2022 Dublin Economics Workshop – William Petty Lecture

A DECADE OF IRISH FISCAL POLICY:

LESSONS LEARNED AND NEW CHALLENGES

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Thank you to Ciarán Mac An Bhaird and the organisers of the Dublin Economics Workshop for the invitation to deliver this year's William Petty lecture.

The Irish Fiscal Advisory Council started work in August 2011, one of the first of a new wave of independent fiscal institutions set up in Europe in the wake of the Global Financial Crisis. This year marks the 10th anniversary of the Fiscal Responsibility Act that established the Council in law.

This is therefore a good time to look back at the past decade of Irish fiscal policy, the Council's role, the lessons learnt and the challenges ahead.

I will draw on a paper published by the Council today co-authored with Elliott Jordan-Doak and available on our website. This looks at Irish economic and fiscal developments over the past decade, applying new tools and data developed by the Council to help look to the future.

Why was the Council needed?

We need to go back to the years prior to the banking crisis to understand the calls from Irish economists, notably Philip Lane, and official reports calling for the creation of an independent fiscal institution (IFI) in Ireland.

The textbook rationale for establishing fiscal councils is - as with independent central banks - to overcome a "time inconsistency" problem: politicians with short electoral mandates borrow now to offer higher spending, lower taxes and faster growth, leaving their successors – and the public – to pick up the bills. Across countries, these problems show up from many angles, including over-optimistic forecasts, extensive off-balance sheet transactions or unpredictable policies.

In Ireland, the key problem has been the procyclicality of budgetary management: excessively expansionary policy in "good times" followed by costly retrenchment in "bad times", leading to instability in the public finances and amplifying – rather than dampening – economic cycles.

Recent Irish economic history begins with the remarkable success of the "Celtic Tiger" era: national income (GNI*) grew at a staggering average annual rate of 5½ per cent from 1995-2007, one of the strongest performances of any advanced economy since 1945. This allowed spending to grow rapidly and taxes to be cut, while fast growth of revenues kept the budget in surplus and the debt ratio on a downward path.

After the 2001 global recession, export-led productivity gains gave way to a new phase as low interest rates fuelled the housing bubble and growing financial imbalances. Measures of the output gap – developed by Eddie Casey at the Council – now estimate a positive output gap of over 5 per cent of national income in 2007 with a modified current account deficit of over 6 per cent of GNI* and high private-sector debt.

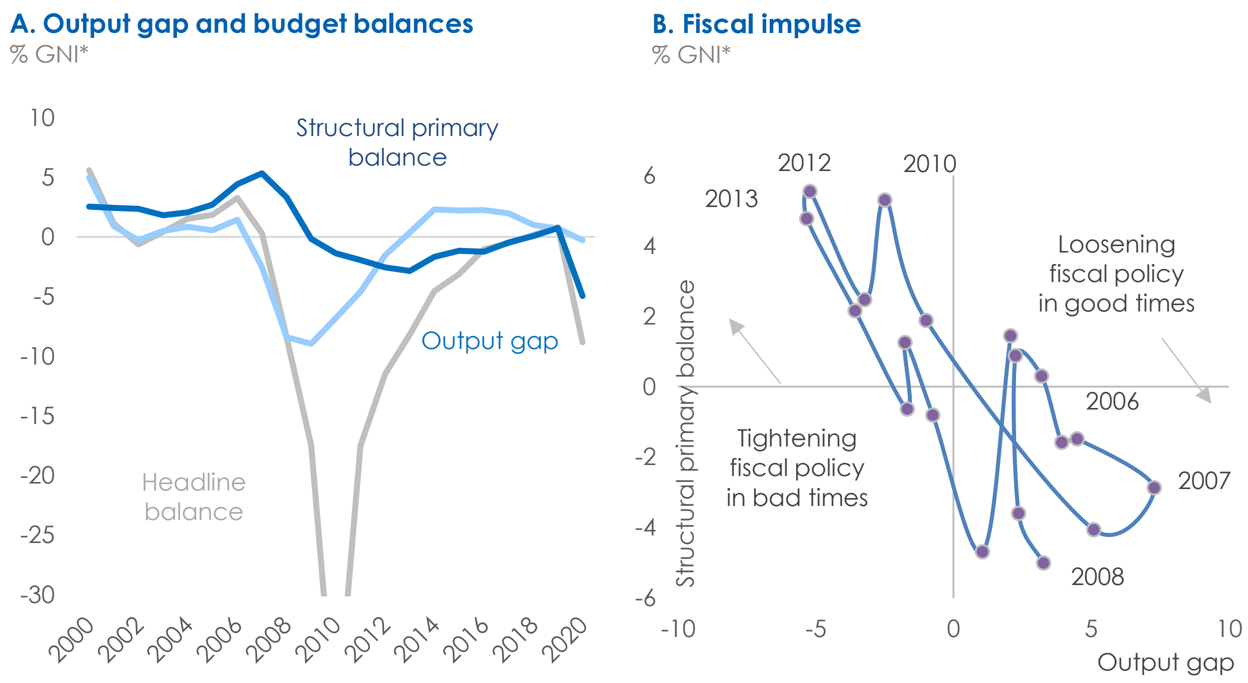
During this period, Ireland actually ran a modest headline budget surplus averaging 1¾ per cent of national income and the debt ratio continued to fall. Furthermore, the

