approximately 50:50 between expenditure and revenue measures. The Government projects that demographic pressures will add approximately €300 million per year, which suggests that approximately half the expenditure increase would meet those demographic pressures. In the report, we ran our own scenario which would suggest that the demographic pressures are somewhat higher than that, potentially close to €500 million rather than €300 million. To this extent, the demographic pressures would come reasonably close to using up the €600 million the Government has identified.

Deputy Peadar Tóibín: One of the interesting points is that it is forecast that GDP will grow by approximately 17.5% by 2020, while Government consumption is to increase by only approximately 5.7%. Is it the stability programme update, SPU, plan that we will have this continuing downward pressure on Government consumption?

Professor John McHale: We focus in particular on non-interest Government expenditure, which is projected to fall by 5% of GDP between 2015 and 2020. There is a graph in the report that shows it has fallen to levels that have not been seen in the decades for which we have data. This is not credible, given that it does not adequately take into account demographic pressures, nor does it take account of the underlying pressures in terms of the cost of providing Government services. It is unlikely to happen.

Deputy Peadar Tóibín: In political terms, it seems like a plan for small government. That is perhaps not an issue on which Professor McHale might touch. Deputies Pearse Doherty and Michael McGrath have previously mentioned the issue that Opposition parties would have an opportunity to put their budget proposals to some kind of unit to have them costed in advance of an election, or even annually, in order that we can have proper discourse rather than accusations that our proposals have been less thoroughly costed than others. Debate could be on the policy rather than on the costing element.

Deputy Michael Creed: Be careful what you wish for.

Deputy Peadar Tóibín: Would IFAC have the facility or the competence to perform this role, now or in the future?

Professor John McHale: Yes. Such a costing arrangement is a very good idea and would strengthen the overall budgetary architecture. However, it would be a very resource-intensive activity and if it were done, it would be very important that it would be done well with much credibility for everyone involved in the process. We would not have the resources to do something like it now and it would take a reasonable lead time to ensure the capacity was in place. Potentially, given adequate resources, we could examine doing it in the future. However, it would not need to be us. An Oireachtas budget office would be an alternative. It is a good idea, but it must be done right and adequately resourced.

Deputy Michael Creed: I welcome Professor McHale and his colleagues. These exchanges have proven to be very worthwhile, and IFAC has done the State some service since it was established, for which I am thankful. It takes a certain amount of character and conviction to come here consistently and throw cold water on us all the time. This is what Professor McHale needs to do. It is important we continue to meet the financial architecture deficit reduction targets. In terms of the overall framework within which we operate, the rules are very good for an economy that moves along seamlessly year after year. However, for an economy such as ours, which has been through a very substantial economic shock and in which capital investment was paused very substantially for several years, has Professor McHale any sympathy with the view that economies need to catch up in terms of the infrastructure deficits that were not attended to during those years, particularly in the area of public expenditure?

Professor John McHale: I agree that capital investment suffered very significantly during the crisis and took a disproportionate share of the hits to expenditure. In terms of the long-term growth potential of the economy and providing key social services, there are disadvantages and deficits that have resulted from the reduced investment. On the other hand, the overall framework is broadly suitable for Ireland as much as it is for other countries. The framework has different elements to it. Until now, we have been in the so-called corrective arm, which, as I noted in my statement, allowed the deficit to rise, not including the cost of bailing out the banking system, to 11.7% of GDP. It is not totally rigid, but it allows countries' deficits to increase substantially when they go into recessions. This helps protect expenditure, including capital expenditure, to a certain degree. However, once the deficit goes above 3% of GDP, one has to start taking actions to ensure it does not completely spin out of control. We did this, and it looks like we will get the deficit below 3% of GDP this year, which is an impressive achievement given that in 2009 we had a deficit approaching 12% of GDP.

Next year, all going to plan, we will move to the next phase, which is the so-called preventative arm of the Stability and Growth Pact. Then, we must slowly move towards a balanced budget adjusted for cyclical factors. Certain adjustments will still be taking place, and expenditure will have to be kept below the underlying growth of the economy. This should allow more room for expenditure increases, although I would not exaggerate the size of them, and it is to be hoped the kind of squeeze that has been taking place in capital spending will be lessened in the years ahead.

Deputy Michael Creed: In Professor McHale's analysis, we will not catch up on seven years of effective pause in capital investment in key infrastructure. There is something highly ironic about the situation whereby I go to the Minister for Public Expenditure and Reform, Deputy Howlin, to discuss key infrastructural issues in my constituency that impact on the national and regional picture. Professor McHale talks in abstract terms whereas we, as politicians at the coalface, deal with practical issues. I live in Macroom which is one of the biggest bottlenecks in the Cork-Kerry road link. The project to build a new bypass is ready to go, yet the Minister, Deputy Howlin, has told me that while he has the money to spend and there was never a better time, he does not know whether he can do it because we have all these rules that say "no". The project has the most favourable cost-benefit analysis of any project on the NRA's books. This is because of seven years of paused investment. Regarding the N28, the relocation of the Port of Cork, the Jack Lynch tunnel, the Dunkettle interchange or any other project people around the country could list, Professor McHale's analysis is that we will never catch up, that while we have a level of capital investment now, we will never be allowed to make up for the seven years' lost time. Bearing in mind this and the requirement to maintain some degree of social cohesion, it has been an admirable characteristic of the endeavour, although some might disagree, that we have tried to bring as many people as possible with us in the economic recovery and have a degree of fairness. I come from the view that we run our household pretty tightly - that we do not go mad. I acknowledge the sins of the past, but there is a degree to which one must provide for repairs to the leaking roof. However, Professor McHale is saying that one must live with the continuous drip from the ceiling because one will never get around to repairing the household properly. I think this analysis is consigning people to never making up for the lost years in meeting the requirement of a modern economy for broadband, proper infrastructure, health services, hospitals and schools. At a political level I do not think one can sell that message. I think we have to sell hope as well as fiscal responsibility.

Professor John McHale: Deputy Creed is certainly correct that we do look at the big picture. That essentially is the job that we have been given. The mandate is very clear that we are looking at-----

Deputy Michael Creed: I am looking for warm water and not cold water all the time.

Professor John McHale: I absolutely understand that Deputy. I know that politics is very local and I understand the pressures that Deputies are under, but if one does not look at the big picture-----

Deputy Michael Creed: We have done the big picture element, that is the deficit reduction. We have met and exceeded those targets. Professor McHale previously admonished committee members for slipping on our targets, but we always met them, notwithstanding his concerns at various stages.