Exchequer was building up assets in the National Pension Reserve Fund (NPRF) at a rate of 1 per cent of GNP each year.

However, despite these developments, policy failed to manage the economic cycle.

First, current estimates of the structural budget balance - based on the standard method of extracting a cyclical component of taxes and spending from the headline figure – now show a modest surplus in these years (Figure 1). The fiscal impulse, the change in the structural balance, points to a modest structural tightening at best. However, this was nowhere near enough to stabilise the economy. Better financial regulation and management should have been the first line of defence, but fiscal policy should have done more.

Figure 1: Procyclicality and the Irish public finances



Source: Department of Finance, CSO, and Fiscal Council workings.

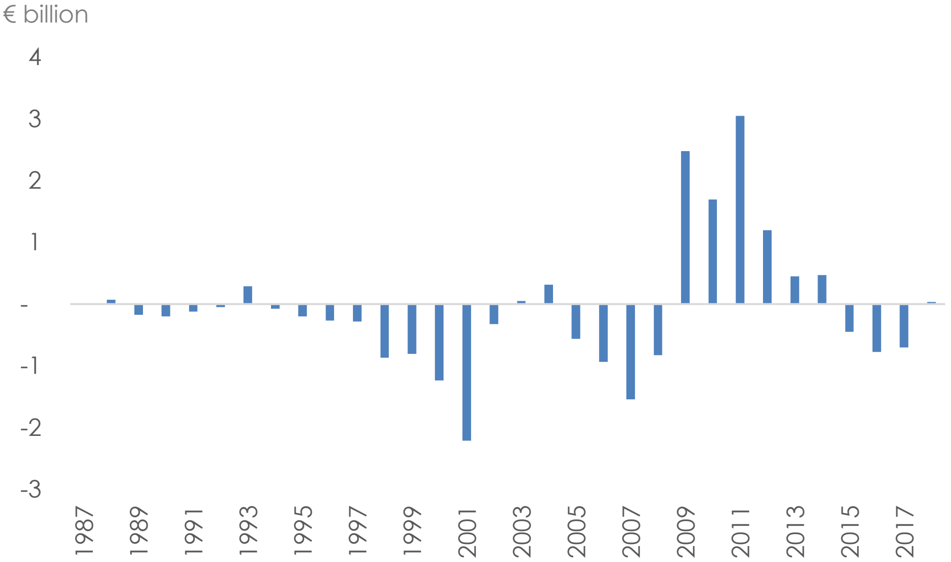
One lesson here is that fiscal policy may need to be very strongly countercyclical in small euro area countries, where interest rates can be at destabilising levels for long periods. This may go far beyond relying on the "automatic stabilisers" and imply both very large deficits and surpluses.

Second, the housing boom generated huge "windfall" revenues from stamp duty and VAT on the sale of new houses. This masked a deeper deterioration in the underlying fiscal position.

This is why the Council has developed "bottom-up" measures of the structural balance that look at explicit changes in taxation and spending, rather than relying solely on standard "top down" estimates that try to derive policy from endogenous fiscal outcomes using models.

Figure 2 shows how discretionary policy changes actually loosened the fiscal position during the boom years with discretionary tax cuts. Government spending doubled in nominal terms between 2000 and 2007.

Figure 2: Discretionary tax policy changes in Ireland 1987-2017

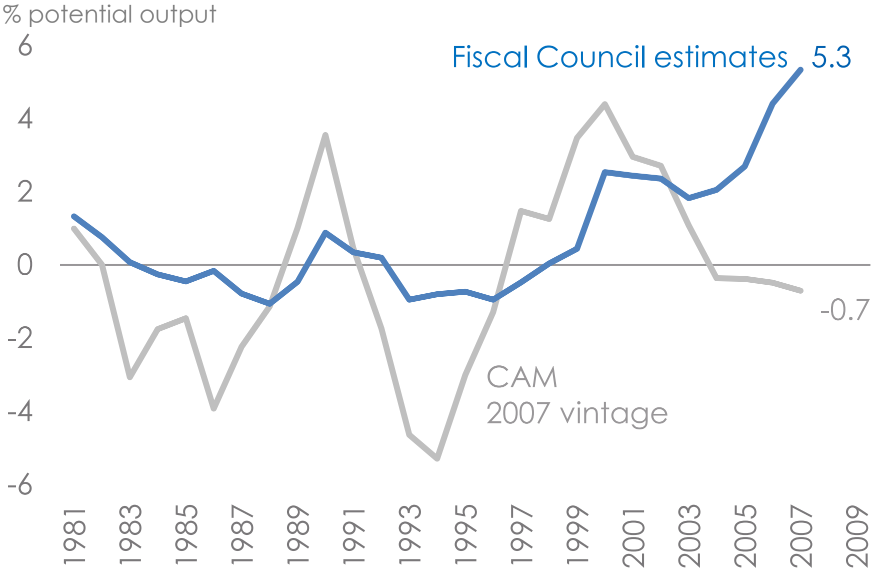


Source: Conroy (2019)

Reining in spending or raising taxes when everything seems to be doing so well is a political challenge, yet this is precisely the situation in which fiscal policy should be used to actively manage imbalances in the economy.

Third, an additional difficulty was assessing the state of the cycle in real-time. The official measure of the output gap was based on the EU Commonly Agreed Methodology (CAM), a "one-size fits all" approach used in the EU fiscal rules. This method is known to be procyclical (Barnes and Casey, 2019). As Figure 3 shows, CAM estimates made in 2007 implied a slightly negative output gap and cyclical conditions that were slowing - a completely different picture from that we know now.

Figure 3: Real-time estimates of the output gap before the crisis were misleading



Source: Department of Finance and Fiscal Council workings.

The development of an informative measure of the output gap by the Council and the switch by the Department of Finance to using a similar measure as the basis of budgetary documentation are significant achievements. Ireland now has a reasonable compass for navigating the economic cycle.

The banking crisis

It is easy now to forget just how grim the years from late 2008 were for Ireland. The housing boom unwound in a dramatic and painful contraction. The same virtuous circle that helped the economy in the previous years turned vicious, fuelling negative feedback loops through the financial sector and the real economy. Unemployment soared, prices fell, thousands emigrated and tax revenues collapsed.

A contractionary budget, the pension levy and the emergency budget of April 2009 led to a fiscal consolidation of around 7 per cent of GNI* in 2009 alone. Despite this, the deficit ratio rose to over 17 per cent of GNI*. In parallel, the Government undertook massive measures to support and recapitalise the banking system, adding to the deficit and debt (Barnes and Smyth, 2013). With Ireland unable to finance itself in the market, the government entered the bailout agreement with the EU, IMF and ECB 2010.