Professor John McHale: Yes, indeed, it has been a very successful adjustment effort. The creditworthiness of the State was one of the things we were concerned about most at our earliest meetings. When we came into existence in the middle of 2011, Irish bond yields were 14%. There was an implied probability that the Irish State was going to default of between 85% and 90% at the time. It was in that context that we felt the adjustment may need to be reinforced to make sure that we did get through it. Ultimately the adjustment has been successful. It is important to remember that the mistakes that really led to the disaster that we went through were made in good times. What we want to ensure is that we put an institutional framework in place that prevents us from ever doing that again. It is hardest politically, and I understand that the demands on members will be greatest, when it seems that times are improving and people want to see investments that may have been postponed in the past, to take place.

Dr. Róisín O'Sullivan: Deputy Creed's point on the need for capital investment and infrastructure really underscores the need for a medium-term perspective on fiscal policy. If one looks at the stability programme update post-2016, there is no allowance for an increase in capital expenditure. It is done on a technical basis pending the capital review, but nonetheless it is not in there. If one thinks about the needs of those kinds of projects, the bypasses, bridges and so on and one looks at that in the medium term perspective, it should then inform one's decision about one's ability to cut the sustainable revenue streams to finance that investment. It is important to distinguish between the deficit, the difference between the revenue flows and expenditure and the size of the gross flows. To have a responsible fiscal policy and to have a manageable deficit does not mean that one cannot have government expenditure if that government expenditure is financed by sustainable revenue flows.

Deputy Richard Boyd Barrett: I thank Irish Fiscal Advisory Council for its latest report and for its work on the anatomy of the economy. To cut a long story short, my interpretation of what the IFAC is saying is that the Government has been playing by the rules to date but all of a sudden it has stopped playing by the rules and the figures for its projections beyond 2015 do not add up. Is that what the IFAC is saying? The Government is now including projections for tax buoyancy and growth, which it cannot reasonably deduce from the figures? Is IFAC saying that it is a pre-election stunt by the Government?

Professor John McHale: We are not making any judgments on motivations but it is a fact that the plan the Government has laid out is not fully in compliance with the rules.

Deputy Richard Boyd Barrett: Is there any sanction for that? What can happen now in that regard?

Professor John McHale: At the moment what is being discussed are plans. The Commission as well as the Irish Fiscal Advisory Council look at the plans. There is no sanction for setting out plans that are not in compliance with the rules. The sanctions come in after the fact and so if we are talking about 2016, if the Government misses key targets by a significant margin in 2016, a judgment will actually be made about that in 2017, once the outturns for 2016 are in. On that basis sanctions might be applied. As we discussed earlier, there is a process before sanctions get applied. In this report we are talking about the plans and the sanctions do not come into the discussions at this stage.

Deputy Richard Boyd Barrett: Does Professor McHale say it is beyond doubt or close to being beyond doubt that the Government's figures do not add up and that in reality the figures will end up outside the targets post the election?

Professor John McHale: No. We are not saying that. Even by budget time, these projections change, so for example, there is a projection for the size of the output gap as part of the projection for the structural balance that I spoke about in my opening statement and that could change. The concern of the IFAC is that we need this framework to protect us from making the kinds of mistakes that were made before, particularly in good times and to set out a plan based on the Government's best projections both on the macro side and the fiscal side is not consistent with that framework. We can set a framework that will make sure we do follow sustainable policies that do not create the kind of vulnerabilities that caused such problems before. It is not a strong prediction that once all the figures are in that the Government will have missed these targets and will be sanctioned. It really is whether we are going to take seriously the new budgetary framework as a means to ensure that we really pursue sustainable growth. I know the Deputy in previous times when IFAC came before the committee has emphasised the importance of sustainable growth. We really see this framework as a key contributor to making sure that we keep the Irish economy on an even keel and do not have a boom-bust cycle that caused such harm before.

Deputy Richard Boyd Barrett: I am very much for sustainable growth. I strongly fear that what we are looking at is a pre-election giveaway without much concern for the rules that previously were apparently sacrosanct for this Government and were the justification for just about every nastiness they inflicted on us.

Having said that I want to ask questions about the metrics and measures that the IFAC is using. Are we constrained by what is actually a useful measure? That is a slightly separate point that I will deal with later. I want to be clear about what IFAC is saying about how the Government is diverging from rules that it previously adhered to and told us we had to adhere to and which puts us in danger of going outside the fiscal targets. Am I correct that the three areas the Government is not taking into account in its projections are demographic pressures, that its growth projections are tenuous and will somebody remind me of the third area? The third one is tax buoyancy. Are those the three areas?

Professor John McHale: They are the quite different areas. To take the middle one on growth first, we have endorsed the growth projections underlying the stability programme and, as such, we do not have a significant issue with those. We produce our own benchmark forecasts which are a bit different, but certainly the Government's projections are within what we consider to be an endorsable range. Once we look beyond 2016, the Government is over-complying with the fiscal rules. The problem is not that it is not complying; it is actually bringing down the structural deficit by more than 1% of GDP per year and is well above the required level of 0.6%. Our problem after 2016 is that the projections are not based on a plan. For instance, we know the Government has a stated intention to have tax cuts post-2016, but those tax cuts are not built into the projections at all. A matter that came up before and which Deputy Boyd Barrett raised again is that on the expenditure side we know there are underlying demographic pressures and other pressures on Government spending which are not built into the projections post-2016 or certainly they are not adequately built in. It leads to the projection that non-interest spending as a share of GDP will fall by 5% of GDP over that period, which is not credible. That is really what our problem is post-2016. It is not non-compliance with the rules, but there is no proper plan based on proper projections, particularly on the expenditure side.

Deputy Richard Boyd Barrett: Shifting the goalposts from the Government's point of view is fairly evident to people, but worth underlining as we enter into the election. There is a more serious argument for saying that we do not have to overshoot the targets. In fact, I was at a presentation given by Michael Taft earlier on an alternative fiscal framework for a progressive alternative economic policy. He said there is absolutely no reason we should try to get to a surplus by 2018, as the Government plans, and that we could do it by 2020 with lesser adjustments. That would give us considerably more space to spend and invest. What does the council say to that?

The other interesting point Mr. Taft made was on the structural deficit as a useful metric and early warning system against possible return to boom and bust. If one looks at the structural deficit for Ireland before the crash, it did not tell one anything about the possibility that a crash was coming. In fact, one would think that everything was rosy in the garden. He says it is a useless measure of whether something bad is about to happen. One thing I have signalled to the witnesses that I therefore consider very worrying and which none of the metrics have picked up was at the centre of the last crash. I refer to property and what is happening there. Housing is a disaster that is going to get worse very quickly, not just from the point of view of those who need it but from the macro point of view. The cost of accommodation is going through the roof, which has all sorts of knock-on effects. Should we not be jumping up and down and screaming alarms, so to speak, over that fact?