The Council's analysis in its first *Fiscal Assessment Report* in November 2011 still captures the situation well:

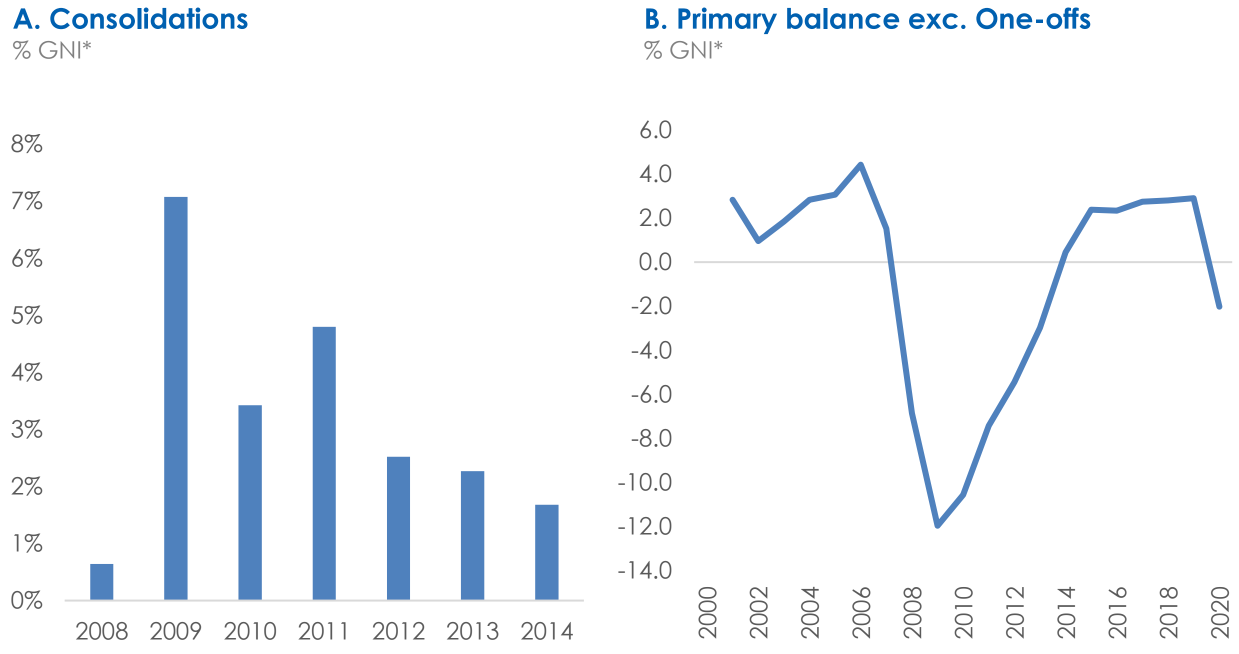
> "*Given the challenges posed by the fiscal deterioration experienced in Ireland and the need to put the economy back onto a sustainable growth path, it is imperative that a balance is struck between restoring the public finances, improving the credibility and creditworthiness of the State, and avoiding undue harm to the economy at a time of weak domestic demand.*"

This set out the basic approach the Council uses to this day. Fiscal credibility and market access are the foundation for fiscal policy. Sound economic management; fiscal sustainability and compliance with the fiscal rules are the main pillars of the Council's assessments.

The Council was largely supportive of the planned consolidation, while recognising the dilemma between measures that would restore creditworthiness and their negative impact on activity. Indeed, risks of a self-defeating consolidation were carefully considered.

Market access was restored in 2013, the deficit narrowed and the economy recovered (Figure 4). However, Ireland paid a heavy price for the excesses of the boom years. The cumulative fiscal adjustment 2008-2014 has been estimated at around €30 billion, approximately 20 per cent of 2014 national income (Scott and Bedogni, 2017). While the level of pre-crisis activity was not sustainable, the 18 per cent fall in output and the 5 years of contraction were severe and left lasting scars.

Figure 4: Fiscal retrenchment and the return to a primary surplus



Source: Scott and Bedogni (2017), CSO, and Fiscal Council workings.