Lastly, the council has a section on the statistical treatment of Irish Water in its report. Can the witnesses summarise it briefly? As I understand it, the council is saying that because of the huge subsidy that has been given to Irish Water and because the charges have been set so low, it cannot possibly cover its costs. It will have to subsidise it with the €100 and all this kind of stuff. One effect is that the capital investment programme is not much. It also affects our deficit. Those subsidies increase our deficit. Is it fair to say, judging from this, that for Irish Water to stop having an impact on our deficit and to cover its own costs, domestic charges would have to increase dramatically?

Professor John McHale: I thank Deputy Boyd Barrett for the questions. In terms of his first question, the Government projects currently that we will be back to structural and actual budget balance between 2018 and 2019. As I have said, that is post-2016 and not based on a fully specified plan. If there was minimum compliance with the fiscal rules, we estimate that one would reach structural balance by 2020. As of now and certainly for 2016, we consider that minimal compliance would be an appropriate policy. We do not advocate going beyond that and reserve judgment about whether it would be an adequate policy for the later years. To the extent that it is an adequate policy, following the rules to do minimum compliance with them and getting to structural balance by 2020 would be an appropriate policy. In that sense, there is no gap between what Deputy Boyd Barrett said Michael Taft was advocating. Certainly, compared with the plans the Government has laid out, which involve very large reductions in the structural deficit post-2016, that would create more space. However, we do not feel they are real plans in the sense that they do not take into account the planned tax reductions. Assuming minimum compliance remains an appropriate policy, reaching structural deficit by 2020 looks appropriate at this stage.

The Deputy is absolutely right about the measurement of the structural deficit. In the run-up to the crisis, the measures of the structural deficit and associated measures of the output gap were extremely poor. In retrospect, we know that we were in an unsustainable situation with the economy operating well above its sustainable projection and the measures of the output gap did not pick that up at the time. As the Deputy said, they essentially gave us nonsense measures of the structural deficit. As such, one of the things we have been working very hard on at the council is to come up with better measures of potential output and, therefore, the output gap and, therefore, the structural deficit. We are working on measures that take into account broader sets of imbalances in the economy, including imbalances in the housing market, imbalances potentially in credit markets, and factors relating to the size of the current account imbalance. We had a very large current account deficit prior to the crisis, a sign of imbalance that was not taken into account at the time. The Deputy's criticism about measurements of the structural deficit and other key aggregates is bang on. To ensure we do not make those kinds of mistakes again, we must improve our ability to measure these things. We and others are working very hard on that.

Vice Chairman: I will stop Professor McHale there. He can come back to Deputy Boyd Barrett's questions afterwards. We are well over the time for his particular section. I call Deputy Arthur Spring.

Deputy Arthur Spring: How does the council think the economy is performing right now?

Professor John McHale: The economy is performing very well at the moment.

Deputy Arthur Spring: Why does Professor McHale think that?

Professor John McHale: One of the very positive features is that growth, to the extent that it had been taking place over recent years, was concentrated in the net export sector. We are now starting to see that broaden out to the domestic sector. It will take a number of years of strong domestic demand growth before people really begin to feel it. Even though we are only at the early stages, having that turnaround from a contracting domestic economy to a growing one is very welcome. We are also starting to see it show up in the labour market. The Deputy will recall that the unemployment rate was over 15%. Now that it is below 10%, we are starting to see a turnaround in migration flows. I know that things are still difficult on the ground, but they are turning around.

Deputy Arthur Spring: Does the professor think the economy has performed better than the council projected in 2011? When he first came before us in 2011, did he think we would be at the point we are at now?

Professor John McHale: We did not make projections in 2011.

Deputy Arthur Spring: I remember that the council asked us to go further in making cuts in 2013.

Professor John McHale: Yes.

Deputy Arthur Spring: We were asked for a further €600 million in budgetary cuts.

Professor John McHale: I will be very honest-----

Deputy Arthur Spring: With a couple more of my colleagues, I was adamant that the council was not in touch with the political atmosphere-----

Professor John McHale: I agree that I may not have been in touch with the political atmosphere.

Deputy Arthur Spring: -----and, in particular, the economic nuances in what was happening on the ground.

Professor John McHale: Even in 2010-2011 I would have viewed myself as one of the more optimistic economists. The Deputy will recall that there was a lot of doom and gloom about the economy.

Deputy Arthur Spring: More than a lot.

Professor John McHale: Looking at the situation in 2011 when the fiscal council came into being, I thought we could get through it with the plan the Government was putting in place, as well as the plan the previous Government had put in place, for a basic adjustment strategy. Even though I was optimistic, in the most likely scenario I knew there were huge risks in terms of growth and what had happened on the European side.

Deputy Arthur Spring: Is the professor confident that the growth achieved is due to an economy not driven by credit and construction as much as it was in the past? I am sure he is familiar with the projected growth rates in tourism and agri-business and aware of our ability to export more high value-added products, resulting in the creation of jobs and net migration. Is he comfortable with the view that we have achieved a sustainable growth model?

Professor John McHale: It is certainly much more balanced sustainable growth than in the mid to late 2000s.

Deputy Arthur Spring: What growth rates would be viewed as normal and sustainable in terms of the framework about which the professor spoke? What are the predicted growth rates?

Professor John McHale: In the medium term we see a sustainable growth rate of between 3% and 3.5% in the economy. It will vary from year to year. We are experiencing catch-up in terms of the unused capacity in the economy. We can do so without unsustainable pressures building. It is unlikely that we would be able to sustain a growth rate of 5% for any length of time without pressures building. We predict growth rates somewhere between 3% and 3.5%. That is the best estimate.

Deputy Arthur Spring: The European average is projected to be around 2.2%. The projected growth rate within the fiscal framework is in the region of just over 2%.

Professor John McHale: That is a very optimistic growth rate for Europe.

Deputy Arthur Spring: Ireland is an outlier in terms of how the framework was envisaged to work at the beginning. Perhaps some of the professor's colleagues wish to comment. I think he said the framework broadly worked for Ireland. An awful lot of what is going on in the country is unique. Ireland has the highest growth rates in Europe. How does this blend into the framework?

The professor talked about meeting targets. He broadly said he agreed with what the Government had in place, but we have been told our growth rates are conservative. During the week the ESRI stated they would be superseded. How does this blend in in terms of whether we will meet our targets? Perhaps the professor's colleagues wish to comment.

Professor John McHale: It would be great to hear from the others.

Deputy Arthur Spring: Does Dr. Kearney want to give us the benefit of her knowledge?

Dr. Íde Kearney: I was hoping I could stay quiet.

Deputy Arthur Spring: As there is no fire, it is all water.

Dr. Íde Kearney: I am not entirely sure I understand the Deputy's question. Is he asking if Ireland has a higher average growth rate than the EU average and that we should we have a different framework?

Deputy Arthur Spring: Yes. Does the framework work when one looks at the model constructed on day one?

Dr. Íde Kearney: I have a very conservative answer. Given the baptism of fire the economy has had in the past ten years and the debt rate with which we are faced, it should be an absolute priority to get the deficit under control and as low as possible.

Deputy Arthur Spring: Is it of paramount importance?

Dr. Íde Kearney: Yes. Despite the austerity package we have experienced in the past seven years, Ireland has still managed to secure its current growth rate. Therefore, we should let the economy grow and try to keep the deficit down.

Deputy Arthur Spring: Does Dr. Kearney think that has been done in a manageable form to date?

Dr. Íde Kearney: Yes.

Deputy Arthur Spring: Given what has been projected, does Professor McHale believe we will miss the targets set for next year?

Professor John McHale: The Government has set out a plan and we are pointing out that, based on its best estimates, it will miss the targets set. That shows a certain lack of respect for the framework. We should never do this to ourselves again. There have been important institutional innovations, including the budgetary framework which we must now respect. I know that this is difficult to do in the lead-up to an election and we understand the pressures, but in a sense, it is a test of how seriously the framework is going to be taken.

Dr. Róisín O'Sullivan: There are elements of the budgetary framework that take the potential growth rate into account. Let us take the expenditure benchmark, for example. If Ireland's potential growth rate is 3%, as opposed to 2% in other countries, under that benchmark expenditure can grow faster. The constraint is making sure we have sustainable revenue sources to finance that expenditure. If our potential growth rate is higher, the rate of growth in expenditure can be higher too. That is allowed for in the framework.

Deputy Arthur Spring: Would we as a result have a higher percentage figure in terms of expenditure than all other countries in Europe?

Dr. Róisín O'Sullivan: Not a higher percentage GDP figure because-----

Deputy Arthur Spring: There is no need to explain. Does the council believe the level of flexibility within the framework is appropriate for a country that is not exactly living within the European average figure? To use the council's terminology, Is the framework flexible enough to be compliant?

Professor John McHale: Along the lines of what Dr. O'Sullivan said, just because Ireland has a relatively high growth rate does not make the framework inappropriate for it. As she said, if one has a higher growth rate, one can have higher expenditure figure. The advantages of the framework in making sure we pursue a sustainable policy are just as great for Ireland as they are for other countries. In newer forms of the framework new flexibilities are being built in. That means that if one's growth rate is lower or one operates well below one's potential, the adjustment one must make is reduced. There are new allowances made for countries which are undergoing certain structural reforms that will have a positive long-term impact on their public finances which can be taken into account. The framework is moving towards being more flexible.

Deputy Arthur Spring: We would all like to see the debt figure lower to give people hope. We also all want the economy to grow, services to expand and people to have more disposable income. The country can borrow money cheaply at a rate which is a long way from the figure of 14.5% in 2011 when we were headed towards default and we can achieve growth rates of over 4.5%. In that instance, would it make economic sense to borrow money cheaply which we could use to grow the economy? Obviously, a return on that investment would help to grow the economy further with the debt staying constant. Does this scenario blend into the thought processes of the council?

Professor John McHale: The Deputy has raised a very good point. If my colleagues and I had complete control over the design of fiscal rules, we would keep current and capital spending separate. We would also apply the rules to current spending rather than capital spending. In terms of capital spending, where one has opportunities to invest and where the cost of capital is well below the rate of return on a project, from an economic perspective, one should undertake these investments.

Deputy Michael Creed mentioned the following but perhaps I did not realise it fully. The concern is that when it is all lumped in together, one will be forced to cut capital spending when the actual projects themselves make sense on an economic basis. I am sure my colleagues agree with me on this, but I think the ideal set of rules would make that distinction between current and capital. Unfortunately, however, they are not the rules we have.

Deputy Arthur Spring: That is very interesting, particularly in a phase where we are trying to catch up on our capital expenditure. I do not know if it worth Professor McHale's while doing a bit of modelling around that and reporting back to headquarters in Brussels to let them know that it is not working for us as well as we would like it to work. I thank Professor McHale for engaging with us. He knows about it better than us.

Deputy Paul Murphy: I thank Professor McHale for the presentation. I want to take up where Deputy Boyd Barrett left off concerning water charges and the EUROSTAT test being off-balance sheet. The test is that over 50% of the revenue comes from market sources in effect. Is that correct?

Professor John McHale: Yes.

Deputy Paul Murphy: Based on figures from the stability programme update and from the Department of Finance, Professor McHale is estimating that €500 million is down as revenue, domestic and non-domestic charges, and €400 million is support from the local government fund and the Exchequer. Would it be correct to say that Irish Water would fail the off-balance sheet market test if the total revenue was to fall below the €400 million, if the €400 million were to remain the same?

Professor John McHale: Our understanding is that EUROSTAT, at least for the moment, will be focusing on billable revenue in making that calculation.

Deputy Paul Murphy: Only billable revenue?

Professor John McHale: Only billable revenue.

Deputy Paul Murphy: If one company in the whole country pays, and no one else paid, it would still pass the test because it is only billable revenue.

Professor John McHale: That is our understanding. If there were a number of years where clearly the revenues were not coming in as billed, they might look at that. Initially, however, our understanding is that billable revenue is being used in that calculation.

Deputy Paul Murphy: Is that a formal note or assessment by EUROSTAT on how it will assess it? Where did Professor McHale get that information? I do not mean to put him on the spot.

Professor John McHale: If the Deputy does not mind, I will consult our expert.

Deputy Paul Murphy: Yes. That is no problem.

Professor John McHale: Our source for that is the Department of Finance.

Deputy Paul Murphy: Okay. That is interesting.

Deputy Richard Boyd Barrett: I thought they knew nothing about what was going on in Irish Water.

Vice Chairman: Rather than having a dialogue, I think we will let Deputy Paul Murphy ask his own questions.

Deputy Paul Murphy: That is interesting because if that had not been the case, and if the support from the Exchequer was counted, one could then do the figures based on that. For example, one could estimate a 50% rate of non-payment and the domestic water charges would result in Irish Water failing the EUROSTAT test. Therefore, it is obviously extremely important how that is calculated.

Another issue in Professor McHale's assessment involves contract manufacturing. Is it fair to say that the driving factor of GDP growth in 2014, which has been relatively substantial, is export growth? Is that the case?

Professor John McHale: It is beginning to shift now. That certainly had been the case over recent years. If the Deputy looks at page 22, he can see the contributions both of domestic demand and net exports to growth.