The recovery

The economy ultimately rebounded strongly from 2013 – output rose by around 15 per cent and unemployment fell from a peak of 16 to almost 10 per cent by the end of 2014, helped by the export-oriented sectors and improvements in the domestic economy. From 2014 to 2019, GNI* grew at an average rate of around 4 per cent.

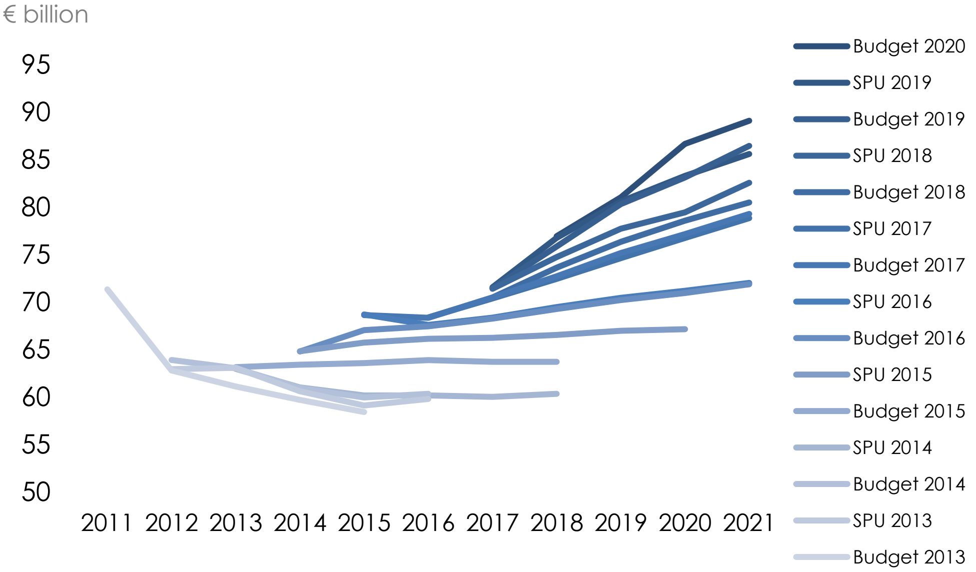
Budget 2014 marked a shift from successive rounds of fiscal tightening as the Government reduced the planned level of fiscal adjustment and increased expenditure. In the following years, fiscal policy was relatively neutral. The headline budget balance improved, but underlying improvement in the public finances stalled from around 2015.

However, two important concerns emerged about the public finances.

First, there were flaws in the management of the public finances. Key aspects of the 2011 reforms were not fully implemented, including the move to multi-year departmental expenditure ceilings, and there were spending overruns both in-year and between year.

Ceilings were set too low and were generated under arbitrary assumptions, leading to consistent upward revisions in spending forecasts (Figure 5)

Figure 5: Vintages of General Government Primary Spending



Source: Department of Finance

Budget forecasts for medium-term spending lacked any real foundation: initially, they were based on constant spending in cash terms and then arbitrary growth rates that were too low to finance the Government's existing programmes.

This led the Council to develop the "Stand-Still approach" to forecasting medium-term public spending. This projects spending based on demographic costs, inflation, wages and policy changes. That is, it is the cash cost of continuing existing policies in real terms.