Deputy Paul Murphy: Yes.

Professor John McHale: One can see over the next few years, including this year, domestic demand becoming increasingly important as a source of growth.

Deputy Paul Murphy: Let us take 2014, for example. If one looks at the figures in mid-2014 and the different factors that make up GDP, all of them - personal consumption, Government expenditure, gross fixed capital formation and exports - with the exception of net exports, were lower at that point in mid-2014 than they were pre-crisis. The exception was gross exports which were miles above net exports.

Professor John McHale: Looking at levels, domestic demand certainly fell hugely during the recession.

Deputy Paul Murphy: It is beginning to climb. How those export figures are calculated is extremely important and has an extremely significant impact on the total GDP figures.

Professor John McHale: Yes.

Deputy Paul Murphy: Therefore, as regards the point Professor McHale is raising - and he is not the only one to have raised it - about contract manufacturing, as I understand it, from mid-2013 to 2014 according to the national accounts, goods exports had increased by 18.4%. According to the external trade statistics, however, they had increased by 1%, the difference being contract manufacturing. It is not the only difference, but it was overwhelmingly contract manufacturing. Is it fair to say that the export figures, and therefore GDP, were massively bloated by the existence of contract manufacturing?

Professor John McHale: There is a complicated story to that. Certainly in the first half of last year contract manufacturing had a huge, positive impact on growth. In the middle of last year we began noting that this was unlikely to continue and was likely to unwind. We outlined in this part of the report the reasons it was likely to unwind. It is really a timing issue. Some of the offsetting import measures only came into play in the second half of the year. Taking the year as a whole, contract manufacturing had no effect on overall growth. It really affected the timing of growth. Looking forward, we would expect the export and import signs to balance out. There could be timing issues which could lead to some volatility in the numbers. Overall, however, while it had a huge impact, it was very likely to unwind. It was the point we were making last year and it did happen as we envisioned. Contracting manufacturing, overall, should not be having a substantive impact on growth.

Deputy Paul Murphy: Professor McHale does not think it has any substantial impact on GDP. One could have multinational or Irish corporations here that are contracting the production of whatever products in China or elsewhere, which are exported elsewhere and have nothing to do with the Irish economy in reality. If that contract manufacturing was stripped out and not counted, it would not make any difference in GDP figures.

Dr. Thomas Conefrey: It will continue to have an impact on the growth flow from the economy, so the growth in goods export figures we see will continue to be heavily impacted by it. The divergence between the export figure in the national accounts that the Deputy quoted, 18% versus what is in the trade statistics, will continue to be there. It will call for a lot of care in interpreting growth figures in the national accounts. The CSO has demonstrated for 2014 that eventually, within the national accounting treatment of this, offsetting royalty imports will occur and the net effect on actual measured growth will wash out over a period. One will continue to need to exercise a lot of caution in interpreting growth export figures for Ireland. They will be impacted by this activity, but the underlying growth numbers that the CSO produces should not give a misleading picture when they eventually settle down.

Deputy Paul Murphy: I have just one general remark, which is not meant to be personally offensive to any of the witnesses. I have a real problem with the Irish Fiscal Advisory Council, or IFAC, in the sense that its role and the way in which it has been set up is part of the deliberate technocratisation of decision-making. It is making economics not something that is political, but the idea that there is a right and wrong to it, whereas I think it is a matter for political debate. Different economists have different views.

IFAC's pre-budget submission was honest and brutal in its assessment of the strategy of the establishment, the capitalist class in this country, and others. It said that maintaining the fiscal discipline required to achieve large primary budget surpluses will become politically harder following a long period of fiscal consolidation and as crisis memories fade. In particular, IFAC mentioned that those groups affected by austerity are against it. Is that not an example of what Naomi Klein calls the shock doctrine, using the shock of a crisis to try to enforce pre-existing neoliberal, ideological and actual economic and structural change to economies? Are the witnesses explicitly saying that memories of the crisis will be used to try to drive through change?

What about the idea that IFAC is really independent? Although I do not doubt the personal integrity of the council members, their economic beliefs all come from a certain school of thought, even though there might be slight differences in their thinking. In what sense are they really independent? They are appointed by the Government, although the Government might not listen to them. Why should they be in a position to say what is right and wrong?

Professor John McHale: I certainly believe we are independent. We approach these problems as macroeconomists doing macroeconomic analysis. We do not come to this with an ideology of trying to shrink government. It so happens that no one on the council is pushing such an agenda.

We have been focusing on the fact that the Government's plans would see a substantial reduction in the size of government. Given the underlying spending pressures from demographics and other areas, we think this should be taken very seriously. Without putting things on an ideological or even policy footing, we believe it is important to recognise these pressures.

We have cautioned against tax cuts at this point. We are certainly not coming into it with any ideological agenda. What we do know is that if those in government do not get their macroeconomics right, if they make mistakes, it destroys people's lives. That is what happened during the crisis. If anything is driving us, it is to ensure it does not happen again. I know it can sound very technocratic and, perhaps, to Deputy Paul Murphy's ears, ideological, when we talk about something like a budgetary framework. We are pushing it because we know the kinds of mistakes that can be made by the political system. None the less, we absolutely believe in democracy and recognise that these choices ultimately have to be made by the Deputies and Senators. Given the kind of pressures politicians are under, they can make mistakes. Sometimes having a technocratic body like ours pushing back a bit-----

Deputy Paul Murphy: That is exactly the point of it. I agree.

Professor John McHale: It can-----

Deputy Paul Murphy: To stop democratic pressures from below. That is the idea that defines everything else.

Professor John McHale: To stop these mistakes that can come out of the democratic process. Maybe Deputy Murphy has a view of the world in which those mistakes just do not occur but they are hardly unique to the Irish political system. We can see that those mistakes sometimes do occur. Ultimately, we do not make the decisions, nor should we. They should be made by people who are democratically elected, namely, the Deputies and Senators. It is to be hoped that having some advice, even if it is coming from a technocratic perspective, will ultimately lead to better decisions, better outcomes and better lives for people in that they are not affected by the incredible turbulence that has turned so many people's lives upside down over recent years. Our goal is to ensure that does not happen again.

Vice Chairman: On that deep philosophical note, I think we will conclude. We could probably sit here and philosophise on the overall economic crisis for quite a time. There were economists of many different hues who sat on their hands for years and did not bring to anyone's attention the fact that 20% of our entire economy was based on the construction sector, for example. They did not shout half loud enough when it came to needing to broaden the tax base and so forth. I do not think economists have command of the truth any more than politicians.

The core point Professor McHale made was that the stability programme update 2015-2016 is not in line with the requirements of the domestic budgetary rule of the preventative arm of the Stability and Growth Pact on a forward-looking basis. I suppose it behoves me to point out for the record that, on a number of occasions, the Irish Fiscal Advisory Council recommended higher adjustments than the Government ultimately followed. To date, the Government's strategy has, I think, proved correct.

Comments by figures such as the Minister for Finance and the Minister for Public Expenditure and Reform have focused on the value of social cohesion and the delivery of key public services. There are aspects to the economy and economic measures whose importance cannot necessarily be fully measured. Social cohesion is one of those aspects on which one cannot put a fixed price. Organisations such as Social Justice Ireland and the Irish Congress of Trade Unions have made that point. Society is more than the sum of its parts. I do not think the Irish Fiscal Advisory Council was ignored; it was listened to and other decisions were made. Those decisions ultimately proved to be correct.

Professor McHale mentioned that the council was cautioning on tax cuts. Earlier today or yesterday, the Small Firms Association, which is concerned that we are dropping in the competitiveness rankings, made the point that if we are to maintain competitiveness, one way to avoid pressure on wage inflation is to give tax cuts. I would have different views on tax cuts. I am just putting that point forward.

The professor also made the point that it would take years for domestic demand to recover, yet I was interested to hear him say that there could be higher than anticipated growth and that the output gap was likely to be closed, which would raise the prospect of the economy overheating. I must admit, that left me somewhat breathless. The idea of the Irish economy overheating after recent years is like shades of 2006 all over again. Given that promoting domestic demand has been such an issue, how could we be looking at overheating?

Professor McHale raised a concern that, if incomes were to rise, households would prioritise eliminating private debt over consumption, which might be a downside for the recovery of the economy. Given that, in its country-specific recommendations, the Commission highlighted the high level of private debt in the economy, would the professor not think it important for households to continue to decrease their private debt rather than to engage in consumption?

I want to raise three issues on the broader horizon. One concerns the sale by the Government of its holdings in Allied Irish Banks and Bank of Ireland. What are Professor McHale's views on the import of this sale for any statements he has made about the current Government strategy? Second, what impact might the uncertainty in the eurozone over the ongoing Greek situation and the possibility of a Greek exit have on Ireland? Are we in a position to withstand it robustly or might it produce a significant downturn in our economy? Third, I understand there is a peer review of the Irish Fiscal Advisory Council being undertaken. Could the professor give us his views as to the operation of the council to date, specifically in international and European contexts? Could he comment on the broader challenges to the organisation in the medium term?

Professor John McHale: I thank the Chairman. I will respond to the question on the peer review and then ask my colleagues to respond on a number of the other topics. The Deputy is correct that the peer review was published today. The review was carried out by an international panel, chaired by the former head of the Swedish fiscal council, Lars Jonung, and two other members. They carried out an in-depth review of the operation of the council, in respect of which they held discussions with many of the stakeholders, including members of this committee, employers, media, unions and other bodies. Overall, its assessment of the job we are doing was positive. The panel made a number of particular suggestions, including in relation to our communications strategy. For some amazing reason it was of the view that our publications are a little turgid, which I do not understand.

Vice Chairman: We would not think that.

Professor John McHale: We will certainly work on ensuring future publications are more accessible to a broader non-specialist audience. We have much to work on. We will strive over the coming months and years to improve our overall performance. We are grateful that the overall assessment was positive.

I welcome that the Irish Fiscal Advisory Council is seen as a pioneer among the new batch of fiscal councils. Currently, all European Union countries have a fiscal council. Even though the Irish Fiscal Advisory Council is relatively new, in that it only came into being in 2011, it was one of the first of the new fiscal councils to be formed. Some fiscal councils have come to visit us to see how we do things. There is a great deal of interest in the way in which we organise things. For example, the Irish Fiscal Advisory Council is the first of the new batch of eurozone fiscal councils to be peer-reviewed. This has been done on a low-cost model, recognising that we have to apply austerity to ourselves also. The UK council also underwent a peer review. As we did ours at a fraction of the cost, there are many councils that are interested in the model we used. We do see ourselves as a leader among, in particular, the smaller eurozone countries. In regard to the Deputy's question regarding the assessment of the job we are doing, we believe we are doing many things well but there are certain things we could do better. We have received useful specific advice of the things we can improve. We are always open to suggestions from this committee and others in regard to how we can do things better. We have heard some very substantive suggestions from this committee in the past about things that we can work on.

Vice Chairman: Perhaps Professor McHale would send the committee a copy of the peer review.

Professor John McHale: Yes.

Dr. Róisín O'Sullivan: On the point regarding social cohesion, one of the biggest threats to social cohesion is a boom-bust cycle in the economy. When people are plunged into the depths of unemployment and difficulty, this tears apart the fabric of society. A budgetary framework to protect against the boom-bust cycles can help preserve social cohesion. These two things are not necessarily in conflict, although I agree that many of the measures we use in economics, such as GDP, are limited in terms of what they are. We do not pretend that these are perfect measures of human welfare and so on, but they are reasonable proxies of these things.

I regret that Deputy Murphy is no longer here. The framework we are talking about, which we are asking the Government to adhere to, was brought about by the political process. Not only was it voted upon and put into domestic legislation, but it was put to a referendum of the citizens of Ireland, who voted for the fiscal compact that brought about many of the newer elements of this fiscal framework. We are not here to try to undermine the democratic process in any way; rather, we are trying to play our role in monitoring the frameworks that were endorsed by the democratic process that has been put in place.

Dr. Thomas Conefrey: On the point in relation to overheating of the economy, the notion that the economy could be overheating now, when unemployment remains close to 12% and domestic demand is barely recovering from its trough during the crisis, is, in a sense, surprising. At the same time, as pointed out by Professor McHale, the level of slack in the economy relative to what it can potentially produce if all resources are utilised is probably relatively small. Also, the growth rates projected for last year, this year and the coming years predict a rapid growth in the Irish economy, so the situation could change quite rapidly. Fiscal policy needs to be cognisant of that and ensure that it is appropriate given the cyclical position of the economy, which has not always been the case in the past.

With regard to debt reduction, the point made in the report, which, perhaps is not sufficiently clear, is not that households should not continue to reduce debt levels. The household-debt-to-GDP ratio in Ireland is among the highest in Europe. The deleveraging process is necessary so that repair of balance sheets can continue. It is true that if households are going through the process of gradually reducing their financial debts, this could dampen consumption for a number of years. Currently, the savings rate is high but it is projected to fall gradually. It is undoubtedly true that as households gradually pay down high levels of debt, this will negatively affect consumption.