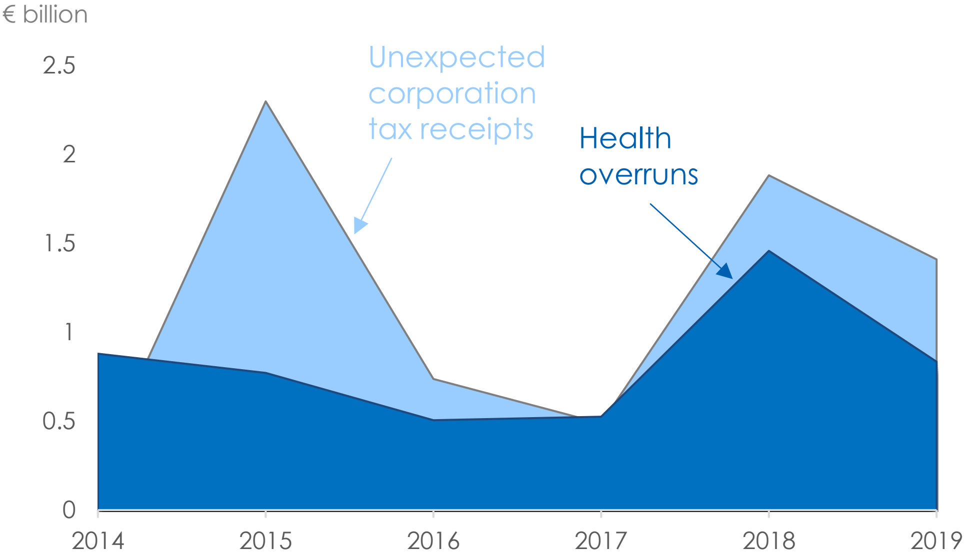
The cost of "standing still" in a typical year is high: well above €2½ billion. This needs to be reflected in fiscal forecasts. It also creates a more realistic picture of the public finances: if people wonder why public services aren't improving as much as the billions announced on Budget day suggest, the answer is simple: most of the additional cash is needed to just to stand still.

The Council assessed the budget forecasts as "not credible" and in 2021 the Department of Finance moved to a new approach to projecting the medium-term spending outlook, including an amount in the near term for the "Existing Level of Services" and an amount in medium-term that would allow for this.

However, it was *within year* spending overruns that had a real impact on the public finances: overspends in health between 2015 and 2019 averaged around €590 million year. Most of the increase in health spending over this period was accounted for by overruns and rather than budgeted spending increases (Casey and Carroll, 2021). This reflects a number of deep-seated issues in budgeting for health and cost management that ultimately created a "soft" budget constraint (Howlin, 2015).

This led to an unhealthy dynamic where positive surprises in corporation tax receipts did not improve the budget balance but were instead used to plug holes in the health budget (Figure 6), a worrying echo of pre-crisis developments.

Figure 6: Unexpected corporation tax receipts have masked health overruns in recent years



Source: Casey and Carroll (2021)

In the June 2018 *Fiscal Assessment Report*, the Council warned that next downturn is probably closer than the previous one. However, no one could have predicted that in March 2020 the Covid pandemic would lead to a full closure and lockdown of large parts of the country.

This time, the full force of the Government's balance sheet could be rapidly mobilised to support households and firms. Ireland's improved fiscal position, coupled with ECB support created space for this strong countercyclical policy response.

A key feature of the Covid supports was that they were temporary. Table 1 looks over the whole period from 2019 to current forecasts for 2025. Covid costs disappear over this time frame. What we see is that the public finances are benefitting from a number of positive underlying trends: strong economic and revenue growth, the surge in corporation tax receipts, lower interest payments and restraint on current spending are allowing the Government to massively ramp up investment while improving the headline budget balance.

Table 1: Comparing 2019 and 2025
Difference 2025-2019

	p.p change in GNI*	€ billion change	% change	Annualised growth rate
GG Revenue	-1.5	22.8	25.8	3.9
Tax Revenue	1.7	23.0	38.8	5.6
Non tax revenue	-3.2	-0.2	-0.7	-0.1
IT	1.0	9.9	43.0	6.1
CT	0.3	4.3	39.3	5.7
VAT	0.3	5.6	36.7	5.4
Other tax revenue	0.0	3.3	31.7	4.7
GG spending	-1.0	23.7	27.5	4.1
Gross Fixed Capital Formation	1.5	6.8	80.0	10.3
Interest	-1.0	-1.4	-31.3	-6.1
Current primary spending	-1.5	18.4	25.1	3.8
GG Balance	-0.5	-0.9		
Level of GNI*		66.3	30.8	4.6

Sources: CSO, and Budget 2022.
Notes: Changes are in the format 2025 level minus 2019 level. As a result, positive values indicate a variable increasing over the period or taking up a larger share of GNI* than was the case in 2019. The annualised growth rate shows what rate of growth applied for every year from 2019 would yield the 2025 level forecast in Budget 2022.