Vice Chairman: Perhaps one of the delegates will respond to the questions regarding sale of our bank shares and a GrExit.

Professor John McHale: On GrExit, it is hard to know how big the shock of a Greek exit would be. Our best guess is that, at least in the short term, we are reasonably well insulated. Even though we do not have that much direct exposure to Greece, we are exposed to countries that are exposed to Greece and so we could get caught up in the turmoil that would follow. The bigger issue is probably further down the road. If things went reasonably well with the Greek exit, this would change the nature of eurozone membership in that as countries get into trouble there would always be doubt about whether they will be able to remain in the euro. This could lead to disruptive speculation down the line. It is something we hope will be avoided. On the other hand, too great a concession to Greece could also have negative affects for Ireland. One of the reasons we have been able to pull out of the crisis is the strengthening of lender of last resort supports within the eurozone. Those lender of last resort supports are based on the idea, essentially, of conditional loans. If those loans are turned into grants, essentially writing off the debts for Greece, or if the conditions are substantially weakened, the concern is that the stronger countries would not be willing to give support in the future. The feeling is that it would not be credible that these would be conditional loans, because ultimately they would not be paid. This could weaken the lender of last resort supports that have been so important in terms of pulling out of the crisis. There are risks to Ireland even if there is no Greek exit, because substantial concessions are made to it. On balance, the hope would be that the two sides can come to an agreement, that Greece remains in the eurozone, and, very importantly, that Greece gets back onto a growth path and puts its crisis behind it. There certainly are risks involved. My colleague Dr. Conefrey will respond to the question about the sale of bank shares.

Dr. Thomas Conefrey: In our reports we have been keeping track not only of Government debt and liabilities on balance sheet but also the contingent liabilities of the State, which at one point during the crisis were large. In terms of how outsiders view the Irish economy, they took these contingent liabilities almost as seriously as actual Government debt on the balance sheet. In addition to the positive news we have seen in terms of the decline in Government debt, we have seen a decline in the size of these contingent liabilities. As we remarked in our November report, this is also an important part of the progress we have seen in the last couple of years. The contingent liabilities have declined. It has been pointed out that the potential exists for some gain to the State. We have done some very aggregate calculations based on publicly available information and estimates of possible maximum gains to the State from recouping the funds invested in the banking system. It would come to approximately 8% of GDP. It would be a one-off reduction in the debt to GDP ratio. It is welcome that these contingent liabilities have reduced in size. It is now plausible that there could be a return to the State from their sale. It would be a one-off gain that would shift the debt to GDP ratio lower. In that sense, it would be important not to overstate it.

Vice Chairman: I will be quick because I am running out of time. In Professor McHale's view, should we take it now or wait for later? In three years' time, it could be worth three times the amount it is worth now.

Professor John McHale: If we were to say we should definitely do it later, we would be saying the markets are currently under-valuing. If we believe we know more about the value of AIB than the markets do, which is possible, we would want to wait. Even though the markets can get things wrong, as we saw in dramatic fashion coming up to the crisis, on the whole we have to be careful in betting against the market when it comes to valuing stocks. That means we can be reasonably relaxed about when we sell. If we sell now, we would get market value. The best guess as to future market value is probably the current market value. Therefore, I would not see it as an urgent priority to sell.

Chairman: That is an interesting perspective. I call Deputy Tóibín.

Deputy Peadar Tóibín: Go raibh maith agat, a Chathaoirligh. Dr. O'Sullivan's response to Deputy Creed's engagement was interesting. One of the witnesses spoke about one of the things missing from this. There is nothing in these rules to prevent the Government from increasing revenue if it seeks to increase expenditure. The Mallow bypass is not being stopped by anybody else's rules, but by a Government determination of what to do with increasing revenue. That goes for the whole infrastructural landscape around the country in areas like housing, broadband and roads. I think that is an important issue. I would like to get the witnesses' views on a number of external factors that are positive now but could be negative in the future. The matters in question are making a massive input into the growth levels we are experiencing. Factors like the level of the euro, the price of oil and interest rates would have a strong influence on growth levels. Can the witnesses quantify proportionally, if that is possible, how strong these drivers are with regard to growth? Can they forecast the likely behaviour of these drivers into the future?

Vice Chairman: The Deputy is trying to turn the witnesses into soothsayers.

Professor John McHale: If we could make such a forecast, we probably would not be here.

Deputy Peadar Tóibín: Indeed.

Dr. Thomas Conefrey: I have been put on the spot by being asked to quantify them in terms of importance. Given the importance to the Irish economy of exports, particularly to the UK and elsewhere outside the euro area, the exchange rate is probably more important than the price of oil and the level of interest rates. It has a very important bearing on how we project our forecasts for exports. The exchange rate is one of the important drivers of potential Irish exports. It is probably the most important of the three.

Deputy Peadar Tóibín: Would it be possible to say how much of our growth can be attributed to some of those external factors? Would it be 50%, 40% or 30%?

Dr. Thomas Conefrey: It is difficult to assign an exact figure to it. We know how big exports are in terms of economic growth. As the euro exchange rate and the level of external demand are probably the two biggest drivers of that, they have a crucial bearing on determining Irish exports, which account for a very large share of GDP.

Deputy Peadar Tóibín: Okay. The level of demand in Britain and the United States and the exchange rate, both of which are outside the reach of policy drivers in this State, would be big determining factors in the health of the economy.

Dr. Thomas Conefrey: Exactly.

Deputy Peadar Tóibín: I suggest there would still be a certain level of pent-up demand from the crash within the growth levels we see. I am referring to postponed investment. Would the witnesses say pent-up demand and postponed investment over the last seven years are represented in the domestic growth figures?

Dr. Thomas Conefrey: We can look at housing completions as an example. We know there were 11,000 or 12,000 completions last year, which is well below the ESRI estimate of what is needed purely on demographic grounds. Such a level is approximately half of what the ESRI estimates is needed to meet sustainable housing demand in the long run. On that front, we can definitely say the level of housing investment is below what is normally needed in the economy.

Deputy Peadar Tóibín: Do the witnesses have any views on what is necessary to resolve the problems in the housing sector? Perhaps that question is too micro for their analysis.

Dr. Thomas Conefrey: I think it is really outside what we can say.

Professor John McHale: It would be outside our specific expertise.

Deputy Peadar Tóibín: My final question relates to planned Government investment over the coming years. I understand the level of investment is to be cut from 1.8% to 1.5%. We have had a conversation about infrastructural deficits. In a healthy economy that is maintaining its capital stock and ensuring competitiveness in that regard, what is the percentage of GDP in Government investment that is logical?

Dr. Thomas Conefrey: I think a level of approximately 4% is the average for Ireland over a long period. The euro area level would also be approximately 4%.

Deputy Peadar Tóibín: That is twice what it is now and more than twice what it is projected to be.

Dr. Thomas Conefrey: Yes. A chart on page 54 of the report shows that the level it is at now in an historic context for Ireland is extremely low and the projected level is also extremely low.

Deputy Peadar Tóibín: Okay. Sin é. Go raibh maith agaibh.

Vice Chairman: Professor McHale has expressed his reservations about medium-term issues. Perhaps he might extrapolate further down the line in terms of longer-term concerns, such as pension provisions and the ageing population, both of which have been alluded to. At the moment, we are taking a bit of a holiday with what is happening in relation to the oil market and so forth. Where do we stand in terms of issues like energy provision in the longer term? What is Professor McHale's view on what the longer-term concerns for the economy might be?

Professor John McHale: The Chair has asked some big and important questions. Until now, the council's analysis has focused on the near and medium terms. We recently started a new work programme. A new member of staff has joined us to work on a long-term issue. This is our major project for the summer. When we come back to this forum after we bring out our next report - we hope the joint committee will invite us again - we will be in a position to set out the results of that longer-term analysis. That will give us a good sense of what the longer-term fiscal pressures are. Longer-term issues such as energy sustainability really go beyond our mandate. While we have views on these issues, we are not really experts on them. The Deputy would be better off asking people who have significant expertise in those areas to comment on them. We are beginning a major project on the fiscal side and we will be able to comment on that in the context of the next report.

Vice Chairman: Deputy Boyd Barrett wants to come back in before we conclude.

Deputy Richard Boyd Barrett: I have two quick questions. Many people would say that cheap money from Europe contributed significantly to the reckless lending and over-lending into particular sectors that helped to crash our economy. The low interest rates that were favoured to try to move along the economy of central Europe - the core of Europe - were completely unsuitable for us. Are we seeing the same pattern emerging again, with very cheap money being produced essentially to try to lift the stagnant core of Europe off the ground? If so, it has the potential to wreak exactly the same havoc again in economies like ours. That is my first question. I will come back in with a second question.

Professor John McHale: It is certainly something to which we have to pay careful attention. One of the downsides of being a small country in a monetary union, where the interest rate policy is set for the union as a whole, is that it can be quite inappropriate for particular countries and certainly for smaller countries. The Deputy is absolutely right when he says that during the boom phase, we had a monetary and interest rate policy that was inappropriate for Irish conditions. At the moment, because Europe is still very much in a slump and is facing deflationary pressures, we have policy rates that are at very low levels. Until now, it has been to our benefit. As we discussed earlier, we are still operating below potential. It is good to have that stimulus to the economy, particularly when fiscal policy has had to be quite contractionary for other reasons, such as debt sustainability and trying to regain our credit-worthiness. It is something we are going to need to watch as we move towards a situation where the Irish economy may be getting back up to its potential. If it seems we have a monetary policy that is unsuitable for Irish conditions, we may have to use fiscal policy as the only demand management tool that is available. The Deputy will have heard the ESRI expressing concern that current fiscal policy might be stimulative, given where the economy is. I reiterate that the use of fiscal policy for countercyclical demand management is very important when one does not control interest rates.

Deputy Richard Boyd Barrett: I would like to make a second and final point. We want to protect against a cycle of boom and bust. I agree with Dr. O'Sullivan's point that part of that is about having sustainable revenue streams. I would not be quite as harsh on the fiscal council as Deputy Paul Murphy has been. I have got to know its members better - that is why.

Professor John McHale: He will get to know us as well.

Deputy Richard Boyd Barrett: I put it to the witnesses that the problem is that it is very difficult to say what is sustainable and what will not be affected by all sorts of external and cyclical factors, many of which are out of our control. Housing, which is a particular bugbear of mine, is an example of that. Obviously, property tax is a revenue source based on property. We are now seeing how volatile property is. I will not get into that argument now. When I was speaking to a rural Deputy recently, he told me that developers down the country are sitting and waiting at the moment because property prices in the countryside are low. They could apply to get money from the banks to build, but they will not do so because there is no profit in it for them. They are going to wait and the banks are going to wait. The banks would not give them the money now anyway, for exactly the same reason. These developers are going to wait until property prices go through the roof. They are waiting for the crisis to get worse from the point of view of people on the ground, and arguably from the point of view of the economy as a whole. If we cannot house people, we cannot do much else. If we do not have basic things like housing, it is going to be a real problem for our economy, never mind for the people. Is it not the case that State intervention is the only way to address that? I suggest the only way to protect itself against that sort of volatility is for the State to have adequate stock, or to intervene when the market is failing by providing what the market is not willing to provide? That argument could be extended into a number of areas. If the State does not have a significant stake in the economy, we are just sitting back waiting for the next storm to hit us. If we are talking about protecting against boom and bust, we must realise the only way to do that is to provide for a greater level of State control over the economy. That is necessary to ensure we are not subject to whatever storm is coming down the road.

Vice Chairman: I take it the Deputy is putting that as a question.

Deputy Richard Boyd Barrett: Yes.

Professor John McHale: There is a certain philosophical element to the Deputy's question.

Deputy Richard Boyd Barrett: It is of immediate consequence in the case of housing.

Professor John McHale: I agree that there is an important role for social housing and therefore for the Government in the housing market. As we are going to have a private housing sector, we need to make sure it is functioning well. The Deputy laid out a scenario in which people's expectation of price increases leads to behaviour that just makes the problem worse. In this case, the problem on the supply side is the failure to put houses on the market in the expectation of getting higher prices at a later stage and the problem on the demand side is that people who want to get in now because they expect prices to increase are pushing prices up. We saw during the boom phase how that sort of behaviour can lead to a dysfunctional market. It is very important that we avoid the boom-bust cycle in the housing market, just as we do in the economy as a whole. The kinds of measures recently taken by the Central Bank when it set limits on loan to value ratios are very important in that context. As prices go up, people need higher deposits. This reduces their ability to bid higher prices for houses and stops that price cycle from developing. If a possible boom in house prices is stopped from developing, the expectations that lead to the dysfunctional behaviour that has been described cannot get ingrained. If people behave more normally, there will be a more normally functioning housing market. Policies that make the private sector part of the housing market work and facilitate the necessary investments on the social side need to be pursued. The Government and the private sector both have important roles.

Vice Chairman: As we are touching on my favourite topic, I will bring the meeting to a conclusion. On behalf of the committee, I thank Professor McHale, Dr. O'Sullivan, Dr. Kearney and Dr. Conefrey for appearing before the committee today.

The joint committee adjourned at 4.20 p.m. until 6 p.m. on Tuesday, 16 June 2015.