Looking ahead

Budget 2023 is now just 11 days away. This will be a challenging exercise for the Government as it manages the impact of the surge in energy prices and the highest inflation rates in a generation. As set out in the Council's *Pre-Budget Statement*, the Government faces a delicate balancing act in supporting households and avoiding adding to second-round inflation. Better targeting of measures would help.

The management of the energy shock is being supported by the introduction in 2021 by the Government of the 5 per cent Spending Rule. This aims to grow core spending at a steady pace around the trend growth of income and revenues. It addresses a long-standing recommendation of the Council to set a medium-term framework to reduce procyclicality. A solid domestic fiscal framework is a useful addition to the EU rules.

While the Government has sensibly allowed some temporary leeway from the 5 per cent in view of exceptionally high inflation, the rule is providing a useful signal about how to respond to the shock. It is now important that the Budget sticks to that commitment.

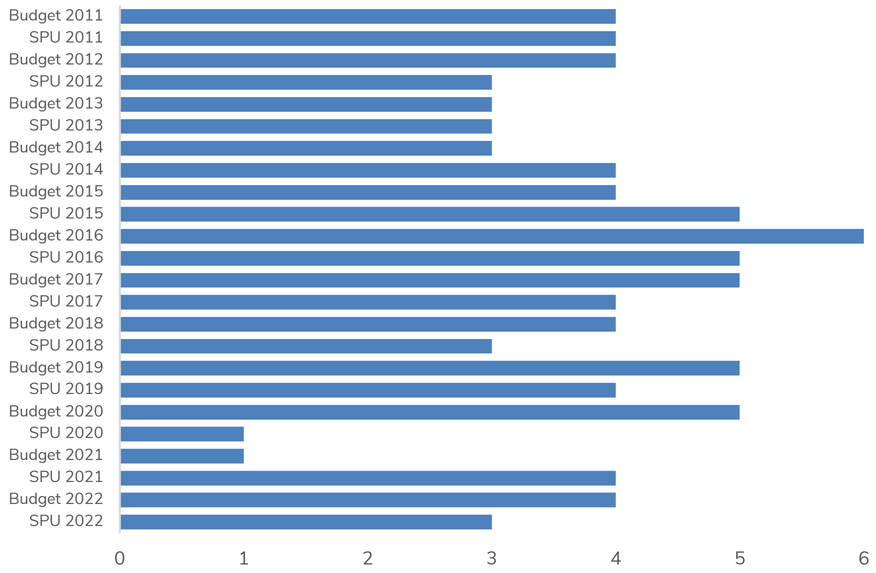
However, the question of how far fiscal policy should be managed by discretion or rules is not fully resolved.

The Spending Rule itself needs to be strengthened. It should be extended to take into account changes in taxation to allow governments that raise taxes to spend more and to close what might become a loophole. Establishing the rule in legislation would make it more credible, providing an opportunity to address a number of design issues including extending it to cover the whole of the General Government.

Over the years, much of the Council's advice in the area of the budgetary framework – enhancing the design of the Rainy Day Fund, improving budgetary forecasting, applying the budget ceilings properly, debt rules – has gone unheeded.

To give one example, the Department of Finance has never managed consistently to publish 5-year ahead forecasts (Figure 7). These should be the bedrock of medium-term, anchored fiscal policy.

Figure 7: Department of Finance forecasts average less than four years ahead
Years



Sources: Department of Finance, and Fiscal Council workings.
Note: Budgets are labelled as "Budget t+1", but published in year t; for example, *Budget 2023* will be published in October 2022, meaning its forecast for 2022 is an in-year forecast (for year t).

This ambivalent approach to the budgetary framework and the reluctance to limit the room for discretionary decisions is shared in many other countries. However, international experience and past experience here suggest that – without a strong institutional anchor – the public finances can be left adrift in the face of short-term political pressures and volatility of the economy.

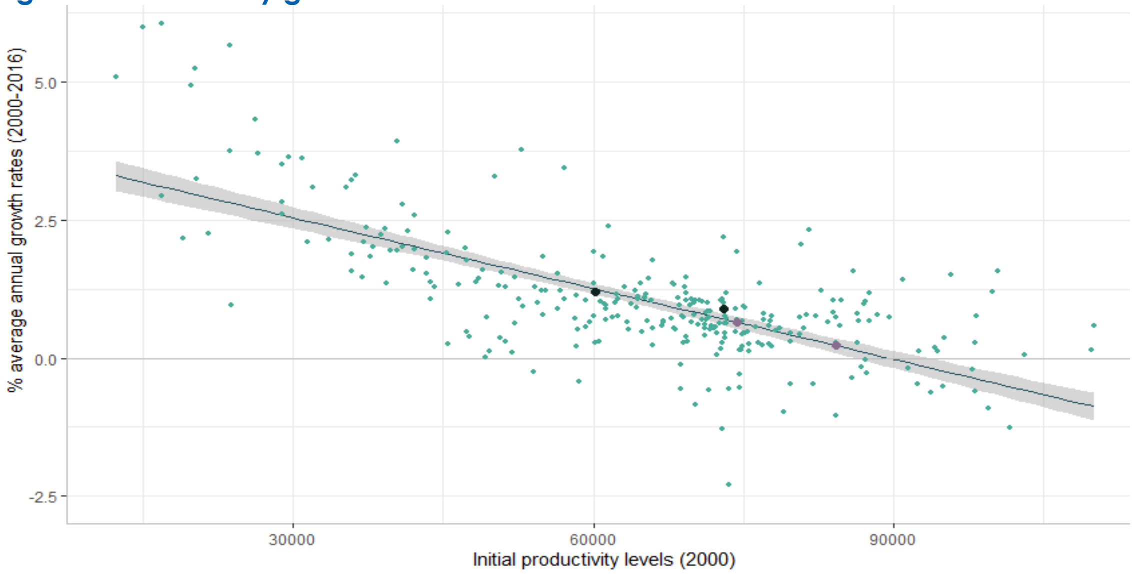
While the 5 per cent Spending Rule provides hope that fiscal policy may be less procyclical in the future, the lack of progress on strengthening the wider budgetary framework raises questions about how governments will navigate the challenges ahead.

The next decade is likely to look very different from the pre-Covid years, where the rapid growth, falling interest rates and surging corporation tax receipts created favourable tailwinds for the public finances.

Ireland is now turning to face four headwinds:

- First, we should expect that growth will slow over time. The Irish "exception" may continue for some time, but, sooner or later, suddenly or gradually, Ireland's growth is likely to slow. Figure 8 shows that Ireland's high output per worker would typically be associated with more sluggish growth.

Figure 8: Productivity growth to slow



Source: OECD, CSO, and Fiscal Council workings.

- Second, Ireland's population will age rapidly in the years ahead as Ireland's baby-boomers retire and life expectancy continues to increase. Within the next couple of decades, the population will be more aged than any European country is today. This will have a major impact on society, growth and the public finances, not least as the State pension system is currently on an unsustainable trajectory.

- Third, meeting Ireland's emissions' reduction objectives and mitigating climate changes will be challenging and costly. The Government urgently needs to make a proper assessment of the policy changes needed and their budgetary impact. For example, a shift towards electric cars would put substantial fuel-duty related revenues at risk.

- Fourth, there is a need to reduce the overreliance on unreliable corporation receipts. Corporation tax receipts were equivalent to 6.5 per cent of national income last year. A sudden reversal would put the public finances at risk. The large inflow of money into the economy adds to cost pressures and needs to be carefully managed. Unwinding this overreliance – perhaps taking inspiration from Norway's management of oil revenues – means that money will need to be found elsewhere to fund day-to-day government spending.

How will Ireland manage these challenges?

The political system will need to make more difficult choices than it has had to face – outside crisis times –at any point over the past generation. Fundamental questions about the size and role of the State, the design of the tax system and the efficiency of public spending can no longer be avoided.

Whatever choices are made, sound management of the public finances must remain as the foundation of economic stability and the sustainability of government action. Strengthening of budgetary institutions and practices and medium-term planning might seem like a low priority as we tackle today's challenges, but are essential to prepare for the decade ahead.

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